Tax Evasion in Lebanon: How Much of a Burden?

BLOMINVEST BANK

***Every national government sustains itself by raising money domestically, through taxes, and by borrowing from local parties or external lenders.** As such, every population has its "potential to pay tax", which in turn impacts the local authorities' revenue collection target every year. Any remaining gap(s) in the national budget is usually financed through borrowing, whether from domestic creditors or from foreign private or public institutions. Foreign aid in the form of grants from some international institutions may also be granted to selective countries if their economies meet particular criteria.*

***To-date, there is no elaborate study nor sufficient data to conclude exactly how much tax revenues the Lebanese government is being deprived of every year.** This can be attributed to imperfections in the tax networks and in the monitoring of all market players operating in the country's various economic activities. Nonetheless, estimations can be made based on a number of domestic parameters and analyses of international benchmarks.*

November 11, 2017

Contact Information

Jr. Analyst: Rouba Chbeir

rouba.chbeir@blominvestbank.com

Head of Research: Marwan Mikhael

marwan.mikhael@blominvestbank.com

Research Department

Tel: +961 1 991 784

Tax evasion is a form of moral hazard. Non-payers evade taxes while the government accumulates the cost and very limited information is available on exactly how much losses the government is making or on who and how many are not paying taxes. Through tax evasion, the government is missing out on a direct source of income, money unpaid by tax evaders.

Frail implementation of corporate governance in Lebanon also enhances tax evasion. Enterprises are finding alternate ways to dodge taxes. The bulk of tax evasion in Lebanon seems to lie in evasions from: the Income tax on corporate profits and Income tax on wages and salaries. Other tax evasions also exist but less severely in Property tax, Taxes on international trade namely Customs, as well as Domestic taxes on goods and services namely the Value Added Tax (VAT).

Structural flaws in the taxation network alongside man-made factors enhance the evasion from tax. An effective tax network is jeopardized by multiple factors, of which: poor scrutiny of enterprises' operations or ledgers, corruption among tax officials, political officials or corporate boards, citizens' habit of evading taxes- whether due to cultural problems or the unclear tax networks set out across the country and flaws in the tax payment & collection systems.

The different tax categories prone to tax evasion in Lebanon are analyzed and the large evasions quantified. Lebanon's GDP stood at $49,459M ($49.46B) in 2015 according to the latest available data from CAS. The form and amount of tax evasion is analyzed in five main categories of tax as per the below.

Tax Revenues Breakdown: Evasion and Potential for Improvement

Comparative Table: Tax Revenues 2015 /2016 (in percent of GDP)			
	Lebanon	OECD average	Latin America & The Carribean (LACs)
TOTAL TAX REVENUE:	**14.21%**	**34.30%**	**22.80%**
Taxes on Income, Profits, & Capital Gains, of which:	**4.04%**	**11.60%**	**6.20%**
Income Tax on Profits of corporates	1.53%	2.82%*	3.30%
Income Tax on Wages and Salaries	0.94%	8.78%	2.90%
Property Tax	**1.64%**	**1.82%***	**0.80%**
Domestic Taxes on Goods & Services, of which:	**5.06%**	**10.76%***	**11.20%**
VAT	4.34%	6.60%	6.00%
Taxes on International Trade (includes: Customs & Excises|)	**2.84%**	**2.74%**	**3.00%**
Customs	0.95%	0.1%*	1.50%
Excises	1.89%	*2.64%**	1.50%
Other Taxes	0.63%	*0.2%**	N/A
Sources: Data on Lebanon, Ministry of Finance; OECD & LACs data: OECD statistics, 2017			
*Data not available for 2015, so avg. over 5 years calculated.			

A. Income Taxes: Taxes on Income, Profits, & Capital Gains

Tax on Corporate Profits

Any registered enterprise in Lebanon is subject to corporate tax on profits at the flat rate of 15%, compared to the OECD's corporate income tax rate of 29.33% on average[1]. In its turn, the ratio of income tax on corporate profits in Lebanon to income tax on profits in the OECD stands at 0.54%, which reflects well the difference in tax rates between the two entities. As such, with the corporate tax in the OECD being almost twice Lebanon's on average, the tax revenues from corporate tax are also pretty much the double. Therefore, Lebanon does not seem to be severely evading taxes on corporate profits. However, an interesting comparison can be made with the contribution of the government's corporate tax revenues paid by the market players of the different taxable economic activities.

Banks in Lebanon pay 64.65% of total corporate taxes. Room for improvement is large for corporate tax collections from "Other" enterprises. In terms of total corporate tax revenues, Lebanese Banks paid 64.65% of the total tax on corporate profits, while the remaining 35.35% constitute all "Other" enterprises. In details, banks' tax payments in 2016 amounted to LBP739B ($490M) of the total

[1] The "Combined corporate income tax rate" figures for the 7 largest economies of the OECD are averaged and used for this study: US, UK, Germany, France, Italy, Spain, and Japan.

LBP1,143B ($758M) corporate tax collections by the local authorities. In comparison, in the OECD, Banks and Financial Institutions (FIs) constitute on average up to 6% of GDP[2] .

Exemptions to corporate tax exist, yet tax evasion in Lebanon appears to be in the informal "other" (non-bank) enterprises. 2015's national accounts show that financial services in Lebanon, namely banks, grasp 8% of Lebanon's GDP, while 37.64% of the GDP is non-taxable because it's constituted of the tax exempt sectors: Real estate (14.48% of GDP), Health and social care (3.46% of GDP), Education (5.26% of GDP), Public Administration (9.32% of GDP), Administrative Services (2.37% of GDP), and Community services (2.75% of GDP).
It's worthy to note that exemptions exist in the OECD, but we estimate them to be much less than in Lebanon, and they could go up to 15% of GDP. This comparison reveals there is room for improving tax payments and collection in the non-bank enterprises of Lebanon.

Hence, the taxable GDP amounts to 63% of actual GDP, and the weight of banks in the taxable GDP goes up to 12.7%. Even though the share of banks in taxable GDP is higher than their share in total GDP, they are still paying a high share of 64.65% of total profit tax. On the counterpart, in the OECD countries, banks are contributing a little bit more than this weight in GDP, and other sectors contribute for the largest part of profit taxes. Therefore, extracting Lebanese banks' contribution to profit taxes from GDP, and extracting the OECD's financial sector profit tax contribution, we deduce that tax evasion exists in income tax on corporate profits in the order of 0.8% to 0.9% of the income tax on profit, equivalent to $400M to $450M.

"Other enterprises" in Lebanon include non-banks, of which approximately 92% are SMEs. Around 92% of the companies in Lebanon are small to medium-sized firms (SMEs) and the authorities' collectability efforts most times stand larger than the firms' actual total payment on profit taxes. Moreover, such businesses tend to submit falsified statements on their profits. Despite the local government's efforts to conduct spot checks and audits on the activity of enterprises all over Lebanon, companies to date - particularly operating in the informal market- still manage to present false financial statements by which they evade taxes or reduce their tax payments. These are hard to estimate though as some may be registered or not, while others operate only regionally or on a very small scope.

Investing in an inclusive taxation network may boost revenues from tax on profits in the long run. In this context, an initial investment for a more efficient tax network that can include these SMEs in the taxation mechanism may be costly at first. Nonetheless, on the long-run, the Lebanese authorities could reap multiple benefits and boost public revenues from businesses.

Tax on Wages and Salaries

Lebanon's income tax rate on Salaries and Wages (S&W) reaches 20%, while the OECD's and the LACs' stand at 39.95% and 21.7%, respectively. For both the public and private sector, taxes on S&W in Lebanon increase progressively from 2% to 20% as per the corresponding income brackets. On the

[2] Luxembourg's FIs constitute the largest portion, 27% of OECD's GDP; but considering it's a small economy, it's excluded from the region's averaging used in this research. The USA holds 7% & Switzerland 9%, while all the FIs of all remaining member states each stand at 5% to 6%.

counterpart, in the OECD, the average tax wedge for a single person stands at the weighted average[3] of 39.95%. Given the OECD tax rate substantially exceeds Lebanon's (almost double) and given the OECD's GDP per capita stands at highs of $42,098 estimated by the OECD in 2016, the comparison is drawn between Lebanon and the LACs to derive the potential of tax evasion on Lebanese tax on W&S.

Evidence from the LACs reveals a tax evasion ranging between 0.8% to 1% of GDP in Lebanon's revenues from tax on W&S. The average wage tax rate in the LACs stands at 21.7%, close to Lebanon's 20%. Nevertheless, the LACs generate 2.9% of GDP in revenues from tax payments on W&S, while the Lebanese lag behind constituting 0.94% of GDP, knowing that the GDP per capita in the LACs according to FRED stands at $8,156 in 2016, while Lebanon's $11,900 GDP per capita is higher. Therefore, adopting a conservative approach throughout the report's findings, the lag in revenue settles at an estimated 1% of GDP, equivalent to $500M.

Income taxes on salaries and wages in Lebanon are shadowed in the informal labour market. According to previous studies conducted by Blom Invest, the Lebanese labour market is characterized by a high degree of "informality", with an 'informal' labour market defined as one where, "*explicit and registered work contracts and/or social security coverage for workers on the job [are absent]"* as per the International Labour Organization (ILO). Thus, the evasion from income taxes on S&W may be linked to the fact that, "*[…] 50% of the working age population works in informal jobs*" according to Haneen Sayed, Human Development Coordinator for Lebanon, Jordan and Syria and co-author of the World Bank 2013 Miles Report.

An influx of cheap and undeclared labour into Lebanon post-Syrian War invaded Lebanese enterprises. Since the onset of the 2011 Syrian Crisis, the workforce in Lebanon comprises of Lebanese nationals competing with Syrian refugee-workers who settle for significantly lower incomes. When the average monthly salary of a Syrian refugee stands at LBP 418,000 (around US$280), the minimum wage of a Lebanese worker is LBP 675,000 (US$450). Hence, local employers were granted a leeway to hire cheap labour, knowing Syrian workers do not need a work permit and most of them remain undeclared to the local authorities. By doing so, domestic enterprises end up evading from the fees of registering employees.

"Other" local enterprises declare employee salaries to be lower than the real salaries to evade social security fees. In Lebanon, employers bear 22% of the social security costs of every employee. As a result, declaring lower salaries becomes a common practice amid the lack of tight governmental monitoring. In fact, approximately 43% of Syrians take on informal positions in industrial and semi-skilled jobs, like carpeting, welding, repairmen, mechanics, handicraft, and food processing according to the ILO. Yet, knowing that most Lebanese enterprises (SMEs) hire less than 10 workers, the wage bracket tackled is the low bracket, which is the main reason why revenues from tax on S&W in the LACs also remain higher.

B. Property Tax

Real estate (RE) is a driver of the Lebanese economy and players have some leeway to evade property tax. Real estate in Lebanon constitutes 14.48% of GDP, and the tax on property includes mainly the Real

[3] The OECD defines "tax wedge", as the total taxes on labour income paid by employees and employers, minus family benefits received, as a percentage of the labour costs of the employer. The weighted average is that of the tax wedges in the 7 largest economies of the OECD used earlier.

estate registration fees, which forms the major taxes paid on property tax in Lebanon. Revenues from RE Registration Fees (7.57% of total tax revenues) stood at LBP 802B ($532M) in 2016, up 3.68% from 2015's. More recently, in H1 2017, revenues amounted to LBP 742.8B ($492.7M), up from LBP 635.8 ($421.8M) in H1 2016. In fact, the main market players in the sector are real estate (RE) agencies, but also a number of RE brokers working in the informal market of RE. These last do not own a corporate office or and so their business transactions most probably slip the official declarations to the Ministry of Finance. The lack of monitoring of such activity gives the dealers leeway to either not record their transactions or record them with an underestimated value to reduce the burden of the property tax payments.

However, compared to the OECD and LACs, the evasion potential from property tax in Lebanon is marginal. Following the conservative approach, the RE sector in Lebanon constitutes a marginal portion of tax evasion as the ratio of income from property tax in Lebanon to income from property tax in the OECD stands at less than 0.1%, while Lebanon's revenues from property tax exceed those of the LACs.

C. Value Added Tax (VAT)

The performance of Lebanon's VAT revenues is compared to countries with an equivalent tax rate. VAT rates vary among countries. In Lebanon, the VAT stands at 10%, compared to the average VAT rate in the OECD which is 19.2%. However, the substantial difference in tax rates renders the comparison challenging. Instead, Lebanon's income from VAT is compared to countries charging an equivalent VAT rate. As such, the VAT rate stands at 10% in Australia and at 8% in Switzerland, both being members of the OECD with rates closest to Lebanon's. Hence, in terms of VAT revenues, Lebanon's amounted to 4.34% of GDP in 2016, while Australia's and Switzerland's add up to 3% of GDP and 3.4% of GDP, respectively.

Nonetheless, Lebanon's revenues from the VAT are higher, owing it to the elevated consumption to GDP ratio. The consumption function overall in Lebanon depends largely on worker's remittances among other factors. As such, consumption to GDP in Lebanon stands at 99% according to the latest national accounts, which is almost double Australia's whose consumption to GDP ratio reaches 57.8%. Therefore, the higher consumption function gives Lebanon more room to evade the VAT even though currently revenues generated from the tax are higher. The evasion is thus estimated to be between 0.5% and 1% of GDP, equivalent to $250M and $500M.

Evasion from VAT may also still exist in discrete forms. Consumers pay the VAT on purchased goods, but the end recipient of VAT payments may not pay it or submit it fully to the government thereby jeopardizing collected taxes. It is also worthy to note that the rates of other non-VAT domestic taxes imposed on goods and services vary among different items and across countries, which makes their comparison less reflective on the reality of the country's public revenues from tax.

D. Taxes on International Trade (Customs and Excises)

Lebanon's revenues from international trade taxes, including customs and excises, lag by 0.16% of GDP compared to the LACs, which quantifies tax evasion at approximately $80M. Lebanon's income from taxes on international trade (customs and excises) amounts to 2.84% of GDP, whereas that in the OECD stands at 2.74%of GDP and the LACs' at 3% of GDP. The comparison of international trade tax to the OECD is inaccurate given the countries within the 'free trade' Euro Zone area are among the OECD member states; these countries do not pay customs duties among each other. This is why the study compared Lebanon's income from international trade taxes to the LACs', and we estimate revenues from international trade taxes lag by a 0.16% of GDP, which amounts to an estimated $80M.

As for taxes from Customs alone, this study estimates tax evasion at $272M. While revenues from Customs in the LACs stand at 1.5% of GDP according to the OECD, Lebanon's amounts to 0.95% of GDP, which lags by 0.55% of GDP equivalent to $272M. The gap may be attributed to the undervaluation of imports in Lebanon.

Wrap Up: Lebanon's Tax Evasion in Figures

In conclusion, total tax evasion from the above –explored items is estimated between $1.1B and $1.7B, whereby the evasion is pretty much equally divided among 4 explored categories of tax revenues: tax on corporate profits, salaries and wages, domestic goods and services (VAT), and taxes on international trade (customs and excises). Moreover, improving tax collection necessitates large efforts from the local authorities; the coordination among the different public administrations involved in the tax network (of which, the customs, the ministry of finance, etc.) is also key.

This study therefore attempts to identify potential gaps in tax administration in Lebanon, yet, it is important to note that no exact figures on tax evasion can be drawn mainly due to many hidden parameters and informal economic activities.

(in US$ millions)	Lower Bracket	Higher Bracket
Income Tax on Corporate Profits	400	450
Income Tax on Wages and Salaries	400	500
Value Added Tax	250	500
Tax on Internaitonal Trade	80	272
TOTAL estimated tax evasion	**1,130.0**	**1,722.0**

Note:
Ranges used for calculation of lower and higher brackets are explained in the report and summarized below:
- Tax on corporate profits: 0.8% to 0.9%
- Tax on salaries and wages tax: 0.8% to 1%
- VAT: 0.5% to 1%
- Customs: 0.16% to 0.55%

Source: BLOM Invest Bank

For your Queries:

BLOMINVEST BANK s.a.l.

Research Department Bab Idriss, Weygand Str. POBOX 11-1540 Riad El Soloh Beirut 1107 2080 Lebanon

Rouba Chbeir, Jr. Analyst

rouba.chbeir@blominvestbank.com

+961 1 991 784

Marwan Mikhael, Head of Research

marwan.mikhael@blominvestbank.com

+961 1 991 782

research@blominvestbank.com