2014 Fiscal Balance: Short-Term Improvement

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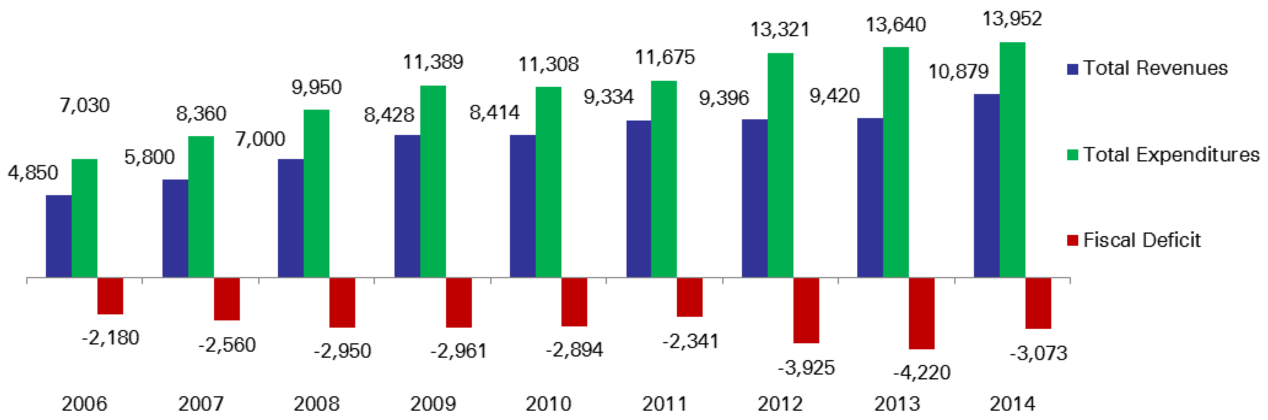
In June 2014, oil prices were slashed from a high of $112 to a low of $58 in December 2014. This bearish trend meant different things to the fiscal balances of oil importing countries and to those of oil exporting countries. For Saudi Arabia, the world's biggest oil exporter, the news meant the Kingdom might face its first fiscal deficit since 2011 while for Lebanon, the news raised hopes for a smaller fiscal deficit. According to Bank of America Merrill Lynch, "the fiscal deficit is likely to ease on lower oil prices but reform remains needed to decrease vulnerabilities".

The following lines depict the improvement witnessed in the Lebanese fiscal balance during the year 2014. However, this improvement might be short-lived as it stemmed from exceptional circumstances. In its latest concluding statement, the IMF noted that "Exceptional factors allowed for a welcome primary surplus in 2014, but without decisive action, fiscal deterioration will continue in 2015."

Overall Improvement in the Fiscal Balance

Lebanon's fiscal balance recorded a significant improvement in 2014. According to the Ministry of Finance, Lebanon's fiscal deficit narrowed by a yearly 27% to $3.07B in 2014. Total revenues grew by a yearly 15.48% to $10.88B and outpaced the 2% yearly growth in total expenditures to $13.95B. The primary balance, referring to the fiscal balance excluding debt service, recovered after two years of being in the red. Lebanon's primary balance stood at $1.31B in 2014 as compared to deficits of $239.68M in 2013 and $109.87M in 2012. The share of the fiscal deficit in the Gross Domestic Product (GDP) retracted from 9.3% in 2013 to 6.4% in 2014 and the share of the primary balance in GDP also recovered from a deficit of 0.53% in 2013 to a surplus of 2.73% in 2014.

Government Revenues, Expenditures and Fiscal Balance (In $M)



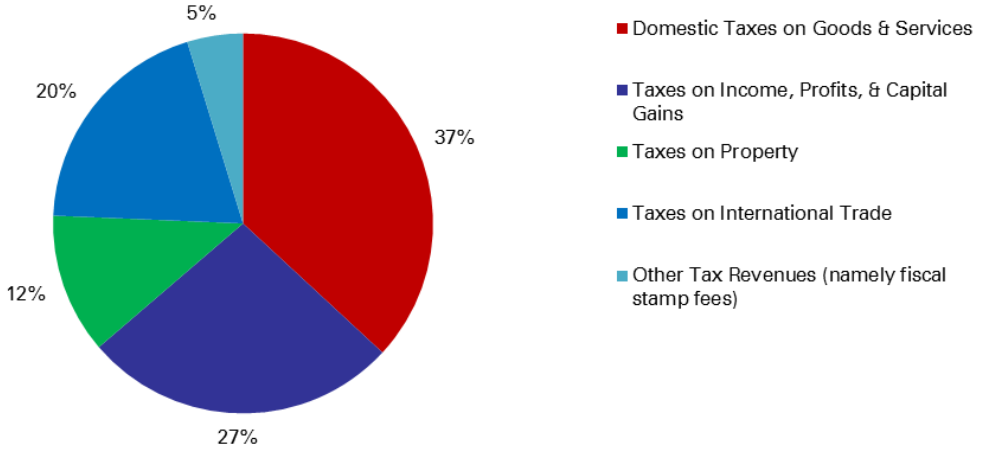
Source: Ministry of Finance

Revenues Registered Upturns across the Board

Both tax and non-tax revenues boosted total budget revenues in 2014. Budget revenues increased from $8.88B in 2013 to $9.78B in 2014, as tax revenues rose from $6.71B in 2013 to $6.89B in 2014 and as non-tax revenues increased from $2.17B in 2013 to $2.89B in 2014. Treasury receipts also grew from $541.30M in 2013 to $1.1B in 2014.

Tax Revenues: All on the Up at the Exception of Taxes on International Trade

Composition of Tax Revenues in 2014



Source: Ministry of Finance

The 2.69% growth in tax revenues to $6.89B in 2014 came on the back of upturns in:

- Taxes on domestic goods and services
- Taxes on income, profits and capital gains
- Taxes on property

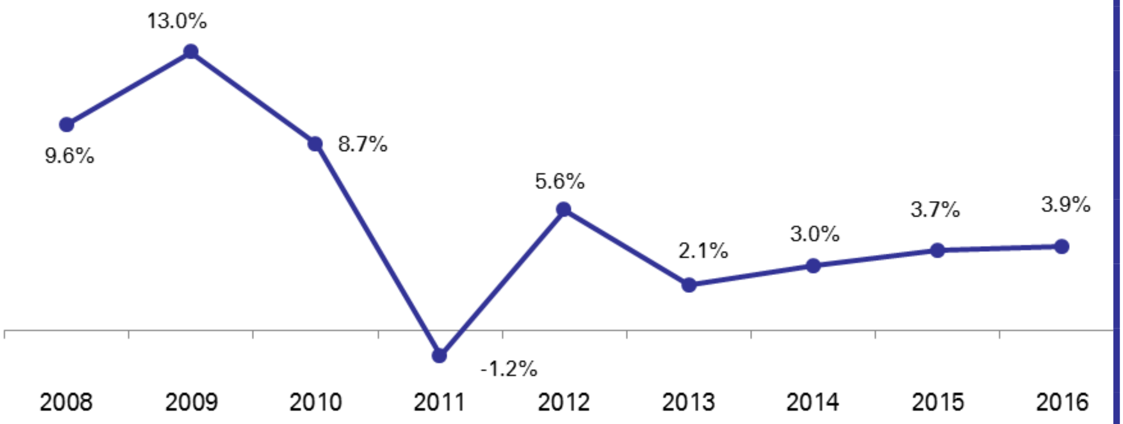
These upturns overshadowed the downturn in taxes on international trade.

Taxes on domestic goods and services

In 2014, the Value Added Tax (VAT) generated almost the same revenues as in 2013. The Value Added Tax (VAT) generated $2.19B in revenues in 2014 as compared to $2.18B in 2013. The fact that the VAT revenues remained almost steady can be explained by two things: first, the improved collection of VAT along with the adherence of new businesses to the VAT system; second, since the VAT is applied on both domestic and imported goods and since the value of collected customs' fees dropped in 2014, the small uptick in the VAT can be therefore linked to higher consumption of domestic goods.

However, the 2014 growth in VAT revenues pales in comparison with that of previous years, when the economy was expanding rapidly. The 0.2% upturn in VAT revenues is minor compared to double-digit growths of 11.8% in 2009 and 10.5% in 2010. The slowdown in growth, demand and consumption after 2010 lies behind the weaker evolution of VAT revenues. According to Business Monitor International, the real growth of private final consumption slumped from 8.7% in 2010 to -1.2% in 2011. After recovering from this low base, the real growth of private final consumption settled at a low floor reaching 3.0% in 2014.

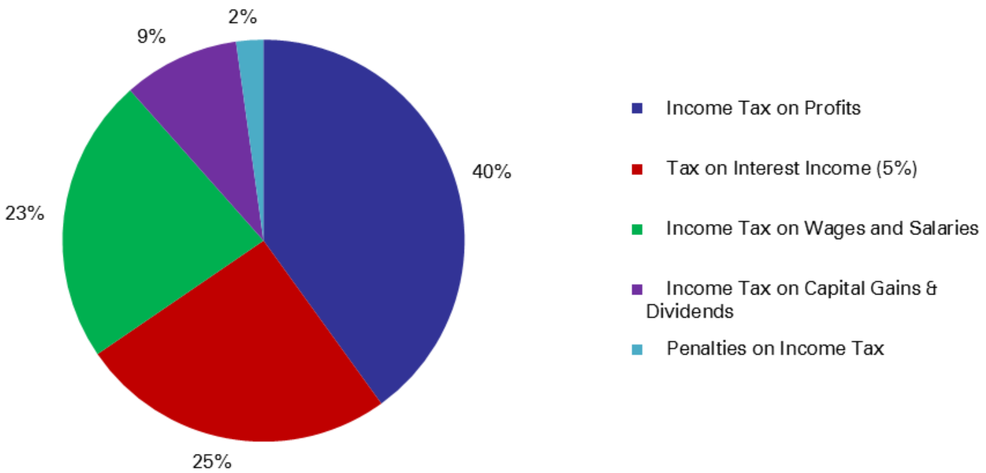
Real Year-on-Year Growth of Private Final Consumption



Source: Business Monitor International

Taxes on income, profits and capital gains

Composition of taxes on income, profits and capital gains



After falling in 2013, the income tax on profits recovered in 2014 due to the collection of some arrears (uncollected taxes from previous years) and to the administrative and compliance efforts led by the Ministry of Finance. The higher revenues generated by the income tax on profits came about due to these extraordinary collections which do not represent the current subdued economic backdrop.

Meanwhile, the 5% tax on interest income also generated higher revenues in 2014 as deposits in the Lebanese banking sector posted yet another robust growth of 6% in 2014 to $144.18B. Taxes on income, profits and capital gains also got a boost from increases in the income tax levied on wages and salaries, the income tax levied on capital gains and dividends and the penalties on the income tax. Taxes on property which include the built property tax and real estate registration fees also rose in 2014 because they concern projects that have started three to four years ago, when the real estate sector was still booming, and that are being delivered during 2014. Moreover, efforts in standardizing the valuation of properties and fighting corruption seem to be bearing fruit.

Taxes on international trade

However, taxes on international trade, which include customs, excise on tobacco and cars all registered decreases in 2014 since the overall value of imports declined by an annual 3.48% to $20.49B in 2014. In fact, the purchasing power of Lebanese consumers rose due to the appreciation of the US dollar against the euro and the low oil prices but it might also be that consumers continued to buy the same basket of imports with a lower price tag and directed their excess in purchasing power to domestic goods. The steering of excess purchasing power to domestic goods supports our above assessment of VAT receipts.

However, overall tax revenues have been subdued ever since economic growth started to slump back in 2011. Double-digit growth rates have gradually turned into either minor single-digit growth rates or into decreases. The few recoveries in growth posted by some category of tax revenues are merely a recovery from a low-base.

Annual Growth Rate of Tax Revenues

	2010	2011	2012	2013	2014
Tax Revenues	11%	-1%	3%	-1%	3%
Domestic Taxes on Goods & Services, of which:	10%	3%	2%	1%	1%
Value Added Tax	10.5%	3.3%	-0.7%	0.6%	0.2%
Taxes on Income, Profits and Capital Gains, of which	11%	18%	4%	-1%	12%
Income Tax on Profits	11%	28%	-3%	-3%	15%
Income Tax on Wages and Salaries	8%	20%	15%	12%	9%
Income Tax on Capital Gains and Dividends	19%	14%	22%	-22%	13%
Tax on Interest Income (5%)	13%	4%	-1%	2%	8%
Penalties on Income Tax	8%	80%	6%	16%	25%
Taxes on Property	34%	5%	4%	1%	4%
Taxes on International Trade	5%	-22%	3%	-4%	-5%

Non-Tax Revenues Boosted by One-Off Telecom Transfers

Non-tax revenues increased from $2.17B in 2013 to $2.89B in 2014. This improvement was due to upturns in the following revenues:

- Revenues from Casino du Liban
- Transfers from the Telecom Surplus
- Revenues from the Port of Beirut

The Telecom revenues are by far the largest government non-tax revenues. Telecom revenues amounted to $2.01B in 2014, up by a substantial 41% from 2013's $1.43B. The increase in telecom transfers in 2014 was the core element ensuring the recovery of the primary deficit and the resorbing of the overall fiscal deficit. This upturn is however short-lived as it came about due to exceptional one-off transactions: The Ministry of Telecom transferred $1.3B over the period January-August 2014 to the Ministry of Finance. The Ministry of Finance also cashed-in on accrued telecom revenues worth $0.4B for the period January-May 2014 on behalf of municipalities. Since these revenues have not been redistributed to municipalities, they contributed in boosting non-tax revenues.

Had it not been for the one-off telecom transfers, the fiscal deficit would have represented 7.6% of GDP rather than 6.4% and the primary surplus would have represented 1.52% of GDP as compared to the actual 2.73%.

Port of Beirut's transfers to the Treasury have increased in 2014. However, the increase is not due to higher Port revenues but rather to low transfers back in 2013, when large investment projects were carried out, as the Port's transfers to the Ministry of Finance represent what is left of the Port's revenues after accounting for its current and investment spending. Notably, government revenues from the Port of Beirut were the second largest constituent in the income from public institutions and government properties.

Total Expenditures Focused on Personnel Costs, Interest Payments and EDL Transfers

Total expenditures grew by a yearly 2.28% to reach $13.95B in 2014. Expenditures are mainly disbursed for Personnel Costs (salaries, wages, retirement and end of service indemnities) which represent 32% of total expenditures and which grew by a yearly 4% to reach $4.46B in 2014. Interest payments (on domestic and foreign debt) represent 30% of total expenditures while transfers to Electricité du Liban (EDL) constitute 15% of total expenditures.

Amongst these components, the largest yearly increase of 11% was registered in the value of interest payments which totaled $4.19B in 2014. This increase was mainly due to the 18% upturn in domestic interest payments to $2.61B and was due to a lesser extent to the 0.31% uptick in foreign interest payments to $1.58B. The value of domestic debt increased by an annual 9.7% to $40.96B in 2014 while foreign debt declined by an annual 2% to $25.61B. Interest payments on both domestic and foreign debt have increased more than the increase in the stock of debt while interest rates did not change. Therefore, the increase in interest payments may be due to the fact that banks are favoring long-term higher-yield debt instruments in the face of shrinking profit margins. Longer debt maturities are also serving the debt management strategy of the government that wants to lock interest rates for longer maturities before the expected increase in the Federal Reserve's rates and to reduce its refinancing risk in an unstable domestic political environment. The average maturity of Lebanon's Treasury-bills' portfolio was indeed extended from 1,048 days during July 2012 – June 2013 to 1,221 days in the period July 2013 – June 2014.

As for transfers to EDL, they increased in 2014 in spite of the slump in oil prices. The effect of lower oil prices has not been materialized in lower transfers to EDL since the transfers of 2014 correspond to a previous consumption period. An illustrative example: The January to August 2014 fuel oil bill is related to the consumption period August 2013 – April 2014, during which the slump in oil prices has not yet started. However, in the coming period, the effect of low oil prices is bound to be reflected in lower transfers to EDL.

The structure of the government's expenditures reveals the marginalization of capital expenditures. Current expenditures make up 96% of total expenditures while capital expenditures, excluding the foreign financed parts of the projects that are provided directly to the Council of Development and Reconstruction, make up only 4% of total expenditures. The importance of capital expenditures lies in the fact that they are destined for long-term investments aimed at boosting the country's infrastructure: Building roads, airports, water networks…etc. and hence increasing the potential gross domestic product of the economy.

However, with a large fiscal deficit and a substantial debt burden, the government may not have the necessary resources to boost capital spending. That is why Lebanon should resort to structures such as privatization, public-private partnerships (PPP) and Build-Operate-Transfer (BOT) where the private sector tends to the problem of lack of public funds by financing a given project in exchange for a stake in the future profits.

Overall, Lebanon's fiscal deficit tightened in 2014 but this was due to one-off transactions that boosted government revenues. If we were to seek a lasting improvement in the fiscal balance, reforms need to be implemented to steer government spending towards long-term productive investments that would boost economic growth which in turn will generate higher government revenues. However, implementing any kind of fiscal policy requires the political deadlock to be untangled. Due to political instability, the country has not been able to pass a budget for the past 10 years and problematic issues such as the passing of the new rent law (which experts believe may generate $1.2B in built property tax for the government), and the financing of the salary scale remain unresolved.

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