SOMALIA

Budget Policy Brief #2

Prepared by Staff and Associates
of the Horn Economic and Social Policy Institute (HESPI)

August 2024

SOMALIA BUDGET POLICY BRIEF #2

By

The Horn Economic and Social Policy Institute (HESPI)

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Preface

This Budget Policy Brief (BPB) is the second assessment of the macroeconomic and fiscal framework for Somalia through the second quarter of 2024 (Q2). It covers the developments of the principle macroeconomic indicators; including economic growth, inflation, the debt burden situation of the country, and the Federal Government of Somalia (FGS) and Federal Member States' domestic revenue mobilization and expenditure performances. The brief is organized into the following sections: Recent Macroeconomic developments; Government Budget Operations; Fiscal developments outturn; comparison of fiscal operations; Federal Member States financial operations. The analysis underlying the Budget Brief has been facilitated by data made available by the FGS Ministry of Finance, Federal Member States(MFS) and other public agencies.

Following this Preface and Key Messages, the content of the Brief is organized into six (6) sections as follows: Recent Macroeconomic Developments, Federal Government of Somalia Operations, FGS fiscal developments outturn for the first half of 2024, FMSs financial operations for the first half of the year, the Special Issue coverage: Domestic Revenue Mobilization Reform, and Findings and Recommendations of the Budget Policy Brief # 2.

This Budget Policy Brief was prepared by staff and associates of the Horn Economic and Social Policy Institute (HESPI), and we are grateful to them all particularly the primary contributor to the special coverage of the domestic revenue mobilization reform section—Mr. Jafar M. Ahmed the former Director of the Revenue Department of the Ministry of Finance of Somalia

Key Messages of Budget Policy Brief

Issues	*Recommendations*	*Action Responsible party*
Very low revenue to GDP ratio, evidences the urgency for domestic revenue mobilization	• *Increase domestic revenue mobilization through urgent reform of tax policies and strengthened administration.*	*Ministry of Finance, Directorate of Revenue.*
The unpredictability of donor funding flows inhibits sound budget performance.	• *Enhance the predictability of donor finance disbursements and thoroughly assess pledges efficacy.* • *Strengthen absorptive capacity of government ministries, departments and agencies*	*Ministry of finance, director General, and director of aid coordination*
Limited spending on social services delivery, and low spending on capital investments.	• *Augment domestic revenue generation and/or external funding* • *Limit the non-essential spending on recurrent budget, and the leakage from all public spending. Provide higher priority to social sectors spending and to capital investments.*	*Ministry of Finance, Director General and Director of Budget*
Low revenue base of FMSs	• *Diversify and broaden the revenue base of Federal Member States and increase financial transfers from the FGS.*	*Ministries and Departments of the Federal Member States Federal Member States*
Participation of the public in the budget processes is limited	• *Strengthen public participation, and transparency and accountability in the government budget formulation, and oversight.*	*Ministry of Finance and Parliament*
Post-HIPC debt sustainability	• *In order to have room for debt servicing, Domestic Revenue must be sufficiently enough to cover recurrent expenditure by 2027.*	*Ministry of Finance, Directorates of Revenue, and Budget.*

1. Recent Macroeconomic Developments

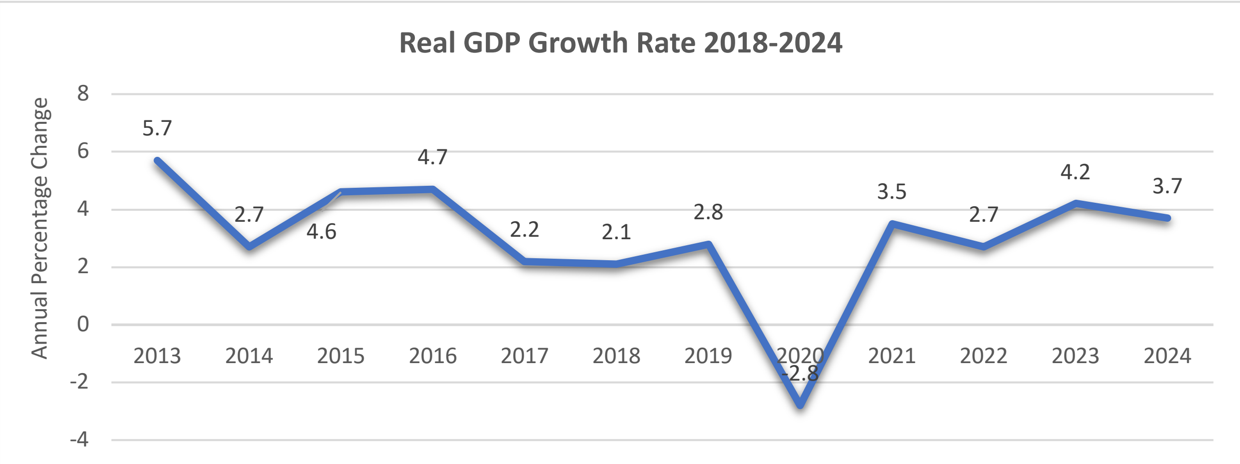
Somalia has been pursuing wide-ranging reforms to strengthen critical economic and financial institutions to recover from the persistent shocks related to the recurrence of extended insecurity, severe droughts and floods, and the impact of the COVID-19 pandemic. During 2018-22, the growth rate remained at very low single digits because of the adverse effects of the prevailing insecurity on agriculture and other productive sectors. In part reflecting the improving climate and other conditions such as recovery in agriculture, more significant inflow remittances, and higher investments, the real GDP is projected to grow by 3.7 percent in 2024, from 4.2 percent in 2023 (table 1: Key Macroeconomic Indicators).

TABLE 1: Key Macroeconomic Indicators

Economic Indicator	FY2022	FY 2023	FY2024
GDP, Nominal(Millions)	10,420	11,515	12,489
Real GDP Growth (%)	2.4	2.8	3.7
Per Capita	664	695	676
Average annual inflation	6.8	5.7	4.1
Debt to GDP (%)	37.4	6.6	6.1

Sources: FGS and IMF staff estimates and projections 2024.

FIGURE 1: Real GDP Growth Rate



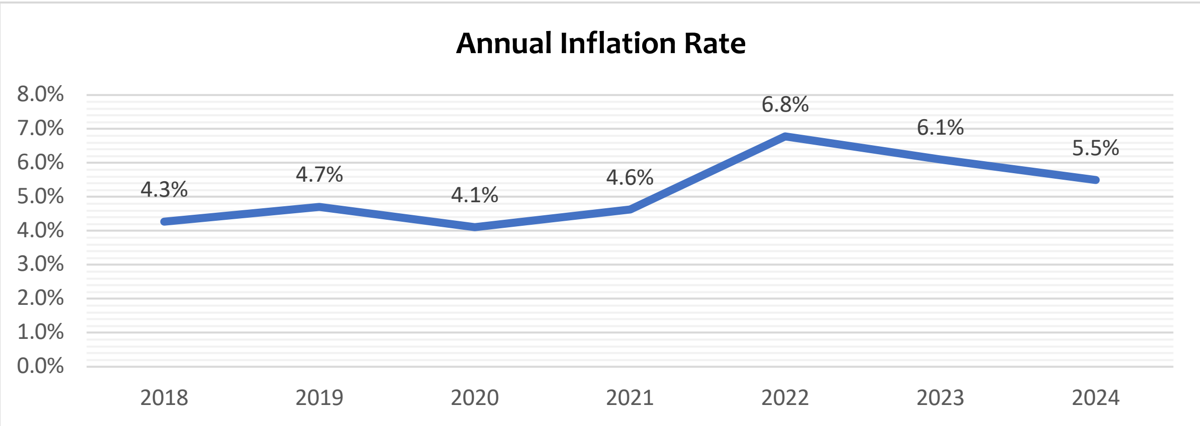
Source: SNBS and IMF projections, 2024

Somalia's economy has shown promising signs of growth, making a significant rebound in 2023. This growth was primarily driven by the strong performance of the livestock sector, particularly the surge in livestock exports, and the good performance in the agricultural sector. The total livestock exports increased in 2024, contributing to 40 percent of the real GDP growth. The country is confronted with a complex web of interconnected challenges, making generating sustainable and inclusive growth a formidable task. These challenges, which range from the need to stabilize and secure rural areas, the volatility in domestic political stability, the uncertainties in the global environment, and the risks posed by adverse climate conditions, are all compounded by critical governance challenges. The imperative for practical cooperation and coordination across all levels of government is crucial to address these challenges. Furthermore, the widespread food insecurity and the scarcity of employment opportunities are severe impediments to poverty alleviation and hinder the country's transition to sustained and higher economic growth rates.

Average Inflation Rate

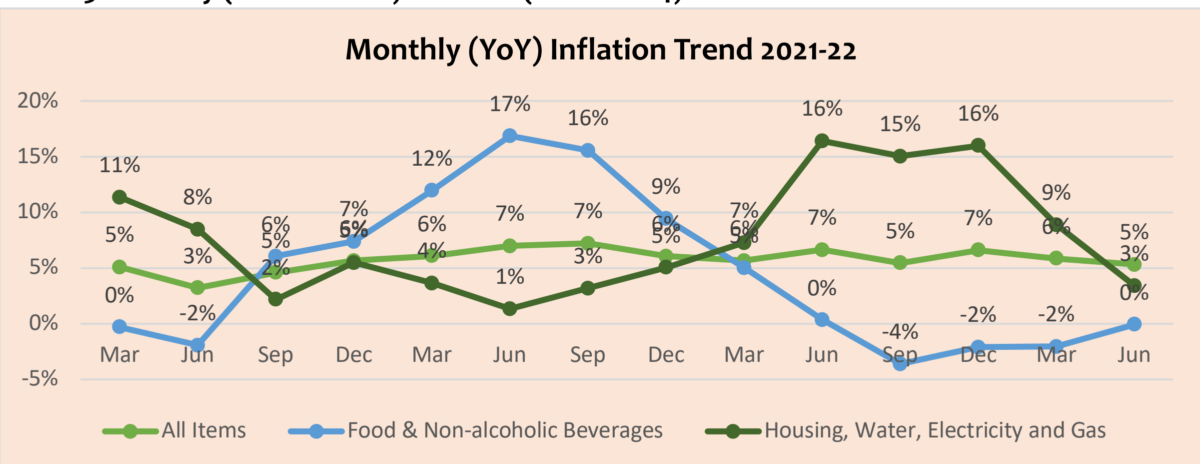
Since 2018, the average annual inflation rate has remained in single digits and declined from 6.8 percent in 2022 to 6.1 percent in 2023. This decrease can partly be attributed to better crop production and reduced commodity prices. These factors are projected to further reduce the inflation rate to 4.8 percent in 2024. In the first quarter of 2024, the average inflation rate recorded 5.9 percent, from an average of 5.6 percent in the same period last year. The main driver of inflation in this period was the price increases for the Eid Al-Fitr, Al-Adha purchases, and other global conflicts including Ukraine war and Israel-Palestine conflict.

FIGURE 2: Annual Average Inflation Rate



Source: SNBS and IMF estimates, 2024

FIGURE 3: Monthly (Year on Year) Inflation (2021 – 2024)



Source: SNBS and IMF estimates, 2024

In June 2024, the inflation rate stood at 5.3 percent (YoY), compared to 5.2 percent and 4.8 percent in April and May, respectively. On average, the second quarter of 2024 recorded 5.1 percent, compared to 5.9 percent in the preceding quarter and 6.5 percent in the last year. The average annual inflation is projected to decelerate to 5.5 percent in 2024 from 6.1 percent in 2023. Food and beverages, housing, water, electricity, gas, and health are positive contributors, providing a stable foundation for the economy. On the other hand, communication(41.44 percent), recreation(31.60 percent) and hotels & restaurants(28.14 percent) are negative contributors.

Somalia's Debt Burden

The country's journey to the Highly Indebted Poor Countries (HIPC) debt relief completion point in December 2023 is a testament to its commitment to fiscal responsibility. This commitment has significantly reduced Somalia's national debt-to-GDP ratio from a burden of over 60 percent in 2018 to a promising level of 6 percent in December 2023. In concrete terms, the public debt decreased from US$5.3 billion at the end of 2018 to US$0.6 billion at the end of 2023. This decline in public debt sets a positive trajectory for the country's financial future, assuming improved financial management is maintained and the sound management of contracting new external debt is put in place and sustainable levels of indebtedness are ensured over the medium and long term.

TABLE 2: Somalia Debt Burden (Before and After HIPC Program)

	2018		2022		2023	
	In millions of US$	% of GDP	In millions of US$	% of GDP	In millions of US$	% of GDP
Total Public Debt	5,345.1	64.6	3,894.8	37.4	766.3	6.6
Total External Debt	5,268.1	63.6	3,827.0	36.7	698.4	6.0
Multilateral	1,535.7	18.6	1,074.9	10.3	467.7	4.0
Bilateral	3,730.1	45.1	2,749.5	26.4	230.3	2.0
Paris Club	3,037.6	36.7	2,004.5	19.2		
Non-Paris Club	692.6	8.4	745.0	7.2		

Source: IMF Estimates and Projections, 2024.

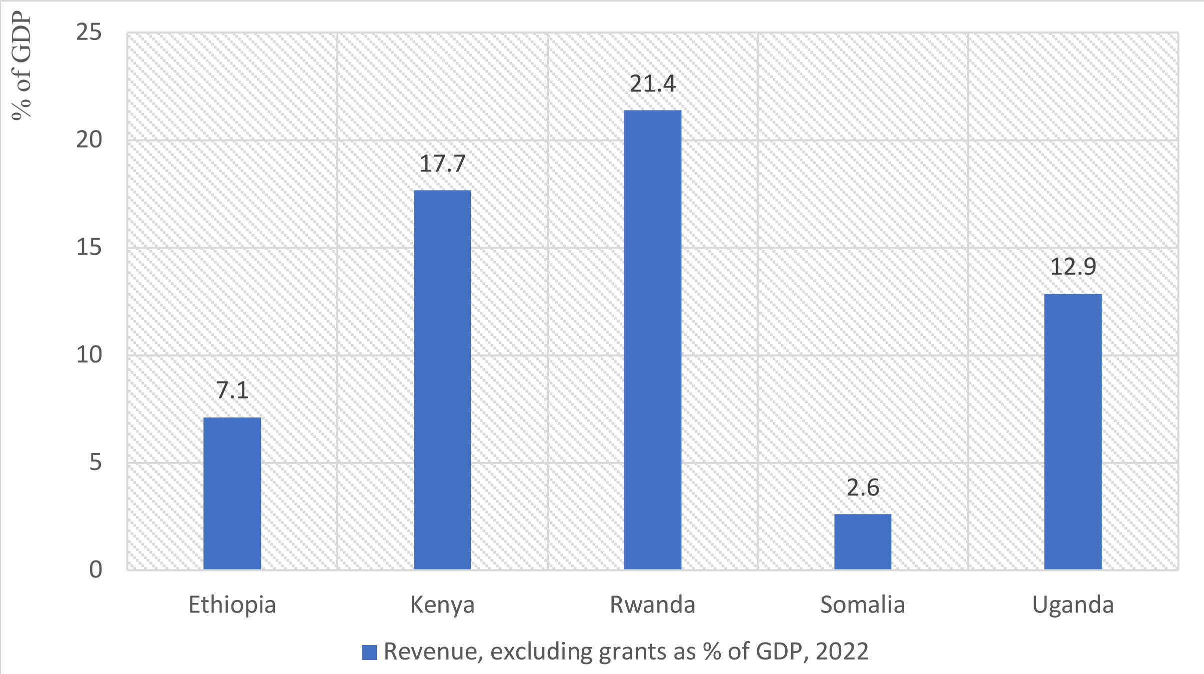
2. Government Budget Operations

Somalia has been operating under a challenging fiscal environment, marked by inadequate domestic revenue mobilization, limited delivery of essential public services, and a heavy dependence on external grants. The government's efforts to reform this complex fiscal landscape, with significant international support, have been ongoing. However, the slow progress of these reform efforts, as demonstrated by the public database of the past five years, underscores the need for more effective strategies to address the fiscal challenges.

Revenue and Expenditure Trends

Somalia's GDP revenue (excluding grants) is not just low; it's alarmingly low, standing at a mere 2.4 percent. In comparison, Somalia is an extreme outlier in its limited capacity to raise domestic revenue when compared to the Eastern African countries. This, however, has been due to the instability that the country has suffered for the last three decades. Before the war in 1991, Somalia's tax to GDP ratio was about 12%(?). Somalia's overall challenge in area of revenue mobilization remains catching up with East African countries like Rwanda, for instance, which currently has a revenue share of GDP at a staggering 21.4 percent, followed by Kenya at 17.7 percent, Uganda at 12.9 percent, and Ethiopia at 7.1 percent of GDP.

FIGURE 4: Selected Government Revenue (excluding grants) as % of GDP (2022)



Source: World Bank Database, 2024

The annual domestic revenue in 2019-23 averaged 2.4 percent of GDP and ranged from 2.3% to 2.7% annually (Table 3), with tax revenue averaging 1.68 percent of GDP annually. Non-tax revenues yielded a modest 0.8 percent of GDP annually during the five years ended 2023. The challenges in domestic revenue generation are not just severe; they are urgent and demand immediate attention(see section 6: Domestic Revenue Mobilization Reform). The need for action is pressing. Despite numerous reform efforts, the strengthening of domestic resource mobilization has remained slow and needs to be improved. The causes for this situation are complex, including generalized insecurity and instability and apparent weaknesses in tax and non-tax administration.

The country's fiscal expenditures have been significantly constrained by the limited domestic revenue and the precarious reliance on external grants with unpredictable disbursement schedules. As demonstrated in Table 3 fiscal accounts summary, the overall annual expenditure of FGS fluctuated from 2.9 percent of GDP in 2019 to 4.1 percent in 2022 over the past five years. Recurrent expenditure of the FGS, which constituted about 80 percent of the total public spending annually, was primarily allocated to the compensation of employees, accounting for almost 70 percent of aggregate expenditures. This left only modest amounts for goods and services or transfers to the federal member states.

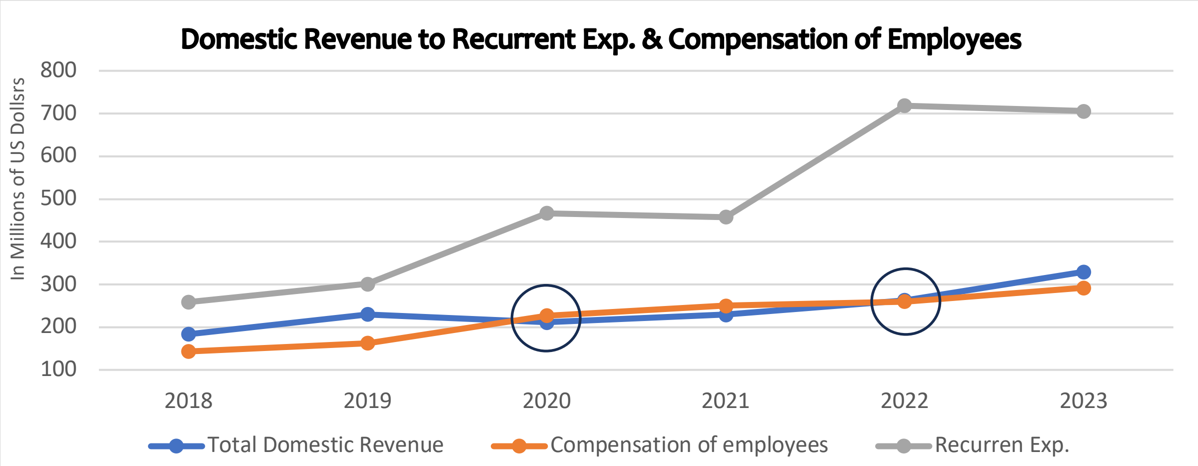
TABLE 3: Somalia Fiscal Accounts (Percent of GDP)

	2019	2020	2021	2022	2023	budget 2024
Revenue excluding projects	**3.2**	**4.0**	**2.7**	**4.2**	**3.8**	**4.0**
Domestic revenues	2.4	2.3	2.3	2.5	2.7	**2.8**
Tax	1.6	1.5	1.7	1.7	1.9	1.9
Non-tax	0.8	0.8	0.7	0.8	0.8	0.8
Budget support grants	0.7	1.7	0.4	1.6	1.1	1.2
Expenditure excluding projects	**2.9**	**3.7**	**3.6**	**4.1**	**4.0**	**4.3**
Operational expenditure	2.3	3.0	3.2	3.3	3.4	3.6
Compensation of employees	1.7	2.4	2.5	2.4	2.5	**2.6**
Good and services	0.7	0.6	0.7	0.9	0.8	0.9
Interest	0.0	0.0	0.0	0.0	0.0	0.1
Other expenditure	0.6	0.7	0.4	0.8	0.6	0.7
Transfers to FMS	0.4	0.7	0.4	0.7	0.5	0.6
Social benefits	0.0	0.0	0.0	0.0	0.0	0.0
Capital expenditure	0.1	0.0	0.0	0.1	0.1	0.1
Overall balance excl. projects	**0.3**	**0.3**	**-0.9**	**0.0**	**0.1**	**-0.3**
Projects grants	0.2	1.4	1.1	2.8	2.5	4.4
Project expenditure	0.2	1.4	1.1	2.8	2.5	4.4
Total revenues incl. projects	**3.3**	**5.4**	**3.8**	**6.9**	**6.4**	**8.4**
Total expenditure incl. projects	**3.1**	**5.1**	**4.7**	**6.9**	**6.5**	**8.7**
Overall balance incl. projects	**0.3**	**0.3**	**-0.9**	**0.0**	**0.1**	**-0.3**

Source: Somali Authorities and IMF Staff Estimates.

Given the limited revenue performance and the relatively high demand for employees' compensation, it's clear that more than domestic revenues are needed to cover employees' compensation alone (see figure below). This underscores the urgent need for additional revenue sources. Even including the annual budget support grants received for five years ended in 2023, limited fiscal space was available to deliver essential public services, including education, health, and social protection support, during the period. Though modestly improved performance has been evidenced for the last two years, whereby domestic revenue covered the spending of civil and security personnel, and January to June 2024 data following the same pattern, the requirement to cover all recurrent expenditures by 2027 remains a daunting challenge. This emphasizes the gravity of the situation and the need for strong domestic revenue mobilization reform action.

FIGURE 5: Domestic Revenue to Recurrent Expenditure and Compensation of Employee



Source: MoF, 2024

The fragile fiscal profile is further demonstrated by the evidence that the entirety of capital expenditures during the period was funded by external project grants and that total reordered public sector capital investments fluctuated from 0.2 percent in 2019 to 2.8 percent of GDP in 2022. Recorded capital expenditures from the government's regular operating budget have been very limited, excluding donor related projects.

The Federal Government of Somalia's budget for the fiscal year 2024, with a total resource envelope estimated at US$1,040.8 million, marks a significant milestone. This is the highest level since 2012, a testament to the government's dedication to economic growth and development when the FGS adopted its first comprehensive budget. The endorsed 2024 budget, 13 percent higher than the preliminary estimates of US$917 million in 2023, demonstrates the government's commitment to increasing its financial resources for the betterment of the country. This year's budgeted domestic revenue, which is estimated to increase by 22 percent compared to the estimated outturn of 2023, further underscores the government's efforts.

For the fiscal year 2024, the government is set to spend US$1,079.3 million, with a financing gap of US$38.5 million. *The budgeted expenditure is 17 percent higher than the 2023 outturn, and reflects that, over 90 percent is earmarked for recurrent expenditure, with the largest portions allocated to the payroll of civil and security personnel (33 percent) and the use of goods and services (30 percent).* Grants allocated to Federal Member States total 20 percent, and social benefits total 8 percent of the total expenditure allocations. The total share of budgeted spending allocated to capital expenditure during the year is US$ 63.1 million (equivalent to 5.8 percent).

TABLE 4: Government Fiscal Operations in 2023-2024

Description	Revised Budget 2023	Budget 2024
Total Revenue and Grants	917.3	1,040.8
Total Domestic Revenue	283.3	346.2
Tax revenue	189.9	241.4
Non-tax revenue	93.4	104.8
Total External Grants	634.0	694.6
Current - Grants Bilateral	30.0	68.1

Description	Revised Budget 2023	Budget 2024
Current - Grants - Multilateral	604.0	626.5
Total Expenditure	922.7	1,079.3
Total Recurrent Expenditure	869.2	1,016.2
Compensation of employees	296.7	361.6
Use of goods and services	208.7	327.6
Interest & Other Charges	5.8	9.8
Grants	157.8	216.4
Social Transfer	190.0	87.7
Subsidies	9.0	13.2
Other expenses	1.2	-
Total Capital Expenditure	53.5	63.1
Consumption of fixed capital	53.5	63.1
Financing Gap / Surplus (-) or (+)	- 5.4	- 38.5

Source: MOF, 2024

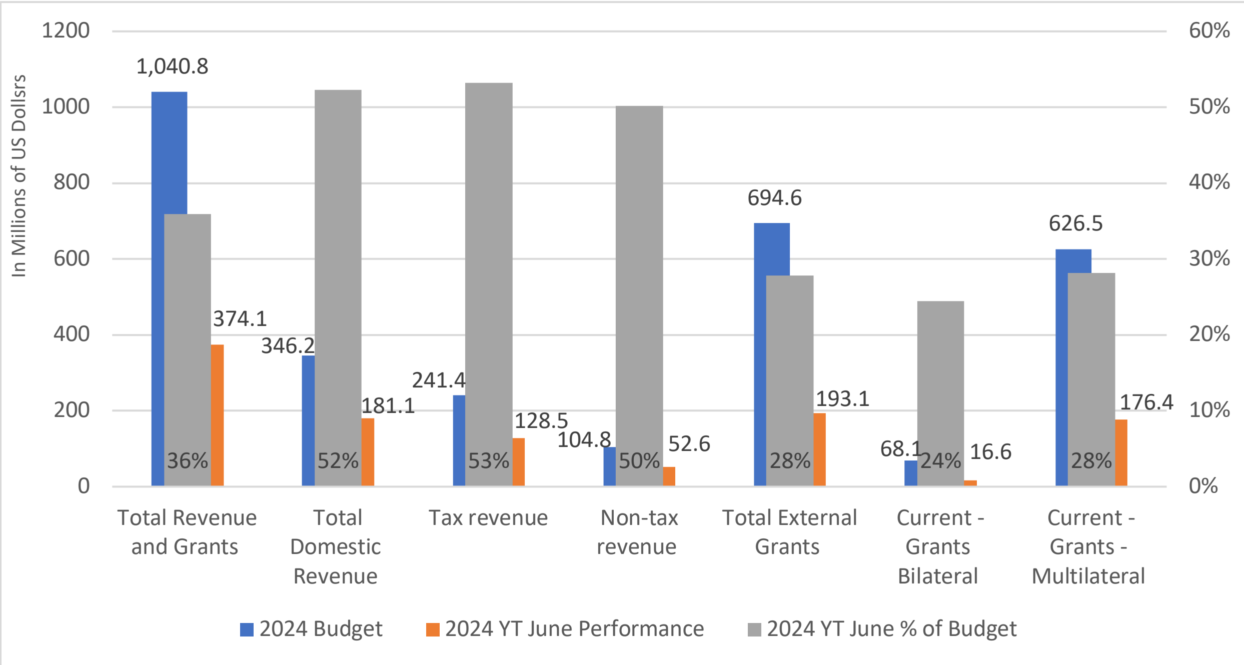
Sectoral Expenditure Allocation Priorities

The 2024 FGS expenditure allocations for the administrative sector were the highest, accounting for US$ 382.9 million (35 percent). The second most significant portion of the budget is allocated to Defense and Security, with US$ 255.6 million (24 percent). In contrast, the third largest budget is allocated to the economic sector, US$ 232 million (equivalent to 22 percent.) The social sector's share, which accounts for 19 percent of the total annual expenditure of Somalia for the budget year 2024, reflects the government's efforts to make a firm commitment to social welfare and development, especially in the education sector, where the government continuous to hire teachers to increase the overall quality of education in the country.

3. FGS Fiscal Operations Outturn in the First Half of 2024

The fiscal performance of the Federal Government of Somalia's through the second quarter of the year has been analyzed, through the midpoint of the fiscal year in June 2024. The FGS fiscal revenue outturn amounted to US$374.1 million, a significant increase from the same period last year. Domestic revenue rose by 32 percent and external grants increased as compared to the previous year's comparable period. On the spending side, total expenditure has increased by 70 percent, with a significant portion going towards increased FGS budget support to FMS and social transfers. In the second quarter of 2024 alone, the FGS collected 25 percent of the total revenue and grant target receipts. Total domestic revenue recorded 26 percent of the budget target, performing about one percentage point over the quarter of the envisaged budget amount. Tax and non-tax revenue met the budget target (26 percent). Donor grants (representing 70 percent of the planned budget resources) performed significantly, with 24 percent of the target being realized, up from only 4 percent of the target in 2024 Q1. Given the unpredictability of external grant disbursements, particularly for project funding, lags in commitments or schedules of disbursements of donor pledges or low absorption capacity of government projects by recipient institutions, which refers to [the inability of the institutions to effectively utilize the funds for the intended projects], could explain the low performance of external grants.

FIGURE 6: Government Revenue Performance in the First Half of the Year Through June 2024

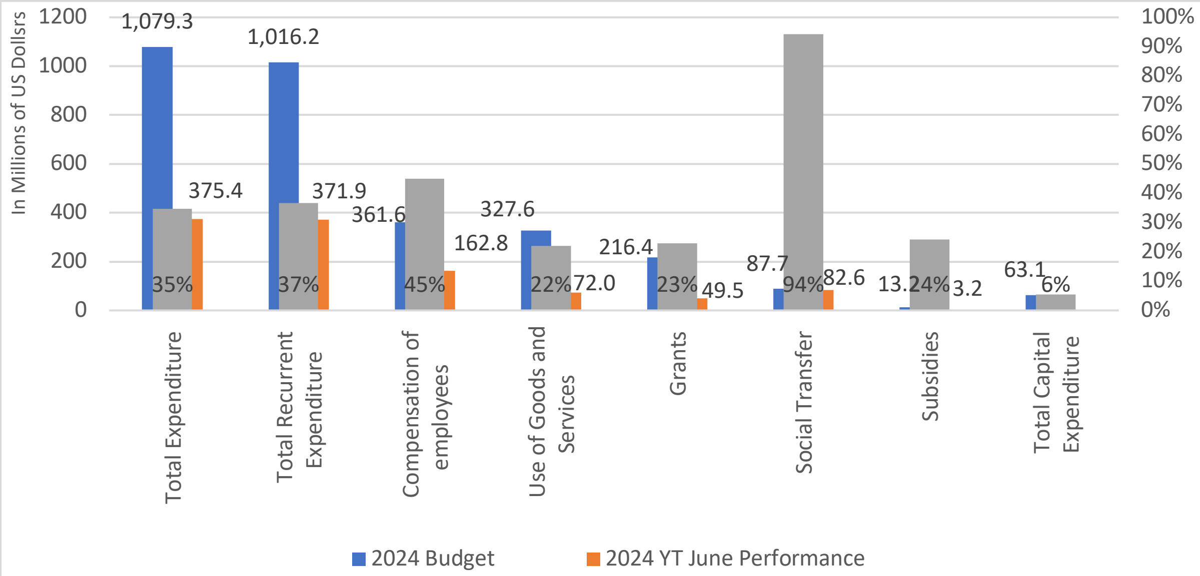


Source: MOF, 2024

On the expenditure side, FGS had spent US$375.4 million for the first half of government operations of the fiscal year 2024 (equivalent to 35 percent of the annual spending target). Recurrent expenditure amounted to US$371.9 million, representing almost 99 percent of the total spending on the reporting period. Meanwhile, spending on capital expenditure stood at US$3.5 million, potentially undermining the potential investment in government projects that could, in turn, contribute to the future enhancement of FGS tax revenue. Spending on the compensation of civil and security personnel represented the highest category of the FGS spending, representing 43 percent of the total spending. Employee compensation was recorded at US$162.8 million (45 percent of the spending target). It increased by 23 percent compared to the same period last year, thus crowding out the effect on spending activities that could generate more revenue for the government. This was followed by social transfers, with total spending of US$82.6 million (94 percent of the spending target), and expected to potentially exceed the spending target by the end of the fiscal year. Government spending on goods and services stood at US$72 million and increased by almost 45 percent compared to last year. In the first half of the fiscal year 2024, FGS spent less than a quarter of its running cost target, potentially underpinning the logistics to deliver critical mandates. However, the significant increase in FGS grants to FMS, almost doubling to a record of US$49.5 million (equivalent to 23 percent of the spending target), up from US$25.8 million in the same period last year.

FGS spending on capital expenditure represented only 6 percent of the spending target, which is to record US$3.5 million. Spending on capital has shown a marginal growth of 5 percent compared to last year from spending of US$3.3 million.

Figure 7: Government Spending for the Year to June 2024



Sources. Ministry of Finance, 2024

4. Comparison of Fiscal Operations in 2023 Q2 and 2024 Q2

Overall, the performance of 2024 Q2 significantly surpasses that of last year's period in revenue and spending, except for interest payments. By more than two factors, the total revenue outturn of 2024 Q2 outperformed the total receipts of the same period in 2023 Q2. Domestic revenue receipts rose by 24 percent compared to the same period last year, while grants recorded a remarkable increase from US$16 million to US$166 million in the same period the previous year.

The total expenditure of the FGS in 2024 Q2 amounted to US$249 million (higher than the spending of the same period last year by two factors), up from US$118.9 million recorded in 2023 Q2. Compensation of employees almost doubled, and FGS grants to FMS increased significantly, from US$13.6 million in 2023 Q2 to US$35.6 million. The use of goods and services showed an increase of 46 percent, indicating the growth and expansion of the FGS. As a result of the performance in fiscal receipts and expenditure rationing, the financing surplus of US$6.7 was recorded in 2024 Q2, from a financing gap of US30 million in 2023 Q2.

TABLE 5: Quarterly Fiscal Operations in 2023 Q2 and 2024 Q2

Description	2023 Q2	2024 Q2
Total Revenue and Grants	**88.6**	**255.7**
Total Domestic Revenue	**72.3**	**89.3**
Tax revenue	50.8	62.7
Non-tax revenue	21.5	26.6
Total External Grants	**16.4**	**166.4**
Current - Grants Bilateral	0.8	11.0
Current - Grants - Multilateral	15.6	155.4
Total Expenditure	**118.9**	**249.0**
Total Recurrent Expenditure	**116.6**	**246.7**
Compensation of employees	67.9	82.2
Use of goods and services	30.2	43.9

Description	2023 Q2	2024 Q2
Interest & Other Charges	4.5	0.9
Grants	13.6	35.6
Social Transfer	-	82.6
Subsidies	0.5	1.5
Other expenses	-	-
Total Capital Expenditure	**2.3**	**2.3**
Consumption of fixed capital	2.3	2.3
Financing Gap / Surplus (-) or (+)	- **30.3**	**6.7**

Sources. MoF, 2024

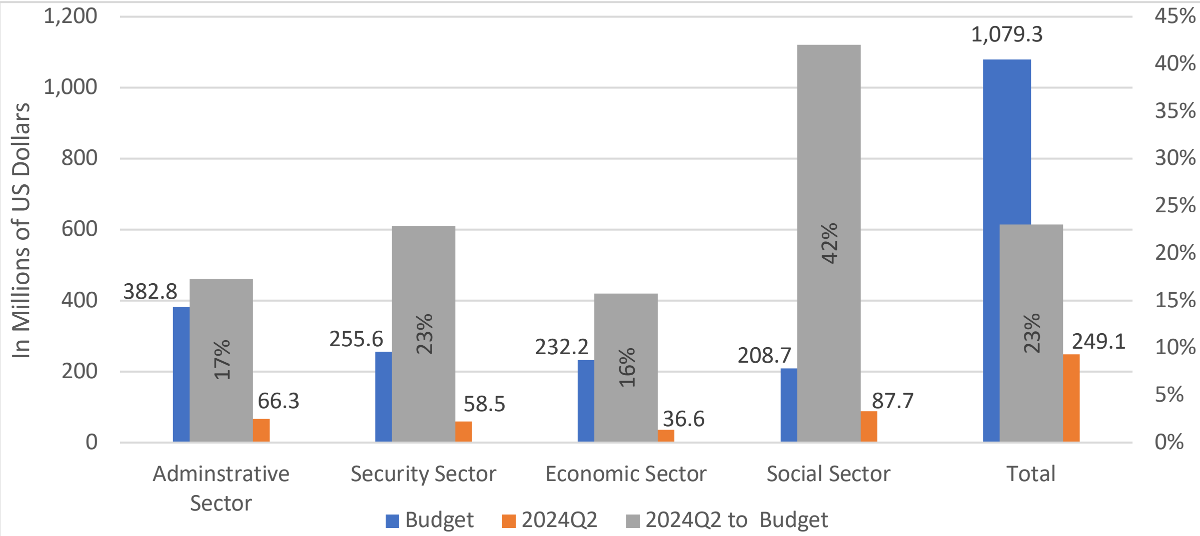
In the second quarter of 2024, FGS spent 23 percent of its planned spending target, amounting to US$249 million. The social sector represented 35 percent of the sectoral spending, followed closely by the administrative sector at 27 percent, the security sector at 24 percent, and the economic sector at 15 percent. During the second quarter, spending on the social sector remained the largest, with 42 percent of the spending target, followed by the security sector, with a spending target of 23 percent. Spending on administrative and economic sectors was the least, representing 17 percent and 16 percent of the total spending target respectively.

TABLE 6: Sectoral Spending in 2024 Q2

	Budget	2024 Q2	2024 Q2 to Budget
Administrative Sector	382,848,178	66,264,831	17%
Security Sector	255,607,280	58,539,423	23%
Economic Sector	232,175,773	36,569,000	16%
Social Sector	208,684,552	87,695,343	42%
Total	**1,079,315,783**	**249,068,597**	**23%**

Source: MoF, 2024

FIGURE 8: Sectoral Spending in 2024 Q2



Source: MoF, 2024

Table 7: Comparing Medium-Term Projected Fiscal and Revenue Performance

Description of Fiscal Variable	2024 Q1	2024 Q2	2024 Actual Semi-annual Budget (Q1+Q2)	2023 Actual budget	2024 budget Projected	2025 budget Projection	2024 Mid-term budget performance in percent (%)
Total Revenue and Grants	118.4	255.7	374.1	738	747.3	744.7	50.06
Total Domestic Revenue	91.7	89.3	181	329.6	357.5	423.5	50.63
Tax revenue	65.80	62.70	128.50	260.60	282.50	316.60	45.49
Non-tax revenue	25.90	26.60	52.50	69.00	75.00	107.00	70.00
Total External Grants	26.70	166.40	193.10	408.50	389.80	321.20	49.54
Current - Grants Bilateral	5.60	11.00	16.60	0.80	28.10	30.00	59.07
Current - Grants - Multilateral	21.10	155.40	176.50	407.70	361.70	291.20	48.80
Total Recurrent Expenditure	**125.20**	**246.70**	**371.90**	**720.30**	**755.60**	**783.40**	49.22
Compensation of employees	80.60	82.20	162.80	292.20	310.50	338.10	52.43
Use of goods and services	28.10	82.20	110.30	138.20	150.20	151.20	73.44
Interest & Other Charges	0.90	0.90	1.80	13.20	2.20	13.00	81.82
Grants	13.90	35.60	49.50	126.30	162.60	147.50	30.44
Social Transfer		82.60	82.60	130.60	107.00	42.80	77.20
Subsidies	1.70	1.50	3.20	5.40	6.20	6.20	51.61
Other expenses			0.00	0.00	-		
Consumption of fixed capital	1.2	2.3	3.5	14.4	16.9	84.4	20.71

Source: MOF, 2024

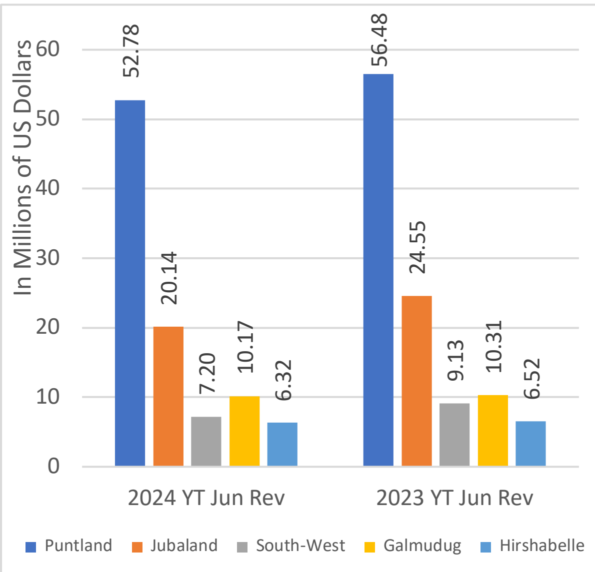
The fiscal and revenue performance has been reviewed with the medium-term budgetary budget strategy for 2024. The first mid-term revenue and expenditure performance were successful, as shown in the 2024 mid-term budget performance Table 7. The budget strategy for the fiscal year 2024 emphasized the increased capacity of domestic revenue mobilization. The outturn for revenue and grants of the 2024 budget year is projected at $747.3 million against a target of $986.6 million, implying a 75.7 percent performance. Accordingly, the outturn for domestic revenue is projected to increase to $357.5 million against a target of $345 million (a projected performance of 103.6%). In comparison, external grants are projected to decrease to $389.8 million against a target of $641.5 million (a projected performance of 60.8%).

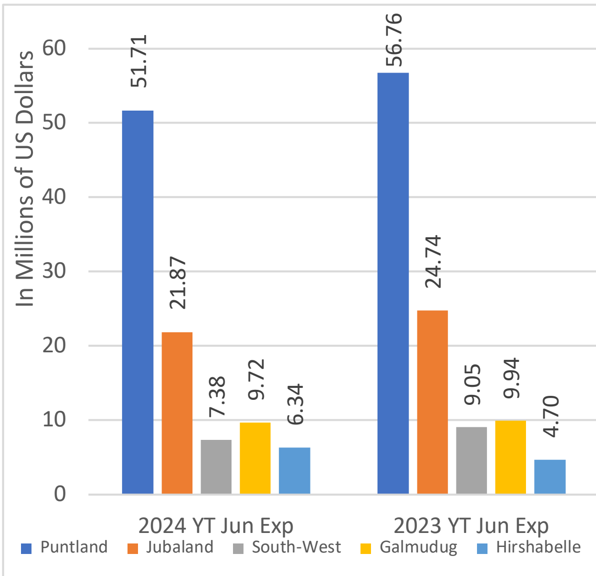
The 2024 semi-annual overall total revenue and annual grants performance was 50.06 percent. Similarly, the performance of semi-annual tax revenue and multilateral grants was 45.49 percent and 48.80 percent, respectively. This result represents more than 90 percent of the mid-term plan and is considered a good performance in line with the budget strategy for fiscal year 2025.

The budget strategy for fiscal year 2024 also identifies priority areas to be funded during 2024. This requires a coordinated and consolidated effort to strengthen internal capacity, further increasing the transparency of current spending. It's important to note that all spending is carefully aligned with the medium-term strategic priorities, ensuring that the government makes informed decisions. The mid-term strategy prioritizes defence or security, agriculture, health, education, energy, and infrastructure expenditures, including SMEs investment.

5. Federal Member States Financial Operations and Governmental Relations

FIGURE 9: Federal Member State Revenue and Expenditure for the first Six Months of 2024





Source: MoF, 2024

The revenue performance in the first and second quarters at the Federal Member States (FMSs) reveals the reliance on international trade taxes in states with seaport operations. Puntland and Jubbaland have reported significantly higher collections compared to other FMSs, emphasizing the necessity for budgetary support to maintain federal cohesion. The Federal Government of Somalia (FGS) lacks sufficient resources to cover its operating costs, let alone achieve fiscal equalization, a crucial goal that underscores the importance of harmonizing tax collection across the country to increase revenue collection to be able to cover operating costs of the government at both FGS and FMS levels.

Major Challenges and Issues to Advance Intergovernmental Fiscal Relations

Although Somalia is officially a federal state, there is a significant opportunity for more institutional structures to be designed to address the issues of intergovernmental fiscal relations. The nascent attempt to facilitate dialogue on intergovernmental budgetary relations between the FMS and the FGS is a promising start. By adopting a more systematic approach, Somalia can promote broader intergovernmental fiscal ties between the different levels of government. This could lead to improved financial stability and development, as it would ensure a more coordinated and efficient use of resources. Enhancing necessary coordination and policy directions will be a key step in implementing effective intergovernmental budgetary relations.

Successful intergovernmental fiscal relations hinge on recognizing the political collocation of decentralization, existing capacity to deliver services, and economic incentives in the intergovernmental budgetary systems. The trust deficit resulting from the prolonged civil war is a significant barrier that must be urgently and decisively addressed. Many policymakers in the federal member states are hesitant to relinquish power to the federal government of Somalia. The regional administrations' roles, scope, and functions must be determined and agreed upon. The key is to establish the most efficient, effective, and economically viable division of functions and financial relations among levels of government.

The existing political environment at all government levels doesn't prioritize advancing intergovernmental fiscal arrangements. Policymakers don't see any immediate political dividend in giving up such important and symbolic issues without a general agreement on the budgetary federalism framework. However, it's crucial that different levels of governments work towards this consensus, as it will provide a solid foundation for future fiscal arrangements. Through the intergovernmental fiscal federalism coordination committee and Ministers of Finance Forum, the FGS engaged the FMS on customs harmonization, taxation, and budget support, highlighting the importance of unity in decision-making.

6. Special Issue Coverage: Domestic Revenue Mobilization Reform

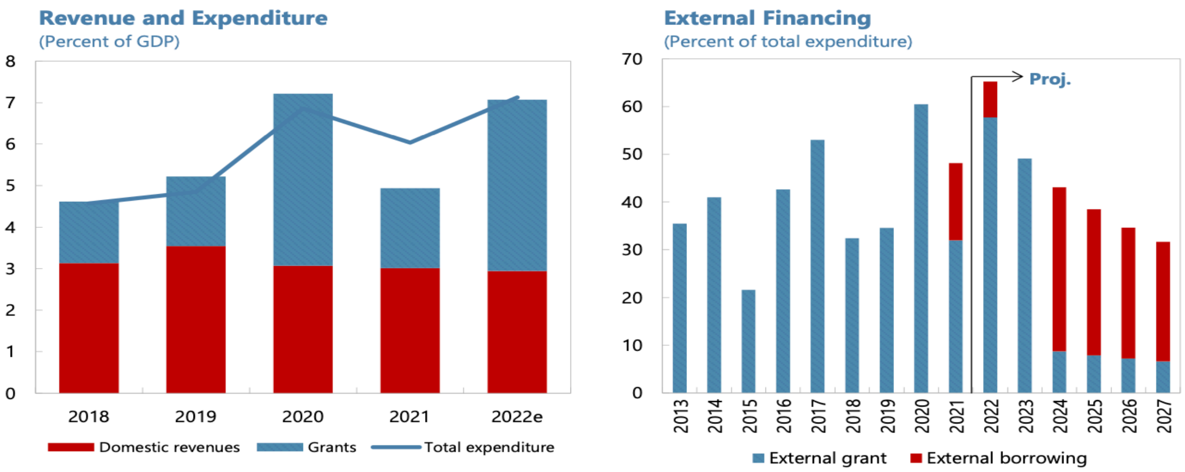
Introduction

This annex to the Budget Policy Brief #2 for Somalia summarizes the assessment, findings, and recommendations of the domestic revenue mobilization reforms. If implemented, these reforms will enable the government to finance services delivery and investments in public infrastructure and critical economic sectors. They also have the potential to create fiscal space to mitigate the impact of climate shocks and food insecurity.

The Federal Government of Somalia (FGS) is currently struggling to establish a nationwide revenue system due to a lack of technical capacity and territorial control throughout the country. While revenue collection and administration has improved somewhat in Mogadishu, the independent revenue collections of federal member states (FMS) have led to unequal revenue distribution among them. Each FMS currently relies on its own taxation systems. In 2021, the World Bank facilitated a high-level dialogue on customs between the FGS and FMS, resulting in an agreement on a national tariff schedule that unfortunately has not yet been implemented. It is crucial for the FMS to collaborate in a coordinated effort to address this issue.

Somalia has made some efforts to rebuild its tax capacity, but it remains low and insufficient to cover the government's core fiscal operations. Historically, Somalia has one of the lowest tax-to-GDP ratios in the world with domestic revenue now around 3 percent of GDP, which is only possible after implementing several tax policies and revenue administration reforms. However, Somalia continues to rely on international trade taxes, which barely cover mandatory government spending. Figure 1 shows the overall domestic revenue has not been sufficient to cover the compensation of employees and other recurring expenditures. The revenue gap is financed with external grants and will be covered by external borrowing soon. This situation underscores the urgent need for further reforms to enhance Somalia's tax capacity and reduce its reliance on external sources, a crucial step for the country's economic development.

FIGURE 10: Somalia - Fiscal Indicators



Source: Somali Authorities and IMF Staff estimates

Source: Somali Authorities and IMF Staff estimates.
Note: External borrowing in 2021 and 2022 reflects use by the MoF of its share of the SDR allocation.

Current Assessment & Findings

With the crucial backing of international financial institutions like the World Bank (WB), the International Monetary Fund (IMF), and the African Development Bank (AfDB), Somalia's transitional governments embarked on the re-establishment of the federal tax system. The initial focus was on lump-sum and negotiated collections to alleviate immediate fiscal pressures. The FGS targeted easily collectible taxes and user fees with reform support, including financial aid, technical expertise, and policy guidance through capacity buildings.

Significant efforts were made to strengthen public financial management (PFM) systems and enhance tax administration capabilities, including partial digitalization and training, increasing efficiency. By 2017, the income tax collection was expanded to the private sector after being levied only on civil servants as taxpayers for over five years, a major step towards broadening the tax base and increasing revenue. Efforts continued by the reintroduction of sales tax on imports, telecommunication services, and hotels in Mogadishu as part of the IMF's reform requirements. The Ministry of Finance, also took over non-tax revenue collection from other diverse public institutions, significantly increasing the revenues from user fees and charges.

SOMALIA IMPLEMENTED MAJOR DOMESTIC REVENUE REFORMS, IMPROVED TAX INFRASTRUCTURE, AND CAPACITY-BUILDING EFFORTS, RESULTING IN GROWTH IN DOMESTIC REVENUE COLLECTION FROM $69 MILLION IN 2013 TO $329.5 MILLION IN 2023. THIS INCREASE IS A TESTAMENT TO THE REFORM EFFORTS TAKEN AND SETS A PROMISING TRAJECTORY FOR MORE COMMITMENT IN THE FUTURE.

FIGURE 11: FGS revenue by source in million USD

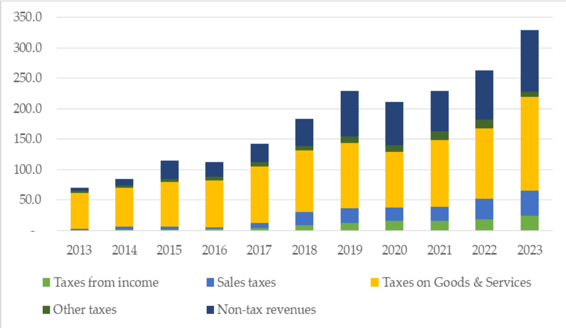
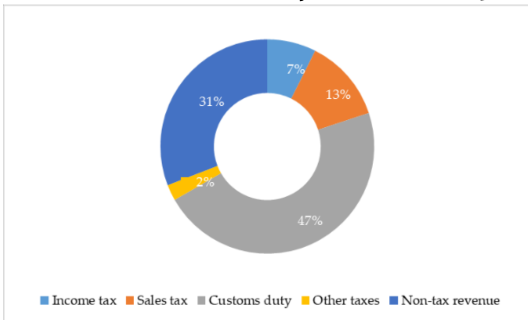


FIGURE 12: FGS revenue by source in 2023



Source: MoF annual reports published in 2024.

The Ministry of Finance recently published a medium-term revenue roadmap, of which the below table highlights measures expected to be implemented in 2025 toward improving domestic revenue mobilization.

TABLE8: Measures Anticipated in the 2025 budget

▪ Personal income tax enforcement and implementation of a new income tax law
▪ Reaching out to new taxpayers of income tax and simplifying the tax regime
▪ Continue rental income tax reforms and enforcing property transfer tax
▪ Enforcing corporate income tax with a focus on large and medium taxpayers
▪ Increasing the enforcement of sales tax collection from hospitality, telecom, airline and imported goods
▪ A general enforcement of sales tax to SMEs and informal businesses
▪ Continuing road tax reforms
▪ Enforcement and cargo examination at customs and standardizing package measures.
▪ Installing a non-tax revenue portal

Current Challenges

The country faces current challenges that underscore the urgent need for comprehensive reforms in Somalia's taxation system. These complex and multifaceted issues demand immediate and concerted efforts to build a robust and effective revenue collection framework.

- **Urgent need for updated tax legislation:** One of the most pressing challenges in Somalia's taxation system is the immediate requirement for effective legal frameworks and robust tax policies to facilitate efficient revenue collection. The existing tax legislation, primarily enacted in the pre-war period, urgently needs to be updated. Their outdated nature contributes to a narrow tax base, undermining the effective expansion of taxable economic activities and the change of business models in the past three decades. Currently, revenue amounts to only 2.8 percent of GDP, with international trade taxes being predominant. The low adherence to and compliance with existing tax laws, coupled with high resistance to their enforcement, exacerbates this issue. Despite having a draft of a new income tax law, most taxes are negotiated, reflecting the weak human and institutional resource capacity in tax policy formulation systems and administratively falling short of implementing statutory tax rates.

- **Revenue management issues:** Revenue management in Somalia is highly susceptible to fraud, corruption, and embezzlement due to the absence of robust systems for compiling and disseminating data/statistics. The current legislation does not assign revenue functions and shares to any level of government, leading to ongoing discussions on the Fiscal Federalism framework. The unresolved stalemate between the Federal Government of Somalia (FGS) and the Member States hinders the sharing of vital tax information and the timely harmonization of fiscal regimes. Additionally, political interference in tax policy and administration further undermines the effectiveness of revenue management.

- **Non-autonomous tax administration:** The tax administration body in Somalia is a non-autonomous directorate within the Ministry of Finance, characterized by several structural deficiencies such as the absence of a strategic plan, mission, vision, and objectives on one hand and inadequate resources to implement and manage the tax system on the other. All support functions of the administration and staffing are shared with the Ministry of Finance and Civil Service Commission respectively. This shared structure makes it harder to employ skilled staff and establish a separate budget for tax administration. More importantly, it perpetuates the interference of the political elite in the process of tax administration and enforcement, further undermining its effectiveness.

  Reliance on international trade taxes: Somalia's heavy reliance on taxes from international trade is another major challenge. These taxes form a considerable share of FGS domestic revenues, averaging over half, and are assessed through cumbersome physical controls and face-to-face interactions. ***The tax rates are specific in nature and not ad valorem, meaning they are based on the volume, weight, or number of units rather than the value of goods.*** This system complicates tax collection and increases opportunities for evasion. Though reliance on customs revenue is common in fragile economies, the case of Somalia differs in the scale (percentage of domestic revenue) and type of duty (package-based). This practice not only undermines the collection of potential customs revenues but also highlights the urgent need for revenue diversification to reduce the country's vulnerability to changes in international trade patterns.

- **Security:** Ongoing conflicts and the presence of extremist groups such as Al-Shabaab – who are already taxing the same economic base, create a highly unstable environment, severely hampering effective tax collection. Insecurity limits the accessibility of certain regions, leading to a narrow tax base as many areas and economic activities remain unreachable due to security threats, making it impossible for tax officials to operate effectively. Security challenges also prevent the business (taxpayers) from growing and exacerbate the cost of business, which is already high.

- **Weak governance and institutional capacity:** Political instability and weak governance structures significantly limit the government's capacity to enforce tax laws and regulations. Poor infrastructure, insufficient training for tax officials, and pervasive corruption result in inefficiencies within the tax administration. Additionally, the large informal economy operates outside the formal tax net, complicating tax collection efforts due to the need for proper documentation and records.

- **Dependence on external aid:** Somalia's heavy reliance on international aid reduces the incentive for the government to develop a robust domestic revenue system. Aid often comes with conditions that limit the government's flexibility in managing finances and prioritizing revenue collection reforms.

- **The complexity of the tax system:** A complex and opaque tax structure discourages compliance of taxpayers who predominantly remain uneducated. This increases opportunities for evasion. As a result, high levels of tax evasion are attributed to weak enforcement and low taxpayer morale. Sources of complexity include barely understandable tax laws, lack of taxpayer education, and dealing with several in-country tax administrations that differ in tax rates, processes of tax collection, and enforcement. Hence, socio-cultural issues, such as limited awareness and understanding of the importance of taxation among the population, contribute to low compliance rates. Clan-based loyalties and dynamics often override national obligations, affecting tax collection efforts.

- **Economic constraints:** Low economic activity and underdevelopment limit the potential for generating substantial tax revenues. A higher level of unemployment means the country collects less revenue from personal income taxes. In addition, the dominance of agriculture, informality, and large numbers of SMEs, which are all difficult to tax effectively, further restrict revenue potential.

- **Political economy issues:** The political economy within Somalia's tax administration and government reduces the efficiency and effectiveness of revenue collection. Organized business and clan networks dominate Somali politics for personal gain, exploiting local resources and manipulating the political landscape.

Conclusions and Recommendations

Mobilizing domestic revenue and enhancing revenue administration systems are critical elements of any effective fiscal strategy. With its unique economic landscape, Somalia must prioritize these aspects to ensure long-term fiscal stability and growth. The following outlines a series of strategic conclusions and recommendations to bolster Somalia's revenue collection capabilities and improve fiscal governance.

Implementation of the Revenue Acts: To streamline revenue administration and enhance awareness nationwide, the Federal Government of Somalia (FGS) shall extend the Revenue Acts to the Federal Member States (FMS). A robust implementation plan should focus on increasing awareness and building capacity across all FMSs. This includes developing administrative and enforcement capacities, issuing necessary guidelines, and improving compliance within customs. As economic sectors such as telecommunications and petroleum, FGS must ensure national fiscal management remains within the FGS central authority purview (in contrast to sector regulators operating independently within their mandates. This separation is vital to safeguarding fiscal revenues and ensuring effective regulatory oversight.

Tax policy and legislations: FGS should implement the Extractive Industry Income Tax Law and finalize related regulations and policies within the medium term. These actions, along with the introduction of comprehensive tax policies, enacting the Income Tax Bill, and considering new tax laws, including modern VAT and Digital Service Tax (DST), will enhance tax components and expand the base. This potential impact should instill a sense of hope and optimism. Introducing a turnover tax and assessing the potential revenue impact of the new income tax are also crucial steps. These measures should be complemented by a vigorous tax administration effort, focusing on economic recovery and enhanced tax audits to ensure compliance.

Customs reform: Customs tariffs in Somalia are currently applied on a 'per package' basis, leading to various challenges, including classification subjectivity, potential corruption, and unequal treatment of traders. Reforming customs is central to building a stable revenue base. Despite significant increases in customs collections, the revenue remains low compared to GDP. To address this, the following series of reforms are proposed:

- Adopting the Harmonized System (HS): Implementing an 8-digit code system to classify imported products better, thus providing flexibility in tax policy design and fairness in tax assessments.
- New Valuation System and Tax Rates: Transitioning to a valuation process compliant with the 1994 WTO agreement, initially using reference values before moving to transaction values.
- Mandatory Customs Declarations: Ensuring accountability by requiring shipping lines and traders to lodge declarations in the Somali Customs Automated System (SOMCAS).
- Adapting SOMCAS: Modifying the IT customs system to support new classification and valuation methods, enhancing transparency and trader compliance.
- Training Department: Establishing centralized and specialized training for customs officers, carriers, traders, and brokers.
- Convergence of FMS and FGS Customs Policies: Implementing a two-step approach to align customs procedures and tax rates across ports, supported by reliable data and SOMCAS (Somali Customs Administration System)

Security and political stability: The government must enhance security measures, work towards stabilizing conflict-prone regions, and pursue greater political stability. These initiatives allow for a broader tax administration. This will furthermore help the growth of businesses and the reach of new taxable activities.

Development of ICT capabilities: Developing a modern, efficient revenue collection system is essential for improving revenue collection in Somalia. This involves using technology to automate tax assessments and payment processes and establishing a centralized revenue collection system to strengthen the coordination between government agencies. Developing and deploying the Integrated Tax Administration System (ITAS) is highly recommended.

Capacity building: The Ministry of Finance, now responsible for revenue collection, must identify and train change agents within the tax administration. This includes strengthening governance, improving infrastructure, and providing comprehensive training for tax officials. The Ministry of Finance should support various tax types, revenue forecasting, analytics, and tax treaties. It should also strengthen information exchange on tax matters in light of fiscal federalism agreements. By taking on these responsibilities, the Ministry of Finance can ensure that the tax administration system is efficient and effective, leading to improved revenue collection.

Introduction of autonomous Tax Administration Agency, with strengthened governance. Implement the much-discussed Autonomous Revenue Authority administered outside the Ministry of Finance and with enhanced anti-corruption measures, such as a code of conduct for tax administration staff, to prevent corruption and ensure that tax laws and regulations are enforced fairly and impartially. Strengthen accountability mechanisms by establishing an independent tax ombudsman office, creating tax dispute resolution mechanisms, and promoting transparency in tax revenue collection. Increase transparency in tax administration by publishing information on tax collection, audit activities, and enforcement actions to the public.

Taxpayer education: Enhance taxpayer education and outreach by conducting public education campaigns, developing a taxpayer charter, and training taxpayers on their rights and obligations. In addition, create a taxpayer services unit that provides responsive and effective services to taxpayers, such as timely processing of tax returns and inquiries. This unit will serve as a point of contact for taxpayers, addressing their concerns and ensuring that they understand and fulfill their tax obligations. By providing excellent service, the unit can increase taxpayer satisfaction and compliance, leading to improved revenue collection.

Targeted policy dialogues: Engage policymakers and civil society in discussing taxation and fiscal federalism. Somalia must gradually reduce its dependence on international trade taxes and external aid to foster self-reliance by enhancing domestic revenue mobilization through improved tax policies and administration.

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