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Staff Country Reports

**Lebanon: Report on Observance of Standards and Codes—
Fiscal Transparency Module**

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INTERNATIONAL MONETARY FUND

LEBANON

**Report on the Observance of Standards and Codes (ROSC)
Fiscal Transparency Module**

Prepared by the Fiscal Affairs Department

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May 5, 2005

EXECUTIVE SUMMARY

At the request of the authorities, the IMF has conducted an assessment of fiscal transparency practices in Lebanon in relation to the requirements of the IMF *Code of Good Practices on Fiscal Transparency*. The present report provides this assessment, based on discussions with the authorities and other organizations, the authorities' response to the IMF fiscal transparency questionnaire, and other sources of information. The IMF *Manual on Fiscal Transparency* (<http://www.imf.org/external/np/fad/trans/manual/>) should be consulted for further explanation of the terms and concepts discussed in this report.

This assessment comes at a critical juncture in Lebanon. Following the civil war, the economy went through a process of rapid reconstruction, but the fiscal situation has become increasingly fragile, with debt levels reaching around 180 percent of GDP. Implementation of the authorities' program that underlies the Paris II agreement requires substantial reforms, including in the fiscal sector. As the objective of economic and financial policy in Lebanon is to bring the country back to a sustainable fiscal path, the report identifies a number of weaknesses relevant to the area of transparency that constrain the authorities' efforts in achieving that objective, making recommendations to address them.

There appears to be insufficient public understanding of, or interest in, the critical need for sustained fiscal reforms, and the government's program of reform needs to be based on more analysis, including a clearly articulated vision of what the strengths and problems are. The authorities need in particular to support their case for fiscal tightening by including in the budget documents a comprehensive medium-term framework, with clear objectives on debt reduction and an assessment of risks. The assumptions underlying the government's forecasts should be transparent, and scrutinized by all.

The successful implementation of these medium-term objectives requires a revamping of the way the government plans, executes, and assumes responsibility for its actions, hence of all elements of budget preparation and execution. Although this can only be gradual improvements should be sought on:

- the quality and scope of economic analysis available to the Ministry of Finance (MoF), the parliament and the public;
- budget preparation, in particular at the sectoral level, with detailed appropriations and firm limits;
- the efficiency of the expenditure cycle, strengthening controls, and the fight against corruption;
- the responsibility of line agencies in managing their funds and transparency of their operations; and
- the quality of reporting to Parliament, supported by stronger external audit.

The above will require changes to Lebanon's legal framework, bringing it closer to best international practice, including through the much needed introduction of a permanent Budget System Law.

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DOCUMENTS AND INSTITUTIONS: ACRONYMS AND WEBSITES

BdL	Central Bank	Banque du Liban	http://www.bdl.gov.lb
BSL	Budget Systems Law		
CAC	Chart of Accounts		
CC	Commitment Controller		
CdC	Court of Accounts	Cour des comptes	
CDR	Council for Development and Reconstruction		http://www.cdr.gov.lb
CIB	Central Inspection Board		
COD	Chamber of Deputies (Parliament)		
CoM	Council of Ministers		
DD	Disbursement Directorate		
DMFAS	Debt management financial accounting system		
EdL	State electricity company	Electricité du Liban	http://www.hydro-electric.gov.lb
FAD	Fiscal Affairs Department		
GDDS	General data dissemination system		
GFS	Government Finance Statistics		
HCC	High Customs Council		
IDAL	Investment Development Authority of Lebanon		http://www.idal.com.lb
IMunF	Independent municipal fund		
INTRA	INTRA Bank holding company		
IT	Information technology		
LL	Lebanese pounds		
LTU	Large taxpayer unit		
MCL	Money and Credit Law		
MoF	Ministry of Finance		http://www.finance.gov.lb
NSSF	National Social Security Fund	Caisse nationale de sécurité sociale	
PAD	Public Accounting Directorate		
PAL	Public Accounting Law		
ROSC	Reports on Observance of Standards and Codes		
TOFE	State financial operations table	Tableau d'état des opérations financières	
TSA	Treasury single account		
VAT	Value-added tax		

Lebanon: Basic Data

Type of government: Republic

Fiscal year: Calendar

Population: 4 million (estimate)

GDP (2003): US\$18.1 billion (IMF estimate)

Debt/GDP (2003): 184.7 percent of GDP (IMF estimate)

I. INTRODUCTION¹

1. This draft report provides an assessment of fiscal transparency practices in Lebanon against the requirements of the IMF *Code of Good Practices on Fiscal Transparency*. The assessment has two parts. The first part is a description of practice, prepared by the IMF staff on the basis of discussions with the authorities and their responses to the fiscal transparency questionnaire, and drawing on other available information.² The second part is an IMF staff commentary on fiscal transparency in Lebanon.

II. DESCRIPTION OF PRACTICE

A. Clarity of Roles and Responsibilities

2. **Government and public entities are clearly defined in the legislation and their structure broadly follows international statistical principles.** General government comprises the central government, public enterprises, and local governments. The main part of the central government are the central administration agencies (Presidency, Prime Ministry, Council of Ministers (CoM), and 30 line ministries). In addition, there are some 70 national public entities,³ including 24 administrative public entities, the majority of which are under the control of the central government. The most important of these bodies is the Council for Reconstruction and Development (CDR), which manages all significant investment activities (both foreign- and domestic-financed). A small number of administrative bodies operate as extrabudgetary funds, the most prominent being the *caisse nationale de sécurité sociale* (NSSF) responsible for health care, family allowances, and pensions. The government's state-owned enterprises include the state electricity company (EdL) and four water authorities. A number of other state-owned enterprises operate under private law. These include telecommunication, postal services, casino, lottery, and transportation infrastructure (e.g., ports). The local governments comprise 905 municipalities (*communes*), which are run by elected assemblies and have their own autonomous budgets.

3. **Government activities are clearly distinguished from those of public financial institutions and nonfinancial public enterprises.** Public bodies of the central

¹ Discussions on fiscal transparency were held in Beirut during September 5-17, 2004. The Fiscal Affairs Department (FAD) staff team, comprising Messrs. Jesús Seade, Luc Leruth, Stephan Danninger, Jean-Luc Helis (all FAD), and Benoît Chevauchez (member of the FAD panel of experts) met with officials from the MoF, the Banque du Liban (BdL), EdL, the *Cour des comptes* (CdC), the CDR, the NSSF, the Chairman of the Economic and Budget Committees in Parliament, and the ministries of education and public works. The mission worked concurrently with a World Bank Country Financial Accountability Assessment team.

² The report follows a revised outline compared to the sequencing presented in the *IMF Transparency Manual*, seeking to improve the logical sequence in the presentation by switching sections B (Open Budget Preparation, Execution, and Reporting) and C (Access to Public Information).

³ Provisions for administrative and commercial entities are laid out in Decree 4517 of 1972.

administration do not undertake commercial activities. Quasi-budgetary operations undertaken by nonbudgetary entities are limited in nature, although their size can be large. For example, EdL provides electricity below cost-coverage to a number of consumers and imposes a tariff with features reflecting social objectives. The same applies to water supply. In the case of telecommunications, administrative and other expenditures of the Ministry are presented in an annex budget (not binding), and deducted from commercial receipts before the net amount is transferred to the Treasury account. While this situation impairs transparency, it also reflects a confusion between the regulatory and commercial functions of the Ministry. Quasi-fiscal activities undertaken by the Banque du Liban (BdL: the central bank) are discussed below.

4. **Restrictions on management autonomy of public entities, and inadequate enforcement of financial reporting, blur the financial relationship between the central administration and the rest of the public sector.** Law 4517 from 1972 regulates most public bodies outside the central government administration. It regulates their management structure and authority, defines supervisory bodies and control arrangements, and specifies their financial operations. Several agencies, such as the BdL, municipalities, and the NSSF are exempted, and operate on the basis of special legislation. The 1972 law is particularly problematic for public entities with an investment character. EdL, for example, is not in a position to hire employees at competitive wages. Its tariffs are also not regulated in a manner compatible with sound financial principles. The situation is further complicated by the existence of mutual liabilities or financial arrears resulting from disputed claims. While financial controls have been imposed on these bodies to safeguard the government's interest, their level of reporting is insufficient. In other sectors however, regulations are broadly adequate. Management of key entities, such as the state-owned cellular network licenses, operate under commercial principles.

5. **The 2000 Privatization Law (Law No. 393) has established the legal basis for the sale of state assets and provided sound principles for the process itself.** The privatization of two cellular network licenses—the largest government assets under private management—was postponed contrary to commitments under Paris II. Privatization in other sectors is only at initial stages. A law on the regulation of the electric sector was approved in 2002 in preparation for privatization, but no further measures have been taken. Discussions on the nature of the private sector involvement in the water sector are ongoing; a differentiated approach among regions with different needs and potential is being prepared with help from the World Bank. Current financial and accounting conditions in the electricity and water sectors will require considerable restructuring before privatization, and their legal status as public bodies will need to be revised. Other public enterprises (such as Middle East Airlines, LibanPost) are already viable and managed under commercial principles, although regulatory authorities do not yet exist.

6. **Government equity holdings are extensive and not comprehensively reported. However, holdings in the financial sector are limited.** Holdings by the government are either direct or through a holding company, INTRA. The list of equity holdings is not publicly available. INTRA is a holding company held by the government, the BdL, and a

number of foreign investors. Its participations include the Finance Bank, Casino du Liban, and real estates. In addition, BdL holds direct equity in commercial corporations, such as the national carrier Middle East Airlines where it is the sole owner. The BdL also acts as a manager of banks that have been overtaken following financial difficulties. Although the government still holds equity in a number of banks (e.g., the Housing Bank), these are small entities. The state-owned agricultural bank has ceased to operate and is under liquidation.

7. The Law on Money and Credit (MCL) provides the BdL with financial and administrative autonomy, but its independence has been compromised in the past. During the last two years, the central bank provided ample financing to the government.⁴ Fiscal dominance in the wake of the financial crises during 2002 and 2003, and implementation of the Paris II program, created exceptional circumstances that greatly facilitated access to central bank financing.⁵ Nonetheless, given the high debt level, safeguarding BdL independence is crucial to prevent the moral hazard of further fiscal slippages. Central bank independence is also compromised through the BdL's regulatory framework. Candidates for the posts of Governor and the Deputy Governors are proposed by the Minister of Finance and appointed by the CoM. The supervisory board of the bank includes representatives from the MoF and the Ministry of Economy, although the law specifies that they cannot interfere with the management of the bank. The MCL requires the BdL to coordinate with the government to ensure compatibility between the functions of the BdL and the objectives of the government.⁶

8. The regulatory framework governing the banking sector is sound, but legislation for the commercial sector is antiquated and undermines domestic competition. Banking sector regulation is carried out by the banking control commission located at the BdL. It follows international practices. A Financial Intelligence Unit has been recently created. However, regulations for the insurance market are outdated and a new draft law has recently been submitted to Parliament. In the commercial sector, domestic competition is hindered by: (i) limitations to market entry through licensing and other restrictions, as well as cumbersome procedures for the establishment of enterprises; (ii) inefficient and monopolistic practices in the provision of services, including telecommunication; and (iii) inadequate exit procedures, including the lack of a bankruptcy law. Efforts are underway to address some of these gaps through legislation on consumer protection, competition, food safety, and E-commerce.

⁴ Articles 88-91 in the Law for Money and Credit regulate the authorization of government financing.

⁵ In 2003, central bank financing equivalent to 14 percent of GDP was granted through various different financial transactions and is described in detail in the authorities report "One Year Progress after Paris II" available at www.finance.gov.lb. As part of the Paris II agreement, the government wrote off a significant amount of government liabilities against a revaluation of gold reserves.

⁶ Article 75 of the Money and Credit Law stipulates that "the BdL should use means as it may deem capable of ensuring exchange stability, and more specifically operate on the open market, following agreement with the Ministry of Finance."

9. **Weak local government capacities, complex legal regulations, and unclear expenditure assignments have blurred fiscal relations between the central government and local authorities.**⁷ Municipalities enjoy autonomy over their own budget, but are not allowed to borrow. A tax-sharing arrangement is in place and funds are channeled through the independent municipal fund (IMunF), which is required to distribute revenue based on a formula.⁸ Own-revenue sources are clearly defined by law, but not always collected by the smaller municipalities due to weak capacity. These institutional and capacity bottlenecks have led to disputes over service responsibilities and cost-sharing with the central government, such as for funding the management of garbage collection and solid waste treatment. These services are performed by a private company around the Beirut area, and absorb a large share of local revenue from the tax-sharing arrangements. The central government has signed contracts through the CDR and charges the costs to the IMunF prior to redistribution. Due to the uncertainties over the responsibilities for past and future liabilities no agreement is in place on a final settlement for cost-sharing among municipalities, and this ultimately poses a contingent liability for the government.

10. **The constitution clearly defines the roles of the executive, legislative, and judicial branches, with a clear distribution of responsibilities and tasks for fiscal management.** Legislative powers are vested in a single body, the parliament,⁹ whose members are granted immunity from prosecution and are allowed to assume ministerial positions. The establishment of an independent judicial branch is defined in Article 20 of the Constitution. The executive branch comprises the President (elected by Parliament), the Prime Minister, and the CoM.

11. **The parliamentary debate focuses mainly on the composition of expenditure.** It is worth noting that Parliament cannot increase the aggregate level of expenditure proposed in the draft budget. The constitution allows parliamentarians to increase expenditures only if they agree on equivalent expenditure cuts in other areas. Due to the fact that debt service absorbs about 60 percent of public expenditures, room for amendments is narrow. Lack of specialized support and staff resources hampers the quality of parliamentary budget work.

12. **In the fiscal area, the distribution of tasks and responsibilities between the different branches of the government follows traditional constitutional rules.** The *executive* is in charge of preparing and implementing the budget and tax laws. The CoM,

⁷ The main legal basis is Law 118 from 1997 which establishes the autonomy of municipalities, defines the executive structure, supervisory bodies, and gives revenue and expenditure assignments. Other relevant regulations can be found in decrees #1917 (1979), #5595 (1982), and Law 60 (1988).

⁸ A formula has been established by law after negotiations between the MoF and the Ministry of Interior. Funds should be distributed according to the number of registered population and average income in a municipality. However, the formula may be subject to discussions as no data exist on local income levels.

⁹ Although Parliament can delegate this power, as is done in the case of setting customs tariffs.

chaired by the Prime Minister or the President, adopts the annual budget by a majority of two thirds of the cabinet members. Within the executive, the MoF has a very prominent role during both the preparation and implementation phases. The CoM is mandated to resolve the difficulties that may arise between the MoF and the line ministries. The *legislature* (Parliament and its Finance Committee) is responsible for voting and controlling the budget.¹⁰ If the budget is not duly voted on time, the government is authorized, under certain conditions, to enforce it by decree (see Box 2 below). The role of Parliament during implementation is limited to specific circumstances, such as approving requests for reallocations or additional appropriations. As for ex-post controls of the executed budget, Parliament approves the financial statements, which must be submitted before the promulgation of the new budget. A constitutional provision stipulates that the CoM can dissolve Parliament if it returns an annual budget plan with the aim of paralyzing the government. Finally, the CdC is established as an independent body and not attached to Parliament, but linked administratively to the CoM, which also appoints its staff.

13. There is no budget systems law (BSL) in Lebanon to lay out the requirements of the annual budget process and implementation of the annual budget law.¹¹ Fiscal management is governed by the Lebanese Constitution and by the Public Accounting Law (PAL).¹² The PAL includes some elements of a BSL but also contains provisions commonly found in texts of a lower legal status in other countries, such as provisions for procurement. The PAL is not a comprehensive document which impedes the scope for reforms in the area of financial management. It defines all budget preparation and execution procedures, including provisions on timing, and accountability.¹³ However, it does not include provisions on the content and structure of the annual budget law, nor does it specify a resource allocation strategy taking into account macroeconomic and fiscal constraints. The PAL defines administrative accountability, only in terms of financial compliance and not in terms of effectiveness of performance. The roles of various institutions in the fiscal process such as the Budget Directorate, Treasury, and spending ministries are clearly defined, but need refinement, especially with regard to the role of the CdC.

¹⁰ Parliament votes the budget article by article. The legislature discusses and votes the budget during the ordinary Parliament session (between mid-October and the end of the year).

¹¹ In certain countries, such a budget systems law would take the form of an organic budget law.

¹² Constitution of Lebanon May 26, 1926 and amended in 1990 (Article 81-89), Law number 14969 PAL from December 30, 1963. A reform proposal for the PAL was submitted to Parliament in 2000 but not approved. While it contained important reform measures it did not reflect a fundamental overhaul of PAL as suggested in the 2004 FAD TA report on public expenditure management.

¹³ Provisions on accountability are specified in the following articles: Article 110 for the control of the Treasury Director over Treasury advances; Article 112 for the Minister's spending responsibilities; and Articles 194 to 197 for audit and issuance of financial statement by the Public Accounting Directorate.

14. **The relations between the budget and some key autonomous entities are not well defined and are characterized by weak coordination and a lack of transparency that hinders the assessment of underlying fiscal risks.** This applies in particular (but is not limited) to: (i) the unity of the budget (separation of capital and current budget, in particular through CDR); (ii) the public bodies with commercial activities (such as EdL); (iii) extrabudgetary funds (such as the autonomous NSSF or the IMunF, which is discussed later); and (iv) entities covered by an annex budget (also discussed later). The most important cases are as follows:

- **CDR's** operations are partly financed from (i) donors' funds; (ii) regular project subsidies granted by the line ministries; (iii) transfers coming from the budget; and (iv) from municipalities. Thus, only a portion of the public funds (ii and iii) are duly budgeted. The yearly CDR budget and financial settlements are submitted to the CoM and to Parliament. But a coordination with the current budget is then complicated by the fact that CDR can propose projects during the budget year, which separates decisions over the capital component of the project from decisions over the associated recurrent costs say for maintenance. A visa from the MoF is required before the CDR can seek approval for a project.
- **EdL's** financial situation directly affects the budget. However, it is also constrained in its operations: At the current level of tariffs, the breakeven point is around US\$24 per barrel and needs government support.¹⁴ The MoF is not in a position at the beginning of the year to anticipate the level of this subsidy, making the approval of its yearly budget and financial statements a purely formal exercise.¹⁵
- Although **NSSF** cash reserves are high (and partly invested in government bonds), their operation raises several transparency concerns (see Box 1). Parliamentary control is almost inexistent,¹⁶ and social security expenditure is not recognized as a major constraint to the fiscal stance in spite of its size. There is no systematic assessment of future pension liabilities (except for a recent study by the World Bank) and the present accounting system is on a modified cash basis and does not recognize the cost of entitlements. The financial relations with the central government are

¹⁴ Electricity tariffs have a social components with lower rates for small users and specific sectors, and are billed according to time period, amount consumed, and peak time usage. The present tariff structure is not based on economic principles. Changes to tariffs are proposed by the EDL Board and require approval by the Cabinet of Ministers.

¹⁵ There are other factors complicating the assessment of cross liabilities. For example, the transfer to the municipalities of part of the VAT (net) collected by EdL, based on electricity consumption in each municipality.

¹⁶ The NSSF budget is approved by its Board, mainly composed of representatives of unions and employers, and ratified by the CoM.

marked by a dispute: a recent ten-year plan to absorb its arrears to the NSSF has started but the government did not yet fully meet its obligations for 2004.

Box 1. Extrabudgetary Social Security Funds and Future Liabilities

The NSSFs are the largest extrabudgetary funds in Lebanon with annual expenditure of about one-tenth of the central budget. They are divided into three branches:

- Health and maternity, with universal coverage, except for agricultural and foreign employees, reimbursing up to 95 percent of the costs incurred for drugs, medical services, and hospitals;
- family allowances for children and mothers, covering all employees and social insurance beneficiaries, and up to five children; and
- pensions paid as an indemnity upon retirement for private sector employees with some exclusions.

Revenue comprises: social levies collected directly by the Social Security Administration (the contribution rate is 23.5 percent); the government's contribution as an employer; and a direct governmental transfer to cover expenditures of the health branch. The size of the obligations associated with the latter are disputed. At end-2003, the three funds were balanced overall, reflecting a surplus of 1.3 percent of GDP in the retirement fund, offsetting the deficit of 0.4 percent and .7 percent in family allowances and health care respectively.

The medium-term financial situation of the NSSF is affected by structural imbalances, in particular in the health sector. A sharp cut in contribution rates, poor collection, and a significant increase in expenditures since 2001 have pushed two funds (family and health) into deficit. The losses are financed from a drawdown of assets primarily held by the pension fund. Cross-subsidization from the pension fund has delayed the adoption of measures to restore sustainability and has created a financial liability for the government.

Involvement by the legislature is restricted to the ratification of changes in social levies. Through their vote on the central governmental budget however, there is an indirect involvement, for example through appropriations for transfers to the NSSF in some ministries' budgets (e.g., Ministry of Labor).

15. **In light of the government's fiscal position and the BdL's objective to peg the exchange rate, mechanisms for the coordination of the MoF and the central bank are not sufficiently strong or systematic.** Due to the shared policy instrument (interest rate), the need to coordinate debt management between the government and the BdL is high. Exchanges on policy issues take place frequently, albeit on an informal basis with no regular schedules or agenda. In particular, there exists no formal forum for coordination of policies among key decision-makers, nor an agreement on the format of policy coordination despite the legal requirement for the BdL to coordinate with the MoF. In the past, this has led to some tensions in policy choices and weakened central bank independence. The need for more formal policy coordination is also underlined by the level of quasi-fiscal activities that the BdL undertakes on behalf of the government (discussed below).

16. **Significant progress has been made in clarifying tax laws and procedures in key areas.** The new Customs Code (2000) and the Value-Added Tax (VAT) Law (2002) meet international standards, with the exception of sectoral exemptions. They are based on modern tax policy principles, and implemented through streamlined and, for the most part, automated

processes. By law, any tax has to be approved by the legislature.¹⁷ However, Lebanon has no uniform tax code or regulations and there is no unit in charge of tax policy.

17. **The delegation of authority in the formulation of tariff policy has compromised the system of checks and balances that should underlie legislation. Besides, An overly complex tax system, including a schedular income tax with onerous regulations, limits clarity.** In theory, responsibility for tariff changes lies with Parliament. But, in the tariff areas, this has been delegated (for renewable three-year periods) to the CoM, which continues to change tariffs when deemed necessary often upon suggestions by the Ministry of Finance, and in turn mandates the High Customs Council (HCC) to execute them. The HCC comprises three members at the Director General level, who are appointed by the MoF. This situation results in confusion and increases room for arbitrariness and scope for influence on policy or even potentially corruption. The situation also hampers the elaboration of a coherent tariff policy, a problem further exacerbated by the absence of systematic costing of tariff changes. Significant intransparencies still exist in other areas, including in the area of income tax, although preparations for a tax policy and administrative reform are underway, and a number of specific and local nuisance taxes were not repealed when the VAT was introduced. The existing income tax legislation is based on a schedular system with different regulations and procedures for various sources of taxable income. The income tax legislation does not include provisions for taxpayer rights and responsibilities. Regulations are not comprehensive and are dispersed across different CoM decrees and ministerial directives. Administrative procedures are not standardized.

18. **A number of tax administration reforms are underway, including combating corruption, and have started contributing to a strengthening of clarity and accountability of the revenue administration.** The automation of tax deductions on salaries and the creation of a tax roll unit are two initial steps paving the way for a needed overhaul of the tax system. The eventual establishment of a large taxpayer unit (LTU), whose role will initially be limited to the business income tax, will contribute to additional improvements in transparency. The MoF's overriding objective is to adopt a uniform code of tax procedures in parallel to a reorganization of the tax administration from its current tax type organization to an integrated tax department (along functional principles). A detailed implementation plan for administrative reorganization has been completed, while a draft tax procedures code awaits endorsement by the Minister of Finance, before it can be sent for approval by the CoM. Legal uncertainties pose a risk to these developments such as the delay currently experienced in passing a law formally establishing the VAT Directorate. At the level of the customs administration, the implementation of ASYCUDA has served as an instrument of customs modernization, which resulted in the elimination of antiquated practices (such as the use of dual exchange rates) while reducing the number of contacts between customs employees and their clients.

¹⁷ Article 81 of the Constitution specifies that no public tax may be imposed, established, or collected except by a comprehensive law which applies to the entire Lebanese territory.

19. **Civil servants are subject to a code of conduct.** This code, prepared by the Office of the Minister of State and Administrative Reform was published in February 2002. An internal code of conduct for the MoF is in preparation and the citizen's charter for a new public administration, citizen partnership was approved by the CoM on November 15, 2001. The code supplements Law 112 of 1959 establishing the rights and duties of civil servants. The penalties law dates back to 1943 and is no longer in line with international practice. For example, no specific law exists regarding conflicts of interest or insider trading. Other codes and laws are being prepared, for example the law on illicit enrichment, and the code on the use of public money. There is no specific code of conduct for customs or tax employees.

B. Open Budget Preparation, Execution, and Reporting¹⁸

20. **Budget classification and the timeframe for budget preparation are adequate.** But the annual budget preparation process is not sufficiently guided by macroeconomic constraints. The budget classification meets the 1986 GFS standard and comprises economic administrative, and functional classifications. The timetable for budget preparation (see Box 2 below) is in line with international practice, but budget submission deadlines have not always been respected largely due to political difficulties, leading to late approval by Parliament. Budget preparation is characterized by a bottom-up approach: no macro-fiscal constraint is established upfront, neither in terms of an aggregate balance, nor in terms of the overall level of expenditures. The absence of an overall envelope is in turn replicated at the sectoral level, as no CoM orientation is adopted and the budget circular only gives indicative ceilings based on last year's budget appropriations thereby inviting open submission by line ministries. Budget manuals exist, but are often not abided by. As a result, the total of these submissions far exceeds sustainable levels and the ensuing bargaining process with the MoF is cumbersome and time consuming.

¹⁸ The section corresponds to part C in the *IMF Fiscal Transparency Manual*.

Box 2. Budget Cycle and Calendar for Budget Preparation and Approval

Budget preparation is governed by the Constitution and the PAL and consists of two phases:

- Governmental preparation phase
 - By end-April, the budget circular is sent to line ministries.
 - By end-May, line ministries prepare their budget bids.
 - Between early-June and end-September, line ministry bids are discussed, revenue projections are refined, and the budget proposal is finalized.
 - The budget proposal is sent by September 1 to the CoM for approval.
 - The budget proposal is sent by the first Tuesday following October 15 to Parliament for approval, along with a budget statement made by the Minister of Finance.
- Legislative approval phase
 - Between mid-October and end-December the budget proposal is debated in Parliament. The scrutinizing process is mainly the responsibility of the Finance Committee, and includes discussions with ministers and senior MoF officials. Consultation with other committees takes place (mainly focused on expenditure allocations) before the plenary session
 - By end-December, approval (sometimes postponed to end-January).

If the budget is submitted on time, the executive can rely on a constitutional provision that allows the enforcement of the budget bill by decree, if the parliamentary debate has not come to an end within the envisioned timeframe. However, if responsibility for the delay lies with the executive (late budget submission), the budget will be executed through monthly appropriations equal to 1/12 of the previous year's appropriations.

21. **The validity of the main indicator of the fiscal position in the budget—the overall balance of central government—is compromised by its limited scope.** It does not include social security and municipalities, nor foreign-financed investment. Given the potential large contingent liabilities, this omission is of concern. However, the authorities have made a serious effort to monitor all external debt obligations contracted by CDR. The budget document also reports on current public debt levels and the primary balance as indicators of the government fiscal position. The development of these indicators is monitored throughout the year and analyzed in regular reports by the MoF, which are posted on the website and circulated to Parliament (see section C).

22. **Budget forecasts are clearly presented in the budget documents, but only for the year concerned.** The discussion of macroeconomic assumptions is very limited. Given the absence of national accounts, an informal discussion of the assumptions takes place internally. The link between the assumptions in the budget and the estimates for revenue and expenditure is not transparent. In particular, the lack of detailed information on wage and public pensions outlays, hampers the estimation of a major expenditure item. Moreover, political interference seems to influence expenditure projections and composition, partly reflecting the unconstrained budget preparation process.

23. **There is no formal macroeconomic unit within the organizational chart of the MoF. As a result: (i) discussions on medium-term fiscal policy objectives are limited; and (ii) no medium-term economic framework is included in the budget documents.** Currently, macroeconomic and risk analysis are undertaken by a donor financed unit at the MoF, which is responsible for a wide range of advisory functions.. Medium-term forecasts are not regularly produced or published. However, the authorities indicated that a macro model exists, but is restricted for internal use only.¹⁹ Consequently, there is no clear methodology to translate medium-term fiscal objectives and policies into the budget. Similarly, analysis of sensitivity of the estimates to changes in economic variables or policies is not carried out systematically, although some elements have been included in budget documents from time to time.²⁰ Since Paris II, the authorities have enhanced their strategy for public debt management, although an assessment of the risk associated with movements of interest rates should urgently be undertaken and published. A multi-year appropriation law for investment expenditure in key sectors already exists (*loi de programme*).
24. **Objectives of major programs are not announced or costed, and actual progress against these objectives is not reported.** Although some cost evaluations of new policies appear in the budget statement, they remain vague and do not cover all measures. The authorities have received technical assistance from FAD to pave the way for a gradual implementation of program budgeting, which it is their intention to introduce by 2008.
25. **Following the computerization of the accounting system in the MoF, the authorities are now in a position to track the status of expenditure items and assess the level of payment arrears, but the latter are not systematically monitored. The lack of control on carryovers distorts the annuality principle of the budget.** The public expenditure cycle is comprehensive but generates a number of delays and inefficiencies because it is overly complex and involves a multiplication of administrative steps. The implementation of an interface with four key ministries or agencies (education, interior and security services, health, and public works) makes it possible to track an item at each stage of the expenditure management cycle (described below), including “DENOs,”²¹ treasury advances, and various forms of expenditure “delays.” The assessment is also facilitated by the double-entry general accounting procedure, but there is no systematic monitoring. The emergence of arrears in Lebanon can mostly be attributed to the delays caused by duplication in ex-ante controls (discussed below) and cash constraints. However, the existence of important carryovers in the investment budget could also become a source of substantial

¹⁹ The Paris II document contained simulations based on this model.

²⁰ The 2004 budget document included alternatives scenario for privatization proceeds.

²¹ DENOs stands for “*Dépenses exécutées mais non-ordonnancées*,” or expenditure items that have been executed but were not appropriated. This is one of the types of “arrears” that can occur at various stages of expenditure cycles related to the francophone system.

arrears.²² Currently, subject to the MoF's approval, ministries can carry over to the following year committed appropriations of current expenditure as well as uncommitted appropriations of capital expenditure.²³ The accumulation of carryovers results in the simultaneous execution of several budgets during the year. Given that public entities are not required by law to give priority to the clearance of carryovers, the accumulated amounts could relate to budgets approved three or four years before the ongoing budget. This practice complicates budget preparation and execution, weakens budgetary control, and undermines budget transparency.

26. The lack of financial planning, weak cash management, and the use of ad hoc treasury advances, implies that the expenditure management cycle is not well integrated. Cash management by the MoF is constrained by limited information on the cash balance and future flows despite progress in this area. Efforts have been undertaken at the MoF to develop a public debt management strategy using a comprehensive debt data base that complements the financial accounting system (DMFAS) for the external debt. This system allows and has been used to generate alternative scenarios based on interest rate changes. However, the current instruments used for the purpose of cash planning do not meet best practice (e.g. estimates for cash outflows are not based on regularly submitted expenditure plans by line ministries).

27. Treasury advances to public entities, beyond the issue of proper scrutiny of the appropriation process, also complicate cash management and thus, indirectly contribute to the buildup of arrears. Although the PAL requires repayment of these loans within the year, there are cases of default. The law then mandates an ex-post appropriation as part of the budget of the subsequent year and the loan is regularized as a transfer. The mission also noted that the practice of paying salaries and pensions in advance, at the beginning of the month, limits liquidity management.

28. A comprehensive internal control system is in place, but there are duplications, implementation is weak, and not all public entities are covered (see Box 3). Moreover, internal controls are generally restricted to compliance with respect to legal procedures and there is little follow-up of the findings and recommendations, which hampers effectiveness.

²² Carryovers are regulated by Article 114 of the PAL.

²³ Carryovers have only recently been taken into account in negotiations during budget preparation, but they are not treated uniformly.

Box 3. Public Expenditure Cycle

1. The accounting unit at the ministry prepares a commitment request based on supporting documents. The request is signed by the accountant;
2. the authorizing officer (minister, general director, head of department or head of unit, according to the amount of the commitment request) signs the request;
3. the accounting unit directly records the commitment request in the information technology (IT) system of the MoF if it is connected, and sends it to the commitment controller (CC);
4. the CC from the MoF reviews and approves the request (deadline: five days, renewable one time for complementary information). The CC may control the availability of allocations, proper classification, and compliance with all applicable rules and laws including nonfinancial;
5. the commitment request, with the supporting document and a report of the CC, is sent to the CdC, if the transaction is subject to CdC's ex-ante control. The CdC has ten days, renewable one time, for performing this control;
6. the commitment request, with the CdC's approval, is returned to the CC, who signs and stamps the request. One copy is sent to the head of the central commitment control department within the MoF. The approved commitment is entered in the IT system of the MoF, and the allocation is reserved;
7. the accounting unit at the spending ministry receives the original copy of the approved commitment request with the supporting documents;
8. expenditure is implemented, and certification that goods or services have been received is done by an "acceptance committee," including technical and financial experts of the spending ministry;
9. commercial invoice or the liquidation and payment authorization form is signed by the "acceptance committee," and sent to the accounting unit at the spending ministry;
10. the accounting unit prepares and sends the payment authorization request to the Disbursement Directorate (DD) within the MoF;
11. the DD checks and signs the payment authorization request and prints out the payment order;
12. payment orders are grouped in batches (bound files) with supporting documents and sent to the payment orders department at the Treasury;
13. the payment orders department at the Treasury checks and signs the payment order;
14. payment is made at the cashier's office or through the BdL—commercial bank route.

29. **The system of internal controls is characterized by duplications in ex-ante controls and a weakness of internal audit capacity.** Duplications in ex-ante controls occur at two levels: (i) commitments: there is a duplication between the commitment controller of the MoF located in line ministries and those of the CdC; and (ii) within the MoF: there is a duplication between the DD, which controls payment orders, and the Treasury which performs the same operation before payment. The involvement of the CdCs at the ex-ante control also causes additional delays and compromises its capacity to ensure an efficient external audit of government activities as discussed later.²⁴

30. **Central government organizations do not have a generalized internal audit system, and internal audits are mostly undertaken by the Central Inspection Board (CIB),** an entity administratively linked to the CoM and created by Law 2460 of November 1959. The CIB undertakes financial inspection in order to ensure the proper use of public funds, mostly limited to legal compliance.²⁵ However, the scope of its responsibilities is limited. In particular, the CIB is not authorized to inspect the CDR, the *Université du Liban*, or the BdL, and only inspects the judiciary, the army and security forces with respect to legal compliance. If the report deals with financial issues, a copy must be submitted to the public prosecutor of the CdC for review. The annual report is submitted to the Prime Minister with copies to Parliament, the Civil Service Council, and the CdC. It may impose penalties such as salary cuts or promotion delays, and refers the serious cases to the court. A recent program of cooperation (institutional performance assessment), supported by a task force under the supervision of the CIB and the Ministry of State Reforms, has started to audit 15 ministries using performance audit procedures.

31. **The quality of in-house internal control and audit, as well as accounting and reporting procedures in public commercial and noncommercial bodies, is poor and uneven.** In order to start addressing these weaknesses, the MoF has created within the Public Accounting Directorate (PAD) a unit in charge of auditing on a regular basis the legality of their operations. This unit, established by Ministerial decree, has started operating and efforts are being made to meet international standards.

32. **Public procurement rules are detailed in the PAL and recruitment in the civil service is by open competitive examination, but there have been issues of transparency.** They apply to most public procurement of goods and services, and to all institutions, except for the army and the domestic security services. If the cost exceeds LL 0.8 million, a public tender is required. Externally financed procurement operations are undertaken in conformity with the rules of the institution concerned. Domestically financed procurements are generally announced in the Official Gazette and the national press. Other things equal, preference is given to a Lebanese enterprise if its bid is less than 10 percent higher than the best bid made

²⁴ Certain classes of commitment requests must be approved by the CdC (for example if worth more than LL 75 million for public procurement and more than LL 25 million for services).

²⁵ It is also responsible for administrative, engineering, education, health, social, and agriculture inspection.

by a foreign enterprise. For the domestic counterpart funds of foreign-financed investment projects, there is a proposal to subject them to the procurement rules applied by the donor. Since 1959, a Public Procurement Directorate under the supervision of the CoM, must organize the procurement process and approve all contracts exceeding LL 75 million, except for those undertaken by the CDR (and the army and security forces). Responsibility for smaller contracts falls under the ministry or public entity concerned. Resources available for enforcing fair and transparent procurement processes are very limited and there have been abuses (e.g., by “slicing” contracts or abusing exceptional provisions). The authorities have recently started the preparation of a procurement code to remedy the situation. Entry into the civil service is by open competitive examination, but the announcement often fails to adequately define the necessary skills or to provide precision on key aspects of the exam. For example, the same examination is used by the MoF for recruiting managers in tax administration, treasury, or control activities even though these would require different skills and basic training. Promotion is determined mainly by seniority, and individual managers in ministries are not allowed to hire, fire, or introduce merit-based promotion schemes. The situation is different in some public entities, where more flexibility is provided. Basic wages in the civil service are regulated. However, it is in practice difficult to assess the overall monetary value of the compensation package, due to various supplementary forms of payment.

33. **The accounting system of the central government has progressed toward international standards and in principle allows for an adequate recording of budget operations**, including for the preparation of reports on the fiscal and financial execution of central government operations, based on current budget and accounting classifications. However, the restricted coverage of the budget limits the overall validity of these statements and there is little demand by government agencies for the information that the system could produce.²⁶

34. **The accounting system comprises the *budget accounting*, which describes outturns in terms of use made of the appropriations voted by Parliament, and the government’s *general accounting system*, which is based on the cash principle.** The accounting system is based on the principles outlined in the PAL from 1963.²⁷ The budget accounting system is a single entry system, which tracks the status of budget execution (acceptance for revenue, and notification, commitment, validation, and payment orders, for expenditure), including the amount of appropriated funds available, for each appropriation. Identification is based on a new budget classification, developed in 1997 and in conformity with the GFS 1986. Under the general accounting system, revenue is recorded when

²⁶ The central government’s accounting system is not applied to other public entities (local governments, EBFs and public entities).

²⁷ The PAL is based on the French legislation, and is extremely detailed. It adheres to the principle of separating payment authorization officers from accounting officers.

collected, and expenditure is recorded when authorized by the public accountant and paid. It is a modified cash-basis system due to the presence of a complementary period. The system is based on an adapted public chart of accounts (CAC), in conformity with the national CAC and follows international standards (GFS 1986). Preparations for the introduction of GFS 2001 have begun.

35. **The CAC reflects the economic classification of the budget, but not the administrative or functional classification.** It records opening balances, stocks of debt and financial assets, and payables on a payment order basis. By nature, its use is confined to the tracking of transactions processed by the Treasury. It is capable of generating a statement of financial position, although the scope is limited as indicated earlier.

36. **The budget nomenclature and the accounting classification are broadly harmonized (see Table 1).** However, in classes 6 and 7, there appear to be differences vis-à-vis the economic classification of current revenue and expenditure, but limited to the subparagraph level. Although the differences appear to be minor, the correspondence between other accounts of the CAC and GFS 1986 categories, such as capital revenue, capital expenditure, net lending, and financing, is not easy to establish. Class 8 is not used.

Table 1. The Government Accounting Framework

Contents	
Class 1	Financing and results
Class 2	Fixed assets
Class 3	Liaison accounts
Class 4	Liabilities (transactions with creditors and debtors)
Class 5	Financial accounts
Class 6	Expenditure accounts
Class 7	Revenue accounts
Class 8	Stocks

37. **The accounting system for the central governmental is broadly adequate.** The Treasury produces a monthly trial balance, and the accounting department has started to generate a number of reports for internal purposes, which include a monthly budget execution statement, a monthly accounts statement, and a monthly revenue report. However, financial accounts have not been audited for several years (partly due to the fact that the entry-balance issue has not been resolved) so that it is not possible to determine the quality of the data used as input. Lack of information on the NSSF, municipalities and other government bodies, and the fact that they have weak and incompatible accounting systems, do not allow the generation of financial accounts for the general government.

38. **Neither the national tax administration nor the customs administration officials are given specific legal protection from political interference. The operations of these administrations are audited by the CIB, but the scope and frequency of these audits is limited.** Political interference exists. The rules governing the interactions of agents of the tax administration with their clients lack transparency. However, those at the (not yet existing)

LTU or in charge of the VAT are subject to stricter rules that are published on the web. At the level of customs, the adoption of international standards has led to a shift in the burden of proof to favor taxpayers, in case of disputes on valuation or other. Fees that are collected by customs on smuggling activities are all transferred to the budget, but a portion (6 percent) is returned to the customs department for incentive purposes.

39. **The legislature does not undertake a mid-year review.** However, the legislative authorities receive systematic information midway through the fiscal year from the MoF. The MoF may also be called by members of Parliament to answer specific requests. Parliamentary commissions do not have the capacity to review and exploit available information. This generates a difficulty because the formal involvement of Parliament in the budget process tends to be higher than in most countries. For example, pursuant to the Constitution (Article 88), no operation financed by a loan can be undertaken except by virtue of a law presented to Parliament. The high level of Parliament involvement in budget execution is attuned to the political context prevailing in Lebanon..

40. **The closure of accounts at the end of the fiscal year poses a major problem.** The core financial accounts, or “*comptes de gestion*” (with the limitation of scope that has already been discussed), are available from the new system, but the Treasury has only produced those of 1997.²⁸ The authorities have indicated that the financial accounts from 1998 to 2000 should be ready by the end of 2004 (no financial accounts were produced before 1997). Although they are not supposed to be submitted to Parliament, the “*comptes de gestion*” must be judged by the CdC on the one hand, and are a critical input into the certification of the “*Loi des Règlements*” on the other hand. As indicated below, the delays in the production of the “*comptes de gestion*” have prevented the CdC from presenting its report to the CoM. As the Constitution requires that the “*Loi des Règlements*” of year t-1 be approved by Parliament before approval of the budget for year t+1, the “*Loi des Règlements*” has been submitted by the CdC under a “temporary visa” and therefore subject to the possible revision of the CdC later. The problem is exacerbated by the length of the complementary period. In order to address the problem of arrears and allow more time to regularize some accounting operations, the authorities have increased the length of the “*journée complémentaire*” to three or four months, although it should be limited to one month according to the PAL. This practice is in conflict with the annuity principle, and also complicates the preparation of final financial accounts and blurs the transparency of operations.

²⁸ However, customs maintains its own accounts. When the financial accounts are prepared, the public accounting department in the MoF consolidates the Treasury and customs accounts after having checked them both.

C. Public Availability of Information²⁹

41. **The budget documents cover the central government and do not include any information on foreign-financed investment, extrabudgetary funds (notably social security), or local governments.** The budget bill is the main budgetary document comprising articles of the annual budget law, tables on the appropriation of line agencies, and three annex budgets: the national lottery, the general directorate of grains and beetroot, and the Ministry of Telecommunications.³⁰ The budget bill is accompanied by a “budget statement” which is the base of the budget speech made by the Minister. The statistical presentation of the data in the budget does not meet international standards and omits the balance sheet or information on the financing component of central government operations (e.g., Treasury advances and other lending operations). The budget does not include foreign-financed component of investment activities, which are undertaken by the CDR (as mentioned in the previous section). Neither these activities, nor the operations of the main extrabudgetary funds or municipalities are in any way covered or consolidated with the central government.

42. **Defense expenditures are reported in the budget in the same manner as other line ministries’, but have a privileged status at the time of execution.** The breakdown of defense expenditure follows the budget classification at the same level of detail as other ministries and the investment budget component follows a specific multi-year law covering a three-year period. Pursuant to the 1963 Accounting Law, the military, as well as the security forces and customs, enjoy a more flexible expenditure process and specific procurement rules.

43. **The budget document focuses primarily on the current and budget year, it discloses limited information on past fiscal outturns and provides no forward projections.** The only exception is for investment expenditures in key sectors of the economy (roads, defense, health, education, and others) for which multi-year appropriations exist. Data on past and current year revenue and expenditure outcomes (first six to eight months of the preceding year) are reported in the budget statement. No information on annual outcomes for the two preceding years, or projections for the whole current year are available. Information on the budget for individual spending ministries is listed in supplementary tables, and only contains the voted appropriations in the last two budgets. In recent years, efforts have been undertaken to improve the information content of the budget statement. However, despite the fiscal sustainability concerns and the availability of a multi-

²⁹ The section corresponds to part B in the *IMF Fiscal Transparency Manual*.

³⁰ Their budgets are not approved by a specific vote and reflect nonbinding estimates of expenditure and receipts (from commercial activities and transfers from the central budget). Each is subject to its own accounting and cash management rules. While the lottery and the Ministry of Telecommunications undertake profitable commercial activities, the general directorate of grains and beetroots runs a deficit and is used to channel budgetary transfers to farmers.

year fiscal reform program (Paris II reform strategy), medium-term estimates have not been provided in the budget document. Those that exist, on major investment items as noted above, are not estimates or statements of intentions, but binding appropriations, thus creating a rigidity that can turn out to be undesirable under certain conditions. There are no plans to expand the information in the budget document by covering a longer time-horizon (backwards and forward), or by providing data on a broader government concept, such as the general government.

44. Contingent liabilities and other budgetary risks are only partially assessed.

Contingent liabilities associated to guarantees contracted by public entities are systematically recorded and regularly monitored. However, the level of future liabilities arising from unfunded entitlement programs (namely pensions) are not indicated in the budget. Similarly, risks arising from restructuring or privatization of public entities, or from legal action against the government, are not systematically monitored or assessed. In particular, nonbudgetary legislation is not reviewed for its implied fiscal cost (e.g., government contributes to health care costs for certain groups). Nonetheless, the government has undertaken a limited number of assessments of future financing implications in specific sectors such as pension obligations (end-of-service indemnities). The assessment of fiscal liabilities arising from an interest subsidy program, which is executed by the BdL on behalf of the government, is hampered by lack of feedback from the BdL on the terms of the underlying loans.

45. Tax expenditures are not systematically assessed, and estimates of the impact of new measures do not appear in the budget. Most tax laws have provisions for statutory exemptions which can only be granted through law. For the income tax, the scheme of exemptions is particularly complex. Due to the schedular income tax system, the granting of basic allowance for each income source means a cascading of revenue losses. No estimates are available as to their aggregate cost. Some sectoral exemptions are granted in the VAT.³¹ A significant tax concession was recently granted through the administrative capping of retail gasoline prices by adjusting excise rates; given the social objective of this measure, it should be regarded as a tax expenditure, and one whose cost is hard to discern. The estimate for its full-year revenue impact is close to 1 percent of GDP for 2004, but varies with the oil price. Except for specific purposes, such as the discussion of the new VAT legislation and the capping of gasoline prices, few estimates have been prepared or disclosed to the public. The absence of a tax policy department and the intransparencies in the income tax code have hampered any effort in this respect.

46. Quasi-fiscal activities are extensive and are not costed. In 2003 the BdL provided loan facilities in the amount of US\$200 million to EdL to cover operating losses.³² Part of these losses were due to inefficiencies, but a main reason was that EdL and other public

³¹ Article 56 of the VAT Law.

³² Article 92, the Law on Money and Credit Law authorizes the central bank to grant financing to public bodies under exceptional circumstances.

enterprises (e.g., water distribution) are required to provide their services below cost coverage. The BdL also encourages lending in the housing market and in microfinance, by lowering reserve requirements for banks that provide such loans. The costs of these various quasi-fiscal activities are not estimated, and therefore not included in the budget documents or presented to Parliament. In 2003, public outlays to EdL to cover operational losses and debt repayment obligations amounted to 2½ percent of GDP. But direct transfers represent only part of the picture, as to the full cost of such activities also includes any accumulation of arrears at the level of each public entity and forgone profit for investment or transfer to the government.

47. **Information is published on gross public debt, but not on financial assets.** The public debt department at the MoF produces comprehensive information on gross public debt. However, the maintenance of debt records is carried out using different systems and by different agents.³³ While public debt coverage is comprehensive, debt data have not been audited by the CdC or other bodies. In a break with past practice, the budget document for 2004 included a short section providing information on the level of debt in the wake of the Paris II agreement. Since 2001, the MoF publishes quarterly debt tables, but does not include information by holder and by currency. It also publishes information on debt developments in its quarterly and annual report which is available on its website. These include information on euro bonds liabilities. The terms and outcome of a recent debt exchange on euro bonds conducted by the MoF were fully disclosed. Data on public financial assets of the NSSF and the national deposit insurance funds are reported in the annual statement of the two bodies. However no systematic monitoring of financial assets or their disclosure is undertaken or planned.

48. **Public access to fiscal data is good in practice, but legal requirements for their regular publication are limited.** There are no specific provisions in the PAL for reporting fiscal data. However, the MoF has taken the initiative of publishing a number of documents that include: the quarterly financial statement; a monthly statistical table; and an annual economic and fiscal report. These documents are complemented by a number of special reports.³⁴ The reports are freely available on the Ministry's website. Lebanon subscribes to the GDDS and has posted its metadata on the electronic bulletin board since January 2003. Public access by taxpayers to relevant information in the tax and customs areas is good for the VAT and for customs. For instance, VAT administration communicates policies and regulations through various sources (e.g., newsletter, email, hotline, seminars, and

³³ All foreign-financed debt are maintained through the DMFAS, which is managed jointly by the BdL and the MoF. Domestic debt, mainly through T-Bills, is recorded separately by the BdL. Data entry into DMFAS is done by the BdL. CDR as the government's agent for contracting foreign-financed project financing supplies records provided. Consolidation of projects domestic and foreign debt is carried out by the MoF using Excel software.

³⁴ The Paris II progress report (2002, 2003), Reform Program at the MoF (2003), Investment Climate in Lebanon (2003).

conferences). Similarly, the customs administration provides access to taxpayer information (regulations, forms, and statistics) upon request at its office and through its website.

D. Assurances of Integrity

49. **Reliability of budget estimates is compromised by significant spending from carryovers and through extrabudgetary treasury advances.** Large discrepancies exist between budgeted amounts for investment expenditure and actual spending (see Table 2). Estimates for interest expenditure—the largest single item—were largely in line with outturns in 2002, but were significantly underestimated in 2003. Outlays for public wages and pensions have been regularly over budgeted in recent years. Discrepancies for non-interest current expenditures differ primarily due to treasury advances given to EdL, which are not consolidated in the reports to Parliament. On the up-side, budget estimates for revenue have become increasingly reliable. Budget forecasts for tax revenue have been broadly in line with budget estimates during 2002 and 2003 at an aggregate level.³⁵ This masks offsetting forecast errors for individual items. In 2002 and 2003, VAT receipts were underestimated while revenue from taxes on international trade were overestimated. Publications by the MoF include explanations for some of these discrepancies, but they are not systematically analyzed.

Table 2. Budget Estimates and Actuals

	2002			2003		
	Budget	Actual 1/	Percentage Difference	Budget	Actual 1/	Percentage Difference
	(In billion LL)					
Selected items						
Wages, salaries, and pensions	3,155	3,008	-4.8	3,353	3,078	-8.2
Other primary current expenditure 2/	896	922	2.9	850	1,086	27.7
Domestically financed investment expenditure	824	392 3/	-47.5	397	713	79.5

Sources: Ministry of Finance; and IMF staff estimates.

1/ Other primary current expenditure includes extrabudgetary advances to EdL from the Treasury. Actual investment expenditure investment includes spending from carryovers and the accumulation of arrears (only in 2002).

2/ Does not include Treasury outflows for shared tax revenue to the IMunF.

3/ In 2002 the level of investment expenditure was constrained by liquidity problems.

³⁵ In 2002 the percentage deviation of collected tax revenue from budgeted revenue amounted to 1.0 percent and 4.4 percent respectively, which is within a reasonable margin of error.

50. **The annual budget law does not include regular statements on accounting policy.** Accounting policies are approved by the Minister of Finance. However, as basic changes in regulation require a change in law, Parliament is informed about changing accounting standards.

51. **The processes of account reconciliation and fiscal reporting allow for the reconciliation of budget, accounting, and financial data.** But as the methodology is not published and the data not reported, their reliability cannot be assessed. The data centralization system ensures ongoing reconciliation of fiscal and accounting data at the accounting department of the MoF, in respect to the amounts payable by the Treasury. This accounting unit is responsible for supplying all the consolidated and centralized data on the government's financial transactions to the other directorates in the MoF and the Treasury. The centralized monthly statements are prepared at the end of the month. Moreover, reconciliation of the Treasury's financial data with the accounts of the financial institutions is made on a daily basis. The master Lebanese pounds (LL) account is #36, which is used for most receipts and payments, but no comprehensive and systematic reconciliation reports are produced.

52. **Lebanon in principle has a treasury single account (TSA), but this is fragmented (i.e., there is no “*unité de caisse*”), which further hampers consolidation and prevents efficient cash management.** Public sector entities holding accounts in the BdL do not operate these on a zero-balance basis with the TSA and these accounts are not reconciled frequently. There are also four LL accounts for treasury bills, an account for the proceeds of a recent large debt swap operation with domestic commercial banks, and separate accounts for VAT refunds, interest withholding tax, and grants. The CDR has a separate LL account at the BdL, as do most public institutions. There are also nearly 40 transit accounts operated by line ministries for various purposes, although these are mainly foreign currency accounts. In principle, neither the MoF nor any other public body has LL accounts at commercial banks. However, there are a few exceptions. For example, the EdL has an account in a commercial bank that was used to settle foreign currency transactions with a neighboring country, and the NSSF was allowed to hold assets in commercial banks. There are also donor accounts for funding government expenditure, which are located with commercial banks.

53. **The external auditors of the CdCs are guaranteed independence but their relationship with the executive is not in accordance with international standards.** Article 87 of the Constitution plans the creation of the CdC by a special law (but does not create it). The missions, organization, and operational procedures of the CdC were established by the decree-law of September 16, 1983 on the CdC, to oversee the finances of the central government, main local governments, and public entities. CdC's highest members (including the President, six Presidents of the Chambers, and 36 judges) have the status of magistrates and may not be removed. The President is appointed by decree of the CoM. However, the CdC's ability to operate independently could be hampered by a lack of control over the use of its own resources (which are allocated by the executive). Some external

auditors are hired to perform audits in public entities, and municipalities. These activities are not yet fully developed and the independence of the auditors is not clearly established.

54. **Very unusually, the activities of the CdC are more focused on ex-ante controls than external audits.**³⁶ Conflicting opinions exist about whether the ex-ante control function of the CdC is a cause of significant inefficiency in processing transactions. It clearly duplicates other controls, however, and also places the CdC in a situation where it compromises its position ex-post. These ex-ante controls are maintained on the grounds that other mechanisms are weak, but the CdC in Lebanon appears to be an exception to international practice. Only in a few other countries, such as Belgium, the “*cour des comptes*” still undertakes ex-ante audits – also called “visas”.

55. **The CdC’s role in external audit is weak.** Its external audit covers the quality of management of finances of the central government, the local governments, and public entities,³⁷ the financial accounts of the government accounting officers, and the final budget execution reports. The CdC faces great resource constraints because of its focus on ex-ante control; the absence of financial accounts; and an inadequate framework (no work schedule, no adapted methodologies, guidelines, training and evaluation of work). The situation should improve as the CdC is being connected to the IT system of the MoF, but utilization of that link has been minimal.

56. **The legislature does not follow up on external audit reports.**³⁸ The CdC must elaborate its annual report, and occasionally produce reports on specific items. The annual report is addressed to the President of the Republic, with a copy to the President of the Parliament, and is published in the Official Gazette. Nevertheless, as its external audit activities are limited (no external audit of financial accounts are performed and final budget execution reports are not audited), the annual report does not include substantial conclusions and temporary visas are issued on the “*Loi des Règlements*” (as discussed earlier). The annual report is obviously not produced according to international standards and is not published.

57. **Coverage of government statistical systems is limited and upgrades are impeded by coordination and institutional issues.** Significant statistical gaps exist in the areas of national accounts, prices, nonbudgetary fiscal accounts, public enterprises, balance of

³⁶ This applies to transactions worth more than LL 75 million for public procurement, LL 50 million for direct contracts, LL 25 million for services, LL 15 million for grants, and LL 5 million for revenues. These thresholds are relatively low, generating important work. Three of the seven chambers are solely involved in this ex-ante control.

³⁷ At the moment, only 52 municipalities are audited by the CdC, including Beirut and Tripoli, following a decree of the CoM. Some of the public entities are not audited by the CdC, as is the case for CDR and BdL.

³⁸ The last of the four roles of the CdC is to give opinions (“*avis consultatifs*”) regarding financial issues, in general linked to a draft legislation.

payments, labor markets, and social indicators. These deficiencies compare to a largely adequate coverage on monetary accounts, financial markets data, public debt statistics, and central government budgetary accounts. The government widely recognizes the main shortfalls and has initiated various projects to improve data through a new household survey and ongoing efforts to establish a set of national accounts. These initiatives are however undertaken by different agencies, weakening the integrity of the production of statistical data. Formally, the Central Administration of Statistics has the legal mandate as the main statistical agency, but the Prime Minister has also named a statistical coordinator, which has blurred the assignment of responsibilities.

III. IMF STAFF COMMENTARY

58. **Lebanon has made progress toward meeting the requirements of the fiscal transparency code in a few areas, including:** the introduction in 1997 of a new budget classification based on the 1986 GFS methodology; the computerization and automation of a wide range of budget and treasury processes; the near completion of a TSA, and regular and timely publications on fiscal performance.

59. **In many other areas however, Lebanon falls short of the requirements of the code.** For example: (i) there is no multi-year budget framework, which for a country with Lebanon's level of debt must be most important to investors and observers, nor is the budget accompanied by an audited report on execution for the previous year or two; (ii) the budget coverage does not include all government activities (in particular part of those undertaken by the CDR); (iii) significant extrabudgetary and quasi-fiscal activities remain; (iv) expenditure control is based on cash rationing and overly complex; (v) there is no external audit; (vi) comprehensive economic and financial information about the general government and state enterprises is not available; and (vii) some of the recent tax administration reforms, such as the introduction of the VAT which has taken place without providing a proper legal underpinning for its new administration.

60. **The program initiated in the last few years and endorsed by the international community in the context of the Paris II agreement encompasses a wide range of reforms, including in the fiscal area.** The overriding objective of the government is to restore fiscal sustainability while maintaining broad-based growth. The following recommendations aim at supporting the efforts of the government by building on the progress already achieved. The guiding principle of the strategy proposed by the mission is to give the MoF the means to carry out its core functions more effectively. This requires:

- reinforcing certain key functions and generally strengthening operations at the MoF;
- strengthening its relations with line ministries and other public bodies, in particular through increased accountability for all concerned;

- ensuring Parliament receives the requisite flow of information and has the necessary resources to effectively perform its role and develop a productive dialogue with the MoF; and
- improving relations with think-tanks and the general public, to reinforce confidence and win support for government policies through better information and services.

Most of the recommendations that are listed below do not require a change in the law. That applies in particular to the critical and urgently needed integration of a modern MTEF. Other recommendations, on the other hand, would require a change in the law or the introduction of a new one, such as the Budget System Law. The BSL would be essential to streamline and broaden the coverage of the budget process and, most importantly, to introduce a top-down approach with line ministries. A sound and practical new budget system, would enable the government to translate its vision into a strong reform agenda in pursuit of a sustainable fiscal stance.

A. Strengthening the MoF and Key Central Agencies

61. **Improving MoF operations requires reforms along a variety of dimensions.**

These include: a top-down approach to budgeting, a stronger legal basis by giving the MoF a pivotal role in the budget process; streamlining internal operations and functions; and better access to information. Recommendations are discussed below:

Four key recommendations on role, framework, and procedures

R1 The MoF should develop the capacity to effectively implement a top-down budget approach. This requires two measures. First, a formal statement endorsed by the CoM (including a functional breakdown of expenditures, establishing priorities) for the next budget year should be made at an early stage of budget preparation. It would collectively bind the cabinet and should be made public and/or presented to Parliament. Second, within the MoF, a medium-term macroeconomic framework needs to be developed and integrated in the budget process. The MoF already has a group of skilled advisors at the Minister's office which could constitute the core of a macro-fiscal unit within the MoF.³⁹ This unit would also be in charge of costing new measures and, more generally, of providing the MoF with the information required to develop its policies. This also includes the assessment of tax expenditure and fiscal risks, and the quantification of all critical measures with an impact on the budget.

R2 Adoption of a permanent BSL. The legal framework for the preparation and execution of budget laws should be condensed into a dedicated BSL to improve the transparency of rules for fiscal management rather than by marginally revising the

³⁹ UNDP project "Capacity Development for Fiscal Reform and Management" (Leb 03/003).

current PAL.. The preparation of a BSL would constitute the opportunity to integrate all the elements necessary to broaden the scope of the budget process. Many of the recommendations that are found in this report also would need to be included in the BSL, in particular:

- the pre-requisites for implementation of a top-down approach to budgetary allocations to line ministries and the conditions for the development and use of a MTEF;
- a redefinition of appropriations as the maximum amount of cash expenditure during one year with a predetermined commitment profile. This would help reduce the stock of carryovers accumulated over time. It would also ensure that public entities broadly execute their budget appropriations during the year for which funding was approved, and that the sequencing of commitments is in line with the macroeconomic framework.;
- the definitions of budgetary and extra-budgetary operations, in particular leading to a full integration of CDR in the budget; the content of the budget document; and the nature and frequency of budget reporting;
- the provisions for a new control and audit system.

R3 Full access to relevant fiscal information: The MoF, being ultimately responsible for the financial situation of the general government, should have effective access to all relevant information of government and public bodies, including social security, EdL, the IMunF, and all others. Information on their financial situation should be transmitted according to rules and standards defined by the MoF, and its should be vested with the power to approve their main financial transactions. The authorities should also develop a framework for transparent management of government equity holdings; the improvement of regulations for the management of public employment; and the introduction of legal requirements for the disclosure of fiscal information on public enterprises and municipalities. The NSSF should be subject to these recommendations with immediate effect.

R4 Improve the current accounting system. This is essential to accurately and truthfully record consolidated accounting information and to produce summary statements of general government financial operations. The implementation of an efficient accounting system should be facilitated as more ministries get linked to the MoF's IT system. Cash accounting standards should be clarified, and a move toward an accrual accounting system is highly desirable for the eventual implementation of performance budgeting.

R5 Strengthen the independence of the BdL. In particular, the BdL should stop making loans, especially to EdL, and make publicly available information on its equity holdings..

Improving capacities and processes of the MoF

- **Develop a tax policy unit.** At this stage, there is no such body in the tax area that can assess and advise on tax policy considerations.
- **Treasury advances should only be made according to their definition** (i.e., as a mechanism restricted to exceptional circumstances). The practice of using them as cash injections and later regularizing them as transfers should be stopped.
- **Sound methodologies should be used for reconciling accounting and bank data.** Each reconciliation statement should include revenue and expenditure accounts and explain any discrepancy with bank accounts maintained with the central bank and commercial banks.
- **Improve cash and debt management, which would help develop a strategy to gradually reduce the stock of arrears. This should be done by:**
 - obtaining from line ministries short- and medium-term cash flow forecasts in order to develop and update a rolling annual financial plan;
 - establishing a specific cash management unit within the MoF;
 - breaking down annual appropriations by months or quarters;
 - completing the coverage of the TSA, by imposing that all public sector agencies hold their accounts in the BdL on a zero-balance basis with the TSA; and
 - developing a longer-term strategy for debt management in close coordination with the BdL and placed within a medium-term macro-fiscal framework.
- **Adhere strictly to the legal limit for the complementary period.** Implementation of an integrated fiscal reporting system can be expected to facilitate compliance with the complementary fiscal period by accelerating data recording and centralization.
- **Enhance policy coordination with the BdL.** Coordination between the MoF and the BdL should be clarified and made more systematic. Regular coordination meetings (“forum”) at policy and technical levels should be established—based on an inter-agency agreement—, where the exchange of information and the decisions and assessments of each institutions is recorded.

Other measures

- **The law to establish a VAT administration should be adopted.**
- **The LTU should be fully implemented and serve as a model for disseminating tax administration modernization reforms.**
- **Cease all netting operations.** The Ministry of Telecommunication should urgently separate its operational and commercial activities from its administrative and regulatory tasks. A specific line item should be appropriated in the central government budget to cover the latter. Besides clarifying the twin role of the institution, this would facilitate putting a stop to the current practice of netting expenses out of the transfers to the budget. Other ongoing netting operations should be identified and ceased.

B. Strengthening Relations with Line Ministries and Other Public Bodies

62. **The MoF can only concentrate on its core function as the guardian of public funds if responsibilities for their management are shared with other stakeholders such as line ministries and other government and public bodies.** Presently, the burden of the fiscal constraint is carried by the MoF. The current arrangement for budget preparation, as discussed above, does not allow for enough accountability of line agencies with respect to fiscal targets. Besides, the MoF also bears responsibility for the most critical phases of the expenditure process. As indicated in the second section of the report, it can be taken to court if a line ministry overspends. Thus, credit managers in line ministries are somewhat distanced from fiscal responsibility objectives. The MoF, in the interest of sustainable and sound finances, should share a larger part of its financial power, responsibility, and expertise with the spending agencies.

63. **The delegation of responsibilities must however be undertaken in conjunction with a strengthening of controls to allow for the progressive development of good expenditure management practices, supported by a sound structure within each line ministry.** However in parallel, the MoF must also develop its own capacity and control systems to safeguard a systematic decentralization of spending authority. Importantly, such reforms would pave the way for the eventual adoption of performance budgeting, a long-term objective in Lebanon.

Assuming core role in the budget process

- **Budget preparation should follow a top-down approach.** The “budget circular” should indicate for each ministry the maximum level of expenditure for next year (requesting indications on project cuts or add-ons should that level be changed) and give precise guidelines on routine items. The budget directorate should be vested with the authority to conduct discussions with the line ministries. Its capacity should be

strengthened and an appropriate methodology for analysis and negotiations developed.

- **Tighten control over size of civil service.** Given the long-term impact of recruitment in any civil service career, the budgetary control of the yearly public wage bill is not sufficient. A staff ceiling should be put for each ministry in the budget law and the financial control should be vested in giving the visa to recruitments.

Assessment of policies and risks

- **Assess and plan for contingent liabilities.** The MoF needs to systematically assess the size of contingent liabilities and other fiscal risks, a task that will be facilitated by the development of the macro-fiscal unit. This information needs to be disclosed to the CoM and Parliament. Only then will it be possible to cease carrying out extrabudgetary activities such as treasury advances to EdL.
- **Clarify relations with municipalities.** Sound financial relations require clearer expenditure assignments, which can be assessed against available funding. This will likely require legal action. In the short run, reporting requirements need to be established and capacities built to fulfill them. This may require strengthening the legal and institutional budget framework for municipalities.
- **EdL should be corporatized.** Corporatization would lead to more transparent accounting practices and enhanced reporting of subsidy/quasi-fiscal arrangements.

Streamlining the expenditure system through better control systems

- **Streamline the ex-ante control system.** The CdC involvement in the commitments control process and the duplication of controls performed by the DD and the Treasury should be eliminated. These actions should be supported by strengthening independence and efficiency of the commitment controllers of the MOF within the line ministries and by developing electronic signature procedures.
- **Develop rules and standards for internal audit.** The MoF should gain higher responsibility in the formulation of internal audits. Line ministries should become responsible for their own internal audits. The role of the MoF should increasingly be focused on the control of their operations through the CIB. The latter could be developed into a general inspectorate of finance which is responsible for supervision, coordination, and training of all internal audit units.
- **Improve external audit.** Strengthening external controls, which is covered in the next section, would significantly contribute to the strengthening of the expenditure cycle.

- **Revise procurement rules.** The draft procurement code should be finalized in a manner compatible with international standards. Audit of procurement activities should be strengthened, in particular at the level of the public entities, and a centralized information mechanism (including a procurement database) to monitor the implementation of these contracts must be developed. Legal provisions for punishing abuses should be strictly enforced.
- **Strict enforcement of rules and regulations.** The CdC and other control bodies should begin to exercise their full enforcement powers through penalties and by initiating judicial procedures.

Delegation of responsibilities

- **Short term.** A first step in this direction could be the transfer of responsibility for *ordonancement* (and the corresponding resources) from the MoF to the spending ministries. Commitments for routine or petty expenditures could similarly be delegated. This should be complemented by risk-based commitment controls through the MoF.
- **Medium to long term.** Transition of more significant spending responsibilities could be linked to the development of internal control and the loosening of the external commitment control: each time a spending agency brings evidence of effective and reliable control systems for its financial management, the external control could be relaxed.

C. Strengthening the Interaction with Parliament

64. **The Constitution has given Parliament a key role in the budget process.** It is currently not in a position to fully perform its duties, however, due to insufficient information, a weak CdC that only reports to it for information purposes, and poor resources. A fundamental overhaul is needed to address this issue, including changes to the decree-law of September 16, 1983.

Access to information

- **Increase the quality and scope of the information included in the budget document.** The budget documents should include comprehensive information on government financial activities, including (but not necessarily limited to) an assessment of lending and borrowing forecasts as well as a financial balance sheet; quasi-fiscal activities; contingent liabilities; debt level and debt service projections; outcomes for previous years, and a medium-term scenario. The assumptions underlying the macroeconomic framework should be clearly spelled out in order to facilitate and strengthen the debate.

- **Publication requirements need to be enshrined in the law.** While the MoF has undertaken a number of welcome initiatives to produce regular reports and newsletters, many of them available to the public, it is not under any obligation to do so. This should be corrected in order to prevent future governments, perhaps less committed to transparency, to backtrack on such initiatives.

Development of external audit functions

- **Give to Parliament greater oversight control over the CdC** and thus improve access to the critical information it is supposed to produce (i.e., the *Loi des Règlements*).
- **Refocus the CdC's role on ex-post audits in line with international practice and develop appropriate external audit methodologies.** This would require putting a stop to its current activities at the level of ex-ante controls, which duplicate functions already performed by other agencies.
- **A clear and transparent division of tasks has to be implemented between internal and external audit,** which should remain the main CdC's activity. Appropriate external audit methodologies have to be developed, especially to ensure an efficient audit of financial accounts and final budget execution reports.
- **Respect budget execution rules and deadlines regarding the audit of financial accounts and final budget execution reports.** This will require that the final financial accounts stop being prepared on a zero-balance entry.
- **The CdC needs to develop its capacity to perform external audits.** In the longer term, this will also be required to allow it to conduct performance audits.
- **Resources should be made available to Parliament to assess the increased flow of information,** including through increased staffing for research assistants.

Other issues

- **The delegation of authority on tax policy matters for tariffs and excises should be revoked.** It weakens the checks and balances needed in the formulation of tax policy and compromises the integrity both of tariff policy and of its formulation.
- **The budget of all three NSSFs should be subject to the same approval procedures and transparency requirements as the central budget.** A parliamentary debate should be required.

D. Outreach

65. **To increase awareness in civil society about the importance of fiscal reforms and the seriousness of the debt situation, the government needs to plan and conduct a comprehensive campaign.** Support from the public is indeed critical to move forward on the reform path. Yet, most recommendations presented in this report are not controversial and, adequately presented to the public, could demonstrate the commitment of the government to serious reforms. There is a need to:

- **Develop a code of conduct for customs and tax employees.** Existence of such a code should improve their relationship with their clients, the taxpayers. Service orientation is already in place in some areas, where efforts are being made to improve service and transparency (at customs and at the VAT administration, or through the publication of notes on the progress of reforms on the MoF's website), but these must be pursued, in particular with the forthcoming creation of the LTU and the adoption of a new tax procedures code.
- **Adoption of a general income tax.** Replacement of the existing schedular income tax system by a new income tax law based on modern principles would go along way toward improving the clarity of the tax base and transparency of its administration.
- **Think-tanks and the general public should be informed.** They should be encouraged to scrutinize the assumptions, models, and other similar information, especially with regard to the budget. This would enhance the quality of the debate and increase transparency.
- **"Draw a line in the sand."** By announcing that, from a certain date, the rules on administrative and judiciary punishment for corruption will be strictly enforced, and by demonstrating their commitment, the authorities would create a receptive climate in the public for reforms in the area of transparency.