Lebanon's Fiscal Performance in 2017: Short-lived Improvement

BLOMINVEST BANK

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Contact Information

Research Analyst: Rouba Chbeir

rouba.chbeir@blominvestbank.com

Head of Research: Marwan Mikhael

marwan.mikhael@blominvestbank.com

Research Department

Tel: +961 1 991 784

The fiscal balance of Lebanon, an oil-importing economy, managed to record a larger primary surplus and a smaller deficit in 2017 even though international oil prices rose to an average price of $54.73 per barrel compared to $45.13 in 2016. In addition, optimism accompanied the election of a new president, which enabled the Lebanese authorities to pass a series of long-awaited laws.

However, the improvement is temporary, and the IMF's latest concluding statement explained, *"[…] higher personnel and interest costs will be main contributors to further deteriorating fiscal position over the projection horizon. […] A fiscal consolidation plan with front-loaded fiscal adjustment, embedded in a credible budget, is urgently needed."*

The study aims to delineate the changes in government income and spending over the year, shed light on the movement in key accounts, and explain the "short-lived" nature of the improvement in the Lebanese fiscal balance in 2017, noting that the government recorded a "one-off tax windfall" from national banks and approved a new salary scale expected to exceed estimated costs – all within an environment of subdued growth and rising interest rates.

Fiscal Balance: Overall Improvement

Lebanon's fiscal balance significantly improved in 2017. According to the Ministry of Finance, Lebanon's fiscal deficit retreated from $4.94B in 2016 to $3.76B (LBP 5,662B) in 2017. Therefore, the fiscal deficit's share of the Gross Domestic Product (GDP) fell from 9.97% in 2016 to 7.57% in 2017. The contraction came on the back of a 17.1% year-on-year (y-o-y) growth in fiscal revenues to $11.62B (LBP 17,524B), which outweighed a 3.5% y-o-y uptick in government expenditures to $15.38B (LBP 23,186B).

Lebanon's primary surplus also grew. Despite the bullish trend of oil prices that raised the average price of a barrel of oil to $54.73 in 2017 from $45.13 in 2016, Lebanon's primary balance - the fiscal balance excluding the debt service - registered a surplus of $1.43B (LBP 2,152B) in 2017 composing 2.88% of GDP, up from $20.56M (LBP 31B) in 2016. It is worthy to note that the primary surplus had shrunk between 2015 and 2016, going from $724.38M (LBP 1,092B) to $20.56M, respectively.

Some exceptional factors supported the improved revenues. The Lebanese authorities collected elevated one-off tax revenues amounting to approximately $850M from banks' exceptional profits that resulted from BDL's swap operations in 2016. Moreover, in H2 2017, the Lebanese parliament approved a hike in the salary scale of public sector employees and pensions of retired civil servants. This was

accompanied by a number of new taxes and increased fees to fund that raise, and the changes effective in 2017 were mainly the dividend distribution tax, passenger tax, and taxes on the lottery, tobacco, and alcohol.

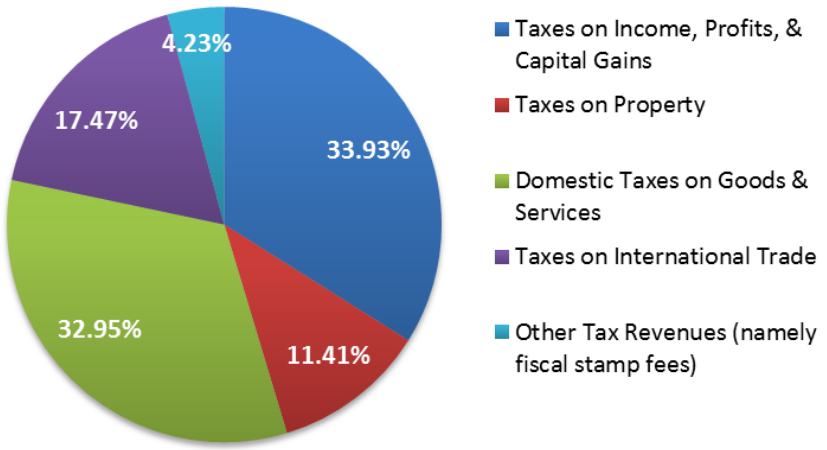
2017 carried optimism as well as headwinds to the Lebanese economy. On one hand, the government reaped higher tax revenues from banks (more details below). On the other hand, transfers to Electricite du Liban (EDL) were on the rise, partly due to the recovery witnessed in oil prices. In their turn, interest payments grew by 4.7% y-o-y to $4.9B in 2017 while GDP growth prospects remained subdued for 2017 and 2018, rendering the country's debt more unsustainable.

2017 Revenues: Up

Tax and non-tax revenues including treasury receipts rose by a yearly 17.1%. Budget revenues increased from $9.28B in 2016 to $10.78B, as tax revenues (constituting 70.65% of total public revenues) climbed from $7.03B in 2016 to $8.21B in 2017 and non-tax revenues (22.06% of total) rose from $2.25B to $2.56B in 2017. Treasury receipts also grew from $643.45M in 2016 to $847.1M in 2017.

Tax revenues recorded upticks across the board. The 16.8% y-o-y increase in tax revenues to $8.21B in 2017 came on the back of upticks in all of the 5 categories depicted below.

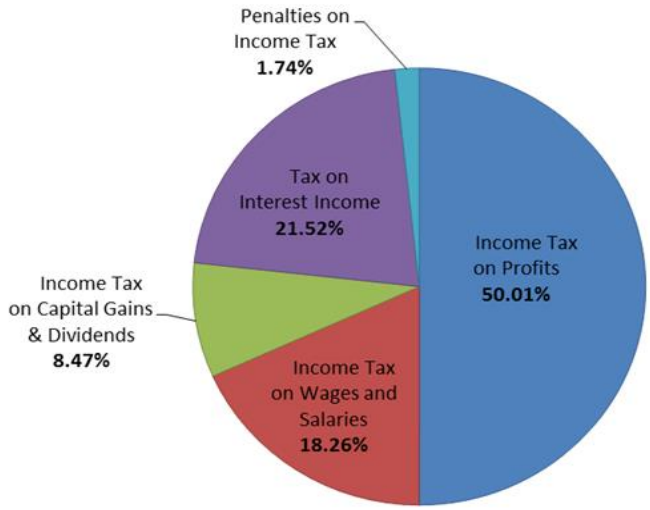
Tax Revenues' Composition



Source: BLOMInvest Bank; Ministry of Finance (MoF)

Taxes on Income, Profits, and Capital Gains

Composition



Source: BLOMInvest Bank; MoF

Income tax on profits recorded a significant rise. It rose from $758M in 2016 to $1.4B in 2017, having recorded a much smaller increase of 3.67% last year. The improvement can be largely linked to the exceptional profits made by commercial banks from participating in BDL's swap operation of 2016. In fact, the Ministry of Finance in collaboration with the Association of Banks instructed the banks to pay around $850M in corporate income tax, which would help cover the public salary scale commitments estimated at approximately $796M. Moreover, it is worthy to mention that corporate tax rate among others, was raised from 15% to 17% in Q4 of 2017, as part of the series of tax reforms introduced to help cover the commitments in the new public salary scale.

Income tax levied on wages and salaries & on interest income also recorded yearly upticks. The former grew by 9.3% to $508.79M by end 2017 driven by the higher salaries that were approved and effective Q4 2017. Similarly, revenues from interest income rose to $599.67M, up by an annual 10.5%. This can be partly associated to the increase of the tax on interest income from 5% to a rate of 7%, and partly to the banking industry that remained resilient amid the 2017 Hariri-Saudi Arabia (November) Crisis. In fact, banks' private sector deposits augmented to $168.66B by end 2017, adding a yearly 3.28%. Nonetheless, it is important to mention that the crisis only impacted the composition of these deposits. In fact, total private deposits in LBP declined in face of a temporary "loss of confidence" in the country's security, but they were offset by rises in USD-denominated deposits. Consequently, the dollarization ratio of deposits was elevated to 68.72% in 2017.

Income tax on capital gains & dividends was supported by higher tax rates on dividends. In 2016, the account posted a marginal 1.8% increase, while it rose by a yearly 23.5% in 2017 to end the year at $236.15M. The series of tax reforms introduced in the era of the new president included, among other changes, hiking the tax rate on dividend distribution from 5% to 10% effective December 2017.

Domestic Taxes on Goods & Services

In 2017, the government collected an additional $160.5M from the value added tax (VAT) compared to last year. The VAT (85.22% of total taxes on locally consumed goods & services) amounted to $2.31B in 2017 compared to $2.15B last year. The tax rate was hiked to 11% from 10%,

effective January 2018. However, the higher VAT revenues[1] in 2017 may be tied to the 21.27% annual rise in oil prices which was also reflected in Lebanon's oil imports rising by 2.69% y-o-y to $4.2B in 2017.

Interesting substantial rises were witnessed in the private car registration fees and passenger departure tax. The income from passenger departure (traveler's) tax rose by 19.2% to $136.65M in 2017, while the private car registration fee added 7.6% y-o-y to $168.49M. A portion of the tax reforms introduced in H2 2017 - partly to help finance the public salary but also to improve fiscal performance - hiked the traveler's tax while the airport witnessed 3.5M departures in 2017, close to 2016's 3.9M. Meanwhile, the registration of new cars grew by 2.54% y-o-y to 39,863 cars compared to a 6.67% annual downturn to 38,874 cars registered the year before. As a result, income from cars' registration fees shot up from $156.55M to $168.49M.

Taxes on International Trade

Taxes on international trade added 2.2% y-o-y to $1.43B, as customs revenues, gasoline and car excises rose. Taxes on international trade which include customs and excises, gained an annual 2.2% to stand at $1.43B in 2017 as the activity by the end of the year picked up across all customs offices except Abboudieh. In details, revenues from the customs rose from $468.33M in 2016 to $492.2M in 2017. In turn, the fuel excise added a marginal 1.5% y-o-y to reach $458.4M in 2017, on the back of oil prices rising by 21.27% y-o-y to $54.73 per barrel in 2017**.**

The cars excise registered a 5.2% annual growth in-line with the higher revenues from private cars' registration revenues. Car excises move in the same direction as revenues generated from taxes on private car registrations fees (a component of domestic taxes). With the income from cars' registration fees shooting up by a yearly 7.6%, cars excise in turn rose from $329.68M to $348.92M in 2017.

Meanwhile, returns from tobacco excises slumped as the local CEDARS brand overtook the market. Tobacco excises fell from 2016's $151.24M revenues to $130.68M in 2017. According to BLOMInvest Bank's study on the cigarettes industry in Lebanon, the smaller excises in 2017 are justified because the Regie, a state-owned monopoly in the Lebanese tobacco industry, revamped the local brand CEDARS in 2015. As a result, the upgraded product gained up to 70% of the market share by 2017, knowing that the ministry of finance (& ultimately the government) generate the main tobacco revenue from the tax structure on "imported" tobacco products. In fact, the tax structure on tobacco products is composed of a 5% custom charge & a 108% internal excise fee, which is charged on "imported" tobacco products while "local" tobacco goods are exempt from this tax model.

Taxes on Property

The uptick in property revenues is mostly related to BDL's subsidized housing loans during 2017. 68.22% of the income from property taxes is generated from real estate registration fees which climbed by 20.2% y-o-y to $639.47M in 2017**,** while the built property tax also grew by 10.7% y-o-y to $187.73M. The number of RE transactions climbed by 14.46% y-o-y to 73,541 transactions by December 2017, and the improved performance in the sector was largely thanks to BDL's subsidized loans.

[1] VAT revenues in 2017 would be better explained in reference to the original Customs' data on 2017's value of mineral fuel&oil imports, before it was revised in 2018. The original data showed that the value oil imports surged by 39.67% y-o-y to $5.14B in 2017 which may justify the corresponding climb in VAT revenues over the year. Meanwhile, the Customs' 'reviewed' data depicts that oil imports' value rose by 2.69% y-o-y to $4.2B in 2017, which leaves the VAT revenue interpretation not very clear.

Non-tax revenues

Non-tax revenues grew by 14% y-o-y to $2.56B in 2017. Upticks were recorded across the board in Telecommunication services (50.08% of total non-tax revenues), Vehicle control (8.54% of total), Passport fees and public security (7.29% of total), Property Income i.e. rent from Rafic Hariri International Airport (6.88%), Port of Beirut (4.53% of total).

Non Tax Revenues: Key Accounts		
(in USD millions)	**2016**	**2017**
Income from Public Institutions and Government Properties, of which:	1,576.78	1,757.21
Revenues from Casino Du Liban	67.00	80.93
Revenues from Port of Beirut	90.22	116.09
Budget Surplus of National Lottery	38.47	53.73
Transfer from the Telecom Surplus	1,265.01	1,284.25
Transfer from Public Financial Institution (BDL)	40.46	40.46
Property Income (namely rent of Rafic Hariri International Airport)	68.99	176.45
Other Income from Public Institutions (interests)	5.31	4.64
Administrative Fees & Charges	516.09	585.74
Penalties & Confiscations	27.86	25.87
Other Non-Tax Revenues (mostly retirement deductibles)	128.69	196.35

Source: MoF

Telecom revenues are the largest government non-tax revenues, yet consumer-friendly costs may keep them subdued. Telecom transfers remained subdued in 2017, rising by 1.5% y-o-y to $1.28B. The incremental increase can be associated to the decrease of telecom prices to households over the year, as DSL package costs slipped by almost 50% from their original prices. The plan of the Telecom Ministry is to price new technologies in such a way they can be afforded by most citizens. Nonetheless, the strategy is double edged as half of the non-tax revenues in Lebanon are generated from telecom services.

Income from the Port of Beirut (PoB), the airport, national lottery, and some administrative charges improved, partly thanks to 2017's tax reforms and partly to the stabilized conditions in Syria. PoB and the international airport grasped 70% and 18.38% of the activity at the customs offices, respectively. In details, with the situation stabilizing in Syria, Lebanon acted as the hub for the first aspects of reconstruction there. This boosted activity at PoB, which may explain the 29.1% yearly rise in the port's revenues to $116.1M. Similarly, income from the airport climbed to $176.5M in 2017 from $68.9M last year as airport passengers totaled 8.24M, a 10-year high for Lebanon, compared to 7.71M passengers in 2016. In their turn, tourist arrivals added 9.98% y-o-y to 1.86M by December 2017, driven by bigger numbers of tourists coming from Europe, the Arab countries, and the Americas.

It is worthy to note that among the increased taxes imitative of Q4 2017, the tax on the national lottery was raised from 10% to 20% of the awarded prize. Hikes also applied to the notary public rates and the proportionate stamp duty charges, which albeit raised revenues from these components.

Meanwhile, revenues from the vehicle control fees, commonly known as *mecanique*, more than recovered. In 2016, vehicle control offices suffered severe operational delays which slashed the corresponding revenues by 20.3%. However, in 2017, income from vehicle control shot up from $150.6M to $218.9M.

Key Expenses were disbursed for personnel costs, interest payments, & EDL transfers while Capital expenditures were sidelined

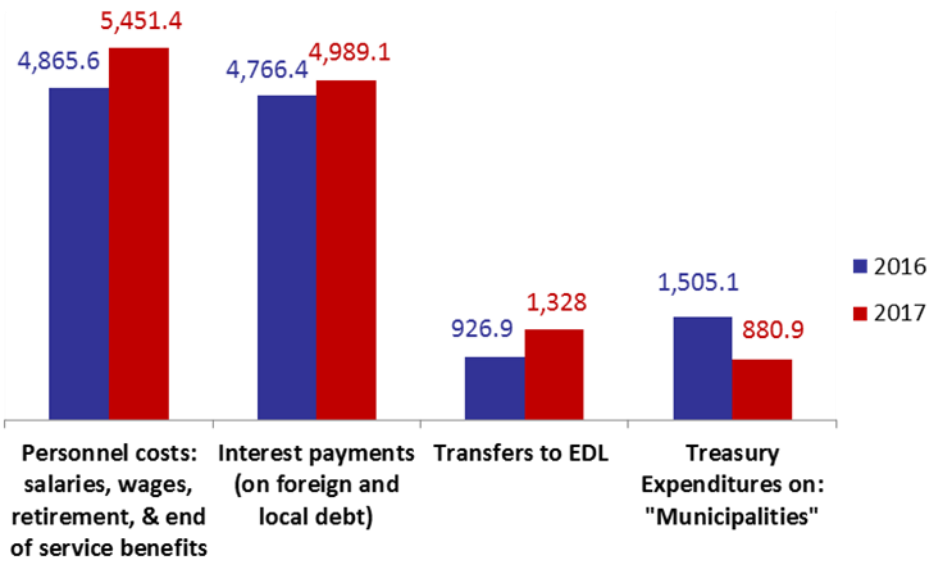
Public expenditures expanded by 3.5% to $15.38B. Disbursements for personnel costs (salaries & wages, retirement & end-of-service indemnities) constituted 35.44% of 2017's total expenses compared to 32.73% of 2016's, and they grew by a yearly 12% to $5.45B. In turn, interest payments (32.44% of total expenses) rose by 4.7% y-o-y on the domestic and foreign debt to $4.99B in 2017. Transfers to EDL added 43.3% y-o-y to $1.33B by the end of the year.

In Q3, parliament passed the public salary scale law. It began to materialize in the country's 2017 personnel expense. Personnel costs in 2017 rose four times more than they did in 2016 such that they constituted 10.58% of GDP in 2017 compared to 9.81% of GDP in 2016. The magnified expense is only the first wave of hikes expected in the costs of public salaries following the passing of the salary scale law in 2017. More dramatic increases are expected when the costs fully materialize in 2018, given these are expected to exceed budget allocations.

However, the largest yearly increase in 2017 among the key components was the 43.3% annual upturn in EDL transfers. Compared to 2016 when EDL transfers temporarily contracted as a result of the global drop in oil prices, EDL costs reached $1.33B in 2017 largely due to the 21.27% spike in average oil prices to $54.73.

In turn, interest payments on the unsustainable debt heightened. Lebanon's gross public debt reached $79.52B by December 2017, as it added a yearly 6.19% and therefore continued being on an unsustainable path. The debt-to-GDP ratio climbed from 151% in 2016 to 153% in 2017, and it is projected to expand to 157% in 2018 as per the IMF. Debt-servicing in 2017 took up 9.31% of GDP (at $4.99B), increasing from 9.25% of GDP last year while economic growth stalled at 1% in 2017.

Yearly Development of Key Expenditures (in $millions)



Graph: Blom Invest Bank; MoF

Treasury expenditures to municipalities retreated. 2017's treasury transfers declined by a yearly 41.5% to $880.93M, on the back of a 60% y-o-y downtick in government payments to the municipalities to $412.6M.

The structure of the government's expenses focused on current expenditures and sidelined capital investments (capex). Capex in Lebanon is low and constituted 5.15% of total public spending while current expenditures captured 87.2%. Nonetheless, in 2017, Capex reached $791.38M, climbing by 10.6% y-o-y thanks to a 19.4% yearly increase in construction projects in progress to $585.74M. A bigger rise in capex however may emerge starting 2018, once the CEDRE investments begin to materialize.

2017 Carried Urgent International Calls for Fiscal Consolidation

2017 carried a number of achievements to the country. The beginning of the new president's era spurred optimism into the market which enabled parliament to pass a series of long-awaited laws, namely the public salaries hike among others. The first national budget since 2005 was also passed that year and the fiscal deficit narrowed.

However, the improved fiscal performance is short-lived and poses significant threats. The improvement came largely on the back of the one-off revenues from (banks') tax on profits, a new salary scale expected to exceed the estimated $796M, an environment of rising interest rates which magnifies the debt-servicing, and slow economic growth. In light of 2017's fiscal performance, the IMF, Moody's, and other institutions insisted on urgent fiscal consolidation, calling on the government to adopt an implementation mode of serious reforms that may narrow the deficit and set debt on a sustainable trajectory.

For your Queries:

BLOMINVEST BANK s.a.l.

Research Department Bab Idriss, Weygand Str. POBOX 11-1540 Riad El Soloh Beirut 1107 2080 Lebanon

Rouba Chbeir, Research Analyst

rouba.chbeir@blominvestbank.com

+961 1 991 784

Marwan Mikhael, Head of Research

marwan.mikhael@blominvestbank.com

+961 1 991 782

research@blominvestbank.com