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Lebanon
Public Expenditure Reform Priorities For Fiscal Adjustment, Growth and Poverty Alleviation

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Lebanon Fiscal Year
January 1st-December 31st

Currency Equivalent
Currency Unit = Lebanese Pound (LBP).
Exchange Rate = LBP 1,507.5 per US$ (as of June 27, 2005)

Atlas GNI per capita: US$4,980 (as of December 31, 2004).

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Abbreviations and Acronyms

ABL	Lebanese Banking Association
APEC	Asia Pacific Economic Cooperation
BdL	Banque du Liban (Central Bank of Lebanon)
BOT	Build Operate Transfer
CAS	Country Assistance Strategy (World Bank Document)
CAS	Central Administration of Statistics
CDR	Council for Development and Reconstruction
CFAA	Country Financial Accountability Assessment
CIB	Central Inspection Board
CIS	Community of Independent States
CPI	Consumer Price Index
CPIA	Country Policy and Institutional Assessment
CPPR	Country Portfolio Performance Review
CSB	Civil Service Bureau
DBOT	Design Build Operate Transfer
DOT	Department of Tenders
DPT	Diphtheria, Pertussis and Tetanus
EdL	Éléctricité du Liban (Lebanon Electricity)
EDP	Education Development Project
EMU	European Monetary Union
ENA	Ecole Nationale d'Administration
EOSI	End-of-Service Indemnity
ERF	Economic Research Forum
EU	European Union
FAD	Fiscal Affairs Department (IMF)
GATFA	Greater Arab Trade Free Area
GDDS	General Data Dissemination System
GDP	Gross Domestic Product
GIT	Generalized Income Tax
GFS	Government Financial Statistics
GFMIS	Government Financial Management Information System
GNI	Gross National Income
GoL	Government of Lebanon
GST	General Sales Tax
HMIS	Health Management Information System
HR	Human Resources
IDAL	Investment Development Authority of Lebanon
IMF	International Monetary Fund
ICT	Information and Communication Technology
IT	Information Technology
Kwh	Kilowatt per hour
LBP	Lebanese Pounds
LIBOR	London Inter Bank Offering Rate
MENA	Middle East and North Africa

MNSED	Middle East and North Africa Social and Economic Development (Group)
MoE	Ministry of Education
MoET	Ministry of Economy and Trade
MoF	Ministry of Finance
MoPH	Ministry of Public Health
MoSA	Ministry of Social Affairs
MTEF	Medium-Term Expenditure Framework
MW	Mega Watt
NGO	Non-Governmental Organization
NHA	National Health Accounts
NSSF	National Social Security Fund
OECD	Organization for Economic Co-operation and Development
OMSAR	Office of the Minister of State for Administrative Reforms
PER	Public Expenditure Review
PM	Prime Minister
PPP	Purchasing Power Parity
SDC	Social Development Center
SME	Small and Medium Enterprises
SMP	Statistical Master Plan
SOE	State-Owned Enterprises
TB	Treasury Bills
TFP	Total Factor Productivity
TIMSS	Trends in International Mathematics and Science Study
UK	United Kingdom
UN	United Nations
UNDP	United Nations Development Programme
UNIDO	United Nations Industrial Development Organization
US	United States
VAT	Value Added Tax
WDI	World Development Indicators
WHO	World Health Organization
WTO	World Trade Organization

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Executive Summary

The Economic and Political Setting

It is now time for Lebanon to decisively move from declining reconstruction and perilously managing its public finances to securing new sources of revitalization and development. Lebanon has achieved considerable success during the past fifteen years in reconstructing its war-damaged economy. The country has also achieved a newfound sense of confidence and optimism from its recent political renewal. Yet, its economic conditions remain very fragile. This is a critical time for all decision-makers, political parties and the Government to re-examine the fundamental economic constraints to a better outlook for the country's citizens. New sources of growth, a revitalized private sector, and greater opportunities for jobs and employment have to be established. New ways of addressing social safety nets and targeting social expenditures to the country's less well-off must be devised. And a new social contract between the country's citizens and the State has to be designed to redefine the core functions of the state away from providing rents and employment for narrow political interests to an efficient and lean national government providing critical public services for all citizens. An encouraging international climate exists for supporting Lebanon's progress in these directions, provided a national consensus on key reforms of its economic policies can be reached in the months and years ahead.

A key element of removing the binding economic constraints to Lebanon's future growth and social progress lies fundamentally in dealing with the country's huge public debt, which needs to be contained and reversed by deep-seated fiscal adjustment. That fiscal adjustment will require a number of difficult and painful choices: to raise new taxes, contain overall public spending, cut spending in unproductive areas, reduce entitlements for relatively privileged groups, privatize public enterprises, and restructure public debt. None of these can happen without a strong buy-in and vision of a different future from all cross-sections of society, especially as it relates to restructuring public spending priorities. The recommendations of this review of public expenditures in Lebanon are thus guided by the twin objectives of identifying a set of public expenditure reforms that could simultaneously contain public spending to support fiscal adjustment *and* structurally improve Lebanon's growth potential and social protection. Both are critical if the Government wishes to regain the confidence of its citizens and the credibility of its policies with creditors.

Securing the Objectives: Fiscal Adjustment, Growth and Poverty Alleviation

With the world's highest debt to GDP ratio, any sustainable growth and poverty alleviation strategy for Lebanon has to consider the avoidance of financial turbulence as its main immediate element. Lebanon's public debt ratio of 165 percent of GDP by year-end 2004 - and closer to 200 percent if account is made for the Government's arrears and Central Bank losses on a consolidated public sector basis - is clearly unsustainable in the face of the slow growth in the economy and the high interest rates on its debt. The deterioration of the financial situation in Lebanon following the assassination of former PM Hariri (February 14, 2005), coupled with the rising global interests and deceleration of economic activity in the MENA region have further

increased Lebanon's vulnerability to a full-fledged confidence crisis. Past experience around the world systematically demonstrates that private markets cannot indefinitely accommodate rising public debt ratios. Even the most faithful investors can eventually lose confidence in the Government's capacity to service its debt, and a major crisis can then ensue, with potentially devastating effects on the country's economic and social fabric. Protecting Lebanon from a crisis-led deep recession is a high priority for an effective growth and poverty alleviation strategy.

Maintaining financial stability alone, however, will not be sufficient to achieve the country's economic and social objectives, as the country's current fiscal imbalances already severely affect economic activity and social conditions. High public deficits and rising debt have themselves contributed to the sharp deceleration of real GDP growth since the mid-1990s, following the initial post-war boom of reconstruction. The channels for these strong negative effects are persistent government borrowing requirements that have raised real interest rates to very high levels, and rising macroeconomic risks of financial crisis (associated with higher debt) that have crowded out and reduced private investment (and in turn private capital accumulation and productivity growth). In recent years, the real economy benefited from an exceptional combination of favorable external shocks, but the long term growth potential of the Lebanese economy remains constrained, in the face of very limited productive investments and deep-seated structural barriers to private sector activity. With slow growth, social conditions and inequalities are worsening, and Lebanon's human and natural capital stocks are eroding. Unemployment is growing, prompting young generations of qualified workers to emigrate in large numbers. And insufficient attention and investment to protect the environment have entailed irreversible degradation of land and water resources. In this context, Lebanon has no alternative but to seize all opportunities to immediately reduce the deficits and debt levels to considerably lower levels, with the objective of putting the country's debt to GDP ratio on a steadily declining slope to ultimately regain fiscal solvency.

Regaining the credibility and confidence of creditors and citizens through careful containment of the Government's primary spending is of utmost necessity. Along with tax increases, privatization and debt restructuring, containment of non-debt public expenditure has to play a key role in restoring fiscal sustainability, both from accounting and signaling perspectives. Any saving on public spending will contribute to a higher primary surplus, hence reinforcing the likelihood of a successful fiscal adjustment. And World Bank staff calculations suggest that sizeable savings could be made on unproductive expenditures without compromising the provision of public goods and services. But perhaps more importantly, cutting back on unproductive and inefficient public expenditures will send a strong and credible signal of Lebanon's commitment to address, at its roots, its fiscal imbalances and improve its overall use of public funds. This is an indispensable condition to protect growth during the adjustment by convincing potential investors and citizens that their situation will improve in the medium run. International experience underlines the critical role of credibility in ensuring successful fiscal adjustments episodes, where the short-term negative impact on output of public expenditure cuts can turn rapidly positive in anticipation of a better economic future, and greater investment opportunities. Financial markets will respond to improved credibility by lowered interest rates; investors will respond by increased capital inflows and financing investment, ensuring faster growth; and citizens will respond by a greater willingness to carry the burden of adjustment if it

is distributed fairly. In Lebanon, the immediate negative impact of fiscal adjustment on growth should not be underestimated, given the size of the debt stock and its related financing needs, the high degree of capital mobility and the significant barriers to investment activities in many sectors. At the same time, and unlike many countries, Lebanon can also benefit from a very large investment potential, given the country's exceptional ability to attract foreign funds, and recent episodes – Paris II for instance – that have illustrated the potentially huge response of financial markets to perceived greater fiscal credibility. The quality of expenditure containment is thus a key dimension of any adjustment plan.

Beyond the pressing objective of gaining fiscal space, public expenditure reform should also be designed with the aim of improving the investment climate and reinforcing social protection. Public primary expenditures are low in Lebanon (at 21 percent of GDP approximately), and cannot support alone the burden of adjustment. Debt sustainability analysis conducted by the World Bank suggests that the primary surplus would need to exceed 10 percent of GDP (up from 1 to 2 percent in 2004, including arrears) to simply stabilize the debt to GDP ratio. Depending on the growth in economic activity, 2 to 4 percentage points of GDP could be saved through bold expenditure containment over a five-year period. Clearly, large tax increases would hence need to accompany and even probably precede these measures, given the difficulty to rationalize expenditures in a very short period, which could prove to be politically challenging in the Lebanese context. Other possible ingredients to curb the debt - namely debt restructuring, privatization and external assistance, are also far from being easily achievable. And even if all these ingredients could be mobilized together rapidly, the debt to GDP ratio would still remain largely above 100 percent in the foreseeable future, leaving Lebanon vulnerable to financial disruption. At any time a confidence shock could eliminate the long and painful efforts undertaken to adjust fiscally. Hence, expenditure containment for its own sake will look irrelevant in the face of its high political and social costs, and additional objectives are required to justify it. Improving Lebanon's growth potential through better public service delivery and investment climate and reinforcing social protection are the natural candidates. Indeed, several important structural obstacles to growth and social protection are directly related to poor public expenditure management (unproductive public administration, corruption, ineffective resource allocation, poor management of public enterprises). In other words, large spending in some sectors is the symptom of inefficiencies and weak governance, and expenditure reform, if properly designed, can prove to be a very powerful means to foster growth and alleviate poverty, beyond its impact on protecting the economy from financial crisis.

Success in rationalizing public expenditures is contingent on citizens' acceptance of a new social contract, which would redefine the nature of their relationship with the State of Lebanon. However important might be the objective of expenditure containment, spending cuts will immediately affect civil servants, current beneficiaries of public services and largesse, and overall economic activity through a contraction of aggregate demand. Unless citizens can rapidly perceive an improvement in the nature of their relationship with the State and feel that the burden of adjustment is equally shared across the population, the indispensable political support for a deep reform agenda will fade away rapidly. The overall design of strategy should therefore attach considerable importance to its political feasibility. This will mean that social protection should be reinforced in the immediate phase of spending declines, to protect the most vulnerable segments of society against its immediate negative effects. Privatization programs should

consider and deal carefully with the fate of current state-owned enterprises' employees and also seek a good compromise between economic, fiscal and social impacts, by setting, for example, low tariffs and connection fees for basic privatized services. Finally, all economic constituencies should contribute to the adjustment effort, for instance through the implementation of a generalized income tax imposed on all sources of incomes. In the longer term, institutional reform should aim to shift the structure of current spending patterns from objectives of narrow political redistribution to that of efficient public goods provision to all sections of society.

Key areas of expenditure reform comprise reducing the civil service and reforming pension schemes, changing the management and control over large loss-making public autonomous agencies and enterprises such as the EDL, improved budget processes and execution, and expanded social protection. Some of the policy options envisaged in this review can be implemented rapidly, irrespective of the fundamental choices that Lebanon should make regarding the future role and responsibilities of the State. Pension reforms and power sector reforms are very high on the agenda and could save some 2-4 percent of annual GDP in public spending. Other related actions will require immediate diagnostics to expand the options. They include a civil service census and a review of public employees' functions and remunerations; a review of social spending coverage and targeting efficiency; the auditing of all extra-budgetary funds and government arrears; and the complete re-examination of existing public investment commitments. It also concerns the institutional capacity and legal means required to effectively implement any strategic reform, notably through: the restoration of the Civil Service Council's executive powers and the Court of Accounts' independence and capacities; the revision of procurement and public accounting laws; the reinforcement of Lebanon's statistical and planning capacities; the imposition of hard-budget ceilings to ministries during budget preparation; the consolidation of current and capital budgets; the immediate stoppage of arrears' build-ups practice and the limiting carry-forward of expenditures. Turning to the medium-term,, choices needed to be made regarding the role of the State of Lebanon, and to adjust strategic policy design in the following areas: the structure of public pension schemes and wage and benefits, social protection and safety nets, provision of public infrastructure and regional development, performance-based budgeting, and roles and responsibilities of extra-budgetary funds in the provision of public goods and services. The menu is large and urgent and described further below by main subject areas.

Reducing the Size of the Public Labor Force for Better Service Delivery

Lebanon's overall public wage bill is low by international standards, but opportunities exist for considerable savings through future retirements that should be used to build a competent civil service capacity. Lebanon's public labor force is numerous, underpaid and unmotivated, subject to corruption and unresponsive to people's needs, which is a major element of citizens' dissatisfaction with the State. At the same time, many civil servant positions are left vacant. On the whole, it is safe to say that the Government in Lebanon is severely overstaffed for the functions it currently performs. A better paid, more competent, smaller public force should be the objective. In the next ten years, up to 45 percent of the current public labor force (some 220,000 workers, including civil servants, contractual workers and military) will retire. The Government should reap this golden opportunity to reduce its labor force through attrition, as it presents less technical and political difficulties than retrenchment. Funds saved on the current

wage bill should be used to increase civil servants' salaries, regularly train staff and cover reallocation costs of some staff to new tasks. In the short run, this will necessitate (i) a review of employment needs and adequacy to Government's objectives, (ii) a civil service census (iii) a termination of the current hiring and wage freeze in place since 1997, and (iv) the full restoration of the Civil Service Council's executive powers. It will also critically necessitate a reform of the current civil and military pension schemes, whose deficits are fully covered by the budget, to contain their fiscal cost in the face of a growing number of retirees. Finally, with a view to re-build capacity within the administration to ensure continuity and accountability, the reliance on parallel staffing structures should also be reduced as much as possible.

A rapid and effective rightsizing of the public labor force is conditioned on the need for reform of civil and military pension schemes. Government employees (and more broadly the populations') acceptance of a large retirement plan is most likely contingent on the development of effective safety nets and sustainable pensions schemes. Public employment has progressively become in the post–war period an expanded social safety net, which needs to be replaced by other more effective ones, to get the support of the population and satisfy citizens. Today though, formal safety nets are inadequate and weak (see below), and public (civil and military) pension schemes are unsustainable financially – hence unable to absorb large number of new retirees without seriously compromising the fiscal adjustment objectives evoked above. Various options of reform to restore the public pension schemes' financial sustainability are nevertheless feasible, and could yield significant additional fiscal and developmental benefits. World Bank staff calculations indeed suggest that a simultaneous reform of public and end-of-service indemnity schemes could permit the rapid integration of the various public and private pension schemes, at low fiscal costs. This would eliminate the implicit Government's pension debt over the long run (currently above 50 percent of GDP), reduce inequalities between public and private workers (in terms of coverage) and facilitate labor mobility between public and private sectors.

Public labor force non-wage benefits should eventually be replaced with higher wages. Obviously, the reform of public pension schemes would eventually necessitate reducing the benefits accruing to current and new retirees, as considered much too munificent (Lebanon's military and civil schemes are respectively ranked first and second most generous schemes in the MENA region) in the face of Lebanon's financing capacities, demographic structure and inequalities in access to pension coverage. On the same token, benefits (family allowances, education, and health) to public sector employees should be reviewed[1] in light of actual social needs, and probably replaced with more direct and effective means of channeling assistance to the poor. This decline in non-wage benefits would typically be offset with higher wages in the public sector. Not only would this permit reinforcing social protection policies effectiveness, but would also establish a better link between individual performance and remuneration in the public sector.

[1] Data gathered with the recently completed household budget survey should permit to review the effectiveness (targeting, coverage) of current social policies.

Revisiting the Role of Extra-Budgetary Entities

Lebanon's budget is burdened with large transfers to extra-budgetary entities, whose activities need to be audited and consolidated into the budget. Public autonomous agencies, funds and enterprises operating outside of Parliament's control (hence not concerned by the budget cycle) represented 19 percent of total public spending in 2004. While not part of core activities of the Government, their activities have important fiscal implications. Very often, the absence of any binding budget constraint (governance problems, lack of accountability and accounts) prompts these entities to run large arrears and losses, which are eventually covered by the Government in the form of grants or loans. In 2004, 9 percent of non-debt public expenditures went to cover public electricity and water companies operational losses and debt repayments. Subsidies can obviously be justified (in the case of positive externalities for instance), but have to be explicit to remain under Parliament control, facilitate medium term expenditure planning and reinforce extra-budgetary funds accountability. As posing a significant risk of seeing public funds not being spent for the purposes for which they have been appropriated, it is hence important that (i) the Government rapidly have at one's disposal a set of audited consolidated financial statements that cover all non-budgetary entities; and (ii) that public autonomous agencies and funds budgets be fully consolidated into the budget of the Government and their accounting, reporting, oversight and governance structures be significantly improved.

The role of these extra-budgetary entities, as providers of public goods, should be re-assessed and the decision to maintain them in the public domain made accordingly. Over the last years, the Government has legally or technically paved the way for the privatization of some of these agencies and enterprises, but two elements, inter alia, have probably prevented its realization so far. First, the role and responsibilities of entities foreseen to be privatized have yet to be spelled out, in order to forge consensus on their destiny. Some of them are indeed playing important roles in terms of providing implicit subsidies or additional public revenue in the form of monopolistic rents. Actually, some public enterprises are generating net revenue for the Government, but maybe at the expense of greater competition and growth. A greater participation of the private sector in these enterprises/agencies – up to privatization, would require an ex-ante distinction between "normal" private commercial operations and the set of instruments (tax and subsidies, regulation of tariffs and standards, etc.) that would remain in the hands of the Government to regulate markets and provide public goods. Second, some of these entities need major overhaul (including audited accounts, investments, debt relief, etc.), such as the electricity company, and a credible regulatory framework first to eventually attract private investors' interest.

Privatization should accompany fiscal adjustment, with a view to primarily promote growth. For heavily indebted countries like Lebanon, it is critical that privatization proceeds be used to reduce the debt stock. But when privatization proceeds are used to retire debt, the Government should ensure that this is done as part of a package of measures that are sustainable from the financial point of view in bringing the stock of debt down. Otherwise, the reduction in interest payments will be short lived, and a perverse debt dynamic will resume as soon as privatization proceeds run out. The potential privatization proceeds will therefore be wasted if they are not used in the context of an overall fiscal consolidation agenda. Furthermore,

privatization should aim in priority at promoting cost effective private service delivery. Indeed, the incentive to increase the sale price (through granting monopolistic positions to new private incumbents or imposing low requests in terms of future capital investment outlays) might be at the expense of future improvement in the service. As tempting as it is to measure the efficacy of privatization in terms of sales price, it is the long-term impact on quality and price of service, and its contribution to spurring growth and economic development that is most critical.

Improving Current and Capital Expenditure Management

Expenditure management can be improved to raise public spending efficiency. The economy and Government's budget are not receiving the full benefits of the public expenditures that are being made, as evidenced for instance in terms of social and investment outcomes. Various elements are candidates to explain such shortcomings: outdated procurement policies, absence of competition among suppliers of goods and services purchased by the Government, lack of planning and consolidation between current and capital expenditure, high fiduciary risks and corruption stemming from inappropriate control and audit framework. A revised draft public procurement law was prepared by the Government but was never passed by the Parliament. However, if approved and implemented, such a law would not only greatly enhance the efficiency and transparency of public procurement procedures, but it would also accelerate disbursement on donors' projects. Recent steps taken by the Government to reform procurement practices regarding drugs and fuel purchasing illustrate the extent to which savings can be made by reinforcing competition among suppliers. The adoption of a competition law would definitely help in generalizing these efforts to most government purchases. The revision of the now outdated Public Accounting Law and the development of ex-post performance evaluation would mitigate corruption risks stemming from a lengthy, complex and non-transparent expenditure control process, with a view to shift public practices from compliance to responsibility. Granting greater institutional independence to the Court of Accounts vis-à-vis the Government and reinforcing its capacities would also be a crucial step in this direction.

The adoption of a Medium Term Expenditure Framework (MTEF) would equally permit reducing wasted expenditures related to public investment decisions (i) not supported by sufficient counterpart budgets for operation and maintenance or (ii) simply stopped before completion in the face of poor macro-economic planning capacity at the Ministry of Finance and absence of accrual accounting. The role of the Council for Development and Reconstruction (CDR), which manages on behalf of the Government most of the public investment projects, must be redefined to become an implementation agency of Ministries, which would regain control of their investment budget. And while an MTEF is very important, for it to be effective decision processes at the center of Government have to be reformed. This includes early government decisions on priorities and (in the current situation) policy decisions on cost savings and service reductions which are communicated to ministries for their budget formulation process. It implies the use of hard budget ceilings for formulation of the budgets and reforms of the budget process within Ministries, to move away from simply summing up the cost of inputs.

In the short run, the Government should immediately stop accumulating arrears. Although not yet audited and tentative (in the absence of accrual accounting), the amount of arrears accumulated as of end-2004 by the Government vis-à-vis the social security, government

employees, suppliers and households is seemingly sizeable, at approximately 10 percent of GDP. Building-up arrears has various negative consequences: poorer fiscal transparency, higher tariffs for private services, weaker social safety nets, and greater difficulties to implement investment projects. In this respect, not accumulating new arrears is a first immediate priority, which will nevertheless add about one percentage point of GDP to primary spending (as measured on cash basis). Addressing the stock though, is a much more difficult undertaking, which could consist in transforming some of the arrears into formal debt and the remainder being repaid progressively over years.

Capital expenditure levels must be protected and investment plans entirely reviewed. Public investment spending is not commensurate to outcomes. In spite of large amounts disbursed since 1992, public investments are not yielding the benefits that should be expected, as evidenced by the number of projects not yet completed, the poor quality of the transportation system, the high costs of power and communications utilities and the rapid deterioration of the environment. Nevertheless, this unfortunate verdict does not justify further compressing capital expenditures, as Lebanon is now reaching a point where its investment expenditures barely suffice to prevent the degradation of its current stock of infrastructures. In these conditions, the marginal cost of further containing public investment in terms of foregone growth most likely exceed the marginal gain stemming from its impact on public deficit. On the other hand, investment projects under preparation or already committed far exceed what Lebanon could realistically absorb in the next years without severely undermining its capacity to adjust fiscally. Priority should hence ultimately be given to the maintenance of existing facilities, within an overall envelope consistent with the objective of raising the primary surplus. This would notably require limiting carry-forwards in the budget framework. A greater use of donors' funds should also be sought, for its impact on debt service and maturity profile, but also because it would require moving on reforms that present other advantages: CDR reform, Procurement Law, Parliament ratification procedures, public investment planning, and lower reliance on arrears.

Reinforcing Social Protection

From a functional perspective, public social spending requires particular attention, as it is a key element of a successful transition. Public social spending is high in Lebanon (more than half of government primary expenditure including pensions), and is a candidate for a deep review in a period of necessary expenditure containment. Enhanced social protection is also a critical ingredient to insure the political feasibility of a drastic fiscal adjustment, as greater demand for public social services and equity considerations will emerge in the transition. Yet, seemingly high levels of inefficiencies imply that the first order of priority in the social sectors is to raise the productivity of public social sector expenditure rather than increase their resource envelope. A reduction in social spending via employment benefits to government employees is one such priority, savings being assigned to improve the supply of public social service delivery to the needy. A second is the more efficient regulation of private provision in terms of pricing and quality and coordination between the private and public sectors in the social arena, which ultimately requires from the Government the design of a long-term strategic vision for its social policy: norms of social services and protection, choice of Government's instruments for provision, financing and regulation of social services.

In the shorter run, there is a pressing need to strengthen safety nets. One basic objective of any social policy should be to protect human capital from irreversible losses occurring during crises (economic, political, natural disasters). Fiscal consolidation would typically aim at reducing the risk of financial crisis, but probably not sufficiently in the next years to justify a continued absence of protection for citizens against their potentially devastating impacts. The more so since the few safety nets existing in Lebanon would themselves be severely weakened by financial disruption. More generally, it is believed that Lebanon's level and characteristics of social protection are not adapted to the developmental needs of a middle-income small open economy, and could actually be an impediment to growth. Dismissed as ineffective, expensive and even detrimental to growth, it is now increasingly understood that assisting individuals, households and communities in dealing with diverse risks is needed for sustained economic and social development. Hence there is a need to reinforce existing safety nets and to plan for the mobilization of new ones. If in place before a crisis occurs, properly designed social safety nets can serve as an automatic fiscal stabilizer and contribute to greater macroeconomic stability, and can bypass political pressures for panic allocation during the crisis, or for making spending permanent after the crisis is over. In planning for safety nets, desirable principles to be adhered to include adequacy in terms of coverage and benefit levels, greater targeting efficiency, and transparency to manage expectations that assistance is temporary. Various options can currently be envisaged in Lebanon, from scaling up some of the social programs to introducing conditional cash transfers. Most of these options would nevertheless necessitate the availability of reliable and periodic data on the incidence of social spending to assess its efficiency and develop targeted and means-tested programs. This is maybe the greatest priority for Lebanon in terms of social policy today. As far as existing institutional safety nets are concerned, it could also be envisaged to reinforce the robustness of end-of-service indemnity and guarantee of deposits funds by (i) rapidly settling arrears accumulated with them and (ii) allowing them to diversify their investment portfolio for a better protection against various financial risks.

Forging a National Consensus on Public Expenditure Reforms

In the face of the urgency of the situation and difficulties ahead, Lebanon needs to forge consensus on fiscal reforms through a national political pact encompassing all key actors. Successful fiscal stabilization episodes in the world have all been achieved by strong and determined executive powers, benefiting from sufficient political support to sustain adjustment efforts over several years.

Political support will necessitate an equitable, credible, transparent and comprehensive adjustment plan, which can only be designed with the participation of all national stakeholders. A comprehensive public sector reform agenda should cover simultaneously four fronts: public administration, public financial management, civil service and corruption. In the Lebanese context, addressing the deficiencies in these four domains could go a long way in improving the credibility of the institutions vis-à-vis the population and the donors, and contribute positively to a successful fiscal adjustment. While the consensus is widespread in terms of identifying the public sector management woes which are afflicting Lebanon, finding a solution which can be translated into an appropriate action plan is much more difficult. The problem is both the lack of a deep debate on possible policy options and the difficulty to move out of a currently low non-cooperative political equilibrium. Each segment of the society would

currently seek to have the other pay the price of adjustment. It is in effect a "prisoner's dilemma" where all segments will gain from cooperating, and lose in the end if each side sought to evade the cost. Moving towards a higher cooperative equilibrium will require a comprehensive (in terms of policy areas) and inclusive (in terms of participants) process to forge a national pact on key reforms and action plan. Fragmented piecemeal efforts to address public sector reforms are unlikely to succeed without first re-defining the role of the State and second secure the means and resources needed to fulfill it. Such a redefinition of the Government's core responsibilities requires input from all stakeholders, to eventually place efficient and effective service delivery to citizens at the center of all State's actions.

Introduction – Public Expenditure Review Scope and Objectives

1. **Public Expenditure Reviews (PERs) are conducted by the World Bank in all its client countries, typically every 4 to 5 years.** PERs are part of the Bank's core diagnosis reports, whose content reflect analysis necessary for Bank country programs and strategy formulation. PERs examine processes of resources allocation within and among sectors and assess the equity, efficiency and effectiveness of these allocations in the context of the macro-economic framework and sector priorities. In Lebanon, the World Bank conducted a review of public investment expenditures in 1995 and a review of public social expenditures in 1999. It never completed a comprehensive review of public expenditure since the end of the civil war in 1991.

2. **Lebanon's current priority – in the face of high public deficits and unsustainable debt dynamics – is to contain and rationalize public expenditures in every possible sector while improving the efficiency of social spending.** The Government of Lebanon (GoL) is fully aware of the need to address urgently its fiscal imbalances through expenditure containment, to eventually restore fiscal sustainability (see for instance the Government strategy presented at the donors' Paris II conference in November 2002[2] and the budget law 2003; the PER Concept Note and the World Bank's Draft Country Assistance Strategy (CAS) discussed with the Government respectively in December 2003 and January 2005 emphasized this priority as well). The Government of Lebanon also acknowledges the need to protect and improve the efficiency of social expenditures, in order to protect the poorest segments of the Lebanese population from adverse economic circumstances. Hence the primary focus of this PER on cross-cutting issues regarding: (i) expenditure containment (public employment and wage policies, pensions, transfers, subsidies, capital expenditures, debt management and privatization) and (ii) social spending efficiency.

3. **Nevertheless, the needed containment of primary public expenditures should be understood as a transition to restore fiscal sustainability and enhance growth prospects.** The private provision of services is unusually high in Lebanon, but cannot replace that of the Government in some key sectors, where the latter needs to reengage. There is no optimal/unique prescription for either the size or design of the public sector. Generally, beyond the core public activities, justifiable on the grounds of market failures (externalities, natural monopolies) or the existence of pure public goods (non rival and non excludable, and the consequent inability to charge for these services), the design and implementation of public expenditure priorities and the associated public-private mix require detailed assessment and careful country-specific tailoring. In Lebanon, the absence of well-defined public policy objectives - and the absence of tools to assess the efficiency of public expenditures in meeting these objectives, calls first for actions that would help Lebanon to better identify the current role of its administration, and, accordingly, where it should ideally concentrate its interventions. In turn, Lebanon will need to acquire the

[2] See Republic of Lebanon (2002): "The budget for 2003 that has already been submitted to the Parliament is an austerity budget that envisages [an increase in revenue and] a further reduction in the ratio of non-interest expenditures to GDP. Expenditures are being reduced across the board, except for social sectors so as to protect those most affected by the worsening of the economic situation in recent years."

means to achieve efficiently its policy objectives, which will require the modernization of the civil service and budget processes. The second part of the PER is devoted to these longer-term issues.

4. **This Public Expenditure Review aims at assisting Lebanon in its fiscal stabilization effort.** The containment of public expenditures could entail painful choices, which will first require an analysis to identify where spending pressures lie (contingent liabilities, social sectors), and how to address them. And ideally, elimination of non productive spending should replace containment as the main instrument of adjustment – not least to sustain growth in the face of a withdrawal of fiscal stimulus. The PER seeks to identify what critical and realistic short and longer term measures can be implemented in this regard to achieve this objective. Thus, the PER is intended to provide a succinct and actionable view of the main priorities in public expenditure reforms that lie ahead, drawing on the lessons of comparable global experience and the particularities of Lebanon. In the process, it is expected to provide a means of discussing with the Lebanese authorities various options on addressing key areas of public expenditure reforms.

5. **This Public Expenditure Review does not come alone, and benefits from many parallel ongoing activities**: beyond the World Bank's last reviews of capital (1995) and social expenditures (1999) – whose main recommendations remain still largely valid (and are therefore only briefly discussed), we rely in this report on the Country Financial Accountability Assessment (CFAA) and the Pension Report recently completed by the World Bank (World Bank 2005a, 2005b), the Policy Note on Fiscal Stabilization transmitted to the Ministry of Finance in November 2004 (World Bank 2004a), the Debt Management and Hydrocarbon Strategy Reports (World Bank 2004b, 2004d) as well as on the IMF's Public Expenditure Management Report (IMF, 2004). Thus, this review does not intend to repeat in details the findings of these documents; rather, it is aimed at examining public expenditures with a view to: (i) assist the fiscal transition, (ii) reinforce safety nets and the targeting and coverage of social spending, and (iii) develop modern capacity in the provision of public goods.

6. **This Public Expenditure Review is organized as follows.** Chapter I provides the macro-economic framework and discusses the need for fiscal adjustment. Chapter II looks for possibilities to contain primary expenditures in the next five years. Chapter III reviews the efficiency for current social expenditures, and explores ways to improve their efficiency with the view to (a) better support human development during the ordinary course of the economy and (b) prevent human capital deterioration during any possible economic crisis. Finally, Chapter IV discusses options to improve civil service and move towards performance budgeting in the medium-to-long run.

Chapter I. Fiscal Adjustment for Growth[3]

The Immediate Challenge: Fiscal Adjustment for Growth and Poverty Alleviation

7. **Current public fiscal deficits and debt level remain far too high in Lebanon and undermine the country's potential growth performance.** In Lebanon, public deficits have been well above 10 percent of GDP on average over the period 1991-2004 (see Annex I), and the public debt to GDP ratio, roughly estimated at 165 percent of GDP by end-2004 - and even closer to 200 percent if account is made for Government's arrears and Central Bank debt on a consolidated basis, is the highest in the world. International experience suggests that persistently high public deficits and debt strongly reduce long-term growth. The empirical literature on the impact of fiscal policy on long-run growth is considerable, and its conclusions are mixed, as fiscal policy can influence growth through different channels[4]. However, fiscal deficits and debt, once they reach very high levels, incontrovertibly exert a strong net negative impact on growth. For example, a study on 39 developing countries in the 1990s (Baldacci et al., 2003) finds that increasing the fiscal deficit by 1 percentage point of GDP led on average to a decrease in per capita real economic growth of a 0.2 percentage point, in countries where the deficit initially exceeded 2.5 percent of GDP. Applied to Lebanon, this result would mean that public deficits recorded over the past decade may have cost 3 percentage points of foregone real per capita GDP growth every year.[5] Similarly, another study (Patillo et al., 2004) finds that the size of external public debt begins to have a strong negative effect on growth once it exceeds 35-40 percent of GDP. The typical channels or reasons for these strong negative effects are persistent government borrowing requirements that raise real interest rates to considerably higher levels, and/or inflation and/or rising macroeconomic risks of financial crisis (associated with higher debt) that crowd out and reduce private investment (and in turn private capital accumulation and productivity growth). How big these effects have been in Lebanon cannot be precisely measured, but it is certain to have been a major cause of the crisis in growth and social conditions over the past decade.

8. **The debt situation is at the heart of the Lebanese long-term growth challenge, and should not just be seen as a financial problem.** Public deficits and rising debt have most likely contributed to the sharp deceleration of real GDP growth – less than 3 percent annually on average since 1997, following the initial post-war boom of reconstruction in the early 1990's.[6]

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[3] This chapter draws heavily on World Bank (2004a), and subsequent discussions with the Ministry of Finance.

[4] One can generally distinguish three types of channels through which fiscal policy affect economic activity: the effects of public services and investment on the productivity of the private sector; the effects of the tax system on resource allocation and incentives, and the effects of public deficits and borrowing on the private sector.

[5] Lebanon has exceptionally strong comparative advantages that should allow much faster longer-term real GDP growth, well above 5 percent every year. These include strong entrepreneurial skills, high human capital, an open economy, a favorable geographical position and a modern financial sector able to attract large foreign investment, which should help Lebanon base to future growth on the development of a modern, competitive and outward-oriented economy. All these characteristics are considered in the long-run growth empirical literature as fundamentally favorable to growth (see Barro and Sala-I-Martin, 1995, or Sachs and Warner, 1997, for instance). In contrast, the same literature underlines the negative impact of high government deficits and poor institutional framework on long-run growth.

[6] Official national accounts time series do not exist in Lebanon. We rely in this report on MoET's preliminary estimates for the period 1997-2004.

Broadly speaking, the post-war economic history of Lebanon can be split into two sub-periods. In the period 1992-2000, GDP growth continuously decelerated, following a typical pattern of debt crisis[7], whereby high interest rates and risks discourage private investment and reduce fiscal space for public investment (see Table 1: between 1997 and 2000, total investment as a share of GDP went down from 30 to 21 percent). Since the year 2000, the situation has become more complex. The debt continued to grow, but its impact on interest rates was mitigated by (i) greater resort to foreign-currency denominated debt instruments[8], (ii) debt restructuring efforts, with the assistance of the international community and Lebanese banks[9], (iii) and significant efforts from authorities to bring up the primary surplus (see Table 1), maybe triggering non-Keynesian confidence effects (see below). The real economy[10] was also helped by an unusual combination of favorable external shocks – continued low global interest rates and high regional inflows of capital and tourism in particular.[11] In Lebanon itself, in spite of rapid broad money growth, banking credits to the domestic private sector have actually decreased in real terms since 2000,[12] illustrating the absence of domestic investment counterpart to the current positive external shocks. The bulk of private investment finds little room in which to base its potential for growth in Lebanon, other than non-traded goods and services – real estate and government debt.

[7] Between 1992 and 2000, public debt ballooned from an initial 35 percent to 150 percent of GDP, the result of large capital expenditure investments, explosive growth in public sector employment and social spending. Taken together, these three economic and social reconstruction-related developments added some cumulative 75 percent to the stock of debt to GDP, while the remainder was the accumulation of interest on debt.

[8] In the face of the increasing dollarization of the deposits base, the Government of Lebanon (GoL) had little choice but to swap towards foreign currency-denominated debt instruments (Eurobonds, with lower remuneration, as the exchange rate risk is perceived to be eliminated). The GoL started to use such instruments in December 1993, and until August 2000, the share of total public debt labeled in foreign currency ranged between 10 and 25 percent. Since then, this share grew up regularly, to reach approximately 50 percent nowadays.

[9] Following the Paris II conference in November 2002, donors contributed US$2.4 billion to debt restructuring (15-year dollar denominated Eurobond rates at concessional terms), and commercial banks US$3.6 billion (2-year Treasury Bills at zero-interest rates), while the Central Bank wrote-off US$1.8 billion worth of Treasury Bills from its books.

[10] Real GDP growth in Lebanon was estimated at 5-6 percent in 2003 and 2004, the result of significant private net capital inflows, sustained demand for domestic goods and services, and booming exports of goods (towards Iraq) and services (tourism in particular). Yet, the long-term average growth rate in Lebanon is believed to be much lower, at 2-3 percent, and the current performance probably corresponds to a high phase in the business cycle. Long-term growth is impeded by (i) strong Dutch disease effects stemming from massive capital inflows; (ii) high real interest rates and investment risks in the face of unsustainable public debt; and (iii) a poor investment climate (inefficient utilities and public service delivery, monopolies, corruption, etc).

[11] From 3.6 percent on average in the 1990s, real GDP growth in the MENA region went up to 6.1 percent in 2003 and 5.2 percent in 2004 (World Bank, 2005c).

[12] Between December 2000 and December 2004, banks' credits to the private sector grew up by 8 percent (source: Banque du Liban, BdL). During the same period the consumer price index rose by approximately 10 percent (9.6 percent according to the Consultation and Research Institute, 11.4 percent per MoET's preliminary estimates), and money supply (M3 plus non residents' deposits) grew up by 47 percent (source: BdL). Non performing loans are also reported to be high, reflecting the poor quality of the private investment activity.

Table 1. Macro-Economic and Fiscal Developments, 1997-2004

	1997	1998	1999	2000	2001	2002	2003	2004
Gross domestic product (US$ billion)	15.6	16.9	16.9	16.6	16.9	18.4	19.9	21.8
Real GDP growth (%)	3.6	2.3	-1.2	1.1	4.2	2.9	4.9	6.3
Private consumption (% of GDP)	88.1	88.7	85.6	82.4	88.7	85.7	83.4	82.2
Private investment (% of GDP)	22.8	22.4	19.3	16.1	17.0	15.9	17.6	18.1
Public consumption (% of GDP) a/	16.5	15.4	16.3	17.2	17.1	17.0	15.2	15.0
Public investment (% of GDP) a/	7.0	6.7	4.1	4.9	3.8	3.9	4.0	4.2
Exports (% of GDP)	13.9	13.0	13.4	13.6	15.3	15.9	17.3	21.3
Imports (% of GDP)	48.0	41.8	37.2	37.2	41.2	36.1	37.3	41.4
Current account balance (% of GDP)	-30.6	-23.4	-19.1	-18.2	-19.9	-17.8	-20.3	-18.9
Revenue (% of GDP)	15.7	17.6	19.5	19.0	18.2	21.0	22.2	22.9
Primary expenditures (% of GDP) a/ b/	25.7	19.7	21.0	26.9	19.0	20.6	19.7	20.6
Debt expenditures (% of GDP)	14.5	13.1	14.2	16.8	16.9	16.7	16.3	12.3
Primary balance (% of GDP) b/	-10.0	-2.1	-1.5	-7.9	-0.8	0.4	2.5	2.3
Overall balance (% of GDP)	-24.5	-15.2	-15.7	-24.7	-17.7	-16.3	-13.8	-10.0
Public debt (% of GDP)	97.8	109.5	132.5	150.7	166.8	170.8	167.7	164.8

Source: World Bank Staff calculations based on MoF, MoET and BdL. Figures are on cash basis (i.e do not include arrears). a/ The sum of public consumption and investment might differ from primary expenditures, as the former is subject to national accounts definition and does not include foreign-financed capital expenditures. b/ Transfers to EdL to cover its debt service and principal debt repayment are here considered primary spending. Foreign financed capital expenditures are included in primary spending.

9. **The negative impact of fiscal imbalances on growth is compounded by structural problems.** Concomitantly, deep-seated structural barriers to the growth of a competitive and vibrant private sector also hobble the growth potential of the economy. These range from very poor, inefficient and loss-making public services in power, water, customs and ports, to undeveloped and inefficient public services in education, health and other social sectors (see Chapter III), and a configuration of inefficient and costly regulatory barriers to private investment activity, including significant monopolies and a pegged exchange rate that hurts the profitability and competitiveness of key sectors of domestic employment and growth such as agriculture, tourism and other services.

10. **The cost of non-action is high and rapidly growing.** With slow growth, social conditions and inequalities are worsening[13]; unemployment is growing, prompting young generations to emigrate in large numbers[14]. The severe fiscal adjustment undertaken in the recent

[13] There are no reliable indicators of trends in unemployment, poverty or social conditions in Lebanon. Nonetheless, most accounts point to deteriorating social conditions. What is known about poverty is still limited to surveys from several years back (CAS, 1997). At that time, poverty incidence was estimated by the Bank at over 20 percent of all households, with rates varying from as high as 25-50 percent in the poorest districts of North Lebanon, Bekaa and South Lebanon. Real per capita income growth for Lebanon as a whole has been since close to nil, and probably negative in some of these poorest areas, since, in contrast, Beirut and Mount Lebanon seem to have benefited from the current economic upturn (as evidenced for instance in construction activities). This could suggest that poverty rates have risen since 1997 in the poorest regions of Lebanon, aggravating already high regional inequalities (UNDP, 2003).

[14] Unemployment was formally estimated by the International Labor Organization at about 9 percent in 1997. Kasparian (2003) estimated that the unemployment rate rose to 12 percent in 2001, mostly the result of higher unemployment among women (at 18 percent in 2001 against 7 percent in 1997). Unemployment rates for young

years – through VAT notably – impacts the purchasing power of the most vulnerable households who do not see in return greater social benefits.[15] In addition, high and unsustainable debt levels entail very large risks of financial disruption – and induced economic recession. Past experience around the world systematically demonstrates that private markets cannot indefinitely accommodate rising public debt ratios. Even the most faithful investors can eventually lose confidence in the Government's capacity to honor its debt, and a major crisis then ensue, with potentially devastating effects on economic and social fabrics, as evidenced by the international experience (see Table 2).

Table 2. Duration, Output and Fiscal Losses of Financial Crises, 1994-2003.

	Number of crises	Average duration (years)	Fiscal cost (%GDP)	Output loss (%GDP)
All countries	30	3.7	18	17
Emerging market economies	23	3.3	20	14
Developed economies	7	4.6	12	24
Banking crises alone	11	3.3	5	6
Banking and currency crises	19	4.1	25	30

Source: Carstens et al. (2004). Notes: the output loss is the cumulated deviation from trend growth three years after the crisis. The fiscal cost corresponds to that of banking resolution.

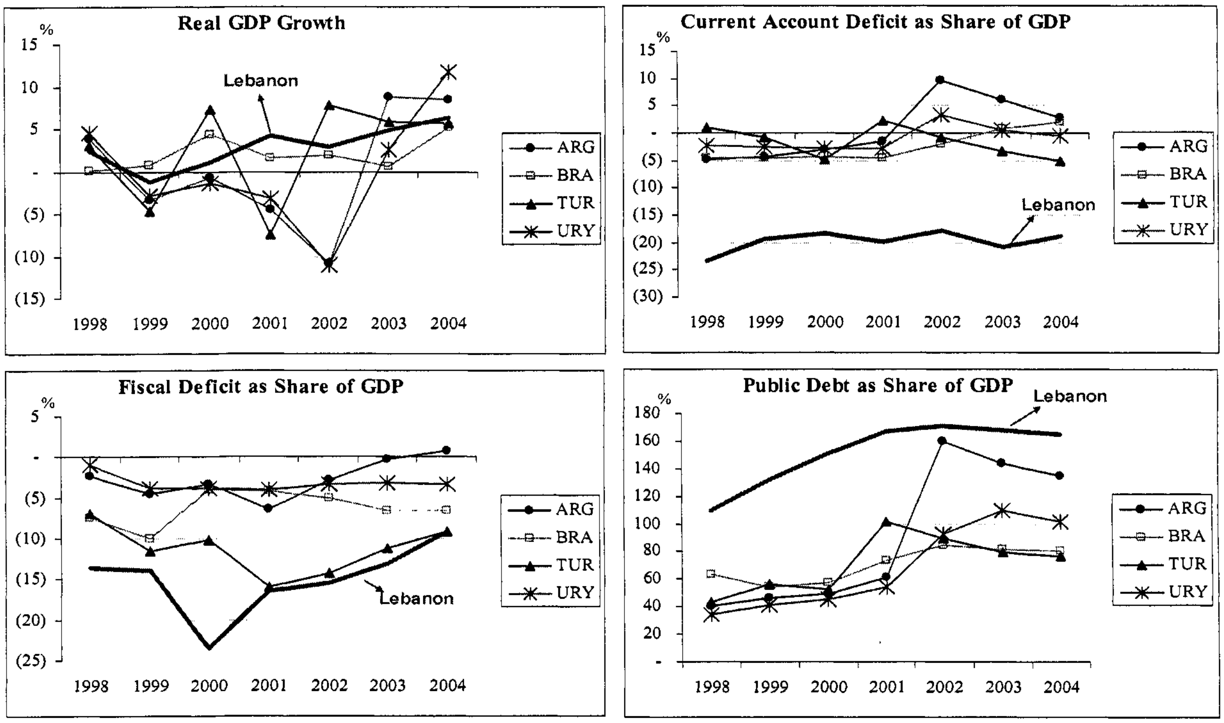
In Lebanon, the public debt dynamics is such that sooner or later, the Government will no longer be able to service it. Comparison with countries having experienced fiscal/financial crises in the recent years (see Figure 1) indeed suggests that Lebanon is by all accounts (fiscal, external, and the debt stock) in a worst pre-crisis situation than most of its comparators.[16] In this context, Lebanon has no alternative but to seize all opportunities to immediately reduce the deficits and debt levels to considerably lower levels.

adults in the age group 15-24 are also at least twice the national levels. Thirty-eight percent of active adults aged 35 or less (and 58 percent of unemployed active adults aged 35 or less) envisage emigrating. Between 1996 and 2001, 32,000 persons (1.5 to 2 percent of the total active population) could have emigrated every year (against 21,000 between 1991 and 1995), most of them for economic reasons (Kasparian, 2003).

[15] The deadly riots of May 2004 – following the rise in oil prices – clearly illustrated the social disaffection of many groups, and their growing opposition to fiscal adjustment, the latter being solely perceived as a net transfer from taxpayers to debt holders.

[16] On the other hand, Lebanon probably benefits from the fact that most of its public debt is intermediated by domestic banks, which have large access to foreign savings (commercial banks' deposits represented 311 percent of GDP by end-2004; and current account deficits have been well above 20 percent of GDP on average since 1992) from the Lebanese Diaspora and Gulf countries. Over the years, the banking sector has progressively become locked into financing the growing public sector financing needs (by year-end 2004, more than half of commercial banks' assets were invested in Government Bonds or placed at the Central Bank), and has found itself trapped into a situation where it becomes critical for its own viability to maintain the solvency of its most important client, the Government. This country-specific characteristic could explain to some extent the greater resilience of the Lebanese financial system to what is perceived to be an unsustainable debt dynamics.

Figure 1. Economic Performance in Fiscal Crisis Countries



Source: World Bank staff calculations

Cutting Primary Expenditures and Privatizing Public Assets

11. **Further fiscal consolidation will require a drastic containment in non-debt expenditures.** Privatization and tighter debt management[17] will not suffice to put the debt to GDP ratio on a steep declining curve, unless accompanied by a much higher primary surplus. The level of the primary surplus needed to stabilize the debt to GDP ratio varies in time, with interest rates and the GDP, and is therefore difficult to identify accurately. Nonetheless, debt sustainability analysis conducted by the World Bank concludes to the need to raise the primary surplus above 10 percent of GDP (up from approximately 1 to 2 percent in 2004, including arrears) to simply stabilize the debt (including arrears, at approximately 10 percent of GDP by end-2004, see below) to GDP ratio. The deterioration of the financial situation in Lebanon following the assassination of former PM Hariri (February 14, 2005)[18], and the announced rise in global interests and deceleration of economic activity in the MENA region[19] make this general

[17] Debt management can be improved in many ways, notably in order to reduce interest rates, currency or rollover risks, (see World Bank 2004b). But it cannot pretend to significantly reduce the public debt service in the absence of macro-economic adjustment. See Box 1 on debt management.

[18] In the two months following the assassination of former PM Hariri, US$5 billion worth of LBP-denominated deposits were converted into foreign currencies, US$2 billion left the country, and domestic interest rates basically doubled, severely undermining already weak GoL and BdL medium term financial positions.

[19] Lebanese merchandise exports and the coincident indicator of economic activity developed by the Central Bank exhibit both a strong (co-integrated) correlation with world oil prices. World Bank econometric analysis also suggests a strong correlation between the LIBOR and Lebanese deposits rates (in US$; source: ABL). On average, a 100 basis points increase in the LIBOR induces a 75 basis points increase in deposits rates labeled in US$. MENA

statement even more valid today. Increasing the primary surplus will necessarily require cutting back on primary expenditures. Clearly, in the face of the adjustment needed and the relatively small size of primary public spending, large tax increases would need to accompany (and even probably precede, given the difficulty to rationalize expenditures in a very short period) expenditure cuts, and are technically feasible through the introduction of a global income tax or increases in VAT and other taxes' rates for instance.[20] But after several years of continued efforts to raise fiscal revenue (see Annex 1: between 1997 and 2004 tax revenues as a percentage of GDP went up from 11 to 16 percent), this might be politically challenging unless accompanied with a serious public expenditure containment which would not lead the private sector and households to bear alone the whole burden of adjustment. World Bank staff calculations (see Chapter II) suggest that bold expenditure reform would permit to contain nominal growth in expenditure at approximately 2 percent a year. In these conditions, raising up the primary surplus to 10 percent of GDP would require increasing the tax pressure to 27 percent of GDP (up from 23 percent in 2004) with a 5 percent annual growth rate in nominal GDP; to 25 percent with a 7 percent annual growth rate in nominal GDP; and to 29 percent of GDP with a 3 percent annual growth rate in nominal GDP.

12. **More importantly, cutting back on unproductive and inefficient expenditures will send a strong and credible signal of Lebanon's commitment to address at its roots its fiscal imbalances and improve its overall use of funds – or better governance**, an indispensable condition to preserve growth and convince potential contributors (debt holders, the international community, etc.) to assist Lebanon in its efforts to adjust. International experience indeed suggests that fiscal stabilization which concentrates on unproductive expenditure cuts rather than tax-based adjustment is more likely to succeed in reducing the debt to GDP ratio[21]. Tax increases, if distortionary, will permanently affect growth. On the contrary, the short-run negative impact on output of expenditure cuts (through multiplier effects) is likely to turn positive in the medium-long-term, in anticipation of higher disposable income (see below). This in turn calls for cuts in wage-related and transfers expenditures (pensions or subsidies to public enterprises for instance, see Chapter II) which are rather permanent (less flexible) in nature and thus reinforce the credibility and durability of the adjustment and its impact on disposable income prospects.

GDP growth is forecasted to decelerate from 5.2 percent in 2004 to 4.3 percent in 2006 (and oil prices to drop 5 percent). In the same time, the US$ LIBOR is forecasted to jump by 300 basis points (World Bank 2005c).

[20] According to the Ministry of Finance, the long-awaited global income tax (as envisaged since 2002; see Republic of Lebanon, 2002) could now be implemented rapidly. The threshold of VAT exemption could be further lowered and its rate increased. The tax on interest income could also be increased. Other important sources of taxation, on land property and transactions for instance, could be contemplated by the Authorities. The implementation of the professional tax, which was adopted by the Parliament in 2001, is still pending.

[21] European Commission 2003, McDermott and Wescott (1996).

Box 1. Improving Public Debt Management

By end-2004, Lebanon's public debt approached US$36 billion, or approximately 165 percent of GDP (excluding arrears), the highest ratio in the world. In 2004 the debt service stood at about 12 percent of GDP, down from 16.5-17 percent in the period 2000-03. The vast majority of the debt is held by private investors – by Lebanese commercial banks, in particular, which are highly exposed on the sovereign risk (more than half of their assets are in public bonds or at the Central Bank). Half of the debt is labeled in foreign currencies, mostly in U.S. dollars. The debt labeled in the local currency has an average maturity of 1.5 years, against more than 6 years for the debt labeled in foreign currency. Yet maturities are not evenly distributed, with 78 percent of the current debt to mature over the period 2005-09, including 64 percent over its first two years.

In coordination with the IMF, the World Bank completed in 2004 a report on public debt management (World Bank, 2004b). Given the size of the debt service in total public expenditures (37 percent in 2004), any improvement in debt management can have a significant impact on fiscal accounts. The next paragraphs summarize its main findings.

Governance. Compared to international sound practice, Lebanon's debt management suffers from the absence of defined objectives, overlapping institutional responsibilities and inadequate accounting and auditing. The report recommends (i) strengthening and clarifying the legal framework with priority given to the implementation of debt management objectives, (ii) establishing an integrated debt management unit at the MoF, and (iii) improving the quality of financial reporting. The Government has taken some steps to remedy the situation, most notably the introduction of a draft law to establish an expanded debt management department at director level in the MoF.

Risk management. Lebanon lacks a medium-term debt management framework which hampers effective risk management. An analysis of the public debt portfolio suggests significant currency, interest rate and roll-over risks, which leads to recommending a greater use of long-term LBP denominated debt instruments. Implementation of this needs to take account of the high cost of debt servicing, as well as market demand and the balance sheet structures of banks. The introduction of three-year Treasury Bills in late 2003 and management of roll-over risk through operations such as the voluntary exchange for Eurodollar bonds are steps in the right direction. Beyond that, a strategic framework for debt management should be implemented, identifying key risk indicators.

Coordination of monetary and fiscal policies; cash management. The primary Treasury Bills (TB) market is used as an instrument of monetary policy - with significant impact on debt management. The coordination with fiscal policy remains insufficient, and cash flow management is weak. The report recommends (i) enhancing the coordination between MoF and the Central Bank over monetary policy and debt management (ii) improving coordination with fiscal policy through better forecasting capacities (of financing needs) at the MoF. In the medium-term, monetary policy would ideally be implemented through influencing short term rates and allowing longer rates to respond more flexibly to market sentiments and economic fundamentals. Developing a local bond market would help in this regard, increasing the resilience of the economy and transmission of monetary policy. This would notably require the development of an institutional investor base. The MoF and Central bank have improved coordination at an operational level and the draft law described above provides for a more formal mechanism for consultation and coordination on public debt management, through the establishment of a Higher Council for Debt Management.

13. Privatization should accompany fiscal adjustment, with a view to primarily promote growth. For heavily indebted countries like Lebanon, it is critical that privatization proceeds be used to reduce the debt. But a cautionary remark is called for here: when privatization proceeds are used to retire debt, the Government should ensure that this is done as part of a package of measures that are sustainable from the financial point of view in bringing the stock of debt down. Otherwise, the reduction in interest payments will be short lived, and a perverse debt dynamic will resume as soon as privatization proceeds run out. The potential privatization proceeds will therefore be wasted if they are not used in the context of an overall fiscal consolidation agenda. In addition, privatization should aim in priority at promoting cost effective private service delivery. Any Government faces substantial pressure to maximize privatization revenues, and the first measure by which success of the sale is likely to be judged is the sale price. However, the incentive to increase the sale price might be at the expense of future improvement in the service. There are at least two ways of boosting the sale price at the expense of the future. First, the Government might be tempted to grant whole or partial monopoly privileges to new private incumbents. Indeed, international evidence on telecom privatization suggests that when Governments sold monopoly concessions, they generated twice as much on average as they did when they granted non-exclusive contracts, but this was at a tremendous cost to the performance of the sector and growth of the economy. Second, a Government may request less in terms of future capital investment outlays, which would boost the sale price. Both strategies are dangerous, especially in sectors as critical to the economy as power and telecom. As tempting as it is to measure the efficacy of privatization in terms of sales price, it is the long-term impact on quality and price of service, and its contribution to spurring growth and economic development that is most critical.

The Impact of Expenditure Containment on Growth: Keynesian versus Credibility effects

14. Growth, though, might be hurt in the process. Lebanon cannot ignore the potentially negative impact of public expenditures containment on economic growth in the short-run, through a contraction in aggregate demand (Keynesian effect).[23] The extent to which GDP will contract will in turn depend on the reaction of domestic interest rates.[24] A large decline in

[23] In a standard Keynesian model (IS-LM, considering the real and money markets' effects of the fiscal multiplier and the nature of the exchange rate regime) contractionary fiscal policy affects domestic demand, unless the positive effects of lower deficit financing foster investment and private consumption through lower interest rates. In Lebanon, the issue is rendered more complex by the fact that interest income represents a significant share of households' disposable income - some 10 percent in 1997. As a result, the positive impact of declining interest rates on investment and private consumption could be somewhat offset by lower households' disposable income (wealth effect).

[24] World Bank simulations using a simple Keynesian model illustrate this fact. A five percent decrease in public absorption would entail a 1.5 percent decline in GDP with unchanged interest rates. In contrast, the decline in GDP would be much more modest, 0.5 percent of GDP, if interest rates were to drop by 200 basis points during the same time.

interest rates during fiscal adjustment would minimize its short-term cost for the economy - and would possibly make it easier to pursue throughout several years. But several elements could prevent a rapid decline in interest rates. First, barring a credible fiscal adjustment program, reduced public consumption would not necessarily entail a large drop in the Government's financing needs. While, in a typical setting, lowered government consumption would reduce by a large amount its financing needs - thereby exerting a downward pressure on interest rates, this shall not be so much the case in Lebanon given its high indebtedness level. Indeed, strictly speaking, interest rates are not determined by the deficit level, but by the stock of public debt level[25], more than seventeen times higher as of end-2004. Accordingly, reducing by 5 percent primary expenditures would reduce the public deficit by 11 percent, but would only reduce the Government's financing needs by 1 percent. Second, capital is highly mobile in Lebanon and reacts rapidly to change in remuneration and perceived risks (World Bank, 2004). In this case, reduced Government's financing needs (money demand) will only exert a minor impact on interest rates if money supply is declining simultaneously with lower net capital inflows. Finally, commercial banks' immediate ability to fully convert loans to the Government[26] into investment and consumption loans to the private sector is questionable, in the face of their already high level of exposure to the private sector.[27] So far, loans to the private sector are in vast majority labeled in US Dollars and covered with high collateral requirements.[28] Hence the potential for further decline of lending interest rates in US Dollars is most likely lower than that in Lebanese Pounds (as the exchange rate risk could decline with fiscal stabilization). Besides, developing investment banking will take time, as most banks do not yet have sufficient capacity to assess the economic value of a large number of investment projects (specially with SMEs) and to take risks accordingly. Consequently, new savings available for loans to the private sector might actually be lower than those released from Government's books.

15. International evidence of fiscal consolidation, however, sometimes contradicts these predictions of short-term negative impact on growth. Theoretical predictions (for which restrictive fiscal stances would result in short-run negative impact on aggregate demand) were not always supported by the facts. Growing evidence has been accumulated that the value of fiscal multipliers is likely to be small and falling over time and even sometimes opposite to those predicted by the theory. Cases have been notably documented of EU countries in which tax increases or expenditure cuts have been followed by accelerated growth in the short-term (expansionary fiscal consolidation episodes), the two most famous cases being Denmark and Ireland in the 1980s. Even within the limited experience of the Middle East region itself, successful fiscal adjustment, debt restructuring and faster growth have sometimes accompanied each other. For example, in the early 1990s when Egypt was affected by an external debt crisis, a large restructuring of debt and a deep fiscal adjustment were simultaneously responsible for resurgence in growth as confidence returned to the economy. Similarly in Jordan, the large reduction in public debt to GDP in the late 1990s and a relatively tight fiscal policy were

[25] See for instance Drudi and Prati (2000), who link theoretically and empirically the interest rate to the debt stock level (by opposition to the deficit).
[26] By end-2004, commercial banks' claims on the public sector (Government and Central Bank) represented 163 percent of GDP and 53 percent of their assets.
[27] By end-2004, commercial banks' claims on the private sector represented 73 percent of GDP (and 23 percent of their assets). According to professional bankers, Lebanon's domestic credit market has now been saturated since 2000, and banks cannot significantly raise their exposure to the private sector under current prudential regulations.
[28] In January 2005, 82 percent of commercial banks' claims on the private sector were labeled in foreign currencies.

accompanied by a comparatively swift reduction in domestic interest rates and faster GDP growth – also helped by a reduction in international interest rates. However, in both cases, the debt restructuring was a critical component and was helped immensely by Paris Club debt negotiations; in the case of Lebanon, with virtually all of its debt privately and domestically held, there are no such avenues and the restructuring of that debt has to happen within the institutional confines of Lebanon itself – see below.

16. Analyses of expansionary fiscal consolidation episodes underline the critical role of credibility. A number of explanations were put forward to explicate the emergence of expansionary fiscal consolidation through "non-Keynesian effects".[29] In particular, it seems that the reduction in budget deficit may lead to an increase in private consumption already in the short-term through wealth and confidence effects. In this sense, the credibility of consolidation is crucial, i.e., the fiscal adjustment should be perceived to lead to a permanent increase in future disposable income streams via reduced taxation. Consolidations leading to a substantial improvement of the budget balance, or starting from a situation of high debt to GDP ratios[30] are more likely to improve consumers' expectations. Fiscal consolidations may also affect investment positively, through higher expected profits with lower taxation. In most cases, the macro-economic environment preceding expansionary consolidations periods is characterized by slow growth and negative output gaps (large unused capacities), as it is the case in Lebanon at present.

17. The response of financial markets to greater fiscal credibility is potentially high in Lebanon. Two episodes during the period 1991-2004 signaled that credible government actions might significantly lower the country risk (hence interest rates and the cost of fiscal consolidation): the period immediately following Paris II, during which interest rates have fallen dramatically, and the period between January 1999 and July 2000, during which the spread over the LIBOR (in US$) fell by one percentage point, probably following the decline in public deficit over GDP by approximately 10 percentage points in 1998 and 1999 compared with 1997 (see Table 1). Similarly, quantitative analysis conducted by the World Bank suggests that capital inflows are strongly responsive to the evolution of the perceived economic country risk in Lebanon. Improved credibility on the sustainability of structural reforms could then foster a significant response in terms of higher foreign capital inflows (World Bank, 2004).

[29] See European Commission (2003) for a detailed discussion of expansionary fiscal consolidation episodes.

[30] International evidence suggests that the higher the debt overhang, the greater the impact of fiscal adjustment on interest rates. Drudi and Prati (2000) defend the idea that bringing up the primary surplus is particularly powerful in bringing down interest rates when a country is highly indebted. On the contrary, bringing up the primary surplus will have little impact on interest rates if a country is lowly indebted. This non-monotonic relationship between interest rates and the primary surplus stems from the fact that governments have an incentive to tighten their fiscal regime when the signaling effect on credit ratings is larger (i.e. when a sufficiently large stock of debt has been accumulated). This interactive effect between debt and the primary surplus on interest rates was observed in OECD countries, as well as in Brazil in the 1990s.

Policy Options

18. In this regard, a successful policy-package should consider three essential elements: (i) the Authorities need to work on improving the credibility of their commitments in order to reverse anticipations and lower interest rates; (ii) the investment climate needs to be improved simultaneously to raise the potential response of the private sector to better macro-economic conditions; and (iii) its political feasibility should be insured by an equitable distribution of the burden of adjustment across groups. With these conditions the short-term negative impact of fiscal adjustment on growth will be rapidly offset by its longer-term rewards.

19. To raise anticipations of a successful fiscal stabilization, governance issues must be frontally addressed. The immediate negative impact of fiscal stabilization plans on aggregate demand might be offset by enhanced anticipations of a brighter economic future. Lebanon could be particularly receptive to a change in economic perceptions, as its potential to mobilize new financial resources – from abroad in particular – is huge. The communication element of the package is in this respect essential, and the ingredients of a credible commitment are: clear objectives, an action plan, a timetable, publicly monitorable progress indicators, and full accountability for results. It can be improved by (i) locking in the reform process in the signature of binding international agreements[31] and (ii) improving the nature and transparency of economic information[32]. The other element of a credible policy-package is to work on improving structurally the overall use of public funds (transparency, accountability, medium term planning) – governance. The agenda is large, but there are reforms which could rapidly pay off in terms of higher credibility. It includes notably the enacting of a fiscal responsibility law[33], the passage of the procurement law, the full budgeting of existing contingent liabilities (e.g. pensions, see Chapter II) and the restructuring of EdL. In the longer run, reforms to modernize the civil service, budget processes' transparency and efficiency and the planning of capital expenditures are needed (see Chapter IV).

20. In parallel, there are several structural reforms which would improve the responsiveness of the private sector to better macro-economic conditions. While demand

[31] Such as the EuroMed or WTO accession, which sets the rules of competition and transparency? The signature of structural adjustment loans programs with the IMF and the World Bank also enhances the credibility of consolidation plans as they are supervised by international bodies and rendered less painful with the credits provided by the institution to facilitate the adjustment.

[32] Lebanon ranks 109th out of the 117 countries of more than 1 million inhabitants listed by the World Bank in terms of statistical capacity.

[33] Many countries have explicit fiscal rules and these pre-commitments to binding fiscal action are sometimes very important to tie down accountable actions on the part of both the Government and the Parliament and other actors. These are most evident in the EU where member countries have tied themselves to fiscal discipline (budget deficits not to exceed 3 percent of GDP, and fiscal consolidation agreements in newly accession countries) as a condition of joining the EMU, with an agreed framework for fiscal surveillance. In the UK, as well, a Code for Fiscal Stability and transparent policy objectives have been in force for some time, underpinned by two fiscal rules: a "golden rule" that allows Governments to borrow only for investment and not current spending over the business cycle; and a "sustainable investment rule" to ensure that public debt remain at a prudent level. These two rules provide an over-riding framework for budgets and fiscal actions. Elsewhere, fiscal Responsibility Laws have been enacted in Brazil, Peru, and Argentina and are planned in Colombia, Ecuador. Such laws do not prevent budget flexibility in the face of unexpected shocks. Kuwait, for example, has set up a stabilization fund that is built upon when conditions are favorable and drawn from when they are not (ERF, 2002).

management will be key, the structural agenda should not be neglected. In the short run, fiscally neutral reforms should seek to improve the supply (investment) response to interest rates decline. Beyond privatizing public assets with a view to promote sound competition, there is a large agenda to improve the response of the private sector to a better macro-economic environment in Lebanon: reliable and affordable power supply; modern ICT infrastructure; efficient trade facilitation systems (including customs, border crossing, and transport logistics); a streamlined regulatory system for business entry, operation, and exit; modern corporate governance and capital market regulations; protection of intellectual property rights; and a legal framework to ensure competition in competitive markets as well as for restricted markets (utilities, public services, and natural monopolies). Some of these reforms could be undertaken in the short run at low fiscal cost.

21. **But at the end of the day, reducing the debt remains a political challenge, which will require a strong consensus among stakeholders.** Good technical solution, although obviously needed, will nevertheless not suffice. Recent episodes of fiscal adjustment attempts in Lebanon – the inability to sustain in the budget 2004 the efforts initiated with Paris II for instance – illustrate the limits of a technical program not supported by a strong political consensus. By contrast, successful fiscal stabilization episodes in the world have all been achieved by strong, cohesive and determined executive powers, benefiting from sufficient political support to sustain adjustment efforts over several years (Nabli, 2004). This will necessarily require equitably sharing the burden of adjustment and reinforcing social protection. A stabilization plan which would let the poor bear the full burden of adjustment would be short-lived, as it could not generate broad-based support for reform.

22. **Enhanced social protection in the transition is important**, given that fiscal consolidation might have a negative impact on employment in the short run. There is a strong political economy value as well as economic reasons to enhancing social protection measures in the immediate phase of spending declines. These could include community development programs targeted at ensuring greater access to social services (education, health, etc.), regional programs targeting the poorest areas, and conditional cash transfers. In the longer run, the overall social protection strategy needs to be re-evaluated (See Chapter III). In addition, immediate protection for public sector employees of privatized enterprises will need attention. Public utilities currently employ large numbers of employees, who are bound to comprise a sizeable political deterrent to privatization. It is essential that the process be managed up-front. Without agreed actions, few bidders are likely to emerge for some of the over-manned and over-staffed employees. Options include absorbing surplus employees in other departments temporarily, voluntary retirement schemes, and involuntary redundancies over time with compensation payments. Paying for such expanded programs should be part of the agenda on the design of fiscal adjustment programs.

23. **Privatization should benefit the population**. The privatization program should seek a good compromise between its economic (cheaper and better utility costs) and financial (the reduction of the debt stock) impacts. But one could also make sure that debt retirement particularly favor the poor and vulnerable sections of the society. Thus, privatization revenues could be prioritized to the reimbursement of the Treasury Bills portfolios in Lebanese Pounds of both the National Social Security Fund (mainly pension fund reinvested surpluses) and the

Institute of the Guarantee of Deposits. In the first case, the pension of thousands of workers would be disconnected from the debt risk. And in the second case, the small depositors would be protected, as the amount guaranteed does not exceed four thousand US Dollars per depositor, which is equivalent to the average deposits of more than two-thirds of the Lebanese depositors. Setting low tariffs and connection fees for basic privatized services will also be imperative for poverty alleviation.[34]

24. Debt holders should contribute to the effort of adjustment. Each segment of the society would seek to have the other pay the price of adjustment. It is in effect a "prisoner's dilemma" where all segments will gain from cooperating, and lose in the end if each side sought to evade the cost. But overall losses would be significantly reduced if spread across the society. For an adjustment to be politically viable, those who have benefited from the debt would have to contribute to the cost of adjustment in a manner proportional to the profits earned. Otherwise the program would most likely fail politically, as it would be perceived as a net transfer from the vast majority (the taxpayers, the civil servants) to the happy few holders of the public debt. The fact that Lebanon's debt is largely domestic is helpful in this regard, as it is in the interest of creditors to maintain financial, social and political stability. In 2003, commercial banks probably contributed to the efforts of stabilization as some prerequisites were met: commercial banks' efforts were part of a broader effort, with clear commitments from the Government, donors and the Central Bank; and collective bargaining prevented free-riding behaviors. In the event, banks benefited from greater financial stability to double their disposable profits. As banks' exposure to sovereign risk is very high, it is again in their utmost interest to preserve the solvency of their principal debtor, the Government. In this respect, the latter could further exert its monopolistic power to convince banks to contribute more to the overall effort of stabilization.[35] Beyond their positive influence on the political feasibility of the adjustment, these actions would also directly contribute to the adjustment in the form of lower debt service.

25. Expenditure rationalization cannot guarantee fiscal stabilization, but remains crucial for growth. Given the size of Lebanon's current fiscal imbalances and debt stock, bold expenditure reform alone is most likely not a sufficient condition to restore fiscal sustainability. Tax increases, privatization, debt restructuring and the financial support of Lebanon's friends are also needed to bring back the debt to GDP ratio to more quiet waters, but are not granted. In Jamaica, a decade of bold fiscal adjustment has not succeeded in curbing down the debt dynamics[36]. And at any time a confidence shock could eliminate the long and painful efforts

[34] The key to a pro-poor privatization policy is two-fold. First, ensure competition and an effective regulatory framework to ensure efficient delivery of the service. Second, explicitly take into consideration the poor fractions' ability to pay. Policy choices largely depend on existing conditions. For example, if most of the poor are already connected to the service, then they tend to benefit more if the tariffs are chosen as the competitive variable in a concession process. In contrast, if most of the poor segments are not connected, then requesting target connections or target capital investment commitments have a higher potential of benefiting the poor. Choices also include a subsidy policy, whereby connection fees can be subsidized, or tariffs be designed to ensure a low rate for basic needs, and then progressively increase for higher rates of consumption.

[35] Various options could be envisaged in this regard, from debt restructuring (as it happened after Paris II) to raising the interest rate tax (currently at 5 percent of interest income), which allowed in 2004 the collection of 0.7 percent of GDP.

[36] In spite of a primary surplus of 10 percent of GDP on average over the period 1993-2003, the debt to GDP ratio went up from 114 to 149 percent during the same period. Slow growth, a financial crisis and the political difficulty to maintain consistently fiscal efforts throughout a long period (in 1996, the Government raised significantly the

undertaken by Lebanon to bring up its primary surplus, as vulnerabilities will remain high in all circumstances in the foreseeable future.[37] Hence expenditure containment for its own sake could look irrelevant in the face of its high political and social costs, and additional objectives attached to it are required to justify it in all circumstances: (i) improving Lebanon's growth potential through a better public service delivery and investment climate and (ii) reinforcing social protection are the natural candidates. Indeed, several important structural obstacles to growth and social protection are directly related to poor public expenditure management (unproductive public administration, corruption, ineffective resource allocation, and poor management of public enterprises) [38]. In other words, large spending in some sectors is the symptom of inefficiencies and weak governance, and expenditure reform, if properly designed, can prove to be a very powerful means to foster growth and alleviate poverty, beyond its impact of protecting against financial crisis.

wage bill and primary spending) illustrate the downside risks of any fiscal adjustment program (World Bank, 2004c).

[37] Simulations suggest that a reasonable combination of bold fiscal adjustment measures, debt restructuring, privatization and donor assistance could bring back the debt to GDP ratio to approximately 150 percent of GDP in a five-year period, assuming no confidence shock along the road.

[38] The revenue side is not the subject of this PER. Nevertheless, it is believed that a reform of the tax system could also significantly help mitigating inequalities and distortions.

Chapter II. Containing Primary Spending: What Can Be Done?

26. **The functional classification structure of the budget reflects Lebanon's priorities; the economic classification the means to achieve it.**[39] While the former is of the sovereign domain and relates to choices that go beyond the scope of a public expenditure review (such as military spending for instance), the latter can always be discussed on efficiency and sustainability grounds. Furthermore, the functional classification does not necessarily match outcomes in Lebanon. Social spending, for instance, is not only the aim of the ministries of Education, Social Affairs and Health (see Chapter III). Other ministries contribute as well to social spending, making the functional classification difficult to interpret from a performance point of view. Besides, most of the problems currently faced in the various administrative entities (ministries, agencies, etc.) are common in nature, and very often related to governance issues. From this perspective, it makes sense to look primarily at the budget through its economic classification, and try – with a view to support fiscal consolidation (see Chapter I) – to identify where sources of savings could potentially lie in the following categories: (i) wage, salaries, benefits and (ii) pensions of civil servants, militaries and contractual workers, (iii) transfers to extra-budgetary entities, (iv) other current expenditures and (v) capital expenditures, without affecting the provision of public goods.

Table 3. Economic Classification of Public Primary Spending

	2000	2001	2002	2003	2004
Wage, salaries and compensations (% of GDP)	8.3	8.4	7.8	7.5	7.0
Pensions (% of GDP)	3.4	3.3	3.1	2.8	2.5
Transfers to extra-budgetary entities (% of GDP) a/	-	-	-	2.5	2.9
Other current expenditures (% of GDP)	-	-	-	2.4	3.2
Capital expenditures (% of GDP) b/	4.1	2.4	2.9	3.1	3.2
Other primary expenditures (% of GDP) c/	3.8	0.9	2.0	1.5	1.9
Total primary expenditures (% of GDP)	26.9	19.0	20.6	19.7	20.6

Source: World Bank staff calculations based on MoF and MoET. Expenditures are on cash basis (i.e. exclude arrears). a/ transfers to EdL to cover their debt service and principal debt repayment are here considered primary spending; b/ capital expenditure includes CDR expenditures. c/ other primary expenditures mostly encompass the settlement of arrears and carry-overs. See Annex I for further details.

Wages

27. **Wages and Salaries (including benefits, advances, compensation, but excluding pensions) of civil servants, military forces and Government's contractual workers represent 7 percent of GDP and 34 percent of primary expenditures.** Public wage expenditures in Lebanon are not particularly high by international standards (compared to 8 percent of GDP on average in middle income countries), and any attempt to modify frontally their structure is likely to face fierce opposition – hence producing little chance of success in Lebanon's current political environment. This is even more so since public wages are apparently

[39] See Annex 1 for a detailed report of functional and economic classifications.

low in absolute[40] and relative terms[41], and have been de facto frozen (along with hiring in the civil service) since 1997.[42] Yet, the average age of the Government's civil (including non civil servant public employees) and military employees are respectively 42 and 33, and about 20 percent of them could retire in the next 5 years (and 45 percent in the next 10 years) under current pension regulations[43], so that it might be advisable to work on replacement policies (net flows) rather than on the labor force stock directly. Besides, the privatization of some public functions (19 percent of the public labor force works in State Owned Enterprises, see Chapter IV) should help lowering the overall public labor force. Replacing only two out of three pubic workers retiring in the next ten years, halving the number of contractual workers and privatizing the public electricity company in the next five years could eventually help Lebanon saving about 1.0 percent of GDP per year on its public wage bill. But this fiscal space should be used rapidly to modernize its civil service, once public needs are better defined and civil service reform is forcefully engaged.

28. **Working on replacement policies calls for a reflection on employees' functions.** But reliable data on the number of employees of the public administration, their qualification or their geographical distribution do not exist. Despite numerous efforts to rectify this situation, there are four databases for public employees (these are at the Civil Service Bureau, the Ministry of Education, the Armed Forces and the MoF) without systematic linkages between them. The MoF also manages the payroll but the extent to which the payroll matches actual employment is not controlled. Any attempt to rationalize wages and wage-related expenditures will primarily require a civil service census of the existing public labor force, approximately estimated at 220,000 (see Chapter IV).

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[40] Public employees (civil and military servants and contractual workers) received in 2004 US$31 per day on average in PPP terms, to be compared with US$35 in Jordan for instance.

[41] In the absence of recent labor force surveys, it is difficult to establish a strict comparison between public and private remuneration. National accounts for 1997 (MoET, 2003) report that labor compensation represented 41 percent of GDP at factor cost (the remainder 59 percent are gross operating surpluses - profits). With 35 percent of Lebanon's population being active and an unemployment rate of 11.5 percent (Kasparian, 2003), the average per capita labor compensation in the private sector would be 8 percent lower than that in the public sector (not controlling for personal characteristics) in 2004. But national accounts typically underestimate the real contribution of labor to GDP, as they ignore invisible labor remuneration, such as the implicit labor income of employers, unpaid family workers and self-employed workers, generally sizable in agriculture and services. Under the (still conservative) assumption that labor remuneration could represent 50 percent of GDP, then private sector per capita labor remuneration would be 16 percent higher than that of the public sector. Most econometric estimates of labor contribution to GDP in middle-income countries put this share between 50 and 70 percent.

[42] The decision to increase wages was passed at the Parliament in November 1998 but was never implemented. As a result, the Government built up the equivalent of LBP1500 billion worth of arrears vis-à-vis its employees, see below.

[43] Thirteen percent of the contributors to the civil scheme are about to retire in the next 5 years and 30 percent in the next 10 years; 20 percent of contributors to the military scheme are about to retire in the next 5 years and 43 percent in the next 10 years); 24 percent of contributors to the EOSI program are about to retire in the next 5 years and 51 percent in the next 10 years (Source: World Bank staff calculations). Under the assumption that public employees not contributing to the civil or military schemes (maybe 120,000 persons) are contributing to the EOSI program and have the same demographic structure than the population of all contributors to the EOSI program, then it is estimated that 20 percent of the 220,000 public labor force could retire in the next five years.

29. Public employment accounts for approximately 18 percent of total employment and has effectively become an expanded social safety net in the post–war period with considerable overstaffing. This ratio is very high by international standards and consistent with the observations of (i) low individual remuneration in the public sector and (ii) moderate public wage bill as a percentage of GDP. As emphasized in Chapter III, a significant share of Lebanon's public social spending takes the form of benefits for public employees (0.9 percent of GDP and 15 percent of public social spending, excluding pensions). Reducing the public labor force through attrition is hence contingent on the development of wider safety nets and sustainable pension schemes (see below and Chapter III).

30. At the root of the inability to rightsize public labor force is the governance structure. A Civil Service Council was introduced in 1959 to take away personnel and hiring decisions from the different Government departments and Ministries. It was intended to reduce favoritism and introduce merit within the Lebanese civil service. The council has a powerful board and its executive officer has the same powers as a minister. However, the authority of the council has gradually been undermined and over time become largely paralyzed by sectarian politics. [44] This situation prevents it from becoming the natural hub for reforms of human resource management in Lebanon.

31. The Government has no explicit employment policy nor any indication or assessment of future staffing needs. In addition to lack of reliable data about the current size of the civil service, the Authorities do not have plans for human resources management or directions for future recruitment. Despite the large size of the public administration, there are also chronic shortages in special skills. The extent to which Lebanon will be able to contain its public wage bill, thus, depends on forging consensus on the role of the State in the provision of services.

32. Clarifying the role of the State is crucial to overcome Lebanon's political obstacles. Fragmented efforts to address public sector reforms are unlikely to succeed without addressing the issue of civil service reform and reducing the size of public sector employment. Current efforts focus on combating corruption, improving the climate for private sector development and strengthening the regulatory powers of the public sector. While these efforts are good in their own right, they may not succeed without clarifying the role of the State. These measures individually have only marginal effects on the situation of public administration in Lebanon, yet taken together do not amount to much either, since they are touching at many reform areas, without solving any. A comprehensive multi-pronged approach is required.

33. Unless the issues of recruitment, remuneration and retrenchment are addressed, the public sector will remain inefficient, costly and prone to corruption. The civil service is currently over-staffed with people who have little training and who are unprepared to tackle the modern demands of public administration. A new and aggressive human resources strategy,

[44] In 1993, there were strong initiatives for reforms and some 3,000 employees were retrenched for not living up to their obligations or were under-qualified for the positions they held. Since then, further retrenchment became politically rather difficult (see Chapter IV). Public hiring has traditionally played an important social safety net (see Chapter III) and a political role in Lebanon, insuring a redistribution of public resources across the various sectarian groups.

which focuses on the recruitment of qualified staff and identification of performing staff, is needed to introduce new blood into the system. Human resources management reforms have to be conducted in accordance with changes in management practices and introduction of performance management and monitoring into the civil service. These issues are discussed in Chapter IV.

Pensions[45]

34. **Pensions and end-of indemnity services for civil servants, military and Government's contractual workers account for 2.5 percent of GDP and 12 percent of primary public expenditures**[46]**.** Various schemes co-exist: two defined-benefits pay-as-you-go systems for civil and military services, and an end-of-service indemnity (EOSI) program for government's contractual workers. The latter is directly managed by the National Social Security Fund (NSSF), financed through capitalization, and also covers private (formal) sector workers. The two pension schemes for civil and military staff provide benefits higher than contributions and are therefore financially unsustainable.[47] Their combined deficit approached LBP810 billion in 2004 (2.5 percent of GDP, entirely financed by the budget), and could reach LBP1225 billion in 2010 (2.8 percent of GDP for a 5 percent annual GDP growth rate over the period 2005-2010) in the absence of any major reform. The implicit debt of the system has already attained more than 50 percent of GDP (World Bank 2005b).[48] The long term financial stability of the end-of-service indemnity program is also not guaranteed, but has sufficient reserves to keep the system afloat until 2020 without entailing additional fiscal costs. This relative stability is nevertheless conditioned on the reimbursement of arrears (or its conversion into formal debt) accumulated by the Government vis-à-vis the NSSF (some LBP867 billion or 2.6 percent of GDP by end-2004[49]), and the avoidance of new arrears. It is also conditioned on the possibility for the NSSF to (i) protect its pension reserves from being diverted to financing other NSSF programs (e.g., health and family allowance, which cumulated a deficit close to 1.0 percent of GDP in 2003) and to (ii) optimize its financial placements from a risk and return perspective[50].

35. **Reforming public pension schemes is urgently needed, feasible, and could generate sizeable savings in the short run.** Reforms of the military and civil service pension schemes are possible, through parametric changes (e.g. gradually modifying contributions, benefits formula, or eligibility conditions). The system would remain open to new entrants and calculations assume a mild expansion in the number of contributors[51]. A comprehensive package[52] of

[45] This section draws heavily on World Bank (2005b).

[46] This category does not include Government's contributions (as employer) to the end-of-service indemnity program for its contractual workers.

[47] Defined benefits received by retirees are higher than what sustainability would entail given the current retirement age, life expectancy and the contribution of beneficiaries. The situation is particularly severe for the military scheme, which contributed alone to 4/5 of the public pension scheme deficit in 2004.

[48] This corresponds to the present value of pension promises (as the system is based on defined benefits) made to current retirees and to current contributors.

[49] This figure also includes arrears accumulated by the Government vis-à-vis NSSF health and family allowance programs.

[50] The NSFF is legally bound to invest its funds into LBP-denominated instruments, which leaves little room for risk diversification.

[51] This assumption is not inconsistent with earlier discussions on reducing the size of the civil and military administration, as a lower number of contributors could be compensated with higher individual remunerations (see

parametric changes in the civil service and military schemes could reduce the deficit to up to LBP594 billion in 2010 (or 1.4 percent of GDP), against LBP1225 billion in the absence of any reform. In other words, a comprehensive reform could help saving 1.4 percent of GDP each year by 2010 (and up to 1.9 percent by 2050). Accordingly, the implicit debt of the system would go down from 66 percent (without reform) to 30 percent (with reform) of GDP in 2010.

36. **But the Government could also consider closing public schemes to new entrants, as it would provide greater long-term developmental benefits, beyond fiscal aspects.** Basically, the schemes for the civil service and the military would stop accepting new members. Those who would stay in the current scheme would face some gradual adjustments in the system, along the lines discussed in the previous paragraph. New civil servants and military personnel, on the other hand, would join the reformed scheme for private-sector workers.[53] Basically, Lebanon would converge, over time, to an integrated pension system. Although significantly improving the long-term fiscal stance, this operation would typically entail higher costs for the Government in the short run (compared with keeping the schemes open), as the latter would have to transfer to the NSSF the contributions of new members and its contributions as employer. Besides, the contribution rate envisaged in the reformed private sector scheme is twice higher than that in the civil and military schemes. Net fiscal gains, though, would remain substantial, as the closure of existing pension schemes to new entrants combined with their reforms would still permit to save 1.2 percent of GDP in 2010 (against 1.4 percent if schemes remain open to new entrants, see above). Furthermore, this reform would eliminate the implicit Government's pension debt over the long run, reduce inequalities between public and private workers and facilitate labor mobility between public and private sectors (see also Chapter IV). Finally, from a political economy perspective acknowledging the difficulty to introduce all parametric changes, a transfer of new entrants to the reformed private sector scheme would actually become less expensive from a fiscal point of view.

Transfers to Extra-Budgetary Entities

37. **Transfers to extra-budgetary entities represented 2.9 percent of GDP and 14 percent of the Government's primary expenditures in 2004.**[54] They mostly comprise transfers to public autonomous agencies, public enterprises and private non-profit institutions[55] - 2.6 percent of GDP, the remainder, 0.3 percent of GDP, being constituted of explicit subsidies to SMEs (soft loans for agricultural and export sectors, oil price subsidies for the transport sector).

Chapter IV). Contractual workers and employees of public agencies and enterprises are not considered in these calculations as covered by NSSF.

[52] Calculations envisage the elimination of allowances and lump sums, the elimination of the multiplier that applies to the number of years of contribution in the military regime, the inclusion of career wages in pension formula, the reduction in the accrual rate, the increase in the retirement age and contributions and penalties for early retirement.

[53] The current end-of-service indemnity program imposes large and uncertain costs on employers, which can reduce labor demand and encourage tax evasion. It also restricts the mobility of the labor force across firms and contributes to the fragmentation of the labor market. Nor does it provide adequate protection to plan members. The draft law prepared in early 2005 to transform the current program into a fully-funded defined contribution program permits to address these shortcomings and is financially sustainable. This reform would nevertheless entail additional fiscal resources (in the range of 1 percent of GDP), but only after 2020.

[54] Transfers to the NSSF and the Independent Municipal Fund (although both extra-budgetary funds) are excluded from this category and discussed in the other current expenditures section.

[55] Non Governmental Organizations (NGOs) in particular, through the Ministry of Social Affairs, see Chapter III.

Out of the former category, 1.8 percent goes to the electricity company (EdL) and water authorities to cover their operating losses and debt repayments. The final destination of the remaining 0.8 percent is difficult to trace, as it is not explicitly reported in budget documents, but it is believed that the bulk of it goes to support financially autonomous agencies, and cover their losses in some cases. Indeed, the ability of SOEs and public autonomous agencies to build arrears (and the associated practice of transfers from the Government to cover it) makes any serious expenditure planning unachievable (World Bank 2005a), and calls for the full inclusion of these extra-budgetary entities into the budget framework.[56]

38. **At the heart of any reform of public enterprises / autonomous agencies[57] lies the question of their ultimate role in the provision of public goods.** Over the last years, the Government has legally or technically paved the way for the privatization of some of these agencies and enterprises, but two elements, inter alia, have probably prevented its realization so far. First, the role and responsibilities of entities foreseen to be privatized have yet to be spelled out, in order to forge consensus on their destiny. Some of them are indeed playing important roles in terms of providing implicit subsidies or additional public revenue in the form of monopolistic rents. Actually, some public enterprises are generating net revenue for the Government[58], but maybe at the expense of greater competition and growth. A greater participation of the private sector in these enterprises/agencies – up to privatization, would require an ex-ante distinction between "normal" private commercial operation and the set of instruments (tax and subsidies, regulation of tariffs and standards, etc.) that would remain in the hands of the Government to regulate markets and provide public goods. Second, some of these entities need major overhaul (including audited accounts, investments, debt relief, etc.) and, primarily, a credible regulatory framework to eventually attract private investors' interest.

39. **From fiscal and economic points of view, the reform of Éléctricité du Liban (EdL) is a clear priority.** Government's transfers to EdL are threefold: treasury advances (to cover operational losses), debt coverage and investments subsidies. Only a part of theses transfers are structured as loans, and often thereafter converted to grants. The Government estimates that during the last decade, its yearly financial support to EdL was close to LBP500 billion, not accounting for Government's financial support of capital expenditure. Transfers to EdL amounted to LBP492 billion in 2004 (1.5 percent of GDP, not including Central Bank loans to EdL, which amounted to LBP250 million in 2004). Restoring EdL's financial autonomy would hence definitely exert a strong impact on Government's fiscal sustainability itself. Regained financial autonomy and reliability of service delivery could also allow the reduction of the cost of power[59] for producers and consumers, to the benefit from greater economic activity.

[56] World Bank (2005a) also recommends that a new law on public enterprises be prepared, with a view to strengthening governance processes and improving auditing and reporting practices. It is also highly recommended that the Government increases its oversight of public enterprises and discontinue the practice of converting loans to grants without prior Parliamentary approval.

[57] There are currently 72 public enterprises or autonomous agencies (including the Central Bank, the NSSF, EdL, IDAL, Water authorities, CDR, councils of the South and Displaced, etc.), some of which have commercial activities. See World Bank (2005a) for the detailed list.

[58] In 2004, revenue from public institutions and government property amounted to 4.4 percent of GDP, out of which 4.0 percent from the sole Telecommunications sector.

[59] By regional and international standards electricity tariffs are high in Lebanon (US¢ 8.6/Kwh). Furthermore the lack of reliable service encourage consumers and producers to use other sources of supply (mainly diesel

40. A combination of factors explains EdL's precarious situation. EdL lacks a well articulated and comprehensive energy policy, as well as an appropriate Governance structure. The MoF's quasi obligation to cover losses (to avoid blackouts) and growing subsidies inhibit EdL from adopting a sound financial discipline. EdL's production costs are well in excess of what should be expected from a largely thermal based system. These high costs of supply are exacerbated by the high rate of commercial (illegal connections) and technical losses. The tariff structure is un-adapted to the demand patterns, preventing EdL from fully exploiting its monopolistic position; EdL lacks staff in sufficient number and with adequate skills, in the face of its inability to hire, as decided by the Government. While EdL's number of staff (2,250) seems to suggest that labor efficiency is high, what it masks is the fact that EdL lacks sufficient number of skilled staff allowing it to improve its efficiency and increase its collection rate. Furthermore, the fact that EdL's financial accounts were not certified during the last three years, suggests that the operator lacks the management and financial staff capable of implementing a sound and sustainable reporting system.

41. Reform efforts have been recently made, but the most challenging issues have not been tackled yet. Without implementing a comprehensive set of corrective actions the quality of electricity supply is likely to deteriorate (as some plants get close to their end-of-life cycle[60]), and the burden on the Government's budget could further increase. The new electricity law from September 2002 only constitutes a first step in filling the lack of a comprehensive strategy to restore EdL's financial sustainability.[61] Some credit can also be given to EdL for improving bill collection and reducing the number of illegal connections in the recent years. It has prepared for the introduction of natural gas through the construction of two combined cycle plants (and associated pipe lines for transmission to one of them), and a contract to import natural gas from Syria has been signed.[62] But while a switch to a largely gas based power system would help to reduce generation costs, it would not be sufficient by itself to resolve the problems in the power sector. For example, some key transmission and substation projects designed to remove bottlenecks in the system and allow for import of electricity have still not been completed. Necessary institutional reforms to improve governance of the sector appear to have been assigned much lower priority.

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generators), which are more expensive but more reliable. It is estimated that private generation amounts to 20 percent of the electricity production in Lebanon (World Bank 2004d).

[60] Lebanon's actual capacity for electricity generation is at 1,400 MW, and will further decline unless some capacity investments are made. Lebanon's current needs are estimated close to 2,000 MW, and could reach 2,500 MW in the medium term if industrials were to renounce to generate their own electricity.

[61] On September 5, 2002, the Parliament approved Law # 462 which outlines the way the electricity sector is to be governed and provides the basis for introducing private sector participation. However, the law is silent on a timeframe for implementation, on how many corporatized entities should be created for generation and distribution. There is also no provision requiring the private or public entities in the sector to provide electricity at the lowest possible economic cost in an environmentally sustainable way or to introduce market based incentives or competition. No substantive preparatory work has been done so far to implement the industry structure envisaged under the law.

[62] Importing gas from Syria will not solve all problems: first, because there is currently no pipe line between Syria and the southern plant (Zahrani); second because Syria's supply capacities of natural gas are probably insufficient to meet Lebanon's needs.

42. The Government and EdL have recognized that there are no quick fixes to the problems of the power sector. They have developed a roadmap which set a comprehensive program in motion, which could result in reliable electricity supply at reasonable cost and power utilities which can operate without government financial support. Provided that an appropriate Governance structure can be put in place, introduction of private sector participation could be an appropriate tool to help achieving the Government's objectives. However, it will take several years to implement such a program. The comprehensive approach proposed by the roadmap has the following key elements: (i) build capacity to implement reforms (ii) reduce the cost of supply and improve systems reliability; (iii) prepare and initiate the corporatization and commercialization process; (iv) prepare an interim management contract (for about 2 to 3 years; (v) design a long term strategy, including options for the optimal industry structure and further private sector participation and an appropriate regulatory framework; and (vi) initiate a public relations campaign.

43. Any comprehensive strategy will also entail up-front costs. EdL can save some money on two fronts: by reducing generation costs and technical and commercial losses. At current gas and oil prices, some LBP300 billion worth of generation costs could be saved every year with the two main plants (Bedawwi and Zahrani) switching to natural gas from 2007 onwards. Around LBP225 billion could also be saved by replacing two other fuel plants (Jiyyeh and Zouk) coming to the end of their life with natural gas plants at the 2010 horizon. And another LBP60 billion could roughly be saved annually by halving technical/commercial losses[63]. All in all, this full package of savings could basically eliminate EdL's operational losses in a five-year time.[64] But achieving these transformations will require physical investments in the generation, transmission and distribution sectors in the order of US$1.15 billion. Part of these investments could be financed with soft loans from donors, while others could take the form of BOT and DBOT contracts. In the meantime, some significant savings could be made in the procurement of oil and diesel, by revising bidding / tendering practices and setting less stringent standards. Initial steps taken by the Ministry of Energy and Water in these directions could already permit to save US$60 million in 2005.

Other Current Expenditures

44. This category covers transfers to the Social Security, Hospitals and Municipalities (2.5 percent of GDP and 13 percent of primary expenditures) and Government's operational expenditures (0.7 percent of GDP and 3 percent of primary expenditures). The first set of expenditures is largely under-funded, and has represented a major source of the

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[63] Twenty-three percent of the electricity produced is not billed or collected (commercial losses), while another 15 percent is lost during transmission (technical losses). The Government envisages bringing down these two ratios to 10 percent, by rehabilitating the transmission and distribution networks and placing intermediate and end-use meters to identify the source of commercial losses.

[64] These calculations do not include the repayment of the part of EdL's outstanding debt, which has not been consolidated with that government debt, nor in reverse the settlement of Government and public entities arrears with EdL (unpaid bills). In the absence of consolidated accounts for the whole public sector (Central Government, municipalities, public enterprises, autonomous agencies) and for EdL in particular, it is difficult to estimate these amounts. These calculations do not include either pension liabilities accumulated by EdL vis-à-vis its employees. As the latter are civil servants, such liabilities are part of the overall government implicit debt discussed in the section on pensions.

Government's built-up arrears (including LBP867 billion vis-à-vis the NSFF, LBP139 billion vis-à-vis the Hospitals, and LBP800 billion for expropriations by end-2004). As such, it is difficult to envisage a compression of government spending in these areas in the short run. The regularization of flows should take place rapidly while the stock of arrears should at least been converted into official debt (see below). This does not, however, prevent the Government from starting to re-evaluate its overall social protection strategy along the lines discussed in Chapter III.

45. Operational expenditures could be rationalized through a revision of procurement rules and practices. Ministries and public agencies have to abide by an antiquated Public Procurement Law and procedures dating back to 1959 and 1963.[65] A revised draft public procurement law was prepared by the Government but was never passed by the Parliament. If approved and implemented, it would greatly enhance the efficiency and transparency of public procurement procedures and would allow donors to rely increasingly on national public procurement systems. Not only would this help to rationalize operational expenditures, but it would also accelerate disbursement on donors' projects – see below. Reaping all the benefits of more transparent procurement rules would nevertheless be conditioned on greater competition in the supply of goods and services consumed by the Government (see Chapter I).

Capital Expenditures

46. Consolidated Public Investment expenditures amount to approximately 3 percent of GDP and 15 percent of primary expenditures.[66] Out of the total, broadly one fourth is financed by donors, in the form of subsidized loans, while the rest is domestically funded. Typically, the cost of domestically financed capital expenditure is higher than that of foreign-financed, as interest rates on the domestic public debt are roughly double than those incurred on donors loans. Besides, the debt profile is different, with longer maturities for donors' loans.

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[65] According to these, public procurement is based on a centralized system managed by the Department of Tenders (DOT) of the Central Inspection Board (CIB). All procurement is to be listed in the annual General Schedule, which is finalized after the State Budget is approved. The legislation puts DOT in charge of carrying out the tendering for procurement of works and goods. Bid evaluation is mandated to the Central Committee for Tenders, whose members are approved by the CIB. This system worked at a time, when procurement of goods consisted of a limited number of standard goods and types of public works, and could therefore be managed efficiently by a core of qualified officers in DOT. The establishment of the Council for Development and Reconstruction (CDR) in 1977 specified the provisions regarding the financial and accounting transactions, including procurement procedures, applicable to CDR. Since then and for a number of years, CDR has taken over the management of a significant proportion of the public procurement. And more recently, in the absence of sufficient staff in the DOT, and as a result of the diversity and specificity in the scope of goods, works and services to be procured, ministries have taken in some cases advantage of exceptions provided by the Cabinet to manage their procurement. The current situation is, therefore, legally confusing and hardly sustainable. The previous legislation has become obsolete and its provisions no longer satisfy the requirements of a modern, transparent and efficient public procurement system.

[66] On top of public investment figures reported in the budget one should add foreign-financed (through loans) investment expenditures managed by the CDR. Though, the latter include some CDR contracts (up to US$100 million per year) with private enterprises which deliver regular services, and as such, should not be counted as capital expenditures.

47. **The economy and Government's budget are not receiving the full benefits of the capital expenditures that have been made.** In spite of US$8.5 billion disbursed between 1992 and 2003, the number of projects that have not yet been completed is large[67]. The major investments made in the power and telecommunications sectors, close to a quarter of total capital expenditures since 1992, are not yielding the benefits that should be expected: as discussed previously the electricity company is not financially autonomous, and power and communications costs are among the highest in the region. The sizable investments in roads are not being adequately maintained, and the physical investments in other sectors, particularly in the social sectors, have not been complemented with institutional development and policy reforms. Cost recovery in most sectors is limited.

48. **Nevertheless, in the face of future needs, there is little scope to further reduce public investment expenditure.** Maintenance and rehabilitation expenditures needed over the next five years are estimated by CDR (CDR, 2004) at a minimum of US$1.7 billion (or 1.4 percent of GDP every year, under the assumption of a 5 percent annual nominal GDP growth), not including the replacement of the two power plants coming to the end of their life (see above) and estimated at 0.7 percent of GDP. Hence, the sole maintenance of the public capital stock (not considering natural resources), including a complete overhaul of the power sector would broadly cost 2.3 percent of GDP every year (over the period 2005-9)[68], and any new investment project should be financed on top of this figure. With broadly 3 percent of GDP devoted to public investments, Lebanon is far below successful comparator countries[69], and further reducing this figure would most likely affect negatively economic output. Recent literature indeed points to the utmost need to maintain a minimum set of public infrastructure to enable growth (Arestoff and Hurlin, 2005).

49. **On the other hand, the total amount of investment plans under preparation most likely exceeds what Lebanon can financially afford in the next five years.** A total of US$5.2 billion worth of public investment projects are currently under preparation or have already been committed by the Government, in the form of capital budget carryovers, outstanding payment orders, ongoing CDR contracts, and the balance of program laws (multi-years budgets for which no budget appropriations have been made - although part of which may have already been contractually committed). This would represent annually an outlay of 4.1 percent of GDP on top of the 2.3 percent of GDP needed for maintenance, which would greatly undermine Lebanon's possibility to contain its primary expenditures in the near future. In all cases, there is a need to reduce the overall envelope of planned investments and reform public investment planning procedures (see Chapter IV).

50. **From a financing perspective, reducing the cost of public investment depends on raising the share of donors' funding,** as interest rates on donors' loans are cheaper than that

[67] For instance, an estimated US$1.2 billion had been spent by end-2003 on foreign funded projects that had not yet been completed (Source: World Bank staff calculations based on CDR data).

[68] Using a completely different methodology (based on the estimate of the current public capital stock and the assumption of a 3.3 percent depreciation rate), the Ministry of Economy and Trade concludes that the depreciation of public infrastructures represented 2.4 percent of GDP in 2002 (MoET, 2005).

[69] Tunisian and Jordanian public capital expenditures have been turning around 7 percent of GDP in the recent years. OECD countries used to invest about 5 percent of their GDP in public infrastructures until the mid-70s (Arestoff and Hurlin, 2005).

financing the public deficit. Raising this share depends first on utilizing more existing loans signed with donors. By end-2003, up to US$1.8 billion worth of future projects had been committed by donors for the next years, which would require counterpart funds in the range of US$400 to US$500 million.[70] Delays on these funds are costly, as they entail commitment fees for donors - typically around 0.5 percent of the unused funds. Raising the share of foreign-financed investment is contingent on a complete re-examination of the current portfolio of planned investments (both domestic and foreign-financed projects). It is also contingent on reforming CDR institutional responsibilities, procurement laws, parliament ratification procedures and settling arrears on expropriations which all reduce Lebanon's absorptive capacity of foreign funds for investments, as underlined in the World Bank's Country Portfolio Performance Review (CPPR) undertaken in late 2002. But even under optimistic assumptions, the potential savings stemming from a greater use of foreign funds would remain modest in comparison to the decision made regarding the overall envelope of public investments. Indeed, moving to a situation where half of public investment projects would be financed by donors (US$1.8 billion over five years if public investment remains at 3 percent of GDP) would only permit to save up to 0.05 percent of GDP every year. The main financial benefit would actually lie in the fact that donors' foreign loans have longer maturities (including grace periods), which could permit to reduce debt service in the short run and mitigate roll-over risks as well. On the other hand, greater reliance on foreign funds from donors would ceteris paribus increase the share of the public debt denominated in foreign currency and related vulnerabilities (see Box 1 on debt management). Probably more important in this process are the prerequisites which would permit to the use in a sustainable manner donors' funds more effectively: CDR reform, procurement law, parliament ratification procedures, public investment planning, capital and current budget consolidation. All these would reinforce the capacity of the Government of Lebanon to appraise the macro and micro economic relevance of investment projects. Some of these issues are discussed in more details in Chapter IV.

Possible Medium Term Expenditure Outlooks

51. There is significant scope to rationalize primary public spending over the next five years. The combination of the various reforms discussed in the previous paragraphs could permit significant fiscal space for adjustment, while laying the ground for a more effective provision of public goods. The table below illustrates in a prospective scenario the gains that could result from (i) the reform of civil and military pension schemes, (ii) the rationalization of current expenditures, (iii) the overhaul of the power sector (leading to the financial autonomy of EdL by 2010) and (iv) greater absorptive capacity of foreign loans. Reform of the civil service would be neutral fiscally (i.e., the wage bill would continue to grow at 3.3 percent every year, per its growth rate 1997-2004), as the reduction of the public labor force through attrition would be used to train government employees and develop a more effective incentives' framework.[71] This scenario is compared to another one ("status quo") where the Government would maintain per

[70] Preliminary estimates for end-2004 put the sum of projects that have been committed by donors for the next years at approximately US$1.5 billion.

[71] Replacing only two out of three pubic workers retiring in the next ten years, halving the number of contractual workers and privatizing the public electricity company in the next five years while maintaining the current nominal growth in wage expenditure would permit to spend 35 percent more by workers in 2010 than in 2004, in the form of training or wage increases.

capita primary public spending in real terms (i.e., allowing for a 2.5 percent annual increase in nominal terms, per inflation and population growth rates between 1997 and 2004), except for pensions, which would grow up by 7.1 percent annually in the absence of reforms, and the wage bill, which would go up by 2.1 percent as the Government would continue to impose wage and hiring freeze, hence saving through attrition.[72] By end 2010, the difference in total primary spending between the two scenarios could amount to approximately LBP1,000 billion. Comparing the situation by end-2010 with that of end-2004, a full package of reforms would permit to contain annual growth in nominal expenditure at 1.8 percent over the period, against 4.0 percent in the absence of reforms. Both scenarios assume that the Government stops accumulating new arrears vis-à-vis its employees and the NSSF from 2005 onwards – see below. Table 4 below reports the scenarios under the assumption of a 5 percent annual increase in nominal GDP. Under such an assumption, expenditure reform could contribute to a 3.5 percentage point increase in the primary surplus over GDP.

[72] Wages would continue to go up by 3.3 percent annually the result of promotions, but the wage bill would increase less rapidly, as one-third of the employees retiring would not be replaced.

Table 4. Prospective Public Expenditure Outlooks (as a percentage of GDP)

	2004	2005	2006	2007	2008	2009	2010
Status Quo Scenario							
Wage, salaries and compensations a/	7.0	7.5	7.2	7.0	6.8	6.7	6.5
Pensions b/	2.5	2.6	2.6	2.7	2.7	2.8	2.8
Transfers to extra-budgetary entities c/	2.9	2.9	2.8	2.8	2.8	2.8	2.8
Other current expenditures d/	3.2	3.4	3.3	3.3	3.2	3.1	3.0
Capital expenditures e/	3.2	3.1	3.1	3.0	2.9	2.8	2.8
Other primary expenditures e/	1.9	1.8	1.8	1.7	1.7	1.7	1.6
Total primary expenditures	20.6	21.2	20.9	20.5	20.2	19.8	19.5
Reform Scenario							
Wage, salaries and compensations f/	7.0	7.5	7.4	7.3	7.2	7.1	6.9
Pensions g/	2.5	2.3	2.1	2.0	1.9	1.7	1.6
Transfers to extra-budgetary entities h/	2.9	2.5	2.2	1.9	1.6	1.4	1.2
Other current expenditures i/	3.2	3.4	3.3	3.1	3.0	2.9	2.7
Capital expenditures j/	3.2	3.2	3.2	3.2	3.2	3.2	3.2
Other primary expenditures k/	1.9	1.8	1.8	1.7	1.6	1.5	1.5
Total primary expenditures	20.6	20.8	20.0	19.2	18.5	17.8	17.1

Source: World Bank staff calculations. Nominal GDP is assumed to grow by 5 percent annually. Notes: a/ the wage bill is assumed to grow at 2.1 percent annually (see main text). As of 2005, the Government stops accumulating new arrears vis-à-vis its employees; b/ the deficit in civil and military pension schemes goes up to LBP1225 billion by end 2010 (see main text); c/ transfers to EdL go up to LBP700 billion by end 2010. Other transfers go up by 2.5 percent annually (i.e. stay constant in real per capita terms, per the inflation and demographic rates 1997-2004 – see main text); d/ grows up by 2.5 percent annually. As of 2005, the government stops accumulating new arrears vis-à-vis the NSSF; e/ grows up by 2.5 percent annually; f/ the wage bill is assumed to grow at 3.3 percent annually. As of 2005, the Government stops accumulating new arrears vis-à-vis its employees; g/ the deficit in civil and military pension schemes goes down to LBP704 billion by end 2010 (see main text); h/ transfers to EdL are eliminated by end 2010 (see main text). Other transfers grow up by 2.5 percent annually; i/ goes up by 0.3 percent annually, the result of a 10 percent drop in prices by 2010 (the result of improved procurement practices and reduced corruption) before inflation and population growth. As of 2005, the Government stops accumulating new arrears vis-à-vis the NSSF; j/ goes up by 5 percent annually; k/ goes up by 0.3 percent annually, the result of a 10 percent drop in prices by 2010 before inflation and population growth.

52. **Estimated Government's stock of arrears, at LBP3425 billion (10 percent of GDP) by year-end 2004, should be settled in the next years.** The recent computation of arrears by the Ministry of Finance, although tentative and yet un-audited, reveals sizeable contingent liabilities: various arrears (delays of payment) have been accumulated over the recent years, mainly vis-à-vis extra budgetary funds (NSSF and the Institute of the Guarantee of Deposits), private operators (hospitals, contractors), households (through the expropriation of their land) and public employees (for which a wage increase decision was adopted by the Parliament, Laws # 716, 717, 718 on November 5, 1998 but never applied since, as confirmed by various tribunal decisions). Building-up arrears has various consequences: poorer fiscal transparency, higher tariffs for private services[73], weaker social safety nets, and greater difficulties to implement investment

[73] It is likely that private operators ask for premiums when dealing with the Government, to cover the risk of delays in payments.

projects[74]. In this respect, not accumulating new arrears is a first priority, which will nevertheless add about one percentage point of GDP to primary spending, as reflected in expenditure outlooks above.[75] Addressing the stock though, is a much more difficult undertaking, which could consist of transforming some of the arrears into formal debt and the remainder being repaid progressively over years. The calculations above assume that the full stock of arrears (at end 2004) is converted into formal debt.

Table 5. Government's Arrears as of end-2004 (LBP Billion)

NSSF and the Institute of Guarantee of Deposits	1,062
Hospitals	139
Expropriations	800
Wages	1,304
others	119

Source: MoF, June 2005.

[74] As a large number of public investment projects (including donors financed projects) are stalled before cases (payments of arrears) are legally settled.
[75] Some LBP100 billion annually to the NSSF and another LBP270 billion to public employees, or 1.1 percent of GDP in 2004.

Chapter III. Raising the Efficiency of Social Spending and Strengthening Safety Nets

53. **Raising the efficiency of social sector spending is critical to support the fiscal adjustment.** As underlined in Chapter I, enhanced social sector service delivery and protection is a must in Lebanon, given the short run negative impact fiscal consolidation might have on employment. In addition, the demand for public social services is expected to increase with fiscal contraction (and households' reduced ability to afford private services, health and education). Yet, limited fiscal resources and high levels of inefficiencies imply that the first order of priority in the social sectors is to address the inefficiencies within and raise the productivity of public social sector expenditure rather than increase their resource envelope. A reduction in social spending via employment benefits to civil servants (including the military, judicial and security personnel) is one such priority. A second is the more efficient regulation of private provision and coordination between the private and public sectors in the social arena.

54. **At the same time, safety nets need to be strengthened.** Among others, risks of financial crises cannot be underestimated in Lebanon given the high public debt level and banks' exposure to sovereign risk. Fiscal consolidation would typically mitigate such vulnerabilities. But on the road to fiscal sustainability, Lebanon will remain greatly vulnerable to confidence shocks, including its greatly volatile regional and domestic political environment. Recent international experiences tell us how deep financial crises can hurt social fabrics and create irreversible damage to human capital (in the form of lower children food-intake or higher school drop-outs for instance), and underline the need to be prepared in the event. More generally, it is believed that Lebanon's level and characteristics of social protection are not adapted to the developmental needs of a middle-income small open economy, and could actually be an impediment to growth. Dismissed as ineffective, expensive and even detrimental to growth, it is now increasingly understood that assisting individuals, households and communities in dealing with diverse risks is needed for sustained economic and social development (World Bank, 2003b). Hence the need to review what could be done in the short and long run to insure adequate protection against major shocks for the Lebanese population.

55. **Overall, Lebanon needs to define a long-term social strategy and plan for it**. A strategic vision for overall social and human development is missing in Lebanon. There is an absence of a comprehensive and integrated social policy and agreed upon sector strategies by line ministries. A national commission for strategy/policy/coordination of social policy is needed to lead the effort.

56. **This chapter reviews existing social sectors spending in Lebanon,** and explores ways to improve the efficiency and equity of social sector services with the view to: (a) better support human capital development during the ordinary course of Lebanon's economic development; and (b) prevent human capital deterioration during an economic crisis. The sectors covered by this chapter are primarily those of the Ministry of Education (MoE), Ministry of Health (MoH), and to a lesser extent the Ministry of Social Affairs (MoSA), given its relatively small size.[76] The

[76] There are other agencies and sectors relevant to the present study (for example, pensions, labor and broader civil service issues, pricing of utilities–such as water or electricity, provision of infrastructure – such as housing and roads, agricultural and other subsidies, support to SMEs or microfinance and so on). Some of them (for example,

report utilizes administrative data and published research and is based on a review of previous assessments of these three sectors, as well as, information collected during selected field visits. It does not aim at re-evaluating in depth the characteristics and efficiency of the three social sectors nor the various programs supported by the social ministries, but rather at putting social sector service delivery and protection into a macro-economic, budgetary and risk perspective.

Social Sector Expenditure and Outcomes

57. **Social sector spending in Lebanon is high, in nominal terms and as a proportion of GDP, with more than 70 percent of that spending coming from the private sector.** The sum of public and private social spending stood at approximately 21 percent of GDP in 2004, out of which 15 percent was supplied by the private sector (Table 6). The remainder, which constitutes public social expenditures, stood at 6 percent of GDP. This is low compared to other MENA countries[77], but it represents a high percentage of public primary expenditures: in 2004, social public spending (as defined by the operations of MoE, MoH and MoSA) represented 26 percent of primary expenditures. If expenditures channeled through other agencies are included (functional expenditures), social public spending amounts to 38 percent of primary expenditures. Furthermore, accounting for public pensions and end-of-service indemnities would put total social expenditures at 24 percent of GDP, and public social expenditures at more than half of government primary expenditures in 2004.

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pensions) are covered in parallel reviews from the World Bank (see Chapter II) while others have been addressed in various ways in the past and will not be directly the focus of the present study.

[77] Public social expenditures (excluding pensions) represent 9 percent of GDP in Morocco, 10 percent in Egypt, 12 percent in Iran, 14 percent in Jordan and Tunisia, and 15 percent in Algeria.

Table 6. Public and Private Social Expenditures (LBP Billion and as percentage of GDP)

	1998*	2004	2004 as percentage of	
			GDP	Primary spending
Administrative Expenditures (A)	1,157	1,318	4.0%	25.9%
Education	761	864	2.6%	17.0%
Health	291	345	1.1%	6.8%
Social Affairs	105	109	0.3%	2.1%
Functional Expenditures[1] (B)	570	600	1.8%	11.8%
Education	358	365	1.1%	7.2%
Health	183	216	0.7%	4.3%
Social Affairs	29	19	0.1%	0.4%
Total Public Expenditures (A+B)	1,726	1,918	5.8%	37.8%
Education	1,120	1,229	3.7%	24.2%
Health	473	561	1.7% [3]	11.0%
Social Affairs	134	128	0.4%	2.5%
Private Expenditures (C)	4,186	4,829	14.7%	
Education	1,760	2,030	6.2%	
Health	2,427	2,799	8.5%	
Social Affairs [2]	n.a.	n.a.	n.a.	
Total Public and Private (A+B+C)	5,913	6,747	20.6%	
Education	2,880	3,259	9.9%	
Health	2,900	3,360	10.2%	
Social Affairs	134	128	0.4%	

Source: World Bank staff calculations. Public expenditures are computed based on Ministry of Finance Budgets 1998 and 2004. Private expenditures estimates are extrapolated from World Bank's 1997 PER for education and national health accounts from 1999. * Figures for 1998 are expressed in 2004 prices, to allow a comparison in real terms with 2004. Notes: 1/ Functional Expenditures are additional public social spending channeled not through the responsible ministry but through other public entities such as ministries of Interior, Defense, Agriculture, Information, Coops, etc. 2/ Private expenditure by NGOs and others on social sectors is known to be sizable but no reliable estimates exist. 3/ WHO data from the NHA shows public health expenditures as percentage of GDP to be 3.4 percent in 2002

58. **Total social sector spending is not commensurate to outcomes.** Though commendable in many respects, health and education indicators are commensurate neither with the overall (private plus public) spending in these sectors nor with Lebanon's stage of development. International comparison of health outcomes, relative to per capita expenditures, suggests that returns to health spending are low in Lebanon. Per capita health spending in Lebanon, at approximately US$500 per year, is four times higher than that in Jordan or Tunisia. Yet, infant mortality is the same, maternity death much higher, and life expectancy only slightly better in Lebanon (Table 7). A similar picture emerges for education. At US$4,000 GNI per capita in 2002, Lebanon had a lower primary completion rate than Tunisia, Jordan, Iran, Algeria, and Egypt, all countries with significant lower GNI per capita (Table 8). The primary completion rate in Lebanon has also not shown any improvement between 1995/6 and 2003/4. Another international benchmark of the performance of Lebanon's education system is the 2003 Trends in International Mathematics and Science Study (TIMSS) scores. TIMSS assesses student learning in 8th grade in Mathematics and Science. As presented in Table 8, the national performance of 8th grade Lebanese students was 393 in science and 433 in mathematics. Both these scores are below the international averages of 474 and 467, respectively, and in science, Lebanon was outperformed by all participating MENA countries (except Saudi Arabia).

Furthermore, when adjusted for level of income Lebanon performs well below expectations (Figure 2).

Table 7. Health outcomes and per capita spending, selected MENA Countries

	Infant Mortality Rates per 1,000 live birth (2002)	Maternity death per 100,000 live births (1995)	Life Expectancy at Birth (2002)	Per Capita Health Spending (US$) (2002)
Oman	12	120	74.1	1138
UAE	8	30	75.4	752
Kuwait	10	25	76.9	630
Lebanon	26	130	70.8	499
Bahrain	7	38	73.3	430
Saudi Arabia	21	23	73.1	352
Jordan	25	41	72	134
Tunisia	24	70	72.7	118
Iran	35	130	69.3	96
Algeria	38	150	70.7	62
Morocco	39	390	68.4	56
Syria	23	200	70.3	42
Egypt	35	170	68.9	38
Yemen	78	850	57.4	20

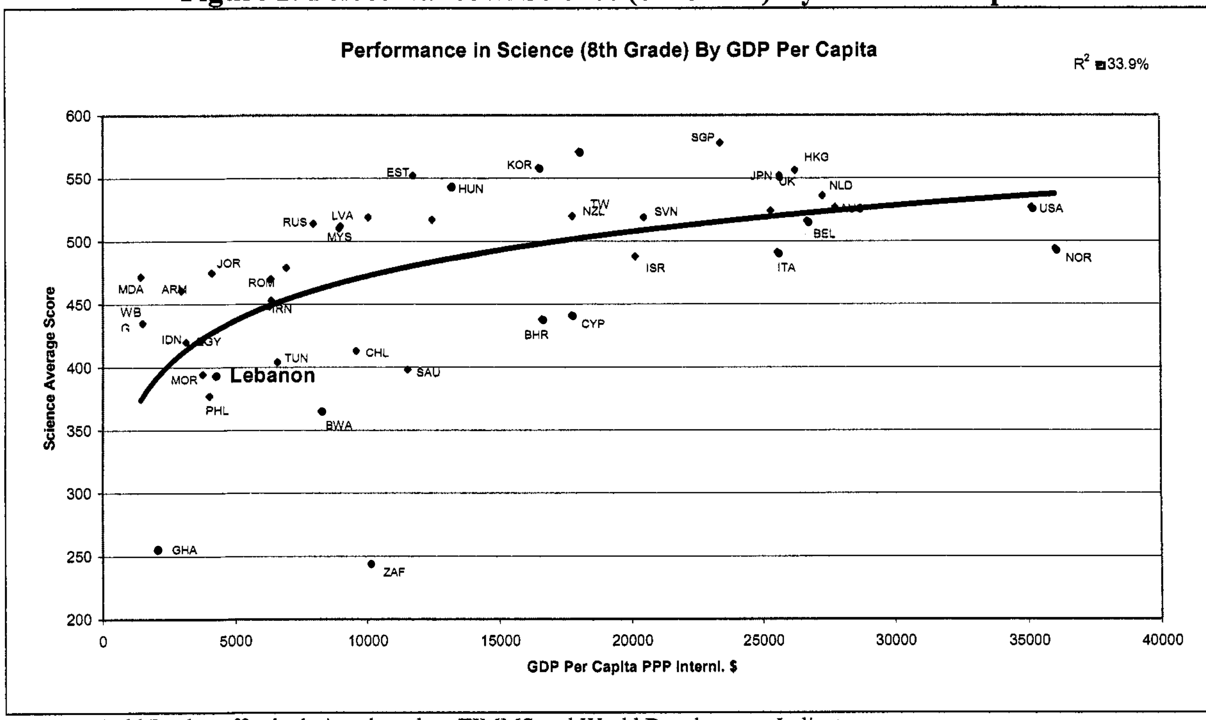
Source: World Bank staff calculations. Note: Data are for 2002 or last year available.

Table 8. Education indicators and GNI per capita, selected MENA Countries

	GNI per capita (US$) (2002)	Adult literacy rate (%)	Primary Completion Rate (%)	Repeaters as % of total enrolled, primary	TIMSS Science Scores, 2003 (1)	TIMSS Mathematics Scores, 2003 (1)
Upper Middle Income	5,160	91.50	93.40	5.20	474 (2)	467 (2)
Lebanon	3,900	86.50	88.00	9.70	393	433
Tunisia	1,990	73.20	98.80	9.80	404	410
Jordan	1,760	90.90	98.20	0.50	475	424
Iran, Islamic Rep.	1,740	77.10	107.30	4.30	453	411
Algeria	1,720	68.90	95.50	11.60	..	..
Egypt, Arab Rep.	1,470	56.10	89.30	5.10	421	406
Morocco	1,170	50.70	67.50	13.70	394	384
Syrian Arab Republic	1,090	82.90	87.50	6.80	..	..
Yemen, Rep.	490	49.00	65.00	4.30	..	..

Sources: WDI, EdStats, TIMSS, World Bank staff calculations. Notes: Note: Data are for 2002 or last year available. 1/ Trends in International Mathematics and Science Study (TIMSS) 8th grade scores. 2/ International Average (different groups of countries than "Upper Middle Income" classification).

Figure 2. Performance in Science (8th Grade) By GDP Per Capita



Source: World Bank staff calculations based on TIMMS and World Development Indicators.

59. Nor is public spending commensurate to outcomes. Figures discussed so far compare different education and health attainment indicators across countries, controlling for per capita GDP. Though, these comparisons could give a biased picture of Lebanon's public expenditure efficiency, for two reasons: first because there is a well known positive association between social spending and GDP[78]; second because social spending in Lebanon is mostly private, as described in Table 6. But this is actually not the case. Controlling for these two factors, Herrera and Pang (2005) estimate that input efficiency - excess (public) input for a given level of (public and private) output is of the order of 79-87 percent for education[79] and 71-75 percent for health[80]. In other words, Lebanon uses at least 25 percent more inputs (public spending) to produce the same health outcomes than best practices countries[81] (and at least 13 percent more inputs for education). And this does not account for the fact that Lebanon's share of private spending in total social spending (at least for health – but also probably for education) is much higher than in most of the countries considered in this study (more than 180, including industrialized countries)[82].

[78] This positive association between expenditure and the level of economic development stems from the fact that wages tend to be higher in richer countries, reflecting the higher marginal productivity of labor. This in turn tends to increase the cost of labor-intensive activities such as health and education.

[79] Net primary and secondary school enrolment.

[80] Life and Life disability-adjusted expectancy at birth and immunization rates (DPT and measles).

[81] Korea, Malaysia, Thailand, Trinidad and Tobago, Oman, United Arab Emirates, Mauritius, Kuwait, Chile.

[82] Private spending on health over GDP averages 2.3 percent for the 187 countries sampled – to be compared with 10.2 percent in Lebanon. There is no similar figure for private education. Public education spending averages 4.5 percent of GDP for 166 countries sampled.

60. **Social sectors in Lebanon include some state-of-the-art health and education facilities, which have little impact on the poor.** Lebanon has specialized in state-of-the-art health and education services, such as plastic surgery for instance, which is targeted to an international and rich Lebanese customer base. These activities have flourished in recent years, and now represent 5 to 10 percent of GDP. Much of these services, however, are inaccessible to a large segment of the population and serve to further deepen the duality of the Lebanese social sector system.

61. **High price levels are one of the explanations for the low value for money of social spending in Lebanon.** Price levels are high in Lebanon, maybe the result of strong Dutch disease effects stemming from massive capital inflows (see Chapter I), and much above what should be expected from its developmental stage (as measured in nominal per capita GNI). When converted into purchasing power parity (PPP) terms, one dollar in Lebanon is worth half of what it is in Jordan (Table 9). Furthermore, these observed differences in national price levels most likely understate the actual differences in non-tradable sectors, to which most social services are a part of. Thus, while Lebanon appears to spend on health four times more per capita than Tunisia, in PPP terms it spends only 60 percent more.

Table 9. Price levels in comparator countries in 2003

	GNI per capita (US$)	GNI per capita (PPP)	Domestic Prices Index
Lebanon	4,040	4,840	0.83
Upper Middle income	5,340	9,900	0.54
Uruguay	3,790	7,980	0.47
Jordan	1,850	4,290	0.43
Malaysia	3,780	8,940	0.42
Turkey	2,790	6,690	0.42
Latvia	4,070	10,130	0.40
Mauritius	4,090	11,260	0.36
Egypt	1,390	3,940	0.35
Tunisia	2,240	6,840	0.33

Source: World Development Indicators.

Social Sector Efficiency

62. **Available indicators suggest low internal efficiency of Lebanon's public social expenditures.** In education for example, Lebanon has one of the lowest ratio of pupils to teachers at the primary level (17:1) in the region and an extremely low ratio at the secondary level (8:1) (Table 10). This is a reflection of the highly politicized process of teacher recruitment and placement, as well as, the lack of planning in school placements.[83] It also signals a high share of personnel expenditures relative to other education expenditures. While there are no international norms for the "right" pupil to teacher ratio, it is generally considered that such ratios can go up to 40:1 in primary education and 25:1 in secondary education without compromising the quality of education. Furthermore, empirically, class size is not found to affect student performance. Therefore, increasing the pupil to teacher ratio in Lebanon would make the

[83] In 2003/4, there were 348,144 students and 42,352 teachers in the public sector, excluding university, reflecting a pupil - teacher ratio of 9. In 6 of the 26 governorates, the pupil-teacher ratio was below 5.

system more efficient and cost-effective without impacting school quality. This would eventually require a reduction in the number of teachers, given the slow demographic growth rate in Lebanon (estimated at 1.3 percent, Kasparian, 2003).

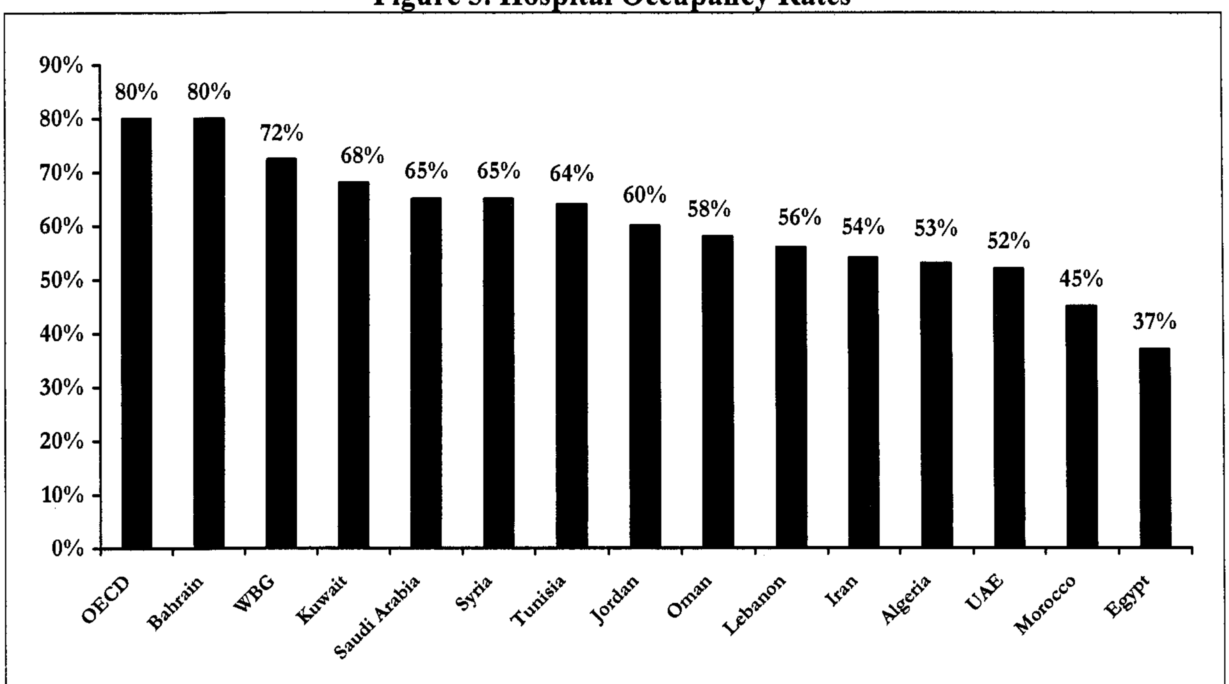
Table 10. Pupil to Teacher Ratios (2002)

	Primary education	Secondary education
Lebanon	17.0	7.6
Saudi Arabia	11.8	11.7
Jordan	20.6	14.3
Oman	21.1	16.5
Egypt, Arab Rep.	22.5	17.4
Syrian Arab Republic	24.0	17.9
Morocco	28.2	18.1
Tunisia	21.9	20.1
Algeria	27.5	20.8
Iran, Islamic Rep.	24.4	28.9

Source: World Development Indicators.

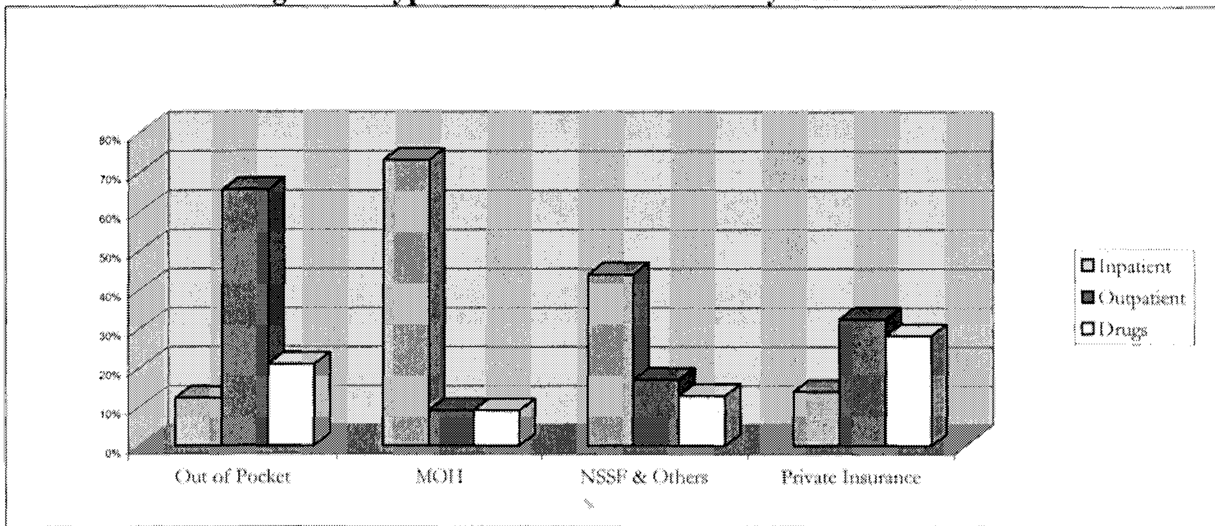
In health, inefficiencies are demonstrated through the low occupancy rate (56 percent) in public hospitals (Figure 3). Other evidences of inefficiency are the relatively high levels of public (and NSSF) expenditures on hospital-based curative care versus more basic out-patient care (Figure 4). The MoH spends almost 70 percent of its budget on inpatient care while devoting only less than 10 percent of its resources to out-patient type services, a pattern mirrored, albeit to a lesser degree by the NSSF. In Jordan, by contrast, MoH expenditures on hospital services constitute about 50 percent of overall expenditures.

Figure 3. Hospital Occupancy Rates



Source: World Development Indicators

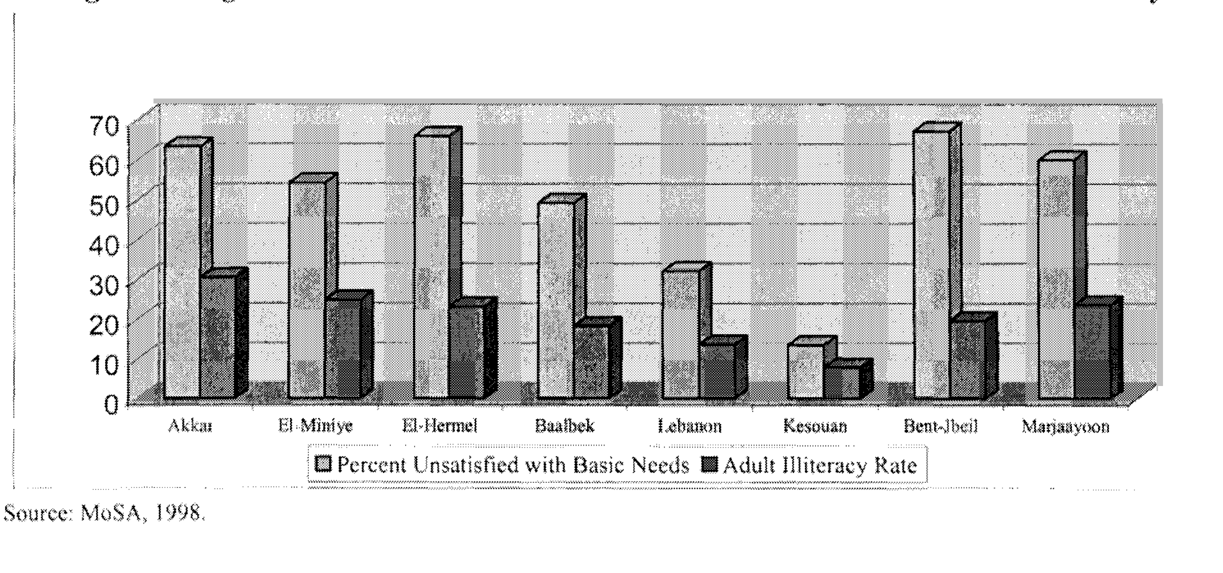
Figure 4. Type of Health Expenditure by Source in 2000



Source: World Bank staff calculations based on MoH.

63. **Regional inequalities in social indicators are also significant in Lebanon** and there is ample evidence to suggest that geographical allocations of public resources are driven by political rather than equity considerations. The regional variation in the percentage of the population unsatisfied with basic needs (meaning the poor) and adult illiteracy rates is wide and points to the imbalances in access to public social services in Lebanon (Figure 5). Another indicator is the percent of poor who are beneficiaries of MoSA social assistance. Table 11 shows that even though the highest share of population with low satisfaction of basic needs resides in North Lebanon, that governorate has the lowest share of the poor who are beneficiaries of social assistance.

Figure 5. Regional Imbalances in Satisfaction with Basic Needs and Adult Illiteracy



Source: MoSA, 1998.

Table 11. Beneficiaries allocation among Mohafaza't (Governorates)

Governorate	Population with low satisfaction of basic needs (poor)		Beneficiaries of social assistance	
	Share in Governorate	Total	Total	Share in poor
Beirut	19.2	78,221	8,211	10.5
Mount Lebanon	26.0	297,819	16,608	5.6
North Lebanon	48.9	327,928	5,555	1.7
South Lebanon	39.0	110,392	6,621	6.0
Bekaa	43.8	175,152	4,934	2.8
Nabatieh	51.4	105,581	1,832	1.7
All Lebanon	35.2	1,095,363	43,761	4.0

Source: MoSA, 1998, 1999. Note: The population with low satisfaction of basic needs is based on the 1996 Population and Housing Survey; data for the beneficiaries of social assistance is for 1999.

64. **The internal efficiency of public social spending is hampered by a severe misallocation of resources.** About 15 percent[84] of public social spending (excluding pensions) takes the form of benefits to public sector employees (some of which are increasing with salaries). Beyond its negative impact on labor market efficiency (see Chapter IV), this spending is not targeted towards the poorest segments of the population and entails large opportunity costs. Indeed, if these benefits were directed at improving the supply side of social services (for example, better quality schools and health services nationally), they would result in greater benefits for all Lebanese, especially the poor.

65. **The lack of coordination between providers also generates important waste.** From a developmental perspective, it is important that clear policy objectives and targets guide budgetary allocations, and, in turn, the budget itself generates the adequate information to insure a proper funding of key policy objectives. This review of public expenditures could not identify neither clear policy objectives nor how budgetary allocations relate to them. This issue is not specific to social sectors (as is neither the quality of the public administration or governance), and should be dealt with through civil service, public administration and budget process reforms (See Chapter IV). Yet, it implies at the sector level an overlapping of public providers in the provision of heath, education and social services, hence redundant or excessive capacities. The insufficient coordination[85] with the private sector, in the face of lacking information on the nature and extent of services provided and absence of sector and nation-wide objectives (which could help both public and private operators to plan future needs and investment opportunities), is also a great source of potential duplication and waste of national resources.

66. **A major impediment to understanding social expenditure and being able to make policy based on evidence is the absence of reliable and periodic data on:** (i) the incidence of public social spending (targeting, coverage, cost effectiveness) and (ii) the nature and impact of private social spending which renders difficult the analysis of their overall social utility. Box 2 shows that much needs to be done with regards to health, education and poverty/social statistics.

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[84] As measured by the sum of family allowances and advances for education and health granted to public sector employees, some LBP 288 billion in the Budget Law 2004.

[85] Worth noticing however that the Ministry of Health made important progresses in that regard in the recent years by putting in place an accreditation system for public and private hospitals, hereby setting quality and price standards.

Box 2. Information and Statistical Issues

The information on budget and social outcomes in Lebanon is neither systematic nor comprehensive. Aside from some discrete studies on specific topics, critical information for design of policies is simply non-existent (for example, a consistent poverty line, no matter how arbitrary but nevertheless useful for inter-temporal comparisons). Recent reports have identified the weak institutional and management capacity of line ministries and also of the Central Administration of Statistics (CAS) as one of the crucial issues to be addressed. The lack of data seriously hampers the day-to-day management, sound planning, and budgeting of the public sector. This holds true not only at the central level but also at the governorate, district and school levels. With missing information from a census, which should constitute a benchmark for socio-demographic statistics, sometimes even the most elementary of statistics (such as net enrollment rates) have to be based on extrapolation of survey data. Data on outcomes are also lacking. Finally, reliable data on the private sector, which play a pivotal role in provision of social services in Lebanon, are even less available. Even when data exist, they are not willingly shared. Beyond historical legacies, there are other hurdles in the development of a statistical base that include issues of control by governmental authorities as well as lack of trained and experienced staff in statistics at the central level and in line ministries.

The CAS has recently designed a strategy for rebuilding a sustainable economic and socio-demographic statistical system. The strategy defines an action plan to introduce improved methods and procedures, up-grade human resources and equipment, as well as to undertake a number of household and establishment surveys. While the need to revitalize the existing system cannot be overstressed, the legal and institutional framework governing the Lebanese statistical system needs also to be reformed in order to provide a larger autonomy to CAS, the means to better coordinate with local users and producers of statistics, and a more open access to data by users, associated with a clearer dissemination strategy – namely a Statistical Master Plan (SMP).

The World Bank contributed to the writing of the first General Data Dissemination System (GDDS) report for Lebanon in 2002, and made a series of recommendations regarding social sectors. With respect to health statistics, the report recommended (a) the creation of a statistics unit within Ministry of Health with adequately trained and skilled staff and sufficient financial resources; (b) the development of a comprehensive Health Management Information System (HMIS) encompassing the public as well as the private sectors; (c) the design and implementation of a data dissemination strategy for health statistics, guarantying data confidentiality and integrity; (d) the regular update and expansion of the health facilities map (carte sanitaire); and (e) strengthening the coordination with CAS. With respect to education statistics, the report recommended clarification of the roles various agencies involved in the collection and dissemination of statistics (such as the CERD and the Ministry of Education); capacity building (acquisition and training) for data reporting from the school level in the public as well as private sectors all the way to the Ministry of Education, CERD and CAS; (c) pre-determined deadlines for the timely reporting of information; and (d) the completion of a comprehensive education School Map. Finally, with respect to poverty statistics the report recommended (a) capacity building for carrying out poverty analysis and poverty mapping; (b) the completion of the Housing, Building, and Enterprise Listing in order to up-date the sampling frame required to undertake the Multi Purpose Household Survey; and (c) the introduction of a Multi Purpose Household Survey, which is currently underway.

67. **Finally, a strategic vision for overall human development or specific sectors is simply missing in Lebanon**. The Government is preparing some sector strategies (for example, in education) but a broader approach needs to integrate all social aspects.

68. Given the above inefficiencies, inequities, misallocation of resources and the almost total absence of a sector-wide strategy and reliable data, the justification for raising public social spending for developmental purposes appears relatively weak, at least before significant efforts are made to address the shortcomings presented above. The next section provides some recommendations that can help put Lebanon on the path to achieving better social sector outcomes.

Planning for Long Term Social Development

69. Lebanon needs to define its long-term social strategy and plan for it. To create additional gains in human development, Lebanon would need to overcome a series of constraints it currently faces. Some of the constraints are historical (such as external regional issues or internal confessional policies) which are also partly responsible for the high private spending and the small role of the public sector. This is in turn confounded by macroeconomic imbalances. Both precondition opportunities in all sectors of the economy, including the social sectors. Thus addressing governance issues can be key for releasing and making more efficient use of public funds and thus improving the provision and impact of social services. Historical and macroeconomic constraints are of course hard to overcome in a short period of time, especially when consensual politics are required. Such reforms can be realistically expected to need a decade to implement, if not longer, which points to the urgency of starting today.

70. But immediate actions on the social side can and should start in parallel. The first and foremost is the development of a comprehensive and integrated social sector strategy and specific sector strategies (health, education, social development) that are agreed upon by all stakeholders. A national commission for strategy/policy/coordination of social policy will be needed to lead the effort.

71. From a purely public expenditure perspective, various cross-cutting reforms need to be considered. An important principle to keep in mind is that public expenditures should focus on key public goods domains (primary health care and education, and social protection for instance), and complement the provision of social services supplied by the private sector, particularly given the historically large size of the latter in Lebanon. In addition, better regulation of the private sector is needed (such as setting up an accreditation and quality assurance mechanism for universities) and enhanced coordination between the private and public sectors must be sought. Beyond general recommendations regarding public expenditure management or civil service reform, the following actions could be considered in the social sectors[86]:

- Public social sector spending must be focused on poor and low-income groups and on reducing regional disparities;
- Through changes in the public sector salary system, incentives and a level playing field in the labor market must be created by gradually shifting away from the currently "benefit

[86] There are additional areas of government interventions that can have effects on the social sectors but are not examined in this chapter though they should be part of any human development strategy. Such issues range from an overall assessment of the performance of the Government's budget process (including specific recommendations for the budget, for example performance based budgeting) to sectoral issues such as pensions, labor, employment, unemployment policies, civil service performance and reform, water, electricity, housing, roads, infrastructure, rural development, civil society/NGOs, SMEs development, informal and income generation policies including microfinance, and producer subsidies.

based" system and towards increasing the share of wages and decreasing the share of benefits in total worker compensation;

- Targeted and means-tested programs must be introduced;
- Overlap between different Ministries and agencies in provision and financing of social sector services must be reduced.[87]
- Information and data systems must be developed and utilized for: (i) efficiently supporting budgetary allocations and monitoring of public expenditures on the social sectors; (ii) identifying private expenditures by private and non-governmental providers (for cost and competition/efficiency purposes) and also by users (household expenditures for effectiveness/equity purposes); and (iii) conducting incidence analysis (benefits of social services).

In addition, there are measures that each sector should consider. These are briefly discussed below:

72. In health, the government should focus its efforts on a few key health policy objectives: (i) enhancing the financial protection of poor households from the costs of ill health; (ii) improving health status outcomes particularly among the poor rural areas; and (iii) promoting greater client satisfaction with the health care system. Short to medium term measures which could help efforts towards achieving these objectives include: improving the target efficiency of MoH expenditures on catastrophic care; developing a new reference pricing model for drugs; developing National Health Accounts -- an information tool critical to making improvements in public health spending. Lastly, actions can be taken on health legislation already finalized by the Ministry of Health and waiting for parliamentary approval. Approving the "Carte Sanitaire" legislation is one such example and would be an important step towards the rationalization of public and private expenditures in the health sector. Such legislation will enable the government to better track and regulate overall investments in the sector; and could improve, if implemented well, the efficiency, quality and equity of health care services in the country.

73. In education, the first essential step is the development of a comprehensive sector strategy that is agreed upon by all stakeholders.[88] Finding ways to lower the unit cost of public education, which is primarily driven by the extremely low pupil to teacher ratios, needs to be agreed upon. This could include placing a moratorium on teacher hiring and maintaining it until the ratio improves. A gradual phasing out of the school grants to public sector employees needs to be implemented. Targeted instruments should be developed to reach the school-aged children who never went to school, or who have dropped out early.

74. In social development, coverage of the vulnerable groups needs to be enhanced through better targeting. The Social Development Centers (SDCs) under MoSA need to be reviewed, both in terms of locations, effectiveness, and efficiency. Duplication with other Ministries needs to be reduced. Partnerships with civil society and NGOs should be better organized and standardized to improve accountability of service providers receiving MoSA grants.

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[87] One example here is the overlap between the MoSA activities in the areas of education, training and health with those provided by the MoE and MoH.

[88] Under the ongoing World Bank funded Education Development Project (EDP), the development of such a strategy is being undertaken.

The need to Strengthen Lebanon's Safety Nets

75. **Crises can irreversibly affect human capital in the absence of adequate safety nets.** One basic objective of social policy is much more humble than improving human development: it is the prevention of irreversible losses in human capital. One major effect of crises (economic, manmade or natural disasters) is a relatively quick deterioration of social indicators and an aggravation of poverty in particular (World Bank, 2001). The recent macroeconomic crises in many Asian (1997–99) and Latin American (1994–95, 1999) countries have prompted many countries to reassess the adequacy of their social safety nets to assist poor and vulnerable population groups. Similarly, the waves of natural disasters and the economic and social consequences that have afflicted Africa and many countries in Central America and South Asia over the past two decades also suggest the need for a more effective response to crises. A public social safety net can be an important counter-cyclical tool to help protect the incomes and human capital investments of the poor and vulnerable in times of crisis. Effective social safety nets must be able to respond in a timely and flexible manner to changing needs without relying extensively on administrative discretion. Setting up safety nets during a crisis is difficult. Increasing evidence suggests that it is better to have mechanisms in place beforehand that can be scaled up (and down) as needed.

76. **Crisis events underline the utmost need to put systems in place in advance.** The literature on crisis[89] indeed suggests three generic lessons:

- Social safety nets should be in place before a crisis occurs;
- Pre-crisis planning is essential – in the sense of accurate and timely available information on programs, beneficiaries' characteristics, incidence and so on;
- There is a wide range of instruments that can be used but each has different demands on administrative capacity and none can be usefully applied to all countries, all circumstances and all times.

77. **Formal safety nets are generally inadequate in Lebanon.** A few institutional safety nets exist in Lebanon, but none of them could play an important counter-cyclical role in the event of a sudden financial crisis. The end-of-service indemnity fund managed by the National Social Security Fund, which could be mobilized to cushion the impact of massive lay-offs is mostly invested in LBP-denominated Treasury Bills, whose value would necessarily shrink in the event of a currency crisis. Moreover, the Government would be in an even more difficult position to reimburse the arrears it accumulated with the NSSF. The same remark applies to the Institute of Guarantee of Deposits, whose funds are invested in LBP-denominated Treasury Bills. The pension schemes for military and civil servants are financed on a pay-as-you-go basis, and have no reserves. Health care benefits covered by the MoH and the public insurance funds would also be adversely affected by a financial crisis given their heavy reliance on general revenue financing. Finally, there is no unemployment insurance system in Lebanon.

78. **Informal safety nets are strong, however they can be equally susceptible to a crisis.** Lebanese families (inside and outside of Lebanon) and communities traditionally provide

[89] For example, Sumarto et al. (2000) and APEC (2001).

informal safety nets in Lebanon – as they did for instance during the war, but these mechanisms could prove to be inadequate (for instance, if it becomes technically more difficult to send money from abroad in the midst of a banking crisis), or insufficient in the case of a systemic shock. Lebanon's wide NGO network and active civil society organizations, on the other hand, could become instrumental in the event of a crisis, as they are probably more robust to financial or political disruption.

79. **The experiences of other countries may be largely irrelevant for Lebanon unless the crisis is sufficiently delayed so that formal safety mechanisms are put in place.** For example, the unemployment insurance fund in Korea had sizable surpluses at the onset of the crisis and that facilitated financing the broadening of coverage when the East Asia financial crisis hit. The low initial level of public debt in many Asian countries allowed them to expand social protection programs and spending on safety nets. Other countries, such as Peru, have created fiscal stabilization funds that can be used during crises.

80. **Though one does not necessarily expect that Lebanon's response to a crisis would be improvised and discretionary, it will take time to establish a largely coherent social safety net program.** In addition, fiscal management issues and governance concerns are likely to lengthen delays in implementation. But this does not imply that Lebanon should not start strategizing for the better development as well as crisis management of the social sectors. The authorities, governmental and non-governmental, recognize that Lebanon is in need of a sustainable and effective safety net. If they are in place before a crisis happens, properly designed social safety nets can serve as an automatic fiscal stabilizer and contribute to greater macroeconomic stability and can bypass political pressures for panic allocation during the crisis or for making spending permanent after the crisis is over.

81. **In designing and planning for safety nets, desirable principles to be adhered to** include adequacy in terms of coverage and benefit levels (but not resulting dependency), efficiency (well targeted with little leakages to the non-poor), efficacy (consistency to policy objectives), and transparency.[90] In this context, conventional social safety net programs that have been tried elsewhere include conditional cash and in-kind transfers, price subsidies, fee waivers for public services, feeding and nutrition programs, public works programs, micro finance programs, and social insurance programs (in particular, pensions and unemployment benefits).[91]

Given the above, the following safety nets can be considered in Lebanon:

82. **Protecting current social spending on education, health, and social programs:** As a first principle of financial crisis, public expenditure on social sectors needs to be protected from budgetary cuts. Normally this entails ensuring that these expenditures do not loose value in real terms. In Lebanon, despite the fact that there are inefficiencies in all these programs (public

[90] The idea here is that the selected measures should provide adequate protection without creating dependency among recipients (e.g. through limiting size and duration of benefits); be targeted, consistent with economic targets of fiscal and macroeconomic policy.

[91] Each policy instrument has different objectives (for example, employment creation, direct relief and so on) and can use different mechanisms for targeting for example, self-targeting, means-tested targeting, categorical and geographic targeting, community-based targeting, or proxy means testing targeting. Each needs to be assessed separately for its applicability to Lebanon.

schools, primary health centers, SDCs), it is the case that the programs reach the poor since those who can afford to do so go to the private sector. Therefore, there already is a degree of self-targeting in who has access to public services.

83. **Selectively scaling-up some of the existing public programs:** Most existing social public programs are considered (or supposed to be, in the absence of any incidence analysis) socially inefficient from a cost-effectiveness perspective. But scaling them up in the event of a crisis could prove to be a second-best solution in the face of the inherent large difficulties that would face any Government to quickly design and implement new safety net mechanisms during turbulent times. Specifically, while on average, the SDCs run by MoSA are inefficient there are those that are considered effective and well-targeted. A quick review of those SDCs with a view of scaling them up if needed would be a good first step. Secondly, MoSA distributes much of its funds (70 percent) through NGOs. Some of these NGOs are known to be effective and accountable. Additional funds could be channeled through these NGOs.

84. **Scale up existing social funds, reinforced with additional targeting mechanisms:** Social funds are flexible financing schemes for poverty alleviation executed by local groups that promote public investments in small-scale projects in a variety of sectors identified, and in many cases carried out, by local groups (communities, local Governments, NGOs). They have worked well primarily in pockets of poverty in rural areas. Public works programs for the poor could be an element of the social fund. One option would be to impose on contractors the use of labor-intensive technologies, with a view to develop employment generation programs. Another condition would be to set low wages. By doing so, such programs self-target the unemployed poor.[92] However, caution is advised as international experience shows that social funds are not eminently pro-poor (pervasive leakages to the non-poor can occur), suffer from concerns about accountability and quality of created infrastructure. The use of social funds in Lebanon (managed by the World Bank and the European Union in particular) is yet nascent, and could be partly amended to become more instrumental for poverty alleviation. A key element of scaling up the existing social funds in Lebanon would be to bundle the existing ones into one single autonomous social fund.

85. **Introducing conditional cash transfers:** Conditional cash transfers are public programs that provide cash to the needy in exchange for verifiable changes in behavior. Often they are tied to children's school attendance or vaccinations, or can be conditional on work search or training. Conditional cash transfers have been shown to reach the poor and are particularly effective when school and health facilities already exist but poor children do not attend and do not receive vaccinations regularly. This is applicable in the case of Lebanon where supply of facilities is not the constraint nor expected to be in the event of a crisis. Conditional cash transfers would help sustain demand for the basic services if implemented properly. Another type of conditional cash transfer that can be considered in Lebanon is a "social pension", i.e. a flat rate pension targeted to those above a certain age and not in receipt of a pension. Low levels of each type of benefits would ensure self-targeting.

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[92] It is often argued that such programs would prove to be unsuccessful in the presence of a low-skilled immigrant labor (which would be the main beneficiary). This problem could nevertheless be overcome by verifying the nationality of candidates. And as this type of program ensures efficient self-targeting and entails modest fixed costs, it is not too costly to test and expand in case of success.

86. **Waiving hospital co-payment fees for the poor.** While the poor can be admitted into public hospitals in Lebanon, they nevertheless have to pay a 15 percent co-payment, which can be a significant amount for the poor and especially in times of economic hardships. One option to consider is waiving the co-payments or at least reducing it significantly.

Chapter IV. Building Capacity for Better Provision of Public Goods

87. **Tackling governance issues is critical to support the fiscal adjustment.** As underlined in Chapter I, the fiscal adjustment would be supported much more broadly if it were perceived primarily as aimed at improving governance. If seen as a means to permanently reduce waste, inefficiency and corruption, it will be supported politically over time. By the same token, it will also reinforce the credibility of the Government's plans vis-à-vis its financiers, financial markets and the donor community, hence possibly mitigating borrowing costs and financing itrs implementation.

The Current Situation

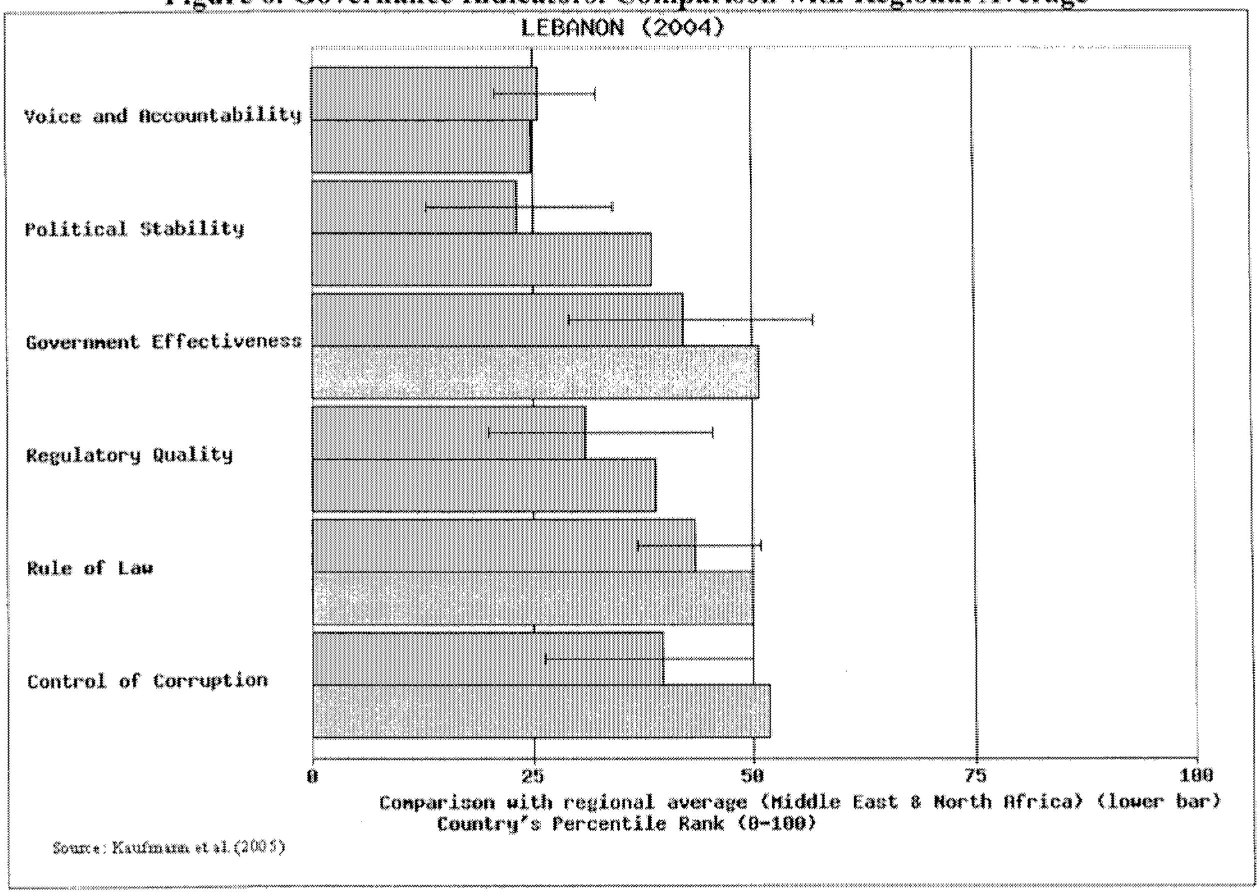
88. **Lebanon's overall governance quality is well below what would be expected given its level of income, and moreover, is deteriorating over time.** As evidenced by Figure 6, despite faring better than most countries in terms of voice and accountability, in most other important areas relevant to governance, including political stability, government effectiveness, regulatory quality, rule of law, and control of corruption, Lebanon is doing worse than average for the MENA region. Time series comparison over the period 1996-2004 reveals that Lebanon is also faring comparatively worse today than it was in 1996 on virtually all governance indicators (see Figure 7). These are troubling findings, given the fact that Lebanon in 1996 had just got out of a civil war, and the physical infrastructure of its public administration had been completely destroyed and thus its ability to provide services to the citizen was seriously hampered.

89. **Lebanon appears to fall short of other countries at similar income levels in the indicators specifically measuring the quality of public administration.** This highlights the presence of bureaucratic corruption, points to a weakness in the enforcement of rules and regulations and identifies shortcomings regarding the quality of the budgetary processes, public management and the efficiency of revenue mobilization. This evaluation is consistent with country specific assessments on Lebanon's public administration. The ills of the public administration have been thoroughly evaluated and analyzed over time and there is a strong domestic consensus over the deficiencies highlighted above: today, the Lebanese public widely views the public administration as being wasteful, corrupt and inefficient and totally unresponsive to the needs of its citizens.

90. **Corruption is endemic and costly.** In 2004, Transparency International's corruption perception index ranked Lebanon 97th out of 133 countries. In the region, it is tied with Algeria in terms of perception of corruption; only Yemen and Iraq score lower among Arab countries. In terms of corruption in public administration, Lebanon is below the median worldwide, with worse scores than most of the countries in the MENA region according to the World Bank (World Bank 2003a), and the World Economic Forum (World Economic Forum, 2002). The cost of weak governance in MENA amounts to over one percent point of missed growth per annum (World Bank, 2003a). Transaction costs for starting a business are among the highest in the world, amounting to almost 130 percent of GNI per capita (World Bank, 2005d), contract enforcement is slow and costly because established property are not effectively respected and enforced through the judiciary. Moreover, it takes more than two years to recover private debt in

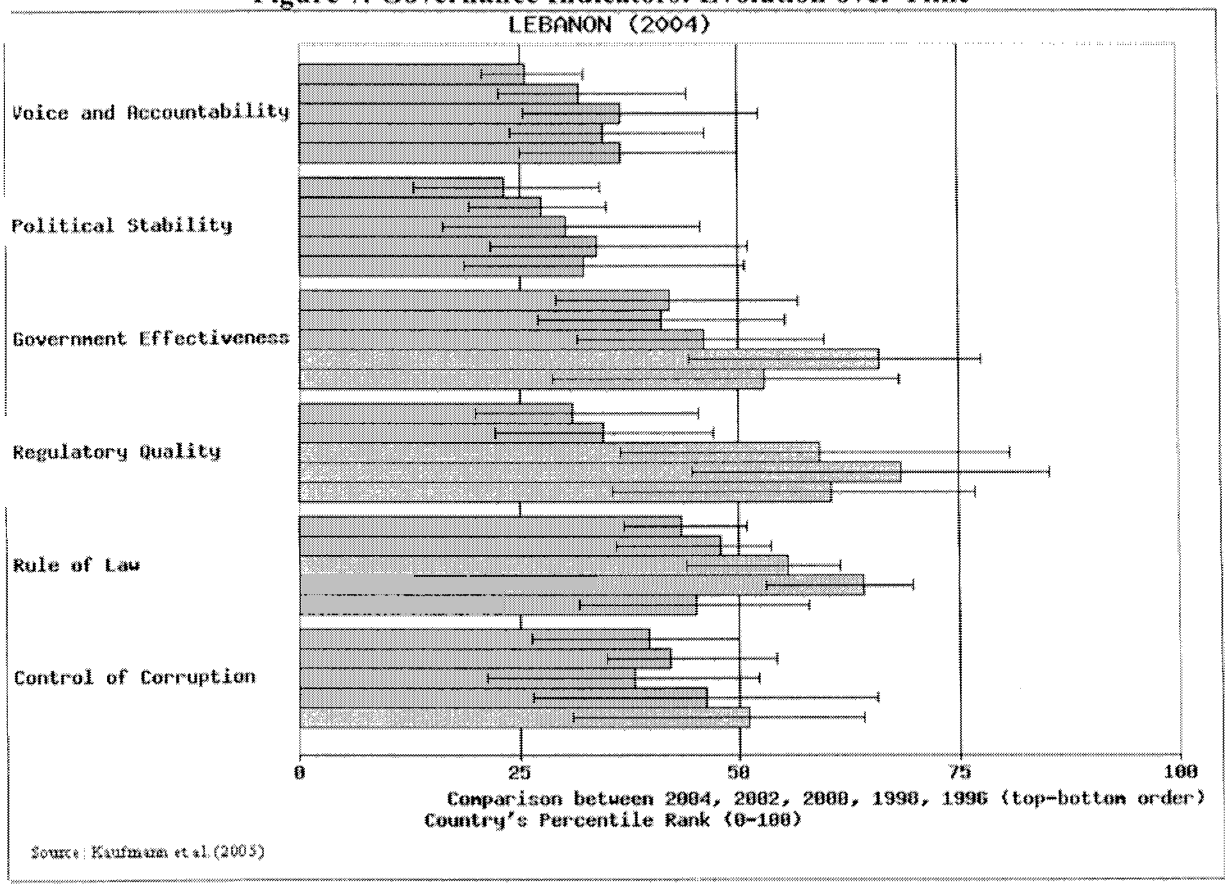
Lebanon. There are 27 different procedural actions that the creditors need to take in order to recover their money. As each step typically involves a court fee or a payment to a lawyer, the cost of commercial litigation in Lebanon is prohibitive. Higher transaction costs resulting from inefficiencies in customs clearance procedures, land transport regulations, and requirements that prevent competition from foreign suppliers (e.g. business licensing, exclusive distribution systems and restraints on parallel imports, and nationality requirements) as well as informal constraints (corruption and political barriers) or raise the costs of services provided by local firms are also very important.[93] Finally, transaction costs associated with the red tape generated in the administration of complex documentary requirements for both citizen and business are higher in Lebanon than in most countries with similar income levels.

Figure 6. Governance Indicators: Comparison with Regional Average



[93] In Lebanon, making additional payments (informal payments by traders to customs and other trade-related officials) is reported to be common practice. Not a single company interviewed in Lebanon was exempt from additional payments for clearance of an import transaction. Half of the responding Lebanese companies estimated that companies were required typically to make between 2 and 17 additional payments to customs officials (Zarrouk, 2003).

Figure 7. Governance Indicators: Evolution over Time



91. **While there have been improvements in the management of public finances, significant weaknesses remain.** Progress has been made in the recent years, following IMF/Bank assistance in terms of (i) introducing a new, more transparent and more functional budget classification (1986 GFS), (ii) computerizing the budget directorate and treasury/payroll/pensions operations to ensure more timely budget submissions, (iii) establishing a single Treasury Account at the Central Bank thus improving accountability, (iv) revising the chart of public accountants and accounting procedures to increase transparency, (v) designing a budget preparation manual for spending ministries to ensure predictability and increase systematization of budget submissions; and (vi) preparing a new financial accounting law. These are important steps forward. However significant weaknesses remain. The recently completed Country Financial Accountability Assessment (World Bank 2005a) describes Lebanon's Budget framework as fragmented and representing a high fiduciary risk due to the presence of extra-budgetary entities and public enterprises who make major financial transactions outside of the budget framework in an already weak oversight framework, the absence of a unified investment and operating expenditures, and the complexity of the expenditure control framework.

92. **The level of coverage of the Budget is relatively low.** Public autonomous agencies, funds and enterprises operating outside of Parliament's control (hence not concerned by the budget cycle) represented 19 percent of total public spending in 2004. The current budget's financial activities -- characterized by a dual budget cycle -- lack transparency and severely

underreport the activities of the public sector. The official government budget, prepared by MoF and approved by Parliament only covers central government spending as executed by 29 first-line entities and 76 second-line entities. Foreign Financed Investments (FFI) under the purview of the CDR and a number of other public autonomous entities operate outside of the regular budget. These include Éléctricité du Liban (EdL), the National Social Security Fund, Banque du Liban (BdL), the National Archives Agency, four consolidated water authorities, public hospitals, and over 60 other entities. While not part of core activities of the Government, their activities have important fiscal implications. Very often, the absence of any binding budget constraint (governance problems, lack of accountability and accounts) prompts these entities to run arrears and losses, which are eventually covered by the Government in the form of grants or loans.

93. **Ministerial scrutiny over budget submission is lacking.** Currently, the development of budget requirements within ministries is not the reflection of well-developed priorities within a sector. Instead, within ministries, the accounting staff simply rolls up the individual, unconstrained, budget submissions from all of its budget entities. This aggregated budget is presented to the minister, who signs it for transmission to MoF. This mechanistic approach to developing budget submission is not consistent with an environment where financial resources are scarce and need to carefully be monitored to improve their impact.

94. **There is no link between the capital budget of the Government and its operating budget.** Thus a completed capital project will not automatically generate an approved future stream of operation and maintenance expenses required to maintain the capital project during its lifetime. The very tangible effect of this situation is that Lebanon's physical infrastructure is eroding and this affects the quality of public services. During the past ten years, Lebanon's public administration infrastructure has been largely rebuilt. The process of reconstruction which directed billions of dollars into the economy, created a functional infrastructure for the majority of services. However, funds for operation and maintenance of this equipment are scarce. As a result, much of the information technology equipment that has been acquired has become obsolete, and many of the capital expenditures that have been made are beginning to seriously erode. This affects the ability of the administration to provide adequate services.

95. **The Lebanese budget system is very rigid and cumbersome.** It is entrenched in a legalistic tradition which encourages redundant and time consuming ex ante controls, thus hampering the ability of spending ministries to deliver services in a timely fashion. An internal ex-ante control exercised by MoF employees located in the line ministries focuses on legal compliance with the Parliament's appropriation and all other applicable legislation affecting the particular transaction. The controllers in this case perform no verification for the timing of cash flows, thus line ministries can presently commit their entire appropriation at any time of the year, with no regard for whether MoF is able to finance it. This contravenes best international practice, which encourages ex-ante controls to be exercised by the concerned line ministry financial officer. In addition, a Court of Account Ex-Ante control is performed for those commitments that exceed certain thresholds. The Court of Accounts has 10 days to review the request and make its recommendation. This is passed back to the controller, who then sends the approved request to the ministry's accounting unit for onward processing. Refused requests are returned to the originating unit. The Court of Accounts intervention in ex-ante verification of transactions

contravenes best international practice as it puts the Court of Accounts in a potential conflict when it performs its ex-post verification of the transaction.

96. **The public labor force is unqualified, lacks motivation, and is oblivious to citizen's needs or demands, responding instead to sectarian political considerations.** The public administration has effectively become an expanded social safety net in the post–war period with considerable overstaffing. This dilutes the accountability and productivity of the public sector and affects the delivery of services to the citizen. The most reliable estimates put active public sector employees at about 220,000 people.[94] They are distributed as follows: (i) military and security personnel of about 95,000; (ii) 42,000 teachers; (iii) some 33,000 employees in public autonomous agencies and state-owned enterprises; (iv) about 15,000 people in the general administration which are regular civil servants, out of 25,000 positions in the organizational structure; (v) additional 13,000 are contractual and daily workers in the civil service; and, (vi) approximately 12,000 people are employed by the municipalities. Most of the government employees are considered unmotivated, underpaid and not expected to produce quality services beyond the bare minimum. On the whole, given the large numbers of people who are not actually providing any value added within the ranks of Government, it is safe to say, that the Government in Lebanon is severely overstaffed for the functions it currently performs. The relative age of the workforce (see Chapter II) further reduces the means to motivate the workforce beyond the purely monetary incentives.

97. **Public administration is largely dysfunctional due to existence of dual structures.** After deciding on a hiring freeze in the civil services, the Government relied on contractual workers to ensure the functioning of the state departments and ministries. Contractual workers receive higher wages than regular civil servants, and they are not bound by civil service regulations on issues related to hiring, evaluations, and promotions. This de facto creates a dual structure of employment and has been the main cause for dysfunction. In addition to this dual employment structures, a number of consultants (mainly financed by UN agencies and other donors) are largely involved in the day-to-day operations of ministries and the conduct of strategic work of ministries. This creates a dichotomy within the ministries, where there are staff sometimes performing similar tasks while earning very drastically different salaries, and definitely creates tensions and resentments within the public sector, which also have very negative effects on the performance of public administration and its staff. This also complicates the reporting system and dilutes accountability, and hampers the delivery of effective services.

98. **While the educational attainment within the civil service is quite good, employees are poorly trained.** Only very few staff within the civil service are considered illiterate, with a large proportion holding bachelors degree or above. However, the years of the war reduced markedly the qualified manpower in the post-war era and very little has been invested in ensuring that civil servants are trained. Training provided by the Civil Service Council was limited. In 2003, the Government has formed the Ecole Nationale d'Administration du Liban (twinned with ENA in France) to improve the level of training for civil servants. Training is today one of the most pressing and important challenges facing public administration.

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[94] Source: Staff's interview with Yahia Hakim, December 2003. Some reports, like Salem (2003) put the total number of public employees in Lebanon at 260,000.

99. Public servants' wages are largely inadequate and provide a poor motivation and incentive framework. As already mentioned in Chapters II and III, while spending on wages, salaries and associated benefits represent the second largest component of fiscal spending after interest payments, the wage represents a disincentive to efficient working conditions. In addition, the working hours for public administration are very short compared with other countries and with the private sector. Currently, public administration works a total of only 32 hours a week spread over 6 days.

The Reform Agenda

100. A comprehensive public sector reform agenda should simultaneously cover four fronts: public administration, public financial management, civil service and corruption. In the Lebanese context, addressing deficiencies in these four domains could go a long way in improving the credibility of the institutions vis-a-vis the population and the donors, and contribute positively to a successful fiscal adjustment. By contrast, fragmented piecemeal efforts to address one of these issues are unlikely to succeed without simultaneously addressing the others. Current efforts to improve the civil service are being fought on the margins. They focus on marginal measures to combating corruption, improving the climate for private sector development and strengthening the regulatory powers of the public sector. While these efforts are good in their own right, they may not succeed without concurrently re-defining the role of the State and improving financial, expenditure and human resources management. The key priorities in public sector reforms should be (i) the definition of the environment and the needs of the public sector; (ii) the development of a longer term human resource management policy (addressing the issues of size, recruitment, wages, training, *etc.*); and (iii) the modification of the administrative culture, focusing on customer relation and service, and emphasizing streamlined procedures, delegating authority to the lowest level of competence; and deepening reforms in the clusters of excellence, and (iv) the reduction of corruption.

Public Administration

101. The Reform Strategy should focus on narrowing the scope of Public Sector intervention: doing less but doing it better. The public sector in Lebanon intervenes in many domains, but remains weak in those sectors where the private sector cannot participate: core state responsibilities (such as fiscal and economic policy, foreign affairs, order, justice, external security and relations with other layers of Government), the regulation of social sectors (education, HR, culture, welfare and social policy), the management of economic resources (which generally includes industrial and trade policy, natural resources and infrastructures) and the correction of market imperfections (monopolies, externalities, asymmetry of information, etc.). Within each country, given its social, political and economic context the exact function of any given ministry varies. While overlapping of institutional responsibilities is certainly not specific to Lebanon, an obvious characteristic of the Lebanese institutional structure is the high number of ministers and ministries as can be seen in Annex 2. While these may reflect the realities of the political system in Lebanon, it is worth noting that there is a tradeoff to be made between institutional efficiency and representation.

102. Concentrating government resources in core activities and institutions is cost-effective. International evidence in public management suggests that reducing the number of institutions tends to increase the flexibility of government action, improve efficiency and – eventually- reduce costs, by cutting back bloated and inefficient public agencies and moving towards greater marketization of the economy. International experience also suggests that streamlining portfolio positions improves coordination and execution of policy and that by grouping functions into homogeneous units it is possible to facilitate the exercise of distinctive authority by ministers, without risks of overlap or gaps, and thus foster accountability. Making cabinet decisions will be easier with a fewer number of ministers at the table each vying to push their agenda, a practice that almost always dilutes the decision-making process for large collegial Governments. Fewer ministries are also likely to greatly simplify the budget process, increasing transparency and efficiency of resources more directly to outcomes and away from operation and maintenance. Finally, a reduction in the number of ministries is likely to forcefully reinforce the message that the State will restrict its actions to that of a regulator and refrain from activities in which the private sector can legitimately perform at least similarly.

103. Decision making in the Lebanese public sector is highly centralized. This creates a culture of centralization and refusal of responsibility that only hampers the civil service by creating additional delays. Lower levels of the executive authority could more effectively undertake many decisions.[95] Delegation of task at the lowest level of competence does not require important legislative framework as the law already provides for this. Its actual implementation will greatly improve the efficiency of the public service, provided it is monitored. Finally, strengthening municipalities to enable them to undertake the tasks, which are constitutionally allocated to it, is an important step to improve public service delivery. Subsequently, focusing on decentralization, and encouraging additional devolution of tasks to lower levels of Government should/could be envisaged.

104. Reducing government intervention by simplifying bureaucratic procedures. Most government services are exceedingly cumbersome. They require a large number of signatures, visits and expenses on the part of the citizens. Law does not mandate most of these bureaucratic steps, rather by customs and use. Reviewing these activities, with the aim of reducing the time and money necessary to conduct these operations, will be cost-effective and will have a positive impact on the citizens. There are very successful examples in Lebanon where simplification of procedures has reduced time and cost and improved service delivery. For example, passports can now be applied for and delivered by post. The land cadastre, cited before, is another successful example.

[95] For example, the Council of Ministers often decides on the move of a janitor from one school to another or the approval of training courses for civil servants.

Box 3. Institutional Reform Worldwide

The experience of Asia and Latin America demonstrates that fewer ministries may ultimately lead to reduction in the cost of administration. Countries in the Southern Hemisphere and Asia relied much more heavily on the strict enforcement of rules such as blocking rehiring and elimination of ghost workers than their counterparts in transitional economies of Eastern and Central Europe. Focusing on one time reduction of the number of ministries as a tool for correcting a narrow set of problems such as wage compression and productivity usually meant that states in Latin America and Asia had increased expenditure in the short run but were much better off in the long run in terms of productivity and overall savings.

While there is no optimal number of ministries to which every country should aspire that would automatically improve efficiency, a broad look at the relationship between the size of the cabinet and the economic and social performance tells us that laggards in terms of economic reform and performance tend to be those countries that have a larger cabinet. Belarus, a country that has not done much to modernize its economy, lies on one extreme with 30 cabinet members. Tajikistan has 26 ministers and 9 chairmen of government committees which attend cabinet meetings. The Community of Independent States (CIS) economic reform laggards such as Ukraine, Russia and Moldova also tended to have a relatively large (and often changing) number of government ministries.

Successful reformers tend to have a fewer ministries: Slovakia (14), Hungary (13), Lithuania (13), Slovenia (15) and Poland (10). In Latin America, the average number of ministries is 15. Brazil, the largest country on the continent and French Guinea, one of the smallest, have the most ministries, 23 and 24 respectively. Most of the countries in OECD have around 14 ministries on average. This is a slight reduction over the period of post-war expansion when governments in Europe got involved in social and economic policy planning.

What needs to be taken away from this discussion is that there is a clear link between government restructuring and financial gains. For the most part, fewer ministries means fewer employees and subsequently less government spending.

Source: Protsyk (2002).

Public Financial Management

105. **Building a Medium Term Expenditure Framework (MTEF) to improve the allocation of public money and its effectiveness should be considered a priority**. This will allow the unification of capital and current expenditure budgets, thus allocating appropriate resources for both the construction and maintenance of public infrastructure and will assist moving towards program budgeting. This will focus the budget process in the evaluation of outcomes, and create a systemic incentive for improved services. It will allow for the streamlining of the expenditure circuit and the reduction of many of the crippling ex-ante controls which make the system cumbersome and legalistic. Furthermore, it will entrench moving towards accrual budgeting which has now become the international standard. Finally, it will enable the integration of simplified and computerized applications into a single GFMIS improving transparency and speeding up reporting. This is a long and complex list of activities given the limited implementation capacity which exists on the ground. Accordingly its implementation will require the sequential execution of the different necessary actions and a strong emphasis on management of the reform process. Within this process, tackling the

achievement of Performance / Program budgeting should come first given its potential impact in transforming the incentive system in the list of priorities, with a view to trigger a shift in public sector mentalities (away from political considerations; and towards resources allocation corresponding to needs).

106. **The MTEF is the key feature of a modern performance-related budget system** as it recognizes the importance of fiscal sustainability / discipline as a necessary condition to meet any other government objective. It is an instrument to reconcile medium term macro and sectoral objectives. In Lebanon, the need for political balance in public expenditure allocation and the absence of consolidation between current and capital budgets makes the move to an MTEF difficult. It also requires a change in the nature and amount of accountability/responsibility of public officials, towards fewer ex ante controls in exchange of more accountability for results. Options for an MTEF combine various dimensions, including the level of sectors desegregation, the participation of non-governmental bodies (Parliament, civil society, donors) in the setting of priorities, and the extent to which the MTEF becomes an instrument for competitive resource allocation. What is not an option but a must is the need to develop forward-looking macro frameworks and outcome-based sectoral strategies.

107. **The development of the MTEF system requires upfront planning and political decisions to be made to ensure the appropriate design.** Various resource allocation mechanisms can be envisaged, once the macro-envelope is decided: (i) envelope per ministry/sector decided upfront, (ii) competition between ministry/sector until the last minute, (iii) proportional allocation. The MTEF can also be confined to fixing a macro-envelope and putting the budget decisions in a forward-looking perspective (as multi-year budgeting does not exist anywhere). Options for program budgeting include the program structure (i.e., the definition of sectors objectives, functions, activities; at the ministerial, sub ministerial or intra-ministerial level), the specification of performance indicators (a small number of relevant outputs to be preferred to outcomes, as measurable and assignable; costing possible without accrual accounting) and the various aspects of performance management. Finally, the reasons for program budgeting need to be spelled out, to gain support within the administration: individuals incentives; allocating resources based on past and/or expected performance; enhanced information on budget achievements.

108. **Improvements in budget fundamentals will have to be conducted in parallel.** Accordingly, work can start in earnest. There is no need to have an accrual accounting and integrated management system before starting to move on improving budget fundamentals.

Among them:

109. **Current and capital budgets must be unified**. After ten years of activity, CDR role should be revisited to fit the changing times. Its role could be redefined to become an implementation agency of Ministries, which could regain control on their investment budget. Accordingly, closely integrating current and capital budgets, consistently with best international practice could (i) improve aggregate control of budget expenditures and priorities, (ii) link the future budgetary expenditure implications of the investment budget, and (iii) improve the flow of

information between the MoF and CDR during the separate budget formulation processes. In this respect, the possibility of carry-forwards should be limited in the budget framework.

110. **The draft Public Procurement Law prepared by the Government should be approved and implemented.** Such a law would not greatly enhance the efficiency and transparency of public procurement procedures, but it would also accelerate disbursement on donors' projects. Recent steps taken by the Government to reform procurement practices regarding drugs and fuel purchasing illustrates the extent to which savings can be made by reinforcing competition among suppliers. The adoption of a competition law would definitely help in generalizing these efforts to most Government's purchases.

111. **The Public Accounting Law should be reviewed.** The revision of the now outdated Public Accounting Law and the development of ex-post performance evaluation would mitigate corruption risks stemming from a lengthy, complex and non-transparent expenditure control process, with a view to shift public practices from compliance to responsibility. Granting greater institutional independence to the Court of Accounts vis-à-vis the Government and reinforcing its capacities would also be a crucial step in this direction.

112. **Extra-budgetary entities' activities need to be audited and consolidated into the budget.** As posing a significant risk of seeing public funds not being spent for the purposes for which they have been appropriated, it is hence important that (i) the Government dispose rapidly of a set of audited consolidated financial statements that cover all non-budgetary entities; and (ii) that public autonomous agencies and funds' budgets be fully consolidated into the budget of the Government and their accounting, reporting, oversight and governance structures be significantly be improved.

113. **Hard budget ceilings need to be imposed on ministries**. While an MTEF is very important, for it to be effective decision processes at the center of the Government have to be reformed. This includes early government decisions on priorities and (in the current situation) policy decisions on cost savings and service reductions which are communicated to ministries for their budget formulation process. It implies the use of hard budget ceilings for formulation of the budgets and reforms of the budget process within ministries, to move away from simply summing up the cost of inputs.

114. **The Government should immediately stop relying on accumulating arrears.** Although not yet audited and tentative (in the absence of accrual accounting), the amount of arrears accumulated as of end-2004 by the Government vis-à-vis the social security, government employees, suppliers and households is seemingly sizeable, at approximately 14 percent of GDP (see Chapter II). Building-up arrears has various negative consequences: poorer fiscal transparency, higher tariffs for private services, weaker social safety nets, and greater difficulties to implement investment projects. In this respect, not accumulating new arrears is a first immediate priority, which will nevertheless add about one percentage point of GDP to primary spending (as measured on cash basis).

Civil Service

115. Unless the issues of recruitment, retrenchment and wages are addressed, the public sector will remain inefficient, costly and prone to corruption. A new and aggressive Human Resource strategy, which focuses on recruitment of qualified staff and identification of performing staff is needed to introduce new blood into the system. Human resources management reforms have to be conducted in accordance with changes in management practices and introduction of performance management and monitoring into the civil service. A better paid, more competent, smaller public force should be the objective. Note that given the public service's relative age, the Government need not conduct an aggressive retrenchment of its public workforce (see Chapter II). Reduction of redundant employees can be achieved through attrition. Creating a new salary structure which is in par with private sector levels, and developing an appropriate recruitment strategy which is transparent and rewards merit and qualification foremost are also a must. In the short run, this will necessitate (i) a review of employment needs and adequacy to government's objectives, (ii) a civil service census, and (iii) a termination of the current hiring and wage freeze in place since 1997. With a view to re-build capacity within the administration to ensure continuity and accountability, the reliance on parallel staffing structures should also be reduced as much as possible.

116. Public labor force non-wage benefits should be replaced with higher wages. Obviously, the reform of public pension schemes which should accompany the reduction of the public labor force through attrition (see Chapter II) would eventually necessitate reducing the benefits accruing to current and new retirees. On the same token, benefits (family allowances, education, and health) to public sector employees should be reviewed in light of actual social needs, and probably replaced with more direct and effective means of channeling assistance to the poor. This decline in non-wage benefits would typically be offset with higher wages in the public sector. Not only would this permit to reinforce social protection policies effectiveness, but would also establish a better link between individual performance and remuneration in the public sector.

117. Strengthening the central oversight bodies such as the Civil Service Council, the Central Inspection Commission, Central Audit are essential aspects of the public sector reform agenda. These agencies are now highly sclerotic and need to reorient their activity along modern concepts of human resources management, and concentrate on developing a vision for the civil service of tomorrow and its functions.

118. Few institutions have made great strides in terms of administrative reform. The Ministries of Finance (MoF) and Economy and Trade constitute a core of excellence within the public administration. Their reform processes have started with the assistance of donors. The new VAT is being managed with new employees who received intensive training and better incentives. Similarly, the automation of the custom administration and the change of its business procedures led to remarkable achievements in terms of productivity and better results. Deepening these reforms would be to focus on systematizing the training functions, especially for existing employees, as well as focusing on the development of these administrations in areas away from Beirut. In addition, OMSAR needs to be empowered to promote change and its role needs to be further clarified.

119. There is a need to focus on processes first and technology second. Ironically, E-government is one of the rare agenda items that all parties espouse and encourage. While its merits, in terms of increasing transparency, are significant and they have a real impact in reducing corruption by eliminating the human middleman, its efficiency depends on making sure that the sequence of actions is correct. This sequence is to focus on the simplification of processes first and computerizing the procedure second. In Lebanon, enormous attention is dedicated to the development of the technical solution, but not as much on the simplification of processes. This could systematize inefficient processes that encourage corruption rather than reduce it.

Corruption

120. Any credible attempt at Public Sector Reform will have to address corruption frontally and in a sustainable fashion. No credible fiscal and governance reform can be forged without addressing the issue of corruption frontally. As has been mentioned throughout this chapter, patronage and sectarianism have created significant distortions in the public sector, and among them significant corruption. Corruption is often associated with public procurement. A UN assessment conducted in 2003 mentions that that over 43 percent of companies in Lebanon "always or very frequently" pay bribes and another 40 percent "sometimes" do.

121. Launching an anticorruption program does not require dramatic initial steps beyond a credible leadership and finding an appropriate entry point for anticorruption work. Small gains can provide useful levers to sway public and official opinion. Entry points should be chosen to tackle high profile problems that respond to public opinion or business dissatisfaction. The Government of Lebanon has indicated that it is planning to create the position of Ombudsman as a mean to address corruption. This could be an important step, provided the Ombudsman is able to perform its duties unfettered by the usual considerations which hamper the functioning of the Government in general.

122. Nevertheless, proper sequencing should be designed to enhance the credibility of leadership and to ensure early tangible results to strengthen the constituency for reform along the way. First, it requires a critical mass of mutually reinforcing reforms that ultimately builds into a comprehensive program. Isolated islands of integrity can provide an entry point and a valuable demonstration effect but may only survive a short time before being swamped by corruption at other levels. In order to be mutually reinforcing, the strategy must also be balanced. This suggests a mix of corruption-prevention and enforcement measures combined with substantial public involvement and education to strengthen the constituencies for reform.

123. Sustainability requires the eventual development of a broad coalition in support of the strategy. Though gaining entry to anticorruption work might require an initially narrow approach, any strategy that relies only on high-level leadership will be vulnerable to the many uncertainties of the political process. The strategic commitment to gain entry must be broadened to incorporate key state institutions and organizations within the civil society. Small- and medium-sized enterprises, professional societies, trade associations, and labor unions can all serve as important partners in an anticorruption strategy. The development of a broad coalition

will reduce the vulnerability of anticorruption strategies to leadership changes and ensure that politicians ignore the corruption issues at their peril. Where civil society remains severely repressed or is emerging only slowly, a combination of fear and/or lack of familiarity with civic involvement may inhibit popular participation in an anticorruption strategy. The strategy will need to include a component that can accelerate its emergence by canvassing client groups, promoting collective action, giving voice to the poor, and setting up monitoring of government services at both national and sub-national levels. External donors can play a role in funding and supporting mechanisms of voice but should ensure that they do not dominate or pre-empt the development of authentic and autonomous participation, sustainably based in the community.

124. Sustainability requires the resources and expertise to see often complicated reforms through to completion over the long haul as well as deliver the credible early results noted above. This implies a mix of short-term measures and adequately funded medium-term programs that can dig deeper into the underlying causes of corruption and build institutions that can resist it. Well-intentioned reforms that are not realistically backed with sufficient resources and expertise will backfire. Governments must assign budget resources as well as competent administrators to these programs. Civil society can only do so much on its own. Business associations and NGOs can help identify priorities and can monitor results, but they cannot deploy the political will and resources of the State that ultimately are needed to reform the State and create the framework for transparent and competitive markets.

Annex 1. Developments in Public Finance, 1991-2004

Overview

125. **High fiscal deficits characterized Lebanon throughout the post-war period.** Both high spending levels and lower revenue mobilization efforts were behind the high fiscal deficit. Heavy borrowing in the 1990s and the mounting debt burden have become the main factor behind the high and rising fiscal deficits. Payments arrears surfaced regularly since 1996. A first massive payment of arrears occurred in 1999, but arrears had built up again since and amounted to 10 percent of GDP by end-2004. As a result, the consolidated public debt over GDP could have reached 175 percent of GDP by end-2004.

126. **A turn around in primary fiscal balance occurred since 1997 with major cut in fiscal deficits.** Fiscal revenues increased by more than 7 percentage points of GDP since 1997. Major efforts to increase tax revenues improved revenue mobilization despite reduction in customs revenues as a result of reduction in import tariffs. The most impressive effort have been the introduction of the value-added tax (VAT) in 2002, taxes on interest income from deposits in 2003 and continuous improvement in tax administration. On the expenditure side, the bulk of adjustment took place at the expense of capital spending. Since 1997, the primary balance gained 12 percentage points of GDP. At the same time though, debt service continued to grow, the result of growing debt, somewhat offsetting gains achieved on the primary balance. Only in 2004, when the impact of debt restructuring efforts from donors and commercial banks undertaken in 2003 was felt, did the debt service started to decline. See Table 13.

Quality of Fiscal Data

127. **Lebanon's budget system does not comply with the principle of unity.** The Central Government has dual budget: (i) the general budget approved by the Parliament and (ii) the Budget of the Council for Reconstruction and Development (CDR) approved by the Cabinet. The GoL differentiates between domestic and foreign financing capital expenditure, with the latter excluded from the budget balance. The CDR, an off-budget institution, carries out the bulk of capital expenditure. This system complicates the process of maintaining aggregate control on fiscal spending, which creates difficulties in linking current and capital spending and fragments sector priorities. The data given in this chapter includes both the foreign-financed investments and the investment financed by the government budget (see Chapter I and II for comprehensiveness of budget).

128. **The quality of fiscal data is relatively poor, despite recent progress in improving coverage and frequency of data.** The coverage of fiscal statistics is incomplete and its full details are not available on a timely basis. The off budget expenditures are all regrouped under the item Treasury expenditures, which includes transfers to the power company, municipalities, expenditures on previous exercises and a multitude of other expenditures. The administrative classification of expenditures is available since 1993, but is not comprehensive. The available economic and functional classifications only date back to 1997. A summarized economic classification is available for earlier years. Most of budget data published are on cash basis.

Public Expenditure Structure and Evolution

129. **Dominated by interest payment and wages and salaries, current fiscal spending represented 85 percent of total fiscal spending during the period 1991-2004 in Lebanon.** During the same period, more than three quarters of this spending can be classified as inflexible because of allocations to only wages and salaries and interest payments. The combined share of wages and salaries and interest payments reached as high as 80 percent of total current spending in the last four fiscal years. In particular, interest payments increased from about 4.7 percent of GDP in 1991 to a peak of 16.9 percent of GDP in 2001. Allocations for wages, salaries and associated benefits (pensions, indemnities and end of service benefits) remained fairly stable and increased from 8.5 percent of GDP in 1991 to 10.5 percent of GDP in the last four fiscal years. See Table 14.

130. **All other components of current spending (excluding interest payments and wages and salaries) represented only 22 percent of current spending during the period 1991-2004.** This share declined to about a fifth of total current spending in the last four fiscal years. Within that category of spending, transfers have been the major item. Transfers to EdL and other extra-budgetary agencies averaged 2 percent of GDP during 1991-2004. Subsidies for sugar and beat were eliminated and the GoL introduced targeted subsidies for transportation and lower interest rates for SMEs. Allocations for goods and services were meager and have been around 0.8 percent of GDP during the same period (compared to an average of 6.5 percent of GDP in other Middle-Income Countries). Other Treasury outflows increased in the last five years and they averaged LBP800 billion during 1999-2004. It should be noted that payment arrears in both current and capital spending started since 1997 and continued over the period until 2004 with the persistence of substantial year to year carry over.

131. **The bulk of expenditure containment that took place between 1997 and 2004 resulted from a major cut in domestically financed capital and investment spending.** Total capital spending increased steadily after the end of the civil war, averaging 8.5 percent of GDP between 1994 and 1997. Since then it continued to decline steadily and it represented 2.9 percent of GDP in the last four years. The additional capital spending financed outside the budget by donors directly through the Council for Reconstruction and Development (CDR) represented 27 percent of the total since 1993.

132. **The structure of the functional classification of the budget is consistent with the economic classification.** Available since 1997, the structure constantly shows the public debt transactions as the largest share of the expenditures with 41 percent of total expenditures between 1997 and 2004. Over the same period, the defense and security, education, health and social affairs, all function with a high level of employment absorbed 39 percent of expenditures. See Table 14.

133. **The military and security expenditures capture a substantial share of the budget.** Military expenditures increased by 6 percent a year on average since 1995. The increase in the years following the end of the war was more intensive. As a part of the peace-building efforts, several members of the militias were incorporated into the military and the security services and

the army almost doubled their staff since the end of the war. Military and security expenditures (including pensions) peaked at 8.2 percent of GDP in 2001 and represented 41 percent of primary spending between 1997 and 2004.

134. **Social expenditures increased rapidly during the past ten years.** Between 1994 and 2004, expenditures on education increased by 9 percent on average each year, and rose as a share of GDP from 2.1 percent in 1994 to an average of 2.6 percent since 1998. The health sector also benefited from substantial increases with an average annual growth rate of 10 percent between 1994 and 2004. The ratio of health expenditures to GDP rose from 0.8 percent in 1994 to more than 1 percent in 2000-2004.

Public Revenue Structure and Evolution

135. **Fiscal revenues increased by an annual average growth rate of 21 percent during the period 1991-2004**. The GoL revenue base was considerably weak at the end of the war in 1990, and should not have exceeded 5 percent of GDP. Fiscal revenues rapidly increased to 15 percent of GDP at the end of the year 1991, as fiscal administration started operating normally. The 1992 devaluation had a severe impact on fiscal revenues and brought them down to 13 percent of GDP. Then, with the recovery of the economic activity, fiscal revenues rose slightly to 13.3 percent of GDP in 1994. The revenue to GDP ratio then increased to 19.5 percent in 1999 triggered by both the increase in tax rates and the improvement in tax administration. At end 2004, the revenues to GDP ratio reached up to 23 percent due to the introduction of the VAT and the tax on the interest revenues of deposits. See Table 15.

136. **Taxes on international trade (customs and excise) have been the major source of tax revenues in Lebanon over the period 1991-2004.** They increased from 5.4 percent of GDP in 1993 to 7.8 percent of GDP in 1999. A targeted reduction in import duties was implemented in late 2000. Some custom fees have also been reclassified and considered as consumption tariffs. A number of goods were also exempted from custom duties in 2003 (mainly industrial raw material) and a number of bilateral and regional agreements with Arab countries led to reduction in custom revenues. Consequently, customs revenues declined to 4.9 percent of GDP in 2004.

137. **Taxes on income and profit increased, although from a small base.** They represented only 1.3 percent of GDP in 1993, declined to 1 percent of GDP in 1995 following the reduction of tax rates and increased steadily since 1996, reaching 2.8 percent of GDP in 2004. As a result of adoption of the tax regularization law in 2001 and the tax audit of large taxpayers in 2001, taxes on income and profits increased rapidly in the last three years. In 2003, a 5 percent tax on interest on bank deposits was also adopted yielding 0.7 percent of GDP in 2004. Conversely, taxes on property, mainly registration fees, went back in 2004 to their 1993 level, 1.2 percent of GDP, after peaking at 1.7 percent in 1999.

138. **A Value-Added Tax was introduced in February 2002.** A VAT (at a rate of 10 percent on goods and services, with few exemptions) was introduced in February 2002, adding about 5 percentage points of GDP to tax revenues by end 2004. This raised the share of taxes on goods and services from only 1.3 percent of GDP in 2001 to 6.5 percent in 2004. Revenues from VAT are expected to stabilize from 2005 onwards as the consequences of the improvements in

collection and the reduction of the threshold for businesses to LBP150 million were already effective in 2004. Gasoline tax was raised during 2001-2002, but was again reduced and the price of gasoline ceiled in 2004. The petroleum tax then decreased by LBP175 billion (0.5 percent of GDP) between 2003 and 2004.

139. **Non-tax revenues remain weak in Lebanon.** During 1993-1997, non-taxes revenues in Lebanon varied between 1 and 2 percent of GDP in comparison with 14 percent in other Middle-Income Countries. Despite increases in subsequent years (5.8 percent of GDP at end 2004) they remain weak. Revenues from the Telecom sector (cellular and fixed lines) are by far the largest sources of non-tax revenues (4 percent of GDP in 2004). They are followed by the administrative fees, charges, fines and forfeits as well as smaller revenues from the Central Bank (BdL). The importance of grants declined from the high levels witnessed in the mid-1990s and other Treasury revenues declined from 2.2 percent of GDP in 2000 to 1.3 percent in 2004.

Table 12. Lebanon Fiscal Stance, 1991-2004

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Total Revenue	656	1318	1947	2645	2935	3313	3833	4544	4962	4853	4680	5831	6654	7514
% of GDP	15.1	13.2	14.1	16.4	15.4	15.4	16.0	17.8	19.5	19.4	18.3	21.0	22.2	22.9
Total Spending	1,196	2,219	3,069	5,379	6,342	7,732	9,662	8,386	8,959	10,932	9,167	10,334	10,793	10,775
% of GDP	27.5	22.2	22.2	33.4	33.4	35.9	40.2	32.8	35.2	43.7	35.9	37.3	36.0	32.8
Primary Spending	990	1,700	2,286	3,891	4,467	5,079	6,180	5,034	5,335	6,735	4,855	5,712	5,919	6,753
% of GDP	22.7	17.0	16.5	24.1	23.5	23.6	25.7	19.7	21.0	26.9	19.0	20.6	19.7	20.6
Debt service	206	519	784	1,488	1,875	2,653	3,482	3,352	3,625	4,197	4,312	4,622	4,874	4,022
% of GDP	4.7	5.2	5.7	9.2	9.9	12.3	14.5	13.1	14.2	16.8	16.9	16.7	16.3	12.3
Balance	-540	-901	-1,123	-2,734	-3,407	-4,419	-5,829	-3,842	-3,997	-6,079	-4,488	-4,503	-4,139	-3,261
% of GDP	-12.4	-9.0	-8.1	-17.0	-17.9	-20.5	-24.3	-15.0	-15.7	-24.3	-17.6	-16.3	-13.8	-9.9
Primary Balance	-335	-382	-339	-1246	-1532	-1766	-2347	-490	-372	-1882	-176	119	735	761
% of GDP	-7.7	-3.8	-2.5	-7.7	-8.1	-8.2	-9.8	-1.9	-1.5	-7.5	-0.7	0.4	2.5	2.3

Source: World Bank staff calculations based on MoF, MoET, IMF. Figures are on a cash basis and exclude CDR. Figures are in LBP billions unless otherwise stated.

Table 13. Economic Classification of Expenditures 1991-2004

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Total Fiscal Spending	1,195	2,219	3,069	5,379	6,342	7,732	9,662	8,386	8,959	10,932	9,167	10,334	10,793	10,775
% of GDP	27	22.2	22.2	33.4	33.4	35.9	40.2	32.8	35.2	43.7	35.9	37.3	36.0	32.8
A. Current Spending (incl. arrears)	1,035	2,073	2,624	3,954	4,640	6,002	7,695	7,251	7,679	9,909	8,550	9,529	9,878	9,723
% of GDP	23.8	20.7	19.0	24.5	24.4	27.9	32.1	28.4	30.2	39.6	33.5	34.4	32.9	29.6
1. Wages & salaries	370	660	1,295	1,710	1,869	2,261	2,466	2,352	2,760	2,908	2,992	3,008	3,087	3,094
% of GDP	8.5	6.6	9.4	10.6	9.8	10.5	10.3	9.2	10.8	11.6	11.7	10.9	10.3	9.4
o/w pensions	..	..	..	..	..	..	..	577	749	844	834	857	844	810
2. Interest payments	206	519	784	1,488	1,875	2,653	3,482	3,352	3,625	4,197	4,312	4,622	4,874	4,022
% of GDP	4.7	5.2	5.7	9.2	9.9	12.3	14.5	13.1	14.2	16.8	16.9	16.7	16.3	12.3
o/w Domestic debt	204	454	754	1,472	1,745	2,468	3,224	3,051	3,214	3,572	3,470	3,278	3,108	2246
o/w Foreign debt	2	65	30	15	131	185	258	301	410	625	842	1,345	1,766	1,776
3. Other current expenditures & transfers	459	754	360	566	700	767	1,247	779	855	1420	909	1,064	1,283	1,529
o/w material & supplies	..	..	..	..	..	..	133	133	112	123	151	130	121	116
o/w external services	..	..	..	..	..	..	92	97	81	90	89	80	81	113
o/w transfers to private hospitals	..	..	..	..	..	..	..	..	..	..	..	234	267	236
o/w transfers to the NSSF	..	..	..	..	..	..	..	..	..	..	..	..	..	89
o/w transfers to EdL	35	145	0	247	218	122	150	7	144	582	283	305	413	492
o/w interest subsidies	..	..	..	..	..	..	..	..	..	..	..	54	66	72
o/w transfers to water authorities	..	..	..	..	..	..	..	..	..	..	..	..	..	85
.o/w diesel subsidies	..	..	..	..	..	..	..	..	..	..	..	..	..	17
.o/w other current transfers	424	609	360	319	482	645	871	542	348	410	221	227	272	271
o/w other current expenditures	..	..	..	..	..	..	..	..	170	215	165	34	63	38
4. Municipalities	..	141	185	190	196	131	215	199	167	434	110	345	180	461
5. Other, including arrears & carry over	..	..	..	..	..	190	285	569	273	950	227	490	454	617
B. Capital Spending	160	146	445	1,425	1,702	1,730	1,967	1,135	1,280	1,023	617	805	915	1052
% of GDP	3.7	1.5	3.2	8.8	9.0	8.0	8.2	4.4	5.0	4.1	2.4	2.9	3.1	3.2
Capital Spending domestically financed	160	146	393	1250	1216	1223	1467	656	824	713	325	610	714	817
Capital Spending financed from abroad	..	..	52	175	486	507	500	479	456	310	292	195	201	235

Source: World Bank staff calculations based on MoF, MoET, IMF. Figures are on a cash basis and include CDR. Figures are in LBP billions unless otherwise stated.

Table 14. Functional Classification of Expenditures 1991-2004

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
General Government Services	..	..	..	..	..	..	1,961	1,986	2,360	2,530	2,522	2,566	2,473	2,533
o/w military & security, including pensions	..	..	..	..	1,321	1,431	1,550	1,571	1,886	1,963	2,091	2,123	2,082	2,103
% of GDP	..	..	..	..	7.0	6.7	6.5	6.1	7.4	7.8	8.2	7.7	6.9	6.4
Community and Social Services	..	..	..	462	626	558	1,873	1,693	1,465	1,403	1,167	1,344	1,462	1,422
o/w education affairs	..	..	..	338	467	408	703	696	644	682	700	728	785	795
% of GDP	..	..	..	2.1	2.5	1.9	2.9	2.7	2.5	2.7	2.7	2.6	2.6	2.4
o/w health affairs	..	..	..	124	159	150	222	221	180	259	251	298	346	315
% of GDP	..	..	..	0.8	0.8	0.7	0.9	0.9	0.7	1.0	1.0	1.1	1.2	1.0
o/w social and welfare	..	..	..	..	..	..	727	536	463	348	122	178	201	165
% of GDP	..	..	..	..	..	..	3.0	2.1	1.8	1.4	0.5	0.6	0.7	0.5
Economic Services	..	..	..	..	..	..	1,147	1,028	1,228	1,086	573	803	861	884
% of GDP	..	..	..	..	..	..	4.8	4.0	4.8	4.3	2.2	2.9	2.9	2.7
Public Debt Transactions	206	519	784	1,488	1,875	2,653	3,482	3,352	3,625	4,197	4,312	4,622	4,874	4021
% of GDP	4.7	5.2	5.7	9.2	9.9	12.3	14.5	13.1	14.2	16.8	16.9	16.7	16.3	12.3
Total	1,195	2,219	3,069	5,379	6,342	7,732	9,662	8,386	8,959	10,932	9,167	10,334	10,793	10,775
% of GDP	27.4	22.2	22.2	33.4	33.4	35.9	40.2	32.8	35.2	43.7	35.9	37.3	36.0	32.8

Source: World Bank staff calculations based on MoF, MoET, IMF. Figures are on a cash basis and include CDR. Figures are in LBP billions unless otherwise stated.

Table 15. Government Revenue 1991-2004

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Total Fiscal Revenues & Grants	656	1318	1947	2645	2935	3313	3833	4544	4962	4853	4680	5831	6654	7514
% of GDP	15.1	13.2	14.1	16.4	15.4	15.4	16	17.8	19.5	19.4	18.3	21	22.2	22.9
A. Total Revenues	656	1318	1750	2138	2862	3242	3760	4489	4950	4753	4643	5830	6654	7514
% of GDP	15.1	13.2	12.7	13.3	15.1	15.1	15.7	17.6	19.5	19	18.2	21	22.2	22.9
1. Tax Revenues	656	1251	1236	1546	2084	2558	2694	3067	3324	2860	2918	3995	4502	5169
% of GDP	15.1	12.5	8.9	9.6	11	11.9	11.2	12	13.1	11.4	11.4	14.4	15	15.8
Taxes on Income & Profits	..	..	175	250	190	248	327	328	481	427	585	727	783	908
% of GDP	..	..	1.3	1.6	1	1.2	1.4	1.3	1.9	1.7	2.3	2.6	2.6	2.8
Taxes on Property	..	..	168	197	254	346	364	356	433	272	273	300	321	405
% of GDP	..	..	1.2	1.2	1.3	1.6	1.5	1.4	1.7	1.1	1.1	1.1	1.1	1.2
Taxes on domestic goods & services	..	..	95	163	230	286	295	334	351	320	331	1287	1678	2148
% of GDP	..	..	0.7	1	1.2	1.3	1.2	1.3	1.4	1.3	1.3	4.6	5.6	6.5
o/w VAT Rev.	..	..	..	..	..	..	..	..	..	..	..	993	1361	1763
% of GDP	..	..	..	..	..	..	..	..	..	..	..	3.6	4.5	5.4
Taxes on Int. Trade (customs & excise)	0	406	746	883	1357	1616	1646	1959	1974	1753	1632	1616	1640	1612
% of GDP	0	4.1	5.4	5.5	7.1	7.5	6.9	7.7	7.8	7	6.4	5.8	5.5	4.9
Other taxes	656	845	52	52	52	63	61	89	84	89	97	65	80	96
% of GDP	15.1	8.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.4	0.4	0.2	0.3	0.3
2. Non-Tax Revenues	..	67	166	288	410	438	662	954	1222	1332	1340	1390	1716	1906
% of GDP	..	0.7	1.2	1.8	2.2	2	2.8	3.7	4.8	5.3	5.2	5	5.7	5.8
BdL Profits	..	..	63	72	80	94	71	81	27	35	21	20	0	0
% of GDP	..	..	0.5	0.4	0.4	0.4	0.3	0.3	0.1	0.1	0.1	0.1	0	0
Telecom (cell & fixed)	..	..	5	2	0	0	141	320	580	653	650	785	1086	1310
% of GDP	..	..	0	0	0	0	0.6	1.3	2.3	2.6	2.5	2.8	3.6	4.0
Administrative Fees, charges, fines & Forfeits	..	..	17	24	32	69	311	387	419	385	425	397	389	370
% of GDP	..	..	0.1	0.2	0.2	0.3	1.3	1.5	1.6	1.5	1.7	1.4	1.3	1.1
Other non-tax rev.	..	67	81	190	298	275	139	166	196	259	244	188	241	226
% of GDP	..	0.7	0.6	1.2	1.6	1.3	0.6	0.6	0.8	1	1	0.7	0.8	0.7
3. Other treasury rev. (incl. municipalities)	..	..	348	304	368	246	404	468	404	561	385	445	436	439
% of GDP	..	..	2.5	1.9	1.9	1.1	1.7	1.8	1.6	2.2	1.5	1.6	1.5	1.3
B. Grants	..	..	197	507	73	71	72	55	12	100	36	2	0	0
% of GDP	..	..	1.4	3.2	0.4	0.3	0.3	0.2	0.0	0.4	0.1	0.0	0.0	0.0

Source: World Bank staff calculations based on MoF, MoET, IMF. Figures are on a cash basis and exclude CDR. Figures are in LBP billions unless otherwise stated.

Annex 2. Government Institutions in various selected countries

	UK	Germany	France	Macedonia	Lithuania	Lebanon
			Core Functions			
HR, Fiscal & Economic Development Policy	Treasury	Federal Ministry of Finance	Ministry of Economy, Finance & Industry	Ministry of Finance	Ministry of Finance	Ministry of Finance Ministry of Administrative Development
Foreign Affairs & Foreign Aid	Foreign & Commonwealth Affairs Department of International Development	Federal Ministry for Economic Cooperation & Development Foreign Office	Ministry of Foreign Affairs State Ministry for Overseas Affairs	Ministry of Foreign Affairs	Ministry of Foreign Affairs	Ministry of Foreign & Emigrant Affairs
Internal & External Security	Ministry of Defense Home Office	Federal Ministry of Defense Federal Ministry of Interior	Ministry of Defense Ministry of Interior	Ministry of Defense Ministry of Interior	Ministry of National Defense Ministry of Interior	Ministry of Interior & Municipalities Ministry of Defense
Legal Advice to Government	Attorney General, Advocate General, Solicitory General	Federal Ministry of Justice	Ministry of Justice	Ministry of Justice	Ministry of Justice	Ministry of Justice
Relations with other levels of Government				Ministry of Local Self Government		
			Social Sectors			
Education & HR Development	Department of Education & Employment	Federal Ministry of Education & Research	Ministry of National Education, Research & Technology	Ministry of Education	Ministry of Education	Ministry of Education & Higher Education
Culture & Heritage	Ministry of Culture, Media & Sports		Ministry of Culture & Communication Ministry of Youth & Sports	Ministry of Culture & Communication Ministry of Youth & Sports	Ministry of Culture Ministry of Information	Ministry of Information Ministry of Culture Ministry of Youth & Sports
Health	Ministry of Health	Federal Ministry of Health	State Ministry of Health	Ministry of Health	Ministry of Health	Ministry of Health

Welfare & Social Policy		Federal Ministry of Labor & Social Affairs Federal Ministry for Family Affairs, Senior Citizens & Youth	Ministry for Employment & Solidarity	Ministry for Employment & Solidarity	Ministry of Labor & Social Policy Ministry of Emigration	Ministry of Labor Ministry of Social Affairs Ministry of the Displaced
			Economic Resources			
Industrial Trade & Policy	Department for Trade & Industry	Federal Ministry of Economics & Technology	State Secretariat for Industry	State Secretariat for Industry	Ministry of Economy	Ministry of Industry Ministry of Economy & Trade
	Ministry of Agriculture, Fisheries & Food	Federal Ministry for consumer protection, food & agriculture Federal Ministry of Environment, Nature Conservation& Nuclear Safety	Ministry of Agriculture & Fisheries State Ministry for Small & Medium Size Business, Trade & Handicrafts	Ministry of Agriculture & Fisheries State Ministry for Small & Medium Size Business, Trade & Handicrafts	Ministry of Agriculture Ministry of Environment	Ministry of Energy & Water Resources Ministry of Agriculture Ministry of Tourism Ministry of Environment
Infrastructure	Ministry of Infrastructure	Federal Ministry of Infrastructure	State Ministry for Postal Services, Telecom & Space Ministry of Civil Engineering, Transport & Housing	State Ministry for Postal Services, Telecom & Space Ministry of Civil Engineering, Transport & Housing	Ministry of Transport	Ministry of Public Works & Transport Ministry of Telecommunications
Total	12	14	16	16	16	22

Source: Schiavo-Campo and Sundaran (2000) and World Bank staff.

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