

## Beyond the “Muddle-Through” Option: The Case for a New Tax Deal in Lebanon

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Lebanon stands today at the crossroads of a more strenuous and challenging muddle-through phase on one hand, and progressive recovery on the other.

The road it will end up taking will ultimately depend on a series of sound and rational decisions, chief among which is the reform of the country’s taxation system. **A new tax deal** could ensure the country’s greater fiscal stability, allow for the funding of social programs, and rebuild trust between citizens and the government.

These policy objectives are fundamental if the country is to exit one of the worst financial crises of modern times and alleviate the despair of a sizable part of its population that has been plunged into poverty.

Inevitably, such a system would need to reconcile growth with equity, particularly given the extensive financial damage that has been wrought upon individuals and households.

In the report “[How can a new tax system restore growth and equity](#)”, the teams of the Institute of Finance Basil Fuleihan and Financially Wise-Lebanon, make the case for a new tax deal that would be designed to address the current system’s inefficiencies and weaknesses.

### A Decade of Contradictions

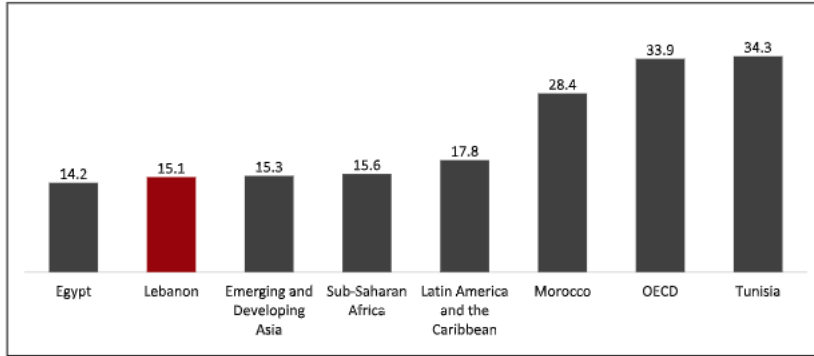
The decade that preceded the crisis can indisputably be considered one that was marred by contradictions. Broadly speaking, the current tax system continues to be an amalgamation of tax policies implemented in an ad-hoc manner without a medium-term plan or strategic foresight.

**Quick fixes can’t replace a long-term vision.** Piecemeal tax measures eventually created a dysfunctional tax regime that was neither sustainable nor conducive to greater economic growth. Despite constituting the largest share of total state revenues, the picture is much grimmer when benchmarked to the country’s GDP. In that regard, and according to the IMF, tax revenue has dropped from 15.1 percent to no more than 6.6 percent between 2019 and 2023. (IMF, 2023)

Nearly deprived of its main source of revenue, the State’s functions have greatly slowed down or in many cases come to a halt. Tax collection, already limping prior to the crisis, has been unable to offset this flop in tax revenues.

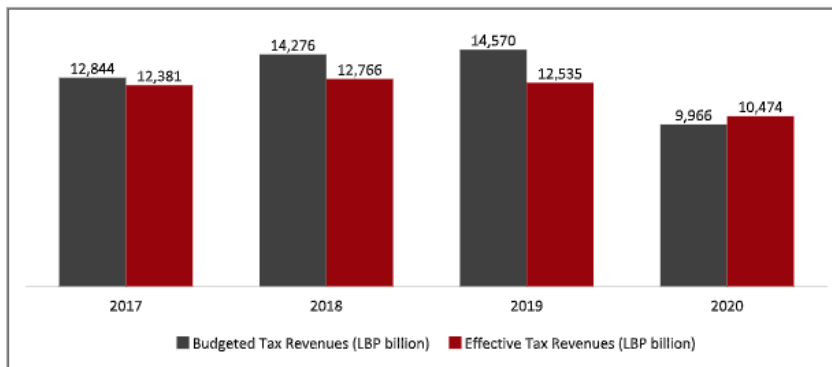
Consequently, current spikes in VAT collection are no reason to celebrate. They need to be viewed as circumstantial and unsustainable.

**Figure 1.** Lebanon’s Tax Revenues in Comparison to MENA and OECD (2021)



Source: IMF World Economic Outlook October 2021; OECD (2021) Revenue statistics in Africa.

**Figure 2. Lebanon’s Tax Revenue (Un)Predictability**



Source: MoF, Public Finance Monitor 2021

***Low tax revenue aggregates and low tax revenue predictability are symptoms of the system’s overall inefficiencies.***

### Human Capital: On Depletion Mode

Decades of constant weaving to build talents and skills within the tax administration, a great deal of which was coordinated by the Institute of Finance Basil Fuleihan, have been dealt a critical blow by the economic crisis.

The tax authority has witnessed a significant level of deterioration in staff productivity, owing greatly to the country’s deteriorating work conditions, escalating living expenses, currency depreciation, income erosion, weak leadership, and the departure abroad of skilled human capacities, mostly to join higher paid jobs at consulting firms advising ministries of finance across the region. With little incentives and an overwhelmingly negative outlook, productivity within the public sector has stalled.

**The tax administration can’t be left on autopilot.** This talent drain imperils the tax administration’s ability to roll-out reforms and weakens its rapport with taxpayers. Ultimately, this would lead to increased tax fraud and evasion, an issue that the country had to deal with well before the crisis.

### Keeping the Books in Order

History has demonstrated that tax records are correlated with successful State-building. In Lebanon, the tax administration faces several challenges in maintaining the integrity and effectiveness of its registries and operations.

While data regarding taxpayers is available, the registries remain vulnerable to inaccuracies and potential cybercrimes due to the absence of automated verification processes. Weak risk management allows for tax loopholes, often benefiting specific groups of taxpayers and affecting overall revenue predictability.

### A dysfunctional system widens inequalities and deters voluntary compliance

Food on the table comes before voluntary tax compliance. While the depletion of human resources exacerbates compliance checks, complex and continuously changing procedures, corruption, inefficiencies, interruptions in automated services, to name few of many constraints prevent people from opting for voluntary tax compliance as a rational choice.

Such dysfunctions widen inequalities among taxpayers at a time where the rift between those earning in US Dollars and those earning in Lebanese Pounds continues to widen. Undoubtedly, tax dispute resolution that is timely and effective will prove unavoidable in the settlement of unpaid taxes. At present time, confidence in tax dispute resolution is at its very low.

**Figure 3:** Different Tax Application to the Same Tax Base

FISCAL YEAR	PERIOD DESCRIPTION	WAGE EARNED IN USD	APPROXIMATE TAX WITHHELD (EQUIVALENT IN USD)
2019	Prior to the crisis	24,000	974
2020	Yearly average exchange rate on the parallel market: 6,705 LBP	24,000	217
2021	Yearly average exchange rate on the parallel market: 16,820 LBP	24,000	87
2022	Yearly average exchange rate on the parallel market: 30,313 LBP	24,000	462

Source: Author's calculations

### Progressivity: A Lost Gamble?

Lebanon has a set of progressive taxes that are much lighter than their equivalent tax schemes in OECD countries. Yet despite their relative competitiveness in that regard, the evidence points to significant flaws within their inherent design.

These shortcomings primarily stem from the absence of cumulative filing, which eventually creates loopholes that undermine the intended progressivity.

Owning a house and living abroad is a go-to strategy for those seeking to circumvent progressivity altogether. Indeed, non-residents are exempt from progressivity, and the built property tax, among others, lacks cumulative progression.

While income tax progressivity was eroded by currency devaluation and the existence of multiple exchange rates, the 2022 budget law amendments widened the gap between different earning categories and accentuated disparities across labor income categories.

These are just a few examples, with many more being listed in the full [report](#).

### The Road Ahead

Ultimately, the achievement of equitable taxation hinges on a country's social contract and its capacity to harmonize taxation goals with economic and societal development objectives. This process typically commences by formulating a clear strategy for the government's fiscal role, resource allocation, income redistribution, economic growth, and economic stabilization, all of which need to be in coherence with broad macroeconomic principles.

The Lebanese case is intrinsically unique, and given current challenges, two avenues remain possible:

- A. Firstly, a far-reaching, long-term exercise that would entail anchoring reform within a national political and policy dialogue. This participatory approach would allow reconfiguring the country's tax system towards greater progressivity. This would include consolidated tax structures, a wealth tax, earmarked taxes, targeted incentive schemes, bolstered administrative capabilities, and enhanced public financial awareness.
- B. The second scenario which might as well go in parallel with the long-term plan, would involve implementing immediate, corrective measures to stabilize the existing system in the short to medium term. These measures encompass bolstering revenue collection, stemming the loss of skilled personnel, enhancing policy design, streamlining procedures, and intensifying citizen engagement.

Evidence around the world has shown that when citizens like what the government is doing with its tax revenue, they more are likely to comply. In contrast, if citizens did not like how the government was spending taxpayers' money, then their appetite for evasion would augment.

In a country where inequities are at records heights, fostering equity in society is a building block for restoring the lost trust. Tax reform is fraught with complexities, resistances, and defiance, but it is a must for a country that needs to recover.

This blog reflects research results and opinions of the writers based on the report "How can a new tax system restore growth and equity in Lebanon", 2023, by Institute of Finance Basil Fuleihan and Financially Wise-Lebanon

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