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CONSULTATION AND RESEARCH INSTITUTE

COMPETITION IN THE LEBANESE ECONOMY

A Background Report for a Competition Law for Lebanon

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I. INTRODUCTION

1. Objectives of the study

This report has been prepared at the request of Lebanon's Ministry of National Economy. It serves as a background study for a draft Competition Law that the Lebanese Government intends to submit to Parliament. The Law aims at enhancing competitive conditions in the economy in order to improve efficiency and productivity, thus providing a stronger basis than currently prevailing for sustained growth in output and employment.

The main objective of the report is the evaluation of the degree of competition in the Lebanese economy. This evaluation should constitute a starting point for the drafting of the Competition Law; it can also serve more general purposes of informing macroeconomic and sector policies for enhancing the productivity and growth of the Lebanese economy.

Since 1975, the structure of the Lebanese economy has undergone significant changes following 15 years of warring conditions, followed by more than a decade of reconstruction. Although economic recovery has been relatively quick, growth has not been as strong as expected, averaging only 3.7% during 1993-2002 despite the stimulus of a strong increase in government expenditures, in terms of GDP. This modest performance constitutes *prima facie* evidence that the Lebanese economy is constrained by structural rigidities, among which the weakness of market competitive forces may be a major element.

2. Methodology and data sources

In evaluating the degree of competition in the Lebanese economy, the analysis in the report will be largely based on the standard industrial organization model of Structure-Conduct-Performance. The analysis will also draw on two other models that bring insight to the evaluation of market competition. These are the models relating to the concepts of "entrepreneurial discovery" of the Austrian School and "market contestability".

The main characteristics relevant to market structure and business conduct or behavior will be studied for the major activities of the economy (agriculture, industry, services), and for specific markets or economic activities.

Following a presentation of the demand and supply conditions that govern business operations in the Lebanon, the analysis will focus on the two principal characteristics of market structure, namely market concentration and barriers to entry. Business conduct or behavior will be assessed in relation to pricing policies and restrictive practices that constrain competition. However, because of the nature of the variable itself, the data needed for an adequate analysis of business conduct have rarely been the subject of surveys and are difficult to collect anyway. As a result, the analysis concerning business restrictive practices will be largely based on limited and indirect evidence.

No attempt will be made to assess the impact of the degree of competition and of business conduct on market performance. This relationship, though at the heart of competition analysis, is ambiguous in the standard industrial organization model itself and, in addition, is outside the terms of reference of the report. It is ambiguous because a given economic performance can be imputed to a given market structure, or to a specific business conduct that is independent of structure, or to a conjunction of both with given initial conditions.

The data used in the report are mostly from official sources. Above all, the data pertaining to the Value Added Tax (VAT) for the year 2002, provided by the Ministry of Finance, represent the primary source of information for the analysis of market structure, and concentration in particular. Although the VAT has been introduced only in February 2002, the data collected to date have the distinct advantage of being quite recent and detailed, and constitute by far the most important data input in the report. In addition, the report uses data that have been derived from recent official surveys on the national accounts for 1994-95, household living conditions in 1997, manpower resources in 1997, and on industry in 1998-1999 (see Republic of Lebanon and République Libanaise, various years).

Regarding information on business conduct, which includes pricing and restrictive practices, the data used are mostly qualitative and have been collected by the authors from limited sources. These data should be taken as providing information of a general rather than specific nature.

3. Outline

Following the introduction, part II discusses the basis for a Competition Law and its objectives, particularly in a developing-country context such as that of Lebanon. Part III provides an overview of the macroeconomic environment, with details on the structure of the Lebanese economy and its performance since the end of the war in 1990.

Part IV addresses the central issue of the report by evaluating the degree of competition in the economy from a market structure perspective, with emphasis on concentration and barriers to entry and exit. Competition from a business conduct perspective will be analyzed in part V, with focus on the extent of restrictive practices in markets.

Part VI discusses the issue of privatization, the conditions for its success, and the need for a regulatory agency.

The findings of the report and its recommendations are summarized in part VII. Based on these findings, recommendations are presented regarding the Competition Law, in particular with respect to principles and elements that would need to be adopted in (or excluded from) the Law. The section also addresses the issue of the need for a regulatory institution, e.g. a Competition Authority, its main functions and prerogatives. Finally, recommendations are made in relation to competition policies in general --as opposed to laws-- that could benefit economic performance, with emphasis on those that would be relatively easy to implement.

II. WHY A COMPETITION LAW AND FOR WHOM?

1. The benefits of competition

1.1 Competition laws are the products of a fundamental view in economic analysis, which is that competition is good for economic efficiency and growth. This view occupies a central place in economic analysis.

In the mainstream economic model, competition is essential for achieving efficient outcomes and for stimulating growth. Indeed, in the standard economic literature, the economic benefits that are expected from a market economy critically depend on the assumption of competitive markets that exist throughout the economy.

Competition can be viewed as either a structure or a conduct characteristic in a specific market. As a structural characteristic, it denotes a market situation with a large number of sellers, large enough so that no one seller, or a group of sellers, can have a significant influence over price. From this perspective, competition is the absence of market concentration in the hands of the few, and hence the absence of power, or so-called "monopoly power", over price determination in particular. The size of each seller would have to be small, not in absolute terms but relative to the total size of the market.

As a conduct or behavior characteristic, competition denotes what Adam Smith referred to as "independent striving" by sellers for client patronage. Competitive conduct means, above all, the absence of restrictive practices and collusion among sellers, such as price fixing and market-sharing arrangements that limit rivalry among sellers.

Whichever concept is used, competitive forces produce market pressures that are expected to drive sellers, by necessity rather than choice, to productive efficiency, i.e. to produce any chosen level of output at the least cost possible. This is the central benefit, namely efficiency, which competition is supposed to deliver spontaneously without any need for intervention or coordination by any authority. It remains one of the most fundamental principles of economic policy in general, and competition laws in particular.

1.2 Although the focus of competition analysis usually is on price and static productive efficiency, the standard analysis also holds at the dynamic levels of allocation of resources and innovation. The view is that, if competition holds throughout the economy, with low or insignificant barriers to entry, capital resources would then move more freely across activities and regions in a given economy, thereby increasing efficiency, the volume of economic activity, employment and growth.

Competition should be viewed as a process that is more complex than that of simple price competition. It involves a continuous allocation and reallocation of resources in the face of changing market conditions, creating new products and/or processes of production. This dynamic view of the competitive process is, however, more emphasized in the analysis of the Austrian School (on which more below) and of Schumpeter, with his entrepreneur as the carrier of new competition and change.

Mainstream economics views the benefits of competition as going beyond the simply economic to the political and philosophical. In fact, competition is deemed desirable from an economic as well as political point of view because it is compatible with public freedoms and the absence of economic power. It is also consistent with equality of opportunity for sellers through the absence of artificial barriers to entry, and is supportive of freedom of choice for consumers whose demands would be more effectively satisfied at lower prices in competitive than in monopolistic markets. Competition is therefore a fundamental economic and social objective that is deserving of laws and policies to promote it.

On the other hand, the absence of competitive structures and conduct, i.e. the existence of monopolistic power, is expected to produce an inefficient performance and an inequitable distribution of income. Laws and economic policy should then strive to contain the harmful effects of imperfectly competitive markets, or monopoly power in general, with their restrictive practices that inhibit competition.

Monopolistic structures and behavior can be self-reinforcing or path-dependent processes. In other words, a monopolistic market structure has a tendency to reinforce itself over time and thus become more difficult to remedy. This highlights the need for action from outside the market, usually in the form of public policy. Moreover, constant vigilance is required because markets are essentially dynamic, and competitive markets can turn monopolistic over time. A regulatory agency or authority would fulfill such a role.

2. The Industrial Organization paradigm

2.1 The concept of competition is well developed, particularly in its empirical aspect, in the economics branch Industrial Organization (IO). IO analysis uses the following standard paradigm:

Structure → Conduct → Performance

The paradigm refers to a market for a specific product. The structure of a given market comprises various parameters, chief among which are the number of sellers and buyers, the height of barriers to entry and exit, and the extent of product differentiation. Conduct, or firm behavior, mostly refers to pricing and investment policies. Performance is the focus of the paradigm in that it shows the outcome of a specific market structure and conduct, particularly in terms of economic growth, or productive and allocative efficiency, employment, and equity regarding income distribution.

Although the arrow sign (→) here indicates causation, with the main direction of influence running from structure to conduct, then to performance, the model allows for feedback effects, which can be quite strong depending on market circumstances. In turn, conduct and performance can also affect market structure. Moreover, public policies themselves play an important outside role, affecting structure, conduct and performance. A competition law is an example of such a public policy.

Missing from the above simple diagram is a multitude of “basic conditions” that affect market structure, and operate with it in determining economic performance. Basic conditions refer to the supply and demand conditions that govern business operations. They include, for instance, the country’s endowment with raw materials and its technological development on the supply side, the rate of growth of incomes and the availability of substitutes for specific products on the demand side.

2.2 Purely or totally competitive market structures are very difficult to obtain in reality. This would require, among other conditions, homogeneous products, a large number of sellers who are price takers, and insignificant barriers to entry. The competitive ideal is in fact not very useful as a policy guide. This has led to the creation of the concept of "workable competition", which is an operational norm that can be used in the empirical studies of markets to assess their degree of competition (see Scherer and Ross).

Workable competition is said to operate when the following conditions hold with respect to structure, conduct and performance. In structure, two main conditions are required: the number of suppliers should be as large as permitted by scale economies and there should be no artificial barriers to entry. Artificial barriers to entry usually exist in the regulatory environment, e.g. difficult-to-obtain or expensive licenses to operate. Natural barriers to entry are the ones associated, for example, with large capital requirements and/or a relatively large minimum efficient scale of operation that is necessitated by technological considerations, such as in electricity generation.

In addition, workable competition requires that sellers avoid restrictive practices such as collusion among themselves to fix prices. Performance should be efficient, and the level and quality of output should be responsive to consumer demands. As for profits, they should be enough to reward efficiency, investment and innovation, including new products and processes.

Of course, the difficulty remains in estimating whether a given market is workably competitive or not if only some of the above conditions hold. That leaves room for assessment by the analyst, especially since competition is better seen as a continuum rather than as a binary situation.

2.3 The IO paradigm is not the only useful model for the analysis of industrial organization or competition issues. The report refers to two well-known alternative views on competition: the entrepreneurial discovery view associated with the Austrian School and contestable market theory (see Kirzner and Baumol, respectively).

a) In the economics of the Austrian School, competition is essentially dynamic rivalry, the emphasis being on dynamics under uncertainty. The driving force in the market is the entrepreneur, who acts by taking advantage of opportunities and then introducing change in the market in terms of products and prices. Competition becomes a dynamic process of market evolution under conditions of uncertainty where no particular market structure is ideal, and where market failures are inexistent or irrelevant. Actors in a market are not price takers but price and quality makers in a dynamic process of competition.

In such a dynamic environment, only efficient firms would emerge, whether the markets are concentrated or not, and what matters most is complete free entry. Thus, with the Austrian School, legal and government institutions play a limited but critical role in enforcing property rights and in ensuring free entry, particularly by abolishing artificial barriers.

b) Contestable market theory also emphasizes the critical importance of free entry, but from a different perspective. According to this theory, market competition is established not by the actual number of sellers but by the presence of potential entrants. With perfect contestability, market forces would operate to bring the industry to its "optimal" structure, i.e.

a structure with the largest number of firms compatible with the lowest cost and price configuration possible, in a given technological and demand environment.

The distinguishing characteristic of contestable markets is the absence of sunk costs. Sunk costs are fixed costs that cannot be recovered. To the extent that sunk costs are inexistent or unimportant, entry and exit are relatively easy, and hence markets are contestable. For instance, in Lebanon, to the extent that legal procedures are complex and time-consuming, then sunk costs become relatively important, together with the barriers to entry and exit. From this perspective, Lebanese markets appear to be less contestable or competitive than under a more efficient legal system.

Although other structural elements also matter, such as the degree of vertical integration in a given market and the breadth of its product line, it is the conditions of entry that matter most. Sunk investments determine the conditions of entry and exit, in the sense that the more substantial sunk investments are the more costly the conditions of entry and exit equally are.

3. Competition in developing countries

3.1 Economic growth and development in developing countries is associated with structural change, and increased competition is a device to induce needed structural change. Competition, however, works in complex ways that go beyond the simple drive to cost efficiency and product improvement. The competitive drive subjects sellers to rivalry pressures in a framework of business survival and, as such, it operates on practically all aspects affecting the firm and its profitability. Hence, the objective of an enhanced competitive environment becomes a major part of a policy of structural change.

The IO paradigm remains the standard in the analysis of competition issues. It is, however, more suited to industrial economies, with their relatively developed markets and institutions, than to developing countries that suffer, in addition to their underdeveloped institutions, from an inadequate database for empirical analysis. In this regard, the Austrian School view of competition and contestable market theory may both be more appropriate than the standard IO paradigm for the analysis of competition issues in developing countries. The reason is not only that the two alternative models are less data demanding, but also because of theoretical relevance with their emphasis on enabling institutions and entry conditions.

3.2 The above comments emphasize the role of institutions, in particular the political and legal systems, in creating an adequate environment for competition and growth. The point is that competition, which is the focus of the study, does not necessarily have to be promoted through policies directly affecting market structure or conduct. Competition, and investment, can be more effectively promoted indirectly through the establishment of clear and business-friendly rules of the game through the introduction and implementation of relevant laws, such as a Competition Law, and the operation of an efficient administrative and legal system. In other words, in the context of developing countries, one should not take institutions as given for they matter a great deal in their impact on economic activity and growth.

It is an established principle that increasing returns is a principal source of growth, and increasing returns much depend on the economies derived from large-scale operations. In countries with relatively small markets, such as Lebanon, size can then be a serious limitation. Evidence is, however, mounting that provides hope to small economies: learning and efficient organization are more important and reliable sources of increasing returns than scale economies. These factors improve with competition and institutional development[1]. These new theoretical and empirical developments support the view that institutions play an important positive role in fostering competition and growth, and should therefore provide comfort and encouragement to small developing countries. It is in this institutional context that a Competition Law should be first placed.

3.3 The benefits of competition and the need to promote competitive structures and behavior may appear to be self-evident, but the issue is not a straightforward one in developing countries.

Indeed, in small developing countries, the number of small establishments is usually very large. In Lebanon, establishments with at most 10 workers represent approximately 90 percent of all establishments, which points to the existence of ample room for potential economies of scale that can be a significant source of growth. Moreover, increased competition in small developing countries may lead to a dilution of profits, which could adversely affect investment. In other words, the issue in Lebanon may be more one of a need to increase the size of enterprises, and then perhaps increasing concentration to take advantage of scale economies and increased profits for investment rather than an issue of increasing competition.

Clearly, this is an important issue for consideration in the analysis of Lebanese markets, and indirectly in the Competition Law proper. However, this is an essentially empirical issue. Specifically, it is whether significant economies of scale exist in well-defined markets to justify the objective of an increased firm size through, say, the promotion of mergers and, if so, whether the realized economies will outweigh any competitive loss due to increased market concentration. The scale economies may also be associated with a scale large enough to constitute a natural monopoly or oligopoly, as in the case of an airline or a phone network. Moreover, the issue is whether increased competition in specific markets does significantly reduce profits to affect adversely the supply of capital needed for the expansion and development of enterprises in those markets.

3.4 To sum up, competition is a dynamic and complex process. It is dynamic because it takes place over time with continuously changing market conditions and players, and it is complex because it is identified by various structural and behavioral considerations.

Chief among the structural characteristics are barriers to entry that affect actual and potential competition, and their importance in significantly affecting competition is emphasized by practically all views in the discipline. Competitive conduct or behavior is also multi-dimensional, involving mainly pricing, but also a drive to efficiency, the introduction of new products and processes, marketing, etc.

Competition laws focus on conduct, above all the containment if not elimination of restrictive practices. In small developing countries such as Lebanon, institutions, in their various administrative and legal aspects, are crucial in creating and maintaining an environment that promotes competition by reducing artificial barriers to entry and limiting restrictive practices.

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[1] See Arthur, 1998.

4. The objectives of a Competition Law

4.1 Competition laws seek to promote competitive structures and behavior, and to prevent, anticompetitive or restrictive practices. However, competition is not an end in itself. The ultimate objective of competition policy in general, and competition laws in particular, is consumer welfare that is served by lower prices, better quality products and, eventually, by a more efficient and dynamic economy.

In fact, the objective of consumer welfare may sometimes become secondary to other economic objectives. In many instances, the authorities have to strike a balance between competition, on the one hand, and a greater market concentration that brings the benefits of the economies of large-scale production on the other. In small economies, the size of some markets may be small in relation to the minimum efficient scale of production so that only a few sellers can efficiently operate. Sometimes the size of the market allows for only one efficient operator --the case of a natural monopoly-- as in the energy sector in some countries. In other words, the market size may not be large enough to take advantage of scale economies, and the authorities may then attach priority to the efficiency provided by scale economies over the benefits of competition.

US antitrust laws, for instance, have emphasized consumer welfare and the need to break-up market power. The continuous focus on breaking monopoly power has been based on the structural facts of the US economy, in particular its large markets in relation to minimum efficient scales of production. The implication of these facts has been that the US markets are, in general, large enough to accommodate a relatively large number of sellers that can both compete and take advantage of scale economies. US markets have thus not had to forego competition for the sake of scale economies.

In the competition laws of the European Union (EU), on the other hand, the objective of consumer welfare has been subsidiary to that of market integration in the context of the EU. A related objective has also been the promotion of the economic power, associated with size, of EU firms in order for them to compete better with US and Japanese firms.

4.2 Competition laws may therefore have to address conflicting objectives. The most common conflict is between more competition and market concentration. The choice of market concentration, rather than more competition, can be justified by the benefits of economies of scale that would materialize with lower costs and lower prices and would thus more than offset the disadvantages of concentration. In this regard, a solution is to allow cooperation or the merger of small and medium enterprises for economies-of-scale purposes, as Germany does. However, to justify the choice of greater market concentration, it becomes necessary to provide prior evidence of the existence of significant economies of scale, and that these economies appear only at relatively large levels of output that are not compatible with a competitive structure.

Two other sets of conflicting objectives may be of special relevance to small developing and open economies such as Lebanon. The first conflict opposes the benefits of lower prices to consumers from increased competition to the associated reduction in firms' profits and, hence, in their capacity for investment and expansion. The second conflict relates to the more familiar opposition between the promotion of competition through the relaxation of import barriers, on the one hand, and the need for temporary protection of infant industries, particularly those in dynamic technological sectors, on the other.

Competition laws and policies would have to address these conflicts, and their resolution much depends on the circumstances of the markets in question. In any event, it is recommended that the burden of the proof fall on those advocating a relaxation in competition rules and regulations, in that the benefits of reduced competition would have to be clearly demonstrated in specific markets before acquiescing to a reduction in competition.

To illustrate, agreeing to protecting an industry from foreign competition would have to be based on the establishment of unequivocal benefits --in terms of gains in efficiency, productivity, expansion, etc. -- to be derived from such protection. In addition, protection should be temporary, with the proviso that the protected enterprise may be penalized failing the achievement of most of the promised gains. This is necessary in order to avoid protection becoming one of business privileges and power rather than a means to promote domestic industries and greater competition with imports in the future.

4.3 Regarding protection from imports, it is sometimes proposed that competition laws can be viewed as a substitute for an increased opening up of domestic markets to external competition and that, therefore, higher trade barriers, or a postponement of a lowering of trade barriers, may be afforded with the introduction of a competition law.

True, increased foreign competition can be untimely if the domestic sellers are not ready for the challenge owing to a variety of reasons, including a restrictive economic environment and relatively weak competitive instincts. Domestic markets can thus become more efficient following adjustment to competitive pressures introduced by a competition law but before opening up to foreign competition. As noted above, these empirical issues require information and analysis at the specific market level.

In any event, the opening up to foreign competition is an inevitable and ultimately salutary development, especially since the Lebanese economy has historically been a very open economy, by any standard of measurement. Even if they are introduced before increased competition from imports is allowed, competition laws remain an essential element of a reform package and should be viewed as complementary to foreign competition. The objective of competition laws is to enhance the efficiency of domestic production, including exports, which is the best strategy for competing with imports.

4.4 Competition laws should be viewed as integral to an overall competition policy package that could include administrative and judicial reforms seeking a more efficient and business-friendly administrative and judicial process. While a competition law provides, on its own, obvious economic benefits, these benefits are compounded when the law is implemented as part of a general competition and reform package.

To make competition laws effective, three basic elements are required: a competition or antitrust law that is as dynamic as the changing structure and performance of the economy, a dedicated enforcement agency staffed by professionals, and an efficient legal process. These issues will be taken up in more detail in the last section of the report.

III. THE MACROECONOMIC ENVIRONMENT

1. Economic developments and performance

1.1 With the ending of the war in late 1990 and the implementation of a new constitution, Lebanon entered a new political and economic era. An immediate task of government was to initiate the process of reconstruction and rehabilitation of the physical and administrative infrastructure. However, during 1991-92, pressures intensified on the exchange rate of the Lebanese Lira (LL), adding substantial inflationary pressures on Lebanon's open economy. A stable exchange rate policy, which still holds to date, was then quickly introduced as underpinning the economic reconstruction strategy.

The political and financial stabilization that followed were instrumental in a sustained resumption in growth. As Table 1 below shows, price stabilization was quickly achieved, with inflation, measured by the consumer price index (CPI), falling from 100% in 1992 to single digits in 1994 and almost no price inflation during 1999-2001[2]. Inflation in 2002, estimated at around 2%, has been mostly driven by the newly introduced 10% value added tax (VAT).

The 1990s were not totally uneventful. Frequent Israeli incursions into Lebanon and destructions of power stations had their adverse economic impact. While economic growth had strongly resumed since 1991, it started decelerating since the mid-1990s, and GDP growth during 1993-2002 averaged 3.7% per annum.

Unfortunately, the successful stabilization policy has been costly in terms of relatively high interest rates that, in addition to mounting government expenditures, significantly contributed to the large fiscal deficits and associated public indebtedness. A fiscal consolidation process began in 2001, strengthened by structural reforms that culminated with the introduction of the VAT in early 2002.

In the external sector, merchandise exports have registered only modest growth, in part hampered by a gradually appreciating, then stable, nominal exchange rate and the necessarily long gestation period before the rebuilding of infrastructure can materialize its positive impact on productivity. Nonetheless, the overall balance of payments has often remained in surplus, mainly owing to continuously strong capital inflows.

Table 1 below (updated in 2004) provides a summary view of Lebanon's economic performance since 1992.

[2] See Consultation and Research Institute, *Monthly Consumer Price Indices for Beirut and Suburbs*, various years.

Table 1
Lebanon – Economic Indicators

	Unit	1992	1995	1998	2001	2002	2003
Real sector							
Population [1]	Millions	3.5	3.8	4.1	4.2	4.3	4.3
GDP -current market [2]	LL billions	10,009	18,996	25,824	26,540	27,532	28,645
GDP -current market	$ billions	5.8	11.7	17.0	17.6	18.3	19.0
GDP growth	%	4.5	6.5	3.0	1.5	2.0	2.0
CPI increase	%	99.8	10.6	4.5	0.0	2.0	2.0
Public finance [3]							
Revenues	$ billions	0.7	1.9	3.0	3.1	3.9	4.4
Expenditures	$ billions	1.3	3.9	5.6	6.1	6.9	7.2
Overall balance	$ billions	-0.6	-2.0	-2.6	-3.0	-3.0	-2.7
Net government debt	$ billions	2.5	7.2	17.1	27.0	29.4	31.4
o/w in foreign currencies	$ billions	0.4	1.3	4.2	9.6	14.6	15.6
Overall balance/GDP	%	-10.8	-17.0	-15.3	-17.0	-16.4	-14.5
Net government debt/GDP	%	40.5	60.8	100.5	153.4	160.9	165.2
		42	61	101	153	161	165
External							
Merchandise exports/GDP	%	10.3	5.4	3.5	4.7	5.2	7.4
Merchandise exports	$ billions	0.6	0.6	0.6	0.8	1.0	1.4
Trade balance	$ billions	-3.2	-5.9	-5.9	-5.9	-5.0	-4.7
Overall balance	$ billions	0.1	0.3	-0.5	-1.2	1.6	3.3
Financial							
BDL gross foreign reserves [4]	$ billions	4.6	8.0	9.1	6.9	8.3	14.0
Net foreign assets (NFA) [5]	$ billions	6.7	9.9	9.7	8.1	10.3	14.5
NFA/GDP	%	116	84	57	46	56	76
TB yield -weighted average	%	25.5	22.4	17.0	14.3	14.2	12.3
Exchange rate average	LL/$	1,713	1,621	1,516	1,508	1,508	1,508

Sources: Banque Du Liban (BDL) and Ministry of Finance publications; World Bank Development Report and the IMF's IFS and GFS (various issues); Consultation and Research Institute.
Notes: 1- The official estimate is 4,005 thousand in 1997 (Rép. Lib., 1998a).
2- GDP of the base year 1997 has been officially adjusted upward by 5.4%. The same rate is applied to all GDP estimates as of 1992.
3- Fiscal data are for central government, including treasury operations.
4- Foreign reserves consist of foreign currencies and gold at market prices.
5- Net foreign assets are of the banking system.

1.2 Efforts by the Lebanese Government towards fiscal consolidation and reform have recently been rewarded by substantial amounts in financial assistance. At an international meeting for Lebanon, held in Paris in November 2002, financial assistance of up to $4.4 billion was pledged by several countries, mostly in the form of soft loans that can be used to refinance debt at significantly lower interest rates. In addition, domestic banks joined the international donor effort by pledging a package of $2 billion in Treasury bill financing at zero interest rate.

In return, the Lebanese Government has undertaken to implement further fiscal consolidation and reforms, including, in particular, an ambitious privatization program that constitutes, with the recently obtained financial assistance, a unique opportunity for breaking the vicious debt dynamics that Lebanon has been suffering from in the last few years. In this context, a Competition Law would send to both domestic and foreign economic agents clear signals about the government's determination to sustain its structural reform efforts.

2. The structure of output and employment

Starting in the mid-1990s, the authorities implemented a series of much-needed surveys to update the macroeconomic database, particularly the national accounts, employment and household living conditions, including household budget allocation. The major results of the national accounts and manpower surveys are summarized in Table 2 below.

Table 2
Output and Employment Structure

	1997
Output structure (%)	
Agriculture	6.3
Manufacturing and mining	13.5
Energy and water	1.5
Construction	9.4
Transport & communications	5.3
Commerce	21.3
Housing	8.5
Services	22.6
Public administration	11.6
	100.0

Employment structure (%)	**1997-98**
Agriculture	15-20
Industry	15
Services	65-70
	100

Sources: Rep. of Leb., 2003; Rep. of Leb. and FAO (2000); Rép.Lib. 1998a.
Notes: Industry is mining, manufacturing and utilities.

The survey results confirmed prior opinion that the Lebanese economy has not experienced much change in its output or employment structure, compared to the period before the war in 1975. Barring the significant increase in construction output and employment, which are explained by the upsurge in reconstruction activity at the time of the surveys, the share of manufacturing or industry in either output or employment has remained within 1 to 2 percentage points of its share in 1973-74.

The same conclusion applies to agriculture and services. Although the 1997 manpower survey noted a 9 percent share of agriculture in total employment, the joint Ministry of Agriculture and FAO agricultural census of 1997-98 resulted in data that point to a share within 20 to 25 per cent of total employment, versus practically the same range in 1973-74). The census results regarding employment in agriculture appear (to the authors of this report) to be more realistic than those obtained by the 1997 manpower survey.

Commerce has maintained its traditional dominant share in the economy, and agriculture remains hampered by low investments and productivity. As for manufacturing, with its potential for economies of scale and linkages with other activities, it has unfortunately failed to expand in any significant manner. Worse, rough evidence points to a continuing decline in manufacturing activity, in terms of both output and employment, since the late 1990s. Competition issues in manufacturing will be discussed at greater length in the analysis below.

3. The basic conditions of business operations

As a prelude to the empirical analysis of competition proper in the Lebanese economy, a brief description follows of the basic demand and supply conditions that govern business operations.

In the Industrial Organization paradigm, the demand and supply conditions define the technological, legal, economic and business practice environment within which enterprises operate. They constitute a leading determinant of market structure and indirectly affect, not necessarily in a small degree, business conduct and economic performance.

3.1 Supply conditions refer, in general, to the material, human and institutional endowments of the economy. An examination of Lebanon’s natural endowments provide a first, though strong, indication that the potential of these endowments is insufficiently exploited, and that the obstacles preventing a better exploitation lie more in the domain of artificial than natural barriers.

Lebanon is a small country with a temperate climate, but its road network is underdeveloped, especially in the regions outside central Lebanon. The small area of the country is a neglected important economic asset. Improvements in the road network should reduce transportation costs, increase market boundaries for products and thus favor investment and competition. Moreover, Lebanon’s water resources in rivers and subsoil reserves are plentiful but are inadequately used for agriculture or household use. Though known mineral resources are unimportant, these resources have not been well mapped.

The supply conditions of raw materials is therefore unnecessarily restricted, which implies that business-operating costs can be reduced with a better development and utilization of natural resources.

Business costs can also be reduced with a modern and effective judicial system. Although the general body of Lebanese laws is modern and is currently being updated, the judicial system and associated institutions that are in charge of law implementation are largely inefficient. Litigation is often time consuming, its outcome largely uncertain and costly to all parties concerned. This is a serious handicap in the modern business world, particularly in developing countries seeking to promote investment from both domestic and foreign sources. Ineffective legal institutions can thwart the entry of new businesses, which represents a major constraint on the competitive process.

In contrast, business attitudes to opportunities and receptiveness to new technology are favorable to risk taking and competition. Businessmen (and businesswomen) in Lebanon keep abreast of technological developments, mostly through travel and frequent contact with suppliers abroad. The computerization of operations has become a continuous process that is gradually taking in enterprises of all sizes.

Regarding labor, unionization is fragmented and weak, and labor costs are relatively low. Minimum monthly wages have not been revised since 1996, currently amounting to approximately $200 per month. However, the low level of labor costs is associated with a labor productivity that has remained low and that has even failed to surpass its level prior to the war.

Notwithstanding the low level of absolute labor costs, low labor productivity in Lebanon is an obstacle to new investment. It is largely a reflection of the low education level of the labor force: in 1997, about two thirds of the employed had at most only a complementary level of education, bearing in mind that the quality of education had significantly deteriorated since the 1980s[3].

3.2 Demand conditions relate, in particular, to the national income levels, its distribution and growth. They also refer, among other elements, to the availability of substitutes in product markets, purchasing methods and other selling conditions.

Income levels have significantly improved since the early 1990s, as Table 1 shows, but growth and employment opportunities have been sluggish in the last few years. Stagnant economic activity and a rising tax burden have constrained aggregate demand although, it should be noted, competition among sellers intensifies with a decline in economic activity. Nonetheless, weak economic growth has checked the expansion of markets and limited new entry and competition.

The distribution of income in Lebanon has historically been skewed, with the implication that the demand for luxuries has expanded at the expense of mass production. In 1997, the lower half of households in Lebanon earned around 21 per cent of total income, while the top 10 per cent earned around 39 per cent[4]. A more even distribution of income and wealth would have stimulated the demand for products of mass production and thus provided a stimulus to local industry and markets.

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[3] See République Libanaise, 1998a.
[4] See République Libanaise, 1998b.

At a micro level, in specific product markets, the greater availability of substitutes is a powerful check on market power since, by making demand curves more elastic, it checks a seller's power to raise prices and provides incentives to lower them. Lebanon's open economy, and its policy of reduction of tariff and trade barriers, is a significant step towards the provision of domestic markets with more substitutes and, hence, more competition. In this regard, a relaxation of the official support for exclusive agencies would also work in the same direction of greater competition to the benefit of the consumer.

Finally, with financial and political stabilization, payments methods have improved in the last few years towards extending medium and long-term credit to consumers, which has provided support to individuals with middle disposable incomes and helped expand the customer base in many markets.

IV. CONCENTRATION IN LEBANESE MARKETS

This section begins the empirical analysis of competition in the Lebanese economy. First, some methodological notes explain the approach and data used in the analysis. This is followed by the empirical findings regarding concentration in Lebanese markets.

1. Methodological notes

The immediate measure of market or monopoly power is market concentration. Market concentration is a structural characteristic that usually refers to the sales share of the largest one, three or five, or any small number of sellers in a specific product market. Concentration ratios have also been used for the largest four, five, and even eight sellers in the US. These ratios are denoted, respectively, by CR4, CR5 and CR8. Sales are the most widely used variable in concentration measures, although this can be some other relevant magnitude, such as capital, employment or output. It is also the only feasible one in the case of Lebanon, following the availability of Value Added Tax (VAT) data.

A measure that is similar to CR is the Herfindahl-Hirschman Index ($HHI = \sum S_i^2$, where S_i is the market share of the i^{th} seller). This measure has the advantage of combining information on both the number of sellers and their total distribution. Although CR and HHI are highly correlated at low CR values, their correlation weakens as CR increases, which means that the combined CR and HHI indicators provide a useful basis for analysis as market concentration increases.

The most important issue in the measurement of concentration, or market power in general, is the delineation of the boundary of the market for which concentration is to be measured. In defining a market, substitution possibilities on the demand side are the critical determinant. Sellers are competitors, and hence their products belong to the same market, if their products are "good" substitutes in the eyes of buyers. If the candidate substitute products are A and B, the test is what happens to quantity bought of B when the price of A changes, and vice versa. In other words, the test is whether the cross-elasticity between A and B is "high" enough to make them close substitutes that belong to the same market.

Methodologically speaking, the interpretation of cross-elasticity is not an exact approach and can be misleading. Moreover, demand elasticity changes at different price ranges and hence can vary over time. Common sense evaluation then becomes an important factor in the determination of market boundaries.

The process of defining market boundaries starts with the United Nations International Standard Industrial Classification of All Economic Activities (ISIC, Revision 3). The VAT Department at the Ministry of Finance has adopted this Standard, and adapted it to domestic conditions by adding a number of 4-digit activities and extending some to the 6-digit level. The report adopts this classification, and uses the VAT and merchandise import data in 2002 that have been supplied by the Ministry of Finance.

Concentration measures are usually estimated for specific product markets. Aggregate concentration measures for a group of activities or for the whole economy can also be estimated using, for instance, data on interlocking directorates or control by family groups throughout the economy at large. These measures are, however, outside the scope of this report and would be, in any event, severely hampered by the absence of reliable data. The concentration measures that are calculated in this report are therefore for single product markets in industry and services. For agriculture, where no recent data on sales, or other relevant variable, are available for single products or markets, concentration is measured for the whole activity.

2. Concentration in agriculture

Table 3 below summarizes the results of the agricultural census that was undertaken by the Ministry of Agriculture and FAO during October 1, 1997 – September 30, 1998. The total number of farmers exploiting agricultural land was approximately 195,000 and the total farm area 2.5 million dunums (one dunum is 1,000 square meters, or about a quarter of an acre) [5].

Table 3
Farm Distribution by Farm Area, 1997-98
(Cumulative distribution)

Number of farmers	Farm area
Top 1%	25%
5%	47%
10%	58%
20%	73%
Bottom 10%	0.4%
50%	8%
75%	22%

Source: Republic of Lebanon and FAO, 2000

Concentration in agriculture is presented in Table 3 as a distribution of farmers, or farms, in relation to farm area. By viewing farm area as proportional to output, the table reveals a distribution of aggregate agricultural output in relation to the number of farmers. The figures in the table clearly show quite a skewed distribution: 5 per cent of all farmers exploit 47 percent of the total farm area whereas, on the other end of the distribution, the smaller half of the farmers operating in Lebanon exploit only about 8 per cent of the total farm area. The corresponding Gini coefficient, which provides a summary measure of the degree of inequality of the distribution, is 0.69, which is quite high[6].

[5] Each farmer is associated with one farm, so that the total number of farmers is equivalent to the total number of farms.
[6] A coefficient exceeding 0.30, say for income distribution, is characteristic of developing countries, and a coefficient exceeding 0.50 usually reflects strong inequality.

These high-concentration figures are tempered, on the other hand, by the fact that they do not account for imports and they refer to the sector as a whole rather than to separate markets for specific agricultural products. Considering these factors would make the degree of concentration smaller than what is implied by the table above. Moreover, most agricultural products are quickly perishable, which reduces the market power of sellers, compared to sellers of manufactures and services.

Market power in agriculture has a bearing on the prices of the products of other activities in the economy, the influence being in line with the extent of agricultural supplies to the other activities. However, this price impact appears to be limited. In fact, based on the 1995 national accounts estimates, agriculture contributes only about 6% of total domestic inputs and about 13% to total value added or GDP. While the exact figures relating to the contribution of agriculture to economic activity may be underestimated, the strength of linkages between agriculture and the rest of the economy remain relatively weak.

3. Concentration in manufacturing and services

3.1 Ideally, the measurement of market concentration, and the study of competition in general, are best approached at the level of the single market. Thus, measuring concentration simultaneously in hundreds of markets at the national level clearly does not present the same degree of precision as that given by measurement at the single market level. The concentration measures that are detailed in this report do provide, however, a first and general view of the degree of concentration in practically all of Lebanon’s markets, thus setting an objective basis for policy formulation and for further analysis of concentration and competition in specific markets.

Table 4
Market and Establishment Distribution
by Activity and ISIC Code

Economic activity	**ISIC Code**	**Number of Identified Markets**	**Number of reporting establishments**	**Reporting establishments (in %)**
Agriculture [1]	01-02	5	19	0.3
Mining and quarrying	10-14	4	16	0.2
Manufacturing products	15-37	115	1,356	18.3
Food, textiles, apparel and leather [2]	15-19	(30)	(383)	(5.2)
Wood, paper and media	20-22	(14)	(268)	(3.6)
Chemicals, plastics, metallic and non-metallic [3]	23-28	(37)	(485)	(6.6)
Machinery and equipment	29-35	(27)	(152)	(2.1)
Other	36-37	(7)	(68)	(0.9)
Electricity, gas and water supply	40-41	3	28	0.4
Construction	45	21	507	6.8
Sale of motor vehicles and motorcycles [4]	50	7	506	6.8
Wholesale and commission trade, except for (50)	51	20	1,043	14.1
Retail trade, except for (50)	52	51	2,166	29.3
Hotels, restaurants	55	9	283	3.8
Transport, storage and communications	60-64	14	290	3.9
Financial intermediation [5, 6]	65-67	8	19	0.3
Real estate, renting and business activities	70-75	36	805	10.9
Education [6]	80	4	9	0.1
Health and social activities [6]	85	6	101	1.4
Other community, social and personal service	90-95	17	117	1.6
Extra-territorial organizations and bodies	99	2	14	0.2
Undetermined	----	----	123	1.7
Total		**322**	**7,402**	**100.0**

Source: Compiled from data supplied by the VAT Department, Ministry of Finance.
Notes: 1- Includes forestry. 2- Includes tobacco products. 3- Includes petroleum products. 4- Includes sale of spare parts, repair, and sale of automotive fuel. 5- Includes insurance, other financial services. 6- Commercial banks, most educational, health establishments are excluded because they are VAT-exempted.

The report has used the VAT data for the last three quarters of 2002, relating to the domestic sales and exports of 7,402 establishments that are subject to VAT reporting[7]. These are the establishments with annual sales of at least LL 500 million (about $332,000) and that have submitted the required information to the Ministry of Finance. Nonetheless, the reported data include establishments with annual sales below the LL 500 million threshold.

Table 4 above summarizes the details concerning these establishments, particularly their allocation into 322 separate markets. These markets are mostly classified at the 4-digit level of ISIC, with 98, or a little less than the third, at the more detailed 6-digit level. Data are not available for some categories of enterprises, such as commercial banks, medical doctors and educational establishments, which all are exempt from VAT and are not required to report for VAT purposes.

Table 4, and the concentration measures relating to it, is not comprehensive in that they do not include some categories of establishments. These are the establishments that are out of scope of VAT, namely those with annual sales of less than LL 500 million, plus a few activities that are VAT-exempted such as those undertaken by commercial banks, medical personnel, and educational establishments. In addition, omitted from the coverage are VAT-eligible establishments that nonetheless have failed, for one reason or another, to submit to the Ministry of Finance the required information for the year 2002.

3.2 Tables 5-7 below present the summary results on the state of concentration in Lebanese markets.

The total number of markets is 288, instead of 322 as in Table 4, because of the exclusion of all markets in activity sections 8 (education, health and social work) and 9 (other community, social and personal service activities) that mostly include non-profit activities. Also omitted from Table 5 are activities 75 (public administration and defense, and compulsory social security) and a few commercial banks, which reported data though they are in principle excluded from reporting. These 288 markets, which consist of 7,029 establishments, are the subject of our analysis below.

The CR1, CR3 and CR5 indicators refer to the concentration ratios of the largest 1, 3 and 5 establishments, respectively, in given markets. The concentration ratios are cumulative in that each of the concentration indicators covers all the markets. For example, CR3 for the concentration range 40-60% also includes all the markets that have less than 3 establishments, say 1 or 2, but where the concentration ratio of these markets falls in the

[7] The survey covers 7,742 establishments, of which 340 have been excluded because they have no data applicable to the measurement of concentration. This leaves 7,402 establishments with applicable data, including 123 establishments with undetermined economic activity.

relevant range 40-60%. Similarly, CR5 also included all the markets with less than 5 establishments but with the relevant range.

The turnover in each market consists of domestic sales, exports, and the imports of merchandise that correspond to the market in question. The merchandise imports for the year 2002 have been allocated to the markets only in agriculture and manufacturing (ISIC sections 0-3). The reason for including imports only in these markets is because merchandise imports act as substitutes, and hence competing products, in the markets for agricultural and manufacturing products. The study of concentration and competition in separate markets requires the inclusion of substitute imports in these markets.

The total turnover of $20,374 million, used in Tables 5-7, double counts imports. These are added to the markets in agriculture and manufacturing, in addition to their implicit inclusion in various markets, in commerce in particular. The total turnover figure is nonetheless kept without correction because already it does not take into account all the establishments, large and small, that have not reported for VAT purposes. VAT officials estimate the sales turnover of these establishments to be at least 25 percent of the reported data, i.e. about $ 5 billion, which is very close to the value of merchandise imports used in this study ($5.3 billion). Moreover, reducing the total turnover figure would, overall, tend to increase concentration ratios.

3.3 Table 5 shows the distribution of markets according to CR1 values, i.e. the values of the market shares of the largest, or dominant, firm. The report uses the words ‘firm” and “establishment” interchangeably.

Table 5
Market Distribution
by 1-Firm Concentration Ratios (CR1)

CR1 Range	Number of Markets	%	Number of establ.	%	Turnover ($ millions)	%
80 – 100%	34	11.8	349	5.0	1,763	8.7
60 – 80%	18	6.3	118	1.7	681	3.3
40 – 60%	51	17.7	474	6.7	2,135	10.5
20 – 40%	61	21.2	1,299	18.5	2,870	14.1
0 – 20%	124	43.1	4,789	68.1	12,925	63.4
Total	**288**	**100.0**	**7,029**	**100.0**	**20,374**	**100.0**

Source: Compiled from data supplied by the VAT Department, Ministry of Finance.

A major reason for the study of market concentration is to identify oligopolistic structures that are likely to exhibit oligopolistic behavior. In empirical studies in the US, the threshold concentration value has been 40 percent for the 4-firm concentration ratio (CR4). The implication is that the likelihood of monopolistic or oligoplistic behavior increases in tandem with the increase in the concentration ratio beyond the 40 percent level for the largest 4 firms.

The report also adopts the 40 percent threshold as a reference level. In general, the interpretation of CR values needs to be qualified by statistical and specific market considerations, as is done below.

CR1 distribution shows that about 36 percent of Lebanese markets, with 23 percent of total turnover value, had a dominant firm with a market share of at least 40 percent. Note that the application of the 40 percent threshold to CR1 is a conservative approach since the likelihood of monopolistic behavior is quite strong in markets where dominant firms have market shares of at least 40 percent,.

Table 6
Market Distribution
by 3-Firm Concentration Ratios (CR3)

CR3 Range	Number of Markets	%	Number of establ.	%	Turnover ($ millions)	%
80 – 100%	83	28.8	653	9.3	3,362	16.5
60 – 80%	36	12.5	388	5.5	1,120	5.5
40 – 60%	47	16.3	1,141	16.2	3,591	17.6
20 – 40%	62	21.5	3,512	50.0	6,982	34.3
0 – 20%	60	20.8	1,335	19.0	5,321	26.1
Total	**288**	**100.0**	**7,029**	**100.0**	**20,374**	**100.0**

Source: Compiled from data supplied by the VAT Department, Ministry of Finance.

Table 6 shows the distribution of markets according to CR3 values, i.e. the concentration ratio values of the largest 3 establishments. This CR3 distribution may be the most telling of the state of oligopolistic or monopolistic structures in Lebanese markets.

In 2002, about 58 percent of Lebanese markets, representing a little less than the third (31 percent) of the establishments had a concentration ratio of at least 40 percent for the largest 3 establishments. Of course, these markets include those with less than 3 establishments and a concentration ratio of at least 40 percent. The corresponding share of the total turnover for these “oligopolistic” markets is 40 percent (about $8 billion).

Table 7
Market Distribution
by 5-Firm Concentration Ratios (CR5)

CR5 Range	Number of Markets	%	Number of establ.	%	Turnover ($ millions)	%
80 – 100%	110	38.2	939	13.4	3,989	19.6
60 – 80%	40	13.9	915	13.0	3,246	15.9
40 – 60%	40	13.9	1,960	27.9	3,924	19.3
20 – 40%	48	16.7	2,899	41.2	5,290	26.0
0 – 20%	50	17.4	316	4.5	3,926	19.3
Total	**288**	**100.0**	**7,029**	**100.0**	**20,374**	**100.0**

Source: Compiled from data supplied by the VAT Department, Ministry of Finance.

Table 7 shows the distribution of markets according to CR5 values, i.e. the concentration ratio values of the largest 5 establishments. If the threshold concentration value is raised in this case to 60 percent, the result would still be one of a relatively large number of oligopolistic markets. In fact, about 52 percent of markets, representing a little more than the quarter of establishments and about 36 percent of turnover value, have a concentration ratio for the largest 5 establishments of at least 60 percent.

The summary results concerning concentration in Lebanese markets can be stated as follows: at least half the markets in Lebanon, which account for at least 40 percent of the total market turnover value, may be considered to have monopolistic or oligopolistic structures. These markets are likely to exhibit a corresponding behavior in terms of pricing and restrictive practices.

3.4 Several qualifications need to be borne in mind with regard to the concentration measures and the results obtained in the tables above.

There are factors that lead to the underestimation of market concentration or power. The principal ones are:

- Defining market boundaries at the common 4-digit level is considered too broad a delineation of boundaries. Defining markets at the 6-digit level, and even higher, is more accurate but it would reduce the market size and tend to increase the degree of concentration in markets.
- Vertical integration among enterprises limits competition in downstream markets. The VAT data clearly do not include information on the degree of vertical integration in Lebanese markets, and the report estimates of concentration implicitly assume that all markets are independent.

- Similarly to the case of vertical integration, apparently independent and unrelated markets may in fact be ‘concentrated” through a common ownership by a conglomerate. An illustration is an importer and wholesaler, who can be the exclusive agent of many of these imports, who sells these products in many unrelated markets.
- Some businesses, e.g. in retail trade and services, operate in localized rather than one national market. Geographical considerations therefore segment the national market and tend to raise concentration levels.

On the other hand, the major sources of overestimation of market concentration are:

- Including in the VAT database all the “small” enterprises, i.e. those with annual sales of less than LL 500 million, and all the VAT-eligible enterprises that have not reported data would tend to reduce the concentration levels.
- The VAT data classify establishments according to the ISIC code of their principal product or activity. The markets of the principal and secondary products can be quite different, e.g. gas stations selling food items, libraries selling phone cards, etc. The secondary products may then have to be classified in other markets, which would increase the size of those markets and reduce their degree of concentration. However, since all the sales, of the principal and other products, are classified according to the ISIC code of the principal activity, the concentration ratio for that code becomes overestimated. The net effect of these errors cannot be determined.
- The non-allocation of undetermined products to specific markets (see Table 4 above) reduces the size of the market and, hence, overestimates the degree of concentration in markets where these omitted products belong.

The report considers that the balance of these estimation errors lies on the side of under- rather than overestimation of market and economic power.

4. Concentration in specific markets

The report includes as an Appendix a list of all the markets that have been identified from the VAT data. The Appendix table shows the full list of the markets and their corresponding ISIC codes, domestic sales, exports, imports and market size. The concentration ratios, CR1, CR3, CR5 and the Herfindahl-Hirschman Index (HHI) are also shown for each market.

4.1 Commercial banks are not subject to VAT. Concentration in the commercial banking market is directly calculated from data on total deposits (in LL and foreign currencies) at all the commercial banks, as at the end of 2001.

At end 2001, CR1, CR3 and CR5 for total deposits in commercial banks were 14%, 32% and 48%, respectively. In other words, the largest three commercial banks in Lebanon then held about a third of total deposits and the largest five held about half the deposits. The Gini coefficient for the distribution of total deposits was 0.68, which indicates a strongly skewed distribution. A distribution according to total assets should be similar to that of deposits, whereas a distribution according to credit to the private sector is likely to be even more skewed.

Following the significant bank merger activity that took place in the course of 2002, concentration in banks should now be greater than what it was about a year ago.

4.2 Table 8 below shows from the Appendix a selection of markets that are characterized by high concentration ratios. The criteria of selection are either a CR1 of at least 40 percent or a CR3 of at least 60 percent, and a relatively large market size of at least $25 million.

Table 8
High-concentration Markets

ISIC Code	Economic activity	CR1	CR3	HHI [1]	Number of establish.	Market turnover ($ millions)
	Manufacturing products					
1554	Soft drinks	45%	69%	26%	10	172
1555	Mineral waters	52%	88%	34%	5	27
2103	Hygienic paper and diapers	41%	59%	20%	16	109
2421	Pesticides and other agro-chemical products	59%	64%	35%	5	95
2424	Soap	57%	77%	35%	19	89
2425	Detergents and house cleaning products	49%		24%	2	61
2694	Cement, lime and plaster	46%	65%	25%	16	75
2695	Articles of concrete, cement and plaster	40%	57%	18%	88	225
2892	Treatment and coating of metals; general mechanical engineering	48%	100%	37%	3	249
3130	Insulated wire and cable	67%	85%	47%	5	61
453901	Repair of electrical elevators	43%	79%	27%	13	21
	Wholesale trade					
5050	Liquid fuel	95%	96%	90%	218	169
512103	Live birds and other animals	86%	99%	75%	4	43
514100	Solid, liquid, gaseous fuels, related products	43%	83%	27%	14	107
514101	Liquid fuels and mineral oils	88%	98%	77%	23	89
514102	Liquid gas in bottles	71%	95%	54%	5	33
	Services					
7123	Renting of electronic equipment (computers)	42%	83%	28%	19	38
9000	Sewage and refuse disposal, sanitation and similar activities	58%	94%	45%	9	115

Source: Compiled from data supplied by the VAT Department, Ministry of Finance.
Note: 1- HHI is the Herfindahl-Hirschman Index.

Regarding Table 8, and the Appendix, the reader needs to be reminded that the numbers are based on the VAT data as reported by the various establishments. This means that the actual concentration and market size conditions may actually be significantly different from the numbers shown for a specific market. The main sources of error would be inadequate reporting by establishments in the first year of operation of the VAT system, and problems of classification of both domestic establishments and imports with the appropriate ISIC codes. Nonetheless, the estimates in their totality do provide a fair reflection of the degree, if not of the minimum degree, of concentration in Lebanese markets.

The numbers in Table 8 show a greater incidence of high concentration in manufacturing than in other activities. However, this may be a misleading impression. In commerce or trade in particular, economic power is likely to be greater than the numbers indicate since single traders operate in different markets more frequently than in manufacturing.

A major factor that can explain the high concentration levels in Lebanese markets is the relatively small size of these markets, which is mainly determined by the size of the economy as represented by its GDP level. In manufacturing in particular, the size of a market is small "relatively" to the minimum efficient scale of production and the associated capital requirements. A minimum efficient scale of production reflects the state of the industrial arts and the extent of economies of scale present in specific markets. This is analyzed at length in section 3 of the next part of the report.

High concentration implies monopolistic and oligopolistic behavior, with the expectation of collusion among enterprises, and other restrictive practices that lead to prices being greater, and investment lower, than they would be under conditions that are more competitive. A critical element in the understanding of enterprise behavior is the height of barriers to entry, and that is independently of the state of concentration in the market and the reasons behind it. This is the subject of the next part of the report.

V. BARRIERS TO ENTRY

The measurement of concentration in various markets in Lebanon has provided a preliminary but not sufficient assessment of market power. A more comprehensive picture of market power is offered after a consideration of the barriers to entry, which perhaps constitutes the principal characteristic of market structure and determinant of competition in markets.

In contestable market theory, the conditions of entry and exit, as represented by sunk costs, are the single most important determinant of the degree of contestability, or potential competition, in a given market. As such, barriers to entry and exit should be the primary focus of an economic policy that aims at enhancing competition.

1. The contestability of markets: Barriers to entry and exit

1.1 Entry costs, similarly to exit costs, are disincentives on entering a market. So entry and exit barriers operate in a similar manner, and "barriers to entry" are here often used in short for "barriers to entry and exit". When markets have free entry and exit, they are called perfectly contestable markets.

Traditionally, barriers to entry refer to the cost and time it takes a new firm to enter a market. This useful definition gives an indication about the absolute cost that a potential or new firm would have to incur to enter a market. However, it is too general a definition and does not distinguish between the cost conditions faced by a new entrant and those incurred by an incumbent or already operating firm. Strictly speaking, barriers to entry are defined as a cost that must be incurred by a new entrant that an incumbent firm did not have to bear. For the purposes of this report, barriers to entry will be assessed from both the absolute and relative cost perspectives.

One approach to the measurement of the absolute barriers to entry starts with a detailed study of a market's technology, its business and legal environment, the availability of raw materials and labor, etc. The costs of entry to the market are evaluated, and a subjective assessment is then made as to the size of the barriers to entry.

A more systematic approach divides barriers to entry into two general groups, natural and artificial. Natural barriers to entry usually are technical in character (e.g. production technology) or derive from some market structure parameter (e.g. market size) to such an extent that they lead to prohibitive cost conditions in a given market environment. Artificial barriers, as the name indicates, are mainly related to rules, regulations and norms that are imposed and that practically restrict entry at least to some enterprises.

Natural barriers are not necessarily constant barriers that escape change. Rather, the speed with which these barriers can be reduced largely depends on the speed of change in the structure of the market in question and the economy at large. Some natural barriers to entry relate to the ownership of scarce raw materials or some specialized skills that are in short supply. These types of barriers are, however, relatively few. The more prevalent types of natural barriers are classified into four types, based on the pioneering work in the mid-1950s by the economist Joe Bain on competition in US manufacturing industries:

- Economies of scale
- Capital requirement
- Absolute cost advantage
- Product differentiation

Each one of these will be taken up in turn below, with focus put on economies of scale and capital requirement, which, in Lebanon, lend themselves to statistical investigation more easily than the other two.

Natural and artificial barriers to entry in a given market may contain common elements so that the two sets of barriers may overlap. This is why the discussion of artificial barriers mostly refers to the administrative and regulatory environment, in terms of administrative procedures, laws and regulations that raise the time and cost associated with market entry, either absolutely and/or relatively to incumbent firms. They may also refer to business practices, such as limit pricing and agreements among incumbent firms that make it difficult for new entrants to operate profitably. It is, however, the regulatory environment that usually is the focus of remedial measures.

1.2 Following Joe Bain's work, noted above, the level of barriers to entry can be divided into three types, according to the ability of incumbent enterprises to raise prices in view of the advantage they possess in terms of existing barriers to entry:

- Very high, for markets where enterprises can raise price by at least 10% above the competitive level
- Substantial, for markets where price can be raised between 7 and 10% above the competitive level
- Moderate to low, for markets where price can be raised between 4 and 7% above the competitive level

These rates of price increases represent stringent criteria that can make most barriers to entry in Lebanon of the very high variety. The criteria are understandable, however, if applied to the US economy, which is characterized by large markets that can accommodate the exploitation of scale economies and competitive structures at the same time (see on this issue section 3 below), in addition to the implementation of severe antitrust laws.

It would of course be difficult to apply these criteria on Lebanese markets because, in the first place, it would not be empirically feasible to determine the reference competitive level of prices. However, one would also expect that, with barriers to entry, prices would be increased by more than 10 percent in most Lebanese markets. A rough empirical support for this assessment is a comparison of prices in Lebanon of imported products with the prices of the same products in their country of origin.

2. Factor costs as barriers to entry

Although factor costs do not operate as barriers at the national level since, barring cases of price discrimination and access to factors on preferential terms for some enterprises, factor costs equally apply to all domestic sellers. However, the impact of factor costs, and factor productivity, is relevant and important in the domain of foreign trade for both exports and imports.

Merchandise exports in 2002 amounted to approximately $ 1 billion, or about 5 per cent of GDP, versus an average of 19 per cent of GDP in the few years prior to 1975. Clearly, Lebanese exports still have a long way to go. The following is a brief investigation on the importance of factor costs on domestic production and exports.

a) Labor

Absolute labor costs are not high in Lebanon. Indeed, since 1996, minimum wages have stood unchanged at LL 300,000, or about $200 per month. Minimum wages are operative in the labor market since they are widely applied to unskilled positions in manufacturing and services.

However, what mainly matters in issues of competitiveness is productivity and not only costs, whether of labor or any other factor of production. Lebanon's GDP in 2002 at constant prices in still at approximately the same level as in 1974. Based on a labor force of approximately 1.5 million in 2002, which is about double the labor force in 1974, this means that the average productivity of labor is currently about half its level in 1974. The conclusion is that labor productivity has in fact declined or, has not improved at best, compared to its level in the period just prior to 1975.

The line of causation between low wages and low productivity is not always clear. Low wages may be due to low productivity, but low wages may also elicit low productivity on the part of workers. In any event, a decline in, or stagnant, labor productivity over a relatively long period has important adverse implications for domestic competition and competitiveness with foreign markets.

Usually, new investments positively respond to increasing productivity and are negatively affected by low productivity. The implication is that the rate of new entry in markets is slower in the absence of increasing productivity, which does not favor greater competition in markets.

b) Capital

The Lebanese economy, if ever, has rarely suffered from capital shortages. This is best illustrated by an open external account with a balance of payments that is frequently in surplus, and by a free domestic capital market. However, access to capital has not been relatively easy or inexpensive, as represented by the level of interest rates on loans and by the ease or difficulty of access to credit.

The average nominal interest rates on loans in LL and US dollars to the private sector were 17.3 and 10.6 percent, respectively, during 2000-2002, and this is after having declined from previous years. The average weighted nominal rate on all loans, in LL and US dollars, was 11.6 percent during the period in question, with a corresponding real interest rate of about 11 percent. This is quite a high lending rate in an economy that has averaged during the last three years an annual growth rate of only 1.2 percent.

Clearly, these interest rates are prohibitive to many businesses, especially when growth in economic activity is ranging between 1 and 2 per cent. In addition, most bank lending is extended short-term, usually in the form of renewable overdrafts, although banks have been making modest attempts to extend more medium-term loans to borrowers. Thus, the cost of capital is relatively high to the private sector, especially in the absence of strong economic growth and the scarcity of medium and long-term lending to business concerns.

If the hire of capital can be expensive to some businesses, it can simply be inaccessible to many others. As noted previously, about 90 percent of businesses in Lebanon are small-scale enterprises employing at most 10 workers. Many of these enterprises are not considered by banks to be good risk or to have sufficient collateral in support of an eventual bank facility. As a result, bank credit to the private sector is very concentrated among a relatively small number of large-size enterprises.

Indeed, at end June 2002, only 1 percent (845 beneficiaries) of all bank loan beneficiaries had received 52 percent ($16 billion) of total bank loans to the private sector. The loan range for each of those beneficiaries was in excess of LL 5 billion ($3.3 million). On the other end of the distribution, the bottom 79 percent (about 66,000 beneficiaries) had received only 8 percent ($1.3 billion) of total loans. The loan range for each one of those beneficiaries was less than LL 100 million ($66,000).

c) Land

In a small-size country such as Lebanon, with a concentration of population and economic activity in the center, and particularly in the capital Beirut, land prices are bound to reflect this situation. Land prices and space rentals are significantly more expensive in Greater Beirut than in other parts of the country.

Although country size and population density are important explanatory factors of land prices, the legal framework can also significantly influence prices. Inheritance laws in Lebanon often lead to situations where real estate, and land in particular, is parceled to an increasing number of heirs over time, sometimes in the dozens. The parceling of land, and the legal and financial difficulty associated with giving it back its unitary character, have contributed to a reduction in the supply of land as a factor of production, and hence to a rise in its price.

As an illustration of land prices, during 2000-2002, the average price per square meter of land in Greater Beirut was $2,056, with a range of $375 to $3,575. In contrast, the average price in other parts of the country ranged from as little as $11 (in Hermel) to $274 (in Sidon)[8].

To add to the cost attractiveness of operating outside Greater Beirut and urban centers, the Government has offered fiscal incentives, in terms of tax exemptions, to businesses that operate in rural areas. The incentives seem to have had little impact since enterprises of all sorts, including in manufacturing, remain heavily concentrated in and around the capital.

Although the number of small establishments has increased in rural areas, the concentration of employment and value added produced remains high in central Lebanon. The failure of

[8] See Lebanon Opportunities, various issues.

large enterprises to move to less expensive locations in rural areas, despite the additional attractiveness of financial incentives, is proof that any savings from relocation may be viewed by these enterprises to be more than offset by costs associated with distance between rural and urban areas, costs of transportation and communication in relation to workers and customers. This phenomenon serves to highlight the central importance of the upgrading and modernization of the transportation network throughout Lebanon, as a device to promote new investments, the creation of new enterprises, and greater competition.

3. Natural barriers to entry: Economies of scale

Economies of scale indicate a relationship between cost and output. They arise when average cost falls as output increases, which is a favorable situation to enterprises and an incentive to expand production. If average cost increases with an increase in output, the situation is one of diseconomies of scale, which constitutes a check on output expansion.

3.1 As economies of scale continue to appear with larger levels of output, a given market size would then be able to accommodate fewer and fewer efficient enterprises or establishments. This means that an enterprise contemplating entry in the market would originally have to bear higher unit costs of production, compared to the incumbent enterprises that already enjoy the scale economies. It is this phenomenon that can make economies of scale an important barrier to entry.

Economies of scale are most relevant and best exploited in industry, which is the reason for the focus of their study on manufacturing activity. The presence of economies or diseconomies of scale, and the extent of their exploitation, is usually assessed at the plant, enterprise or single market level, which is best done by engineering studies and is well beyond the scope of this report.

Economies of scope is a concept that is similar to, but more general than, economies of scale. Economies of scope arise when the enterprise is producing or selling two or more products, which afford it a reduction in costs through the utilization of common inputs, in addition to other savings such as in purchasing and marketing expenses. Economies of scope can be particularly important in Lebanon where the small size of the market has led enterprises, in various activities and not only manufacturing, to sell more than one product. Trading enterprises can realize substantial savings from the economies of scope.

However, the data that are available for the purpose of this report relate only to single-product markets or to the principal product sold by each enterprise, which implies that the report can only focus on economies of scale as such rather than economies of scope.

Economies of scale (scope) can present the policy maker, especially in small economies, with the dilemma of choosing between either more efficiency or more competition, but not both. Economies of scale can be an important source of efficiency by affording enterprises lower unit costs of production, which can be an important incentive for investment and a source of growth. However, they also are a major determinant of market concentration.

The dilemma is best approached empirically through a contrast between the extent of potential scale economies in the market in question, on the one hand, and the increase in market power, or decrease in competition, that the realization of scale economies would entail on the other. In this regard, for instance, German authorities encourage the merger of small and medium-size enterprises in order to take advantage of economies of scale, which indicates a priority attached to efficiency over concentration[9].

3.2 A way of resolving the above-mentioned dilemma is to aim for obtaining the largest number of enterprises or establishments that can be afforded by existing economies of scale. A useful concept in this regard is that of “minimum efficient scale of production” (MES). In a given market, MES is the smallest level of output at which the average unit cost of production is minimized.

Given a market size, e.g. total annual production or sales, a specific MES level entails a maximum number of efficient enterprises that the market can accommodate, with each enterprise producing at the minimum unit cost possible afforded by available technology. For instance, if the MES is about equal to the market size, the optimal market structure would consist of only one enterprise, making the market a “natural” monopoly; if the MES is about 20 percent of the market size, then the optimal number of enterprises would be five, and so on. This measurement of the optimal or maximum number of enterprises that is entailed by a given market size and an MES level can serve as a benchmark for estimating whether a market is naturally or artificially concentrated.

However, the question that needs to be first asked is: Are there significant economies of scale that are unexploited in the Lebanese economy?

The answer is yes. Indeed, the dominance of the Lebanese economic landscape by small enterprises, say those with 10 workers or less, constitutes prima facie evidence of the lack of exploitation of any potential efficiencies that economies of scale can offer. More systematically, however, a study that has used the Ministry of Industry’s survey for 1998-1999 to investigate the extent of scale economies in Lebanese manufacturing has found that labor productivity significantly increases with establishment size, and that productivity is close to the highest attained level in the group of establishments with at least 25 workers. These establishments constituted only about 2 percent of the total number of establishments in manufacturing, employed only about a quarter of its workforce and produced about half of its value added. The study further estimated that taking advantage of insufficiently exploited scale economies would at least double the total value added in manufacturing[10].

The above-mentioned study estimated the MES associated with existing scale economies by major grouping of manufacturing activity. The results are shown in Table 9.

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[9] See Singleton, 1997.
[10] See Gaspard, 2004.

Table 9
Economies of Scale and Barriers to Entry - Selected Markets

ISIC Code	Economic activity	MES [1] ($millions)	Market size ($millions)	Max. no. of establ.	Current no. of establ.[2]
	Manufacturing products				
1533	Prepared animal feeds	4.0	51	13	5
1542	Sugar	4.0	51	13	1
2101	Pulp, paper and paperboard	5.5	157	29	6
2421	Pesticides, other agro-chemical products	4.0	95	24	5
2425	Detergents, other house-cleaning products	4.0	61	15	2
2892	Treatment and coating of metals; general mechanical engineering	2.7	249	92	3
3130	Insulated wire and cable	5.0	61	12	5

Sources: Gaspard, 2004; and estimated from data supplied by VAT Department, Ministry of Finance and in Republic of Lebanon, 2000.
Notes: 1- The minimum efficient scale of production (MES) has been estimated at the 2-digit ISIC level, which was then applied to the corresponding markets at the 4-digit level (see text below).
2- Number of establishments that reported to the VAT Department in 2002.

3.3 The following procedure has been used to arrive at the results in Table 9. MES is assumed equal to that level of sales in establishments where labor productivity is at or close to the highest level attained, productivity being measured in terms of value added. This level was found to correspond to various establishment sizes, depending on the nature of economic activity. Optimal sizes were, however, mostly with at least 20 workers.

The average sales, or MES, level was first estimated for each manufacturing branch (available only at the 2-digit level in the 1998-99 industrial survey) as that average sales level in establishments with the highest productivity. Next, market size was estimated as the sum of domestic manufacturing output plus the corresponding imports of the same type commodity. Domestic output is derived from the VAT data on total sales during 2002[11]. While this estimation method provides only a rough approximation to the true MES level, it has the benefit of providing a quick indication regarding markets where there are strong indications that competition may be increased without jeopardizing scale economies.

Following the estimation of MES, markets have been selected as exhibiting a potential for new entry, based on the following conservative criteria. Only large markets have been considered, “large” being arbitrarily set at sales of at least $10 million. In addition, the selected markets are those where the number of currently operating establishments does not exceed six, and where the potential number of establishments that can efficiently operate in the market is significantly larger than the actual one.

[11] It should be noted that the VAT data includes many reporting establishments with total sales that are well below the mandatory minimum of LL 500 million.

The estimation of MES in commerce and other services is not as straightforward as in manufacturing. One can nonetheless set a minimum level of sales in each market, but that would be too arbitrary. Short of a reasonably reliable approach, the report does not attempt to provide MES estimates outside manufacturing.

4. Natural barriers to entry: Capital requirement

4.1 Financing requirements can be an important barrier to entry facing entrepreneurs. The difficulty may be associated with either the amount of investment required to enter the market and/or the financing terms of the new investment. The latter aspect regarding the cost of capital has been discussed in section 2 above, where it has been noted that interest cost can be relatively high and access to capital difficult. This section will therefore concentrate on the related issue of the amount of capital requirement as a barrier to entry.

Table 10
Newly Registered Capital and Employment in Manufacturing
(Average 1998-2000)

Economic activity	**Capital per establishment** ($ thousands)	**Workers per establishment**	**Capital per Worker** ($ thousands)
Manufacture of:			
Food products and beverages	336	10	33
Textiles and apparel	140	14	10
Leather products and footwear	69	6	11
Wood products and furniture	68	7	9
Paper products	245	8	32
Chemical products	187	6	31
Non-metallic products	358	8	43
Metallic products	105	6	17
Machinery and equipment	146	9	15
Jewelry	152	8	19
Other manufactures	486	11	46
Average	**203**	**8**	**25**

Source: Administration Centrale de la Statistique, *Bulletin Statistique Mensuel*, various issues.

The information in Table 10 above relates to data on newly registered establishments commencing various activities in manufacturing during 1998-2000. Clearly, new manufacturing establishments are small, whether measured in terms of capital or workforce. One inference is that new establishments can and do start operations with a small capital investment and that, as such, capital requirements do not constitute a significant barrier to entry.

Another more likely inference, which this report adopts, is that the predominance of small new establishments and the relative scarcity of large new ones in manufacturing are at least in part due to the high cost of and difficult access to bank capital. As noted previously, the average weighted bank loan rate (weighted by the distribution between $ and LL loans) during the last three years 2000-2002 was 11.6%. This rate corresponds to a real rate of about 11%, which becomes particularly prohibitive in periods of slow economic activity.

Access to capital on longer terms and lower interest rates can contribute to new entry and to the exploitation of existing economies of scale. These economies of scale do exist and can be substantial in manufacturing. In addition, the risk associated with new ventures often is borne by a single or few entrepreneurs. Finding ways to share the risk with, say, venture and/or bank capital, would significantly reduce the barriers associated with capital requirements and provide stronger incentive for entry with establishment sizes that give scope to taking advantage of economies of scale.

Capital requirements also act as high barriers to entry in professional activities, as opposed to industrial or trading activities. A good example is that of medical doctor services. Entry into this market usually requires a relatively large capital investment, in the form of schooling fees and expenses in well-known universities, and a waiting period of a number of years before the medical doctor is in a position to earn the expected large income.

The establishment in state universities of free or small-fee medical schools of good professional standing would contribute to a significant reduction in entry costs. This would increase competition in the market of medical services by increasing the supply of good medical services and reducing their costs, to the benefit of the consumer. Competition, and the benefit to the consumer, is reduced to the extent that prices for the professional services in question are centrally set by, for instance, the professional association.

4.2 The other natural barriers to entry that are briefly discussed below are the absolute cost advantage barrier and product differentiation. The brevity of the discussion does not necessarily reflect the importance of these issues but rather the absence of reliable detailed information to analyze them.

An absolute cost advantage refers to the cost differential between incumbent and new enterprises. When an entrepreneur contemplates entry in a market, the fact that incumbent enterprises incumbent operate at significantly lower unit costs than a new enterprise constitutes a barrier to entry. The relative efficiency of incumbents may be due to numerous factors and not only economies of scale, if any.

Data on absolute cost advantage are difficult to obtain in most markets. Nonetheless, these barriers should not, in themselves, pose a policy problem in Lebanon since they prevent less efficient enterprises from entering a market where more efficient enterprises are already operating. This is a typical textbook case where incumbents are driven to production efficiency in order, among other things, to prevent new entry.

Product differentiation refers to a market where similar products have different characteristics, e.g. personal computers, soft drinks, legal services, etc. The issue of barrier to entry arises in direct relation with the degree of differentiation of the product. Whether the differentiation is genuine or perceived as such by consumers, new enterprises would have to incur higher marketing costs than the established enterprises, and charge lower prices to attract customers, which constitute barriers to new entry. Advertising plays a central role in creating in the mind of the consumer an image of superiority or exclusivity of the advertised product. In this regard, advertising expenses are used as a measure of the extent of product differentiation and of the related barrier to entry.

5. Artificial barriers to entry

While the distinction between natural and artificial barriers to entry is not always clear-cut, a discussion of artificial barriers to entry usually focuses on the regulatory environment.

5.1 There are numerous official regulations that govern market entry in Lebanon. Most are standard safety and precautionary regulations that should not be taken as barriers to entry[12].

Laws on standards are technical regulations that equally apply to domestic products and imports. They may involve product testing, which is mostly conducted on food-related items. These regulations also affect tender documents in relation to government purchases.

Other standard regulations affect minimum capital requirements, for instance in joint stock companies and limited liability partnerships where minimum capital currently stands at LL 30 million and 5 million, respectively. These requirements clearly are not prohibitive.

There also are special regulations regarding foreign capital, such as the exclusion of foreign participation in media-related companies, and ceilings on the ownership of non-Lebanese individuals or entities in real estate and joint-stock companies. However, these regulations are motivated by political rather than economic considerations.

5.2 More important are the laws, regulations and procedures that constitute genuine barriers to entry that hinder competition. The report considers three such barriers that are deemed artificial in that they can be directly addressed by the authorities. These barriers relate to the legal and administrative processes, exclusive agencies and protection in general.

a) The legal process

Following the hiatus imposed by the war on legislative work, an official Committee for the Modernization of Laws has been at work for a number of years in order to bring Lebanese laws up to international standards. While many procedures relating to the Penal Code have been updated, little has been done to date regarding either the procedures or substance of commercial laws. Lebanese commercial law is largely based on French commercial law since France’s Mandate period, and most of its revisions date to the early period after independence. The civil procedures and the substance of Lebanese commercial law need substantial updating to bring them in line with modern business practices, e.g. in the domains of limited liability companies, bankruptcy proceedings, debt instruments, etc.

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[12] For details, see the internal document on business legislation of the Ministry of National Economy and Trade, 2002.

However, independently of the need to modernize the practice and content of Lebanese laws, it is in the domain of the legal process itself, i.e. the implementation of the laws, that many of the artificial barriers to entry lie. Lebanese courts are understaffed, and the legal process is long. Many enterprises involved in legal cases often have to wait many years before a ruling is passed, and additional years are further required at every stage if the case is appealed and then taken to the equivalent of the Supreme Court (Cour de Cassation). Even simple small cases, say rent disputes between tenant and landlord, may take a few years to settle. The lengthy legal process translates itself into unnecessary costs to enterprises and represents, as such, a disincentive to invest or to enter a market.

Exit procedures can also be time-consuming and costly. Businesses wishing to close down or terminate their operations may encounter a protracted exit process. Exit may be particularly expensive if labor disputes arise concerning the amount of compensation that should be paid to workers following termination.

Cases in Lebanon's Courts of Law can therefore take a long time to adjudicate and can be quite costly to the parties concerned. Moreover, the legal merit of a party's case may have little bearing on the ruling, which increases the degree of uncertainty and cost associated with the legal process. Of course, this cost burden, and hence the barrier to entry, is greater the smaller the enterprise. It is probably this characteristic of uncertainty that more important as a barrier to entry than predictable costs, and thus has the more adverse influence on the incentive to invest.

b) The administrative process

Despite recent efforts by Government to simplify and streamline procedures, the administrative process in Lebanon still has a long way to go before it can be called business friendly, particularly for small and medium enterprises.

Although most administrative procedures equally apply to all parties concerned, these can actually be discriminatory. Indeed, one expects that the larger the enterprise the more easily it can meet its administrative requirements. Generally speaking, the traditional Lebanese way of dealing with the administration through the so-called "wasta", or preferential treatment, implies a differential administrative burden and expense on individuals and enterprises, depending on the importance of one's "wasta". This means that the barriers to entry are discriminatory in their implementation on both incumbent and prospective enterprises.

Administrative regulations sometimes operate as genuine barriers to entry in that they may only apply to new enterprises. Indeed, some environmental regulations that have recently been introduced govern the operations of new enterprises but not incumbents, thus making new enterprises subject to higher operating costs compared to incumbents, other things equal.

c) Exclusive agencies and protection

Exclusive agents enjoy effective legal and administrative protection in Lebanon. Imports that are covered by an exclusive agency cannot be legally imported into Lebanon except through the legally entitled exclusive agent. Following an extensive debate of the issue, a draft law has recently been sent to Parliament proposing that government protection be gradually abolished over a 5-year period. The draft law effectively places questions relating to exclusive agencies in the legal domain, without any direct official protection or interference at the point of entry into Lebanon.

The law, if passed, should favor market entry, stimulate competition, reduce prices and benefit the consumer. The argument by exclusive agents that the quality of the product concerned, including after sales service, maintenance, etc., would be adversely affected by the new law to the detriment of consumers' interests is not justified. It is the market or the competitive process itself that will ensure that the price and sales of a particular product are set at levels that correspond to the inferior or superior quality of the product. The seller would have to respond in terms of price and quality to competition in the market, and the more intense the competition the lower the price and/or the higher the quality of the product. Profit margins may be reduced, but efficiency and consumer welfare will be promoted to the advantage of the whole economy.

The issue of exclusive agencies raises the wider important issue of official protection given to commercial enterprises, usually from the competition of imports. To illustrate, foreign entities in the insurance market should provide twice the amount of guarantees required from Lebanese entities. Although this report does not make a detailed presentation of markets that currently benefit from protective measures, it underlines the importance of the issue of protection in its impact on competition, efficiency and economic growth by underlining the principles that the policy maker needs to apply in protection matters.

The report emphasizes three principles that need to be taken into account by the policy maker when the issue of protection arises:

- First, an economic case for protection should be made. Only commodities enjoying strong demand, particularly export demand, should be considered for protection. Candidate commodities are usually in manufacturing, which is the principal source of dynamic growth in developing countries. Compared to other activities, manufacturing offers, over long periods, the advantage of mass production through economies of scale and the generation of more employment opportunities. In this regard, it would be equally important to avoid protecting stagnant activities or ones where the country is at a comparative disadvantage, e.g. textiles.

  Examples of dynamic branches in manufacturing can be varied, including electrical machinery and equipment that have been exhibiting a relatively good export performance. However, the traditional branches of food and apparel can have their dynamic niches too, say organic foods and fashion clothing. A good example of a dynamic activity outside manufacturing is computer software.

- Protection should be extended only over a limited period of time, say 3 to 5 years, lest it becomes a protection of privilege and inefficiency rather than a spur to greater productivity and competitiveness.

- Specific targets should be set for the entity benefiting from protection. These can be objectives that policy seeks to promote, namely efficiency and competitiveness. Examples are the achievement, after a number of years, of a minimum volume of exports and/or a selling price that is close to competing import prices. Failure to achieve the set target(s) may be penalized by reimbursement of the benefits received by way of protection.

6. A summing-up

6.1 Productivity studies indicate that there are important potential economies of scale to be exploited in Lebanon. However, given the relatively small size of the economy, these scale economies, and the associated capital requirements, constitute a significant natural barrier to entry by prospective investors. The high cost of capital, represented by the difficulty of access to medium and long-term financing and the relatively high rates of interest, also is a related barrier to entry.

It is also the view of the report that significant artificial barriers to entry in Lebanese markets are concentrated in the legal and administrative processes that can be time-consuming, discriminatory and costly. These barriers can be at least as important as those associated with economies of scale and capital requirement.

The application of the concept of MES points, however, to the possibility of taking advantage of scale economies without necessarily increasing concentration in several markets, particularly in manufacturing branches as noted in Table 9 above. Identifying the main obstacles or barriers that prevent new entry in these markets requires a detailed and separate study for each market.

6.2 Official policy seeking to promote competition necessarily focuses on structural parameters and on restrictive practices. In the case of structural parameters, policy measures attempt to reduce market concentration and barriers to entry. Restrictive practices (which are the addressed in the next part VI), on the other hand, are matters of conduct and can be subjected to penalties. The report strongly takes the view that the reduction of barriers to entry would be the optimal policy target in Lebanon.

The attractiveness of barriers to entry as a main policy target in Lebanon, and in developing countries in general, largely stems from policy in these countries being hampered by underdeveloped administrative and legal institutions and an inadequate information base. Developed and efficient official institutions are crucial instruments in addressing issues of concentration and restrictive practices. Moreover, interference by interest groups to influence policy in these areas can undermine the effectiveness of policy measures. These considerations may render the reform process inefficient or even counterproductive. Focusing on barriers to entry, on the other hand, is a less market-intrusive and more effective approach.

In contestable market theory, the barriers to entry, as represented by sunk costs, are indeed the only legitimate policy target (see sections 2.3-2.4 in part II above). This approach is particularly appropriate to Lebanon where markets are dynamic and direct policy instruments may be deficient. In a dynamic market setting, where markets with a high degree of concentration may of themselves become more competitive over time, direct intervention may thus be unnecessary. Policy would then better focus on minimizing entry and exit costs. In this regard, the report considers the legal and administrative reforms, and access to and the reduction of the cost of capital, as priority policy targets for the promotion of competition.

VI. PRICING AND RESTRICTIVE PRACTICES

Restrictive practices are the facts of non-competitive conduct. In the Industrial Organization paradigm, they arise from or are facilitated by non-competitive market structures, i.e. markets that have a relatively high degree of concentration and/or high barriers to entry. However, restrictive practices may also be assessed on their own, i.e. independently of any consideration of market structure.

Economic structure, such as market concentration and barriers to entry, can be a general target of economic policy, whereas restrictive practices are usually the direct target of antitrust laws and regulations. This is why a discussion of restrictive practices is heavily laden with legal considerations.

Part V discusses restrictive practices in Lebanese markets, but with much less detail than in the case of economic structure. It presents a general review of pricing behavior and regulations in Lebanon, in addition to a general discussion of restrictive practices based on the limited information that is available.

1. Pricing behavior

Business conduct or behavior is multidimensional, with price constituting one of its major dimensions. Other dimensions include investment and location strategy, selling terms and conditions, business alliances, etc.

1.1 In practice, the Lebanese economy is an open and free economy and only a few prices are directly regulated. The norm is that sellers freely set the prices of their products, subject only to market considerations. Legally, however, the Minister of Economy and Trade has the right to set a ceiling on commodity selling prices or profit rates. Where no ceiling is indicated, the maximum selling price should not exceed twice the amount of cost[13]. The Ministry itself includes a National Council for Price Policy, with representatives from various public and private institutions, among whose functions is to recommend prices and profit rates for domestic and imported products.

These rules are rarely enforced and, in any event, would be quite difficult to implement owing to accounting and administrative limitations. Some markets, on the other hand, are directly regulated; they are mainly in the utilities sector, such as energy products (including electricity), regular postal services, telecommunications, but also medicinal drugs and tobacco products.

While regulated prices are relatively few, Government has nonetheless recently implemented liberalization policies that seek to promote competition through the elimination of existing restrictions in regulated markets. The introduction of the Open-Skies policy in 2000 has cancelled the “5th Freedom Rights” enjoyed by the national carrier. Parliament has already received draft laws regarding the liberalization of oil and medicinal drug imports, whereby price ceilings rather than price levels are set. Moreover, as previously noted, a draft law has

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[13] Decree-Law 73/83, Articles 6 and 7.

been submitted to Parliament proposing the abolition of official protection of exclusive agencies over a 5-year period.

These liberalization policies are supported by privatization projects (discussed below), the most important of which is the impending sale to the private sector of the rights of cellular phone communication. Other privatization projects are expected to follow in the domain of energy and other public utilities.

1.2 Regarding pricing in the private sector, the typical theoretical model about pricing behavior is the competitive model where enterprises are price takers with no or little influence on price levels. The competitive model, however, has become more of a reference than an empirical model that can explain actual price developments. Its applications in practice are limited to a few markets with homogeneous products and a large number of sellers, as in domestic agricultural markets, especially at the retail level, and in international primary commodity markets.

The vast majority of markets are characterized by heterogeneous products that are sold in imperfectly competitive markets. Many of these markets have oligopolistic structures with a few dominant sellers who have a significant influence on market price. This is also the case of markets in Lebanon, as the previous part on concentration has shown. The problem with oligopolistic markets, as opposed to pure competition and pure monopoly, is that price and output are usually indeterminate, much depending on the specific circumstances of the market.

Empirical studies in many countries have nonetheless concluded that most enterprises follow a mark-up pricing approach, which we believe to be also followed in Lebanon. Mark-up pricing is a system whereby price is determined as average cost plus a mark-up. The mark-up is a profit margin that is added on the average cost of the product, all costs and expenses included.

The mark-up or profit margin level largely depends on the degree of market concentration and on the height of barriers to entry. Profit margins and prices increase with market concentration and tend to fall as markets become more competitive. Similarly, higher barriers to entry tend to maintain higher profit margins and prices in relation to more competitive conditions.

1.3 Barriers to entry have a particular influence on pricing behavior, which underlies their importance as a policy target. When barriers to entry are lowered, incumbent enterprises may be induced to lower prices and/or output in order to deter new entry. This is called “limit pricing”, which means setting the price and/or output at levels where new enterprises view entry in the market as unprofitable.

Limit pricing may involve output restriction in order to leave little residual demand to potential competitors and maintain relatively higher prices, unless new entrants are more efficient than the incumbents are and can therefore take market share by lowering prices. In any event, lowering entry barriers can have a strong downward influence on profit margins and prices, and on the promotion of competition in general.

Independently of structural and behavioral considerations, however, an effective Consumer Protection Agency that focuses its work on product quality control, monitoring product specifications, would much contribute to the promotion of exports and to the improvement of product quality.

2. Restrictive practices in Lebanese markets

Available information is clearly limited in the case of behavioral variables such as business conduct, and more severely so if the variable relates to illegal practices such as restrictive agreements among enterprises. The report can therefore include no documented information in this regard, but it presents below a detailed outline of restrictive practices that can serve as a basis for the Competition Law and competition policy in general. Some anecdotal evidence on restrictive practices will be mentioned to provide some indication about these practices in Lebanese markets.

2.1 Restrictive practices are deliberate behaviors that aim to exclude potential entrants in the market, prevent the expansion of incumbents and/or force their exit. The ultimate purpose of restrictive practices is to limit competition in order to increase market power and profits.

The US is the country with the longest experience in antitrust laws, which date back to 1890 when the Sherman Act became effective. It is also the country where restrictive practices can be heavily penalized. The European Community and individual European member countries, particularly the U.K., also have had a long experience in antitrust laws, but their attitude towards restrictive practices has been more lenient than that of the US.

Recently, however, the European Commission has introduced reforms in its antitrust rules, giving the Commission and national regulators more effective powers. These include the power to impose greater fines against what they see as the most serious restrictive practices that afflict the European economy: cartels and abuses of dominant position[14].

In the US, the Sherman Act has led to two types of court ruling in antitrust cases. The first is the "rule of reason", which weighs economic evidence and arguments to assess the existence of a so-called "intent to monopolize". The second, the "*per se* rule", is more stringent and is solely based on evidence of restrictive practices, such as agreements among enterprises, without consideration of the economic effects of the practice or agreement.

2.2 Restrictive practices often take the form of agreements, formal or informal, among a relatively small number of operating enterprises in a given market. Agreement-based practices in the US and Europe are usually more subject to charges of illegality than other types of agreement.

An illustrative list of agreements that restrict competition includes:

- Price fixing, e.g. Resale Price Maintenance (RPM), which usually is an agreement between an original seller and a reseller that prescribes a minimum price at which the reseller may sell the product.
- Dividing the market in exclusive spheres of influence, which can be geographical areas in which each seller would exclusively operate.

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[14] See Guerrera, 2002.

- Allocation of consumers by seller, whereby each seller has the exclusivity of dealing with a group of customers.
- Exclusion from the market of enterprises that do not abide by agreement-based pricing norms.
- Exclusive franchising and exclusive dealing

Other restrictive practices that are not necessarily based on agreements but usually consist of pricing policies that reflect a single enterprise's strategy include:

- Price discrimination, such as tying and bundling of products whereby the availability of one product is contingent upon the purchase of other goods and services, e.g. special inks that can be used only with special printer brands.
- Predatory pricing, which consists of an enterprise initially lowering price of its product, possibly even incurring losses, in order to drive competitors out of business, which would then be followed by a raising of the price. This policy is also used to prevent new entry.
- Limit pricing, which was discussed above.

Lebanese law prohibits restrictive agreements (Law 73/83). Article 14 specifically prohibits cartels or agreements that "limit competition … resulting in an artificial increase in prices or in preventing prices from falling". This is a weak legal prohibition in that the burden of the proof is on showing that the agreements would lead to an "artificial" increase in prices, which is difficult to define or determine, or would prevent prices from falling, which is a counterfactual event that is difficult to establish.

Lebanese law regarding restrictive agreements also is not sufficiently dissuasive since the maximum penalty amount is LL 100 million (equivalent to about $67,000) and/or 10 days to 3 months in jail[15]. To be dissuasive, the penalty would have to be significantly higher than the benefits expected to be derived from the agreement in question.

Although agreements between sellers are difficult to detect, indirect evidence can point to their existence. Cellular phone services in Lebanon are currently provided by a duopoly, Cellis and LibanCell. The fact that call rates charged by these two enterprises have been practically identical since their inception a few years ago constitutes strong *prima facie* evidence of collusion regarding prices. In fact, cellular phone rates are quite high in Lebanon: 13 cents per minute for dedicated lines, plus an upfront fee, and 35 cents for prepaid phone cards, versus 3 to 8 cents in other Arab countries.

Competition between Cellis and LibanCell would have led to a reduction in call rates. Price reductions could have taken the standard form of competitive packages offered to customers with, for instance, a number of free calls during evenings and weekends. This is the case in the US, where competition in the cellular phone services market is fierce.

Excess profits are the most important signal to potential entrants to join a market, where excess profits may be defined as profits that are above an average rate in other activities in the Lebanese market. The best policy in terms of competition is to allow free entry in this profitable market. This should benefit the consumer through lower prices and better quality

[15] Law 73/83, Articles 34 and 26, amended by Laws 72/91 and 490/96.

of service. However, this is a case where Government priority has been to generate more revenues rather than seek to reduce prices to consumers.

2.3 Restrictive practices apply horizontally and vertically. Vertical restrictions or restraints operate between sellers and are imposed by an original seller on another seller downstream. Horizontal restraints operate between sellers at the same level of the production chain; they may also operate between a seller and the ultimate consumer.

a) Vertical restrictions

Vertical restrictions include, from among the examples cited above, RPM, territorial restrictions concerning locations where a product may be resold, tying or bundling, and exclusive franchising and dealing.

In Lebanese markets, formal agreements may be few but not necessarily informal ones. A manifestation of the existence of agreements among sellers is the absence of price competition and a unison movement of prices charged by sellers in the market. Agreements, however, do not exclude competition in other domains such as advertising and selling terms.

Vertical restrictions are an important consideration in the analysis of competition in markets because seemingly competitive markets may turn out to be restricted in their competitive structure by vertical constraints. Illustrations abound in the retail consumer market, e.g. soft drinks, cosmetics, where numerous sellers are constrained by wholesaler-imposed RPM.

Exclusive agencies, discussed above, are vertical restrictions that currently enjoy legal and administrative protection in Lebanon. The draft law that was sent to Parliament proposes that government protection be gradually abolished over a 5-year period. Passage of the law would favor market entry and stimulate competition.

Other vertical restrictions that can be prevalent in Lebanon are territorial allocations of a market among sellers. Outside Lebanon, these have usually been prevalent in the building materials markets, including cement.

Tying and bundling examples are computer software and printers, in the latter case ink refills being particular to the product rather than standardized.

b) Horizontal restrictions

Horizontal restrictions mainly include price discrimination, which can take various forms such as personal, group or product discrimination, predatory pricing and limit pricing. The illustrations of horizontal restrictions will be restricted to price discrimination examples.

A typical example of personal discrimination is haggling over the price of any product, with various consumers ending up paying different prices for the same product. A more pervasive form of price discrimination in Lebanon is related to professional services, including those provided by lawyers, consultants, mechanics, electricians, plumbers, etc.

The discrimination exercised by these professionals is mostly related to the “size-up-the-income” variety, in which fees charged to the customer are often based on the income or wealth level of the customer as perceived by the seller. Thus, residents of high-income neighborhoods are usually charged higher rates for the same electrical and plumbing services than residents of lower-income areas.

A significant form of price discrimination continues to occur in the cellular phone services market. This is the two-part tariff discrimination whereby the consumer first pays a flat fee for the right to purchase as many units of the product at a specified price, in this case the subscription fee. The price charged for calls is the second part of the tariff. The first part of the tariff, i.e. the subscription fee, is a way to capture consumer surplus and, more important in view of the amounts paid, a way to make consumers finance capital expenditures.

Product discrimination is also exercised in Lebanese markets. It involves charging different prices for the same product that is packaged and sold under different brand names. Examples are canned foods, and so-called white goods such as refrigerators, gas cookers, etc.

Finally, not all restrictive practices have the same adverse impact on competition. For instance, US courts have been more lenient with vertical than horizontal restraints. Both US and European country courts have been much less lenient with restrictive practices such as cartel agreements, dominant firm abuses and territorial restrictions. However, no matter how restrictive practices are, they will be less likely to endure and harm market competition if barriers to entry are low rather than high.

VII. PRIVATIZATION AND COMPETITION

The Lebanese authorities have decided to embark on a privatization program that encompasses most public sector enterprises. The decision was reinforced in the recent Paris II Meeting that provided substantial financial assistance for the refinancing of public debt. For their part, the authorities undertook to implement over a five-year period ambitious structural reforms, including a privatization program.

Part VI discusses the conditions for the success of the privatization program and the pitfalls it needs to avoid in order that the program succeeds in promoting competition in the Lebanese economy.

1. Privatization in Lebanon

1.1 Privatization of public assets is usually driven by a paramount objective: efficiency, which should translate itself into lower costs, lower prices and a better quality of the product sold. As such, privatization seeks to achieve the same fundamental objectives as those of competition. Other objectives of privatization also work towards enhancing the competitive process. These are a broadening and deepening of capital markets through the issuance of shares to the public at large, and a speeding up of the structural reform process.

The issue of privatization is a relatively recent one in Lebanon. It has been mainly prompted by the need to improve efficiency in the delivery of public services. Over the years since the late 1980s, the public enterprise Electricité du Liban (EDL) and the national carrier Middle East Airlines (MEA), a private company with majority ownership by the public sector, have accumulated large amounts of losses and debt. These and other financial developments have led to an alarming increase in the fiscal deficit and in public debt, which has necessitated radical reforms, of which privatization is a major component.

In the case of MEA and other publicly-owned private concerns, such as the finance company Intra, the issue is not, strictly speaking, one of privatization. Public ownership of these companies came about following government financing over a number of years of continuous operating losses in these companies, and of capital asset purchases in the case of EDL. The cellular phone companies, Cellis and LibanCell, are private companies where “privatization” would involve the sale or long-term rental of the national cellular transmission rights that are public property.

Most of the institutions that are publicly owned are candidates for privatization. The ones that have been indicated as principal targets for sale in the document presented at the Paris II Meeting are in the power and telecommunications sectors, essentially the cellular phone rights and EDL. However, there also is a long and comprehensive list of other candidates for privatization, or for the sale of the public sector share in them. These include public utilities such as water, transportation, postal and hospital services, and also the oil refineries, Casino du Liban, Intra, the lottery, etc.

1.2 Several laws have recently been passed to speed up the privatization process. It started with the Privatization Law, No. 228 of May 2000, which has set among its main objectives the enhancement of the competitiveness of the economy and the protection of consumers' interests, objectives that are very much in line with what privatization should in principle achieve.

The Privatization Law was followed by the Investment Promotion Law, No. 360 of August 2001, which established The Investment Development Authority of Lebanon (IDAL) and accorded the highest priority to Information Technology projects. Subsequent laws have focused on the sectors that were being primed for privatization, namely telecommunications and electricity.

The Law on Telecommunications, No. 431 of July 2002, allows for a third operator of cellular phone services. Clearly, this should allow for more competition and a decrease in prices, though collusion among three enterprises in a lucrative market remains highly probable. The Law also stipulates the establishment of a telecommunications Regulatory Authority that should encourage competition in the market and, at the same time, generate more revenues for the state.

However, these objectives of more competition and more state revenues may be contradictory, at least for a number of years. This is especially true if, as likely, the demand for cellular phone services is inelastic over a relatively large range of prices. Allowing more competition may in fact bring in more enterprises and lower prices, with lower revenues to Government compared to a situation of two or three operators. Considering its difficult debt situation, the Government's priority currently is greater revenues rather than lower prices to consumers.

The Law on the Regulation of the Electricity Sector, No. 462 of September 2002, establishes administrative and financial independence for the separate phases of production, transmission and distribution of electrical power. Privatization is projected only for production and distribution activities, with transmission to remain publicly owned. The Law also stipulates a Regulatory Authority.

2. Guidelines for privatization

In implementing a privatization program, a primary principle to remember is that privatization is an instrument towards productive efficiency and consumer benefit and not an end in itself. In this regard, this section states important guidelines that need to be adhered to in the implementation process.

2.1 The prime candidates for privatization in Lebanon are in the telecommunications and electricity sectors. These are sectors with significant economies of scale that, given the size of the Lebanese market, may give rise to natural oligopolies. We say "may" give rise because the determination of the optimal number of efficient enterprises, i.e. with the minimum efficient scale of production or MES, would have to be empirically determined in each market.

In general, competition is promoted by unbundling activities in which economies of scale are important from those in which they are not[16]. In the case of electricity, vertical unbundling would separate generation, transmission, distribution and collection, but transmission is likely

[16] See World Bank, *World Development Report 1994*.

to remain a natural monopoly in view of the relatively large economies of scale associated with this activity. The Privatization Law allows for these considerations, but it does not mention collection as a separate activity.

In the case of telecommunications, and cellular phone services in particular, the issue is one of horizontal unbundling, which means allowing more competing enterprises to enter this profitable market. Despite a probable, and perhaps understandable, reluctance on the part of Government to allow as many enterprises to enter as the market will allow, freedom of entry in this dynamic market carries substantial benefits to the economy overall through spillover effects to many other sectors and not only to consumers.

2.2 Generally speaking, a successful privatization requires several ingredients. In Lebanon's case, chief among these is a Regulatory Agency for privatized public utilities such as electricity, water, telecommunications, transportation, etc.

The need for a Regulatory agency arises especially with natural monopolies or oligopolies, which would be the case with many utilities in Lebanon. The main functions and attributes of the Agency would be to:

- Assure adequate maintenance and sufficient long-term investments to prevent failures and shortages, as may occur in the case of electricity. Indeed, it is in the nature of many utilities with relatively important economies of scale that substantial long-term investments are required.

- Monitor price increases and service quality, particularly regarding public utilities such as electricity in rural and remote areas, in order to prevent an accentuation of social and economic disparities.

- Preserve its autonomy from both government and private sector pressures in order to be effective in its ability to limit the abuses of monopoly power.

Since final consumers are the best monitors of prices and service quality, non-government organizations (NGOs), especially those dealing with consumer issues, can be associated with the monitoring process. NGOs are quite active in Lebanon, and many have positively contributed to addressing social problems in the country.

3. Contrarian views

Privatization is not without its critics, and many of their arguments are relevant to the economies of developing countries, including Lebanon.

The first concern raised by the critics of privatization relate to the investment needs associated with privatized industries. The power, water and transport sectors, for instance, require a long-term view for the purposes of investment, maintenance and upgrading. This necessary long-term view can be at odds with the short-term perspective of private investors, which could lead to a situation of insufficient investments. Investment failures of this kind occurred with the privatized railways in the UK (contrary to the more efficient publicly owned French railways), and electricity in California.

Second, it is not clear why the state should fail as an operator but succeed as a regulator[17]. This concern underscores the need for an independent and professional Regulatory Agency, as noted above.

Third, public services that are publicly owned and operated do not necessarily have to be inefficient as many examples across the world indicate.

Finally, and more important, there is a strong case in Lebanon for a reasonably efficient public service that is managed with a national perspective. Electricity and postal services and a road network that are developed with a view beyond the financial horizon, and delivered to all households at reasonable prices, can provide a tangible and useful link among citizens, and between the authorities and citizens themselves.

[17] See Willig, 1993

VIII. FINDINGS AND RECOMMENDATIONS

This last part first summarizes the findings of the competition survey undertaken in this report, which is mostly based on the VAT enterprise data for the year 2002. The report concludes with recommendations concerning the forthcoming Competition Law, and the Competition Authority that would originate from it, and with recommendations concerning policies that can enhance competition in Lebanese markets.

1. Competition in the Lebanese economy

The 2002 VAT data point to a relatively high degree of concentration in Lebanese markets.

Using the conservative norm of a concentration ratio for the largest three establishments (CR3) of at least 40 percent (a standard norm is at least 40 percent for CR4), the VAT data indicate that 58 percent of the markets, with a little less than the third of the establishments, fall in this category. These markets have a total turnover value of $8 billion, which is about 40 percent of the total estimated turnover in all the relevant markets.

These concentration numbers, by themselves, indicate that Lebanese markets are not very competitive, and that monopolistic and oligopolistic behavior may be prevalent. The absence of widespread competition is due to a number of factors, of which a major one may be the small size of markets in association with relatively large economies of scale. This condition is illustrated by a minimum efficient scale of production (MES) that is large relative to the size of the market. However, analysis also has shown that, in some markets (see Table 9), MES can be small relative to the size of the market and yet concentration has remained high.

This state of affairs usually implies the presence of high barriers to entry that prevent markets from becoming more competitive that they currently are. Capital requirements, as dictated by MES, in addition to the cost of capital and low labor productivity, also can be important barriers to entry.

These barriers to entry are mostly “natural” in that they are mostly determined by technological considerations and the general performance of the economy rather than that of a given market. The report views the administrative and legal institutions and processes in Lebanon as important “artificial” barriers to entry and exit that policy needs to focus on.

The structural considerations of concentrated markets and high barriers to entry and exit would largely explain restrictive practices in Lebanese markets. In view of the nature of the variable, it is difficult to document the report with evidence on the extent restrictive practices.

2. Recommendations regarding the Competition Law

This report has been written with the purpose of serving as a background study for the Competition Law that is expected to be soon discussed by Parliament. The Competition Law, and associated Competition Authority, is the subject of this section.

2.1 The previous section has highlighted the findings of the report regarding the state of competition in the Lebanese economy. It has pointed to the high degree of concentration in many Lebanese markets, but also to the fact that this market power may be the result of the small size of the Lebanese economy and the various barriers to entry encountered by potential entrants to markets.

Policy may have to make a choice between greater competition, on the one hand, and more concentration but with the advantage of the efficiency of economies of scale, on the other. The choice, however, would have to depend on the empirical details of specific markets.

Lebanese laws address the issue of restrictive practices, but in general terms. Law 73/83, Chapter 4, refers to "*Ihtikar*", i.e. "monopolization", and to "illegal competition". In addition, it is restricted in its applications since it focuses on "fraud" and "false information" rather than restrictive practices in general. More important, this Law is difficult to implement since it grounds the illegality of the practice on the "intention to limit competition" and on price and quantity changes that are not "the natural result of the rule of supply and demand", which are very difficult to identify or establish.

2.2 In this regard, it is suggested that the following principles guide the drafting of the new Competition Law for Lebanon.

- Reduction of barriers to entry and exit

  "Freedom of entry is the sine qua non of the competitive process"[18]. Indeed, aiming at the reduction of barriers to entry and exit, rather than concentration *per se*, should be the focus of the Competition Law and the overriding principle of competition policy in general.

  Minimizing barriers to entry is a fair and efficient approach since it provides a sort of equality of opportunity to potential entrants and then lets market forces decide on the outcome. More important, it is the least prone to costly errors of judgment since it does not pretend to know the optimal structure of a market or what this structure should be in the future. Markets are essentially dynamic entities that are subject to continuous changes in demand and supply conditions, such as changes in tastes and technology. Highly concentrated markets may therefore become more competitive in the future or simply unattractive to investors by virtue of natural market developments, all without intervention.

  In practice, the focus on reducing barriers to entry and exit entails a serious effort at implementing administrative and legal reforms in order to streamline procedures and reduce the time and costs associated with the administrative and legal process. Both consumers and sellers, i.e. the economy overall, would significantly benefit from these reforms.

  The approach is particularly convenient for Lebanon since it would be the least intrusive in the process of economic activity and the least subject to pressures by interest groups. It would also benefit the small and medium enterprises, which constitute more than 90 percent all enterprises operating in Lebanon, which would

[18] Singleton, 1997, p.1.

enhance their competitive power since their "access" to administrative and other privileges is weaker than for large enterprises.

- Reporting of seller agreements

  Competition laws usually deal with matters of conduct or behavior rather than structure. They make illegal restrictive practices that constrain competition. Lebanese laws, on the other hand and as noted above, are ambiguous and, when specific, only refer to "fraud" and "false information".

  The new Competition Law should address the whole question of restrictive practices. Clearly, on both grounds of principle and feasibility, the Law cannot make all restrictive practices illegal. However, it can require the reporting by sellers to a Competition Authority (see below) of all their restrictive agreements, explicit or implicit. This currently is the case in the European Union where companies notify the Commission of their agreements in order to escape fines[19].

  In the case of Lebanon, the Competition Law can restrict charges of illegality to a few practices, such as agreements to fix prices and to share markets or sources of supply.

- Other Law and NGO support

  Laws and institutions that seek to promote the interests of the consumer, or the citizen in general, contribute to the process of competition by providing a countervailing power to that of established economic power.

  In this regard, the implementation of the Competition Law can be made more effective through the introduction of a Consumer Protection Law and the establishment of a Consumer Protection Agency that would be more effective than the existing Consumer Protection Office at the Ministry of National Economy (MOE). An agency that regularly and effectively monitors the implementation of standard weights and measures, and the quality and conformity of products with their labeled contents, would significantly enhance competition among sellers and promote exports.

  In addition, non-government organizations (NGOs) who focus their work on legal, administrative and other matters relating to the citizen's dealings with government, or business in general, can redirect business energy and behavior towards efficiency rather than unorthodox ways of increasing sales and profits.

2.3 It is recommended that a Competition Authority, with autonomous powers of decision, enforce the Competition Law at a first level of ruling, which can then be appealed, if necessary, in a standard Court of Law.

At present, Decree No. 6821, of December 1973, entrusts the MOE with the fight against "*Ihtikar*", and with the promotion of competition for the good of the economy in general and the protection of the consumer in particular. The new Competition Authority can operate under the auspices of the MOE, with general oversight by the Minister.

[19] See Guerrera, *op.cit*.

It is important to stress, particularly in the Lebanese context, that the establishment of an official Competition Authority, though desirable in itself, nonetheless carries the risk of an added bureaucracy that can be subject to political and interest group interference, especially in view of the economic stakes involved. These considerations lead to the following recommendations regarding the attributes of the Competition Authority:

- The Authority should be independent, small and professional.

  The Authority can be set up as an administratively and financially independent entity, with a budget that is financed by the Chambers of Commerce & Industry and the Bankers' Association and/or through a fee levied on registered capital at the MOE.

  Professional staff would include a magistrate, a senior civil servant and professional economists, in addition to research and support staff. The total number of staff should be kept to a minimum manageable number.

- The Authority's mandate would be mainly to review notified agreements and adjudicate cases of restrictive practices. Appealed cases would be taken up by the Courts of Law.

  The Authority's mandate should also be an advisory one regarding, for instance, new relevant legislation and economic policy. It can also be an informative one, through the public dissemination of an Annual Report that would review the Authority's work during the year, together with a review of economic, technological and other developments and trends that can significantly affect competition in the Lebanese markets and the competitiveness of exports.

3. Recommendations regarding competition policies

A Competition Law is one element, though an important one, in a package of competition policies. The report proposes below policies that can contribute to enhancing the degree of competition in Lebanese markets.

- Reforms that bring about streamlined legal and administrative processes are of critical importance in reducing barriers to and costs of entry and exit. Economic activity and exchange in general, take place in an institutional (legal and administrative) setting. Efficient institutions thus become a basis for reducing transaction costs and, consequently, for efficiency in transactions.

- The merger of small and medium enterprises, especially in manufacturing, should be encouraged through tax incentives. The objective is to take advantage of potential economies of scale, which would require specific market studies to guide policy.

- The upgrading and expansion of the road transportation network would reduce transportation costs and prices. More important, it would facilitate the expansion of individual markets to their national dimension and beyond, and increase competition while taking advantage of scale economies.

- The authorities need to carry out the pro-competition policies that have already been initiated. Of particular mention in this regard is the draft law on commercial representation and exclusive agencies. By abolishing state protection of exclusive agencies, the law would place the issue where it belongs, namely between the company and the exclusive agent, while creating the opportunity for more competition and lower prices to consumers.

These policies would create an environment that is positively responsive to business initiative. They would make official institutions accommodating rather than prohibitive, reduce the cost of market entry and exit, and foster investment and competition.

Many of the report's recommendations are of a general order. This is not necessarily a drawback because the recommended policies cut across many activities, and their implementation would have a widespread rather than localized impact. On the other hand, policies regarding specific markets would need to be informed by the detailed conditions of operation of the individual markets themselves.

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