LEBANON

SELECTED ISSUES

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LEBANON

SELECTED ISSUES

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THE IMPACT OF THE SYRIAN CONFLICT ON LEBANON

The conflict in Syria is having wide-ranging effects on Lebanon. The refugee influx is unprecedented, stoking sectarian tensions, exacerbating already-precarious security conditions, and straining the economy. The paper analyzes the various transmission channels of the Syrian crisis—though quantification is hampered by the lack of reliable data—with particular focus on the impact on fiscal performance and labor markets; it also takes stock of international donor efforts to date. Absent additional international support, the needs of both refugees and affected Lebanese communities will not be met. Sound government policies—including implementation of a concerted policy framework to deal with refugee issues and a commitment to fiscal discipline—will send credible signals to donors and help mobilize budget support.

A. Introduction

1. The conflict in Syria is overshadowing Lebanon. The impact of the crisis is being felt throughout the economy, and there is virtually no sector that has not been affected. It is difficult though to disentangle the various channels, for a number of reasons. The economy was already softening when the conflict in Syria began in early 2011; data are insufficient and not reliable; some of the effects are yet to become fully apparent; and there is considerable uncertainty as to the timing of a resolution of the conflict. Lebanon has been generous to allow an unprecedented influx of Syrian refugees. The economic, social and political costs of hosting the refugees have become the most visible effects of the crisis. While quantification of the various effects is a complex exercise, this paper seeks to take stock of the main channels—with a particular emphasis on the fiscal costs and the impact on the labor market.

2. The paper is organized as follows. The next section presents some key facts about the refugee influx. It is followed by overviews of it main effects on Lebanon’s economy, in particular the expenditure pressures associated with the refugee presence, the impact on poverty and inequality, and the added strains on labor markets. The fourth section describes the response by the international community to help Lebanon cope with the Syrian crisis. Conclusions are laid out in the last section.

B. The Refugee Influx

3. There are over one million Syrian refugees in Lebanon. The refugee influx is the most visible and long-lasting spillover from the Syrian crisis. The number of officially

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1 Prepared by Francisco Parodi.
registered refugees in Lebanon reached 1.09 million as of end-May 2014, with unofficial estimates of the total number of refugees from Syria, including unregistered refugees, ranging from 1.1 to 1.5 million. The United Nations High Commissioner for Refugees (UNHCR) forecasts that, on current flows, there will be about 1.5 million registered refugees by year-end.

4. **Lebanon has received the largest number of refugees in the region.**

Registered refugees account for about 25 percent of the pre-Syrian crisis population in Lebanon, the highest proportion of the five countries most affected by the Syrian refugee crisis. For illustrative purposes, the influx is comparable to the United States experiencing a refugee influx the size of the Canadian population, or Germany absorbing the combined Austrian and Swiss populations.

5. **The impact of the refugee influx has spread throughout Lebanon.** The authorities have been generous in allowing refugees into Lebanon through an open-border policy. Unlike Jordan and Turkey, Lebanon has not hosted refugees in official camps. Refugees have spread over 1,600 informal settlements, mostly in northern Lebanon and the Bekaa Valley. The influx of refugees has stoked tensions in many host communities, as refugees compete against Lebanese workers for jobs, particularly in the low-skill segment, seek shelter and accommodation in the private housing market, and utilize already-strained public services and infrastructure.

6. **The duration and scale of the refugee influx are unknown.** Given the protracted and uncertain nature of the crisis, it is not known whether and when the refugees will be able to return. For projections purposes, staff assumes that the Syrian crisis will be resolved by 2016, when refugees would begin to gradually return to Syria.

**C. The Economic and Social Impacts**

7. **The crisis in Syria has impacted key areas of the Lebanese economy since its outset in 2011.** Lebanon was immediately affected, largely because of security concerns due to its proximity to the conflict, as well as its dependence on Syrian territory as a conduit for several major sectors of activity, particularly trade and tourism (see Box 1).

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2 UNHCR tracks the number of Syrian refugees in Egypt, Iraq, Jordan, Lebanon and Turkey on a regular basis on: http://data.unhcr.org/syrianrefugees/regional.php.

3 Not setting up camps has been the deliberate policy so far. In recent weeks, cabinet has started discussing the possibility of establishing designated areas for the refugees, as their number and associated costs have escalated.
Box 1. Main Spillover Channels and their Impact on the Lebanese Economy

The conflict in Syria has heightened political and security uncertainty. It has deepened the sectarian divide in Lebanon and the region, with various Lebanese political factions drawn into the Syrian crisis, which has also contributed to violence inside Lebanon.

Heightened uncertainty contributed to lower consumer and investor confidence, further depressing economic activity. GDP growth is estimated to have slowed to 2.5 percent in 2012 and 1.5 percent in 2013, from an average rate of 9 percent in 2007-10. High frequency indicators suggest that uncertainty weighed on construction, real estate, and business activity. Recent Purchasing Managers Index surveys show that businesses have experienced cuts in output and new orders, and reductions in payrolls.

Overall inflation has been broadly in line with regional peers, but higher food and rent inflation might particularly affect the refugees and Lebanese poor. While food inflation was 1.7 percent in 2013, the average price for the food basket for the poor, tracked by World Food Program (WFP), has increased by 4 percent in 2013, roughly double than the official food inflation index. Rents have also reportedly increased by 20–100 percent, depending on region, forcing refugee families to share housing to save on housing costs or seek temporary or improvised accommodation.

Security developments in Syria have disrupted goods trade. Goods exports have declined as land-ports used to export goods to the MENA region (most notably fresh fruit and vegetables) have seen substantial drops in activity. Meanwhile, imports of goods have seen limited growth over the same period, as import demand associated with the increase in Syrian refugees have likely more than offset a shift of import composition toward items with lower values (“flight away from quality”).

The deterioration in security has also affected the tourism sector. The sector mainly depends on the large Lebanese diaspora and GCC countries for most of its business. The conflict in Syria blocked all land routes to Lebanon for GCC visitors. Moreover, GCC countries issued travel warnings to their citizens against visiting Lebanon starting in 2012. In 2013, tourist arrivals were 60 percent of their 2010 level. Hotel occupancy rates as of end-2013 were 51 percent, compared to 68 percent in 2010.
Box 1. Main Spillover Channels and their Impact on the Lebanese Economy (concluded)

The current account deficit remains large, at about 13 percent of GDP both in 2012 and 2013. While tourism-related receipts have shown sharp declines, increases in demand for local services by Syrian refugees have likely driven growth of services receipts. Net current transfers have picked up, reflecting significant humanitarian assistance, as well as lower remittance outflows due to Syrian workers likely supporting relatives that moved to Lebanon.

The direct impact on the banking sector has been contained so far. Lebanese banks have unwound most of their positions in Syria; their assets in Syria declined by about two thirds since 2011.


1 Reflecting the baseline refugee influx scenario projecting 1.6 million refugees by end-2014 compared to 914 thousand at end-August 2013.

2 Funds needed to reinstate access to and quality of public services to pre-crisis levels.

The Fiscal Impact

8. The impact of the Syrian crisis on fiscal performance will be extensive. In September 2013, the World Bank concluded an in-depth and comprehensive Economic and Social Impact Assessment (ESIA) of the Syrian conflict on the Lebanese economy. On the fiscal front, the study envisaged a sizable negative fiscal impact of $2.6 billion in 2012–14 (about 6 percent of 2013 GDP), through lower revenue and higher expenditure to cover the immediate needs of the crisis. Using a bottom-up and sectoral approach, the ESIA also estimated the stabilization needs (the spending needed to bring service delivery and quality to pre-crisis levels) to be an additional $2.5 billion.

<table>
<thead>
<tr>
<th>Impact cost</th>
<th>Stabilization needs</th>
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</thead>
<tbody>
<tr>
<td>Economic impact (output loss compared to potential output)</td>
<td>7.5</td>
</tr>
<tr>
<td>Fiscal impact (change in the overall fiscal balance)</td>
<td>-2.6</td>
</tr>
<tr>
<td>Revenue (foregone due to lower economic growth)</td>
<td>-1.5</td>
</tr>
<tr>
<td>Expenditure (additional demand for public services, consumption of subsidized goods, and debt financing costs)</td>
<td>1.1 2.5</td>
</tr>
<tr>
<td>o/w social and human development</td>
<td>0.3 1.4</td>
</tr>
<tr>
<td>o/w infrastructure</td>
<td>0.6 1.1</td>
</tr>
</tbody>
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1/ Reflecting the baseline refugee influx scenario projecting 1.6 million refugees by end-2014 compared to 914 thousand at end-August 2013.

9. **Tax revenues have softened since the onset of the crisis.** While part of the decline was due to excise tax and VAT exemptions for fuel and gasoil that were granted in 2011 and 2012, respectively, revenues related to tourism and consumption-related sectors experienced large declines. For instance, VAT revenues for hotels and restaurants as a percent of GDP fell by 27 percent in 2010–13, whereas VAT revenues for retail trade fell by 10 percent during the same period.

10. **Spending associated with the Syrian crisis has partly contributed to the deterioration in fiscal performance.** Total spending increased from 29.6 percent of GDP in 2010 to 30.4 percent in 2013. Part of the increase can be attributed to selected social spending, which has risen by 0.5 percent of GDP since 2010. The humanitarian response to the crisis has been so far mostly funded directly by international donors outside of the budget process. The fiscal impact on infrastructure and social services provided to both Syrian refugees and the Lebanese population will likely be reflected with a lag.

11. **Budget execution trends reveal underlying pressures in social spending and infrastructure.** The direct budgetary costs are not known with precision, as there are no dedicated budgetary lines for refugee-related spending by line ministries; expenditure tracking is further hampered because refugees are not concentrated in specific areas or camps.

12. **Pressures on social spending are reflected in the following three areas:**

   - **Health:** The complex structure of the health system masks substantial expenditure pressures. Health-related spending increased by 0.4 percent of GDP in 2010–13. This is mainly due to rising costs for medicines and larger transfers to hospitals. According to the World Health Organization, the Lebanese health care provision system is reportedly already working beyond capacity, particularly public hospitals and primary health centers. Equipment is worn down, and medicines are being depleted rapidly. Even though about 85 percent of the health sector is operated by the private sector, the government subsidizes it via reimbursements for services. In addition, while international donors pay for most of the costs associated with provision of selected health services to refugees to the Ministry of Public Health or medical-care providers, there are effects on public finances of the increased demand for health services among refugees that will materialize over the medium term.

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5 Ministry of Finance data on social expenditures (Table 15 of annual Public Financial Management reports) for years 2010–13 and Ministry of Finance and UNDP (2014).

6 Ministry of Finance data on total “health” expenditures, as reported in Table 15 of annual PFM reports.
• **Education:** Education spending has been contained so far because of donor assistance and some excess capacity that existed prior to the crisis. It has remained broadly constant at around 0.6 percent of GDP in 2010–13. The number of Syrian students for School Year 2013–14 reached about 70,000, compared to 300,000 Lebanese students. Lebanese public schools already had extra capacity to absorb about 100,000 students prior to the refugee influx. However, there is a long-term impact on infrastructure that will emerge over the medium term. If donor funding declines in future years, the ministry of education would need to find financing to cover the costs of school attendance by Syrian refugees. This cost would be larger if additional Syrian children attend school in the coming years.

• **Other social spending:** Other social spending increased only by 0.1 percentage points since 2010 to 0.6 percent of GDP in 2013. The Ministry of Social Affairs does not dedicate funds to Syrian refugees. According to the World Bank ESIA, government spending on social safety nets prior to the refugee influx was only 1.3 percent of GDP in 2010, one of the lowest in the MENA region. Despite being tasked with coordinating the response to the crisis and providing assistance to affected communities through more than 200 social development centers, the ministry received grants from international community of only $2 million in 2013. However, social spending requirements to address the impact on the Lebanese population will be higher in coming years, given the impact of the crisis on poverty and income inequality (see section on inequality and poverty impact below).

13. **The influx of refugees has exacerbated pre-existing weaknesses in infrastructure.** Following decades of conflict and inadequate infrastructure spending levels, the provision of infrastructure in Lebanon compares unfavorably to other countries in the region. Capital spending averaged only 1.6 percent of GDP in 2010–13, compared to the MENA average of 6 percent. According to the World Bank ESIA, additional spending of $1.3 billion (2.7 percent of 2014 GDP) will be necessary to bring infrastructure provision back to pre-crisis levels.

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7 MoF data on Education, as reported in Table 15 of annual PFM reports. The figures cited in this paragraph exclude spending for wages and salaries of the general directorates of education and technical education, and transfers to Lebanese University from the headline “Education” numbers.

8 According to UNHCR, about 400,000 refugee children are currently outside the formal education system.

9 The data includes social spending by the Ministry of Social Affairs and transfers to mutual funds as reported in Table 15 of the PFM reports.

The most immediate impact is on electricity provision. Electricité du Liban has provided only about 18 hours per day on average of electricity prior to the influx of refugees. Improvements had been made to increase supply in recent years. Two power barges supplying about 250 MWH began operations in 2013. The additional power supply was supposed to benefit the Lebanese population. However, according to the Ministry of Energy, the additional electricity demanded by refugees equals roughly the increase power supplied by the barges, therefore delaying much-awaited improvements in electricity provision. The World Bank ESIA estimates the cost of providing electricity to the Syrian refugee population at $170 million for 2013. This cost is expected to rise to $354 million for 2014 as refugee numbers continue to increase.

Infrastructure maintenance costs have doubled since 2010 to 0.4 percent of GDP in 2013. The costs of maintaining existing infrastructure now absorbs 31 percent of the domestically-financed infrastructure budget, compared to 25 percent in 2010.

Impact on Inequality and Poverty

The refugee influx is also having a profound social impact. Prior to the Syrian crisis, poverty in Lebanon was significant. The latest official poverty rate is 27 percent of the population (according to the UNDP, based on 2004-05 data). As a result of the crisis, income inequality and poverty are on the rise:

- The World Bank ESIA estimates that there could be up to 170,000 more Lebanese poor by end-2014, on top of the approximately one million Lebanese living below the poverty line before the crisis.

- Income inequality will likely rise as Syrian refugees accept much lower wages than Lebanese workers for similar jobs. Most refugees work in agriculture and personal services sector, and are reportedly willing to accept wages that are 25–50 percent of the going wage for similarly skilled Lebanese workers. In addition, while refugees have access to a number of support programs financed by donors, social safety net programs for the Lebanese poor are inadequate and poorly funded (though some international donors are stepping in, see section on international donor support).

- Low-income households are also affected by substantial increases in rents (reportedly up 50–100 percent in some areas of the country compared to pre-crisis levels) and higher inflation of basic food items.

While some groups are benefitting from the crisis, the overall social impact is no doubt negative. Reportedly, some business owners have hired cheaper labor, property owners have charged higher rents, and retail businesses benefit from catering to Syrian refugees.
Impact on Labor Markets

16. **Labor markets were already suffering before the refugee crisis.** Labor market conditions have been difficult since the 1970s, with emigration of highly-skilled workers and immigration of low-skilled workers, mostly from Syria. According to the World Bank, Lebanon created only 3,800 jobs per year (one for every six new entrants to the labor market) in 2005–09; while some 22,000 new Lebanese entrants are expected each year until 2019 (excluding the Syrian refugees). The unemployment rate stood at 11 percent in 2011, slightly above the MENA average of 10 percent, reflecting insufficient job opportunities. As is the case elsewhere in the MENA region, unemployment is much higher among the youth—over one third of labor force participants aged 15–24 are unemployed. Around half of the labor force is employed in the informal sector. According to the International Labor Organization (ILO), working conditions (in particular working hours and worker safety) are generally poor, particularly for unskilled workers. The labor policy framework is also deficient, with antiquated labor legislation and uneven enforcement.

17. **The refugee crisis is adding significant pressures, especially on unemployment.** The unemployment rate among refugees is roughly 30 percent (Box 2). By end-2014, the labor force is expected to increase by about 50 percent compared to 2011. More than 60 percent of refugees work in the low-skilled sector; as mentioned above, they are willing to accept much lower wages than Lebanese workers, putting downward pressure on wages and displacing Lebanese workers. Many Lebanese workers that depended on two jobs for monthly income are reportedly losing one of their jobs to lower-paid Syrian refugees. As a result, the unemployment rate could rise to 20 percent.

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12 Assuming a cumulative influx of 1.56 million Syrian refugees by end-2014 and that one-third of the refugee population will remain in Lebanon as of end-2019. Economically active participation ratio is based on estimates from the ILO (2013).
Box 2. Labor Force Features of Syrian Refugees and Impact on Labor Markets

According to the ILO, the impact of the refugee crisis on the labor market is extremely serious, particularly for low-skilled workers, wages, and unemployment. An ILO field survey of 400 households (about 2,000 respondents) in 2013 found the following key facts:

- More than half of the refugees are below age 18. In general, the educational level of the refugees is low—one out of 3 is illiterate or semi-literate, and 40 percent have completed primary education. Only 3 percent have a university degree.
- Forty-seven percent of refugees are economically active. The average unemployment rate is 30 percent. There is a large gender gap; 68 percent of women are unemployed.
- The main sectors of employment for the refugees are domestic services and agriculture.
- Ninety-two percent of refugee workers do not have a formal contract; 72 percent of refugee workers have temporary employment (daily, monthly, and seasonal), and only 23 percent are monthly wage earners.
- The average monthly wage is about LL 418,000 (about $280), much lower than the minimum wage of LL 675,000 and wages earned by Lebanese counterparts. For instance, the average income of residents in north Lebanon is LL 696,000 compared to average refugee earnings of around LL 360,000 in Akkar or in the Tripoli region.
- Wage competition has intensified—around 90 percent of resident un-skilled workers in north Lebanon and Bekaa reported a loss in income. In Baalbek, the daily wage for unskilled workers dropped by 30–50 percent.


18. Illustrative scenarios highlight the challenge of reducing unemployment, even under scenarios assuming that the refugees begin to return to Syria in 2016. Staff used the long-run employment-growth elasticity estimated by the World Bank for Lebanon at 0.2. This elasticity is much lower than Fund’s estimated MENA average of 0.5 and reflects Lebanon’s inability to generate jobs.

- Under the baseline scenario, unemployment would be reduced only marginally. The economy would generate only about 50 thousand total jobs in 2015–19, compared to roughly 110 thousand new entrants to the labor force during the same period. Unemployment would therefore remain elevated, at around 20 percent (blue line in the chart).

- Growth alone might not be sufficient to make a significant and sustainable dent in unemployment. Higher growth rates (of 5–6 percent) would help reduce unemployment, but not bring it significantly below the baseline levels (black line in the chart).

13 These trajectories are based on Fund’s employment template (see Chami et al., 2012).
19. If the return of refugees takes place well after 2016, a more aggressive policy package would be needed.

- Simulations of alternative scenarios with all refugees remaining in Lebanon beyond 2016 suggest that the unemployment rate would remain over 20 percent by 2019.

- Even assuming that a comprehensive reform package were implemented starting in 2015, with positive effects on both growth and the employment elasticity, the unemployment rate would still remain above its 2011 level by the end of the projection period. In this case, an additional challenge for the authorities would be to address the permanent changes to the composition of the labor force and the larger number of low-skilled workers, calling for a new job-creation strategy.

20. Regardless of the duration of the Syrian crisis, active measures are needed to stem the disruptions in the Lebanese labor market. According to the World Bank and ILO, policies should include public works employment schemes, emergency employment centers, local economic development plans, skills enhancement centers, and special programs targeting women and youth to help employ refugees and displaced Lebanese workers. In addition, the existing safety net programs for the Lebanese poor should be widened to mitigate disruptions in the labor markets. Over time, modernizing labor market legislation and improving compliance with labor laws would help limit the informal labor market.

21. The Syria crisis provides an opportunity to improve work on labor issues. Donors have turned their attention to Lebanon as a host country, and are providing funding for projects for refugees that can also help Lebanese workers. For example, the ILO will conduct a household survey in Lebanon that will canvass not only refugees, but also Lebanese workers—thus starting to fill a much felt gap in labor markets data.

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D. International Donor Response

22. The international community has stepped up humanitarian assistance to the refugees. In 2013, as the refugee influx intensified, donors disbursed or committed more than $1 billion (about 2 percent of GDP) for humanitarian aid—or $800 million more than in 2012.\textsuperscript{16} Disbursements and interventions were made directly to organizations working on the ground to assist the refugees, and were not channeled through the budget or other government ministries or agencies. The UNHCR has taken the lead in coordinating the humanitarian efforts by multilateral donor institutions, bilateral aid agencies and NGOs (Box 3).

23. Direct donor support to mitigate the impact of the crisis on Lebanese host communities is substantially lower than humanitarian aid. According to the Ministry of Finance, in 2013 international donors have pledged $46.5 million in bilateral development grants to the Lebanese government. However, only $2 million of the total was disbursed to the Ministry of Social Affairs to deal with the Syrian crisis. In addition, of the $42 million in grants pledged in 2012 to Lebanese ministries, none was related to the Syrian crisis.\textsuperscript{17}

24. The authorities are appealing to the international community to help support the needs of the Lebanese communities. In October 2013, the authorities presented a prioritized roadmap, prepared with the assistance of the World Bank and the United Nations, to (i) expand economic opportunities and enable private sector investment; (ii) restore and build resiliency of public services; and (iii) build social cohesion.\textsuperscript{18} This roadmap articulates a clear set of criteria to mitigate the costs identified in the ESIA and provides a sequencing of the (quantified) priority interventions. At the same time, cognizant of the reluctance of some donors to provide direct budget support given Lebanon’s weaknesses in public financial management, the authorities have requested the establishment of a World Bank-administered trust fund to provide a financing mechanism for the roadmap. As of June 2014, donor pledges to the trust fund total $28 million (compared to short-term needs identified in the roadmap of about $400 million). In addition, some programs currently targeting refugees are being extended to the affected

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\textsuperscript{17} There are other grants for Lebanon for development and military purposes that are not captured in either MOF or OCHA figures.

\textsuperscript{18} World Bank and United Nations (2013b).
Lebanese poor. For example, starting in mid-2014, the World Food Program will extend food assistance to 50,000 Lebanese poor, as part of the National Poverty Targeting Program.19

**Box 3. The United Nations Regional Response Plan for Syrian Refugees**

The United Nations High Commissioner for Refugees (UNHCR) office has taken the lead in coordinating humanitarian assistance. This effort is part of the Regional Response Plan (RRP), and covers more than 80 donor agencies in Lebanon. In 2013, the RRP 5 for Lebanon executed $880 million out of the budgeted pledges of $1.2 billion. The authorities are seeking humanitarian funds for the RRP 6 for Lebanon totaling $1.72 billion for 2014, of which $376 million have been pledged by donors so far.2

Donor agencies are providing assistance in a number of critical areas, including the registration of up to 4,000 refugees per day, and the provision of protection and psychological support for 240,000 children. Of particular importance are efforts to provide food, shelter, education, and health to the Syrian refugees:

- **Food**: The World Food Program (WFP) currently provides $32 per month in food assistance via e-vouchers to 700,000 refugees to maintain adequate food consumption and protect them against resorting to negative coping mechanisms (e.g., stealing or not providing adequate food to children). Refugees can purchase food and other staples in 285 locally-owned stores. In 2014, this program will result in estimated retail sales of more than $225 million (0.5 percent of GDP).

- **Shelter**: Rising rental costs and shortages of big buildings that could be used by refugees pose barriers for adequate shelter. For example, in 2013, some 240,000 individuals received shelter assistance from the international community. This includes more than 85,000 people living in precarious informal settlements.

- **Education**: About 70,000 refugee children enrolled for the school year 2013–14. International donors are paying for teacher salaries of the second shift, and providing funding for needed school repairs and equipment.

- **Health**: The rapid increase in refugees has put a significant strain on the Lebanese health system, which is mostly privately funded and user fee-based, albeit with large indirect subsidies from the government. Humanitarian partners fully funded over 488,000 primary health care interventions in 2013. However, secondary care visits are only 75 percent funded, if related to life-threatening reasons. The remaining 25 percent is supposed to be paid by the patient but in many cases goes unpaid, further exacerbating existing arrears problems for hospitals. Tertiary care (like cancer treatment) is not funded by the international community—and in most cases out of financial reach for the refugees.

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1 UNHCR (2014b).
2 UNHCR (2014a).

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19 In 2011, the Ministry of Social Affairs established the National Poverty Targeting Program as the first means-tested assistance program for the poorest and most vulnerable Lebanese families.
E. Conclusions and Policy Implications

25. **The conflict in Syria is having a broad and likely long-lasting impact on Lebanon.** Some of the effects of the crisis are still unfolding and may be long lasting, particularly because the resolution of the Syrian conflict is uncertain—with the timing and number of refugees returning to Syria unclear—and some of the costs will materialize in the future. The uncertainty is undermining confidence and depressing economic activity. In addition, the large influx of refugees has put further strains on the weak conditions that predated the crisis, such as the inability to create jobs, inadequate social safety net, insufficient electricity provision, and poor infrastructure. The crisis is a challenge but also presents an opportunity to address these long-standing weaknesses.

26. **Tackling the unprecedented refugee crisis requires strong international support.** There has been a large international humanitarian response, but much more is needed. There is also a need to extend the support to the affected Lebanese communities. Absent additional support, the needs of both the Lebanese communities and the refugees will not be met. Lebanon does not have the fiscal space to take on all crisis-related needs. Sound government policies—including the implementation of a concerted policy framework to deal with refugee issues and a commitment to fiscal discipline—will send credible signals to donors and help mobilize the needed budget support.
References


———, 2014a, “RRP 6 Funding Status.”


DESIGNING A FISCAL FRAMEWORK FOR A
PROSPECTIVE COMMODITY PRODUCER:
OPTIONS FOR LEBANON

Lebanon might become a natural gas producer over the next decade. It will thus need to reformulate its fiscal framework to take into account potential revenue from natural resources. The prospective fiscal framework should initially be focused on ensuring fiscal sustainability and intergenerational equity—given that natural resources are exhaustible; managing volatility of resource revenue could be considered at a later stage. Strong institutional arrangements need to underpin the prospective framework, with the pace of resource wealth use set in line with Lebanon’s capacity constraints.

A. Background

1. Lebanon is expected to become a commodity producer over the next decade—although presumably smaller than others. Recent seismic surveys suggest that Lebanon’s gas resources could be in excess of 25 trillion cubic feet (tcf)—not particularly large by international standards. Still, revenue could potentially increase significantly for many years to come, although starting from 2020 at the earliest. Cross-country evidence shows that resource revenue is substantial in many countries, with reliance especially high in some developing countries.

2. Changing status to a commodity producer introduces challenges to macro-fiscal management. Natural resource revenues are exhaustible, raising issues of sustainability and intergenerational equity. This calls for smoothing government consumption over time, to avoid the need for massive fiscal adjustment once the resource wealth has been depleted. Furthermore, high dependence on natural resources can result in high volatility of revenues and spending. Indeed, volatility has been much higher among commodity producers than in non-commodity producers (Figure 1). Accordingly, procyclicality of fiscal policy can be a very serious concern in commodity producers, where spending during boom and bust commodity price episodes is found to be more procyclical than in non-commodity producers.

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1 Prepared by Mariusz Jarmuzek.
3. **Against this background, the Lebanese authorities will inevitably face a number of important fiscal policy challenges.** There will be a need to decide on (i) how to assess the macro-fiscal stance to inform policy decisions; (ii) what revenue shares to save and invest, considering large developing needs as well as significant capacity constraints; and (iii) how to set up or strengthen institutions to ensure an efficient and transparent use of resource wealth.

4. **This paper is structured as follows.** The next section provides an overview of fiscal frameworks in commodity-producing countries. The paper then discusses some options for revamping Lebanon’s fiscal framework, taking into account long-term fiscal sustainability and exhaustibility as well as price volatility issues. It identifies some key institutional considerations to ensure that resource wealth is used efficiently and transparently, and provides conclusions and policy implications.

**B. Considerations for Fiscal Frameworks in Commodity-Producing Countries**

5. **First and foremost, commodity producers need to go beyond traditional measures of fiscal stance in their fiscal policy formulation.** When a country relies significantly on resource revenue, the overall fiscal balance and the primary balance can be misleading indicators of the fiscal stance (Box 1). The appropriate measure is obtained by excluding resource revenue, as done in non-resource primary balances (NRPB).

6. **Exhaustibility and price volatility are key issues for fiscal frameworks in commodity producers.** The Fund has recently refined its advice for formulating fiscal policy in these countries. Exhaustibility raises issues of sustainability and intergenerational equity, and calls for smoothing government consumption over time. Price volatility often leads to revenue (and spending) volatility and might require the adoption of policies to limit procyclicality. The relative importance of these

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2 This section draws on Baunsgaard et al. (2012) and IMF (2012a), IMF (2012b), and IMF (2012c).
objectives varies by country circumstances, such as the degree of resource dependence and the reserve horizon (the shorter the horizon, the more important exhaustibility considerations would be). Thus, fiscal policy should focus on: (i) ensuring long-term sustainability; (ii) providing instruments to help manage volatility; and (iii) strengthening fiscal institutions.

Box 1. Assessing the Macro-Fiscal Stance in Commodity Producers

For countries with short reserve horizons, the key fiscal indicator to assess the fiscal stance is the non-resource primary balance (NRPB). The NRPB is computed by excluding resource revenue from the primary balance; it identifies the impact of government operations on domestic demand, since resource revenues typically originate abroad. A lower NRPB would indicate an expansionary fiscal stance. Setting fiscal policy on the basis of this indicator can help delink fiscal policy from the volatility of resource revenues, and facilitates an explicit link to the sustainability framework. For example, a sizeable fiscal expansion after a spike in natural resource prices and revenues—whereby both revenue and spending increase—would not be detected if the fiscal stance were measured on the basis of the overall or primary balances, whereby the NRPB would rightly point to a loosening of fiscal policy.

Targeting a structural primary balance is an important complement to the NRPB in countries with long reserve horizons. In these countries, resource revenues can be decomposed into a structural component and a cyclical component using various approaches, including a price-based smoothing rule (see the next section). The structural primary balance is equal to the NRPB plus the structural component of resource revenues. In this manner, the structural primary balance target could be set to ensure a sustainable fiscal policy framework, and the smoothing rule would delink expenditures from externally-driven volatility in commodity prices. The structural balance approach allows for the assessment of the sustainability of fiscal policy in a similar manner as for non-commodity-producing countries.

Ensuring long-term sustainability

7. **In countries with short reserve horizons, ensuring long-term sustainability should be the main focus of the fiscal framework.** Pressures in countries running a large non-resource primary deficit could arise well ahead of the time when resources are exhausted. To prevent this outcome, fiscal policy should be anchored in the NRPB target derived from applying three possible methodologies: the Permanent Income Hypothesis (PIH), the Modified Permanent Income Hypothesis (MPIH), and the Fiscal Sustainability (FS) approach.

- **The traditional PIH framework sets the fiscal target (NRPB) at a level that is consistent with future financial wealth.** Under this approach, the NRPB remains constant over time, and is financed by the rate of return on the net present value of projected resource revenues, so that the resource wealth remains constant over time and is never depleted.

- **The MPIH can help accommodate a more front-loaded spending path than allowed under the traditional PIH.** Instead of preserving financial wealth at a constant level over time, the MPIH allows financial assets to be drawn down for a few years during the scaling-up period. The drawdown would, however, need to be offset by fiscal adjustment in the future, to rebuild financial assets to the same level as under the traditional PIH.
- **The FS framework accounts for the potential impact of the scaled-up spending on growth and non-resource revenues.** This is a significant departure from the MPIH. An NRPB allowing a drawdown of government wealth to build human and physical capital and eventually stabilizing it at a lower level than under the PIH or the MPIH can still be consistent with fiscal sustainability objectives. Lower financial wealth will however generate a lower stream of resource-related income to the budget, resulting in a lower NRPB. Fiscal spending can still be stabilized at a higher level because higher growth will generate larger non-resource revenues.

**Managing volatility**

8. **In countries with long reserve horizons, managing volatility should be the main focus of the fiscal framework.** Price volatility can lead to procyclicality and undermine sustainability. For example, resource revenue surges may induce spending increases, generating a fiscal impulse—as measured by changes in the NRPB—that is large in relation to existing supply, thus reinforcing economic cycles and volatility. Sustainability issues arise when commodity producers spend more than their expected long-term resource revenues. This can occur when they extrapolate temporary increases in prices and misprice their resource wealth, and/or fail to maintain appropriate fiscal buffers to sustain current spending levels. All these actions can lead to the boom-bust cycles so often seen in commodity-producing countries.

9. **In these cases, a structural primary balance derived from a price-based smoothing rule can be useful to anchor fiscal policy.** A simple way to mitigate the impact of price volatility is to target an overall primary balance based on a “notional” price that includes either backward-looking prices, futures prices, or some combination of the two. The primary balance computed in this way is called “structural” since it is based on some underlying commodity price (rather than just the current one). This simple rule can be intuitive for policy makers since it includes resource revenues in the fiscal target (differently from the “pure” NRPB); it can also help support solvency through prudent forecasting of structural revenues by deliberately under-projecting the sustainable resource price. The choice of the price formula reflects a tradeoff between a preference for smoothing expenditures (when a longer smoothing period is chosen) and a need to adjust to changes in price trends (when a shorter moving average is selected), with implications for financial savings.

10. **A complementary expenditure growth limit can help reduce procyclicality.** This extended rule can limit the growth of government spending in nominal or real terms, or as a percent of non-resource GDP. Such a rule is desirable to guide the scaling up of public investment where there are absorptive capacity constraints (Berg et al., 2012) and where the volatility of resource windfalls requires precautionary savings (van der Ploeg, 2011). It also helps smooth out volatility because it sets floors and ceilings for spending growth.
Strengthening fiscal institutions

11. **A credible commitment to macro-fiscal stability and effective use of resource wealth should be supported by a strong public financial management (PFM) system.** The PFM system should ensure as part of the budget process (i) a transparent and comprehensive presentation of resource revenue and the underlying non-resource fiscal position; (ii) a sustainable long-term fiscal strategy based on prudent revenue projections; and (iii) transparent mechanisms for project appraisal, selection, and prioritization of investment to ensure that the resource revenue is used to support long-term economic development. The World Bank’s Extractive Industries Transparency Initiative (EITI) sets transparency requirements in the reporting of natural resource management covering both revenue and spending—and therefore can be helpful to commodity producers.

12. **A fiscal responsibility law could establish a legal basis and an effective enforcement mechanism for a new rule-based fiscal policy.** Fiscal responsibility laws (FRLs) are permanent institutional arrangements to promote fiscal discipline, increasingly gaining support in advanced economies and emerging markets in Latin America, Europe, and Asia. FRLs may include procedural and numerical rules, or both. *Procedural rules* aim to enhance transparency, accountability, and fiscal management by generally requiring the government to commit up front to a monitorable fiscal policy strategy, usually for a multi-year period, and to report and publish fiscal outcomes and strategy changes on a routine basis (for example, Chile and Peru). *Numerical fiscal rules* in FRLs are also common, and are intended to establish permanent constraints on fiscal policy, generally in terms of an indicator of fiscal performance. Mechanisms to encourage enforcement encompass sanctions for noncompliance—both reputational (for example, in European countries) and personal on public officials (for example, in Brazil).

C. Options for Lebanon’s New Fiscal Anchors

13. **The government should start developing a new fiscal framework reflecting Lebanon’s prospective commodity-producer status.** Based on the discussion above, two scenarios reflect different assumptions on prospective resources:

- **Baseline scenario—short reserve horizon.** Simulations aim at ensuring sustainability by computing benchmarks and comparing key fiscal indicators for: (i) the traditional PIH rule; (ii) the modified PIH rule; and (iii) the fiscal sustainability rule.

- **Alternative scenario—long reserve horizon.** Simulations illustrate the trade-offs of various alternative price-based rules in terms of smoothing out volatility and generating different levels of financial assets. Two anchors are considered: (i) price-based structural balance rules; and (ii) price-based structural balance rules augmented with expenditure limits.
Ensuring sustainability

14. **The baseline scenario assumes a hypothetical production profile drawing on existing information and international experience.** The main assumption is based on recoverable reserves of around 13 Tcf, obtained by discounting recoverable reserves of over 25 tcf by half, to account for uncertainty associated with new fields. Production is assumed to start only in 2021, reflecting the need to finalize negotiations with bidding firms by end-2014, and to advance on exploration by 2018. Drawing on international experience, production is expected to last for 35 years, with full capacity reached by 2036. It would decline at a fast rate after 2043 so that by 2055, production levels would be significantly lower. Given the assumed decline, the government should have saved over time a sufficient share of resource revenues to prepare for this scenario, and invested in productive assets that support growth in the rest of the economy.

15. **Under this baseline production profile, resource revenues are moderately sizeable.** They are estimated to reach around 4 percent of GDP and represent almost 14 percent of total revenues by the end of the next decade. This would be a substantial source of revenue to the budget and could provide much needed fiscal space to address pressing development needs. Serious deficiencies in the infrastructure sectors have deepened impediments to Lebanon’s competitiveness, fiscal stability, and economic growth. Thus, resource revenue could provide a good opportunity to invest in high-return infrastructure projects in electricity, telecommunications, water, and the transportation network—these have been singled out as binding constraints for raising Lebanon’s growth potential (World Bank, 2012). In particular, the electricity sector requires a major overhaul, focusing on improving service delivery

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3 The assumed production profile draws mainly on the experience in Israel, which shares the same basin as Lebanon; it is also consistent with Mozambique’s experience.

4 The fiscal impact focuses only on revenue, while there could be some impact through transfers to the electricity company. The latter are quite sizeable and could free up significant amounts of resources.
through increased generation capacity, reduced fiscal burden, and enhanced institutional and legislative set-up for private sector participation (GoL, 2010).

**The PIH Framework**

16. **The PIH framework sets the fiscal target consistent with future financial wealth.** Under current estimates, NRPB consistent with a PIH rule is a deficit of about 0.9 percent of GDP. The constant NRPB—combined with an assumption of constant non-resource revenue at 22 percent of non-resource revenue—stabilizes primary expenditure permanently at 23 percent of non-resource GDP. This approach has the advantage of simplicity and stability, though it is relatively conservative.

![Figure 2. PIH Framework Results](source: IMF staff calculations)

**The Modified PIH Framework**

17. **The MPIH framework sets the fiscal target consistent with future financial wealth, but allows for scaling up investment.** In the calibration for Lebanon, an MPIH scenario allows for an increase in annual capital spending equivalent to 5 percent of non-resource GDP on average, for 5 years (over the period 2019–24 in the chart). The period of front-loaded investment then needs to be compensated by an annual improvement in the NRPB smoothed over more than 10 years.
The Fiscal Sustainability Framework

18. The FS framework explicitly takes into account the growth impact of the additional public investment. After the period of front-loaded investment, a new PIH exercise is performed for the remaining gas wealth and financial assets accumulated until then, but taking into account the growth impact of the additional public investment. Assuming a permanent additional effect of 1 percent on real growth and a reduction in the positive value of the interest rate-growth differential, the wealth level eventually decreases to around 35 percent of non-resource GDP; the NRPB is stabilized at a lower deficit. The fiscal multiplier of public investment is assumed to become larger than 1 just after the front-loaded period, and to return to its steady state level of 1 in the long run. Even if the NRPB is lower under the FS framework than under the PIH, the level of primary expenditure is higher due to the additional growth impact and the multiplier effects of the economy.
Managing volatility

19. **The alternative scenario is based on a hypothetical production profile assuming long reserve horizon and increased production.** This scenario reflects significantly more optimistic assumptions on the recoverability of the reserves, estimated to be around 25 Tcf (and not discounted as under the baseline scenario). Production is assumed to start in 2021, but is expected to last for more than 35 years, with full capacity reached by 2036 and kept until 2050. Given that the resource horizon is long, managing volatility would be the main focus of fiscal policy.

20. **The hypothetical production profile generates substantial resource revenues.** They are estimated to reach around 7 percent of GDP and represent almost 25 percent of total revenues by 2030, followed by some gradual decline afterwards.

**Price-based structural balance framework**

21. **The proposed structural primary balance is based on international experience with price-based rules.** Three price-based rules are analyzed: (i) Ghana rule, with a five-year rolling average of historical oil prices (5/0/0); (ii) Trinidad and Tobago rule, with rolling average of oil prices for the last 5 years, the current year, and the futures prices for the next 5 years (5/1/5); and (iii) Mongolia rule, with 16-year moving average comprised of 12 years of historical prices, a current year forecast, and 3 years of futures prices (12/1/3).

22. **There are tradeoffs in implementing the selected price-based rules.** Assuming a structural balance target of 0 percent of non-resource GDP, all the rules deviate from it given the volatility public finances are exposed to. The Mongolia price rule (12/1/3) generates the highest level of financial savings and expenditure smoothing compared to the other rules. The Ghana price rule (5/0/0) generates the least volatility in terms of expenditure, but results in the largest accumulation of financial liabilities compared to the other rules. Finally, the Trinidad and Tobago price rule (5/1/5) generates the highest volatility in terms of expenditure and financial savings are marginally negative. Given the above results, the Mongolia price rule is chosen as a benchmark for Lebanon simulations.
23. **Structural balance targets need to be carefully set.** The Mongolia price rule produces a high sensitivity of the fiscal performance to different structural balance targets. While different targets do not result in substantially different overall primary balances, they can however have a large impact on financial savings. Targeting a structural balance of -1 percent of non-resource GDP could lead to an accumulation of financial liabilities. Targeting 0 percent of non-resource GDP structural balance would not lead to periods of debt accumulation or result in the disruption of budget implementation, but at the same time it would not generate savings consistent with intergenerational equity either. More conservative structural balance targets of at least 1 percent of non-resource GDP would ensure accumulation of sufficient savings to protect against downturns and prevent abrupt cuts in spending.
**Price-based structural balance with expenditure limits framework**

24. **A price-based rule augmented with an expenditure growth rule would limit procyclicality.** The Mongolia price rule (12/1/3) with expenditure growth limited to 3–7 percent per year in real terms would permit Lebanon to accumulate some savings close to 70 percent of non-resource GDP by 2050.

![Figure 7. Price-Based Structural Balance with Spending Rule Results](source: IMF staff calculations)

**Selecting among options**

25. **The optimal fiscal response to Lebanon’s prospective gas resources depends on several factors not yet fully known.** There are only preliminary indications on the size of gas reserves, with both upside risks in case of new discoveries and downside risks if currently estimated deposits underperform. Further, the rate of gas production and prices are difficult to predict given uncertainties about the actual investment plans over the next decades; and that Lebanon’s position in the international gas market has not yet been defined. Finally, contract negotiations are still ongoing and the fiscal regime has not yet been formulated. Based on these considerations, this paper can only provide some preliminary analytical considerations regarding possible options.

26. **The prospective fiscal framework should initially focus on ensuring fiscal sustainability and intergenerational equity.** Given existing uncertainties, both the MPIH and FS frameworks seem relevant because they are based on sustainability objectives and account for the scaling up of public investment—of great importance to Lebanon given its significant gaps in physical and human infrastructure. If substantially more resources were to be confirmed, Lebanon should select the option based on long reserve horizon and focus its fiscal framework on managing volatility, with fiscal anchors determined by price-based structural balances. A price-based structural balance and its modification to limit spending growth could be applied, given Lebanon’s susceptibility to procyclicality and weak institutional capacity.
D. Strengthening Lebanon’s Institutions

27. **Substantial PFM reforms are essential in preparation for the more complex environment that would arise with the natural resource windfall.** Specifically, the following aspects of PFM need to be addressed to put a prospective fiscal framework on a sound footing:

- *The presentation of gas revenue should be transparent and comprehensive.* The ministry of finance (MoF) should build capacity to provide reasonable forecasts for natural resource prices, production, and fiscal revenues, as well as to analyze risks related to the central scenario. It would be equally important to ensure transparent and consistent presentation of non-resource fiscal balances.

- *Budgets should have a medium-term focus, with a strong revenue forecasting framework.* The MoF should strengthen the macro-fiscal unit charged with forecasting resource revenue through building capacity to identify risks to macroeconomic stability, growth and debt sustainability, as well as monitoring budget execution during the year. These outputs would form the basis for effective medium-term economic and fiscal frameworks to shift the focus of policy away from purely short-term objectives.

- *The coordination and selection of public investment projects should be strengthened.* As the size and complexity of investment projects tend to increase substantially, it is important to have in place a robust public investment unit capable of selecting projects and preparing cost benefit analysis. As a first step, the unit should develop an operational manual to help guide their operations and procedures. Furthermore, the internal control systems need to be further developed to allow timely follow-up of project implementation. This may require hiring new staff, including engineers and other technical experts that can ensure proper monitoring of project implementation.

- *The government could adopt the World Bank’s EITI.* Lebanon is currently not participating, but could benefit from it through an improved investment climate by providing a clear signal to investors and international financial institutions that the government is committed to greater transparency.

28. **The Lebanese authorities are also considering setting up a Sovereign Wealth Fund (SWF).** SWFs generally help achieve two main objectives: (i) fiscal and macroeconomic stabilization; and (ii) accumulation of financial savings for intergenerational equity and fiscal sustainability. A third less common objective is the financing of development needs. In Lebanon, the 2010 Offshore Petroleum Law includes the establishment of a SWF to manage gas revenues. Some possible uses would include debt repayments and infrastructure spending. The SWF is expected to be established at the central bank.

29. **A comprehensive policy framework should underpin the operations of the SWF.** The SWF should operate under clear corporate governance rules and should be integrated within the government’s budgetary policies (see Das, Mazarei and van der Horn, 2010). For example, if gas revenues were used to pay public debt while government borrowing continued apace, debt would
be on an upward path again; experience in many countries shows that accumulating assets in a SWF while the government continues to borrow heavily does not lead to good management of natural resource wealth. Therefore, SWFs are not a substitute for fiscal adjustment. Spending decisions should not be linked to flows in or out of the SWF, nor SWF asset levels; and gas revenue earmarking for various purposes should be avoided, as it would lead to budget rigidities.

30. **In the absence of a strategy for fiscal consolidation and debt reduction, discussions of SWFs would be premature.** It is important to start a dialogue on the role that SWFs could play so that policymakers and public at large can have a more informed debate around these issues. The establishment of a SWF should be eventually spelled out, in detail, in a separate law that would specify the legal and administrative framework for the fund, the investment options, how the returns would be spent and how the fund should be linked to the general budget.

31. **Over time, an FRL could also strengthen fiscal discipline by anchoring fiscal decisions on a rule-based framework.** International experience suggests that a well-designed FRL can contribute to improved fiscal management, if supported by critical preconditions, mainly including a strong political commitment to fiscal discipline, sufficiently developed PFM systems, and good transparency and accountability practices. While some of these elements are currently not present in Lebanon, they could nonetheless be developed over time.

E. **Conclusions and Policy Implications**

32. **Lebanon will need to reformulate its fiscal framework to take into account potential windfall from natural resources.** If natural resources are confirmed and proven to be sizeable, Lebanon will become a commodity producer; this implies that natural resource exhaustibility and price volatility will gain special importance for fiscal policy formulation. Exhaustibility raises issues of sustainability and intergenerational equity, and calls for smoothing government consumption over time, ensuring balanced growth, and avoiding the need for abrupt and significant fiscal adjustment once resource wealth has been depleted. Price volatility complicates fiscal planning because it leads to revenue volatility and procyclicality. The relative importance of these objectives varies by country circumstances, in particular based on the degree of resource dependence and reserve horizon.

33. **As current estimates put Lebanon’s gas resources at relatively moderate levels, prudent policies should be implemented.** For example, an aggressive borrowing policy in anticipation of future resource revenues would be counterproductive, given the uncertainty about the magnitude and the temporal profile of the expected resource revenue. The authorities should thus adopt a very prudent approach to fiscal policy when preparing to manage gas resources.

34. **The prospective fiscal framework should initially focus on ensuring fiscal sustainability and intergenerational equity.** Fiscal anchors could be preferably determined by the MPIH or the FS framework—as they both account for scaling up of public investment. If substantially more resources were to be confirmed, fiscal anchors could be determined by the price-based structural balance frameworks. Both the price-based structural balance and its modification to limit
expenditure growth could be of relevance for Lebanon, given its susceptibility to procyclicality and weak institutional capacity.

35. **Strong institutional arrangements need to underpin the prospective framework, with the pace of resource wealth use set in line with capacity constraints.**

- Substantial PFM reforms are essential in preparation for the more complex environment arising from the natural resource windfall. Specifically, reforms should include: (i) transparent and comprehensive presentation of gas revenue and non-resource fiscal position; (ii) medium-term budget focus, with strong revenue forecasting framework; (iii) stronger budget coverage; (iv) stronger coordination and selection of public investment projects; and (v) adherence to the World Bank’s EITI initiative.

- Consideration of a Sovereign Wealth Fund should be integrated in sound fiscal policies, to ensure good management of the gas wealth.

- Adopting a fiscal responsibility law could strengthen fiscal discipline by anchoring fiscal decisions in a rule-based framework over time—once the preconditions for a successful implementation of an FRL have been put in place.
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INSURANCES AND STOCK EXCHANGE, YET UNDERDEVELOPED SECTORS\textsuperscript{1}

While Lebanese banks are major regional players, insurances and the stock market lag behind both world comparators and the region. Recognizing the untapped potential of the two sectors, Lebanon launched reforms—a new insurance law has been pending parliamentary approval since 2005 and a new capital markets law was adopted in 2011. This paper discusses why the Lebanese financial sector is unevenly developed and how insurances and the stock exchange could grow in the presence of a large banking sector.

1. **Lebanon’s nonbank financial sector is underdeveloped.** Lebanon’s banks are major regional players with their assets almost fourfold the size of GDP. Insurances and the stock market though lag behind both world comparators and the region.\textsuperscript{2} Both sectors are small with the latter dominated by one large real estate company (Solidère) and several banks.

2. **Strong nonbank financial intermediation could support growth.** Developed stock markets could help local companies raise more funding at a lower cost, including by attracting foreign savings (Levine and Zevros, 1998). They could also help companies diversify sources of funding and reduce their dependence on banks. While evidence on the relation between growth and a developed insurance sector is less conclusive, insurances could encourage risk-averse agents to engage in economic activity (Ward and Zurbruegg, 2000, and Arena, 2006). They also could encourage longer-term finance and effective risk management. Finally, insurances could enhance the efficiency of the banking system by reducing losses through credit guarantees.

3. **Lebanon has launched reforms.** A new insurance law has been pending parliamentary approval since 2005. Parliament adopted in 2011 a new capital markets law. The law, following a series of earlier reforms,\textsuperscript{3} aims to strengthen the organization, regulation, and control of financial markets; set up a court for dispute resolution; and transform the Beirut Stock Exchange (BSE) into a private sector company.\textsuperscript{4} Recognizing the untapped potential of the two sectors, the authorities

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\textsuperscript{1} Prepared by Najla Nakhle.

\textsuperscript{2} Comparators used in this paper are mostly the nineteen countries with the largest bank assets-to-GDP ratios (above 85 percent and ordered according to size): Bahamas, Hong Kong, UK, Switzerland, Bahrain, Singapore, Japan, China, Jordan, UAE, Australia, Vietnam, Canada, Israel, Republic of Korea, Djibouti, Aruba, Tunisia, and the USA. Saudi Arabia and Libya are also included to provide a regional comparison.

\textsuperscript{3} Previous reforms of the Beirut Stock Exchange include signing a cooperation agreement with the Bourse de Paris for the provision of a state-of-the-art electronic trading system, the launch of a Remote Trading System, and the approval of e-trading.

\textsuperscript{4} Insurances are regulated by the Insurance Control Commission (ICC), which is well established (World Bank, 2013). The ICC is responsible, among other, for monitoring the sector, reviewing the financial statements and other documents of the insurance companies, conducting on-site visits, and recommending the issuance or withdrawal of licenses.
asked the World Bank last year to conduct a Financial Sector Assessment Program (FSAP) Development Module on capital markets and the insurance sector.

4. **This paper discusses how insurances and the stock exchange can be developed in the presence of a large banking sector.** The next section compares the size and structure of these sectors in a regional and international setting. The paper then presents possible reasons as to why the banking sector is large while insurances and the stock market are underdeveloped, and lays out policy considerations in the concluding section.

A. **Size and Structure of the Financial Sector**

5. **Lebanon’s insurances and the stock market are dwarfed by banks.** With assets of about 400 percent of GDP, Lebanon is among the top international banking centers, after the Bahamas, Hong Kong, and the United Kingdom. Compared with most other centers, though, the insurance sector and the stock market are small (Figure 1). Particularly for insurances, this might be surprising, given their complementarity to and close relationship with banks. In fact, even those regional peers with a smaller financial sector appear to have a larger insurance sector. The small size of the stock market might be less surprising as banks could be viewed as close substitutes for financing the economy.

**Insurances**

6. **The insurance sector is relatively small compared with other banking centers.** Though Lebanon has a higher insurance penetration compared with its regional peers, the sector is underdeveloped compared with OECD countries. Lebanon’s insurance assets amounted to almost 9 percent of GDP in 2011 compared with an average of 45 percent in the OECD in 2010 (Figure 2). Its premia amounted to 3 percent of GDP compared with 6 percent of GDP in the OECD in 2010.

7. **Life insurance trails behind nonlife insurance.** The insurance sector is concentrated in nonlife insurance while life insurance is relatively small.5, 6 This is in line with international comparators. Initially the nonlife sector is more important for insuring transportation and trade. The sector develops further as households acquire cars and compulsory third party insurance is introduced. Then mortgage markets develop and only then life insurances and pension products follow suit (Lester, 2010).

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5 The life insurance sector covers indemnity to the beneficiaries after the insured dies. The nonlife insurance sector covers indemnities from losses of fire, car accidents, civil liabilities, and work-related injuries, among others.

6 While nonlife is larger than life insurance among MENA countries, this is not the case in high-income OECD countries.
Figure 1. Bank and Non-Bank Sector Indicators for Lebanon and Selected Comparators

Financial Sector Size and Structure (percent of GDP)

Bank and Non-bank Assets (percent of GDP)

Stock Market Capitalization to GDP

Sources: IFS; Bankscope; FinStructure; and IMF staff calculations. Data are for 2011 or the most recent date available. Non-bank assets include assets of insurance, mutual funds, pension and other financial intermediaries.

Note: The vertical and horizontal blue lines show the average for the sample countries excluding the Bahamas.
Figure 2. Insurance Sector Overview for Lebanon and Selected Comparators

Sources: FINSTAT; Insurance Sector Annual Reports; and IMF staff calculations. 2011 or most recent data available.
Stock Market

8. **Lebanon’s stock market also trails behind.** There are only ten listed companies at the BSE\(^7\) and the stock market turnover ratio is low (Figure 3).\(^8\) However, Lebanon fares slightly better in terms of stock market capitalization, as the listed companies are large.

![Figure 3. Stock Market Indicators for Lebanon and Selected Comparators](image)

Sources: FINSTAT; and IMF staff calculations. 2011 or most recent data available.

B. Why is the Financial Sector Unevenly Developed?

9. **This section discusses factors behind the development of the financial system.** It first discusses possible reasons for the rapid development of banks. It then links their development with that of insurances and the stock market.

Banks

10. **Banks have grown significantly in the past decade.** Deposits grew on average by more than 10 percent per year during 2000–12 and credit to the private sector by about 7½ percent. The sector’s assets rose in turn at an average annual rate of 11 percent. As a result, the share of financial services as a percent of GDP grew from 6½ percent in 1997 to almost 8 percent in 2010.

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\(^7\) The BSE is the central organized market for stocks, established in 1983. Although the law stipulates that the BSE comprises a securities market as well as a market for raw materials including precious metals, only the former have been traded, with currently a total of 28 listed securities belonging to ten companies. These are six banks (among which one has a listed fund), two cement companies, one real estate company, and one car importer. Solidère’s shares constituted 20 percent of total value and 12 percent of total shares traded on the BSE in 2013.

\(^8\) The stock market turnover ratio is defined as the total value of stocks traded divided by the market capitalization.
11. **The growth of the banking sector could reflect several factors:**

- **The banking secrecy law.** The law, adopted in 1956, requires banks not to reveal any financial information about their clients to any third party. Exceptions apply only when a written authorization is granted by the client or in the case of bankruptcy. Such high bank secrecy is prevailing in few countries only (Singapore and Switzerland in the sample reviewed in this paper).9

- **The diaspora.** The large diaspora maintains close ties to Lebanon and supports the economy, including through remittances and deposits placements.10 The loyalty of the diaspora might explain why Lebanon’s banking sector is so large, despite the country being considered as subject to high political risk and corruption (Figure 4). It might also explain that Lebanon is an outlier in terms of the size of its banking system when compared with countries with similar per-capita income.

- **Convertibility.** The Lebanese currency, which has been pegged to the U.S. dollar since 1999, is freely convertible and there are no restrictions on the flow of capital.

- **Relatively high returns on deposits.** Average deposit rates have been significantly higher than in the U.S., creating arbitrage incentives. Also, interest earned on bank deposits is taxed at a final withholding of 5 percent compared with a top personal income tax rate of 20 percent.

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9 Outside the sample reviewed, Luxemburg, offshore centers, and tax havens have similar bank secrecy laws.

10 Official data point to a share of nonresident deposits in total deposits of about 20 percent. Accordingly to unofficial estimates, this share could be twice as much. There is no clear definition of nonresidents (many Lebanese living abroad have deposits in banks and are counted as residents because of the presence of family and ownership of assets when in fact they should be classified as nonresidents).
Figure 4. Bank Assets and Income, Corruption, and Political Risk Levels in Lebanon and Selected Comparators

Sources: World Development Indicators; Political Risk Services Group; Transparency International; and IMF staff calculations.
Note: The vertical and horizontal blue lines show the average for the sample countries excluding the Bahamas.
Insurances

12. **The close relationship with banks helped develop insurances.** Banks are cross-selling insurance products through their branches. Also, relationships between banks and insurances have been strong through startups, acquisitions, joint ventures, and distribution alliances—where insurance companies sell their products through the banks’ distribution network. As a result, the size of the insurance sector grew over the past decade, while the number of companies declined from 61 in 2001 to 52 in 2010, of which 12 are fully or partially owned by banks (Ghobril and Hawa, 2004).

13. **Nonetheless, insurances face obstacles to their development.**

- **High fragmentation.** According to Lester (2010), “low entry requirements led to a fragmented and marginally efficient structure—including a significant number of inoperative licenses and ‘brokers in disguise’.” As a result of the large number of insurances, the gross premium per insurer divided by per capita income is among the lowest in the MENA, at 0.2, and much lower than the MENA and OECD averages (0.8 and 1.6, respectively). This reflects many medium and small insurances that might not have the necessary technological, financial and human resources to compete on innovative products, market share and profitability. They also might not be large enough to build and fund adequate risk pools.

- **Outdated legal framework.** The insurance law of 1968 was amended in 1999. According to Lester (2010), “the insurance legislation (in Lebanon) is very outdated and the supervisor (ministry of economy) has had to cope with a hostile sector in trying to introduce a modern risk based approach.” Following the recommendations of the World Bank, a draft insurance law was submitted to parliament in 2005, but is pending. The draft calls for integrating supervisory aspects, raising capital requirements, and providing risk-based reserves.

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11 There are no public insurance companies. Lebanon’s insurance sector is open with low barriers to entry.

12 It should be noted that the tax treatment does not appear to have been unfavorable to the development of the insurances and stock markets. Dividends of listed and non-listed companies are taxed at 5 and 10 percent, respectively, and profits at the corporate level. The corporate tax rate is at 15 percent, and not all profits are subject to the tax. Overall savings get a favorable treatment as pension contributions are deductible from tax (at the individual level) and pension income is exempt from tax, while interest income, whether from banks or insurance companies, is taxed.

13 The World Bank’s FSAP notes that—though supervisory practices have already been developed—they should be enhanced with increased market penetration and the development of new products.
• **Lack of transparency.** The sector suffers from financial, operational and statistical weaknesses, according to Ghobril and Hawa (2004). Lebanon has only three rated insurance companies; for these, the Issuer Credit Rating (ICR) is considered adequate while the Financial Strength Rating (FSR) is considered good. None of the insurance companies in Lebanon are listed on the BSE; there are also no public disclosure obligations.

### Stock Market

14. **Lebanon’s stock market might be overshadowed by the large banking sector.** Some studies have shown that a large banking sector can lead to substitutability between debt and equity, and thus constrain the development of capital market. Yartey (2008) demonstrates, for a sample of 42 emerging markets, that while bank credit—as a proxy for banking sector development—has a positive and significant impact on stock market development, the square of this variable—as a proxy for a large banking sector—has a significant negative impact. Indeed, major businesses in Lebanon are financed mostly by bank credit (Marcopolis, 2012).

15. **Other factors might have also held back the development of the stock market:**

• **The dominance of family businesses.** Small and medium-size enterprises constitute more than 90 percent of enterprises and employ 94 percent of the labor working in enterprises. Around 80 percent of enterprises employ less than 19 workers and only 3 percent employ more than 100 employees (Ministry of Industry, 2007). These family businesses rely on relationship banking and depend mainly on bank credit as the major source of funds. Family businesses might be hesitant to opening up to external partners and subjecting themselves to enhanced transparency and disclosure requirements for listing on the BSE.

• **Earlier lack of an independent regulatory authority and a master plan.** Before the establishment of the Capital Markets Authority (CMA), the BSE had been both the exchange and the regulator, thus operating without an external independent oversight and a clear framework of dispute resolution between buyers and sellers. A stronger regulator would boost confidence and strengthen investor protection. To this end, the authorities established in August 2011 the CMA, which is tasked, among others, with organizing and developing financial markets; protecting investor rights; reducing systemic risks; regulating the work of licensed stock exchanges; and setting the regulatory framework for the listing of financial

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14 According to A.M. Best, a rating agency for the insurance sector.

15 The ICR assesses the ability of an insurance company to meet its senior obligations; while the FSR represents the insurer’s ability to meet its obligations to policyholders. Lebanon’s ratings range between BBB- and BBB+ for the former and from B+ to B++ for the latter (see A. M. Best).

16 Economic and Social Development Commission in Western Asia (2007).

17 The CMA is an administratively and financially autonomous entity. It is governed by a seven-member board, which includes the central bank governor, the directors general of the ministries of finance and economy, the chairman of the Banking Control Commission (BCC) and three independent experts.
instruments and licenses brokers, rating agencies and investment schemes. The CMA issued its first set of regulations in June 2013, pertaining to disclosure policies; these will serve as the foundation of financial disclosures and shareholder rights in joint-stock companies.

- **A high risk perceived for Lebanon compared with other regional stock markets.** The stock market index appears highly sensitive to political and security incidents. All major political and security events, like the assassination of Prime Minister Hariri (February 2005) and the war with Israel (July 2006), had a strong impact on the market’s performance.

- **Other investment opportunities.** High-yielding government papers attract both local and international investors and could compete with listed securities.

- **Delayed privatization.** The Privatization Framework Law dates back to 2000. However, no privatization has yet taken place. Privatization could encourage more companies to list on the BSE.

### C. Developing Insurances and the Stock Market

16. **Developing insurances and the stock market requires addressing the obstacles to their development.** This section discusses policy considerations for their general development in light of the large banking sector. It also summarizes the sector-specific recommendation of the World Bank’s FSAP of July 2013.

#### General Policy Considerations

17. **Several criteria determine whether a financial center becomes successful.** According to Tan and Chen (1999), the center should boast a suitable geographic area and time zone, follow international accounting standards, and have a solid legal system, a strong local economy, a stable currency, and a “harmonious political environment and effective government.” The center should also be equipped with qualified and skilled human resources and well-developed infrastructure.

18. **Lebanon needs to improve its competitiveness.** The country’s human resources are well qualified, its currency is stable, and the country follows international accounting standards. But Lebanon needs to address its large infrastructure deficit. Also, recurrent political deadlocks have delayed the approval of many laws. In addition, the perception of corruption and the poor business and governance environment create uncertainty and handicap entrepreneurship, while the lack of transparency discourages investors from establishing new businesses or investing in already existing firms (Kyobe and Nakhle, 2012).
19. **Managing the nexus with the banking sector is critical.** There are likely to be positive externalities for banks from developing the insurance sector because of their complementarity. This though does not necessarily apply to developing the stock market. In fact, the high bank secrecy together with the substantial returns on deposits might have limited the development of the stock market and could do so as well in the future. Evidence from other countries is mixed. Japan, for example, witnessed a poorly sequenced liberalization of the financial markets at the expense of the banking system, which led to a banking crisis in the late 1990s (Box 1).

**Box 1. Banking Sector and Financial Market Development in Japan**

In the early 1980s, Japan launched a deregulation process that aimed at providing level playing field competition between banks and other financial institutions by removing regulatory protection of banks (Hoshi and Kahyap, 1999). Through this process, banks were restricted to traditional activities and could not expand into financial innovations. This made large Japanese borrowers move to capital markets and away from traditional bank financing. While firms and borrowers started relying particularly on bonds for financing, banks—with interest rates on deposits set at artificially low levels—were left with savers, but weaker customers, smaller businesses and real estate investments. The accumulation of deposits with little investment opportunities—for example loan securitization was not allowed until 1990—led to an increase in banks’ bad loans amounting to some 7 percent of GDP in the late 1990s. Ultimately, a banking crisis in the 1990s forced the sector to shrink.

20. **In developing the stock markets, regulators should prevent the weakening of banks through proper regulation and tight supervision.** Recent literature shows that banks and capital markets could co-evolve. Banks are better positioned to provide expertise in credit analysis\(^\text{18}\) of borrowers and the stock markets would then provide them with financing. Developed stock markets could also lower financing frictions and decrease the banks' cost of equity, allowing banks to raise additional capital (Song and Thakor, 2010). Singapore provides an example where, despite bank secrecy regulations, the banking sector and the stock market co-evolved (Box 2). Some experiences in developing stock markets in the region are presented in Box 3.

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\(^{18}\) According to Bossone (2010), banks support capital markets in many ways. These include bank loan agreements that provide positive signals to investors on the prospects of firms, particularly those that do not have established reputations. Also banks that operate in large capital markets environment enjoy, among others, reduced costs through more efficient instruments of risk management.
D. Conclusions and Policy Implications

21. **The Insurance Sector Regulation Law should be passed.** The insurance sector has developed through an evolutionary process rather than significant innovation. In addition, market players have expertise in operating the current business model, but are weak when it comes to risk identification and management. The private sector should develop wider-ranging insurance products (for instance, to deal with catastrophic exposure), invest in competent resources, and adopt a vision of improved governance within an overall sector development strategy (ICC, 2010). The government should support these efforts by further developing its supervision capacities and the legislative framework, including by passing the Insurance Law. The new law is expected to reduce sector fragmentation and encourage consolidation through mergers (Ghobril and Hawa, 2004).

22. **The CMA is developing a plan to increase the supply of and create demand for the listed securities.** This should be done in cooperation with the central bank and the Banking Control Commission. The key measure to increase supply is to privatize large state-owned enterprises such as the two telecom companies and the Electricité du Liban, and list the Middle East Airlines and the Casino du Liban. Also, the authorities could encourage nonlisted banks and insurances to launch IPOs, and push for the enactment of the sector-specific public-private partnership laws. Demand could be created by attracting long-term investment into the pension and insurance sectors and collective investment schemes. On the former, the authorities should push forward the pension reform agenda as accumulated funds would eventually be invested in long-term productive instruments. Regarding the second, the CMA should help promote the listing of collective investment schemes.

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**Box 2. Banking Sector and Financial Market Development in Singapore**

Singapore launched its financial liberalization process in the 1960s. It promoted consolidation among banks and allowed increased foreign participation by providing regulatory and fiscal incentives. In particular, Singapore established a two-tier banking sector, separating domestic banking units—the only entities allowed to deal in Singapore dollars—from Asian currency units that could operate offshore. This segregation helped promote the country as an international financial center while protecting domestic banks.

The rapid growth of the Asian Dollar Market in the 1970s and 1980s transformed Singapore into an international foreign exchange market. In parallel, the government established the Stock Exchange of Singapore in 1973. Reforms undertaken since then included (i) allowing for secondary foreign listings; (ii) nonresident trading; and (iii) opening up the stock market for smaller high-tech companies. This ultimately transformed Singapore’s stock market into one of the largest in the world. At the same time, commercial banks doubled their assets within two decades to 123 percent of GDP in 2011.

Possible modification of the tax incentives for listed companies should be part of a comprehensive strategy. Currently, the tax treatment of dividends varies—non-listed companies are subject to a 10 percent tax on dividend payments, while listed companies pay 5 percent, in an effort to promote listing of companies. A current proposal to remove this incentive should be part of a comprehensive strategy to develop the stock market, including the appropriate tax system.
24. **A few success stories could help jump start the stock market.** According to the CMA, selected future listings would attract companies into the stock exchange. When Solidère first listed its stocks on the BSE in September 1996—eight months after the relaunch of the exchange—it was perceived as a great success. However, the stock became very sensitive to political developments and with its shares dominating the exchange, its performance affected the whole market.

25. **There is no substitute for a stable macroeconomic and political environment.** A successful development of financial markets must hinge on sound macroeconomic fundamentals to provide confidence to investors and companies alike.

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20 The BDL issued circular 331 in August 2013 offering banks incentives to invest in start-ups that could ultimately be transformed into listed companies.
References


