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Somalia Vision for Private Sector

Mr. Peter Middlebrook, Mr. Hussein Siad, Dr. Hussein Haji, and Mr. Abdisalan Artan

Introduction and Background

The private sector should emerge as the primary engine of growth and employment in Somalia. However, for that to happen, the current over dependence on the 'enabling environment' ideology must be complimented with significant investment in market-based infrastructure. Only then can the vacuum created by an economy devoid of both rules and infrastructure be bridged. As a result, the background study does not deploy a standard business environment or investment climate approach, but instead it delivers four emerging thematic areas that will be critical to filling the current vacuum: economic corridors, special economic zones, financial markets and value chains. The study therefore explores the importance of (i) regional resource corridors (ii) special economic zones (iii) financial markets and (iv) agricultural value chains in powering the engine of growth, around an 'anchor', 'ancillary' and 'spinoff' investment framework.

The study therefore covers macro (i.e. policy and regulations), meso (i.e. institutional) and micro (i.e. firm level) levels. It pushes the idea that private sector expansion cannot happen in a vacuum, and instead, improving the foundations for growth are essential for an expansion in private capital. For example, should the new US$ 15. 9 billion Horn of Africa Initiative move towards implementation, major anchor and ancillary infrastructure developments will open up markets and provide completely new opportunities for the private sector. This is not just in terms of forwards and backwards linkage, but also in terms of direct growth and employment multipliers. If a major shift is going to occur in terms of private sector investment, the provision of public goods will be essential.

The study is supported by the results of a rapid firm level survey, providing qualitative insight on issues such as access to financial markets, power, corruption and trade, from which the authors can understand how the private sector views the 'risks' and 'rewards' framework in Somalia, and importantly, how public private dialogue can be improved.

The principal objective of the study is therefore to document the current state of the private sector; assess the key challenges facing the operations of private sector; the state economic regulations and the government's involvement in major economic activities and sectors; as well as the promotion and facilitation of private sector investments, and generation of a productive employment. The specific objectives include the following:

- a complimentary approach to supporting the expansion of the private sector;
- the potential for economic corridors and special economic zones;
- the challenges and opportunities for financial markets development;
- the potential of value chain constraints;
- the role of Government in facilitating and boosting private economic activities; and,

- a complimentary approach towards a new vision for the private sector.

The authors believe that for public investment – and investments supported by institutional investors – to be more effective, the entire planning process for the Somalia economy must be refigured. Over the course of the past decade, many billions of dollars have been committed to assist in kick starting the economy, and yet, impact has only been modest at best. The approach argued for here, would provide more catalytic impacts, and allow a large cohort of enterprises to emerge as part of what is called an enterprise-led development approach. Given government's weak fiscal capacity, leveraging private capital has never been more important. For this to happen, the new approach to development financing must be more actively deployed to support major anchor and ancillary investments, as has begun to emerge through the recent Horn of Africa Initiative.

Anchor, Ancillary and Spinoff Investments

Most private sector development approaches focus on improving the business regulatory environment. This approach comes from the perception that what largely impedes the expansion of private capital is sub-optimal policy, regulatory and institutional practices, lack of energy, human resources and other factor inputs such as finance. However, in order for the private sector to be given the chance to emerge as the engine of growth, both 'hard' and 'soft' infrastructure is required. A body cannot stand tall without a skeleton! In this context it is important to note that market development can only occur when the rules of the market are agreed and established and when the necessary infrastructure is in place to allow products and services to be supplied across markets; near and far. Currently however, lack of internal and regional markets integration undermine the potential of private sector demand and supply equivalence.

Although there are many ways of planning an economy, it is useful to think about linking anchor, ancillary and spinoff investments together, rather than each Ministry developing its own discrete set of projects that never fully has the multiplier impact required. For example, as Somalia develops its regional trade corridors and ports, a wider range of ancillary services can now build on this infrastructure. Power, water, ICT, law and order and other ancillary services now have a location, a purpose, and market demand. A port or special economic zone (for example) requires resources to be established, but once established, it also allows whole new sets of productivity to be enabled.

Of course, anchor projects need anchor investors, as do ancillary projects. As a result, part of the economic planning process involves clarity of resource mobilization and investment governance. In this context, international work has demonstrated that the 'total investment returns of individual projects' are more than the sum of the 'individual projects' if certain investments are grouped, prioritized and sequenced in a particular way. (*Geopolicity/US State, 2010*). The authors therefore assume that the goal of regional infrastructure development is to facilitate the spatial organization of economic activity as a catalyst for faster growth.

The evidence that supports the stated economic conclusions includes:

- **Regional Integration Impact**: ADB estimate that regional trade benefits in South Asia increase the Economic Rate of Return for related regional investments by 3.5 per cent1 and that the impact of infrastructure investment on productivity depends more on the size of a country's infrastructure network than on its level of development. *(See ADB Institute, 2009)*

- **Trade Cost Reduction Impact**: A similar study estimates that the accumulated reduction in trade costs resulting from 'infrastructure' and 'communications' investment between 2010 –2020 to be 11.5 per cent and 12.1 per cent respectively, for Central Asia. *(See ADB, 'Infrastructures for a Seamless Asia', Pg. 118)*

- **Road Corridor Impact**: A road network project in Kazakhstan aims to create a corridor throughout Kazakhstan, helping to link Uzbekistan and the Kyrgyz Republic with the Peoples Republic of China (PRC). ADB calculate a GDP growth premium of 3.19 per cent of baseline GDP by 2015, with significant GDP gains to countries as far as EU (0.27 per cent) and the US (0.15 percent). *(ADB, 'Infrastructures for a Seamless Asia', Pg. 97)*

- **Trade Related Income Impact**: Regressing countries' income per person on their trade share (trade between countries) as well as their size (within-country trade) shows that the trade elasticity of income is about 1.4, that is, a 1 per cent increase in the trade share on average raises a country's income per person by 1.4 per cent. (ADB, Economics Working Paper No. 234). In Thailand, around 40 per cent of survey respondents associated electricity with increases in income (Chatterjee et al. 2004). In India, poverty rates were lowest for households near good roads and with electricity, and highest for households with neither *(ADB, 2004)*.

- **Trade Creation and Network Externalities**: Regional integration increases access to a wider selection of goods and services at a lower cost due to decreasing transaction costs. The main economic benefit of regional infrastructure therefore derives from the development of network externalities. *(ADB, 2010)*

The authors see the primary set of anchor investments as the proposed regional trade and resource corridors. From such anchor investments, a host of other hard and soft infrastructure can be positioned to transform local economies. Moreover, given that regional trade demands the use of harmonized systems, lowering transaction costs and regulatory friction, such corridors carefully balance hardware with software. For example, should one day Somalia seek to export certain agricultural products to the rest of the Horn of Africa, not only is the product quality control, aggregation, certification, packaging, cold storage and marketing required, so is a formal trade regime where the rules of importation and exportation are made clear to all parties. Without storage and product transportation, the entire value chain will only extend to local markets, denying producers a potential price dividend in markets wider afield. In other words, market development must be planned, and cannot be assumed to emerge from a chaotic trading system.

Project level analysis alone does not explicitly analyze an investment's distributional impact, although grouping investments within an **'anchor, ancillary and spinoff'** framework provide for considerable upstream and downstream benefits. Such benefits include:

- **Indirect impact**: anchor and ancillary projects spend money on upstream and downstream goods and services;

- **Spillover Impact**: anchor projects provide demand for the infrastructure services needed to operate and maintain the ancillary projects;

- **Catalytic Impact**: anchor and ancillary projects improve the productivity of local Micro to Small Medium Enterprises (MSMEs) allowing them to increase value addition; and,

- **Imputed Impact**: anchor projects yield net government revenues, allowing continued investment in infrastructure services.

Analysis confirms that infrastructure investment and development are strongly correlated. Connective infrastructure reduces the economic distance between locations—the time and cost of trading between them—and thus expands and the markets. Somalia's future growth prospects are therefore heavily dependent upon physical integration within the wider region.

Such an approach supports positive multipliers. The integrated approach ensures that positive impacts from one investments have far greater effects over space and time. Large scale infrastructure generally has a lifetime of 30 years or more, meaning that the multiplier effect will also continue over such a period too. When investments are grouped – such as when a special economic zone provides power, water, financial and trade services – the direct, indirect, induced and catalytic impact begins to work in favor of the economy.

Conclusions

The new vision for private sector development in Somalia must be radically different from international consensus, which has led to a focus on business and investment climate reforms in the hope of creating an enabling environment for growth. However, outside of financial markets and telecoms – both of which have benefited from strong external regulatory interests - enabling conditions simply do not exist. There are very few public goods, and firms therefore to pay the full cost of market and price discovery. This makes firms uncompetitive, which undermines rewards (profits) and increases risks (costs).

There are a number of major problems with the blind application of international practice in the Somali context, as summarized below:

- **The Private Sector Cannot Develop in a Vacuum**: In the absence of critical public goods, where market-based infrastructure (hard and soft) provide a foundation for businesses to operate, risks outweigh rewards. Most foreign direct investment in Somalia for example is strategic in nature (i.e. sovereign investment around ports etc.) or companies operating in Somalia with so- called sweetheart deals. So far, there are very few long-term investors.

- **Success in Financial Markets and Telecoms Tells Us Little**: Success in expanding financial markets and telecom operators is often touted as two examples of success. However, both of these sectors have links with security and stability and they have therefore been afforded considerable support. Neither sector is a large employer. The main employment sectors of the economy (i.e. agriculture, construction etc.) continue to lag behind expectations and remain hugely underinvested.

- **Public Private Dialogue (PPD) has a Limited Value Unless it has a Context**: Undertaking public private dialogue is important to strengthen public policy and to improve public and private coordination. However, PPD is most effective when it has a specific sector, program or project under discussion. For example, PPD around the Horn of Africa Initiative might focus on how to improve the catalytic and spinoff effects of anchor and ancillary infrastructure, therefore providing a very practical example that is focused on a clearly defined set of interests.

- **Public Private Partnerships are a Key Policy Tool, But Reform Pace is Slow**: As government fiscal challenge (s) are likely to remain for many years to come, the role of concessions in many sectors must be increased. Sectors such as education, health, agriculture, infrastructure, power, municipal waste and water can all benefit from Public Private Partnerships, allowing private capital to support the expansion of these sectors. For this to happen, government capacity in this space must be boosted. A PPP law, policy, regulations and a PPP Unit must be established, alongside a pipeline of projects where transaction advisory can assist in taking procurement of PPP projects to the market. Given the costs of energy, its ranking as a constraint by the private sector, unleashing PPPs in the energy space with the support of development finance institutions appears critical

- **De-risking Private Equity Has Yet to Begin**: In the absence of public goods, the only way to tip the balance of risks to rewards in favor of rewards is to de-risk private capital. There are a wide range of models that can be deployed to achieve this approach, including blended financing modalities for sectors, catalytic first loss capital, export credits and even subsidized financial products targeted at specific sectors.

Trying to foster an enabling environment for the private sector requires considerable investment in both hard and soft market- based infrastructure. Moreover, if hard infrastructure (i.e. ports, roads, product storage, packaging etc.) is lacking, a narrow focus on improving laws and regulations will not overcome the main hurdles being faced by enterprises. The proposed Horn of Africa Initiative provides a considerable opportunity to fill this vacuum by investing in economic corridors, electricity and ICT, however, the absence of special economic zones, industrial processing zones and spinoff investments for small to medium enterprises undermines the impact that this effort may have on the wider economy. The importance of conducting focused PPD around the Horn of Africa Initiative in order to improve catalytic and spinoff impacts should not be understated.

Recommendations

Specific recommendations reached through the research provide above are as follows:

- Once an anchor investors has decided to finance a major project, it is critical that government considers how best to multiply the impact of that investment, in terms of direct, indirect, induced and catalytic impacts. Building special economic zones or industrial processing zones for agricultural processing alongside major trade corridors amplifies the impact of the anchor investment.

The proposed corridors will take years to put in place, and given that they are regional in nature, the costs and benefits of the investments need to be clearly defined, including attribution of costs on the Somali side. Corridor governance for these projects will need to be carefully considered, as well as the options for concessions to manage the corridors. The central role of the private sector as potential concession holders must be fully explored, thus increasing the role of the private sector.

- There is currently very limited experience in special economic zones in Somalia, which can play a critical role in supporting business formalization, and in creating centers of excellence that becomes cash cows for the economy. Given the lack of capital and capacity in government, PPP would appear to be the primary modality to take this forward. Should SEZ and industrial processing zones be established, a large number of domestic and foreign companies are likely to seize the opportunity to invest, increasing the impact on productivity and employment.

- The governance of the financial sector in Somalia remains very much in its infancy, and the capacity of the Central Bank (CBS) must be improved on the monetary policy side, its role vis a vis shaping primary and secondary capital markets and fostering inclusion must be highlighted. In terms of retail banking there are a wide range of financial products demanded by producers, traders, product developers, marketers and export in the agricultural sector. Government must work with finance sector to improve financial inclusion in order to get financial markets to work more effectively for enterprises and for the poor. Similarly, over the longer term the full range of Islamic financing products will need to be strengthened.

- Survey results show that private sector constraints that should be urgently addressed include insecurity, high costs of finance, lack of access to permanent and affordable energy, weak human resources and a complete lack of public goods in the market development space (i.e. feeder roads, cold storage etc.). While efforts to increase market-integration are important – lowering input costs and increasing output gains and profitability – so are efforts to develop a viable export base beyond livestock and fisheries. The SMEs sector could emerge as one of the drivers of growth and jobs creation across productive, industrial and service sectors. For that to happen, the 'public goods vacuum' needs to be filled and plans must be made to maximize the potential spinoff and catalytic impact of the various mega projects that are planned.

- The power of the private sector, to be more responsive to the potential upside gains of market expansion makes good sense. Economic corridors and ancillary investments such an SEZ and small-scale industrial processing can assist in transforming productivity, and profitability. The Horn of Africa Initiative needs to move from planning to execution. Along that path, the opportunity exists to fill the vacuum in public goods around which the private sector will naturally play its value-addition role.