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Local Public Finance in Libya: Learn to Walk before You Run

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Abstract:

Libya is a unitary state, with the central government in the capital Tripoli. The legal framework in Libya delegates a huge number of expenditure areas to the municipalities, but in reality the municipalities do not offer this huge number of public services to the people due to capacity deficits in local administration, fiscal deficits (low volume of revenues as well as unpredictable revenue flows) and a lack of political willpower. For this reason, the paper provides six detailed recommendations for the future concept of the local public finance system in Libya.

JEL Classification: H7, G20, R10

Keywords: Libya, local public finance, intergovernmental finance system.

1 The findings, interpretations, and conclusions expressed in this paper are entirely those of the author. They do not necessarily represent the view of the ILPF GmbH or CBS Business School. An earlier version of this paper was provided in July 2019 as "Options for Reforming the Intergovernmental System as well as the Local Public Finance System in Libya" for USAid Libya.

1 Introduction

Libya is a unitary country, with the central government in the capital Tripoli, 22 districts, and 121 municipalities. The number of municipalities has already increased over the last few years, because – based on law 59 / 2012, in combination with decree number 180 / 2013 and decree number 540 / 2013 – the central government generated a total of 99 new municipalities. Those original 99 municipalities were split up further by the central government in several stages to create a total of 112 municipalities by July 2014. Nowadays there are 121 municipalities, 118 of which are already established, whilst three additional municipalities are in the process of being founded.

In the years 2013 and 2014, around 85 municipal councils were effectively elected under the supervision of the Central Committee for Municipal Council Elections, and in those municipalities where no elections were conducted, ad hoc local councils, inherited from the revolution period in 2011 and selected by popular acclamation or through other non-official electoral processes, remained in place.[2]

Libya had more than 6.7 million inhabitants[3] in 2018 and an exact distribution between the 121 municipalities is located in the appendix. The expenditure assignment of the municipalities in Libya is twofold. On the one hand, the legal framework for decentralisation is mainly law 59 / 2012, and article 25 of the respective law has listed a number of expenditure areas, which are fully presented in the appendix. On the other hand, the majority of the municipalities are only acting as an agent for the central government, in issuing identification cards, for example, or doing simple works like cleaning the public parks or taking care of street lighting. In some areas, such as water utilities, there are special purpose public entities which work independently and away from any municipal control.[4] The so-called municipal guard, which is responsible for example for the local markets, collects the market fee without any municipal supervision[5] and is an agent of the national Ministry of Local Government (MoLG).

[2] See UNDP, 2015, page 11.

[3] The World Bank has reported 6.3 million people for 2017, see World Bank, 2019, page 1.

[4] It must also be considered that the Great-Man-Made-River-Project (GMMRP) is the biggest central water supplier in Libya, and for this reason, the decentralised water supply is quite a tricky task, and the municipalities can only collect some user fees. On the other hand, it must be borne in mind that the Libyan population does not have a high tax morale, because historically, no fee at all was charged for such basic services.

[5] In April 2019, decree number 56 / 2019 was issued, and in article 19 of the respective decree, it was postulated that the mayor of the municipality should supervise the Municipal Guards and determine the decision of the Minister of Local Government on the link between the municipal guards and the municipality, and the communication system between them. However, as in various other areas in Libya, there is a huge discrepancy between the law and its practical implementation in the municipalities.

To summarise the expenditure level, the legal framework delegates a huge number of expenditure areas – housing, planning, roads, basic health, securities, permits, water utilities, electricity – to the municipalities, but in reality the municipalities do not offer this huge number of public services to the people, because of capacity deficits of the local administration (knowledge as well as equipment), fiscal deficits (low volume of revenues as well as unpredictable revenue flows) and a lack of political willpower.

Another huge weakness in the intergovernmental framework in Libya is that the municipalities are not mandated to collect taxes or to receive in reality any fixed portion of national taxes. Apart from a small amount from user fees, the municipalities have only vertical transfers from the central government as their sole source of revenue. The following table explains the structure of these vertical grants from 2013 until 2018 based on the value per citizen[6] in US-dollars[7]:

	2013	**2014**	**2015**	**2016**	**2017**	**2018**
Wage reimbursement	3.6 US-$	3.0 US-$	2.7 US-$	3.7 US-$	3.6 US-$	10.8 US-$
Funds for local expenditure	60.5 US-$	30.2 US-$	15.1 US-$	18.3 US-$	21.5 US-$	12.1 US-$
Funds for local investments	24.2 US-$	241.9 US-$	72.6 US-$	0 US-$	0 US-$	0 US-$

Table 1: Vertical grants from the central government from 2013 until 2018 (own calculation based on law 13 / 2014 and budget plans of central government, mainly from the budget plan of the MoLG for 2013 to 2018)

The allocation factor of the wage reimbursement fund is the salary structure of the municipalities. The local employees are hired and fired by the MoLG and the MoLG transfers the exact salary amount to the municipalities and the municipalities pay out the salary. For this reason, this fund could be called a zero sum game for the municipalities, because they cannot influence the personnel structure themselves, and they

[6] For the calculation a total population of 6.2 million people was used for every year, which is the median of these respective six years.

[7] The average exchange rate used for the period was 1 Libyan Dinar = 0.75 US-Dollar.

are again acting only as an agent of the central government. This situation is an extreme violation of the principle of administrative decentralisation.[8]

The funds for local expenditure and local infrastructure are supposed to be distributed between the municipalities based on the three indicators population, geographical area, and a lump sum. However, neither the exact basis of data nor the exact calculation are published by the MoLG, and the transfer system could therefore be described more as an ad hoc system, which creates a lot of negative potential for political pork barrelling.

Moreover, the municipalities also have the problem of a time lag in the availability of the resources. In 2018, for example, the first allocation of the fund for local expenditures was released in September and October.

In combination with the low fiscal autonomy of the municipalities already presented, local expenditure is dependent on federal revenue transfers that leave little room for any freedom of fiscal policy. Unfortunately, a low quality of education and health services leads to low living standards, and their improvement is the key to raising the economic prospects of the municipalities in Libya. Only well educated people with a sound public service delivery are able and willing to pay taxes, because both tax morale and the tax ratio in relation to GDP[9] – only 1.5% in 2018[10] – are extremely low in Libya.

2 Local public finance and intergovernmental transfer around the world

The decentralisation of expenditure and public functions is only "one side of the coin" of fiscal federalism. A key question is also how this delegation is to be financed and how independent the subnational and local authorities are to be in their provision of public goods and services.

The Anglo-Saxon countries like Canada, the USA and the United Kingdom provide their local authorities with a very extensive system of property taxation. A local property tax has the advantage that a direct link between the benefit and cost of the public goods can be established. This direct link between the preferences of the citizens in

[8] In administrative decentralisation, the central government gives regional and local authorities the right to provide and manage public goods under their own full responsibility. For example, the local units are allowed to hire and fire their employees or to offer a particular level of child care.

[9] GDP in Libya was estimated to be 43.6 billion US dollars or 69.32 billion Libyan dinars in 2018.

[10] The total public revenues in Libya amounted to 35.9 billion Libyan dinars (LYD) in 2018, made up of 33.5 billion LYD from oil revenues and 2.4 billion LYD from non-oil revenues. The non-oil revenues themselves divided into 1.1 billion LYD of tax revenue, 0.4 billion LYD in customs revenue, and 0.9 billion other revenues. Source Central Bank of Libya, 2018, pages 61–62.

terms of local public goods and the policy makers who have to provide the local public goods, cannot be created by grants or transfers.

Besides a local property tax, several European countries – namely Switzerland, Belgium, Croatia and the Scandinavian countries – give significant tax autonomy to their local authorities and therefore a local surcharge on the personal income tax is common.

A third possibility for financing local authorities has been chosen by Austria, Bolivia, Germany, Pakistan and Poland, who have developed local tax systems with their own revenues as well as tax-sharing. The following three figures summarise the different local taxation concepts, as well as the pros and cons of tax sharing and local tax structures around the world:

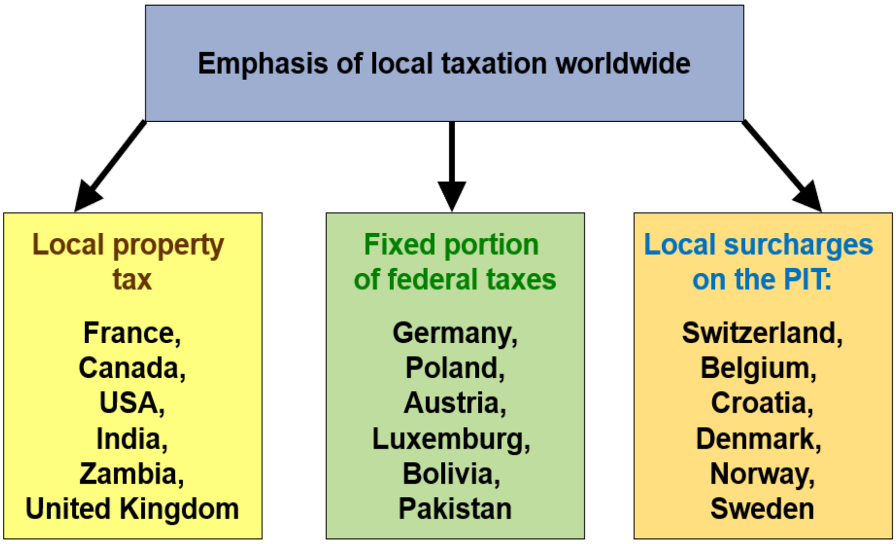

Figure 1: Options for local taxation (Werner, 2019)

	Tax sharing	Own revenues
Pro	❖Stable revenues, because the taxes are not strongly affected by economic fluctuation ❖Common tax for all tiers of government	❖High revenue autonomy and direct link to the local accountability ❖No political pork barrelling possible
Con	❖No revenue autonomy and for this reason a low local accountability ❖ lower transparency	❖No stable revenues flow ❖Administration issue

Figure 2: Pros and cons of tax sharing and own revenues (Werner, 2019)

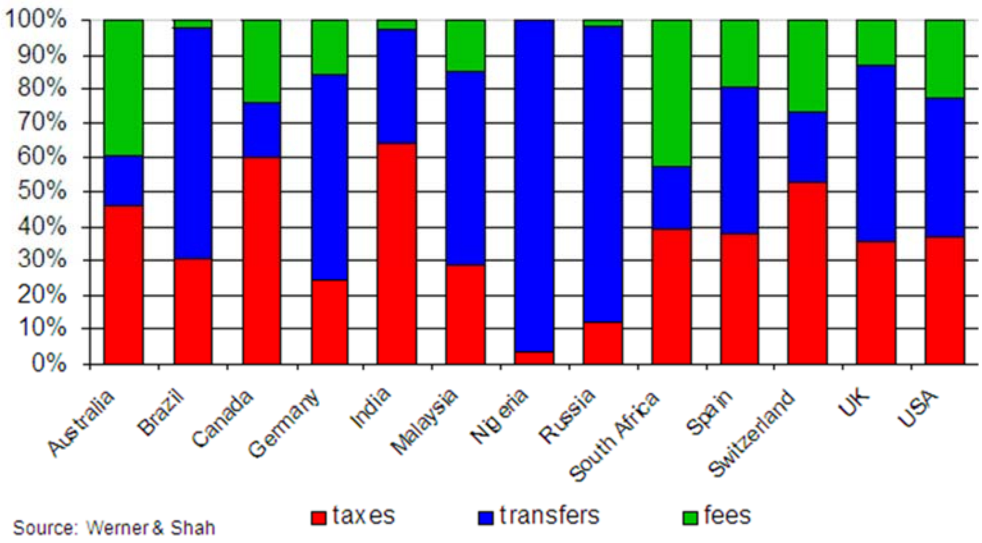

Figure 3: Local public finance structure around the world (Werner, 2019)

The pros of a tax-sharing system are stable revenues, because the taxes are not as strongly affected by economic fluctuations, and a common tax for all tiers of government, which strengthens the solidarity between the different tiers of government ("we are all sitting in the same boat"). The cons of tax-sharing are the lack of revenue autonomy and for this reason a lower level of local accountability and less transparency than in the Anglo-Saxon model with an intensive property tax, or in the Scandinavian model with a local piggy-back tax on the national personal income tax.

Nevertheless, vertical grants are also needed in the Anglo-Saxon model, in the Scandinavian model and the German model. Grants and transfers avoid external effects and spillovers; for example, a local jurisdiction benefits from services of other local authorities without participating in the cost. This situation often exists in the relationship between a metropolitan city and its suburbs.

But why should a country use intergovernmental transfer or even a fiscal equalisation system? The reasons are diverse and could be summarised in

- bridging vertical fiscal gaps, e.g. Canada,
- bridging fiscal divide through fiscal equalisation, e.g. Indonesia and the province of Aceh,
- setting national minimum standards, e.g. Denmark and Sweden for their education sector,
- compensating for benefits spillovers, e.g. Switzerland and Germany with their city states,
- influencing local priorities or political pork barrelling, e.g. with the US Homeland Security grants, earmarked grants for capital investments,

- dealing with infrastructure deficiencies and creating macroeconomic stability in depressed units through incentive grants, e.g. Cohesion Fund of the EU, bail out dilemma in federal countries.

When a country wants to create an equalisation system, the first general question to be answered is whether the equalisation system should consist of direct, horizontal transfers between the subnational entities or whether it should be purely a vertical equalisation system, meaning that there is a transfer between the different tiers of government, for example from the central government to the provinces or from the regions and municipalities.[11]

The majority of the equalisation systems worldwide are vertical systems, but the German equalisation system among the 16 federal states has a strong horizontal element, for example. Another example of horizontal equalisation is the Swiss education equalisation system for the universities. In Switzerland, there are 12 universities, and two of the twelve are institutions of the central government. The remaining 10 universities are located in 10 cantons and therefore 16 of 26 Swiss cantons do not have to finance a university directly. It is however often the case in Switzerland that a student lives in one canton, but attends the university of a neighbouring canton. This situation can be used as a classical example of spillovers. To solve this problem the canton in which a university is situated receives funds from the other cantons, where the commuting students live. The calculation of the funds is very detailed, so that the different costs of a faculty towards a university and the respective duration of the studies of every student have to be borne in mind for the calculation. The direct payments from one canton to another are an example of horizontal equalisation.[12]

The second question to answer is whether the equalisation system should be based mainly on revenue equalisation or on cost equalisation. Well-known examples of revenue equalisation are the Canadian equalisation system between the provinces (see Boadway, 2004; Bird / Vaillancourt, 2007 and Tombe, 2018) and German equalisation between the federal states (Werner, 2003; Spahn / Werner, 2007 and Werner, 2018). In contrast, Australia and Scandinavian countries such as Denmark or Sweden (see Werner / Shah, 2005) base their respective equalisation systems on the concept of cost equalisation.

[11] Normally a vertical equalisation system is a top-down approach, but in the case of the European Union and Bosnia-Herzegovina (from 1995 until 2005, see Werner, Guihéry and Djukic, 2006) there is a bottom-up approach, because the central government was politically weak and did not have its own taxation right, for example.

[12] For detailed description see Werner, 2008.

Revenue equalisation means that a rich local unit is considered rich because it possesses more fiscal revenues per capita than the national average.

Cost equalisation means that the different expenditure needs of municipalities or regions are considered and extra burdens are rebalanced or compensated for in the respective equalisation system or rather in formula.

In Denmark, for example, the local units are responsible for primary education, which means that when you have a lot of young families in your municipalities, your expenditure costs are higher than those of a city with the same total population, but without a huge number of pupils. The equalisation system in Denmark therefore has a so-called demographic composition[13], which means the population is divided into different age groups, and the municipalities receive their funds based on the individual age of every citizen. Citizens in the age groups from 6 to 16 and older than 85 years generate the highest funds for the municipalities, and people in the age group from 20 to 24 generate the lowest funds in the equalisation formula.

Sometimes there is extreme variation in the topographical situation within a country. For example, if you want to construct an asphalt road in Nepal, it is quite easy to do so in the flat area along the Indian border, but if you construct the same asphalt road in the mountainous terrain of the Himalayas, the production costs of the road are three times higher because of the need for bridges and more intensive earthwork.

Switzerland has included so-called "load-balancing" (*Lastenausgleich*) in their equalisation formula, which is intended to relieve the unquestionable burdens the cantons are subject to through no fault of their own as a result of the spatial development of the economy and the population. Through this component, the central government of Switzerland will transfer 710 million US dollars to the cantons in 2019. The following two figures describe the two principle questions of the equalisation system.

[13] Besides the demographic factor, there is also another factor which balances the respective socio-economic circumstances of each citizen, for example if a person is unemployed or not or if the person is a migrant or not.

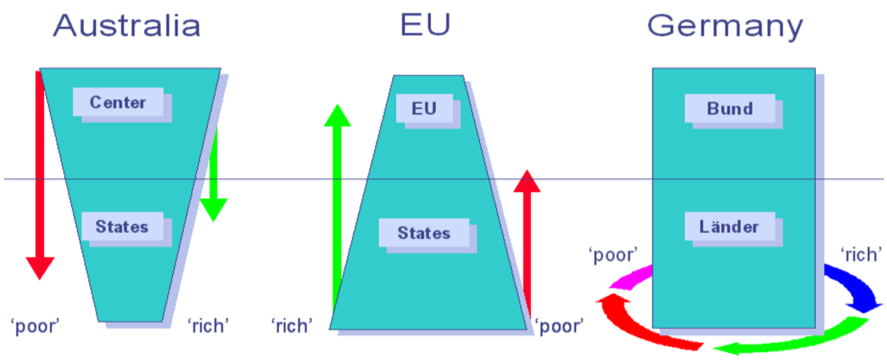

Figure 4: Local public finance structures around the world (Spahn / Werner, 2007)

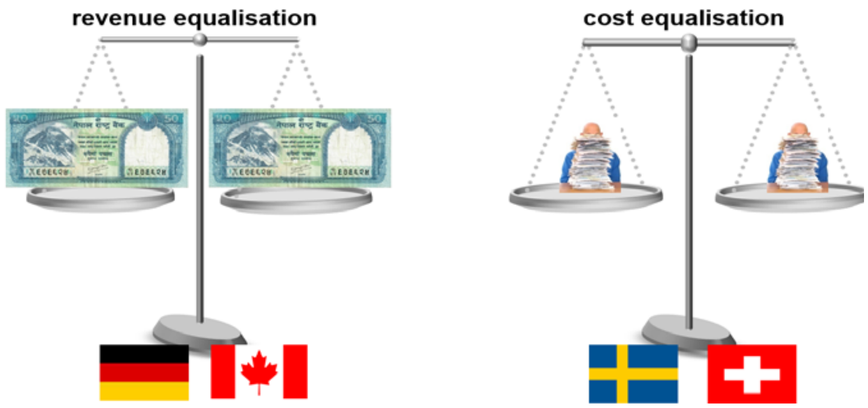

Figure 5: Difference between revenue equalisation and cost equalization (Werner, 2018)

While the German system mainly equalises revenue disparities between the federal states, the Swiss university education equalisation system considers the different expenditure needs of each canton.

Revenue equalisation systems are easier to administer and more transparent. However, revenue equalisation systems are generally unable to take spillover into account. In the view of this author, revenue equalisation should be used solely for regions or provinces, while a local equalisation system should be based on cost equalisation.

The third question to consider in any equalisation system is the institutional arrangement, which could be classified in the following way:

- central government **agency** ("It's sink or swim")
  - MoF as in China, Croatia, Italy and Poland
- national **legislature** ("A cobbler should stick to his last")
  - the Brazilian constitution has fixed the Senate of Brazil
- intergovernmental **forum** ("avoid a toothless paper tiger")
  - Bolivia, Canada, Indonesia, Germany and Montenegro

- independent agency / **grant commission** (“political outsourcing”)
  - Australia, India, Pakistan, South Africa and Uganda

The following paragraphs explain the different concepts of an independent agency and an intergovernmental forum using Australia and Canada as examples.

Australia has a strong, vertical fiscal imbalance in favour of the central government. It corrects this imbalance by using asymmetric vertical grants (based on the goods and services tax) with an implicit equalising effect. The Australian Commonwealth Grants Commission (CGC), set up in 1933, advises the central government and the Australian states. As an advisory body, the CGC is asked to calculate appropriate ratios of per capita grants for the distribution of general revenue assistance from the Australian Government to the states and territories. The central government as well as states and territories accept the suggested distribution of the grants to the states, even though *de jure* the right to make the final decision belongs to the Commonwealth Minister for Finance and Administration.

The Australian system of fiscal equalisation is one of or even the most complex and thorough systems of all federations worldwide. Australia has put in place an explicit and ambitious equalisation scheme that aims at full, standardised budget equalisation. In establishing a point of reference for such a scheme, Australia not only attempts to evaluate the standardised taxing capacity of its states, but also of standardised expenditures adjusted for needs and cost differentials among jurisdictions.

This all-embracing approach to equalisation in Australia is often criticised for its complexity and lack of transparency. Even the CGC itself observes that “the simplification of methods should be a priority going forward” (see CGC, 2004, page 84).

The Canadian equalisation system is embedded in a heterogeneity of different forms of cultural heritage, with the major French-speaking province of Quebec, the bilingual mixed province of New Brunswick and the eight English-speaking Anglo-Saxon provinces. On the one hand, Canada has one of the highest forms of subnational tax sovereignty in the world, but on the other hand, the economically weak provinces, which are mostly located on the Atlantic Ocean coastline, are heavily influenced by the vertical equalisation grants of the central government in Ottawa.

On 5th December 2003, the premiers of Canada’s 10 provinces and 3 territories created the Council of the Federation. The Council of the Federation’s objectives are to promote interprovincial territorial cooperation, to foster the relations between governments based on respect for the Constitution and recognition of the diversity within the Federation, and to show leadership on issues important to all Canadians. This intergovernmental forum is a council without the central government and shows the political strength of the provinces in Canada. The Canadian Intergovernmental Conference Secretariat (CICS) is a neutral agency which provides administrative services required for the planning and conduct of intergovernmental conferences. The CICS was established in May 1973 and is an impartial agency at the service of 14 governments (central, provincial and territorial).

3 Recommendation for Libya

The *first recommendation***.** The local governance system in Libya is currently undergoing substantial changes as significant steps are undertaken towards greater decentralisation of service delivery and fiscal responsibilities. This decentralisation initiative requires that persons possessing the necessary technical skills be available to both the Ministry of Local Government and the municipalities (and the provinces, if and when these are established). To ensure that a sufficient pool of persons possessing the needed technical skills are available, it is recommended that the "Abu Saleem Local Governance Center" be reinvigorated to serve as a local governance public service academy. Currently this advanced training institution is dormant, because no courses are being held and the institution exists virtually only on paper. However, the municipalities in Libya have a huge personnel deficit in terms of administrative knowledge and skills; and the general principle for successful decentralisation is that "finance follows function, and function follows capacity."

The *second recommendation***.** To ensure the legitimacy of the local officials who are managing local financial resources – including those generated as own source revenue and those transferred by the central government – it is imperative for the country to continue holding nationwide local elections every four years. Democratic legitimation is important to the establishment of the tax-benefit connection at the local level and can send a clear signal of normality, peace, and stability to the people.[14] Moreover, it is crucial to the deepening of social accountability and community participation that local governments be made answerable to their constituencies.

The *third recommendation***.** It is necessary to introduce significant types of own-source revenue for municipalities in Libya. Currently, the municipalities are highly

[14] An international example is the Pakistani province of Khyper Pakthunkhwa (KP), close to the border with Afghanistan. The province was confronted with the "War in North-West Pakistan" in 2004, which was an armed conflict between the regular Pakistani army and various armed militant groups, such as the Tehrik-i-Taliban Pakistan (TTP), Jundallah, Lashkar-e-Islam (LeI), Tehreek-e-Nafaz-e-Shariat-e-Mohammadi (TNSM) and al-Qaeda.. Local elections were held in KP on 30th May 2015, and a total of 84,420 candidates contested 41,762 seats on district, town, neighbourhood and village councils. They were the first local elections in the province for ten years, because the last local elections in the province had taken place in February 2005. The local councils that had been elected then were dissolved on 20th February 2010 after their term of office ended, and they were replaced by administrators until the 2015 elections.

dependent on vertical transfers from the central government and have no fiscal autonomy. One of the key issues for the Libyan local authorities is thus to release them from their fiscal dormancy, and enable them to generate own-source revenues.

Own-source revenues may be either taxes or fees, but fees and user charges also imply direct costs for a local jurisdiction; no fees are generated if no service is offered. For this reason, taxes are always preferable to fees.

Based on the classification of Figure 1, only the option of property tax seems to be advisable in the Libyan context, because there is no enhanced personal income tax system in Libya yet, which would allow a piggy back of local surcharges on the national personal income tax, as in the Nordic countries, Switzerland, Belgium and Croatia. Moreover, a tax sharing system such as that of Bolivia, Pakistan or Germany is also not possible, because there is no valued added tax to share in Libya and – even if there were – tax sharing of this kind would not increase the fiscal freedom of the municipalities in Libya enough.

Hence, the introduction of a local property tax could be the only main source for gaining local revenues. However, the introduction of a property tax system is not a short-term goal, it has to be seen as a medium / long-term goal, as its introduction requires a thorough strategy and implementation plan, which could be developed during the next five years.

A general problem of all property tax systems is the question of how to obtain a market-based valuation of the property without generating high administrative costs.

In the Libyan case, there is only an incomplete nation-wide cadastre. Furthermore, since properties are sold without conveyance duty / real estate transfer tax, it is not possible to determine property values on the basis of selling prices, either.

A tailor-made property tax system for Libya should thus use the following concept:

- tax administration and tax collection should be handled by the central administration, with the central government receiving 15% of the total tax revenues as a refund for administration costs. This feature can be compared to a tax sharing system.
- the tax rate should be fixed independently by every municipality and the central government should set only a minimum tax rate. This feature guarantees high revenue autonomy for the municipalities.
- in Libya there is an incomplete cadastre for the properties, and therefore it is not possible to evaluate the properties based on the selling prices of neighboring properties. The assessment of the property thus has to be handled by the central government along the following general guidelines:

- Three benchmark indicators could be used to determine the tax assessment base for real property:
  - (a) maximum ground space,
  - (b) maximum number of floors, and
  - (c) size of property.[15]

  All three figures would be multiplied and, in order to attract incentives for optimal land use, it would be irrelevant whether the property is fully constructed or undeveloped.
- The municipalities would divide individual building sections into special building zones[16], to which they would allocate individual building zone factors. The municipalities themselves would decide not only how high this building zone factor should be but also how big the zone should be.
- The municipalities would also set the local real property tax rates, with all zones being subject to the same municipal assessment rate.
- The real property tax rates set by municipalities would be subject to a minimum / maximum range established by the central government. This is to ensure that municipalities do not set rates that are either excessive or so low that the property tax contributes only marginally to a municipal budget.

Hence, the new local real property tax would be calculated in the following manner:

Ground space · Floor number · Size of property · Zone factor · Local tax rate = Tax liability

In addition, a process for valuing real property will need to be established. Various valuation approaches based on limited surveying work have been used in developing countries. These approaches should be reviewed with an eye to establishing a mass valuation process best suited to the current Libyan context. A new property tax system such as this one could be implemented within the next five years in Libya, if there is a common political will-power. Moreover, a well-conceived and properly managed

[15] Indicator c is measured in square meters, whereas the two indicators a and b are measured in decimal numbers and calculated in relation to the total size of the property. For example, if a property has a size of 400 square meters and the building on this property has two floors, with a ground space of 240 square meters, the respective benchmark indicators are a = 0.6, b = 2.0, and c = 400.

[16] Based on decree 225 / 2018 the municipalities are newly responsible for offering construction permits. Article 11 of this decree orders also a filed survey by the office of urban planning and public property (OUPPP). The democratic elected mayor – with the assistance of the OUPPP – could suggest the building zones and to lower the corruption factor such building zones need the approval of the local council.

pilot program involving a small number of municipalities could be completed within two to three years. Such a pilot program could establish the basis and build the culture and experiences for the new property tax system.

The *fourth recommendation*. It is to introduce a transfer system that is formula-based and ensures that national income, mainly from the oil revenues, reaches all citizens through decentralised, improved service delivery in Libya. The basic vertical transfer could have the nature of a block or unconditional grant. Additional vertical transfers could be made in the long term in the form of categorical grants; i.e. grants provided for a specific purpose, such as education or health. The amount of any vertical transfer, regardless of type, should be determined in strict accordance with a formula that is highly transparent and easy to administer.

To prevent any future ad-hoc decision-making or even political pork barrelling, it is essential for the Ministry of Local Government to publish all information – the formulae, collected data and calculation for every municipality – in advance on the internet. Such a transparent process allows the municipalities to control the whole work flow of the transfer system on the one hand, and at the same time, the civil society can also cross check how funds have been delivered from the central government to their respective municipalities. The following block grant formula is a transparent and easily administrable example for Libya:

$$T_i = 0.50 \cdot (POP_i / POP_{nation}) + 0.40 (Dev_i – Dev_{nation}) + 0.10 (LocalRev_i – LocalRev_{nation})$$ [17]

T_i: receiving transfer of the local authority i

POP_i: number of inhabitants in local authority i based on the census of 2006

POP_{nation}: total population of the whole nation based on census of the year 2006

$LocalRev_i$: collected own revenues in local authority i per capita (based on census 2006)

$LocalRev_{nation}$: total collected own revenues in the nation per capita (census 2006)

Dev_i: development index[18] of the local authority i

Dev_{region} average, nationwide development index

[17] In a previous version a ratio of 75% population and 15% development index was selected by the author. However, the local partner has clearly responded that such a high portion of population is politically undesirable. From the technical aspect the author wants to underline again that population is a very transparent indicator as well the only fully available data set for Libya. Moreover, the author emphasizes again that the selection process of any future criteria for the developing index will create even more political tension, but finally the author fulfills the wish of the local partner and revises the formula.

[18] The development index considers for example the topographic situation, the climatic circumstances or the burden from Libyan refugees in every municipality individually.

In the years without any revenues from the future property tax, the formula can use the indicator "LocalRev" instead – a "population readjustment factor" to strengthen the urban centres in Libya. A metropolitan area has per capita higher expenditure needs than a city with just 10,000 inhabitants. For example, the number of inhabitants in the municipalities with more than 100,000 citizens would be "readjusted" in the formula, i.e. the inhabitant numbers would be multiplied by a factor of 1.35.

Moreover, in the first years after the introduction of the local property tax, the "LocalRev" indicator could be an incentive grant, which would mean that, for every Libyan dinar collected from property tax, the municipality would receive an additional Libyan dinar from the transfer system to generate an incentive to collect the tax in a proper way. However, in the long run this indicator should be changed to an equalisation grant, which would reduce the fiscal gap between fiscally rich municipalities and fiscally poor municipalities.

In addition to block grants, many IGF regimes around the world establish for one or more categorical grants to provide financing for specific purposes. Categorical grants are sometimes desirable because they ensure a much stronger correspondence with objective needs-based indicators in critical expenditure areas (e.g., health, education) than can be achieved if fiscal resources are allocated solely through a general unconditional block grant. Categorical grants could be viewed in some instances as eroding the fiscal autonomy of the local units, as it limits the autonomy of local mayors to independently determine about their fiscal resources. From that perspective at a theoretical level of accountability, unconditional block grants make more sense than earmarked grants. However, under the current transitional circumstances in Libya it can not necessarily be expected to fully and accurately reflect the priority needs of local citizens. Given this, and in the interest of ensuring national minimum standards of public goods, earmarked grants are sometimes considered preferable. For this reason, Libya should give serious consideration to the types of categorical grants. Libya should start with a formula-based block grant, and should seriously consider designing and implementing a categorical grant mechanism in the next 2–4 years in key service provision areas (e.g. education, health care), in a manner that would effectively supplement the block grant formula.

The *fifth recommendation*. It is recommended that a pooled financing arrangement be established to enhance municipal revenue through a Local Development Fund (LDF). Besides taxes, fees and vertical transfers, the concept of local borrowing also has a huge effect on the delivery of infrastructure. Possible options for the local government borrowing system are:

(1) Severe restriction and generally no independent local borrowing[19]
   - Ethiopia, China (until 2015) and Pakistan
(2) Pooled municipal government debt through a provincial government agency
   - Canada and India
(3) A municipal bond system
   - USA, Mexico, Poland, Czech Republic, Slovakia, Hungary, China (since 2015) and South Africa
(4) Commercial and private banks
   - France, Belgium = until the collapse of Dexia
(5) Public "savings banks" with a normal commercial business
   - Austria, Germany
(6) Public central institution or a public bank without any commercial business
   - Denmark, France, Norway and United Kingdom

Because of the limited capital market in Libya, options three, four and five are not possible, and the examples of South Africa or the United Kingdom[20] prove that the municipal bond system is not always a silver bullet. Moreover, a public banking institution is not a realistic possibility under current institutional circumstances either for Libya, given the major institution-building requirements implied, and the checkered governance and financial viability track record of such entities in general in emerging market settings.

However, instead of unregulated access to the capital market, Libya might consider combining the concept of pool financing and the establishment of a local infrastruc-

[19] National law restricts any form of local borrowing. For example, the Pakistan province Punjab has reformed their local government system in April 2019. Article 149, clause 1 of the respective law says that a local government may with the previous sanction of the government of Punjab raise a loan. In China the national Ministry of Finance has operated with a similar strict regulation. National law restricts any form of local borrowing. For example, the Pakistan province Punjab has reformed their local government system in April 2019. Article 149, clause 1 of the respective law says that a local government may with the previous sanction of the government of Punjab raise a loan.

[20] In the United Kingdom, the UK Municipal Bonds Agency was created – in addition to the Public Works Loan Board – to lower the long-term financing costs of British municipalities through the bond market. The Municipal Bonds Agency was introduced by the Local Government Association with the idea that multiple councils banded together would have enough clout to raise hundreds of millions of pounds. The theory was that investors would be reassured by lending across a diverse "pooled" spread of councils. The response of the capital market to this concept was reserved, especially after the fiscal crisis at Northamptonshire County Council.

ture finance mechanism. Including rural entities in a common pooled financing system is almost certainly cheaper for the urban areas in Libya, because if the gap in infrastructure delivery between rural and urban entities increases, then rural depopulation will also increase, putting pressure on the infrastructure provisions of urban authorities.

One option that Libya might consider is the establishment of a Local Development Fund (LDF). A LDF could, for example, offer municipalities grant financing for future local infrastructure projects, but not for current expenditures. There are various potential mechanisms for financing such a fund. One possibility would be the dedication of 10% of national tax and customs revenues. Currently, Article 49 of Law 59 provides that 10% of national tax and customs revenue is to be allocated to the provinces; however, the provinces do not currently exist, so perhaps a legal mechanism might be found to make this funding available to local governments.

On the other hand, it must be borne in mind that there are currently low national tax revenues, and customs revenues are not significant. In addition to these current constraints, the creation of an LDF or other local finance institution will require substantial institutional capacity building, as well as the development of a robust system of safeguards to protect against abuse and pork barrel arrangements. Grant allocation should in fact be made on the basis of a rigorous cost-benefit / cost-efficiency analysis regarding the net benefits of an infrastructure project financing proposal.

The *sixth recommendation*. It is to create a stabilisation fund (see Werner, 2012) for oil revenues – as in Russia for oil or in Chile for copper – to reduce the negative economic effects of any oil price fluctuation for Libya.[21]

The *seventh recommendation.* It is to widen bank account access and provide full fiscal responsibility for all collected fees, revenues from property rents, and revenues from the sales of property by the municipalities ("own source revenues bank accounts"). Recently the competence for some[22], but not all, fee collections by the so-called MH5 of the MoF's accounting department has already been reduced, but it certainly provokes criticism based on inadequate transparency when the fees are not

[21] Such a stabilisation fund is not a new instrument rather it should be a general principle of the already existing Libyan Investment Agency. Moreover, the Libyan Investment Agency (LIA) should also consider the Extractive Industries Transparency Initiative (EITI) and it should be politically decided a priori how much money from this fund should be used for the local units.

[22] The transfer of authorities to municipalities that started in late 2018 and early 2019, when MoLG issued a series of decrees authorising municipalities to carry out a number of functions as stated in article 25 of law 59 of 2012 and to point out decree number 14 of 2019 issued by the minister of local government on municipal fees where municipalities are authorised to collect fees and have their own source revenue bank account at a local commercial bank.

collected directly by the municipalities. Instead, all such revenues are transferred from the MoF to the MoLG, and the MoLG then sends them to the municipalities; local units thus have no possibility to control the flow of capital.

4 Conclusion

Local public finance and fiscal transfers are a highly technical as well as political issue. Institutional arrangements can reduce or increase fiscal conflicts. Thus, the importance of the institutional arrangement of the future equalisation system in Libya cannot be underestimated. Because of limitations in the administrative capacity of the national MoLG and in the quality and accuracy of available data in Libya, any new equalisation system must be simple and transparent. It should use the existing data on population figures, though a new census should be undertaken as quickly as possible to acquire an even more reliable indicator. The suggested concept of pooled financing and the creation of an institution to provide debt financing to local governments for local infrastructure projects, like the MIA, which could be a municipal development fund administrated purely by the MOLG or a combination of MOLG with some additional local representatives, offers subnational entities a longer term option for financing infrastructure investments. It also fulfils the so-called golden rule of fiscal policy, whereby a government – including a local government – may only borrow to finance investments and not to fund current spending. The following table classifies the seven recommendations of this article in terms of their temporal implementation.

Short term **within one year**	**Medium term** **within 1–3 years**	**Long term** **within five years**
• A transparent formula for the block grant vertical transfer • Full operation of the local governance school • Full bank account access rights for the municipalities in the area of fees and any revenues from property	• Municipal Development Fund (MDF) • Oil stabilisation fund • Local elections throughout Libya • Pilot application of a local property tax • Establishment of two or three categorical grant transfer mechanisms and the formula for each as well as for the block grant	• A nationwide local property tax

5 Appendix

The following table classifies the municipalities based on population figures in 2018:

Size of population	# of municipalities	Band
Over 500,000	1	A
From 100,000 – 499,999	19	B
From 75,000 – 99,999	7	C
From 50,000 – 74,999	6	D
From 25,000 – 49,999	27	E
From 10,000 – 24,999	37	F
From 5,000 – 9,999	13	G
From 1,000 – 4,999	10	H
Under 1,000	1	I

Table 1: Population structure of the municipalities in Libya (Ministry of Local Governments, 2019)

The expenditure assignment of the municipalities in Libya is twofold. On the one hand, the legal framework for decentralisation is mainly law 59 / 2012, and article 25 of the respective law determines the following expenditure areas:

(1) Urban planning
(2) Health and social affairs
(3) Water utilities
(4) Street lighting
(5) Sanitation / public hygiene, for example waste management
(6) Local transportation, for example the public transportation system or licences for private taxis
(7) Public parks
(8) Shelter / social housing
(9) Public space management, for example licences for billboards or pedlars, control of the traffic and provisions of parking lots
(10) Cemeteries
(11) Civil registry affairs, for example birth certification, civil status or identification cards as agents of the central government
(12) Regulation of local markets and slaughterhouses
(13) Construction and maintenance of local roads and bridges
(14) Licences for economic activities of private companies
(15) Monitoring of the environment and public health, for example pollution and the safety of commercial premises, foodstuff inspections and pest control in private or commercial properties

The following Box 1 explains the concept of pooled financing in India.

<u>Box 1</u>: Pooled financing like the Tamil Nadu Urban Development Fund in India

The Tamil Nadu Urban Development Fund (TNUDF) was established in 1996 and is mainly financed by the regional government of Tamil Nadu and the World Bank.

The fund manager of the TNUDF is Tamil Nadu Urban Infrastructure Financial Services Limited (TNUIFSL). The regional government holds 49% shares of the TNUIFSL and the remaining 51% of shares belongs to three national banks. The daily management responsibility of this fund belongs to the ICICI Bank, which holds with 21%, the largest share of the three Indian banks.

Eligible Borrowers for the Tamil Nadu Urban Development Fund include both urban local bodies in India and any private institutions that create urban infrastructures in India.

The TNUDF uses both capacity development and polled financing for the infrastructure financing. Polled financing means that several projects are pooled and lumped together in a bond issuance, and this can provide a significant reduction of transaction costs and improved pricing. Especially for smaller and less creditworthy local authorities, this concept makes sense.

Currently, a sum of Rs. 3,510.19 crores is available at the TNUDF for providing financial assistance for the implementation of urban infrastructure projects.[23]

The lesson to be learned from the Tamil Nadu Urban Development Fund in India is that the local units should use the idea of polled financing as much as possible to reduce their financing costs. Moreover, the urban areas should not be blind to the financial situation of their surrounding rural entities. To include those rural entities in a common polled financing is surely cheaper in the long run for the urban entities, because if the infrastructure delivery gap between rural and urban entities increases, then the rural depopulation will also increase and the urban authorities will have pressure on their own infrastructure.

Furthermore, the aspect of capacity development should not be underestimated, as financial institutions such as commercial banks or pension funds from abroad expect very qualified dialogue partners.

[23] Tamil Nadu Urban Development Fund, 2019, page 2.

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