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LEBANON

PUBLIC FINANCE REVIEW

PONZI

Finance?



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International Bank for Reconstruction and Development / The World Bank
1818 H Street NW
Washington DC 20433
Telephone: 202-473-1000
Internet: www.worldbank.org

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EXECUTIVE SUMMARY

I. **Lebanon’s macro-financial bankruptcy is with such (relative) scale and scope that it has likely undermined the political economy of post-civil war Lebanon**—The Second Republic.¹ This political economy thrived under large inflows of deposits that funded a public-private privilege² for the few (including the financial sector) and political patronage that exercised dominion over public administration. The finality of the sudden stop in October 2019, however, seems to be leading to the disintegration of this political economy, as manifested by a collapse of the most basic public services, persistent and debilitating internal political discord, and the resignation/exodus of some of the social and economic elite who have traditionally benefited from this model. The poor and the middle class, who were never well-served under this model in the first place, are carrying the main burden of this bankruptcy. In fact, Lebanon is undergoing a socio-political-economic transition to an as-yet-unknown re-configuration.³

II. **The Public Finance Review (PFR) analyzes Lebanon’s public finances over a long horizon, to understand the roots of the fiscal profligacy and its eventual insolvency.** To do so, the PFR links three critical elements in three Sections. **Section I: Fiscal Policy in the Second Republic; Section II: Macro-Financial Restructuring; Section III: Public Service Non-Delivery.** A fourth critical element is geopolitics, which is beyond the scope of the PFR. Taken together, these form critical determinants of the outcomes for any future socio-political-economic re-configuration.

III. **We qualify our work with the following important caveats.** Firstly, while the examination herein focuses on public finance, it is balance of

payments (BoP) considerations that drove economic policy over the examined period. Motivated by BoP pressures, quasi-fiscal operations undertaken by the central bank generated massive costs that were unseen, unacknowledged and under-reported. Further, Lebanon continues to be the largest per capita host of refugees globally, as a result of the eruption of the Syria war. The PFR does not dissect this global public good that has been rendered since 2011, as it has been more thoroughly assessed in the Bank’s 2020 publication *The Fallout of War: The Regional Consequences of the Conflict in Syria*.

Section I: Fiscal Policy in the Second Republic

IV. **Section I illustrates the role of public finance in the elite capture narrative, identifying and—to the extent data permits—quantifying diverted resources.** Methods behind GoL’s consistent and acute departure from orderly and disciplined fiscal policy are identified. This departure was not due to the lack of resources—where sizable capital inflows persisted for decades—or alternatives—with incessant warnings, advice and advocacy for reforms from local stakeholders and international partners. Instead, the departure was highly consistent with the objective of serving the interests of an entrenched political economy, which instrumentalized State institutions using fiscal and economic tools.

V. **Fiscal activities reveal the two most prominent and systematized features of this political economy, namely:**

- i. Debt accumulation to reinforce the confidence channel in the macro-financial system. This

1 Lebanon’s economic crisis is likely to rank in the top 10, possibly top three, most severe crises episodes globally since the mid-nineteenth century. Lebanon’s Nominal GDP plummeted from close to US\$55 billion in 2018 to an estimated US\$22 billion in 2021, with US\$ GDP/capita falling by around 60 percent. Such a brutal contraction is usually associated with conflicts or wars. ([Spring 2021 Lebanon Economic Monitor](#), LEM).

2 The collusion of public and private representatives at macro and micro levels to guarantee capture of resources.

3 As early as Spring 2016, the World Bank declared the bankruptcy of the business model for the political economy of The Second Republic; “... a socially and economically bankrupt model, whereby human capital is exported in return for inflows that finance rent-seeking activities that aggravate imbalances.” ([Spring 2016 LEM](#))

was necessary to maintain robust deposit inflows under a fixed exchange rate, the overvaluation of which permitted excessive consumption, generating an illusion of wealth.

- ii. The realization of political and financial benefits from both excess costs imposed on the citizenry and privileges granted to the few. This occurred through distribution channels involving subsidies and profit-making that were centralized around public services, further entrenching the power-sharing confessional system.

VI. **From analyses undertaken, the PFR identifies five financial accounts for the Second Republic:**

- a. Official public internal and external accounts (fiscal, balance of payments, debt etc.);
- b. Undisclosed losses accumulated in BdL accounts and presented only symbolically under “other assets” in the BdL balance sheet;
- c. GoL deferred or refused due payments (i.e., arrears) that amount to forced debt and/or losses on beneficiaries;
- d. Excessive money creation by BdL; and
- e. The absence of, or significant deficiencies in, basic public services that taxpayers financed publicly, and then once again via substitute services from private providers (electricity, water, etc.).

VII. **The above elements prefigured the massive losses that were imposed on the depositors after the collapse.**

Section II: Macro-Financial Restructuring

VIII. **Key Policy Decisions (KPDs) for the restructuring of the macro-financial system—primarily, public debt-fiscal-monetary-financial sectors—are identified and simulated.** Section II updates Technical Assistance offered by the Bank under the PFR to the GoL in early 2020 to help authorities devise a crisis management strategy. We are able to gauge some of the losses in the system, as partially observed through the balance sheets of the three main stakeholders: Government, BdL, and the banking sector.

IX. **For illustrative purposes, we undertake scenario analysis and the simulations incorporated, with the aim of gauging the impact of KPDs.** Key takeaways:

- Lebanon’s macro-financial system became characterized by strong interlinkages between the fiscal-monetary-financial sectors, rendering one dependent on the other, as one sector’s liabilities constituted another’s assets, binding oversized balance sheets.
- Debt restructuring measures (both domestic and foreign debt) will fail to reduce the debt-to-GDP to below 100 percent and sufficiently create a fiscal space. Hence, growth is essential for debt sustainability.
- Debt restructuring measures will incur substantial losses on BdL and commercial banks.
- Unification of the exchange rate will significantly shrink BdL’s and banks’ balance sheets.
- An essential outcome of reforms in the financial sector would be to notably improve BdL’s Net International Reserve (NIR) position, which is currently estimated to be significantly in the negative.
- Transparency regarding the disclosure of standard central banking information, such as NIR, and the use of recognized international accounting practices is a critical component of the strengthening of transparency and accountability of public finances. In fact, the sheer size of the sovereign, BdL, and banking system balance sheets would have never reached the elevated levels reached by the eve of the crisis in 2019 if economic actors had been able to see that the NIR had turned negative long time before the crisis.

Section III: Public Service Non-Delivery

X. **Section III analyzes the implications of Lebanon’s macro and structural policies on the (failed) provision of key basic services to the population.** We illustrate failures in core components of the social contract as manifested by low (and falling) quality of basic public services in the following sectors: Water, Electricity, Transport, Health, Education and Social Protection.

XI. The PFR shows serious gaps in the financing of basic public services, prevailing long before—and aggravated by—the current crisis. On the revenue side, low cost-recovery led to an unsustainable fiscal burden and negatively impacted the provision of electricity and water to the population. The sector analyses confirm the inefficiencies in public spending, which reflect the stressed macro-fiscal conditions analyzed herein. The low level of capital expenditures resulted, among others, in lack of investments in additional electricity generation capacity and network maintenance. This, in turn, constrained Electricité du Liban (EdL) from meeting electricity demand, promoting instead costly and highly polluting alternatives provided (very lucratively) by the private sector.

XII. The successive shocks that hit Lebanon since 2019 affected both the supply and demand sides in critical sectors. The collapse of the local currency and ensuing economy-wide shortages in foreign exchange (FX) have resulted in sharply increasing costs across sectors. The sectors also suffered from shortages of goods and services in the economy, resulting in the deterioration of the quality of service provided. The high inflation rates have led to sharp declines in the purchasing power of salaries for public sector employees (among others). Critical sectors are losing thousands of qualified personnel in the ensuing brain drain from the country. The end of the FX subsidy exacerbated the inflationary environment for households. Their coping strategies consisted of looking for more affordable alternatives (such as moving their children from private to public schools) when available, or simply reducing their utilization of services through, among others, less hours of generators' electricity, lower consumption of water or delayed health care.

XIII. The compounded crises further revealed the fragility of Lebanon's service provision model, itself a product of elite capture of State's resources for private gains that necessitated weakening of public service delivery. While addressing such

fragility would be a medium- to long-term agenda, Lebanese people need immediate assistance. This section proposes a series of sector-specific measures and policies aiming at addressing the immediate needs of the population while engaging in medium-long-term reforms to improve the performance, sustainability and resilience of public service provision. The proposed measures focus on the following main objectives:

- *Ensure sustainability and affordability of basic services* through proper investments, better cost-recovery policies and improved governance, notably in Water, Electricity and Transport sectors.
- *Enhance equity in public spending* particularly through reducing out-of-pocket (OOP) healthcare expenditures, realigning education financing, prioritizing progressive social protection interventions targeted to the poor and vulnerable, and addressing the structural problems of the public pension to ensure sustainability and fairness.
- *Improve efficiency in government spending throughout the sectors.* This would include, among others, rebalancing the health system toward preventive and primary care, containing overall health care expenditures (notably pharmaceutical), more efficient allocation of inputs to public schools (teachers and infrastructure) and adopting policies to reduce the high student repetition.

XIV. Furthermore, as expounded on in the [Lebanon Systematic Country Diagnostic](#) (SCD 2016),⁴ the hollowing of the state is a desired/deliberate outcome intended to cement public-private privilege for principal benefactors of Lebanon's post-civil war economy. Elite capture of State's resources for private gains necessitated weakening of public service delivery so that (1) lucrative and dollar-inflated private sector contracts could step in (e.g., oil import business, generators, waste collection, but also private schools, hospitals etc.), and (2) confessional groups could tighten their grip

⁴ [World Bank \(2016\) "Lebanon Systematic Country Diagnostic"](#).

on citizens by supplanting the State in these service provisions. For Lebanon's public finances, public policy, and the public sector to start delivering for its citizens, this fundamental feature of the pre-crisis regime needs to be overhauled.

Policy Implications

XV. An important value added for the PFR is that it presents analyses and policy recommendations across the economy during crisis conditions with a perspective for long-term sustainability. Both the Macro and Sector sections suggest urgent interventions that are consistent with longer term reforms that have been examined, analyzed and stressed repeatedly by the Bank for decades.

XVI. Long-term macro and structural deficiencies were left unresolved over the post-war period,

despite numerous in-depth analyses and accessibility of financing. In a series of policy notes, the World Bank identified critical macro, structural and sectoral reforms to help mitigate risks and boost potential growth. In December 2016, the WB published a White Paper that included World Bank staff assessment on needed reforms for a new Government to introduce and implement, following two and a half years of a Presidential vacancy and institutional paralysis.⁵ This list was later developed and attuned in the WB Strategic Assessment of the Capital Investment Plan (CIP) for Lebanon⁶ that was presented in the CEDRE conference in Paris in April 2018. Lastly, in the Fall 2020 Lebanon Economic Monitor (LEM), entitled, *The Deliberate Depression*, the Bank presented a reform agenda that looked to strengthen the overall economic management in Lebanon in a way that is more inclusive and more accountable (see [Box 1](#)).

5 World Bank (2016), *Priority Reforms for the Government of Lebanon, December 2016*.

6 Harake, Wissam and Christos Kostopoulos (2018), *Strategic Assessment: A Capital Investment Plan for Lebanon*, World Bank Group, Washington DC.

Box 1. Main Pillars of the Reform Matrix as Published in the LEM Fall 2020.

At the heart of the proposed reform agenda are governance and accountability reforms that seek to strengthen overall economic management in Lebanon in a way that is more inclusive and more accountable; in doing so, the proposed reform agenda seeks to rebuild trust. The reform agenda compromises the following five pillars:

1. **A Macroeconomic Stabilization Program:**

Lebanon needs to arrest high inflation, rapid currency depreciation and the proliferation of multiple exchange rates. It needs to put in place a path to public debt sustainability based on debt restructuring and a sustainable fiscal framework, and to include a strong social protection package. The challenges of fiscal adjustment, and the necessary banking sector restructuring will require full realization of resulting losses according to international accounting norms, which will need to be distributed according to the hierarchy of claims and in an equitable manner taking into consideration past realized benefits.

2. **A Governance and Accountability Reform Package:**

Lebanon needs to address the primary sources of corruption and inefficiency in the public sector in order to create budgetary savings, improve development impact, and begin to rebuild trust between government and citizens. Reforms under this package aim to rebuild trust by: (1) strengthening management of public funds through public finance, investment, and debt management reforms; (2) reforming public procurement, in part to increase fair private sector participation; (3) improving transparency and inclusion through complying with and joining the Open Government Partnership (OGP); and (4) boosting accountability through anti-corruption and judicial reforms. These reforms can be viewed as the building blocks of a public sector reform that is needed to rebuild the Lebanese state.

3. **An Infrastructure Development Reform Package:**

Lebanon's dilapidated infrastructure is a developmental constraint. Among the vital basic services that are needed, Lebanon lags in (1) electricity, (2) telecommunications, (3) port system, (4) transportation, and (5) water and sanitation. Lebanon needs urgent investment in these sectors, which the state can ill afford, and which the private sector is unwilling to undertake, given opacity and weak regulatory governance. Reforms to limit fiscal and quasi-fiscal deficits of state-owned enterprises, strengthen management, regulation and governance, and encourage private investment will need to be prioritized.

4. **An Economic Opportunities Reform Package:**

The economic crisis will bring new opportunities that primarily stem from domestic price adjustments and the depreciated currency. Enterprises and finance must identify these opportunities and use them to create new jobs. Lebanon will need to lighten the burden that it places on its enterprises by simplifying processes and procedures, reduce operating costs, and undertake fundamental reforms to level the playing field. Lebanon will also need to ensure that the banking sector can perform its intermediation function. These reforms can be supported by an economic development plan that ensures markets work efficiently and are unhindered by specific sectoral constraints to growth.

5. **A Human Capital Development Reform Package:**

A key aspect of sustainability and growth for Lebanon's economy is recapturing the human capital potential. For Lebanon, part of the challenge is the fiscal constraint of supporting necessary public services. The other part of the challenge is sector efficiency and management. A strategy for stabilization, economic efficiency, and restoration of trust needs to include reforms that support the development of human capital, and at the same time create fiscal space to dedicate this type of expenditure to support such reforms in a sustainable budget framework.

