

**LEBANON:**

**PROMOTING POVERTY REDUCTION AND SHARED PROSPERITY**

**A Systematic Country Diagnostic**

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## TABLE OF CONTENTS

<b>ACKNOWLEDGEMENTS .....</b>	<b>I</b>
<b>EXECUTIVE SUMMARY .....</b>	<b>VI</b>
<b>RÉSUMÉ ANALYTIQUE .....</b>	<b>IX</b>
<b>الملخص التنفيذي .....</b>	<b>XII</b>
<b>I. COUNTRY CONTEXT .....</b>	<b>1</b>
A. BACKGROUND.....	1
B. SCD THESIS: TWO OVERARCHING CONSTRAINTS LIMIT LEBANON’S DEVELOPMENT .....	4
C. A CONFESSIONAL COUNTRY SUBJECT TO CONFLICT .....	6
1. <i>The Evolution of Confessional Governance and Conflict in Lebanon</i> .....	6
2. <i>The Symbiotic Relationship between Confessional Governance and Conflict</i> .....	13
<b>II. GROWTH, POVERTY, AND JOBS .....</b>	<b>15</b>
A. GROWTH DEVELOPMENTS AND ANALYSIS .....	15
B. POVERTY AND JOBS.....	17
<b>III. LEBANON’S CHALLENGES AND OPPORTUNITIES.....</b>	<b>43</b>
A. OVERARCHING CHALLENGES.....	43
1. <i>Lebanon’s Confessional Governance: Elite Capture Hidden Behind a Confessional Veil</i> .....	44
2. <i>Fragility, Conflict, and Violence</i> .....	45
B. NESTED CHALLENGES AND CONSTRAINTS .....	45
1. <i>Macroeconomic vulnerability</i> .....	46
2. <i>Infrastructure: mismanagement and insufficient investment</i> .....	50
3. <i>Weak and deteriorating institutions and governance</i> .....	57
4. <i>Uneven human capital and skills mismatch</i> .....	61
5. <i>Challenging business climate and access to finance limiting competition</i> .....	66
6. <i>Environmental degradation</i> .....	69
C. STRENGTHS, SOURCES OF RESILIENCY, AND OPPORTUNITIES .....	71
<b>IV. RISKS AND SUSTAINABILITY .....</b>	<b>76</b>
A. MACROECONOMIC AND FISCAL SUSTAINABILITY .....	76
B. POLITICAL AND SOCIAL SUSTAINABILITY.....	78
C. ENVIRONMENTAL RISKS AND SUSTAINABILITY .....	78
D. INFRASTRUCTURE AND PUBLIC SERVICE SUSTAINABILITY.....	80
E. HYDROCARBON WEALTH AND RISKS (CONFLICT, MACROECONOMIC AND FISCAL MISMANAGEMENT) .....	81
F. AGRICULTURE SECTOR RISKS AND OPPORTUNITIES .....	83
<b>V. PRIORITIZING THE CHALLENGES AND HIGHLIGHTING OPPORTUNITIES.....</b>	<b>84</b>
A. METHODOLOGY .....	84
B. RESULTS OF PRIORITIZATION.....	86
C. OPPORTUNITIES FOR UNLOCKING CONSTRAINTS .....	90
1. <i>Mitigating the Impact of the Overarching Constraints on Development</i> .....	91
2. <i>Opportunities to Unlock the Nested Constraints</i> .....	95
<b>BIBLIOGRAPHY .....</b>	<b>97</b>
<b>ANNEX I. STATISTICAL SYSTEM AND THE SCD.....</b>	<b>103</b>
<b>ANNEX II: ECONOMIC PERFORMANCE AND THE CIVIL WAR.....</b>	<b>105</b>
<b>ANNEX III: SUPPLEMENTAL POVERTY AND ACCESS TO PUBLIC SERVICES TABLES AND CHARTS .....</b>	<b>107</b>
<b>ANNEX IV: 2013-14 ENTERPRISE SURVEY: ADDITIONAL RESULTS.....</b>	<b>110</b>

Note: The Executive Summary is available in Arabic and French.

## LIST OF BOXES

BOX 1. THE ECONOMIC AND SOCIAL IMPACT OF THE SYRIAN CONFLICT ON LEBANON .....	11
BOX 2. THE PROFILE OF THE LEBANESE MIGRANTS POINTS TO A SIGNIFICANT “BRAIN DRAIN” .....	26
BOX 3. PERFORMANCE OF THE INFORMATION, COMMUNICATION, AND TECHNOLOGY (ICT) SECTOR .....	52
BOX 4. EDL: THE POSTER CHILD OF CONFESSIONALLY-INDUCED WASTE IN PUBLIC SPENDING .....	53
BOX 5. THE IMPACT OF THE SYRIAN CONFLICT ON LEBANON’S ENVIRONMENT .....	70
BOX 6. CLIMATE CHANGE IMPACTS ON LEBANON .....	79
BOX A.1. HOI CALCULATIONS .....	109

## LIST OF FIGURES

FIGURE 1: LEBANON STANDS OUT IN PERCEPTIONS OF CORRUPTION AND ELITE CAPTURE .....	4
FIGURE 2. CORRUPTION IN POLICY EXECUTION: LEBANON STANDS OUT AGAIN REGIONAL PEERS AND OECD COUNTRIES.....	6
FIGURE 3. LEBANESE GOVERNANCE INDICATORS HAVE TUMBLED FROM AN ALREADY WEAK LEVEL SINCE 2005/2006.....	6
FIGURE 1. AFTER AN INVESTMENT-LED RECONSTRUCTION, LEBANON’S GROWTH TURNED PRIMARILY CONSUMPTION-DRIVEN .....	16
FIGURE 2. SERVICES DRIVE GROWTH BUT THE SECTOR’S SENSITIVITY TO SECURITY IMPARTS VOLATILITY TO THE ECONOMY .....	16
FIGURE 3. GOOD GOVERNANCE REDUCES ABSOLUTE POVERTY .....	19
FIGURE 4. TRANSPARENCY AND GOVERNMENT EFFECTIVENESS.....	19
FIGURE 5. HOUSEHOLD BUDGET SURVEY RESPONSE RATES BY REGIONS, 2011/2012.....	21
FIGURE 6. SELF-ASSESSED ECONOMIC CLASSES IN LEBANON AND COMPARATORS (2013) .....	21
FIGURE 7. JOB CREATION HAS BEEN MOSTLY IN LOW PRODUCTIVITY SECTORS .....	24
FIGURE 8. HALF OF THE LABOR FORCE IS IN THE INFORMAL SECTOR .....	24
FIGURE 9. LABOR FORCE PARTICIPATION RATES REMAIN LOW IN LEBANON, ESPECIALLY AMONG WOMEN .....	25
FIGURE 10. EMIGRATION RATE BY EDUCATIONAL ATTAINMENT .....	26
FIGURE 11. SPECIALIZATION AND OCCUPATION OF LEBANESE EMIGRANTS.....	27
FIGURE 12. PARTICIPATION RATES BY REGION .....	27
FIGURE 13. EMPLOYMENT STATUS BY REGION .....	27
FIGURE 14. UNEMPLOYMENT RATES .....	28
FIGURE 15. INFORMALITY IS HIGHER AMONG THE POOR.....	29
FIGURE 16. MEAN MONTHLY EARNINGS BY QUINTILES AND EMPLOYMENT STATUS .....	29
FIGURE 17. EDUCATION LEVELS BY EMPLOYMENT STATUS AND MAIN SECTORS OF EMPLOYMENT IN THE PRIVATE SECTOR .....	30
FIGURE 18. YOUNGER FIRMS CREATE MORE JOBS .....	30
FIGURE 19. YOUNG FIRMS GROW FASTER BUT BELOW THEIR POTENTIAL.....	31
FIGURE 20. FIRM ENTRY IN LEBANON IS LOW RELATIVE TO REGIONAL COMPARATORS.....	31
FIGURE 21. OBSTACLES TO FIRM OPERATIONS AND GROWTH.....	32
FIGURE 22. POLICY IMPLEMENTATION LACKS CONSISTENCY AND PREDICTABILITY .....	32
FIGURE 23. ELECTRICITY SERVICE DELIVERY IS POOR AND UNDERMINES FIRM PERFORMANCE .....	33
FIGURE 24. SPATIAL DIFFERENCES IN ELECTRICITY SERVICE DELIVERY .....	33
FIGURE 25. ACCESS TO FINANCE AND SMEs AND LARGE FIRMS .....	33
FIGURE 26. LEBANON: FIRMS CONSTRAINTS TO FINANCE .....	34
FIGURE 27. SIZE OF INFORMAL ESTABLISHMENTS.....	35
FIGURE 28. CONSTRAINTS TO GROWTH AMONG INFORMAL FIRMS .....	35
FIGURE 29. WILLINGNESS AND CONSTRAINTS TO FORMALIZATION .....	36
FIGURE 30. MAIN PERCEIVED BENEFITS TO FORMALIZATION .....	36
FIGURE 31. SYRIAN REFUGEE INFLOW AND INFORMAL FIRM CREATION .....	37
FIGURE 32. REMITTANCES FROM LEBANESE EMIGRANTS AROUND THE WORLD .....	38
FIGURE 33. FREQUENCY OF REMITTANCES .....	39
FIGURE 34. LEBANON: USE OF REMITTANCES.....	39
FIGURE 35. EMIGRATION RATE BY EDUCATIONAL ATTAINMENT .....	40
FIGURE 36. PERCEPTIONS ABOUT HOUSEHOLD INCOME IN LEBANON (IN PERCENT, 2010).....	41
FIGURE 37. A LARGE GAP BETWEEN RETURN ON CAPITAL AND ECONOMIC GROWTH, LIKELY RAPIDLY WIDENED INEQUALITY .....	41
FIGURE 38. PUBLIC AND PRIVATE ACCESS TO WATER IN MOUNT LEBANON ACROSS INCOME CLASSES .....	42
FIGURE 39. PUBLIC WATER IS SALINE ACROSS INCOME CLASSES .....	42

FIGURE 40. TEST SCORES ON MATH AND SCIENCE ACROSS SCHOOLS .....	43
FIGURE 41. STUDENT COMPOSITION BY ECONOMIC BACKGROUND ACROSS SCHOOLS (PERCENT).....	43
FIGURE 42. CIRCUMSTANCES CONTRIBUTING TO INEQUALITY OF OPPORTUNITY IN TIMSS MATH TEST SCORES IN LEBANON .....	43
FIGURE 43. POLICYMAKING & DELIVERY OF SERVICES: LEBANON IS PERFORMING BADLY BOTH REGIONALLY AND GLOBALLY .....	43
FIGURE 44. THE RAPIDLY GROWING ROLE OF “WASTA” AND CONFSSIONALISM .....	44
FIGURE 45. POLITICAL INTERFERENCE IN PUBLIC EMPLOYMENT IN LEBANON ARE THE WORST IN THE REGION .....	44
FIGURE 46. GOVERNMENT SPENDING IS DOMINATED BY LARGE INTEREST PAYMENTS, TRANSFERS TO EdL AND PERSONNEL COST .....	48
FIGURE 47. COST OF PUBLIC SECTOR EMPLOYEES IN LEBANON COMPARED TO COMPARATOR COUNTRIES .....	48
FIGURE 50. FLOW OF FUNDS FROM THE PUBLIC SECTOR.....	49
FIGURE 51. AFTER A DECADE OF PRIMARY FISCAL SURPLUSES, LEBANON IS BACK TO DEFICITS AND LARGE OVERALL DEFICITS .....	50
FIGURE 52. AFTER REMARKABLE—BUT CYCLICALLY BASED—DEBT REDUCTION, THE ELEVATED DEBT RATIO IS RISING AGAIN .....	50
FIGURE 53. LEBANON’S COMPARATIVE COMPETITIVENESS REVEALS MACRO, INSTITUTIONS & INFRASTRUTURE WEAKNESSES.....	51
FIGURE 54. LEBANON’S GLOBAL COMPETITIVENESS INDEX REVEALS GAPS IN BASIC REQUIREMENTS .....	51
FIGURE 55. FIXED AND MOBILE BROADBAND PRICES IN THE MENA REGION.....	52
FIGURE 56. THE CUMULATIVE COST OF TRANSFERS TO EdL SINCE 1992 REACHES 55 PERCENT OF 2013 GDP .....	54
FIGURE 58. THE QUALITY OF LEBANESE PUBLIC FINANCE INSTITUTIONS IS WEAK AND GETTING WORSE .....	57
FIGURE 59. TRUST IN INSTITUTIONS.....	58
FIGURE 60. AWARENESS OF CITIZENS’ NEEDS .....	58
FIGURE 61. LOW PUBLIC SERVICE QUALITY AND SPATIAL INEQUALITY IN PUBLIC SERVICE DELIVERY SET LEBANON APART .....	59
FIGURE 62. THE QUALITY OF PUBLIC POLICY MAKING AND SERVICE DELIVERY DETERIORATED SHARPLY SINCE 2006 .....	59
FIGURE 63. LEBANESE JUDICIAL OUTCOMES ARE PERCEIVED AS SIGNIFICANTLY TAINTED.....	59
FIGURE 64. LEBANESE REVEAL A PROFOUND LACK OF TRUST FOR KEY CORE PUBLIC INSTITUTIONS OF THE COUNTRY .....	59
FIGURE 65. LEBANON SCORES POORLY COMPARED TO COMPARATORS ACROSS ALMOST ALL DB INDICATORS .....	60
FIGURE 66. LEBANON’S KEY CONSTRAINTS TO DOING BUSINESS .....	60
FIGURE 67. LEBANON RANKS AS THE WORST AMONG COMPARATOR COUNTRIES IN QUALITY OF INSTITUTIONS .....	60
FIGURE 68. LEBANON IS PERCEIVED AS THE MOST CORRUPT AMONG COMPARATOR COUNTRIES .....	60
FIGURE 69. GEOGRAPHIC COVERAGE .....	63
FIGURE 70. EQUAL ACCESS TO SERVICES .....	63
FIGURE 71. LEBANON’S GENDER INEQUALITY HAS WORSENED MARKEDLY OVER THE PAST FEW YEARS.....	65
FIGURE 72. LEBANON RANKS POORLY ON GENDER EQUALITY IN THE REGION.....	65
FIGURE 73. REGULATORY ENFORCEMENT .....	68
FIGURE 74. QUALITY OF BUSINESS ENVIRONMENT BY REGION .....	68
FIGURE 75. LEBANON: ACCESS TO FINANCE BY FIRM SIZE, LOCATION AND FORMAL VERSUS INFORMAL STATUS.....	69
FIGURE 76. LEBANON: EDUCATION AND WORKFORCE DISTRIBUTION .....	69
FIGURE 77. ENVIRONMENT DEGRADATION IS LARGE AND MULTI-DIMENSIONAL IN LEBANON (2005) .....	69
FIGURE 78. LEBANON: SHORT-TERM FOREIGN LIABILITIES EXCEED TOTAL FOREIGN ASSETS. ....	73
FIGURE 79. GROSS PUBLIC DEBT IS ELEVATED AND ON A RISING AND UNSUSTAINABLE PATH.....	77
FIGURE 80. THE PUBLIC SECTOR’S GROSS FINANCING NEEDS ARE EXTREMELY LARGE WHICH CREATES LARGE REFINANCING RISKS ....	77
FIGURE 81. EFFECT OF GIANT OILFIELD DISCOVERY ON INTERNAL ARMED CONFLICTS (1946-2008) .....	82
FIGURE 82. WORD CLOUD OF MOST PREVALENT NESTED CONSTRAINTS, BY THEME, IN TOP THIRD .....	90
FIGURE 83. NUMBER OF MICRODATA SURVEYS DEPOSITED IN THE WB’S CENTRAL MICRODATA CATALOGUE .....	104
FIGURE 84. NATIONAL POVERTY RATES AS REPORTED IN WDI FOR LEBANON AND SELECTED COMPARATORS .....	104
FIGURE 85. LEBANON’S GDP PER CAPITA TRAILED ITS 1974 PEER GROUP UNTIL A RAPID CATCH UP DURING THE 2000s.....	105
FIGURE 86. THE LEBANESE ECONOMY RETURNED TO ITS 1974 41 PERCENT SIZE OF THE US ECONOMY ONLY IN 2009 .....	105
FIGURE 87. THE CIVIL WAR HALVED LEBANON’S GDP; IT TOOK A GENERATION TO RETURN IT TO ITS PRE-CONFLICT LEVEL .....	106
FIGURE 88. LEBANON’S POST-CONFLICT RECOVERY PERFORMANCE IS COMPARATIVELY STRONG.....	106
FIGURE 89. SHARE OF DIFFERENT CLASSES AMONG RESPONDENT IN LEBANON AND COMPARATORS BY EDUCATION .....	107
FIGURE 90. SHARE OF DIFFERENT CLASSES AMONG RESPONDENT IN LEBANON AND COMPARATORS BY EMPLOYMENT STATUS .....	107
FIGURE 91. HOUSEHOLD INCOME CLASS GROUPS ACROSS RESPONDENTS WITH DIFFERENT LABOR FORCE STATUS .....	107
FIGURE 92. POVERTY RATES AMONG HOUSEHOLDS OF DIFFERENT SIZE IN 2012 .....	108
FIGURE 93. POVERTY RATES AMONG HOUSEHOLDS WITH DIFFERENT NUMBER OF KIDS IN 2012.....	108
FIGURE 94. COVERAGE, HOI AND DISSIMILARITY INDEX FOR A SELECTED SET OF COUNTRIES BASED ON MATH TIMSS SCORES.....	108
FIGURE 95. POVERTY RATES IN 2012, FINANCIAL CAPABILITY SURVEY .....	109
FIGURE 96. LARGEST OBSTACLES TO BUSINESS OPERATIONS IN LEBANON .....	110

## LIST OF TABLES

TABLE 1. POVERTY AND INEQUALITY MEASUREMENT IN LEBANON, 1961-2014 .....	19
TABLE 2. MORE PRODUCTIVE FIRMS CREATE MORE JOBS .....	31
TABLE 3. LEBANON: PUBLIC EXPENDITURE, POVERTY AND BASIC NEEDS .....	62
TABLE 4. LEBANON HAS A HIGHER RISK OF CONFLICT FROM HYDROCARBONS EXPORTS THAN THE AVERAGE COUNTRY .....	83
TABLE 5. LEBANON: HEAT MAP OF IDENTIFIED PRIORITY AREAS .....	88
TABLE 6. MARGINAL EFFECTS FROM PROBIT MODEL EXPLAINING BEING IN BOTTOM 40 PERCENT .....	107
TABLE 7. OLS REGRESSION EXPLAINING MATH TEST SCORE FROM TIMSS .....	108



## EXECUTIVE SUMMARY

- i. **Lebanon’s political development since independence has been influenced primarily by its evolving confessional system.** However, this system, originally established to balance the competing interests of local religious communities, is increasingly seen as an impediment to more effective governance as it has resulted in a paralysis in decision-making and a general hollowing out of the state. Lebanon’s confessional system has also proven extremely vulnerable to external influence, which has bred and exacerbated local conflict and violence.
- ii. **The Lebanese economy has grown at a moderate pace over the past decades, but growth has been uneven due to large, frequent and mostly “political” shocks, to which the economy has been resilient.** Real GDP grew on average by an estimated 4.4 percent from 1992 to 2014 but this performance masks the impact of many shocks (domestic, international, political and/or confessional) that Lebanon faced over this period. The latest such shock is the ongoing conflict in neighboring Syria, which, given the strong linkages between the two countries, is generating large and negative spillover effects in Lebanon. The country’s macroeconomic framework has, nonetheless, proven resilient to all the large shocks it has so far faced.
- iii. **With low growth quality, Lebanon has struggled to reduce widespread poverty and to generate inclusive growth as job creation has been weak and of low quality.** Poverty incidence has been elevated and broadly unchanged for the past 25 years. Since the end of the civil war, extreme poverty has hovered at between 7.5 to 10 percent, while using the upper poverty line about 28 percent of the population was poor. The distribution of poverty has also been unequal with poverty levels being highest in the north and south of the country, and in small, dense pockets in the suburbs of large towns which reflect the unevenness of economic growth and development. A key factor underlying the lack of inclusive economic growth is low employment-growth elasticity. In Lebanon, job creation has trailed the high growth in the labor force, and jobs have typically been of low quality. More recently, both poverty and jobs have likely been negatively impacted by the Syrian conflict and, in particular, by the large influx of refugees. Lack of quality jobs at home continues to push a large share of Lebanese abroad, especially the educated youth.
- iv. **In this context, the World Bank Group (WBG) has undertaken a Systematic Country Diagnostic (SCD) to identify the main constraints Lebanon faces to generate jobs** (both in quantity and quality) which is recognized in the country as the pathway to reducing extreme poverty and promoting shared prosperity (i.e., WBG’s Twin Goals). The SCD is based on a comprehensive analysis of available evidence (noting data deficiencies described herein) and has benefited from extensive consultations with Lebanese experts, private sector representatives, members of the NGO community, and the Government of Lebanon, among other stakeholders.
- v. **The SCD posits that, at the root of Lebanon’s failure to generate inclusive growth and jobs, are the presence of two mutually reinforcing and pervasive (overarching) constraints.** These are (1) *Elite capture hidden behind the veil of confessionalism / confessional governance*, and (2) *Conflict and violence* (stemming, in part, from the broader dynamics of conflict in the Middle East). The two overarching constraints impose a heavy burden on the economy, with the cost of confessional governance estimated at 9 percent of GDP annually. Illegal activities are not sanctioned by the state when involving politically/confessionally connected and/or wealthy actors, exacerbating elite capture and the pervasive patronage system. Influence of economic stakeholders and personal connections (known as “wasta”) is more likely to influence policy execution and enforcement of the rule of law. Thus, elite capture and corruption is endemic and undermines the achievement of the Twin Goals in Lebanon. Similarly, the cost of the conflict and violence is large and recurrent. These include the 1975-1990 civil war that halved the country’s economy, the 2006 conflict with Israel which resulted estimated direct damages of USD2.8 billion, and USD700 million in indirect damages, or more recently the Syrian conflict which is estimated

to have cost the Lebanese economy USD7.5 billion in foregone output and widened the fiscal deficit by USD2.6 billion through 2014.

vi. **The SCD posits that other (more traditional) constraints are nested within the two overarching constraints of elite capture institutionalized by the confessional system and fragility of the country and conflict-affected region at large.** Nested constraints affecting Lebanon’s potential to deliver sustained and high economic growth to its people include macroeconomic instability, weak business environment, insufficient investment in infrastructure (especially in lagging regions), skills mismatch with labor market needs, and weak institutions and regulatory framework. The SCD posits that, absent the destabilizing impact of confessional governance and domestic and regional conflicts, these nested constraints would be significantly less binding than they currently are. Thus, constraints specific to the electricity sector or the educational system, for example, are “nested” within these overarching constraints which both makes reform at the sector level especially challenging and compounds sector constraints.

vii. **To prioritize Lebanon’s development constraints, the SCD team designed a voting methodology that captured the complexity of Lebanon’s constraints, is transparent, and verifiably robust.** The prioritization process included the following steps: (1) Establishing a comprehensive list of specific constraints, based on the analytical work done in the SCD; (2) Requesting each World Bank Group expert that worked on the Lebanon SCD to score each of previous constraints from least to most binding based on five criteria (impact on goals; time horizon of impacts; preconditions; complementarities; and evidence strength); (3) Ranking of the above expert scores based on the average score of each individual constraint so that the resulting prioritization is conducted at the intensive margin—which enables reformers to directly tackle the country’s specific bottlenecks. As common themes and sectors emerged from the resulting list of constraints, a list of 11 *ranked* priority areas was established. This list includes the twin overarching constraints of confessional governance and conflict and violence, eight nested sectors, and one foundational constraint of data availability and quality. Finally (4) sensitivity analysis/robustness checks were performed. They found that, reassuringly, priorities identified were robust to all reasonable alternatives used.

viii. **While Lebanon’s twin overarching constraints are deep-rooted potential ways to mitigate them do exist.** These can be classified in two types of strategies: (1) directly aim to lessen the overarching constraints themselves; and (2) work on lessening the nested constraints by designing a reform program that is incentive-compatible with the existing overarching constraints. The first strategy carries the potential of a large development payoff but, given the deep-rooted and symbiotic nature of the two overarching constraints, this strategy will take time to bear fruits. The second strategy is more suited to deliver gains in the short-term, but given the weight of the overarching constraints, these gains are likely to be more limited in scope. Examples of the first strategy include implementing key outstanding elements of the Taef Accord such as the adoption of a decentralization law, the creation of a lower chamber of parliament that would be elected on a non-confessional basis, improving access to (statistical) information, promoting political stability, and institutional reform and development. Examples of the second strategy include: a political economy and conflict exposure analysis of nested sectors, a grand bargain package of reforms, an opportunistic approach (i.e., being ready to seize windows of opportunity when they arise), working around elite capture, ‘horizontal’ social engagement, and managing the Syrian refugee influx and turning it into an opportunity.

ix. **Subject to the design of reforms that are incentive compatible with the twin overarching constraints the following opportunities could materially improve Lebanon’s development prospects:** a) reduce macro-fiscal vulnerabilities; (b) improve governance and effectiveness of public institutions; c) address energy gaps to increase productivity of the private sector and reduce the macro-fiscal burden; d) strengthen ICT so Lebanon is fully connected to the global economy and can develop jobs needed in the 21<sup>st</sup> century; e) modernize the education sector to ensure youth have skills relevant to employers; f) improve the business climate to ease the burden on firm creation and operation; g) increase

investments in transportation so people and products can move efficiently; and h) address environmental issues to protect Lebanon's natural resources, including water. Reforms in these areas must be tackled with a sense of urgency if Lebanon is to generate the number and quality of jobs it needs for its citizens and achieve progress towards the Twin Goals, to avoid further deterioration in the well-being of citizens and, importantly, to manage the added pressures stemming from regional conflicts.

## RÉSUMÉ ANALYTIQUE

- i. **Depuis l'Indépendance, le développement politique du Liban a été influencé principalement par l'évolution de son système confessionnel.** Initialement établi pour maintenir l'équilibre entre les intérêts des communautés religieuses locales, ce système est toutefois perçu de plus en plus comme un obstacle à une gouvernance efficace, dans la mesure où il a entraîné une paralysie au niveau de la prise de décision et un blocage général de l'Etat. Le système confessionnel du Liban s'est avéré également extrêmement perméable aux influences externes, ce qui a nourri et exacerbé les conflits et la violence internes.
- ii. **L'économie libanaise s'est développée à un rythme modéré au cours des dernières décennies, mais la croissance a été inégale en raison de chocs importants et fréquents, notamment "politiques", auxquels l'économie a été résiliente.** Le PIB réel a augmenté en moyenne d'environ 4,4 pour cent de 1992 à 2014, mais ce rendement masque l'impact de nombreux chocs (nationaux, internationaux, politiques et/ou confessionnels) auxquels le Liban a fait face au cours de cette même période. Le dernier choc est le conflit en cours en Syrie, qui, compte tenu des liens étroits entre les deux pays voisins, génère d'importantes retombées négatives sur le Liban. Il n'en demeure pas moins que le cadre macroéconomique du pays a pu résister à tous les chocs importants auxquels il a été jusqu'à présent confronté.
- iii. **Avec une croissance de faible qualité, le Liban a peiné à réduire son large taux de pauvreté et à générer une croissance partagée (trop peu d'emplois créés et peu productifs).** L'incidence de la pauvreté a été élevée et globalement inchangée au cours des 25 dernières années. Depuis la fin de la guerre civile, l'extrême pauvreté a oscillé dans une fourchette allant de 7,5 à 10 pour cent tandis que le seuil supérieur de pauvreté a oscillé autour de 28 pour cent de la population. La répartition de la pauvreté a également été inégale avec des niveaux qui sont plus élevés dans le nord et le sud du pays, ainsi que dans certaines banlieues de grandes villes, reflétant ainsi le caractère inégal de la croissance économique et du développement. La faible élasticité de la croissance de l'emploi est un des principaux facteurs contribuant à l'absence d'une croissance économique inclusive. Au Liban, la création d'emplois a été inférieure à la croissance de la population active, et les emplois ont généralement été de faible qualité. Plus récemment, la pauvreté et l'emploi ont probablement été affectés par le conflit syrien et, en particulier, par l'afflux massif de réfugiés. Le manque d'emplois de qualité dans le pays contribue à l'expatriation de nombreux Libanais, en particulier les jeunes diplômés.
- iv. **Dans ce contexte, le Groupe de la Banque Mondiale a mis en place un Diagnostic Systématique du Pays (DSP) afin d'identifier les contraintes auxquelles le Liban est confronté dans ses efforts de création d'emplois.** L'emploi est reconnu dans le pays comme la voie primordiale à la réduction de l'extrême pauvreté et à l'accès à une prospérité partagée (ce sont les deux objectifs du Groupe de la Banque Mondiale). Le DSP est basé sur une analyse complète des données disponibles (en tenant compte des carences des données existantes) et a bénéficié, entre autres, de consultations approfondies avec des experts Libanais, des représentants du secteur privé, des membres d'ONG, ainsi qu'avec le gouvernement Libanais.
- v. **Le DSP fait état de deux contraintes dominantes générales se renforçant mutuellement, et qui sont à l'origine de l'incapacité du Liban à générer une croissance inclusive et forte en emplois.** Première contrainte : l'accaparement des ressources par une élite qui se cache derrière le voile du confessionnalisme / gouvernance confessionnelle. Deuxième contrainte : les conflits et la violence (attribuables en partie à la dynamique générale de conflit au Moyen-Orient). Ces deux contraintes dominantes générales sont un lourd fardeau pour l'économie. Par exemple, le coût annuel de la gouvernance confessionnelle est estimé à 9 pour cent du PIB. Les activités illégales ne sont pas sanctionnées par l'Etat lorsqu'elles impliquent des personnalités ayant des connections confessionnelles/politiques et/ou étant

riches, ce qui exacerbe l'accaparement des ressources par une élite et renforce le favoritisme omniprésent. Ce sont l'influence des partenaires économiques et les liens personnels (appelés "Wasta") qui sont le plus susceptibles d'influer sur l'exécution des politiques et l'application des lois. L'accaparement des ressources par une élite et la corruption sont ainsi endémiques et compromettent la réalisation des objectifs doubles de réduction de l'extrême pauvreté et l'accès à une prospérité partagée au Liban. Parallèlement, le coût du conflit et de la violence est important et récurrent ; ceux-ci incluent la guerre civile de 1975-1990, qui a réduit de moitié la taille de l'économie, le conflit de 2006 avec Israël qui provoqué des dégâts directs estimés à 2,8 milliards de dollars et indirects évalués à 700 millions de dollars, et, plus récemment le conflit syrien qui aurait coûté à l'économie libanaise 7,5 milliards de dollars en perte de production et creusé le déficit budgétaire de 2,6 milliards de dollars de 2012 à 2014.

vi. **Le DSP fait état d'autres (mais plus traditionnelles) contraintes imbriquées dans les deux principales dominantes que sont l'accaparement des ressources par une élite, et la fragilité et les conflits.** Ces contraintes nichées affectent le potentiel du Liban à assurer une croissance économique forte et durable; elles comprennent l'instabilité macroéconomique, un environnement des affaires difficile, une insuffisance des investissements au niveau des infrastructures (notamment dans les régions qui accusent un retard au niveau du développement), un déséquilibre des compétences par rapport aux besoins du marché du travail, des institutions et un cadre réglementaire faibles. Le DSP part du principe qu'en l'absence de l'impact déstabilisateur de la gouvernance confessionnelle et des conflits nationaux et régionaux, ces sous-contraintes imbriquées auraient nettement moins de conséquences qu'elles ne le sont actuellement. Ainsi, ces deux contraintes dominantes ont des conséquences négatives au niveau des secteurs (par exemple, l'électricité, l'éducation) et rendent toute réforme au niveau sectoriel particulièrement difficile.

vii. **Pour établir un classement des obstacles au développement du Liban, l'équipe DSP a conçu une méthodologie de vote permettant de saisir de manière transparente et robuste la complexité des contraintes libanaises.** Ce processus de priorisation comprend les étapes suivantes: (1) établir une liste exhaustive des obstacles spécifiques, sur la base du travail d'analyse effectué dans le DSP; (2) demander à chaque expert du Groupe de la Banque Mondiale qui a travaillé sur le DSP Liban de classer chacun des obstacles précédents sur la base de cinq critères (impact sur l'objectif; durée de l'impact; conditions préalables; complémentarités; force de la preuve); (3) classement des notes des experts en fonction de la moyenne des notes obtenues pour chaque contrainte individuelle de sorte que l'ordre de priorité résultant de ce processus est effectué sur une marge intensive, ce qui permet aux réformateurs de s'attaquer directement aux goulots d'étranglement spécifiques du pays. Comme des thèmes et des secteurs communs sont apparus dans la liste des contraintes, une autre liste de 11 domaines jugés prioritaires a été établie. Celle-ci comprend les deux contraintes principales que sont la gouvernance confessionnelle et les conflits et la violence, huit autres secteurs sous-jacents, et une contrainte fondamentale qui est la disponibilité des données et leur qualité. Finalement (4) une analyse de sensibilité/vérification de la solidité des données a été effectuée et a permis de constater, de manière rassurante, que les priorités identifiées étaient robustes à différentes méthodes d'agrégation des votes individuels.

viii. **Même si les deux contraintes fondamentales du Liban sont profondément ancrées, il existe des moyens susceptibles de les atténuer.** Ceux-ci peuvent être classés dans deux types de stratégies: (1) s'attaquer directement aux contraintes dominantes pour les réduire; (2) travailler sur la réduction des contraintes sous-jacentes à travers la conception d'un programme de réformes qui tient compte des contraintes dominantes existantes. La première stratégie véhicule un potentiel de réussite important au niveau du développement, mais, étant donné la nature profonde et symbiotique des deux contraintes dominantes, cette stratégie prendra du temps avant de porter ses fruits. La deuxième stratégie est plus adaptée pour donner des résultats à court terme, mais étant donné le poids des deux contraintes dominantes, ces résultats sont susceptibles d'être de portée plus limitée. Des exemples de la première stratégie incluent la mise en œuvre d'éléments clés de l'accord de Taëf jusqu'à présent suspendus : l'adoption d'une loi sur la décentralisation administrative, la création d'une chambre basse du parlement qui serait élue sur une base non confessionnelle, l'amélioration de l'accès à l'information, la promotion d'une stabilité politique, d'une

réforme institutionnelle et du développement. Des exemples de la deuxième stratégie incluent : une analyse de la politique économique et de la vulnérabilité des secteurs concernés face aux conflits, un ensemble de réformes, une approche opportuniste, une action autour de l'accaparement des ressources par une élite, un engagement social 'horizontal', et la transformation de la présence importante de réfugiés syriens en opportunité.

ix. **Sous réserve de concevoir des réformes qui tiennent compte des deux contraintes dominantes du Liban, les actions suivantes pourraient sensiblement améliorer le développement du pays:** (1) réduire les vulnérabilités macro-budgétaires; (2) améliorer la gouvernance et l'efficacité des institutions publiques; (3) combler les carences énergétiques afin d'améliorer la productivité du secteur privé et de réduire le fardeau macro-budgétaire; (4) renforcer le secteur des télécommunications ce qui connecterait pleinement le Liban à l'économie mondiale et pourrait développer des emplois; (5) moderniser le secteur de l'éducation pour former des jeunes ayant les qualifications requises par les employeurs; (6) améliorer le climat des affaires afin d'alléger le fardeau administratif entravant la création d'entreprises; (7) accroître les investissements dans le secteur du transport pour faciliter la mobilité des personnes et les échanges commerciaux; et (8) régler les problèmes écologiques afin de protéger les ressources naturelles du Liban, y compris l'eau. Les réformes dans ces domaines doivent être traitées rapidement si le Liban veut générer le nombre et la qualité des emplois souhaités par la population, stopper la détérioration du bien-être de bon nombre de ses citoyens et, surtout, pouvoir gérer les pressions résultant des conflits régionaux.

## المخلص التنفيذي

1. **لطالما تأثر لبنان، منذ أن نال استقلاله، بنظام الطائفية السياسية الذي رسم خارطة الدولة عبر العقود.** وكان الهدف، في الأصل، من إنشاء نظام سياسي بطابعه الطائفي هو تحقيق التوازن بين المصالح المتنافسة للمجتمعات المذهبية المحلية، ولكن ما لبث أن تحوّل هذا النظام ليصبح في نظر الكثيرين عائقاً أمام الحوكمة السليمة والفعّالة، حيث أدى إلى شلل واضح في عملية أخذ القرار وصناعة السياسات وبالتالي إلى إفراغ مؤسسات الدولة. كما أثبت النظام الطائفي في لبنان بأنه الوسيلة الأقوى لتعريض البلد إلى التدخلات الخارجية التي بدورها سببت في تغذية الخلافات والصراعات بين الفئات المحلية.
2. **شهد الاقتصاد اللبناني نمواً معتدلاً عبر العقود الماضية، لكن تفاوتت نسبة النمو من عام إلى آخر بسبب الصدمات الكبيرة والمتكررة والتي كان معظمها من الطابع السياسي، بحيث أبدى الاقتصاد صموداً ملحوظاً في وجه تلك الصدمات.** سجل الناتج المحلي الإجمالي الحقيقي نمواً بمعدل 4.4 بالمئة بين العام 1992 والعام 2014، وقد عمل هذا الأداء على إخفاء آثار العديد من الصراعات (المحلية، والعالمية، والسياسية، وأو الطائفية) التي واجهها لبنان خلال الفترة المذكورة. ومن أحدث تلك الصدمات هي الحرب القائمة في سوريا، والتي نظراً للروابط الوثيقة بين البلدين، نتسبب في تداعيات سلبية هائلة ترهق لبنان. لكن استمر الاقتصاد الكلي اللبناني في صموده النسبي أمام الصدمات الكبيرة التي يواجهها البلد حتى يومنا هذا.
3. **لقد عمل لبنان على الحد من انتشار الفقر وتحقيق نمو اقتصادي شامل، وذلك في ظل ضعف فرص العمل وتدني نوعية النمو.** ولم تتغير مؤشرات الفقر التي سجلت ارتفاعاً منذ حوالي 25 سنة. وبينت الدراسات بأن نسبة الفقر المدقع ما بعد الحرب الأهلية تراوحت بين 7.5 بالمئة و10 بالمئة. ومن خلال استخدام الخط الأعلى للفقر، أظهرت البيانات أن 28 بالمئة من إجمالي السكان اعتُبروا ضمن الفئات الفقيرة. كما أن التوزيع المناطقي لنسبة الفقر لم يكن متساوياً، إذ بلغ أقصاه في شمال وجنوب البلاد، مع تواجد بعض البؤر الصغيرة والمكتظة في ضواحي المدن الكبيرة، مما يدل على عدم التوازن الحاصل في نمط النمو الاقتصادي ومسار التنمية. أما العامل الأهم في عدم تحقيق النمو الشامل فيمكن في نقص المرونة اللازمة بين عملية التوظيف والنمو. وقد تزامنت جهود خلق فرص العمل في لبنان مع ارتفاع ملحوظ في القوى العاملة، لكن افتقدت تلك الفرص النوعية المطلوبة. وقد تأثرت على الأغلب قضايا النمو والفقر وفرص العمل مؤخراً بشكل سلبي بسبب تداعيات الأزمة السورية على لبنان، وبالأخص التدفق الكبير للأجانب السوريين إلى البلد. ولا يزال جزء كبير من اللبنانيين، وبالأخص الشباب الحاصل على شهادات جامعية، يلجأ إلى الهجرة خارج البلاد طلباً لفرص نوعية في مجال العمل لا يوفرها لبنان.
4. **في هذا السياق، قامت مجموعة البنك الدولي بإعداد تشخيص منهجي للبلد بهدف تحديد العوائق والقيود الأساسية التي يواجهها لبنان في مجال خلق فرص العمل (من حيث النوعية والكمية)، العامل الذي يعتبر الأهم في عملية الحد من الفقر المدقع وتعزيز الرفاه المشترك (تلك هي أهداف مجموعة البنك الدولي).** يعتمد هذا التشخيص على تحليل شامل للأدلة والحقائق المتوفرة (وتجدر الإشارة هنا إلى محدودية البيانات)، كما استفاد التشخيص من جولات استشارية مكثفة تضمنت خبراء لبنانيين، وممثلين عن القطاع الخاص، وأعضاء المجتمع الأهلي والمنظمات غير الحكومية، إضافة إلى ممثلين عن الحكومة اللبنانية وآخرين من المعنيين وأصحاب الشأن.
5. **يفترض التشخيص بأن جذور الفشل في توليد النمو المتكامل وفرص العمل تكمن في عائقين أساسيين مترابطين، أولاً: الحكم الطائفي، أي تولي الحكم من قبل طبقة نخبوية تستخدم ذريعة الطائفية قناعاً لها. ثانياً: الصراع والعنف الناجمين، جزئياً، عن صراعات واسعة النطاق في منطقة الشرق الأوسط. ويفرض هذان العائقان المترابطان أعباءً ثقيلة تنهك الاقتصاد اللبناني، حيث تُقدر الكلفة السنوية للخل الناجم عن الحكم الطائفي بـ 9 بالمئة من الناتج المحلي الإجمالي. وبحسب الهيكلية القائمة، لا تُحاسب الدولة المواطنين الذين يخالفون القانون إذا ما كانوا من المقربين من النخبة المسيطرة طائفيًا، أو من هم على صلة بأصحاب النفوذ الأثرياء، مما يعزز من سلطة النخبة المسيطرة ويغذي نظام المحسوبية. كما أن منهجية "الواسطة" والعلاقات الشخصية مع أصحاب النفوذ غالباً ما تؤثر سلباً على تنفيذ السياسات وتطبيق القانون. وهكذا يتفشى الفساد في أعماق الطبقة النخبوية الحاكمة ليصبح داءً مزمناً يمنع البلد من تحقيق أهدافه التنموية. كما أن كلفة الصراع والعنف باهظة ومتكررة، فالتاريخ يشهد على الحرب الأهلية (1975-1990) التي استنزفت نصف الاقتصاد اللبناني، والصراع مع إسرائيل عام 2006 الذي تسبب في خسائر مباشرة هائلة بلغت 2.8 مليار دولار أميركي، وخسائر غير مباشرة قُدرت بـ 700 مليون دولار أميركي، والصراع في سوريا مؤخراً الذي كلف الاقتصاد اللبناني حتى الآن 7.5 مليار دولار أميركي من جزاء الخسائر في القطاعات المنتجة وتوسيع العجز المالي بحوالي 2.6 مليار دولار أميركي خلال العام 2014.**
6. **كما يبين التشخيص بأن هناك قيود أخرى (أكثر تقليدية) متداخلة ضمن العائقين المترابطين في صميم النخبة المسيطرة، وقد تأسست تلك القيود عبر النظام الطائفي القائم، والوضع الدقيق في البلد، وظروف المنطقة المتضررة من جزاء الصراعات المسلحة بشكل عام.**

وتؤثر القيود سلباً على إمكانيات لبنان في تحقيق النمو الاقتصادي المستدام الذي يضمن العيش الكريم للمواطنين، بما في ذلك عدم استقرار الاقتصاد الكلي، والمناخ الضعيف لأنشطة الأعمال، والاستثمارات غير الكافية في مجال البنى التحتية (وبالأخص في المناطق المحرومة)، وعدم التوازن بين الكفاءات المعروضة وحاجات سوق العمل، وضعف المؤسسات والأطر التنظيمية. كما يفترض التشخيص هذا، بأن غياب نظام الحكم الطائفي والنزاعات الداخلية والإقليمية، تكون تداعيات القيود المذكورة محدودة أكثر. وبالتالي، القيود التي تتعلق بقطاع الكهرباء وقطاع التعليم، على سبيل المثال لا الحصر، فهي متداخلة ضمن العوائق الأخرى المترابطة، مما يؤدي إلى تعطيل العمليات الإصلاحية وإلى تفاقم التداعيات السلبية على القطاعات الأخرى.

**7. ويهدف وضع العوائق التي تعرقل الجهود التنموية على سلم الأولويات، قام فريق البنك الدولي بتصميم نظام تصويت للتحقق من مدى حدة تلك العوائق بشكل شفاف وسليم. تضمنت عملية تحديد الأولويات الخطوات التالية: (1) إعداد لائحة شاملة بالعوائق والقيود وفقاً للعمل التحليلي الذي يستند عليه هذا التشخيص؛ (2) الطلب من خبراء البنك الدولي القيمين على التشخيص بتحديد العوائق من الأكثر إلى الأقل وقبلاً، وذلك بناءً على 5 معايير (تداعيات تلك العوائق والقيود على الأهداف المرجوة، والمدة الزمنية للتداعيات، والشروط المسبقة، والعوامل المُكمّلة، وقوة الأدلة)؛ (3) وتحديد الأولويات الناتجة عن معدل درجات التصويت بحسب الهامش المكثف – مما يسمح للإصلاحيين مخاطبة التحديات التي تواجه مسار التنمية. وقد نتجت عن عملية التصويت هذه لائحة تحدد 11 قطاعاً ضمن سلم الأولويات، وقد شملت عائق نظام الحكم الطائفي والصراعات/العنف، إضافة إلى القطاعات المتداخلة وعدم توفر البيانات. وأخيراً (4) تم التحقق من دقة التحاليل وقوة الأدلة، وقد تم التأكد من متانة المنهجية المتبعة بالنسبة إلى تحديد الأولويات.**

**8. في حين أن جذور العائنين التوأم المترابطين عميقة في صميم النظام، هناك وسائل للحد من تأثيرهما، نصنفها كالاتي: (1) استراتيجية تهدف مباشرة إلى الحد من تفاقم تداعيات العائنين المذكورين؛ (2) واستراتيجية ترمي إلى تطوير برنامج إصلاح حافز أقوى يُبطل النظام القائم. الاستراتيجية الأولى تحمل إمكانيات عديدة في مجال تحقيق الأهداف التنموية، لكنها تتطلب وقتاً طويلاً لحصد النتائج نظراً لعمق جذور العائنين. أما الاستراتيجية الثانية فهي مناسبة أكثر لتحقيق النتائج على المدى القريب، ولكن بشكل محدود نظراً لعمق القيود. نذكر بعض الأمثلة حول الاستراتيجية الأولى كتطبيق بنود أساسية من إتفاق الطائف من خلال اعتماد قانون اللامركزية، وإنشاء مجلس مصغر ضمن البرلمان يتم انتخابه على أساس غير طائفي، وتحسين كيفية الحصول على المعلومات الإحصائية، وتعزيز الاستقرار السياسي، وإصلاح المؤسسات وتطويرها. أما الاستراتيجية الثانية فتتضمن الأمثلة التالية: العمل على تحليل شامل يبين حدة التداعيات السياسية والاقتصادية بالنسبة للقطاعات المتداخلة، وتصميم حزمة كبيرة من الإصلاحات، وفرض نهج الاستفادة من الفرص حينما تُتاح، والعمل على موضوع الطبقة النخبوية المسيطرة، والمشاركة الاجتماعية "الأفقية"، وإدارة قضية النزوح السوري إلى لبنان وتحويلها إلى فرصة محتملة.**

**9. إذا تم تصميم الإصلاحات التي تفرض حافزاً أقوى في وجه العائنين القانمين، سوف تتحسن آفاق التنمية في لبنان بشكل جوهري، وذلك عبر (أ) الحد من ضعف الإطار المالي الكلي، (ب) تعزيز الحوكمة الفعالة في المؤسسات العامة، (ج) معالجة الثغرات في قطاع الطاقة بهدف زيادة إنتاجية القطاع الخاص والحد من الأعباء المالية، (د) تعزيز قطاع تكنولوجيا المعلومات والاتصالات لربط لبنان بالاقتصاد العالمي وخلق فرص العمل المطلوبة في القرن الـ 21، (هـ) تحديث قطاع التربية والتأكيد على ضرورة تزويد الشباب بالمهارات بحسب احتياجات سوق العمل، (و) تحسين مناخ أنشطة الأعمال وتخفيف الأعباء في مجال تأسيس الشركات وتشغيلها، (ز) زيادة الاستثمارات في قطاع النقل لتسهيل حركة الأشخاص والبضائع، (ح) معالجة قضايا البيئة لحماية الموارد الطبيعية في لبنان، بما في ذلك الموارد المائية. كما يجب التنبيه إلى البعد الطارئ عند تصميم البرنامج الإصلاحية للقطاعات المذكورة آنفاً، إذا ما أراد لبنان خلق الوظائف الكافية ذات النوعية، لإفادة المواطنين وتحقيق هدف الحد من الفقر المدقع وتعزيز الرفاه المشترك، وذلك لتجنب تفاقم الأوضاع المعيشية، ومعالجة الأعباء الإضافية التي تفرضها الصراعات الإقليمية على وجه الخصوص.**



## I. COUNTRY CONTEXT

### A. BACKGROUND

1. **Lebanon is a small open economy of high middle income status with a population of 4.5 million people in 2013.** GDP per capita was about USD17,390 in PPP terms and USD9,905 in current dollars in 2013. Services and trade are the most important sectors with tourism and financial services being a backbone of the national economy. The country went through civil war, external conflicts and several waves of Palestinian, and more recently, Syrian refugees. In spite of its political instability, the country is well known for its high level of human development and open economy as well as a large, educated and diversified diaspora (World Bank, 2010a).

2. **The country is acutely fragile with elevated risks of violence and conflict due to the impact of a confessional system of governance that has increasingly led to paralysis of decision-making and is prone to external influence.** This is most apparent from the ongoing ‘spillover’ from regional conflict dynamics, including the ongoing war in Syria. This fragility and vulnerability is a product of decades of recurrent conflict and violence, political instability and deep social and economic inequalities. This has resulted in the state being ‘hollowed out’ in the face of confessional/sectarian<sup>1</sup> interests and the imperative of preserving confessional peace at the expense of effective governance efficient service provision. Apart from the high social costs and destruction of the social fabric of the country, the Lebanese economy suffered tremendously from the civil war, which resulted in devastating material damage to infrastructure and loss of productivity. While modest growth resumed following the end of hostilities in 1990, this growth did not result in equitable development, but instead reinforced sectarian cleavages and grievances. Numerous donor 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, donor funding had limited contributions to the efficient targeting of much needed social service provision and the promotion of equitable economic growth and job creation. However, the country has been able to achieve a sub-optimum combination of economic boom driven primarily by high growth in the banking sector in some years of global turmoil and a “muddle through” period of low growth due to insufficient policy reform, as we have seen over the last two years as the regional spillovers have increased. This situation is now becoming more tenuous as Lebanon tries to cope with the deepening and prolonged impact of the Syrian conflict in terms of dealing with the massive refugee influx and having to manage the tensions generated as a result of opposing Lebanese confessions supporting different sides in the Syrian crisis. This has left Lebanon with very little capacity to absorb or manage new shocks and stresses, and severely constrains the country’s prospects for long-term, sustainable growth and development.

3. **The Lebanese economy has grown at a moderate pace over the past decades, but growth has been uneven due to large, frequent and mostly “political” shocks, to which the economy has shown remarkable resiliency.** Real GDP grew on average by an estimated 3.6 percent from 1965 to 2014 (4.4 percent from 1992 to 2014)<sup>2</sup>, but these figures mask the impact of the many shocks (domestic, international,

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<sup>1</sup> Throughout this SCD, the term confessional will be used to refer a consociational system of government based on an equitable distribution of political and institutional power among religious communities. In Lebanon, this definition of confessionalism is often used interchangeably with sectarianism, though the latter is also commonly used to denote forms of political and social identity, organization and action based on religious difference and often exclusive interests. Throughout the SCD, we use the term confessional as the primary term to denote the political system and its functioning, and the use of ‘sect’ and ‘sectarianism’ to denote the specific interests, actions and organization of religious and identity-based groups.

<sup>2</sup> GDP figures between 2004-2011 are based on the Lebanese national accounts published by CAS in July 2013, while data for 2012, 2013 and 2014 are based on staff projections pending final GDP estimates from CAS.

political and/or confessional) Lebanon faced over this period. The latest such shock is the ongoing conflict in neighboring Syria, which, given the strong linkages between the two countries, is generating large and negative spillover effects in Lebanon. As the country has weathered repeated and large shocks relatively well—at least compared to what many might have expected—Lebanon has developed an almost inherent resiliency. The country, for example, is proud to be one of few nations never to have defaulted on its sovereign debt, even after going through 15 years of civil war or having its debt-to-GDP ratio being the largest in the world in the mid-2000s.

**4. With low growth quality, Lebanon has struggled to reduce widespread poverty, which remains at high levels and exhibits considerable geographic and social variation.** Based on available (but unsatisfactory) data, poverty incidence has been elevated and broadly unchanged for the past 25 years. This is the case whether poverty is measured using the lower (extreme) or upper poverty lines<sup>3</sup>. Since the end of the civil war, extreme poverty has hovered at between 7.5 to 10 percent, while using the upper poverty line about 28 percent of the population was poor.<sup>4</sup> The distribution of poverty has also been unequal with poverty levels being highest in the north and south of the country, and in small, dense pockets in the suburbs of large towns which reflect the unevenness of economic growth and development. Not only has poverty been widespread and persistent since 1990, but it contrasts significantly with progress made during the decades prior to the civil war when poverty was more than halved from 1961 to 1974 (from 50 to 22 percent) though data comparability is an issue, as detailed in Chapter 2).

**5. In addition to monetary poverty, a broader section of the population suffers from non-monetary dimensions of poverty** (e.g., they suffer from a lack of adequate levels of education, health care and access to basic infrastructure). Though Lebanon is an upper middle income country, weak and deteriorating public institutions mean that the state is unable to deliver satisfactory quality public services widely to the population. While more affluent citizens are able to compensate by purchasing private goods and services (e.g., private schools, bottled water, and electricity generators, etc.), the poor and lower middle class are unable to compensate fully for their limited access to basic services, which adversely affects their living conditions and quality of life. This prevalence of non-monetary poverty in certain groups is a reflection of pervasive inequities and hence the lack of shared prosperity in Lebanon today.

**6. Lebanon has failed to generate inclusive growth as job creation has been weak and of low quality.** A key factor underlying the lack of inclusive economic growth is low employment-growth elasticity, which at 0.2 is low even by Middle East and North Africa (MENA) standards. In Lebanon, job creation has trailed the high growth in the labor force,<sup>5</sup> and the jobs that have been created have typically been of low quality and productivity in sectors such as services which contributed to one third of jobs created during the 2004-09 period. More recently, both poverty and jobs have likely been negatively impacted by the Syrian conflict and, in particular, by the large influx of refugees. Confronted with a bleak record on poverty reduction and an inability to boost shared prosperity, Lebanese stakeholders revealed in a World Bank (2014d) country survey that social protection and job creation ranked as their second and third development priorities, respectively (public sector governance ranked first). In fact, job creation ranked as the most important factor in reducing poverty and the third most important for shared prosperity (after a growing middle class, and consistent economic growth). Lack of quality jobs at home continues to push a large share of Lebanese abroad, especially the educated youth, with negative impact on the

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<sup>3</sup> Poverty lines are defined in Chapter II, paragraph 43.

<sup>4</sup> Extreme poverty was estimated at 7.5, 10, 8 and 8.7 percent in 1993, 1997, 2005, and 2007, respectively. Using the upper poverty line, poverty was estimated at 28 (28.5) percent in 1993 (2005). As detailed in Chapter 2, section B, indicative evidence show that progress in reducing poverty has been unlikely since the 2005 surveys.

<sup>5</sup> The labor force has been growing robustly due to an increase in the working age population, in addition to the slow increase in labor force participation, particularly among women (See Chapter 2 below).

economy's longer term potential and the Lebanese polity (as youth represent a potentially vibrant voice for change, which is currently 'voting with their feet' instead of pushing for change at home). This outmigration of the qualified youth is also a significant loss to the economy as the country is losing a productive resource and having to compensate by hiring expatriate workers.

**7. The uneven distribution of social and physical infrastructure in Lebanon is an important factor limiting economic opportunities and improvements in quality of life.** Geographical disparities in Lebanon are exacerbated by spatial variation in infrastructure and service delivery. Areas where services and infrastructure are especially inadequate are more likely to have excluded population groups with limited access to opportunities. However, beyond and above the stark spatial inequality, the country suffers from relatively weak basic infrastructure which affects people's job opportunities, their quality of life, and Lebanon's long term economic growth. Lebanon's under-developed infrastructure is one of the most important factors in explaining the poor quality of growth and stagnant poverty levels.

**8. The nature of Lebanon's post-civil war reconstruction has resulted in a macroeconomic environment characterized by structurally weak public finances that create large vulnerabilities for the economy.** Immediately after the end of the civil war, as donor financing did not come to Lebanon, the country financed its large reconstruction effort through borrowing.<sup>6</sup> 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 inflation and the currency had stabilized, the debt stock had risen markedly, especially when compared to the recovery in economic growth. This generated concerns about debt sustainability and kept Lebanon's risk premium elevated, which, in turn, worsened debt dynamics and stymied the economy's growth potential.

**9. While Lebanon faces stark and pressing development challenges, reform efforts to improve the quality of institutions and promote growth have been limited.** Due to the difficulty in reaching consensus in Lebanon (see below), pressing and large constraints to Lebanon's economic development remain unaddressed, although in many (maybe most) cases the solutions are well-known and documented. These missed reform opportunities are prevalent in the deteriorating infrastructure sector (especially the electricity sector, see below), the poor quality of public institutions that are unable to provide satisfactory service levels, an antiquated business environment, and an unsustainable macroeconomic environment, among others.

**10. Major deficiencies exist in the data about Lebanon's poverty and income distribution, as well as among its economic and governance measurements.** Beyond the weak quality, poor reliability and limited availability of data needed to assess progress towards the Twin Goals of poverty reduction and shared prosperity,<sup>7</sup> the weakness of the statistical system is widespread and impedes economic analysis at the macroeconomic and sectoral level. These deficiencies include: (i) the lack of regular information on the development of labor markets and living conditions of households; (ii) weak balance of payments statistics; (iii) weak inflation statistics; and (iv) long delays (up to three years) in the release of annual national accounts. This systemic weakness of the statistical system is, to a large extent, the outcome of the Lebanon's confessional polity and years of conflict (see below), both of which have weakened the country's institutions considerably. While the weaknesses of the statistical system are gradually being addressed, the current state of the system significantly limits the scope of analysis of Lebanon's constraints to growth

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<sup>6</sup> Donor financing subsequently arrived, starting with the Paris I conference of 2001, once Lebanon's public debt level had become a concern.

<sup>7</sup> Lack of microdata can affect the quality of other statistics as well, for example national accounts (as the national accounts need to be estimated with limited underlying surveys, in contrast to standard practice in most countries).

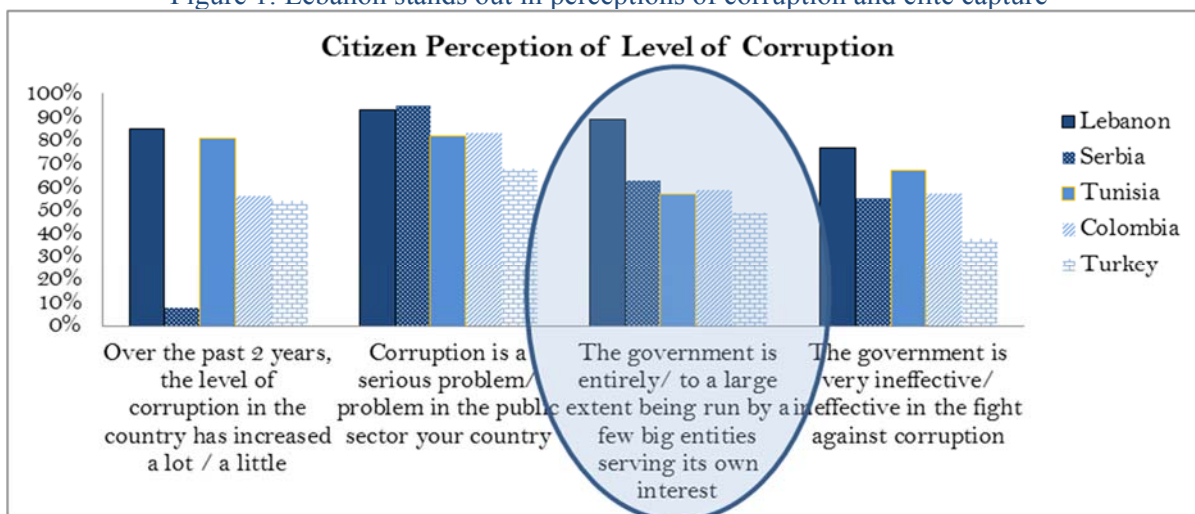
(e.g., the constraints on the HRV-type Growth Diagnostic of Berthelemy et al., 2007).<sup>8</sup> Most important for the sake of the present Systematic Country Diagnostic (SCD), they are especially constraining for the analysis of the Twin Goals given the weaknesses of both the poverty and income distribution data. It is with these important limitations and associated caveats that the present SCD was undertaken.

## B. SCD THESIS: TWO OVERARCHING CONSTRAINTS LIMIT LEBANON’S DEVELOPMENT

11. **This SCD posits that, at the root of Lebanon’s failure to generate inclusive growth and jobs, are the presence of two mutually reinforcing and pervasive (overarching) constraints.** These are (1) *Elite capture hidden behind the veil of confessionalism / confessional governance*, and (2) *Conflict and violence* (stemming, in part, from the broader dynamics of conflict in the Middle East). While the SCD stresses the predominant impact of these two overarching constraints on the country’s development, many other factors have also contributed to Lebanon’s lack of poverty reduction and failure to achieve high, sustained and inclusive growth. Chapter I.C below provides an overview of the birth and evolution of these two overarching and mutually reinforcing/symbiotic constraints. Chapter III.A provides a detailed description and analysis of these two constraints.

12. **The two overarching constraints impose a heavy burden on the economy, with the cost of confessional governance—the first overarching constraints—estimated at 9 percent of GDP annually** (Chaaban, 2014). Illegal activities are not sanctioned by the state when involving politically/confessionally connected and/or wealthy actors, exacerbating elite capture and the pervasive patronage system (Figure 1). Influence of economic stakeholders and personal connections (known as “wasta”) is more likely to influence policy execution and enforcement of the rule of law (Figure 2). For example, funds from the Lebanese public sector are equally as likely to flow to kin/family as the needy/poor. Direct pocketing to public servants or superiors reaches 25 percent of funds, compared to about 10 percent in the OECD (Figure 51 page 49). Thus, elite capture and corruption is endemic and undermines the achievement of the Twin Goals in Lebanon.

Figure 1: Lebanon stands out in perceptions of corruption and elite capture



Source: Global Corruption Barometer, 2013.

<sup>8</sup> The Growth Diagnostics is a methodology developed by Ricardo Hausmann, Dani Rodrik and Andrés Velasco to determine the underlying reasons why some developing economies are not growing as fast as might be expected. The growth diagnostic approach is based on the idea that there may be many reasons why an economy does not grow, but each reason generates a distinctive set of symptoms. These symptoms can become the basis of a differential diagnostic in which the analyst tries to distinguish among potential explanations for the observed growth rate of the economy (Hausman et al., 2008).

13. **The cost of the conflict and fragility—the second overarching constraints—is large and recurrent.** Throughout its history as a State, Lebanon has frequently been impacted directly or indirectly by major domestic and regional conflicts. The economic and social costs of these have been elevated and have had a long lasting impact on the country. These include the 1975-1990 civil war that halved the country's economy, the 2006 conflict with Israel which resulted estimated direct damages of USD2.8 billion, and USD700-800 million in indirect damages (World Bank, 2010), or more recently the Syrian conflict which is estimated to have cost the Lebanese economy USD7.5 billion in foregone output and USD2.6 billion in lost fiscal revenue and added public spending between 2012 and 2014 (World Bank, 2013d).

14. **The SCD posits that other (more traditional) constraints are nested within the two overarching constraints of elite capture institutionalized by the confessional system and fragility of the country and conflict-affected region at large.** Nested constraints affecting Lebanon's potential to deliver sustained and high economic growth to its people include macroeconomic instability, weak business environment, insufficient investment in infrastructure (especially in lagging regions), skills mismatch with labor market needs, and weak institutions and regulatory framework. Chapter III.B provides a detailed analysis of the key specific nested constraints in Lebanon. The SCD posits that, absent the destabilizing impact of confessional governance and domestic and regional conflicts, these nested constraints would be significantly less binding than they currently are; this magnifying impact is best illustrated by the following two examples related to infrastructure and governance:

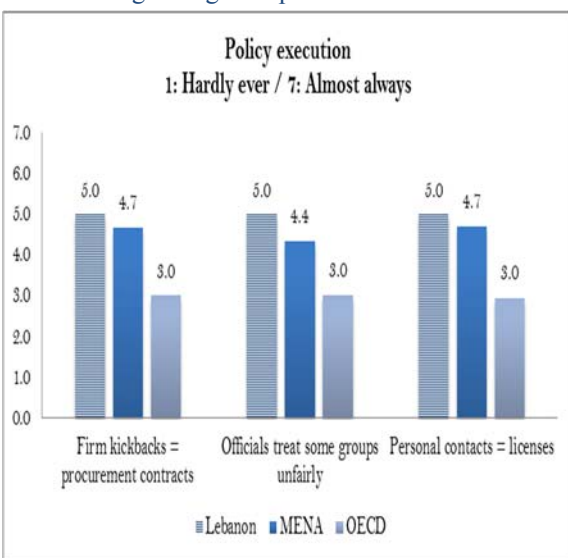
- **Example 1: the deleterious impact of the two overarching constraints on the infrastructure sector.** the strong influence of private sector and sectarian interests in government facilitated by the confessional system of governance has both impeded equitable and efficient distribution of investments in infrastructure (both construction and maintenance), and precluded the development of a national strategy that addresses infrastructure development as part of a broader holistic and inclusive development vision for the country (UNDP, 2009). As a result, budget spending and investments in infrastructure have tended to be guided by considerations of confessional quotas and 'electoral geography' rather than actual needs. In terms of regional conflict dynamics, the infrastructure sector has been significantly impacted by both the physical damages caused by the 2006 Israeli military operation and the pressure placed by the large number of Syrian refugees currently in Lebanon. With respect to the latter, the refugee influx has severely strained the capacity of key infrastructures, notably water, sanitation, electricity and solid waste management and municipal services, including in terms of access, distribution and quality (World Bank, 2013d).
- **Example 2: the overarching constraints have gradually pushed Lebanon into a 'governance trap'.** This has occurred through several, mutually reinforcing channels. First, the confessional system of government, with its focus on balancing and seeking consensus among all confessions (based on the exercise of veto rights), represents an unstable equilibrium in practice, in which conflict is omnipresent, but contained by formal and informal mechanisms for bargaining and consensus-making. When confessional interests are not satisfied through this system, either decision-making could be imposed by an outside party or violence is utilized as a last, but nonetheless relatively frequent, recourse. Once the outside broker (often Syria) left the country, veto rights became more powerful; this sharply increased paralysis in decision making in the country (e.g., the last voted budget law was for 2005 and it was voted in 2006<sup>9</sup>), as can be seen by a marked and sustained slide in a variety of Lebanon's governance indicators (Figure 3). The former was most often used up to 2005 when Syria still had a military presence in Lebanon. For latter was

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<sup>9</sup> None of the post-war budgets were voted within constitutional time and the last officially closed fiscal accounts are those of 2003 although those from 1993 till 2003 need major adjustments.

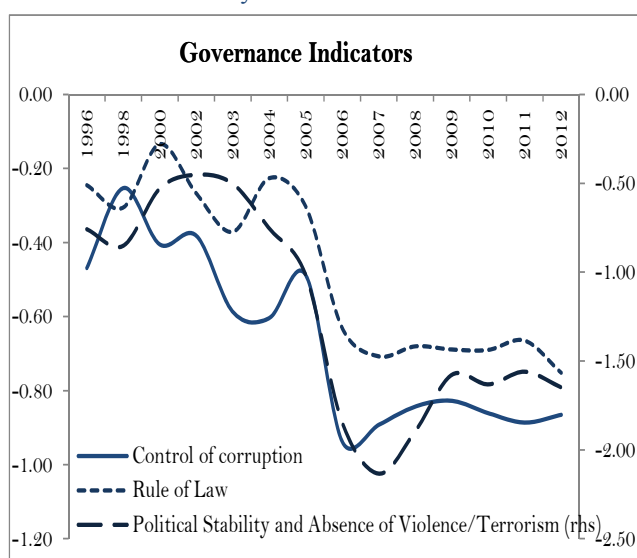
the case, for example, in 2008, and with increasing political polarization due to the Syrian conflict, the risk of political conflict ‘spilling’ outside the machinery of government into violence is high. Second, and linked to the first, Lebanon’s government is today acutely vulnerable to regional conflict dynamics, due to the alliances that exist between regional actors and specific confessional organizations, some of which constitute ‘states within the state’ and arguably possess capabilities stronger than those of the Lebanese government.

Figure 2. Corruption in policy execution: Lebanon stands out again regional peers and OECD countries



Source: Quality of Government Expert Survey, 2010.

Figure 3. Lebanese governance indicators have tumbled from an already weak level since 2005/2006



Source: World Bank, 2013 Worldwide Governance Indicators.

### C. A CONFESSIONAL COUNTRY SUBJECT TO CONFLICT

15. **Lebanon’s confessional system of governance has evolved, in part through conflict, from its original goal of protecting minority rights to one with important, and dysfunctional, elite capture features.** In order to situate and frame the analysis of Lebanon’s current development challenges, this section (1) provides a brief historical overview of the genesis of the two overarching constraints (Section C.1); and (2) highlights the critical symbiotic relationship between these two constraints and the implications this has for the country’s development (Section C.2).

#### 1. The Evolution of Confessional Governance and Conflict in Lebanon

##### The Immediate Post-Independence Period (1943-1975)

16. **In recognition of the sectarian structure of its society the Lebanese state was constituted as a ‘consociational’/confessional democracy.**<sup>10</sup> Although recognized as a state in 1920, Lebanon only obtained formal independence in 1943 with the end of the French mandate. Given the sectarian structure of its society the Lebanese state was constituted, through its constitution and its unwritten National Pact, as a

<sup>10</sup> Consociationalism is a form of government involving guaranteed group representation, and is often suggested for managing conflict in deeply divided societies. It is often viewed as synonymous with power-sharing, although it is technically only one form of power-sharing. When consociationalism is organized along religious confessional lines, it is known as confessionalism, as is the case in Lebanon.

‘consociational’ democracy based on equality among confessional groupings. This system was intended to avoid hegemonic power of one group over others. In reality, the 1932 census which had shown that Christians were 54 percent of the population was used as the basis for the distribution of seats in Parliament on a ratio of six to five (later extended to other public offices). As a result, at the onset of the Republic, power was dominated by the Christian Maronites who occupied the seat of the President, controlled key civil service jobs, and consolidated most of the country’s wealth. Lebanon at that time operated as a presidential democracy, mirroring the French model. This allowed for a functioning executive to lead state affairs and ensure decisions were made. As a result, the system was relatively stable, which facilitated the development of institutions,<sup>11</sup> and the country enjoyed a relatively high degree of economic growth. Lebanon was, nonetheless, not impervious to external shocks during this period—notably the Arab-Israeli war in 1948 and 1967 (Makdisi, 2007).

**17. The pre-war governance model promoted political liberalism and ensured regular presidential and parliamentary elections, as well as a temporary strengthening of the state through economic and administrative reforms** (Makdisi, 2007). The Presidency of Fouad Chehab (1958-64), marked a period of state/public administration building in Lebanon. During this presidency—called the Chehabist period—Lebanon embarked upon a program of reforms to strengthen the Lebanese state, and expand the state’s role in the provision of social services to reduce some of the social and economic imbalances. State-run agencies such as the Litani River Authority, the public education system including the Lebanese University, and the National Social Security Fund were established during this period. Afterwards, however, the state, through the ruling elite, practiced patron-client relationship and increasingly intervened and distorted markets<sup>12</sup> in order to generate and divide rents amongst its constituencies (Lebanese Transparency Association, 2007). As a result, the central authority of the state and political institutions weakened over time as they yielded to growing elite capture of state prerogatives. Thus, what was initially a confessional system meant to provide checks and balances to protect confessional minorities evolved into the system of clientelism that prevails today.

### **Civil War and External Intervention (1975-1990)**

**18. By 1975, the confessional formula had reached its limits.** The displacement of the Palestinian Liberation Organization (PLO) from Jordan to Lebanon in 1971 and its continued struggle (now led from Lebanese territory) against the State of Israel<sup>13</sup> gave rise to increasing tensions between Palestinians and their supporters,<sup>14</sup> and Lebanese Christian factions led by the Maronites. By 1975, the confessional system was no longer able to contain the growing tensions and civil war broke out with devastating consequences. Over the 15 years of its duration, the conflict mutated several times, leading to the *de facto* fragmentation of the country into competing sectarian and militia ‘fiefdoms.’ Shifting alliances, changing motivations of belligerents, and the emergence of powerful new domestic groups (notably Hezbollah) exacerbated by external intrusions (including the Israeli invasion of 1982 and its occupation of the south until 2000, and the Syrian intervention which lasted from 1976 until 2005) significantly shaped power and conflict dynamics in the post-war period. Given its duration and reach into the Lebanese state and society, the Syrian intervention had a particularly significant impact on Lebanon, especially in terms of governance, elite capture, impediments to building effective and independent state institutions, and quality of life.

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<sup>11</sup> For example, establishing the civil service bureau and the Central Bank.

<sup>12</sup> Such as awarding public contracts, securing employment, and the like to their constituencies

<sup>13</sup> The Cairo Agreement of 1969 brokered by Egypt legalized the military presence of the PLO in Lebanon with the underlying objective of fighting the Israeli Army. PLO fighters, soon started setting up check points across the country, raising tensions with various communities, chief among them the Christians.

<sup>14</sup> And behind them Syria, a major supplier of arms, which dispatched in June 1976 Palestinian units under its control.

Quoting Picard and Ramsbotham (2012; p. 72) “the status of Lebanese political leaders from all factions was dependent on good relations with Syrian military officers and with Damascus.”

**19. The Civil War caused major human suffering, significant physical destruction, and also significantly weakened the central authority and legitimacy of the state.** At the end of the conflict, the country’s infrastructure were in ruins, with over 150,000 people killed (5 percent of the population), an estimated 17,000 missing persons, and an estimated USD30 billion in forgone output (at 1974 prices)—Makdisi (2004). The war generated a new crop of leaders, weakened the executive, and created mini-states. Over the course of the war, militias developed their own economies, operated ports, imposed taxes, and set-up their own institutions (Traboulsi, 2007). The public administration in 1990 was lacking both staff—with half of civil service posts vacant (World Bank, 2011d)—and infrastructure, and was unable to deliver basic services (El Zein and Sims, 2004). To avoid civil service implosion the government resorted to recruiting contractual labor. This measure, however, brought in both the qualified and unqualified; and in the end, it created a parallel structure without injecting a new and skilled workforce into the public administration. As a result, most public services and utilities lacked capacity and lost their true function, becoming instead simply sources of rent-seeking, employment, bribery, and transfers for the benefit of warlord constituencies.

**20. As the state progressively withered during (and after) the civil war, NGOs and the private sector stepped in to provide services ranging from electricity to social services.** This important outcome of the civil war persists today as the capacity of the public sector to deliver high quality services throughout the country remains impaired. Thus, in an area such as the provision of social services<sup>15</sup> Lebanon now has an almost total dominance of NGOs/civil society. This strong engagement from NGOs/civil society enabled the continuation of basic services where the state (as well as local governments) had dissolved, but, it also meant the state could not get an adequate footing in provision of basic services for the poor after the war ended; the state still finds itself today in a situation where there is less pressure from the population for it to increase the scope and quality of public service delivery given the extent of NGO/private sector supply of such services.<sup>16</sup> Nonetheless, while high private provision has helped fill some of the gap left by the state, it still leaves many poor out of the system which adds to inequality in quality and quantity of services available, especially as some of these non-state actors operate on a confessional basis.

### **Post-War Reconstruction (1990–2005)**

**21. The conflict formally ended through the 1989/90 Taef Accord which aimed at making the confessional system more equitable; however, its partial implementation, in fact, enabled the (wartime) elite to solidify its power behind the veil of confessionalism.** While ending the war, the parts of the Taef Accord that were implemented did not succeed in building institutions and a functional political system. Instead, it weakened the President, failed to introduce a functioning alternative and embedded confessionalism, which evolved into a parallel governance structure outside the constitutional institutions, commonly referred to as “the Troika”.<sup>17</sup> The representation and the powers of the Christians were diminished, while the Sunni, the Shia, and others like the Druze and Allawites made gains compared to the pre-civil war situation whereby parliament moved from a six to five ratio between Christians and Muslims to an equal share, which remains in place today. Importantly, critical parts of the Taef Accord have never been implemented (e.g., the creation of a Lower House that would not be confessionally-based, coupled with an Upper House that would be confessionally-based; and decentralization that would move decision-

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<sup>15</sup> NGOs, such as religiously affiliated NGOs, provided services such as education grants, food stamps, or services for battered women, orphans.

<sup>16</sup> The private sector or even individuals provided (and continue to) electricity, water, etc.

<sup>17</sup> The Troika included the President of the Republic and the heads of government and parliament, respectively representing the three largest religious groups: the Maronites, the Sunnis and the Shias.



making on public service delivery closer to the user). These would likely have significantly reduced the power of confessionalism in policy-making.

22. **With the war ended, Lebanon enjoyed a relative period of stability between 1990 and 2005.** This period was characterized by a post-war investment boom in some infrastructure sectors,<sup>18</sup> a revamped political system that preserved stability—though at the expense of effectiveness and efficiency—and a climate of relative security underwritten by the presence of Syrian forces. Economic growth was moderate, primarily concentrated in infrastructure and tourism sectors, but ultimately unsustainable as the largely public-sector financed reconstruction, underwritten at high real interest rates under an environment of moderate real GDP growth, led to a ballooning budget deficit and, ultimately, skyrocketing public debt. Economic growth during this period was also unequal, disproportionately benefiting some areas and populations groups, which fueled perceptions of discrimination and marginalization and kept sectarian tension alive (see poverty section in Chapter 2).

23. **The Taef-derived political system, despite resulting in confessionally-based elite capture, was manageable and functioning (though not efficiently) as long as a power-broker was able to impose decisions.** The political governance formula introduced by Taef resulted in a government and state operating at the level of ‘lowest common denominator’ in terms of efficiency and quality of services. The system made decision-making almost impossible (given the effective veto power on decisions that key religious groups have), which required extra-institutional solutions and/or the intervention of an external power-broker (at that time, Syria) with enough clout to force key confessional groups to come to an agreement. In the face of weak government and public institutions, sectarian institutions consolidated into de facto ‘states within states’ thanks to the absorption of militia members into the public administration. Meanwhile, warlords turned politicians, ministers and even heads of the executive and legislative branches of government.<sup>19</sup> Thus, warlords were ultimately integrated into the system and became representatives of their confessions, a system that continues today. Mechanisms of subsidies and transfers were developed by the new political class who used the public sector as a source of political rent and to secure the allegiance of their various constituencies. This perpetuated patronage and clientalism as dominant forms of economic and social organization. Reforms were introduced only if the welfare of the Troika was unaffected and the power-broker was in agreement, thus restricting the set of feasible reforms to a very small number.<sup>20</sup> Over time, the quality and efficiency of public sector delivery of goods and services became severely affected by this state of affairs.

### **The Political Economy Deadlock (2006–present)**

24. **The assassination of ex-Prime Minister Rafiq Harriri and the subsequent withdrawal of Syrian forces (until then the *de facto* power broker) in 2005 created a new political dynamic.** The ‘Cedar Revolution’ that followed the assassination culminated in two major events which resulted in the withdrawal of the Syrian forces and the polarization of political forces into opposing coalitions. In their present form, the first is led by the pro-Syrian Hezbollah movement and a key Maronite Christian representative (“March 8”) and the other led by a shifting alliance of Sunni and other Maronite Christian groups (“March 14”). Because of the Harriri assassination and without a power-broker, the political polarization between March 8 and March 14 has widened rapidly and persists up to today. The two camps dominate the political landscape and given their sharp differences and mutual mistrust, a gridlock has ensued paralyzing the country. The Presidential post has been vacant twice, and several months have been

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<sup>18</sup> The majority of the investment was in the road network, the airport, the telecommunication sector, and the sewage network.

<sup>19</sup> Leenders (2003) finds that 39 cabinet posts were held by ex-militia leaders between 1989 and 2003.

<sup>20</sup> An example of such reform is the introduction of a value added tax in 2002, at a time of severe fiscal stress when non-action would have clearly negatively impacted all confessions and their leadership.

required each time to form a government, with major governmental decisions or measures necessitating months of discussion and extra-institutional bargaining.

25. **Violence and conflict returned to Lebanon due to both domestic and regional events.** In 2006 a 34-day assault as well as an air and sea blockade by Israel resulted in huge damage and setbacks to the country's economic recovery. The 2006 attack generated substantial economic losses throughout the country, including to key transport and services infrastructure and housing, reversing some of Lebanon reconstruction gains since 1990 (World Bank, 2007b). Meanwhile, in 2008 political tensions between the March 8 and March 14 groups reached a zenith, spilling into a brief armed conflict that resulted in the former taking-over Beirut. This domestic conflict was resolved through the 'Doha Accord' brokered by Qatar.

26. **The Syrian conflict that started in 2011 is having a significant destabilizing impact on the political/confessional, security, economic and social conditions in Lebanon.** The Syria crisis has led to both an escalation of tension between March 8<sup>th</sup> and March 14<sup>th</sup> coalitions as well as more broadly among Sunni and Shi'a groups within Lebanon, owing to their affinities with belligerents on either side of the Syrian conflict. Tensions have been exacerbated by the increasing pressure on already stretched and weak public and, especially, social services and local communities as about 1.1 million Syrian refugees have crossed the border and officially registered with the UNHCR (representing over 25 percent of the Lebanese population). In addition, several violent incidents have led to a deteriorating security environment and local communities are increasingly seeing the refugees as threats to social stability, with a number of municipalities having instituted curfews specifically targeting Syrians. A detailed estimate of the economic and social cost of the Syrian conflict on Lebanon can be found in World Bank (2013d)—see Box 1 below for a summary of those findings.

27. **Without an external power-broker, the post-2006 period exposed Taef's weaknesses—severe polarization and a consolidation of the sectarian state-within-a-state phenomenon, resulting in political deadlock.** Without a power-broker, the political divide between March 8 and March 14 widened and deadlock has ensued with each religious sect (even within coalitions) regularly exercising its *de facto* veto power to block any decision, be it administrative, economic, or political that did not further its direct interests or risked advancing the interests of other groups. In the political sphere, between 2005 and early 2015, caretaker governments ruled for about two years, an international accord in Doha was required to elect a president in 2008 after a six month vacancy, and since May 2014 the Presidency has been vacant again. Meanwhile, Parliament is regularly not functioning due to a lack of quorum. The result of which is that, for example in 2007, not a single law was passed. In 2013, that number reached 2—although these related to extending the mandate of the parliament and delaying parliamentary elections. Five and fourteen laws were passed in 2008 and 2009, respectively. In the administrative and economic sphere, basic functions of the executive and parliament, such as passing a national budget stopped (the last approved budget is from 2005). Further, important decisions related to restructuring of the labor force in *Electricité du Liban* (EdL), establishing a regulatory authority for the oil sector, or removing illegal building structures dating mostly from the civil war all caused turmoil, sit-ins, and tension. Such events or failed attempts at reform multiplied in recent years and in most cases had a sectarian element. In short, a rules-based system ceased to exist and a system based on compromise and political horse-trading now prevails.

### Box 1. The Economic and Social Impact of the Syrian Conflict on Lebanon<sup>21</sup>

*The conflict in Syria is having a large and negative impact on Lebanon's economy, its social fabric, and its public services. The cumulative losses in economic activity reached an estimated USD7.5 billion by end-2014. Social cohesion is deteriorating partly due to combination of rising poverty, a worsening labor market, rising insecurity, and a deteriorating core public services. The latter are under pressure given the sudden and large increase in demand arising from the Syrian refugee influx. The fiscal cost of Syrian conflict is estimated at USD2.6 billion through end-2014. Across all core public services, the surge in demand is currently being partly met through a decline in public service access and quality. It is estimated that an additional spending of USD2.5 billion would be required to reinstate the access to and quality of public services to their pre-Syrian conflict level.*

#### Economic Impact

**24. The conflict in Syria—a country that is closely linked, through historical, social and economic ties to Lebanon—is severely and negatively impacting the Lebanese economy.** Lebanese growth is estimated to be down by 2.9 percentage points each conflict year. This is generating cumulative losses in economic activity of USD7.5 billion through 2014. The largest impact arises through the insecurity and uncertainty spillovers which profoundly and negatively affect investor and consumer confidence. The resulting lower economic activity is putting downward pressure on government revenues which, combined with rising demand for public services stemming from the large refugee influx, is generating large costs for the budget and damaging Lebanon's structurally weak public finances. These costs are largely driven by the influx of refugees into Lebanon.

**25. After an initial negative impact of the Syrian conflict on the trade sector, firms have gradually adapted to the shock and have found ways to cope or benefit.** As an economy with a large trade sector, Lebanon is significantly exposed to Syria not only due to its role as a trading partner, but also because a sizable share of Lebanese trade transits through Syria and because of the risk a destabilized Syria creates for Lebanon's large services exports, especially tourism. The first half of 2013 witnessed sharp reductions in trade flows, particularly for food products and consumer goods. Data through 2014 reveal, however, that while Lebanese exporters to Syria have suffered from a drop in demand in the Syrian market (but less so than their Jordanian counterparts), other Lebanese exporters have started to export to Syria to fill the gap in Syrian production. Data also suggests that Syrian refugees in Lebanon provide important impetus to Lebanese services exports.

**26. The Syrian conflict and the resulting large refugee influx into Lebanon have cost the central government budget and estimated USD2.6 billion through end-2014.** The Syrian conflict shock is putting Lebanon's public finances under severe and unsustainable strains, given Lebanon's initial weak public finances. On the revenue side, spillovers from the conflict are estimated to cut USD1.5 billion in revenue collection through end-2014, due to a combination of direct impact on key sectors (e.g., tourism) and indirect impacts through weaker economic activity. On the expenditure side, total budgetary spending by the Government alone is estimated to grow by up to USD1.1 billion over the same period, mostly because of the sharp increase in demand for public services by the Syrian refugees. The wider fiscal deficits, lower economic growth, and rising interest risk premium due to the Syrian conflict have halted Lebanon's remarkable progress in reducing its debt-to-GDP ratio; for the first time since 2006, Lebanon's debt ratio rose again in 2012 and has continued since.

#### Human Development and Social Impact

**32. The Syrian conflict is estimated in health, education and social safety nets to have a fiscal cost of USD308 million through 2014 while USD1.4 billion (3 percent of GDP) will be needed for stabilization—i.e., to restore access to and quality of these services to pre-conflict levels—including USD166 million for short-term job creation.** The conflict is estimated to negatively and materially affect the poverty, livelihoods, health and human capital conditions of the Lebanese people. By end-2014, some 170,000 additional Lebanese are estimated to have been pushed into poverty (over and above the current 1 million below the poverty line). Lebanese regions with a high poverty incidence are also the ones that are hosting large numbers of refugees. An additional 220,000

<sup>21</sup> This section mostly derives from World Bank (2013d).

Lebanese, primarily unskilled youth, are expected to become unemployed. The influx of refugees has challenged the already weak public social services sector in Lebanon and social tensions, including gender issues, among refugees and Lebanese communities are on the rise. For example:

- **The increase in demand for *health* services caused by the Syrian conflict is straining Lebanon's health system.** The conflict in Syria is impacting Lebanon's health system through: (1) increased demand for health care services; (2) increased unpaid commitments of the Ministry of Public Health (MOPH) to contracted hospitals; (3) shortages in health workers including specialists and nurses; (4) a sharp rise in communicable diseases and the emergence of previously absent diseases, such as leishmaniasis; and (5) increased risks of epidemics such as water-borne diseases, measles, and tuberculosis. Overcrowding, lack of water and sanitation infrastructure and other poor environmental conditions also pose significant risks to increased infections, as outbreaks of lice and scabies among refugees have shown. Thus, demand for health services has markedly increased. In addition, strong demand for hospital care is crowding hospitals and compromising access to healthcare, thus exerting financial pressure on hospitals, increasing costs, and generating medication shortages. In the medium- to long-term, the impact of delayed health care could result in increased overall levels of morbidity, particularly for the vulnerable.
- **The increase in demand for *education* services arising from the Syrian children refugees is leading to mounting fiscal costs, an adverse effect on quality of public education, and a significant need for non-formal education.** Prior to the Syrian conflict, basic education enrollment in Lebanon had been stable at over 90 percent for a decade. Although public schools only accommodated 30 percent of total students, they catered predominantly to children of lower socio-economic status. Since the onset of the Syrian conflict, and the influx of refugees into the country, the Ministry of Education and Higher Education (MEHE) provided open access to refugees in its public schools. In 2012, 40,000 refugee children were accommodated in public schools for a budgetary cost of USD29 million. An additional USD24 million in costs were financed by donors through UN agencies, which the MEHE would otherwise have had to bear. These costs continued to escalate with the rapid increase in the refugee population. These figures do not reflect the 65 percent of refugees who are not enrolled in formal schooling, thus creating significant needs for non-formal/out-of-school education, necessary to control the onset of child labor and other negative social consequences.

### Infrastructure Impact

**33. The fiscal cost of the Syrian conflict on infrastructure is estimated at USD589 million through 2014, while USD1.1 billion would be required for stabilization,** including USD258 million for current spending. The country's infrastructure (defined as water and sanitation, municipal services, electricity and transport), already severely constrained, was ill-prepared to cope with increased use resulting from the surge in refugees. The cash-strapped and under-capacitated local and municipal governments and establishments are severely impacted by the crisis as they now extend basic services and tend to the immediate needs of both refugees and host communities. Specifically:

- **Water supply and sanitation systems, already facing acute pre-crisis challenges have had to meet an additional estimated water demand of 7 percent of the pre-crisis demand.** This increased in water demand has resulted in severe water shortages in 2014 as it coincided with a dry winter year which therefore resulted in limited water accumulation in the country's reservoir. Stabilization interventions to reinstate pre-crisis levels of service to host and refugee communities include: (1) humanitarian relief interventions such as distribution of bottled and tanked water, chlorination kits and storage tanks to the most vulnerable populations; (2) additional capital and operation and maintenance costs, provision of urgent equipment, and additional short-term infrastructure for restoring water supply infrastructure; and (3) acceleration of infrastructure investments and institutional reforms such as storage and transfer infrastructure, distribution network rehabilitation and replacement, water and wastewater treatment and irrigation expansion and improvement.
- **A markedly visible decline in the level and quality of solid waste management and municipal services has resulted from the sudden and sharp increase in demand by Syrian refugees.** Solid waste generation has doubled in several areas of the country, which is contributing to ground water contamination, pollution of water resources and spread of water-borne disease. To reinstate pre-crisis levels of service to host and refugee communities include: (1) the closure and rehabilitation of open and uncontrolled municipal solid waste dumps;

(2) establishing composting, separating and landfilling facilities, and; (3) extending financial support to host municipalities to cover the expected additional operational and capital expenditures.

- **Increased electricity demand due to the incoming Syrian refugee population is estimated at 251 MW by end-2014.** The Syrian crisis, through the sharp increase in electricity demand, has added to the sector structural deficiencies, namely insufficient installed capacity, low efficiency, high losses and inadequate infrastructure, resulting in poor reliability, inadequate levels of supply and extensive load shedding. The interventions required to reinstate pre-crisis levels of electricity service to the Lebanese population and meet the needs of refugee communities include: (1) capital investment in generation capacity and associated transmission and distribution networks; and (2) institutional capacity and technical assistance for project preparation and implementation.

- **Regions with high influx of refugees witnessed sharp traffic increases on some roads, resulting in accidents and the rapid deterioration of the transport network.** The Syrian crisis affected Lebanon's transport sector in the form of: (1) increased wear and tear of the road and transport network; (2) substantial increase in traffic volumes causing congestion; and (3) a near halt of Lebanon's thriving transit business particularly for freight. In order to restore transport sector performance to pre-crisis levels, investments in the following areas are needed: (1) asset preservation primarily including enhanced road maintenance; (2) capacity increases including network reconstruction, widening and expansion; and (3) public transport solutions such as mass transit.

## 2. The Symbiotic Relationship between Confessional Governance and Conflict

28. **The progressive hollowing out of state institutions and a turbulent environment perpetuate recurring and mutually reinforcing dynamics of conflict and elite capture** (hiding behind a confessional veil). Lebanon fits well the paradigm of conflict, violence and fragility described by the World Bank's (2011e) 2011 World Development Report, wherein the absence of resilient institutions and a turbulent regional and international environment perpetuate recurring and mutually reinforcing dynamics of conflict and fragility. Viewed from this perspective, the two overarching constraints—the confessional system of governance, and the country's vulnerability to the dynamics of conflict in the Middle East—result in a set of internal and external stresses that together have perpetuated instability and currently impose serious constraints to Lebanon's development prospects. Specifically, the various crises and conflicts over the years due in part to these structural stresses have yielded consequences which in turn have perpetuated fragility in Lebanon and continued to exacerbate social and political cleavages. This has led to new stresses and conflicts, while transforming old ones, and a context where it is difficult to discern clear patterns of causality. Consequences include:

- **A fragile and dysfunctional political system and state, unable to regulate conflict and exercise sovereign authority.** At the heart of Lebanon's confessional political system is the tension between the conflict-mitigating goals of the consociational approach and the ultimately discriminatory impact of a social contract in which the relationship between the state and its citizens is mediated through confessional and sectarian affiliations and interests. In order to prevent future sectarian conflicts following the civil war, the Taef Accord strengthened the confessional system through broader 'spreading' of political power and institutional responsibilities. This had the impact of paralyzing decision-making (given the need for broad consensus for every decision), further entrenching sectarian interests at the heart of state institutions, and reducing the autonomy and effectiveness of the state. The state was in effect 'hollowed out' with sovereign authority effectively transferred to sectarian actors and organizations, and institutions rendered incapable of effectively carrying out basic state functions across numerous sectors. At the same time, the system remained deeply conflictual through the establishment of a 'permanent' competition over political power, resources and state privileges intended to benefit sectarian interests, political actors and constituencies. In the views of some, a return to violent sectarian conflict was only averted through the 'national' regulation of political competition through Syrian occupation through 2005, which ensured a certain degree of stability and decision

making. The weakness of the state was highlighted following the Syrian withdrawal, where competition between political forces, long ‘buffered’ by the Syrian presence, led to immediate political deadlock and crisis, and a brief resumption of violent conflict in 2008.

- **The entrenchment of sectarianism as an alternative and parallel system for organizing social, economic and political life.** During the civil war, religious groups and militias constituted “states within states”, effectively governing, administering and defending populations. Following the civil war, this governance dimension of sectarianism was transformed and further entrenched, with territorial-administrative borders between groups becoming institutional in nature. A key feature of sectarian organization has been their role in providing key social services such as education and health, and provision of welfare support to the most vulnerable groups. While this has been arguably beneficial in the absence of effective state institutions, it has deepened both societal cleavages and institutionalized a discriminatory and inequitable system for regulation of social and economic life, given that provision and targeting of services has often been linked to electoral campaigning. When combined with the privatization of public service delivery and direct financing by the state, this has also led to steep inequalities in access to services due to exorbitant costs for service delivery set by private sector actors.<sup>22</sup>
- **Lebanon’s post-civil war economy has been significantly influenced by sectarian politics and the social relationships that evolved during the civil war, resulting in uneven growth, opaque management of public resources and widespread corruption that have in turn exacerbated elite capture and sectarian cleavages.** These led to the emergence of a government and economy dominated by a small number of individuals, who controlled access to individual sectors and exerted strong influence, through clientelist practices, on the distribution of resources. Lebanon’s reconstruction drive, and resulting economic growth boom, in the 1990s is criticized as having benefited a small segment of the population, with most investments concentrated in Beirut, and profits accruing primarily to an affluent elite. During this period, social spending was not prioritized, on the basis of expected ‘trickle down’ benefits from reconstruction investments – which did not occur throughout the country (UNDP, 2009). As the previous chapter on poverty highlights regional disparities are stark in Lebanon, with the bulk of the poor population living in peripheral areas (particularly the north and the south). Lebanon scores below the average for the world, OECD, and MENA countries on a range of policy making and service delivery indicators (see Section B.3 below). Extremely poor scores characterize obstacles to public action, quality of services delivered, needs-based and territorial coverage of public services. This inequality, combined with the lack of governments to implement a national development plan, has led to perceptions of sectarian-based economic discrimination (which has often been used by political groups to mobilize support and action), and further reinforced political competition and conflict between sectarian groupings over control of the economic levers of power in government (Kraft et al., 2008).
- **The ‘fusion’ of external with internal dynamics in Lebanon has perpetuated the country’s vulnerability to regional conflicts and instability.** Lebanon has historically been affected by external (i.e., regional and international) dynamics in a number of different ways, including (1) as a theater for regional conflicts and the pursuit of external objectives (political and military), including the Israeli-Palestinian conflict and Syrian interventionism; (2) the use of regional political alliances by Lebanese actors to strengthen their political power domestically; and (3) the ‘spillover’ of regional conflict and their destabilizing impacts (political, security and economic)—notably the current conflict in Syria. Over the years, some of these external factors have become an integral part of the domestic political

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<sup>22</sup> For an analysis of the impact of service privatization and confessionalism in the context of the health sector, see Kasturi and Mehio-Sibai (2004).

landscape, both in terms of the identities and political agendas of some groups (which are both national and trans-national in nature), and in terms of the role played by Lebanese groups in the dynamics of conflict elsewhere in the region. The current regional conflict between Shi'a and Sunni groups in Iraq and Syria, for instance, is exerting a strong negative influence in Lebanon, polarizing communities and transforming sectarian tensions and cleavages, from a Muslim-Christian to a Sunni-Shi'a conflict. This is resulting in strong negative impact on growth, poverty, and equality.

29. Having provided the background and the thesis of Lebanon's development challenges, the remainder of this report is structured as follows: Chapter II provides an overview of Lebanon's growth, poverty, and jobs performance. When possible—given data limitations—the overview takes a long term approach to the performance of those sectors, aiming to highlight trends and structural factors rather than short-term or cyclical phenomenon. The analysis of this chapter offers a diagnostic of Lebanon's performance in creating sustainable and quality jobs which are necessary to reach the Twin Goals mentioned above. Chapter III details Lebanon's challenges and opportunities as far as reaching the Twin Goals is concerned. Two overarching challenges are first presented while nested challenges/constraints follow. The chapter concludes with factors of strength, sources of resiliency and opportunities for Lebanon. Chapter IV delves into key risks and vulnerabilities surrounding Lebanon's development model. Finally, based on the analysis of the previous chapters, Chapter V presents a prioritized list of challenges and highlights some opportunities for the country.

## II. GROWTH, POVERTY, AND JOBS

### A. GROWTH DEVELOPMENTS AND ANALYSIS

30. **Since the end of the civil war, the Lebanese economy has expanded at a moderate pace, but has been volatile due to frequent shocks** (Figure 4).<sup>23</sup> While real GDP grew by an estimated 4.4 percent on average from 1993 to 2014<sup>24</sup>, the volatility around that average was, however, large at 3.2 percent (1 standard deviation). Six separate periods of growth can be observed during the post-civil war period (Figure 4):

- i. *Post-war recovery and reconstruction boom* (1991-95). Growth averaged 12.9 percent between 1991 and 1995 due to large public investment aimed at reconstructing the country's infrastructure and Beirut's center, as well as large public consumption.
- ii. *Public debt concerns impacted growth* (1996-2000): Growth decelerated significantly between 1996 and 2000 to average 2.4 percent, due to shocks (conflict with Israel in April 1996) and mounting concerns regarding the rapid growth in public debt which exceeded 100 percent of GDP (Figure 53). Private consumption and investment slumped, leaving net exports as the only growth driver (Figure 4).
- iii. *Growth resumed as external assistance improved confidence* (2001-2004). While public deficits expanded briskly and pushed the country towards the highest debt-to-GDP ratio in the world, confidence nonetheless improved thanks to the Paris I and II international donor conferences of 2001 and 2002. With improved confidence, private consumption drove growth with real GDP growth averaging 4.1 percent.

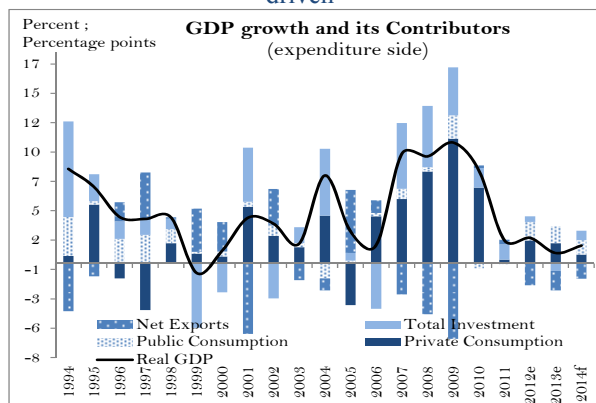
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<sup>23</sup> Annex II provides an overview of the economy's performance prior and during the civil war. This long-term perspective on growth illustrates the lasting impact that the conflict had on Lebanon's core growth drivers (human, physical, and social capital).

<sup>24</sup> GDP figures from 2004-2011 are based on the Lebanese national accounts published by CAS in July 2013, while data for 2012, 2013 and 2014 are based on staff projections pending final GDP estimates from CAS.

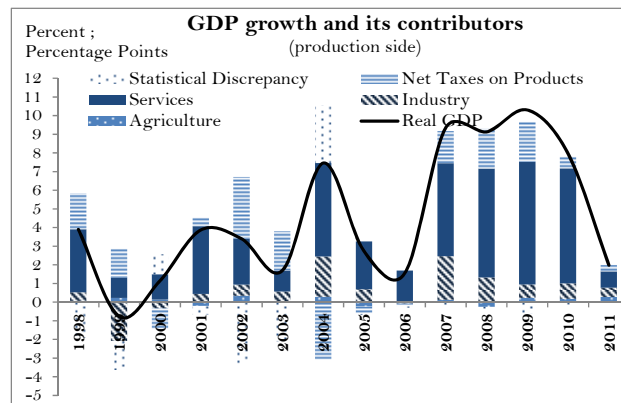
- iv. *Domestic and external political shocks hit growth (2005-06)*. The assassination of Prime Minister Rafic Hariri in February 2005 and the summer 2006 conflict with Israel severely impacted the economy with real GDP growth averaging only 2.2 percent.<sup>25</sup>
- v. *Recovery and safe-haven economic boom (2007-10)*. Economic growth was buoyed by the January 2007 Paris III international donor conference and expanded by an average 9.2 percent, a record average despite repeated security incidents and the global financial crisis/recession.<sup>26</sup> Part of the recovery in the economy's growth rate simply stemmed from a "base effect" as the economy had suffered from two weak years (2005 and 2006). Seen as a relative safe haven by the Lebanese diaspora and given excess liquidity from Gulf countries (driven by record high oil prices), deposits flowed into Lebanese banks and fueled a surge in real estate investment. While the global financial crisis spread to most countries, Lebanon found itself benefiting as its banking system attracted depositors concerned with the viability of their banking institutions in developed countries. The confidence of depositors was the result of a tightly regulated banking system with high liquidity and a focus on traditional commercial banking (and therefore little exposure to the toxic assets, such as mortgage-backed securities, which were at the heart of the financial crisis). Lebanon's strict bank secrecy and relatively high rate structure were additional factors for some depositors. Surging private consumption also contributed to growth during this time frame.
- vi. *An overstretched economy hit by domestic and external political shocks (2011-14)*. As the real estate boom ran its course (with prices overextended), investment decelerated. Meanwhile, private consumption, the other key growth driver of the 2007-10 years, was sharply and negatively impacted by the political vacuum in early 2011 following the fall of Saad Hariri's unity government and then the onset of the Syrian conflict which brought numerous security issues and an influx of refugees. With confidence falling, average real GDP growth has slumped to 1.7 percent over the last three years.

Figure 4. After an investment-led reconstruction, Lebanon's growth turned primarily consumption-driven



Source: CAS and World Bank staff calculations.

Figure 5. Services drive growth but the sector's sensitivity to security imparts volatility to the economy



Source: CAS and World Bank staff calculations.

<sup>25</sup> The conflict with Israel resulted in large human losses, infrastructure damage and economic losses. Direct damages are estimated at USD2.8 billion, and USD700-800 million in indirect damages (World Bank, 2010).

<sup>26</sup> Major security incidents included the Nahr-el Bared conflict in the summer of 2007 and armed clashes between opposing political factions in May 2008.



31. **The services sector—historically a key growth driver—has been severely impacted by events since 2011 and has contributed significantly to Lebanon’s low growth in recent years.** (Figure 5). Between 1997 and 2011, the services sector accounted for an average of 74 percent of real GDP compared to 49 percent in the group of comparator countries.<sup>27</sup> In contrast, the agricultural sector accounted for, on average, 5.6 percent of real GDP. Given its dominant share of the Lebanese economy, the deceleration in growth observed in the services sector since 2011 dragged growth down significantly, led primarily by the domestic trade and tourism; the real-estate and financial sectors have been able to withstand some of the shock, in part thanks to specific stimulus packages introduced by the central bank.

32. **The high dependence on the real-estate and tourism sectors—which are sensitive to security shocks—imparts strong and relatively frequent volatility to the Lebanese economy.** The real estate sector has accounted for 50 to 70 percent of total gross fixed capital formation (GFCF) since 1997. Given the fact that the sector tends to attract mainly unskilled labor, which in Lebanon is provided by cheaper foreign workers, economic growth from the sector has not resulted in significant employment gains for Lebanese nationals. Thus, while the real estate and construction sectors accounted for a large share of GDP (17.1 percent on average between 2004 and 2011) they employed an average of only 7.8 percent of the Lebanese workforce between 2004 and 2009. Similar findings arise across the MENA region where the real estate sector accounts for around 46 percent of FDI, but contributed only 19 percent of job creation between 2003 and 2011 (World Bank, 2012f).<sup>28</sup> In the tourism sector, hotels and restaurants, as well as the wholesale and retail trade sectors, accounted for 16.8 percent of GDP between 2004 and 2011, but are highly susceptible to political and security shocks. Consequently, the deteriorating security and political situations since 2011 has negatively and severely impacted these sectors. The negative impact of the Syrian conflict on the real estate sector has to some extent, however, been mitigated by repeated stimulus packages from the *Banque du Liban* (though subsidized loans offered by commercial banks) that aim to improve access to affordable mortgages, which has enabled the real estate sector to partly stabilize during the period 2012-14.

33. **From the demand side, private consumption has been Lebanon’s dominant growth driver during the 21<sup>st</sup> century, but it is highly sensitive to confidence and security shocks.** Private consumption accounted for 75 percent of real GDP growth between 1998 and 2010 (Figure 4). This contribution, however, shrunk to 17 percent in 2011 and remains subdued since due to the weak security stance and lowered investor confidence. Low levels of exports and an over-reliance on imports to meet domestic demand resulted in a persistent trade balance deficit that hovered between 22 and 33 percent of GDP during 1997-2011 (based on the July 2013 CAS National Accounts release). Squeezed due to a lack of fiscal space and a lack of an approved budget since 2006, public investment dwindled from 6.3 to 1.4 percent of GDP between 1997 and 2011, far below the average of 3.6 percent in the group of comparator countries. Available indicators suggest that sluggish economic activity since 2011 was the result of a severe drop in private consumption as the deteriorating security and political situation negatively impacted consumer confidence.<sup>29</sup> Demand from the large influx Syrian refugees, however, has partially offset the decline in private consumption.

## B. POVERTY AND JOBS

34. **In a World Bank (2014d) survey of Lebanese citizens, public sector governance reforms ranked number one in the Lebanese development priorities.** Key aspects of this governance challenge

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<sup>27</sup> This group has the same GDP per capita (PPP terms) as Lebanon in 2013. It includes Azerbaijan, Belarus, Cuba, Gabon, Mauritius, Mexico, Romania, Suriname, Turkey, Uruguay and Venezuela.

<sup>28</sup> National accounts data in this paragraph refers to data consistent with the July 2013 CAS National Accounts release.

<sup>29</sup> The AUB/Byblos Bank consumer confidence index dropped by 33.9 percent and 9.9 percent (yoy, sa) in 2012, 2013, respectively (Latest available annual numbers).

include elite capture of business, discretionary implementation of regulations, and rampant corruption, which all affect achievement of the Twin Goals. In fact, international evidence shows that an increase in the quality of governance can help reduce absolute poverty by up to 20 percent (Figure 6). It has also been shown that transparency matters for government effectiveness (Figure 7).

**35. Lebanese consider job creation and social protection among their top development and shared prosperity priorities.**<sup>30</sup> In a World Bank (2014d) survey of country stakeholders, Lebanese revealed that social protection and job creation/employment ranked second and third, respectively, in their development priorities behind public sector governance, as noted earlier. In this same survey, 66 percent of Lebanese view the country as headed in the wrong direction (with only 8 percent saying it is headed in the right direction), which reveals a profound dissatisfaction with current policies. These views are consistent with growth not having been inclusive as employment growth elasticity is weak, even compared to MENA countries.

**36. Though data are lacking, inadequate productive job creation has likely stymied rapid poverty reduction and shared prosperity in Lebanon.** As discussed below, we know little about medium- to long-term poverty trends in Lebanon. However, global evidence suggests that wages and employment are the primary drivers of poverty reduction (Inchauste et al., 2014). In Lebanon, job creation has trailed labor force growth. Data analysis also suggests that developments in labor markets have not been conducive to creating more domestic employment opportunities, especially formal private sector jobs. Most job creation has been in low productivity sectors, especially in trade. Only about one in three labor force participants have a formal sector job. Thus, without more and better earning opportunities, households in Lebanon have difficulty in achieving substantial welfare improvements.

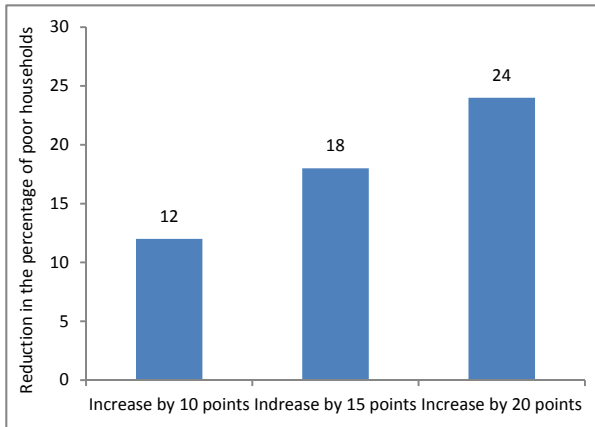
**37. Moreover, the lack of government effectiveness and adequate fiscal space have limited the reach of the public safety net which could have augmented income for the poor.** In Lebanon, social protection interventions constitute of social insurance and labor market interventions (often include contributory schemes such as pensions), social services (access to services such as health and education) and narrowly targeted social assistance programs. However, these programs reach only a small share of the population and are not considered to adequately address the needs of the poor. Thus, the population remains heavily reliant upon earnings to life them out of poverty and possibly on private safety nets (such as remittances) though little is known about this source of income in poverty reduction.

**38. In recent years, it appears that the supply of low skilled workers has grown rapidly due to the Syrian crisis, thus adversely impacting incomes for low-income and poor Lebanese.** The jobs that have been created have typically been of low quality (e.g., low skills, often informal) and gone to non-Lebanese (e.g., laborers in the construction sector). Both poverty and jobs have been severely and negatively impacted by the Syrian conflict and in particular the large influx of refugees into Lebanon. Thus, the prospect for poverty reduction in the near term appears to be grim in Lebanon, though government reforms in the medium term could have a significant impact on raising the welfare of the poor.

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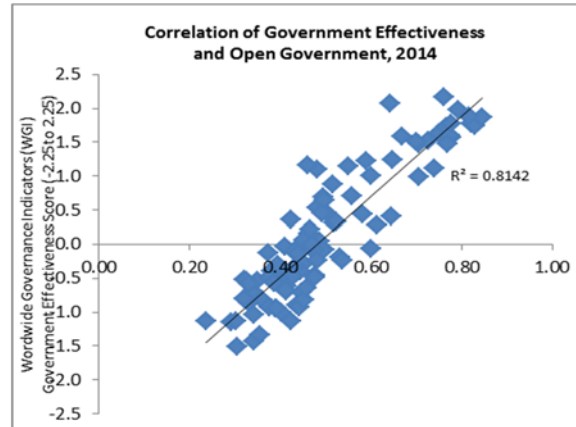
<sup>30</sup> Social protection consists of policies and programs designed to reduce poverty and vulnerability by promoting efficient labor markets, diminishing people's exposure to risks, and enhancing their capacity to manage economic and social risks, such as unemployment, exclusion, sickness, disability and old age (World Bank. 2001).

Figure 6. Good governance reduces absolute poverty



Source: Steve Knack (2002).

Figure 7. Transparency and government effectiveness



Source: World Justice Project, Open Government Score (0.0-1.0).

### C.1. Measurement of Monetary Poverty and Inequality (1961-2012)

39. **Despite the lack of micro-data, there have been sporadic attempts to measure living conditions in Lebanon since 1960s.** Table 1 below summarizes the main findings from different reports between 1961 and 1997. It should be noted, however, that there is little basis to compare these estimates over time, since all surveys that were conducted appear to be different in terms of methodology and sample size. Further, there is very little documentation on how welfare aggregates and poverty lines were constructed across time. The trends presented below should, therefore, be understood to be subject to this strong caveat.

Table 1. Poverty and inequality measurement in Lebanon, 1961-2014

Author	Survey year	Main findings
Mission IFRED (1961)	1960	50 percent of population below poverty line
Schemeil (1976)	1973-75	22 percent of population below poverty line
UN-ESCWA (1995)	1993	28 percent of poverty and 7.5 percent of extreme poverty. Poverty was concentrated in Bekaa and North Lebanon regions. Higher poverty rates among agricultural workers.
UNDP (2004)	Summary	Share of low income population declined from 50 percent in 1959-1960 to 22 percent in 1973-1974 and increased again to 52 percent in 1994-1995
Gaspard (2004)	Summary	Income based Gini declined from 0.5 in 1960 to 0.44 in 1997. Gini based on expenditures declined from 0.51 in 1951 to 0.47 in 1997.
UNDP (2008)	2004-05	28.5 percent of poverty and 8 percent of extreme poverty in 2004/2005. The Gini coefficient was about 0.361. Large regional disparities in headcount poverty rates with the North, South and Bekka being the poorest. Poverty was highest, deepest and most severe for illiterate and unemployed individuals. Agricultural, self-employed and non-salaried workers were more likely to be poor. Using backward and forward simulations, extreme poverty was shown to decline from 10 percent in 1997 to eight percent in 2004/2005, but increasing afterwards to 8.4 percent in 2007.
CAS	2011-12	Data to be analysed once the large non-response bias has been addressed.
World Values Survey, the Arab Barometer and the Survey on Financial Capability	2010-13	About 30-32 percent of population estimated to be poor using subjective wellbeing questions and income information (measured in different ways in different surveys).
World Bank (2013e)	2012-14	Syrian crisis is estimated to increase poverty among Lebanese population by 170,000 people by 2014 with existing poor being pushed deeper into poverty.

40. **The pre-civil war Lebanese economy was characterized by high income inequality and falling, but still elevated poverty.** Notwithstanding comparability issues among early studies, high levels of income inequality and poverty rates in the 1960s were followed by rapid declines in poverty in the 1970s (Table 1). The first poverty study was published by Mission IRFED (1961) and showed that 50 percent of the population in Lebanon had income below the poverty line. The same report documented wide regional disparities in living standards and high inequality among the population. The second study by Schemeil (1976) showed 22 percent of poor in 1973-1975 before the civil war. According to Gaspard (2004), income inequality was relatively high with Gini coefficients of 0.51 and 0.55 in 1960 and 1974, respectively.<sup>31</sup>

41. **Post-civil war poverty and inequality remained high.** After the civil war, the UN-ESCWA (1995) estimated consumption-based poverty to be at 28 percent and extreme poverty at 7.5 percent in 1993 and 10 percent in 1997. As the IRFED study was based on income, poverty estimates in 1960 and 1993 are not comparable. Nevertheless, according to UNDP (2004), poverty, measured as percentage of population with low income, has been U-shaped: falling from 50 percent in 1959-1960 to 22 percent in 1973-1974 and increasing again to 52 percent in 1994-1995. In terms of inequality, income-based Gini coefficients declined modestly from 0.5 in 1960 to 0.44 in 1997. Similarly, Gini coefficients based on expenditures also declined modestly, from 0.51 in 1951 to 0.47 in 1997 (Gaspard, 2004).

42. **Lebanon has the majority of its poor located in urban areas** (World Bank, 2011c). An estimated 88 percent of Lebanon's population lives in urban areas. In a poverty mapping exercise completed in 2004, Lebanon's Economic and Social Fund for Development found more poor people in small pockets of dense poverty on the suburbs of large towns than in all of rural Lebanon. The entire rural population of Lebanon represents a fraction of the population living in slums in Lebanon (30 percent in 2004).

43. **No significant progress on poverty reduction has likely taken place so far in the 21<sup>st</sup> century.**<sup>32</sup>

<sup>33</sup> The main findings of the 2004-05 multipurpose household survey are as follows (UNDP, 2008):

- *Extreme poverty affected 8 and 8.4 percent of the Lebanese population in 2004-5 and 2007, respectively.* This includes the percentage of households being below the extreme poverty line or that were not able to meet their most basic food and nonfood needs.<sup>34</sup>
- *28.5 percent of the population was poor using the upper poverty line in 2004/05.*
- *Striking regional differences in consumption per capita and headcount poverty rates were identified across regions with the North, South and Bekka being the poorest.* From the overall poor population 27.3 percent were concentrated in relatively affluent Mount Lebanon, and 38 of total poor were concentrated in the North; more strikingly, 46 percent of the extremely poor population is located in the North region.

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<sup>31</sup> The Gini index measures the extent to which the distribution of income or consumption expenditure among individuals or households within an economy deviates from a perfectly equal distribution. A Gini index of 0 represents perfect equality, while an index of 1 implies perfect inequality.

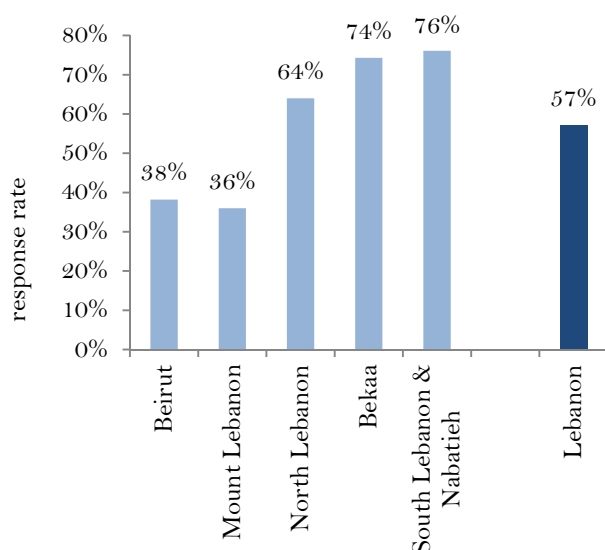
<sup>32</sup> After 2000, the Ministry of Social Affairs, supported by the UNDP, and in partnership with the Central Administration of Statistics (CAS), undertook the first multipurpose household survey (living conditions and household budget survey) conducted during February 2004 to April 2005 on about 13,000 households distributed nationwide. The sample covered the whole *de facto* population, except the Palestinian population living in the refugee camps. Extreme, lower and upper household specific poverty lines were constructed based on the costs of basics needs approach (Since lower poverty line is used as eligibility criteria in the National Targeting Program, it has been updated using CPI from USD2.4 per capita per day to USD3.84 in 2013—World Bank, 2014).

<sup>33</sup> Average annual per capita poverty lines in LBP were as follows: 844 (food poverty line), 1,332 (lower poverty line) and 2,172 (upper poverty line). Any household that spent less than the upper poverty line was considered as poor.

<sup>34</sup> The poverty estimates for 1997 and 2007 were obtained using backward and forward simulations (UNDP, 2008).

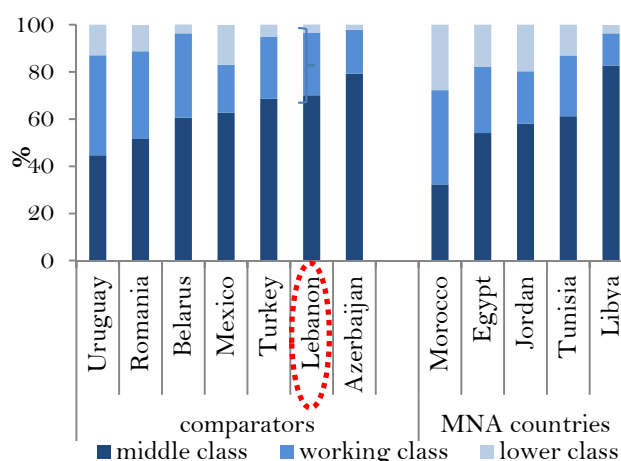
- *Inequality within regions was found to account for most of the inequality in Lebanon.* Lebanon’s Gini coefficient was estimated at 0.361 in 2004/05 using spatially adjusted consumption per capita. This is on par with the average of MENA countries and much lower than inequality in Latin America countries. Inequality was the highest in the North which also had the lower consumption per capita. North and Mount Lebanon were the two regions with the lowest consumption growth between 1997 and 2004/05. The North region was also distinct because of the lowest elasticity of poverty to consumption growth which may be related to highly unequal distribution in this region.
- *Poverty is particularly acute in rural areas and agricultural households.* Compared to Lebanon’s overall poverty rate of 8 percent, over 20 percent of households engaged in agriculture fall below the poverty line. The sector’s high productivity<sup>35</sup> and high poverty rates is a reflection of the very small land holdings—with 90 percent of all farms between 0.1 and 4 hectares, and an average farm size of less than 1.5 hectares, limiting the scope for full time employment. Moreover, Lebanon’s agricultural sector is currently experiencing downward pressure on wage labor. The arrival of more than one million Syrian refugees seeking jobs in rural areas has contributed reduced wages in the agricultural sector. Furthermore, unlike other sectors, there is no legal restriction concerning agricultural labor and no minimum wage requirements for Syrian refugees. The huge amount of surplus labor yields the prospect of generating social tensions.

Figure 8. Household budget survey response rates by regions, 2011/2012



Source: CAS.

Figure 9. Self-assessed economic classes in Lebanon and comparators<sup>36</sup> (2013)



Source: World Bank staff calculation based on WVS, wave 6.

Note: Surveys were conducted in different years in different countries. “Do not know” and “no answer” were excluded from calculations. Middle class includes lower middle class, middle class and upper class. No definition of classes was provided to respondents.

**44. A 2011/12 Household Budget Survey was implemented, but several problems were encountered during data collection questioning reliability and representativeness of obtained data.**

<sup>35</sup> High productivity among small farms is relatively common in developing and emerging markets. While small farms are more productive than large farms, they still cannot get out of subsistence agriculture given their constraint on their land size, lack of rural advisory services, market imperfections (among others).

<sup>36</sup> Two comparators groups have been selected. The first includes countries with similar economic development—having 2010 GDP per capita in PPP within 10 percent of Lebanon’s (Azerbaijan, Belarus, Romania, Turkey, Mexico and Uruguay). The second includes MENA countries: Egypt, Tunisia, Jordan, Morocco and Libya.

The World Bank team is currently working with the Central Administration of Statistics (CAS) to explore ways to adjust for such high non-response rates.

*C.2. Insights on Poverty Based on Non-Traditional Surveys (2010-14)*  
(based on self-reported income and subjective wellbeing)<sup>37</sup>

45. **While the lack of reliable recent micro-data prevents carrying out traditional poverty analysis, valuable information on poverty can be obtained from other surveys.**<sup>38</sup> For example, surveys which capture subjective wellbeing provide an understanding of people's own assessment of their welfare. Further analysis of the respondents' education or employment characteristics also provides useful information on what Lebanese consider to be characteristics of households who consider themselves poor and those who do not.

46. **A striking and consistent result across all surveys is that, despite the 2007-10 record GDP growth, poverty remained elevated in Lebanon in the 2010s.** One striking result is that all three surveys yield poverty estimates that are very close (measured in different ways in different surveys), namely about 30 percent of population. In particular, about 30 percent of respondents from the World Values survey considered themselves as belonging to working or lower class in 2013 (Figure 9); about 29 percent of individuals from the Arab barometer survey in 2010 believed their households were in low income group and experienced significant difficulties in meeting their needs (Figure 39); and finally, 31.7 percent of households from a national financial literacy and capabilities survey had income per capita lower than the poverty line, which was taken from the 2004 multipurpose survey and inflated to 2012 prices.<sup>39</sup>

47. **Using individual demographic and socio-economic characteristics in conjunction with welfare status provides a general picture on poverty correlates.** In particular, according to the World Values Survey, being in the middle class (per subjective perception data) in Lebanon is associated with having tertiary education and having a full time job or being self-employed. The lowest likelihood of being in middle class is associated with being unemployed, a housewife and with no without formal education (Table 6 page 107). Similarly, better education and having a job have significant negative association with being in the bottom 40 percent of population based on self-assessed income situation (see results in Table 7 page 108). According to the Arab Barometer survey, the highest share of middle income households (self-reported) is observed among respondents working as employers of firms and professionals such as lawyers, teachers, doctors. The respondent groups (by employment status) that disproportionately reported being low income households were individuals employed as agricultural workers, housewives and those who are not employed (Figure 90 page 107).

48. **The survey on financial capability shows that income poverty is closely associated with demographic variables, as well as head of household's education and labor force status.** Thus, poverty is more pronounced among households with many children. In particular, the poverty rate increases from 24 percent in households without children to 88 percent in households with more than 4 children (Figure

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<sup>37</sup> Detailed results of the analysis along with description of the data are provided in the background note Vishwanath and Atamanov (2014) "Microdata and poverty measurement in Lebanon", World Bank.

<sup>38</sup> In the absence of recent microdata, having information from other surveys which have self-reported information on household income or/and people's perceptions about their wellbeing can be useful. In particular, three different sources roughly covering the period between 2010 and 2014 have been used: the World Values Survey, the Arab Barometer and the Survey on Financial Capability. All three surveys contain rich information on subjective wellbeing and individual/household characteristics of respondents. Self-reported income was collected in some of the surveys. Combining monetary information with subjective wellbeing helps to triangulate results using imperfect proxies for poverty in recent years.

<sup>39</sup> The average poverty line in 2004/05 was LBP2,172,000. Cumulative inflation between 2004/05 and 2012 was 51.1 percent.

A6). Being employed in the formal sector or being an employer decreases the likelihood of poverty. Finally, households with well-educated heads (tertiary education) have much lower chances of falling into poverty (Figure 95ab page 109).

### *C.3. Estimated poverty impact of the Syrian crisis (2012-14)*

49. **Part of the lack of progress in reducing poverty during the 2010s is the result of the Syrian conflict, which is estimated to have pushed thousands of Lebanese into poverty from 2012 to 2014.** In the absence of reliable and recent poverty data to assess the impact of the Syrian conflict on poverty, a global Computable General Equilibrium model named GTAP (Global Trade Analysis Project)<sup>40</sup> was used to simulate the impact of the Syrian conflict on poverty in Lebanon (World Bank, 2013e). These models have important shortcomings to estimate poverty<sup>41</sup> so the specific point estimates obtained should be understood as indicative ones. Shock variables included the headcount of refugees, the headcount of labor force, disposable income and real GDP. The Syrian crisis was projected to increase poverty among Lebanese population by 170,000 people by 2014 with existing poor being pushed deeper into poverty. The channels for the transmission of Syrian crisis are higher inflation (increase in domestic income and demand), fewer employment opportunities due to lower economic activity, and lower wages (excluding labor income of immigrants) mostly reflecting slower economic activity and a sharp increase in the labor force due to the influx of refugees.

### *C.4. Job creation and the Twin Goals*

#### *C.4.1. Growth, jobs and productivity*

50. **Lebanese see job creation as a critical factor towards reducing poverty and the third most important—especially for young people—for shared prosperity.** Moving out of poverty and improving the wellbeing of workers and their families in a sustainable way entails enhancing labor market opportunities. This is particularly the case in Lebanon where Lebanese stakeholders ranked job creation as the factor that would contribute most to reducing poverty (World Bank, 2014d).<sup>42</sup> Jobs drive development and are “not a by-product of economic growth” (2013 World Development Report (WDR)); jobs can be transformational along the following dimensions: (i) *living standards*: individuals around the world work their way out of poverty through improved livelihoods by their ability to earn a decent and reliable income stream; (ii) *productivity*: as workers improve the way they work and become more efficient, more productive jobs are created and less productive jobs are destroyed; and (iii) *social cohesion*: jobs gather people from different social and ethnic background and thus improve social cohesion. The 2013 WDR has also shown that the challenges and structural problems that impede the creation of decent jobs vary across countries.

51. **In Lebanon, unemployment, informality and poverty are strongly correlated pointing to a key role that jobs can play in reducing extreme poverty and promoting shared prosperity.** As detailed above, being poor in Lebanon is associated with being unemployed or engaging in low-

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<sup>40</sup> For the initial documentation of the GTAP model, see the book by Hertel (1997); for more recent literature and latest version of the model, see: <https://www.gtap.agecon.purdue.edu/models/current.asp>.

<sup>41</sup> For example, a global GTAP does not have the detailed modeling of the economy needed for a very precise estimation. Also, as the World Bank study was undertaken in August 2013, available data often did not include more than a few months when a large number of refugees were in Lebanon; some of the understanding of the channels through which the Syrian conflict would impact poverty might therefore not be fully captured.

<sup>42</sup> Other key factors, in decreasing order, were economic growth, social protection, rural development, public sector governance, equality of opportunity, education, anti-corruption, and balanced regional development.

productivity/informal employment. Not surprisingly, poverty rates are much higher among unemployed persons. However, incidence, depth and severity of poverty are the highest among non-salaried employees (El-Laithy et al., 2008).<sup>43</sup> Such employees constitute more than one third of the working poor, while another third of the working poor are self-employed. In contrast, salaried employees and employers have the lowest poverty incidence. This suggests a large extent of poverty among unskilled Lebanese in informal and low productivity employment, and large gaps in earnings between formal/skilled and informal/unskilled jobs. Expanding access to better jobs, and improving productivity and earnings of the bottom 40 percent of the population can significantly contribute to poverty reduction and promote inclusive growth in Lebanon.

**52. Lebanon faces a considerable employment challenge as economic growth has not translated into sufficient job creation.** Even during periods of relatively rapid economic growth, Lebanon experienced weak private sector job creation due to such factors as poor governance and weak infrastructure. Between 1997 and 2009, real GDP expanded at an average rate of 4.4 percent per year, yet employment grew only by 1.1 percent (World Bank, 2012a). This indicates an employment growth elasticity of only 0.2, which is considerably lower than those observed in other countries in the region. Insufficient job creation is one of the main causes of persistently high unemployment rates.

**53. The jobs created by the economy have been concentrated in low productivity sectors demanding low skilled workers.** The majority of jobs created in Lebanon are in low-productivity sectors (Figure 10). Between 2004 and 2009, the main contributors to net job creation were trade (61 percent) and low productivity services sectors (33 percent), followed by construction (10 percent). Agriculture and industry shed jobs and higher productivity services such as information and communication technologies or finance, have registered very little growth (only 5 percent of total net job creation). Two thirds of the employed are in trade and services and half of the labor force remains in the informal sector (Figure 11). One third of wage employees and almost two thirds of the self-employed are engaged in low productivity services (e.g., wholesale and retail trade, repair of motor vehicles, transportation and storage). High productivity services (e.g., information and communication, financial and insurance activities) employ only 14 percent of wage employees and 3 percent of the self-employed.

Figure 10. Job creation has been mostly in low productivity sectors

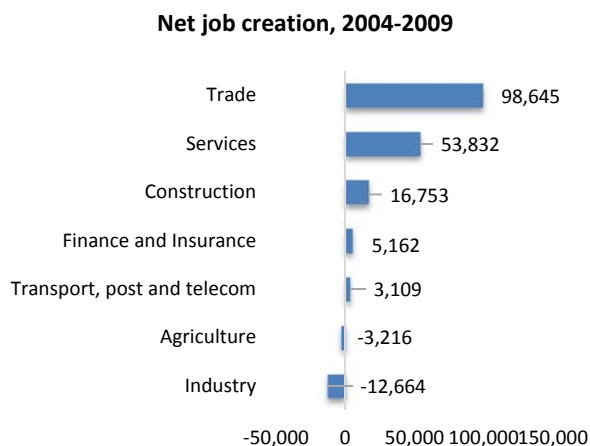
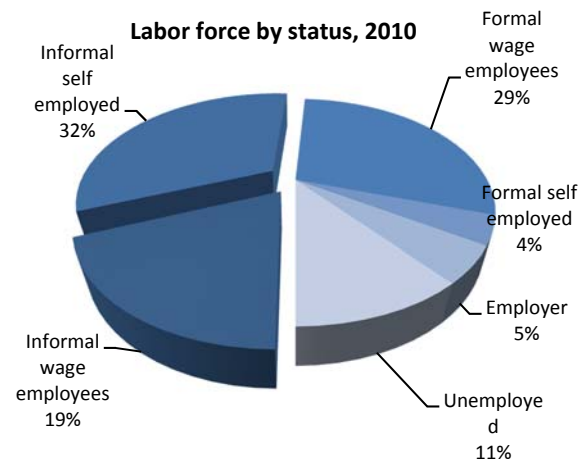


Figure 11. Half of the labor force is in the informal sector



Source: WB staff calculations based on data from CAS (left); Staff calculation based on Employee-Employer Survey 2010 for Lebanon (right).

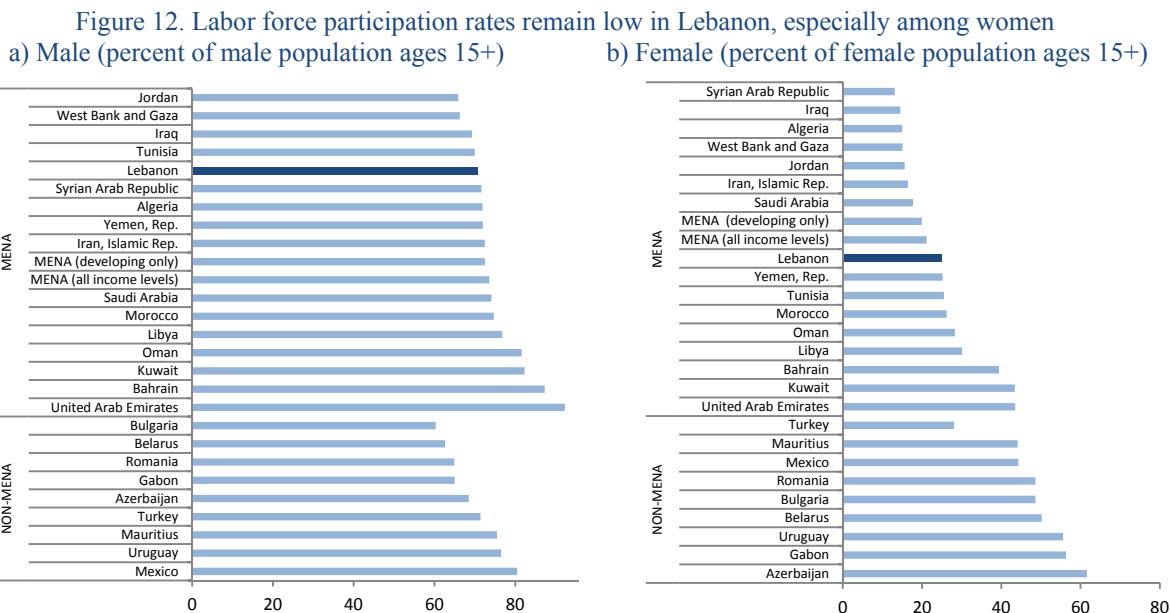
<sup>43</sup> Employee paid weekly, hourly or piece-rate basis.



### C.4.2. Demographics, labor force and migration

54. **Even though participation rates remain low, especially for women, the labor force has been growing in Lebanon both due to demographics and increasing participation.** The labor force has been growing robustly, in part driven by an increase in the working age population, but also due to slowly increasing labor force participation, particularly among women.<sup>44</sup> Lebanon continues to have low participation rate with less than half of the working age population participating in the labor market. The male labor force participation rate (70 percent) continues to be on the lower side compared to other MENA countries, but largely comparable with non-MENA countries with similar level of development (Figure 12a). Female labor force participation, on the other hand, is more in line with MENA averages, but lags significantly behind non-MENA comparators with the exception of Turkey (Figure 12b). Although current participation rates are low, particularly for women, they are on an upward trend.<sup>45</sup> Not taking into account the recent influx of refugees, 23,000 individuals, on average, enter the labor market each year. To absorb them, the economy would need to create more than 6 times the number of jobs it creates (on average, only 3,400 net jobs per year between 2004 and 2007).

55. **The influx of refugees from the ongoing Syrian conflict is having a profound impact on the socio-economic situation in Lebanon, exacerbating labor market conditions** (World Bank, 2013d). The (official) refugee influx has reached one quarter of the population of Lebanon, increasing already high unemployment and poverty. As a result of that influx, the labor force is expected to be increased by as much as 35 percent, with major changes taking place among women and youth. Because of the low level of education of the Syrian refugees, most will join the supply of low skilled workers, and informality is likely to increase as a result. Almost half of the Syrian refugee workers are involved in agriculture or domestic services, followed by 12 percent working in construction. Therefore, competition between Lebanese and Syrian workers for low-quality, low-skilled jobs will increase likely leading to higher unemployment and depressed wage incomes in this labor market segment.



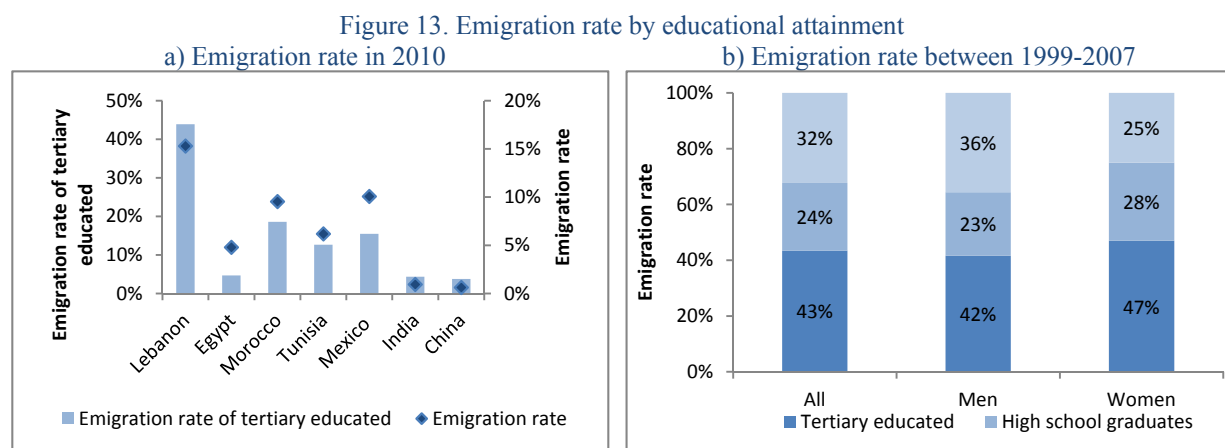
Source: WDI, Employee-Employer Survey 2010 for Lebanon. Note: Latest available year in 2000s.

<sup>44</sup> During 2004-2010, the labor force grew at an average annual rate of 2.2 percent. Half of which was explained by a growing working age population.

<sup>45</sup> Over the past decade, the total participation rate increased moderately, largely driven by increases in participation of women, especially young educated women (i.e., women participation rates have increased from 22 to 26 percent from 2004 to 2013).

56. **Emigration is a major source of access to employment and better economic opportunities for Lebanese.** About 15 percent of the Lebanese population is estimated to have emigrated (2010) mainly driven by the political instability in Lebanon and the search for better economic opportunities in foreign countries. Comprehensive studies on the situation of Lebanese migrants are scarce; existing evidence suggest that their employment opportunities improve markedly upon migration, but that some gender disparities persist. Analyzing the situation of Lebanese aged 18 to 35 who emigrated between 1992 and 2007, Kasparian (2009) finds that while 61 percent of migrant men were employed in Lebanon prior to their emigration, following emigration their employment rate reaches 91 percent. For women, however, employment only increases from 32 percent to 36 percent while inactivity rises by 9 points to 59 percent. Lebanese migrants also appear to be well integrated into the labor market of recipient countries even when compared to countries with historically high emigration and large diaspora.

57. **The high emigration rate of population with tertiary education could, in addition to the influx of Syrian unskilled labor, accentuate the scarcity of skilled labor.** Presented with the lack of high productivity/wage jobs at home and given lucrative opportunities for work abroad, as many as 44 percent of the tertiary educated Lebanese have emigrated (Figure 12a). While no quantitative impact assessment of these labor outflows on the Lebanese economy exist, such large emigration shocks are likely to have sizable effects on labor supply and wages. Evidence from Mexico shows that a 10 percent increase in emigration rate in a given skill group raises the wages of workers in that skill group by about 4 percent (Prachi, 2007). Given the differences in emigration rate across educational level and gender (Figure 12b), emigration could contribute to increase the wage gap across gender and skill groups and overall wage inequality in Lebanon. These high levels of emigration of the tertiary educated Lebanese could accentuate the scarcity of key skills and ultimately constitute a heavy drag on productivity and growth.<sup>46</sup> Studies point to a significant “brain drain” due to emigration (see Box 2).

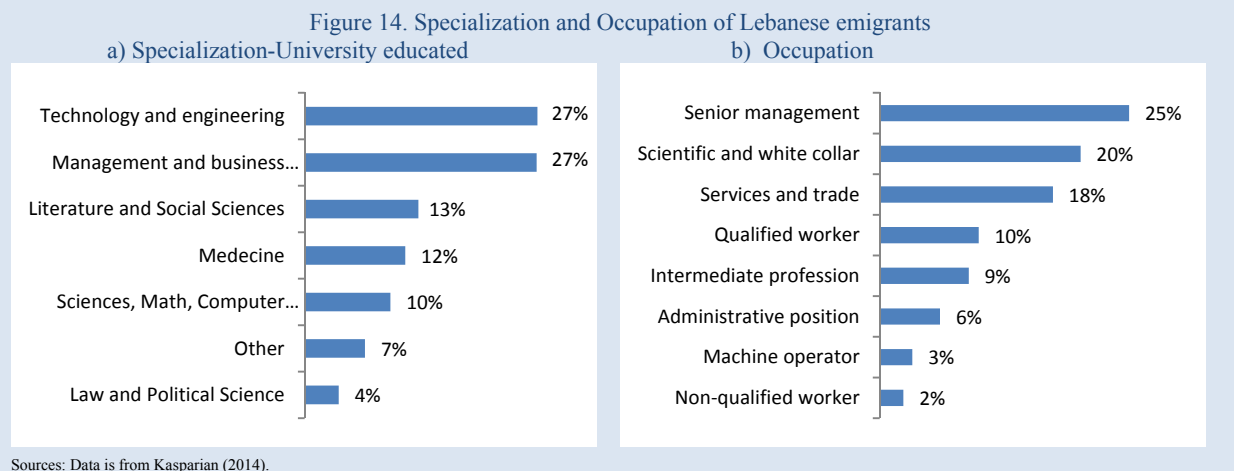


Source: Left panel is from the WDI. Right panel is adapted from Kasparian (2009) and shows the emigration rate between 1999 and 2007 by gender and skill group.

**Box 2. Educational and occupation profile of the Lebanese migrants points to a significant “brain drain”**

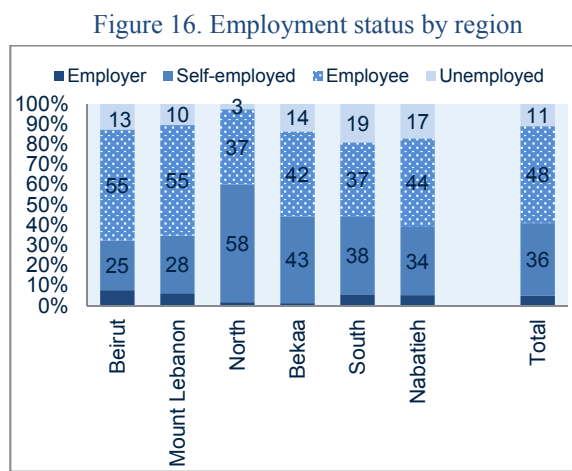
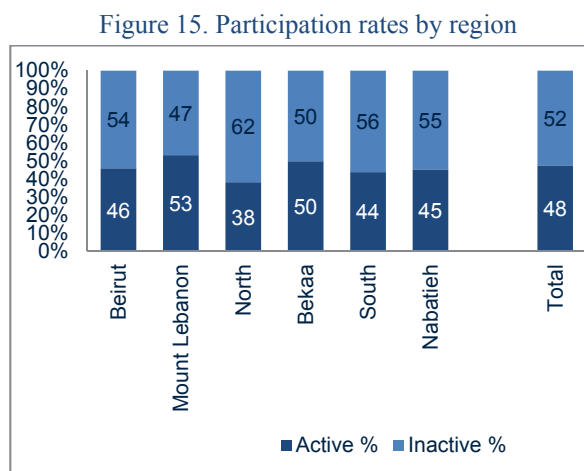
<sup>46</sup> While labor inflows into Lebanon (e.g., immigrant workers, refugees) could compensate for the high emigration among skilled workers, there is limited reason to believe this is the case. First, the profile of immigrant workers and refugees in Lebanon appears to be overall similar to the profile of the resident Lebanese population (World Bank, 2013d), indicating that such inflows are currently unable to close the skilled labor supply gap opened by emigration. Second, labor laws, in particular those geared towards managing the political and social impact of refugees from certain countries, limit the integration of refugee into the Lebanese labor market such as in high skill professional fields.

Kasparian (2014) finds that among Lebanese emigrants who undertook university studies (25 percent of emigrants in the sample study) about 26.6 percent were in engineering and technology and 9.8 percent studied sciences, mathematics and computer science. About 26.5 percent of university-educated emigrants specialized in management and business services, 13 percent in literature and social sciences and over 11 percent studied medicine (Figure 14a). Many occupy middle and senior management positions critical for operational efficiency and productivity (Figure 14b). A quarter of emigrants hold senior management positions, 20 percent are in scientific and other white-collar professions and 17 percent are in services with a majority of traders.



### C.4.3. Access to jobs

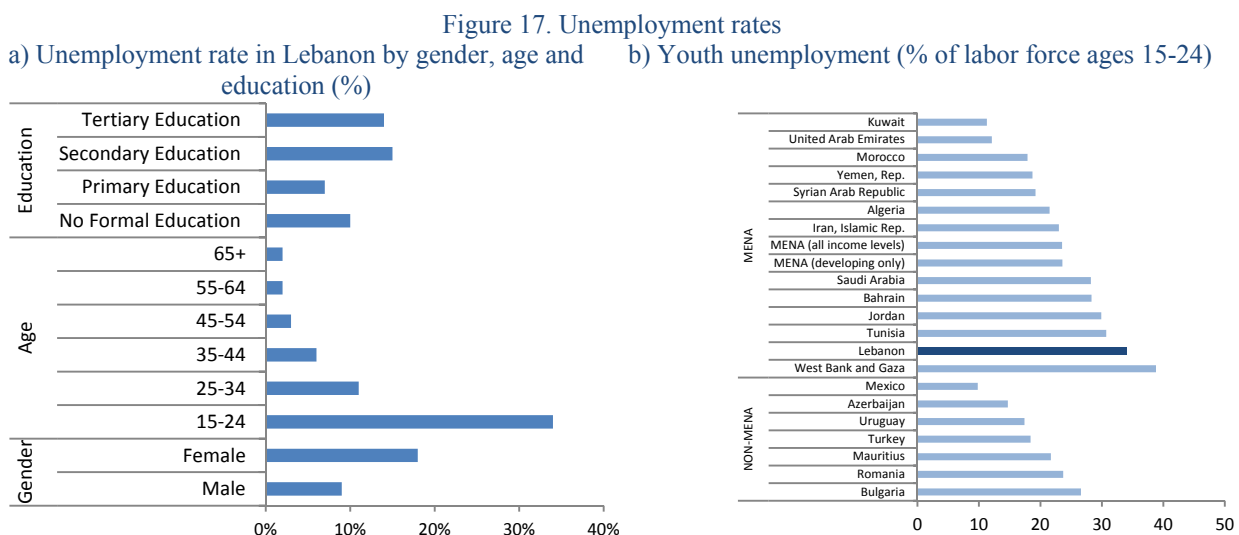
58. **Labor market outcomes and access to better jobs are uneven among population groups or regions.** Labor force participation rates, unemployment and type of employment (wage/self-employment, formal/informal) vary markedly across population groups (youth, women) and regions. More disadvantaged regions tend to have lower participation rates and higher unemployment, which could in part be due to spatial disparities in infrastructure and service delivery, identified earlier (Figure 15 and Figure 16 below). Participation rates are notably lower in the North, where labor force participation is lowest at 38 percent, and are somewhat lower in the South and Nabatieh. Unemployment is highest in the south of the country (South and Nabatieh). In the North the majority are self-employed, while in Beirut and Mount Lebanon, over half of the labor force is wage employees.



Source: Staff calculations based on data from CAS (left); Staff calculation based on Employee-Employer Survey 2010 for Lebanon (right).

59. **Unemployment is high, especially among women and youth, and is often of long duration** (Figure 17). Before the Syrian crisis unfolded, around 11 percent of the labor force was unemployed. Such high rates reflected in part long average durations of the unemployment (close to 13 months for men and 10 months for women). Unemployment rate among women is twice as high as among men. Youth unemployment rate (34 percent) is alarmingly high even by regional standards and especially compared to other countries outside MENA. Current unemployment rates are likely to be significantly higher given slower economic growth and impact of the Syrian conflict.

60. **Informality remains a salient feature of the Lebanese economy and labor markets, particularly for the poor.** Half of the labor force in Lebanon is in the informal sector: 20 percent are in the informal wage employment while another 30 percent are self-employed lacking access to social security (World Bank, 2012a). The informality rate is significantly lower for the wealthier segment of the Lebanese population as 74 percent of individuals in the poorest quartile of earnings are informal wage employees while the share of informal employees is only 15 percent among individuals in the highest quartile (Gatti et al., 2013; Figure 18). Informality is both associated with poorer working conditions<sup>47</sup> and presents a constraint to running a formal business.<sup>48</sup> Hence, quality of jobs in Lebanon overwhelmingly continues to be poor, especially for the more disadvantaged workers, and business environment remains challenging in light of high informality. Most informal workers are involved in small retail trade, personal and vehicle repair services. About 66 percent of informal firms are engaged in the selling of food, clothes, household items, electronics and other goods.



Sources: WDI, Employee-Employer Survey 2010 for Lebanon. Note: Latest available year in 2000s.

61. **Earnings inequality is high in Lebanon and labor mobility low.** Given differences in access to job opportunities and significant education and skill premiums, earnings inequality is high in Lebanon.<sup>49</sup> There is a significant wage disparity both across employment statuses and within (Figure 19). Informal

<sup>47</sup> In terms of working conditions, evidence suggests that formal workers have access to better benefits (e.g., annual leave, maternity and sick leave) and better job quality (e.g., higher earnings, having a written contract, longer employment tenure).

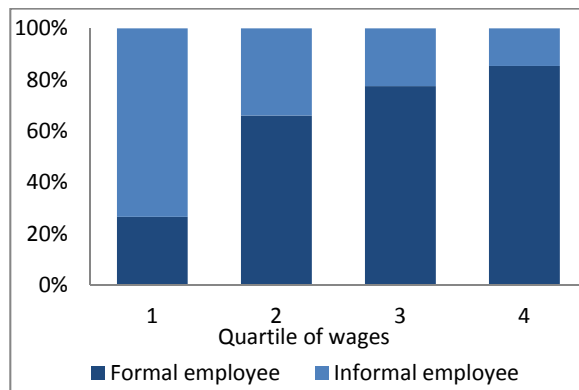
<sup>48</sup> Fifty three percent of business owners and top managers identify competition against unregistered / informal firms as a major constraint in Lebanon, as opposed to 28 percent in the MENA region. Disaggregated further, this appears to be the biggest constraint in more rural areas (and specifically North Lebanon where informality rates are higher (Enterprise Survey Data, 2013/14).

<sup>49</sup> Other things being equal, having higher tertiary education increases hourly wages by 32 percent for men and 52 percent for women relative to having only primary education. Cognitive skills have a positive effect in addition to the effect of education (World Bank, 2012a).

employees have the lowest earnings and their earnings are more compressed. Those in the top quintile earn, on average, about 3.3 times more than those in the bottom quintile. Formal employees earn significantly more compared to the informal employees, and those in the top quintile have wages 3.6 times higher, on average, than those in the bottom quintile. Self-employment earnings are the most varied (the ratio of mean earnings in the top quintile to the bottom quintile is 4.5) given the diverse nature of self-employment. Consistent with this, self-employed in the bottom quintiles generally earn less than the formal employees, while the situation is reversed for the top two quintiles of respective earnings distributions. Labor mobility is low with transition rates from one status to another (for example, informal to formal or self-employed to wage employee) at less than 10 percent.<sup>50</sup>

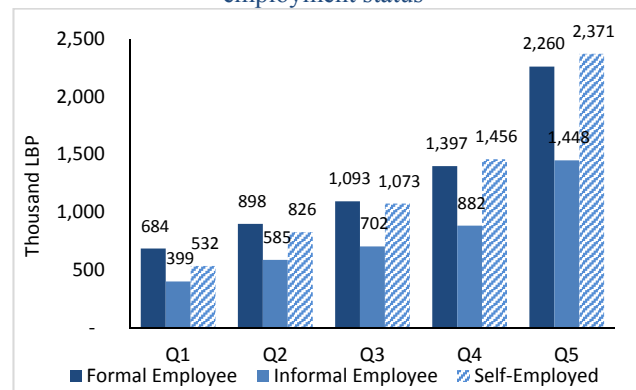
**62. Education levels are strongly correlated with having better private sector jobs, but job search constraints and connections (“wasta”) may inhibit labor mobility and job access** (Figure 20). Overall education levels in the labor force remain low (42 percent have primary or less education) with great variation by employment status and sector of work. More than half of the self-employed have primary education or less compared to just 27 percent among wage employees. This is not surprising given that the overwhelming majority of self-employed work in low-productivity/low-paying jobs. In contrast, more than 40 percent of wage employees have tertiary education and this share reaches almost 75 percent among wage employees working in high productivity services in the private sector.<sup>51</sup> While there appears to be a strong correlation between educational attainment and access to high productivity/high wages private sector jobs, additional barriers and constraints related to job search and connections may inhibit labor mobility. For instance, in Lebanon personal contacts remain the most prevalent mechanism to find a job. Furthermore, connections also appear to play an important role in hiring, especially in the public sector.

Figure 18. Informality is higher among the poor



Source: Staff calculation based on Employee-Employer Survey 2010.

Figure 19. Mean monthly earnings by quintiles and employment status

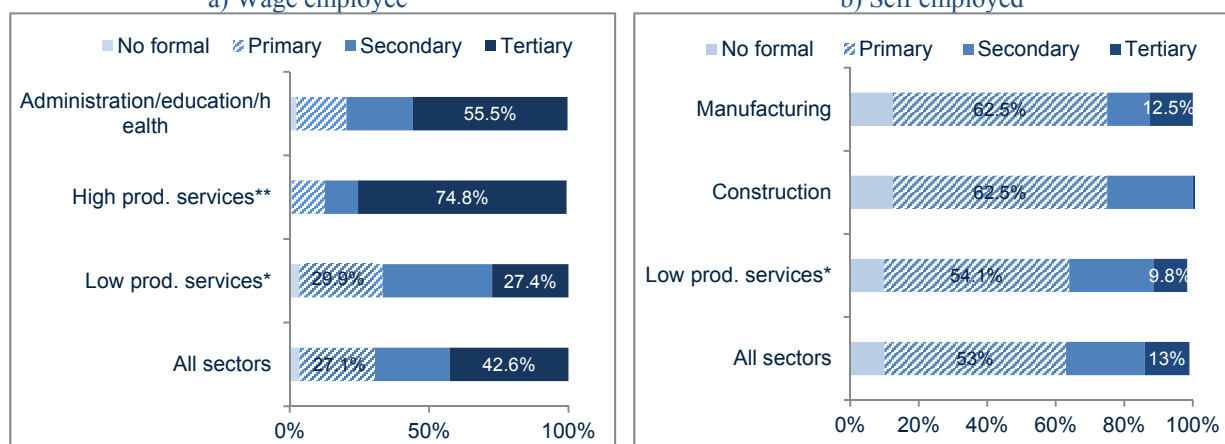


Source: Staff calculation based on Employee-Employer Survey 2010.

<sup>50</sup> On a month to month basis over December 2007-2010 (World Bank, 2012a).

<sup>51</sup> Beyond formal education, cognitive skills appear to have additional positive effects on earnings for wage employees, while non-cognitive skills affect the likelihood of working in the informal sector (World Bank, 2012a).

Figure 20. Education levels by employment status and main sectors of employment in the private sector



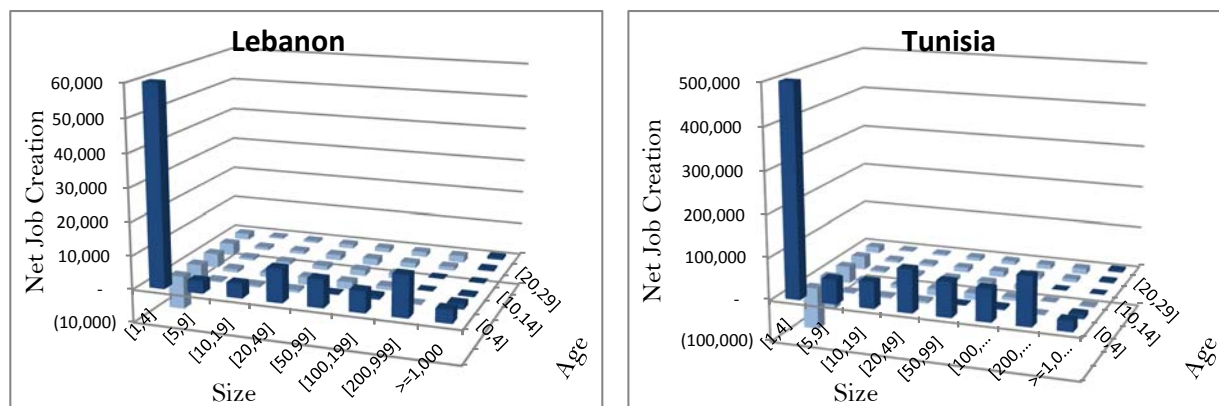
Note: \* wholesale and retail trade, repair of motor vehicles; transportation and storage, accommodation and food service activities, real estate activities; \*\*information and communication; financial and insurance activities; professional, scientific and technical activities.

Source: Employee-Employer Survey 2010 for Lebanon.

#### C.4.4. Jobs dynamics at the firm level

63. **Younger firms and more productive firms have been the main engines of formal job creation in Lebanon.** Recent evidence on the firm-level determinants of job creation shows that in Lebanon—as in most countries in the region as well as in high-growth economies—it is younger firms and more productive firms that create more jobs (World Bank, 2014j). Figure 21 below illustrates this finding in the case of firm age. It shows that, while older firms tended to shed workers both in Lebanon and Tunisia, net job creation was positive for firms in their (first four years) startup period. Micro-startups—firms between 0 to 4 years of activity and with less than 4 workers—generated about 66,000 jobs in Lebanon between 2005 and 2010, accounting for 177 percent of aggregate net job creation. The second largest number of jobs (12,000) was created by young large firms with 200-999 employees.

Figure 21. Younger firms create more jobs



Source: From World Bank (2014). The graphs show net job creation in Lebanon from 2005-2010 and in Tunisia from 1996-2010. Size-age categories that created jobs are in dark blue while categories that shed jobs are in light blue.

64. **Startups grow faster during the first years of operation, but below potential pointing to the presence of substantial constraints to startup growth in Lebanon.** Young firms grow and expand employment faster than older firms. In Lebanon, firms aged 2 to 4 years increased their employment by 19 percent per year during their first two years of operation while employment among firms 25 years and above grows by 12 percent (Figure 22). Yet employment growth among young firms in Lebanon is below potential

when compared to other countries in the region. In Morocco for instance, firms 2 to 4 years increase their employment by 25 percent during their first two years of operation while for firms 25 years and above employment growth is virtually similar to firms in Lebanon. The loss in employment is substantial; assuming that 1,000 firms under 2 years old start with an average of 4 workers and operate for two years, they would create 293 less jobs per year in Lebanon than in Morocco.<sup>52</sup>

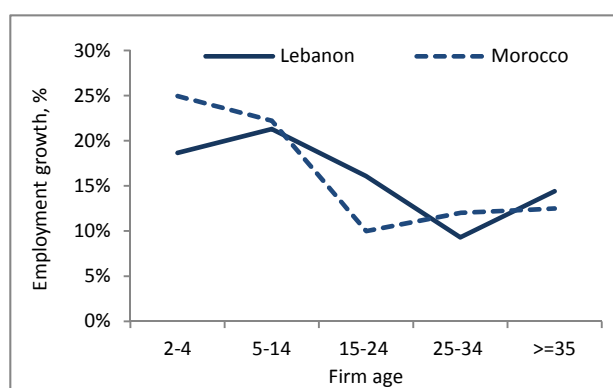
Table 2. More productive firms create more jobs  
(Dependent variable is firm employment growth)

	Lebanon (All sectors)	Tunisia (All sectors)	Turkey (All sectors, 20+)	Egypt (Manuf., 10+)	WBG (All Sectors)
Labour Productivity	0.039***	0.029***	0.007***	0.007	0.022
Controlling for firm size and age	Yes	Yes	Yes	Yes	Yes
No. of Observations	141,061	129,516	176,665	7,925	3,075
R-Squared	0.4	0.34	0.03	0.1	0.41

Source: From World Bank (2014d). Notes: The dependent variable is firm employment growth defined using the Davis-Haltiwanger-Schuh growth rate. Regressions are weighted by the average size of firms over the growth period. \*\*\* indicates significant at the 1 percent level. Job growth is measured annually and productivity is measured in the beginning of the period. In Egypt, data include manufacturing & mining establishments with at least 10 employees; in Turkey, firms with at least 20 employees are considered. The estimation periods are 2005-10 in Lebanon and Turkey, and 2007-11 in Egypt. Labor productivity in Egypt is significant at the 1 percent level when the job creation rate measured over the 4-year period is regressed on initial labor productivity in 2007.

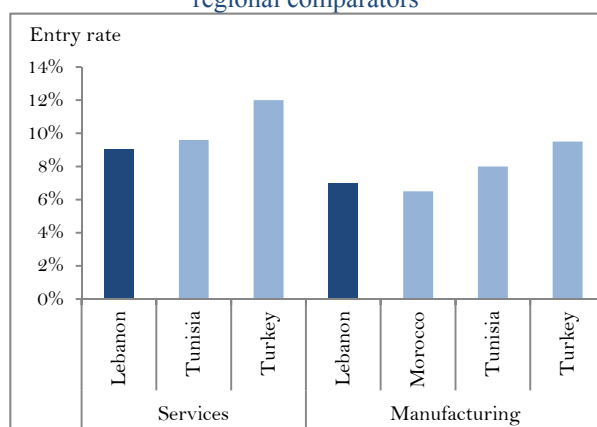
65. **However, weak firm entry and productivity growth still constrains job creation.** In addition to firm age, firm productivity is a key determinant of job creation (World Bank, 2014d). In Lebanon a 1 percent increase in firm productivity raises job creation by 3.9 percent which is one of the highest elasticity of job creation to productivity in the region (Table 2). Consistent with these findings, fast growing firms—the so called “gazelle” firms—are more productive and younger than non-gazelle firms. However, firm entry and productivity growth were too weak—partly due to barriers to entry—to unleash faster job creation in Lebanon. Firm entry rates in the manufacturing and services sectors in Lebanon are low relative to regional comparators (Figure 23). For instance the entry rate of new services firms is only 9 percent in Lebanon compared to 9.6 percent in Tunisia and up to 12 percent in a fast-growth economy such as Turkey.

Figure 22. Young firms grow faster but below their potential



Source: World Bank staff calculations from Enterprise Survey data; 2013 survey for Lebanon and 2007 survey for Morocco. Annual

Figure 23. Firm entry in Lebanon is low relative to regional comparators



Source: Adapted from World Bank (2014j). Entry rate is the share of new firms in a given year over the number of firms in the previous

<sup>52</sup> In this scenario, the aforementioned firms would create 760 jobs in Lebanon and 1,000 jobs in Morocco during the first year (difference of 240 jobs). During the second year, they would create an additional 904.4 jobs in Lebanon and 1250 in Morocco (difference of 345.6 jobs). The average difference in the number jobs created in the first two years is 292.8.

employment growth rates were calculated using firm employment level during the survey year and two years prior to the survey.

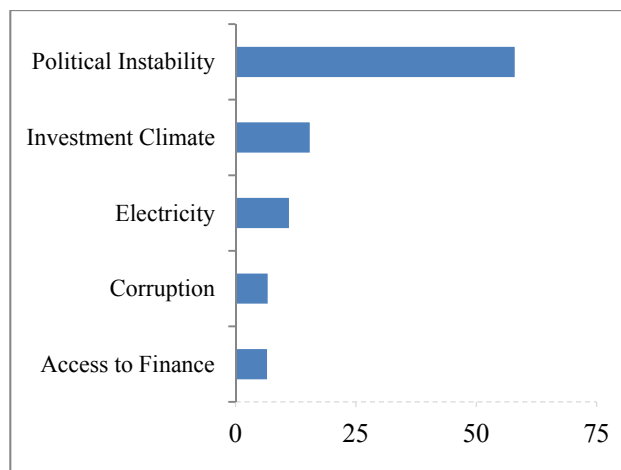
year. The data time coverage is 2005-2010 in Lebanon, 2005-2010 in Turkey, and 2007-2011 in Egypt.

#### C.4.5. Constraints to firm entry, growth, and formalization

**66. Businesses identify political instability, the investment climate, electricity, and corruption as the chief obstacles to their operation and growth.** Political instability ranks, by far, as the most severe constraint on firms’ ability to run their operations and grow (with 58 percent of firms reporting it as such). The second leading obstacle is the weak “investment climate”<sup>53</sup> with 15 percent of firms identifying it as a major or severe constraint followed by electricity (11 percent), corruption (7 percent) and access to finance (7 percent)—Figure 24. This ranking of major constraints remain the same across the different cuts of data (firm age, size, sector and location), although the percentages vary with larger shares of youngest firms and medium sized businesses and those operating in North Lebanon and in the services sector Greater Beirut and South Lebanon listing political insecurity as the predominant constraint. It should also be noted that some of these constraints are not mutually exclusive. For instance, political instability weakens institutions and could undermine transparency and accountability thereby fueling corruption and poor service delivery.

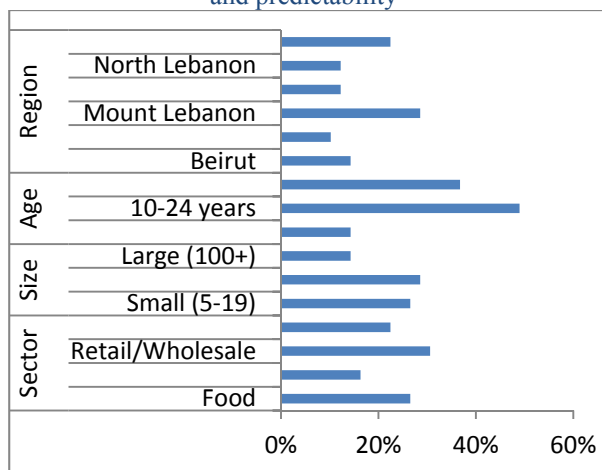
**67. Many firms have to pay bribes to get services such as operating licenses, construction permits or import licenses.** Firms in Lebanon face demands for bribes or feel that a payment is needed when they engage in most operational activities such as construction (42 percent of firms report expecting to give a bribe), obtaining electrical connection (17 percent) or operating license (12 percent). This contributes to limiting competition, and the entry and expansion of firms that are unable to circumvent such barriers. The high incidence of bribe payment and corruption is closely linked to the multitude of licenses and authorization requirements as well as unclear laws and regulations which often lead to discretionary policy implementation. This ultimately accentuates the barriers to business creation and growth that such licenses and authorization requirements constitute and leads to competition and private sector growth.

Figure 24. Obstacles to firm operations and growth



Source: WB staff calculations from Lebanon Enterprise Survey 2013/14. Figures are survey-weighted. Top five national-level obstacles shown. Investment climate indicator pools eight relevant indicators (tax rates and administration, customs and trade regulations, licenses and permits, labor regulations, courts, access to land, informal practices).

Figure 25. Policy implementation lacks consistency and predictability



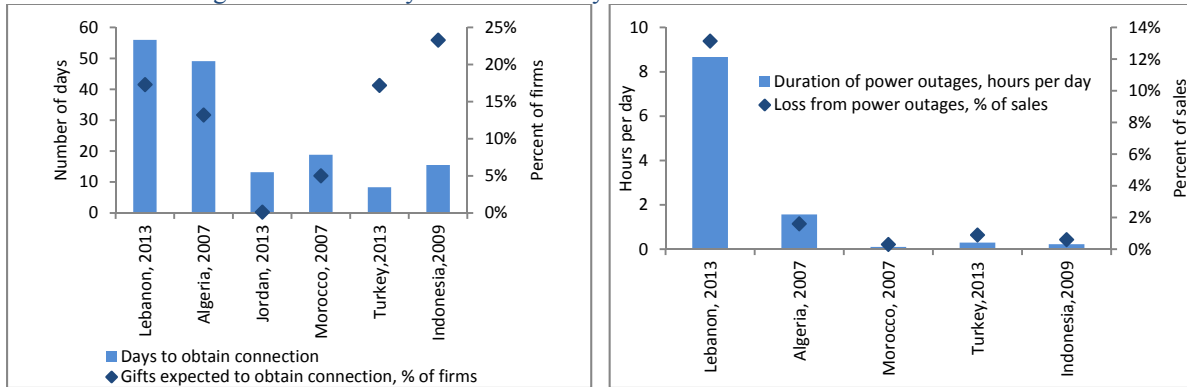
Source: WB staff calculations from Lebanon Enterprise Survey 2013/14. Figures are survey-weighted.

<sup>53</sup> This composite category termed “investment climate” comprises tax rates and administration, customs and trade regulation, labor regulations, licenses and permits, access to land, courts and informal practices.



68. **Entrepreneurs in Lebanon find regulatory and policy implementation uncertainty to be a significant impediment to business operations.** Medium-aged and medium sized firms are particularly negatively impacted as are those firms located in Mount Lebanon and in retail and wholesale business activities (Figure 25). However, this appears to affect smaller firms and those outside the capital city to a larger degree. As a consequence firm managers spend, on average, over 12 percent of their time dealing with various government entities. The lack of clarity in laws and regulations opens the doors to discretionary implementation and leads to red tape and corruption, and limits potential for firm growth and investments.

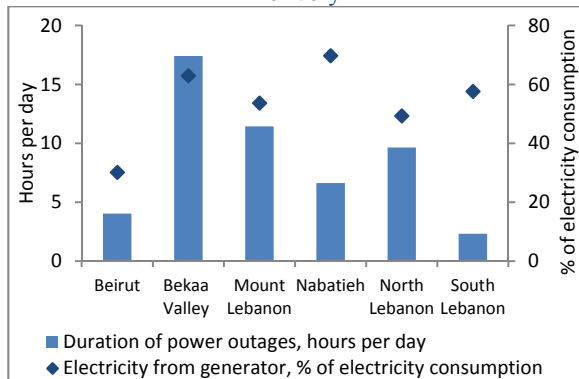
Figure 26. Electricity Service Delivery is Poor and Undermines Firm Performance



Notes: Authors' calculations from Lebanon Enterprise Survey 2013.

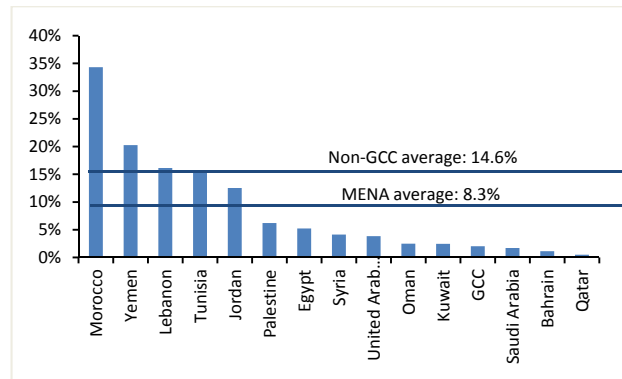
69. **Firms face poor electricity service delivery, with significant regional variation, and incur large losses as a result.** Firms in Lebanon have to wait 56 days to obtain an electricity connection upon submission of their application, compared to 13 days in Jordan and 19 days in Morocco (Figure 26). Once connected, firms receive very poor service. They experience over 50 power outages per month of an average duration of 5.2 hours which is about 8.7 hours per day. The impact on businesses is large; the average firm loses 6 percent of its sales because of power outages. Poor electricity service delivery masks large differences in service quality across regions. Firms in Beirut and South Lebanon experience on average 2 to 4 hours of power outages per day compared to 11 hours per day in Mount Lebanon and up to 17 hours in Bekaa Valley (Figure 27).<sup>54</sup>

Figure 27. Spatial Differences in Electricity Service Delivery



Sources: WB staff calculations from Lebanon Enterprise Survey 2013/14.

Figure 28. Access to finance and SMEs and Large Firms

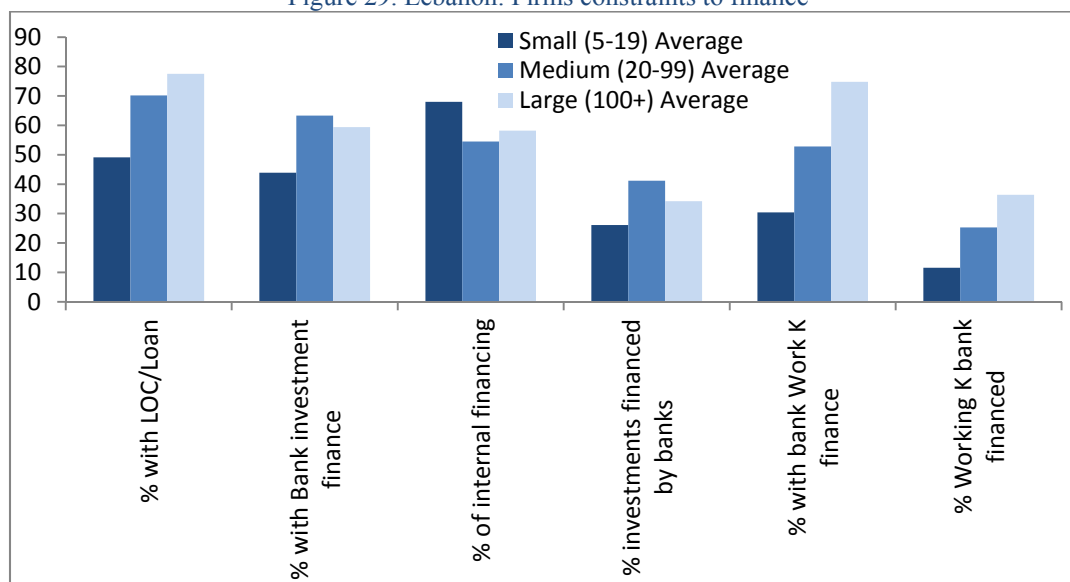


Sources: World Bank and Union of Arab Banks (2010).

<sup>54</sup> Firms adopt various costly coping strategies such as such as producing electricity with power generators; over 91 percent of firms own or share a power generator. Outside Beirut power generators provide over 50 percent of firms' electricity consumption. In the Bekaa valley and Nabatieh, firms draw 62 percent, respectively 69 percent, of their electricity needs from generators

70. Although Lebanon performs well regionally in lending to SMEs, it's banks' conservative lending policy limits access to credit although this is partially mitigated by incentive programs of the Government and the *Banque du Liban (BdL)*. The share of SME loans as a percentage of total banks' loans is around 16 percent in Lebanon, the highest share in MENA after Morocco at 34 percent and Yemen at 20 percent (Figure 28; World Bank and Union of Arab Banks, 2010). Lebanese firms depend significantly on the banking sector for their financing, as 53 percent of all firms, 50 percent of small firms and 63 percent of medium-sized firms report having contracted a bank loan. Overall, domestic commercial bank finance account for 24 percent of firms' working capital finance and 39 percent of their investment finance. These results are due to various incentive and support programs to SME lending provided by the GOL and BdL since 2000, for example subsidizing interest payments of SME borrowers, extending special guarantees to SMEs, and granting exemptions on compulsory reserves of creditors.<sup>55</sup> It is unclear how much of this business would appeal to the commercial banks in the absence of these incentive programs. In many markets internationally, despite the absence of extensive incentive programs SME finance has proved a profitable business for those banks that have developed expertise to address the specific risks associated with the sector. Notwithstanding the considerable government and BdL support programs, access to credit remains among the top constraints to business and growth as identified by Lebanese firms. In addition, accessing credit remains a challenge especially that the value of required collateral remains significantly high, 166 percent of loan value on average, and around two thirds of enterprises in the ICA sample reported that their most recent loan required collateral (World Bank, 2010d).

Figure 29. Lebanon: Firms constraints to finance



Sources: WB staff calculations from Lebanon Enterprise Survey 2013/14.

71. Notwithstanding a relatively favorable overall access to finance environment, important gaps remains. Smaller firms, in particular, have a reduced reliance on banks to finance business needs. This transpires through a reduced dependence on bank lines of credit and loans, a smaller proportion of

<sup>55</sup> An example of one of the region's most successful Credit Guarantee program is Kafalat, a Governments (and donor) subsidized loan guarantee scheme aiming at improving access to finance amongst SMEs. According to ICA, Kafalat reached a significantly high percentage of surveyed firms (38 percent). The majority of ICA firms with a Kafalat guarantee were still required to have substantial collateral. This is an important challenge and obstacle for small and start-up firm. The main benefit of Kafalat guarantee for all ICA firms was the longer-term type of lending. Small firms, in addition, paid lower interest rates, thus reducing their cost of financing (World Bank, 2012g).

investment and share of bank financing in investment and working capital, together with increases in internal financing sources (Figure 29). Insofar as the smaller companies tend also to be younger, might have weaker collateral, and limited financial track record, their access to bank financing can be particularly challenging. As noted earlier and detailed in World Bank (2014j), younger firms are the main engines of job growth in Lebanon so relieving their financing constraint is particularly important for achieving the Twin Goals of poverty reduction and shared prosperity. In that regard, the recent launch of the *BdL* Circular 331 initiative designed to make up to USD400 million of non-bank financial products including the provision of start-up equity available, plus a complementary IBRD-supported initiative by Kafalat to provide even earlier high risk seed capital are particularly welcome.

**72. The majority of informal firms are small, Lebanese owned and managed by those with relatively low educational attainment.** The average informal firm has USD 2,455 of sales per month. Median monthly sales are USD 995 indicating that there are, however, large differences across firms.<sup>56</sup> Firm with less than 4 employees dominate the informal sector, representing over 91 percent of all firms (Figure 30). The majority of informal firms are managed by the Lebanese (about 87 percent), followed by Syrians (8 percent) and Palestinians (4 percent). Educational attainment among informal firm owners is unsurprisingly relatively low: 46 percent have only primary education and 9 percent have no education, while only 16 percent have tertiary training.

**73. Informal firms identify increased lower priced competition and corruption as the most severe constraints to their operation and growth.** Fifty three percent of informal firms surveyed report that lower priced competitors is the biggest obstacle to their ability to run their operations and grow (Figure 31). The second leading obstacle is corruption with 22 percent of firms identifying it as a major or severe constraint followed by access to finance (8 percent). The poor supply of electricity is particularly problematic for informal firms engaged in small manufacturing activities. For instance about 76 percent of bakeries cite electricity as a major or severe constraint. Other constraints do not appear to disproportionately affect some sectors over others.

Figure 30. Size of Informal Establishments

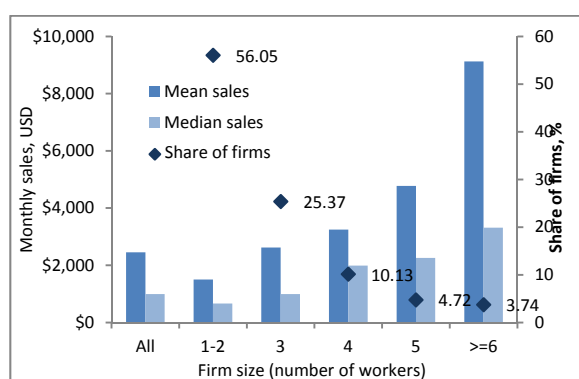
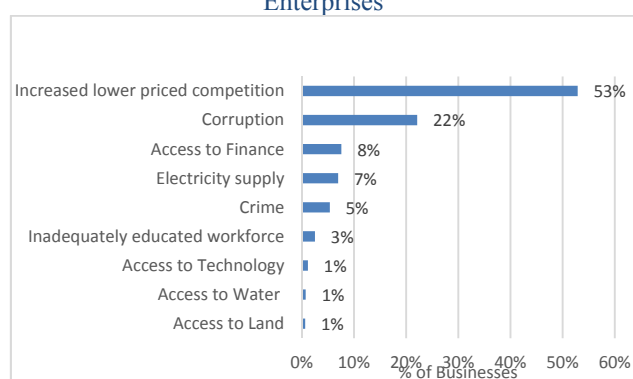


Figure 31. Biggest Obstacles to Operations of Informal Enterprises



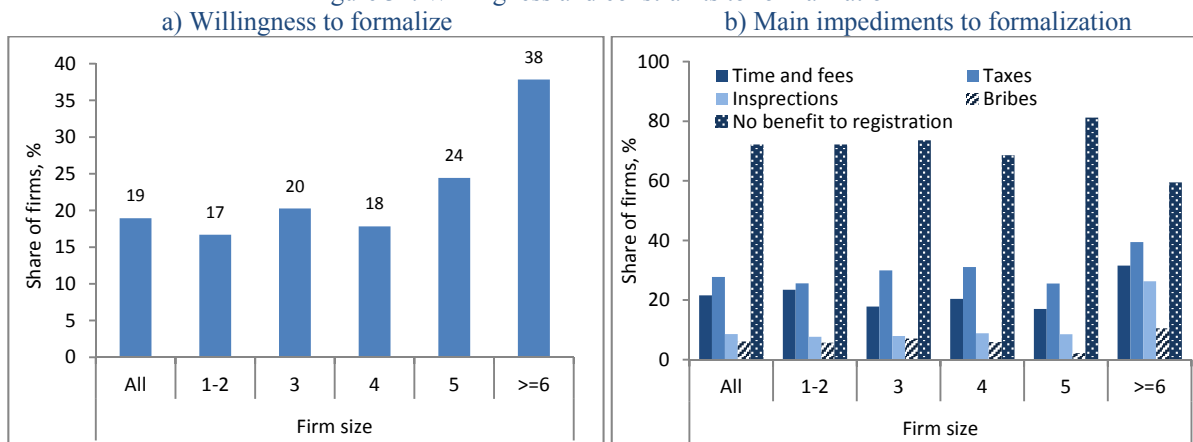
Sources: World Bank staff calculations from Lebanon Enterprise Survey – Informal Sector 2013/14.

**74. Willingness to register and formalize activities is low, particularly among small firms because of limited perceived benefit to registration** (Figure 32a). Among larger informal firms the time, fees, taxes and inspections that registering involves also matter for firms’ decisions to remain informal, indicating

<sup>56</sup> One or two-person firms—which account for 56 percent of informal firms—have an average monthly sale equal to about USD 1,500. Average monthly sales reach over USD 9,000 for informal firms with 6 or more workers but such firms account for 3.74 percent.

a propensity to opt out of the formal sector as a mechanism to escape policy enforcement. About 72 percent of informal firms report that they do not register their firm because of no real benefits to registration (Figure 32b). The other main reasons for not registering are the time and fees involved with the process (21.6 percent) and higher taxes (27.7 percent). Impediments to formalization related to time and fees, higher taxes, more inspections and meetings with government officials appear more important for larger firms. Among firms with 6 workers and more, 59.5 percent consider that there is no benefit to registering their firm, 39.5 percent do not want to register their firms because of higher taxes, 32 percent because of the time and fees involved and 26 percent because of more inspections and meetings with government officials. These findings indicate that informal firms in Lebanon choose to opt out of the formal economy in order to fall below the radar screen of enforcing authorities given a low opportunity cost of informality.

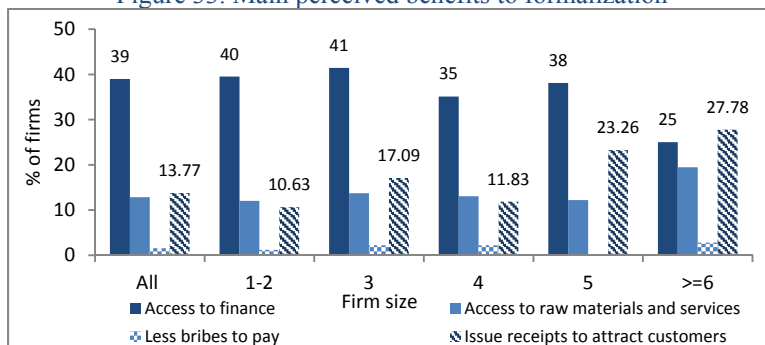
Figure 32. Willingness and constraints to formalization



Source: WB staff calculations from Lebanon Enterprise Survey – Informal Sector 2013/14.

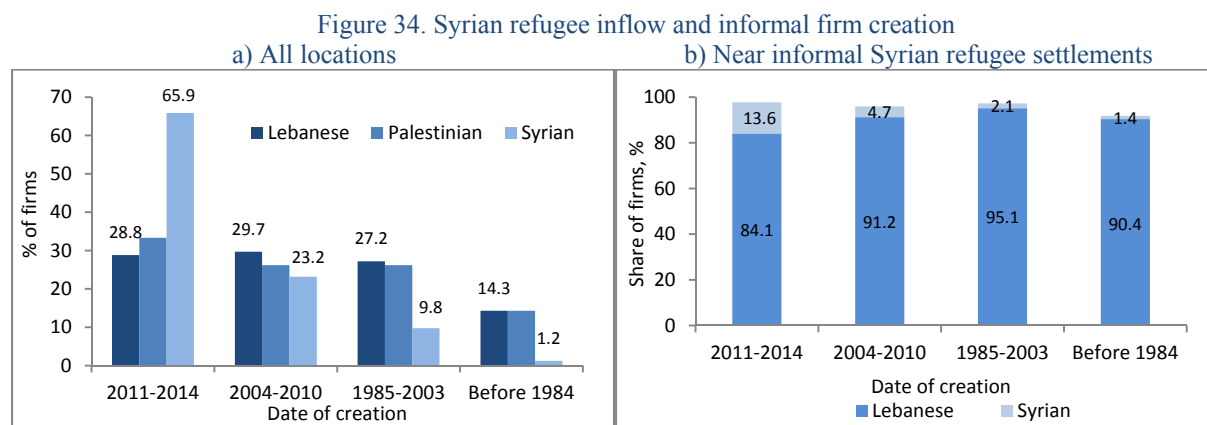
75. **Programs to increase formalization would be more impactful if combined with policies to improve access to finance, reduce taxes and simplify tax procedures for small firms.** The main benefits to formalizing as perceived by informal entrepreneurs is in improving access to finance (39 percent of firms), in the ability to issue receipts and attract customers (13.8 percent of firms) and in better access to raw materials and government services (12.8 percent of firms)—Figure 33. Few entrepreneurs expect formalization to reduce bribe payments. Smaller firms see larger benefits in improving access to finance with formalization. Among larger firms the ability to expand the client base through the emission of receipts that would come with formalization also plays a significant expected benefit. These findings suggest that policies to increase formalization would have higher impact if they are combined with programs to improve access to finance among newly formalized businesses as well as measures to reduce taxes and simplify tax procedures for small firms.

Figure 33. Main perceived benefits to formalization



Source: WB staff calculations from Lebanon Enterprise Survey – Informal Sector 2013/14.

76. **The inflow of Syrian refugees led to an increase in Syrian owned informal firms, but there is little evidence of displacement of Lebanese firms.** About 66 percent of all informal businesses managed by Syrians were opened after 2011 compared to 29 percent of businesses managed by Lebanese indicating that the onset of the conflict in Syria and the resulting inflow of refugees led to the creation of many informal businesses in Lebanon. However, there is little evidence that Syrian-managed informal businesses displaced Lebanese businesses. The shares of Lebanese-managed informal businesses created in 2004-2010 and in 2011-2014 are virtually equal. In locations close to informal Syrian refugee settlements, informal businesses managed by Syrians represent 13.6 percent of businesses opened between 2011 and 2014 compared to 4.7 percent for businesses opened between 2004 and 2010, but Lebanese businesses still account for over 84 percent of the new businesses near these Syrian settlements (Figure 34b).



Source: WB staff calculations from Lebanon Enterprise Survey – Informal Sector 2013/14.

### *Diaspora and remittances*

77. **Thanks to their strong economic standing abroad and deep ties at home, emigrants support relatives through large, relatively frequent and stable remittances.** Lebanon has the largest inflow of remittances than any other country of similar size (Figure 35a).<sup>57</sup> Remittances from emigrants residing in Arab countries play a significant role followed by North America, Western Europe and Africa (Figure 35b).<sup>58</sup> Remittances are frequent and stable, especially for emigrants who have children or parents in Lebanon. About one in every four emigrants remits regularly; about 96 percent of emigrants who are household heads and have spouses and children in Lebanon remit regularly. About 44 percent of migrants who have their parents at home remit regularly. Less frequent remittances are more common among emigrants with only brothers or sisters in Lebanon or lesser blood relationships (Figure 36a). While the frequency of remittances is lower for the diaspora who left Lebanon decades ago and is well established abroad, it remains substantial (Kasparian, 2014). About a third of emigrants who left less than 10 years ago remit regularly compared to about 17 percent for those who left over 25 years ago (Figure 36b).

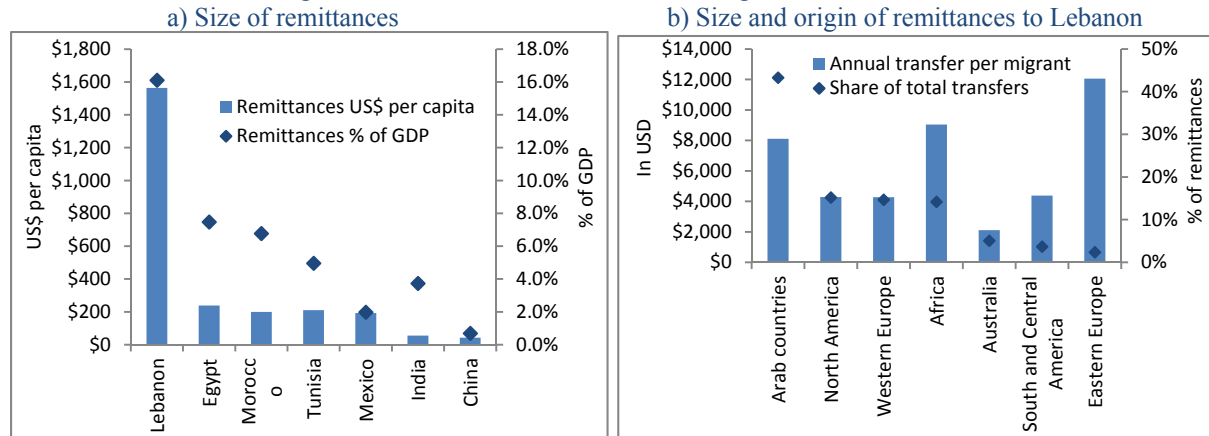
78. **Remittances contribute largely to investments in education and health of Lebanese households thereby supporting human development and the skills of the next generation.** Remittances support household invest in education, their impact is significant at all levels, from primary school to university. About 39 percent of remittance-receiving households partially or fully rely on these transfers to

<sup>57</sup> Remittances were 1,600 USD per capita or 16 percent of GDP in 2012 followed in MENA by Egypt (238 USD per capita, 7.5 percent of GDP) and Morocco (200 USD per capita, 6.8 percent of GDP).

<sup>58</sup> Kasparian (2014) finds that emigrants from Arab countries are the leading source of remittances followed by emigrants in North America, Western Europe and Africa.

finance primary school education. This number reaches 46 percent for tertiary education (Figure 37a). The contribution of remittances to health care is also significant. Among remittance-receiving households 24 percent rely on remittances from abroad to pay for medications compared to 4 percent who rely on remittances from within Lebanon (Figure 37b).

Figure 35. Remittances from Lebanese emigrants around the world

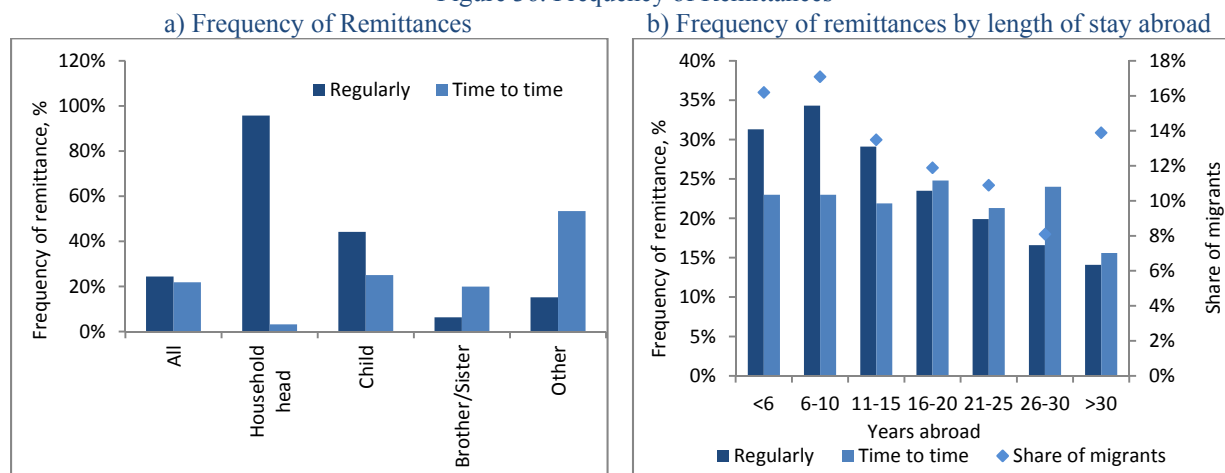


Sources: Right panel is data from the World Development Indicators. Left panel is adapted from Kasparian (2014).

79. **While the diaspora has maintained strong ties with Lebanon its participation in the political and economic life remains limited.** Lebanese migrants send remittances, visit the country, contribute to business creation and trade, have supported philanthropic activities and help communities at times of conflict and natural disasters (Hourani, 2007). For instance, at the macroeconomic level, the diaspora has contributed to meeting the government financing needs by buying treasury bills emitted especially to target emigrants. The Lebanese Children’s Fund, first created in Cyprus in 1995, later opened several country offices to collect philanthropic donations and supported over 24 organizations in Lebanon (Rahme, 2007). Successive governments have to varying degrees attempted to link the diaspora and Lebanon through efforts such as the creation and expansion of Lebanon’s diplomatic and consular missions and permitting the creation on Lebanese soil of organizations related to emigrants’ interests.<sup>59</sup> The large potential for investment in business by the diaspora is not fully realized because Lebanese entrepreneurs abroad find that the policy environment at home is too uncertain and corruption too rampant.

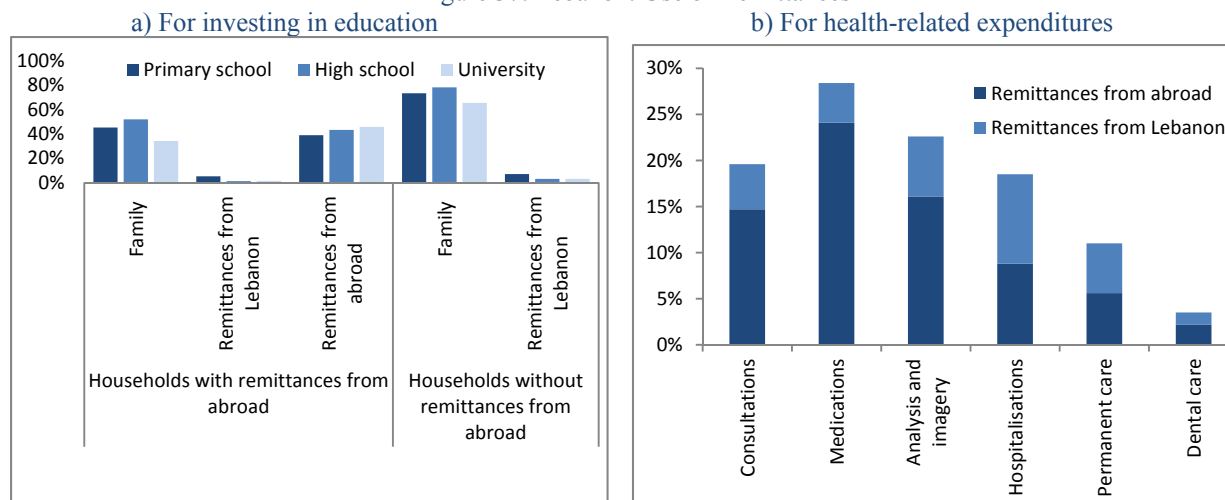
<sup>59</sup> However the diaspora still voices its demand to the government in regard to two central issues: the restoration of the right to citizenship for the descendants of Lebanese migrants and the enacting of the right to vote in Absentia for those residing abroad.

Figure 36. Frequency of Remittances



Sources: WB staff using data from Kasparian (2014).

Figure 37. Lebanon: Use of Remittances



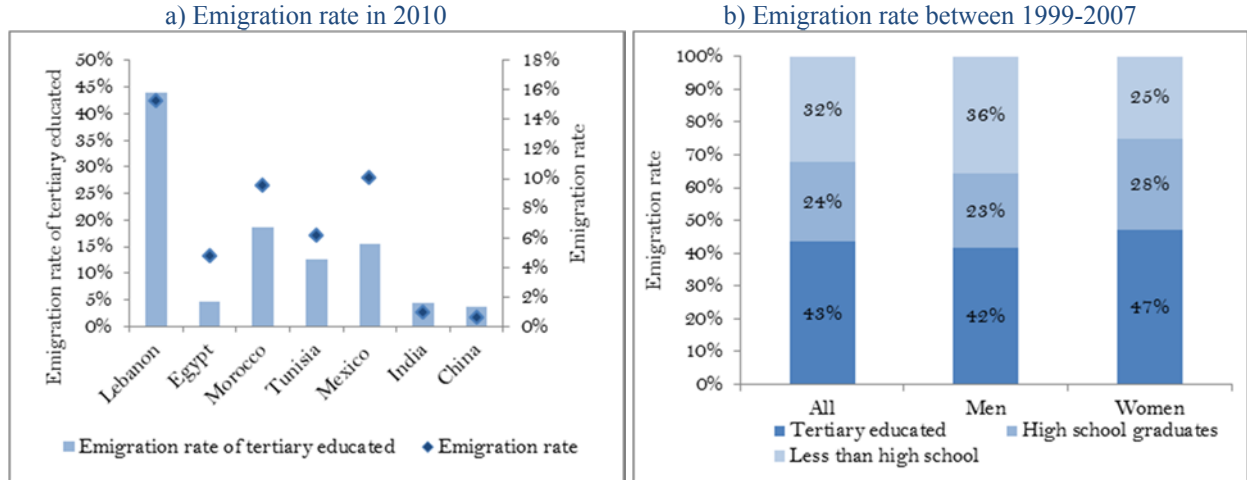
Source: World Bank staff using data from Kasparian (2014).

80. **Importantly, the large number of Lebanese abroad represents an opportunity to tap into a rather well-educated, prosperous and connected to home country pool of people.** High levels of remittances from the diaspora have also helped keep the Lebanese economy afloat, along with the strong banking system.<sup>60</sup> Diasporas and diaspora networks abroad are especially important reservoirs of knowledge about trade and investments opportunities, as well as technical and scientific expertise. According to the OECD, the Lebanese diaspora residing in the OECD stands out in terms of the size of their high-skilled population, representing about 3.4 percent of Lebanese population. A recent World Bank consultation with the Lebanese diaspora points to a strong desire and satisfaction in giving back and staying connected with Lebanon and abroad. Many of the interviewees referred to their background and experience growing up in a war and having the natural ability to adapt and take risk. They often expressed willingness to give more if proper and more transparent venues were instituted to alleviate the current mistrust among diaspora in home country institutions. Despite the gloomy business environment in Lebanon, diaspora

<sup>60</sup> In 2013 (latest available data), remittances constituted 6.8 percent of GDP.

members tend to believe that there is an important role for the diaspora to play. Individual efforts, such as connecting, investing, and mentoring, can play a crucial in particular sectors (e.g., high-tech, ICT, solar energy) and in development projects in remote and rural areas. Diaspora members are often attached to their city of origin in which they are willing to improve the local infrastructure.

Figure 38. Emigration rate by educational attainment

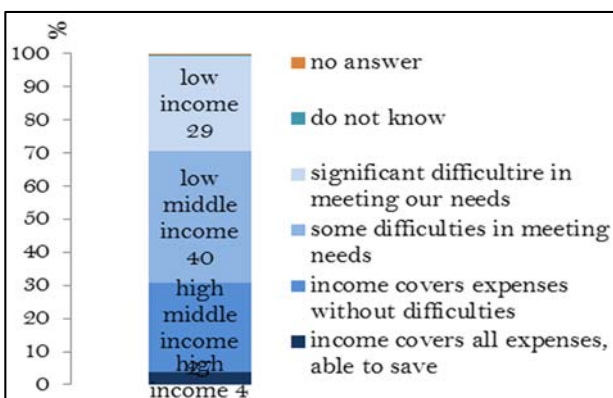


Source: Left panel is from the WDI. Right panel is adapted from Kasparian (2009) and shows the emigration rate between 1999 and 2007 by gender and skill group.

81. **Despite limited micro data, macro data reveal that the financing strategy for reconstruction and towards indebtedness is widening income inequality in Lebanon.** The strategy to finance the reconstruction and recovery through borrowing rather than taxation (at least over the medium-term) clearly benefited wealthier Lebanese citizens: not only did they not face a high tax burden (taxes in Lebanon are relatively low compared to comparator countries) but they also benefited from a relatively high real (after tax) return on capital (proxied, for lack of better data, by the after tax real average effective interest rate on public debt). As shown in Figure 40, this rate of return ( $r$ ) on capital was significantly higher than ( $g$ ) real GDP growth rate over the post-war period (i.e., over 1993-2013:  $r = 7.1$  percent  $>$   $g = 4.6$  percent). As noted by Piketty (2013) such a high gap (2.5 percent) between  $r$  and  $g$  generates persistent and large income inequality as  $g$  proxies for the upper bound on real wage growth over the long term.

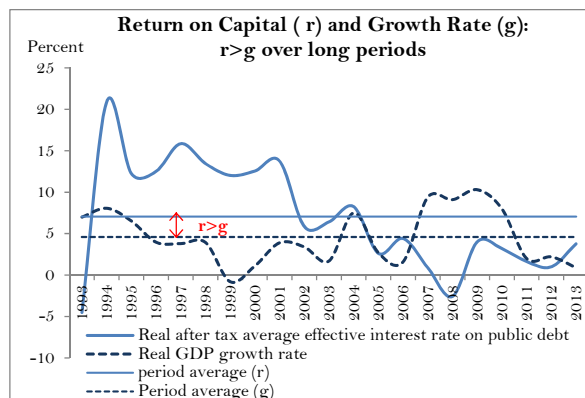


Figure 39. Perceptions about household income in Lebanon (in percent, 2010)



Source: World Bank calculation based on Arab Barometer.  
Note: Weighted.

Figure 40. A large gap between return on capital and economic growth, likely rapidly widened inequality



Source: CAS and World Bank Staff calculations. The 1993-2013 average of the after tax<sup>61</sup> real average effective interest rate on public debt is 7.1 percent while the period average real GDP growth rate is 4.6 percent. The 2.5 percentage points gap between r and g is large.

### C.5. Multi-dimensional poverty and inequality in access to and quality of public services

82. **Non-monetary dimensions of poverty are high in Lebanon due to the limited availability of good quality social and infrastructure services.** Shared prosperity is difficult to achieve without a favorable and conducive environment for equitable and sustainable growth. The government plays a critical role in creating this environment by maximizing the human and productive potential of a society regardless of exogenous circumstances such as gender, place of birth, parental wealth, religion or ethnicity. One of the channels how the government can maximize human and productive capacity is by effective provision of public goods such as education, water, roads, and electricity. This section briefly discusses inequality in access to and quality of selected basic public services—water and education—in Lebanon.

#### Water

83. **A recent survey of the relatively affluent mohafaza<sup>62</sup> of Greater Beirut and Mount Lebanon region (GBML) indicates high variability in access and quality.**<sup>63</sup> According to the data collected, public access to water was not universal in GBML and varied across residence and households with different wealth status. In particular, 70 percent of the population from the top 60 percent of the distribution has access to public network compared to 58 percent among the vulnerable bottom 40 percent of the population. There is a substantial variation in access to public network across municipalities as well. For example, access to public network is almost universal in Metn, and less than 10 percent in Aley. Furthermore, the quality of public water is worse among the most vulnerable households from the bottom 40 percent compared to wealthier households. For example, service water is saline for 46 percent of household from the bottom 40 compared to 32 percent among the top 60 percent of the population.

84. **The quality of the public water system delivery is poor with the majority of subscribers experiencing frequent interruptions in water supply.** Average water supply in the public network is

<sup>61</sup> Interest rate income in Lebanon is subject to a schedular tax of 5 percent (withheld at source).

<sup>62</sup> A mohafaza is an administrative unit equivalent to a governorate. Lebanon has six mohafazas.

<sup>63</sup> This section discusses the results of a survey conducted by the Consultation and Research Institute to assess the impact of the Bisri dam project. The number of observations was 1,200 households and they were located in Greater Beirut and Mount Lebanon. No recent national survey on access to safe water exists in Lebanon.

much shorter than experienced from non-public sources: 6 versus 13 hours per day, respectively. Only 20 percent of households connected to public network have water available every day in the wet season (December through May) compared to 90 percent among households using water from other sources. An estimated 82 percent of subscribers were not satisfied with the public network service.<sup>64</sup>

Figure 41. Public and private access to water in Mount Lebanon across income classes

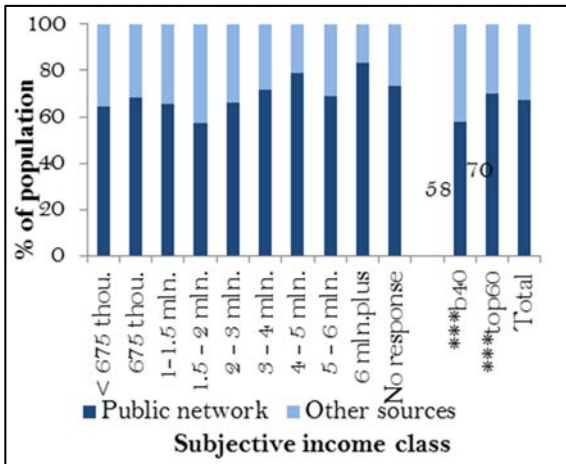
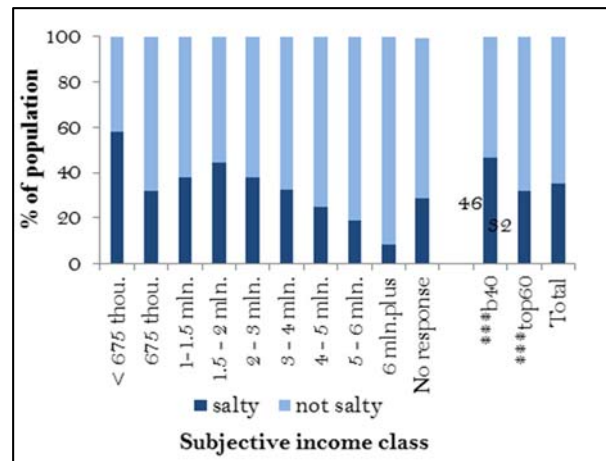


Figure 42. Public water is saline across income classes



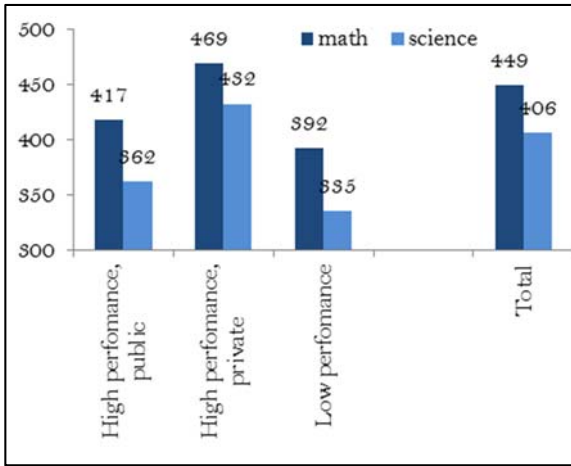
Source: Consultation and research institute. Water Supply Augmentation Project: Household Survey. World Bank staff calculations.  
 Notes: \*\*\*Average access to public network is lower among the bottom 40 percent of the population than among top 60 at 1 percent significance level. Precise income data are not available from the survey, therefore upper income threshold was imputed each household from particular income group to calculate income per capita. As a result income per capita reflects the upper bound approximation.

## Educational Outcomes

85. **A significant gap exists in Lebanon in terms of educational achievements between public and private education, which is reducing equality of opportunity among children** (Figure 43). Children from wealthier and middle-class households are concentrated in high performing private schools while the highest share of disadvantaged children is observed in schools with low performance (Figure 44). Household characteristics, area of residence, and access to services have a large impact on math and science educational outcomes. Simple cross-tabulations show a substantial variation in test scores in math and science across regions, area of residence, parents' education, access to ICT and durables in Lebanon. Residing in remote rural areas is also associated with the lowest test scores in Lebanon. Parents' education is a strong predictor of children's performance in test scores as well. Living in a family where parents do not have any secondary education is associated with the lowest test score. Data also show that father's education and residence (region and location of school) are two the largest contributor to inequality of opportunity, accounting for 44 and 23 percent of total inequality respectively (Figure 45).

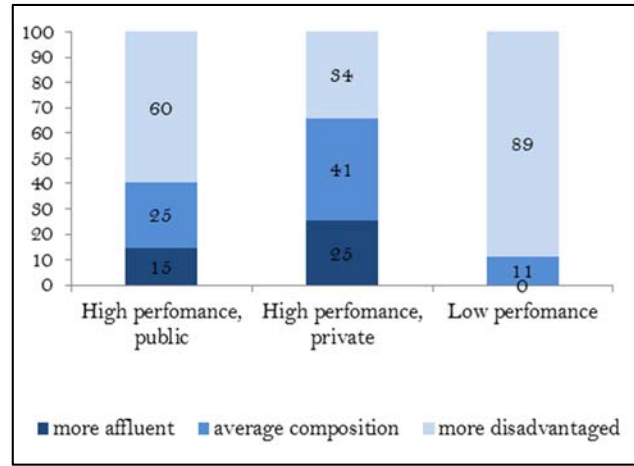
<sup>64</sup> As a result, 43 percent of connected households are willing to choose a plan among hypothetical plans with the best water service and the highest water fee (continuous connect time and high water quality).

Figure 43. Test scores on math and science across schools



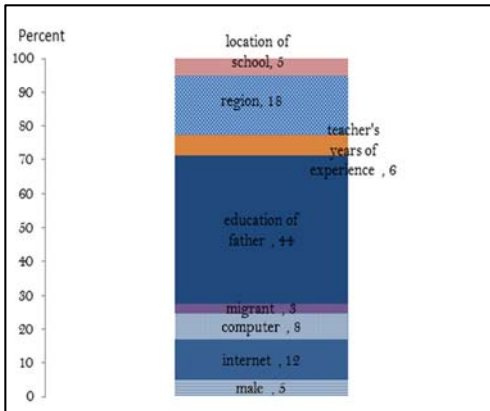
Source: TIMSS 2011, Paul Cahu. Students' weights were used.

Figure 44. Student composition by economic background across schools (percent)



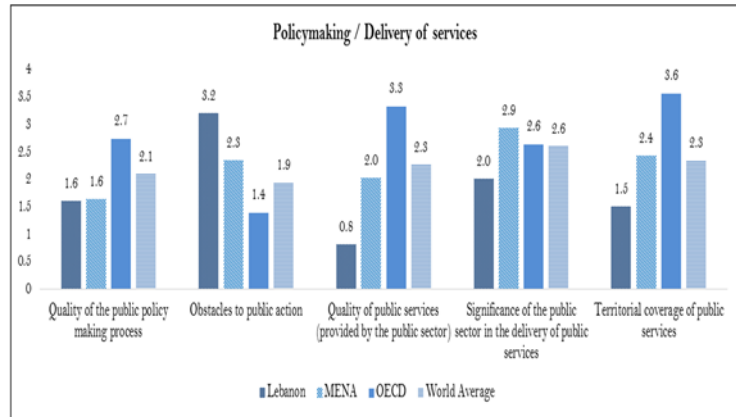
Source: TIMSS 2011, Paul Cahu. Note: students' weights were used.

Figure 45. Circumstances contributing to inequality of opportunity in TIMSS math test scores in Lebanon



Source: TIMS 2011, World Bank staff calculations.

Figure 46. Policymaking & Delivery of Services: Lebanon is performing badly both regionally and globally



Source: Institutional Profiles Database, 2012.

### III. LEBANON'S CHALLENGES AND OPPORTUNITIES

#### A. OVERARCHING CHALLENGES

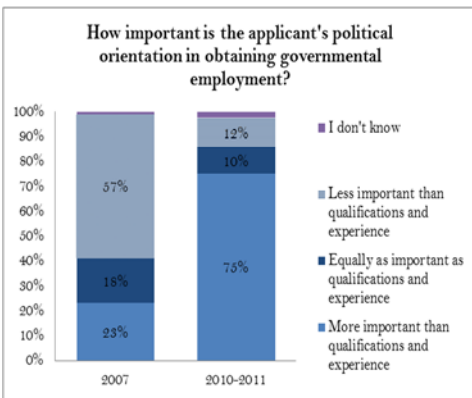
86. **The confessional system of governance—in its current incarnation where it has been captured by elites—and national and regional conflict dynamics constitute overarching constraints that have engendered deep structural inequalities and deficiencies, inhibited economic growth and inclusive development, and are at the core of the country's current fragility and vulnerability to destabilizing national and regional shocks.** These constraints affect growth and development across all sectors, which must be taken into account when analyzing sector-specific challenges and priorities. The main ways in which these twin constraints are manifested is described below.

## 1. Lebanon's Confessional Governance: Elite Capture Hidden Behind a Confessional Veil

87. **Lebanon's economic growth and development pathway since independence cannot be considered separately from the country's (evolving) confessional system of governance.** This is due to the role of confessionalism in providing not only the basis for Lebanon's political system, but also in determining economic and social relationships and forms of organization. In this respect, the confessional system can be said to have exerted a constitutive—and not exogenous—influence in structuring economic growth and development trajectories. Key manifestations of this overarching constraint include:

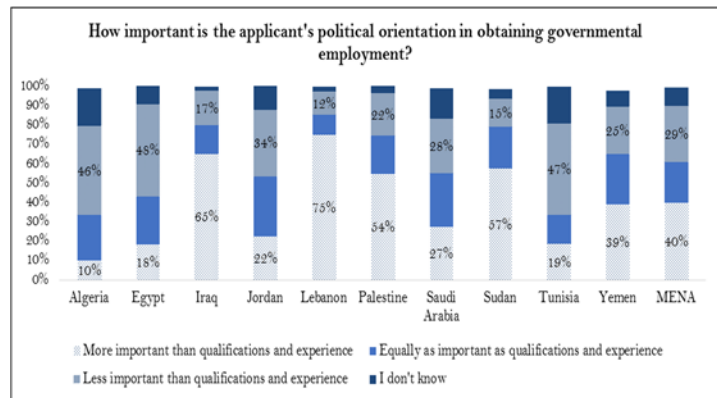
- *The absence of political consensus on national priorities among political actors severely constrains the ability of the government to develop and implement long term and visionary development policies.* Continuing tensions between domestic political actors, often manifested in confessional terms, have resulted in a deadlock within the legislative and executive branches of government. As a result, key development plans and policies have not been ratified or implemented. This 'constraint' is rooted in the nature of the confessional system itself (more specifically in the partial implementation of the Taef Accords).
- *The confessionally-driven staffing of public institutions at the expense of merit-based criteria impedes the state's ability to deliver quality public services efficiently and to generate inclusive and sustainable growth (Figure 46).* The need to maintain a sectarian 'balance of power' within institutions, reflected in both staffing and a division of responsibilities for resource allocation, results in sectarian interests being prioritized over the need for equitable and adequate provision of services, and a general lack of transparency and accountability. This problem has worsened markedly in Lebanon in the past decade (Figure 47), to the extent the country is now the worst performer among MENA countries (Figure 48).

Figure 47. The rapidly growing role of "wasta" and confessionalism



Source: Arab Barometer (various years).

Figure 48. Political interference in public employment in Lebanon are the worst in the region



Source: Arab Barometer Survey 2013.

- *Confessional structuring of socioeconomic relations.* As described in Chapter 1, the Lebanese state emerged from the civil war in weakened form, with its sovereign role and capabilities displaced by sectarian organizations and interests, which in certain cases assumed *de facto* responsibilities for territorial administration and governance. In this context, individual social and economic rights and opportunities are defined through sectarian affiliations and patronage/clientelistic relationships with sectarian leadership. This has provided sectarian actors and organizations considerable authority and in some case political autonomy. Given Lebanon's confession-based system of power sharing, this has also meant that sectarian affiliations have become key organizing principles in the provision of public

services and financial allocations, all of which serve to perpetuate severe regional income disparities and uneven access to and quality of public services.

- *Weak electoral accountability.* The 1960 Parliamentary Elections Law and the role it gives to confessions result in elections where political parties' platforms have limited economic and social content and are focused on defending the share of the confession in its access to public resources. When faced with limited prospects of improving the quality of public services and institutions and the impact these have on growth, many Lebanese opt to emigrate.

## 2. Fragility, Conflict, and Violence

88. **For most of its history, Lebanon's internal stability and political, social and economic dynamics have been directly affected by regional conflict dynamics.** For the purposes of the SCD, two dimensions are of particular salience, given the constraints they impose on governance and economic and social stability:

- *Regional alliances and weakening of state authority, governance and institutional capacity.* A key feature of politics in Lebanon is the establishment of alliances between domestic political actors (namely confessional groupings/sects) and regional actors, usually in some form of clientelistic relationship where transnational support is exchanged for external support for domestic agendas (Hourani, 2013). At present, the alignment of Lebanese groups with opposing sides in the Syria conflict—March 8 led by Hezbollah with the Syrian regime and March 14 with the Syrian opposition—is threatening to undermine the delicate confessional balance, with growing potential for destabilization and conflict. This is directly impacting governance and state institutional capacity, paralyzing an already problematic governmental decision-making apparatus, and undermining the ability of state institutions to contain increasing insecurity and violence (Barnes-Dcey, 2014).
- *The refugee influx and economic and social destabilization.* As of January 2015, over 1.1 million Syrian refugees have officially sought refuge in Lebanon, resulting in severe pressures and competition over social services and jobs. In addition to the fiscal burden and limited absorptive capacities of government services and communities (World Bank, 2013d), there is increasing concern that deepening vulnerability and increasing tensions could lead to a breakdown in relations between host and refugee communities, and upset the delicate confessional balance within society, further polarizing sectarian tensions at political level.

## B. NESTED CHALLENGES AND CONSTRAINTS

89. **The above overarching constraints have been the root cause and also led to the exacerbation of Lebanon's longstanding and well identified development and private sector challenges.** In fact, two recent studies have analyzed Lebanon's growth constraints and drivers. The first study is by Berthélemy et al. (2007). Following the Hausmann, Rodrik and Velasco's (HRV) growth diagnostic methodology, Berthélemy et al. (2007) identified binding (nested) constraints to growth in Lebanon. Key among these is the country's fiscal imbalances and the resulting macroeconomic risks. These include crisis risk that affects the nature and quality of investments. The efficiency of public spending and services also has a major impact on economic activity as it poorly complements private investment (e.g., weak infrastructure, and especially electricity) and widens the inequality gap and pronounced regional disparities. The second study is by the World Bank (2012e) and focuses on Lebanon's long-term sustainable growth drivers. It finds that the key constraints include: (i) macroeconomic volatility, and in particular the risk of continued fiscal imbalances and severe macroeconomic shocks that these imbalances may create; (ii) infrastructure gaps, especially in electricity, water, transport, sanitation and telecommunications; and (iii) deficiency in banking

sector intermediation due to fiscal dominance: highly productive industries and innovative activities do not seem to benefit from financial inflows that mainly end as short-term deposits in banks or real estate acquisitions. Furthermore, despite Lebanon's strong banking sector, access to finance for MSMEs remains a constraint.<sup>65</sup>

90. The following sections review in some detail the key nested constraints Lebanon is facing. These are the overall macroeconomic environment, infrastructure, institutions and governance, human capital, the business climate, access to finance, and the environment.

## 1. Macroeconomic vulnerability

91. **The macroeconomic environment displays large vulnerabilities due to precarious public finances and Lebanon's exposure and vulnerability to regional instability and conflict.** According to the World Economic Forum's (WEF) Global Competitiveness Index the weakness of the macroeconomic environment is Lebanon's biggest constraint both in absolute terms and also compared to either MENA countries, comparator countries in PPP terms or comparators in terms of stage of development (Figure 54). Lebanon's macroeconomic environment is ranked as the second worst in the world according to the GCI ranking of 144 countries (Figure 55). This weakness arises because of the country's structurally weak public finances, wherein the impact of the twin overarching constraints described above has been significant. The predominance of confessional interests in government institutions and the challenges this poses to effective decision making have prevented establishment of appropriate checks and balances and sound coordination of economic and fiscal policies (Madkisi, 2007). Moreover, Lebanon's location at the intersection of several conflicts in the region has been a source of constant shocks to Lebanon's macroeconomic stability, including both the significant fiscal impact of the Syrian refugees (World Bank, 2013d), as well as security-related shocks which have led to major declines in key productive sectors, especially tourism and trade (Bertelsmann Stiftung BTI, 2014). Until a few years ago Lebanon had the highest debt-to-GDP ratio in the world. A period of strong growth from 2007 to 2010 has markedly reduced that ratio, mostly due to a cyclical improvement although some expenditure rationalization also took place. The underlying large structural fiscal deficit has, however, not been fundamentally addressed and, on the contrary, has widened in part due to the introduction of permanent revenue-eroding measures (e.g., the VAT exemption on diesel). With growth tumbling since 2011 and with a large fiscal burden associated with the Syrian crisis driven by a combination of lower revenue and higher expenditures primarily related to the cost of providing public services to Syrian refugees, the debt-to-GDP ratio is rising again (Figure 53), resulting in a marked deterioration of the country's macroeconomic environment—Figure 52). Based on current policies and projections, debt dynamics are not sustainable (IMF, 2014).

92. **Determined under a confessionally-oriented regime, fiscal policy is non-transparent, lacks basic accountability, and is therefore captured by vested interests, inefficient and unproductive.** The budget process is in disarray. There have been no approved budgets since 2005 due to a variety of factors, including political polarization in Parliament and the dispute regarding extra-budgetary expenditures.<sup>66</sup> The

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<sup>65</sup> The World Bank Enterprise Survey data reveal that almost 42 percent of firms identify access to finance as a major constraint, which is above the regional average of 38.5 percent and significantly higher than the 29 percent global average. Furthermore, despite the efforts initiated by the Central Bank and other governmental and quasi-governmental agencies (such as Kafalat) to promote SMEs and improve their access to finance, the IFC SME Job Study found that entrepreneurs and small businesses cite obtaining access to credit as a constraint due to a limited track record, large collateral requirements, and lack of an established relationship with the financial intermediary. The financial sector's incentives to intermediate a large share of its liabilities towards productive investments remain weak and collateral requirements in proportion of loans are high. Product regulations have also tended to bias investment decisions in Lebanon in favor of either liquid instruments or real estate.

<sup>66</sup> As provided in Article 86 of the Constitution and public accounting law decree № 14969/1963, in the absence of approved budgets for the years 2006-2013, government expenditures are incurred on the basis of the "one-twelfth rule", pursuant to which the government is authorized to spend monthly one-twelfth of the last approved Budget (i.e., the 2005 Budget) and other enabling

last officially closed fiscal accounts are those of 2003. Spending has been conducted largely through enabling legislation, treasury advances and ad-hoc measures. Even prior to 2005, fiscal policy was non-transparent due to basic impediments such as having a different budget classification between the approved budget law and the executed budget. Lack of proper oversight, including over extra-budgetary entities that receive significant government funding and are only answerable to certain confessions/politicians, helps entrench a culture of non-transparency and capture of fiscal policy for confessional purposes. This lack of transparency and accountability creates room for fiscal leakages, inefficiencies and corruption. Furthermore, key documents on the government's national budget and financial activities remain unpublished or not produced. This limited access to information inhibits potential third party accountability mechanisms (e.g., informed citizen voting power, CSOs, media) making the management of public resources an ad hoc and discretionary endeavor. The constraints imposed by the confessionally-structured system of political and administrative decision-making have been recently exacerbated by increasing polarization linked to the conflicts in Syria and Iraq, leading to paralysis in both policy development and implementation (Bertelsmann Stiftung BTI, 2014).

**93. The public financial management system suffers from several constraints that hinder its proper functioning, weaken its transparency and result in an inefficient use of public resources.** While some reforms have been implemented,<sup>67</sup> Lebanon's public financial management system is outdated imposing considerable inefficiencies within the budget cycle and reflecting a fragmentation in the budget and treasury functions. The wage bill and an unsustainable pension for civil servants<sup>68</sup> are sources of public spending inefficiency. The wages and salaries scale for the civil service is non-transparent revealing large gaps and distortions within the public service itself as well as a large benefit packages which distorts the general equilibrium of the labor market. On the human resources level, the implementation of competency based meritocratic recruitment could be enhanced. There also exists a significant gap in capacity in the civil service with vacancies reaching 41 percent for leading positions and 70 percent across the civil service (Moubayed Bissat, 2013). Additionally, the absence of policy orientation concerning civil service reform coupled with deficiencies in human resource management and training hinder the formation of human capital, mobility of workforce, and diversity management. Such challenges further strain the State's "capacity to govern" along with the threat of rising violence and conflict in neighboring countries exacerbating an already weak control environment vis-à-vis the implementation of rules and guidelines. Trust in government has been eroding with increasing corruption, vested interests, and confusing policy choices (Arab Barometer surveys). Finally, accountability is hindered given the scant availability of information which reduces transparency and participation.

**94. Lebanon's expenditures are characterized by large budget rigidities which limit fiscal space and flexibility to react to shocks.** These expenditures are concentrated on personnel costs, debt servicing and transfers to Electricity du Liban (EdL) (Figure 49), the combination of which accounted for an average of 81.6 percent of total spending during the period 2006-13. The wage bill (as a share of GDP) for public sector employees in Lebanon is not excessive when compared to a group of comparator countries, though

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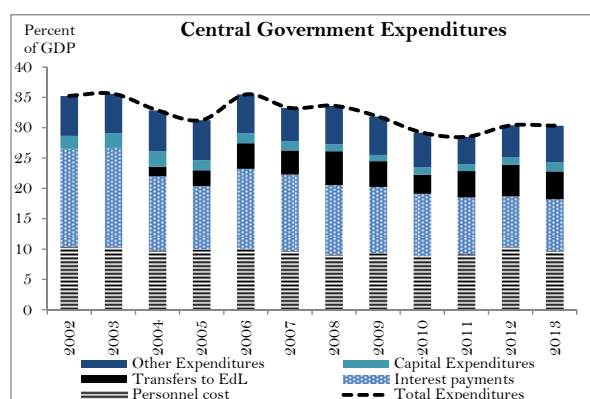
legislation. In October 2012, Parliament approved an increase in the legal spending limit from the last approved budget. During the period 2006-2012, successive Governments have incurred extra-budgetary expenditures. There was a controversy regarding the extra-budgetary expenditures incurred during the period 2006-2010 with certain members of the March 8 Coalition having requested a review of these expenditures by the Audit Court. The Minister of Finance and other members of Parliament have proposed draft laws seeking to approve the extra-budgetary expenditures that have not yet been approved. This controversy has contributed to the non-approval of the Budgets for the years 2006-2012 by Parliament, which in turn limits the Government's ability to have a Budget approved for 2013.' Government of Lebanon (2014).

<sup>67</sup> Most recently these include budget preparation reforms such as the adoption of a new budget classification in line with GFS 2001 as of the 2014 Budget Proposal.

<sup>68</sup> This is due to a high real implicit rate of return on contribution reaching 12 percent for civilian personnel and 13 percent for military personnel compared to a sustainable rate of 3 percent (Assadissa, 2013).

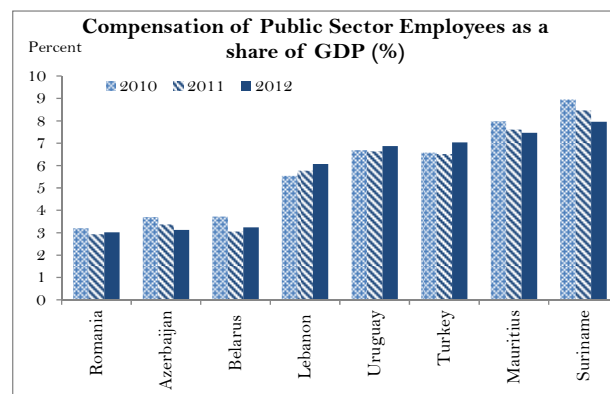
benefits are generous, especially the pension (which is, however, heterogeneous among public sector employees with some such as the army and judges having a very generous scheme compared to others)—Figure 50. The issue is more about the quality of public services these public sector employees are able to deliver. Reflecting the large public debt, interest payments have been sizeable, accounting for one third of total expenditures and about 60 percent of total revenue and grants.

Figure 49. Government spending is dominated by large interest payments, transfers to EdL and personnel cost



Source: Ministry of Finance, and Bank staff calculations.

Figure 50. Cost of public sector employees in Lebanon compared to comparator countries



Source: Ministry of Finance, and Bank staff calculations.

95. **Unproductive spending and fiscal leakages are significant and widespread, and crowd out effective social safety net programs and improvements in living conditions (through better services) for the population.** As detailed below, the energy sector is a major drag on public finances. Between 2006 and 2014, the government transferred an average of 4.3 percent of GDP to EdL each year. EdL’s production is both inefficient and insufficient, with a generating capacity of 2,019 MW, compared to a peak demand of 3,195 MW. This results in systematic and long daily blackouts, causing the extensive use of back-up private generators at a cost that is three times the level of EdL tariffs (IMF, 2014). Moreover, whereas only about half of total electricity production costs are recoverable, electricity tariffs have remained unchanged since 1996 (when the price of oil was USD23 per barrel)—(World Bank, 2008b). In addition to the EdL leakage, other sources exist both on the expenditure and revenue sides, such as spending on civil service and military pensions or tax exemptions (see World Bank PER (2005b) for details). Corruption is perceived as endemic. Given these large, inefficient and in the short-term non-discretionary items, the budget in Lebanon has limited resources left to pursue meaningful anti-poverty programs, social safety nets, and investment in basic infrastructure.

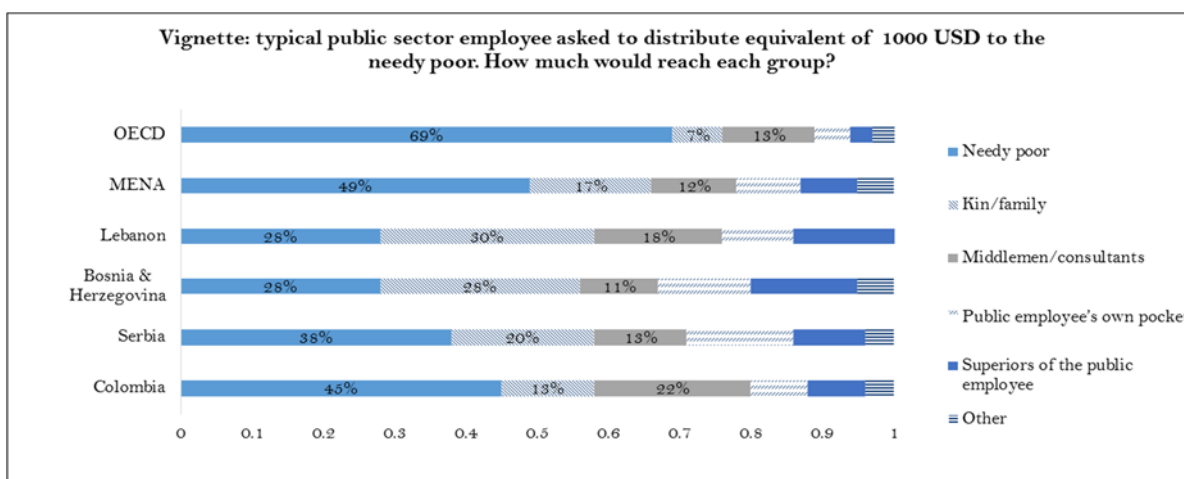
96. **Low public capital expenditures have reduced potential growth** (Barthélemy et al., 2007). The lack of fiscal space combined with a lack of a budget approval since 2005 have resulted in a sharp fall in public spending on capital projects—these have averaged around 1.5 percent of GDP since the beginning of the millennium, which is significantly below comparator countries. As a result, the country’s infrastructure network and quality have deteriorated, particularly transportation, water supply and electricity—services important for the population’s well-being. Further, low public investment in these sectors has caused capacity to lag behind demand, leading to a reduction in potential economic growth and an overall deterioration in living conditions.

97. **The debt-financed post-war reconstruction, coupled with inefficiency and unproductive spending, has resulted in an over-indebted sovereign.** In contrast with the pre-civil war period when the public sector was a net saver, Lebanon’s public finances in the post-war period have been structurally and persistently weak—during 1993-2013, the overall fiscal deficits averaged 12.4 percent of GDP (Figure 52).



This has been driven by below potential growth, high borrowing costs (certainly compared to the economy's growth rate as shown in Figure 40), and weak efficiency of public spending partly due to an inability to rein in waste and corruption (World Bank PER, 2005b). As a result of these high and persistent deficits, Lebanon's public debt peaked at 185.2 percent of GDP in 2006, the world's highest debt-to-GDP ratio at the time (Figure 53). Between 2006 and 2010, high and sustained GDP growth significantly improved Lebanon's fiscal balances and lowered the debt ratio by about 40 percentage points. The underlying structural fiscal balance, however, did not improve. As a result, once growth tapered off, debt dynamics stopped improving. With the added fiscal impact from the Syrian crisis (estimated at an additional spending of USD1.1 billion for the period 2012-14—World Bank, 2013e), the debt ratio started rising in 2013 and is projected to continue increasing over the medium term given current policy and regional turmoil, and factoring in the expected increase in global interest rates.

Figure 51. Flow of funds from the public sector



Source: Quality of Government Expert Survey, 2010.

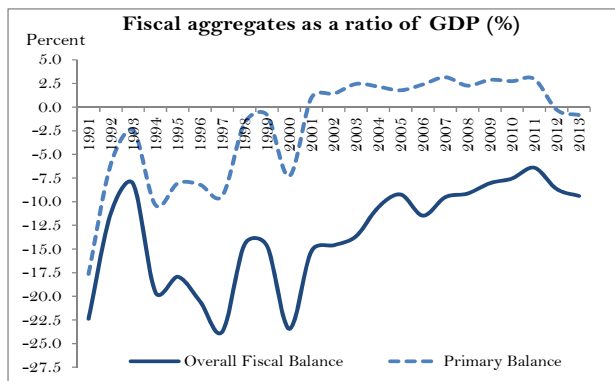
98. **The domestic banking system, relying on the diaspora and Gulf funds, has been willing to finance the large public debt build up... at the expense of the private sector and a large exposure to the sovereign.** At the end of the civil war, the lack of foreign aid necessitated the mobilization of private funds to finance the country's large reconstruction needs. This motivated the resurrection of a prominent pre-war banking culture, successfully reconnecting with the large expatriate community, which the war had enlarged. A successful introduction of a fixed exchange rate regime (to the US dollar) to anchor expectations and stop a currency crisis that erupted in 1992, has resulted in a very stable nominal exchange rate, with the Pound/Dollar peg unchanged since 1997. Both peg and high interest rates on government debt enabled the banking system to attract foreign deposits profitably by offering high interest rates on pound and dollar deposits, and use these to finance the government. Given the scale of the public debt, the banking sector has reached a size seen in only a few countries in the world. At the same time, returns from lending to the private sector have to be better than the low risk, low cost and high margins banks are making by lending to the sovereign if financial inclusion is to be improved. While for connected firms this is less an issue, it is an important concern for the rest of the private sector and especially for SMEs (as shown Figure 66 on page 60, access to finance is the 6<sup>th</sup> most problematic factor to doing business).

99. **To maintain the peg, *Banque du Liban* is trapped in a Stackelberg follower role<sup>69</sup> vis-à-vis the fiscal authority;** it is the residual buyer of sovereign debt while ensuring banks offer attractive dollar

<sup>69</sup> For a game-theoretic analysis of monetary and fiscal policy coordination issues using a Stackelberg competition model, see, for example, Lambertini and Rovelli (2004).

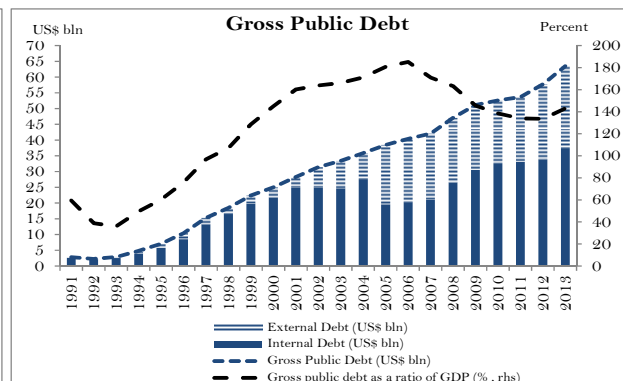
spreads to finance the current account. Under sustained severe fiscal dominance and a banking sector balance sheet that is over three times GDP, the BdL ensures that banks keep attracting foreign deposits and that the public sector gross financing needs are met. For the former, BdL has introduced certificate of deposits or various subsidized refinancing schemes. For the latter, BdL is the residual buyer of government debt in the primary or secondary markets. The resulting banking-sovereign feedback loop undermines BdL's independence which could ultimately prevent it from achieving its monetary policy objectives. Importantly, BdL is unable to stop being a Stakelberg follower vis-à-vis the fiscal authority until the size of the public debt and the public sector's gross financing needs shrink sufficiently that they do not endanger macro stability.

Figure 52. After a decade of primary fiscal surpluses, Lebanon is back to deficits and large overall deficits



Source: Ministry of Finance, and World Bank staff calculations

Figure 53. After remarkable—but cyclically based—debt reduction, the elevated debt ratio is rising again



Source: Ministry of Finance, and World Bank staff calculations

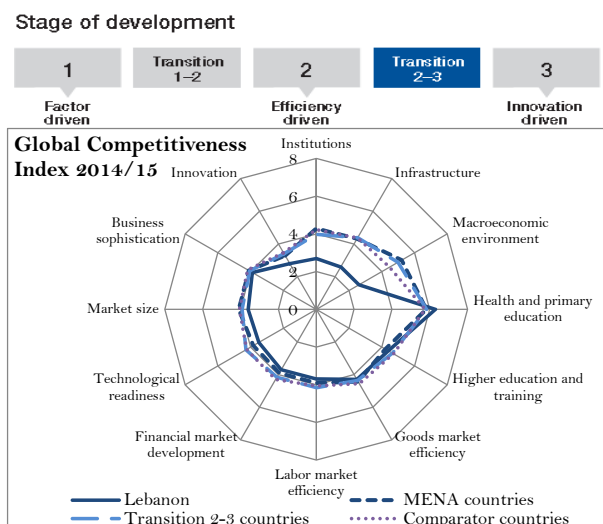
100. **While commercial banking has flourished, this sector has a limited capacity to address a range of outstanding financing needs. Gaps persist in micro and SME financing needs as well as availability of longer term financing facilities for infrastructure and PPP projects. Some of these gaps could be addressed by the further development of Non-Bank Financial Institutions (NBFIs) such as those offering leasing, factoring, microfinance and capital market solutions.** While NBFIs could play a larger role in the provision of more inclusive financial services, they are constrained, in part, by the lack of adequate legal and regulatory environments. For instance in the case of the microfinance sector, there has been some good progress, but a significant unmet demand remains which in part is attributable to the burden of an existing regulatory framework not tailored to this specific sector. Helping to address a critical gap, BdL has recently launched an innovative incentive program (Circular 331) that encourages banks to invest in early stage equities, which should boost supply of capital, particularly for early stage companies and potentially higher growth businesses that offer the greatest short to medium term potential for job creation. Meanwhile, Likewise, longer-term financing mechanisms also need work to build institutional capacity and establish appropriate regulatory environments before they can play their role in funding large-scale infrastructure and PPP projects. Strengthening financial infrastructure related to collateral registries, settlement and custody systems, and credit information, among others, would improve risk management and promote inclusiveness.

## 2. Infrastructure: mismanagement and insufficient investment

101. **Lebanon's weak infrastructure base has curtailed economic development and the population's wellbeing.** The key basic services that Lebanon lags behind in are telecommunication, electricity, safe water, sanitation and transportation. These services are not only essential for growth in productivity and aggregate income, but also for ensuring a basic level of living standards for people. Furthermore, better infrastructure can have a positive impact on income inequality since it allows low

income groups access to better and more productive opportunities, thus increasing the returns on their assets. It also enhances health and education outcomes, thus improving human capital.

Figure 54. Lebanon’s Comparative Competitiveness reveals macro, institutions & infrastructure weaknesses



Source: World Economic Forum, 2014/15 Global Competitiveness Index and World Bank staff calculations.

Figure 55. Lebanon’s Global Competitiveness Index reveals gaps in basic requirements

	Rank (out of 144)	Score (1-7)
GCI 2014–2015	113	3.7
GCI 2013–2014 (out of 148)	103	3.8
GCI 2012–2013 (out of 144)	91	3.9
GCI 2011–2012 (out of 142)	89	3.9
<b>Basic requirements (37.7%)</b>	<b>127</b>	<b>3.5</b>
Institutions	139	2.7
Infrastructure	122	2.6
Macroeconomic environment	143	2.6
Health and primary education	30	6.3
<b>Efficiency enhancers (50.0%)</b>	<b>85</b>	<b>3.9</b>
Higher education and training	67	4.4
Goods market efficiency	71	4.3
Labor market efficiency	123	3.7
Financial market development	102	3.7
Technological readiness	86	3.5
Market size	76	3.6
<b>Innovation and sophistication factors (12.3%)</b>	<b>101</b>	<b>3.3</b>
Business sophistication	75	3.9
Innovation	119	2.8

Source: World Economic Forum, 2014-15 Global Competitiveness Index

102. **Lebanon’s infrastructure is deficient compared to similar countries and acts as an impediment to private sector expansion and job growth.** According to the WEF’s Competitiveness Index, infrastructure is Lebanon’s second weakest comparative constraint, and is materially below various sets of comparator countries (Figure 54 and Figure 55). Among the nine infrastructure sub-indicators Lebanon has two among the bottom 10 percent of world ranking (out of 144 countries) and four are at the bottom 25 percent of the world. Specifically, for the quality of electricity supply, Lebanon ranks as the second worst country in the world (143/144). It ranks 120<sup>th</sup> for quality of roads, and 114<sup>th</sup> for mobile phone subscriptions per 100 population. Investments in infrastructure can lead to significant job creation as, according to the World Bank, every USD1 billion invested in infrastructure has the potential of generating, on average, around 110,000 infrastructure related jobs in oil-importing countries in MENA. The World Bank Enterprise Survey data also highlights electricity as the second biggest obstacle to private sector firms in Lebanon, after political instability.

103. **Lebanon’s weak broadband networks and services constrain growth and private sector activity.** Recent studies estimate that a 10 percent increase in broadband penetration increases economic growth from a range of 0.24 to 1.50 percentage points and would increase the employment rate by around 10 percent.<sup>70</sup> The jobs created would be both skilled and unskilled. Direct jobs relate preeminently to civil works and construction of broadband infrastructure, which mainly employs unskilled jobs. Indirect and induced jobs can be both unskilled and skilled. However, network-effects (i.e., spillover) jobs are mainly high skill jobs. The diversity of Lebanon’s workforce and the breadth of high-skilled human resources would not be a constraint for the sector to take off. The potential to develop new services in intermediary sectors, such as e-banking or e-health, and complete new industries, such as export-oriented IT-enabled services, open the door for multiple new private sector led job opportunities. The rise of mobile applications businesses and the fragmentation and delocalization of global employment through crowd-sourcing is opening multiple new job opportunities for those connected through broadband to these new platforms. If

<sup>70</sup> See Katz et al. (2010), McKinsey (2010), Qiang and Rossotto (2009), and Czernich et al. (2009).

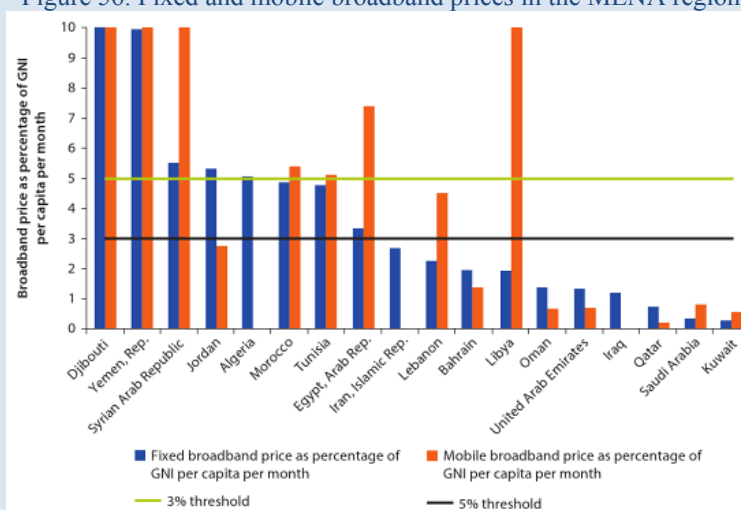
Lebanese workers and the economy are not connected to these new job opportunities, Lebanon will likely face severe constraints in the future, especially as it aspires to move to high income status. Box 3 below provides more details on recent reforms in the sector and its outstanding constraints.

**Box 3. Lebanon: Performance of the Information, Communication, and Technology (ICT) sector**

Since 2011, the government has taken a more active role in strengthening the supportive infrastructure of the ICT sector. Improvements in telecommunications infrastructure and policies have extended mobile and broadband services coverage and reduced prices. In 2014, mobile penetration extended to almost 100 percent of the population and mobile broadband was launched and services almost 50 percent of the population (mostly through 3G service). Broadband fixed prices have been reduced significantly, and today they are in line with the regional average of USD 28 (OECD Basket)—See Gelvanovska et al. (2014).<sup>71</sup> However, the limited coverage of fixed broadband and the high prices of mobile broadband with an average price of USD 55 (almost double the regional average of USD 25),<sup>72</sup> makes broadband still unaffordable for a wide range of the population (Figure 56). Quality of connection and access to high speeds remains an issue, particularly for business. Coupled with uncertain electricity, access to quality broadband remains a key infrastructure concern for entrepreneurs.

**Government actions have extended coverage and reduce prices.** However, the sector relies on government action and investment to improve coverage and services to meet an increasing demand of citizens and business. Without reform that introduces private sector-led investment and competition, the sector will be unable to cope with the surging demand of the economy to continue upgrading infrastructure, extend coverage and reduce prices. In the long term, this is likely to continue impacting productivity of firms and the economy. High broadband costs and low quality will also have an impact on technology entrepreneurship, an area that has the potential to create new entrepreneurship and employability opportunities for the youth.

Figure 56. Fixed and mobile broadband prices in the MENA region



Source: Gelvanovska et al. (2014). Note: For West Bank and Gaza data are not available; values for Djibouti: fixed broadband: 22.1 percent, for Libya mobile: 32.4 percent, fixed broadband: 77.2 percent, Republic of Yemen: 10.0 percent, Syrian Arab Republic mobile broadband: 13.8 percent.

**104. The electricity sector is a striking example of an underperforming sector negatively affecting Lebanon’s macroeconomic situation, economic growth, and households.** First, fiscal transfers to the

<sup>71</sup> Price data from Dec 2012.

<sup>72</sup> Price data from Dec 2012.

vertically integrated public utility *Electricité du Liban* are the cause of an important part of the country's public debt. Second, different sources consistently point towards electricity as being a binding constraint to Lebanon's competitiveness and ease of doing business. And third, despite consumers' willing to pay significantly more for a good quality electricity service, a majority of them own private generators whose revenues are estimated at USD1.7 billion (or 4 percent of GDP) to compensate for the deficiencies of the public service delivery. The burden on consumers is inequitable, while poor regions go without public electricity for 12-13 hours every day, richer ones such as Beirut are subject to 3 hours of daily blackouts. Political and confessional cleavages are preventing reforms that have been on the table for more than 30 years from materializing. This has allowed EdL to keep underperforming with high non-commercial losses, and low billing and collection ratios. This is partly due to its inability to recover costs given a freeze in tariffs in place for over 20 years. More details on the electricity sector poor situation can be found in Box 4 below.

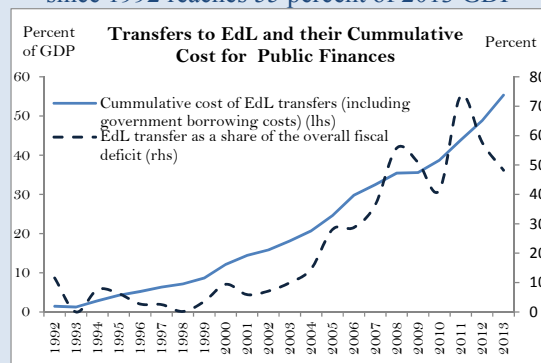
**105. Lebanon's poor transport infrastructure and cumbersome procedures hinder trade and competitiveness.** The World Bank's Logistics Performance Index (LPI), which benchmarks countries' performance on trade logistics, reveals that import and export costs in Lebanon are relatively high. While Lebanon's cost of domestic exports via its ports and airport is relatively cheap compared to the regional average and that of upper middle income countries, mostly due to short distances within Lebanon, it is significantly more expensive for both land-based exports and imports via its ports and airport to the region. This places Lebanon at a large disadvantage to act as a trade hub for the region, a role it played successfully in the past. According to the LPI, the major impediments to logistics in Lebanon are weak infrastructure and cumbersome procedures. This is in contrast to the important role that transportation plays in the economy: the transport and telecommunications service sector employs about seven percent of Lebanon's working population (mostly transport). From the perspective of job creation, the sector is particularly important to the poor both because service providers and employees tend to come from less well-off households (e.g., truck drivers, taxi drivers, microbus owners and drivers) and because the labor intensive construction of transport infrastructure employs primarily poor and unskilled labor.

**Box 4. EdL: the Poster Child of Confessionally-Induced Waste in Public Spending that Plagues Public Finances, Businesses, and Households since 1981**

**The staggering recurrent transfers to *Electricité du Liban*, the national electricity company, illustrate the perennial structural issues that escalate over time as political consensus for reform is lacking.** EdL dominates electricity supply in Lebanon. The company is a vertically integrated utility. By itself the company is a major source of macroeconomic vulnerability for the country given the large drain on public finances it has generated over time, and that it continues to impose. However, given the sector's highly politicized/confessionalized nature, reforms have not materialized.<sup>1/</sup>

**The public finance drag of EdL is staggering—it accounts for about 40 percent of Lebanon’s public debt—and is escalating rapidly as transfers now account for over half of Lebanon’s fiscal deficit (Figure 57).** Transfers to EdL have averaged 2.3 percent of GDP from 1992 to 2013. These costs, however, have steadily increased over time. As a result, during the 2006-2013 period, transfers to EdL averaged 4.4 percent of GDP per year which represents 55 percent of the country’s fiscal deficit during those years. Since 2012 they have exceeded USD2 billion per year. As the overall fiscal balance has been in deficit since 1992, transfers to EdL were effectively paid through borrowing. Using the rolling average effective interest rate on public debt since 1992 to price that borrowing cost, one finds that the cumulative cost of EdL transfers from 1992 to 2013 is a staggering 55.4 percent of 2013 GDP. With Lebanon’s public debt-to-GDP ratio at 143.1 percent, almost 40 percent of Lebanon’s total public debt can be attributed to EdL. Alternatively, Lebanon’s debt-to-GDP ratio would have been 87.8 percent instead of 143.1 percent if EdL had not been loss making.

Figure 57. The cumulative cost of transfers to EdL since 1992 reaches 55 percent of 2013 GDP



Source: Ministry of Finance, and World bank staff calculations.

**EdL financial losses, their sources, and how to address them have long been known (e.g., World Bank, 1983), but have yet to be addressed by policymakers three decades later.** The financial losses of EdL started being substantial in 1981 due to “theft of electricity from EdL through illegal connections and unbilled consumers. This has meant that with the normal power line losses at about 12 percent, only about 54 percent of the energy generated and purchased by EdL was billed to consumers.” These losses have arisen “despite a government subsidy on the ex-refinery price of fuel oil and gas oil paid by EdL in 1982 equivalent to 29 percent and 20 percent of the respective refinery prices.” One of the recommendations from this 1983 World Bank report was that “the Government should urgently discuss the problem of illegal connections and excessively overdue accounts with EdL, and should set up practical measures to help EdL to restore normal conditions in the sale of electricity. The Government should discuss with EdL their operating cost level and financial requirements and the extent of the tariff increase necessary to enable EdL to pay for its current oil purchases, meet its debt service and break even on its operating account.”

**Despite the large and subsidized budget for EdL, the power supply remains patchy for 92 percent of households, who need to be linked to private generators.** The revenues of the latter are estimated at USD1.7 billion or 4 percent of GDP (Roberts, 2013). The poor quality of service delivered in the electricity sector can be attributed to corruption, mismanagement, and to confessional system where segments of the supporting infrastructure (e.g., workers, service providers) are protected by their respective sectarian leaders.

**Aside from significant but longstanding operational inefficiencies, the Government’s tariff policy has further compounded EdL’s losses and its reliance on budgetary transfers.** A large portion of budgetary transfers to EdL can be attributed to a nominal tariff freeze in place since 1996, which caps EdL’s tariff at a level derived from an average oil price of USD23/barrel—far below cost recovery levels. Transfers are also explained by other factors that contribute to low revenue (such as inefficient tariff structure, low billings and collection), and very high production costs (such as high operations and maintenance cost of power plants due to insufficient regular maintenance, aging assets, and high technical losses).

**The failures of the electricity sector widen inequality in the country (World Bank, 2009c).** Inequities arise from a variety of effect: (i) consumers who are not billed are being cross subsidized by taxpayers and EdL customers that are paying their bills; (ii) consumers who suffer from electricity blackouts are faced with higher cost alternatives (e.g., private generator for the rich, candles for the poorest consumers); (iii) electricity rationing is highly inequitable and pro-rich. Poor regions go without public electricity for 12-13 hours every day, while richer ones such as Beirut are subject to 3 hours of daily blackouts. Despite this major constraint on daily life and livelihood, government efforts are more prone to help equalize benefits each confessional groups receive as opposed to need-based/ pro-poor service delivery. Nahas (2008) states that seven thermal power production sites were identified in the early 1990s for the electricity sector, not because of the demand requirements, but because “each

community insisting on having its own power plant, ... and subsequently the Government launched the construction of two hardly justifiable plants in Tyre and Baalbeck.” (Nahas, 2008).

**Consumers are willing to pay significantly more to have high quality electricity supply yet policy-makers have not addressed the issue in over thirty years.** Living without electricity is a social and economic burden for Lebanese households. As revealed in a World Bank’s (2009c) Social and Impact Assessment (household) survey, there is a strong demand for having higher electricity quality even at a much higher price: over half of respondents would be willing to pay double their current expenditures, contingent upon receiving 24 hour service. This same study calculated that the share of electricity expenditures (EdL and private sector) in household budget is relatively low, even for lowest income quintiles. Simulations also reveal that even relatively high tariff increases across the board do not lead household expenditures to exceed international norms for any quintile. The impact on the poor and less well-off consumers, would, however, need to be carefully assessed and compensated if needed.

**The poor quality of electricity supply hurts economic activity.** Development and cost efficient investment in energy systems has a proven correlation to GDP growth. When electricity supply experiences frequent interruption or is prohibitively expensive, economic growth tends to slow down or even contract. Electricity ranks as the most binding constraint to doing business in Lebanon. As noted earlier, Lebanon scores as the second worst country in the world in terms of quality of electricity supply in the 2014-15 World Economic Forum’s Global Competitiveness Index. Similarly, according to the World Bank’s 2013/14 Enterprise Survey, 55.1 percent of Lebanese firms identify electricity as a major constraint to business operations and competitiveness.

<sup>1/</sup> For example, in 2012, attempts by EdL to outsource its distribution retail services to private service providers, met with strong and sometimes violent resistance from a highly factionalized workforce. The divisions within EdL’s workforce are a direct result of Lebanon’s confessional approach to governance and public employment, and highlight the constraints on rational management decision making within a confessional system.

**106. Poor transportation impedes private sector development and access to markets in lagging regions.** This results in high monetary and non-monetary costs for both households and businesses. As noted above, Lebanon ranks 120<sup>th</sup> out of 144 countries on road quality. Lebanon’s road network, while substantial at 22,000km<sup>2</sup>, is in poor overall condition.<sup>73</sup> Traffic congestion is rife in the greater Beirut area as the transport system is underdeveloped compared to most cities in the region. Further, there has not been major expansion in the road network since the 1960s, all north-south traffic has to go through Beirut’s central streets, there is no mass transit system in Beirut, and there are no reliable public transport systems.<sup>74</sup> Compounding the problem of no reliable public transportation is the relatively high cost of vehicle ownership in Lebanon: import dues on vehicles can exceed 50 percent of a vehicle’s value, higher than most countries, while gasoline is (correctly) not subsidized as in most other regional countries. All of these result in lower wellbeing and decreased connectivity while they push up accident rates, and economic and financial costs with detrimental impacts on economic growth and inclusion. As an indication of the order of these burdens, spending on transportation represents about 15 percent of household expenditure, which is a disproportionately high amount compared to other countries, while urban traffic congestion-related waste and inefficiencies cost the economy no less than four to five percent of national GDP yearly (Government of Lebanon, 2011b). These high costs are important: as a trade and service oriented economy Lebanon depends heavily on its transport system for the moving of people (tourism/airline), and goods (trade and transit business).

<sup>73</sup> Experts estimate that only 15, 65, and 20 percent of Lebanon’s main road network is in good, fair, and poor condition, respectively. By comparison, in Jordan (the other upper middle income services-oriented economy in the region that most resembles Lebanon’s), 60, 28 and 12 percent of the road network is in good, fair, and poor condition, respectively.

<sup>74</sup> All cities in the region have either built such systems (Tunis, Rabat, Dubai, Cairo) or are in the process of building them (Amman, Riyadh, Jeddah).

107. **High transport costs disproportionately affect the poor.** The inefficient and costly transport sector is creating increased disparities between Beirut and the regions. Economic activity is centered in Beirut, and poor transportation is contributing to that as industries and services are induced to relocate to Beirut to be closer to demand and population centers. Poor road quality is a trademark of underdeveloped regions in Lebanon, due to their relatively weak political leverage. Any reform for economic and political decentralization, while very welcomed, requires the improvement of the transportation connectivity as an essential prerequisite. The rural poor cannot afford housing in Beirut where employment opportunities are, and the commute to Beirut is both expensive and time consuming despite short distances. The lack of a reliable public transport system requires the urban poor to use outdated, overcrowded, and unsafe buses and microvans to meet their transportation needs. While it is difficult to quantify the cost of deteriorating roads, particularly rural roads, on the economy and lower-income groups in Lebanon due to the unavailability of data, there is widespread evidence of rural road rehabilitation programs in other countries dramatically improving incomes of rural populations.<sup>75</sup>

108. **Lebanon's very poor road safety record represents another major drain on the economy.** Weak road safety management, including poor road infrastructure quality, together with bad behavior and lack of enforcement, has had detrimental effects on road safety in Lebanon. In 2012, traffic police reported 595 fatalities while the Red Cross registered 6,700 injuries. These figures are widely considered to be under-reported, and the WHO (2013) estimates the number of fatalities at 950. According to the World Bank (2013j) the economic cost of road traffic fatalities and injuries in Lebanon is equivalent to 5.5 percent of national GDP, higher than most other regional countries.

109. **Water supply services are below the levels expected in a middle income country, with significant ramifications on the poor in particular.** Despite relatively high per capita water endowment, Lebanon uses over 66 percent of its water resources in a largely unsustainable manner. Agriculture consumes over 60 percent of available water and employs 20 percent of the labor force, many of whom are poor, but only contributes an average of six percent per year to GDP. Seasonal mismatch between water supply (at its peak in the rainy winter) and water demand (peaking in the hot, dry summer months) is exacerbated by the very low water storage capacity,<sup>76</sup> deficiency of water supply networks and, on the demand side, fast rising demand from municipal and industrial sectors. A poorly sequenced investment program and absence of viable business model for wastewater have left 92 percent of Lebanon's sewage running untreated into the watercourses and the sea. Responsibility for irrigation has not been transferred to regional Water Establishments as planned and proposals to decentralize management to water user associations and increase cost recovery have not been implemented. More than half of the irrigation schemes lack adequate operation and maintenance. Returns to water are low and the country is missing opportunities to increase production and trade in high value crops.

110. **Dysfunctional land and housing sectors disproportionately affect the poor.** Housing affordability is an issue of particular concern for low and middle income groups in Lebanon. The house price to income ratio is 9 in Lebanon – almost double the typical ratio in an OECD country of less than 5 (World Bank 2011c; UNHABITAT, 2011). The average cost of a square meter of an apartment in Beirut was approximately 4,200 – 6,800 USD in 2011 – approximately 2 to 4 times the cost of apartment space in the capital cities of other Mashreq and Maghreb countries. There is substantial socioeconomic segregation with limited mixed income housing. Dysfunctional land markets and land policies impact the poor directly and through the constraints they impose on firms. Key land challenges include ineffective means for servicing land, and insufficient and ineffective land taxation. The new (and controversial) rent law passed

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<sup>75</sup> Morocco's rural roads program in recent years has caused a drop of 43 percent in the cost of transporting goods and a concomitant rise of 39 percent in average monthly income per household among the rural poor.

<sup>76</sup> Lebanon only stores 6 percent of total resources, compared to the MENA average of 85 percent.

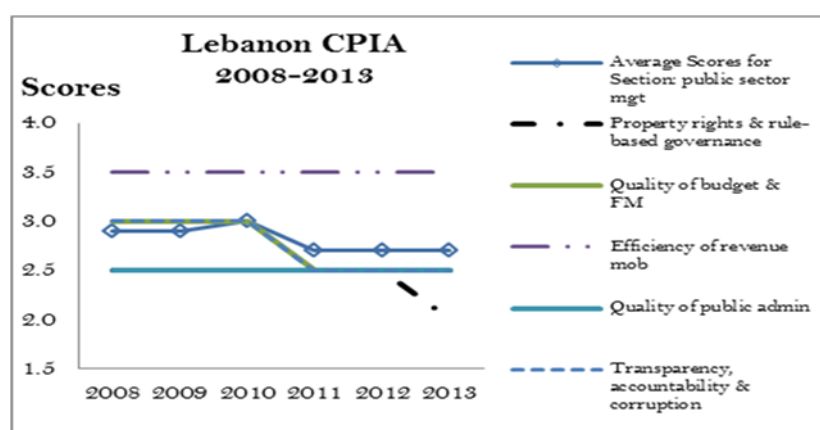


in April 2014 to remove old rents is likely to affect about 200,000 apartments, mainly in Beirut. The application of such legislation presents a number of risks: (i) the displacement of low and middle income groups, who will find it difficult to find affordable housing, a problem that is compounded by the presence of 1.1 million displaced Syrians throughout the country; (ii) major demographic changes in different parts of Lebanon and in the socio-economic profile of Beirut, leading to increased gentrification; and (iii) the potential for destruction of the ancient fabric as lucrative high density buildings are raised in the core of historic districts which threatens a loss of the remaining urban cultural heritage at the heart of the cities.

### 3. Weak and deteriorating institutions and governance<sup>77</sup>

111. **Poor governance and weak institutions are significant constraints that exacerbate the challenges posed by the existing confessional system.** Institutions in Lebanon are extremely weak, characterized by both inefficiency and corruption, and a ‘governance’ trap whereby political stability is maintained through subordination of national prerogatives to consensus among sectarian interests at the cost of strong institutions focused on the public good. In this configuration, it is noteworthy that *Banque du Liban* stands out as an effective and respected institution, because its considerable powers are legally ring-fenced, including being financially independent of the government.

Figure 58. The quality of Lebanese public finance institutions is weak and getting worse



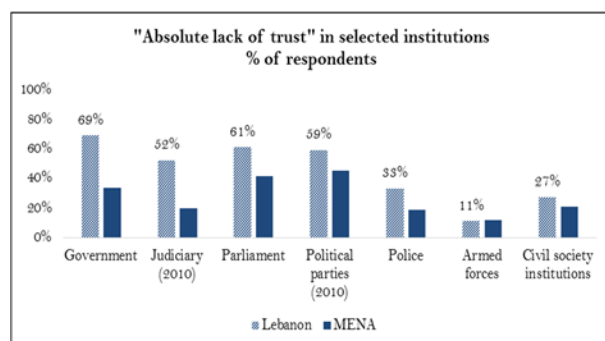
Source: World Bank CPIA, 2008 to 2013.

112. **Lebanon scores poorly on many aggregate governance indicators and its performance is not only below the regional average, but it has also markedly declined over the past decade,** as shown on Figure 3 on corruption ranking, the rule of law, and political stability, and Figure 58 on quality of institutions show. According to the Global Competitiveness Index (GCI) institutions are the third weakest comparative constraint of the country, and while the gap with comparator countries is not as large as with infrastructure and the macroeconomic environment, it is nonetheless substantial (Figure 54). In fact, Lebanon’s institutions rank 139<sup>th</sup> out of 144 countries. Out of 21 institution sub-indicators in the GCI and in 15 (71 percent) of them Lebanon ranks among the 10 percent worst countries in the world. The worst rankings are for public trust in politicians (worst in the world: 144/144), wastefulness of government spending (second worst in the world: 143/144), favoritism in decisions of government officials (142/144), irregular payment of bribes (142/144), business cost of terrorism (140/144), efficiency of legal framework in challenging regulations (139/144), intellectual property protection (139/144), judicial independence (138/144), transparency of government policymaking (138/144), and diversion of public funds (137/144). These weaknesses are also reflected in polls of Lebanese citizens. In a 2013 Gallup World Poll, Lebanese

<sup>77</sup> This section summarizes the analysis of existing governance data gathered from the AGI Portal ([www.agidata.org](http://www.agidata.org)).

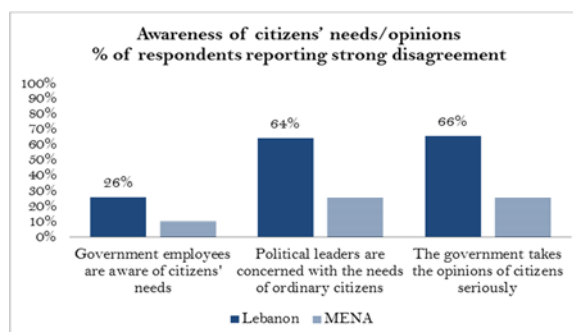
reported low confidence in: a) their national government (37 percent) and the judiciary, b) that elections are honest (15 percent), and c) that their government is not corrupt (4 percent).

Figure 59. Trust in institutions



Source: Arab Barometer, 2013.

Figure 60. Awareness of citizens' needs

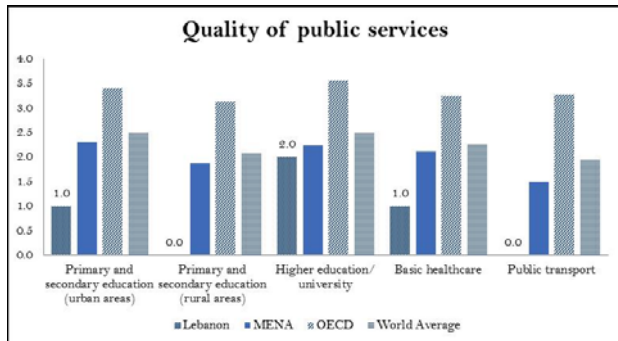


Source: Arab Barometer, 2013.

113. **Aggregate governance indicators, however, hide a significant heterogeneity in terms of institutional performance within the country.** Public services do not reach all citizens in the same way and with the same quality, as both the Enterprise Survey of the Informal Sector and the Institutional Profile Database report. These differences are significant across cities and between urban and rural areas (Figure 61). The quality of public policy making and of service delivery, which was already weak to start with, has deteriorated markedly since 2006 (Figure 62).

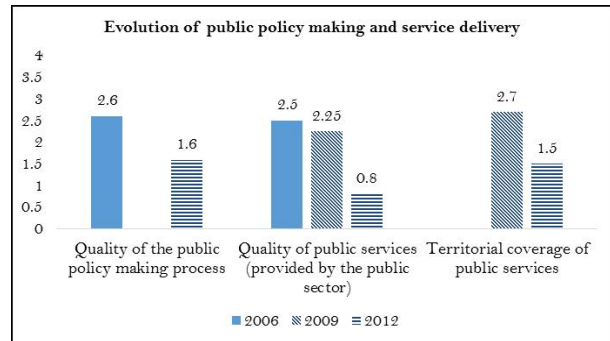
114. **The judicial system is slow, costly, and corrupt, which increases transaction costs for enterprises.** Contract enforcement is slow and costly, with high costs associated with lawyers' fees. Lebanon is the slowest country in the MENA region, taking over 700 days on average to enforce a standard contract. Predictability of rules and regulations is generally deficient partly due to the lack of access by judges to legal information and training, so that dispute resolution tends to be inconsistent. Despite a number of reform actions, corruption remains a serious problem in the judicial sector, particularly with court administration staff. The fairness and independence of the judiciary has been called into question based on the extent to which the confessional system has extended to judicial appointments. Predictability also suffers from the poor quality of legislative drafting and review, which is at least partly due to the lack of resources available to the legislative drafting unit of the Ministry of Justice. Judges, lawyers and government officials have noted that improperly drafted legislation too often results in uncertainty as to whether new laws supplement, amend or replace existing laws, prompting the need for frequent amendments, and difficulty for discerning the meaning of the law by the public. This increases transaction costs suffered by businesses. Enforcement of judicial decisions can also be problematic.

Figure 61. Low public service quality and spatial inequality in public service delivery set Lebanon apart



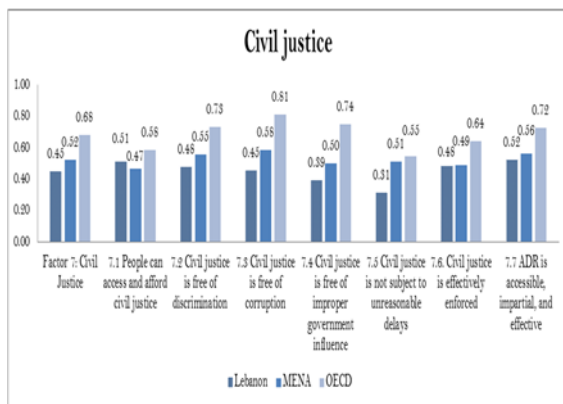
Source: Institutional Profiles Database, 2012

Figure 62. The quality of public policy making and service delivery deteriorated sharply since 2006



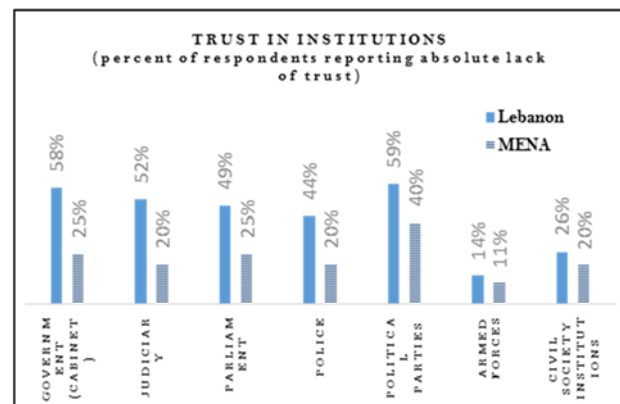
Source: Institutional Profiles Database, 2012

Figure 63. Lebanese Judicial outcomes are perceived as significantly tainted



Source: World Justice Project Rule of Law Index, 2014

Figure 64. Lebanese reveal a profound lack of trust for key core public institutions of the country

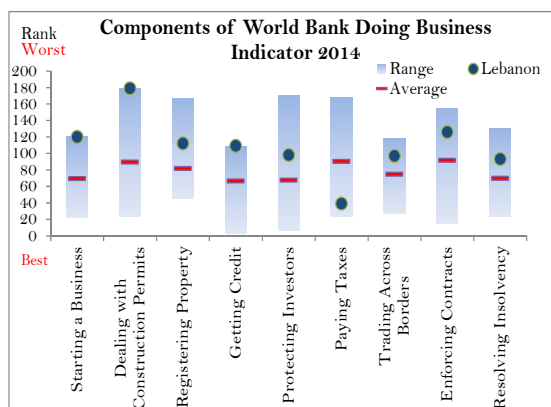


Source: Arab Barometer, 2010-2011.

115. **There is a significant gap between the *de jure* dimensions of governance and the *de facto* implementation of the same laws and regulations... leading to a culture of weak accountability and impunity.** Long and repeated periods of care-taking governments have eroded accountability. A large and growing number of senior positions in the administration remain vacant due to deadlock on hiring based on confession, exacerbating already unclear lines of accountability. Regulations governing income and asset disclosure are weak, as are conflict of interest regulations. Lebanon has no proper freedom of information framework, including relevant legislation and regulations.<sup>78</sup> Access of civil society to information on public affairs, including budgetary information, is difficult. Boundaries between the public and private sector persona of policymakers are ill-defined. Most high ranking politicians/policymakers are connected to major financial and real estate interests either directly or through their close relatives. Monopolies linked to politicians hinder competition and create obstacles for entry of new firms.

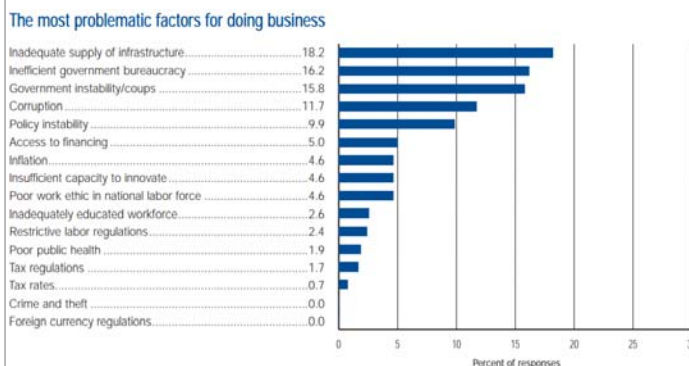
<sup>78</sup> Two draft laws, however, exist: one on the Right to Access to Information and the second on Whistleblower Protection; these were submitted to Parliament in 2009 and 2010, respectively.

Figure 65. Lebanon scores poorly compared to comparators across almost all DB indicators



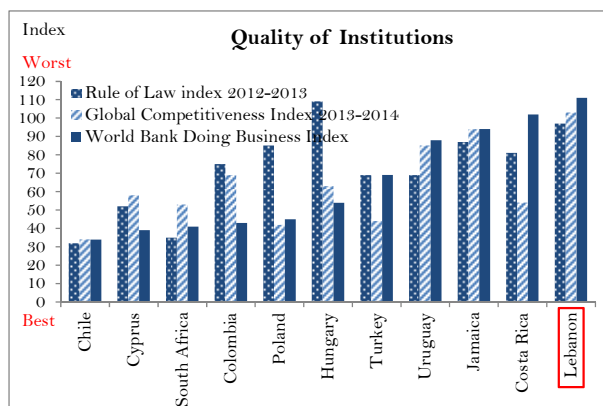
Source: World Bank, Doing Business, 2014. The average is for a group of countries with GDP per capita in PPP terms within 10 percent of Lebanon's in 2013. The countries are Azerbaijan, Belarus, Cuba, Gabon, Mauritius, Mexico, Romania, Suriname, Turkey, Uruguay and Venezuela.

Figure 66. Lebanon's key constraints to doing business include infrastructure, and confessionally-related governance issues



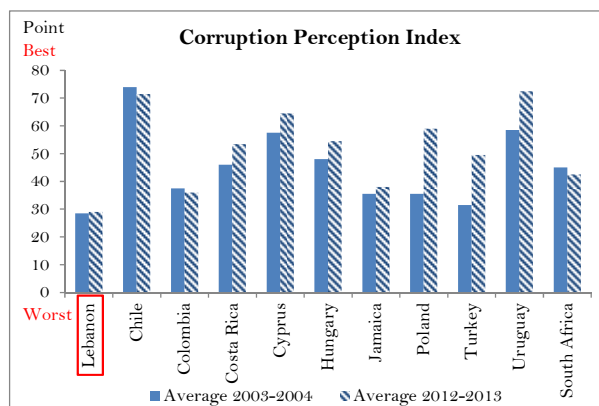
Note: From the list of factors above, respondents were asked to select the five most problematic for doing business in their country and to rank them between 1 (most problematic) and 5. The bars in the figure show the responses weighted according to their rankings.  
Source: World Economic Forum, 2013 Global Competitiveness Index.

Figure 67. Lebanon ranks as the worst among comparator countries in quality of institutions



Source: World Bank and World Economic Forum.

Figure 68. Lebanon is perceived as the most corrupt among comparator countries



Source: Transparency International.

116. **The management of civil servants is profoundly tainted by favoritism and nepotism.** Political orientation rather than experience and skills appear to be the key factor influencing the decision to hire a civil servant (Figure 48 page 44). These factors play a more significant role in Lebanon than in any other countries in the region and their importance has increased markedly over the past few years (Figure 47 page 44). These public sector jobs are sought after since they offer income security and benefits for those who are able to obtain them.

117. **Local governments have historically been disempowered, and there has been limited upward and downward accountability of these governments.** Lebanese local governments have limited mandate and financing. This is reflected in the low share of public expenditure executed by Lebanese local governments—e.g., 6 percent in 2007 relative to an average of 20 percent in countries with unitary governments around the world (World Bank, 2007c). Furthermore, central government transfers to Lebanese local governments are irregular and often delayed, constraining their ability to invest in and sustain good quality services and infrastructure. Mechanisms for upward and downward accountability are limited. There is limited measurement and transparency regarding the performance of local governments.

118. **The public procurement system is weak, resulting in poor public accountability and widespread rent-seeking.** Lebanon has systematically been ranked on lower spectrum of transparency international index surveys as far as governance is concerned (2014: 136<sup>th</sup> out of 175 countries). Improved public governance implies improved public accountability and the quality of administration, and the addressing of the problem of bribery and corruption. A major area for improvement is public procurement to establish government procurement policies that are transparent and open to a wide range of bidders including SMEs. That is where having a modern public procurement law, including possibility of e-procurement, would reduce the cost of delivery of goods and services, and help in removing part of corruption and bribery that are rampant in the private and public sectors. Systematic corruption has added materially to the cost of public procurement. The control of corruption is weak, at 22 percent in 2010 according to Transparency International, Lebanon ranks as the fourth weakest out of 18 countries in the MENA region (ahead of Iraq, Libya, Yemen, and Syria). Further the quality of the goods and services fail to meet the required standards. Major public procurement impediments include: (i) lack of a comprehensive public procurement law; (ii) a weak control environment that does not enforce the implementation of rules and guidelines; (iii) lack of private sector international competition; (iv) deficiency in human resource capacity and training, coupled with procurement not being considered as a profession; (v) lack of institutional procurement complaint mechanism; and (vi) the lack of procurement performance information/data.

#### 4. Uneven human capital and skills mismatch

119. **Heterogeneous human capital development.** As revealed by the World Bank's inequality-adjusted 2013 Human Development Index (HDI), while Lebanon performs relatively well in terms of human capital, the country faces large inequality of opportunities and outcomes among its citizens.<sup>79</sup> Opportunities are more a function of confessional polity and "*wasta*" rather than meritocracy. Nearly 80 percent of the respondents on the Arab Barometer (2013) agreed that obtaining employment through connections is extremely widespread, compared to the MENA average of 60 percent. Over 70 percent of respondents cited the applicant's tribe and/or political orientation as more important than qualifications in obtaining employment in the public sector, as compared with 40 percent across MENA. Both figures are the highest percentages of all countries in the MENA region.

120. **The structural inequalities created by the confessional system of government are also evident in the social services.** Although social spending in Lebanon has been historically high (with over 70 percent coming from the private sector), investment expenditure has not matched the geographic distribution of poverty (see Table 3 below), and the privatization of service delivery has resulted in exorbitant costs which has disproportionately affected the poor (Sen and Mehio-Sibai, 2004). The substitution of welfare support and direct delivery of social services by confessional organizations, while beneficial to the most vulnerable populations for the most part,<sup>80</sup> has further weakened the ability of the state to deliver, regulate and improve the quality of social services.

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<sup>79</sup> Lebanon's inequality-adjusted HDI is 20.8 percent lower than its HDI, among the largest losses in the group of countries in the high human development category.

<sup>80</sup> Despite the important role of confessional organizations in provision of social and welfare services, it is important to note that inequalities exist even in coverage for 'in-groups'. In many cases, service provision by confessional organizations is politically motivated and selective, i.e. targeting important electoral constituencies, implying that the most vulnerable do not necessarily benefit (For a fuller analysis, see Cammet et al., 2010).

Table 3. Lebanon: Public expenditure, poverty and basic needs

Mohafaza	Total public investment expenditure (million US\$; 1995-2005)	Poverty incidence (percent, 2004)	Allocation of public investment expenditure (share)	Distribution of low satisfaction of basic needs (share; 1995)	Distribution of poverty (share; 2004)
Beirut	734	5.85	16	8	2
Mount Lebanon	1,111	19.56	25	30	27
North	1,415	52.57	32	26	38
Bekaa	247	29.36	6	15	13
South	918	42.21	21	10	16
Nabatieh	42	52.57	1	11	4
Total	4,467	28.55	100	100	100

Sources: MoSA, CAS, and UNDP (2009)

121. **Inequality in Lebanon is particularly stark in income and in education, and less pronounced in health** (with losses of 30, 24.1, and 6.7 percent, respectively, compared to the non-inequality adjusted HDI index). In part this arises from the weakness of the state in delivering high quality public services—a difficulty that is compounded in poorer regions of the country (See Figure 69 and Figure 70). With low rates of return on skilled human capital at home, Lebanon is facing severe difficulties in attracting and retaining talent (e.g., WEF’s Human Capital Index of 99/122 and 97/122, respectively; the emigration rate of the tertiary educated reaches 43.9 percent according to the WEF’s 2013 HCI). These factors are impacting the country’s development’s prospects as skilled labor is difficult to find, and many Lebanese do not reach their full human capital potential. A particular challenge is therefore to reduce skills mismatch with private sector needs: post-secondary schools addressing skills for ICT, tourism, healthcare, construction sectors. This is also undermining Lebanon’s poverty reduction and social and economic inclusion efforts as social/economic mobility is difficult for individuals born from low skilled parents.

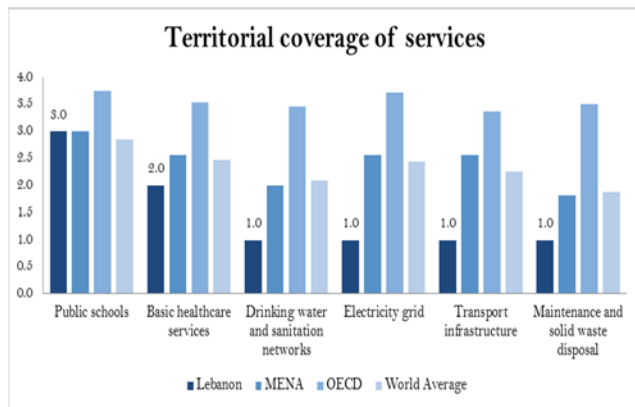
122. **The Syrian crisis and the associated large influx of refugees has severely stressed access to and the quality of public services in Lebanon, especially those related to human capital** (World Bank, 2013d). The cost for the central government budget of meeting additional demands for health, education and social safety nets for 2012-2014 is estimated at USD308-USD340 million (this excludes demand which is being met through international humanitarian assistance). In the health sector, the refugee influx has resulted in significantly increased demand for health care services, leading to shortages in health workers and financial pressure on hospitals, which the government is unable to meet. Health care costs have increased significantly, resulting in significant welfare impacts on host communities, who are less able to afford quality healthcare services. In the education sector, the impact of the refugee influx has also resulted in mounting fiscal costs, diminished quality of public education, and increased need for informal and out of school education. If not managed, the extra burden on the education system could decrease the learning performance of Lebanese students. In both the health and education sectors, the ‘crowding out’ of Lebanese host communities due to the large number of Syrian refugees is increasingly becoming a source of tension and undermining social cohesion and stability.

- *Education: the co-existence of multiple systems with sharply different quality levels.* Education in Lebanon is characterized by multiple adjacent systems, including public and private systems, functioning independently from each other. Public schools educate only about 31 percent of students

in Lebanon, despite being free and alternative options being for the most part expensive.<sup>81</sup> The remaining students are in private schools (53 percent), in free private (and state-subsidized) schools, which are often confessionally-based (13 percent), or attend UNWRA schools (3 percent), which are for Palestinian students. This revealed preference for non-public schools reflects the poor quality of public schools<sup>82</sup> and has large and negative implications on the poor and their struggle to escape poverty traps. Indeed, based on the 2004 household survey, poverty and education are highly correlated in Lebanon. Data also reveal that the poor tend to attend lower-quality public schools, and the wealthy attend higher-quality private schools (UNDP, 2008). The higher quality associated with private schools means that public-school students are likely to learn less and face more difficult job prospects upon graduation. This sets up inter-generational transmission of both lower learning levels and lower income. It should also be noted that the education system in Lebanon, because of its strong stratified nature—along income and confessional lines—does not perform its classic civic mission of being the “glue” that binds citizens to the state.

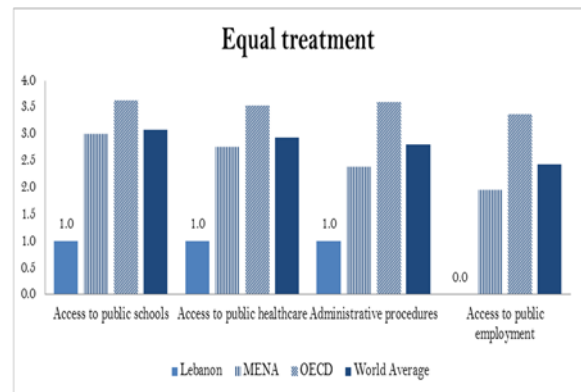
Relative to other MENA countries, Lebanon’s adjusted primary net enrollment rates are slightly above average at 96 percent. However, secondary net enrollment rates in Lebanon at 67 percent lag behind the MENA average of 72 percent. When compared with countries with similar level of development, Lebanon’s secondary net enrollment rate is significantly lower than the average of 81 percent.

Figure 69. Geographic coverage



Source: Institutional Profiles Database, 2012.

Figure 70. Equal access to services



Source: Institutional Profiles Database, 2012.

- *Health: a two-class system with an inefficient and inequitable public health sector and a high quality private sector.* Lebanon exhibits relatively good health status among the population but, as with education, it contains strong inequality in terms of geographical, income, and gender as far as access to and quality of health services is concerned. For example, some regions (Bekaa and North Lebanon) have pockets of depressed rates of socioeconomic and associated health status. Health inputs exhibit similarly stark geographical inequality.<sup>83</sup> Service delivery is complex with both public and private

<sup>81</sup> Lebanon’s private education system is also free for a large share of students (World Bank, 1999 Education PER) as these receive public or private subsidies. These subsidies are available to (i) children of public employees (accounting for about 19 percent of all students in Lebanon), (ii) households in which at least one member is a private-sector wage earner (5.7 percent of pupils have received grants from private employers—a small share as surveys find that many employers avoid paying grants)—and (iii) students that are simply exempted from school fees (about 8.5 percent of students).

<sup>82</sup> Public schools exhibit lower academic outcomes in international and national assessments. The level of public school students was 10 percent lower than that of private schools in the 2011 Trends in International Mathematics and Science Study (TIMSS) results.

<sup>83</sup> For example, Mount Lebanon has the highest density of physicians and nurses (42 percent and 33 percent), compared to Bekaa, with only 7.8 percent of Lebanon’s physicians and 19 percent of nurses (Ammar, 2009).

institutions as providers. The system is also inefficient and expensive as public resources are predominantly allocated to curative and pharmaceuticals while primary care and generics receive limited allocations. With only 50.1 percent of the population receiving health insurance, out-of-pocket expenditures are the largest source of health financing and a shared inequitably<sup>84</sup> across households. The obligation to pay directly for services, is subjecting a large proportion of the population to financial hardship, even impoverishment. Data also suggest that catastrophic health expenditures vary significantly across regions. In the Nabatieh region, about 35 percent of households incur catastrophic health expenditures, while the national average is 7 percent. The health system reflects the broader economic and political situation of the country in that different health payers and providers (MOPH, the social security fund, and the various specialty fund-holders) all fall under different ministries or management responsibilities making any attempts at national, comprehensive health sector reform very challenging. To improve Lebanon's health system, increased accountability in the quality and delivering of public services and further strengthening of the regulatory system are critical. Among the main obstacles facing the sector and its ability to expand coverage is inadequate public spending on health and the skewed spending on curative care compared to prevention and primary health care.

- *An underperforming and under-covering social safety net (SSN) system.* Lebanon's social safety net system ranks among the weakest in the world (117 out of 122 in the WEF's 2013 HCI). Lebanon, similar to the MENA region, suffers from key factors that hamper the effectiveness of SSNs: (a) offering a multitude of small, fragmented and poorly targeted programs that do not have a significant impact on poverty or addressing inequality because of their low coverage, high leakage, and limited benefit levels—weak capacity of public institutions coupled with lack of reliable and consistent data also hampers program effectiveness; and (b) relying primarily on inefficient and pro-rich universal subsidies which crowd out more-effective interventions. Fragmented and relying overwhelmingly on categorical and geographic targeting, Lebanon's non-subsidy SSN program spending did not exceed 1 percent of GDP in 2013,<sup>85</sup> while price subsidies (diesel, bread, and domestic production of tobacco) account for a negligible 0.03 percent of GDP. The 1 percent of GDP spent on SSNs in 2013 did not contribute to reducing poverty or addressing inequalities and proved to be weak in protecting vulnerable Lebanese. If electricity subsidies and, in particular, the transfers to *Electricité du Liban*, spending on SSNs increases dramatically to above 5.6 percent of GDP. The electricity subsidy is perceived as a social safety net for the Lebanese poor with a progressive tariff fixed in 1996. As electricity subsidies suffer from high leakage and offer a small benefit value to the poor, the programs' efficiency as a social safety net is weak and should be replaced by better-targeted and more efficient programs. (World Bank, 2009c). The inability to provide adequate social safety nets by the government diminishes citizen trust in the State (Figure 59). Similarly, the absence of feedback mechanisms create a disconnect between the government and needs of citizens (Figure 60).

**123. Inequality in Lebanon is particularly stark among gender once political empowerment is taken into account.** According to the World Economic Forum's Global Gender Gap Report of 2014, Lebanon is the World's eighth worst country in terms of gender equality, ranking 134<sup>th</sup> out of 142

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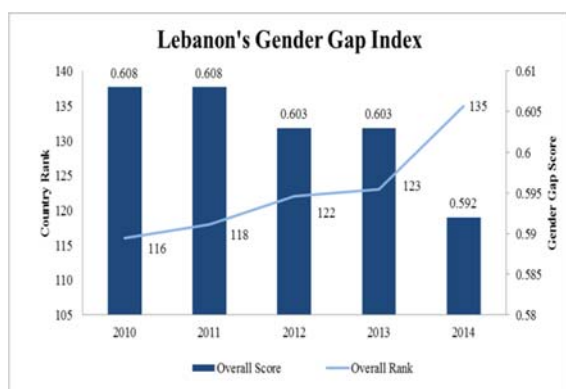
<sup>84</sup> The poorest households spend about 14 percent of their income on health, while the richest households allocate 4.2 percent (World Bank, 2013).

<sup>85</sup> These include (i) social services and programs targeted to certain categories of the population (e.g., disabled persons, juvenile delinquents, school dropouts, orphans) provided by MOSA with the majority of its budget distributed to NGOs and welfare associations; and (ii) fee waivers for hospitalization in public and private hospitals which is for use of hospital services by those not covered by the National Social Security Fund and lacking the means to purchase insurance. Finally, the MOSA established the National Poverty Targeting Program, the first poverty-targeted social assistance program for the poorest and most vulnerable Lebanese families.



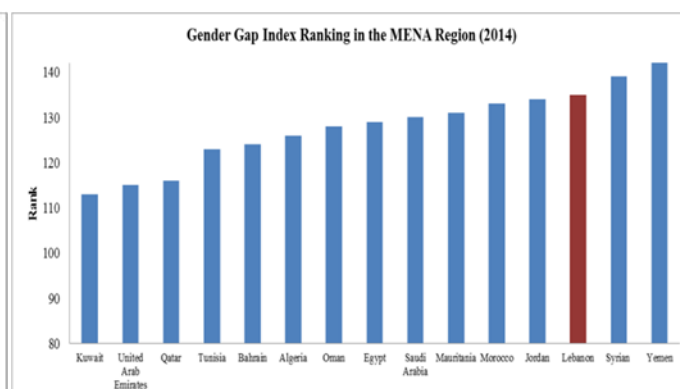
countries<sup>86</sup> surveyed with a gender gap score of 0.592.<sup>87</sup> This low score is mostly driven by the poor performance of the country in terms of political empowerment (the Global Gender Gap Index measures the relative gaps between women and men across four key areas: health and survival, education attainment, economic participation, and political empowerment). Using this index Lebanon ranks third to last in the MENA region, where only war-ridden Syria and Yemen have a worse gender gap ranking of 139 and 142 respectively (Figure 72). Notwithstanding the weak ranking, Lebanon's Global Gender Gap absolute scores are very similar to those of other MENA countries (specifically the difference between Lebanon's score in 2013 and the 5<sup>th</sup> highest score in the MENA region does not exceed 0.01 points). Since 2010, Lebanon has seen a consistent decline in its global index rank and relative gender gap score primarily as a result of consistently close to zero scores in political empowerment (Figure 71).

Figure 71. Lebanon's gender inequality has worsened markedly over the past few years



Source: World Economic Forum's Global Gender Gap Report of 2014.

Figure 72. Lebanon ranks poorly on gender equality in the region



Source: World Economic Forum's Global Gender Gap Report of 2014.

**124. Lebanon's gender inequality is among the worse ranking MENA countries in Economic Participation and Political Empowerment, but performs noticeably better in the areas of education attainment and health.** Lebanon's political empowerment index is second to last in the world (last in the MENA region), with a score of 0.01. The low score is due to the historically low number of women elected in parliament or appointed as ministers as only three women were elected in parliament in 2008, and no woman was appointed in the previous council of ministers in 2014. However, this particular score does not correctly portray the role of women in political issues in comparison with other Arab and MENA countries. While countries like Kuwait and Saudi Arabia may receive a higher political empowerment score for recently appointing more women as ministers in a particular year, women in Lebanon have taken part in political life since 1952.<sup>88</sup> In terms of economic participation, Lebanon ranked 133 out of 142 countries, due to relatively low levels of female participation in the workforce (female to male ratio of 0.34), and low estimated earned income for women (female to male ratio of 0.27). The female labor participation rate in Lebanon is on par with the MENA region and has been steadily increasing as discussed earlier, albeit from a low level. In education attainment, Lebanon has closed the gender gap in secondary and tertiary education with a female to male ratio exceeding 1.00; however, female enrollment in primary education is at a relatively low level of 90 percent, while male enrollment in primary education exceeds 97 percent. Consequently, Lebanon remains at rank 106 out of 142 in educational attainment. Finally, Lebanon's health

<sup>86</sup> Only the Ivory Coast, Iran, Mali, Syria, Chad, Pakistan and Yemen scoring lower on the 2014 Gender Gap Index.

<sup>87</sup> 0.00=inequality, 1.00=equality.

<sup>88</sup> Women in Lebanon were granted the right to vote in 1952, while countries like Qatar, Bahrain, Oman, and United Arab Emirates only did so over 50 years later.

and survival ranking was the highest among the four key areas (62 out of 142); the sex rate at birth, and the healthy life expectancy are almost equal between men and women.

## 5. Challenging business climate and access to finance limiting competition

125. **The Lebanese economy is constrained by significant structural rigidities.** While political uncertainty dominates business' investment decisions according to newly available ICA data, investment climate issues, ranks as the next most important principal constraint to business. While traditionally the private sector in Lebanon has demonstrated considerable resilience—adapting in a challenging and volatile investment climate—the proximity of conflict in neighboring Syria, increasing domestic political instability and an uncertain geopolitical environment have considerably increased perceived risk exposure. This has led entrepreneurs and companies to prefer short-term and liquid investments, to the detriment of economic growth.<sup>89</sup> These factors, together with 'traditional' investment climate constraints intervene at all stages of the firm life cycle, namely:

- *Establishing and closing a business* are challenging and expensive tasks. As a result, Lebanon ranks as 104 out of 189 economies on the ease of starting a business (2015 Doing Business). High minimum capital for starting a SARL is required by the commercial code, and the fixed mandatory cost imposed by lawyers for creating a new company, even small ones, continue to impose significant barriers to entry for small entrepreneurs. Exit (insolvency and liquidation) remains costly, non-transparent and slow; Lebanon ranks 136 on the resolving insolvency Doing Business indicator.
- *Running a business* is also challenging.
  - *Weak contestability and competition:* Contestability of markets is weak given significant barriers to entry—especially legal and administrative measures—and widespread pricing policies and restrictive practices. There is no competition law. As a result, half of Lebanon's domestic markets are considered oligopolistic to monopolistic and a third of them have a dominant firm with a market share above 40 percent (MoET, 2003). In particular, the political influence of import monopolies captured by a limited number of exclusive agents stemming from a Pricing and Monopolies law of 1967 makes it difficult to see any reforms in this area before some time. There are few restrictions on conflicts of interest for head of state, ministers, and MPs in the legislative framework, limiting preventative anti-corruption efforts. Business and political figures are often thus, one in the same. Such elite capture and widespread lack of competition in the economy is suspected of having a large negative impact (i) on economic efficiency and ultimately on growth and jobs, but also on (ii) consumer welfare and is particularly detrimental to poor households and households in the bottom 40 percent.
  - *Weak corporate governance:* In 2006 the Lebanese Transparency Association spearheaded the first Corporate Governance Code in Lebanon focused mainly on Lebanese joint stock companies. This can serve as a model for other types of businesses and nonprofit organizations, both in Lebanon and throughout the Middle East. To date, only a limited part of this code has been implemented by the private sector. Banks, however, have been active and responsive under the supervision of the *Banque du Liban* (in particular, circulars have been issued in 2011 where all banks are required to adopt a Code of Corporate Governance; this code is meant to

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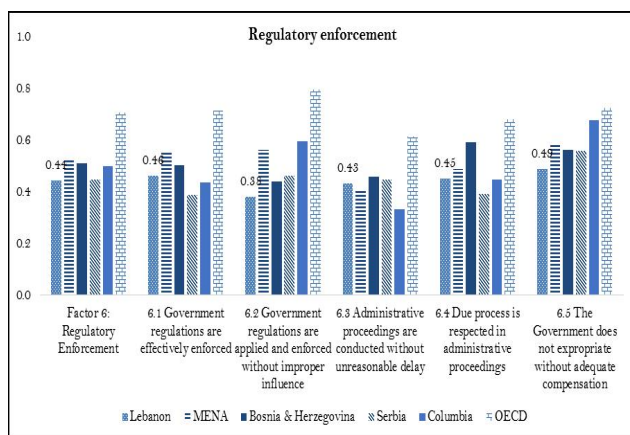
<sup>89</sup> The Lebanese private sector, like the broader political, social and economic system, has proved remarkably resilient to instability and shocks (both domestic and regional) over the years, which it has been able to mitigate and manage with some degree of success, as a 'cost' of doing business. Current threats to security and political stability though (and in particular those related to the Syrian conflict) are considered a 'higher order' and more fundamental and far-reaching set of risks, potentially beyond the capacity of domestic 'coping mechanisms' to handle.

improve transparency and facilitate the monitoring of banks by different stakeholders.) Improvement of corporate governance practices would improve accountability, transparency and decision-making, as well as help firms attract external capital.

- *Administrative complexity and uneven enforcement.* Tax administration and business regulation remains nontransparent, outdated and complex. Dealing with construction permits in Lebanon ranks 164 out of 189 economies according to the World Bank’s 2015 Doing Business report, with the process taking a minimum of 244 days to complete. Also, variation among firms in obtaining a permit is reported to be high and linked to how connected the firms’ owners are. This is a cross cutting challenge identified by the private sector which affects investors operating a business in various sectors of the country. It is also an area where there is high incidence of corruption with the Municipal authorities. Contract enforcement remains problematic while acceptable laws are in place, and their enforcement is slow, unpredictable and costly to businesses. Lebanon consistently scores lower than the MENA average for regulatory enforcement and lower than the MENA average, OECD, Bosnia, Serbia, and Colombia on indicators of improper influence in enforcement and expropriation (Figure 73). The difficulty that lenders encounter to foreclose assets negatively impacts private sector lending. The Enterprise Survey data of 2013/14 reveal that corruption continues to be identified as a serious obstacle to business operations, but ranks fourth after political instability, the investment climate, and power supply (Access to Finance ranks fifth). This finding is consistent across firm size, age, sector, and location (see Figure 96 page 110 in the Annex). The Enterprise survey data also show that the weaknesses in the investment climate are not just “*de jure*” but also “*de facto*”. While there have been positive improvements in days to clear exports and imports, significant delays remain in obtaining electrical, water connections, operating licensing and construction permits. Moreover there is significant variability in the time taken, most starkly in the case of construction permits.
- *Access to skilled labor* is a challenge, as detailed in Chapter 2.
- *Closing a business* in terms of both cost and time is a further significant deterrent to entrepreneurial risk taking. This is a constraint in many MENA countries and Lebanon has better Doing Business measures than its regional neighbors. However, Lebanon’s systems for dealing with “Out of Court” debt restructuring processes, insolvency issues and bankruptcy are outdated and suppress business development in Lebanon.
- *The informal sector in Lebanon is quite large* (estimated at 30 percent of GDP in 2011; IMF), with a larger portion of informality taking place especially in more rural areas. This suggests the possible capture of the formal sector by vested interests in the urban centers and the informal sector constraining competition in the rural areas (Figure 74). The informal sector has likely expanded significantly due to the influx of over 1.4 million Syrian refugees. Such a large influx—as highlighted in other fragile and conflict-affected situations—could both ‘crowd out’ the formal economy (undermining competitiveness and the role/capacity of the state) and existing informal sector firms where the majority of Lebanese poor earn their living, and worse, lead to further political destabilization through the progressive criminalization of the informal sector by uncontrolled rent-seeking, exploitation and domination of trade networks (Rossis, 2011).

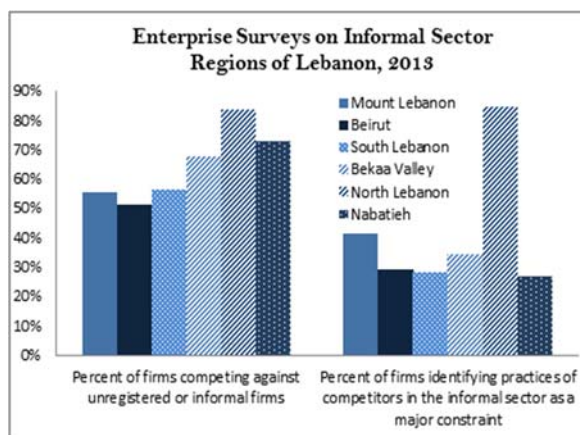
*The informal sector seems to be severely affected by the presence/competition of/from Syrian refugees.* The evidence from the 2014 Informal Enterprise Survey<sup>90</sup> further identifies that it is in areas where there is a concentration of Syrian refugees where the competition from lower-priced competitors is ranked by the largest majority of businesses as the principal constraint to their operations. Also of note is that corruption is the second ranked constraint according to the businesses covered in the survey. The full picture is shown below.

Figure 73. Regulatory enforcement



Source: World Justice Project – Rule of Law Index, 2014.

Figure 74. Quality of business environment by region



Source: Lebanon Enterprise Survey, 2013/14.

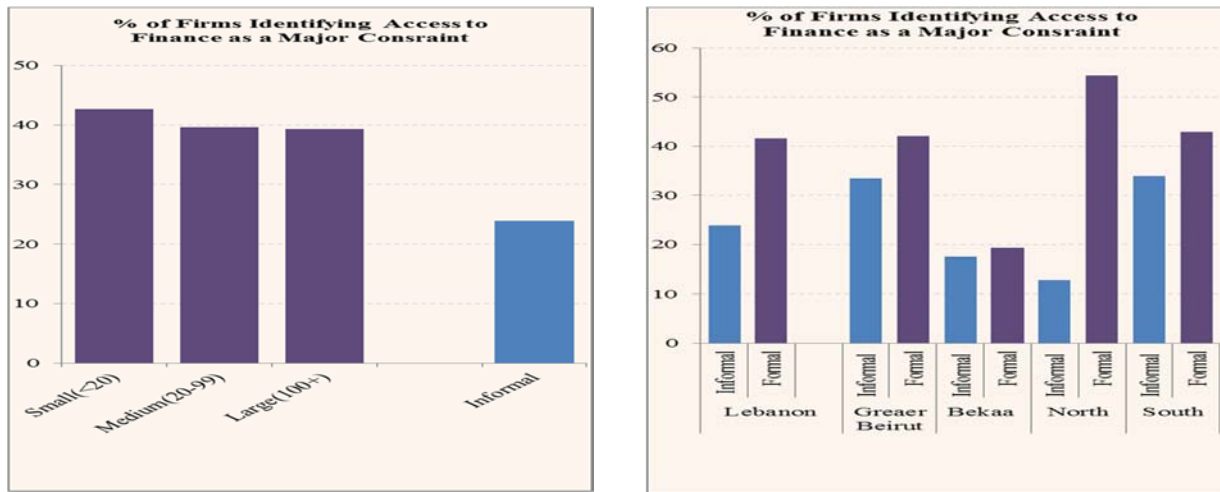
126. **As noted earlier, while access to finance is not the overriding constraint as in many other MENA countries it is still very significant and a larger constraint to small and medium enterprises** than large and informal firms. It remains a significant obstacle (in excess of 40 percent) to formal firms across the country, with the exception of the Bekaa valley (Figure 75). Ongoing efforts initiated by the Central Bank and other governmental and quasi-governmental agencies (such as Kafalat) to promote SMEs and improve their access to finance are showing potential for some success but limited track records, large collateral requirements, and lack of an established relationship with the financial intermediary hinder particularly start-up firms.<sup>91</sup> As a result of the recent 331 Circular initiated by BdL Lebanon currently has had a catalytic effect on venture capital; this bodes well for the future of early-stage equity investments though the sector is still in its infancy. Supply of viable companies (the deal-flow) to meet the demand by VCs is limited necessitating filling the gap in financing and non-financing needs of innovative high-growth potential companies at the seed and early stages of development. Re-balancing the market as such has implications for job creation. Enterprise survey data reveal that small firms and “other services” sectors (including ICT) show the greatest job creation over the 2010-13 period and evidence from firm surveys in other countries show that young companies who experience high growth early on create the bulk of SME jobs (Kauffmann Foundation). However, evidence from focus groups—in addition to the survey data—highlight that entrepreneurs and start-ups are not sufficiently supported by traditional credit services from commercial banks. Given the lending behavior of commercial banks, a key aspect of support to foster increased private sector-lead job creation requires a focus on non-bank financial sector and related

<sup>90</sup> This survey is not statistically representative of the country. The sample was drawn from random walks undertaken by enumerators in targeted urban and peri-urban areas (additionally stratified to ensure locations with and without known concentrations of Syrian refugees). The enumerators were each operating within pre-defined areas following a grid delineation of the target locations. The informal enterprise survey had a sample of 1,015 informal businesses drawn from four regions of Lebanon (Bekaa, Greater Beirut, North and South Lebanon) and 25 urban and peri-urban areas. Businesses interviewed were small manufacturers, retail providers and other services. Almost 600 enterprises from the sample were 1 person businesses, 186 had 3-5 employees, and 260 were two-person operations.

<sup>91</sup> These findings are confirmed by a recent IFC SME Job Study (World Bank Group, 2014f). This study found that entrepreneurs and small businesses, especially those run by women, cite obtaining access to credit as a constraint.

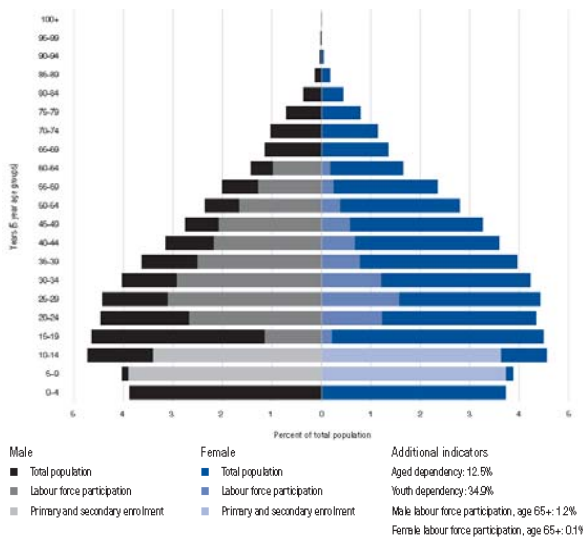
institutional reform such as the work being done currently in terms of the development of the payments systems, capital markets authority, leasing, and microfinance sector. It also includes the diversification of financing products that a strengthening of the equity, credit, insurance and microfinance systems makes possible to facilitate PPP financing, insurance services and equity for start-up and high growth potential businesses as well as introducing reforms on secured transactions, which would allow SMEs or offer banks to accept moveable collateral, thus enabling higher and safer lending, and as consequence larger job creation.

Figure 75. Lebanon: Access to Finance by Firm Size, Location and Formal versus Informal Status



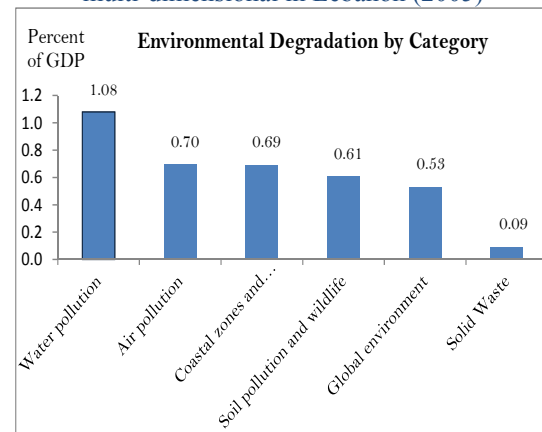
Source: Enterprise Surveys 2013/14. Indicators for formal firms are survey-weighted. Informal enterprises are un-weighted.

Figure 76. Lebanon: Education and Workforce Distribution



Source: World Economic Forum, 2013 Human Capital Report.

Figure 77. Environment degradation is large and multi-dimensional in Lebanon (2005)



Source: World Bank (2011a).

## 6. Environmental degradation

127. **Lebanon suffers from large environmental degradation.** This results from many factors, and disproportionately impacts the poor (World Bank, 2011a). In 2005 the environmental cost was estimated at 3.2 percent of GDP. Figure 77 reveals that water and air pollution as well as coastal erosion are the costliest

causes of environmental damage in Lebanon. Environmental degradation affects poorer communities in a disproportionate manner as they are more directly reliant on ecosystem services for their well-being. “Damage to the environment, as well as a lack of clean water and land suitable for farming or growing food, leads to more hunger, illness, poverty and reduced opportunities to make a living” (World Wide Fund, 2014). In addition, poorer households are more susceptible to environmental pollution by virtue of differences in health status and access to medical care. The leading sources of environmental degradation are the following:

- *Water pollution is a growing concern in Lebanon.* Untreated sewage, industrial effluent and agricultural runoff are often discharged into valleys, rivers and the Mediterranean sea creating substantial pollution of water resources. Key sources of pollution include (i) households, as only 8 percent of wastewater is treated (Ministry of Energy and Water, 2012);<sup>92</sup> and (ii) industries where most industrial waste streams are discharged untreated into major water bodies including the Mediterranean sea and the Litani river. Even operational, downstream municipal water treatment facilities lack proper technological capabilities to treat such toxic effluents, thereby representing a serious threat for the water quality of potable water supplies, irrigation, and ecosystem services.<sup>93</sup> A third source is agriculture where the runoff and infiltration of residues from fertilizers and pesticides is exposing Lebanon’s water resources to additional pollution sources. In drinking water and groundwater samples collected in major Lebanese cities chlorine and organophosphate pesticides were frequently detected in large quantities (Kouzhaya et al., 2013).
- *Municipal solid waste disposal is a persistent issue.* As of 2007, only 53 percent of municipal solid waste was disposed in the two sanitary landfills of the country: Nahmeh and Zahlé. These figures are likely to have worsened substantially due to the influx of Syrian refugees over the past two years (World Bank, 2013e). The remaining solid waste is being disposed in a contained landfill and 700 open dumps. As a result, open and uncontrolled dumps polluting air, watersheds, and coastal zones are still common (World Bank, 2011a).

#### **Box 5. The impact of the Syrian Conflict on Lebanon’s Environment**

This box summarizes the finding of a recent assessment undertaken by Ministry of Environment (MoE)<sup>1/</sup> on the impact of the Syrian Conflict on the environment in Lebanon. In addition to huge social and economic challenges, the Syrian Conflict (and the associated large number of refugees into Lebanon) is putting serious pressure on Lebanon’s fragile natural resources and ecosystems. The main impacts are:

- **Solid waste management:** the incremental quantity of municipal solid waste attributed to refugees is estimated at 325,000 tons per year, representing a 15.7 percent increase in municipal solid waste generation. While part of the waste is being managed within existing solid waste facilities more than half the waste generated is disposed of in open dumps which increases land, soil and water contamination and creates serious health risks.
- **Water supply and quality:** the increase in domestic water supply is estimated between 43 and 70 million m<sup>3</sup>, representing an increase national water consumption of 8-12 percent. This increase has exacerbated an already stressed water situation in Lebanon (in 2013/14) and resulted in decreasing groundwater table levels (ranging between 1 to 20 meters in a number of wells across the country between April 2013 and April 2014). The consumption of poor quality water, and improper sanitation and hygiene in refugee settlements have also increased the cases of diarrheal and other communicable diseases. The resulting increase in pollution load from wastewater discharge has also been significant.

<sup>92</sup> 2012 data. They do not take into account the sharp increase generated by the large influx of refugees.

<sup>93</sup> Project Appraisal Document - Lebanon Environmental Pollution Abatement Project, The World Bank, 2014

- **Air quality:** while it is difficult to precisely attribute increase in air pollution, the study has nevertheless relied on estimate of emissions resulting from incremental demand of road transport, residential heating, open burning of solid waste and electricity production. The results indicate an increase of 20 percent in emission of air pollutants in Lebanon (measuring for PM<sub>2.5</sub>, PM<sub>10</sub>, SO<sub>2</sub>, NO<sub>x</sub> and CO).
- **Land use and ecosystems:** the influx of refugees has increased Lebanon population density from 400 to 520 person/km<sup>2</sup>. This urban densification leads to many environmental and social stresses including more waste generation, water and sanitation problems, noise pollution, and crowdedness. For refugees outside urban areas who have settled in informal tented settlements, this has resulted in encroachment on agricultural land, excessive felling of forest trees and fragilization of sensitive ecosystems.

A conservative assessment of the environmental management plan to mitigate the environmental impact of the Syrian Conflict is estimated at USD3.5 billion (with USD300 million in operation and maintenance per year). This estimate is conservative as it only accounts for measures that could be quantified during the preparation of the report.

1/ Ministry of Energy (2014), "Lebanon Environmental Assessment of the Syrian Conflict," September. Study undertaken by the Lebanese MoE with support from the European Union and UNDP.

### C. STRENGTHS, SOURCES OF RESILIENCY, AND OPPORTUNITIES

128. **Despite a challenging environment, Lebanon possesses a number of important growth drivers, sources of resilience, and significant opportunities.** These have enabled the economy to perform well amidst adversity. For example, Lebanon experienced the strongest post-conflict recovery compared to countries with conflicts lasting over 10 years (see Annex II page 105). Lebanon was also one of the fastest growing economies in the world during the Global Recession that started in 2008. Lebanon's resilience even in times of great stress has helped prevent a relapse of the violence witnessed during the civil war, and creates opportunities for both stabilizing the country and addressing fundamental structural problems. In particular:

- **Relatively strong human capital.** Compared to countries in the region or at similar level of development, Lebanon performs relatively well: Lebanon ranks 65 out of 187 countries in the World Bank's 2013 Human Development Index which puts the country in the "High Human Development" (second category below "Very High Human Development"). Using the World Economic Forum's 2013 Human Capital Index, Lebanon's performance is not as strong (74/122), however, due to severe underperformance in its "enabling environment". Lebanon is, nonetheless, particularly strong in education, where it significantly outperforms its upper-middle income and its MENA peers with a ranking of 32/122 in the WEF's HCI. Lebanon invests heavily in its human capital, especially in education, primarily through high private spending. The quality of the (privately dominated) education system is high, with a rank of 13 out of 122 countries in the WEF's 2013 HCI. While return on human capital is low in Lebanon, many Lebanese continue to invest strongly in (private and high quality) education which allows them to compete favorably at the international level and get well paid jobs abroad, especially in the GCC (this brain drain, however, results in talent retention issues at home, as discussed earlier). Lebanon's health outcomes also improved markedly and compare favorably with MENA countries or countries with similar level of development.<sup>94</sup>

<sup>94</sup> Indeed, despite challenges, Lebanon continued to invest in population-based disease prevention programs that helped achieve significant improvements in health status and in attaining the Millennium Development Goals (MDGs) and even go beyond other MENA countries. Similarly, the MoPH, being aware of the inefficiencies in the system, especially in the curative sector, launched

- **Diaspora and large remittance flows.** Given large and sustained out-migration, Lebanon has one of the largest diaspora in the world in terms of proportion to resident population. Remittances are a large and stable source of financing for the country, both for the balance of payments and for public finances. Lebanon was the 9<sup>th</sup> largest country in the world in terms of personal remittances received,<sup>95</sup> as a ratio of GDP in 2013 (at 17.7 percent). Remittances are also contributing to the buoyancy of the real estate sector, and are key to the continued growth of the banking sector, among others. The Lebanese diaspora, which is very skilled, and mostly residing in countries with advanced economies, has strong linkages to their home country. Beyond remittances, the Lebanese diaspora community can contribute to the economic development of Lebanon through productive and pro-development investment, mentorship and business networking.
- **Strong support from the international community when the country is facing critical times.** Given the scope of shocks and macroeconomic vulnerabilities that the country has experienced, the country would have been in a dire economic situation had it not received the support in difficult times from the Friends of Lebanon. The Paris I, II, and III (2001, 2002, and 2007, respectively) conferences, as well as the 2008 Doha Agreement are such examples. International support received from the international community to help Lebanon with the severe development impact that the Syrian crisis and especially the large number of Syrian refugees is creating has, however, been more muted, possibly a reflection of the difficult domestic polity and regional and international geopolitics.
- **A dynamic private sector despite its constrained environment.** Lebanon's people have a long and illustrious merchants/traders' tradition, going at least back to the Phoenicians. There is therefore a longstanding culture and recognition of the role of private firms and markets. The geographic situation of the country, at the crossroads of the East and West, has perpetrated this strong private sector services tradition throughout the ages. Throughout this rich history, the private sector has always had a strong international orientation. The large and globally diversified Lebanese diaspora is one illustration of this internationally competitive human capital. These sources of economic vitality still exist today which, when combined with new opportunities for trade and investment throughout the region, constitute significant sources of resilience and potential growth once the right political, institutional and security conditions are created. In addition to the current fragility of the country and turbulence of the region, a key challenge is to delink private sector and sectarian interests, by increasing accountability and better managing conflicts of interest and mitigating corruption opportunities, while promoting a more equitable distribution of investments into lagging regions. While overall positive, the private sector (and to a certain degree civil society)—through its alignment with sectarian actors and interests—also contributes to reinforcing inequality. Unlocking the inclusive development potential of the private sector could yield important gains, especially in the absence of improvements in public social spending and policies in the near term. 'Non-sectarian' private sector engagements can also help bridge divides and tensions between sectarian communities by building confidence, trust and collaboration.
- **A resilient, large and profitable banking sector that is the lynchpin of the country's (non-inclusive) development model since the civil war.** Lebanon's banking sector is liquid, profitable and well regulated by BdL. In 2013, the tier one capital to risk-weighted asset ratio was 12.2 percent, double the Basel III requirement. Tier one capital constitutes the principal funding source for commercial banks, with the deposit to total liabilities ratio at 87.5 percent. By 2015, BdL mandates that banks should have an additional 4 percent conversion buffer, compared to the Basel III mandated 2.5 percent. Moreover, banks are highly liquid, non-performing loans are low and return on equity is in the double

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several reform efforts to improve the regulatory system namely establishing the hospital accreditation program and developing a fairly advanced hospital performance-based contracting mechanisms.

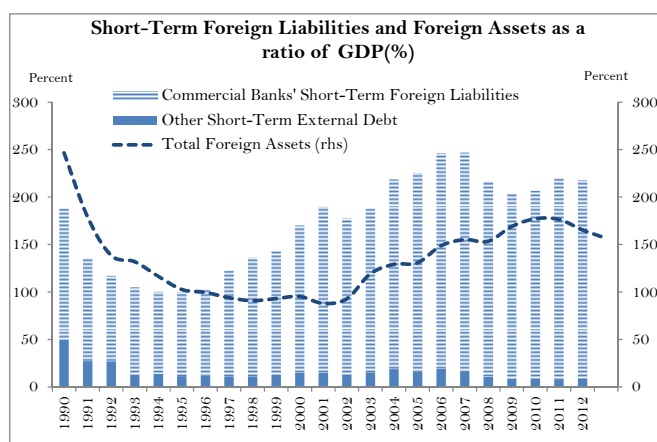
<sup>95</sup> Personal remittances are defined by the World Bank as personal transfers and compensation of employees. "The data is the sum of two items defined in the sixth edition of the IMF's Balance of Payments Manual: personal transfers and compensation of employees" (WDI, 2014)



digits. There is, however, a substantial exposure to the sovereign, with over 55 percent of bank assets concentrated with the public sector and BdL. In an effort to diversify, banks have expanded regionally, with mixed results to date (e.g., diversification into Syria has proved costly because of the conflict, whereas diversification into other MENA countries has been more positive).

The sector's strength mitigates sustainability concerns regarding the sovereign and overall macroeconomic weaknesses for several reasons. First, an estimated 80 percent of government debt is held by domestic financial institutions and BdL. Additionally, large external financing needs are partly met by deposits of Lebanese expatriates who are familiar with the political and security situation of the country and the region, and who have strong confidence in the BdL and the Lebanese banking system. As a result, deposits have been growing at an average of 14 percent annually since 1993, attracted by large interest rate spreads.<sup>96</sup> Due to base effects, the growth rate in non-resident inflows is decelerating over time, from an average of 21.5 percent during 1993-2002 to 16.2 percent during 2003-11 and to an average of 7.4 percent since 2011 and the onset of the Syrian crisis. This lower rate of growth remains sufficient to meet the country's financing needs.<sup>97</sup> Other mitigating factors include banks' substantial net foreign assets (NFA)<sup>98</sup> and sizable gross international reserves at the BdL, which constitute comfortable buffers that help anchor investors' confidence. Additionally, the BdL has demonstrated its readiness to be the ultimate guarantor of the financial sector via its large foreign exchange reserves and tested crisis management, especially its interventions in the government debt market.

Figure 78. Lebanon: Short-term foreign liabilities exceed total foreign assets.



Source: Banque du Liban, MoF, and World Bank staff.

Notwithstanding its proven resiliency to large shocks, the size of the sector exposes the country to significant macroeconomic risks. Lebanon's short-term foreign liabilities surpass its reserve of foreign

<sup>96</sup> The key interest rates in this arrangement are the international dollar rate, a local rate on dollar deposits, and a local rate on LBP deposits. The spread between the local and international dollar rates attracts deposits in dollar, while the spread between LBP and local dollar rates encourages deposits in local currency. Nonetheless, like much of the economy, Lebanon's banking system is highly dollarized (64 percent dollarization rate).

<sup>97</sup> A growth rate of 8 percent is sufficient to cover the country's financing needs and keep reserves high (IMF, 2014).

<sup>98</sup> Lebanon's banking sector has proven resilient through several pronounced cycles, with a tier one capital to risk-weighted asset ratio of 12.2 percent in 2013, though both profitability (still double digits) and asset quality have deteriorated during the Syrian crisis. Banks' liquidity fully depends on BdL's willingness to refinance government debt and redeem its CDs (55 percent of banking assets concentrated with the public sector and BdL). Bank profitability also reflects an "accommodating" BdL (e.g., incentive programs, cheap funding) and the lack of diversification within the banking sector as many are lending to the same select clients and few have significant revenues/operations from outside of Lebanon to diversify macro risk. The move by Audi Bank to develop a more regional franchise is one approach banks are pursuing to diversify this risk.

assets (Figure 78), which expose the country to a sudden stop scenario whereby a sudden change in investor confidence towards the country would immediately result in the need for drastic policy measures. The former are largely foreign liabilities of commercial banks, which reached 222 percent of GDP in 2013. On the other hand, Lebanon's total foreign assets, consisting of BdL gross foreign reserves (foreign currency and gold) and commercial banks' foreign assets, was 157 percent of GDP in the same year.

- **Strong political self-preservation motive.** At the political level, the restraint exhibited by all groups with respect to the Syrian conflict illustrates a general desire to avoid the kind of descent into conflict and warfare associated with the civil war. The situation, however, remains fluid and recent events in Tripoli and Aarsal—with severe clashes with ISIS—showed how quickly escalation can occur.
- **Agglomeration that is associated with higher income potential.** Lebanon is one of the most urbanized countries in MENA and the world. Its urban population is estimated at 89 percent (WB Economic Monitoring Note), with almost four million people living in cities and urban areas. It is estimated that 64 percent of the Lebanese population live in large agglomerations, mostly in the city of Beirut and its surrounding suburbs along with Tripoli, Saida, Tyr and Zahle (Ibid). However, contrary to patterns observed around most of the world, the share of the population in the primary city in Lebanon – Beirut – has declined over time (World Bank, 2011c). Measures that increase factor mobility may help increase the productive potential of Lebanon's cities.
- **Agriculture.** A small and stable part of the economy that is highly productive by regional standards. Agriculture's share of GDP has remained relatively stable at around 6 percent, roughly equivalent to the regional average of 8 percent. Lebanon's varied altitude (sea level to 2,000 meters) and annual rainfall (200 to 1,600 mm) has resulted in a range of agricultural products, including grains, orchard fruits, olives and tubers (mainly potatoes), as well as milk and processed dairy products. However, while it is estimated that only 3 percent of the labor force is employed full time in agriculture, this figure may be as high as 20 percent when part time and seasonal labor is included). This compares to a regional average of 29 percent, resulting in labor productivity which is over 15 times the regional average.

Future growth of the agricultural sector will require continued upgrading of supply chains for high value products—in particular fruits, vegetables and livestock products for regional, European and domestic markets. Lebanese products have achieved good quality reputations and are particularly competitive in the GCC countries, Turkey and Egypt, with some market entry in Europe. However, expanding or even maintaining these markets will require additional investments in quality control and certification to meet increasingly stringent phytosanitary and food safety standards. At the same time, expansion of production of these products will require investments in high quality irrigation systems on lands currently focused on lower value, mainly rain-fed grain production. These investments are consistent with both improving farm incomes as well as generating additional, sector-based employment throughout the value chain.

129. **Looking forward, Lebanon's economy and its prospects for more inclusive growth could also be bolstered by potentially game-changing opportunities.** These include:

- **The recovery and reconstruction of currently troubled Middle East countries (Syria, Iraq).** More generally, peace and stability in the region would strongly benefit Lebanon. The World Bank (2013e) estimated that the conflict in Syria is lowering Lebanon's real GDP growth by 2.9 percentage points every year. Not only would peace in Syria be expected to lift this negative conflict spillover, but the recovery and reconstruction of Syria would also likely include strong positive spillover for Lebanese firms. Lebanese entrepreneurs and banks were playing an important and rapidly growing role in the

mid-2000s in Syria's economy as it moved towards greater market-based mechanisms. Given their familiarity with Syria, the Lebanese private sector should be well positioned to benefit rapidly from an expanding Syrian economy. Iraq is another market where Lebanese businesses have comparative advantages that can be leveraged as the situation on the ground stabilizes.

- **Hydrocarbon wealth.** Recent 3D seismologic mapping of Lebanon's offshore reveals the likely presence of sizeable hydrocarbon resources (likely in excess of 25 trillion cubic feet, mostly gas)—IMF (2014). The discovery of such a large amount of natural resources could be a game-changer for Lebanon, as it could provide sufficient financial resources to address the country's legacy of fiscal profligacy (i.e., the large public debt), and the associated large current account deficit, as well as to invest in badly needed infrastructure and social services. This could result, over the medium-term, in a Lebanon with reduced balance sheet vulnerabilities (lower public debt, smaller banking sector), more fiscal space, and less need for high interest rates on deposits to attract funds into the country. While no fiscal revenue is likely to accrue to the sovereign before 2020, international evidence shows that these revenues could be substantial, especially for relatively small economies. Becoming a gas producer could also enable Lebanon to use some of its gas resources to fuel its power generation sector (which is designed for gas inputs, but has so far been fuelled by more expensive and less efficient oil). The hydrocarbon wealth, therefore, represents a sizeable opportunity for the economy to generate jobs and enhance welfare of the population (it also brings challenges, as discussed below). There is also the potential for hydrocarbon wealth being Lebanon's demise if it continues on this current governance path of weak institutions and poor accountability. In order to avoid resource curse (or 'dutch disease') good governance (in the form of strong institutions and accountability mechanisms, which unfortunately Lebanon has yet to establish) needs to be at the forefront of this new sector (Jamali and Le Borgne, 2014).
- **Levant trade integration.** As a small open economy with a strategic location among regional trade routes, Lebanon could materially benefit from strengthened trade integration in the region (in a post-Syria conflict period and given a more stable Iraq). As detailed in a recent World Bank (2014g) report, economic complementarities between Egypt, Turkey, Jordan, Lebanon, Iraq, Syria, and the Palestinian Territories are significant, with substantial welfare gains expected from increased trade and investments and, ultimately, economic integration. With a population of 224 million, a land area of 2.4 million km<sup>2</sup>, a nominal GDP of USD1.4 trillion, and proximity to major markets and transportation corridors, these "New Levant" countries have significant economic weight and promise. Similarities in stages of economic development, resource endowments, or factor costs generate high potential to benefit from competitiveness and complementarities. The volume and structure of trade and investment flows among these Levant countries indicate that there is large untapped potential for deeper and wider integration in the sub-region.
- **Enhancement of the third tier of government.** Reforms to decentralize authority and empower local governments could help address concerns about inequities in public spending and service delivery, and could serve as a means for increasing trust in and the accountability of the state. Despite previous attempts to decentralize authority, the operationalization of these reforms has been limited and the Lebanese state remains extremely centralized and resource allocation to local governments is perceived to be done in an inequitable manner. The former president of Lebanon introduced a draft law on administrative decentralization in April 2014. If these reforms are supported and introduced, they could provide an impetus for increasing the capability of local governments, and increasing transparency and accountability of the actions of local governments.

## IV. RISKS AND SUSTAINABILITY

### A. MACROECONOMIC AND FISCAL SUSTAINABILITY

130. **Lebanon’s political economy is such that key stakeholders have few incentives to change the economy’s suboptimal local equilibrium, unless an imminent crisis is feared.** Due to the confessional-driven approach to policy making and its resulting large unproductive and inefficient spending combined with limited revenue mobilization, the sovereign has large structural financing needs which it finds easy to meet through the banking system. The banking sector has limited alternative in terms of lending to the private sector, given the risk premium required over the “risk free” and simple business of lending to the sovereign. Hence, other than tourism and real-estate, which are externally driven, the private sector is, at some level, subject to a selective crowding out effect (World Bank, 2012e). The result is an economy that is more dependent on its own brain drain and on highly cyclical sectors that are sensitive to external shocks. The resulting macroeconomic volatility is a primary source of uncertainty for domestic and foreign investors, inhibiting private investment, and thus, reducing potential output. The lack of fiscal space results in a squeeze on investment, causing infrastructure degradation, particularly with regard to transportation, water supply and electricity. This also lowers potential output. Key stakeholders in the economy, such as policymakers and the business elite, however, have limited incentives to push for reforms as the limited contestability of markets (economic and political) ensures good rents. Only in times of stress have reforms been introduced and implemented, such as the introduction of the VAT in 2002 during the fiscal crisis.

131. **While Lebanon’s macroeconomic environment is highly vulnerable, the country has been able to withstand large shocks as these same vulnerabilities limit exit options and outside financing has, so far, arrived during shocks.** Lebanon’s high debt level, large twin deficits (fiscal and current account), a large banking system, and a highly dollarized pegged economy present significant macroeconomic vulnerabilities (IMF, 2014; Barthélemy et al. 2007). These vulnerabilities have been present for nearly two decades in Lebanon. Nonetheless, in times of stress Lebanon has, so far, always avoided a crisis thanks to a powerful set of stabilizing forces:

- *A strong financial sector that has helped sustain Lebanon’s macroeconomic stability and resilience to shocks.* As indicated earlier, traditional banking sector indicators of capital, liquidity and NPLs are all robust in Lebanon and are critical to maintaining confidence during periods of stress.<sup>99</sup> Banks also recognize the risks of over-lending to the sovereign, but to some extent feel unable to reduce it due to perceived lack of alternatives and, for LBP deposits, an inability to lend out. Many have expanded regionally to boost growth and diversify, and are increasingly interested in Africa given links with diaspora.
- *Armageddon as the alternative to the status quo.* Investors and lenders fully understand that given the country’s multiple and intertwined balance sheet vulnerabilities, stopping to fund the country’s large gross financing needs would impact the peg and result in massive and sudden financial insolvency for core parts of the economy (e.g., the sovereign, the banking system) and would impoverish a large part of the population through balance sheet shocks and a surge in inflation, with likely dire social impact.

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<sup>99</sup> The banking sector’s exposure, especially the balance sheet mismatch on short-term foreign assets, nonetheless exposes the country to sudden stops. Crucially, Lebanon’s short-term foreign liabilities surpass its reserve of foreign assets, which expose the country to a sudden stop. Short-term foreign liabilities are largely those of commercial banks, which reached 222 percent of GDP in 2013. On the other hand, Lebanon’s total foreign assets totaled 157 percent of GDP in the same year.

- *The status quo is financially rewarding for those able to benefit.* Given the stability of the peg—unchanged in nominal terms since 1997—lending to the sovereign in pounds by using dollars has been a very profitable carry trade for depositors and investors.
- *A core group of supporting rich countries.* For financial and/or or geo-political reasons, Lebanon has (until recently) always received prompt and decisive financial support from core supporting countries. Timely support included the transfer from Saudi Arabia of USD1 billion to the BdL at the onset of the 2006 Israel conflict and another USD1 billion in early 2008 during a domestic political gridlock to instill confidence in the peg. GCC countries, Europe and the US have also provided political and financial support through a series of donor conferences (Paris I, II and III in 2001, 2002, and 2007, respectively), in which Lebanon pledged to undertake structural reforms (which remain broadly unimplemented) in return for financial aid. As Lebanon remains a relatively small economy compared to the wealth of its supporting countries, the financial assistance provided is large enough that it can be effective in boosting confidence.
- *A supportive and wealthy diaspora with strong ties to Lebanon.* Once strong signal of support is received from rich donor countries, the diaspora’s confidence in the peg is strong enough that capital outflows, when they have occurred, have remain manageable and short-term.

132. **Notwithstanding the economy’s remarkable resiliency to shocks, based on current policies and projections, public debt dynamics are not sustainable.** The IMF, in its 2014 Article IV consultation, undertook a detailed debt sustainability analysis based on three scenarios: baseline, constant primary balance and historical. The results indicate that public debt is expected to increase from over 143 percent of GDP in 2013 to 155 percent in 2019 (Figure 79). Gross financing needs will also deteriorate from around 30 percent of GDP in 2013 to 40 percent by 2017 (Figure 80). Such large gross financing needs represent a significant vulnerability to sudden stops which would result in a crisis, with severe impact on poverty and inclusive growth. Additionally, debt dynamics and financing needs are sensitive to significant macro-economic shocks, especially to growth, interest rates and contingent liability shocks.

Figure 79. Gross public debt is elevated and on a rising and unsustainable path

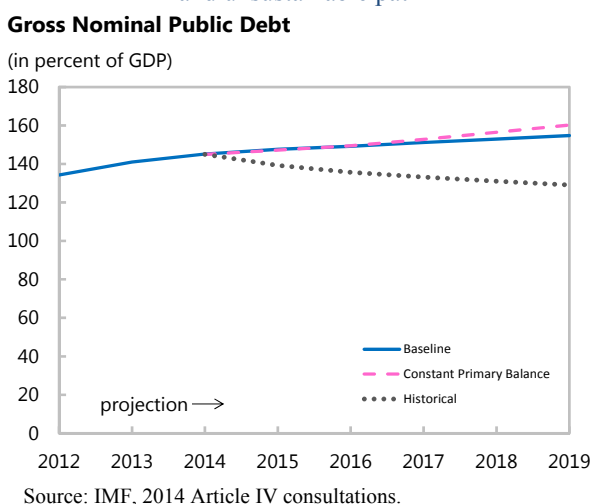
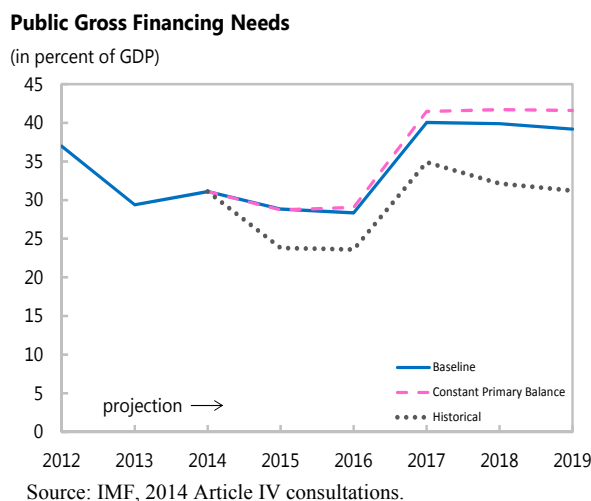


Figure 80. The public sector’s gross financing needs are extremely large which creates large refinancing risks



## B. POLITICAL AND SOCIAL SUSTAINABILITY

133. **Since 2005, all governance and institution indicators have markedly worsened as the policy-making process has come to a halt, highlighting the limits of Lebanon's post-civil war governance arrangements.** The political equilibrium achieved with the Taef Accord showed its limits after 2005 as no outside actor has been capable of enforcing decision making when domestic politics have become more divisive and resulted in a political standoff. As seen discussed in Chapter 3 (section B.3 on Governance and Institutions), key governance indicators such as the control of corruption and the rule of law have worsened rapidly and significantly since 2005/06. Similarly, political instability and the incidents of violence and conflict have risen since 2005/06. These trends are present regardless of the source of data (Worldwide Governance Indicators, CPIA, Bartlesmann Institute).

134. **Such a marked deterioration in quality of governance and policy-making indicators raise strong concerns regarding Lebanon's (inclusive) growth potential going forward** given the core role that institutions and governance play in a country's development process (e.g., World Economic Forum's 2013 Global Competitiveness Report). While the current political situation does not allow for the implementation of much-needed country-wide governance reforms, an alternative, more gradual approach could support the implementation of reforms aimed at improving the business environment and service delivery at the local level, while engaging in much more complex reforms (human resource management) at a later stage.

135. **The Syrian conflict at large is challenging the already delicate societal and inter-communal balance in Lebanon.** A porous border and close links between political and militarized groups in Lebanon and Syria have resulted in an exacerbation of existing political divides along sectarian lines and led to violent incidents across the country. The conflict spillovers, including the steady stream of Syrian refugees, are seen as an existential threat to the country. Refugees have the largest impact on the poorer host population (competition for low-cost housing, basic commodities and low-wage jobs), and the continuous waves of displacement are leading to an increase in poverty rates among the Lebanese population. This raises prospects of large backlash from the host population.

## C. ENVIRONMENTAL RISKS AND SUSTAINABILITY

136. **Lebanon's growth model is also unsustainable on the environment front, as highlighted by the depletion of the country's total wealth.** To measure sustainability, all forms of capital (wealth), including physical, financial, natural, human and social (intangible) forms of capital are required to generate income, now and in the future. Wealth analysis allows us to ask if GDP growth is sustainable – or if we are living off our capital, including natural capital. A country's total wealth can be measured through an Adjusted Net Savings (ANS). The ANS measures the true rate of savings in an economy after taking into account investments in human capital, depletion of natural resources and damage caused by pollution. In 2012, Lebanon's ANS was -2.2 percent of Gross National Income. This is dangerously low and compares to +17.8 percent of GNI in middle income countries and +7 percent in low income countries.<sup>100</sup> A negative ANS implies that Lebanon is not accumulating any wealth, but rather running down its wealth (as defined above).

137. **The sustainability of Lebanon's growth is even more concerning once expressed in per capita terms, which is the measure citizens care about.** In economies with growing populations, and especially in developing countries that aspire to higher material standards of living for their citizens, sustainable development requires not just increasing wealth, but also increasing per capita wealth (World Bank, 2014h

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<sup>100</sup> World Bank (2014), World Development Indicators (WDI), Washington DC.

and 2014i). Unfortunately, Lebanon has witnessed a continuous depletion of its per capita wealth (with wealth defined in the previous paragraph) over the past years, decreasing by USD416 in 2005 and USD667 in 2010 (all in 2010 USD (World Bank, WDI 2014)). By contrast, during the same period, MENA countries, on average, increased their wealth per capita by USD101, and upper middle income countries expanded theirs by USD1,039. Lebanon ranks in the bottom third of upper middle income countries that depleted their wealth per capita in 2010. Lebanon's per capita wealth depletion is mostly driven by the large depreciation of produced capital (15.5 percent of GNI) and a comparatively limited increase in human capital formation (1.4 percent of GNI). Natural capital depreciation, as currently estimated, is negligible though likely underestimated to a significant degree as factors such as coastal erosion, water and sanitation, fisheries, and marine resources are not yet included in the calculations. Several of these omitted factors, however, are particularly weak in Lebanon, and have been rapidly worsening over the past years, in part driven by the surge in the population living in Lebanon due to the large influx of Syrian refugees since 2012 (World Bank, 2013e).

**138. Large and rapidly growing environmental degradation could materially impact Lebanon's key growth drivers, such as tourism.** For example, the country's natural heritage is being impacted by uncontrolled urban sprawl, quarries, and solid waste dumps, resulting in a progressive pressure on major outstanding natural sites such as the Karst heritage of Lebanon in the Caza of Kesrouan and the natural bridge of Fakra and Nabaa el Laban (World Bank, 2011a).

**139. Haphazard urbanization has been impacting the cities' environment, their morphology, and their ability to facilitate economic growth.** Numerous illegal constructions and building additions occurred during the civil war and are still evident today. The more recent years have witnessed a surge in building permits, new constructions and residential developments in the major cities, largely in the absence of strict enforcement of urban planning and building regulations. The result is urban congestion, depletion of open spaces, a deteriorated urban landscape, and a threat to the architectural heritage. The price of real estate and rents has multiplied, and housing prices have been associated with segregation between the affluent areas and the poorly serviced neighborhoods where services (water, sanitation, roads networks) is strained and the quality of life suffers.

**140. The influx of refugees has created additional pressure on natural resources.** The 1.1 million UNHCR-registered Syrian refugees (as of January 2015) that have entered Lebanon since the beginning of the Syrian conflict represent an increase of over 25 percent of the Lebanese population prior to the crisis. Most refugees are concentrated in the already impoverished areas of the Bekaa (35 percent) and North Lebanon (35 percent) that were previously underequipped in public services. This surge in population puts an additional strain on social services and scarce resources, such as solid waste management, clean water and sanitation.

#### **Box 6. Climate Change impacts on Lebanon**

**Lebanon's climate change model projections suggest a more rapid warming than the global average and an annual reduction of precipitation.** This would lead to less runoff, more evapo-transpiration, and increased periods of drought. The average number of heat wave<sup>a</sup> days observed in cities in MNA is between zero to a week. It is expected to increase to 93 days in a 2°C world and over 187 days in a 4°C world (Lelieveld et al. (2013) cited in World Bank, 2014). Additionally, by 2040, maximum temperatures are predicted to increase between 1°C around the coast of Lebanon up to 2°C in the mountainous inland; by 2090 the increases are from 3 to 5°C respectively. Significant reductions are projected for rainfall, which will be more severe from the coastal to the inland areas, ranging from -10 percent to -20 percent for 2040 and -25 percent to -45 percent for 2090.

**Snow water storage and the ski winter season are also likely to become a growing concern due to climate change.** It is noteworthy that mountain areas in Lebanon play an important role in water supply and also play an

important role in attracting tourists during the winter months. However, under climate change, mountainous areas are expected not only to experience a reduction in total precipitation, but also a reduction in the fraction of precipitation falling as snow, thereby affecting snow cover and snow water storage. Changes in melt-water regimes are expected to bring about a shift in peak river flows towards the earlier months in the year, with negative impacts for downstream riparian systems in terms of water availability and seasonal shortages during the hot and dry summer months. *Lebanon's Second National Communication* analyzed the upper Nahr el Kalb basin under a stylized warming of 2°C and 4°C. Snowpack volume was therein projected to shrink from a total of 1,200 million m<sup>3</sup> to 700 million m<sup>3</sup> and 350 million m<sup>3</sup> respectively.

**Other vulnerable sectors to climate change include agriculture, electricity, coastal zones, forestry public health and human settlements and infrastructure, for which adaptation measures need to be implemented.**

Agriculture is one of the most vulnerable sectors due to limited water availability and pressures of population growth and urbanization affecting the agricultural yield of crops particularly for fruit trees. Higher electricity demand due to cooling demand in the summer will require between 87 and 438 MW expansion of installed capacity given that an increase in related total consumption will be 1.8 percent for a 1°C increase in temperature and 5.8 percent for a 3°C increase. At current sea level rises averaging approximately 20mm/year in the Levantine basin, a 30-60cm rise in 30 years will significantly impact coastal zones and human settlements and infrastructure. In addition to changes in temperature and rainfall, expected changes in Lebanon's bioclimatic levels will adversely affect Lebanon's forests and nature reserves, frequency and periodicity of fire events, and regeneration rate, overall area and population of certain tree species to decrease. Direct and indirect effects of climate change will affect public health on many fronts with an estimated 2,483-5,254 additional deaths per year between 2010 and 2030 expected due to increases in temperatures, with vulnerable groups more at risk.

<sup>a</sup> Heat wave days are calculated by the warm spell duration index (WSDI), which is defined as the longest annual spell of at least six consecutive days with maximum temperatures exceeding the local 90th percentile relative to a reference period (in days).

*Sources:* Lebanon's Second National Communication to the UNFCCC, Ministry of Environment, 2011 ; World Bank (2014) "Draft Turn Down the Heat III," Washington DC ; and Lelieveld J., et al. (2013), "Model projected heat extremes and air pollution in the eastern Mediterranean and Middle East in the twenty-first century," Regional Environmental Change, Springer-Verlag,.

## **D. INFRASTRUCTURE AND PUBLIC SERVICE SUSTAINABILITY**

**141. The non-viable financial situation of the electricity sector is undermining the sustainability of public finances and limits EdL's capacity to improve electricity supply to households and industry.** EdL's assets, including its power stations, are rapidly aging. Its large financial problems also limit its capacity to invest in much needed additional production capacity. In June 2010, the Government endorsed a Policy Paper for the Electricity Sector. This paper outlines policy and investments aimed at increasing the level and quality of electricity supply, managing demand growth, decreasing the average cost of electricity production, increasing revenues, improving sector governance and ultimately improving service delivery and reducing the fiscal burden that the sector places on public resources. However, the majority of plans laid out on paper remain unimplemented, and the sector continues to be a significant drain on the Lebanese economy.

**142. The rapid and massive influx of Syrian refugees in Lebanon since 2011 is further straining Lebanon's already weak infrastructure and is adding stress on already vulnerable communities and municipalities** (World Bank, 2013d). The Syrian refugee influx is equivalent to a 25 year shock for Lebanon: in its 2005 infrastructure master plan for the 25 years ahead, the Council for Development and Reconstruction (CDR) had forecast an increase in the Lebanese population of 1.5 million over these 25 years. This is a number of registered Syrian refugees could soon be reached in Lebanon. With regards to communities and municipalities, municipal services are not geared to such a spike in population, leading to a decrease in the quality of services (with potential long term negative impact). Social cohesion is straining and tensions are rising in communities where refugees are finding it hard to sustain themselves and hosts are affected by overcrowding, saturation of basic public services, rising rents, pressure on salaries and



increasing costs. The arrival of a large number of Syrian refugees has also challenged the already delicate societal and inter-communal balance in Lebanon. Lebanese women and girls are particularly affected by the Syrian refugee crisis, in a context of greater insecurity and a palpable rise in violence.

**143. Decentralization has long been discussed as a possible answer to address the continued and unsustainable deterioration in key public services.** During his term, President Suleiman introduced a draft law on administrative decentralization in April 2014. Called for in the Taef Accord, the legal reforms aim to redistribute the authority, responsibility and financial resources needed to provide public services across tiers of government. The bill contains 147 items and prioritizes the powers and rights of the municipalities, particularly with respect to financial autonomy. The aim is to create an elected council in each of the country's 25 qadas with wide-ranging financial and administrative powers. However, decentralization reforms in Lebanon are linked to the confessional structure of government and the way power is shared between the various groups, thus passage of the draft law is expected to prove challenging.

**144. Service delivery at the municipal level is overburdened by the surge in demand for these services at a time when their finances remain erratic.** Municipal financing is another perennial issue in Lebanon. These revenues are broadly considered to be insufficient and provided in a manner that greatly constrains the ability of municipalities to offer services and conduct local development projects. Municipalities have two main sources of revenues: transfers from central government which are distributed through the Independent Municipal Fund (about 70 percent) and local taxes and fees representing the remaining 30 percent. The Independent Municipal Fund allocations are based on (i) the number of registered voters in the municipality (not the number of actual residents) and (ii) the total amount of revenues collected in the previous two years. This formula is considered inequitable as it fails to take into account the size of individual municipalities and makes it difficult for smaller municipalities to provide an acceptable level of service. In addition, payments from the Independent Municipal Fund tend to be irregular, with payments sometimes being delayed by up to two years.

#### **E. HYDROCARBON WEALTH AND RISKS (CONFLICT, MACROECONOMIC AND FISCAL MISMANAGEMENT)**

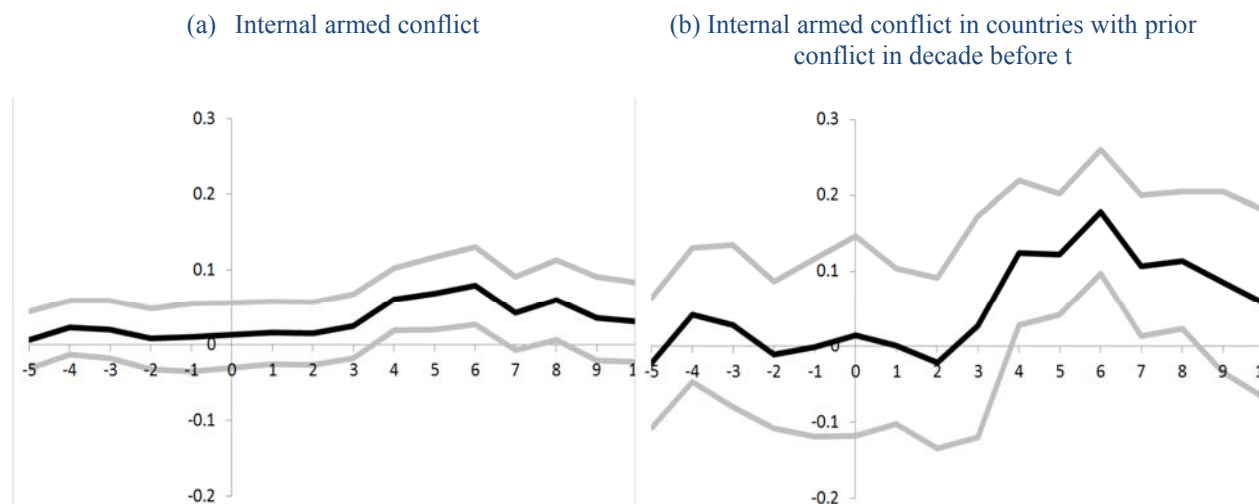
**145. Large hydrocarbon discoveries carry significant social tension and conflict risks for Lebanon.** That is due to the fact that windfall revenues from hydrocarbon discoveries (or from increases in the price of hydrocarbons) can spur violence in the attempt to appropriate these revenues.<sup>101</sup> As supported by recent evidence, this is more likely to be the case in countries where political violence can achieve political and economic gains. For example, Lin and Michaels (forthcoming) find that, on average, giant oilfield discoveries increase the risk of internal armed conflicts by about 5-8 percentage points within 4-8 years of discovery vis-à-vis a baseline probability of about 10 percentage points. This effect is even larger for countries that experienced at least one civil conflict in the decade before the discovery (Figure 81). Similarly Cali and Mulabdic (2014) find that increases in the value of point-source commodity exports (driven by international prices) lead to a higher risk of conflict.<sup>102</sup> They also identify a number of factors that affect the relation between the value of hydrocarbon export revenues and the risk of conflict. The most significant of them are the level of economic inequality, the level of ethnic and religious divisions and a history of recent conflict. The increase in conflict risk is higher in countries with higher values of ethnic and religious fractionalization, with greater levels of economic inequality and with the presence of a civil conflict in the last 10 years.

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<sup>101</sup> Various theoretical models can account for this effect – usually called ‘state prize’ or ‘rapacity effect’ (e.g., Besley and Persson, 2009; and Dal Bó and Dal Bó, 2011).

<sup>102</sup> Point-source commodities include hydrocarbons and mineral products (Cali and Mulabdic, 2014).

Figure 81. Effect of giant oilfield discovery on internal armed conflicts (1946-2008)



Source: Lin and Michaels (forthcoming). The x-axes report the number of years before or after t, ranging from t-5 to t+10. The black lines show the estimated coefficients and the grey lines show the 95percent confidence intervals based on robust standard errors clustered by country.

146. **Lebanon fits the profile of a country exposed to conflict risk from hydrocarbon exports worryingly well.** The country has a relatively high level of economic inequality and of religious fractionalization, and it is experiencing a low intensity civil conflict.<sup>103</sup> These characteristics increase the risk of conflict induced by hydrocarbons discovery in Lebanon relative to the average country. In Table 4 we quantify this increased risk due to each of these factors on the basis of the marginal effects computed in Cali and Mulabdic (2014). For example for a country with the average level of religious fractionalization (i.e., 0.35), a standard deviation increase in hydrocarbons and mineral exports raises the risk of conflict by 2.5 percent. At the level of fractionalization of Lebanon (i.e., 0.79) the increased risk is more than double at 5.7 percent. A similar story applies to the two other main factors, economic inequality and recent conflict. On the other hand other factors, such as level of democracy, of accountability, the presence of conflict in neighboring countries and the share of trade with neighbors, yield smaller differences between Lebanon and the average country.

<sup>103</sup> This conflict categorization follows from the International Country Risk Guide (ICRG) data as the UDCP/PRIO armed conflict database. In the first seven months of 2014 ICRG assigns an average value of 2 to Lebanon in the ‘civil war’ category (in a scale to 1-4), placing the country in the top decile of that category. The current low intensity conflict in Lebanon would also be in line with the definition of UDCP/PRIO of “a contested incompatibility that concerns government and/or territory where the use of armed force between two parties, of which at least one is the government of a state, results in at least 25 battle-related deaths.”

147. **Another key risk with becoming a commodity producer and exporter are the associated macroeconomic and fiscal challenges.** One common economic challenge is the possible occurrence of the “Dutch disease”. The Dutch disease refers to the risk that sustained large external inflows could rapidly stimulate aggregate domestic demand and the economy beyond its potential thereby creating inflationary pressures and leading to real exchange rate appreciation. This would, in turn, diminish the export competitiveness and possibly lead to persistent trade account deficits. While the resource-extraction sector can generate substantial revenues, this sector is not labor intensive. Hence, any loss in competitiveness from the non-resource part of the economy could potentially result in large employment losses (World Bank, 2014e). Another challenge would be the high volatility of revenues and spending—typically higher than for non-commodity producers—and associated procyclicality (IMF, 2014). In addition, resource revenue is exhaustible, raising issues of sustainability and intergenerational equity. This calls for smoothing government consumption over time, and avoiding the need for massive fiscal adjustment once resource wealth has been depleted (IMF, 2014).

Table 4. Lebanon has a higher risk of conflict from hydrocarbons exports than the average country

	Mean	Lebanon	Avg. Effect	LBN Effect	Signif.
Inequality (Gini)	45.44	55.33	2.10%	4.20%	Y
Religious fractionalization	0.35	0.79	2.50%	5.70%	Y
Recent conflict	0.28	1	2.20%	4.10%	Y
Level of democracy	-1.21	7	1.90%	1.90%	N
Accountability	3.24	5	2.40%	0.90%	N
Neighbors in conflict	0.52	Yes	2.00%	2.30%	N
Share trade neighbors	0.12	0.03	2.00%	2.10%	N

Source: based on Cali and Mulabdic (2014) for the computations; for the mean and Lebanon values: Solt (2009) for inequality data; Alesina et al. (2003) for religious fractionalization; recent conflict: UCDP/PRI0 (for mean) and ICRG for Lebanon; polity 2 data for level of democracy; ICRG for accountability; UCDP/Prio (for mean) and ICRG for neighboring conflict; COMTRADE for share of trade with neighbors. Mean is the mean value of the variable across the entire sample over which the marginal effect of the export price index are computed in Cali and Mulabdic (2014); Avg. effect is the increased probability of conflict due to a standard deviation increase in the point-source commodity export index measured for the mean value of the variable; LBN effect is the same increased probability measured at the value of the variable for Lebanon.

## F. AGRICULTURE SECTOR RISKS AND OPPORTUNITIES

148. **In general, the lack of diversification of incomes of farm-based households raises significant risks regarding the sector’s impact on the Twin Goals.** The primary concerns regarding the sustainability and risk with relation to agricultural growth and poverty reduction concerns the need to facilitate diversification of incomes of farm based households through both on-farm (increased production of high value products and value addition), and off-farm employment opportunities. In addition, some on-farm investments will require land consolidation to permit scale economies in production. Government’s ability to influence the sector is limited largely to capital investments due to the low budget allocations to the Ministry of Agriculture and very low levels of staffing, which limits the ability of the Ministry to provide standard agricultural services.

149. **If unaddressed, the huge amount of surplus labor from Syrian refugees yields the prospect of generating social tensions in rural areas.** This is because the massive increase in labor supply and the sudden availability of relatively cheap labor has led to a decline in real wages and reduced opportunities for “decent” jobs. For example, according to an FAO study, the influx of Syrian workers may have caused a reduction of up to 60 percent in the daily agricultural wage rate (FAO, 2013). According to an ILO survey in 2013, three out of four Syrian refugees are paid less than US\$ 400 per month. Moreover, the low wages may impact on the nutritional standards for poorest quintiles of the population, which may negatively affect young children and female health.

150. **The Syria crisis has resulted in shifts from exports to domestic food production.** A significant change has been a shift from exports previously oriented towards the Syrian market towards domestic production. Moreover, prior to the civil war, Syria subsidized fertilizers and pesticides. Many Lebanese

farmers traded or smuggled agricultural inputs from Syria. As this informal and cheap source of agricultural inputs has dried out, farmers need to rely on inputs from the domestic market, which is increasing production costs. The tense security situation of farmland alongside the Syrian-Lebanese border, and the diversion of trade routes, also increased production costs. While the export sector has been hurt, the massive amount of refugees representing some 25 percent of the Lebanese population, has led to increased domestic demand for domestically produced food items. This is predominantly the case as food aid distributed by the international community to Syrian refugees is typically made in cash. At the same time, there has been a sharp decline in imported Syrian agricultural products. This has benefited Lebanese farmers who produce for the domestic market as they face less competition and are benefitting from cheap labor supply.

151. **The change in the market structure presents both opportunities and challenges.** It is likely that the shift will have significant impact over the medium term on Lebanon's agricultural sector. On the one hand, the increase in domestic demand alongside massive labor supply could be regarded as an opportunity to further develop the agricultural sector in Lebanon. On the other hand, the on-going shifts in the production structure suggest upcoming challenges as the Lebanon needs to diversify its exports into alternative markets. One option is that the export sector needs could re-orient production towards new markets in regional markets or perhaps Europe. As the sector is dominated by a dynamic private sector, this re-orientation process could be supported by providing adequate market information for entrepreneurs.

## V. PRIORITIZING THE CHALLENGES AND HIGHLIGHTING OPPORTUNITIES

152. This chapter presents a prioritized list of the most critical constraints facing Lebanon in accelerating progress toward the Twin Goals in line with the SCD's primary objective, and suggests opportunities to address them. As diagnosed in Chapter III, Lebanon faces substantial overarching and nested constraints that have challenged progress towards achievement of ending extreme poverty and promoting shared prosperity in a sustainable manner. Should the status quo persist, Lebanon risks an exacerbation of an already fragile situation as presented in Chapter IV. While these constraints may seem daunting to tackle simultaneously, the SCD highlights those constraints that are critical, which if addressed can have meaningful impact towards achieving growth, inclusion and sustainability for Lebanon.

153. **The SCD's prioritization of constraints aims to assist in the identification of reforms to support growth and poverty reduction efforts by the Government and donors, and to inform the World Bank Group's Country Partnership Framework,** which will be defined and agreed with the Government of Lebanon. The agreed Framework will outline the World Bank Group's work in Lebanon over the next 4-5 year period. As the SCD is a public document, it is also intended to be a resource for the general public.

### A. METHODOLOGY

154. **While any prioritization of development challenges contains large subjective and normative components, the methodology designed in this SCD sought to be analytical, transparent and participatory.** The prioritization of Lebanon's constraints to job creation and to the achievement of the Twin Goals were achieved through the following process:

- *Establishing a comprehensive/long list of constraints.* These were obtained from the analytical work done for chapters 1-4 of the SCD. The robustness of the analytical work in identifying a comprehensive set of constraints was validated through extensive stakeholder consultations.<sup>104</sup>

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<sup>104</sup> The multidisciplinary SCD team of experts across 16 Global Practices and Cross-Cutting Solution Areas from the World Bank, IFC and MIGA contributed analysis based on existing literature and new analysis to identify constraints. Between June and December 2014, the World Bank also held eight stakeholder consultations with civil society, academics, think tanks, private sector

Hence, whenever the latter identified constraints that were not adequately reflected in the initial analytical draft of the SCD, World Bank sector experts were asked to take this new information into consideration, along with available supporting evidence, in revising the SCD.

- *Expert scoring of each of the long list of constraints.* World Bank Group experts that worked on the Lebanon SCD scored each of the above list of constraints. These experts consisted of broadly two types of World Bank Group staff: (1) sector experts that are assigned to Lebanon as part of their country coverage (e.g., water sector expert assigned to working on Lebanon and a few other countries); these experts are very knowledgeable on the relative strength and weaknesses of Lebanon in their specific sector of expertise; (2) country experts that work on a broad range of sector issues in Lebanon (e.g., country economist, program leaders); these experts would be very knowledgeable about the comparative strength and weaknesses of sectors within the economy. The WBG experts also included a good representation of staff based in Lebanon and those based outside of Lebanon. This diversity in terms of sector and country background as well as a desirable mix of birds-eye view and deep local knowledge was meant to provide as strong assurances as possible that the ranking of priorities that emerges from the expert votes is correctly capturing the complexity of the country's development challenges. The diversity of WBG experts was also an ideal way to check for the robustness of the ranking obtained (as detailed in the bullet point below). In deciding on each constraint's score, experts were instructed to base their assessment using the following five criteria:
  - i. Impact on goals: assessing the size of the potential impact on eliminating poverty and ensuring a sustainable increase in the welfare of the less well-off. Relative to the other criteria, the overall impact on achieving the Twin Goals has the highest weighting;
  - ii. Time horizon of impacts: calculating the balance of short-term and longer-term impacts when looking at the timeframe under which the impact can be expected to be realized so to include interventions that will deliver quick (visible) wins;
  - iii. Preconditions: identifying the constraints that need to be addressed first in order to unlock wider potential;
  - iv. Complementarities: weighing the degree to which addressing these constraints would have influence across different domains (growth, inequality, sustainability) and/or would magnify the positive impact of addressing other constraints;
  - v. Evidence-base: evaluating the degree of confidence in the evidence base (for the problem and solution);

Political feasibility, which has been used as a criterion in other World Bank SCDs, was not incorporated as a separate criterion as it was already captured in the overarching constraint of elite capture.
- *Ranking of the expert scores (prioritization at the intensive margin).* The results from the World Bank Group experts were tabulated and a ranking of the constraints was produced based on the average score of each individual constraint. To provide a reasonable trade-off between having a narrow-focused set of priorities and having too long a list of priorities which would dilute the whole prioritization exercise, the team decided that Lebanon's priorities consist of the top third of the ranked constraints. As common themes and sectors emerged from this top third of constraints, this generated a list of 11 *ranked* priority areas. It is important to note, however, that while priority

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and public sector representatives in Beirut and Tripoli, and additional sessions with government representatives, UN and donor representatives, youth, and a sample of the Lebanese diaspora in Washington DC. These consultations provided additional insights and validated or informed new constraints.

areas have been identified, the prioritization exercise was undertaken at the *intensive margin* (i.e., while the education sector is one of the areas identified, the constraint identified as a top priority was not the sector itself but a specific issues such as the “Stark inequality in education between the public and private education systems” or the “Influx of Syrian refugees that exacerbates problems related to access and quality of education in public schools”). The value added of a ranking based at the intensive margin is that it provides clear directions on the specific issues that are bottlenecks for the country to develop and create numerous quality jobs.

- *Sensitivity analysis/robustness checks.* To check the sensitivity or robustness of the ranking of priorities that emerged from the above scoring process, the impact that alternative ranking criteria would have on the priorities identified were analyzed.<sup>105</sup> As described above, the fact that the WBG experts were coming from very diverse professional and personal backgrounds enabled to analyze the robustness of the ranking by splitting the voting results along these various factors. Reassuringly, priorities identified were robust to all reasonable alternatives used.

## B. RESULTS OF PRIORITIZATION

155. **Eleven priority areas for reform were identified and ranked.**<sup>106</sup> Of these eleven areas, two consist of the overarching areas of a) elite capture behind a veil of confessionalism / confessional governance, and b) conflict and fragility. The nine nested areas—in *prioritized* order of binding constraints—are related to governance, ICT, energy, macroeconomics and the fiscal environment, the business climate, education, transport, the environment and water. Data availability also arose, as a foundational constraint. A heat map reflects these eleven areas across the ranking framework’s five criteria (Table 5). At the individual constraint level, of the top 10 scoring constraints, the top four were related to governance, ICT, and two energy constraints followed by elite capture, conflict, and macroeconomic and fiscal constraints.

156. **Jobs emerged strongly as the outcome/goal that stakeholders perceive is needed for Lebanon and its citizens to achieve their development potential.** ‘Jobs’ does not feature as a separate cluster in the top constraints as it is the outcome of existing challenges rather than a determinant. Weak job creation, especially for the increasing number of women in the job market and in locations beyond Beirut (e.g., Tripoli), limits the development of economic and human capital and high unemployment is often of long-duration. The stakeholder consultations highlighted that insufficient job creation was a cross-cutting theme particularly for the poor with the caveat that social protection has also a strong role to play for the more vulnerable members of society. The consultations also emphasized that the lack of quality and well-remunerated jobs was pushing youth and others who are disillusioned with the status quo to emigrate. An already-low jobs producing economy has also been exacerbated by the influx of Syrian refugees who are increasingly competing for jobs and putting downward pressure on wages, especially affecting the unskilled, women and youth. Unlocking the constraints prioritized would stimulate the creation of jobs which have the potential to be transformational by affecting living standards, productivity and social cohesion.

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<sup>105</sup> These included using the results of the scores from (1) the core SCD team on the ground that they would have more comprehensive knowledge of Lebanon’s constraints; (2) all the voters that answered at least 120 out of the 122 constraints on the ground that voters that only answered a small subset of questions would not have a comprehensive assessment of Lebanon’s development challenges.

<sup>106</sup> The average score of the final list of 122 constraints stood at 3.3 with a standard deviation of 0.5. The highest ranking one-third of constraints was captured at a cutoff of the highest scoring 41 constraints corresponding to 11 key priority areas when clustered thematically.

157. The following paragraphs synthesize the top third of constraints grouped by cluster. The two overarching areas are first presented, followed by the nested constraints, listed in the order by which the highest ranked constraint of that cluster appeared in the voting results. Figure 82 illustrates the prevalence of each of the nested constraints in the top third by cluster.

158. **An overarching constraint for Lebanon is pervasive elite capture and corruption, hidden behind a confessional veil.** Significant progress on job creation/achievement of the Twin Goals is severely constrained due to a confessional system of governance that has been captured by elites who drive the distribution of power and whose actions lack accountability. This system results in political interference in public institutions and ensures a concentration of political influence and wealth among a few families, at the expense of broader economic development and robust job creation. It also fails to manage conflicts of interest between the business community and the political elite which creates economic rents. Ultimately, this system is fueled by corruption as a primary driver, including payment of bribes, which permeates both the public and private sector.

159. **Conflict, security and fragility, including the recent Syria crisis, is another overarching constraint.** Lebanon suffers from a fragile and dysfunctional political system resulting in a state that is severely constrained and, at times, unable, to regulate conflict and exercise sovereign authority, due to both internal and external factors. Security shocks have historically rendered growth volatile. A recent demonstration of such fragility is the recent Syrian crisis and ensuing Syrian refugee influx which is affecting Lebanon's economy and exacerbating already existing problems of access to and quality of education, health, public and social services, as well as contributing to environmental degradation. Conflict also aggravates corruption, which directly links to the elite capture overarching constraint above.

160. **Governance emerges as the top nested constraint for Lebanon, with the lack of political will and vision, and the lack of capacity of government institutions (including the judiciary) as particularly binding.** Governance and institution-related challenges are the most binding nested constraints for Lebanon's achievement of the Twin Goals with the top ranking constraints across all constraints being "lack of political will, capacity and institutions to design and enact new laws, policies, and strategies, and to implement reforms." Stakeholder consultations highlighted a lack of vision for Lebanon and leadership for the country whether manifested by insufficient planning, a lack of continuity of government policies, or absence of clarity on what the vision is for addressing short and long term challenges, including poverty. Public institutions are perceived as extremely weak, inefficient and corrupt, possessing low capacity to provide high quality services, which is particularly damaging to vulnerable and less well-off citizens. The judicial system is singled out as slow, costly and corrupt, also suffering from a lack of capacity and saddled by an inefficient and outdated legal framework. Other predominant governance constraints include (i) an absence of political consensus on national priorities among political actors due to severe political prioritization since 2006 that has paralyzed decision-making; (ii) weak accountability of the executive; (iii) favoritism in decisions of government officials; and (iv) a State that is totally absent or hollowed out for many parts of society.

161. **Infrastructure deficiencies significantly hamper the achievement of the Twin Goals, especially telecommunications infrastructure, broadband and internet services.** Given its complementarities with all sectors, the currently weak ICT sector is severely limiting job creation, growth and ultimately the development of human capital and was the second highest ranked constraint, and the highest infrastructure related constraint. More reliable and lower cost telecommunication and internet services would positively affect citizens and the private sector alike.

Table 5. Lebanon: Heat map of identified priority areas

	Priority Area	Summary of Constraints	Impact on goals			Time horizon of impacts			Pre-condition?		Complementarities			Evidence Base				
			Small	Medium	Large	Short	Medium	Long	Yes	No	Weak	Medium	Strong	Weak	Medium	Strong		
Overarching	Elite capture under confessionalism veil	Corruption and lack of accountability, conflict of interest between business community and political elite, concentration of political influence and wealth among few families, confessional system that drives distribution of power and political interference in public institutions.																
	Conflict, security and fragility (including recent Syrian conflict and refugees)	Fragile and dysfunctional political system and state, unable to regulate conflict and exercise sovereign authority, conflict as overarching constraint affecting macroeconomy, jobs, environment, with recent Syria crisis increasing competition for jobs, economic and fiscal costs, exacerbating environmental degradation, weak public and social services access and quality of education in public schools																
Nested	Governance and Institutions	Lack of political will to implement reforms, weak and inefficient public institutions, absence of political consensus on national priorities, lack of vision and planning to address challenges such as poverty, weak accountability, slow, costly and corrupt judicial system, low capacity of public sector to deliver quality public services, lack of continuity of government policies, favoritism in government officials' decisions, state that is absent/hollowed out for many parts of society.																
	ICT	Infrastructure deficiencies including need for improved telecommunications infrastructure, mobile phone subscriptions, broadband and internet services.																
	Energy	Energy sector and EdL specifically as source of macroeconomic vulnerability and lack of political will and vested interests prevent effective reforms.																
	Macroeconomic and fiscal environment	Unequal economic development across Lebanon, fiscal policy that lacks basic accountability, captured, inefficient and unproductive; public financial management system suffers from constraints that hinder its proper functioning, frequent shocks rendering growth volatile, lack of approved budgets (since 2005), Syrian crisis impact on economy and public finances, unproductive spending/fiscal leakages, diversion of public funds, macro-fiscal framework with large vulnerabilities.																
	Business Climate	Weak business environment for private sector limits firm creation, reduces efficiencies and competitiveness of operations, monopolies linked to politicians hinder competition, lack of diversity in economy mainly focused on real estate and tourism, relatively high import and export costs, bad infrastructure and cumbersome procedures.																
	Education	Stark inequality in education between public and private education systems, influx of Syrian refugees that exacerbates problems related to access and quality of education in public schools.																
	Environment and Water	Large and rapidly growing environmental degradation particularly water pollution, a deteriorated water supply network, lack of universal access to potable water, and Syrian refugee crisis exacerbating environmental degradation incl. solid waste and access to clean water and sanitation.																
	Transport	Lack of reliable public transportation combined with high traffic congestion in Greater Beirut.																
	Foundation	Data availability and access to information	Lack of strong statistical base and capacity to collect data to measure poverty and other issues, as well as lack of access to information by civil society which is exploited by politicians.															

Source: World Bank staff. Note: the color coding is as follows: red = very binding; orange = moderately binding; yellow = slightly binding.

162. **The energy sector is in unequivocal need of reform.** This sector captured the third and fourth top scoring constraints. A lack of political will, vested interests and corruption all prevent effective reforms in



infrastructure, especially energy which cuts across all aspects of the economy. EdL is a major source of macroeconomic vulnerability given its drain on public finances and its impact on the balance of payments, with the sector suffering from operational inefficiencies, an outdated tariff policy and serious deficiencies across the entire chain from generation to distribution. Reforms in this sector require special attention given its impact on public finances, on the business climate (where electricity is the second biggest obstacle to private sector firms), and on poverty reduction, where the poor have limited access to both government supplied electricity and private generators.

**163. The macroeconomic and fiscal environment exhibits large vulnerabilities and has led to unequal economic development across Lebanon.** Numerous macroeconomic and fiscal constraints entered the top third scored, the second highest number of the nested constraints after governance. The highest ranking of these relates to unequal economic development across the country which has disproportionately benefitted some areas and population groups while others, including border areas, have been largely ignored. Fiscal policy and public finance management constraints dominate this cluster led by fiscal policy that lacks basic accountability, is captured, inefficient and unproductive, in need of oversight and suffering from a stalled budget process. The lack of approved budgets since 2005 is itself perceived as an impediment to the Twin Goals as it undermines the efficiency, accountability, and contestability of public policy decisions. Unproductive and wasteful government spending, the diversion of public funds, and fiscal leakages are significant and widespread, and crowd out effective poverty reduction and social safety net programs. The inefficient use of public resources is attributed to a public finance management system that suffers from challenges that hinder its proper functioning and weaken its transparency. Frequent shocks, especially those related to the security environment, render growth volatile and contribute to a largely vulnerable macro-fiscal framework including high fiscal deficits and an over-indebted sovereign. The recent Syrian crisis has exacerbated these weaknesses by further straining the economy and public finances.

**164. The weak business climate limits firm creation by the private sector directly affecting job generation and thus achievement of the Twin Goals.** Four constraints related to finance, markets, trade and competitiveness enter the top third. New firms face obstacles to entry due to a weak business environment that reduces efficiencies and competitiveness of operations, and to monopolies linked to politicians cum businessmen that hinder competition. The lack of diversity in the economy, mainly focused on real estate and tourism, also impedes firm creation. From a competitiveness perspective, particularly for trade, relatively high import and export costs, bad infrastructure and cumbersome procedures all contribute to an uninviting business climate.

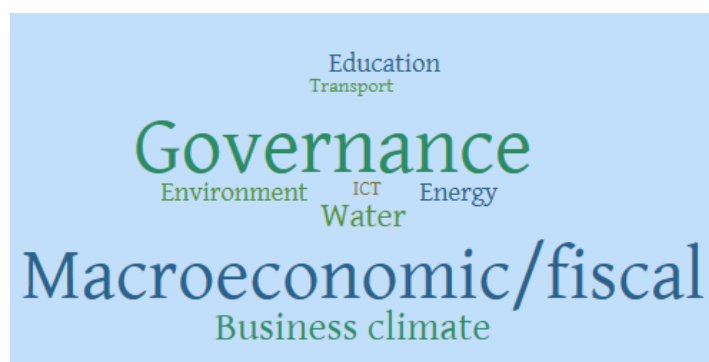
**165. Stark inequality in the access to and quality of education between public and private education systems is a challenge to human capital accumulation for a large share of the population.** Education is key to the accumulation of human capital which is critical to obtaining high quality jobs, economic growth and shared prosperity. While Lebanon exhibits relatively strong average human capital particularly in education, the poor quality of public school education generates large inequality of opportunities among citizens depending on the wealth and income status of their parents. This, in turn, widens inequality in the country, both spatially and over time. The recent influx of Syrian refugees has heightened this problem in public schools with some schools overcrowded and teachers managing different curricula to accommodate the different needs of Lebanese and Syrian children, which is impacting the quality of learning of all students.

**166. Large and rapidly growing environmental degradation and lack of universal access to potable water are important binding constraints given that environmental risk impacts poverty.** The environment, with a focus on water issues, was reflected in four constraints with the highest concern being a deteriorated water supply network due to low public capital expenditures. Environmental degradation is

a key constraint particularly water pollution from untreated sewage, industrial effluent and agricultural runoff discharged into water bodies. The Syria refugee crisis is rapidly exacerbating environmental degradation given the already limited quality and capacity of public water supply, solid waste challenges and access to sanitation.

167. **A lack of reliable public transportation combined with high traffic congestion in the Greater Beirut area impedes the Twin Goals.** While this is the last infrastructure constraint to break into the top third, it has repercussions on both households and businesses resulting in monetary and non-monetary costs. The impact of an unreliable public transport system lowers country-wide connectivity, negatively weighing on economic growth and inclusion.

Figure 82. Word cloud of most prevalent nested constraints, by theme, in top third



168. **Data availability and access to information is a foundational constraint that impacts evidence-based policy making and impedes an informed population.** Major deficiencies exist in the timeliness of data, the reliability of available data due to weak overall statistical capacity, and limited data coverage with poverty, income distribution, and economic measurements such as balance of payments exhibiting weaknesses. While some ministries have enhanced disclosure of data and reports published, the general public has limited or no access to information that is typically publicly available in other countries given that a freedom to information act has yet to be enacted. Such knowledge and facts gaps can be used by the elite to sustain a confessional discourse.

### C. OPPORTUNITIES FOR UNLOCKING CONSTRAINTS

169. **Internal challenges and pressures from the Syrian crisis have placed Lebanon at a cross roads; the country must urgently capitalize on opportunities to unlock its development constraints.** While Lebanon has proven resilient to a myriad of internal and external crises it has often (re)acted only in the face of crisis. Today Lebanon is confronting a possible ‘perfect storm’ phenomenon as it faces a multitude of protracted shocks. These include significant internal and external security threats, a presidential vacuum, widening macroeconomic vulnerabilities, and the arrival of an unprecedented number of refugees. These have the potential to alter Lebanon in significant ways over the medium term. The protracted nature of these shocks is of particular concern as it is testing the limits of the country’s resiliency. Faced with this long-lasting and multifaceted shock, political leaders, decision-makers, the private sector and civil society need to be engaged to realize the extent of Lebanon’s challenges, agree on a vision for the future and implement ambitious reforms. Quick wins for job creation need to be urgently considered, particularly for vulnerable groups. While recognizing that the dysfunctionality of policy making in Lebanon has reached new highs in recent years, there is no room for complacency at this uncertain time of internal and regional instability and heightened risks.

170. **At the same time, the Syrian conflict continues to significantly undermine the stability of Lebanon, its development, as well as the twin overarching constraints of elite capture and fragility.** At this juncture, considerable uncertainty surrounds future trajectories in the Syrian crisis. For the purposes of this document, however, three medium-term scenarios can be identified, along with possible implications for Lebanon’s overarching constraints:

- **Resolution of the conflict in Syria (‘best case’ scenario).** A ceasefire and/or an eventual negotiated resolution of the conflict in Syria would lead to the cessation of large-scale violence and conflict, and lead to an improvement of security conditions throughout the region. The implications for Lebanon could include a decrease in domestic political tensions and polarization, and increased space for dialogue and reform. Improving security conditions in Syria could also lead to the beginning of the return of refugees, though with a prolonged presence in Lebanon for the majority still a possibility due to limited social and economic conditions in Syria over the short-term. Finally, the start of economic recovery and reconstruction in Syria would provide the Lebanese private sector with significant opportunities for investment, trade and services;
- **Continuation of the current situation (status quo scenario).** The continuation of the current trajectory of the conflict in Syria, characterized by periodic ‘positional’ warfare (i.e., no major or decisive military operations) and insurgent activity, and limited will/prospects for peace negotiations, would continue to exert strong destabilizing influences on Lebanon, deepening its fragility. In this scenario, aggravation of both overarching constraints could be possible, including the deepening of elite/confessional divides, resulting in increased risks of political/social destabilization; and a progressive downward spiral of the economic and fiscal situation due to both governmental inaction and unmanaged pressures created by the refugee situation.
- **Escalation of the conflict in Syria.** A significant escalation of the conflict in Syria, including increased large-scale military confrontations and violence, could lead to further waves of population displacement as well as renewed drives by belligerents to mobilize further support through regional networks and alliances. In such a scenario, the risk of a significant ‘spill-over’ of the conflict in Lebanon could severely destabilize the country, with possible implications including the wholesale collapse of the current domestic political equilibrium; the degeneration of political and sectarian tensions into violent confrontations; and the collapse of the government and state institutions. Potential political destabilization and the possibility of renewed large-scale influx of Syrian refugees into Lebanon could also significantly destabilize the social and economic situation, leading to popular unrest and aggravated tensions between communities throughout the country.

### 1. Mitigating the Impact of the Overarching Constraints on Development

171. **While Lebanon’s overarching constraints are deep-rooted—being the result of decades of institutional, social, and political evolution—potential ways to mitigate them do, however, exist.** Regardless of how the situation evolves in Syria, important opportunities nonetheless exist for addressing Lebanon’s twin overarching constraints, thereby bolstering the country’s resilience and reducing its vulnerability to external shocks.<sup>107</sup> These sources of resiliencies and reform options can broadly be classified in two types of mitigation strategies, namely: (1) directly aim to lessen the overarching constraints themselves; and (2) take the overarching constraints as a given and work on lessening the nested constraints by designing a reform program that is incentive-compatible with the existing overarching constraints. By

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<sup>107</sup> Despite the various internal and external factors which contribute to Lebanon’s fragility, there are also a number of important sources of resilience, including gains achieved over the past decade, which have prevented a relapse of the violence witnessed during the civil war, and constitute opportunities for both stabilizing the country and addressing fundamental structural problems.

aiming to lessen the overarching constraints the first strategy carries the potential of a large payoff for the country's development but, given the deep-rooted and symbiotic nature of the two overarching constraints, this strategy will take time to bear fruits. The second strategy is more suited to deliver gains in the short-term, but given the weight of the overarching constraints, these gains are likely to be more limited in scope and might be contingent on the emergence of "windows of opportunity".

172. **The following options illustrate ways of approaching reform in a country with deep-rooted and encompassing overarching constraints like Lebanon today.** It is stressed that, given the very fluid nature of Lebanon's two overarching constraints, these options should be seen as indicative of the overall approaches to reform that should be undertaken. Also, these options do not claim to be comprehensive.

### **Strategy 1: Lessening the Overarching Constraints (Benefits: medium-term but large)**

- *Implementing key outstanding elements of the Taef Accord* would likely yield significant results in terms of lessening elite capture. These include a decentralization Law, the creation of a lower chamber of parliament that would be elected on a non-confessional basis (while having the upper chamber maintaining a confessional basis in order to protect minorities' rights). Specifically:
  - *Decentralization:* in the context of elite capture through the confessional political system, decentralization, if properly designed, could be a means to restore the link between elected policy-makers and voters/consumers of public services. Empowering local governments through decentralization may mitigate opportunities for elite capture. Divesting power (financial, political) to the local government, or at least that of a few priority services, could create a clear line of accountability from the local officials to the citizens they represent, and facilitate the responsiveness to citizens' needs. Working to implement the draft Decentralization law of 2014, could leverage the viability of this option.
  - *Creation of a non-confessional lower chamber of Parliament:* the creation of a second chamber that would be, by design, non-confessional and would be tasked to legislate based on a non-confessional basis would likely significantly lessen the power that a few elites have been able to amass over the years by using the veil of confessionalism. Minorities' confessional rights would still be protected through a upper chamber of Parliament but this chamber, as the upper chamber, would not have the key agenda setting role that it currently has.
- *Improving access to (statistical) information.* Access to information is a core tenet of an open and inclusive society, and constitutes an integral part of creating a level playing field. It would allow more fair competition within the private sector, and would help civil society and citizens to hold government accountable. It would also help show the real costs – both economic and social - of the current system of governance. Increased transparency by the Lebanese public sector would offer access to government information and socio-economic data and statistics. This could facilitate participation by citizens, media, and CSOs in informed policy dialogue, be used as a tool to increase accountability as these groups would be able to scrutinize information. Adopting proactive disclosure measures, as a first step before passing legislation (as legislation does not necessarily translate into implementation; implementation is often rather a function of political will in individual ministries, departments, and agencies) could mitigate elite capture in terms of moving towards equal access to information, limited discretionary opportunities, and increased accountability.

- *Strategically improving services in high demand from the public and the private sector may create appropriate demand and provide an incentive for public officials to put the public interest ahead of serving elite capture.* In Lebanon, actual responsibility for local service delivery falls under the remit of the central administration, which is captured by the elite. As such, public sector spending, human capital, and ultimately, delivery of services is not necessarily governed by need, but essentially a patronage system based on religious sect and political party alliances. In addition, many local officials are appointed by the central government, as opposed to elected locally. Improving the services most used or considered most important by the general public can result in increased demand for reforms from across confessions, which in turn can increase the incentives of public sector entities to further reforms. Such sectors may include health, education, land administration and access to personal documents. The same can be said for reforms that would benefit the private sector more broadly. Reforms could be implemented through automation of common documents, e-services, simplification of administrative procedures and addressing low-level corruption, such as bribery of administrative officials. Service delivery improvements may ultimately lead to a shift in attitudes towards the serving the public interest rather than protecting elite capture.
- *Promoting political stability.* At the political level, the restraint exhibited by both Hezbollah and Sunni groups with respect to the Syrian conflict illustrates a general desire to avoid the kind of descent into conflict and warfare associated with the civil war. The gains achieved through national dialogue processes since 2006 and through instruments such as the Doha Accord—though interrupted—are important steps nonetheless that could be built upon as the basis for a new political consensus on the nature of the political system and definition of national priorities. Key pathways for action could include: (1) promoting renewed national dialogue and reconciliation, building on post-2006 precedents; and (2) creating space for participatory dialogue and engagement on critical political and governance reforms, with a focus on increasing equitable and inclusive decision-making and governance at all levels.
- *Institutional reform and development.* Despite the destruction of the 2006 conflict with Israel and the current pressures created by the Syrian refugee crisis, there has been investment in the strengthening of national institutions over the past years, including through international assistance. While these investments have not always translated into more equitable or efficient public services, they do nonetheless provide an important foundation for future capacity development efforts oriented towards increasing transparency and equitable service provisions, and as a starting point for future economic and development reform programmes. Key pathways for action could include: (1) reform of key institutions, including transparency in targeting and allocative decision-making processes, and quality / equity of service provision (an additional focus could include risk-based targeting); (2) strengthening of public-private partnerships on social spending, based on common policy/planning frameworks and transparent/equitable rules governing allocation; and (3) and developing institutional capacity development programmes in key sectors, with a focus on addressing demographic and regional inequalities, and promoting ‘citizen’-based policy development (as opposed to more narrow sectarian/confessional approaches).

## **Strategy 2: Tackling the Nested Constraints by Designing Reforms that Incorporate Existing Overarching Constraints**

- *Political economy and conflict exposure analysis of nested sectors.* In the absence of the two overarching constraints, designing reforms at a sector level would mostly focus on the technical issues that need to be reformed within the sector. In Lebanon, given the two overarching constraints, undertaking a technical analysis of sector reforms needed is a necessary but not a

sufficient condition for reforms to actually take place and be successful. For the latter to happen, a prior analysis of (1) key stakeholders' incentives and powers, and (2) of the sensitivity of the sector to be reformed to conflict and fragility is required. If, for example, the stakeholder analysis reveals that one powerful confessional party derives strong personal rents from the sector and is in a position to veto any reform attempts in the sector, then even the most solid technical solution to the sector will not lead to the desired results. Once sector reformers have a solid understanding of the impact that confessional governance and conflict and fragility have on the sector, they must then design a reform package that is incentive compatible with these two overarching constraints. The next bullet points provide examples of how such a package could be designed.

- *Grand bargain: increasing the pie for society while ensuring that elites' relative (or absolute) standing is not affected.* Grand bargaining can help mitigating competition over power (political and economic) between the confessional parties and elites that have captured the Lebanese economy. Currently, the status quo among the elite is to respect each other's sphere of influence through assigning religious confessions to, for example, lead specific ministries and the services delivered to their own constituents. Grand bargains would encourage different stakeholders to 'share the pain' of reforms in return for sharing the benefits. In order for grand bargaining to be successful, an understanding of common strategic interests, incentives, access to information, power conditions, extent of mutual trust, and accountability enforcement need to be identified. Another option is that the alternative to not cooperating (e.g., conflict) is dire and imminent. Grand bargaining would most likely go beyond political parties in Lebanon to involving or incorporating international actors who influence Lebanese politics.
- *Opportunistic approach:* being ready to seize windows of opportunity when they arise, such as when the overarching constraints become temporarily less binding (e.g., because a regional peace accord significantly lessens both confessional governance and conflict and fragility). Such an opportunity might currently be opening up in the governance sector where several reform initiatives have recently been launched or are about to. For example, the Ministry of Finance is considering wide-ranging reforms to the land administration process, and has taken some steps to address the widespread corruption in the land administration process. The Ministry of Health has taken steps to address unsafe food and drug practices. Stakeholders could support and use these interventions to create spillover effects that benefit governance in other sector as well. For example, by improving general accountability mechanisms involving the public sector, or promoting access to information and transparency that touch on many different sectors.
- *Working around elite capture,* i.e. working with actors outside the public sector that could advocate for necessary reforms and/or bring key services to citizens. Many actors—private sector, civil society, political parties, and religious groups—currently compensate for the lack of services offered by the public sector which is captured and as a results, services are delivered more so on an ad hoc basis, with poor accountability measures.
- *'Horizontal' social engagement.* Lebanon's civil society and private sector are often considered through sectarian filters, i.e., as organizations which are part of the broader sectarian system and institutions to which they are affiliated. But the history of Lebanon since the civil war also highlights their potentially positive role in helping foster integrative and horizontal dynamics with respect to both political and economic issues. A key opportunity and strategic pathway is thus to strengthen the integrative and non-sectarian organization and engagement of civil society and the private sector, and in particular the 'Arab Spring generation' in the development of inclusive national agendas on reform and institutional development. At local level, the engagement of these actors in the mitigation of social tensions (including those associated with the refugee influx) could

support the strengthening of social cohesion and resilience, and facilitate development of mechanisms to manage associated social and economic pressures.

- *Managing the Syrian refugee influx and turning it into an opportunity.* It is likely that Lebanon will need to address a protracted presence of Syrian refugees over the medium term regardless of how the Syrian crisis develops. While humanitarian assistance has been essential in sustaining the refugees and partially mitigating associated fiscal requirements, there is an opportunity to both consolidate and sustain these gains over the medium term, while also strengthening and improving public and private capacities as a development outcome in their own right. This bridging of the humanitarian-development continuum could include three potential strategic pathways: (1) improving safe asylum space through strengthening of host communities capacities to manage economic and social tensions associated with the refugee presence; (2) provision of support to the government to address fiscal requirements, while also developing the basis for medium term improvements in infrastructure and public service delivery; and (3) promoting greater self-reliance and economic autonomy among the refugee population through targeted livelihoods assistance and policies for their medium-term inclusion in the national economy. Point 2 is critical for a country like Lebanon to provide to the international community the global public good of hosting refugees while also preventing or mitigating the proliferation of global public bad such as international terrorism (should prevention interventions such as tackling poverty be left largely unfunded).

## 2. Opportunities to Unlock the Nested Constraints

173. **Subject to the design of reforms that are incentive compatible with the twin overarching constraints—as described above—the following opportunities could materially improve Lebanon’s development prospects:**

- *Infrastructure reforms in ICT, electricity, water supply and transport would transform the quality of life for all, in addition to stimulating job creation.* Electricity sector reform is paramount and would result in cost recovery for EdL, improved fiscal and external balances and reduced CO2 emissions. Reliable electricity would satisfy a prerequisite to support the transport sector which would itself unleash improved connectivity and stimulate growth. Such reforms would pave the way to attract FDI and stimulate a diversification of investments for the Lebanese private sector from real estate and government bonds, which would enhance Lebanon’s competitiveness. Factoring in renewable energy in Lebanon’s energy mix is an opportunity for green jobs, particularly as Lebanon seeks to meet its target of 20 percent of the energy mix met by renewable energy by 2020. Upgrades in ICT infrastructure would generate jobs as would new related services in intermediary sectors pertaining to broadband that could be developed in e-banking, e-health and in new industries such as export-oriented IT-enabled services. Such ICT advances would also support Lebanon’s burgeoning technology ecosystem and stimulate further the creation of more high quality jobs.
- *Some of the challenges of the Lebanese labor market could be addressed through targeting agriculture and water investments.* The agricultural sector experiences shifts in its production structure and declining wage income. Yet the Syrian crisis presents a sizeable opportunity for domestic producers. Concrete investments could be the support the rehabilitation of irrigation schemes both through soft and hard infrastructure investments, consistent with the Government’s 2015-2019 agricultural strategy, which aims to continue to revitalize the sector (Water scarcity and efficiency is identified as a main constraint for the expansion of agricultural production). Moreover, the export sector will need to re-orient itself away from traditional markets in Syria and further diversity. I will need upgrading of supply chains for high value products in particular fruits and

vegetables. Likely areas of support could be in the area of analysis and market information systems, targeted export promotion programs, and institutional support to enhance the sectors efficiency and organization.

- *Investments in human capital are crucial with opportunities existing at all levels of education.* Quality early childhood education has been documented as a barrier to escaping poverty and could be a medium-term win. At the secondary and tertiary levels, educational programs that are better suited to meet the demands of the labor market in Lebanon are critical. Related, the presence of career counselors to guide the choice of youth in their selection of major and career is another opportunity. Youth need to be given hope that they can be a catalyst for change in Lebanon and be given the skills to succeed. For the most part, they are disengaged from the political process and demotivated to impact any real change in Lebanon in the prevalent economic and political situation, hence their strong propensity to emigrate. Curricula revisions to ensure graduates have skills employers need are necessary, as is the need to integrate entrepreneurship skills in the education system at the secondary and tertiary level to motivate those youth who are interested in initiating start-ups and creating their own jobs. Establishing common spaces for youth from different backgrounds such as community centers and sports clubs could mitigate confessional geographic delineations.

174. **While technical solutions are known for achieving reform and progress in each of the prioritized constraint areas, additional ‘soft’ opportunities can be considered.** There is scope for the state to regain trust from its citizens with state rebuilding as key and rule of law at its heart. The above bullet point on ‘Horizontal social engagement’ is one such option. Another option is that, in addition to focusing on job creation, the government could propose and implement a youth engagement policy, launch campaigns on good governance, organize competitions to promote Lebanese identity, and publish inspirational and economically empowering content such as on jobs, scholarships and grants. Behavioral change in the administration could be inspired through positive stories by recognizing those administrations, agencies and leaders that are delivering on their mandate in serving citizens well.

175. **Lebanon could transform negative pressure points into positive ones.** Confessionalism, when not exploited as a veil for corruption and elite capture, can serve to foster and respect Lebanon’s diversity. Entry points in the confessional system could be identified in order to drive change such as engaging the confessional structure in planning and discussions on public goods, job creation and economic growth. Lebanon can also redefine itself amidst demographic changes. For example, the country could capitalize on its changing comparative advantage in the agri-food business. Opportunities also exist for Lebanon’s private sector given its experience in recovery and reconstruction as currently troubled countries in the region stabilize.

176. **The Lebanese diaspora has an important role in supporting reform.** The strong support of Lebanon’s diaspora in providing a large remittance base has been a source of strength for Lebanon. The diaspora could be mobilized to influence key decision makers in Lebanon to support reforms and could play a role both in supplying talent, funding investment in productive assets, and mediating domestic political tensions by helping focus private sector and civil society efforts away from confessional interests.



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## ANNEX I. STATISTICAL SYSTEM AND THE SCD

177. **Overall statistical capacity in Lebanon is weak in part due to the lack of resources and autonomy of the Central Administration for Statistics** (World Bank, 2007a and 2010a; IMF, 2014). This is reflected in the low statistical capacity indicator constructed by the World Bank. In 2010 Lebanon had the second lowest indicator after Gabon among countries at similar levels of economic development measured by GDP per capita in PPP terms. Data weaknesses impede both decision-making and economic and social analysis. For instance, the span and frequency of the national accounts data limit the scope of the analytical work that can be undertaken in the SCD. Neither cross-country regressions nor estimation of potential output, which requires the use of advanced econometric techniques (such as filtering), can be performed with the currently available data (See Annex II for details).

178. **Besides low resources and capacity, a key reason underlying the weak statistical system in Lebanon is the political and sectarian sensitivities associated with data.** Because of the delicate political/confessional equilibrium described in the main body of the SCD, there are particular issues with collection of household level data in Lebanon. Given the sectarian nature of the political system, population demographics, which are the foundation on which much of a country's statistical system is built, have always been a sensitive and highly politicized issue. There is a fear that some groups may claim more power in case statistics show a shift in population demographics (Lebanese Information Center, 2013). The last official census in Lebanon was conducted in 1932. The Lebanese administration updated the 1932 census results in 1942. The latest update of the population figures was made in 1964, drawing on civil status registers within the Ministry of the Interior (EU, 2009).

179. **Lebanon is lagging behind in collecting and making available micro data compared to other middle income countries, which are the data needed to monitor the Twin Goals.** Figure 83 shows the number of micro data surveys available in Central microdata catalogue of the World Bank. There are only 16 surveys for Lebanon in the catalogue compared to 63 surveys for Turkey or 71 surveys for Mexico. A particularly severe problem in Lebanon is the lack of household surveys and data. Among those 16 surveys deposited in the catalogue only two are household budget surveys. These household surveys are the type of data from which poverty and income growth distribution estimates are obtained. Lebanon also does not have regular labor force surveys, which limits the analysis of the labor market and jobs developments.

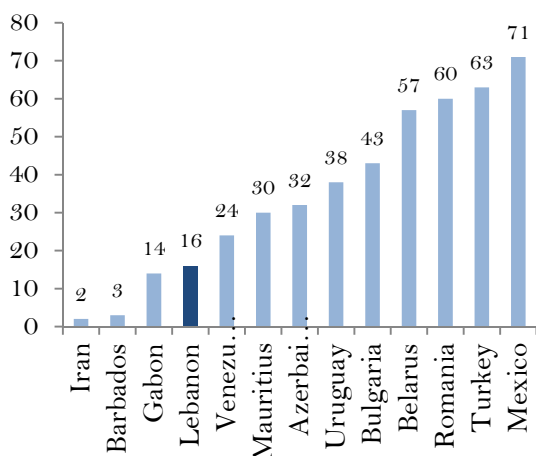
180. **Lack of microdata in the World Bank catalogue can be driven by lack of availability and/or lack of access.** For example, there is a plethora of household budget surveys collected in Iran, but they are just not shared with the World Bank. In contrast, there were only two household budget surveys conducted since 2000 in Lebanon and only one of them was used to measure poverty and inequality. Figure 84 provides evidence for this showing that for Lebanon national absolute poverty rate is available only for 2005 year, while for many other countries national absolute poverty rates are measured regularly.

181. **Partly driven by such political/sectarian issues, the importance of data collection and statistics is not highlighted in the Government's policy strategy documents.** For example, data issues are not mentioned in the national social development strategy of Lebanon (Ministry of Social Affairs, 2011) even though the latest poverty estimates were for 2005. This imposes an important constraint on the government's ability to accurately assess and define core social development and poverty reduction goals, which in turn perpetuate important social and economic inequalities. These reinforce political and social cleavages and exacerbate tensions, perpetuating and deepening Lebanon's vulnerability to conflict.

182. **Beyond data issues to analyze the Twin Goals, some important issues also exist with the statistical information available for economic monitoring and analysis.** These include:

- *National accounts:* In addition to being compiled only on an annual basis, Lebanese national accounts cover only the 1997-2013 period (as of December 2014). Recent improvements in the compilation of national accounts have taken place as CAS published, in October 2013, new national accounts for the 2004-2011 period based on (i) a new framework that is consistent with the international standards (UN SNA, 2008) and (ii) new data (e.g., VAT returns, imports of services).
- *Balance of Payments:* Despite some modest improvements (such as the compilation of an International Investment Position Statement), the IMF (2014) notes that current account data have a number of uncertainties relating to estimates of private sector services, workers' remittances and investment income. The quality of the capital and financial account data is also weak as uncertainties plague data on FDI, equity investment, nonbank private sector and corporate borrowing abroad.
- *Prices and Inflation:* Prior to December 2013, consumer price inflation data did not provide a comprehensive breakdown of prices (rental data are now collected on a monthly basis), (ii) an updated weighting scheme to the inflation basket and (iii) a geographical breakdown of the consumer price index (CPI). The CAS's CPI also did not accurately reflect the dynamics of aggregate prices in Lebanon as rental surveys, which accounted for 16 percent of the old CPI basket, were only undertaken once every three years. CAS also did not collect CPI data between January and May 2013 resulting in a break in the CPI series.
- *Labor Market and Productivity:* The latest official unemployment data are from 2009.<sup>108</sup> No labor force survey is periodically undertaken. Data on total factor productivity are unavailable. The absence of these data prevents analytical work of the role of different factors of production and technological changes in driving growth.
- *Access to capital and returns to private investments:* Limited data on sectoral access to capital exist. While data on the cost of finance can be obtained, private returns to investment data are unavailable.

Figure 83. Number of microdata surveys deposited in the WB's Central Microdata Catalogue



Source: World Bank staff compilation based on Central Microdata Library as of 21st of April, 2014.

Note: countries selected had GDP per capita in USD PPP 10 percent higher or lower than Lebanon in 2010.

Figure 84. National poverty rates as reported in WDI for Lebanon and selected comparators



Source: Based on Azevedo, J.P. (2011) wbopendata: Stata module to access WB databases, Statistical Software Components S457234 Boston College Dpt. of Economics. WDI data as of 6/19/2014. Same comparators countries as in Fig. 1. There are no numbers for Iran and Barbados.

<sup>108</sup> The one off MILES project (World Bank, 2012) somewhat attenuates the lack of labor market data but these date from 2010.



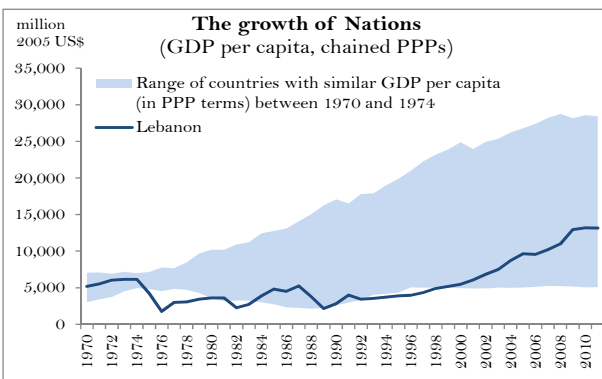
## ANNEX II: ECONOMIC PERFORMANCE AND THE CIVIL WAR

183. As Lebanon’s economic performance is materially affected by fragility and conflict, a long term perspective on the country’s growth is instructive. For example, Lebanon’s economic performance has been profoundly affected by the 1975-1990 civil war and has had lasting impacts on all core determinants of economic growth, from human and physical capital to its institutional and social capital.

184. **Led by services and private consumption, economic growth and growth per capita were robust between 1950 and 1974.** The Lebanese economy grew, on average, by an estimated 7 percent during 1950-1974 (Makdisi and Sadaka, 2003). During this same period, real GDP per capita growth exceeded 3 percent (Gaspard, 2004) and a similar 3.3 percent during 1964-74 (Eken et al., 1995). While robust, this per capita growth performance was nonetheless lower than the average growth of seven neighboring countries.<sup>109</sup> In terms of sectoral contributions to GDP, the large services sector (69.5 percent of GDP) was the main growth driver in the immediate pre-civil war period (1966-1971). On the expenditure side, during that same period private consumption which accounted for 78.5 percent of GDP, was by far the main growth driver (World Bank, 1973). Hence, at the onset of the civil war, the structure of the economy was one of a developed economy where agriculture and industry were relatively small.

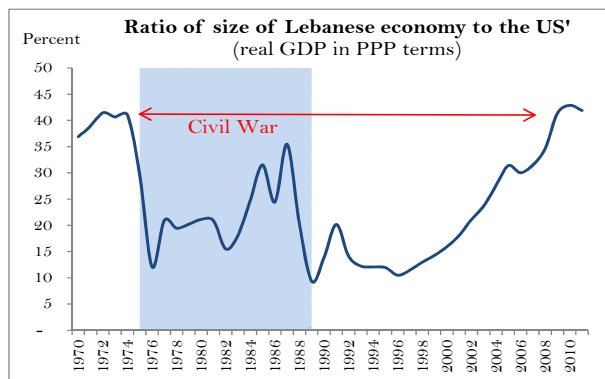
185. **Lebanon suffered large and persistent economic and human (among other) losses due to the civil war** (Figure 87). Human losses are estimated at 144,000 fatalities (or 5 percent of the resident population at the time) and more than 184,000 injuries (Makdisi and Sadaka, 2003). Lebanon’s economy halved during the civil war<sup>110</sup> due to a large decline in investment, the dislocation of goods and labor markets, large destruction of its physical capital stock (estimated at USD25 billion), and large emigration of an estimated 200,000 (7.3 percent of the population) skilled Lebanese (Eken et al., 1995; World Bank, 1993). The economy only returned to its pre-conflict (1974) level in 1998. In per capita terms, given rapid population growth (and notwithstanding the casualties of the civil war and the large and sustained outward migration) per capital real GDP only returned to its 1974 level in 2002. Thus, in economic terms, it took one generation to return to (average) welfare that the country had prior to the war. As described in Chapters 1 and 2, the war also took its toll on institutions, governance, and the role of the state.

Figure 85. Lebanon’s GDP per capita trailed its 1974 peer group until a rapid catch up during the 2000s



Source: World Development Indicators, 2014. The comparator countries are Hungary, Antigua and Barbuda, Chile, South Africa,

Figure 86. The Lebanese economy returned to its 1974 41 percent size of the US economy only in 2009



Source: Penn World Tables 8.0 and World Bank staff calculations.

<sup>109</sup> These are Cyprus, Jordan, Syria, Tunisia, Israel, Turkey and Egypt.

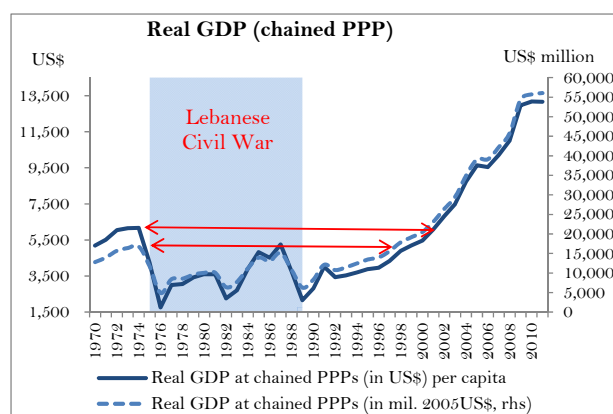
<sup>110</sup> By 1990, real GDP stood at 48 percent of its 1974 level according to data from the Penn World Table (8.0). Eken et al. (1995) find the same number by putting together various information sources.

Turkey, Cyprus, Poland, Colombia, Jamaica, Costa Rica, and Uruguay.

186. **The civil war set back Lebanon’s development for at least one generation.** In the early 1970s Lebanon ranked in the top 31 percent of countries in the world in GDP per capita (PPP terms). That ranking dropped markedly because of the civil war and has not yet been fully recovered (Lebanon was in the top 35 percent of countries in 2011<sup>111</sup>). A slightly more positive assessment arises when looking at Lebanon’s performance against countries that had the same PPP-adjusted GDP per capita in 1974 as Lebanon. As shown in Figure 85, Lebanon trailed its comparators (12 countries) until the 2000s. Since then it has rapidly caught up and by 2011, Lebanon ranked towards the middle of its 1974 peer group and is now again at par with Chile and Turkey but still far behind the group’s top performers (e.g., Cyprus with a PPP-adjusted per capita GDP that is 114 (43) percent higher than Lebanon). Similarly, the size of the Lebanon economy recovered only in 2009 the gap it had compared to the U.S. economy in 1974, i.e., 41 percent (in PPP terms)—Figure 86.

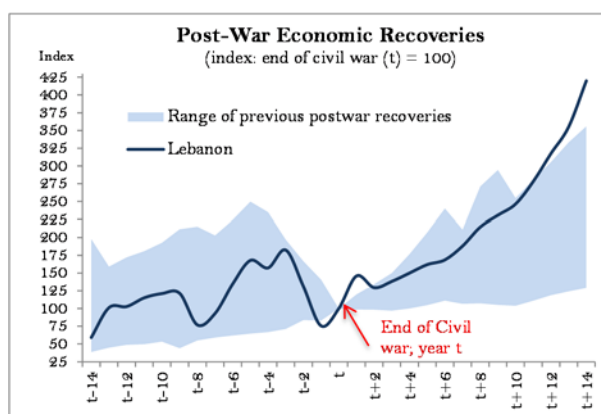
187. **The country’s recovery from the civil war was comparatively strong** (Figure 88). While the civil war set Lebanon and its population back by a generation in terms of development, a comparison of Lebanon’s recovery with that of other post-conflict countries is revealing. Compared to 12 post-conflict countries that had a conflict duration of at least 10 years,<sup>112</sup> Lebanon’s real GDP rebounded rapidly and later became the best performing one. This good performance might be attributed to (i) Lebanon’s highly skilled human capital, (ii) a rapid and large inflow of capital early on in the recovery and reconstruction process that has since been maintained, in large part due to remittances of the large Lebanese diaspora and (iii) large scale reconstruction efforts.

Figure 87. The civil war halved Lebanon’s GDP; it took a generation to return it to its pre-conflict level



Source: Penn World Table 8.0 data and World Bank staff calculations

Figure 88. Lebanon’s post-conflict recovery performance is comparatively strong



Source: Penn World Table 8.0 data and World Bank staff calculations

<sup>111</sup> Source: Penn World Tables 8.0 and World Bank staff calculations.

<sup>112</sup> Real GDP (at chained PPPs) is normalized at 100 at the last year of each conflict. The comparator countries were selected from the list of conflict countries in the 2011 World Development Report that have experienced conflicts of at least 10 years during 1960-2011. The resulting countries are Lebanon, Liberia, Mozambique, El Salvador, Nepal, Peru, Sierra Leone, Angola, Guatemala, Indonesia, Rwanda, South Africa and the Republic of Congo

## ANNEX III: SUPPLEMENTAL POVERTY AND ACCESS TO PUBLIC SERVICES TABLES AND CHARTS

Figure 89. Share of different classes among respondent in Lebanon and comparators by education from WVS, circa 2013

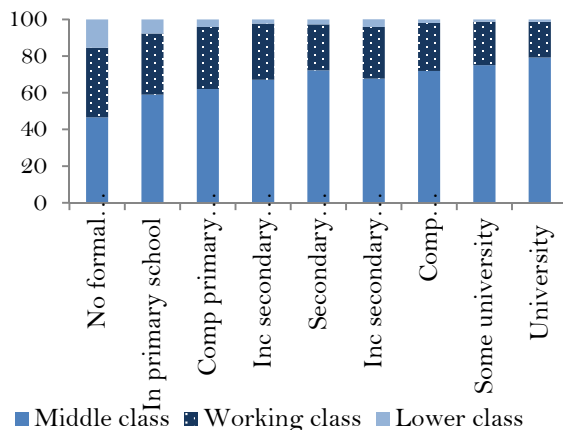
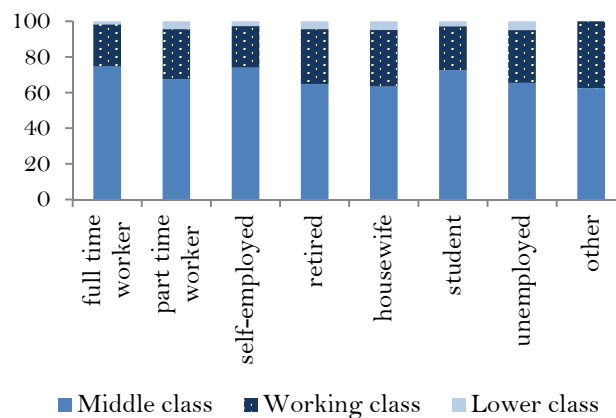


Figure 90. Share of different classes among respondent in Lebanon and comparators by employment status from WVS, circa 2013



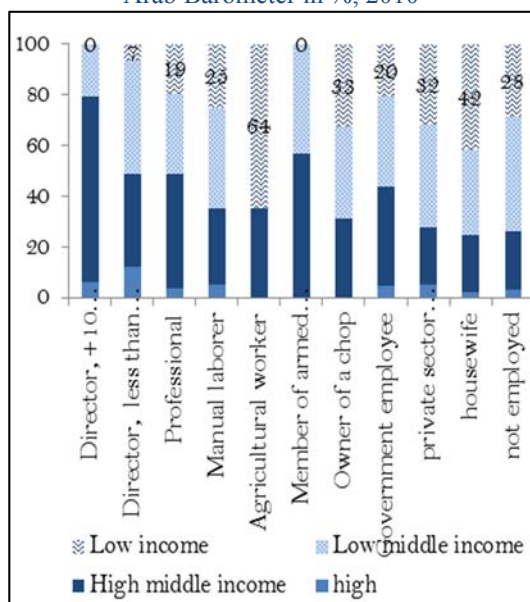
Source: World Bank staff calculation based on WVS, wave 6. Note: Surveys were conducted in different years in different countries. “Do not know” and “no answer” were excluded from calculations.

Table 6. Marginal effects from probit model explaining being in bottom 40 percent of respondents based on self-assessed ranking of income scale in Lebanon in 2013, WVS

Explanatory variable	coefficient	t-statistic
age	-0.001	[-0.133]
Age squared	0	[0.445]
male	0.014	[0.493]
education		
no education	omitted	
Incomplete primary school	-0.118*	[-1.899]
Complete primary school	-0.165***	[-3.636]
Incomplete secondary school: technical	-0.228***	[-5.946]
Complete secondary school: technical	-0.186***	[-4.241]
Incomplete secondary school: university	-0.207***	[-4.970]
Complete secondary school: university	-0.220***	[-5.228]
Some university-level education	-0.221***	[-5.050]
University - level education, with degree	-0.292***	[-7.658]
employment status		
Full time	-0.0953**	[-2.053]
Part time	-0.041	[-0.727]
Self employed	-0.181***	[-4.139]
Retired	-0.061	[-0.981]
Housewife	-0.108**	[-2.180]
Students	-0.084	[-1.608]
unemployed	omitted	
N		1,159

Source: World Bank staff estimation based on WVS, wave 6. Note: “Do not know” and “no answer” were excluded from estimation. \* 10 percent level of significance, \*\* 5 percent, \*\*\* 1 percent.

Figure 91. Household income class groups across respondents with different labor force status from Arab Barometer in %, 2010



Source: World Bank staff calculation based on Arab Barometer. Note: individuals without answers about household income status were excluded from calculation.

Figure 92. Poverty rates among households of different size in 2012

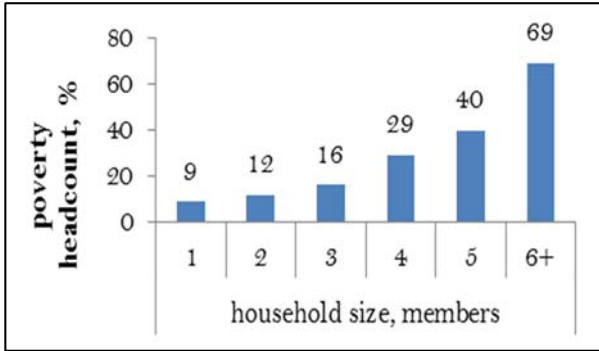
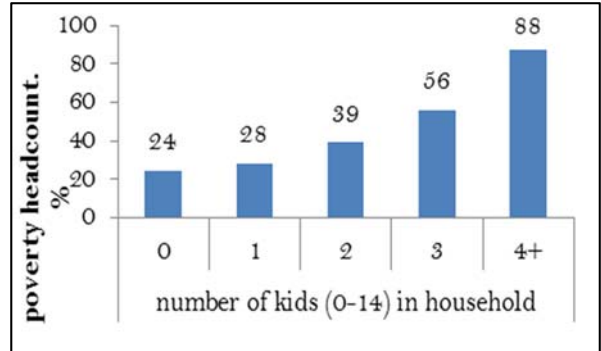


Figure 93. Poverty rates among households with different number of kids in 2012



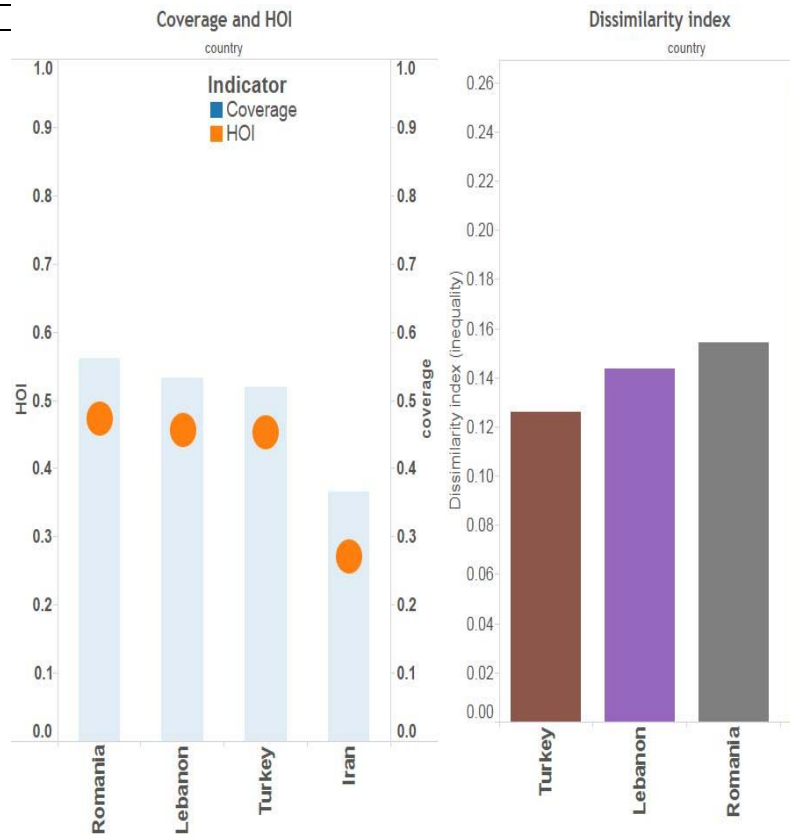
Source: Financial capability survey 2012. Note: World Bank staff calculation.

Table 7. OLS regression explaining math test score from TIMSS

		Dependent variable: Math score
teachers' experience		
experience 10-20		1.4 [3.956]
experience 5-10		-20.44*** [4.182]
experience <5		-21.68*** [4.577]
more than 20 years		omitted
access to internet and computer		
no internet		-13.43*** [2.451]
no computer		-29.41*** [3.771]
Migrant		
was not born in the country		-9.343*** [2.971]
Attitude to math		
like a little math, science		-18.97*** [2.612]
do not like math, science		-35.08*** [3.615]
completely dislike math and science		-52.14*** [3.390]
like math and science a lot		omitted
Region		
Bekaa		7.997 [5.312]
Mount Lebanon		20.68*** [5.178]
Banlieue		3.5 [4.418]
Nabatieh		-21.63*** [6.345]
North		-14.48*** [4.949]
South		-17.83*** [5.172]
Beirut		omitted
Area of residence		
Suburban		14.55*** [4.269]
Medium size city		14.92*** [3.163]
Small town		1.943 [3.740]
Remote rural		-13.58 [8.671]
Urban		omitted
Boy		5.819*** [2.243]
English		-2.75 [2.832]
Constant		481.9*** [5.353]
Observations		3,438
R-squared		0.198

Source: TIMSS 2011, Paul Cahu. Notes: \* significant at 10 percent, \*\* at 5 percent, \*\*\* at 1 percent. Observations with missing values were removed from estimations: 536 from 3974 observations. T-statistics are shown in parentheses. Students' weights were used.

Figure 94. Coverage, HOI and Dissimilarity index for a selected set of countries based on math TIMSS scores



Source: TIMSS scores provided by Paul Cahu. HOI is calculated by Aziz Atamanov.

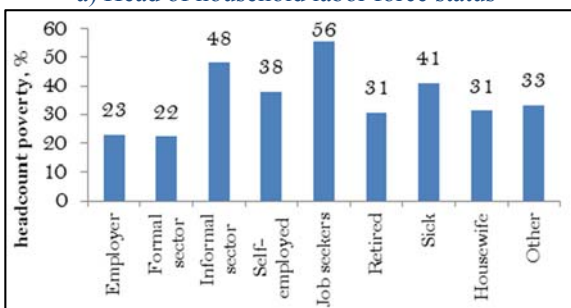
Notes: 8th grade kid has opportunity if his math scores are higher or equal to the average score of Iran, Turkey, Romania and Lebanon (countries having similar GDP in and available in TIMSS).

Source: TIMSS 2011, author's calculations.

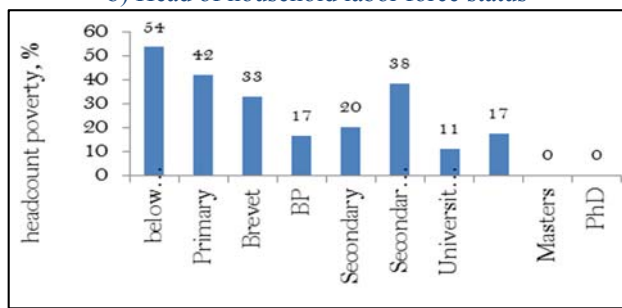
Notes: Students' weights were used. Dissimilarity index measures inequality of opportunity and ranges from 0 to 1 with higher values meaning higher inequality. 8th grade kid has opportunity if his math test score is higher than the average for Lebanon, Turkey and Iran: 439.

Figure 95. Poverty rates in 2012, Financial capability survey

a) Head of household labor force status



b) Head of household labor force status



Source: Financial capability survey 2012 and WB staff calculation.

### Box A.1. HOI calculation

The Human Opportunity Index (HOI) is a measure which combines into a single indicator both the coverage or access to a particular opportunity and how equitably that access is distributed. More formally:

$HOI=C*(1-D)$ , where C is average coverage rate for opportunity, D is dissimilarity index or inequality of opportunity.

The HOI index runs from zero to 1. A society with universal coverage will have HOI equal to 1 or 100 percent. On the other hand, a society with coverage of 90 percent that is unequally distributed in favor of one group (say urban population) will have a HOI lower than 90 percent, with the exact value depending on how unequal is access across rural and urban population. Intuitively, the HOI takes access to opportunity and discounts it if opportunity is not allocated equitably.

The D-index measures the dissimilarity of access to an opportunity across different groups of people (in our case urban/rural) compared with the average access rate for this opportunity for the whole population. The D-index ranges from 0 to 1, and equals zero in a situation of perfect equality of opportunity. The D-index can be estimated econometrically and decomposed into contribution of characteristics selected to define groups of population.

Simple numerical example illustrates how HOI is calculated (Cuesta and Narayan 2011)

	Number of children of age 6-10 enrolled in school	
	Country A (100 children)	Country B (100 children)
Urban (50 percent of population)	40	30
Rural (50 percent of population)	20	30
Total enrollment	60	60

Average enrollment or coverage rate for both countries is the same – 60 kids or 0.6 (60/100). However, in country A, access in rural areas is lower than equal allocation: 20 versus 30. Ten children need to be reallocated to achieve equality.

$$HOI_A=C(1-D)=0.6*(1-10/60)=0.5$$

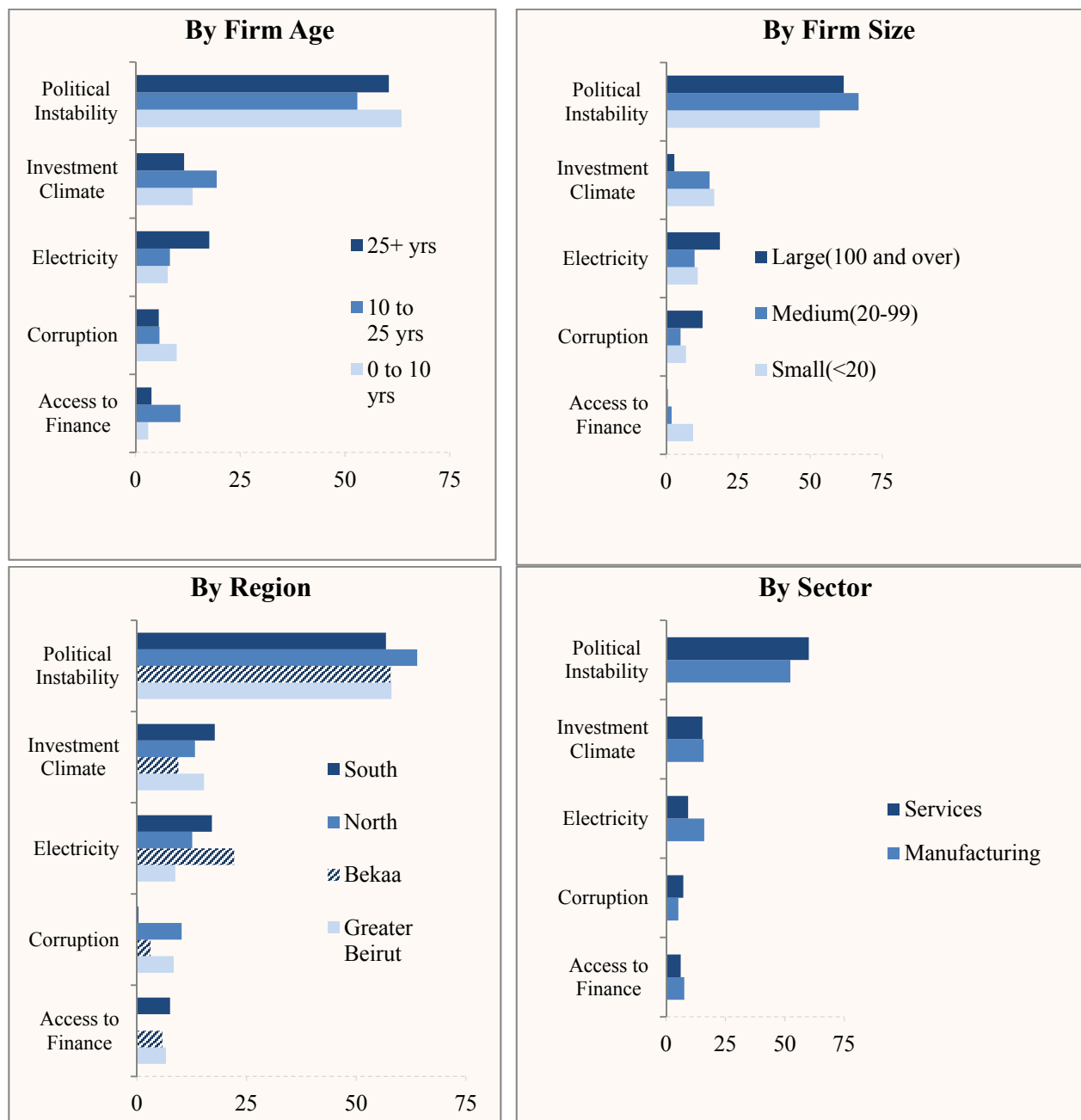
$$HOI_B=C(1-D)=0.6*(1-0/60)=0.6$$

As a result, HOI for A country is 0.5 and lower than the coverage rate of 0.6.

Source: Adopted from Barros et al. (2009), Cuesta and Narayan (2011)

## ANNEX IV: 2013-14 ENTERPRISE SURVEY: ADDITIONAL RESULTS

Figure 96. Largest obstacles to business operations in Lebanon



Source: Enterprise Surveys 2013/14. Figures are survey-weighted. Top five national-level obstacles shown.

Investment climate indicator pools eight relevant indicators (tax rates and administration, customs and trade regulations, licenses and permits, labor regulations, courts, access to land, informal practices)