Infrastructure investments essential, overdue

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Lebanon Needs to Unlock More Growth

Economic growth in Lebanon has long been associated with growth in real estate, construction and tourism. In the period 2007 – 2010, the country's real GDP growth hovered in the range of 8% to 10% mainly on account of large local and foreign investments in real estate and construction as well as a high tourism activity. Tourist arrivals made yearly double-digit leaps and peaked at more than 2 million tourists in 2010, unemployment gradually declined from 9.2% in 2007 to 6.2% in 2010 and the construction area authorized by permits doubled from 8.4 million sqm in 2007 to 16.03 million sqm in 2008.

The tides have shifted and Lebanon's main economic drivers have suffered from 2011 to date. Lebanon is surrounded with countries where revolts have erupted in domino-fashion as of 2011 and has since then been particularly impacted by the Syrian war. At the time of writing, the Syrian war continues to generate spillovers on the Lebanese scene, the most important of which is the influx of 1.5 million Syrian refugees. A stock of unsold units has piled up in the real estate sector on account of dry demand, and the composition of tourists drifted away from heavy spenders to tourists with limited purchasing power. Accordingly, growth has dropped to an anemic 1% in 2016, the IMF said.

In order to boost growth, investments in the economy must generate added value. For example, some might argue that investments in real estate are appealing in the sense that the value of land in Lebanon is more likely than not to assume an upward trajectory given scarcity of land. However, buying a land and "sitting on it" is neither an output generating activity nor a job creating activity. According to Mr. Marwan Mikhael, Head of Research at Blominvest Bank, "we cannot expect to see growth rates of 8% again without investing in value generating activities such as infrastructure investments that will increase potential output".

Although they hold enormous potential for value creation and for social welfare, a negligible fraction of the government's expenditures are dedicated to infrastructure investments. Lebanon has chronically been suffering from a lack of fiscal space with the fiscal deficit reaching $4.94 billion in 2016 and the gross public debt reaching a staggering $74.89 billion. According to data from the Ministry of Finance, in the years 2008 to 2016, capital expenditures made up an average of only 4% of total expenditures. This low percentage cements the idea that infrastructure investments have been marginalized, while personnel cost, debt service, purchase of materials and supplies along with other various transfers (most of which are transfers to the loss-making state-owned electricity company EDL) took up around 80% of total expenditures in 2016.

Absent a clear vision for the future, infrastructure investments are likely to remain stifled. Lebanon spent the past decade without a budget making it impossible to lay out future economic plans and establish key performance indicators. However, a clear vision in this respect is crucial to incite confidence from foreign and local investors as it allows them to draw a somewhat clear roadmap of their risk and return structure. During the period 2008-2016, an average 20% of capital expenditures was simply dedicated to maintenance: while the Acquisitions of Land and Buildings for the Construction of Roads, Ports, Airports, and Water Networks was the smallest account and represented only 0.07% of total expenditures and 1.45% of total capital expenditures in 2013 and has been nil from 2014 till 2016.

Private Public Partnerships

Even a country like Lebanon, with one of the highest debt to GDP ratios in the world, can engage in infrastructure investments. Soft loans and grants are one financing option while Public Private Partnerships (PPP) is another. Lebanon has explored both financing options with 17 PPP projects from 1958 till 2013 and billions of dollars in soft loans and grants. We hope that future PPP projects will improve both the quality and the quantity of infrastructure and act as a stimulant to investment and growth.

PPP projects allow the government to share risks and to scan through several propositions that would meet its output specifications. In PPP projects, the private and public sectors both bare and share certain risks; the private sector is responsible for risks related to on-time, on-budget completion, while the public sector is responsible for changes in regulation, politics or the tax system. Unlike standard procurement where the government specifies inputs, in PPP projects the government specifies outputs subject to key performance indicators. The design through which these output specifications are met is at the discretion of the private sector. This allows the government to choose the winning bidder not only based on the price factor but also based on a pool of factors such as design and environmental impact.

The risk- adjusted cost to government in traditional public procurement is higher than the cost in PPPs. In traditional government procurement, the initial capital outlay lies on the back of the government, not to mention the capital expenditures (Capex) overrun which is normally around 20% and the operating expenditures (Opex) overrun which stands at 35%. Meanwhile, in PPP there are no capital outlays out of the government's pocket, no Capex or Opex overruns, which is an important advantage for a country with lack of fiscal space.

The realm of PPP in Lebanon holds some growth-boosting characteristics. The first is that financing of the project falls on the private sector against a stream of long-term revenues, an ideal setting for a country with a large public deficit. The second is that the PPP project has to involve actual construction and building as opposed to just providing working capital; and the third is that the private sector is responsible for the operation and management of the project. This last characteristic offers the private sector every incentive to ensure the success of the venture since it will suffer losses from, and be held accountable for, any mishaps throughout the operation and management phase.

PPP projects can offer Lebanon job opportunities that it desperately needs. According to the secretary general of the Higher Council of Privatization and PPP (HCP), Mr. Ziad Hayek, "a PPP program worth $6.22 billion is expected to create 215,000 jobs, among which 89,000 jobs for university graduates". Job creation is much-needed in Lebanon with a recent World Bank report highlighting that 53% of the working age population is inactive in the North, a region particularly suffering from a lack of infrastructure investments especially in the electricity sector.

Lebanon's PPP history inspired a new PPP law, which was finally passed by Parliament after a decade of delay. The law prepared by the HCP was envisioned to ensure more transparency in the entire PPP process, to involve all stakeholders and to lay out clear procedures that would allow for any glitches to be tackled on-the-go rather than in the advanced stages of the project.

Inclusive decision making and efficiency are tackled in the design of the new PPP law. Decision making is inclusive since a committee including a representative from the concerned minister and of the minister of Finance, and chaired by the secretary general of the HCP is formed. Moreover, prior to the selection of the winning bidder, draft tender documents which include draft contracts are prepared and constitute the basis for consultations with the prequalified bidders. This is an important step whereby bidders have leeway to see a concrete draft of the contract and have enough time to express objections or request amendments prior to the contract award.

The new PPP law has also taken into consideration the burdensome bureaucracies involved in the creation of new companies in Lebanon. According to the World Bank's Doing Business Index 2017, Lebanon ranked 139th out of 190 countries on the "starting a business" indicator. However, under the new PPP law, the winning bidder, who must establish a Lebanese Joint Stock Company, benefits from several exemptions; the new special purpose vehicle is exempt from, among other exemptions, a minimum of third Lebanese shareholding, and from providing a work permit for its Chairman and/or CEO.

Investing in infrastructure can reap tremendous rewards for economic growth but also for economic development. The potential held in infrastructure investments has long been known and recognized but it has been muted by political turmoil, bureaucracy and lack of efficiency. The new PPP law can be a turning point for infrastructure investments in Lebanon with the HCP already having a few PPP pre-feasibility studies in the pipeline.

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