

## **Private sector response to the absence of government institutions in Somalia\***

Draft, July 30, 2004

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“One of the major changes in Somalia over the past decade has been the growth of the private sector. Economic deregulation and privatization have accompanied the radical localization of governance. The growth of the private sector is closely linked to processes of globalization. In the context of weak and often ineffectual public administrations, the private sector is playing an instrumental role in providing social services and shaping development. As a market economy has replaced a centrally planned economy, development had become market-driven rather than government-led.”

(“Human Development Report 2001: Somalia”, UNDP: Nairobi, Kenya, p.41)

"There are a lot of opportunities to do a lot of different things without someone saying you can't.... I think that if we can build on our strength, that is, basically, peace, we can achieve a lot. I think a lot of people are sick of fighting. People just want to get on with their lives and make the most of it." - *Moustapha Osman, export-importer, quoted in "Entrepreneurs of Somaliland", Dave Fick, 2002.*

“Today, it's up to you to run as fast as possible. Government has nothing to do with any kind of business. It's free now, and we want to keep it that way” - *Abdulkader Hasni Elmi, owner of the Maan-Soor Hotel, quoted in "Commerce Rises from Ashes in Somalia", Ann Simmons, Los Angeles Times, 1998.*

\* The authors want to express their deep gratitude to all Somali businessmen that we interviewed, for their candor, patience, and informative stories. A distinct and warm recognition is due to Mr. Mohamed Djirdeh Houssein, Chairman of the Somali Business Council, for his unfailing support of this project. We also received invaluable help from our World Bank colleagues Ms. Ayaan Adam, Mr. Osman Ahmed, Mr. Ian Bannon, Ms. Sarah Cliffe, Mr. Mohamed Gouled, Mr. Mohamoud A. Noor, and Mr. David Potten, as well as from Mr. Ismail Ahmed (IDS), Mr. John Prendergast (ICG), and Mr. Ahmed H. Esa (IPRS). Last but not least, we wish to extend our gratitude to the Nairobi office staff for their kind assistance.

## Background and scope of the study

Civil war erupted in Somalia following the fall of the autocratic regime of Siad Barre in 1991. Peace was established to varying degrees in the different regions of Somalia. The civil war first abated in the Northwest (1994), and subsequently in the Northeast (1998). Lastly, and less so, in the central and southern parts, with limited and sporadic hostilities still occurring in Mogadishu. The past year has seen a worsening of the peace and security situation in the Northwest specifically, and across the country.

The study is based on 31 interviews with most major companies representing each of the significant industrial sectors in the country, based in Northwest Somalia (e.g. Daallo, Dahabshiil, STG), Northeast Somalia (Amal, Sometel), and south Somalia and Mogadishu (Damal, Jubba, Towfiiq), as well as businessmen based in Dubai and Nairobi. In addition to entrepreneurs, the study has benefited from discussion and advice from Somali lawyers, the Chairmen of all major Somali industry associations, the Chairman of the Somali business council, locally active NGOs, and IFIs including UNDP, and EC. In certain sections, the study focuses on the experience of a particular region; however, most findings and conclusions can be extended to the entire country.

### 1. Government regulation versus private solutions: what works?

Somalia has been characterized by a limited government, as in the Northwest following the establishment of peace and security around 1994-5, or no recognized government, as in Southern Somalia. The absence of restrictive government policies, state provision, regulation, and control, has tended to encourage competition and entrepreneurship. A vibrant private sector moved in to establish basic markets such as retail trading, hotels, and newspapers. Hargeisa, in the Northwest, offers retail outlets selling everything from cosmetics and books to computer systems. There is active real estate development and construction in the area. Financial houses have started experimenting with checking accounts and travelers checks. Somali traders have penetrated markets in neighboring countries and remained competitive.

Private entities have further moved in to provide basic infrastructure and institutions. Electricity and telephones have been offered to towns that never benefited from those services in the prior regime where government regulated the economy (pre-1991). A local cellular phone call costs 10 cents/minute, one of the cheapest rates anywhere in Africa.<sup>1</sup> Prices for international phone calls have fallen from \$5-7/minute pre-1991 to \$0.50/minute. Water is available from micro entrepreneurs at affordable prices in the vast rural areas where state water provision facilities are unavailable. Air, sea and land transportation are all in private hands. Daallo Airlines flies Paris-Djibouti for 60% of the price of Air France. Courts have been replaced in commercial matters by traditional elder-driven dispute resolution mechanisms, which is a relatively quick procedure and is free.

Do these success stories mean that government regulation is redundant and has no role in the development process; that the private sector should be left to its own devices? Far from it. Market failures, such as monopolies, coordination failures, externalities, and public goods provision, preclude efficient market outcomes in the absence of regulation. For example, the largest 4-5 livestock exporters / consumer goods importers, who are also the only ship-owners in the country, dominate the market, and restrict entry to the most attractive deals. As another example, telecom companies are not interconnected among themselves due to lack of coordination, so that an international call is needed, in order to call the next door neighbor. A third illustration of a market failure due to inadequate regulation are externalities, such as harm to the environment (land transport), or the avoidance of observing high quality product standards (restaurants, livestock exports, medicinal drugs). Finally, Star Mini Market in Hargeisa maintains its own security due to the lack of public security and a police force, a pure public good.

The private sector has failed as frequently as it has succeeded in terms of efficiency. Traders can pay their international partners only if they have a registered offshore office (usually in Dubai). Airline carriers

maintain the runways and self-handle, which wastes resources and lowers service quality. The lack of adequate commercial /lending legislation stunts firm growth. Finally, weak quality standards are responsible for a four-fold reduction of livestock exports, the main foreign exchange source. Health and education for the socially weak, cannot be profitably provided by the private sector and are therefore not available in the absence of state involvement.

State involvement may correct efficiency failures, but it has shortcomings of its own. Government failure, in the shape of corruption and excessive bureaucracy, prevents regulation from fully solving market failures.<sup>2</sup> For example, the Ministry of Commerce in Hargeisa licenses import-export firms, shipping, airlines, telecoms, and *hawilaad*. Those licenses are not linked to any government services or company rights. For example, the telecoms licenses are not linked to the right to use a given frequency, so that having paid the license, a telecom can fully expect new entrants to claim frequencies in current use. Municipal dues are collected from firms with a fixed location, and firms with computers (stalls are not taxed). Taxes are perceived as pay-off to avoid harassment, rather than payments in exchange for public goods provision. Similarly, municipal governments collect tolls on the Berbera-Hargeisa road; however, the funds are not fully directed to road maintenance. The Airport Authority in Hargeisa imposes landing fees of \$1000 per landing, but provides little in return: there is inadequate safety regulation, airport services and maintenance. The Berbera Port Authority collects import-export duties, board dues and other charges (e.g. manifest charge), and has a monopoly on loading / unloading services. However, the port continues to lack vital cargo handling equipment and storage facilities, and its loading time and cost compare unfavorably with those of privately managed ports such as Djibouti, Dubai, Aden. Finally, it is not uncommon for the state to compete with private players in profitable markets (electricity provision, p. 8). Curiously, private entities have also been known to claim government prerogatives (the court in Northern Mogadishu, p.9).

To sum up, heavy regulation carries the risk of corruption, weak property rights, and state capture, just as private solutions have their limits in correcting for market failures – both approaches can stunt development and growth. This can be seen in a comparison of Somalia, where regulation is limited, to several groups of countries with relatively much heavier state presence (Table 1). Take French Africa, where government involvement is particularly significant, to run a horse race between private and state solutions. In Somalia, health, education, and social safety provisions are plainly inadequate, poverty is high, and infrastructure (to the extent there is data) is lacking. Yet, surprisingly, countries with heavier government presence demonstrate very similar outcomes: the Gini coefficient in Somalia is 40 (perfect equality scores 100), vs. 42 in French Africa, a set of countries at a markedly higher average level of development (GDP/capita of \$788 vs. \$226). In Somalia, 43% of the population live at \$1 or less a day, and in French Africa this figure is 32%. Both Somalia and French Africa offer roughly 3km of roads per 1000 people, and 15 (28 respectively) telephones per 1000 people. In French Africa, 63% of the population has access to health facilities, and 63% to sanitation. Those numbers in Somalia are lower, though not dramatically so, at 55% and 50%, respectively. Access to water and education in Somalia are markedly worse relative to any of the comparison groups: 60% of French African people can acquire safe water, as opposed to 21% of the Somali.<sup>3</sup> Illiteracy rates are 81% in Somalis, and 45% in French Africa, and gross enrollment is 17%, as compared to 87%, respectively.<sup>4</sup> These differences are in part explained by the nomadic lifestyle of more than half of the Somali population, as well as its traditional beliefs, as well as lack of peace and security in certain parts of the country (e.g. the figures are much improved for the Northwestern part, by far the region with the longest peace history). Yet current enrollment levels across Somalia are higher than their peak in the 1980s.<sup>5</sup> These figures demonstrate the pitfalls of both private sector and government failures.

The remaining sections of the study overview each of the major industries in Somalia in turn: (1) telecoms, (2) import, export, shipping, (3) money transfer operations; (4) airlines, (5) education, health, and safety nets, (6) foreign exchange, (7) electricity, (8) land transport, (9) water provision, and (10) courts, law and order, contract enforcement, property rights, and self-regulation. For each sector, the strengths and weaknesses of both state presence and private solutions are identified, delineating the areas where state

presence or well-enforced regulation can deliver the efficient outcome, as well as instances where a private solution is sufficient. Whenever possible, comparisons are made with other countries, or with Somalia in its pre-1991 period. The following conclusions emerge from the sectoral overview:

- (1) In poor countries, there is a modicum of services that the state needs to provide, which are too costly to be privately procured, e.g. property rights, rule of law, coordination.
- (2) Simple and transparent rules work best, as they minimize bureaucratic rent creation.
- (3) Regulation is best directed at correcting only significant deviations from efficiency, in order to capitalize on scarce government enforcement capacity.
- (4) The level and complexity of the regulatory burden that an economy can tolerate depends crucially on the level of development of the country.

The last fact (4) cannot be emphasized enough and is frequently ignored by policymakers. UK labor regulation in the early 1900s were far less complex and enforcement-intense than Mexico's existent labor laws, yet UK's GNP/capita in 1900 and Mexico's in 1987 are roughly equal.<sup>6</sup> The complexity, rent-extraction opportunities created, and enforcement cost of regulation can stunt development and growth. For example, the Hargeisa construction sector will expand considerably as a result of creating a functioning property registry; however, city building provisions on aesthetic architectural appearance are unwarranted, as they would be abused due to lack of understanding and disclosure, and would prove expensive to enforce.

## 2. Telecommunications – limits to coordination: equipment duplication, inter-connectivity

As the first telecom companies started operation using the pre-1991 land-line infrastructure, new entrants partnered with international giants such as Sprint, ITT, Telenor, and offered GSM connection, while in parallel building their own networks of land-lines. Since 1996, early entrants like Soltelco and STC reduced prices, while improving service, in an effort to capture market share. From the mid 1990s on, other private wireless companies such as Barakaat, Aerolite, and later Somtel, sprung up. As a result of competition, all major towns are served by telephone services that are superior to and cheaper than those of most African countries. International call prices have fallen in the 1990s from \$5-7/minute to \$0.50 in large cities and \$1.50 in smaller cities where population density is too low for competition. Local call vary from \$0.10 to \$0.35/minute depending on competition. Service coverage is considerably wider now than prior to the collapse of the central government.<sup>7</sup> Telecoms provide fax, internet, and mail/package delivery services.

The industry is characterized by lack of standardization in the telephone numbers and frequencies used, as well as duplication of equipment, and limited inter-connectivity among different telecom providers. Thus, Telsom, STC, and Soltelco each have a set of poles in Hargeisa. In order to be able to call all Hargeisa inhabitants, one needs a subscription to four different telecom firms. Whether this failure to coordinate can be solved in the absence of regulation is an open question: initial steps in this direction have been undertaken. For example, Soltelco and Aerolite succeeded in interconnecting their local services. However, interconnectivity is unpopular due to issues with settling the inter-payments on shared equipment and connection. In the long run, there is reason for optimism, since interconnectivity is a herding equilibrium problem: once the major operators interconnect, it will be in the interest of all remaining ones to join. In Mogadishu, all firms share the same poles, and Nationlink and Olympic share microfiber. Also, firms expanding their pole network in Mogadishu allow usage rights to competitors by agreement. Limited sharing of a black list of persistent payment defaulters is also practiced. Negotiations to establish a national network linking all systems have started within the framework of the telecoms association, the Standing Committee of Telecommunications Companies.

## 3. Import, export, shipping – externalities: livestock quality standards

Livestock (sheep, goats and camels) are a major export of Somalia.<sup>8</sup> The animals are exported on the hoof, mostly to neighboring Arab countries, by sea, though there are growing initiatives for meat export by air to

the Middle East. Other exports include hides, skins, frankincense and myrrh. For the most part imports are consumer goods: electronics, batteries, dishes, lamps, clothes, foodstuffs, mostly from Dubai. Some large scale construction materials and foodstuffs are imported from Latin America and South and East Asia. The import-export market is composed of 20-30 middle-size players, who export a few thousand to a few dozen thousand head a year, and 4-5 large traders. Three traders own ships, the rest charter their transport. Shipping agents, offering ship or dhow<sup>9</sup> space, form a competitive market, accessible even for small traders. A ship can realistically make 10 trips between Dubai and Somalia in a year.

The private sector solution to international trade payments/ guarantees is worth describing in detail. There is no correspondent banking so financial houses do not offer letters of credit. In order to pay a foreign trading partner, offices are opened abroad (mainly Dubai) and foreign banks are used. This is an expensive and time-consuming undertaking. Opening an office in Dubai costs \$5,600-10,600 and takes a few months. Traders must deposit 100% of the payment before the bank issues the letter of credit. Leveraged letters of credit (e.g. 10% down until merchandise delivery) are only offered to relatives / long-term business partners of the bank owners. Thus frequently a sum of money as high as \$1.5 million is frozen at the bank for 45 days prior to the merchandise delivery. A further complication is that large amounts of cash are avoided by banks due to money-laundering concerns.

The most pressing regulatory change for the export trade is to conform to international health and safety standards. The sector has shrunk to one quarter of its peak size in 1997, due to lacking quality standards regulation for export of animals, and the resulting bans on livestock exports from Somalia in Feb. 1998-Mar. 1999, and again since Sep. 2000.<sup>10</sup> Other veterinary services of need are vaccination, certification, holding grounds, stock routes, and quarantine stations. The livestock sector is served by a large number of private Somali veterinarians who provide a (for-profit) health delivery system, including vaccination and veterinary drugs.<sup>11</sup> Private sector solutions are susceptible to capture and have enforcement problems. For example, Somali traders complain that in Jizan, the Somali agents of the Saudi traders incite the Saudi customs to reject livestock under the false pretenses of "health grounds", in order to keep the market under control either because of over-supply, or because of another shipment they want to give priority to, or for clan reasons...<sup>12</sup> Further, uniform enforcement of vaccination is virtually impossible due to the unique culturally and historically determined manner of livestock purchase by traders from breeders - the animals are sourced from the entire country, as well as Ethiopia, via middlemen that are impossible to monitor.<sup>13</sup>

**Box 1. Functioning of financial houses – the money transfer mechanism.**

*Hawala* is a money transfer system based on trust that is practiced in many Muslim countries. It functions as follows. A person in New York wishing to send his money home to his family in Tog-waajale gives the *hawala* agent in New York the sum in cash, paying a 5% commission. The agent deposits the cash in a local bank account to be transferred to the company bank account either in Djibouti or Dubai. The agent then faxes or emails the clearinghouse in Hargeisa, sending information on the amount, the sender, the recipient and instructions as to where to deliver in Tog-waajale. 'Clearinghouse' refers to the central location of the remittance company, where all funds and records are sent. The clearinghouse contacts the agent closest to where the recipient lives and instructs them to transfer the money to the recipient, usually in USD. "[The recipient] goes to one of the money houses in [Tog- waajale], in order to pick up [the cash]... Upon arrival he is directed to an anteroom where he waits in turn to see a cashier. Clerks check his name on a computer print out to make sure that a money transfer has arrived for the person. When his name is called, he goes to a backroom where stacks of US dollars cover a wooden table and three individuals sit behind it. He gives his name to the cashier, shows proper identification, and is required to answer several questions. Because 'official' ID cards and passports are easily manufactured and forged, he is asked about his clan and lineage relations that his [living-abroad relative] has provided as security against fraud. Knowledge of one's kinship relations is used as a convenient check on the person's identity and presents a unique twist on the use of 'tradition' in modern transactions. Only after he has answered the questions to the satisfaction of the bankers can he pick up the cash." The transaction is usually completed within 24 hours. The money never actually crosses the ocean – the clearinghouse settles the accounts at a later date. *Hawala* can transfer funds to most major cities in Europe, North America, and the Middle East. *Hawalas* are completely unregulated. Records of the transactions are not always kept. Source: Omer, Abdusalam, "Supporting System and Procedures for the Effective Regulation and Monitoring of Somali Remittance Companies (*Hawala*)", 2003.

#### 4. Hawala financial houses – international recognition: transparency, financial reporting

The main advantage of the *hawala* money transfer operation is that it is simple, basic, cheap (Box 1).

Amounts of about \$500mln-\$1bln are annually remitted into Somalia from aboard via the *hawala* system, mostly to the urban population (less than 5% of the rural population receive remittances). Average household remittance per annum is \$4,170 to a mean family size of 6.9. The share of remittances in household income is 64%.<sup>14</sup>

In addition to official *hawala* transfers, physical remittances are estimated at an additional 40% of funds remitted through *hawalas* between Djibouti, Nairobi, and Dubai, and Somalia; and at 10-20% of funds transmitted between the rest of the world

and Somalia. In addition to money transfer, some *hawalas* now offer a wider range of bank-like services such as travelers checks (Box 2) and non-interest bearing deposits. Consumer lending may also be offered on occasion, e.g. a car loan, though those are mostly financed with remittance money. Smaller consumer credit is obtained from relatives and friends, who lend /gift the cash in return for future goodwill.

Business lending by *hawala* seems unviable even with collateral, both for religious reasons, and due to business preferences for direct involvement of an investor / lender in the operations they are financing. Limited short-term (1 year) trade credit (against security such as expected receivables collected directly by the creditor) is usually available from international partners. Leveraged letters of credit can provide very short-term financing (30-45 days). A traditional form of cooperative financing of inventory is popular, especially among women (Box 3). Finally, an ambiguous and not much discussed source of financing for *hawala* themselves is to collect deposits “for safekeeping”. In spite of such limited financing possibilities, businessmen can accumulate significant start-up and expansion funds sourced from savings, remittances, or by combining several partners / clan relatives.

*Hawilaad* have been experiencing considerable problems with legalization of foreign branches and

##### Box 3. Micro-lending: *hagbed*

Women’s group credit sharing arrangements are organized among 10-20 women who know and trust each other: they either work together, or live in the same area of town, and/or belong to the same sub-clan. The chairperson of the group is chosen according to her influence in the clan and the respect she enjoys. All participants in the arrangement pay daily or weekly contributions, depending on their income level. The women receive the accumulated money in order, though changes can be warranted in case of a mourning or an accident. Traditionally used to purchase household goods or jewelry, *hagbed* is now put to business uses to open small coffee / tea shops or pasta restaurants, or to replenish inventories. The *hagbed* group needs stability and duration: else women may disappear as soon as they get the capital. Clan and proximity act as incentives to limit such behavior.

Source: Marchal, Roland, “The Post War Somali Business Class”, 1996.

compliance with host country regulations. These are due, first, to the lack of familiarity of host countries with the simplified form of the *hawala* financial service, so that full bank or financial company regulations are imposed on *hawala*. Those can be quite costly, especially in view of inadequate bookkeeping and reporting skills of *hawala* manager/owners and agents.

##### Box 2. New *hawala* services: travelers checks for *hagg*

Checks for *hagg* (a pilgrimage to Mecca and Medina, for about 5 days following Ramadan) are offered by Daallo, written on Radj Bank, Saudi Arabia. Daallo has a checking account with Radj Bank, where a certain amount of cash is deposited. The checks are sold to clients against (any amount of) cash, and are written in Somalia. This service is frequently combined with the provision of a “pilgrimage visa” (against \$500 and a passport), which permits travel to certain towns with religious significance only. Following the pilgrimage, a flight is taken from Jeddah back to Somalia. Due to high demand during the season, there is a few weeks wait to get on the plane, and during that time Somalis purchase presents and goods for themselves and family back home. This shopping experience necessitates the “travelers check”. The check is cashed in the Jeddah branch of Radj Bank, and spent on presents, avoiding the risk of loss or theft.

Source: Authors’ interviews with Somali businessmen. 2003

#### 5. Airlines – externalities and consumer protection: safety standards

The sector is entirely privately owned, and is sizeable: by 1997 14 firms with 62 craft were in operation. Currently, five carriers operate, dominated in size by Daallo Airlines. The airlines use Djibouti, Dubai and Nairobi as bases of operation. The carriers run cargo and passenger flights, special charters and long-term IFI/NGO contracts within Somalia, the Middle East, and East and Central Africa, as well as Europe.<sup>15</sup> The planes are leased, sometimes wet-leased (with crew). The craft is usually Russian (AN or IL), manned by

Eastern-European crews and a permanently available mechanical engineer in case of faulty operation of the craft during flight. Daallo Airlines wet-leases a Boeing from a UK carrier, claiming higher consumer confidence given the lack of government safety regulation in commercial aviation. Prices of Somali carriers are competitive relative to foreign airlines. For example, Daallo Airlines flies Djibouti-Hargeisa for 60% of the price of Air France. The current airline industry has significantly increased the provision of routes as compared to the pre-1991 government regime. In 1989, the national carrier, Somali Airlines, partly owned by Alitalia, operated a single jet Airbus 310, and carried international flights from Mogadishu to London, via Dubai and Djibouti. Domestic service linked Mogadishu with Berbera twice weekly, and there were weekly flights to Hargeisa and Kismayo. In contrast, currently there are almost daily flights between Mogadishu, Berbera, and Hargeisa, on several competing airlines, as well as two flights a week to Bossasso, Galkayo, and Burao. International routes provision has also improved: flights are available from Hargeisa or Mogadishu to Paris, London, Dubai (Sharjah), Djibouti, Aden, and Nairobi.<sup>16</sup>

Regulation of private airlines, specifically in view of safety, is needed. Airport services /handling and maintenance are inadequate. Passenger services at all airports are rudimentary or non-existent. Most of the airports don't have well trained air traffic controllers, fire service and weather information, runway lights or full airport enclosure against stray animals. Handling services and runway maintenance are mostly privately provided. Yet some substitutes have been privately implemented. For example, the craft is checked at each host-country hub, and grounded if its state is found unacceptable. Further, the wet-lease assures a modicum of maintenance and pilot skills. Competition and demand push quality down, however, as customers consistently demonstrate a preference for low prices at the expense of safety.

#### 6. Education, health, and safety nets – government under-provision is poorly supplanted by private initiatives

Private schools in Somalia represent 71% of primary schools, 55% owned by communities / parents, and 17% by private individuals (Box 4). Local authorities manage the remaining schools.<sup>17</sup> Government-run primary schools are insufficient in number and understaffed. They were characterized in interviews as “lower in quality than their private alternative”. Private donations, from diaspora or domestic and foreign religious organizations, as well as community donations of premises, are frequent financing methods for educational institutions. Fees paid by parents is an alternative source of funding. In 1998/99, 36% of the primary schools in the country as a whole were free or cost less than \$12/year, 22% cost between \$12-36, and 5% were more expensive than \$36. The full annual cost per student is \$41.<sup>18</sup> Primary school teachers have more university degrees than in other African countries; however, women are underrepresented, both among teachers and school heads.<sup>19</sup>

There is no government regulation for mandatory primary schooling nor an official entry age - this decision is left to the family. The Ministry of Education has established curricula and minimum standards for private schools to follow, but it has no meaningful enforcement capacity. Primary education suffers from inadequacies of physical facilities, instructional materials (including pupils' textbooks and teachers' guides), as well as gender disparity.<sup>20</sup> Other problems are excessive concentration of schools in urban centers, and inadequate time for teaching, as teachers supplement their income with alternative jobs.

Private clinics, diagnostic facilities, and pharmacies function in most major cities and towns, and are relatively affordable, but of debatable quality. Basic equipment is available to the physicians; however, more intricate tasks require flying the patient to a neighboring country. Doctors are available even in remote villages. The lack of doctor and nurse certification is detrimental to the quality of health care in the country. Reputation effects are not sufficient to supplant medical diplomas, given the unobservable character of the quality of care. As the Somalis say: “The patients who survived with praise the doctor, and those who died will say nothing”. On the other hand, government-run hospitals are insufficient in number, understaffed and reportedly of lower quality than their private alternative. State-employed physicians as a rule maintain a private practice as well. Drug quality standards are vital, as medication is sold outside of pharmacies, in stalls on the street; and products are frequently sold past their expiration dates.

Health, education, and safety nets for the very poor cannot profitably be provided by the private sector, leaving a clear mandate for government presence in these sectors. The existing gap in state provision of those services is not being filled. The role of a safety net has been played by private remittances from the diaspora, alms, religious organizations, loans from the extended family or clan. For example, vulnerable groups traditionally do not pay for water: upon request, they are allocated a modest quantity for free from private catchments by the owners.

### 7. Foreign exchange – a near-perfect competition

Several local currencies are used on the territory of Somalia – the old and new Somali Shilling, and the Somaliland Shilling. The period of 1994-6 was characterized by considerable inflation, due to seignorage financing of the civil war effort, as well as overwhelming lack of confidence in the new currencies. A second sharp drop in the currency value, during 2000-2001, was caused by the Saudi Arabia ban on livestock exports and the closure of the business conglomerate Al Barakaat.

The disadvantages of the local currency have caused a de facto dollarization of the Somali economy. The central bank has lost its control over foreign currency flows and the exchange rate. In addition, the currency tends to be abused by the powers that be. Further, “these local currencies are inefficient means of transaction. They are fragile and bulky to carry causing them to be traded in bundles without counting. ... [Finally], the practice of some warlords to print new currency adds to the erosion of confidence in the local currency and results in high degree of instability.”<sup>21</sup> The local currency is only used for non-tradable services such as wages, taxes and rural trade. Instead, private exchange services are provided by *hawala*, import/exporters, and small street dealers, of all clans.

Foreign exchange markets come very close to being perfectly competitive: there is unrestricted entry, no regulatory limitations, and transparency. Unrestricted entry is only possible due to the multiplicity of players with access to foreign currencies, from different clans and industries, so that coordination and collusion costs are exorbitant. Lack of regulation is only possible due to the feebleness of the central bank hard currency reserves. Finally, transparency is achieved, as is the case for other important commodities, by paying some individuals to move around and provide information on the exchange rate's variations, as well as by making extensive use of the radio / phone networks.”<sup>22</sup>

### 8. Electricity: striking the right balance of state and private service provision

Electricity is produced with privately owned generators, purchased second-hand from neighboring Dubai.

#### Box 4. Amoud University in Borama

Borama residents felt the need for a graduate institution in 1997, as nearly 8,000 students were in [primary and secondary] schools in Borama and its vicinity. The University's Board was elected from among the Borama elders, and its management was chosen among academics. Donations from the Borama business community and residents jump-started the rehabilitation initiative of Amoud (e.g. community labor was used to build the gravel road to the university). The university is formally owned by the community of Borama. Currently, students pay a monthly tuition fee of \$15 that covers a fraction of the university's operating costs, the balance funded by donations of local and diaspora businessmen and organizations.

Amoud University's first entrance examination resulted in 69 qualified students for the yearlong preparatory courses in basic sciences, English, and mathematics, of which 47 enrolled in the first Amoud University class. The university has two departments, education and business administration. Education was selected as a foundational discipline due to the country's dire need for qualified schoolteachers. Business administration is intended to feed fresh energy into the private sector. Other disciplines envisaged for the future include public administration, public health and medicine, veterinary medicine, and agriculture.

*Source: Samatar, Abdi Ismail, “Somali Reconstruction and Local Initiative:*

Providers frequently combine this business with either telecoms provision or importation of fuel, due to the complementarities involved (Box 5). Somali businessmen divide cities into manageable quarters that could be supplied with generated electricity. The menu of choices for electricity provision is tailored to customer needs (evenings only, daytime only, or 24 hours). The providers also do not require a meter (a major expense for a Somali), but charge based on the number of



light bulbs in the house. For example, the daily consumer tariff in Hargeisa is \$0.35/lightbulb.<sup>23</sup> The industrial tariff for big business with electric meters in Mogadishu, e.g. Sahafi Hotel, is \$0.40/kWh.<sup>24</sup> [Electricity is provided] even in smaller towns that did not have electricity when Somalia had a functioning government.”<sup>25</sup>

A state-owned electricity company started operation in Hargeisa in 2003, driving the private generators out of business due to lower subsidized rates. Given scarce state funds and a lack of involvement in areas of more pressing need, state electricity provision is not easy to justify in lucrative urban areas where private provision is available.

### 9. Land transport

Freight and passenger transport, conducted via trucks, busses, taxis, donkey carts, and tippers, is affordable and links even the remotest villages to the main towns (in the dry season).

Trucks travel among villages on regular intervals to supply the population with water, fuel, and food, and to provide rides (for example, a drive from Buraao to Bossasso costs \$5/person). In the rainy season, most roads are poor or impassable. There are tarmac roads linking Mogadishu, Bossasso, Buroa, Berbera, Hargeisa north; Mogadishu and Kismayo south; and Mogadishu Baidoa, Bardheere west. Even on tarmac, a long caravan of heavy trucks could encounter problems in the wet season. Most other roads follow pre-1991 gullies created by oil exploration activities. As tracks are repeatedly used, the upper soil level erodes, deepening the gullies so that eventually they are not usable for roads. The poor condition of roads may hinder the development of certain industries, such as fishing. Road works may not be provided by the private sector as coordination may fail among the numerous small truck companies (especially if some exist for a shorter time) to undertake action. The government collects tolls on the Berbera-Hargeisa road; however, the funds are not used for road maintenance.

### 10. Water provision

All water away from the big cities is privately owned/supplied or communal. Water is transported to rural areas from a city’s public supply, collected in cement catchments (*berkeds*) by private entrepreneurs, or sourced from communal wells or private boreholes. An active system for water delivery has developed, spanning very small operators to truck-owners. For example, there are over 800 *berkeds* in Eastern Sanaag alone, 350 shallow wells and 27 boreholes. Water sells for \$2.50 - \$5/m<sup>3</sup>, but its cost can increase several times after prolonged droughts. Destitute and poor families traditionally do not pay for water, those with slightly more funds borrow from relatives in difficult times. UN estimates of the average current indebtedness of an Eastern Sanaag family, after 4 years of draught and at prices of \$19/m<sup>3</sup> (Oct 2003), are \$50-100 per family for water alone. Urban water development could be self sustainable and need not be public. For example, the Hargeisa Water Agency is self-financed, and reportedly, efficient and fast in installation and service provision. Water provision concessions in large towns have been courted by the

#### Box 5. Electricity provision in Galkayo

Abdirazak Osman set up a telephone contracting company in Northeast Somalia with American partners. ... As he was laying telephone cables, people asked Mr. Osman if they were for electricity. No, he said, but the idea was born, and once Galcom, the telephone company, was running, he raised \$400,000 from his American and Somali partners, bought two generators and started up an electricity company. He advertised by putting up street lights and providing free power to the hospital and other public buildings. Now, he says, he has more customers than he can cope with.

Mr. Osman’s telephone and electricity companies, a \$1m investment so far, also play a political role in Galkayo. They are based in the northern part of the town, which is being brought under the control of the fledgling state of Northeast Somalia. The southern part of the town, inhabited by a different clan, is still in the hands of a clan militia. Mr. Osman has set up a telephone sub-station in that part of town and is offering it electricity too, leveraging his bargaining power to prevent further fighting.

Mr. Osman is typical of the entrepreneurs who have taken full advantage of the lack of government in the country to create nationwide businesses. “The collapse of Somalia has been good for business,” he says. “In many ways it is much better off than before. Then we had state monopolies and bureaucracy and corruption, and all the wealth was in Mogadishu. There has been no telephone system here since the late 1980s.”

*Source: The Economist. Aug 28. 1999.*

private sector in view of the business' profitability; unsuccessfully. There may be a role for the public sector subsidies in rural water provision.<sup>26</sup>

#### 11. Courts, law and order, contract enforcement, property rights, and self-regulation

The legal system as far as commercial matters are concerned is either fully dysfunctional or riddled by delays and corruption. The lack of commercial laws or their application (contracts, company laws, lending, foreign investment laws, etc) greatly limits the growth of the private sector. For example, there is no concept of limited liability. Book-keeping and accounting procedures are rarely used, even by large enterprises. Partnerships tend to be short-lived as a result of unresolved disputes. On the other hand the individual or family businesses have a high rate of insolvency, due to lack of risk-sharing. Even when laws exist, they are not enforced or publicized. Since formal courts are dysfunctional, written agreements are usually avoided by businessmen. The Institute for Practical Research and Training in Hargeisa notes a "deeply rooted cultural suspicion of written documents [which] is aggravated by the inefficiency in the formal (modern) court system. The modern courts lack qualified personnel, and court officials are underpaid, which introduces the dangers of corruption and nepotism."<sup>27</sup> In the short run, establishing a formal judicial system may not solve these issues, as illustrated by the experience of the Islamic court set up in North Mogadishu. Militias and judges were recruited, the officials were respected religious leaders. The court succeeded in enforcing the law with an exemplary commitment and incorruptibility for several years, until the leader of the Court, Sheykh Ali Dheere, advocated an extension of the Courts' mandate, beyond keeping law and order, taking over the port Eel Mahan, setting up a taxation system, and casting an eye to political positions. At this point, warlords and clan leaders rose to take power away from the court, which was now openly competing with the authorities for state functions.

To resolve commercial disputes, traditional conflict-resolution mechanisms run by elders are used. Enforcement (or "collection of damages") is also carried out by the clan, after the negotiations have concluded. In terms of contractual relations, enforcement has been based on reputation, clan relations, and trust. Religion also plays an important role in reducing disputes. Many of the successful *hawala*, telecoms, airlines, energy and urban water companies are self-selected respected religious people who trust one another irrespective of clan background.<sup>28</sup> This is sustainable in a small community where interaction is repeated. Looking forward however, as business is conducted with parties outside of the community, repeated relationships and the guarantee of clan will not be as effective. Nevertheless, private dispute-resolution mechanisms meet with some success, especially within a single clan, as the following disputes illustrate (Box 6). In addition to being free, resolution is relatively fast by international standards (1-2 years). The private sector has further imported legal and judicial services provision via off-shore registration, to benefit from the joint stock company structure (e.g. STC Ltd.).

Financial houses have used agency (as opposed to employment) contracting to establish their offices abroad. Agents are responsible for the management of their offices including compliance with local rules and laws, payment of rent, procurement of equipment (fax, computer), office supplies and hiring of local staff.<sup>29</sup> The agent and the financial house agree on the terms of profit sharing, say 30% of profits. A written agreement is signed, more for reference than enforcement purposes, spelling out bonuses, procedures, agent obligations, and the agent's share in the profit. Upon initiation, the agent provides a guarantee deposit to the financial house, ranging from \$10,000 up, which serves as a security against the threat of an agent walking away with all the cash in his office. The agent has a limit on cash holdings at any one time. Any cash over his capacity figure is sent back to the financial house. The above agent relationship is designed in a manner that minimizes moral hazard and contract rescission. In practice, the structure of the relationship, coupled with clan pressure, results in very few agents defaulting to the financial house.

Property rights, especially real estate ownership, are underprotected due to the lack of a fully implemented registration and mapping process. Unregistered private property is considered by law owned by the state.<sup>30</sup> As incomes rise, Northwest Somalia has been experiencing a construction boom in recent years. Cheap

construction materials are imported from as far as South and East Asia. Several reputed architect firms provide design, contracting and construction services, such as Daryeel Construction and Contracting Ltd. Daryeel has 400 local staff of professional builders and surveyors and handles around 100 constructions annually. Real estate registration has not been practiced nor enforced. Few municipalities have plans and plot numbers, and that only for property in the center of town. A private (customary law) solution to the lack of property registration has been applied. Ownership is certified and recognized by building on the land purchased, and further by occupying the premises. Ownership conflicts, such as restitution of land to returning diaspora, are resolved within the clan. Squatters are offered side payments.

Somalia authorities have not been capable of providing lasting peace and security in the country, post-1991. In contrast, business relations have tended to mitigate civil conflict, in their quest for trade and profits. This section illustrates the *abbaan* (contracted protector) arrangements used by livestock traders on their way from the breeder's village to the coast or livestock market. These arrangements are a unique private solution to insecurity and civil unrest, used by livestock traders to transport their fare safe and sound, through territories controlled by different clan groups that are often antagonistic (Box 7).

Industry associations hold some promise in providing self-regulation, inasmuch as they are independent of the influence of any particular industry player. The latter is problematic, for example, since an industry association can never represent the interests of potential entrants, nor those of customers. For instance, a doctor and nurse certification enforced by the medical association would incentive-compatibly be used by insiders to exclude outsiders. Some coordination issues can be resolved, however, as was noted in the case of the telecoms industry. Enforcement of member compliance is also not beyond the cure of voluntary associations, though this has not yet been achieved in Somalia. In the airline industry, cooperation in endorsing tickets and interline agreements is not feasible due to problems in transmission of advance payments. However, one could easily envisage a punishment mechanism for any defaulting member that

Box 7 - Abbaan and the organization of the caravan (livestock) trade

The *abbaan* system, used before colonial times in Somalia, and rendered obsolete by peace and security after independence, has made an impressive comeback with the civil war and explains why the trade links have been open during the worst times of the civil war.

To reach the coast in safety, a caravan obtains protection on its journey among many different and often hostile clans; this is achieved by a semi-institutionalized form of safe-conduct. The leader of the caravan enters into a relationship of protection with an *abbaan* (patron) from each clan on his way. A patron is selected for his probity, status, and above all in a society where force is important, for the strength of his lineage. He is given gifts in return for his services, and is responsible for the security of the caravan, for its goods and for the lives of those on it. Attacks on a protected caravan are attacks on the patron and his lineage whose honor and name can only be upheld by prompt retaliatory action. It is the duty of the patron and his agnates to obtain reparation for any injuries inflicted on the caravan and to hand over the just amount of compensation to the injured lineage.

To ensure against contract rescission by the *abbaan*, the following threat-points exist. First, the *abbaan* would incur the enmity of the caravan owner's lineage. Second, the *abbaan* would lose his reputation and consequently, his livelihood as protector. Bitter verses, composed by deceived caravan owners to vilify their *abbaan*, sweep through the country and blacken a lineage's reputation: "*Haddii aad safar alle tahay, Cali Suufi kuma arkeen*" (If you want to be a good traveler, do not meet the Cali Suufi!).

Source: Roland Marchal, "*The post civil war Somali business class*".

would eliminate the problem. Similar issues with inter-payments settlement prevent telecoms from sharing equipment and gateways. The sharing of information, such as the list of payment defaulters, tips on promotion, industry improvements, as well as sharing of office space / lawyers and accountants (for offices abroad) is also practiced with relative success. Finally, associations are credible in undertaking collective cost activities such as ferreting out market information, promotion at foreign fairs, lobbying the government, procuring increased bargaining power in foreign trade. In sum, careful optimism is not inappropriate for the potential of industry associations to self-regulate in the short to medium run, as a second best solution in the absence of regulation.

In conclusion, private solutions relying on traditional clan customs have been

viable in Somalia and have a role to play in the envisageable future, in the areas of dispute resolution,

contract enforcement, and property rights protection. In the long run, however, as growth introduces outside players into the economy, regulation would have to replace tradition.

### Conclusion

The vibrant Somalia business community has successfully developed new markets from the ruins of civil war, in the context of a severely limited government presence and regulation. In addition to the provision of basic goods and services, the private sector has offered essential infrastructure, and health and education services, whose coverage in some cases extends beyond peak levels achieved under the pre-1991 regime characterized by active government presence.

In spite of such accomplishments, the private sector has not delivered the optimal market outcomes achievable, and there is a role for some regulation. On the other hand, heavy state involvement carries the risk of corruption, weak property rights, and state capture. This study identifies the strengths and limitations of both state involvement and private solutions, on the case of major Somali industries. We delineate the areas where targeted, well-enforced regulation is appropriate, as well as instances where a private solution is sufficient.

The optimal level and complexity of the regulatory burden on business depends crucially on the level of development of the country. In poor countries the state should focus its scarce resources on the provision of a modicum of services, e.g. property rights, rule of law, standardization and quality provisions. Profitable projects should not be operated by the government in poor countries, even in traditionally government dominated sectors such as infrastructure, health, and education. Rules and laws should be simple and transparent, to ease enforcement, and should focus on preventing significant problems, as opposed to fine-tuning minor business faults and market inefficiencies.

**Table 1**

Comparison of certain social and infrastructure indicators

	Somalia	Africa, income \$0-300	Africa, income \$226-\$300	French Africa	Neighbour countries <sup>(1)</sup>
Per capita household income	\$226	\$204	\$263	\$788	\$438
<i>Poverty and income distribution</i>					
Gini coefficient <sup>(2)</sup>	40	45	45	42	47
Extreme poverty <sup>(3)</sup>	43%	59%	64%	32%	52%
<i>Infrastructure</i>					
Road 1000 km/ 1 million people	3	3	3	3	3
Telephones per 1000 population	15	6	7	28	10
<i>Sanitation and health</i>					
Access to health facilities <sup>(4)</sup>	55%	56%	60%	63%	62%
Access to safe water	21%	53%	54%	65%	60%
Access to sanitation	50%	42%	44%	54%	63%
<i>Literacy and education</i>					
Gross enrollment	17% <sup>(5)</sup>	83%	86%	87%	66%
Adult illiteracy rate	81%	48%	48%	45%	35%

Source: Socio-Economic Survey 2002: Somalia, The World Bank / UNDP Somalia, Watching Brief 2003, and WDI.

Notes:

(1) The sample includes Kenya, Djibouti, Ethiopia.

(2) A value of 10 signifies perfect equality.

(3) Share of the population with per capita income less than \$1 PPP per day.

(4) Percentage of the population with access to a health facility.

(5) 20.8% for boys and 12.7% for girls.

## ENDNOTES

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- <sup>1</sup> The average rate for African countries is \$0.24/minute, and only six out of 43 countries with available data have cheaper rates than Somalia (ITU, 2002 data).
- <sup>2</sup> Djankov et al. "Regulation of Entry", QJE 2002.
- <sup>3</sup> The figure is 52% for urban population, however, the nomadic population, which makes up more than half of the total population in the country, has barely access to treated water (only 3% report such access).
- <sup>4</sup> In the case of education, other factors explain some of the immense gap in the Somalia indicators relative to those of other countries: nomadic mode of life of more than half of the population, coupled with traditional beliefs that Quranic education is the only type of knowledge needed in life, as well as traditional gender beliefs. The *modus operandi* of Quranic schools is for religious men to train children to memorize the Holy Koran. In some cases, other disciplines necessary for developing the Muslim world-view (e.g. Arabic language) are taught. Cheap and flexible, equally accessible to boys and girls, attended 50%, Quranic schools may seem like a promising venue for basic education; however, an experiment run by UNICEF suggest otherwise (Morah and Musa, 1997; UNICEF-Somalia, 1999a).
- <sup>5</sup> UNICEF, "Survey of Primary Schools in Somalia 2002/3", 2003.
- <sup>6</sup> Madison (1989), UK's GNP/ capital in 1900 was \$4588 (1993 USD), and that of Mexico was \$4062 in 1987 (1993 USD).
- <sup>7</sup> Noor, Mohamood, The Absence of Government in Somalia: Positive and Negative Impact on Socioeconomic Sectors, 2000.
- <sup>8</sup> For a detailed discussion of the livestock sector, see for example Peter Little, "Somalia: Economy Without State", 2003.
- <sup>9</sup> Smaller version of a sea-craft, usually very old and in a state of disrepair.
- <sup>10</sup> Committee on Economic Recovery, Institutional Building and Resource Mobilization, "3<sup>rd</sup> Draft Report", 2003.
- <sup>11</sup> Prior to the civil war, the Somali veterinary code in Law no. 20 of 1967 was in force, administered by the National Veterinary Board (NVB).
- <sup>12</sup> Marchal, Roland, "The Post War Somali Business Class", 1996.
- <sup>13</sup> Livestock traders set up a network for purchasing the animals, composed of subcontracted traders called *dilaal*. Herders from the entire Somalia, as well as some parts of Ethiopia, bring their livestock to a market place, usually a village, or a well. The *dilaal* visits a number of villages and wells, and collects the livestock in warehouses owned by the livestock trader, and located in district main markets or in regional town markets. Once a sufficient number of animals have been accumulated, the *dilaal* transports them by trucks or on foot to the export port (Mogadishu, Kismaayo if working, Boosaaso, Berbera). The livestock exporter will purchase the livestock from the *dilaal* and export it to Saudi Arabia, Yemen and, to a lesser extent, Egypt and Dubai. Marchal, Roland, "The Post War Somali Business Class", 1996.
- <sup>14</sup> Ahmed, Ismail, "Remittances and their Economic Impact in Post-war Somaliland", 2000.
- <sup>15</sup> Noor, Mohamood, The Absence of Government in Somalia: Positive and Negative Impact on Socioeconomic Sectors, 2000.
- <sup>16</sup> 1989 air route and traffic information is from "Removing Barricades in Somalia: Prospects for Peace", US Institute for Peace, October 1998.
- <sup>17</sup> UNICEF, "Survey of Primary Schools in Somalia 2002/3", 2003.
- <sup>18</sup> UNICEF, "Primary Schools' Survey Data", 1998/99.
- <sup>19</sup> Adapted from "Somalia Year 2000 Education for All" Assessment Report, World Education Forum, UNESCO, 2000.
- <sup>20</sup> Bennaars et al., 1996; Development Solutions for Africa, 1998; Retamal and Devadoss, 1998; UNICEF-Somalia, 1998, 1999; UNDP, 1998; Wamahi et al., 1999.
- Somali parents perceive the economic value of education for their children; however the direct and opportunity cost of education may be too high for all or even any children to be sent to school. The children are an important helping hand to the family. The boys rear the cattle, the girls fetch water, heat the stove, and help with the younger children and with the cooking. This is especially true for girls, resulting in a rather skewed student gender balance. In the case of nomads, which compose 55% of the Somali population, the cost of sending a child to a stationary school is exorbitant: not only does the family lose a helping hand with the animals, but they burden a relative with sheltering and caring for the child, while the nomadic family move in search of pasture and water for the entire year.
- <sup>21</sup> Noor, Mohamood, The Absence of Government in Somalia: Positive and Negative Impact on Socioeconomic Sectors, 2000.
- <sup>22</sup> Marchal, Roland, "The Post War Somali Business Class", 1996.
- <sup>23</sup> Marchal, Roland, J.A. Mubarak, M. Del Buono, D. L. Manzollilo, "Globalization and its impact on Somalia", UNDP/UNDOS, Nairobi, January 2000.
- <sup>24</sup> Marchal, Roland, "Survey of Mogadishu's Economy", EU report, 2002.
- <sup>25</sup> Noor, Mohamood, The Absence of Government in Somalia: Positive and Negative Impact on Socioeconomic Sectors, 2000.
- <sup>26</sup> Committee on Economic Recovery, Institutional Building and Resource Mobilization, "3<sup>rd</sup> Draft Report", 2003.
- <sup>27</sup> Mohamoud, Mohamed Haji, "Revitalizing the Private Sector", 2000.
- <sup>28</sup> I thank Mr. Mohamood Abdi Noor for this insight.
- <sup>29</sup> Abdusalam Omer, "Supporting System and Procedures for the Effective Regulation and Monitoring of Somali Remittance Companies (Hawala)".
- <sup>30</sup> 1975 Real Estate Law, Art. 1