Lebanon's Fiscal Dynamics Exacerbated in 2018

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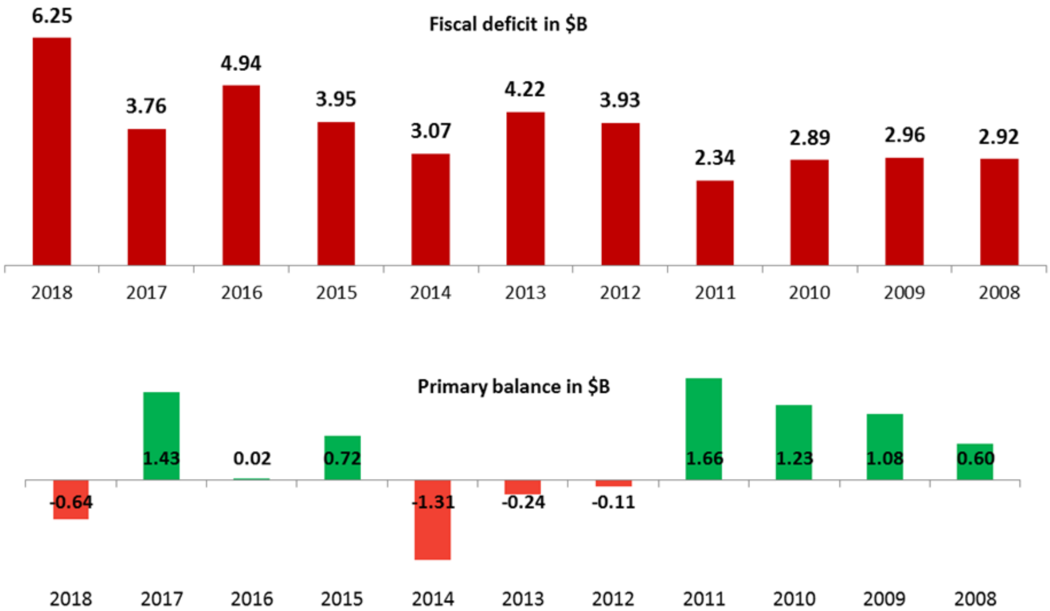
Lebanon's fiscal performance weakened considerably in 2018. The country lost the primary surplus to a primary deficit and recorded a 10-year high fiscal deficit of $6.25B.

The exacerbated fiscal dynamics mirror the compound effect of a 30% hike in average international oil prices, a game changer for an oil importing economy, in addition to underestimated personnel expenses from the public salary scale law endorsed in 2017 but projected to fully materialize in 2018.

The substantial fiscal slippage came as no surprise. Economists expected the bigger impact of the salary scale to mark the year 2018, while policy-makers approved a set of tax law-changes to finance the salary scale. However, the regional economic slowdown, alongside the national environment of high inflationary pressures and elevated interest rates albeit kept growth and the activity in the growth drivers (tourism and real estate), subdued.

The study aims to trace and interpret the prime changes in public income and spending over the year and shed light on key accounts to explain the considerable exacerbation in the Lebanese 2018 fiscal performance.

Fiscal Deficit in 2018: A 10-year high



Source: Ministry of Finance (MoF); BLOMInvest Bank

Lebanon's fiscal deficit surged to 10.9% of GDP in 2018, owing it to the high costs of oil and the salary scale law passed in 2017. The country's fiscal deficit expanded by 1.7 times in a year, from $3.76B (LBP 5,662B) in 2017 to $6.25B (LBP 9,415B) in 2018. In fact, it surged from 2017's 6.8% of GDP to 10.9% this year, thereby exceeding the IMF's forecast of a fiscal deficit reaching 9.1% of GDP. The substantial fiscal slippage came on the back of a 15.68% annual increase in public expenses to $17.79B (LBP 26,820B) which represented a full materialization of the public salary scale passed by parliament in Q3 2017. It is worthy to note that public personnel expenses began to partially materialize in 2017's budget when the authorities also introduced a set of tax hikes to finance the scale. Nonetheless, by December 2018, government revenues lost 0.68% year-on-year (y-o-y) to stand at $11.55B (LBP 17,405B).

It followed that the country's primary balance read a deficit of $635.6M, as growth stalled and prices shot up. Lebanon's primary balance, the fiscal balance excluding debt servicing costs, unveiled a primary deficit of $635.6M in 2018 (1.11% of GDP), compared to a primary surplus of $1.43B (LBP 2,152B) in 2017. In fact, growth stood at 1% compared to 1.2% in 2017 while the study conducted by BLOMInvest Bank and linked Lebanon's Purchasing Managers' Index[1] to GDP growth, revealed stifled growth rates in 2018. A dramatic 30% annual increase to $71.7/barrel of oil in 2018 and an 'expensive' salary scale passed for public servants drove the average inflation rate up from 4.44% in 2017 to 6.08% in 2018.

Core Expenses: Personnel costs fully materialize, Debt servicing & EDL transfers Up

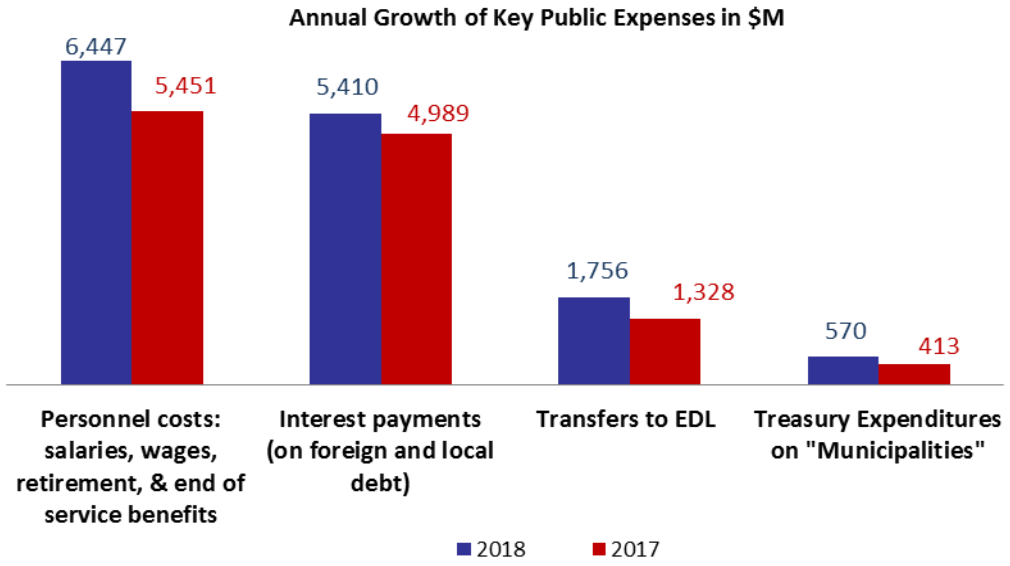
Public expenditures shot up by 15.68% y-o-y in 2018, compared to a 3.5% uptick last year. Government spending this year amounted to highs of $15.38B, with Current expenses composing 86.3% of the total while Capital expenditures (Capex) grasped a share of 5.2% of total spending. In fact, disbursements for Personnel costs[2] alone composed 36.2% of total public spending (compared to a share of 35.4% in 2017) and totaled $6.45B. In turn, Interest payments on Lebanon's public debt (30.4% of total expenses) rose by 8.44% y-o-y to $5.4B in 2018, compared to half the increase (or 4.68%) to $4.9B last year. Meanwhile, Transfers to EDL which composed 9.9% of total expenses added 32.26% y-o-y to $1.26B by the end of 2018. In their turn, overall Capital expenditures grew by 15.78% y-o-y in 2018 compared to 10.59% in 2017, and ended the year at $916.5M.

Parliament passed the public salary scale law in Q3 2017, yet it only fully materialized in 2018's Personnel expense. Personnel costs in 2015 constituted 9.1% of GDP. The ratio jumped to 9.3% and 9.9% of GDP in 2016 and 2017, respectively. By 2018, personnel costs occupied a magnified 11.2% of GDP with a balance of $6.45B, up by a yearly 18.26%, noting that in 2017 the public salary scale commitments were estimated at approximately $796M. Hence, Personnel expenses in 2018 most likely represent the full cost of passing of the salary scale law in 2017.

EDL transfers registered the largest increase among 2018's core spending components, with a 32.26% annual upturn. Compared to 2017, EDL transfers rose at a slower pace, yet costs incurred reached $1.76 B in 2018 largely due to the 30.98% y-o-y spike in average oil prices to $71.69 per barrel. It is worthy to note that improvements are expected to surface starting H2 2019 and 2020, as the government passed a full-fledged electricity reform plan in April 2019. The rate of success of the plan this time round may be attached to a greater willpower of policy-makers to boost government revenues via raising electricity tariffs from 9.5 cents per kilowatt hour (kwh) to 14.2 cents per kwh, as electricity generation is increased.

[1] PMI is a measure of the private sector's activity or performance published by BLOM and IHS Markit for Lebanon.
[2] Personnel costs: include all costs attached to employee's salaries & wages, retirement & end-of-service indemnities.

In turn, Interest payments escalated while debt continues to grow unsustainably. The debt-to-GDP ratio by December 2018 hit 148% of GDP, still below the IMF's projected 158%, but total public debt amounted to $85.13B in 2018 which was a considerable 7.06% y-o-y uptick. Actually, interest payments in 2017 and 2016 took up 9.08% of GDP on average, as they stood at $4.99B and $4.76B, respectively. By 2018, debt servicing-to-GDP increased to 9.41% of GDP while economic growth stalled at 1% in 2018. It is worthy to also note that interest payments on foreign debt (41.5% of total interest costs) were 1.3 times larger than 2017's and amounted to $2.2B in 2018. Meanwhile, those on domestic debt settled at $3.17B, down from 2017's $3.23B.



Source: MoF; BLOMInvest Bank

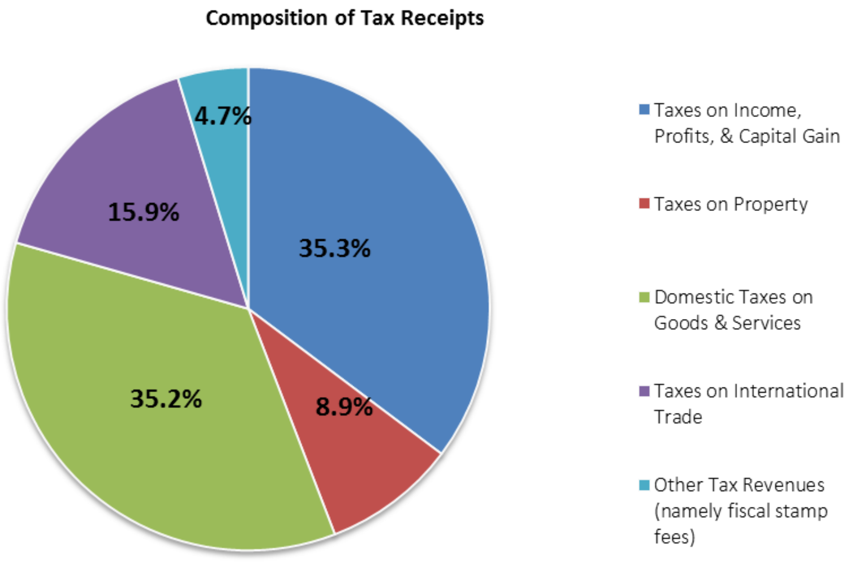
The government's fiscal policy model relies on current spending, but some projects in construction boosted Capex in 2018. Capex remained below 5.2% of total spending at $916.5M in 2018, but projects under construction as per the MoF witnessed an annual 18.07% growth to $691.42M. Unlocking the CEDRE investments remained a challenge during 2018, as policy-makers struggle to unanimously agree on and implement proposed draft and needed reforms to regain the international community's trust and financial support.

Treasury expenditures to municipalities rose by 1.3 times in 2018. While treasury transfers in 2017 had lost 41.5% y-o-y to $880.88M on the back of a 60% y-o-y downtick in government payments to municipalities to $413M, these last added a yearly 38.25% to $570M thereby boosting total transfers by 34.05% y-o-y to $1.18B in 2018.

2018 Revenues: Barely Budged, Tax Reforms Introduced

Total public revenues including treasury receipts lost 0.68% y-o-y to $11.55B in 2018. Budget (tax & non-tax) revenues stood at $10.74B, down by a marginal 0.36% y-o-y as Tax revenues constituted 73.3% of total revenues, compared to last year's 70.65% share of the total and rose to $8.47B. Non-tax revenues (19.7% of total) slumped by a yearly 11.46% to $2.27B in 2018 while Treasury receipts slipped by 4.79% y-o-y to $806.7M over the same period.

Tax revenues recorded mixed performance across its components. Revenues from tax rose by 3.11% y-o-y to $8.47B in 2018, owing it to upticks in 3 of the 5 tax categories: taxes on income and profits, domestic taxes on G&S, and from fiscal stamp fees. As such, the remaining tax receipts registered downticks. It is worthy to note that some tax reforms passed in 2017 require more time to materialize, while others merely reversed one-off events.



Source: MoF; BLOMInvest Bank

A. Taxes on Income, Profits, and Capital Gains

Income tax on profits was slashed by a significant 35.39% y-o-y, owing to this year's rebalancing of 'one-off' bank earnings made in 2017. The breakdown of this component reveals public receipts from Taxes on corporate profits (30.2% of the total component) fell from $1.4B in 2017 to $900.45M in 2018, noting these rose by almost 84% in 2017. Income tax on corporate profits actually witnessed a rebalancing action as it no longer carried 2017's corporate income tax totaling $850M (paid by commercial banks' exceptional profits from participation in BDL's 2016 swap), which explains its contraction. Even though Lebanon increased the corporate tax rate from 15% to 17% in Q4 of 2017 during the series of tax reforms, the one-off revenues unaccounted for in 2018 had a much larger impact, noting that commercial banks' assets are worth 434% of GDP, reflecting Lebanon's very large banking sector and thus the size of its contribution to the government's tax receipts.

Meanwhile, Taxes on interest income surged from $599.96M in 2017 to $1.19B in 2018 while Income tax on wages and salaries added 13.48% y-o-y. Taxes on interest income (40% of total component) witnessed a significant improvement largely because the tax on the interest of bank deposits was raised from 5% to 7% within the series of new tax laws (hikes of 2017). In its turn, the passing of the higher public salary scale attracted a larger stream of revenues from wages paid out. Accordingly, receipts from the income tax on the higher wages and salaries (composing 19.3% of the total component) generated the government $577.17M in 2018.

Revenues from Tax on capital gains & dividends rose in 2018, but the rate of increase was slower than 2017's. The account posted a large increase of 23.5% in 2017, but in 2018 the uptick was capped at 17.13% y-o-y, given the impact of last year's tax rate hike on dividend distribution from 5% to 10% effective December 2017 was attenuated by end 2018. Therefore, receipts from taxes on capital gains and dividends added to $276.29M in 2018.

B. Domestic Taxes on Goods & Services (G&S)

The Value added tax (VAT) generated an additional $242.3M to the Lebanese government. The new VAT rate of 11%, hiked from 10% effective January 2018 continued to solidly improve government receipts by around 1.5 times when compared to 2017. In fact, receipts from the VAT alone (composing 85.4% of total Domestic taxes on G& S, or 30.09% of total tax receipts) amounted to $2.55B in 2018, up by a yearly 10.51%.

Moreover, receipts from Private car registrations grew in 2018, but probably due to citizens registering "used" cars. Private car registration fees (grasping 6% of domestic taxes) added 5.66% y-o-y such that the government to touch $178.03M in 2018 despite the decline in registration of new cars. In fact, total new cars registered fell by 11.46% y-o-y to 35,301 in 2018 as per data from the AIA. Therefore, the uptick in revenues from car registrations is most probably attributed to an increase in the registration of used cars.

The passenger departure tax (4.8% of total domestic taxes) generated an additional $5.15M for the government. The passenger departure (traveler's) tax receipts grew by 3.77% to $141.88M in 2018. This is primarily linked to the series of tax reforms of H2 2017 which, among other components, hiked the traveler's tax. With a bustling airport, the number of passengers shot up by a yearly 7.36% to 8.84M by December 2018, as departing passengers particularly rose by 7.15% y-o-y to 4.4M.

C. Taxes on International Trade

Excises on fuel which comprised 33% of total taxes on international trade lagged in 2018. In details, the gasoline excise lost 3.28% y-o-y to settle at $668.17M in 2018, owing it mainly to the previously mentioned 30.98% y-o-y hike in the average prices of international oil during 2018.

The cars excise registered a 13.96% annual slump despite growing revenues from private car registrations. Car excises (22.3% of total trade taxes) conventionally moves in the same direction as revenues generated from taxes on private car registrations fees - a component of domestic taxes. However, in 2018, the latter slipped by an annual 13.96% to $452.45M, while the former rose by 5.66% y-o-y. It seems the information currently available is insufficient which leaves our interpretation inconclusive.

D. Taxes on Property

Revenues from all property taxes lost 19.41% y-o-y largely due to BDL halted housing loans. The government collects revenues from property via the Built property tax & Real estate registration fees. While housing loans weighed down on BDL's balance sheet by 2018, the central bank withdrew the loans subsidy scheme when Lebanon faced a challenging period of persistent economic slowdown in its main growth drivers, namely real estate. In fact, subsidizing housing must be at the heart of the government's economic policies, rather than the central bank's, noting that such loans weighed down on BDL's balance sheet in 2018. In details, Real estate registration fees (65.3% of total property tax receipts) lost 22.84% y-o-y to $493.4M in 2018, while Built property tax receipts also slumped by 0.16% y-o-y to $187.17M. According to the data from the General Directorate of Land Registry and Cadastre, the number of RE transactions retreated by a substantial 17.44% y-o-y to reach 60,714 transactions by December 2018.

Non-tax revenues: Overall Downtick

Non Tax Revenues: Key Accounts		
(in USD millions)	**2018**	**2017**
Income from Public Institutions and Government Properties, of which:	1,451.2	1,757.2
Revenues from Casino Du Liban	89.5	80.6
Revenues from Port of Beirut	73.0	116.0
Budget Surplus of National Lottery	40.4	53.4
Transfer from the Telecom Surplus	1,070.7	1,284.2
Transfer from Public Financial Institution (BDL)	40.1	40.3
Property Income (namely rent of Rafic Hariri International Airport)	130.7	176.6
Other Income from Public Institutions (interests)	5.09	4.5
Administrative Fees & Charges	627.57	585.6
Penalties & Confiscations	23.98	25.9
Other Non-Tax Revenues (mostly retirement deductibles)	168.17	196.3

Source: MoF

Non-tax revenues dropped by 11.46% y-o-y to $2.27B in 2018. Downticks were recorded across the Telecommunication services (47.1% of total non-tax revenues), Passport fees and general security (8.1% of total), Property Income i.e. rent from Rafic Hariri International Airport (5.8%), and Port of Beirut (3.2% of total) while Vehicle control (10% of total) and Casino du Liban (3.9% of total) registered upticks.

Telecom revenues remained subdued as they remain unchanged from 2017's consumer-friendly costs. Telecom generates almost half of the government's non-tax revenues. In 2018, telecom transfers lost 16.63% y-o-y to $1.07B. The Telecom Ministry in 2017 aimed to render new technologies accessible to most citizens, noting that its works and new fiber optic plans throughout 2018 remain not finalized.

Revenues from the Port of Beirut (PoB) and the airport fell despite 2017's tax hikes. In 2018, PoB and the international airport grasped 69.2% and 21.6%, respectively, of total activity at the customs offices. Nevertheless, the port's revenues lagged by a yearly 3.52% to $231.53M, thereby leading to an annual 37.12% decline in revenues in 2018. Similarly, income from the airport lost 25.98% y-o-y to $130.7M in 2018.

Meanwhile, revenues from the vehicle control fees (*mecanique*) added an annual 3.35%. Vehicle control offices climbed to $226.18, up from 2017's $218.86.

Revenues from Passport fees and general security fell by 1.75% y-o-y. The government introduced the new biometric passports in 2017 which resulted in a 1.93% uptick in revenues from passport fees in the same year. As most citizens had to renew passports within the first year, income from passport fees in 2018 fell by 1.75% y-o-y to $184M.

Fiscal Consolidation Efforts: Stalled in 2018

Lebanon's poor fiscal performance in 2018 came as no surprise. Experts and policy-makers had projected Lebanon's short-lived improvement in 2017 on the fiscal front. In fact, the one-off revenues from (banks') tax on profits were not going to support 2018's fiscal performance. In turn, the new salary scale was also expected to exceed the estimated $796M, and the full cost of public salaries materialized entirely in 2018. In addition, 2018's environment of high interest rates and inflationary pressures continued to inflate debt and debt servicing costs while economic growth stifled.

Lebanon did not succeed to regain the trust of its people and investors' confidence to unlock CEDRE funds in 2018. Throughout the year, international entities (IMF and World Bank) as well as credit-rating agencies unanimously reiterated the need for fiscal and structural reforms to spur economic growth. Yet, the hopes of unlocking CEDRE funds in 2018 remained unattained as fiscal consolidation efforts by the Lebanese government lagged behind. The country still awaits conclusive action and decisions on the draft budget and the series of serious reforms that may narrow the deficit and set debt on a sustainable trajectory.

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