Public Finance

Public finances suffer from a chronic and deep deficit, threatening economic, financial and social stability. It worsened in recent years to reach 9.5% of GDP in 2013 as a result of indiscriminate and uncontrolled spending, failure to approve the public budgets, the burden of displaced Syrians, low economic growth rates, and the decline in tax revenues. The fiscal deficit reached 6.2% of GDP in 2014 and 8.56% in 2015[*]. These causes were echoed in the primary balance, which turned from a surplus in the years 2007 to 2011 to a deficit in the years 2012 and 2013, then to a large surplus in 2014 (1,970 billion Lebanese liras – LL –) due to the significant increase of revenues from telecom by 40% (980 billion liras), followed by a surplus of 800 billion liras in 2015 due to a much less deficit in EDL accounts, which decreased by about 1,200 billion liras.

The situation of public finance is worrisome, especially with the upward trend of the fiscal deficit which is in dire need of immediate reforms, including simultaneous reforms in tax and spending policies, in addition to new measures that would foster economic growth and the GDP.

Spending policy:

1. The growth of public expenditure

The total spending (public budget + treasury) during the years 2007 to 2014 increased by about 67%, from 12,587 billion liras to 21,032 billion liras, but spending to GDP ratio decreased from 33.45% to 28.17%.

The evolution of public spending was as follows:

- Rises in 2007 and 2008 by 36.6%, due to increased EDL expenses by 52%, and increased allocation of salaries and wages by 38%.
- Stability of public spending in the years 2009 and 2010.
- Higher public spending in 2011 and 2012, by about 14% per annum, due to

(*) Adnan Daher: Preambles of the General Budget 1921 - 2012.

increased provisions for salaries and wages by approximately 21.5%, and increased transfers to EDL by about 29%.

Evolution of the public spending (Budget + Treasury), in billions of LL:

	2007	2008	2009	2010	2011	2012	2014
Total spending	12,587	14,957	17,167	17,047	17,601	20,081	21,032
Salaries and wages	3,583	3,97	4,936	5,066	5,533	6,723	6,727
Debt service	4,94	4,957	5,784	5,893	5,655	5,457	6,314
Investment spending	558	514	550	701	676	760	883
Transfers to EDL	1,479	2,43	2,259	1,797	2,626	3,408	3,157

2. The evolution of major expenditure items:

a) Allocations for salaries, wages and add-ons: They made up 32% of total spending in 2014, compared with 29% in 2007, registering during the years 2007 to 2014 a gradual increase of 87.74%. The increase mainly comprised pensions and end-of-service compensations with an increase of 106%, from 889 billion liras in 2007 to 1,893 billion liras in 2014.

The reasons for the spending increase are: The raise of the minimum wage by 200,000 liras in 2008 (totaling about 400 billion liras), the 'cost of living raise' within the 'salary scale' project in 2012 (about 850 billion liras), and the large recruitment policy in education and security departments since 2007 until year 2014, in addition to transforming outworkers into regular employees.

We expect this rise in wage allocations to continue in the coming years due to the absence of real reforms in the public sector, and the increase in political appointments, especially in the sectors of education and security forces. Likewise, we fear that a significant rise will have been witnessed in 2014 and the coming years in the 'pensions and end-of-service spending' if the new salary scale was approved, as about 21% of public sector employees would then retire in the following five years at magnified new salaries.

The number of public sector employees is about 165,000, if we count administrative and military personnel, in addition to teachers and retirees. These are distributed as follows: Faculty 28,486; outworkers in education 24,653; the military 93,576; administrative personnel 17,226; add to that the retirees who count about 80,000.

b) Public Debt Service: Public debt service constituted 30% of total public expenditure and 38.5% of total public revenues in 2014. Between 2007 and 2013, it witnessed a slight rise, by about 15.6%, from 4,940 billion liras to 5,714 billion liras, despite the increase in public debt amount during this period by about 51%, from $42 billion to $63.5 billion. The slight rise in debt service is due to the fact that the monetary and fiscal authorities succeeded in reducing interest rates on the public debt between 2% and 3% (percentage points). It is also due to the decrease in global interest rates to record low levels, even to zero for the US dollar, and to the high liquidity level of the banking sector starting 2008.

The average interest rate on LL Treasury Bonds was around 6.89% in 2014, compared to 9.25% in 2007, and the average interest rate on Eurobonds was 6.40% in 2014 versus 8.5% in 2007. We now fear that interest rates on the dollar might rise in the global financial markets in the coming years, as a result of the gradual change of the US monetary policy. This would reflect negatively on the public debt service.

Finally, it should be noted that the public debt service dropped dramatically as a proportion of GDP, from 13.12% in 2007 to 8.45% in 2014, for a total decrease of 64%, due to the significant growth of the gross domestic product by 89.9% during the period 2007-2014, compared with 27.8% growth of the public debt service.

c) Transfers to EDL: These financial transfers represented 15% of total expenditure and 4.4% of GDP in 2014; they were the largest source of financial bleeding for the public Treasury, as they rose between 2007 and 2014, by 113%, from 1,479 billion liras in 2007 to 3,157 billion liras in 2014.

Lebanon benefited in 2015 from the decline in global oil prices, therefore EDL achieved a drop in the deficit of nearly 1,200 billion liras.

Introducing reforms at the EDL becomes one of the most important challenges for the State due to the sector's risks on the public Treasury and its impact on the economy and businesses, as well as on the daily life of citizens. The government should bring about a reform process for this institution through a review of the tariffs, improving collection, switching to the use of natural gas instead of fuel oil, reducing technical and non-technical waste, renovating distribution and transport networks, increasing production capacity, in addition to forming a regulatory body for the sector and establishing a partnership between the public sector and the private sector.

Transfers to EDL have reached about 20,215 billion liras in the period from 2007 to 2014, and constituted in 2014 about 48% of the public budget deficit.

Finally, the adoption by the Parliament of a bill to “authorize the government to grant temporary electricity production licenses to the private sector for a period of two years” is considered a positive and healthy decision for the sector.

Three items (provisions for salaries and wages, debt service, and transfers to EDL) represented 77% of the total spending in 2014, which means that the government’s capacity to increase social benefits and investment is weak.

d) Investment expenditure: They accounted for about 1.28% of GDP in 2014 and less than 1.2% in the years 2007 to 2009. The size of the investment expenditure is weak compared to neighboring countries, where the ratio is up to 2.8% in Morocco, 4.1% in Egypt, 6.6% in Turkey, and 7.4% in Jordan.

The weakness in investment spending has a negative effect on the development of infrastructure and water and road networks; it also reflects negatively on economic growth and on the capacity to attract investors, companies, and businessmen. The State should bank on the partnership between the public sector and the private sector to implement its investment projects due to the weakness of its financial capacities.

Tax policy

The tax policy has low efficiency, as it failed to attract investment, achieve fiscal justice, balance between direct and indirect taxes, or reduce tax evasion. Its only target was to search for tax sources in order to increase revenues without paying attention to the implications of this policy on the economic and social levels. It also neglected its role in the economic growth process, such as to activate investment, generate jobs, improve social and living conditions, and achieve justice and fairness in the distribution of income.

1. Evolution of total public revenues:

a) General revenue growth: Total revenues increased in the years 2007-2014 by about 7,651 billion liras or 87.45%, from 8,749 billion liras in 2007 to 16,400 billion liras in 2014. Increases were especially registered in 2009, by 20.4%, due to a surge in tax revenue by about 24.8% in 2011 by 11%, due to the increase of non-fiscal revenues related to telecom profits, and in 2014 due to the growth in Treasury revenues by 103%, and telecom revenues by 33%.

- Tax revenues have been affected in the period 2010 - 2014 by the slowdown in economic activity and the elimination of the 5,000 lira fees on gasoline, in addition to the cancellation of the VAT on diesel oil, which resulted in losing yearly revenues equivalent to 500 billion liras and 300 billion liras respectively.

- Telecom revenues constitute about 70% of non-tax revenues; they have increased during the period from 2007 to 2014 by about 84%, from 1,660 billion liras to 3,054 billion liras.

b) Total public levies: Total public levies in 2007-2014 registered 21.96% of GDP in 2014 and 24.32% of GDP in 2009.

- Total public levies declined in recent years, from 23.9% of GDP in 2011 to 20.8% of GDP in 2013, due to the Syrian crisis, the weak growth of non-tax revenues, and a higher growth of the GDP compared to that of overall revenues.

The evolution of total public revenues

	2007	**2008**	**2009**	**2010**	**2011**	**2012**	**2014**
Tax revenues	5,583	7,177	8,960	9,976	9,885	10,187	10,388
Non-tax revenues	2,511	2,612	3,069	2,043	3,468	3,286	4,354
Total revenues	8,749	10,553	12,705	12,684	14,070	14,164	16,400
Total revenues/GDP	21.51%	23.5%	24.32%	22.66 %	23.9%	22.49%	21.96%

2. Characteristics of the fiscal system

a) A weak fiscal load: The tax burden in Lebanon is weak, ranging from 17.8% of GDP in 2010 to 13.9% of GDP in 2014, compared to 18% in Jordan, 21.6% in Tunisia, and 23% in Morocco.

- The tax burden declined as of the year 2011 from 16.8% of GDP to 13.9% of GDP in 2014, impacted by the Syrian events and the slow economic growth.

Note: The tax burden in Lebanon may increase by more than 12% if the Government took into account, among tax revenues, those collected from the telecom sector, which constitute more than 60% of total telecom income; this means that the tax burden could rise to 19.1% of GDP in 2011 instead of 16.8% and 16.7% of GDP in 2014 instead of 13.9%.

Telecom income ranged between 1,660 billion liras in 2007 and 3,034 billion liras in 2014, accounting for more than 65% of non-tax revenues.

b) The structure of tax revenues: Domination of indirect taxes: Indirect taxes formed, on average, 67% of the total tax revenues in the period 2007-2014; they mainly relied on VAT revenues, which accounted for about 32% of total tax revenues. But we noticed at the same time that the indirect tax share has strongly decreased from 68.54% of total tax revenues in 2010 to 63.92% in 2011, due to the cancellation of some fees on gasoline, worth 500 billion liras, in addition to the rise in income tax revenue on corporate profits by about 27.8%, and on wages by about 20.4%.

Structure of tax revenues

	2007	**2008**	**2009**	**2010**	**2011**	**2012**	**2014**
Total tax revenues	5,583	7,177	8,96	9,976	9,885	10,187	10,388
Direct tax share (%)	32.95	32.74	29.5	31.46	36.08	36.4	38.9
Indirect tax share (%)	67.05	67.25	70.5	68.54	63.92	63.6	61.1
Tax revenues/GDP (%)	14.83	16.03	17.15	17.8	16.8	16.18	13.9

3. The distribution of total tax revenues

Total revenues collected in 2014 amounted to about 10,388 billion liras composed of:

a) Direct taxes: They amounted to 4,040 billion liras and accounted for 38.9% of total tax revenues, distributed as follows:

- Income tax on income, profits and capital reached 2,795 billion liras, including:

• Income tax on profits: 1,119 billion liras, or 10.77% of the total tax revenues. These revenues are considered low, as a result of the low rate of income tax on profits at 15%, compared to Morocco at 30%, Turkey at 20%, Egypt at 30%, Jordan at 24%, and Syria at 28%. Lebanon has adopted a low rate to attract corporate investment, but it did not achieve that goal.

• Income tax on wages and salaries: 643 billion liras, or 6.19% of total tax revenues. This tax is also low as a result of the low tax rates which range between 2% and 20%; it mainly affects public and private sector employees, or basically middle and low-income class.

• Income tax on bank interest: 711 billion liras, or 6.84% of total tax revenues. It is also low because of the low tax rate of 5%.

• Tax on property: 1,245 billion liras, or 12% of total tax revenues. It is considered to be low because it does not include the profit tax on real estate, and due to the low level of fees on real estate properties (5% to register a property...) as well.

b) Indirect taxes: 6,348 billion liras, or 61.10% of the total tax revenues. Their breakdown is as follows:

- Taxes on goods and services: 3,811 billion liras, or 36.68% of the tax revenues, mainly including:

• VAT: 3,302 billion liras, or 31.78% of the total tax revenues. It is considered low as a result of many exemptions on goods and services in the health, education, agriculture and transport sectors, and as a result of the application of a single low rate (10%), even on luxuries. By comparison, VAT rate reached 16% in Jordan and 18% in Tunisia. So we suggest to apply multiple VAT rates, one for luxury goods and another for basic commodities.

• 2,042 billion liras, or 19.65% of the total tax revenues. They are also considered low, due to the abolition of gasoline, worth 500 billion liras, and the lack of clarity in the classification of goods among luxury, non-luxury, and basic goods, when setting up the tariffs...

• Other tax revenues (especially stamp): 495 billion liras, or 4.76% of total tax revenues.

The fiscal deficit

The budget deficit has become a serious concern in the last period, as it took in 2012 and 2013 an upwards trend, after it had recorded important declines in the years 2007 to 2011, from 10.22% of GDP in 2007 to 5.9% in 2011. In 2014, it scored a deficit of 6.2% of the gross domestic product, while public revenues increased by 15.48% (2,200 billion liras). The primary balance also is becoming a concern after it turned from a surplus in the years 2007 to 2011, reaching record levels of 2,505 billion liras, or 4.25% of GDP, to a deficit of 166 billion liras in 2012, and 366 billion liras in 2013 (0.3% of the gross domestic product). In 2014, it achieved again an exceptional surplus of 1,970 billion liras.

Public budget deficit: Primary balance

	2007	2008	2009	2010	2011	2012	2014
Public budget deficit	3,845	4,197	4,438	4,342	3,571	5918	4,632
Deficit/GDP (%)	10.22	9.65	8.38	7.57	5.9	9.4	6.2
Primary balance	1,102	900	1,625	1,855	2,505	(166)	1,970
Primary balance/GDP (%)	2.9	2	3.11	3.3	4.25	(0.3)	2.64

The deficit in public finances requires adequate measures to improve the primary balance, reduce debt service, and increase the size of the gross domestic product.

As a comparison, the European Union had set, according to the Maastricht agreement, a maximum tolerable fiscal deficit below 3% of GDP (Golden Rule). While we note that few European States have committed themselves to this ratio, in 2013 the majority actually exceeded it: Portugal 4.9%, France 4.3%, Spain 7.1%, and Greece 12.7%.

As for oil-importing Arab countries, they have recorded a deficit in public finances in 2013 amounting to 14.6% of GDP in Jordan, 5.4% in Morocco, 5.9% in Tunisia, and 14.1% in Egypt, while oil exporting countries recorded a surplus of 28.7% of gross domestic product in Kuwait, 11.3% in Qatar, 8.3% in Saudi Arabia, and 7.1% in the UAE.

Finally, it should be noted that had the Lebanese Parliament adopted the proposed salary scale, without installments and without insuring appropriate real resources for it, this would have caused record highs for the deficit in the general budget in the year 2015. The deficit would have exceeded 12% of GDP as a result of the inaccuracy in cost and revenue expected figures, and for failing to take into consideration the enormous consequences of the salary scale on the end of service compensation cost in the coming years, as approximately 21% of public sector employees would retire during those years. They would have reached about 1,893 billion liras in 2014, representing 9% of total spending, compared with 889 billion liras in 2007, an increase of 1,004 billion, or 113%.

Reforming public finance

Public finance reform may be achieved by setting an annual ceiling for the deficit, then gradually lowering it to reach in the medium term less than 5% of GDP, and by improving the primary surplus to reach in the medium term between 5 and 7% of GDP. Public finance reform may be achieved through simultaneous and integrated steps that consist of the following factors.

Reform of the spending policy

1. Rationalize spending: It aims to reduce wasteful spending, fight corruption, and improve the efficiency and productivity of the public sector, according to the following procedures:

- Reduce wasteful consumption expenditures (fuel, communications, equipment ...), the costs of hospitalization and garbage collection, in addition to the costs of the customs and real estate administrations, as well as exercise tight control on tax revenues from corporate profits and on the number of undeclared taxpayers…
- A gradual abolition of the Council of the South, the Fund for the Displaced, and the High Relief Authority.
- Reduce spending on non-profit associations, and tighten control over their activities to ensure their transparency and credibility, especially as their annual expenditures exceed 250 billion liras.
- Activate the role of control bodies, particularly by expanding the powers of the Central Inspection Bureau.

- Strengthen the role of the Accounts Court to tighten control over public spending.

2. Improve cash management through the establishment of a unified Treasury bank account where all public money will be deposited, in order to have an efficient management of the financial surplus existing in the accounts of some public institutions which are not in use currently.

3. Modernize the public tender law to fight waste and corruption and ensure transparency.

4. Introduce reforms to EDL, the main source of waste of public money, as this public institution owes to the public Treasury from 1993 to 2014 about 24 billion dollars, accounting for about 36% of the total public debt.

5. The reform of the public sector: Public sector reform should aim at increasing productivity, reducing waste, and containing its growing cost, through the following steps:

- Freeze hiring in the public sector for three years to contain the rising cost of wages, and retirement and end of service pensions.

- Reduce the size of the public sector through the recruitment of one person to replace every two employees who retire.

- Conduct a comprehensive survey on the public and educational sectors to find out their true headcount needs and the number of superfluous staff.

6. Reform the pension and end of service system: This is one of the most important challenges of the government because of the high cost of this system on the general budget, as it represented in 2014 about 2.6% of GDP; and this percentage is expected to rise in the coming years.

The public sector operates according to two systems for retirement and end of service: The first is dedicated to military and security forces, and the other to civil servants. A third system applies to the private sector. The government is working on integrating the three systems into one unified system.

7. Decrease debt service by reducing the size of the public debt (privatization -

securitization) and its cost (diversify its funding sources, substitute domestic debt by foreign one...).

8. Define an annual ceiling for the increase in total expenditures that would be linked to the GDP growth rate.

9. Improve the management of public-owned land: The Lebanese State owns about 79,000 plots, distributed all over the territory.

PM Najib Mikati previously put forward the idea of establishing a national institution for the management of public assets in order to improve revenues that could be sourced from them.

10. Introduce an administrative reform in order to improve productivity and efficiency.

11. Strengthen the partnership between the public sector and the private sector for the implementation of infrastructure projects.

Reform of the tax policy

It aims at increasing taxes to 23% of GDP and achieving justice and fairness in their distribution by improving their collection and the tax structure itself, so that the direct taxes share of total tax revenue would rise to 40%. Reform should be a catalyst factor to investment and the economy, generating jobs, contributing in addressing social and living problems, and achieving fiscal evenness among economic sectors.

The most important reform steps are the following:

- Introduce the tax, which adds together all sources of income for each taxpayer; it should increase tax revenues and reduce tax evasion.
- Raise the tax rate on the income of individuals for the higher income bracket to 25% (currently, this tax ranges between 2% and 20%).
- Raise the tax rate on bank deposits' interest from 5% to 7%.
- Increase taxes on alcohol and tobacco.
- Reconsider the custom duty rate on a number of commodities.
- Introduce a tax on the real estate profit at a rate of 15%. But it should include a fiscal exemption when the transaction concerns the main residence of a household, for a maximum

of two homes. It should also include a 10% reduction for each full year of ownership. The seller would be exempt from this profit tax if the ownership lasted for a full 10 years.

- The application of several rates for the VAT: 15% for auxiliary items and 10 percent for basic commodities[1].

- Re-introduce taxes on gasoline and diesel fuel.

Tax reform also needs efficient steps to curb tax evasion and to combat wastage, including:

- Modernizing the fiscal administration through the recruitment of adequate staff and the introduction of modern technologies.

- Creating an administrative body directly related to the Director General of the Ministry of Finance, dedicated to the auditing of the declared corporate profits and the declared property values when registering real estate transactions.

- Activating the collection administration to actually recover the money ensuing from building violation settlements.

- Adoption by the Parliament of the draft law pertaining to the fines on maritime public properties.

Fixing the financial accounts

Correcting the inaccuracies in the financial accounts allows the government to approve the ‘closing accounts’ pending since 2003 (the latest closing account proposition was approved). This is a prerequisite for the approval of the general budget (Article 87 of the Constitution and 195 of the Public Accounting Act), as it helps to regulate spending, facilitate legislative and judicial control, and return to fiscal discipline, transparency, and clarity.

The Director General of the Ministry of Finance succeeded in fixing the final financial accounts until 2010.

The Public Debt

The public debt is a chronic and troubling backlog in Lebanon. It increased in recent years as a result of the surge in public finance deficit and the slowdown in GDP growth. The public debt has economic, financial, and social risks, which affect economic growth and investment, and also limit the State’s welfare assistance and its contribution to

(1) There is no consensus on the multiplicity of the VAT percentage.

investment. It also degenerates public finance accounts, leads to the destabilization of the global financial markets' confidence, and induces rating agencies to reduce their sovereign credit rating as well as the rating of the Lebanese banking sector as the main financier of the sovereign debt. Furthermore, it raises interest rates for public and private borrowing, and threatens the monetary stability in the medium term.

The European Union fixed, in its Maastricht agreement, a maximum public debt to GDP ratio at 60% (the Golden Rule). But only a few EU countries committed to this standard, as the ratio in 2013 was around 175% in Greece, 93.5% in Spain, 129.5% in Portugal, 123% in Ireland, and 93.5% in France. Lebanon should reduce its public debt to GDP ratio in the medium term to less than 100%.

1. The growth of public debt

The total public debt amounted to about 100,365 billion liras in 2014, equivalent to 66.57 billion dollars, compared to 63,406 billion liras (42.06 billion dollars) in 2007, an increase of 50.9%. It is expected to reach $70.2 billion in 2015 and account for 138% of GDP.

In contrast, the public debt to GDP ratio recorded between 2007 and 2014 a decline from 168% to 134.4%, due to a GDP growth rate that exceeded the public debt increase.

Growth of the public debt (in billion LL)

	2007	**2008**	**2009**	**2010**	**2011**	**2012**	**2014**
Total public debt	63,406	70,941	77,112	79,298	80,887	86,959	100,365
Debt to GDP (%)	168	159	148	142	137	138	134.4

2. The distribution of the public debt

The total public debt was distributed, between the years 2007 and 2014, in the following manner:

- The domestic public debt in Lebanese liras: It reached in 2014 about 61,752 billion liras, accounting for 61.5% of the total public debt, compared to 31,373 billion liras in 2007, accounting for 49.7% of total debt.

- In 2014, the Central Bank of Lebanon (BDL) was holding 32% of the domestic lira debt and the banking sector 51%, a total of 83%, in comparison to 28.9% for the BDL and 53.5% for the banking sector in 2007, or a total of 82.4%. These percentages indicate the stability of the domestic debt financing sources.

- The external debt in foreign currencies: It amounted to about 38,613 billion liras, or 25.61 billion dollars, at the end of 2014, accounting for 38.5% of the total public debt, compared to 32,033 billion liras (21.25 billion dollars), or 50.3% of the total debt in 2007.

The reason for the decline in the share of foreign currency debt in the total public debt is related to the debt restructuring policy, as monetary and fiscal authorities succeeded in extending Lira-denominated Treasury bonds to 10 and 12 years, and reducing their interest rates so that they became close to the Eurobonds levels.

Distribution of the public debt (in billion LL)

	2007	2008	2009	2010	2011	2012	2014
Total public debt	63,406	70,941	77,112	79,298	80,887	86,959	100,365
Public debt in LL	31,373	43,465	44,973	48,255	49,340	50,198	61,752
Public debt in foreign currencies	32,033	27,476	32,739	31,043	31,547	36,761	38,613

Eurobonds constituted about 90% of the total public debt in foreign currencies in 2014. Lebanese banks hold 66.5% of them, equivalent to about 23,767 billion liras or 15.765 billion dollars, compared to a stake amounting to 16,670 billion liras ($11 billion) in 2007, an increase of 42.5 %.

3. The decline in the average cost of public debt

The public debt average cost decreased from 7.7% in 2007 to 6.29% in 2014, an 18.3% decline due to the following reasons:

- Decrease in the overall interest rate for the lira-denominated domestic debt from 8.3% in 2007 to 6.37% in 2014, down by about 23%, due to excess liquidity in liras in banks as of 2008, and their inability to employ them.

- The drop of the overall interest rate of the public debt in foreign currencies from 7.10% in 2007 to 6.16% in 2014, down by about 13.2%, as a result of several factors:

Record low interest rates at the US and European central banks, and a significant increase of the capital flows that exceeded the banks' absorption capacity during the period 2008-2010, in addition to a surge in investors' and business' confidence in Lebanon, the flexibility and strength of the banking sector, and the wise policy of the BDL.

Debt service of the public debt (in billion LL)

	2007	2008	2009	2010	2011	2012	2014
Total paid interest	4,694	4,957	5,784	5,893	5,655	5,457	6,314
Paid interest on domestic LL debt	2,515	2,847	3,663	3,763	3,552	3,333	3,934
Paid interest on foreign debt	2,179	2,110	2,121	2,131	2,103	2,124	2,380

4. The cost of the public debt and GDP growth

Nominal GDP growth rates notably exceeded interest rates for debt in the years 2007 to 2009, which led to a significant decline of the public debt to GDP ratio; in the following period, the GDP growth rates were less than debt interest rates (in the years 2010 and 2011).

Nominal GDP annual growth should be higher than the debt interest rate to maintain economic and financial stability and to ward off risks.

Debt cost compared to GDP

	2007	2008	2009	2010	2011	2012	2014
Average debt cost (%)	7.7	7.81	8.15	7.64	7.13	6.74	6.96
Average nominal GDP growth (%)	14.5	18.9	16.7	7.1	5.15	6.98	4.9

5. The evolution of interest rates and maturities

a) The evolution of average interest rates on LL Treasury bonds was the following:

- The 36-month category attracted in 2014 the largest share of the total Treasury bonds in lira (38.8%), the 60-month category 23.33%, and the 84-month category 20.8%. In 2007, the 60-month category (the longest maturity in the market then) acquired a share of 12.30%, whereas the 36-month category had a share of 69.50%.

- Interest rates on 36-month Treasury bonds fell by about 30.3% between 2007 and 2014, and on the 60-month bonds by about 41.4%.

- The monetary and fiscal authorities have succeeded in prolonging the Lira Treasury bonds term to 10 and 12 years at an interest rate of 8.24% and 8.74% respectively in 2014, an indication of the investors' and depositors' confidence in the strength of the monetary situation and the rightness of the applied monetary policy.

- The average term of the LL Treasury bond portfolio rose from 1.62 years in 2007 to 3.15 years in 2014.

- The average real interest rate for Treasury bonds in lira was about 3.5% during the period 2007-2014.

Evolution of the average interest rates

	2007	2014	Change
3-year LL Treasury bonds (%)	9.32 (%)	6.48 (%)	- 30.3 (%)
5-year LL Treasury bonds (%)	11.5 (%)	6.52 (%)	- 41.4 (%)
7-year LL Treasury bonds (%)	-	7.75 (%)	-
5-year Eurobonds (%)	6.25 (%)	5.15 (%)	- 17.6 (%)
7-year Eurobonds (%)	7.375 (%)	6.15 (%)	- 16.6 (%)
15-year Eurobonds (%)	8.25 (%) 9 (%)	6.75 (%)	- 18.18 (%)

b) The evolution of the average interest rates and maturity terms of Eurobonds:

- Interest rates on the 7-year Eurobonds decreased by 16.6%, from 7.375% in 2007 to 6.15% in 2014, and interest rates on the 15-year Eurobonds decreased by about 18%, from 9% in 2007 to 6.75% in 2014.

- The average age length of the Eurobonds portfolio changed from 5.01 years in 2007 to 6.1 years in 2014.

- The average real interest rate on Eurobonds was approximately 2.5% in the period 2007-2014.

c) Comparison between the interest rates on Eurobonds and interest rates on LL Treasury bonds:

The interest rate on the 5-year Eurobonds was 5.15%, compared to 6.74% for LL Treasury bonds for the same term, a difference of 1.59%. The interest rate on the seven-year Eurobonds was 6.15%, compared to 7.5% for LL Treasury bonds for the same maturities, i.e. a margin of 1.35%. The Government may replace the internal debt by external debt for these two categories in order to reduce the cost of public debt, but the margin has become narrower while the risk level is higher. The Government should target long maturities in excess of 10 years, where the margin is larger with less risk.

d) The fluctuations in interest rates in the Beirut market on LL Treasury bonds or Eurobonds are contained and minor, as if the Beirut interest rate market was independent, where prices are determined according to internal factors (deposit growth, the level of liquidity, the fiscal deficit...), far from the effects of foreign markets.

6. Limited public debt risk

The cost of the Lebanese debt rose in the first months of 2014 because of the political and security risks, and the declining economic and financial indicators. The spread on Eurobonds reached about 380 basis points, compared to a spread of approximately 288 basis points in emerging markets.

Lebanon's economy can absorb the public debt risks in the medium term for the following reasons:

- Sterilization by the BDL of the lira liquidity by encouraging banks to subscribe to certificates of deposit and long-term lira Treasury bonds, in addition to its success in extending maturities to 10 and 12 years. It also urged banks to propose loans in lira instead of dollars.

- The time distribution of debt in foreign currencies and the extension of their maturity, so as to alleviate the financial pressure on the State.

- The sources of public debt financing, in lira or in foreign currencies, are internal (commercial banks and the Central Bank of Lebanon) at more than 80% of the domestic LL debt and 70% of foreign debt Eurobonds.

- The high liquidity in foreign currencies within the banking sector, where the deposit dollarization ratio is about 65% of total deposits, which contributes to ensuring due payments in foreign currency and facing impending obligations.

- BDL's reserves in foreign currencies, valued at $38 billion, enhance the confidence of depositors in their national currency.

- The government's ability to contain the public debt existing in the financial market, which constituted between 61% and 68% of the total public debt in the period 2007-2014, with a value of between 38,622 billion liras (25.62 billion dollars) and 65,377 billion liras (43.36 billion dollars).

7. Evolution of the net public debt

The net public debt declined from 156% of GDP in 2007 to 115.7% in 2014, a drop by 26%. In contrast, the net public debt rose about 36.19% over the period 2007 to 2014, from 58,939 billion liras in 2007 to 86,398 billion liras in 2014.

Indicators show that GDP growth significantly exceeded the growth of the net public debt during this period.

Evolution of the net public debt

	2007	2008	2009	2010	2011	2012	2014
Net public debt (billion LL)	58,939	62,615	66,590	67,819	69,903	74,043	86,398
Net public debt to GDP (%)	156	140	127	121	119	118	115.7

How to deal with the public debt crisis

Addressing the public debt crisis is one of the government's most important challenges due to its economic, financial and social repercussions; this should be done through the following procedures and factors.

1. Increase nominal GDP growth: Lebanon's economy needs a political and security stable environment to achieve strong economic growth rates; it also requires large investments in infrastructure, activating the partnership between the private and public sectors, and directing investments towards the knowledge sector, or sectors with high added value or high competitiveness.

The Lebanese economy needs an adjustment in its operating model, because the current model is not effective, as it is based on the services sector and is unable to create enough jobs. It encourages emigration and remains a hostage of internal and external political relations and security issues. That's why, the local economy requires now a new model based on innovation. It also needs the implementation of reform processes related to a new concept of the State and its role, the taxing and spending policies, and the labor market. It should rely on new industrial bases that enjoy better competitiveness, clear goals, and an orientation toward green innovation.

From 2011 to 2014, the economy recorded a weak growth rate, less than 1.5%, due to the repercussions of the Syrian crisis, uncertainty, and the paralysis of constitutional, parliamentary and executive institutions, in addition to the lack of political and security stability, which significantly affected the two main engines of growth, investment and tourism. In contrast, the economy registered a strong growth in the years 2007 to 2010 with an average of 8.5% as a result of Lebanon's success in containing the global financial crisis of 2008 and the Dubai crisis of 2009, as it became a safe haven for investments and deposits, and a main touristic oasis in the region, with 2.3 million tourists in 2010, while foreign direct investment exceeded $4.5 billion and financial flows $20 billion in 2009.

Evolution of the GDP

	2007	**2008**	**2009**	**2010**	**2011**	**2012**	**2014**
Real growth rate (%)	9.4	9.1	10.3	8	2	1.5	1.5
GDP (billion LL)	37,629	44,748	52,235	55,965	58,851	62,963	74,656

The gross domestic product almost doubled during the years 2007 – 2014, from 37,629 billion liras in 2007 to 74,656 billion liras in 2014. The significant growth was especially achieved in the years 2007, 2008 and 2009, with an average growth of nearly 17% annually, due to the strong rise in real growth rates and inflation rates.

The containment of the public debt growth requires a nominal GDP growth higher than that of the public debt.

2. A decline in real interest rates on the public debt: Any further reduction in interest rates requires the continuation of the restructuring policy, through the replacement of internal debt, particularly that exceeds ten-year maturity, by external debt of the same maturities, as the external debt is still less than 50% of the total debt, representing 38.5% in 2014. In addition, the margins between domestic LL debt and external dollar debt for the long term exceed 1.5%. We may also cut the actual rate by diversifying sources of financing for the public debt (external soft loans).

3. Privatization: It needs an internal consensus and external investments. Privatization should stimulate growth, improve social services, and reduce the cost of services. Likewise, the State should encourage partnership processes between the public sector and the private sector. The most important public facilities that are candidates for privatization are: Intra Company, Middle East Airlines, the transport sector, fixed telephony, the water sector, and the two cellular phone companies.

4. Oil and gas income (with emphasis on transparency): This will contribute to solving the majority of Lebanon's economic, financial, and social problems, especially those related to the public deficit and the worsening debt size; it would also turn Lebanon into a key hub for services, investment, and finance in the region.

5. Securitization: The State would be able to collect instant money ranging between 8 and 10 billion dollars from global financial markets, at low interest, through securitization for ten years of the telecom sector revenues that reached about two billion dollars in 2014.

6. Improve the primary surplus: It contributes to cover a part of the debt service. We note in this context that the primary surplus amounted to 2,505 billion liras in 2011, accounting for 4.25% of GDP, and covered 44% of the debt service, which led to a slight increase of the total public debt not exceeding 2%. We also noticed slight increases in the total public debt in the years 2009 and 2010 because there were significant primary surpluses. In contrast, public debt increased in the year 2012 by 7.5%, and in the year 2013 by 10%, when the primary surplus turned into a primary deficit.

The improvement of the primary surplus is a prerequisite to contain the public debt. It can be achieved through a reformed tax policy that promotes revenues, and a better spending policy that contains expenditures and wastage.

7. Increase inflation rates, but on condition that its consequences remain within control and containment, on the social, economic, and financial levels.

Evolution of the primary balance (deficit-surplus)

	2007	2008	2009	2010	2011	2012	2014
Primary balance (LL billion)	1,102	900	1,625	1,855	2,505	(166)	1,970
Debt service (LL billion)	4,940	4,957	5,784	5,893	5,655	5,457	6,314
Total public debt (LL billion)	63,400	70,941	77,112	79,298	80,887	86,959	100,365

Improving public debt management

- Create an administrative unit for the management of the public debt within the Ministry of Finance; its tasks would be to improve public debt management with respect to its distribution between the domestic debt in lira and foreign debt in foreign currency, based on the interest rates, maturities, and risks.

- Establish a secondary market for the trading of LL Treasury bonds, and expand the holder base.

- Develop a medium-term public debt strategy that includes key targets (Ministry of Finance source):

• Reduce the risk of refinancing by maintaining an orderly pattern in the process of debt repayment.

• Reduce the risk of debt repayment by contracting another debt, through lengthening the debt portfolio repayment period.

• Stabilize the share of foreign currency debt below the 50% ceiling of the total public debt.

• Increase the proportion of public investments that are financed through soft loans.

The situation of the public debt and the confidence of financiers depend on the ability of the State to always respect its financial commitments. The reduction of the public debt to GDP ratio is a complex process due to internal political differences and the difficulty to implement reforms in public finance through privatization or securitization. Furthermore, the increase in GDP growth rate requires a stable internal and regional political and security environment. The government should therefore work now on stabilizing the public debt to GDP ratio and put it on a downward path, while waiting for better internal and regional circumstances. It should also strengthen the resilience of the economy and the steadiness of social conditions to face expected upcoming shocks.

The General Budget

It is a legislative instrument that authorizes the government to spend revenues and collect taxes and fees. It includes all spending and revenue estimates for the coming year. It constitutes a comprehensive economic and social vision that aims economically at stimulating growth, controlling inflation, supporting institutions, promoting regional development, developing infrastructure, and securing jobs. Its social targets include improving social, health and educational benefits, reducing unemployment, decreasing poverty, securing a social safety net, narrowing the gap between rich and poor, and achieving justice in income distribution.

Notes on the preparation of the general budget by the successive governments

1. The lack of a comprehensive vision in the budget

The majority of public budgets remained without economic and social vision. Their goal was limited to the search for sources to increase revenues, and for ways to reduce the fiscal deficit. This led to the aggravation of social and economic problems, and the loss of the budget's economic and national role.

2. The non-respect of the constitutional deadlines[*]

The preparation of the budget and its approval's process require the following steps:

- The Minister of Finance should submit the draft budget to the Cabinet by September first.
- The Minister of Finance should submit to the legislature by November the draft budget, in its finalized version as it was adopted of the Council of Ministers.
- The Parliament should ratify the budget before the end of the ordinary session period; in case it failed to do so, the President of the Republic, in accord with the Prime Minister, calls immediately for an exceptional session that continues until the end of January.

3. In case no budget has been approved, the Transitory Twelfths process is applied

Successive governments have been spending since 2006 on the Transitory Twelfths base, as the last general budget passed in Parliament dates back to the year 2005.

(*) Adnan Daher, "The General Budget in Lebanon, Preparation and Ratification".

Transitory Twelfths budget characteristics:

- The Transitory Twelfths budget is considered a temporary and exceptional budget that gives the government the right to spend and collect fees and taxes for a period of one month. But it has become in the Lebanese context a budget without time limits, giving spending rights until a full new budget is approved. In this context, it should be noted that all successive governments since 2006 committed legal and constitutional irregularities in their spending, as they overrode their legal expense authorization, because:

- The provisions of the Transitory Twelfths budget do not allow ministries to take measures that would increase the financial burden on the last State budget that was approved by the Parliament, i.e. the 2005 budget.

- They do not take into account new needs anticipated for the following year or necessary amendments to the collection and spending schemes.

Article 60 of the Public Accounting Act stipulates that Transitory Twelfths budgets are set on the basis of the permanent funds earmarked in the budget of the previous year, taking into account what was added to them, and dropped from them.

Article 86 of the Lebanese Constitution stated: "...Previous year's budget must be taken as a basis, then add to it whatever other permanent supplementary credits were introduced, and remove from it the credits that have been dropped."

In this context, the Parliament approved in 2008 Law No. 63 which authorized the government to grant employees an additional 'cost of living' of 200,000 liras for a total value of 400 billion liras. Furthermore, Law 238/2012 opened additional credits worth 8,315 billion liras, under the government of PM Najib Mikati; law 1/2014 added new credits worth 626 billion liras, law 15/2014 added credits worth 340 billion liras, and more recently Law 11/2015 added credits worth 4,500 billion liras.

The total spending legally authorized became 24,181 billion liras, to which should be added credits that go back to the program-laws, and unused credits transferred from previous years.

4. Payment of salaries and pensions for public sector employees

No government may stop paying salaries, pensions, and end-of- service compensations, as:

- Salaries and pensions are considered, according to the Public Accounting Act, permanent basic expenses that hold a mandatory and priority characteristic within the public spending, when the government sets up the distribution and allocation of credits. Articles 62 and 63 of the Public Accounting Act allow the Minister of Finance to reserve funds for the whole year if they are related to salaries and equivalent expenses.

- Salaries and wages are debts owed by the State's Treasury, and do not require a previous authorization from the Parliament, as they are not subject to the Transitory Twelfths rule; the Government should pay them through payment orders and not credit commitments.

- The payment of salaries and pensions is part of the supreme national interest, security, stability, and continuity of public facilities.

- Legally, the right to a salary arises as a result of the contract between the employee and the State, which gives rights to employees in exchange for work done, and constitutes a binding debt that the State must honor, in exchange for this work.

Article 55 of the Public Accounting Act stipulates that the contract alimony is: Accomplishing a work that results in a binding debt for the Government.

This type of contract has a permanent and continuous effect; it is automatically renewed whenever its grounds are still in effect, and remains binding for the State. So the government has to primarily safeguard compulsory and permanent expenses (salaries, pensions, end-of-service compensations, debt service...), then consumption spending and all other expenses.

In case credits earmarked for pensions and salaries are exhausted, the government may:

- Introduce a bill before the Parliament to open extra credits in accordance with Article 27 of the Public Accounting Act, which states that "no additional credits would not opened up except by law" and Article 85 of the Constitution, which states that "no exceptional credit may be opened up, but by a specific law."

- Open supplementary credits in accordance with Article 26, paragraph 2, of the Public Accounting Act, which stipulates: "The government may open up by decree necessary supplementary credits, which will be covered from the reserve funds..." And in case reserve funds are not sufficient or unavailable, Article 196 of the Public Accounting Act states that the deficit should be registered in the credit account...

As a conclusion, we can say that salaries and wages are expenses binding to the government, and should be funded from general revenues, the reserve funds, the Treasury credits, or through loans in case of Public Treasury's incapacity. But the most appropriate solution for financial discipline, efficiency control, and observing the law is through "legalizing spending", which means opening up additional credits through the Parliament.

5. Lack of account closure

The account closing or closure is a comprehensive audit tool that comprises all budget conclusions, and a posterior control tool for the Parliament on the budget implementation by the government, in accordance with the authorization that had been granted to it. It includes final spent amounts, revenues, and results, and allows comparison between the projections contained in the budget bill and the real numbers occurring at the end of the budget year.

Article 87 of the Constitution imposes the presentation each year before the Parliament of the final accounts, for approval before the publication of the following budget.

Article 197 of the Public Accounting Act also requires the government to refer the account closure draft (for the previous year) to the Parliament before November first, accompanied by the general report put down by the Audit Court.

Based on this, no budget may be passed for the year 2016 without the Parliament's approval of the closing accounts for 2014, unless the government submits a draft law authorizing the Parliament, exceptionally, to approve the 2016 budget without being accompanied by the account closure bill for 2014, provided that the government commits itself to present the final financial accounts for the year within a specified period of time (for example, three years).

It should be noted that the last account closure approved by the Parliament was in 2003, and it was annexed to the 2005 draft budget. It should be noted too that the General Directorate of the Ministry of Finance has recently made major achievements on the public accounts level, as it was able to determine the input and output balances for the final financial accounts, and to reconstitute the accounts pertaining to the BDL, the Treasury credits, budget credits, and temporary registers, as well as handled a large part of the final financial accounts until 2010; it also started to develop a clear and transparent framework to ensure the regularity of public finances.

The Ministry of Finance should prepare account closure bills for the years 2004 to 2014 and transfer them to the Parliament for approval, for the sake of maintaining consistent public finances.

6. Non-inclusive budgets

The principle of inclusiveness requires that all revenues and expenditures without exception should be itemized in the general budget, in order to allow the assessment of the overall financial situation. Inclusiveness prevents wastage and gives the parliamentary and judicial authorities the possibility to check the validity of the budget implementation.

Therefore all public financial operations should be included in the budget, especially those related to loans and donations managed by the Council for Development and Reconstruction and the High Relief Authority which are currently realized outside the budget.

7. Increased reliance on Treasury credits to finance the State's needs

Reform steps for the preparation of the general budget

1. Adherence to the general principles of the budget:

• Improve the inclusiveness of the budget.

• Promote the principle of 'collective' resources, or non-allocation of revenues: The 'collective' principle means that all revenues should be included in the revenue section, and all expenses in the expenditure section; in other words, a particular resource may not be allocated for a certain expense (the salary scale, its cost and resources should be included within the general budget without allocation).

• Always respect the annual budget principle: This requires that the budget should be placed for one year, and not to be extended through spending by the Transitory Twelfths method.

• Always respect the unity of the budget principle: This requires registering all State spending and revenues in one single account, which means that there is a need to lessen the specific accounts registered outside the budget, pertaining to guarantees, trust accounts, account credits...

2. Refrain from opening up credits on the basis of non-approved public budgets or make excessive recourse to the Treasury credits to finance the State's needs. The State is supposed to return to fiscal discipline through the adoption of the general budget annually.

3. The Cabinet should determine a ceiling for the total spending that is imposed by available resources, so that it does not exceed the GDP growth rate.

4. Cancel the practice of rescheduling non-used credits to the following year, in order to comply with the annual budget principle.

5. Switch to a budget structure that is based on performance and programs. This facilitates the accountability process and allows the assessment of the public administration's performance; it also allows monitoring the spending efficiency and setting targets in accordance with the priorities of the government.

6. Amend the Public Accounting Act: The current law was issued in December 30, 1963 and no longer meets economic, financial and social developments, nor the changes in the concepts of public financial management.

7. Adopt a medium-term framework for spending to enhance the government's ability to forecast revenues and expenses in order to reduce the fiscal deficit. This will require from the ministries to provide estimates of their needs for the medium term (Ministry of Finance source).

8. The Ministry of Finance is working on improving the framework for the public budget in two directions:

- Restructuring the Budget and Expenditure Control Directorate and establishment of a Department for Economic Analysis.

- Developing a new legal framework for the preparation of the general budget, whether by amending the Public Accounting Act, or through the adoption of a new budget classification (amendments to the administrative, economic, and functional classifications).

9. Tax legislations should be separated from the budget, and tax laws should be issued distinctly from the budget.

10. There should be a gradual commitment to two golden rules: The first is that the fiscal deficit should not exceed 5% of the gross domestic product, and the second is that the public debt to GDP ratio should not exceed 100%.

11. The Ministry of Finance should be entrusted with the setting up of a draft law for accountability in public finance; its goal being to fix the budget deficit and public debt levels (Fiscal Accountability Law).

The draft budget for 2015

The 2015 budget has been prepared under security and workers' pressures; so it turned out to be traditional with no economic vision or reforms, and did not include any measures to stimulate growth or to contain the displaced Syrians crisis.

The 2015 budget is considered just a series of figures, with a lot of additional spending on unproductive items, such as salaries and wages, and additional taxes that were set to fund part of the new salary scale. The output was a worrisome deficit.

An initial reading of the general budget's figures shows the following:

General expenditures - They induce the following observations:

1. General expenditures were estimated at 23,362 billion liras, equivalent to 30.7% of GDP, compared to 20,500 billion liras of real spending in 2014, an increase of 2,862 billion liras, or 14%, whereas GDP growth in 2015 is estimated at about 6.5%, far less than the growth of public spending.

2. Salaries and wages registered a significant increase by more than 10%, or 355 billion liras, as a result of increasing the number of public sector employees by about 7%, or 11,700 people, for security, political and social reasons: Recruitment of 10,500 security and military personnel (152 billion liras), regular enrollment of 2,500 previously volunteer members in the Civil Defense (42 billion liras)...

3. The three main items, salaries (6,342 billion liras), debt service (6,585 billion liras), and transfers to EDL (3,056 billion liras) constitute approximately 68.4% of the total public expenditures.

4. Public expenditures did not include the salary scale project, nor the cost of the required salary adjustments for public sector employees, which are supposed to cost 1,300 billion liras, divided over two years, or 650 billion liras for the first year.

5. Expenditures barely included any cost pertaining to the displaced Syrians needs. The recent Kuwait conference promised an assistance amounting to $3.8 billion for the displaced Syrians (four million outside their countries), as Lebanon is already hosting 1.2 million refugees and needs about one billion dollars more.

6. EDL: Its deficit was estimated at about 3,056 billion liras. The general budget did not take into account the positive implications of the falling global oil prices on the EDL deficit, which is estimated at 1,100 billion liras if the price of an oil barrel remained less than $60 in 2015. The government should benefit from this saving in order to complete its new power plants and rehabilitate old ones, so that the production capacity would increase. It also has to start implementing reform steps for the electricity sector (reconsider the tariffs, etc.).

Tax revenues - They induce the following observations:

1. Tax revenues were estimated at 12,108 billion liras, equivalent to 15.9% of GDP, compared to 10,825 billion liras estimated for 2014, an increase of 1,283 billion liras or 11.85%. The increase resulted from new tax measures providing additional revenue estimated at about 1,330 billion liras. This means that there is no anticipation of growth in the tax revenue that could result from an improvement in economic activity.

2. The structure of tax revenues: The increasing share of direct taxes.

• Direct taxes: They were estimated at 4,956 billion liras and accounted for 41% of total tax revenue, compared to 3,973 billion liras, accounting for 36.7% of total tax revenue, estimated for 2014. The increase is due to new tax measures that would improve the expected revenue from income, profits, and capital taxes, by about 928 billion liras.

• Indirect taxes: They were estimated at 7,151 billion liras, accounting for 59% of total tax revenue, compared to 6,851 billion liras in 2014, an increase of about 301 billion liras, or 4.39%.

- Tax revenues did not take into account the effects of a cheaper euro and falling oil prices:

• A decline in the euro rates by about 15% could reduce the import bill from the Eurozone amounting to $6.3 billion by about $800 million. This may cause a loss of customs revenues and VAT of more than 150 billion liras.

• The decline in global oil prices to $60 a barrel may cause a loss of revenues in the value added tax on gasoline of more than 150 billion liras, whereas diesel is exempt since 2012 from the value added tax and other fees.

3. VAT revenues are over-estimated, as the budget anticipated an increase of 6.2%. So are customs revenues which were anticipated to rise by 3%, and tax on profit revenues anticipated to rise by 32.8% in 2015.

4. Most significant new tax measures: The tax on bank interests rose to 7%. This tax, decided upon insistence from the Speaker of the House, mainly affects the banking sector, as it would cost it about 300 billion liras. The corporate tax was also raised to 17%. An excise duty was imposed on diesel fuel (4%), while a real estate profit tax was introduced at an average rate of 15%.

The fiscal deficit:

It was estimated at 7,728 billion liras, accounting for 10.16% of GDP. It is a worrisome figure because it has implications on interest rates, the sovereign credit rating, and the banking sector. It is feared that the deficit would have risen to 8,328 billion liras, accounting for 10.9% of GDP, if the Parliament had passed the salary scale bill, and the first installment of 600 billion liras was added to the total spending.

Real Growth:

It was estimated at 2.7%, an exaggerated figure as we expect it to remain weak, less than 1.5%, because there is no anticipated improvement on the political and security levels, the World Bank having estimated growth for 2015 at about 2.5%. Lebanon needs a 5% growth to maintain social stability.

Inflation:

It was estimated at 4.5%. This is also considered too high, as IMF estimates inflation to be 1.1% in 2015 due to falling global oil prices and cheaper euro, whereas food prices are expected to remain stable in the international markets.

Public debt:

It was estimated at $71 billion, accounting for 140% of GDP, and distributed into 38.5% of external debt and 61.5% of domestic debt. The public debt to GDP ratio took an upward trend in recent years.

On the legal level:

The adoption of the 2015 draft budget requires to be accompanied by the draft account closure report for 2013 and by the Audit Bureau report, in accordance with

Article 197 of the General Accounting Act. Also, Article 87 of the Constitution imposes the submission of the final financial accounts to the Parliament for approval before the publication of the budget for the second following year. But it also authorizes the Parliament to exceptionally approve through constitutional amendment the 2015 draft budget without being complemented by the account closure report, provided that the government committed itself to submit the final accounts for the year 2013 within a specified period of time (for example, three years).

Main Recommendations:

1. Include in the 2015 draft budget the additional cost of the salary scale project, for two years, estimated at about 650 billion liras in 2015, along with the additional tax measures that are supposed to fund it, estimated at 510 billion liras. These tax amendments include a rise in the VAT rate to 11% (300 billion liras), higher stamp fees on construction permits (150 billion liras), and increased duties on imported spirits (60 billion liras), so as to comply with the budget inclusiveness principle. The Speaker of the House asked the Minister of Finance to add an appendix to the general budget pertaining to the salary scale project.

2. Intensify international contacts to contain the crisis of the displaced Syrians, as the Kuwait Conference pledges are insufficient and the Treasury's capacities are weak.

3. Reconsider the draft budget figures after taking into account the effects of falling oil prices and the euro exchange rate on the financial transfers to EDL and the tax revenue.

4. Reduce investment spending by postponing some projects, due to the lack of capacity to implement them (water supply, CDR ...) and activate the partnership between the public sector and the private sector (P.P.P.) for infrastructure, electricity projects...

The salary scale project

The Mikati government referred to the Parliament the salary scale project aiming at revising the wages and salaries of the public sector employees. It is a rightful project that is 16 years late, as the last salary adjustment had been decided and applied in 1998, with retroactive effect from 1996. The government has also approved in late 2008 Law No. 63 which granted all public employees a monthly 'cost of living' lump sum worth 200 thousand liras.

The salary scale project includes the following components:

- Bill No. 10415: It aims at the creation and modification of some taxes in order to fund the salary adjustments and the 2008 increase.

- Bill No. 10416: It aims at adjusting salaries according to the salary scale scheme and the latest increase.

The salary scale project concerns about 165,300 beneficiaries, permanent and temporary regular employees, and individual outworkers, distributed among 19,226 regular administrative beneficiaries, 53,139 educational staff among which 24,653 are outworkers, 93,576 beneficiaries from the military and security corps. Added to them are about 80,000 retirees.

Public sector employees are divided into several administrative classifications (public administration, teaching staff, military and security forces). According to their level, they are distributed into categories (five categories), categories into ranks (first and second), and ranks into degrees (22 degrees).

Several committees were created within the Parliament to study the salary scale draft. They issued four different reports on the cost of the scale and the possible financial resources to fund it: The initial project prepared by the Mikati government; the report of the first parliamentary subcommittee (headed by MP Ibrahim Kanaan); the report of the Joint Parliamentary Committee; and two reports presented by the second parliamentary subcommittee (headed by MP George Adwan).

The four committee reports convened on dividing the salary scale project into three main sections:

1. Rights and equity: Bill N°: 10416, which aimed at giving employees their rights, and determining the cost of the scale.

2. Available resources: Bill N°: 10415, which aimed at identifying funding sources available for the scale.

3. Reforms: They dealt with the reform steps for the public sector.

Second report issued by the second parliamentary subcommittee (MP George Adwan)

The second parliamentary subcommittee (MP George Adwan) issued its second report, pertaining to the coverage of the salary scale cost, which obtained the approval of most political forces. They also agreed to cancel the retroactive effect and the proposed installments for two years of the salary scale increase. They granted six exceptional grades to public administration employees and to the teaching staff. But the report faced objection from the military, who considered it unfair, and asked MPs to separate their salary scale from those of the civil servants categories. The report also faced protest from the union of private school teachers as they considered that they have not been treated on equal grounds with their colleagues in the public sector.

The report of the second parliamentary subcommittee proposed the following tax measures:

Bill 10415: It included the following tax revenues totaling 1,762 billion liras:

- Raising the VAT rate to 11%: 300 b.
- Raising the relative fee rate from 3 to 4 per thousand: 110 b.
- Raising the stamp fee on phone bills: 60 b.
- Raising the stamp fee on invoices and receipts: 45 b.
- Increasing the stamp fee on building permits by 1.5%: 150 b.
- Adding a fee on cement production: 50 b.
- Doubling the fees for public notaries: 30 b.
- Increasing taxes on spirits: 60 b.
- Increasing the exit fee on travelers by land: 25 b.
- Increasing the exit fee on travelers by sea and air: 100 b.
- A fee on container loads: 30 b.
- Fines on built marine properties: 75 b.
- Raising the tax rate on lottery prizes: 6 b.
- Amending Article 45 of the income tax law and introducing a new tax on real estate profits: 150 b.
- Amending Article 32 and raising the tax on corporate profits to 17%: 120 b.
- Amending Article 72 of the income tax law by cancelling the reduced rate on dividends distribution: 40 b.
- Raising bank interest tax rate from 5% to 7% and including the interbank interest profits in this tax: 410 b.

Comments on the proposed tax measures

1. Direct taxes and indirect taxes:

a) Direct taxes: 870 billion liras, accounting for 49.3% of the total proposed taxes
- A tax on real estate profits: 150 b.
- Amending the income tax, Article 32: 120 b.
- Amending the income tax, Article 72: 40 b.
- Increasing the stamp fee on building permits: 150 b.
- Raising the tax rate on bank deposit interests: 410 b.

b) Indirect taxes represent 50.7% of the total proposed tax revenues, most notably raising the VAT to 11%: 300 b.

2. Taxes on the economic sectors:

a) The banking sector: 460 billion liras (imprecise), accounting for 26.1% of the proposed revenues, including:

- Amending the income tax rate, Article 51: 410 billion liras; this estimation is low and inaccurate, as we expect the outcome to reach 550 billion liras, resulting from the revenues of the banking sector's own investments (380 billion liras), in addition to the result of raising tax rates on customers' deposit interests (170 billion liras).
- Amending Article 32 of the income tax law: 50 billion liras.

b) The real estate sector: 318 billion liras, or 18% of the proposed revenues.
- A tax on real estate profits: 150 b.
- The amendment of Article 32 on corporate tax: 18 b.
- Stamp fee on building permits: 150 b.

Bank and real estate tax revenues represent 44% of the proposed revenues, or 778 billion liras.

3. Fines on public marine properties:

75 billion liras. We notice that this measure tripled the fees which were imposed by Decree 2522 in 1992. Estimation should be based on actual 2014 prices, and public properties should be divided according to their category (commercial, touristic, residential).

On the other hand, there is a difficulty in collecting this tax, because it needs political consensus which is not available now. Furthermore, estimates are unclear and inaccurate; they ranged in previous years between 50 billion and 150 billion liras.

The Parliament should approve the bill pertaining to the settlement of marine property violations, which may provide an annual revenue exceeding 600 billion liras in the next three years.

4. Raising VAT to 11% for an expected revenue of 300 billion liras, enters within the framework of the reform steps decided at the international Paris conferences dedicated to Lebanon's assistance. It is easy to collect this tax, as the State gets 75% of the VAT at the customs border offices. This tax affects all segments of the population and raises the inflation rate.

It would have been worthier to raise VAT on luxury and non-necessary items (specific list) from 10% to 15% which would have affected the well-off social segments and taken into account the current difficult living conditions of the less privileged.

Bill No. 10416 related to the cost of the salary scale: 1,940 billion liras.

There are no conclusive or precise cost figures for the salary scale; the estimated amount is distributed as follows:

a) The lately applied salary increase: 850.915 billion liras. To be paid to public sector employees with retroactive effect since February 2012. It reaches about 71 billion liras per month, and is distributed as follows:

- Administrative body: 49.35 b.
- Faculty members: 92.92 b.
- Outworkers in general education: 24.3 b.
- Outworkers in technical education: 22.8 b.
- Military: 390.2 b.
- End-of-service compensations: 64.8 b.
- Retirees: 206.3 b.

b) Adjusting salaries: 1,089 billion liras. There are no final figures; the estimated amount is distributed as follows:

- Administrative body: 66.5 b.
- Granting 6 degrees to the administrative body staff: 92.4 b.
- Faculty members: 96.16 b.

- Granting 6 degrees to the teaching staff: 115 b.
- Military and security corps: 227 b.
- Retirees: 148 b.
- End-of-service compensations: 105.9 b.
- Free schools: 58 b.
- Public institutions: 160 b.

Note: The total spending related to the military staff is expected to exceed 802 billion liras, constituting more than 41.5% of the total salary scale.

Reforms

Reforms go together with the salary scale bill and aim to increase the efficiency and productivity of the public sector and control its cost; they include the following measures:

- Determine the coming role of the public sector and the basis for a better cooperation and partnership with the private sector.
- Manage the excess staff in the public administration and education sectors.
- Develop a future plan for the public funds, councils, and institutions.
- Stop all recruitment in public administrations for two years (and replace two retired employees by one).
- Halt all recruitment in the public institutions that suffer from a deficit in their budget, and perform an assessment study to see if they should be kept or not (privatization, public-private partnership).
- Stop all employee and outworker recruitment in the public sector.
- Amend working hours and increase them from 32 hours to 35 hours per week.
- Finalize anti-corruption draft laws.
- Carry out a thorough survey of public departments, institutions, and schools, to ascertain the number of employees, outworkers, and freelancers, and determine their cost.
- Establish a single social security system.
- Expand the prerogatives of the Central Inspection and enhance the accountability process.
- Amend Article 34 of the pension and end-of service system.

Economic and financial implications of the salary scale

1. It will impede the economy: The proposed tax measures will hamper the ailing economy which recorded important declines in recent years, from 7% in 2010 to less than 1% in 2013, as they affect consumption, income, and profits; they target several economic sectors (real estate, banking, commerce), as well as all population strata.

We fear at the same time that the public salary increase would induce similar requests from the private sector.

As for betting on a positive extra consumption due to increased salaries, the effectiveness of such a bet is highly questionable, as data showed the weak effects of the first salary rise for public sector employees, which was applied since February 2012, on economic growth in the years 2012 to 2014.

In parallel, it should be noted that the extra consumption may widen the deficit of the trade balance and the balance of payments.

2. The salary scale will raise the inflation rate: It will lead to uncontrolled and unjustified rises in the prices of goods, due to the lack of effective government control, the greed of traders, and the monopolistic system, combined with such other elements as increased demand for consumer goods.

We also have to point out that the first repercussions of the salary scale have already appeared, even before the adoption of the whole package, through rises in tuition fees in private schools and universities.

3. A threat to monetary stability in the medium to long term: The salary scale will lead to inflation and declining purchasing power of the national currency in the medium term, as a result of injecting a large non-productive cash mass in the consumption market, in the form of salaries that would give the beneficiaries the possibility to contract bank loans worth many times the new salary.

4. Negative effects on public finance and debt. It will raise the deficit to more than 12% of GDP, for the following reasons:

- Lack of accurate figures about the real cost of the scale. Furthermore, the declared costs do not include other increases in public spending that may result (bonuses, allowances, transportation, medical care, schools fees...).

- The funding sources will be inadequate and insufficient as a result of the economic slowdown, the difficult social conditions, the problems faced by businesses, and the increased cost of the scale.

- The scale induces in fact non-productive current expenses, which will raise the share of salaries in public spending from 21% to more than 26%, at the expense of other social expenditures and investments.

- The general budget expenditures will rise in the coming years (social expenditures, investment, debt service, displaced Syrians expenses), versus unchanged overall revenues as a result of political instability and lack of security, whether internally or regionally, and as a result of the difficult economic conditions and the decline in activity for most economic sectors, especially services (tourism, trade, real estate).

- Enrollment of about 15,000 people in the military and security forces in the coming period, because of the ailing security situation.

- There will be disturbing effects on pensions and end-of-service compensations, as their volume will rise in parallel with the new salaries. The retirement-related spending will even grow in a larger amount in the coming years, due to fact that 22% of employees will retire in the short term, and they will be replaced by new staff with higher salaries.

Pension expenses and compensations have already increased starting 2010, by about 32%, from 1,391 billion liras to 1,831 billion liras in 2013.

The deterioration of public finances will trigger a growth in public debt higher than that of the GDP. This will prompt the international rating agencies to reduce the Lebanese sovereign credit rating which, in turn, will raise interest rates onto both the public and private sectors, and shake the confidence in the Lebanese banking sector.

Installments

The parliamentary committee’s decision to divide the burden of the salary scale over two years (payroll increases amounting to 1,089 billion liras) is a positive and wise financial resolution, as it alleviates the effects of the scale on the economic, financial, and inflationary levels. It also gives the State an opportunity to find additional financial sources resulting from the evolution of the economic situation, from better waste control, or from improving the collection and reducing tax evasion.

The government should have opted for four- or five-year installments, instead of two years, so that the effects would be absorbed in a more comprehensive way, and the employees would not lose their new earnings or purchasing power, due to the fact that economic conditions will remain difficult in the coming stage.

The adoption of the scale is a due right for public sector employees, but its implementation without knowing its precise cost, and without securing permanent and temporary resources, will pose significant risks and consequences that would be difficult to overcome in the next phase.

The government should include the scale, with all related expenditures and resources, in the draft general budget, not just a part of it (the latest salary raise), in compliance with the rules of inclusiveness, unity, and annualized aspect of the budget, in order to ensure better transparency and clarity in the real figures of the public finance deficit.