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Could Oil Shine like Diamonds?

How Botswana Avoided the Resource Curse and its Implications for a New Libya

Paula Ximena Meijia & Vincent Castel

1 Introduction

At the heart of the socio-economic grievances that led to Libya's revolution was the rentier economy of the Qaddafi regime. Though oil resources had permitted Libya to accumulate wealth, the country suffered from a number of macroeconomic concerns. By 1973, Libya had a dualistic undiversified economy dominated by the state, afflicted by pervasive rent seeking and regulatory deficiencies (Vandewalle, 2011). The effects of the rentier characteristics of Libya's economy permeated both the economic and political structures of the country. Excessive oil resources had allowed the political elite to hallow out governmental institutions – allowing those in power to operate without oversight.

Though the system remained in place for over 40 years, as the revolution demonstrated, Libya's social contract was untenable: the unequal distribution of wealth, the country's poor track record on transparency, governance and corruption, as well as diminishing opportunities for the development of human capital created grievances against the former regime which could not be acquiesced in the usual manner. No longer able to buy the support of its citizens, the former government was confronted with a revolution.

Unfortunately, Libya's story is not unique. Traditional economic theory would suggest that the macroeconomic imbalances of the Libyan economy and the social unrest that ensued were unsurprising. Rather, Libya's political economy followed the usual trajectory of resource abundant economies (Collier and Goderis, 2007 and Ross, 1999). According to the theory of the resource curse, resource abundant economies tend to grow less rapidly and are more prone to conflict than resource-scarce economies. It has been argued that this is because resource abundant economies tend to suffer from Dutch disease; insufficient economic diversification; rent seeking and conflicts; corruption and undermined political institutions as well as loose economic policies (Iimi, 2007). Indeed, Libya's economy, suffered from all of these symptoms.

Though large number studies have found strong evidence that resource abundance leads to poor or unequal growth and politi-

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cal instability, there are exceptions to this rule. Botswana is case in point. Though the country is one of the world's largest producers of diamonds, it is one of the few countries that has managed to turn its resource into a blessing rather than a curse. Botswana went from being one of the 25 poorest countries in the world to becoming an upper-middle income economy in 1998, reaching a per capita GDP of 9,200 USD in 2004 (Transparency International). The question that then presents itself is how did Botswana escape the pitfalls of the resource curse, ensure stable growth, and save its wealth for use by future generations? And what lessons can be applied to Libya in its transition?

The following sections of this paper will address these questions by first explaining the dynamics of the resource curse, its manifestation in Libya, and contrasting Libya's experience with Botswana's wealth management. It will be argued that in order to manage its natural resource wealth, Botswana implemented a three-pronged approach. First, it aimed at pursuing pursued economic diversification, second, it de-linked expenditure from revenues and developed other expenditure smoothing mecahnisms in order to render it less susceptible to alternations in revenue relating to the price fluctuation of its resource. Finally, it invested surplus revenues for the use of future generations. Moreover, the paper will explain that the reason these policy strategies worked in Botswana while they have failed to produce similar results for other countries is due to Botswana's good governance. A number of policy recommendations for Libya will then be presented, drawing from Botswana's successful wealth management policies.

2 What is the natural resource curse?

Since the 1970's resource rich countries in the developing world have consistently underperformed resource poor countries when it comes to economic growth, income inequality and good governance. According to Wienthal (2006), it has been well established that – controlling for income – the more intense a country's reliance on mineral exports (measured as a percentage of GDP), the more slowly its economy grows. In fact, between 1960-1990, the GDP per capita of mineral rich countries increased by 1.7% compared to the 2.5-3.5% growth of mineral poor countries.

These counter-intuitive trends however are more complex than those figures suggest. The abundance of a resource is after all, not the cause of poor growth. Rather, the abundance of a resource creates incentives for poor wealth management which in turn result in less rather than more growth.

Governments depending on few commodities are particularly susceptible to a number of macroeconomic challenges. The first is the excessive volatility of commodity prices. According to Asfaha, this has had severe implications for commodity-dependent nations – that is, nations whose national revenue are mainly drawn from the export of a particular resource – because cycles of booms and busts in real national incomes create problems for macroeconomic management. Short-term revenue instability is a particularly challenging context for macroeconomic planning and especially fiscal policy management given that expenditure patterns in these countries tend to follow revenue patterns. Cycles of booms and busts in the commodity price translate into cycles of booms and busts in fiscal expenditures. "As a result fiscal policy becomes pro-cyclical, implying that sending goes up (and taxes down) in periods of booming prices and spending goes down (and taxes up) in periods of price busts"(Asfaha, 2007).
Moreover, the expenditures of pro-cyclical fiscal policies are not necessarily efficient. It has been found that spending often fuels expenditure on the current account and a low-return on public investment programs. This approach to fiscal management is an understandably common pitfall when looked at from the perspective of the governments, which often operate on a short-time horizon. Always seeking to extend their tenure (be it through elections or rentier state policies), governments are likely to spend windfall revenues quickly and in an inefficient manner such as by increasing wages and subsidies, which for those same political reasons are difficult to reduce once revenue dries up. For example, in 2005, Libya spent 5.5 bn USD on fuel price subsidies, of which oil subsidies comprised 42% at 2.3 bn USD and electricity subsidies accounted for a similar amount at 2.2bn. Problematically, Libya's fuel subsidy inefficiencies do not end there. Because the General Electricity Company of Libya (GECOL) uses subsidized prices for oil and gas in the generation of electricity, for the end consumer electricity is doubly subsidized. As a result, consumers pay less than the actual subsidized cost of the supply, and according to a Monitor Group analysis (2006) many do not pay at all. Illustrative of the inefficiencies and losses created by this system, GECOL's transmission and "other" losses amount to 40%.

Investment in low-return and over-ambitious projects, is another common

The 5 Challenges Facing Resource-Rich Economies

1) Buffering itself from excessive short-term revenue volatility;
2) Protecting the wider economy in particular manufacturing and agriculture from contraction ie. Dutch Disease;
3) Establishing strong socio-economic institutions for economic and revenue based diversification;
4) Insuring itself against the long-term decline of revenue due to the likely depletion of resources and;
5) Ensuring inter-generational equity.

Source: Asfaha 2007.

wealth management mistake made by resource-abundant economies. Asfaha notes that most public investment projects associated with commodity booms in most countries were found to yield minimal, zero or in few cases negative rates of return.

Though Libya did not suffer from foreign debt accumulation, many resource abundant countries can blame their poor growth on this tendency as well. Foreign debt accumulation occurs because many resource-abundant economies consider busts to be temporary and booms to be long term. As a result they begin to borrow on the strength of their well-performing commodity and continue to do so as a means to finance their deficits when their commodity performs poorly and their revenue drops.

Yet another common problem that contributes to the resource curse is Dutch disease. As the country's management focuses more on the booming sector, the competitiveness of other sectors, primarily manufacturing and agriculture, diminish resulting from the price appreciation of the currency during resource booms.

Related to this issue is the problem of limited economic diversification. Resource abundant economies tend to over emphasize the importance of resource extraction in their economy which in turn reinforces their dependence on that product and its place in the market cycle.

Perhaps one of the most problematic issues resulting from resource abundance and the poor management of resource wealth is institutional weakening. There is a tendency for large windfall revenues to weaken institutions. For instances, direct access to income from the commodity reduces the incentives for a government to establish a tax system. At the same time, however, the implicit reciprocity between tax collection and the social services provided by the state are severed. Commodity booms thus encourage rent-seeking and patronage networks by removing citizen participation in the creation of state revenues and therefore render the state decreasingly accountable to its citizens.

Finally, the macroeconomic and fiscal policy challenges created by resource abundance are further pronounced by the uncertainties surrounding the long-term sustainability of some natural resources. Economies dependent on non-renewable resources, including Libya and Botswana, constantly face a trade-off between current revenues and future revenues. That is, they are not only challenged by inter-temporal budget constraints, or the impact of boom and bust cycles on their revenue, but on intergenerational equity.

In spite of the many challenges associated to resource abundance, Botswana has managed to overcome some of challenges usually posed by the "resource curse". Botswana's experience is also a valuable counter-example of the potential Libya has regarding its resource wealth management. Indeed, Botswana and Libya shared a number of characteristics before the discovery of their natural resources.

The first obvious similarity they share a fairly small population. Botswana had a population of about 2 bn in 2010, while Libya had 6.3 bn inhabitants. More importantly perhaps, the two countries shared the same inherent constraints to development upon independence: limited human capital and poor physical infrastructure.

When the country achieved independence, only 22 Batswana had graduated from University and 100 from secondary school. Meanwhile the country had just 12 km of paved road (Acemoglu, 2001). Libya started off with similarly poor conditions, except that since then the country has been unable to improve these constraints. Libya's overall infrastructure was low, consistently ranking in the bottom of all metrics of infrastructure quality (Monitor Group, 2006) a concern that has only been augmented with the recent revolution. While the Libyan work force has, on the other hand, achieved a good basic level of education and boasts high literacy rates, the quality of education is very poor and as result there remains a shortage of advanced skills needed in the labor market. According to the Libyan Business Executive Survey (Monitor Group 2006), Libya ranked 110 of 111 countries in their overall quality of education and in the bottom 1/3 of all indicators measured in education.

How Botswana managed to overcome these inherent development constraints and at the same time is on the right track to avoid the resource curse becomes a crucial question for Libya as its political transition has created an opportunity for the types of policy reforms that made Botswana a success case. Before further expanding upon the policies that Botswana has relied on in order to counter the problems often faced by resource rich countries, the manifestation of the resource curse in Libya will first be presented.

3 The Manifestation of the Resource Curse in Libya

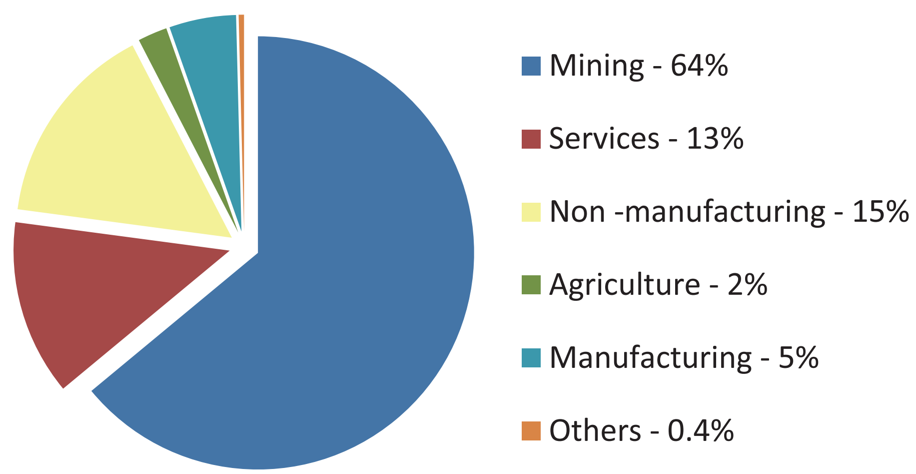
Endowed with one of the largest proven oil reserves in Africa, Libya was one of the wealthiest countries of the continent prior to the 2011 civil war. Since discovery of oil in the 1950's, Libya has been amongst the top performers with regards to living standards in the region. The country boasted a per capita income of US$14,000 in 2008, a literacy rate upwards of 80%, and a life expectancy at birth of 74 years. Moreover, the country outperformed regional standards by achieving a real GDP growth rate of more than 5% over the last decade, fiscal surpluses of more than 35% and external account surpluses above 40% of the GDP (Kolster and Mejia, 2011).

Although these indicators may suggest that Libya escaped the resource curse, a number of alternative indicators suggest otherwise. Rising inflation, high unemployment, the unequal distribution of wealth and the country's poor governance track record were deeply associated to the state's poor management of its oil revenue.

In fact, though the manifestation of the resource curse in Libya differs slightly from the usual trajectory of poor growth levels of other resource rich countries, it actually follows the trend of resource rich countries in the MENA region very closely. According to a 2012 IMF study of the economic performance or resource rich countries in the Middle East and North Africa over the last 40 years, rather than exhibiting poor levels of growth, these countries maintain high levels of income per capita, but perform poorly when going beyond the assessment based on standard income level measures (Rabah and Nabli, 2012).

Libya, like other resource rich countries in the MENA region, experienced particularly low and non-inclusive growth as well as high levels of macroeconomic volatility. Moreover, the Libyan economy was virtually undiversified and entirely dominated by the hydrocarbon sector, which generated close to 70% of GDP, more than 90% of government revenues and 95% of export earnings. The

Figure 1 GDP by Sector 2010 - Libya



Source: African Economic Outlook.

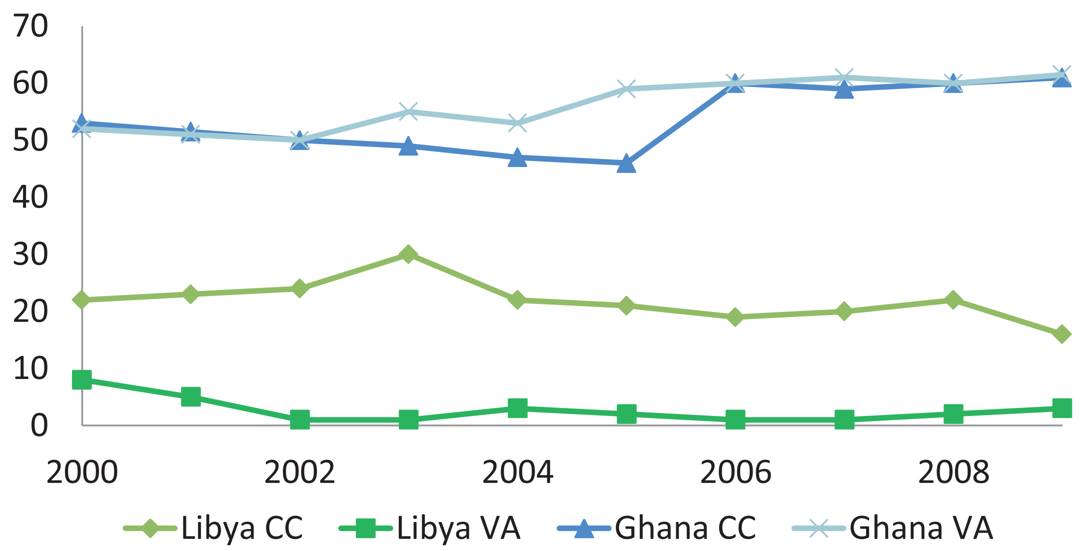
very limited backwards and forwards integration of the industry confined the wealth generated from oil riches to export and fiscal revenues, while it generated less than 5% of employment in Libya (Kolster and Mejia, 2011).

Perhaps the most obvious manifestation of the resource curse in Libya was the impact that oil had on state institutions. Libya's clientalist state structure, which centralized economic power in the hands of the state, created an environment in which individual interests both outweighed and were in conflict with, the interests of the common good. As a result, government accountability suffered and the social contract depended on the state's ability to provide rents to its people in exchange for their acquiescence.

To illustrate the impact of the rentier mentality on Libya's governance record, in 2009, Libya ranked in the 5th and 12th percentile for voice and accountability, and government effectiveness, respectively, according to the Kauffman index (World Bank, 2009). According to the Mo Ibrahim report of 2011, Libya was ranked in the bottom half of the index in 2010, demonstrating a particularly high imbalance between its performance on Human Development, where it was ranked in the top 10, and its performance on Participation and Human Rights where it was amongst the lowest performers. Libya's performance in Safety and Rule of Law and Sustainable Economic Opportunity, were also comparatively weak. It was in this context of poor representation and unequal distribution of wealth that the revolution took place, further aligning Libya with yet another common manifestation of the resource curse: propensity for violent conflict.

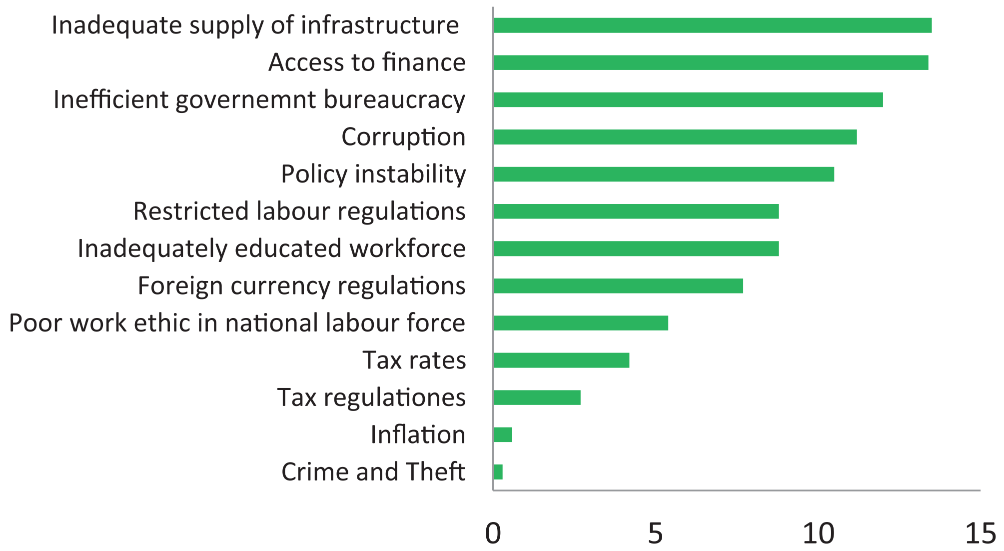
In addition to poor citizen representation, the lack of transparency in government and the tendency for rent-seeking by the state also seriously affected the development of the private sector and consequently hindered the diversification of the economy. Though the previous government attempted to reform the economy, vested interests by the political elite resulted in the inconsistent implementation of policies and reversal of reforms. As a result, Libya's private sector has been historically stifled by a number of issues including limited sources of financing to SMEs, the inconsistent application of property rights, and the focus of most of the economy's resources on the oil sector. Development of the non-oil sectors including services requires broad participation through domestic or foreign private sector investment. Poor economic governance has consistently discouraged investment in the non-oil sector.

Figure 2 Voice and Accountability (VA) and Control of Corruption (CC)



Source: R. Kauffman "Libya's Startling Failure: Unforeseen or Ignored" February 2011.

Figure 3 **Business Constraint 2008 - Libya**



Source: Global Competitiveness Report 2008.

Libya's Economic Freedom

According to the 2012 Economic Freedom Index by the Heritage organization, Libya's overall rank for economic Freedom is 176. The country is ranked last in the Middle East/ North Africa region.

Even following structural reforms undertaken by the previous regime, substantial structural rigidities, aggravated by the weak rule of law and systemic corruption, marginalize the private sector and hurt productivity growth, employment and efforts at modernization.

Libya's economic freedom suffers primarily from the following:

a) Rule of Law: The judiciary is not independent and there has been a history of expropriation. Corruption is also a major problem;

b) Regulatory Efficiency: Only limited private entrepreneurial activity has been successful. State meddling in business decisions is extensive, and the application of regulations was inconsistent and non-transparent; and

c) Limited government: Taxation has not been regularly enforced since 2002.

However, the revolution in Libya has created an opportunity for the country to reverse its previous mismanagement of the oil wealth and the culture of poor governance that dominated both the private and public sector.

Learning from Botswana's best practices, Libya can avoid its previous mistakes and turn its resource abundance into a blessing that will allow the country to surmount the challenges associated to its transition.

4 How Botswana Escaped the Resource Curse

Botswana has become renowned for its ability to manage its mineral wealth effectively and escape the resource curse. One of the most diamond-rich countries in the world, it has experienced remarkable growth for several decades. Though the impressive 14% GDP growth achieved during the first years after independence is now near 3.5%, Botswana is still one of the fastest growing countries in Africa.

Impressively, the growth of the country's economy was accompanied by a transformation of its economic sector. Not only did the mineral and government sector experience growth, but real growth was sustained even when the mineral and government sectors slackened. The country has also been applauded for its good governance, political stability and strong fiscal discipline (Leith, 2000).

At the heart of Botswana's successful resource wealth management and its avoidance of the resource curse was a three-pronged approach: first, Botswana pursued economic diversification to render it less dependent on the volatility of the mining sector; second, the country de-linked expenditure from revenue and finally it invested surplus revenue for use by future generations. The dynamics of Botswana's policies will be further explored, demonstrating that at the center of the country's success laid its ability to avoid the usual pitfalls that threaten countries benefiting from a resource boom.

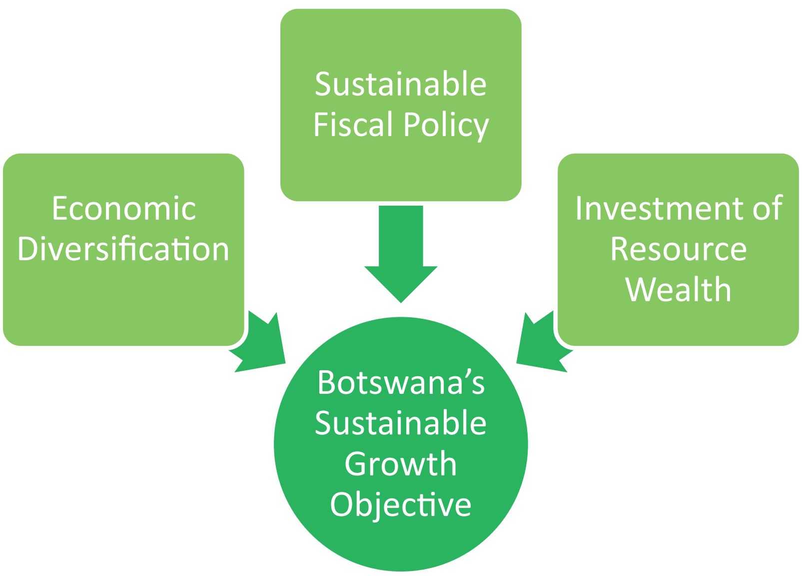
A) Economic Diversification

Botswana strategically pursued economic diversification for two important reasons. First, the government recognized the danger of relying on the mineral sector for the majority of its revenue. This approach renders states very susceptible to the price shocks of the sector they depend on. More importantly however, the state recognized that mineral wealth, or the country's "inherited wealth", was limited in that the wealth acquired from mining would only last as long as there were diamonds in the ground. "Created wealth" on the other hand could provide the country with an answer to its objective of achieving long-term sustainable development. It was also paramount important for Botswana to develop the non-mineral sectors given the narrow linkage of the mining sector with the rest of the economy, especially in employment creation, (with the sector directly employing today only 2.0 % of the labour force).

In order to promote economic diversification, the government has taken on a number of steps including the creation of the Business and Economic Advisory Council (BEAC) in 2005. The council was mandated to identify constraints hindering economic diversification; formulate a key strategy and action plan to overcome those constraints; and identify projects for Botswana to move forward. The council then produced two documents, "Botswana Excellence: A Strategy for Economic Diversification and Sustainable Growth" and "Action Plan", which were approved by the cabinet in December 2006 and November 2008 respectively (Government of Botswana, 2009).

Botswana's economic diversification has, since the implementation of the Action Plan, focused around the following 1) creating a business friendly environment; 2) providing the structures and incentives that serve to improve Botswana's business capacity through training and business development efforts; 3) addressing policy and institutional matters such as ensuring the stability of the financial sector; 4) providing instruments of support for diversification initiatives including the promotion of privatization; and 5) creating projects to drive diversification through the support of agriculture and tourism among other sectors(Government of Botswana, 2009).

Figure 4 Mapping Botswana's Sustainable Development Objective



Even before the implementation of this action plan, the contribution of the mining sector to the GDP, as illustrated below, had been decreasing. Manufacturing contribution for instance increased from 8.5 percent to 11.4 percent in 2001. Moreover, at independence manufacturing output comprised mainly meat and meat products, but in 2001 accounted for only 14 percent, while other consumer goods comprised 35 percent of output, and the intermediate goods 51 percent (Kapunda, 2003).

However it should be noted that Botswana's economic diversification is still under pressure and poses a major challenge to the government. As the government was able to put in place requisite infrastructures and institutions for private sector competitiveness-the sole driver of economic diversification, homegrown private sector remains weak, meanwhile the key targeted sectors notably manufacturing haven't fully yielded intended results. Among various factors to the slow pace in economic diversification including small domestic market, high cost of labour (propelled largely by government financial muscle), and lack of skill-mix as per the market demand. Though it has been argued that there is still room for further diversification, particularly through the strengthening of the manufacturing and agricultural sectors, Botswana has made important progress especially when compared to Libya.

Indeed, Libya's experience during the revolution is a perfect example of the importance of economic diversification. Though it is true that the war would have had a negative impact on the economy in general, that the conflict put a 6 month stop to oil exports and that this translated into the contraction of the economy by 41.8% speaks to the importance of diversifying the economy as a means of developing its resilience.

B) The Creation of Sustainable Fiscal Policy

In addition to efforts aimed at diversifying the economy, critical to Botswana's success was the government's ability to de-link expenditures from revenue. By avoiding pro-cyclical expenditures, the government also avoided excessive investments in low-return projects, expenditure entrenchment, debt accumulation, a loss of competitiveness in manufacturing and the weakening of institutions and transparency (Asfaha, 2007). Indeed, de-linking expenditures from revenue is no small feat. Because mineral revenues constituted a major source of government revenues, there existed considerable political pressure to spend everything in the treasury. Understanding how Botswana was able to save, invest or efficiently used any excess revenue is crucial for understanding how the country escaped the resource curse. In order to ensure spending was moderated during booms and increased during busts, Botswana closely adhered to its National Development Plan and both formal and informal fiscal rules.

National Development Plans

Botswana relies on a 6 year planning cycle with mid-term reviews to update the plans in response to changes in the economy. National development planning and its integration with the annual budgetary process have been crucial in its role of promoting the efficient management of the country's windfall gains—mineral rent and foreign aid (Maipose). Beyond the considerations taken into account in the drafting of the National Development Plans, their oversight, structure and recurrent nature are also a fundamental source of Botswana's successful wealth planning track record.

The Ministry of Finance and Development Planning has a central role in the development and implementation of the plan. However, the creation of the National Development Plans involve a broadly based consultative system of committees that include members of civil society as well as senior political offices. Culture of consultation matters most in the case of Botswana where Parliament decisions are also reviewed by the House of Chiefs constituted by 35 members, eight of whom being hereditary chiefs of Botswana's principal tribes (baKgatla, baKwêna, baMalete, bamaNgwato, baNgwaketse, baRôlông, baTawana, and baTlôkwa). Although the House of Chiefs has no legislative or veto power, it acts as an advisory body to the Parliament and it ensures that all bill affecting tribal organization and property, customary laws are discussed by the House a priori. With this traditional culture of consultation with the grassroots, it enabled Botswana to embrace the culture of transparence and accountability, especially on government officials.

Adherence to the National Development Plans are ensured by a rule that makes it illegal to implement any additional projects without going back to parliament once the plan has been approved. The plans therefore prevent the inception of projects for which no provision was made to cover the total costs over time.

Importantly, when considering domestic investments, the National Development Plans take into account the absorptive capacity of the economy. According to Sarraf and Jiwanji "Since the availability of skilled manpower was a large constraint in Botswana, the government felt that increasing development expenditure beyond the capacity of the country would result in a rate of return lower than what could have been earned on alternative assets."

Along these lines, Botswana's multi-year planning system also helped keep expenditures in check by taking into consideration the feasible paths of expenditure projected by the Ministry of Finance and Development Planning. Feasibility checks include the sustainability of recurrent expenditures. According to this guideline, even if the capital budget is affordable in the plan period it is reduced if the costs cannot be covered with confidence (Leith, 2000).

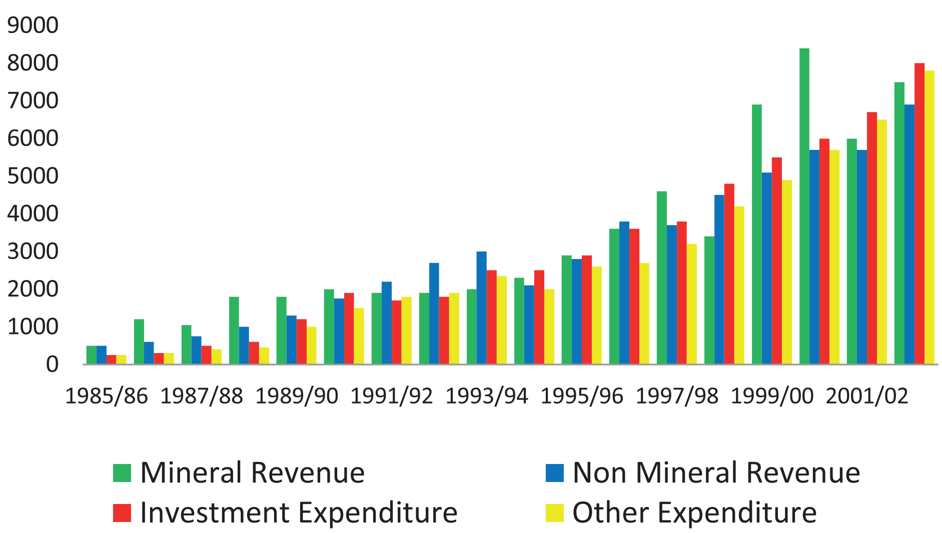
In essence, Botswana's National Development Plans are guided by strict rules, integrated into the annual budget, but they also take into account the needs of various sectors within society by insuring they are represented during the drafting process.

The Establishment of Fiscal Guidelines

Although implicit in the discussion of Botswana's development plans, the presence of a number of fiscal rules in Botswana's wealth management process merits its own analysis given the important role they have played in the creation of a sustainable fiscal policy. Cognizant of the fact that its mineral wealth will soon be depleted, the government has created both formal and informal fiscal rules to prevent excessive spending and ensure fiscal sustainability. Among these, is the principle of sustainable budgeting, which was introduced in 1994, and aimed to ensure that all mineral revenue be invested productively or saved rather than be used for consumption. This rule led to the creation of the Sustainable Budget Index (SBI) – defined as the ratio of non-education, non-health recurrent expenditure to non-mining revenue. "While it is not a legal requirement, an SBI of no greater than unity is targeted in order to ensure non-investment expenditure be financed by non-mineral revenue and conserve the country's wealth" (Kojo, 2010). Another fiscal rule introduced in 2006 as part of the Mid-term review of the National Development Plan sets the maximum government expenditure at 40 percent of GDP to be consistent with the projected medium-term government revenue.

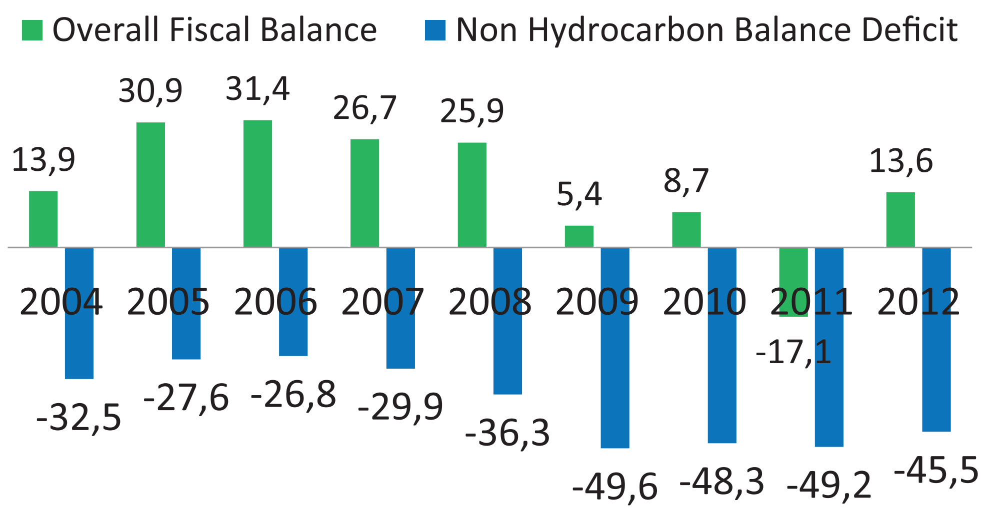
Botswana's fiscal rules, however, were not only focused on limiting expenditures. They also focused on increasing the productivity of revenue spent and limiting debt. For instance, the 2006 Mid-Term Review targeted increasing the share of development spending in the budget to 30% by 2008/9. While, section 20 of the Stock and Treasury Bills act prohibits the government's total domestic debt guarantees from exceeding 20 percent of GDP (Kojo, 2010).

Figure 5 Botswana Mineral Revenue and Investment Expenditure 1985-2004



Source: Iimmi, 2007.

Figure 6 **Libya Fiscal Balance 2004-2012 (Percent of GDP)**



Source: African Economic Outlook 2011.

The government of Botswana has not always followed its fiscal rules. However, Botswana has overall run a prudent fiscal policy, allowing it to avoid many of the pitfalls experienced by other resource rich countries. Figures 8 and 9 particularly demonstrate how Botswana and Libya differentiate with regards to the use of mineral and non-mineral revenues. Botswana's approach has been to focus on sustainability. The prevalence of Libya's non-hydrocarbon fiscal deficit demonstrates the contrary approach, and hints at what a future fiscal balance may look like when the country has depleted its natural resource.

It is nevertheless important to note that a sober fiscal policy is but one aspect of Botswana's approach to combatting the challenges confronted by mineral-rich states. In addition to controlling spending, the government has made important strides in ensuring that revenues are also saved and invested so that future generations may also benefit from the country's wealth even after it has been depleted.

The Pula Fund: Saving and Investing Mineral Revenues

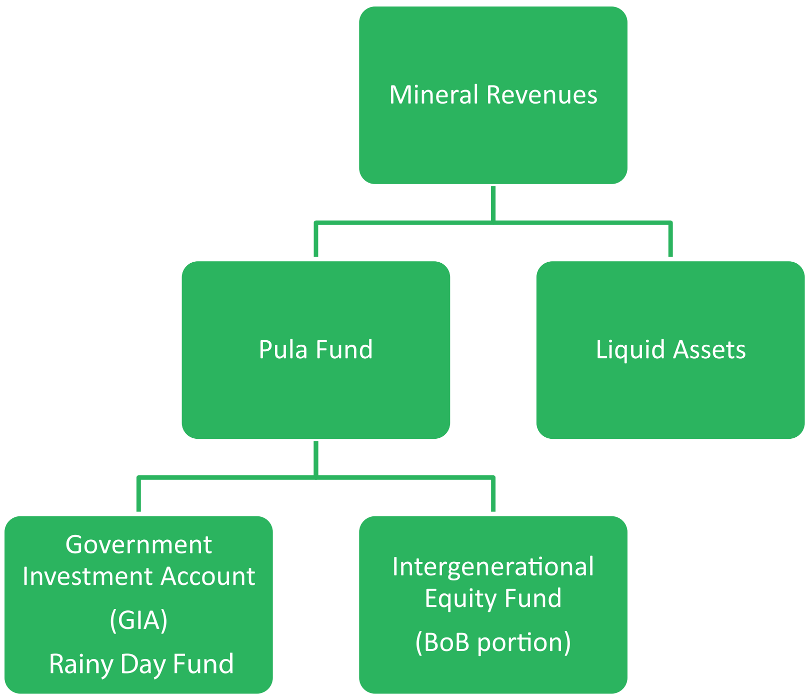
Botswana's policy for investing revenues originating from its mineral wealth has focused primarily on The Pula Fund. The Pula Fund was established in 1993 and was subsequently re-established in its current form under the new Bank of Botswana Act (1996). The objective of the fund was to provide greater flexibility in the management of international reserves and greater certainty in the forecasting of annual dividend payments to the government from the Bank of Botswana (BoB). The BoB Act split Botswana's international reserves into two portfolios: the liquidity portfolio, to provide the foreign exchange needed for normal day to day international transactions and the Pula Fund, to be invested in long term assets to achieve higher returns (Kojo, 2010).

The Pula fund is managed by the BoB and is comprised of the Government Investment Account (GIA), which reflects savings from accumulated fiscal surpluses, and the BoB's reserve accumulation. The Pula fund has two functions, it is at the same time a stabilization fund and a savings fund for future generations. The stabilization aspect of the fund takes previous years' fiscal surplusesand saves them in the Government Investment Account. This account is then used to finance fiscal deficits. Meanwhile, the BoB portion functions as the intergenerational equity fund, to ensure that the mineral revenues are invested in such a way that future generations can also profit from the resource, even after it has been depleted. The Bank of Botswana has invested Pula fund assets in foreign currency denominated assets. According to Truman (2008), the assets of the Pula fund reached 7 billion USD in 2008.

While Botswana has been successful in accruing assets as means of ensuring inter-generational equity through its sovereign wealth fund as well as using it to smooth commodity price volatility, it is important to take into account that the creation of a commodity fund does not necessarily ensure politicians will not take its assets when it is flush. Indeed, part of the reason Botswana has been successful in preventing these practices by adhering to the rules that prevent the government from interfering in the investments of the funds as well as in using its assets.

Research on the successful management of intergenerational equity funds has found that their success relies on the country's ability to prevent the government from altering the budget or the rules surrounding the fund. As was previously noted, Botswana's requirement for parliamentary approval of changes to the budget had promoted the efficient management of its intergenerational fund (Asfaha, 2007). Yet other countries with sovereign wealth funds have not been as successful. Asfaha (2007) explains that national revenue funds are ultimately ineffective if institutions ensuring the government's observance of the funds rules are absent. That is to say, strong institutions and good governance are a prerequisite for effective fund management.

Botswana's Savings, Investment and Spending Structure for Mineral Revenues



Libya's Sovereign Wealth Fund

Indeed, Libya's sovereign wealth fund is a perfect example of a fund that was poorly managed and whose effectiveness in ensuring intergenerational equity was hampered.

Libya's sovereign wealth fund, the Libyan Investment Authority (LIA), is tasked with investing Libya's savings abroad. The LIA is thought to manage some $50-70 billion of assets and in 2011 were said to amount to $10,000 for every Libyan. Though the LIA's assets are significant, the structure of the fund, and Libya's poor governance track record has hampered its investment objectiveness.

While the LIA is governed by a Board of Trustees consisting of a mix of government officials and Libyan banking expert, the fund ultimately answers to the Prime Minister. As illustrated earlier however, the rent seeking culture prevalent in the country affected all aspects of the economy and the sovereign wealth fund was no exception.

There have been numerous reports of alleged cases of mismanagement, accusing the LIA of becoming a complex network of investments run by a tight-knit circle. An audit by professional services firm KPGM in May 2010 depicted argued that the institution was in disarray and unable to manage its ambitions investment strategy. Many of the deals made were said to be politically motivated.

Furthermore, in August 2011 it was reported that some $2.9 billion were missing from the accounts of the Libyan Sovereign Wealth Fund and that those investigating the body had found misappropriation, misuse and misconduct of funds.

Following the overthrow of the former regime, however, Rafik al Nayed was appointed interim head of the LIA by the NTC. He has announced his intention of bringing greater transparency to the wealth fund by creating an independent task force to probe irregular transactions.

Source: Oil4all.

5 Good Governance: A Pre-Condition to Successful Wealth Management

Botswana's successful management of its resource wealth was made possible by the institutions it put in place. The presence of institutions like the Pula Fund, and the existence of sustainable fiscal rules are necessary but not sufficient for the responsible management of its diamond revenues. Botswana's success has been enabled by its stable political system, and most importantly its culture of good governance. Good governance, epitomized in the form of its legitimate and accountable government, has fostered long-term decision making. Moreover, the presence of a vocal and integrated civil society has encouraged broad consensus in the formulation of economic policies. It is in this way that good governance has provided the right incentives for the government to uphold its own fiscal rules and respect its savings and investment institutions and promote economic diversification.

According to Iimmi (2006), Botswana's success story has demonstrated that four aspects of governance are particularly important for natural resource management. These practices include: 1) voice and accountability; 2) government effectiveness; 3) market friendly regulation and 4) anticorruption policies. The way in which these measures promote the effective management of resource wealth, and what Libya can learn from such policies, will be explored below.

The presence of voice and accountability, which is the sum of the protection of civil liberties and rights as well as the political process, is necessary for the management of resource wealth because it permits society to discipline those in authority who abuse resource extraction. By involving society in maintain a government accountable for its wealth management practices, they are better able to prevent the establishment of a rent-seeking culture. In the case of Botswana, its track record on voice and accountability is especially strong. The government has a written constitution to which all branches of government are subjected. Moreover, executive actions are subject to review. Transparency International has consistently ranked Botswana in the top 25% of countries and always at the top of the list for African states. Botswana relies on a number of structures to ensure its accountability measures remain strong. For instance, the Parliament's Public Accounts Committee is responsible for the scrutiny of public service expenditures and calls on accounting officers to testify in case of misappropriation or other irregularities (AfDB, 2009).

Government effectiveness, or the quality of public services and competence of civil servants, is also important because resource management policies are highly dependent upon the institutions and individuals implementing them. For Botswana, the self- imposed fiscal rules have permitted the government to limit the use of diamond revenue, and where possible invest it effectively so that future generations may also benefit from the country's mineral wealth.

There is also need to put into perspective historical background of the diamond discovery in Botswana. It was in 1971 when the first mine was opened in Orapa, followed by another one in Jwaneng in 1982 all operated by De-Beers and owned in joint venture at 50-50% between the Government and the De-Beers, a south Africa based Diamond Company. Here the ownership is key in terms of appropriation of diamond proceeds and its deployment. Since the ownership was not between companies, but between the State and the De Beers; to a significant extent, it diffused influence of individual interests, particularly politicians to tape into the resources.

Cognizant of the importance that establishing long-term favorable relationships with the private sector will have in the efficient exploitation of its mineral wealth and in the development of alternative sectors, the country has made sure to establish market friendly policies. According to Iimmi, contracts related to natural resources commonly extend for more than 10 years and the term for diamond mining leases is 25 years. Moreover, the government has provided BWP 3 million to Public Enterprises Evaluation and Privatization Agency (PEEPA) to develop a regulatory policy legal and institutional framework for PPPs in the country. The general economic policy environment is business friendly: there are no foreign exchange controls and there are few non-tariff barriers to imports, although trade requires a license. Taxation is favorable with a standard income tax rate of 25% for individuals and 15% for manufacturing and international financial services (AfDB, 2009).

Finally, anticorruption policies allow for the transparent distribution of resource benefits. The African Development Bank (2009) noted that corruption is not a problem in the country, but rather the country benefits from a transparent budgetary and procurement process. There is a system of checks and balances for accounting procedures and internal auditing. The system is backed by a computing system that rejects any payment or over payment that is not authorized in the budget. The accounting system complements the budgetary process in terms of controlling expenditures, monitoring the disbursement of funds and revenue collection (AfDB, 2009). Botswana has also encouraged anti-corruption measures through the establishment of an independent anti-corruption authority in 1994, the Directorate of Corruption and Economic Crime, which has the authority to report corruption cases directly to the president. The constitution also makes the attorney general independent of the government and politicians. It is the combination of Botswana's fiscal sustainability measures and its culture of good governance that have created the conditions necessary for the country to turn its natural resource into a blessing. The section that follows will outline which practices in particular Libya can draw from in this moment of transition to improve the efficient use of its oil resources.

6 Policy Recommendations for Libya

As was demonstrated earlier, though Libya's economic track record demonstrated impressive levels of growth, its oil resources also caused great harm to the economy. Unequal distribution of wealth and a culture of rent-seeking, amongst a number of other macroeconomic imbalances, created a precedent in which oil resources were misused, and often as means for the former regime to stay in power. Now that the revolution has taken place, Libya stands at a crucial intersection. In its grasp lies an opportunity for the country to improve its wealth management so that its oil resources become a source of equal growth and stability.

Botswana, whose economic trajectory is an exception amongst economies rich in natural resources, has a great deal of lessons to share for Libya. The following policy recommendations are drawn from Botswana's best practices in mineral wealth management.

1. **Establish Sustainable Fiscal Policy Rules**: As indicated by the IMF (2005), it is important to introduce explicit fiscal rules for the treatment of natural resource revenues. Any windfall gains should be deposited in a special account and used for designated economic and social development. The country could also adopt a non-oil deficit target to promote economic diversification. By officially de-linking expenditure from natural resource revenues the government would be making a public commitment to responsibly manage the nation's wealth. The public nature of the commitment would make the government accountable to its citizens if it reneged on the policy. In addition to sustainable fiscal policy rules, Botswana has relied on strict National Development Plans overseen by parliament to ensure expenditure smoothing; a policy option Libya may also benefit from.

2. **Ensure Good Governance**: Fiscal policy rules and investment guidelines are insufficient to guarantee that the government will always apply its responsible strategy. In order to ensure these policies help Libya to promote the efficient management of its oil wealth, it will have to promote good governance in the country. The case of Botswana highlighted in particular the following areas as important focus points for resource rich countries:
   • Voice and Accountability: By establishing transparency in its new government, and ensuring a system of checks and balances Libya will be able to counter its previous rent-seeking culture. The recent elections which took place in Libya are an important step in establishing an accountable and representative government who will take into account the interest of its citizens while establishing fiscal policies. Moreover, the government's fiscal policy could gain much from encouraging stake holder participation in the creation and regulation of the nation's budget.
   • Government effectiveness: Improving the institutions in place will enable the Libyan government to better regulate the use of oil revenues. Following Botswana's example, the country could promote capacity building in administrative activities and financial accounting.
   • Market Friendly Regulation: Because natural resource development must by necessity involve a long-term relationship with private parties, market unfriendly policies like those in place in Libya under the previous government not only discouraged investment in the oil sector, they also discouraged investments in alternative industries, ultimately hindering much-needed economic diversification. Libya should institute favorable and predictable regulations that promote investment including lower and uniform taxes as well as the protection of property rights.
   • Anticorruption policies: Given Libya's poor track record on corruption, this recommendation is crucial if the country intends to guarantee the legitimate use of the country's wealth. In Botswana, the government has created institutions dedicated to pursuing corruption at all levels of government. By establishing an independent judiciary, as well as an Ombudsman, Botswana has been able to punish as well as prevent corrupt practices. Libya could apply a similar system to encourage a culture of good governance. Moreover, Libya should complement these measures by encouraging corporate governance through the disclosure of the terms of contracts and profit-sharing arrangements as well as the publication of external audits.

3. **Promote Economic Diversification**: As Libya's experience demonstrated during the 2011 revolution, relying excessively on one resource for its revenue renders an economy extremely vulnerable to shocks in that sector. Botswana has understood that its mineral wealth can become a weakness if the country depends on it exclusively, and as such has made a consistent effort at diversifying the economy and promoting other sectors. Though this is certainly a long-term objective to be pursued by both countries, Libya stands to gain greatly by pursuing this venue for sustainable growth. According to a study implemented by Monitor Group, the country has great potential in furthering the tourism, construction and services sectors among others. However, unless Libya is able to improve the conditions for businesses in the country, it will be unable to foster growth in alternative industries.

4. **Promote Efficient Investment policies**: Though Libya has not had a deficit problem, the conflict and its impact on the oil sector demonstrated the country's susceptibility to shocks in the sector. As such, Libya should follow Botswana's example and use the surpluses gained during the better years to finance public expenditures when the revenues go down. Another especially applicable lesson for Libya regarding investments relates to the management of Botswana's sovereign wealth fund. Though Libya has a sovereign wealth fund in place, recent claims regarding its mismanagement have illustrated the importance of ensuring that its management is in line with the government's broader development objectives. Libya's fund requires operational objectives to derive appropriate investment policy. Given claims of misappropriation and misuse of funds, the country would also benefit greatly from funding, withdrawal and spending rules. By applying such measures Libya will be better able to guarantee its natural resource wealth benefits future generations as well.

7 Conclusion

While economic research has established a link between natural resource wealth and a series of macro-economic imbalances, otherwise known as the resource curse, the case of Botswana demonstrates that natural wealth is hardly a sentence to poor, unequal growth. By applying a series of sustainable fiscal policy measures, including the efficient investment of natural resource revenues for use by future generations, and accompanying these policies with good governance and strong institutions, Botswana has been able to turn its resources into a blessing rather than a curse.

Libya stands at a development crossroads in the aftermath of the 2011 revolution. The interim government can take the opportunity for reform created by the revolution to apply the important lessons drawn from Botswana's resource wealth management. In doing so, Libya's new leaders will be able to overcome the legacy of wealth mismanagement established by the former government. If distributed evenly, Libya's oil wealth could improve the standard of living of all Libyans and furthermore act as an important source of investment industries and development initiatives. Rather than allowing its vast oil wealth from becoming a liability, Libya can use its resources to ensure the responsible management of its revenues and apply these funds to promote inclusive growth.

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