THE PUBLIC DEBT

Since the end of the 15 year civil war, Lebanon has been witnessing a soar in its public debt figure. Over the 1993-2009 period, gross public debt increased from 59% to a maximum of 180% as a percentage of Gross Domestic Product (GDP). In fact, figures for public debt as a percentage of GDP in Lebanon rank among the highest in the world.

What are the reasons and consequences of this abnormally high public debt? What solutions have been forward by the Lebanese government to deal with it?

The Rise and Reasons for the Public Debt

In the years preceding the civil war, Lebanon was one of the most dynamic economies in the Middle East and North African (MENA) region, benefiting from a strong comparative advantage in the services sector, particularly in banking and finance. The economy was also characterized by low inflation, high rates of economic growth, large balance of payment surpluses, small budget deficits and political stability, which all made it a highly attractive business center.

Following the war, primary deficits were a recurring phenomenon. In part, they were a reflection of the reconstruction related surge in expenditure and slow recovery of the revenue generating capacity. Due to poor tax collections and inflation, traditional revenue collection methods were not a reliable or a stable source of financing infrastructure and other needed post-war projects. The demand for revenue essentially outstripped its supply and the government resorted to rely on financing the budget deficit and prospective spending via the issue of Treasury Bills and by borrowing from local sources.

However, the civil war, that lasted from 1975 to 1990, put a heavy toll on the nation. In addition to the 130,000 to 200,000 Lebanese who died during the war and the tens of thousands who fled the country, the financial costs were astounding, draining Lebanon of an estimated $25 billion to $30 billion in lost property and revenues. After the war, Lebanon was faced with the challenge of reconstructing its economy and dealing with the stark social and economic inequalities that existed to a lesser extent before the war and that were exacerbated afterwards.

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and international markets. A succession of Lebanese Eurobonds managed by Merrill Lynch were sold to investors who ranged from Lebanese banks, merchants in the Diaspora, Gulf central banks and investment agencies, Swiss private banks, French insurance companies, emerging market fund managers in New York, London and Hong Kong. This has ultimately burdened the budget with interest payments. Together with the fact that real interest rates have remained relatively high in Lebanon since the civil war, the country’s ominous debt creation and crisis have compounded.

Furthermore, interest rates themselves have been a source of detriment to the public debt. In the mid 90’s for instance, they were set at extremely high levels, reaching 40% at times. The economic rationale for this was to combat hyperinflation and stabilize the value of the Lebanese pound, which has deteriorated as a consequence of the Central Bank printing money during the war. As the government was obliged to issue T-Bills to finance its expenses, the high rates of interest on the T-bills would soon lead Lebanon into a spiraling level of debt. Therefore, one could acknowledge that the stabilization of the monetary and economic system came at the expense of the public finances.

The Economist Dr Toufic Gaspard also holds the government responsible for the abnormal growth of the debt. He argues that poor choices were made regarding the allocation of expenditures, claiming that money was heavily spent towards inflating public salaries and financing public sector projects rather than on productive investment. Over the 1993-2008 period for instance, only $12 Billion was assigned to productive investment projects out of a total spending budget of $102 Billion, whereas $52 Billion was allocated towards public salaries and projects.

**Consequences of the Public Debt**

According to Nassib Gharib, head of the economic research and analysis unit at Byblos Bank, the overly inflated public sector is an obstacle to economic growth. A large public debt has a negative effect on local banks’ international credit ratings. Credit ratings are a reflection of the credit worthiness of an individual, institution or country and basically inform a lender or an investor the probability of that the government, this case, will repay back their debts. A poor credit rating indicates a higher risk of the country’s government to default on their loans. This will lead to higher interest rates or a refusal of the loans by the creditors.

The effects of higher rates and loan rejections would be detrimen-
tal to the Lebanese economy, as it depends on foreign capital inflows and cheap concessional loans to finance economic and social projects as well as debt servicing.

Furthermore, higher interest rates will also make borrowing from local banks very costly for Lebanese individuals and prospective businesses, thus reducing consumption, investment, employment and eventually, much needed economic growth. One may also question the sustainability of the public debt. It is interesting to note that Lebanon has never fallen behind or defaulted on its debt payments. This puts more confidence in Lebanon’s ability to grow.

Growing debt is dangerous for the Lebanese economy. Generally, two rational solutions exist when it comes to solving debt matters: 1) an outright debt reduction strategy and/or 2) a revenue generating approach. A number of options reflecting these approaches have been put forward in order to reverse the burden.

1) **Privatization**

Talks of privatizing the mobile networks, MTC Touch and Alpha, and Electricité du Liban (EdL) have been on the negotiating table for some time. This strategy would both increase revenues and reduce public expenditures.

Officials had estimated to generate around $6 billion from the licensing of the two mobile networks before the financial crisis hit the global economic system. It was contended that this finance would go towards repaying a share of the public debt.

A partial privatization of EdL would also relieve the huge constraints it is posing on the government’s treasury. As depicted by the Ministry of Finance fiscal figures, EdL expenditures have represented 11.5%, 11.7% and 16.2% of total expenditures in 2006, 2007 and 2008 respectively and 57.8%, 63.7% and 64.6% of Treasury expenditures. Furthermore, transfers to EdL increased by 7.9% in 2007 and a staggering 64.3% in 2008, noting that the company is causing serious constraints on the government’s public finances. EdL’s inefficiency ranges from its old, unmaintained infrastructure of factories to the distribution of power

**Source:** MoF

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At the end of the civil war, the public debt figure stood at around $3 billion. This figure has now reached $47.2 billion—an increase of 573% over a 20 year period.

“In recent times, the state has spent at least $3 billion each year simply on repaying the interest on the public debt.”

Dr Toufic Gaspard
and collection of fees as well as the government’s poor management and operation approaches.

2) VAT increases

The introduction of the VAT in 2002 has been hailed as a public finance success. By 2004, VAT receipts amounted to 23.6% of total tax revenues and around 5.1% of GDP in 2005. As part of the reform package presented at the Paris III conference on Assistance to Lebanon, the government proposed to raise the VAT from 10% to 12% in 2008, and 15% in 2010 in order to continue the successful coverage it had brought to the public deficits and to relieve some of the debt burden.

This solution however has not transpired. The timing for this rise is not right given the slowdown in the local and global economic environment. Furthermore, a closer effect of a rise in VAT on inequality reveals that, although the effect on the members of the population living in extreme poverty would be limited due to their higher consumption of VAT exempt items as a percentage of their income, overall poverty will be significantly affected as households just above the poverty line might fall into destitution as a result of the rate increases.

3) Reducing Expenditures

Official statistics often show that the expenses invoked in the budgets and the expenses actually achieved are always significantly different. This may reflect a lack in planning and the need for a new structure for and re-evaluation of expenses. Furthermore, cutting down on unnecessary expenditures and improving their transparency so that corruptive actions are spotted and dealt with accordingly, is essential.

4) Economic growth

In parallel with the adoption of a well planned and strict fiscal budget over a number of years, economic growth should also attain a reasonable level in order to reduce the debt. Achieving this would require a sound package of reforms to improve the investment climate and the business environment. This would initiate new sources of tax revenues for the government without posing a threat on the social and economic consequences of raising the VAT.

5) Lower interest rates

The Economist Dr Toufic Gaspard, has stressed the need for Lebanese banks to contribute to a solution to the public debt.
points out that the interest rate paid by the Lebanese government on the overall debt between 1993 and 2008 amounted to 14%. Comparing this with LIBOR, this leaves Lebanese banks to benefit from a 9% margin over this period. However, this may lead to a conflict of interest at the local and international levels. Lower rates would result in a reduction of credit from foreigners. According to those creditors, Lebanon would be a high risk investment, especially in an environment where liquidity on international markets is tight.

**Conclusion**

In short, the reasons for the large public debts in Lebanon are due to an imbalance of expenditures and revenues. Following the war, expenditures were consistently greater than the government revenues. A number of suggestions have been made in the past regarding the reasons for and the deterioration in this imbalance.

A solution to the reductions in Lebanon’s public debt will not be easy: whether it is a strategy to reduce expenses or increase revenues, there always will be some criticism from conflicting parties. Increases in the VAT will not be favored by the public and reductions in expenditure would be detrimental to the social and economic wellbeing of the nation. But one thing is for certain: A lasting and large fiscal adjustment effort is needed in the many years to come in order to reach a sustainable fiscal position. Furthermore, a black and white solution would not work in favor of the Lebanese economy. Rather, a number of actions would have to operate simultaneously in order to limit the potentially damaging effects of reductions in the public debt.
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