

PROJECT INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

Report No.: PIDA24119

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| Project Name | Somalia Recurrent Cost & Reform Financing Project - Phase 2 (P154875) |
| Region | AFRICA |
| Country | Somalia |
| Lending Instrument | Investment Project Financing |
| Project ID | P154875 |
| Borrower(s) | Federal Government of Somalia, Government of the Federal Republic of Somalia |
| Implementing Agency | Ministry of Finance, Ministry of Finance, Interim Jubba Administration |
| Environmental Category | |
| Date PID Prepared/Updated | 27-Mar-2015 |
| Date PID Approved/Disclosed | 04-Feb-2017 |
| Estimated Date of Appraisal Completion | |
| Estimated Date of First Grant Approval | 25-Jun-2015 |
| Appraisal Review Decision (from Decision Note) | Appraisal is after Decision Meeting based on the Fragile Country guideline |

I. Project Context
Country Context

1. Somalia has been in conflict for over twenty years. Since the collapse of the Siad Barre government in 1991, southern Somalia has experienced cycles of conflict that fragmented the country, destroyed legitimate institutions and created widespread vulnerability. Between 1988 and 1993, civil war destroyed Mogadishu and Hargeisa, resulted in massive civilian deaths and exacerbated the 1991 famine that had thousands of victims. Peace conferences finally led to the formation in 2000 of the Transitional National Government, and then the Transitional Federal Government in 2004, though a still unconducive environment for constructive and productive development. In 2012, there was a peaceful and legal transfer of power from the transitional to a full-fledged federal government in Mogadishu, with a four-year term under a provisional constitution approved by an appointed parliament. This generated domestic political momentum and triggered international re-engagement. Regional countries and international actors have strengthened their efforts to support and sustain this window of opportunity, endorsing a New Deal for Somalia at the September, 2013 Brussels Conference and pledging \$2.4 billion against a set of five priority Peace-building and State-building Goals (PSG) set out in a Somali Compact (Compact) and the Somaliland Special Arrangement (SSA). The Compact preparation process sought to be inclusive of Somalia's different regions and communities and also establishes a new aid framework

- the Somalia Development and Reconstruction Facility (SDRF) which provides a single governance platform for coordinating international assistance with Compact priorities delivered through windows administered by technical agencies (including the World Bank).

2. In contrast to the war-torn south, northern areas have put in place functioning institutions that have succeeded in sustaining stability although considerable development challenges remain. Somaliland and Puntland have developed hybrid forms of governance, which have guaranteed higher levels of peace, security and institutional development. While substantial development challenges remain, the starting point for development work is nevertheless different in the north.

3. Somalia has experienced a rapid, fluid and complex process of political agreements on emerging federal member states. The Federal Government of Somalia (FGS) is leading political dialogue with regional entities as a basis for incremental state formation within a federal model. Starting with the August 27, 2013 Addis Ababa agreement on the formation of the Interim Juba Administration (IJA), this process has contributed to pressure on the FGS to articulate a framework within which Somalia's resources, including international assistance, are shared between the levels of government-- in line with agreements on administrative and functional assignments. As a result of the de facto highly devolved revenue and expenditure assignments that have developed in Somalia, the delivery of basic public services currently takes place at a sub-national level. Similarly, the Puntland Charter that was enacted in 1998 specifies that Puntland is a temporary state that will be incorporated into Somalia as a federal state once a government is in place in Mogadishu. It was agreed that Puntland's priorities for revenue and public financial management reforms (2014-2016) should be taken into account in the Somali Compact and that Puntland's participation in the New Deal aid architecture was important - particularly in the Somali Development and Reconstruction Facility (SRDF).

4. With years of conflict and low investments in health, Somalia is ranked comparatively low globally on various health indicators and is off-track to achieve health-related Millennium Development Goals (MDGs). Globally, it ranks second highest for Total Fertility Rate (6.32), fourteenth lowest for life expectancy at birth (51), and second highest for Maternal Mortality Ratio (1,000 per 100,000 live births). Coverage of essential health services is very low in Somalia, with the contraceptive prevalence rate being 14 percent and skilled birth-attendance being 33 percent, as of 2011.

5. Despite the increase in the number of schools, enrollment and the pupil-teacher ratio since 2006 in both Somaliland and Puntland is far below the Sub-Saharan Africa average. In Somaliland, gross enrollment ratio (GER) at the primary level is forty-four percent, with the GER for boys and girls at fifty percent and thirty-eight percent respectively. Although the teachers' cohort has continued to grow, the Pupil Teacher Ratio (PTR) stands at 31:1, with significant regional disparities. The Gender Parity Index (GPI) increased from 2006, with the GPE as high as 0.75; and gender gaps continue at all levels in education sectors. The status of primary education in Puntland is quite similar to Somaliland. There's no data available on either completion rates or learners' achievements.

6. While transition rates from Grade 8 have increased, the increase in the number of pupils in primary schools, combined with limited investment in expanding secondary education provision, has resulted in a serious bottleneck. Over fifty five percent of children in the 6-13 age-group are out of school and about 21 percent of youth (age 14-29) are neither working nor in schools. Though Somalia is a young country, with over seventy percent of the population under the age of thirty and a growing youth population, there are inadequate education and skills-development programs to provide a second chance for out-of-school youth. This poses a huge challenge to the socio-economic development of Somalia. This challenges is further accentuated by gender disparities

especially in lower secondary schools with only twenty eight percent of girls transitioning to such schools.

Sectoral and institutional Context

7. Somalia's economy has been shaped by sustained conflict and remains vulnerable to shocks. In the absence of state regulation and institutions, a vibrant informal sector has developed, boosted by approximately US\$1.2 billion in annual remittances from the roughly one million Somalis living in the Diaspora. While the informal sector has thrived, the absence of regulation coupled with elite capture in key economic sectors undermines the inclusiveness of economic development. Overseas Development Assistance or ODA (including both humanitarian and development assistance), amounted to approximately US\$1.0 billion in 2012, but around two-thirds of this is humanitarian, especially in southern Somalia, and therefore has a more short-term emergency focus rather than providing for sustainable development.

8. Somalia's overall macroeconomic situation is very difficult to assess because of severe data limitations. Accurate national accounts data do not yet exist for the whole of Somalia. However, Gross Domestic Product (GDP) is currently estimated at approximately US\$5.20 billion, comprising US\$1.60 billion for Somaliland and US\$3.7 billion for southern Somalia, including Puntland. Public expenditure is estimated to account for 6.5 percent of GDP, compared with private sector consumption of 138 percent of GDP; agriculture and services are the key contributors to GDP. Somalia's trade deficit is estimated to have grown in recent years, reaching more than US\$2.50 billion in 2014, up from US\$165.0 million in 2000 (financed by assistance and remittances). Imports consist mainly of manufactured and petroleum products from regional trading partners. The economy is largely dollarized and the Somali shilling, used only for smaller transactions, is volatile and appreciated against the dollar in 2013 with inflows of investment and aid. The shillings in circulation are old, depreciated and, in some instances, counterfeit, which limits their use in transactions. With little or no control over the domestic money supply, and little foreign reserves, the Central Bank has no influence over the exchange rate.

9. Revenue forecasts in the 2014 FGS budget were unrealistically high when compared to both 2013 and 2014 outturn. The 2014 budget revenue projection was US\$188 million, a 60% increase from the 2013 outturn of US\$117 million. The preliminary revenue outturn for 2014 was US\$151 million, a shortfall of \$37.20 million or 20% on budgeted levels. However, revenue increased by 29 percent (US\$33.90 million), in nominal terms over 2013 figures. The increase was as a result of tax revenues, which increased by 23 percent (US\$14.80 million), and non-tax revenue that increased by 302 percent (US\$12.60 million). Taxes on income, good and services, and trade increased by 54, 51 and 20 percent, respectively, in 2014.

10. Both domestic revenues and donor funding have under-performed relative to projections in the 2014 budget-- by 16% and 25% respectively--, but the latter has been far more unpredictable. Monthly revenue figures show that on-treasury donor funding was highly unpredictable during 2014, undermining budget execution. Donor funding averaged US\$4.80 million per month, but varied from lows of US\$50,000 – US\$100,000 per month to highs of US\$8.20 million-- US\$8.30 million per month. Domestic revenues were more predictable, averaging US\$6.50 million per month during 2014.

11. Monthly expenditures have closely matched monthly revenues during 2014 reflecting the cash-based nature of budget management. Expenditures have averaged US\$12.52 million per month, while revenues have averaged US\$12.61 million per month. Budget figures to the end of October, 2014 suggest that total monthly expenditures on compensation of employees (including security sector allowances), amount to an average of US\$6.40 million per month (excluding January when no salary payments were made). This mainly comprises wages and salaries at US\$2.0

million, and allowances at US\$4.30 million. In September, 2014, the RCRF reimbursed US\$1.40 million in compensation to employees (both wages/salaries and allowances of eligible civil servants), equivalent to 57.5% of the budget level and 71.7% of actual monthly spending on wages and salaries.

12. The major spending organisation during 2014 was the Armed Forces, with 23.0% of the budget and 28.8% of actual spending, or US\$43.3 million; with over half accounted for by allowances (US\$20.90 million or 54%). Total monthly expenditure by the security sector as a whole amounted to approximately US\$3.60 million, of which US\$2.70 million was spent on compensation of employees (predominantly allowances), and US\$2.60 million was spent on non-salary recurrent costs.

13. The build-up of arrears signals a lack of expenditure control and undermines the cash budget. Arrears at the end of 2013 were US\$30.4 million (16.1 percent of the budget), which were carried into the 2014 budget. However, only US\$1.3 million was paid in 2014 and an additional US\$13.8 million accrued, mostly on wages and salaries of FGS employees. The build-up of arrears is not a good signal and affects service-delivery. The full extent of arrears is not known, but it can be roughly estimated by taking the difference between the US\$91.0 million budgeted for compensation for employees and the actual amount as an estimate, as wage estimates are usually closer to the actual. As of the end of 2014, the estimated stock of outstanding arrears was US\$43.0 million (the stock of arrears as of the end of 2013, minus net repayment of US\$1.3 million and a new accrual of US\$13.8 million).

14. Revenue estimates in the 2015 budget again appear unrealistic, projected at US\$240.0 million (US\$88.7 million or 59% above 2014 preliminary collections). Projections bear little link to realized collections in 2014, with limited underlying action planning to support increased collections. While some progress has been made in that the budget is nominally balanced (compared to an unfinanced shortfall of US\$28.0 million in the 2014 budget), the inflated revenue figures conceal a continued structural, fiscal shortfall. A more 'realistic' revenue scenario would see total revenues for 2015 estimated at US\$155.0 million, US\$64.0 million less than the draft budget.

15. In line with revenue projections, expenditure is projected at US\$240.0 million in the 2015 budget, an increase of US\$88.98 million on 2014 estimated outturn (60%). The main components of the increase in expenditure are: (i) a 42% (US\$32.2.0 million) increase in compensation of employees; (ii) a 40% (US\$22.9 million) increase in goods and services; (iii) a 1,280% (US\$15.7 million) increase in repayment of arrears and advances. These increases are unlikely to be fully realized during budget execution due to anticipated revenue shortfalls.

16. The increase in compensation of employees is particularly important to understand, because these expenditures will be non-discretionary-- if not paid they will constitute arrears obligations. The increase is driven by a US\$12.0 million increase in compensation of employees between the 2014 and 2015 budgets, comprising: (i) a US\$2.0 million increase in wages and salaries, including a planned 20% increase in the number of civil servants from 3,756 to 4,508; (ii) a US\$10.0 million increase in allowances concentrated on 15 organizations, with security sector organizations receiving the biggest increases.

17. Assuming that the realistic revenue projection is realized, the FGS will receive an average of US\$16.20 million per month (US\$195.0 million per year). There will therefore be a significant shortfall (US\$45.0 million), requiring cutbacks to expenditures through 'cash rationing' during budget execution, although revenues would be adequate to meet budget levels for compensation of employees (including security sector allowances), which will amount to a maximum of US\$109.40 million (US\$9.1million per month), if the budget is fully implemented. In practice, extrapolating from experience in 2014, actual expenditures on compensation of employees will likely be

approximately 85% of budgeted levels, likely because of unfilled posts. Assuming the same 85% budget execution rate for compensation of employees during 2015, monthly cash expenditures on employees could be around US\$7.7 million per month, or about 47.5% of monthly revenue under the realistic scenario. Approximately US\$102.0 million would then remain (after paying wages, salaries and allowances) to finance other parts of the budget. Revenues would cater for Goods and Services (budgeted at US\$80.5 million), Grants (budgeted at US\$16.0 million) and Contingencies. However, budget funds would not be enough to cater to repayment of arrears of the order of US

18. The extent of further accumulation of arrears during 2015 will depend in large part on how quickly commitment controls can be introduced into the payment process and SFMIS during 2015. The strengthening of non-salary payment process controls is therefore of huge fiscal importance as well as being an important milestone for the strengthening of the PFM system. Since revenues are likely to fall short of the legally appropriated expenditure levels, and in the absence of commitment controls in fiscal year 2015, further arrears accumulation seems likely.

19. For fiscal responsibility and sustainability, the FGS need to rapidly revise its 2015 revenue projections and reduce expenditures accordingly-- if the assumptions used to make the budget projections have changed with the new government in place. In parallel, the Federal Government need to develop a clear action plan to support improved revenue collection. A strong focus on revenue mobilization, with adequate action planning and the required human and financial resources, could result in significant revenue increases. However, this will not happen without concerted action; thus, an FGS revenue assessment is planned for 2015. The objective would be to assess the priority needs for improving tax mobilization; including, sequencing and a timetable and likely resourcing implications for reform actions sufficient to provide an adequate revenue base for FGS.

20. The Appropriation Act for the 2015 budget provides for 4,496 civil servants. In addition to the public workforce captured in budget documentation, there are significant off-budget workforces with significantly greater geographic dispersion than those currently on budget. This includes donor-funded health and education workers. In the case of education, the Global Partnership for Education (GPE) pays X number of teachers through a government payroll process managed by the Ministry of Education, making payments through M-Money and banks, and checking teachers' attendance by telephone, thereby overcoming the challenge of paying geographically dispersed officials. In the case of health, workers are paid through implementing partner agencies.

21. However, the Ministry of Health assumed responsibility for paying Regional and District Health teams, funded by the Joint Health and Nutrition program (JHNP), and will need a payroll solution to be developed for these staff, possibly involving their incorporation into the FGS payroll. There are an estimated (1,000) health service delivery staff in Somalia as a whole, comprising: (i) around 600 funded by NGOs (198 known, 400 estimated); and, (ii) around 400 to be funded through JHNP NGO implementing partners. The Ministry of Health also pays a number of central staff on a contract/off-budget basis..

Payroll System in FGS

22. Monthly payroll processing currently involves Ministries, Departments and Agencies (MDAs) submitting pay lists in hard copy to the Ministry of Finance. These submissions are subject to multiple manual checks, first by the Accountant General's Department against both the annual budget, and against a list of civil servants provided by the NCSC. The Auditor General's office also performs a check on these pay lists. Once checked, the Accountant General forwards the pay lists to the Central Bank of Somalia (CBS). The CBS is responsible for payroll execution, and provides a final check with civil servants required to present a photographic identification (ID) card and provide finger print identification through a biometric system to collect their monthly salary

payment in cash. Changes to pay lists to reflect new hires, deaths, promotions and other changes require manual alterations to lists in three different places: the Ministry or Department; the NCSC; and CBS. The system is therefore characterized by multiple duplicative payroll checks, and time consuming manual reconciliation exercises. There are also issues arising from weak interfaces between agencies, poor quality registries, and a lack of systematic time and attendance information, precluding the alteration of salary payments owing to non-attendance at work. The current legislative framework does not provide for adjustments to salaries based upon time and attendance. The salary payroll system and process is given in Figure 1 below.

23. A number of incremental payroll and human resources reforms are planned and under implementation. In 2014, the SFMIS was expanded to include a payroll module. This will help to automate the process within the Ministry of Finance, generating checks automatically and strengthening the payroll execution process. The human resources module that will be added to the SFMIS will be administered by the National Civil Service Commission (NCSC) and will automate the management of the master 'nominal roll' of civil servants. Further work under the Capacity Injection Project will define civil service jobs and those of the new Subject Matter Experts (SMEs) to be financed under the project. Terms of Reference and job definitions have been defined for the existing SMEs. Work has been initiated by the NCSC to track the competition for the various SMEs by looking at and reviewing competitive rates for various job descriptions within Government (in-country and among the various bilateral and NGOs that hire qualified Somalis from the Diaspora). This is expected to set the salary range (pay and perquisites) for future projects.

II. Proposed Development Objectives

The Development Objective of the project is to support the government to provide credible and sustainable payroll and to establish the foundation for efficient budget execution and payment systems for the non-security sectors in FGS and eligible interim and emerging states.

III. Project Description

Component Name

Support to Core Government Functions of MDAs in FGS

Comments (optional)

Component 1: Support to Core Government Functions of MDAs in FGS (US\$84.00 million). The project will finance: the salaries of eligible non-security sector civil servants in the MDAs; the cost of staff injected under the capacity injection mechanism (CIM); an incentive payment linked to the achievement of agreed annual revenue targets; and non-salary operating costs for MDAs.

Sub-Component 1:1: Financing of Eligible Civil Service Salaries in non-security sectors

Sub-Component 1:2: Financing of Salaries and Allowances to Government staff and young graduates recruited under the Capacity Injection Mechanism (CIM)

Sub-Component 1:3: Financing of Eligible Non-Salary Recurrent Costs for MDAs

Sub-Component 1.4: Incentive Payments linked to achievement of annual revenue targets

Component Name

Intergovernmental Fiscal Transfers to Core Functions of Sub-National Authorities

Comments (optional)

RCRF sub-national financing will reward accountable and transparent government in line with RCRF broader principles. Regions and federal member states will need to comply with clearly defined 'Readiness Criteria' before receiving financing. These criteria are currently under discussion and consultation, and will cover the following dimensions: (a) macro-fiscal, including fiscal assessments such as the one currently underway in Puntland; (b) PFM; (c) public administration;

and, (d) social service delivery impact It is expected that RCRF financing would be accompanied by matching funds for targeted service delivery expansion.

Component Name

Support of Recurrent Costs in the Health and Education sectors

Comments (optional)

The project would support the FGS, Puntland and IJA to expand their service delivery systems through improvement of accountability systems and support of recurrent costs in the education and health sectors. The specific activities include financing: (i) the set-up of basic accountability systems in both sectors in year (US\$3 million); (ii) eligible salaries and allowances for teachers and health workers (US\$14 million); and, (iii) eligible non-salary recurrent costs in the sectors (US\$4 million).

Component Name

Project Management and Coordination

Comments (optional)

The component would support coordination, administration, communication, management, procurement, monitoring and evaluation (M&E), as well as impact-evaluation, auditing and dissemination of project activities in FGS, Puntland and the IJA. It would finance dedicated staff to cover administration, M&E, financial management, procurement and communications. It would also support efforts to develop and strengthen the Fiduciary Sections of the Offices of Accountant General in FGS, Puntland and IJA regional governments through the financing of equipment, furniture and fillings, capacity building, technical assistance, non-salary recurrent costs, and other inputs as required.

IV. Financing (in USD Million)

| | | | |
|---|--------|-----------------------|---------------|
| Total Project Cost: | 144.00 | Total Bank Financing: | 0.00 |
| Financing Gap: | 0.00 | | |
| For Loans/Credits/Others | | | Amount |
| Borrower | | | 0.00 |
| Free-standing TFs AFR COUNTRY DEPARTMENT, South 2 | | | 144.00 |
| Total | | | 144.00 |

V. Implementation

66. The RCRF Phase II project implementation arrangements will draw heavily on those developed under the RCRF Phase I Project in FGS. The project will maintain an Oversight Board, an Operating Team, an External Assistance Fiduciary Sections (EAFS) in FGS, Puntland and IJA, and an Independent Monitoring Agent under the MPF umbrella. The project will be supported by the DFID and leverage the UK Stability Fund to pilot IJA salaries in year 1.

VI. Safeguard Policies (including public consultation)

| Safeguard Policies Triggered by the Project | Yes | No |
|--|------------|-----------|
| Environmental Assessment OP/BP 4.01 | | x |
| Natural Habitats OP/BP 4.04 | | x |
| Forests OP/BP 4.36 | | x |
| Pest Management OP 4.09 | | x |

| | | |
|--|--|---|
| Physical Cultural Resources OP/BP 4.11 | | x |
| Indigenous Peoples OP/BP 4.10 | | x |
| Involuntary Resettlement OP/BP 4.12 | | x |
| Safety of Dams OP/BP 4.37 | | x |
| Projects on International Waterways OP/BP 7.50 | | x |
| Projects in Disputed Areas OP/BP 7.60 | | x |

Comments (optional)

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