

***LEBANESE FISCAL POLICY
AND EVOLUTION OF ITS BUDGET DEFICIT
THROUGH 1993-1999***

***By
RAMZI AZZI***

***A research project submitted in partial fulfillment
of the requirements for the degree***

of

***Master of Business Administration
(M.B.A.)***

In the Faculty of Business Administration & Economics

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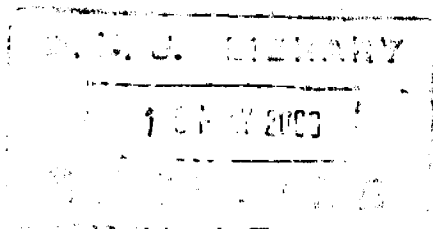


TABLE OF CONTENTS

Introduction

Chapter I: Fiscal Functions: An Overview

- Modes of analysis
- Need for Public sector
- Major Functions
- Coordination of Budget Functions

Chapter II: A Brief History of Lebanese Economy (1993-1998)

Chapter III: Lebanese Recent Economic Developments (1993-1998)

- 1- Movements in Gross Domestic Products
- 2- Fiscal Developments
- 3- Outstanding Debt
- 4- Balance of Payments
- 5- Inflation and Price levels
- 6- Exchange Rate and International Reserves
- 7- Monetary Developments

Chapter IV: Economics of the Public Debt

- 1- Growth of the debt
- 2- Structure of the Debt

Chapter V: Lebanon in comparison to other Economies

- 1- Comparative Revenue Structure
- 2- Comparative Expenditure Structure
- 3- Comparative Deficit and Debt Structure
- 4- Lebanon compared to other post-war Economies
- 5- The post-war II Recovery Program

Chapter VI: Economic Implications of the Debt

- 1- Interest cost and fiscal solvency
- 2- Impact of the debt on future generations

Chapter VII: Analysis of the 1999 Budget proposals

- 1- Revenues
- 2- Expenditures
- 3- Overall Position

Chapter VIII: A Framework for a deficit reduction effort

- Revenue measures
- Expenditure planning and control
- Debt Management
- Technical Remarks

Conclusion

List of Tables

Table 3-1. Growth rate of real GDP

Table 3-1a. Nominal GDP growth (LL)

Table 3-1b. Nominal GDP growth (USD)

Table 3-2. Public Finance-Budget 1993-□ □ 1999

Table 3-3. Summary of Public Finance –Actual

Table 3-4. Outstanding Debt, 1993-1998

Table 3-5. Summary of Balance of Payments 93-98

Table 3-6. Inflation rates, 93-98

Table 3-7. Gross foreign exchange reserves

Table 4-1. Distribution of Treasury Bills by Subscriber

Table 4-2. Public Debt

Table 4-3. Government Revenues and Expenditures

Table 4-4. Summary of Government Finances (1993-1999)

Table 7-1. Total Revenues (Budget 98, Budget 99 & Projected 99)

Table 7-2. 1999 Progressive Tax scales of wages and salaries

Table 7-3. 1999 Progressive Tax scales of commercial & professional profits

Table 7-4. Progressive scales of revenues > LL.20millions

Table 7-5. Scales of tax inheritance

Table 7-6. Total Expenditures (budget 98 & 99)

Table 7-7. Current expenditures

Table 7-8. Expenditures distributed by ministries

Table 8-1. Summary of projected government Finances 1993-2003

Table 8-2. Summary of balance of payments 93-98.

List of CHARTS

Chart 5-1. Total Revenues in % of GDP

Chart 5-2. Non-Tax Revenues in % of total Revenues

Chart 5-3. Tax Revenues in % of total Revenues

Chart 5-4. Total Expenditures in % of GDP

Chart 5-5. Wages and Salaries in % of total Expenditures

Chart 5-6. Interest Expenditures in % of total Expenditures

Chart 5-7. Total deficit in % of GDP

Chart 5-8. Total Net Debt in % of GDP

Chart 7-1. Projected Tax Revenues for 1999

Chart 7-2. 1999 Current Expenditures Distribution

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- **Scope:** It is beyond the scope of this project to consider the political and social dimensions of reducing the deficit. Rather the report will concentrate more on the fiscal issues and, where relevant, will consider briefly the interaction between budgetary issues and other macro-economic variables. The project in itself is conducted on a data collection basis gathered from different resources public and private, books and editions some in Arabic, some in English, and some in French. The time period taken to gather needed data was extended until Corm's projected budgetary policy issuance. This in addition to the lack of information. In fact, the standards of data availability and reliability in Lebanon do not measure up to any respectable level of transparency and accountability in a democratic state. So analyzing the budget deficit in Lebanon faces some major constraints – the lack of reliable data.

- **Aims and objectives:** The objective of this project is to illustrate the evolution of the budget deficit over the last 7 years. It is not offered as a blueprint for Lebanon's fiscal troubles. It is aimed to highlight the issues, mechanisms and kinds of measures employed or needed to be employed in constructing a viable deficit reduction effort in Lebanon.

- **Review of the Literature:** This paper will comprise Five parts:
 - PART I: is aimed to give a theoretical overview about Public Finance and the three major Functions concerning the Public Sector and which are:

- Allocation Function: The process by which total resource use is divided between private and social goods and by which the mix of social goods is chosen.
- Distribution Function: The adjustment of the distribution of income and wealth to ensure conformance with what society considers a fair or just state of distribution.
- Stabilization Function: the use of budget as a mean of maintaining high employment, a reasonable degree of price level stability, and an appropriate rate of economic growth, with allowances for effects on trade and on balance of payments.

PART II: will cover the Lebanese economic history in brief; Its integration into the world, requirements and constraints, government priorities and the road ahead. This part will also shed light on the recent past, present and near future of the macroeconomic position in the country. The analysis encompasses an overview of the actual economic and financial performance from 1993 to recent 1999 followed by synopses of the 1998 budget and the 1999 breakdown. This analysis is divided into seven parts:

- Movements in GDP
- Fiscal developments
- Outstanding Debt
- Balance of payments
- Inflation rates and Price levels
- Exchange rate and international Reserves
- Monetary developments

PART III: talks about the Lebanese Economics of the Public Debt, Public Expenditures and Revenues. It explains the different features of the debt growth, the Debt Structure, and its impact on fiscal solvency and future generations. This Part sheds then light on how Expenditures grow, what are the types of these expenditures and the reasons that cause them to grow. All these along with the Budget Structure Analysis that comprises:

- The Revenues: contents and measures. Its balance with GDP growth, the taxation impact and other fees collection.
- Expenditures: planning, control and main budget outlays such as Debt service and wages.
- Debt management: measures and tools used to finance public sectors and the negative impact that have been occurred.
- Impact of external sector; namely impact on Lebanese balance of payments.
- Revenue enhancement: because deficit reduction cannot rely solely on expenditure containment, for revenue enhancement must play a critical role in this regard. The whole revenue collection process has been examined and reforms will eventually touch the entire range of operations. Three revenue areas, however, that together constitute the largest revenue source, deserve special mention: Income Tax, Land Registration and Customs.

PART IV: will conduct a comparison of our budgetary position to that's of other economies, especially those of surrounding Arab countries and of post-war; And this in order to be able to assess our deficit more explicitly.

PART V: will try through a personalized framework to reduce budget deficit to shed light on some measures that might help on curbing the deficit. Then, an overall evaluation will be initiated along with a comment on Corm's projected budget.

- **Methodology**: The main methodology approach used is a quantitative one. It is mainly based on Data collection. The research will be backed up with different references, local and international, in Arabic, English, and French and in Theory and practice. (See attached paper of References).

INTRODUCTION

It is now recognized in Lebanon that continuing to incur very large fiscal deficits is unsustainable. The growth in the public sector deficit was among the main developments in public finance since 1993 which is considered to be the first normal year of the post-war period. And this provoked a one-time jump in revenue collection. On the expenditure side, however, the situation did not allow for planned levels of spending. And this combination resulted in a substantial contraction of the fiscal deficit to currently more than 13% of GDP. In fact and with an enhanced expenditure capacity, government expenditures increased, for instance, between 93 and 95 by 94%. The biggest jump occurred in 1994 when expenditures increased by 72%.

What happened is that since the end of the war in 1990, a post-war recovery program was initiated. The Lebanese government launched its reconstruction plan that consisted of a US\$.17 Billion rehabilitation for basic economic, physical, and social infrastructures. But the increasing high

Source: Economic Analysis Unit, AUDI Bank.

governmental investments that lead to a surplus in the State's expenditures over its receipts created a relatively high public debt. In order to service this debt and pay back the interest at maturity, the Lebanese government was therefore obliged to launch a tax campaign that while considered by the majority as random imposed in fact a burden on the economy. This of course with a shift of resources from private to public sector and low per capita income lead the country again to the post-war recession.

Eventually, the cost of servicing this borrowing became too steep. It is estimated that paying the interest debt consumed almost all the revenues collected. The reverse fact is also true, namely that the primary balance in the budget is in much better shape when interest payments are excluded. A crucial element in the necessary fiscal adjustment is tackling the heavy burden of repaying debt. Measures to reduce the deficit, however, are not simply technical steps designed to achieve certain numerical objectives, but also reflect a political will to carry them out. There is also the social dimension to the extent that reducing the deficit requires additional taxation and careful thought concerning areas of expenditures.

While this is inevitable in any budgetary formula, the selection process becomes more crucial when the deficit needs to be reduced drastically. The government needs to be seen as fair in apportioning the burdens and sacrifices. While Public Finance is known to be the regulator of the economic activity and

thus closely linked to general risk in any country, therefore, it's directly affecting the functioning of the economy.

It is beyond the scope of this research project to consider the political and social dimensions of reducing the deficit. Rather the report will concentrate largely on the fiscal issues and, where relevant, will consider the interaction between budgetary issues and other macro-economic variables.

This project is not a blue print for a deficit reduction policy. Rather it is to highlight the issues and outline the instruments involved. Especially, those carried out by the former government and those of the new one, namely the five-year of plan of minister Corm that aims to bring debt down from 123% of GDP to 98% in 2003 and cut the budget deficit to below 5% of GDP from its current 13%.

The answers to the issues that will be raised are in the final analysis judgmental; Lebanese society, as a whole, is required to arrive at a reasonable consensus on certain fundamental questions as a basis for creating an effective fiscal adjustment policy. These questions might be: What level of expenditures can the country afford? What pattern and level of taxation is fair and appropriate in Lebanon? What size of public sector is proper for Lebanon? What are the trade-offs between holding assets and incurring debt?

Chapter I

FISCAL FUNCTIONS:

An Overview

Over 35% of GDP was purchased by the Lebanese government in 1994 (while it is about 20% in the United States); total government expenditures including interest payments equal 50% thereof and tax revenue absorbs about only 15% of GDP. Although in some developed countries in Western Europe, governmental share of economic activity is frequently over 50% but this discrepancy in the Lebanese budget structure is shocking.

We will not deal with the entire range of economic policy but limit ourselves to that part which operates through the revenue and expenditure measures of the public budget. Other aspects, such as the operation of the public enterprise, and the conduct of monetary policy, are only minor budget items, but of great importance as instruments of economic policy. Yet, we will deal with

Source: Ministry of Finance

them only where they are associated with the economics of budget policy. The term ‘public sector’ as used here thus refers to the budgetary sector of public policy only.

Modes of Analysis

In an analysis of the public sector, various types of questions may be asked. They include the following:

1. What criteria should be applied when one is judging the merit of various budget policies?
2. What are the responses of the private sector to various fiscal measures, such as tax and expenditure changes?
3. What are the social, political, and historical forces which have shaped the present fiscal institutions and which have determined the formulation of contemporary fiscal policies?

Question 1 requires a type of economic analysis that deals with how things should be done and asks how the quality of fiscal institutions and policies can be evaluated and how their performance can be improved. The answer requires setting standards of “good” performance. Corresponding to the analysis of efficient behavior of households and firms in the private sector, defining such standards calls for a type of economics, which is referred to as “welfare economics” in professional jargon. Its application to the public sector is more difficult, however, because the objectives of fiscal policy are not given but must be determined through the political process. Moreover, objectives of efficiency in

resource use must be supplemented by considerations of equity and distributional justice.

Question 2 must be asked if the outcome of alternative policies is to be traced. If the merit of a corporation profits tax or of a sales tax is to be judged, one must know who will bear the final burden, the answer to which in turn depends on how the private sector responds to the imposition of such taxes. Or if aggregate demand is to be increased, one must know what the effects of the reduction in taxes or increase in public expenditure will be; effects that once more depend upon the magnitude and speed of responses by consumers and firms in the private sector. Analyzing the effects of fiscal measures thus involves what has been referred to as the type of economic analysis, which deals with predicting, on basis of empirical analysis, how firms and consumers will respond to economic changes and with testing such predictions empirically.

Question 3 likewise involves an approach that asks in this case why the fiscal behavior of government is what it is. This is not only a matter of economics but also includes a wide range of historical, political, and social factors. How do interest groups try to affect the fiscal process, and how do legislators respond to interest group pressure? How are the fiscal preferences of voters determined by their income and their social and demographic characteristics, and how does the political process, in fact, serve their preferences?

Need for Public Sector

Why is it that a public sector is required? If one starts with the premises generally accepted in our society that (1) the composition of output should be in line with the preferences of individual consumers and that (2) there is a preference for decentralized decision making, why may not the entire economy be left to the private sector? Or, putting it differently, why is it that in a supposedly private enterprise economy, a substantial part of the economy is subject to some form of government direction rather than left to the “invisible hand’ of market forces?

In part, the prevalence of government may reflect the presence of political and social ideologies, which in depart from the premises of consumer choice and decentralized decision making. But this is only a minor part of the story. More important, there is the fact that the market mechanism alone cannot perform all economic functions. Public policy is needed to guide, correct, and supplement it in certain respects. It is important to realize this fact, since it implies that the proper size of the public sector is, to a significant degree, a technical rather than an ideological issue.

Major Functions

Although particular tax or expenditure measures affect the economy in many ways and may be designed to serve a variety of purposes, several more or less distinct policy objectives may be set forth. They include:

1. The provision for social goods, or the process by which total resource use is divided between private and social goods and by which the mix of social goods is chosen. This provision may be termed the *allocation function* of budget policy. Regulatory

policies, which may also be considered a part of the allocation function, are not included here because they are not primarily a problem of budget policy.

2. Adjustment of the distribution of income and wealth to ensure conformance with what society considers a “fair” or “just” state of distribution, here referred to as the *distribution function*.
3. The use of budget policy as a mean of maintaining high level of employment, a reasonable degree of price stability, and an appropriate rate of economic growth, with allowances for effects on trade and on the balance of payments. We refer to as these objectives as the *stabilization function*.

While these policy objectives differ, any one tax or expenditure measure is likely to affect more than one objective. As will be noted presently, the problem, therefore, is how to design budget policy so that the pursuit of one goal does not void that of another.

In discussing the provision of social goods (*The allocation function*), reference is made to goods and services, which must be paid for through budgetary finance. Whether the production of these is by a public agency or whether the goods and services are purchased from a private firm is a different matter. Provision for social goods poses problems, which differ from those which arise in connection with private goods. Since social goods are non rival in consumption, consumer preferences are not revealed by consumer bidding in the market. Therefore, a political process and budgetary finance are required.

The pattern of distribution, which results from the existing pattern of factor endowments and their sale in the market, is not necessarily one which

Source: Musgrave R.A. & Musgrave P.B. Public Finance and Fiscal Policy (see references)

society considers as fair. Distributional adjustments may be called for, and tax and transfer policies offer an effective means of implementing them, thus calling for a *distribution function* in budget policy.

Tax and expenditure policies affect aggregate demand and the level of economic activity. Their conduct has important bearing on maintaining economic stability including high employment and control of inflation. Hence, the *Stabilization function* enters as the third budgetary concern.

Coordination of Budget Functions

A major problem is how to conduct fiscal policy so that its major objects – including allocation, distribution and stabilization – can be met at the same time.

As noted before, budget policy involves a number of distinct objectives, but these overlap in practice, thereby complicating an efficient policy design, i.e., a design, which does justice to its diverse goals.

Suppose first that the public wishes an increased supply of public services. Increased taxes are needed to pay for these, which leads in turn, to the question of how they should be distributed. Depending on what taxes are used, taxation may well change the distribution of income that remains available for private use. Hence, some voters may favor (reject) the proposal change in public services because they like (dislike) the associated change in distribution rather than because they like (or dislike) the public service. Ideally, the two issues would be separated; society would provide for what is considered a fair state of distribution and then adjust the financing of public services in line with the

benefits which taxpayers derive therefrom. Because this two-step procedure is difficult to accomplish, decisions on the provision of public services tend to be mixed with and distorted by distributional considerations. Similar reasoning also applies in the reverse direction, when the supply of public services and hence taxes are to be reduced.

Next suppose that society wishes to shift distribution in the direction of greater (lesser) equality. Such a shift may be accomplished by using progressive (regressive) taxes to finance transfers to lower (higher) incomes. But it may also be done by increasing (reducing) the supply of public services of particular value to low (high) income groups. This however interferes with the pattern of public services which consumers want to obtain at a given distribution of income. Once more, once policy objective may be implemented such that it interferes with another.

Finally, consider the role of fiscal policy in stabilization. Suppose that a more (less) expansionary policy is needed. This may be accomplished by raising (lowering) outlays on public services or by reducing (raising) the level of taxation. In the former case the allocation objective of fiscal policy is interfered with, whereas in the latter it is not. However, in the latter case there is the further question of how changes in the level of taxation are to be implemented. For stabilization measures to be neutral regarding both allocation and distribution goals, proportional changes in the level of tax rates might offer the appropriate solution.

Source: Musgrave R.A. & Musgrave P.B. Public Finance and Fiscal Policy (see references)

After all, there are many exceptions, which call for qualification of the simple rules just given. Nevertheless, it is important to keep in mind that there are distinct policy objectives and policy should try to minimize conflicts among them.

And this is what Lebanon is suffering from now where the impact of these conflicts on public finances and on Lebanon's financial conditions in general are very profound and not easy at all to minimize. The public may have been overburdened by the multiplicity of taxes during war but these taxes were perhaps more efficiently collected. And given that real incomes dropped steeply, it is quite conceivable that the tax burden as a proportion of GDP rose during the war period. Once peace was restored, the authorities had not only to reassert control over revenue sources and rebuild the tax system, but they also had to secure the compliance of a public which had grown cynical because of its experience during the war years.

Expenditures were also affected by the abnormal situation that prevailed during the war period. The Government continued to pay wages and salaries to employees of a public administration that essentially was not functioning. Post-war Government had to confront the challenge of administrative reform.

We shall see in fact later on along through the chapters ahead the conflicts and problems that are facing Lebanon's Public sector, their causes and the trend of their evolution.

Chapter II

A BRIEF HISTORY OF LEBANESE ECONOMY

Economic System

Lebanon has a long tradition of free trade and investment facilities, with free market pricing for most goods and services, an unrestricted exchange and trade system and extensive links with the developed world in practically all economic activities. The Government has maintained a generally non-interventionist stance toward private investment, and public ownership has generally been limited to infrastructure and utilities. There are no restrictions on the movement of capital and goods by residents and non-residents of the republic, including on entry or exit of firms or on access to foreign exchange, which makes Lebanon a supportive system for private sector development.

The Government continues to favor a strong role for the private sector in a liberal policy environment. It welcomes foreign investment in the economy. There are no legal restrictions on setting up and operating private businesses in Lebanon., subject to limited exceptions. Investment in infrastructure activities historically has been undertaken by the public sector. The absence of exchange controls in Lebanon allows foreign investors freely to import and export capital in any form they wish.

The Lebanese economy, characterized by freedom of exchange and transfers, is based on private initiative. The private sector is estimated to contribute over 80% to aggregate demand and includes such as agriculture, manufacturing, construction, trade, and tourism, in addition to services such as banking and finance, hotels and restaurants, media and advertising, and consulting and engineering. The manufacturing and industrial sectors are estimated to contribute approximately one-fifth of the National Income. They are provided only with a limited level of protection from international competition.

Recent Economic History

The Republic had developed into a prosperous, lower middle income country by the mid-1970s. Economic growth averaged 5% per year during the period 1960-1970 and then accelerated to 7% per year in the period 1970-1975. 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 contributing to overall growth of income. Having grown at an average of 3% per annum since 1960, per capita gross national product (GNP) was estimated at US\$.1,070 in 1974, just prior to the outbreak of the conflict in April 1975.

Source : The Merrill Lynch International Offering Circular Of March 8, 1999

Estimates put the Republic's GNP per capita at about US\$.820 in 1990- barely one third of its 1975 level in real terms. Damage to infrastructure and physical assets due to the conflict amounted to US\$.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 sizeable emigration of skilled manpower constituted a major loss to the economic potential of Lebanon. As a result, from 1975 to 1990, aggregate national output steadily declined. In addition, the confidence in, the 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 dearth in Government revenue and the growing expenditure on public services led to large and rapidly growing Government budget deficit. These negative developments, along with the prevailing political uncertainty, plunged the Lebanese economy into a vicious cycle 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 cessation of hostilities was followed by a sharp recovery in the economy in 1991. According to IMF estimates, GDP rose by almost 40%, and inflation moderated in the course of the year. Large capital inflows, along with a partial recovery of exports, resulted in an overall balance of payments surplus of over US\$.1 billion. However, the fiscal deficit remained high in 1991 (46% of

expenditures). At the start of 1992, public confidence in economic management was shaken by what was perceived as a weak budget incorporating large wage 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. By the beginning of 1992, Banque Du Liban stopped supporting the Lebanese Pound, the value of which declined to all-time lows. The cycle of deficit financing, dollarization and capital outflows led to escalating inflation and exchange rate depreciation, with the value of the Lebanese Pound reaching LBP 2,420 per US\$. in September 1992.

Since 1992, the economic recovery program of the respective Hariri Government rested on the dual, and sometimes-conflicting tasks of economic revival and stabilization. This framework aimed to rehabilitate the country's damaged infrastructure, replenish the depleted capital stock, reinstate traditional public services and social programs and provide a conducive environment for the return of the expatriate Lebanese community, while pursuing exchange rate stability and anti-inflationary policies. This strategy has been successful to a certain extent. As the government-led reconstruction program got underway and with the normalization of the economic environment, real economic growth (GDP) averaged 5.7% over the period from 1992 to 1997. At the same time, the foreign exchange rate gradually appreciated, reaching LBP 1,516 per US\$. at the end of 1998. The inflation rate was reduced from over 120% in 1992 to approximately 3% in 1998, interest rates have gradually declined since 1995 and gross foreign currency reserves have been accumulated. However, the Hariri

Government's success in improving monetary stability and its focus on establishing the conditions for Lebanon's economic regeneration have been at the cost of increased budget deficits and consequential public borrowings. As of December 31, 1998, the budget deficit represented approximately 13.8% of GDP, an improvement over 1997; as of December 31, 1997, the budget deficit represented 23.48% of GDP. (See Chapter III).

A significant priority of the new government is the reduction of the budget deficit through, among other things, a containment - followed by a reduction - of public expenditures. If the Government is successful, such reduction should lead to a reduction in the public debt to GDP (in % terms), a reduction of borrowing needs of the Republic and a decrease in interest rates.

Source : The Merrill Lynch International Offering Circular Of March 8, 1999.

Chapter III

LEBANESE RECENT ECONOMIC DEVELOPMENT

1. Movements in Gross Domestic Product

With the restoration of peace and stability, GDP has registered high growth rates throughout the period extending from 1993 to 1995, averaging a real growth rate of 6.5% per annum. Moreover, the recovery has brought annual per capita incomes from less than USD1, 000. in 1990 to an estimated USD2,600. in 1995. In 1996, real economic growth is estimated at 4.0% amounting to LL.20, 417.Billion in nominal terms. In 1997, it also grew at 4.0% and at an estimated rate of only 3% in 1998.

Table 3-1 shows estimates of GDP evolution for the years 1993-1998:

TABLE 3-1: GDP EVOLUTION (1993-1998)

	1993	1994	1995	1996	1997	1998
GDP (at market prices) billions of LBP	13,122	15,305	18,028	20,417	22,880	24,509
Exchange rate, LBP per US \$ (period average)	1,741	1,680	1,621	1,571	1,539	1,516
GDP (at market prices) millions of US Dollars	7,537	9,110	11,122	12,996	14,867	16,167
Growth of real GDP	7.0%	8.0%	6.5%	4.0%	4.0%	3.0%
Growth of Nominal GDP	38.0%	16.6%	17.8%	13.2%	12.1%	7.1%
Inflation	29%	8%	10.6%	8.8%	7.8%	4.0%

Source : Merrill Lynch International Offering Circular Of March 8, 1999

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2. Fiscal Developments

Turning to the fiscal front, the Lebanese Government has been confronted with the difficult tasks of macroeconomic stabilization and fiscal consolidation on one hand, and reconstruction expenditures and greater resource allocation to social services on the other while avoiding a dramatic increase in taxation after more than fifteen years of suffering. Consequently, the Government initially stabilized the macroeconomic situation then began to increase reconstruction expenditures and social services as well as emergency expenditures due to exogenous shocks. All this was occurring at a time when revenue collection was continuously increasing at a significant pace.

TABLE 3-2: Public Finances – Budget 1993-1998: (in Billions of LBP)

	1993	1994	1995	1996	1997	1998
Total expenditures (a+b)	3,017	5,204	5,856	7,225	9,162	7,816
<i>a- Current Expenditures</i>	<i>2,624</i>	<i>3,954</i>	<i>4,640</i>	<i>6,002</i>	<i>7,695</i>	<i>6,549</i>
<i>- Interest Expenditures</i>	<i>784</i>	<i>1,488</i>	<i>1,875</i>	<i>2,653</i>	<i>3,378</i>	<i>3,214</i>
<i>b- Capital Expenditures</i>	<i>393</i>	<i>1,250</i>	<i>1,216</i>	<i>1,223</i>	<i>1,467</i>	<i>1,267</i>
Total Revenues	1,855	2,241	3,033	3,533	3,753	4,430
Total Deficit	1,162	2,963	2,823	3,692	5,409	3,386
Deficit/GDP	8.85%	19.36%	15.66%	18.08%	23.64%	13.82%
Revenue/GDP	14.14%	14.64%	16.82%	17.30%	16.4%	18.07%
Expenditure/GDP	22.99%	34.00%	32.48%	35.39%	40.04%	31.89%

Source: Central bank of Lebanon

During 1993, total treasury revenues increased from 12% of GDP in 1992 to 14% and by 63% in absolute terms. During that year, import duties more than doubled due to administrative improvements and tighter control over ports of entry. The year 1993 also witnessed a slight deceleration in treasury expenditures (around 23% of GDP), which proved essential and allowed for an expansion in investment outlays in the following years. Another reason behind this containment is the late approval of the 1993 budget (in December 1993) which caused expenditures, during that year, to be implemented according to the 1992 budget appropriations. Interest payments rose from 23% to 26% of total expenditures in 1993. This increase in domestic interest payments was due to the Government's on-going policy of non-inflationary financing of the deficit through the issuance of domestic treasury bills. Also, given that treasury bills were the main tool used by the Bank of Lebanon for Open Market Operations,

domestic debt increased to maintain monetary stability. Most significantly, the fiscal outcome in 1993 was tighter than projected in the 1993 Budget law. Accordingly, the budget deficit declined from 13 to less than 9% of GDP.

In 1994, the overall fiscal deficit more than doubled to about 19% of GDP. This expansion in the fiscal deficit, caused by the 72% rise in expenditures, is explained by the late Parliament approval of the 1993 budget. Therefore, in 1994, spending for both the 1993 and 1994 budgets occurred with only revenues for 1994 being collected. This, along with the intensification of the reconstruction effort and the increase in current expenditures, rendered fiscal policy more expansionary.

In 1995, the budget deficit was expected to represent 14% of GDP and 44% of expenditures. However, the outcome for 1995 was somewhat different. Indeed, treasury expenditures increased by 12% compared to 1994, partly due to the increase in the weighted average yield on the treasury bills which reflected the uncertainty that surrounded the presidential elections and the resulting decline in confidence. Nevertheless, revenues grew by 35%, albeit slightly lower than anticipated in the budget. As a result, the deficit to expenditure ratio declined by around 9% points when compared to 1994. The overall fiscal deficit in 1995 declined by 4% points relative to GDP reaching 15.6%.

During 1996, fiscal developments have not emerged as initially expected due to a decline in revenues caused by slow economic growth and an unanticipated increase in public expenditures. The main cause of these

developments was the Israeli aggression on Lebanon in April, the regional political situation, and the Lebanese Parliamentary elections. As a result, some domestic and foreign investors postponed investment decisions and avoided major expenditures. Consequently, as mentioned above, overall economic growth is estimated to be in the range of 4% which adversely affects total revenues. Indeed, revenues have registered a 12% shortfall. On the other hand, largely due to the Israeli aggression, public expenditures had to be increased by LL.767 Billion. Overall public expenditures in 1996 have reached LL. 7,225 Billion while revenues have reached only LL.3, 533 Billion, thereby rendering a deficit to expenditures ratio of about 51% and a primary deficit of LL.1, 039 Billion.

During 1997, like the past years, the Lebanese economy had to face problems in assuring overall economic stability and finding ways to increase revenues on one hand and increase the social services and spend on the reconstruction on the other hand while avoiding the increase in taxation. Therefore, the Government had to assure primarily the necessary revenues and secure the monetary and economic stability in the country.

The actual expenditures for 1997 reached about LL. 9,162 Billion, which are LL.2, 722 Billion more than anticipated in the 1997 Budget. As a result, the expenditures to GDP increased from 35% in 1996 to 40% in 1997. On the other hand, the revenues reached only 92% of what was expected in the budget; i.e. LL. 3,753 Billion, due to the slow economic growth, the non-collection of some revenues which were expected and the appreciation of the Lebanese currency against foreign currencies which is essential in calculating customs duties.

Consequently, the deficit which reached LL. 5,409 Billion that year was affected mainly by:

- 1- The past years' amounts that were brought forward and others deposited in the Central Bank and which are amounts considered to be spent.
- 2- The considerable debt service (interest and issuance of part of public debt in foreign currencies) resulted from the high interests of the years 1995 and 1996 that were then increased because of the shaky political situation, the Israeli aggression, and the Parliamentary elections. Added to this, the issuance of the 1997 treasury bills and the cost of supplementary borrowings concluded that year.
- 3- The issuance of new laws stipulating the opening of new credits in order to secure increases in the wages and face health problems.
- 4- Not collecting all expected amounts mentioned in the budget.

For 1998, the Hariri Government set a stricter budget, which reflected total estimated treasury expenditures, including carryovers from previous budgets and municipal spending amounting to LL. 600Billion. The budget also reflected the Government's aim of improving the Republic's debt dynamics. Since the expenditure side of the budget continued to be dominated by non-discretionary spending (such as interest payments, wages and salaries), the Hariri Government recognized that deficit reduction must be addressed through consensus in the country on the need to address the fiscal issue.

The 1998 budget sought to address the fiscal imbalance by incorporating the following items:

- A decrease in expenditure by reducing allocations to most ministries
- The cancellation of most budget carryovers for 1995 and prior years
- A more realistic recognition of expenditures, by adding non-budget treasury expenditures, thus reducing the potential for systematic overshooting of budgeted expenditures that was prevalent in prior years
- And the introduction of new revenue measures, such as increase in custom duties, road use tax, passport issuance fees, fees for foreign workers' residency permits, duties on cement deliveries and a 5% tax on services provided by restaurants and hotels.

Unlike prior years, 1998 expenditures (excluding foreign financial expenditures) of LL. 7,816 Billion were below budgeted expenditures of LL. 7,920 Billion. As noted earlier, revenues increased from LL. 3,753 Billion in 1997 to LL. 4,430 Billion in 1998. The ratio of budget deficit to GDP improved from 23.64% in 1997 to 13.82% in 1998. The decrease of expenditures and increase in revenues was principally due to the successful implementation of the revenue enhancement and expenditure containment measures introduced in the 1998 budget.

In May 1998, the Government submitted a bill for approval by the Parliament proposing amendments to the salary scale of public sector employees. Pursuant to the proposal bill, which became a law, increases in wages and

salaries will take effect as of January 1, 1999. The Hoss Government has made deficit reduction a principal priority.

The table 3-3 shows a summary of Central Bank Operations between 1993-1998:

TABLE 3-3: Public Finances (1993-1998) *In Billions of Lebanese Pounds*

	<i>1993</i>	<i>1994</i>	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>
Revenues	1,855	2,241	3,033	3,533	3,753	4,430
Indirect taxes, of which:	743	921	1,483	2,289	2,150	2,596
<i>Customs duties</i>	<i>663</i>	<i>791</i>	<i>1,320</i>	<i>1,632</i>	<i>1,722</i>	<i>2,104</i>
Direct and other revenues	1,112	1,320	1,550	1,244	1,603	1,834
Expenditures	3,017	5,204	5,856	7,225	9,162	7,816
Current Expenditures	2,624	3,954	4,640	6,002	7,695	6,549
<i>Salary and wages</i>	<i>1,295</i>	<i>1,710</i>	<i>1,869</i>	<i>2,261</i>	<i>2,466</i>	<i>2,725</i>
<i>Interest expenditures</i>	<i>784</i>	<i>1,488</i>	<i>1,875</i>	<i>2,653</i>	<i>3,378</i>	<i>3,214</i>
<i>Other</i>	<i>545</i>	<i>756</i>	<i>896</i>	<i>1,088</i>	<i>1,851</i>	<i>610</i>
Capital expenditures	393	1,250	1,216	1,223	1,467	1,267
Deficit	1,162	2,963	2,823	3,692	5,409	3,386
Financing	1,234	2,955	2,825	4,476	5,642	-
<i>Foreign</i>	<i>293</i>	<i>1,017</i>	<i>371</i>	<i>357</i>	<i>292</i>	-
<i>Domestic</i>	<i>941</i>	<i>1,938</i>	<i>2,454</i>	<i>4,119</i>	<i>5,350</i>	-
<i>Banking system</i>	<i>751</i>	<i>1,247</i>	<i>1,002</i>	<i>2,948</i>	<i>3,936</i>	-
<i>Central Bank</i>	<i>(118)</i>	<i>(1,545)</i>	<i>(33)</i>	<i>(1,207)</i>	<i>2,+693</i>	-
<i>Commercial banks</i>	<i>870</i>	<i>2,792</i>	<i>1,035</i>	<i>4,155</i>	<i>1,243</i>	-
<i>Non-bank Private</i>	<i>190</i>	<i>691</i>	<i>4,452</i>	<i>1,171</i>	<i>1,414</i>	-
Discrepancy	72	(8)	2	784	233	-

Source : Merrill Lynch International Offering Circular Of March 8, 1999

3. Outstanding Debt:

As at December 31, 1998 net outstanding public debt of the Republic was at LBP. 25,732 Billion (consisting of LBP. 19,544 Billion of net domestic debt and LBP. 6,188 Billion or US\$.4,104 Million of public external debt).

The table below shows the Republic's net public sector debt for the periods extending from the end of 1993 until the end of 1998:

TABLE 3-4: Debt Evolution (in billions of LBP)

	1993	1994	1995	1996	1997	1998
Net Domestic Debt	4,407	6,712	9,287	13,358	18,381	19,544
Public External Debt	734	1,439	2,127	2,922	3,673	6,188
Net Public Debt	5,141	8,151	11,414	16,280	22,054	25,732

Source : Merrill Lynch International Offering Circular Of March 8, 1999

Total net public debt as a percentage of GDP increased from 46% in 1992 to approximately 79% in 1996, approximately 96% by the end of 1997 and an estimated 105% in 1998.

Internal Debt

The Government has elected to finance the budget deficit principally through the issuance of LBP.-denominated Treasury Bills (with maturity of three months, six months and twelve months) and Treasury Bonds (with maturity of 24 months). The weighted average yields on Treasury Bills and Treasury bonds increased significantly during 1995, due to uncertainties surrounding the Presidential elections, but have been declining since October 1995. As at

December 31, 1998, approximately 90% of outstanding Treasury Bills and Treasury Bonds have maturities of one year or more.

External Debt

The outstanding public external debt as at the end of 1992 and 1993 was approximately US\$. 362 Million and US\$.429 Million respectively. In 1994, public external debt rose to US\$.873 Million following a US\$.400Million Eurobond issue. By the end of 1995, public external debt was US\$.1,332 Million, reflecting a further US\$.300Million Eurobond issue and increased overseas borrowings for reconstruction expenditures, including expenditures on projects being executed through CDR . At December 31, 1996, public external debt was US\$.1,883 Million, reflecting continued reconstruction expenditures and a US\$.100Million Eurobond issue. Public external debt reached US\$.2,405 Million at the end of 1997, reflecting a US\$.100Million Eurobond issue guaranteed as to principal only by the World Bank, a Deutsche Mark 250 Million issue and continued CDR borrowing. In addition, the Republic issued a US\$.400Million Eurobond shortly after the repayment at maturity of an outstanding Eurobond of the same principal amount. Public external debt reached an estimated US\$.4,104Million at December 31, 1998 reflecting a US\$.1,000Million Eurobond issue in two tranches in April 1998, a US\$.350Million bond issue in September 1998 and a US\$.100Million bond issue in October 1998. The proceeds of the bond issues, which took place in 1998, were applied in the refinancing of public debt denominated in Lebanese Pounds. Over the medium term, public external debt is expected to grow due to the continuing

reconstruction expenditures and to the refinancing of public debt denominated in Lebanese Pounds.

4. Balance of Payments:

Lebanon is a predominantly importing country and is characterized by large trade deficits. However, net foreign income earnings, remittances and earnings from tourism, banking, insurance, and other services help to offset the trade deficits.

After the appointment of the first Hariri Government, in October 1992, the fourth quarter of 1992 showed net inflows of US\$.550 Million, resulting in a US\$.54 Million balance of payments surplus for the year, although imports rose steeply during that period. In 1993, the first full year of the Hariri Government, the current account deficit increased but was more than offset by large capital inflows, leading to a balance of payments surplus of US\$.1,170 Million. The trend continued in the following two years, with the overall balance recording a surplus of US\$.1,131 Million in 1994 and US\$.256 Million in 1995. The balance of payments temporarily deteriorated in 1995 as a result of the uncertainty relating to the Presidential elections which were scheduled for the summer 1995. The overall surplus of US\$. 256 Million was the result of renewed confidence and the large capital inflows that followed the extension of the President's term. The balance of payments recorded a surplus of US\$. 786 Million in 1996 and US\$.420 Million in 1997. However, the balance of payments registered a deficit of US\$.487 Million in 1998. The Government believes that this deficit was due, in large part, to the turbulence in certain financial markets in 1998 and a

consequent withdrawal of funds by foreign investors in Lebanese treasury bonds as part of an overall reduction of exposure to emerging markets.

The table 3-5 sets out information relating to the Republic's foreign trade from 1933- to 1998:

TABLE 3-5: Balance Of Payments *In Millions of US Dollars*

	1993	1994	1995	1996	1997	1998
Current account	(3,688)	(4,100)	(4,587)	(4,507)	(4,153)	-
<i>Trade Balance</i>	(4,224)	(4,866)	(5,906)	(6,209)	(6,248)	(5,819)
Exports-f.o.b.	684	676	816	783	649	716
Imports-f.o.b.	(4,908)	(5,541)	(6,722)	(6,992)	(6,897)	(6,531)
Services	(142)	31	438	425	635	-
Unrequited transfers	378	735	881	1,277	1,460	-
Capital account	4,858	5,231	4,843	5,293	4,573	-
Direct Investment	1,811	2,100	2,933	2,552	2,672	-
Portfolio Investment	-	-	-	-	70	-
External Public Disbursements	126	542	613	525	995	-
Amortization on external public debt	(41)	(134)	(103)	(20)	(449)	-
Non-bank short-term capital	790	110	450	186	186	-
Other capital	2,173	2,613	950	2,050	1,099 ¹	-
Overall Balance	1,170	1,131	256	786	420	(487)²

Source: High Council of Customs/ Banque Du liban and Ministry Of Finance

Notes:

Line items which have not been quantified are not available as of the date this study.

1- Includes a US\$.500Million deposit from Saudi National Commercial Bank in December 1997.

2- Includes a US\$.100Million deposit from the Kuwaiti Investment Authority in February 1998.

*

* *

5. Inflation and Price levels:

Since 1993, inflation is estimated to have declined to approximately 9% per annum in 1996, 8% per annum in 1997 and only 4% per annum in 1998. This marks the first prolonged return to relative price stability. The current level of inflation, which remains low despite the presence of a large budget deficit, is attributable to the following principal reasons:

- The implementation by Banque Du Liban of a tight monetary policy, including maintaining a stable exchange rate (by using a nominal anchor policy with US. Dollar) and high interest rates on Lebanese Pound assets; and
- The openness of the Lebanese economy, which causes excess demand on the domestic market to be satisfied by a corresponding increase in imports.

TABLE 3-6: Inflation Rate (LBP)

	1993	1994	1995	1996	1997	1998
Inflation rate	29%	8%	10.6%	8.9%	7.8%	4%

Source: Banque Du Liban

6. Exchange rate and International reserves:

Foreign exchange rate stability is a primary policy objective of the Government and Banque Du Liban. Banque Du Liban's exchange rate policy since 1993 has been to anchor the Lebanese Pound nominal exchange rate to the Dollar. In practice, this has led to a gradual appreciation of the Lebanese Pound since 1992 against the U.S. Dollar of 1.2 % to 3% annually. Although several

external factors can influence the exchange rate, including general investor confidence in the economy, the authorities expect to continue to gear their policy instruments toward maintaining strength and stability in the exchange rate. Direct intervention in the currency markets supplements this policy when necessary to smooth excessive volatility of the exchange rate. Exchange rate stability over time should enable Banque Du Liban to lower gradually domestic interest rates.

Foreign currency reserves are generally placed by Banque Du liban outside the Republic with other central banks or with highly rated international banks. They include a limited amount of highly rated foreign debt securities. Although not legally obligated to do so, Banque Du Liban has been pursuing a policy of setting aside, and segregating from its foreign exchange reserves, certain foreign currency amount corresponding to the maturing external public debt obligations of the Republic. These foreign currency amounts are being made available to the Republic for payment of its external public debt obligations, against payment to Banque Du Liban of equivalent amounts in Lebanese Pounds.

TABLE 3-7: Central Bank's Foreign Currencies & Reserves

In Millions of U.S.Dollars

	1993	1994	1995	1996	1997	1998
Gold	3,603.6	3,556.1	3,571.8	3,410	2,670.3	2,651
Foreign Currencies	1,460	2,751	3,026	3,934.8	2,959	3,318.3
Reserves	10.2	10.7	10.9	11.2	11.4	11.6
LBP Exchange Rate (as end of period)	1,711	1,647	1,596	1,552	1,527	1,508

Source: Banque Du Liban

7. Monetary Developments:

As a result of high inflation prior to 1992, the Lebanese economy became substantially dollarized. Since October 1992, monetary policy has been targeted at stabilizing the Lebanese Pound exchange rate and controlling the inflation rate and money growth. The return of confidence in monetary stability and high returns on investment in LBP-denominated financial securities led to a significant decline of the dollarization of the economy and to a build up in foreign exchange reserves until the end of 1996. Thus, the proportion of foreign currency deposits as a share of total deposits decreased from 73.6% in December 1990 to 56.3% in June 1997, before increasing to 63.9% at the end of 1997 and 65.5% at the end 1998 due in part to the turmoil generally affecting emerging markets and following the Asian debt crisis. Foreign exchange reserves declined in 1997 and the first quarter 1998 to U.S.\$2,413 Million, due to the successful intervention of Banque Du Liban in the currency markets to stabilize the Lebanese Pound exchange rate in the face of foreign currency purchasing pressure. As at the end of 1998, net foreign exchange reserves were U.S.\$3,318 Million.

Chapter IV

ECONOMICS OF THE PUBLIC DEBT

The Growth of Public Debt has been the hottest issue in the debate over responsible fiscal policy. Critics not only are faulting deficit finance for its inflationary effects while in process, but are also warning of the future consequences of debt accumulation and its burden upon later generations.

This chapter will trace the growth of the debt and examine its structure. There follows an analysis of the economics of the public debt, including the problem of fiscal solvency and of burden transfer to future generations.

1. Growth of the Debt

(1992-1993):

In 1993, the budgetary policy was reflected by an improvement in the *Public Finance* conditions. The ratio of revenues to expenditures increased from 43.8% in 1992 to 60.2% in 1993. In fact, while revenues rose by 78.7%, expenditures progressed by only 30.1%, thus reducing the deficit by 7.7%. In terms of percentage of expenditures, the deficit decreased from 56.20% in 1992 to 39.86% in 1993. This reduction reinforced the confidence of the private sector in the State's structures, and led to a decline in interest rates and to an increase in the inflows of capital.

(1994):

The gross internal public debt rose by 60% reaching LL9,320.7 billion at the end of 1994, that is progressing in volume of LL3,498.1 billion, compared to the rise of LL1,728.1 billion in 1993. If we consider the net figures (gross discounted value minus the public sector's creditor accounts held at the Central Bank and at commercial banks which reached LL2,638.9 billion), we observe a real growth of the debt of 50%, the latter attaining LL6,681.8 billion, a growth of LL 2,248.2 billion or 2.9 times that of 1993.

Source: Economic Analysis Unit, AUDI Bank.

The growth in the Net Debt resulted from the more important rise in current and investment spending than in revenues. The service of the debt which represented almost 25% of spending, along with the public servant's wages that reached LL 1.500. billion had considerably inflated the current level of spending. On the other hand, the CDR's disbursements amounted to about US\$ 300 million while the investment spending of the various ministries represented nearly US\$ 350 million. 1994's deficit must have reached 55% to 57% of the expenses, leading to a deterioration of the indebtedness ratios. The difference between the gross and net real debt results from the effects of the monetary policy and the massive subscriptions in Treasury Bills.

(1995):

The deficit of 1995 relative to expenditures while improving with respect to 1994 (47.2% and 55.9% respectively), remained well above the budgetary forecasts.

The internal public debt rose by 28.7% in 1995, attaining LL11,997.3 billion. A growth of LL2,676.5 billion compared with LL3,498.1 billion in 1994. If we consider the net figures (gross discounted value minus the public sector's creditor accounts held at the Central Bank and at commercial banks which reached LL2,701.4 billion), we observe a real growth of 39.1% of the debt, rising from LL6,681.8 billion to LL9,295.9 billion, that is a LL2,614.1 billion rise in volume equivalent to 1.2 times that of 1994.

The growth in the net debt resulted from the more important rise in current and investment spending than in revenues, within the context of an important improvement of revenues to expenditures ratio which rose from 43% in 1994 to 52% in 1995.

The debt service which represented almost 32.4% of spending, along with the public servants' wages that reached LL 2,000 billion had considerably inflated the current level of spending. 1995's deficit has reached 47.2% of expenditures (against 55.9% in 1994), leading to a slight decline of the indebtedness ratios even though these latter remain high.

According to the figures published by the Central Bank of Lebanon, the foreign debt denominated in foreign currencies grew by 67.2% from US\$ 771.8 million to US\$ 1,312.6 million. The rise of the debt resulted essentially from the government's issuance of US\$300 million Eurobonds.

(1996):

The net internal public debt rose by 43.61% in 1996, from LL.11, 997.2 billion on 1995 to LL.17, 228.8 billion on 1996, i.e. an increase in volume of LL.5, 531.6 billion m compared with that of LL.2,676.5 billion in 1995. If we consider the net figures (gross discounted value minus the public sector's creditor accounts held at the Central Bank and commercial banks, which amounted to LL.3, 870.6 billion), we can see a real growth of the debt by 43.70%, the latter rising from LL.9, 295.8 billion to LL.13, 358.2 billion, i.e. an increase in volume of LL.4, 062.4 billion, equivalent to 1.6 times that of 1995.

The growth in the net debt is the result of a bigger increase in current and investment spending than in revenues in the context of a slight deterioration in the revenues/expenditures ratio, which went from 52% in 1995 to 48% in 1996. The debt service, which accounted for almost 36.8% of expenditures, and public employees' salaries, which amounted to over LL.2, 200. Billion, considerably increased current spending.

A detailed analysis of the figures at the end of the year shows that the problem comes both from insufficient revenues (87.8% of the budgetary estimates) and excessive spending (111.9% of budgetary estimates). Since the debt service amounted to 102.2% of budgetary estimates, the excess in spending comes from current and investment spending.

According to AUDI Bank's estimates, only one third of the shortages in revenues, which amounted to LL.490. Billion, can be tied to on the Israeli operation on April. The rest comes from the imbalance between tax imposition and the economy's recovery and reconstruction needs.

The external debt in foreign currencies increased by 35% in 1996, from US\$.1,312.6.Mlios. to 1,769 Millions, due essentially to the issuance of US\$.100.Millions in Eurobonds and withdrawals on financial protocols.

(1997):

The Gross internal debt rose by 14.58% in 1997, from LL.17, 228.8 Billion in 1996 to LL.19, 741.6Billion in 1997, i.e. an increase in volume of LL.2, 512.8Billion, compared with that of 2,676.5Billion in 1996. If we consider the net figures (gross discounted value minus the public sector's creditor accounts held at the central bank and commercial banks, which amounted to LL.1, 406.6 Billion), we can see a real growth of the debt by 37.26%, the latter rising from 13,358.2 Billion to 18,336.0 Billion, i.e. an increase in volume of 4,4997.8 Billion, increasing by 22.5% compared

The growth in the net debt is the result of a deterioration in the revenues/expenditures ratio, which went from 48.9% in 1996 to 40.9% in 1997. The debt service, which accounted from almost 36.9% of expenditure, and public employee's salaries, which amounted to over LL.2, 500.Billion, significantly increased current spending.

A detailed analysis of the figures at the end of the year shows that the problem comes both from insufficient revenues (19.5% of budgetary estimates) and excessive spending (142.3% of budgetary estimates). Since the debt service amounted to 125.3% of budgetary estimates, the excess in spending comes from current spending. According to our estimates, 40% of the revenue deficit, which amounts to LL.362.Billion, can be ascribed to the slowdown in growth, the rest coming from the weakness in the resource mobilization ratio.

The external debt in foreign currency increased by 32.9% in 1997, from US\$.1,769 Million to US\$.2,351 Million, due essentially to the fungible issue of EDL of US\$. 100Million guaranteed by the Wold Bank and withdrawals on financial protocols.

(1998):

The gross internal public debt rose by 9.53% in 1998, from LL.19, 787.1 Billion as of 31/12/97, to LL. 21,672.2 Billion as of 31/12/98, an increase in volume of LL.1, 885.1Billion in comparison with 2,558.3 Billion in 1997. If we consider net figures (gross discounted values minus the public sector's creditor account held at the Central Bank and commercial banks rose to LL. 2,141.9 Billion), we observe a real growth of the debt of 6.25%, the latter moving from 18,381.5 Billion to 19,530.3 Billion; That is an increase in volume of 1,148.8, a decline of 77% relative to that in 1997.

The moderate growth in net public debt results from an increase in the coverage ratio of expenditures by revenues from 40.9% in 1997 to 56.7% in 1998. A detailed analysis of end of year figures shows that the improvement comes both from revenues (96.3% of budget estimates) and expenditures (98.9% of budget estimates). Debt service represented 100.4% of budget estimate.

Foreign debt rose by 78.6% in 1998, moving from US\$. 2,351. Million to US\$. 4,200Million. Foreign debt represents 26.9% of GDP in 1998, a level far below average for emerging markets.

(As of 30/06/1999):

Gross internal public debt increased by 1.4% in the second quarter of 1999, going from LL.26, 672.2 Billion as of 31/12/98 to LL.22, 488.9 Billion as of 30/06/99. Since the beginning of the year, real debt grew by 3.0%, increasing by LL.594.5 Billion.

As for the foreign debt, it grew by 12.3% compared to December 1998, going from US\$. 4,200 Million to US\$. 4,717 Million last June because of the issuing of US\$.540Million in Eurobonds in February. This debt has increased in September by US\$.700. Million as a result of a new Eurobond issue is carried out jointly by Credit Suisse First Boston and Morgan Stanley.

2. Structure of The Debt

(1993):

The real internal public debt rose in 1993 by 52.9% (against 87.5% in 1992). The real growth of the state indebtedness resulted from a rise of LL677.9 billion in the direct advances to the treasury and a surplus of LL1,674.5 billion of Treasury bills in circulation. The structure of the debt was altered in favor of the advances, which share in the total debt increased from 7.1% in 1992 to 14.6% in 1993. This development resulted essentially from a change in the structure of the debt, where the Central Bank's advances to the Treasury progressed from 9.4% of the total to 20.3%, without significantly altering the proportion of bills and direct advances in this financing.

Source: Economic Analysis Unit, AUDI Bank.

The Central Bank's advances to the Treasury are mainly constituted of direct advances. The balance of the Account 31036 increased by LL443.8 billion, that of the Fuel Fund by 12.2 billion, that of EDL by 220.0 billion, and that of Tripoli's refinery by 14.1 billion. If we deduce from the debt the surplus in the Treasury bills' subscriptions and the public sector's creditor accounts, the volume reaches LL4, 976.5 billion, a progression of 41.7% from 1992's volume LL3, 511.5.

In 1993, the Treasury Bills' subscriptions exceeded the maturing ones by LL 1,894.6 billion, thus raising the volume of the portfolio from LL4, 129.7 billion to LL 6,024.3 billion. The surplus of subscriptions over the financing needs of the state's amounted to LL 618.2 billion. It reflects the growth of the bank's deposits in Lebanese pounds which stemmed from the foreign exchange market and the US\$/LL conversions.

(1994):

The nominal evolution of the debt resulted in 1994 from a rise of LL25.5 billion in the direct advances to the treasury and a surplus of LL3, 216.9 billion of Treasury Bills in circulation. The structure of the debt did not witness significant modifications in 1994 relative to 1993. The share of the advances still recorded 0.9% of the total while that of bills registered 99.1%.

The Treasury Bills subscriptions in 1994 exceeded the maturing ones by LL3, 216.9 billion, thus raising the volume of the portfolio from LL6, 024.3 billion in December 1993 to 9,241.3 billion in December 1994. The massive

increase in subscriptions is essentially accounted for by the bank's share amounted to 88.1% of the total rise (LL2, 835. billion). We noted surpluses throughout the first nine months of the year, through the fourth quarter recorded a deficit of LL 97.4 billion which reflected both a rise in spending and conversions of LL assets into foreign currencies following the government crisis which led to President Hariri's threat of resignation.

The distribution of Bills by category of subscribers showed a slight modification in 1994 relative to 1993. The share of commercial banks progressed from LL 2,835.0 billion, raising their portfolio volume from LL 4,437.3 billion to LL 7,272.3 billion. It represented 78.7% of the total against 73.7% in 1993. The share of the BDL declined by LL 390. Billion. Its subscriptions amounted to LL 28.7 billion, that is 0.3% of the total against 7.0% in 1993. The share of subscriptions by the public as well as by financial and public institutions rose by LL 771.7 billion, bringing the total volume of their portfolio to LL 1,940.3 billion, that is 20.9% of the total against 19.4% in 1993.

Lebanon has long been characterized by the excessive level of its public internal debt and its inability to contain inflation. However, in the past two years, it partly succeeded in eliminating one of the two major factors of destabilization of its currency.

(1995):

The difference between the gross and the net real debt stems in 1995 from the pursued monetary policy and the massive subscriptions in Treasury Bills.

The change in the nominal debt resulted from the growth in direct advances to the Treasury of LL 77.4 billion and from the rise of LL2,599.0 billion in Treasury Bills in circulation. The structure of the debt did not exhibit any major modifications in 1995 relative to 1994. The share of the advances remained constant at 1.9% and that of bills at 98.1%.

The rise of LL77.4 billion in direct advances to Treasury from LL81.8 billion in 1994 to LL159.2 billion in 1995 resulted from an increase in the Central Bank's advances to the Tripoli refinery, the Electricity of Lebanon, and the Fuel Autonomous Fund.

The net balance of Treasury Bills' subscriptions relative to maturing ones recorded a surplus of LL 3,573.7 billion in 1995, raising the size of the portfolio from LL 9,241.3 billion in 1994 to LL 12,815. Billion in 1995.

Out of this global volume, LL 2,293.1 billion were registered during the fourth quarter following the trend observed on the foreign exchange market and the resulting conversions from foreign currency holdings to Lebanese pounds holdings. Unlike the preceding years, the massive increase in subscriptions stemmed from the public with LL1, 623.4 billion (45% of the total), the share of the banks represented LL 1,772.4 billion (50% of the total).

(1996):

In 1996, the nominal change in the debt was the result of a rise in direct advances to the treasury of LL.5,184.3 billion in the Treasury Bills in circulation. There was no significant change in the structure of the debt in 1996, compared with 1995. The proportion of advances held at 1.3% and that of Bonds at 98.7%.

The rise of LL.47.3 billion in direct advances to the Treasury, which went from LL. 177.2 billion to LL.206.5 billion, is the result of movements on the accounts of the Tripoli Refinery, the Electricite Du Liban and the Fuel Autonomous Fund at the Bank of Lebanon. These movements are, in fact, a reflection of developments related to changes in the portfolio of Treasury bonds in circulation and those in the State's revenues and expenditures.

The net balance of Treasury Bills in relation to maturity dates registered a surplus of LL.4, 207.3 billion in 1996, increasing the volume of the portfolio from LL.12, 815.0 billion in 1995 to LL.17, 022.3 billion in 1996. The massive increase in subscriptions comes, contrary to previous years, from banks and financial institutions, with LL.3, 681.5 billion (87.5% of the total), the public's share being LL.525.3 billion (12.5% of the total).

(1997):

The nominal change in the debt is the result of a rise in direct advances to the Treasury of LL.2.9 Billion and an increase of 2,509.9 Billion in Treasury Bills in circulation. There was no significant change in the structure of the debt

in 1997, compared with 1996. The proportion of advances held at 1.1% and that of bonds at 98.9%.

The net balance of Treasury Bill subscriptions in relation to maturity dates registered a surplus of LL. 2,509.9 Billion in 1997, increasing the volume of the portfolio from 17,022.3 Billion in 1996 to 19,532.2 Billion in 1997. The massive increase in subscriptions comes, contrary to previous years, from banks and financial institutions, with LL.1, 411.5 Billion (56.24% of the total), the public's share being LL.1, 098.4 Billion (43.76% of the total). The distribution of bonds over the various maturities shows a clear fall in long term subscriptions. The decline in the average life of portfolios from 366 days was translated by a corollary decrease in the average current yield from 18.53.% in 1996 to 15.33% in 1997.

(1998):

The debt nominal evolution results from an increase in direct advances to the Treasury of LL. 40.3 Billion and a rise in Treasury Bills in circulation of LL. 1,844.8 Billion. The debt's structure did not undergo major modifications in 1998 compared to 1997. The share of advances remains at 1.2% and that of Treasury Bills at 98.8%.

The net balance of Treasury subscriptions with respect to maturing bills registered a surplus of LL. 1,844.8 Billion in 1998, taking the portfolio's global volume from LL.19, 577.6 Billion as of 31/12/97 to LL.21,422.5 Billion as of 31/12/98. The increase in subscriptions results exclusively from the bank's share

with LL.2, 727.4 Billion. The financial institutions and the public's share declined by LL.608.6 Billion and that of the Central Bank by LL.274. Billion.

(As of 30/06/1999):

Till June 99, the nominal growth of the debt was resulting from the decrease in direct advances to the Treasury and the rise in Treasury Bills in circulation. The structure of the debt did not undergo major modifications in June. The share of advances is stable at 1.1% and that of Treasury Bills at 98.8%.

The net balance of Treasury subscriptions with respect to maturing bills registered, in the second quarter, a surplus of 311.3 Billion, taking the portfolio's global volume to LL. 22,242.5 Billion at the end of June.

Let us redescribe this fiscal evolution through illustration where we can better see changes intended to highlight the issue:

Distribution of Treasury Bills by Subscriber
(Billions of LL)

Table 4-1:

YEAR	Commercial Banks	BDL	Financial Institutions	Public Administrations	Public	Total
1993	4,437.3	418.7	8.5	190.3	969.8	6,024.3
1994	7,272.3	28.7	20.4	455.6	1,464.3	9,241.3
1995	9,044.7	0.0	29.5	653.1	3,087.7	12,815.0
1996	12,555.8	0.0	200.4	802.4	3,463.7	17,022.3
1997	13,654.2	274	513.5	528.4	4,562.1	19,532.2
1998	16,151.0	13.5	NA	NA	3,950	21,422.5
30/06/1999	16,295.0	219.7	NA	NA	3,722	22,242.5

Source: Economic Analysis Unit, AUDI Bank.

Another aspect of this public debt in Lebanon is, as we have seen, its distribution by types of holders because it affects the liquidity structure and the position of the capital markets. So, an important element of debt is its distribution among subscribers to Treasury Bills. Commercial banks have systematically been the main subscribers to T-bills, in the order of some 70%, followed by the public. This pattern is persisting. The Central Bank, which was initially a minor subscriber to T-bills in 1993, withdrew from the T-bill market by 1995. Financial institutions and public administrations increased their subscription rates but they held only a small portion of the market, amounting to some 7%.

So we can notice by this how dangerous the situation is still because it is only the privately held public debt that poses problems of management when it comes to the role of the debt as a part of the economy's liquidity structure.

In addition, the overall debt maturity structure in Lebanon remains heavily concentrated in the short-term. Investors in Lebanon still feel uncertain about the future (hyperinflation may reoccur and maybe get worse). So they prefer to avoid long-term commitments. Thus, it is expedient to refund maturing issues on a short-term basis, but in so doing, the liquidity claim structure is still increasing.

Public Debt
(Billions of LL)

Table 4-2:

YEAR	Gross Internal Debt	External Debt (\$m)	Gross Total Debt	Public Sector Deposits	Net Total Debt
1993	5822.6	326.8	6,381.8	1,389.0	4,993.0
1994	9,320.7	771.8	10,591.9	2,638.9	7,953.0
1995	11,997.3	1,312.6	14,092.2	2,701.4	11,390.8
1996	17,228.8	1,769.0	20,052.1	3,870.6	16,181.5
1997	19,741.6	2,351.0	23,331.6	1,405.6	21,926.0
1998	21,672.2	4,200.0	28,005.8	2,141.9	25,863.9
30/06/1999	22,488.9	4,717.0	29,602.1	2,350.6	27,251.5

Source: Ministry of Finance – Banque Du Liban .

Government Revenues and Expenditures
(in Billions of LL)

Table 4-3 :

	Revenues	Expenditures	Deficit
1993	1,855	3,017	1,162
1994	2,241	5,204	2,963
1995	3,033	5,856	2,823
1996	3,534	7,288	3,754
1997	3,753	9,162	5,409
1998	4,430	7,816	3,386
30/06/1999	2,126	3,791	1,665

Source: Ministry of Finance.

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Reading these figures are alerting and it is now recognized in Lebanon that continuing to incur very large fiscal deficits is unsustainable. The impact in fact of the conflict on public finances and on GDP is very profound. HOW?

The size of the debt in relation to GDP matters because it affects the liquidity position of the economy and of the investors holding. But of equal or greater importance is the level of interest service it requires.

But before going through details, let us see the illustration of this relationship that summarizes government finances:

Summary of Governmental Finances (1993-1999)
(in Billions of LL)

Table 4-4:

	1993	1994	1995	1996	1997	1998	30/06/99
GDP	13,120	15,340	18,060	20,410	22,880	24,509	NA
REVENUES	1,855	2,241	3,033	3,534	3,753	4,430	2,126
EXPENDITURES	3,017	5,204	5,856	7,288	9,162	7,816	3,791
DEFICIT	1,162	2,963	2,823	3,754	5,409	3,386	1,665
DEFICIT/EXPEND.	38.5%	57%	48%	51.5%	59%	43.3%	44%
INTEREST	754	1,472	1,745	2,682	3,378	3,214	NA
REVENUES/GDP	14.1%	14.6%	16.8%	17.3%	16.4%	18.1%	
EXPEND./GDP	23.0%	33.9%	32.4%	35.7%	40%	31.9%	
DEFICIT/GDP	8.9%	19.3%	15.6%	18.4%	23.6%	13.8%	
INTEREST/GDP	6%	10%	10%	11%	15%	13%	
INTEREST/EXPEND.	25%	28.3%	29.8%	37%	37%	41%	
REVENUES/EXPEND	61%	43%	52%	48%	41%	57%	56%
GROSS DEBT	6,381.8	10,591.9	14,092.2	20,052.1	23,331.6	28,005.8	29,602.1
NET DEBT	4,993.0	7,953.0	11,390.8	16,181.5	21,926.0	25,863.9	27,251.5
GROSS DEBT/GDP	48.6%	69.0%	78.0%	98.5%	102%	114%	
NET DEBT/GDP	38.1%	51.8%	63.0%	79.6%	96%	106%	

Source: Ministry of Finance – Banque Du Liban.

As we can see, between 1993 and June 1999 revenues have been equivalent to 14-18 percent of the GDP. In the same five years, expenditures have been about one-third of the GDP. The resulting deficit, equivalent to some 15-19 percent of the GDP, was financed by borrowing, predominantly in local currency, at high interest rates.

Chapter V

LEBANON IN COMPARISON TO OTHER ECONOMIES

A description of recent economic developments of the Budget remains incomplete unless it is placed within an international context. To gain a better understanding of the current economic situation, Lebanon's economic performance should be compared to that of other countries. Below, Lebanon's main economic indicators will be compared to those of a sample of 20 countries including 5 major industrial countries (USA, United Kingdom, France, Germany, Canada), 3 small industrial countries (Sweden, Belgium, Greece), 4 Latin American countries (Brazil, Mexico, Colombia, Venezuela), 7 Middle Eastern countries (Jordan, Kuwait, Tunisia, Egypt, Morocco, Cyprus, Turkey) and one rapidly developing country, namely Thailand.

This diversity renders the comparison rather limited, and should only serve as a rough guide to Lebanon's economic ranking within a group of countries.

International Monetary Fund (IMF) data of the average outcome 1990-1995 of the selected countries is compared to Lebanon's 1995-1997 data. Based on the above, we find that Lebanon is characterized by the following features:

1. A low government revenues to GDP (low tax burden) ratio with slightly high proportion of non-tax revenues to total revenues, and a somewhat low proportion of tax revenues to total revenues.
2. A high expenditures to GDP ratio with a high proportion of wages and salaries to total expenditures and very high and growing proportion of interest payments to total expenditures.
3. A large ratio of deficit to GDP.
4. A relatively but stabilizing level of debt to GDP ratio with low foreign debt and high domestic debt thereby resembling the debt structure of industrial rather than developing countries.

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1.Comprative Revenue Structure:

As we can be seen below (see CHART 5-1), when compared to the group of 20 countries mentioned above, Lebanon ranks 15th in terms of revenue to GDP ratio. Clearly, this indicates that Lebanon is a lightly taxed economy with revenues to GDP only registering 16.8% in 1995.

TOTAL REVENUES (in % of GDP) Avg. 90-98

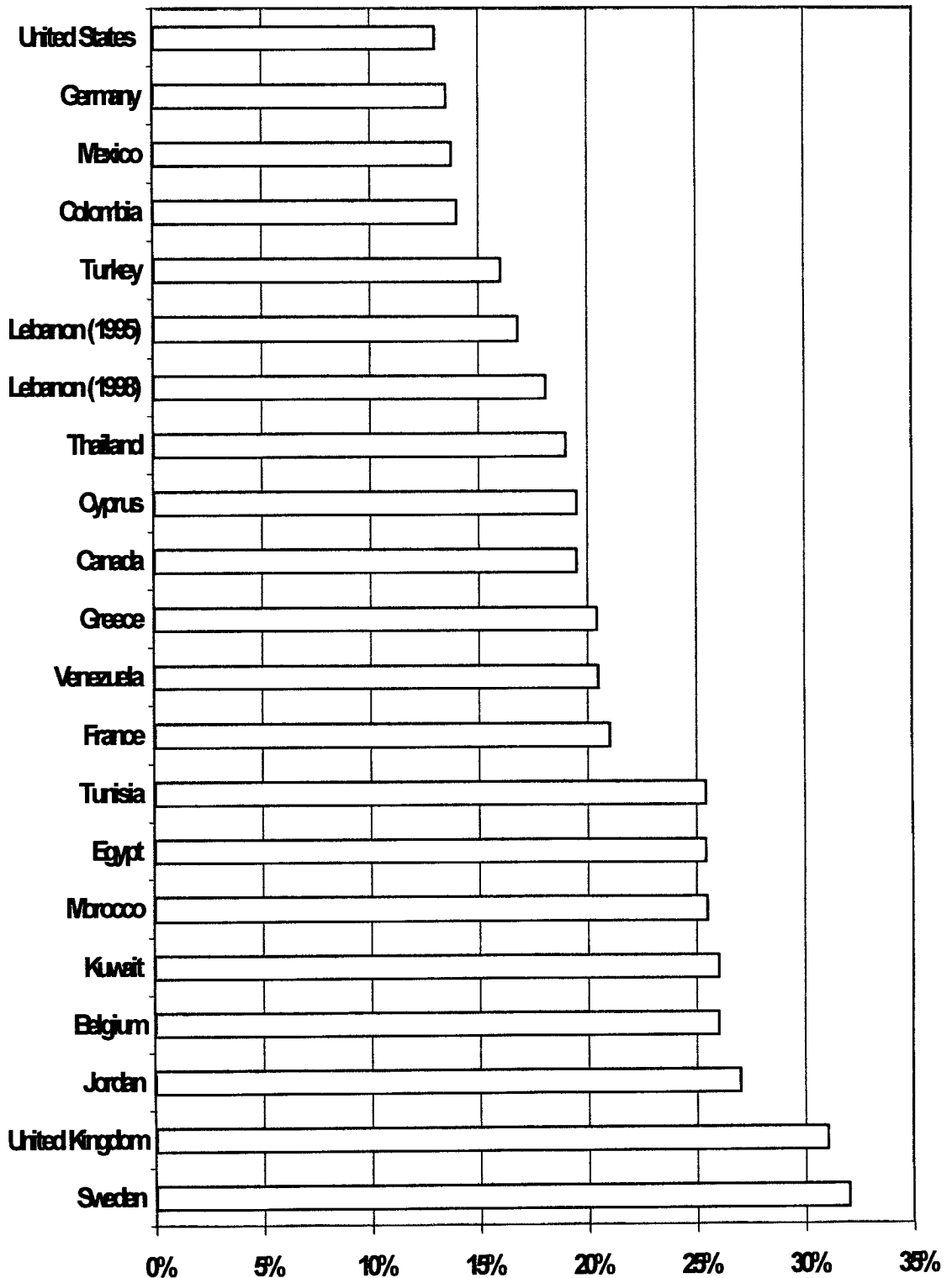


CHART 5-1: Source: Ministry of Finance

Moreover it is noted that Lebanon ranks eight in terms of the proportion of non-tax revenues and fifteenth in terms of its tax share revenues in total revenues:

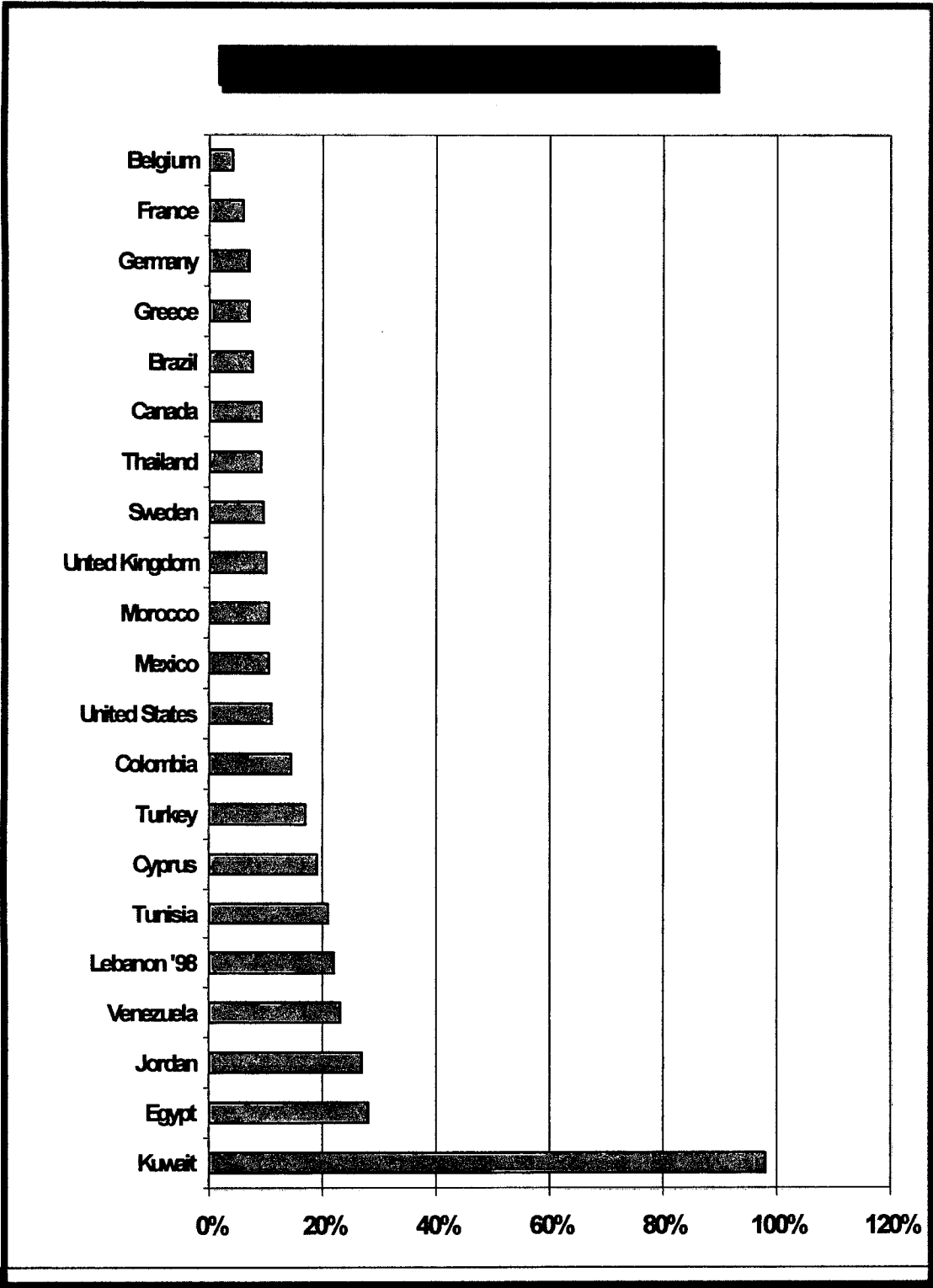
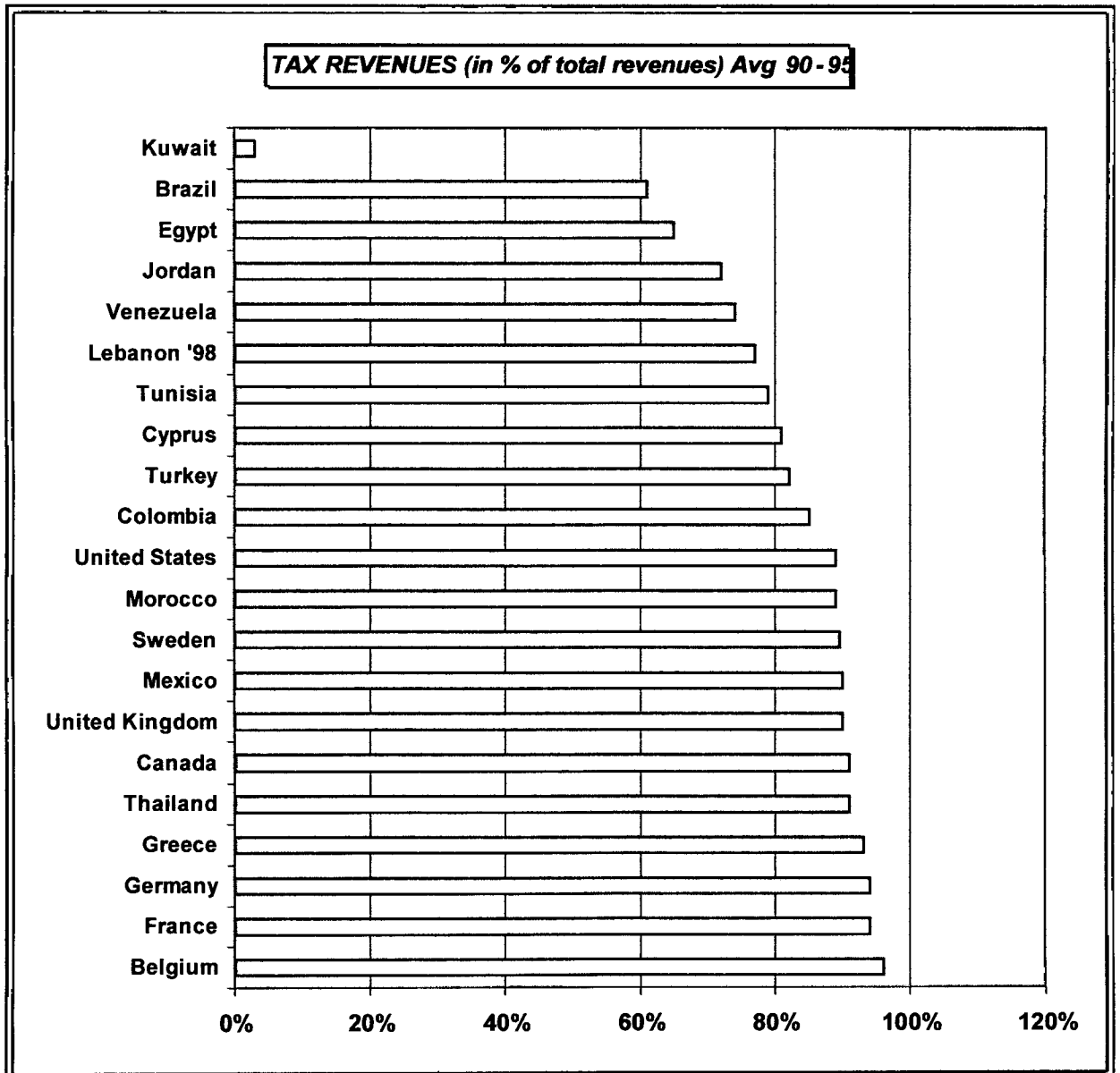


CHART 5-2- Source: Ministry of Finance

CHART 5-3:



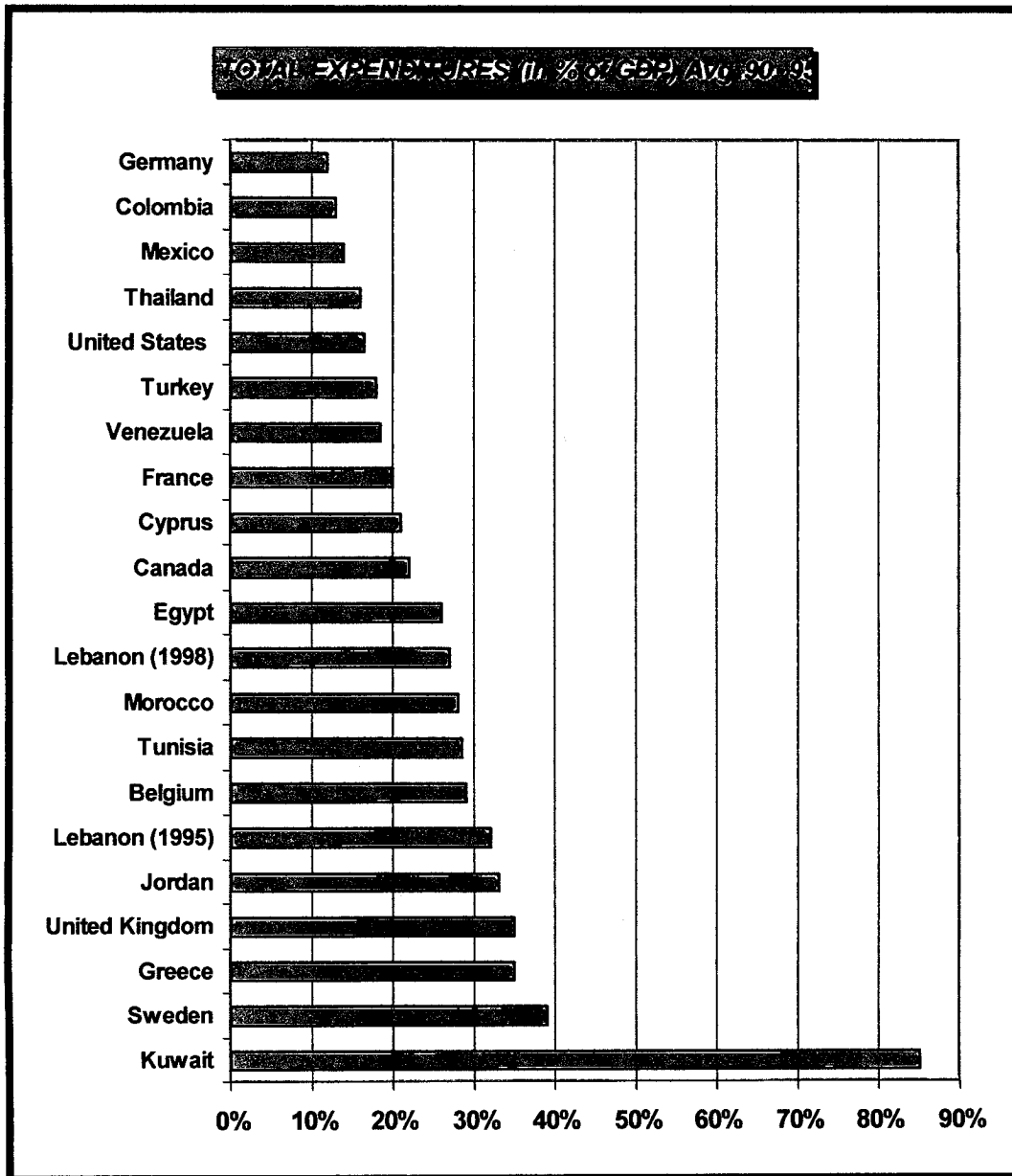
Source: Ministry of Finance

Hence, it is obvious that further efforts are needed to raise revenues to GDP and to enhance the role of tax revenues in total revenues. However, major strides have already been achieved over the past 7 years with revenue to GDP increasing from 10.34% in 1992 to 16.82% in 1995 and to 18.1% in 1998.

2. Comparative Expenditure Structure:

In 1995, Lebanon's expenditure to GDP ratio registered 32.48%, which ranks as the sixth highest ratio among the group of 20 (see CHART 5-4):

CHART 5-4:



Source: Ministry of Finance

Despite this potential improvement in Lebanon's expenditure indicator, the structure of Lebanon's expenditure remains heavily skewed towards salaries and wages, and interest payments. In a sense, Lebanon's expenditure dilemma is not only one magnitude, but rather, of distribution with the overwhelming majority of resources going towards covering non-discretionary expenditure items. Interest expenditure and wages and salaries together exhaust 76% of total expenditures in 1998 of which wages and salaries alone represented 35%:

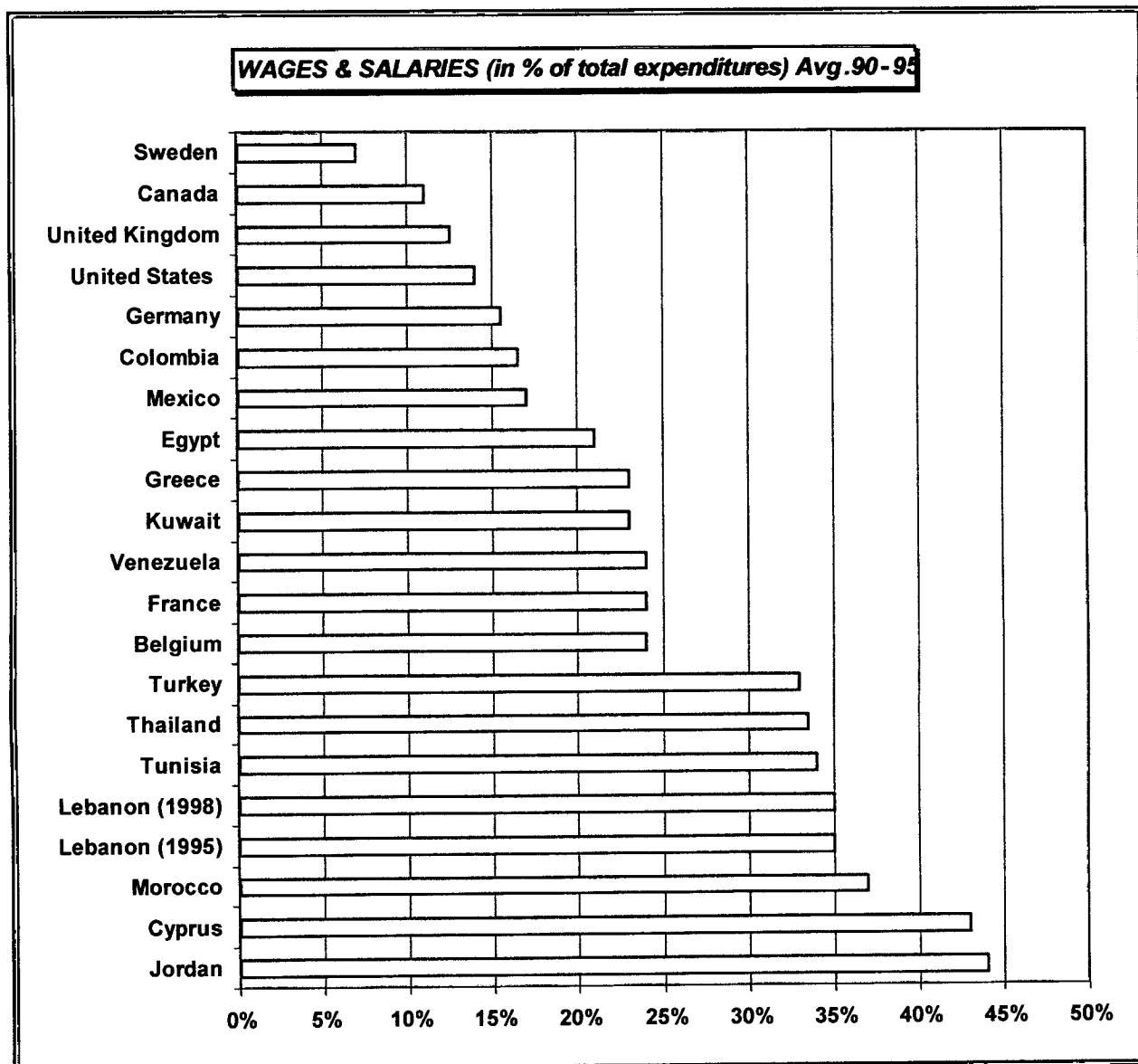
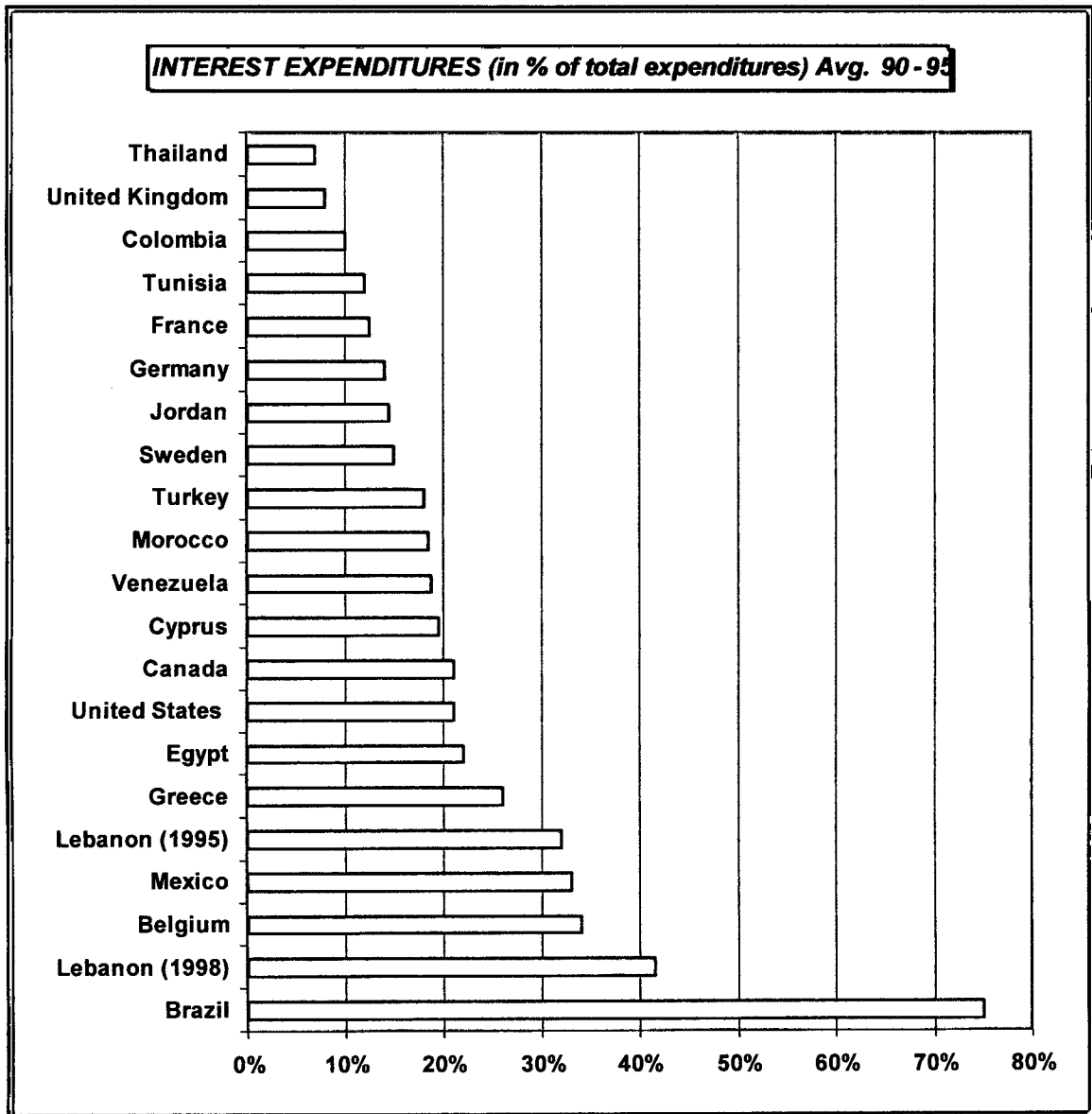


CHART 5-5 - Source: Ministry of Finance

Interest payments on the other hand were increasing much further from 32% of total expenditures in 1995 to about 41% in 1998. And this places Lebanon second only to Brazil in terms of the proportion of interest expenditures. (see below CHART):

CHART 5-6:



Source: Ministry of Finance

3. Comparative deficit and Debt Structure:

The current level of revenues and expenditures to GDP has rendered Lebanon with a very large albeit declining deficit. Naturally, these budget deficit lead to an accumulation of public debt primarily in high interest domestic debt. As a result Lebanon has a large debt to GDP ratio. However the growth rate of debt has been reduced. Furthermore, it is noteworthy that foreign debt constitutes a small proportion (24%) of total debt:

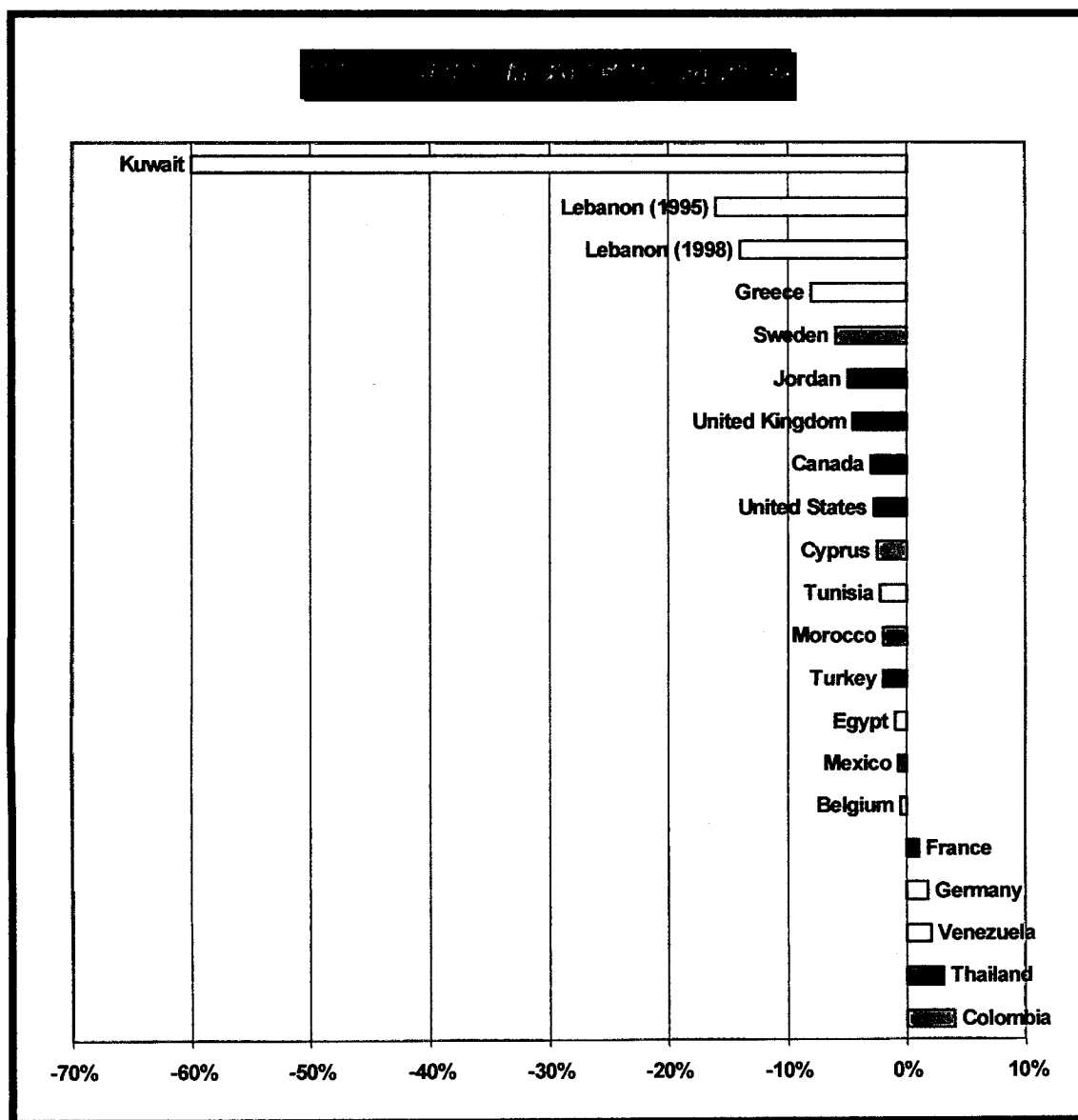
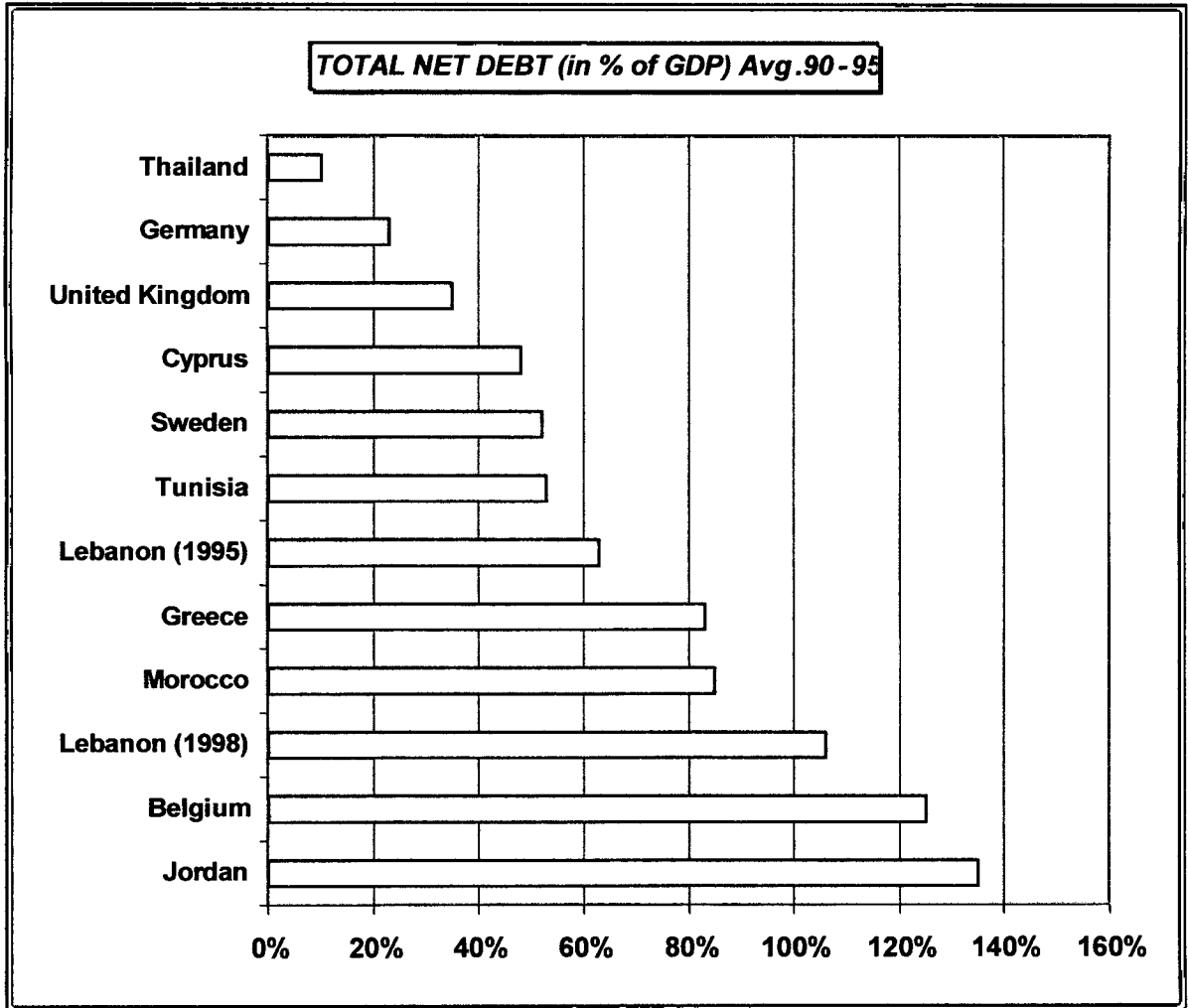


CHART 5-7: Source: Ministry of Finance

CHART 5-8:



Source: Ministry of Finance

4. Lebanon Compared to other Post-War Economies:

Above, the current economic indicators of Lebanon were contrasted with those of other countries. A major flaw in such a comparison is that, unlike the other countries, the Lebanese Government today is managing an economy emerging from a violent and protracted series of events that lasted almost two decades.

It is, therefore, useful to compare Lebanon today with other countries that faced the challenge of managing a war damaged economy. The list of countries is large and has been reduced to five; namely the United Kingdom, France, Italy, Germany, and Japan as they struggled to overcome the effects of the Second World War.

In the immediate post-1945 period, when the fighting ceased, the European countries and Japan faced a host of crippling economic realities. The magnitude of the problems faced by each nation varied. In their effort to convert their respective industries to peacetime uses, some were more successful than others. In doing so, the United Kingdom was the most successful, with France and especially Italy, running a distant second. Germany and Japan made little, if any, progress.

In the immediate after World War II, Japan experienced a severe economic regression. Real national income in 1946 was only 57% that of 1934-36; foreign trade was so minimal that even two years later, exports were only 8% and

Source: Ministry of Finance

imports 18% of the prewar figures. In 1947, the price level increased a hundred times; with wages down to only 30% of their 1936 level, the purchasing power of wages in Japan was less than one-tenth of the prewar level. In sum, the situation in 1946 and 1947 did not provide a stable and healthy basis for reconstruction. High inflation, rampant speculation, high government and balance of payments deficits, were symptoms of instability (shared with Italy and France). With a relatively low level of aid coming into the country, the Japanese Government found great difficult in tackling such economic problems.

The German economy's gradual emergence from the chaos of the summer of 1945 showed no more sense of direction than did the Japanese. German national income and output in 1946 was less than one-third of that of 1938. In 1947, industrial production was approximately one-third, and average productivity around one-half their prewar levels. A severe shortage of raw materials and export markets was compounded by strict controls upon industry. This control was often blamed for the loss of foreign exchange earnings and the flourishing of barter and the black market. It is especially difficult to chart the exact course of recovery in Germany at least not until massive aid started pouring into the country, the monetary reform implemented ant the national debt canceled.

As the European countries emerged from the second wold war, it was difficult to differentiate, in economic terms, between France and Germany. France witnessed large-scale fighting in 1944, which destroyed much of its infrastructure and rendered its transport system unusable. By the end of the war,

French imports and exports plunged to almost nothing, and the national income stood at half its 1938 level; foreign currency reserves were depleted, and the French Franc was not accepted on the foreign exchange markets. Furthermore, prices doubled between 1945 and 1946. According to official indices, real wages fell to only 60% of prewar levels. Because of the black market, these figures overestimate real purchasing power.

Italy's economic fate seemed almost as grim. At the end of the war, Italy's gross national product was equal to its 1911 level, and was less by 40% in real terms its prewar level. Real wages were down 26.7% of their 1913 value. Extremely low wages coupled with a rapid inflation prevented increase in the standard of living. By 1947, price increases were running at nearly 100% according to the official cost of living index, and rather more if the black market is taken into consideration. The gravity of Italy's economic position can be better understood, when one considers that in 1947, productivity was slightly more than half its prewar level, and the country was running a deficit in both the government budget and the balance of payments. Faced with the above problems the government, at the time, seemed to have very few solutions.

The United Kingdom fared best in its post-war recovery period. Still the country faced a host of economic difficulties. By the end of the war, the national debt was approaching three year's GDP (twice the 1930's level). Gold and dollar reserves were rundown, and domestic machinery worn out. The country faced difficulties in financing its imports bill; the balance of payments deficit of 4% of GDP had to be cut, and the constantly present inflationary threat eliminated. In

fact, in 1945, J.M.Keynes warned of the “financial Dunkirk” that was facing the nation if aid was not quickly provided. Without such help, Keynes warned “... a greater degree of austerity would be necessary than we have experienced at any time during the war...” The economic situation in Britain would have been much worse, the economic recovery delayed further, had it not been for the USD.3.5 Billion loan that Keynes himself negotiated in Washington in 1945.

The post-war economic experience of Europe and Japan was characterized by rising unemployment, cuts in consumption, accelerating inflation, rampant speculation, budget and balance of payments deficits, and lack of effective planning.

5. The post-World War II Recovery Program:

On June 5, U.S. Secretary of State Marshall proposed a European Recovery Program (ERP). The ERP, which became known as the Marshall Plan, was a massive program of economic aid to Western Europe. Initially, Marshall suggested that USD.5. or USD.6. Billion a year might be required from the United States; the final aid package amounted to about USD.30. Billion, a huge sum in the late 1940's. While the Marshall Plan was confined to Europe, a similar shift of policy towards Japan soon followed.

Source: Ministry of Finance

As soon as the Marshall Plan was announced, the International Monetary Fund and the World Bank eased their tough lending conditions; together they lent more than USD.1.Billion to Europe in the next twelve months. Furthermore, the US congress agreed to extend a USD.600. Million in emergency aid for France, Italy, and Austria to tide them over until Marshall funds became available. By 1949, total net ERP aid after utilization of drawing rights to only five European countries represented about 9% of those countries'GDP.

Even with all the available funds, economic recovery in Europe and Japan was not immediate. Complete recovery did not occur until the mid-1950's, and after undertaking several drastic measures. In most countries, and the U.K. in particular, labor unions cooperated with the governments and accepted wage sacrifices. Indeed, all sectors sacrificed because of the war. Through hard work and perseverance, however, they were able to surmount the social and economic difficulties they faced.

War recovery periods differ from country to country. Lebanon's economy has traditionally depended on tourism, services, and trade. Rebuilding these sectors requires financial investment, and more importantly, time. Furthermore, Lebanon, during the period of turmoil, did not benefit from the presence of a fully functioning public administration. In fact, Lebanon emerged in 1990 with its state apparatus dismantled and ineffective. This administrative weakness was, and to this day remains, one of the major challenging tasks facing Lebanon.

It took the European countries a decade and a half to fully offset the damages of war, and Japan even more. Today, Lebanon is confronting some of the same difficulties that those countries experienced.

Chapter VI

ECONOMIC IMPLICATIONS OF THE DEBT

Having reviewed the growth and the status of the debt, we can now turn to its economic implications. The problem is how outstanding debt affects the functioning of the economy, i.e. how the debt consequences bear on future economic. Will not continued debt accumulation lead to fiscal bankruptcy?

Or, if granted that fiscal bankruptcy is unrealistic, does not debt finance place an unfair burden on future generations?

1. Interest cost and fiscal solvency:

Eventually, however, the cost of servicing this borrowing became too deep. It's estimated that paying the interest on the domestic debt might consume almost all revenues collected. The reverse fact is also true, namely that the primary balance in the budget is in much better shape when interest payments are excluded. A crucial element in the necessary fiscal adjustment is tackling the heavy burden of repaying debt.

In fact, with these higher interest rates, not only the Government incurred itself high repayment cost but also led the economy to recession. And as the debt grows larger and larger, how will it ever be possible to repay it? In fact, public debt need not be repaid, since the budget and the economy are a continuing undertaking. The debt is 'refunded'. In short, refunding operations are a management problem and whether we can 'repay' the debt is a misdirected question. The issue rather is how interest service will affect the economy and how outstanding debt enters into the liquidity structure of the economy.

To service this debt, interest must be paid. Taxes raised to finance these payments impose a burden on the economy. This burden doesn't arise because resources are withdrawn from the economy but because it affects investments, decreases consumption, and leads to economic recession with slower growth. This is on one hand. On the other hand, Taxes which will be imposed to finance this cost of debt carry usually a deadweight loss and this places another burden on the economy(*).

(*)The tax rate t required to finance interest is given by $t=id/(1+id)$, where i is the interest rate and d is the ratio of debt to national income Y . With a high increase in i and d , the increase of t will be relatively very small.

The severity of such effects is likely to rise as the ratio of tax-revenue (needed to serve the debt) to GDP increases. In 1997, Debt service reached LL.3,200 and was higher than tax-revenues collected of LL.3,152, which is abnormal.

Conceivably, it appears as if it is heading towards larger ratios so as to pose a serious problem. But from past experiences, debt accumulation during wars may be so drastic as to lead to fiscal breakdown and debt repudiation in the postwar period like ours today. These events occurred in Europe countries after both world wars.

The danger inherent in continuing high deficits lies in fact not so much in their effect on the magnitude of debt as in their current impact on the fiscal-monetary mix and thereby on the economy's rate of saving and hence, growth which both in fact are affected nowadays in Lebanon. Continuing expansion of the debt combined with a constant GDP would lead in fact to infinite Debt-to-GDP ratio. But GDP also expands and it may be shown that an increasing ratio of deficit to GDP combined with a constant (or decreasing) rate of growth of GDP will cause both the ratio of debt to GDP and the ratio of interest to GDP to grow steadily; And that is why it is better to keep growth of GDP > than the ratio of Debt-to GDP):

More specifically, the Debt-to-GDP ratio approaches $\frac{i}{\square/r + i}$, where \square is the growth rate of GDP and r is the ratio of deficit to GDP. With $\square=7\%$ and $r=5\%$. The debt-to-GDP ratio approaches 1.4. The interest-bill-to-GDP ratio approaches =

$$\frac{i}{\square/r + i}$$

With i (interest bill to debt) = 10% and r and \square as before, the interest-bill-to-GDP ratio approaches 6.7. But with actually $i=12\%$, $r=14\%$ and $\square=2\%$ (estimated), the limit goes to 36.4.

Source: Public finance and Fiscal Policy, 5th ed., McGraw HILL, 1989.

2. Impact of the debt on future generations:

Granted that fears of fiscal bankruptcy are unrealistic, does not debt finance place an unfair burden on future generations? How does such a burden transfer come about and what is its bearing on fiscal equity?

If resources are fully employed, an increase in public services shifts resources from the private to the public sector, leaving less for the production of private goods. And this what happened in Lebanon all through the past seven years. By this resource release, the burden is borne by the present generation.

At first mechanism of burden transfer is provided through reduced capital formation. Given such system, any transfer of resources from private to public use leaves the private sector with fewer resources. In this sense, the burden of today's public expenditures is borne by today's generation. But the resource withdrawal from the private sector may be from consumption or from capital formation. In the first case, the welfare of the present generation, as measured by its consumption, is reduced and the income of the future generation is unaffected. In the second, the consumption welfare of the present generation is untouched while the future generation will inherit a smaller capital stock and thus enjoy a lower income. In this sense, the future generation is burdened. If we assume that further that tax finance comes out of consumption and loan finance comes out of saving (like what is happening in Lebanon), it then follows that loan finance burdens future generations.

Source: Public finance and Fiscal Policy, 5th ed., McGraw HILL, 1989.

The mechanism of burden transfer through foreign borrowing differs in several respects. A first difference is that there is no need for generation 1 to reduce its expenditures. Outlays in the private sector can remain intact because the additional resources needed for the public outlay are acquired abroad. Loan finance now imposes a burden on generation 2 not by leaving it with reduced capital endowment at home but by saddling it with an obligation to service the foreign debt. Taxes must be paid to finance interest paid to foreigners rather to domestic holders of the debt. And this what inevitably is going to promulgated in Lebanon through new fiscal policies.

Although the mechanism of burden transfer may be used to spread the cost of public investment, it cannot be used to spread the cost of development program, broadly defined, because such a program requires that total formation (public and private) be increased. But no gain is made toward achieving this objective if public capital is loan-financed, where this causes an offsetting decline in the rate of private capital formation. The mechanism of burden transfer through internal loan finance is unfortunately therefore inapplicable. Such is not the case, however, with regard to foreign borrowing, the role of which will considered further when development finance is examined.

Chapter VII

ANALYSIS OF THE 1999 BUDGET PROPOSALS

The new government headed by Prime Minister H.E. George Corm submitted the to Parliament the proposals for the 1999 along with a financial recovery program that rests on the twin pillars of tax reform and privatization, taking into consideration the necessity of more tax justice and balance. These steps were put within precise and studied programs set for coming years.

Main challenges faced while preparing the 1999 budget proposals:

1- The economic situation and its impact upon the public finance:

- The public finance dilemma, and its of two parts:
 - Continuing to incur high deficit rate that reached in 1998 45% of expenditures and 13.8% of GDP.
 - Volatile accumulation of public debt from 49% of GDP in 1993 to 114% in 1998, leading to considerable increases in debt servicing.

Source: Ministry of Finance.

□ Economic crisis:

The economy witnessed, due to accumulated deficit, a remarkable and a continued slow-down in the growth rate since 1996. Added to this, the high level of unemployment and the cost of production that limits to some extent the investment opportunities.

2. Additional Expenditures:

Some expenditure items had to be calculated into the 1999 budget because they were inherited from previous years, like:

- The increase in wages and salaries of about LL.500.Billions.
- The increase of the debt service by LL.700.Billions
- The continuing support of the Lebanese Electricity Institution, both by importing the needed Fuel and repaying its external debt.
- The increase of councils' expenditures, especially those of The Reconstruction and Development Council and the council of the South and of the Displaced.

Now as for the whole 1999 budget proposals:

Revenues were estimated at LL.4, 990.Billions, and expenditures at LL.8,360.Billions, resulting in an estimated deficit of LL.3,370.Billions. The details for revenue and expenditure proposals are as follows:

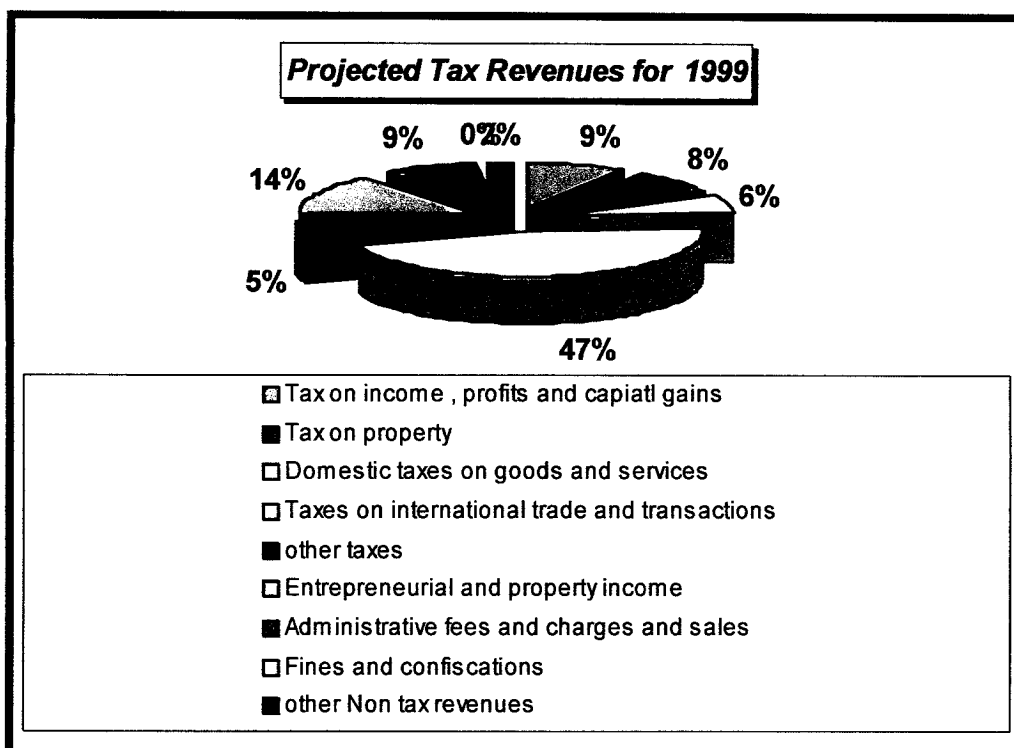
1. Revenues:

Revenues are estimated to increase by about 13% in 1999 to LL.4,990.Billions, of which LL.3, 725.Billions as Tax revenues (as 75% of total revenues) and LL.1, 265.Billions as Non tax revenues:

Table 7-1: TOTAL REVENUES

	Budget 1998	Actual 1998	Proposed Budget 1999
Tax on income , profits and capital gains	440	390	455
Tax on property	410	356	422
Domestic taxes on goods and services	296	234	312
Taxes on international trade and transactions	2,190	1,895	2,286
other taxes	230	676	250
TOTAL TAX REVENUES	3,566	3,551	3,725
Entrepreneurial and property income	554	486	719
Administrative fees and charges and sales	406	353	450
Fines and confiscations	11	18	18
other Non tax revenues	63	22	78
TOTAL NON-TAX REVENUES	1,034	879	1,265
TOTAL REVENUES	4,600	4,430	4,990

Chart 7-1:



Source: Ministry of Finance

1st- Tax modifications:

The most important modifications that have been entered to the Revenues of 1999 are:

□ The reconsideration of wage and salary taxation because levels and scales of these taxes are relatively low compared to those of neighborhood and developed countries. Therefore, the HOSS government reconsidered those taxes to be more balanced, increasing thus the family deduction value from LL. 6Millions to LL. 12,5Millions for the married couple with 5 children. The average maximum tax reaches on the other hand 11,7% for the married couple with 3 children.

□ The widening of tax scales imposed on wages and salaries with an moderate increase of taxation on higher scales by progressive 20%, like follows:

Tax Scales (wages & Salaries)

Table 7-2:

SCALES	TAX %
Up to LL.6, 000,000.	2%
From LL.6, 000,001. To LL.15, 000,000.	4%
From LL.15, 000,001. To LL.30, 000,000.	7%
From LL.30, 000,001. To LL. 60,000,000.	11%
From LL. 60,000,001. To LL. 120,000,000.	15%
From LL. 120,000,001. And above	20%

Source: Ministry of Finance

And to be fairer, the scales were made so as the tax burden up to LL.41,5 Millions salary would have less impact on those married couples with 3 children.

- The increase of average tax on lump sum wages from 2% to 3%.
- The reconsideration of the income tax law imposed on commercial profits as well as on those of personal establishments and professions. And here also by increasing the level of family deductions from LL.6Millions to LL.12,5Millions for the married couples with 5 children and tax rate on higher scales up to 25%, progressive as follows:

Table 7-3: Tax Scales (Commercial/Personal Est. & Professions)

SCALES	TAX RATE
Up to LL. 9,000,000.	5%
From LL. 9,000,0001. To LL. 24,000,000.	10%
From LL. 24,000,001. To LL. 54,000,000.	15%
From LL. 54,000,001. To LL. 104,000,000.	20%
From LL. 104,000,001. And above	25%

Source: Ministry of Finance

And therefore, the tax rate along with the family deductions will not exceed the 16,7% for the married person with 2 children, which is considered to be the average measure of a family in Lebanon.

- The reconsideration of corporate tax rates, increasing them on Profits from 10% to 15% and from 5% to 10% on Dividends.

- The reconsideration of the taxes imposed on Current equities and allowances of the board of directors' members from 5% to 10%.
- The reconsideration of taxes imposed on fixed assets reevaluation by increasing them from 6% to 10%.
- The reconsideration of constructed property taxation divided into a Relative and a Progressive one:
 - A Relative Tax with a fixed rate of 4% to be imposed on the overall net revenues of the whole building after deducting LL.6Millions of the owner's house and of two others.
 - A Progressive tax to be imposed in addition to the Relative one on all that exceed LL.20, 000,000. of the total net revenues generated by one tax-payer from all what he owns or exploit in each district apart. And these taxes will be imposed according the scales and the averages in table below where the maximum tax rate would not exceed 12,5%:

Table 7-4: Construction Property Taxation

SCALES	TAX RATE
From LL.20, 000,000. To LL. 40,000,000.	2%
From LL. 40,000,001. To LL. 60,000,000.	4%
From LL. 60,000,001. To LL. 100,000,000.	7%
From LL. 100,000,001. To LL. 180,000,000.	10%
From LL. 180,000,001. And above	15%

Source: Ministry of Finance

- The reconsideration of the tax scales imposed on inheritances, deeds, wills, donations where the rate was increased to 16% on the last scale of 1st category inheritance as follows:

Table 7-5: Inheritances, deeds, wills & donations Tax Scales

SCALES of Tax on Inheritance	Category1	Category2	Category3	Category4	Category5
Up to LL. 30,000,000.	3%	6%	9%	12%	16%
From LL. 30,000,001. To LL. 60,000,000.	5%	9%	12%	16%	21%
From LL. 60,000,001. To LL. 100,000,000.	7%	12%	16%	21%	27%
From LL. 100,000,001. To LL. 200,000,000.	10%	16%	20%	26%	33%
From LL. 200,000,001. To LL. 350,000,000.	13%	20%	24%	31%	39%
From LL. 350,000,001. And above	16%	24%	28%	36%	45%

- Category1: Family members
- Category2: Parents
- Category3: Relatives other than parents, brothers and sisters
- Category 4: Uncles, aunts, nieces and nephews.
- Category5: other taxpayers.

Source: Ministry of Finance

The modifications of some consumption fees:

- The increase of customs fees on luxurious commodities or some products competing with those manufactured locally.
- The increase in the 20 liters of gasoline by LL. 2,000., knowing that more than half of this increase is referred to the increase in prices world wide.
- The increase of customs fees on tobacco and its derivatives.
- The increase of work and foreigners permits fees, assuming that this would contribute to solve the unemployment problem and reorganize the employment market in Lebanon.
- The increase of Airport fees.

2nd- Tax Reductions and Exemptions:

- Decrease of the customs fees on the industrial raw materials that are not produced locally.
- Decrease in the real estate registration fees by 15% for Lebanese and foreigners from 6% to 5.1%.
- Decrease in domestic telephone fees from LL. 20,000. to LL. 12,000.
- Settling income taxpayers' situation for the years 1987-1991.
- Cancellation of all penalties imposed on non-paid taxes and fees up to 1998.

2. Expenditures:

On the expenditure side, budget expenditures are expected to reach LL. 8,360.Billions proposed as follows:

Table 7-6: TOTAL EXPENDITURES

(Billions of LL.)	Budget 1998	Budget 1999	Difference	%Growth
Current expenditures	3,572	3,602	30	0.84%
Financial expenditures	3,200	3,900	700	21.88%
Total of First Part	6,772	7,502	730	10,78%
Total of Second Part (Investment expenditures)	548	858	310	56,57%
TOTAL EXPENDITURES	7,320	8,360	1,040	14,21%

Source: Ministry of Finance

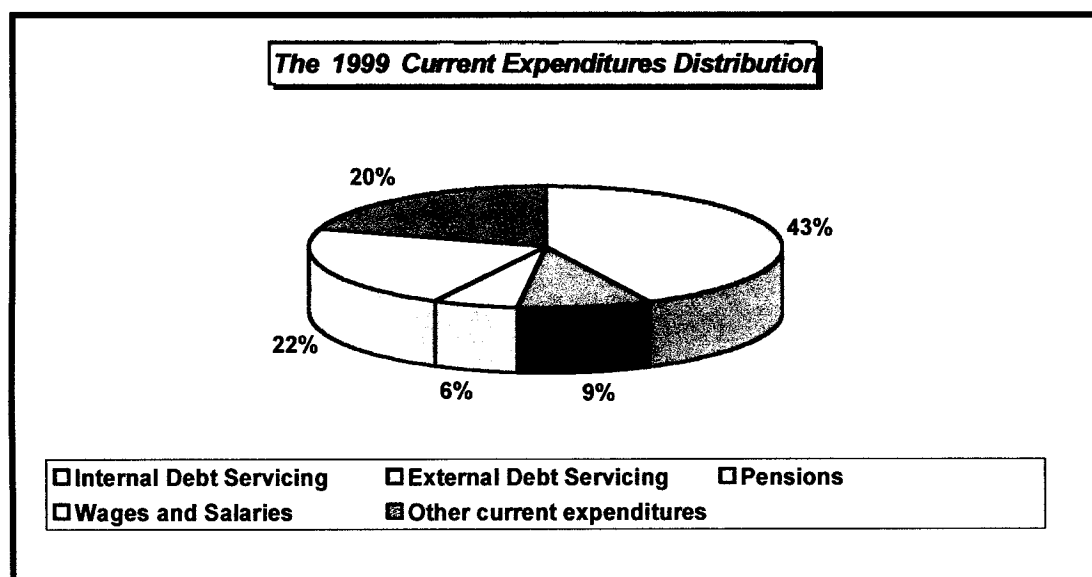
1st- The current expenditures:

The current expenditures for 1999 reached LL. 7,502 Billions, representing the biggest part of total expenditures and are constituted of Debt servicing and Wages and Salaries.

Table 7-7:**The Current Expenditures**

(in Billions of LL.)	Budget 1998	Budget 1999	Difference	% Growth
Internal Debt Servicing	2,900	3,200	300	42,65%
External Debt Servicing	300	700	400	9,33%
Pensions	300	434	134	5,78%
Retirement Indemnities	220	310	90	4,13%
Verdicts and reconciliations	5,98	5,99	0,012	0,08%
Banking commissions	0,7	0,7	-	0,01%
Wages and Salaries	1,361	1,644	284	21,92%
Employees' social services	196	198	2	2,64%
Social welfare for public administrations	97	94	-3	-1,26%
Social welfare institutions	367	144	-223	-1,92%
Rentals and related services	51	59	8	0,79%
Transportation	8	6	1,9	0,08%
Raw materials and maintenance	110	100	10	1,33%
Administrative expenses	47	37	10	0,5%
Other current expenditure items	11	9	-2	-0,12%
Hospitalization expenses	218	220	2	2,93%
Educational expenses	1	0,5	-0,6	0,01%
Other social welfare	298	244	-54	-3,25%
Budget reserves to be used for various items	280	95	-184	-1,28%
TOTAL CURRENT EXPENDITURES	6,772	7,502	730	100%

Source: Ministry of Finance

CHART 7-2**Current Expenditure Distribution**

Source: Ministry of Finance

2nd- The Investment and Constructive Expenditures:

The Hoss government was desirous on increasing the rate of investment expenditures in the proposed budget where the second part expenditures reached LL. 857 Billions i.e. a 10<2% of total budget.

The Table below shows the second part of expenditures as distributed on different ministries: **TABLE 7-8:** (in Millions of LL.)

Ministry	Amount	Ministry	Amount
1 Presidency of council of Ministers	489,595	16 Ministry of Tourism	430
2 Ministry of resources	87,841	17 Presidency of Republic	375
3 Ministry of public Works	85,584	18 Ministry of Information	298
4 Ministry of Transportation	74,662	19 Min.of Municipal&Rural	234
5 Ministry of National Defense	36,981	20 Min. of Post&Telecomm.	164
6 Ministry of Culture&Higher Educat.	34,344	21 Ministry of Econ.&Trade	154
7 Ministry of Interior	13,193	22 Parliament	130
8 Ministry of Education	12,371	23 Ministry of Displaced	123
9 Ministry of Vocational&Technical t.	10,330	24 Ministry of Industry	115
10 Ministry of Public Health	4,271	25 Ministry of Social Affairs	91
11 Ministry of Foreign Affairs	2,543	26 Min.of Housing&Coop.	73
12 Ministry of Agriculture	1,252	27 Ministry of Labor	43
13 Ministry of Finance	1,083	28 Ministry of Oil	30
14 Ministry of Justice	539	29 Ministry of Emigrants	30
15 Ministry of Environment	450	30 Constitutional Counsel	7
TOTAL		857,334	

Source: Ministry of Finance

3. Overall Position:

There are several favorable features in the 1999 budget proposals that are shown through expenditure orientation by lowering the current expenditures and increasing the investment and constructive ones. Thus, aiming towards better spending that enables to share the private sector in removing the cyclic economic trend.

On the other hand, the government worked on leveling up the revenues by reconsidering some taxation rates and scales. It tried on the same time to realize better fairness by redistributing wealth and creating better conditions to keep on social and economic balance.

The government therefore was able to decrease deficit despite the wages and salaries and the public debt servicing increases expected in 1999. The government also tackled the “delays” problem by issuing special T.Bills that can assure liquidity in the Lebanese market.

In fact, what has been counted in the 1999 budget proposals rests on ambitious and realistic reform plans in the same time. Fore, this budget is a first step in a five-year plan that aims to reorient the budget and readjust the public finance.

This plan rests on four basic pillars:

- 1- Tax reactuation and reform by imposing the Value-Added tax and implementing the unified income tax program.
- 2- Reorganization and restructure of public sector through administrative reform so expenditures would be more oriented and therefore shrunk.
- 3- Letting the private sector share into some infrastructure projects and privatization of some public entities to offset a part of the public debt.
- 4- Public debt restructure and improving its management by establishing a unit within the ministry of finance to handle the public debt management.

Chapter VIII

A FRAMEWORK FOR A DEFICIT REDUCTION EFFORT

Described below is a simple framework for a deficit reduction effort. It is not offered as a blueprint solution for Lebanon's fiscal troubles. Rather it is intended to highlight the issues, mechanisms and kinds of measures that would need to be employed in constructing a viable deficit reduction effort in Lebanon. The answers to the issues that will be raised are, in the final analysis, judgmental. Lebanese society, as a whole, is required to arrive at a reasonable consensus on certain fundamental questions as a basis for creating an effective fiscal adjustment policy. Broadly these questions are: What level of expenditures can the country afford? What pattern and level of taxation is fair and appropriate in Lebanon? What size of public sector is proper for Lebanon? What are the trade-offs between holding assets and incurring debt?

The objective in this illustration exercise is to eliminate the budget deficit denominated in Lebanese Pounds over the four fiscal years 2000-2004 and to limit the deficit to a maximum of the equivalent of 3% of GDP. The assumptions underlying this scenario are:

One) Annual GDP growth of 6% in 2000, 8% in 2001, 10% in 2002 and 12% in 2003.

Two) Revenue growth in line with the nominal expansion of the GDP

Three) A freeze in nominal terms on total expenditures in Lebanese Pounds at LL.8,000.Billions in 2000 with only slight unpredictable increases of about 2.5% each year until 2003.

Broadly, total expenditures are estimated to attain about LL.8,360.Billions in 1999 and revenues approximately LL.4,990.Billions. With these preliminary estimates, the deficit would be equivalent to nearly 13.5% of GDP that is considered to be this year stagnant at about LL.25,000.Billions with an inflation approaching zero. (See table 1). Specifically, it is assumed that:

1. Revenues would increase mainly by LL.3,000. additional increase in 20liters of gasoline, a 5% sales tax and a value-added tax, and a LL.5 Billions revenues to be collected in 5 years from sales of assets (privatization procedure).

2. Total expenditures would be limited to LL.8,000. starting year 2000 with slight increases each year to LL.8,600. in year 2003. Such an objective, however, would appear to be unrealistic. But, if it is to be implemented

effectively, it would require steep cuts in spending, much more than appears to be under current discussion. There is a widespread view that a significant amount of government spending is squandered. Without taking a position on this matter, practical considerations dictate that a fiscal policy cannot be established on the assumption that waste would be reduced if not eliminated. The first step should be to achieve the savings, by reducing waster, and at once this becomes a fact to adjust fiscal policy accordingly.

3. Social and capital expenditures to be financed from the proposed package of approximately \$1Billion of borrowed cash would be spread over a number of years and would be included under the LL. 8,000.Billions limit for total expenditures. Under present procedures this proposed borrowing, and the expenditures it would finance, can be presented and approved by parliament under legislation separate from the budget. But from an analytical point of view (for the purpose of this exercise) these expenditures are considered as being covered by the overall ceiling on government spending, and the drawings on the loans as part of the financing of the budget deficit.

With these assumptions, revenues and expenditures are calculated almost to balance at the equivalent of respectively 21.3% and 24.4% of GDP in 2003; somewhat higher than the historical levels experienced in Lebanon in the pre-war years (under 20% of the GDP). On the basis of these assumptions more than three-quarters of the adjustment effort would fall on measures to reduce spending, and the balance accounted for by the new methods of obtaining revenue.

Obviously, the proportions of the mix could be varied. It is believed, however, that in Lebanon's present circumstances reducing spending would appear to be more feasible technically and politically as well. Technically, because curtailing expenditure could ensure that spending limits are not exceeded, while revenue generation is less predictable. Politically, expenditure restraint, more than revenue augmentation, could be perceived as a passive instrument. Finally, within the spending limit, the authorities could exercise some flexibility in rearranging, admittedly to a limited degree, the pattern of expenditures. In fact, when considerable savings in interest payments is achieved, the room for non-interest expenditures would increase.

*Summary of Government Finances 1993-2003
(in Billions of LL)*

TABLE 8-1:

	Actuals						Estimated	Projected			
	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
GDP	13.12	15.34	18.06	20.41	22.88	24.51	25.00	26.50	28.62	31.48	35.26
REVENUES	1.86	2.24	3.03	3.53	3.75	4.43	4.99	5.50	6.50	6.90	7.50
EXPENDITURES	3.02	5.20	5.86	7.29	9.16	7.82	8.36	8.00	8.20	8.40	8.60
DEFICIT	1.16	2.96	2.82	3.75	5.41	3.39	3.37	2.50	1.70	1.50	1.10
DEFICIT/EXPEND	38.5%	57%	48%	51.5%	59%	43.3%	40.3%	31.3%	20.7%	17.9%	12.8%
REVENUES/GDP	14.1%	14.6%	16.8%	17.3%	16.4%	18.1%	20%	20.8%	22.7%	21.9%	21.3%
EXPEND./GDP	23.0%	33.9%	32.4%	35.7%	40%	31.9%	33.4%	30.2%	28.7%	26.7%	24.4%
DEFICIT/GDP	8.9%	19.3%	15.6%	18.4%	23.6%	13.8%	13.5%	9.4%	5.9%	4.8%	3.1%
REVEN./EXPEND.	61%	43%	52%	48%	41%	57%	56%	69%	79%	82%	87%

Source: Banque Du Liban

Revenue Measures

Treasury revenues would be expected to rise in line with the anticipated growth in the GDP. Some measures might be needed to ensure that this happens. If this was the only thing to occur, the ratio of revenues to GDP would remain at approximately the 18% level, and the deficit, in the context of the scenario, would not be eliminated. Hence the need for additional revenue measures estimated at the equivalent of 3% of GDP.

To ensure revenue growth balanced along with the expansion in the economy, the efficiency of the tax system would have to be strengthened in order to reflect economic trends. Tax laws would need to be enforced and collection procedures improved. Duties, fees, and utilities charges should be collected. Without strict enforcement, revenue collections would lag and public utilities would experience financial difficulties, translating into additional burden on the Treasury. Wheat and petroleum prices would need to reflect international prices, and in the case of the latter commodity to secure significant income for the budget.

In addition to ensuring that receipts keep pace with growth in the economy, new revenue measures are needed to raise the revenue-to-GDP ratio. The Hoss government has effectively raised the income tax from the range of 2%-10% to 3%-21% (which are still the lowest in the Mediterranean region), but while these direct taxation had been revised, the larger part of new revenues would likely need to be raised from indirect taxes – especially a sales tax or a

value-added tax. Most of Lebanon's neighbors in the eastern Mediterranean region have a sales tax.

When and if Lebanon starts implementing an association agreement with the European Union, a further strengthening of the indirect tax already in place would need to be undertaken in order to recoup revenue losses resulting from the tariff duty reductions which is required in the partnership agreement with the EU.

Value-added tax (VAT) is a step that we cannot escape from since we became an observer country within the World Trade Organization (WTO). So this is something that we should confront, and the sooner the better. But it is preferable to start with a very low rate, like 3%, and keep custom duties as they are for the time being. This would give us time to start educating people about the concept of VAT. Once the government set up the administration, the rates can then be increased with a corresponding decrease in custom duties.

Besides the new direct taxation imposed by the government and a tax sales to be implemented in the 4 projected budgets, two main sources of revenues were also considered. First, the increase of the 20liters gasoline by LL.3,000. And this increase would generate about LL.200.Billions for the budget. Added to these, a tax increase on tobacco. Second, the privatization of the major institutions like telecommunications, electricity, MEA, the tobacco régime that would generate about LL.5Bbillions in the next 5 years.

Expenditure planning and control

Total expenditures in the budget in Lebanese Pounds are estimated at LL.8,360.Billions in 1999. The objective for the four years 2000-2003 could be to place an absolute limit on these expenditures at LL.8Trillion in 2000 up to LL.8.6Trillion in 2003. This ceiling could be comprehensive and include all disbursements from the specialized funds (CDR, council for the Development of the South and the fund for the displaced people) and from cash borrowing abroad. The only expenditures that would not fall under the ceiling would be project expenditures financed by external loans secured on appropriate terms. Strict implementation of the ceiling on aggregate expenditures, assuming nominal GDP growth of from 6% in 2000 to 12% in 2003, could be expected to reduce effective government spending by 9% of GDP to about 24% of the GDP in 2003.

In the context of Lebanon's fiscal arrangement, meaningful priorities of expenditures would make better sense if all government outlays (excluding project expenditures financed entirely by external loans) were examined simultaneously and relative to each other, regardless as to whether the legal formalities require it or not. In the budget itself, expenditure flexibility is virtually non-existent because budgetary outlays are dominated by given items such as wages and interest on the debt.

Debt Management

Interest payments on the public debt have risen sharply in recent years and in 1999 are estimated to account for nearly half of budgetary expenditures. Consequently, a crucial element in attempting to achieve viable spending policies under a ceiling would be to reduce the burden of interest payments. Every Lebanese Pound not lost in repaying the interest payments is a freed resource available to finance other outlays. Reversing the trend in interest payments is vital for a successful reduction of the deficit. Without it the budget is in danger of being overwhelmed by the swelling tide in interest payments.

There are four ways to achieve this objective, and all four instruments could be used simultaneously. First, of course, is to reduce the fiscal deficit itself, and therefor the financing needs of the budget. Second, is to reduce interest rates. Third is to reduce the stock of the debt, and fourth is to reduce rearrange the debt structure away from high interest instrument and towards relatively lower interest-bearing instruments.

The impact of a contracting budget deficit on interest payments is obvious and direct. A lower deficit would reduce the financing needs of the budget and could be expected to lower the interest rates at which the financing is obtained. It would also reduce the increase of the debt and it could also help in securing lower interest rates on the refinancing of maturing debt instruments.

In addition to reducing the deficit in 2000, the authorities have an unusual opportunity, through liquidity management, to effect a significant lowering of the

interest rates structure. In the recent past, a significant accumulation of public sector deposits has occurred. These had increased from LL.1,4 Trillion at the end of 1993 to LL.2,7 Trillion at the 1st quarter of 1999, representing more than the amount needed in a liquid account for normal transactional purposes. The authorities could allow a withdrawal of deposits of LL.1 Trillion in each 2000 and 2001 to finance a major portion of the projected budget deficit. The impact on new financing requirements for the budget would be very substantial, which could translate into a very significant reduction in interest rates. Again, a lower interest rates structure would open up opportunities for refinancing maturing debt to reduce further the burden of interest payments. Lowering interest rates could also be helpful in encouraging domestic economic activity.

The refinancing referred to above calls for replacing a portion of the existing Lebanese pound debt by new debt instruments, also denominated in Lebanese pounds, carrying lower interest rates and hopefully longer maturities as well. Refinancing through conversions into foreign debt instruments to take advantage of interest differential might not be prudent. The interest rates differential, and therefore the savings, would diminish as Lebanese demand for foreign borrowing rises in order to effect the refinancing. It would also mean burdening the Lebanese economy with the exchange risk, which is presently, carried by the holders of pound-denominated debt instruments. Finally, the servicing of a growing foreign debt would constitute an additional burden on the balance of payments.

The use of Lebanon's assets to reduce the stock of debt merits careful consideration. A cost benefit analysis could be undertaken to determine the balance of advantages between asset holding and debt reduction. In this assessment no category of assets should be excluded, including public corporations which might be privatized, as well as gold holdings. At the same time, the assessment would examine how many assets could be used and in what mix and proportions. In all cases, any use of assets must be surrounded by safeguards designed to ensure that the proceeds are used only in the context of a permanent reduction in the stock of debt. Given the seriousness of the subject, consideration could be given to enacting legislation that would spell out under what circumstances the assets could be used and with what safeguards. We will have to wait and see in fact the fruit of the privatization program proposed by the minister of finance George Corm. A program that according to him should generate the equivalent of \$.5.Billions in a time limit of 5 years.

To what extent should the debt be reduced? Clearly, one immediate objective is to strengthen the budget by freeing it from the burden of excessive debt payments. Beyond that task, the question that needs to be asked is what level of debt would be appropriate for Lebanon. There are no established guidelines for debt levels. Much depends on the circumstances and the objectives of the country concerned. For a small country like Lebanon, endeavoring to recapture its position as a significant financial center, the example, of the competition such as Luxembourg and Switzerland (less than 25% of the GDP) might be contemplated as a long-term goal. Broadly, a conservative debt load would range up to 30% of the GDP. The Maastricht criteria of up to 60% of the GDP, which was enhanced

to ensure relatively strong currencies within the European Monetary Union, is approximately halfway between the conservative position and the zone of risk at over 100% of the GDP. These categorizations present a rough guideline. No one should imagine that at 99% of the GDP there is no danger, and that at 101% of the GDP a crisis would erupt. Jordan presents an example of a country in the region that allowed its debt-to-GDP ratio to rise significantly above the 100% mark in the 1980s. Beginning late in that decade, and for almost ten years, it implemented several adjustment programs, negotiated debt reschedulements and sought debt relief before recovering to below the 100% mark.

Based on the fiscal results of 1998 & the estimated preliminary ones for 1999, Lebanon's net total debt to GDP is indicated at the equivalent of 114% (see Table1), the gross debt ratio is calculated to reach a higher level. The difference between the two ratios is accounted for by the considerable accumulation of public sector deposits. Given the existence of these liquid assets, which could be used to reduce quickly the stock of gross borrowing, it would be reasonable, under these special circumstances, to give more weight to the net debt concept, reducing it gradually by utilizing the accumulated deposits and therefore lessening the budget demand for borrowing. This aftermath could enhance interest rates reduction and longer term T.Bills. †

But reducing domestic rates aggressively (i.e. by some 3-5% points) in order to contain the fiscal deficit could, as a side effect, result in unsettling the balance of payments position, involving some reserve losses. This could come about because the strength in Lebanon's balance of payments situation in recent

years has been dependent to some degree upon attracting funds through the mechanism of high interest rates. The current account balance is influenced by significant inward private transfers (see Table 2):

*Summary of Balance Of Payments
(in millions of \$)*

TABLE 8-2

	1993	1994	1995	1996	1997	1998
Exports	686	743	985	1018	644	715
Imports	-4908	-5541	-6755	-7559	-7457	-7060
Trade Balance	-4222	-4798	-5770	-6541	-6813	-6345
Services + Private Transfers + Capital Movements	5391	5929	6026	7327	7233	5857
OVERALL BALANCE	1169	1131	256	786	420	-488

Source: Banque Du Liban

Clearly, the Capital inflows have more than financed the current account deficits and contributed to the reserves building up.

The gross foreign exchange reserves have increased from \$1.5 billion at the end of 1992 to above \$6.5 billion at the end of June 1999. The question that could be asked is whether there was a need to increase reserves to such extent. This increase has not been cost-free to the government. Because while accumulating reserves, the state budget cost was also increasing along with the high interest rates on government treasury bills.

A principal purpose of the reserves is to give confidence and help support the stability of the exchange rate. The difficult question is how much reserves are needed to achieve this objective. There is no straightforward answer to this question. A high reserves level might not be enough if the fiscal deficit is excessive, while a moderate level of reserves could be sufficient if the fiscal deficit is eliminated. Confidence in the currency is not dependent solely on the level of reserves, particularly when a significant portion is attracted by high interest rates. Confidence is also generated by strong policies designed to eliminate the fiscal deficit and by the performance of the economy as a whole.

All of this is as we said earlier beyond the scope of the present report.

It would be paradoxical to suggest that an effort to strengthen the fiscal position in Lebanon could lead initially to pressures on the balance of payments because normally a strengthened fiscal stance tends to help improve the balance of payments position and vice versa. Lebanon, however, now finds itself in this predicament because while the growing fiscal deficits contributed to the weakening of the current account of the balance of payments, the high interest rates contributed to attracting net capital inflows sufficient to create an overall surplus in the external account. If fiscal deficit reductions now assume an important priority, then the policy makers will need to consider how to reduce interest rates, and therefore the burden on the budget, while protecting the balance of payments position, a potentially delicate operation in its initial phases. Much will depend upon the strength and credibility of the total program designed to reduce the fiscal deficit.

Indeed, the task needed to tackle all these issues would require a number of teams. And that is what M. Corm and his team is trying to do nowadays. It might be useful however to mention three broad principles as a starting point for public discussion.

First, the smaller the government sector is, the better. This would be in line with Lebanon's traditional policy of relying on private initiatives to drive the economy; it is also the general trend in the world today. On the expenditure side, total government outlays, including investment financed by foreign loans, in the neighborhood of 25% of the GDP would appear to be feasible provided that sufficient priority is given to ensure an adequate and fair level of social services. Within the total of government spending, the portion that is clearly related to the consequences of the war, in particular the transfer payments for compensation, should be identified and phased out as soon as possible. On the revenue side, there should be room to raise domestic receipts to at least 22% of the GDP level, both through more efficient implementation and collection of existing and newly introduced taxes. Even at that level, the Lebanese tax burden would be lighter than in non-oil producing countries of the region.

Second, with lower interest rates structure, the banking system should reorient its activities away from investments in government treasury bills and toward its traditional role of financing the private sector.

Third, serious and careful consideration needs to be given to privatizing some public entities. The issues here are complex and an adequate regulatory

framework to protect the public interest should be developed. At the same time, the utilities that may be privatized, as well as existing private enterprises, should be allowed to operate efficiently – that is not to be burdened by restrictive regulations - and to compete regionally and beyond. On the other hand, when offered to public, shares must be distributed to people with restrictive or limited portions to be sold to wealthy and politically powerful persons in the country. All this would be consistent with Lebanon's traditional open and liberal economic philosophy.

Technical remarks

This report has explored an illustrative path for a deficit reduction effort. Needless to say, there are many other possible permutations for such an effort, each carrying within it implied consequences. For example, if it is considered that budgetary expenditures could not be reduced to less than 30% of the GDP, the implicit consequence would be either to increase the bid to generate new revenues very substantially or risk a continuing deficit. Here, the approach would require a very severe deficit reduction program implemented over a short period of time, and to accept the possible consequences for employment and social stability.

There are also timing issues. Why spread the effort over four years or a five-year plan that was set by the Minister of Finance, M.Corm? Would it be credible? A longer period would encompass more than one administration.

Would successive administrations be committed to the same program set by the actual Hoss government? Would such and political conditions tolerate such an approach? Then there are the aspects of the unknown, surprises such as severe aggression from abroad that could disrupt the most carefully laid plans.

A third category of questions would revolve around the validity of the underlying particular scenarios and plans. Could not the economy grow much faster in real terms? Would not a regional peace treaty transform the situation? In this area, it is important not to allow oneself to wishfully assume the problem away, nor to sink into paralyzing pessimism. The illustrative scenario discussed in the report while not pessimistic is very demanding, and nevertheless could use a margin of safety.

It is clear, however, that in Lebanon's circumstances the effort to reduce the deficit will have to be comprehensive, utilizing a wide range of instruments, and cast in the context of the medium-term program that is pursued with determination. Scenarios can be invented, developed, scrutinized and adjusted. Their intent is to explore, enlighten, and stimulate discussion. But in the end the only scenario that really counts is the one articulated and implemented by the government.

CONCLUSION

This report was completed in early November 1999 before the discussion on the budget proposals for 2000. As we said before, it doesn't offer a solution to Lebanon's fiscal difficulties. Instead, it invites reflection on a number of issues and measures that could be enhanced and presented for the consideration of policy makers and the public at large now that all available data and fiscal evolution have been exposed through this report.

In the end, the actual choice of economic instruments or combination of instruments, to tackle the fiscal situation will require defining specific, social, and economic priorities.

Of course, the new government headed by the prime minister HOSS is promising. The general orientations of the financial reforms included in the five-year plan are certainly positive. Lebanon's financial recovery rests on twin pillars of tax reform and privatization, said Finance Minister George Corm who aims to bring debt down from more than 114% of the GDP to 98% by 2003, and cut the

budget deficit to 5% of the GDP from its current 14%. Value added tax is to be introduced on the other hand in 2001, with financial help from the European Union and technical help from the International Monetary Fund. The government, Corm said, intends to bring its income from taxes up to 19% of GDP. It currently stands at 14%.

Corm also looked forward to privatization to reduce the state's wage burden, which currently accounts for 40% of the budget, with 189,000 state employees on its books, including 40,000 receiving pensions. The sectors up for privatization are the telephone service, electricity, water, the airport, ports, the national flagcarrier MEA, and the Intra Bank Investment.

Privatization is the most sensitive variable in the five-year adjustment scenario. Each \$US.1 Billion less raises the debt ratio by 5% at the horizon 2003. It is thus important to accelerate privatization and include it in the 2000-2001 budget.

Ultimately, no matter what the government's choice may be at the time being, a country that was able to rebuild two decades of war destruction in six years, counting only upon its own resources, can only inspire optimism. What is needed is only a real political will, a full-fledged determination to achieve the objectives set by the government.

Another main critical issue should be on the other hand tackled: the waste and corruption dilemma (through a real will to continue launched administrative reforms) that is believed if both eliminated or at least reduced substantially, legitimate spending can be increased with no need for additional taxation.

And finally, a clear vision as to where the country is heading in fiscal terms would help generate public support for difficult decisions, whether in terms of spending or revenues. In fact, launching open discussions in fiscal issues with the public could help a lot in making Lebanese people comprehend and accept their budget limitation. In addition, it would be more constructive if transparent cyclic economic reports are exposed by the minister of finance openly to people so that they can understand their government's reluctance or improvement and be able to judge accordingly. Socially, the situation would be more balanced by this government-people closeness.

After all, Lebanon has unfortunately the fate of being geographically where it is now, surrounded by unstable regimes and passing through a peace process turmoil that might turn to be at the end very fruitful or bring Lebanon's economy back down to where it was during war or 10 years ago!!!

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