LEBANON ECONOMIC VISION

ASSESSMENT

INTRODUCTION

On October 20, 2017, the Council of Ministers approved the launching of a study aimed at setting a National Economic Plan (NEP). On January 20, 2018, the cabinet tasked global consulting firm McKinsey & Company with the NEP.

On July 4, 2018, McKinsey & Company presented Lebanon with a report on the ideal economic model it should follow, entitled “Lebanon Economic Vision, and ways to achieve it”.

INTRODUCTION

The Vision is a five-year plan aimed to boost the country's stagnant economy and create jobs through diversification and modernization of potentially competitive productive sectors. The vision looks at key productive sectors: natural resources, agriculture, industry, tourism, knowledge economy, financial services, education, healthcare, real estate, construction, retail, trade, logistics, transport, communications, electricity and water, and the role of expatriates.

The Vision also proposes "quick wins" to ease the economic slowdown, which include setting up a construction zone for prefabricated housing that can be used in the rebuilding of Syria and Iraq, boosting tourism, and opening new markets for a few Lebanese crops. The vision aims to increase real GDP growth to 6 percent yearly within three years of reforms being implemented, halve the unemployment rate in five to seven years, and raise the contribution of the productive sector from 14 percent of GDP to 25 percent by 2025.

"Lebanon Economic Vision", Full Report.

OBJECTIVE

In this context, Friedrich Ebert Stiftung (FES) aimed to conduct an overall review and assessment of the *Lebanon Economic Vision*, from the perspective of the principles of Social Democracy, in view of providing Lebanese stakeholders with an analysis that empowers their lobbying and advocacy efforts.

METHODOLOGY

The first step comprised the review of existing literature produced by FES relating to the underpinnings of a socio-democratic approach that embodies the core ideas and values of FES.

The second step encompassed the review and summary of the Vision.

The third step consisted of the assessment of the Vision. The team underlined preliminary discrepancies in the Vision vis-a-vis FES socio-democratic values and core ideas, identified controversial or missing elements, and proposed alternatives whenever relevant.

In the following sections, fragments in green (left of the slide) refer to key elements from the Vision, while fragments in a blue frame refer to the assessment of the study team.

LEBANON’S ECONOMIC ASPIRATIONS

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In order to guide the development of the vision, McKinsey selected a number of benchmarking countries: Ireland, Honk Kong, Georgia, Switzerland, and Singapore. These countries were selected based on the following criteria: small territory with large neighbors, limited population, limited natural resources, large diaspora (some countries)

The benchmarking criteria are too vague and wide. Most small territories have ipso facto large neighbors, a limited population and limited natural resources. Moreover, although the report states that only some of the benchmark countries have large diaspora, actuality only Ireland has a significant diaspora although it goes back to the 1800s.

Alternative criteria: GDP per capita, GDP components, similar endowments (territorial, human, economic). Guided by the concern of similar capacities leading to success in other cases.

LEBANON'S ECONOMIC ASPIRATIONS

Lebanon grapples with 3 major challenges:

- A highly volatile economy
- Limited government ability to ignite growth
- A non-conducive business environment

These identified challenges are but symptoms of the real structural challenges with which Lebanon grapples, namely:

- The regional geopolitical instability that has been directly and indirectly impacting the Lebanese economy throughout its recent history
- The sectarian consociational political system which stifles democratic accountability, undermined state institutions, and fostered rent-seeking, cronyism, and corruption at the expense of the welfare of the citizenry

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- The intertwined interests of the political and business elites, which capture the largest share of the economic surplus, were in opposition to the presence of a strong state with a clear economic vision and regulatory role that serve the public interest
- The unbridled neoliberal economic model that hinges on exaggerated consumerism (mainly from imports) as a determinant of growth leading to excessive public and private indebtedness. The resulting soaring public debt limits the capacity of the government to invest and ignite growth and limits the financial resources available for investment by the private sector (crowding out factor);

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The fact that the report identifies challenges that are in reality symptoms of deeper structural dysfunctions in Lebanon's economy, led the authors to propose unrealistic solutions in unrealistic timeframes that will not bear fruit unless the underlying dysfunctions are addressed.

LEBANON'S ECONOMIC ASPIRATIONS

Lebanon needs to build its economy around consistent principles:

- Focus the government resources and efforts on priority areas
- Improve the business environment by reducing cost of doing business, addressing corruption in the public sector and improving overall business environment
- Diversify the Lebanese economy sectorally and by source of geographic inflows thereby reducing the volatility caused by exogenous factors
- Develop high value-added future-proofed productive sectors, relieving the distress that has been caused by a large current account deficit
- Ensure a healthy public sector through fiscal discipline including improved collection and rational spending, thereby controlling public debt

Based on the Social Democratic platform, three principles must have equal considerations in economic policy: Growth, social justice, and sustainability. However, the principles charted in the Vision document focus almost exclusively on growth and overlooks social justice and sustainability.

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Regarding social justice, social democratic principles state that "*economic growth (…) is a necessary condition from a social democratic standpoint, but not an end in itself, and it must take social equality and justice into consideration. The proceeds of a dynamic and productive economy have to be distributed fairly*"* . This is not only a matter of principle but makes sense from an economic point of view. Growth requires a minimum level of social equality and "people who benefit from social protection are more willing to deal with change, take risks and innovate"** .

*Simon Vaut et al., *Economics and Social Democracy*, Social Democracy Reader 2, Division for International Cooperation, Friedrich Ebert Stiftung, Berlin, 2011
**Rodrik, Dani (1997), *Has Globalization Gone Too Far?*,Washington, DC., in Vaut et al.

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The third pillar of a sound economic policy from a social democratic perspective is sustainability which encompasses an environmental, an economic and a social dimension. Environmental sustainability ensures that natural resources are conserved for future generations. Economic sustainability prevents endangering and destabilizing the economy through the short term pursuit of profit. Social sustainability guarantees the participation of all members of society and resolves existing social tensions generated by social inequality* .

*Simon Vaut et al., *Economics and Social Democracy*, Social Democracy Reader 2, Division for International Cooperation, Friedrich Ebert Stiftung, Berlin, 2011

LEBANON'S ECONOMIC ASPIRATIONS

Mid-to-long term horizon Vision 2025: A re-ignited productive economy supported by overhauled business environment:

- ❖ Fixed hygiene factors of economic competitiveness
- ❖ Fiscally disciplined and accountable government
- ❖ Jumpstarted target productive engines
- ❖ Demonstrated showcases of success

This vision is quintessentially neoliberal as it views the sole responsibility of the state as ensuring the best environment for business and investment to the detriment of more important state responsibilities in regulating the market and ensuring social protection*. In fact, this vision fails to mention the welfare of citizens as the overarching goal of the "re-ignited" productive economy.

The SD platform emphasizes the importance of the welfare provision role of the government. "Welfare state denotes a democratic state that, in accordance with its constitution, not only guarantees basic rights and personal and economic freedoms (state under the rule of law), but also takes legal, financial and material measures to equalize social differences and tensions.**"

* David Harvey, *A Brief History of Neoliberalism*, Oxford University Press, 2007
** Alexander Petring et al., Welfare State and Democracy, Social Democracy Reader 3, Friedrich Evert Stiftung, Division for International Cooperation, Berlin, 2012

LEBANON'S ECONOMIC ASPIRATIONS

Three main criteria were adopted to select the priority productive sectors:

- ❖ Lebanon's comparative advantages in terms of endowments and competitiveness
- ❖ The size of regional and global opportunities in terms of size and diversification of inflows
- ❖ Lebanon's macro aspirations: economic aspirations (GDP growth and job creation), fiscal and monetary stability (limited deficit, reduced national debt), and social impact (regional balance and wealth distribution)

Little evidence is provided to support the purported comparative advantages. Indeed, Lebanon is deemed uncompetitive in the situational analysis of most of the selected sectors.

Moreover, the selection approach includes indicators (GDP growth and job creation) that are not supported by convincing evidence. They rely on basic linear regressions using the benchmarked countries. Indeed, the estimated number of newly created jobs in the Vision is twice the number created during the 2004-2009 period knowing that the years 2007-2009 registered the highest historical economic growth rates.

SECTORAL ENGINES FOR LEBANON'S ECONOMIC GROWTH

AGRICULTURE

Diagnosis

- ❖ Dominance of low-value crops, including tobacco which is cultivated at a loss, and of small average holding sizes
- ❖ Low productivity for many crops (e.g. olives), due to outdated techniques and low investment in technology
- ❖ Inefficient local markets in which farmers are vulnerable to unfair practices (e.g. by markets & distributors), partly due to weak cooperative systems
- ❖ Poor access to global markets such as the EU, largely due to non-compliance with international standards (e.g. SPS for potatoes) & weak post-harvest infrastructure
- ❖ Illegal cultivation of cannabis

The diagnosis captures the key bottlenecks that hamper the growth of this sector. However, it lacks three major obstacles, namely: the saturation of regional and global markets, Lebanon's inability to reach the production volume required to become cost competitive, and the oligopolistic nature of the agricultural input market.

AGRICULTURE

Recommendations

A. Promote and support the application of modern methods and technologies to improve yield and quality of agricultural produce (finance R&D and facilitate financing of technology installations)
B. Improve local (and regional) food markets, with a focus on transparency and efficiency (digital solutions to improve transparency, capacity building for cooperatives)
C. Support transition towards higher-value crops and livestock (value chain analysis across all products, opt-in subsidy program for tobacco farmers, support R&D)
D. Facilitate access to international markets (compliance with international standards, expansion of post-harvest infrastructure, identification of high-potential markets and adaptation of cultivation practices)
E. Explore legalization of cannabis cultivation

The assertion that Lebanon has the largest arable lands in the Middle East seems doubtful unless the vision is counting wooded areas within this definition.

In the current globalized markets, this comparative advantage (short distances) becomes largely irrelevant. Rather, low production costs (and high market volume constitute the real comparative advantage (for instance, bananas from Ecuador).

Indeed, the selection of agriculture as a priority sector that may act as a lever for the Lebanese economy does not seem highly defendable, as displayed in the Vision (slides 53 or 668 of the Vision).

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A more reasonable course would be to support the cultivation of crops that constitute inputs for competitive agro-food and medicinal industry sub-sectors.

Although the recommendations are sound, they cannot be universally applied to all currently cultivated crops whether viable or non-viable. Rather, a prioritization exercise is needed prior to investing in the reform of this sector.

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From an environmental sustainability perspective, care should be taken to prevent forest or wild areas from being destroyed for agricultural exploitation. Use of resources such as water should be taken into account while selecting priority crops. Moreover, the vision recommends expanding the livestock sector which has known negative environmental impacts.

Finally, in line with the social justice principle, the recommendations should tackle the issue of high employment informality (around 90%) and the high incidence child labour in this sector.

INDUSTRY

Diagnosis

- Low competitiveness: High costs of factors of production; High cost of private electricity generation; rising land and labor costs; unfavorable business environment; and ineffective transportation network
- Low quality: Shortage of skilled technical labor; limited application of international standards;
- External market shocks: Reduced regional demand for key products; and constraints on land transportation due to the Syrian conflict

The diagnosis of the industrial sector is relevant and valid. One additional factor may be added, namely the predominance of micro and small enterprises characterized by simple processes, informality of labor, and a low presence of business-to-business exchange.

INDUSTRY

Recommendations

A. Prioritizing high-potential subsectors: food-processing, high-end design and marketing (jewelry, cosmetics, soaps, napkins), Syrian reconstruction (pre-fab, furniture), high-skill products (pharmaceuticals)

B. Developing National Integrated Industrial Parks (NIIPs) to serve as areas of excellence which overcome comparative disadvantages (infrastructure, support services, regulatory one-stop shops)

The prioritization of sub-sectors is based on a thorough analysis of Lebanese exports

The recommendations do not take into account access to markets and the flooding of Lebanese and regional markets with cheaper products. Indeed, most countries rely on some protectionist measures to allow nascent industries to flourish before exposing them to stiff competition. In the case of Lebanon, the majority of trade agreements has been detrimental to Lebanese exports and may need to be reviewed or better enforced.

In line with the environmental sustainability perspective, the revival of the industrial sector should take into account the sustainability of natural resources and prevent the exacerbation of current pollution issues in Lebanon.

TOURISM

Recommendations

A. Focus on attracting leisure tourists from 15 source countries (Arab countries, core European countries, Diaspora countries) by building core offerings (city and entertainment, sun and sea, culture) in three cities (Beirut, Byblos, and Sour) and develop ultra-luxury eco-tourism hubs

B. Grow the Meeting and Incentive segment (with a focus on UAE, Qatar, Kuwait, KSA, and Iraq)

C. Position Lebanon as a convenient destination for regional medical tourists by offering specialized services

The recommendations did not mention the importance of internal tourism as a resilient source of visitors for rural areas.

The recommendations did not sufficiently highlight the role of the environment in the growth of this sector. More specifically, a reform of the tourism sector needs to prioritize the solid waste management problem. Nor did these recommendations emphasize the environmental sustainability repercussions of an increased volume of tourists.

Finally, from a social justice point of view, social protection for the high number of seasonal workers in this sector should be introduced.

KNOWLEDGE ECONOMY

Recommendations

A. Become a highly productive digital economy, acting as a digital talent hub

B. Position Lebanon as a leading regional outsourcing destination for BPO services (finance and accounting, HR, marketing and sales) and a global hub for middle east research and analytics service desks (outsourcing park)

C. Become a regional creative hub in a specific set of niches (branding, fiscal and non-fiscal incentives)

D. Become an educational hub, attracting regional (undergraduate and medical studies) and international students (Middle Eastern and Arabic studies) (quality of education in public schools, decision tools/surveys)

While the assumption that Lebanon can become a digital hub in the region is reasonable, this venture requires sizeable investments (e.g. the Beirut Knowledge Village) that may not yield the expected outcomes. Indeed, the Vision does not provide any cost estimates however preliminary of the cost of these proposed projects.

FINANCIAL SERVICES

Recommendations

A. Strengthen the financial services sector to enable the country's economic development agenda (beyond banking)
B. Position Lebanon as an investment management and offshoring hub (diaspora, levant, Africa, and the Caspian region)
C. Develop centers of excellence in specific niches (project finance, digital and analytics, actuarial studies, equity and investment research)

The financial services sector has historically had a regressive influence on income distribution in Lebanon. It is therefore important to regulate this growth and ensure that any incentives given to this sector are counterbalanced by progressive incentives that benefit lower income groups.

Moreover, financial services are not labour intensive by definition and are therefore unlikely to generate employment. In fact, this is acknowledged by the Vision which estimated total employment in this sector to remain constant at 50 thousand between 2018 and 2025.

DIASPORA

Recommendations

A. "Seed": Prepare the next generation of Lebanese workforce and monitor emigration

B. "Radiate": Develop a solid diaspora database and promote national identity to strengthen the bond between Lebanon and its diaspora (vibrant communities in countries of residence)

C. "Reap": Leverage the diaspora network through encouraging productive investments, opening access to export markets, and transferring knowledge

D. "Advocate": Harness and formalize advocacy through establishing a diaspora advisory board (advise the GoL and advocate for Lebanon's interest)

The concept of "diaspora" needs to be more clearly defined. How many generations does the Vision include in its definition of diaspora, knowing that sizeable ways of out-migration date back to the early 19th century?

Moreover, it is uncommon for an economic vision to present "diaspora" as an economic sector. It could at the utmost be viewed as a source of support or an enabler.

Finally, the inclusion of the "seed" recommendation seems to countermand the classical role of a government in providing decent opportunities to all its citizens rather than grooming them for "export" .

REQUIRED ENABLES TO SUPPORT THE ASPIRATIONS

INFRASTRUCTURE

1. Launch infrastructure projects including pre-planned projects (Beirut rapid-bus public transport, airport rehab, Ras Baalbek-Syrian border highway, fiber network) and new projects (construction technology zone focused on Syria and Iraq, Beirut Knowledge Hub Park, as well as Sour, Byblos, and Beirut walkway improvements)
2. Improve Beirut's efficiency by enhancing transportation, waste management, and pollution; improving governance; developing a comprehensive urban plan.
3. Reform the power sector

According to the Vision, the CEDRE conference total pledge of USD 11.1 billion (92% of which consists of loans) would only be sufficient to cover half of the required funds for the Capital Investment Program (CIP). Moreover, while CEDRE estimates the need for USD 2 billion of infrastructure investment per year , the Vision estimates a need for USD 4 billion of capital investment per year. In view of Lebanon's excessive public debt which is identified as a constraint by the Vision itself, this enabler may end up further crippling the budget instead of igniting the economy.

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Based on FES economic policy guidelines, "public debt represents redistribution in favor of capital owners who have lent money to the state and whose interest income is paid out of the taxes predominately levied on wage earners". Therefore, this sizeable public infrastructure agenda financed almost exclusively by debt poses serious social equity concerns

GOVERNMENT

1. **Reform public administration (productivity measures, digitization, anti-corruption purge)**

2. Reform public finance (1% annual reduction in fiscal deficit out of GDP, expenditure ceiling, revenue growth in terms of tax level and tax collection effort)

3. Increase legislative productivity (business environment, laws related to the vision's priority sectors)

Digitization of the administration and the launching of e-government initiatives are necessary and can be implemented in the absence of any structural impediments.

On the other hand, the proposed productivity and anti-corruption measures are restricted to the policy level while the real challenges reside in the implementation capacity of public institutions. The Vision ignores the repercussions of the consociational sectarian political system on public administration which generates dual lines of accountability in the civil service, impedes oversight and renders these reforms quasi-impossible to achieve.

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As the Vision recommends, the two means of reducing the current public deficit are to decrease public expenditures or increase public revenues.

In terms of public expenditures, the current structure of the public budget leaves the government barely any wiggle room. Indeed, according to the Vision itself, operating expenditures constitute only 24% of total government expenditures knowing that interest payments capture 32% of the budget and wages, salaries and benefits another 33% (slide 16).

Consequently, ministry budgets which support all public services are already stretched to the limit. Therefore, the Vision's recommendation of imposing strict expenditure ceilings is not likely to lead to any significant savings unless a significant reduction of public services is envisaged . The reduction of public services will have serious social equity repercussions as it will lead to disproportionately affect lower income citizens who rely on public education and public healthcare.

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One good candidate for expenditure reduction is wages and salaries. However, in the absence of any plans to take drastic measures such as laying off public servants or reducing their pensions, a measure that would have catastrophic social equity repercussions in a country where formal decent employment is enjoyed by a small share of the citizenry, the only other resort is to curtail the benefits of the upper echelons of the political branches and the civil service namely: the overly generous benefits and pensions of ministers, MPs, and tier 1 civil servants, and the private school subsidies granted to civil servants.

Finally, an assessment of the current expenditure structure reveals that the budget is currently weighed down by a sizeable debt service share (33%) that cripples the government and prevents it from spurring the economy. Interestingly, the vision, while acknowledging the high debt to GDP ratio is at the same time proposing to increase it by taking on additional debt.

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The other lever proposed by the Vision is an increase in revenues through a more effective collection of taxes. Although this proposition is reasonable, social equity concerns dictate that this effort be accompanied by a restructuring of the taxation system towards increased progressivity, in a country characterized by one of the highest levels of concentration of revenue and wealth in the world.

Moreover, 70% of current tax revenues stem from indirect taxes such as VAT which are by definition regressive. Meanwhile, capital taxation is among the lowest in the world. Moreover, the tax base is currently eroded by a large number of exemptions that benefit religious assets and foundations among others.

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Moreover, the Vision proposed floating (privatizing) state owned enterprises. From an economic sustainability perspective, care should be taken before letting go of the very few revenues generating enterprises that the government of Lebanon has held on to. Moreover, the current institutional weakness of the Lebanese government makes it unable to effectively regulate and oversee these sectors. The social democrat platform raises two major concerns in this regard. The first is whether privatization would substitute a private monopoly to a public one. Previous experiences of privatization in this country seem to suggest that this will indeed be the case. The second concern, is that private investor would neglect the long-term quality and sustainability of the service. The case of the Lebanese telecom sector supports this assumption.

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The Lebanese government faces challenges in the implementation of its current laws and regulations. Indeed, business friendly laws have been passed recently but remain unenforced. In turn, legislative productivity and the passage of additional laws are not sufficient for the creation of the desired business friendly environment.

Finally, while the Vision includes some environmental and social equity measures such as laws to protect Lebanon's ground water (slide 1108) and laws to increase female labor participation (1109), it largely focuses on business facilitation laws and sidesteps many legal reforms that are crucial form a social equity perspective such as an anti-trust law, formalization of labor, decent wage, private sector pension reform, etc.

INSTITUTIONALIZATION MECHANISMS

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The report proposes setting up a Performance Management and Delivery Unit (PMDU) that reports to the Council of Ministers and performs five key functions: strategic planning, program management (implementation oversight), performance management, delivery support (debottlenecking), and marketing and public relations (image of the vision and its projects).

The institutionalization of the Vision in a relatively structure that spans ministers and entails significant salaries (attractive compensation and benefits) seems counter-productive in view of the budgetary constraints stressed elsewhere by the report. This is exacerbated by the fact that these seemingly temporary structures turn out to be permanent more often than not and have no legal authority to break the vertical lines of authority already established in government statutes.

A better alternative would a revival of the Ministry of Planning that would have clear authority and lines of communications and accountability and would sustainably perform these five proposed functions.

FLAGSHIP PROJECTS

SEAMLESS END-TO-END TOURISM JOURNEY

The tourist journey currently suffers from: an unclear value proposition of Lebanon as a tourist destination, unorganized and unclear process at the airport, lack of 'tourist friendly cities.'

The report proposes: mapping the end to end tourist journey and understanding key pain points, designing the ideal journey and assigning owners to each part, and defining efficient data collection mechanisms.

Moreover, as part of the tourism specialty, 4 environmental initiatives are proposed:

1. Clean Lebanon's beaches and update water regulations
2. Develop and protect eco-tourism areas
3. Upkeep cleanliness in anchor destinations
4. Update solid waste management regulations and develop sustainable waste management solutions

This seems wider than a discrete well-defined project and more like a prioritization of some of the proposed initiatives in the tourism sector. One recommendation is to upscale the sector from traditional modes of delivery through the use of online platforms to reach wider markets and to collect additional data on tourists.

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SMART LEBANON KNOWLEDGE HUB

Based on a preliminary assessment, the report advises developing physical clusters in Greater Beirut and Tripoli. The hub would be anchored around these two physical clusters and scattered virtual corridors. The Tripoli Outsourcing Park would host business and knowledge intensive outsourcing services, while the Beirut Knowledge Village would include digital, creative, education, and financial districts in partnership with leading institutions.

Despite the attractiveness and relevance of these projects, a considerable weakness in the vision is that no budget estimates were provided. In a country saddled by public debt, it would be irresponsible to embark on such risky endeavors without considering their cost.