

MANAGING THE TAXATION OF INFORMAL BUSINESS SECTOR IN MOGADISHU

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Abstract

Somalia has been in civil unrest since 1991 which led the country to a social, economic and political instability and destructed governance systems including taxation culture. During the fragility period, businesses in different scales have grown formally and informally with no public bodies asking to pay a tax. The new government established in 2012 started to officially prepare the country's first budget after collapse the former central government as it focused on revenue collections and re-establishing the tax culture in the capital city of Mogadishu, which hosts the most informal business activities in the country.

This paper aimed to present how the revenue department manages to tax the informal business sector, challenges in place and finally it recommends some possible solutions. The study utilizes a mixed methodology of data collection which contains (1) an interview of economists, tax officials and owners of small scales businesses and (2) a capture of available data from the ministry of finance archive. The results show that the informality widely exists in small and medium enterprises, while principle challenging factors in managing sector taxation were: the country's nature of economy, existence of specialized tax-heaven sectors, limited administrative and enforcement capacity, high cost of formalizing the businesses and a historical weakness in engagements of the business society.

This study recommends to revenue authorities in both national and regional level to better develop joint tax policy, administration and enforcement strategies that reduce the extent of informal activities happening out of tax net. It also highlighted the importance of sequencing the reforms, establishing a promising environment to the SMEs and providing tax payer education by teaching a simple tax system to the public.

Keywords: informal business sector, SMEs, taxation, Mogadishu, Somalia.

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INTRODUCTION

Since its first appearance in the early 1960s, the term informal business sector has become so popular that nowadays it is used with different meanings for different purposes. On first enquiry of the term informal business sector, most people think of illegal activities, such as trading in drugs, paying bribes or avoiding taxes, also one can even assume that the informal business sector is a transitional route to formal business as economies grow and regulation becomes stronger (Chambwera, MacGregor, & Bake, 2011).

The total economy is divided into two sectors: the informal and formal, according to (OECD, 2002), the term informal business sector is referred to market-based production of goods and services, with the primary objective of generating employment and incomes to the persons concerned, that escapes detection in the official estimates of Gross domestic product (GDP).

In the case of mixing all theories above, informal business sector is the carrying out of business activities outside the recognized regulatory organizations of the government, non-registration with companies' registration agency, not included in the official GDP and sometimes not paying taxes.

The issue of taxation of the informal business sector in developing and transition countries has received increasing attention in recent years. In their study, (Joshi, Prichard, & Heady, 2012) say that difficulties of taxing informal business sector comprises of limited revenue potential, regressive to the poor people and women, high costs of collection, opportunities for corruption and potentially perverse impacts on small firms, and benefits of informal taxation are accountability of government to more of its people, economic growth, important source of local government revenue, governance, tax compliance and Taxpaying culture.

Somalia's prolonged social turmoil led the country to a social, economic and political instability as supremacy of systems and taxation cultures have disappeared. A similar result was found by (Mohamud & Isak, 2019) in their study of country's tax reforms. The taxation history in Somalia began in the colonial era, with Italy and Britain taxing their respective colonies separately. At that time it is likely the most of businesses were provided by their companies and the people were aggressively taxed as they had strong fiscal police which no one could challenge. In addition, under the military regime, most businesses were state owned and fewer monopolistic private companies in certain sectors. The situation sustained in similar way until civil war erupts in 1991. In this period, informal businesses have massively grown with no strong regulatory bodies and tax regime in place (Mohamed, Isak & Roble, 2019).

In early civil war era, few big private sector operators were enjoying a relative power more than the transitional governments of that particular time and it was only 2012 when the government strongly focused on domestic revenue collections and re-establishing the tax culture in Mogadishu. This time, the government faced a wide range of resistance from business communities and also from politicians who at time was either a shareholder or stakeholder in any way.

In order to raise revenue and provide social services to the citizens, the finance ministry started with some of the formal and informal businesses and urged them to paying taxes primarily while gradually reinforced tax laws, which were not materialized after the civil war (Isilow, 2019). Finally, Somalia federal government implemented taxes for both large and medium formal and informal business (Isilow, 2019). Adding to that, more not-for-profit organizations have obeyed to paying taxes. The Somali government is gradually upgrading tax collection efforts both formal and informal despite the challenges of doing so in a volatile environment.

This paper aims to present the how the concerned tax offices managed to tax the informal sector in Mogadishu which is the seat of the federal government. The study employs mixed types of data. Firstly, it uses available business data from the ministry of finance archive. Secondly, it interviews economists, tax officials and owners of small scales businesses in order to have their views in different angles and cover gaps coming from the data of the tax offices. With this regard, the study identifies some key pressing challenges and finally it recommends several possible solutions.

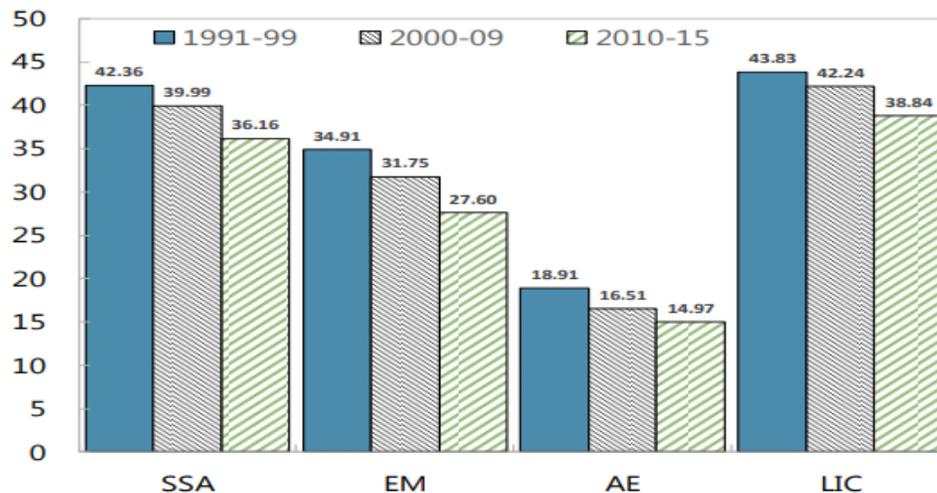
LITERATURE REVIEW

Once upon a time, economists paid no consideration to business and economic activities carried out outside the formal framework of the economy. Sociologists and anthropologists were the only ones who appeared to study the importance of such business activities. However, 1950s and 1960s, the subject matter of informal sector's gained an increasingly importance among economists (Gërkhani, 1999). It was in the developing countries that the informal business sector was originally observed and tracked by an increased attention in developed countries.

According to (Feige, 2016), the informal business sector is described as the sum total of business activity pursued without the sanction of the authorities. It is neither taxed nor represented in a country's GDP. Other explanations depict it as business activities lacking straight accounting procedures, characterized by high frequencies of non-reporting or underreporting and are excluded from social measurement such as the GDP.

Take the below figure 1 as an example. The advanced economies AE have the lowest rate of informal economy ratio to the GDP as low income countries LIC and Sub-Saharan African SSA region experience the highest rate of shadow economy.

Figure 1: Shadow Economy by income level (average, percent of GDP)



Source: International Monetary Fund

Somalia experiences presence of extensive informal sector, even though there is no country statistical data for this issue. The neighbor and regional countries' share of informality is very high. Schneider, (2005) identifies that shadow economy's portion of the GDP accounts 42% in Ethiopia, 36% in Kenya and 45% Uganda as average Sub-Saharan African countries where Somalia includes has above 36%. This gives that Somalia's case can be worsening due to severe fragility (Kalyundu & Norregaard, 2020).

The informal business sector is not entirely without taxation. Obviously informal workers and businesses do not pay income tax and VAT in the same way of formal business sector and mostly they fall below the thresholds authorities set for paying income tax. They are not registered as VAT, but they do pay VAT on inputs they purchase, without any chance of a refund (Action Aid, 2018).

In Zambia informal sector taxation was introduced in 2004, beginning with the Presumptive Tax on taxis and minibuses and the Turnover Tax on small-scale enterprises. Later, a Base Tax on marketers (2005) and an Advance Income Tax (AIT) (2007) for cross-border traders were introduced (Phiri & Kabaso, 2012).

According to (Oduwole & Sanni, 2014), Tanzania also has a turnover tax and presumptive taxes, It's different then Zambian taxes, it is progressive, and its threshold is much lower than in Zambia. They collected the presumptive tax through a Block

Management System (BMS) by which units of tax collectors move from building to building in the regions to identify SMEs and informal businesses charging presumptive taxes based on turnover from records or an estimate/presumption of turnover where there are no records available.

According to (United Nations, 2019), presumptive tax has turned out to be the common way of taxing the informal economy in developing countries. Presumptive taxation involves the use of indirect means to determine tax liability. In Kenya as stated by (Ndaka & Katee, 2017), Kenya implemented a turnover tax (TOT) in 2008 at a rate of 3% for SMEs with less than 5million shillings but more than 500,000 shillings annual turnover to replace both income tax and VAT.

In Ghana the government collects a flat rate turnover tax of 3 per cent for small firms to replace standard VAT, while microbusinesses are covered by a tax stamp regime, in which a fixed tax is paid on a quarterly basis, the Tax Stamp regime for collecting income tax from small traders (Ehun, 2015). In Ethiopia, informal business firms are required to pay a presumptive tax on income based on turnover instead of income tax and VAT (Bongwa, 2009).

Irrespective of two decades of civil war and unrest political, the economy of Somalia has remained survive as an informal business sector, based mainly on small businesses, livestock, agriculture and other informal businesses for their living. Somalia is classified by the United Nations as one of fragile and developing country. The structure of the economy has extremely changed during these decades. Current situation is unlike the 1970s and 1980s, when most of the output of a small manufacturing sector and many services were provided by the public sector (Central Bank of Somalia, 2012).

In 2012, the established government strongly focused in domestic revenue collection and launching the tax framework commencing to collect presumptive tax from the accessible businesses, then road tax and property tax (municipality collects it currently) (World Bank, 2017).

The informal sector widened gradually in the aftermath of the downfall of the military rule in 1991. The informalisation of the economy started in the late 1970s with urbanization and the growth of demand for wage labour. The development of a formal private sector was difficult during the socialist regime, but even after the change of political orientation in the late 1970s most businesses continued as state-owned. This forced many small businesses to go into the informal sector (WEBERSIK, 2006).

Not only the national government, but also subnational authorities are facing their own challenges in raising revenues from business that are not in the fiscal net (Mirito, 2016).

Abshir et al, (2020) describe that challenges related with taxing the informal sector is not unique to Somalia, other countries have applied measures to ensure appropriate taxation of their informal sector. Specifically, above literatures which are Zambia and Tanzania have increased their tax bases with effective taxation of the informal sector.

Taxation of the informal economy appears to be a potentially important source of government revenue, as the informal sector comprises a large like case in Somalia; however, informal businesses are often taxed. This is done through numerous types of fees, local taxation, market taxes, charges and licensing costs, which may be levied locally, nationally or both. Many of Informal Business sector in Mogadishu is not registered and have not license in Mogadishu, as only large and medium business have business license (Abshir et al, 2020).

The Ministry of Planning, Investment and Economic Development, (2020), citing the 9th National Development Plan, part the strategy is to formalize the informal businesses, offering them a framework of certainty through flexible regulation and tailored business services, offering greater protection from extortion, while benefiting from tax revenue, NDP-9 also support the development of a more business-friendly environment by updating administrative and bureaucratic procedures.

On the other side, informal sector in Somalia has challenges especially in this year as it affected by Covid-19, (Abdullahi & Sharif, 2020) many informal businesses have locked down their activities while others have been hugely impacted by the restrictions and efforts to fight COVID-19 as their lives is based on income from daily activities. Some of the local and informal sectors that corona virus has had the highest impact directly or indirectly are small and medium sized businesses such as teashops, hawkers, shoe shiners, vegetable and fruit sellers, khat traders/sellers, Bajaj and bus drivers, milk and tea vendors, travel agencies, roadside cafes, restaurants, remittances, school teachers, construction workers, university lecturers, clothes businesses and other imported goods businesses

In respond to COVID-19, Ministry of finance implemented short term fiscal responses toward COVID-19 impact by making a 100% import tax relief on necessary commodities of rice and dates³, and a 50% reduction of import tax on wheat flour and cooking oil (Ministry of Finance, Somalia, 2020). These responses aimed to prevent a price hike of necessary commodities as other relive costs increased at that particular time including shipping costs.

³ The full relief of import duty from dates reflects its massive consumption during Ramadan moth, in which Muslim communities around the globe fast.

In conclusion, while taxing the informal sector, there are some ideas to take care rendering the literatures; firstly booming businesses in the informal which are making a good income should be captured and taxed by increasing incentives to formalize and charging penalties for failure to do so. Secondly the simplest way to tax the informal sector is indirectly, by taxing the goods and services that it buys and sells, most obviously through broad bases consumption tax and import and export duties. Finally, presumptive and turn over taxes were most successful fiscal instruments in more literatures and are targeted to the informal sector. Somalia plans to start turnover tax in the coming year as fiscal economists keep eye on it and later assess whether it succeeds or fails. Federal Government of Somalia succeed in taxing the informal sector indirectly, tested presumptive taxes in past and is planning to impose turnover taxes in next year. However, current practices do not predict in short to medium term, an indication of incentivizing the businesses for formalization and strong enforcements against so.

DISCUSSION OF THE RESULTS

1. The taxation culture officially came to Mogadishu in 2012 after long time of absence and soon started dealing with the informal businesses. After prolonged civil war since 1991, tax collection practices disappeared throughout the country. Absence of active government during that time caused the business and economic transactions happen informally. However, since the re-establishment of 2012 government, the ministry of finance commenced building its fiscal framework including collection of revenues from business communities and the overall public. Taxes managed by the federal government include income tax – both corporate and individual levels, sales tax, stamp duty, registration and road tax, while import and export duties are collected at the customs points including (air and sea)-ports. There are regional jurisdiction taxes which are administered by Mogadishu Municipality which are property taxes, local market levies and other charges as it receives a certain level from the customs revenue (Isak & Ali, 2019).

2. Firstly, the government started ad hoc fiscal operations including disorganized tax collection. After ending of the transitional period and having a new government in 2012, the federal ministry of finance faced with multiple challenges including lack of resources to run the government operations and provide the much needed public goods and services. Building a rapid fiscal muscle was really required and ad hoc tax collections immediately started to execute a newly enacted mini budget for the last four years of 2012. An income tax collection from the public servants has started by deduction at sources. Goods and service taxes and income taxes collected from business by force. At this particular time, tax system was extremely weak, criticized as reaching the target was too far. Collections were characterized by improper assessments, a merely cashier dependence, large level of loop-holes, high tendency of

collusions between officers and taxpayers and coercive style of enforcement by using the fiscal police. Despite the above conditions, the government grasped a possible level of revenue from businesses with a biggest portion from customs. Property taxes and some other regional level charges were given to the municipality administration by Regional Administration Law (Isak & Ali, 2019). Neither core revenue functions established nor taxpayers' complains listened. Taxpayer registration, segmentation, tax education, verifications and arrears management policy in place. In addition to that, administering the informal sector and SMEs was even in the list of the dreams the ministry could have. However, it was a good start of learning as issues tend to stabilize as fiscal capacity was improving.

3. The situation turned into fixed or negotiated amount of payments. In 2014 the tax responsible offices initiated taxing the formal and informal business sector by fixed amount of tax for each business, based on their capital level. The kiosk is recognized as low level payer and a corporate as a large payer and so on. A fixed amount of tax is a lump sum tax that is not calculated as a measurement of the tax base (consumption, income or wealth). This amount is subject to present every tax liable to the payer regardless of the amount or rate legally provided revenue laws. Fixed amount of taxes like a poll tax or sin tax are regularly reflected regressive effects, but could have progressive impacts if used for the luxury goods and services, the government accepted a lump-sum amount from businesses, for example \$20 monthly for small businesses and agreed amount higher than that to the medium and large businesses.

Also the federal government reintroduced some other taxes, which are road tax for taxing the vehicles and trucks that are using the public road, registration tax for imported vehicles which is also fixed tax and for property transfer which is a charge imposed on the transfer of ownership or title of property from one individual or entity to another. The federal government collected above taxes to get some revenue and provide social services to the Somali population as the finance ministry was still struggling limited fund to fulfill its obligations for being the sole funding source to such needy society. Collection of negotiated payment was an immediate solution of pressures coming from business communities, especially few top business owners who did not pay taxes from 1991.

4. The ministry of finance reached a time of applying existing laws due enlarged fiscal muscle. In 2017, The Government of Somalia has developed tax reform which touches both tax administration and policy. The Inland Revenue department started reapplication the existing tax laws, by closing discussions of paying a negotiated amount. At this particular time, the fiscal reforms had a political support from top offices of the country. Any tax payments should follow the rules and regulations set by the law. Businesses started paying core tax such as sales taxes and income tax for personal and

corporates. Correspondingly the cabinet of ministries issued ministerial instructions and regulations to cover some of legal gaps concerning to tax collection as the tax laws were not up to date. Regulations were issued with the purpose of legalizing some taxable areas and amending a few of the tax rates applied to particular goods and services, Somalia still needs complete and up to date tax laws which address current and potential tax issues. However, this principle of taxation including equity, fairness and justice were completely absent. Small and medium enterprises were out of the framework as they were neither licensed nor asked to pay taxes. Weak administrative capacity, instability, insecurity and multiple payment burdens on the small business were core challenges in place.

5. Tax base extended and developed a policy of taxing informal sector indirectly. All above evolutions summed up to form a learning tool and a way of thinking as the government started to receive advices from most expert international partners which are the World bank and International Monetary Fund. Multiple reforms have been implemented such as the reintroduction of broad based sales tax and income tax. The ministry of finance started collections of the sales taxes in Mogadishu port. Businesses protested against this policy citing that sales tax has to be paid by the last consumer, while the ministry of finance insisted to collect it in the customs due to several reasons. Firstly, to reduce administrative costs and increase enforceability, with regard to the security challenges that the country faced. Secondly, it was the simplest and best way to tax the informal sector indirectly, since they only trade with these commodities coming through the customs. In income tax base is broadened to the both the private sector (personal and corporate) and non-profit organizations, with regard to personal income tax. This is a good example of broadening tax base throughout a country. Also the revenue department implemented policies included the improvement of the application of existing tax laws, the reduction of the informality of the process by requiring businesses to register with the tax authority and re building district tax office to capture informal business using branch and blocks of districts. At this point, business communities repelled against the reform packages of the government as this period, the government experienced a continued upward trend of domestic revenue. However, administration capacity was extremely limited as presence of widespread manual operations could not been ignored.

6. Taxpayer registration and improved management started at this time. In mid-2018, the federal government implemented important economic reforms in general and fiscal reforms in particular. Among them was establishing of large and medium taxpayers office, segmentation and other positively impacted instruments which led the government to exceed domestic revenue targets in the first time after civil war. Registration started to formalize more business activities including hotels, telecommunications, financial institutions, transport, light factories, non-profit

organizations and more informal sector operators. Issuance of Tax Identification Number (TIN) for registered entities and Tax Compliance Certificate (TCC) for compliant have started. Furthermore, the ministry of finance issues a directive of not welcoming a non-compliant entity to any tender from ministries, non-profit and UN organizations. Renewal of their licenses is also conditioned to have a TCC. At this point, registration of taxpayers yielded a positive through formalizing more SMEs and informal operators.

7. The government of Somalia is planning to implement a turnover tax in Mogadishu, which aimed to get the informal operators including small scaled businesses into the taxation frame. The struggles of the federal government has brought several activities in the tax net including hospitality, telecom operators, and airline companies as consumption tax is paid in advance by the traders. Furthermore, tax regime is expected to accommodate new business entities and help the government in formalizing the shadow economic activities happening out of tax framework. Turnover taxes materialized positive implications in several developing countries including Tanzania (Oduwole & Sanni, 2014). This is also aimed to generate more tax revenue to the government. However, there is a lot to do, as evidences in different literature are showing that this tax policy instrument is likely to bring more business entities in the government's fiscal book if well managed.

INFORMAL SECTOR IN MOGADISHU

1. The country's current nature of economy supports the existence of a huge informal sector, as informality widely exists in the region. Even though there is no country level statistical data on the shadow economy, the neighboring countries have high average of informal economy as it accounts for Sub-Saharan African countries, where Somalia is a regional member, the average of shadow economy of the GDP is more than a third. Given the fragility situation of Somalia, it is likely to be worse than in the region. The result is supported by (Kalyundu & Norregaard, 2020).

2. The activities of most dominant (specialized) sectors of the economy are informal and are legally tax heaven. Tax laws fully exempt the application of taxes on transactions arising from agriculture, livestock and fishery sectors. This has led the tax authorities to ignore formalizing the operators in these markets as other relative administrative fees are managed by the lie ministries. Most of tax laws were enacted during the evolution agriculture industry in Somalia as this sector was also state companies dominant; the bias for SOEs has exceeded the required long term tax policies. The significance of these sectors was also reported by (Kalyundu & Norregaard, 2020).

3. The weakness of administrative and enforcement capacity let the informal sector exist in a widespread. Although the government formalized several activities in sectors in Mogadishu, still most activities of retail businesses are neither formalized nor taxed. The informal sector is not well managed due the fact that tax system is still fragile; tax administration capacity is very limited. The weakness includes lack of sufficient equipment, low level of information technology. Even though company law passed, still commercial licensing capacity is limited. Other studies including (Isak, 2018) have found the same results. These administrative weaknesses distort the possibility of that some core functions of a tax administration are not undertaken (Raballand & Justine, 2020).

4. Most of SMEs in Mogadishu city stay informal because of too high cost to access and stay formal. SMEs complain about doing business in Mogadishu at high cost. These costs tend to increase when shifting to formal sector or working under regulatory framework in other words. Studies by (Loayza, 1997) and (Soto, 1988) also explained such phenomenon. If incentives are not provided, the SMEs that are mostly informal can't be brought to the formal economy. Somalia is among the worst countries to run a business as the environment does not smoothly support the SMEs to grow quickly. In the doing business report of 2020, Somalia ranked the lowest country in 190 economies (World Bank, 2020).

5. Extremely little engagements of the business community have historically existed. The results of interview from long serving and retired tax officials has shown that there has always been a historic less engagements of public in general and business communities in particular. In pre-independence period, the ruling colonial administration did not engage any taxpayer and they instead took a coercive strategy of enforcing their fiscal demands. Post-independence governments have not paid the necessary care to the private sector. Furthermore, the case became very extreme when the socialist military regime came in 1969 and established state owned enterprises to run almost all goods and services supply, while most of existed private companies were nationalized. Upon the eruption of the civil war in 1991, a period of anarchy started and over-whelming non-state actors have imposed uncountable payments on the public and business societies specifically. In addition, the current government should provide multiple taxpayer services including: tax education, providing transparency services, solving the multi-payments in place and finally friendly execute the fiscal side of social-state contract. Fjeldstad et al, (2018) address the importance of improving taxpayer-tax administration relations. The public also require to hear about where does their money go and how managed.

CONCLUSION AND RECOMMENDATION

Somalia's tax system has been recovering rapidly in Mogadishu and slightly in other sub-national states. Having too informal businesses really burdened on the nation's tax collection. Informal sector, which comprises a wide range of small scales businesses and agricultural sector operators were not properly taxed in Somalia and Mogadishu particularly. This paper presents how informal sector is treated by the fiscal offices Somalia employing a set of business data of the ministry of finance and interviewing economists, tax officials and small business owners in Mogadishu, Somalia. Observed challenges included: the country's economic structure, presence of specialized tax-relieved agriculture sectors (agriculture, livestock and fishery), limited administrative and enforcement capacity, high cost of formalizing the businesses and a historical weakness in engagements of the business society. This study recommends to revenue authorities in both national and regional levels:

1. To develop joint tax policy, administration and enforcement strategies that reduce the extent of informal activities happening out of tax net. This is also suggested by (Kalyundu & Norregaard, 2020).
2. Study recommends setting prioritizing and sequencing of reforms, since recent tax reforms can be simply defined being a basic level, hence tax administration need to be integrated though getting sequenced tougher reforms. IMF's (2017) also highlighted this importance.
3. Making the tax system very simple, understandable to stakeholders and is not damaging the businesses. Simplifying the tax procedures for the public removes requiring unnecessary practices in tax returns payments as well (Bird, 2015). In other words Fjeldstad et al, (2018) recommend "do not harm" and Bird, (2015) suggests "keep it simple". These two strategies together build a proper tax administration in fragile countries.
4. Better taxpayer services can improve the necessary engagements of the business community as it reduces the long term existing gap between authorities and taxpayers. Establishing a taxpayer education scheme and continued business registration is highly recommended.
5. The government should friendly incentivize the SMEs in Mogadishu and simplify the formalizing process. Burden of payments and complex procedures pose high cost to small scaled entities and hence discourage them shifting to the legal framework. This process requires participation multi-cross-cutting public institutions including revenue offices, municipality, and commerce ministry and so on.

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