BANKIGA DHEXE EE SOOMAALIYA
البنك المركزي الصومالي
CENTRAL BANK OF SOMALIA

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Somalia's Government Fiscal Operations

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Central Bank of Somalia

Somalia's Government Fiscal Operations

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Central Bank of Somalia

May 2023

EXECUTIVE SUMMARY

Somalia has a set of unique challenges – from persistent and recurring environmental shocks to prolonged insecurity and political instability. On top of these challenges, the country has one of the most restrictive fiscal spaces in the world. More specifically, total domestic revenues are below 3 percent of GDP while domestic tax revenues are around 2 percent of GDP. Consequently, domestic revenues are unable to satisfy the Federal Government's (FGS) basic expenditure needs, which are more than 8 percent of GDP. More than 90 percent of the Federal Government expenditure is devoted to recurring costs in the form of compensation of government employees and security personnel and the use of public goods and services. Public sector capital spending practically does not exist, and general public services are broadly absent. As a result of the severely restricted fiscal space, the Federal Government relies heavily on multilateral and bilateral grants which are estimated to have contributed close to 73 percent of the fiscal target, as of December 2022, and 64 percent of the YTD total fiscal receipts. Only 27 percent of the programmed budget was expected to be sourced from domestic revenues though this reached 36 percent of the actual budget.

Consequently, the fiscal performance of the FGS has consistently been under stress, particularly over the past couple of years. As mentioned above, this is mainly due to few domestic revenue streams and overreliance on external grants (bilateral and multilateral), which has intensified uncertainty and impeded basic public service provision, especially when grants fall due to political reasons.

Even though the FGS operates on a balanced budget, occasionally fiscal gaps do occur, which must be financed. For example, between the second half of 2021 and the first half of 2022, all budget support by international partners was withheld due to the delays to conclude the parliamentary and presidential elections. This resulted in significant and pressing financing gaps. The FGS had to exhaust its fiscal buffer, secure short-term advances from the Central Bank of Somalia and eventually utilize its IMF Special Drawing Rights allocation.

This policy brief emphasizes the importance of addressing the persistent weak fiscal space in Somalia. As noted in the Central Bank of Somalia's Quarterly Economic Review (2022Q4) and in the Ministry of Finance's End-Year Budget Fiscal Performance Report (FY2022), it is imperative for the FGS to considerably increase its revenue mobilization as a matter of priority. This policy brief makes several policy recommendations, identifying alternative policy options that should be considered to enhance revenue mobilization, public financial management, and public sector integrity.

INTRODUCTION AND CONTEXT

Poor execution of donor-funded projects and lower absorption remain a serious challenge for the FGS. The lower absorption rates are due to weak project management and implementation capacity on the government side while the weak execution is mainly due to complex procurement and disbursement procedures by donors. Additionally, perceived integrity issues and corruption risks too cannot be ignored in the context of Somalia, which adds to the complexity. Thus, the execution rate of donor-funded projects throughout the last three years has not exceeded 46 percent, on average, which indicates there might be an underlying issue with the management of donor funds that needs to be addressed and resolved.

On the 30th of June 2022, the House of the People and the Upper House of the Federal Republic of Somalia's parliament jointly passed the 2022 fiscal budget for the FGS. The prolonged election delays and the absence of legitimate representation in the two chambers of parliament were the main reasons the budget approval process was delayed by six months (it was supposed to be approved in Dec 2021).

In 2022, the FGS estimated its target budget allocations to be around US$945 million. Yet, the existing cumulative data points to an expected fiscal gap. This gap is projected to have widened further because of the delays in planned elections that consequently led to shortfalls in expected donor funding. Somalia stood to gain a lot from the irrevocable IMF debt relief program. However, due to the delay in elections and subsequent political uncertainty, the Heavily Indebted Poor Countries (HIPC) initiative was jeopardized by political stalemate, which made it difficult for the country to gain timely financial support. Inevitably, the government was forced to constitute budgetary restraints.

Somalia's domestic revenue portion of its fiscal target is significantly low, with an estimated contribution of 27 percent in the fiscal year 2022. Fortunately, actual domestic revenue collection amounted to $262.8 million in 2022, which was 105 percent of the target of $250 million. Domestic revenues were 15 percent higher than the amount collected in 2021 ($229.6 million).

Considering 2022Q4 only, the FGS received a total fiscal receipt amounted to US$267.7 million but spent $309.5 million. The excess spending of US$41.8 million was largely financed by withdrawals from the fiscal buffer and IMF SDR. Total recurrent expenses were around US$303 million, which is 98 percent of total spending while capital expenditure was spent only US$6.2 (2 percent of the total actual recorded expenditure spending).

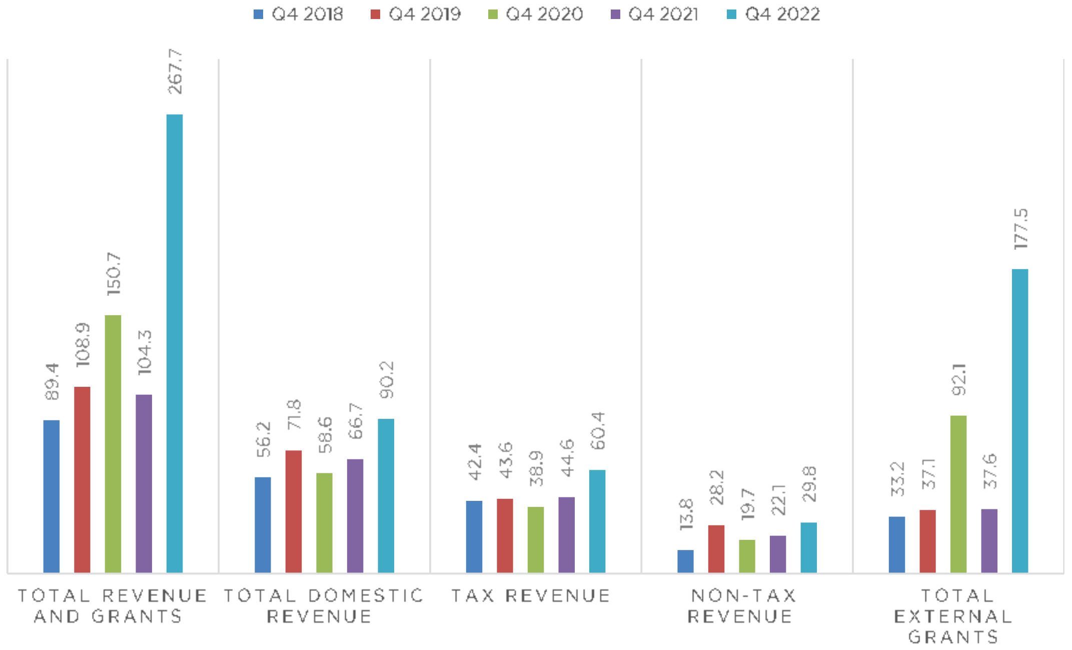
Although the government is making efforts to maintain its expenditures within the fiscal spending envelope, the reality is that the actual recorded expenditure is increasing. This is evident in the actual recorded government expenditure for 2022, which reached more than US$ 731 million. Therefore, overall expenditure has significantly increased by 54 percent compared to the previous year. Unfortunately, while expenditures are increasing substantially, the revenues and grants are unable to keep up with them, resulting in an expected fiscal gap of around US$10 million in 2022. Most of the fiscal gap was incurred in 2022Q4, where expenditures reached significant levels (a gap of about US$42 million).

When the government is unable to raise enough resources to run its expected programs, then this puts unnecessary pressure on government agencies and undermines basic public service provision. This, in turn, makes it difficult for the country to emerge from fragility and insecurity.

In 2022, overall recurrent expenditure (mainly salaries of civil servants, security personnel, basic social benefits, and the purchase of goods and services) totaled US$718.2 million, which represents 98 percent of total spending. This is significantly higher than the US$457.8 million spent on recurring costs in 2021 fiscal year. Only US$13.2 million was channeled into capital spending in 2022 against the $42.8 million budgeted for the year. Capital spending is only 2 percent of the total actual recorded expenditure, 18 percent lower than the level of the previous fiscal year.

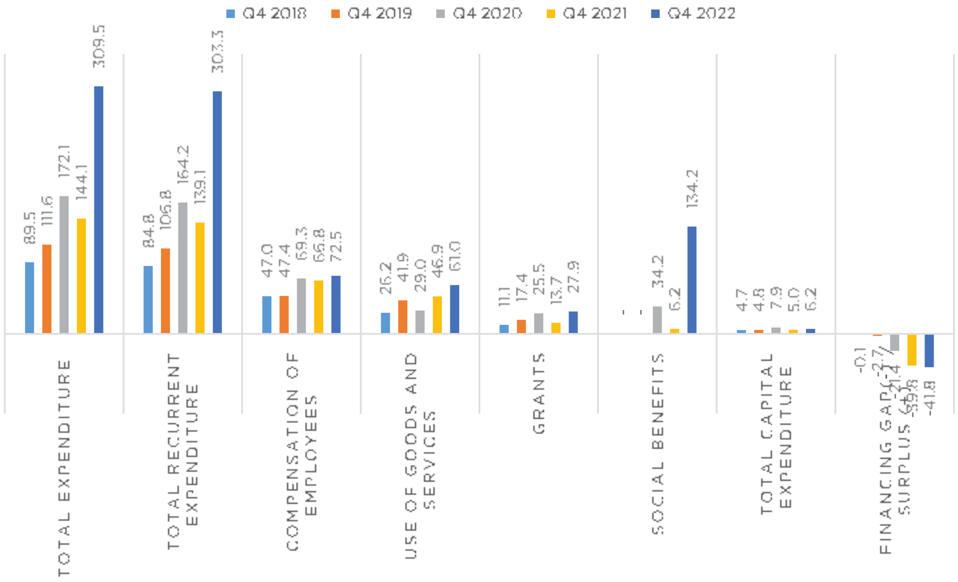
The low capital expenditure allocation implies that the country is unable to invest in its development in the form of machinery and equipment, and infrastructure (e.g., roads), which would have benefited the country and economy over time. Once the country invests in its development, then both domestic revenue mobilization and service delivery are expected to improve. The limited capital expenditure is also likely to scare away potential investors that would have otherwise helped to build the economy.

Figure 1: Quarterly Revenue and Expenditure Comparison (2018Q3-2022Q4)



Source: MoF, 2022

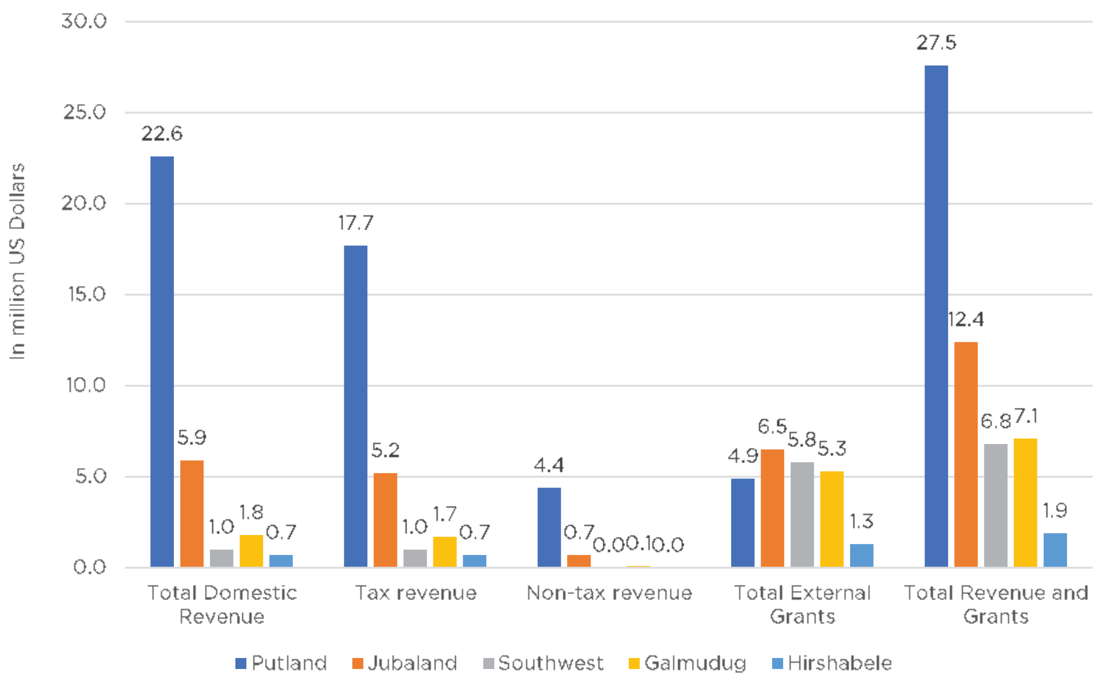
In 2022Q4, FGS recorded its highest total domestic revenue and recurrent expenditure since 2018Q4 (Figure 1). Moreover, the grants received during the fourth quarter of the fiscal year 2022 were US$177.5 million, up from US$38 million which represents a significant jump of 378 percent, when compared to the grants received in 2021Q4 which was more than five-fold. This was due to the withholding of grants between the second part of 2021 and the first part of 2022 given the delayed elections.



Source: MoF, 2022

Although the FGS was meant to operate a balanced budget, there was, as mentioned before, a widening fiscal gap has been observed over the past couple years due to expenditure commitments. For instance, in 2022Q4, total expenditure was much higher than the revenue and grants received. Worryingly, capital expenditure has been generally low since 2018Q4. This indicates low investments in assets that would have, in turn, supported the growth of the economy over time.

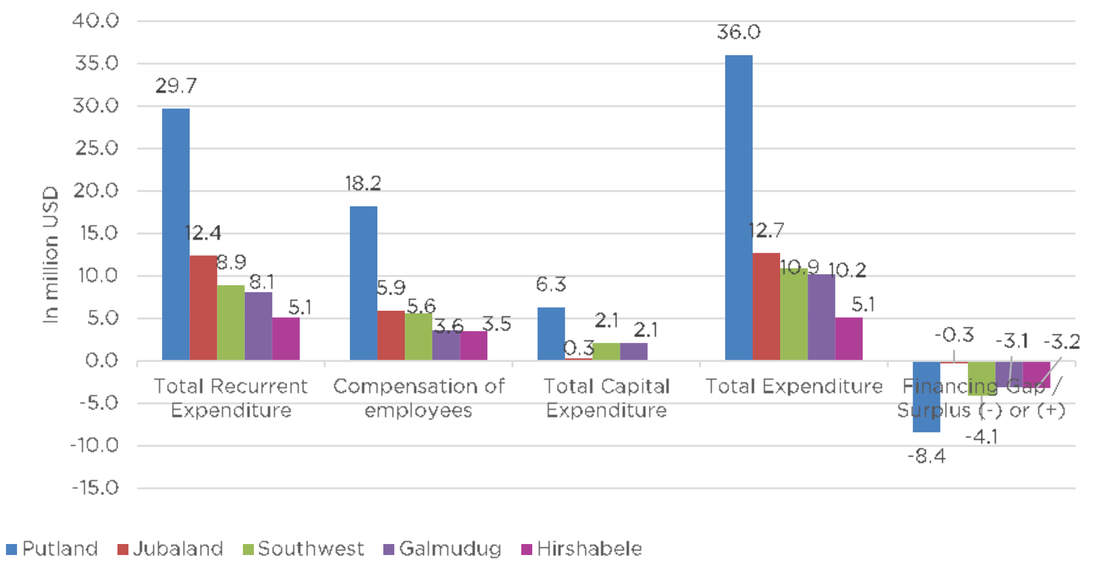
Figure 2: The Summary of Federal Member States Grants and Revenues 2022Q4.



Source: MoF, 2022

During 2022Q4, the Puntland State of Somalia generated the highest fiscal receipt (US$27.6 million) of all Federal Member States (FMSs, see Figure 2). Jubbaland, Galmudug, Southwest, and Hirshabelle received, respectively, US$12.4 million, US$ 7.1 million, US$6.8 million, and US$1.9 million. Although all FMSs recorded higher total fiscal receipts (revenues and grants), none of them was able to cover its expenditure commitments. Consequently, they all recorded fiscal gaps (Figure 3).

Figure 3: Federal Member States Expenditure Q4 of 2022



Source: MoF, 2022

KEY NOTABLE ISSUES

1. Domestic revenue mobilization remains insufficient to cover basic FGS recurrent expenditures.
2. There is high dependence on external grants just to cover the basic operational needs of the FGS.
3. Grants usually come with many pre-conditions, which may limit the government's ability to target priority sectors. Also, as grants are being used for operational needs, the government is unable to allocate sufficient resources to development projects and programs.
4. Donor-funded projects and programs have both weak execution and absorption rates due to complex procurement and disbursement rules by donors but also weak implementation capacity by the government.
5. Perceived integrity and corruption risks add to the complexity of donor-funded projects and programs.
6. The tax base is extremely low, and taxes are dominated by indirect sources such as customs, which is a concern.
7. Domestic revenues as a share of GDP remain quite low (tax revenue to GDP is, on average, around 3 percent in (2018 - 2022), making it challenging for the government to provide basic public services.
8. Due to the unreliability of external grants, and the mismatch between revenues and expenditures, fiscal gaps are likely to occur to the detriment of the overall fiscal balance.
9. The FGS's continued inability to meaningfully boost its capital expenditures (as an instrument of fiscal policy) implies that it has had negligible influence on the performance of the wider economy.
10. Somalia's debt relief process and ongoing IMF ECF program requires successful completion. This process underpins Somalia's future access to concessional resources.
11. The importance of maintaining a fiscal buffer cannot be overemphasized given the dynamics of Somalia's fiscal performance.
12. Utilizing temporary advances from CBS or using IMF SDR allocations have significant costs and may undermine fiscal sustainability.
13. To spend over 90 percent of government budgets on recurrent costs is not a viable fiscal strategy.

POLICY RECOMMENDATIONS

Finalize concrete arrangements on fiscal federalism and adopt revenue- and resource-sharing agreements between FGS and FMSs:

- Adopt an integrated and harmonized/unified fiscal federalism framework and broaden the tax system of the country.
- Implement integrated arrangements covering resource-sharing agreements.
- Expand public sector provision at all levels including FMSs.

Government needs to significantly enhance domestic revenue mobilization to lessen its dependency on external grants:

- Widen the share of domestic revenues by widening the country's tax base to at least offset recurrent costs. There is also a need to incorporate more revenue streams into current revenue sources to improve revenue receipts.
- Government should enhance its tax, legal and administration capacities to enable a more effective tax regime.
- Tap into the country's productive sectors such as natural resources (oil and gas), agriculture, and fishery sectors to generate more domestic revenues.

Implement policies to strengthen productive capital expenditures:

- To ensure better performance of the economy, the government needs to allocate a portion of project grants to capital expenditure such as machinery, property, equipment, and infrastructure to benefit the economy over time.
- Allocation of sufficient budget and investment to capital expenditure would lead to the creation of long-term assets, generating future revenues and economic growth over time. This will also improve production facilities and boost operational efficiency.
- Government should set a target limiting its recurrent spending in favour of more targeted capital spending if it wishes to succeed in boosting economic growth and creating more jobs.

Adopt effective policies to govern public debt and borrowing policy:

- There is a need for the FGS to formulate a medium-term debt management strategy in line with its long-term debt sustainability to ensure that its financing needs and its payment commitments are done at the lowest possible cost, both in the short and long-term, consistent with prudent debt management.
- Debt management capacity needs to be developed given the complexity of debt acquisition and implications.
- The FGS should put in place the necessary legal and regulatory frameworks for effective debt management.

Implement policies that promote a favourable economic climate through a stable political environment and enhanced public sector integrity:

- Enhance the overall economic climate by focusing on key bottlenecks such as infrastructure, access to finance, access to domestic and external markets, and by enforcing the rule of law.
- Improve political and economic stability by enhancing transparency and accountability within the public sector.
- Promote an enabling environment through dedicated programs aimed at addressing petty corruption.

Foster public engagement and inclusivity in the budget-making process:

- To enhance the link between the FGS and taxpayers, the FGS should have a public communication strategy relating to taxes and expenditures. Also, the FGS should deliver tangible public projects that can impact on the lives of the citizens, which can be showcased.
- The FGS should put in place effective public involvement strategies to increase its responsiveness to and accountability to the citizens. This will enhance the FGS' credibility and improve public trust.
- The FGS should consider the establishment of a public investment management strategy as a matter of priority.
- The FGS should support a more efficient and well-executed budgeting processes with public and stakeholder participation. This will enhance revenue mobilization and the targeting of right priorities.

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