HIRSHABELLE STATE OF SOMALIA

Public Financial Management Law, 2018

Applicable from

31 March 2018

Instruction B –
Fiscal Impact Analysis for Introduction of New Legislation

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1. Authority, Purpose & Scope

1.1 This Instruction is issued pursuant to Section 13, Paragraph 2 of the Public Financial Management Law, 2018.

1.2 The purpose of this legislative requirement is to encourage a rigorous examination of the impact of proposed legislation on government revenues and expenditures. Fiscal impact analysis helps connect policy, implementation planning, economics and public financial management by estimating the economic and fiscal (revenue and expenditure) impact of either a) proposed projects, policies, or tax changes on new government revenues and new expenditure over a defined period of time or b) on-going government operations on the State's jurisdiction. Conducting these analyses enables the comparison of revenue to costs associated with new legislation, encouraging a debate around whether the State government can meet new demands for services, or must raise revenues to meet new service demands. This analysis is critical to bringing a realistic, objective sense of the cost of legislation into the policy discourse.

1.3 The purpose of this Instruction is to provide guidance regarding the nature of fiscal impact analysis to be conducted and the process of validating the identified fiscal impact of proposed legislation. This instruction also authorizes the Economic Analyst within the Ministry of Finance to work alongside Ministries developing new legislation, or amendments thereto, to develop fiscal impact analysis reports.

1.4 This Instruction is directly applicable to all government agencies, that are funded from the Consolidated Fund, proposing new legislation or amendments to existing Acts.

2. Instructions

2.1 A fiscal impact analysis must accompany all proposed legislation submitted to the Legislature for approval. These analyses must endeavor to present an unbiased assessment of the impact of proposed legislation on new government revenues and expenditures.

2.2 The Economic Analyst in the Macro-Fiscal Unit is accountable to the Minister for providing a critical review of fiscal analysis reports accompanying proposed legislation. In

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the instance where proposed legislation is put forward by the Ministry of Finance, the Economic Analyst shall conduct the fiscal impact analysis.

2.3 Section 3 of these instructions present suggested methodologies for conducting fiscal impact analysis. This section is brief as the Ministry refers to established handbooks and manuals for conducting fiscal impact analysis and economic analysis in Section 4, and instead identifies methods determined by the Macro-Fiscal Unit to be most appropriate given our data and resource constraints. Section 5 provides the structure and required information to be presented in the fiscal impact analysis accompanying all proposed legislation, Section 6 provides a description of the process to be used by the Macro-Fiscal Unit in reviewing fiscal impact analysis reports and finally, Section 7 provides details regarding interim provisions regarding the development of fiscal impact analysis reports.

3. Methodology for Conducting Fiscal Impact Analysis

3.1 Fiscal impact analysis examines the net fiscal impact of a proposed legislation by estimating the additional public resources required to meet new expenditures necessary to meet the legislation's policy objectives. Three methods for calculating expenditures have been identified as feasible approaches to conducting fiscal impact analysis, drawing from existing best practices while keeping in mind the scarcity of critical population, GDP, inflation, and unemployment statistics at the State level by the Ministry's Macro-Fiscal Unit. Those preparing a fiscal impact analysis should select an appropriate methodology for estimating revenue and expenditure and their selection in the fiscal impact analysis report (below). Methodologies used in fiscal impact analyses may deviate from these methods, but should highlight reasons for doing so in their justification.

3.2 *Calculating Revenues*: Revenues to be considered are identified in the State's Revenue Law. Those preparing fiscal impact analysis are referred to Schedules 1 – 5 of the Revenue Law, and Schedule 3, where all legal current fees and rates of taxes are provided. New government revenues required to implement proposed legislation must consider the existing tax framework, and furthermore must account for the costs (expenditure) of collecting these new revenues. Past revenue data, including revenue outturns, are available on the Ministry's public website and by request from the Revenue Department.

3.3.1 *Calculating Expenditures – Average Costing Methods*: Typically, the most often used of fiscal impact analysis methodologies, average costing methods assign costs to proposed

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legislation based on current average costs of providing associated services per unit (i.e., per capita, per household, per student, or employee) multiplied by the number of new service units. This method is most appropriate when proposed legislation represents an increase in existing government services. The per capita multiplier technique, service standard technique, and proportional valuation technique are the forms of average costing methods.

3.3.1.1 *Per capita multiplier technique* – Legislation-induced costs are determined by multiplying the new per capita government expenditure (including but not limited to compensation of employees, use of goods and services, other expenses, grants, social benefits, assets and liabilities) by the total number of people, employees, and clients affected by the proposed legislation. Average costs of government operations per capita and per client are good estimates of future operating costs stemming from proposed legislation over the medium to long term.

3.3.1.2 *Service standard technique* – Legislation-induced costs are determined by examining the total number of additional government employees by civil service grade required as a result of proposed legislation, along with the annual capital expenditure outlays necessary to support this growth in government employment. This technique is most appropriate when proposed legislation creates an increased demand for public employees.

3.3.2 *Calculating Expenditures – Marginal Costing Method*: Marginal costing methods often require qualitative judgement to estimate specific changes in government revenue and expenditure expected from proposed legislation. Nevertheless, given the scarcity of available economic data, the following technique is generally a more feasible method for conducting fiscal impact analyses in the Hirshabelle state of Somalia. This method requires a more localized appreciation of existing supply of and demand for public goods and services but provides a more realistic estimate of new revenues and expenditures than average costs derived from partial or poor data.

3.3.2.1 *Case study technique* – Case study analysis relies on semi-structures interviews with public officials to assess plans to expand or maintain local provision of public goods and services, and then determine whether the proposed legislation addresses either excess or deficient service provision. This technique offers unique insights into the immediate and long-term impacts that other methods may not provide, although its accuracy is constrained

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by the ability of interviewees to predict the consequences of proposed legislation on government revenue and expenditure.

4. Established handbooks and manuals for conducting fiscal impact analysis

4.1 A wide range of techniques and methods exist for determining the impact of proposed legislation and project decisions on government revenues and expenditures. Instead of replicating that work in these instructions, the Ministry refers those preparing fiscal impact analyses to the two following handbooks available with the Ministry's Macro-Fiscal Unit by request.

4.2 *The Fiscal Impact Handbook*[1] - This handbook details six fiscal impact analysis techniques in a step-by-step format as well as providing recommendations for how these methods can be tailored to meet the local context. The six methods covered in this handbook are the per capita multiplier method, the case study method, service standard, proportional valuation and employment anticipation methods. As identified in Section 3 above, those preparing fiscal impact analysis should consider applying the per capita multiplier, service standard, and the case study method given the lack of reliable information available about GDP and employment statistics.

4.3 *Handbook on Economic Analysis of Investment Operations*[2] - While designed for impact investment firms, the methodologies presented in this handbook are applicable to the context of analyzing the fiscal impact of proposed legislation. The handbook provides readers with analytical tools that are grounded in economic theory, but practical and simple to apply, integrating financial, economic and fiscal analysis to enable decision makers to look at the merits of a legislation from the perspective of various stakeholders, particularly the government. The Handbook is presented to two parts – a main text and a Technical Appendix. The main text provides tools for fiscal and economic analysis and discussions on issues that commonly arise in the evaluation of policy in any sector. The Technical Appendix provides the necessary guidance to estimate effective costs. Those preparing fiscal impact

1 Burchell, R. W. and D. Listokin (1978). The Fiscal Impact Handbook: estimating local costs and revenues of land development, Center for Urban Policy Research, Rutgers University Press, 504 pages.

2 Belli, P. et al (1998). Handbook on Economic Analysis of Investment Operations, Operational Core Services Network Learning and Leadership Center.

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analyses are referred in particular to Chapter 1 (Overview of Economic analysis), Chapter 2 (Rationale for Public Provision), Chapter 5 (Getting the Flow Right: Identifying Costs and Benefits), Chapter 8 (Cost Effectiveness) and Chapter 13 (Gainer and Losers). For proposed legislation in health, education, and transport sectors, this manual also provides techniques for assessing policy within these sectors in Chapters 8 through 11. The Technical Appendix provides methods for estimating costs and expenditures using only a rudimentary knowledge of algebra and geometry, along with a basic understanding of concepts of supply, demand, and elasticity. The appendix also provides examples of how these concepts were applied to actual case studies.

5. Structure of the fiscal impact analysis report

5.1 While those preparing fiscal impact analyses accompanying proposed legislation may deviate from the methodologies presented above, they are required to produce a fiscal impact analysis report that accompanies the proposed legislation. The fiscal impact analysis report must follow the heading structure and clearly present information requested under the following headings:

5.2 *Proposal Description* - This section should provide a clear description of the proposed legislation, including but not limited to:

1. The jurisdiction being affected by the proposed legislation;
2. Government agencies charged with the implementation of the proposed legislation;
3. A list of policy objectives introduced by the proposed legislation;
4. A list of policy outcomes to be achieved by the implementation of the proposed legislation.

5.3 *Impact Estimation Methodology* - This section should state the selected methodology for estimating the fiscal impact used in the analytical report. It must provide a clear explanation of the process used to determine revenue and expenditure estimates associated with the proposed legislation. If the chosen methodology is selected from either handbook from Section F above, then the report must include a description of how the methodology was adapted to suit the local context and a description of how it was followed. Where alternative methodologies are proposed, a detailed description of the methodology and a further explanation of why the methodology is suitable for the analysis being conducted must be provided.

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5.4 *Thorough Review of Estimate Assumptions* - This section should provide a detailed review of assumptions underpinning revenue and expenditure estimates associated with the proposed legislation. This review should include but is not limited to:

1. Clear statement of assumptions made
2. Narrative justification of whether the assumption is true, providing evidence where possible to substantiate the justification
3. Identification of conditions or new developments which may undermine the validity of assumptions made
4. Where assumptions pertain to the availability of donor financing, these must be made explicit and any formal agreement (i.e., an MoU, commitment letter, etc.) must be included in the annexes along with a commentary of past accuracy and timeliness of the donor's disbursements.

5.5 *Fiscal Impacts* - This section should provide a detailed breakdown of all new government revenues and expenditures resulting from the adoption of proposed legislation. All estimates should be calculated on an annual basis (using the State's fiscal year, i.e., January 1 to December 31) for a period of ten years from the introduction of the proposed legislation. Estimates should be constructed based on four scenarios:

1. Baseline Scenario – the baseline scenario presents current government revenue and expenditure before the introduction of the proposed legislation. This information is readily available on the Ministry's website.
2. Scenario 1 – this scenario should present government revenue and expenditure with a 50% application of the proposed legislation in year 1.
3. Scenario 2 – this scenario should present government revenue and expenditure with a 100% application of the proposed legislation in year 1.
4. Scenario 3 – this scenario should present government revenue and expenditure with a gradual increase in application (i.e., a 25% application in year 2, a 50% application in year 4, 75% application in year 6, and 100% application in year 8).

This section should be further broken down into Revenue and Expenditure sub-sections. To facilitate comparison between the baseline and the three application scenarios, those preparing fiscal impact analysis must use the classifications and definitions of revenue and expenditure contained in the Government Financial Statistics Manual (2014). Utilizing this

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coding structure ensures that the analysis is comparable and that all analyses accompanying proposed legislation follow the same convention.

5.6 *Net Fiscal Impact* - This section should provide the calculations of net fiscal impact. Net fiscal impact is a simple calculation of total expenditures less total revenues. Based on the result, this section should identify whether the proposed legislation has:

1. A positive net fiscal impact – Net fiscal impact is greater than zero when total expenditures exceed total revenues. In this case, further explanation and analysis is required to determine how government will meet this revenue gap.
2. A negative net fiscal impact – Net fiscal impact is less than zero when total revenues exceed total expenditures. In this case, analysts need to consider how these surplus revenues will be spent given the State's balanced budget constraint.
3. No net fiscal impact – Net fiscal impact is nil when total revenues equal total expenditures. While possible, this is a rare case and fiscal impact analysis reports suggesting no net fiscal impact resulting from the adoption of proposed legislation will be subject to extreme scrutiny.

5.7 Annexes - This section should provide relevant supplementary information or underlying data used to prepare the fiscal impact analysis report. It must, at a minimum, contain:

1. Any background information, baseline assessments, needs assessments, or relevant documentation used to justify the development of the proposed legislation;
2. All underlying data and analytical workbooks used to prepare revenue and expenditure estimates;
3. Transcripts and lists of interviews of key officials or experts, where appropriate;

6. Process for reviewing fiscal impact analysis reports

6.1 Fiscal impact analysis provides a framework for analyzing government revenue and expenditure arising from the introduction of new legislation. It is, however, essential that a critical review drives a discussion on the validity of assumptions and the calculation of estimates so that, the fiscal impact analysis report accompanying the proposed legislation provides an accurate, reliable estimate of revenue and expenditure associated with the implementation of the proposed legislation.

6.2 The Economic Analyst in the Macro-Fiscal Unit within the Ministry of Finance shall be responsible for supporting the development and conducting a review of all fiscal impact analysis accompanying proposed legislation and supporting me in providing an opinion on the accuracy and reliability of estimates to the Legislature.

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6.3 The Economic Analyst will use the following process for reviewing fiscal impact analysis reports:

1. Conduct a thorough review of the selected impact estimation methodology to determine its suitability given the nature of the legislation being proposed and the context in the jurisdiction being affected by the proposed legislation;
2. Interrogate the validity of assumptions underpinning the revenue and expenditure estimates, and where critical assumptions are found to be false to provide new estimates based on the corrected assumption;
3. Determine whether the four scenarios provided in the fiscal impact section have been properly constructed, are free of mathematical errors, and correctly account for changes in the economic environment; and
4. Determine whether the net fiscal impact has been correctly computed.

6.4 After completing this process, the Analyst shall prepare an opinion paper for my review containing a summary of their findings for discussion with Line Ministries involved in the preparation of the proposed legislation.

7. Interim Provisions

7.1 Cognizant of the limited internal expertise within government agencies to perform a fiscal impact analysis to accompany proposed legislation, this instruction authorizes the Economic Analyst to work alongside government agencies developing new legislation or amendments to existing Acts to develop the fiscal impact analysis report.

7.2 The Economic Analyst will still be required to provide a separate opinion paper regarding the quality of the prepared fiscal impact analysis in accordance with Section 6.2 of this instruction.

7.3 The status of this interim provision will be reviewed by the Ministry and the Council of Ministers on an annual basis and remain in force until the issuance of a revised version of this instruction.

8. Entry into Force

8.1 This Instruction is deemed to have entered into force on date issued of **31/03/2018**

Mr. Mohamed Mohamud Abdulle
Minister of Finance and Economic Development

Hirshabelle State of Somalia