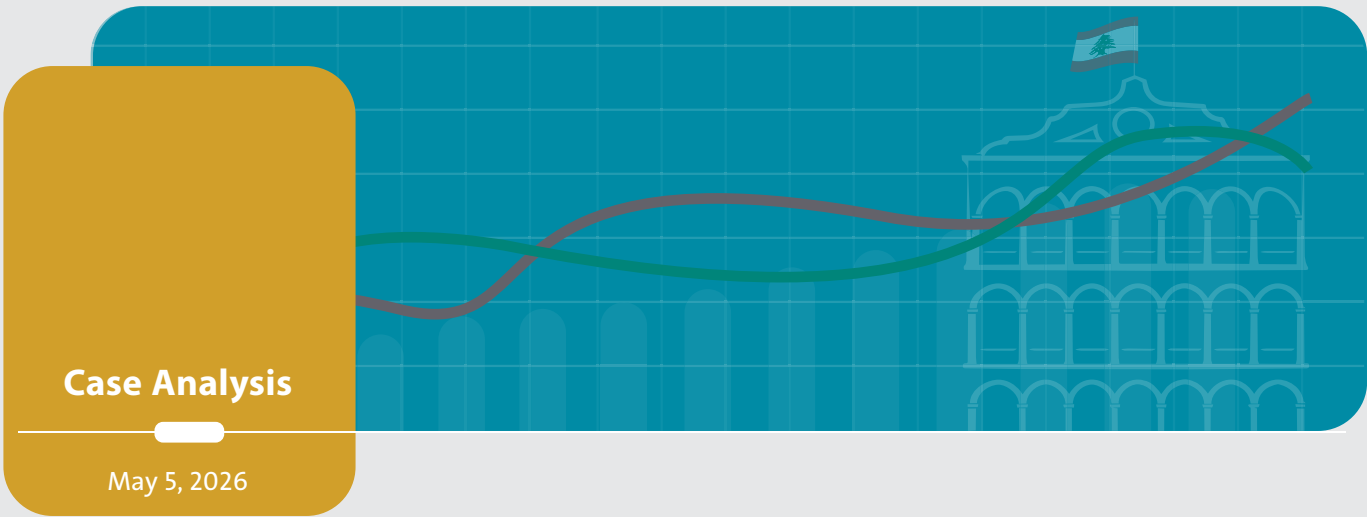


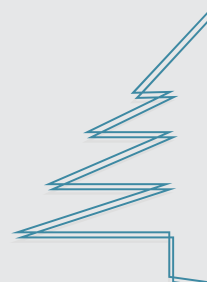


Case Analysis

May 5, 2026

The Resurgence of Twin Deficits

War-Related Implications for Lebanon's Public Finance



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Contents

Introduction	1
The 2026 General Budget: Projections and Policies	1
The Recurrence of War-Induced Shocks	2
Revenue Losses: USD 1 Million Daily	2
Expenditures Under Pressure	3
Financing Through Debt	4
From Surplus to Deficit	5
Institutional Dysfunction	6
Conclusion: The Resurgence of the Twin Deficits?	7
References	7

Introduction

Public finance in Lebanon faces mounting challenges due to the ongoing war in Lebanon and the region. Current estimates indicate a decline in public revenues and a rise in expenditures, compounded by institutional constraints linked to the potential issuance of facilitative measures, such as extending payment deadlines or granting exemptions. These pressures are further exacerbated by underlying factors, including the financial and monetary collapse since 2019 and the war in 2024, which prompted the migration of public sector employees to private sector and abroad. As a result, the Lebanese government may be unable to maintain its zero-deficit fiscal balance target, potentially placing public finances back into a recurrent cycle of twin deficits—fiscal and current account deficits—that has characterized the Lebanese economy for decades.

The 2026 General Budget: Projections and Policies

On February 10, the 2026 General Budget Law was issued, detailing expenditures amounting to LBP 538,415 billion (USD 6.01 billion based on an average exchange rate of LBP 89,500 per US dollar), representing an increase of LBP 93,201 billion (approximately USD 1 billion) compared with 2025. On the revenue side, the 2026 budget projected a balanced budget by year-end, for the third consecutive year.

This budget was formulated on the assumption of stability and security, within a framework aimed at ensuring fiscal solvency and achieving a primary surplus as a safeguard for financial stability. Accordingly, the Ministry of Finance projected a real economic growth of approximately 2.5 percent in 2025 and an estimated growth of 3.5 percent for 2026. Key drivers of this anticipated growth include expected external financing from World Bank-supported reconstruction and development projects, alongside European Union grants to support socio-economic recovery and the activation of a deposit recovery mechanism.

The Lebanese Ministry of Finance also projected that the inflation rate would decline to approximately 8 percent by the end of 2026, following a prolonged period of elevated inflation that peaked in April 2023 at 268 percent. Inflation subsequently declined following exchange rate stabilization, reaching 45 percent in 2024 and 15 percent in 2025.

Within the context of improving fiscal solvency, the Ministry of Finance set a target of achieving a primary balance surplus of no less than 2 percent of GDP. This target is intended to enable the government to meet its outstanding obligations, including debt servicing and reducing the public debt-to-GDP ratio over the medium and long term. This objective is to be pursued through a revenue-enhancement strategy centered on improving tax compliance, broadening the tax base, and rationalizing tax exemptions. On the expenditure side, priorities include, among others, "strengthening financial and monetary stability, enhancing institutional capacities, and building effective administration". Accordingly, operational spending is expected not to exceed 50 percent of total budgetary allocations.

Revenue sources in the 2026 budget were distributed as follows: 81.6 percent from tax revenues and 18.4 percent from non-tax revenues. Tax revenues were estimated at LBP 439,613 billion (USD 4.9 billion), compared with non-tax revenues of LBP 98,802 billion (USD 1.1 billion).

Tax revenues are derived from five main categories:

- 47.5 percent, or the equivalent of LBP 255,789 billion (USD 2.85 billion), from domestic taxes on goods and services;
- 13.7 percent, or the equivalent of LBP 73,907 billion (USD 825.7 million), from taxes on international trade and transactions;

- 10.7 percent, or the equivalent of LBP 57,647 billion (USD 644.1 million), from taxes on income, profits, and capital gains;
- 6.68 percent, or the equivalent of LBP 36,007 billion (USD 402.3 million), from property taxes;
- 3 percent, or the equivalent of LP 16,261 billion (USD 181.6 million), from miscellaneous tax revenues.

On the expenditure side, fiscal policy has established clear limits, reflecting the rationale that the objectives of strengthening fiscal solvency and achieving a primary surplus do not allow for an increase in current expenditures, which account for 89.4 percent of the total spending, compared with 10.6 percent allocated to capital expenditures. Consequently, the government is expected to pursue expenditure rationalization and tighter control over spending.

The Recurrence of War-Induced Shocks

The 2026 budget was drafted within the context of a recovery trajectory that began following the end of the war between Lebanon and Israel in the autumn of 2024. The 2024 budget was approved without any reform, as the government opted to allow further deliberations with a view to incorporating reform measures into its 2026 budget, a process that extended for over fifteen months. However, this trajectory remained highly fragile, according to the World Bank, given its reliance on temporary factors, such as the expansion of the cash-based economy and improved tax collection, in the absence of structural reforms in the financial sector. In its periodic *Lebanon Economic Monitor*, the Bank concluded that any significant shock could quickly undermine these projections and return the economy to a contractionary path.

Indeed, the "major shock" materialized on March 2, with the onset of missile exchanges between Lebanon and Israel and the subsequent expansion of Israeli military operations. These developments have significantly altered the fiscal landscape, both in terms of expenditures and revenues, while generating further losses. It is worth noting that in the 2024 war, during which, over a period of sixty-six days, from September 23 to November 26, 2024, the Lebanese treasury incurred significant losses in both revenues and expenditures. Yet the impact was not confined to this timeframe, as the broader economic fallout of the war weakened businesses, and undermined their capacity to meet tax obligations. Furthermore, the government adopted a series of measures, including the suspension of all tax payment deadlines, in addition to granting exemptions to those directly affected by the war.

Revenue Losses: USD 1 Million Daily

Prior to the outbreak of war in the autumn of 2024, revenues during the first nine months of the year amounted to LBP 235,999 billion, representing a monthly average of LBP 26,222 billion. During the subsequent three months, as the war's impact became more evident in economic activity and tax collection, total revenues dropped to LBP 70,035 billion, corresponding to a monthly average of LBP 23,345 billion.

The subsequent revenue loss between these two periods can be measured by the difference in the monthly averages, which can be converted into a daily loss. On this basis, the decline in average monthly revenue amounted to LBP 2,877 billion, equivalent to approximately LBP 95.9 billion per day. At an exchange rate of LBP 89,500 per US dollar, this loss is estimated at roughly USD 1 million per day in public revenue, representing an 11 percent daily decline.

When these losses are disaggregated by revenue sources, customs duties appear to have been among the most severely affected. Average monthly collections fell from approximately LBP 3,994 billion in the pre-war period to around LBP 3,316 billion during the final months of the year, representing a monthly loss of nearly

LBP 678 billion, or roughly LBP 22.6 billion per day. This decline is primarily attributed to reduced import activity, driven by a weakening domestic demand and disruptions to segments of transport and trade chains during the war.

Value-added tax (VAT) revenues also recorded a notable decline, although it was relatively less significant. Average monthly collections declined from approximately LBP 10,212 billion in the pre-war period to around LBP 9,426 billion afterward, representing a monthly loss of nearly LBP 786 billion, or roughly LBP 26 billion per day. This decline reflects a contraction in domestic consumption across several sectors, despite continued demand for essential goods, alongside weaker tax collection during the war and in the period that followed.

On the other hand, telecommunications revenues recorded a relatively sharper decline. Average monthly collections fell from approximately LBP 1,779 billion to roughly LBP 1,277 billion, representing a monthly loss of nearly LBP 502 billion, or about LBP 16.7 billion per day. This decline reflects the broader slowdown in economic activity and reduced consumption of some services during the war and the months that followed.

This comparison highlights a notable exception: real estate fees increased during the final months of the year, with the average monthly collections rising from around LBP 746 billion to LBP 1,090 billion. This increase is likely attributed to the registration of deferred transactions or the settlement of certain real estate deals prior to the end of the fiscal year. It may also reflect prevailing market concerns regarding the potential expiration of exchange-rate-related exemptions, or anticipation of a government increase in real estate registration fees. These factors may explain the opposite trend observed in this revenue item compared with other revenue sources.

Broadly, these figures demonstrate that the war not only led to a contraction in economic activity but also directly undermined administrative collection capacity. With public revenue losses estimated at nearly USD 1 million per day, fiscal stability has become increasingly exposed, particularly in light of rising emergency expenditures related to relief efforts, displacement, and the maintenance of essential services. Consequently, a prolonged conflict risks widening the fiscal gap, posing additional challenges for the Treasury in financing core expenditures and maintaining a minimum level of fiscal stability.

Based on these calculations, each additional day of conflict results in a corresponding loss of public revenue. However, these figures capture only the direct losses incurred during active hostilities, reflecting a contraction in economic activity and disruptions to trade and consumption. The full economic impact of the war typically becomes apparent only after military operations cease, as its effects persist over a longer period through reduced investment, institutional disruption, and a delayed return to normal levels of economic activity. Consequently, the post-war period is likely to entail additional losses in public revenue driven by continued economic contraction and a faltering recovery. While detailed monthly revenue data for 2025 is currently unavailable to measure this extended impact, the recessionary effects on revenue will undoubtedly persist for several months. Tax-liable institutions have been burdened by the need to rebuild part of their capital or to purchase new inventories of raw materials and final goods. Simultaneously, household purchasing power has shifted toward damage repair and securing alternative housing, which has contributed to a general surge in residential rental prices.

Expenditures Under Pressure

No significant surge in spending was recorded in the immediate aftermath of the war on November 26, 2024. This reflects a decision by the Lebanese government to implement austerity measures. The 2025 General Budget did not allocate any funds for reconstruction; instead, the government relied on the limited sums allocated to the High Relief Commission and the Council for South Lebanon. Allocations to the Council for South Lebanon, a large portion of which was directed towards salaries, wages, and previously initiated projects, amounted to approximately LBP 1,022 billion. Meanwhile, allocations to the High Relief Commission amounted to approximately LBP 62 billion, also largely devoted to salaries, wages, and ongoing projects. Furthermore, the cabinet approved the transfer of no more than LBP 900 billion (approximately USD 10 million) for rubble removal. By contrast, the

estimated cost of reconstruction, including initial rubble removal, repair of minor, moderate, and critical damage, and reconstruction of destroyed buildings, exceeds USD 10 billion.

During the previous war, the government did not bear the costs of housing allowances for displaced people, nor did it cover the costs of minor and moderate damages. However, during the 2026 budget discussions, the cabinet allocated USD 89 million for what was termed "structural damages." Amidst the prevailing political polarization in Lebanon, particularly between Hezbollah and factions advocating for its disarmament, the state's monopoly over the use of arms, and the labeling of Hezbollah as an outlaw organization, it is anticipated that the affected populations may demand greater government involvement in compensation and housing support. Should this development occur, it would impose a significant burden on a Treasury already reeling from the systemic fiscal collapse of 2019.

Furthermore, the Treasury faces significant off-budget liabilities, most notably the costs associated with restructuring of sovereign debt denominated in foreign currency (Eurobonds). Since the state ceased servicing its debt in March 2020, more than USD 40 billion in debt obligations had come due by early 2026. According to estimates by prominent financial institutions, the state can, at best, service 30 percent of this debt. This scenario would generate an additional liability of approximately USD 15 billion, equivalent to roughly 45 percent of the USD 33 billion nominal GDP projected by the World Bank for 2026, prior to the outbreak of the war.

The Treasury also carries approximately USD 1.6 billion in outstanding payments to Iraq for fuel shipments delivered to Électricité du Liban (EDL) between 2024 and 2025. In addition, the Treasury is required to recapitalize approximately USD 1 billion in Special Drawing Rights (SDRs) in order to avoid financial charges estimated at around USD 40 million, which would otherwise continue to accrue as long as Lebanon's SDR balance remains negative.

However, one of the most pressing expenditure challenges facing the government relates to the public sector. Civil servants are demanding wage adjustments, as current salaries represent less than one-third of their pre-2019 collapse value. Under pressure from protests, the government approved salary increases and additional allowances for public sector employees totaling LBP 69,810 billion, equivalent to USD 780 million. This decision was intended to be financed through an increase in the domestic consumption tax on gasoline by USD 3.50 per 20-liter canister, a measure projected to generate roughly USD 450 million in revenue. However, between the introduction of the gasoline tax on February 16, 2026, and March 17, the price of a 20-liter gasoline canister rose by USD 9.6, driven by surging global oil prices. This substantial increase carries broad inflationary repercussions across all prices, including public procurement costs and government expenditures.

The fiscal burden extends beyond this, as it extends to a set of liabilities recognized by the Ministry of Finance, but for which no financial allocations were made in the 2026 budget, leaving them as obligations to be met by the Treasury. Most notably, Lebanon faces USD 2.2 billion in debt service obligations related to concessional loans and subscriptions to international institutions. Additionally, the Treasury is legally obligated under the Code of Money and Credit, particularly Article 113, to recapitalize Banque du Liban (BDL). Banque du Liban incurred substantial losses following the 2019 financial collapse. These losses cannot yet be precisely determined, as discussions are ongoing regarding the extent of potential write-offs. Overall, these losses exceed USD 50 billion, though they could potentially decline to around USD 30 billion should the government enact legislation permitting significant write-offs. The annual cost of recapitalizing BDL is expected to range between USD 500 million and USD 600 million, to be paid in the form of annual interest on perpetual bonds.

Financing Through Debt

Despite the austerity measures implemented since the beginning of 2024, the Lebanese government has authorized parallel spending outside the formal budget framework. The government has secured USD 964 million

in loans from the World Bank and the European Union for a range of projects, including: a USD 250 million loan for reconstruction, supplemented by USD 7 million in French funding; USD 200 million for agricultural transformation; USD 250 million for renewable energy; and USD 257.8 million for the water sector.

Disbursement has already begun for some of these loans, while others remain undisbursed. This situation represents a double-edged sword. On the one hand, the state is expected to meet the requirements of rapid response to displacement, including providing cash transfers to displaced individuals and livelihood support through the distribution of food rations, and essential household items. However, these needs are expected to become even more acute in the forthcoming period, particularly following the cessation of hostilities, as efforts intensify to facilitate the return of displaced populations to their towns and villages. Expenditures deemed essential today—even when financed through borrowing—are likely to generate substantially greater needs in the post-war phase.

This off-budget spending, which does not appear in government ledgers or public budgets, constitutes public debt that Lebanon is obligated to record and service through installments. Regardless of how modest or long-term these installments may be, they remain integral to Debt Sustainability Frameworks (DSF) mandated by the International Monetary Fund (IMF) as a prerequisite for approving any country's financing program. Consequently, the debt-to-GDP ratio has increased. Although the government may seek to this reality at present, these liabilities will inevitably surface, likely after it have accumulated, leaving public finances in an even more precarious position than they currently face.

A further challenge arises from the government's reliance on such loans to stimulate economic growth. This approach is explicitly reflected in the premises of the bill 2026 General Budget submitted by the Minister of Finance, which states:

"Achieving sustainable growth rates requires a stable security and political environment. It is hoped that the consolidation of stability and security will contribute to enhancing growth, projected at 3.5 percent for 2026, coupled with an influx of external financing from the World Bank's reconstruction and development projects, as well as anticipated grants from the European Union to support social and economic recovery..."

This framing suggests that the government is relying on loan-financed growth, without accounting for the medium and long-term implications of rising debt for the budget, the economy, and society.

From Surplus to Deficit

It is noteworthy that the reliance on loans to stimulate growth is coupled with an ambitious pursuit of a primary surplus of 2 percent of the projected GDP for 2026. This target amounts to LBP 53,700 billion, or USD 600 million, equivalent to 9.9 percent of the total value of 2026 budget. Achieving this surplus is contingent upon an improvement in revenues, which have been pegged to a stable average exchange rate of LBP 89,500 pounds per US dollar. Consequently, revenues derived from international trade transactions, customs duties, domestic taxes on goods, and value-added tax (VAT) will account for the largest share of the projected tax revenues. Indeed, the budget estimates that:

- 34 percent of total revenues will be generated from value-added tax (VAT), representing an increase of 54.5 percent compared with the 2025 budget estimates;
- 13.7 percent will stem from customs duties, reflecting an increase of 100 percent compared with the 2025 budget;
- 13 percent will be derived from domestic taxes on goods, representing an increase of 90 percent compared with the 2025 budget;

- 10.7 percent will come from taxes on income, profits, and capital gains, representing an increase of 63.5 percent compared with the 2025 budget.

These figures suggest that the economy is subject to significantly increased fiscal burdens. Consequently, in addition to the difficulty of meeting these projections amid the repercussions of the war, achieving the desired primary surplus appears highly unlikely. While public finances did record substantial surpluses over the past two years, amounting to LBP 57,668 billion in 2024 (USD 645 million) and LBP 138,310 billion (USD 1.5 billion) during the first ten months of 2025 (latest available data available data), the deterioration in revenues, coupled with the surge in emergency expenditures, is likely to make achieving a surplus extremely difficult, if not impossible. Indeed, these developments may ultimately lead to a reversal of the fiscal trajectory, resulting in a deficit rather than the projected surplus.

Institutional Dysfunction

A new factor has emerged—one that was not as evident during the 2024 war—namely, "institutional dysfunction," affecting public administration. In the years following the financial and monetary collapse, the administration has experienced what is commonly described as "brain drain."

According to data from the Civil Service Board, vacancies in public administration span all grades of public service employment. However, the most critical shortages are concentrated in leadership positions within the first and second grades. In 2024, the overall vacancy rate in public administration reached 72 percent. While the government managed to fill some first-grade positions in 2025, it failed to address the vacancies in the second grade, which constitutes the operational backbone of the administration, where the vacancy rate stands at 80 percent. Furthermore, public sector employment has lost its appeal due to the decline in salaries, wages, and benefits. Salaries remain at approximately one-third of their 2018 levels, while benefits have deteriorated significantly. This institutional dysfunction directly undermines the efficiency of revenue collection mechanisms. Moreover, much of the public administration suffers from shortages in operational equipment and a severe lack of computerization and digitization.

The war may constitute an additional catalyst for brain drain, prompting further emigration of skilled professionals still serving in the public sector. Wartime conditions introduce serious operational constraints on maintaining administrative functions, as civil servants are displaced from their homes to areas deemed safer. Consequently, government offices cease operations in regions exposed to hostile attacks, effectively removing large economic zones from the tax collection base. Areas such as South Lebanon, the Bekaa Valley, and the southern suburbs of Beirut, which carry significant economic weight in terms of production and consumption, particularly across the agricultural, commercial, and service sectors, thus fall outside the state's effective fiscal reach.

Moreover, carrying out core administrative functions, which underpin the revenue collection process, has become increasingly difficult. It is also important to note that the technical infrastructure supporting revenue collection operations has suffered repeated malfunctions due to the absence of routine maintenance, leading in several instances, to the suspension of electronic payment systems. As a result, revenue collection may become technically unfeasible, even when taxpayers demonstrate a willingness to settle their fiscal obligations.

The impact of institutional dysfunction is not confined to the wartime period itself; rather, it extends into the post-war phase, as the government grants tax exemptions, extends payment deadlines, or suspends payment obligations, measures that were indeed adopted following the previous war.

Conclusion: The Resurgence of the Twin Deficits?

The 2026 General Budget was drafted without adequate consideration for contingencies, *force majeure*, or major shocks. This oversight has effectively undermined the budget's underlying assumptions, placing revenue and expenditure projections on a reverse trajectory. Should the anticipated surplus turn into a deficit, and should large figures related to direct war damages and economic losses—estimated at around USD 14 billion during the previous conflict—begin to emerge, the consequences of the current war are likely to be even more severe and tragic. These developments may manifest in the resurgence of the twin deficit phenomenon. Such scenario would carry significant implications, reviving the structural pattern that characterized the Lebanese economy for many years, namely the coexistence of a current account deficit and a fiscal deficit, which ultimately culminated in the 2019 economic collapse. According to World Bank data, the current account deficit remains a persistent structural challenge despite its relative decline. This deficit peaked in 2022 to 34.6 percent of GDP, declined to 15.8 percent by the end of 2025, and was projected to reach 16.1 percent by the end of 2026 based on pre-war estimates.

Consequently, exchange rate stability is also likely to be under threat. The current stability is inherently fragile and relative, predicated on a tax collection mechanism that effectively compels taxpayers to convert their dollar-denominated income, in an economy that is largely dollarized, into Lebanese pounds to meet tax obligations. Liquidity in Lebanese pounds is injected exclusively by Banque du Liban. Furthermore, war-related social pressures are expected to intensify, potentially exceeding the state's fiscal capacity to respond to growing needs, or breaching the parameters established to maintain financial and monetary control. Prospects for "anticipated reforms" also appear limited, particularly as the immediate post-war focus will likely shift toward managing the challenges of displacement, shelter provision, and reconstruction, especially given the already slow pace of reform implementation.

Ultimately, this outlook assumes that shocks remain within manageable limits. However, an escalation of the conflict could deepen the crisis, disrupting supply chains and jeopardizing food and energy availability, as well as further increases in their prices.

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