Background

This document is issued as an attachment to the 2107 Budget Call Circular by the Minister of Finance, Federal Republic of Somalia. Input to this document comes from the 2107 Budget Strategy Committee (BSC) formed under the authority of the Minister of Finance to provide advice on the appropriate strategy to adopt in producing a realistic and affordable budget for the Federal Government of Somalia (FGS) for fiscal year 2107. The strategy document was endorsed by the Cabinet on [23 June 2016].

Executive Summary

The federal budget is extremely small by international comparison, at about 3% of GDP, and is largely being used to pay public sector salaries and security costs, which dominate the budget. The budget is characterised by insufficient revenue collection which have in recent years resulted in expenditure arrears. There is virtually no programmatic expenditure (e.g. for services to the people – like medicines).

The Somali government is committed to sustaining its efforts to rebuild the economy, improve social conditions, and move toward normalizing relations with international financial institutions. In this regard, it has formulated a reform program for the period May 2016–April 2017 that focuses on implementing prudent macroeconomic policies, while strengthening institutional capacity for macroeconomic management. This program is outlined in our Staff Monitored Program (SMP) with the International Monetary Fund. The SMP has a number of indicative fiscal targets for the period which determines that the FGS Budget needs to be zero cash balanced, and with further borrowing not possible. Additionally there is an indicative target for no new expenditure arrears to be generated.

Accordingly, the 2107 Budget must be balanced on a cash basis; and the revenue forecasting needs to be conservative to ensure the budget is realistic and able to be executed without generating new expenditure arrears. Only resources that are under the control of the Government are to be included in the Appropriation Bill. To achieve the level of fiscal discipline required to produce a balanced budget, Ministries, Departments and Agencies are required to base their 2107 budget requests on the amount of resources allocated to them in the 2016 Revised Budget.

Priorities of the FGS

The budget is the key instrument through which the Government implements its policies, and the Budget Strategy Paper is a key link between Government's overall policies and the annual budget. The purpose of this document is to set out how the Government intends to achieve its policy objectives over short to medium terms through the budget. In doing so the basic macroeconomic framework presented in this paper forms the basis of resource projections and indicative expenditure allocations.

The BSC has been informed by the government of the priority areas for attention in 2017. These priority areas are:

-
-
-
-

Ministries, Departments, and Agencies (MDAs) are required to take these priority areas into account when framing their detailed budgets for 2107.

Principles

The budget is prepared in accordance with a set of principles endorsed by the BSC and considered appropriate for sensible and sustainable fiscal management in Somalia at this time; the principles developed in consultation with the International Monetary Fund and other key international partners. The principles are:

(1) The budget is prepared on a cash basis;
(2) The budget is managed within a medium term fiscal framework;
(3) The budget is limited to the funds that are under the control of the government;
(4) Rules for cash rationing expenditures are included in the appropriations law passed by Parliament; and
(5) The urgent priority needs for budget repair in FGS include implementing an emergency revenue mobilisation plan and implementing a strategy to eliminate expenditure arrears.

Overarching these principles is to firstly identify what resources are available, rather than as in the past, to add-up the assessed needs of ministries. By this method, usually referred to as a top-down approach, the assessed resource envelope is calculated, and this establishes the amount of funds available for spending. From that envelope, ministries are provided guiding expenditure ceilings against which they are required to develop their detailed estimates. This approach will require further development over the coming years, and for 2107 the intention is to use the 2016 Revised Budget allocations as the initial expenditure ceiling. Details of the expenditure ceilings are contained in the 2107 Budget Call Circular.

Fiscal Rules

To assist adherence to the budget principles, a set of fiscal rules have been endorsed by the BSC. These rules are:

(1) Debt limit – the budget makes no addition to government debt
(2) Budget balance – the budget has a zero cash balance
(3) Expenditure – fiscal discipline is aided by expenditure ceilings limited to the 2016 Revised Budget
(4) Revenue – all windfall revenues are where possible to be allocated to reducing expenditure arrears.

Fiscal Summary

Revenue

The following table indicates the revenue position of the budget in recent years.

(million US$)	2015 Actual	2016 Budget	2016 Revised	Change on Budget $	Change on Budget %
REVENUE	141.2	246.3	214.2	-32.1	-22.7%
DOMESTIC REVENUE	**114.3**	**139.2**	**114.1**	**-25.1**	**-21.9%**
Tax Revenue	**82.4**	**107.8**	**93.0**	**-14.8**	**-17.9%**
Income and corporate taxes	1.9	5.1	4.2	-0.9	-48.4%
Taxes on international trade	71.1	86.0	77.0	-9.0	-12.7%
Other domestic indirect taxes	4.8	12.6	4.8	-7.8	-161.9%
Other taxes	4.5	4.1	7.0	2.9	64.6%
Non-Tax Revenue	**31.9**	**31.5**	**21.1**	**-10.3**	**-32.3%**
DONOR FUNDED	**26.9**	**107.1**	**100.0**	**-7.0**	**-26.2%**
Bilateral Assistance	2.8	30.0	34.0	4.0	139.3%
Multilateral	24.1	77.0	66.0	-11.0	-45.7%
proportion of domestic funds	80.9%	56.5%	53.3%		

Compositional issues are readily apparent, with Donor revenue estimated at over 46% of total revenue in 2016. The revenue trend for Domestic revenue is positive, and remains reasonably strong, but must continue in this vein for a number of years to permit resources to be directed comprehensively to the usual range of goods and services a government is expected to provide to its citizens.

The dominance of Trade Taxes as a proportion of domestic revenues underscores the weakness in income and corporate taxes, and in consumption taxes. Each of these categories requires major efforts to improve the legal and administrative basis for collecting these taxes.

Finally the large increases in non-tax revenue (primarily Airport and Harbour fees and visa charges) indicates the improvement that can come from improved administration (the airport and port operations are managed by a private company on behalf of the FGS), and a secure environment.

Whilst detailed revenue forecasts for 2107 are underway, indication are that the total resource envelope will be similar to that for 2016 – i.e. about $US200 - 220 million, and achievement depends critically on continued international assistance.

Expenditure

The recent expenditure trends are shown in the table below:

(million US$)	2015 Actual	2016 Budget	2016 Revised	Change on Budget $	Change on Budget %
EXPENDITURE	135.5	246.3	240.0	-6.3	-4.7%
RECURRENT EXPENDITURE	**133.2**	**223.2**	**226.4**	**3.2**	**2.4%**
Compensation of employees	52.9	91.3	99.7	8.3	15.8%
Use of goods and services	53.1	81.3	77.1	-4.2	-8.0%
Grants	13.8	16.1	16.1	0.0	0.0%
Contingency	2.6	2.4	2.1	-0.3	-10.0%
Repayment of arrears and advances	10.8	32.0	31.4	-0.6	-5.6%
CAPITAL EXPENDITURE	**2.3**	**23.1**	**13.6**	**-9.6**	**-416.9%**
Capital	2.3	23.1	13.6	-9.6	-416.9%
BALANCE	**0.0**	**0.0**	**-25.8**	**-25.8**	
compensation as share of total spending	39.1%	37.1%	41.5%		

Compositional issues dominate the expenditure budget. The budget is salary centric, with more than 40% of spending allocated to staff salary support. The proportion of security sector spending is just short of 30% of the revised 2016 Budget. These large shares of spending crowd-out opportunities for funding other spending areas – such as interest payments on debt; transfers and subsidies to government business enterprises and for private sector development; spending on health and education, which is vitally needed to improve living conditions; infrastructure capital spending; and a social safety net. Additionally failure to pay these expenses when due can give rise to arrears since wages and security costs are not discretionary.

Spending as a proportion of GDP is extremely low at about 3%. This proportion can only grow once revenue expands; and provided staff numbers and wage rates are kept under tight control.

To implement the budget in accordance with the principles and rules noted above, expenditures in aggregate should be limited to about $US200 - 220 million for 2107.

Risk Assessment

The budget strategy is subject to financial risks, which include unexpected financial pressures the government may encounter in the future; the probability that the projected revenues may not be achieved; and that spending may exceed the estimates listed in the budget. The following risk matrix identifies the main risks, provides an estimate of likelihood, impact, and steps that can be taken to mitigate the risk.

Risk	Likelihood	Impact	Mitigation or management strategy
Overall security situation deteriorate	Medium	• Poor revenue performance, delay in disbursements and economic decline. • Worsening humanitarian situation • Reduce prospects for economic growth • Increase costs in service delivery	• Improve security situation through reconciliation and inclusive approach • Strengthen security personnel • Provide security needed equipment • Improve certainty of security compensation
Arrears to security force	Medium	Exacerbate insecurity and contribute to poor revenue performance	Implement improved SNA identification and secure funding for timely payment of salary
Collection of corporate taxes (Telecommunication and remittances companies)	Low	• Delay in the introduction of corporate taxes would put expected revenue at risk	Ministry of Finance submit corporate tax bill to the Parliament and implement it on time

Budget income: 40% consists of grants from donors	Medium	• Donor delay or cancel of disbursements could collapse the budget	Include in the budget only firm commitments backed with funds made available to the budget
Increase compensation of employees as a share of total expenditure	Medium	• The increase in compensation of employees risk crowding out in investment and other priority areas	Keep compensation of employees to a level that is acceptable or feasible to available revenues
Weak enforcement of rule of law		• Slow development of integrity institutions which are necessary to facilitate private sector development and promote growth and development	Create awareness on the need for the government to raise taxes and build integrity institutions.