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Policy Brief

For an efficient, fair, and inclusive taxation system

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About the author
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Executive Summary

The Lebanese government's financial recovery plan adopted on April 30, 2020, proposes a comprehensive program aimed at resolving its deep-seated macro-economic, financial, and institutional problems. In it, the cabinet promised to restore confidence, boost economic growth, promote a healthy financial system, and achieve debt and financial sustainability.

More specifically, the government aims to address financial and fiscal imbalances, bring down the current account deficit, put public debt on a firm downward path by, among other things, increasing fiscal resources and improving tax compliance. To this end, it proposes to broaden the tax base and improve tax collection through several general measures, as well as to review tax exemptions and incentives.

The plan, however, fails to address two key issues: First, it does not rectify the loopholes in the tax incentives and exemptions that have failed to encourage investment. Although these are meant to encourage investments, they did not meet their intended objectives over the years. Second, the plan fails to adopt reforms that could increase tax revenues.

Hassan Diab's government also declared in its plan its intention to implement a large overhaul of the tax system and introduce a global income tax framework. But rather than proceeding with an in-depth review and amendment of the current outdated tax regime, the plan puts forward the same measures that were already in place, which include increasing brackets and percentages on current scheduled taxes and some indirect taxes and levies such as VAT.

Since Lebanon finds itself in a precarious situation, capacity building and global reforms are unlikely to be met until some level of financial stabilization and development has been achieved. Still, nothing prevents the government from overhauling the tax regime so it becomes inclusive, fair, and efficient. To this end, this brief examines the counterproductive tax incentives and exemptions currently in place, and recommends tax reforms, based on some elements of the government's financial recovery plan.

Modification of tax incentives and exemptions

Tax incentives and exemptions are adopted to encourage certain economic activities by the authority. They are meant to shape the production, consumption, and investment decisions of businesses. They are also needed to contribute to the development of underdeveloped areas as well as encourage economic activities in certain sectors and industries. Beyond raising revenues and redistributing wealth, tax policies which include incentives and exemptions must be carefully designed and evaluated according to key objectives lest they have unintended consequences. Furthermore, tax policies should focus on effectiveness and efficiency and not only on the cost-benefit. Indeed, an assessment should be made on the rationale behind such measures, mainly how tax incentives can, on the long run, attract foreign direct investments to create jobs and boost economic activity.[1] And so, tax incentives may not meet its stated objectives if the other factors are weak or unstable. Consequently, in certain cases, it is recommended the already existing deficiencies are corrected rather than provide investors with additional tax benefits.

Beyond raising revenues and redistributing wealth, tax policies which include incentives and exemptions must be carefully designed and evaluated according to key objectives lest they have unintended consequences

In Lebanon, tax policies including exemptions and reduction of taxes have failed to meet their objectives. For instance, the decrease in taxes on capital (such as capital gains, dividends, interests, among others) that were used to promote productive investment through private financing have been counterproductive throughout the years. The beneficiaries of such measures, once their disposable income increased, chose to save their extra income rather than reinvest it in the productive economy, which would have led to the creation of jobs and sustainable growth. Similarly, the policy of stimulating real estate activity by reducing registration and transfer duties and/or capital gains tax and exempting them from the VAT has led to a surplus of vacant apartments, and consequently, a sector crisis. These apartments do not correspond to the demand on the market, with most citizens unable afford

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One should take into consideration, however, that foreign investment is also dependent on other factors such as good infrastructure, stable political and economic environment, and legal steadiness.

their high value. Those empty apartments also benefit from a full exemption of taxes on built properties. This situation has had a devastating effect on the economic growth since the real estate sector has been one of its key drivers over the past two decades.

Outdated and counterproductive tax incentives

Some tax incentives—which were enacted in the late 1950s—have become obsolete and therefore unsuitable to the changing environment. Among those, the permanent exemption from income tax granted to educational institutions since 1959[2] that was originally intended to combat illiteracy and increase school registration in general. However, the implementation of such an exemption, after the eradication of illiteracy, resulted in the selective use of it as a tax benefit and profit generating tool, leading to the increase of private schools and universities without any serious regulation.Consequently, this decreased the level of public education, and lowered and downgraded the status of public schools and universities.

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Another example of tax incentives' counterproductive effects is the one granted to maritime and aerial transportation companies. This created a monopolistic situation and unlawful competition in favor of Middle East Airlines (MEA) with a permanent and unjustified increase of travel and transport rates. The permanent exemption, provided to the national company by the 1959 income tax law,[3] has allowed MEA to abuse its dominant position and stifling all competition, leading to higher or excessive rates.

A further case of unjustified exemption is that of investment banks and medium- and long-term credit banks (specialized banks) that was adopted in 1983. Decree-law number 50 exempted them from the 17% income tax (at the current applicable rate) during the banks' seven financial years following the date of incorporation. They then would benefit from another exemption up to a ceiling of 4% of the banks' paid-up capital which is considered as a deductible charge. This measure remains in place despite the sector's flourishing performance.

Another counterproductive exemption is the one applied on assignment of shares in Lebanese joint stock companies (SAL). Since 1994, it has allowed many tax evaders to transfer their assets and real estate properties to third parties assignees or heirs without any tax liability.

Finally, there is also the issue of favoritism through the whole informal sector. This includes those who have never complied during the past decades

2 Article 5 of the income tax law.

3 Article 5 of the legislative-decree No 144, with its amendments.

with their tax obligations and duties, either for lack of tax consciousness and fiscal citizenship or because they were protected by their political leader and 'zaims'. Moreover, banking secrecy, loopholes, and deficiencies in the laws are used on a large scale to evade or avoid paying taxes. In some situations, there is no tax reporting due to implicit acquiescence by authorities in permitting the use of the perceived or real loopholes.

A need for new informed policies

Based on all of these misuses of exemptions, there is a need to implement efficient new policies that are informed by new data and studies of taxpayers' behavior vis-à-vis tax incentives. In order for these incentives to be effective, they must be coupled with other factors, such as legislative and political stability, infrastructure quality, human resources, and a fair and reliable judicial system, to name a few. Also, instead of granting an incentive for 5-10 years, efforts should be made to evaluate them on a regular basis to see whether it is achieving its intended goals.

There is no doubt that the government's main mid-term goal should be to address the deficit in the balance of payments and the trade balance by promoting private investment and exports. In this regard, the cabinet should use a range of new incentives available to both local economic agents and foreign investors to attract foreign capital. These incentives would also help carry out projects that will serve to enhance and modernize the country's infrastructure, to ensure a fair and sustainable development of regions and national territories. These will also improve the agricultural and industrial sectors in order to create jobs, bring in foreign exchange, stimulate growth, and finally increase budgetary revenues.

The government should adopt new investment policies, such as tax provisions, to promote investments and benefits

Among the indicated measures, the government should adopt new investment policies, such as tax provisions, to promote investments and benefits. These exemptions and benefits will vary depending on the nature and amount of the planned investment. The goal of such measure is to reassure the investor with long-term commitments, including the stabilization of tax burdens for a fixed period.

Free zones (i.e. designated areas or ports where certain taxes or restrictions on business or trade do not apply) are also another mean of achieving the above-mentioned objectives since they ensure, on the one hand, the possibility of securing jobs and territory planning for the purpose of having a sustainable development. On the other hand, they allow the investor to reduce taxation and minimize complications accompanied by legislative and bureaucratic constraints.

Finally, among the concerns with the review of tax incentives, is the necessity for the state to help stimulate new fields such as the business environment and innovation. A list of targeted areas and sectors is provided to that end in both the government's financial recovery plan and the 2018 McKinsey report.

Better tax collection

As a condition to any foreign assistance, the government has to follow two short-term objectives. The first is to target easy-to-collect taxes and selective high-yielding excise taxes. The second objective is to focus on measures that would broaden the tax base and improve compliance rate and tax collection. This can be done through concentrating on areas where tax compliance is significantly below benchmarks. It should then be followed by deeper reforms which include modernizing fiscal institutions and pushing for fiscal reforms through medium-term revenue and expenditures strategies. Even though the easiest way to increase revenues would be to target easy-to-collect taxes such as VAT, customs duties at the border, and selective high-yielding excise taxes, those taxes are regressive and very far from the desired objective of fairness and equity. Given the current recession and inflation—and very soon stagflation—increasing brackets and tax rates on some scheduled taxes will lead to the undesired outcome of financing the salary scale three years ago.

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Mobilizing revenues more efficiently implies a broad consensus on several measures and on the steps that should 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, whenever conceivable. A better governance of public finances is also needed and necessarily goes through the rationalization of public expenditures.

How to modernize Lebanon's tax system?

The government may have to start with establishing a modern system of taxation, passing an efficient tax policy, and following a number of guiding principles. And this is no easy task: The structures of our economy have not changed sufficiently, corruption remains endemic, inequalities have worsened, and our growth is uneven and has never led to sustainable development. A first step toward the right path should be to focus on the resourceful and gradual inclusion of the informal sector to the formal sector by providing those in a precarious situation a clear and simplified legal device and the necessary social coverage.

Combat tax evasion

First, a distinction should be made among those who do not pay their taxes. Indeed, in order to fight tax evasion, it will be necessary to differentiate 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 advantages.

The struggle against fraud and tax evasion will also depend mainly on whether the economic activity generating from the tax base is within the reach of the authority of the state. Moreover, it will need to involve other complementary important measures. These include tackling several loopholes in the current tax system such as scheduled taxes and banking secrecy, improving procedures to apply for a tax identification number for all residents (whether Lebanese or not), and passing the general income tax with progressive measured rates.

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The general income tax

Adopted in 1959, the current scheduled taxes exclude important revenues and assets from the tax base. This makes the adoption of the general income tax on the whole revenue (or general revenue) a high priority to fight tax evasion. General income tax is progressive by income brackets with different revenues scales and encompasses all kind of revenues and earnings that are not subject to another tax. However, these measures need to be accompanied by an implementation of appropriate technical and technological procedures to make sure they are paid and to crack down on those breaking the law. Using this perspective, the competent authorities can build better systems to tackle tax evasion with digital solutions, especially concerning the detection of fraudulent behavior of importers at the border. Finally, digital tools, through data mining, provide the option of more effectively tracking down wealth and proceeds from tax evasion before it is hidden away.

VAT, earmarked taxes, and foreign assets

Other taxation reforms should be taken into consideration, such as the VAT. Indeed, its scope should be extended to all economic activities, and its ceilings and rates should be reorganized to guarantee its neutrality and equity, particularly for the products of first necessity, which should remain exempted at a 0% rate.

Another reform includes the introduction of earmarked taxes, which increase taxpayers' knowledge of how taxes are channeled. This, in turn, would increase their vigilance over the efficiency of the service provided and could help improve it. In this context, public authorities could introduce new taxes or increase rates of current taxes on activities that are harmful to public health and prejudicial to the environment, such as cement quarries and factories.

In addition, income derived by Lebanese residents from foreign movable assets (such as interests, dividends, arrears, and bonds) are liable for tax in Lebanon. However, for years, they have not been included in most of the taxpayers' tax returns, due to the lack of financial literacy, banking secrecy, or absence of any international cross border mechanism for exchange of financial and tax information. Those revenues are subject to tax on movable capital income at the normal rate of 10% and have to be declared annually.

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A regularization of these taxes should be considered. According to the legal provisions in force, tax recovery period expires within practically seven years in total. Regularization could be achieved similar to the one applied in several developed countries like France or Italy through a fixed percentage (3-5%) of the whole capital held abroad. The proceeds will be considered as earmarked taxes and allocated to the sovereign fund or to the potential dedicated deposit recovery fund. This would undoubtedly bring back some of what is considered stolen money, and could mitigate the effect of any haircut and compensate local depositors' losses.

Tax administration should be able to rely as well on simple regulations or application rules, short tax forms, as well as fair and well-balanced procedures. Additionally, efficient structures for conflict resolution are necessary because simple tax legislation can reduce 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 paramount to make sure that the administration is no longer a judge and a party at the same time. In other words, it should not be the one to elaborate the texts, apply them, and control their execution, all at once, as it is currently the case.

Civic mindedness and a fair tax system

Civic-mindedness is essential, so is taxpayer compliance, which would improve when people know that they are treated equally, and that those who do not comply will experience adverse consequences. And so, through broader taxation, the government could raise additional revenues in an equitable manner to fund inclusive growth as well as social and infrastructure programs. This should occur in parallel with an effort to harmonize taxes through the regrouping of disparate fiscal provisions into a General Tax Code, which would encompass all the tax laws currently distributed in various legislations.

Creating a sense of fairness will also undoubtedly encourage all citizens to contribute willingly in the financing of state expenditures and activities

Building trust and cooperation with taxpayers becomes in present day a priority of the new compliance improvement approach. Creating a sense of fairness will also undoubtedly encourage all citizens to contribute willingly in the financing of state expenditures and activities. Hence, if citizens perceive that the system is reasonably fair, then they will comply and the collection of taxes will increase substantially. Nonetheless, equity should be evaluated within the contest of the entire tax system, not just the income tax and not on case-by-case basis. A key priority is therefore to build a broader and more equitable tax base and reprioritizing government spending (more particularly devoting revenue windfalls) toward infrastructure and social priorities, notably to fund essential shared service, such as education, healthcare, public safety, and retirement pensions. All are important and are put in danger with the current financial crash.

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New data needed

In order to succeed, new taxation policies should be based on the results of a preliminary impact study and a statistical system with reliable data, and on studies of taxpayers' reactions. The data collected will be necessary for all analyses and reflections to measure the impact of these taxes on income, inflation, consumption, and tax revenues. It is a fundamental tool for preparing policies.

The state's ability to mobilize resources to support growth and diversification of the economy remains fundamental for achieving inclusive and sustainable development and this should not be neglected. The success of any financial recovery plan depends on the good balance between these two constants as well as among competing interests. The challenge is huge and the Lebanese government can no longer postpone taking the right and fair decision to reform its tax system.

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