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THE POLICY/REGULATORY ENVIRONMENT FOR PRIVATE INVESTMENT IN SOMALIA

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SRI Project Number IMU (550)-1622
Contract Number 649-0132-C-6009

Prepared for: USAID/Somalia

By: International Policy Center
SRI International-Washington

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Vice President
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FOR PRIVATE INVESTMENT IN SOMALIA

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PREFACE

This report presents the findings and recommendations of a study of the policy/regulatory environment for private investment in Somalia. The study was commissioned by the United States Agency for International Development Mission to Somalia (USAID/Somalia) and was conducted under the joint sponsorship of the Ministry of Commerce and Industry of the Government of the Somali Democratic Republic (GSDR) and the Somali Chamber of Commerce. Funding was provided by USAID/Somalia under the Policy Initiatives and Privatization Project (649-0132).

The study was undertaken by a team from the Washington, D.C.-based International Policy Center (IPC) of SRI International, a private, nonprofit research and consulting organization. The project was managed under the overall supervision of Dr. William B. Bader, Vice President, SRI-Washington. The SRI project team included Philip E. Karp, IPC political economist and team leader, and Jan-Hendrik Van Leeuwen, a consultant to SRI.

Plans for the study were drawn up in the course of meetings in Washington between SRI and USAID/Somalia staff. Prior to travelling to Somalia, the SRI team reviewed materials available in the United States on Somalia's investment climate and met with cognizant individuals in the U.S. Government, international donor organizations, and GSDR officials posted in the United States.

The field portion of the study was undertaken in the latter half of January, 1986. During their two weeks in Somalia, the team members met with officials of the GSDR, USAID/Somalia, and international donor institutions, and with managerial staff from numerous private business enterprises. At the senior levels of the GSDR, the team was received by General Hussein Kulmie Afrah, Vice President of the Somali Democratic Republic and Minister of Planning, and General Abdalla Mohamed Fadil, Minister of Industry and Commerce, both of whom were helpful in arranging for the team to meet with selected officials from their respective ministries. Colonel Adbullahi Warsame Nur, Minister of Revenue, was kind enough to convene a working session with senior officials of his ministry to discuss taxation and tariff policies. Mr. Ibrahim Egal, President of the Chamber of Commerce, was instrumental in arranging interviews with private businessmen. A complete list of persons interviewed by the project team is presented in Appendix 1.

While in Somalia, the members of the SRI team presented two half-day seminars, attended by GSDR officials, private businessmen, and representatives of multilateral and bilateral donor organizations. The topic of the first seminar was the role of government policies in creating a proper climate for private investment. The second focused on fundamentals of investment promotion.

Prior to leaving Somalia, the team prepared a summary of its preliminary findings and recommendations, and presented formal briefings to the donor community, a joint audience of private businessmen and officials of the Ministry of Industry and Commerce, and a group of officials of the Ministry of Planning. Following completion of the field portion of the study, the team reconvened in Washington to prepare this report.

The members of the SRI team would like to extend their appreciation to all of those individuals in Somalia and in the United States who gave of their time to meet with us. We would like to extend special thanks to Mike Huston and Abdulkarim Ashur of USAID/Somalia, and Abdullahi Essa, Ahmed "Shell", and Abdi Suleiman of Arab Essa, Ltd. for their invaluable assistance.

EXECUTIVE SUMMARY

The study culminating in this report was conducted under the joint sponsorship of the Ministry of Commerce and Industry of the Somali Democratic Republic and the Somali Chamber of Commerce. Funding for the study was provided by the United States Agency for International Development Mission to Somalia. The study was conducted by a team from the International Policy Center of SRI International, a private, nonprofit U.S. research and consulting organization. The objective of the study, and this report, is to provide an independent assessment of the existing policy/regulatory environment for private investment in Somalia in order to guide the development of strategies for promoting private sector growth.

The SRI team has concluded that, based on Somalia's endowment of economic resources (primarily land, labor, climate, and geographic location) and comparative advantages, there is considerable potential for increased local and even some foreign private investment, particularly in agriculture, livestock production, and labor-intensive manufacturing.

However, this potential is unlikely to be realized until certain fundamental constraints are addressed. The SRI team, as well as most of the Somali enterpreneurs interviewed during the course of this study, recognize that a number of positive steps have already been taken, including liberalization of pricing and marketing of food grains, improvements in foreign exchange management, and moves toward privatization of the Chamber of Commerce. As a result, many Somali businessmen reported that they are considering new ventures which would have been out of the question two years ago.

On the other hand, the SRI team has identified a number of major policy-related problems/issues that pose serious constraints to private investment in Somalia. These key problem areas can be summarized in three categories -- lack of a positive environment for private sector growth; inadequate system for mobilizing and intermediating savings and credit; and specific policy, legal, regulatory, and administrative constraints.

Perhaps the single most serious constraint to increased private investment in Somalia is the absence of a positive, supportive environment for productive private sector activity. Substantial reservations about the wisdom of a free-market economic orientation appear to exist at various levels within the GSDR. This has often resulted in slow or inconsistent implementation of announced policy reforms. Within the private sector, a lack of faith in the ability of the GSDR to establish and implement policies conducive to productive and profitable business activity has created an environment in which evasion or circumvention of formal rules and regulations is pervasive and generally accepted.

An essential precursor to accelerated economic development in Somalia is an increase in levels of domestic capital mobilization. Inflows of external capital must be supplemented by domestic savings and the repatriation of Somali capital currently held outside the country. However, current policies and institutional structures discourage mobilization and efficient allocation of savings and credit.

Negative real interest rates discourage domestic savings while encouraging those firms lucky enough to obtain credit to overborrow. The absence of a competitive banking system provides the existing state-owned financial institutions with little incentive to operate efficiently or to repsond to consumer needs and interests. The persons interviewed by the SRI project team were virtually unanimous in their assessment that the Somali banking system is failing to play a sufficiently positive role in promoting private investment. Indeed, many went so far as to argue that the banking system actually acts as a deterrent by channeling the limited amount of credit available into nonproductive ventures.

The SRI team has identified a number of categories of specific policies, regulations, and procedures which pose major constraints to private investment. Public-sector encroachment is perhaps the most serious. Many of the sectors in which Somalia enjoys is greatest comparative advantages are currently reserved for state-owned enterprises which are granted monopoly positions. The resulting negative impact on the economy is two-fold. First, the low operating efficiency of most of these state enterprises causes resources and potential opportunities to go unexploited. Secondly, government monopolization of key production sectors causes a large portion of private investment capital to be channeled into ventures of questionable economic value.

Public sector encroachment has also resulted in a serious deterioration of Somalia's service infrastructure. State control of banking, insurance, shipping, clearing of imports, and petroleum distribution has led to a system characterized by high fees and poor service. The intervention of the Somali cooperative movement in the production and distribution of goods and services adds to this inefficiency.

Other specific constraints include burdensome administrative controls, restrictive labor legislation, an unnecessarily complex system of taxation, inadequate investment incentives, inappropriate macroeconomic policies, and a chaotic legal framework. Adding to the deterrent effect arising out of the content of many of the laws and regulations affecting investors is the problem of inconsistent application. There is a strong perception -- whether or not warranted -- among both Somali and foreign businessmen that policies, laws, and regulations are not administered in a consistent fashion.

One of the factors contributing to this problem is the discretionary nature of many of the rules and regulations governing business operations. Another contributing factor is the lack -- in many cases -- of any formal statement of rules and regulations. Both of these factors give rise to perceptions -- whether or not justified -- of favoratism or discriminatory treatment. Clear, explicit statements of policies and procedures would help to improve the transparency of government decisionmaking -- a factor which is of considerable importance to investors.

Improving the climate for private investment in any country is a long-term undertaking. Ultimately, the creation of an environment conducive to the development of a viable, competitive private sector in Somalia will require action on a number of fronts. This report includes a number of recommendations for initiatives which appear to offer potential for visible and demonstrable results. These recommendations are offered as constructive suggestions, based on SRI's previous work (in some 25 countries) on private sector development.

- A three-pronged strategy should be followed to encourage the mobilization of domestic savings and investment. First, licenses should be granted for the establishment of one or more private commercial banks. Second, a comprehensive program of financial and technical assistance should be undertaken to strengthen the Commercial and Savings Bank of Somalia. Third, monetary policy should be oriented toward achieving and maintaining an environment of positive real interest rates.

- To encourage an export orientation, the existing export tax should be eliminated, and specific measures to promote exports should be examined. One initiative that could hold particular promise is the establishment of a system of in-bond manufacturing or an export processing zone. Such an initiative could serve both to encourage private investment in export-oriented manufacturing and to demonstrate the efficacy of an outward-looking industrialization strategy.

- A further review should be taken of regulations and administrative controls affecting investors. As a first step, clear statements of these rules as well as of implementation procedures and criteria should be developed and published. This should be followed by efforts to eliminate those controls that are not absolutely necessary, and to streamline implementation of those that remain in effect.

- As a signal to private investors of its commitment to provide positive incentives for private sector growth, the GSDR should enact a specific statute for the encouragement of new investments. This approach has been used successfully by a number of countries to promote both local and foreign investment. The statute should provide investors with a set of basic guarantees as well as a basic set of incentives, both of which would be applied across the board to all investors.

- A strategy and timetable should be developed and publicly announced for opening up to competition the productive sectors of the economy which are currently closed to private sector participation. The objective should be to improve overall economic productivity by fostering greater efficiency. Therefore, the strategy chosen should move toward a more competitive environment, rather than simply transfering public-sector monopoly enterprises to private monoply ownership.

I. INTRODUCTION

The objective of this study is to provide an independent assessment of the existing policy/regulatory environment for private investment in Somalia. The rationale for this approach is that an essential precursor to any successful efforts to promote private sector development in a particular country is a clear understanding on the part of both donors and the host government of the contraints and/or opportunities for private investment resulting from existing laws, policies, regulations and administrative procedures.

A. Structure of the Report

This report is organized as follows. The remainder of this section provides a brief introduction to the Somali economy, focusing on the structure of the economy, government economic policy orientation, and recent economic performance. Section II, which comprises the bulk of the report, discusses three major problems/issues which the SRI team has identified as key constraints to private enterprise development in Somalia. These include:

- Lack of a positive environment for private sector growth.
- Inadequate system for mobilizing and intermediating savings and credit.
- Specific policy constraints to private investment in agriculture, livestock, agribusiness, and manufacturing.

In discussing these three sets of constraints, the report both identifies the nature of their deterrent effect on private investment and offers possible solutions. Section III presents the team's findings with respect to nine key study questions included in the project scope of work. The final section reviews the team's main conclusions and presents its recommendations.

B. Economic Background

The purpose of this section is to provide a brief description of the structure and recent performance of the Somali economy. This description is by no means intended to be exhaustive. Rather, the objective is to provide some context for later discussions of the policy/regulatory environment.

Structure of the Economy

Somalia's economy is dominated by the agricultural sector, which accounts for over 55 percent of GDP. Approximately 50 percent of Somalia's 5.9 million inhabitants (including refugees) are nomads or semi-nomads who depend on livestock for their livelihoods. Livestock production accounts for about 40 percent of GDP, over half of total employment, and over three-quarters of export earnings.

Somalia possesses a land area of about 64 million hectares including a hot and arid coastal plain, rugged mountains and plateaus, and lowlands of varying rainfall and fertility. About 8.2 million hectares are considered arable. Of the remaining land, about 60 percent is suitable for grazing. Due to limited infrastructure, particularly a lack of adequate irrigation, only about 10 percent of the arable land is currently under cultivation. Rainfed crop production is concentrated primarily on sorghum. The small amount of land under controlled irrigation is utilized to produce bananas (Somalia's only major export crop), sugar cane, citrus fruits, rice, and maize.

Despite considerable potential for both marine and inland fisheries, fishing currently accounts for only about 2 percent of GDP, exports, and employment. The manufacturing sector remains small, accounting for only slightly over 7 percent of GDP. About one-third of GDP is generated by the service sector. An important factor in Somalia's national income is workers' remittances. Over the past decade, more than 100,000 Somalis have found employment in the Gulf States. Remittances, which the World Bank currently estimates at about $80 million per year, have in some years accounted for up to one-third of Somalia's total foreign exchange earnings.

Economic Policy Orientation

Somalia has undertaken a number of radical economic policy shifts since independence. During the immediate post-independence period, Somalia pursued a mixed-economy development strategy. Livestock and food-crop production were almost entirely in private hands, and the service, agribusiness, and nascent manufacturing sector attracted both local and foreign private investment.

Following the revolution in 1969, the new government undertook a major shift in the institutional and policy framework for economic development. Over the course of the 1970s, the government greatly extended public sector ownership and control over the economy. Nationalization of foreign and domestic enterprises resulted in total public sector control of banking, insurance, agricultural marketing and wholesale trade. The government also took control of nearly all medium- and large-scale manufacturing enterprises. Only livestock and food grain production were left primarily in private hands.

Since 1981, the government has begun to shift away from state ownership and control towards a more market-oriented economy. Although a number of important positive steps have been taken, including a series of devaluations of the shilling, liberalization of agricultural pricing and distribution, and a hike in allowable interest rates, progress toward economic liberalization has been slow and often inconsistent. The legacy of the 1970s remains evident throughout the economy. The manufacturing sector continues to be dominated by public enterprises, many of which are granted monopoly positions. Most major industries, including oil refining, sugar processing, and the manufacture of textiles, edible oil, matches, footwear, packaging materials, aluminum utensils, detergents, and electrical fittings are in public-sector hands. In the service sector, public-sector institutions are granted exclusive control over banking, insurance, and international shipping. Public enterprises are also granted monopoly control over several of Somalia's key exports, including bananas (through a joint venture with an Italian company), hides and skins, and frankincense and myrrh.

Recent Economic Performance

As a result of a number of factors, including adverse weather conditions, unfavorable international economic conditions, and an inappropriate domestic policy strategy, Somalia's real GDP fluctuated widely during the 1970s, recording near-zero growth for the decade as a whole. Since the government's policy shift in 1981, moderate growth has been recorded in most productive sectors. The notable exception is manufacturing, which remains largely under government control.

In the agricultural sector, increases in grain production have been offset by a sharp decline in livestock offtake due to the ban on the import of Somali animals imposed by Saudi Arabia in 1983. The ban has been lifted for camels, sheep, and goats, but remains in effect for cattle. Prior to the ban, Saudi Arabia accounted for over 90 percent of Somalia's livestock exports.

The stagnation of output in manufacturing is generally attributed to low productivity rather than to inadequate levels of investment. Despite low-to-negative levels of domestic savings, Somalia's gross domestic investment has held steady at around 20 percent of GDP due to large inflows of foreign aid.

Somalia faces a chronic, structural imbalance in external trade, which is only partially offset by capital inflows from worker remittances and concessional assistance. This imbalance has been exacerbated in recent years by a decline in export earnings due to the drop in livestock exports to Saudi Arabia. Somalia's external debt has risen rapidly to a current level of over $1.5 billion. Without the debt relief granted by the Paris Club in March 1985, Somalia's debt-service obligations for 1985 would have amounted to about $120 million, or over 100 percent of estimated export earnings.

Somalia's precarious external accounts position has been aggravated by recent monetary and fiscal developments. During 1981 and 1982, the GSDR exercised considerable fiscal restraint, reducing expenditures as well as domestic borrowing. This led to some reduction in the budgetary deficit and to a decline in inflation. In 1983, the budgetary deficit increased somewhat, but a concomitant increase in external borrowing allowed the government to further reduce its borrowing from the domestic banking system. However, when export earnings plummetted in 1984, the government was unwilling to cut back further on expenditures, resorting instead to massive domestic borrowing which resulted in record inflation as well as further appreciation of the real effective rate of exchange.

In the midst of this deteriorating economic and financial situation, the government adopted a major adjustment program for 1985 under a new IMF Stand-by agreement. The program is designed to reduce inflation and external imbalances through demand control measures and improvements in resource allocation. The core of the program is continued devaluation and the establishment of a free foreign exchange market for most non-government transactions, the elimination of most import and export restrictions, a dismantling of price controls, and reductions in government expenditures.

Progress in implementation of the program has been slower than expected, and the economic situation has continued to deteriorate. Negotiations are currently underway to establish a revised timetable for implementation of the proposed reforms.

II. MAJOR POLICY CONSTRAINTS TO PRIVATE INVESTMENT

In any business environment there are a broad range of variables that act either as inducements or as deterrents to private investment. Many of these, such as geographic location, natural resource endowment, domestic market size, etc., are largely beyond government control. What is entirely in a government's control is the policy environment facing private investors.

Bearing this in mind, the SRI team's objective has been to identify existing policies, legal frameworks, regulations, and administrative controls and procedures that deter private investment in Somalia, and to offer some possible solutions.

This section presents those policy-related problems/issues that have been identified by the project team -- on the basis of some fifty interviews with private businessmen and government officials -- as posing the greatest constraints to private investment in Somalia. The project team recognizes that, on many of these issues, the interests of the government and those of private investors are clearly not the same. Solutions that would be viewed as "optimal" by investors may be at odds with current political and administrative realities or may be inconsistent with certain social goals established by the government.

A. Lack of a Positive Environment for Private Sector Growth

The SRI team has concluded that perhaps the single most serious constraint to increased private investment in Somalia is the absence of a positive, supportive environment for private sector activity. Relations between the government and private sector are characterized, at best, by mutual mistrust. On the government side, substantial reservations about the wisdom of a free-market orientation appear to exist at various levels. On the private sector side, the lack of faith in the ability of the government to establish and implement policies conducive to productive and profitable business activity has created an environment in which evasion or circumvention of formal rules and regulations is pervasive and generally accepted.

The government has in recent years made a number of policy pronouncements regarding its commitment to a greater private sector role in the economy. However, progress on implementation of these pronouncements has often been slow. The constraints to speedier progress appear to be two-fold. First, many of the policy changes needed to stimulate private sector activity imply government revenue losses in the short term, and in some cases impose additional financial demands on the already stretched financial resources of the public sector. Secondly, many of the changes contemplated involve a reorientation of the government's role in the economy. Some groups and individuals within the government are reluctant to relinquish public sector involvement in, or control over, productive economic activity.

A successful demonstration of increased private sector contribution to the economy, through productive investment, creation of new employment opportunities, and good corporate citizenship could help to alleviate the concerns of some policymakers. Action is required on the part of both the government and the private sector. The government must provide a policy framework which will allow the private sector to demonstrate the contributions it can make to the economy. Privatization of currently unprofitable parastatal manufacturing enterprises could both serve as an opportunity to demonstrate the efficiency of the private sector, and help to mitigate some of the revenue constraints hindering other types of liberalization. The private sector, for its part, must reciprocate by adhering to legitimate government laws and regulations. Business associations like the Chamber of Commerce can play an important role in this respect by establishing and enforcing norms of responsible business behavior.

B. Inadequate System for Mobilizing and Intermediating Savings and Credit

Accelerated industrial development in Somalia will require not only continued capital inflows into the economy, but also improvement in the system for generating and allocating credit. It is clear that current levels of external commercial borrowing and donor assistance are not sustainable. Somalia has already accumulated substantial arrears on its external debt service obligations, and forces are at work in the United States and other countries which threaten to reduce levels of foreign assistance.

Many countries are seeking foreign direct investment as an alternative to aid or commercial borrowing. However, this is not a realistic option for Somalia, given current domestic and international conditions. Not only Somalia, but African countries in general, are finding it extremely difficult to attract new foreign investment. International investors are currently presented with far more attractive and less risky opportunities in other parts of the world.

Thus, the task at hand for Somalia is to mobilize the capital of its own citizens by providing an environment which will encourage domestic savings and the repatriation of capital that is currently held outside the country. This will require a significant change in the institutional and policy structure of Somalia's banking system. The Somali monetary and financial system consists of the Central Bank of Somalia, the Commercial and Savings Bank of Somalia (CSBS), the Somali Development Bank (SDB), and the State Insurance Company of Somalia. All of these institutions are publicly owned.

The Somali monetary authorities rely primarily on quantitative controls, supplemented on occasion by an adjustment in allowable interest rates, to control credit. In a few instances, the Central Bank has extended credit directly to industrial enterprises, but most available financing is extended by the CSBS and the SDB. The former provides short-term credit, and currency exchange and letter of credit services. The latter restricts its role to the provision of long-term financing for investment purposes.

The persons interviewed by the SRI project team were virtually unanimous in their assessment that the Somali banking system is failing to play a sufficiently positive role in promoting private investment. Indeed, many went so far as to argue that the banking system actually acts as a deterrent to new investment. On the lending side, many reported that credit is either unavailable, or is available only to "preferred" customers. It is true that a large percentage of domestic credit (65 percent as of mid-1984 according to the IMF) has been appropriated by the public sector. Furthermore, there is a widespread perception among both domestic investors and international donors that the limited amount of credit available is often allocated on a discretionary basis rather than according to principles that would ensure optimum economic and/or financial return. Part of the problem stems from a lack of adequate systems and expertise in the area of credit evaluation.

The general shortage of credit is, to a large extent, a result of negative real interest rates. On the one hand, deposit interest rates that fail to keep up with inflation discourage domestic savings. On the other, negative real interest rates on loans constitute an implicit subsidy to borrowers, encouraging those able to obtain credit to borrow more heavily than they might otherwise. The net result is that the level of credit available to other borrowers is reduced.

Several steps have already been taken which are aimed at improving the functioning of the banking system. The GSDR recently commissioned a study of banking and financial services and is reportedly considering licensing one or more private banks with foreign participation. The SCSB and the SDB are reportedly considering the establishment of an integrated financing facility whereby SCSB would provide short-term financing of working capital while SDB would provide investment financing. A logical and welcome extension of such cooperation would be the establishment of a unified system for evaluating credit applications with the stated objective of targeting credit toward investments that best exploit Somalia's comparative advantages.

C. Specific Policy Constraints

The SRI team has identified several categories of policies and procedures which pose constraints to private investment. Many of these policies are motivated by legitimate government concerns, or are aimed at achieving particular national goals. Nonetheless, they limit the options, operating flexibility and often the profitability of private enterprises and in so doing discourage new investment and reduce overall economic productivity.

Public-Sector Encroachment: A number of sectors in which Somalia enjoys its greatest comparative advantages are currently reserved for state-owned enterprises which are granted monopoly positions. Examples include the Hides and Skins Agency (granted exclusive control over international processing and trade in leather goods), Myrrh and Frankincense Agency, and Somalfruit (banana exports). Other public-sector production monopolies include the National Petroleum Agency, Tobacco Monopoly Agency, and State Printing Agency.

The original rationale for government control over these sectors was that publicly-owned enterprises could most efficiently exploit the country's productive resources. However, granting monopoly powers to state-owned firms reduces their incentive to operate efficiently, particularly when they are granted subsidized access to credit, foreign exchange, and other inputs.

The current policy of public-sector monopoly control of key sectors has a negative impact on the economy in two respects. First, the low operating efficiency of most of these enterprises causes potential opportunities to go unexploited. For example, several of those interviewed reported that whereas butchers and slaughterers in rural areas used to provide their services free of charge in exchange for the hides and skins of the animals they processed, selling the hides, in turn, to middlemen or directly to exporters, the hides and skins of many animals are now discarded since the Hides and Skins Agency enjoys a monopoly over processing and export. A related loss to the Somali economy results from the smuggling of hides and skins and frankincense to neighboring countries.

A second, and equally negative result of government monopolization of key production sectors is that a large portion of private investment capital is channeled into ventures of questionable economic value. The private manufacturing sector in Somalia consists primarily of import-substitution projects, many of which produce low-to-negative value added. This situation reflects, in part, the poor economic evaluation capabilities of Somalia's investment financing institutions. Nevertheless, the SRI team feels that, given the chance, Somali entrepreneurs would begin to channel their investments into ventures which would yield greater benefits both to themselves and to the economy as a whole. In the fisheries sector, for example, a liberalized policy regarding private-sector participation has led to a marked increase in investor interest.

Public-sector encroachment has also resulted in a serious deterioration of Somalia's service infrastructure. The impact of state-control of the banking sector has already been discussed. Public-sector monopolization of international shipping, insurance, clearing of imports, and petroleum distribution has resulted in similar deficiencies. The fees charged by the State Insurance Company and Shipping and Clearing Agencies are well in excess of those charged by service agencies in other countries and the services provided are reported to be uniformly poor or nonexistant. A number of private businessmen interviewed by the SRI team indicated that despite the high premiums charged by the State Insurance Company, the company rarely pays if goods are lost. Others reported that the Somali Clearing Agency provides absolutely no services whatsoever. The agency collects a fee on all bills of lading, while private forwarding agents undertake actual clearing and forwarding operations.

Adding to the inefficiencies associated with the handling, transportation, and distribution of goods and services in Somalia is the presence of a cooperative movement which provides little in the way of services, but obstructs the free flow of trade and raises costs to both members and consumers. The cooperative structure was established in 1973, during the period of Soviet influence. The stated aim was to move toward full-scale collectivization of the economy. At present, the stated purpose of Somali cooperatives is to provide services to their members and to the public at large. "Industry-wide" cooperatives currently exist in six sectors: agriculture, fisheries, transport and building materials, food and services, livestock and forestry products, and handicrafts and small industry.

The cooperatives are intended to provide services to their members, thereby improving operating efficiency as well as service to final customers. In the passenger transport cooperative, this approach has been singularly successful, with a well-run, affordable, mass-transportation system the result. Unfortunatley, most of the other cooperatives have become little more than mechanisms for enforcing "official" prices and for collecting revenue, providing little or no service to members or customers.

Administrative Controls: Administrative controls designed to monitor flows of goods and services and to ensure that regulations are enforced inevitably result in some cost and time burden for businesses. The task for government is to find an acceptable compromise between its need to stay informed, and the need for businesses to operate efficiently. If a businessman is forced to spend much of his time or to expend substantial resources dealing with bureaucratic red tape, his day-to-day operations will suffer, as will profitability.

Most of the businessmen interviewed by the project team complained both of the burden associated with the plethora of administrative controls to which they are subject and of problems of inconsistent application. The red-tape associated with clearing goods through the port of Mogadishu was identified as a particularly onerous constraint. Several business managers reported that they have had no choice but to employ one or more full-time "expeditors" in order to ensure that papers get processed and goods keep flowing, and even then, managers reported that they themselves had to become involved in clearing large shipments. As another example, the owner of an agribusiness enterprise reported that during the course of a recent overland shipment of grapefruits from Afghoy to Djibouti, he had encountered 32 individual checkpoints, all of which required the payment of one type of fee or another.

Labor Legislation: Current Somali labor legislation poses a constraint to private investment, particularly in operations that employ large numbers of workers, or which are subject to seasonal or cyclical variations in the size of the workforce. In the public sector, employment regulations have been liberalized to give greater freedom and discretion to managers. However, laws governing private-sector employment remain much more restrictive in character, if not in actual enforcement. Officially, all hiring by private businesses must proceed through the State Recruitment Board, and decisions must be approved by a workers' committee. The committees also must approve any firing decisions, and workers who are terminated are eligible for generous severance benefits.

Most small, privately-owned businesses reported that they enjoy de facto freedom from these restrictions. However, several enterpreneurs indicated that, as long as the current legislation remains on the books, they would be very reluctant to invest in any venture requiring a large workforce. This may be one of the major factors contributing to the dearth of labor-intensive manufacturing ventures in Somalia, despite the country's apparent comparative advantage in this area.

Taxation: Taxation is always a contentious issue between government and the private sector. Aside from the obvious need to generate revenue, taxation is an important policy tool by which a government can pursue certain social goals. The ultimate goal of private business, on the other hand, is profits; and the general perception of businessmen is that taxes lower profitability.

While it is impossible to reconcile these conflicting motivations completely, a good way to start is to make the tax system as simple as possible. This is of benefit to both the government and the businessman. The businessman can more easily determine what his tax burden will be, and therefore can more easily make investment decisions. From the government side, the simpler the tax system, the greater the ease of tax collection.

The current tax system in Somalia is anything but simple. Virtually every businessman interviewed by the SRI team identified the complexity of taxation as one of the major constraints to doing business in Somalia.

Somali businessmen are currently subject to a myriad of taxes and administrative fees including taxes on income, profit, sales, and exports. A production tax has recently been introduced for most products. In addition to these taxes, which are administered by the Central Government, there are a number of types of municipal taxes that are levied by local governments.

It is the understanding of the project team that the Ministry of Revenue is planning to undertake a review of the current tax system with a view toward unification and simplification. Such simplification, coupled with improvements in tax collection procedures, would be an important step in improving the climate for private investment.

One sector in which taxes and other fees are a critical constraint is production for export. To the extent that taxes raise the local cost of production, it makes it more difficult for Somali producers to compete in world markets. While there are clearly other factors which reduce the cost competitiveness of Somali exports, the existing 10-25 percent export tax is certainly the most visible, particularly when compared with the subsidies or grants provided by other countries to encourage production for export.

Investment Laws and Incentives: The current framework of laws and incentives aimed at encouraging private investment could be strengthened both in terms of content and application. This applies both to laws governing foreign investment, and to rules governing local investment and joint-ventures.

The incentives and guarantees offered by the current foreign investment law (Law Number 7, 1977) are much less attractive than those offered by countries with which Somalia is likely to compete for foreign investment (e.g., Kenya and Mauritius). Specific problems include the lack of a clear distinction between productive and non-productive investments; discretionary application of investment incentives -- an incentive package is currently negotiated for each investment on a case by case basis -- inadequate guarantee of compensation in the case of nationalization; and insufficient provision for arbitration in the case of disputes between the investor and the government. Appendix 2 contains a more in-depth discussion of some of the shortcomings of the existing law governing foreign investments.

Current laws governing domestic investment are also in need of improvement. Whereas the foreign investment law requires that the government act on an investment application within a specified timeframe, no such provision governs applications for industrial licenses by domestic investors. Some investors interviewed by the SRI team reported that they have been waiting for as long as two years for a decision on their applications. Others reported that they were granted approvals, only to have them rescinded a few months later.

While streamlining the approval process would certainly be welcomed by prospective investors, an ideal step would be to eliminate the approval requirement altogether. To the extent that an investor is willing to risk his own capital, and is able to meet the appraisal requirements of co-financiers, he should be allowed to invest in any venture other than those which government may specifically wish to proscribe (e.g., weapons manufacture). Under this type of approach, industrial licensing would become a registration rather than an approval procedure. This would also help to allay existing concerns that approvals are currently granted on an arbitrary or discriminatory basis.

Macroeconomic Policies: Many of the current constraints to private investment in Somalia are direct or indirect results of the existing macroeconomic policy orientation. In a broad sense, the best thing that the GSDR can do to improve prospects for private investment in Somalia is to adopt and to maintain a set of sound macroeconomic policies.

The cornerstone of sound macroeconomic policy is fiscal control. Reducing the size of the government budget deficit would reduce inflationary pressures, balance of payments problems, and the need for the public sector to monopolize scarce financial capital.

Cutting the public sector deficit implies action on both the revenue and expenditure side of the budget equation. On the expenditure side, inadequacy of financial discipline and expenditure control is a serious problem. Little attention is paid to the recurrent cost implications of GSDR and donor-financed investments, and in the case of development expenditure, there is little uniformity in accounting and control procedures.

Most public-sector manufacturing enterprises have been net users of government resources. Due to chronic operating losses, they have failed to make any contribution to the government budget through taxes. In fact, most have been forced to borrow heavily from the government to finance both working capital and capital investment and have accumulated substantial arrears on repayment of these obligations.

Divestiture of inefficient state-owned enterprises is one option which could provide a quick infusion of revenue and reduce the drain on government budgetary resources. Short of divestiture, steps are required to rehabilitate these enterprises through the introduction of financial incentives and improved management structures and techniques.

On the revenue side of the equation, measures are required to improve collection. However, longer-term increases must come from a broadening of the tax base, which can only be achieved by encouraging increased private investment. There is no doubt that tax evasion in Somalia is widespread. However, there is also little doubt that a significant percentage of the taxes that are paid by Somali businessmen never reach government coffers. It should be recognized that measures that may be expedient in collecting revenues in the short run may have adverse revenue implications in the longer run if they serve to discourage increased private sector activity.

Without going into a detailed discussion of GSDR tariff policy, it bears noting that Somalia's current tariff system contributes to the inefficiency of the industrial sector. To encourage the development of a viable industrial structure, Somalia should seek to move toward a tariff structure that reinforces the country's comparative advantages. The current system of protection of import substitution industries encourages manufacturing of final products which involve little or no local value-added. An appropriate tariff structure for Somalia should be oriented toward encouraging labor-intensive manufacturing for export. In the import substitution sector, the orientation should be toward production of intermediate goods where comparative advantages exist. A number of countries have successfully implemented programs to encourage local production of manufacturing inputs, providing incentives and information along with short-term tariff protection to domestic producers.

Legal Framework: The existing legal framework governing business activity in Somalia was identified by many of those interviewed as a serious constraint to private investment. Somalia has little in the way of a unified legal framework. Laws which are currently on the books reflect the vestiges of traditions of Italian, British, Islamic, and clan law. In many areas, two or more sets of laws may remain in effect. Rather than modify existing laws and decrees when the government elects to implement a new policy or regulation, the common practice either has been to enact a new set of rules, which then exists on the books along with the old legislation, or merely to announce a de facto policy change which is not embodied in any formal legislation. In the latter case the old regulations often are left intact, even though they are no longer enforced.

This practice creates considerable uncertainty for investors. Investor concerns over the failure of the government to modify existing labor legislation formally were noted earlier. Foreign investors, in particular, view ambiguity and/or inconsistency of laws and regulations as a major disincentive.

Inconsistent Policy Application: In addition to the problem of inconsistent or contradictory laws and regulations, the perception, if not the reality of inconsistent application of government policies poses a disincentive to private investment in Somalia. While investors and entrepreneurs clearly resist being subjected to restrictive policies and regulations, what they oppose even more is a situation in which certain of their competitors may be free from these restrictions. If policies are applied across the board in a consistent fashion, an investor can at least be sure that his competition faces the same constraints that he does. On the other hand, if there is any ambiguity regarding the consistent application of laws and regulations, norms of responsible business behavior tend to break down quickly and businessmen will expend considerable effort in circumventing what they view as arbitrary policies. This is what is happening in Somalia.

One of the factors contributing to this problem is the discretionary nature of many of the rules and regulations governing business behavior. For example, most of the incentives available to encourage private investment are not automatic. Rather, they may be made available -- on a case-by-case basis -- at the discretion of one ministry or another. This practice gives rise to perceptions -- whether or not justified -- of favoritism or discriminatory treatment.

Another contributing factor is the lack -- in many cases -- of any formal statement of the regulations governing business activity. One of the questions the SRI team asked in most interviews with GSDR officials was whether any documentation of rules and regulations affecting business are available to investors. The team also asked whether statements of the criteria governing decisionmaking are available. In nearly every case, the answer to both questions was negative.

Clear, explicit statements of policies and procedures would help to improve the transparency of government decisionmaking -- a factor which is of considerable importance to investors. Transparency simply means that rules and procedures are uniform, clearly visible, and known to all affected parties. Greater transparency is of particular benefit to small businesses which may not have sufficient access to decisionmakers.

III. REVIEW OF MAJOR FINDINGS

SRI's scope of work identified nine key study questions to be addressed by the project team in its interviews, report and recommendations. While most of the issues raised in these questions have already been discussed, this section will briefly review the project team's findings regarding each study question.

How do private investors, both indigenous and foreign, view Somalia's investment climate? There is very little foreign-investor interest in Somalia as an investment site. In many respects, this lack of interest has little to do with the realities of Somalia's investment climate. Over the last five years, there has been a generalized decline in levels of international investment in developing countries. Part of the explanation lies in the attractive investment opportunities that have been available in Europe and the United States. At the same time, foreign investors have become more responsive to risk than reward, pulling capital out of troubled countries or regions in favor of safer opportunities in other parts of the world. Foreign investors tend to take a generalized view of the world, and the general perception shared by many investors is that Africa is a risky place to do business.

There are also a number of factors specific to Somalia which deter foreign investors. The current legal framework governing foreign investment is one major deterrent. The current set of incentives and guarantees offered to foreign investors in Somalia is considerably less attractive than that offered by competitor countries, several of which have established comprehensive investment codes. Foreign investors are also deterred by the discretionary nature of many of Somalia's investment policies. Automaticity and uniformity of guarantees and incentives would help to dispel some of the existing uncertainty.

Local investors are cautiously optimistic about the current investment climate. They are by no means blind to the fundamental constraints that do exist, but are pleased by the positive steps that have been taken over the past three years. Many local investors interviewed by the SRI team indicated that they are seriously examining new investments that would have been out of the question two years ago. On the other hand, many local investors complained of mixed signals from the government, such as the recent placement of revenue police in most manufacturing enterprises in Mogadishu.

<u>What are the key policy-related constraints to private enterprise in Somalia?</u> The identification of such constraints has been the main objective of SRI's study. As discussed in section II of this report, the major constraints identified by the project team are: the absence of a positive environment for private sector growth; inadequacies in the system of mobilization and allocation of credit; public-sector encroachment in manufacturing and services; overly burdensome administrative controls; a cumbersome tax system; problems of macroeconomic management; and inconsistent application of policies and regulations governing business activity.

<u>To what extent are GSDR officials aware of the relative "assets and liabilities" of Somalia's investment climate?</u> There is a general consensus that the GSDR has become increasingly aware of existing policy constraints to private investment. Many difficult policy steps have already been taken, and others are reportedly under review. The important step now is to ensure that these policies remain in force and are applied in a consistent manner. Investors are encouraged by positive policy changes. But they must become confident over time that new rules will remain in force for a long enough time to justify investments which do not provide quick returns.

The SRI team learned of a number of cases in which a new policy pronouncement was followed by a temporary improvement in operating conditions, only to deteriorate after several months. For example, several businessmen who were encouraged by the elimination of quantitative controls on imports now report that the current system, whereby imports permits are required for registration purposes, is no less burdensome than the old system of discretionary approval.

Do the current activities/policies/practices of relevant GSDR agencies assist or deter private enterprise? While the GSDR has taken a number of positive policy steps, implementation practices often continue to deter investors. Once an appropriate set of policies is put into place, it is the responsibility of government to ensure that they are carried out fairly and effectively. Perhaps the most serious constraint to the development of a healthy, productive, private business sector in Somalia is the situation -- in part based on perception and in part on reality -- of arbitrary, discriminatory application of government policy.

What level of resources should be devoted by donors and the GSDR to investment promotion and other private sector initiatives? It would be premature for either the GSDR or international donors to expend any significant volumes of resources or efforts on active investment promotion. Until significant improvements are made in the investment climate, active investment promotion efforts are unlikely to achieve positive results, and may even be counterproductive. SRI has seen all too many cases in which countries have wasted millions of dollars trying to promote investment in climates that are fundamentally inhospitable to private enterprise. Investors are lured, through advertising, promotional seminars, and offers of all-expense-paid trips, to visit an investment site, only to find that serious policy constraints make investment there unattractive. Investors so "burned" are reluctant to reconsider an investment site, even when conditions have improved.

The most appropriate strategy for the GSDR and donors at this point would be to devote their resources toward efforts to improve the investment climate by removing existing constraints and providing local investors with positive incentives and opportunities. Evidence of local investor confidence in the Somali economy would be the best possible signal to foreign investors considering Somalia as an investment site.

How can existing expenditures of resources be marshalled more effectively to promote private sector development? One factor which has limited the effectiveness of past efforts to promote private sector development has been inadequate coordination of international donor assistance. The responsibility for this lack of coordination lies both with the GSDR and the donor agencies themselves. Several of the donors currently operate commodity import programs as part of their overall assistance efforts. Several of these programs reserve a portion of covered commodities for private importers. These programs have provided an effective boost to the Somali private sector, but their effectiveness would be even greater if the donor agencies involved would agree to a common set of procedures.

There is also a need for the donor community to coordinate their policy dialogue efforts with respect to removing policy-related obstacles to private investment. Multi-donor policy dialogue initiatives could be an effective tool for improving the investment climate.

<u>To what degree can Somalia's private sector be enlisted in an advisory and/or promotional capacity?</u> The Somali business community has been encouraged by the government's commitment to privatize the Chamber of Commerce. They view this move as a sign that the government is becoming more responsive to private sector needs and concerns. The project team feel that a truly private Chamber of Commerce can play a very positive role in Somalia, both in terms of representing private sector interests to the GSDR and in encouraging responsible business behavior.

<u>Given the current investment climate, what reasonable goals and expectations should be developed for private sector initiatives in Somalia?</u> One of the greatest problems plaguing other private sector initiatives examined by SRI has been wildly over-optimistic expectations. Promoting private investment is a long-term process. Immediate results cannot reasonably be expected, even in the best of circumstances. Foreign investment capital will not reverse course overnight. Investors must become confident, over time, that improvements in investment conditions are not transitory.

Given the past history of GSDR policy, and the serious constraints that remain, Somalia cannot realistically expect any major influx of foreign investment in the near future. If conditions improve, and local investors begin to show greater confidence, prospects for attracting foreign firms could improve over the longer term.

While the potential for increased local private investment is greater, expectations should not be overblown. Considerable potential for increased local investment exists in agricultural, intensive livestock production, fisheries, and services. However, given the existing scarcity of managerial and technical skills, expectation for increased local investment in industrial ventures should be kept modest.

IV. RECOMMENDATIONS

Improving the climate for private investment in any country is a long-term undertaking. Ultimately, the creation of an environment conducive to the development of a viable, competitive private sector in Somalia will require action on a number of fronts. In the meantime, it is the view of the SRI team that the GSDR, the Somali private sector, and the international donor community should seek to identify targets of opportunity for specific action. The objective should be to encourage initiatives that appear most feasible (both politically and administratively) and which appear to promise visible and demonstrable results.

With this orientation in mind, the SRI team would like to offer a number of specific recommendations, several of which already have been discussed elsewhere in this report. We hope that these recommendations will be received in the spirit in which they are offered; as constructive suggestions based on our findings in Somalia as well as our previous work (in some 25 countries) on private sector development and our extensive experience in advising international corporations on investment issues. It is the right and responsibility of the government and people of Somalia to choose the policy course they wish to follow. Our objective has been to provide as clear a picture as possible of current conditions and possible alternatives in order to guide this decisionmaking.

- A three-pronged strategy should be followed to encourage the mobilization of domestic savings and investment. First, licenses should be granted for the establishment of one or more private commercial banks. Second, a comprehensive program of financial and technical assistance should be undertaken to strengthen the Commercial and Savings Bank of Somalia. Third, monetary policy should be oriented toward achieving and maintaining an environment of positive real interest rates.

- To encourage an export orientation, the existing export tax should be eliminated, and specific measures to promote exports should be examined. One initiative that could hold particular promise is the establishment of a system of in-bond manufacturing or an export processing zone. Such an initiative could serve both to encourage private investment in export-oriented manufacturing and to demonstrate the efficacy of an outward-looking industrialization strategy.

- A further review should be taken of regulations and administrative controls affecting investors. As a first step, clear statements of these rules as well as of implementation procedures and criteria should be developed and published. This should be followed by efforts to eliminate those controls that are not absolutely necessary, and to streamline implementation of those that remain in effect.

- As a signal to private investors of its commitment to provide positive incentives for private sector growth, the GSDR should enact a specific statute for the encouragement of new investments. This approach has been used successfully by a number of countries to promote both local and foreign investment. The statute should provide investors with a set of basic guarantees as well as a basic set of incentives, both of which would be applied across the board to all investors.

- A strategy and timetable should be developed and publicly announced for opening up to competition the productive sectors of the economy which are currently closed to private sector participation. The objective should be to improve overall economic productivity by fostering greater efficiency. Therefore, the strategy chosen should move toward a more competitive environment, rather than simply transfering public-sector monopoly enterprises to private monopoly ownership.

Conclusion

The SRI team believes that the time is ripe for initiatives such as those outlined above. The GSDR has recognized that serious problems do exist, and has already taken a number of positive steps to improve the investment climate and restore private sector confidence in the economy. These steps include liberalization of pricing and marketing of food grains, improvements in foreign exchange management, and moves toward greater privatization of the Chamber of Commerce.

The SRI team has also concluded that, based on Somalia's endowment of economic resources (land, labor, climate, and geographic location) and comparative advantages, there is considerable potential for increased local, and even some foreign private investment, particularly in agriculture, livestock production, services, and labor-intensive manufacturing.

While considerable potential does exist, and positive steps have been taken, continued improvement in the investment climate will be required before Somalia can realistically expect any significant increases in levels of private investment. Furthermore, one of our concerns is that if measures are not taken to remove remaining policy constraints, the momentum that has been developed thus far will be lost.

Appendix 1

LIST OF INTERVIEWS

GSDR

Ahmed Mohamed Aden, Director General, Ministry of Industry and Commerce

Hussein Kulmie Afrah, Vice President, Somali Democratic Republic

Abdullahi Ainab, Director General, Ministry of Livestock

Ibrahim A. Deria, Economic Counsellor, Somali Embassy (Washington)

Abdalla Mohamed Fadil, Minister of Industry and Commerce

Hussein Elabe Fahiye, Permanent Secretary, Ministry of Planning

Ahmed Mohamed Farah, Minister of Water and Mineral Resources

Mohamed H. Hassan, Permanent Secreatry, Ministry of Fisheries

Abdullahi Moallim, Director General, Ministry of Labor and Sports

Abdulkarim A. Mohamed, Director, Somali Investment Promotion Office (New York)

Abdullahi Sheikh Mohamed, Technical Director, Ministry of Planning

Issa Haji Mussa, Deputy General Manager, Somali Development Bank

Abdullahi Warsame Nur, Minister of Revenue

Mohamed Sheikh Osman, Minister of Finance

Mohamed Abokor Raghe, Director, Private Investment Promotion, Ministry of Planning

Abdurahman Aden Sabri, Deputy Director, Foreign Trade, Ministry of Industry and Commerce

Mohamed H. Salah, Economic Advisor, Ministry of Planning

Mohamed Aboker Sheikh, Permanent Secretary, Ministry of Agriculture

Osman Haji Yusuf, President, Commercial and Savings Bank of Somalia

Abdurahman Mohamed Yusuf, Director, Foreign Trade, Ministry of Industry and Commerce

PRIVATE SECTOR

Abdulkadir Mohamed Aden, President, Agroservices, Ltd.

Abdullahi Haji Ali, Somcomputer Company

G.M. Beder, Chamber of Commerce

Elmi Ali Bullale, Administrative Director, Suila Paint Industry

Ahmed M. Darman, President, Warmash Wire Products Company

Ibrahim Egal, President, Chamber of Commerce

Abdullahi Essa, Director, Arab Essa Company

Bashe Mohamed Farah, Managing Director, Ali Mohamed Farah Co.

M.N. Gutale, Managing Director, E.A. Industrial Consulants, Ltd.

Miryam Gassen, Operations Manager, ISC Industries

Amund Haarde, General Manager, Somali GRP Products Company

Jirdeh Hussein, Chairman, Jirdeh Hussein Enterprises

Mohamed H. Hussein, Livestock Import Export

Ibrahim Salah Ibrahim, Managing Director, Islah Commercial Agency

M.M. Khawi, Chamber of Commerce

Mohamed Abdulkadir Mohamed, Director, Agroservices, Ltd.

Ali Sheikh Mohamed, Chairman, Somali Prefab Building Materials

Mohamed Muro, Chairman, ISC Industries

Artur Roon, Production Manager, Somali Prefab Building Materials

Abdulkadir Ibrahim Salah, Assistant Managing Director, Islah Commercial Agency

Hassan Elmi Samantar, Director, Somali Floor Tiles

Osman Samantar, President IGFC

Nasser Said Seif, President, Somali-Italian Commercial Electronics

Mohamed Ali Shirwa, Chairman, Juba Livestock and Hides Company

Eisa Weheliye, Manager, Hashi Weheliye and Sons

Abdullahi Yusuf, Chairman, Haplas

Abdurahman Ahmed Yusuf, Managing Director, Somalresearch

Sharif M. Zeno, President, Sharif Zeno Garmet Factory

UNION OF SOMALI COOPERATIVES

Warsame Abdullahi Ali, Chairman, Union of Somali Cooperatives

Ali Mohamed Ahmed, Vice Chairman, Union of Somali Cooperatives

Nur Osman, Vice Chairman, Union of Somali Cooperatives

Mohamed Ali Shmed, Planning Director, Union of Somali Cooperatives

USAID

Abdulkarim Ashur, USAID/Somalia

Louis A. Cohen, Mission Director, USAID/Somalia

Mike Huston, Private Sector Advisor, USAID/Somalia

Gary LaBombard, CIP Officer, USAID/Somalia

Bud Munson, Associate Assistant Administrator, AFR/PRE

Gary Nelson, Deputy Mission Director, USAID/Somalia

Malcom Novins, Private Sector Advisor, PRE/PPR

Meridith Scoville, Program Economist, USAID/Somalia

Loring Waggoner, PIP Project Officer, USAID/Somalia

U.S. DEPARTMENT OF STATE

James Bond, Economic/Political Officer, U.S. Embassy, Somalia

Chris Chatfield, Commercial Officer, U.S. Embassy, Somalia

Paul Daley, Economist AF/EPS

John Hirsch, Charge d'Affairs, U.S. Embassy, Somalia

Christopher Murray, Country Desk Officer for Somalia (Washington)

INTERNATIONAL DONOR AGENCIES

Swadesh R. Bose, Country Economist, World Bank

Brian Falconer, Resident Representative, World Bank

Ulrich Leist, (GTZ) Advisor, Somali Development Bank

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Appendix II

January 26, 1986

To: Hussein Elabe Fahiye, Permanent Secretary
Ministry of Planning

From: P. E. Karp, SRI International

Re: Foreign Investment Law

As I promised, I have prepared a brief set of comments on Somalia's current law governing foreign investment (Law Number 7, 1977). Before I present my specific comments, I would like to make a few general points about what investors look for in an investment law, and about how investment laws fit into a country's overall investment climate.

While investment laws are of considerable importance, they are only one part of a range of policies, regulations, and practices that shape a country's investment climate. Investors are influenced by a whole gamut of policy-related factors including labor practices, customs procedures, taxation, foreign exchange controls, price controls, interest-rate policies, etc. Investors look for a policy environment that provides incentives for productive, profitable economic activity. They also look for clear statements of policy as well as consistency and stability of implementation. The thing investors fear most is uncertainty; not uncertainty in market conditions, but uncertainty in policies or policy application. Investors want to be sure that policies will remain in place for a long enough period of time to allow them to achieve expected returns on their investments.

Turning to investment laws per se, what an investor looks for in an investment code is a clear statement of what he can expect from Government, and what Government can expect from him. Thus, the investment law should specify the regulations and requirements with which investors must comply; it should specify what guarantees and incentives the Government will provide; and it should include a clear description of the rules associated with the investment approvals process and instructions regarding investment applications. Investors are particularly interested in a clear statement of the legal guarantees that they will be afforded. The specific legal guarantees that investors generally look for include a promise of full and prompt compensation in the case of nationalization; protection of patents, trademarks, and designs; equality before the law for domestic and foreign-owned firms; and a clear statement of the process for resolving disputes with the Government.

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ANALYSIS OF CURRENT INVESTMENT LAW

The structure and general composition of the current investment law are adequate. Most of the major issues that an investor looks for in an investment are addressed. However, there are a number of specific provisions of the current law that make it unattractive to investors. These will be discussed one by one below.

The Government and people of Somalia have the right and responsibility to establish the conditions under which private foreign investment must operate. However, in establishing these conditions, it is important to understand how they are perceived by foreign investors. The objective of my comments is to help improve this understanding.

Article 1

Section 1: The form that investment applications should take needs to be specified. Does the Government require a complete feasibility study, or merely a general statement of the investment idea? I would suggest that a feasibility study be required which presents the following information; value of capital, equipment, and technology to be invested; number of and types of jobs to be created; intended market; source of requirements; expected output.

Section 2: Value of machinery, equipment, etc. should be based on purchase price plus shipping cost rather than on customs valuation.

Section 3: Valuation of patent rights, trade marks, etc. is currently discretionary. Valuation should be based on current market price.

ARTICLE 5

The distinction between "productive" and "nonproductive" investment is not adequately defined. Determination is discretionary and arbitrary. Any economically viable investment that produces goods and services should be encouraged.

ARTICLE 6:

Statement of time-frame for review and approval/ disapproval of applications is positive and should be adhered to.

ARTICLE 8:

Section 2: By providing that investors lose the right to transfer unused quota after three years, the Law encourages investors to repatriate capital more quickly than they might otherwise if no such restriction were in force. The objective should be to encourage investors to hold their capital in Somalia for as long as possible.

ARTICLE 10, ARTICLE 15

These provisions should be replaced by a basic incentives package which is offered to all investments which meet certain criteria to be established by the Government. Under the current law, incentives are granted on a case-by-case basis. This results in arbitrary discrimination between one type of investment and another.

If the Government does wish to provide a differential incentive package, the differential should be based on clearly thought out targets/priorities. For example, special incentives could be used to target investment in particular regions (e.g., outside Mogadishu), sectors, or in investments for export.

ARTICLE 17

Section 3: "Equitable" compensation should be replaced by "full and prompt" compensation.

ARTICLE 18

Procedures for arbitration as well as powers of the arbitration board are not clearly defined. Provision should be made for referral of disputes to international arbitration (e.g., through ICSID) should the investor be unsatisfied with local arbitration.

ARTICLE 19

Section 6: One year is often insufficient time to get an enterprise operating profitably. Investors should be given 3-5 years in which they have freedom to employ expatriate staff as they deem necessary. However, investors should be required, as part of their initial application, to submit a plan and timetable for the substitution of expatriate employees in technical and middle-level management positions.