2016: Deterioration of Lebanon's Fiscal Performance

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By 2016, the Syrian Crisis was in its fifth year. Lebanon recorded climaxing political, economic, and regional vulnerabilities, which constituted a direct impediment to economic growth. During the year, the continued global slump in oil prices was a "temporary" advantage for an oil-importing economy like Lebanon. October 2016 also carried a positive, needed breakthrough for Lebanon, as the two-and-a-half year political deadlock was released with the election of a new president, and shortly afterwards, the formation of a new cabinet. However, in reality, the country's fiscal deficit as well as its primary surplus continued deteriorating through 2016, coupled with exacerbated debt metrics. On the long-run, the financial, fiscal, and economic woes risk tarnishing the government's credibility vis-à-vis foreign investments and expatriates' remittances, both of which are crucial to the dynamics of the Lebanese economy. Therefore, 2016's fiscal performance calls again for fundamental reform of national policies and a draft national budget, to help dilute the tax revenues debilitated by the Syrian Crisis and tighten the belt on current spending while enhancing capital expenditures to secure long-term growth.

Public finance: General Overview

Lebanon's overall Fiscal Deficit Widened by 25.09% in 2016. According to the Ministry of Finance, Lebanon's fiscal balance was exacerbated in 2016, with the deficit climbing by a yearly 25.09% to LBP 7,453B ($4,944M). The year carried multi-faceted developments, namely the ongoing regional repercussions of the Syrian crisis and the national election of a new president for Lebanon in October 2016. The World Bank's April 2017 Lebanon economic outlook report also confirmed that progress on fiscal reforms in the past year was absent. The growth in the fiscal deficit came on the back of a 9.9% increase in expenditures, which outpaced the 3.63% uptick in total government revenues.

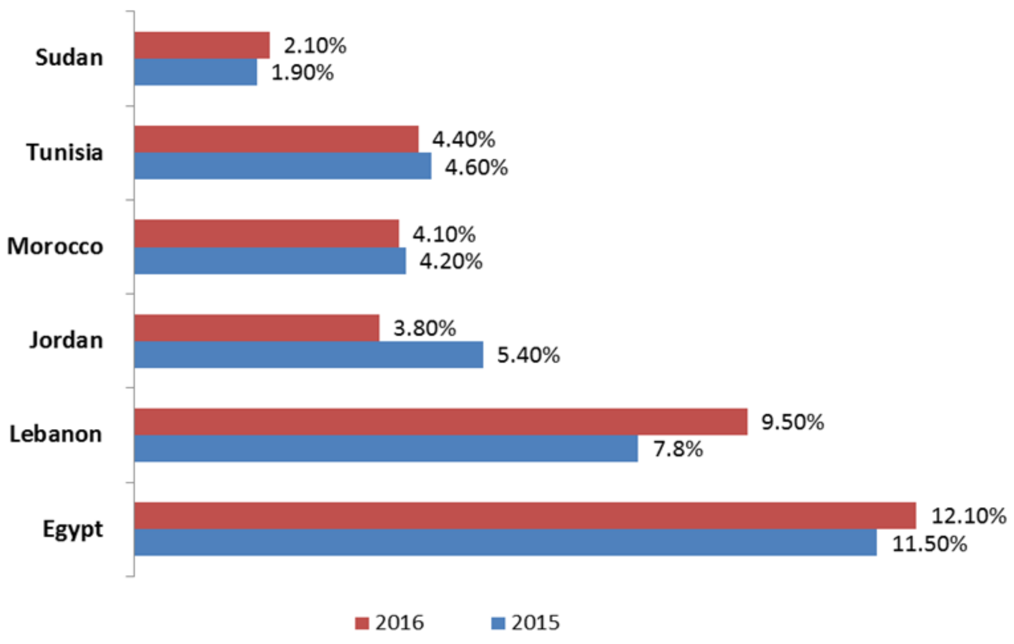
Lebanon remains a marginally growing economy and this capitalizes on its "frail" macro-fiscal framework. The World Bank reiterated in April 2017, "*Lebanon [i]s the largest host (on a per capita basis) for displaced Syrians*". The presence of Syrian refugees coupled with the absence of urgent structural reforms on government revenue and/or spending in 2016 inflated expenses and provoked the swelling of the fiscal deficit.

As a result, the primary surplus (the fiscal balance excluding debt servicing) in 2016 was 'capped' at a modest 0.04% of GDP and lagged behind two benchmarks. The primary surplus is key within a highly indebted economy, for it indicates the country's ability to put high national debt-to-GDP ratios on a sustainable path. However, Lebanon's primary surplus alarmingly lagged behind 2015's surplus of 1.4% of GDP, which was largely nurtured by the global 46.1% slump in average oil prices between 2014 and 2015. The country's surplus contracted from 2015's LBP 1,092B ($724.4M) to LBP 31B ($20.61M) last year.

Lebanon ranked "before last" on 2016's fiscal performances among regional oil-importing economies. A regional comparison of the deficit balances among some of the oil-importing economies reveals the fiscal deficits of Egypt, Jordan, Morocco, and Sudan grasped 12.1%, 3.8%, 4.1 %, and 2.1% of GDP, respectively, in 2016, while Lebanon's constituted a 9.54% of GDP, up from 2015's 7.76% stake.

However, with the implementation of IMF-reforms, Egypt's fiscal deficit is projected to narrow. Egypt's Fiscal Deficit in 2016 constituted 12.01% of GDP and is expected to decline to 10.86% in 2017, as per the World Economic Outlook. In Lebanon, 2016's deficit stood at 9.54% of GDP and it remains unclear how it will follow in 2017. In addition, growth rates for Egypt are estimated at 4.3%, 3.5%, and 4.47% in 2016, 2017, and 2018, respectively, whereas Lebanon's stand at 1%, 2%, and 2.5%, respectively.

Overall Fiscal Deficit in Regional Oil-importing Economies (% of GDP)



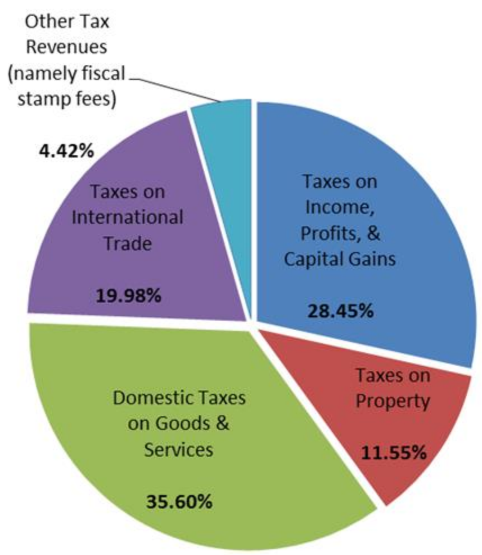
Graph: Blom Invest Bank; Data: Lebanese Ministry of Finance (MoF), IMF Article IV, & World Bank

Government Revenues

Total government revenues, including budget (tax and non-tax) revenues and treasury receipts rose by a yearly 3.63%. Budget revenues rose from LBP 13,365B in 2015 to LBP 13,989B in 2016 as tax revenues rose by 2.69% year-on-year (y-o-y) to stand at LBP 10,597B and non-tax revenues recorded a 2.62% annual uptick to reach LBP 3,392B. In turn, treasury receipts rose from LBP 800B in 2015 to LBP 970B in 2016.

The year-on-year (y-o-y) growth in total tax revenues was fueled by the growths registered in 4 out of the 5 taxation constituents.

Constituents of Tax Revenues in 2016



Source: Blom Invest Bank; Data: Ministry of Finance

The annual up ticks were recorded in taxes on: *Domestic goods and services*; *Income, profits, and capital gains*; *International Trade*; and *Property.* These masked the decline registered in "*Other" tax revenues* (from fiscal stamp fees).

Key Accounts in 2016's Tax Revenues

		2015	2016
Tax Revenues *(in LBP billions)*	Domestic Taxes on Goods & Services, of which:	3,717	3,773
	Value Added Tax (VAT)	*3,159*	*3,234*
	Private Car Registration Fees	*238*	*236*
	Taxes on Income, Profits, & Capital Gains, of whicl	2,887	3,015
	Income Tax on Profits	*1,103*	*1,143*
	Income Tax on Wages and Salaries	*667*	*702*
	Tax on Interest Income (5%)	*767*	*819*
	Taxes on International Trade, of which:	2,064	2,117
	Customs	*713*	*706*
	Excises, of which:	*1,350*	*1,411*
	Gasoline Excise	*629*	*680*
	Tobacco Excise	*239*	*228*
	Cars Excise	*477*	*497*
	Taxes on Property, of which:	1,179	1,224
	Built Property Tax	*239*	*255*
	Real Estate Registration Fees	*773*	*802*

Source: MoF

Revenues from the Value added tax (VAT) imposed on domestic and imported goods and services (G&S) climbed by 2.38% y-o-y. The VAT is the largest constituent of taxes on G&S consumed locally. As such, internally collected VAT stood at LBP 3,234B in 2016, instead of LBP 3,159B in 2015.

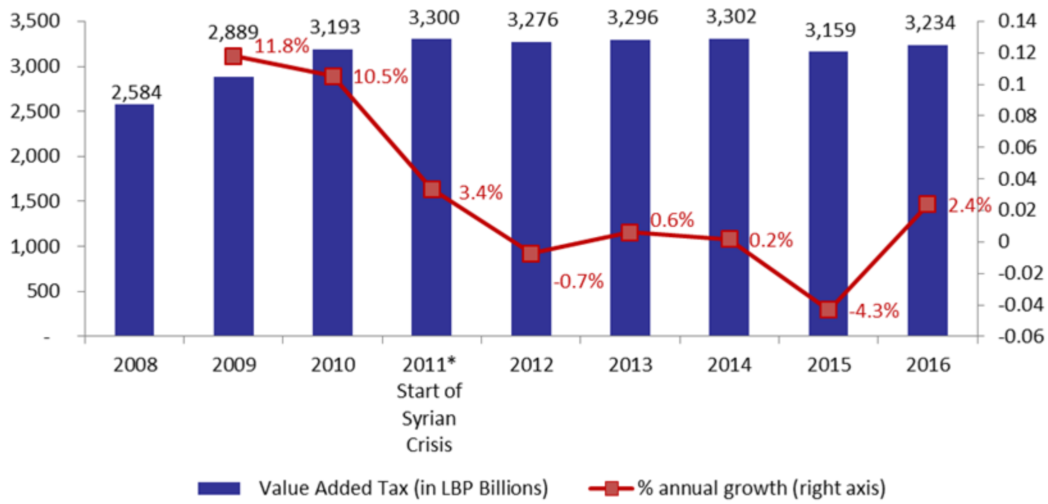
The rise in 2016 VAT revenues can be partly attributed to the government's expansionary fiscal stance. The year 2016 showed no sign of inflationary pressures; the average yearly inflation rates stood at -3.68% and at -0.77% in 2015 and 2016, respectively. Therefore, the VAT tax revenue rose as the Lebanese government adopted fiscal policy as a tool to raise income whilst expenditures continued to rise (as the next section will explore). Lebanon is a highly indebted economy (debt reached 144% of GDP, equivalent to $74.89B by December 2016) with very limited fiscal space, so actively boosting tax revenues can create room within the nation's budget for better public finance management.

Nonetheless, Domestic taxes on G&S driven by the VAT witnessed a deceleration in growth since the Syrian Crisis.

First, it is important to note that Private consumption increased by an annual 3% in 2015 and stabilized at the same rate in 2016 and 2017. Second, Domestic taxes on G&S increased by an incremental 1.51% y-o-y to LBP 3,773B in 2016 on the back of decelerating growth rates recorded for VAT revenues. Income from VAT contracted by a 4.3% y-o-y in 2015 and grew by a marginal 2.4% in 2016, compared to growth levels pre-Syrian crisis as depicted below.

Hence, the rise in Domestic taxes (driven by VAT revenue increase) is not a positive indication to an improving economy in 2016. Overall, Lebanon suffers an ongoing slump in total Domestic tax revenues since 2011, the year the Syrian crisis struck, as depicted below.

V.A.T: Revenues and Growth (yearly)



Graph: Blom Invest Bank; Data: MoF

Private car registration fees remained almost constant (grasping 2.23% of Domestic taxes) despite the decline in the drop in registration of new cars. Revenues from fees on cars' registration fell from LBP 238B in 2015 to LBP 236B in 2016 mainly due to the 6.7% drop in registration of new cars. In 2015, total new cars registered amounted to 41,654 cars, compared to 38,874 cars in 2016. Therefore, the 0.97% y-o-y uptick in 2016's car registration revenues may be attributed to an increase in the registration of used cars.

As for the Income tax component, it maintained an upward trend since 2014, constituting 28.45% of tax revenues in 2016. Income tax divides income into 4 main constituents: income on Profits (10.79% of total income tax), followed by wages and salaries (6.62%), capital gains and dividends (2.72%), in addition to tax on interest income (7.72%).

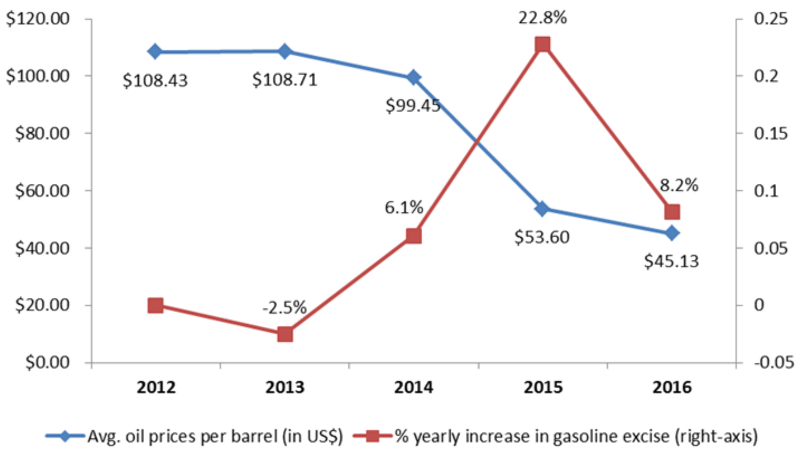
Income tax on profits rose by 3.67% y-o-y, owing to the collection of dues from the closure of many businesses. After contracting in 2015, income tax on profits recovered from LBP 1,103B to LBP 1,143B in 2016. It is worth mentioning that profits' taxes collected in 2016 are in general related to companies' results of 2015. Since the latter year witnessed a decline in the activity of the private sector, profits' taxes were expected to decline. However, the closure of 1,866 enterprises after they filed to the Ministry of Finance the *ceasing of operations* and obtained a letter of discharge from the ministry, led to a one-off increase in the profits' taxes, as the results of the Ministry's audit of these companies' accounts inflated 2016's income tax on profits.

The 5% income tax on Interest was also pulled up thanks to the resilient banking sector. Revenues from interest income rose from LBP 767B in 2015 to LBP 819B in 2016, as banks' private sector deposits edged up by 7.2% in 2016 to hit $1625.B in 2016.

Similarly, income tax levied on Wages and salaries recorded a yearly 5.14% uptick. They increased from LBP 667B in 2015 to LBP 702B in 2016.

As for taxes on International trade, they increased as a result of higher excise revenues. Total taxes on trade gained an annual 2.57% to stand at LBP 2,117B in 2016. Even though Customs' revenues fell from LBP 713B in 2015 to LBP706B in 2016, the decline was shadowed by the higher returns from gasoline and cars' excises. In details, the fuel excise added 8.15% y-o-y to reach LBP 680B in 2016, on the back of lower oil prices that increased fuel consumption. The average oil price slid by a yearly 16% and stood at $45.13/barrel in 2016.

Fuel Excise and Average Oil Prices



It is worth noting that in November 2016, the OPEC decided to cut oil production in order to lift prices up; however, higher oil prices only began to appear by H_1 2017. The price stood at $53.4/barrel by June 2017.

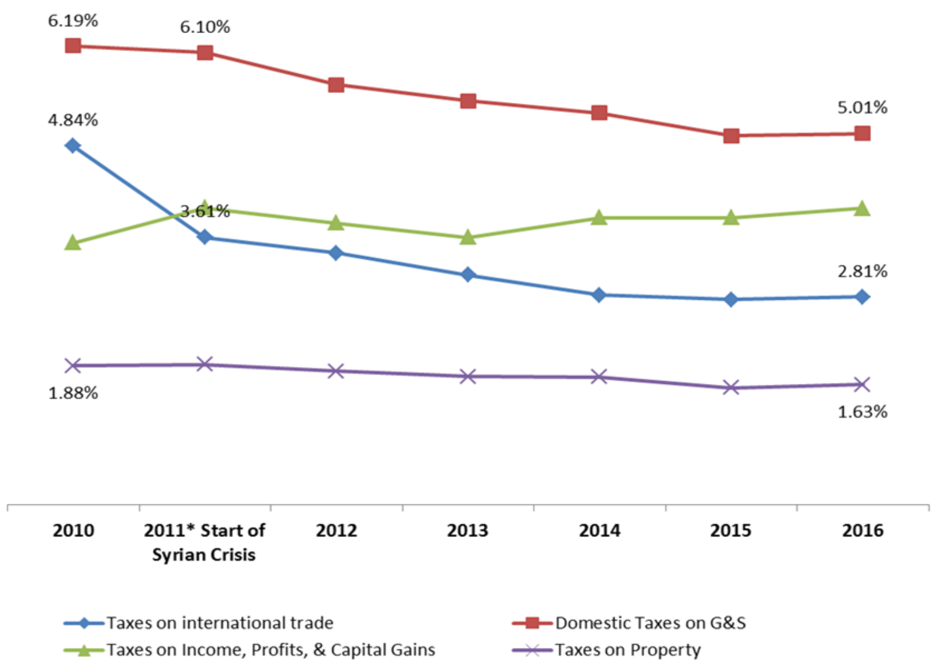
Graph: Blom Invest Bank; Data: Reuters & MoF

The cars excise registered a 4.2% annual growth even though revenue from car registration stalled. Usually, cars excises move in the same direction as revenues generated from Private car registration fees (a component of Domestic taxes). However, in 2016, the latter slipped by an annual 0.97%, while the former rose by 4.2% y-o-y. The information available to-date leaves the interpretation inconclusive, but this may be a result of new cars not being officially registered. They are probably being sold through proxies, especially knowing that the number of imported used cars witnessed an increase in the same year. The yearly 4.29% drop in Tobacco excises which amounted to LBP 228B in 2016 were shadowed by the larger increases.

Lastly, Property taxes rose by 3.84% y-o-y to LBP 1,224B in 2016. In 2016, the real estate (RE) industry marginally improved, with the number and value of RE transactions growing by yearly 1.92% and 1.42% to reach 84,380 transactions and $8.53B in 2016, respectively. Therefore, RE registration fees paid to the government climbed to LBP 802B instead of LBP 773B in 2015. The number of construction permits also increased by 13.3% y-o-y to hit 17,097 permits by Dec. 2016, so Built property tax rose by 6.88% to stand at LBP 255B.

It seems that the Syrian Crisis has decelerated the growth rates of the country's Tax revenues and their constituents.

Tax Revenue Structure & Performance (in %GDP): Pre- and Post-2011 Syrian Crisis



Graph: Blom Invest Bank; Data: MoF

As for Non-tax revenues, they increased by 2.62% y-o-y to LBP 3,392B. These were driven by higher revenues mainly from:

- Telecommunication services (which grasped 56.23% of total non-tax revenues),
- Passport fees and public security (8.16% of total),
- Vehicle control (6.7% of total)
- Port of Beirut (4% of total), and
- Rafic Hariri International airport (3.07% share).

The above increases offset the declining government income from Casino du Liban (2.97% of total).

Key Accounts in 2016's Non-Tax Revenues

		2015	2016
Non- Tax Revenues *(in LBP billions)*	Income from Public Institutions and Government Properties, of which:	2,313	2,377
	Transfer from the Telecom Surplus	*1,860*	*1,907*
	Revenues from Port of Beirut	*117*	*136*
	Revenues from Casino Du Liban	*110*	*101*
	Property Income (namely rent of Rafic Hariri International Airport)	*98*	*104*
	Administrative Fees & Charges, of which:	793	778
	Passport Fees/ Public Security	*163*	*258*
	Vehicle Control Fees	*285*	*258*

Source: MoF

In details, Telecom transfers improved by a yearly 2.51% but remain below 2013's level, with prospects to remain subdued. In June 2014, the Ministry of Telecommunication reduced internet and mobile charges, which slashed government revenues from the sector in the following years. In 2016, income from Telecom stood at LBP 1,907B, exceeding 2015's revenues that amounted to LBP 1,860B. Nonetheless, revenues were still inferior to those generated before the 2014 reduction in telecom rates (2013 telecom income totaled LBP 2,156B) and their growth may be hampered by a recently-approved initiative. In June 2017, the Cabinet agreed to increase internet speed and slash prices by 50 to 60%, as confirmed by Telecom Minister Jamal Jarrah. This may keep the key revenues generated to the government from the Telecom sector subdued through the coming periods.

Similarly, revenues from the Port of Beirut (PoB) registered a yearly uptick, as the entity became traders' preferred choice for goods' transport. The total volume of imported and exported merchandise through PoB rose by 6.33% y-o-y to 8,737 tons by December 2016, which partly explains why revenues from the public entity were lifted by 16.1% y-o-y to LBP 136B. Moreover, data on goods transported through Lebanon's different Customs' offices in 2016 revealed that trader preferences shifted, for the fifth year in a row, in favor of maritime and air transport due to the Syrian War disrupting traditional land-transport. Therefore, PoB grasped more than 2/3 of the value of goods (approx.69.44% of goods), followed by the Rafic Hariri Airport (estimated 22.32%), and the remaining by the Port of Tripoli.

Revenues from Lebanon's international airport were also boosted by 6.23% as tourism and thus airport passengers picked up in 2016. Income from the airport climbed to LBP 104B. The rise was partly attributed to the political breakthrough in Lebanon during Q_4 2016 and partly to the yearly 11.23% increase in tourist arrivals from Europe, the Arab countries and America (1.69M tourists by Dec.2016 according to the Ministry of Tourism).

Moreover, activity at the airport improved in 2016 as the total number of passengers (arrivals and departures) increased by a yearly 6.63% to stand at 7.71M.

Therefore, income from Passport fees and public security advanced by 7.16% y-o-y to LBP 277B in 2016. Government revenues rose as the Lebanese General Security declared that Lebanon will begin issuing biometric passports starting August 2016 and the International Aviation Organization later announced it would no longer accept passports that have been renewed by hand. So both, residents and expatriates were forced to renew their IDs in compliance which lifted the income for the government.

Meanwhile, revenues from Casino du Liban (CdL) and the Vehicle Control Fees (referred to as "Mecanique" locally) dropped. In 2016, government revenues from CdL continued to be inflicted, while Vehicle Control Offices suffered severe operational delays. In fact, Vehicle Inspection Centers were "*temporarily shut down [for three months]*" in November 2016, upon the exceptional decision of Lebanon's Minister of Interior in response to public drivers' protests against the rising fees of automotive inspections. Consequently, the government lost a yearly 8.39% of income from the casino which stood at LBP 101B in 2016. Similarly, income from Vehicle Control slipped by an annual 11.96% to LBP 227B.

Government Expenditures

Key Accounts in 2016's Non-Tax Revenues

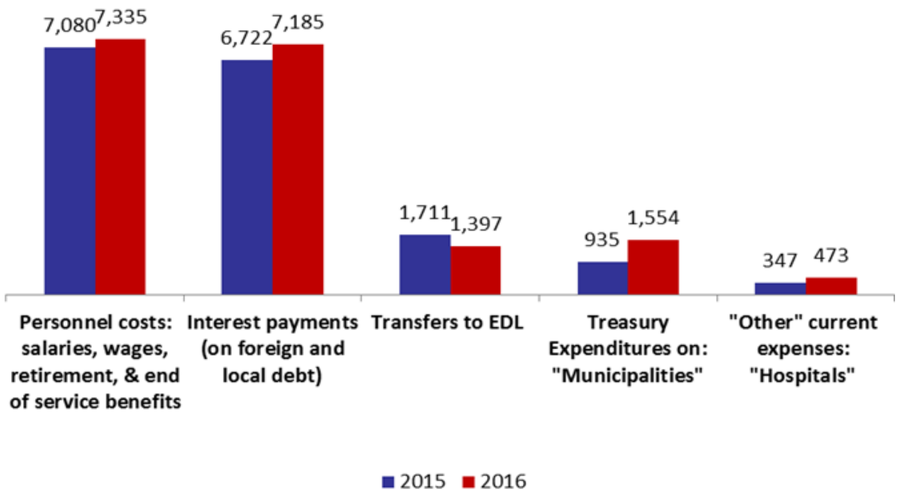
	2015	2016
Current Expenditures (in LBP billions)		
Personnel Costs	*7,080*	*7,335*
Interest Payments (on both domestic and foreign)	*6,722*	*7,185*
EDL Transfers	*1,711*	*1,397*
Treasury Expenditures, of which: Municipalities	*935*	*1,554*
Other current :Hospitals' expenditures	*347*	*473*
Capital Expenditures (in LBP billions)	322	475
Construction in Progress, of which:		
Council of Development and Reconstruction	*257*	*363*
Ministry of Public Work and Transport	*66*	*111*

Source: MoF

Public spending expanded by an annual 9.9% to stand at LBP 22,412B ($14.9B) in 2016, driven by an annual increase in Current expenditures, but also a noticeable rise in Capital expenditures (Capex). In fact, Current expenditures, including treasury spending, improved by a yearly 5.88% and stood at LBP 18,638B. Capital spending rose by 21.59% y-o-y to reach LBP 1,079B in 2016, which is a good indication for longer-term growth and economic performance. Treasury expenditures also rose from LBP 1,616B to LBP 2,269B.

The structure of Current expenditures was characterized by a small increase in interest payments but a large decline in the transfers to EDL. Personnel costs, including: salaries, wages, retirement, & end of service benefits (32.73% of total expenditures), Interest payments on domestic and foreign debt (32.06% of total), as well as transfers to Electricité Du Liban (EDL) (6.23% of total) were highest in the Current expenses category. They constituted 71% of total public spending in 2016 and 76% in 2015. Moreover, treasury expenditures on Municipalities (6.93% of total expenses) increased noticeably in 2016.

Yearly Development of Key Expenditures (in LBP billions)



Graph: Blom Invest Bank; Data: MoF

The country's debt burden continues to fuel deficits and weigh down on the economy. According to the FT/June 2017, "*Lebanon is the third most indebted public sector in the world, [outpaced] by Japan and Greece*". The country's debt stood at 138% of GDP in 2015, climbed to 144% of GDP in 2016, and according to IMF projections, debt-to-GDP is expected to reach 160% by 2021.

The Debt-service to GDP ratio increased in 2016. Debt-servicing in 2016 took up 9.54% of GDP, increasing from 9.02% of GDP in 1 year only, with economic growth estimated at only 1% in 2016. Accordingly, interest payments rose on both domestic and foreign debts.

Absent fiscal planning, interest payments on rising local and foreign debts inflated government spending in 2016. In details, the value of Interest payments climbed by an annual 6.9% in 2016 as illustrated above, owing it to the 7.57% annual upturn in foreign interest payments to LBP 2,576B, as well as a 6.52% rise in domestic interest payments to LBP 4,609B in 2016. This came on the back of Lebanon's magnified gross public debt which ended 2016 with a yearly uptick of 6.51% to $74.89B, as a result of annual 8.18% and 3.83% upticks in local and foreign debts to LBP 70,535B and LBP 42,360B, respectively.

Transfers to EDL declined substantially in 2016, but the contraction is only "temporary". EDL transfers were reduced by 18.33% y-o-y. They stood at LBP 1,397B in 2016, substantially lower than 2015's transfers despite higher volumes of imported fuel and gas oils over the year. Knowing that EDL imported 16.26% more fuel oil than gas oil in 2016, with the latter dropping by 2.36% y-o-y, the eased burden of EDL transfers on the government budget is attributed to the global decline in the average price of crude oil by 16% y-o-y to $45.13/barrel.

As for Personnel expenses, they remained relatively stable. Personnel costs rose by an incremental 3.6% to LBP 7,335B, so the expense stood at 9.74% of GDP in 2016 instead of 9.5% in 2015, reflecting a minor change.

Treasury expenditures to Municipalities rose noticeably in 2016. Treasury expenditures rose from LBP 1,616B in 2015 to LBP 2,269B in 2016, mostly driven by the rise in government payments to the municipalities which rose from LBP 935B to LBP 1,554B. This 66.2% surge is due to payments of amounts accumulated from previous years.

Other current Hospital expenditures were remarkably inflated too and the outlook is grim with the crisis ongoing in Syria. The substantial influx of Syrian refugees to Lebanon is unprecedented as per the unanimous statements of international institutions. Accordingly, as Syrians settled in Lebanese host communities, the strain on the country's weak infrastructure grew, including the pressure of increased demand on healthcare services. This explains the rise of the government payments to hospitals by 36.23% to LBP 473B in 2016.

Nonetheless, 2016's Capital Expenditures climbed to their highest levels in 8 years and surpassed 2013's. Capex comprised 4.8% of total expenses in 2016. However, compared to 2015, the value of Capex rose by 21.6% to reach LBP 1,079 last year. This is the highest Capex level reached in 8 years and it is largely attributed to increases in Constructions in progress between the Council of Development and Reconstruction (CDR) and the Ministry of Public Work and Transport. CDR's projects in progress were financed by LBP 363B in 2016 compared to LBP 257B and spending on projects ongoing with the Ministry of Public Work and Transport reached LBP 111B in 2016, compared to LBP 66B in 2015.

The rise of Capital expenditures in 2016 revealed an improvement in the country's rigid spending structure. High Capex, if properly managed, may indicate a healthy management of public spending. Hence, the increase witnessed in Lebanon's 2016 capital expenses may be the only positive indication to a long-term rehabilitation of the widened fiscal deficit, as higher Capital spending may begin tackling the weak infrastructure further exacerbated by the influx of Syrian refugees.

Ways Forward: Managing Lebanon's Public Finance

In light of the explored, Lebanon had recorded primary surpluses from 2008 to 2011 when the surplus reached highs of LBP 2,505B. However, in the same year, the Syrian crisis hit Lebanon and the resilience of its economy was shaken. Lebanon marked primary deficits in 2012 and 2013 which were reversed in 2014 and 2015. However, by 2016, the surplus had immensely diminished, with Lebanon saddled by a substantial debt and a very large fiscal deficit.

Fiscal planning and a parliament able to agree on and set a budget to control, manage, and discipline either the expenditure and/or the revenues of the government budget have become crucial.

Moreover, "*By regional and international standards, Lebanon's tax performance is significantly below its potential*" (IMF, 2017). As such, and in light of 2016's fiscal performance, the Fund urged the Lebanese government to reform the VAT regime, which, according to its findings, is one of the most promising ways to improve fiscal performance, from the revenue-side.

However, Lebanon needs to implement multiple, urgent structural reforms that can simultaneously increase revenue-generation sources and improve revenue collection, as well as encourage spending on infrastructure and long-term projects capable of nurturing productive investments and inclusive growth.

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