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# FINANCIAL DEVELOPMENTS IN 2017 -

## BETWEEN THE BURDEN OF THE TAX BASKET AND THE RISKS OF INFLATED PUBLIC SPENDING

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# FINANCIAL DEVELOPMENTS IN 2017 - BETWEEN THE BURDEN OF THE TAX BASKET AND THE RISKS OF INFLATED PUBLIC SPENDING

## Introduction

During the last decade, Lebanon recorded climaxing political, economic and regional vulnerabilities which have impeded the economic growth and significantly strained its public finances. With a huge debt burden, chronic fiscal deficits, an increase in current spending, a deteriorated primary budget surplus, the absence of urgent structural reforms on government revenue and the failure to fulfill pledges of economic and financial reforms made at separate international donor conferences during the 2000s, came to exacerbate the dire situation.

In addition, economic activity remained well below potential, inhibited by decidedly volatile geopolitics and security conditions. Indeed, one of the key issues facing Lebanon is the economic and social impact of the Syrian crisis, now in its seventh year. According to the European Civil Protection and Humanitarian Aid Operations commission report[1], up to 1.5 million Syrians have taken refuge in Lebanon since the conflict started in March 2011, a figure equal to one-third of the overall population. The Syrian refugee crisis has strained Lebanon's public finances and service delivery, worsening poverty incidence among Lebanese with unemployment reaching a record high.

Into the bargain, the intrinsic and unhealthy links between politics and economics in Lebanon have negatively impacted on economic growth, social justice and stability, rendering public spending highly inefficient, encouraging clientelism and corruption in fiscal affairs and

1 To review the report, check the following link: https://ec.europa.eu/echo/files/aid/countries/factsheets/lebanon_syrian_crisis_en.pdf

impeding proper oversight and accountability over public finance. Since 2005, disagreement vis-à-vis accountability over previous fiscal accounts has prohibited subsequent budgets from being endorsed by parliament. Public spending has since been mostly conducted through treasury advances and ad hoc measures, which left fiscal policy rickety, lacking a mid-term vision.

Prospects can deteriorate further with the reversal in oil prices, increases in international interest rates, and an appreciation of the Euro, which have so far been favorable to the Lebanese economy. One can only hope that regional instability will be reduced and that the internal political process will not revert back to stalemate. But even under the most promising scenarios in these two areas, the economic challenges the country is facing remain daunting.

Against this challenging environment, the 2017's fiscal performance has carried positive and much needed breakthroughs for Lebanon's financial, fiscal and economic woes, registering multi-faceted developments with the ratification of the public sector's long-standing salary scale bill stalled in the legislature since 2012, the approval of a tax hikes package and passing the first state budget in 11 years.

The current paper intends to underline that Lebanon's public finances are projected to remain structurally weak without introducing significant structural reforms. Simple taxation redistribution without a sustainable fiscal policy able to generate a structural change cannot solve Lebanon's long-standing economic, fiscal and financial deadlock. Not to mention that the endorsed tax hikes package has mostly affected the country's traditional economic drivers: Real estate, construction, banks and tourism. Broadly speaking, the government's short term revenue goal may overlook the goal of achieving a long term fiscal sustainability, inhibiting Lebanon's return to the development path.

The paper will detail the tax measures and attempt to assess their might-be subduing effect on the national economy, especially along the absence of a serious reform for public spending. The paper is divided as follows:

The first section will present the tax provisions approved in the tax basket law along with the taxes introduced by the Budget Law 2017, decrees, and decisions taken by the Minister of Finance to implement these taxes.

The second section will feature general comments and observations on tax proposals and their impact on economic activities and investment environment.

The third section will focus on the main taxes and point towards some challenges the tax administrations might face in implementing and collecting the new taxes, along with the bureaucratic burden and complications caused for small taxpayers, which might result in a pattern of behavior of tax avoidance or evasion.

The fourth section will emphasize the need to introduce any taxes within the framework of a comprehensive economic vision, to avoid tax improvisation solely based on attempts to expand government's revenues, without assessing their economic, social and administrative impacts.

## 1- Endorsed Tax Basket and Procedures

### a- The Tax Basket:

Following the Constitutional Council's dramatic decision to revoke the tax hike motion in its entirety over procedural and financial violations, the Lebanese Parliament has approved law No. 64 after amending its articles 11 and 17. The new law went into effect on 26 October 2017, introducing new taxes as well as an increase of rates on existing taxes, deemed essential to fund the additional cost of the new salary scale for civil servants. It stipulates increases in 17 tax revenue streams.

The main increases in taxes along with their unofficial estimated revenues are:

- An increase in VAT from 10% to 11% , which might add LBP300 billion in revenue,
- An increase from 0.30% to 0.40% on proportionate stamp duty, which might add LBP45 billion in revenue,
- A LBP2500 on landline bills and LBP250 on prepaid cell phone cards,
- An increase of 200% on imported alcohol, which might add 60 billion in revenue,
- An increase in taxes levied on imported tobacco products (LBP250 on every cigarette pack, LBP250 on every pack of tombac and LBP250 on every cigar), which might add LBP30 billion in revenue,
- An increase of 100% on notary public fees, which might add LBP30 billion in revenue,
- An increase in taxes charged on travellers upon exiting the Lebanese territory on flights which last destination exceeds 1250km, which might add LBP60 billion in revenue,
- An increase from 10% to 20% in taxes charged on national and foreign lottery awards, which might add LBP10 billion in revenue,
- An increase from 10% to 15% on capital gain from disposal of fixed assets applied on all taxpayers (Including normal persons), which might add LBP100 billion in revenue,
- An increase from 15% to 17% on corporate income tax, which might add LBP70 billion in revenue,
- An increase from 5% to 10% on dividend distributions for companies listed on the Beirut Stock Exchange

(BSE), which might add LBP10 billion in revenue,

- An increase from 5% to 7% on deposit interest for both private depositors and banks, including interest derived from treasury bills bank, deposit at Banque du Liban (BDL) and interbank deposits, which respectively might add LBP320 billion and LBP550 billion in revenue,

- An increase on flat stamp duty on various invoices up to LBP20.000, which might add LBP70 billion in revenue.

The main newly introduced taxes include:

- LBP6000 excise duty charged on the production of each ton of cement, which might add LBP35 billion in revenue,

- LBP5000 tariff charged on foreign travellers upon their entry to Lebanese territory by land, which might add LBP10 billion in revenue,

- LBP80.000 and LBP120.000 tariff charged on 20 feet and 40 feet shipping containers bringing goods to Lebanon, excluding transit passage, which might add LBP65 billion in revenue,

- New fines to be paid by seaside projects owners on illegal use of the Maritime Public Properties, which might add LBP200 billion in revenue,

- A 2% tax on the value of any real estate sales contract. The law allows for this tax to be deducted from registration fees, provided the sale is registered within one year of the date of the contract.

**b- Other taxes and tax procedures introduced by the Budget law, decrees and the Minister of Finance's applied decisions:**

In addition to the taxes and tax procedures introduced by law 64, 2017, several amendments to the taxes and exemptions applicable in Lebanon and some new tax procedures were introduced by Law no. 66 - Budget Law, gazetted on November 7th, 2017, as well as by decrees, and applied decisions taken by the Minister of Finance. The most important are:

- Enforcing a financial stamp fee and license fee on water investment.

- Reducing the threshold for mandatory registration with the VAT department to a turnover that exceeds LBP100 million in four consecutive quarters.

- Retaining the right of tax rebate for VAT-exempt operations provided that the refund request is submitted at the end of each year and within a 20-day period instead of the six-month period previously granted.

- Extending the deadline for tax authority to pay tax refund, should the delay in tax rebate is caused by bureaucratic hurdles.

- Subjecting VAT taxpayers to provide stock and fixed assets inventory before January 20th, 2017.

## 2- Scattered and Dispersed Taxes: The devil is in the details

The devil is often in the details; small things within the tax hikes package were overlooked and could cause serious problems later on.

**Increasing VAT from 10% to 11% and reducing the threshold for mandatory registration from a turnover that exceeds LBP150 million to LBP100 million:**

The effectiveness of the VAT in raising public revenues has been praised since its introduction almost fifty years ago. This simple non-distortionary indirect tax has proved itself as a 'money-making machine' resorted to by many countries. Yet, the administrative burden resulting from lowering the threshold for mandatory registration with the VAT department (from a turnover of LBP150 million to LBP100 million), will be very high for the staff of relevant departments, especially in terms of audit and control. There are no indicators regarding the expected number of new registrants, but some estimates suggest an increase that could reach 12% of the current number of about 40.000 members, which equal 5000 new registrants.

In addition to the burdens borne by the tax authority, it is also expected that a large number of small business owners will face challenges in managing their already volatile business. Many of them are subject to the estimated profit tax or even lump-sum profit tax. They will be complied to maintain business records through complex bookkeeping and accounting system.

It should be mentioned that this measure was not prompted by the government but rather by the different economic associations which consider that part of the current crisis is due to tax evasion, especially the value added tax; this perception is quite exaggerated.

**An increase from 5% to 7% on deposit interest for both depositors and banks, expanding its application to banks' interest income from deposits at the BDL and interbank deposits:**

This expansion may at first seem to be appealing for the Treasury given the expected income. Yet, it has several caveats; some relevant ones are addressed bellow:

- The legal objection expected to be submitted by the Association of Banks on the basis that interests earned by the banks will not account as their own money for large part of it is owed to depositors. Should banks achieve positive margins, it will be inevitably indicated in their annual statements and be therefore subject to income tax.
- It should also be recalled that BDL is currently

limiting the banks' dividends distribution which does not exceed 35% to 40%; the remaining dividends are included within the banks' capital funds, in preparation for the conditions of "Basel III" regarding banks' capital requirements which has been raised from 12% to 15%.

- On the other hand, the Lebanese banking sector is going through a delicate phase and there is no longer a profit spurt such as the one witnessed between 2008 and 2010; the flow of foreign remittances and the balance of payments shifted since 2011 from a surplus of $7 billion in 2009 to an annual average deficit of $1.5 billion. We should also mention the pressures and conditions put forward on Lebanese banks by many countries, especially the US Treasury, in the context of countering money laundering, financing terrorism and tax evasion. Adding to that the difficulties faced by banks in Lebanon, especially medium and small ones, required to freezing additional reserves to cope with high operational and loans risks.

It is absolutely necessary to coordinate with BDL before taking any decisions to avoid any discrepancy within the banking sector, especially with respect to the balance of payments and the risks of transferring deposits to countries that do not impose taxes on interests earned.

**An increase from 10% to 15% on capital gain from disposal of fixed assets applied on all taxpayers, including natural persons:**

This tax will be imposed for the first time on natural persons after it was only levied on institutions, companies and natural persons who sell several realties per year, and are subject to a 10% improvement tax. Hence, there is doubt about the additional income estimates for this new tax, especially in light of the worrying recession the real estate sector is witnessing.

Many questions are also raised:

- What will happen to real estate, especially apartments that have been sold years ago by installments or under an irrevocable procuration and have not yet been registered in the name of new owners, for their current registration fees could sometimes exceed their effective selling prices?

- On what basis will the costs of improvement made by owners on real estate be calculated, especially the built ones?

It is evident that taxes and fees on real estate profits realized by natural persons should be a pillar of the tax effort exerted by all Lebanese taxpayers. However, streamlined mechanisms for implementation are a must to avoid unfairness and risk of non-compliance.

**LBP6000 excise duty charged on the production of each ton of cement:**

Economic associations were always suspicious of product taxes; the adoption instead of sale taxes has always been a better choice. Levying product taxes is considered as an interference of the public sector in the administrative affairs of companies. If a cement company wants to increase its stock, it will have to shoulder additional financial burdens.

**Lifting of the reduced tax rate of 5% on dividend distributions for joint stock companies:**

Listed companies on the BSE only benefited from this reduction. The move was aimed at stimulating the financial markets' growth. Although it failed to boost the performance of the BSE, its lifting will further contribute to the loss of what little credibility the BSE still enjoys, for impulsively revoking provided investment incentives is not advisable. It is primordial to maintain legislative stability, unless changes are made within a context of a comprehensive reform and development plan.

It should be noted that the listing of shares on financial markets will greatly reduce tax evasion and will force companies to commit to greater transparency and thus help improving tax collection.

**Enforcing a financial stamp fee and license fee on water investment:**

Imposing this fee is essential to preserving natural resources, yet it should be considered within the context of a comprehensive policy for water resources management.

**Subjecting VAT taxpayers to provide stock and fixed assets inventory before January 20th, 2017:**

This provision is a stark example of hasty financial decisions, for deliberations were restricted to inner circles within the Ministry of Finance. Challenges to implementing such a provision have forced financial authorities to extend deadlines, requesting only a plain stock and fixed assets inventory.

## 3-Diagnosed Vulnerabilities:

Recent tax practices have shown that the Lebanese state's tax policy lacks in strategic perspective, and is ill managing the financial effort required by economic associations and taxpayers of various categories. This vulnerability can be diagnosed as follows:

- Focusing on taxes to ease the fiscal deficit instead of rationalizing current spending by implementing a tight expenditure policy and reducing waste.

- The endorsed salary scale adjustment for public sector employees has introduced high wage raises; securing its funding will be difficult amid the recession the country is witnessing since more than seven years.

- It is necessary to highlight the cross-estimation differences extent of hyperbole that has accompanied the process of preparing and endorsing the salary scale adjustment, especially in what pertains to appraising its cost, the magnitude of the beneficiaries, its impact on future civil servants hiring and on pensions considered nowadays as a crucial component of government expenditure in public budgets. All these elements, which add to the costs of the salary scale adjustment, have not been explicitly considered.

- Lack of accurate data on the expected cost of the salary scale adjustment, assessed by some at $800 million annually, while others estimated it between $1.4 and $1.7 billion, when calculating all the direct and indirect costs it implies. Despite extensive deliberations on the salary scale by the Council of Ministers and the numerous parliamentary committees, observers were astonished when the parliament endorsed it without having insightful and accurate figures regarding its expected cost.

- The extended array of tax revenue stream affected by the tax hikes package amidst a severe recession, which could expose the domestic economy to further downturn that the increase of purchasing power ushered by the implementation of the wage scale adjustment will not be able to compensate.

- The tax hikes package has sparked wide condemnation from almost all production stakeholders, deemed as creating a poor investment climate and endorsed beyond any economic trends. They decried subjecting the long-debated tax reform package to political rift engulfing Lebanon since decades, and endorsing it without any serious and weighted insight.

- The government failed to quell a public outcry over new taxation by invoking the long-period of time during which the country has not witnessed any tax increase or new taxation for failure to pass a budget since 2005. Contrary to the prevailing fiscal illusion over the executive authorities burdening citizens with tax increases, the last tax increase was endorsed 15 years ago (5% tax on deposit interest, budget for the year 2003), while consecutive governments have approved a tax overhaul to cut some taxes, including decreasing taxes on gasoline by LBP5000/per 20 liters, and exempting diesel oil used for household consumption from VAT.

- The opacity of the tax adoption process, as its planning was limited to a restricted circle of officials in the Ministry of Finance, especially within the Directorate of Revenue; even other crucial and concerned departments in the ministry were left out. Economic and social stakeholders were also excluded from the planning process, including foreseeing the taxation's redistribution impact on the national economy.

- Failure to foretell the economic and social impacts of the endorsed tax hikes, and their repercussions on the productivity, performance and profitability of private institutions, business cycle and entrepreneurial activity. These tax deductions are estimated to account for 2% to 2.5% of GDP, a very high percentage in light of Lebanon's economic recession witnessed for more than seven years.

- Failure to provide reliable estimates of the output effects of tax increases in term of revenue generation, offering instead approximate gross figures offsetting the wage scale adjustment. The Minister of Finance emphasized during the parliamentary debates, that the expected return of the tax hikes package will be about LBP1600 billion per year, while some MPs estimated that the expected revenues will exceed LBP2200 billion and others question the ability of the Ministry of Finance to achieve these rates in light of the deteriorating economic situation, especially if the banks succeed to suspending the application of tax increase on the interest generated from their deposits at the BDL and from interbank deposits.

- Failure to appraise the ability of relevant authority in terms of verification and collection or the increased risks of tax evasion and avoidance.

- Failure to adopt any incentive measures for the productive sectors to mitigate the economic hindrances caused by the new tax hikes.

- Failure to raise the ceiling of tax rebates for taxpayers and keeping it at the same level for more than 12 years, while completely ignoring any effects of the inflations that have occurred during this period.

- Introducing new taxes and fees on income and consumption without identifying transparent collection mechanisms, which could prove to be complicated and pave the way for administrative discretion and rampant corruption, especially in what pertains to fines to be paid by seaside projects owners on illegal use of the Maritime Public Properties.

- Held taxpayers responsible for the relevant authority's failure to collect taxes extending its deadline to do so, while imposing penalties on taxpayers for failure to honor a tax liability.

- Failure to look beyond national borders in order to conduct comparative studies of tax legislations between Lebanon and neighboring countries. Concerns are growing over companies and corporates transferring their business to these countries because of the endorsed tax reform, especially those that use Lebanon as a base for investing abroad.

## 4- Proposals

With a sluggish economic growth since 2011, a skyrocketing public debt and increased regional and international economic and political risks, the Lebanese government should be prompt to adopt structural financial reforms aimed at: Rationalizing government spending, ending corruption and waste of public money, making the necessary adjustments to improve balances in the public finances and the adoption of clear and transparent mechanisms.

Hence the need to adopt a comprehensive fiscal policy that balances between implemented taxes and public expenditure, foresighting possible economic, financial and social scenarios, along with building on sound rules adopted by most developed countries that can be adapted to the Lebanese situation.

These **so-called golden rules** are on the way to becoming constitutional principles in many countries. They can be summarized in Lebanon as follows:

a- Avoid any primary deficit

b- Gradually reducing the total budget deficit to 5% of GDP within 4 years

c- Reducing the public debt to 120% of GDP within the same 4 years period

Along with these golden rules, it is crucial for Lebanon to develop a public fiscal policy based on a coherent plan and laws that ensure continuity and the principle of inclusiveness, rather than adopting cross-cutting and scattered clauses within non-interrelated laws and provisions in the public budget or decrees and decisions. The tax legislation should:

1. Rely on the real tax proposals revenue, their simple implementation and low administrative cost.

2. It should not impede economic growth.

3. Respect the principle of continuity and stability.
4. Approach productive sectors of the economy in a motivating and helpful way.
5. Respect the principle of equity in taxation.

In addition, a set of targeted proposals is due:

1- Ensuring the participation of economic associations in the tax planning process.

2- Ensuring the participation of international bodies in the tax planning process for a comparative look at other countries' tax legislations and procedures.

3- Progressive imposition of taxes to avoid economic shock.

4- Developing rational and specialized media campaigns to avoid public and political decry.

5- Adopting a series of incentives that could mitigate taxation's negative impacts on establishments and preserve a good investment climate.

6- Ensuring a level of fairness between taxpayers and the treasury through subjected both parties to the same administrative conditions and legal regulations.

7- Considering possible reforms to the VAT policy as applying reduced rate on basic products (between 5 and 7%), and high rate on other goods and services (between 12 and 15%). Instead of lowering the registration threshold as to include small taxpayers, it would be wiser to consider applying different rates. In comparison with some countries, for example, Morocco applies seven VAT rates, so Lebanon could reach two or three different rates.

Applying different VAT rates could create additional administration and compliance burdens. However, gained experience and the development of the electronic declaration can reduce the risk of administrative glitches. In addition, the percentage of income sources from the value added tax reduces the risk, as 70% of the collections are generated by import and therefore collected from the customs administrations, while more than 20% are collected from big taxpayers.

The ability to manage public finances along basic rules and regulations to maintain financial and monetary stability and avoid diverting investments, is the core of the much-needed framework for achieving regular and sustainable growth as well as securing sufficient resources for the treasury.

| TABLE of TAX PROPOSALS* | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Article number | Tax Adjustment | New Taxes | Existing Taxes | Increase Ratio | Expected Revenues Billion LBP | Collection | Economic Impacts | General Comments |
| 1 | increase in VAT | 11% | 10% | 10% | 300 | +++ | Negative impact on business activities | High costs on consumer |
| 2 | Proportional fiscal stamp duty rate | 0.4% | 0.3% | 33% | 45 | ++ | High costs on business activities | Outdated tax to be replaced |
| 3 | Flat fiscal stamp duty rate | Various taxes | Various taxes | | 70 | +++ | High estimated revenues difficult to be achieved. High costs on business activities | High costs on consumer |
| 4 | Tax on cement production | LBP6000 on the production of each ton of cement | New tax | | 35 | +++ | High construction costs | Risks of resorting to tax product |
| 5 | Tax on alcohol | X3 | Various taxes | 200% | 60 | ++ | Risks of increasing the burden on the tourism sector | Risks of increased smuggling. |
| 6 | Tax on imported cigarettes, Tombac and Cigars | Various taxes | Various taxes | | 30 | ++ | High costs on consumer | Risks of increased smuggling. |
| 7 | Amended Notary public fees | LBP20.000 | LBP10.000 | 100% | 30 | ++ | High administrative transaction costs | Risks of weakening the legal documents to avoid fees |
| 8 | Fee charged to non-Lebanese traveling by land to Lebanon | LBP5000 | New tax | | 10 | ++ | High estimated revenues difficult to be achieved especially with smuggling being on the rise. | High estimated revenues difficult to be achieved especially with smuggling being on the rise. |
| 9 | Tax on Outgoing Tickets | Various Taxes | Various Taxes | | 60 | +++ | High cost of travel to and from Lebanon, currently considered as the most expensive in the region. | High cost of travel to and from Lebanon, currently considered as the most expensive in the region. |
| 10 | Fee on freight entering the ports excluding transit | LBP80.000 And LBP120.000 | New tax | | 65 | +++ | High costs on business activities | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| 11 | Fines on illegal seaside projects | undefined | New tax | | 200 | +++ | High estimated revenues difficult to be achieved. Complex mechanisms to determine fines. | Emerging disputes between the state and the owners, especially the new ones; risk of rampant bribes and political interference. |
| 12 | tax on national and foreign lottery awards | 20% | 10% | 100% | 10 | +++ | Modest revenues | Modest revenues |
| 13 | Tax on capital gains from sale of fixed assets | 15% | 10% | 50% | 100 | +++ | Risks of increasing estimates and rising costs in the real estate sector. | Jeopardize the real estate sector. |
| 14 | Advance payment on real estate sales contracts | 2% | New Tax | New Tax | 0 | +++ | High costs on business small activities. | Implementation challenges; several exceptional cases |
| 15 | Increase in the corporate income tax | 17% | 15% | 13% | 70 | +++ | Weakness of investment ability | Risks of increased tax evasion |
| 16 | Tax on dividend income | 10% | 5% | 100% | 10 | +++ | Listed companies on the BSE only benefited from this reduction. The move was aimed at stimulating the financial markets' growth. | Although it failed to boost the performance the BSE, its lifting will further contributing to the loss of what little credibility the BSE still enjoys. |
| 17a | Increase on deposit interest for depositors | 7% | 5% | 40.00% | 320 | +++ | Risk of increasing fiscal imbalances, especially with respect to the balance of payments | Risk of raising interest on deposits and thus on public debt and its cost. |
| 17b | Increase on deposit interest for banks | 7% | 5% | 40.00% | 550 | +++ | Banks' objection to this measure, which carries heavy burdens, and will be charged to customers. | Risks of raising interest on deposits and loans |
| TOTAL | | | | | 1965 | | | |

* Current estimates

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