Making Public Finance Management the Central Instrument of Policy and Recovery In Somalia

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1. Introduction

Somalia's state public finances in the 15 years through 1990, and before the onset of the conflict and state collapse, was in dismal shape and was not sufficiently functional to deliver public services to the over whelming majority of the population. Back then, the Government budget mainly consisted of defense and internal security expenditures. Only a small portion of the budget was committed for social and development needs, such as health care, education and maintenance of existing assets.

Government revenue weakened considerably over the years largely on account of poor tax policies and administration, leakage and a steep decline in economic activity. The ratio of the Government's domestic revenue to GDP averaged about 7 percent over the 1980s; 6 percent from 1985 to 1989. By comparison, the revenue ratios over the 1980s in low income sub-Saharan African countries averaged 18 percent of GDP; indicating how dismally low the country's revenues were by the norms of the region. The base of the tax system also narrowed, and consisted for the most part of income and profit tax, customs and excise duties on few products like tobacco, matches and sugar.

Government expenditures in Somalia between 1981 and 1989 averaged around 27 percent of GDP a year, with the average over the 5 years through 1989 even higher at 32 percent. Excluding the foreign contribution to the public investment program, government expenditures averaged about 13 percent of GDP in 1981-89.

Owing to the high expenditures and low revenues, budget deficits before grants averaged around 20 percent of GDP in 1981-89. However, domestic financing of the deficit amounted to only about 1 percent of GDP, and domestic bank financing of the deficit was generally low. In the first half of the 1980s, most of the foreign financing was in the form of loans, but in the second half it was largely in the form of grants. The foreign loans relied on in the earlier years led to high foreign debt and to external arrears problems. The large dependence on foreign financing also led to unsustainable expenditure profile in public expenditure management.

Budget Structure and lack of Transparency:[2] Government expenditures in the country were classified under three sub-accounts: The Ordinary budget contained recurrent expenditures that were financed by revenue raised domestically except for foreign interest payments. The Ministry of Finance (MOF) was responsible for budgeting government recurrent expenditures as well as revenues. The domestic development budget contained expenditures of projects that were undertaken by the Government without the participation of donors. Somalia's development plan was the responsibility of the Ministry of National Planning (MNP) while the Government budget was prepared by the MOF. There was no link between planning and budgeting. Foreign funded Public Investment Program (PIP) contained the budget for donor funded projects. This budget received very little contributions from the Government. The MNP was responsible for planning and budgeting of the PIP.

The ordinary and domestic development budget reflected government funded expenditures while the PIP contained external funded expenditures. The government defined public budgeting as containing only expenditures under ordinary and domestic funded development budgets. The two budgets were not integrated to provide a comprehensive picture of government expenditures and included recurrent

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[1] Budget Formulation Seminar and Training for TFG Officials, February 25- March, 15, 2008. Debre Zeit.

[2] Somalia: Crises in public expenditure management. World Bank, March 1991.

expenditures for investment as well as financial transfers. The integration of the two budgets was difficult due to unclear expenditure classifications and frequent changes. The Public Investment Program funded by donors was excluded from the Government budget and did not have any link to government's other expenditures. Nevertheless, the PIP included recurrent, investment and transfer expenditures. The lack of integration and transparency among three budgeting systems made it difficult for the Authorities to have a clear indication of total budgetary expenditure allocation. As a result, there was very little basis for evaluating the budget performance to meet the government's objectives.

There was a lack of coordination among and within institutions responsible for formulating, spending and accounting budgetary expenditures. Ministry of Finance (MOF) was responsible for budgeting for all government expenditures and was expected to coordinate with Ministry of National Planning (MNP) and other Ministries. However, there were no established formal guidelines that facilitated coordination among the Ministries.

In order to improve budget planning and coordination, the authorities should have ensured that all central government expenditures were covered in one budgeting system and the link between planning and budgeting strengthened through better coordination between the Ministers of Finance, Treasury and Planning. Autonomy should have been given to the revenue collection departments, and the government's budget should have been comprehensive, and every effort made to include externally financed development projects in the over all capital account.

In the 1980s, there was a major shift of expenditure allocations away from economic and social services to general services dominated by defense and security expenditures. The expenditure, under the government controlled budget, for defense and security increased sharply while expenditure for wages and operations and maintenance of social and economic sectors of government fell drastically. Spending on economic services declined from 24 percent of government-controlled expenditures (i.e., ordinary and domestic development budgets) in 1974 to 11 percent in 1988. Over the same period, expenditure on social services declined from 16 percent to 4 percent. More significantly, within the ordinary budget the combined share of economic and social services fell from 36 percent in 1974 to 6 percent in 1988.

The civil service grew from around 20,000 employees in 1974 to over 45,000 in 1989. During the same period, the total civil service wage bill fell in real terms; to the extent that the average real wage in 1989 was only 6 percent of the level in 1974. This contributed to many high skilled and capable personnel leaving government services to take employment in other professions that paid better compensation. In general, government employees suffered low morale and provided poor quality services.

Operations and maintenance expenditures dropped by 67 percent in real terms between 1974 and 1989. The predictable result was that hardly any thing was done. The low recurrent costs funding led to a deterioration in education and health services delivery in particular. Most of the gains in education following the expansion of literacy and enrollment, following the adoption of Somali as the language of instruction in 1972, were reversed in the 1980s due mainly to sharp decline in government funding for education. The number of primary schools fell by 22 percent from 1981 to 1989, school buildings deteriorated drastically, text books and supplies almost disappeared, and salaries of teachers were eroded in real terms.

Indicators of health in Somalia were among the poorest in Africa in the late 1980s. In 1987, life expectancy in Somalia was 47 years, infant mortality was 150 per thousand, and child death rates were 19 per thousand; while the averages for Africa in the same year were 51 years, 115 per thousand, and 16 per thousand, respectively. Government recurrent expenditures on health were equivalent in 1989 to US$ 0.11 per person, compared to about US$ 5.50 in Kenya. Doctors and staff were ill-paid, drugs and supplies were scarce, maintenance was neglected, and real salaries of health sector employees fell sharply as did those of other public servants.

External Debt: As noted above, in the past Somalia relied mostly on external borrowing with the majority of the loans coming from external donors. Somalia's external debt burden grew rapidly through the 1980s. The total public external debt increased from $230 million in 1975 to $1,449 million in 1983. During the 1970s Somalia could easily obtain external loans but since the 1980s the structure and terms of borrowing changed dramatically. Government revenue was low, most of the investment in the country was financed by donor contributions, and Somalia was in deep economic crises during this period. As a result, the Government in desperation started to raise loans on non-concessional terms. These loans had high interest rates and short maturity, which led to further accumulation of debts and interest arrears. Eventually, the government had no recourse but to restructure existing debt service obligations including payments arrangements and debt relief in order to match the country's payments capacity. Debt and interest arrears have been accumulating since Somalia's central authority collapsed in 1991, leading to an estimated stock of debt in excess of US$ 3 billion in 2005.

2. Challenges and opportunities for Somalia's Economic Reconstruction and Institutional Building

The civil conflict in Somalia brought about the destruction of both public and private assets such as economic and social infrastructures. The devastation included all forms of state institutions and enterprises notably public utilities; some private factories and businesses, as well as social facilities in particular hospitals and schools. The negative impact also included (i) a decline in crop production, both basic cereals for domestic consumption and for export; (ii) the lack of vetinary services for livestock, the back bone of Somalia's foreign exchange earnings and (iii) illegal exploitation of marine resources by foreign fleets.

The near two decades long civil war further impoverished the population of one of the least developed countries in the world (even in the best of times), and endangered the survival of millions of Somalis. Based on current trends, even with hard economic and social data non-existent, it is indisputable that Somalia has retrogressed in all the targets of the Millennium Development Goals. In the critical areas of eradicating extreme poverty and hunger, achieving universal primary education, reducing child mortality, and ensuring environmental sustainability, Somalia has fallen far behind while countries in peace have progressed towards these universal goals.

Despite the lost decades and the negative outcomes enumerated above, the Somali society has proven resilient in some areas and has devised copping mechanism even with the absence of an effective central authority. In testimony to the ineffectual or constraining influence of the pre-conflict central governments, the absence of appropriate economic policies, bloated bureaucracy and numerous state-owned monopolies constrained the activities of the private sector; as a consequence the absence of these constraints during conflict years, unregulated and unrestricted private initiatives resulted in some rare positive outcomes. The positive developments include: the money transfer agencies or

Hawalas, the development of wide access to telecommunications and airlines connections, as well as substantial increase in fish and livestock exports prior to the Saudi Arabia ban on Somali exports.

There are multiple causes of the collapse of the Somali central state, and the disintegration and ensuing destruction of the socio-economic institutions. Important among these factors are poor economic governance and mismanagement of the role of the central state responsibilities. Foremost among the failures of the state has been an inability to improve the economic well-being of the population, to implement a sustained strategy to fight poverty and generate equitable growth. Somalia's past central governments also failed to establish transparent and accountable institutions, and an effective good use of public resources.

The Somali society and leadership have a unique opportunity to learn from the causes of the collapse of the central state and, in a dispassionate and objective manner, to devise new forms of governance and institutions that would avoid a relapse and that stand a fair chance of success. The 1991 winner of the Nobel peace price stressed that human development and dignity implies commitment to creating conditions under which individuals can develop a sense of self worth and security, and that such development will not be fostered in people who have to live the threat of violence and injustice, with bad governance and instability, or with poverty and disease.

In framing the macroeconomic governance of Somalia for the future the cause of human development and dignity, and the fight against poverty and disease should be central and the only focus. An important principle is therefore for the state to be provided the mandate and to perform only those functions that it has a clear and evident advantage over the private sector, such as developing rules and regulation to oversees market imperfections, and to deliver services that are in the public domain including the conduct of fiscal and monetary policies, or not in the capacity of the private sector to deliver such public services in economic and social sectors.

3. Opportunities for recovery and reconstruction[3]

Somalia at the beginning of the 21st century needs a vision for socio-economic reconstruction and recovery and a strategy that is informed and guided by an enlightened leadership, and a national commitment and will. Key components of this vision and strategy are a Somalia in which:

- Peace, stability, and unity are paramount so that the nation and individuals could pursue poverty reduction, and high quality economic growth.

- Good governance and the rule of law are supreme to make leaders and public servants accountable, and allow for the creation of wealth and the sharing of benefits of recovery and development.

- Private sector plays a leading role in the economy and the government is responsible for the regulatory framework and instituting appropriate macroeconomic framework.

- Public sector services such as health, education, sanitation, water etc are reconstructed and made efficient and responsive to the needs of the communities through the active

[3] The report of the Committee on Economic Reconstruction, Institutional Building and Resource Mobilization of the national reconciliation conference, December, 2002

participation in planning and implementation. The private sector can also provide such services with proper government supervision.

- Natural resources are managed in a sustainable manner in order to assure a bright future for the generations to come.

- A strong, diversified, and competitive economy will be pursued to effectively cope with the challenges of development and to adapt to changing market conditions, in the country and the global economy.

- Economic infrastructure (ports, roads, irrigation, etc.) will be rebuilt and maintained to facilitate economic activities and social services.

- Human capacity is rebuilt and nurtured as an educated and competitive labor force is essential for reconstruction and effective performance of public services, expanded and new employment opportunities. Imparting new skills and building capacity will assist in the demobilization of militia.

- Credible and autonomous macroeconomic institutions are in place, including a monetary authority and public service.

- Appropriate macro-economic policy is implemented to ensure financial stability, sustainable external accounts, and low inflation, and

- A competent, well remunerated and autonomous public (civil) service kept to affordable levels and must be insulated from political influence

4. Managing Public Finances as the Central Instrument for Reform, Recovery and Development

Establishing Credible Public Finance Management. The absence of an effective central government has created a vacuum in the area of traditional fiscal and monetary policies. While reliable indicators on national accounts, sector production, financial and price developments are scarce or unavailable, the fragmentation of the country into mini enclaves and absence of central taxing authority resulted in drastic reduction in revenue collection and public expenditure. Even in relatively peaceful parts of the country, the management of public finances is in shambles, and no central monetary authorities function. The effective conduct of proper macroeconomic polices is therefore non-existent in Somalia of 2008. The Transitional Federal Government (TFG) of Somalia lacks a national budget 3 years into its mandate, and has not managed to collect any significant domestic revenues. The domestic tax/revenue does not even cover salaries of the TFG and other recurrent costs and investment in vital socioeconomic sectors remains unattended.1

The management of fiscal policies is a key instrument of managing macroeconomic policy in all countries, developed, low income and post-conflict. The formulation and execution of government budgets, national and sub-national reflect the vision of the authorities on fiscal policy reforms and management of state affairs. Together with fiscal policies, monetary policy formulation and implementation is essentially targeted at achieving price stability in countries where the instruments to conduct such policies are available and effective. Through the coordination of appropriate fiscal and monetary policies, nations manage their macroeconomic affairs.

In post-conflict countries, the instruments to ensure macroeconomic stability, initiate reconstruction and restore growth are often limited to public finance management. Often the central institutions to conduct monetary policy such as a central bank are ineffective or inoperative, and the instruments and markets through which monetary management are effected are of limited efficacy or are non-existent. In most post-conflict countries, the authorities must strengthen or even reestablish institutions and systems to manage monetary and credit policies. In this context, a post-conflict country must therefore seek to attain macroeconomic stability, reconstruction and recovery through the management of public finances and specially through budget formulation, implementation and monitoring.

Translating a government's vision on taxes, expenditures and financing are key in defining macroeconomic successes that a post-conflict country is likely to achieve, and the development model it wishes to pursue. A government’s efforts to collect domestic revenue, manage well its own-resources and donor financing, and the ability to manage its expenditures are key to attaining stability and sustainable recovery. Accordingly, establishment of systems and procedures for control of public finances are necessary prerequisites for economic recovery and development. A government that is not managing its public finances well would most likely face economic hardships in the form of domestic economic instability and/or lack of sustainability in its external balance of payments.

The contribution of public finance: The management of public finance plays a critical role in contributing to economic stability, growth, and poverty reduction, as well as enabling governments to effectively deliver public services to the population. The key linkages between public finances and the strategic objectives of sustainable high economic growth, and poverty reduction are evident at the aggregate and sector levels, and at level of individual programs.

At the aggregate level, lack of credible and sound fiscal management can result in high inflation and economic instability, and lack of sustainability in the external accounts. As inflation tends to hurt the poor and people with fixed incomes most severely, poverty and income inequality can be exacerbated. During fiscal and general economic instability, expenditure cutbacks often occur in crisis mode and target discretionary spending, including investments and non-wage operating costs. Essential safety net expenditure and service delivery to more vulnerable also suffer under economic crisis conditions.

At the sector level, fiscal mismanagement and weak budget processes can result in misallocation of resources and inadequate service delivery.

At the individual programs levels, lack of sound fiscal management can result in resources being wasted through inappropriate standards, and funds not being properly directed to the intended purposes. Investment projects could be initiated without proper funding for running costs and proper equipment and materials for the delivery of services.

5. Key challenges for PMF in low income countries

There are many daunting challenges that LICs face in public finance management. Key among these challenges are ensuring fiscal sustainability; ensuring sound budget formulation; mobilizing adequate domestic revenue; prioritizing expenditure; enhancing the effectiveness of budget execution; effectively delivering services to the general public; ensuring adequate institutional and capacity development; and effectively utilizing external financial and technical assistance.

Establishing the pre - requisites of fiscal sustainability: Fiscal sustainability in the medium- and long-term perspective requires prudent budget formulation and execution in all countries. In particular, governments should adopt strong policies to mobilize domestic resources, contain expenditures and limit borrowing to sustainable levels. Uncontrolled fiscal deficits funded by domestic and or external borrowing lead to inflationary pressure, weakened external accounts and unsustainable debt profile. In the case of post-conflict low income countries, the approved expenditures should be limited to the available envelope of domestic revenue and concessional external assistance.

The mobilization of domestic revenue is key to progress towards fiscal sustainability. One of the principal characteristics of post conflict countries and many other low income countries is the limited initial capacity to generate domestic tax revenue. The adverse impact of conflict on the economy; poor administration in tax assessment and collection, low tax compliance, and general inadequate data and record to improve tax audits contribute to low yield of domestic taxes. It is not uncommon to have a country's domestic revenue collections amounting initially to low single digits as a percentage of its GDP. In the case of Somalia, domestic tax collections were practically non-existent in the years since 1991.

6. Requirements of sound budget formulation

In all economies and specially in a post-conflict country, the management of the budget and fiscal policies are key. A number of technical requirements should be met for a budget to be a proper instrument of national policy:

- First, the budget needs to give an over all picture of public finances. If parts of public expenditures (e.g. security related expenses or politically motivated spending) are excluded, one cannot assess the impact of the budget on the macroeconomic developments, or provide meaningful priorities on sector expenditures. Unless there is a comprehensive budgeting, including donor funded projects and programs, the needed scrutiny on sector allocations are not feasible and setting proper sector allocation priorities is not viable.

- Second, the budget must follow a classification system that allows meaningful analysis. If the classification is not based on clear GFS functional and economic classifications, then the impact on growth, poverty reduction and other economic targets will be hard to construe. A budgetary control mechanism could also function effectively and efficiently only when the accounting and reporting formats conform to consistent best international practices.

- Third, budget formulation and execution need to be based on transparency and accountability, and should be participatory. The importance of proper accountability and transparency in public finance management is one of the basic requirements. A country specially in post-conflict environment should establish robust systems of safeguarding the collection of domestic resources and control of public expenditures. Accountability and transparency reduce the risk of misuse of public resources and the impact of corruption. In addition, institutional controls and oversight are facilitated by accountability and transparency. The inclusion and participation by all stakeholders is also essential in order to gain legitimacy. Budget formulation processes, which are open to local civil society, donors, members of parliament, research institutes, and "all comers" --at annual public expenditure reviews -- have become a model to emulate for a number of low income countries and have been adopted in recent years by many post-conflict countries specially in the Africa region.

- Fourth, a country's development and reconstruction strategy needs to be translated from annual to multi-year strategy. Reconstruction and development are not one-off expenditures but need a longer framework in budget formulation and execution to translate this within the medium and long-term. In view of the urgent need to reconstitute the human and capital infrastructure, post-conflict reconstruction is by nature a multi-year and medium-term effort. A multi-year program for public resources management promotes and facilitates assessments and readjustments of a country's reconstruction and development objectives.

- Fifth, for low income countries, budget formulation and execution have become the key instrument and point of dialogue between donors and the authorities on economic policy reforms and achieving sustainable economic growth. As disintegration of institutions and governance processes are often associated with conflict situation, weak institutional capacities lead to a larger role for donors in a post-conflict situation. A significant obstacle to sustainable recovery is the erosion of national ownership in the recovery effort in a situation of limited institutional capacities and in insufficient legitimacy in the initial post-conflict phase. A more open and collaborate relationship with international donors that allows for policy dialogue and effective national implementation is desirable in these circumstances. Accordingly, an open and participatory formulation and monitoring (together with principal donors) of national budgets ensures coordination and enhances sound management of public resources management in post-conflict countries.

An effective and operative federal fiscal structure: The conduct of appropriate fiscal operations at the various levels of government is also a key variable in the vision of a Federal Somali National State to be reconstructed and its capacity to deliver adequate services. On the revenue side the powers and authority to levy taxes of the different levels of government need to be clearly agreed, codified and harmonized. There are numerous examples globally of federal fiscal structures, with the authority to tax and responsibility to allocate resources for expenditure delineated among the levels of governments. Depending on the level of decentralization of fiscal responsibilities and devolution of decision making to local authorities, viable and harmonized structures need to be designed and put in place.

Among most federal fiscal structures, a commonality is that an explicit element of revenue sharing has to be agreed upon and put in place. Invariably, the central authority or federal level will collect more than the other levels; and this is likely to be so if the customs revenue have to be collected at the federal level. Accordingly a revenue sharing formula based on such criteria as a share of an entity of the total population, a need based on level of development, and other considerations are factored in the revenue sharing formula. Other taxes, including resources based taxes should be allocated on a shared basis. An analytical and considered fiscal federal structures should be investigated with appropriate institutions and organizations.

7. Establishing an effective monetary authority

As a result of the collapse of the Somali central authorities, the tools of managing a monetary system are also non-existent and are often shared with private actors. In this case, the lack of a central monetary authority has created multiplicity of currencies to respond to the need for a medium of exchange and other monetary functions. This development has led to balkanization of the monetary space of the national or original Somali Shilling, which is occupied by illicit or local administration sanctioned currency-each with a very limited territorial circulation. A unified monetary space with a nationally sanctioned and managed currency is an essential prerequisite of reconstruction and rebuilding the Somali national state. The steps to get from the current situation to a properly functioning monetary authority that will be entrusted not only with managing the national currency, but other key functions such as managing the national official foreign reserves and maintaining price stability need to be addressed with urgency. An operative and effective central bank or monetary authority responsible for price stability and appropriate exchange rate management is essential. Such institution could also facilitate stability and competitiveness of the economy as key considerations, and be a pillar in sound public finance management.

The re-establishing of a functional monetary authority demands an autonomous institution that will be free from political interference. The governing Board of Somalia’s future central bank or monetary authority needs to be composed of a management team with fixed and renewal term appointments that could not be terminated without proof of incapacity to perform assigned duties; and directors that comprise academia, private sector and public representatives as a minority (if at all). In a federal government set up, the various states will need to be represented at the Board of the central monetary authority, but if necessary on a rotation basis to maintain a limited board membership.

In view of multiplicity of currencies in circulation, including cross border and convertible international currencies, a successful currency reform is also mandatory at a very early stage. By necessity this requires specific and analytical preparatory work. An early approach should be made to institutions with the requisite expertise such as “first world central banks or the International Monetary Fund” that have assisted countries with similar recent experiences (Afghanistan, Bosnia and Herzegovina, East Timor, and Iraq).

There are no credible and useful statistics on money in circulation in Somalia, including old and new Somali Shillings, regionally printed currencies and even unaccounted for private imports of currency notes. Information available suggests that in 1998 currency in circulation was modest and was estimated to be only US$19 million equivalent or 2.5% of GDP. The practice of some private actors to print new currency has not only added to the confusion, but it has eroded any confidence one might have in the local currency and resulted in high degree of instability. In addition, the denominations of the current local variations of the Somali Shilling are inefficient means of payment and transactions. They are fragile and bulky to carry causing them to be traded in bundles without counting. Although this is in part compensated by the utilization of other currencies (US dollar, UAE dirham, Ethiopian birr, Kenyan shilling, etc.) in commercial transactions in urban centers, the need for local currency is a major constraint to economic activities throughout the country, and national currency reform is urgently required.

8. Debt management and financial resources mobilization

Somalia urgently requires a review of the current domestic and international indebtedness and considerable debt relief to return to credit worthiness. The level of existing external debt is clearly unsustainable, and Somalia should qualify for enhanced HIPC debt relief, once the needed economic reforms are in place. Unwinding the stock of debt arrears requires efforts to engage all creditors as soon as feasible, and to put in place mechanisms to seek bilateral and multilateral debt relief and financial support. A key requirement of such a request is to seek reactivation of Somalia's membership in key international financial institutions, such as the International Monetary Fund, the World Bank and other Development Institutions.

A key component of the macroeconomic management, both for domestic fiscal management and externally is the management of a country's debt profile. At the national level a clear strategy to manage domestic and external borrowing needs to be designed. Equally or even more important, a country's authority to borrow particularly externally has to be managed with the overall macroeconomic stability and sustainability. The level of government that is authorized to commit the nation in terms of debt obligations, as well as the legal authority—full Cabinet or Parliament— has to be designated and clearly legislated.

In view of its level of development and the immense needs for reconstruction and relief, Somalia requires support of the international financial community for the foreseeable future. In whatever form such resources transfer have to be sought, an effective mechanism of utilizing external assistance in a transparent and accountable manner needs to be put in place and priorities rationalized to avoid the mess and misuse characterized by past regimes in Somalia.