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Libya: Technical Assistance Report—Public Financial Management Reform Priorities in the New Environment

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INTERNATIONAL MONETARY FUND AND WORLD BANK

LIBYA

PUBLIC FINANCIAL MANAGEMENT REFORM PRIORITIES IN THE NEW ENVIRONMENT

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ABBREVIATIONS AND ACRONYMS

CBL	Central Bank of Libya
CD	Certificate of Deposit
CoA	Chart of Accounts
COFOG	Classification of the Functions of Government
FAD	Fiscal Affairs Department
FAA	Financial Audit Agency
GFMIS	Government Financial Management Information System
GFSM 2001	Government Finance Statistics Manual Of 2001
GRA	General Revenue Account
INTOSAI	International Organization of Supreme Audit Institutions
IPSAS	International Public Sector Accounting Standards
IT	Information Technology
LIA	Libya Investment Authority
LYD	Libyan Dinar
METAC	Middle East Technical Assistance Center
MFU	Macro-fiscal Unit
MoF	Ministry of Finance
MoP	Ministry of Planning
MTFF	Medium-Term Fiscal Framework
NOC	National Oil Company
PPA	Public Projects Authority
PFM	Public Financial Management
RTGS	Real Time Gross Settlement
SU	Spending Units
SWF	Sovereign Wealth Fund
TSA	Treasury Single Account
UN	United Nations

PREFACE

At the request of the Libyan authorities, a joint IMF/World Bank public financial management (PFM) mission, co-led by Ralph Chami (IMF, MCD) and Jorge Araujo (World Bank), visited Tripoli during January 19−28, 2012. The PFM team specifically comprised Sailendra Pattanayak (overall technical head/coordinator), John Gardner, Borja Gracia (all IMF, FAD), Pierre Messali (World Bank) and Salvatore Schiavo-Campo (World Bank expert). The purpose of the mission was to undertake an assessment of the PFM framework and systems and advise the authorities on addressing the immediate priorities in the wake of the recent revolution.

At the Ministry of Finance (MoF), the mission met with Mr. Hassan Zagulam, the Minister of Finance; Dr. Nagia Bouazzi, Head of the MoF Consultation Team with the joint IMF/World Bank PFM mission; Mr. Abdalla Ali Khalifa, Director, Financial Institutions and Cooperation Department; Mr. Khaled Al-Beij, Director, Budget Department; Mr. Meloud Massoud El-Reghbany, Director, Monitoring and Evaluation Department; Mr. Ali Al Ruzeiqi, Director, Accounting Department; Dr. El-Siddiq El Shaibi, Director, Social and Economic Planning Department; Mr. Ahmed El-Malyan, Director, Treasury Department; Mr. Mohamed Gergoum, Financial Controller Department; Mr. Mostafa Farag, Internal Audit Department; and other senior staff. At the Ministry of Planning, the mission met with Dr. Eissa El-Tewajri, Minister of Planning; Mr. Ahmed Ali El-Saleh, Deputy Minister of Planning; and other senior staff. At the Central Bank of Libya, the mission met with Mr. Sami Rais, Senior Advisor to the Governor; Dr. Khaled Ali Kagigi, Executive Director for Central Banking Operations; Mr. Musbah Alkari, Director of Reserves Department; Mr. Emhamed M. Elhegagy, Director Issue Division; Dr. Ezzeddin M. Ashur, Deputy Director, Research and Statistics Department; and other senior staff.

The mission also met with Mr. Abulaid A. Salem and other senior staff of the National Oil Corporation (NOC); and representatives of the Financial Audit Agency (FAA) and representatives of two line ministries: Ministry of Higher Education and Scientific Research; and Ministry of Housing and Infrastructure.

The mission wrapped up its findings and recommendations on January 28, 2012 in a meeting with Mr. Mostafa Abo-Shagour, Deputy Prime Minister; the ministers of finance and planning; and other senior staff of the MoF.

The mission would like to thank all of the above individuals and institutions for their warm hospitality and courtesy extended throughout its stay, and for the open and candid discussions of all issues. Support from the World Bank Tripoli office, particularly from Marouane El Abassi, Country Manager, and Hend Irhiam, Operations analyst, is gratefully acknowledged. We also wish to thank Ms. Iman Shakeeb and Ms. Nida Alkhatib for providing excellent interpretation and translation assistance.

EXECUTIVE SUMMARY

In the wake of the Revolution, Libya faces a number of challenges to establishing a robust, efficient and transparent public financial management (PFM) system and ensuring a sustainable use of its hydrocarbon resources. While the findings and recommendations of the 2011 FAD report, as well as of the World Bank's 2009 Working Paper on Public Expenditure, remain broadly valid and should form part of a PFM reform strategy for the medium term,[2] this report sets out key reform priorities in the post-revolutionary transition with a view to laying the ground for more fundamental reforms.

Macro-fiscal policy and framework

There is a need to establish a clear macro-fiscal policy framework with a consistent fiscal rule reflecting the country's economic objectives and the volatile nature of revenues. The Sovereign Wealth Fund (SWF) managed by the Libyan Investment Authority (LIA) and the Budget Reserve Account at the Central Bank of Libya (CBL) should be fully integrated in this framework. The creation of a Macro-Fiscal Policy Unit (MFU) at the Ministry of Finance (MoF) in charge of elaborating medium-term fiscal projections and analysis will enhance fiscal policy formulation and help make the budget a strategic policy tool linking national policy objectives to macro economic performance.

Sovereign wealth fund

It is recommended that the SWF (currently operating through the LIA and Budget Reserve Account) should be a financing fund system with clear and rigid inflow and outflow rules. Unlike the existing arrangement, it would need to be a dynamic and completely transparent and accountable system. The Budget Reserve Account and the LIA portfolio could be merged to create a single system with two sub-portfolios, with separate portfolio management objectives aligned with their respective stabilization and savings purposes.

The SWF system should be based on clear and regulated investment criteria. There should be no domestic currency investments which could adversely impact monetary policy. There should be no direct or indirect domestic investments which could lead to conflicts of interest and fragmentation of the budget. Other than outflow rules relating to long-term objectives or specified contingency events, outflows from the SWF system would only be to support the budget directly—all development spending would be through the state budget.

Budget preparation

The formulation of Libya's budget remains fragmented. The authorities should focus on the following key priorities**:** (i) ensuring a unified budget process, including full integration of

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[2] Marco Cangiano et al, "A Roadmap for Further Public Financial Management Reforms,' January 2011, Fiscal Affairs Department, IMF; and World Bank, "Working Paper on Public Expenditure," 2009 (Washington D.C.).

recurrent and capital budgets; (ii) introducing a medium-term perspective to inform the annual budget; (iii) strengthening the policy context of budgeting; and (iv) presenting a comprehensive and clear budget. Reforms in these areas can be progressively introduced starting with fundamental building blocks such as enhancing the structure of budget presentation and the content of the budget circular; introducing a budget strategy paper at the start of the budget preparation, to strengthen the linkage between policy priorities and budgetary allocations; and establishing a budget preparation calendar that specifies the role and functions of different agencies at various stages of the budget process and key deadlines.

The specification of the respective functions of the MoF and the newly created Ministry of Planning (MoP) and the coordination between them needs immediate attention to ensure that the role of the MoF as the government's core institution for fiscal management is not undermined and that capital and current expenditure decisions are fully integrated.

An inventory and review of all uncompleted pre-revolution investment projects should be launched to decide which ones should be completed. In the immediate future, decisions should be made on which among the largest projects should be completed without delay and funded as part of the development budget for 2012. Measures should also be taken to improve public investment management.

Budget execution control

Under the existing legal and regulatory framework, budget expenditures cannot exceed the initial ceilings specified in the annual budget law. However, in practice this is not enforced at the stage of expenditure commitment. Therefore, a commitment control system should be introduced to keep track of commitments in the "appropriation book" and enforce it through the financial controllers in spending units. To eliminate overlaps between the financial controller, the internal auditor and the Financial Audit Agency (FAA), and to develop a proper internal audit function over the medium term, a working group should be set up to review the internal control system.

Accounting and reporting

The thrust of reforms in the next few years should be on developing and implementing an internationally accepted budget classification and its associated chart of accounts, among other things, to set the stage for eventually establishing a Government Financial Management Information System (GFMIS). A working group led by the Budget Department, with representation from all relevant stakeholders, should be set up to develop a hierarchical administrative classification and an economic classification based on the IMF *GFSM 2001*. Upgrading these classifications should be considered as a basic step of introducing a computerized GFMIS with a view to improving the comprehensiveness, transparency, reliability and timeliness of budgetary information. Until the new classifications are implemented, *GFSM 2001* based fiscal reports to monitor key fiscal indicators could be generated using a bridge table to reclassify the existing chapter- and item-based fiscal data.

Government banking arrangements

In order to manage government liquid financial assets efficiently, it is necessary to develop a treasury single account (TSA) structure at the CBL with all cash consolidated in a "top" account. Sub-accounts can enable accounting and control mechanisms required for budget execution. It is necessary to close non-core treasury accounts and to link the TSA to the SWF system. Excess cash balances at line ministry commercial bank accounts should be brought under the TSA, including trust and escrow monies, and these accounts should then be swept into the TSA on a daily basis.

The payments system should become more dynamic and centralized. As with Chapter Three payments, treasury should cease pre-funding allocations for other chapters and ensure that expenditures are paid as they become due in order to maintain control over cash resources. Once a GFMIS accounting system is implemented, the payments system can become fully centralized and integrated with the accounting and control system.

Cash management

In order to perform effective government cash planning, it is important to build capacity in the MoF/treasury and line ministries for cash flow forecasting. This will necessitate good communication of planned expenditure information from the spending units to the treasury and development of forecasting skills. The treasury should be able to produce a projected aggregate TSA balance across the fiscal year which is regularly updated.

As cash planning becomes more accurate and systematic, treasury must develop the methodology to calculate TSA cash buffer requirements. The cash buffer will need to absorb cash level volatility due to forecast errors. This cash buffer will have important linkages to the SWF system as it interacts with budget execution for stabilization purposes. For cash management purposes, it will be important to develop a T-bill market over the medium-term.

Managing the reform agenda

As recommended in the 2011 FAD report, managing the proposed reform agenda would require setting up a task force, led by the MoF, to coordinate with all the relevant agencies. As a first step, the task force should develop a time bound implementation plan for each reform measure which also identifies necessary technical assistance. Many of the recommended reforms will require a review of the existing legal framework which may result in enactment of a new public finance law. The review should be started immediately with a view to implementing required legal changes in the medium term.

The report provides a summary of the key recommended reform measures in each area discussed above (see Table 1). Both the IMF and World Bank stand ready to provide further support for the implementation of Libya's PFM reform agenda.

Table 1. Summary of Priority Reform Measures

Recommended Measure	Timing	Responsibility
Macro-Fiscal Policy and Framework and SWF		
Adopt a macro-fiscal framework with stabilization and savings objectives	December 2012	MoF
Create a Macro-Fiscal Unit at MoF reporting directly to the minister	April/May 2012	MoF
Configure TSA, Budget Reserve account, LIA as financing fund	December 2012	MoF/CBL/LIA
Develop and pass inflow/outflow rules for stabilization/savings portfolios	December 2012	MoF/CBL/LIA
Pass laws and regulations to ensure SWF is transparent and accountable	December 2012	MoF
Commence operation of SWF as stabilization/savings SWF	January 2013	MoF/CBL/LIA
Budget Planning and Preparation		
Specify respective roles and functions of the ministries of finance and planning and cooperation modalities	June 2012	MoF/MoP/CoM
Issue one budget circular for both recurrent and development expenditures	June 2012	MoF/MoP
Introduce a Budget Strategy Paper before the start of budget preparation	June 2013	MoF/CoM
Combine the investment and recurrent budget preparation in line ministries by merging the respective divisions.	June 2013	MoF/MoP/CoM/Line Ministries
Provide indicative resource ceilings for the recurrent and capital expenditure aggregate envelopes	June 2013	MoF/MoP/CoM
Provide indicative resource ceilings for each ministry	June 2014	MoF/MoP/CoM
Launch inventory and review of all uncompleted pre-revolution projects	Immediate	MoP/MoF
Create a Public Investment Management unit	April 2012	MoP/MoF
Budget Execution Control		
Clarify the concept of commitment in the financial regulations	June 2012	MoF
Make financial controllers control/authorize commitments against budget allocations and record them in the "appropriation book."	July 2012	MoF/Line Ministries
Use more intensively the current financial inspection procedures	May/June 2012	MoF
Set up a working group to review the internal control system	August 2012	MoF/FAA/Line Min.
Accounting and Reporting		
Set up a working group to develop administrative and *GFSM* 2001-compatible economic classifications	June 2012	MoF/Line Ministries
Use the new administrative and economic classifications in budget preparation and execution	April 2013	MoF/Line Ministries
Prepare a conceptual design document for a GFMIS	December 2013	MoF
Government Banking Arrangements		
Reconfigure treasury bank accounts at CBL to form a TSA structure	June 2012	MoF/CBL
Change payments system to avoid pre-funding allocations for all chapters	December 2012	MoF/CBL
Bring all balances in ministry commercial bank accounts into TSA	December 2012	MoF
Cash Planning and Management		
Devise and implement a capacity building program for cash forecasting	June 2013	MoF/Line Ministries
Develop methodology to calculate appropriate TSA cash buffer levels	December 2012	Treasury
Commence development of a T-bill market for cash management	January 2014	Treasury/CBL

I. Macro-fiscal Analysis and Use of Oil Revenue

A. Macro-fiscal Policy Framework

1. **The design of a fiscal framework for Libya should be determined by clear and sound fiscal policy objectives, existing economic and institutional conditions and resource revenue dependency.** The main objectives of fiscal policy include: (i) macro-fiscal stability; (ii) development and infrastructure needs; (iii) macro and microeconomic absorption constraints; and (iv) savings for future generations. Large proven oil and gas reserves ensure significant hydrocarbons revenue for the foreseeable future while the level of development and the consequences of last year's revolution have created significant development and infrastructure needs. Ultimately, the weight given to each objective depends on social preferences although macro-fiscal stability is a precondition to any of the other objectives. Thus, the key objective for Libya's macro-fiscal framework seems to be to manage macroeconomic stability while balancing the need to invest domestically to overcome capital constraints, and increase non-hydrocarbons and private sector led growth.

2. **The high volatility of hydrocarbon revenues, which represented 90 percent of total revenue in Libya in 2010, has important implications for the fiscal framework:**

- Isolating spending from this volatility requires saving during high hydrocarbon prices and dissaving when prices are low.
- Framing spending plans in a medium-term context since forecasts of natural resource revenue are very uncertain.
- Requiring a more cautious optimal spending path, including capital spending to avoid inefficient spending and the interruption of spending programs due to lack of resources in the short-term.

3. **Once policy objectives are established, a policy framework can be designed based on a policy rule or guideline to anchor fiscal policy around a fiscal indicator.** The most common frameworks for resource abundant countries include the permanent income hypothesis, non-resource balance rules, "structural" balance rules and expenditure rules (see Appendix 1).

4. **International experience suggests that flexibility of the fiscal framework and associated policy targets is important for their durability and credibility.** There is a tradeoff between rigidity (which results in obsolete frameworks that are circumvented) and flexibility (which, if in excess, could undermine its credibility). Discussions on changing expenditure paths due to changing political realities are better addressed explicitly rather than in an ad hoc manner. In this connection, focusing on procedural rules rather than numerical targets (as in Chile), relying on flexible guidelines rather than strict rules (as in Norway) and including explicit revision clauses have proven successful in other countries.

B. Fiscal Forecasting and Analysis

5. **Macro-fiscal units (MFU) play a strategic role within ministries of finance in terms of carrying out fiscal policy analysis and helping improve the quality of government policies.** Their characteristics vary across countries but some basic functions are generally shared. The MFU should be in charge of macro-fiscal analysis, tax policy analysis, medium- to long-term macro-fiscal forecasting including revenue and expenditure envelopes, and debt policy and sustainability issues. An MFU should be responsible for ensuring that all policy issues that have fiscal implications (e.g., financial sector issues that may have implications for the budget), but do not fall within the portfolio of other units in the MoF, are taken into account. This unit should report regularly on macro-fiscal events and inform the ministry on key policy discussions and initiatives. Although they generally do not play a role in the day-to-day functioning of a MoF, they have a critical strategic role in the formulation of fiscal policy since their work cuts across revenue, and expenditure issues. Capacity in the MoF for macroeconomic and fiscal policy analysis is necessary to ensure that fiscal policy is consistent with the government's macroeconomic policy objectives.

6. **The fiscal framework, whether a simple annual framework or a medium-term fiscal framework (MTFF), needs to be consistent with macroeconomic policy objectives.** The relationships between the annual and medium-term fiscal framework and macroeconomic policy objectives can be captured through a formal financial programming model, in which the fiscal sector is analytically linked to the real sector of the economy, the monetary sector and the external sector.

7. **A rolling MTFF sets aggregate revenue and spending envelopes, including capital spending, for three forward years and identifies resulting financing flows.** In the case of Libya, this would require producing revenue projections disaggregated by hydrocarbons and non-hydrocarbons as well as aggregated recurrent and development spending. Within recurrent spending, overall ceilings for wages, goods and services and subsidies (Chapters 1, 2 and 4 respectively) should also be produced (see Appendix 2 for a more detailed description). Thus, the unit should be involved in the preparation of the budget circular at the beginning of the budget process establishing its macroeconomic framework[3] and requesting budgetary units to prepare their intended list of programs. Similarly, the unit would also be involved in the later stage when budget ceilings for each line ministry are established, after line ministries have submitted their priority programs.

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[3] Macroeconomic analysis and projections (inflation, real GDP growth, etc.) should ideally be assigned to independent institutions including the CBL. Until such capacity is built, the unit could rely on the expertise of other institutions for macroeconomic forecasts (e.g., IMF and World Bank).

8. **The MFU analysis should include**:

- The appropriateness of the government's short-term and medium-term fiscal stance and priorities;
- The appropriate fiscal response to imbalances;
- Contingent liabilities and long-term fiscal risks, including in particular, those associated with the volatility of hydrocarbons prices; and
- Quasi-fiscal activities in the public sector.

9. **An effective MFU will require qualified staff producing high quality work with the cooperation of other MoF departments as well as departments and agencies outside the MoF.** Gathering good data from the various government agencies that produce them (CBL, statistical office, Ministry of Planning) will be critical for the success of the MFU. Also, a close interaction with the budget department and, to a lesser extent, the treasury department, will be necessary.

10. **In the absence of a comprehensive macroeconomic policy framework, the budget lacks a medium-term strategic orientation**. Although development projects are prepared on a multi-year basis, this is done in isolation from recurrent spending plans which are budgeted annually. The medium-term impact of current spending decisions is not internalized. Similarly, little if any consideration is given to the macroeconomic effect of fiscal policy, particularly in the context of a fixed exchange rate system and volatile revenues. Furthermore, in an environment of plenty hydrocarbon related revenues, financing considerations are ignored.

11. **Although a medium-term development program is produced, there is neither a clear fiscal indicator to anchor fiscal policy nor an articulated longer-term perspective for overall fiscal policy.** Annual capital and recurrent budgets are prepared without an explicit spending envelope consistent with macroeconomic, fiscal and development objectives. Furthermore, financing needs are not a factor in deciding the fiscal stance nor are stabilization or savings objectives explicitly linked to budget aggregates. Budget decision making is mostly guided by a bottom-up needs assessment process at line ministries with financing being treated as the residual.

12. **Macro-fiscal forecasting capacity is lacking in Libya and economic policy formulation is fragmented**. The creation of a MFU at the MoF is being considered by the authorities. Currently, there is no specialized unit within the MoF in charge of macro-fiscal analysis and forecasting. Furthermore, no forecasting beyond the current budget year is performed and revenue projections are elaborated elsewhere (National Oil Company (NOC) and revenue and customs departments). Also, the macroeconomic impact of the fiscal stance reflected in the budget is not analyzed.

Recommendations:

13. **The government should adopt, over the medium term, a macro-fiscal framework, and associated fiscal rule, that captures both stabilization and savings objectives**. Given Libya's hydrocarbon wealth, its stage of development, and large infrastructure and reconstruction needs, the mission believes that the government should adopt a framework that combines (i) stabilization objectives to ensure macroeconomic stability; and (ii) saving objectives to ensure some intergenerational equity. LIA, or any other existing or future resource fund, should be fully integrated into this framework.

14. **The MoF should create a MFU as a directorate reporting directly to the Minister of Finance (through a senior advisor)**. This will facilitate the unit's work and enhance its profile with other departments. By reporting directly to the Minister, it will establish its strategic role and be better positioned to provide analytical support to key fiscal policy initiatives. The MFU will need to work closely with other departments within MoF and external agencies including CBL and statistical agencies.

15. **The MFU's capacity should be built gradually over time and will require significant training and the assistance of an international advisor.** Initially the unit should have three analytic sections: (i) revenue unit;[4] (ii) MTFF and macroeconomic unit; and (iii) long-term analytical unit. In addition, they will need some staff with IT and data management skills. This will require a department with staff of around eight, although it is unrealistic to hire the full complement quickly. Furthermore, since the unit requires high level skills, a large training component will be required.

16. **Over the short-term for the 2014 budget preparation,[5] the MFU should be responsible for:**

- *Elaborating a rolling MTFF*, to be endorsed by the Council of Ministers/Cabinet, sent to Parliament for information and forming the basis for the overall budget ceiling, including its main aggregates. The framework should be at least partially updated mid-year.

- *Initially, the MTFF should incorporate an articulated and sustainable fiscal deficit target underpinned by clear government policies and strategies.* The deficit target should be based on the non-hydrocarbon balance (for its derivations see Tables 1

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[4] The revenue unit under the MFU should complement the role of similar units in the Revenue and Customs departments, with the latter taking a more micro oriented, less strategic role.

[5] The 2013 budget should attempt if possible a simplified MTFF with total revenues and spending projections.

and 2 in Appendix 2). Brief descriptions of policy actions to support MTFF projections should also be discussed.

- *Reporting on developments through the year for fiscal management purposes.* Initially these reports could be semiannual and do not have to be very detailed. They should aim to provide an indication to senior officials of whether fiscal developments are on track and explain deviations relative to the budget. More detailed reporting should, initially, be on an annual basis, covering fiscal developments in the context of broader macroeconomic developments. As the unit consolidates, these reports should become monthly and quarterly.

17. **Over the medium-term and as capacity is enhanced, the MFU should:**

- *Create a tax policy capacity, particularly for the hydrocarbons sector.* In some countries tax policy units are created separately reflecting the required technical expertise required, particularly related to oil sector fiscal regime issues.

- *Elaborate detailed hydrocarbons related revenue forecasting.* These should be developed from the bottom-up reflecting oil-field specific production and costs structures. Revenue forecasts should be presented with some sensitivity analysis with respect to variations in production, cost and price assumptions.

- *Elaborate debt sustainability analysis,* with particular focus on the net wealth position of the government over the medium- and long-term.

- *Produce good quality analysis of key government cross-cutting fiscal structural issues with macroeconomic implications.* This might include the cost of a potential civil service reform, pension reform or other efficiency issues in government spending.

II. A Libyan Sovereign Wealth Fund – Linkage to the Macro Framework and Operational Aspects

A. Linkage to the Macro Framework

18. **A sovereign wealth fund (SWF) can be a useful instrument of macro-fiscal management if it is fully integrated in the policy framework**. However, it should not be a substitute of fiscal policy, nor should the fund inflow-outflow rules substitute for appropriate fiscal rules. Trying to moderate spending by creating a SWF with rigid rules has failed in many countries due to the lack of borrowing constraints, which has allowed governments to spend the revenue that was supposedly being saved by the fund. A SWF is, therefore, a complementary tool and an instrument of fiscal policy. That is to say, the accumulation of financial assets in a fund with intergenerational objectives should be derived from the actual fiscal surpluses determined in the policy framework. In this regard, the fund can support the

implementation of a sound counter-cyclical fiscal policy while enhancing its transparency and credibility.

19. **In the case of Libya, both stabilization and savings objectives seem relevant**. Libya needs to address the impact of the volatility and uncertainty of hydrocarbon revenues on macroeconomic variables such as inflation, the real exchange rate, and real GDP growth. At the same time, Libya can benefit from provisioning for the eventual exhaustion of hydrocarbon resources, particularly given the uncertainty about the persistence of current high prices.

20. **Success of SWFs with stabilization and savings objectives has been mixed and critically depends on the consistency between SWF operations and fiscal policy as well as on its flexibility.** International experience suggests that a SWF is most likely to survive when (i) the government has sufficient funds left to finance transfers from the budget to the fund either when hydrocarbon related revenue is high or for savings objectives; and (ii) the government transfers resources from the fund to the budget for counter-cyclical reasons when hydrocarbon prices are low or to pay for unforeseeable emergencies (See Appendix 3).

21. **The Libya Investment Authority (LIA) is currently Libya's SWF with a broad mandate to invest in foreign and domestic assets.** Although the main investment objective of the LIA is to build a savings fund for intergenerational equity, it has also been given mandates to function as a stabilization fund and a domestic economic development fund. The LIA is not integrated in the fiscal framework and inflows and outflows are not clearly regulated. The LIA is funded by surplus hydrocarbon revenues, transferred by the MoF, but the rules of funding are discretionary and not explicitly outlined in the LIA law.

B. Operational Objectives and Rules for a Libyan SWF

Objectives

22. **Libya's oil-based economic characteristics can be compared to that of other countries with natural resource-based SWFs.** For example, Chile and Norway are both small open economies which benefited from resource windfalls, and channeled some of the earnings into SWFs (see Appendix 3, Box 4 for descriptions of these and other SWFs). Both countries used their SWFs as vehicles for fiscal policy to smooth the impact of the economic and commodity cycles. Both also designed funds to accumulate savings over the long term, to compensate for the eventual depletion of their natural resources.

23. **Given Libya's current and potential economic situation, these stabilization and savings objectives would seem relevant to Libya as well.**

- **For fiscal and macro-stabilization,** Libya equally needs to address the impact of the volatility and uncertainty of oil revenues on inflation, the real exchange rate, and real GDP growth with such revenues being even more important for the public finances and real economy than in Chile and Norway. Libya shares the characteristics of being a small economy where output swings can be dramatic since domestic cycles are augmented by terms-of-trade shocks and other external spillovers.

- **For building up financial savings,** Libya can also benefit from provisioning for the exhaustion of oil reserves, particularly while there is uncertainty about how long current high prices will persist. Although infrastructure needs are large and will require considerable oil revenues to finance, the absorption capacity to implement these is restricted at present and there is a strong case for intergenerational savings beyond whatever buffer is needed for predictable stabilization needs.

24. **The temptation to use the SWF directly to finance domestic development objectives should be strongly resisted.** Such objectives might include infrastructure spending and investment in domestic financial markets.

- International experience shows that direct spending by a SWF generates a number of serious problems. Most critically, it undermines a transparent budget process. It makes it likely that budget activities will be duplicated; it fragments fiscal policy; creates confusion about institutional responsibilities; and weakens systems for policy coordination (Appendix 3, Box 5).

- Similar problems arise if a SWF provides transaction support domestically through guarantees, loans, and equity participation. These operations are (or can become) hidden quasi-fiscal activities that should be included transparently in the budget.

- Financial investments in domestic markets can contradict the macro-fiscal stabilization objective of a SWF by injecting and withdrawing volatile cash resources affecting the economy and domestic financial institutions.

- For all of the above reasons, a SWF should be limited to funding budget activities rather than augmenting or replacing them.

25. **Improving fiscal transparency and financial returns on government assets can be formulated as ancillary objectives of a SWF.**

- SWFs can be instruments to enhance the visibility of fiscal policy management (e.g., the government's (net) flows, changes in its net worth) and its credibility (if properly managed). In addition, they can help to promote awareness of government financial constraints over the long term. The general public can find it useful to focus on the flows and balances of a SWF as a summary indicator of the soundness and direction of fiscal policy. In Libya, particularly at this juncture, this complementary objective could be used as a strong additional argument to obtain support for reform to the fiscal policy framework.

- Many SWFs also explicitly aim to improve returns on large or rising financial assets, subject to prudent degrees of risk. Increased returns can help create additional fiscal space to fund current and future spending. The scope for doing so is most relevant when a government begins to accumulate assets beyond its potential stabilization needs.

Inflow – Outflow rules

26. **The mission recommends that a SWF in Libya should operate as a financing fund.** This would channel government budget surpluses directly to the fund and would avoid the fund behaving inconsistently with fiscal policy as articulated in the budget. Besides eliminating any need or incentive to bypass the fund in order to accommodate changes in fiscal policy priorities, a financing fund is the most transparent of SWFs since its wealth reflects the summary outcome of government's policy choices. This transparency enhances the credibility and durability of the SWF.

27. **International experience suggests that financing funds are more durable than contingent and revenue-share funds.** Contingent or revenue-share rules can sometimes allocate money to the SWF even if the budget envisages spending these resources elsewhere—meaning that government can end up borrowing just to feed the SWF. Governments usually adopt these rules with the expectation that removing "high" revenues from the budget will help control expenditures, but the indirect link is less transparent and more difficult to enforce than a financing link. Thus such rules can lead to tensions in asset and liability management if the borrowed deficit-finance (or perhaps arrears) has higher costs than the returns to the SWF or creates risks that offset the risk-optimization strategy of the SWF. Many countries have eventually changed, bypassed, or eliminated rigid accumulation rules.

28. **The deposit and withdrawal rules for a financing SWF will be, in principle, the same under any fiscal policy framework.** For Libya, the SWF would accumulate wealth from the following sources:

- Designated starting capital, being the balance of the LIA and the Budget Reserve Account;
- Automatic receipts of any fiscal surplus, which in turn would be established by application of whatever fiscal framework/rule is operational in Libya (see Section I) and may result from greater than anticipated oil revenues.

29. **The uses of SWF wealth would be as follows:**

- Financing of fiscal deficits which result from the application of the fiscal framework/rule (in line with budget and supplementary budgets) and may result from lower than anticipated oil revenues;
- Extraordinary withdrawals consistent with escape clauses under the fiscal framework (if any);
- Long-term objectives of savings assets such as pension liabilities, asset-liability operations designated by government such as pre-paying debt, and budget support following the depletion of commodity resources.

30. **Defining the SWF as a financing fund rules out the need for much further institutional specification**—since it is the fiscal framework rather than the SWF that accommodates changes in fiscal priorities. However, some additional provisions can help to ensure that the SWF remains subordinate to the pre-defined fiscal framework.

- Experience suggests that designating the SWF as a government account rather than giving it its own institutional persona will avoid the emergence of conflicting interests about the management and use of the fund. The existence of an entity such as the LIA, however, with its personnel and institutional resources already in place, would likely overrule this argument. Clear new laws and regulations concerning the LIA will help to avoid conflicts of this nature.[6]

- In similar vein, the SWF should be prohibited from spending, from providing guarantees or loans, from borrowing, or from pledging its assets.

- A stabilization objective calls for investing the SWF's financial assets only abroad, particularly since it involves revenue sources that originate from abroad. This helps isolate the economy from volatile revenue sources and domestic financial intermediaries from SWF inflows and outflows.

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[6] IMF/World Bank report *Libya: Libya Investment Authority – Governance Arrangements* – Pihlman et al., December 2011.

- There should be no cap on accumulation, since the SWF is intended as the government's main savings vehicle. This is particularly relevant to the LIA whose current cap has led to past confusion about where to place budget surplus assets and appears to have been the reason behind the creation of some domestic development-related extrabudgetary funds.

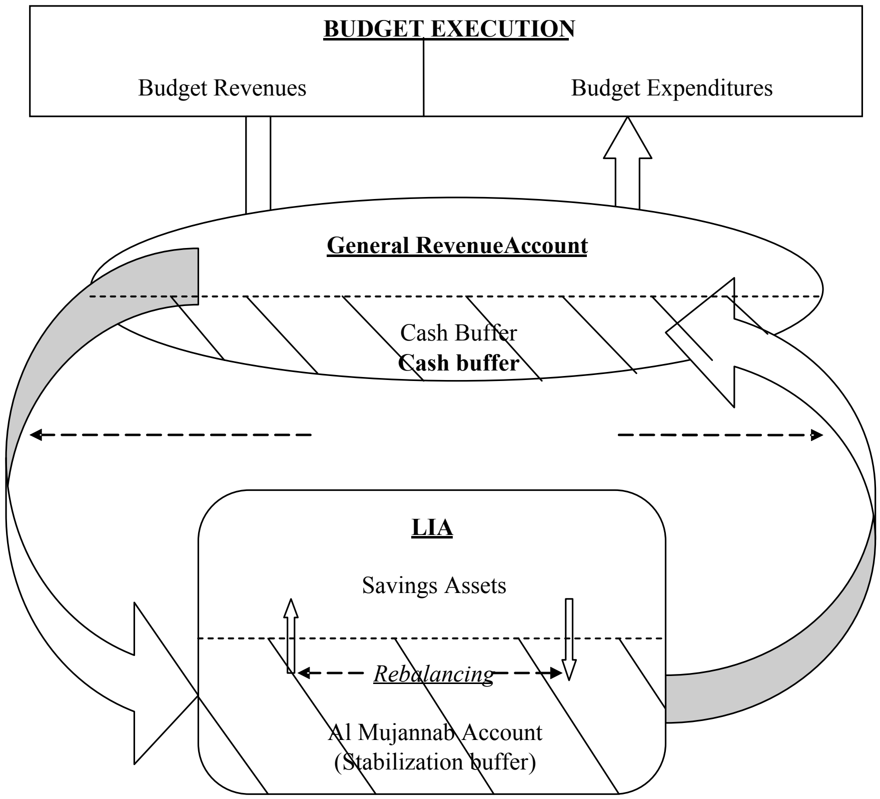
31. **As discussed above, the establishment of a SWF operating as a financing fund implies close links with the execution of the budget and cash management.** In particular, the operational and institutional arrangements for incorporating a stabilization element of the fund into public financial management are important from efficiency and cost perspectives. Similarly, the legislative framework surrounding the SWF needs to be robust in order for it to interface smoothly with the ordinary business activities of government.

SWF operational arrangements

32. **The choice of a financing-fund type SWF means that net balances of budget expenditures and revenues flow through a stabilization buffer held in the fund.** For this reason, operation of the stabilization buffer will be closely linked to the MoF's central government cash management process. In Libya, cash flow forecasting and active cash management remain to be developed and a treasury single account (TSA) at the CBL is not well established, although there is reasonable coverage of central government business with all revenues flowing into a general revenue account (GRA). It would be appropriate, therefore, to retain a targeted buffer level of cash in the GRA for daily fluctuations in revenue and expenditure mismatches.

33. **The required GRA cash buffer should regularly be recalculated by determining the volatility of cash flows and the errors in any cash flow forecasts being made.** Where the actual level of cash is above or below the target, the difference should be passed to, or from, the SWF stabilization buffer (Figure 1). This process will allow the budget surplus or deficit to be reflected in the stabilization buffer balance throughout the year and not just at year-end. The extra cost of holding buffer cash in the GRA rather than in the SWF depends on the accuracy of the cash managers' cash flow forecasts. As government cash management techniques become more advanced and effective, the GRA buffer level can be reduced significantly.

Figure 1. SWF Stabilization Buffer



34. **The Budget Department sets quarterly budget allocations which allow spending units to plan and make expenditures over the next three months.** Although this aids cash planning across the year, it cannot substitute for more refined cash flow forecasting which should be done at least on a monthly basis—and preferably daily. While cash management is improving, the government should rebalance the GRA and the SWF on a monthly basis with a view to doing so more frequently as cash planning improves. As the time between rebalancing the GRA with the stabilization buffer becomes shorter, the required buffer balance will decline.

35. **The financing fund model of a SWF allows for a minimum of rigid operational rules for inflows and outflows through the stabilization buffer to the GRA.** Where the principal source of revenue variation derives from movements in oil prices, these can automatically be accommodated through the stabilization buffer as budget execution proceeds. When oil prices are higher than budgeted, the corresponding surplus revenue

flows into the stabilization buffer as the GRA is rebalanced. Similarly, when prices are lower, the required extra resources are furnished by withdrawals from the stabilization buffer.

36. **Earmarking of stabilization buffer funds should not be permitted since they are destined for general budget support through the GRA as required.** If it is necessary to amend budget plans to maintain the fiscal target during the year, this should be performed by means of approved supplementary budgets which amend budgeted expenditure as required. Thus, if there is a shortage of non-oil revenue during the fiscal year for reasons such as lower inflation or decreased economic activity, this must be met through reduced expenditures and not by an extra resource inflow from the stabilization buffer.[7]

37. **Internationally, many SWFs have started with the objective of fiscal stabilization and have grown into large savings funds.** The structure of the proposed Libyan SWF should allow this to happen should oil prices maintain their current strength and trend. This structure requires operational rules which allow excess funds in the stabilization buffer to be transferred to savings assets and which restrict flows back into the stabilization buffer only for long-term development planning or contingency situations.

38. **Rebalancing between the stabilization buffer and the savings assets should take place at planned intervals.** This need not be as often as rebalancing between the stabilization buffer and the GRA but might be performed annually or when unanticipated events occur[8] to allow efficient management of surplus financial resources. At that point, any excess funds in the stabilization buffer should be transferred to savings assets for longer term investment.

39. **Under the proposed framework, savings assets may need to be mobilized to support the stabilization objective in case of a sustained oil revenue shock**. Consideration could be given to smoothing the decline of the stabilization buffer once it reaches a certain threshold to avoid the need to take costly spending adjustments or to borrow expensively. This mechanism would need to be accompanied by assurances that fiscal adjustment is being introduced in response to a (permanent) oil price change or else the savings component may also succumb to rapid depletion. Therefore, short-term requirements other than those specifically considered to be contingencies should not be met by withdrawals from the savings assets. For day-to-day cash shortages when the

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[7] Asset-liability management techniques would provide analysis on whether to decrease debt at the expense of savings. This area is not covered by this report.

[8] E.g., much higher oil prices or production than envisaged in the macro-fiscal framework or difficulties in implementing budgeted capital development projects.

stabilization buffer is low, use should be made of expenditure restrictions and/or short-term borrowings to replenish the GRA buffer.

40. **Saving entails the long-term investment of assets and any alternative use of these funds entails careful consideration by the government.** The government will need to decide the circumstances under which it will allow savings assets to be used to top up the stabilization buffer if required in the rebalancing process. These circumstances may be specifically of a long-term nature such as covering pension liabilities. The proposed fiscal framework should encompass situations such as these which allow for escape procedures. Government decisions on utilizing savings assets for short-term contingencies should be consistent with this aspect of fiscal rule implementation.[9]

41. **The SWF system in Libya was set up in 2006 before the financial crisis.** It appears to have been hastily designed with little forethought for any situation other than continuing oil-based budget surpluses. It has the main elements of an internationally accepted SWF structure, but with few clear rules regulating its flows. The current LIA law and regulations and legacy practices relating to the Budget Reserve Account appear confused and, in the past, adhered to only when expedient.[10] New clear laws and rules are vitally necessary for the SWF to act effectively as anything other than a pure savings mechanism. The current financing difficulties resulting in time-consuming decisions at cabinet level are a symptom of the existing structure.

42. **The operation of the current Libyan SWF structure is also more static than dynamic**. Only once a year, an instruction is given to move budget surpluses from the treasury financing account to the Budget Reserve Account; only three or four times since 2006, instructions have been given to transfer funds from the Budget Reserve Account to the LIA for longer-term investments (despite a law to this effect). At times of cash shortage, there is no automatic and dynamic method of withdrawing funds from either of these funds. For the Libyan SWF to function as a budget stabilization vehicle and as a savings fund, it should be restructured with clear and strict rules under which dynamic transfers and transactions can take place to achieve these objectives.

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[9] More detailed discussion of rebalancing the stabilization buffer with the savings assets requires asset-liability management analysis which is not considered in this report.

[10] IMF/World Bank report *Libya: Libya Investment Authority – Governance Arrangements* – Pihlman et al., December 2011.

43. **Recommendations:**

- The MoF and the government should design rules and dynamic transaction mechanisms to allow a restructured SWF to operate with the objective of budget stabilization as well as a savings vehicle; and

- The government should undertake the legal and governance reforms regarding the SWF structure as outlined in the forthcoming IMF-World Bank report.[11]

III. Budget Planning and Preparation

A. Key Weaknesses in Budget Preparation

44. **Before the revolution, there were a number of weaknesses in budget planning and preparation, which were highlighted by the 2011 FAD report and 2009 World Bank report.** Almost all of these earlier findings remain valid. The key weaknesses are the following:

- Budget formulation remains fragmented and mostly driven by a mechanical and incremental approach, especially for current spending.

- Although the capital projects component of the development budget (Chapter III) is prepared and authorized on a three-year basis, capital budget spending is not guided/constrained by an overall ceiling as determined by a MTFF in line with government's fiscal policy objectives, nor are projects always selected on grounds of developmental priorities.

- The preparation of the recurrent and development budgets follows two separate and uncoordinated processes, with institutional separation both at the central and line ministries/agencies levels.

- There are a number of issues in budget presentation, classification and coverage. The budget classification does not follow internationally accepted standards and the distinction between "current" and "capital" allocations is blurred.

- The coverage of the budget circular is limited to wages and goods and services (Chapters I and II) and does not provide guidance on the macroeconomic parameters (such as GDP growth and inflation) that need to be taken into account in ministries'

[11] IMF/World Bank report *Libya: Libya Investment Authority – Governance Arrangements* – Pihlman et al., December 2011.

budget proposals. It also does not provide ceilings for budget preparation by line ministries/agencies.

- The budget is yet to become an effective policy tool. The linkage between government's policy priorities and budgetary allocations remains weak and not articulated in a budget policy/strategy paper. No distinction is also made between ongoing and new policies and initiatives.

B. Reform Priorities in the Wake of the Revolution

45. **The new government has not yet had an opportunity to address these weaknesses, which have been compounded in practice by the damage and upheaval associated with the revolution.** There has also been a further reduction of budget preparation capacity, not least due to change of key staff in several agencies. While the findings and recommendations of previous IMF and World Bank reports remain broadly valid and should form part of a PFM reform strategy for the medium term, the current need is to identify from among them those that are at once important, urgent and feasible in the immediate post-revolutionary transition.

46. **Going forward, the authorities need to focus on the following key reform priorities in the transition context:** (i) ensuring a unified budget process, including full integration of recurrent and capital budgets; (ii) introducing a medium-term perspective to inform the annual budget; (iii) strengthening the policy context of budgeting; and (iv) developing a comprehensive and clear budget presentation. Even if reforms in these areas may have to be less than substantive during the transition, they can be progressively introduced starting with fundamental building blocks of the reform architecture such as the structure of budget presentation, content of the budget circular, content of the budget policy/strategy paper, specification of the role and functions of various agencies, and the budget preparation calendar (see Appendix 4).

Ensuring a unified budget process

47. **All aspects of budget integration, not just the organizational aspect, need to be addressed to ensure a unified system of budget management.** For example, the presentational integration of both budgets could be further enhanced by subsuming respective recurrent and investment budget allocations under each ministry in the budget. This would also set the stage for a unified approach at the level of line ministries/agencies not only for the preparation of the budget, but also for its execution, accounting and reporting. It is, however, emphasized that presentational integration is only one aspect of budget integration, which also requires budget process integration and institutional integration (see Box 1).

Box 1. Three Aspects of Budget Integration

Presentational integration—As a first step towards budget integration, it is useful to develop a combined presentation of the two budgets (recurrent and investment budgets) based around the line ministry structure which also incorporates a description of the objectives of the ministry.

Budget process integration—The process for preparation and execution of the operational and investment budgets should be integrated. For example, there should be a single set of instructions (including the issuance of the budget circular) for preparation of both budgets, and the process of budget negotiation with line agencies and finalization of their allocations should be conducted jointly (even through two separate agencies, such as the MoF and a Planning Department/Ministry, may have a role to play in budget preparation).

Institutional integration—A single institutional entity should be made responsible for managing budget preparation (although inputs, particularly on investment planning, project appraisal/selection, etc., may be provided by a Planning Department/Ministry). At the line ministry level also, there should not be separations between the staff responsible for the recurrent budget and the staff working on the investment budget. To achieve full budget integration, such institutional divisions, if any exists, will need to be removed.

48. **The current fragmentation in the preparation of recurrent and development budgets weakens and complicates the fiscal and economic management role of the MoF.** Recurrent (Chapters 1 and 2 and 4) and development budgets (Chapter 3) are essentially prepared separately. The MoF issues a budget circular for the preparation and submission of the recurrent budget covering Chapters 1 and 2, while the planning department (now a ministry) guides the line ministries/agencies in preparing their respective investment projects and their submission. Line ministries and agencies do not prepare a combined budget submission for recurrent and investment budgets. They prepare and submit these two budgets separately. The MoF and the planning department (now a ministry) then conduct separate budget discussions with individual line ministries for finalization and submission of the respective budgets to the Cabinet/Parliament for approval, without having a full view of the line ministries' operational and investment expenditure needs and how these are articulated to reflect the national and sectoral priorities. This presents a number of problems, in particular:

- It inhibits a proper discussion of the policy objectives behind government expenditures and the trade-offs between investment and recurrent expenditure.

- It raises the prospect that the fiscal implications of investment projects will not be fully considered (particularly when the decision on the capital budget envelope is not constrained by an MTFF in line with government's fiscal policy objectives) with a risk of either current expenditures needing to expand significantly or projects not being fully maintained or used once complete.

49. **The new government of Libya has recently decided to establish a separate Ministry of Planning (MoP).** This decision implies that the diverse entities involved in development strategy and public investment planning and selection decisions under the

previous regime would be either abolished or subsumed under the new ministry of planning, in a manner and timetable to be decided.[12]

Box 2. Core Functions and Other Accompanying Functions of a Ministry of Finance

Core functions

- **Macro-fiscal coordination and policy.** This includes macroeconomic and fiscal policy issues as well as monitoring and analysis of international economic developments.

- **Budgeting function.** This includes budget preparation, sectoral expenditure policy, monitoring of expenditures, microeconomic policy, and management of intergovernmental financial relations.

- **Treasury functions.** This includes execution of payments, accounting of government revenue and payment transactions, supervision of budget execution, cash and debt management, fiscal/financial reporting and asset management, and disbursement of civil service pensions.

- **Management of government revenue.** This includes policy for taxes, customs and excise, and other tax revenue, and tax and customs administration.

Other accompanying functions – The inclusion of these responsibilities in the portfolio of the MoF will depend on the country specific situation.

- **Financial sector regulation.** This includes regulation of financial markets and the business sector.

- **Oversight of state-owned enterprises (SOEs).** This includes policy on SOEs, guidelines and oversight for their functioning, capital injections, operating subsidies, etc.

- **Internal audit.** This includes policy guidelines and regulations (to regulate internal audit at the line ministry and agency level) on internal audit, including oversight of internal audit delegated to line ministries/agencies.

- **National economy.** This includes regional cooperation, investment treaties and agreements, capital investment and developmental plans, and privatization policy.

- **Procurement.** This included procurement policy, regulation, and oversight of procurement operations at the level of line ministries/agencies. A specialized agency (such as a Central Procurement Agency) outside the MoF has been set up in several countries to provide such oversight and monitor the implementation of procurement laws/regulations by line agencies.

50. **The new structure, including the respective roles and functions of the ministries of finance and planning, needs to be thought through and decided carefully, especially in light of the critical PFM responsibilities of the MoF.** This is all the more important given that the merger of the ministries of planning and finance in the past was in effect not operational and did not remedy the dual budgeting problem. Continued fragmentation in

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[12] However, several entities involved in project execution have been placed under the authority of the new Ministry of Housing and Infrastructure.

budget decision making is likely, among other things, to undermine the role of the MoF as the government's core institution for fiscal management (see Box 2 for a brief description of the core functions of an MoF in line with generally accepted international practices and other responsibilities often given to an MoF).

51. **The MoF should be responsible for the preparation of the integrated recurrent and investment budget.** As the investment budget constitutes a significant part of public expenditure allocation in Libya, in practice the decisions on expenditure policy and intersectoral priorities cannot be taken independently of the criteria used for funding of development projects. It is, therefore, necessary that the roles and functions of the ministries of finance and planning are clearly specified and the two ministries coordinate closely at every stage of the decision making process.

52. **Recommendations:**

- With the approval of the Cabinet, define clearly the respective roles and functions of the ministries of finance and planning consistent with the MoF responsibility for overall fiscal management. While the MoP would be responsible for the development strategy amongst other functions (see Appendix 8), the MoF should be responsible for formulating the budget in close cooperation with the MoP. For this purpose, the ministers of planning and finance should agree on: (i) the mandates of their respective ministries, with clarity and without gaps or overlaps; and (ii) explicit modalities of regular coordination and cooperation among them—to be binding on their regular activity and for which they would be accountable to the Cabinet.

- For the 2013 budget preparation, develop a single budget circular to guide the preparation of both the recurrent and investment budgets consistent with the fiscal framework (see Appendix 5 for illustrative contents of a budget circular). Also, the MoF and MoP should conduct joint negotiations with line agencies for finalization of their allocations, including for investment projects.

- From the 2014 budget onwards, combine the investment and recurrent budget preparation in line ministries/agencies by merging the respective divisions.

Strengthening the policy context of budgeting with a medium-term perspective

53. **There is no separate budget outlook or strategy paper that is prepared earlier in the year for presentation to Cabinet and Parliament.** Such a document is an important feature of the budget process in many countries[13] and allows for establishing an agreed basis

[13] Examples include the Spring Budget Bill in Sweden, the Pre-Budget Report in the United Kingdom, the Medium-Term Budget Policy Statement in South Africa, and the Budget Framework Paper in Uganda.

for the development of the coming budget prior to the presentation of the detailed budget proposals and line ministries/agencies' estimates. Typically, a budget strategy paper includes information on: (i) the medium-term macroeconomic forecast; (ii) fiscal policies and forecasts for revenue, debt, and deficit; (iii) medium-term targets or limits for the fiscal rules (explicit or implicit); (iv) information on fiscal risks; (v) statement of responsibility about the reliability and completeness of the information; (vi) analysis of public expenditure trends; (vi) review of inter-sectoral expenditure priorities, and of spending programs within the major sectors; and (vii) medium-term line ministry/agency resource ceilings. Over time, the medium-term expenditure information could be developed to cover discussion of expenditure priorities and spending and performance forecasts for major spending authorities (Appendix 6).

54. **Recommendation:**

- Introduce a Budget Strategy Paper for the 2014 budget, to be prepared during the second quarter of 2013 at the conclusion of the preparation of the MTFF. For the 2014 budget, it should include indicative resource ceilings for aggregate recurrent and capital expenditure, which could be further broken down for each line ministry/agency from 2015 budget onwards. The Budget Strategy Paper for 2014 budget should be presented for cabinet approval and subsequent Budget Strategy Papers should be presented to parliament for information and general debate.

Comprehensive and clear budget presentation

55. **A sound budget classification is a key aspect of clear budget presentation and transparency in allocations.** In the immediate term, the authorities need to focus on adopting a hierarchically organized administrative classification and a GFSM 2001-based economic classification. This issue is further discussed in Section V below.

Government investment

56. **Libya's development budget has been traditionally very large, but the efficiency of expenditure and integrity of processes have been low.** Government investment expenditure has averaged about 20 billion dinars in 2008-10, equivalent to almost half of total government expenditure and about 20 percent of GDP. However, the impact of development expenditure on the country's economic growth, diversification, and wellbeing of the Libya population was far smaller than its large amounts could have produced.

57. **An analysis of the public investment management situation before the revolution identified major weaknesses.** These included the lack of sector policies to guide investment decisions; weak and unenforced public investment procedures; uncoordinated execution of many investment projects through a proliferation of contracts; arbitrary allocations on many substantial investments; and, as noted earlier, "dual budgeting," whereby decisions on

investment projects and the capital budget were taken separately from decisions on the recurrent budget.[14]

58. **During the current transition, it is necessary to address the issue of how to handle the public investment "overhang."** A large number of government investment projects had been launched but not completed before the onset of the revolution in February 2011. Moreover, the long interruption and physical damages associated with the revolution have likely affected the cost of the projects and caused some degradation of the works that had been completed. Detailed data on these projects should be collected, as the basis for the assessment of the completion costs and the cost-benefit analysis of each project would be necessary to justify the allocation needed to complete it.

59. **The investment projects inventory and review will take substantial time and may require technical assistance.** In the immediate future, the government must decide which of the largest among these projects clearly deserve to be completed without delay and should be funded as part of the development budget for 2012. This is especially important because the existing, severe implementation capacity constraints are likely to persist through much of 2012, thus precluding the launch of major new investment projects.

60. **In the post-revolutionary context, it is possible to begin building a new system of public investment management that is consistent with the requirements of good governance, national development and international good practice**. This will require sustained efforts to build institutional, organizational, technical and human capacity. The MoP should take the lead in this effort in close consultation with other relevant government entities and guided by international experience, particularly from post-conflict environments.[15]

61. **Recommendations:**

- Launch an inventory of all uncompleted pre-revolution investment projects and review each project. The inventory and review would be led by the MoP, in cooperation with the ministries and entities concerned, to decide for each project whether it (i) should be retained and completed as originally designed or with minor cost updating and design adjustments, and thus funded commensurately as soon as the circumstances permit; or (ii) requires major modifications and redesign, pending which no budgetary appropriation would be made; or (iii) should be discontinued and either mothballed or broken up for disposal of the physical assets and equipment. The cleaned-up inventory of ongoing

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[14] World Bank, *Libya: Working Paper on Public Expenditure,* September 2009.

[15] World Bank, *Conflict, Security and Development*, World Development Report, 2011; Doug Porter et al., *Managing Public Finance and Procurement in Fragile and Conflicted Settings*, Background Paper for the 2011 WDR, October 2010.

projects would provide an up-to-date database on which eventually to build a coherent and efficient public investment program. While a major part of the task can be contracted out, Libyan officials should be directly and substantially involved, in order to use the review, among other things, to develop their own understanding of the principles, methodologies and procedures of investment project appraisal, monitoring and evaluation.

- An inter-ministerial committee composed of the ministries of planning, finance and the concerned line ministries has been formed to decide on which few of the largest projects should be completed and funded in 2012. Since the urgency of the matter precludes an in-depth cost-benefit analysis, the seven general criteria listed in Box 3 may help the committee in its deliberations.

Box 3. General Criteria for Selection of Projects to be Funded in 2012

- Focus on the few largest projects;
- Importance of the project for the basic functioning of the economy and essential public services, and thus projects in (a) transport; (b) housing; (c) water and sanitation in the major cities; (d) power supply;
- Potential contribution of the project to the reconstruction/rehabilitation of structures particularly damaged by the war in the worst-affected urban areas (e.g., Misrata, Sirt);
- Geographic considerations;
- Extent of actual project completion (not of project disbursements) complemented by quick inspection of the current physical state of the works, in order to arrive at an approximate quantification of the costs of completion;
- Realistic assessment that the implementation capacity exists to complete the project rapidly; and
- Potential of the project to achieve a "quick win" and give the population a visible sense of progress and of concrete accomplishment.

- Take the following actions to begin improving public investment efficiency and programming in the future: (i) establish a central public investment management unit in the MoP; (i) formulate an action plan, in consultation with the major line ministries, to strengthen their capacity to design and monitor investment projects; (ii) review, in consultation with the ministries of finance and economy, procurement standards and regulations;[16] (iii) establish a central clearing house of proposals and programs of

[16] The World Bank has led such assessments in most countries in the region through its tool called "Country Procurement Assessment Report" (CPAR).

technical assistance on public investment to government entities;[17] and (iv) open channels of systematic public feedback on investment needs and project implementation.

IV. Budget Execution Control

62. **The January 2011 FAD report identified the main weaknesses of the expenditure control system and made several recommendations.[18]** Most of the weaknesses have not been addressed and, therefore, the following key recommendations remain valid:

- Implementation of a proper commitment control system;
- Review of the respective roles of the financial controller and internal auditor to reduce overlaps in their functions; and
- Over the medium term, development of an internal audit function consistent with international practices, which builds on the existing control function.

63. **This section identifies immediate priorities to strengthen internal control, including expenditure control.** With regard to expenditure control, the discussion covers issues related to controls both at aggregate and expenditure transaction levels.

A. Expenditure Control at Aggregate Level

64. **The State Fiscal Law[19] and executive regulations stipulate that the budget expenditures be executed within the authorized appropriations in the budget law.** The procedure of virement allows line ministries under certain circumstances and conditions, and with the approval of the MoF and/or the Cabinet, to increase the initial appropriation under a chapter by correspondingly decreasing the appropriation under another chapter, thus keeping the aggregated amount of appropriations unchanged.

65. **The automatic carryover of unspent capital expenditures[20] from the current to**

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[17] The purpose would not be to dictate or interfere with such programs, but to facilitate assistance, minimize transaction costs, assure consistency with national institutional development needs and macroeconomic developments, and prevent the emergence of preferred “enclave” type arrangements with their associated distortions and governance and corruption risks.

[18] The 2010 FAD mission, however, was not informed of the prominent role played by the Financial Audit Agency (FAA) in the internal control system. The FAA reviews all procurement contracts above a certain threshold as well as payments under these contracts. (This is further discussed below.)

[19] Promulgated October 24, 1967.

[20] Development projects under Chapter 3.

the subsequent fiscal year affects the overall limit of authorized expenditure.[21] While this practice of automatic carryover allows effective multi-year management of capital projects, it could result in increasing the aggregated amount of available spending authority since the amount of carryover in one year may be very different from that in the following year (especially because capital projects can be very large and total capital investment comprises a substantial part of the state budget).

66. **The Fiscal Law and executive regulations also stipulate a two-stage procedure of funds allocation to line ministries to prevent budget overrun**:[22]

- Budget allotments (or authorizations to spend) are first issued by the MoF Budget Department on a quarterly basis (or in some cases, monthly basis), limiting the risk that spending units may commit the bulk of their appropriations early in the year, increasing the pressure for an overrun later in the year.

- Cash releases are operated by the MoF Treasury Department on a monthly basis and reconciled each quarter against quarterly budget authorizations, effective disbursements, and bank statements.

67. **Budget execution monitoring needs strengthening to allow for necessary adjustments to budget allotments and cash releases in the event of potential gaps between revenues and expenditures.** In particular, the amount of the authorized allotments and released funds should be adjusted during the year to achieve the targeted overall budget balance. For example, the amount of the monthly released funds could be reduced from one-twelfth currently (say to one-fifteenth) provided that adjustments (i.e., increase or decrease in funds allocation) would be made during the following months or quarter in line with an updated forecast of revenues and expenditures based on actual budget execution. Although (due to a situation of cash surplus) such monitoring mechanisms were not in place before the revolution, these could be implemented within a relatively short period of time, in particular for the recurrent expenditures other than wages and salaries.[23] These procedures should also be coordinated with the cash planning and management framework discussed in Section VI.

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[21] The carry-over is stated in the Article 10 of the State fiscal Law.

[22] These procedures are implemented on a routine basis by the MoF. Although they are cumbersome and lack manuals of implementation, they are well rooted in the budget execution practices of line ministries. Their objectives and modalities are well understood, making the control more predictable for the line ministries.

[23] From a legal perspective, the implementation of these procedures do not require revising the 1967 Fiscal law, at least in the short term, and could be done through provisions in the annual budget law.

B. Expenditure Control at Transaction Level

68. **As stated in the 2011 FAD report, the concept of "commitment" is not clearly defined in the Libyan PFM framework and does not, in practice, prevent expenditure arrears.** The FAD report pointed out the lack of clarity—including at the level of financial controllers—of the concept of commitment, which is the first crucial step in the expenditure process. A proper commitment control system can ensure the existence of a required appropriation/budget allotment prior to incurring any expenditure. The 2011 FAD report indicated that such requirement, while stated by the State Fiscal Law (Article 20), was defined in an ambiguous manner and, more importantly, that the practice led to confusion between the "commitment" and the "payment order" stages, enabling contracts to be signed without sufficient assurance on the availability of the budget appropriations/allotments. As a result, arrears emerged if budget and/or cash coverage is not available.

69. **The 2011 FAD report identified several weaknesses in commitment recording and control.** Commitments are recorded in the "appropriations book" only before making the payment and not at the stage of entering into an obligation for future payment (e.g., signing a contract or placing an order for delivery of goods and services). Moreover, the financial controllers in line ministries control expenditures that are already committed and destined for future payment. These weaknesses increase the risk of generating and accumulating payment arrears, particularly in the current context of cash shortages and increased pressure on the expenditure side (mainly due to the efforts of reconstruction).[24] The lack of a mechanism to record and account for payment arrears further undermines the efficiency and transparency of the Libyan PFM system.

70. **The main recommendation of the 2011 FAD report to introduce a commitment control system remains valid.** It is important to note that the recording of commitments requires limited modification (if any) of the fiscal law. It could be introduced relatively quickly by modifying the existing expenditure process so that commitments are duly recognized (according to a clear definition—see Appendix 7) and recorded at the appropriate stage. A subsequent step of introducing a fully-fledged commitment control system would be required as shown in Appendix 7. In the medium term, the development of a GFMIS and the clarification of the roles of the financial controller and internal auditor should greatly facilitate the implementation of a proper commitment control system.[25]

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[24] Discussions with line ministries indicate that arrears are already accumulating, although the mission was not provided with data to confirm this.

[25] Many countries worldwide have implemented integrated information systems for computerizing basic functions of expenditure execution and the subsequent accounting and reporting functions. Most systems include commitment control modules.

C. Internal Audit

71. **The enhancement of financial control should be an immediate priority, while the development of the internal audit function is important as a medium-term reform.** The reform of ex ante financial control, especially commitment control, and strengthening of ex post financial inspection should be given priority under the current circumstances[26] while a more comprehensive internal audit reform should be launched at a later stage. The 2011 FAD report identified the weaknesses of existing internal audit procedures and their redundancies with financial control.[27] It also provided guidance on how to gradually develop the internal audit function by building on the existing features of the MoF Internal Audit Unit.[28] The 2011 FAD report provided a sequenced capacity building plan which focuses on: (i) identifying core systemic risks in the PFM system in coordination with the financial inspection unit; (ii) developing/defining a typology of risks; (iii) sharing these first results with the financial control units; (iv) developing a risk-based strategy for systemic audits; and (v) starting the implementation of this strategy. In the longer term, the MoF Internal Audit Unit could be entrusted with a role of guidance and coordination of other audit units set up in some major line ministries.

D. External Audit

72. **The Financial Audit Agency (FAA), the external auditor of all public entities in Libya, audits the final budgetary accounts.** The final accounts for 2006 are the last final accounts audited, and the agency was, at the time of the mission, in the process of examining the 2007 accounts, the last accounts produced by the MoF. These delays in the preparation of final accounts by the MoF and their audit by the FAA contribute to the lack of transparency

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[26] In the current circumstances, the financial inspection function could usefully be strengthened by: (i) increasing the share of inspections in the work program of the MoF Internal Audit Unit; (ii) focusing inspections on risks of fraud and corruption linked in particular to increased volume of expenditures due to reconstruction efforts; and (iii) using an embryonic risk-based approach to select inspection cases (instead of just on sole complaint basis).

[27] The 2011 FAD report pointed out the weaknesses of the internal audit in line ministries and its numerous overlaps with financial control—especially for compliance and regularity control (commitment control remaining the exclusive responsibility of financial controllers)—that needed to be eliminated.

[28] The existing MoF Internal Audit Unit, different from the internal audit units established in line ministries, has three different types of tasks: (i) it audits the MoF's expenditure transactions; (ii) it makes inspections, on a complaint basis, in identified government agencies to investigate fraud; and (iii) it reviews (ex post) the performance of financial controllers in line ministries with a view to ensuring their efficiency. The 2011 FAD report noted that the tasks of inspection and *ex-post* review of financial control function, due to their systemic features, have elements somewhat similar to those performed by internal audit and the knowledge and accumulated experience of this unit at the MoF could be used to develop a proper internal audit function in the medium term.

of the PFM system. The FAA focuses its audit methodology mostly on compliance and legality and has yet to adopt a modern risk-based approach aimed at assessing the systemic risks. The budgeted revenues are not audited by the FAA.

73. **The FAA is also involved in ex ante control of expenditure, which potentially undermines its independence.** The agency is in charge, by virtue of law, of clearing all procurement contracts exceeding LYD 500.000. The clearance is performed ex ante, before the contract is signed, and is binding on the respective spending unit.[29] All documents and invoices (irrespective of their amounts) corresponding to the implementation of these contracts (more than LYD 500,000) are also submitted for the pre-approval of the FAA. This function needs further review in relation to the current procurement procedures in Libya,[30] but nonetheless raises a serious issue of independence of the agency vis-à-vis the Executive. INTOSAI strongly argues against any kind of ex ante involvement of the external auditor in tasks such as the signature of procurement contracts. It also overlaps with the compliance control function of the financial controller and internal auditor in line ministries. This dual function of the FAA should be re-assessed as a priority with a view to phasing out its ex ante control of the invoices corresponding to the contracts already approved. Such controls should be exercised by the financial controller and the internal auditor.

74. **Recommendations:**

Short term

- The MoF should clarify the concept of commitment in the financial regulations, making it the first stage of the expenditure cycle.
- Financial controllers should be required to authorize newly defined commitments against budget allocations and record them in the "appropriation book."
- Use more intensively the current financial inspection procedures.

Medium- to long-term

- The MoF should review the role of the financial controllers and the internal auditors at the spending unit level and resolve the existing overlaps.

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[29] A specific committee also has a role in controlling and providing guidance on the bidding contracts procedure in the procurement area.

[30] The mission could not meet the head of the FAA, but only two representatives of the institution. The discussion focused primarily on the role of the FAA in the internal control process.

- The MoF should plan for the gradual introduction at the MoF of an internal audit function starting by developing systemic audit at the spending unit level and defining a risk-based audit approach building on the findings and recommendations of financial inspections.

- The authorities should rethink the involvement of the FAA in the ex ante control of procurement contracts and their corresponding invoices, and these controls should be exercised by the financial controllers and internal auditors.

V. ACCOUNTING AND REPORTING

A. Key Weaknesses in the Accounting and Reporting Framework

75. **The 2011 FAD report recommended several measures for addressing the weaknesses in the accounting and reporting framework.** As there have been no further changes since the last FAD mission, almost all of its recommendations remain valid. The key weaknesses in the accounting and reporting framework are the following:

- There is no double-entry system as each financial transaction is recorded as a single entry in the cash journal. The absence of a double entry system complicates the internal consistency and integrity of accounts, including the accuracy of financial information.

- The lack of a comprehensive chart of accounts (incorporating an internationally accepted budget classification) limits the capacity of the accounting and reporting framework as an aid to financial decision making.

- The recording of financial transactions and the preparation of monthly and annual accounts rely on manual systems, leading to delay and inefficiency.

- The aggregated annual account for the budget sector is prepared with a substantial time lag and inter-entity transactions are not eliminated during consolidation.

- Both in-year and end-of-the year reporting suffer from the lack of an internationally accepted classification to facilitate economic decision making and enhance transparency and accountability.

B. Reform Priorities in the Near Term

Budget classification and chart of accounts

76. **The thrust of reforms in the next few years should be on developing and implementing an internationally accepted budget classification and its associated chart of accounts.** As far as budget classification is concerned, the focus should be to first develop (i) a hierarchical administrative (or organizational) classification; and (ii) an economic classification based on the IMF GFSM 2001. The functional classification, based on the UN COFOG, could be derived from the lowest level of administrative classification. The

administrative classification is essential for accountability purposes and identifies the organization/entity that is responsible for managing the resources allocated to it for implementing specified policy objectives, such as the ministries of education and health or, at a lower level, schools and hospitals.[31] The economic classification includes classification of revenue, expenditure, assets and liabilities and retained earnings. This classification is the basis for collecting information for economic/fiscal decision making and preparing government finance statistics.

77. **In the medium term, the authorities should consider developing an IT-based Government Financial Management Information System (GFMIS) to implement the new budget classification and chart of accounts and modernize the financial reporting system.** Governments are increasingly using GFMIS to modernize their accounting and reporting systems. A GFMIS can improve the PFM framework by (i) providing real-time financial information that managers can use to formulate budgets, and manage resources; and (ii) supporting the preparation of financial reports and statements. A well implemented GFMIS can help governments achieve effective control over public finances and enhance transparency and accountability. Therefore, it must be designed to support the function of the public sector and handle the complex structure of budget organizations as well as to ensure compliance with budget laws and public finance rules.[32]

78. **The way a chart of accounts is designed and the GFMIS configured is critical to the effectiveness of the accounting and financial reporting system.** The chart of accounts is the hub of any GFMIS. While the business/user needs analysis is a critical element to developing a chart of accounts and several underlying principles should be followed, the following issues need to be specifically considered in the context of developing the chart of accounts for a GFMIS (i) establishing one global/unified chart of accounts; (ii) using simple and basic logic and limiting the number of accounts; (iii) deciding the accounting basis—cash, accrual or in transition (from cash to accrual); (iv) understanding and using the vast functionality of modern computer systems; and (v) scalability to provide room for future growth.[33]

79. **Upgrading the budget classification should be considered itself as a basic step—indeed one of the main preconditions—of introducing a computerized GFMIS.**

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[31] D. Jacobs, J. Helis and D. Bouley, 2009, Budget Classification, *Technical Notes and Manuals*, (Washington: International Monetary Fund).

[32] A. Khan and M. Pessoa, 2010, Conceptual Design: A Critical Element of a Government Financial Management Information System Project, *Technical Notes and Manuals* (Washington: International Monetary Fund).

[33] S. Pattanayak and J. Cooper, 2011, Chart of Accounts: A Critical Element of the Public Financial Management Framework, *Technical Notes and Manuals* (Washington: International Monetary Fund).

- ***Administrative or organizational or classification*:** The mission recommends a three-level scheme for introducing an administrative classification. In Libya, the ministries and some other central authorities are at the top of the hierarchy receiving allocations from the budget. These entities should be included in the first level of administrative classification. At the second level are subordinate/affiliated agencies and/or provinces preparing and executing their budgets under the overall supervision/control of the first level entities. At the third level (or lowest level), the authorities should include organizations that receive allocations (not necessarily specified in the budget law) from the second level organizations. Each project with a dedicated budget should also be identified at this level. Since projects are managed through special organizational arrangements and have their own budgets, each of them can be seen as a subdivision of the spending unit responsible for its management. The organizational (or administrative) hierarchy and the proposed classification coding system with illustrative examples are also presented in the Table 2 below.

Table 2. Illustrative Administrative Classification for Libya

Level of organizational or administrative classification	No. of digits	Description	Illustrative Examples of the Organizational Classification Code
1st	2	Ministries or central authorities (e.g., Financial Audit Agency, General People's Congress, etc.) receiving direct allocation from the budget and subordinate to another entity except to Cabinet/Parliament	01: People's General Congress; 02: Ministry of Public Security; 03: Ministry of Justice; 04: Ministry of Finance; 05: Ministry of Health and Environment; 06: Ministry of Education and Academic Research; etc..
2nd	2	Intermediate level between a ministry (or central authority) and the lowest level administrative unit having a separate budget.	06.01: General Committee for Education and Academic Research; --------; 06.08: National Organization for Academic Research
3rd	2	Lowest level administrative unit or a subordinate budget organization having a separate budget. Projects could also be included at this level.	06.08.XX: an individual scientific research center under the National Organization for Academic Research; ---------; 06.08.YY: a capital project with dedicated budget under the National Organization for Academic

- ***Economic classification.*** It is important to appreciate that Libya would not adopt an accrual-based *GFSM 2001* (which would require full accrual accounting) in the foreseeable future, but only a classification system that is based on *GFSM 2001,* with appropriate modifications to suit the requirements of budget management and the Libyan cash accounting environment. The treatment of nonfinancial assets is a good example of such modifications. As the Libyan authorities follow cash accounting for nonfinancial assets, the purchase of nonfinancial assets should be regarded as expenditures. Also, for budget and appropriation management purposes, the purchase of nonfinancial assets must be shown as expenditures. Table 3 below shows the GFSM codes, in particular for the expenditure classification, and how they relate to current chapter-based classification used in Libya.

Table 3. Illustrative Economic Classification for Libya (based on GFSM 2001)

Sl. No.	Suggested Chapter Name	GFSM Code	Items description	Current Libya Chapter/Chapters
1	Compensation of employees	21	Salaries, wages, allowances and retirement rewards	Chapter 1 and some items of chapter 3
2	Purchase of goods and services	22	Goods, Services, including Maintenance.	Chapter 2 and some items of chapter 3
3	Interest	24	Interest payments-Domestic; and Interest payments - External	To be identified
4	Subsidies	25	Subsidies (to public corporations or bodies and private enterprises)	Chapter 4
5	Grants	26	Grants	Some in Chapters 2 and 4
6	Social benefits	27	Social security benefits, social assistance benefits, etc.	To be identified
7	Purchase of nonfinancial assets	31	Fixed assets, Nonproduced assets, Inventories, Valuables	Capital component of Chapter 3
8	Acquisition of financial assets	32	Domestic, and Foreign– (currency, deposits, lending, shares, advances)	To be identified
9	Repayment of loans and sales proceeds involving financial assets	32	Domestic, and Foreign – (e.g., currency, deposits, lending, shares, advances)	To be identified
10	Repayment of Debt	33	Domestic, and Foreign – (e.g., loan instruments)	To be identified
11	Drawdown (receipts) of Debt	33	Domestic, and Foreign – (e.g., loan instruments)	To be identified

Note: Capital expenditure is mainly included in Sl. Nos. 7 and 8. Chapters 8 to 11 are financing items.

80. **The following implementation issues are also to be kept in mind while adopting a new budget classification system in Libya:**

- The development of the new classification system, including its coding structure, should include participation of all key stakeholders, in particular, key representatives from the MoF, MoP, Ministry of Economy, and a few key line ministries/agencies. A complete census of all administrative entities[34] should be undertaken, including their nature (departmental entities, non-commercial organizations, etc.), their relationship to the budget, and hierarchical position (based on control and reporting lines) in government.

- The existing framework of budget classification regulations, procedures, instructions as well as forms and manuals used for budget preparation, execution and accounting would need be revised to reflect the new classification structure.

- It would be necessary to train the staff involved in budget preparation and execution to use the revised classification for budget management.

- The switchover from the old to the new classification should be undertaken at the beginning of a fiscal year.

81. **The current reporting system is mostly related to budget execution and does not provide comprehensive information to monitor fiscal developments.** Each first level budget organization or spending unit submits in-year budget execution reports on a monthly basis linked to their cash funding by the treasury. Separate budget execution reports are prepared for each chapter. However, there is no practice of preparing consolidated reports either for each sector or for the government as a whole—the latter showing all revenue flows (including all oil revenues, not just that part which is used to fund budgeted expenditures), all cash outflows (including those that are not necessarily appropriated through the budget) and the financing transactions.

82. **Recommendations:**

Short term

- Set up a working group led by the Budget Department, with representation from the MoF (Treasury, Budget Execution Follow-up, and Accounting Departments), the Ministry of Planning, and a few large line ministries to develop a hierarchical administrative classification and economic classification based on the IMF GFSM 2001.

- Initiate the budget preparation process for 2014 using the new administrative classification and the GFSM 2001-compliant economic classification. This would require changes to budget submission templates and the budget appropriation structure. There is no need for an independent segment on functional classification, which can be derived from the administrative classification.

[34] The mission was informed that a review of all administrative entities is currently underway to identify their budgetary status.

- Revise the structure and coding used in appropriation books (maintained by financial controllers) and cash journals to control and report on budget execution using the new classifications starting with the 2014 budget.

- Prepare a correspondence (or bridge) table to be used during the transition period (i.e., until the new classification is used in budgeting) to derive the cash-based GFSM 2001 compatible fiscal data (at the first level of GFSM 2001) from the existing chapter-based budget execution data.

- Prepare, in coordination with the MFU, fiscal outturn reports, at least on a quarterly basis to start with, using the recommended report template (see Appendix 2) to specifically monitor the key fiscal indicators. This report could be generated by using the bridge table to reclassify the existing chapter and item based fiscal data.

Medium term

- Prepare (with technical assistance) a conceptual design document for GFMIS, which should include the new budget classification and other classifications as part of its general ledger chart of accounts. If the GFMIS is to be accepted by users as the primary financial accounting/information system of the government, its functionalities need to be identified at the conceptual design stage.

- Develop a detailed action plan for the design and implementation of the GFMIS, which will be a complex and challenging reform. This plan should give sufficient attention to the need for training and capacity building of staff required to operate the system.

VI. Banking Arrangements and Cash Management

83. **Cash management reform progress has been adversely affected by the events of the revolution during 2011.** The 2011 FAD report recommended a series of actions to be taken to improve the banking arrangements and cash planning for the government. Since the last FAD mission, there has been little change in these procedures or structures either at the MoF, the CBL, or in the line ministries.

84. **The financial situation which has prevailed during the year has, however, significantly changed the attitude of officials to the importance of efficient government cash management.** Whereas previously budget and cash surpluses were the norm, the year saw the evolution of a significant budget deficit and a shortage of cash with which to pay priority expenditures. Previous assumptions that sufficient cash would always be available at each quarterly CBL settlement and that the end-year settlement would result in a transfer of surplus cash resources to the Budget Reserve Account were proved false.

85. **The Libyan government retains significant liquid financial resources but these were not available to it during 2011 to make expenditure payments as and when necessary.** For a period during the year, this was due to frozen offshore assets and the effects of the disturbances. The other primary reasons for the cash shortage, however, were unwieldy and non-transparent arrangements in place for government banking and asset management, and the lack of cash planning at the MoF Treasury Department. The knowledge that liquid assets existed has also hampered the formation of cash management techniques. These might have been used to alleviate the cash shortage situation if a well developed short-term government securities (T-bill) market had been created which was independent of CBL instruments for monetary policy operations.

86. **It is important that the government uses the current changed attitude to cash availability, and for more openness and transparency, to introduce changes to its cash management capabilities.** While some government officials feel that a return to normality will also see a return to large budget surpluses and little need for methods to alleviate cash shortages, others believe that the capital infrastructure and development needs of the country under a new government will necessitate the continuation of budget deficits for many years.

87. **These differing viewpoints highlight the uncertainty surrounding the ready availability of financial resources to meet the government's needs in the future.** In order to handle such uncertainty, processes and procedures to enable the treasury to meet its expenditure requirements in an efficient, effective, and transparent manner should be developed as soon as possible. Such processes must include the ability to plan ahead for expected cash shortages and surpluses; to satisfy the cash needs during times of shortage through drawdown of assets or efficient borrowings; and the facility to increase financial assets in times of surplus in a tightly controlled and transparent way. These processes will therefore also need to be subject to new laws and regulations.

A. Government Banking Arrangements and Payment System

88. **Government banking arrangements remain diffused and operating cash resources are dispersed across many accounts in the CBL and the commercial banking sector.** Additionally, financial assets which have built up over years of budget surpluses are in accounts and funds which are not readily available for budget purposes when required. The treasury is implementing a program to reduce the number of bank accounts at the CBL including extrabudgetary accounts by closing them and returning their balances to the respective owners. The MoF currently has drafted a letter to this effect and is awaiting government clearance to commence this program.

89. **The structure of a treasury single account (TSA) and the method for sweeping accounts have been described and recommended in the 2011 FAD report and remain valid.** It is necessary for the four treasury expenditure accounts at the CBL which conform to the budget chapter classification and the general revenue account to become sub-accounts

of a consolidated "top account." This will then form a standard TSA structure. Line ministry accounts at commercial banks and their own revenues should be swept into the TSA on a daily basis. In this way, the treasury can be sure that it knows the full extent of its available cash balances at any one time. The CBL IT systems appear to be capable of managing these structural and transactional changes although some upgrading may be necessary.

90. **As described in the 2011 FAD report, the payments system of the government is fragmented.** For Chapter 3 expenditures, invoices are paid as they are received. This operates through a type of letter of credit provided by the CBL to the commercial banks used by the line ministry. Up to the budget allocation release ceiling, payments made by the line ministries from their commercial bank accounts will be reimbursed to the commercial banks the same day by the CBL. This is an effective and efficient payment method which allows the treasury to retain its cash resources until required and provides sufficient control through budget allocations.

91. **For the other budget chapters, payments are still made to the line ministries on a block funding basis.** As budget allocations are made by the budget department on a quarterly basis, the treasury transfers cash on a quarterly or monthly basis to the line ministry commercial bank accounts before expenditure payments are required. The 2011 FAD report recommended that these expenditures should be funded in the same way as those of Chapter 3 in order to ensure that the advantages of the TSA structure (also described in that report) are captured by the treasury. This recommendation remains valid and such a change and its implications for the accounting system will be necessary prior to the implementation of a GFMIS.

92. **The operation of the treasury accounts at the CBL is through a quarterly account settlement process rather than in real time.** The treasury expenditure accounts, which fund budget chapters, are kept separately from the general revenue account. Payments from expenditure accounts are made on a debit basis leading to overdrafts as the quarter proceeds. General revenues, both oil and non-oil, are transferred on a daily basis to the general revenue account which builds up balances throughout the quarter. At the end of each quarter, transfers are made from the general revenue account to the expenditure accounts to bring them back to a zero balance. Whilst cumbersome for both treasury cash management and the CBL, these bank account activities are internal to the CBL and not considered problematic from an operational perspective.

93. **The CBL has a limit on the aggregated amount of overdrawn balances permitted in the treasury expenditure accounts.** This limit is set at 20 percent of the estimated total budget revenues of the previous year. The CBL has a control function through operation of this limit and can refuse to make payment on pre-funded chapters or provide the letters of credit to commercial banks necessary for chapter three payments. This control has been utilized in 2011 since the limit on the overdrawn expenditure accounts has been reached.

94. **At the end of each fiscal year, the balance in the general revenue account, if in surplus, is transferred to the government's budget reserve account at the CBL.** From 2006, a law has specified that savings in the budget reserve account should be transferred to the LIA for its investment management. This action occurred in 2007 and 2008, but has been intermittent since then due to investment performance difficulties at the LIA and political interventions. For these reasons, there are considerable sums of money in the Budget Reserve Account and the LIA accounts at the CBL and abroad.

95. **At the end of 2011, there were insufficient funds in the general revenue account to cover the overdrawn balances in the expenditure accounts.** This negative balance, being the aggregate of budget activities over the fiscal year, represented the budget deficit for the year. Although the transfer of a budget surplus to the budget reserve account is virtually automatic, requiring an ordinary bank transfer instruction from the MoF, transfers back to the budget from the Budget Reserve Account (or the LIA) at present require an exceptional Cabinet level decision and instruction.

96. **In addition to the sums owned by the government in the budget reserve account and at the LIA, there remain very significant amounts of money at the commercial bank accounts of the line ministries.** This issue was highlighted in the 2011 FAD report but in April 2011—the latest figures available to the mission—there was still LYD6 billion in government deposits in commercial banks. The treasury admits that large balances are still held by line ministries in these accounts as at the end of 2011. It is understood that these balances represent an array of different pools of money. Some are related to trust funds held by ministries on behalf of others (staff, dependents, and citizens' dues, etc.); others are in escrow as guarantee payments awaiting completion of projects; and some accrue from under-spent pre-funded budget allocations.

97. **The line ministries and spending units are required by the treasury to return all unspent allocations to the general revenue account at the CBL at the end of the year.** This action is being performed as evidenced by reductions in the commercial bank balances in January and February (see chart in 2011 FAD report). If the recommendations of the 2011 FAD report are implemented, this single transaction would not be necessary (since expenditures would not be pre-funded) or would take place daily (through bank account sweeping).

98. **In countries where an effective TSA structure exists, all monies at the control of the government should be contained within it and available to the treasury as fungible liquid assets.** The creditworthiness of the government should not be in question regarding its ability to repay money held in trust or in escrow. The accounting system of the government and the central bank should be sufficiently accurate and robust that owners and beneficiaries of such assets would not prefer to trust the systems of the commercial banks. The treasury should retain the power to ensure that all such sums held in line ministry

accounts are available to it and that liabilities such as payments made to others under trust arrangements are recognized in its accounting system and by law.

99. **The treasury has indicated that it will reduce pre-funding payments to line ministries during 2012 according to their commercial bank balances in order to rectify this situation.** The treasury knows the balances that line ministries hold in their bank accounts and can effect this plan operationally by underfunding the budget allocations monthly or quarterly. It is unclear, however, whether it has the legal authority to force the entities to utilize the trust and escrow funds for expenditure payments. It will be important to resolve this uncertainty since, if not, this rectifying action will lead to expenditure arrears.

100. **Thus far, the expenditures account balances at the CBL have yet to be settled although settlement is expected, following a cabinet decision, by the beginning of February 2012.** It appears that significant, although unquantified, expenditure arrears have been building up due to a bottleneck in the payments process. It is suspected, though not confirmed, that this is due to the unsettled accounts at the CBL being over the overdraft limit and, thus, allowing the CBL to hold back payments.

101. **As the overdraft limit in the expenditure accounts was reached, the treasury and the government have considered options to relieve the situation.** Borrowing through treasury bills is one option. In Libya, the major purchasers of treasury bills would need to be the public commercial banks. Without a developed government securities market in the country, recourse to borrowing through issuance of these securities would be piecemeal and probably through political persuasion rather than market-driven demand. The liquidity and solvency status of the commercial banks might be at risk if they were forced to finance the government through purchase of unmarketable treasury bills. There is also the disconcerting element that forcing these banks to invest in treasury bills would be akin to the government telling one of its arms to borrow at significant cost from the other.

102. **The alternative option for accessing funds to settle the CBL treasury accounts is to withdraw assets from the budget reserve account.** The government has decided to use this route rather than borrowing to finance the deficit. The problems and timing over such decisions would be overcome if there were in place transparent, rigid, and logical rules regulating the inflows and outflows of all the government accounts and funds. The design of the macro-fiscal framework (see Section I) which, through the use of fiscal rules, determines the fiscal balance under varying oil price environments, utilizes as its operational instrument active cash management techniques and asset-holding funds. The rules under which flows between these funds and accounts are regulated determine the budget stabilization capability and the savings element of the fiscal design.

103. **Recommendations:**

- MoF and the treasury should continue to implement the reforms recommended in the 2011 FAD report relating to banking arrangements which include: the formation of a TSA structure at the CBL; the sweeping of line ministry and spending unit account balances at commercial banks on a daily basis into the TSA; eliminating pre-funding of budget allocations for non-chapter three expenditures through greater use of centralized payments; increased use of electronic payments; and commencing discussions regarding market-related interest payments on government overdrafts and deposits at the CBL together with banking service fees payable to the CBL by the treasury.

- The treasury should continue its program to reduce the number of non-core bank accounts at the CBL.

- The MoF and the government should consider the legal implications of withdrawing trust and escrow monies from the commercial bank accounts into the TSA and perform this task once legally and operationally feasible.

- The government and the CBL should rationalize government bank accounts and asset funds (including the LIA) in order to perform adequately budget stabilization and savings roles as described above.

B. Cash Planning and Cash Management

104. **As with the government banking arrangements, little progress has been achieved on cash planning and cash management reforms since the 2011 FAD report.** The discussion and recommendations of the 2011 FAD report remain valid and should continue to serve as a guide to prioritization of these reforms for the MoF and its treasury.

105. **In conjunction with the reforms relating to the payments system and operation of the government bank accounts, the treasury needs to design a cash planning system.** This will require the building of capacity for expenditure forecasting at the MoF and the line ministries over time. As discussed in the 2011 FAD report, the treasury will need to design spreadsheet analysis of aggregate cash forecasts in order to understand the expected flows through the TSA and to analyze and correct forecasting errors. This will allow the MoF and government to be aware of imminent cash shortages and periods of cash surplus.

106. **Further to the findings of the 2011 FAD report, it has become evident that, with the sudden arrival of cash and budget deficits, active cash management is vital for government business operations as well as the needs of the CBL**. Accurate cash forecasts can serve to forewarn the treasury of the need to access short-term financing arrangements in times of anticipated shortage. Where cash surpluses are projected, it can be determined whether these will be short or long-term events. Such information can inform the treasury

managers' decisions on whether to invest these surpluses to allay liquidity risk or for longer-term management and savings.

107. **In these decisions, a crucial point of focus should be on the need for, and appropriate size of, a cash buffer to be maintained in the TSA.** It is this buffer which is the interface between the longer-term savings elements of the fiscal policy framework and the budget stabilization activities of the cash manager (see Diagram 1). The cash buffer is primarily intended to absorb forecasting errors in government cash planning. Where cash plans and forecasts can be made with a high degree of accuracy and certainty, the buffer may be very low (or even zero when there is a very deep and liquid short-term T-bill market accessible at short notice). If there is little or no confidence in the cash projections of the government and/or there is the possibility that, in times of difficulty, access to short-term financing may prove problematic, a large cash buffer is necessary to continue government operations without recourse to expenditure arrears.

108. **In countries where budget deficits are the norm, the primary interface of the cash buffer is with the government securities markets for short-term financing.** Conversely, in natural resource-rich countries such as Libya, where the medium-term fiscal framework shows that a prudent policy of budget surpluses is to be followed, the interface will be with the stabilization and savings vehicle—the SWF. As discussed in detail in Section II, the SWF/TSA interface must be strictly controlled and operate under transparent inflow and outflow rules. These rules will be based on a number of parameters which allow for the size of the cash buffer, a short-term liquidity element to protect and stabilize the budget under volatile adverse movements in oil prices, and the desired level of longer-term savings for intergenerational needs and natural resource depletion concerns.

109. **Recommendations:**

- The MoF and treasury should continue to implement the reforms recommended in the 2011 FAD report relating to cash flow forecasting.
- The T-bill market should be developed over the medium-term to enable cash management activities for in-year cash shortage relief.
- The treasury should commence a program to build capacity at the MoF and the line ministries to produce and analyze aggregate cash forecasts in order to produce an expected profile of the TSA balance in the year ahead.
- The treasury should analyze the volatility of errors in the cash forecasts with the objective of determining the necessary size of a suitable cash buffer to be held in the TSA in order to absorb the impact of adverse forecasting errors.

Appendix 1. Fiscal Frameworks for Hydrocarbon Intense Economies[35]

Permanent income hypothesis. Using a welfare-based approach, the standard PIH strategy suggests that consumption should be smoothed over time. To be sustainable, expenditure should be limited to the annuity value of expected future revenues. This entails upfront borrowing when permanent income from natural resources exceeds actual resource revenue, but saving and accumulating assets when actual revenue exceeds the permanent income (e.g., Barnett and Ossowski, 2003). A more conservative strategy is to only spend the return on resource revenues accumulated in a fund. Both strategies have the effect of transferring much of the consumption increment to future generations. However, in countries like Libya the marginal social value of an incremental dollar spent today is higher than in the future and capital scarcity implies that the rate of return to capital is likely to be high. It is therefore optimal to invest more resource revenues domestically "to bring forward the development of the economy" (van der Ploeg, 2011).

Non-resource balance. In this case a fiscal balance excluding, fully or partially, hydrocarbon related revenue would be targeted. In some cases only the "normal" hydrocarbon related revenue is spent. In addition to insulating fiscal policy from the volatility of resource revenue, non-resource balance targets can be determined by short-term demand management considerations. Alternatively, model-based scenarios (e.g., from DSGE models) can be used to determine policy targets in line with absorptive capacity and longer-term projections. The inherent complexity of these frameworks makes it difficult to explain to the broad population.

"Structural" balance rules. In this case only the "structural" component of hydrocarbon related revenue is spent every year. This approach deals explicitly with hydrocarbons price volatility and, in principle, ignores exhaustibility issues and changes in hydrocarbons production volumes. The "structural" component of revenues can be independently estimated through formulas or an independent committee as in Chile. A variety of price formulas can be used, including a moving average of past prices, or a moving average of both past and futures (markets) prices as in Mexico and Trinidad and Tobago. The latter would make the rule more credible by reducing the gap between the current and the formula prices. The choice of the "structural" target can incorporate long-term sustainability considerations by, for example, targeting a "structural" surplus rather than a balance which would result in savings over time to provide for some intergenerational equity. By contrast, scaling up objectives within this framework could be accommodated by specifying less ambitious targets or paths as informed by absorption capacity analysis.

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[35] Based on Fiscal Frameworks for Natural Resource Intensive Developing Countries, Bausngard et.al. (2012), IMF, forthcoming.

Expenditure growth rule. This rule would limit the growth of government spending in nominal or real terms or in percent of non-hydrocarbon GDP. The advantage of such a rule is its visibility and that it can be related to the economy's absorption capacity making it attractive for scaling up objectives. However, this approach neglects revenue developments, like tax revenue cuts or increases; therefore, it can be more effective if it complements an overall balance rule (like in Peru) or a "structural" rule (as in Mongolia).

Appendix 2. Medium-Term Fiscal Framework

An MTFF translates the government's medium-term fiscal policy intentions into macro-fiscal aggregates taking into account the available resource envelope. The aim should be to demonstrate that fiscal policies are capable of achieving the development goals set by the society while choosing the desirable path for using hydrocarbon revenue across generations. The MTFF would initially set the macro-fiscal aggregates for the coming three years, with particular attention to the next financial (budget) year (see Table 1). Over time, as it becomes well established in Libya's policy formulation, it will also be used to established key sectoral strategies and objectives (in line with the development plan). The size of the budget and its resource components—hydrocarbon and non-hydrocarbon revenues—would be defined at this stage along with the new policy measures (e.g., the annual wage increase). The MTFF should be translated into a fiscal strategy document that explains the underlying logic behind the global expenditure envelopes, based on the government's priorities, and the projected revenue path. It will also discuss financing issues including how would deficits be financed (e.g., drawdown on the budget reserve account deposits, government securities) or how will surpluses be allocated (e.g., increase the budget reserve account deposits, transferred to LIA). It should also outline existing uncertainties and risks.

The MTFF is an iterative exercise comprising four main elements: (i) aggregate oil and non-oil revenue forecasts; (ii) aggregate expenditure forecasts based on existing policies (representing a "baseline" or "passive" no change in policy scenario), but adjusted for expected changes in macroeconomic conditions as appropriate (such as prices or GDP growth); (iii) the estimated baseline fiscal surplus/deficit ("fiscal balance") generated by the forecasts for each of the three years, including its impact on the contingency reserve or Budget Reserve account; and (iv) the desired level of the (non-oil) fiscal balance which will determine the fiscal stance or impact of fiscal policy on economic activity. The latter should be consistent with the medium and long-term objectives as established in the overall policy framework which would include, among other things, economic stability, growth, intergenerational equity and fiscal sustainability considerations and determined by the MTFF/Fiscal Strategy document. Both revenue and spending should be broken down into items that are linked to macroeconomic developments or are of macroeconomic significance (see Table 1) and any policy changes should be factored in at this stage (e.g., taxes, wage increases, and development spending). A GFSM 2001 compliance presentation is provided in Table 2 together with the correspondence (or bridge) linking it to the transitional presentation suggested in Table 1. This will allow deriving the cash-based GFSM 2001 compatible fiscal data (at the first level of GFSM 2001) from the existing chapter-based budget execution data.

Importantly, MTFF should analyze the consistency between the baseline projections used as baseline (representing a no change in policy scenario) with the spending envelope implied by the fiscal rule adopted as part of the policy framework. If the MTFF spending is below that obtained applying the fiscal rule, there is "fiscal space" available to, potentially, be used on further priority reforms. Any shortage would require spending consolidation or revenue increases for fiscal policy to be consistent with the overall policy framework.

The MTFF should therefore be consistent with the government objectives established in the fiscal framework and any fiscal rules associated with it. The elaboration of the MTFF will require cooperation and coordination with other departments within MoF and external agencies to establish the mechanisms for obtaining the relevant information such as size and composition of government deposits from the CBL or actual revenues and expenditures from the treasury department.

Appendix Table 1. Hypothetical Medium-Term Fiscal Framework

		Actual	Preliminary	Budget	Projection		
		2010	2011	2012	2013	2014	2015
[1.1] + [1.2] = [1]	Total revenue	125	26	116	158	190	162
[1.1]	Hydrocarbon revenue	100	10	90	120	140	110
[1.2.1] + [1.2.2] +[1.2.3] = [1.2]	Non-hydrocarbon revenue	25	16	26	38	50	52
[1.2.1]	tax revenue	15	10	16	24	30	31
[1.2.2]	nontax revenue	8	5	9	13	16	17
[1.2.3]	capital revenue	2	1	1	1	4	4
[2.1] + [2.2] + [2.3] = [2]	Total expenditure	79	71	97	108	114	119
[2.1.1] + [2.1.2] + [2.1.3] + [2.1.4] = [2.1]	Current expenditure	52	63	75	82	85	88
[2.1.1]	Wages	20	30	35	38	40	43
[2.1.2]	Goods and services	14	10	15	17	20	22
[2.1.3]	Subsidies	18	22	24	26	24	22
[2.1.4]	Interest	0	1	1	1	1	1
[2.2]	Capital expenditure	25	5	19	24	27	30
[2.3]	Net Lending	2	3	3	2	2	1
[1] - [2] = [3]	Overall balance	46	-45	19	50	76	43
[1.2] - [2] = [4]	Non-hydrocarbon balance	-54	-55	-71	-70	-64	-67
[3] + [5] =	Discrepancy between overall balance and financing	2	-22	10	8	0	0
[5.1] + [5.2] + [5.3] = [5]	Financing	-44	23	-9	-42	-76	-43
[5.1.1] + [5.1.2] = [5.1]	Domestic	-49	15	-12	-48	-85	-54
[5.1.1]	Change in cash and deposits 1/	-50	7	-15	-49	-88	-57
	of which:						
[5.1.1.1]	Budget Reserve account	-26	5	-14	-26	-60	-30
[5.1.1.2]	LIA	-22	0	0	-18	-17	-25
[5.1.1.1] + [5.1.1.2] = [5.1.2]	Domestic borrowing (net)	1	8	3	1	3	3
[5.1.2.1]	Loans	0	8	1	0	1	1
[5.1.2.2]	Government bonds	1	0	2	1	2	2
[5.2]	External borrowing (net), loans	2	4	1	0	1	1
[5.3]	Privatization proceeds	3	4	2	6	8	10

1/ A minus sign represents increase in deposits

Appendix Table 2. Hypothetical Medium-Term Fiscal Framework - GFSM 2001 Presentation

Bridge from MTFF Table 1			Actual 2010	Preliminary 2011	Budget 2012	Projection 2013	2014	2015
[1.1] + [1.2.1] + [1.2.2]	[a]	Total revenue	123	25	115	157	186	158
[1.1]	[a.a]	Hydrocarbon revenue	100	10	90	120	140	110
[1.2.1] + [1.2.2]	[a.b]	Non-hydrocarbon revenue	23	15	25	37	46	48
[1.2.1]		tax revenue	15	10	16	24	30	31
[1.2.2]		nontax revenue	8	5	9	13	16	17
[2.1]	[b]	Expense	52	63	75	82	85	88
[2.1.1]		Compensation of employees	20	30	35	38	40	43
[2.1.2]		Purchase of goods and services	14	10	15	17	20	22
[2.1.3]		Subsidies	18	22	24	26	24	22
[2.1.4]		Interests	0	1	1	1	1	1
	[a] - [b]	Gross operating balance	71	-38	40	75	101	70
	[a.b] - [b]	Gross non-hydrocarbon operating balance	-29	-48	-50	-45	-39	-40
[2.2] - [1.2.3]	[c]	Net acquisition of nonfinancial assets	23	4	18	23	23	26
	[d] = [a] - [b] - [c]	Net lending (+)/borrowing(-)	48	-42	22	52	78	44
	[d] -[a.a]	Net non-hydrocarbon lending (+) /borrowing(-)	-52	-52	-68	-68	-62	-66
	[d] - [e] + [f]	Discrepancy between net lending/borrowing and total	2	-22	10	8	0	0
	[e]	Net acquisition of financial assets	49	-8	16	45	82	48
		Domestic	49	-8	16	45	82	48
-([5.1.1] - [5.1.1.2])		Currency and deposits	28	-7	15	31	71	32
[2.3]		Loans	2	3	3	2	2	1
-([5.1.1.2] + [5.3])		Equity and investment fund share	19	-4	-2	12	9	15
		Foreign	0	0	0	0	0	0
	[f]	Net incurrence of liabilities	3	12	4	1	4	4
		Domestic	1	8	3	1	3	3
[5.1.2.2]		Debt securities	1	0	2	1	2	2
[5.1.2.1]		Loans	0	8	1	0	1	1
[5.2]		Foreign (loans)	2	4	1	0	1	1

Appendix 3. International Experience on SWFs

Appendix Box 1. SWFs in Resource-Dependent Countries

I. SWFs with stabilization objectives

Chile's Economic and Social Stability Fund (FEES, 2006) was created by the Fiscal Responsibility Law as part of reforms that institutionalized the operation of a structural balance rule for fiscal policy formulation and implementation. It replaced a price-contingent copper stabilization fund. The FEES receives as inflows the actual central government surplus (net of contributions to the Pension Reserve Fund and to the recapitalization of the central bank). Its funds can be drawn on if desired, according to needs defined in the annual budget law. The FEES accrued substantial financial assets until 2008 as Chile ran large fiscal surpluses, given a substantial increase in copper prices relative to the long-term copper prices used in the calculation of structural mineral revenue and in the determination of the structural balance. Subsequently, Chile has withdrawn resources from the FEES to finance fiscal deficits deriving from a fall in actual copper prices and fiscal stimulus packages during the crisis.

Mexico's Oil Revenue Stabilization Fund (FEIP, 2000) has inflows from a special levy on oil revenues and 40 percent of excess oil revenues relative to the budget oil price. The fund's balance is capped; once the upper limit is reached, any excess revenue is earmarked for various spending initiatives. The resources of the fund can be used to compensate for a decrease in estimated income, up to a limit of 50 percent of the fund's balance at the end of the previous year. Given that Mexico has run overall deficits, it has had to borrow to finance transfers to the FEIP.

Algeria's Revenue Regulation Fund (RRF, 2000) receives residual hydrocarbon revenue on top of the budget price, as well as exceptional advances by the central bank for debt amortization. Its resources can be used to finance the budget if actual hydrocarbon revenue is less than budgeted or to reduce national debt. No withdrawals are allowed if the balance falls below US$10 billion. The accumulation of deposits at the RRF was not transparent during the recent boom in oil prices. The government bypassed the provision to deposit revenues above the ones implied by conservative oil prices by issuing debt that was subsequently repaid by the fund. More recently, the government has withdrawn resources from the RFF to cover part of the fiscal deficits.

Russia's Reserve Fund (RF, 2008) was established from part of the resources of an oil stabilization fund. Oil and gas revenue in excess of the budget allocation is deposited in the RF until its balance reaches 10 percent of GDP (excesses are to be transferred to a savings fund). RF assets can be withdrawn to cover financing needs in the case of oil and gas revenue shortfalls. Its assets can also be used for early debt repayments. Since its establishment, the RF has been gradually depleted (it amounts to less than 1 percent of GDP now compared to 10 percent of GDP in 2008) as the non-oil balance has been much higher than oil revenue.

Appendix Box 1. SWFs in Resource-Dependent Countries (concluded)

II. SWFs with savings objectives

Norway's Government Pension Fund Global (GPF-G). GPF-G is the new name of the Government Petroleum Fund, which was created in 1990 as a fiscal policy tool to support the long-term management of exhaustible petroleum revenues (proven petroleum reserves at end 2009 would last less than 15 years at current production levels). The GPF-G supports the implementation of a fiscal guideline introduced in 2001 that hold the structural non-oil central government deficit over time to 4 percent (equal to the expected long-run rate of return in real terms) of the assets in the GPF-G. The guideline is quite flexible as temporary deviations are permitted over the business cycle or in the event of large changes in the value of the GPF-G (to reduce the pro-cyclicality embedded in the guideline's formulation). The name of the Norwegian SWF does not imply an earmarking of its resources to pension liabilities (or any other purpose); the name change was just part of a broader pension reform, highlighting the GPF-G's role in meeting the rapid rise in public pension expenditure over the long term. GPF-G's inflows consist of all state net petroleum revenues transferred from the budget, while it transfers back to the budget the sum needed to cover the non-oil budget deficit (as measured in the final budget revision late in the year). Therefore, the net allocation (withdrawal) to (from) the GPF-G largely reflects the overall budget surplus (deficit). Norway has recorded fiscal surpluses of around 5 percent in recent years, down from the double digits recorded during the oil price boom in 2005-08. Hence, deposits into the fund have continued, but the value of total assets has recorded large fluctuations due to the recent swings in global equity prices and exchange rates.

Pension Reserve Fund in Chile (FRP). This fund aims at meeting future pension costs. For that purpose, it receives annual contributions from the budget of 0.2 percent of GDP irrespective of the fiscal balance, and up to 0.5 percent of GDP if there are fiscal surpluses exceeding 0.2 percent of GDP. The government has had to borrow to make contributions to the FRP in recent years given overall fiscal deficits, but the mandatory contributions to the fund are low.

Alaska's Permanent Fund (1976) receives 50 percent of mineral revenues (up from 25 percent in 1980). It pays annual dividends to the population based on a fraction of the fund's realized earnings, as a safeguard against pressures to spend the oil revenue. In practice, the dividends have come to be seen as entitlements, and the government has borrowed substantially at times to finance increased spending. This debt accumulation runs against the intended intergenerational transfer of resources.

Fund for Future Generations (FFG). Several countries, including Gabon (FFG) and Kuwait (RFFG), have created FFGs financed by a fraction of annual oil revenue (between 10 and 25 percent). The use of the funds' resources is relatively general, including (despite the funds' title) for discretionary transfers to the budget. In the case of Gabon, this can happen only when the fund's balance surpasses a certain threshold. The allocation of a large fraction of oil revenue to the RFFG in Kuwait has been smooth as the government has recorded very large overall surpluses. In Gabon, this has not always been the case as fiscal surpluses have been much smaller than in Kuwait.

Appendix Box 2. A SWF for Domestic Development: International Experience

Development support by SWFs (in most cases explicitly named Development Funds) can be categorized in two groups: extra-budgetary spending and provision of transaction support.

Extra-budgetary spending

Alberta's Heritage Fund stopped direct economic development and social investments in 1997 (notably after a survey of the public on their preferences), retaining its objective of funding priority social projects by providing government with sustainable income rather direct investments. In the *Russian Federation* and *Kazakhstan*, resources from SWFs were used to support domestic financial systems through third parties (a development bank and a distressed asset fund). The investment rules of the SWFs were changed to allow them to acquire sizable long-term deposits and bonds of those government entities. Although helping to address critical policy needs, these investments directly exposed the balance sheets of SWFs to the risks of the government interventions and potential quasi-fiscal losses.

Transaction support

Such operations can span several modalities: provision of guarantees, loans or subsidies, or direct equity investments in domestic public and private companies.

- **Provision of guarantees, loans, or subsidies**. The oil stabilization fund in *Iran* is mandated to set aside 50 percent of its reserves for low interest-rate in foreign exchange lending to private domestic entrepreneurs in priority sectors. The operations of the fund are regarded as non-transparent and there is little information on investment performance. The *Venezuelan* Investment Fund provided continuous transfers and cash injections in state electricity companies and took equity stakes in loss-making manufacturing firms. The *Alberta* Heritage Fund earlier provided low-interest financing to state firms. Investments were undertaken outside the standard budget process with little transparency. This activity became the largest component of the fund, and most of the loans were written off.

- **Equity investments.** There have been some successes in this area, but also examples of opaque governance and financial losses. *Singapore's* Temasek and *Malaysia's* Khazanah both report long histories of favorable returns. Both are long-established investment funds—Temasek was formed in 1974 and Khazanah in 1993—with highly-developed institutional capacity and investments diversified across industries and sectors, both domestically and externally. Neither appears to invest directly in infrastructure projects, but rather in construction, transport, and logistics companies that execute these. In *Dubai,* this model ran into problems in 2009, when the government investment fund, Dubai World, and its real estate development arm, Nakheel, were forced to declare a standstill in payments on $26 billion of debt. This reflected, in part, the global financial crisis and heightened market tensions, including linked to Dubai's booming property market, but also issues of questionable investment decisions, clarity of governance, and transparency.

Appendix 4. Illustrative Budget Preparation Timetable

While the following timetable may be suitable for Libya (beginning in 2013), the exact dates are only an illustration, and modifications may be needed to suit the country's situation and government preferences. Also, because the government is still engaged in the preparation of its first budget, for 2012, the timetable suggested below would have to be substantially foreshortened in order to be applicable to the preparation of the budget for 2013. However, even if some of the steps will need to be compressed, the government should prepare the budget for 2013 along similar lines, and then follow the full calendar for the preparation of the 2014 budget and all subsequent ones—adjusting dates and deadlines according to experience and ministries' feedback but not reducing the process to less than months—from issue of the circular to budget approval.

February-March	Preparation of the macroeconomic and fiscal framework by the Ministry of Finance (MoF); presentation to parliament for information and general debate; approval by government, including the indicative expenditure envelopes for each ministry and agency
April 1	Issue of the budget circular by MoF
June 1	Submission of ministries' budget requests to the MoF
June-July	Budget negotiations with each line ministry/agency
August	Review by MoF, in consultation with ministries of planning planning and economy, and submission of preliminary draft budget to Council of Ministers
September	Review of preliminary draft budget by Council of Ministers; updating of macroeconomic and fiscal framework by MoF
October 1-15	Finalization of draft budget and presentation to Parliament
Oct 15-Nov 15	Review by parliamentary committees; public hearings
Nov 15-Dec 15	General debate in Parliament
By Dec 31	Formal budget approval by Parliament

If the budget has not been formally approved by Parliament before the start of the new fiscal year on January 1, normally the executive may be authorized in the public finance legislation to continue spending at a maximum rate of 1/12 the budget of the previous fiscal year. This practice is to be strongly avoided, and reserved to extraordinary circumstances. If it is allowed to become a habit, the credibility of the budget process is jeopardized and the implementation of government programs and public services severely damaged. However, a "supplementary" budget (package of budget amendments) is almost certain to be necessary during the fiscal year and would be presented to Parliament for approval based on procedures similar but expedited compared to those for approval of the annual budget.

Appendix 5. Content of a Budget Preparation Circular

The budget circular, prepared and issued by the ministry of finance, contains the information needed by each line minstry and agency to formulate its budget proposals, as well as the instructions on how to do so. It launches the budget preparation process by the ministries and agencies, after the basic macroeconomic projections have been completed and endorsed by the CoM.

The level of detail will vary from country to country, depending mainly on data availability and consideration of administrative capacity, but even if in a tentative and general manner at first, the budget circular should contain:

- a statement of government policy priorities, both national and for each sector respectively.
- the major economic parameters (expected inflation rate, employment, exchange rate, oil price, etc.
- a statement of the macroeconomic targets and projections (the tables summarizing the macroeconomic framework could be appended to the circular).
- indicative expenditure amounts available to each ministry/agency.
- the guidelines for the budget requests from each ministry/agency, and other instructions—e.g., maximum personnel posts, rules to prevent reclassification, etc.
- the prescribed uniform format of the budget requests—consistent with the expenditure classification and to be followed strictly.
- the timetable of budget preparation and the deadline for presenting the budget request.

As experience is gained and capacity grows, the substance and level of detail in the budget circular will progressively increase, thus facilitating the improvement of the ministries' budget requests and the overall efficiency of the budget.

Appendix 6: Outline Structure for a Budget Strategy Paper (BSP)

BSPs are typically organised around three main elements: (i) the macroeconomic outlook and medium-term macroeconomic forecast; (ii) medium-term fiscal policy and management; and (iii) medium-term spending plans and priorities. The main features of each of elements are set out below.

Macroeconomic Outlook	▪ review of underlying macroeconomic conditions and challenges – global, regional and national; ▪ macroeconomic outturn for the previous year, analysis of recent trends, identification of key macroeconomic policy and management issues; ▪ updated macroeconomic forecast for the current year and medium-term forecast for the coming three years; ▪ implications for economic and fiscal policies and strategies; and ▪ analysis of key macroeconomic risks, sensitivity analysis and mitigation strategies.
Fiscal Policy and Management	▪ a summary of fiscal developments, covering broad fiscal aggregates for recent years and medium-term forecasts; ▪ an assessment of the extent to which fiscal performance in the budget year just completed was consistent with fiscal policy; ▪ an analysis of the key fiscal and macroeconomic problems which fiscal policy needs to address (e.g., recessions, debt levels, high future spending requirements, etc.); ▪ fiscal objectives and how they relate to the key challenges facing fiscal policy; ▪ fiscal targets for both the short and medium terms, an explanation of the relation of the budget to the fiscal targets; and ▪ a discussion of any short-term departure from medium or longer term fiscal objectives (e.g., a temporarily high deficit as a result of a recession), with an explanation of how the government proposes to move back to compliance with its fiscal objectives.
Public Spending Priorities and Provisional Resource Allocations	▪ analysis of recent trends in public spending by economic item and by sector; factors driving major trends and changes (policy factors, inertial factors etc.); ▪ identification of key expenditure policies to be addressed over the medium-term (e.g., high levels of wage bill spending crowding spending on service operations and maintenance); ▪ key government policies and priorities that will impact significantly on resource allocations between major sectors and programs, funding requirements and how requirements can be met from within the available fiscal space; ▪ resource allocation implications covering both on-going expenditure commitments and initiatives (implicit priorities) and new requirements linked to stated government policy priorities (explicit priorities); ▪ identification of priority sectors in which spending will need to be increased significantly, sectors where emphasis should be on consolidation of functions and containing expenditure; sectors in which there is significant scope for efficiency savings; and ▪ indicative resource ceilings for each major sector and major spending program.

Appendix 7. Comparison of Expenditure Control Practices

Libya Practices	International Practices
1. *Purchase order* is sent to supplier by SU. No prior budget commitment is issued, however a copy of the purchase order is sent to the Financial Controller and internal auditor. The purchase order is informally checked against available funds (budget authorization). If funds are not available, no procedure automatically stops the process and an arrear may be generated.	1. *Purchase order* cannot be issued unless a prior budget commitment has been issued. Financial controller has to clear the commitment against the availability of a budget allocation. If budget allocation is insufficient, clearance is denied and the purchase order cannot be sent to the supplier by the SU. No arrear is generated.
2. Goods and services are delivered and verified. Then a *payment request* is sent by SU with a check to supplier. These documents are sent to the Financial Controller (and internal auditor) for control, approval and signature. The Financial Controller checks the payment request against the budget allocation and if a portion of the allocation is available to finance the payment, the payment request becomes a payment order and he signs the check accordingly. He verifies the available allocation in the "Appropriation book."	2. Goods and services are delivered and verified. The *payment request* with a check to supplier is sent to financial control. The payment is necessarily authorized through: (i) the budget allocation preempted earlier by the previous commitment, and (ii) the *outstanding commitments* (already issued and related to other purchase orders). The principle of this control system, called *commitment control system*, is to prevent new commitments being initiated without taking into account the budget allocation available and previous commitments regardless of expenditures already paid. In practice, some flexibility is introduced in order to take into account lags in the spending.
3. The Financial Controller sends the payment order and the check to the SU financial department for payment.	3. Same practice
4. The Financial Controller reports on the "Allocation book" the payment order and the so-called commitment only when a payment is rejected for whatever reason. Once payment is made, the commitment is exhausted.	4. Commitment is recorded before expenditure is incurred and booked in dedicated columns before the payment order is issued. Once the latter is done, the corresponding commitment is exhausted and cleared (deleted).

Appendix 8. Ministry of Planning Functions (related to PFM)

The functions of a Ministry of Planning would normally include, among others:

- formulation of the country development strategy, including development of related sectors (in cooperation with respective sector ministries) and the poverty reduction strategy;

- setting investment project preparation guidelines and appraisal methodologies;

- formulation of the public investment program and development of sector strategies (in close cooperation with the MoF to ensure their affordability as well as consistency with overall macroeconomic objectives/targets); and

- capital development project monitoring and evaluation (particularly of large investment projects).