CURRENCY EQUIVALENTS  
(as of July 27, 2006)  
LYD 1 = US$ 0.76  
US$ 1 = LYD 1.31  

FISCAL YEAR 2006  
July 1 – June 30  

ABBREVIATIONS AND ACRONYMS  
CBL Central Bank of Libya  
CIT Corporate Income Tax  
CPI Consumer Price Index  
DOE Department of Energy  
ETF Economic Transformation Fund  
EU European Union  
GBOT Government Board for Ownership Transfer  
GDP Gross Domestic Product  
HS Harmonized System  
ICOR Inverse of the Marginal Productivity of Investment  
ICT Information and Communication Technology  
IF Investment Fund  
IMF International Monetary Fund  
INTOSAI Organization of Supreme Audit Institutions  
IPRS Intellectual Property Rights  
IT Information Technology  
LAIF Libya Africa Development Fund  
LYD Libyan Dinar  
LFIIB Libyan Foreign Investment Board  
LPG Liquefied Petroleum Gas  
MENA Middle East and North Africa  
MFTR Memorandum of the Foreign Trade Regime  
MIGA Multilateral Investment Guarantee Agency  
MTEF Medium Term Expenditure Framework  
MTFF Medium Term Fiscal Framework  
NBC National Banking Corporation  
NGL Natural Gas Liquids  
NGOs Non Governmental Organizations  
NOC National Oil Company  
NPLs Non Performing Loans  
NPV Net Present Value  
OECD Organization for Economic Co-operation and Development  
OPEC Organization of the Petroleum Exporting Countries  
ORF Oil Reserve Fund  
PPP Purchasing Power Parity  
SMEs Small and Medium Enterprises  
SOEs State-owned Enterprises  
SSF Social Security Fund  
TFP Total Factor Productivity  
UN United Nations  
USGS U.S. Geological Survey  
WHO World Health Organization  
WTO World Trade Organization
ACKNOWLEDGEMENTS

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Peer reviewers were Uri Dadush and Shahrokh Fardoust. Guidance was provided by Mustapha Nabli (Sector Director and Chief Economist).

Valuable comments were provided by Zoubida Allaoua, Marcos Ghattas, Linda English, and Mohamad Elhage (IMF).

Valuable support from the counterpart team organized by the Ministry of Finance in Libya is gratefully acknowledged. The report was produced further to a preparatory mission that visited Tripoli from June 26 to July 8 2004 and produced a first draft in October 2004; a mission to discuss the preliminary draft, from November 26 to December 1 2005; and a follow-up mission, on March 27-30 2006. The team benefited from discussions with the following ministries, banks, and agencies (some of which provided written comments to the first draft of the report): Secretary of the General People’s Committee, General Planning Council, General People's Committee for Economy and Trade, General People's Committee for Planning, General People's Committee for Finance, General People's Committee for Health, General People's Committee for Education, Central Bank of Libya, Commercial Banks, Customs administration, Libya Foreign Investment Board, Tripoli Chamber of Commerce, Board for the Transfer of Ownership, National Authority for Information and Documentation (NIDA), National Supply Company (NASCO), National Oil Company, General Electricity Company of Libya, Sha'beyat of Tripoli, Sha'beyat of Zaouia, Social Security Fund, Economic Transformation Fund, State Owned Enterprises.

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# SOCIALIST PEOPLE’S LIBYAN ARAB JAMAHIRIYA
## COUNTRY ECONOMIC REPORT

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EXECUTIVE SUMMARY

i. The Libyan economy is dominated by hydrocarbons and the public sector. With the hydrocarbon sector representing about 72 percent of GDP (in nominal terms), 93 percent of government revenues, and 95 percent of export earnings, Libya appears to be one of the less diversified oil-producing economies in the world. Libya witnessed a growing government intervention in the economy after a socialist State was instituted in the early 1970s. But falling world oil prices in the early 1980s and the impact of economic sanctions caused a serious decline in economic activity, eventually leading to a slow rehabilitation of the private sector. Reflecting the heritage of the command economy, three quarters of employment is still in the public sector, and private investment remains dormant at around 2 percent of GDP.

ii. The sizeable oil wealth has supported decent living standards for Libya’s population and socioeconomic development compares favorably with MENA standards. One of the poorest countries in the world in the 1950s, Libya now ranks ahead of several other oil-producing countries in terms of per capita GDP, measured in purchasing power parity. Universal enrollment in primary education has been achieved and the illiteracy rate is well below the regional average, even though quality is an issue. Indicators of health care provision have improved, while Libya has achieved some of the lowest infant mortality rates among middle-income countries. Laws and regulations do not discriminate against women. But while female literacy is above the MENA average, female participation in the labor force is low because of lack of economic opportunities.

iii. Economic performance has been shaped by changes in oil revenues— At 2.6 per cent per year on average, real GDP growth was modest and volatile during the 1990s, reflecting the inefficiencies of the state-driven economy, stagnant oil production and revenues, and the impact of economic sanctions. Since 2000, real GDP growth has been boosted by high oil revenues, reaching 4.6 percent in 2004 and an estimated 3.5 percent in 2005.

—and the external balance has been preserved. Inflation has been tame, as prices were controlled and wages frozen since 1981, while cost-driven deflation has surfaced since 2000, mainly due to the unification of the exchange rate. Libya’s external current account remained generally in surplus, also reflecting the restraining impact of sanctions on imports, and gross official reserves have surpassed US $39 billion in 2005, equivalent to 31 months of imports.

II. Making Oil Work for Growth and Jobs

iv. Libya has the potential to raise oil production and revenues significantly in coming years given its large reserve base— Cumulative oil production to date is equivalent to 60 percent of present estimates of recoverable reserves, but gas production is less advanced than oil, with cumulative production only 12 percent of reserves. Mean estimates of yet undiscovered, recoverable reserves are significant, about 20 percent of currently proven reserves. With current investment plans to raise capacity, Libya’s production could increase substantially considering current OPEC quota shares. Over the long run, alternative scenarios project the net present value of the government’s hydrocarbon revenues at between 7.3 to 19.8 times the level of 2005 GDP. Oil wealth
could generate a sizeable permanent income stream for Libya, ranging from 29 percent of 2004 GDP in a conservative reserve/price scenario, to above 50 percent of 2005 GDP in more favorable scenarios.

—but the main challenge for Libya is to promote growth of the non-oil sector, and spur diversification of its economy. Growth of about 6.5 percent in the non-oil sector would be needed to reduce the unemployment rate—currently estimated at around 25 percent—by half in a 10-year period. Projected high oil revenues will provide finance for growth but will not necessarily spur sustained growth in the non-oil sector. Libya’s unsuccessful experiment with the state-driven model of economic development, based on import substitution, has drawn attention to the limits of using the oil revenues for financing investment of public enterprises in selected industries. Such diversification will be achieved if far reaching reforms are put in place to facilitate private sector development in all sectors.

v. **Non hydrocarbon GDP growth has been weak and oil revenue volatility has been transmitted to non-hydrocarbon GDP growth.** Since 2000, non hydrocarbon real growth has been boosted by high oil revenues, but has remained lower than in other comparators in MENA despite the lifting of UN sanctions. Non hydrocarbon GDP growth, however, accelerated to 4-4.5 percent in 2004 and 2005. The volatility of non hydrocarbon GDP growth has been relatively high, owing to swings of domestic investment, dominated by the public sector, that have been closely associated with changes in oil revenues. Although an oil reserve fund was established in 1995, with implicit saving and stabilization objectives, the non-oil deficit has tended to increase when oil revenues are on the rise, and at times to decrease when oil revenues decline, imparting procyclicality to the fiscal stance.

vi. **Weak non-oil GDP growth reflects both insufficient private investment and low productivity of capital**—At about 16.7 percent of non oil GDP on average during 1998-2003, investment in the non oil sector remains low compared to neighboring countries in North Africa. Moreover, growth is hampered by poor productivity of investment. The productivity of labor in the non-oil sector points to a similar weak performance, with average annual growth hovering at around -2 percent. Negative productivity growth has persisted in manufacturing since the mid-1990s, and has been observed also in services (the main driver of non-oil GDP growth) and agriculture. Weak productivity performance reflects the inefficiencies of the state-driven model of economic growth, but also the impact of sanctions and of the isolation from the international economy.

vii. **Improving efficiency and productivity growth is a precondition for faster growth and a greater investment effort.** Over the medium term, sustaining faster growth would require a significant increase in the investment ratio, to around 25 percent of GDP. But this would also call for a substantial improvement in productivity. With stagnant productivity, combined with distortions (administered prices, entry barriers) and dysfunctional product and factor markets, profitability remains low and there is little scope for the much needed greater private investment.

viii. **Strong productivity growth is also a prerequisite for competitive diversification out of hydrocarbons.** With open and well-functioning markets in place, private investment would take advantage of unrealized potential for growth and diversification. Services is a good example of a sector where Libya presents unrealized potential in
comparison to other oil-producing economies. Growth of services would hold benefits for job creation and could offset part of the adjustment costs of the transition to the market. The potential for direct job creation is important, because in Libya services provide jobs to a relatively smaller fraction of the total employed population compared to countries with a similar level of per capita GDP.

ix. **Projected high oil revenues will provide finance for growth but will not necessarily spur sustained growth in the non-oil sector.** Barring the state-driven model of development of the past, there seem to exist three broad strategic options for using the large financial resources from oil as a means to foster non-oil growth:

- Using accumulated oil revenues to expand public investment in infrastructure as a means to directly propel non-oil sector growth;

- Distributing part of the oil windfalls to households, as a means of bolstering incomes and phasing out other distorting subsidies, while possibly ensuring better stability in the face of oil revenue volatility.

- Saving part of the oil windfalls for the future; using the rest strategically to improve human capital and build strong social safety nets, while, at the same time, accelerating the pace of structural reforms needed for a transition to a market-led economy integrated with the rest of the world.

x. **The decisions concerning public investment in (social and economic) infrastructure would better be de-linked from the presence of hydrocarbon windfalls.** Using hydrocarbon windfalls to expand public investment would not insulate fiscal policy from the volatility of oil revenues. Moreover, in Libya, the development budget already represents a fraction of GDP significantly larger than in comparator countries, suggesting limited absorptive capacity for further increases and possibly low efficiency of spending. Efficiency considerations would call for public investment to be driven by the productivity and cost of public capital.

xi. **To foster non-oil growth and job creation in Libya, the oil windfalls should be used strategically, with the aim of facilitating the transition to a competitive, market-led economy.** Contrary to other transition economies in the early 1990s, Libya has built a comfortable financial position and can afford the cost of safety nets needed to cushion the adjustment cost of the transition. Making optimal use of the hydrocarbon revenues would call for strengthening public finance management over the medium term, by adopting a transparent framework for budget formulation and execution, combined with expenditure discipline, and sound practices for management of oil windfalls. This would help anchor the transition in macroeconomic stability, while securing the sustainability of the required social safety nets and increased spending on human resources. In due time, a combination of strategic options could be envisaged, with an increasing part of surplus oil revenues progressively transferred to households.

xii. **Over the long term, the intermediation of hydrocarbon windfalls through the household and business sectors might produce superior long run growth performance, but should go in tandem with considerable strengthening of the investment climate.** When oil windfalls are intermediated by households they can be potentially funneled to more productive—or welfare-enhancing—spending than when spent by the public sector. This is so especially when cash transfers to households replace distorting subsidies to energy or other consumption goods. Transferring oil windfalls to households
may also better insulate the economy from the volatility of oil revenues, as temporary changes in oil revenues could spur savings rather than unsustainable public expenditure. A different model of intermediation of the hydrocarbon revenues may help unlock the economy’s long-term productive potential, provided cash transfers are designed appropriately so as not to distort work incentives and reforms to strengthen the investment climate and promote the efficient use of resources are implemented at the same time.

xiii. **Libya faces the challenge of enabling the “new economy”, led by the private sector, to gain strength**, a precondition for faster non oil growth and job creation. Main challenges include building a sound investment climate, with strong institutions to support open markets; reinforcing the banking system, to play fully its role in the financing of the investment; and ensuring an effective and sustainable social protection for the most vulnerable, to facilitate a smooth transition.

xiv. **Enhancing the quality of Libya’s human resources will be essential to improve productivity, diversify out of oil—especially in services—and compete in the global economy.** The ability of the education system to equip individuals with skills that allow them to take advantage of the increased opportunities that a dynamic and changing economy offers is also crucial for a successful transition to the market. Libya’s public expenditure in education is high but there are questions regarding quality and the efficient use of resources.

xv. **Improving the quality of governance would also deserve particular attention because it underlies the development reform agenda.** Progress on the three priority fronts will call for mutually reinforcing initiatives to promote transparency and predictability of regulations, institutions to support the competitive functioning of key markets, and reforms to improve public sector management and accountability. At the present time, various measures of the quality of governance rank Libya very poorly compared to other countries.

**III. Strengthening Public Finance Management**

xvi. **Public expenditure has been restrained in 2004-2005 despite booming oil revenues, but public finance management suffers from lack of transparency.** Consolidated public expenditure (including net lending) was 43 percent of GDP on average over 2001-2005, a level significantly higher than in comparator countries. Libya spends relatively more on wages and salaries than other economies in transition, while the development budget (public investment) is also large. The non-hydrocarbon deficit remains sizeable, at above 33 percent of GDP, but despite booming oil revenues it has not increased in 2004 and 2005. As a result of relative fiscal restraint in 2004-2005, and with the price of oil projected to remain at a high level, the downside risks to the budget seem small. A large share of public expenditure—52 percent in 2003—was previously not integrated in the budget, undermining fiscal discipline and the effectiveness of controls in budget execution. It is noticeable, however, that most extra-budgetary expenditures have been included in the 2005 and 2006 budgets, in particular those related to defense and subsidies, with the share of extra-budgetary spending dropping to 12 percent in 2005. Better transparency of the budget would greatly facilitate fiscal policy formulation and help improve the efficiency of public expenditure.
xvii. **Management of oil revenues should be underpinned by stabilization and savings objectives.** In line with this objective, the authorities are currently in the process of creating a Stabilization Fund. For it to play its role, it is essential that such a Fund is designed with clear accumulation and withdrawal rules, a comprehensive legal status, managed transparently and integrated into the budget. Also, in order for the Fund to be successful in stabilizing the non-oil economy by insulating it from fluctuations in the oil-economy, it is essential that the Fund’s investment strategy rules prohibit it from making investments in the domestic market. The stabilization and savings objectives of the Fund should in no case be mixed with other economic objectives, which could be addressed by dedicated investment funds as part of the budget process.

xviii. **To build appropriate safeguards for macroeconomic stability, the fiscal framework should be anchored on an indicator that is unaffected by the short-run changes in hydrocarbon revenues**, such as the non-hydrocarbon primary fiscal deficit, measured as a ratio to non-hydrocarbon GDP. An option to ensure long-term fiscal sustainability would be to target a non-hydrocarbon primary fiscal deficit that does not exceed a conservative estimate of the “permanent hydrocarbon income stream” over an appropriately defined medium-term time horizon.

xix. **The public financial management system has some strengths, but important challenges lie ahead.** Budget preparation procedures are relatively simple and bottom-up driven, but nevertheless allow some substantive interaction with line-ministries. However, the budget is fragmented, with no institutional mechanism in place for ensuring coordination between current and investment expenditures throughout budget preparation. The budget classification system should be improved to allow budget preparation on a programmatic basis. Reporting suffers from weaknesses, especially for capital expenditures and for decentralized spending. Budget information systems are rudimentary, with no integrated information system in place. Accounting is cash-based and hampered by frequent administrative changes while issuance of financial statements is irregular. The audit system is mainly focused on the external Audit, which is compliant with international standards. However, ex ante control and internal audit are ill-defined.

xx. **Appropriate mechanisms for expenditure management should be put in place to ensure fiscal discipline over the medium term.** The rule that 70 percent of budgeted oil revenues must be devoted to the development budget and 30 percent to other expenditures is detrimental to public expenditure efficiency and budgetary planning. It could be replaced by spending ceilings for each region and ministry at the beginning of the annual budget process. Conditional on the elimination of extrabudgetary spending practices, a medium-term rolling expenditure framework should be developed for a period of 3-5 years to help prioritize programs that can be afforded over the medium term. At the same time, implicit and contingent liabilities such as those for pensions and non-performing loans of public enterprises should be valued and recognized.

xxi. **Promoting efficiency in public expenditure would encompass a vast reform agenda.** Increasing the transparency of quasi-fiscal actions would facilitate better spending prioritization and efficiency. Implicit subsidies are sizeable—in 2003, implicit subsidies to energy products are estimated at the equivalent of 18.5 percent of total government outlays, or about 7 percent of GDP. Implicit subsidies to energy bear a significant efficiency cost, estimated at 3.7 percent of GDP in the case of Libya. They
also have a questionable impact on income distribution. They could be converted into explicit subsidies and made transparent. Decentralization should be reassessed, but eventually the capacity of local governments to collect their own revenues should be improved and incentives for fiscal discipline and efficient use of resources should be established. Equalization transfers to less well-off local governments could be designed. Over time, the cost-effectiveness of public spending could be increased by encouraging competition in the provision of public services from the private sector, non-governmental organizations and even other levels of government.

IV. Building a Strong Investment Climate

xxii. The early stages of Libya’s economic transition have witnessed a withdrawal of the State from economic activity and gradual opening for increased private investment. Still, significant constraints to private sector development remain. Key priorities for reform include:

- further simplifying the approval process for business entry in competitive sectors, in particular for foreign investments which are still subject to a process that may lead to administrative discretion and uncertainty in the selection of projects and sectors;
- lifting any remaining restrictions on foreign participation in services such as distribution, and finance, where there is substantial scope for efficiency gains and employment creation;
- reducing the ambiguity of laws governing land and property ownership and ability to rent;
- reforming the labor code to provide necessary flexibility to business operation while promoting appropriate working conditions and occupational safety standards;
- replacing the progressive corporate tax rate with a low flat rate at a level comparable to that in countries with a favorable business environment; consolidating and harmonizing taxes levied on imports; and,
- pursuing reforms in customs administration with the aim of tackling informal trade and reducing excessive delays in clearance.

xxiii. It is however undeniable that much progress has been made over the past years. Recent progress includes simplifying business registration for local firms, towards a more declarative process; opening of more sectors for foreign investment, including services, agriculture, telecommunications and real estate; reduction of the minimum number of shareholders in larger firms (Musahamat); introduction of almost all types of legal commercial entities; reduction of the corporate tax rate; trade liberalization and unification of the exchange rate; a new competition law that has been submitted to the Cabinet; and unification of the commercial and company laws.

xxiv. In contrast with these improvements, the recent decision setting the minimum capital requirement for foreign investments at $50 million is, de facto, a ban on most foreign investments Libya could potentially attract in the non-oil sector. Despite progress on other fronts, this decision is a serious setback to the reform agenda, which inevitably sends strong negative signals to foreign as well as local investors. Flows of FDI in non-hydrocarbon sectors and intentions of investment have already declined significantly in response to this decision. The Libyan authorities are currently
considering reverting to a more open regime, by reducing the minimum capital requirement for foreign investment.

xxv. More fundamentally, reinforcing key institutions to support the emergence of a market-oriented economy remains a challenge—in particular the judiciary and public administrations dealing with firms. Promoting a system of checks and balances and appeals in public administration would be an important underpinning for private sector development, to avoid abuse, arbitrariness and rent-seeking opportunities. It is also essential to strengthen the independence and the governance of the judiciary, so that the rule of law is in force for all, including public administrations, large and small investors, and any other economic actors.

xxvi. While the authorities are committed to privatizing the State-owned sector, the current strategy of ownership dilution by public sales is unlikely to lead to the type of efficiency improvements expected, at least for medium and large firms. Individual ownership remains limited to 10 percent of capital—a constraint that is inconsistent with the objective to move to a market economy, where limits on ownership shares should not be capped by law. International experience has shown that no institutional or legal arrangement can really enforce the independence of State-owned enterprises (SOEs) and change their managers’ incentives, until they are privately (majority-) owned by an individual or a firm shareholder, granting management control. Even if some progress has taken place since 2004—some SOEs have been privatized and/or financially restructured; some outstanding debts of SOEs have been absorbed by the treasury; SOEs now fall under the commercial code and commercial companies laws; and the idea of foreign participation in privatization deals is now accepted—it remains unclear whether sales to strategic majority investors will be authorized and to which extent hard budget constraints are imposed on the remaining state-owned firms in the course of the transition, and how independent they are from Government interference.

xxvii. In parallel to privatization, it is essential and urgent to improve the investment climate for accelerating private sector development and to put in place a safety net to mitigate the transition’s effect on employment. The current oil windfall gives Libya a unique window of opportunity to put in place a generous safety net that can facilitate these reforms from a social standpoint, and therefore maintain, throughout the transition phase, the objective of social justice and equity that are fundamental to the Libyan people.

xxviii. On the trade liberalization front, while tariffs have been recently abolished for all commodities, a list of products is still subject to a consumption tax and a production tax—which inefficiently protects existing domestic production. While some reasonable level of protection may be warranted in this transition period, the current consumption-production tax scheme leads to distortions that penalize investment in new activities while protecting existing activities, some of which may be bound to fail. It is suggested that this distortionary tax be replaced by a reasonable uniform tariff structure.

xxix. Promoting Libya’s multilateral trade policy commitments, especially through WTO accession, will be an important anchor of reform. Strong multilateral commitments will bolster the credibility of Libya’s reform process, thus fostering both domestic and foreign investor confidence. But WTO members will expect reforms in the
basic structure of economic management—including establishing the rule of law as opposed to administrative discretion, guaranteeing national treatment in taxation, and fully implementing international agreements on customs valuation. WTO accession provides a good opportunity for comprehensive review and reform of Libya’s trade institutions.

V. Financial Sector Reform

xxx. Banking represents the backbone of the Libyan financial system. The Government is in the process of preparing a program of financial sector reforms. A particular focus of the program would be the restructuring of state-owned banks and, for some of them, an adjustment in ownership structure to include or increase private sector participation in the capital of such banks. There is acknowledgement of the importance of updating and strengthening the financial sector’s legal, regulatory and supervisory environment. These initiatives should go in parallel with the efforts aimed at restructuring the banking system and addressing the portfolio problems besetting state-owned banks. In the absence of reforms, the banking system would not be able to play fully its role in the intermediation of national savings and the financing of economic growth in the non-oil sector.

xxxi. State-owned banks need a clear strategy and an effective corporate governance structure for their activities. Recent legislation setting corporate governance standards for financial institutions makes progress towards better management and greater operational independence of public banks. However, Libyan public banks still need a management structure supported by up-to-date skills in such critical areas as credit, investment, risk management, and information and control systems. Privatization of state-owned banks should be viewed as an opportunity to attract a qualified category of strategic investors with a proven track record into the financial industry so as to improve banking sector efficiency. The current option of privatizing through owner dilution to the public will not bring the efficiency improvements that are generally witnessed when banks’ majority ownership is transferred to a strategic investor of good reputation and expertise in the sector.

xxxii. The new banking law reinforces the independence of the Central Bank of Libya (CBL) and offers a good legal framework for the regulation of banking activities, even if some provisions call for improvement. In particular, full independence in conducting monetary policy should be strengthened by ensuring that the representation of the government (Secretariat of Finance) in the Board of Directors is limited, with no veto power. Also, the role of the CBL in regulating the terms and conditions of credit extension or investment by commercial banks, should be reduced.

xxxiii. Despite the progress brought by the new banking Law that specifies and limits its duties and responsibilities, the CBL remains the owner of the public banks, with the associated potential conflict of interest between ownership and regulation. It is essential that the Libyan authorities consider separating ownership of banks from their regulation by the CBL. Ownership should either be transferred to the General Secretary of Finance or to an asset-management institution that the latter owns. Until such a transfer takes place, the CBL should under no circumstances be involved in operational decisions made by banks, or in individual credit decisions.
xxxiv. **Financial sector reform has also progressed with partial interest rate liberalization**— Interest rates have been liberalized on deposits, while a ceiling on the lending rate has been set above the discount rate. Progressively, this ceiling should be phased out, to prevent a possible erosion of bank profitability in a competitive bid to attract deposits, and to allow banks to serve corporate clients with a wider range of risk profiles. Initial steps for the establishment of a stock exchange have been taken.

—but for much-needed improvement in intermediation in Libya, it is important that an enabling environment for the operation of banks be established. For banks to lend prudently, they ought to operate within an environment that enables them to assess, price and manage risks. To do so, they need to rely on sound and standardized statements of borrowers' operational and financial conditions. The seal of independent, qualified auditors would be an added layer of comfort. The faith in, and reliance on the rule of law, enforced through a transparent and efficient judicial system would provide further guarantee to creditors that terms of contracts would be adhered to, while security interests in loan collaterals can be realized.

xxxv. **Banking supervision needs to be strengthened to foster the development of a sound financial sector.** Current loan classification criteria and loan provisioning would need to be enhanced to reflect adequately the true quality of banks' loan portfolios in line with international standards. Over the medium term, the focus should be placed on the overall effectiveness of risk management practices in banks, as banks can often be in full compliance with rules and regulations yet be at risk for insolvency due to poor risk management practices.

**VI. Enhancing the Effectiveness of Social Protection**

xxxvi. **Establishing an effective social safety net will facilitate the transition to a market-led economy.** Particular attention should be paid to adverse effects on vulnerable population groups from sudden drops in income during the transition period. The establishment of a continuous monitoring system of the wellbeing of the population would help target groups at risk. The 2003 household budget survey is an indispensable starting point, and should be undertaken annually and be routinely used by government authorities in the design of public policy.

xxxvii. **A cash benefit system that is able to target needy households on short notice could be designed.** The Government has the elements of such a system near at hand, since the current distribution system for subsidized foodstuffs is reputed to reach every household in Libya. If this is the case, adjustments that need to be made to this network to allow the targeted distribution of cash benefits should be examined.

xxxviii. **Severance and retraining programs for civil servants and public enterprises employees would need to be formulated.** Employees becoming redundant as a result of the restructuring of administrations or of public companies will need to receive support to facilitate their transition to other occupations in the private sector. This would also require retraining to improve their employability in the private sector.

xxxix. **Reforming the pension system to contain the accumulation of unfunded pension liabilities, improve efficiency, and equity should also be on the agenda.** The Social Security Fund (SSF) is paying benefits that are too generous relative to
contributions and current retirement ages. As a consequence, the SSF is accumulating an
implicit pension debt that might already have attained 50 percent of GDP. The system is
also prone to regressive redistribution and is distorting labor supply and savings
decisions.

VII. Managing Reform Options

xl. **Structural reforms are highly complementary** — Reducing the constraints to
efficiency and private investment should not be done in a piece-meal manner, without
addressing the fundamental underpinnings of these constraints. The experience of the
transition economies underscores the importance of pursuing rapid reforms on many
fronts, in order to send strong and credible signals to investors.

—yet, the challenges raised by the reform process should be taken into account to
prioritize and sequence the reform strategy. Prioritization of a reform program is
difficult, for many reasons. All actions are important, and the right sequencing depends
not only on the expected benefits from each action, but also on the difficulty of
implementation. Some reforms are politically sensitive (privatization, public
employment downsizing) and require significant consensus-building, and strong political
will. Other reforms, especially in the investment climate, financial sector, and social
protection, require considerable capacity building of the public administration with
respect to their new regulatory roles. Thus, reforms with even a modest pay-off may
need to get high priority if they are quick and easy to implement, while others with
higher benefits might be deferred if they are costly in terms of administrative capacity
and political capital.

xli. **To build credibility and reform momentum, it is recommended that the Libyan
Government embark on a well-sequenced strategy to improve the investment climate,
strengthen social sector policies, and reinforce public finance management**: A core
set of options for short-term (up to 24 months) actions is outlined, to send strong signals
to investors and make decisive changes in the business environment. It is recommended
that this action plan be complemented by a medium-term (from 2 to 5 years) core reform
agenda that addresses structural and institutional bottlenecks. Clearly the Government is
in a much better position to assess the proposed sequencing, especially on grounds of
political feasibility. But this proposed sequencing of reform options may be useful in
laying out an agenda for consideration. The table that follows highlights main steps in
such an agenda, based on the analytical findings in this report. Additional reform options
that the government may wish to consider as a complement of the core reform agenda are
outlined at the end of each chapter.
### Summary of Proposed Core Reform Options

<table>
<thead>
<tr>
<th>POLICY PRIORITIES</th>
<th>CHALLENGES AND POLICY GOALS</th>
<th>SHORT-TERM MEASURES (UP TO 2 YEARS)</th>
<th>MEDIUM-TERM MEASURES (2 TO 5 YEARS)</th>
</tr>
</thead>
</table>
| Public finance management | • Insulate the fiscal stance from volatile oil fiscal revenues  
• Secure long-term fiscal sustainability in the presence of an exhaustible hydrocarbon revenue stream  
• Ensure that budget allocations match development priorities  
• Improve the quality of public service delivery  
• Improve the workings of fiscal decentralization | **Management of oil revenues**  
• Transform the Oil Reserve Fund into a Stabilization Fund with clear accumulation and withdrawal rules, as well as investment strategies that do not allow for investment in the domestic economy – something that separate, dedicated funds, integrated in the budget process, should do.  
• Adopt a comprehensive legal status for the ORF, clarify its rules and purposes, ensure transparency of its operations and integrate the fund into the budget  
• Consolidate progress towards eliminating extra-budgetary expenditures | **Management of oil revenues**  
• Add a saving function to the Oil Reserve Fund—to reflect the non-renewable character of oil wealth—based on a conservative estimation of permanent hydrocarbon revenue  
• Enhance the budget classification system, reporting, information systems, and ex-ante control and internal auditing |
| Investment | • Promote efficiency | **Maintaining fiscal discipline and promoting efficiency in public expenditure**  
• Set appropriate targets for the non oil budget deficit as a ratio to non oil GDP  
• Initiate an analysis of public expenditures with a view to assessing their effectiveness and matching of the government’s economic and social priorities  
• Further streamline administrative barriers to business entry and operation.  
• Eliminate restrictions to investment in service | **Maintaining fiscal discipline and promoting efficiency in public expenditure**  
• Elaborate a rolling Medium Term Expenditure Framework (MTEF) for a period of 3-5 years as a main tool of fiscal planning  
• Make implicit subsidies explicit and transparent in the Budget  
• Evaluate implicit and contingent liabilities such as those for pensions and non-performing loans of public enterprises  
• Reconsider the appropriate scope for public expenditure decentralization |
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</table>
| **climate and privatization** | and fast productivity growth  
• Encourage private investment  
• Promote the creation of SMEs  
• Promote fast job creation  
• Improve the quality and reduce the cost of backbone services | sectors in foreign investment law and related regulations (example: trade, distribution).  
• Further the restructuring of public enterprises by: (i) reducing debt; (ii) selling off non-core activities and services; (iii) selling unused assets (land and buildings); (iv) reducing overstaffing; (v) clarifying titling and ownership issues.  
• Review the current privatization strategy, to favor strategic investor acquisitions of medium and large public enterprises.  
• Abolish the consumption/production taxes and service fees and replace them with a low-tariff trade regime, also ensuring low tariff dispersion. | • Launch a full review of the business legal framework in order to harmonize and modernize legislation.  
• Complete the restructuring of public enterprises  
• Privatize state-owned SMEs in a 5-year time-frame  
• Complete liberalization of telecommunications and create independent regulatory body  
• Undertake a thorough review of all laws, regulations, and policies that affect international trade and investment, in preparation for WTO accession negotiation |
| **Financial sector reform** | • Strengthen the soundness of the banking system  
• Modernize the banking system  
• Ensure competitive access to finance by SMEs  
• Promote an active money market—a precondition for domestic financial market | • Amend articles 14 and 56 of the new banking law, towards increased operational and policy independence from the government, and towards less intervention in the credit policies of commercial banks.  
• Strengthen corporate governance of state-owned banks and define a clear strategy for these banks  
• Enhance loan classification criteria and loan provisioning in line with international standards  
• Take steps to strengthen banking supervision | • Open the banking system to the participation by foreign banks  
• Seek strategic investors for the privatization of remaining state-owned banks  
• Initiate corporate sector reforms (accounting, auditing and the rule of law) as a complement to banking sector reform  
• Develop the credit information systems of the Central Bank |
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<tbody>
<tr>
<td>Social protection</td>
<td>development</td>
<td>• Seek strategic investors for the privatization of at least one state-owned bank</td>
<td>• Establish a cash-benefit system that is able to target needy households on short notice</td>
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<td></td>
<td>Build a well-targeted social safety net to cushion the cost of the transition to the market and protect the most vulnerable</td>
<td>• Separate ownership of banks from the regulatory role of the CBL</td>
<td>• Design severance and retraining programs for civil servants and public enterprise employees</td>
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<td></td>
<td></td>
<td>• Progressively allow for a wider interest rate lending spread and, eventually, its phasing out</td>
<td>• Adopt plan to gradually phase out indirect subsidies</td>
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*Social Assistance and Labor Market Programs*
I. TRENDS IN SOCIAL AND ECONOMIC DEVELOPMENT

A. The Structure of the Economy

1. **The Libyan economy is dominated by hydrocarbons**—At the time of independence (1951), the Libyan economy was based mainly on agriculture, which employed more than 70 percent of the labor force; and contributed about 30 percent of the GDP, dependent on climatic conditions. Before the discovery of oil and gas, Libya was one of the poorest countries in the world. However, by 1961 substantial quantities of oil had been discovered and greatly supported the country’s socio-economic development. Thus, with a population close to 5.5 million, Libya had an estimated per capita GDP of US$6,800 in 2005. Measured in nominal terms, and owing to the recent increase of the price of oil, the share of the hydrocarbon sector has been constantly increasing, and represented an estimated 72.6 percent of GDP at factor cost in 2005 (Figure I.1a). Oil also represented 93 percent of government revenues and 95 percent of export earnings. However, reflecting the impact of sanctions and the lack of investment in the hydrocarbon sector (see below), the share of oil in the economy in constant prices has been on a slightly declining trend during the 1990s, before rising to 32 percent in 2004. When the size of the oil sector is measured in nominal terms, Libya appears as one of the less diversified oil-producing economies in the world. In 2002, the share of hydrocarbon revenues in Libyan GDP was almost double that of Saudi Arabia and nearly threefold that of Iran (Figure I.1b).

![Figure I. 1: The share of oil in the Libyan economy](image)

2. **Although oil production has grown below potential.** Libya’s oil production rose rapidly during the 1960s to more than 3 mb/d by 1969, making it one of the dominant members of OPEC at the time. Libya became an OPEC member in 1962 and nationalized assets of foreign oil companies in the mid-1970s. Libya’s oil production has largely followed OPEC’s overall production profile, although over the last fifteen years its output has grown only modestly, compared with OPEC’s average growth of around 3 per cent per annum. Libya’s oil capacity has been constrained by lack of investment, mainly due to economic sanctions. However the country’s oil sector is again attracting foreign capital and technology, and production is rising. Current production of 1.65 million barrels per day (mb/d) is little more than half the
peak of the early 1970s. However, the country has the resource base to raise production capacity significantly.

Figure I. 2: Libya Crude Oil Production and Export Revenue

Figure I. 3: GDP components, Real terms

3. **Services is, by far, the second most important sector of economic activity.** Measured in *nominal* terms, the contribution of services to GDP declined to 16 percent in 2005, from 46 percent on average during 1990-99, reflecting the soaring price of oil. However, in *real* terms, output in services grew faster than total GDP, so that the share of services reached 45 percent of GDP in 2005, from about 40 percent in the early 1990s (Figure I.3). Despite this increase, the contribution of services to GDP remains below the average in upper middle-income countries (53.8 percent) and MENA countries (49.5 percent). Construction and manufacturing each contribute around 7 percent to GDP (in real terms), a share that has remained largely constant over time. At 8 percent of GDP, the Libyan agricultural sector contributes to the economy less than the average in MENA countries (12.5 percent) but more than the average of upper middle-income countries (6 percent).

B. **The Economic and Political Regime and Economic Development**

4. **Libya witnessed a growing government intervention in the economy after it turned to a socialist State in the early 1970s.** During the decade after the discovery of oil, Libya was operated as a dual economy, with little connection between the oil and the non-oil sectors. The oil companies employed limited quantities of local labor and paid a portion of their profits to the government in royalties and taxes. This model of development came to an end with the regime change of September 1, 1969, led by Colonel Qadafi. The economy, which was largely financed by the booming oil revenues of the 1970s, was marked by two programs:

- The “Libyanization”—the process of replacing foreign-owned firms with Libyan nationals.

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1. Libya's hydrocarbon export revenues have been dominated by petroleum, with only a tiny portion from natural gas (via LNG). Crude oil accounted for 82 percent of export revenue in 2003, with 15 percent from refined petroleum products. Condensate, LPG and natural gas only account for a combined 3 percent of export revenues.
The nationalization program, embarked upon in the mid-1970s, along with the foreign direct investment prohibition. All commercial banks with foreign minority ownership were fully controlled by the government by the end of 1970 and had been merged into five banks. The insurance industry was also totally nationalized and merged into two companies. Moreover, the government either nationalized oil companies or became a participant in their concessions and their production and transportation facilities (see Library of Congress, 1987).

5. Nationalization went in tandem with an ambitious plan of economic modernization and industrialization. The industrialization plan was modeled largely on the experience of neighboring Algeria. During the 1970s, industrialization mainly relied on the downstream oil industry and light processing. In the late 1970s, the industrial sector was planned by the government, which had assumed control over those industries that were deemed sensitive or too large to be managed by the domestic private sector. The industrialization program had two major goals: the diversification of income sources and import substitution. Considering these objectives, the plan met with some apparent success, as several categories of imports began to decline in the late 1970s, but the impact on household welfare was questionable. From the early 1980s the government’s priority shifted towards encouraging the development of heavy industry. Indeed, during the period of high oil prices the development of import-dependent heavy industry seemed feasible, as Libya enjoyed cheap energy costs and possessed the foreign exchange to pay for raw material imports.

6. Economic policies were geared towards achieving an egalitarian society by washing out class differences. Many of the regime’s most radical economic policies began in 1978, soon after the codification of the Libyan Leader’s economic theories in the second volume of his Green Book. Most of the post-1977 economic policy innovations were designed to inhibit the private accumulation of wealth, with the aim of promoting a more equitable income distribution. Changes in the economic regime went in tandem with a radical redesign of political institutions (Box 1.1). Most prominent changes in the economic regime included:

- Rental payments for property were abolished, changing all residential tenants into instant owners. Ownership of property was limited to one house or apartment per family. The private sector real estate industry was thus eliminated, and the new owners were required to pay monthly “mortgage” payments—usually amounting to about one-third of their former rent—directly to the government. However, low-income families were exempted from this obligation.
- The employer-employee relationship was abolished, on the principle that a Libyan citizen could not hire another Libyan citizen to avoid any subordination relationship. Thus, Libyans had to be partners in order to do business. As a result, private ownership was banned for an individual but possible for a group of Libyans. Workers were urged to participate in the

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2 Processing of foodstuffs was a high priority, and the largest number of plants built during the 1970s were in this area. Other major manufacturing projects during the decade included textile complexes, an oil refinery, petrochemical plants, a fertilizer factory, and an electrical cable plant (Library of Congress, 1987).
management of the enterprises in which they worked through “workers’ committees” which, in principle at least, ran the most important companies.

- Under the egalitarian socialist principle, women were expected to fully participate in all aspects of life in the same way than men did (see below).

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**Box I. 1: The structure and ideological foundation of the Libyan political regime**

On March 2, 1977, Libya adopted a new approach to democracy in a provision known as the Declaration of the Establishment of the People’s Authority. The declaration changed the official name of the country to the Socialist People’s Libyan Arab Jamahiriya, established a popular direct authority through a system culminating in the General People’s Congress (GPC), and the assignment of responsibility for defending the homeland to every man and woman through general military training.

The GPC is a unique system in accordance with the Third Universal Theory introduced by Qadhafi in his Green Book. The Third Universal Theory rejected the class exploitation of capitalism and the class warfare of communism. The theory sought to eliminate class differences. It embodied the principle of consultation (shura), by which community or even national affairs would be conducted through mutual consultation in which the views of all citizens were exchanged.

The GPC, still in place, consists in a pyramidal committee system. The lowest level is represented by the basic people’s committee, to which every citizen over the age of 16 belongs under the principle that “true democracy exists only through the participation of the people, not through the activity of their representatives”. In 2000, all executive and legislative authority were decentralized to 26 municipal councils that make up the GPC. Centralized control is maintained in the areas of the economy, finance, energy, defense and security; infrastructure, foreign affairs, social security and trade. Each local government has its own budget.

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7. **During Libya’s experiment with socialism private sector activity was stifled**— In the most radical of the measures, all private property rights were eliminated in March 1978. Later in the year, most private trading, retail and wholesale, was abolished. The only type of private sector activity that the government did not actively seek to eliminate was small service-providing firms (mostly self-employed), which were not viewed as inherently exploitative. Private savings accounts were eliminated, as was the right for professionals to maintain private practices. The Central Bank’s credit policy was confined to supporting the government’s development effort. It limited credit to the private sector and directed it instead to state entities. As a result of the severe repression of private business activity, a large number of Libyan managers and skilled workers left the country. However, private investment and ownership were encouraged in agriculture, even for foreigners. Thus, Egyptian and Moroccan farmers could own a farm in Libya as long as they worked the land.

8. **—but, owing to collapsing oil revenues in the 1980s, the socialist experiment was short-lived**. The last phase of the socialist period was characterized by an intensive effort to build industrial capacity, but falling world oil prices in the early 1980s dramatically reduced government revenues and caused a serious decline in the economic activity. The decline in oil prices during the 1980s reduced Libya’s advantage in terms of energy costs and greatly cut the supply of foreign exchange. Whereas in the late 1970s it may have been possible both to import industrial raw materials and subsidize food imports, by 1987 it was becoming increasingly clear that foreign exchange earnings were insufficient to fund both industrial development and
extensive subsidies. This led to a progressive rehabilitation of private sector activity. Beginning in 1988, Libya took some steps towards liberalization with a greater scope allowed to private enterprise in the retail trade, small-scale industries and agricultural businesses. In September 1992, a privatization Law was passed, but this initiative had no impact on the structure of the economy.

9. **The opening to the market in the early 1990s was hesitant and not sufficient to energize growth.** A number of factors explain the limited success of the partial opening to private economic activity in the early 1990s. First, key institutions for the market to play its role as an allocating mechanism had been removed (labor and real estate markets, credit markets) and replaced by a distributive state. Second, the State's intervention in the economy remained pervasive: Price controls for basic food products continued; tariff protection and non-tariff barriers remained high, so that parallel markets for consumer goods (brought in from Algeria and Tunisia) were thriving; banks were supporting public enterprises through directed allocation of credit; and the private sector's access to credit remained restricted. Third, property rights were not secure and regulatory uncertainty remained high. To these fundamental impediments to the functioning of a market-oriented economy was added the impact of the international sanctions.

10. **Beginning in the mid-1980s, Libya was subject to both US and UN sanctions.** The first US sanctions were introduced in 1986, prohibiting US companies from any trade or financial dealings with Libya, while freezing Libyan assets in the US. The *Iran-Libya Sanctions Act* of 1996 imposed extra-territorial measures against non-US firms investing more than US$20M in one year in Libya. It was renewed in 2001 for a further 5 years. UN sanctions came into effect in 1992, following the Lockerbie bombing in December 1988, prohibiting all international flights to Libya, stopping arms, aircraft and oil equipment sales (including spare parts) and freezing Libyan assets, except those necessary for oil transactions. Further to Libya's cooperation in the resolution of the Lockerbie case, UN sanctions were suspended in 1999, and lifted in 2003. US sanctions were lifted in 2004, as a result of Libya's cooperation in international efforts aimed at non-proliferation of Weapons of Mass Destruction.

11. **Sanctions primarily impacted oil companies doing business in Libya but also the rest of the economy.** The Libyan economy was seriously affected during the 90s by a critical shortage of spare parts and lack of access to raw materials and new technologies, which imposed serious limitations upon Libya's industrial infrastructure. Income from tourists also plummeted. Although major development projects seemed unaffected, such as the Great Made Man River (Box 1.2), smaller projects, including the construction of desalination plants, were slowed down. The government was also forced to cut agricultural subsidies, thus stalling its effort to boost the agriculture sector. While sanctions did not prevent Libya from maintaining trade relations with Western European countries, they impacted growth during the 1990s, and were at the origin of relatively higher domestic prices than in the past, due to shortages and a reduced variety of products on the local market.
12.  Reflecting the heritage of the command economy, public sector ownership in the economy still remains widespread. Three quarters of employment is in the public sector, and private investment still remains dormant at around 2 percent of GDP. Serious attempts at economic reform are now underway, with the aim of promoting transition to a market-led economy and closer integration with the rest of the world. Progress and challenges in the reform are analyzed in the following chapters of this report.

C. Social Development

13. The sizeable oil wealth has supported decent living standards for Libya's population—Libya ranks ahead of several other oil-producing countries in terms of per capita GDP adjusted for differences in purchasing power parity (PPP GDP—Figure 1.4). Reflecting swings in oil revenues, per capita PPP GDP hovered around US$ 9,269 on average during 1990-2002, reaching US$ 9,966 in 2004.

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3 About 67 percent of the water generated by the GMR was originally intended for uses in the agricultural sector.
This level of per capita GDP in PPP is about 25 percent lower than in Saudi Arabia and Oman, about the same as in Trinidad and Tobago, and an estimated 30 percent higher than in Iran. As further discussed in chapters IV and V, despite frozen wages, living standards have been supported through an extensive social safety net, with the provision of free housing, education and healthcare, subsidized food and utility prices and sizeable energy subsidies.

14. **but, as other MENA countries, Libya is coming under intense demographic pressures**— Libya posted a 3.3 percent rate of population growth during 1960-2003, higher than the MENA average. Demographic growth has recently slowed to the MENA average of 2 percent, owing to the decline in the birth rate during the 80s, which went down from 49 per 1000 people during the 60s and 70s to 27 per 1000 in 2002. Libya also posts one of the highest urbanization rates both in the region and in the world. In 2003, 86 percent of the population was urban, compared to 45 percent in 1970.4

15. **while tensions in the labor market are becoming acute.** Although no reliable estimates are available, unemployment is reportedly acute. With more than 50 percent of the population under the age of 20, labor market tensions will increase in the future. Moreover, despite the bias of the rigid labor market regulations in favor of hiring Libyan workers, the mismatch of the educational system with the needs of the market (see below) has resulted in the perpetuation of a large pool of expatriate workers, with typically better-suited education and higher productivity. However, because of labor shortages for hard manual work, Libya has also attracted important numbers of less skilled economic immigrants. Expatriate workers represent an estimated fifth of the labor force, although, in the absence of a labor force survey, estimates are surrounded by considerable uncertainty. Although significant, the proportion of expatriate workers is still lower than in oil producing countries in the Gulf.5 Foreign workers mainly come from the Maghreb countries, Egypt, Turkey, India, the Philippines, Thailand, Vietnam, Poland, Chad and Sudan. They tend to earn relatively high wages as they take either skilled jobs or hard manual jobs with high pay. Census data for 2000 show that the share of expatriates earning over LYD 300 (US$230) per month was 20 percent, compared to only 12 percent for Libyan nationals. In the absence of employment opportunities in the private sector, Libyans seem to prefer the job security and fringe benefits offered in the public sector, despite the relatively unattractive pay of public sector jobs. A campaign encouraging conversion of qualified civil servants to entrepreneurship—in the face of public sector over employment and a continuous fall in productivity—does not seem to be producing the desired results.

16. **Educational attainment indicators are better than the region average.** Libya has achieved universal enrollment in primary education and, the 14 percent illiteracy rate is below the regional average of 34 percent. This is an improvement relative to the early 1960’s, when 40 percent of the adult population was illiterate, and enrollment in primary education was only 60 percent. Secondary school enrollment

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4 Comparatively, Tunisia and Egypt post lower rates of respectively 64 and 42 percent, while Kuwait and Qatar post the highest rates in the MENA region with respectively 96 and 92 percent in 2003.

5 In Saudi Arabia, foreigners accounted for 67 percent of the kingdom’s labor force in 2004, holding a vast majority of the private sector jobs in the non-oil sector. In the United Arab Emirates, the share of foreign workers is even higher at 88 percent.
substantially increased between 1970 and 2002, from 21 to 105 percent. Tertiary enrollment has recorded a similar pattern, increasing from 3 to 58 percent in the same period. However, despite comparatively high school enrollment levels, the illiteracy rate in Libya is higher than that in upper middle-income countries, which post an average of 9 percent in 2002. Rates are even lower for selected countries such as Chili (4%), Croatia (2%), and Argentina (3%).

17. **The quality of education is, however, open to question.** Although different options and curricula are available for Libyan students, there are concerns about the quality of the content and the actual access to up-to-date knowledge and expertise. These concerns are related to (i) the country’s isolation for more than a decade, (ii) the high unemployment rate combined with the displacement of local workers by foreigners, and (iii) the ban of foreign languages from the curricula. Libya would need a strong human capital foundation to respond to actual needs as the economy opens up further and private investment takes off. The education system will have to promote the kind of skills needed in an economy where internationally competitive services and the private sector play a more dominant role.

18. **Health care services have improved.** Health care provision has apparently improved, with one physician per 770 people by 1997 (most recent available data), from one doctor per 3,860 people in 1965. There were 850 people for every nurse in 1965 and 350 per nurse in 1992, close to rates in the OECD countries. The infant mortality rate fell accordingly, from 160 per 1,000 in 1960 to 16 per 1,000 in 2002. However, although Libya, along with Tunisia, has achieved some of the lowest infant mortality rates in the region, it is performing below upper middle-income countries, such as Chili (10 per 1000), Croatia (7 per 1000), and Malaysia (8 per 1000). The life expectancy has increased as well, from 52 years in 1970 to 72 years in 2002. Better health outcomes also reflect the improvement of sanitation facilities and access to safe water, for both urban and rural population, for which the gap has been substantially narrowed. However, Libya’s health care system has suffered greatly since the mid 1980s because of the sanctions and Libya’s international isolation. It became difficult for Libyan health care workers to obtain medicine, surgical supplies and parts to repair medical equipment. Patients could not leave the country to get specialized treatment. The large number of Libyan nationals who seek health care services in neighboring Tunisia points to continuing concerns about the quality of health care in the country. Further analysis is needed to assess the performance of the health care system and better understand these trends.

19. **Libya gives almost the same rights to women and men.** Libya, as many of the MENA countries, signed in 1989 the UN Convention on the Elimination of all forms of Discrimination against Women, with few reservations regarding marriage and family life. Legally, Libyan women are equal to men. Under the egalitarian socialist principle, women are expected to fully participate in all aspects of life. They have access to education, as well as to political and social life, including military training. The Constitution (Article 4 and Principle 11) gives women the right to exercise the work of their choice, in all sectors. Regulations explicitly state that men and women are treated equally with regard to freedom of movement. Women have the right to conclude their own marriage contract and to get a divorce by the court.
20. **Female participation in the labor force is low.** Although Libya ranked high among MENA countries in the 1960s in terms of women labor force participation, it fell behind by 2000. With a female participation rate of 19.3 percent, Libya currently ranks just before Oman, Iraq and West Bank and Gaza. One of the explanations for this deterioration is the limited scope for private sector activity and especially the limited development of activities that have traditionally been open to female participation, such as textiles and garment manufacturing. It also reflects the impact of restrictive regulations as well as social and cultural impediments as in many others countries in the region.

21. **Despite high girls school enrollment in comparison to the MENA region average, gender disparities still persist.** As of 2000, Libya had among the highest female primary, secondary and tertiary school enrollment ratios in the MENA region. Those ratios have drastically improved since 1980, bridging the gap between men and women. As a consequence, at 71 percent, the women literacy rate is above the MENA average of 54.8 percent. However, the women literacy rate remains below that for men (91.8 percent).

D. **Recent Economic Developments**

22. **Macroeconomic performance has been shaped by fluctuations in oil revenues.** Real GDP growth was modest and volatile during the 1990s, shaped by changes in the price of oil and reflecting the decline in oil production as a consequence of economic sanctions enforced by the US and the UN since 1986. The average growth during that period was about 2.6 percent, with a peak of 13.5 percent recorded in 1991 and downturns in 1994, 1998, and 1999. During the 1990s, non-oil GDP growth was slow and volatile as well, at 3 percent on average, owing to pervasive State controls and the decline of government’s revenues. As sanctions were suspended by the UN in 1999, and oil prices rose, growth has gradually picked up (Table I.1).

23. **Reflecting significantly higher oil production and prices, Libya’s economic performance has recently improved.** The macroeconomic situation remains strong, with real GDP growing at an estimated 3.5 percent in 2005, slightly down from 4.6 percent in 2004. Growth of non-hydrocarbon GDP has accelerated to 4.6 percent in 2005 and 4.1 percent in 2004, up from 2.2 percent in 2003. Non-hydrocarbon GDP growth was broad-based, driven by construction and utilities, such as electricity, gas and water, but also trade, hotels, transportation, and other services. However, growth in manufacturing and agriculture has remained tame. Non oil growth would need to further accelerate on a sustained basis to absorb the labor force which is projected to grow by 3.3 percent in the years ahead.

24. **Inflation has been tame, as prices were controlled and wages frozen since 1981, while deflation has surfaced since 2000.** During 2000-02, Libya posted an
annual average deflation of 7.2 percent (while money supply increased on average by 9.2 percent annually). The unification of the Libyan dinar (between February 1999 and January 2002) has contributed to the deflation process (Box I.3). The unification of the exchange rate induced a drop in the prices of imported goods that were priced at the special rate—which appreciated by 132 percent between February 1999 and May 2003. The trend has been amplified by the cut in tariffs by 50 percent, and also by the one-off tariff exemptions granted to the State enterprises in 2002 in order to offset the devaluation of the official exchange rate in January 2002.

Table I. 1: Libya: Summary macroeconomic performance 1991-2005

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<tr>
<td>Real GDP</td>
<td>3.4</td>
<td>1.8</td>
<td>-0.4</td>
<td>1.1</td>
<td>4.5</td>
<td>3.3</td>
<td>9.1</td>
<td>4.6</td>
<td>3.5</td>
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<td>Real Non-Hydrocarbon GDP</td>
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<td>2.6</td>
<td>0.9</td>
<td>3</td>
<td>6.8</td>
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<td>1.2</td>
<td>7.0</td>
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<td>CPI</td>
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<td>2.6</td>
<td>-2.9</td>
<td>-8.8</td>
<td>-9.9</td>
<td>-2.1</td>
<td>-2.2</td>
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<td>Balance of Payments (billion US$ unless otherwise noted)</td>
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<td>0.8</td>
<td>1.6</td>
<td>6.5</td>
<td>4.1</td>
<td>0.6</td>
<td>5.0</td>
<td>7.3</td>
<td>16.0</td>
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<td>Gross Official Reserves in months of imports of GNFS</td>
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<td>6.7</td>
<td>6.7</td>
<td>13.1</td>
<td>14.1</td>
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<td>Central Government Finances (% of GDP)</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td>30.6</td>
<td>36.5</td>
<td>39.8</td>
<td>45.7</td>
<td>43.1</td>
<td>51.4</td>
<td>54.4</td>
<td>59.1</td>
<td>73</td>
</tr>
<tr>
<td>Expenditure</td>
<td>30.7</td>
<td>34</td>
<td>32.8</td>
<td>31.3</td>
<td>44.3</td>
<td>41.2</td>
<td>44.6</td>
<td>444.0</td>
<td>41.2</td>
</tr>
<tr>
<td>Overall balance</td>
<td>-0.1</td>
<td>2.5</td>
<td>6.9</td>
<td>14.4</td>
<td>-1.2</td>
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<tr>
<td>Non-hydrocarbon Overall Balance</td>
<td>-16</td>
<td>-20.6</td>
<td>-10.5</td>
<td>-17</td>
<td>-30.3</td>
<td>-30.2</td>
<td>-37.6</td>
<td>-36.1</td>
<td>-36.0</td>
</tr>
</tbody>
</table>


25. More recently deflation has subsided. Although deflation continued during 2004, its rate slowed to about -2.2 percent. In 2005, the trend has reversed, with the CPI increasing by an estimated 2.5 percent. The temporary factors that contributed to deflation in 2001-2002, including the impact of the appreciation of the special exchange rate on import prices, have abated. However, downward pressures on prices persisted as increased competition from private sector imports, resulting from trade liberalization, has put significant pressure on public enterprises to lower their prices.

Box I.3: Libya—developments in CPI inflation

From 2000 to 2004, Libya witnessed broad-based deflation, with declining prices of both goods and services (top Figure). This development appears to have been mainly cost- rather than demand-driven, as domestic demand, boosted by strong oil revenues, has gathered steam in recent years.

Commodities that were imported at the old special rate accounted for about 24 percent of the CPI basket, while locally produced goods with imported materials account.

9 In February 1999, the Central Bank of Libya introduced a dual exchange rate regime by establishing a "special" rate close to the prevailing parallel market rate, to be used for transaction related to personal imports, travel, medical treatment abroad and pilgrimage. Since then, the exchange rate policy intended to narrow the spread between the official and the special rates through depreciations of the former and appreciation of the latter. In January 2002, the authorities unified the exchange rate system through a one-step devaluation of the official rate.
26. **A significant cushion of reserves has been built.** Contrary to other oil-producing countries that suffered crises following the oil price declines in the 1980s and early 1990s, Libya’s external current account remained generally in surplus, also reflecting the restraining impact of sanctions on imports. Thus, Libya was able to accumulate substantial foreign-exchange reserves. Gross official reserves were about US$ 6.7 billion (11.4 months of imports) on average in 1995-98 (Table I.1). With favorable oil prices Libya’s reserves had more than doubled by 2002, reaching US$15 billion (the equivalent of 20 months of imports). The current account surplus is estimated at about 40.8 percent of GDP in 2005, and gross official reserves have surpassed US$39 billion in 2005, equivalent to 31 months of imports—a high level of reserves when compared to other oil producer countries.

27. **The fiscal balance has been preserved, although public expenditure has been boosted by high oil prices.** The government’s budget has been, on average, balanced during the 1990s. Since 1999, the budget has posted a surplus, although the dependency on oil revenues is significant, with a sizable non-hydrocarbon budget deficit hovering at around 36 percent of GDP since 2003. Boosted by steeply rising oil revenues, public expenditures increased from 31 percent of GDP in 2000 to 44 percent in 2004, conveying to fiscal policy a resolutely expansionary stance. Public expenditure is estimated to have declined to 41.2 percent of GDP in 2005, driven by a sharp decline of extrabudgetary spending. With soaring hydrocarbon revenues, the overall fiscal surplus is estimated at 31.8 percent of GDP in 2005, up from 9.8 percent in 2003.

28. **The economic outlook in 2006 is encouraging.** Given data revisions and recent developments, real GDP is expected to grow at close to 5 percent in 2006, with growth of non-oil GDP remaining steady at around 4 percent, driven by construction, mining, the services sector (mostly private activities), and transportation. The inflation outlook is benign, with the CPI expected to increase by 3 percent in 2006. Due to higher oil prices and production, the current account surplus is expected to
further increase to close to 43 percent of GDP, while gross official reserves may further rise to cover 40 months of imports.

E. The Quality of Economic Information

29. **Weak data availability and quality call for caution in analytical assessments.** Although the government has recently made progress in improving statistics collection, there are still concerns regarding the unavailability of some data, particularly in public finances as illustrated by the absence of detailed data on local government expenditures. On the fiscal side, budgetary data lack transparency as extrabudgetary spending remained sizeable until 2004, at about 32 percent of total public expenditures—see chapter V). Moreover, the quality of the national account compilation is questionable, owing to the significant delays in the receipt of data, the use of outdated surveys, and the lack of internal consistency of estimates. Reliable data related to unemployment are not available. Information on the incidence of poverty is also missing, making it difficult to appropriately target the welfare interventions of the state. In the case of the education and health sectors, there is no reliable system to collect and transfer basic data on outcomes and expenditures from the regions to the center. One of the consequences is that there is no information about the total level of expenditures in these sectors. In the case of the Social Security Fund, information systems are also outdated and this makes it difficult to conduct any assessment of the long-term financial sustainability of the scheme.
II. LIBYA'S KEY DEVELOPMENT CHALLENGE: MAKING OIL WORK FOR GROWTH AND JOBS

A. Libya Holds Strong Long-Term Potential For Raising Hydrocarbon Revenues

30. Libya is well endowed with oil and gas resources, and the country has great potential to increase oil and gas production in the future. With relatively modest domestic demand, it also has the potential to increase exports of both fuels well into the future. Libya's current level of recoverable crude oil reserves is 39.1 billion barrels (Bbbl) and natural gas reserves are 51.3 billion cubic feet (bcf) or 1450 bcm. Known recoverable gas reserves are less than a quarter the size of oil reserves on an oil equivalent basis. The estimates represent only proven, economic reserves that are planned for development. They do not include undeveloped proven reserves or estimates of probable and possible reserves. Libya’s profiles of cumulative production to date differ for oil and gas, with cumulative oil production equivalent to 60 percent of present estimates of recoverable reserves (Figure II.1a). Gas production is less advanced than oil, with cumulative gas production only 12 percent of cumulative reserves (Figure II.1b).

31. Estimates of yet undiscovered, recoverable reserves are significant. In the latest U.S. Geological Survey (USGS) assessment of world oil and gas reserves, it places Libya's mean oil reserves of undiscovered oil at 8.3 Bbbl (Table II.1). The USGS includes probability ranges for reserves actually occurring, and places an upper estimate for oil at 15.3 Bbbl—at 5% probability. For natural gas reserves, the USGS shows a mean reserve estimate of 21.1 tcf, or 600 bcm, with an upper limit of 47.2 tcf. Natural gas liquids (NGL) have a mean estimate of 0.9 Bbbl, with an upper limit of 2.1 Bbbl. It should be stressed that reserve estimates tend to rise over time through greater knowledge from increased exploration and development. Since 1981, USGS estimates of global oil and gas reserves have risen by 76 percent and 66 percent,

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10 The only caveat with regard to domestic demand is that enduring subsidies on domestic consumption have the potential to limit exports (see calculations of implicit energy subsidies in chapter V).

11 No estimates were provided for reserves of LPG and condensate.
respectively, mainly because of chronic underestimation of reserve growth in already discovered fields.

<table>
<thead>
<tr>
<th>Table II. 1: Estimated Undiscovered Hydrocarbon Resources in Libya</th>
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<tbody>
<tr>
<td></td>
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<tr>
<td>Oil (million barrels)</td>
</tr>
<tr>
<td>Gas (billion cubic feet)</td>
</tr>
<tr>
<td>NGL (million barrels)</td>
</tr>
</tbody>
</table>

F95 represents a 95 percent chance of at least the amount tabulated (other percentiles defined similarly).


32. **Libya has the potential to raise oil and gas production significantly in coming years given its large reserve base.** The possibility of significant reserve growth could also expand its capacity to produce and export hydrocarbon fuels into the future. The only limitation to oil production and exports over the past 20 years has been the lack of upstream investment and the commitment to OPEC quotas. Given current investment plans to raise capacity, a major constraint might be adherence to its OPEC quota. Natural gas exports, on the other hand, have the potential to grow more freely without a policy constraint on output. Libya has the potential of being a major low-cost gas supplier situated close to Europe, where gas demand is expected to expand significantly in the coming two decades. However Libya will face increasing competition as the EU liberalizes its gas and electricity markets, and prices are likely to be increasingly de-linked from oil prices. In future, maintenance of large subsidies on domestic gas demand could distort the sector and potentially limit exports.

33. **Alternative scenarios point to a steady increase in Libya’s oil production up to 2025.** The Libyan authorities expect oil production capacity to rise above 2.1 mb/d by 2010, from 1.65 mb/d presently, before falling to 1.8 mb/d in 2014. The Ministry’s data for natural gas production is roughly twice as large as figures cited by several other reliable sources, e.g., the IEA, US DOE, and various consultants. Projections are also provided by the US Department of Energy, based on three scenarios for the world oil market (Table II.2). By 2025, forecasts of OPEC production range from 40.4 mb/d to 67.6 mb/d. The comparable range for world oil demand is 108 mb/d to 132 mb/d, compared with around 85 mb/d today. There are no resource constraints on OPEC being able to produce these volumes over the forecast period—although the upper levels for oil demand growth and OPEC production are thought unrealistic. Under current OPEC quota shares, Libya’s share of 5.36 percent translates into a production range of 2.2 mb/d to 3.6 mb/d in 2025. Though the DOE obviously feels that Libya’s production capacity would not rise to the upper level, all scenarios indicate a significant increase in production.

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12 Under the current World Bank oil price forecast—$59/bbl in 2006 falling to $47/bbl in 2010—oil revenues would average $30.0 billion per year over the 2004-2010 period, before falling to $17.4 billion in 2014 because of lower production and oil prices.
34. Over the long run, the net present value of the government’s hydrocarbon revenues is estimated at between 7.3 to 19.8 times the level of 2005 GDP. The estimation of the net present value (NPV) of government revenues from crude oil and natural gas production is based on various assumptions of reserves, production profiles, and oil and gas prices. The NPV of government hydrocarbon revenues over a long-term time horizon, up to 2100, is calculated on the basis of three scenarios about reserves and three different assumptions about oil and gas prices (summary in Box II.1 and details in Annex 1). The range of estimates is plausible, and assumes that additional reserves will be discovered under favorable investment and market conditions. The estimations of the total NPV of hydrocarbon revenue in 2005 US$, based on a 4 percent discount factor, range from US$ 287 billion to US$ 777 billion (Table II.3)—i.e., from 7.3 to 19.8 times the level of 2005 estimated GDP.

**Table II.2: Projections of OPEC Production and Capacity**

<table>
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<tr>
<th>Three Scenarios</th>
<th>(mb/d)</th>
<th>2002</th>
<th>2010</th>
<th>2015</th>
<th>2020</th>
<th>2025</th>
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<td><strong>Reference Case</strong></td>
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<tr>
<td>OPEC Production</td>
<td></td>
<td>28.3</td>
<td>37.0</td>
<td>40.0</td>
<td>45.5</td>
<td>51.4</td>
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<tr>
<td>OPEC Capacity</td>
<td></td>
<td>30.6</td>
<td>39.9</td>
<td>43.7</td>
<td>49.7</td>
<td>56.0</td>
</tr>
<tr>
<td><em>of which Libya</em></td>
<td></td>
<td>1.6</td>
<td>2.0</td>
<td>2.2</td>
<td>2.5</td>
<td>2.9</td>
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<tr>
<td><strong>High Price Case</strong></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>OPEC Production</td>
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<td>32.0</td>
<td>31.2</td>
<td>33.1</td>
<td>35.0</td>
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<td>OPEC Capacity</td>
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<td>35.0</td>
<td>35.1</td>
<td>37.8</td>
<td>40.4</td>
</tr>
<tr>
<td><em>of which Libya</em></td>
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<td>1.6</td>
<td>1.8</td>
<td>1.8</td>
<td>2.0</td>
<td>2.2</td>
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Production includes natural gas liquids and condensate.
Oil Price Assumptions in 2025 (2003 $): Ref. $48; Hi $54; Lo $21


There are various attempts to estimate a country’s “permanent income” from hydrocarbon production. They invariably rely on estimates of remaining recoverable reserves, and a production profile of the “fixed”, depleting resource over a long period. Given assumptions of government take, resource price, costs, and the discount rate, the present value of the government’s “permanent” revenue stream is calculated. Needless to say, any estimate is surrounded by uncertainty of the quantity of reserves, while the results are sensitive to assumptions of prices, discount rates, and other factors. In addition, some of the basic assumptions such as costs, prices and taxes are held constant, when, in fact, they are likely to change.

Production profiles in Libya were sketched to 2100, reflecting that production does not suddenly run out, but rather has a “long tail” even after suffering large period of decline, as reserves continue to be added from new or existing pools (see Figure, corresponding to the mid-reserve scenario).
However, the bulk of the reserves in these scenarios are produced by 2060, and revenues are calculated for the period to 2060. Government take was assumed at 60 percent of total production value, close to the average share from limited data received from Libyan authorities, and similar to levels in other countries (e.g., 63.5 percent in Algeria). Real oil prices per barrel are set at conservative levels of $25, $40, and $55 in constant US dollars. Gas prices are increasingly de-linked from oil and reflect more competitive markets in all three scenarios. The discount rate is set at 4 percent, reflecting an assumption about the long-run rate of return on accumulated assets out of hydrocarbon revenues.

Oil reserves in low case are set at the current estimate of recoverable reserves of 39 Bbbl. Two higher scenarios of 44 Bbbl and 49 Bbbl were chosen, based on reasonable expansion of recoverable reserves, and reflect estimates of undiscovered oil reserves in Libya by the United States Geological Survey. For gas, the low case reserves were set at 1450 bcm, the current level of known recoverable reserves. Mid-case reserves are set at 1900 bcm, and high-case reserves are 2500 bcm, again reflective of the USGS estimate of undiscovered reserves. Condensate and LPGs are not included, but these could add significantly to aggregate hydrocarbon production and revenues.

1 This is broadly in line with real interest rates on long-term US Treasury bonds of 2 percent (receiving a 60 percent weight) and real stock returns of 7 percent (receiving a 40 percent weight). This is only for illustrative purposes, as the optimal bond and stock weights in a portfolio should be determined using a Capital Asset Pricing Model.

| Table II. 3: Net Present Value (NPV) of Government Hydrocarbon Income to 2060. (2003 US$ billion) |
|---------------------------------------------------|-------------|---------|---------|
| Reserves                           | Low | Mid | High   |
| Prices $25                        | 287.3| 452.8| 617.7  |
| Prices $40                        | 322.9| 509.3| 695.4  |
| Prices $55                        | 360.5| 568.7| 777.0  |

Oil prices constant 2005 $ per barrel.
Gas prices constant 2005 $ per thousand cubic meters.
Discount rate 4 percent.
Government take = 60 percent of total production revenue

Source: World Bank

35. **Oil wealth could generate a sizeable permanent income stream for Libya.** Although oil wealth is exhaustible, appropriate financial management—as explained further below—can help convert this exhaustible revenue into a permanent income stream that can be enjoyed indefinitely by future generations. The permanent hydrocarbon revenue stream can be calculated as an annuity, over an infinite time horizon. The annuity is equal to the present value of the hydrocarbon revenue stream over the shorter extraction period (see technical details and link with long-term fiscal sustainability in Annex 2). With a 4

![Figure II. 2: Permanent Hydrocarbon revenue (2005 prices, in % of 2005 GDP)](image-url)
percent discount rate, a permanent income of US$11.5 billion is estimated in the low-case reserve and price scenario, corresponding to 29.3 percent of estimated 2005 GDP. With a low-reserve and mid-price scenario, the permanent hydrocarbon income is estimated at US$18.1 billion (46 percent of 2005 GDP). The permanent hydrocarbon income stream could climb to as much as US$ 20.4 billion (52 percent of 2005 GDP) in a mid-reserve and mid-price scenario and to much higher levels under more favorable reserves / price assumptions (Figure II.2).

36. **Production and revenue projections are surrounded by considerable uncertainty.** There are significant risks to future levels of Libya’s oil production depending upon OPEC’s pricing and production policy (and other market factors), and whether Libya remains a solid member of OPEC and maintains its current share of OPEC output. Should global demand become more sluggish at high prices than indicated above, it is possible that the demand for OPEC oil will increase very little. In such case, Libya’s oil revenues will be much lower than projected, and the country may end up with sizeable surplus capacity in the medium term. A large surplus may subsequently impinge upon foreign investment in the oil sector. In the more distant future, there are greater uncertainties about the growth of global oil demand, especially in developing countries. But there are also uncertainties about the growth of petroleum-based transport fuels, and growing environmental concerns over hydrocarbon use and global warming. There are no resource constraints far into the distant future, and new technologies continue to lower the cost of production and shift supply curves outward. Thus crude oil prices are likely to remain extremely volatile, with economic forces exerting downward pressure on prices, while OPEC production restraint pushes prices upwards, often well above the costs of production.

B. **Making Optimal Use of the Hydrocarbon Financial Resources, To Promote Non-Oil Growth, Cope With Volatility, and Secure Fiscal Sustainability**

37. **Libya’s main development challenge is to promote growth and job creation in the non-oil sector.** Creating enough jobs for Libya’s rapidly growing labor force will require significantly faster growth in the non-oil sector. The labor force, which is currently estimated at 1.8 million workers, is expected to grow at 3.3 percent per year over the medium-term. Labor force growth is also likely to be bolstered by greater participation of women, given the low current levels of the female participation rate. Under rather favorable assumptions about the employment elasticity of growth (assuming an elasticity of 0.75), it is estimated that the

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**Figure II.3: Growth requirements in non-oil sectors to reduce unemployment rates**

Assumes that total factor productivity grows at 1% per year and that the average capital per worker remains constant.

productive non-oil sectors will need to grow at least at 4.5 percent per year to absorb new entrants to the labor market and to avoid an increase in the unemployment rate (Figure II.3). Much higher growth, of about 6.5 percent, would be needed to reduce the unemployment rate—currently estimated at around 25 percent—by half in a 10-year period.

(i) Patterns of growth and volatility in the non-oil sector

38. **Non-oil GDP growth has been weak, compared to other oil-producing countries and transition economies.** At about 2.8 percent since the early 1990's, Libya's non hydrocarbon real GDP growth has been at the low end of growth seen in other oil-dependent economies and below population growth. Since 2000, non hydrocarbon real growth has been boosted by high oil revenues, but has remained lower than in other comparators in MENA despite the lifting of UN sanctions (Algeria, Iran—Figure II.4). Other oil-producing economies that have adopted market-oriented reforms, (Kazakhstan, Azerbaijan) have seen significantly faster non hydrocarbon GDP growth, offsetting the adjustment costs in the initial phase of the transition.

39. **Oil revenue volatility has been transmitted to non-hydrocarbon GDP growth.** As other oil-producing countries, Libya was exposed during 1991-2002 to important terms-of-trade shocks, stemming from the volatility of the price of oil. But Libya's exposure to terms-of-trade volatility was particularly strong, reflecting the poor diversification of the economy out of hydrocarbons (Figure II.5a). Large terms of trade shocks translated into relatively high volatility of non hydrocarbon GDP growth (Figure II.5b). As suggested by international experience, high volatility is a factor of poor long-term growth performance and might be painful for the society as a whole (Box II.2).
Box II. 2: The adverse impact of volatility on growth

Evidence across a large group of countries, over 1981-2000, suggests that higher volatility, as measured by the changes in the terms of trade, was associated with lower long-run growth (Figure), although other variables may explain this negative correlation, such as weak governance and bad investment climate. Volatility in key macroeconomic variables such as the terms of trade, inflation and real exchange rate, heightens uncertainty, lowering the risk-adjusted returns on investment, and hence leading to lower private investment. High volatility also increases bank exposure to credit risks and impedes the development of an efficient banking system. Banks are more inclined to supply short-term credit, at the expense of long-term financing. This potentially lowers the cost of financing of long-term productive investment. High risks of financial intermediation also increase the level of collateral required by the banks, thus hampering access to finance by small and medium enterprises.

<table>
<thead>
<tr>
<th>Growth rate 1991-2003</th>
<th>standard deviation</th>
<th>Coefficient of variation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>1.6</td>
<td>2.8</td>
</tr>
<tr>
<td>Oil &amp; Mining</td>
<td>2.4</td>
<td>8.0</td>
</tr>
<tr>
<td>Construction</td>
<td>4.8</td>
<td>14.8</td>
</tr>
<tr>
<td>Industry (Utilities + Manufacturing)</td>
<td>1.8</td>
<td>6.3</td>
</tr>
<tr>
<td>Services</td>
<td>3.6</td>
<td>3.3</td>
</tr>
<tr>
<td>GDP</td>
<td>2.8</td>
<td>2.9</td>
</tr>
<tr>
<td>Non oil GDP</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(ii) Macroeconomic policies and the management of volatility

40. **In the non hydrocarbon sector, volatility has been particularly acute in industry and construction.** Since the early 1990s, in industry and construction the standard deviation of growth has been more than three times higher than the average growth rate, a volatility comparable to that of the oil sector (Table II.4). By contrast, the volatility of growth has been much smaller in agriculture, and even less so in services—the sector that has contributed most to growth of non-oil GDP. Although the higher volatility of growth in industry, relative to services, is not unlike the patterns seen elsewhere, the very high level seen in Libya may further increase the risk premia faced by investors, thus hampering efforts to promote private investment in the years ahead.

Table II. 4: Growth and volatility by sector of economic activity

1991-2003

41. **Appropriate government policies, and strong social and economic institutions, can mitigate the impact of volatility on growth.** International experience suggests that prudent fiscal policies are key to insulating the economy from external
shocks. Prudent fiscal policies provide room for absorbing the shocks, without placing excessive strains on domestic demand in order to maintain a sustainable fiscal and external position. Moreover, strong financial systems will be in a better position to cushion the impact of volatility on growth, by allowing more efficient allocation of resources across economic sectors in the face of greater uncertainty. Flexible labor markets also help cushion the impact of shocks on employment and, thus, on domestic demand and growth.

42. In Libya, policy has failed to insulate effectively the economy from the cycle of oil. Changes in domestic investment, with a multiplier impact on domestic demand, have been the main source of volatility of non-hydrocarbon GDP growth. Swings of domestic investment have been closely associated with volatility in oil revenues (Figure II.6). Domestic investment, dominated by the public sector, often had to be cut drastically to preserve the fiscal balance, in the face of weak oil revenues, during much of the 1990s. By contrast, public investment has soared since 2000, due to the increase in oil revenues.

43. Fiscal policy has been imperfectly insulated from the cycle of oil. Although an oil reserve fund (ORF) was established in 1995 with implicit saving and stabilization objectives, in periods of high oil prices, public expenditure was allowed to rise substantially, financed by the fund. By contrast, because of the large share of government expenditures financed by hydrocarbon revenues, when these revenues were on the decline, fiscal balance was only at times preserved through expenditure compression. The non-oil deficit has thus tended to increase when oil revenues are on the rise, and at times to decrease when oil revenues decline imparting procyclicality to the fiscal stance (Figure II.7).

44. Since 2000 the non-oil deficit has increased dramatically. From 1997 to 2001, the ORF operated in practice as a stabilization fund. When oil prices were relatively low during 1998-1999, there were net withdrawals from the fund (at a modest rate of 2 percent of GDP). Following the surge in oil prices in 2000, the ORF’s balance almost doubled. However, with a surge of extra-budgetary expenditure
starting in 2001, discretionary financing of such expenditures from the fund reached about 14 percent of GDP in 2003. The non-hydrocarbon fiscal deficit has thus hovered around 35 percent of GDP during 2002-2005, up from 17 percent in 2000. Moreover, current expenditure, particularly wages and salaries, has grown very rapidly over time to exceed their earmarked allocation from the budgeted oil revenue (30 percent of budgeted oil revenues). On the contrary, development expenditure, reflecting the limited absorptive capacity of the Libyan economy, fell short of the earmarked oil revenue allocation (70 percent of budgeted oil revenues). Thus, as further discussed in the next chapter, efficiency of public expenditure has become problematic.

45. **The impact of oil revenues on the money supply has been imperfectly sterilized through imports.** Increases in Libya’s non-oil fiscal deficit have generally resulted in an increase in money supply. But, at the same time, expenditures have resulted in higher imports, partly sterilizing the increase in money supply through a decline in net foreign assets of the banking system. As a result, the driving force behind the monetary expansion in Libya has been the part of the impulse imparted by the non oil fiscal deficit that did not leak through the balance of payments. However, the current situation of excess liquidity could pose a risk for macroeconomic stability. The rise in liquidity has not resulted in inflation pressures, as inflation has been disconnected from monetary developments—also reflecting the still pervasive controls on the economy. However, as the factors that led to deflation since 2000 are non-recurrent in nature, it is expected that in the period ahead, the inflation outcome will depend to a large extent on monetary developments. Over the medium term, until effective monetary instruments are developed, the most effective measure to control the rapid growth in money supply is to prevent an overly expansive fiscal stance.

46. **The downside risks to the fiscal and external positions seem relatively limited.** With the price of oil projected to remain at a high level, of around US$60 per barrel in a baseline simulation, the downside risks to the budget seem limited. A sensitivity analysis based on a US$15 decline in oil prices off the baseline shows that the overall fiscal surplus would still remain at around 22 percent of GDP (IMF, 2006). The external current account would also remain in surplus, projected at 27 percent of GDP, so that foreign exchange reserves would continue to build up under this scenario. On current policies, a decline in the oil price of US$30 below the baseline projection would be required for the fiscal surplus to be absorbed. The required drop in the oil price for the external current account to turn into deficit would be, all else equal, around US$33.

(iii) Strategic options for the use of hydrocarbon financial resources

47. **Projected high oil revenues will provide finance for growth but will not necessarily spur sustained growth in the non-oil sector.** Libya’s unsuccessful experiment with the state-driven model of economic development based on import

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13 The required reserves resulting from Central Bank of Libya regulations are high, representing above 8 percent of broad money supply. But because of limited lending opportunities, by the end of 2003, the excess liquidity of commercial banks (as measured by commercial banks deposits with Central Bank minus required reserves) was also high, amounting to 2.8 billion LYD and representing 20 percent of broad money supply. In May 2004, the government bought back its debt from the banking system, and, as a result, the excess liquidity reached 34 percent of broad money supply.
substitution (see chapter I) has drawn attention to the limits of using the oil revenues for financing investment of public enterprises in selected industries. Barring this model of development, and based on experience and lessons from other oil-producing countries, there seem to exist three broad strategic options for using the large financial resources from oil as a means to foster non-oil growth:

(i) Using accumulated oil revenues to expand public investment in infrastructure as a means to directly propel non-oil sector growth—but also increase household revenues and thus provide a multiplicative impulse to growth.

(ii) Distributing oil windfalls to households, as a means of bolstering incomes and domestic demand growth, while possibly ensuring a better stabilization mechanism against oil revenue volatility.

(iii) Saving part of the oil windfalls for the future; using the rest strategically to improve human capital and build strong social safety nets, while, at the same time, accelerating the pace of structural reforms needed for a transition to a market-led economy integrated with the rest of the world.

Option A

48. It could be argued that using surplus oil revenues to fund higher public investment may have a better growth pay-off than accumulating savings—Libya uses a large fraction of oil revenues to finance current and capital public expenditures and the associated non-oil fiscal deficit. Surplus oil revenues are being saved in the Oil Reserve Fund. Is there scope for stimulating growth by using these accumulated savings to expand public investment in infrastructure? Indeed, higher public investment could generate productivity gains by filling “infrastructure gaps” that may increase the cost of business operation and reduce competitiveness. Filling such infrastructure gaps, especially in transport and Information and Communications Technology, could also contribute to better integration into international trade. Public investment could also contribute to upgrade and expand housing where social needs may be acute. It could also be argued that higher public investment (especially in non-traded goods sectors such as housing) would also contribute to increasing household incomes and could thus have a multiplicative impact on non-oil GDP growth—though at the expense of higher imports and possibly balance-of-payments vulnerabilities.

49. But the decisions concerning public investment in (social and economic) infrastructure would better be de-linked from the presence of hydrocarbon windfalls. Despite the attractiveness of using hydrocarbon windfalls to fill infrastructure gaps and as a direct stimulus of growth, several considerations would argue for de-linking oil revenues and public investment in infrastructure:

• Using hydrocarbon windfalls to expand public investment, instead of saving part of the surplus revenues, would not insulate fiscal policy from the volatility of oil revenues. Demand-driven growth in the non-oil sector would be vulnerable to a downturn in the price of oil as past episodes of shrinking oil revenues have demonstrated.

• Efficiency considerations would call for public investment to be driven by the productivity and cost of public capital. Although the presence of hydrocarbon windfalls could temporarily lower the cost of financing public investment, eventually the decisions whether the return to investments is worth the
expense is independent of hydrocarbon wealth and should be better taken in the context of medium-term expenditure planning. In Libya, the development budget already represents a fraction of GDP significantly larger than in comparator countries, which may suggest limited absorptive capacity for further increases and low efficiency of spending.

- Using oil windfalls to finance increases in domestic demand would risk exerting pressure on domestic costs (once most of the slack in the labor market is absorbed). Higher domestic costs, along with a possible exchange rate appreciation due to current account surpluses, would expose the economy to the “Dutch Disease” syndrome—unless strong efficiency and productivity gains offset the increase in unit labor costs.

Option B

50. **The intermediation of part of hydrocarbon windfalls through the household and business sectors might produce superior growth performance in the long run.**

The way hydrocarbon revenues are intermediated matters for economic performance. When the hydrocarbon revenues are exclusively intermediated by the state, as is the case in Libya, the pattern of expenditures and the amounts allocated to savings and investment may be different from the patterns that would prevail if the rents were transferred to the private sector. Hydrocarbon windfalls may be transferred to households and businesses through different channels—such as lower personal and corporate income taxes; lower indirect and payroll taxes; or through direct transfers. In the case of Libya in particular, direct transfers of hydrocarbon revenues to households could be considered as a welfare-improving substitute to the distorting energy and consumption food subsidies (see chapters III and V). Although the various instruments have a different impact, when hydrocarbon windfalls accrue to households and businesses private consumption and investment will increase directly, stimulating economic activity in the short run. Increased household savings out of oil revenue transfers would also funnel investment, if properly intermediated by the financial system, thus expanding productive capacity and output in the long term. Simulations for some countries have established that when a temporary windfall is intermediated by the government, the impact is likely to die out almost completely in the long term. By contrast, with intermediation by the household and business sector the long-term increase in GDP might be sustained (see, for example, World Bank 2003f for the case of Algeria). The dividend distribution policy implemented by the Alaskan Permanent Oil Fund is an example of a broad-based intermediation by households (Box II.3).

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14 When the windfall accrues to the government, productive capacity increases only indirectly, to the extent public investment in infrastructure boosts private sector productivity, thus producing a somewhat limited impact on output in the long run. By contrast, when the windfall is intermediated by the private sector investment and productive capacity expand directly in the long term.
Box II. 3: The Alaska permanent oil fund

The Alaskan model has become a famous example of dividend distribution from oil revenues to citizens. Indeed, although Alaska has the largest oil fields in North America, Alaskans decided to distribute a portion of the income of a Permanent Fund each year to eligible Alaskans as a dividend payment. The Alaska Permanent Fund (see http://www.apfc.org) was established in 1976 in order to transform non-renewable oil wealth into a renewable source of wealth for future generations. Basically, slightly more than 30 percent (at least 25% according to the law) of all mineral lease rentals, royalties, royalty sales proceeds, federal mineral revenue-sharing payments, and bonuses received by the State are placed in a Permanant Fund, the principal of which is to be used only for those income-producing investments specifically designated by law as eligible for permanent fund investments. The fund has two parts: (i) the principal, which is invested permanently and cannot be spent without a vote of the people; (ii) the income, which can be spent, and decisions regarding its use are made each year by the legislature and the Governor. The remaining State revenue received from oil taxes and royalties goes into the General Fund for general purpose spending, and 0.5% goes into the Public School Trust Fund.

In the Alaskan model, the government equitably distributes resource rents to the people, thereby securing democratic common heritage rights to land and natural resources. Practically, oil income goes into a fund and dividends are distributed among Alaskan citizens, not from current oil revenues, but from the fund income. Eligible Alaskans (at least one-year residents of Alaska - every woman, man and child - who applied for) receive a yearly dividend since 1982 (right figure). For many Alaskans, the dividend adds more than 10 percent to the income of their family, principally in rural areas. The remaining earnings go toward inflation proofing the Fund principal. Any residual income is added to principal, retained as undistributed income, and transferred to the General Fund. However, earnings, and consequently dividends, are not granted since the Alaska Constitution states that the Fund’s principal cannot be spent. The dividend can only be paid from Fund earnings from the investment portfolio. The Alaska Permanent Fund Corporation, an independent institution managing the Fund, is currently considering another method for determining the annual payout that would remove the distinction between principal and earnings and guarantee the distribution of five percent of the Fund’s total market value each year.

The Alaska model is probably not exactly applicable to many countries, but there may be analogues to it, in terms of encouraging direct grants to individuals. This might help spark involvement by civil society in what is actually happening to oil revenues, increasing transparency, and strengthen mechanisms for oversight.

51. Transferring oil windfalls to households may also better insulate the economy from the volatility of oil revenues. Effectively insulating the economy from volatile oil revenues calls for saving temporary revenues for the future, with a view to stabilizing expenditure—which should be financed by the estimated permanent oil revenue stream. Experience suggests that governments often fail to do so, either owing to poor governance, or because they find it hard to resist pressures from various constituencies when sizeable financial assets have been accumulated. Governments thus often resort to procyclical policies that exacerbate the cycle of oil. Libya is no exception to that rule as examined in the previous chapter. By contrast, there is ample empirical evidence that the consumption behavior of households is precisely grounded on their perception of permanent income. Temporary changes in oil revenues, if intermediated by households, could thus spur savings rather than unsustainable domestic expenditure. and with freedom of capital movements in place,
increased household savings could be diversified in a foreign held portfolio, thus effectively sterilizing the higher oil revenue inflows. Still another option would be to transfer to households the income stream from the accumulated oil revenue savings—as in the case of the Alaskan Permanent Oil Fund described above. This would mitigate the procyclicality of the transfers since the income stream out of accumulated savings would not be related to the cycle of the price of oil (see Figure in Box II.3).

52. Increased household intermediation of hydrocarbon revenues is an option that requires careful design and should go in tandem with considerable strengthening of the investment climate. Direct transfers of hydrocarbon rents to households should be appropriately designed so as not to distort incentives to work. In addition, if the investment climate is weak, higher household and business sector revenues out of hydrocarbon windfalls may boost private consumption but fail to be spontaneously converted into productive investment. This risk may be especially relevant in Libya, where—as further explained in chapter IV—weaknesses in the investment climate, constraints to the efficient use of resources, and still poorly functioning institutions (including the banking system) hinder the mobilization of savings and private investment. Shifting to a different model of intermediation of the hydrocarbon revenues may thus help unlock the economy’s long-term productive potential, provided the necessary reform initiatives to strengthen the investment climate and promote the efficient use of resources are phased in at the same time. The authorities are encouraged to consider the possibility of implementing this option in the long term, accompanied by progress on the structural reform front.

Option C

53. Using the oil windfalls strategically, to facilitate the transition to a competitive, market-led economy, is a superior option for fostering non-oil growth and job creation in Libya. As further explained in the next section, achieving fast and sustained growth over the medium term would call for well-coordinated initiatives to accelerate the transition to a market-led economy fully integrated with the rest of the world. Contrary to the transition economies in Eastern Europe and Central Asia in the early 1990s, Libya has built a comfortable financial position, thanks to high oil prices since 2000, and can afford the cost of safety nets needed to cushion the adjustment of the transition to the market. This would greatly help step up the pace of required reforms—an important condition for a successful transition to a dynamic market-oriented economy. Indeed, evidence from the economies in transition suggests that the quicker a high level of liberalization is reached and sustained, the sooner the economy can attain higher growth (Box II.4). Strengthening Libya’s human capital assets is also an important requirement for improved competitiveness and successful integration in the international economy. This third option would therefore call for using part of Libya’s surplus oil revenues both for designing efficient safety nets and for enhancing the quality of human capital. The rest of surplus revenues should be saved for stabilization purposes or for future generations. A variant of this option could also allow some fraction of the oil revenues to be reinvested in the oil sector, to expand and modernize production capacity and take advantage of high oil prices. Increasing investment in the exporting sector would not risk boosting domestic costs and disrupting competitiveness, as long as the extra oil revenues from greater production capacity are saved. In due time, a combination of
options B and C could be envisaged, with an increasing part of surplus oil revenues progressively transferred to households.

54. **Making strategic use of the hydrocarbon revenues calls for strengthening public finance management over the medium term.** The analysis of the reform agenda associated with the third option outlined above constitutes the main thrust of this report. However, a prerequisite for implementing this option is a serious reinforcement of public finance management. A strong framework for budget formulation and execution, combined with expenditure discipline and sound practices for management of oil windfalls, would help meet several simultaneous challenges:

- Establishing strategic priorities in the use of oil revenues, to improve human capital and build social safety nets for the transition;
- Anchoring the transition on macroeconomic stability—by insulating the fiscal stance from volatile oil fiscal revenues, and securing fiscal sustainability in the face of a possible fall in the price of oil, social expenditure pressures, and the contingent liabilities of the public sector (e.g., the non-performing loans of public banks). Macroeconomic stability is an important anchor of the transition as it allows to:
  
  (i) improve visibility and mitigate risks for investors;
  
  (ii) hedge against external current account pressures in case of a sustained drop in the price of oil, which could put the reform program and Libya’s trade integration at a risk of backtracking;
  
  (iii) secure the sustainability of social protection expenditures and safety nets designed with the aim of absorbing the social cost of the transition.
- Coping with domestic cost pressures that stem from overspending large oil revenues ("Dutch disease" effects);
- Saving for future generations in order to secure long-term fiscal sustainability and preserve inter-generational equity.

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**Box II.4: Speed of reform and economic growth**

The speed of reform is at the center of a controversial debate. Some economists argue for advancing reforms in all areas as fast as possible, to enable synergies among different components, for example privatization together with liberalization of prices and trade. In contrast, others criticize such a strategy as going ahead with reforms that can be implemented quickly without waiting for those that take more time, such as creation of institutions that support markets, significantly reduces the benefits of these reforms. There is however evidence that output in each year is significantly associated with the level of policy reforms achieved up to that year. So the quicker a high level of liberalization is reached and sustained the sooner the economy can attain higher growth. The figure in the right illustrates the progress of reforms between 1990 and 1998 (a score of less than 0.4 indicates limited progress in reform). Countries which have adopted more reforms in the shortest time are those which are performing the best and have relatively succeeded their transition, although still incomplete.

![Progress in Policy Reform, 1990s](chart)

55. **Maintaining long-term fiscal sustainability would require a savings strategy over time, because hydrocarbon fiscal revenues are exhaustible.** Libya, as most oil-producing economies, can afford the “luxury” of a large non-oil fiscal deficit, to the extent the revenues from oil resources can secure a sufficient and stable financing over time. However, although in practice oil reserves may extend over a long period of time, based on inter-generational equity considerations, the country should eventually prepare for being an economy without oil. The savings strategy should aim at accumulating substantial assets, with two options in mind regarding the use of these savings in the long term:

- The *income stream* from the accumulated assets could be used to finance the non-hydrocarbon fiscal deficit once hydrocarbon resources have been depleted. In a sense, this strategy would aim at transforming an exhaustible stream of hydrocarbon revenue into a perpetual stream of financial revenue through appropriate savings over time. This would allow maintaining a large non-oil deficit even after the country runs out of oil revenues and keeping taxes low.
- The alternative would be to finance the non-hydrocarbon deficit by gradually drawing down accumulated assets once hydrocarbon resources are exhausted, while, at the same time, progressively increasing taxation to ensure long-term fiscal sustainability, when the accumulated savings are depleted. This option might be considered if the real rate of return on accumulated savings (a mix of bonds, stocks and real assets) were significantly lower than the rate of return on productive investments that could be financed by drawing down savings. The level of required savings accumulation would be different in each case.

Issues related to public finance management are discussed in further detail in the next chapter.

56. **Enabling The “New Economy”, Led By The Private Sector, To Gain Strength—A Precondition For Faster Non Oil Growth and Job Creation**

56. **Weak non-oil GDP growth reflects both insufficient investment and low productivity of capital**— At about 16.7 percent of non oil GDP on average during 1998-2003, investment in the *non hydrocarbon sector* remains low compared, for example, to neighboring countries in North Africa (Table II.5). The weak investment effort is holding back non oil growth. But an additional drag on growth comes from poor productivity, as reflected in the very high Incremental Capital Output Ratio.
The ICOR remains about 60 percent higher than in Algeria and 90 percent higher than in Tunisia, signaling a low return to non-hydrocarbon sector investment. This reflects the inefficiencies of the state-driven model of economic growth, but also the impact of sanctions and of the isolation from the international economy.

<table>
<thead>
<tr>
<th>GDP Growth</th>
<th>Investment to GDP Ratio</th>
<th>ICOR (residual)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Libya</td>
<td>1.8</td>
<td>16.7</td>
</tr>
<tr>
<td>Tunisia</td>
<td>4.8</td>
<td>23.6</td>
</tr>
<tr>
<td>Algeria</td>
<td>4.2</td>
<td>24.8</td>
</tr>
</tbody>
</table>

1 Incremental Capital Output Ratio

---while the growth of labor productivity in the non-oil sectors has also been negative--- The low capital productivity observed in Libya may, to some extent, reflect the use of capital-intensive methods of production—a heritage of the command economy of the past. However, the productivity of labor in the non-oil sector points to a similar weak performance, with negative growth during most of the 1990s and average annual growth hovering around –2 percent (Figure II.8a). Negative productivity growth has persisted in manufacturing since the mid-1990s, and has been observed also in services (the main driver of non-oil GDP growth) and agriculture (Figure II.8b). Usual caveats apply to these estimations due to the weak quality of data—especially on employment.

---and tentative estimations suggest negative Total Factor Productivity (TFP) growth in the non-oil sector. Estimations of TFP in Libya are much more hazardous, owing to the absence of reliable capital stock estimations. Some very tentative calculations—based on a hypothetical capital/output ratio of 2—suggest a
slightly negative growth of TFP over the 1990s (Box II.4). Non-oil GDP growth seems to have been mainly driven by employment growth, in line with the negative growth of labor productivity recorded during most of this period (Figure II.4a). The contribution of capital accumulation to non-oil GDP growth seems rather limited (less than half the contribution of labor), in keeping with the relatively low investment ratios observed in the past (Table II.5).

Box II. 5: Estimations of Total Factor Productivity (TFP) in the Libyan non-oil sector

Proper estimation of TFP in Libya is not possible due to the absence of reliable capital stock estimates. However, to gain some insight on the underlying trends, an initial value of the capital stock was assumed in 1990, based on a hypothetical capital/output ratio of 2 in the non-oil sector as a whole. This is close to the capital output ratio observed, for example in Algeria, an economy with a similar structure and command economy heritage as Libya. Using this initial value for the capital stock (in constant 1997 prices), a time-series was calculated using data on gross fixed investment in the non-oil sector and assuming a depreciation rate of 5 percent per year.

TFP in the non-oil sector was calculated based on this hypothetical time series for the capital stock, and using the available employment data. Standard estimates were used for the elasticity of output to labor and capital inputs, of 0.7 and 0.3 respectively. Constant returns to scale were assumed. The estimation does not include a separate indicator for the quality of labor, due to the absence of reliable estimates of skill levels or educational attainment of the labor force. Therefore, the impact of skills on GDP growth is partly subsumed in the estimated TFP growth, meaning that these estimates tend to overestimate the underlying TFP growth trend.

The estimations suggest, on average, a negative contribution of TFP to non-oil GDP growth, of about -0.2 percent for the whole period (Figure). It should be noted that the estimations are sensitive to alternative assumptions about the capital/output ratio and, thus, should be interpreted with caution.

59. **Improving efficiency and productivity growth is the precondition for faster growth and a greater investment effort.** Over the medium term, sustaining a growth rate of about 5.5 percent would require a significant increase in the investment ratio, to around 25 percent of GDP. But this would also call for a substantial improvement in productivity, bringing the ICOR down to around 4.5, a level similar to that seen in comparators. This would require significant improvements in efficiency, leading to sustained, positive TFP growth. Indeed, faster GDP growth, in the short term, will come from efficiency gains and a turnaround in productivity growth. With stagnant productivity, combined with distortions (administered prices, entry barriers) and dysfunctional product and factor markets, profitability remains low and there is little scope for the much needed greater private investment. As explained in chapter IV, important regulatory and institutional reforms would be required to strengthen the investment climate, promote efficiency, and increase the productivity of investment.

60. **In Libya, as in other oil-producing economies, strong productivity growth is also a prerequisite for competitive diversification out of hydrocarbons.** Large hydrocarbon revenues often make it difficult for oil-producing economies to achieve competitive diversification out of hydrocarbons in traded goods. These revenues tend to exert pressure on domestic costs and the exchange rate, thus hampering the competitiveness of traded goods sectors (“Dutch disease” effect). This may be particularly true in Libya, where high per capita oil revenues would tend to increase
real wages in the long term. It is thus particularly important that competitiveness be supported by strong labor productivity growth, driven by improved corporate efficiency, use of modern technology, performing business services, and continuous improvement in labor force skills.

61. **With open and well-functioning markets in place, private investment would take advantage of unrealized potential for growth and diversification.** High per capita oil revenues may exert pressure on labor costs, but they also create potential for growth in non traded sectors, such as construction and services. Services is a good example of a sector where Libya presents unrealized potential in comparison to other oil-producing economies. This is estimated at roughly twice the current level of services GDP, or 40 percent of total 2002 GDP (Figure II.9). Realizing this potential in a 10-year period would boost growth by about 3.4 percent on average per year, while multiplier effects would further enhance growth.

62. **Growth of services would hold benefits for job creation**— Growth in services will directly create employment for Libya’s population. The potential for direct job creation is important, because in Libya services provide jobs to a relatively smaller fraction of the total employed population compared to countries with a similar level of per capita GDP (Figure II.10). In comparison to these countries, Libya’s employment is relatively higher in industry and construction (also reflecting large public work programs such as the Great Man-Made River) and about the same in agriculture. Moreover, efficient services—especially in transportation, trade, and information and communications technologies—will improve efficiency and productivity growth in the industrial sector of the economy, and thus contribute to a much needed improvement in competitiveness. The competitiveness of the tourism sector, that has a great potential to expand, will also be enhanced. Efficient services are thus an important precondition for an increase in private investment and job creation in the economy as a whole.

63. **—and could offset part of the adjustment costs of the transition to the market.** With the fraction of employment in services in total employment about 10 percentage points lower than in other upper middle-income countries, diversification and growth in services is strategically important in the transition to the market. In comparison to this unrealized potential in services, employment in manufacturing—
where jobs, in state-owned enterprises, are most vulnerable during the transition—represents only 12 percent of total employment. Realizing the potential for employment growth in services would provide an important cushion to job losses in manufacturing, even in the extreme case where 8 out of 10 manufacturing jobs were to be temporarily lost.

64. **Efficiency in services would be a key determinant of Libya’s long-term living standards, requiring a strong investment climate, close integration with the world economy**—With a given hydrocarbon endowment per capita and oil prices, in the long run, productivity in services will be a critical determinant of income per capita and living standards. Efficiency in services would require competition—supported by dismantling state monopolies and promoting a liberal FDI regime—and a high-quality legal and regulatory infrastructure. Accession to the WTO would provide a coherent framework for promoting both the trade liberalization agenda and a strong investment climate in services. With the right framework in place, Libya could also develop potential for services exports, exploiting its proximity and links with Europe, the Arab world, and Africa (for example, in high-end tourism, transportation, finance).

65. **—and a steady improvement of workers’ skills.** Developing excellence in services requires a conducive regulatory environment, but experience suggests that human capital is among the main drivers of service performance (Pilat, 2000). This is so for several reasons: (i) Many traditional services are labor-intensive and people are the main resource; (ii) Innovation in services is strongly dependent on the skills, expertise and experience of service workers, as their tacit knowledge and experience with customers are crucial to the development of new service products or processes; (iii) Service performance is closely linked to the interaction between the consumer and the service provider, with the quality of the service provided depending greatly on service workers’ skills; (iv) The extensive use of ICT in many services requires workers who are sufficiently skilled and familiar with these technologies. Investment in human capital is thus an important component of services sector performance and calls for continuous training and updating of skills. A broad education policy, emphasizing multidisciplinary, lifelong learning, will be crucial to developing such skills.

66. **Furthering the transition to a market-oriented economy is the key to improve efficiency and productivity growth.** The transition to a market-led economy will encourage private (domestic and foreign) investment and the creation of new firms willing and able to compete in open markets. It will also support the much needed improvement in efficiency and productivity growth, by removing existing constraints to the efficient use of production factors. The Government has embarked on an important program of first-generation reforms to promote a more competitive environment for doing business, by reducing trade protection and unifying the exchange rate. It also intends to accelerate the pace of privatization of public enterprises. Key initiatives undertaken by the government are reviewed in chapter IV.

67. **Establishing a framework that guarantees property rights and the rule of law is the precondition for the transition to a market-led economy**—In market economies, law defines the rules of the game and gives individuals the rights and tools to enforce them. Where the rule of law is in force, laws and regulations are
applied fairly and transparently. The state becomes mainly responsible for enforcing the law. Legal frameworks are particularly important to create the right incentives for private sector development, because transition involves changes that require entry of new firms, exit of unviable firms and increased competition. To that purpose, economic laws have at least four functions: defining and protecting property rights; setting rules for exchanging these rights; establishing rules for entry into and exit out of productive activities; and promoting competition by correcting market failures. Early on, transition economies have to draft and enact legislation in the fundamentals areas of property, contracts, company organization, bankruptcy, and competition. Moreover, in an environment of transfer of assets from the state to private hands, in conjunction with price and trade liberalization, enforcing the rule of law is crucial to avoid asset stripping, impose discipline and encourage private initiatives.

68. **and should go in tandem with continuing reforms on two fronts:**

- **Creating a strong investment climate,** by promoting a high-quality regulatory framework for investment (limiting regulatory risk and discretion), with open and functional product and factor markets. This would be key to encourage domestic investment and attract foreign investment—which Libya needs not mainly as a source of finance but as a source of improved technical and business know-how.

- **Pursuing public enterprise reform and privatization.** With about 75 percent of total employment in the broader public sector, reforming public enterprises is key to fostering efficiency and productivity growth. Privatization of public enterprises is an important element in any effort to improve corporate efficiency and performance, but has to go in tandem with the creation of open and competitive markets for all potential investors. At the same time, it is important that hard budget constraints be imposed on distressed public enterprises, so that they face sufficient incentives to restructure and compete in open markets.

The main lines of the reform agenda on these two fronts are further elaborated in chapter IV.

69. **Promoting a financial system providing payments services, mobilizing savings, and efficiently allocating financing for investment is a key underpinning of a well-functioning market economy.** Well-functioning financial systems ensure firms the ability to seize emerging investment opportunities and reduce the reliance of small firms to internally generated cash. They also impose discipline on firms, thus driving efficiency, both directly and by facilitating new investment and market entry. According to empirical evidence, doubling private credit as a share of GDP is associated with an increase in average long-term growth of almost two percentage points (World Bank, 2004). In Libya there is substantial room for gains, as credit to the private sector is still very limited, and total domestic credit is a small fraction of...
GDP compared to other upper middle-income countries—including oil-producing countries (Figure II.11). Banking represents the backbone of the Libyan financial system, but the operation of banks has been hampered by widespread state ownership, a long tradition of directed credit to state-owned enterprises, controlled interest rates, and absence of credit culture. The government has embarked on a program to strengthen the banking system, privatize the state-owned banks, and promote the financial industry outside the banking system. Priorities in financial sector reform are reviewed in chapter V.

70. **Effective and sustainable social protection would facilitate a smooth transition to a market-oriented economy.** The positive effects of the transition on the economy and on standards of living will be balanced by greater economic risk and uncertainty among the population. The social protection system takes on an important role in mitigating economic shocks to individuals and households, when the economy will observe reallocations of labor and capital across sectors. Particular attention needs to be given to vulnerable population groups, which have fewer means to deal with risks and are less well equipped to take advantage of new economic opportunities. Within a sound fiscal framework that secures fiscal sustainability, Libya’s comfortable financial position associated with sizeable oil revenues could be used strategically, with the aim of reducing the social cost of the transition to a competitive market economy, by financing well-designed safety nets, tax reform, and investment in human capital. These issues are discussed in further detail in chapter VI.

71. **Summing up, Libya faces a simultaneous policy challenge in the years ahead:**

- Making optimal use of the hydrocarbon financial resources, to facilitate the transition to a market-led economy, cope with volatility, and secure fiscal sustainability over the medium- and long-term.
- Enabling the “new economy”, led by the private sector, to gain strength—a precondition for faster non oil growth and job creation.

Rising up to the first challenge calls for strengthening public finance management, as further explained in chapter III. Addressing the challenge of the transition requires well-coordinated initiatives on the three-pronged reform agenda outlined above: (i) Building a strong investment climate; (ii) promoting financial sector reforms; and (iii) designing an efficient social protection system. Challenges in these areas are reviewed in chapters IV, V, and VI. At the same time, improving the quality of Libya’s human resources and the quality of governance are crucial underpinning issues of the reform agenda over the medium term. These issues have not been analyzed in depth at the current stage, so that the report is limited to some preliminary observations summarized below.

D. **The Challenge of Improving The Quality of Governance and Education**

72. **To implement the reform agenda outlined above, the role of the State would have to change.** Over and above the need for strong political will to spearhead and champion the reforms, the State would also have to rise up to the double challenge of increasing its role as a regulator while decreasing its role as an interventionist. This would entail an increase in the capacity to regulate markets, enforce decisions, and
ensure a level-playing field among market participants by providing strong, effective and reliable public services and market institutions (customs, tax authority, competition authority, judicial bodies). It would likewise mean that the State accepts to let the private sector play a stronger role in land and credit markets, in the investment process and in the provision of services to enterprises and of infrastructure, and in the production of those goods and services that do not exhibit public good or strategic features.

(i) Governance

73. **Improving the quality of governance deserves particular attention because it underlies the development reform agenda.** Progress on the three priority fronts (improving the investment climate, enhancing social protection, strengthening public finance management) will call for mutually reinforcing initiatives to improve the quality of governance. There is growing evidence that good economic governance is critical to foster private investment; take advantage of increased global flows of information, goods, and capital; and improve resilience to shocks (World Bank, 2003a, also see Box II.6). and experience from the transition economies in the 1990s has shown that key to a successful transition is the quality of governance in a country (World Bank, 2002).

- As discussed below, establishing an enabling environment for a competitive private sector would call for initiatives to promote transparency and predictability of regulations, and institutions to support the competitive functioning of key markets (efficient judiciary; regulatory framework for labor and land markets). Transparency and effective enforcement of "hard budget constraints" would also be a key underpinning of a successful public enterprise reform and privatization program. The challenge of improved governance is also at the core of the financial sector reform agenda—for example to strengthen governance and operational autonomy of public banks; upgrade banking supervision on a risk-based approach; and improve corporate transparency.

- Libya is also facing challenges in public sector management and internal accountability. Rising to the growth challenges would call for further strengthening public sector governance in a number of areas. As explained below, initiatives should focus on improving the comprehensiveness and transparency of the budget, by eliminating off-budget spending practices and integrating the Oil Reserve Fund in the budget. Public finance management should be cast in an appropriate medium-term framework that takes into account the need to insulate the economy from the volatility of oil revenues and ensure fiscal sustainability. Strengthening the efficiency of public service delivery, especially in social sector policies, would call for transparent interventions by eliminating the extensive implicit subsidies, appropriate incentives in the civil service, and better institutional arrangements for fiscal decentralization.

74. **Unfortunately, at the present time, various measures of the quality of governance rank Libya very poorly compared to other countries.** Although there seems to be an improvement, since 1998, in the different measures, except voice accountability, Libya consistently appears in the group of countries rated as having
very poor governance (Figures II.12a-f). These indicators of course only reflect perceptions of international investors, rather than actual facts and data on corruption and government efficiency. However, such perceptions are extremely important to investors, and they usually reflect a significant share of the reality of governance in a country.

**Box II.6: Governance and growth—empirical evidence**

Evidence from developing countries strongly supports the view that good governance contributes to growth and social development. Good governance reduces regulatory uncertainty and establishes an incentive structure that promotes investment and efficiency, thus contributing to faster growth. Good governance also promotes efficiency in public expenditure and thus the development of the kind of human capital needed for sustained growth.

For example, according to calculations, weak governance in MENA costs an estimated 1 percentage point in foregone annual GDP growth. According to an empirical analysis across developing countries the growth rate is a function of a measure of the institutional quality, but also of the domestic investment, the degree of openness, resource endowments, initial income levels and terms of trade. The estimated growth rate of the MENA is around 1.1 percent. However, when the Latin American or East Asia’s institution quality average is assigned to the estimation while keeping all other variables constant, MENA growth rate increases to 2 percent.

Better governance also sustains growth by making economies more flexible to adverse shocks. Growth in a weak governance environment has proved either incapable of delivering higher quality investment, or fragile, as in post-1997 Indonesia. On the contrary, Malaysia and Thailand’s greater public accountability and better developed administration quality and internal accountability mechanisms proved much more flexible in coping with the shocks. The sensitivity of growth to governance was smaller in MENA countries with higher-quality public administration (figures below).

![Graphs showing index of quality of administration by region](image)

A weighted average of three indexes: rule of law, bureaucratic quality and corruption, as measured in 1982.

**Source:** World Bank, 2003a

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16 These indicators (compiled by D. Kaufmann, A. Kraay, and M. Mastruzzi, 2003) reflect the statistical compilation of responses on the quality of governance perception drawn from 25 separate data sources constructed by 18 different organizations: large number of enterprises, citizens, expert survey respondents in industrial and developing countries, survey institutes, commercial risk-rating agencies, think tanks, non-governmental organizations, and international organizations. The ranking is presented in percentile. It indicates the percentage of countries worldwide that rate below the selected country/region (subject to a margin of error) at a certain level of confidence. For instance, a rate of 75% means that 75% of the countries rate worse and an estimated 25% of the countries rate better than the considered region/country. Higher values imply better governance ratings.
Unless the state of governance and the efficacy of the government are improved, even a technically well-designed economic reform program is likely to fail. The Government should embark on an ambitious administrative reform program to fight against corruption, to promote transparency and accountability. The actual effects of such programs will only materialize over the medium to long run, but the impact on the perception of foreign investors who are today quite hesitant towards the Libyan market should be significant.

Figure II. 12: Libya governance indicators in international perspective

Source: D. Kaufmann, A. Kraay, and M. Mastruzzi, 2003
Improving governance is key to successfully managing the political economy of reforms in the transition to the market. Dealing with political economy issues is perhaps the single most important determinant of a successful transition to the market (Box II.7). This is so because the transition to the market entails costs and benefits which are unevenly distributed. Disciplining the “old economy” entails short-term costs, while gains from the emergence of the “new economy” will require a longer term horizon to accrue. Moreover, winners tend to be a diffuse constituency (because of the longer term horizon of the gains from reforms), while losers are concentrated. The uneven time profile of costs and benefits, along with the uneven distribution of winners and losers, may reduce the pace of reforms needed to discipline the old sector. However, experience from transition economies suggests that, despite the costs involved, policies to encourage the emergence of the “new economy” have to go hand-in-hand with enforcing discipline on the “old economy”. It is important that reforms lead to a rapid establishment and effective functioning of the institutions that encourage entry and competition and to implement policies that offset the costs of the transition to vulnerable groups.

Box II.7: Political economy and pace of reforms can make or break the transition

Politics of reforms are a key component during transition to market economy because of three factors: (i) costs accrue in the short-term while gains take more time to materialize; (ii) every reform has its own set of winners, with a diffuse constituency, and losers, which are more concentrated; (iii) gains and losses are not static meaning that early winners from initial and intermediate stages of reforms may lose from further reforms. The right figure illustrates the gains and losses in income for three different constituencies present in an economy in transition. The state workers, lacking the skills to become new entrants in the competitive market, face a sharp drop in income as discipline calls for downsizing the sector. The new entrants, or the active players of the transition, are state workers with skills allowing them to become new entrants in the competitive market. They face significant adjustment costs at low level of reforms as they exit the state sector. Moreover, they realize gains only when enough progress has been made with policy and institutional reforms to promote and support new entry into the competitive market. The oligarchs and insiders have de facto control rights over state assets and are the immediate beneficiaries of liberalization and privatization. They gain in the early stages when reforms are not combined with discipline and encouragement. But these gains dissipate as further reforms lead to increased competition and market entry.

Given that pattern of gains and losses, it appears that winners and losers from reforms play a fundamental role in the transition process. Workers and managers may oppose enterprise restructuring and privatization. The general public will oppose policies leading to price increases such as removal of subsidies and price controls. Uncertainty about property rights before privatization allows insider managers to tunnel assets and attempt to prevent establishment of clear property rights and corporate governance rules.

The major risk facing transition economies is the “reform freeze”, a situation of partial reforms towards liberalization, without discipline, and a business environment characterized by an uneven playing field. In fact, initial winners from transition tend to stall reforms when they reach a certain degree of reforms, as indicated by the point R1 in the figure. The risk to see reforms stopped is high considering that two groups, insiders and state workers, are facing declining incomes after R1. This has led to a so-called partial reform paradox in many transition economies, mainly CIS countries, in which governments lack credibility. To meet this challenge, governments must appear credible to potential new entrants in its commitments to follow through with the long and difficult process of economic reform. Government must also be able to constrain oligarchs and insiders from using their initial advantages to ruin further
reforms that would create a more competitive market economy. It is only when reforms reach a critical threshold \((R_2 \text{ on the figure})\) that added gains for new entrants are enough to compensate losses of other groups or generate pressure to neutralize opposition to continued reform. One of the reasons behind the relative success of transition in China is the ability of the government to contain abuses from partial reform to some extent by exercising tight political control over asset stripping, arbitraging between controlled and market prices for private gain, and corruption. In contrast, the collapse of state institutions and in the absence of framework of property rights have led to widespread tunneling and theft of state assets.

Gains and losses depend also on how radical the first move in the reform process is at the start of the transition. Radical move brings greater initial adjustment costs to both state workers and enterprises. However, when reforms lead to a rapid establishment and effective functioning of institutions that encourage entry and competition, investment rises and jobs are created, and initial costs are minimized. Radical reforms generate fewer distortions and imbalances that would have otherwise allowed the oligarchs and insiders to extract rents and tunnel assets, and hence reducing opportunities to influence policies and hold reforms.

More than ten years of experience in transition to market economies have revealed some fundamental steps to be taken early on in order to achieve a successful transition. It is essential to establish strong market-supporting institutions, make sure that new private enterprises drive the transition and put in place social policies needed to support losers during the transition.

77. Civil society participation in the policy making, monitoring and evaluation is invaluable to the success of reforms in transition. Key among components of a vibrant civil society are NGOs, consumer and producer associations, and the media. Their participation tends to foster a public debate whereby the nature of the costs and benefits of reforms, as well as their respective horizons, are unveiled. Broad and genuine representation is also key to constrain the power of interest groups to capture the state during the transition.

(ii) Education

78. Improving the quality of education is a key enabling factor for medium-term growth. Improving the quality of Libya’s human resources will be essential for it to improve labor productivity, diversify its economy—especially in services—and compete in the global economy. The ability of the education system to equip individuals with skills that allow them to take advantage of the increased opportunities that a dynamic and changing economy offers is also crucial for a successful transition to the market. With high enrollment rates at all levels of the system and thus high completion rates the Government and families should be ready to turn their attention to continually improving the quality of schools and learning.

79. The model of public provision and financing of education services in Libya has been successful in expanding access and improving macro indicators of educational attainment, but gender and regional inequalities persist. The country has achieved universal enrollment in primary education and, at 14 percent of the population older than 15 years of age, the illiteracy rate is among the lowest in the region. This is an impressive improvement relative to the early 1960’s when 40 percent of the adult population was illiterate and only 60 percent of the relevant age group enrolled in primary education. The illiteracy rate among women, however, is still more than twice than among men (22% Vs. 8%). There are also large variations by region. In Shararat Elula, Jabel Elgharbi, and Kahlij Sirte illiteracy rates are above the national average.
The level of public expenditure in the sector is among the highest in the world. In 1997, Libya spent 7 percent of its GDP in the education sector – all levels comprised – of which 82 percent were allocated to current education expenditures. The few countries with similar or higher levels of spending include Sweden (7.7%), Denmark (8.8%), Malaysia (7.9%), and Lesotho (10%). Rich countries with traditionally generous education systems such as France and Germany spend 5.8 and 4.6 percent of GDP respectively. While the current level of spending is unknown, it is likely to be higher than before. Indeed, the number of teachers has been growing at an average of 7 percent per year while real GDP stagnated. Thus, unless wages have sharply deteriorated in real terms, their share in GDP must have increased. At the same time, the development budget has been growing faster than real GDP.

In basic and intermediate education there are concerns regarding quality and the efficient use of resources. As shown in Figure II.8, student teacher ratios have fallen sharply over the past 10 years, leading one to think that learning and other indicators would be improving concomitantly. However, standard measures of internal-efficiency of the education system such as repetition and dropout rates and international comparisons of learning assessments in math and sciences are not yet available in Libya. Without information to diagnose adequately the quality of the Libyan education system, policy makers cannot make sound decisions on what needs to be done to improve the system. It is not clear what impact low student teacher ratios have had on school quality. Teachers reportedly have little motivation to promote students excellence, as remuneration and promotion policies are disconnected from their performance in class. While the Government has rightly sought to give more autonomy to schools, governance structures and budget allocation policies do not provide incentives to use resources efficiently and contain costs. Schools managers are appointed and removed by the municipalities and often have pressure to act as employers of last resort. It is estimated that 20-30 percent of teachers are not teaching. Parents do not participate in the governing body of the schools. Budgets to schools are allocated on a historical basis taking into account new hiring of teachers and administrative staff.

Clearly, a better measure for international comparisons is the level of expenditures per student expressed as a share of GDP per capita. Unfortunately for other countries this information is disaggregated by education level, which is not the case in Libya.

Since 1998, the government has been devolving management responsibilities to local governments (municipalities), in education and other sectors. Mechanisms to ensure that expenditures at the sectoral level are reported back to the central level still need to be put in place.
82. **In higher education, centralized planning is generating an oversupply of graduates who, in the absence of government intervention, would fill the ranks of the unemployed.** Among those high school graduates who continue their studies, 82 percent enroll in universities, compared to 50 percent in the 80s. It is estimated that each year there are 27,000 new university graduates entering the labor market – or close to 1.5 percent of the labor force. Most of them seem to have trouble finding a job in the private sector. The public sector has been the employer of last resort. The problem is that investments in higher education are being distorted by artificially low costs and the prospects of job security in the public sector. Without mechanisms to ensure that university programs are preparing students for jobs in the private sector, there will continue to be a mismatch between the number of university graduates and their skills and the demands of the private sector.

83. **If the economy is to diversify away from the public sector and gain competitiveness while improving opportunities to vulnerable groups, the education system will need to adapt.** Some of the issues that will need to receive attention include: (i) reviewing governance, management and budget allocation processes to promote a continual focus on improving quality and efficiency in resource utilization; (ii) improving the relevance and pertinence of programs at the post-primary levels to improve young people’s chances of finding a job in the private sector and better respond to future market demands; and (iii) building capacity to set education policies and to measure and monitor educational outcomes at the school and regional level. Further analytical work and policy dialog will be required to define a comprehensive reform strategy for the education sector.
III. **THE CHALLENGE OF STRENGTHENING PUBLIC FINANCE MANAGEMENT**

A. Libya's Public Expenditure System In The International Context

84. **Public expenditure in Libya is high by international standards.** Consolidated public expenditure and net lending (General Government level, including extrabudgetary spending and transfers from the social security fund, but excluding implicit subsidies) is estimated at 41 percent of GDP on average during 2000-2004. This level of public spending exceeds levels recorded in economies in transition in East Europe and Central Asia and in fast-growing MENA countries such as Tunisia (Figure III.1). Propped up by buoyant hydrocarbon revenues, public expenditures have soared by 128 percent in nominal terms between 2001 and 2005, while the size of nominal non-hydrocarbon GDP over the same period has grown by only 36 percent. Judgments on whether the consolidated level of public expenditures is “right” in any particular country are difficult, because much depends on cultural factors, the extent of social safety nets, and the efficiency of public expenditures. In view of existing distortions in the mechanisms for allocating public resources in Libya (sizeable off-budget spending; implicit subsidies; overstretched decentralization—see below) the potential for efficiency gains in public expenditure management seems significant. Realizing this potential would allow significant savings in public spending, and increasing efficiency in public expenditure would allow better management of the non-oil fiscal deficit, the latter being a precondition for macroeconomic stability and for the sustainability of public expenditure in the face of volatile oil revenues.

85. **Initiatives are being taken to reduce the large part of expenditure that was off budget.** Almost a third of government expenditure was off budget in 2004, whereas in 1999, extrabudgetary expenditure was only 6 percent of GDP. Off-budget spending has increased over time to reach a peak of 23 percent of GDP in 2003 and half of total general government expenditure (IMF, 2006). This trend is associated with the increase in hydrocarbon revenues over time. (Table III.1). Attaining fiscal discipline is difficult when such a large share of expenditure is not integrated in the budget. Further, extrabudgetary spending decreases transparency in the allocation of public outlays among alternative ends, thereby complicating the formulation of fiscal policy and increasing the likelihood of inefficiency in public expenditure. Recent developments indicate an improvement as estimated extrabudgetary expenditure has been reduced in 2005 to 4.2 percent of GDP.
Table III.1: Budgetary and Extrabudgetary Expenditure, % GDP 1999 – 2005

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total expenditure</td>
<td>32.8</td>
<td>31.3</td>
<td>44.3</td>
<td>41.2</td>
<td>44.6</td>
<td>44.0</td>
<td>41.2</td>
</tr>
<tr>
<td>Current</td>
<td>26.0</td>
<td>21.1</td>
<td>34.3</td>
<td>27.5</td>
<td>35.2</td>
<td>26.2</td>
<td>16.4</td>
</tr>
<tr>
<td>Capital</td>
<td>6.9</td>
<td>10.2</td>
<td>10.0</td>
<td>13.7</td>
<td>9.4</td>
<td>17.6</td>
<td>19.3</td>
</tr>
<tr>
<td>Net lending</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.3</td>
<td>5.4</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Budgetary</th>
<th>Extrabudgetary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Budgetary</td>
<td>26.6</td>
<td>6.3</td>
</tr>
<tr>
<td>Extrabudgetary</td>
<td>25.9</td>
<td>5.3</td>
</tr>
</tbody>
</table>

Source: IMF (2006)

86. **Libya spends relatively more on wages and salaries than other economies in transition.** The government wage bill was about 11 percent of GDP on average over 2000-2004, lower than in some MENA countries, but above levels seen in transition economies in Eastern Europe and Central Asia (Table III.2). Given the substantial volatility of oil revenues, this high level of expenditure on wages and salaries adds rigidity to Libya’s budget. Moreover, the size of the wage bill could further increase in the near future because government wage levels have not been increased since 1981 and may need to be adjusted.

Table III.2: Budgetary Expenditure, International Comparison, % GDP, Average 2000-2004

<table>
<thead>
<tr>
<th></th>
<th>Capital Expenditure</th>
<th>Wages and Salaries</th>
<th>Other Purchases of Goods and Services</th>
<th>Subsidies and Current Transfers*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Azerbaijan</td>
<td>4.3</td>
<td>4.6</td>
<td>5.1</td>
<td>9.7</td>
</tr>
<tr>
<td>Estonia</td>
<td>3.2</td>
<td>7.6</td>
<td>9.3</td>
<td>15.8</td>
</tr>
<tr>
<td>Georgia</td>
<td>1.6</td>
<td>3.3</td>
<td>5.5</td>
<td>5.7</td>
</tr>
<tr>
<td>Latvia</td>
<td>3.6</td>
<td>7.0</td>
<td>7.8</td>
<td>16.5</td>
</tr>
<tr>
<td>Moldova</td>
<td>3.3</td>
<td>7.1</td>
<td>7.5</td>
<td>11.6</td>
</tr>
<tr>
<td>Poland</td>
<td>3.0</td>
<td>6.8</td>
<td>10.2</td>
<td>19.5</td>
</tr>
<tr>
<td>Tunisia</td>
<td>7.7</td>
<td>12.1</td>
<td>2.1</td>
<td>2.7</td>
</tr>
<tr>
<td>Libya</td>
<td>12.2</td>
<td>10.6</td>
<td>3.9</td>
<td>1.9</td>
</tr>
</tbody>
</table>

*Includes Subsidies and other Transfers, Social Transfers and Subsidies to the economy

87. **Libya’s development budget is relatively large compared to that in other economies in transition.** Over the period 2000-2004, the share of capital expenditure in GDP was well below 8 percent in most of the comparator countries shown in Table III.2, while Libya allocated 12 percent on average of its GDP to the development budget. The efficiency of allocating such a large proportion of GDP to investment in Libya is questionable, given the limited capacity of the economy to absorb investment.

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19 These international comparisons on the allocation of public expenditures should be interpreted with caution, owing to the significant size of extrabudgetary expenditure in Libya. Moreover, the preparatory mission was not in a position to review in a meaningful way the functional allocation of public expenditures, because for a significant part of the administrative budget (60 percent) executed by the regions the information on the allocation of expenditure by government functions is not readily available.
88. **Explicit subsidies and transfers have grown significantly.** In 2004, subsidies, mainly for food, and other transfers in the budget represented 2.1 percent of GDP. Food subsidies have grown by a factor of 5.5 between 2000 and 2005, boosted by large hydrocarbon revenues. In 2005 flour subsidies (amounting to half of food subsidies) were almost equivalent to the administrative budgets for justice and foreign affairs combined. Inefficiencies related to the design of food subsidies are further examined in chapter VI. Pension benefits paid by the Libyan Social Security Fund are the equivalent of 1.4 percent of GDP (see chapter VI). Other transition economies with a strong tradition of social protection spend more than 15 percent of GDP in transfers, and the relative share of transfers is also higher in the neighboring country of Tunisia.

89. **—but implicit subsidies are sizeable.** Implicit subsidies are channeled to the economy mainly through fixed low consumer prices, for example for gasoline—and production subsidies, for example for fuel used in electricity production. Directives to state-owned enterprises to charge below-market prices to consumers provide benefits that might otherwise be financed directly by subsidies from the budget. The pricing of petroleum products in Libya involves large quasi-fiscal expenditures of this type. In late 2003, for instance, the price of gasoline at the retail level was around half the free on board price in the Mediterranean. Thus, in 2003, implicit subsidies are estimated to be equal to just under a fifth of total government outlays (18.5 percent), or about 7 percent of GDP (Table III.3).²⁰

<table>
<thead>
<tr>
<th>Energy product</th>
<th>Domestic price compared to international price (in %)</th>
<th>Amount in US$ million</th>
<th>Percent of total</th>
<th>In % of total government outlays</th>
<th>Estimated deadweight loss (in % of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Diesel</td>
<td>20.0</td>
<td>955.8</td>
<td>51.6</td>
<td>9.5</td>
<td>2.7</td>
</tr>
<tr>
<td>Gasoline</td>
<td>44.0</td>
<td>477.5</td>
<td>25.8</td>
<td>4.8</td>
<td>0.5</td>
</tr>
<tr>
<td>Fuel Oil</td>
<td>24.3</td>
<td>249.5</td>
<td>13.5</td>
<td>2.5</td>
<td>0.4</td>
</tr>
<tr>
<td>Kerosene</td>
<td>7.4</td>
<td>106.4</td>
<td>5.7</td>
<td>1.1</td>
<td>...</td>
</tr>
<tr>
<td>LPG</td>
<td>22.8</td>
<td>61.4</td>
<td>3.3</td>
<td>0.6</td>
<td>0.1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>1850.6</strong></td>
<td><strong>100.0</strong></td>
<td><strong>18.5</strong></td>
<td><strong>3.7</strong></td>
</tr>
</tbody>
</table>

Note: See Box III.1 for method of calculation.

90. **Implicit energy subsidies result in significant efficiency costs**—Subsidization keeps the price of energy products (and thus the marginal utility to consumers) at below marginal revenue (the export price in the free market), and therefore results in efficiency costs. Because of the diminishing marginal value of increased domestic consumption of energy products to consumers, the loss in government (export) revenue from the subsidization outweighs the associated increase in the consumer surplus (also see Gupta et al., 2002). The resulting “deadweight loss” is a non-linear function of the gap between the domestic and the border price of energy products. In 2003, the efficiency loss in Libya is estimated at about 3.7 percent

²⁰ The costs to Libya would have been far greater if May 2004 international prices had applied. In this case, subsidies implicit in 2003 consumption were roughly 123% of 2003 government capital expenditure, over half (55%) of total budgetary expenditures, and over a quarter (29%) of total government outlays.
of GDP for the four main subsidized energy products (excluding kerosene, see Table III.3, and also Box III.1).

91. and missed opportunities to improve consumer welfare. The estimated efficiency cost corresponds to foregone government revenue that could have been used either to increase productive spending (such as on human capital or infrastructure), or to increase household revenue through direct transfers or lower taxes. Had the foregone government revenue (corresponding to the estimated deadweight loss of 3.5 percent of GDP) been transferred to households, the possibilities for increased private consumption or savings would have considerably expanded. As a result, consumer welfare would have improved.

Box III.1: Calculating the cost of implicit energy subsidies in Libya

* Estimations of implicit subsidies
Subsidy calculations are based on domestic price and tax data supplied by the National Oil Company (NOC) for heavy fuel oil, diesel, gasoline, kerosene and liquefied petroleum gas (LPG). There is price discrimination between end users according to sector—depending on whether users are consumers, the public sector, electricity production or the armed forces. Consumption of each product was weighted by the price including tax in each sector to obtain the Libyan domestic price in 2003. International spot prices collected for the various fuels free on board in the Mediterranean are an annual average for 2003. It was assumed that if fuels were imported by Libya they would bear the same taxes as the domestic product. In calculating international prices for these products in 2003 the exchange rate used was 1.256 LYD per US$. The estimated implicit subsidies are shown in Table III.3.

* Deadweight loss estimations
The deviation from efficient pricing results in a deadweight welfare loss, where the government revenue loss exceeds the domestic consumers' surplus driven by the subsidized domestic price below the free market (export) price. Estimations of the deadweight loss (DWL) have triggered considerable attention. The loss has been approximated using the traditional method elaborated by Harberger (1964), assuming perfectly elastic supply. This linear approximation is precisely accurate in the case of small deviations from the optimum and for the case of two goods (which is close to the present case). The deadweight loss is defined by 
\[ \text{DWL} = \frac{1}{2} \alpha \eta \frac{P_d}{P} \], with \( p_i \) the free-market (export) price and \( p_d \) the domestic (subsidized) price; \( \alpha \) is the domestic consumption share in the GDP, \( (P_d * C) / GDP \); and \( \eta \) is the long-run uncompensated price elasticity of oil demand, assumed equal to -0.5. The deadweight loss was calculated for heavy fuel oil, diesel, gasoline, and liquefied petroleum gas (LPG). Kerosene was excluded because of concerns that the large price discrepancy associated with a relatively low domestic consumption would tilt the loss erratically up. Because of the large discrepancy between the domestic and the free-market price of energy products, the estimations are sensitive to the choice of base for the calculation of the subsidy rate (\( p_d \) or \( p_i \)). Therefore, the subsidy rate used in the calculations is the average of the one calculated relatively to domestic prices and the one based on the free-market price, \( (p_i - p_d) / p_i \). Results are sensitive to the choice of elasticity. For products with higher elasticity the loss will be higher.

Although approximations are subject to criticism, they remain popular and are useful and relatively easy and quick means of gauging the magnitude of the losses imposed by various distortions.

92. Implicit subsidies to energy and infrastructure have a questionable impact on income distribution. The usual motive behind subsidization of energy and utility services is to aid those with low incomes. But household expenditure data from various countries show those with higher incomes usually benefit more because consumption rises with income. For example, in Mexico and Ecuador, the top decile of the population accounts for over 30 percent of household electricity consumption (Gupta et al. 2002). More targeted means of helping those with low incomes are preferable to subsidies for consumption as discussed in chapter VI.
93. **The authorities may want to consider making the sizeable energy subsidies transparent in the budget.** Making the energy subsidies transparent would support better expenditure prioritization, in a context where improving the efficiency of spending for social protection is a priority to facilitate Libya's transition to the market. This would not necessarily affect the budget deficit. Prices to domestic users could be kept regulated if so desired, but budgetary transfers to the electricity production or gas distribution companies would have to compensate for the higher cost of oil products in the face of regulated prices. These transfers would be matched by extra revenues for the NOC that could be allocated to the budget.

94. **Transparency of energy subsidies would set the stage for broader domestic energy price reform.** Eliminating energy subsidies would support greater efficiency, by promoting a shift out of energy-intensive methods of production and consumption patterns. The benefits for environmentally sustainable growth would also be substantial. Reform should go in tandem with appropriate compensation schemes, to cushion the impact of the elimination of the subsidies on the most vulnerable. This would be welfare-improving, as transfers would broaden the scope of household consumption choice compared to support through subsidized prices. An assessment of the inflationary impact of phasing out the subsidies and of the incidence on the vulnerable would be a prerequisite of reform. Box III.2 offers some estimations of the first-round inflationary impact of removing subsidies to petroleum products. Of course, domestic energy price reform is a difficult issue and considerable care must be taken in designing its "road map". A careful evaluation of the domestic and international situation would be needed to decide on the appropriate phasing strategy and the design of the necessary social safety net measures.

<table>
<thead>
<tr>
<th>Box III.2: The first-round inflationary impact of a removal of petroleum subsidies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimating the full impact of the removal of petroleum subsidies on inflation requires an assessment of different effects: (i) the first-round effect on the CPI through the increase in the price of energy products (electricity, gasoline for transportation, etc.); (ii) the second-round impact through the increase in the cost of goods and services that use energy products in their production; (iii) the possible third-round impact, owing to an increase in wage costs if there is indexation to higher inflation.</td>
</tr>
<tr>
<td>Due to the absence of appropriate information to gauge the second-round impact (such as input-output tables), only a rough estimation of the first-round impact of energy subsidy removal was attempted. A first scenario assumes full liberalization (adjusment to international prices) in one year, with 100 percent pass-through to the CPI. A second scenario assumes a liberalization phased in over three years, with 25%, 50, and 100 percent gradual adjustment. In the first scenario there is a one-off spike of CPI inflation up to 26 percent (Figure). In the second scenario the impact is more modest, with a maximum 9 percent CPI increase in the first year.</td>
</tr>
</tbody>
</table>

95. **Risks to medium-term fiscal sustainability in Libya result from implicit and contingent liabilities of the public sector.** Their adverse repercussions may not be apparent in the near term, but they may surface later, causing financial distress that would require much costlier remedies. Significant contingent liabilities in Libya originate in the non-performing loans to public enterprises, accumulated in the portfolios of public banks. If certain loss-making public enterprises were to be kept in operation for social or other sectoral policy reasons, it would be important that public bank loans (even provisioned by the Treasury) be replaced by transparent subsidies in
the budget. This would help recognize an important implicit liability of the state and contribute to sounder budget management. This would also effectively sever the links of these enterprises with the banks and help restore the soundness of the banking system on a permanent basis.

96. Implicit liabilities also arise from the financial situation of the pension system. As discussed in chapter VI, the pay-as-you-go pension system currently operating in Libya is equivalent to a government bond. The public sector borrows from contributors and then repays them back when they retire, at an implicit rate of return. Other countries in the region with less generous systems and lower coverage rates have accumulated implicit pension debts often above 50 percent of GDP. The size of the pension liability in Libya (i.e., the value of the implicit government bond) for both civil servants and private sector workers could be as high. In fact, it could be even higher if one adds the pension liability of the military whose pensions are financed directly from the general budget.

97. Ensuring sustainability of public expenditures and efficient delivery of public services are Libya’s two main fiscal challenges. Attaining these goals would appear to require substantial changes in budget preparation and management, with a view to introducing forward planning. That should be underpinned by reforms in budget formulation and management to meet three requirements for well-performing budgetary systems:

- control of public resources—especially of oil revenues;
- prioritization of the allocation of resources with the aim of maintaining expenditure discipline;
- management of programs and delivery of services effectively and efficiently.

B. Strengthening Management of Oil Revenues

98. Management of oil revenues should be underpinned by stabilization and savings objectives. As in most oil-producing countries, the challenge in Libya is to stabilize budgetary expenditures in the context of high volatility of oil revenue, thus minimizing the adverse effects of pro-cyclical policies. At the same time, owing to the exhaustible and non-renewable nature of oil wealth, consideration should be given to the accumulation of oil revenue so as to ensure the long-term sustainability of expenditures and intergenerational equity. Through the creation of the ORF, the Libyan government is paying attention to the stabilization and saving objectives and trying to meet these respective challenges.

99. In establishing the ORF in 1995, through a budgetary rule but without explicit objectives, the Libyan authorities were aiming at reducing the substantial volatility of the oil revenue stream, and saving oil resources over the long run. If, from 1997 to 2001, the ORF operated as a stabilization fund, it failed since 2001 to
accumulate resources on a net basis, due to the financing of huge discretionary extrabudgetary expenditure. Over the period, about US$ 9 billion was accumulated, based on favorable oil prices. However, the ORF balance has remained relatively constant since 2000, despite the exceptional increase in oil export revenues (Figure III.2). Fiscal management has also been complicated by the recent creation of a new extra budgetary fund, the Investment Fund (IF), with unclear investment objectives and rules governing its operations and accumulation of assets. In addition, a new extrabudgetary fund of US$5 billion, the Libya Africa Development Fund (LAIF), was established in February 2006.21

100. **On the basis of past experience, it is recommended to create (or to transform the ORF into) a stabilization fund with clear and precise accumulation and withdrawal rules.** The Government is currently considering options for the establishment of a Savings and Stabilization Fund in replacement of the ORF. The rules of accumulation (and withdrawal) can be stated according to different technical schemes:

- Adopting a conservative but realistic oil reference price in the budget (the stabilization fund will then be a price-contingent fund);
- Setting appropriate targets for the non-hydrocarbon budget deficit, (measured as a ratio of non-hydrocarbon GDP);
- Estimating a “permanent hydrocarbon income stream”—with the aim of targeting a non-hydrocarbon fiscal deficit that does not exceed the “permanent hydrocarbon income stream” over an appropriately defined medium-term time horizon.

The rationale of fiscal rules anchored on the non-hydrocarbon budget deficit is further elaborated in the next section. The schemes outlined above will determine reference values, above which exceeding oil revenues will be transferred to the fund for accumulation; or, on the contrary, below which appropriate withdrawals will be transferred to the budget. The reference values will have to be assessed periodically on the basis of a rolling medium-term framework.

101. **It is important to ensure that withdrawal rules avoid financing of extrabudgetary discretionary spending.** The stabilization function is achieved if the withdrawals are strictly reserved to transfers from the Fund to the overall budget, according to the reference value within the scheme adopted. The Government’s decision in 2005 to eliminate extrabudgetary spending financed by the ORF is a step in the right direction. However, discretion in the operation of the ORF still remains as it was also decided to allocate off-budget LYD 3 billion of ORF resources to specialized banks, to finance a housing program and subsidized loans to farmers and SMEs.

102. **The revenues belonging to the Fund should be maintained in an account, with the Central Bank, that is separate from the main treasury account.** The Fund should be kept as a separate entity and integrated into the budget: all transfers to and from the Fund's account should appear as explicit line items in the budget (“transfers to the Fund” and "transfers from the Fund”).

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21 The LAIF can invest domestically and abroad, and has started its activities with two major projects: the building of a Qadafi tower in Dakar (Senegal) and a canal in Mali.
103. **The Fund should receive a comprehensive legal status and be transparent.** A law should clearly state the nature and role of the Fund, with precise rules, purposes and objectives, and define its auditing and control. Whatever detailed scheme is adopted, it is important to ensure that it will be transparent; there should be regular disclosure of its inflows and outflows and the Fund's activities should be submitted to an independent auditor.

104. **Adding a savings function.** After satisfactory performance of the stabilization function of the Fund, provided by a fiscal accumulation rule, a saving function can be added to reflect on a longer term basis the non renewable character of oil wealth on a longer term basis. An approach based on the estimation of the “permanent hydrocarbon revenue stream” could be used for saving purposes, with “temporary” oil revenues—those in excess of the permanent revenue stream—saved for future generations (see next section).

105. **The oil reserve fund is a necessary, but not sufficient condition for fiscal sustainability.** Oil reserve funds cannot by themselves substitute for the commitment of the government to pursue a sound fiscal policy. Oil funds are also subject to considerable pressure for spending, once they have accumulated significant reserves. The necessity to maintain fiscal discipline over the medium term is a prerequisite for fiscal sustainability. This would call for combined initiatives towards (i) a rules-based approach to fiscal policy, and (ii) the adoption of a framework to maintain expenditure discipline over time.

**C. Criteria For Long-Term Fiscal Sustainability**

106. **To build appropriate safeguards for macroeconomic stability, the fiscal framework should be anchored on an indicator that is unaffected by the short-run changes in hydrocarbon revenues.** Such an indicator should provide a good measure of the fiscal stance and the underlying pressures on the fiscal accounts. The non-hydrocarbon primary fiscal deficit, measured as a ratio to non-hydrocarbon GDP, would be the strongest anchor for fiscal policy. Setting appropriate targets for the level of the primary non-hydrocarbon deficit would allow the de-linking expenditure from volatile hydrocarbon revenues, thus reinforcing macroeconomic stability. Changes in the non-hydrocarbon primary balance should be used as a basis for measuring changes in the fiscal stance (also see Barnett and Ossowski, 2002).

107. **It is important to secure the sustainability of the non-hydrocarbon fiscal deficit in the long term.** This calls for deciding “the right size” of the non-hydrocarbon primary deficit. Moreover, quasi-fiscal operations and fiscal risks stemming from the contingent and implicit liabilities of the government should be properly valued and taken into account when deciding about a prudent permissible level of the non-hydrocarbon primary deficit. Improving the visibility of quasi-fiscal operations, and monitoring government contingent liabilities is important in order to resist the pressure to increase public expenditures in “good times”, when oil revenues go up.

108. **A rules-based fiscal policy in Libya could be anchored on the concept of the “permanent hydrocarbon income stream”.** Roughly stated, the rule could target a non-hydrocarbon primary fiscal deficit that does not exceed the “permanent
hydrocarbon income stream” over an appropriately defined medium-term time horizon. Surplus hydrocarbon revenues (i.e., revenues in excess of the “permanent hydrocarbon income stream”) should be saved. Linking primary government expenditures to the “permanent hydrocarbon income stream” would set an upper limit to the non-hydrocarbon primary fiscal deficit over time, in a way that would be consistent with long-term fiscal sustainability. As indicated in the intertemporal solvency framework in Annex 2, the rule would ensure that existing debt is matched by future primary surpluses, whose present value exceeds the value of the debt. At the same time, such a rule could provide a useful anchor for stabilization purposes. This would help smooth out public expenditures over time and prevent unwanted expenditure cuts in case of sharp oil price reversals, thus reducing the pro-cyclicality of the budget.

109. Operationalizing that fiscal rule would require estimating Libya’s “permanent income” from hydrocarbon production, based on an estimation of the net present value (NPV) of government’s hydrocarbon revenue over a long period. These calculations invariably rely on estimates of remaining recoverable reserves, and a production profile of the depleting resource over a long period. They are also based on assumptions about government take, resource price, costs, and the discount rate. As mentioned in the previous chapter, any estimate is subject to considerable uncertainty about the quantity of reserves and prices, discount rates, and other factors (such as costs and taxes).

110. Despite “upside uncertainty”, fiscal prudence would require using conservative estimates of the permanent hydrocarbon income stream, combined with periodic reassessments. “Upside uncertainty” pervades “permanent hydrocarbon income” calculations as reserve estimates at any single point in time reflect what is then known, and do not depict ultimate recovery, which is unknowable. However, missing some upside potential for government spending, due to underestimation of “permanent hydrocarbon fiscal revenues”, would not put long-term fiscal sustainability at risk. By contrast, overspending, based on unrealistic projections of hydrocarbon revenues, would pose fiscal risks—as corroborated by the experience of many oil-producing countries. Fiscal prudence would thus call for considering conservative estimates of permanent hydrocarbon revenue in assessing the sustainability of the fiscal position. Over time, and depending on changes in the long-term outlook for prices and reserves, the fiscal rule could be adjusted with periodic updates of the underpinnings of the “permanent hydrocarbon income” calculations.

111. Except under very conservative price and reserve criteria for the estimation of permanent hydrocarbon revenue, the current fiscal position would be sustainable in the long run. Reflecting higher spending, with support from strong oil revenues, Libya’s non hydrocarbon budget deficit has steadily increased since 2001, hovering at around 35 percent of GDP since 2003. The current fiscal position would be sustainable in the mid- and high-price scenarios for the price of oil, regardless of the

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22 Using non-conservative scenarios as a “speed limit” for targeting the right size of the non hydrocarbon fiscal deficit would pose two risks: First, the accumulation of savings would be slower, compromising the achievement of inter-generational equity objectives. Second, the fiscal position would be imperfectly insulated from the volatility in oil revenues, since a lower than expected price of oil would, sooner or later, trigger a compression of public expenditures.
scenario for the level of reserves. The fiscal position would not be sustainable over the long run only under a very conservative (low-case) price scenario, and a low- or mid-case scenario about the recoverable oil and gas reserves (shaded boxes in Table II.3). The non oil deficit would be only marginally sustainable in the low-price/high-case reserve scenario. The existing fiscal margin of comfort points to the simultaneous challenge of maintaining fiscal responsibility and discipline, while using hydrocarbon revenues strategically to finance productive expenditures and facilitate the transition to the market. Appropriate prioritization of investments would be needed to ensure that the economy has the absorptive capacity to efficiently use the available financial resources in the short run.

D. The Challenge of Strengthening Budget Management

112. The legal framework of the public financial management system is governed by a comprehensive Financial Management Law. This law embraces all aspects of the financial management system, such as budget preparation, formulation, approval by the Legislative, budget execution, accounting, reporting, auditing. Many decrees and circulars also govern the related procedures and processes. The analysis below provides a summary assessment of the framework, but a thorough review of this set of laws and rules should be undertaken in order to assess its robustness and provide guidance about possible updates or modifications.

(i) Budget preparation and formulation

113. Budget preparation is swift— The budget preparation process starts in mid-year—in June for the current expenditures and August for development expenditures. The main steps of the process are outlined in Box III.3. The procedure is relatively simple and bottom-up driven, but nevertheless enriched with some real discussion with line-ministries, that could be an indicator of the ownership of their budget and its execution during the year. To strengthen budget preparation, a review of the realism of the macroeconomic forecasts and the related budgeted revenues would be advisable, to assess the quality of this forecasting that conditions the realism of the entire budget and its downstream execution.

114. —but fragmented. A segregation of management between the current budget and development budget all along the preparation process, is potentially a concern in particular because: (i) no institutional mechanism seems to be in place for ensuring the adequate fit between current and investment expenditures starting with the very formulation stage of the budget; and, (ii) the Government is committed to allocating automatically each year 30 percent of budgeted oil revenues to current expenditures and 70 percent to development, which may be a source of inefficiency in the allocation of resources; (iii) the fragmentation of the budget makes it difficult to adequately program expenditures for operation and maintenance, which is key for the efficient operation of public capital. The budget is not built on the basis of a Medium Term Expenditure Framework (MTEF), but a first step of Medium Term Fiscal Framework (MTFF) is already completed, which could make further reform toward a MTEF easier and smoother.
115. **The budget still lacks transparency.** The budget law includes two different types of sub-budgets: the current budget and the development budget. Extra-budgetary funds were equivalent of 52 percent of total government outlays in 2003, but their size has been reduced (Table III.1). They are still not mentioned in the budget law, so that the comprehensiveness of the budget is compromised. Such extensive extrabudgetary funding provided a huge incentive to evade budget controls, undermining the effectiveness of controls in budget execution, and eventually undercutting the credibility of the entire budget process. In addition, a consolidated budget at the General Government level is still missing. This makes it difficult to get a accurate view of the size of Government and expenditure allocations in view of the considerable decentralization of expenditures to local administrations.

116. **The budget classification system should be improved.** The budget classification is not compliant with GFS 2001 and does not include a functional classification of expenditures. As a consequence, a programmatic approach of the budget is currently uneasy to implement.

**(ii) Budget execution**

117. **The budget is executed according to mixed methods following traditional and more modern procedures.** Budget funds are first allotted to the line-ministries' budgets and then released to the budget authorizers. The execution is different according to the nature of expenditures. Current expenditures are executed on a quarterly basis, without significant delay for allotting and releasing the funds to the line-ministries. At the end of the fiscal year, no carry-over is allowed for financing the payment arrears. However, the budget law includes an item appropriation (unique and global) aimed at financing the arrears of different budgets. This procedure is a positive sign of the concern of the Ministry of finance about the risk of accumulation of arrears. The amount of appropriation is 29 million dinars in 2006.
118. **Development expenditures carried on by line-ministries must be first authorized by the Ministry of planning, prior to the allotment of funds.** The Ministry of Planning examines each project and its full documentation in order to ensure the readiness and maturity of the project to be launched, before authorizing the release of funds to the budget ministry. The real functioning of this procedure of authorization (content, delay) remains to be assessed since it may be a crucial factor of the efficiency of the subsequent project expenditure implementation. The regime of prior authorization indicates a mixed system combining heavy involvement of the Ministry of Planning and probable lack of autonomy of the line-ministry. This is likely to be a factor of slowness of the implementation process without providing real quality guarantees. Such a situation may be an obstacle to the set-up of any budget management reform, more focused on the performance and responsibility of the budget officer. Development expenditures are managed under a so-called multi-year framework. The quality of the procedure remains to be assessed, but a first positive and convergent element could be the automatic carry-over of unspent funds at the end of the year, which is typically a component of a multi-year approach.

119. **The budget execution is monitored by the Budget Directorate and the Planning Committee.** A mid-year report is sent to the Cabinet and Legislative but no debate is organized. The quality of the information of this report very much depends on the quality of the reporting (see below). But an interesting tool of the monitoring procedure is a provision of the budget law setting-up a fund-reserve to be used in case of contingency but to be frozen and cancelled in case of deviation of the budget execution. This procedure, rare in the region, is compliant with more recent evolutions of the international budget management benchmarks tending to make monitoring more predictable and less disrupting for the budget officers. A well-organized procedure appears to also exist in case of deviation (memorandum to the government, new circular to line-ministries).

120. **A standard cycle of expense is being followed.** The different steps include: commitment, tender committee, purchase order, committee for service delivery check and certification, payment order, and payment. The autonomy of the budget officer within line-ministries seems to be well-defined by the rules. The payment procedure is secured by the obligation to get two different signatures for the issuance of the check (signature of the budget authorizer, signature of the accountant). The occurrence of fraudulent practices seems low with regard to the institutional mechanisms.23

(iii) **Deconcentration and decentralization**

121. **Decentralization in Libya has been ambitious.** Decentralization has been said to represent the public sector equivalent of privatization, and it is of interest that Libya is doing both. But the scale of decentralization in Libya appears to have been exceptional: 50 percent of the administrative budget and 60 percent of the development budget have been decentralized. The procedure of expenditures’ delegation to the 20 regional entities, the Sha’beyat (their number has been reduced

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23 The function of ex ante control (pre-disbursement audit) needs to be reviewed and assessed, either at the central or at the local level. This has not been undertaken as part of this study.
from 35 to 20 at present), seems smooth and relatively secured by the setup, in each region, of a Regional Committee directly linked to the Ministry of Finance.

122. **Assessment of the institutional capacities of deconcentrated budget units is needed.** The Regional Committees are in charge of the payments for all line-ministries expenditures at the local level. They report their activities to the Ministry of Finance and they are subject to a financial control. An assessment of the institutional and financial capacities of these deconcentrated units needs to be undertaken in view of their heavy responsibilities. The fact that most staff employed at this level were previously posted at the central level in the ministries reduces, however, the risk of structural and permanent local deficiencies. The decentralized expenditures, i.e. expenses financed either by regional revenues or by transfers of the national central budget and implemented by local entities (municipalities, districts), are also important. An assessment of the institutional and financial capacities of these local entities (municipalities, districts) is also needed.

123. **Decentralization has put pressure on public expenditure.** Assessments of institutional capacity are needed also because the decentralization initiative has been blamed for excessive increases in the public sector wage bill in Libya, resulting from massive hiring by the regions. Increases in the wage bill since 2001 point to some loss of budgetary control over regional expenditure. Decentralization should hardly have led to any increase in public sector staffing in Libya, however, since decentralization here has only involved deconcentration, or the dispersion of responsibilities within the central government to regional branch offices.

124. **The authorities have recently come to the conclusion that their decentralized system needs to be redesigned.** Consequently, they have decided to undertake a major administrative reform that strengthens the role of the central government, and aims to improve governance, which has significantly deteriorated under the previous decentralized system (fragmented projects, waste of resources, regional vested interests). Under the new system, in addition to reducing the number of regions, the position of secretary of region (the equivalent of a prime minister for the region) has been abolished, and all the regional sectoral secretaries (regional sectoral ministers) have now to report to the central government. Also, seven ministries have been reestablished.

**(iv) Reporting and accounting**

125. **Reporting suffers from weaknesses, especially for capital expenditures and for decentralized spending.** The reporting is based on a monthly centralized collection of information about payments made both at central and local levels. For the latter, information comes from the 20 Regional Committees. It is uncertain whether the payments reported are reconciled with the payment orders (issued by the budget authorizers) and with the banking statements of payment. Commitments are not reported. From the own evaluation of the Ministry of Finance, the quality of this reporting in terms of accuracy and timeliness is low, in particular as regards capital expenditures. These are reported on a half-yearly basis, instead of monthly for current expenditures.
126. **Accounting is cash-based and hampered by frequent administrative changes.** The accounting is based on quarterly collection of information for more security given the low reliability of the monthly collection. It is uncertain whether the accounting is based on a double entry system. It is based on cash-basis system, so that commitments are not accounted for, and accruals, assets and liabilities are ignored. This rudimentary level of reporting and accounting is confirmed by the fact that no financial statements have been issued since 2002, the last available statements being related to the fiscal year 2001. It seems that the frequent changes of the administrative structures are worsening the issuance of financial statements.

127. **Information systems are rudimentary.** Budget management and reporting functions are mostly manual. No integrated information system is in place. Some ministries report an in-house computerization of some components of budget management and reporting functions (Access systems), but no integration with the Ministry of Finance has been designed. So far, no credible plan of computerization has been issued and a huge task is still to be tackled.

128. **The cash management system lacks clarity.** The implementation of a real Unified Treasury system (Treasury Single Account) remains uncertain. Apparently each line-ministry and public entity registered at the budget hold an account at the Central bank, but it is not clear how the centralization and the daily balance is operated for the whole sector. In addition, it is uncertain whether the ministries hold other accounts in the banking system which escape from the unified circuit.

(v) **Auditing**

129. **The audit system is mainly focused on the external Audit, the ex ante control and the internal audit being ill-defined.** The external audit is operated by the General People's Committee Institution for Auditing and Technical Supervision (named below as Office). This Office is compliant with most of International Organization of Supreme Audit Institutions (INTOSAI) criteria, in terms of institutional and financial independence. Thus, the Office is referring to the Legislative, its President is appointed by the Legislative, while its budget is approved by the Legislative through a dedicated committee. The Office has a network of 32 local offices over the regions, with an average of 40 staff by office.

130. **The methods of audit of the Office also are reported to be compliant with INTOSAI in particular:**

   o The work-program of audit is established on a risk-based approach for some entities and controls, while all entities subject to public audit (around 400 entities) are effectively audited each year.
   o The methodology of audit includes its 3 required categories:
     - Compliance audit
     - Financial audit
     - Performance audit
   o The Office formulates an opinion about the audited accounts
   o The Office can adjust the inaccurate accounts and get the money back if fraudulent or send back the accounts to the Budget Committee (Legislative).
131. Given the absence since 2002 of financial statements for the budget, the Office reports numerous controls about the inventory of temporary and intermediate accounts. The Office issues an annual report to the Legislative, which is simultaneously disclosed to the public. This indeed fulfills a major recommendation of INTOSAI. This report gathers the main results, findings and recommendations of the annual activity of the Office.

132. **Human and institutional capacity of the audit office seems satisfactory.** The human capacities of the Office are reported to stand at a high level: 350 auditors, 20 audit assistants and 200 administrative staff. The recruitment of the auditors is made at a high level of skills: master's degree plus 2-year experience minimum, while some 50 auditors have a higher level of instruction. Training also seems important: The Office claims yearly training of 50 percent of the staff, whether it is through internal workshops, training of trainers or training of auditors in international audit cabinets (45 auditors in 2006). Therefore, the assessment of the Office as regard to the benchmark INTOSAI is quite good and largely above the average of the Middle-East region with comparable systems of audit. However, the Office has never been assessed by an independent reviewer, such as a peer-reviewer. A more thorough field assessment of the Office’s capacity would be required to confirm these preliminary findings.

133. **The internal audit units in line-ministries remain ill-defined and uneven depending on the ministry.** The assessment of their capacity and methodology remain to be done. However, an important and negative element for the assessment of their efficiency is the fact that they report to the Financial head of the Ministry and not the Minister itself, which is non compliant with the criteria of independence.

**(vi) Maintaining expenditure discipline over the medium term**

134. **There have been several attempts at attaining fiscal discipline in Libya that have not achieved the desired results.** Most notable has been the experience with the rule that 70 percent of budgeted oil revenues must be devoted to the development budget and 30 percent to the administrative budget. This rule was instituted after a burst of hiring and the resulting increased wage bill, together with outlays on what was in effect consumption by bureaucrats. Experience in 2003 indicated, however, that the government of Libya could not live within this constraint, and expenditure categories such as medicines and food subsidies had to be reclassified in the development budget to meet the 70/30 rule.

135. **A “top down” planning process with respect to planning and budgeting, based on fiscal limitations and accountability, should be established.** By way of contrast, the present approach to budgeting in Libya might be described as a “bottom up” process, driven by the accumulation of existing commitments that need to be financed in any particular year and by availability of unforeseen revenues in the immediate budget period. An important initial step in budget preparation would be for the government to establish spending ceilings for each region and ministry at the

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24 Another aspect of the institutional and financial capacity of the Office is related to the fact that the Office holds the Secretariat general of AFROSAl (as the Tunisia Court of Accounts holds the secretariat of ARABOSAI).
beginning of the budget process. To ensure that ministers feel committed to the ceilings, this initial allocation should be anchored in a specific cabinet decision.

136. **A Medium Term Expenditure Framework (MTEF) should be developed as a main tool of fiscal planning.** The MTEF should be anchored on sound budget formulation and execution principles, conditional on the elimination of extrabudgetary spending practices. It should include both existing expenditure commitments as reflected in approved policies and reserves for other purposes, including new activities and contingency reserves for unforeseen events. A medium term expenditure framework shows what programs can be afforded over the medium term: it is a policy-determined limit to the total expenditures that are to be undertaken during a defined time frame. Its foundations are an assessment of future revenues available to the State and estimates of on-going expenditure commitments. The preparation of a MTEF is an important contribution to ensuring that current fiscal policies are sustainable, providing more stability for budget planning and allowing budget prioritization to be done on the basis of more complete information. Three to five years is the range typically adopted in such medium term expenditure frameworks and reflects the normal time horizon over which one can expect government organizations to plan their activities in detail.

137. **An MTEF would also help with other objectives of fiscal management.** Elsewhere, for instance, a MTEF has also been found to be one of the best methods of linking capital spending to associated recurrent spending. As in many countries, responsibility for capital and recurrent budgets is now separated in Libya and there is little coordination at the operation level between the Ministries in charge of these budgets. International experience suggests that these “dual budgets” may well be the single most important culprit in the failure to link planning, policy and budgeting, and is often at the origin of poor budgetary outcomes. The most important cause of these problems may be the tendency for project capital expenditure to be approved without proper consideration of the ongoing operating cost consequences. Medium term expenditure plans should bring together current and capital budgets and show the consequences for operating expenditures of new project spending.

**E. Improving Efficiency In The Delivery of Public Services**

138. **Increasing the transparency of quasi-fiscal actions would facilitate better spending prioritization and efficiency.** Countries that are less well off than Libya are making such quasi-fiscal actions visible and transparent. By making subsidies transparent, decision-makers may better assess the strategic allocation of public expenditures, while the possible impact of the subsidies on the government’s fiscal position can also be evaluated. The most important potential benefit from transparency is that the subsidies are no longer open-ended. Getting the subsidies out in the open usually leads to questions as to whether the objective of the subsidy could be achieved more efficiently by other means.

139. **A number of other public sector management issues bear on the question of improvement of the delivery and financing of public services, including:**

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25 Yemen also used to provide a subsidy to electricity production by charging its electricity utility a below-market price for its fuel. This practice was replaced in Yemen’s 2002 budget by provision of an explicit subsidy to the Public Electricity Company.
- fiscal decentralization
- payment for public services
- privatization of production of non-public goods and services

140. Although decentralization is in the process of being redesigned, measures could be considered to raise the capacity of local governments to collect their own revenues. Libya's deconcentrated subnational governments, the Sha'beyat, are assigned the national wage taxes collected in each of these jurisdictions to finance their activities. This system of returning revenues to the regions in which they are collected was common in many former socialist states, and has the problem that it benefits the richer regions or those that have the most economic activity. The Government of Libya was aware of this problem, and tried to temper the outcome by use of a formula that provided additional assistance to low-income Sha'beyat. This system was abandoned after experiencing some difficulties, however, and was replaced by the current formula where the amount of additional assistance provided to the Sha'beyat is 70 percent weighted by population. Further adjustments to this formula are now being studied, but the central government should not reward negative behavior in transfers to subnational governments.

141. Revenues for local governments could be collected either by user fees or taxes that correspond to the benefits received from the services they provide. Where benefits of their infrastructure services are captured by local users in proportion to use, user fees should often finance provision of most of the services. Where direct user fees are inappropriate (e.g., local roads), local governments should have access to a suitable tax base that is a proxy for use of local services. The property tax is generally considered to be appropriate for this purpose: unlike the more mobile things that national governments can tax such as the income of taxpayers, property cannot move around. For these reasons, the property tax is usually reserved exclusively for local government use.

142. Conditional transfers enable national interests to influence subnational government actions without central government micromanagement of the functions concerned. There are good reasons for some of these transfers. When local governments are responsible for education, health or even infrastructure services that have effects that spill over outside the local community, they are usually supported financially by national or intermediate levels of government. This financial support takes the form of grants, revenues from shared taxes or access to taxes related to ability to pay. The central government can encourage the provision of services with such externalities by offering to share particular costs provided that the project or program meets certain conditions or minimum standards.

143. Creating an equalization fund would be a necessary step for effective fiscal decentralization. Subnational governments in less well-off areas cannot afford to offer the services supplied by better off localities. The solution to this problem that is a feature of intergovernmental finance throughout the world is “equalization” transfers to poorer subnational governments, which have the objective of enabling all subnational governments to supply essential services with the same local tax effort. Equalization payments are common in developed, developing and transitional countries. Such “equalization” payments (so-called because they are intended to equalize the per capita fiscal capacity of subnational governments) are often provided
by other members of the same level of government in federal states, or by the central
government in others. They are unconditional, since they are intended to solve a fiscal
problem and not encourage the provision of particular services. Such formula-based
equalization payments do not adversely affect the local accountability for local
spending decisions whose desirability was stressed earlier.

144. **The transition to a market-oriented economy could be supported, and the quality of public services improved, by promoting competition between the private sector, NGOs and even other levels of government in the provision of public sector services.** Contracting out production of public services to the private sector is widespread for services such as trash collection, road maintenance and janitorial services for public facilities. Competitive contracting for infrastructure construction is also common. International experience shows that the private sector is consistently superior to the public sector in delivering capital projects on time and within budget. In some cases, notably water and sewerage works, the public sector may hire private firms to operate publicly owned facilities.

145. **Eventually, the goal of budgeting should shift towards getting results from the spending of public resources rather than just allocating inputs.** While Libya is a long way from results-oriented budgeting, this goal should be kept in mind as being that to which the country should be striving. It is not too early to start toward this goal in Libya, for instance, by beginning to incorporate some performance indicators as part of the budget. The long-term objective should be to have a comprehensive budget system that gives a complete breakdown of all budget expenditures, the activities they finance, the outputs that are produced and the outcomes that are realized and the linkages between the different parameters.

146. **Summing up, core reform options and complementary initiatives** the government may wish to consider in the short term and over the medium term, in order to strengthen the public finance management system, are as follows.

- **Core reform options**
  - **In the short term**
    - Transform the Oil Reserve Fund into a Stabilization Fund with clear accumulation and withdrawal rules
    - Adopt a comprehensive legal status for the ORF, clarify its rules and purposes, ensure transparency of its operations and integrate the fund into the budget
    - Eliminate practice of using the ORF for funding extra-budgetary expenditures
    - Set appropriate targets for the non oil budget deficit as a ratio to non oil GDP
    - Initiate an analysis of public expenditures with a view to assessing their effectiveness and matching of the government’s economic and social priorities
  - **Over the medium term**
    - Add a saving function to the Oil Reserve Fund—to reflect the non-renewable character of oil wealth—based on a conservative estimation of permanent hydrocarbon revenue
    - Elaborate a rolling Medium Term Expenditure Framework (MTEF) for a period of 3-5 years as a main tool of fiscal planning
    - Make implicit subsidies explicit and transparent in the Budget
• Evaluate implicit and contingent liabilities such as those for pensions and non-performing loans of public enterprises
• Reconsider the appropriate scope for public expenditure decentralization

➢ **Complementary reform initiatives**
   
   (i) **In the short term**
   
   • Establish spending ceilings for each region and ministry at the beginning of the annual budget process
   • Eliminate the rule that 70 percent of budgeted oil revenues must be devoted to the development budget and 30 percent to other expenditures

   (ii) **Over the medium term**
   
   • Develop plans to address the implicit and contingent liabilities of the public sector
   • Raise the capacity of local governments to collect revenues that correspond to the benefits received from the services they provide
   • Encourage the introduction of user fees to finance provision of most local infrastructure services
   • Consider assigning to local governments a suitable tax base, such as the property tax, to finance local services
   • Introduce appropriate equalization transfers to less well-off local governments
   • Encourage competition in the provision of public services from the private sector, non-governmental organizations and other levels of government
IV. **BUILDING A STRONG INVESTMENT CLIMATE IN OPEN MARKETS AND REFORMING STATE-OWNED ENTERPRISES**

A. Main Pillars of the Transition to a Market-Oriented Economy

147. *The transition to a market-oriented economy will rest on building up a sound investment climate, market incentives for entrepreneurs and open markets with equal treatment to all investors.* Whether it is in (i) easing barriers to investment through simplified administrative procedures, or (ii) improving access to quality factors of production (land, infrastructure, human resources), or (iii) building strong market institutions (e.g. the customs, the judiciary, the public administration, the market information system), or (iv) improving the functioning of the credit market; the ability of Libya to conduct successfully these structural reforms will determine the success of its transition.

148. *The core of this transition will involve a major review of the legal framework for investment, and the strengthening of the capacity and the independence of the judicial system to enforce the rule of law.* Despite recent improvements, the laws and regulations governing business activity remain inconsistent with the requirements of a market-oriented system. Beyond the legislative apparatus, it is essential to the functioning of a market economy that the rule of law is enforced equally to all. This requires improving the capacity of the judicial system to resolve business disputes, but – most importantly – strengthening the independence and the governance of the judiciary, so that the rule of law is in force for all, including public administrations, large and small investors, and any other economic actors.

149. *In addition to facilitating new investments, improving efficiency among existing firms will also be key in this transition, in particular among public enterprises which currently dominate the Libyan industrial sector.* Such improvements will best be attained by transferring ownership to private, strategic investors, foreign or local. Before such privatization program progresses, it will be key to: (i) impose hard budget constraints on public enterprises, (ii) strengthen their operational independence, and (iii) ensure that the State does not intervene in the credit market to support loss-making enterprises.

150. *Promoting Libya's multilateral trade policy commitments, through WTO accession and a possible association agreement with the EU, will be an important anchor of reform.* Experience from neighboring countries (Tunisia and Morocco) shows that multilateral commitments, especially the EU association agreement, have been strong anchors of reforms. They have provided a comprehensive direction on reforms supported by technical assistance and flow of funds. Strong multilateral commitments are essential to provide a great deal of credibility to Libya's reform process. Libyan international commitments will in turn bolster investor confidence, both internally and abroad. Evidence shows that the lack of credibility is a key factor of the policy uncertainty that often hampers investor sentiment (Box IV.2).
B. Recent Reform Initiatives and the Growing Size of the Private Sector

151. The early stages of Libya’s economic transition have witnessed a withdrawal of the State from economic activity and gradual opening for increased private investment. Major bottlenecks to private sector activity that were in effect for a long time are progressively being lifted with an acceleration of the process in the recent months. Recent progresses of particular note are summarized in Box IV.1. The speed and decisiveness of the changes indicate a commitment of the authorities to further much-needed reforms. The authorities are strongly encouraged to maintain this momentum, as many challenges and important reforms still lie ahead.

Box IV.1: Structural reform initiatives to promote private sector development

- The liberalization of foreign investment, with the passing of Law #5/1997 and its amendments, and the creation of the Libyan Foreign Investment Board, acting as a one-stop-shop for foreign investors. Also, allowing 100% foreign ownership in Libyan companies is certainly a positive development that potential foreign investors would welcome. Libya has also concluded a number of international conventions on investment (such as the MIGA Convention and a number of bilateral investment treaties).
- The creation of almost all legal forms of modern enterprise, like holding companies, agency firms etc.
- The simplification of the process of enterprise creation for domestic investment with time-bound automatic approval, simplified procedures and the reduction of possibilities of discretionary refusals of applications by the administration, which are now based on a declarative basis to local authorities through a notary public. This should translate in much easier and faster business creation, even if implementation of these rules will need to be assessed at the local level.
- The reduction of the minimum number of shareholders in larger firms (Musahama) to 10, a number much closer to international standards compared to 25 or 500 which were in effect in the past. (law #21/2002, amended by law 1/2004).
- The trade liberalization, and its corollary, the unification of the exchange rate. In 2002 the multi-tiered exchange rate system was unified in effect through a devaluation of the Libyan Dinar.
- A privatization program was initiated in 1987 with the sale of about 150 productive industries, whose ownership was transferred to employees. In 2000 a Privatization Committee was established and the Government has announced plans to implement a more comprehensive privatization program. The passing of the privatization decree (#313/2002): a strong commitment to embark on full privatization of 360 public enterprises from all competitive sectors, in a fixed timeline. To conduct this program, a dedicated agency reporting directly to the Secretariat of the General People’s Committee has been created, with a clear mandate and dedicated budget. The ownership of some of these SOEs, probably the smaller ones, will be transferred to workers while others will be publicly offered; it is likely that some preference be given to employee ownership, at least for a percentage of the shares; however, foreign participation is not excluded a priori. This new phase of the privatization program could in fact be pro-actively used by Libya to attract more FDI into the country.
- The reduction of the number of subsidized products and number of State import monopolies, and the reduction of regulated activities to a minimum list, comparable to what is practiced elsewhere (e.g. health, education, security, hydrocarbon sector, and environmentally sensitive activities).
- The reduction of the marginal corporate tax rates, with the upper-income bracket rate reduced from 60% to 40%. Also significant cuts in personal taxes.
- A Commercial Agency law and a Free-zone law were enacted. The free zone is under development and is not yet operational.
- The planned reform of the labor code, which could allow for regular labor contracts between employers and employees of Musahama firms (shareholding companies).
- The planned reforms of the laws governing property and rentals, allowing for lease contracts on property with no obligation to buy, which de facto closely mimic formal rental contracts. Moreover, it is now possible for public administrations and public enterprises to rent out land and buildings to private operators.
151. These reforms have contributed to increasing the role of the private sector in economic activity. This is indeed reflected in the number of registrations that took place in the recent years, most of them being Fardi, Usari and Tasharuki micro-enterprises, as opposed to larger Musahama firms (Figure IV.1).

![Figure IV. 1: Enterprise registration, 1992 - 2005](image)

Fardi and Tasharuki cumulative registrations: 1992-2005
Musahama cumulative registrations: 1992-2005

*: years 2003 and 2004 extrapolated.

152. Still, the size of the Small and Medium Enterprises (SME) sector remains small and the private sector is still overwhelmingly dominated by small micro-enterprises, traders and artisans. Among registered private Libyan enterprises, around 98.6 percent are micro-enterprises of the Fardi, Usari or Tasharuki type, the rest are mostly shareholding companies (Musahama). In fact, based on a study conducted in 2003, only about one third of registered firms had filled a tax return that year, suggesting that many may actually not be operating. Most of the potential for further private sector growth lies ahead – in particular with the development of the small SME sector – as many areas are clearly underexploited, particularly in services.

153. Despite attractive incentives offered by Law No. 5/1997, foreign direct investment outside of the hydrocarbon sector is picking up only slowly. The recent measure imposing a minimum investment amount of US$50 million has reduced drastically the inflow of foreign investment proposals – the current project of reducing this requirement will send a strong positive signal. Since the opening to foreign investment that followed the passing of law #5 in 1997, 187 projects have been approved. Out of these, 55 projects have been cancelled for not being in accordance with the Law No. 5. Among the 132 projects approved (totaling slightly more than 5 billion LYD, 96 percent of which being foreign capital – and about 12700 jobs, 83 percent of which national), only 38 projects are under operation, while 52 are being implemented and 42 are being constituted (Figure IV.2). Given the small size of the local industry, this performance is much below the potential of the Libyan economy. Among the reasons cited by foreign investors who back-tracked from their initial interest or cancelled their projects are: the difficulty to access industrial land and the lack of clarity in the property-right status; and the bureaucratic processes. As further explained below, a number of dimensions of the regulatory environment for
foreign direct investment can be improved. Moreover, Libya still suffers from a mixed perception by foreign investors regarding the credibility of the reform agenda and the soundness of the overall business environment as it relates to the quality of economic governance (see below).

Figure IV. 2: Foreign direct investment projects: 2000-2006

Source: Libyan Foreign Investment Board (data as of February 2006).

C. Improving Business Regulations and Reducing Policy Uncertainty

154. The State has begun to withdraw from economic activity, but the regulatory framework that supports the transition to the market, suffers from major deficiencies. In particular, private sector activity is still heavily dependent on discretionary decisions and approval procedures on behalf of the administration. This is compounded by the fact that the laws and regulations governing business activity are changing rapidly, while the decrees and texts that should detail how these laws should be applied and enforced, are lagging behind. Moreover, key regulations regarding the land and labor markets, taxation and the trade regime, need to be reviewed to be consistent with the functioning of a market economy.

155. Discretionary power to public administrations (in particular, local authorities) appears in many areas of business activity, despite recent improvement in business creation procedures. Such leeway and non-clarity in the regulations inevitably lead to rent-seeking situations, corruption, opportunities to limit competition and protect existing businesses, and considerable uncertainty to entrepreneurs. International experience suggests that firms in developing countries rate policy uncertainty as their dominant concern among investment climate constraints (Box IV.2). The most notable examples of policy uncertainty for business operation in Libya include:

- The approval process for foreign investment under Law No. 5, even if the Libyan Foreign Investment Board plays a positive role of facilitation, the regulations are still far from best practice;
- The positive list of sectors open to foreign investment;
- Minimum capital requirements for Musahamas and foreign companies;
- Ambiguity in the laws governing land property and ability to rent;
- The rapid change in the legal apparatus is creating increased uncertainty as many decrees of application of the new laws remain unpublished, and some new laws appear to be inconsistent with old, outdated laws26.

**Box IV. 2: Policy uncertainty is a top concern for investors in developing countries**

A recent World Bank investment climate survey shows that for firms in developing countries, policy uncertainty is their top concern among other investment constraints, such as skills, regulation, tax and macroeconomic instability (right figure). Uncertainty may influence investment in different ways: firms may ask higher rates of return, may shorten their planning horizon, thus influencing the level and form of investment, the choice of technology, and the willingness to train workers. They may also consider an initial limited investment or refuse to invest at all.

Policy uncertainty results from imprecision and ambiguity in policies and law, the way these latter are practically implemented and the credibility of governments to deliver what is promised. Firms are more likely to invest when policies are regarded as credible and there are various strategies to enhance governments’ credibility:

- **Provide guarantees through national constitutions**: this can include constitutional prohibitions on the expropriation of property coupled with independent judiciaries able to enforce those rules. Political restraints are associated with lower perceptions of investment risk.

- **Ensure discretion on sensitive subjects to more autonomous agencies**: this can be achieved by putting in place independent central banks and specialist regulatory agencies, mainly in infrastructure.

- **Provide specific contractual commitments on sensitive matters, enhanced by making them subject to international arbitration**: this is a common strategy for major natural resource and infrastructure projects, and increasingly common on matters of taxation for a broader range of activities.

- **Enter international agreements that commit governments to sound policies**: They enhance credibility by increasing the costs of reneging on relevant policy commitments. Mexico willingness to sign the North American Free Trade Agreement was mainly triggered by the need to send a credibility message to foreign investors who doubted about the unilateral economic liberalization credibility.

Many countries tried to improve their credibility in different ways. In transition economies, this was one rationale for mass privatization programs. In Bolivia and Chile, similar effects were obtained by including pension funds among the investors in privatized utilities. In Uganda, determination of policymakers to stick with reforms enhanced the credibility of the government’s commitments to create more productive society.


156. **Despite recent improvements that led to a more declarative process, the approval process in business creation remains intrusive**— Whether creating a Fardi, Tasharukyia, Usari or Musahama firm, investors and entrepreneurs request approval to operate. This request is accompanied by clearances regarding the suitability of the premises, evidence of qualification and health certificate. A committee then decides

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26 A case in point is that the Libyan Commercial Code dates back to 1955, and the labor code dates back to 1970 (Law No. 58). Recent changes—most notably laws 21/2002 and 21/2004—partially supercede these outdated laws, but not completely.
whether to approve the request, based on unclear criteria. International best practice shows that business entry in unregulated sectors (i.e. excluding, for example, health and sanitation, or environmentally sensitive sectors) should be made on a declarative basis, with a clear list of documents to be submitted that give automatic right to the business license. Verifications of conformity to environmental, security, health and construction standards should be made ex-post, to verify that the investor is abiding by the law. No assessment of the feasibility of the project or the skills' fit of the investors should be made by the administration. While the decentralization of the process for local investment can be instrumental in speeding business entry, such discretionary powers to public officials can also increase uncertainty for investors or create opportunities for rent seeking and abuse at the local level. While maintaining such a decentralization process, the uncertainties and opportunities for arbitrariness in business entry should be significantly reduced, while installing a (central) appeal system for rejected applicants, for example, by expanding the role of LFIB.

157. **as is the approval process for foreign investment under Law No. 5.** Similarly to local investment procedures, and despite an attractive framework, approval of a foreign investment follows from a careful analysis from the Libyan Foreign Investment Board. As further explained in the next section, this practice is not consistent with international best practice (resting on simple registration or notification rather than approval procedures) and should be reviewed.

158. **The positive list of sectors open to foreign investment is restrictive.** Article 8 of Law No. 5 provides that foreign investment is allowed in “....Industry, Health, Tourism, Services, Agriculture....” and any other area determined by the GPC – areas that have recently been expanded to include telecommunications and transport, but not retail trade. However, as further explained below, when regulations beyond Law No. 5 are examined, it appears that in a number of key sectors with great potential for attracting foreign direct investment and realizing efficiency gains market access is restricted.

159. **Minimum capital requirements for Musahamas and foreign companies are unclear or way too high.** These are not specified by the law (except for foreign investments, for which the minimum capital required is US$50 million) and are left to the discretion of public officials at the time of the investment proposal. To avoid any opportunities to create barriers to entry, the international best practice is to set a low level of minimum capital requirement, leaving to investors the freedom to choose the level required for their activity.

160. **Ambiguity in the laws governing land property and ability to rent.** While the law recently allowed administrations and public enterprises to rent land and premises, no indication was made on how the rent is estimated, the type or term of concession contracts, the ability to use the land as collateral. In fact all of these are left to the discretion of the local authorities. A similar ambiguity limits the development of a private rental market, as formally only leasing agreements are accepted for private land and houses, with no obligation to buy at the end of the leasing period (de facto mimicking a rental contract).
In addition to removing the uncertainty related to existing laws, there is a need to review key regulations governing the labor market, the land market, the trade regime, and corporate taxation:

- **The labor regulation.** The government is currently in the process of reviewing the labor code. It is important that the new legislation gives flexibility to firms to control the size and quality of their labor force. At the same time the labor code should mandate employers to provide appropriate working conditions to their employees and to adopt occupational safety standards.

- **The land market.** A private land market coexists with a public land market, with a price gap that leads to distortions and speculation. The market needs to be unified and the legal framework for industrial land revamped. Industrial zones with independent (private) management should be developed. Parallel to this, the service and maintenance of infrastructure in industrial zones should be opened to private participation.

- **The trade regime.** Important initiatives to promote openness to trade have been implemented. To improve the transparency of import duties and reduce the scope for discretion, it is advisable that import duties and other taxes levied on imports be consolidated and harmonized. Although a reasonable degree of protection may be sought at the initial stages of the transition to the market, it is important that a credible and ambitious time-frame for reducing protection be announced to create sufficient incentives for restructuring and efficiency gains.

- **The tax regulation.** The progressive corporate income tax should be replaced by a flat tax, because it provides incentives to split companies, thus impeding corporate growth, and increases the room for discretion in the interaction with the tax administration (see Box IV.3). This tax rate should be reduced to levels comparable to countries with a favorable business environment (currently the top rate is at 40 percent - plus 4 percent Jihad tax—among the highest in the region).

### Box IV.3: The Corporate Income Tax (CIT) in Libya

Despite the recent significant tax cuts, that the corporate tax system is rather complex and not extremely competitive.

- The CIT rate structure is a complex one. The rate is progressive, i.e., it varies with the amount of profits realized. The new structure for corporate tax entails a charge of 15% on profits of LYD 200,000 (about US$155,000) per year rising, in stages, to a top rate of 40% charged on profits in excess of LYD 2m a year. This system is more complex to administer than a system where there is a single or flat rate applying to all activities and forms of companies, regardless of the size of the profits.

- There seems to be relatively broad discretion in the CIT procedure. The "deemed profit" system currently in place enables the tax authorities to assess the amount of profits that a company "is deemed to have made" given its size and sector of activity. This amount of profits can apparently be discussed (some even use the term "negotiated") between the company and the tax authorities. A system where the taxable income is determined through discussions with the tax authorities is not best international practice and can generate un-necessary opportunities of corruption or favoritism. Long-established or large companies with the "right" accountant or connection to the tax authorities can probably obtain a satisfactory outcome while more recent or less connected firms may secure a less favorable decision and tax liability. This clearly raises an issue of fairness as well as a question of efficiency in the administration of the tax procedures.
162. *All of these weaknesses may not be constraining at the present stage since private sector development outside of micro-enterprises is in its infancy, but authorities should start addressing these in the very short term. At the outset, they represent significant uncertainty to local and foreign investors.* Most of these reforms require institution strengthening, legislation review and investments. These are time consuming reforms and often politically difficult changes to implement. Unless these are addressed in the short-term, these issues will start to be increasingly constraining to private investment. The result would be a private sector dominated by a few large firms, with no opportunities for healthy competition and productivity growth.

D. Strengthening Market Institutions and Enforcing the Rule of Law

163. *While progress in the regulatory apparatus is undeniable, reinforcing the necessary institutions to support the emergence of a market economy is lagging behind.* Whether in the judicial sector, the public administration, the customs, the competitive framework, or the market information framework, the withdrawal of the State from economic activity has to be accompanied by a reinforcement of its regulatory role and the improvement of its administrative services to enterprises.

164. *In parallel to opening-up to private investment, strengthening the institutions supporting the functioning of competitive markets, should be a short-term priority.* In particular, the authorities should reinforce the following institutions, which have been identified as weaknesses in the current investment climate:

- **The judiciary.** With the transition, the legal framework is evolving rapidly. There may be a need to strengthen the judiciary as a key institution for sustainable economic development. A thorough review of the judicial system would be advisable to confirm the need for and design a judicial modernization/strengthening program based on actual needs and constraints and benefiting from lessons of experience of other transition countries.

- **The public administration.** While the full decentralization of the administration can help spur local investment, a system of checks and balances, and appeals, need to be put in place to avoid abuse, arbitrariness and rent-seeking opportunities at the local level. Moreover, strengthening the administrations that interact with firms is needed. This will require reviewing the administrative processes in order to move from the current culture of control and approval, towards a more business-friendly culture of public service and ex-post control that enterprises are abiding by the law. It will also require extensive training as the laws and regulations are changing rapidly.

- **The customs.** Reforms in customs administration should be pursued to improve professional and technical skills and operational capacity with the aim of tackling informal trade; improving coordination across all border management agencies to reduce excessive delays in clearance; adopting
modern, risk-based approaches to clearing imports and exports (see section 6 below).

- **The competitive framework.** A competition law is under preparation. It is important that competition policy be consistent with international best practice, to create contestable markets and facilitate market entry and the growth of new, innovative companies. This will be a key factor to promote sound private investment and productivity growth. In the medium term, a strong, independent, and well-endowed competition authority should be put in place.

- **The market information framework.** For a market economy to function well, investors, bankers and other market players need to have access to reliable information, in particular sectoral information. Currently, the availability of recent and reliable information is lacking in Libya. The information system needs to be strengthened and be made available to all market participants.

165. Market institutions need to be strengthened in Libya, but only the enforcement of the rule of law will give these institutions the independence and the legitimacy to play their role. Enforcing the rule of law equally to all economic actors, as well as the administration, is at the heart of a well functioning market economy. This is particularly the case for the judicial system, which is central to any market economy, but is even more important in the context of a transition, where laws are changing rapidly, major ownership transfers take place – in particular through privatization -, and competition increases. Currently, very few business disputes are settled through Libyan courts. This is likely to change as the markets develop. Also, the capacity of the judiciary to enforce the rule of law – often more so than the laws themselves – is a key ingredient to reinforce investors’ confidence, particularly foreign investors.

E. Attracting Foreign Direct Investment (FDI)

166. Despite the significant steps towards liberalization of foreign investment, Libyan authorities seem to favor an interventionist approach to attracting foreign investment, promoting large projects, after careful screening, in sectors where there is no or little domestic production. With the exception of this fundamental flaw, Law No. 5 is rather liberal. A Libyan investor, repatriating capital from a foreign country, can be considered as a foreign investor for the purpose of the law, a clear signal to the Libyan diaspora. Many guarantees critical for foreign investors are enshrined in the law, with the notable exception of the “national treatment” guarantee. Incentives are also sub-optimal and not in line with best international practice. Clearly, this is more a policy issue than a problem with the law itself. Investment Laws are as good or bad as the policies they are designed to implement. What needs to change is the investment policy and the attitude towards FDI. Changes to the law will naturally follow. The regulatory framework for FDI is assessed below with regard to three critical issues: (i) Admission of Investment; (ii) Guarantees accorded to investors; and (iii) The issue of Investment Incentives.

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27 Law No. 7 of 2003 also allows Libyans to invest in joint ventures with foreign investors (in local currency, or in kind), and benefit from the incentives of Law No. 5.
167. **On the positive side, foreign investment has recently been opened to new sectors, including transport, oil refining, and insurance.** These sectors have also been opened up for privatization. However, the retail trade sector remains closed to foreign investment, although it has the potential to promote significant efficiency improvements, as well as job creation. Also, joint ventures between Libyan and foreign investors are now permitted to benefit from the incentives of Law #5, with no limit on their respective shares. In line with these positive developments, the authorities should consider reforming Law No. 5 so that its provisions be extended to all investments, whether local or foreign.

168. **However, in contrast with these improvements, the recent decision setting the minimum capital requirement for foreign investments to US$50 million is, de facto, a ban on most foreign investments Libya could potentially attract in the non-oil sector.** Despite progress on other fronts, this decision is a serious setback to the reform agenda, which inevitably sends strong negative signals to foreign as well as local investors. Flows of FDI in non-hydrocarbon sectors and intentions of investment have already declined significantly in response to this decision. The Libyan authorities are currently considering reverting to a more open regime, independent of investment size.

(i) **Admission of Investment into Libya under Law No. 5**

a) **Sectors open to foreign investment:**

169. **A number of key sectors are, either by law or de facto, closed to foreign direct investment.** Law No. 5 is somehow deceptive in this regard. Art. 8 provides that foreign investment is allowed in “,...Industry, Health, Tourism, Services, Agriculture,...” and any other area determined by the GPC. A rapid reading of the law may lead the casual observer to conclude that Libya is fully open to FDI given the fact that industry, services (which tourism and health are subsets of) and agriculture are the three components of any economy. When the regulatory framework beyond Law No. 5 is examined, however, it appears that:

- FDI is not allowed in the trade/distribution sector, both retail and wholesale; and commercial agents can only be Libyan nationals;
- Telecommunications (both the fixed line and mobile network) are still a State monopoly, thereby depriving foreign investors from an opportunity to invest in a sector that has attracted considerable amounts of FDI around the world, including most developing and transition countries;
- Foreign participation in the banking and financial sector, while not formally forbidden, does not seem to be currently considered by the authorities.

170. For FDI to flourish and Libya to realize its potential for growth, especially in services, there should be as few restrictions as possible. Closing entire sectors to foreign investment, de facto or de jure, conflicts with the stated governmental objective of attracting more FDI outside the oil sector and diversifying the economy in services. Experience from developing countries suggests that injecting greater competition in services holds important potential for efficiency gains that benefit the economy as a whole (Box IV.4). The Government might want to consider lifting some of these restrictions by opening more sectors to foreign participation, either through...
liberalization (allowing private sector involvement in former monopolistic sectors or activities), new 'greenfield' investment, or the acquisition of existing companies (for instance through the privatization program). The Law is as good or bad as the investment policy it seeks to implement. A decision to change the investment policy has to be made first; then the law can be easily and quickly revised to reflect the new policy.

**Box IV. 4: Benefits of liberalizing services**

Developing countries should capture a lot from service liberalization. General equilibrium model estimations suggest that service liberalization could generate static gains estimated at 9.4 percent of GDP on a baseline growth path over a decade. Benefits to developing countries from service liberalization are almost six times those of liberalizing merchandise trade (right figure). Estimated static gains for any of four categories of services—trade and transport, financial services, communications and other private services—exceed those of total merchandise trade liberalization. Moreover, liberalizing key services, such as transport and telecommunications, significantly facilitates the development of export capacity in other services, especially in tourism and information technology. East European and former Soviet Union countries have started the transition with a much larger industrial sector and much smaller service sector than market economies with comparable per capita income. However, during the transition, the industrial sector contracted to about a third of the economy and service sector grew to about half.

The MENA region still lags behind in terms of GATS commitments to open services to competition. Countries in Eastern Europe have been more keen to commit to service liberalization, with little variability among countries. In the financial sector for example, MENA countries have embarked on reforms only in the 1990s, almost two decades after East Asia and Latin America. As a consequence, foreign bank presence in MENA is much lower (left figure), depriving the domestic private sector from potential benefits, such as improve their efficiency, foster competition among banks to develop niches and lower interest margins. As of the latter, the right figure below shows that in 1998, Central Europe and the Baltics countries have lower interest rate spreads (the difference between the average interest rate and the resident deposit rate), resulting from a more comprehensive financial restructuring.

Service liberalization is considered a major element of the transition to a market-driven economy as it is an essential driver for employment, thus offsetting part of the adjustment cost of the transition. Recent experiences of countries in East and Central Europe, where privatization and trade liberalization went in tandem with service liberalization, show that service liberalization has a considerable potential to generating large increases in the job market. In most of these countries, services’ share in employment has significantly increased. In Ukraine, the service sector accounts for 44 percent of the employment in 2001, up from 15 percent in 1990. In Poland and Azerbaijan, the share went up from about one third of the employment to half of it. Indeed, unlike trade in goods, most trade in services requires local employment and does not normally carry the same short-term employment risk as liberalization of merchandise. The main explanation is that service liberalization attracts foreign direct investment, as it is the most important mode for cross-border provision of services. FDI not only promotes jobs locally but also leads to the introduction of new technologies that improve efficiency and competitiveness for the domestic private sector.
171. **The system of positive list that is used in Law No 5 is sub optimal.** Best practice is to clearly state in the FDI Legislation what the sectoral restrictions are, using a negative list system to do so. The best investment codes provide in unambiguous terms that “foreign investment is free in the country in all sectors and activities except in a number of sectors where some restrictions exist”. Then these sectoral restrictions are listed, preferably in a document attached to the Law as annex and with executive rather than legislative value (such as a decree or governmental decision). The benefit of having the list itself in an executive level document is that, as the country advances in its liberalization program, it will be easier to revise the list than if it were included in the body of the law itself. Experience suggests that the list should be as short as possible. A long list of sectors where there are restrictions will send a very negative signal to the investor community, i.e., that in spite of official pronouncements, the country is not really open to foreign investment.

(b) **Majority ownership**

172. **Majority ownership is an issue where Law No. 5 follows best practice.** There is under Law No. 5 no limit on equity participation of foreign investors. This corresponds to best international practice and constitutes a very significant progress vis-à-vis the previous situation.\(^28\)

(c) **The procedure to invest**

173. **The procedure in place for FDI admission into Libya is one of screening/approval.** In short, the foreign investor has to submit an official application to LFIB, including a detailed feasibility study and 5-year financial and economic projections.\(^29\) The LFIB reviews the application and submits its recommendations to the Secretary who makes a determination. The Board also determines the minimum capital that the Libyan corporation to be formed should have (recently a minimum capital requirement of US$50 million has been imposed, which is way too high, but the authorities are currently considering reducing this to about US$5 million which would still remain quite high by international standards. In many countries, a limited liability or even a joint-stock company can be formed with only a fraction of this amount. The authorities are thus explicitly favoring large investments in sectors where local industry is not present). The business license is granted for 5 years, renewable, and gives access to the investment incentives discussed in a subsequent section. No other registration is in theory required from the foreign investor.

174. **In addition to not being consistent with international best practice, this system could cause unnecessary delays and uncertainty for investors, even if the Libyan Foreign Investment Board’s mandate is precisely to facilitate the process – moving to a higher rate of foreign investment will require less intrusion in the investment process.** As it is designed, the process will inevitably lead to biased

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\(^28\) Under the 1970 legislation, foreign investors were forced into joint venture arrangements with Libyan (public) investors and the foreign party’s participation could not exceed 49% thus leaving the majority and control of the joint venture to the Libyan partner(s). Needless to say this double constraint of forced joint venture and of minority foreign ownership did little to attract FDI into Libya.

\(^29\) A Libyan Foreign Investment Board (LFIB) was established under the Ministry (General People’s Committee) of Planning, Economy and Commerce to implement Law No. 5.
decisions to protect local companies when foreign investment will increase and projects will be submitted to compete with already existing businesses. Once they will secure a large FDI project in a sector they want to expand, it is unclear whether other authorizations will be issued for projects in the same sector, be they domestic or foreign. Such a strategy has failed in most countries that experimented with it. It can also create rents and private monopolies and thus it minimizes the efficiency gains that should result from increased private investment. Also what a Government views as a priority may not always coincide with foreign investor's perceptions of what constitute an interesting opportunity. Because of this unfortunate choice of approach and procedure, Law No. 5 - that was designed to signal to the foreign investor community that Libya was open for business- does not place Libya among the most attractive destinations for foreign investment when compared to neighboring countries like Egypt and Tunisia.

175. **The international trend is to replace the screening procedure and feasibility study with a simple notification or registration system.** Egypt, for instance, did away with the screening procedure/approval requirements for all new projects in 1996/97. Turkey abolished it in 2003. These are two examples that fully reflect international trends. The procedure can be the same as that in place to form a company under domestic law. People who oppose the abrogation of the screening and feasibility procedures often cite the linkage to investment incentives. The fact is that incentives, if any are offered, should be granted as automatically as possible. In other words, there should be clear guidelines and criteria for the eligibility to incentives and all investors meeting these criteria should have access to them without a discretionary decision.

(ii) **Guarantees to investors**

176. **Law No. 5 provides several key guarantees that foreign investors expect to find—even though the guarantee is not always as broad as it could have been:**

- The right to open an account in a convertible currency in a Libyan commercial bank for the needs of the project (art. 16)
- The right to repatriate profits (art. 12.C). This is apparently allowed once a year only (“annually”).
- Protection against expropriation. A very good standard of protection is recognized by Law No. 5 (art. 25) and can be considered as equivalent to best international practice.
- The right to employ expatriates (art 12. D) “when local workers are not available”. More liberal investment regimes do not place any restriction on expatriate employment. Employing expatriate workers is very costly and experience shows that foreign investors spontaneously limit the number of expatriates they employ and try to fill as many positions as possible with local employees.
- Right to own or lease land is guaranteed (art. 15).
- Finally, access to arbitration is also recognized (art. 24).
177. **However, one of the most fundamental guarantees, and one offered in many countries around the world which is missing is the guarantee of “National Treatment”**. National treatment guarantees that there shall be no discrimination between a foreign and a domestic investor and this has many concrete implications. It also helps judges or arbitrators interpret a specific legislative provision in disputes opposing the investor and the State or a governmental agency. National treatment should be granted to foreign investment without reservations or exclusions.

(iii) **Investment Incentives**

178. **Law No. 5 provides for a rather generous package of investment incentives.** Under Art. 10, the foreign investment project that is authorized by LFIB receives:

- An exemption from corporate income tax (tax holiday) for 5 years, with a possible 3-year extension, provided that net profits are re-invested in the project; during this period losses can be carried forward. The exemption covers CIT and stamp duties on legal documents.

- An exemption from customs duties and taxes on the imports of machinery, tools and equipment needed for the execution of the project. An exemption from customs duties and taxes on the imports of equipment, spare part, and primary materials is also granted for the operation of the project, for a period of 5 years.

- Exemption from excise taxes for goods that are exported.

179. **The tax incentive regime is not consistent with best practice.** First, identical incentives are not available to domestic investors in Libya. It is strongly recommends that all investors be treated equally, regardless of nationality, to ensure a level-playing field and competitive operation of markets. Thus it is advisable to harmonize the tax incentives across all investors. A second issue is the proper place for any incentives: fiscal incentives, if any, should be authorized in the tax code while any other incentives should be in other appropriate legislation – not in the foreign investment law.

180. **Although some tax incentives can be useful at the beginning of a country’s efforts to attract FDI, they are not without risks and negative implications, especially tax exemptions.** Tax incentives introduce distortions in the economy and across sectors (between firms that receive them and those that do not). They are fiscally costly. They generate a strong opportunity of corruption and nepotism. They have no proven efficacy in attracting FDI. Experience suggests that incentives are effective when they are: (i) simple; (ii) precise in terms of who gets them; (iii) clear on the benefits they offer; (iv) targeted to specific aspects of investments rather than being too general; (v) post facto, that is, extended after the targeted investment is made; (vi) transparent, allowing for little or no discretionary decisions and (vii) involve lower rates of taxation.

181. **A wiser strategy, that an increasing number of countries are opting for, consists in putting in place a more competitive business environment through a series of targeted reforms.** There are many things that investors find more attractive than a tax exemption granted through a lengthy and discretionary process, including
better quality infrastructure, more qualified labor, easier access to land, less burdensome administrative procedures, etc. In the tax area, it may be argued that lowering the CIT rate and abrogating the Jihad tax while at the same time fostering transparency in the tax procedures would be a reform that would appeal to many potential investors. Experience shows that when a better business environment and more competitive tax system is in place—which can be achieved in progressive stages—tax holidays can be abrogated without harmful consequences on FDI promotion efforts. Tax holidays can also be replaced by tax credits, allowances, or accelerated depreciation, all instruments that investors find very attractive and that create less distortion in the economy.

182. To the extent that Libya wishes to offer tax incentives to potential foreign investors, such incentives should be offered:
- equally to domestic and foreign investors
- equally across sectors/activities
- made available in the form of tax credits, tax allowances, or accelerated depreciation (rather than tax holidays or exemptions)

183. Summing up, there is real potential for more foreign investment into Libya's economy. The country enjoys significant mineral resources (this factor alone offers cheap and abundant sources of energy as well as opportunities to provide a range of services to the oil industry), a large territory close to the European market, as well as a rich cultural heritage and beautiful natural features (a long coastline and the Sahara desert). Together the last two assets, if properly managed, offer clear opportunities for quality investments in the tourism sector.

184. —but, in the context of stiff competition, Libya's only chance to realize this untapped potential is to put in place a first-class business environment, free of the constraints that currently make Libya a difficult place to invest. In particular, some of Libya's assets (such as proximity to Europe) can legitimately be claimed by Libya's neighbors in the Maghreb and Mashreq. These countries can also claim to enjoy a better business environment, more liberal economic policies, and more favorable investors' perceptions; they already have significant FDI inflows, having joined the "race" for FDI much earlier than Libya.

F. The Public Sector and the Current Privatization Strategy

185. With a public sector representing a large share of non-hydrocarbon GDP and 70 percent of employment, opportunities for new private 'entrants', whether foreign or domestic, are necessarily limited. The State retains strong monopolistic positions in key infrastructure sectors such as telecommunications, electricity, ports, roads, etc. Public utilities seem to be, by and large, inefficient; they often provide low-quality public services, consume extensive subsidies, and are reported to have obsolete equipment. But, as already mentioned, these public utilities, that could strongly benefit from foreign participation (because of their urgent need for advanced management techniques, technology, and capital infusions) and that are of high interest to foreign investors in many countries are currently closed to foreign investment. Public utilities are not the only problem. The State also owns or controls many normally private commercial activities (such as commercial banks). Many foreign investors are not attracted to countries/sectors in which they will have to
compete with Government-owned entities that may enjoy large subsidies, state protection or other advantages that will distort competition. The current plans to restructure the public sector, privatize or liquidate many SOEs, and open more sectors (such as telecom, banking and other service sectors) to competition and foreign participation may change this state of things and open more ‘space’ for the private sector, including FDI, to flourish.

186. **The general framework for privatization was established in 2000, however the strategy is not fine-tuned and a pragmatic, learning-by-doing approach has been adopted.** There is no privatization law per se, but a framework has been adopted which defines the overall strategic approach. The program is ambitious in scope as it intends to sell out all 360 enterprises in those sectors, which do not include the utilities (electricity, gas, and telecoms), the oil and gas sector, the banking sector and the air and maritime transport sectors. Most of these enterprises are overstaffed and incur recurrent losses, as recruitment in the past was based on social grounds rather than on economic efficiency. Moreover ongoing trade liberalization since 2001 has led many of them to stop operations as their products were no longer marketable.

187. **While the authorities are committed to privatizing the State-owned sector, the current strategy of ownership dilution by public sales is unlikely to lead to the efficiency improvements expected, at least for medium and large firms.** Individual ownership remains limited to 10 percent of capital – a constraint that is inconsistent with the objective to move to a market economy, where ownership shares should not be capped by law. International experience has shown that no institutional or legal arrangement can really enforce the independence of SOEs and change their managers’ incentives, until they are privately (majority-) owned by an individual or a firm shareholder, granting management control. Even if some progress has taken place since 2004 - some State-owned enterprises (SOE) have been privatized and/or financially restructured; some outstanding debts of SOEs have been absorbed by the treasury; SOEs now fall under the commercial code and commercial companies laws; and the idea of foreign participation in privatization deals is now accepted -, it remains unclear whether sales to strategic majority investors will be authorized and to which extent hard budget constraints are imposed on the remaining state-owned firms in the course of the transition, and how independent they are from Government interference.

188. **In parallel to privatization, it is essential and urgent to improve the investment climate for accelerating private sector development and to put in place a safety net to mitigate the transition’s effect on employment.** The current oil windfall gives Libya a unique window of opportunity to put in place a generous safety net that can facilitate these reforms from a social standpoint, and therefore maintain, throughout the transition phase, the objective of social justice and equity that are fundamental to the Libyan people.

189. **To that effect, two new Funds have been introduced in 2003 as a support to the privatization program.** The first fund is aimed at supporting new activities by employees in overstaffed public enterprises in the process of privatization. A second fund helps public companies to improve their financial situation, level of activity, and the quality of their products. This fund is financed from: revenues from import taxes levied on luxury goods, the sale of enterprise’s inventories, part of the recent increase
in the price of cement and steel, part of the revenues from the privatization of public companies, and the government budget.

190. **Two strategic priorities motivate the way the authorities intend to conduct privatizations:** first, *employment protection coupled with a generous social safety net* for employees who will be - as a last resort - displaced. Second, as a general rule, and as far as this is feasible, *shares are to be divested to a large number of individual owners* to avoid concentrated ownership and to favor Libyan ownership.

191. **Lessons from international experience in privatization are in many aspects in contradiction with the current strategy** (also see Box IV.5). Given that the process is at its early stages, the authorities are encouraged to reassess the current privatization method and have the Government Board for Ownership Transfer (GBOT) seek expert advice in the areas of firm evaluation, competitive bidding, and to draft a comprehensive privatization law.

- **In general, privatization through employees’ ownership does not produce good outcomes.** It usually leads to poor corporate governance. As a general rule, it is important that one or a group of investors acquire a significant share of capital and get corporate control over the privatized companies. Only then can these main shareholders interests be aligned with management interest. The authorities are encouraged to review the privatization strategy for Libyan public SMEs, to allow for local investors to acquire significant shares of capital at the initial shares’ offering stage.

- **The sales process to foreign investors should be based on international competitive bidding.** This is not only important to allocate the capital to the most promising investor and maximize the sales value, but also as a strong signal of good governance towards international investors, which is important beyond the privatization transactions per se.

- **Prior to privatization, public enterprises should be partly restructured.** Large SOEs are often overly integrated, highly indebted, and overstaffed. The authorities should, prior to privatization, engage in the difficult tasks of (i) reducing SOE debt (at least the short term debt resulting from accumulated losses); (ii) selling non-core activities and services; (iii) selling unused assets (land and buildings); (iv) starting to reduce overstaffing; and (v) settling titling and ownership issues.

- **The process should be time-bound with clear verifiable steps.** Important in any transition is to build consensus for the benefit of reforms, and sending clear and credible signals for investors. Defining a time-bound and credible privatization program with a dedicated communication strategy (inclusive of all stakeholders) are key in this regard.
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- **The privatization agency should have clear rules and an explicit mandate.** For example, it should have an independent legal existence, and its CEO should have all incentives to maximize the probability of success. Its financing should partly be based on the privatization receipts and it should report directly to the highest authorities.

- **In the transition period to privatization, public enterprises should be faced by market-oriented incentives.** In particular, it will be key to: (i) impose hard budget constraints on public enterprises, (ii) strengthen their operational independence, and (iii) ensure that the State does not intervene in the credit market to support loss-making enterprises.

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**Box IV. 5: Methods of privatization: lessons learned from the East European countries**

Privatization is a key element in the transition from planned to market economy. Different countries adopted different methods and speeds. While privatization of small enterprises, usually by simple methods based on auctions, is considered a success, the privatization of medium and large size enterprises is more complex and is still an ongoing process in some countries. Methods most commonly adopted are:

* **Mass privatization through diffuse ownership of vouchers.** Vouchers became the cornerstone of economic reformers because, in many cases, they thought that a fast and massive transfer was needed to definitely anchor changes and create new owners who would support further market reforms, especially in the context of political uncertainty. It was also considered as a way to give purchasing power to the population in a transparent and fair way. The performance of enterprises privatized through mass voucher methods was disappointing in countries such as Russia, Czech, and Slovak Republic. Three main reasons explain it: first, the lack of resources and skills to drive enterprise restructuring; second, the absence of a regulatory framework governing enterprises; and third, the weakness of surveillance by creditors because of delays in privatizing the largest banks.

* **Direct sales.** This method was adopted by fewer countries and drove good results in Poland and Hungary, not in the Slovak Republic for their second round of privatization. Direct sale to concentrated owners was not enough. Hungary and Poland had both open and transparent methods. In contrast, Slovak Republic program favored politically connected parties and had the potential for corruption. Moreover, Hungary was the only country (with Estonia) that fully opened its firms and banks privatization program to foreign investors, which brought needed investment, know-how and competition. By mid 1990s, Hungary worked out much of the large stock of bad loans and its economy was performing well in the second half of the 1990s.

* **Competitive case-by-case auctions.** A major positive feature of this method adopted by the Federal Republic of Yugoslavia is to restrict the distribution of subsidized shares to insiders to a maximum of 30 percent of shares, thus making the majority of shares available for strategic investors, more to dedicated to pursue long run profit maximization. This method is highly recommended for medium-size enterprise. Very large enterprises should be privatized only when a clear strategic investor is identified.

Privatization in East and Central Europe has led to diverse results and one certainty: complementary economic reforms in the banking sector as well trade and price liberalization, and an adequate institutional framework make successful privatization more than methods and speed do. The institutional framework included strong mechanisms of corporate governance such as rules to protect minority shareholders, rules against insider deals and conflicts of interest, and an appropriate accounting, auditing and disclosure standards. It would also include takeover, insolvency, and collateral legislation, as well as strong creditor surveillance by well-run private banks. Considering the above, the ideal strategy would be to transfer assets as rapidly as possible to individual investors or concentrated groups of strategic investors through open, fair, and transparent methods. Such countries as East Germany, Hungary and Estonia have adopted this strategy with positive outcomes.

G. Trade Policy Reform and Customs Administration

(i) Trade policy

192. **Libya has taken steps to promote openness to trade.** Licenses were abolished and tariffs eliminated on all goods, except cigarettes for health purposes. This is a unique case in the region and very rare worldwide (only Hong-Kong, Macao, Singapore and Switzerland have currently set tariffs to zero). Trade restrictions on some products remain. There are four products for which imports are reserved to State enterprises: raw gold, tobacco, veterinary medicines and vaccines (besides oil and security related products). Import bans also remain for 18 items (down from 31 in 2003). While some are for religious, health, ecological and ideological considerations, others are aimed at protecting the local industry (telephone equipment for fixed lines, liquid pasteurized milk, mineral water, flexible PVC plastic pipes, etc.). Export bans apply to iron, copper, aluminum scrap and coal.

193. **Exemptions from import duties granted to public sector companies to offset the impact of exchange rate unification in 2002 have been abolished.** Activities remaining exempted from import duties are those related to diplomatic exemptions, migrants' belongings, investment incentives, external financing, grants and assistance, non governmental agencies and conditional exemptions.

194. **However, the discriminatory Consumption Tax and Service Fee is equivalent to trade protection and reduces the transparency of the trade regime.** For selected sensitive imported goods that are also produced locally, the Authorities levy the Consumption Tax on imports (mostly at 25 percent and for some products at 50 percent). A production tax at a uniform rate of only 2 percent is levied on the equivalent local production of these goods. This distortion serves to create an obvious protection of local production from imports. An additional 4 percent charge is levied on all imports to cover customs fees (Service fee). An importer thus potentially faces two add-on charges: the service fee and the consumption tax, both collected by the Customs Department. Indeed, the authorities justify these taxes by the need to provide temporary protection to newly privatized firms and to reduce fraud and corruption at the Customs Department.

195. **The classification of goods subject to the consumption tax lacks transparency.** A hundred products (up from 76 in 2003) broadly defined are concerned (see Table in Annex 4). As a result of the 2005 reclassification of goods subject to the two taxes, the average consumption tax rate increased to 29.1 percent,

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30 In 2003, import tariffs ranged between zero and 100% (compared to tariff peaks of 425% previously). The simple average tariff rate was 16.5%, down from 17% in 2002. The trade-weighted average tariff (based on trade values for 2002) was higher at 19.9%.  
31 Up to 2005, the consumption and production taxes dispersion was higher: 10, 15, 20, 25, 30, 40 and 50% for the former, and 2, 3, and 5% for the latter.  
32 A rough calculation suggests that the consumption tax increased the simple average duty applied to imports from 16.5 to 18.5% in 2003. The trade weighted average duty rises from 19.9 to 23.4% once the discriminatory consumption tax is taken into account. Hence, the consumption tax leads to a significant increase in the burden of taxation of imports.  
33 Customs Department used to collect an additional tax, the regional and social solidarity tax that was a percentage of the import duty. Since import duties per se do not exist anymore, this tax does not exit anymore.
from 26.5 percent in 2003, while the average production tax was reduced to 2 percent, from 2.6 percent in 2003. The authorities are however currently working on identifying these products following the trade nomenclature (Harmonized System) as previously recommended by the IMF and World Bank. The new classification (HS 6 digit) will likely reveal a higher number of products subject to the consumption tax.

196. **As a first step, it is advisable that taxes levied on imports be converted into tariff rates.** The consumption and production taxes create strong incentives for discretionary interpretation, misclassification, lobbying from local producers seeking protection, and, ultimately, corruption. To promote a sound investment climate, these taxes should be integrated into the tariff rate structure. This would ensure greater transparency and a more realistic and accurate picture of the protection level. Moreover, these taxes violate one basic WTO principle, that of national treatment, and will have to be removed when Libya negotiates WTO accession. This will also be an obstacle to a possible negotiation of an Association Agreement with the EU.

197. **As a second step, harmonized tariff rates (or currently Consumption tax) should be reduced within a clearly announced timeframe.** Although a modest degree of protection may be sought at the initial stages of adjustment towards a market-oriented economy, it is important that a credible and ambitious time-frame for reducing protection be announced to create sufficient incentives for restructuring. International experience suggests that high levels of protection usually delay adjustment, as they prolong the life of inefficient public enterprises without providing strong enough incentives for more ambitious restructuring. High protection also weakens incentives of private sector companies to improve efficiency and become competitive in open markets. Reduced protection will also guarantee Libyan citizens access to a wide range of goods at internationally competitive prices and better quality. The fact that the reduction in tariffs of imported raw materials and intermediate inputs increases the effective protection of domestic producers should also be factored in when designing an appropriate schedule for the reduction of nominal tariff protection for goods with locally produced substitutes. Exporters should be compensated (for example, with an appropriately designed duty drawback scheme) for the tariffs paid on imported capital goods and raw materials so that they are competitive on the international market.

198. **Efforts should be continued to reduce protection dispersion.** Taxes and tariffs should be set as uniform a rate as possible. The government should bring down the highest rates first and increase the uniformity of the tariff schedule. Social costs created by taxes are proportional to the square of the tax rate, so reducing the highest rates brings the greatest static welfare gains. Moreover, it is the best known way to reduce the discretion and potential administrative bottlenecks in the trade system. A wide range of tariff rates increases the administrative burden in applying trade policy and collecting tariff revenue and is less effective in preventing smuggling and corruption. In general, a given amount of tariff revenue will be more efficiently collected through a small number of tariff bands. These efforts should be accompanied by a more simplified and better-defined classification of goods.

199. **State import monopolies have been reduced but price distortions still remain in a number of markets.** State-owned companies now face competition from the private sector, which can freely import and/or produce these goods. However, price
and profit margin controls still remain in a number of markets (for example, for private sector imports of subsidized consumption goods), although enforcement capacity of these controls seems weak. Import bans that cannot be justified on the basis of religious reasons should be eliminated as they directly affect consumer welfare. Health and ecological issues should be addressed through appropriate product standards.

200. Opening to competition key backbone services—such as telecommunications, financial services, and transport—is an important condition for competitiveness and growth. Regulatory reforms that will inject more competition in markets for services and network industries, through private sector participation in the provision of services, will force operators to improve efficiency and pass on the lower production costs to users. As already discussed, creating more opportunities for private sector investment in services will also generate more jobs and help offset the short-term adjustment costs from the reduction of protection for import-competing industries (World Bank, 2003a).

201. Complementary reforms tackling behind-the-border impediments to trade are crucial for trade reform success. Trade reform works best for economic efficiency and productivity growth when it goes in tandem with complementary reforms to eliminate behind-the-border impediments in customs, standards, ports, communications, and other barriers to trade. These barriers are the less tangible but a recent survey of 230 companies in eight Arab countries34 shows that (i) on average, one percent of the value of imports is paid as “additional payments” to customs officials; (ii) it takes two to five days on average to release goods imported by freight from customs and two to ten days for sea shipment. In contrast, the norm is less than six hours to clear air freight, less than 24 hours to clear sea freight, and less than four hours to clear shipment by road. Removing these barriers will considerably improve Libya’s attractiveness to foreign investment while promoting the competitiveness of domestic companies.

(ii) Accession to the World Trade Organization

202. WTO accession provides a good opportunity for comprehensive review and reform of Libya’s trade institutions. One benefit of the accession process is that it forces the government to examine all laws, policies, and institutions affecting international trade and investment. It provides the opportunity to integrate trade policy into the country’s overall strategy for economic reform. Libya will be expected to make binding commitments on more than just the levels of customs duties. Libya will need to reform laws and institutions in many policy areas traditionally thought of as purely domestic concerns. It will give the opportunity to Libya to send a message to foreign investors that it is open for business and accepts international discipline in crucial areas. As a consequence, this means that WTO accession cannot be the sole concern of the trade ministry. Experience from other countries shows that institutionalized inter-ministerial cooperation and participation of the private sector are necessary if Libya is to avoid delays in accession negotiations.

34 Countries are: Egypt, Gaza-West Bank, Jordan, Lebanon, Saudi Arabia, Syria, Tunisia, UAE (Zarrouk, 2003)
WTO accession negotiations will place a high demand on administrative resources. Like all other candidate countries, Libya will be expected to first undertake a thorough review of all laws, regulations, and policies that affect international trade and investment. Known as the Memorandum of the Foreign Trade Regime (MFTR), this review follows a standard format and must contain all of the following:

- a general description of Libya’s economy, economic policies, political structure, and the framework of its basic laws,
- a description of all policies that affect trade in goods, whether traditional trade policies (e.g., import and export licensing, customs duties, other charges, export taxes, quantitative restrictions, regional agreements) or internal policies that have even indirect effects on goods trade (e.g., industrial and agricultural subsidies, intellectual property rights, standards, commodity taxation, government procurement), and
- a description of all laws, regulations and policies affecting internationally tradable services (e.g., banking, insurance, telecommunications, transportation, business services), whether these affect cross-border trade in services, the establishment and operation of enterprises to provide services within Libya, or the movement of individuals into Libya to provide services.

Assistance from experts knowledgeable about WTO documentary requirements can reduce delays in accession negotiations. WTO submissions must follow a prescribed format. The methodology used to calculate agricultural subsidies, for example, is unique to the WTO. Libya can substantially reduce frictions in the early years of accession negotiations by relying on international experts who have prepared similar documents in other countries.

WTO members will expect reforms in the basic structure of economic management. After the review of the MFTR is concluded, WTO members will ask Libya to ensure that its economic policies conform to basic WTO norms of transparency and nondiscrimination, and to the terms of specific WTO agreements. While reforms will be necessary in many areas, the ones that may attract the most attention in Libya’s accession negotiations are the following four:

- Establishing the rule of law. As other sections of this report point out, administrative discretion rather than the rule of law shapes many private sector decisions in Libya. WTO members will expect Libya to ensure that all economic policies affecting international trade and investment have a clear legal basis, are applied equally to foreign and domestic firms with minimal discretion by government officials, and incorporate clear appeals procedures.

- National treatment in internal taxation. Certain internal taxes are applied on imports but not on domestically supplied goods. Such provisions violate WTO rules; their elimination will be a priority for WTO members. Rationalizing the current system of commodity taxation will also increase transparency of the incentive structure affecting domestic and international trade, and should therefore be a priority for Libya as well.
- Customs valuation. WTO members will require Libya to fully implement the WTO Agreement on Customs Valuation as a condition of membership. A central tenet of this agreement is that imports be valued according to the price actually paid or payable. The government should treat this as an integral part of the broader customs reform agenda outlined in the previous section of this report.

- Intellectual property rights (IPRs). Certain WTO members will place great importance on Libya bringing its IPR regime in line with international best practices. This will require Libya to accede to the major IPR treaties and conventions, write or revise laws on copyrights, patents, integrated circuits, trade secrets, trademarks, plant variety protection, and geographical indications. To ensure that the Libyan economy benefits from these legal reforms, the government should expand its capacity to administer IPRs, develop extension programs to the business community about the commercial application of IPRs, and foster the emergence of market institutions that connect inventors with entrepreneurs.

206. Additional reform issues. WTO members will also insist that Libya undertake reforms in a number of other areas as a condition of accession, including inter alia laws on special economic zones, government procurement, standards, and antidumping. WTO rules also ban the use of quantitative import restrictions and export subsidies in manufactured goods trade. All of these are conditions of accession, though arguably less urgent for Libya than the priority areas discussed above.

207. WTO members will request Libya to make commitments in market access, service sector liberalization, and agricultural subsidies. The particular commitments will emerge during the course of mostly bilateral negotiations with WTO members. (One should note that only the candidate country makes concessions in these negotiations, not the existing members.)

- WTO members will ask for greater access to the Libyan market for goods and services of interest to their exporters. Based on other accession negotiations, one can expect WTO members to ask Libya to open its banking and telecommunications sectors. Members will also request Libya to eliminate all special charges or duties imposed solely on imports other than ordinary customs duties. In addition, members will ask Libya to reduce certain types of government support to agriculture.

- The World Bank stands ready to assist Libya in developing the analytical capacity to assess the economic impact of these commitments. Experience in other countries suggests that Libya would benefit from reducing barriers to FDI in financial services, telecommunications, and transportation.

- One problem that will affect Libya's negotiations on agricultural subsidies is the government's reliance on off-budget, implicit subsidies. The government can address this problem through reforms in public expenditure management outlined in the last chapter of this report.
208. **Other commitments.** In addition to the priority areas above, WTO members will also request commitments in a number of other areas. These might include the reduction in the number of goods that face testing requirements, acceding to plurilateral codes such as the Information Technology Agreement and the Government Procurement Agreement, permanent elimination of export taxes, and specific regulations that affect trade in goods of interest to WTO members.

(iii) **Customs administration**

209. **Customs administrations around the world play a vitally important role in the implementation of a range of critically important government policies such as revenue collection, trade facilitation, the production of accurate trade statistics, and the protection of society from a range of social and national security concerns.** Without an effective, efficient, responsive and ethical Customs administration Libya will be unable to establish a business environment that ensures its business community can compete on equal terms with foreign commercial interests and will be unable to attract the quality and quantity of foreign investment necessary to ensure the establishment of a vibrant and productive domestic private sector. Likewise, it will frustrate Libya's plans to join the WTO as membership entails the implementation of a number of Customs and border management related requirements.

210. While the Libyan Customs administration's strengths provide a sound foundation for the establishment of a comprehensive reform and modernization program, it is also characterized by a number of fundamental weaknesses that require urgent attention. Addressing these weaknesses would require a comprehensive vision and business plan for the future matched to a sound planning and resource allocation framework necessary to ensure effective design, and implementation of a reform and modernization strategy. Main weaknesses include:

- **The lack of an integrated IT strategy, system and associated infrastructure** necessary to facilitate the adoption of modern approaches to Customs administration such as risk management, post clearance audit, and the use of commercial intelligence; The current import/export process is entirely paper-based with information technology employed only for statistical recording purposes. It is characterized by excessive documentation, repeated checking of the same information and extremely high levels of physical verification;

- **Inadequate attention to identifying, collecting and analyzing key operational statistics, compliance records and performance indicators relating to a range of important Customs activities.** Such information should include such indicators as the time taken from lodgment of Customs declaration to release of goods; the percentage of consignments selected for physical verification, the results of such verifications, and the compliance record of individual traders;

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35 The International Monetary Fund undertook a comprehensive review of the Libyan Customs administration in 2004 (IMF, 2004). The present assessment endorses the Customs-related conclusions and recommendations contained in the IMF report and notes that a number of the key recommendations have already been implemented. The priority areas for reform outlined below aim to ensure the effective implementation of the IMF recommendations.
- The lack of a formal compliance management or improvement strategy designed to identify and differentiate between traders that are compliant and those that are not. As a result, incentives to reward high compliance and disincentives to reduce non-compliance are almost non-existent. All traders, regardless of their compliance record, currently face similar administrative procedures and regulatory controls. Ensuring effective enforcement capacity would be key to tackle the reportedly high levels of informal trade and smuggling that occur between Libya and neighboring countries.

- Inadequate coordination and integration between Customs and other border management agencies including Agriculture, Health and Standards leading to excessive delays in clearance;

- Inadequate physical infrastructure, technical aids, and professional and technical skill levels. Non-intrusive contraband detection equipment, combined with upgraded technical and professional skills would be necessary to facilitate the transition between current systems and procedures and those necessary to cope with an increasingly sophisticated trading environment;

- A control mentality that pervades all border management agencies and prevents the adoption of modern, risk based approaches to clearing imports and exports.

211. At the operational level it is recommended that Customs:

- Establish a high level Reform and Modernization Committee made up of representatives of all key operational areas. The Committee, with external expert assistance, should articulate and gain agreement to a future vision and business model for Customs and border management in Libya. It will also be responsible for developing the 3 - 5 year strategy necessary to achieve effective implementation of the vision; and

- Convene a high level Border management Reference Group or steering committee led by the Secretary of the Libyan Customs administration and made up of high level representatives of the business community and all other government agencies involved in border management. The role of the group will be to oversee the work of the Reform and Modernization Committee and to guide the development of the future vision and reform strategy.

212. Summing up, core reform options and complementary initiatives the government may wish to consider in the short term and over the medium term, in order to build a strong investment climate, are as follows.

- Core reform options

  (i) In the short term
  - Further streamline administrative barriers to business entry and operation.
  - Eliminate restrictions to investment in service sectors in foreign investment law and related regulations (example: trade, distribution).
• Begin the restructuring of public enterprises by: (i) reducing debt; (ii) selling off non-core activities and services; (iii) selling unused assets (land and buildings); (iv) reducing overstaffing; (v) clarifying titling and ownership issues.

• Abolish the consumption/production taxes and service fees and replace them with a low-tariff trade regime, also ensuring low tariff dispersion.

(ii) Over the medium term

• Launch a full review of the business legal framework in order to harmonize and modernize legislation.

• Complete the restructuring of public enterprises

• Privatize state-owned SMEs in a 5-year time-frame

• Launch liberalization of telecommunications and create independent regulatory body

• Undertake a thorough review of all laws, regulations, and policies that affect international trade and investment, in preparation for WTO accession negotiation

➢ Complementary reform initiatives

(i) In the short term

• Eliminate progressivity in corporate tax rate and set rate at a low, competitive level, for both domestic and foreign investors

• Replace positive list of allowed sectors in Investment Law #5, by negative list of limited scope.

• Set minimum capital requirement for joint-stock and partnership company to a fixed, and small amount.

• Review privatization strategy and possibly issue new privatization law.

• Simplify and better define the classification of goods in the customs code and reduce the dispersion of tariffs

• Pursue reforms in customs administration with the aim of tackling informal trade and improving coordination across all border management agencies

(ii) Over the medium term

• Launch a large scale judicial reform (capacity building, training and judicial organization reform)

• Initiate programs of capacity building of market-supporting institutions: customs, regulatory institutions, public administration.

• Launch administrative reform in government agencies dealing with the enterprise sector.

• Launch a long-term plan for upgrading the infrastructure in industrial zones.

• Reform the industrial land market and create privately-managed new industrial zones.

• Open utilities sectors to private participation

• Announce a plan for reduced tariff protection to create adequate incentives for public enterprise restructuring and efficiency
V. PRIORITIES IN FINANCIAL SECTOR REFORM

A. Background

213. The Government and the Central Bank of Libya (CBL) have launched a series of measures in support of financial sector reforms. A particular focus of the program is the restructuring of state-owned banks and, for some of them, an adjustment in ownership structure to include or increase private sector participation in the capital of such banks. In this context, the authorities have already embarked on significant steps in:

- re-assessing the legal framework for the banking system, with the passing of the new Banking Law No. 1/2005, as well as the Anti-Money Laundering Law No. 2/2005;
- partial privatization through public sale of shares of the Al Sahari Bank, and preparation for the privatization of the Wihda Bank;
- recapitalization of all five public banks;
- licenses granted to four private banks and one foreign bank;
- merging of 21 regional banks into one bank;
- reinforcing of banking supervision capacity;
- partial interest rate liberalization (see below);
- exchange rate unification and foreign exchange liberalization (adherence to Article VIII of IMF);
- granting of independence to public commercial banks to close non-profitable branches;
- authorizing Libyan commercial banks to lend to foreign firms operating in Libya;
- strengthening regulatory and prudential oversight;
- devising plans for balance sheet restructuring of state-owned banks;
- charting the path for privatization of state-owned banks.
- building the legal and regulatory underpinnings for the insurance industry; and,
- setting-up the legal and institutional framework for the launch of the equities market.

214. There is acknowledgement of the importance of updating and strengthening the financial sector’s legal, regulatory and supervisory environment. These initiatives should go in parallel with the efforts aimed at restructuring the banking system and addressing the portfolio problems besetting state-owned banks. In the absence of reforms, the banking system would not be able to play fully its role in the intermediation of national savings and the financing of economic growth in the non-oil sector.
B. Strengthening and Restructuring of the Banking System: Governance, Portfolio and Ownership

(i) Status of domestic banking

215. **Banking represents the backbone of the Libyan financial system.** Insurance is small and the equities market is nonexistent while fixed income instruments are limited to a small stock of outstanding government securities. In addition to the Central Bank, there are a dozen financial institutions including commercial and specialized banks (in addition to the regional banks). Commercial banks have some LYD14 billion in aggregate assets; the three specialized banks have LYD4 billion and the regional banks LYD 0.25 billion. In aggregate, banking system assets are equivalent to about 60 percent of GDP, indicating that the domestic banking system has considerable potential for growth particularly for a middle income, oil producing country. Commercial bank loan portfolio accounts in aggregate for LYD7 billion i.e. a loan/deposit ratio of about 50 percent in gross value. On a net basis, when adjusting for the stock of non-performing loans (NPLs), the ratio would further decrease.

(ii) Legal framework

216. **The new banking law reinforces the independence of the Central Bank of Libya (CBL) and offers a good legal framework for the regulation of banking activities, even if some provisions call for improvement.** In particular, full independence in the operational conduct of monetary policy should be further strengthened by ensuring that the representative of the government in the Board of Directors (Secretariat of Finance) is not involved in operational decisions related to monetary policy (Article 14 of Law No. 1 of 1373 P.D.). Once the goals of monetary policy have been set in a consultative manner between the Government and the CBL, policy implementation (and accountability) should rely solely with the CBL. Also, the role of the CBL in regulating the terms and conditions of credit extension or investment by commercial banks, should be reduced (Article 56).

217. **Despite the progress brought by the new banking Law that specifies and limits its duties and responsibilities, the CBL remains the owner of the public banks, with the associated potential conflict of interest between ownership and regulation.** It is essential that the Libyan authorities consider separating ownership of banks from their regulation by the CBL. Ownership should either be transferred to the General Secretary of Finance or to an asset-management institution that the latter owns. Until such transfer takes place, the CBL should under no circumstances be involved in operational decisions made by banks, or in individual credit decisions.

(iii) Institutional strengthening and the structure of governance of public financial institutions

218. **State-owned banks need a clear strategy and an effective governance and managerial structure for their activities.** After the lax lending practices to SOEs of the 1980's and early 90's, which are responsible for a major share of bank NPLs, the tightening of credit policies, and more strict management oversight, have led over the past few years to progress in addressing portfolio and operational problems. Nonetheless, the road to satisfactory and sustainable performance for state-owned
banks is still long and steep. Further strengthening of these banks is still required so they may operate and grow in an environment likely to become increasingly open and competitive. Assistance would be required for the state-owned banks in their drive towards building a strong management structure adequately supported by professional banking teams, enhancing corporate governance, developing a clear business strategy, and building more up-to-date skills in such critical areas as credit, investment, risk management, and management information and control systems.

(iv) Regional banks

219. **Libya has 48 so-called regional banks operating and providing services across the country, including some remote areas.** Over a short period of time, these banks have reportedly shown a relatively good record in terms of deposits collection, offering thus an outlet for savings to low income households especially in traditionally underserved areas. Their activities are also somewhat coordinated through the National Banking Corporation (NBC) which offers them a number of corporate services (accounting, training,...). A number of these regional banks however are too small and inefficient; some would probably be insolvent but are allowed to maintain their activities as a result of regulatory forbearance driven by social considerations. Given their large number, they undoubtedly place a heavy burden on existing supervisory capacity. The banking authorities are presently in the process of consolidating these institutions under the umbrella of the NBC (21 have been merged so far), of which they would become full branches rather than stand-alone financial entities. Such a decision will help ease the burden on the supervisory authorities.

(v) Non-performing loans and need for portfolio restructuring

220. **The issue of non-performing loans and distressed assets needs to be – and is reportedly being – addressed by the authorities.** Various schemes relating to the non-performing loans of SOEs are being discussed within the government, some involving for instance an exchange of the NPLs of specific SOEs for debt issued by the Treasury or the Central Bank, depending on which of the two entities would be the shareholder. It would be useful that the restructuring plans be based on thorough and independent audits of the bank portfolios, and on a clear view by the authorities on the future governance structure of, and decision making processes within, the state-owned banks to ensure that the errors and transgressions of the past, particularly as far as credit extension (especially to SOEs) is concerned, are not to re-occur. Financing of SOEs, which represent a significant portion of the country’s economic base, should be subject to rigorous credit underwriting and repayment standards, while their operations should be subject to hard budget constraints.

(vi) Privatization of state-owned banks

221. **The authorities have embarked on a privatization strategy through dilution of ownership by selling shares to the public – most recently with the Sahara Bank, and in preparation for the Wahda Bank.** Special committees have been appointed to assess the values at which bank shares may so be transferred. Experience in transition economies has shown that some privatization schemes are more likely to be successful than others in achieving the efficiency gains that are usually sought from
ownership transfer and change. In particular securing the interest and participation of strategic investors and partners appears to be one of the critical elements of success in bank privatization. Divesting government holdings in financial institutions to unspecified, let alone unqualified, private interests would by itself not be sufficient a condition for ensuring the success of privatization. The opportunity to attract a well qualified category of investors with a proven track record in the financial industry into the ownership and governance structure of state-owned banks has been the most reliable ingredient of successful bank privatizations. The objectives and benefits to be achieved by bank privatization – i.e. generating revenues for the government, simply transferring ownership, improving banking sector efficiency, etc. – ought to be clearly defined by policy makers. In this regard, the experience of many countries has shown that merely diluting ownership away from government holding in favor of disparate and inexperienced interests would not yield the anticipated outcomes in terms of improved banking sector efficiency measured by higher levels of financial intermediation, credit extension, resource mobilization and banking services.

(vii) Promoting access to finance: the link between strengthening the banking sector and corporate sector reforms

222. A key determinant to the success of the private sector-led growth approach, will be to improve the capacity of the financial system to channel savings to private sector investment. Until recently, the public enterprise sector in Libya was the only beneficiary of corporate lending by banks. The banking sector administratively channeled funds to public enterprises, while the marginal private sector consisted only of micro-enterprises with no formal access to finance. For the new private sector to grow, banks need to acquire the capacity to serve this new segment, and need to operate in an environment prone to the development of a sound credit market.

<table>
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<th>Box V.1: The Libyan Development Bank</th>
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| The Development Bank was created in 1981. It is the only provider of medium-term loans to the enterprise sector, which is currently dominated by small and medium-size firms. It finances 100% of new investment and extension projects in industry, services and tourism, with fixed interest loans (5%) of five to six year maturities. As comparison, other commercial banks in Libya only offer working capital loans with maturities of one year or less, and 7.5% interest rates. The Bank operates 43 branches across Libya and employs about 400 staff. Although it can take equity shares in companies, it has not done so yet. It is envisaged that equity participations will be taken in the context of privatization deals. Loan sizes vary between 30 to 100 KDA for small projects, 100 and 1000 KDA for medium-sized projects, and more than one million DA for large projects. Most of the loans go to private sector clients, except for a few extension loans to the public sector. At the end of 2003, it had about 900 active projects in its portfolio, and repayment rates estimated to be around 75%. Only very few foreclosures on collateralized assets have been enforced following client defaults.
| It does not offer working capital loans, deposit products or any other financial services to their clients, except letters of credit which were introduced only recently. Since 2001, the Bank is heavily decentralized with ultimate approval of loans being the responsibility of each branch manager, who is a member of the People’s Committee of the Chaabiya. Although it operates on commercial terms, the Bank has a developmental objective that is set by the authorities, who allocate the Dinar amount of loans that each Chaabiya branch can extend. The People’s Committee – via the Chaabiya branch head – has the authority to refuse a loan application or to direct credit to specific projects. These corporate governance constraints are not prone to sound lending, and the operational independence of the Bank should be strengthened to ensure adequate and prudent allocation of capital.
| The Development Bank also needs to be strengthened in its capacity to serve the enterprise sector. It lacks a good information system, its staff needs to be trained on modern credit and risk management techniques, and incentives of its branch managers need to be geared towards more commercial practices. It also lacks any good information on the sectors it is supposed to serve, and have no information on the credentials of the clients that approach it for loans. |
223. Efficient financial intermediation to the private sector requires that the Libyan banks be reinforced and equipped to serve the growing segment of private enterprises, in particular small and medium sized firms. It requires that bank staff be trained in modern credit management techniques; that banks be reorganized to better serve the private sector; that the banks be equipped by modern information systems and risk assessment tools; and finally that incentives of bankers – in particular loan officers – be reviewed to ensure that they adapt to this new clientele, and strike a good balance between private sector portfolio growth and prudent lending. The weaknesses of the Development Bank (see Box V.1), the major provider of lending to small and medium enterprises in Libya, illustrate the need for such restructuring and capacity building of banks.

224. For banks to efficiently intermediate finance to the private sector, they ought to operate within an environment that enables them to assess, price and manage risks, in order to lend prudently. To do so, they need to conduct analyses and due diligence based on reliable, representative and standardized statements of borrowers’ operational and financial conditions. The seal of independent, qualified auditors would be an added layer of comfort. The faith in, and reliance on the rule of law, enforced through a transparent and efficient judicial system would provide further guarantee to creditors that terms of contracts would be adhered to, security interests in loan collaterals can be realized, and, in short, debt obligations would be repaid. Operating and extending credit without such a framework may simply imply that banks are transgressing their prudential obligations, violating their fiduciary responsibilities towards depositors, and sowing the seeds for future portfolio problems. Reform of corporate sector regulations should thus go hand in hand with banking sector reforms.

225. The development of a reliable and comprehensive credit information system, as well as a good market information system is essential to a well-functioning credit market. Credit information is key for good risk-assessment and for the development of the credit market. It is also essential that credit bureaus be functioning at the early stages of this transition as this is a period of increased enterprise creation and intensified transaction flows – a time where a lot of credit information can be built. Currently, the credit information provided by the Central Bank of Libya to commercial banks is limited to an “attestation of non-indebtedness of firms”.36 Finally, the lack of good market and sector information in Libya, and its importance to enterprises is equally important for bankers who need it to assess the expected profitability of the investment projects that are submitted to them.

(viii) Financial sector distortions and the structure of interest rates

226. Financial sector reform has also progressed with partial interest rate liberalization — interest rates have been liberalized on deposits, while a ceiling on the lending rate has been set above the discount rate. Progressively, this ceiling should be phased out, to prevent a possible erosion of bank profitability in a competitive bid to attract deposits, and to allow banks to serve corporate clients with a wider range of risk profiles. Spreads should also properly cover administrative costs (to the extent that banks operate efficiently) and provide an acceptable return on

36 Sha’hadat aadam al’madyounyia.
shareholder equity. Steps to liberalize further interest rates would be conditioned by the development of a well-functioning, liquid money market. This would also facilitate the management of bank liquidity in the face of significant swings in oil revenues.

227. **Currently the Central Bank of Libya (CBL) does not pursue an active monetary policy and its tools to conduct monetary operations are limited.** Direct instruments have played a prominent role in the conduct of monetary policy, particularly interest rate controls and, to a lesser extent, directed credit. Inflows of oil income, budgetary operations, together with private sector demand for foreign exchange, have determined the monetary outcome in Libya. To more effectively manage excess bank liquidity, the conduct of monetary policy should be improved within a well-defined framework, through the development of indirect monetary instruments and of a money market. The possibility granted by the draft banking law to the CBL to issue certificates of deposit is a first measure in the right direction in order to better manage bank liquidity.

(ix) **Non-bank financial institutions**

228. **There is considerable potential for development and growth of the financial industry outside the banking system.** Insurance is small with total premia accounting for less than one percent of GDP. There is no domestic equities market. Besides commercial bank loans there is no debt market beyond a limited stock of outstanding government securities. There are no corporate or mortgage bonds, while collective investment schemes such as mutual funds play a marginal role. Leasing is hardly developed. The authorities recognize the potential for growth in the non-bank sector and have started to chart the path towards establishing the appropriate legal and regulatory framework for the industry. Amongst the recent initiatives in this context is the nomination of an Insurance Commissioner within the Companies Division of the Ministry of Economy. The Insurance Law, which dates back to 1970, would need to be revised to reflect updated practices. The insurance supervisory framework would need to be enhanced and modernized in line within international standards. In terms of capital market development, the nucleus of a unit has been established within the CBL to initiate the upstream process leading eventually to the creation of a stock exchange in Libya. Were the role and mandate of this unit to evolve from a focus on legal and regulatory analyses towards an operational phase involving market transactions, it would be crucial that the unit be moved out of the Central bank.

C. **Strengthening Banking Supervision**

(i) **Moving Towards Supervision by Risk**

229. **Libya's current compliance orientation toward banking inspection and supervision is a critical function of any banking supervision system.** Banking supervision and inspection seem largely oriented towards ensuring that bank branches are in compliance with rules, regulations, policies and procedures. It is vital that
supervisors verify that banks are operating within the legislative and regulatory framework and that they adhere to effective policies and procedures.\textsuperscript{37}

230. **However, the current approach needs to be enhanced to include a focus on the overall effectiveness of risk management practices in banks — something the CBL has recently been focusing on and building capacity for.** Global experience has shown that banks can often be in full compliance with rules and regulations yet are at risk for insolvency due to weak risk management practices, especially in credit risk which is the single largest cause of non-performing loans and bank failures around the world. Recognizing that a compliance based supervisory framework has its strengths and limitations, many countries have adopted a risk based approach to banking supervision. Enhancing the current approach to bank inspection by adding a risk based approach would be more effective in identifying and addressing critical weaknesses in banks’ practices such as credit risk management, bank corporate governance, operational risk, and all other risks.

231. **In practice, in a risk based supervisory framework, the focus is at the Bank level versus at the branch level.** A risk based approach does not preclude compliance inspections and, in fact, assessing for compliance continues to be a critical supervisory function in a risk based framework. Inspectors should continue to inspect a sample of key branches of a bank to ensure that there is adherence to a bank’s own policies and procedures, as well as compliance with laws, regulations and supervisory policies and procedures. This should be a complement to banks’ own internal controls.

232. **In a risk based approach, banks are responsible for developing their own risk management practices, together with policies and procedures with which to conduct them.** Therefore, banks themselves will need to ensure that they are managing risk prudently and monitoring compliance on an ongoing basis. They will need to regularly perform internal audit and internal control inspections of their own branches. The draft of the new banking law will require each bank to have a compliance unit. This is a positive step toward assuring that the primary responsibility for compliance with policies and procedures rests with the banks themselves.

233. **In a risk based supervisory framework, the role of banking inspection expands to review the adequacy of banks’ risk management systems.** In Libya there are at least two years between inspections of a branch so there is a need to rely on banks’ own internal control, internal audit and compliance functions to review operations with much greater frequency. An additional level of oversight is provided by external auditors. However, at present, audits of bank financial statements are not being conducted in a timely manner.

234. **In order to conduct risk based supervision, supervisors need to be reliable and accurate consolidated financial information from the banks.** There should be a review of the quantity and quality of the current information that is being received by the Banking Supervision Division to ensure that it is timely, and accurately reflects the financial condition of banks in order to facilitate a risk based approach to

\textsuperscript{37} The preparatory mission of the report has not had a chance to assess the level and depth of the analyses performed during inspections.
supervision. The authorities need to ensure that international accounting standards are being adhered to by the banks but also by bank borrowers to facilitate sound credit decisions.

(ii) **Loan Classification & Provisioning:**

235. *The current loan classification criteria need to be enhanced to meet international standards. Based on current classification criteria, loan loss provisioning does not adequately reflect the true quality of banks' loan portfolios.* The current criteria do not fully allow for timely recognition of deterioration of credits, which is likely to have adverse consequences for banks performance and the quality of their loan portfolios. Banks may not take sufficiently proactive measures to recover loans in a timely manner if they are not deemed seriously deficient. It would be important to confirm the accuracy of the current level of non-performing loans through an independent audit.

236. *Banks' judgment should be relied on more when they are considering more severe classifications than allowed by the present guidelines.* Currently, they cannot do so without administrative appeals and the process should be less cumbersome. Generally, banks will know more about a borrower's financial condition, and in a more timely manner, than an inspector or other third party will.

(iii) **Capacity Issues for the Banking Supervision Division**

237. *Currently, the sheer number of branches currently under supervision makes it difficult for the Banking Supervision Division to provide effective oversight of the banking sector.* Additional staffing, alone, would not adequately address the process of banking supervision in its present mode of operation. Supervising the Agriculture Bank, the SREIB, and the Development Bank will only add to the burden.

238. *With 391 bank branches in Libya, of which 350 are under supervision, the Banking Supervision Division is to be commended for having inspected as many as half the branches under its supervision in the past year.* The Banking Supervision Division recently developed its own inspection manual which addresses banks' administration, organization, training, financial ratios, and compliance matters. Since the manual expands the functions of inspectors during on site examinations, there is likely to be a further strain on the capacity of banking supervision as inspections now will take 4 weeks versus 2 weeks. It is important to ensure that the new inspection manual, which should serve as a very useful guide to inspectors, as well as the proposed amendments to the Banking Law are consistent with international best practice.

239. *Recent initiatives go in the right direction and should be strengthened.* Particularly commendable is the initiative, already submitted to the legislature, to have the Banking Supervision Division responsible for inspection of the Agriculture Bank, the SREIB or the Development Bank (except for Letters of Credit issued by Development Bank). As Libya's banking system moves toward a market orientation it needs to ensure that policies and procedures, and laws and regulations are evenly applied across the sector to enable a level playing field in the banking sector. The authorities should also finalize plans to merge the 48 regional banks under one
umbrella which would facilitate their oversight and supervision by the Banking Supervision Division in a risk based framework.

240. **Main areas where technical capacity should be upgraded in order to move to a more risk based approach to banking supervision include:** (i) developing risk based policies and procedures for banking supervision; (ii) training of banking supervisors, especially in the areas of asset quality, loan portfolio management and overall credit risk management as well as bank corporate governance; (iii) enhancing current loan classification and provisioning to meet international standards; and (iv) developing supervisory guidelines for the oversight by banks of their compliance, internal audit and internal control functions.

241. **Summing up, core reform options and complementary initiatives** the government may wish to consider in the short term and over the medium term, in order to strengthen the banking sector and lay the groundwork for financial sector development, are as follows.

> **Core reform options**

(i) **In the short term**
- Strengthen corporate governance of state-owned banks and define a clear strategy for these banks
- Enhance loan classification criteria and loan provisioning in line with international standards
- Take steps to strengthen banking supervision
- Amend the Banking Law to: (i) grant full independence of the CBL from the Secretariat of Finance in conducting monetary policy; (ii) reduce significantly the provisions that regulate credit policies of commercial banks.

(ii) **Over the medium term**
- Open the banking system to foreign bank participation
- Seek strategic investors for the privatization of state-owned banks
- Initiate corporate sector reforms (accounting, auditing and the rule of law) as a complement to banking sector reform
- Develop the credit information systems of the Central Bank

> **Complementary reform initiatives**

(i) **In the short term**
- Transfer ownership of public banks away from the CBL to the Secretariat of Finance or a dedicated asset-management institution
- Take steps to develop an active interbank market
- Further liberalize interest rates offered by banks

(ii) **Over the medium term**
- Consider moving toward a framework of supervision based on risk
- Liberalize interest rates
VI. ENHANCING THE EFFECTIVENESS OF SOCIAL PROTECTION

242. As the Government of Libya moves towards a more open economy and greater dependence on market forces, the positive effects on the economy and on standards of living will be balanced by greater economic risk and uncertainty among the population. Under such circumstances, human development - the ability of the education and health care systems to equip individuals with skills that allow them to take advantage of the increased opportunities that a dynamic and changing economy offers in terms of more productive and better-paid jobs - becomes crucial. Likewise, the social protection system takes on an important role in helping individuals and households manage economic shocks. Particular attention needs to be given to vulnerable population groups, which have fewer means to deal with risks and are less well equipped to take advantage of new economic opportunities. The reminder of this chapter presents a general assessment of the social protection systems in Libya.

A. Social Protection In The Transition

243. The social protection system is particularly important during the transition phase, when the economy will observe reallocations of labor and capital across sectors. Social protection programs help people manage economic risk by alleviating poverty and reducing the likelihood of falling into poverty. They mitigate the effects of drops in incomes of individuals and households and seek to ensure minimum standards of living; and they enhance the ability of workers to find their way in the new economy through interventions in the labor market and re-training programs. Combined with effective education and health systems, social protection programs are essential in managing economic risk and ensuring that all members of society become partners in the economic growth process. Social protection programs may include a variety of interventions, as further explained in Annex 3.

244. Libya is beginning the transition towards a more open economy with a relatively regulated formal economy and an extensive social infrastructure. This includes low-cost housing and utilities, free education and health services, subsidized foodstuffs, relative job security in the public sector (covering 70 percent of recorded employment) and a fairly generous pension system for public sector employees, as well as short-term benefits such as sick pay and maternity leave. Moreover, informal intra-family support mechanisms are said to play a prominent role in ensuring well-being. As a consequence, Libya appears to have reasonable social indicators, given income levels in the country, including high levels of education, core health indicators at reasonable levels, and some expectations among the population regarding the Government's role in reducing risk. Other formal social protection programs, such as active labor market programs and targeted assistance programs, have not developed. Little is currently known about poverty and inequality, although analysis of the 2003

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38 In reviewing the social protection sector, the preparatory mission was not able to have discussion in a number of areas, notably employment authorities, the national food corporation, social benefit services and formal charities. The mission also learned prior to leaving of a rural bank, serving micro-project initiatives. This should not, however, materially affect the general thrust of the conclusions in the report.
household budget survey should be able to provide useful information in those areas once the information has been processed.

245. **The transition can be expected to put the current social protection system to test.** While an open economy and greater reliance on market forces is likely to produce beneficial outcomes such as higher productivity and faster rates of growth, it may also increase inequality and exacerbate poverty, as well as increase economic insecurity. Privatization may cause major job losses as divesting governments cut the workforce to prepare for privatization, or as new owners of privatized firms shed excess labor to improve efficiency (Box VI.1). It becomes increasingly important to be able to identify population groups and households at special risk and focus assistance at them.

246. **However, in contrast with most other transition countries, Libya has and will continue to have significant oil resources for a long time to come.** This will
allow the Government a much broader scope for effective action than is usually the
case in transition economies, and it may make poverty targeting less urgent. The
challenge for the Government will therefore not necessarily be to make difficult trade-offs between competing interests, but rather to increase the efficiency with which
resources are used to mitigate the adverse effects of the transition, and provide a post-transition safety net that is appropriate to the needs of the vulnerable segments of the population, and at the same time not excessive.

247. Whatever safety net is designed, whatever social programs are implemented,
they should be calibrated with particular care to the incentives they provide to the population. Are the programs sufficient to provide adequate protection, and do they at the same time encourage work? If not, resources will be wasted. Much of the structural unemployment experienced in Europe today reflects inadequate attention to this aspect, as well as illustrating the difficulties of correcting the situation once such policies take root.

B. Social Insurance: Pensions and Short-Term Benefits

248. The Libyan Social Security Fund (SSF) covers 75 percent of the labor force,
the highest coverage rate in the region, and pays benefits equivalent to 1.4 percent of GDP. The high level of coverage is achieved given the importance of the public sector as an employer. The SSF provides pensions and various cash assistance benefits for all categories of workers, finances health services, and a basic pension—currently set at LYD 40 per month—for all elderly poor. The main revenues of the SSF come from a 15 percent (16.5 percent for the self-employed) wage tax. The system is mandatory for the entire employed population. Thus, it covers civil servants, private sector and state-owned enterprise employees, and the self-employed. Under a separate law, the SSF manages the pension scheme for the military.

249. Financially, the SSF is unsustainable and it is likely to have accumulated a substantial implicit pension debt that threatens fiscal sustainability as well as the welfare of future generations. The reason is the generosity of the system that targets high replacement rates and is paying an implicit real rate of return on contributions above 5.5 percent per year (Figure VI.1). Countries in the region with similar demographic structures, lower coverage rates, and less generous systems (e.g., Morocco and Jordan) have implicit pension debts above 50 percent of GDP. The implicit debt of the SSF could be larger. This debt represents the amount of resources owed to current plan members, without taking into consideration further accrual of pension rights. In fact, the SSF is already displaying an operational deficit of LYD 19.6 million or 0.18 percent of GDP, which is being covered by using the SSF reserves. Over the medium term, the gap between contributions and benefits is expected to continue widening despite a still-low dependency ratio.

39 Information systems are underdeveloped and the demographic and financial data necessary to compute this liability are currently not available. The SSF has not had an actuarial valuation for the past 16 years.
The government is accumulating arrears with the SSF, but these are not the only cause of the financial problems. In 2003 new arrears reached LYD 111.8 million. For instance, military pensions should be financed by the central budget. Yet, in 2003, out of LD 48 million in expenditures, the government only transferred LYD 5.4 million to the SSF. However, even if the government were to normalize its contributions, a deficit of 0.16 percent of GDP would persist. This is because, in retaliation to the moratoria, the SSF is not paying its contributions to the Ministry of Health. In 2003 these contributions represented LYD 100.9 million – a similar amount to the new government arrears for that year.

As in other countries in the region, the system is prone to adverse distributional transfers and is a source of economic inefficiencies. In terms of equity, benefit formulas and eligibility conditions create high heterogeneity in rates of return as a function of wage histories and enrollment/retirement strategies. Hence, while redistribution takes place within the system it is unclear who benefits the most. Transfers might not necessarily go from high- to low-income workers. The fact that the system is accumulating an unfunded pension debt also implies a transfer from future generations (including low-income workers) to the present generation (including high-income workers). In terms of efficiency, the system provides incentives for evasion, the strategic manipulation of wages, and retirement over work. This is explained, in part, by the fact that only the last three years of salaries count toward the pension and by the absence of penalties for early retirement.

There are also concerns regarding current governance structures, which are likely precluding the management of the funds in the best interest of plan members.
The SSF has assets equivalent to 4.7 percent of GDP, the majority composed of government debt and real estate. Bank deposits constitute only 8 percent of total SSF assets. The SSF was originally created with a Tri-partite Board, including representatives from employees, employers, and the government. The Prime Minister appoints and removes the Chairman of the Board. Thus, the SSF is not insulated from political influence. The fact that the government has seized a large share of the SSF reserves actually reflects the conflict between plan members' interests and government's interests. Today there is no governing body in place. Thus, the level of accountability of the Chairman of the SSF to plan members is further diluted.

253. **The government is undertaking a detailed assessment of the SSF.** The authorities are committed to introducing a series of reforms to improve management and investment policies, as well as to control the growth of the implicit pension debt. The World Bank is ready to provide technical assistance in a number of areas identified with the authorities: (i) assess the financial situation of the SSF while building internal capacity in actuarial analysis; (ii) audit and evaluate the current portfolio of investments, assess current strategies in terms of investment policies and provide training for fund’s management; (iii) design a comprehensive reform package for the SSF and an implementation plan; (iv) guide the design and implementation of an integrated information system—particularly during the early stages.

C. **Labor Market Regulations and Programs**

254. **The gradual integration of Libya in the global economy will also require appropriate programs to facilitate the reallocation of the labor force across sectors.** First, to diversify the economy and improve competitiveness the government will have to reconsider the size of the public sector and restructure SOEs, which often implies reducing the number of employees. Second, as a result of increased competition there will be a movement of resources, labor and capital, from economically non-viable to viable sectors. Because more flexibility for firms implies higher risks for workers who are no longer guaranteed jobs for life, it is essential to put in place an efficient and financially sustainable unemployment benefit system. Employees affected by reallocations will need support to preserve their levels of consumption during the transition and to improve their employability. This usually takes the form of severance package and retraining programs, as well as unemployment benefit schemes. A wealth of international experiences is now available to design these programs.

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40 The preparatory mission has had limited information regarding the current labor code, a part from the fact that a minimum wage (currently set at LYD 85 per month) is enforced. The labor code, however, is known to be a complex piece of legislation and foreign investors are usually advised to obtain expert advise before engaging in labor contracts. The government is currently reviewing this labor code.

41 The purpose of an unemployment benefit system is to facilitate job search for laid-off workers over relatively short periods of unemployment. It is not a mechanism for dealing with long-term unemployment, for which special social assistance schemes are used. The unemployment benefit can take the form of either insurance, where workers contribute through a payroll tax, or assistance, where a benefit is paid from general budget revenues. To the extent that enterprises cannot pass on labor costs, i.e. the scheme raises the cost of labor to the enterprise and contributes to discouraging hiring, an assistance scheme might be preferable. In any case, in designing the scheme, attention needs to be paid to eligibility (i.e. extent of work history needed), the replacement rate in relationship to the wage, and the duration of the benefit, which usually is in terms of months and linked to a gradual reduction in the benefit. In addition, unemployment benefit schemes are often tied to active job search by the beneficiary, as well as participation in training and re-training programs.
The only government initiative so far has been the establishment of the so-called Economic Transformation Fund (ETF) that provides credit to prospective entrepreneurs (public sector workers transiting to the private sector or the unemployed, as well as graduates entering the labor market). It has several design problems. First, the ETF's mandate appears too broad: it targets population groups that cover a variety of different needs, skill levels and socioeconomic backgrounds; and investment proposals that range from LYD 15,000 to LYD 3 million. Clients in such circumstances will have a broad variety of needs to be met to be successful, including equipment finance, startup and working capital, skill needs and advice. The ETF provides only medium-term equipment loans. Second, it focuses its support on initiatives in protected sectors, where the incentives to be efficient and innovative can be expected to be slight. As the economy liberalizes and competition increases, it is unlikely that many of those enterprises will survive.

In general, international experience with credit programs of the ETF type, even well-designed ones that offer a variety of necessary services, have a modest impact on job creation. This does not mean that they should not be undertaken; however, they have to have the capacity to tailor closely their assistance to the particular needs of their clients. This is critical, if they are going to successfully promote job creation.

D. Social Assistance

The Libyan formal social assistance system emphasizes subsidies: it provides untargeted consumer subsidies for food, utilities and housing, as well as supply-side subsidies that implicitly favor the consumer. While the subsidies may represent an important and justifiable transfer of public resources to the population, neither the size nor the impact of the subsidy is easy to determine: the system lacks sufficient transparency to evaluate either its effectiveness or its costs, and it offers little opportunity for informed policy making by the authorities. While specific numbers are difficult to come by, because of the lack of transparency of the system, it is not unlikely that the current subsidy system may have significant adverse effects on labor supply in the economy.

(a) The consumer food subsidy

Generally, systems of universal consumer food subsidies will be regressive when wealthier population groups consume more of the subsidized product. At the same time, the welfare impact is higher on the poor, as their share in total spending on food is usually higher, and their caloric intake is increased by the subsidy. If the subsidy is focused on foods that are more likely to be consumed by the poor, the welfare effect on poor households is further strengthened.

The Libyan food subsidy system appears to dampen the regressive effect of the subsidy – every individual gets the same amount. It is not entirely clear whether the selection of items is pro-poor, but to the extent that the subsidized food basket represents a fair selection of staples, it should not have an adverse poverty effect.

The fiscal costs of the food subsidy amount to some 5 percent of current budget expenditures. While relatively modest, they do impose financing
requirements on the budget and in that way may affect the tax structure. To the extent the subsidy inhibits the development of domestic production or distorts consumption patterns as these respond to government-set prices rather than market signals, distortions also may be carried into the macro-economy.

261. **Efficiency considerations may argue for moving to cash transfers, and possibly even targeted transfers:** a universal subsidy is an expensive way of ensuring basic consumption needs, including maintaining an extensive distribution chain from importers to cooperatives, and creating opportunities for leakages and even intermediary payments, as well as distorting prices in the market place.\(^{42}\) Transparency considerations would also argue for a cash transfer, as cash transfers render the cost to society explicit. and welfare considerations would argue for a cash transfer, as cash transfers would increase incomes and consumer choice.

262. **The Libyan authorities are in the process of reconsidering the current food subsidy system, including shifting to cash benefits.** Reform of the system will be challenging: consumers' expectations are conditioned by the current, quite generous, program; and the administrative experience is largely limited to the present system, which may place constraints on the institutional capacity to implement more than marginal reforms, at least in the short term.

**(b) Utility subsidies\(^{43}\)**

263. **Utility pricing involves across-the-board subsidies.** These are financed from the Oil Fund and in the case of electricity through favorable pricing of oil products, which are the principal inputs in electricity production in Libya. It is estimated that the subsidy elements in electricity is some 60 percent (Figure VI.2). This leads to over-consumption, especially among residential users.

![Figure VI.2: Direct Consumer Subsidy in the Electricity Sector](image)

Source: World Bank calculations on the basis of information provided by the General Electricity Company of Libya

264. **The Government is considering introducing life-line tariffs to curb excess consumption.** However, without some prior knowledge about beneficiaries, especially such aspects as utility connection ratios, household expenditures, and the

\(^{42}\) Beyond these aspects, some consideration should be given to the composition of the food subsidy. Currently, the calorie count of the package is estimated at 3,300 calories. This compares with the 2,100 calorie per person per day nutritional minimum that is accepted internationally according to FAO and WHO recommendations.

\(^{43}\) The preparatory mission has only had the opportunity to review the situation in the electricity sector, but the comments on electricity may well also apply to the water supply sector. Calculations of implicit energy subsidies are presented in chapter V.
potential impact of subsidy mechanisms on the poor and the non-poor, any interventions risk being either inadequate or excessive. Here, the results of the 2003 household budget survey may be invaluable in guiding policy making and subsidy design. More generally, any utility subsidy mechanisms under consideration should be guided by the following considerations (using household budget survey data and other available statistical information in government ministries and statistical bureaus):

(i) the extent to which the poor are being reached (coverage);
(ii) the leakage of the subsidy to the non-poor (targeting);
(iii) predictability of the benefit for the poor;
(iv) fiscal impact;
(v) impact on the financial position of the utility;
(vi) the extent of pricing distortions and other unintended side-effects due to the subsidy;
(vii) administrative simplicity.

265. A note of caution: international experience shows that subsidy mechanisms that perform well according to some of the criteria may perform poorly according to others (e.g., high coverage is usually associated with low targeting). Furthermore, not all subsidy mechanisms are applicable or perform equally well across all utility services (the lack of metering, for example, may pose a problem for life-line tariffs). Therefore, it has not been possible to identify one subsidy mechanism that outperforms all other mechanisms irrespective of country circumstances and preferences. It is possible, however, to identify subsidy mechanisms that, drawing on the above criteria, are unlikely to be top performers. These are the mechanisms of no-disconnection, across-the-board price subsidy funded from cross-subsidy, and burden limit.

(c) Housing subsidies

266. Responsibility for housing production appears to be mainly with the government44 An extensive and hard-to-quantify subsidy element facilitates access to housing: input subsidies and an absence of interest payments on deposits appear to be passed on by the public Housing Bank to the benefit of the consumer; likewise, the consumer has access to long-term (thirty-year) housing loans on concessional terms. In some instances, it appears that the repayment of such loans is waived. Public sector workers receive a monthly housing allowance that ranges from 12 percent to 25 percent of salary.45

267. The system of housing subsidies raises several concerns. From the perspective of a social safety net, the main justification for providing housing assistance (of any kind) is that adequate shelter is a basic need that governments have a responsibility to fulfill. This appears to be the motivation behind the Libyan government’s interventions in the housing market. Main concerns with the current system include: (i) the lack of transparency in the subsidy; (ii) potential inefficiencies arising from insufficient competition in primary and secondary housing markets; and

44 The preparatory mission did not have access to data on the housing market, but there is anecdotal evidence of an active private sector in both the primary and the secondary market.
45 Of course, this housing allowance covers “housing” in a broad sense, including rent or mortgage payments, as well as utility fees.
(iii) the provision of long-term loans on concessional terms, which over time may adversely influence the financial viability of public financing of housing production, as inflation erodes the value of repayments.

(d) Directions for reform

268. The absence of transparency in the subsidy system makes it difficult to determine either effectiveness or cost, consequently offering little opportunity for informed policy making. It also argues for abolishing subsidies and replacing them with targeted support mechanisms, either by means of direct cash transfers or mechanisms that allow utility services to poor households to be maintained. In any case, the transition towards a market economy can be expected to put the current system of social protection to test. It will in particular require a better understanding of the impact of various social protection programs, and in particular the adequacy and relevance of various consumer-oriented subsidies in protecting the population against economic shocks. It will therefore be important to review the current subsidy system with a view to increasing its transparency, in particular with regard to the true costs of the subsidies; or, as the case may be, move altogether towards a system of cash transfers, either targeted or unlimited. A main issue in moving towards a system of cash transfers may be ensuring access to the benefit, i.e. a benefit delivery system that can reach all potential beneficiaries.

269. The objectives for the food subsidy should be reviewed and agreed on in order to form a basis for a reform of the subsidy, including an adjustment of its calorie content to better coincide with WHO recommendations. The groundwork should be laid for a better understanding of the impact of transfer payments and subsidies on the well-being of households. This should include the undertaking of household budget surveys on a regular basis to allow the identification of at-risk households and monitor the effects of social protection programs on their well-being.

270. Three main lines of action should be pursued. As the Government pursues the transition to a market economy, critical public initiatives will need to be introduced early on to facilitate the reallocation of labor and protect vulnerable population groups when necessary. The authorities are encouraged to focus on three priority areas at an early stage:

271. The establishment of a continuous monitoring system of the well-being of the population. The 2003 household budget survey is an indispensable starting point, as the information gathered through the survey should be able to provide a baseline of the welfare situation of the population, as well as identifying households at risk for subsequent targeting of benefits. The household budget survey should be undertaken annually, and the information become available to and routinely used by government authorities in the shaping of public policy.

272. A cash benefit system that is able to target needy households on short notice. The Government has the elements of such a system near at hand, since the current distribution system for subsidized foodstuffs is reputed to reach every household in Libya. If this is the case, the Government should immediately examine the

46 Such subsidies may take different forms: life-line tariffs, price discounts for selected groups, burden limits and earmarked transfers
adjustments that need to be made to this network to allow the targeted distribution of cash benefits.

273. **Severance and retraining programs for civil servants and public enterprise employees.** Employees losing their jobs as a result of civil service reform or the restructuring of public companies will need to receive support to facilitate their transition to other occupations in the private sector. This involves not only income support, but also retraining to improve their employability in the private sector.

274. **Summing up, core reform options and complementary initiatives** the government may wish to consider in the short term and over the medium term, in order to design an efficient system of social protection, are as follows.

- **Core reform options**
  - (i) **In the short term**
    - Establish a continuous monitoring system of the well-being of the population
    - Design severance and retraining programs for civil servants and public enterprise employees
  - (ii) **Over the medium term**
    - Establish a cash-benefit system that is able to target needy households on short notice
    - Adopt plan to gradually phase out indirect subsidies

- **Complementary reform initiatives**
  - (i) **In the short term**
    - Update the demographic and financial data of the SSF and conduct analysis of the long-term financial situation of the fund
    - Design mechanism to refinance the debt of the government with the SSF
    - Prepare proposal for the design of a new management and information system
  - (ii) **Over the medium term**
    - Adopt plan to gradually phase out indirect subsidies
    - Review current governance structures and investment policies and prepare recommendations to create incentive to manage the funds in the best interest of plan members
    - Draft integrated reform program and necessary legislation
    - Prepare regulation to support the emergence of private providers of pensions – on a voluntary basis.
Annex 1. Long-term hydrocarbon production and revenue projections for Libya

Permanent Income Calculations

There are various attempts to estimate a country’s “permanent income” from hydrocarbon production. They invariably rely on estimates of remaining recoverable reserves, and a production profile of the “fixed”, depleting resource over a long period. Given assumptions of government take, resource price, costs, and the discount rate, the present value of the government’s “permanent” revenue stream is calculated. Needless to say, any estimate is surrounded by uncertainty of the quantity of reserves, while the results are sensitive to assumptions of prices, discount rates, and other factors. In addition, some of the basic assumptions such as costs, prices and taxes are held constant, when, in fact, they are likely to change.

We attempted a simple calculation of the net present value (NPV) of government revenues from Libya’s crude oil and natural gas production to 2060, based on various assumptions of reserves, production profiles, and oil and gas prices. Production profiles were sketched to 2100, reflecting that production does not suddenly run out, but rather has a “long tail” even after suffering a large period of decline, as reserves continue to be added from new or existing pools. However, the bulk of the reserves in these scenarios are produced by 2060, and revenues are calculated for the period to 2060. Government take was assumed at 60 percent of total production value, close to the average share from limited data received from Libyan authorities, and similar to levels in other counties (e.g., 63.5 percent in Algeria). There was no attempt to look at export revenues only, because if resources are priced at international levels, it does not matter (for this calculation) whether the resources are for export or domestic use. Real oil prices per barrel are set at $25, $40, and $55 per barrel, and the discount rate is 4 percent. Gas prices are increasingly de-linked from oil and reflect more competitive markets in all three scenarios. Oil reserves in low case are set at the current estimate of recoverable reserves of 39 Bbbl. Two higher scenarios of 44 Bbbl and 49 Bbbl were chosen, based on reasonable expansion of recoverable reserves, and partly reflect estimates of undiscovered oil reserves in Libya by the United States Geological Survey47. For gas, the low case reserves were set at 1450 bcm, the current level of known recoverable reserves. Mid-case reserves are set at 1900 bcm, and high-case reserves are 2500 bcm, again partly reflective of the USGS estimate of undiscovered reserves. The range of estimates is plausible, and indicates that additional reserves will be discovered under favorable investment and market conditions. Condensate and LPGs are not included, but these could add significantly to aggregate hydrocarbon production and revenues.

The results depend heavily on reserve estimates and production profiles, and are highly sensitive to oil prices and discount rates (effects of the latter not shown). The mid-case results show the NPV of total government revenues from oil and gas to 2060 of $509 billion, in constant 2005 dollars. Gas revenues are a small fraction of that for oil, because of the relatively low levels of current and future gas production, which are largely determined by expected levels of developed reserves. Total revenues across cases range from $287 billion to $777 billion, with oil providing the bulk of revenues in all cases. Note that the projections are significantly above projections from the draft in 2004, because of large revisions to oil and gas price assumptions. Oil prices in the low, middle, and high cases are higher by 39 percent, 60 percent and 72 percent, respectively.

An attempt was also made to calculate net revenues after cost, assuming oil development and production costs of $5 per barrel, and corresponding gas costs of $0.50 per million btu. Assuming 89 percent government take after cost (as in the case of, say, Algeria), mid-case revenues are $663 billion, which is 30 percent higher than the above estimate—suggesting that development and operating costs are over-stated. Using an assumption of government take of 60 percent of net revenue, yields a much lower level of revenues of $447 billion, indicating the sensitivity of key assumptions.

The results are surrounded with considerable uncertainty and should be used with caution for a number of reasons. Remaining recoverable reserves are unknown and unknowable. Estimates at any single point in time reflect what is then known, and does not depict ultimate recovery, which again is unknowable. For the oil industry, reserves are inventory (a flow) which are constantly being consumed and replaced. Thus it is common to have a reasonably steady reserve-to-production ratio (R/P) of some 10-15 years (in OPEC countries it is much higher but the same

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investment rules for development apply). In the US, which has been heavily explored and
developed, reserves in 1950 were 25 billion barrels; but over the 1950-1994 period the industry
extracted over five times that amount and it still had nearly 24 billion barrels on the shelf\textsuperscript{49}. Importantly, the US R/P ratio stood around 10 years over the entire period. In 2006, the US still
had more than 21 billion barrels of oil reserves and an R/P ratio of nearly 9 years. Thus, taking a
reserve estimate as \textit{fixed or ultimate} at any point in time, even in a mature producing country like
the US, can generate very misleading results. Global reserves and production have tended to
grow over time, the result of increasing investment, knowledge, and new technology. In the
history of the conventional oil industry that is approaching 150 years, the current level of global
reserves of 1.1 trillion barrels exceeds the total amount of oil that has been produced by around
100 billion barrels. That is, to date the industry has replaced more than the world has consumed.
Moreover, costs have generally declined, shifting supply curves to the right in many regions\textsuperscript{50}. It
indicates that until now, increasing knowledge has greatly overwhelmed the effect of diminishing
returns. More recently, development costs have been increasing due to rising prices of energy and
materials, shortage of equipment, services, and technical personnel, and increasing taxes.
However new technologies and increasing capacity of the service and materials sectors can
reverse these costs increases.

Natural gas reserves are even more speculative because gas resources are
much less developed than for oil, partly reflecting the greater difficulty of getting
gas to market. The first attempt to compile a global inventory of gas reserves
was not completed until the early 1960s
by the Oil and Gas Journal. For 2004, the
global R/P ratio for gas was 67 years
(versus 41 years for oil), and for many
countries it exceeds 100 years\textsuperscript{51}. This
reflects the relatively low volume of
production compared to the size of
reserves, and in part is due to the fact that
the reserves are far from lucrative markets (hence the phrase “stranded gas”). In Iran and Qatar,
the 2\textsuperscript{nd} and 3\textsuperscript{rd} largest holders of gas reserves after Russia, R/P ratios are more than 300 and 600
years, respectively. For Libya, its gas R/P ratio is 213 years, according to BP figures, reflecting
its low level of production.

The production profiles chosen are quite arbitrary, and the bulk of production is “squeezed” into
fifty-five year period to 2060 (see graphs). In most cases production declines at a rate of 5
percent in later years in order to exhaust the reserves, but this may be unrealistic for total
production (although it may be reflective of specific pools). Even in very mature areas, it is
possible to add reserves and mitigate a sharp fall-off in output (e.g., in the US, where production
has declined on average by 1.8 percent per year since 1970 (see graph), and new reserves
continued to be added).

With low reserve assumptions, production profiles peak at relatively low levels and easily fall toward zero by 2100. For higher reserve assumptions, production must bulge upward and decline more rapidly to fit into the period. This results in an apparent exaggeration for the high-case gas scenario. However, in the case of Algeria, its production surged above this level over a similar period. Looking at the low case oil reserves, the production profile appears reasonable, although crude oil output does not return its previous peak. In the high-case scenario, production rises above the earlier peak.

For government revenues, the level of oil and gas prices affects government revenues significantly. Government revenues are calculated at 60.0 percent of total production, which assumes domestic consumption priced at international levels. Large domestic subsidies will result in lower government revenue than indicated, particularly for gas.

Real oil prices range from $25 to $55, and in all cases assumes continued oligopoly power by oil producers. However, recent prices have been above this band, and as recently as 2002 prices have been below this range. Sustained real oil prices above $55 are thought unlikely given the negative impact on demand, and the additional increases in supply from high prices. As markets adjust, prices would be expected to fall. The World Bank base case has real prices falling to the low $30s per barrel in the longer term. In addition, artificially sustaining prices well above the costs of production is difficult and, as has been seen in the past, can become unsustainable. While OPEC has abandoned a target range for oil prices, many think OPEC will want to keep real prices between $40 and $50/bbl. The low price scenario might appear unreasonable as a price floor, given recent developments in global oil markets, but nominal prices in 2010 would be $26.8/bbl—above the average level of $17.6/bbl between 1986 and 1999. It is not unreasonable to think that prices could fall below this level by 2010. There are also risks to natural gas prices over the forecast period. In the absence of a producer cartel, prices could increasingly become de-linked from oil, and more closely reflect supply costs and supply and demand conditions in individual markets. Increasing use of liquefied natural gas will tend to globalize natural gas markets, but it is not thought to become large enough in the medium term to effectively “set” prices. Nevertheless future price levels remain uncertain.

The level of government take is reasonable, but if one attempts to fine-tune the calculations by looking at development and production costs, it would need to model the supply side in greater detail and more closely assess royalties, taxes, and other charges. Costs will not remain static, perhaps rising in the near term from shortages and rising prices of services, materials and labor, but later falling from advances in technology and increasing capacity of those factors of production now in short supply. In later year, costs could again rise as more “permanent” depletion sets in. But the timing of these transitions is highly uncertain.
Libya Oil Production (Annual and Cummulative) and Government Revenue Projections
(Under 3 Oil Price Assumptions)
Libya Natural Gas Production and (Annual and Cumulative) and Government Revenue Projections (Under 3 Oil Price Assumptions)
The discount rate of 4 percent is an appropriate level in general. However, whether the demand for oil will continue to rise over the forecast period is highly uncertain, given uncertainties of new technologies, environmental considerations, and policies of both oil consumer and producers (e.g., persistent cartel behavior seeking high prices). A higher discount factor than 4 percent could also be considered.

Finally, this exercise only looked at crude oil and natural gas, and excluded condensate (sometimes referred to as NGLs) and LPG, in part to focus on crude oil which is under OPEC quota, and because of more limited data for these resources. However, these liquids would have to be included in any “permanent income” calculations, as they can be a significant source of revenue. In 2003, condensate exports were $156 million, and LPG exports were $51 million. This compares with $95 million for LNG exports and $10.7 billion for crude and petroleum product exports combined.

Uncertainty of Long Term Hydrocarbon Revenues

It is difficult to judge future long-term revenues for Libya’s oil and gas exports, in part due to the uncertainty of international prices and export volumes. It is important to stress that both elements are at risk. For most of the past 30-35 years, oil prices have been broadly determined by OPEC production restraint. Recently, strong demand in China has helped to significantly tighten the global oil balance, and OPEC is presently trying to keep prices from going too high, which could impact global economic activity and oil demand. However, with limited spare capacity OPEC has more difficulty controlling the upside to prices. On the production side, a sharp rise in Libya’s oil production capacity, from expected inflows of foreign investment, may exceed its prevailing quota and production could be forced to be shut-in if it adheres to its quota. Gas export volumes are not producer-constrained as for oil, and strong growth in European gas demand is expected to necessitate higher imports. Gas export prices to Europe, as well as LNG, are tied to oil prices, but this may change as Europe continues to liberalize its gas markets and as a global “spot” market for LNG develops. Increasing competition is likely to result in lower gas prices.

Oil Prices

If OPEC continues to restrain output to keep prices significantly above the costs of production, oil prices will remain extremely volatile and inherently unstable. High prices will dampen the demand for OPEC oil, which could impinge on its market share and ultimately on its pricing power. An optimum OPEC strategy might be to select a price that is reasonably high, yet allows the demand for OPEC oil to grow moderately. Whether OPEC will choose, or can indeed maintain, such a path is uncertain. At present, strong growth in China is helping OPEC achieve much higher prices. In the long term, OPEC faces the possibility of a structural shift in oil demand (e.g., major advance in non-oil transport, or from environmental pressures), in which case an optimum growth path would prove more difficult. But even without such shifts, the ability of OPEC to manage prices effectively is questionable. The group might choose to simply fixate on high prices and let its production stagnate. Or its market power may erode from supply competition from within, resulting in much lower prices.

In most commodity markets, prices are not artificially determined. The World Bank projects that real prices for most commodities will continue their long-term decline, as new technologies help lower the costs of production and shift supply curves outwards—even though periods of fluctuating demand will contribute to cyclical price patterns. In the long term, the level of demand generally determines the volumes supplied, and prices broadly follow the costs of production. However, interventions in the market which significantly distort prices, e.g. OPEC production restraint, can unleash powerful economic forces that, in the long run, can render such interventions unsustainable.
**Oil Production**

As a member of OPEC, Libya's production volumes are at risk, as high prices limit current and future production levels. If countries develop productive capacity faster than the growth in demand, surplus capacity will develop. This could occur in Libya if it adopts an aggressive investment strategy. If the rapid increase in investment is from foreign companies, tensions could develop if foreign companies cannot recoup their investments because of OPEC production quotas—even though terms relating to OPEC quotas may be spelled out at the onset. The government and companies may feel that increasing world demand (plus a somewhat higher OPEC quota) will allow production to increase in a timely fashion. However OPEC's high-price policy could thwart demand growth, and may result in large volumes of shut-in resources. Either investment might have to slow to reduce surplus capacity, or supply competition within the organization could put considerable strain on the organization's ability to sustain high prices.

Libya's future productive capacity will depend—in addition to the level of demand—on its resource endowment, level of investment, and government policies. At present there is potential to significantly increase productive capacity, limited only by the level of investment. For the distant future, physical reserves play an important role, but it is difficult to judge the size of ultimate recoverable reserves. Certainly it will be higher than today's estimate of 39 Bbbl of recoverable reserves. But what the status of reserves and production might be in, say 2060, is difficult to judge.

**Natural Gas Volumes and Prices**

Libya's future gas revenues will largely depend on the volume of export growth, given the present low level of exports. Should export levels rise significantly, they are likely to be less at risk than for oil, as there is no quota system in place for gas. Moreover, gas demand in Europe and the world in general is expected to grow strongly as the environmentally preferred fuel of choice. Natural gas prices are often directly linked to oil prices through long-term contract, thus any risk to oil prices is a risk to gas prices. However, gas (and other energy) markets are being liberalized around the world, and increasingly gas prices will be determined by gas-on-gas competition. While gas and oil prices will continue to compete for the same user in some markets, increasingly gas prices will be "de-linked" from oil prices—including for LNG. As spot markets develop—including for LNG—there will be a tendency to move away from long term contracts, now the norm for LNG and gas imported into Europe. One upside risk to prices would be if gas exporters formed a quasi-cartel similar to that of OPEC. However, as for oil, artificially high prices require a trade-off of lower production.
Annex 2. A rule for long-term fiscal sustainability with an exhaustible hydrocarbon revenue stream

A fiscal rule is derived with the aim of meeting two parallel goals in the presence of an exhaustible hydrocarbon revenue stream:

- Saving for future generations;
- Securing long-term fiscal sustainability

**Saving for future generations based on the permanent hydrocarbon revenue stream**

The net present value (NPV0) of the hydrocarbon revenue stream consistent with the extraction horizon (N) of the depleting reserves is:

\[ NPV_0 = \sum_{i=0}^{N} \frac{Z_i}{(1 + r)^i} \]

where, \( Z_i \) is the projected value of the hydrocarbon revenue stream based on a discount factor \( r \), and on the projected extraction volume and the path for the real price of hydrocarbons (as a ratio to the GDP deflator).

The permanent hydrocarbon income stream (\( \bar{Z}_0 \)) is the annuity over an horizon stretching beyond \( N \), whose present value is equal to that of the projected hydrocarbon revenue stream (NPV0). Assuming an infinite time horizon, the permanent hydrocarbon revenue is given by:

\[ \sum_{i=0}^{\infty} \frac{\bar{Z}_0}{(1 + r)^i} = \frac{\bar{Z}_0}{r} = NPV_0 \quad \text{so that,} \quad \bar{Z}_0 = r \times NPV_0 \]

A policy aimed at saving part of the exhaustible hydrocarbon revenue stream to support the living standards of future generations would consist of depositing each year in a contingency fund the surplus of hydrocarbon revenues over the permanent hydrocarbon revenue stream. To meet the first goal above, savings could be used to pay down debt, or to finance future expenditures.

**Annual savings** = \( S_t = Z_t - \bar{Z}_0 \)

**Long-term fiscal sustainability**

With savings for future purposes deposited in a contingency fund, the government’s annual budget constraint would be given by (lower case letters denote ratios to GDP):

\[ \Delta b_t = \frac{(r - \gamma)}{(1 + \gamma)} b_{t-1} + g_t - \tau_t - \bar{z}_t \]

where,
- \( b_t \) = public debt as a share of GDP;
- \( \tau_t \) = non-hydrocarbon fiscal revenues in per cent of GDP;
$g_t =$ primary public expenditures in per cent of GDP (current and capital expenditures);
$\bar{z}_t =$ permanent hydrocarbon revenue in per cent of GDP as estimated at $t$.
$\gamma =$ projected long-term GDP growth rate

Or, with $\sigma_t = \tau_t - g_t$ denoting the primary non-hydrocarbon fiscal deficit in per cent of GDP:

$$\Delta b_t = \frac{(r - \gamma)}{(1 + \gamma)} b_{t-1} - \sigma_t - \bar{z}_t$$

Maintaining long-term fiscal sustainability is the second goal pursued by the government. Given the initial debt ratio ($b_0$); the permanent hydrocarbon revenue stream as a ratio to GDP ($\bar{z}_0$); the projected non-hydrocarbon primary fiscal deficits ($\sigma_t$); and the projected long-term real interest rate and GDP growth rate—securing long-term fiscal sustainability would call for a path of primary fiscal surpluses ($\bar{z}_0 + \sigma_t$) such that:

$$b_0 \leq \sum_{t=0}^{\infty} \frac{\bar{z}_0 + \sigma_t}{(1 + r - \gamma)^t} \quad \text{with} \quad r - \gamma > 0$$

An option would be a fiscal policy rule that requires a constant non-hydrocarbon primary deficit in per cent of GDP ($\sigma_t = \tau_t - g_t = \lambda$). Securing long-term fiscal sustainability would then involve a rule that meets the following criterion:

$$b_0 \leq \frac{\bar{z}_0 + \lambda}{r - \gamma} \quad \text{or, equivalently,} \quad -\lambda + (r - \gamma)b_0 \leq \bar{z}_0$$

According to that rule, the permanent hydrocarbon income should at least cover the excess of government primary expenditures over non-hydrocarbon fiscal revenues, including an adjustment that ensures a constant debt-to-output ratio, given the difference between the long-term real interest rate and growth rates.
Annex 3. The mechanisms of social protection schemes

Main interventions in the area of social protection include:

(a) *social insurance schemes*, involving labor pensions, short term benefits (i.e. sickness and maternity benefits) and unemployment insurance; these are based on insurance principles and usually financed by participants by means of payroll taxes;

(b) *social assistance benefits*, which may consist of cash transfers and in-kind benefits (the latter consist of a range of goods and services that may be directly provided, subsidized or paid for by means of vouchers); financed from general tax revenues and usually targeted at poor households in order to raise their consumption to or maintain it at socially acceptable levels. Cash transfers aim at raising incomes of beneficiaries, while in-kind benefits usually aim at increasing consumer access to particular goods or services. In general, cash transfers represent a more efficient and welfare enhancing way of transferring resources to the population than in-kind benefits. The cost of cash transfers to society is transparent, and they provide the beneficiaries with a greater freedom of choice;

(c) *Employment promotion and facilitation* through active labor market programs (training, placement services, information, etc) and job creation schemes (public works, micro-credit, production funds, etc) that enable current workers to take advantage of the gains in the new economy.

(d) *Informal social safety nets*, relating to community and kinship support, may also form an important part of the social protection system.

*Social insurance* and *employment promotion and facilitation* schemes are employment related programs, i.e. in most instances the beneficiaries have a work history that justifies their eligibility. *Social assistance* schemes (together with informal social safety nets) form a basic social safety net to cope with the issue of limited resources at the individual or household level. They are either universal, i.e. available to all families, as is the for instance the case with the Libyan basic food package, or targeted to confer benefits disproportionately on families with limited resources. Targeting requires the identification of eligible people, usually through household budget surveys that allow the determination of household characteristics that are highly correlated with poverty and vulnerability. The rationale for targeting is the existence of a budget constraint that makes broader provision of a social assistance benefit unaffordable.
Typology of targeting mechanisms

- **Means testing** involves testing the household for income

- **Proxy means-testing** determines eligibility on the basis of one or more indicators correlated with poverty, which are easier to observe than income, f.i. household size, location, level of education, etc

- **Self-targeting**, where individuals declare eligibility based on their own choices, f.i. in the case of subsidizing products that are more attractive to poor households than to wealthier ones.

Targeting also requires the determination of eligibility for a social assistance benefit. While there is no inherently correct means of determining eligibility, it is usually measured using an *absolute poverty line*, often related to a minimum level of nutritional and social need \(^{52}\), or a *relative poverty line*, related to prevailing income levels, for instance 50 percent of the mean per capita income. Anyone below the poverty line would be eligible for a social assistance benefit.

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\(^{52}\) For instance the daily cost of a representative food basket providing a minimum daily calorie count (a basic nutritional requirement) plus essential non-food goods and services.

<table>
<thead>
<tr>
<th>Products</th>
<th>2003 list Production tax</th>
<th>2003 list Consumption tax</th>
<th>2005 list Production tax</th>
<th>2005 list Consumption tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mineral and sparkling water for non medical use</td>
<td>2</td>
<td>30</td>
<td>2</td>
<td>25</td>
</tr>
<tr>
<td>Lemonade, perfumed water and beverages for non medical use</td>
<td>5</td>
<td>30</td>
<td>2</td>
<td>25</td>
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<tr>
<td>Ice cream</td>
<td>5</td>
<td>35</td>
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<td>25</td>
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<tr>
<td>Juices</td>
<td>5</td>
<td>30</td>
<td>2</td>
<td>25</td>
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<tr>
<td>Animal food</td>
<td>3</td>
<td>15</td>
<td>2</td>
<td>25</td>
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<tr>
<td>Sweet products</td>
<td>5</td>
<td>30</td>
<td>2</td>
<td>25</td>
</tr>
<tr>
<td>Biscuits</td>
<td>5</td>
<td>30</td>
<td>2</td>
<td>25</td>
</tr>
<tr>
<td>Cigarettes</td>
<td>3</td>
<td>35</td>
<td>2</td>
<td>25</td>
</tr>
<tr>
<td>Clothes</td>
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<td>20</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cotton towels</td>
<td>2</td>
<td>30</td>
<td>2</td>
<td>25</td>
</tr>
<tr>
<td>Printed cotton fabrics</td>
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<tr>
<td>diapers</td>
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<td>2</td>
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<td>Cosmetics cotton</td>
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<td>25</td>
<td>2</td>
<td>25</td>
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<tr>
<td>Fillings and nets for medical use</td>
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<td>25</td>
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<tr>
<td>Blankets</td>
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<td>Carpets</td>
<td>3</td>
<td>25</td>
<td>2</td>
<td>25</td>
</tr>
<tr>
<td>Shoes (except women and kids shoes)</td>
<td>2</td>
<td>25</td>
<td></td>
<td></td>
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<tr>
<td>Wooden Furniture</td>
<td>2</td>
<td>20</td>
<td>2</td>
<td>25</td>
</tr>
<tr>
<td>Wooden doors</td>
<td>2</td>
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<tr>
<td>School books</td>
<td>2</td>
<td>15</td>
<td></td>
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<tr>
<td>Paper tissue</td>
<td>2</td>
<td>25</td>
<td>2</td>
<td>25</td>
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<tr>
<td>Cement (Portland, black)</td>
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<tr>
<td>Cement (Portland)</td>
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<tr>
<td>limestone</td>
<td>3</td>
<td>50</td>
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<td></td>
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<tr>
<td>Plaster in bags</td>
<td>2</td>
<td>25</td>
<td></td>
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</tr>
<tr>
<td>Bricks</td>
<td>2</td>
<td>25</td>
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<td></td>
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<tr>
<td>Floor Tiles</td>
<td>2</td>
<td>25</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ceramic floor and wall tiles</td>
<td>2</td>
<td>25</td>
<td></td>
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</tr>
<tr>
<td>Glass sheets (not colored, colored, ....)</td>
<td>2</td>
<td>20</td>
<td></td>
<td></td>
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<tr>
<td>Sanitary ceramic items</td>
<td>2</td>
<td>10</td>
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<td></td>
</tr>
<tr>
<td>Marble</td>
<td>2</td>
<td>30</td>
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<td></td>
</tr>
<tr>
<td>Salt</td>
<td>2</td>
<td>30</td>
<td>2</td>
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<tr>
<td>Caustic Soda</td>
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<td>50</td>
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<tr>
<td>Hypochlorite Sodium (Potassium)</td>
<td>3</td>
<td>50</td>
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<tr>
<td>Hydrochloride Sodium</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Hydrochloride Acid</td>
<td>2</td>
<td>25</td>
<td>2</td>
<td>25</td>
</tr>
<tr>
<td>Varnish paint (except maritime and airplane varnish)</td>
<td>3</td>
<td>25</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Perfumes</td>
<td>5</td>
<td>50</td>
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<tr>
<td>Shampoo</td>
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<td>50</td>
<td>5</td>
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<tr>
<td>Solid Soap</td>
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<tr>
<td>Green Soap</td>
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<td>25</td>
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<td>Powder Soap</td>
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<td>25</td>
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<tr>
<td>External and internal tires for transport vehicles</td>
<td>3</td>
<td>10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Multi vinyl chloride</td>
<td>2</td>
<td>30</td>
<td>2</td>
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<tr>
<td>Products</td>
<td>2003 list</td>
<td>2005 list</td>
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<tr>
<td>-------------------------------------------------------------------------</td>
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<tr>
<td></td>
<td>Production tax</td>
<td>Consumption tax</td>
<td>Production tax</td>
<td>Consumption tax</td>
</tr>
<tr>
<td>Liquid Chlorine</td>
<td>2</td>
<td>25</td>
<td>2</td>
<td>25</td>
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<tr>
<td>Various plastic pipes (in 2005, limited to 0.750 to 400mm pipes)</td>
<td>2</td>
<td>30</td>
<td>2</td>
<td>25</td>
</tr>
<tr>
<td>various plastic products (boxes, bottles, bags, chairs...), limited</td>
<td>2</td>
<td>30</td>
<td>2</td>
<td>25</td>
</tr>
<tr>
<td>in size in 2005</td>
<td>2</td>
<td>30</td>
<td>2</td>
<td>25</td>
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<tr>
<td>Industrial foam (sponge)</td>
<td>3</td>
<td>25</td>
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<tr>
<td>Bedstead</td>
<td>3</td>
<td>10</td>
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</tr>
<tr>
<td>Water disposal pipes</td>
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<td>25</td>
<td>2</td>
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<tr>
<td>Electrical Wires</td>
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<td></td>
</tr>
<tr>
<td>Trailers</td>
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<td>Countryside cars</td>
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<tr>
<td>wheelbarrows</td>
<td>2</td>
<td>20</td>
<td>2</td>
<td>25</td>
</tr>
<tr>
<td>Trucks (in 2005, limited to weight larger than 1.5 tons)</td>
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<td>25</td>
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<tr>
<td>Vehicules for merchandise transportation (more than 3 tons)</td>
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<td>25</td>
<td>2</td>
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<tr>
<td>&quot;Manual&quot; cars</td>
<td>2</td>
<td>40</td>
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<tr>
<td>Iron for arms</td>
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<tr>
<td>Radio receivers</td>
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<td>Recorders</td>
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<tr>
<td>Standard fans</td>
<td>2</td>
<td>40</td>
<td></td>
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</tr>
<tr>
<td>Trays</td>
<td>2</td>
<td>40</td>
<td>2</td>
<td>25</td>
</tr>
<tr>
<td>Heaters (Oil, Electric)</td>
<td>2</td>
<td>15</td>
<td>2</td>
<td>25</td>
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<tr>
<td>Home Water heaters</td>
<td>3</td>
<td>25</td>
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<tr>
<td>Home Stoves</td>
<td>3</td>
<td>15</td>
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<td>25</td>
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<td>Home Freezers</td>
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<td>25</td>
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<tr>
<td>Home Refrigerators</td>
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<td>15</td>
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<tr>
<td>Welded spiral pipes</td>
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<tr>
<td>Welded vertical pipes</td>
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<td>25</td>
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<tr>
<td>Aluminum spraying pipes for irrigation</td>
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<td>extensions</td>
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<td>Iron pieces (angles and other specials forms)</td>
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<td>Nails</td>
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<td>Cooking Utensils and other aluminum)</td>
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<td>Aluminum doors and windows</td>
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<td>Bikes (normal of all kinds)</td>
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<td>Electrical cables (average and high intensity) (in 2005, limited for</td>
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<td>more than 1000 volts)</td>
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<td>Irrigation pumps (high and medium pressure)</td>
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<td>Home Air conditioning</td>
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<td>Assembled or not</td>
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<td>&quot;Harissa&quot;, hot pepper paste</td>
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<td>Boxes for trucks and transportation cars</td>
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<td>Electric towers</td>
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<td>Improved wheat and barley grains</td>
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<td>Yacht more than 75 horsepower, 10 meters and 6 persons weight</td>
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<td>Wig, eyebrow and eyelash</td>
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<td>Home and healthy utensils</td>
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<td>Ivory and derivatives</td>
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<td>Clothes and stuff from ???</td>
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</table>
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