FEDERAL GOVERNMENT
OF SOMALIA

Somalia Financial Governance Report 2023

Harnessing Financial Governance for Economic Development and State Building

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FOREWORD

This is truly a special edition of the annual Financial Governance Report as we pass the tenth year of the Financial Governance Committee (FGC). Since 2013, the Federal Government of Somalia has been proactively engaged in a transformational journey to improve financial governance and achieve macroeconomic stability and growth. The year 2023 is also a special year for Somalia as, after a near decade of dedicated economic and fiscal reform implementation guided by the International Monetary Fund (IMF), we finally reached the Completion Point of the Highly Indebted Poor Countries Initiative (HIPC). This success is testament to the strong commitment of the Somali people and government to reforms and it will unlock new opportunities for financing Somalia's vast developmental needs at this critical time of positive development in the state building process.

The 2023 FGC report clearly highlights the decade long successes in steering and achieving reforms and results in domestic revenue mobilization, Public Financial Management and Good Governance. Domestic Revenue Mobilization remains our top priority given the need to finance the costs of administering our government, delivering basic public services to the Somali population and responding to global challenges including the devastating recurrent and cyclical climate shocks. To this end, I am proud that government revenues continue to increase as we seek to further improve tax administration through the utilization of technology and updated modern laws, as well as better enforcement.

In addition to the above, tangible steps are being taken to control public expenditure and achieve value for money for taxpayers through the rigorous implementation of Somalia's Procurement law. Furthermore, I am confident that the new Audit Bill and strengthening external audit capabilities will contribute to better accountability and transparency in Somalia's public finance management processes.

The 2023 FGC Report places a spotlight on the impressive reforms at the Central Bank of Somalia (CBS). The CBS transformation over the last decade makes it an example of reform success with the Bank now having better governance, stronger leadership, and local, national and international operational footprint. The CBS continues to go from strength to strength in the key areas of financial sector regulation, institutional capacity building and development as well as establishing a national payment system.

Despite all the above successes, the FGC Report also shows that there are clear areas for improvement to further deepen and spur economic growth in Somalia. As a government, we are absolutely committed to raising domestic revenue further, deepening Public Financial Management, progressing the Inter-Governmental Fiscal Federalism agenda as well as enhancing financial sector regulation and development. Moreover, given that Somalia's post HIPC future is anchored on trade and effective utilization of its natural resources, we will strive to manage the latter transparently and equitably in line with the existing procurement and concessions laws and regulations.

In conclusion, the successes evident in this report would not have been possible without the dedicated staff at the Ministry of Finance, the CBS and all other relevant Federal Government and Federal Member State institutions. It would also not have been possible without the positive collaboration of Somalia's international partners and the FGC members and international delegates. As we go forward, our government will seek to strengthen these partnerships further to deliver transformative economic and developmental results for the resilient Somali people.

Bihi Iman Egeh
Minister of Finance

ABBREVIATIONS

AfDB	African Development Bank
AML/CFT	Anti-Money Laundering / Countering the Financing of Terrorism
ATMIS	African Union Transition Mission in Somalia
CBS	Central Bank of Somalia
COVID-19	Coronavirus 2019
CPI	Corruption Perceptions Index
CSCCC	Cross-Sectoral Committee on Climate Change
DAC	Development Assistance Committee (OECD)
DFI	Development Finance Institution
ECF	Enhanced Credit Facility
EIIT	Extractive Industries Income Tax (Act)
FGC	Financial Governance Committee
FGR	Financial Governance Report
FGS	Federal Government of Somalia
FMS	Federal Member States
GDP	Gross Domestic Product
HIPC	Heavily Indebted Poor Countries (Debt Relief Initiative)
IBAN	International Bank Account Number
ID	Identification
IDA	International Development Association
IFT	Instant Funds Transfer
IMCC	Interministerial Concessions Committee
IMF	International Monetary Fund
IPRs	Interim Procurement Regulations
KYC	Know Your Customer
MDB	Multilateral Development Bank
MMO	Mobile Money Operator
MoECC	Ministry of Environment and Climate Change
MoF	Ministry of Finance
MoPIED	Ministry of Planning, Investment and Economic Development
MTB	Money Transfer Business

NCCC	National Climate Change Committee
NPS	National Payment System
OAG	Office of the Auditor General
ODI	formerly Overseas Development Institute
OECD	Organisation for Economic Cooperation and Development
OPM	Office of the Prime Minister
PFM	Public Financial Management
PPA	Public Procurement Authority
PPP	Public–Private Partnership
PSA	Production Sharing Agreement
PwC	formerly PricewaterhouseCoopers
QR	Quick Response
RTGS	Real Time Gross Settlement
SCALED-UP	Somalia Capacity Advancement, Livelihoods and Entrepreneurship, through Digital Uplift (project)
SCORE	Somalia Core Economic Institutions and Opportunities (project)
SFF	Special Financing Facility
SFMIS	Somalia Financial Management Information System
SNA	Somalia National Army
SOMCAS	Somalia Customs Automated System
SOMQR	Somalia Quick Response (code)
SWIFT	Society for Worldwide Interbank Financial Telecommunications
TCC	Tax Clearance Certificate
TFG	Transitional Federal Government
TSA	Treasury Single Account
UAE	United Arab Emirates
UK	United Kingdom
UN	United Nations
US	United States of America
USAID	United States Agency for International Development

EXECUTIVE SUMMARY

Introduction

Somalia concluded 2023 with international achievements spanning external debt relief, regional economic integration, lifting of arms restrictions, and support for security sector transition. At the same time, it continues to face challenges from climate change, intergovernmental political dynamics, conflict with Al-Shabaab, regional tensions with Ethiopia, and severe budgetary pressures. How the Federal Government of Somalia (FGS) builds on its recent achievements and responds to these challenges will determine the country's prospects for economic development, state building, and fiscal sustainability from 2024. Maintaining sound financial governance and pursuing further reforms will be critical for achieving these objectives and is a priority shared by the FGS and its international partners.

The Financial Governance Committee (FGC) supports long-term state building and economic development in Somalia by providing strategic high-level advice on financial governance to the FGS. Topics encompass a wide range of fiscal issues, as well as the financial sector, with an emphasis on government concessions and contracts. The FGC is chaired by the Minister of Finance and comprises senior FGS officials and international advisers. Regular in-person meetings allow for confidential discussions, often based on written analysis and advice.

Progress in financial governance and future priorities are reviewed annually in a Financial Governance Report (FGR), published by the FGC. To mark the decade of reforms that culminated in international debt relief in December 2023, the 2023 FGR provides a ten-year retrospective review of financial governance achievements in Somalia since 2013. It contains a spotlight chapter on central bank and financial sector reforms, which offer valuable lessons that can be replicated elsewhere in the FGS. Finally, it considers the economic reform priorities of the FGS following its achievement of debt relief under the Heavily Indebted Poor Countries (HIPC) initiative.

Achievements since 2013

The legacy of two decades of conflict meant that the newly established FGS in 2012 was barely functional, with outdated laws, few staff, and manual, error-prone procedures. It faced systemic challenges to mobilising revenue. Its tax base was extremely small,

and it had no taxation authority beyond Mogadishu. It was heavily reliant on customs duties from Mogadishu port, where goods were significantly undertaxed relative to their value. Public financial management (PFM) systems were weak, and there was no accountability for the use of resources. Contracts were awarded without scrutiny or competition. Reviews by the FGC found that all of the major contracts negotiated during this time suffered from major deficiencies. The secrecy surrounding the awarding of contracts in the natural resource sectors––especially petroleum and fisheries––was of particular concern. Development partners provided sizeable humanitarian and development assistance to Somalia, which was delivered predominantly outside of government systems. Somalia carried a large and unserviceable stock of external debt.

Financial governance is now demonstrably stronger than it was a decade ago, and reforms have been pursued across every domain of public finance. FGS revenues have increased more than fourfold in United States (US) dollar terms since 2013, although the tax base remains centred largely on Mogadishu. The FGS has started to collect revenue from sectors that are regulated nationally, such as telecommunications (telecom), air navigation, and tuna fishing. Customs duties remain the largest source of FGS revenue, but now account for only half of all revenue collected. Revenue administration has been modernised through new legislation, and the FGS now has stronger tools to improve taxpayer compliance with revenue obligations. Similarly, customs administration has been automated and aligned to international standards. Values-based customs tariffs have been introduced, but the amount of tax paid on imports remains low. Although the FGS has made significant progress in revenue mobilisation, the ratio of revenue to gross domestic product (GDP) is less than 3 percent and is far below the norm for fragile states.

There has been clear improvement in public expenditure management systems and procedures. The Ministry of Finance (MoF) operates a cash budget, supported by a modern legal framework. To limit the scope for accumulation of arrears, spending agencies are issued monthly cash limits in line with revenue availability. The budget execution process has been automated, and all government funds have been consolidated into a single account structure within the Central Bank of Somalia (CBS). Automation of the interface between the MoF and the CBS has improved cash management and payment processes. FGS payments, including salary payments, are no longer made in cash. This reform, which took several years to complete, has eliminated a significant historical source of leakage of public funds.

The rising cost of the state since 2013 has posed a sustained challenge for expenditure management. Although domestic revenues have increased fourfold in the past decade, the FGS's operational costs have grown even more, driven by an increase in salary payments since 2016. The FGS has relied on periodic budget support from development partners to bridge the funding gap between its domestic revenues and its operational costs. This has involved careful stewardship of expenditures by the MoF on a month-to-month basis to avoid accumulating arrears.

The FGS has adopted a new legal framework to provide a clearer and more transparent basis for public sector contracting. It makes open competition the default method for all procurement by the FGS. It establishes a decentralised approach to public procurement and a partially decentralised approach to concessions, but institutional capacity for implementation remains low. Security sector rations and fuel contracts have been competitively tendered for three successive rounds, with demonstrated gains in value for money. The FGS has yet to implement competitive tendering for concessions. Contracts continue to be awarded on a sole-source basis, despite the significant risks for transparency and value for money. The FGS has taken steps to resolve several flawed contracts signed prior to 2016. Concession agreements to operate the port and airport in Mogadishu were renegotiated to improve the terms and clarify the contractor obligations.

Agreements on fiscal federalism at a technical level between the finance ministers of the FGS and the Federal Member States (FMS) have established building blocks for improved intergovernmental harmonisation. These agreements cover duty rates on khat and tobacco, adoption of value-based customs tariffs, harmonised revenue laws and administration, a common budget classification, and the distribution of external budget support. Intergovernmental transfers have provided essential financing to FMS budgets and have prompted PFM reforms at the FMS level. The transfers have not been large enough to offset the significant differences in revenue-raising capacity between those FMS with and without major ports, which is necessary to ensure a fair distribution of resources, as required by the Constitution. At the political level, the FGS and FMS have reached agreements on the allocation of powers. This new dispensation, which is intended to be part of the revised Constitution, will require adjustments to the current practice at the FGS and FMS levels.

External audit capacity has improved considerably. The Office of the Auditor General (OAG) has undertaken and published annual audits of the FGS financial statements. The audit findings have helped to drive iterative improvements in the quality and comprehensiveness of the FGS annual financial statements. Compliance audits of selected FGS institutions have effectively identified weaknesses in financial governance practices, such as off-budget revenues and non-compliance with procurement procedures, with recommendations for remedial actions. Special audits by the OAG have revealed the risks posed by external financing that bypasses government systems. Revisions to the legal framework for audit have strengthened the independence of the Auditor General from the executive.

Both domestic and external factors have been critical in enabling reform progress since 2013. Increasing domestic revenues, ensuring the flow of international funding, and attaining debt relief have acted consistently as motivators for the FGS. Some reform aspects, such as the adoption of new laws, policies, and regulations, have proven easier to achieve. It has been more challenging to embed and implement reforms to how the government operates in practice. Strong and sustained political backing for reforms has typically been required. Individual reform leadership by senior technical officials has also been a material factor in enabling reforms to succeed, complemented by technical assistance from international partners. Strategic advice by the FGC has helped to inform and support FGS actions.

Reforms achieved over the past decade need to be deepened and sustained if they are to contribute to a lasting transformation in Somalia. Institutional legitimacy, which is a critical driver for building peaceful states, can take a generation to be established. Three continuing priorities stand out.

Complete customs harmonisation across Somalia – Customs harmonisation will be important for increasing Somalia's revenue-to-GDP ratio over the medium term. The technical building blocks required to complete the reform are in place, but they must be agreed to and implemented by all stakeholders, including the FMS. A gradual transition can then be made to tax levels that are consistent with the value of the goods being imported.

Manage natural resources transparently and equitably – Natural resources are a critical financial governance issue because of their importance to federal relations, their potential magnitude, and their propensity to trigger conflict in fragile states. Fisheries and petroleum have considerable potential to contribute to economic transformation in Somalia, if well managed. For fisheries, that means all stakeholders adhere to the new legal and institutional framework and the FGS resumes its licensing role. For petroleum, that means building institutional capacity to oversee exploration and development, producing regulations, and conducting transparent and competitive licensing.

Transform capabilities and compliance for concessions and procurement – The gap between legal requirements and current practice is substantial, and it exposes the FGS to financial governance risks. Pressure to avoid open competition in the award of contracts remains high. Capacity to ensure that contracts are implemented in accordance with contractual requirements is limited, particularly for complex concession contracts. FGS institutions need to strengthen their capacity and improve their compliance through establishing procurement units and procurement committees, and by appointing qualified procurement personnel. Regulatory and oversight institutions need to be strengthened or, in some cases, established.

Spotlight on central bank and financial sector

After the collapse of the Somali state in 1991, the CBS was unable to perform any of its functions. State-owned commercial banks also ceased operating, and Somalia became disconnected from the international financial system. International remittances to Somalia were delivered in cash through unregulated, privately owned money transfer businesses (MTBs). All transactions in the local Somali economy were cash-based.

The formation of the FGS in 2012 provided an opportunity to reestablish the functions of the CBS. The challenges it faced were enormous. Its institutional and staff capacity was extremely weak, and it lacked any capital with which to fund its operations. All of its systems were manual, and it lacked any connectivity with the international financial system, local commercial banks, or the MoF. All government transactions were conducted in cash, creating a significant risk of misappropriation of public funds. Concerns persisted about the governance of the CBS and its lack of independence. It had three different governors in 2013 and no board of directors was appointed.

The financial sector was unregulated, unlicensed, and unsupervised. No payment system existed between financial institutions in Somalia. Transfers from one institution to another required customers to withdraw and deposit funds in cash, exposing them to significant risk. The economy was effectively dollarized. Counterfeit Somali shilling notes remained in circulation for low-value transactions, and some of the FMS continued to issue counterfeit currency. Somalia's financial sector was viewed internationally as too high risk to establish correspondent banking relationships.

Strong reform progress over the past decade has covered most areas of the CBS mandate and has benefited from several enabling factors. The FGS top leadership has provided sustained political commitment to the independence of the CBS, while senior executives and the governing board have provided strong and stable leadership for the institution. There has been a clear strategic orientation to the direction, priorities, and sequencing of reform. The CBS adopted a new organisational structure to support its transformation into an institution that is policy-oriented and organised by function. The CBS staff have job descriptions, reporting lines, and performance objectives. Over sixty qualified professionals have been recruited on a merit basis, including three senior executives. Multilateral financing partners have provided extensive technical assistance to support the reforms.

The CBS function as fiscal agent to the government has been transformed by systems automation. All FGS transactions are processed by the CBS electronically, and all payments are settled in real time. Interconnectivity between the FGS and the CBS has given the MoF direct access to the FGS account balances, thereby enabling better cash flow management. Government cash flow management has also been assisted by the provision of temporary direct advances from the central bank, which are permitted under the legal framework. Branches have recently been opened in some of the FMS in preparation for the CBS expanding its operations and providing fiscal agent services there. The CBS has correspondent relationships with banks in three different countries and has reactivated its account with the Federal Reserve Bank of New York. Some progress been made in recovering frozen assets of the former Somali state held by international banks.

The regulatory framework for financial institutions has been strengthened, and the CBS has expanded the scope and quality of its regulatory activities. All commercial banks operating in Somalia are now licensed, covering banking services for deposit taking, asset financing, and investments. The CBS conducts annual on-site supervision. All MTBs are subject to the licensing regime, and their regulation has supported the government's efforts in the area of anti-money laundering and combating the financing of terrorism (AML/CFT). Mobile money operators (MMOs) also fall under the CBS's regulatory purview, and licensing covers almost all of the mobile money market in Somalia. Ongoing reforms to the legal framework will bring all other types of financial sector institution under the regulation of the CBS. Screening of cross-border transfers, enhanced payment controls, and the introduction of the National ID have strengthened AML/CFT.

A national payment system (NPS) has been developed and introduced, which connects all licensed commercial banks in Somalia and allows them to transact with each other electronically through a clearing and settlement system managed by the CBS. It reduces risk for bank customers by eliminating the need for movement of cash between commercial banks and it strengthens the ability of the CBS to monitor the activities of commercial banks. All licensed banks have recently adopted the use of International Bank Account Numbers (IBAN) for all transactions through the NPS. A further innovation is the rollout of a standardised national Quick Response (QR) code for Somalia (SOMQR), which will enable seamless and secure payment transactions.

The CBS has made significant progress towards becoming a policy-oriented, functionally organised institution. A new organisational structure has been adopted, supported by clear job descriptions and reporting lines, staff performance objectives and appraisal, and an annual training plan for all staff. The CBS staff has been expanded and professionalised, with a competitive and merit-based approach to new recruitment through written assessment and interviews. Internal systems in the CBS have been overhauled and modernised, including the automation of operations and accounting. A full suite of internal policies, procedures and manuals has been developed. Strengthened internal controls have supported the repeated achievement of a clean external audit opinion. Research and statistics capacity has increased, and regular Quarterly Economic Reports are now published.

Political commitment by the FGS leadership to sound governance of the CBS has been maintained. Two successive CBS governors have each served a four-year term, and the current governor has been reappointed for a second term. The CBS Board meets regularly, has established board committees, and has ensured compliance with annual financial reporting and audit responsibilities. It has supported the organisational restructuring of the CBS and the implementation of merit-based staff recruitment.

Although the CBS has made substantial progress in implementing reforms since 2014, efforts need to continue. Existing reforms of the CBS functions and capabilities need to be expanded and deepened, alongside the enactment of all pending legislation. In financial sector supervision, there is a need to increase the regulatory reach of the CBS to cover all financial sector institutions and to strengthen its capacity to enforce financial sector regulations. Further enhancements to national payment and settlement systems will support instant payments and create interoperability across different payment instruments and platforms. Rollout of the National ID will help to reduce illicit transactions and stronger Know Your Customer (KYC) controls will support greater integration to the global financial system. The operational independence of the CBS needs to be ensured, and it must be put on a sustainable financial footing through adequate capitalisation so that it no longer relies on commission from FGS revenue.

Longer-term priorities include extending the operational reach of the CBS across all FMS to support fiscal federalism. Enhanced geographical coverage will also promote financial sector development by providing services to commercial banks operating in the FMS. Launching the first phase of currency reform is another priority for the FGS and is

important for financial inclusion in Somalia. It will help the most vulnerable populations, who have limited access to formal financial services, and will benefit small-scale traders. The first phase, which involves replacing counterfeit low-value notes, will require external financial support and agreement of all the FMS.

Agenda and priorities from 2024

Somalia has an exceptional opportunity to expand its strategic focus following the attainment of debt relief and increased regional economic integration. Two objectives stand out: increasing growth and economic development to support the country's transformation, and remodelling investment relationships with international partners from the public and private spheres. Wider sustainable development and state-building priorities will also remain vital. This overall strategic agenda lies at the heart of the Centennial Vision 2060 for Somalia.

Strong financial governance will be a critical ingredient in future progress. Somali citizens, prospective investors, and international partners have a shared interest in seeing the state improve its fiscal position and manage public resources effectively. Reforms should contribute to transforming the enabling environment for investment and growth, as well as building investor confidence. They will provide the foundations for increasing state capacity and legitimacy, both of which are needed to mobilise additional and sustained government revenue. There are risks, too. A failure to build on existing reforms will keep the FGS fiscally constrained, unable to increase public investment, and highly reliant on external financing.

The strategic agenda for financial governance for the FGS from 2024 will involve completing and sustaining prior reforms initiated in the last decade, as well as building capabilities to anticipate and manage new opportunities and risks. It will need to encompass three broad objectives: to scale up government financial resources, to manage the future affordability of the state, and to achieve value for money from state resources.

<u>1. Scale up government financial resources</u>

Increasing domestic revenue collection, from the current very low revenue-to-GDP ratio of 3 percent, must be prominent in the FGS agenda. A broad-based approach by the FGS across will be needed all major areas of economic activity. Improved collection of corporate income taxes, especially from the telecom sector and other large businesses, is essential to expand the revenue base. Completing customs harmonisation across all FMS is necessary to enable a gradual transition to levels of customs duties that are consistent with the value of the goods being imported.

External borrowing will become another potential source of government financing following the achievement of debt relief. The FGS has committed to borrow only for capital expenditure and development projects, and only on concessional terms. A sustainable approach must emphasise the quality of new borrowing and guarantees, the estimated economic return on investments, and the alignment of borrowing to priorities. The Council of Ministers will need to provide direction on the overall prioritisation of new borrowing. While only the Minister of Finance has the authority to borrow on behalf of the government, all FGS institutions will need to understand their roles and responsibilities in the borrowing process. The MoF will need to expand its technical capacity to assess and negotiate loans, and to manage new debt.

Boosting the volume and share of external financing that uses government systems is a long-standing objective of the FGS. Although these systems have improved demonstrably over the past decade, bilateral development partners continue to channel their funding through third-party providers. The reasons often relate more to risk appetite and domestic political considerations in the countries providing the assistance than to the objective performance of the FGS systems. Some multilateral agencies have already made significant progress in how they align their financing. The FGS should continue to encourage its international partners to adjust their practice by communicating the improvements in government systems, and by exploring pragmatic and innovative approaches.

Scaling up access to international climate finance, especially from the various multilateral climate funds, is a high priority for the FGS. As this effort ramps up, it will be important that climate finance be provided quickly and efficiently and used effectively. Many of the same financial governance considerations that apply to external development

finance will also arise for climate finance. The FGS will need to develop a pipeline of bankable climate-related investment projects, to work effectively with intermediary implementing partners, to ensure effective intergovernmental and cross-government coordination, and to maintain coherence between climate finance requirements and petroleum sector development. The MoF should push for the use of government systems and ensure compliance with the PFM Act.

2. Manage the future affordability of the state

Maintaining control over current and future state costs requires the FGS to have a strategic vision of the role and size of government in Somalia. Fiscal expenditures have been rising rapidly, and the state remains heavily reliant on external budgetary financing. Even with efforts to mobilise additional revenue, the FGS will need to limit the trajectory of expenditure growth to avoid unaffordable future liabilities. Several cost drivers will challenge the fiscal position, including the transfer of security sector costs to the FGS budget, implementation of the new pay and grade policy, fiscal federalism and expansion of the state at all levels, and stabilisation and service delivery requirements in territory liberated from Al-Shabaab.

The FGS will need to manage actively the costs associated with further state growth. It will need to be especially vigilant about sector institutional reforms that raise fiscal costs. New sector legislation often leads to the establishment of semi-autonomous government agencies, which increase public expenditure and create future liabilities. The FGS should use existing legal provisions to scrutinise draft laws that further expand state costs, and it should develop a policy to regulate the circumstances in which new agencies can be created.

Civil service reforms, such as the merit-based recruitment and management of government employees, can help to improve the efficiency and performance of the state. They offer a lever for the FGS to use in proactively managing costs and affordability. The introduction of merit-based employment practices in the CBS has been an important driver of institutional development and reform. The FGS should replicate this approach across other government institutions.

3. Achieve value for money from state resources

Enhancing strategic investment planning and project selection for public infrastructure will become more critical as the FGS increases its emphasis economic development. With almost all investment projects in Somalia currently funded by external partners, project selection risks being driven by external criteria that are not well aligned to an FGS strategy for economic development. Increased ability by the FGS to tap private financing sources to support new investment through public–private partnerships (PPPs) or concessions may drive further fragmentation. Cross-government coordination in the prioritisation and selection of projects across all sources of financing—public or private, domestic or external—will be vital, and a strong focus is needed on ensuring that all investments offer an economic rate of return. Cooperation and agreement on investment planning with the FMS will also be necessary for some projects.

Capable management and delivery by FGS sector institutions of specific investment projects will be critical. Major infrastructure projects are complex undertakings that bring new strategic risks. The FGS will need to safeguard public assets, limit the scope for corruption, and maximise value for money. It will require significantly increased capacity for public investment management through all stages of the project cycle: identifying, structuring, and appraising potential projects; assessing fiscal commitments and contingent liabilities; designing contracts; managing transactions; managing contracts; and dealing with unsolicited proposals. To ensure that PPPs/concessions deliver value for money, the FGS will need to strengthen the legal framework and the effectiveness of oversight institutions.

Natural resources, if managed transparently and effectively, have high potential to contribute to economic transformation in Somalia. They are a financial governance priority because of their scope to produce large-scale revenues, their importance to intergovernmental relations, and their propensity to create conflict. The fisheries sector needs to ensure that all stakeholders adhere to the newly agreed legal and institutional framework and that its provisions are implemented. In the petroleum sector, FGS institutional capacity to oversee exploration and development requires significant further development. Regulations need to be developed, and all future contracting must be carried out transparently and competitively. The FMS must be willing to cooperate with the FGS in the exploitation of petroleum resources.

Enabling factors for the post-HIPC priorities

Several factors that were critical for enabling reforms over the past decade will remain highly relevant. These include an overall authorising environment conducive to reform, high-level political backing for specific reform measures, high-calibre senior leadership in key FGS institutions, constructive international dialogue and conditions, and access to extensive external technical assistance.

In a new context, considerations such as domestic political dynamics and international reputation will also become more important. Intergovernmental relations between the FGS and FMS, the fiscal bargain between the FGS and the private sector, and cross-government coordination among FGS institutions will all influence economic development and state building in Somalia. The FGS leadership will need continuously to make the case for further reform to all stakeholders. The extent of the FGS's commitment to state building and good governance will have an important bearing on investor confidence.

Overall, the strong progress made by the FGS in the decade since 2013 serves as a benchmark for the commitment and effort that will be needed in next decade to ensure that strong financial governance continues to underpin economic development, state building, and fiscal sustainability.

I. Introduction

Change and continuity: the Somali context in the wake of debt relief

Somalia is experiencing both a considerable improvement in its circumstances and prospects, and strong continuity in the priorities the country must tackle.

The end of 2023 marked a pivotal international moment for Somalia, with multiple major strategic objectives achieved. On November 20, Somalia successfully co-hosted a Global Food Security Summit with the United Kingdom (UK) and United Arab Emirates (UAE) in London.[1,2] On November 24, the country achieved accession to the East African Community—more than a decade after it first applied to join the bloc.[3] On December 1, its arms embargo was fully lifted by the United Nations (UN) Security Council after 30 years of restrictions.[4] On December 2, it confirmed the phasing out of all African Union troops by the end of 2024, after an 18-year presence.[5] On December 7, at the 28th meeting of the Conference of the Parties (COP 28) to the United Nations Framework Convention on Climate Change, the United States (US) and UK committed to jointly co-anchor Somalia as a pioneer country for the Task Force on Access to Climate Finance.[6] On December 12, the international community pledged to rebuild Somalia's security forces at the Somalia Security

1 Halqabsi News. 2023. "Somali President Co-hosts Global Food Security Summit in London." November 20.

2 Global Food Security Summit London 2023 website: https://ukglobalfoodsecuritysummit.com/

3 East African Community. 2023. "East African Community continues on a trajectory of expansion as Summit admits Somalia into the bloc." Press Release, November 25. (n.b. The Treaty of Accession to the EAC was then signed on December 15.)

4 UN Security Council. 2023. "Security Council Lifts Arms Embargo on Federal Government of Somalia, Unanimously Adopting Resolution 2714 (2023)." Press Release, December 1.

5 AU Transition Mission in Somalia. 2023. "ATMIS, FGS and UNSOS Announce Resumption of Second Phase of Troop Drawdown." Press Release, December 2.

6 USAID Somalia. 2023. "US committed to increase Somalia's Access to Climate Finance." Twitter/X post, December 7.

Conference in New York,[7] and on December 13, the country achieved the Completion Point for the Heavily Indebted Poor Countries (HIPC) initiative to secure a US$4.5 billion debt write-off from global lenders after a five-year process.[8] On the domestic front, on December 9, Somalia's parliament approved a federal government budget of over US$1 billion for 2024,[9] while gains continued to be made in the campaign against Al-Shabab.[10,11] Somalia thus starts 2024 with a new vista and greater opportunities to pursue foreign investment, economic growth, climate resilience, and national security.

Existing challenges will also persist in 2024 and beyond. Somalia has suffered from two years of persistent drought and famine, followed by heavy flooding in late 2023 caused by El Niño. The country remains chronically vulnerable to the effects of climate change and extreme weather events. Yet it lacks access to the large-scale financial resources that are needed urgently to support adaptation and future resilience.[12,13] Political dynamics between the Federal Government of Somalia (FGS) and the Federal Member States (FMS) are not yet fully stable and have delayed efforts to achieve a lasting political and constitutional settlement and consensus on a model of fiscal federalism. Despite territorial gains in the military campaign against the Al-Shabaab militant group, the conflict persists, and national security costs are likely to remain substantial. Somalia faces a significant challenge in its relations with neighbouring Ethiopia, which has signed a Memorandum of Understanding with Somaliland that reportedly trades sea access in exchange for recognition of Somaliland's sovereignty.[14,15] Alongside these environmental, political, and security challenges, Somalia is faced with the demands of operating a state that is expanding rapidly in scope, size, and cost. Pressures for revenue generation and increased spending will continue to dominate in an environment that is still characterised by relatively weak institutions and low fiscal capacity.

7 GoobJoob News. 2023. "Major Donors Endorse Somalia's Security Plan in New York." December 13.

8 IMF and World Bank. 2023. "IMF and World Bank Announce US$4.5 billion in Debt Relief for Somalia." Joint Press Release on Enhanced Heavily Indebted Poor Countries Initiative—Completion Point, December 13.

9 Somali Signal. 2023. "Somali parliament approves $1 billion budget for 2024 as country nears debt relief milestone." December 10.

10 Garowe Online. 2023. "Al-Shabaab suffers more defeats in Somalia war." December 5.

11 Somalia National News Agency. 2023. "Ministry of Defense: 130 Al-Shabaab Militants killed during operations." December 24.

12 The Guardian. 2023. "Climate funding must be faster and easier, says deputy PM of flood-hit Somalia." December 6.

13 UN Assistance Mission in Somalia. 2023. "Statement by the Special Representative of the Secretary-General to the Security Council on the Situation in Somalia." June 22.

14 Somalia National News Agency. 2024. "Ethiopia-Somaliland port deal: A quest for recognition or a provocation to Somalia?" January 5.

15 Security Council Report. 2024. Somalia: February 2024 Monthly Forecast, January 31.

These contextual factors will test financial governance in the year ahead and over the medium term. Somalia's response will determine its ability to exploit—advantageously and sustainably—its post-HIPC transition.

The FGS has affirmed its commitment to strengthening financial governance. The Council of Ministers approved Directives on Strengthening Financial Governance Integrity in May 2023,[16] which were then endorsed by the President.[17] The FGS also launched a Modern Governance Strategic Direction Program in October 2023,[18] with the objective of improving transparency and accountability.

In providing debt relief in December 2023, the international community stated its expectation that the FGS will maintain reform momentum and deepen structural reforms.[19] International partners have noted the fundamental importance of state building and good governance,[20] and the continuing need to enhance transparency and accountability through greater attention to improving governance.[21] This shared objective between the FGS and its international partners has been actively supported by the work of the Financial Governance Committee (FGC) since 2014.

Role of the Financial Governance Committee

Purpose and scope

The FGC is a high-level strategic advisory body to the FGS. Its purpose is to support improvements in financial governance as a foundation for economic and social development, political stability, and overall good governance (Box 1).

The FGC was established in early 2014 by mutual agreement between the FGS, international financial institutions, and bilateral development partners.[22] It provides a forum for confidential discussion and advice on FGS strategic priorities and reform actions. The FGS gives serious consideration to advice provided by the FGC and seeks to implement it unless it believes there is a compelling reason not to do so.

The scope of FGC dialogue covers:

- How improvements in financial governance can contribute to the broad, long-term economic development agenda for Somalia.
- How FGS policies, institutional reforms, and technical capacity can strengthen the overall financial governance environment and reduce financial governance risks.

BOX 1 What is 'financial governance'?

The term financial governance covers a broad agenda. It spans the mobilisation, management and oversight of public resources, including public money and other public assets such as land, property and natural resources, as well as the regulation and oversight of the financial sector.

Sound financial governance plays a vital role in creating and maintaining the enabling environment needed for sustained economic development and foreign investment.

Financial governance addresses both the current integrity and performance of public resource management, as well as the active reform measures to drive further improvement. Transparency, accountability and anti-corruption are often central priorities for countries seeking to strengthen financial governance.

The principal institutions typically responsible for financial governance are the Ministry of Finance, the Central Bank, and the Supreme Audit Institution. In addition, the Office of the President, the Office of the Prime Minister, the Council of Ministers and the Parliament all have a crucial guiding influence.

[16] Office of the Prime Minister. 2023. "Strengthening Financial Governance Integrity Directives." Press Release, May 11.

[17] Office of the President. 2023. "President Hassan Sheikh Mohamud Supports Cabinet's Anti-Corruption Directives: Major Steps to Combat Corruption and Foster Accountability." Press Release, May 11.

[18] Somalia National News Agency. 2023. "Somalia Launches Modern Governance Strategic Direction Program." October 16.

[19] IMF and World Bank. 2023. "IMF and World Bank Announce US$4.5 billion in Debt Relief for Somalia." Joint Press Release on Enhanced Heavily Indebted Poor Countries Initiative—Completion Point, December 13.

[20] Foreign, Commonwealth, and Development Office (UK). 2023. "Communique by the Federal Government of Somalia and the United Kingdom of Great Britain and Northern Ireland on the signing of a strategic partnership." Policy Paper, November 21.

[21] IMF and World Bank. 2023. "Joint Staff Advisory Note on the Mid-Term Review Report of the Somalia Ninth National Development Plan." December 21.

[22] International financial institutions here include the International Monetary Fund (IMF), World Bank, and African Development Bank (AfDB). Bilateral development partners here include the governments providing official development assistance to Somalia, as well as the European Commission.

- How the FGS can address and resolve any specific financial governance issues or challenges that arise in the short term.
- How the FGS can engage with the international community to enhance the scale, sources, terms, and effectiveness of development finance and technical assistance.

The FGC members collectively review their strategic agenda and areas of priority on an annual basis, in line with their mandate.[23] The FGC screens potential topics using the following criteria:

- Topics should be of critical importance to maintaining or strengthening financial governance in the short, medium, or long term.
- The FGC should have a comparative advantage, beyond the ordinary role of other institutions and mechanisms, in addressing a topic.
- There should be a realistic prospect that FGC involvement can achieve a positive impact.

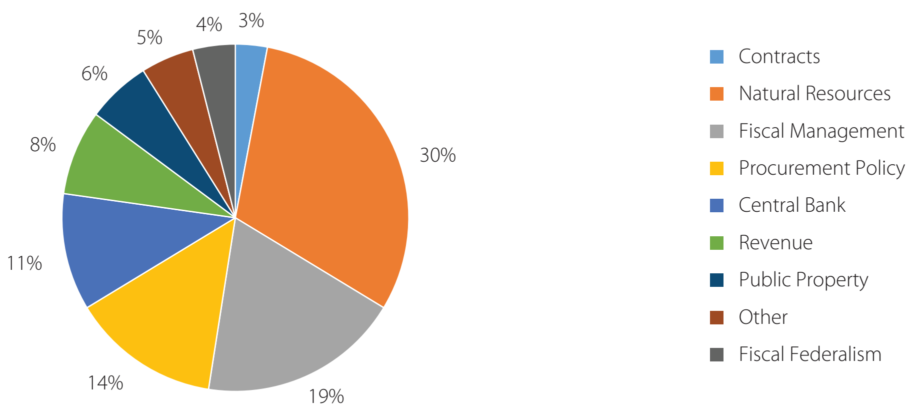
Individual FGC members and other financial governance stakeholders may propose specific topics for consideration by the FGC.

The scope of FGC engagement and advice since 2014 has encompassed revenue mobilisation, public expenditure management, natural resources management, public procurement and concessions, protection of public assets, fiscal sustainability, intergovernmental fiscal relations, asset recovery, and central bank governance. Advice has covered matters of policy development, institutional strengthening, and implementation. While the FGC focuses primarily on the federal government level, it has also addressed matters of fiscal federalism that are relevant to the FMS.

The FGS assigned the FGC a specific mandate in 2014 to review and provide advice on all concession agreements[24] and all FGS procurement contracts of US$5 million or higher in value. In the past decade, the FGC has formally reviewed more than 60 concession agreements and procurement contracts (Annex A). It has successfully supported the FGS to conduct competitive procurement transactions, to renegotiate concession contracts, and to resolve contractual disputes.

The FGC provides advice to the FGS through a combination of in-person dialogue, written advisory notes, and expert technical analysis. Advisory notes are discussed in FGC meetings, and meeting decisions reflect the collective view of all FGC members. The topics covered by FGC Advisory Notes reflect the scope of engagement by the FGC (Figure 1). The FGC discussions are confidential, but meeting summaries are published on the MoF website.[25]

Figure 1: Distribution of FGC Advisory Notes by topic, 2016 – 2023



[23] The mandate of the FGC is renewed periodically by agreement between the FGS and the four international sponsoring institutions (IMF, World Bank, AfDB, and European Commission). It was last renewed formally in June 2022, for a two-year period, and was reconfirmed by the incoming administration in June 2022. The next renewal of the mandate is due in June 2024.

[24] Concession agreements grant an interest in a public asset to a private entity for a specified period in return for a fee, royalty, or other consideration, whereas procurement contracts govern the purchase of public goods, works, and services.

[25] The Multi-Partner Fund is funded by Denmark, the European Commission, Finland, Germany, Italy, Norway, Sweden, Switzerland, the UK, and the US.

Membership and organisation

Members of the FGC are appointed from both Somali institutions and international partners. The FGC is chaired by the Minister of Finance, and it includes the Governor of the CBS and senior representatives of the President and the Prime Minister.

International members of the FGC include representatives of the World Bank, International Monetary Fund (IMF), African Development Bank (AfDB), and bilateral development partners, including the European Commission. The FGC receives expert support from a dedicated Concessions Adviser and an FGC Secretariat. Funding for FGC operations is provided by the World Bank, through the Multi-Partner Fund,[26] and the European Commission.

The FGC meets in Mogadishu on a regular basis.[27] Representatives from other FGS institutions may be invited to FGC meetings to discuss a specific agenda item. Those participants typically include the minister and/or a senior government official with designated responsibility in FGS for the topic under discussion.

Purpose of the Financial Governance Report

The FGC publishes an annual Financial Governance Report (FGR),[28] which reviews progress in areas covered by the FGC, typically during the previous year. The purpose is to provide outreach to a broader audience beyond the FGS counterparts who would engage directly with the FGC. This audience includes Somali citizens, parliamentarians, and the international community.

Since the work of the FGC is largely confidential, the FGR is an important annual vehicle for communicating publicly about the scope of FGC activities and about Somalia's financial governance achievements, challenges, and future priorities. It does not attempt to provide a comprehensive review of all economic and financial governance topics. Its focus is limited to those topics where the FGC has provided some engagement through discussion, analysis, or advice.

The 2023 FGR departs from previous reports by taking a longer retrospective view on financial governance achievements in Somalia. Reaching the HIPC Completion Point is an extraordinary

[26] The Multi-Partner Fund is funded by Denmark, the European Commission, Finland, Germany, Italy, Norway, Sweden, Switzerland, the UK, and the US.

[27] The FGC has held 62 meetings since 2014, with six to eight meetings in a typical year.

[28] Financial Governance Committee webpages: https://mof.gov.so/publications/financial-governance-reports

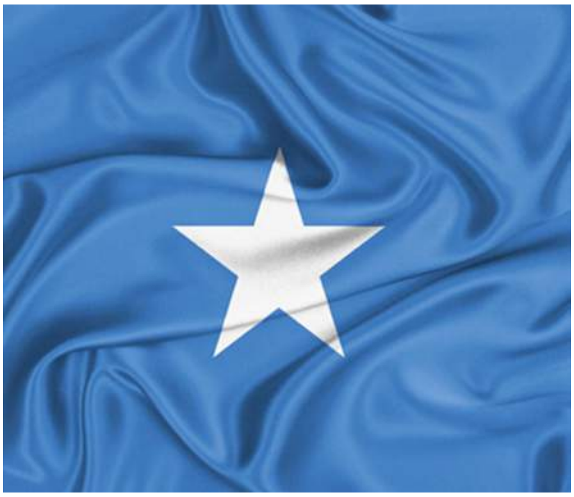
milestone for the country, and this warrants a more expansive assessment than the typical annual time frame of the FGR. Furthermore, the decade of institutional experience now held by the FGC since its establishment in early 2014 positions it well to provide this retrospective. The FGR 2023 therefore takes as its starting point the status quo ante in 2013.

Since 2020, the FGR has included an additional 'spotlight' chapter that goes into greater depth on a specific financial governance topic of concern to the FGC.[29] The purpose is to review achievements over a multi-year period, to analyse the lessons relevant for future policies or reforms, to identify any persistent barriers to progress, and to make recommendations on potential future priorities. This year, the FGR spotlight focuses on a decade of Central Bank and financial sector reforms. The scope and depth of these reforms offer valuable lessons that can be replicated elsewhere in the FGS, particularly in terms of performance management and systems development.

Organisation of the report

Following this opening chapter (Chapter I: Introduction), the remaining parts of the FGR 2023 are organised as follows:

- **Chapter II** reviews the achievements of successive governments in strengthening financial governance from a baseline in 2013 until the HIPC Completion Point at the end of 2023. It focuses on fiscal issues, looking at revenue mobilisation, expenditure management, procurement and concessions, fiscal federalism, and accounting and audit. It then considers the enabling factors underpinning achievements in these areas, before identifying reform areas where further work is needed to complete and consolidate the progress made to date ('unfinished business').



- **Chapter III** provides an in-depth review of financial governance reforms in the central bank and financial sector since 2013. It follows a similar structure to Chapter II, starting with a baseline assessment before reviewing the major areas of achievement. It covers fiscal agent services to FGS; licensing and supervision of the financial sector; payment, clearing, and settlement systems; CBS governance; and CBS organisation and staffing. It concludes with a discussion of future priorities.
- **Chapter IV** sets out objectives and priorities from 2024 on. It considers the contours and opportunities in the new landscape following the HIPC Completion Point, with a strategic orientation towards economic development and state building. It sets out a strategic agenda that encompasses three broad objectives for the FGS: scaling up government financial resources, managing the future affordability of the state, and achieving value for money from state resources. It identifies the enabling factors that will need to be in place to sustain effective financial governance.

[29] Spotlight chapters in previous FGRs have covered FGS procurement and concessions (2020), improving sector alignment with financial governance reforms (2021), and financial governance risks during the political transition (2022).

II. Achievements in Strengthening Financial Governance Since 2013

Starting point[30]

Somalia's first internationally recognised government in more than twenty years was formed in September 2012. The legacy of two decades of conflict and displacement meant that the FGS was barely functional. Government agencies were housed in war-damaged buildings. They had few staff, most of whom were unqualified for the positions they held.[31] There were no job descriptions, personnel records, or employment contracts, and the terms of service for government personnel were unclear. Almost all governing laws dated from the 1960s and 1970s, and they were largely unfit for purpose. Government procedures, to the extent that they existed, were predominantly manual, prone to error, and poorly implemented. Owing to the almost total collapse of the banking system, all government transactions, including salary payments, were conducted in cash.[32]

The challenges facing the FGS were systemic. Its tax base was extremely small. Revenues amounted to 1.2 percent of gross domestic product (GDP) in 2013, or just US$69 million. The FGS had no taxation authority beyond Mogadishu. Within Mogadishu, its revenues were almost entirely dependent on

[30] As noted in Chapter I, financial governance spans the mobilisation, management, and oversight of public resources (including public money and other public assets such as land, property, and natural resources), as well as the regulation and oversight of the financial sector. This chapter does not cover central banking and the financial sector, which are addressed separately in the following chapter.

[31] Office of the Auditor General. 2013. FGS Management Letter for the Year Ended December 31, 2012.

[32] Ministry of Finance. 2013. FGS PFM Self-assessment report and proposed Public Financial Management Strengthening Initiative.

imports coming through Mogadishu port. Customs duties accounted for 85 percent of total revenues. Assessment was based on the size of the container, rather than on the value of its contents, leading to significant undertaxation of high-value items. The MoF noted that the volume-based approach to customs valuation was one of the weakest areas of Somalia's tax system.[33] Fragmentation of revenue administration also undermined the FGS's revenue effort. Some third parties collected revenues on behalf of the FGS without appropriate monitoring,[34] while some government agencies retained the revenues that they collected instead of remitting them to the CBS.

Financial governance was extremely weak. The MoF acknowledged that the public financial management (PFM) system suffered from illegality, leakage, and a lack of transparency.[35] External observers suggested that some revenue deposits into the CBS were not accounted for, and that up to 80 percent of withdrawals were used for private purposes.[36] Government agencies withdrew cash in bulk from the CBS to pay staff salaries, with no accountability. Limited revenue mobilisation, coupled with poor expenditure management, meant that the FGS was unable to meet the running costs of government effectively, let alone to deliver services. It often accumulated arrears and at times left salaries unpaid.

FGS contracts were awarded without scrutiny or competition, and without any consideration of affordability and value for money. Most of the FGS's contracting activity centred on concessions for the management of infrastructure assets,[37] the management of natural resources,[38] and the delivery of government services.[39] The FGS also entered into several major public procurement transactions, including sole-source supply contracts for security sector rations and one contract for the acquisition of six coast guard vessels whose cost exceeded the FGS's annual revenue at the time. Ex post reviews by the FGC found that all of the contracts negotiated suffered from major deficiencies and failed to protect the interests of the FGS.[40]

The nontransparent way in which government officials negotiated contracts for the management of public assets and purchase of goods raised concerns over misappropriation of public funds and abuse of sovereign legitimacy for private gain.[41] The secrecy surrounding the FGS's award of contracts in natural resource sectors (especially oil and gas, and fisheries) was of particular concern, as transparency in these sectors was seen as essential for the development of nascent federal relations with the Somali regions and for the sound management of natural resource wealth for the benefit of all Somali citizens.[42]

The challenges faced by the FGS affected every facet of financial governance (Table 1).

Development partners provided sizeable humanitarian and development assistance to Somalia for many years. Total humanitarian and development aid in 2013 was estimated at just under US$1.2 billion,[43] or 20 percent of GDP in 2013—almost 20 times more than the revenues collected by the FGS. This funding was provided predominantly by bilateral donors and composed of grants delivered outside of government systems. The FGS could not borrow externally, as Somalia had not serviced its external debts since 1991 and had accumulated large arrears. Somalia's outstanding external debt stock amounted to approximately US$5 billion.

33 Ministry of Finance. 2013. FGS Financial Statements for the Year Ended December 31, 2012.

34 Office of the Auditor General, 2013.

35 Ministry of Finance. 2013. Budget Policy Framework 2014.

36 UN Security Council. 2013. Report of the Monitoring Group on Somalia and Eritrea pursuant to Security Council resolution 2060 (2012): Somalia. Document S/2013/413, July 12.

37 Mogadishu port, airport, and public land and buildings.

38 Seismic data acquisition, oil and gas exploration, and fisheries management.

39 Tax and nontax revenue collection, production and sale of textbooks, and vehicle licensing.

40 Further details can be found in the FGR 2020, which includes a spotlight chapter on public procurement and concessions.

41 UN Security Council. 2014. Report of the Monitoring Group on Somalia and Eritrea pursuant to Security Council resolution 2111 (2013): Somalia. Document S/2014/726, October 13.

42 IMF. 2015. Somalia: 2015 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for Somalia (July 29).

43 Ministry of Planning. 2019. "Aid Flows in Somalia 2019."

TABLE 1 Overview of weaknesses in financial governance in 2013

Domain	Legal framework	Legal framework
Revenue	Body of laws on direct taxation (1966) Customs Law (1968)	- Tax assessment process entirely manual - All payments made in cash - Manual receipts - Customs revenues levied by volume rather than value - Revenue collections by third parties on behalf of the FGS inadequately monitored - Government agencies retain revenues at source without authorisation
Budget	Financial and Accounting Procedures of the State (1961)	- Government agencies not involved in budget preparation - Revenue estimates unrealistic - Expenditure classifications inadequate
Payroll	Civil Service Law (2006)	- Payrolls unverified - Salaries paid in cash - Funds for salary payments withdrawn by government agencies from the CBS in bulk and paid offsite
Procurement	Financial and Accounting Procedures of the State (1961)	- No procurement planning - Contracts negotiated directly without competition and without reference to budgetary availability - Weak to non-existent contract management
Treasury	Financial and Accounting Procedures of the State (1961)	- No cash management process - Treasury cashbook maintained manually and prone to error - All expenditures made in cash - Supporting documentation often inadequate - Advances not requited - Bank statements not reconciled with cashbook - Frequent arrears accumulation - Cashbooks not maintained within government agencies - Public funds held in bank accounts outside of the CBS
Accounting	Financial and Accounting Procedures of the State (1961)	- Transactions outside of treasury main account not reported on or accounted for - FGS financial statements not prepared in line with international standards - Annual accounts not prepared within government agencies
Audit	Law of the Magistrate of Accounts (1972)	- Operational independence of the Auditor General restricted - Audit recommendations limited and often not implemented
Inter-govern-mental Fiscal Relations	2012 Provisional Constitution 2006 Petroleum Law	- Allocation of powers between the FGS and the FMS not agreed - Tax rates not harmonised - Contestation over management of natural resources (fisheries, petroleum) - No agreement on revenue sharing - No system for sharing fiscal reports

Sources: Office of the Auditor General, 2013; Ministry of Finance, 2013; UN Somalia and Eritrea Monitoring Group, 2013

International development partners were largely unwilling to provide funding direct to the FGS because of the chronic weakness of country systems. Almost all funding was programmed bilaterally by partners without FGS involvement and was delivered by third parties. Some partners provided a small portion of financial assistance to support the FGS's operational costs. Much of this funding was channelled through the accounting and consulting firm PwC,[44] which acted as a fund management agent for the FGS in 2012–13.[45] PwC took responsibility for transferring funds to the FGS and providing payment confirmation to the funding partner. This arrangement enabled the provision of financial support to the FGS without making use of country systems.

Strengthening financial governance: main achievements between 2014 and 2023

Against the 2013 baseline, the FGS's reform progress over the past decade has been substantial. This progress has been achieved in the face of multiple climate shocks, a global pandemic, continued insecurity, and two changes in administration.

The FGS's sustained commitment to reform in a highly challenging operating context has been recognised by Somalia's external creditors, enabling it to achieve debt relief under the HIPC initiative. At the Completion Point in December 2023, Somalia's debt stock stood at US$637.8 million, or 5.5 percent of GDP, and the FGS can resume borrowing externally as of 2024 (Box 2).

[44] Formerly called PricewaterhouseCoopers.

[45] Ministry of Finance. 2013. FGS PFM Self-assessment report and proposed Public Financial Management Strengthening Initiative.

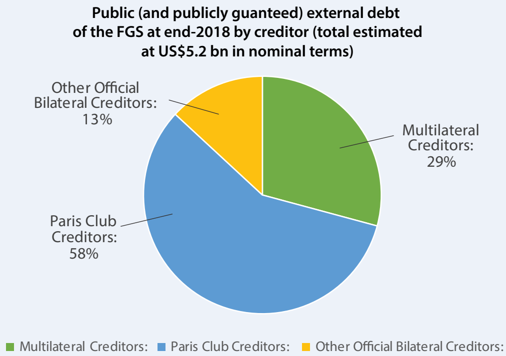
BOX 2 Somalia's external debt before and after HIPC debt relief

Somalia's public and publicly guaranteed external debt: At the end of 2018, the FGS's public and publicly guaranteed external debt was estimated at US$5.2 billion, around 34 percent of GDP. This included US$5 billion in arrears.

Before HIPC

Breakdown of creditors before the HIPC process:

- **Multilateral creditors:** These creditors accounted for 29.2 percent of the total debt, with the International Development Association (IDA), IMF, and AfDB together accounting for 18.5 percent of total debt.
- **Paris Club creditors:** Led by the United States, these creditors accounted for 57.7 percent of the total nominal debt.
- **Other official bilateral creditors:** These include Algeria, Bulgaria, Iraq, the Kuwait Fund for Arab Economic Development, Libya, Romania, the Saudi Fund for Development, and the Abu Dhabi Fund and constituted 13.1 percent of the total debt



Arrears: As of the end of 2018, 96 percent of the FGS's external debt was in arrears, totalling US$5 billion. This included US$1.3 billion of arrears to multilateral creditors and US$3.7 billion to bilateral and commercial claimants. Arrears to bilateral creditors represented 73.5 percent of total arrears, with 59.7 percent owed to Paris Club creditors and 13.7 percent owed to other official bilateral creditors.

HIPC process

Decision point (March 2020): Application of the traditional debt relief mechanism just after the decision point reduced Somalia's external debt from US$5.2 billion in net present value terms to US$3.5 billion.

Completion point (December 2023): The Paris Club's debt relief initiative, beyond the HIPC framework, has resulted in the cancellation of all Paris Club debt. After the comprehensive implementation of debt relief measures under the HIPC Initiative, the Multilateral Debt Relief Initiative (MDRI) and additional beyond-HIPC assistance had reduced Somalia's debt to approximately US$638 million, or 5.5 percent of GDP, by the end of 2023.

Somalia: External Debt over HIPC initiative

	Before HIPC, end-2018		After arrears clearance, end-2022		At completion point, end-2023	
	millions of US$	*percent of GDP*	*millions of US$*	*percent of GDP*	*millions of US$*	*percent of GDP*
Total	5268.1	63.6%	3827.0	36.7%	637.8	5.5%
Multilateral	1535.7	18.6%	1074.9	10.3%	405.6	3.5%
Bilaterals	3730.1	45.1%	2749.5	26.4%	232.2	2.0%
Commercial	2.3	0.0%	2.5	0.0%	2.5	00%

Sources: Somali authorities and IMF staff calculation

Financial governance is demonstrably stronger in Somalia than it was a decade ago. Reforms have been pursued across every domain of public finance, encompassing **revenue mobilisation, expenditure management, procurement and concessions, fiscal federalism, and accounting and audit.** Comprehensive reforms have also been implemented in the **CBS and wider financial sector.** Reforms have been multidimensional, including modernisation of legal and regulatory frameworks relating to financial governance (Box 3), strengthening of policies and procedures, systems development and automation, organisational development, and capacity building.

This section highlights the most significant areas of FGS progress in financial governance, resulting from the reforms. While not exhaustive, the coverage reflects areas where the FGC has been involved since 2014 as an advisory body to the FGS on matters of financial governance. The FGC has contributed to FGS reforms through strategic dialogue, policy advice, and, in some areas, targeted technical assistance. Most importantly, it has provided a forum for confidential deliberation among senior FGS officials and international advisers.

Progress in financial governance relating to the CBS and the financial sector is addressed in the 'spotlight' chapter (Chapter III). The FGC has followed this agenda closely since 2014, especially developments with respect to strengthening CBS governance and recovering frozen assets.

Revenue mobilisation

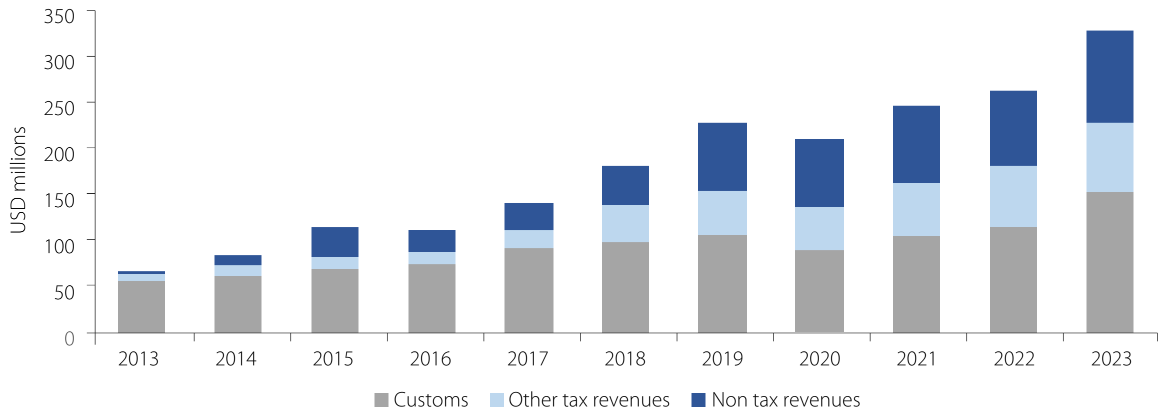
FGS revenues have increased more than fourfold in dollar terms since 2013. In 2023, they amounted to US$329.5 million, equivalent to 2.9 percent of GDP (Figure 2; Table 2). The FGS tax base remains largely centred on Mogadishu. However, FGS has started collecting revenue from sectors that are regulated nationally, such as telecommunications (telecom), air navigation, and tuna fishing. Customs duties on imports into Mogadishu remain the largest source of FGS revenue, but now account for only half of all revenue collected. Other sources of tax revenue include personal income taxes and sales taxes. Nontax revenues have also grown considerably. The main components of nontax revenues include fees from the Mogadishu port and airport, passport and visa services, air navigation, and telecoms spectrum licensing.

BOX 3 Laws relevant to financial governance passed since 2012

- Procurement Act (2016, amended 2020)
- Public Financial Management Act (2019)
- Revenue Administration Act (2019)
- Customs Act Amendments (2020)
- Statistics Act (2020)
- Petroleum Act (2020)
- Extractive Industries Income Tax Act (2023)
- Audit Act (2023)
- Fisheries Act (2014 and 2023)

(See also Chapter III, Box 11, for laws applicable to CBS and the financial sector.)

Figure 2: FGS revenues 2013–23, US$ millions



Source: MoF

TABLE 2 FGS revenues 2013–23, US$ millions

Revenue	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Customs	59	64	71	76	93	100	107	91	109	116	154
Other tax	6	10	11	12	19	39	48	48	54	66	73
Nontax	4	11	32	24	31	44	75	72	67	81	102
Total	**69**	**84**	**114**	**113**	**143**	**183**	**230**	**211**	**230**	**263**	**329**
growth rate		22%	36%	-1%	27%	29%	25%	-8%	9%	14%	25%
% of GDP	1.2%	1.3%	1.6%	1.5%	1.7%	2.2%	2.4%	2.3%	2.3%	2.5%	2.9%

Source: MoF.

Modernisation of revenue administration has supported FGS revenue collection efforts. The 2019 Revenue Administration Act provides the FGS with tools to improve taxpayer compliance with revenue obligations. These tools include issuing taxpayers with unique Tax Identification Numbers, requiring them to file annual returns, making tax assessments, conducting tax audits, and issuing Tax Clearance Certificates (TCCs). The FGS's revenue administration reforms are integrated with other dimensions of public finance reform. Companies bidding for government contracts must possess a valid TCC, and FGS vendors will not be paid unless they have a TCC. The MoF reports to the Cabinet the value of all tax exemptions granted on a quarterly basis, as required by the 2019 PFM Act, and publishes them on the MoF website.[46]

Customs administration has been modernised. The FGS has updated its classification of goods to align it with international standards and introduced value-based customs tariffs based on the duty rates applicable in the East African Community. It has eliminated manual customs procedures by implementing an automated customs administration system (SOMCAS). Importers load their manifest details and goods declarations into SOMCAS, which can then calculate the amount of duty they are required to pay, based on the applicable duty rate and a reference value of the goods.

Although FGS has introduced value-based customs tariffs, the amount of tax paid on imports remains low, and customs revenues have grown by a smaller amount than other revenues over the past decade.

[46] Tax exemptions are granted mainly on donor-financed imports.

This is because the goods reference values used to calculate the amount of revenue owed by the importer are far lower than the actual transaction values.[47] Although the FGS introduced the value-based customs tariff in February 2022, it set the goods reference values at artificially low levels so that the duties paid by Mogadishu importers would be comparable to the amounts they had previously paid under the volume-based system. Introducing transaction-based reference values at the same time as introducing value-based customs tariffs would have caused a sharp increase in import taxes, with a knock-on effect to market prices and inflation. The FGS took the view that customs reforms needed to be introduced gradually and coordinated across all ports in Somalia to minimise disruptions in the domestic market and to avoid tax competition between ports.

As a first step in addressing this discrepancy, the FGS increased the reference values of a number of goods entering Mogadishu port by 50 percent in May 2023. Although the reference values are still significantly lower than transaction values, this adjustment enabled the FGS to increase customs revenues by 31 percent in the second half of 2023.

Growth in other tax revenues has been driven largely by the reintroduction of sales tax on a number of goods. Sales tax is now levied on hotels operating in Mogadishu, airline tickets, telecom services, and imported goods coming through Mogadishu port and airport. The FGS has also increased its revenues from income tax by extending personal income tax collection to private sector employees in Mogadishu. It has made comparatively limited headway in collecting corporate income tax from private sector actors. The FGS hopes to increase corporate income tax collections once the legal framework for income tax has been modernised. A new Income Tax Act has been drafted and is due to be submitted to Parliament in 2024.

FGS nontax revenues are mostly collected either by third parties contracted by the government to manage a public asset or deliver a public service (port fees, airport fees, air navigation fees, visa fees, passport fees) or as a result of licensing processes (tuna licensing, telecoms licensing, oil and gas concessions) (Table 3). The FGC has provided extensive advice to the FGS on how best to maximise transparency and value for money in these arrangements, which are often complex and can be challenging to manage in a low-capacity environment.

[47] In many cases, the reference values are just a fraction of the actual transaction value of the goods.

TABLE 3 FGS revenues from concessions and licensing 2016–23, US$ millions

Revenue source	2016	2017	2018	2019	2020	2021	2022	2023
Port fees	16.0	20.8	25.8	27.2	34.6	25.6	29.3	30.2
Airport fees	2.5	2.5	3.4	3.8	3.3	2.8	3.1	3.9
Visa and passport fees	4.4	7.2	9.5	11.2	7.9	11.2	15.6	18.3
Air navigation fees				12.2	15.7	11.3	15.1	20.4
Tuna licensing				1.0	2.2	2.1		
Telecoms spectrum licensing				8.7	1.7	1.2	4.1	8.4
Petroleum rental fees & signature bonus				1.9			7.0	2.6
Total	**23.0**	**30.5**	**38.7**	**66.0**	**65.5**	**54.1**	**74.3**	**83.8**

Source: MoF.

Although the FGS has made significant progress in revenue mobilisation, its revenue-to-GDP ratio remains significantly lower than the norm for fragile states. The revenue-to-GDP ratio in fragile states averaged between 11.5 percent and 12.5 percent in recent years,[48] compared to less than 3 percent in Somalia. FGS revenues have grown by 1.5 percent of GDP over a decade, whereas in other fragile states, tax collection has increased by 3.5 percent of GDP, on average, from the lowest level over a period of three years.[49]

The FGS will need to maintain and intensify its revenue reform efforts in the coming decade to expand its revenue base and increase its fiscal viability. Particular focus is required in two areas: completing customs reforms and increasing the collection of corporate income taxes, especially from large businesses. The FGS will also need to avoid pressure to enter into contractual arrangements that give revenue away needlessly to third parties, or that enable FGS institutions to retain revenues at source without proper scrutiny. Concessions contracts should be awarded only when strictly necessary, and their terms should offer value for money to government.

Expenditure management

FGS expenditure management procedures have improved significantly over the past decade. The MoF operates a cash budget, supported by a modern legal framework (2019 PFM Act). To limit the scope for arrears accumulation, it issues spending agencies with monthly cash limits in line with revenue availability. If revenues are lower than budget estimates, expenditures are prioritised according to sequestration rules that give priority to salaries and security sector rations over other expenditures. Commitment control procedures prevent spending agencies from making budgetary commitments that exceed their cash limits.

Improvements in expenditure management procedures have been supported by the introduction of the Somalia Financial Management Information System (SFMIS) and the Treasury Single Account (TSA). The SFMIS has automated the budget execution process and enabled the MoF to enforce commitment controls in line with cash availability. The TSA brings all government funds together into a single account structure within the CBS. The PFM Act requires all revenues to be deposited into the TSA. It does not allow a spending agency to hold an account outside the TSA, unless authorised by

48 Akitoby, B., Honda, J., and K. Primus. 2020. "Tax Revenues in Fragile and Conflict-affected States: Why Are They Low and How Can We Raise Them?" IMF Working Paper WP/20/143.

49 Akitoby et al. 2020.

the Accountant General. The Accountant General fully accounts for all deposits into the TSA and all withdrawals from it.

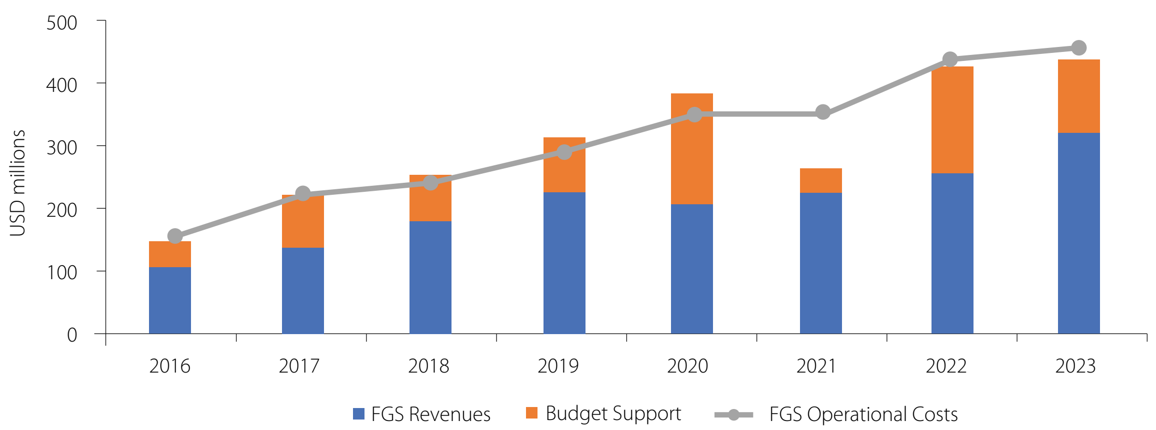
Treasury processes have been further enhanced by automation of the interface between the MoF and the CBS. Connectivity between the SFMIS and CBS systems has eliminated manual processing of FGS payment instructions by the CBS and has removed delays in information sharing between the two institutions. The MoF has direct access to TSA account balances in the CBS, enabling it to manage its cash flow more effectively.

FGS payments, including salary payments, are no longer made in cash. The CBS processes all FGS transactions electronically. Vendors are paid through direct-to-bank transfers, and salaries are paid to individuals' accounts. This reform took several years to achieve and represents a major improvement in the FGS financial governance environment. It has eliminated a significant historical source of leakage of public funds. It is the combined product of payroll verification initiatives, treasury system automation through the introduction of the SFMIS, and financial sector reforms. On the vendor side, vendor account details are uploaded in the SFMIS and are a condition of payment. On the payroll side, biometric registration was carried out for FGS civilian personnel in 2013–15 and for noncivilian personnel in 2019. Biometric registration of civilian personnel was a condition for on-budget financing from the Government of Norway (Box 4), while biometric registration of noncivilian personnel was a key element of the FGS's roadmap for security sector reform. These biometric registration processes have enabled the FGS to verify the existence of payees and to capture their electronic payment details in the institutional payroll, which is then paid through the SFMIS.

The coverage and effectiveness of FGS payroll reform efforts has diminished over time. More than 5,300 new civilian employees have been hired since 2017 without being added to institutional payrolls. The number of nonpayroll civilian employees (known as 'temporary workers') slightly exceeds the number on the payroll. These temporary workers are still paid directly to their bank accounts, but many of them receive salaries that exceed the highest amount set out in the public service pay scale. The FGS is now working to integrate all employees into institutional payrolls and to institute stronger wage bill controls. It has also established a Pay and Grade Policy that sets out salary scales for all employees, including temporary workers.

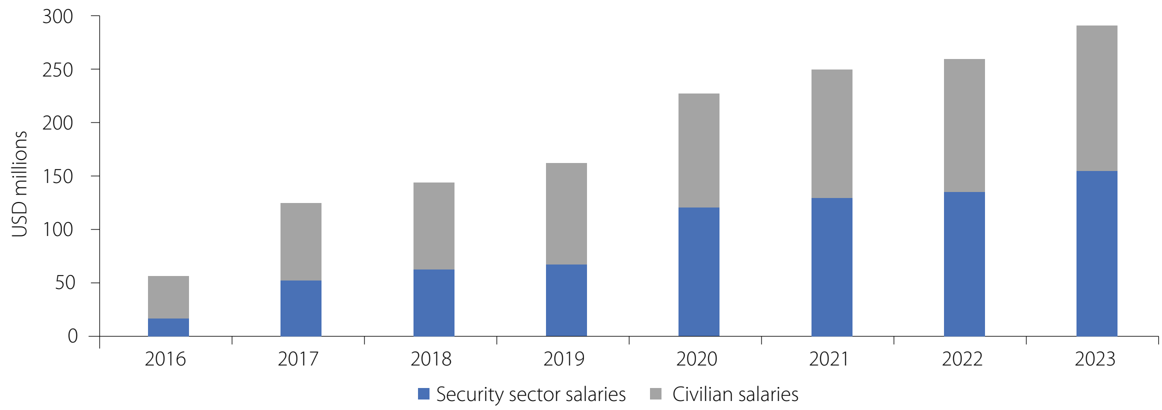
The FGS's expenditure management capabilities have been tested to the limit repeatedly over the last few years, as its operational costs continue to exceed its domestic revenues. Although domestic revenues have increased fourfold in the past decade, the FGS's operational costs have grown even more, driven by a fivefold increase in salary payments since 2016 (Figure 3; Figure 4; Table 4).

Figure 3: **FGS revenues and operational costs, 2016–23, US$ millions**



Source: MoF

Figure 4: FGS salary payments, 2016–23, US$ millions



Source: MoF

BOX 4 The Norwegian-funded Special Financing Facility and payment of FGS salaries

The Special Financing Facility (SFF) was designed explicitly to support a country-led transition out of fragility. Its main objective was to provide the FGS with funding that it could use to build political legitimacy through the regular payment of civilian salaries and the delivery of simple development projects of value to local communities, while meeting international standards for transparency and accountability to donors.

The SFF's design focused on mitigating the risk of using FGS systems. It provided funding on a reimbursement basis for expenditures that were independently verified as being eligible. An independent monitoring agent contracted by the Government of Norway was responsible for assessing whether the expenditures being claimed by the FGS were eligible and advising the Norwegian government accordingly. For salary payments to be eligible for reimbursement, employees had to be biometrically registered and to collect their salaries in person from the CBS.

The first government salary payments under the SFF took place in August 2013. Initially, just under 500 employees in three FGS institutions qualified for SFF funding, but over time more employees progressively underwent biometric registration. By mid-2014, over 2,500 employees in 34 institutions had been registered. In total, the SFF contributed approximately US$9 million in funding for ten months of government salary payments from August 2013 to July 2014. The SFF's eligibility conditions helped instigate salary payment reform. However, the SFF was not able to ensure timely payment of FGS salaries, as the Norwegian government reimbursed eligible expenditures with a considerable time lag and the FGS lacked sufficient liquidity of its own to cover salary payments in the meantime.

The SFF provided a pathway for the establishment of a larger, multidonor facility administered by the World Bank. World Bank staff were closely involved in the design of the SFF's procedures, and they were able to make use of this knowledge in the design of the Multi-Partner Fund, which was approved by the World Bank Executive Board in December 2013 and commenced operations in August 2014. Its first component was a Recurrent Cost and Reform Financing Facility, which took over the provision of funding for government salary payments, using the same system instituted under the SFF.

Source: FGC, based on MoF historical data

TABLE 4 FGS salaries and operational costs 2016–23, US$ millions

	2016	2017	2018	2019	2020	2021	2022	2023
Security salaries	18	53	62	67	120	131	135	155
Civilian salaries	38	72	81	95	107	119	124	137
Total Salaries	**55**	**125**	**142**	**162**	**227**	**250**	**260**	**292**
Total FGS operational costs	**160**	**228**	**250**	**298**	**354**	**355**	**445**	**468**
Salaries % of operational costs	35%	55%	57%	54%	64%	70%	58%	62%

Source: MoF.

Since 2013, the FGS has relied on budget support from development partners to bridge the funding gap between its domestic revenues and its operational costs and to avoid accumulating payment arrears. This balancing act has required careful MoF stewardship of expenditures on a month-to-month basis, because external budget support to the FGS is not disbursed evenly across the year. Under the terms of its IMF programme, the MoF must manage FGS cash flow to ensure that the TSA always has sufficient funds to cover on-time payments for salaries and security sector rations.

In 2021 and 2022, when international partner concerns over electoral delays meant that budget support disbursements were put on hold, the pressure on budget execution was especially acute. Without the windfall of a one-off global allocation of special drawing rights by the IMF,[50] the MoF would almost certainly have failed to pay salaries on time and been obliged to accrue arrears. With the allocation from the IMF, coupled with a temporary advance from the CBS, the MoF was narrowly able to keep government finances on track until elections were held in May 2022.

The rising cost of the state since 2013 has posed a sustained challenge for expenditure management. While FGS systems for expenditure management have improved considerably over the past decade, these systems will continue to be placed under considerable pressure for the foreseeable future, as revenues remain insufficient to cover the government's operational costs. FGS efforts to increase revenue need to be accompanied by careful management of the size of the state to reduce the FGS's vulnerability to repeated fiscal crises.

Procurement and concessions

The FGS adopted a new legal framework to provide a clearer and more transparent basis for public sector contracting in 2016. The 2016 Procurement Act applies to public procurement of goods, works, and services, and to concessions for the use or development of a public asset.

The Procurement Act makes open competition the default method for all procurement by the FGS and defines when and how other methods may be used. It establishes a decentralised approach to public procurement and a partially decentralised approach to concessions. In 2020, the FGS introduced amendments to the Procurement Act to strengthen its oversight provisions with respect to public procurements. These amendments require FGS institutions to register all contracts with the Auditor General as a condition of contract effectiveness.

Work on the rollout and implementation of the Procurement Act is ongoing and is starting to bring greater order to FGS contracting practices compared to the unregulated free-for-all that prevailed a decade ago. However, institutional commitment to the requirements of the new legal framework remains sporadic and implementation capacity is limited.

[50] See the Financial Governance Report 2022 for details.

Legal and institutional arrangements for public procurement

The Procurement Act designates each FGS institution as a 'procuring entity' responsible for conducting its own procurements. To gain authorisation to conduct procurement transactions, an FGS institution must establish a Procurement Unit and a Procurement Committee and be certified as a procuring entity by the Public Procurement Authority (PPA). The PPA has not yet been established.[51]

Limited procurement capacity across the FGS is a major constraint to full implementation of the Procurement Act. Most FGS institutions do not currently meet the Act's requirements for certification as a procuring entity. To bridge some of the immediate challenges to implementation of the Act, the Council of Ministers issued Interim Procurement Regulations (IPRs) in March 2018. The IPRs notified FGS institutions of their responsibility to conduct procurement in accordance with the Procurement Act and required them to seek support from the MoF Procurement Department when conducting public procurement transactions with a value above US$100,000.[52]

Under the IPRs, the role of the MoF Procurement Department is to support the procuring FGS institution to prepare bid documentation, issue the tender, and ensure that bids are evaluated in line with the requirements of the Procurement Act. The procuring FGS institution remains responsible for specifying technical requirements, chairing the bid evaluation committee, and making contract awards.

Legal and institutional arrangements for concessions

The Procurement Act's provisions with respect to concessions apply explicitly to a wide range of sectors, including oil and gas, minerals, agriculture, fishing, forestry, electricity, and public infrastructure. Each FGS institution is responsible for conducting its own concessions tender processes and for awarding concession contracts, subject to central oversight by an Interministerial Concessions Committee (IMCC). The IMCC is chaired by the Minister of Finance and comprises members from six other FGS institutions.[53]

The Procurement Act provides for the establishment of a Concessions Technical Unit, a specialised technical unit in the MoF, to support the work of the IMCC. The unit has not yet been established. The MoF Procurement Department has been called on to provide support to the IMCC in the interim, but it does not have dedicated concessions expertise to review the costs, benefits, and risks of concessions projects and has relied heavily on advice from the FGC.

FGS institutions have tended to be reluctant to submit concessions contracts to the IMCC for approval. Attempting to circumvent IMCC review has been common in cases where an FGS institution engages in direct negotiation with a private sector entity. It is also symptomatic of the broader challenges faced in strengthening cross-government coordination within the FGS.[54] The Minister of Finance, as chair of the IMCC, has been able to require some FGS institutions to submit their proposed concessions for IMCC review prior to award,[55] but has not been successful in all cases.[56,57] In cases where contracts have been awarded without IMCC oversight, the FGC has reviewed them ex post, but as of yet, its recommendations have not been implemented.

[51] Until the PPA is established, its functions are performed by the MoF Procurement Department.

[52] The IPR arrangements are enabled by the provisions of the Act, which allow the delegation of procurement functions to a qualified institution.

[53] These include the Ministries of Justice, Planning, and Federal Affairs, as well as the State Attorney General and two other FGS institutions, nominated by the Council of Ministers, that represent the collective interest of various sectors of the economy connected with the concession, other than the Minister responsible for the sector.

[54] Further details can be found in the Financial Governance Report 2021, which includes a spotlight chapter on improving sector alignment with financial governance reforms.

[55] For example, airspace management, passports tender, and import quality assurance.

[56] Most notably, the seven oil and gas contracts awarded by the Minister of Petroleum to Coastline in February 2022. However, smaller concessions, such as those for textbook development and production and education certificates awarded by the Ministry of Education and a development lease awarded by the CBS, have also avoided oversight.

[57] Coastline Exploration Limited. 2022. "Coastline Exploration signs seven Production Sharing Agreements in the Federal Republic of Somalia." Press Release, February 19.

To strengthen the effectiveness of the IMCC, the Cabinet has recently approved a set of IMCC Standing Operating Procedures,[58] which explain the role of the IMCC and spell out the process that FGS institutions wishing to enter into a concessions contract should follow. Among other things, the Standing Operating Procedures require the Minister of Finance, as chair of the IMCC, to sign all concessions contracts as a witness. The intent behind this provision is to make it more difficult for FGS institutions to circumvent IMCC oversight.

Competitive tendering

In line with the requirements of the Procurement Act, the FGS has started to introduce competitive tendering for major public procurement contracts. While the implementation of these reforms remains a work in progress, valuable precedents have been established in terms of the positive effects for expenditure management, transparency, and improved value for money. The FGS first committed to competitive tendering of security sector rations contracts in 2015. These rations contracts had previously been awarded on a sole-source basis without any transparency, fuelling suspicions of corruption. Initial tender processes were conducted for the army, police, and intelligence services in 2016, although without full oversight in all cases.

Since then, the MoF Procurement Department has successfully supported FGS security sector institutions to conduct three rounds of fully competitive tenders for the award of rations and fuel supply contracts (in 2019, 2021, and 2022). These contracts cover the army, police, intelligence services, and prisons. They constitute the FGS's largest recurrent purchase of goods and account for more than 15 percent of nonwage expenditures per month. The 2019 tender round helped to reduce unit prices on some goods by as much as 30 percent compared to earlier supply contracts. Across the three tender rounds, there has been a positive evolution in FGS tendering processes for high-volume goods and a strengthening of bid participants. The FGC reviewed all three tender processes and found them sufficiently competitive and transparent to justify contract award.

58 Inter-Ministerial Concessions Committee Standard Operating Procedures. 2023.

The FGS has not yet made substantive progress in introducing competitive tendering for concessions contracts. Contracts have continued to be awarded on a sole-source basis, even though direct negotiation often undermines the principles of transparency and value for money. In the limited number of cases in which FGS institutions attempted to initiate tender processes for concessions,[59] weak project preparation and tender management practices discouraged bidder participation. In these cases, only one qualified bid was received, and so FGS did not benefit fully from holding a competitive process. FGS institutions lack in-house capacity to develop concession tenders appropriately, yet they are reluctant to seek external assistance. While cost considerations may be a factor, FGS institutions are also unpersuaded of the need to invest time in preparing and conducting tenders properly. They typically prefer to conduct direct negotiations or proceed with an incomplete tender process so that a contract can be awarded rapidly. Such approaches can lead to poorly specified contracts that expose the FGS to performance risks or fiscal risks.

<u>Resolution of legacy contracts</u>

The FGS has taken steps to resolve several contracts signed prior to 2016 without proper scrutiny and transparency. Following initial FGC advice, the FGS amended or set aside several contracts across a range of sectors, including fisheries, power, petroleum, and ports (Annex A). One contract ended up being subject to an arbitration claim, which the FGS eventually won after a lengthy and costly legal process in the Netherlands.[60,61] Not all legacy contracts have been resolved, however. Some continue to be implemented as signed,[62] or have remained in place but have not been enforced.[63]

The FGS has renegotiated two major infrastructure concessions for the management of Mogadishu port and airport, respectively. These concessions were signed in 2013. The FGS received external technical, legal, and financial support to conduct the renegotiations, which commenced in 2016 and took several years to complete. The revised airport concession was signed in 2019 and the revised port concession in 2020. The revised concession agreements correct some of the major shortcomings in the original agreements. They clarify the obligations of the concessionaire, including for infrastructure investment and operational performance; ensure that there is an objective basis for agreed revenue shares; and increase transparency around revenue payments. They also include provisions that were missing from the original agreements, including provisions for contract monitoring, reporting, and termination (Box 5).

The FGS has also amended and extended two major services concessions for the provision of passports and issuance of visas. These concessions were originally signed in 2013 and 2015, respectively. Subsequent FGC review identified various shortcomings in the contracts, including the lack of any provision for handing back the services and associated systems and data to the FGS at the end of the contract term.

The passport concession was amended and extended in 2022 to clarify the obligations of the concessionaire and establish a clear handover procedure prior to contract expiration. The extension has given the FGS time to prepare an international competitive tender to select a new passport provider. The FGS is receiving external support[64] for the development of contract specifications and tender documents. The visa concession was amended and extended in 2023 to provide clear requirements and timelines for handing back the services to the FGS. The FGS intends to take over responsibility for visa issuance once the current contract has expired.

[59] 2020 Passports Tender, which did not result in a contract award; and 2023 Import Quality Assurance tender, which resulted in a contract award.

[60] The contractor for the purchase of six coast guard vessels took FGS to arbitration in the Netherlands in 2018 for failure to pay. The arbitration panel dismissed the contractor's claim in September 2023, finding that the parties to the contract had jointly assumed that a third party would be willing to provide financing but had not adequately reflected this in the contract.

[61] Global Arbitration Review. 2023. "Somalia defeats claim over coastguard contract." October 6.

[62] Petroleum sector: Soma Seismic Agreement; and Transport sector: Airport Taxi Service. (See Annex A.)

[63] Ports sector: Mogadishu Dry Port, and Port Scanning. (See Annex A.)

[64] Funding has been committed by the Government of Denmark, using the United Nations Office for Project Services as the implementing entity to support the FGS.

BOX 5 Revised port and airport management agreements

The FGS awarded contracts for the management of Mogadishu Port and Mogadishu Airport on a sole-source basis in 2013. The FGC reviewed the contracts in 2014 and advised the FGS to renegotiate them to clarify the contract terms, establish a fair commercial basis for revenue sharing, and agree on the investments that needed to be undertaken at the port and the airport during the contract period.

The FGS initiated renegotiation processes for both contracts in 2016. The negotiations were led by multi-institutional FGS negotiation teams, supported by lawyers funded by the Africa Legal Support Facility and by technical and financial advisers funded by the Africa Legal Support Facility (for the airport concession) and the World Bank and European Union (for the port concession).

In May 2019, the FGS signed a revised airport agreement with Favori, the Turkish firm managing Mogadishu Airport. The revised agreement runs until 2028. Its terms increase revenue payment transparency by adjusting the revenue due to the FGS from a share of profits to a share of airport gross revenue. The contract establishes a clear investment plan and sets out requirements for the contractor's operational performance. Requirements for monitoring and reporting are also clearly specified, as are provisions for termination.

In October 2020, the FGS signed a revised port agreement with Al Bayrak, the Turkish firm managing the Mogadishu port. The revised agreement runs until 2034. It sets aside US$52 million of port revenue for investments in port infrastructure during the first five years. It also specifies a procedure for the FGS and Al Bayrak to agree on a long-term plan covering port investment from years six to fourteen and enables the FGS to terminate the agreement after five years if the long-term plan cannot be agreed.

There are a number of important lessons to be learned from the port and airport contract renegotiation processes. While the negotiations were led at a technical level by the responsible sector ministry, the direct engagement of the prime minister's office and the MoF in the negotiation team was instrumental in ensuring the necessary linkages between the technical, financial, and political aspects of the negotiations. In addition, the FGS would have been unable to participate meaningfully in the negotiation discussions without the support of its legal, technical, and financial advisers.

Fiscal federalism

The principles of fiscal federalism are established in the 2012 Somalia Constitution,[65] as follows:

- Article 50(b) requires power to be given to the level of government where it is most likely to be exercised effectively.
- Article 50(e) requires the fair distribution of resources.
- Article 50(f) states that revenue-raising responsibility shall be given to the level of government where it is most likely to be exercised effectively.

Observed practice has diverged substantially from these principles, as each FMS has defined its own tax base and collected whatever revenues it was able to access. This approach has given a significant revenue advantage to the FMS that operate major ports (namely, Bosaso in Puntland and Kismayo in Jubaland), while also creating conditions for horizontal tax competition among FMS and vertical tax competition with the FGS. The FGS initially lacked policy tools and financial resources to address these distortions.

Since 2016, the FGS and FMS have come to a series of technical agreements on fiscal federalism, which have helped establish building blocks towards greater intergovernmental harmonisation. These agreements have been reached at the MoF level through regular meetings of finance ministers and finance officials as part of the Intergovernmental Finance Ministers Forum.

[65] Federal Republic of Somalia: Provisional Constitution, adopted August 1, 2012.

The earliest agreement was on harmonisation of duty rates on *khat*, cigarettes, and tobacco. This has been followed by agreements in principle to harmonise revenue laws and administration, and to adopt value-based customs tariffs. The FMS have also adopted the same system of budget classification as the FGS. They have started providing the FGS with monthly expenditure reports to enable the consolidation of fiscal data.[66] Agreement has been reached on the vertical distribution of donor budget support between the FGS and the FMS (60:40, net of agreed deductions) and on the horizontal distribution of the 40 percent FMS share among the FMS (Table 5). The FMS have agreed to spend 50 percent of their transfers on service delivery in health and education.

These agreements between the FGS and the FMS have cumulatively created the conditions for regular transfer of resources (Figure 5) and have promoted PFM reforms at the FMS level. The agreements also enable joint FGS–FMS audit processes. Most of the intergovernmental transfers have been funded by financial support from international development partners. An exception is Banadir Regional Administration, which receives a 15 percent share of Mogadishu port revenues from the FGS.

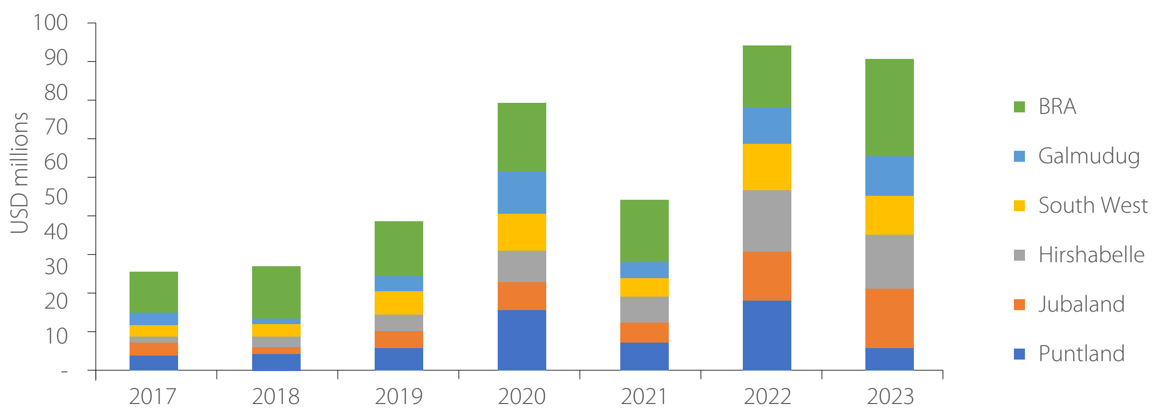
Intergovernmental transfers have provided essential financing to FMS budgets, particularly for those FMS that lack major ports, namely Hirshabelle, Galmudug, and Southwest; for these FMS, transfers from the FGS are equal to or greater than their revenue collections. However, the transfers have not yet achieved the constitutional objective of "fair distribution of resources,"[67] as they have not been large enough to offset the significant differences in revenue-raising capacity between the FMS that have major ports and those that do not.

TABLE 5 Formula for distributing donor budget support between FMS

Component	Weight
Equal share	57%
Revenue enhancement (performance-based)	15%
Expenditure management (performance-based)	15%
Audit and reporting (performance-based)	10%
Fiscal gap equalisation	3%

Source: MoF.

Figure 5: **FGS transfers to FMS and Banadir, 2017–23, US$ millions**



Source: MoF

[66] Reports published on the MoF website: https://mof.gov.so/publications/consolidated-fiscal-reports

[67] Provisional Constitution, 2012, Article 50(e).

At the political level, the FGS and FMS have reached several milestone agreements on the distribution of powers. In 2018, the FGS president and the five FMS presidents agreed on intergovernmental responsibilities for the management of natural resources (specifically fishing, petroleum, and minerals). These agreements were supplemented by sector-specific revenue-sharing agreements and subsequently codified in federal legislation through the 2020 Petroleum Act and the 2023 Fisheries Act. In 2022, the FGS and FMS (excluding Puntland) reached agreement in principle on the allocation of powers between the FGS, FMS, and local governments. This was followed up in March 2023 by the National Consultative Council endorsing a preliminary agreement on revenue assignment (Table 6).[68]

The agreements on the allocation of powers and revenue assignment are intended to advance the process of finalising the Constitution. Their provisions diverge in various ways from current practice, meaning that a number of adjustments will be required at the FGS and FMS level if they are to be implemented effectively.[69,70]

Accounting and audit

There have been significant improvements in the FGS's audit capacity over the past five years. The Office of the Auditor General (OAG) has undertaken annual

audits of the FGS's financial statements, accompanied by compliance audits of selected FGS institutions. The audits have been submitted to Parliament and published online.[71]The financial audit findings have helped to drive iterative improvements in the quality and comprehensiveness of the FGS's annual financial statements. They have also helped identify areas in which treasury procedures require strengthening.

Unauthorised retention of revenue collected by FGS institutions continues to be a challenge, albeit less systemic than in the past. The most recent annual audit (for the financial year that ended on December 31, 2022) identified the need to improve the oversight of revenues collected by the port and airport concessionaires to confirm that the amounts they remit to the FGS are consistent with the amounts due as per the terms of their concession contracts.

TABLE 6 Intergovernmental revenue assignment, March 2023

FGS	Shared FGS/FMS	FMS
• Customs duties • Excise duties • Telecoms sector license fees • Financial sector license fees • Capital gains tax • Federal stamp duty • Road tax (highways and interstate roads) • Natural resource revenues • All other fees approved by the Federal Parliament	• Sales tax • Rental income tax • Personal income tax • Corporate income tax • Professional/notary fees • Other stamp duties	• Property taxes • Property transfer tax • FMS stamp duty • Agricultural and market fees • Road tax (state roads) • Vehicle registration fees • Drivers licence fees • Other fees subject to state law

Source: National Consultative Council

68 UN Security Council. 2023. Situation in Somalia: Report of the UN Secretary-General. Document S/2023/443, June 15.

69 For example, the National Consultative Council agreement designates international ports and airports as an FGS responsibility, whereas at present, each FMS operates their own ports and airports, including international ones.

70 Somali Public Agenda. 2023. "Agreements on power allocation and the judiciary through Somalia's National Consultative Council: how to move beyond the current political impasse." Governance Brief No. 20, February 13.

71 Office of the Auditor General website: https://oag.gov.so/

The annual compliance audits have highlighted ongoing weaknesses in financial governance practices at the institutional level. They illustrate the extent to which FGS institutions lack procurement capacity. Many FGS institutions have not established the necessary internal procurement structures and do not adhere to the tendering requirements of the Procurement Act.

The compliance audits have identified numerous instances in which FGS institutions receive funding from external partners outside of country systems. This funding is not appropriated in the annual budget and is disbursed to unauthorised accounts held outside the TSA. It is not subject to FGS budget execution procedures. International partners originally justified this practice on the premise that FGS systems were too weak to be trusted. Now that these core systems have been established and embedded, the continued practice of providing funding directly to the FGS in a way that avoids the use of country systems risks undermining those country systems.

The OAG has conducted several special audits on topics of relevance to financial governance. These include information system audits of the SFMIS and security sector personnel management systems, and special audits of COVID-19 procurement and external assistance to the Ministry of Health.

The COVID-19 procurement special audit prompted the MoF to develop guidelines for FGS institutions on the use of emergency procurement procedures, which were adopted by the Cabinet in 2023.

The audit of Ministry of Health external assistance showed the risks associated with bypassing country systems. It reviewed US$6 million in donor funding provided by three international agencies[72] between 2017 and 2019. It found that the funding was not appropriated in the FGS budget, did not disburse through the FGS Treasury, and was held in bank accounts operated privately outside the CBS. The audit identified multiple instances of fraudulent payments using these funds. Four FGS officials were convicted in August 2020 on charges of misuse of public funds.[73]

72 The three agencies include the United Nations Children's Fund, United Nations Population Fund, and World Vision.

73 Garowe Online. 2020. "Somali court jails senior health ministry officials for corruption." August 24.

Despite the improvements in audit capacity over the last five years, there have been lingering doubts over the OAG's independence from the executive. The FGS took steps in 2023 to address these concerns by modernising the audit legal framework. The 2023 Audit Act strengthens the independence of the OAG by removing the unilateral power of the executive to appoint and dismiss the Auditor General.

Enablers of financial governance reform

A combination of enabling factors, both internal and external, has been critical to the progress made by the FGS in pursuing reforms to strengthen financial governance. When one or more of these factors has not been in place, progress on particular issues has been less marked or overall reform momentum has stalled. Some dimensions of reform have proven easier to achieve, notably the adoption of new laws, policies, and regulations. External dialogue, conditions, and advice have often provided valuable impetus in these cases. Embedding and implementing reforms to the way government operates has been more challenging. It has typically required strong and sustained political backing for specific reform measures. Even when political support is in place, individual reform leadership by senior technical officials has been a material factor in enabling reforms to succeed.

While it is misleading to generalise about the necessary conditions for financial governance reforms over the past decade, six enabling factors stand out.

Overall authorising environment for reform

High-level political commitment has been necessary to the pursuit and implementation of the overall financial governance reform agenda. Political transitions in 2017 and 2022 reinforced progress by giving renewed presidential authorisation for reforms to continue and by enabling the continuation of support from the international community.

Financial imperatives and other external strategic drivers have been influential at the top political level. Increasing the level of domestic revenue and ensuring the flow of international funding have been consistent motivators for the FGS in pursuing reforms. The goal of successive administrations to achieve debt relief provided especially strong reform motivation, as strengthening financial governance has been integral to completing the HIPC process.

Political backing for specific reform measures

Delivery of some individual reforms has been possible only with explicit support from the political leadership. This factor has been especially important for reforms that involve or affect FGS institutions beyond the core institutions of MoF, CBS, and OAG.

Notable examples are the maintenance of zero financial arrears accumulation by FGS, completion of biometric registration for the security sector, renegotiation of high-value concession contracts for Mogadishu port and airport, repeated competitive tendering for supply of security sector rations, and maintenance of operational independence for the CBS.

Calibre of senior leadership in key institutions

The leadership role of key FGS officials has been decisive for maintaining reform momentum in the face of multiple domestic and external challenges facing Somalia. The individual roles of Minister of Finance, Governor of the CBS, and Auditor General, supported by their senior technical officials, have been critical in areas where there has been reform progress.

External financing incentives and technical assistance

International partners have worked closely with the FGS to identify reform priorities and to provide tangible near-term incentives for their delivery. The FGS's achievement of the quantitative performance conditions and structural benchmarks in successive IMF programmes has kept the reforms on track. That progress has enabled the provision of budget support by the World Bank, European Union, and AfDB and provided a pathway to HIPC debt relief.

Disbursement of budget support has in turn been critical to the FGS in handling acute budget pressures and meeting expenditure commitments. Budget support instruments have provided additional incentives for reform delivery through prior actions and performance conditions. The commitment by some international partners to use government systems has also been instrumental in developing and strengthening those systems. Examples include Norway's funding for salary payments (Box 4), the World Bank's recurrent cost financing support,[74] and European Union funding for police stipends.

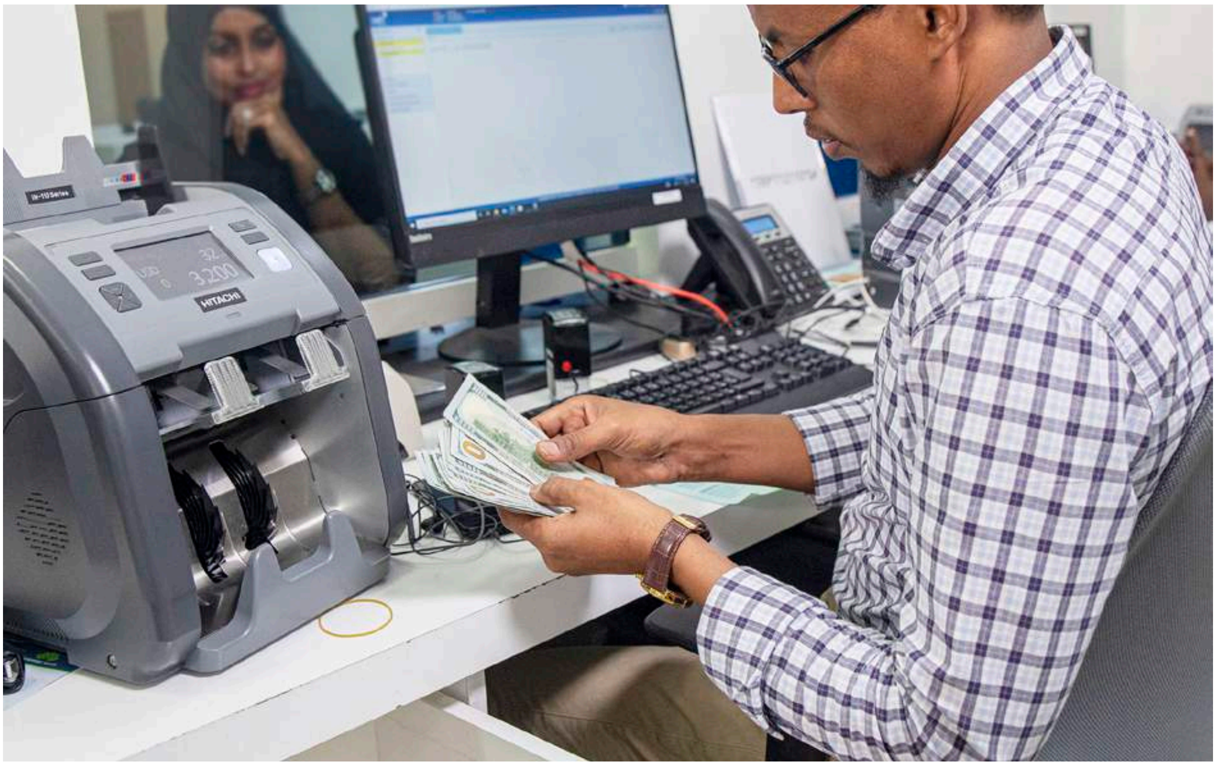
International partners have provided crucial technical assistance to support financial governance reforms. These reforms have required extensive work on systems development, capacity building, legal and regulatory drafting, and policy development. The MoF, CBS, and OAG have all benefited from this extensive technical assistance over the past decade.

Access to timely strategic advice

Strategic advice by the FGC has helped to identify issues for inclusion in the reform agenda across the domains of revenue mobilisation, expenditure management, central bank governance, and natural resource revenue management. It has supported FGS actions on strategic financial governance issues, such as concessions and procurement, and has provided a valued space for senior FGS officials to discuss and deliberate on the opportunities and challenges for strengthening financial governance. International members of the FGC have acted as an independent 'sounding board' for the FGS, providing just-in-time advice across a wide range of issues.

Unfinished business from the past decade

The financial governance reforms achieved over the past decade need to be deepened and sustained if they are to contribute to a lasting transformation in institutional legitimacy and performance in Somalia. World Bank comparative research has found that institutional legitimacy, which is a critical driver for building peaceful states, can take a generation to be established.[75] Even the fastest-transforming countries have taken 15–30 years to raise their institutional performance from that of a fragile state to that of a functioning institutionalised state. In this context, it is unsurprising that some of the reforms initiated by the FGS since 2013 are not yet complete.



[74] Funded by resources from the World Bank and from the World Bank Multi-Partner Fund.

[75] World Bank. 2011. World Development Report 2011: Conflict, Security, and Development. Washington, DC: World Bank.

While all the reforms launched in the past decade need to be consolidated and completed, three stand out as vital for Somalia's continuing transformation into a stable, well-governed, and effective state.

1-Completing customs harmonisation across Somalia

Customs harmonisation is key both to fiscal sustainability and to state building. Without this harmonisation, the FMS that have seaports can potentially create tax competition with the FGS by undercutting Mogadishu's tax rates in an effort to increase their own traffic volumes. Tax competition may benefit an individual FMS in the short term, but it will limit the overall collection of customs revenue in Somalia. It will also hinder significantly the fiscal sustainability of the Somali state as a whole.

To achieve customs harmonisation, all the FMS will need to adopt in full the FGS customs reforms—namely, SOMCAS installation, a common value-based customs tariff, and common reference values for goods. The technical building blocks required to support reform are now in place, but they must be agreed to and implemented by all stakeholders. Jubaland has adopted the value-based customs tariff and installed SOMCAS, but it has not harmonised all of its reference values due to concerns over the impact of revenue increases on trade in Kismayo. Puntland has suspended cooperation with the FGS and is not participating in customs harmonisation at all. The FGS needs to secure political consensus with the FMS on the long-term benefit of customs harmonisation and a commitment to its implementation.

Once the FGS and FMS are all using the same customs system and applying the same customs tariff and reference values, the final step in the reform process will be to raise the reference rates for goods so that they reflect market values. This final step will need to be phased appropriately and will require extensive sensitisation of importers. While the political economy challenges of applying market values should not be underestimated, it will play a key role in increasing Somalia's revenue-to-GDP ratio over the medium term.

2-Managing natural resources transparently and equitably

The 2012 Constitution states that the allocation of natural resources shall be negotiated between the FGS and the FMS. Natural resources are a critical financial governance issue because of their importance to federal relations, the potential magnitude of the resources involved, and their propensity to trigger conflict in fragile states when poorly managed.[76] Fisheries and petroleum have considerable potential to contribute to economic transformation in Somalia. To realise this potential, and to avoid conflict risk, these natural resources need to be managed soundly and transparently within a framework that is accepted by all stakeholders.

Fisheries

Good progress has been made in developing an intergovernmental framework for fisheries management, but political and institutional risks to progress remain. The 2018 FGS–FMS agreement on fisheries management established a basis for tuna licensing by the FGS. The FGS conducted four licensing rounds between 2018 and 2021, which yielded just over US$5 million in revenue. Revenue from the first three rounds was shared with all FMS in accordance with the 2019 interim revenue-sharing agreement. Revenue from the fourth round was not allocated directly to the FMS, but instead used by the FGS to meet FMS election expenses.

A revised legal and institutional framework for fisheries management has been agreed. The 2023 Fisheries Act and its Regulations have established the respective roles and responsibilities of the FGS and FMS in managing fisheries zones and licensing fishing vessels. A joint FGS–FMS Fisheries Management and Development Council is responsible for determining revenue sharing. Revenue sharing terms will need to be reconfirmed, as the 2019 arrangements were only agreed on an interim basis.

The main challenge will be to ensure that all stakeholders adhere to the new legal and institutional framework and that its provisions are implemented. The FGS needs to perform its licensing role transparently and in a timely fashion. It did not conduct any tuna licensing in 2022 or 2023. Licensing delays cause unnecessary revenue loss and undermine sound fisheries management, as actors other than the FGS may step into the vacuum to authorise or conduct illegal fishing activities. Puntland remains outside the new framework, as it has suspended all cooperation with the FGS. This nonparticipation presents a risk to sound fisheries management, particularly if Puntland issues fishing licences that are not legal under federal law for activities with harmful environmental impacts (such as trawling).

Petroleum

The petroleum sector presents significant financial governance risks. One or more commercial oil finds could yield the government billions in revenue over a period of 20–30 years. This revenue could be transformational to Somalia's development prospects. But, if poorly managed, it could trigger conflict or enable corruption. It is vital that reforms are completed to ensure that the petroleum sector is managed effectively within a clear legal framework. Revenues need to be managed sustainably and transparently, to the benefit of all Somali citizens.

The FGS has made progress in developing the legal and institutional framework for petroleum, but the reforms are not complete. The Petroleum Act was passed in February 2020. A Model Production Sharing Agreement (Model PSA) was finalised in November 2021, which provides standard terms for oil and gas contracting. The Model PSA was approved by the IMCC, as required by the Procurement Act. The Extractives Industries Income Tax (EIIT) Act was passed in 2023; it was a requirement for completing HIPC debt relief.

Regulations to the Petroleum Act are due to be developed. They are a priority for the FGS, as they are needed to manage the implementation of PSAs effectively particularly with respect to environmental issues and transparency. On the institutional side, the capacity of the FGS to oversee petroleum sector exploration and development in line with the requirements of the legal framework remains very limited, and strengthening it will require significant work.

[76] Bauer, A., Gankhuyog, U., Manley, D., Halling, S., and V. Venugopal. 2016. "Natural Resource Revenue Sharing." New York: Natural Resource Governance Institute.

Petroleum contracting has moved ahead of the completion of the legal framework and development of sector institutional capacity. The FGS signed seven final PSAs in 2022,[77,78] following direct negotiations with a firm that had acquired rights through a seismic survey agreement signed in 2013.[79] These PSAs were not approved by the IMCC, as required by the Procurement Act. An ex post review by the FGC indicated a number of areas in which the terms of the PSAs differ from the Model PSA and from Somalia's legal framework and may not offer value for money. Weak sector capacity to manage these seven PSAs, combined with gaps in the legal framework due to the lack of regulations, raises the risk that the FGS may not be able to ensure that the signed PSAs are well implemented to the benefit of Somalia.

Political agreements reached on petroleum are ambitious and have substantial fiscal implications. The FGS reached an agreement with the FMS on petroleum management and revenue sharing in 2018 (the 'Baidoa Agreement'), which was subsequently embedded in the 2020 Petroleum Act. The management arrangements include joint provisions that are highly complex for an environment with low institutional capacity, such as Somalia. The accompanying revenue-sharing arrangements provide for a highly unequal revenue distribution, which would almost exclusively benefit those FMS where the resources are located.[80] Puntland has rejected the 2020 Petroleum Act, citing various inconsistencies with the constitution.

Enhanced efforts are needed to ensure that the petroleum sector and associated revenues are effectively and transparently managed to mitigate potential fiscal, conflict, and corruption risks that could otherwise undermine the effectiveness of the state. The FGS urgently requires strengthened capabilities to oversee exploration and development. Future contracting needs to be transparently and competitively managed in line with approved contractual terms and Somalia's laws. All FMS must be willing to cooperate with the FGS in the exploitation of petroleum resources. The FGS should review current revenue-sharing arrangements for consistency with the constitutional requirement of fair distribution of resources.

[77] The agreements with Coastline LLC were signed in February 2022 by the Minister of Petroleum of the outgoing Farmaajo administration. They were made effective in October 2022, when they were endorsed by the Minister of Petroleum of the incoming Hassan Sheikh administration.

[78] Coastline Exploration Limited. 2022. "Somalia open for business as President throws his support at major oil exploration agreement." Press Release, October 21.

[79] Petroleum Africa. 2013. "Soma Oil & Gas Enters Somalia." August 7.

[80] See Financial Governance Report 2019 for details.

Transforming capabilities and compliance for concessions and procurement

There remains a significant gap between Procurement Act requirements and current practice amongst FGS institutions, both for procurement and concessions. This gap exposes the FGS to significant financial governance risk. Pressure to avoid open competition in the award of contracts remains high. Avoidance is often justified on the basis that the contract awards are 'urgent' when, in most cases, institutions lack the capacity to prepare tenders properly or simply have no interest in competition. Capacity to ensure that contracts are implemented in accordance with contractual requirements is limited, particularly for complex concessions contracts.

To sustain and embed current procurement reforms, the FGS needs to work on two fronts simultaneously: capacity and compliance.

On the capacity front, the FGS needs to acquire dedicated concessions expertise to improve the quality of concessions tenders. It needs to develop and embed capacity to oversee concessions implementation. FGS institutions need to establish procurement units and procurement committees, and to acquire qualified procurement personnel. Establishment of the PPA is important for the development of procurement capacity across government.

With respect to compliance, current efforts to strengthen IMCC oversight of concessions awards need to be sustained and uniformly applied. Establishment of the Concessions Technical Unit, which provides technical support to the IMCC, is essential. The FGS also needs to make use of the public procurement oversight and enforcement tools available to it under the Procurement Act. This includes establishing the central Contracts Committee provided for under the Procurement Act to oversee high-value procurement, certifying FGS institutions as procuring entities, and nullifying contracts that have not been tendered appropriately.

Sustaining other ongoing reforms

It will be important not to take existing and hard-won improvements for granted or to assume that they will be self-sustaining. Where significant progress has already been made, consolidation will become crucial. Building on areas of achievement that have underpinned HIPC debt relief, the FGS will need to sustain its efforts in the following key areas of fiscal management:

- Embedding nascent efforts to strengthen the collection of corporate income tax, which will be vital for revenue mobilisation.
- Ensuring that all government revenues are remitted to the Treasury Single Account and maintaining effective expenditure controls.
- Deepening external audit reforms, with a focus on maintaining audit standards and ensuring that OAG recommendations are followed up and addressed.

Alongside this agenda, continuing work is needed to build on the progress made since 2013 to strengthen the CBS and the financial sector. Those priorities, which span the functions and capabilities of the CBS, are presented separately in Chapter III.

III. Spotlight on Reforms in the Central Bank and Financial Sector Since 2013

Backstory: collapse of the financial sector between 1991 and 2012

Prior to 1991, the Central Bank of Somalia was regulated by the 1968 Central Bank Act. The 1968 Act established three main functions for the CBS: to act as a fiscal agent to the government, to supervise commercial banks and other financial institutions, and to issue currency and control inflation. Commercial banking services were provided separately by state-owned enterprises.

Following the collapse of the Somali state in early 1991, the CBS was unable to perform any of its mandated functions. Its premises were looted, and it ceased to be operational. State-owned commercial banks also ceased operating, and all correspondent banking relationships were terminated. The Somali economy became wholly disconnected from the international banking system.[81]

Money transfer businesses (MTBs) moved into the space created by the absence of formal financial sector institutions. MTBs were unregulated, privately owned entities that facilitated the transfer of funds into and out of the country—either by flying US dollars into Somalia in cash, or by making settlements between accounts held by traders outside the country. They also offered

[81] Private banks operated in Somalia in the 1960s, but they were all nationalised in 1970. The state-owned commercial banks were: Commercial and Savings Bank, Cooperative Bank of Somalia, Somali Commercial Bank, and Somalia Development Bank.

deposit-taking services. All transactions in the local economy were cash-based, and there was no formal private sector lending.

The demise of the central bank meant there was no control over the issuance of domestic currency. Private individuals acquired currency-printing facilities and issued counterfeit currency for use in local transactions, causing inflation to spiral. By the mid-2000s, the value and credibility of the Somali shilling was so debased that the economy became dollarized. The shilling was used only for low-value transactions.

Beginning in 2009, the Transitional Federal Government (TFG) attempted to reestablish the CBS with support from international partners. The TFG passed two key pieces of legislation in April 2012:

- The Central Bank of Somalia Act (CBS Act) reaffirmed the mandate of the CBS to issue currency, provide fiscal agent services to the government, and regulate financial institutions. It also required the CBS to hold and manage Somalia's foreign exchange reserves, formulate and implement monetary and exchange rate policies, and administer payment, clearing, and settlement systems.
- The Financial Institutions Law provided a legal basis for CBS regulation of commercial banks and MTBs. Following the law's enactment in 2012, the CBS issued licences to three privately owned commercial banks and two MTBs.

Despite these legislative reforms, continued instability in Somalia meant that the CBS was still largely unable to performs its functions effectively.

In August 2012, a new Federal Parliament was elected in Mogadishu. The Federal Parliament elected Hassan Sheikh Mohamud as President of the FGS in September 2012, enabling the formation of the FGS to replace the TFG. This in turn triggered international reengagement with Somalia and renewed efforts to restore the functioning of the CBS. A new Central Bank Governor, Abdusalem Omer, was appointed by the President in January 2013 (Box 6).

Starting point for reform: challenges facing the Central Bank in 2013

The challenges confronting CBS and the incoming governor in 2013 spanned the full range of CBS functions, as well as the governance and institutional capacity of the CBS. Six major concerns stood out.

Lack of CBS connectivity to the MoF, commercial banks, and the international banking system

Although the CBS was mandated to act as the fiscal agent to the FGS, it had no interconnectivity with the MoF. The CBS used manual systems and basic software to make accounting transactions, which were then manually reconciled with the MoF's own ledgers. This was a time-consuming process, prone to human error. As a result, the MoF lacked up-to-date information on its available cash balances and could not manage its cash flow effectively.

BOX 6 Governors of the Central Bank of Somalia since 2013

- January to September 2013: Abdusalem Omer
- September to October 2013: Yussur Abrar
- November 2013 to April 2019: Bashir Isse
- April 2019 to present: Abdirahman Abdullahi

Note: The CBS Act 2012 stipulates that the CBS Governor may serve a four-year term, which can be renewed once.

The CBS lacked a core banking system and had no interconnectivity with commercial banks. It had no capacity for receiving revenue, or making payments, electronically on behalf of the FGS. FGS revenues were either deposited at the CBS in cash or transferred from commercial banks by cash or cheque. Government payments were made either in cash or by cheque. Salary payments, which constituted the largest FGS expenditure, were made in cash. FGS officials would physically collect funds in bulk from the CBS to pay civil servants and military personnel.

The CBS was disconnected from the international banking system, so the only way to bring funds into Somalia was to fly in cash. Owing to concerns over money laundering and the financing of terrorism, international banks were wary about engaging with the CBS. Reestablishment of the CBS's connection to the SWIFT messaging system for international financial transfers and establishment of an international correspondent banking relationship was an early priority in 2013. It was achieved with the support of the Norwegian-funded SFF (Box 7).

Lack of regulation and supervision for commercial banks, MTBs and mobile money operators

The CBS was unable to implement its banking supervision responsibilities in any meaningful way in 2013. Although licences had been granted to three commercial banks and two MTBs in 2012, the CBS lacked the regulatory procedures and appropriately qualified staff to conduct effective supervision of these entities. Many other unlicensed financial institutions continued to operate. By the start of 2014, as many as six commercial banks and fourteen MTBs were reportedly operating without a licence.[82] Mobile money services provided by telecom firms were also entirely unregulated.

Due to the absence of a proper regulatory system and the continued operation of nonregulated entities, the CBS was unable to protect customers' funds effectively or to detect and prevent money laundering and terrorist financing activities. Somalia's financial sector continued, therefore, to be considered extremely high-risk from an international perspective. That prevented further reengagement with the international financial system and the establishment of further correspondent banking relationships.

Remittances to Somalia continued to flow through MTBs, and funds were delivered in cash. The MTBs often experienced difficulties in securing a transfer route and consequently offered services at a relatively high cost to remitters and receivers.

BOX 7 The Norwegian-funded Special Financing Facility and correspondent banking relationships

The CBS received support with reestablishing connectivity to the international banking system in 2013 as part of the process of setting up the Norwegian-funded SFF for the payment of FGS salaries. To provide financing to support the FGS's payment of salaries, the Government of Norway needed to find a way to transfer funds to the CBS.

The SFF assisted the CBS to reestablish its connection with SWIFT messaging systems, but the CBS lacked any international correspondent banking relationship through which SFF funds could be transferred from Norway. With SFF support, the CBS established a correspondent banking relationship with a Kenyan bank for the transfer of the first tranche of SFF funds to the FGS in August 2013. However, the Kenyan bank closed the correspondent account immediately after the transfer had been made. After a further search, the SFF was eventually able to assist the CBS to open a more permanent correspondent banking relationship with Ziraat Bank in Turkey, paving the way for subsequent SFF transfers in 2014.

[82] IMF. 2021. "Somalia: Technical Assistance Report––Bank Supervision and Regulation." IMF Country Report No. 21/68.

Lack of a payment and settlement system for financial sector institutions

No interbank payment system existed in Somalia in 2013. If a customer wanted to transfer funds from an account in one commercial bank or MTB to another, they could do so only by withdrawing cash from one institution and depositing it at the other. Larger financial sector actors developed vertical linkages between MTBs, commercial banks, and mobile money operators (MMOs). A customer who received funds through a specific MTB would use the banking services provided by its affiliated commercial bank or the mobile money services provided by its affiliated telecom provider.

The absence of a payment and settlement system increased costs for Somali consumers, who were tied to monopolistic service providers. It increased their risk exposure through a reliance on cash payments, and it reduced efficiency.

Lack of CBS resources to issue new Somali currency and conduct monetary policy

The CBS's responsibility for issuing Somali currency was reaffirmed in the 2012 Provisional Constitution, which stated that monetary policy was an exclusively federal power.[83] The economy remained effectively dollarised however. The CBS did not have sufficient funds to issue a new Somali currency and lacked the necessary foreign exchange reserves and technical capacity to conduct monetary and exchange rate policies.

Counterfeit Somali shilling notes remained in circulation for low-value transactions, and new counterfeit currency continued to be issued on an *ad hoc* basis in some FMS. The effect was to destabilise the livelihoods of local traders through price inflation and a reduction in the value of their savings.

Limitations in CBS staffing, systems and procedures, and financial resources

The institutional capacity of the CBS in 2013 was extremely limited. It had a skeleton staff of 84, of whom just 16 were professionals and the remainder support staff.[84] Internal procedures were not clearly documented, and systems were entirely manual. Staff capacity was very low, there was no clear segregation of duties, and lines of reporting were unclear. These internal weaknesses constrained the ability of CBS to deliver its mandated functions.

The CBS also faced severe budgetary constraints. It lacked any capital from which it could earn interest income. Its budget was funded almost entirely by a 1.5 percent commission on FGS revenues. Total CBS income in 2013 was only US$3 million.[85]

Weaknesses in CBS independence and governance integrity

Concerns mounted in 2013 about the integrity of CBS governance and its lack of independence from the FGS. The 2012 CBS Act provided for the establishment of a Board of Directors to supervise CBS activities and operations,[86] and it reaffirmed the autonomy of the CBS.[87] No board was appointed in 2013, however, and the circumstances surrounding a contract with a private law firm for recovery of the frozen assets of the former Somali state indicated that the CBS was not independent in practice (Box 8).

[83] Provisional Constitution, Article 54.

[83] Central Bank of Somalia. 2013. Strategic Plan 2013–2018.

[85] Central Bank of Somalia. 2014. Reports and Financial Statement for the year ended 31st December 2014.

[86] Central Bank of Somalia Act. 2012. Law no. 130, April 22. Article 10.

[87] CBS Act. 2012. Article 6.

BOX 8 **Frozen asset recovery and the threat to CBS independence and integrity**

Concerns over CBS integrity first emerged in July 2013, when a report by the UN Somalia and Eritrea Monitoring Group alleged that the CBS was at the heart of "systematic misappropriation, embezzlement and outright theft of public resources."[88] The governor resigned in September 2013, while strongly denying the allegations.[89]

The newly appointed governor then resigned within seven weeks, citing political interference with CBS operations and pressure to sanction corrupt deals.[90,91] She stated that she had refused to sanction a contract between the CBS and an American law firm, Shulman Rogers, that her predecessor had been instructed to sign. The contract gave the law firm power of attorney to act on behalf of the CBS in the recovery of frozen assets of the former Somali state held in various bank accounts abroad for a sizeable fee. The contract had been awarded on a sole-source basis, without any transparency over its terms. Governor Abrar took the view that the Shulman Rogers contract put frozen assets at risk and opened the door to corruption.[92,93]

These events demonstrated that political commitment to CBS independence would be a prerequisite for effective financial sector reform. The ensuing crisis in confidence led to renewed FGS and international community efforts to strengthen and reform the role of the CBS. It was also a major contributing factor to the establishment of the FGC in 2014. A new governor was appointed at the end of November 2013, and a Board of Directors was appointed in April 2014.

A decade of achievements: central bank and financial sector reforms since 2014

The CBS has made strong progress in delivering reforms in most areas of its mandate over the past decade. It has also transformed its internal capacity and strengthened its governance. These achievements have been enabled and driven by several factors:

- Sustained political commitment to the independence of the CBS by top FGS leadership.
- Strong and stable leadership of the CBS at the senior executive and governing board levels.
- Provision, and effective use, of extensive technical assistance from the IMF and World Bank.[94]
- A merit-based culture for the recruitment and management of CBS personnel.
- Clear strategic orientation in the direction, priorities, and phasing of financial sector reform.

A Roadmap for Financial Sector Development has guided the reform process.[95] Specific reforms have been subject to structural benchmarks under the IMF Staff Monitored Programme, Enhanced Credit Facility (ECF), and HIPC debt relief programme. International partners have emphasised the importance of a sound financial sector for debt relief and the provision of multilateral financing to Somalia.

Several areas of achievement stand out (Figure 6).

88 UN Security Council. 2013. Report of the Monitoring Group on Somalia and Eritrea pursuant to Security Council resolution 2060 (2012): Somalia. Document S/2013/413, July 12.

89 Reuters. 2013. "Somalia replaces central bank chief criticised in U.N. report." September 19.

90 Financial Times. 2013. "Somalia central bank governor resigns after seven weeks." November 3.

91 Organized Crime and Corruption Reporting Project. 2013. "Somalia: Head of Central Bank Resigns Citing Corruption." November 5.

92 Her suspicions were confirmed when the lawyer involved (Jeffrey Shulman) was indicted in 2020 by the US Justice Department.

93 US Department of Justice. 2020. "Maryland Lawyer Charged with Defrauding Financial Institutions and Other Entities to Obtain Control over $12.5 Million of Somali Sovereign Assets." Press Release, December 3.

94 IMF assistance has been provided through its multi-donor Trust Fund for Capacity Development in Macroeconomic Policies and Statistics for Somalia. World Bank assistance has been provided through its SCORE and SCALED-UP projects, funded by a combination of the Multi-Partner Fund and IDA resources.

95 Central Bank of Somalia. 2018. "Somalia: A Roadmap for Financial Sector Development." First draft 2017, operational framework 2018. (Produced to fulfil a structural benchmark for the First Review of the Second IMF Staff Monitored Program.)

Figure 6: Main CBS reform domains and specific areas of achievement since 2014

Strengthening CBS capability		Transforming CBS functions		
CBS governance	**CBS organisation & staffing**	**Fiscal agent services for FGS**	**Lcensing & supervison of financial sector**	**Payment, clearing & settlement system**
- Operational independence from FGS - Governor & Deputy Governor appointments - Board of Directors in place - Clean annual audits by OAG external audior	- Organisational restructuring into functional directorates - Merit-based staff recruitment & performance management - Internal systems, policies & procedures established - Research capacity established & statistics regularly published	- CBS systems upgrade & interconnectivity with MoF systems - Branch openings in FMS - Connectivity with international banking system - Recovery of frozen assets	- Stronger regulatory framework for supervision of financial sector institutions - Licensing & supervision of commercial banks, MTBs & MMOs - Stronger famework for Anti Money Laundering & Countering the Financing of Terrorism - Launch of national ID system (for KYC)	- National Payment System established covering licensed commercial banks - International Bank Account Numbers adopted - Roll-out of Standardised national Quick Response code

Upgrading the fiscal agent services provided to the government

Iterative improvements in CBS and MoF systems, and their interconnectivity, have transformed the role of the CBS as fiscal agent to the government. FGS revenues are no longer deposited at the CBS in cash, and FGS payments are no longer made in cash. The CBS pays all FGS employees, security personnel, and vendors directly to their accounts, reducing the scope for fraud and corruption. These developments were first made possible by the acquisition of tailored bulk payment software in 2017. Installation of a core banking system followed in 2018, which established an automated connection between the CBS and commercial banks in 2019.

Connectivity between the financial management system operated by the MoF (the SFMIS) and CBS systems was established in 2019. That eliminated the need for manual processing of FGS payment instructions and removed delays in information sharing between the CBS and the MoF. All FGS transactions are now processed by the CBS electronically, and all payments are settled in real time—yielding significant increases in system efficiency. The MoF has direct access to FGS account balances at the CBS, enabling it to manage FGS cash flow more effectively.

The CBS has been able to assist the FGS in managing cash flow pressures. The 2012 CBS Act permits the CBS to make temporary direct advances to the FGS to offset fluctuations in revenues and expenditures.[96] The Act limits such advances to 15 percent of the gross recurrent revenue of the FGS in the previous year, and it requires full repayment within 12 months. Temporary direct advances by the CBS were made to the FGS in 2021, 2022, and 2023. These advances helped to ensure regular and timely execution of FGS salary payments following pauses or delays in budget support disbursements from international partners. The advances were restricted to the limit established in the CBS Act, and they were fully repaid within the stipulated time frame.

[96] CBS Act. 2012. Article 29.

The CBS has been preparing to expand its operations to the Federal Member States. The first CBS branches outside Mogadishu were opened in Dhusamareb, in Galmudug State, in August 2023, and in Baidoa, in South-West State, in September 2023. Three more branch openings are planned in Hirshabelle, Jubaland, and Puntland by the second quarter of 2024. The branches will provide fiscal agent services to the FMSs. They will also provide payment services, such as deposits and withdrawals, to commercial banks located in the FMS and will, eventually, act as regional currency centres.

Improved relationships and credibility with the international banking system have enhanced the CBS's fiscal agent capabilities. The CBS has increased the number of its correspondent banking relationships to include banks in Djibouti, Qatar, and Turkey. In 2020, it reactivated its account with the Federal Reserve Bank of New York for the first time in 30 years, and the account is now fully operational. CBS access to the SWIFT messaging system has been upgraded to the latest standard (ISO 20022).

Recovery of the frozen assets of the former Somali state, held by international banks, has proceeded without further incident since 2013. With FGC support, the CBS developed an Asset Recovery and Management Strategy in 2014, setting out the process for recovering frozen assets and transparent procedures for their utilisation once recovered. The CBS has received assistance from the World Bank, through the Stolen Asset Recovery programme, and from the World Bank Legal Department on the identification and recovery of assets held in international banks. Assets amounting to US$11.48 million have been recovered since 2014.

Strengthened regulation, licensing, and supervision of financial sector institutions

The CBS has strengthened the regulatory framework for financial institutions and expanded the scope and quality of its regulatory activities (Table 7). Several prudential regulations and guidelines have been issued since 2015,[97] and the capacity of the CBS Licensing and Supervision Department has been strengthened.

All commercial banks operating in Somalia are now licensed by the CBS, with a total of 13 licences issued to Somali-registered commercial banks. These banks provide services covering deposit-taking, asset financing, and investments in equities, land, and property. As of September 2023, Somali commercial banks held overall deposits amounting to US$1.334 billion and loan portfolios amounting to US$507 million. The CBS Board of Directors approved licences in 2022 for two foreign banks to conduct banking activities in Somalia for the first time in 50 years.[98] The first branch was opened in October 2023.[99]

TABLE 7 Overview of the licensed financial sector in Somalia

Type of institution	Licenced entities (end December, 2023)	Volume of financial activity (end September, 2023)
Commercial banks (Somali)	13	Deposits: US$1.334 billion Loan portfolios: US$507million
Commercial banks (foreign bank branches)	2	
Money transfer businesses	15	Inward transfers: US$2.5 billion
Mobile money operators	4	Reported transactions: US$7.8 billion
Other (foreign exchange bureaus, asset financing companies, microfinance providers, insurance providers)	Not currently licensed	

Source: CBS data

97 Central Bank of Somalia website: https://centralbank.gov.so/currency-and-banking-operations/
98 The East African. 2022. "Somalia licences first two foreign banks since 1970." July 4.
99 Halqabsi News. 2023. "Turkish Bank Ziraat Katilim Opens First International Branch in Somalia in Over 50 Years." October 29.

The CBS conducts monthly off-site analysis and annual on-site supervision of commercial banks. It issues directives to limit any deficiencies and deviations from existing regulations. Being subject to regulation by the CBS has simplified Somali commercial banks' access to international financial institutions, correspondent payments, and international settlements. Somali commercial banks have around 20 active correspondent banking relationships, mostly in countries where Somalia has significant business relationships.

All money transfer businesses known to be operating in Somalia are subject to the CBS licensing regime. The CBS has licensed 15 MTBs. Regulation of MTBs is necessary for Somalia's efforts on the anti-money laundering and combating the financing of terrorism (AML/CFT) agenda. As with commercial banks, the CBS conducts monthly off-site monitoring of MTBs and annual on-site supervision. Total inward transfers to MTBs amounted to US$2.5 billion in the third quarter of 2023. Many MTBs remain closely linked to licensed commercial banks.[100]

The CBS has extended its regulatory activities to mobile money operators. The CBS has established a Memorandum of Understanding with the National Communications Authority, and regulations covering the activities of MMOs were issued in 2019. Given the major role played by mobile money as a medium of financial exchange in Somalia, as well as the close links between MMOs, MTBs, and commercial banks, effective regulation of MMOs is necessary for overall financial stability.

Licencing of MMOs commenced in 2020. By early 2022, licences had been issued to three MMOs.[101] These operators account for 70 to 80 percent of the mobile money market in Somalia, and they have close connections to licensed commercial banks.[102] A fourth operator was licensed in 2023. The CBS receives a monthly data return from licensed MMOs. The total value of reported mobile money transactions was US$7.8 billion in the third quarter of 2023.

Other types of financial sector institutions remain outside the regulatory reach of CBS. Those include foreign exchange bureaus, asset financing companies, and microfinance providers. Revisions to the Financial Institutions Law have been drafted to enable the CBS to extend its regulatory coverage to all financial sector institutions. These revisions are due to be submitted to Parliament during first quarter of 2024, following stakeholder consultations. The CBS has also drafted an Insurance Bill and National Payment Bill to enable regulation of insurance and payment service providers respectively. These two Bills have been submitted to Parliament.

Since 2021, the CBS has been able to screen its cross-border transfers for compliance with international requirements on AML/CFT. Since 2022, the CBS has enhanced its payment control functionality to protect itself against making unlawful payments. The National ID, launched in September 2023, will help both financial sector institutions and FGS agencies to prevent and deal with the threat posed by illicit transactions by enabling enhanced Know Your Customer (KYC) processes.

Development and implementation of the national payment system and a national Quick Response (QR) code

CBS started the development of a national payment system (NPS) for Somalia in 2019, with assistance from the World Bank. The NPS is an interoperable system that connects all commercial banks in Somalia and allows them to transact with each other electronically through a clearing and settlement system managed by the CBS.[104] Development of the infrastructure to support the NPS required the establishment of a private fibre-optic network connecting the CBS and commercial banks, as well as a cloud-based data centre to provide disaster recovery. Extensive work was undertaken to upgrade

[100] Eight out of the 13 licenced Somali commercial banks have connections to licensed MTBs.

[101] Hormuud, Somtel, and Somlink

[102] Hormuud telecom/Salaam Somali Bank; Somtel (e-Dahab)/Dahabshil Bank; Somlink(e-Besa)/IBS Bank

[103] In more technical terms, the NPS integrates automated clearing house (ACH), real-time gross settlement (RTGS), and instant funds transfer (IFT) functionality into a single platform, with links between the CBS and commercial banks.

the core banking systems of commercial banks to enable them to interface with the NPS and to train their staff on the NPS.

The NPS was launched in July 2021. All 13 licensed commercial banks are connected to the system. Since then, almost two and a half million transactions have been cleared and settled through the NPS, with a total value of over US$3.5 billion. (Figure 7).

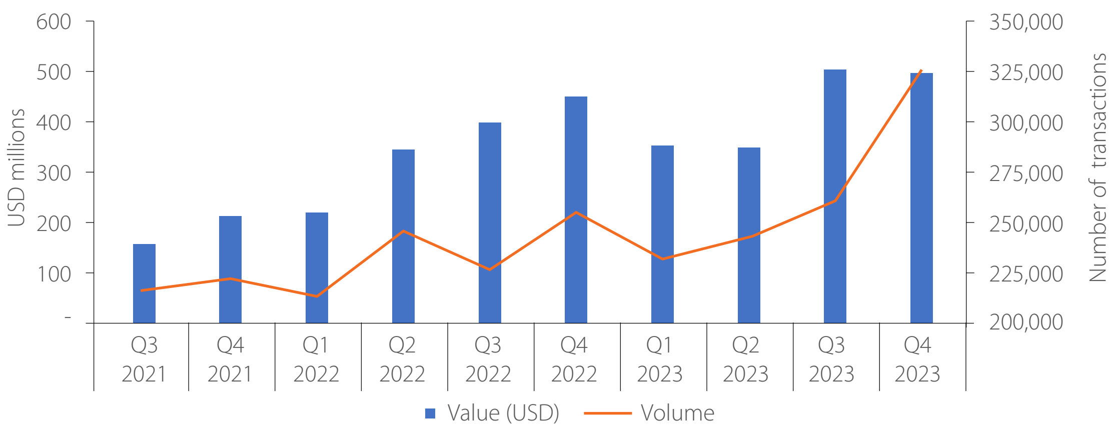
The CBS further enhanced the effectiveness of the NPS in March 2023. All licensed banks in Somalia adopted the use of International Bank Account Numbers (IBAN) across all transactions passing through the NPS. Use of IBAN will improve cross-border payments and reduce operational processes by enabling the NPS to validate bank account numbers electronically and to select the payment route without manual involvement. An additional benefit of IBAN is reduced delays in international transfers to Somalia originating from IBAN-compliant countries.

Establishment of the NPS is a milestone in the transformation of Somalia's financial sector, and in the CBS's role as regulator. The NPS reduces risk for bank customers by eliminating the need for the movement of cash between commercial banks. It also increases system efficiency and strengthens the CBS's ability to monitor the activities of commercial banks. These are essential steps in restoring the credibility of Somalia's financial sector and supporting its reintegration with the global financial system.

Alongside the NPS, the CBS launched a standardised national QR code for Somalia (SOMQR) in June 2023. The SOMQR sets the parameters for all payment service providers regulated by the CBS to issue QR codes to merchants and consumers in the country. It will facilitate payment services that are fast, easy to use, and cost-effective. The aim is to promote seamless and secure payment transactions to accelerate the transition towards a cashless economy. In addition to commercial transactions, the SOMQR will enable person-to-person payments and transfers, as well as government service transactions (such as collection of taxes and fees).

Once fully implemented, customers of all banks and MMOs will have the ability to use mobile applications to exchange funds instantly.[104] The SOMQR will enable consumers to make transactions at business premises (such as shops and restaurants) and government fee collection offices, regardless of where the merchants' bank accounts are located. The NPS Bill, which has been submitted to Parliament, will enable the CBS to regulate payment system operators and payment service providers more effectively in relation to the SOMQR.

Figure 7: Transactions through the national payment system: July 2021–December 2023



Source: CBS data

[104] The mobile applications will be issued by their bank or MMO.

Transformation of CBS institutional capacity, recruitment processes, and internal systems and policies

Guided by a Transition Plan, the CBS has made significant progress towards becoming a policy-oriented, functionally organised institution. This suite of internal institutional reforms has provided the CBS with a critical foundation for implementing its Strategic Plan for 2020–2024.[105]

A new CBS organisational structure was adopted in 2019. Each staff member has a clear job description and line of reporting, with the reporting lines organised in functional groups. Each staff member also has performance management objectives that are reviewed annually as part of a performance appraisal process. The CBS has an annual training plan designed to build the capacity of all staff so they can contribute effectively to the achievement of the overall CBS goals.

CBS staffing has been expanded and professionalised. The CBS now has 205 employees, the majority of whom are qualified professionals. The 22 staff who were beyond the pensionable age have been given voluntary severance packages and made redundant. Since 2020, staff recruitment has been conducted on the basis of merit (Box 9). The CBS leadership competitively recruited qualified senior executives to fill three managerial positions in the new function-based organisational structure.[106] The posts were advertised nationally and internationally. An external recruitment firm based in the UK was contracted to manage the hiring process, which involved stages of assessment including shortlisting, interviews, reference checks, and psychometric testing. The top three candidates for each position were then referred to CBS leadership for final interviews. A panel led by the CBS Governor selected the best candidate for each position. The three senior executives were appointed in 2020.[107]

The CBS has made considerable process in overhauling and modernising internal systems. The systems for bank operations and accounting have been automated.[108] A series of policies have been developed to guide internal procedures, including an operations manual, human resource policy, financial management policy, foreign account management policy, procurement policy, information and communications technology policy, and audit rotation policy. Improvements in its internal controls have helped the CBS achieve a clean audit opinion from its external auditors for the past three years. Audited annual financial statements for the CBS are published on the CBS website.[109]

BOX 9 Implementation of merit-based recruitment at the central bank

Since 2020, the CBS has employed merit-based recruitment for staff in 43 posts. To initiate recruitment, the hiring department must include the post in the CBS's annual workforce plan and prepare a job description that is approved internally. The posts are advertised online. Short-listed candidates are invited to sit a written examination. The candidates with the top eight to 15 scores on the written examination are invited to participate in an oral interview. Based on performance on both the written and oral assessments, the top candidate is recommended for hiring. A recruitment report is prepared, reviewed by the Executive Director overseeing the hiring department (or the General Manager if applicable), and then sent to the CBS Governor, who makes the final decision. A total of 6,880 applicants have applied for the 43 posts advertised since 2020, with an average of 160 applicants per post.

105 The Transition Plan and the Strategic Plan were both endorsed by CBS Board of Directors, with Board Resolution 43/B-C-D of October 28, 2019.

106 Executive Director, Monetary, Financial Policy, and Regulation; Executive Director, Currency and Banking Operations; General Manager, Financial, Administrative and Support Services.

107 The Executive Director for Monetary, Financial Policy, and Regulation took a new job in the UK in 2023. His replacement was recruited from within the CBS through a merit-based process.

108 Using Core Banking Temenos (T24) and Enterprise Resource Planning (ERP) Oracle software.

109 Available at: https://centralbank.gov.so/reports-publications/

The CBS has made a significant effort to increase its capacity for research and statistics. The Research and Statistics Department now produces regular Quarterly Economic Reports, which examine Somalia's recent macroeconomic and financial sector developments against prevailing global economic conditions. These quarterly reports also provide key datasets for real, external, fiscal, and financial sector statistics.[110] The Research and Statistics Department also produces and publishes consolidated annual reports (Box 10).

Strengthened CBS governance framework and effective operational independence

The FGS leadership's political commitment to sound governance of the CBS has been maintained since 2014 and through three successive administrations. Appointments to the Board of Directors and the positions of Governor and Deputy Governor have all been made in accordance with the 2012 CBS Act, and the CBS has been enabled to operate independently.

The Governor and Deputy Governor each serve a four-year term, which can be renewed once. Successive CBS Boards of Directors have been appointed: in April 2014 with a term until March 2020, and in March 2020 with a term until March 2024.

The CBS Board of Directors meets regularly at least once every two months. It has been active in ensuring that the CBS has the necessary internal structures for sound governance. Internal governance committees have been established, including an Audit Committee, Human Resources Committee, Supervision Committee, and Senior Management Committee. The Board has ensured that the CBS complies with its annual financial reporting and audit responsibilities, as per the CBS Act. It has given strong support to the organisational restructuring of the CBS, the adoption of merit-based staff recruitment, and oversight arrangements for licensing and supervision.

As discussed above, the FGS has respected the provisions of the CBS Act when borrowing from the CBS for cash management purposes through temporary direct advances. Temporary direct advances by the CBS in 2021, 2022, and 2023 were restricted to the limit established in the CBS Act and were fully repaid within the stipulated time frame.

Building on success: objectives for CBS and financial sector development

The CBS has made substantial progress since 2014 in developing its own capacity and reforming Somalia's financial sector. The last decade has seen a significant shift from a high-risk, unregulated, fragmented, cash-based environment to a more regulated one with greater system efficiencies and controls.

BOX 10 Publication of statistical information by the CBS

CBS reports are published on a dedicated page of the CBS website. The following data sets are available:

- Monthly inflation data
- Monthly exchange rate data
- Monthly import and export data
- Monthly commodity price data
- Annual FGS revenue and expenditure data
- Quarterly consolidated balance sheet of commercial banks
- Quarterly remittance data
- Quarterly NPS transactions

Source: CBS website – www.centralbank.gov.so

[110] Available at: https://centralbank.gov.so/reports-publications/

The reform process is by no means complete. Existing reforms of CBS functions and capabilities need to be expanded and deepened, while new priorities—such as CBS operations in the FMS and currency reform—will need to be set in motion. Several pieces of draft legislation need to be passed in 2024 to underpin the next phase of reforms (Box 11). The CBS is also updating its Strategic Plan, which will guide future reforms.

Expanding and deepening existing reforms

Financial sector supervision: increase and expand the CBS's regulatory reach and capacity to reduce financial sector risk

The CBS needs to increase its supervision of commercial banks, complete the regulation of MMOs, and expand its regulatory reach to other financial sector institutions beyond commercial banks and MTBs. Work is needed to improve the quality of data submitted by commercial banks, which would allow Somalia to report internationally on financial stability indicators. The CBS will also need to strengthen its capacity to enforce financial sector regulations.

Enactment of the revised Financial Institutions Law and the Insurance Bill are the next steps, followed by the development of implementing regulations for this new legislation.

Payment and settlement systems: enhance the capability of the NPS to improve efficiency for customers

The CBS is due to initiate a national payments 'switch' in early 2024. It will commence with instant payments and eventually make mobile money, card-based retail payments, and commercial bank accounts interoperable. Establishment of a credit reference bureau and centralised system for collateral registration will enhance financial sector intermediation.

Enactment of the NPS Bill is the next step, followed by the development of implementing regulations to help ensure that the NPS is properly regulated and that payments made through the NPS are appropriately protected.

AML/CFT: Develop the national identification system, so that financial sector institutions can implement more robust KYC controls

Somalia continues to be perceived to be high-risk from an AML/CFT perspective. Rollout of the National ID system that was launched in September 2023 will help financial sector institutions and government agencies to prevent and deal with the threat posed by illicit transactions.

Over time, this initiative should boost international banks' confidence and thereby facilitate Somalia's reintegration with the global financial system. The country's progress towards stronger AML/CFT controls will be a crucial factor in the 2024 Middle East and North Africa Financial Action Task Force Mutual Evaluation Assessment, which in turn will have a bearing on its access to correspondent banking relationships, trade financing, and foreign direct investment.

BOX 11 Developments in the CBS and financial sector legal framework since 2012

- Central Bank of Somalia Act (2012)
- Financial Institutions Act (2012)
- Anti-Money Laundering and Countering the Financing of Terrorism Act (2016)
- Targeted Financial Sanctions Act (2023)
- Insurance Bill (draft)
- National Payment Systems Bill (draft)
- Financial Institutions Bill (draft)
- Amendments to CBS Act (draft)
- Amendments to AML/CFT Act (under development)

CBS independence: Increase the operational and financial independence of the CBS

The CBS's ability to maintain its reform trajectory will be contingent on continued political commitment to sound CBS governance. As indicated by the country's experience in 2013, any perceived risk to the independence of the central bank can have a significant, negative impact on stakeholder confidence in the CBS and the financial sector more generally. Political support for sound CBS governance and noninterference in CBS operations needs to be a continued priority to protect the gains made to date and enable further reform. The CBS is in the process of drafting amendments to the 2012 CBS Act to further strengthen its autonomy.

The CBS budget is not yet on a sustainable footing financially. The current transitional arrangement, whereby the CBS's operational budget is financed mainly by commission charges from FGS revenue (1.5 percent) is necessitated by the CBS's lack of capitalisation. In the absence of alternative sources of sustainable funding, commission income is essential to finance CBS operations. Yet the CBS's reliance on commission as its main source of financing limits its independence and causes its revenues to fluctuate in line with FGS revenues. As an illustration, CBS revenues amounted to US$7.4 million in 2021, compared to US$9.1 million in 2020.[111] In 2022, they rose to US$11.3 million. This is not a sustainable approach in the medium term. It is essential for the CBS to be adequately capitalised so it can develop an independent and sustainable revenue model to deliver on its mandate.

Embarking on longer-term reforms

Extend the CBS's countrywide reach by reestablishing operations in all FMS

The CBS plans to have completed the opening of branches in all five FMS by the end of 2024. Once those branches have been established, the priority will be to extend the CBS's operational reach across Somalia. An operational presence in each FMS will enable the CBS to provide fiscal agent services to FMS governments, thereby strengthening fiscal federalism and state building. It will also support financial sector development by providing services to commercial banks operating in the FMS.

Countrywide operational reach is essential for currency reform as well, as CBS branches will play a key role in the collection of old banknotes and distribution of a new currency and will act as regional currency centres.

Launch the first phase of currency reform to support financial inclusion

Issuance of a new currency is important for financial inclusion—especially for the most vulnerable populations, who have limited access to formal financial services. It would facilitate payments for small-value transactions, which would benefit the small-scale traders who suffer most from the continued circulation of counterfeit notes. A Somali currency is also necessary for the CBS to conduct monetary policy and ensure price stability, in line with its mandate.

Implementation of the currency project is a complex undertaking and must be managed carefully on a phased basis. The CBS has developed a phased plan for the resumption of currency issuance, starting with the replacement of the counterfeit low-value notes (1,000 Somali shillings) currently in circulation. Issuance of higher denominations will be planned for a later date, contingent on two factors. First, the CBS will require capitalisation so that its assets, especially in foreign exchange reserves, match the value of the new currency. Second, it will require considerable capacity development and further capitalisation to conduct monetary policy effectively.

The CBS is unable to finance currency reform itself. It has secured technical support from the World Bank for implementation of the first phase of the reform, through the 'Kalkaal' currency exchange project. External financial support is needed to fund the estimated US$70 million cost of the Kalkaal project.

A major condition for proceeding with the issuance of a new currency will be political commitment from FMS, which the FGS must negotiate.

111 Central Bank of Somalia. 2021. Reports and Financial Statements for the year ended December 31, 2021.

IV. Financial Governance Agenda and Priorities from 2024

Contours and opportunities in a post-HIPC landscape

New era, new priorities, new paradigm

With the achievement of HIPC debt relief confirmed, Somalia has an exceptional opportunity to expand its strategic focus in 2024—both domestically and internationally. Two FGS objectives stand out as especially pertinent with respect to their implications for the evolution of the financial governance agenda. First is increasing growth and economic development to transform Somalia. Second is remodelling relationships with international partners across the public and private spheres.

The parallel announcements in December 2023 of Somalia's attainment of international debt relief worth US$4.5 billion and accession to membership in the East African Community have propelled economic development to the top of the country's policy agenda. New access to a regional economic bloc and restored access to the global financial system should bring tangible medium- and long-term opportunities for trade, investment, private sector development, and regional integration. The FGS is committed to taking full advantage of those opportunities—notably for job creation and the development of productive sectors, such as agriculture, livestock, fisheries, and green energy. A 2023 report by

Somalia's National Economic Council sets out this coming agenda.[112] To exploit these opportunities effectively, the FGS will need to sustain and strengthen its financial governance.

The end of the HIPC regime also marks the transition to a different paradigm in relations between Somalia and its international partners. In narrow terms, it means the end of a zero-borrowing framework with an opening of access to external borrowing on concessional terms.[113] In broader and more strategic terms, it shifts Somalia's engagement with the international community into a more expansive dialogue about how to encourage and facilitate external investment.[114] HIPC completion also helps the FGS to signal to a wider set of international partners, such as development finance institutions and the private sector, that Somalia is a viable investment prospect. To make the most of these opportunities, the FGS needs to strengthen domestic revenue mobilisation so that it can cover operational costs from its own resources and does not need to borrow for consumption.

The FGS is under no illusions about the scale and ambition of the task that lies ahead.[115] These are opportunities to be seized, not guaranteed paths to prosperity. Moreover, economic development is only one dimension of Somalia's sustainable development agenda. Peace and security, climate resilience and adaptation, social development and equity, and state building remain equally important. These priorities sit at the heart of the new Centennial Vision 2060 for Somalia, which has set a long-term core objective to "transform Somalia into a middle-income country with a capable state" by 2060.[116] Each of these adjacent and complementary strategic priorities will rely, at least to some degree, on the success of FGS actions to attract external investment and enable economic growth that boosts government revenues and private incomes.

Financial governance—a vital ingredient in future progress

The FGS finished 2023 with a strengthened international reputation, which it must guard carefully and bolster through 2024 and beyond. Achievements in 2023 have raised expectations about the future role of the state in a context where the government is expanding rapidly but not yet able to cover its operational costs from its own resources. Somali citizens, prospective external investors, and international development partners alike have a common interest in seeing the state improve its fiscal position and manage public resources effectively (including money, land, property, and natural assets). The FGS will need to accelerate and deepen its reform agenda to deliver against these expectations. Strong and dynamic financial governance will play a crucial role in establishing and strengthening the overall enabling environment for fiscal stability, investment, growth, and sustainable development.

If addressed and successfully implemented by the FGS, strong financial governance will contribute significantly to transforming the enabling environment for investment and growth in Somalia. Investor confidence will be predicated on the understanding that the FGS is a sound business partner, capable of covering its own costs, servicing its debts, providing regulatory stability, awarding contracts transparently, and managing its assets effectively.

Sound financial governance will also provide strong foundations for increasing institutional capacity and legitimacy, which evidence shows is central to building a peaceful and capable state.[117] Institutional capacity is a key determinant of a government's ability to raise revenue,[118] while legitimacy is considered essential for state building and agreement on a political settlement.

[112] National Economic Council. 2023. State of the Economy Report (Volume 1). An Annual Report to the President by the National Economic Council on Economic Issues Shaping Somalia's Future Prosperity.

[113] IMF. 2023. Sixth Review under the Extended Credit Facility Arrangement and Request for a Three-Year Arrangement under the Extended Credit Facility.

[114] Halqabsi News. 2023. "World Bank delegation Arrives in Mogadishu for investment talks." December 19.

[115] Hassan Sheikh Mohamud. 2023. "Somalia has reached its debt relief milestone. Now the real work begins." Published in The Guardian, December 13.

[116] National Economic Council. 2023. "Centennial Vision 2060 and Presidential Initiatives."

[117] World Bank. 2011.

[118] Akitoby et al. 2020.

There are significant risks to further progress if the FGS does not build on existing reforms and address emerging priorities. While the upside opportunities in the post-HIPC era may be increasingly attainable, the downside risks of not persisting with reforms are also serious.[119] Without additional revenue mobilisation, the FGS will continue to be fiscally constrained, with limited capacity to service its debts. It would need to borrow to finance recurrent spending, limiting the scope for increasing public investment and supporting economic investment. Somalia would be of less interest to serious and credible investment partners, and more likely to attract opportunistic investors focused on short-term gain at the expense of the state. These developments would, in turn, undermine the confidence of Somali citizens and international partners and the perceived legitimacy of the state. For these reasons, it is vital that the FGS maintain its current reform path.

Framing Somalia's financial governance agenda from 2024

Building on the foregoing analysis, the FGS reform priorities from 2024 involve completing and sustaining prior reforms as part of the task of long-term state building in Somalia, as well as building capabilities to anticipate and manage new strategic opportunities and risks in a post-HIPC environment. While many of the foundations are now in place, important work remains to build the institutional capacity of the state and to ensure effective reform implementation.

Accordingly, the strategic agenda for financial governance for the FGS will need to encompass three broad objectives:

- *Scaling up government financial resources* – On the domestic revenue front, priorities for the FGS will be to embed efforts to strengthen the collection of corporate income tax, to complete customs harmonisation across Somalia, and progressively to increase the value of customs duties. On the external financing side, the FGS will need to ensure the quality and sustainability of government borrowing and financial liabilities, to build capability for the absorption and effective use of increased climate finance, and to boost the volume and share of external financing that uses government systems.
- *Managing the future affordability of the state* – Specific priorities will be to maintain active control over the current level and future growth trajectory of state costs, to avoid further proliferation of new state institutions, and to expand merit-based processes for the recruitment and management of FGS personnel in support of an efficient and effective public sector.
- *Achieving value for money from state resources* – Priorities will be to maximise the effectiveness of state investments in public infrastructure, to upgrade capabilities and compliance for concessions and public procurement, and to ensure transparency in the management of state assets, including land and property. Particular attention needs to be paid to managing natural resources (especially petroleum and fisheries), and their associated revenues, transparently.

For each of these three objectives, the main priorities are considered in turn.[120]

1- Scale up government financial resources

<u>Increase broad-based domestic revenue collection</u>

Somalia's government revenue-to-GDP ratio remains significantly lower than the norm for fragile states. The revenues of the FGS have grown by only 1.5 percent of GDP over a decade, to a current level of 3

119 IMF and World Bank. 2023.

120 For fuller discussion of the actions needed by the FGS to complete and sustain prior reforms, see 'unfinished business' in Chapter 2.

percent. The FGS will need to maintain and intensify its revenue reform efforts in the coming decade to expand its revenue base and increase its fiscal viability. A particular focus is needed to increase the collection of corporate income taxes, especially from large businesses. Once the legal framework for income tax has been modernised in 2024, the FGS will need to make strong headway in collecting corporate income tax from private sector actors.

Revenue mobilisation from large businesses will need to focus particularly on the telecom sector, which is a major area of economic activity in Somalia. Work by the FGS will involve bringing effective tax rates on the telecom sector up to a level comparable to that of countries in the region.[121]

Customs harmonisation is also key to fiscal sustainability. All FMS will need to adopt in full the FGS customs reforms. Once the FGS and FMS are all using the same customs system and applying the same customs tariff and reference values, the reference rates for goods will need to be increased gradually so that they reflect market values. Applying market values will play a key role in increasing Somalia's revenue-to-GDP ratio over the medium term.

Beyond the specific priority for corporate income tax and customs duties, there needs to be a general FGS objective to broaden the tax base in Somalia through increased formalisation of the large informal sector that currently avoids taxation.[122] These policy measures will need to be accompanied by improved tax administration and compliance.

Ensure that government borrowing and financial liabilities are appropriate and sustainable

Now that the FGS has attained debt relief, it can borrow to increase the availability of government resources. However, if such resources are not used responsibly and effectively, borrowing can undermine longer-term fiscal stability. Even with the achievement of HIPC debt relief, Somalia will continue to carry an external public debt burden of US$637.8 million, or 5.5 percent of GDP (Box 2).

The FGS has stated that it intends to finance recurrent spending from domestic revenues and external grants. It will not borrow to finance consumption. It will borrow only for capital expenditure and development projects. It has agreed with the IMF that it will borrow only on concessional terms , and that annual borrowing and guarantees will be capped so that the annual budget deficit does not exceed 3.5 percent of GDP.[123] These parameters reflect a shared assessment of the sustainable level of government borrowing for the next three years.

The decision by the FGS to continue with an IMF programme following HIPC completion shows its commitment to sustainable borrowing. Nonetheless, with the limitations to the volume and terms of its borrowing and guarantees, and the ambitions for productive investments to spur economic growth and revenue generation, the FGS will need to pay close attention to the following considerations:

- Quality of new borrowing and guarantees—including terms and conditions, speed of disbursement and delivery, and any wider non-financial requirements.
- Adequacy of the estimated economic return on capital/investment spending.
- Alignment of borrowing purposes to stated government priorities, especially for investment in economic infrastructure and the productive sectors.

The MoF will require further technical capacity development to scrutinise and negotiate loan terms and fiscal liabilities effectively, as well as capacity development on contract and debt management. More broadly, the FGS will also want to continue its active engagement with the full range of international financial institutions and multilateral

[121] IMF. 2023.

[122] National Economic Council. 2023. State of the Economy Report.

[123] As part of the new IMF ECF program, the FGS has committed to zero contracting or guaranteeing of any new external, nonconcessional debt, and to zero contracting of any new domestic debt. The FGS has committed to keeping deficits below 3.5 percent of GDP, financed with concessional loans, of which at a minimum 1.5 percent of GDP will come from multilateral creditors that provide highly concessional financing terms (at least 50 percent grant element).

development banks (MDBs) to achieve advantageous and preferential terms for any packages of financing, technical assistance, conditions, modalities, and operating procedures—with a strong emphasis on Somalia's continuing fragility and climate risks.[124]

Under the terms of the PFM Act, only the Minister of Finance has the authority to enter into borrowing and guarantees on behalf of the FGS, with parliamentary approval. This provision should provide an effective check on suboptimal or uncontrolled borrowing, but all FGS institutions will need to understand their roles and responsibilities with respect to loans and guarantees. The Council of Ministers will need to provide direction on the overall prioritisation of new borrowing. Under the new IMF programme, the FGS has committed to issue by mid-2024 a Prime Ministerial Decree that articulates the key parameters for debt policy and establishes the procedures to be followed for new borrowing and issuing of sovereign guarantees.[125]

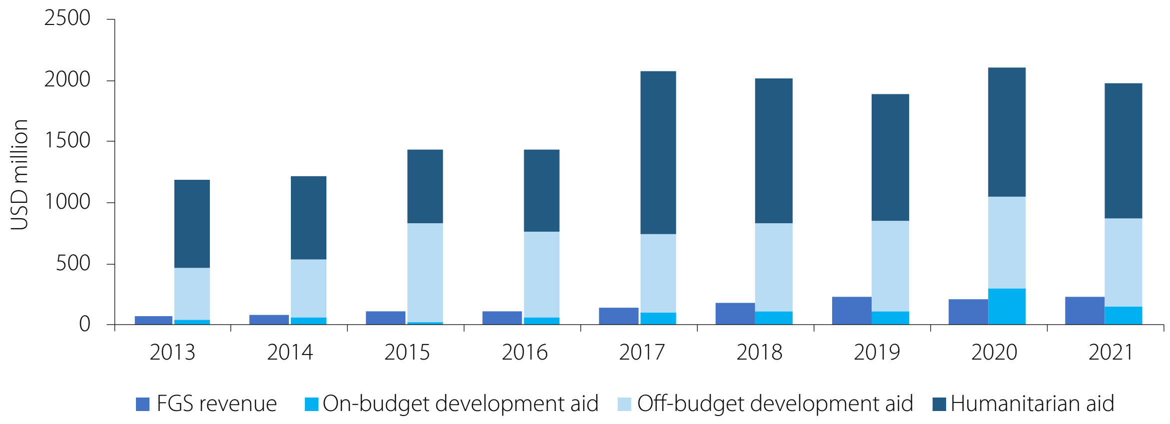
Boost the volume and share of external financing using government systems

FGS systems for PFM have become progressively more robust over the past decade, but these improvements have not been matched by a transformation in how development partners––notably bilateral partners––provide their funding. Most funding continues to be channelled through third-party providers and does not come through government systems.

International partners continue to provide substantial levels of funding to Somalia, averaging 21 percent of GDP. In 2021, they provided just under US$2 billion, almost ten times the level of revenue collected by the FGS. Of the total provided, 55 percent was classified as humanitarian assistance and 45 percent as development assistance. Only 7 percent was channelled through government systems (Figure 8). A large majority of this on-budget financing is provided by just three international partners, namely the World Bank, the AfDB, and the European Commission.

The reasons why most international partner funding does not use government systems often relate to risk appetite and political judgements in the countries providing the assistance. Perceptions of the relative fiduciary risk in using government systems tend to be overstated, while the assumption is often made that bypassing those government systems can achieve better direct results. The contradictions are well known; development partners invest significant political effort, technical assistance, and financial resources to reestablish government systems in fragile and low-capacity countries, yet they continue to bypass the state as a delivery institution and thus undermine its effectiveness.[126]

Figure 8: FGS revenue and donor aid, 2013–21, US$ millions



Source: MoF, MoPIED

[124] The agreement by the World Bank Board to extend grant terms under IDA20, as well as the agreement by the IMF and World Bank Boards to issue waivers for a HIPC Completion Point trigger, demonstrate that reasonable flexibility can be found in the case of fragile states. The FGS should continue to press all its financing partners for maximum speed and flexibility in their operations.

[125] IMF. 2023. ECF Structural Benchmark #5.

[126] Bypassing government systems has not always proven to be effective, in practice, at minimising fiduciary risk. See discussion in Chapter II on the misuse by Ministry of Health officials of donor funding provided directly to the FGS outside government systems. See also FGR 2021.

The FGS should continue to encourage its international partners to endeavour to use government systems by explaining and demonstrating that progress in strengthening those systems since 2013 has fundamentally reduced the level of fiduciary risk. It is an important point of principle. However, it is a challenging argument to pursue in the current global environment for official development assistance, which is characterised by high levels of risk aversion and a strong orientation towards project-based approaches. Creative and pragmatic methods will be needed if the FGS is to increase the share of external financing that uses government systems (Box 12).

Build capability to absorb climate finance and to use it effectively

The FGS has identified scaled-up access to international climate finance[127,128] as one of its top post-HIPC priorities. It is right to do so; Somalia has been subject to repeated droughts and flooding in the past decade. It has urgent needs for investment

BOX 12 Potential avenues for international dialogue on using government systems

The FGS might consider the following approaches when requesting international partners to increase their use of government systems. Rather than solely making an argument based on the principle that partners should align their support, the FGS can be more pragmatic and multi-faceted.

- *Build an evidence base and directly address perceived fiduciary risks.* Much of the effort to increase the use of government systems will involve intensive dialogue with each of the major FGS financing partners to understand the perceived risks and how they can be mitigated or managed. The more specific and evidence-based that dialogue becomes, the greater the prospects of identifying mechanisms to increase alignment with government systems.
- *Scale up the use of pooled and multipartner funding mechanisms.* These mechanisms often use multilateral agencies as an operational platform and therefore have the capability to use government systems. The FGS can encourage bilateral financing partners to channel a larger share of their funding through these mechanisms to increase the use of government systems. The Somalia Multi-Partner Fund operated by the World Bank is one example.
- *Push for full compliance with Somalia's PFM Act.* Some UN programmes, funds, and agencies already provide direct funding to FGS institutions, but they do so in a way that does not make proper use of government systems. These entities have been identified in the annual audit reports of the OAG. The PFM Act outlines the requirements for compliance. The FGS can engage directly with those agencies to request full alignment and explain the procedures involved.
- *Ensure greater coordination and discipline by FGS institutions.* Mixed messages are often sent by different FGS institutions to their financing partners. While the MoF, MoPIED, OPM, and other centre-of-government institutions request financing to use the FGS budget and TSA, some FGS sector institutions will request direct financing that bypasses the FGS budget and TSA to increase their leeway over the use of the funds. The FGS needs to be consistent in dialogue with international partners about how financing is provided.
- *Create stronger incentives for alignment by financing partners.* Financing partners will not only consider the risks of using government systems, but also assess whether there are direct benefits in doing so. Often, providers of budget support, especially general budget support, will expect privileged access to policy dialogue with the government on certain agendas. The FGS can consider whether there are credible options for this type of approach in Somalia.
- *Focus on sector specific strategies.* General budget support which provides an unearmarked contribution to the government budget may be increasingly difficult for financing partners. Instead, the international community may find it easier to design financial support designated for specific sector and tied explicitly to policies or reform plans in that sector (for example, a police trust fund in the security sector).

127 While there is no agreed definition of what constitutes climate finance, it can be treated as financial resources mobilised and provided to fund actions that mitigate and adapt to the impacts of climate change. It covers a quadrant of public and private finance, and international and domestic finance. It also covers two longstanding distinctive purposes (mitigation and adaptation), to which a third purpose (loss and damage) was added operationally in 2023.

128 Watson, C., Schalatek, L. and A. Evequoz. 2023. "Climate Finance Fundamentals 2: The Global Climate Finance Architecture." Climate Funds Update. ODI and Heinrich Boll Siftung.

in adaptation and resilience, as well as a strong case based on exposure and fragility. Multilateral climate funds such as the Green Climate Fund, the Adaptation Fund, and the Global Environment Facility are important untapped or underutilised sources[129,130] —potentially among many others in a complex global climate finance architecture.

Assuming the FGS succeeds in increasing its access to climate finance,[131] it will be imperative to ensure that it is provided efficiently and used effectively. Sound financial governance is identified in a recent IMF Staff Note as an important ingredient for accessing climate finance and using it to build climate resilience.[132] Many of the financial governance considerations that apply to development finance will also arise for climate finance (Box 13).

The FGS should bring together all of the institutions that are directly relevant to climate finance to reflect on the potential challenges around access, absorption, and effective use. The FGS should also consider the additional capabilities that may be required and how to develop or acquire them.

Based on its experience with development finance, the FGS could already take some preparatory and precautionary actions. The FGS should require that climate finance use government systems wherever feasible and that it follow the PFM Act and the Procurement Acts where applicable. The FGS should avoid creating new policies, procedures, and institutional structures to manage climate funds. It should instead use existing government systems and the processes developed for handling development finance. The MoF should be fully engaged in, and party to, all funding decisions on climate finance.

129 Barriers to increased access by Somalia to finance from the GCF, Adaptation Fund, and GEF include arduous accreditation procedures for direct funding and lack of accredited FGS institutions; limited capacity in the new Ministry of Environment and Climate Change (MoECC) to develop proposals; weak coherence and coordination across government on policies and proposals; and fragmented and competing priorities among international implementing agencies.

130 Quevedo, A., Ali Kazmi, B., Loyaan, F., Gulati, M., Spearing, M., Vazquez, M., Balfour, N., Opitz-Stapleton, S. and Y. Cao. 2023. "Financing Climate Adaptation in Fragile States: A case of Somalia." Policy Brief. Supporting Pastoralism and Agriculture in Recurrent and Protracted Crises (SPARC). ODI.

131 The UK and US governments committed at COP-28 in December 2023 to assist FGS in accessing finance from the global climate funds. They have confirmed their support for Somalia as the sixth 'pioneer country' for the Task Force on Access to Climate Finance.

132 Jaramillo, L., Cebotari, A., Diallo, Y., Gupta, R., Koshima, Y., Kularatne, C., Jeong Dae Lee, D., Rehman, S., Tintchev, K. and Yang. F. (2023). "Climate Challenges in Fragile and Conflict-Affected States." IMF Staff Climate Note 2023/001.

BOX 13 **Financial governance considerations in accessing and managing climate finance**

Several interrelated issues will warrant careful attention and advance preparation by the FGS in 2024 as it embarks on efforts to scale up climate finance:

- *'Bankable' project development.* Even if access to climate finance is fast-tracked, specific approvals, disbursements, and implementation are likely to be linked to project development and readiness. That would require advance preparation for project concepts and feasibility studies, with coordination across FGS institutions. Some major climate-related investment projects may be structured in the form of concessions and/or public–private partnerships (PPPs). The FGS will need adequate capacity for project preparation and clear internal procedures for project approval.
- *Intermediary implementing partners.* FGS institutions may not have the demonstrated capacity required to achieve accreditation for direct access to global climate funds in the short term.[133] The FGS is likely to rely upon accredited international agencies (such as MDBs, bilateral development agencies, and international nongovernmental organisations) as intermediary implementing entities.[134] If direct budgetary resources are unlikely in the short term, the coordination of off-budget climate financing with FGS priorities will be essential. Similarly, it will be important to ensure that any funds passed by intermediary implementing entities to FGS institutions are reflected in the budget and use government systems.
- *Intergovernmental cooperation and fiscal relations.* Relevant FMS governments will need to be actively consulted and involved at all stages where activities or investments relating to climate finance may affect them. There are also potential questions about the intergovernmental allocation of any future climate finance flows that are provided on-budget, and whether FMS institutions could eventually seek direct accreditation with the global climate funds.
- *Cross-government coordination and cooperation.* Multiple FGS institutions are envisaged to have a role in the coordination of climate finance and climate change activities.[135] While sector responsibility is assigned to the Ministry of Environment and Climate Change (MoECC), other relevant FGS institutions and committees will include OPM, MoPIED, MoF, and the Somali Disaster Management Agency, the National Climate Change Committee (NCCC), and the Cross-Sectoral Committee on Climate Change (CSCCC).[136] Effective coordination across these entities will be needed.
- *Coherence across climate finance and petroleum sector.* The Ministry of Petroleum and Mineral Resources and the Somali Petroleum Authority have stated their intention to launch a licensing round for oil and gas production once the regulations have been issued for the EIIT Act and the Petroleum Act.[137] At the same time, the MoECC and MoF are planning to accelerate and increase their efforts to access international climate finance. Careful coordination, also involving OPM and the MoPIED, will be needed to ensure coherence and avoid any conflicting actions or approaches that could undermine the FGS's chances of accessing climate finance.

[133] Green Climate Fund Independent Evaluation Unit. 2023. "Second Performance Review of the Green Climate Fund." Final report (Vol. 1).

[134] Quevedo et al. 2023.

[135] Ministry of Environment and Climate Change. 2020. "Somalia National Climate Change Policy."

[136] The NCCC is a multi-stakeholder, high level policy coordination committee and is responsible for the overall climate change activities in Somalia. The CSCCC encompasses all sectors which have stake in the policy implementation.

[137] IMF. 2023.

2- Manage the future affordability of the state

Maintain control over current and future state costs

A strategic perspective is required on the overall cost of the Somali state and its affordability in the medium and long term. Fiscal expenditures have been rising rapidly, and this trend is set to continue in the post-HIPC years. The 2024 Budget will increase by US$123.6 million, or 11.9 percent, against the revised estimate for 2023.[138]

Reliance on external financing continues to be high.[139] FGS annual revenues for 2024 are estimated at US$345 million, while operational expenditures, excluding donor projects, are estimated at US$531 million.[140] The recurrent cost financing gap of US$186 million will be met largely from external budget support. Most of the direct budget support to the FGS has been provided to date through World Bank grants. However, the terms of World Bank funding to Somalia are expected to change from grants to concessional loans by July 2025 in accordance with Somalia's reduced post-HIPC debt burden.[141]

Although it is redoubling its efforts to mobilise revenue, the FGS will also need to limit expenditure growth if it is to avoid borrowing to finance recurrent costs from July 2025 on. This restraint will require the FGS to take a strategic perspective on the size and cost of government to avoid locking in unsustainable costs.

Several future cost drivers are already apparent and envisaged by FGS. They include:

- *Security sector costs and trajectory.* The FGS announced a Security Sector Development Plan in December 2023,[142] which received strong international support.[143,144] It will eventually bring the full cost for the security sector onto the FGS budget, at an estimated level of US$315.7 million in 2029. This full cost liability would transfer to the FGS following a transition period of external support through a planned new multipartner trust fund. More immediately, the FGS plans to complete the handover from the African Union Transition Mission in Somalia (ATMIS) by the end of 2024 and to take over those security responsibilities from 2025.[146,147]
- *Fiscal federalism and development of multilevel governance.* The Somali state continues to grow at all levels and there is an agreed model of multi-tier of governance, comprising three levels (federal, member state, and local). The allocation of powers to each level of government was agreed by members of the National Consultative Council in December 2022.[148,149] An agreement on the arrangements for fiscal federalism was then reached by Ministers of Finance of the FGS and the FMS in March 2023.[150] Expansion in the scope and scale of government at each level will continue to increase the overall cost of government.
- *Civil service reform and alignment of the government wage bill.* Once the FGS has integrated remaining nonpayroll compensation of FGS employees into a single payroll in the first half of 2024, it has committed to align salaries of temporary personnel with the existing pay scale of permanent employees and to implement the FGS Pay and Grading Policy for all government personnel.[151] These policy changes will have implications for the level of government expenditure.

[138] FGS Budget 2024, Table 6.1.

[139] UN Security Council. 2024. "Situation in Somalia: Report of the UN Secretary-General." Document S/2024/129, February 2.

[140] FGS Budget 2024, Table 6.1.

[141] There was an agreement in December 2023 at the IDA20 Mid-Term Review meeting in Zanzibar to extend grant terms for Somalia by the International Development Association (IDA)––the concessional financing arm of the World Bank––until the end of the IDA20 cycle in June 2025.

[142] Federal Government of Somalia. 2023. "Security Sector Development Plan––Chapeau Paper." Prepared for the Somalia Security Conference, New York, December 12.

[143] GoobJoob. 2023. "Major Donors Endorse Somalia's Security Plan in New York." December 13.

[144] Somalia Security Conference. 2023. Communiqué, New York, December 12.

[145] FGS. 2023. Security Sector Development Plan––Chapeau Paper.

[146] AU Transition Mission in Somalia. 2024. Announcement on planning for post-ATMIS in 2025. Twitter/X, January 18.

[147] International Crisis Group. 2024. "Somalia: Making the Most of the EU-Somalia Joint Roadmap." January 30.

[148] FGS. 2022. Agreement on the Allocation of Powers (signed December 28, 2022) at a meeting of the National Consultative Council, Mogadishu, December 25-28, 2022.

[149] The President of Puntland did not attend the meeting of the National Consultative Council, nor consent to the agreement on allocation of powers.

[150] FGS. 2023. Agreement on Resource Sharing (signed March 17, 2023) at a meeting of the Forum of Ministers of Finance, Baidoa, March 15-17, 2023.

[151] IMF. 2023.

- *Post-conflict stabilisation and service delivery.* One pillar of the campaign against Al-Shabaab is to stabilise liberated territories by rapidly extending the government's role and activities into those areas through security and service delivery. There is an expectation over the medium term that revenues redirected from Al-Shabaab to the FGS and FMS, and new revenues from increased economic activity, will offset the increasing cost. There are risks, however, related to the timing and sufficiency of these redirected flows to support stabilisation costs.[152]

The financial governance concern, therefore, is that uncontrolled state growth—or state growth without an underpinning strategic vision on the role and funding of the state—will cause continual fiscal instabilitys. The FGS will perennially be trying to make revenues keep pace with escalating expenditures, rather than determining an intended trajectory of expenditure based on a vision for state growth.

The FGS could use the formulation of the Centennial Vision 2060 and the preparation of the next National Development Plan to articulate a vision for state growth that explicitly connects the envisaged role and size of the Somali state with a set of credible medium-term fiscal and financing scenarios by the MoF. It would be helpful to make explicit links to the Tax Policy and Revenue Administration Roadmap that will be developed by the MoF in 2024.[153]

Avoid further proliferation of new state institutions

One area requiring particular attention and control by the FGS is sector institutional reforms that raise fiscal costs. The passage of sector legislation regularly leads to the creation of new, usually semi-autonomous, government agencies. New agencies escalate the overall fiscal costs borne by the FGS, as well as the future liabilities implied in sustaining those costs. At the same time, the growth in new agencies does not always lead to improvements in regulatory independence or public sector performance.[154]

The FGS has committed to prioritising and managing expenditure within a tightly constrained resource envelope in the short to medium term. That should include using existing provisions of the PFM Act to moderate and contain the expansion of costs for FGS institutions. Article 25 of the PFM Act already empowers the Minister of Finance, the Cabinet, and the Parliament to exercise scrutiny and control over the fiscal implications and affordability of new laws (Box 14). An additional FGS policy is needed to regulate the circumstances in which new government agencies can be created.

BOX 14 Existing provisions for review of the budgetary implications of new laws

Article 25 of the PFM Act on "Declaration of Budget Implications of a Draft Law" contains the following provisions:[155]

- Any FGS institution that is drafting a law must prepare a declaration of budgetary implications and submit it to the Minister of Finance prior to submission of the draft law to Cabinet (Article 25:2).
- The Minister of Finance must provide an opinion to Cabinet on the affordability of the draft law based on the declaration of budgetary implications (Article 25:3).
- All draft laws submitted to Parliament must be accompanied by a statement on their budgetary implications, in terms of their impact on revenue and expenditure for the first and subsequent fiscal years (Article 25:1).
- The Minister should prepare detailed instructions for use by FGS institutions in the preparation of a declaration of budgetary implications (Article 25:4).

[152] UN Security Council. 2023. Situation in Somalia: Report of the UN Secretary-General to the Security Council. Document S/2023/758, October 13.
[153] IMF. 2023. ECF Structural Benchmark #1.
[154] FGC. 2021. "Improving Sector Alignment with Financial Governance Reforms". Spotlight chapter in the Financial Governance Report 2021.
[155] Ministry of Finance. 2019. Public Financial Management Act.

<u>Expand merit-based recruitment and management for government personnel</u>

An efficient and effective public sector will help the FGS to control costs and to manage the affordability of the state. Carefully selected and targeted civil service reforms can support this objective alongside direct measures to strengthen public expenditure management. The introduction of merit-based recruitment and management for staff of the CBS has been highlighted as an important driver of success in the institutional development and performance of the CBS over the past decade (Chapter III).

The FGS should draw on lessons from the CBS and extend merit-based civil service reforms to other government institutions. Key elements include developing appropriate institutional structures supported by clear job descriptions, applying competitive merit-based recruitment, introducing clear job description and reporting lines, reviewing performance objectives annually through an appraisal process, and developing annual institutional training plans to build the capacity of all staff to contribute effectively to the institution's objectives.

3- Achieve value for money from state resources

<u>Enhance strategic investment planning and project selection for public infrastructure</u>

The post-HIPC orientation by the FGS to economic development, combined with Somalia's significant infrastructure needs, implies a stronger focus on investment in economic infrastructure from 2024. Based on the experience of other countries, investments in the transport, energy, water and sanitation, and information and communication technology sectors are likely to be a high priority.[156] Demonstrating the capability to handle investments in public infrastructure effectively will be essential both for Somalia's future economic development and for the domestic legitimacy that the FGS requires to support further progress with state building.

Strategic investment planning and project selection will become more critical. Much of the focus by the FGS up to 2023 was on the delivery of individual projects. With almost all investment projects in Somalia currently funded by external partners, project selection risks being driven by external assessments and criteria that may not align limited resources closely and coherently to an FGS-led strategy for economic development. This risk is compounded if partner-funded projects circumvent government processes for investment planning or public investment management.

Increased ability by the FGS to tap private financing sources to support investment projects through PPPs/concessions (Box 15) may drive further fragmentation of investment planning unless there is a clear overall strategy on investment selection across all sources of financing, public or private, or domestic or external, in line with FGS priorities. There also needs to be a strong focus on ensuring the economic rate of return for all investments.

BOX 15 What are public–private partnerships?

Public–private partnerships (PPPs)[157] enable private sector involvement in the delivery of public assets and services that have traditionally been provided by the government. They may include contracts for third-party development and management of new or existing public assets/services, as well as those under which a private partner only manages existing assets or provides or operates public services. Contractor payment may come from the government budget, contractor collection of user fees, or a combination. PPP contracts can create significant liabilities for the government and are often complex to develop. As a result, specific oversight requirements are typically required for the award and management of PPP contracts.

[156] World Bank. 2018. The State of Infrastructure Public-Private Partnerships in Countries Affected by Fragility, Conflict or Weak Institutions.

[157] World Bank. 2017. Public-Private Partnerships Reference Guide 3.0.

Cross-government coordination will be vital for effective investments, with leadership needed from the Council of Ministers and with important roles for relevant FGS sector institutions, the MoF, the MoPIED, and the OPM. The IMCC will play an authorising and oversight role in cases where private participation is involved. Depending on the physical location of infrastructure investments, one or more of the FMS may need to be actively involved, requiring effective intergovernmental cooperation and agreement on investment planning.

Future investment projects in Somalia are likely to involve a blend of public investment, private finance, and the participation of MDBs and other development finance institutions (DFIs).[158,159] Given the borrowing restrictions established by the FGS to avoid future debt distress, the role of PPPs/concessions in supporting the development of new infrastructure in Somalia is likely to increase. Cross-cutting strategic decisions will be needed on the extent to which the FGS should rely on private financing given associated fiscal risks, and the sectors and projects in Somalia where PPPs/concessions may be feasible and appropriate.

<u>Strengthen sector management and delivery of specific investment projects</u>

Capable management and delivery by FGS sector institutions of specific investment projects will continue to be critical. Major infrastructure projects, potentially involving MDBs, DFIs, and private investors, are difficult and complex undertakings that will bring new strategic risks and financial governance considerations.[160] The FGS will need to safeguard public assets, limit the scope for corruption, and maximise value for money. To do so, it will require significantly increased capacity for public investment management through all stages of the project cycle: identifying, structuring, and appraising potential projects; assessing fiscal commitments and contingent liabilities; designing contracts; managing transactions; managing contracts; and dealing with unsolicited proposals.[161]

Sector institutions currently lack the requisite capacity to conduct proper feasibility studies, to evaluate and scrutinise costs and liabilities effectively, and to ensure that potential projects will match Somalia's long-term needs. Where PPPs/concessions are required, sector institutions must seek the requisite expertise to develop them appropriately and must also ensure transparency and competition for contract awards. All such processes must follow the Somali legal framework and be subject to the authorising and oversight role of the IMCC. Once projects are initiated, sector institutions will require the capacity to oversee complex project implementation, to coordinate multiple domestic and external stakeholders, and to ensure that expected economic benefits for Somalia materialise.

To ensure that PPPs/concessions deliver value for money, the central institutions with oversight responsibility will need to continue to develop the Somali legal framework for PPPs and to build their capacity for its implementation. Work to revise the concessions section of the Procurement Act to regulate more clearly the development and implementation of PPPs/concessions needs to be completed. The role and effectiveness of the IMCC need to be bolstered, notably through establishing a Concessions Technical Unit and building its capacity. The MoF will need a policy, and accompanying capacity, to evaluate the affordability of fiscal commitments and contingent liabilities associated with PPPs/concessions.

158 DFIs are specialised development banks or subsidiaries set up to support private sector development in developing countries. They are usually majority-owned by national governments and either source their capital from national or international development funds or benefit from government guarantees. DFIs can be multilateral organisations, such as the International Finance Corporation, or bilateral agencies, such as British International Investment (formerly CDC Group).

159 World Bank. 2015. Sources of Financing for Public-Private Partnership Investments in 2015.

160 World Bank. 2018.

161 World Bank. 2017.

The role of public procurement in supporting public investment will become more important in driving value for money as government revenue grows. Action will be needed by the FGS to establish the central Contracts Committee for oversight of high-value procurement, and to build procurement capacity within FGS institutions for more decentralised procurement.

Manage natural resources, and associated revenues, transparently and effectively

Natural resources are a financial governance priority in Somalia because of their potential to produce large-scale revenues, their importance to intergovernmental relations, and their propensity to contribute to conflict. Equally, the fisheries and petroleum sectors, if managed transparently and effectively, have high potential to contribute to economic transformation in Somalia.

For the fisheries sector, a top priority is to ensure that all stakeholders adhere to the new legal and institutional framework agreed in 2023 and that its provisions are implemented. The FGS needs to resume its licensing role transparently and in a timely fashion. Licensing delays cause unnecessary revenue loss and undermine sound fisheries management. Puntland needs to be brought into the new framework so that its licensing arrangements are not conducted separately.

For the petroleum sector, one or more commercial oil finds could yield the government billions in revenue over a period of decades. If managed well, such revenues would be transformational. The institutional capacity of the FGS to oversee petroleum sector exploration and development requires significant further development. Regulations to the 2020 Petroleum Act also need to be developed as a priority to support the FGS in managing the implementation of signed PSAs. Future contracting then needs to be carried out transparently and competitively, in line with approved model documentation and the Somali legal framework. All FMS must be willing to cooperate with the FGS in the exploitation of petroleum resources, so the FGS may need to review current revenue-sharing arrangements to ensure fair distribution of resources.

Enabling factors for continuing reform progress after HIPC

The mix of factors that has enabled reforms to strengthen financial governance in Somalia since 2013 will remain relevant to the post-HIPC priorities for the FGS. Chapters II and III of the FGR identify and illustrate the main conditions for success.

The main enabling factors over past decade were:

- An overall authorising environment conducive to reform.
- High-level political backing for specific reform measures.
- High-calibre senior leadership in key FGS institutions.
- Constructive international dialogue and conditions.
- Access to extensive external technical assistance.

In the case of the CBS, the achievements were also predicated on a clear strategic orientation with respect to the reform direction and priorities, and on a merit-based institutional culture.

A distinctive influence in Somalia's reforms over the past decade has been the role of the HIPC process in providing a guiding objective for successive administrations, a cooperative framework for dialogue and priority setting, and a set of unifying incentives for reform. While HIPC's influence should not be overstated, it has provided a positive motivation to improve financial governance and has been a significant component of the overall authorising environment for reform.

The FGS will need to consider how best to sustain the combination and balance of authorising environment, political commitment, effective leadership, international partnerships, and technical assistance needed to deepen existing reforms and to tackle new priorities. Two dimensions will become more important: political dynamics and international reputation.

Political dynamics

Intergovernmental relations between the FGS and FMS, the fiscal bargain between the FGS and the private sector, and cross-government coordination among FGS institutions will all influence future economic development and state building in Somalia. The evolving reform agenda will challenge elements within the FMS, the private sector, and sector institutions that consider their interests to be best protected by a continuation of the status quo. The FGS leadership will need continuously to make a strong case for further reform as a beneficial means to support economic development and effective state building (Box 16).

Taking forward the envisaged priorities, most notably customs harmonisation and natural resources management, will require consensus among the FGS and the five FMS (as well as Banadir). Sustained intergovernmental cooperation will need to be underpinned by agreement on the principles of federalism, clarity on roles and responsibilities in their implementation, and transparency and equity in resource sharing. Agreement and cooperation between the FGS and FMS will also be required for the CBS to expand its operations to all FMS and to implement the first phase of currency reform.

Deepening reform progress to increase the mobilisation of domestic revenue will require extensive engagement and consultation with the private sector. To achieve its medium-term objectives of increasing customs tariffs to align them more closely with market values and of increasing corporate income tax collection from large businesses, the FGS will need to provide advance notice, build support, and foster compliance for a gradual and sustainable series of upward adjustments. More broadly, the FGS will need to continue its efforts to strengthen the social contract with Somali citizens[165] as a path to reducing the relative size of the informal economy.[166]

BOX 16 What is state building?

State building is a crucial long-term objective for countries emerging from fragility and conflict. However, it is often invoked as an objective without clear articulation of what it means and requires in practice.

The Organisation for Economic Co-operation and Development (OECD) defines state building as "purposeful action to develop the capacity, institutions and legitimacy of the state in relation to an effective political process for negotiating the mutual demands between state and societal groups."[162] This definition emphasises the centrality of state legitimacy, as well as the inclusive political processes required to achieve that legitimacy.

The OECD also highlights that state building is "an endogenous process."[163] In other words, it can be supported by external actors and incentives, but it cannot be motivated, imposed, or driven by them.

A conceptual review by the World Bank and the United Nations Development Programme distils four essential elements of state building:[164] centrality of state–society relations (i.e., social contract); political character (i.e., how power and authority are used, and in whose interest); transactional process concerned with state legitimacy, responsiveness, and accountability; and endogenous process, shaped by national actors.

A consistent thread in the literature is that state building, especially in fragile states, is largely a domestic political process concerned with strengthening the legitimate relationship between the state and society.

162 OECD. 2009. "Concepts and dilemmas of State building in fragile situations: From fragility to resilience." OECD Journal on Development, vol. 9/3.

163 OECD. 2011. "Supporting State building in Situations of Conflict and Fragility: Policy Guidance." DAC Guidelines and Reference Series.

164 Ingram, S. 2013. "State building: Concepts and Operational Implications in Two Fragile States: Sierra Leone and Liberia: The Cases of Sierra Leone and Liberia." A Joint Initiative by the World Bank's Fragile and Conflict-Affected States Group (OPCFC) and the United Nations Development Programme's Bureau for Crisis Prevention and Recovery.

165 Cloutier, M., Hassan, H., Isser, D., and G. Raballand. 2022. "Understanding Somalia's social contract and state-building efforts: Consequences for donor interventions." WIDER Working Paper 2022/123.

166 National Economic Council. 2023. State of the Economy Report.

Sustaining existing reforms and addressing new priorities will require effective horizontal coordination across government entities. The MoF and OPM are key actors at the centre of government tasked with leading the reform agenda, while the MoPIED has an important role to play in setting priorities and managing relationships with international investment partners. Strong coordination with sectors responsible for infrastructure (including ports and transport) will be vital, given their strategic importance for economic growth and revenue mobilisation. Similarly, sectors responsible for natural resources (such as fisheries and petroleum) have a key role to play in generating revenue and supporting fiscal federalism through transparent and equitable resource sharing. The MoECC needs to be engaged actively, alongside the MoF and the MoPIED, in the efforts to mobilise international climate finance.

International reputation

Relationships with international partners and investors across the public and private spheres will evolve following HIPC. The IMF has approved a new three-year programme that permits limited concessional borrowing, while in December 2023 the World Bank extended grant terms to Somalia until the end of IDA20 in June 2025.[167] Bilateral development partners have started to develop and agree new strategic partnership frameworks with the FGS. There is a shared agenda to improve access to external grants and concessional financing (including official development assistance and climate finance), to boost public and private investment (including foreign direct investment), and to promote policies targeting economic growth. The FGS's commitment to state building and good governance underpins these agreements, which should provide valuable external reinforcement for further reform progress. Similarly, prospective investors will want to have confidence in the quality of financial governance as part of their appraisal of the broader investment environment in Somalia.

Improving international perceptions of financial governance in Somalia will be a vital enabling factor in attracting financing and investment over the coming decade. Despite progress on multiple fronts in the past decade and achievements, such as HIPC completion, in 2023, Somalia languishes at the bottom of the annual Transparency International Corruption Perceptions Index (CPI).[168] The CPI for 2023, published in January 2024, ranked Somalia 180th out of 180 countries (below countries such as South Sudan, Syria, and Yemen), with a score of 11/100. This score and rank have remained stubbornly low and immovable since the start of the CPI series in 2012. The FGS could use the ambition of improving its CPI score and ranking—and the positive implications this would have for attracting financing and investment into Somalia—as an enabling factor for continuing to strengthen financial governance.[169]

Snapshot of the post-HIPC objectives, priorities, and enablers

Somalia's post-HIPC reform agenda is multifaceted. It is rooted in the FGS policy goals of economic development and state building, in line with the Centennial Vision 2060. It spans revenue raising, natural resources, external financing, expenditure management, and the financial sector, among other areas. It covers the FGS and FMS, as well as

[167] National Economic Council. 2023. State of the Economy Report.
[168] UN Security Council. 2024. "Situation in Somalia: Report of the UN Secretary-General." Document S/2024/129, February 2.
[169] Transparency International. 2024. Corruption Perceptions Index 2023.

coordination across government institutions. It seeks to deepen existing reforms, while simultaneously working to harness new opportunities and confront new risks. This is predominantly a domestic agenda, but also one predicated on strong international partnerships. Success will be contingent on strong financial governance and will require an array of enabling factors, with a guiding political imperative at the centre of them. The FGR 2023 has attempted to capture this dynamic context and to identify a set of priorities and enablers for the start of the post-HIPC era in 2024 (Table 8).

The strong progress made by the FGS in the decade since 2013 serves as a benchmark for the commitment and effort that will be needed in next decade to ensure that strong financial governance continues to underpin economic development, state building, and fiscal sustainability in Somalia.

TABLE 8 Overview of the objectives, priorities and enablers for 2024 and beyond

Overview of the objectives, priorities and enablers for 2024 and beyond	Enabling factors
1. Scale up government financial resources • Increase broad-based domestic revenue collection • Ensure that government borrowing and financial liabilities are appropriate and sustainable • Build capability to absorb climate finance and to use it effectively • Boost the volume and share of external financing using government systems **2. Manage the future affordability of the state** • Maintain control over current and future state costs • Avoid further proliferation of new state institutions • Expand merit-based recruitment and management for government personnel **3. Achieve value for money from state resources** • Enhance strategic investment planning and project selection for public infrastructure • Strengthen sector management and delivery of specific investment projects • Manage natural resources, and associated revenues, transparently and effectively	• Overall authorising environment conducive to reform • High-level political backing for specific reform measures • High-calibre senior leadership in key FGS institutions • Constructive international dialogue and conditions • Access to extensive external technical assistance • Intergovernmental cooperation between the FGS and FMS • Fiscal bargain between the FGS and the private sector • Cross-government coordination among FGS institutions • Reputation with international partners and investors • Increasing territorial security

Annex A: List of all contracts reviewed by the FGC since 2014

#	FGS institution	Contract	Contractor	Contract type	FGC formal review	Status
1	Central Bank of Somalia	Land lease and redevelopment	Riverside Holding	Concession	2016, 2018	Contract signed; not implemented
2	Central Bank of Somalia	Asset recovery	Shulman, Rogers, Gandal, Pordy & Ecker PA	Concession	Not reviewed	Cancelled
3	Commerce and Industry	Import/ export quality assurance	Proje Gözetim Mühendislik (PGM Project)	Concession	2015, 2016	Recommendations from FGC review incorporated; contract signed but not implemented.
4	Defence	SNA Rations	AGETCO	Procurement		Discontinued following FGC recommendation that security sector rations contracts should be competitively awarded.
5	Defence	SNA Rations	AGETCO	Procurement	2017	Competitively awarded; subsequently cancelled
6	Defence	SNA Rations	Kasram	Procurement	2017	Contract irregularly awarded; annulled shortly prior to conclusion.
7	Defence	SNA Rations – Lot 1	Scandinavian Trading	Procurement	2019	Competitively awarded; concluded
8	Defence	SNA Rations – Lot 2	East Africa Trading	Procurement	2019	Competitively awarded; concluded
9	Defence	SNA Rations – Lot 1	United Group of Companies	Procurement	2021	Competitively awarded; concluded
10	Defence	SNA Rations – Lot 2	Scandinavian Trading	Procurement	2021	Competitively awarded; concluded
11	Defence	SNA Rations – Lot 1	United Group of Companies	Procurement	2023	Competitively awarded; operational
12	Defence	SNA Rations – Lot 2	Scandinavian Trading	Procurement	2023	Competitively awarded; operational
13	Defence	Supply of 6 marine patrol boats	AMO Shipping Company Ltd.	Procurement	2014	Contract was signed; not implemented.
14	Defence	Equipping and training Coast Guard	Atlantic Marine and Offshore Group	Procurement	Not reviewed	Contract was signed; not implemented. Subject to an arbitration claim.
15	Defence	Logistics	SKA	Unclear	2018	FGC recommended nullification; status unknow.
16	Education	Textbooks	Beder Printing House	Concession	2018	Operational (new amendment signed in August 2020); FGC recommended it should be renegotiated and/or cancelled
17	Education	Certificates	Security Printing Press	Concession	2019	Contract signed; FGC recommended nullification; status unknown.
18	Finance	Collection of property transfer registration tax	M&T Solutions Ltd	Concession	2016	Cancelled

#	FGS institution	Contract	Contractor	Contract type	FGC formal review	Status
19	Finance	Collection of road tax	Smart General Service Ltd.	Concession	2016	Cancelled
20	Finance	Khat tax collection on behalf of FGS	The ADCO Group of Companies	Concession	2015	Cancelled
21	Fisheries and Marine Resources	Protecting, licensing, and promoting policy and institutional development of fisheries sector	Somalia-FishGuard Ltd.	Concession	2014	Did not proceed
22	Galmudug Regional Government	Oil production sharing agreement	Petro Quest Africa (CN)	Concession	2014	Did not proceed
23	Somali Police Force	Police rations	Perkins Logistics	Procurement	2016	Contract was signed; partially incorporated FGC recommendations; concluded
24	Somali Police Force	Police rations	Muna Transport	Procurement	2019	Competitively awarded; concluded
25	Somali Police Force	Police rations	Hanad Construction & General Trading	Procurement	2021	Competitively awarded; concluded
26	Somali Police Force	Police rations	Real Gold Construction and General Services	Procurement	2023	Competitively awarded; operational
27	Immigration Directorate	Visas	Empire Tech Solutions Ltd.	Concession	2018	Operational; FGC recommendations incorporated in extension signed in 2023
28	Immigration Directorate	Passport Production	Ebtkaraat Smart System	Concession	2018	Operational; FGC recommendations incorporated in extension signed in 2022
29	Immigration Directorate	Passport Production Tender Documents		Concession	2020	Tender was cancelled
30	NISA	NISA rations	Horn Logistics	Procurement	2016	Contract was signed; partially incorporated FGC recommendations; concluded
31	NISA	NISA rations	Express logistics	Procurement	2019	Competitively awarded; concluded
32	NISA	NISA rations	Express logistics	Procurement	2023	Competitively awarded; operational
33	Ministry of Internal Security	Scanning services for Mogadishu port	M&T Solutions Ltd	Concession	2016	Contract was signed; not implemented
34	Justice	Prisons rations	Bakhaari Logistics	Procurement	2018	Contract signed; FGC comments were not addressed; contract now concluded
35	Justice	Prisons rations	Bakhaari Logistics	Procurement	2021	Competitively awarded; concluded
36	Justice	Prisons rations	Sam Logistics	Procurement	2023	Competitively awarded; operational

#	FGS institution	Contract	Contractor	Contract type	FGC formal review	Status
37	Petroleum and Mineral Resources	Model terms for petroleum exploration, development, and production	Model Oil and Gas Production Sharing Agreement	Concession	2016, 2019, 2021	Approved by IMCC in November 2021 for use in future oil and gas licensing.
38	Petroleum and Mineral Resources	Seismic data analysis	Mubadala Oil and Gas Holding Company LLC (CN)	Concession	2014	Agreement expired
39	Petroleum and Mineral Resources	Seismic exploration	Soma Oil and Gas Exploration Limited	Concession	2014	Contract signed; did not incorporate FGC recommendations. Concluded.
40	Petroleum and Mineral Resources	Geospatial analysis	CGG Data Services AG/ Robertson GeoSpec International Ltd.	Concession	2014, 2015, 2016	Contract signed; incorporated FGC recommendations; operational
41	Petroleum and Mineral Resources	Collation, analysis, and marketing of petroleum data	Spectrum ASA	Concession	2015	Contract signed; incorporated FGC recommendations; operational
42	Petroleum and Mineral Resources	Acquisition, processing, and marketing of geophysical data	TGS-NOPEC Geophysical Company ASA	Concession	2014	Did not proceed
43	Presidency	Rations	Regional Suppliers Company Ltd.	Procurement	2018	Status unknown
44	Ports and Shipping	Management of port operations	Albayrak Turizm Inşaat Ticaret A.Ş.	Concession	2014; 2020	Renegotiated agreement signed 2020; FGC recommendations incorporated
45	Ports and Shipping	Harbour, fishing port, and related infrastructure developments	Great Horn Development Company	Concession	2014	Did not proceed
46	Ports and Shipping	Lease and concession for operating Mogadishu port container terminal	Mogadishu Port Container Terminal and Simatech International	Concession	2014	Did not proceed
47	Ports and Shipping	Management and operation of a container yard and freight station at Mogadishu dry port	Mogadishu International Port and Simatech International	Concession	2016	Contract signed; not implemented.

#	FGS institution	Contract	Contractor	Contract type	FGC formal review	Status
48	Posts and Telecoms	Telecoms gateway	VBH Holdings SPA	Concession	2016	Did not proceed
49	Power and Water	Electricity generation	Polaris Energy SDN BHD	Concession	2015	Did not proceed
50	Transport and Aviation	Airport operations	Favori LLC	Concession	2014, 2019	Renegotiated agreement signed 2019; FGC recommendations incorporated
51	Transport and Aviation	Vehicle licensing	Modern Technology Ltd.	Concession	2016	Cancelled
52	Transport and Aviation	Airport taxi shuttle service	Sahel	Concession	2017	Operational; FGC recommended it should be renegotiated
53	Transport and Aviation	Airport hotel	Sat Service LLC	Concession	2018	Interim agreement signed with FGS in early 2020; full contract needs to be developed
54-59	Information, Culture, and Tourism	6 leases for development of property in Mogadishu	Various	Concession	2019	Contracts signed; FGC recommended they should be cancelled or revised
60	Somali Bureau of Standards	Consignment Based Conformity Assessment Program	Bureau Veritas	Procurement	2021	FGC provided recommendations on tender documents; Contract signed
61	Ministry of Ports and Maritime Transport	Certification and Registration Services for Maritime Vessels	American Registry of Shipping	Concession	2021	Did not proceed
62	Petroleum and Mineral Resources	Production Sharing Agreements	Coastline Exploration	Concession	2022	Contracts signed; FGC recommended amendments
63	Somalia Bureau of Standards (SoBS)	Product conformity assessment (PCA) services	TBD	Concession	2023	FGC provided recommendations on tender documents
64	Ministry of Ports and Maritime Transport	Electronic Cargo Tracking Notice	Premier Technology Supply and Services Company	Concession	2023	Contract signed; now suspended
65	Ministry of Finance	Rental income tax collection	MGS Soft Inc	Concession	2024	Contract signed; incorporated FGC recommendations; operational

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