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مجلس الانماء والاعمار
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SUMMARY REPORT
AND
RECOMMENDATIONS

PA
67-4/25
re: 7/41/70
Letter

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الجمهورية اللبنانية
مكتب وزير الدولة لشؤون التنمية الإدارية
مركز مشاريع ودراسات القطاع العام

Republic of Lebanon
Office of the Minister of State for Administrative Reform
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Introduction

The distinctive characteristics of the Lebanese economy seem to derive from two factors: its location, and the high degree of freedom granted to enterprise. Both have contributed substantially to a high per capita income in comparison with neighbouring countries in the Asian Arab world, and to a highly satisfactory rate of economic growth during the last two decades. Geographic location has oriented Lebanon toward the developed West, while providin a conduit from the West to less accessible Arab lands. Some consequences of this have been the attraction of foreign capital (from both East and West) and a strong emphasis upon commerce and services - financial and other - in the domestic product. While her geographic location has permitted Lebanon a measure of independence from Middle - East political instability, her role as trader and banker has made her somewhat vulnerable to economic instability elsewhere.

Although our assignment related to the tax system and not to governmental expenditures, we wish to record two impressions concerning the present pattern of expenditures. First, infrastructure investment by the government is very uneven with serious lags in provision of streets, highways, and public education. Second, government expenditure on services which improve the quality of living for poorer citizens - provision of parks, playgrounds, health services, protection from exploitation, noise abatement, sanitation and refuse disposal - appears to be deficient. The needs will make strong demands on the budget in the years ahead.

The Revenue System

The table on the following page provides a summary view of revenues of 1967 and 1968. These are general fund revenues, excluding the autonomous agencies and the municipalities. In recent years taxes have gained importance in the total of revenues. Indirect taxes of which the dominant one is customs, provide over 70% of the tax revenue. The expectation, is, however, that improved administration of income taxes will, within a few years, bring a more rapid growth of revenue from direct taxes and this, in turn, will improve the equity of the tax system. Nonetheless, indirect taxes will continue to be of great importance, and this is not regretable. With a few exceptions noted in the report, the indirect taxes are justifiable in theory and carry acceptable rates. They seem to avoid serious regressive effects; they have, as a group, demonstrated revenue flexibility, and are relatively well administered. Overall the tax system seems to be mildly

Budget Revenues, 1967 and 1968

	Revenues L. L. Millions		Percent of Total	
	1967	1968	1967	1968
Total	518.9	578.6	100.0	100.0
1. Taxes	411.8	471.7	79.4	81.5
a) Direct taxes	113.7	123.0	21.9	21.2
1) Income and profits	63.2	62.6	12.2	10.8
2) Built-on property	36.8	41.2	7.1	7.1
3) Inheritance	2.9	3.6	.6	.6
4) On cars	10.9	15.7	2.1	2.7
b) Indirect taxes	298.0	348.7	57.4	60.2
1) Customs	146.0	177.6	28.1	30.8
2) Fuel	55.4	58.4	10.7	12.2
3) Tobacco	32.7	33.7	6.3	5.8
4) Cement	5.2	4.9	1.0	.8
5) Alcoholic beverages	1.7	1.7	.3	.3
6) Salt	0.1	0.1	-	-
7) Entertainment	1.5	1.8	.3	.3
8) Revenue stamps	19.9	27.1	3.8	4.7
9) Other	35.5	43.4	6.9	5.3
2. Non-taxes	107.2	106.9	20.7	18.5
Pension deductions	12.9	13.5	2.5	2.3
Oil royalties	33.9	34.3	6.5	5.9
Other	60.4	59.1	11.7	10.3

Useful ratios	1967	1968
Direct taxes/total taxes	27.6%	26.0%
Customs/ total taxes	35.4%	37.8%

progressive as family incomes rise up to, say, L.L. 20,000 per year. Thereafter progression flattens out. (See Taylor memo No. 1, p.p. 8-11). As will appear in the report, restructuring of income taxation will bring more progression in the middle and higher ranges of income.

The objective of our efforts has been to structure the tax system so that it (a) produces reasonably adequate revenue now; (b) contains sufficient inherent elasticity to produce increased revenue as the economy grows and as administration improves, without the necessity for major restructuring; (c) provides a maximum of equity among taxpayers, consistent with revenue requirements and administrative competence; (d) provides minimal discouragement to the strategic elements important to a high rate and appropriate paths of economic development; and (e) offers opportunities for temporary modifications in taxes which will permit crisis adjustments when particular and unusual needs are to be met.

The immediate requirement is to get the tax house in order to provide a solid base for action. This means, first, assurance that no important tax sources or measures have been ignored, and second, that components of the tax system are soundly structured and integrated in a manner which imposes upon taxable capacities as equally as possible, given the income generation and distribution patterns of the country.

The proposals in the report will clearly imply that there are areas of unusual strength and weakness in the present tax structure. Little will be said about the areas of strength except to notice aspects which can be improved. By and large, this observation applies to the indirect taxes. Our recommendations in the area of direct taxes are far-reaching and have been given the more intensive study, for we feel that in this area there is a great deal of ground to be made up. The improvements contemplated involve re-structuring of the major taxes themselves, and a revolutionary change in the quality of their administration. While this latter problem has not fallen within our purview, we have recognized its importance and have attempted to frame our proposals in terms of present and future administrative capabilities. Frankly, we are betting quite heavily on the results of the proposals as to organization, procedures, and personnel training which our colleagues are preparing.

We regard this as a summary report of the results of our study, containing little more than a bare listing of our recommendations. We feel justified in this approach, first, because nearly all of the recommendations have been worked out in frequent consultation with the Director General and his selected informal advisory group, and we are confident that they are familiar with the background studies and discussions which led to the recommendations. Second, there are two sets of background papers which should be considered as appendages to this report. The first is a set of papers produced by Mr. Maxwell, dealing with the major indirect taxes. These describe the bases and rates applicable to these taxes, and contain the recommendations reproduced here.* The second is a set of papers on the major direct taxes, written by Mr. Taylor at the end of his longer stay in 1969.** Again, the analysis leading to recommendations will be mainly found in those papers rather than in this report.

* Maxwell, Papers on Indirect Taxes, Lebanon, 1970

** Taylor, Tax Policy Papers, Lebanon, 1969

I. RECOMMENDATIONS OR SUGGESTIONS CONCERNING INDIRECT TAXES

Indirect taxes in 1968 provided 74% of the tax revenue of the Lebanese Government, and this proportion is not likely to change much in the near future. Since the important ones have modest rates, since their incidence is not significantly regressive, and since administration is usually good, this is not a bad prospect. Indirect taxes fall into two parts: (a) internal excises on goods domestically produced, and (b) customs duties or external excises on goods produced abroad.

Excises

1. The most important of these are on inflammables which in 1968 yielded LL 100.2 million. Of this benzine yielded 88% from a rate of 19.19 L.P. per litre. Since the demand for benzine in Lebanon is inelastic, moderate increases in the rate would be revenue-productive. The incidence of this tax is acceptable. The excise (7.77 LP per litre) on kerosine, however, is regressive. It certainly should not be increased, and the long-run aim should be reduction. Butane bears no excise. Use is growing rapidly, and heavy consumer use is by middle and upper-income people. An excise on it would be revenue-productive and equitable. At a rate of 10%, it would raise about LL 600,000. Since pricing of this product is negotiated, introduction of a tax might, perhaps, be arranged without a matching increase in price.

2. Entertainment taxes: In principle, these are reasonable, and the current rates are moderate. Indeed, the rate of 2% of gross receipts on places offering consumption and also entertainment is so low as to produce an insignificant revenue. While this is a difficult tax to administer, its base is so reasonable that special administrative effort should be exercised and the rate increased to, say, 10%. The two taxes on the gross value of betting at the Beirut Race Track, and the two taxes on tickets, are reasonable in basis and rates. In 1968 they yielded LL4, 824, 340. Each of the pairs of taxes should be combined, since retention of two levies on the same base is administratively awkward. Moderate increase in rates of these taxes would yield a more than proportionate increase in revenue.

Alcoholic beverages: Domestic production of them is taxed very lightly. Raising the excise rates would be revenue-productive, and no shift to consumption of imported beverages would take place since these would also pay the increased excises.

3. Salt and Cement: An insignificant revenue from the excise on salt is tolerable because the tax is old and light. The cement excise raised a revenue of LL4. 9 million in 1968 from operations of three plants. This excise, which raises building costs by a small amount, is tolerable because it is light and easy to collect.

4. Régie : The broad objective of the Régie in pricing of tobacco products sold in Lebanon is maximization of net revenue. Since the annual fee, the Army tax, the municipal tax, and the income tax paid to the Government by the Régie amounted in 1968 to LL 42.3 millions, this objective is achieved. The whole process of manufacturing and marketing tobacco products is now firmly controlled through the Régie, and taxing is not a severable operation subject to governmental decision. The likelihood is that, in the near future, the present revenue from the Régie will shrink rather than grow.

5. Fiscal stamp duties : These are on ten main classes of "instruments" used as "a written proof to a judicial or administrative authority". The duties are fixed or ad valorem. The fixed duties are modest and probably produce little revenue; the ad valorem are at rates of 1-2 mills on instruments involving amounts of money. The duties are usually paid by fiscal stamps sold via dealers who receive a commission of 2.5% deducted in advance from the price of the stamps. Cash payment is allowable in certain cases, e.g. for stocks and debentures issued by share companies.

The major and over-riding barrier to analysis is that the present use of fiscal stamps conceals from the Government what it is doing since the uses to which the stamps have been put cannot be ascertained. While it is certain that many of the uses produce an insignificant revenue, the method of collection hides what they are.

The following suggestions are offered: (1) the Government should study the fixed duties with the intention of repealing those which serve no clear public purpose (other than raising revenue), and of reducing the remaining ones to the level of fees. (2) With respect to ad valorem duties, it should, whenever possible, extend the method of cash payment as a substitute for stamps. (3) The remaining ad valorem duties would often fall on instruments of low value from which the revenue is small and the nuisance cost is large. Serious consideration should be given to exemption of low-value instruments.

6. Customs Duties: Administration of the tariff is efficient, although determination and execution of tariff policy has faltered because of a conflict between revenue-productivity and protection. The Customs Board, unable to establish criteria for rejection or application of protection, operates too much in response to short-run pressures. The recommendation is made that, drawing upon the aid of economic technicians, it formulate policy guidelines.

The Board should examine the very large number of dutiable items with a low yield. (Each of 811 items in 1968 yielded under LL10,000). Except when the low yield is the result of highly protective duties, the Board should ordinarily place such items on the free list or merge them into related categories.

Some 45-50 items have differentiated rates, one low (1-2%) and one high (18-25%). Except when policy or equity reasons are strong, such differentiation should be avoided. Whenever it is retained, the Board should consider either lifting the low rate to 5% or placing the items on the free list. The former step would produce about LL 7-8 million in revenue.

Items which carry a straight (undifferentiated) 1% rate should be placed on the free list, or, alternatively be subject to a 5% rate.

The Municipal or Port Tax of 3.5% on imports by sea or air should be revised so as not to apply to exempt goods. Duties on other imports could be raised (perhaps by a uniform percentage) to offset the revenue loss. Consideration should be given also to merging the separate duties of the Reconstruction Tax with the regular duties.

Imported foodstuffs of wide consumption not domestically produced should either be on the free list or bear a low duty, for the sake of equity. The major duty in the tariff of Lebanon which infringes this rule is that on un-roasted coffee which, in 1968, carried an effective duty of over 50%. This duty should be lowered.

The current duties on gin, vodka, etc. are much lower than those on whiskey. They should be raised to yield an additional revenue of LL425, 000.

Imported dutiable goods - wines are a good example - pay excises whenever such excises are imposed on domestic items. If, in the future, the duties are raised on such imports, a parallel increase in the excises should usually be enacted in order to avoid import substitution.

7. General Expenditure Taxes : A brief memorandum explains the main types, with most attention to the value-added tax. In the foreseeable future Lebanon should not need such a tax.

8. Motor Vehicle Taxes : Fees for "mechanical inspection" which comprise fees for examination and driving licences, annual renewals, levies on net load capacity, and traffic dues currently raise LL 29 million. Of this, 60% is estimated to come from annual traffic dues assessed on private passenger cars and trucks according to horsepower on a scale which diminishes yearly according to the age of the vehicle (1st year LL 8 per engine horsepower, 6th year and thereafter LL 3). Of the LL29 million, LL 18 million goes to the Treasury. An excise on motor vehicle sales produces LL 5 million, bringing the total revenue from motor vehicles to LL 34 million.

The recommendation is made that, effective in three years, the base of the annual traffic dues be shifted from horsepower to value. The value base would be fairer, and would, besides, be convenient since it is now the base for the first registration fees, the excise on vehicle sales, and customs duties, and since it adjusts automatically to changes in price-level.

Studies should be made of incremental costs imposed by various types of vehicles, and possible utilization of a ton-mile tax resting on the findings.

The formalities connected with motor vehicle ownership and use are complicated and bureaucratic; every conceivable change creates new formalities. The Registration Department should be instructed to prepare a new plan aimed directly at simplification.

The generalization that highway-user taxes (the tax on benzine plus taxes on ownership and use of vehicles) are special benefit taxes has not been given serious consideration in Lebanon. Application of the generalization requires preliminary economic and engineering studies to reckon future highway needs & costs. Lebanon should make these studies so that its tax and expenditure policies with respect to highways rest on a logical basis.

Revenue Effects

I. Various structural increases (decreases) in indirect taxes are suggested in the report. These changes, which might well be made on equitable or administrative grounds and not merely with an eye to their effect on revenue, are as follows:

1. Impose an excise on butane. At a 10% rate this would currently raise LL 600, 000 a year.

2. The tax of 2% on gross receipts of places offering consumption and also entertainment should be raised - possibly to 10% - and enforcement should be tightened. An additional yield of LL 100, 000 might be secured.

3. Some loss of revenue would result from adoption of my suggestions concerning fiscal stamp duties. I cannot offer a figure.

4. If the low duty on the 45-50 items with differentiated customs rates were raised from 1% to 5%, an additional yearly revenue of LL 7-8 million would result.

5. Lowering the duty on unroasted coffee to half the present level would decrease revenue by LL 2. 1 million.

6. Increasing the duties on gin, vodka, etc. to the level of those on whiskey would yield an additional revenue of LL 425, 000.

II. If modest increases of revenue were desired beyond that provided by normal growth in tax bases, what should be provided by indirect taxes ? In my opinion, not much. Even though the indirect taxes now utilized are acceptable in principle and carry reasonable rates, direct taxes offer the major unutilized revenue potential. One possible qualification of this generalization concerns alcoholic beverages. Taxation of imports is much higher than taxation of domestic production. The intention is, of course, to encourage domestic production, and this is accomplished. A significant increase in excises on alcoholic beverages would, I believe, be justifiable as a structural change in the system of indirect taxes.

II. THE DIRECT TAXES

We adopt the budget classification in identifying "direct" taxes. They are, with the general budget revenues they produced in 1968, as follows: (in LL. thousands)

Income and Profits Tax	62.143
Built-on Property Tax	40,497
Transfer or Succession Tax	3,621
Forests Tax	124
Motor Vehicles Tax	15,668
Total	122,053

Taxes and fees on motor vehicles and motor fuel are partly direct and partly indirect. They have been considered as a group, and recommendations are made concerning them under the category of indirect taxes in this report. The very minor forest tax has not been studied, and no comments or recommendations are made.

The major recommendations with respect to direct taxes concern the Tax on Income and Profits and the Built-on Property Tax -- the latter is recommended to be integrated into the Income and Profits Tax. The Transfer and Succession Tax has been given cursory examination, and is briefly dealt with later in the report.

1. The Integrated Tax on Income and Profits

The fundamental criticism of the present taxes on income and profits arises from their schedular character. Five classes of income: wages and salaries, non-commercial (largely professional) income, commercial income, interest on movable assets, and real estate rental income (subject to the separate Built-on Property Tax), are taxed at varying rates, some of which are progressive and some proportional. In addition, there are differences with respect to the bases of the taxes. A personal exemption is allowed as a subtraction from the base of the first three - except in the case of commercial income of incorporated companies -- but not of the last two. There are also different degrees of "netness" of income in the bases; non-commercial and commercial profit incomes are net of the costs of earning them, interest on movable assets is taxed on a gross base, and the Built-on Property Tax allows deduction from gross rentals of most direct operating expenses but not depreciation or interest. The base of the corporate income tax is the total net income of the corporation, while the bases of all others relate to the incomes of individuals. Rates applied to these differentiated types of income vary considerably, and must to some uncertain extent be regarded as offsetting differences in calculation of the tax base.

The complex picture of an income tax described in the last paragraph raises serious problems with respect to equity, revenue productivity, and administration. The separate treatment of differentiated streams of income, especially under progressive rates, has resulted in wide differences in burden, (a) between individuals whose incomes are defined as being different, e.g., wages and salaries, and commercial income; and (b) between individuals with identical amounts of income, one representing a single type and another representing a combination of types.[1] It follows that wide equity variations among taxpayers permit considerable loss of potential revenue from the aggregate national income base. The un-integrate character of the tax, combined with differential severity of rates, encourages shifts of income from high to low rate categories, and the fact that a particular controller sees the declaration of only one portion of a mixed-type income reduces the probability that failure to report income will be readily detected.

a. Toward Integration of the Tax.

The important characteristic of the recommendation is its aggregation of an individual's incomes of various types into a single base. We have not gone all the way in this, however, for it has seemed impossible to enforce the integration of interest on movable assets into the tax, and the widespread use of bearer shares by corporations has prevented the inclusion of their dividends into the aggregated base.

b. Major Provisions of the Proposed New Law.

1) The taxpayer shall make a single return combining wages and salaries; net income from unincorporated enterprises, including professions, and rental income from real estate. No return is required if total income is not in excess of the personal exemption. The income of corporations is largely but not entirely subject to a separate tax, as will be seen below.

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1. See Taylor, "A 'Global' Tax on Income", Tax Policy Papers, Lebanon, 1969, #3, pp. 3-5, for fuller treatment of this matter.

Income from movable assets continues to be taxed separately as in Title III of the 1959 law, although company directors' fees should be taxed as commercial income.

a. Wages and salaries received shall be entered on the return in full, and tax withheld by employers will be credited against the amount of total tax due.

b. The profit of enterprises shall be determined as in the 1959 law, with its amendments and interpretations.

c. Dividend receipts by holders of nominative shares in corporations will be included in the global return. Amounts of tax withheld from such dividends by the corporation will be credited against the individual's total tax as calculated without withholding.

d. Rental receipts subject to taxation shall be computed as under the present Built-on Property Tax Law. The Built-on Property Tax Law shall become a part of the Income Tax Law, and rental receipts shall be classed as commercial income, subject to the rates of the new combined Income Tax Law.

e. If total withholdings from wages, salaries, and dividends exceed the computed tax on the individual's aggregate income before withholding, he shall be entitled to a refund of this excess.

2. Personal Exemption.

The Tax shall be assessed on combined net incomes of individuals after allowing personal exemption of L.L. 2000 for each real person if unmarried, L. L. 3000 if married but childless, and L. L. 4000 if married and with children.

3. Rates of Tax

a. Basic tax. That portion of combined income in the form of wages and salaries shall be subject to a basic tax rate of 4%. Non-industrial and non-commercial incomes shall be subject to a basic tax rate of 6%. Industrial and commercial incomes (including real estate rentals) shall be subject to a basic rate of 8%.

b. Surtax. In addition to the basic tax, combined net incomes in excess of L. L. 10,000 shall be subject to surtax, without differentiation as to type of income, at the following rates:

Aggregated Net Income (L. L.)	Tax and Rate
1 - 10,000	0%
10,001 - 15,000	2%
15,001 - 20,000	LL 100 plus 5% on excess over 15,000
20,001 - 25,000	350 " 8% " " 20,000
25,001 - 30,000	750 " 11% " " 25,000
30,001 - 40,000	1850 " 14% " " 30,000
40,001 - 50,000	3250 " 17% " " 40,000
50,001 - 75,000	5000 " 21% " " 50,000
75,001 - 100,000	10,250 " 24% " " 75,000
100,001 - 150,000	16,250 " 27% " " 100,000
150,001 - 200,000	29,750 " 30% " " 150,000
200,001 - 300,000	44,750 " 33% " " 200,000
300,001 - 500,000	77,750 " 36% " " 300,000
500,001 and over	149,750 " 39% " " 500,000

c. Special Provisions of Law Required by the Combined Tax:

1. Since there is a single return combining wages and salaries, non-commercial income, commercial income , and real estate rentals, there should be a single filing date for all of these types of income.

2. The employer's return on wage and salary tax withheld should be in the hands of controllers on the date for filing the combined return. This is also true of reports by corporations on directors' fees and taxes withheld from nominative shareholders.

d. Desirable General Changes in the New Law.

1. The law should require all profit receivers to report their profits on a real profit basis. The "declared" profit basis, with its net/gross coefficients should be dropped. The administration should be empowered to estimate profit when, in its judgment, this is necessary.

2. Withheld taxes on wages and salaries should be paid quarterly to the Treasury on either an actual or an estimated basis, with final reporting and payment by January 15 of the following year. A plan for shift to the new basis, and for gradual collection of delinquent withheld taxes should be prepared at the earliest possible time.

3. Complementary and supplementary assessments should be dated as of the date the return was due, and interest penalty computed to the date of payment.

4. The law should provide that delivery of an assessment notice to the last known address of the taxpayer constitutes adequate notice for a valid assessment.

5. Existing uncertainty regarding professional secrecy in Articles 20, 101, and 104 should be cleared up, and the law should provide access to the names of patients or clients of professional taxpayers.

6. Information returns should be required of all partnership, fiduciary and joint ventures, to aid in administration.

7, Article 93, regarding the processing of protests, should be amended to allow administrative denial of protests which are untimely, invalid, or not accompanied by factual support, without having to refer them to the appeals committee for action.

8. The present Article 45 should be repealed. In its place something like the following should be substituted:

> "The basis for calculation of annual depreciation allowances under Article 7 (7) of this law shall be the fair value of the asset on January 1, 1960 if acquired on or before that date, or its actual cost price if acquired subsequent to January 1, 1960."

9. The statute should make clear that, under the voluntary assessment system, the legal burden of proof is upon the taxpayer except in fraud cases, where the government must prove willfulness. That is, additional assessments are presumed to be correct unless proved otherwise.

10. This law, and the commercial code, should be more specific as to the types of records necessary to be maintained for tax purposes. It should recognize modern methods of record-keeping by machine, punch card, and computer.

11. The statute should give the Director General the power to grant immunity from prosecution to an informer who comes in with clean hands.

12. Can the bank secrecy law be modified or interpreted to give the court access to such information in fraud cases?

13. Fees paid to directors of companies should be classed as commercial income and not as Title III income. They should be fully reported by the company to the tax administration.

2. Treatment of Corporation Net Income [1]

An income tax system which applies progressive rates to a base of the total net income of corporations while applying the same progressive rates to a base of individual incomes from unincorporated enterprises usually imposes heavier taxes upon the corporate form of business organization than upon assciations of unincorporated types earning the same net income. In addition, such a tax system applies identical rates to all shareholders in the corporation, regardless of differences in the amounts of income they receive. The ideal solution to this problem of inequities is to tax the major part of the corporation's net income to its individual owners, at graduated rates appropriate to the amounts which they individually receive. This is the manner in which partnerships are taxed.

Special conditions in Lebanon, particularly the almost total reliance of corporations upon bearer shares which protect the anonymity of shareholders from the tax administration, and the unusually large proportion of corporate earnings typically retained, make it difficult to apply the ideal solution of integrating the corporate sector into the general income tax to any large extent. This is especially true when there is no tax on capital gains realized from the transfer of shares. As the industrial sector of the economy grows, it will presumably be necessary for corporations to gain access to sources of capital beyond particular family

1. See Taylor, "Taxation of Income of and from Corporations", Tax Policy Papers, 1969, #4, for full treatment of the principles involved.

fortunes. When this develops, it will be useful to have encouraged the use of nominative shares, and presumably the need for greater distribution of earnings will appear. Our recommendation with respect to the tax treatment of corporate income, while narrowly applicable under present conditions, would be both favorable to the development of these trends and equitable under the new conditions.

a. Major Provisions of the Proposed System

1. The "Corporate Tax". After exemption of the first L. L. 10, 000, this tax is imposed upon the net income of the corporation, at the rate of 10% up to L. L. 25, 000 , and at 20% on the remainder. This tax is justified by the special privileges granted to the corporate form of organization. The low starting rate is a concession to the small corporation, and is not intended to make the tax more than minimally progressive. This rate advantage disappears quite rapidly; the average rate is 6% for the corporation with L. L. 25, 000 of net income before exemption, 15. 5% when net income is L. L. 100, 000, and 19. 1% at L. L. 500, 000.

2. Tax on Retained Earnings and Tax Withholding from Distributed Earnings. After subtracting from total corporate net income the L. L. 10, 000 of exemption and the "Corporate Tax" liability, the remainder is either (a) retained earnings or (b) distributed earnings.

a. The "Retained Earnings Tax". 20% on that portion of the remainder not distributed.

b. Witholding from distributed earnings. 20% on that portion distribute

1. Distributions to bearer share holders will be subject to the 20% withholding rate, and this withholding will be final.

2. Distributions to nominative shareholders will be withheld at the 20% rate, but the shareholders will report gross dividend receipts (before withholding) on his own combined income tax return, and be allowed a credit against his combined income tax equal to the amount shown by withholding receipts as having been withheld by the corporation from his dividends.

The corporation, in addition to issuing withholding receipts to nominative shareholders, will be required to make an annual report to the tax administration, indicating:

1. Total net income earned for the year.
2. Amount of corporate tax paid.
3. Amount of the year's net income retained, and tax paid thereon.
4. Amounts of the year's net income distributed:
    a. To bearer shareholders, in total, and tax withheld.
    b. To nominative shareholders, in total; individually before withholding, by name; and tax withheld individually, by name
5. Directors' fees paid, by name; and any tax withheld from gross directors' fees paid to each individual, by name.

It is important to note that the tax withheld in any year from distributed income applies only to distributions of earnings from that tax year. If distributions are made from earnings of prior years, these will have paid the retained earnings tax at the time and will not again be subject to tax.

The rates recommended would seem to protect revenue collections from the corporate sector adequately. The benchmark selected was the average tax rates on taxpaying corporations in the 1967 assessment survey, which for foreign corporations was 32.97%, and for domestic corporations 31.13%. Average rates under the program here recommended work out as shown in the following table (assuming no credits taken). These figures will, of course, be reduced by any credits to which the individual nominative shareholders is entitled, but the amounts of income distributed to nominative shareholders is now presumed to be very small.

Corporation Net Income	Average Rate of Tax
L.L. 25,000	16.80%
50,000	24.80
100,000	29.60
200,000	33.20
300,000	34.13
500,000	34.88
1,000,000	35.44
2,000,000	35,72
5,000,000	35,89

The plan proposed falls short of ideal in several respects. The rate of corporate tax is high, but required to guarantee a hard core of revenue to the Treasury, at least during the transition. Not much progress can be made toward treating shareholders like partners so long as bearer shares are widespread and the overwhelming portion of net income is retained. But the plan makes a start in the proper direction, and it may be worthwhile to explain the reasons for some features which may be subject to criticism.

One of these features is the L.L. 10,000 exemption from all parts of the tax. This is necessary in order to guarantee the advantage to the small corporation intended by the low starting rate of corporate tax. For small income corporations, the low rate is a significant advantage if one looks only at the "Corporate Tax". But the greater such advantage, the larger the proportion of net income which enters the base of the retained earnings and the withholding taxes. With the 10% rate on the L.L. 25,000 of net income and with no exempt minimum, the average total tax rate is 28% for a corporation with net income of L.L. 25,000, as compared with 35.96% for one with net income of L.L. 1,000,000. (The computations ignore credits to nominative shareholders). The corporate tax favor to the small corporation is largely offset by the fact that a larger proportion of its before-tax net income becomes subject to the flat 20% rate on retained earnings and withholding. The proportion of before-tax income carried into the base of the second taxes is 90% for the L. L. 25, 000 corporation, and 80. 25% for the L. L. 1, 000, 000 income corporation. The L. L. 10, 000 exemption proposed has the effect of changing the average rate of total taxes on the small corporation (L. L. 25, 000) from 28% to 16. 8%, while for the L. L. 1, 000, 000 corporation the change in average is from 35. 96% to 35. 89%.

There is some temptation to apply a lower rate of withholding to dividends of nominative shareholders than the 20% proposed. It has been suggested that this might be 8%, the basic rate on commercial income under the combined income tax. This has an attraction because it withholds the proportional element of the combined tax only, fully and accurately withholding from the shareholders who would not be personally subject to surtax. But whether larger income shareholders would pay more than 8% would depend upon the ability of the administration actually to globalize the returns of individuals effectively during the transition period. The danger of significant revenue loss during the transition argues for a higher withholding rate. Indeed, when administration proves itself able to cope effectively with the intended withholding adjustments, it would be wise to reduce the "Corporate Tax" rate(s) and increase the withholding tax rate.

3. Revenue Effects of the Income Tax Proposals

The revenue consequences of the income tax changes proposed here are taken to be dependent upon (1) changes in the bases of the taxes, (2) changes in tax rates, and (3) effectiveness of administration under the new laws. The broad base of taxation -- the magnitude of the national income of the country -- is excluded from the analysis, on the grounds that the tax changes proposed are not expected to have an influence upon economic activity in the near future. On the other hand, the changes recommended are intended to make the income tax more sensitive to changes in the magnitude of the economic base.

1. Impact of base changes upon revenues

The major change is that of combining incomes from most sources into a single surtax base to which progressive rates are applied. This aggregated base will, to the extent that administration is successful, push middle and higher incomes into tax brackets significantly higher than at present. Whereas the rates at the lower end of the progressive scale for various types of income have been applied more than once for mixed incomes, they will apply only once in the future, and the effect upon revenue should be considerable.

A second change in the base of taxable income is the increase in personal exemptions. The revenue-reducing effect of this may, however, be largely offset by eliminating the multiple use of exemptions in the past when several streams of income were received. The aggregation into a single return should rather easily prevent repeated application of the exemption.

2. Rate changes

The rates proposed represent in no case an obvious reduction, and in general their increase is substantial, even though the highest marginal rate remains below 50%. The major part of rate increase has come through the surtax, where types of income formerly very much favored -- salaries and professional incomes -- will now be required to pay the same rates as commercial incomes. The largest effective rate increases occur with respect to salaries above L. L. 20, 000, and to professional incomes above L. L. 25, 000. The adoption of the proportional basic rates -- all higher than the starting rates now in effect for the various types of income -- would provide a considerable guarantee of the maintenance of revenues.

It is not a simple matter to quantify the revenue effects of rate increases, for there is very little basis upon which to judge, except in the case of corporations, the pattern of income or exemptions distribution. But one could feel quite confident that the rates proposed, barring more than a modest and temporary slackening of administrative effectiveness, should produce from 15% to 25% more revenue. Corporations and their shareholders should produce about 10% more, and being on a "real profit" basis there should be little reason to expect their reporting of net income to show decline. Rental incomes should yield somewhat more than the Built-On Property Tax has been producing, for there is no change in definition of the base while surtax rates will be substantially higher for larger properties.

3. Administration

The seriously unpredictable variable during the transition period is the quality of compliance with the proposals that can be expected. The administration will face new challenges with the globalizing requirement. This may mean that efforts directed toward installation of new procedures and new forms will mean less attention available to returns. The bringing of new and formerly evading taxpayers into the rolls will probably suffer during the transition. Quite possibly also, auditing and consequent supplementary assessments may decline as attention is turned to revised procedures. And we cannot ignore the fact that higher rates and the globalization of income will, at least during the changeover, intensify incentives to evasion, although presumably the areas where evasion is relatively easy are those where the tax has never produced much revenue. On the whole, it seems probable that revenue gains may not be greater than 10% per year during the first two years of the new taxes. After that, the rate of revenue growth should be higher, but this depends upon the intelligence and the diligence of administrative officials. However, even if these goals are attained, optimism for the longer future would be quite in order.

4. Are the proposed rates too high?

A new look at the proposed rates suggests that we may have been too ambitious for early and rapid rise in income tax revenues. The combined rate increases may well be excessive, with announcement effects conducive to evasion and even to political action, If there is agreement on this, guidelines for downward adjustment may be in order.

a. The most sensible first step should be to consider the proposed rates as including the present "add-ons" -- the Municipalities Tax and the Reconstruction Tax. If Lebanon can do without these additional rates, on income tax, the solution would be to amend the decrees establishing them to provide for earmarking and distribution of portions of the revenues which the proposed rates themselves would produce. The larger of these two "taxes" -- the Municipalities Tax -- is clearly a scheme for transfer of about 9.75% of income tax collections to the municipalities. It seems doubtful that the Reconstruction Tax actually goes into clearly identifiable projects, and therefore may not justify a special distribution. Why cannot reconstruction purposes be handled by allocation of general funds through the budget, making the present identification unncessary? If there is a genuine Reconstruction Fund, the distributions should be 9.75% of total income tax revenues to the municipalities, and 1.8% to the Reconstruction Fund. These special purposes would then find the amounts of money available to them essentially the same as under the present system.

b. If the above action is thought to leave the new tax rates excessively high, the proper course of action would be an essentially horizontal rate reduction. We have given considerably more attention in our studies to the relative positions of classes of taxpayers under the proposals than to the absolute level of the aggregate rate structure of direct taxes. If reductions are to be undertaken, therefore, it is important to leave the interpersonal relationships essentially intact. This means that any rate reductions should be as nearly horizontal as is possible without using fractions of percentage points. If such a reduction is contemplated, the recommended first step would be to lower the basic rates of income tax from the proposed 4-6 to 3-5%. The basic rates should not be lowered by more than one percentage point for each class of income. If still further relief is desired, a moderate horizontal reduction in surtax rates would be in order.

4. Succession and Gift Tax

A report for insertion here is forthcoming.

5. COMMENT ON SPECIAL LAND TAXES

We have given brief consideration to plans for three special land taxes: (1) a land increment tax, (2) a tax on land improvement resulting from public works, (3) a tax on building sites. These plans have been worked out and approved by the advisory group to the Director-General. What we offer here are comments and questions; we have not followed the course of discussions closely enough to justify the making of firm recommendations.

I. Land Increment Tax

The tax is on "realized" capital gain from the sale of land suitable for building in (a) cities, (b) suburbs, (c) an area along the coast up to a depth of four kilometers from the sea.

The base of the tax is the difference between (a) the last purchase price plus 6% interest per year on this plus certain other expenses incurred, and (b) the net selling price. If the last purchase was before 1950, the base is the value of the land in 1950.

The increment realized is divided by the number of years the land was held before sale (up to a maximum of 10). To the average yearly increment the income tax rates (basic plus surtax) on commercial profits are to be applied, and the result multiplied by the number of years.

Sales below L.L. 3000 are to be exempt.

Comment:

(1) Why not a tax on gains from sale of real property? Why narrow the base by restricting it to land? The answer offered is that the built-on

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property tax takes care of taxation of developed property, and that the aim of the proposal is to strike at unbuilt-on property. But gains from sale of built-on property will often be, in considerable part, gains from appreciation in value of the land, and these gains will not be taxed.

(2) Should capital gains which are only a fraction of total capital gains be taxed by a special tax? The answer offered is that the land increment tax is a first step toward general capital gains taxation. If so, should not the first step be a little longer?

(3) Should this tax be imposed now? The tax will raise a new and special set of administrative responsibilities. Can Lebanon meet these responsibilities concurrently with those imposed by integration of the income tax and the new tax on corporate profits? Perhaps the land increment tax should be reserved for a second stage of major reform.

(4) Should receipt of property by inheritance be regarded as realization? The proposed decree does not regard transfer by inheritance as realization, and therefore the tax can be avoided by use of this form of transfer. Moreover, the proposal sets 1950 as the base for land acquired before 1950. Property purchased before 1950 and transferred by inheritance after 1950 will have a 1950 base.

(5) Why should 6% interest be added to the last purchase price when this amount of imputed income has not been and could not be taxed as income?

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II. Tax on Land Improvement Resulting from Public Works

This is a tax at 50% on the increase in the value of land resulting from state or municipal public works. The area presumed to benefit from he improvement is to be defined by a special committee in each Mohafazah. The value-increase is to be the difference between (a) the assessed value of the land two years before the date of expropriation of land for the public project, plus 10%, and (b) its assessed value one to three years after completion of the improvement.

Comment:

1. Two types of improvements should be noted, (a), such as irrigation, where annual charges based upon benefits received can readily be assessed on users, and (b), improvements such as a new road, where the benefits are not an annual flow but a lump sum. The government can capture benefits from the second type of improvement only by a special assessment such as is provided in this draft decree. But it can, and probably should, capture benefits from the first type by annual charges. In both cases the aim should be to recover cost of the improvement, plus interest.

2. The draft decree places determination of the value-increase and of the area benefited in the hands of a special committee in each locality. A committee should have one professional assessor (from a small staff in the Ministry of Finance, from which members would serve on several local committees). Determination of the area of benefit and of the value-increase is difficult, and taxpayers should be protected against arbitrary assessments.

3. Increase in value of less than 10% are exempt. Should not the exemption be in terms of an amount of money, e.g. L.L. 3000?

4. Should a ceiling on the amount of the tax be stated? We suggest that it be the cost of the improvement plus interest, in order to protect against arbitrary assessments.

III, Tax on Building Sites

This is a 1% tax on property value, restricted to building sites and only to the difference between (a) their assessed value as agricultural, forest, or pastoral land, plus 50%, and (b) their actual value less an exemption of L.L. 200,000 "for each person".

Assessment is to be entrusted to local committees in each Mohafazah. Reassessment is to be made every five years.

Comment:

The aim seems to be to strike at large vacant urban lots or vacant near-urban land, and to provide an incentive to build on it.

1. What is land "suitable for building"? Does the plan contemplate that a parking lot is a suitable "building" use? If so, this seems to be a mistake.

2. Is not a tax at a rate of 1% yearly too low to be effective, especially when reassessment is to be made at five-year intervals and when a deduction of L.L. 200,000 is provided for each person? A piece of land owned by five persons, which has an imputed agricultural value of L.L. 50,000, would not be subject to tax until it had risen in value for real estate development to L.L. 1,075,000 -- 50,000 + .50(50,000) +

5(200,000) -- and would then be taxed at only 1%. Is the tax incentive strong enough to force construction on it rather than to hold it for future gain?

3. Should assessment be entrusted to local committees? This job is a professional one which should, moreover, be handled uniformly over the country. This might be achieved by placing a professional assessor as a member of each local committee. Each should serve on several committees.

III. STATISTICAL REQUIREMENTS

A major impediment to clear and relevant analysis of tax policy and administration in Lebanon is the paucity of factual information about institutions in the economy and the impact of the tax system upon the various economic sectors. The recent investment in the computer center provides resources for provision on a current basis of critical statistical time series. The pilot survey of assessment in 1967 (on 1966 incomes) was intended both to provide much information on current operations which was previously available only by personal estimate, however enlightened, and to begin a continuing collection of time series. This sort of information needs to be provided annually as soon as possible after completion of the year's assessment and collection activity. After a number of years, the annual data will permit the observation of trends, which will reflect gradual changes in the structure of the economy and, probably more important, provide guidance for the tax administration in allocation of its resources to realize optimally the results intended in the tax laws.

As a minimum, the following tables should be prepared annually:

1. <u>Assessment</u>

a. Income Tax assessments, by category of taxpayer. (All of Lebanon). The categories should be (at least), domestic corporations, foreign corporations, individuals (including partners), and non-residents. For each category, the following should be shown:

- number of taxpayers, current taxes assessed, penalties, percentage rate of tax, and average assessment per taxpayer. Percentages should be calculated for each column.

b. Income Tax assessed, by administrative division of the country. For each division, number of taxpayers , taxes assessed, penalties assessed , and total assessments and penalties. Percentages should be calculated for each column.

c. Income Tax assessments, by type of assessment. (All of Lebanon) The types are real profit, declared profit, and estimated profit. For each category should be shown the number of taxpayers, taxes assessed, penalties assessed, total, and average tax per taxpayer. Percentages and totals should be calculated for all columns.

d. Income tax assessments by type of register and type of taxpayer. (All of Lebanon). The types of register are basic, supplementary & complementary, penalties assessed, deductions from assessments, and deductions from penalties. The columns are domestic corporations, foreign corporations, individuals, non-residents, and total. For each column, statistics should be shown for number of returns and for amounts assessed.

e. Assessment by standard industrial classification categories of business activity, detailed to the third digit. (See Table 7, 1967 Survey).

The columns should show, at least, the number of taxpayers in each category, amount of assessment, and ratio of tax to income. The numbers in each column should distinguish assessments and returns for the income year in question, and assessments for prior years.

f. Taxes withheld on salaries and wages.

The categories in column 1 are domestic corporations, foreign corporations, individuals, associations and trade unions, independent government agencies, and administrative departments of government. These should be further classified, minimally, for Beirut and for the other provinces in the aggregate. The columns should be, number of responding withholding units, number of employees withheld, net amount of salary paid to them, taxable salary, net tax liability, net penalties, and total of net tax liability and net penalties.

g. Since there are special compliance problems with the professions, an annual table should be prepared, including as categories the major liberal professions. Columns should show the number of

- taxpayer units as shown by current records of the professional associations, number of assessees for the assessment year, amounts of assessment, penalties assessed, sum of the last two columns, and ratio of tax to income declared.

2. Collections

Something should be done to prepare time series on <u>collections</u> as opposed to assessments. It is difficult to determine without serious study how far parallel tables for assessment and collection can be prepared. But at least it is very necessary to know by large categories - domestic corporations, foreign corporations, individuals, and non-residents - and by governmental districts, how collections compare with assessments.

The above represent basic time series capable of various uses, which would greatly reduce the guesswork in both policy and administration. And it cannot be too strongly urged that continuity of figures is equally important with their currency. When the basic set of tables is determined, their preparation should be a routine annual assignment to the computer center and the repositories of the raw data. The capacity of the computer center greatly exceeds the above suggested requirements, and special studies can be accommodated as well.

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administer and collect. Ownership and operation of motor vehicles can be determined and taxed as possession of many types of income cannot. What is urged here is that the overall situation be reviewed so that taxation of a particular class of people - highway-users - to secure revenue for collective purposes not be overdone; that general taxation to finance expenditure for collective purposes not be neglected; that administrative considerations concerning ease of enforcement do not over-influence tax discussions.

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