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Somalia's External Debt Relief

Pursuing Economic Reforms Beyond HIPC Initiative

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About the Author

Dr. Uweis Ali is a senior researcher in Economics and Social Development Policy at Heritage Institute. His primary research interests include macroeconomics, international trade, labor and development economics. His recent work focused on financial economics, youth unemployment & human capital. He holds a PhD in economics from the Universiti Putra Malaysia.

1. Executive summary

After more than two decades of isolation from the global financial system, Somalia started to re-engage with international financial institutions (the International Monetary Fund (IMF) and the World Bank) in 2013 to seek technical and financial assistance to revive the economy. This re-engagement was the building block for Somalia joining the Heavily Indebted Poor Countries (HIPC) initiative in 2016 to receive debt relief and access grants and concessional loans. HIPC was created in 1996 by the IMF, the World Bank and other multilateral, bilateral and commercial creditors to ensure that the poorest countries in the world are not overwhelmed by unmanageable or unsustainable debt burdens.

This report takes stock of Somalia's external debt relief progress and challenges, and also draws on lessons from other HIPC countries on how to navigate towards the HIPC completion point and beyond in order to consolidate the gains of the economic reform program.

It finds that Somalia has implemented reforms including developing a domestic arrears and repayment schedule plan, completing the plan to modernize revenue and customs administration, strengthening financial licensing and supervision for commercial banks and money transfer bureaus, as well as developing economic statistics.

Other reform initiatives include strengthening public financial management such as establishing biometric registration for a national security force and paying salaries directly; developing a cash forecasting system; improving fiscal transparency and accountability; making progress towards developing the treasury single account; broadening the revenue base and increasing tax collection; submitting an amended National Customs Act to parliament; drafting National Development Plan Nine (NDP9) which is intended to serve as interim poverty reduction strategy paper; and submitting a draft of the Targeted Financial Sanctions Act to the Federal Government parliament in order to address terrorist financing risks.

These reforms have improved the confidence of international development partners and allowed the country to access new financial instruments. Reforms have taken place in spite of fragmented domestic revenue administration under fiscal federalism, poor governance as well as a contested political environment that has eaten away at the fundamentals required to truly take drastic reforms across the country to secure debt relief and promote sustainable inclusive growth.

This study found that despite passing essential laws for improving financial governance, lack of enforcement and operationalization remains the biggest impediment to Somalia's debt management and overall economic reform programs. Several contracts for private companies still operate without corresponding procurement reforms.

Delivering debt relief (and building the overall economy) for Somalia is also constrained by constant political upheavals. The recently concluded election has adversely affected the progress of debt relief as it stalled the ongoing reforms necessary for Somalia to complete the triggers of total debt relief. International finance institutions suspended budget support amid the uncertainty of political instability and repeatedly called on politicians to conclude the election or risk derailing the process of debt relief.

This report has also found that lack of harmonized tax collection structures across the country and a modern legal taxation framework as well as poor awareness among Somali citizens on the importance of paying taxes has impeded the prospect of achieving sustainable economic development. The absence of tax structures for improving domestic revenue mobilization not only challenges the prospect of achieving the completion point of debt relief but also impedes post-HIPC fiscal sustainability. Citizens are reluctant to pay taxes because they question how those resources have been managed as neither the federal government nor the states effectively provide services to the Somali people. Tax collections by illegitimate authorities have further hindered domestic revenue mobilization.

It is worth noting that once Somalia achieves the debt relief completion point, existing grants will dry up and be replaced with concessional loans. Given the nascent state of public finance management (PFM), there is a growing concern that concessional loans will be looted by politicians rather be used to revitalize the economy. In addition, in the absence of a political settlement on fiscal federalism, future borrowing space could spark a new political confrontation between federal member states and the federal government.

Securing complete debt relief and sustainable debt management in the future will require pushing for transparency in the public financial management, prudent debt management and strengthening domestic institutions, as well as prioritizing productive investment from the future borrowing space. Somalia needs to embark on profound financial governance reforms that strengthen the country's regulatory frameworks and operationalize laws that are in place while developing sound macroeconomic policies.

Building robust financial governance and curbing corruption would lead to less wastage of future borrowings, allow financial allocations to reach their intended targets and better prepare Somalia's economy for future debt challenges.

To improve domestic revenue mobilization, which is crucial for the long-term sustainability, the federal and state governments need to agree on a workable intergovernmental fiscal relationship between the FGS and FMS. It is imperative for the new federal leaders together with the state governments to prioritize revenue assignment – in order to increase domestic resources and allow Somalia to finance its development agenda. Since fiscal federalism is one of the contentious issues in finalizing the constitution and might drag on for some time, there is a need to make an interim arrangement that explicitly specifies who collects which taxes. This short-term separation of powers on tax between the FGS and FMS is vital to raising domestic revenue and helping Somalia develop a sufficient fiscal buffer to finance its development priorities and future debt servicing.

The new federal leadership should continue forging a strong partnership with creditor governments and multilateral financial institutions and seek advocacy support from these countries to secure complete debt relief. Several countries, especially those in the region, have benefited from cultivating close relationships with the international community, particularly influential countries like the UK and other creditors in delivering debt relief. Therefore, it is crucial for Somalia to demonstrate external outreach while continuing institutional reforms to ensure the commitment of the international partners.

2. Introduction

In recent years, Somalia has made significant strides towards debt relief by reforming fiscal management, including increased domestic revenue and improved expenditure management. This allowed Somalia to reach the HIPC decision point for debt relief in 2020 – reducing its debt from US$5.2 billion at the end of 2018 (89 percent of GDP) to US$3.7 billion (63 percent of GDP). The HIPC debt relief process has two steps: the decision point and the completion point. The decision point signals a country's inclusion in the HIPC initiative. An eligible government must collaborate with the World Bank and the IMF to build a track record of sound economic policies throughout the period between the decision point and the completion point.

The decision point milestone allowed Somalia to reengage with global financial institutions and access new external grants to help support the ongoing state-building process. Between 2019 and 2020, grants increased from $US100 million to US$285.6 million.[1] In 2021, donor revenue declined to US$147 million, though this sharp decline was due to political uncertainty over the recently concluded elections. However, Somalia's donor support dramatically picked up in 2022 reaching US$694.8 million.[2] The economy has started to rebound after contracting 0.3 percent in 2020. GDP growth is projected to grow at 2.9 percent in 2022 and 3.1 percent in 2023.[3]

Despite the fact that Somalia is on its way to reaching the HIPC completion point by the end of 2023, its governance institutions are very weak which could create post-HIPC challenges. The government needs to create fiscal space to confront the challenges facing the country including reviving the country's institutions, investing in human capital development, fostering inclusive growth and regaining the confidence of international donors after the long-delayed election process.

No in-depth study has ever been conducted to unpack the evolution of Somalia's external debt relief under the HIPC process and the recent debt relief initiative. It is imperative to shed light on the process, look at progress thus far, and the structural challenges and conditions that Somalia needs to secure full debt relief and reengage with international financial institutions. Providing an analytical basis on this debt relief issue will inform the public on the issue of external debt as well as guide policymakers who are devising reforms to accelerate debt relief and enhance fiscal reforms.

This policy report is a detailed look at the debt relief process in Somalia, and the progress that has been achieved to date. It further aims to discuss how Somalia will benefit from the ongoing debt relief process and takes stock of the challenges that are impeding Somalia in securing complete debt relief and economic resilience in the post-HIPC era. Finally, the report makes policy prescriptions to guide the current government in enhancing fiscal performance and achieving full debt relief.

1. Ministry of Finance, Federal government of Somalia. Appropriation Act for the 2022 Budget. https://mof.gov.so/publications/appropriation-act-2022-budget-english-version
2. Ibid.
3. World Bank, 2021. Somalia Economic Update: Investing in Health to Anchor Growth. Accessed at: https://documents.worldbank.org/en/publication/documents-reports/documentdetail/926051631552941734/somalia-economic-update-investing-in-health-to-anchor-growth

3. Methodology

This report's findings primarily draw from secondary data on macroeconomic indicators including GDP, federal government revenue and expenditure and debt stock from the Ministry of Finance, the Central Bank of Somalia, and the National Bureau of Statistics, as well as international data sources such as the International Monetary Fund, and the World Bank. This was followed by an extensive review of the literature comprising peer-reviewed articles, government documents, and other HIPC countries' debt relief documents to provide valuable insights into the processes and practices of undergoing the debt relief journey.

This report also used qualitative interviews to complement the secondary data and literature review. Researchers interviewed around 12 senior government officials in the economic management sector. They included director and senior advisors from the Ministries of Finance, and Planning, Investment and Economic Development. As well as the officials from the Prime Minister of the Federal Government of Somalia. We also interviewed public financial management experts to better understand the best practices of debt management initiatives. We used semi-structured questions about the dynamics of fiscal issues, the FGS's economic reform program, and the challenges and prospects of Somalia's debt relief initiative under the HIPC process.

4. Key Macroeconomic Indicators

For more than three decades, Somalia has experienced protracted conflict and instability which has led to economic problems. However, after several state-building attempts, a new federal government system was initiated, and the first presidential elections that ended the transition period were held in the country in 2012. In the aftermath of the elections, the country has made a commendable recovery in terms of economic growth. In 2013, the gross domestic product (GDP) was estimated at $5.4 billion, and private consumption contributed to the country's economy. [4] Between 2013 and 2019, the Somali economy recorded an average GDP growth rate of three percent. However, the income per capita is among the lowest in the world at $502 in 2021.[5]

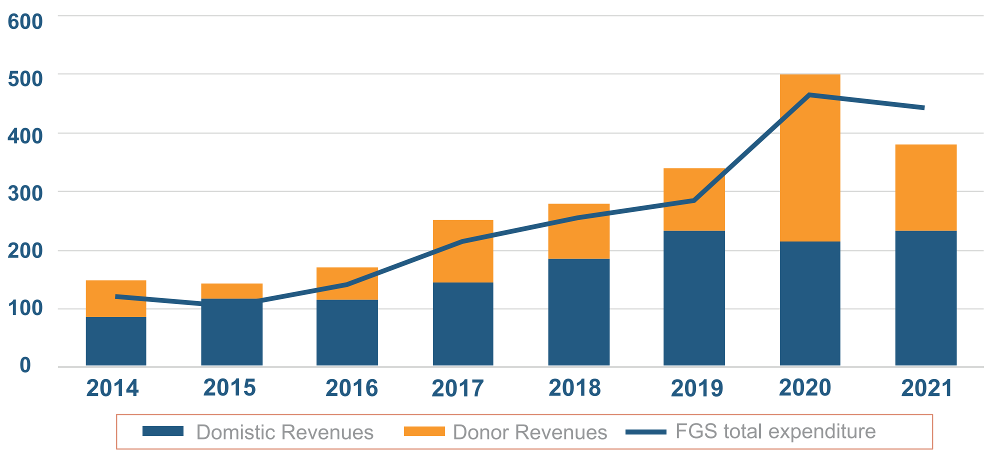
The economic recovery was attributed to the concerted effort to rebuild economic institutions and robust private sector growth, particularly in the construction sector which was bolstered by improved security in the large cities. There were also substantial increases in foreign aid and remittances – which are the lifeline for the Somali people who use them to finance consumption needs such as food, education, and health.[6] These trends have been seen as signs of effective economic reform programs, but also as a result of international development partners' support.

4. World Bank, 2015. Somalia Economic Update.
5. Somali National Bureau of Statistics, 2022. Somalia Gross Domestic Product Report. https://api.nbs.gov.so/wwwroot/Statistics/b3815f95cd2246f3a8516ebd33c4eb32.pdf
6. Word Bank, 2017. Somalia Economic Update.

Nonetheless, the relatively positive economic achievements over the last decade are under threat because of multiple shocks including the global pandemic and climate-related disasters that expose the entrenched vulnerabilities of the Somali economy.[7] At the onset of the Covid-19 pandemic, the inflationary pressures increased, the government's fiscal gains deteriorated, and international trade - imports were rapidly depleted. This resulted in GDP growth rate contracting by 0.3 percent in 2020.[8] GDP is estimated to grow at 2.9 percent in 2021, thanks largely to increased remittances and foreign aid flows.

Somalia's domestic revenues rose significantly after the FGS took measures to improve tax collections including customs modernization. Domestic revenue rose from US$83.4 million in 2014 to US$229.6 million in 2021. In 2022, domestic revenue is forecasted to be US$250.1 million. Donor revenues including budget and project support have increased from US$61 million[9] to US$694.8 million over the period 2014 to 2021.[10] However, the severity of the Covid-19 global pandemic contributed significantly to the decline in revenue mobilization as the Somali government restricted cross-border movements. This reduced international trade tax collection. In the first quarter of 2020, overall revenue collection fell by approximately three percent following global disruptions in the supply chain and movements of people, as taxes on international trade and transactions provide a significant portion of revenue generation in both the federal government and some of the federal member states.[11] As response to Covid-19, the FGS also provided tax exemptions to certain products such rice, dates, wheat flour and cooking oil.[12]

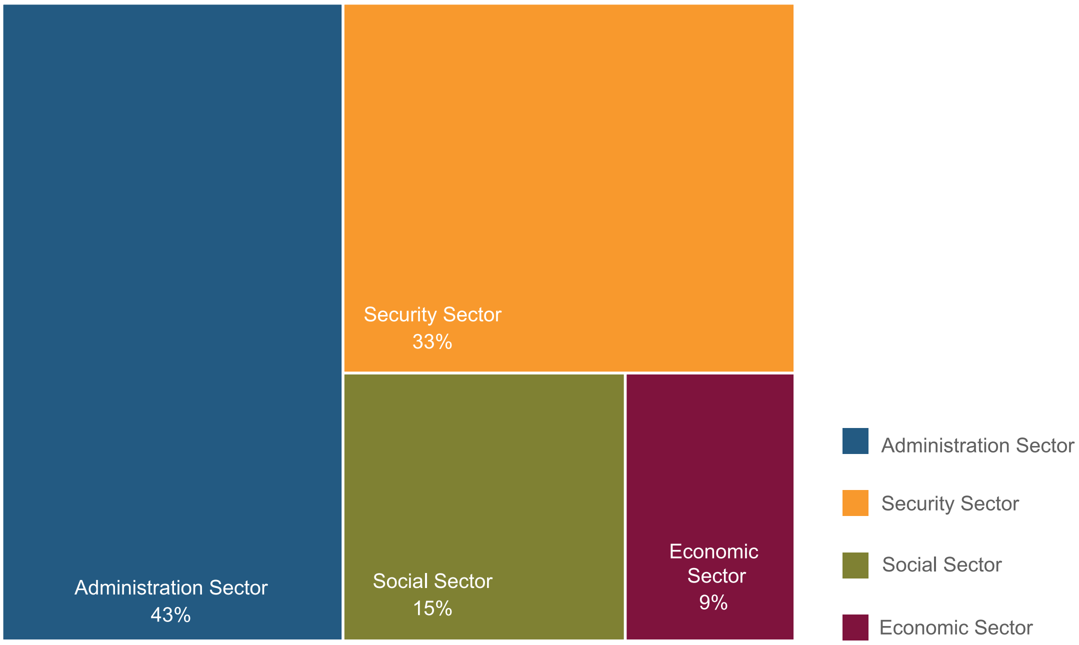
Figure 1: Revenue and Expenditure, 2014-2021 (Millions)



7. World Bank, 2021. Somalia Economic Update, June 2021: Investing in Health to Anchor Growth. World Bank, Washington, DC. © World Bank. https://openknowledge.worldbank.org/handle/10986/36312
8. SNBS, June 2022. Somalia Gross Domestic Product report. https://wp.nbs.gov.so/wp-content/uploads/2022/06/Somalia-Gross-Domestic-Product-Report-June-2022.pdf
9. Ministry of Finance, FGS. Appropriation Act for 2015 Revised Budget.
10. Ministry of Finance, Federal government of Somalia. Appropriation Act for the 2022 Budget. https://mof.gov.so/publications/appropriation-act-2022-budget-english-version
11. Heritage Institute for Policy Studies and City University of Mogadishu, 2020. The economic impacts of Covid-19 on Somalia: a special focus on business impact.
12. Ibid.

On the government expenditure side, Somalia has significantly expanded public expenditure as domestic revenue mobilization and budget support from international development partners increased. The federal government budget, in absolute terms, has risen dramatically from US$35.1 million in 2012 to US$473.8 million in 2021, around twelvefold in the last decade.[13] At the time of writing, the FGS had budgeted US$918 million for 2022, which the newly elected parliament has recently approved.[14] Donor support constitutes more than 73.4 percent of the national budget, raising critical questions about budget sustainability in the future and overreliance on external funding.

Figure 2: Federal Government Expenditure



Although successive governments have taken concrete steps by reforming customs taxes, significant challenges to budget allocations for social and infrastructure remains as wages and administrative cost dominate the government's current budget. It is also worth noting that a substantial portion of government expenditure is allocated to the security sector, accounting for over half of its budget, with a considerable amount being paid for security personnel and administrative overheads (Figure 2).

13. Ministry of Finance data.
14. Ministry of Finance, 2022. Budget Appropriation Act of the Federal Government of Somalia.

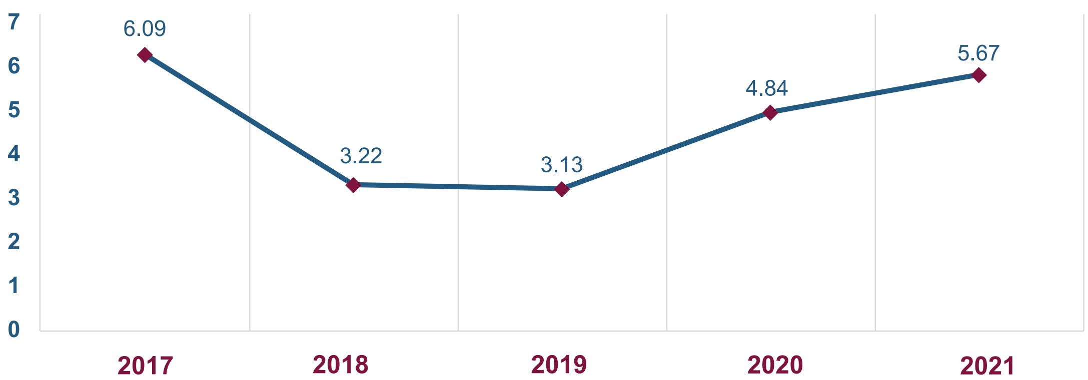
“Somalia continues to struggle to finance its developmental priorities, including providing critical services, given its inability to collect sufficient taxes due to lack of understanding among businesses about the importance of paying taxes and poor institutional capabilities in broadening the revenue basis

As FGS officials noted, Somalia continues to struggle to finance its developmental priorities, including providing critical services, given its inability to collect sufficient taxes due to lack of understanding among businesses about the importance of paying taxes and poor institutional capabilities in broadening the revenue basis.[15] This has led to continued dependence on financial assistance from international partners to cover basic government operations that are critical for sustaining peace in post-transition programs.

Most participants interviewed for this study underscored the importance of the FGS raising revenues and expanding the tax base to maintain the agreed revenue floor and expenditure ceiling, which is part of quantitative targets under the IMF program. Participants also said the federal government should assume responsibility for its national development imperatives.

The country has experienced moderate inflationary pressure from global and domestic factors, including Covid-19 pandemic-induced supply chain bottlenecks, the Russia-Ukraine war and ongoing climatic-induced drought. Figure 3 depicts Somalia's annual inflation rate measured by the consumer price index (CPI). In 2017, CPI stood at 6.09 percent as drought led to an uptick in food prices, housing, water, and electricity. The prices of locally produced commodities such as cereals and maize surged during that drought. However, the inflation rate declined in both 2018 and 2019 to a modest 3.2 percent and 3 percent, respectively. The improved production of local foods and a stable exchange rate were cited as reasons for declining inflation.

Figure 3: Somalia's Annual Inflation rate, 2017-2021



Source: Somali National Bureau of Statistics

15. HIPS interview.

The Covid-19 pandemic increased inflation to 4.6 percent, eroding the purchasing power of Somali households. The disruption of the domestic and international food supply systems as the result of lockdowns and other severe containment measures put upward pressure on food prices. Border closures and other limits on movement reduced the supply of inputs and raised transportation costs, disrupting farming activities and driving up import prices even further. Somali authorities took fiscal measures for essential foods to avert inflationary pressures. This included 100 percent tax relief for dates and rice and 50 percent for floor and cooking oil.[16] In 2021, the consumer price index slightly increased to 5.67 percent. Crucially, the ongoing drought coupled with global crises such as the Ukraine war have increased inflation and put millions of Somalis at risk of food insecurity and poverty. The CPI significantly increased to 7.74 percent in June and July of 2022 due to rising food and drink prices, according to the National Bureau of Statistics.[17]

5. Profile of Somalia's Debt Stock

As economic conditions in developing countries deteriorated during the cold war era, many countries in Africa obtained external borrowing from international financial institutions and bilateral countries. This came at a time when many African nations struggled to raise sufficient fiscal revenues to pay for their increasing expenditures and development needs, resulting in a persistent budget deficit. As a result, they had to rely on domestic and foreign debt to close the financing gap. The decision to borrow is justified by the possibility that, if managed wisely, debt may increase growth through increased capital formation and as consequence productivity which enhances the ability to service and repay the debt. The debt issue in Somalia dates back to the 1970s. Still, the country's debt overhang only became apparent in the late 1980s when its economic performance began to deteriorate quickly, and its balance of payments continued to worsen. The nation had accrued external debt stock of 260% of GDP by1990.[18]

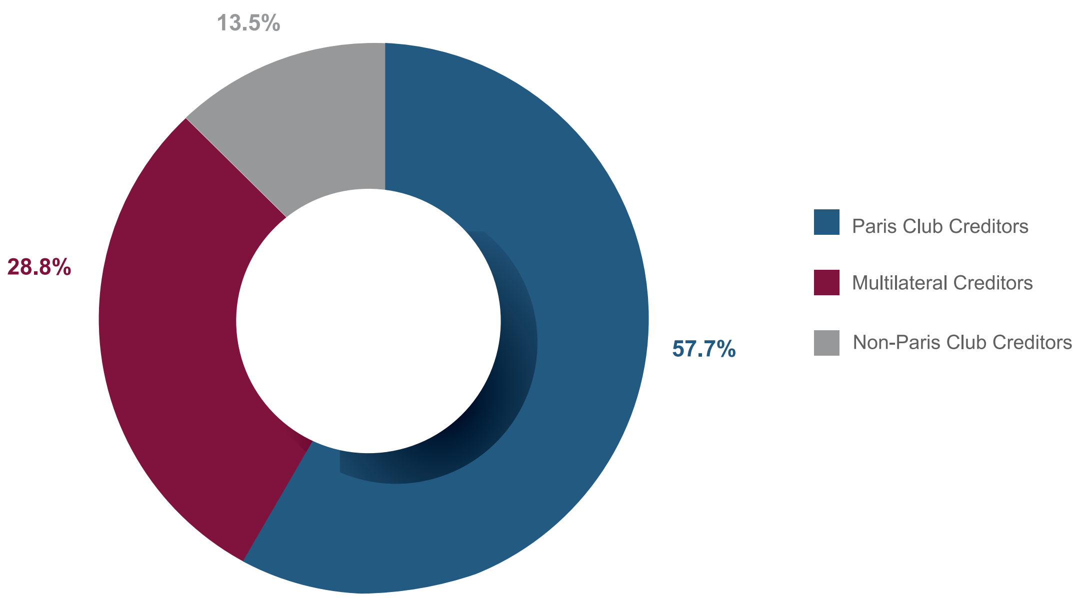
> *"The debt burden substantially increased over the last three decades as Somalia experienced civil war and prolonged conflict when an absence of government meant Somalia was unable to service its debt*

The debt burden substantially increased over the last three decades as Somalia experienced civil war and prolonged conflict when an absence of government meant Somalia was unable to service its debt. With the collapse of the government and the lack of a functioning state, the country couldn't honor its debt payments including debt servicing.[19] Somalia's external debt (over 90 percent of the debt) has accelerated since 1990 due to non-payment of interest and penalties.

16. Heritage Institute for Policy Studies, 2020. The Economic Impacts of Covid-19 on Somalia. https://heritageinstitute.org/wp-content/uploads/2021/01/The-economic-impacts-of-Covid-19-on-Somalia.pdf
17. Somali National Bureau of Statistics, 2022. Consumer Price Index. https://wp.nbs.gov.so/wp-content/uploads/2022/08/CPI_July_2022.pdf
18. Oxfam Briefing Paper, 2019. Liberia Lessons: Enhancing Somalia's Debt Relief Process. https://cng-cdn.oxfam.org/heca.oxfam.org/s3fs-public/file_attachments/Liberian%20Lessons_web%20final.pdf
19. World Bank Group. 2015. Somalia Economic Update, October 2015: Transition Amid Risks with a Special Focus on Intergovernmental Fiscal Relations. https://openknowledge.worldbank.org/handle/10986/23240

According to the Debt Management Unit of the federal government Ministry of Finance, Somalia's external debt including arrears was estimated at about US$5.3 billion in 2019. The majority of the debt is owed to Paris Club creditors at US$3 billion (58 percent) followed by multilateral creditors at US$1.5 billion (29 percent) while non-Paris Club creditors are owed US$0.7 billion (13 percent). However, external debt stock was reduced to US$4.5 billion in 2020 of which US$2.7 billion is owed to the Paris Club, US$1.1 billion to multilateral creditors and US$0.7 billion to the non-Paris Club creditors.

Figure 4: Somalia's External Debt Composition, 2019



Sources: Debt Management Unit, Ministry of Finance, FGS

6. Lessons from HIPC Countries on Debt Relief

After an enduring period of the debt crisis in the late 1980s and the subsequent efforts from the international financial institutions under the structural adjustment, the debt status of the majority of middle-income nations significantly improved following a challenging time. However, a number of low-income countries—the majority in sub-Saharan Africa—retained high levels of external debt. These debt burdens resulted from mismanagement of external debt, weaknesses in macroeconomic management, unfavorable changes in trade conditions, and weak governance.

By the middle of the 1990s, it was evident that more action from the international community was required. In 1996, the World Bank and other multilateral and bilateral organizations initiated the heavily Indebted Poor Countries (HIPC) Debt Relief program.[20] The initiative was created to ensure that the world's poorest nations were not burdened with excessive or unsustainable debts. Countries that satisfy certain policy conditions get their debt reduced. Countries must have an unsustainable debt level, be eligible for concessional assistance from the international development association and establish a track record of reform and sound macroeconomic policies through IMF staff programs, among others.[21]

The HIPC debt relief process has two steps: the decision point and completion point. The decision point signals a country's inclusion in the HIPC initiative. In order to ensure the efficient use of the additional resources, an eligible government must collaborate with the World Bank and the IMF to build a track record of sound economic policies throughout the interim period between the decision point and the completion point. The World Bank and IMF offer limited interim debt relief during this transitional phase. A county reaches the completion point if it maintains satisfactory policies throughout this time and floating HIPC Completion Point triggers.

The HIPC initiative was restructured twice after macroeconomic challenges and poor governance confronted many countries. This led to a new initiative in 1999 called Enhanced HIPC to ease the conditions for countries to faster the debt relief process. As a result, only 17 of the 30 sub-Saharan Africa nations qualified for the HIPC initiative and reached the decision point in 2000. In 2005, the World Bank and The IMF launched a new debt relief program called the Multilateral Debt Relief Initiative (MDRI) to grant 100 percent debt relief to 19 countries[22] including those under HIPC assistance to enable them to allocate more financial resources to curbing poverty, spurring economic growth, and meeting the Millennium Development Goals.[23]

As of 2021, 36 countries from sub-Saharan Africa have successfully undergone this process and made tremendous achievements in reducing their average debt burden. While these countries have generally taken a similar journey toward debt relief, each had had unique challenges, timelines, and advantages in reaching complete debt forgiveness. Uganda was one of the first countries to qualify for the debt relief initiative under the HIPC process in 1997. It reached the completion point in 1998, reducing its external debt to US$650 million, approximately 20 percent of total debt stock.

20. IMF factsheet, 2021. Debt Relief Under the Heavily Indebted Poor Countries (HIPC) Initiative. https://www.imf.org/en/About/Factsheets/Sheets/2016/08/01/16/11/Debt-Relief-Under-the-Heavily-Indebted-Poor-Countries-Initiative
21. Ibid.
22. 19 countries include Benin, Bolivia, Burkina Faso, Cambodia, Ethiopia, Ghana, Guyana, Honduras, Madagascar, Mali, Mozambique, Nicaragua, Niger, Rwanda, Senegal, Tajikistan, Tanzania, Uganda and Zambia.
23. Press Release, 2005: IMF to Extend 100 Percent Debt Relief for 19 Countries Under the Multilateral Debt Relief Initiative. https://www.imf.org/en/News/Articles/2015/09/14/01/49/pr05286

Having successfully attained debt relief under the first HIPC initiative, Uganda joined the enhanced HIPC to reduce its debt stock further, amounting to 700 million. In May 2000, the country achieved a total debt reduction of US$2 billion.[24] To reach the floating completion point, Uganda has successfully completed reforms required by the IMF and the World Bank, shown a strong commitment to poverty reduction, and prepared a full poverty reduction strategy paper.[25]

Burundi embarked on debt relief with the HIPC initiative. It reached the decision point in 2005 and qualified for US$825.7 million in total debt relief. According to African Development Bank, the country fulfilled six out of nine completion point triggers in 2008 and reached its completion point. Although Burundi fell short of the completion point conditions, it was granted debt relief after the government requested exemptions on the other three conditions.[26] Among the conditions required were the creation of a comprehensive Poverty Reduction Strategy Paper (PRSP) with satisfactory performance of its implementation for at least a year; continued macroeconomic stability; allocating the budgetary savings from the temporary HIPC debt relief in line with the priorities established at the decision point; and improving public financial management.[27]

Fragile and conflict-affected countries like Somalia have also experienced complete debt relief through HIPC and MDRI. Liberia entered the enhanced HIPC debt initiative in 2006 and qualified for the decision point in 2008 with satisfactory progress in its post-conflict reform program, including the promotion of good governance and the rule of law, effective macroeconomic management, and development of an Interim Poverty Reduction Strategy Paper. However, the IMF and the World Bank have shown exceptional flexibility regarding some conditions under SMPII to expedite Liberia's qualification to reach the decision point. After two years, Liberia reached the completion point of the enhanced HIPC initiative and attained debt relief of US$4.6 billion.[28] This came after the country successfully implemented 11 out of 12 completion point triggers:[29] the completion of a full Poverty Reduction Strategy Paper and its satisfactory implementation for at least a year; the maintenance of macroeconomic stability as demonstrated by the program(s) supported by the IMF; the strengthening of economic governance through improved public financial management; the implementation of social sector reforms to enhance the delivery of health services and harmonize education payroll; the establishment of an independent anti-corruption commission; the creation and execution of a debt management strategy; and ensuring a high level of accountability and transparency in the extractive industries were among the triggers that were fully implemented.

24. IMF, 2000. HIPC Debt Relief for Uganda Increased to a Total of US$2 Billion: Additional Relief for Uganda's Poverty Reduction Programs.
25. African Development Bank Group, 2000. HIPC APPROVAL DOCUMENT FOR UGANDA: Completion Point under the Enhanced Framework. https://www.afdb.org/fileadmin/uploads/afdb/Documents/Financial-Information/Uganda%20-%20Completion%20Point%20Document%20HIPC%20Initiative.pdf
26. African Development Bank Group, 2009. BURUNDI: COMPLETION POINT DOCUMENT UNDER THE ENHANCED HIPC INITIATIVE. https://www.afdb.org/sites/default/files/documents/financial-information/burundi_-_completion_point_document_hipc_initiative.pdf
27. Ibid.
28. World Bank, 2010. Liberia Qualifies for Complete Debt Relief under HIPC Initiative. https://www.worldbank.org/en/news/feature/2010/06/29/liberia-qualifies-for-complete-debt-relief-under-hipc-initiative
29. AFDB, 2010. Completion Point Document Under the Enhanced HIPC Initiative for Liberia. https://www.afdb.org/sites/default/files/documents/financial-information/liberia_-_completion_point_document_hipc_initiative.pdf

Liberia's debt relief journey provides interesting lessons. The country's approach to debt relief was partly based on cultivating close partnerships with creditor governments and international financial institutions while establishing a tangible track record in implementing structural benchmarks aimed at securing complete debt relief. Liberia has also shown strong political and technical leadership in implementing economic reforms conditions by the HIPC process. The country's president at the time, Ellen Sirleaf Johnson, also lobbied within her international networks to help achieve the nation's debt relief process.[30]

Sierra Leone joined the enhanced HIPC initiative in July 2000, and fulfilled all the necessary criteria for both decision and completion points in 2002 and 2006. It had a satisfactory performance of macroeconomic and structural governance reforms; preparation of a full poverty reduction strategy; private sector development; and human capital improvement development. Sierra Leone has reduced its debt by US$600.3 million of total debt relief assistance, despite the protracted conflict situation, according to the IMF.[31]

What these countries have in common on the debt relief journey under HIPC initiatives is the economic policy initiated and dictated by the IMF and World Bank. In other words, the reforms and conditions are set by international organizations. However, the successful timelines in each of these countries were reviewed to reflect its unique political and socio-economic challenges and the magnitude of their debt burden.

Different countries under the HIPC process have different experiences, as numerous factors have led them to secure debt relief and move beyond the completion point milestone. Sierra Leone's experience in the debt relief process, for instance, shows that the Poverty Reduction Strategy Paper was not only an essential means for articulating a comprehensive strategy for eradicating poverty and clearing debt and arrears but was also a way of sustaining peace and promoting national reconciliation. The government of Sierra Leone organized workshops and seminars to involve participants in the process and solicited insights on the pressing challenges and priorities of the people.[32] To develop the national plan in 2020, Somalia has taken similar steps involving wider stakeholders, including FMS governments and civil society, to capture diverse perspectives and insights on the country's challenges and priorities.

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30. Oxfam Briefing Paper, 2019. Liberian Lessons: Enhancing Somalia's Debt Relief Process. https://cng-cdn.oxfam.org/heca.oxfam.org/s3fs-public/file_attachments/Liberian%20Lessons_web%20final.pdf
31. IMF, 2007. Enhanced Heavily Indebted Poor Countries Initiative: Completion Point Document and Multilateral Debt Relief Initiative. https://www.imf.org/external/pubs/ft/scr/2007/cr0723.pdf
32. African Development Bank Policy Note, 2011. Challenges and Opportunities for Arrears Clearance, Debt Relief and Donor Coordination in Sudan: Sharing African Experiences. https://www.afdb.org/fileadmin/uploads/afdb/Documents/Knowledge/Policy_Note_-_Challenges_and_opportunities_for_arrears_clearance__debt_relief_and_donor_coordination_in_Sudan_%E2%80%93_Sharing_African_Experiences.pdf

Tanzania's experience also underlines the significance of national ownership and the government's capability to grow and develop the capacity to be more potent, better organized, and well equipped in supporting a strong dialogue with citizens, as well as in discussions with development partners in delivering debt relief.[33] In contrast, Somalia hasn't sought national buy-in from wider stakeholders and has not had any meaningful citizen engagement in the debt relief process. Few Somalis know about the ongoing debt relief reform program and many others have been misinformed. Proactive engagement with citizens on debt dynamics and reforms that the government intends to implement is crucial in attaining debt relief.

Critics of HIPC believe that the initiative has been too easy to qualify for, making debtors wasteful and corrupt and subsequently resulting in bad economic policies. Those arguments claim that debt relief program acts as defacto budget support to many HIPC participating governments, and the money ends up at the hands of corrupt decision makers.[34] Money earmarked for social services and poverty reduction is used for personal or private gains at the expense of poor citizens. Domestic governance structures and poor accountability frameworks often make debt relief programs more ineffective in addressing the intended poverty reducing agenda. Moreover, critics also contend that the HIPC initiative is an external driven poverty trap for low-income countries in which funds provided are far from sufficient to address poverty and promote economic growth.[35] The central argument is that this debt relief adjustment pushed by international financial institutions has made matters worse for those HIPC recipient countries.

“The experiences of other regional countries which embarked on HIPC debt relief initiative show that good governance is crucial in post-debt economic development

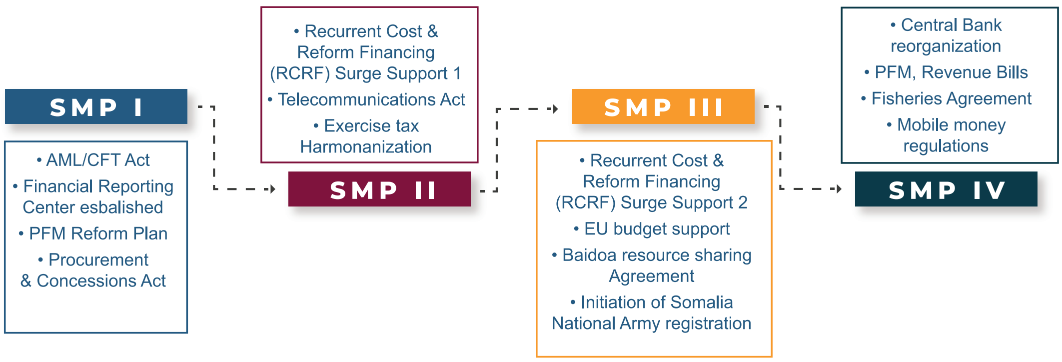
The experiences of other regional countries which embarked on HIPC debt relief initiative show that good governance is crucial in post-debt economic development. There are many countries in the region that have completed their enhanced HIPC debt relief but are still grappling with poor social and economic development. According to a seminal study by Knoll, the reason why highly indebted poor countries experience low levels of investment and economic growth is in part due to the inherited debt stock that serves as a disincentive to investment and productivity-enhancing adjustment efforts because future returns go primarily to creditors.[36] Considering Somalia's nascent governance landscape, the delivery of the completion point will not bring Somali people out of poverty unless the government and international community develop credible domestic financial institutions to help poor Somalis.

33. Ibid.
34. Thomas, 2001. Getting Debt Right. Foreign Affairs.
35. Institute for International Economics. Delivering on Debt Relief. https://www.piie.com/publications/chapters_preview/337/2iie3314.pdf
36. Knoll, M. (2013). The heavily indebted poor countries and the multilateral debt relief initiative: A test case for the validity of the debt overhang hypothesis. https://www.econstor.eu/bitstream/10419/78106/1/756455243.pdf

7. Evolution of Somalia's Debt Relief Process

Following the transition to the federal governance model in 2012, Somalia successfully reengaged with international financial institutions including the World Bank Group in 2013 to seek technical and financial assistance.[37] The bank initiated a Multi-Partner Fund for Somalia in 2014 to provide budget support for the government's emergency expenditures under the Recurrent Cost and Reform Financing Project (RCRF). The agreement, starting with the RCRF, marked a turning point in global engagement from aid to a development partnership based on mutual accountability.[38] Similarly, IMF engagement with Somalia started in 2013 in an effort to provide much-needed capacity building and policy advice to the federal government. These capacity development programs comprised public financial management, financial and fiscal law, tax policy and administration development, central bank organization, governance and macroeconomic and financial statistics, among others.

Figure 5: Debt relief decision point journey



Source: International Monetary Fund (IMF)

7.1 First Staff Monitored Program (2016-2017)

After receiving policy and technical capacity assistance from the World Bank and the IMF, the federal government joined the IMF Staff Monitored Program (SMP) in 2016 which aimed to help rebuild the economy and establish a track record for economic management. The SMP is part of the HIPC process in which national authorities and IMF staff agree on reforms required for the upper-credit tranche (UCT) quality program – a prediction for securing the HIPC decision point.[39]

37. 2019 International Monetary Fund. Article Iv Consultation, Second Review Under the Staff-Monitored Program, And Request for New Staff-Monitored Program— Press Release; Staff Report; And Statement by The Executive Director for Somalia. https://www.imf.org/en/Publications/CR/Issues/2019/07/30/Somalia-2019-Article-IV-Consultation-Second-Review-Under-the-Staff-Monitored-Program-and-48543
38. Ibid.
39. IMF, 2016. Somalia Staff-Monitored Program – Press Release and Staff Report. https://www.imf.org/external/pubs/ft/scr/2016/cr16136.pdf

IMF staff monitor the implementation of agreed economic policy reforms. Against this background, Somalia implemented the first 12-month program with several reform agendas, including setting anti-money laundering and counter financing for terrorism act, establishing Financial Report Center, PFM reform plan, and passing the procurement and concessions act. Somalia completed all the benchmarks and passed the assessment by the IMF staff.

"One of the key benchmarks was the implementation of the procurement law. Some contractors that were initially rewarded for political reasons, and, according to a ministry of finance official, the government terminated dozens of contracts to provide an efficient and transparent procurement system

Some officials interviewed for this study underscored that certain conditions were easy for Somalia to implement during the first debt-relief program including raising government revenue and paying military and security personnel salaries. A PFM official said that these reforms were part of the public financial management law, which was actually a necessary step for reviving the country's financial and economic institutions.[40] One of the key benchmarks was the implementation of the procurement law. Some contractors that were initially rewarded for political reasons, and, according to a ministry of finance official, the government terminated dozens of contracts to provide an efficient and transparent procurement system. He added that those terminations under the new procurement reforms helped address corruption while simultaneously becoming instrumental for completing the staff-monitored programs and the overall debt relief journey.[41]

International partners also played a prominent role in supporting the economic reform agenda. The UK, US and Norway stand out for championing Somalia's journey towards debt relief, according to a former minister of planning.[42]

7.2 Second Staff Monitored Program (2017-2018)

The program's second phase started in 2017 with new reform conditions while building on the achievements of the previous one. The goal of the new SMP was to sustain macroeconomic stability while rebuilding economic institutions and structures and increasing the capability to enhance macroeconomic management and governance. The second SMP had 15 structural benchmarks including the initiation plan and establishment of cash management functions; updating and adopting the PFM bill by the cabinet; concluding renegotiation of all five existing revenue collection contracts; developing an audit program to review and revamp business processes in preparation for automated processing; establishing a national Anti-Counterfeit Center; submitting the Communication Act to parliament to licence mobile network operators; developing a financial sector development roadmap; and submitting a new Statistical Law to parliament.

40. HIPS Interview with a former advisor to the Ministry of Finance
41. HIPS interview with a Senior official at the Ministry of Finance.
42. HIPS interview with former Somali Planning Minister (2022).

The program also had seven indicative targets including a floor for the fiscal balance revenue; non-accumulation of new domestic arrears; increasing arrears payments in the events of revenue windfalls; and a floor on the Central Bank's net foreign assets.[43] Additionally, there were several reform initiatives in the fields of economic statistics, finance, and public financial management.

Somalia made significant strides in all indicative targets and structural benchmarks except for two, according to IMF. They were the renegotiation of revenue collection contracts with five private companies and the eligibility criteria required to achieve 100 percent of non-salary of the recurrent cost and reform financing budget. According to officials interviewed for this study, private companies were collecting taxes from citizens while the minister under the revenue department have hundreds of staff hired for revenue collection. This created a double cost for the government. A senior official at the Ministry of Finance interviewed for this study said, "Look, why do we have to pay salaries if private companies collect taxes on behalf of us".[44] The government has successfully cancelled several contracts with private companies, it resisted strong political pressures.[45]

Government officials noted that domestic revenue mobilization improved significantly during the second SMP. In 2018, domestic revenue rose to US$183.4 million from US$142.6 million in 2017.[46] However, domestic tax collection has been well short of the government's spending priorities, according to a Ministry of Finance official.[47]

The Telecommunication Act was also passed in 2017. It was aimed at providing the institutional, legal, and regulatory foundations for the booming telecoms industry in Somalia. Following consultations with numerous stakeholders, including the FMS and telecom providers, the Ministry of Posts, Telecommunications and Technology submitted the legislation in July and it was approved by both houses of parliament in August. On the financial sector reforms, the Central Bank of Somalia (CBS) regularly undertakes supervision and licensing processes for commercial banks and money transfer operators (MTBs). This has considerably improved the financial and economic figures of the country, given the prolonged weak institutions.

7.3 Third Staff Monitored Program (2018-2019)

In May 2018, the third staff monitored program was approved after the country made satisfactory progress in implementing reforms under the first two SMPs. It built on previous reforms and introduced new ones aimed at achieving a SMP that meets the standards of the IMF's Upper Credit Tranche (UCT) conditionality, which is one of the essential requirements for the country to reach the decision point under the HIPC initiative.

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43. IMF Country Report for Somalia. Second and final review under the staff– monitored program and request for a new staff–monitored program—press release and staff report. https://www.imf.org/~/media/Files/Publications/CR/2017/cr17204.ashx
44. HIPS Interview with ministry of finance official.
45. Minister of Finance, 2018. Financial Governance Report. https://mof.gov.so/publications/financial-governance-report-2018
46. Data from the Ministry of Finance.
47. HIPS Interview with the Director of Revenue, Ministry of Finance.

SMP III comprised 18 structural benchmarks including strengthening public financial management such as establishing biometric registration for a national security force and paying salaries directly into their accounts; developing a cash forecasting system; improving fiscal transparency and accountability; making progress towards developing Treasury Single Account; broadening the revenue base and increasing tax collection; submitting an amended National Customs Act to parliament; drafting the ninth National Development Plan (NDP9) which is intended to serve as an interim Poverty Reduction Strategy Paper (PRSP); and submitting a draft of the Targeted Financial Sanctions Act.[48]

"Overall, the federal government achieved 17 out of 18 structural benchmarks outlined in SMP III. In particular, commendable progress was made in domestic revenue mobilization, and sales tax on imports has become a substantial new revenue source

Overall, the federal government achieved 17 out of 18 structural benchmarks outlined in SMP III. In particular, commendable progress was made in domestic revenue mobilization, and sales tax on imports has become a substantial new revenue source. Similarly, the FGS secured small increases in both corporate and individual income taxes.[49]

Somalia has also taken important steps in intergovernmental transfers and resource sharing. In June 2018, a National Security Council meeting was held in Baidoa to agree on petroleum and minerals ownership and management and resources sharing. The Baidoa Agreement allows the FGS and FMS to jointly administer the nation's mineral and petroleum resources while ensuring equitable service delivery.[50] The primary outcome of the agreement was a set of revenue shares concerning petroleum and mineral resources between FGS and FMS, such as offshore and onshore profit oil, royalty, license fee, production bones, corporate income tax, and export tax, among others.[51] Corporation tax was exclusively given to the federal government, while export revenues will be shared at 60 and 40 percent for the FGS and FMS, respectively. Most participants of this study acknowledged this agreement was an important landmark for the country's economic reform program and intergovernmental fiscal relations as well as a critical milestone for debt relief.

The FGS lobbied hard to convince the IMF, the World Bank and the bilateral creditors that it had done enough to reach both the decision and completion points of the HIPC initiative. However, some creditors opposed the idea. Officials interviewed for this study noted that international partners were reluctant for two reasons: political fragmentation within the federal government system that make harmonized reforms impossible; and barely-functioning financial institutions with limited ability to generate domestic revenues to finance a conditional array of development needs within the HIPC process.[52]

48. 2019 International Monetary Fund. Article Iv Consultation, Second Review Under the Staff-Monitored Program, And Request for New Staff-Monitored Program— Press Release; Staff Report; And Statement by The Executive Director for Somalia. https://www.imf.org/en/Publications/CR/Issues/2019/07/30/Somalia-2019-Article-IV-Consultation-Second-Review-Under-the-Staff-Monitored-Program-and-48543
49. Ministry of Finance data.
50. The Baidoa Agreement, 2018. Agreement on Ownership, Management, and Sharing of Revenues from the Natural Resources of the Country (Oil & Minerals).
51. Ibid.
52. HIPS interview with senior ministry of finance official.

Somalia was able to get US$130 million in pre-arrears clearing funding from the World Bank in 2018.[53] It was used to augment the recurring cost support provided to the FGS and FMS budgets as well as to offer more technical assistance for PFM, domestic resource mobilization, and deepening the financial sector.

However, the FGS once again failed to renegotiate Mogadishu seaport and airport contracts with two Turkish companies which were part of the structural benchmarks and should have been completed by the end of 2018. The Turkish companies were reluctant to agree to the new terms proposed by the FGS which they saw as against their interest. Second, Somalia did not want to disappoint the support and the goodwill that Turkey had shown over the years in providing humanitarian and security assistant.[54]

7.4 Fourth Staff Monitored Program (2019-2020)

Somalia qualified for the fourth and the last SMP in 2019. SMP IV focused on deepening PFM programs, increasing revenue mobilization, expanding the scope of financial sector supervision and regulations and improving the governance of the Central Bank of Somalia. The program comprised 18 structural benchmarks to be implemented within 12 months. These benchmarks included fiscal transparency such as establishing a fiscal buffer and submitting monthly reports; increasing domestic revenue by automating the front-end customs declarations; implementing manifest verification in the customs IT system in Mogadishu port; enacting a revenue bill; issuing mobile money regulations and AML/CFT regulations; passing an amendment to the Statistics Law; and building the capacity to collect key nationwide macroeconomic indicators.[55]

The achievements of SMP IV included revenue mobilization exceeding conditioned targets due to reforms taken by the FGS with the support of international partners. Notably, domestic revenue increased to US$230 million from US$183 million in 2018, resulting in a fiscal surplus for the first time.[56] The FGS also successfully undertook reforms to the financial sector and improved the supervisory capacity of the Central Bank of Somalia and AML/CFT; issued mobile money regulations; enhanced the capacity and governance at the central bank of Somalia; and prepared the strategic plan of the CBS.

53. Minister of Finance, 2019. Financial Governance Report. https://mof.gov.so/sites/default/files/Publications/2019%20Financial%20Governance%20Report_EMAIL_0.pdf
54. HIPS interview with a former advisor in the Office of the Prime Minister.
55. See the full list of benchmarks in the IMF report: 2019 Article IV. Consultation, Second Review Under the Staff-Monitored Program, And Request for New Staff-Monitored Program. https://www.imf.org/en/Publications/CR/Issues/2019/07/30/Somalia-2019-Article-IV-Consultation-Second-Review-Under-the-Staff-Monitored-Program-and-48543
56. Ministry of Finance data.

Other important achievements included drafting NDP9 which incorporated the Interim Poverty Reduction Strategy Paper (IPRSP), a requirement to reach the HIPC decision point. The plan envisages five overarching pillars: inclusive politics; improved security and the rule of law; inclusive growth; improved social development; and resilience to climate change. Although the plan is overly ambitious given the Somalia's lack of money to finance these imperatives, it was an important milestone and achievement.

7.5 The Decision Point – What it Means for Somalia

In March 2020, the IMF and World Bank determined that Somalia had met all the conditions necessary to reach the HIPC decision point. Somalia's debt was reduced from US$5.2 billion to US$3.7 billion, equivalent to 63 percent of GDP. This important landmark opened a window of opportunities for Somalia. It allowed the government to access new financial resources from international development partners to spur inclusive economic growth and social development. According to the IMF, grants increased from around US$100 million in 2019 to US$285 million in 2020, with a large amount of this money coming from the International Development Association (IDA). Moreover, new funding from the World Bank made it possible to launch the Baxnaano program, which gives cash transfers to over 200,000 vulnerable and disadvantaged households to curb food insecurity.

International grants now represent about 73 percent of the total budget (consisting of project funding and direct budget support), showing that Somalia has benefited from reaching the decision point. The World Bank approved US$100 million grants to support Somalia's economic reform program–including strengthening fiscal transparency and furthering revenue mobilization.[57] More specifically, this grant is expected to create the necessary foundation for strengthening intergovernmental fiscal cooperation to advance the ongoing state stabilization agenda, which is essential for promoting inclusive economic growth. Access to these foreign grants is crucial because Somalia cannot finance its urgent developmental needs, according to one senior finance official.[58]

The debt relief outcome is also expected to attract foreign direct investment, demonstrating investors' confidence in government institutions. Re-engagement with multilateral organizations is a success story for Somalia in seeking investment.

57. The World Bank, 2022. Somalia to Strengthen Fiscal Transparency and Inclusive Private Sector Growth with $100 Million from World Bank. https://www.worldbank.org/en/news/press-release/2022/07/27/somalia-to-strengthen-fiscal-transparency-and-inclusive-private-sector-growth-with-100-million-from-world-bank
58. Ibid.

"Reforms under debt relief process was also about changing narrative that Somalia can undertake institutional, policy and regulatory reforms to meet international investment protocols

A senior official of the ministry of planning said the "reforms under debt relief process was also about changing narrative that Somalia can undertake institutional, policy and regulatory reforms to meet international investment protocols," adding specifically that financial governance is a vital instrument for boosting investor confidence in a nation recovering from decades of protracted conflict and instability.[59]

Pursuing policy reforms is critical for the country's economic recovery and development. Almost all government officials interviewed for this study highlighted that while reform conditions were aimed at debt relief, it also was critical for the country's long-term growth. A former PFM advisor said that 'embracing the HIPC initiative was not only good for clearing the books but also for improving the country's nascent institutional landscape'.[60]

HIPC completion point triggers for Somalia

After Somalia reached the decision point of debt relief under the HIPC initiative in 2020, the IMF set several conditions that the country has to fulfill to reach the completion point of clearing its external debt. These conditions include satisfactory implementation of the Poverty Reduction Strategy, which is the NDP-9 for at least a year; maintenance of stable macroeconomics; issuing regulations to implement the PFM Act's provisions on debt, public investment, and national resources revenue management; adoption and apply a single import duty traffic schedule at all ports in the Federal Republic of Somalia; enact Extractive Industry Income Tax Law; development of harmonized education sector with clear respective roles of FGS and FMS on curriculum and examinations; adopt joint national health sector strategy, among others.

According to the recent IMF report, Somalia has made progress for the triggers mentioned above. However, significant challenges remain in achieving some of these conditions. For instance, adopting and applying a single import duty tariff schedule and enacting Extractive Industry Income Tax Law are politically sensitive and contested issues between FGS and FMS. A senior advisor to the Puntland Ministry of Finance interviewed for this study claimed that custom regulations and distribution of roles and responsibilities in social sectors must be politically settled in the constitution, or it will be superficial.

59. HIPS interview with Ministry of Planning official.
60. HIPS interview with former PFM advisor.

8. Post-HIPC Challenges

Somalia has made tremendous progress in economic reform program under the HIPC process. This section explores key impediments preventing Somalia from completing debt relief as well as the plans for post-HIPC economic development.

8.1 Weak Economic Governance

Good quality institutions play a central role in a country's economic development and in particular achieving sustainable debt relief management. Rodrik et al (2004) described this as "institutions rule" in which monetary and fiscal policies are anchored in strong macroeconomic institutions; investors feel secure about their properties; where the rule of law reigns supreme; private incentives are aligned with social goals; idiosyncratic risks are appropriately mediated through social insurance; and citizens have access to civil liberties and political representation.[61] Poor institutional quality is associated with having a less favorable policy environment. In this case, weak institutions could prevent countries from achieving the reforms needed to reach the completion point stage and sustain prudent debt management in post-HIPC.

Most of the officials interviewed for this study said that although the FGS has made institutional reforms over the past few years, mismanagement practices, poor accountability, and lack of transparency in public institutions remain rampant. A senior official at the ministry of finance stressed that corrosive practices still exist among financial governance institutions.[62] A recent Auditor General report flagged widespread misappropriations of public funds – including US$17 million of external support not channeled through the country's financial system as well as unaccounted for Covid-19 funds received by federal member states and the Benadir region.[63] The report further noted that several contracts were awarded to companies without applying open competitive bidding enshrined in the National Procurement Act.

> *"This is evidence that Somalia's financial governance is nascent, and the lack of enforcement and operationalizing of the recently passed financial laws remain the biggest impediment to its debt management and overall economic reform programs*

This is evidence that Somalia's financial governance is nascent, and the lack of enforcement and operationalizing of the recently passed financial laws remain the biggest impediment to its debt management and overall economic reform programs. A former government advisor warned that "if corruption is left unaddressed, future debt relief funds will be used for personal and political gains."[64] He added that if enforcement agencies don't act on corruption, international partners' confidence in continuing to provide financial support to Somalia will be jeopardized.

61. Rodrik, D., Subramanian, A., & Trebbi, F. (2004). Institutions rule: the primacy of institutions over geography and integration in economic development. Journal of economic growth, 9(2), 131-165.
62. HIPS interview with Ministry of Finance official.
63. See FGS Auditor General Report, 2021. Annual Compliance Audit Report for the Year Ended 31st December 2020. http://oag.gov.so/wp-content/uploads/2019/09/Annual-Compliance-Audit-Report-for-the-Year-Ended-31st-December-2020-2.pdf
64. HIPS interview with former Office of the Prime Minister advisor.

Furthermore, Somalia's monetary policy remains dysfunctional despite commendable work over the past few years, passing the establishment of the Central Bank Act in 2012 and the Strategic Plan for 2020-2024. According to the World Bank, the CBS lacks the ability to use monetary policy to handle shocks.[65] De facto dollarization, estimated to account for 75 percent of transactions, ensures price stability. Although Somali shillings are in use, they are almost entirely counterfeits.[66] The policy notes also noted challenges in the bank's supervisory practices and enforcement actions towards AML/CFT regulations. While the government has passed laws to combat financial crimes, adherence is subject to poor understanding and a lack of trust among commercial banks and MTO in the system.[67]

In 2020, Somalia was granted a new reform program called Extended Credit Facility (ECF) by the IMF, a three-year US$395.5 million program to clear its arrears service debt to the fund. The structural benchmarks require Somalia to enact the Targeted Financial Sanctions Law and issue related regulations, operationalize POS machines connected to tax offices and installed at large taxpayers in telecom and tourism sectors, operationalize the Customs Automated System at the ports and airports of Mogadishu, Kismayo, Garowe and Bosaso, as well as issue the Banking Regulations on Capital Adequacy and Liquidity Coverage Ratio. These ECF benchmarks are set to be completed between December 2022 and December 2023. Failure to do this will derail the journey toward the completion point of the HIPC process.

"Like any other public sector institution, human resources, although improving, still present a bottleneck to macroeconomic reforms and growth. Participants in this study reiterated that public financial management systems and other economic institutions suffer from poor human capital

Like any other public sector institution, human resources, although improving, still present a bottleneck to macroeconomic reforms and growth. Participants in this study reiterated that public financial management systems and other economic institutions suffer from poor human capital. Many employees in the economic institutions lack the technical skills and capacity to implement reforms needed for the country's debt relief and economic reconstruction. An official from the Ministry of Finance stressed that "despite government receiving some technical and capacity development assistance from the international financial institutions, there is an enormous skill deficit among our financial institutions, such as revenue mobilization, management of procurement, and concessions." He further argued that public sector institutions should be filled with technically sound individuals to run key institutions.[68]

65. World Bank, 2022. Policy Notes for the New Government: Unlocking Somalia's Potential to Stabilize, Grow and Prosper. https://documents.worldbank.org/en/publication/documents-reports/documentdetail/099540006172236077/p1775040bf5af50b0992a0b4280faf2bf5
66. Ibid.
67. Ibid.
68. HIPS interview with Ministry of Finance official.

8.2 Political Squabbles

Political tensions have been significant impediments to the progress of the debt relief initiative and overall economic development of Somalia. Political squabbles between the FGS and FMS leadership and the recent long-delayed elections almost derailed the IMF ECF program. Economic reforms and resource-sharing mechanisms are contentious due to the ambiguity of the provisional constitution. In 2018, the FGS and FMS successfully agreed on revenue sharing on petroleum and minerals, which was a cornerstone for raising domestic revenue, but the lack of cooperation among the political elites remains to be a profound challenge in its implementation, according to the 2019 Financial Governance Report.[69]

“political fragmentation risks the completion point of the debt relief initiative because, for instance, settlement of fiscal federalism is an outstanding issue that needs the FGS and FMS to agree

Participants of this study also noted that disputes between the FGS and FMS could hinder progress on economic resilience and achieving complete debt relief. A former senior advisor in the Office of the Prime Minister said that “political fragmentation risks the completion point of the debt relief initiative because, for instance, settlement of fiscal federalism is an outstanding issue that needs the FGS and FMS to agree.”[70] However, some officials discounted that the debt relief process had not been affected by constant political upheavals between central and federal member states or opposition. The Director General of the Ministry of Planning said, “The nature of the HIPC process is that IMF and World Bank deal with central government on reform programs, adding that the international partners do not always interfere with our political structure.”[71]

Political tussles over elections have been Somalia's most significant challenge during the debt relief process. The FGS and FMS reached an indirect electoral pact in September 2020. However, disagreements on the delivery modalities delayed the election numerous times, making it the country's most protracted electoral process. Officials who participated in this study acknowledged that the progress of the debt relief was stalled because the political uncertainty during the election period and risked the cancelation of the ECF program.”[72] According to the IMF, budget support from development partners, mainly the World Bank and the European Union, was suspended as they waited for the conclusion of the parliamentary and presidential elections. Budget support grants were US$38 million in 2021 compared to the US$170 million that was anticipated due to the unduly protracted and contentious electoral process. Somalia also missed the ECF’s second and third reviews during the electoral process but was granted a three-month extension. Budget support resumed immediately after the successful conclusion of the elections.

69. Ministry of Finance, 2019. Financial Governance Report. https://mof.gov.so/publications/financial-governance-report-july-2019
70. HIPS interview.
71. HIPS interview with the director general of the Federal Ministry of Planning, Investment and Economic Development.
72. HIPS interview with a senior FGS official.

8.3 Fragmented Domestic Revenue Mobilization

Domestic revenue is the most sustainable source of financing for governments need to fund their development goals and achieve inclusive growth. The FGS has made commendable progress on increasing domestic revenue generation by developing numerous tax-related legislation and improving tax administration mechanisms. Still, the country faces severe fiscal space constraints that limit its ability to finance its national development agenda, including security and service delivery. Critical challenges to increasing domestic revenue include the lack of a harmonized tax collection structures across the country, poor awareness among Somali citizens about the importance of paying taxes, and overall weak macroeconomic conditions.

Given the absence of workable fiscal federalism and lack of agreement on revenue sharing, each tier of government in Somalia collects its own taxes along with different fees. The FGS collects its revenue in Mogadishu, while the FMS have their own collection arrangements. Control over fiscal resources is not defined in the provisional constitution. There is no clarity about how revenue is collected and shared between the FGS and FMS.[73] This is a key impediment to revenue generation which, if not addressed, will impact on the prospect of reaching complete debt relief and long-term economic revival.

> *"Somali government has never been able to establish a transparent and robust tax policy and administrative framework that would help it ensure effective revenue performance and give it the means to foster a shared sense of trust and accountability with the general public*

Citizens' lack of compliance with tax obligations is another major impediment to raising sufficient domestic revenue. The authorities have yet to establish the moral authority to broaden the tax base, as neither the federal government nor the states effectively provide services to the Somali people. According to the director of the Revenue Department, the lack of service provision means Somalis are less likely to voluntarily comply with tax requirements, reducing the already small base from which taxes may be collected. He added that "citizens are always reluctant to pay taxes because they question how those resources have been managed."[74] Recent policy notes from the World Bank also noted the poor linkage between tax obligation and provision of services.[75] In this regard, the Somali government has never been able to establish a transparent and robust tax policy and administrative framework that would help it ensure effective revenue performance and give it the means to foster a shared sense of trust and accountability with the general public.

73. Sharma,Natasha Dillinger,William R, 2020. Somalia - Moving the Federalism Agenda Forward. Washington, D.C.: World Bank Group. https://documents.worldbank.org/en/publication/documents-reports/documentdetail/199431596779832046/somalia-moving-the-federalism-agenda-forward
74. HIPS interview with the Director of Revenue, Ministry of Finance.
75. World Bank, 2022. Policy notes for the new government.

Domestic revenue mobilization is also constrained by the informal nature of tax collection across the country. The government finds it challenging to tax micro-trading networks and other businesses and informal economic activities that operate outside of its jurisdiction.[76] Meanwhile, businesses are taxed by militia groups such as al-Shabaab, which levy a substantial amount of taxes.[77] This informal tax collection further impedes domestic revenue generation and the possibility of reaching debt relief completion point triggers.

"The country has a high risk of future debt stress due to the PFM system's flaws and flagrant financial mismanagement. Somalia might reach the completion point of debt relief but once the country reaches this milestone, existing grants will dry up, and concessional loans will follow

8.4 Post-HIPC Prospects

The pertinent question is whether Somalia is ready for post-HIPC debt management given the poor state of economic governance. The country has a high risk of future debt stress due to the PFM system's flaws and flagrant financial mismanagement. Somalia might reach the completion point of debt relief but once the country reaches this milestone, existing grants will dry up, and concessional loans will follow.[78] Taking on new debt will further strain the quest for sustainable economic development.

Experiences from other HIPC countries show that without robust public financial management and sound institutions, debt relief will not be a boon for the country's future economic trajectory. For example, Uganda has a high debt percentage despite being one of the first nations to benefit from debt relief under the HIPC process in 2000. The country's external debt-to-exports ratio increased from 150 percent in 2000 to 204 percent in 2004, reaching critical levels again.[79]

"Unfortunately, the prospect of benefiting from the debt relief accomplishments looks gloomy in Somalia. There is a lack of strong public financial management that can effectively manage future borrowing to promote a sustainable economic recovery path

Moreover, various analysis has revealed that a significant number of African countries that benefited from HIPC debt relief are now displaying symptoms of debt distress or are at extremely high risk of experiencing it. They include Zambia, Mozambique and Malawi.[80]

Unfortunately, the prospect of benefiting from the debt relief accomplishments looks gloomy in Somalia. There is a lack of strong public financial management that can effectively manage future borrowing to promote a sustainable economic recovery path. The lack of transparency and accountability is likely to foster corruption when authorities borrow, hampering economic reconstruction efforts. There is a growing concern that concessional loans will be looted by politicians rather than used for productive investment to revitalize the economy.

76. Isak, N. N. (2018). Challenges of domestic revenue mobilization in Somalia. International Journal of Economics, Commerce and Management, 6(9). https://ijecm.co.uk/wp-content/uploads/2018/09/6912.pdf
77. Ibid.
78. HIPS interview with a former senior advisor to the Ministry of Finance.
79. Emmanuel Rocher, 2007. New borrowing post-debt relief: risks and challenges for developing countries. CFA Bulletin Digest, (159). https://fondation.banque-france.fr/sites/default/files/media/2016/11/25/159etud.pdf
80. IMF, 2022. List of LIC DSAs for PRGT-Eligible Countries. https://www.imf.org/external/pubs/ft/dsa/dsalist.pdf

> “there is genuine concern that if key outstanding issues are not resolved, debt relief may spark to a new political confrontation between federal member states and the federal government for managing external loans

Without settling fiscal and resource sharing mechanisms, reaching the debt relief completion point is unlikely to bring fruit to the country's sustainable economic management endeavor. The timing of achieving the debt relief completion point in relation to the country's political state is another significant barrier to the beneficial utilization of Somalia's debt-freeing milestone and access to new financial instruments.

A recent IMF report stated that Somalia may secure debt relief in late 2023 if the country finalizes the remaining completion point triggers. However, there is genuine concern that if key outstanding issues are not resolved, debt relief may spark to a new political confrontation between federal member states and the federal government for managing external loans.

9. Conclusion

Years of ineffective government led Somalia to fall into debt arrears. External debt rapidly increased over the last three decades, owing to nonpayment of interest and penalty charges. With support from international development partners, notably the IMF and the World Bank, Somalia has made considerable progress on debt relief in recent years.

It's journey towards the HIPC decision point demonstrated the importance of economic policy reform for resolving external debt. Domestic revenue has improved, and Somalia's federal government has passed several financial governance laws. Economic growth has picked up at an average rate of three percent, showing a nascent recovery after more than two decades of economic downturn. Meanwhile, social development and the private sector have expanded.

However, extraordinary challenges remain before the country can reach complete debt relief and future economic resilience. The absence of capable institutions, constant political instability and low levels of domestic revenue mobilization emanating from fragmented tax collection are among the numerous challenges that Somalia must overcome.

10. Policy Recommendations

1. The new federal government should continue to advance the reforms that are crucial in achieving complete debt relief. Political commitment together with robust technical leadership has resulted in numerous successes under the HIPC debt relief initiative. Continuing the political commitment to this process will also persuade both bilateral and multilateral organizations to forgive Somalia's debt.

2. Somalia's governments should deepen efforts on institutional reforms by developing laws and policies that can curb the pervasive corruption practices in the public sector. There is a need for strong enforcement systems that combat corruption. Sound enforcement mechanisms will further improve the transparency and accountability of the country's damaged institutions and governance. This will help Somalia secure full debt forgiveness, normalize relations with international financial institutions to access new funds and lure much-needed Foreign Direct Investment into the country.

3. Durable political settlement in federalized Somalia must be prioritized, especially in the area of fiscal federalism in order to broaden the revenue base and increase revenue mobilization. The FGS and FMS should agree on the revenue schedule and the structure of each item of tax collection. Officials interviewed for this study were of the view that fragmented domestic revenue collection is a key impediment to raising the government's financing envelope. As improving domestic revenue is a prerequisite for the completion of debt relief, it is important for new the FGS and FMS to enact an integrated revenue and tax administration act. This revenue act is vital to raising sufficient domestic resources to fund the country's development priorities.

4. Somali governments should strengthen their human resources by bringing qualified people into public financial management as well as other economic institutions. Participants in this study reiterated that the poor capacity of manpower in the public institutions – especially in the area of fiscal and monetary development – is impeding the prospects of achieving economic reforms necessary for full debt relief and beyond. Recruiting technical personnel in public financial management and upskilling the existing workforce is crucial in securing debt relief and the overall economic resilience of Somalia.

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5. The FGS and FMS need mechanisms to end the protracted political stalemate that constantly thwarts the political and economic stability of the country. The recent election offers a classic example of Somalia's fragile politics impeding economic reforms, particularly derailing the progress of debt relief. As stable politics and a conflict-free setting are foundations of economic development as well as improving macroeconomic management and external debt management, Somalia should pursue political stability and agree on contested state-building processes. This includes the finalization of constitutions, addressing security as well as electoral issues of the country.

6. International development partners should increase their financial assistance through the government budget. This study found that a large share of donor funding is not channeled into the national budget leaving a significant budget gap for expenditure requirements. Channeling a significant portion of donor projects into the budget will broaden Somalia's fiscal space and enable governments to provide critical services to their citizens. The FGS and FMS must consolidate and strengthen public financial management reforms by increasing absorption capacity and efficiency in public expenditure.

7. Somalia's debt relief process was a product of goodwill by the international partners given the country's nascent state of institutions and the difficulties it faces in absorbing rapid and painful economic reform programs. Participants of the study acknowledged that creditor governments such the US, UK and Norway have had a pivotal role in Somalia's debt relief decision point milestone. Therefore, while international financial institutions should continue their efforts to help Somalia achieve the completion point of debt relief, they need to take caution not to rush to grant complete debt relief without much-needed reforms. Weak public financial management and poor accountability and transparency compounded with contested federal politics raise doubts as to whether Somalia is ready to embrace the total debt relief that comes with new concessional loans from the World Bank's International Development Association (IDA). Jumping to the completion point milestone without addressing these challenges will not only risk that future loans will end up in the pockets of politicians rather than investing in productive sectors and might spark renewed resource-related conflict between FGS and FMS.

8. Somalia should embark on a comprehensive awareness campaign about paying taxes to broaden revenue generation and improve government fiscal space to finance critical services. The current absence of service delivery by all levels of governments as well as poor perceptions of Somalis on paying taxes impedes efforts to raise domestic revenue.

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