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CASE STUDY 4

Enhancing the financial position of cities: evidence from Hargeisa





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About this initiative

Supporting the urban dimension of development cooperation: *Enhancing the financial positions of cities in developing countries to achieve sustainable urban development*

This initiative has been requested by the European Parliament. It is implemented by European Commission and UN-Habitat, supported by the International Growth Centre. These partners are working to identify relevant measures to help mobilise financing for urban development at all levels of government. The work has been undertaken through case studies conducted in Dakar (Senegal), Hargeisa (Somaliland, Somalia), Kampala (Uganda), Kisumu (Kenya), Mzuzu (Malawi), meetings with experts and practitioners, and empirical literature. The initiative works with an Advisory Group, chaired by Professor Sir Paul Collier from the University of Oxford, and consisting of representatives from the European Investment Bank, African Development Bank, UN Capital Development Fund, UN Economic Commission for Africa, and United Cities and Local Governments.

Enhancing the financial position of cities: evidence from Hargeisa

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Summary

The City of Hargeisa, despite being in the very early stages of enhancing its financial position, has achieved significant reform in just a few years since its democratic establishment in 2002. The successes achieved are even more remarkable, considering the fragile context of Somaliland after 30 years of civil war within Somalia, which left widespread destruction and devastation in the city. This is compounded by Somaliland's lack of recognition as a sovereign state by the international community. The case provides an illustrative example of leveraging urbanisation to raise municipal revenues for public service delivery, and in building local government legitimacy to better deliver to the populace.

Given the context, the reforms are those that are easy to implement and effective, including the application of a

simple digitised accounting and billing system, and a fit-for-purpose area-based property tax system. Where other cities have struggled to service more people with a stagnant revenue base, Hargeisa's reforms have meant that population growth has resulted in increased revenues from property taxes and daily vendor collections. At the same time, private contributions of land on the peri-urban fringes offer an opportunity for in-kind land value capture and planned development in the future. Their successes are reinforced by the legitimacy built through participatory governance, which demonstrates what is achievable when communities, local government and the private sector work together.

While Hargeisa has made progress on the basics of own-source revenue, much more is yet to be done to finance

future development. Local government capital expenditure, for instance, is often far below what is budgeted. This is influenced by public demand for current and visible service delivery over and above less visible long-term investments. Furthermore, due to Somaliland's internationally unrecognised status as an independent country, Hargeisa received limited development assistance when compared to other cities in similar contexts. However, a small coordinated effort through a coalition of UN agencies has fundamentally shaped some of the city's reforms. As the country begins to formalise its financial sector, opening up to commercial banking and international investment, development support will be needed to ensure local governments and the private sector are able to capitalise on the opportunities this presents.

Key messages:

- Simple, fit-for-purpose property tax systems ensure revenue can be collected without incurring large expenses and navigating complex procedures.
- Administrative reforms, such as digitising systems and streamlining the number of taxes collected, can have a significant impact on tax efficiency and accountability.
- Planning for future expansion is not only useful for capturing the gains from rapid urbanisation through exaction, but also improves future urban investment.
- Building and maintaining the social contract through participatory planning and visible service delivery is essential in increasing collection rates.
- International opportunities for finance may be severely limited both by an under-developed finance sector, as well as a reliance solely on Islamic banking.
- Well-coordinated development partners provide a strong enabling environment and an anchor for reform.

Urbanisation trends, challenges and financial needs

Somaliland, a self-declared autonomous state since 1991, is one of the poorest countries in the world, with Gross Domestic Product (GDP) per capita in 2017 estimated at US\$ 675.¹ The economy is heavily reliant on agricultural products – livestock in particular – which made up 28 per cent of GDP in 2012.²

As such, growth, output and exports in the country are closely tied to weather conditions. There is limited foreign direct investment in Somaliland, given its lack of recognition as an official state and the fragility of the war-torn context in which it resides.³ This limitation also extends to investment from development partners and NGOs. In addition, government taxation and spending are amongst the lowest in sub-Saharan Africa; the former at 7.2 per cent of GDP⁴ and the latter at ten per cent of GDP.⁵ The government, therefore, has relatively little control over the country's economic resources to ignite investment and consumption.

Estimates of Somaliland's total population stand at around 3.9 million people, with over half of this population living in urban areas.⁶

The urbanisation rate has been incredibly rapid over recent years, primarily driven by climate change and the resultant displacement from farming activities, as well as high birth rates. Citizens are seeking public services and social safety nets through proximity to the city and urban clan networks. Although one in four urban households still do not have enough to meet their daily basic needs, for many, it is an improvement to precarious and unpredictable rural poverty.⁷

Hargeisa, as the capital city of Somaliland, is an epicentre of this urban growth, with the total population roughly tripling over the last ten years. In 2005, the city was estimated to contain 300,000 inhabitants⁸, while current estimates put the city's population at around 1.2 million. While the city has subsequently undergone rapid reconstruction and expansion to accommodate this surge, some difficulties remain. Visitors describe Hargeisa as one of the lowest-rise capitals in the world,⁹ with wealthier diaspora investors accredited with the few notable exceptions. This low density, exacerbated by poor road infrastructure, results in considerable difficulties in both congestion and connectivity.

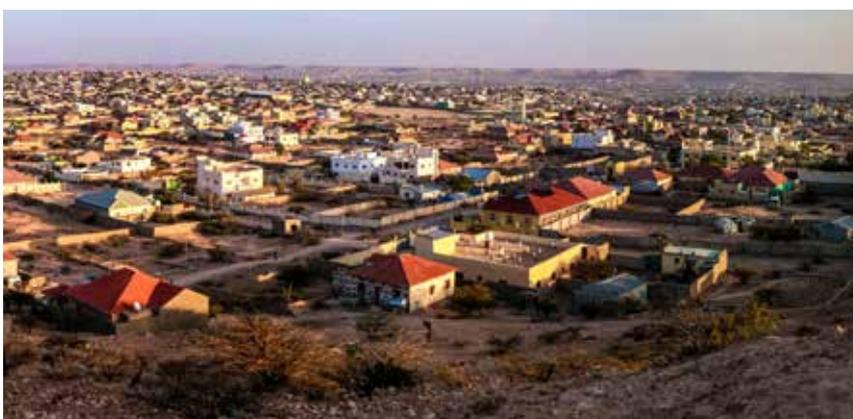
The city is also characterised by high levels of unemployment and informality. Although information at the sub-national level is hard to come by, the World Bank Doing Business in Hargeisa 2012 report provides an indication.¹⁰

According to the estimates provided, the informal economy accounts for about 77 per cent of total employment in the city. One of the critical drivers of this

informality is the lack of development in the formal financial sector, which constrains the ability of businesses to access finance. Of the firms surveyed in Somaliland, 48.8 per cent indicated that access to finance is the number one constraint to doing business as opposed to the global average of 16.9 per cent. This is because the majority of financial services are provided by informal Islamic banking systems that offer short-term deposit schemes and no interest on payments.¹¹

Another driver of informality is the crippling cost of business licences. In 2012, Hargeisa was one of the top 15 most expensive cities in the world to start a business, with 50 per cent of the expense coming from the local business license cost.¹²

Reforms in the financial sector and large-scale investment are desperately needed to address these challenges, ensuring the city's infrastructure is planned and built to accommodate increased populations in a productive and liveable manner, rather than having a sprawling site of crowding, contagion, and congestion.



Aerial view to Hargeisa, biggest city of Somaliland, Somalia © Shutterstock

Municipal finance and urban governance structure

Urban governance structure and mandate

The legal basis for local governance in the country, including the structures and functions of local governments, is set out in the Regions and Districts Law (Law 23). The Law was created in 2002 but revised extensively in 2007, and aims for extensive decentralisation of power to the local districts. It outlines the division of Somaliland into six regions, with each containing several districts, one being the capital. There is a rank assigned (A-D) to each district after assessing its production, economy, total population, and land area which determines the level of responsibility that can be decentralised.¹³ Hargeisa represents the most advanced grade (A), and is the capital of the Maroodi Jeeh region.

While the six regional councils are not elected, the 23 district councils with ranks A through C are, and the expectation is that elections will be at five-year intervals. Grade D districts still require border demarcations to become electoral districts and therefore remain under the Ministry of Interior, which appoints the Mayor and Councillors.¹⁴ Although initially there were only 19 Grade D districts prescribed in the law, there have been a growing number of districts appointed by subsequent presidents, now totalling 59. These have largely been politically motivated along tribal lines.¹⁵ Although the Somaliland Constitution has recognised the importance of district councils for some time, the first direct elections were only held in December 2002. Since then, municipal

elections have only been held again in 2012, skipping 2007, and the 2017 mandated election is now more than 2 years overdue.¹⁶ There are 25 elected councillors in Hargeisa, with the Mayor being elected from within this group.

Article 11(2) of Law 23 outlines each district's responsibility in providing social and economic services to its citizens. This includes health and education provision up to intermediate schooling level, livestock husbandry, security, water, electricity and communications, amongst others. Although Somaliland is striving for a fully decentralised system under Law 23, local government's ability to deliver the service determines the level of responsibility allocated. In practice, therefore, only some elements have been devolved in larger cities such as Borama, Berbera, Buroa, and Hargeisa; however, even in these, the majority of health and education functions remain centralised or fall between the cracks. Hargeisa's budget reflects this with only 5 per cent of the total spent on healthcare and education services.

This approach has resulted in a severe lack of clarity on which level of government has the responsibility to deliver specific mandates. In some cases, the private sector and diaspora have even stepped in to fill the resulting gap in providing public infrastructure and services such as garbage collection, water, electricity, and telecommunications. The lack of clarity has also led to loopholes in overall tax collection, as well as issues of double taxation. To overcome this, the Joint Programme for Local Governance (JPLG), a multi-

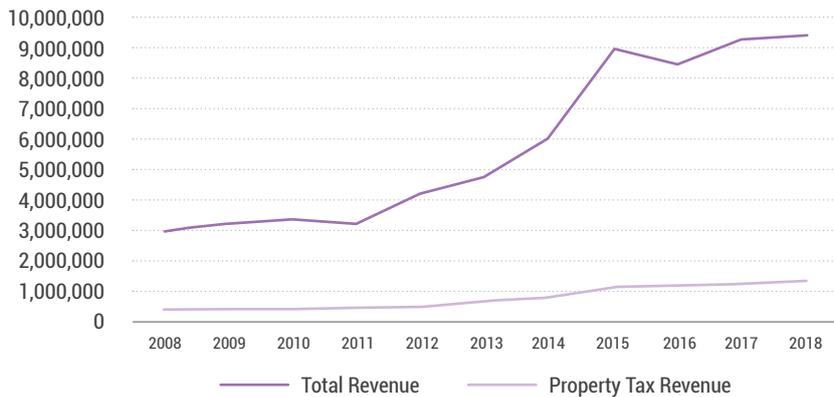
donor initiative including UN-Habitat, UNICEF, UNCDF, ILO and UNDP, has actively tried to support local governments in achieving the capacity for decentralisation since 2008.

Despite the lack of clarity over roles and responsibilities, the central government is actively engaged in supporting and enabling local governments. The Ministry of Interior helps with the coordination of revenue reform activities, harmonising budgets for development partner projects as well as overall government budgets. They also raise awareness of the importance of adequate central government funding for local governments. This engagement is crucial not just for coordinating Hargeisa, but also consolidating approaches and communication between the other city districts as well. The Ministry of Planning helps by acting as the first point of contact and coordination mechanism for development partner support – channelling partners to the relevant ministry, department or district.

Municipal finance overview

As a result of recent reforms in administrative systems, and capturing the gains of rapid urbanisation, Hargeisa's own-source revenue grew from US\$3 million in 2008 to US\$9.4 million by 2018, translating to roughly US\$7 per capita, depending on population estimates. This represents a tripling of revenues in ten years with over 12 per cent growth per annum, as shown in Figure 1 below. It was asserted that a large portion of these revenue increases can

Figure 1: Total own-source revenue and property tax revenue in Hargeisa, 2008-2018 (US\$)



Source: Hargeisa City Council data

be attributed to compliance. According to the budget, since 2016, total property tax compliance has been hovering between 70 per cent and 75 per cent, however, the revenue generated is significantly limited by the informality of the population – both because of the lack of formal systems to collect it, but also the inability for people to pay.

The municipality has a considerable number of local taxes (46), but the top eight make up over 50 per cent of revenues. Figure 2 shows these key own sources of revenue for 2016 below.¹⁷ Of these, the three of critical importance for the municipality to enable the creation of urban wealth and deliver public services appear to be those taxes relating to land: property tax, property transfer duties, and vacant land tax. Looking at property tax specifically, the increases in this crucial source of revenue were 17 per cent per annum, quadrupling in ten years to US\$1.34million in 2018, as shown in Figure 1 above. Overall, between 2008 and 2018, own-source revenues increased by a staggering 233 per cent.

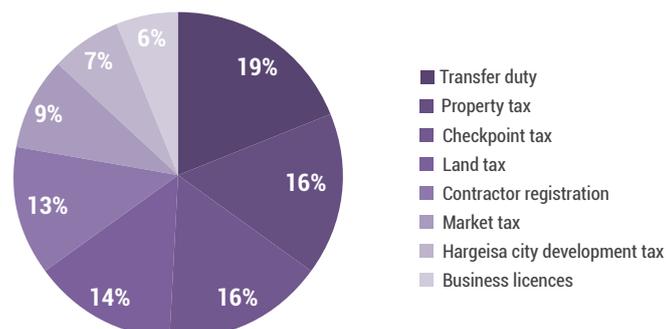
Daily collections are collected predominantly from market vendors and outer city checkpoint taxes. The former is collected largely from informal street sellers, while the latter applies to goods sold in the city coming from outside the city limits. These daily collections should increase in line with the city's growth. Although market taxes halved between 2014 and 2016, this was likely due to an increased focus on checkpoint taxes for goods coming into the city, which alone contributed US\$700,000.¹⁸ Business licences are

also a key source of income, but add significantly to the cost of doing business in Hargeisa and therefore deter investment and keep businesses operating informally. Their exorbitant rates, as explored in a following section, may actually reduce overall revenue that this tax can generate.

The city of Hargeisa also obtains **funds from the central government**. There are two types of central government transfers: the Ministry of Finance's 'Municipal Tax' in the form of a ten per cent share in customs revenues at local customs entry points, and the Ministry of Interior's 'Municipal Subsidy', an equalisation fund based on 12.5 per cent of *cumulative* customs tax throughout the state.¹⁹ While Hargeisa received 23 per cent of its budget from the central government in 2008, central government transfers made up only 11 per cent, around US\$1.1 million, by the end of 2018.²⁰

The Municipal Subsidy from the Ministry of Interior (locally known as 'Kabka') aims to cover the shortfall for development expenditure that remains after taking into account revenues. It is enshrined in law, which states that 12.5 per cent of customs duties should be allocated to the 42 districts,

Figure 2: Top 8 own-source revenues in Hargeisa, 2016



Source: Haas, A. (2017)

with six per cent being shared among grade A districts, including Hargeisa.²¹ However, there are ongoing concerns surrounding the delays and unpredictability in the payment size, which make it challenging for the city to plan for its use.

Furthermore, although it is stipulated in the National Decentralisation Policy that the determination of payments should be based on objective and transparent criteria, there are no known factors driving the distribution till date.²² The ratios for the division of the total amount between various local districts skews in favour of Hargeisa, given that it contributes 85 per cent of economic activity.²³ These ratios, however, do not strictly adhere

to the law and are often amended by presiding Ministers. For example, Hargeisa is currently allocated around 30 per cent of the total nationwide transfer, as opposed to the legally prescribed 51 per cent.²⁴

The 'Municipal Tax' is a more direct form of customs revenue sharing, specific to the customs entry point in that district over and above the Municipal Subsidy. On average, each Grade A district gets about ten per cent of revenues collected at a customs post, transferred by the Ministry of Finance. This tax is a more reliable source of revenue as it is remitted directly to the local government's bank account. Those districts with major customs entry points, such as Berbera, Gebilay,

and Zeila, benefit far more from this tax, and therefore from Central government transfers in general. In Berbera, for example, 68 per cent of revenue came from central government transfers in 2018 due to its location as a port city, far higher than the 11 per cent for Hargeisa as mentioned above.²⁵

The city has limited means of accessing municipal **debt financing**. This is not surprising given the underdeveloped formal financial sector at the national level, with Islamic banking limiting any interest-bearing options. Law 23 also imposes a strict limit on local government borrowing, currently allowing only short-term loans from commercial banks for cash-flow management.²⁶ For capital invest-



Roadside trade in Hargeisa, Somaliland © Shutterstock



Food Market, Hargeisa, Somaliland © Shutterstock

ment, local governments do not meet the creditworthiness requirements, and are therefore unable to undertake longer-term borrowing at affordable rates.²⁷ UN-Habitat is currently supporting a Local Government Finance Policy, which aims to provide clear guidance on borrowing and debt management.

As is the case with the country as a whole, Somaliland's lack of international recognition prevents the city from accessing responsive **bilateral or multilateral development partner support**, apart from significant support from a few dedicated partnerships such as the Joint Programme for Local Governance (JPLG). The JPLG initiated the Service Decentralisation Model (SDM) and the Local Development Fund (LDF). The SDM aims to support the transfer of minimum education and health functions, and between the relevant Ministries, the JPLG contributed US\$567,622 to education and US\$246,000 to health in 2018. The LDF aims to coordinate development spending and incentivise local governments to institutionalise and develop financial management

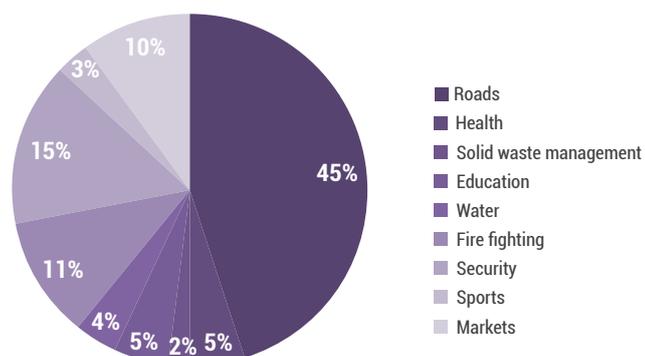
capabilities, as they must meet a set of minimum conditions in order to be able to access the funds. In 2018/19, the fund reached US\$2.3 million.²⁸

In terms of expenditure, according to the data from 2016,²⁹ most of the city's budget (44 per cent) goes towards salaries, followed by operations and maintenance (32 per cent), and then investment in capital stock (23 per cent). While the city's budgeted revenue and expenditure were equal at just under US\$9.8 million, in reality, total expenditure was only US\$6.7 million, leaving

a budget surplus of around US\$1.58 million when compared to actual revenue of US\$8.28 million. This difference was mostly due to lower investments in the capital stock by around 34 per cent. There was also overspending on salaries by around 20 per cent. The spending on operations and management was roughly similar to what was budgeted.

Although these kinds of discrepancies are common, the low capital expenditure is of concern as this is what ensures a sustainable urban future. Long-term strategic vision and quality of investment appear to be one of the weakest areas in terms of capacity in Hargeisa. The high salary expenditure is also of concern given the very disproportionate breakup: as much as a third of it appears to go to the 25 elected councillors, while two-thirds goes to the remaining 1,200 staff members.³⁰ Total budgeted expenditure in 2019 was US\$12.4 million. Figure 3 below shows the breakdown of this expenditure by service, exemplifying that roads make up the lion's share with 45 per cent, followed by security and markets at 15 per cent and ten per cent respectively.

Figure 3: Breakdown of service delivery expenditure, Hargeisa, 2019



Source: Hargeisa City Council data

Reforms undertaken to enhance the city's financial position

Enhancing the capacity of city financial management

Before 2008, Hargeisa municipality had relatively low capacity in financial and investment management. Compared to current standards, there was little appreciation of the importance of raising local revenues. Many systems were out-dated with records requiring manual processing, leading to a lack of transparency and accountability, as well as enormous difficulty in conducting any analysis. Furthermore, tracking money from its neighbourhood source to its spending destination was difficult. There were also several instances where money meant for capital expenditure was spent on operations instead.

Introducing digital accounting, billing and financial management systems

In order to remedy this, new digital systems known as the Accounting Information Management System (AIMS) and Billing Information Management System (BIMS), both funded by UN-Habitat and UNDP, were introduced. Although the implementation of AIMS took place in 2008 and BIMS in 2010, there was a long period of learning and adopting the systems, and therefore substantive revenue changes were only seen in 2014. Once taxpayers had been registered in the system after their first payment, it became much easier to target them for future payments.

AIMS records all revenues and expenditures in the Chart of Accounts (CoA) and produces the financial reports for the districts. It was designed to capture revenues and expenditure in new ways. For example, on the revenue side, the digitised revenue management system enables the city to accurately record annual revenues and allocate these to specific expenditure funds. On the expenditure side, the AIMS system limited the amount of spending according to budgetary allocations to ensure transparency and accountability. Both revenues and expenditures became identifiable as either capital or current, which significantly reduced the opportunity for capital development expenditure to be usurped by current salary or operational expenditure, as was the case in previous years.

BIMS, on the other hand, deals with billing for property tax and business licences. It provided a critical first electronic link from the central accounting department to individual and neighbourhood-level billing. Not only has this enabled the city to see who has or has not paid, it also allows decision-makers to understand the collection performance of districts and if necessary, have targeted follow-ups. Another key positive outcome of the system is improved efficiency in service delivery, such as business licences. As a result of the new easy-to-use system which enables licences to be provided in decentralised government offices, licence application times

have decreased to just one day. The city is now issuing over 6,000 licences per annum, up from 3,000 in 2010. However, this has not yet translated in a reduction in license cost, which is another critical inhibiting factor, discussed in the section on regulatory reform below.

The AIMS & BIMS systems have improved analysis capabilities and transparency in the city, underpinning much of Hargeisa's financial improvement. However, despite this, there are still ongoing challenges with these systems. The lack of automation in the system primarily drives this difficulty, resulting in a disconnect between AIMS, BIMS and broader government departments. Although AIMS and BIMS are inter-connected, they are functioning under two different departments – the former under the Finance and Administration Department, and the latter under the Revenue collection department. Any change in BIMS requires a manual transfer to AIMS representing a challenge in coordination. Recent 2019 amendments to the Law 23/2007, which specified roles and responsibilities of departments, have provided greater clarity and coordination between the departments. However, this does not negate the resulting limited functionality with understanding municipality assets and cash flows, or in forecasting total or project-specific revenues.

Figure 4: Neighbourhood level billing, ready for input into BIMS



Source: Priya Manwaring

The introduction of the Financial Management Information System (FMIS), which is currently being supported by UN-Habitat, is expected to alleviate the aforementioned issues. The FMIS is an automated and integrated accounting system linked with all arms of government with unified CoA and budget codes. This system will allow Somaliland's audit general to get information on the municipality's accounts instantly. Currently, FMIS is fully operational at the central level, with plans underway to decentralise it to the district level. Hargeisa will be targeted as the first district to facilitate a unified accounting system for Somaliland, which will significantly aid the overall process of decentralisation in the country.

Further digitisation and automation reforms are also underway to connect various elements of city operations through an integrated dashboard. This is already leading to considerable efficiency gains felt by citizens – both in paying for services and in tracking their

progress. Services that previously took two months now take four to seven days, with text messages and electronic billboards at the Mayor's office keeping citizens informed of relevant progress. Mobile money payments have also come online, allowing citizens to pay at their convenience. The hope is that this will further increase compliance and trust in government accountability.³¹

Reducing the number of taxes administered

In many cities, including Hargeisa, a common strategy to increase revenues is simply to increase the number of tax types. Between 2014 and 2016, the number of unique local taxes being levied increased from 42 to 67, which is extremely high by world standards.³² However, this strategy does not account for the cost of collecting and administering those taxes, which is often similar to or even exceeds the revenues they bring in. It also contributes to high staff costs and tax fatigue

of residents, as many of these relatively 'expensive' taxes are collected frequently and in-person. With so many payments to keep track of, residents are more likely to be unaware, forget or avoid the nuisance of these payments. Therefore, enhancing the efficiency of the most important taxes and eliminating others could result in higher revenues overall.

While there has been a slight reduction in the number of taxes to 46 since 2017, there is still significant further progress that can be made. This could help in unlocking existing capacity that would otherwise have been taken up in processing a large variety of different taxes, and would enable the city to focus on implementing more in-depth financial reform.

Building human capacity and skills

Alongside enhancing the system's capacity in Hargeisa, several training initiatives have also been underway

to improve human capacity and skills development, particularly given the challenge of high employee turnover in local governments across Somaliland. The city administration in Hargeisa has also been growing – while there were 900 people employed in 2012, there were more than 1,200 by 2015 – and all new employees need to learn and develop the requisite skills.³³

The key stakeholders driving this forward have been the Local Government Institute (a department within the Civil Service Institute), supported by JPLG. This Institute is linked with Hargeisa University (pictured in Figure 5 below) and is essentially a training school for government officials and citizens. Although initially funded by UNDP, it is now fully funded by the Somaliland government.

Local Leadership Management training is one of the key courses offered, intended as an induction for new local councillors, providing them with an overview of local council functions and the resources at their disposal. It covers issues such as decision-making, policy-setting, institutional development, conflict management, negotiation skills, financial management and community empowerment, amongst others. In addition, at the start of every electoral cycle, councillors undergo capacity building to understand their legislative mandates and restrictions. While the intention is for this to happen every five years, in reality, it has happened every ten years.

More frequent capacity building takes place for administrative staff who are on the frontlines of policy change. While this also covers a range of skills and capabilities, the most notable was training in finance and project cycle management.

Capturing land value and unlocking dead capital

Capturing land value is where the city has achieved relative success, implementing systems that are simple and easy to administer and keep updated. Land-based revenues are captured through the property tax, annual land tax, and the property transfer tax, made more efficient with the use of GIS technology. There are also regulations in place for exaction of land on the outskirts of the city – a provision to finance infrastructure and services as the city grows. However, more can be done to ensure these revenues accurately reflect changes in land value, and to clearly connect them to services delivered.

Simply administered property tax

The City of Hargeisa uses an area-based property tax system, designed to match the available capacity and realities of the context. This was employed following the development of a basic cadastre using satellite imagery and surveys conducted between 2004 and 2005 and supported by UN-Habitat.³⁴ Rather than using the standard value-based property tax system driven by market characteristics requiring complex valuations done by personnel of considerable expertise, Hargeisa's system only requires multiplying the area of the building by a location factor. This relative simplicity makes it far easier to maintain and update the register on a more frequent basis and allows the city to enhance its financial position at low cost. However, the simplicity also means it is likely to be more regressive and insensitive to actual changes in value.

Hargeisa's property tax system only requires information on the building's

width and depth, the number of floors, and the location. The tax on each additional floor decreases at a rate relative to the ground floor. The first floor is taxed at 80 per cent of the ground floor, then the second floor at 60 per cent, and so on. In terms of the location bands, while there are 16 locations available in legislation, in practice however, the municipality uses only five. The highest band levies a fee of US\$2 per square metre. The five location bands used are:

1. PTAXCENTER – a tax on property located in the city's centre (mainly commercial buildings);
2. PTAXOPEN – a tax on property that is vacant land (open space or unimproved land);
3. PTAXOUT/OP – a tax on property that is partially used land (partial building and partial unimproved land);
4. PTAXOUTER – a tax on property located outside the city centre (mainly villages);
5. PTAXWALL – a tax on property within a walled compound.

While this approach simplifies administration, it is vital to ensure that there is enough of a range to accurately reflect different location characteristics.

Since the primary purpose of the property tax is revenue generation, tax collection and enforcement are the most critical components of the property tax system. On the whole, citizens seem willing to pay these taxes, and although compliance seems to vary between 50 per cent and 70 per cent, the city states that they have regularly collected up to 90 per cent of budgeted property tax

revenues since 2013. However, enforcement of those who do not comply is relatively weak due to a combination of a lack of political will, data collection and enforcement mechanisms, and in some cases, a lack of taxpayer confidence or an understanding of how the tax is levied, collected, enforced, and used.³⁵ There is also a mis-incentive for late payments as the municipality gives discounts for long-term pending payments.

In addition to the property rates, there are also **taxes on property transfers**. The tax applies a four per cent levy on the sale price when a property is sold, with the Ministry of Finance and City of Hargeisa splitting collection, each getting two per cent of the total amount. This is one of the primary sources of confusion between the roles and responsibilities of different tiers of government, subsequently leading to high levels of double taxation. This discourages citizens from transferring their properties and inhibits efficient functioning of the property market.

There is also an **annual land tax** based solely on the area of undeveloped land, collected by the city of Hargeisa. While land with property on it attracts the highest rate of US\$2 per square metre, undeveloped land attracts a much lower value of US\$0.20 per square metre. There are vast swathes of undeveloped land in the city, and with land speculation rife along with estimations of the diaspora owning around 60 per cent of the city, this undertaxed asset could be a key area for reform. Not only would increasing the vacant land tax bring in revenues, as recurrent property tax, but depending on why it is vacant, it could prompt owners to re-allocate to more efficient use. For example, in Kampala, vacant land constitutes just 8-ten per cent of land in the city, and the estimated revenue loss based on

just two of Kampala's 74 parishes was between US\$65,000 and US\$478,000.³⁶

Expanding the land and property tax registers

In order to capture the city's growth, Hargeisa municipality has been expanding its registered properties through Geographical Information Systems (GIS) mapping. This entails geolocating each property in an area of space and outlining it on the city map. It was first done in 2005 and then again in 2017, at both points showing considerable increase in the tax roll. In 2005, the number of properties increased from 15,850 to 59,000, resulting in an increase in revenue of over 250 per cent. In 2019, nearly 200,000 plots were registered in the GIS system, including commercial and vacant land. Of these, only 80,000 were built upon.

The property tax revenue increases shown in Figure 1 above are largely a result of expanding registers and improving administration systems. However, this data provides even greater benefits, including improved urban spatial planning in the District Development Plans.

Challenges and opportunities in land value capture

Despite these land and property taxes, the municipality continues to struggle in capturing a fair portion of the substantial increases in land values that result from public investment, rapid urbanisation, and speculative investment. As public services are delivered (sanitation, water, improved roads, drainage), land values are expected to increase, and, ideally, so would land and property taxes to recoup some of the costs and encourage land to be transferred to its highest value use. In

some cities, adequate water supply to plots sees land prices increase by ten times the cost of that investment.³⁷ However, the property tax value comes primarily from the location factor, and with limited bands used, capturing the land value increase is unlikely to be fully appreciated.³⁸ While the rates allocated per location band can be updated with Council approval every year by law, in practice this is tricky. Land taxes are also solely area-based and are therefore entirely uninfluenced by the value of their surrounding location.

To improve valuation methods and address enforcement issues, UN-Habitat through JPLG, has commissioned a study on Better Management of Property Taxation, the recommendations of which are expected to be implemented in 2020.

The limited data required for area-based property and land tax is therefore both its advantage and its drawback. True land price increases are only really captured through the property transfer tax, relying on the building or land to be sold. However, as discussed earlier, the tax's cost likely impedes sales, and the city therefore derives less revenue from it than desired. Failure of the government to accurately capture land value actually reduces the efficiency of the market, which is perhaps the reason why Hargeisa is such a flat capital city.

Having said this, the city government has been very progressive in implementing a system of 'in-kind' land value capture. This land capture is a form of exaction, whereby the development of land comes with specific conditions for the benefit of the municipalities. In this case, landowners on the outskirts of the city applying to convert their land from

rural to urban use, must provide the city government with 30 per cent of their land if their application is approved. In this way, the city can access land for needed public infrastructure to service a growing city. At the same time, rent from this land can offer the city a valuable source of additional income to pay for the required infrastructure. Figure 5 shows an example of the municipality's 30 per cent land allocation demarcated for future services on the peri-urban fringe of Hargeisa.

Improving the regulatory environment for access to finance

The most fundamental issue that Hargeisa faces in accessing to finance is the lack of international recognition of Somaliland as an independent state. While this is not a regulatory issue per-se, it has implications on the governance of the country. Since the country is not recognised, most donors work with Somalia through the government in Mogadishu. Funding to Somaliland therefore has to pass through Somalia's government, even though in practice they are separate. Most international investors are also not willing to take on the risk of this political instability.

Despite the state's fragility and limited international assistance, the local government has been able to develop what the city describes as relatively high levels of legitimacy amongst its citizens over time. This citizen buy-in has been developed largely through a strong focus on participatory governance, communication, and visible service delivery. They have also started to conduct regular internal audits and prioritise a 'free and fair' election process in order to boost confidence in the local government's transparency

Figure 5: Land demarcation on the fringe of Hargeisa



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and accountability. Building this legitimacy is essential to ongoing compliance in own-source revenue collection.

Building legitimacy through participatory governance

The most important aspect of participatory governance in Hargeisa is the process of strategic participatory planning. The establishment of local government planning departments has encouraged municipalities to think strategically about the long-term trajectory of issues through five-year 'bottom-up' district development plans. According to the City Council, the strong participation of communities in developing these plans, as well as the budgetary framework, makes the citizens feel the government is working for them. The deep engage-

ment with the community in terms of what they want to spend municipal revenues on, enables citizens to understand what should be delivered and hold the local government accountable, thereby raising motivation to 'invest'. This virtuous circle can help to improve legitimacy with citizens in the short run, as well as in the longer-term if local governments are able to deliver.

In Hargeisa, this appears to have been done very well in some areas, but less so in others. The relatively high levels of tax compliance described by the city, suggests that citizens value their tax payments and are receiving the requisite services in return. However, this short-term delivery has come at the expense of capital expenditure, resulting in little and poor-quality

investment. This is starting to affect both voluntary compliance and trust in government, and will increase over time as the gaps in long-term planning increasingly start to show. During community planning sessions, a significant emphasis is placed on current issues rather than focussing on future ones. There is challenge in balancing participatory planning with less visible, long-term planning for investments.

Other efforts to improve transparency in revenue collection and expenditure further build legitimacy. As mentioned previously, the municipality regularly undertakes internal audits to ensure that the system is transparent throughout and provides a check on financial activities. This unqualified opinion, if successful, increases citizens' trust in the local government. Digital systems such as the AIMS and BIMS, the public dashboard display of city activity, and automated text messages of progress on City Council requests, are also important elements in communication and accountability. The intention to introduce mobile money payment systems to reduce pilferage of daily collections will also further support this.

In some ways, the knowledge that external assistance may not be readily forthcoming may inspire the local council to be more accountable out of necessity. Policymakers are able to construct a social narrative around the collective difficulty and achieving a common purpose – that citizens must come together and assist in tax provision and development. This is further supported through free and fair elections at the local level, which incentivises city officials to deliver their campaign promises and generate revenue separate from national transfers, while also creating a sense of local agency for the citizens.

Developing the commercial financial sector

In Somaliland, access to finance is limited with formal banking (Islamic or conventional) still largely undeveloped, underpinned by a lack of the requisite legal and regulatory structures. Instead, the majority of financial services are provided by remittance companies and informal Islamic banking systems that offer short-term deposit schemes and no interest on payments.³⁹ The supply of investments in the country is therefore severely restricted, hindering the development of both the public and private sectors.

Although regulatory progress has been made, implementation continues to be held up by resources and capacity challenges. The Bank of Somaliland (BoS) Act was passed in 2012, and provides the legal basis for the Bank to act as the supervisor and regulator of the financial system. The Islamic Banking Law was also passed in 2012, and the BoS internal 'Guidelines for the licencing of Banks and Financial Institutions' was passed in 2013. However, a number of critical legal provisions remain unclear, making certain elements difficult to enforce – resulting in unpredictable and incoherent decision-making.

Currently, remittance companies are still the leading providers of financial services. In addition to connecting Somaliland residents with money from the Diaspora, they also facilitate the transfer of funds within Somaliland and provide deposit accounts – essentially acting as quasi-banking institutions. The other financial services more recently available include 'murabaha' used for financing domestic and foreign trade, and 'musharaka', used for longer-term investment financing, and both have grown significantly over time.⁴⁰

Mobile payments, or 'Zaad', have also gained traction as a way to move away from the entirely cash-based system. Mobile payments are accepted by a large group of merchants, including restaurants, hotels, petrol stations and universities, and are even connecting to international providers for cross-border transfers. Currently, 26 per cent of the population have reported using mobiles to pay their bills, one of the highest rates in the world.⁴¹ However, regulations overseeing these transactions are lacking, presenting a possible future risk.

Islamic finance is based on Sharia Law, underpinned by two key principles: the sharing of profit and loss, and the prohibition on the collection and payment of interest⁴². It directs funding to the real economy by promoting risk-sharing, while avoiding excessive speculation, and limits debt to the value of the assets themselves. There are several different Islamic financing 'tools', including *Sukuk* – the Islamic equivalent of bonds. However, instead of conferring debt ownership, *Sukuk* confers a share of an asset, along with the commensurate cash flows and risks. Although still a niche instrument, the use of *Sukuk* to finance infrastructure projects of governments and corporations is growing exponentially. Islamic finance is a US\$2.2 trillion industry in over 60 countries⁴³, and thus enabling the formal Islamic banking sector to thrive could bring enormous benefit in itself.

Having said that, Somaliland is in the minority in having Islamic finance as the only option. Many other Muslim-dominated countries have both commercial and Islamic banking options, with the variety of options offering greater choice and potential for financial inclusion. This regulatory environment currently puts Somaliland at a global disadvantage. The Commercial Banking Act, allowing

for non-Sharia compliant loans, has been drafted, but has been sitting with the House of Representatives since 2012 and remains unpassed.⁴⁴

Clarifying responsibilities and reducing complexity

Beyond the two overarching issues of government legitimacy and enabling the financial sector, there are also a number of more specific governance stipulations that need to be addressed. These include the lack of clarity on coordination between the district or city and central level government taxes, including reducing the overly stringent and complex business licence requirements.

Through the process of decentralisation, there has been frequent confusion around collection responsibilities, resulting in loopholes in addition to double taxation. As mentioned previously, one key example is the tax on property transfers, which is meant to be split equally between central and local governments but has proved difficult to execute in practice. Three actions are necessary. First is to further streamline the number of taxes being levied to avoid duplication, focussing on enhancing the efficiency of those with the highest potential. Second is to amend Law 23 to clearly stipulate who collects what, regardless of responsibility transfers. Third is to improve the payment process and coordinate with national revenue collection so that residents are not overwhelmed by having to navigate payment of multiple taxes to multiple different agencies at different points in time.

In some cases, requirements can be excessive, stifling growth and economic opportunity in the city. A clear example of this is the business licence requirement, which has contributed

significantly to the substantial cost of formally doing business in Hargeisa described above. Furthermore, between 2016 and 2017, the cost of business licences increased from US\$124 to US\$274, with 121 different classifications of businesses to navigate.⁴⁵

This expense and complexity keeps people in informality and reduces the benefits of scale and specialisation that a formal, organised, and conducive business environment can bring. Furthermore, setting exorbitant tax rates can reduce tax revenues overall, as economic growth remains stagnant. There is a need to find a balance between deriving justified revenues and making formal economic activity too costly to partake in. There is also a need to plan for the informal sector properly, finding ways to provide for and capture some of the real benefits that this sector brings.

Realising the potential of investment in improving infrastructure

Hargeisa, like many cities, has struggled with infrastructure delivery due to financing limitations. This is largely a result of the underdeveloped commercial financial sector described above. In addition to the constrained financial environment at the national level, Hargeisa municipality has further legislative restrictions on its ability to take on debt. There are prompt repayment requirements (liabilities must be less than two years), and any debt requires central government sign off. Until regulatory reform, current options therefore revolve around leveraging investments from the community and the diaspora, collaborating with the private sector, and coordinating investment from development partners.

Leveraging the local community and diaspora

One of the primary ways that the city has been able to deliver large infrastructure projects is by leveraging the private sector and the community (both locally and the diaspora). As described above, the district development plans have been a critical reform in leveraging both financial and human resources. This buy-in, combined with an understanding that due to Somaliland's lack of international recognition, outside assistance may not be forthcoming, results in citizens, the diaspora, and firms themselves investing in projects. A key example has been the Hargeisa Bridge over the Marodijeh River – community finance, private sector delivery, and local government vision and coordination provided an essential city connection.

Diaspora have also typically contributed to medical practices and higher education, sharing their skills as well as medicine, equipment and books. Investments are also made into buildings and roads where required, although this has tapered off as development assistance has increased. The University of Hargeisa, founded in 1999, was almost completely organised, managed, supplied and funded by the diaspora, leaning on the local government to help in clearing the land, and commit ongoing revenue for security of the new building.⁴⁶

Research has found that many of the contributions are made along clan lines, and is rarely well coordinated, with consequences for the distributional impacts of the investments made.⁴⁷ However, there are also cases of collective formal and informal associations that mimic aid agencies – identifying the needs, selecting pro-

jects, and assisting local authorities in overseeing implementation.⁴⁸ The relationships built between the local government, NGOs and the diaspora are vital in facilitating and maintaining these investments.

Private sector concessions

Public Private Partnerships (PPPs) are one (often complex) way in which municipalities can overcome financing constraints in delivering services to their citizens. The private sector concessionaire finances some or all of the up-front capital cost, recouping their investment through user fees or scheduled payments from the public sector partner.⁴⁹ A form of PPP, or private sector concession, has been used by Hargeisa municipality in solid waste management (SWM). Before this, for 20 years, the city had specific areas or 'nodes' for collection, as they were unable to afford the needed waste vehicles. Individuals dumped their waste at these nodes, but limited resources and poor scheduling for collection meant that garbage was often left there for a while between collections.

With the aim of relieving waste pressure, the municipality entered into a partnership with the private sector through a concession. The concession started small with collection at a few critical sub-streets. After this, feasibility studies were undertaken, and tenders were put out for further collection areas. The city now has five companies covering different neighbourhoods, both at the household and commercial levels. The municipality provides a subsidy to the private sector for its service, and households pay between US\$2 and US\$5 per month. For many, this is three times the amount they pay in property tax. In addition to overcoming short-term

financing constraints, this private concession has provided jobs for around 1,000 citizens who work for these companies.

However, PPP's are often not the fix-all solution they are touted to be and are typically only feasible for large-value projects over US\$50 million, given the high transaction costs incurred in structuring the deal.⁵⁰ In addition, they require a very strong authorising environment. In undertaking a PPP, the city is also giving up foregone revenues from fees as well as the subsidy provided to private firms. Together, these outweigh the costs of current provision, otherwise it would not be profitable for private firms to undertake. It is essential to consider whether the cost efficiencies of private sector provision outweigh this foregone revenue. If not, efforts to alleviate short-term credit constraints through borrowing might be better for long-term service provision and financial health of the city.

Coordination with development partners

Despite the city having limited recognition from international development partners relative to other cities at similar stages of development, it has had significant assistance from the few involved. Coordinating the input of these development partners to both align with the city's objectives, and with one another, can be a significant challenge, particularly in the future as interaction with them increases. The Ministry of Planning is the first point of contact and coordinator for development partners. A necessary delivery vehicle upon which this coordination takes place is the Somaliland Development Fund (SDF), established in 2012. This single fund ensures two important outcomes:

1. External development partners can support the country's development goals;
2. All development partner projects delivered are aligned with Somaliland's National Development Plan, a five-year plan covering the period 2017-2021 focusing on rapid economic growth, sustainable development, and poverty reduction.

One useful associated reform already underway by the SDF through JPLG is the construction of markets for informal traders. These markets provide three benefits:

1. Traders can coordinate in one place; they have proper amenities and can benefit from proximity to one another;
2. The administration of taxation is more efficient;
3. Rather than daily collection, businesses licenses and bi-annual market fees could be levied and collected alongside rental payments. This decreases the opportunities for pilferage, reduces administration costs, and improves voluntary compliance of easily identifiable traders who need to pay for rent to stay in the market.

However, to be successful and ensure they are used, it is important that these markets are located where informal traders have access to customers with necessary amenities. As outlined above, the JPLG also contributes to the SDM which aims to support the transfer of minimum education and health functions to the districts and cities.

Lessons, success factors and priorities for future reform

Hargeisa has made a number of leaps forward in enhancing its financial position, despite the fragilities of the state. The key lessons revolve around implementing basic systems that are fit-for-context, as well as the city's ability to coordinate various stakeholders to work towards a common objective.

However, Hargeisa still has a long road ahead in enhancing its financial position. With annual revenue totalling around US\$7 per capita, and a vastly under-developed financial sector in the country, there is little scope to take on debt to finance the city's development. Unlocking the supply of investment for long-term financial sustainability will require significant effort from the national government to improve the regulatory environment for finance, both in providing clarity on the existing Islamic Banking Act and working to ensure the Commercial Banking Act is passed.

Within these constraints, the city is continuing to focus on improving the efficiency of financial management processes, with strong development partner support. This will both increase own-source revenue collection, as well as the city's creditworthiness, attracting further concessionary and community or diaspora-based investment.

Lessons and success factors

Digitising and automating operational systems: The AIMS and BIMS systems have improved analysis capabilities and transparency in the city, under-

pinning much of Hargeisa's financial improvement. AIMS records all revenues and expenditures and produces the financial reports for the districts. BIMS deals with billing for property tax and business licences, as well as property matrices with tariff and location categories. It also provides a critical first electronic link from central Hargeisa accounting to individual/neighbourhood-level billing. It enhances accountability as it allows decision-makers to understand the collection performance of a district and if necessary, have targeted follow-ups. In addition, the new easy-to-use system has enabled licence application times to decrease to just one day.

Simple and fit-for-context property tax system: Rather than using the standard market value-based property tax system requiring complex calculations, expensive evaluators, and personnel of considerable expertise, Hargeisa instead uses a simple and low-cost area-based system. Specifically, it entails calculating the building's size multiplied by a rate based on location, thereby only requiring information on the building's width and depth, the number of floors, and the location band as set by the City Council. JPLG also enabled successful expansion of the property register through the use of GIS, increasing the land and property registered from under 20,000 in 2005 to over 200,000 currently. This simplicity of the system, combined with GIS technology, makes it far easier to frequently maintain and update the register, with revenues having increased by a factor of 4 since 2008.

Pre-planning for future urban development: The city government has also been able to implement a system of 'in-kind' land value capture. Landowners on the outskirts of the city applying to convert their land from rural to urban use, must provide the city government with 30 per cent of their land if their application is approved. This system is a form of exaction, whereby the development of land comes with certain conditions for the benefit of the municipalities. In this way, the city can access land for needed public infrastructure to service a growing city. At the same time, rent from this land can offer the city a valuable source of additional income to pay for the required infrastructure.

Strong focus on the social contract and local government legitimacy: The ability to raise municipal revenues has been underpinned both by a commitment to visible service delivery, such as roads and waste management, as well as the clear focus on participatory planning. The city authorities stated that citizens have a strong say in local government planning and projects through the district development plans and have thus, 'bought-in' to the process. However, this is highly dependent on meeting service delivery expectations, and in some areas, limited and poor-quality capital investment threatens the social contract, risking a reduction in compliance and future legitimacy.

Relative self-sufficiency: Rather than be inhibited by Somaliland's lack of international recognition and support,

the City of Hargeisa has fostered an environment of self-sufficiency with regard to public service delivery. This sufficiency has both positive and negative consequences and is useful to leverage for future reforms. While the city may take longer to build up public services without the variety of development partner programmes that other cities have available, it is simultaneously enhancing self-reliance. That local Councillors are locally elected, without reliance on central government funding, further aligns incentives to help stimulate the need for own-source revenue reform.

Leveraging the local community and diaspora:

The diaspora has contributed significantly to the development of the city and the region as a whole, working with local firms, government and individuals to achieve community goals and objectives. This has largely been facilitated and encouraged through the above-mentioned focus on participatory planning. However, as with all other forms of investment in Somaliland, it relies on personal relationships and trust, given the risks attached to the underdeveloped financial sector.

Coordinated and targeted international development partner support:

Although limited when compared to other cities at a similar stage of development, those development partners who have worked with Hargeisa were very well coordinated. Often highlighted as an anchor to much change was the JPLG, which was instrumental in a number of reforms, most notably in setting up the AIMS, BIMS, and in capacity building. It has provided a number of enabling conditions in terms of driving change, fronting initial capital, and providing expertise when the municipality lacked capacity, all in a highly collaborative way.

Central government support: In line with Somaliland's decentralisation policy, the central government is actively engaged in supporting and shaping local government. The Ministry of Interior coordinates revenue reform activities and advocates for adequate central government funding for local governments as the country pushes for decentralisation. The Ministry of Planning acts as a coordination mechanism for international development partner support through the SDF.

Priorities for current and future reform

Integrated financial management system:

The outstanding challenges since the implementation of the AIMS and BIMS systems, such as the system's automation and coordination with other local government departments as well as the national government, are currently being alleviated through the introduction of the Financial Management Information System (FMIS). The FMIS is an automated and integrated accounting system linked with all arms of government with unified Chart of Accounts (CoA) and budget codes. UN-Habitat is supporting the implementation, and Hargeisa will be targeted as the first district to facilitate a unified accounting system for Somaliland, which will greatly aid the country's overall decentralisation process. Further digitisation and automation reforms are also underway to connect various elements of city operations through an integrated dashboard, with text messages keeping citizens informed of progress. The hope is that this will further increase compliance and trust in government accountability.

Mobile money payment systems:

Collecting relatively small fees from many vendors every day is a well-known inefficiency in tax collection. UN-Habitat is currently supporting the government of Somaliland with the introduction of a mobile money payment system, wherein citizens will be able to pay tax via mobile phones, a reform that will hopefully facilitate higher revenue collection, accountability, and transparency. It is promising that currently, 26 per cent of the population use mobiles to pay other bills – the highest in the world.⁵¹ Further down the line, leveraging the mobile money market as a vehicle for financial investments could also be a useful way of widening the base of investors at the community level.

Capturing the value of land appreciation in land and property tax:

With urban expansion, land value increases due to a combination of factors. These include the connectivity to infrastructure, proximity to local services, and expectations associated with future use. Currently, Hargeisa's property tax system does not and cannot fully account for these increases in land value, only differentiating between land in the city centre and outside it. This means that if the municipality delivered similar infrastructure to a specific area of the city, the property owner would fully gain from the increase in associated land value. Using more detailed property location bands to capture land value increases would be a beneficial future aim of reform, as would adding these location factors to the vacant land tax. This undertaxed asset could be a key area for reform. Not only would increasing the tax on vacant land bring in revenues, but depending on why it is vacant, it could prompt owners to invest and develop the land or re-allocate it to a more efficient use.

Clarity over decentralisation of taxes:

The lack of clarity around taxation results in both loopholes and double taxation. Stakeholders mentioned the examples of income tax and business licenses, and in particular, the property transfer tax which is designed to be split. Legislative and institutional clarity on who should be collecting and maintaining these areas of revenue is critical to ensuring there is no further revenue loss or double taxation.

Evaluating the efficiency of local taxes:

Although some progress has been made, there is still an urgent need to critically evaluate the cost-effectiveness of the city levying such a high number of individual taxes. For many of the low revenue taxes, costs for collection may be close to or even higher than the revenues that these taxes bring in, not to mention the tax fatigue experienced by citizens. Instead, focusing efforts on increasing the efficiency of taxes with high potential such as land and property taxes, is likely to be a far more effective way of reaching revenue goals.

Reducing barriers to business formalisation:

Given the enormous size of Hargeisa's informal economy, incorporating it into formal planning is necessary. Even though they are not large businesses, they contribute significantly to economic stabilisation. Nationally, the informal sector is not planned as a key driver of the economy, being absent from Somaliland's National Development Plan. One way to encourage formalisation could be through lowering the cost and complexity of the business licences. In 2012, Hargeisa had the highest minimum capital requirement in the world to begin formal enterprise, with 50 per cent of business start-up costs attributed to the required licence.



Trading on the streets of Hargeisa, Somaliland © Shutterstock

Improved investment expenditure:

Capacity in revenue spending continues to be a challenge in Hargeisa. Limited capital expenditure and poor-quality investment in visible areas are starting to affect both voluntary compliance and trust in government. To combat this, there is a need to focus on longer-term investments, specifically incorporating long-term issues into community plans, as these often focus disproportionately on the issues of the day. Furthermore, if these investments can be connected to increases

in land value, some of the investment could be recouped through land and property taxes.

Local government creditworthiness:

Most of Somaliland's local governments are not creditworthy⁵²; however, Hargeisa is the most financially buoyant. Creditworthiness is critical in order to engage with the growing options for financing. The city has relatively low revenues at US\$9 million, and therefore the size of loans may initially be small. However, in order

to undertake longer-term borrowing at affordable rates in the future, significant improvements in creditworthiness, particularly revenue and cash flow forecasting, would be necessary. Stakeholders cited cross-city learning and study visits to take stock of successful investment management practices taking place elsewhere, as an area of need. A particular interest was how best to leverage and manage PPPs, given that they are one of the few options currently available.

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