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No Country for Poor Men: How Lebanon's Debt Has Exacerbated Inequality

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Recent estimates of wealth and income inequality in Lebanon have been on par with some of the world's most unequal economies. After the country's civil war ended in 1990, Lebanon embarked on a borrowing spree that rapidly expanded the public debt. This debt has exacerbated widening socioeconomic inequalities, creating a situation that now threatens the country's stability.

Until recently, a common misperception has been that Lebanon's socioeconomic landscape is relatively equal. But data suggest otherwise. Based on income tax figures, the richest 1 percent of Lebanon's population claimed 25 percent of the total national income between 2005 and 2014. Bank deposits reflected this unequal distribution. Data from 2017 showed that 20 percent of all deposits were concentrated in 1,600 accounts—only 0.1 percent of all deposit accounts.

How did the public borrowing of the 1990s affect the distribution of income in Lebanon and exacerbate socioeconomic inequality? The terms of lending imposed a high debt-servicing burden on the state, leaving it with relatively little money to spend on more equitable redistributive efforts. Three factors after the civil war had a seriously regressive effect on income distribution: First, between the end of the civil war and the mid-2000s, the public debt increased by 2,120 percent, while per capita GDP grew almost fourfold. Second, postwar public borrowing initially drew almost exclusively on the domestic market in the form of government bonds issued in Lebanese pounds. And third, an alarmingly high interest rate on the debt was denominated in pounds.

While none of these factors individually skewed income distribution, their combined effects resulted in sustained profits to one economic sector: commercial banking. A rapid accumulation of ever-growing rents in the hands of just a few banks meant that little to none of that wealth trickled down to other sectors. The public borrowing of the 1990s and early 2000s was, in large part, a plan with known adverse redistributive consequences. But little has changed today, even as Lebanon tries to tackle its debt problem.

HOW THE PUBLIC DEBT CONTRIBUTED TO INEQUALITY

Lebanon's public debt alone does not indicate that wealth is distributed unequally. Even the ratio of debt to GDP (currently estimated at 150 percent) is not a sufficient cause for alarm. After all, Japan's debt was 234 percent of its GDP in 2017, but the country is neither on the brink of a debt crisis nor is it characterized by acute socioeconomic inequality when compared to other industrialized countries.

Two aspects specific to Lebanon's growing public debt have perniciously affected equality. First, the terms of borrowing were highly unfavorable for the treasury. The Lebanese government entered a spiral of deeper indebtedness in order to meet its debt-servicing obligations. Second, public borrowing relied on a narrow domestic lending base.

Today, government bonds yielding the highest interest rates worldwide barely match the rates Lebanese bonds offered during the 1990s. In Turkey and Argentina, government bonds promised over 20 percent annual return in 2018. However, the market interest rates on individual savings accounts in both countries remain higher than yields on government bonds. This gap between the interest that banks pay depositors and the returns from holding government debt has major implications for an economy's credit market. Banks cannot idly make profits by lending the government money that has been gathered from individual deposits, because the yield from government bonds is lower than the interest owed on private savings accounts. Instead, to attract deposits and still make a profit, banks have to identify opportunities to lend at rates higher than what the banks pay on deposits. In a market where the returns on savings accounts surpass the interest on government bonds, the presence of the government as a potential borrower does not crowd out private borrowers.

In Lebanon during the 1990s, government bonds traded at a substantial discount, with yields reaching upward of 36 percent on several occasions. They also delivered a yield much higher than the interest rates banks were offering on time deposit accounts—on average around 6.6 percentage points lower in the first half of the decade. Banks were presented with an advantageous interest rate spread. High-interest government bonds gave banks a return that largely surpassed the banks' relatively modest obligations to depositors on savings accounts. As a result, banks no longer had to put in the financial and risk-management legwork to identify business opportunities with high returns in the private sector. Not surprisingly, the private credit market was largely sidelined.

The consequences appear clearly in the banking sector's statistics and financial statements. The banks' holdings of government bonds as a share of total banking sector assets increased steadily during the 1990s. Furthermore, the larger the spread between interest rates on government bonds owed to banks and interest rates on savings accounts owed to depositors, the larger the banking sector's total asset holdings and the more prominent the government bonds in the banks' balance sheets. Total assets in the sector's consolidated balance sheet grew at a compound rate of 25 percent between 1993 and 2000 and approximately eightfold over the two decades since 1993. In the years between 1993 and 2000, pound-denominated government bonds also constituted an average of 27 percent of this growing banking asset base. Loans in pounds to the commercial sector, however, made up a risible 5.4 percent of total banking assets.

This profit scheme was not, in principle, confined to commercial banks. Anyone with money to spare could have benefited from the higher returns on government bonds when compared to bank deposits. However, in the postwar economic landscape, the base of available savings was modest and shallow. After years of uncertainty, individual reserves were depleted and resources spread thin. The size of an average deposit was relatively small, and the typical depositor's liquidity needs were better met with relatively flexible savings accounts in banks than with longer-term financial assets, such as government bonds. Banks, therefore, benefited from consolidating funds from small and liquid deposits and using them to buy less-liquid government debt instruments. That's why, during the 1990s, banks came to hold two-thirds of the public debt, with the remaining third in the hands of Lebanon's central bank and other public institutions.

Today, the banking sector's head start shows in its performance. BLOM Bank netted $731 million in 2017, close to the profits claimed in 2016 by Schroders, the sixth-highest-earning bank in the UK. Bank Audi recorded a net profit of $559 million in 2017, which put it ahead of Standard Chartered, the seventh-most-profitable bank in the UK. Only twenty years earlier, the entire Lebanese banking sector's profits were $436 million.

The banks' skyrocketing profits were not paralleled in other economic sectors. Growth in the banking sector was more akin to a windfall of rents, rather than the result of financial risk taking, indispensable intermediation, or acuity in identifying investment opportunities that might have lifted other sectors. The total profit of the top fourteen banks in Lebanon has hovered around 4.5 percent of GDP since 2015. In 2016, the profits of the top fourteen banks represented less than 1 percent of GDP in the UK; 0.2 percent in Germany; and 0.9 percent in the United States.

Therefore, the market for government bonds afforded a rapidly expanding opportunity for indolent returns that banks alone were primed to seize. These sustained profits to one economic sector tell a story of rising inequality through a rapid accumulation of rents in the hands of a few banks. But this account of the distributional consequences remains incomplete. Lenders are not the only agents in this game. In principle, Lebanon's government, as a borrower, could have used the funds it raised to benefit poorer socioeconomic classes. Therefore, to comprehensively consider the redistributive effects of the public debt, one has to also scrutinize the borrower.

A VERY LIMITED LEEWAY FOR PROGRESSIVE SPENDING

One way the government can use the public debt to help reduce inequality is by spending the money it borrows in a way that favors equitable redistribution. Examining government expenditures offers a clearer picture of the public debt's redistributive consequences. In Lebanon's case, this breakdown shows there was little room for progressive spending, as the terms of borrowing determined a substantial part of government expenditures, too.

Government outlays take on several forms. One is debt-servicing payments that flow from the treasury back to lenders. This particular form of spending has been regressive in Lebanon's case, with the banking sector having benefited the most. But debt servicing is only a part of government expenditures; other outlays have their own distributional impact.

What was the fate of the remaining outlays after Lebanon's debt-servicing obligations were met? The short answer is that it did not matter. Interest rates on government bonds were so high that, once debt servicing was factored in, the government was left with relatively little money to spend anywhere else. The terms of borrowing in the early 1990s meant that interest payments on pound-denominated debt constituted, on average, 45 percent of total government spending, leaving just over half of total government expenditures to finance all other public spending needs. When scaled to government receipts, by 1996, interest payments represented close to 68 percent of the budget deficit. In other words, two-thirds of any new debt was being issued only to finance interest payments owed on existing debt.

As early as 1998, annual spending on the servicing of the debt in Lebanese pounds surpassed the government's budget deficit. Five years into Lebanon's public borrowing binge, the new debt the government was incurring annually was no longer sufficient to cover interest payment obligations on outstanding debt in pounds. This meant that part of debt servicing now had to be financed through other government receipts, namely tax revenues. And while the lending base to the Lebanese government was narrow, the tax base, in contrast, excluded no one. If it was not bad enough that interest payments on the debt were accruing to a small group of economic actors, now all Lebanese had to foot the bill.

The redistributive implications of this situation were, and remain, dire. Not only is the tax base in Lebanon unjustly broad, its various constituents bear the burden inequitably. The Lebanese taxation system relies heavily on indirect taxes—mostly consumption taxes—levied on goods and services rather than on personal incomes, capital gains, or wealth. Consumption taxes are arguably easier to administer than personal income taxes. They typically take the form of a flat tax that applies at sale, across the board, regardless of the volume of sales or the characteristics of the consumer. When goods and services, rather than, say, earnings or assets, are taxed, the amount of tax paid per unit sold is the same for all buyers, rich or poor, making the tax regressive. And when tax revenues from the value-added tax (VAT), import duties, and the tax on telecoms are added up, they represent close to 60 percent of Lebanon's total tax revenues.

What this means is that at least $3 of every $5 in taxes are collected regressively in Lebanon and used to finance the $9 that go straight to commercial banks out of every $20 spent by the government. While that still leaves the redistributive effects of remaining tax revenue and government spending unaccounted for, these crude metrics already tell us a great deal. It does not matter how progressive the levy is for the remaining 40 percent of tax revenues, or how systematically pro-poor the 55 percent of government outlays left after debt servicing are, the available margin of maneuver after debt servicing remains too narrow and implies that the battle against inequality is lost from the start.

AN ALTERNATIVE APPROACH WAS POSSIBLE

Irrespective of how the reconstruction money was ultimately spent, was there another way that the government could have raised the funds for postwar reconstruction and rehabilitation? In principle, the discount on government bonds accounts for the risk involved in lending to the public sector. Therefore, some may argue, the exorbitant interest rates Lebanese government bonds were offering during the 1990s reflected the underlying risk of default.

In reality, there were several indications that the terms of borrowing, which were overwhelmingly favorable to lenders, did not fairly reflect market fundamentals. Interest rate spreads were unreasonably high early in the public borrowing period. But, a few years later, the same banks were lending money at much lower rates, with much narrower spreads to a government that had become far less solvent.

Further indication that the spread was unjustifiably wide came in 1998, when Lebanon was pushed to the brink of a fiscal crisis because of its debt-servicing requirements. Once it became clear to banks that the government risked defaulting on its debt, the solution was for the state to borrow internationally. And so the government began issuing bonds in foreign currencies that were traded on the international market. Somehow, the market's assessment of the risk of lending to the Lebanese government put the interest rate on this debt at 8 percent. Thus, the international market loaned Lebanon money at a rate far lower than what was paid to domestic lenders, at a time when the country was more burdened by debt than it had been for years.

Lebanon's tax regime has chronically failed to redress income disparities. But when the country finds itself in fiscal straits so dire that it has to resort to revenues from regressive taxes to meet its even more regressive debt-servicing obligations, the imperative of tax reform becomes obvious. Yet the only changes to the tax code in the years of ballooning debt were the introduction of a VAT and an actual reduction of the more progressive tax rates on corporate profits. Another measure, taken more recently, was an across-the-board rise in VAT from 10 percent to 11 percent—a move that disproportionately saddled the poor.

The government could have mitigated some of the regressive effects of each fiscal development, but it didn't. Comprehensive tax reform is needed to reduce reliance on consumption taxes, while using such taxes should be more selectively applied to luxury goods and goods harmful to one's health—so-called sin taxes. Instead, since the mid-1990s, the Lebanese government has made piecemeal adjustments that have produced instant revenue, while also forcing the middle and lower classes to tighten their belts. The policy choices that prevailed in the decade after the civil war disregarded the underlying regressive redistribution they precipitated and effectively represented a concerted effort to take from the poor and give to the rich.

CONCLUSION

In spring 2019, the Lebanese cabinet met twenty times before it could agree on a budget for the year. The main challenge for the Ministry of Finance was to reduce the budget deficit in order to meet the austerity targets imposed by the international donor community at an April 2018 conference held in Paris. However, the government has been unable to change is its debt-servicing obligations. Today, this legacy from previous borrowing decisions remains an enormous budgetary obstacle to work around.

Instead, the acrobatics in the 2019 budget involved changes to government revenues and spending other than interest payments. Again, the proposals were far detached from the distributional impact they might have had. On the revenue side, as in the past, the government relied primarily on indirect taxes, such as customs duties and government fees. On the spending side, the proposed cuts seemed to come mostly from the budget allotted for salaries and compensation for public sector employees, once thought to be the backbone of the middle class.

The budget negotiations even paid lip service to a proposal that the banking sector should extend low- or no-interest loans to the government. Not surprisingly, the idea was summarily shot down by banking executives and the Central Bank, some of whom argued that extending such a lifeline to the government would reduce incentives for more radical and painful reform measures. The power imbalance favoring a sector that now represents almost 5 percent of GDP is self-perpetuating: the banks are invested in further entrenching their power and are more able to do so with the enormous resources they have amassed.

Yet, such a restructuring of the debt would have helped the government meet its deficit-to-GDP target through less draconian measures than austerity, while correcting a legacy that has bled Lebanon's tax base for the benefit of a handful of banks. And regardless of what the residual incentives are for reform—and whether the government is willing or capable of embarking on such a path—the debt swap might have spared further increases in inequality. Instead, the ruling class has, yet again, decided to work itself out of a financial impasse by taking regressive measures. By so doing, instead of containing widespread discontent, it has only accelerated the ticker on a time bomb.

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