LEBANON'S PUBLIC DEBT

By

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I. INTRODUCTION

Public debt appears to be the origin of many problems that distort the normal functioning of many economies. It is the result of raising expenditures not matched by sufficient revenues and the consequent accumulation of deficits. The financing of these deficits often causes macroeconomic crises.

Nobody can deny that the government of Rafic Hariri has achieved some projects that contribute to the economic growth of Lebanon. But, if some projects have begun to go into effect and see the light, it is mainly due to the country's indebtedness, which has reached a record level over the last period. Yet, to the average citizen, the accumulated national debt is both incomprehensible and frightening. Who can understand debts that are measured in billions of dollars? Who can ever be expected to pay them? The burden of the debt seems larger than anyone could possibly bear. The fear that either the Lebanese government or its taxpayers will be "bankrupted" by the national debt always lurks in the shadows. How justifiable is that fear?

The purpose of this project is to analyze the problem of public debt in general and in Lebanon in particular and propose solutions to debt management. Next, it compared between how exactly each solution must be implemented in Lebanon and how it is actually implemented if it is implemented. In addition, it will try to evaluate briefly whether the Five Year Plan had tackled each solution and how.

The aim of Chapter Two is to provide a general overview of public debt: How it is related to deficit? How financing is done internally and externally? What is the analogy between public and private debt and what is public debt composed of? In addition, Chapter Two shows the burden of public debt such as: high debt servicing cost, inflation, crowding out of investment, sluggish economic growth and the effect on future generations.

Chapter Three presents the evolution of the Lebanese public debt divided to phases according to political or economic reasons. The importance of this chapter is to display what Lebanon has passed through in order to reach the current high levels of public debt.

The fourth chapter emphasizes the implications of the public debt on the Lebanese citizens, which are unbearable whether in the form of inflation or dollarization or crowding out of investment or even on the economic growth of Lebanon as a whole. In fact this chapter represents the motivation behind this project.

To reach solutions to debt management is what to be achieved in this project, and is explained fully in Chapter Five. This chapter is divided into three parts. First, alternatives for government spending are suggested, such as increasing the role of private sector whether in the form of Build, Operate and Transfer (BOT) contracts or in the form of privatization, besides developing capital markets. The second part shows how government expenditures can be reduced through the elimination of corruption, sound budget allocation and fixing deficit ceilings. Moreover, it displays how government revenues could be increased through optimizing tax collection, introducing new kind of taxes and raising the level of taxes already existing. The third part is dedicated to the monetary policy management.

At the end, Chapter Six will be the conclusion of this study, which summarizes our analysis and reach our findings of the whole issue.

II. OVERVIEW OF PUBLIC DEBT

A. Public debt and the budget deficit

1. Relationship between debt and the budget deficit

Budgets are the main tools for governments to control and record their fiscal affairs. The planned expenditures and expected receipts that government spending and tax programs would yield are all shown in the budget for a given year. A budget deficit occurs when expenditures exceed taxes. When governments run budget deficits, they must either print money or borrow from the public to pay their bills. The accumulated borrowed amounts are called the government or public debt. The government debt is simply related to the government deficit: the change in the government debt over a given year is equal to the budget deficit. (Samuelson & Nordhaus, 384-398)

2. Internal versus External Financing

When financing the budget deficit, the government has the choice between internal and external financing, and most commonly a combination of the two.

Internal financing can come in various forms. A basic distinction that can be made is between borrowing from the non-bank public and borrowing from the banking system.

Borrowing from the public means selling bonds to individuals or institutions who have the option of buying or not buying them. In this case, the government must make these bonds attractive enough to persuade buyers to buy them. So, bond prices must come down and interest rates must go up which, in turn, attracts foreign capital and leads to an appreciation of the exchange rate. (Tanzi, 93)

Another way of financing internally is borrowing from the banking system. Borrowing from the banking system may not necessarily mean borrowing from the central bank since the government can borrow from domestic commercial banks. Whether the government borrows directly from the central bank or indirectly by going to the commercial bank, there is an increase in the money supply. (Tanzi, 95)

In addition to internal financing, the government may seek assistance in external financing. External financing of the fiscal deficit can come in different categories, mainly, grants, concessionary loans, and commercial borrowing.

Grants can be of at least three types. First, they can come in the form of cash. A donor country (for example, United States, Canada, France, Sweden, Saudia Arabia) may make available a certain amount of foreign financing to the deficit country to finance the deficit. If the government has expenditures abroad (on imports by the public sector of for servicing external debt obligations), the grant can be utilized directly to meet these needs. Second, grants can come in the form of commodity aid. For example, the government may receive wheat, rice, or some other commodity from a donor country. This commodity may be sold domestically and the funds thus raised may be used to finance the deficit. A third form of grant is project aid: a donor country agrees to cover all the costs associated with the construction of a given project (for example, building, road).

Concessionary loans are loans that come with a lower-than-market rate of interest, have a substantial grace period, and have a long maturity. They may be given by governments or by international institutions (such as the International Bank for Reconstruction and Development (IBRD), the International Development Bank (IDB) and the Asian Development Bank (ADB)). Often, they are tied to projects and thus require domestic counterpart expenditure. They all contain a grant element in the sense that the present value of the (discounted) servicing cost is less than the loan.

The last category of external financing is commercial loans. These can come from foreign commercial banks or from foreign suppliers. Those coming from commercial banks may have maturities ranging from a few months to over a decade. If commercial banks are highly liquid, if they assess optimistically the future economic prospects of the borrowing country, and if the country is willing to pay a premium for getting these loans, this source of financing can become very large in the short run. But, there may come a time when a country finds itself cut out from this source and this is likely to occur when its need for these loans is greatest. In these circumstances, the control that countries have over this source becomes very limited indeed. (Tanzi, 92)

3. Analogy between public and private debt

In many particular respects, public debt must be different from private, and any analogy between the two must be used with great care, as is the case with all analogies. But this does not suggest that the underlying similarity between the individual and public economy as regards debt issue can be overlooked. In the most essential respects, debt issue for the individual and debt issue for the government (which, in its turn, can best be considered as individuals acting politically) are analogous. In each instance, borrowing constitutes an alternative to the more normally accepted means of raising revenues. Borrowing in either case is a means of securing additional current purchasing power without undergoing supplementary current cost. The costs of spending are effectively shifted to future time periods. In such periods, creditors hold a primary claim against the revenue or the income of either the individual or the government. (Buchanan, 231)

It may be fully rational for either the individual or the government to borrow instead of raising the funds in a more normal way. The desirability of borrowing depends on the expected productivity of the spending and the time pattern of the expected yield. Therefore, there is no fundamental difference between the individual and the government economy as regards the essential aspects of debt versus current financing of expenditure. (Buchanan, 332)

4. Composition of public debt

The debt consists of marketable and nonmarketable issues. Marketable issues are traded and are available to all buyers. They include bills, notes and bonds. They differ mainly in their maturity. Bills are issued mostly with maturities of twelve months, but the maturities can also be as short as three months. Notes run from one to ten years and bonds for longer periods. Notes and bonds carry an annual coupon payment and are redeemable at par at the date of maturity. Bills are sold at a discount and pay no interest, with the appreciation in value to maturity representing the investor's return.

Nonmarketable issues are offered to various groups of investors and can be held only by the initial buyer. Nonmarketable issues are held by the individuals in the form of savings bonds. (Musgrave, 546-547)

B. Burden of public debt

1. High debt servicing cost

The net interest paid by the government on the public debt is the most important factor responsible for the growing deficits.

Total deficit = primary deficit + interest payments

The primary deficit represents all government outlays, except interest payments, less all government revenue.

Primary deficit = noninterest outlays – total revenue

Interest has to be paid when there is debt outstanding. The overall budget will be in deficit unless the interest payments on the debt are more than matched by a primary surplus. If there is a primary deficit in the budget, then the total budget deficit will keep growing as the debt grows because of the deficit, and interest payments rise because the debt is growing (Dornbush, 602-603).

2. Inflation

Some governments use the printing of money to finance government spending when these governments cannot (or do not want to) finance all of its spending by taxes or borrowing from the public. This revenue that the government raises by printing money is called seignorage. Indeed, governments that want to finance their deficits through seignorage don't simply print new currency but use an indirect procedure. First, government borrowing must be equal to the budget deficit and a corresponding quantity of new government bonds are printed and sold. Thus the deficit equals the change in the outstanding government debt. However, the new government bonds aren't sold to the public. Instead, the Treasury requires the central bank to purchase the new bonds. The central bank pays for its purchases of new bonds by printing the money needed in new currency. This newly issued currency enters general circulation when the government spends it on its various outlays. (Abel & Bernanke, 597, 599)

This will lead to an increase in the money supply, which in turn will lead to inflation. The rate of inflation equals the growth rate of the nominal money supply minus the growth rate of real money demand:

$$\Pi = \frac{\Delta M}{M} - n_y \frac{\Delta Y}{Y}$$

Where Π is the rate of inflation, $\frac{\Delta M}{M}$ is the growth rate of money supply, n_y is the income elasticity of money demand and Y is the real income, $n_y \frac{\Delta Y}{Y}$ is the resulting increase in the real demand for money (Abel & Bernanke, 240).

Under normal conditions, developed countries rarely use seignorage because they know that continued money creation ultimately leads to higher inflation. Heavy reliance on seignorage usually occurs in war-torn or developing countries, in which military or social conditions dictate levels of government spending well above what the country can raise in taxes or borrow from the public. (Abel & Bernanke, 599)

In the 1920s, Europe experienced hyperinflation, Latin America followed in the 1980s. For instance, in 1985 Bolivia experienced an enormous hyperinflation. At the peak in mid-1985, inflation was at an annual rate of 35000 percent! Like other Latin American countries, Bolivia had overborrowed in the 1970s. When, in the early 1980s, interest rates increased in the world markets, debts could no longer be serviced by taking out new loans for the purpose of paying the interest on the old loans. But the country was not in a position to service easily the very large external debt. The attempt to do so strained the budget and led to high rates of money creation; which in its turn lead to high rates of inflation (Dornbush & Fisher, 666).

3. Crowding out of investment

The most frequently cited problem of government budget deficits is that they displace private business purchases because increasing the deficit raises interest rates. This effect, known as "crowding effect", can be seen by imagining a fixed supply of funds available for potential borrowers. These loanable funds come from the savings of our citizens. Savings must equal borrowing by all entities, so we have:

Savings = Investment + Government Deficit + Net exports

Investment in macroeconomic analyses is the term used for all business purchases. These are assumed to be made directly or indirectly with borrowed funds and are therefore inversely related to interest rates. Thus, an increase in deficit will lead to on increase in interest rates, which will eventually lead to a decrease in investment.

An important alternative to Keynesian macroeconomic theory is represented by the Neoclassical school of thought. Much of the Neoclassical research on the effects of deficit spending was done by Professor Robert Barro of the University of Rochester. Barro argued that deficit-financed tax cuts, keeping government expenditures unchanged, should have no effect on the level of real interest rates, investment, GNP, or any other real measure of economic activity. This theory is known as Ricardian Equivalence and is named for David Ricardo, the nineteenth-century British economist, who first stated that the choice of debt versus taxes to finance government expenditures should be irrelevant to the level of real activity in the economy. (Brown, 206)

The basic concept behind Ricardian Equivalence is that economic agents (people) take their entire lifetime's income into account when making decisions about consumption and savings. A deficit-financed cut in taxes would be viewed by such agents as merely a redistribution of taxes over their lifetime. Knowing they will pay higher taxes in the future to repay the deficit, they save the tax cut instead of spending it. Thus, the Keynesian notion that investment must be crowded out because the increased deficit is competing with a fixed pool of savings is not the case here because savings is assumed to rise one-to-one with the deficit. Because saving rises, interest rates do not and investment is not crowded out. (Brown, 206)

4. Effect on future generations

Who really pays for the benefits of the public services that are financed through debt issue? Who bears the real cost?

Resources are, of course, drawn from the private sector during the period when the public expenditure is undertaken. But do the persons who give up resources really "pay for" the benefits secured? It seems clear that they do not, since they give up current purchasing power, not in any political "exchange" for public service benefits, but instead in a wholly voluntary exchange for the debt instruments which embody some obligation on the part of the government to make a return income payment to holders of such instrument in future periods. (Buchanan, 328)

From this conception, it follows that the real burden of the debt-financed public spending must rest with taxpayers during the future periods when the previously issued debt requires servicing and amortization. Debt creation provides one way of financing public services without cost. It provides a means whereby taxpayers in any given period may shift or postpone the real payment for public services until future periods. Only to the extent to which taxpayers anticipate these future payments and capitalize these into a currently valued reduction in wealth can a "burden" be located at the point of debt issue. (Buchanan, 329)

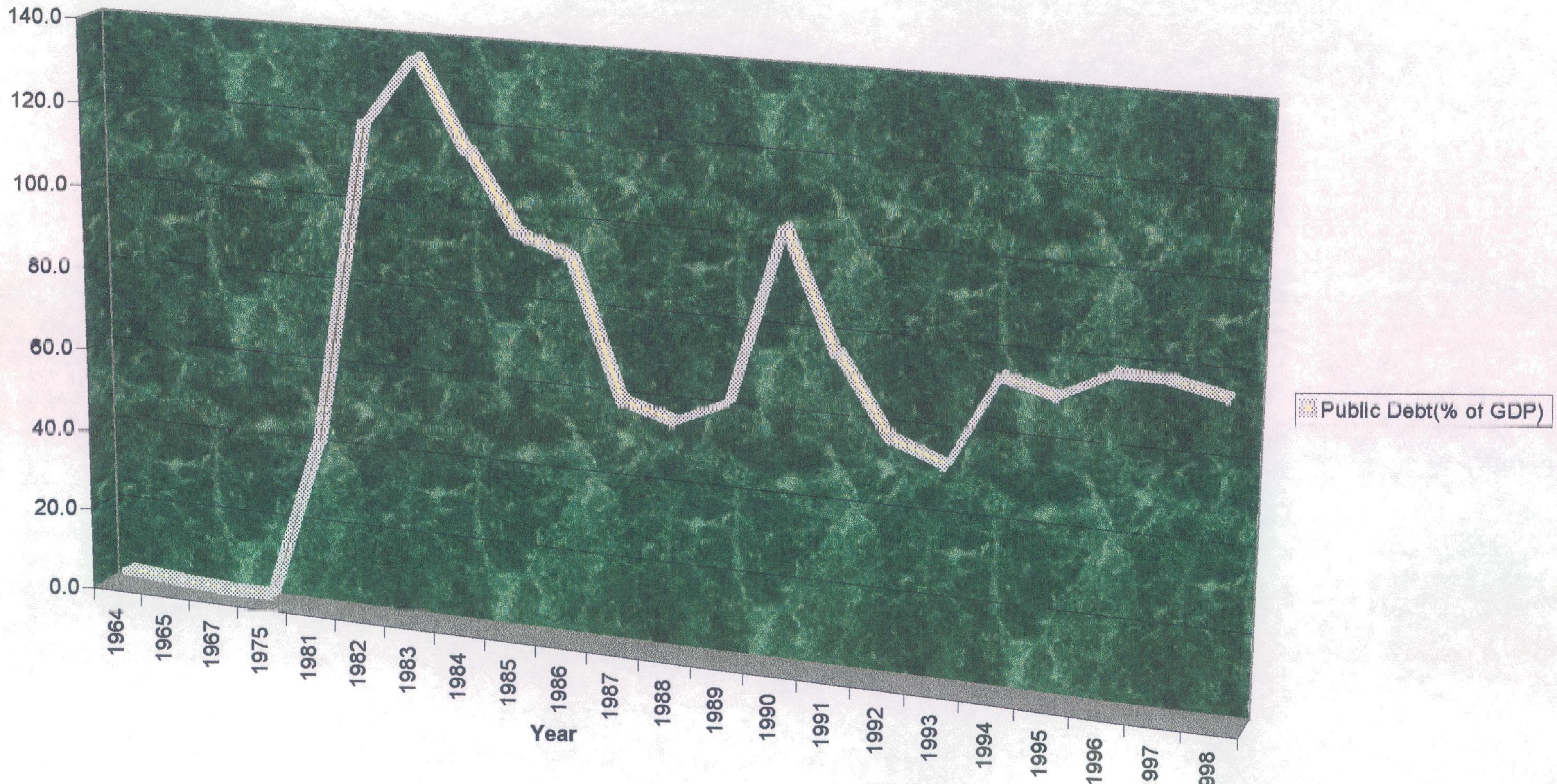
III. EVOLUTION OF THE PUBIC DEBT IN LEBANON

A. Phase 1: Pre –1975:

Prior to the 1975 civil war, the Lebanese economy was one of the healthiest in the Middle East region. The Republic had developed into a prosperous, lower middle income country by the mid-70s. Economic growth averaged 5% per year during 1960-70 and then accelerated to 7% per year in 1970-75. The main source of growth was the services sector, in particular, tourism, banking, insurance and free port activities. The banking sector, aided by a stable and liberal regime, a freely convertible currency, favorable regulations and skilled management, permitted Beirut to serve as a financial center to the Middle East. This environment allowed Lebanese entrepreneurial and financial skills to evolve to a high degree, and in the 1970s its bankers and traders enjoyed an excellent reputation in the region. Although smaller in size than the services sector, the export-oriented agricultural and manufacturing sectors also grew (at annual rates averaging between 4% and 6%), contributing to overall growth of income.

The 1974 budget showed a surplus with revenues constituting 20% of GDP while expenditures amounted to less than 15% of GDP. The country's industrial, commercial, agricultural and financial services sectors were of the most dynamic in the region. Thus, compared to countries at a similar stage of development, the Lebanese economy was considered to be prosperous. Before 1964 the amount of public debt was almost zero. In 1964 it reached 4% of the GDP, then it decreased to 2% in 1975 before the civil war [Figure 1].

Fig.1: Public Debt(% of GDP)



When other countries such as Syria, Egypt and Iraq turned to socialist policies in the 1950s and 1960s, Lebanon maintained its free market traditions. These included an active private sector, which accounted for around 80% of GDP, a freely convertible currency and unrestricted capital mobility. As a result of these favorable regional and local conditions, both capital and expertise flowed to Beirut, fuelling Lebanese growth. Lebanon was also used as a transit center for goods and commodities, a position that was helped by the country's geographical location. (Lebanon, The Annual Business, Economic and Political Review 1997-1998, 42)

The striking fact in this phase is that the government's intervention in the economic activity was minimal and high rates of economic growth were recorded. The government followed the classical school approach, which is based on the assumptions that individuals and firms act in their own best interests and that wages and prices adjust quickly to achieve equilibrium in all markets. Under these assumptions, the invisible hand of the free-market economy works well, with only a limited scope for government intervention in the economy.

B. Phase 2: 1975-1982:

The outbreak of the 1975 civil war was the main determinant behind the country's economic collapse.

The most important sectors of the economy as well as its infrastructure were almost totally destroyed. Damage to infrastructure and physical assets due to the conflict amounted to U.S.$ 25 billion, according to United Nations estimates, with none of the principal sectors emerging from the conflict Unscathed. While limited investment and maintenance expenditure led to the erosion of the capital base, the sizable emigration of skilled manpower constituted a major loss to the economic potential of Lebanon. The country suffered from excessive flight of its domestic capital and less access to flows of foreign capital. Meanwhile, the government's intervention in the economic activity was growing rapidly. The Debt/GDP augmented from 2% in 1975 to 90.5% in 1982. However, confidence in the government helped maintaining confidence in the Lebanese pound: L.L. 3.8 per US$ in 1982 against L.L. 2.5 per US$ in 1975. (Attieh, 60)

C. **Phase 3: 1982-1991:**

In addition to heavy human, material and consequently economic losses caused by the devastating war, the Israeli invasion of 1982 and the Israeli bombings of Lebanese cities caused further deterioration in the economic situation. The government had to increase its spending with the bulk going to the Ministry of Defense. As to revenues, the collection of taxes dropped to a minimum due to tax evasion and to the inability of the authorities to pursue strict compliance on the behalf of taxpayers.

In addition, the confidence in, and credibility of, the Lebanese Pound and economic stability began to erode. The shift in authority from the Government to non-official entities gave rise to a parallel economy that severely hampered the Government's ability to collect revenues as most trading was conducted through unofficial ports of entry. This deficiency in Government revenue and the growing expenditure on public services led to large and rapidly growing Government budget deficits.

These negative developments, along with the prevailing political uncertainty, plunged the Lebanese economy into a vicious circle of large budget deficits leading to monetary expansion and inflation, which translated, into dollarization of the economy and capital flight. This in turn led to a dramatic depreciation of the value of the Lebanese pound and further inflation.

The above disturbances observed throughout the 1982-1990 period were translated in the following distortions of various economic indicators (Baz, 1):

- A 50% drop in GDP
- A fall in the minimum wage from 200$ to 90$
- An average inflation rate of 91.8% per year and an average depreciation of 82.2% of the Lebanese Pound, over the studied period
- A drop of the coverage ratio of public expenditures by public revenues to 16.24% in 1990 from 38.6% in 1983
- A cumulative deficit in the balance of payments of 1.7 billion $
- Massive conversions to foreign currencies, which raised dollarization rate from 29% to around 74% over the studied period.

This period was characterized by the financial authorities' attempt to decrease debt-burden through inflation.

D. Phase 4: 1991 to present:

As the civil war came to an end, significant fiscal adjustments began in 1991. Widespread improvement in revenue collection occurred, particularly with respect to custom duties and non-tax revenue. The state owned telecommunication, water and electricity companies started collecting a higher proportion of their bills, further adding to government income. As a result revenues doubled to constitute 12.6% of GDP. On the other hand, restraint in current expenditure led to a remarkable decline in total expenditure to around 29% of GDP, down from 40% in the previous year. These developments resulted in a substantial reduction in the overall deficit from around 34% of GDP in 1990 to 16% in 1991[Table 1]. GDP rose by almost 40% and inflation moderated in the course of the year [Table 2]. Large capital inflows, along with a partial recovery of exports, resulted in an overall balance of payments surplus of over U.S.$ 1 billion.

However, the fiscal deficit remained high in 1991 (56 % of expenditures) and this called for early adjustment measures. At the start of 1992, public confidence in economic management was shaken by what was perceived as a weak budget incorporating very large increases in the public sector and a large deficit. This, coupled with continued political instability, led to economic stagnation with an intensification of inflationary pressures reflecting both exchange rate depreciation and the resort to central bank finance to cover the budget deficit. Banque du Liban, after losing about U.S.$ 450 million in reserves by the beginning of 1992, stopped supporting the Lebanese Pound, whose value declined to all-time lows. The cycle of deficit financing, dollarization and capital outflows led to escalating inflation and exchange rate depreciation. Events during 1992 showed that the economy was still not out of the danger zone. In a climate characterized by labor unrest and political instability brought on by the first parliamentary elections in twenty years, confidence in the Lebanese pound dropped dramatically. Between

Table 4: Public Accounts in Percentage of GDP

Year	GDP	Revenue (% of GDP)	Expenditure (% of GDP)	Deficit (% of GDP)	Public Debt (% of GDP)
1982	100	21.4	73.8	52.4	119.8
1983	100	26.5	68.7	42.2	135.5
1984	100	8.9	47.5	38.6	114.9
1985	100	7.3	43.2	35.9	97.1
1986	100	5.6	31.7	26.1	92.2
1987	100	2.7	19.4	16.7	60.1
1988	100	1.3	37.2	35.9	56
1989	100	3.4	37.9	34.5	62.1
1990	100	6.4	40.2	33.8	103.8
1991	100	12.6	28.9	16.3	76.1
1992	100	11.0	25.7	14.7	58.2
1993	100	14.1	23.5	9.4	52.8
1994	100	15.1	35.1	20.0	74.8
1995	100	19.1	36.8	17.7	71.3
1996	100	17.3	35.5	18.2	78.2
1997	100	16.4	40.1	23.7	95.5

Source : BDL, various yearly and monthly issues ble 7: Economic growth indicators

Year	Nominal GDP (mn. $)	Real GDP growth rate	Inflation	Exchange rate (L.L./$)	Annual depreciation
1974	3,538	3.11		2.3	
1982	3,307	-36.79	18.8	3.8	
1983	3,019	22.71	7.2	5.7	48.68
1984	3,169	44.48	17.6	8.9	57.52
1985	3,278	24.30	69.4	18.1	103.37
1986	1,242	-6.76	95.5	87.0	380.66
1987	1,628	16.72	487.2	455.0	422.99
1988	2,558	-28.21	155.0	530.0	16.48
1989	2,673	-42.18	72.2	505.0	-4.72
1990	2,343	-13.43	68.8	842.0	66.73
1991	4,701	38.27	51.5	879.0	4.39
1992	5,168	4.50	120.0	1,838.0	109.10
1993	7,669	7.05	29.0	1,711.0	-6.91
1994	9,547	8.50	20.0	1,647.0	-3.74
1995	11,777	7.00	11.0	1,590.0	-3.46
1996	12,996	4.00	10.0	1,552.0	-2.39
1997	14,842	4.00	5.0	1,527.0	-1.61

ource: Ministry of Finance, various yearly and monthly issues

February and September, it fell from L.L. 879 per US$ to L.L. 2830 per US$. Inflation rose to 120% and GDP growth averaged around 4.5%. (Lebanon, The Annual Business, Economic and Political Review 1997-1998, 43)

Rafic Hariri came to power a month after the devastating devaluation and immediately began a program of fiscal reforms. Immediately following the appointment of the Hariri Government in October 1992, there was a significant increase in confidence that allowed the Government to break the cycle of deficit financing, further dollarization and exchange market instability, thereby restoring economic stability and renewing confidence in the Lebanese Pound. This was reflected by the sizable inflow of capital and the substantial shift from foreign currency denominated assets to Lebanese Pound denominated assets. Net foreign exchange reserves continued to grow, reaching U.S.$ 3,026 million by the end of 1995 and U.S.$ 3,935 million at December 31,1996.

The Government moved to improve public sector finances. With the restoration of its authority throughout most of the country, the Government introduced measures aimed at containing and reducing the drain on public resources through public expenditure control and the enhancement of revenue collection. Since November 1992, Lebanon has enjoyed relative macroeconomic stability, with the Lebanese Pound appreciating gradually to reach L.L. 1,552 per U.S. dollar at the end of 1996 and annual inflation falling to 11% in 1995 and around 10% in 1996. In 1997, the Lebanese Pound/U.S. dollar exchange rate was L.L. 1,527 per U.S.$ [Table 3]. However, a significant budget deficit remains. Real GDP is estimated to have grown 68 % since 1990, as the economy stabilized and the reconstruction program began.

Table 3: Inflation and Internal Debt

Year	Inflation %	L.L/$	Internal Debt (bn. L.L.)	Internal Debt (mn. $)
1979	23.7	3.3	2.66	806.1
1980	23.9	3.6	4.43	1,230.6
1981	19.3	4.6	6.89	1,497.8
1982	18.8	3.8	14.03	3,692.1
1983	7.2	5.7	21.16	3,745.1
1984	17.6	8.9	30.77	3,457.3
1985	69.4	18.1	54.37	3,003.9
1986	95.5	87.0	81.72	939.3
1987	487.2	455.0	193.60	425.5
1988	155.0	530.0	521.50	984.0
1989	72.2	505.0	982.00	1,944.6
1990	68.8	842.0	1,590.0	1,888.4
1991	51.5	879.0	2,639.00	3,002.3
1992	120.0	1,838.0	5,135.50	2,794.1
1993	29.0	1,711.0	5,803.70	3,392.0
1994	20.0	1,647.0	9,347.50	5,675.5
1995	11.0	1,596.0	11,997.20	7,517.0
1996	10.0	1,552.0	17,228.80	11,101.0
1997	5.0	1,527.0	19,787.10	12,958.2
1998	6.0	1,508.0	21,685.00	14,380.0

Source: BDL, various yearly and monthly issues

Government revenues increased from L.L. 1,031 billion in 1992 to L.L. 4,430 billion in 1998 [Table 4]. Government revenues as a percentage of GDP increased from approximately 11 % in 1992 to more than 16.4 % in 1997, reflecting better revenue collection procedures. Government expenditures as a percentage of GDP increased from 25.7% in 1992 to 40.1% in 1997, due in large part to the economic recovery program implemented by the Government [Table 1].

The balance of payments was in overall surplus over the past five years, despite growing trade. The balance of payments was U.S.$ 1.13 billion in surplus for 1994. In 1995 and 1996, the balance of payments registered a surplus of U.S.$ 256 million and U.S.$ 786 million, respectively. The first quarter of 1997 registered a surplus of U.S.$ 564.5 million due to the persistent confidence in the Lebanese economy and continuing capital inflows and remittances.

Yet, despite all the above positive signs, the new government switched from printing money to local currency borrowing to finance the growing budget deficit in order to decrease inflation. Treasury bills were raised sharply to attract funds. But by decreasing inflation the Hariri government had increased internal debt by selling all these Treasury bills. In addition, Lebanon's reconstruction plans, launched by the government, were heavily dependent on financing from abroad. Eventually, public debt, composed of internal and external debt, has risen sharply under the Hariri administration. From 58.2% of GDP in 1992, total net public debt increased to 95.5% at the end of 1997, and was expected to exceed 100% of GDP some time in early 1998 [Table 1]. (Finance Lebanon 1998, 18)

In summary, upon taking office in November 1992, the Government was confronted with the challenges of converting the then-existing

Table ([illegible]): Interest Expense (Different Indicators)

Year	Revenue (bn. L.L.)	Interest-exp (bn. L.L.)	Interest-exp (% of Rev.)	Interest-exp (% of Exp)
1979	1.8	0.14	7.78	5.00
1980	2.5	0.28	11.20	7.30
1981	3.6	0.49	13.61	9.80
1982	2.7	1.15	42.59	12.40
1983	4.4	1.67	37.95	14.60
1984	2.5	2.44	97.60	18.20
1985	4.3	5.90	137.21	23.10
1986	6.1	10.90	178.69	31.80
1987	20.1	24.60	122.39	17.10
1988	21.4	80.00	373.83	29.00
1989	45.9	152.10	331.37	29.70
1990	126.4	203.50	161.00	25.60
1991	522.2	205.50	39.35	17.20
1992	1,030.9	518.50	50.30	21.30
1993	1,797.0	787.00	43.80	25.10
1994	2,241.0	1,490.00	66.49	28.60
1995	3,033.0	1,862.00	61.39	31.80
1996	3,536.1	2,692.93	76.16	37.17
1997	3,752.3	3,380.00	90.08	36.89
1998	4,429.7	3,214.00	72.56	41.11

Source : BDL, Ministry of Finance, various yearly and monthly issues hyper-inflationary and economically contracting environment into one of macroeconomic stability and reconstruction. The Government was also required to markedly improve the living conditions of the population, enhance security and rebuild and modernize the infrastructure. However, all this was to be done at the expense of the public debt.

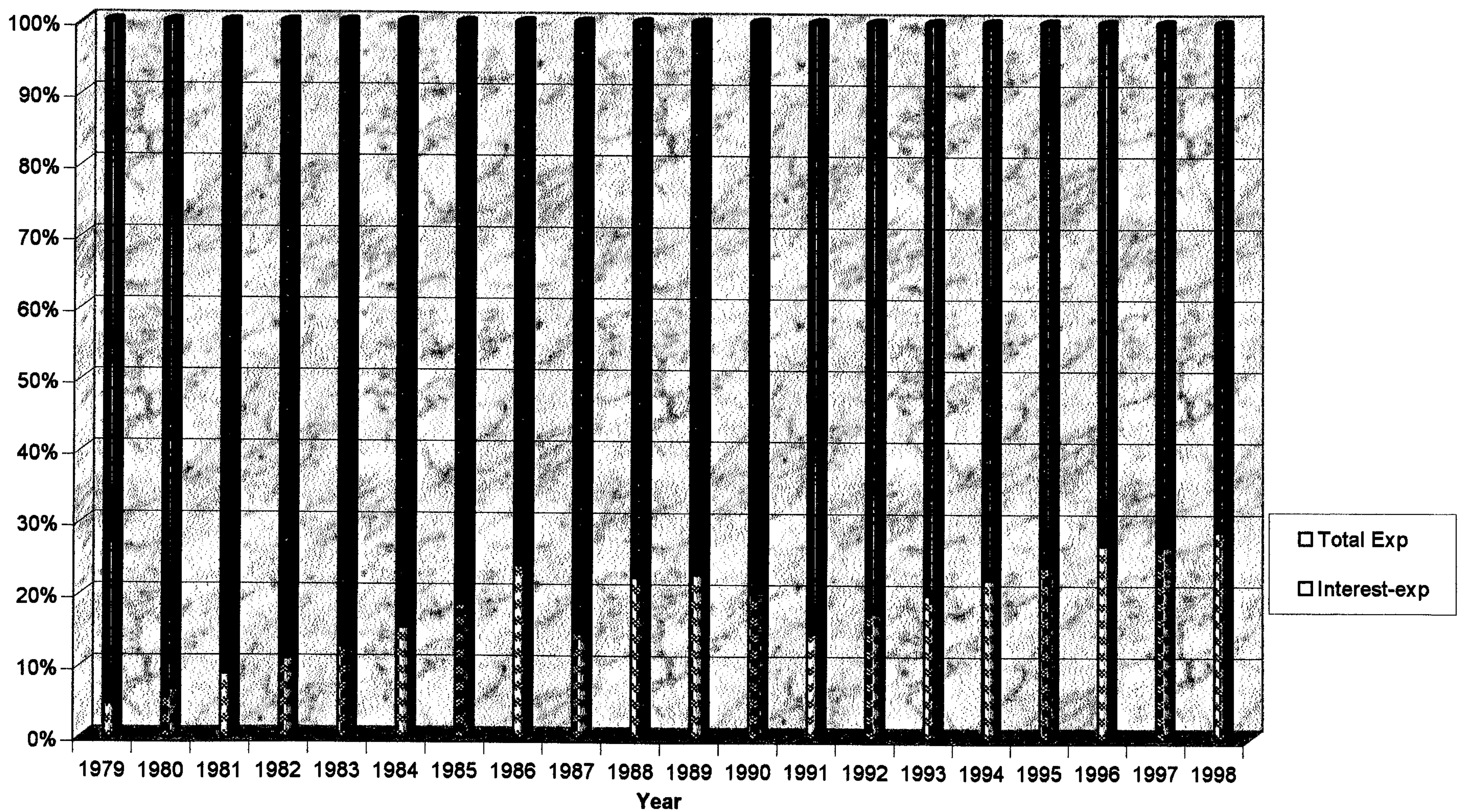
IV. IMPACT OF PUBLIC DEBT ON THE LEBANESE ECONOMY

A. The debt servicing bill

The debt servicing bill for Lebanon was not a matter of concern before May 1979 as interest rates on Tbs were low. In January 1978 and the month before, three-month Tbs offered a 3% rate of interest. Until April 1979, this rate was maintained constant at 2.52%. However, with the persisting financial need of the public sector to induce more subscriptions, the government tended to follow a policy of increasing interest rates offered on Tbs. Hence, since 1980 and until present, interest expenses have been recording high levels. [Table 4]

The policy followed by the Lebanese monetary authorities proved efficient in financing the growing internal debt. Yet, since this debt was contracted at high costs, servicing it became an issue of concern. Interest payments increase and eventually absorbed a greater share of total government expenditures. Before 1979, the percentage of interest payments out of total expenditures was negligible. However, with the evolution of rising trend of public debt, interest payments increased to constitute significant portions. For example, in 1986, servicing public debt represented 32% of total public debt expenditure. In 1987 and in 1991, dropped to around 17% mainly due to a greater recourse to monetary financing. Otherwise, it remained at high levels with interest payments absorbing almost one third of the budgetary expenditures. Specifically, since 1992, this ratio has been constantly rising. [Fig. 2]

Fig. 2 : % of Interest Expense of Total Expenses



While the primary deficit represents the gap between revenues and expenditures (less interest), the secondary deficit can be defined as the budget's need to service its outstanding public debt obligations. These obligations obviously include domestic and foreign components. As interest outlays expanded, the secondary deficit eventually constituted high proportions of the total deficit. While the secondary deficit stood at 14% in 1979, it rose to 32.7% in 1981. It remained at high levels except for 1987 when it dropped to 19.35% mainly due to a lesser burden of debt service in real terms. As shown in table 5, the secondary deficit increased to two thirds of the total deficit. This reflects the fact that as the government reduced its recourse to monetary financing of its budget deficits, the debt burden rose significantly. Therefore, with the rise in the ratio of debt servicing, the Treasury needs to keep debt under reign. Figure 3 shows the average share of secondary deficit from total deficit during 1979 till 1998.

B. Inflation

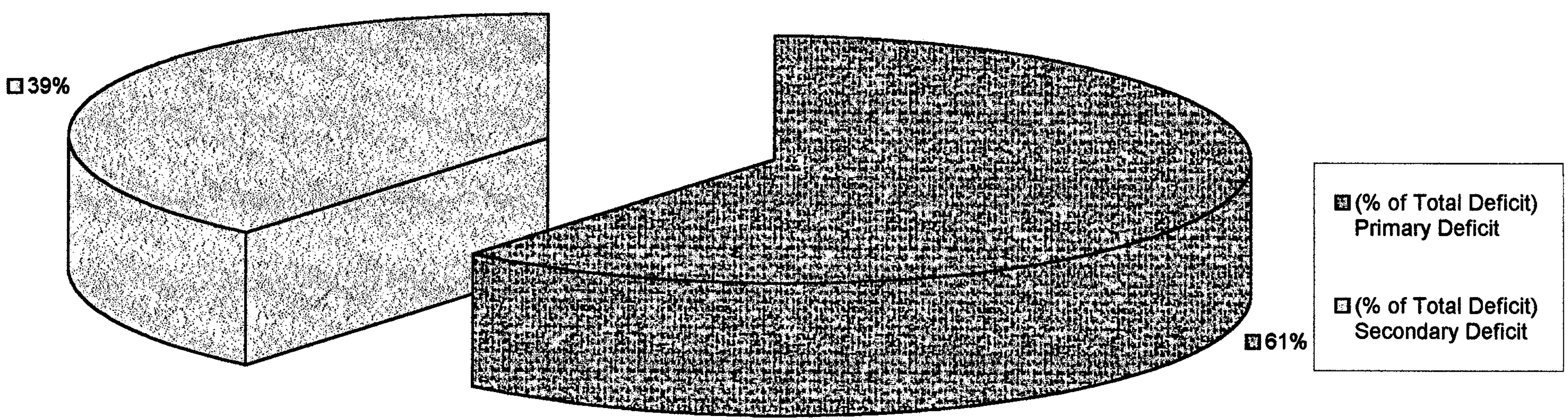
We have explained in chapter one how inflation occurs in order to finance budget deficit: the Treasury requires the central bank to purchase the quantity of money needed in new bonds. The central bank pays for its purchases of new bonds by printing the money needed in new currency. This increase in the money supply ultimately leads to an increase in the inflation rate. With the government ability to raise revenue through its right to create money, debt repudiation through inflation occurs. As the inflation rate accelerated, the obligation of the government declined in real terms. This phenomenon is shown in table 3.

Table [illegible]: Primary and Secondary Deficit to Total Deficit

Year	Primary Deficit (% of Total Deficit)	Secondary Deficit (% of Total Deficit)
1979	86.0	14.0
1980	80.0	20.0
1981	67.3	32.7
1982	82.6	17.4
1983	76.1	23.9
1984	77.6	22.4
1985	72.6	27.4
1986	61.3	38.7
1987	80.7	19.3
1988	68.6	31.4
1989	67.3	32.7
1990	69.5	30.5
1991	69.5	30.5
1992	63.1	36.9
1993	41.2	58.8
1994	49.7	50.3
1995	34.0	66.0
1996	27.4	72.6
1997	37.5	62.5
1998	5.1	94.9

Source : BDL yearly Bulletin - various issues

Fig. 3: Share of Secondary Deficit of Total Deficit



In 1984, the inflation rate was 17.6%. The nominal stock of internal public debt had risen by 40% compared to the previous year. However, this debt decreased in real terms by 10.2%. As the inflation rate rose more significantly, internal public debt in real terms declined. This especially occurred in 1987 when the inflation rate reached a peak high of 487.2%. Over the same period, internal public debt declined to $425.5mn down from $3,848mn in 1983. On the other hand, taken in nominal terms, the debt had risen from L.L. 21.2bn in 1983 to L.L. 193.6bn in 1987. This indicates the fact that as government finances itself through inflation, it transfers the debt-burden to holders of government debt.

Since 1992, the stabilization measures introduced by Hariri's administration have managed to bring inflation under control. Although there are still no official inflation statistics in Lebanon, proxy indicators show that a return to relative price stability is gradually occurring: from a rate of 120%, inflation dropped to 29% in 1993 and 20% in 1994. In 1995, it reached 11% and in 1996, 10%. Inflation figures for 1997 will stand at around 5% climbing to 6% in 1998.

In spite of the rising budget deficit, inflation has been relatively low for three main reasons:

- Government issues of treasury bills have absorbed liquidity from the market and caused monetary contraction.
- The gradual appreciation of the Lebanese pound had increased its value which had contributed to reducing the rate of inflation in Lebanese pound.

• The relative openness of the Lebanese economy, which had ensured that excess demand on the domestic market is normally matched by a corresponding supply of imported goods. (Lebanon, The Annual Business, Economic and Political Review 1997-1998, 48)

C. Crowding out of investment

To bridge the gap between its revenues and its expenditures, the Lebanese government resorted among other measures to borrow from its domestic market. The major form of borrowing was the sale of Tbs, to which commercial banks were the main subscribers. These banks were tempted by the high rates offered on Tbs and hence, allocated considerable parts of their resources into government placement. This allocation especially occurred at those intervals when the fluctuation in the national currency was moderate since speculative gains were not appealing and investing funds in risk-free Tbs was a good decision to be taken.

The persisting financial need of the public sector induced the government to follow a policy of increasing interest rates on Tbs in an attempt to attract potential bill-buyers. This policy proved efficient as internal public debt was rapidly mounting. The increased borrowing of the public sector crowded out eligible domestic private borrowers. Since interest rates were rising leading to higher borrowing costs, private investment and other interest sensitive spending were reduced.

In order to evaluate the extent of crowding out of private sector activity, it would be meaningful to trace the evolution of banks' distribution of credit across private and public entities. Table 6 shows the growing share of bank claims on the public sector from total bank financing during 1991-1998 when domestic debt was surging. Bank

Table 3. Crowding out of Private Sector Financing (In billion LL)

	1991	1992	1993	1994	1995	1996	1997	1998
Bank Claims on the private sector	1,971	4,804	5,992	7,800	10,440	13,026	16,039	19,322
Bank Claims on the public sector	1,309	3,098	3,097	4,347	5,350	8,296	12,223	15,954
Total Bank Claims	3,280	7,902	9,089	12,147	18,376	21,322	28,262	35,276
Shares in Bank financing								
Bank Claims on the private sector	60.1%	60.8%	65.9%	64.2%	70.9%	61.1%	56.8%	54.8%
Bank Claims on the public sector	39.9%	39.2%	34.1%	35.8%	29.1%	38.9%	43.2%	45.2%

Source : BDL Monetary Survey, various yearly issues lending to the private sector from total lending has been gradually decreasing from 70.9% in 1995, to 54.8% in 1998 while banks' claims on the public sector were rising reaching 45.2% in 1998. These figures reflect bank's rising involvement in public financing and its drifting away from private financing [Fig. 4].

The distribution of treasury bills among subscribers is another relevant indicator of the extent of crowding out of the private sector as it shown in table 7. Since banks, who are supposed to be the main suppliers of funds to private investors, have been gradually increasing their share of subscriptions in tbs. Banks were carrying 39.67% of total Tbs in circulation in 1987, while this number reached 75.05% in 1998. Investment by foreigners in Tbs has also been rising implying that even foreign funds and capital inflows are financing government debt instead of private investment.

D. Dollarization

Lebanon's 15-year civil war had a devastating effect on the economy. The immediate response of the public was a portfolio switch to liquid assets. However, the ongoing nature of the conflict and its accompanying high rates of domestic inflation, induced the abandonment of the Lebanese pound in favor of the U.S. dollar and dollar dominated deposits.

Fig. 4: Bank Claims divided between Public and Private Sectors

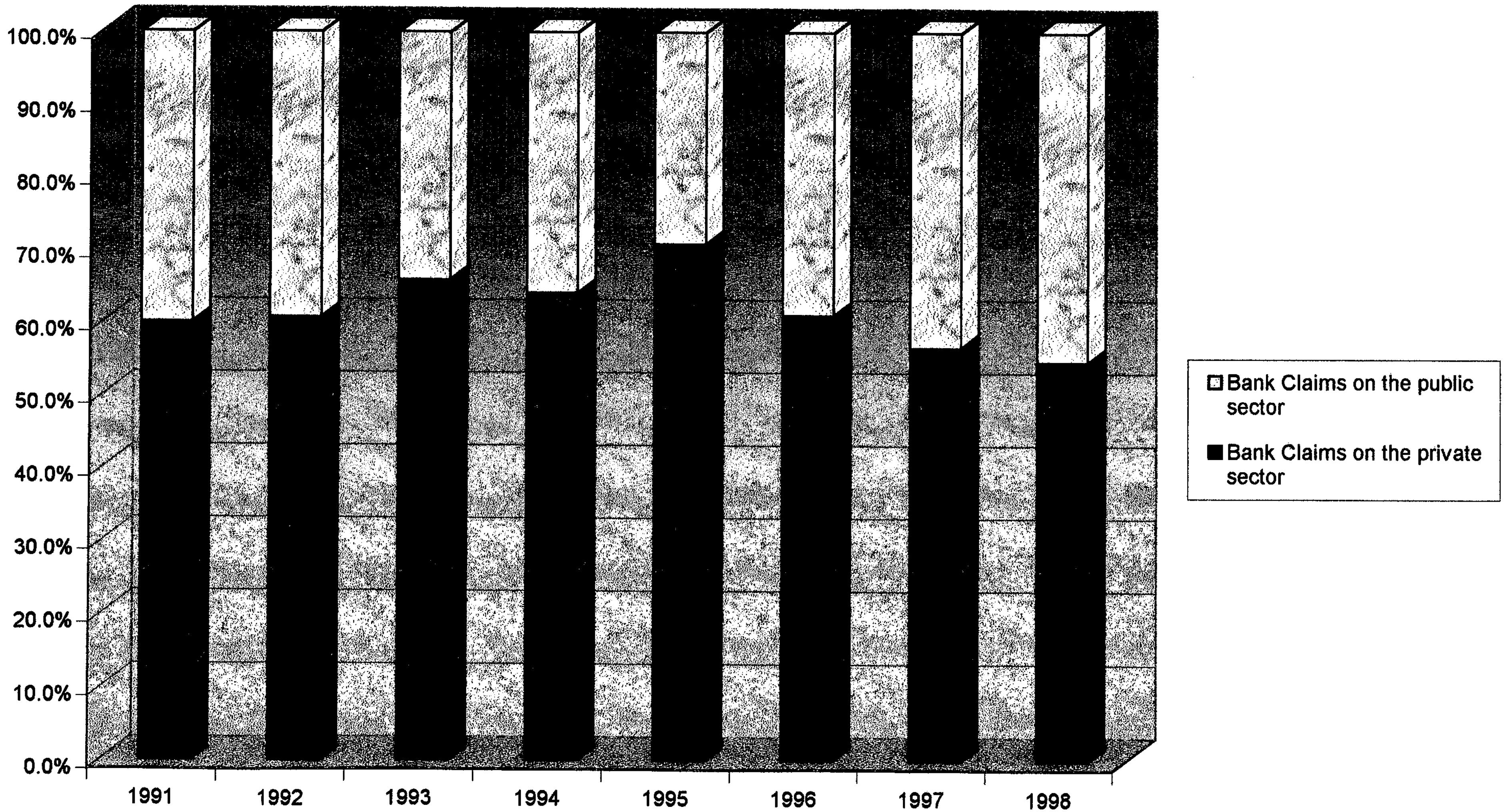


Table 7. Distribution of Public Debt Among Subscribers (in billion L.L.)

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Central Bank	66.31	16.52	26.50	76.21	70.99	142.68	418.40	28.70	0.00	0.00	287.00	14.40
in % of total	52.13%	3.88%	3.37%	5.68%	3.04%	3.00%	6.95%	0.31%	0.00%	0.00%	1.48%	0.07%
Commercial Banks	50.47	325.82	609.78	759.78	1,536.22	3,701.62	4,437.30	7,272.30	9,044.70	12,577.80	13,194.00	15,841.80
in % of total	39.67%	76.51%	77.54%	56.59%	65.84%	77.86%	73.67%	78.69%	70.58%	73.75%	68.08%	75.05%
Financial Institutions	0.71	0.33	0.48	320.00	4.46	3.04	8.50	20.40	29.50	326.40	292.20	66.30
in % of total	0.56%	0.08%	0.06%	23.83%	0.19%	0.06%	0.14%	0.22%	0.23%	1.91%	1.51%	0.31%
Other Institutions	3.40	4.07	4.36	9.86	71.63	93.19	190.30	455.60	653.10	829.90	1,875.00	1,766.40
in % of total	2.67%	0.96%	0.55%	0.73%	3.07%	1.96%	3.16%	4.93%	5.10%	4.87%	9.67%	8.37%
Public	6.32	79.11	145.30	176.85	649.89	813.87	968.80	1,464.30	3,087.70	3,319.50	3,731.70	3,420.40
in % of total	4.97%	18.58%	18.48%	13.17%	27.85%	17.12%	16.08%	15.85%	24.09%	19.47%	19.26%	16.20%
Total	127.21	425.85	786.42	1,342.70	2,333.19	4,754.40	6,023.30	9,241.30	12,815.00	17,053.60	19,379.90	21,109.30

Source: BDL, various yearly and monthly issues

Dollarization is measured by bank deposits in foreign currencies as a percentage of total bank deposits. Even before the war, 25% of bank deposits were held in dollars, reflecting the economy's role as a trade center. During the war, capital flight and the conversion of pounds into foreign currency were seen as ways of safeguarding savings. In 1987, dollarization reached 93%. After dropping for two years, it rose again to 73% in 1990 on renewed uncertainty.

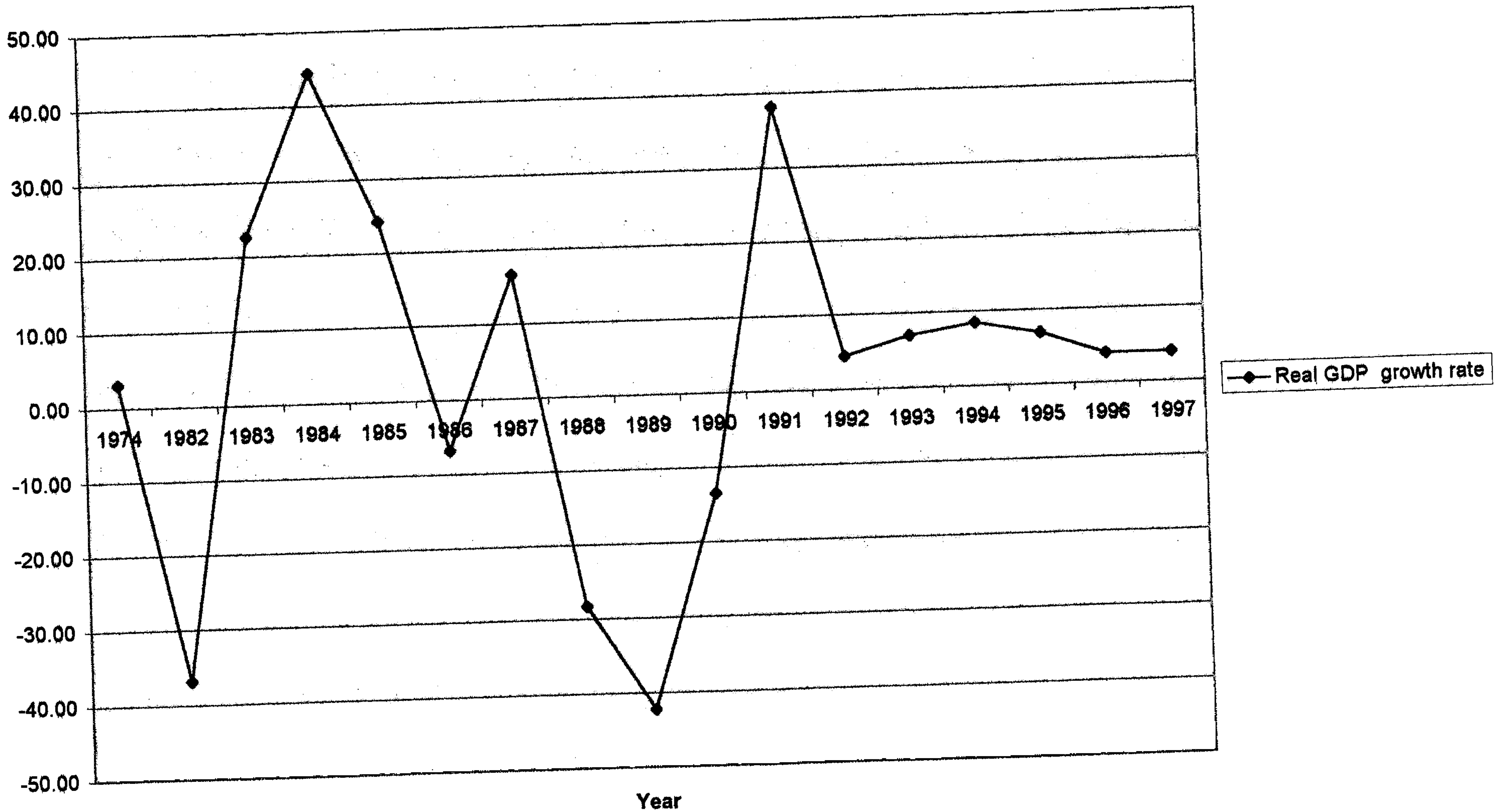
With the return of confidence in 1992, dollarization began to fall. From 59.1% in 1994, it fell to 57% in 1995 and to 56.5% in 1996. In March 1997, it reached a low of 54.7%. Since then the figure has again begun to climb, in part reflecting the fall in interest rates, but, more importantly, uncertainty over government fiscal policies. By September 1997 dollarization had reached 60.6%; rising in six months more than it had fallen in the previous two and a half years. (Finance Lebanon 1998, 19)

E. Economic growth

Economic growth was severely constrained [Table 2]. The growth rate of domestic production and income declined sharply with a negative real GDP growth for 1982, and 1988-1990 [Fig. 5]. Investment spending fell and wealth was destroyed in terms of both human and non-human capital.

The private sector is usually perceived as more efficient than the public sector, given the existence of a highly competitive market for the former relative to a monopolistic market for the latter. Therefore, demand and supply interactions are supposed to determine the best attainable price for the private sector under market efficiency. Could the

Fig. 5: Real GDP growth rate



government perform the work of the private sector at equivalent efficiency rates?

In fact, the Lebanese experience has proved that government was relatively inefficient in the allocation of financing resources as well as their productivity. From among government expenditures shown in table 8 capital expenditures captured the lowest share of the total with around 13.34% on average during 1990-1998. Despite the improvement in capital spending from 4.25% in 1990 to 23.8% in 1996, it is still considered insufficient especially that government's essential goal in its recovery plan was investment-led growth and its primary objective was to achieve reconstruction and rehabilitaiton projects that would accordingly promote economic growth. Consequently, it is expected that capital expenditures should increase drastically in line with government aims. Yet, the level of current expenditures continued to have a much larger share of total government spending averaging around 86.66% in 1990-1998, with an average salaries share of 30.8% and a debt service share of 30.87% [Fig. 6].

Table 8. The Classification of Expenditures

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Total Expenditures	1,109.07	1,288.69	1,296.84	1,698.08	3,097.00	3,540.41	4,598.98	9,161.00	7,320.00
Current Expenditures	1,061.90	1,115.24	1,211.52	1,583.23	2,437.00	2,589.76	3,504.52	8,295.29	6,766.25
in % of expenditures	95.75%	86.54%	93.42%	93.24%	78.69%	73.15%	76.20%	90.55%	92.44%
Salaries	299.25	398.61	385.78	367.52	910.70	1,233.81	1,591.34	3,220.09	2,480.00
in % of expenditures	26.98%	30.93%	29.75%	21.64%	29.41%	34.85%	34.60%	35.15%	33.88%
Debt Service	304.24	221.39	303.02	450.22	883.00	1,147.44	1,690.64	3,844.87	3,200.00
in % of expenditures	27.43%	17.18%	23.37%	26.51%	28.51%	32.41%	36.76%	41.97%	43.72%
Others	458.42	459.24	522.71	765.48	643.30	208.51	222.53	1,230.32	1,086.25
in % of expenditures	41.33%	35.64%	40.31%	45.08%	20.77%	5.89%	4.84%	13.43%	14.84%
Capital Expenditures	47.17	173.45	85.33	114.85	660.00	950.65	1,094.46	865.71	553.75
in % of expenditures	4.25%	13.46%	6.58%	6.76%	21.31%	26.85%	23.80%	9.45%	7.56%

Source: Ministry of Finance,various yearly and monthly issues

V. SUGGESTED SOLUTIONS TO DEBT MANAGEMENT

A mismanagement of the country's indebtedness may render the debt crisis a chronic financial problem with no end in sight. Estimations published in "Emerging Lebanon 2000" shows that a continuation of status quo fiscal and monetary policies would leave Lebanon crippled under the weight of a debt-to-GDP ratio of 186%, a deficit-to-expenditure ratio of 72% and a debt-to-service ratio of over 200%. Such a position may prove irreversible.

In fact, the new regime under Selim Hoss unveiled plans at the beginning of 1999 to launch a Five Year Plan comprised of major fiscal adjustments and Treasury measures aimed at reducing the annual deficit and curbing the growth of the debt-to-GDP ratio by 2003 [Tables 9 &10].

This chapter will try to answer the key policy questions of whether and how to limit or reduce the national debt. Moreover, it will try to evaluate briefly whether the Five Year Plan had tackled each solution and how.

A. Alternatives for government spending

1. Increasing the role of private sector

Throughout the world there has been an increasing trend by governments to use the private sector to develop and implement infrastructure projects. An essential part of the agreement between the Government and the private contractor is the allocation of risk between the parties. That is, when an event occurs which influences the cost or quality of the contracted service, which party must pay to rectify the

'able 9: Fiscal Adjustment Plan (% of GDP)						
'ear	1998	1999	2000	2001	2002	2003
ax Revenue	14.5	16.8	17.1	19.0	19.1	19.3
otal Deficit	-22.7	-13.3	-12.4	-8.3	-5.6	-4.5
otal Debt	118.8	127.6	126.7	115.0	105.4	96.3
otal Debt Service	13.7	14.2	13.8	12.2	9.6	8.7

'able 10: Economic Indicators under the Five Year Plan						
'ear	1998	1999	2000	2001	2002	2003
lominal GDP (L.L. bn)	24,509	25,999	27,716	30,266	32,735	35,403
Real growth rate (%)	3.0	2.0	3.0	4.0	4.5	5.0
Budget surplus (deficit/GDP %)	-22.7	-13.3	-12.4	-8.3	-5.6	-4.5
'ublicrevenue (L.L. bn)	4,430	5,505	5,979	7,209	7,809	8,498
'ublic expenditure (L.L. bn)	9,992	8,958	9,416	9,733	9,633	10,081

ource: Emerging Lebanon 2000, p.28

situation or alternatively, which party gains any benefits which result. A framework will be developed to evaluate the efficiency of a project's risk profile.

In dealing with the private sector, it is hoped that the following outcomes will be achieved:

- Enhance the likelihood of capturing the maximum community benefits for a given project.
- Develop a mutually acceptable and efficient starting point for negotiation of the risk allocation for individual projects and hence increase certainty for private sector participants engaged in the bidding process.
- Reduce the transaction costs incurred in setting up agreements.
- Streamline the Government's internal processes and hence reduce the time taken to prepare projects for the market, and to evaluate bids (Arndt, 3).

a. Build, Operate and Transfer (BOT) contracts:

In order to alleviate the burden on the Treasury, the government has decided to undertake different Build, Operate and Transfer (BOT) agreements, a fashionable device used by many cash-strapped governments. This requires the contractor to build and finance the project at his own expense, operate it until he has recovered his investment, then transfer it to the State.

The main BOT contracts made in Lebanon so far have been to provide two competing cellular-telephone services, one led by France Telecom Mobile Liban (FTML), the other by Telecom Finland International (TFI).

Other BOT contracts will cover a new road from Beirut to the Syrian border, and the proposed Beirut conference center.

Not only BOT contracts guarantee that all the projects will be transferred to the government sooner or later, but also they will return more likely to the government as profitable projects since any contractor will not bid on a project if he has not the right plan to lead the project to its maximum earnings. So why not use the BOT method with other roads than the Beirut-Syria one, or for Electricité du Liban or even for Lebanon's fixed telephone system?

b. Privatization

The issue of privatization in Lebanon is not a subject of debate. In fact, Lebanon's fiscal crisis rather than economic theories and an ideological bias against the role of public sector in the economy, is the driving force behind government policy on privatization. As Marwan Barakat, Banque Audi's head of research says: "We are at a turning point right now, either we move towards the alleviation of the debt, or we go where the state can't control its deficit, which would affect market confidence." According to Barakat, for each $1 billion that the state raises from the private sector, we can reduce the debt to GDP ratio by 6%, leading eventually to an approximate 30% reduction in the debt. Not only the purpose of privatization is to alleviate Lebanon's budgetary problems, but also to provide a more efficient delivery of services and create greater investment opportunities particularly foreign investment. However, we must never forget that the keyword in going ahead with privatization is "transparency" which has to be applied to all stages of the process, from valuation to sale and regulation (Jeffrey, 30). Mohamed Metwally, attending the fourth annual Arab Capital Markets Conference held in Beirut, said "If international investors are going to own less than a $1 million position, it is not worth it for them, you would need companies with more liquidity to make investors convertible about taking positions". He cited large utility companies as examples. "The Lebanese government has to look into big items like power and telecom for privatization, companies with good growth potential in terms of earnings and decent returns to shareholders," he added. Both electricity and telecommunications are held by the public sector and are accused of squandering money and inefficient collection of bills (Ministry of Finance, 1998).

Metwally said investors' choices were "very limited" on the Beirut bourse, where the mood was hit first by the Asian markets crisis last October and then by international rating agencies threatening a downgrade of Lebanon if the government failed to control finances.

"The economy right now is in a state in which they will need to work very hard on managing their debt and managing their budget deficit and I think doing that will bring a lot of confidence into the Lebanese market and the Lebanese economy. That will take some time to establish. You cannot expect investors to jump in right after the first quarter results. You will need to show some sustainability in results before you see the flow of capital back", Metwally added (Ministry of Finance, 1998).

In fact, the government is seeking a way to go ahead with privatization. The Speaker of the Parliament, Nabih Berri, ruled out the possibility of granting the executive branch exceptional powers to oversee the sale of state-owned enterprises. He added that approval for privatization would be granted by Parliament on a case by case basis. The cabinet is preparing a privatization law that sets down the legal framework for the process. It stipulates the creation of a higher council for privatization headed by the Prime Minister and makes provisions for protecting the affected workforce. The draft law would also offer the general public the opportunity to subscribe to shares in privatized entities (Lebanon Invest Research Company, May 15, 1).

One of the main tools used in the fiscal adjustments of the Five Year Plan is privatization. The government aims at running a privatization program that will raise revenue in the short term and relieve the state of some of its inefficient holdings. Measures include the issuance of convertible bond against privatization entities, including bond issued by an independent fund for telecoms, the renegotiations of the agreement between the government and the private GSM operators, and the issuing of a third operating license and the reduction of the state's creditor accounts. Overall, the privatization program, which is expected to include the telecoms and electricity sectors, as well as the governments holdings in the Casino du Liban and possibly Regie, the state tobacco monopoly, is tipped to raise $4bn-5bn (Emerging Lebanon 2000, 28).

Finally, a guiding principle for public investment is that it should complement rather than compete with private investment. Government's involvement is clearly needed to supply public goods such as defense, social security, and where the private sector would undersupply goods and services that benefit the society at large. Yet, it needs not spend scarce and costly resources on activities which the private sector, if allowed, can better achieve.

2. Develop Capital Markets

Capital is the engine of business and employment growth. The productive use of capital is the lifeblood of job creation and growth in any vibrant economy. With a dynamic capital market and a strong entrepreneurial base, promising ideas can be transformed into successful enterprises. Without adequate financing, businesses are limited in their ability to upgrade technology, develop new products and services, and pursue new markets.

Three important reasons are behind the developing of the financial markets. First of all, Lebanon's national product will profit from the financial services. Second, the operations of privatization of certain economic activities of the public sector will be easier in well-developed capital markets. In addition, financial markets contribute in creating liquidity, allowing for risk-sharing and risk diversification, and reducing the potential burden arising from a high level of international debt (Lebanon's Capital Markets, 21).

The Beirut Stock Exchange was established by a government decree on July 2, 1920. Dealings concentrated mostly on gold and foreign exchange. The market, which was the first in the Middle East, attracted investments to France and Syria in addition to Lebanon. Dealers included the mixed French-Syrian-Lebanese concessionaires of public utility companies and all the companies were listed on both the Beirut and Paris Stock Exchanges. The Exchange worked for 34 years without any regulations to govern its operations, until the Lebanese parliament in 1945 enacted such a law. It was amended numerous times in the 1960's, 70's and 80's until the Exchange closed down in 1983 as a result of Lebanon's civil war. After much fanfare and excitement, and thanks to France who helped get the Beirut Stock Exchange on its feet with a grant of $900,000, the Exchange opened its doors and resumed its trading on January 22,1996, after nearly thirteen years of complete inactivity. Less than a year later, the Lebanese, Kuwaiti and Egyptian stock exchanges began cross-trading shares with the aim of boosting the overall activity and market capitalization of their respective markets and for the sake of attracting more foreign capital. According to Mr. Gabriel Sehnaoui, President of the Exchange, "this accord between the three markets will allow for the exchange of information and offers and demands between investors on all three financial locations and will undoubtedly produce very positive results in the near term" (Abdelnour, 2).

As of today, there are eight Lebanese companies that are currently trading with a total capitalization of $2.6 billion compared to Lebanon's GDP of $8.5 billion while dozens of companies are awaiting approval for listing.

While the Lebanese are hopeful that the resumption of the Beirut Stock Exchange's trading activity will return to Lebanon its reputation as the Switzerland of the Middle East, it is clear that both Syria and France are eager to revive the "good old ties" they had with the Lebanese bourse 75 years ago. A time where the Lebanese exchange was used as a financial platform to attract both local and Arab capital for the benefit of these two countries political agendas.

The main questions however remain:

1. Are the proper financial tools in place at the Beirut Stock Exchange to attract the foreign capital required to boost Lebanon's economy?

   It is doubtful that with the system of "fixing" now used at the Exchange, Western institutional investors and other emerging market funds will ever invest in any major way in companies listed on the Beirut Stock Exchange. It is a fact that this system opens the way to all sorts of manipulations and does not reflect the market price of a certain security, which is the result of a balance between supply and demand of that particular share. For example, one has only to follow the daily quotations for Solidere, whose apparent prices indicate a surprising stability, to realize the discrepancy in stock prices. How can for example the average number of shares outstanding offered exceeds 850,000, while demand stays at around a threshold of 40,000?

2. What about regulation of the Exchange?

So far, Lebanon does not have an official Stock Exchange Commission along American lines such as the Securities and Exchange Commission or "SEC". It has a Committee of eight members representing the Ministry of Finance and representatives from various banks, brokers and dealers, both foreign and domestic. Time has come to create a Lebanese SEC if the Beirut Stock Exchange wants to gain real credibility in the international capital markets. There must be a supervisory body that is independent both of the Central Bank and the Ministry of Finance.

3. What about the new agreements between the Lebanese Bourse and the Egyptian and Kuwaiti Exchanges recently concluded to cross trade shares on the three exchanges?

It is a fact of life that agreements have never created markets. The first functions of such accords must be to act as regulators of an already existing market. Maybe Lebanese experts think that they can stimulate domestic demand by dazzling certain credulous investors with the prospect of a sudden spurt in share prices as a consequence of demand in the Arab world. If this is the case, it is not going to work out. The key for the development of any market is to first create demand on the local level. And this is not being done in Lebanon.

4. If we take a close look at the Israeli case, we notice that privatization and deregulation repatriated billions of dollars in capital to the State of Israel, aided primarily by the expert advice of major

Wall Street banks. How could Lebanon learn from and challenge the Israeli example?

Lebanon could learn from the Israeli example by encouraging the funding of well-capitalized institutions that will have easier and a more direct access to the U.S capital markets. Lebanese financiers should not discount the importance of Wall Street firms at the expense of French and Arab financiers, even though the French and their Syrian partners are doing everything they can to replace the Americans in the Middle East. Today, dozens of Israeli-based companies are raising capital in the U.S markets. There is no reason for Lebanese companies not to do the same; and Lebanese financiers should not be discouraged of doing so simply because the requirements of listing a Lebanese company on an American Exchange are much more stringent than anywhere in the world. It is only by entering the US capital markets that Corporate Lebanon will achieve international prominence.

In summary, in a world that is fiercely competing to access capital, Lebanon needs to offer international investors a menu of products not available anywhere else in the Arab world. This will involve "structured finance" types of products. Take for an example Wall Street. Throughout the years, Wall Street has justified its existence to the world by reinventing itself and by always designing new products to access capital. Furthermore, any sophisticated institutional investor looking to invest in Lebanon will look for an exit strategy and some degree of liquidity before backing any Lebanese company. Thus, if the Beirut Stock Exchange plans to be the conduit for Arab and international capital flowing in the region, it would better get its act together (Abdelnour, 2-3).

B. Fiscal Policy Management

1. Government Expenditures

a. Elimination of corruption

Ribbon-cutting ceremonies marking the opening of investment projects—such as roads, irrigation canals, power plants, ports, airports, schools, and hospitals—are every politician's dream. These occasions present splendid photo opportunities, while the very act of cutting the ribbon seems to identify the politician as a contributor to the future growth of the economy. In some countries, however, corrupt politicians appear to choose investment projects not on the basis of their intrinsic economic worth, but on the opportunity for bribes and kickbacks these projects present.

Public investment projects tend to be large and, sometimes, very large. Since their execution is generally contracted out to domestic or foreign enterprises, the first step is choosing a firm to undertake the project. For a private enterprise, getting a contract to execute a project, especially a large one, can be very profitable. Therefore, managers of these enterprises may be willing to offer a "commission" to politicians who help them win the contract. Conversely, in many cases the act of bribery may not start with the enterprise but with the officials who control the decisions—in Lebanon it is apparently impossible to win a government contract without first paying a bribe. A commission of even a few percentage points on a project that costs millions or even hundreds of millions of dollars can be a large sum, one large enough to exceed the temptation price for many otherwise reputable individuals. When commissions are calculated as a percentage of project costs, the politicians or public officials who receive payment for helping the enterprise win the bid will have a vested interest in increasing the scope or the size of the project so they can get larger commissions. A strategically placed high-level official can manipulate the process to select a particular project. He can also tailor the specifications of the design to favor a given enterprise by, for example, providing inside information to that enterprise at the time of issuance of tender.

In all these alternatives that require the collaboration of a corrupt politician or official, the taxpayers will end up with either a more costly project—or a bigger or more complex project than necessary—or a project of inferior quality that will require costly upkeep and repair.

Why does it matter when this happens? It matters because the productivity of capital spending is reduced, which in turn lowers the growth rate of the country.

Widespread corruption in the investment budget will not only reduce the rate of return to new investment in a country, but will also affect the rate of return the country gets from its existing infrastructure. To the extent that corruption has been around for some time, the existing infrastructure has also been contaminated because past investments were also misdirected or distorted by corruption.

Moreover, higher spending on capital projects will reduce the resources available for other spending. Of the other spending categories, one not protected by entitlements or implicit commitments is operation and maintenance—the current public spending required to keep the existing physical infrastructure in good working order. Too often, new projects are undertaken while the existing infrastructure is left to deteriorate. In cases of extreme corruption, operation and maintenance on the physical infrastructure of a country are intentionally neglected so that some infrastructure will need to be rebuilt, thus allowing corrupt officials the opportunity to extract additional commissions from new investment projects.

In general, corruption can affect the economy in various ways:

1. High corruption is associated with high public investment.

   Corruption can reduce growth by increasing public investment while reducing its productivity.

2. High corruption is associated with low government revenue needed to finance productive spending. Corruption can reduce government revenue if it contributes to tax evasion, improper tax exemptions, or weak tax administration.
3. High corruption is associated with low operation and maintenance expenditures. Since corruption and bribery are more effectively related to (that is, it is easier to extract bribes from) new investments (as opposed to infrastructure already in place), corruption may result in lower operation and maintenance expenditure on existing investments. A deteriorating infrastructure increases the cost of doing business for both government and the private sector (congestion, power outages, accidents) and thus leads to lower output and growth.

4. Evidence also shows that higher corruption is associated with higher total expenditure on wages and salaries, which are a large component of government expenditures. It is considered unproductive expenditure because of the salaries and wages of inefficient and unnecessary employees who are hired and promoted because of their political connections and influence.

In sum, economists should be more restrained in their praise of high public sector investment spending, especially in countries where high-level corruption is a problem. The initiative represents, however ,an encouraging start in eliminating the corruption of political leaders. (Tanzi & Davoodi, 10)

If we take Lebanon for instance, evidence on high corruption surfaces every now and then. The mismanagement and corruption in several ministries and agencies, including the hiring of army advisors, was boldly exposed in a report published by the Court of Account. Another example is the case of the "Highway Scandal", where the Ministry of Public Works commissioned a private firm to conduct a study on highways at a cost of L.L. 13.8 billion. When the Court of Account brought the issues out before the public, the fees for the project were somehow reduced to L.L. 5.9 billion. A third example was the disappearance of L.L. 5.3 billion from the port of Beirut. Moreover, in a recent survey of 250 businesses conducted for the Lebanese Center for Policy Studies, 78% of the respondents ranked corruption as a major problem and 62% admitted to paying bribes when dealing with the government (Atallah, No. 1, 34-35). We can cite a lot of other examples but this is not important. What really matters is how to avoid such corruption from now on. Since as it was shown above corruption does not only increase capital expenditures pointlessly but also it increases current expenditures by increasing wages and salaries, it decreases revenue, and it decreases output and growth from deteriorating infrastructure.

The government has already put a plan to eliminate corruption. However, going ahead with the plan is much more difficult than designing the plan itself.

b. Budget Allocation

In formulating the capital budget, senior political figures must make the basic decisions. These decisions determine the size of the total public investment budget, the general composition of that budget (the broad allocation among different categories of capital spending), the choice of specific projects and their geographical location, and even the design of each project.

The result is that, ironically, some public investment can end up reducing a country's growth because, even though the share of public investment in gross domestic product might have risen, the average productivity of that investment might have dropped.

The conventional wisdom of the economics profession is that countries need capital to grow and, more important, that a direct relation exists between capital spending and growth. In other word, if a country engages in capital spending, growth is likely to follow. As a consequence of this belief, the economics profession has been strongly biased in favor of capital spending by governments.

The "golden rule" often advocated by economists states simply that only current expenditure needs to be balanced by ordinary revenue, but that a country can—within limits—safely run a fiscal deficit equal to the capital spending of the government. You should cover the current budget with government revenues, but borrow whatever you can for the capital budget. (Tanzi & Davoodi, 1-3)

However, if we take the case of Lebanon, we notice that the average share of capital expenditures from total expenditures between 1990 and 1998 is only 13.34% [Fig. 6]. Since the government's essential goal in its recovery plan was investment-led growth and its primary objective was to achieve reconstruction and rehabilitation projects that would accordingly promote economic growth, then this ratio is not acceptable especially that this ratio was decreasing from year 1995 to reach only 7.56% in 1998 [Table 8].

The breakdown of the Public Budget for 1998 disclosed in Table 9, reveals that debt servicing accounts for 44% of total public Expenditures, the Council of Ministries accounts for 6% of government spending, while the share of the Ministry of Defense is around 10%. All of the above are unproductive expenses that are draining more than 60% of the budget.

Moreover, we notice in the same table 11 that there is an increase in government ministries that have similar responsibilities. For example, the Ministry of Education, the Ministry of Vocational and Technical Training and the Ministry of Culture and Higher Education all provide similar and related services. Not only in the ministries, but also an increase in development agencies where the responsibility for projects overlap. This is particularly the case with the Council for Development and Reconstruction, the Council for Executing Construction Projects and the Council for Executing Grand Projects in Beirut (Atallah, No.1, 34).

Ultimately, it is not the level of spending as much as its nature and its efficiency that should be put into question. In other words, it is too narrow a view to focus on the level of expenditures rather on their content. The public debt should not only serve for financing general and administrative government expenditures. Rather, it should be devoted to productive investments that would increase national productivity, create

able 11: Distribution of Expenditure among Ministries		
Titles (L.L. million)	1998 Budget Proposal	% of Total Budget
inistry of National Defense	749,971	10%
residency of Council of Ministries	472,676	6%
inistry of Education & Fine Arts	455,600	6%
inistry of the Interior	338,525	5%
inistry of Public Works	124,742	2%
inistry of Hydraulic & Electric Resources	88,515	1%
inistry of Public Health	261,280	4%
inistry of Housing & Cooperatives	53,556	1%
inistry of Foreign Affairs	86,225	1%
inistry of Culture & Higher Education	195,358	3%
inistry of Vocational & Technical Training	26,950	0%
ther Titles	438,354	6%
udget Reserves	828,248	11%
ebt Servicing	3,200,000	44%
otal	7,320,000	100%

ource: Ministry of Finance, 1998

more employment opportunities, and result in a rise of individual income. This situation will consequently enhance the fiscal capacity of the government that will be able subsequently to collect more taxes and increase its revenues.

c. Deficit Ceilings

The efficient way to limit or reduce the national debt is to eliminate the budget deficit that creates debt. For that purpose, it would be useful to establish deficit ceilings that are explicit limitations on the size of the annual budget deficit. Although they may not be rigidly respected, such deficit limitation measures do have some impact. They force ministers to ask how new programs are to be financed. Should other programs be cut back? Should other alternatives of government spending be adopted? Or, should taxes be raised? Because deficit ceilings push these financing questions into the spotlight, they tend to restrain public expenditures, or at least, increase the caution on critical budget decisions.

In fact, the Five Year Plan is an efficient tool for deficit ceilings, since it puts limitations on government spending for not only one year but also five years. The Ministry of Finance is expected to unveil a five year plan of CDR expenditure, at the end of 1999. The plan is under discussion, but it is expected to involve expenditure of around $7.6 bn over the period, 55% of which will be spent on infrastructure with the remaining 45% for regional investment. The plan, which will aim to help stimulate growth and tackle weaknesses in social infrastructure, is expected to include commitment to continue all contracts currently underway that were granted by the previous government (Emerging Lebanon 2000, 28).

2. Government Revenues

Obviously, deficit reduction cannot rely solely on expenditure containment, for revenue enhancement must play a critical role in this regard. Here it is important to recall that due to the severe reduction in revenues during the years of turmoil when the Government tools were completely incapacitated, Lebanon is now faced with the challenging task of rebuilding the State's collection efforts and agencies. The Government must be well aware of the urgent need to increase its revenues to first redress the fiscal position, and second to ensure that the reconstruction and development effort continues untouched. Beginning with the premise that taxes play a double role, revenue generation on the one hand, consumption and investment discouragement on the other; the Government is left with the difficult task of maximizing the first role while minimizing the second. The Government's guiding tax policy principle has been to lower the tax rates in order to reduce the burden on lower income groups and provide investment incentives on the one hand, and to step-up the collection effort on the other. However to achieve the desired revenue levels, the government must not only optimize tax collection, but also raise the level of taxes and introduce new taxes with the objective of increasing revenue and distributing income fairly.

a. Optimize tax collection:

In its efforts to modernize and computerize the collection process and to recuperate from the damages caused by the civil conflict, the Ministry of Finance had to prioritize project implementation from the most to the least urgent. The end result of these efforts will be the enhancement of public revenues and the smooth and efficient collection operation from the points of view of the taxpayer and collector.

The whole revenue collection process has been examined and reforms will eventually touch the entire range of operations. Although tax collections have increased substantially over the last few years, a large gap still exists between what is currently being collected and what could be [Fig. 7]. To bridge this gap the Government, with the assistance of the Canadian Government, has launched a tax administrative reform program. Work has already commenced on creating a comprehensive database that will include all relevant information on all income earners. To insure better compliance with income declarations, an amendment of the law has been proposed to increase the fines on non-reporting tax payers. In this regard, the Revenue Department has 300 tax auditors, which is approximately one auditor per 13,000 residents; whereas, the ratio, in European countries, is one tax auditor per 300 to 500 residents. Clearly, this has been a handicap in collecting public revenues and the reform program will address this deficiency. The reform program will, also, computerize all tax revenue procedures, train all the Revenue Department employees with a special emphasis on providing tax auditors with the latest auditing skills. Also, the Revenue Department database will be linked to the Customs and Land Registration databases. It is expected that once the tax reform program is implemented and the training cycle completed, potential public revenue will become far more collectable (Ministry of Finance, 1997).

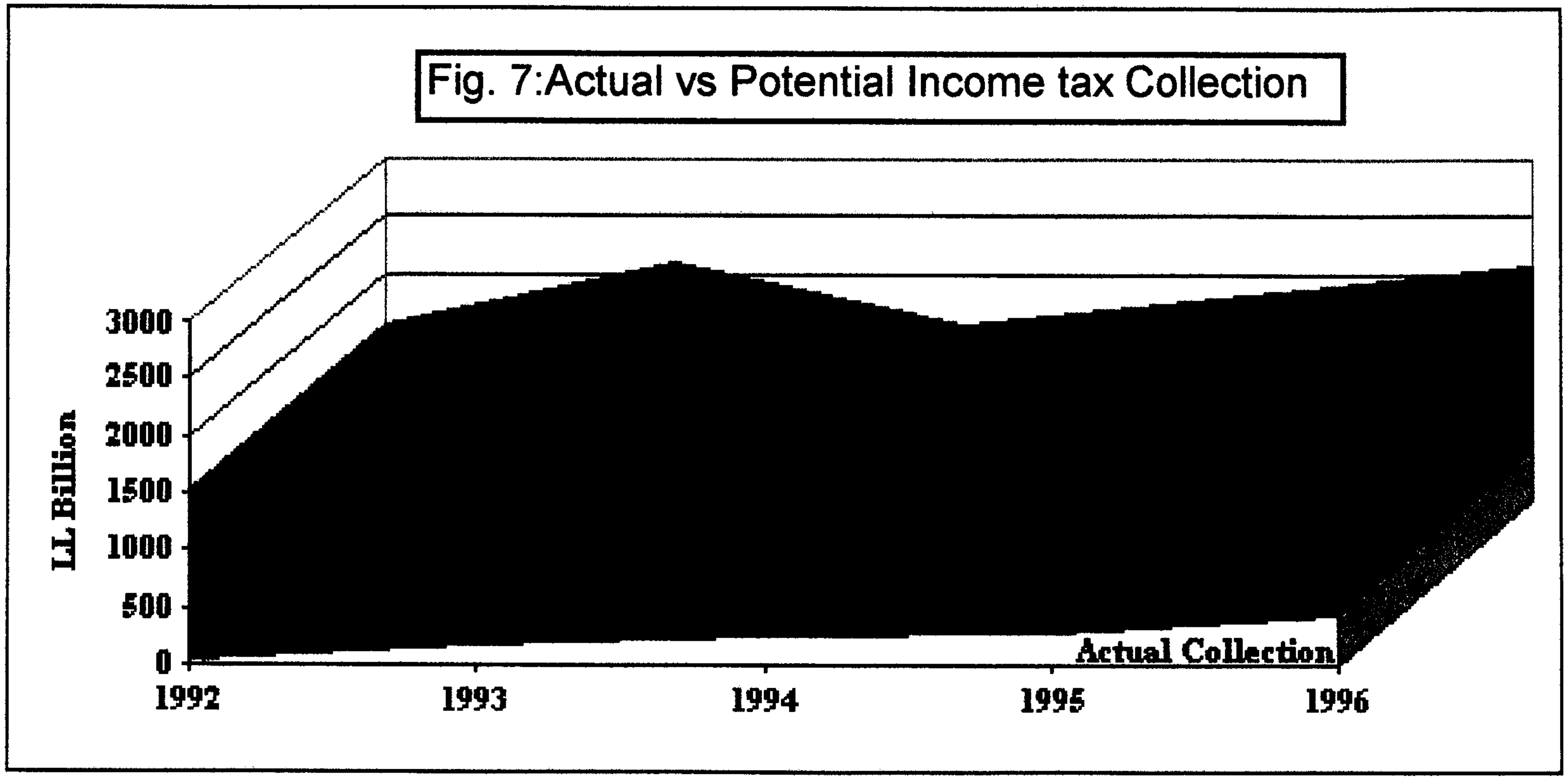


Fig. 7:Actual vs Potential Income tax Collection
LL Billion
3000
2500
2000
1500
1000
500
0
1992
1993
1994
1995
1996
Actual Collection

<u>d. Introduce new taxes</u>

The government is highly dependent on customs and tariffs for its income, which constitute 47% of government revenue. Nevertheless, if the government is still enthusiastic about its participation in the European Union (EU)-sponsored Mediterranean free trade area (EuroMed Agreement) and has aspirations to join the World Trade Organization (WTO), than it must find a way to decrease its reliance on custom revenues. To do so, the government must shift to a new form of tax mainly the Value Added Tax (VAT) and why not the Green Tax:

- **VAT:** VAT is a tax on spending. The tax is borne by the final consumer of goods and services because it is included in the price paid. All legal entities, including foreign legal entities that receive revenue from commercial activities, are liable for a value-added tax (VAT). Companies can apply for refund of VAT payments on all business start-up costs and on goods that are exported.

  The Minister of Finance, Georges Corm, declared in his Five Year Plan that a new value-added tax (VAT) is expected to be implemented in Lebanon by the year 2001. Since the banking secrecy laws have traditionally made it difficult to collect taxes from the self employed, the introduction of VAT and the declarations it requires are expected to make accurate estimations of profit and wages easier. Mr. Corm said the European Union is donating $5.3 million to finance the project and the International Monetary Fund (IMF) will help the ministry introduce the tax by advising on setting up the collection process. The minister expected the VAT plan to be completed within the next three months and that the EU would approve it before the end of the year. He also expected that VAT will generate more revenues than customs fees and predicted that income from the new tax would represent 3% if GDP over a five-year period. Mr. Corm added that VAT will not exceed 10% and that its introduction will not eliminate the need for custom fees (Lebanon Invest, May 22, 1-2).

- **Green tax: Lebanon** is faced with shrinking budget deficit funding and increasing environmental problems. Traditional environmental regulations are not going to cut it. Green taxes are one option; they tax societal 'bads' and not the 'goods.' Green taxes tax the things we want to discourage. They are not neutral, they provide a way to restructure the tax system so the tax burden falls on exactly the things we want to stop. They are a way to achieve emissions reductions and encouraging environmental improvements in the most cost-effective manner. The tax has to produce an incentive to change the polluting habits or behavior (Joe Loper, 1).

c. Raise the level of taxes

The income tax has been neutralized by the previous government, preventing its ability to offset the regressivity of the tax system. It is made up of tax on salaries and wages. In comparison to other countries, income tax contributes a small percentage to total taxes.

For the last few years, the Government has systematically followed a tax rate reduction policy. A reform law, introduced in 1993 (effective 1994), stipulated a lowering of both the tax rates and the number of tax brackets on personal as well as corporate income. The number of personal income tax brackets were reduced from 13 to 5 with marginal tax rates ranging from 2 to 10 percent - previously they ranged from 2 to 32 percent. While corporate income tax has become a flat tax of 10 percent with a 5 percent tax on dividends. Previously, corporate tax rates ranged from 6 to 50 percent.

According to the government, the benefits of the income tax reform law are three-fold:

a) Significant reductions in income tax rates are aimed at easing the burden of tax payments especially on low-income earners.
b) Reducing corporate income tax provides incentive for businesses to increase their level of investment thereby creating job opportunities and stimulating GDP growth.
c) Revenue collection will increase as lower taxes provide a lesser incentive for evasion. In fact, with better administrative procedures, income tax revenues increased following the implementation of the new law.

However, what happened really is that the new tax system has failed to distribute income among the population. A look at the structure of the tax on salaries and wages in 1994 in relation to 1991-1993 or 1974 shows that the new structure is flat versus the progressive rates of 1991-1993 and even 1974. Although the new tax reforms reduced taxes on all income brackets, the greatest beneficiaries are those with the highest income. Second, an increase in taxes will not necessarily scare foreign investment since the latter is dependent on several other factors such as political stability, social equality, and institutional barriers. Third, with lower taxes the revenue will be less despite the lower tax evasion.

Therefore, since the income tax contributes a small percentage to total taxes in comparison to other countries and there are no reason to keep it low, there is an ample margin to increase taxes on salaries, capital and profits from 10% to 20% or even 25%. The government should also consider increasing the tax base by focusing on large and medium companies, the self-employed and professionals. (Atallah, No. 2 &3)

C. Monetary Policy Management

Since 1993, the economic liberalization process has been achieved and maintained through a careful balance between economic adjustment and political stability. Tight monetary policy has assured a stable exchange rate and reduced inflationary pressure to acceptable levels, but ended up raising the debt-service burden and crowding out private-sector investments. A sound macroeconomic policy-mix will make a major contribution to enhancing the environment for higher investment, growth and employment creation, as will the ongoing structural reforms.

The authorities need to accelerate the process of opening significant portions of the reconstruction program to the private sector, to consolidate the recent progress made in deepening and widening financial markets by continuing the gradual downward adjustment in domestic interest rates, and to move ahead expeditiously with the administrative reform project. In fact, interest rates declined significantly during 1993 and 1994 in response to increased domestic and external demand for Lebanese Pounds assets. However, the first three quarters of 1995 witnessed an increase in interest rates, due mainly to the policy objective of maintaining stability in the foreign exchange market in the face of political uncertainties with the approach of the end of the President's term in office. In the last quarter of 1995, interest rates accelerated downwards as the political tensions eased with the extension of the presidential term and they kept on decreasing till nowadays as shown in Fig. 8. Certainly, the issue of interest rates must be a great concern to the government, since the debt service has accounted to 44% of the 1998's budget.

The decrease in rates should be pursued along three objectives: firstly, lower the remuneration of short term savings, encourage the

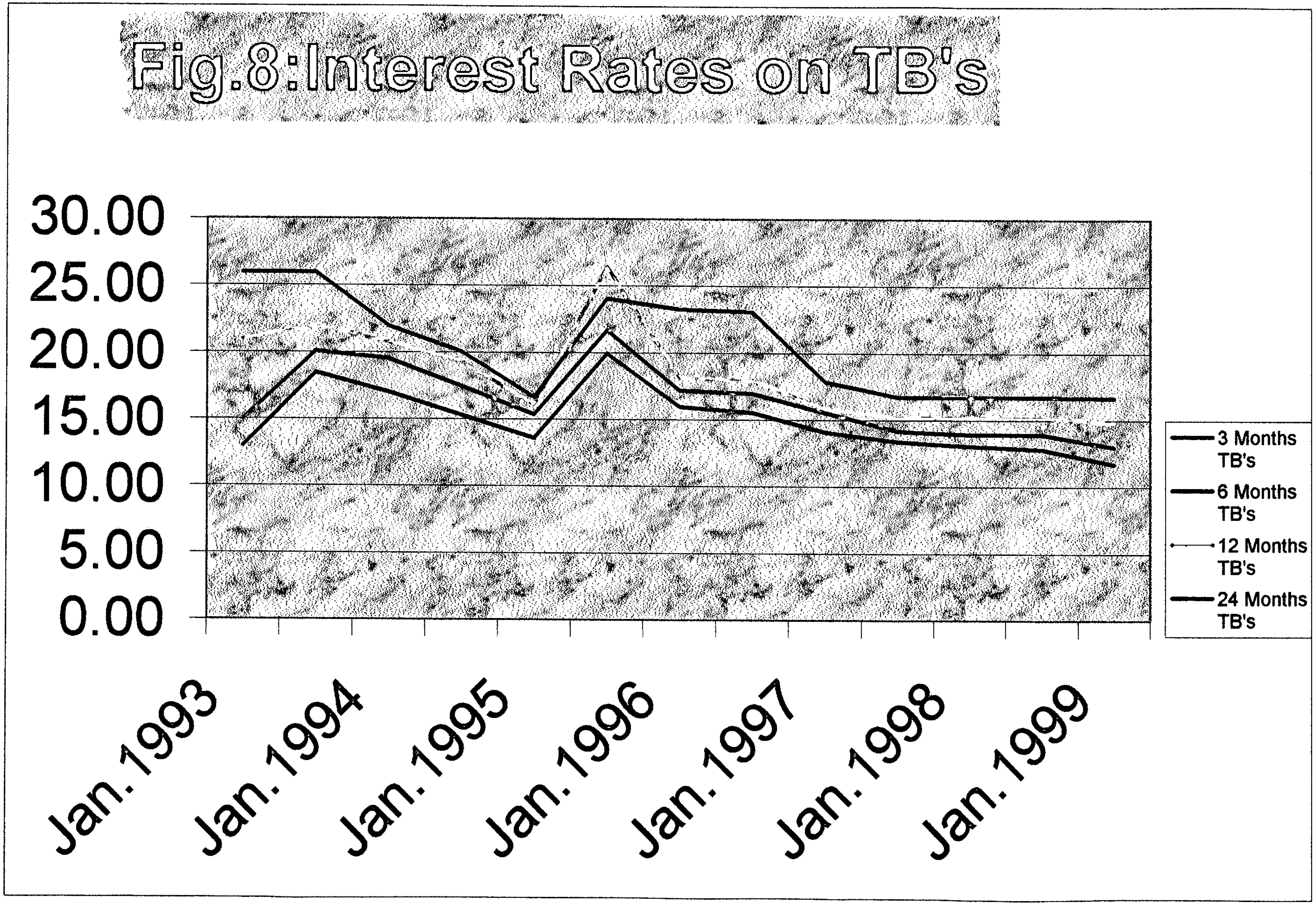


Fig.8:Interest Rates on TB's
30.00
25.00
20.00
15.00
10.00
5.00
0.00
Jan.1993
Jan.1994
Jan.1995
Jan.1996
Jan.1997
Jan.1998
Jan.1999
3 Months TB's
6 Months TB's
12 Months TB's
24 Months TB's

acquisition of longer term securities, and accentuate the steepness of the yield curve for better allocation of savings. This would allow the financing of the budgetary deficit, the decrease of rates, the reconstitution of bank spreads and the financing of the recovery. In fact, a safe and a lasting decrease of the real short-term rates could not occur unless the overall consistency is secured. In this perspective, the monetary policy should be undertaken and evaluated while considering the medium term. It is the best way to enhance the decrease in our rates without neither threatening the Lebanese pounds, nor putting into question the achieved equilibrium. But finally, the monetary policy cannot substitute the essential structural reforms on the market of goods and services, management of public finance and the fiscal system (Quarterly Economic Report, 4th Quarter 1995, 5).

In the past Lebanon used to have a floating exchange rate, which was much better for the economy. The previous government chose not only to have a fixed rate, but in fact to increase its value. According to Mr. Corm, this government has stopped the increase. Since it has tackled the deficit, people are much more relaxed now. They buy Lebanese currency much more easily now, leaving the dollar and going back to the lira. The interest is going down, so the fixed rate is costing the government much less than it was before when it was obliged always to raise the interest rate (Q&A, 9).

VI. CONCLUSION

The economic crisis we're going through results from the fact that the economic and social welfare is quite below the desired level. This situation follows two war decades which have generated important public and current account deficits with an important debt accumulation causing accelerated inflation and strong currency depreciation. Such conditions dampened growth and durably affected the Lebanese per capita income. It is obvious that since 1992 major adjustment efforts have been made but they remain insufficient. Indispensable measures in fiscal, financial, and social policies were permanently delayed as they required political consensus among officials which was, unfortunately, impossible to materialize due to different considerations.

Today's environment is more favorable to the new government, which must take daring and historical decisions.

Interest rate cuts could be advanced as a possible solution to manage the problem of public debt as they induce lower debt service payments. Yet, the unique reliance on interest rates as a policy tools would cause other damages to the economy, since interest rates would have to be cut tremendously, thus creating financial instability. Drastic cuts in the interest rates could destabilize the value of the currency, prevent foreign investment in Lebanon, restrict capital inflows and deteriorate the balance of payments position.

An alternative policy proposal would be to enhance growth prospects. Higher economic growth improves government revenues and the state of the budget revenues and the state of the budget deficit, which implies less dependence on debt financing. The Five-Year Plan targeted a 5% real growth rate in year 2003. I think it is somehow optimistic going from 2%

in 1999. However, if we rely not only on the public sector but also on the private sector in the reconstruction activity, the efficiency and the productivity of the projects will be enhanced. Hence, the role of the private sector should be strengthened and expanded in order to intensify growth prospects.

This will lead us to the privatization of public entities. It is another proposition for easing the burden since it would not only increase government revenues, but also lessen government expenditures which are a main reason for ballooning of public debt. However, in order for the implementation of privatization programs to be successful, certain assumptions have to be considered. The corruption and waste at public institutions would have to be reduced; otherwise the private sector could be as inefficient and wasteful as the public sector. The existence of well functioning and developed capital markets is a necessity in order to allow the adequate trading of shares issued in the aftermath of privatization. The social burden should be carefully looked at since privatized entities will charge higher prices for the provision of goods and services which low-income groups may not be able to afford. Unless the Lebanese government implements these basic conditions, privatization may prove inefficient and lead only to higher costs for the Lebanese citizen without a better return.

The existence of well functioning capital markets is not only a necessity for privatization, but also for accessing capital. Lebanon needs to offer international investors a menu of products not available anywhere else in the Arab world. Moreover, any sophisticated institutional investor looking to invest in Lebanon will look for an exit strategy and some degree of liquidity before backing any Lebanese company.

Fiscal policies are of the main tools that would lead to lower levels of indebtedness, which include the enhancement of tax revenues. A new fiscal measure would be the implementation of a VAT. The VAT could be introduced as a possible substitute of customs duties especially in a country characterized by high imports. However, the VAT requires a high administrative capacity, and a strong commitment on the part of the government. Unlike the income tax, the VAT is not adapted to the individual's financial capacities so its application could be a source of social inequity. A multiple rate structure could bring about a certain degree of fairness in the system, yet it would be a more complex structure and would necessitate a higher administrative cost. In all cases, the VAT must take into consideration the financial capabilities of the overburdened Lebanese citizen.

Green taxes are another kind of new taxes which benefits are not only economical, but also ecological. They provide a way to restructure the tax system so the tax burden falls on exactly the things we want to stop. They encourage environmental improvements in the most cost-effective manner and have to produce an incentive to change the polluting habits or behavior.

Another tax alternative should not be omitted which is the widening of the income tax brackets that would be a more desirable fiscal step whereby the excessively rich class would be taxed more than less wealthy classes introducing more equity in the social system. All the above mentioned taxes cannot be effective without the optimization of the tax collection.

Pertaining to expenditures, first of all, government should eliminate corruption; since it does not only increase capital expenditures pointlessly but also it increases current expenditures, it decreases revenue, and it decreases output and growth.

Government should also focus on the efficiency and productivity of its expenditures particularly by allocating the budget in an effective way. The adequate supervision and effective control over the channeling and employing of spending would save considerable amounts of previously wasted funds, and promote better public sector conditions, and lower levels of debt especially if we have established spending ceilings.

The government, in its Five-year plan, had focused especially on the privatization and the VAT ways to solve the problem of debt. It had tried to eliminate corruption but this will take a lot of time and patience. Moreover, it had automatically put deficit ceilings till the 2003 budget. However, this is not enough at all; since after we will sacrify in the privatization and the risk of unfairness in the implementation of the VAT, we will still reach a debt of 96.3% of GDP. The question is: Is it worth it?

I think the government should not rely only on what is planned; but try to study each solution mentioned above thoroughly in order to reach a better position in the year 2003.

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