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Policy Brief

Why Does Lebanon Need CEDRE? How Fiscal Mismanagement and Low Taxation on Wealth Necessitate International Assistance

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Executive Summary

The CEDRE conference provided another opportunity for the Lebanese government to seek international support for investments in essential public infrastructure. The government used the Syrian refugee crisis as its the central rationale, which would have made international support for Lebanon a moral imperative to secure the country's stability. In questioning this view, this brief reviews the fiscal conditions that gave rise to yet another donor conference in Paris. We argue that the factors which prevented the government from providing the necessary investments in the country's deteriorating infrastructure predate the Syrian crisis and lie within the domestic political economy. We identify two main factors that prevented the government from increasing its share of capital expenditures: First, an oversized public employment sector and high interest payments on sovereign debt severely constrain the governments' fiscal space today and will impose even higher burdens in the future. Second, the tax regime fails to place an equitable burden on wealthy segments of society and large corporations by keeping direct, progressive taxation low and relying instead on indirect and regressive taxes. To avoid future trips to Paris, the government should restructure its spending priorities and adopt a more equitable tax-regime that could finance necessary investments in public infrastructure.

In return for hosting more than 1 million Syrian refugees, the Lebanese government requested support from the international community to finance the country's dilapidated public infrastructure. Lebanon's political elite went to great lengths to argue that the presence of Syrian refugees has exacerbated the poor state of national electricity grids, water supply, and road networks to an extent that the governments' ramshackle finances cannot cope on their own. In response, the international community convened for the April 2018 CEDRE conference in Paris, during which the government secured pledges worth $11 billion for an extensive wish list of infrastructure projects.[2]

However, the government was careful to conceal the structural reasons for the poor quality of the country's infrastructure, which predate the Syrian crisis: First, fiscal mismanagement has severely constrained fiscal space for capital expenditures, and second, the poor management of resources allocated to infrastructure projects has fostered inefficiency and corruption.

... fiscal mismanagement has severely constrained fiscal space for capital expenditures

This policy brief examines the fiscal conditions that gave rise to the CEDRE conference, already the fourth in the succession of the so-called Paris conferences.[3] We argue that the reasons which prevented the government from providing necessary investments in the country's deteriorating infrastructure predate the Syrian crisis and lie within the domestic political economy: Severe budget constraints due to high and rising expenses on public personnel and debt, chronically low tax collection especially for rich segments of society, large-scale tax evasion by corporations and high-income earners, and the long-term absence of a state budget that fostered current over capital expenditures and limited scrutiny over the effectiveness and efficiency of budget allocation. In effect, we demonstrate how the existing tax regime has effectively exempted the wealthier segments of society and corporations from paying their proportionate share of taxes—taxes which could fund investments in public infrastructure.

While the sudden influx of Syrian refugees exacerbated existing challenges, the refugee crisis did not create the conditions that led to the dilapidated state of Lebanon's public infrastructure. Rather, the refugee crisis provided an opportunity for the government to legitimize another call for international assistance.

To prevent future trips to Paris, Lebanon must reform its public finances by addressing inefficiencies in spending and revenue collection. Moreover, Lebanon needs to adopt a more progressive tax-regime that demands higher contributions among wealthier segments of society. In what follows, this policy brief reviews both the expenditure and revenue sides of the public budget to identify structural reasons that prevent the government from increasing its capital expenditures.

2 Government of Lebanon Capital Investment Programme. 2018. 'Conférence Economique pour le Développement par les Reformes avec les Entreprises.' April. Available at: http://www.pcm.gov.lb/Admin/DynamicFile.aspx?PHName=Document&PageID=11231&published=1.

3 An earlier policy brief focused on the poor management of resources allocated to infrastructure projects and highlighted the correlation between spending inefficiency, corruption and the low quality of public infrastructure: Garrote Sanchez, D. 2018. 'Combatting Corruption, a Necessary Step Toward Improving Infrastructure.' Policy Brief. Lebanese Center for Policy Studies.

Oversized Fixed Current Expenditures Constrain Capital Expenditures

Within a state's budget, capital expenditures are allocated to buying, maintaining, or improving a country's fixed assets, such as roads, bridges, or power plants. Capital expenditures constitute necessary investments for a country's economic and social development, as they provide opportunities for the expansion of the economy, social inclusion, and job creation.

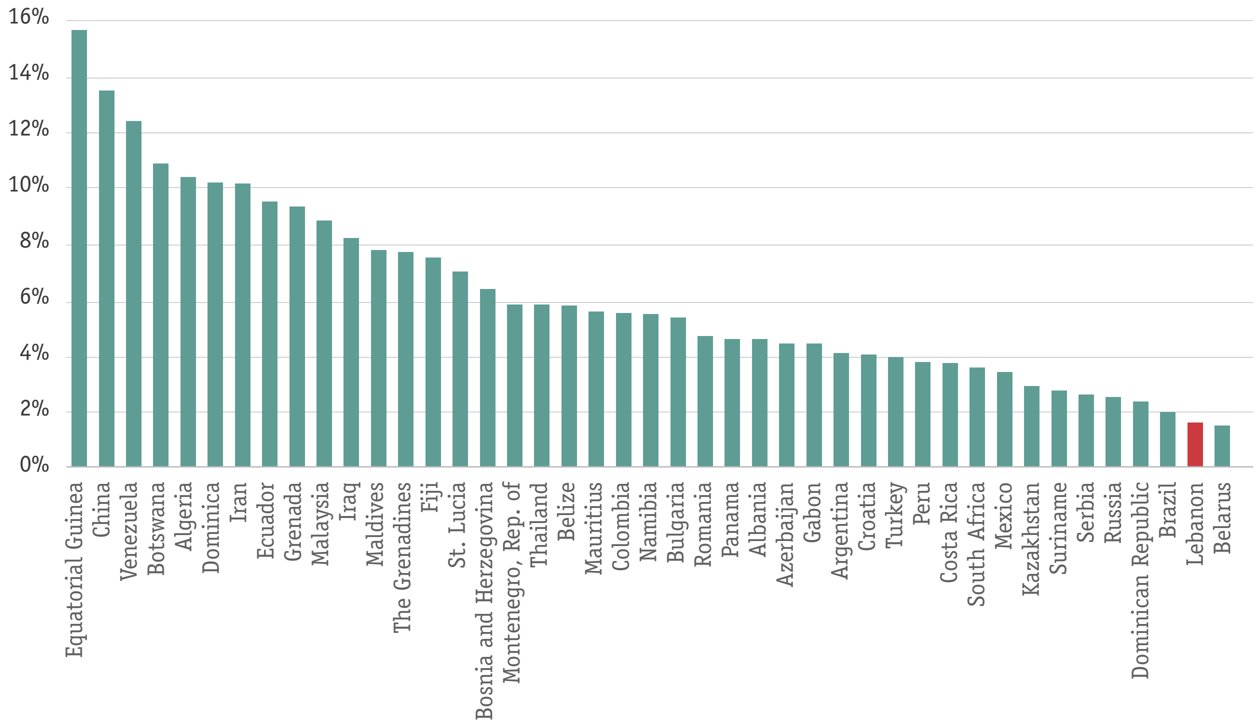
Compared to peer-countries in the upper middle-income bracket, Lebanon has one of the lowest ratios of capital spending to GDP

Since the reconstruction period in the early 90s, Lebanon's capital expenditures have declined steadily. Compared to peer-countries in the upper middle-income bracket of the World Bank classification, Lebanon has one of the lowest ratios of capital spending to GDP (figure 1). With less than 2% of capital expenditures to GDP, Lebanon ranks well below average compared to peer-countries of 6% to GDP.[4]

4 Based on the IMF Government Finance Statistics Database.

Figure 1

Capital expenditures to GDP in upper middle-income countries, 2015



Source **IMF Government Finance Statistics Database.**

The structural reasons for the low share of capital expenditures lie in governmental priorities of budget allocation and tax collection. On the expenditure side, the public budget is severely constrained by three major items: Interest payments on treasury bills, wages for public employees, and transfers, such as to Electricité du Liban. Although on a slightly declining trend, these three components alone constitute some 80% of the state budget and leave little fiscal space to expand capital expenditures in the short-term. Instead, they require consolidated, long-term efforts entailing the improvement of debt management, electricity generation, and effectiveness in public sector administration. However, as interest payments already consume more than 30% of the state's annual budget and more than 50% of total revenues,[5] they pose severe risks to the country's finances[6] and hardly serve as a primary source of additional capital expenditures.

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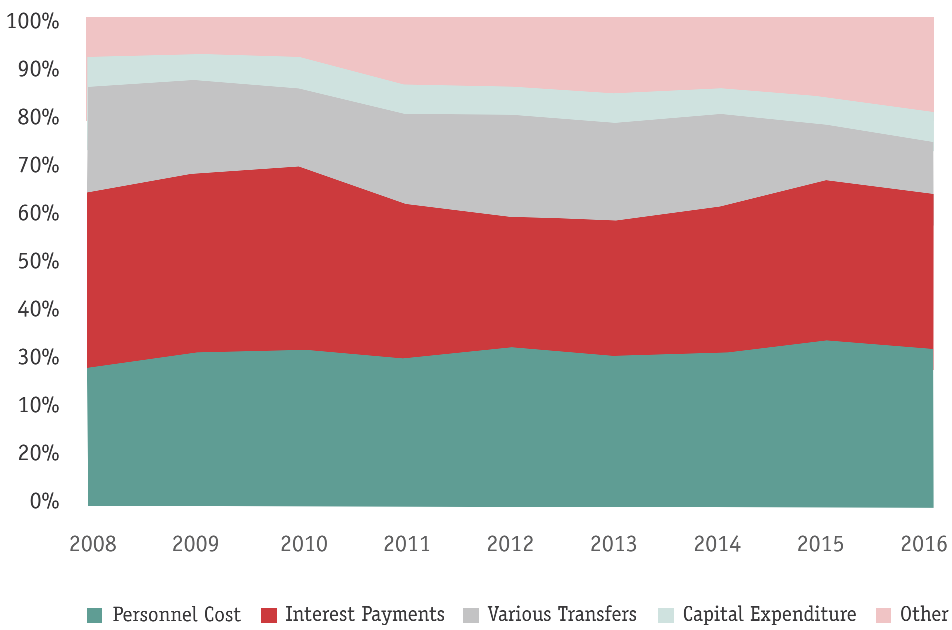
Standard Chartered. 2017. 'Lebanon - Debt Sustainability: What We Need to Know.' On the ground. May. research.sc.com.

6
IMF Article IV Consultation, February 2018. http://www.imf.org/en/News/Articles/2018/02/12/ms021218-lebanon-staff-concludingstatement-of-the-2018-articleiv-mission.

Figure 2

Share of expenditures in the public budget, 2008 - 2016



Source **Lebanese Ministry of Finance.**

The absence of an approved budget from 2005 to 2017 largely prevented the reallocation of funds among ministries, such as providing additional funds for capital expenditures. During those years, the budget was constrained by the 'Rule of 12', which limited expenditures for each ministry to an amount that could not legally exceed the level of past expenditures times a multiplier which was determined based on economic conditions. Such strict rules on budget allocation therefore severely limited the governments' options to leverage the opportunities of an approved budget for political decisions, which advantaged current expenditures at the expense of strategic decisions for long-term investments. What is more, the absence of an approved budget hampered transparent management and oversight over the execution of the budget. The parliament and the Court of Accounts—two key institutions that should play a crucial role in holding the executive accountable—have either been unwilling or unable to exercise their authority to secure efficient spending on capital expenditures.[7]

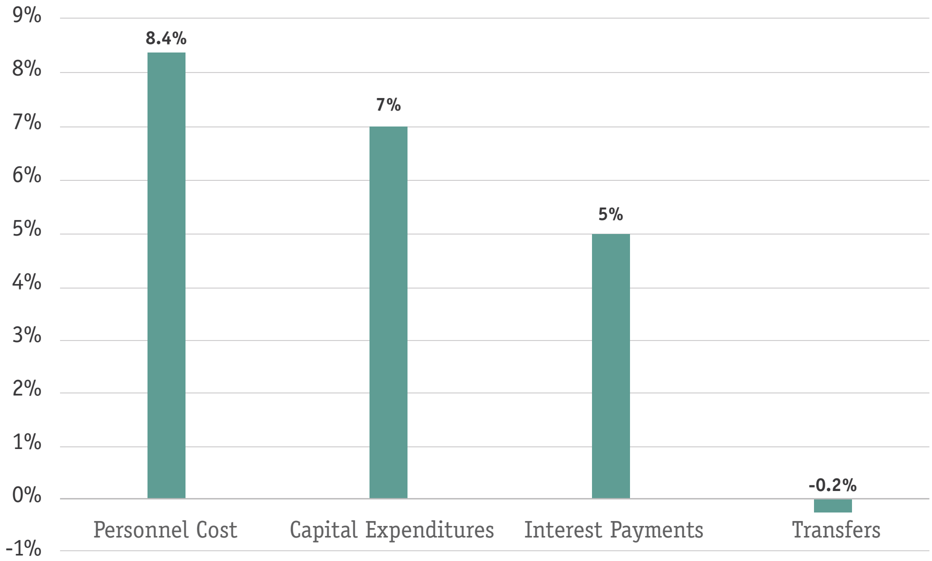
The composition of the budget will continue to severely constrain fiscal space due to the high growth of personnel and other invariant costs. The share of personnel costs was the fastest growing major expenditure item in the public budget, even before the 2017 salary increase for public servants took effect. Personnel costs increased at 8.4% per annum on average from 2008 to 2016. In the same period, interest payments and capital expenditures increased by only 5% and 7% on average, while total transfers declined slightly by (0.2%) on average (figure 3). As personnel costs already consume one-third of the public budget, the 2017 wage hikes for public employees placed further strain on state finances and need to be offset by increased tax revenues. Given the widespread abuse of public employment by the political elite, reducing clientelism in public employment should constitute a major cornerstone in consolidating the public budget in the long-term.

The composition of the budget will continue to severely constrain fiscal space due to the high growth of personnel and other invariant costs

7 Refer to Geagea, N. 2018. In The Lebanese Parliament 2009-2018: From Illegal Extensions to Vacuum, edited by S. Atallah and N. Geagea; Saghieh, N. 2013. 'مجلس النواب: آراء سياسية على حساب مراقبة الموازنة' الموازنة في لبنان: الحاجة الى شفافية في الأرقام ومساءلة حول الأداء. 2013. Lebanese Center for Policy Studies; Maalouf, E. 2013. 'ديوان المحاسبة: تشتت الرقابات وضعف الامكانات' In الموازنة في لبنان: الحاجة الى شفافية في الأرقام ومساءلة حول الأداء. 2013. Lebanese Center for Policy Studies.

Figure 3

Growth rates of major expenditure items in the public budget, 2008 - 2016



Source **Lebanese Ministry of Finance, own calculations.**

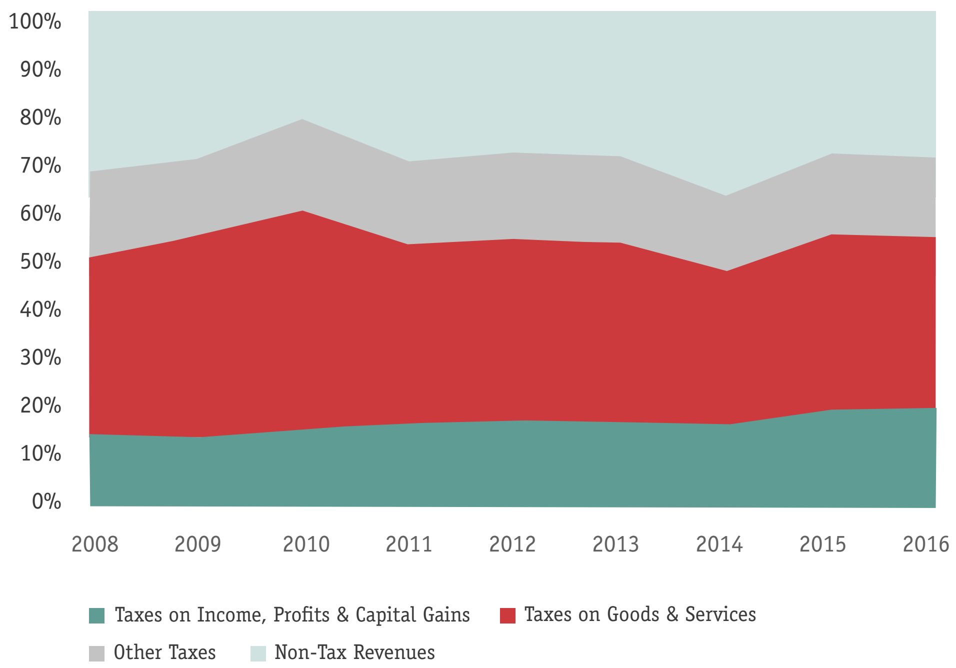
Reliance on Indirect Taxation Precludes Increases in Tax Revenues

A fair and progressive tax regime facilitates social inclusion and equity by collecting taxes based on the ability to pay. The Lebanese government, however, relies on indirect taxation that disproportionately affects the poor and benefits wealthier segments of society. Breaking down the public revenue mix by major sources of income shows that the government relies on a narrow tax base, which primarily comprises indirect, regressive taxes: Taxes on goods and services, such as VAT, and non-tax revenues, such as those garnered from excise fees (figure 4). The contribution of direct, progressive taxes on income and profits from both individuals and corporations combined, by contrast, is comparably low and averages 17% of total revenues over the past decade.

The Lebanese government … relies on indirect taxation that disproportionately affects the poor and benefits wealthier segments of society

Figure 4

Share of tax revenues to total government revenues, 2008 - 2016



Source **Lebanese Ministry of Finance.**

The share of progressive taxes to total revenues increased from 15% in 2008 to about 20% in 2016. However, during the same period, tax revenue items that burden the middle and working classes of society grew at a faster pace than tax items that affect higher incomes. For instance, tax revenues from wages and salaries (12.8%) and domestic taxes on goods (10.8%, such as on tobacco or alcohol) rose faster than tax revenues from corporate profits (8.5%), capital gains and dividends (7.7%), and property (6.2%) (figure 5). These disparate growth rates are particularly worrisome given the latter's lower initial levels, which would necessitate higher growth rates to catch up with the share of indirect taxes. Moreover, inheritance tax, which is a powerful tool to curb income inequality and finance public services, is noticeably absent in the public revenue mix. Yet, the Lebanese government shies away from tapping the country's wealth that is passed on from one generation to the next: From the already low level of direct tax income, revenue from inheritance tax contributes a meager 4.9%. Despite its extremely low levels, the growth of revenue from inheritance tax has been negative in real terms since 2011.[8]

In effect, the current tax regime continues to exert and even increases the disproportionate distribution of the tax burden at the expense of middle and lower social segments. Tax revenues from VAT increased at a slower pace (3%), which, among others, indicates a sluggish development of purchasing power and barely offsets inflation which averaged 3.4% during the same period.[9]

8
Growth rates of inheritance tax cannot be compared directly with growth rates from other revenue sources as its low levels render a comparison of average growth rates with other revenue sources misleading.

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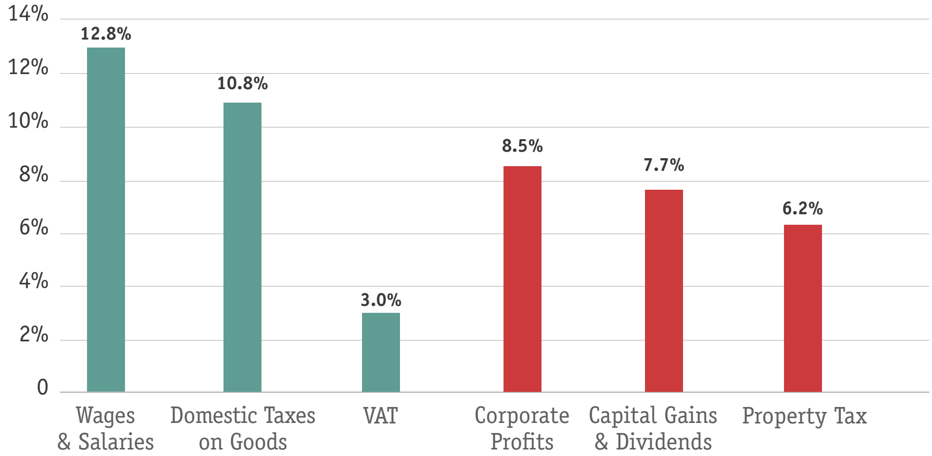
World Bank World Development Indicators.

Figure 5

Growth rate of major tax revenue items, 2008 - 2016



Source **Lebanese Ministry of Finance.**
Note **Blue tax items place a higher burden on the middle class, red items place a higher burden on the rich.**

The distribution of tax revenue items indicates the extent to which government taxes on the wealthier segments of society do not match their increase in income and wealth. The cumulative real growth of national income from 2005 to 2014 is positive only for the top 10% of income earners (figure 6).[10] By contrast, the lower 80% of income earners experienced a negative growth in real income by 10% to 25% over the same period.

Hence, by continuing to rely on indirect taxation, the prevailing tax regime effectively benefits the rich at the expense of the poor. The income growth of wealthier segments of the economy is not matched by increases in revenues from taxes on corporations and rich individuals. This unfair distribution of the tax burden across social segments has contributed to a significant increase in income and wealth inequality.[11]

[B]y continuing to rely on indirect taxation, the prevailing tax regime effectively benefits the rich at the expense of the poor

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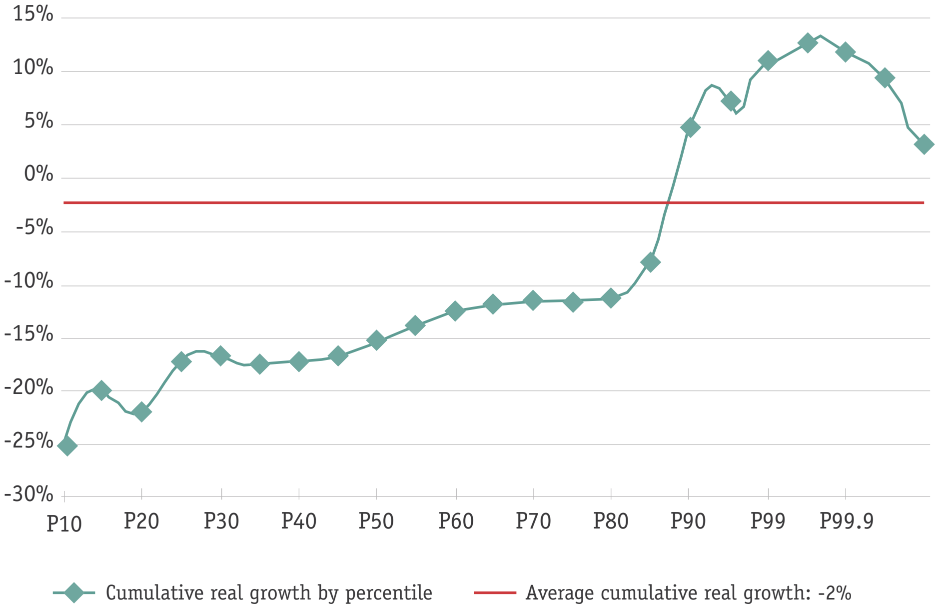
Assouad, Lydia. 2017. 'Rethinking the Lebanese Economic Miracle: The Extreme Concentration of Income and Wealth in Lebanon 2005-2014.' 13. WID. World Working Paper Series. Paris.

11
Assouad (2017) shows that income for the richer segments in Lebanon grew to such an extent over the last decade that Lebanon today ranks among the countries with the highest economic inequality in the world. The author shows that the top 0.1% of the society (roughly 3,000 individuals) receive approximately the same amount of income as the bottom 50% (1.5 million individuals). The richest 1 and 10% of income earners account for 23 and 57% of total national income. Also see: Assouad, Lydia, Lucas Chancel, and Marc Morgan. 2018. 'Extreme Inequality: Evidence from Brazil, India, the Middle East, and South Africa.' AEA Papers and Proceedings 108: 119–23. https://doi.org/10.1257/pandp.20181076.

Figure 6

Cumulative real growth of national income by percentile, 2005 - 2014



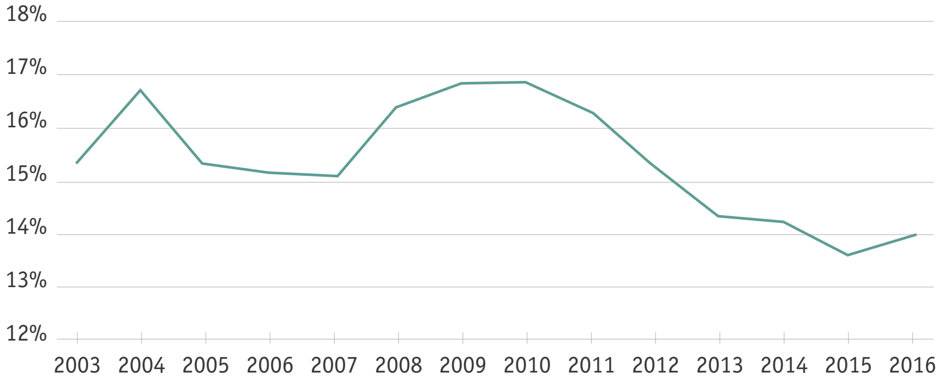
Source **Assouad 2017.**

A declining trend in the ratio of tax revenues to GDP further illustrates the disparity between rising income in the high-income brackets and low direct taxation (figure 7). The share of tax revenues to GDP declined by 2.8% from 16.7% in 2004 to 13.9% in 2016. There are two main implications of this trend: First, declining revenues despite growing GDP and the disproportional rise of high incomes indicates the government's weak capacity to collect taxes it imposes on the wealthier segments of society. The government is either unable or unwilling to tax rich individuals and corporations as their income and profits increase. Second, this trend reflects a tax regime that is highly regressive and places a relatively higher burden on the poor vis-à-vis the wealthy segments of society. The contribution of corporations and high-income earners to national GDP rose faster than their relative taxation.

The government is either unable or unwilling to tax rich individuals and corporations as their income and profits increase

Figure 7

Share of tax revenues to GDP in Lebanon, 2003 - 2016



Source **World Bank, World Development Indicators Database.**

While maintaining low nominal taxation on high-incomes relative to the wealth of the economy constitutes a challenge in and of itself, Lebanon's tax collection is comparably low relative to the size of its economy and susceptible to evasion. Compared to peer-countries in the middle-income bracket, Lebanon's ratio of tax revenues to GDP was 13.6% in 2015, which ranked it well below the world-average of middle income countries with 16.4% (figure 8). Catching up with the world-average of countries with a comparable income could by itself match the pledges of the CEDRE conference. By increasing the share of tax revenue to GDP by the 2.8% needed to be at par with peer countries, Lebanon could raise an additional $1.25 billion per year in revenues, which is equivalent to pledges made by donors at the CEDRE conference ($11 billion over a ten-year period).

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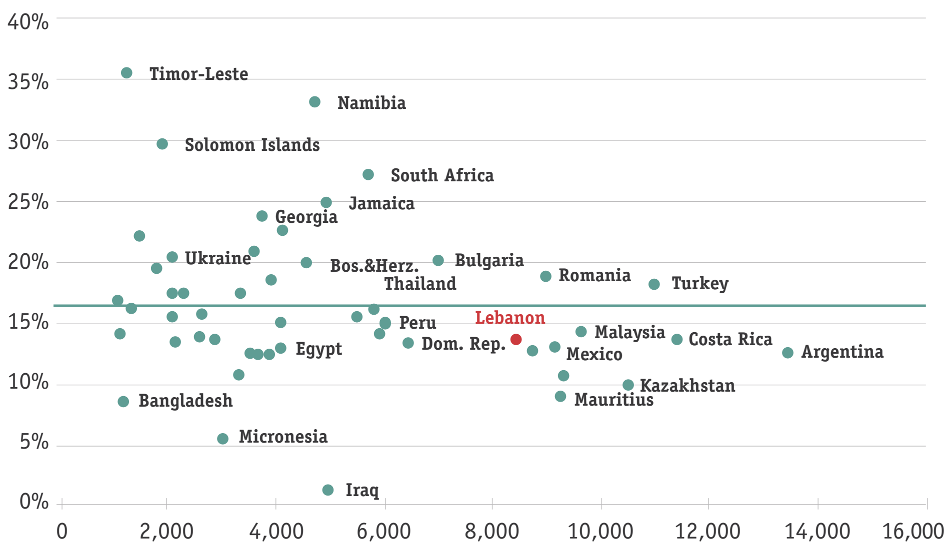
Figure 8

Share of tax revenues to GDP per capita for middle income countries, 2015[12]



Source **IMF, Financial Statistics Database.**

The magnitude of tax evasion constitutes another important indicator for the weakness of the Lebanese government to collect taxes. Two recent reports provide an estimate about the amount of tax evasion in Lebanon, which totaled between $1.13 billion in 2015 (2.28% of GDP)[13] and $5 billion (10% of GDP).[14] Such a fiscal evasion gap is nearly equivalent to Lebanon's budget deficit and in comparison to other upper middle-income countries, Lebanon again fares much worse than the world-average of about 0.7% of GDP.[15] The reports find that income tax evasion on corporate profits as well as on wages and salaries cause the brunt of foregone tax revenue, triggered by frail implementation of corporate governance. In fact, Lebanon's rate of corporate tax evasion to total revenue of corporate taxes amounts to 54%. In other words, the untapped potential for taxation on corporate profits constitutes more than half of the taxes actually paid, which places Lebanon well below the world average (figure 9).[16]

The untapped potential for taxation on corporate profits constitutes more than half of the taxes actually paid

12
The choice of countries compared in this graph is determined by data availability, which is limited for tax data.

13
Blominvest Bank. 2017. 'Tax Evasion in Lebanon: How Much of a Burden?' Beirut. http://blog.blominvestbank.com/wp-content/uploads/2017/11/Tax-Evasion-in-Lebanon-How-Much-of-a-Burden.pdf.

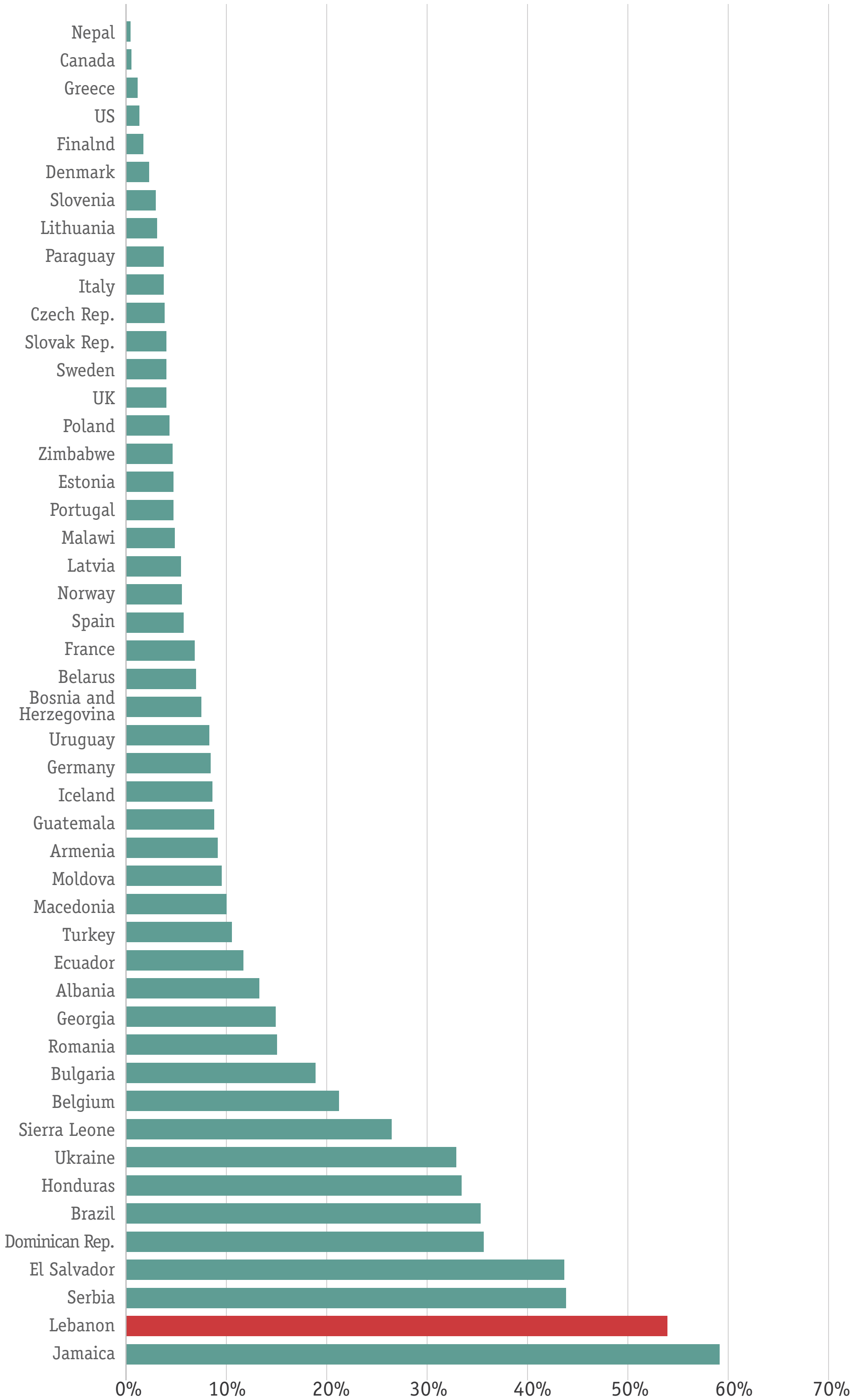
14
Bank Audi. 2018. 'Lebanon Economic Report.' Beirut. http://www.databank.com.lb/docs/Lebanon Economic Report-Q2 2018.pdf.

15
Janský, Petr, and Miroslav Palanský. 2017. 'Estimating the Scale of Profit Shifting and Tax Revenue Losses Related to Foreign Direct Investment.' Prague, Czech Republic. https://ecpr.eu/Filestore/PaperProposal/6439202f-3956-4bcc-8e43-02733e51280a.pdf.

16
Estimating tax evasion is chronically difficult. There exist a variety of methodologies to estimate the extent of tax evasion in a country. Given that the methodologies in the three sources are not directly comparable and can constitute only rough estimates, they need to be read with care. However, they give a sense of the magnitude of the problem.

Figure 9

Share of estimated tax revenue losses on total corporate tax revenue, 2015



Source **Janský and Palanský 2017; Blominvest Bank 2017.**

Avoiding Future Trips to Paris

Our analysis of Lebanon's budget and revenue composition shows that the reasons for the low share of capital expenditures and thereby chronically low investment rates originate in the domestic political economy rather than from exogenous shocks—that is, the Syrian refugee crisis. Contrary to government claims made around the CEDRE conference, the influx of Syrian refugees only exacerbated the pitiful trajectory of deterioration of Lebanon's public infrastructure—it did not create the structural conditions that necessitated international assistance.

We identify several factors for Lebanon's low share of capital expenditures. Lebanon suffers from systematically low tax collection rates and tended to rely on increases of indirect taxation in the past, rather than progressive taxation on wealthier segments of society. Yet, leaving Lebanon's wealth largely untapped, it remains unavailable for necessary investments in public infrastructure and thereby inaccessible for most of the Lebanese population.

Contrary to government claims made around the CEDRE conference, the influx of Syrian refugees only exacerbated the pitiful trajectory of deterioration of Lebanon's public infrastructure—it did not create the structural conditions that necessitated international assistance

To increase the fiscal space for capital expenditures in the national budget, the government would need to ensure a fairer tax regime. Given the high poverty rates in the country, further increasing indirect and thereby regressive taxation to increase the governments' fiscal space to finance capital expenditures entails high risks for the economy and would place further strain on poorer segments of society. Instead, direct and progressive taxation such as higher income tax or taxes on capital gains could constitute a more equitable and economically viable way to finance capital expenditures. However, given the high entrenchment of the political elite with the private sector,[17] increasing taxation of high-income earners and large corporations is unlikely to occur by itself and requires pressure from both international donors and civil society.

Although political parties highlighted inefficiencies in budgetary spending during the 2018 parliamentary election period, they have failed to address its root causes. Instead of classifying expenditures on the few remaining public cultural activities, such as music festivals, as 'wasteful spending' as suggested by the head of the budgetary committee, Mr. Ibrahim Kanaan,[18] the government should 1) review hiring practices and increase efficiency in public sector employment 2) reduce mismanagement in the allocation of revenues and

17
Chaaban, Jad. 2016. 'I've Got the Power: Mapping Connections between Lebanon's Banking Sector and the Ruling Class.' 1059. Working Paper Series. Cairo.

Diwan, Ishac, and Jamal Ibrahim Haidar. 2017. 'Do Political Connections Reduce Job Creation? Evidence from Lebanon.' Mimeo. http://scholar.harvard.edu/files/haidar/files/diwanhaidar-pcjc-01142017.pdf.

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Abu-Nasr, D., D. Khraiche, and O. Ant. 2018. 'It Could Be Crunch Time for World's Third Most-Indebted Country.' Bloomberg. Available at: https://www.bloomberg.com/news/articles/2018-03-05/it-could-be-crunch-time-for-worlds-third-most-indebted-country.https://www.bloomberg.com/news/articles/2018-03-05/it-could-be-crunch-time-for-worlds-third-most-indebted-country.

public procurement, 3) strengthen the tax base by increasing direct taxation, in particular taxes on high incomes, wealth, and inheritance and 4) reduce tax evasion by strengthening tax offices and corporate surveillance. Improving Lebanon's tax regime according to these guidelines can secure sustainable state finances that prevent future trips to Paris.

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About the Policy Brief
A Policy Brief is a short piece regularly published by LCPS that analyzes key political, economic, and social issues and provides policy recommendations to a wide audience of decision makers and the public at large.

About LCPS
Founded in 1989, the Lebanese Center for Policy Studies is a Beirut-based independent, non-partisan think-tank whose mission is to produce and advocate policies that improve good governance in fields such as oil and gas, economic development, public finance, and decentralization.

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