How can a new tax system restore growth and equity?

A Diagnostic Review of the Lebanese Taxation System and Recommendations to Improve Fairness and Efficiency

Executive Summary

In collaboration with

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Executive Summary

Since 2019, Lebanon is mired in a series of compounded crises that drained the country's vital resources and led to the greatest economic depression in its history, plunging a sizable share of its population into severe poverty.

Inequality has reached unprecedented levels. Even prior to the crisis, the richest 10 percent received five times more income than the bottom 50% (Assouad, 2021).

To address rising inequalities, long-due reforms are needed, and the tax system stands at the core of these reforms, expected to meet multiple objectives, notably ensure fiscal sustainability, finance social spending, revamp the economy based on fairness and equity considerations, and restore a minimum level of trust between the citizens and the state.

This report presents a diagnostic review of the Lebanese taxation scheme and attempts to provide different scenarios for the way forward, by looking into: (i) the macroeconomic context, (ii) the legal framework, (iii) the human capacity, (iv) the system performance, (v) and the policy design.

<u>Main conclusions about the macroeconomic context:</u>

- Findings highlighted inadequacies between the macroeconomic context and the tax policy response, with the latter designed and implemented on an ad-hoc basis, with no anchor in a medium-term fiscal framework.
- The adoption of tax measures in silos created a **dysfunctional taxation regime with systemic adverse effects on fiscal sustainability, economic activity, and social justice**.
- **The taxation regime in Lebanon has been suboptimal and did not raise sufficient revenues over time**. The tax to GDP ratio decreased from an already low 15.1% in 2019 (IMF, 2021) to 6.6% in late 2021 (IMF, 2023).
- **Yet, tax revenues have always constituted the largest share of state revenues,** ranging between 69% and 83% of total revenues over the last decade, and further compromising fiscal sustainability.
- **The costs of insufficient tax collection have been significantly high, even prior to the crisis**. The costs, translated in terms of debt interests, and associated with an unraised tax value of 1% of GDP, varied between USD 34 million and USD 36 million between 2016 and 2019.
- **The costs of insufficient tax collection were even higher post-crisis and exacerbated by the adoption of ad-hoc tax measures.** For instance, revenue losses due to the mis-valuation of import taxes alone were estimated at 4.8% of GDP (IMF, 2023).
- In addition, **the only attempt to increase tax rates backfired.** Several measures were introduced in late 2017 and early 2018 aiming to increase tax rates. However, in the context of economic recession, these had a procyclical effect that led to a decrease in revenue collection by 1.8% and to a drop in VAT collection of 15.2% (MoF, 2020).
- In 2021, and **despite a spike in the collected VAT, the overall system started becoming further inequitable**.
- The increase in tax revenues in 2021 directly contributed to narrowing the tax to spending ratio gap. **However, this post-crisis fiscal improvement, driven by a spike in revenue collection, is neither sustainable nor expected to last.**

<u>Main conclusions about human capacity and the tax administration:</u>

- **The overall performance of existing staff across the tax administration decreased drastically** due to deteriorating working conditions, increased cost of living, loss of real income value and the systematic depletion of its skilled labor force since the outburst of the crisis.
- **The tax administration is at risk of running short on capacity in the medium term**, while its skilled labor is being recruited elsewhere. Talent depletion is expected to hamper the administration's capacity to resume properly work and to implement any reform as staff that were groomed and trained for years are leaving.
- **The administration's incapacity to perform its missions is expected to further undermine its relationship with taxpayers and heightens the risk of tax fraud and evasion**.

<u>Main conclusions about systems and processes in place at the tax administration</u> based on the findings of the Tax Administration Diagnostic Assessment Tool (TADAT):

- While the taxpayers' base is solid, the integrity of the taxpayer registry is **vulnerable to more informality, increased inaccuracy in data and information registry, and higher risks of cybercrimes due to the lack of automated verification and cross-check processes.**
- **Weak risk management allows for loopholes in the taxation system that favor specific categories of taxpayers at the expense of overall revenue collection**.
- **The capacity challenges that the tax administration was faced with prevented it from investing resources to support voluntary compliance, knowing that the latter is key to achieve greater fairness.**
- **Recurrent delays and the extension of grace periods for the filing and payment of taxes exacerbated inequality among taxpayers** in terms of cash management and of real tax paid at times of rapid currency devaluation.
- **In a context of weakened audit, the likelihood of under-paying or tax evasion has increased drastically, and indirectly penalized regular filers**. With the crisis, and due to the flight of civil servants, audit programs were no longer conducted on a regular and systematic basis. Coverage was therefore significantly reduced to target primarily high-risk taxpayers which are large taxpayers and corporations. **In terms of equal treatment, taxpayers today face different probabilities of being subject to audit**, with small taxpayers being more likely to attempt tax avoidance compared to large taxpayers.
- **Overall, tax dispute resolution is effective**; yet improvements in terms of timeliness and autonomy vis-à-vis the tax administration are necessary.

<u>Main conclusions about progressivity gaps:</u>

- **Evidence highlighted significant loopholes in the progressivity design of progressive taxes** including specific income taxes, inheritance tax, and property tax, generated largely by the lack of cumulative filing.
- **Non-residents are not subject to progressivity**.
- **Labor income and built property taxes are not cumulatively progressive.**
- Prior to the amendments brought by the 2022 budget law, **the devaluation of the national currency and co-existence of multiple exchange rates have reversed existing income tax progressivity.**
- The amendments introduced by the 2022 budget law have also reversed existing progressivity of the income tax, and **the gap was widened by the currency devaluation for a specific category of individuals.**
- Under the same amendments brought by the 2022 budget law, **tax discrepancy was accentuated across labor income tax categories.**

- **Inheritance tax was subject to systematic evasion.**
- **The VAT tax,** which is the main source of revenues for the Lebanese government**, is regressive on disposable income.**
- Preferential treatments including deductions and exemptions are abundant and tailored in favor of either specific sectors/industries or specific categories of taxpayers. For taxes covered by this study (income taxes, inheritance tax, built property tax, and the VAT), exemptions were granted for at least 135 categories of individuals and industries, and special deductions to at least 27 categories of individuals.
- **The excessive use of preferential treatments has a distortionary impact and widens the inequality gap across taxpayers and categories of taxpayers. It also makes it difficult for the administration to manage related procedures, complicates law enforcement, increases the risk and likelihood of discretionary implementation of the law, and heightens unfairness.**
- Standardizing the criteria for special treatments, including exemptions and deductions, is key to restore a minimum level of fairness.

Recommendations

In view of the assessment, the study attempted to provide a theoretical and practical framework for improving both the efficiency and fairness of the current taxation scheme and to initiate a dialogue around the pillars of reform.

Achieving fair taxation is a variable of the social contract in place in each country and of the authorities' abilities to reconcile taxation objectives with economical and societal developmental goals and ensure the tax burden is fairly distributed across society.

It usually starts by framing the fiscal role of the state including allocation, redistribution, economic growth, and stabilization into a clear strategy, that takes into considerations macroeconomic fundamentals.

Country examples from around the world confirm that there is no single approach to tax reform, but the Lebanese example appears as a distinctive case given the complexity of its political economy. Given current circumstances and the challenges hampering reform efforts, Lebanon can consider two possible paths going forward:

1. **A long-term scenario that would anchor reform into a national political and policy dialogue, and create fertile ground for rebuilding a taxation scheme geared towards more progressivity**, including unified taxes, wealth tax, earmarked taxes, targeted incentive packages, a more performant administration, better aware citizens, etc.
2. **The second option would be to implement corrective measures to stabilize the system in place on the short and medium terms.** Among these measures would be improving revenue collection, ending the capacity drain, upgrading policy design, standardizing procedures, and strengthening citizens' engagement.

While reforming the tax scheme is fundamental to forge a fairer society and support economic development, it is far from being a straightforward process. Change is often fraught with complexities, resistance, and unforeseen developments at the **political**, **institutional**, and **cultural** levels, that all stakeholders would need to identify carefully analyze and seek to address.

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