

April 12, 2020

Memorandum of the Lebanese Government's Reform Program:

Comments on the Tax Measures & Proposals for

an Efficient, Fair and Inclusive Tax Regime

In its Memorandum submitted to the public opinion as a draft for discussion, the Lebanese Government proposes a comprehensive economic program aiming at resolving deep-seated macro-economic, financial and institutional problems, restoring confidence, boosting economic growth, promoting a healthy financial system and achieving debt and financial sustainability in addition to improving the Lebanese system of governance and changing its harmful practices.

Thus, in the face of the dire economic and financial situation, the government aims to address forcefully financial and fiscal imbalances, bring down the current account deficit, put the public debt on a firm downward path, restore the stability of the financial sector and restore confidence including by strengthening resources and improving tax compliance.

In Part D Section 1 (Fiscal Policies), the government proposes inter alia, as Revenue-Enhancing Measures (b), to broaden the tax base and improve tax collection through the listing of several general measures without going into the necessary details (notably regarding the current counterproductive and unfair tax incentives) except for its proposal of “removal of profits and capital gains tax exemptions for holdings and offshore companies and removal of certain VAT exemptions” while it becomes obvious nowadays and more particularly in developing countries like Lebanon, that tax incentives are found to be used in a manner which undermines the intention of the tax law such as where taxpayers have misused or abused the law. This is typically achieved where the course of action taken by a taxpayer is so blatant, artificial or contrived that it can only be explained by the desire to obtain a relevant tax benefit as described in detail below. It may occur as well where the tax incentive is so obsolete and outdated that it does not fulfill its true function of economic lever and does not meet the primary objective of the legislator.

On the other hand, the government declares that it intends to implement a large overhaul of the tax system to have it fairer and more efficient. But rather than carrying out an in-depth review and change of the current outdated tax regime, the Memorandum proposes the same measures of increasing brackets and percentages on current scheduled taxes and some indirect taxes and levies such as the VAT. Of course, we understand that in a fragile situation like the one prevailing at the present time, the capacity building and global reforms are unlikely to be met until a certain stage of economic stabilization and development as well as financial stability has all been achieved. But still, nothing precludes the government from implementing a structural reform of our tax regime in view of rendering it more inclusive, fair and efficient.

On that point, several topics and areas may be tackled, and we propose hereinafter two major segments as a preliminary step.

1. **Modifications in the Current Counterproductive Tax Incentives and Exemptions:**

In order to be efficient and achieve its purposes ultimately, tax incentives should be well assessed by the authorities, as part of the general social and economic vision, with a view to enact comprehensive, proactive pay equity legislation in consideration therewith.

It is now recognized that the tax strikes and modifies the pre-established order of things and has effects on the behavior of economic agents or on the market itself, and more particularly on production, consumption and circulation. It also triggers psychological reactions. For that reason, its use as a lever, for purposes which are not within its ordinary function of covering public expenditures and charges, must be made with great care and attention. Indeed, using the fiscal instrument through incentives for interventionism and cyclical regulation may be beneficial in guiding the economy and developing it as to ensure some equity through the redistribution of wealth, however this use can also be counterproductive both at the institutional and organic level and at the sectorial level and thus can lead to results contrary to those discounted. Some examples may be useful to that end.

As an example of counter productivity, we may identify the exemption for years and/or reduction of taxes on the capital (capital gains, dividends, interests, etc.) in order to promote productive investment through private financing. This has led to opposite results since the beneficiaries of such measures, once their disposable income increased, have found it more useful to save than to invest in the real and productive economy which would have been useful for the creation of jobs and sustainable growth.

Similarly, the policy of stimulating real estate activity by reducing the registration and transfer duties and/or capital gains tax (betterment tax) and/or exempting from the VAT, has led to a surplus and to an inadaptability creating a dangerous hub and consequently a sector crisis. Lebanon gets stuck today with hundreds of thousands of vacant apartments whereas other hundreds of thousands of citizens are deprived of ownership and cannot afford the high price of such apartments and connected inappropriate product range. Hence, the country ended up with this very significant recession triggered by the lack of adapted policies and development programs. This situation had moreover a devastating effect on the development and growth since the real estate sector has always been, during the last two decades, an engine and a key driver of economic growth in Lebanon.

Besides, some tax incentives enacted in the last century became obsolete, outdated and henceforth inappropriate and unsuitable to the changing environment.

Among those, the permanent exemption from income tax that has been granted to the educational institutions since 1959 (article 5 of the Income Tax Law) and that was originally intended to combat illiteracy since it was vital that everyone receives an education and thus increase school registration in general. However and taking into consideration the eradication of illiteracy over the decades, the overall implementation of such exemption resulted in a departure from its original aim and in a selective use of the tax benefit; which has led to school and private university multiplications without any serious control and therefore to a decrease of education level and concomitantly to the lowering/downgrading of the status of the public school and university.

The counterproductive effects apply as well for other permanent or temporary tax incentives such as for maritime and aerial transportation companies that has created a monopolistic situation and unlawful competition in favor of the Middle East Airlines (MEA) with a permanent and unjustified increase of travel and transport rates. Indeed, the permanent exemption provided to the national company by virtue of the income tax law (article 5 of the Legislative-decree No 144 dated 12/6/1959 with its amendments) has granted the latter an abuse of a dominant position that has killed all competition and enabled excessive rates to be charged because of this dominant position.

Another unjustified exemption still applying despite the fact that the sector has flourished and developed, is provided by the Decree-Law No. 50 of July 15th, 1983 applying to investment banks and medium and long term credit banks (specialized banks) whereby they are exempted from the income tax (17%) during the seven first financial years following the date of incorporation; in addition to an exemption afterwards up to a ceiling of 4% of the banks' paid-up capital which is considered as a deductible charge.

Finally, featuring among the counterproductive effects, there is the issue of vested rights, owing to the profits thus acquired by certain groups of taxpayers or citizens, which will be difficult to be challenged as we are experiencing a painful situation currently in Lebanon with the reconsideration of social privileges in the public sector or tax privileges in the private sector. Needless to mention in this regard the urgent need to transform the Lebanese Public Administration from a plethoric, non-performing and budget-consuming administration into a lean, performing and financially sound public administration in which each single public servant will be evaluated and put in the most suitable position, where his or her contribution will be the most efficient and useful to the citizens.

In order to guard against the negative and counterproductive effects and to implement in replacement efficient new incentives, we must use a reliable statistical device which can produce sufficiently precise studies of the reactions of taxpayers on tax incentives. The observation of tax experiments carried out in respect with groups of taxpayers or similar economic agents has shown its utility in order to measure with accuracy the effectiveness of tax incentives. Not to mention that tax incentives must necessarily be accompanied by other factors similarly decisive such as the legislative and political stability, the quality of the infrastructure, the equipment and the workforce, the judicial fair and reliable system, (etc.).

There is no doubt that the main goal of the government on the midterm should be to address the deficit of the balance of payments and the trade balance, by promoting private investment and exports. In this regard, the government should use a range of new adapted incentives opened to both local economic agents and foreign investors to attract foreign capitals and to carry out projects that will serve to enhance and modernize the infrastructure, to develop the territory, the agriculture and the efficient industries with the view of creating jobs, to bring in foreign exchange, to stimulate growth and finally to increase budgetary revenues.

Among the indicated measures, we can mention the establishment of investment codes which include tax provisions promoting investment as well as benefits that may be contractually agreed or based on administrative licenses. These exemptions and benefits will vary depending on the nature and amount of the investment contemplated. The overall is to reassure the investor with long-term commitments, including the stabilization of tax burdens for a fixed period.

Free zones are also another means of achieving the above-mentioned objectives since they ensure, on the one hand, the possibility of securing jobs, planning the territory for the purpose of a sustainable development, achieving priority economic objectives and on the other hand, they entitle the investor to benefit from reduced taxation and stay away from complications and legislative and bureaucratic constraints. Finally, among the concerns that have emerged recently, the necessity of the intervention of the State appears in news fields that are of great importance such as the environment and innovation.

2. Suggestions as to how to Increase Revenues in order to Reduce the Fiscal Deficit while being Fair and Equitable:

It goes without saying that Lebanon is requested today to demonstrate transparency and accountability in its use of public funds and true willing to proceed to serious reforms. The international organizations and donors highlighted the importance of targeting fiscal and expenditures reforms to achieve stability and secure revenues and to help the country exit its fragile situation and avoid total collapse. It is indisputable that the choice of policy and steps in taxation, should be guided by the country's specific circumstances as well as by operational and practical constraints; considering the significant analytic challenges involved in the choice of priorities and urgent needs.

Therefore, we may understand that the Government wishes to focus currently on tax revenue collection as an urgent need to cover the several operating costs and finance the current account deficit within the framework of debt restructuring. The targeting is, on one hand, on easy-to-collect taxes and selective high-yielding excise taxes, on the other hand, on measures aiming at broadening the tax base by improving compliance rate (focus on areas where tax compliance is significantly below benchmarks) and tax collection.

At a later stage and once the country becomes more stable, the objective should undoubtedly be the modernization of fiscal institutions and in-depth fiscal reforms, as well as medium-term revenue and expenditures strategies; taking into consideration certainly the country-specific circumstances and conditions at that time.

Nevertheless, this contingency plan must not mean the exclusion of accessible reforms and should not prevent taking actions to improve tax compliance and reducing corruption and inequity.

Notwithstanding the fact that the easiest way to increase revenues is indeed to focus and target on easy-to-collect taxes such as VAT, customs duties at the border and selective high-yielding excise taxes, those taxes are however regressive and very far from the desired objective of fairness and equity. Moreover, increasing brackets and tax rates on some scheduled taxes in this economic situation of recession and inflation and very soon stagflation, will lead to the same disaster and tragic outcome of the financing of salary scale three years ago. Therefore, all efforts must now be focused on the modernization of fiscal institutions and the broadening of the tax base. Besides, mobilizing revenues more efficiently implies a broad consensus on several measures or steps that should first and foremost be adopted. The most important and fundamental of these measures is to combat tax evasion and fraud as well as to incorporate the informal sector into the formal economy, wherever feasible. A better governance of public finances is also requested and necessarily passes through the rationalization of public expenditures.



Given that the structures of our economy have not changed sufficiently, that the corruption remains endemic, that the inequalities have worsened and that our growth is uneven and never leads to sustainable development, the Government may adopt as starting points, for the establishment of a modern system and an efficient tax policy, a number of guiding principles.

The first of these principles is the intelligent and gradual orientation of the informal sector towards the formal sector by providing concomitantly to those in a precarious situation, a clear and simplified legal device as well as the necessary social coverage.

It would be necessary, in the same way, to distinguish between those who are fleeing taxes and must be duly controlled and sanctioned, and those who make real losses and suffer in order to survive in a competitive market with unequal weapons.

The struggle against fraud and tax evasion also depends mainly on seeing that the economic activity generating the tax base is within the reach of the authority of the State and involves necessarily other complementary important measures. These include, inter alia, tackling several loopholes in the current tax system such as the schedule taxes and bank secrecy as well as the weakness of the notification procedures in view of applying, on the midterm, the tax identification number for each resident, whether national or foreigner, and the general income tax with progressive measured rates.

Indeed, and since scheduled taxes adopted in 1959 exclude important revenues and assets from the tax base, the adoption of the general personal income tax on the whole revenues becomes a high priority. Indeed, this general tax laying on progressive rates is less prone to evasion through base erosion schemes. Needless to precise that the aforementioned measures need to be accompanied by an implementation of algorithms and remote of computer groupings of taxpayers' accounting data, by means of computer interface links in order to highlight the flaws and to pursue the recalcitrant.

In addition, the tendency of resorting permanently to tax rebates and amnesty should be abandoned inasmuch as it affects equity and fairness and causes fiscal civic mindedness. The result of this will be that taxpayers' compliance improve, henceforth with a perception that the most citizens are complying and the ones who do not comply experience adverse consequences. Hence and through broader taxation, the governments could raise additional revenues in an equitable manner to fund inclusive growth as well as social and infrastructure programs, create jobs and fight inequality. This should occur in parallel with an effort of tax harmonization through the regrouping of disparate fiscal provisions in a General Tax Code.

It would also be appropriate to extend the scope of the VAT to all the economic activities, to reorganize its ceilings and rates and to guarantee its neutrality and equity, particularly at the level of the products of first necessity which should remain exempted at a 0% rate.



Other noteworthy reforms include the introduction of the use of earmarked taxes which increases the taxpayers' knowledge of how taxes are channeled, and which in-turn could increase taxpayers' vigilance over the efficiency of the service provided and leads to its improvement. In this context, the public authorities may introduce new taxes or increase rates of current taxes on activities that are harmful to health and prejudicial to the environment (such as quarries and cement factories). Without prejudice to the foregoing, regularization (amnesty) may be adopted for income derived by Lebanese residents from foreign movable assets (interest, dividends, arrears, bonds, etc.) that are liable to tax in Lebanon but were not, for most of the taxpayers, included in their tax returns for years owing to the lack of financial literacy, bank secrecy and absence of any international cross border mechanism for exchange of financial and tax information.

In accordance with the legal and regulatory provisions in force, the period of recovery also known as the limitation period (i.e. the statute of limitations) provided to the Tax Authorities to recover their dues retroactively, expires four years following the end of the year that follows the verified fiscal year (five years in tax years actually) and six years for taxpayers that are "invisible" or unregistered before the Tax Administration (practically 7 years). Therefore, and in order to avoid discretionary tax control and assessment, a regularization in the amount of a fixed percentage (3 to 5%) of the whole capital held abroad may apply. The proceeds will be considered as earmarked taxes and allocated to the sovereign fund or to the contemplated dedicated deposit recovery fund. This would undoubtedly mitigate the effect of any haircut and compensate local depositors' losses while striving to retrieve the stolen asset and money.

Tax administration should be able to rely as well on simple regulations or application rules, short tax forms, fair and well-balanced procedures and efficient and fast organs for conflict resolution since simple tax legislation also reduces the likelihood of tax disputes. Steps to strengthen tax administration and improve taxpayers' compliance can help broaden tax collections in an equitable manner. To this end, it would be necessary to make sure that the administration is no longer judge and party at the same time, that is to say entitled to elaborate the texts, to apply them and to control the execution as it is currently the case.

In conclusion, it must be pointed out that any judgment on an incentive policy is based on the effectiveness of the adopted provisions, which is to say largely dependent on the degree of achievement of the stated objectives. The way to prevent it and to succeed is based on the research of a preliminary impact study and a statistical system with reliable thematic data. In addition, there are sufficiently precise studies of the taxpayers' reactions that must be done. This data is necessary for all analysis and reflection with an econometric model in order to measure the impact of the change of each factor on the income, the inflation, the consumption or the tax revenues. It is a fundamental tool for any decision.

The challenge is substantial but stimulating, and we have very serious reasons to consider deservedly that today the time is no longer to postpone, but to act.

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