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الجمهورية اللبنانية
مكتب وزير الدولة لشؤون التنمية الإدارية
مركز مشاريع ودراسات القطاع العام

The Lebanese Center for Policy Studies

Republic of Lebanon
Office of the Minister of State for Administrative Reform
Center for Public Sector Projects and Studies
(C.P.S.P.S.)

"Reducing the Budget Deficit: A First Reading"

A Working Paper of: **The 1998 Lebanese Budget**
A Research Project of:
The Lebanese Center for Policy Studies

In Collaboration with:

The Commission of the European Communities

Project Team

Lead Researcher and Author:
Mr. Sami Atallah, Researcher, LCPS Economics Research Unit

Project Director and Supervising Editor:
Dr. Samira Atallah, LCPS Executive Director

Project Coordinator:
Ms. Rosie Nasser, LCPS Project Manager

Research Contribution:
Ms. Rana Houry, Researcher, LCPS Economics Research Unit
Ms. Michelle Touma, Researcher, LCPS Economics Research Unit

Secretarial Support:
Ms. Suzie Massaad, LCPS Administrative Assistant

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Reducing the Budget Deficit: A First Reading

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Introduction*

The objective of this paper is to examine the sources, effects, and sustainability of the budget deficit in Lebanon and to propose modest recommendations on how to reduce it. The paper is divided into 7 sections: section I measures the deficit, section II analyzes its sources, section III addresses the means of financing the debt, section IV analyzes the consequences of the deficit and the debt on the economy, section V focuses on its sustainability, section VI examines the government's revenue and its prospects of closing the deficit gap, and finally section VII suggests some policy recommendations to reduce the deficit.

But first, a brief note on the data relevant to the study of the budget deficit is in order. The major constraint in studying the budget deficit in Lebanon is the lack of reliable data. The issue of Gross Domestic Product (GDP), the most basic economic indicator that measures the economic activity, is a classic example of the problem of dubious data in Lebanon. The Directorate of Statistics, a government agency entrusted with measuring the GDP has been unable to collect reliable statistics since 1974 due to financial difficulties. To fill this gap, several GDP figures were measured by governmental departments, private institutions, and international organizations. The discrepancy in the figures is striking. For example, the GDP estimates for 1992 range from \$3.8 billion (Lebanese Banks' Associations 1992), \$5.1 billion (International Monetary Fund), \$5.5 billion (Banque du Liban), and \$6.5 billion (Banque Audi, 1993): thus reflecting a 70% difference between the lowest and the highest values. Moreover, these GDP estimates were based either on production figures or on certain indicators such as international trade, energy usage, and cement consumption which are not accurate substitutes to statistical surveys and sampling. The lack of reliable GDP figures distorts the amount of debt the Lebanese economy can absorb.

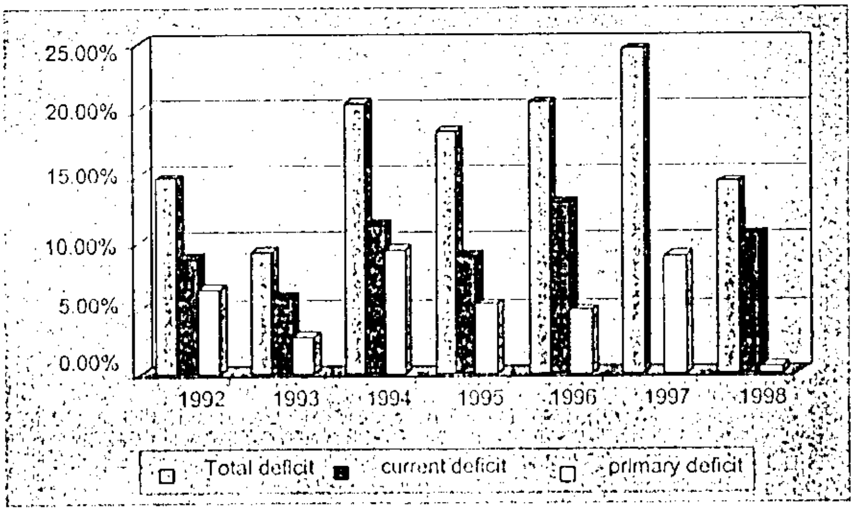
This study approaches the data of the government with skepticism. As for the GDP, the study uses the data published by the Central Bank in *The Financial Market Handbook*, noting that both the GDP figures and GDP growth rates are overstated. For the expenditure and revenues, the study uses the actual figures to the extent of their availability. The analysis examines the variables in real terms unless when noted to give a more accurate judgment on the economic changes in the economy. The real variables are calculated by deflating the nominal variables using the CPI deflator of the Central Bank of Lebanon.

* This study benefited from the review and feedback of Dr. Bassil Fuleihan

Section I – Measurement of the Deficit

In order to diagnose the economic problems of the deficit, the study uses three methods of calculations to measure the budget: total budget deficit, current deficit, and primary deficit. As a result, the analysis concludes that the total budget deficit as a percentage of the GDP is persistently high, and current spending, particularly interest payments on debts, is the main component of the deficit (see figure 1).

Figure 1. The deficits as a percentage of GDP, 1992-1998.



Source: The data for 1992 to 1996 are actual figures from the Central Bank. The data for 1997 are actual figures from the Ministry of Finance. The data for 1998 are estimated figures from the Ministry of Finance. For 1997 and 1998, the total deficit excludes the off-budget spending since it has not been made public by the time this study was finalized.

Total Budget Deficit

Total budget deficit is considered to be the most comprehensive measurement of the deficit available. It is the difference between the revenues and expenditures incurred by the government in the central budget and in off-budget spending. The off-budget spending generally represents spending on capital projects by governmental development agencies such as Council for Development & Reconstruction (CDR).[1] The total budget deficit has ranged from a low of 9.25% in 1993 to 20.57% in 1996, with a yearly average deficit of 16%. The total deficit, excluding the off-budget spending, for 1997 and 1998 are 24.53% and 14.47%, respectively.

The high and persistent level of the deficit in Lebanon is indeed alarming when compared to pre-civil war years when the budget ran a surplus of 5% and 2% of GDP in 1974 and 1975, respectively.[2] When compared to other countries, the deficit in Lebanon largely

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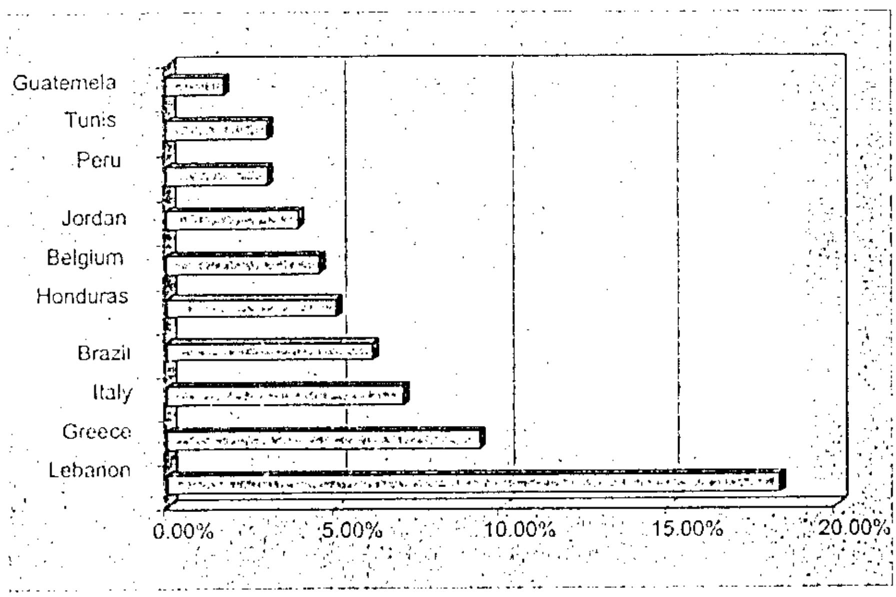
1 The total budget deficit excludes the operation of the Central Bank of Lebanon.

2 See International Monetary Fund [1995], p13

exceeds the deficit in Jordan by 4%, Peru by 3%, Honduras by 5%, and Greece by 8% (see figure 2).

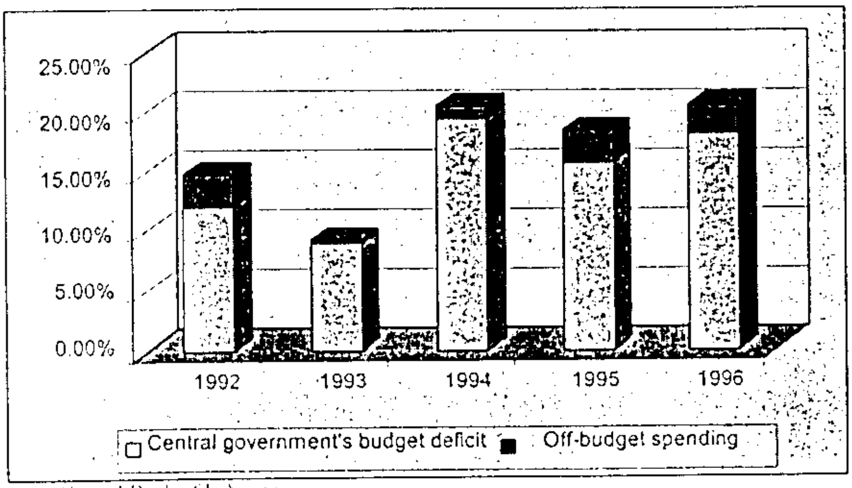
Figure 2. Budget deficit of various countries.



Note. The budget deficit figures above are for 1995, except for Jordan and Tunis are for 1997
Source Figures for all countries, except Jordan and Tunis, are from Abaad issue # 4 [1995] The figures for Jordan and Tunis, are from 'Paribas', Emerging Market Research, autumn 1997

A careful examination of the composition of the total budget deficit in Lebanon indicates that a major component of the deficit comes from the central government budget rather than from the off-budget spending. This means that the high level of the deficit is not due to the capital projects undertaken by the government as part of the reconstruction effort. According to figure 3, out of the total budget deficit of 20.57% in 1996, the off-budget deficit was only 2.5% vis-à-vis the central government budget deficit of 18%. Unfortunately, comparison with 1997 and 1998 is not feasible at this point because the off-budget spending figures have not been made public yet.

Figure 3. Components of the public sector deficit as a percentage of the GDP, 1992-1996.



Source: Central Bank of Lebanon

Current Deficit

The current deficit is the difference between non-capital revenues and expenditures. It is considered to be the "true" deficit since any excess borrowing spent on capital projects does not change the situation of the net assets of the government.[3] In other words, the new debt is actually matched by a new government asset. The current deficit has increased from a low of 5.86% of GDP in 1993 to a high of 12.86% in 1996, signifying that the government has not been able to control its current spending on salaries, interest payments, and other current expenditures. The result of the deficit due to high current expenditure rather than capital spending is alarming since this essentially reduces the capital stock in the economy.

Primary Deficit

The third method of measurement is the primary deficit, which is the difference between the revenues and expenditures excluding the net interest payment from the budget. This method allows an accurate examination of the policies of the current government in any given year by measuring its budgetary stance excluding the consequences of the deficit of the previous years. A government with a zero primary deficit may cover its expenses, excluding the net interest payments. Overall, the primary deficit in Lebanon has decreased in the last few years from a high of 9.4% in 1994 to 1.14% in 1997. This is a sign that the government has tightened its belt by financing almost all of its expenditure excluding interest payment on the debt from earned revenues.

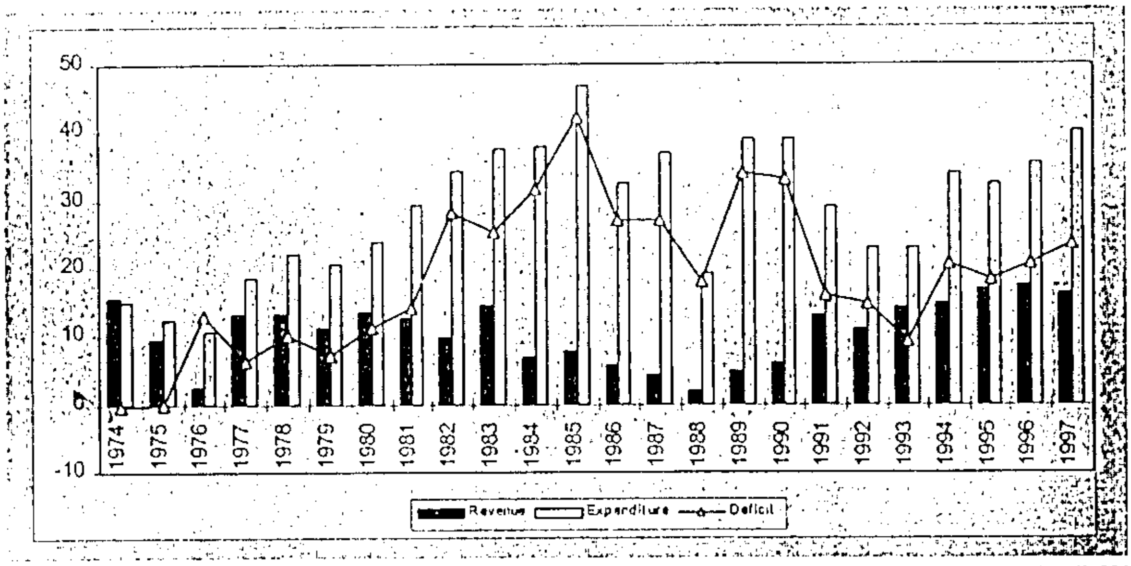
[3] This, of course, assumes that the capital projects are viable.

Section II - The Deficit: Where Did it Come From?

Historical Note

Prior to the civil war (1975-1991), Lebanon enjoyed a budget surplus as a percentage of GDP of 5% in 1974 and 2% in 1975.[4] The civil war had a serious impact on Lebanon's public finances. During the war the yearly average budget deficit was 21.5%, peaking to 42% in 1985. The rise of the deficit was mainly due to the general fall in revenues and the rise in expenditures. More precisely, revenues fell due to the erosion of the authority of the government, the fall in income, the inefficiency and breakdown of tax collection, and the rise of inflation. On the other hand, the government's spending on energy, subsidies, public sector salaries, and interest payments on the public debt were sustained (figure 4).

Figure 4. Revenue, Expenditure, and Budget Deficit as percentage of GDP, 1974-1997.



Source: For 1974 to 1987 figures, see Saidi [1989], p 16 and 17; for 1988 to 1991 figures, see International Monetary Fund[1995], p 13; for 1992 to 1997, calculation based on Ministry of Finance figures. Note that Saidi's figures on revenue include only taxes. The budget deficit figures up to 1992 excluded off-budget spending, which were considered to be negligible during the war.

Consequently, an increase in the money supply, on the one hand, and high political uncertainty, on the other, led to an increase in inflation rates from 6.7% in 1983 to a peak of 482% in 1987 (figure 5). This also resulted in the depreciation of the currency from LL 5.49 to the US dollar at the end of 1983[5], to LL1,838 to the US dollar at the end of 1992.[6]

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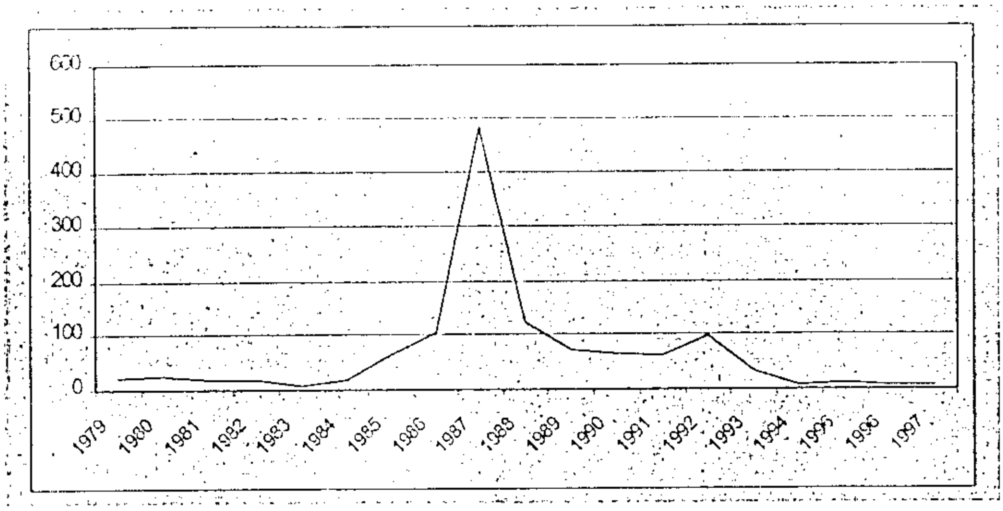
[4] See International Monetary Fund [1995]. However, Saidi [1989] estimated that the budget surplus was 7.4% and 0.2% in 1974 and 1975, respectively. For the purpose of this paper, the magnitude of these figures is irrelevant since the point is to show that Lebanon had enjoyed a budget surplus before the war.

[5] See Al-Khalil [1992], p 87.

[6] See Central Bank of Lebanon, *Quarterly Bulletin*, p 73.

Figure 5. Inflation rate, 1979-1997.



Source: Central Bank of Lebanon

The Taif agreement of 1989 brought an end to the civil war in Lebanon and paved the way for monetary and financial stability in the country. In fact, the ability of the central government to exercise its control over the Lebanese territories, except for the Israeli occupied South, led to an increase of revenues from 5% of GDP in 1989 to almost 13% in 1991. With real government expenditures restrained to 29% in 1991 from 39% in 1989, the fiscal deficit was sharply reduced to 16% of GDP by 1991 from 34% in 1989. As for public debt, it stood at 46% of GDP. By early 1993, the currency stabilized and inflation was controlled, mainly due to the high interest rates on government debt instruments i.e. Treasury Bills.

Table 1. Public Finance, 1992-1998, in real terms, in billion of LL (Base year 1992=100).

	1992	1993	1994	1995	1996	1997	1998 (3)
Revenue	1,031	1,489	1,660	2,033	2,181	2,145	2,527
Expenditure	2,181	2,422	3,855	3,926	4,460	5,235	*4,352
Total Deficit (1)	1,406	975	2,324	2,218	2,592	3,091	1,824
Net Debt (2)	4,383	4,125	6,020	7,641	10,041	12,575	13,951
GDP	9,499	10,534	11,337	12,085	12,603	13,070	13,070
Revenue/GDP	10.85%	14.14%	14.64%	16.82%	17.31%	16.40%	19.30%
Expenditure/GDP	22.96%	22.99%	34.00%	32.48%	35.39%	40.00%	33.29%
Total Deficit/GDP (1)	14.80%	9.25%	20.50%	18.35%	20.57%	23.64%	13.95%
Net Debt/GDP (2)	46.14%	39.16%	53.10%	63.23%	79.67%	96.21%	106.75%

(1) For 1992 till 1996, the total deficit includes as well the off-budget deficit. However, for year 1997 and 1998, the total deficit does not include the off-budget deficit because it has not been published yet

(2) The net debt is the sum of the net domestic debt, which is equal to the gross domestic debt less public sector deposits with Central Bank and commercial banks, and public external debt

(3) The figures for 1998 are estimates

Source: Ministry of Finance and Central Bank of Lebanon

Sources of the Deficit

The major source of the deficit in Lebanon between 1992 and 1998 is rooted primarily in fiscal mismanagement. The second source, which is beyond the direct control of policy makers, is due to a rise in interest rate.

I. Fiscal Mismanagement

The government expenditure has risen in real terms from LL 2,181 billion in 1992 to LL 5,235 billion in 1997, an average increase of 23% per year. As a result, government spending in terms of GDP has reached a peak of 40% in 1997 from only 23% in 1992. A major source of this increase is due to additional spending on government officials, ministries, and programs that add no social benefit. These unproductive expenditures have consumed scarce public resources and consequently weakened any attempt for fiscal adjustment. The paragraphs below focus on two forms of unproductive spending: high wage bill and unaccountable bureaucracy.

Table 2. Breakdown of expenditure by item, 1992-1996.

	1992 %	1993 %	1994 %	1995 %	1996 %	Yearly average change %
Expenditure	100	100	100	100	100	23.31
Current expenditure	*85.60*	*87.00*	*76.00*	*79.25*	*85.25*	*17.27*
Salaries & wages	30.27	42.92	32.86	31.92	31.29	18.57
Other Current expenditures		18.00	13.82	15.54	17.23	12.61
Interest payment on internal debt	20.81	24.99	28.29	29.80	34.71	49.87
Interest payment on external debt	2.96	0.99	1.02	2.00	2.56	12.80
Investment spending	*14.40*	*13.00*	*24.00*	*20.75*	*14.75*	*18.26*

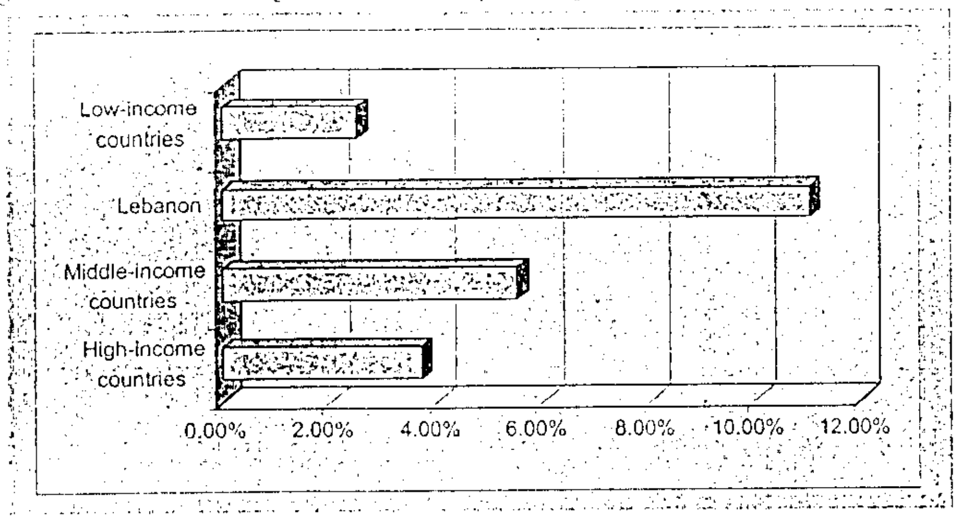
Note. No breakdown figures are available for 1997 and 1998.
Source: Ministry of Finance

1. High wage bill

The continuous increase in public sector wages and salaries has consumed 31.29% of expenditure and 11% of GDP in 1996 (table 2). The large size of the wage bill is unprecedented in the history of Lebanon; even during the civil war it ranged from 18% to 27% of expenditure for a selected number of years.[7] Moreover, the share of the wage bill to the GDP of 11% in Lebanon compares unfavorably with high, middle, and low-income countries whose share is 3.7%, 5.5%, and 2.5% of GDP, respectively, (figure 6).

[7] See International Monetary Fund [1995], p12 and 13

Figure 6 Public Sector wages and salaries as percentage of GDP.



Source: International Monetary Fund

The high wage bill is primarily due to an increase in the following:

i. Government salaries: the government has raised public wages twice over the last 6 years. The most recent increase, which has not been put into effect yet, will cost the government LL 500 billion. The current Minister of State for Administrative Reform, Mr. Hassan Shalaq stated recently that 79 government employees at a public institution received LL 29.7 billion, or an average of LL 350 million each. Such outrageous salaries go beyond the norms of public sector wages.[8]

ii. Number of staff in existing ministries: the government in recent years has hired and promoted civil servants based on their political connection and influence. A report published by the Court of Account exposed incidents of mismanagement and corruption in several ministries and agencies including the hiring of a large number of advisors by several ministries.[9] However, it is important to note that the increase in the staff has been uneven. Government agencies entrusted to supervise and punish civil servants for misbehaving have been severely weakened. This is particularly the case of the Court of Account, which has 118 vacancies out of 189 positions.[10] Note that the function of the Court is to monitor the use of public funds, insure compliance with existing laws and regulations, and prosecute all government employees accused of violating laws and regulations governing the administration of public funds. The Central Inspection Agency, which is entrusted with the responsibility of conducting inspections and investigations throughout the public service and imposing a disciplinary punishment of a limited nature on offending employees, has also suffered from a vacancy of 53%.[11]

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[8] See *Daily Star*, February 12th, 1999

[9] See *An-Nahar*, October 10th, 1997

[10] See *An-Nahar*, October 20th, 1994

[11] See the annual report of the Central Inspection for 1993, p 62

iii. Duplicate ministries. In the last 6 years, the government has created a number of ministries with duplicate responsibilities. For example, Ministry of Education, Ministry of Technical Education, and Ministry of Culture all provide similar and related services. The same applies to the Ministry of Emigrants and Ministry of Foreign Affairs. The increase in the number of ministries and agencies has also resulted in higher current expenditure due to the cost of office space, vehicles, and support staff.[12]

2. Unaccountable bureaucracy

A second source of fiscal mismanagement is the inappropriate use of the allocated budget to ministries and agencies. The lack of transparency and accountability has given rise to wasteful and, sometimes, illegal spending. In addition the absence of a bidding process and/or the lack of transparency in the process itself may be conducive to theft, embezzlement, and misappropriation in contracting public investment projects to the private sector.

The following incidents provide some examples of such spending patterns. Recently, Minister Shalaq exposed several unjustified spending by the previous government. This has included the spending of LL 92 billion on furnishing government-owned offices and LL 64 billion on renting offices for government use. Rehabilitating existing premises, he suggests, could have saved the latter amount. Another example is the withdrawal of LL 261 million by the Chairman of National Bureau of Medicine, who had also incurred LL 93 million of unjustified expenditure.[13] A third example is the case of the highway scandal where the Ministry of Public Works commissioned a private firm to conduct a study on highways for LL 13.8 billion. When the Court of Account questioned the study, the fees were "magically" reduced to LL 5.9 billion.[14] In several cases, public money has disappeared with no one being held accountable. One example is the disappearance of LL 5.3 billion from the Port of Beirut.[15] Electricity du Liban is an another case of unaccounted and missing funds. Moreover, Minister Shalaq has exposed the case of a health center in Wadi Khaled, Akkar, which was allocated LL 490 million but has only received LL 5 million.[16]

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[12] There has also been an increase in development agencies with overlapping responsibilities. This is particularly the case of the Council for Development and Reconstruction, Council for Executing Construction projects, and the Council for Executing Grand Projects in Beirut. Note however, that the wage bill of these agencies shows up in the off-budget spending and not in the central budget

[13] See *Daily Star*, July 27th, 1998

[14] See *As-Safir*, June 25th, 1998

[15] See *An-Nahar*, January 6th, 1998

[16] See *Daily Star*, February 12th, 1999.

Another outrageous case is the embezzlement of $800 million US Dollars in the Ministry of Oil which had been exposed recently and is currently under investigation. As such unaccountability and corruption exist at all levels of governmental institutions.

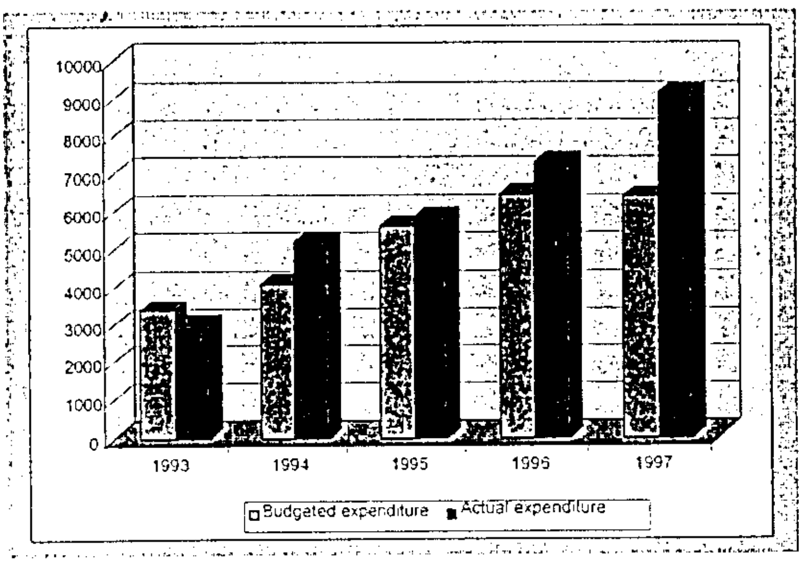
It is a common practice for government bureaucrats to induce bribes from citizens and businesses. In a recent survey of 250 businesses conducted by the Lebanese Center for Policy Studies, 78% of the respondents ranked corruption as a major problem, and 62% have been forced to pay bribes when dealing with government institutions.

Bribes in the form of an extra amount incurred above the official price do not necessarily reduce the government revenues. However, they reduce the ability and willingness of Lebanese citizens to pay official taxes.

A major factor that fueled such unproductive expenditures is the absence of effective institutional arrangements that govern the size, allocation, and use of government resources. The current arrangements are marked by the following:

- The lack of a medium term macroeconomic framework in the discussion of the budget restricts the prospects of evaluating the implications of the public expenditure on macroeconomic variables.
- Lack of formal constraints on the spending of the ministries has consistently resulted in over spending beyond the approved budget. A striking example is the overspending of $195 million by the ministries of defense, interior and health in 1998[17] (Figure 7).

Figure 7. Budgeted versus actual expenditure, 1993-1997.



Source: Ministry of Finance

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[17] See Daily Star, December 7th, 1998

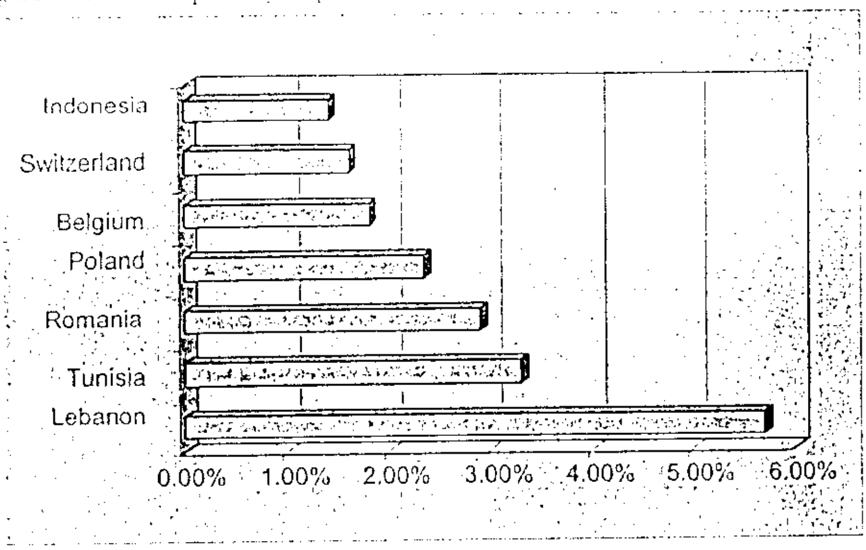
- The existence of off-budget spending undermines the fiscal discipline and causes inefficiency because the costs and benefits of off-budget expenditures are not directly compared with those of the funds included in the official budget.
- The lack of accountability by policy makers has contributed to fiscal mismanagement. The government has never justified over spending and, up till recently, never held a minister accountable.
- The absence of a systematic use of cost-benefit analysis with established assumptions and methodology to guide prioritization among projects and expenditure items has resulted in misallocation in the budget. The high spending on the defense is a case in point.
- The lack of participation from civil society (business community, workers associations, academic community) in the planning process of the budget is unfortunate since they can, not only help in identifying worthy and required projects, but also build consensus for them.
- The absence of a professional civil service with merit-based recruitment, clear tasks, simple procedures, high incentives, and strong oversight measures, has resulted in a large, inefficient, and corrupt bureaucracy.

Two other major points regarding capital investment and defense spending are worth mentioning:

1- Capital investment did not contribute much to the deficit. Capital investments on infrastructural projects have been undertaken by development agencies such as Council for Development and Reconstruction. The money spent on these projects is outside the central government budget and is in the off-budget spending. The magnitude of the deficit in the off-budget spending of 2.5% is small in comparison to the deficit in the central budget of 18% for 1996.

2- Defense spending constitutes around 10.4% of total budgeted spending and 5.7% of GDP, which is very high in comparison to other countries. For example, out of its GDP, Indonesia spends 1.4%, Switzerland 1.55%, and Belgium 1.75% on defense (see figure 8).

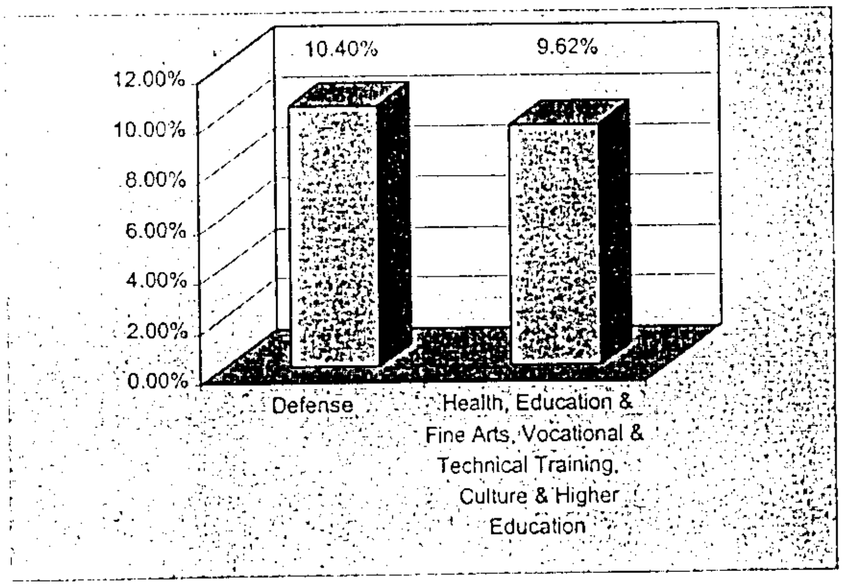
Figure 8. Defense spending as percentage of GDP.



Source: Journal of *Abaad*, December 1995 for all figures except Lebanon. Lebanon's figure is the ratio of the budgeted amount to the Ministry of Defense to total GDP as provided by the Ministry of Finance.

On the other hand, the budget for health has declined as a percentage of total expenditure from 5.41% in 1992 to 3.57% in 1998. To put things into perspective, the amount of money budgeted for the Ministry of Defense in 1998 was 10.4% of total budgeted spending. This was in fact more than the total amount of money budgeted to the Ministries of Health, Education and Fine Arts, Culture and Higher Education, Vocational and Technical Training. Their combined budgets amounted to 9.62% of the total budget of the same year (see figure 9). This is unfortunate since health and education are considered to be a human capital investment, which has major long-term benefits to economic development and growth.

Figure 9. Defense versus Health, Education & Fine Arts, Vocational & Technical Training, Culture & Higher Education of the budgeted amount as a percentage of GDP, 1998.

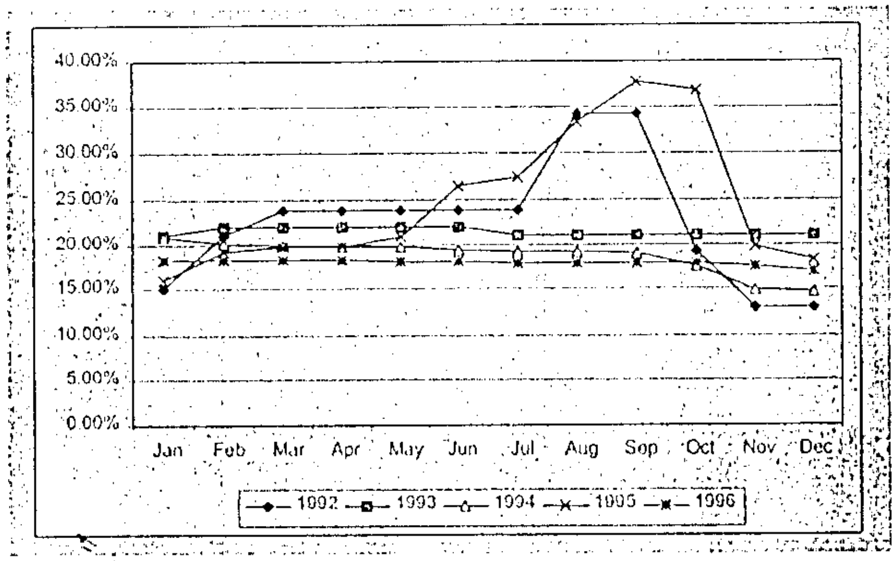


Source: Ministry of Finance

ii Rise in Interest Rate

The second component responsible for the budget deficit is the high interest rate of the Treasury bills, which has resulted in a high interest payment on internal debt. This component witnessed the largest yearly average increase of almost 50% between 1993 and 1997, consuming an average of 35% of expenditure and 13% of GDP for 1997. Moreover, the political uncertainties related to the presidential elections of September 1995 led to an increase in interest rate on one-year government T-bills to 37.85% from 27.69% on similar T-bills issued in October of the same year.[18]

Figure 10. Interest rates on 12 month Treasury Bills, 1993-1996.



Source: Central Bank of Lebanon

The interest payment bill compares unfavorably with many developing countries: interest payment on debt is 8% in Bolivia, 10% in Colombia, 12% in Peru, 15% in Egypt; 21% in Sri Lanka, and 25% in Kenya. This component is not expected to decrease especially since Lebanon is still accumulating large amounts of debt. In fact, the sum of the amount paid on wages and salaries and interest payment is 1.35 higher than the total government revenues for 1996.

In conclusion, one of the major sources of the deficit is fiscal mismanagement. This is most apparent in the increase in public sector wages and the squandering of public resources. Moreover, the lack of institutional arrangement has fueled both high and unproductive spending. Another source of the deficit is the rise in interest rates on T-bills due to political uncertainties. Moreover, it is important to establish that capital spending is not the cause of the deficit. In fact, its share has been very small when compared to the

[18] See p.51 in the Annual Report 1995 of the Central Bank

total deficit. In addition, the type of spending by the government favoring defense and sacrificing health and education has adverse effects on the growth of the economy.[19]

[19] See Diamond [1989], Barro [1991], Grossman [1990], and Easterly and Rebelo [1993] for regression analysis examining the relationship between current expenditure and economic growth

Section III – Financing the Debt

High and persistent budget deficits over the last 6 years have created an enormous pressure on the Lebanese economy. The debt has been primarily financed from domestic sources with a maturity structure of two years. The foreign debt, which used to be relatively small, has been increasing at high rates and, if left unattended, may potentially lead the economy to an international crisis. The purpose of this section is to briefly examine the sources of financing the deficit.

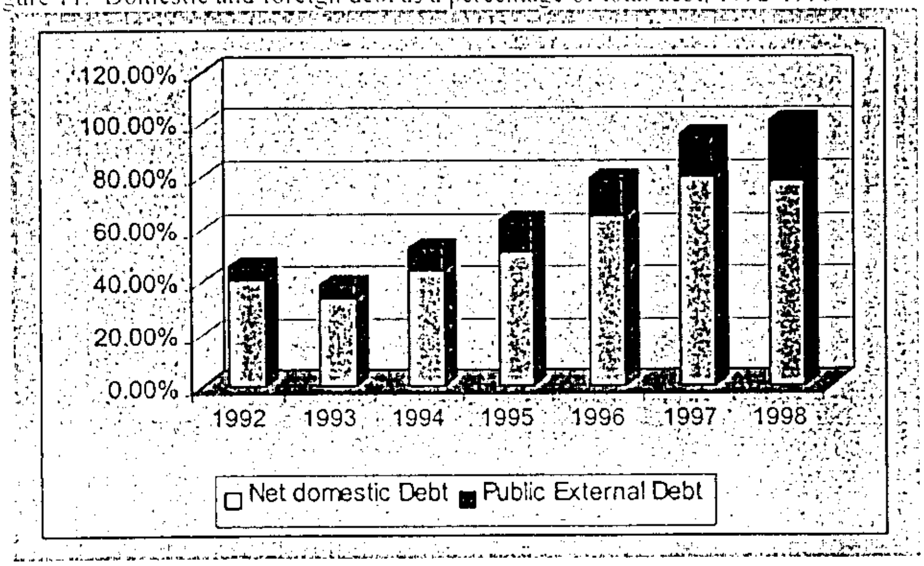
The net public debt, both domestic and foreign, has increased from 46% in 1992 to 100.85% in 1998 (see table 3 and figure 11). In real terms, it rose from LL 4,383 billion to LL 13,180 billion for the same period, an average increase of 28.65% per year.

Table 3. Debt indicators, 1992-1998.

	1992 %	1993 %	1994 %	1995 %	1996 %	1997 %	1998 %
Debt/GDP	46.14	39.16	53.10	63.23	79.67	96.21	106.75
Net domestic debt/GDP	40.92	33.58	43.86	51.51	65.43	80.35	78.27
External debt/GDP	5.22	5.57	9.25	11.72	14.24	15.86	22.57
Total interest payment/GDP	5.46	5.97	9.96	10.33	13.19	13.86	12.39
Interest payment on internal debt/GDP	4.78	5.75	9.62	9.68	12.28	-	-
Interest payment on external debt/GDP	0.68	0.23	0.35	0.65	0.91	-	-

Note: interest payments on internal and external debt are not yet available for 1997 and 1998.
Source: Ministry of Finance

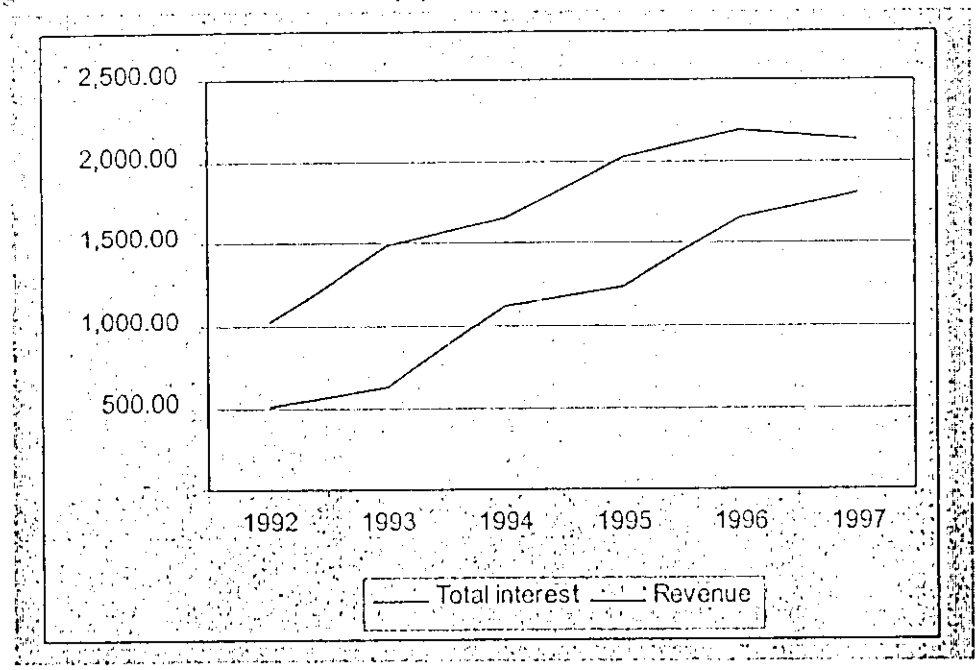
Figure 11. Domestic and foreign debt as a percentage of total debt, 1992-1998.



Source: Ministry of Finance

The accumulation of the debt has resulted in a large interest payment bill, which essentially consumes 85% of total government revenues (see figure 12) and 13.86% of GDP in 1997 (see table 3).

Figure 12. Revenue and total interest payments in billion LL, 1992-1997.



Source: Ministry of Finance

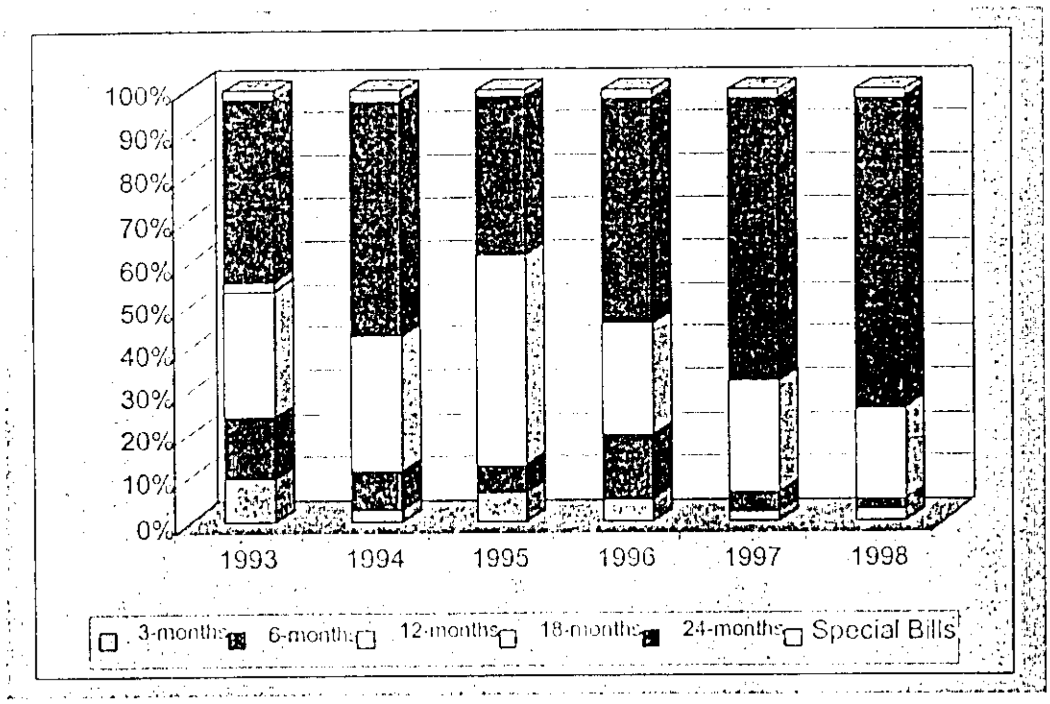
The high levels of debt and interest payment are alarming as they impose a real burden on society at large. Below is a brief account of the two sources of financing the debt: at both its domestic and foreign levels.

Domestic Debt

Domestic debt has been the major source of financing the government deficit. It has increased from LL 3,887 billion in 1992 to LL 10,230 billion in 1998, a yearly average increase of 24%. The domestic debt as a share of total debt has stabilized in the last 2 years to around 75% from 88% in 1992.

The maturity structure of the domestic debt has shifted from short to medium term. In 1993, 70% of the domestic debt had a maturity structure of 12 and 24 months. This figure has jumped to over 90% in 1998 primarily concentrated by 24 month treasury bills (see figure 13).

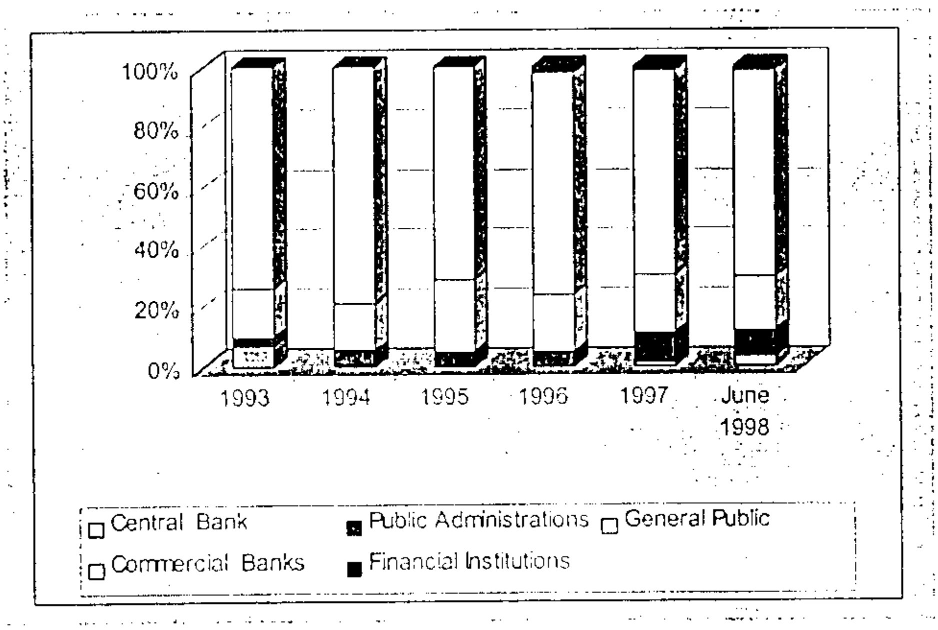
Figure 13. Maturity structure of the domestic debt, 1993-1998



Source: Central Bank of Lebanon

The commercial banks hold roughly 68% of the debt followed by the general public with almost 20% in 1998 (see figure 14).

Figure 14. Holders of the debt, 1993-1998



Source: Central Bank of Lebanon

The denomination of the domestic debt is in Lebanese pounds, which in effect gives the government incentives to pay it off through money creation.

Foreign Debt

Although foreign debt is relatively small compared to domestic debt, it has expanded rapidly from 5.22% in 1992 to 22.57% in 1998 (see table 4). The external debt has serious consequences:

- It is a real burden on society since it requires a transfer from Lebanon to a creditor country
- It exposes Lebanon to external shocks and international crises, such as increases in world interest rates.

The rapid increase of both the debt to export from 83% to 691% and interest to export from 11% to 18% between 1992 to 1998 will very soon affect the creditworthiness of the country and may reduce the ability of the government to borrow from abroad (see table 4).

Table 4. External indicators, 1992-1998.

	1992 %	1993 %	1994 %	1995 %	1996 %	1997 %	1998 %
External debt/GDP	5.22	5.57	9.25	11.72	14.24	15.86	22.57
External debt/export	83	86	141	144	176	323	691
Interest/export	11	4	7	12	18	-	-

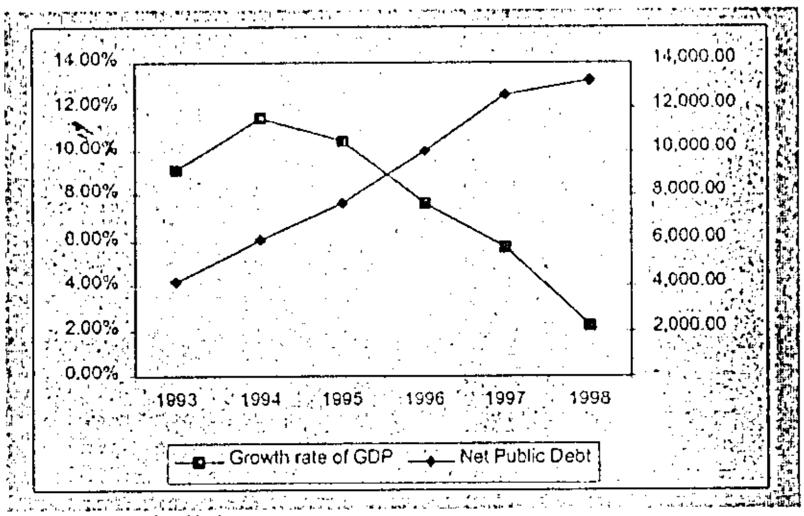
Source: Central Bank of Lebanon and Ministry of Finance

Section IV - Consequences of the Deficit and the Debt on the Economy

Although in the short run the high level of the deficit has stimulated aggregate demand and national income, the economy is suffering from lower investment, a higher trade deficit, and is more vulnerable to international crisis. This section briefly reviews the consequences of the deficit.[20]

The increase in the deficit has resulted in lower investment and has consequently led to a decrease in capital stock. This has essentially reduced the growth rate of the GDP (see figure 15). A closer analysis provides a more interesting finding. In fact, there are two opposite effects of the deficit on investment. The portion of the deficit that finances current expenditure crowds out private investment since banks are more eager to finance the government deficit with high interest bonds than the private sector. In fact, around 90% of bank loans in Lebanese Pounds go to the public sector at very attractive interest rates (see figure 11). However, the government deficit responsible for capital project such as an infrastructural project has a positive effect on private investment simply because public investment complements private investment. However, the crowding out effect has dominated the complementary effect. This is shown by simply comparing the larger magnitude of domestic debt, which generally finances current spending to the relatively smaller foreign debt, which finances capital projects.

Figure 15. Growth rate of GDP versus the level of public debt, 1993-1998.



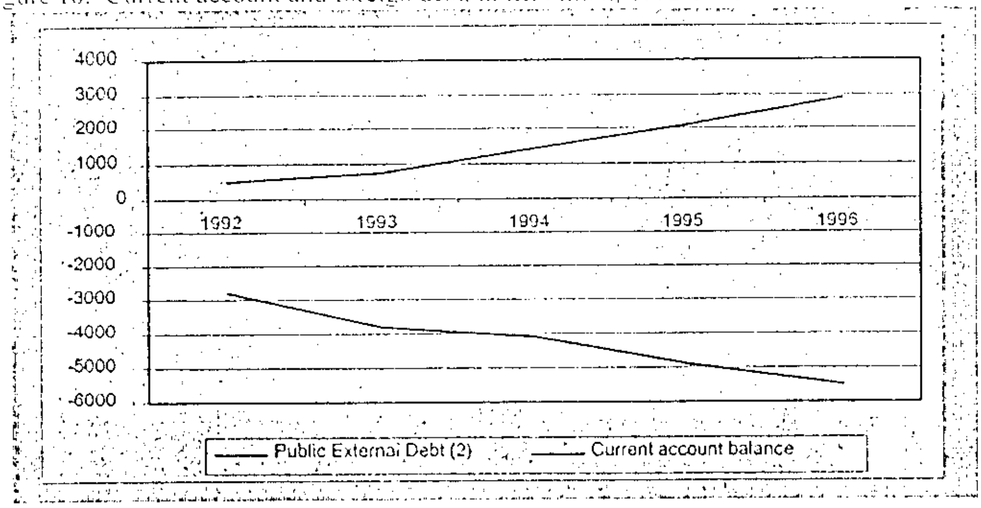
Source Central Bank of Lebanon

The increase in the deficit reduced net foreign investment, which meant that domestic residents now own less capital abroad. Essentially, the decline in net foreign investment has been matched by a decline in net exports. This has resulted in an increase in the trade

[20] The argument put by Barro [1974], better known as the Ricardian Equivalence, explains that fiscal deficits have no effect on aggregate saving or investment or even on the current account of the balance of payments. However, the validity of this argument is questionable as it is based on invalid assumptions such as infinite planning horizons, certainty about future tax burdens, perfect capital markets, rational expectations, and nondistortionary taxes and hence is disregarded in the present analysis.

deficit of goods and services. The ultimate result is two types of deficit: in the budget and in trade (see figure 16).

Figure 16. Current account and foreign debt, in LL billion, 1992-1996.



Source: Central Bank of Lebanon.

The debt service payments for the domestic debt are a transfer among members of the society. The transfer creates some distortion of individual behavior as higher taxes correlate with larger deadweight losses.

The high level of domestic debt, in the case of emergency, may lead to a reduction in interest rate through an expansionary policy, which in turn leads to inflation. Moreover, the increase in the share of foreign debt makes the economy more vulnerable to international crises, which in the case of a loss of confidence may lead to a flight of capital and hence the depreciation of the currency.

Section V - Sustainability of the Deficit and the Debt

The government cannot indefinitely accumulate domestic and foreign debt without incurring harm to the economy. This is because the government would face an intertemporal budget constraint which would impose restrictions on its ability to borrow. In addition, continuous borrowing will have serious implications on the overall formulation of macroeconomic policy targets, such as inflation, output growth, and balance of payments.

For the debt to be sustainable, it is argued that its growth rate should be equal or less than the growth rate of the economy. In the case of Lebanon, the growth rate of debt has exploded between 1994 and 1997. It was only in 1998, that it was reduced significantly (see table 5).

Table 5. Growth of GDP and net public debt, 1993-1998.

	1993 %	1994 %	1995 %	1996 %	1997 %	1998 %
GDP	9.11	11.53	10.48	7.6	5.72	2.19
Net public debt	(5.9)	45.95	26.93	31.40	25.24	4.82

Source: GDP figures are based on individual calculations. The Net public debt is based on Financial Market Handbook of the Central Bank of Lebanon

The primary objective of the government is to stabilize the debt to the GDP ratio. But then, how much must the primary deficit be in order to maintain a constant debt to GDP ratio? A very raw estimate is found in table 6 based on the assumption that no financing is possible from seignorage nor from external sources.[21]

Table 6. Sustainability of the debt, three scenarios.

	Low %	Base %	High %
Real GDP growth rate	0	2	4
Inflation rate	4	4	4
Nominal interest rate	16	15	14
Real interest rate	12	11	10
Primary surplus	12.12	8.9	5.8

And based on this assumption, the primary surplus that the government must attain in order for its debt to GDP to be constant was calculated. The three scenarios, presented in table 6 diverge with respect to real GDP growth rate and weighted average of the real interest rate. With a base scenario of a GDP growth rate of 2% and real interest rate of 11%, Lebanon must produce a primary surplus of almost 9% of GDP. Assuming the revenues go up to 20% of GDP (from 19.3% in 1998), then expenditure to GDP must be equivalent to 11%. In essence, spending must be sharply reduced from 21% of GDP in 1998, excluding interest payments, to 11%. This is quite radical. This is equivalent to eliminating all other current expenditure (which make 6% of GDP) and cutting 3% of

[21] In fact, for a more accurate measurement of the sustainability of the deficit, it is worth adopting the accounting approach to public sector solvency developed by Buiter [1985, 1990]

GDP from salaries and wages. Accordingly, not only must the Lebanese government reduce its spending sharply, but it must also find other sources of revenue. This exercise exposes in numerical terms the necessary adjustments that must be undertaken in order to stabilize the economic condition in Lebanon.

Section VI – Revenue: The Other Side of the Fence

Having examined the sources of the deficit, it is imperative to study the challenges of enhancing the revenue in order to close the deficit gap. The purpose of this section is to examine the reforms achieved in the revenue section with particular emphasis on the level and composition of taxes on the one hand, and on the tax administration, on the other. Given that the tax system in Lebanon is highly regressive (80% of taxes come from indirect taxes), any prospects of generating more sustainable revenue will require initiating a direct progressive tax system and speeding tax administration reforms.

The ability of the government to exercise its authority in all of Lebanon, except for the occupied South, allowed the increase of revenue to GDP ratio from 10.85% in 1992 to 19.3% in 1998, which is comparable to the 15%-20% in 1974.[22]

Table 7. Breakdown of revenue by item, 1992-1995.

	As percentage of revenue			As percentage of taxes		
	1993 %	1994 %	1995 %	1993 %	1994 %	1995 %
Revenue	100	100	100	-	-	-
Total taxes				100	100	100
Indirect taxes	*40.07*	*41.08*	*48.90*	*78.18*	*76.09*	*82.71*
Customs revenue	35.74	35.31	43.53		46.19	
Direct taxes	*11.18*	*12.91*	*10.22*	*21.82*	*23.91*	*17.29*
Income tax	9.42	11.15	7.58	18.37	20.65	12.83
Property tax	0.21	0.23	0.39	0.41	0.42	0.67
Real Estate Fees, other fees	*48.75*	*46.01*	*40.89*	-	-	-

Note: No breakdown figures are available for 1996, 1997, and 1998

Source: Ministry of Finance

The prospects of generating revenues are analyzed at two levels: composition and level of revenue, and tax administration.

Level and Composition of Revenue

The central purpose of the tax system in any country is to distribute the cost of financing government activities as fairly as possible among the population. The Lebanese government collects its revenues from three major sources:

1. Direct taxes - levied on individuals or businesses for which the liability of taxpayers varies in proportion to the income earned, i.e. income tax, property tax.
2. Indirect taxes - levied on goods purchased by the consumer for which the liability of taxpayers varies in proportion to the quantity of goods purchased or sold.
3. Other taxes and fees – these include other sources that do not fall into any of the categories mentioned above.

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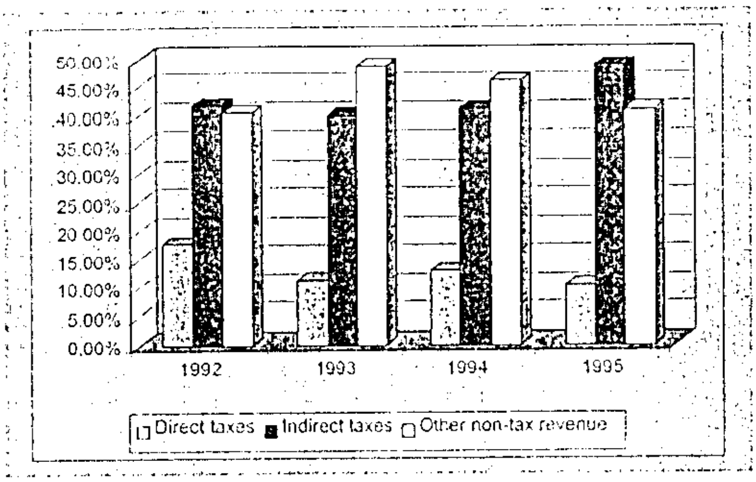
[22] See Saidi [1989] and International Monetary Fund [1995]

Figure 17. Components of revenue, 1992-1995.



Source: Ministry of Finance

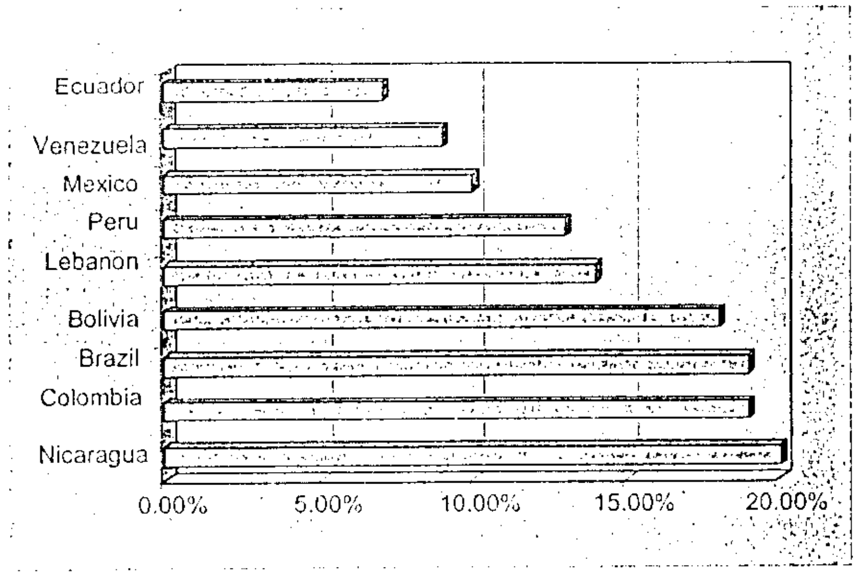
The first observation regarding revenue is the high share of other taxes and fees of 40% in 1995 of government's revenues (see figure 17). This component is made up of several fees, including the following:

- revenue from public board, government institutions, and government property.
- revenue from non-financial board.
- revenue from government financial institution.
- revenue from Casino du Liban.
- administrative fees.
- traffic law and infringement fines.
- revenue from settlements of building violations.

Although the value of these fees in relation to taxes went down in 1995, their value in absolute terms has increased due partly to higher fees on foreign permits and building violations.

The second observation to be made is that the tax revenue of Lebanon as a percentage of GDP of 14% exceeds the 1974 and 1975 share of 11% and 8%, respectively. Moreover, the share of taxes in Lebanon is comparable to other developing countries such as Peru of 12%, Bolivia of 16%, and Colombia of 18% (see figure 18). As such, the situation allows the government to increase taxes by a few percentage points. The question is however, whether this increase should be in direct or indirect taxes. The next section examines the structure of the tax system.

Figure 18. Tax as a percentage of GDP, 1996.

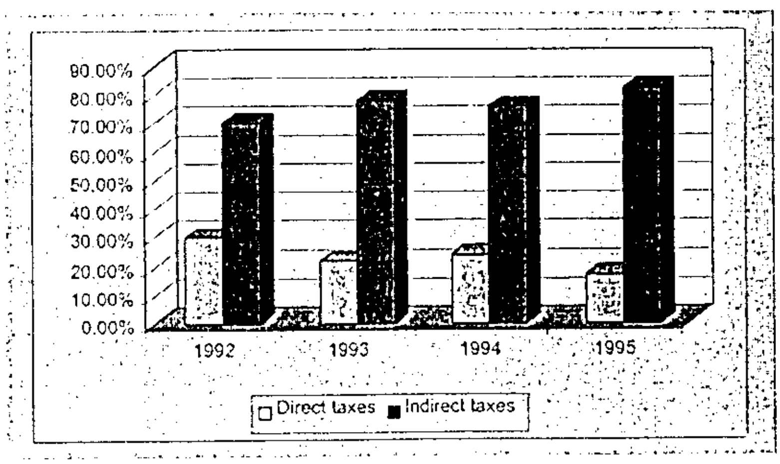


Source: ECLAC for all countries except for Lebanon. The figure on Lebanon is calculated using the Ministry of Finance data

Direct Versus Indirect Taxes

With respect to tax revenue, the government depends highly on indirect taxes. Its share from total taxes rose from 70% in 1992 to 83% in 1995 (see figure 19). In absolute figures, indirect taxes grew from LL 430 billion in 1992 to LL 1,030 billion in 1996, a yearly average increase of 28%. Although no actual figures are available for later years, the proportion of indirect to direct taxes does not seem to have witnessed any drastic change.

Figure 19. Composition of taxes, 1992-1995.



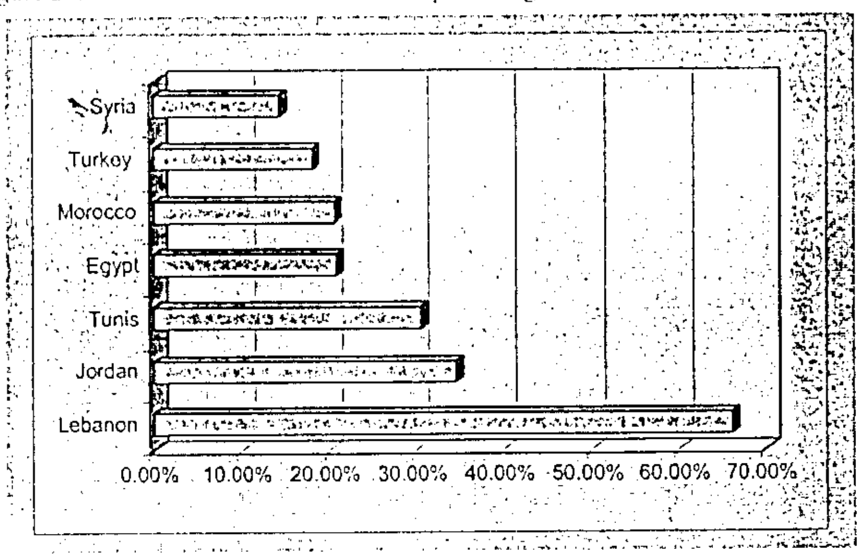
Source: Ministry of Finance

The fact of the matter is that the government relies highly on indirect taxes because they are easier to collect. The major component of indirect taxes is custom tariffs, which constituted 98% of indirect taxes and 46% of total revenue in 1996. Custom revenues increased from LL323 billion in 1992 to LL 1,007 billion in 1996, a yearly average increase of 42% due to the following reasons:

- the ability of the government to impose its authority on Lebanese ports previously controlled by militias
- the removal of the special customs exchange rate which was imposed during the war to lure importers into using government-controlled ports.
- the increase in effective tariff rates from 8% to 15% for the same period.
- the introduction of NAJM which streamlined the custom procedures for clearing goods from the customs.
- the consolidation of customs and other fees under a unified tariff, and the implementation of a harmonized system reduced the number of category commodities and tariff rates. This is expected to lower the custom collection cost.
- the transfer of fees on car fuel to custom fees.
- a general 2% tax on imported goods.

The reliance of the government on custom revenues has reached high proportion in comparison to other countries in the region. In 1995 Lebanon earned 66% of its total taxes from international tax on trade compared to 14.3% in Syria and 34.6% in Jordan (see figure 20).

Figure 20. Tax on international trade as a percentage of total taxes for selected countries, 1995.



Note: The Central Bank measures the taxes on international trade as a percentage to total taxes, rather than as a share of direct and indirect taxes

Source: Central Bank of Lebanon

In addition to custom revenues, non-custom indirect taxes also increased, but at a smaller rate, as indicated below:

- a LL 3,000 per 20 liters of gasoline.
- a LL 2,000 per horse-power imposed on vehicles.

- a 5% tax on hospitality services.
- a tax on petroleum products, tobacco, cement, alcohol, and electricity.

In brief, indirect taxes, which are dominated by custom revenues as percentage of taxes are high compared to other countries. The high share of custom revenues has reached a threshold but might be reduced as a result of the trade agreements Lebanon is negotiating with the EU and some Arab countries.

On the other hand, in absolute terms, direct taxes rose from LL 183 billion in 1992 to LL 208 billion in 1995. However, their share of total taxes declined from 30% in 1992 to 17.3% in 1995 (see figure 19). The major items in the direct taxes include, income tax, transfer of ownership tax, property tax, and motor vehicle tax.

The following section focuses on income tax to show that even the most progressive type of direct taxes has been neutralized by the previous government, which resulted in its inability to offset the regressivity of the tax system.

Income Tax

The total tax on income includes tax on salaries and wages, profits, and capital. The Hariri government enacted tax reform Law 282/93 with the objective to simplify the tax system, increase tax compliance, and encourage savings, and local and foreign investment.

More specifically, the reforms entailed the following:

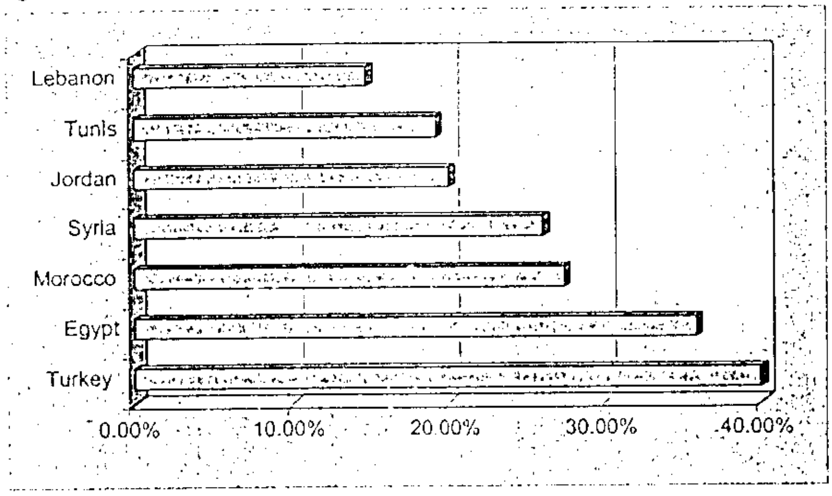
- Tax on profit: Flat rate of 10% on financial companies. Progressive rate of a minimum of 3% on taxable profit not exceeding LL 7,500 thousand to a maximum of 10% on taxable profit exceeding LL 37,500 thousand for commercial and industrial companies. The tax rates before the reforms were a minimum of 6% and a maximum of 50%.
- Taxes on wages and salaries ranged from a minimum of 2% to a maximum of 10% with a total of 5 brackets, compared to a minimum of 2% to a maximum of 32% with 13 brackets.
- 5% tax on capital account, including stocks.

Although the new tax reforms have simplified the tax system and streamlined its procedures, three major failings must be noted:

First, the income tax system failed to raise compliance. In fact, the income tax as a share of total taxes is low and decreasing. More precisely, the income tax as a share of total taxes initially increased from18.37% in 1993 to 20.65% in 1994 but soon fell to12.83% in 1995. After three years, the income tax rose by a dismal 10%, from LL 140 billion to LL 154 billion.

Moreover, in comparison to other countries, Lebanon's share of income taxes to total taxes is below average. For example, as a share of total taxes, Tunis collects 19.2%, Morocco 27.4%, and Turkey almost 40% (see figure 21).

Figure 21. Tax on income and capital as a share of total taxes for selected countries, 1995.



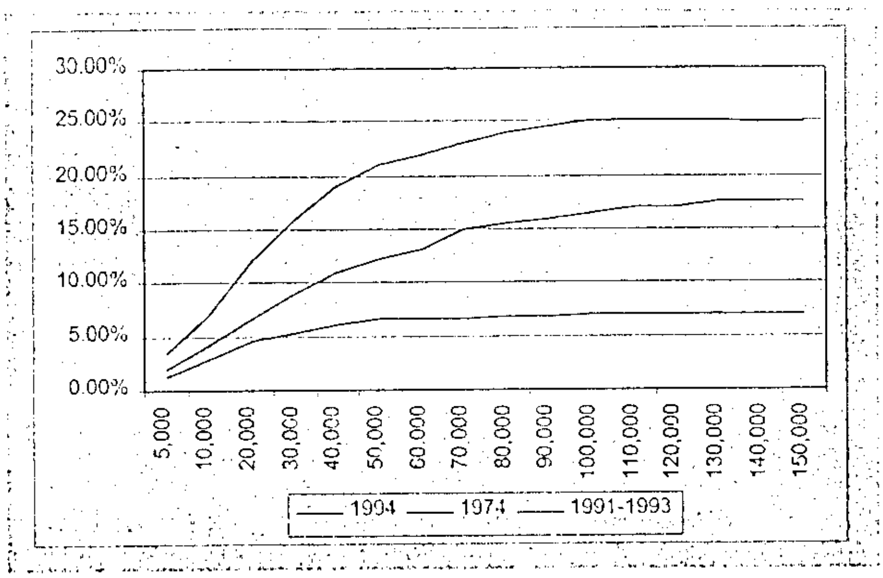
Source: Central Bank of Lebanon

Second, the new income tax system has failed to distribute income among the population. In fact, the Gini coefficient, which measures the income distribution decreased a little from 0.4336 to 0.4265 after the enactment of tax reforms.[23]

An examination of the structure of the tax on salaries and wages in 1994 indicates that the new structure is flat compared to the progressive rates of 1974 and 1991-1993. Although the reforms reduced taxes on all income brackets, the greatest beneficiaries remain those with the highest income (see figure 22).

[23] See Dah, Dibeh, and Shahine [1999]

Figure 22 Tax rates on salaries and wages by annual income in dollars.



Source Journal of *Abaad* [1994] issue # 2 p 115

In principle, the new system reduced the progressivity effect of the income tax and thusly, treats different social groups in a similar way regardless of their financial capabilities.

The third failure of the tax system is its inability to attract foreign investment. Lebanese policy makers implemented low tax rates on income to attract capital. However, the efficiency of such incentive measures has been questioned in several economic studies.[24]

In conclusion, non-tax revenues in Lebanon constitute abnormally a large portion of total revenues. Moreover, the share of taxes to revenue has surpassed Lebanon's historical experiences. As such, there is a definite need and room for an increase in taxes. However, since the tax system is highly regressive, then increase should be in direct taxes, particularly income tax. The contribution of the income tax to total taxes is low due to a decrease in the tax rate enacted in 1993 and to the administrative challenges of collecting such a tax, especially in the presence of bank secrecy laws.

Tax Administration

The second though equally important component of a tax policy is tax administration – i.e. the ability of the government to impose, assess, and collect taxes. The tax administration in Lebanon has been badly hit by the civil war. The result is obvious: inefficient tax collection techniques, inefficient tax administration personnel and methods, lack of information on taxpayers, slow processing of information, weak tax enforcement laws, long lag in receiving tax payments, rare voluntary compliance, and high tax evasion.

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[24] See for example Gillis [1985] and Shah and Toye [1978]

Since 1993, the government has adopted series of tax reforms that aimed to simplify and streamline tax procedures. Although this paper does not examine the reforms thoroughly, the following is a brief presentation of some of the new measures:

a. Increasing the tax base

The dislocation of the citizens and businesses as a result of the civil war restricted the ability of the government to collect and access information on taxpayers. The government however, has recently initiated a survey study that aims to identify all taxpayers. By 1998, the Ministry of Finance had already identified 90 thousand taxpayers out of 175 thousand in 1999.[25]

b. Streamline procedures

The government has made major strides towards reforming tax procedures, especially as they relate to income tax, customs, and real estate fees. Income tax has been streamlined. With the help of the Canadian government, a new system of tax administration is under way. It aims to develop computerized forms for taxpayers, and train tax collectors and employees. Also the imposition of NAJM in the customs with the help of UNCTAD has reduced the procedure of clearing goods from customs from thirteen steps to four. The Ministry of Finance with the help of the World Bank is currently modernizing its real estate department by setting up a computer infrastructure for information to administer the tax system.

c. Tax collection

The collection of indirect taxes has been easy simply because it is collected at source. However, the government continues to face a problem in collecting income tax. In 1995 for example, income tax constituted a dismal 12.3% of total collected taxes. Moreover, according to unofficial figures, of the 50% of identified taxpayers only 36% actually pay their taxes. The government is yet to enforce tax payment through various incentives and penalties.

[25] See An-Nahar, March 15, 1999.

Section VII – How is it Possible to Reduce the Budget Deficit?

The government's budget is not simply a financial plan covering outlays and receipts. The budget is in fact the most important economic policy tool of the government and provides a comprehensive statement of the country's priorities. An attempt to reduce the budget deficit by simply decreasing or increasing certain components of the budget on an ad-hoc basis is doomed to fail. Although the budget deficit may sound as a technical economic problem, in reality it requires economic, political, administrative, and legal solutions. Given the sacrifices that must be incurred by society, the process of determining and implementing the deficit reduction program may be critical to its success. The participation of the Parliament, civil society, business sectors, and the academic community can all play a pivotal role in providing alternatives and sustainable solutions.

What follow are some suggestions in support of potential solutions to reduce the deficit. As a point of departure, a successful deficit reduction program must address these issues: reduction in expenditure, enhancement of revenue, fiscal decentralization, privatization, data transparency, debt management, and investment in government assets.

The core of the deficit reduction program is based on two pillars: 1) a reduction and reform of government's expenditure program, and 2) an overhaul and enhancement of revenue. This study strongly recommends a reduction in spending because

1) it is simply too high in comparison to other countries;
2) a good portion of spending is unproductive;
3) the structure of spending is not conducive for long term growth;
4) tax reforms may not be feasible in the short term, especially when they must meet the efficiency and equity criteria;
5) tax reforms will have diminished benefits if they are not accompanied by an equally efficient expenditure reform. In fact, people would be more reluctant to pay taxes if it is widely known that the revenue collection is mismanaged.

Moreover, a permanent increase in the fiscal primary surplus through expenditure reduction will have important effects on debt sustainability given its tendency to:

- reduce the real interest rate through a reduction in the crowding out effect;
- increase income growth through increased efficiency in resource allocation and reduced interest rates;
- increase the demand for monetary base as a result of reduced inflationary expectations;
- increase the productivity of public programs which may provide a viable option to release resources and reduce the deficit.

On Expenditure

In order to allocate, decrease and utilize government resources efficiently and effectively certain institutional arrangements must be undertaken, including the following:

- Introduce a medium term between 2-4 years macroeconomic framework into the discussion of the budget. This would provide a basis for evaluating the implication of an increase in spending on macroeconomic variables and for incorporating the real cost of inflation. To do so, there is a need to consolidate all the government's off-budgets with the central budget to be included in the macroeconomic framework.

- The government must enforce the explicit rule that limits spending and borrowing. It must also impose penalties on violators and expose them.

- In the case of overspending or higher deficit target, the government must provide and publish an explanation for the deviations.

- There is a need to introduce systematic economic analysis of public programs. This is important because 1) it introduces the concept of scare resources, and 2) allows a basis for selection between two alternatives.

- Empower the role of the Parliament in the budgeting process. This requires the allocation of funds to the Money and Budget Committee in order to hire experts to assist in the process.

- Allow civil society, academic community and the business sector to contribute to policy making by expressing their needs and providing their expertise. This could be through a special program where a specific ministry can hold an open workshop for discussion.

- Reform the bureaucracy by undertaking some of the following measures:

  - eliminate ghost workers
  - freeze hiring on contractual basis. It has just been revealed that that the wage bill of workers on contractual basis is LL 107 billion compared to LL 48 billion for full time workers
  - redefine the responsibility of each ministry and agency
  - reallocate employees within ministries to match between their skills and the needs of the departments.
  - link reward to performance. Abolish the across the board increase. Insulate the merit system from politics.
  - strengthen the agencies entrusted with disciplining public employees for misbehavior, such as Central Inspection Agency and Court of Account.

In practice, the reform of the bureaucracy, which would entail severance pay and social safety net payment may increase spending in the short run but it would decrease it in the long run. The reforms of the bureaucracy will not only reduce the wage bill but can also provide efficiency gains and productivity spillover. A professional and uncorrupted bureaucracy might induce tax compliance and increase tax collection because 1) taxpayers may be willing to pay taxes once government goods and services are efficiently provided; and 2) the reduction of bribery, which has been essentially an illegal tax on citizens, would increase their ability to pay real taxes.

The government might also re-examine and rationalize subsidies on beat root, reallocate some defense spending to education and health as those are the prerequisites of long term economic growth, and reform the procedures of contracting public projects to the private sector.

On Revenue

The government must increase the progressivity of the tax system in order to increase revenue and distribute income fairly. Three sets of suggestions are in order: 1) raise the level of taxes, 2) improve tax administration, and 3) introduce new taxes.
The following is a detailed description of these suggestions:

- Given that income taxes contribute a small percentage to total taxes, especially when compared to other countries, there is an ample margin to increase taxes on salaries, capital, and profits from 10% to 20% or 25%. As mentioned earlier, an increase in taxes will not scare foreign investments since the latter is dependent on several other factors such as political stability, social equality, and institutional barriers. For a start, the government must reduce the red tape, corruption, and other institutional bottlenecks that are hindering foreign investments.

- Reform the income tax administration. The government's objective should be twofolds:

  - The first focus should be on *efficiency*. To this end, the government must increase the tax base with the help of the municipal governments, hire qualified tax collectors, establish large taxpayer unit to monitor the collection of taxes from large taxpayers, impose alternative (instead of the income tax) tax on small taxpayers such as an annual license fee, and use banks to facilitate tax payments.

  - The second should be on the *effectiveness* of the tax administration. Efforts should invested to focus increase voluntary compliance, adopt principle of self-assessment, educate taxpayers, detect problems with tax filing and paying, improve audit coverage, and impose and enforce adequate penalties.

- As for the tax base, the government should focus on large and medium companies, the self-employed, and the professionals. Effective coverage of the tax to a much broader segment increases tax revenues in two ways, 1) by collecting taxes from those not covered; and 2) by making people more willing to pay taxes with the enforcement of a universal tax payment policy.

Since the potential tax base lies in small companies, the self-employed, and the professionals, the government needs to spend relatively more of its scare resources on identifying, assessing, and collecting the taxes from them. A solution to this problem is to have municipal government pitch in. In fact, municipal governments, being closer to the people, are in a better position to identify local taxpayers. The central government must then utilize the local knowledge and improve coordination with the municipal governments.

- With respect to new taxes, the government must consider a "green tax" primarily to promote environmental protection.

- Impose a Value Added Tax (VAT). The upcoming negotiation of the Euro-Med agreements with Lebanon may compel Lebanon to introduce such a tax. Several issues need to be addressed: accounting standards, tax administration, tax rate, exemptions, etc.

- Impose a tax on Treasury Bills.

- Impose tax on coastal properties.

- Impose a VAT with exemptions on basic necessities.

- In the case that an increase in the tax base fails to capture the professionals and small businesses, the government should impose a payroll tax on small and micro small companies. This, in essence, is a flat fee imposed on companies with a specific range of number of employees. Such a tax is appropriate in Lebanon since firms' balance sheets are not transparent and hence regardless of the profit or loss they make in a year, they will still have to pay a fee.

On Decentralization

The government must seriously consider decentralizing its services to local governments for four reasons:

- The burden on the central government budget is very high

- The empowerment of municipal government can ensure development in rural areas, which are generally neglected by the Beirut-centric government, and hence provide opportunity for a balanced growth and development.

- Municipal governments are in a better position to efficiently provide some of the goods and services.

- Being closer to the people, municipal governments are more able to identify and collect local taxes and to provide goods and services.

To meet this end, the government must address the issues of decentralization and local government seriously. This involves the following steps:

- Assign clearly the expenditure assignments to municipal governments. Currently, the law provides undefined and vague responsibilities to municipal governments. This has led to an overlap in responsibilities with line ministries and agencies, and has also reduced accountability. The decentralization of services will not burden the government with extra expenses. It can be guided by the following criteria: economies of scale in production, adequate fiscal capacity, and the ability to manage.

- The government must revise Law 60 of 1988 related to municipal tariffs and fees. This law refers to the type, base, level. rate, margin, identification, valuation, and collection of these tariffs and fees. The Ministry of Finance (MOF) must support and coordinate its activities with the tax administration of municipal governments. A first step is for the MOF to share its database of the modernized real estate department with the concerned municipalities.

- The government must address the issues of the Independent Municipal Fund especially after recent scandals mentioned above. The government must particularly examine the amount and type of taxes and fees deposited in the International Monetary Fund, and their allocation and disbursement.

On Privatization

It is a well-established fact that certain state-owned enterprises are making losses every year and have become a burden on the budget. Two particular cases in point are the Middle East Airlines and Electricite du Liban, which are costing the government $100 million and $150 million a year, respectively. Other state-owned companies are in desperate need for rehabilitation but lack access to necessary funds. For example, the oil refineries in Tripoli and Zahrani, which are currently not operational, will cost the budget $200 million this year.

The debate over benefits and constraints of privatization is far from over. In this case, this study addresses only the benefit of privatization with respect to its ability to raise revenue for the Treasury.

Privatization can have a significant effect on debt sustainability if proceeds from the sale of insolvent public enterprises are used to pay off public debt. At the same time, privatized entities may be a new source of tax revenue.

Accordingly, privatization might improve the Treasury's net worth if the following condition is met: the sale value of the public enterprise, plus the present value of future taxes from the latter, minus government expenditures to put the enterprise on the market exceeds the present value of future losses (if not otherwise privatized).

A case by case study of governmental enterprises must be undertaken in order to determine the need for privatization. A preliminary estimate by Bank Audi suggests that the cost of putting an enterprise for privatization may offset the sale price, and hence the only benefit accrued to the government is that the losses currently incurred are contained. In addition, one must take into account that by the time an enterprise is put up for sale, the public debt would have escalated to maybe 130% of GDP. Therefore, the benefits might be minimal. In other words, although the government must reduce its losses, privatization may be a necessary solution but not sufficient to reduce the public debt.

On the other hand, privatization might have no effect on debt sustainability, especially if an enterprise is profitable and the net income flowing from the stock to be privatized is included in the fiscal primary balance. This should be taken into consideration in the case of profit-making enterprises, such as Casino du Liban.

On Data Transparency

A major problem in examining the problems of the deficit and the debt in Lebanon is the lack of reliable data. Hence, the government must adopt four general principles of fiscal transparency.

- The government must clearly define its responsibilities towards municipal governments. This is essential for transparency and accountability.

- The government must integrate all off-budget spending into the central government budget to be able to clearly analyze the problems of the deficit at hand. This actually means that the budget of the Council for Development and Reconstruction, Council for the Development of the South, the Fund for the Displaced, Port of Tripoli, and others should be integrated into the central government budget. Otherwise, these extra-budgetary activities should be at least covered in budget documents and accounting reports.

- Along with the current year budget, the government should provide the data related to the last two years. This would allow 1) a comparative assessment of the performance of recent budgets. and 2) a projection of the risks involved in adopting the proposed budged.

- The government should regularly publish information on its expenditures, revenues, and debts. This is extremely important in order to assess the government's ability to finance its activities and honor its debt obligations, and estimate the amount of future revenues required to meet all existing commitments.

- The government should publish its information in a timely fashion. The use of discretion in deciding whether, when, how and to whom to release fiscal information can damage a government's credibility.

- The government should accurately classify the revenue and expenditure components. For example, the revenue from the Independent Municipal Fund must not be considered as part of the government's revenue.

- Expenditure should be classified in both economic and functional terms. The government currently publishes its actual spending based on economic classifications. Functional classification, on the other hand, is generally not published for actual spending. In addition, functional categories must be broken into economic components.

- The government should provide an explanation for the deviation of the budgeted versus the actual amounts.

- There is a need to have an effective institutional mechanism that allows the parliament and the public to be assured of the quality of fiscal data and information provided by the government. Hence, there is a need to establish a national audit body which should be appointed by the parliament, and whose purpose would be to examine the financial integrity of the government accounts.

- Since the budgets are prepared with particular assumptions and forecasts, independent experts and civil society members must be allowed to examine them.

- The Directorate of Statistics should be funded to resume its collection and measurement of the GDP and other data. In addition, it should become independent.

On Debt Management

The government should try to decrease interest rates through liquidity management. The public sector deposits have reached LL 4,600 billion, which is more than needed for transactional purposes. The government can finance a major portion of the deficit. This can also reduce the structure of interest rates and hence open up the possibilities for refinancing maturing debt to reduce the burden of interest payments.

On Government Asset

There is a need to examine the value of the properties owned by the government and the possibility of investing them in a transparent fashion. It is not clear what the value of government assets is, but there are indications that they are of high value.

In the case all else fails, the government must seriously consider to reinvest its gold holdings.

Conclusion

If left untamed, the deficit will soon lead the Lebanese economy into a fiscal crisis. In order to reduce the budget deficit, the government should adopt serious reform programs focussed on decreasing and improving the expenditure management system. These programs must also be accompanied with tax reforms and the continuous rehabilitation of the tax administration. Other government objectives should be to transfer its services to local government, and to consider the privatization of inefficient public enterprises.

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