KULLUNAIRADA

CHALLENGING THE SINCERITY OF THE BUDGET'S FIGURES

June 2019

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The proposed budget for 2019 brings in a range of measures aimed at boosting revenues and curbing down expenditures, and is clearly designed to reach a predefined target. We challenge the sincerity of the figures that come at a crucial time for Lebanon especially that all previous budgets had a track record of overestimating revenues and exceeding expenditures.

While the budget does quantify the effects of the proposed measures and lists in details the government's expected revenues and expenditures, it fails to state how these figures were reached. Furthermore, the budget is a single scenario exercise and lacks a corresponding contingency plan. It also does not provide enough details allowing the reader to do his/her own sensitivity analysis.

These questions are based on the assumptions behind the figures and their calculation procedure, in addition to other qualitative aspects. Moreover, the amount of times the budget's figures were altered signals an underlying window-dressing approach. For example, between the last two versions of the budget proposal, revenues from fees on leaving Lebanon rose by 51.06% and those collected from military retirees rose by 45%.

Table 1: Budget's Main Figures

In Billions of LBP	2018 Budget	2018 from Informed Sources[1]	2019 Budget	Delta 2019 Budget - 2018
Total Revenues	18,686	17,400	20,127	15.67%
1 Budget Revenues	18,686	-	19,016	-
2. Budget Expenditures	25,991	26,800	25,840	-3.58%
of which Transfers to EDL	2,100	2,650	2,500	-5.66%
of which Debt Servicing	8,214	8,154	8,337	2.24%
3. Treasury Resources	-	-	1,111	-
4. Treasury Withdrawals	-	-	-	-
Treasury Balance	-	-	1,111	-
Total Deficit	(7,305)	(9,400)	(6,824)	-27.41%
Deficit to GDP	-8.36%	-11.20%	-7.58%	-

- The budget proposes an LBP 6,824Bn fiscal deficit, 27.41% down from 2018's LBP 9,400Bn. The major part of the drop originates from a 15.67% or LBP 2,727Bn rise in budget revenues. On the flip side, expenditures are proposed to drop by 3.58% or LBP 960Bn.

- In absolute values the budget targets a primary surplus of LBP 1,513Bn including transfers to EDL and LBP 4,013Bn excluding them.

[1]Figure published in Al Akhbar, unofficially confirmed by an informed source.

• The result is a deficit to GDP ratio of 7.58% according to the draft sent to Parliament.

RESERVATIONS ON THE UNDERLYING GROWTH ASSUMPTIONS

• The budget assumes that the economy will grow by 1.2% during 2019, while leading indicators of economic activity are signalling a slowdown during 2019 (expanded in appendix).

• The government's projections of economic growth and inflation have continuously missed the proposed figures by the end of the year. Below is a table providing an overview of the most recent misses:

Table 2: Recent Budget Misestimations

	2017 Budget	2017 Actual	2018 Budget	2018 Actual	2019 Budget
GDP Growth Rate	2.20%	0.60%	3.43%	0.20%	1.21%
Inflation	2.00%	4.50%	1.75%	6.10%	1.75%

• Overstating growth affects the budget on two levels:

› It overstates the level of projected tax collection due to an overestimation of its tax base.

› It brings down the deficit to GDP ratio since it inflates the metric's denominator.

RESERVATIONS ON THE SCOPE OF REVENUE INCREASE

• The 15.67 % increase in revenues accounts for 106% of the deficit reduction. The accuracy of this projection is therefore crucial for the credibility of the announced figures.

• Officials have stated that the budget calculations are based on six months of effective application. However, discrepancies have risen while testing them back.

› The budget estimates that the rise in tax on interest from 7% to 10% will lead to a LBP 758Bn* rise in revenues if applied over a six-month period. Assuming that the tax base of this line remained flat in 2019 with respect to 2018, we estimate the rise in this tax to generate an additional LBP 748Bn in revenues if applied over a twelve-month period. Six months of application would generate half that amount (LBP 374Bn) under the additional assumption that the prevailing capital flight situation doesn't eat into the tax's base.

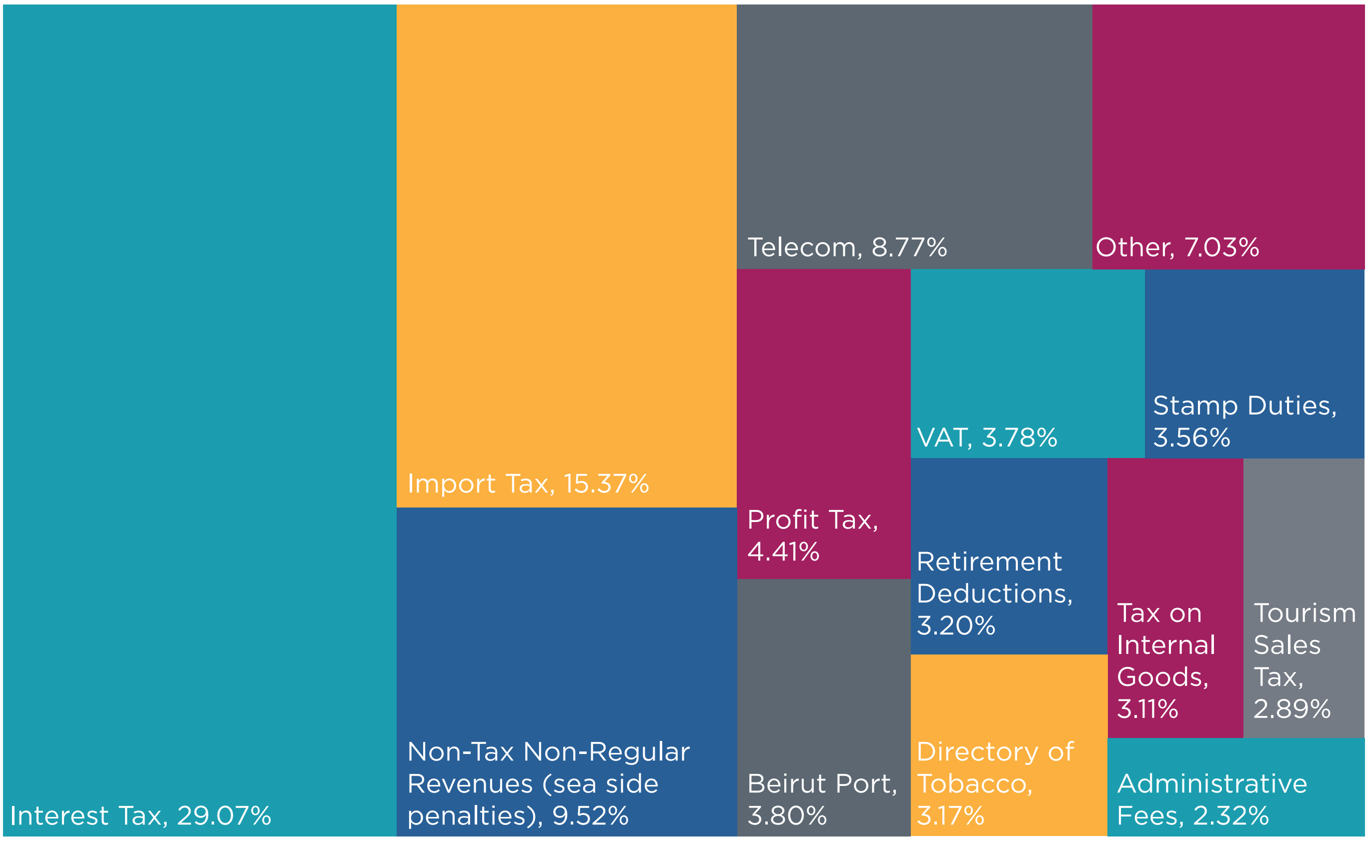
› The 2% tax on imports is projected to generate LBP 400Bn* in additional revenues following six months of effective application. Assuming that imports did not rise during 2019, we estimate this measure will generate LBP 602Bn in added revenues. Hence, under six months of application, this measure should generate LBP 301Bn in further income, assuming that all imported goods are taxed and bearing in mind that this measure explicitly excludes imports from countries which we have signed bi-lateral trade agreements with.

› The proposal includes a LBP 229Bn rise in telecom revenues that has not been explained, especially given the drop by 21.77%* or LBP 421Bn in 2018 vs. 2019. Additionally, telecom revenues underperformed by 26.89%* or LBP 557Bn* with respect to 2018›s budget.

› Income tax revenues are theorized to rise by LBP 115Bn* due to the introduction of a new 25% tax bracket on all income above LBP 225Mn a year. We have reservations on this figure given the threshold to join the top 1% of earners starts at LBP 203Mn, well above the new tax bracket. Furthermore, this tax's revenues dropped, due to the economic slowdown, by 30.9%* or LBP 637Bn* in 2018 vs. 2017.

› Penalties on sea-side developments equate to an LBP 248Bn* rise in revenues. While we can't assess the validity of this figure, we have reservations on it knowing that the measure was included in 2018's budget and many previous budgets but never materialized.

Chart 1: Contribution of each revenue stream to the total rise in revenues



ALTERNATIVE SCENARIOS

We ran an exercise to see what range we can expect the budget deficit to GDP ratio to record based on two variables: first the pace of the economy's growth rate and second the time frame the budget is applied in.

Table 3: Variation of deficit/GDP ratio based on different growth assumptions

Growth Rate	Full Year Application	Half Year Application
-1.20%	-8.07%	-9.60%
-0.60%	-8.02%	-9.54%
0.00%	-7.97%	-9.49%
0.60%	-7.92%	-9.43%
1.20%	-7.87%	-9.37%

QUESTIONING EXPENDITURES

• The 3.58% drop in expenditures does not come due to fiscal austerity but as a result of a vouch from public officials to abide by their assigned budgets after expenditures in 2018 surpassed their planned amounts by LBP 809Bn.

• The estimate for the debt servicing cost, which accounts for LBP 8,337 Bn of total expenditures and whose stabilization accounts for LBP 757Bn[2] of the reduction of the deficit, is not based on an official commitment from the Central Bank or the commercial banking sector. The assumption is that the government will be issuing LBP 11,000Bn in T-bills at a 1% interest rate that would curb down the rollover cost of existing debt.

Note that this deal represents a continuation of the transfer of the deficit to BDL, leading to a quasi-fiscal deficit and eating away from the Central Bank's reserves.

• Out of budget costs, that usually listed as Treasury transactions, are not found in the 2019's budget annex, with no explanations. Note that these equated to LBP 2,185Bn* in 2018 (versus a Treasury resources of 1,251Bn*) and their omission from the 2019 budget have thus contributed significantly to the drop in the deficit.

• The proposal fails to include payments in arrears that have incurred on the Ministry of Finance and amount to hundreds of billions of Liras. These payments are the by-product of the Ministry's decision to seize all non-essential payments following its inability to cover its deficit through the market.

• Transfers to EDL dropped by LBP 150n or 5.66% in 2019's budget. This drop is not supported by any projection of a tariff increase, drop in oil prices or drop in consumption which leads us to wonder how this figure was reached.

• LBP 798.29Bn have been reduced from expenditures through delaying planned expenditures on a wide range of projects. Cutting down expenditure on these projects either indicates that they aren't essential or that the government has winded down on public investment rather than curbing down unnecessary spending and leakage.

[2]Versus its opportunity cost

Disclaimer: "*" equates to taking into account a linear approximation of 2018's figures. Note that this is not an accurate representation of the year's real figures due to the presence of payments in arrears. These backlogged payments are due to the Ministry of Finance's decision to stop all non-essential payments when the Treasury's accounts dropped below their buffer following the funding crisis that materialized during Q4 2018. Such payments include retirement lump sums and public investment bills.

APPENDIX

WORRYING SIGNS OF A CONTINUED SLOWDOWN ACCOMPANIED BY CAPITAL FLIGHT

Worrying signs of a continued slowdown accompanied by capital flight

Economic indicators are showing signs of a prolonged slowdown (0.2% Growth in 2018), along with a relatively high inflation rate. This stagflation is accompanied by capital flight as the macro and fiscal backdrops worsen, raising doubts of the Treasury's ability to meet its obligations. On the other hand, while the balance of payments deficit accelerates, the need for BDL to fill this gap is rising proportionally. Meanwhile BDL has maintained its most recent basket of unconventional monetary policies aimed at topping up its hard currency reserves, offering in exchange sizable profits for the local commercial banking sector.

Furthermore, BDL has been covering the Treasury's commitments from its own pocket. The central bank has paid USD 2.152Bn in directly to cover maturing principal and coupons for Lebanese Eurobonds

Meanwhile signs from leading economic indicators all show that the adverse economic situation will continue:

THE ECONOMY IS SUFFERING

-35.75% Cement Deliveries
Y/Y during Q1 2019

This drop signals a contraction in the real-estate sector which is one of the main drivers of the economy in Lebanon.

-4.27% BDL Coincident Indicator
Y/Y during Q1 2019

This index gauges economic activity across eight key sectors, showing a general slowdown in economic activity across the entire economy.

+2.91% Imports
Y/Y during Q1 2019

Imports have shown signs of seasonality during Q1 2019, however net they have risen by 2.91% during Q1 2019; this signals an acceleration of the loss of dollars slowly crippling the economy.

+4.01% Inflation Rate
Y/Y April 2019

Inflation continued its momentum due to higher oil prices and the strengthening of the USD.

+0.83% Commercial loans
Y/Y February 2019

By itself the figure is neutral; but taking in to mind that the consolidated balance sheet of all Lebanese commercial banks rose by 12.18% Y/Y over the same period, this signals a slowdown in bank lending as a result of the deteriorating economic backdrop and lack of liquidity in the banking system due to BDL's polices.

FINANCING NEEDS ARE GETTING HARDER TO SATISFY

USD 3.305Bn Balance of Payments Deficit
Between January and April 2019

This indicates that dollars are flowing out of the country, in a nation dependent on dollar inflows to fund the fiscal and trade deficits this is worrying scenario. Capital flight has expanded remarkably when taking in to account 2018's deficit of USD 4.823Bn.

-9.24% BDL Foreign Currency Reserves
Y/Y April 2019

BDL has been single-handedly funding the fiscal deficit, balance of payments deficit, and its unconventional monetary policies. This has led to a large drop in its foreign currency reserves and weakened its ability to respond to a speculative attack on the currency peg.

BDL'S POLICES:

Bank	Bank Interest Income YoY Q1 2019
BLOM	+27.20%
AUDI	+15.19&
Byblos	+26.50%

55.2% BDL share of Domestic Public Debt
Of debt released in Q1 2019

VS

1.3% Banking Sector Share of Domestic Public Debt

The Central Bank is continuing its unconventional monetary policies to sustain sufficient demand on the Lebanese Lira, while generating sizable profits for the Lebanese commercial banking sector at the cost of its currency reserves. These polices have led to a rise in leverage across the banking sector and made them reliant on BDL to generate their profits. Indeed, the banks have slowed down loan creation and investing in government debt securities.

Kulluna Irada is a civic organization for political reform, engaged in setting the foundations for a modern, secure, efficient, sustainable and just state. It is funded exclusively by Lebanese citizens in Lebanon and abroad. Kulluna Irada believes transparency, accountability and citizen participation as major constituents of good governance. The organization's goal is to raise awareness on public issues and engage constituencies of the Lebanese society: citizens, NGOs, experts, municipalities, and members of Parliament and Government in order to find and implement sustainable solutions.

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