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AFTER THE CRONY

A New Competitive Economic Model for Lebanon

By Jean Tawilé

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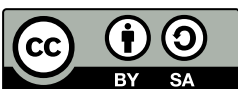


ABOUT THE AUTHOR

Jean Tawile is a political economic consultant in the MENA region and a manager at Saradar Bank in Lebanon. In his other capacities, Tawile serves as the president of the Economic Council at the Kataeb Party, a board member of the Rassemblement de Dirigeants et Chefs d'Entreprise Libanais (RDCL) and head of the budget committee at the Lebanese Association for Taxpayers' Rights (ALDIC). Tawile studied economics at St. Joseph University in Beirut, international finance at SKEMA Business School and management at INSEAD. He is a former advisor at Lebanon's Ministry of Economy.

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EXECUTIVE SUMMARY

Lebanon is today in an economic crisis described in a 2021 World Bank paper as “likely to rank in the top 10, possibly top 3, most severe crisis episodes globally since the mid-nineteenth century.”¹ In an economic and financial crisis that, after a long build-up, became undeniable in 2019 and was exacerbated in the following year by the COVID-19 pandemic and the devastating August 4, 2020 Beirut Port explosion, Lebanon’s population has had to contend with recession so severe that almost 80% of the population are according to a UN assessment from May 2021 estimated to live in poverty, in comparison to just 42% before the crisis. This paper aims to investigate the root causes of the current crisis and put forward an outline for a new and better economic model for Lebanon. Ultimately, with key economic policy changes, Lebanon’s long-standing climate of corruption and economic mismanagement can be replaced by a much more sustainable and productive economy rooted in fair competition.

It is important to note that Lebanon’s crisis was primarily caused by an extensive and entrenched system of cronyism that has been in existence since the end of the country’s civil war period (1975-1990). Virtually the entire economy is controlled by elite political actors who wield their power over public institutions to provision their allies, family members, and networks with special economic favors, ranging from jobs to lucrative contracts to public services. This extensive atmosphere of clientelism has furthered immense high-level corruption and weak state institutions; it has hobbled oversight bodies and led to significant financial losses and unchecked waste of resources in both the public and private sector.

Despite numerous pledges made by Lebanon’s political leadership to citizens and international funders over more than 20 years, and despite accelerating outcries of popular protests on the street, there is virtually no accountability for the corrupt actors that control and benefit from the system. It is clear that the current “model” and practice of cronyism is completely unsustainable and only contributes to the misery of the population.

Although the formation of a new government in Lebanon in September 2021 largely failed to displace any of the country’s established political actors, this new administration is nevertheless responsible for shepherding Lebanon out of its current era of extreme crisis and building towards a more sustainable economic future. This paper on “A New Competitive Economic Model for Lebanon” presents a path toward building a sustainable competitive economy. It will advocate for a redefinition of the role of the state in the economic life and the use of economic policies to unlock the full potential of the economy. It presents a plan to transform the Lebanese economy through ambitious but achievable fiscal and monetary reforms, which need to be instituted

primarily at the federal government level in Lebanon.

The goals of this new competitive model are to address economic uncertainty at a macro level, regain control of the spiraling monetary situation, return the central bank and private sector banks to a state of solvency, and transition the economy over the medium term to a more competitive and equitable model. Each part of this plan will be discussed in greater detail in this paper, but in short, they are as follows:

- ***Halt Lebanon’s precipitous economic collapse through fast-paced, short-term measures.*** This requires regaining control of the country’s deteriorating monetary situation through measures such as reducing the amount of Lebanese Lira cash in circulation, halting the depletion of foreign currency reserves through an effective capital controls law, and ending the country’s reliance on extremely expensive subsidies. In the short term, Lebanon will also have to begin restructuring its banking sector; a process that should be carefully completed in accordance with IFRS 9 and Basel III standards. All steps to halt the country’s economic collapse in the short term should be enacted in careful coordination with the International Monetary Fund (IMF).
- ***In the medium term, address Lebanon’s long-standing twin deficits in its current account and public finances.*** Lebanon has long been exposed to two massive spending deficits – one in its federal expenditures, and the other in its balance of trade due to imbalance of imports and exports. These deficits must be addressed if Lebanon is to achieve macro-stability. The best path to do so is to focus on the reinvigoration of Lebanon’s most productive and high-quality economic sectors, while also investing in durable infrastructures that can support the Lebanese economy for decades to come. Doing so will certainly require the cooperation and support of Lebanon’s large diaspora as crucial source of investments.
- ***Reform public sector governance and fiscal revenue policies.*** Lebanon’s public sector has consistently remained one of the largest hemorrhage points in the nation’s economy as political elites have squandered and raided public funds to lubricate their clientele networks and avert restructuring of inefficient public works, such as the highly dysfunctional electricity sector. Reforms should focus on increasing productivity and reducing corruption in public sector governance through measures such as reducing the size of the public sector, applying coherent and modern job classifications to employee roles, and transitioning to e-government services that are cheaper and easier to both use and trace. Carefully planned reforms should also be made to the Lebanese tax code, which is currently very leaky and overly burdensome for the middle class. Furthermore, to achieve any serious gains in fighting

¹ World Bank Group, *Lebanon Sinking: To the Top 3: World Bank Group, 2021.*

corruption and tax evasion, Lebanon's legislative authorities must abolish the country's existing banking secrecy laws, which at this point serve mainly to obfuscate problematic and illegal financial activity.

- **Generate an environment of fair competition.** For Lebanon's economy to succeed in the long run, reforms must be made that dissolve the country's existing system of crony capitalism and replace it with an environment of fair competition and market-driven economic growth. First, Lebanon is in urgent need of a new investment policy that abolishes rigid bureaucracy and restrictions on foreign investments which in the past have hampered foreign direct investments and facilitated a culture of corruption. This should be coupled with decentralization efforts. Shifting prerogatives away from the central government will give local consumers far greater powers to choose providers for goods and services, thus driving regional economic growth as local firms compete to provide the best services at the lowest cost. A combination of regional and global economic integration efforts coupled with domestic, market-focused reforms can ensure that Lebanon achieves lasting economic stability.

To this day, Lebanon's political elites continue to play the dominant role in governing the country's economy; a power which they largely use to finance their clientele networks at the expense of state finances and public goods. The only feasible cure to Lebanon's curse of crony capitalism is a new economic model that facilitates fair competition, a model that empowers consumers and firms to drive the economy without the burden of political corruption. The best path forward at present is to implement the economic reforms detailed in this paper. By doing so, Lebanon can indeed rise out of its period of darkness and thrive economically in the long term.

INTRODUCTION

Since late 2019, Lebanon has descended into an economic recession so severe that the World Bank paper has described it as “likely to rank in the top 10, possibly top 3, most severe crisis episodes globally since the mid-nineteenth century.”² The crisis, which has been exacerbated by the COVID-19 pandemic and the devastating Beirut port explosion of August 4, 2020, has severely reduced the quality of life of the country’s population, resulting in recurring social unrest, drastically increased poverty rates, and widespread shortages of all manner of necessities. Notably, the explosion at the port also prompted the government of ex-Prime Minister Hassan Diab to step down, leaving the country without a fully empowered government for thirteen months until a new cabinet was formed under Prime Minister Najib Mikati on September 10, 2021. It presented itself as a “salvation” government, sparking cautious hope that it would take at least short-term steps to halt the collapse. But nearly all selected ministers are members of major establishment political parties and, unsurprisingly, Mikati’s government was quickly paralyzed by the same fractious politics that led to the financial meltdown in the first place.

The primary cause of the current economic collapse is that since the end of the country’s civil war in 1990, Lebanon has operated on a system of crony capitalism, which is a system in which political elites grant economic favors and special treatment to politically allied individuals and firms. This in turn has amplified a climate of rent-seeking as the politically connected earn returns well above those that would result from a properly regulated market economy.³ This system is highly problematic. Instead of having the free choice to pick between service providers, consumers are forced to rely on the firms which are most well-connected to the elite individuals that control government contracts and major capital streams. This state of play has in turn generated an environment of high-level corruption, weak state institutions, hobbled oversight bodies, unsound practices in the banking sector and the central bank, and virtually no accountability for corrupt actors. The primary pillar undergirding this failed system is economic policies and practices which consecrate the Lebanese political elite’s clientelist practices, and thus allow sectarian leaders to provision those in their personal networks with otherwise scarce resources, lucrative contracts, and access to capital.

The consequence of Lebanon’s long-standing system of cronyism is an economic crisis so severe that it has made Lebanon “unlivable”, with critical shortages of even basic necessities such as fuel, food, and baby formula now a daily reality for the m. According to the United Nations, Lebanon’s multidimensional poverty rate doubled since the onset of the crisis, increasing from 42 percent in 2019 to a

staggering 82 percent in 2021.⁴ Periodic blackouts, long a part of life in Lebanon, now extend through much of the day across the country since the state electricity provider, Électricité du Liban (EdL) has cycled down several of its plants amid a lack of fuel, forcing the largest hospitals to reduce their activities and others to shut down.⁵ As of September 2021, Lebanon is on the verge of hyperinflation, with the local currency having lost approximately 93 percent of its average value since 2019. The International Monetary Fund (IMF) has estimated that Lebanon’s GDP has contracted by a stunning 34% in the years 2020-21.⁶ All told, Lebanon is now a failed state, with the poor and middle class left to shoulder the impact of the economy’s collapse upon their quality of life.

It is clear that Lebanon needs a better system. Thus, this paper aims to put forward a new and sustainable economic model for Lebanon that will eliminate the rent-seeking practices of the political class and replace them with a system rooted in fair economic competition. It is only competition that can truly put an end to the privileges enjoyed by Lebanon’s elites. As Jean-Marc Daniel, a renowned economist who has extensively studied rent-seeking behavior among political elites, remarked, “Competition is a revolutionary project by nature. It eliminates rents, it breaks the citadels of power, and it redistributes purchasing power by lowering prices towards consumers. [...] Competition is positive because it is threatened in the world. To survive even by its competitors, the company must constantly improve, constantly distinguish itself.”⁷ While the current system of cronyism has indubitably produced catastrophic failure, its collapse presents an important opportunity to implement reforms that can transition Lebanon to a sustainable economic model. As will be discussed in detail in this paper, transitioning to an economy based on fair competition is the country’s best shot to eliminate the clientelist practices of the political elite and build towards a more inclusive, fair, and sustainable future.

² World Bank Group, *Lebanon Sinking: To the Top 3*: World Bank Group, 2021.

³ Qtd. in Aligica, Paul Dragos and Vlad Tarko, “Crony Capitalism: Rent Seeking, Institutions and Ideology,” *Kyklos (Basel)* 67, no. 2 (May, 2014): 159-60, doi:10.1111/kykl.12048, <https://api.istex.fr/ark:/67375/WNG-NQW7M3PQ-F/fulltext.pdf>.

⁴ *Multidimensional Poverty in Lebanon (2019-2021): Painful Reality and Uncertain Prospects*: United Nations, 2021a.

⁵ “Lebanon Struck by Power Cut as Major Plants Shut Down,” *BBC News*, -07-09, 2021. <https://www.bbc.com/news/world-middle-east-57780940>.

⁶ Bisat, Amer, “Lebanon Needs an Emergency Stabilization Program,” Accessed Sep 21, 2021, <https://carnegie-mec.org/2021/08/25/lebanon-needs-emergency-stabilization-program-pub-85201>.

⁷ *L’Etat de connivence. En finir avec les rentes*, Jean-Marc Daniel, Odile Jacob, Paris, 2014 p 104-105.

THE ROOTS OF LEBANON'S ECONOMIC CRISIS

Whereas the economic collapse began officially in 2019, the roots of the crisis extend further back in time, encapsulating Lebanon's foundational political order, which was crafted through elite-level negotiations at the end of the Lebanese Civil War (1975-1990). The Ta'if Accords of October 4, 1989, ended almost two decades of armed conflicts,⁸ and in doing so it substituted warfare with a national unity government representing all major groups that participated in the conflict. The primary feature of the agreement was that all of Lebanon's major political communities have some level of agreed-upon, guaranteed representation; a state of play that made Syria, then occupying Lebanon, the kingmaker of a divided field. In the immediate post-war period, then-Prime Minister Rafiq Hariri employed liberal economic policies and drew upon investment from the Gulf and Western countries to rebuild Lebanon's shattered economy. However, the Ta'if Agreement required that each of the parties who fought in the war receive proportional representation, which meant not just political, but also economic shares.⁹ Thus, the public sector that was formed in the post-Ta'if period was riddled with corruption and mismanagement as parties to the Accords sought to distribute valuable resources, contracts, and capital to their clientele networks.

In February 2005, Rafiq Hariri was assassinated in a motorcade bombing in central Beirut, precipitating broad-spectrum political changes. Namely, the mass mobilization of Lebanese citizens led to the military

withdrawal of Syria from Lebanon in March, bringing about a perceived new era in which Lebanon was free to choose its path without the influence of an occupying power for the first time since 1976, when Syrian forces first invaded the country. Political rivalries between Lebanese political parties were further cooled by an agreement struck in Doha in 2008, thus offering a projection of stability. The Lebanese diaspora, simultaneously assured politically by the Doha Agreement and economically worried by the inclement 2008 global financial crisis, began transferring large funds to Lebanon, which resulted in a positive balance of payments (BoP) through 2011.

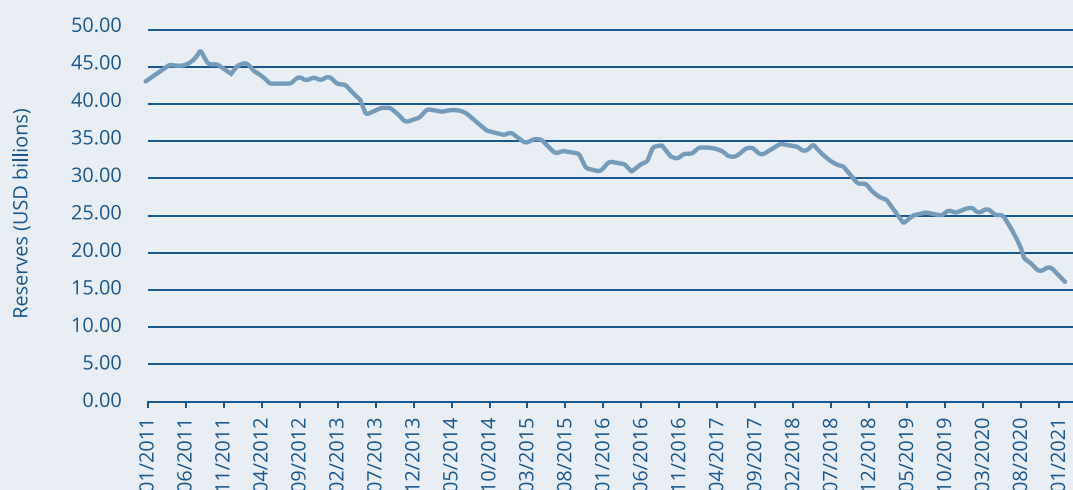
Despite Syria's military withdrawal and the influx of funds from the diaspora, the overall clientelist character of Lebanon's economy remained. Parties used the positive BoP to justify the existing economic model, thereby delaying and putting off needed reforms. Crony capitalist practices continued unchecked and unabated, with state funds effectively constituting a grab bag by which political actors could reward allies and fund sectarian projects. A mirage of moderate economic success was largely upheld by a pegging of the value of the Lebanese Lira at 1,507.5 LBP to 1 USD. However, the influx of funds from abroad largely empowered a long-standing "votes-for-jobs" economy, by which individuals traded electoral votes or other forms of loyalty to political leaders in exchange for public sector jobs and key services, such as education and healthcare.¹⁰

⁸ Parliament of Lebanon, *The Taif Agreement* (4 November 1989).

⁹ Nizamuddin, Talal, "The political economy of Lebanon under Rafiq Hariri: An interpretation," *The Middle East Journal* 60, no. 1 (2006): 102.

¹⁰ Haidar, Jamal Ibrahim and Ishac Diwan, "Clientelism, Cronyism, and Job Creation in Lebanon," In *Crony Capitalism in the Middle East*, 119, Oxford: Oxford University Press, 2019. doi:10.1093/oso/9780198799870.003.0005. <https://doi.org/10.1093/oso/9780198799870.003.0005>.

Net Foreign Assets at Banque du Liban



This system rolled forward on its own inertia for several years until 2011. Cracks in the façade began to show with the onset of the Syrian conflict and refugee crisis, a souring of relations with Gulf states, and extensive overlapping periods without a coalition government, parliamentary elections, or the fulfillment of key governing positions, including the presidency which was vacant from 2014-2016 despite parliament holding over forty votes.¹¹ In addition, 2015 also saw the temporary collapse of trash collection services in Beirut when Sukleen, the company which had previously collected trash and was closely associated with then-Prime Minister Saad Hariri, terminated services at the end of its contract. Citizens were left in a lurch as the government failed to renew the contract or award it to any of the other politically connected firms that applied, resulting in months without any collection services during which garbage piled up in the streets. Riots protesting the government's consistent failure to secure basic services spread through the summer, which were an additional reminder of the state's inability to efficiently manage public services amid the constant meddling of elite political actors.¹²

Hezbollah's military activities and the international isolation of Lebanon

The decline of Lebanon's economy was also expedited by a decision among Hezbollah's leadership to participate militarily in the Syrian conflict, in violation of the Baabda Declaration, which had been signed by the Lebanese parliament in 2012 and affirmed Lebanon's neutral, non-military status with respect to the escalating war in Syria. Hezbollah played a crucial role in preventing the collapse of the Syrian regime in 2014 and 2015. Moreover, Syria was securing oil derivatives for its population by redirecting products imported by Lebanon at a subsidized price. Historical data shows that Lebanon imported 5.7 million tons of fuel in 2011. By the end of 2012, after the start of the Syrian conflict, the figure shot up to 7.6 million tons, which then rose further to an average of 8.2 million tons from 2012 to 2019. This meant that Lebanon's FX reserves were effectively subsidizing Syria's fuel needs.

Hezbollah's regional activities are a reflection of the group's increasingly close alignment with Iran, rather than the interests of the Lebanese state or citizenry. Moreover, its expanding military activities served to heavily isolate Lebanon from international partners. As the party and its militia grew increasingly present in conflicts beyond Lebanon's borders, the organization also used its heavy political weight in Lebanese politics to stymie reforms and prevent meaningful accountability measures for its illegal and illicit activities. Furthermore, Hezbollah is designated

as a Foreign Terrorist Organization (FTO) by the US,¹³ and its militia wing received an FTO designation from the EU in 2013 in response to the party's activities in Syria and its links to a 2012 bombing in Burgas.¹⁴ Hezbollah's decision to participate in the Syrian conflict in clear violation of the Baabda Declaration furthered the breakdown of democracy and the rule of law in Lebanon; a trend which has only accelerated for the duration of the Syrian conflict.

The result has been a climate of international isolation, by which Hezbollah unilaterally pulled Lebanon closer to Iran's paramilitary presence in the region, which in turn pushed Lebanon away from its traditional, and economically critical, allies in the West. Likewise, as tensions increased between Iran and its Gulf neighbors, Hezbollah's close relationship with Iran motivated the United Arab Emirates and Saudi Arabia to urge their citizens against traveling to Lebanon in 2016. This was accompanied by a reduction in Gulf states' embassy missions, thus contributing to Lebanon's diplomatic isolation as many of the country's long-standing economic allies have grown frustrated with Hezbollah's expanding and unchecked political influence.¹⁵

Biting economic collapse

Beginning in late 2019, the decade-long economic decline slipped into a full-blown collapse. Net foreign assets in Lebanon's central bank (Banque du Liban, or BdL), which had reached a peak in August 2011 at \$46.85 billion before entering sustained decline, underwent a steep depletion beginning in 2019. By August 2021, central bank chief Riad Salameh noted that FX reserves at the central bank were down to approximately USD 14 billion.¹⁶ This stood just below the central bank's obligatory threshold, which triggered an end to the system of importation subsidies that previously regulated the prices of most household goods. In turn, prices of even basic necessities ballooned. The American University of Beirut Crisis Observatory reported in April 2021 that the costs of many household essentials had risen by as much as 350%.¹⁷

Facing Lebanon's fiscal and economic collapse, political leaders in Lebanon decided in early 2020 to default on Lebanon's Eurobond payment.¹⁸ This marked the first time that the country ever defaulted on its debts. At the time, many slammed the decision as disordered and warned that it would trigger a

¹³ United States Bureau of Counterterrorism, "Foreign Terrorist Organizations," <https://www.state.gov/foreign-terrorist-organizations/>.

¹⁴ O'Sullivan, Domhnall, *Road to Proscription: The EU and Hezbollah since the Arab Spring*. College of Europe, 2013.

¹⁵ "Saudi Arabia, UAE Urge Citizens Against Traveling to Lebanon," DW News, February 23, 2021. <https://www.dw.com/en/saudi-arabia-uae-urge-citizens-against-traveling-to-lebanon/a-19068698>.

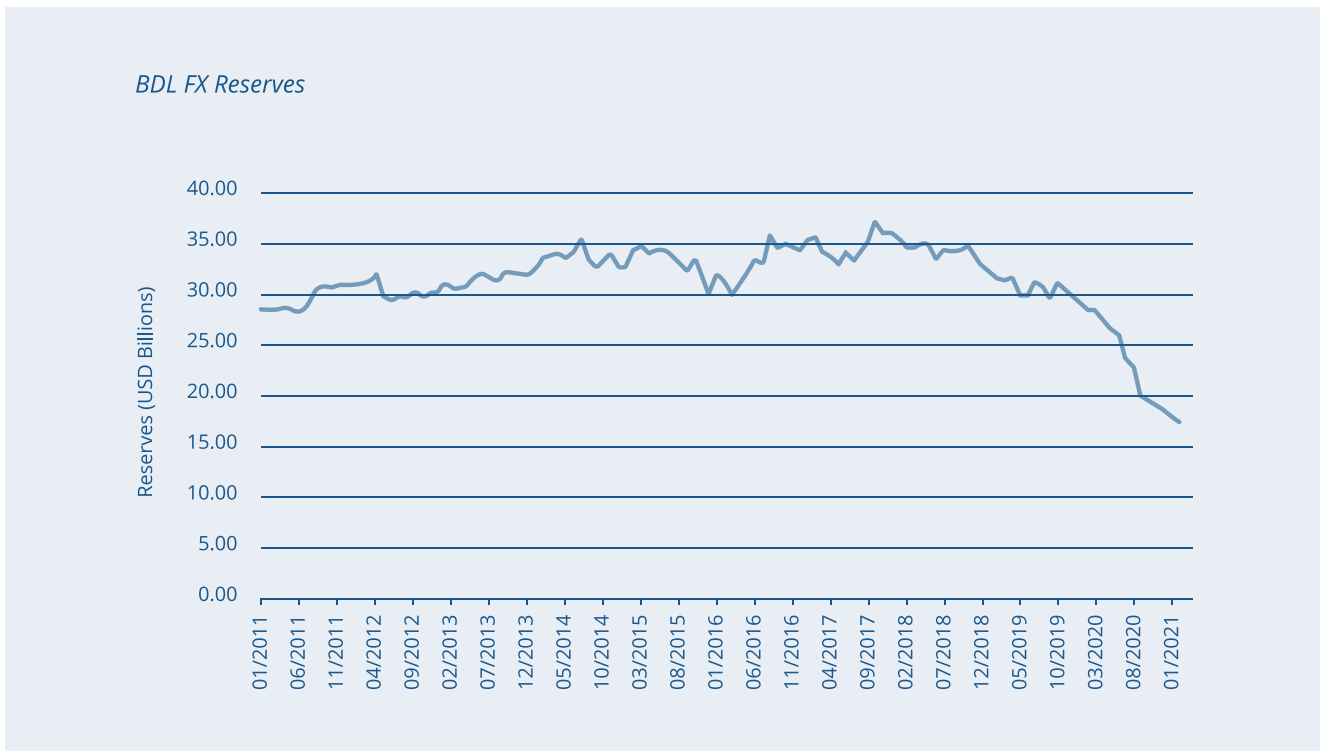
¹⁶ Hardie, Dan, "Lebanese Politicians Condemn Governor for Ending Fuel Subsidy," Central Banking, 16 August 2021, <https://www.centralbanking.com/node/7866986>.

¹⁷ Lebanon Crisis Observatory, "Prices of Basic Necessities." <https://www.facebook.com/CrisisObservatory/photos/a.105341961649567/124044099779353/>.

¹⁸ Agence France Presse, "Lebanon to Default on Debt for First Time Amid Financial Crisis," The Guardian, March 7, 2020, <https://www.theguardian.com/world/2020/mar/07/lebanon-to-default-on-debt-for-first-time-amid-financial-crisis>.

¹¹ "Lebanon Records 44th Failed Attempt to Elect President," The Daily Star Lebanon, September 7, 2016, <https://www.dailystar.com.lb/News/Lebanon-News/2016/Sep-07/370923-lebanon-records-44th-failed-attempt-to-elect-president.ashx>.

¹² Nakhoul, Samia, "Lebanon's Rubbish Crisis Exposes Political Rot," Reuters, 9 July 2015. <https://www.reuters.com/article/us-lebanon-protests-crisis-insight-idUSKCN0R70GQ20150907>.



Source: Bdl

broader and more devastating default across Lebanon's portfolios, although surprisingly this accelerated default did not take place. Proponents of the default argued that it saved Lebanon from an even worse depletion of its FX reserves, thus preserving badly needed funds and eliminating much of Bdl's future debt servicing costs.

Another impact of the country's economic collapse, and perhaps the most devastating to the middle class, was the stress placed upon Lebanon's long-standing currency peg, which had strapped the Lebanese Lira to the dollar at a rate of 1 USD to 1,507.5 LBP since 1997. The IMF had encouraged the floating of the Lebanese Lira since 2015 as a key reform necessary to avert or soften economic crisis, but political leaders and the central bank were loath to remove the currency peg when it could have helped, mainly because doing so threatened to pull off the mask of financial mismanagement, ballooning debt, and monetary weakness that the peg had been concealing. Thus, political leaders kept the peg to effectively hide the state of Lebanon's declining finances from public view until the economic collapse rendered the peg inoperable in 2019. By 2021, the peg was technically still in place for a small subset of goods, but de facto, it was replaced by a widely fluctuating black market alongside several other official exchange rates which apply simultaneously to different imports and exports.

Deliberate policy inaction

With the economy in implosion, Bdl accelerated the printing of cash to pay the public sector wage bill and insulate the political elite from blowback from their partisans, even as printing of Lira contributed further to currency inflation and devaluation. This led to an increase of currency in circulation outside the central bank of 530% between September 2019 and August 2021. In turn, the value of the Lira depreciated by 93% in the same period, with

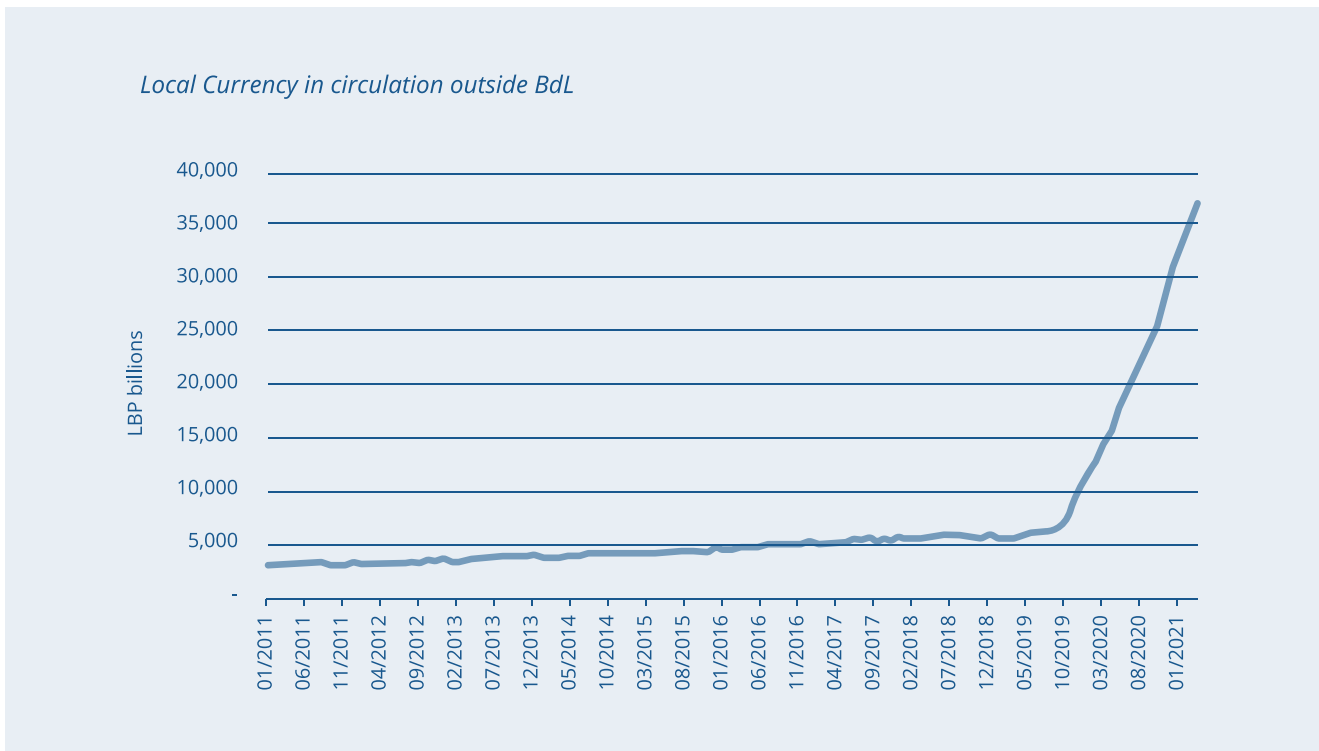
the black-market exchange rate holding in the summers months of 2021 at around 20,000 LBP to 1 USD.¹⁹ Virtually no action has been taken at the parliamentary level to halt the flow of capital leaving the country, tighten the belt around massive public spending, or stem the outpouring of virtually worthless Lebanese Lira. In Spring 2021, a World Bank paper noted that the Lebanese ruling class has reacted to the crisis "with deliberately inadequate policy responses. The inadequacy is less due to knowledge gaps and quality advice and more the result of a combination of (i) a lack of political consensus over effective policy initiatives; and (ii) political consensus in defense of a bankrupt economic system, which benefited a few for so long."²⁰ Indeed, there was virtually zero action whatsoever from the government; a state of play that ultimately empowered the preexisting clientele system because ordinary citizens were rendered even more dependent on existing sectarian and communal networks for their daily needs.

An important result of this deliberate inaction is that Lebanon continued to lack a capital control law, which would have protected the country's foreign currency reserves from irresponsible spending and officially halt capital from flowing out of the country. The absence of such a law has generated a high level of economic uncertainty since the crisis's early days in October 2019, when Lebanese took to the streets to express their outrage at the political class.

The protests, which were triggered by a minor proposed levy on VOIP calls but expressed deep-seated demands for systemic change, led to an unprecedented banking holiday, with all commercial banks closed from

¹⁹ "Lebanon Agrees to Pay World Bank Loan to the Poor in Dollars," *Ap News*, August 23, 2021, <https://apnews.com/article/middle-east-business-lebanon-world-bank-04806aa8a0eea9228eda004185289cab>.

²⁰ World Bank Group, *Lebanon Sinking: To the Top 3*: World Bank Group, 2021.



Source: BdL

October 18-31. After a brief reopening, banks began imposing arbitrary, uncoordinated, and unofficial capital controls, blocking depositors from accessing their funds – only to close again for another 10 days on November 9. Banks have continued to advocate at Parliament for the creation of a uniform capital control law, but in the absence of any action at the state level, banks have since imposed unprecedented ad-hoc restrictions on access to deposits. These directives vary across banks and even between treatments of customers within the same banks, generating considerable popular backlash. In the absence of a capital control law, the country's foreign currency reserves plummeted from \$30.98 billion in October 2019 to \$16.75 billion as of March 2021.

The state's intentional lack of policy action certainly did not occur amid a lack of options. Numerous plans and opportunities to halt the crisis have presented themselves, but legislative authorities have failed to act on any of them. Following the start of the crisis, Lebanon entered into negotiations with the International Monetary Fund for a bail-out package suitable to counter the losses which BdL and its private sector counterparts have suffered. In tandem, Lebanon's government, then under the administration of Hassan Diab's cabinet, had developed an economic plan with financial services firm Lazard, which set a path forward for recovery. However, both of these initiatives collapsed because negotiators from the IMF and Lazard could not agree with Lebanese interlocutors on the size of the losses which Lebanon's central bank and financial sector have sustained amid the crisis; a quantity which Lazard had estimated to be far more massive than that of a fact-finding committee backed by

all of Lebanon's main political parties.²¹ The best way to uncover the true state of Lebanon's losses was identified as a forensic audit of BdL. However original plans to do so were stymied in November 2020 when the Central Bank refused to hand over many documents requested by the auditing firm, Alvarez and Marsal, citing banking secrecy laws.²² In September 2021, the Lebanese government once again resumed plans for a forensic audit with Alvarez and Marsal, but it remains to be seen whether auditors will succeed in unraveling the central bank's opaque finances amid ongoing efforts by political leaders to obstruct the process and shield their corruption from public view.²³

A ballooning informal economy

Finally, an additional impact of the crisis was a massive expansion of Lebanon's large informal economy, which has ballooned between 2019 and 2021 when compared to the last available data from a 2015 IMF study. The IMF's previous assumption had already significantly underestimated the size of the shadow economy at more than 30 percent of Lebanon's GDP, mainly because it did not account for the influx of over 1.4 million Syrian refugees mostly between 2012 and 2015. The inflow of Syrian refugees has led to an increase in Syrian-owned informal firms -- among informal businesses opened between 2011 and 2014, about 66 percent were

²¹ Reuters Staff, "Lebanon's Advisers to Work on Compromise on Financial Plan, Sources Say," Reuters, 17 July, 2021, <https://www.reuters.com/article/us-lebanon-crisis-plan-idUSKCN24I1GS>.

²² Chehayeb, Karim, *Why Does the International Community Want Lebanon to Audit its Central Bank?* Tahrir Institute for Middle East Policy, 2021, <https://timep.org/commentary/analysis/why-does-the-international-community-want-lebanon-to-audit-its-central-bank/>

²³ Sabaghi, Dario, "Lebanon Resumes Forensic Central Bank Audit Amid Obstructionism," DW.com, 19 September 2021, <https://www.dw.com/en/lebanon-resumes-forensic-central-bank-audit-amid-obstructionism/a-59199464>.

managed by Syrians and 29 percent by Lebanese.²⁴

Another contributing factor behind the growth of the informal economy is the protection afforded to informal enterprises by Hezbollah and the political class. Illegal economic networks establish and enhance the predispositions of the public to defy laws, the rule of law, and the regulations of the state. These networks are directly responsible for evading taxes and monopolizing certain parts of the market, which in turn affects competition and augments social unrest and economic inequality. Additionally, illegal networks also stoke organized crime, which creates an environment of insecurity and intimidation and enhances public unrest. Given the low opportunity cost of informality, informal firms in Lebanon choose to opt out of the formal economy and fall below the radar of enforcing authorities. The penetration of the informal economy into every aspect of the political and economic life affects the already challenged democratic institutions in Lebanon. In a wider economic context, the state is deprived of Lebanon’s significant investments as the high degree of informality, coupled with a volatile political environment, makes Lebanon appear unattractive to investors. According to the Index of Economic Freedom Lebanon ranks 154 out of 178 countries.²⁵

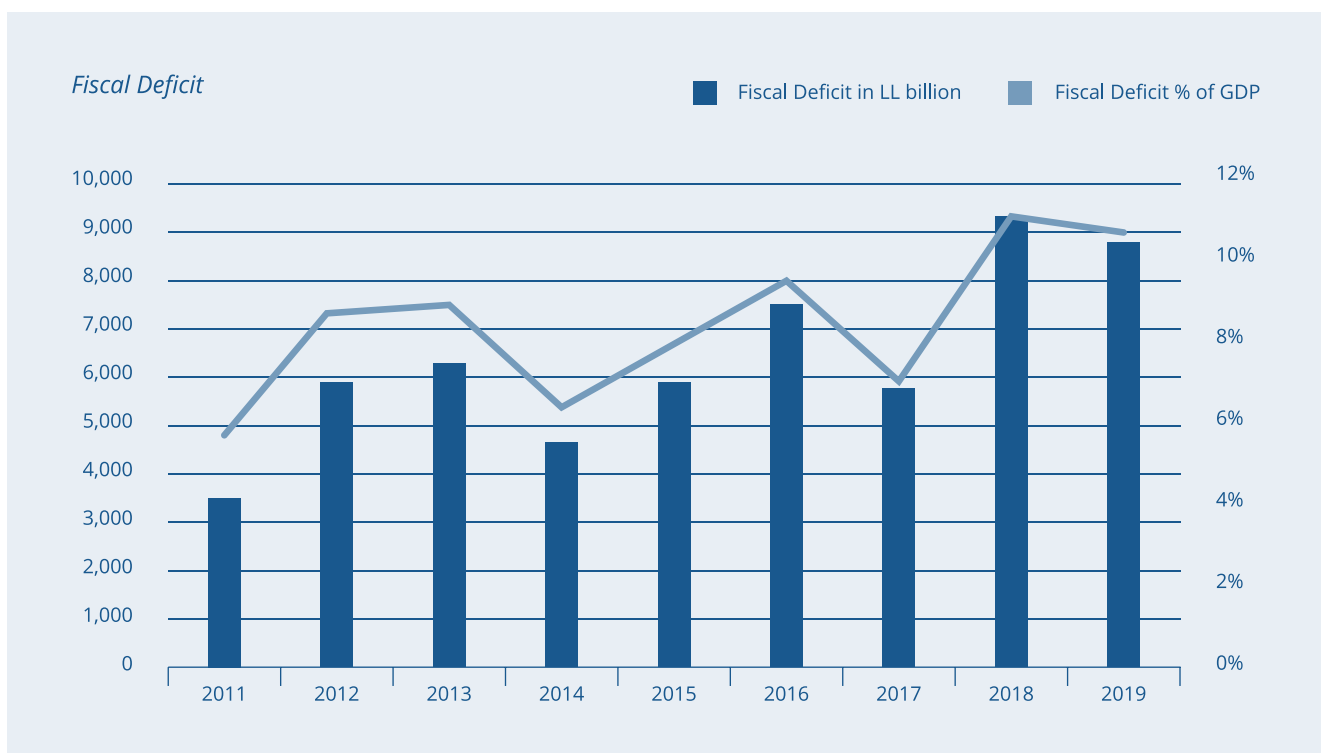
HOW UNSUSTAINABLE ECONOMIC PRACTICES RESULTED IN HIGH TWIN DEFICITS

Lebanon has been exposed to long-standing twin deficits – one regarding its public finance (i.e. the expenditures and revenues of the government), and one regarding its current account (i.e. the amount of money flowing in and out of the country). Both deficits have persisted to fluctuating degrees since the 1990s but became massive in the built-up phase of the economic crisis. Before Lebanon defaulted on its Eurobond payments in March 2020, public debt reached more than 170% of GDP – one of the highest rates in the world. Its fiscal deficit exceeded 11% of GDP in 2018; up from 5.8% in 2011. Meanwhile, the current accounts deficit rose to USD 13.4 billion by 2018, again among the highest in the world in comparison to GDP. In 2019-2020, however, the current account deficit drastically decreased to \$2.5 billion, mainly due to the depreciation of the Lebanese Lira and the resulting decrease in imports, which brought some balance to trade in and out of Lebanon. While this is a welcome macroeconomic reprieve, this deficit still needs to be addressed in the long term by a coherent policy rather than endless can-kicking and emergency measures. Furthermore, under a floated currency, the value of that currency automatically adjusts so that the balance of payments is in equilibrium, and there is thus no effect upon foreign exchange reserves in the central bank. However, without any meaningful long-term reforms, the currency will simply devalue endlessly, much to the detriment of the quality of life of the population.

Much like the country’s economic collapse in general, Lebanon’s post-war political makeup has an important bearing upon the country’s monetary and fiscal position, a fact that underscores how long-standing cronyism has resulted in dangerous imbalances.

²⁴ Le Borgne, Eric and Thomas L. Jacobs, *Lebanon: Promoting Poverty Reduction and Shared Prosperity*: World Bank Group, 2016.

²⁵ Miller, Terry, Anthony B. Kim, James M. Robert, and Patrick Tyrrell, *Highlights of the 2021 Index of Economic Freedom*: Heritage Foundation, 2021.



Source: Bdl

Most apparent about this system have been the extraordinary economic losses absorbed by the state, which were mainly brought on by inefficient, top-down expenditures that depleted the central bank's reserves.

The result of the long-standing system of artificial consensus and political patronage has been a remarkably pervasive climate of rent-seeking, by which political elites draw upon any existing capital flows (be it foreign direct investments, foreign aid or state budgets) and then redirect and re-channel those flows into the pockets of their constituent communities. In a system where key economic benefit such as employment are driven by sect and social position rather than skill, the result is inevitably an immense downward pressure upon productivity and an overall weak and vulnerable economy. The Lebanese state is thus the main sponsor of the sectarian/political elite's clientelist networks; these being the same networks that have drained public funds to an extent that the state can barely afford its existence, let alone public services and the paying of debt. Both deficits must ultimately be addressed if Lebanon is to arrive at long-term economic sustainability. But to do so, fiscal realignment is necessary to reduce costs, rebuild the central bank's reserves, support a more productive and sustainable economy, and reignite Lebanon's ability to export goods.

Many have argued that had it not been for the willful negligence of the elite, the state's financial position could have been salvaged in the last decade, or the damage at least mitigated. However, because elites were unwilling to enact any reforms that would threaten their ability to draw upon public rents to provide for their clientele networks, nothing was done to prevent crushing public sector costs from burning through the state's reserves. Consequently, fiscal deficits grew by 167% from 2011 to 2018. These costs are numerous and wide-ranging, but seven stand out as weighing particularly heavy upon Lebanon's finances since the end of the civil war period:

1. A bloated public sector:

Lebanon has long had a remarkably bloated public sector, fed by high-ranking political leaders who effectively raid state resources to award low-productivity public sector positions to their constituents and allies. Appointments to the public sector positions, from the office of the Director General at a ministry or stated owned enterprise to that of a clerk, require the approval of the sectarian/political elite, who interfere in virtually every nook and cranny of public sector appointments to lubricate their clientelist networks. This results in excessive personnel costs, which by January 2018 constituted 56% of primary expenditure. Little data is available, but the latest investigation by the Central Inspection Bureau shows approximately 110,000 civil servants, excluding the Lebanese Armed Forces, of which more than 10% (approximately 15,200) were hired outside the employment classification framework; a clear violation of the law.

The problem worsened since 2017 when parliament approved an increase to public sector wages just months ahead of parliamentary elections. Lebanon's recurrent budget deficit grew exponentially and uncontrollably thereafter, with public spending on personnel costs swelling from 30% of the 2017 state budget to 50% in 2020. Pensions appear to be the most costly, although they vary among employees, with some, such as the army and judges, having very generous schemes compared to others. A reduction in pensions and benefits, especially for senior civil servants, will be difficult to implement due to vested interests.

2. A dysfunctional state-owned electricity sector:

Lebanon's state-owned electricity sector, financially deficient since 1992, has been another source of funds hemorrhage – in the past decade, the Lebanese government transferred more than USD 15 billion to Électricité du Liban (EdL), constituting an average of 42% of the fiscal deficit in the same period. These costs contributed to the rise in fiscal deficit exceeding 11% of GDP in 2019. Since then, exact figures have been difficult to ascertain as GDP figures remain unclear, with the World Bank listing Lebanon's 2020 GDP as USD 33 billion and the IMF listing it as USD 19 billion. However, regardless of the exact size of the deficit caused by the electricity sector throughout the crisis, the state of collapse of electricity services demonstrates that the sector suffers from a dangerous lack of resources. Even before the crisis, parts of the country suffered 13 hour-long electricity cuts. The fuel crisis that began in 2021 has significantly worsened matters, precipitating an economically devastating collapse of the national energy sector, with blackouts that, in the second half of 2021, range upwards of twenty hours per day.²⁶ With little publicly available fuel to run private neighborhood generators, the entire country exists in a state of extreme energy insecurity.

While the worst impacts of the crisis hit in 2021, Lebanon's energy problems were long in the making. As the public sector became more and more bloated, EdL absorbed many low-skilled workers with no technical expertise, mainly at the direction of political elites seeking to provide their constituents with jobs. This damaged the level of professionalism and quality of services available at EdL, which in turn reduced state capacity and resulted in a poorly trained and unskilled technical workforce. Meanwhile, the country's extensive network of private generator owners has been described by many as a 'mafia', which uses money and political connections to maintain the status quo at EdL and prevent meaningful reforms which could strengthen the central grid.

Political elites have also bickered endlessly over the implementation of new power plant projects and awarding of contracts to energy providers, often drawing criticism that energy contracts were handed out through

²⁶ Ricour-Brasseur, Julien, "Blackouts Across Lebanon: A Heavy Blow to Business," *L'Orient Today*, 19 August, 2021, <https://today.lorientlejour.com/article/1272261/blackouts-across-lebanon-a-heavy-blow-to-business.html>.

corrupt channels rather than given to the provider that could have offered the best service at the lowest price. Some of the most prominent controversies raged over several floating power barges anchored off Lebanon's coast, which have been supplying the country with power since 2012 through a contract signed between EdL and Turkish powership operator Karadeniz Group. However, a Lebanese state prosecutor threatened Karadeniz Group with the seizure of its power barges and a USD 25 million fine over allegations that the Turkish company had employed tactics of corruption to secure its contract with EdL.²⁷ Moreover, the floating power barges were deeply controversial in Lebanon and resulted in significant infighting between political parties as disagreements broke out over whether the power barges were being used to delay or prevent the construction of a more sustainable and permanent domestic power grid.²⁸ Political disagreement over power providers also overshadowed and stalled the possibility of transitioning Lebanon to a more renewables-based power grid, which would have gone a long way toward providing for local energy needs and preventing the ongoing collapse of EdL's system. Overall, the immense presence and influence of corruption in Lebanon's electricity sector has resulted in severely stunted services and halted reforms that could have prevented or mitigated the current electricity crisis.

3. Wasteful spending in postwar reconstruction:

Post-war reconstruction in Lebanon involved a heavy dose of provincial redistribution mechanisms determined along strictly sectarian lines. In the post-war period, the government channeled substantial funds to the Council for Development and Reconstruction, The Central Fund for the Displaced, and The Council of the South to lubricate their clientelist networks.²⁹ State projects, through these public institutions, have frequently been subcontracted to private companies, most of which are owned by members of the sectarian/political elites, their relatives, or their partners. This system is accompanied by an outdated and fragmented public procurement system that to this day does not conform with international standards and guidelines, resulting in inefficiencies and high risks of corruption. Several national efforts to reform this system were attempted in the past fifteen years but failed to achieve desired results, primarily because public procurement became a profitable source of rents for powerful and well-connected elites. It illuminates the very way in which Lebanon's power-sharing arrangement functions.

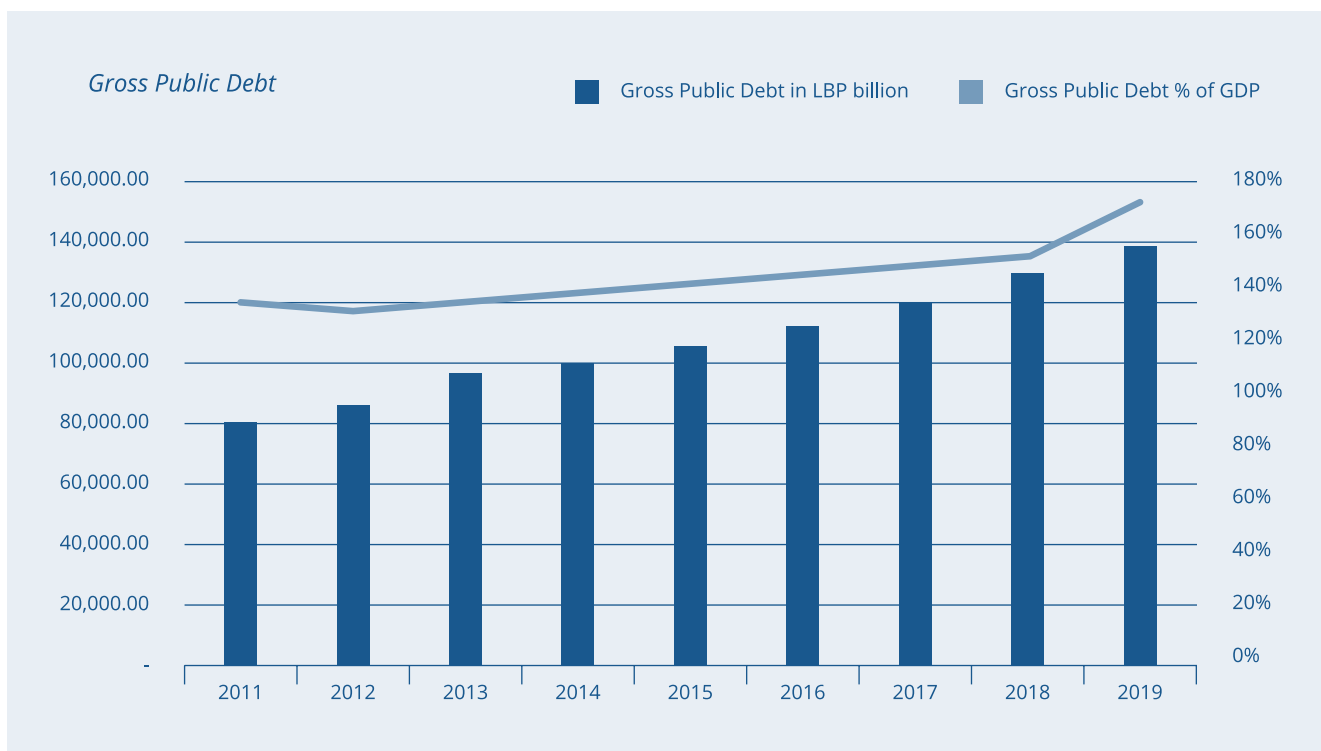
The Council for Development and Reconstruction (CDR) is a perfect example of how Lebanon's elites could influence procurement processes. More than 60% of total CDR spending was granted to only 10 companies, and two firms alone accounted for 23% of total CDR spending, showing the lack of fairness and competitiveness in the procurement and tendering processes.³⁰ The corrupt

²⁷ amaBunghane team. "Powership Company Trails Corruption Claims in its Wake." *Fin24*, June 19, 2021. <https://www.news24.com/fin24/companies/powership-company-trails-corruption-claims-in-its-wake-20210618>.

²⁸ "A floating electricity plant divides Lebanon," *The Economist*, 29 September, 2018, <https://www.economist.com/middle-east-and-africa/2018/09/27/a-floating-electricity-plant-divides-lebanon>

²⁹ "Gherbal Initiative," Accessed Sep 23, 2021, <https://elgherbal.org>.

³⁰ Atallah, Sami, Ishac Diwan, Jamal Ibrahim Haidar, and Wassim Maktabi, *Public Resource Allocation in Lebanon: How Uncompetitive is CDR's Procurement Process?* The Lebanese Center for Policy Studies, 2020, <http://lcps-lebanon.org/publication.php?id=359>.



Source: Ministry of Finance, Bdl

business dealings which dominate public procurement in Lebanon ultimately bring down productivity, as contracts are not awarded to the firms which can deliver the best services at the lowest price, but rather to those who are politically or socially aligned with the elite individuals that control public sector expenditures and contracting.

4. Public Reconstruction Debt:

Immediately after the end of the civil war and in the absence of investments, Lebanon financed its large reconstruction effort through borrowing. Since 1991, the budget deficit has thus been financed almost entirely by issuing debt, largely denominated in domestic currency, to institutions and agents other than the central bank. To attract large capital inflow, the interest rates at which the debt was contracted were initially very high due to a period of triple-digit inflation and a sharp devaluation of the currency at the end of the civil war. By the time that inflation and the currency had stabilized, the debt stock had risen markedly, especially when compared to the speed of economic recovery. From 1993–97, gross public debt, as a percentage of GDP, increased from 49 to 103 percent, and net public debt rose from 38 to 97 percent. This generated concerns about the sustainability of debt and elevated Lebanon's risk premium, which, in turn, worsened debt dynamics and stymied the economy's growth potential.

Numerous conferences in the 2000s were successful in mobilizing much-needed financial assistance for the country, but most of it went to financing the country's burgeoning debt and stabilizing the currency. As such, external funding contributed little to the efficient targeting of much-needed social service provision and the promotion of equitable economic growth, upgrading of infrastructure and job creation. Expenditure on domestic interest payments rose from 4.8 percent of GDP in 1992 to 14.4 percent of GDP in 2000.

5. Debt servicing costs:

The Lebanese state has also settled with another major burden on its reserves: debt service costs (DSCs). DSCs are effectively the costs that one pays to borrow money. Beyond interest payments, servicing costs entail any other fees that the lender – mainly, Lebanese private sector banks – might charge. Gross public debt reached 144.6 trillion LBP in January 2021, double what it was in 2011. In turn, DSCs increased by 50% from 2011 until March 2020 when Lebanon defaulted on its debts, constituting a major expenditure that BdL had to pay out, mainly to the politically connected banks which dominate Lebanon's private financial sector. Furthermore, debt servicing has been a major factor underlying the growth dynamics of expenditure. Lebanon's DSCs, inclusive of total interest and principal repayments, rose over the years. To be sustainable, DSCs must be comfortably payable from current government revenues.

6. Taxation:

Lebanon achieved tax revenues of about 15% of GDP in 2018. This is lower than the average of all developing regions - including Sub-Saharan African (17%), the MENA oil-importers (18%), and Latin America (23%). In the region, its tax revenue to GDP ratio is closest to that of Egypt (16.7%), but far below that of, in terms of per capita GDP, marginally poorer countries such as Morocco (27.8%) and Tunisia (32.6%). Post-war, the tax system in Lebanon underwent several waves of mini reforms, mostly pushed by the administration against politicians' will. But nonetheless, the current tax system fails to raise sufficient revenue and is unfair, inefficient, and leaky. This system is regressive even when compared to that of low-income and highly unequal countries, unfairly hitting the middle class and the poor while having very little impact on the rich. It appears as if designed to protect members of the elite political class and their allies, families, and partners. For instance, indirect taxation - value-added taxes, excise taxes, and tariffs - represents on average around 60% of the total tax revenues and 70% of total revenues.

Even though most developing countries rely largely on indirect taxation - which is easier to collect than income tax - tax collections in Lebanon are in general lower than in other developing countries. The main reason is that the system is full of leaks. If taxes were properly collected, tax revenues would see an estimated increase of about 50% (or 6-8% GDP)³¹. In particular, the collection of taxes at the border, income taxes, and inheritance tax stand out as particularly ineffective. Besides their large size, these leakages have a regressive nature. Tax avoidance is easier for richer taxpayers since fiscal rules allow for several deductions and exemptions. Another issue preventing financial transparency is Lebanon's Banking Secrecy Law, which compels are entities regulated by BdL to secrecy regarding the finances of clients. While originally intended to protect depositors, this law mainly impedes access to information about assets held more by well-off taxpayers; a privilege from which most citizens do not benefit.

7. Imbalanced quasi-fiscal activities:

A final hidden driver of state losses is the quasi-fiscal activities which the central bank engaged in from 2014-2017. These activities constituted of successive and sizeable stimulus packages in the form of subsidized loans (totaling USD 6.1 billion), of which 59% went to the real estate sector. BdL took advantage of those activities to promote dollarization, thereby creating deposits in USD that are "produced" in Lebanon. Under this peculiar system, money was created whenever the banking system made loans. These so-called Lebanese dollars, or Lollars, are

³¹ Bifani, Alain, Karim Daher, Lydia Assouad, and Ishac Diwan, *Which Tax Policies for Lebanon? Lessons from the Past for a Challenging Future: Arab Reform Initiative*, 2021, <https://www.arab-reform.net/publication/which-tax-policies-for-lebanon-lessons-from-the-past-for-a-challenging-future/>.

estimated today at USD 53.6 billion. However, Lollars have contributed to the insolvency and instability of Lebanese banks, as they exist only as a number in a computer. Their value is effectively imaginary, given that they lack any cash to back their worth. As soon as those banks' foreign currency reserves began to dry up amid the current crisis, they were suddenly unable to pay out fresh dollars to those who sought to withdraw money that had been accrued as Lollars, leaving depositors without access to their funds.

On top of this, Lebanon at the cusp of the crisis, introduced a new, poorly targeted subsidy scheme which cost an estimated USD 405 million each month; beyond the stimulus packages, this new expenditure, born of quasi-fiscal activity, drastically sapped BdL's FX reserves. Of the \$14.23 billion decrease in Lebanon's foreign exchange reserves in about two years, a vast majority - \$10 billion - was spent on a subsidy program introduced in September 2019. The government subsidized the imports of essential items, including medication, fuel, and food, through the traders. The system has been criticized as highly inefficient, particularly as it subsidizes the consumption of the entire population - therefore primarily benefitting wealthy individuals who consume more, instead of poor individuals who consume less. In addition, authorities have been unable to monitor prices of subsidized products across the whole country, and even worse, control smuggling across the border. The Minister of Economy at the time, Mr. Raoul Nehme, said the subsidies were imposed "in an effort to curb inflation and protect consumers from soaring prices on some commodities." In an article published in February 2021, however, he acknowledged that "the current subsidies are known to be inefficient, distort markets, and mainly support the rich."³²

POLICIES AND REFORMS TO FACILITATE MACRO-ECONOMIC RECOVERY

Achieving an equitable and successful economic turnaround is only possible if Lebanon can implement relevant reforms which are vital to unlocking promised international aid and set the Lebanese economy on the path of sustainable and inclusive growth. Thus, a comprehensive economic plan aimed at 'jump-starting' the economy and putting it on a path of accelerated, inclusive, and equitable economic growth will have to address structural distortions in the economy with courage and without any further delay. The below plan, which ultimately presents a path toward building a sustainable competitive economy, advocates for a redefinition of the role of the state in the economic life and the use of economic policies to unlock the full potential of the Lebanese. Reducing the cost of doing business, minimizing regulatory barriers, instigating creativity, fostering competition, and improving governance

will enhance the efficiency and competitiveness of the Lebanese private sector and accelerate the recovery of the economy. It will also increase the attractiveness of the Lebanese economy to foreign investments as the economic, financial situation stabilizes, and prospects improve.

Fiscal policy is the cornerstone of any sustainable economic plan, as existing hemorrhage points in the state's financial system will effectively drain any new capital inflows. A new path must be put in place towards public debt sustainability based on debt restructuring. This will constitute a sustainable fiscal framework in which public spending is reorganized such that the state can deliver the social and infrastructure services that can allow for more social mobility and higher labor productivity, and create the needed fiscal space for an adequate social protection scheme.

To manifest a more sustainable future for Lebanon, it is crucial to select achievable macro-economic goals which reduce uncertainty and grant broad-spectrum economic stabilization. This paper posits the following actionable goals which can guide policy efforts and present a North Star, so to speak, to align concurrent and overlapping reforms:

- Double-digit annual GDP growth in the next 5 years.
- An exchange rate regime that minimizes economic losses and allows the currency to float in order to absorb external and internal imbalances.
- Single-digit year-on-year inflation, below 5% by 2025.
- Debt at a maximum of 80% of GDP by 2030.
- A sustainable balance of payments, generated by reducing the current account deficit to a maximum of 10% of GDP over the medium term.

Achieving these macro-economic goals will be no small task. It will require a variety of reforms and legislative steps, some of which will certainly be uncomfortable for governing elites that seek to conserve their political and social positions and stave off accountability for their role in the current crisis. These reforms will nonetheless be necessary if Lebanon is to reverse its misfortune, rebuild its economy, and set a course for sustainability.

The plan essentially consists of four parts: 1) halting the country's precipitous economic collapse through fast-paced, short-term measures, 2) setting a course for sustainable management of the country's twin deficits, 3) reforming Lebanese tax policies to bolster state and municipal revenues, and 4) implementing policies to generate an environment of fair competition. Each of these steps will be discussed at length below. Finally, efforts to align international accountability mechanisms with domestic reform efforts will also be discussed.

³² Nehme, Raoul and Leila Dagher, *Lebanon's Misguided Government Subsidies are Quickly Eating Up its Foreign Reserves*, *International Policy Digest*, 2021, <https://intpolicydigest.org/lebanon-s-misguided-government-subsidies-are-quickly-eating-up-its-foreign-reserves/>.

IMMEDIATE, SHORT-TERM MEASURES TO HALT THE COLLAPSE

The first step necessary to turn Lebanon's economy around has to consist of decisions to stop the country's disastrous collapse through short-term measures. These initial policies, geared towards halting hemorrhaging capital outflows and currency depreciation, can be implemented to substantive effect within a period of six months. Then, with the economic situation stabilized, new pathways will open for a transition to growth.

It is important to note that a deal with the International Monetary Fund is a bottom-line essential ingredient for any future economic transition or stabilization. Lebanon has asked the IMF for a deal worth USD 10 billion, although this is unrealistic and more likely to transpire a provision closer to USD 4 billion³³. However, even this smaller sum is crucial, not because it can drastically improve Lebanon's fiscal or economic position, but rather because international actors and potential investors will view an IMF deal as a vital signal of confidence and improvement. Such a deal would attract foreign investors, particularly from among the Lebanese diaspora. It would also be seen by many as an important step towards unlocking the larger pool of USD 11 billion in infrastructure investments and grants pledged by donor states at the 2018 CEDRE conference. While CEDRE money is predicated on a wider body of fiscal and anti-corruption reforms, the IMF deal will start Lebanon on a better path and open doors towards new capital inflows.

Beyond seeking an IMF deal as a signal of will to recover, monetary and fiscal reforms are necessary to put the brakes on the country's collapse and allow breathing room for more systemic and broader reform packages. The following steps, which can have impact in as little as 6 months, should be implemented as soon as possible:

- The existing system of split exchange rates for different products is untenable and prevents both businesses and individuals from making any reliable economic predictions. With at least twelve separate rates now in effect, the economy and the local currency value are only becoming more uncertain. The IMF can guide Lebanese leaders on how to unify these widely varying exchange rates and establish a transparent foreign exchange platform that is sufficiently liquid and efficient to respond to the market. The role of BdL should be reduced to managing volatility.
- The next step is halting the depletion of foreign currency reserves, at a time when outflows are pushing the central bank towards near-bankruptcy. Immediate action must be taken at the highest levels of government to stem hemorrhage points and preserve remaining FX reserves.

- » An immediate measure must be an effective capital control law, in line with IMF recommendations, which limits the flow of capital out of the country fairly and equitably.
- » Alongside capital controls, the existing subsidy scheme should be replaced by a more cost-effective system that does not sap BdL's FX reserves so drastically. To this effect, the Lebanese parliament approved a new cash transfer program in late June 2021 which will cost USD 556 million per year; drastically lower than the USD 6 billion per annum that was recently being spent on subsidies. Needy families covered under this new system will reportedly receive around USD 93 monthly to help cover the rising costs of basic goods.³⁴ Switching from subsidies to cash transfers is certainly a positive step that will help cushion the impact of the crisis on the poor and middle class; however, the actualization of the program remains in doubt. Lebanese leaders must complete the legislative process and implement this program, in collaboration with the World Bank group and donor countries, and ensure that payments reach the 80% of the population estimated by the World Bank to need support.³⁵

- Another short-term priority which the Lebanese state must attend to is regaining control of the money supply and reducing the quantity of Lebanese Lira notes in circulation.
 - » First, BdL's circular 151 must be repealed, which permits Lollars to be redeemed in Lebanese Lira rather than USD.³⁶
 - » Lebanese banks, the government, and BdL must collectively agree on a fair distribution of the losses incurred by Lebanese entities (estimated at LBP 241 trillion) and develop an underlying policy that aims to insulate depositors as much as possible from the economic impacts of BDL's failed quasi-fiscal activities.
- Along with attending to the Lollars issue, the state must also move to rein in public spending and improve fiscal revenue collection. Lowering the fiscal deficit is crucial because this is the only way

³³ Under regular access, Lebanon could receive a maximum program of USD 3.9bn with an annual limit of USD 1.3bn (145% of Lebanon's quota)

³⁴ Bassam, Laila and Maha El Dahan, Lebanon Parliament Approves Cash Subsidy Costing \$556 Million, Reuters, 30 June 2021, <https://www.reuters.com/world/middle-east/lebanon-parliament-approves-cash-subsidy-costing-556-mln-annually-2021-06-30/>.

³⁵ Lebanon Subsidy Reform: Short-Term Patch Pending More Comprehensive Macroeconomic Reform: World Bank Group, 2020.

³⁶ Banque du Liban, Basic Circular 151 Addressed to Banks (21 April 2020).

to ensure that public sector wages can be paid. Doing so requires targeted steps to reduce the size of the public sector, increase its productivity, and invite a judicious review of the civil service by an independent international institution.

- Beyond the urgent monetary measures mentioned above, a final topic that must be addressed in the short term is the restructuring of Lebanon's banking sector. Delays in dealing with the banking sector crisis is increasing depositor losses and amplifying wealth destruction. The banking sector is of critical importance to build a sustainable economy, unlock productivity growth, secure solid GDP growth, and improve international credit ratings. A careful bank-by-bank restructuring process is crucial to understand industry risk and required actions and should be completed in accordance with international standards; mainly IFRS 9 and Basel III. The intertwining of balance sheets of government, commercial banks, and the central bank suggests a parallel restructuring of BdL's balance sheet will be required.
 - » First, and following an agreement on the fair and equitable distribution of losses (as mentioned in the previous point) between the different stakeholders, a banking resolution directive should be issued. The directive will require each bank to prepare its recovery plan including their recapitalization and provide banks with a way to start solving their mismatching exposure. Some banks will find it difficult to continue to operate. Those banks should either be absorbed by healthier ones if commercial agreement is reached, or will have to be resolved by the BdL thus ensuring an orderly exit of insolvent banks.
 - » In addition, a serious reform of governance in the banking sector and a reshuffling of the current supervision system of the banking and financial sectors in Lebanon is a priority.

SUSTAINABLE MANAGEMENT OF LEBANON'S TWIN DEFICITS

Reducing Lebanon's twin deficits and stabilizing the macro-economy are preconditions for future growth. Regarding the fiscal dimension, improvements to fiscal policy need to be part of a broad and credible adjustment program, and this program needs to be accompanied by political reforms that generate sufficient trust in government. Fiscal and macroeconomic policy is not only about balancing the budget, but also about making it fully transparent and measuring each expenditure and revenue item against economic goals. Fiscal policy is very contextual and shouldn't be imposed as a one size-fits-all policy. Research on the most efficient policies should precede any reforms.

This year, Lebanon experienced a certain degree of reprieve with regards to its current account deficit, as the collapse of the Lebanese Lira has resulted in a huge decrease in imports. A deficit that once stood at USD 15.5 billion in 2018 decreased to a much more benign 2.7 billion by 2020; a reduction of 80 percent.³⁷ While the reduction of this deficit is an important step towards macro-stability, it is a step born only of natural market forces rather than coherent policy action. Moreover, this deficit realignment was mainly caused by a massive decrease in imports, which has weighed heavily on Lebanese businesses that rely on foreign products and equipment. Imports of transport vehicles, metals, textiles, and electrical equipment each dropped by more than 50 percent from 2018-2020 – one factor among many which have caused many small businesses to close across the country.

Nevertheless, this realignment presents an important opportunity to build a stronger, more deficit-resistant economy by decreasing imports and increasing exports. The key is investment in high-value adding and high-quality Lebanese sectors such as cultural and agricultural goods, for which Lebanon has a long tradition of expert artisans and high caliber products (ex. oil, wine, spices, textiles, soap, cutlery). Chiefly due to the skyrocketing costs of imports, appetite is growing quickly in Lebanon for locally made products that can be produced at lower cost from local inputs, along with benefits from reduced transportation costs, lower fees, and fewer complications. Investors should seize this opportunity to build an economy that is not over-reliant on imported products. Reforms that can galvanize Lebanon's most productive economic sectors towards a sustainable and successful business environment will be discussed in greater detail below in the section, "Generating and environment of fair competition".

To be clear, this paper is not advocating protectionism – import substitution will fail if over-practiced because Lebanon lacks the required infrastructure and raw materials. Instead, Lebanon should focus on boosting high-value products and services, which can generate export revenue, while maintaining low tariffs to encourage trade. The goal is for Lebanese products to become more competitive not just locally, but abroad as well, and to complement import substitution with export promotion. Lebanon already has a niche brand identity with emotional affinity and select high-quality goods. Meanwhile, the diaspora presents a ready and willing marketing and consuming base. Authorities must also develop a targeted, well-designed export policy that incentivizes investment in high-value products. This will likely require the resumption of negotiations on Lebanon's accession to the World Trade Organization (WTO), which have essentially been on hold since the last Accessions Working Group meeting in 2009.³⁸

For these reforms to go beyond stabilization and contribute to long-term economic success, they will

³⁷ "Lebanon Current Account Balance, 1980-2020" Knoema.com. Accessed Sep 21, 2021. <https://knoema.com/atlas/Lebanon/Current-account-balance>.

³⁸ World Trade Organization, "WTO | Accession Status: Lebanese Republic," https://www.wto.org/english/thewto_e/acc_e/a1_liban_e.htm#status.

ultimately have to be accompanied by investments in durable infrastructures. A roadmap already exists from the 2018 CEDRE conference, through which a list of infrastructure investments was promised as soon as the money is unlocked. Infrastructure funds are especially necessary for the reconstruction of the Beirut Port, which was a crucial economic lifeline for Lebanon until the destruction of numerous port facilities and adjacent neighborhoods in the massive explosion of August 4, 2020. At present, funds from CEDRE are predicated on a list of reforms that have thus far been prevented by powerful political actors in Lebanon, who fear that the implementation of reforms could damage their political positions. However, in the absence of other funding streams for infrastructure development, the only path to durable infrastructure is by implementing these reforms; a project which Lebanon must undertake in coordination with its international allies.

Another barrier that must ultimately be resolved is the limited access to finance which start-ups and SMEs face in Lebanon, although this will likely take time given the current impotence of the Lebanese banking sector. Sustainable, creative, and effective measures will be necessary in the post-stabilization era to ensure that capital is readily available for struggling and new businesses. A crucial feature will be the return to solvency of the Lebanese banking sector, which will permit local banks to offer larger loans to new enterprises and start-ups. This can in turn signal improved economic conditions in Lebanon, which will incentivize renewed investment from the Lebanese diaspora and reignite much-needed foreign capital inflows. Ultimately, a combination of both domestic and foreign financing will be necessary to provide sufficient resources to Lebanese businesses in the post-stabilization period.

REFORMING PUBLIC SECTOR GOVERNANCE AND FISCAL REVENUE POLICIES

How the government chooses to resolve the ongoing macroeconomic crisis has serious implications for the levels of economic inequality in Lebanon. The current “lirafication” strategy – converting Lollars to Lebanese Lira at a discounted rate – is largely diverting losses from the elites onto the middle class. In parallel, the financing of the fiscal deficit through the quasi-tax of inflation is rapidly eroding the value of the local currency, much to the detriment of the purchase power of working citizens. In other countries that have experienced biting economic collapse, inflation-financed-deficits followed by partial wage adjustments have impacted societies over many years, thus killing growth, damaging local quality of life, and leaving deep scars upon the economy.

Whereas it is difficult to express fiscal data in percentage of GDP because of high inflation, the GDP denominator has risen in nominal terms, while expenditures have remained consistent despite a fall in tax revenues (excluding debt servicing costs, which

stopped after Lebanon defaulted on its debts in March 2020). This suggests that the numerator has sharply fallen as a percentage of GDP, although the situation remains in flux. Thus, fiscal consolidation is necessary to reignite growth and it should be implemented as part of a larger package of reforms aimed at regaining the creditworthiness of the state (through debt reduction) and the solvency of the banking sector. Because the primary fiscal deficit (which is the deficit before payment of interest on public debt) has strongly deteriorated, policymakers should aim to gradually stabilize the primary deficit over 3-5 years.³⁹

In the meantime, Lebanon is facing difficult choices on how to balance the fiscal efforts between expenditure cuts and seeking increases in taxes and other revenues, and also on how to increase revenues. In times of austerity, international historical evidence suggests that cutting expenditures rather than raising taxes is more conducive to recovery, as multipliers tend to be more favorable.⁴⁰ The current system, with its narrow tax base, large holes, and deep regressivity, certainly requires reform. Increasing tax revenues over time requires making the tax code fairer, strengthening tax compliance, and broadening the tax base. It also requires ending exemptions that facilitate rent-seeking and replacing them with exemptions that serve the public interest. More fundamentally, it requires the inculcation of integrity across the board and the promotion of good tax citizenship. Mobilizing revenues more efficiently will involve modifying taxpayers’ behavior, a reform process that requires improving the provision of information, bolstering the rule of law, and promoting confidence in the state.

Therefore, to build a path towards fiscal sustainability, Lebanese authorities should embark on a two-part reform path. The first part involves addressing the outflow points that are depleting public funds, and the second part involves reforming inflows and generating an environment of good tax citizenship and trust in government. These two equally important strategies will be address in turn below:

Part I: Reforming public sector governance to plug inefficiencies and illicit outflows

Putting Lebanon on a path to fiscal sustainability will require sustained efforts to address the primary sources of corruption and inefficiency in the public sector. Doing so will help the state to create budgetary savings, improve development impact, and begin to rebuild trust between government and citizens. Reforms will aim to rebuild trust by: (1) strengthening management of public funds through public finance, investment, and debt

³⁹ Bifani, Alain, Karim Daher, Lydia Assouad, and Ishac Diwan, *Which Tax Policies for Lebanon? Lessons from the Past for a Challenging Future: Arab Reform Initiative*, 2021, <https://www.arab-reform.net/publication/which-tax-policies-for-lebanon-lessons-from-the-past-for-a-challenging-future/>.

⁴⁰ Alesina, Alberto, “Fiscal policy after the great recession,” *Atlantic Economic Journal* 40.4 (2012): 429- 435. Romer, Christina D., and David H. Romer. «The macroeconomic effects of tax changes: estimates based on a new measure of fiscal shocks.» *American Economic Review* 100.3 (2010).

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 restore the Lebanese state.

Lebanese legislative authorities can help to achieve these goals by implementing a wide-ranging set of specific fiscal and monetary decisions aimed at rebuilding this trust. By showing that the government can deliver on promises of stability, accountability, and economic improvement, the state can rebuild its weakened institutions and simultaneously address longstanding deficit issues which have plagued the economy throughout the postwar period. The following reforms should be undertaken:

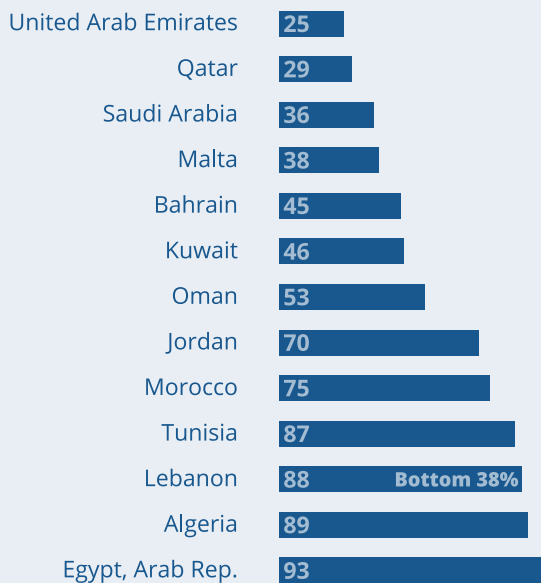
- Moving towards any sustainable level of fiscal expenditure will require the approval of a general budget that respects the principles of unity, annual passage, comprehensiveness, the non-allocation of revenues, and presents a serious commitment to cutting accounts and meeting constitutional deadlines. There should be a ceiling on the budget, followed by a gradual reduction in the deficit each year, to achieve a primary surplus over GDP by 1.5% in 2024.
- Furthermore, budgetary measures should also end treasury advances given to Électricité du Liban, which constitutes a massive drain on the state budget. This should be enacted with the goal of achieving financial balance by 1) reconsidering the applicable tariff, 2) activating collection and controlling theft, 3) providing all consuming units with electronic meters that can be enabled for paying of dues with the prepaid card, and 4) improving the governance and management of Électricité du Liban and reducing operating costs.
- Reforms must also improve the public sector by reducing its size and increasing productivity in the administrative state apparatus.
 - » First, a comprehensive survey must be completed of employees in the public administration, identifying surpluses of manpower in comparison to actual needs and determining the number of employees and contractors, thereby controlling wage costs.
 - » A correct and modern job classification and description system must be implemented across all public sector institutions to clarify the role of employees and eliminate redundant roles.
 - » All 'ghost jobs', in which individuals are added to public sector payrolls even though they do not report to work, must be eliminated as they are created in violation of the law.
- » A "Workforce Transition Plan" should be developed, focusing on providing opportunities for public sector employees to be responsively deployed according to changing government priorities, or train them for finding a job in the private sector.
- » Shoring up funding streams and payrolls within public sector institutions also presents a useful opportunity to roll out e-government services that are more efficient and transparent. This transition would allow the Lebanese citizenry to have better, more efficient, and more expedited access to services, and would also facilitate the reliable and easy payment of dues to the accounts of government ministries.
- To address the massive problem of unaccountable corruption that exists across all manner of public ministries, full forensic audits should be conducted of the accounts of all ministries, public institutions, and public administrations, and for all contracts, tenders, and public deals conducted in the last fifteen years. This will allow judicial authorities to uncover losses suffered due to corruption, identify responsible parties, and halt capital outflows from public sector institutions, thus ensuring taxpayer money is spent as intended rather than disappearing into the pockets of political elites.
- Lebanon's legal framework to support Public-Private Partnerships (PPP) is outdated, full of holes, and under-used. Investment laws should be revised in such manner that regulatory bodies can resolve key issues like market concentration and anti-competitive practices.

Part II: Improving public revenue policies and rebuilding trust

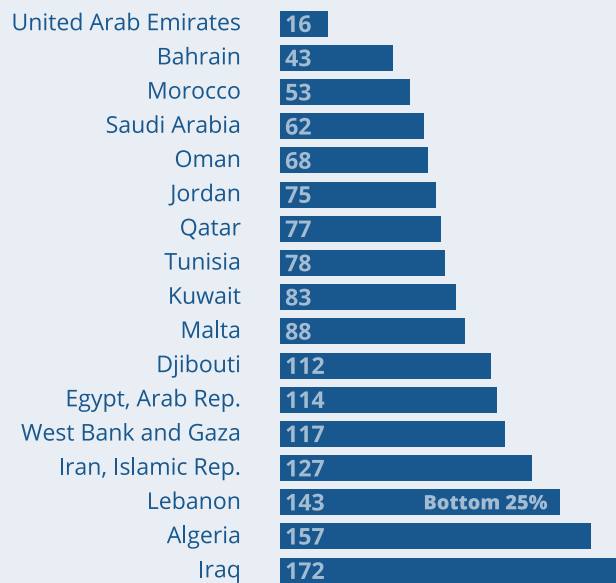
- The second part of Lebanon's path to fiscal recovery will be rooted in legislative and policy changes which increase tax revenues, improve tax services, and generate stronger trust between the government and taxpayers. On the whole, Lebanon will have to take serious steps to address widespread tactics of tax evasion, capital flight, deliberate inefficiency, and perhaps most importantly, the unfair weighting of revenue collection which disproportionately burdens the middle class. However, with significant reform, a new tax code and other crucial legislative changes can generate sustainable fiscal inflows and even help to rebuild the state's extremely damaged public image.
- To establish a more equitable and efficient tax system, a deep reform of the Personal Income Tax system should be considered.

- » First, policymakers should aim to implement a general income tax system that taxes all sources of income together, rather than separately as in the current dysfunctional system.
- » Tax incentives should be considered as a valuable means to promote the public good. Incentives can be a useful tool to encourage economic activity and promote underdeveloped geographical areas, and they have also been used in many countries to attract foreign investment. Instruments such as tax breaks for infant industries, subsidies for research and development, the creation of economic free zones, growth poles, incubators, and support for private sector universities have been widely used in other emerging markets to promote innovation and reward risky investments. These strategies should be emulated in Lebanon. Simultaneously, introducing new taxes to activities that are harmful to public health and/or the environment can be used to finance the creation of a special fund to protect natural habitats.
- Lebanon must also eliminate its banking secrecy laws, which oblige the central bank and all private sector banks to complete secrecy regarding the accounts and financial activities of their depositors. The cost of banking secrecy is very high from a tax compliance perspective - it is obviously bad for income tax, inheritance tax, and capital invested abroad. No fully functional and equitable tax system can be implemented unless banking secrecy is abolished. Moreover, in an increasingly globalized world, Lebanon will have to carefully consider building improved international alliances to prevent tax flight and haven-seeking behavior.
- The government must also act to reduce the size of the informal economy, as informal firms not only reduce fiscal revenues, but also compete unfairly in their markets, frequently underpay their employees, and endanger public health by not being subject to quality and environmental controls. Both sticks and carrots are needed to push informal firms into the formal system so that they can be properly regulated.
 - » The formalization process should be accompanied by the modernization of the tax administration so that taxes can be collected efficiently and with as little leakage as possible. Tax identification numbers should be issued to all residents. Digitizing the system will also help to combat tax evasion and broaden the tax base by allowing the aggregation of taxpayer data from a variety of sources.

Global Competitiveness Indicator 2019
Out of 141 countries



Doing Business 2020
Out of 190 countries



- Finally, in line with a broad need for decentralization of governance, there is a need to empower municipalities on tax issues. Municipal revenues in Lebanon currently consist mainly transfers from the treasury - about 10% of most taxes. However, municipalities receive allotments based on the number of people registered in their constituencies. This benefits cities, which get most of the revenues, to the detriment of small municipalities that often suffer the highest levels of economic inequity. In addition, many municipalities have their waste management costs deducted from their allotments, leaving them with very little resources. Therefore, besides reviewing the sharing formulae, some taxes, such as the built property tax, could be collected directly at the local level, thus reducing corruption and lessening municipal dependence on the central government.

GENERATING AN ENVIRONMENT OF FAIR COMPETITION

Lebanon is a land of economic opportunities and should engage with the world with all its resources to support democracy, free markets, transparency, accountability, and rule of law. By doing so, Lebanon can successfully transition from a rentier, service-based economy to a competitive, efficient, and open-economy model. Lebanon retains four key competitive advantages: educated and motivated human capital, natural resources, pleasant climate and geographic location, and an engaged and well-resourced diaspora. These advantages must be more effectively leveraged to support Lebanon's five high-potential, export-driven sectors: agriculture, industry, tourism, financial services, and the knowledge economy. However, the failure to develop and maintain a favorable business environment over recent decades undermined the competitiveness of the economy and translated to low and declining levels of investments and exports. Even before the crisis, foreign direct investments were in a steady decline from \$4.3bn in 2010 to \$2.6bn in 2018. Similarly, exports also dropped from \$4.2bn to \$2.9bn for the same period.

The key to rebuilding a strong export economy is to enact competition that embodies liberty and equality. The liberty to sell or not to sell, to buy or not to buy, to innovate, create, and invest. Doing so both protects the consumer and promotes a culture of competition that will drive prices down, enhance the quality of goods and services, and boost investment, innovation, and creativity. However, key enabling policy and legislative requirements that are needed to support private initiatives and investments are missing, outdated, or underutilized. Therefore, Lebanese authorities should implement the following reforms which are geared towards structurally transforming the Lebanese economy to one which supports fair competition and innovation:

- First, Lebanon is in urgent need of a new investment policy that abolishes restrictions on foreign

investments causing incidents of corruption and rigid bureaucracy. Opening a country's domestic economy to foreign investments makes domestic firms more competitive and less corrupt. If there is no one to bribe, corruption will weaken at least at the lower levels of the state apparatus. Lessening restrictions will also result in less complicated procedures and easier and more transparent transactions.

- » Authorities should seek to eliminate tariffs and cumbersome permits, as both provide opportunities for firms and individuals to engage in corrupt deals with state officials.
 - » Opening the economy to investment should also be accompanied by a competition law that includes an antitrust enforcement framework, in line with international best practices.
 - » Furthermore, Lebanese authorities can strengthen the competitiveness of the economy by implementing and enforcing the law to reform public procurement, approved in 2021, and also by deploying an electronic public procurement platform that will boost competition, improve transparency, increase efficiency, and limit corruption.
- Another lynchpin of a competitive economic model is decentralization, which involves the localization of governance practices and the shift of powers away from central Beirut towards individual communities and municipalities. In a country such as Lebanon, where the central state is so complex and convoluted that it can be difficult to tell whom to hold accountable for issues of corruption, a process of decentralization would serve to bring governance closer to the people. In turn, citizens would have a better view of exactly who is providing them with services and legislation, thus paving the way towards improved transparency and accountability. Decentralizing the Lebanese political system also has the potential to uplift struggling local economies. In a decentralized context, consumers have greater power to choose between different local providers for goods and services, rather than being forced to rely on a low-capacity central system. This will ignite local innovation as smaller firms compete to provide the highest quality service at the lowest price.
 - Economic integration in Lebanon's local neighbor of states is a key means to benefit from regional opportunities, as most of the countries in the sub-region share common challenges, including limited diversification of production and exports, weak regional and global economic integration, and large youth unemployment. Thus, Lebanon should seek to coordinate with the Levant countries to address common economic and social development issues. Increased regional trade and investment flows can help promote growth and structural change in the region, thereby paving the way for

the most efficient use of the region's resources, value addition, human capital, and diffusion of technology. Regional integration also presents a great opportunity for the expansion of foreign direct investments. Some form of a regional economic zone is an ultimate outcome for the medium to long term, but in the short term – given the current political situation – tangible results can still be reached through sub-regional cooperation in specific areas.

- » In the medium and even short term, Lebanon should arrange bilateral agreements with nearby states to exchange goods for which each has a competitive advantage. One particularly promising point of exchange is water supply, which Lebanon has, and energy resources, which other Levant countries have. US-led negotiations are already underway to supply Lebanon with Egyptian fuel through the Jordanian and Syrian power grid, but this does not rely on any exchange of goods produced in Lebanon. A more sustainable version of this process would be an agreed-upon system of trade that draws upon Lebanon's competitive advantages and exchanges them for goods and resources produced in nearby countries.

Ultimately, it is of note that Lebanon's small production capacity will not be able to compete with imported goods in terms of quantity; rather, the strength of Lebanese goods rests in the relatively higher caliber of its products. Therefore, investing in people is crucial as it will enable them to realize their potential as productive members of society. This is of particular urgency given Lebanon's ongoing brain drain, as educated Lebanese professionals are leaving the country in droves to escape collapsing living conditions and declining salaries. Educating the new generation will ensure that Lebanon's economic rebound can draw upon its most important asset: the productivity and expertise of its workforce. Moreover, human capital is at the center of the sustainable development goals and the World Bank's "global effort to accelerate more and better investments in people for greater equity and economic growth".⁴¹

Lebanon's education sector has long been well respected internationally, particularly its private institutions of higher education, which are among the region's best. However, education is inherently a long-term investment, and cannot contribute on its own to short- or medium-term stabilization efforts. Given both socioeconomic conditions and the COVID-19 pandemic, Lebanese higher education institutions will likely struggle in the next 3-5 years to recruit foreign students and to retain professional staff and current students. Solving these issues is unlikely during the transition period. In short, education cannot contribute on its own to stabilization, and should not

be considered a primary focus of external assistance until more immediate stabilization priorities are met.

However, some support for education can still be justified on two grounds: 1) ensuring that the "lost generation" of students without sufficient formal education is held to a minimum; and 2) prepositioning Lebanon for renewed growth in the education sector in the post-stabilization period. In addition, once some progress is made towards stabilization, attention should be paid to the development of vocational and technical education sectors around which Lebanon can build a more productive economy. It will be important to identify needs and opportunities in vocational/technical education sub-sectors, and to determine how and where relevant facilities and other resources should be deployed. This will allow Lebanon to generate greater opportunities for those who cannot afford four-year higher education, plus provide an improved educational pathway for historically under-supported disadvantaged groups. Overall, any support directed to the Lebanese education sector should ensure that it diversifies beyond its historic focus on traditional and expensive four-year, degree-focused learning.

ALIGNING INTERNATIONAL ACCOUNTABILITY EFFORTS WITH RECOVERY IN LEBANON

The political class's insistence on the current economic regime and resistance to any reforms are putting the lives of Lebanese in danger. With no accountability in sight for these mass economic crimes, the international community must assume a role in serving justice to a Lebanese population whose livelihoods and futures have been deliberately destroyed. Given Lebanon's historic dependence on financial inflows to run daily political and economic life, the international community should, in accordance with the advice of international economic institutions, use its economic power to enforce necessary political changes within Lebanon. This will involve taking a hard line on issues of corruption and credibly threatening to halt aid and sanction individuals who stand in the way of productive change.

A predominant trend in Lebanese history has been a massive reliance on fund inflows and aid from abroad to help Lebanon manage its recurring political crises. However, as aid streams poured in, amounting over time to a greater total sum than the Marshall Plan, little was ever done to check how that money was being spent, whom it was going to, and what projects it was used to build. It is only in recent years that donor states in the international community have begun to pursue accountability for the use of this money. These efforts have so far achieved little success, as nobody in Lebanon has been legally prosecuted or removed from power for crimes of corruption, but these efforts continue to gain steam and have an important role to play in Lebanon's economic and political future.

⁴¹ World Bank Group, "The Human Capital Project: Frequently Asked Questions," Accessed Sep 23, 2021, <https://www.worldbank.org/en/publication/human-capital/brief/the-human-capital-project-frequently-asked-questions>.

Donor states have recently switched from categorically unconditional aid to a conditional aid system predicated on reforms and policy changes; an important step in the right direction. The most prominent example is the CEDRE conference, which conditioned USD 11 billion in loans and grants to Lebanon on a complex and extensive set of reforms. These reforms are a long way from being implemented and the funds may not be unlocked for some time. However, to trade accountability and political change for foreign dollars is the most responsible choice. In the future, other inflows of funding from donor states should follow the CEDRE model and be explicitly predicated upon the implementation of necessary reforms.

While aid was the international community's carrot to draw Lebanese leaders towards reforms, sanctions and financial investigations were the stick. In July of 2021, the European Union adopted a new sanctions framework in reaction to the deteriorating situation and political inaction in Lebanon. This framework threatened to levy targeted sanctions against Lebanese political elites engaged in three main activities, those being: 1) obstructing the formation of a government, 2) obstructing the implementation of reforms to actualize accountability and reform governance of the public sector, and 3) serious financial misconduct concerning public funds.⁴² In a similar line of effort, Switzerland and France have opened inquiries into potential money laundering and conspiracy at the Lebanese Central Bank, particularly investigating the actions of Central Bank governor Riad Salamé, who has been accused in media reports of moving ill-gotten gains out of the country in advance of the economic crisis.⁴³

Overall, these unilateral and multilateral accountability efforts were a step in the right direction. Given the Lebanese ruling elite's extensive record of poorly handling public funds, funding this mismanagement with unconditional foreign dollars that too often stuffed personal bank accounts rather than critical public services was no longer tenable. Given that many Lebanese elites maintain personal bank accounts in Europe, frequently travel to the continent, and store much of their wealth there, EU countries are particularly well-poised to enforce targeted financial consequences on Lebanese leaders proven to engage in high-level corruption and public sector mismanagement. EU states should uphold the existing sanctions framework and continue employing diplomatic and financial pressure in the service of much-needed governmental reforms in Lebanon.

⁴² Lebanon: EU Adopts a Framework for Targeted Sanctions. European Council: Council of the European Union, European Council, 2021, <https://www.consilium.europa.eu/en/press/press-releases/2021/07/30/lebanon-eu-adopts-a-framework-for-targeted-sanctions/>.

⁴³ Cornish, Chloe and Leila Abboud, "France Opens Investigation into Lebanon's Central Bank Governor," *Financial Times*, June 7, 2021, <https://www.ft.com/content/f0f22b78-5c63-4dde-8ced-758d825a1bcc>.

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