

TOUFIC K. GASPARD

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# **A Political Economy of Lebanon, 1948-2002**

*The Limits of Laissez-faire*

BRILL

A POLITICAL ECONOMY OF LEBANON, 1948–2002

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A POLITICAL ECONOMY OF LEBANON,  
1948–2002

*The Limits of Laissez-faire*

BY

TOUFIC K. GASPARD



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PRINTED IN THE NETHERLANDS

To Nada, Kabalan, Yumna and, not least, Alya

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## PREFACE

This book is based on a D.Phil. thesis that I submitted in 1992 at the Institute of Development Studies at the University of Sussex, England. Following a long professional interruption at the International Monetary Fund, it has since been thoroughly updated and re-written. The original message, however, remains intact. In fact, experience has reinforced my belief in it: *laissez-faire* is not the way to go for developing countries, indeed for all countries.

Today, mainstream economics continues to refine the theoretical model of the pure market economy, which is implicitly used by the “Washington Consensus” in advocating standard market solutions to a variety of economic problems. But the need is for economic talent to explore workable and effective solutions to complex economic problems that are governed by politics, rather than, as many do, spend lifetimes in formalizing and praising the benefits of the pure market system that never was.

History has confirmed that command economies can utterly fail, materially and morally. The symmetrical case of a *laissez-faire* economy, on the other hand, is a rare historical event. The attraction of Lebanon in this regard is precisely because of its unique *laissez-faire* condition, which has long operated as approximately as possible to a pure market economy. It is this historical singularity that has provided the drive to write this book.

Writing outside the tradition of mainstream economics has been a lonely exercise, especially since it was also done outside an academic environment. Nonetheless, with time, one accumulates intellectual debts, and memory fails. To my friends, and those few wonderful stimulating authors (above all, Luigi Pasinetti, Joan Robinson and Piero Sraffa), my gratitude.

I dedicate this book to my wife and children, who have paid over a long period more dues than they should have. What has made this difficult to me is that they never complained.

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## A POLITICAL ECONOMY OF LEBANON, 1948–2002: THE LIMITS OF LAISSEZ-FAIRE

### *Abstract*

The main theme of this book is the evaluation of the laissez-faire strategy of development, based on Lebanon's economic experience in 1948–2002. For over 40 years, Lebanon has been the only laissez-faire economy in the developing world. As such, it provides a singular case study of the effectiveness of the market strategy for development that is advocated by mainstream economics.

The book first reviews the mainstream and alternative theories that explore the basis for economic development. A standard assessment of the growth and development performance of the Lebanese economy follows. The main findings are that, in the favorable period of 1948–1974, economic growth in Lebanon was less than what was achieved by neighboring or developing countries in general, and was particularly wanting in relation to the potential that was afforded by capital abundance, a strong financial condition and large export markets. In addition, the distribution of income and wealth remained skewed and the overall level of skills modest. Much of the positive performance achieved has been due to non-market elements, mostly in the form of transfers from households, community institutions and government. The analysis is based on an annotated rebuilding of the major macroeconomic account series since 1948.

The process of industrialization is separately analyzed. Despite experience, accommodating Arab markets and no capital shortage, Lebanese industry could not expand, hampered by low productivity and competition from imports to an open domestic market with a strong currency. However, low productivity was partly alleviated by enhanced mechanization and increasing exports to receptive Arab markets.

An interpretation of the dynamics of the system is presented from a post-Keynesian perspective, with emphasis on behavior in an institutional context. Wages have usually been lower than the urban subsistence level. In response, workers turned to more work within the family, independent occupations with low barriers to entry, and to

emigration. They also obtained income support from various sources of transfers. Businessmen invested little from their surplus despite relatively high rates of profit, and governments generally adhered to a minimalist and passive policy stance, except when the economic interests of the merchant, as opposed to the industrial, class were in jeopardy. In addition, capitalism, as represented by the extent of waged employment, is not found to have expanded or to have manifested the dynamic characteristics that are expected of it.

Laissez-faire did display, however, economic resilience in the unfavorable and frequently warring circumstances of 1975–1990. Focus is put on the unprecedented monetary crisis that culminated in 1987, and on the financial behavior underlying it. The crisis wiped out much of the domestic wealth and dollarized the economy, continuing to date to affect adversely economic performance. Reconstruction during the 1990s has followed the same laissez-faire strategy, exhibiting weak growth, much waste and an unprecedented increase in public debt, putting the economic system on an unsustainable path.

In sum, the laissez-faire regime did not lead to significant growth and development, despite unusually favorable circumstances. The critical failures occurred in the domains of skills, industrialization, and an income distribution that is compatible with social and political stability. A market system is therefore not a sufficient condition for generating these outcomes, even under strongly favorable conditions. Laissez-faire also can be counterproductive when capitalism and political institutions are underdeveloped. The study concludes by proposing basic elements for a development strategy.

## INTRODUCTION

Three outstanding phenomena have characterized the aftermath of World War II. A group of countries, particularly in Europe and subsequently in less developed parts of the world, adopted the command form of economic organization. This was accompanied by widespread state ownership of the means of production and much restriction in the operation of free markets. Second, a wave emerged of newly independent and relatively poor countries, known as less developed countries (LDCs), where governments played a leading, though not exclusive, role in the ownership and management of the economy. Third, a dominant private sector in the developed industrial countries was actively supported by governments began to have increasing recourse to the Keynesian policy of demand management, whereby financial policies were designed to smooth-out the business cycle and to promote employment and economic growth.

These different phenomena in different worlds shared, however, during most of the second half of the twentieth century, a common feature: the assignment of a strategic role to government in economic stabilization and the drive for economic growth and development. This view concerning the positive economic role by governments has been challenged, based, in part, on the observation that countries with economically dominant governments have, for decades, manifested modest and, for some LDCs, even negative growth rates despite relatively high savings rates. The poor performance has been mainly imputed to the intervention by governments in economic activity and, more generally, to the limitations that are put on the free operation of markets.

This assessment has been strongly reinforced by the events that took place in the early 1990s, a period that witnessed a political and economic upheaval that has swept over the command economies in Central and Eastern Europe, and in many parts of the developing world as well. The upheaval has today culminated in an almost universal belief that sustained economic growth can only spring from the market form of economic organization. A market solution implies, in substance, the private ownership of the means of production and

the removal of controls and other obstacles that hamper the free operation of the market price mechanism.

Unfortunately, this conclusion, which attributes the absence of strong or sustained growth to the failures of government intervention in economic affairs, has rarely been balanced, from a logical and symmetrical point of view, by an examination of the economic performance of market economies that are not constrained by economically active governments. Indeed, a narrow definition of government failures is sometimes given as “. . . those actions of government that lead to an outcome inferior to that which would be observed under *laissez-faire* . . .”.<sup>1</sup> *Laissez-faire* is therefore viewed as a reference system that is expected to produce an economically superior outcome by which the performance of other systems should be judged.

It is in this context that Lebanon can provide an interesting and unique case study of the *laissez-faire* strategy for economic development. Lebanon's economy has operated, without interruption since independence in 1943, with free markets and a high degree of *laissez-faire*. Commodities, foreign currencies in particular, have been exchanged in free markets since the end of WWII. At the same time, the economy has been very open to trade, and all resources, including capital, have been exchanged and transferred without restriction. The Lebanese *laissez-faire* system acquires a sharper model aspect when it is realized that it has rarely suffered from capital shortages, at the private or public level, and that capital is mostly owned and controlled by local rather than by foreign entities. In other words, the performance of the economy is closely associated with its *laissez-faire* character. Moreover, the economy can also be viewed as unsoiled with those characteristics, namely capital shortage and foreign ownership of capital, that are often emphasized as instrumental in explaining the underdevelopment of LDCs.

A comment is sometimes advanced that Lebanon's economic performance is closely linked with the country's particular political system of confessional representation, which operates in a politically unstable region. We take a different, and hopefully more interesting, perspective of the matter. We examine the economic performance of a *laissez-faire* system when it is subjected to both favorable and un-

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<sup>1</sup> Krueger, 1990, p. 11.

favorable circumstances rather than just explain its performance by the circumstances themselves. Moreover, *laissez-faire* was in operation in Lebanon for more than a quarter century of civil peace. It continued to operate, after 1975, for more than fifteen years in an almost continuously unsettled security and political environment. The two periods successively provide a favorable and an unfavorable environment, which is ideally suited for the assessment of the strengths and weaknesses of a given system. It is hoped that this perspective will be an instructive one.

This is a book about the political economy of Lebanon during the period 1948–2002. The expression “political economy” is used to stress the role played by institutional factors or social groups, in addition to market forces, in determining economic outcomes. The two years 1948 and 2002, which limit the period of investigation, are quite convenient for our purposes. The year 1948 simultaneously marked the official establishment of the system of *laissez-faire* in Lebanon, the birth of the Lebanese currency and the first year of national income estimation. The year also is distant enough from the date of independence in 1943 and from the end of WWII to represent a good starting period for normal economic activity.

Special attention will be given to the mid-1980s, which witnessed a severe and unprecedented monetary crisis that involved intensive speculation against the Lebanese Pound and inflicted serious damage to the economy’s growth potential. As such, that period provides a test for the performance of the *laissez-faire* system under stress. With the resumption of work by the central statistical office, the national accounts for 1994, 1995 and 1997 have been estimated, and detailed studies of manpower and living conditions in Lebanon in 1997 have been published.

Towards the late 1990s, amidst a stubborn economic recession, the seriousness of the public debt situation began to dawn on government and the public at large. In November 2002, when gross government debt was about \$31 billion and 180 percent of GDP, an international rescue effort culminated with a meeting in Paris of a group of donors, mainly Arab and European, that pledged a total of \$4.4 billion, mostly to refinance part Lebanon’s debt at lower interest rates. Domestic banks joined the international donor effort by providing a refinancing package of \$2 billion at zero interest rate. But the debt situation continues to weigh heavily on the economic and political situation.



The focus of the study will be to appraise of the growth and development performance of the Lebanese economy over a period of half a century in order to assess *laissez-faire* as a strategy for economic development. The appraisal, as will be clear from the analysis, is inspired by post-Keynesian economics. Following a critical evaluation of the mainstream and alternative theories of economic growth and development, the growth and development experience in Lebanon is reviewed, and the process of integration of labor skills in the market analyzed. A separate analysis of industrial performance is undertaken, and the structure and evolution of Lebanon's foreign trade and external economic relations is examined. We then look for evidence on structural growth, particularly growth in total factor productivity. The analysis of the behavior of the main institutional agents finally provides closure to that appraisal by presenting economic behavior in a general context of economic reproduction. The monetary crisis that erupted in 1987 is accorded a separate treatment in view of its importance as a model of speculation in an unrestrained market environment.

Three historical periods are distinguished: the first is the relatively prosperous and peaceful period that extended from 1948 to 1974; the second period of 1975–90 was often unstable and warring; the third and recent period of 1991–2002 has been a period of reconstruction and mostly debt management.

The major statistical series for the period 1948–2002 have been rebuilt and annotated in Statistical Appendices, which include data on the national accounts, labor activity rates and employment, capital stock and price indices. Industrial and balance-of-payment data are also detailed respectively in Chapters 4 and 5. The aim of this statistical effort is to arrive at a long and reasonably consistent series of the main economic indicators, which is still lacking to date. The ultimate aim, though, is to induce a new look at the modern history of Lebanon, which continues to be presented to all as an economic success story. Above all, it is hoped that the moral of our story will go beyond Lebanon and will present many LDCs with an illustration of the limits of a *laissez-faire* strategy for growth and development.

## CHAPTER ONE

### OF SPONTANEITY AND DESIGN: THE MARKET AND ECONOMIC DEVELOPMENT

Reality can never be discovered once and for all  
Truth will always be new

Apollinaire

This book is about the market and economic development. Specifically, it investigates the validity of the main proposition of mainstream economics, namely that a market system is the optimal system for economic growth and development. It does this by examining the performance of an actual *laissez-faire* economy, *laissez-faire* being the epitome of the market form of economic organization.

*Laissez-faire* is a moral program, and the market is its instrument. A product of the Enlightenment, it was conceived as the way to unleash human potential through the restoration of a natural system, a system unhindered by the restrictions of government. “[Natural] society is produced by our wants, and government by our wickedness,” said Thomas Paine.<sup>1</sup> In a similar vein, Adam Smith viewed the economy as a natural system and the market as an organic part of that system. By extension, free markets become a reflection of the natural system of liberty. For Smith, *laissez-faire* was a program for the abolition of laws constraining the market, a program for the restoration of order and for the activation of potential growth.<sup>2</sup>

As a system of thought, *laissez-faire* rests on the following axioms: the individual is the basic unit in society, i.e. the standard of measurement in social calculus; the individual has a natural right to freedom; and the physical order of nature is a harmonious and self-regulating system—a view borrowed from the Physiocrats. A corollary of that last axiom is that government interference can only be disruptive of natural harmony and is therefore inefficient and undesirable. Taken together, these axioms constitute the basic elements

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<sup>1</sup> Viner (1961), p. 50.

<sup>2</sup> Appleby (1996), pp. 6–8.

of laissez-faire thought, although another basic and often-disregarded element is that markets should be competitive, a rule that the early advocates of laissez-faire have always emphasized. Adam Smith's warnings against the merchants' monopolistic and conspiratorial tendencies against the public interest are notorious in this regard.

Three major bodies of economic theory govern the views regarding the relationship between the market and economic development: the neoclassical, the Post-Keynesian and the radical theories of the left. These are theories that have been formulated with the industrial countries in mind. Although the focus of our investigation is development rather than simply growth, the theoretical overview below focuses on these theories because the very eclectic and rich development literature still rests, in many of its pronouncements, on their theoretical foundations. It is therefore appropriate to restrict our theoretical review to an examination of those theories, especially their views on the role of the market in the promotion of growth and development.

### *In the mainstream: the efficiency of markets*

All mainstream economic thinking, which advocates the expansion of the market form of economic exchange, tends towards the institution of laissez-faire. If mainstream economics, with its amalgam of views, theories and policies, is the modern embodiment of laissez-faire ideology, neoclassical economics is its theoretical and coherent exponent.

Like most theories, neoclassical (NC) economics does not constitute a homogeneous body of thought. Nonetheless, one can distinguish two major subgroups, pure NC and Keynesian NC economics—which will henceforth be jointly referred to as mainstream economics. The so-called new classical macroeconomics belongs to the first group, among whom we can cite, for instance, Robert Barro, Milton Friedman and Robert Lucas. Prominent in the second group are Frank Hahn, Paul Samuelson, Robert Solow and James Tobin.

### *Fundamentals of neoclassical economics*

The scaffolding that holds the structure of NC economics is a set of assumptions that ensure the theoretical efficiency and stability of

the market system. Among these are two critical assumptions about rationality, which subsumes a particular type of uncertainty, and decentralization.

The individual is the basic social unit, a rational economic agent whose behavior is motivated by utility considerations. A market economy consists of rational agents who undertake decentralized modes of communication among themselves.<sup>3</sup> Rationality can be given two interpretations, global/substantive or bounded. Global/substantive rationality is all embracing in its reach, taking the form of consistent and comprehensive utility functions. It implies choices that can be made by economic agents among a full set of alternatives to maximize expected utility. This is in contrast to bounded rationality, whereby decision-makers must make choices against incomplete and inaccurate knowledge.<sup>4</sup> Pure NC economics accommodates uncertainty by making it a probabilistic uncertainty, which is grounded and neutralized through market insurance. This form of uncertainty is effectively an extension of the more restrictive global/substantive form of rationality since it guarantees, by assumption, that the market economy is intrinsically stable. This system is referred to as an ergodic, i.e. stable, system.

The second assumption is about decentralized market structures. Decentralization is a crucial structural element because it is about competition, the dynamic force that makes the market the instrument for economic efficiency, and efficiency is the outcome that validates the market. Through price signals resulting from a process of rivalry, the market is supposed to provide rewards and penalties, and hence to constitute a discipline against inefficiency. In the process, the market would direct and allocate resources, as if by an invisible hand, to their most efficient use. Notice that decentralization does not necessarily mean perfect competition, only that rivalry exists among producing units. The pure NC model, with perfect foresight and perfect competition, can be seen as a reference model that shows the tendency of the market economy towards efficiency and stability.

We can now go into some details of the model itself. Hahn gives a compact definition of NC theory. In what he calls “The pure theory of the invisible hand,” the economy is fully described by

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<sup>3</sup> Hahn and Solow, 1995, p. vii.

<sup>4</sup> Simon, 1997, p. 17.

preferences, endowments and by the production technology.<sup>5</sup> This is a description of demand (utility) and supply (cost) conditions. Next come the rules of behavior and market structure. All agents are rational maximizers and treat prices parametrically, i.e. agents are price takers rather than price makers, which is equivalent to perfect competition. Furthermore, markets are complete, i.e. there are markets for all commodities, including futures, thus eliminating uncertainty through complete insurance. These strong assumptions about perfectly competitive and complete markets do not necessarily weaken the NC theory on empirical grounds. Rather, they may be looked at, though generously, as legitimate abstractions serving heuristic purposes for the establishment of the fundamental propositions of NC theory.

Given these assumptions, a set of non-negative prices is shown to exist whereby individual decisions are consistent, i.e. equilibrium prices are feasible. In other words, by starting with greedy individuals who operate in a free market environment, the remarkable result is that it is logically possible for a society to arrive at a consistent and most efficient allocation of its given resources. Hahn rightly claims that this proof is “a major intellectual achievement”.

Now, one could say that the fundamental propositions of NC theory concerning the efficiency of the market form of economic organization are contained in what are called the two Fundamental Theorems of Welfare Economics. Theorem I states that the equilibrium allocation of goods and services produced is Pareto-efficient, i.e. that output is produced at the minimum cost possible and that any reallocation would entail at least one agent preferring the previous equilibrium configuration. Theorem II is more interesting: “. . . every Pareto-efficient allocation can be decentralized—handed over to the invisible hand”.<sup>6</sup> This means that every Pareto-efficient allocation, which corresponds to every possible initial distribution of endowments, can be achieved through the market. The market process is not only efficient but it can also be egalitarian. Therefore, the goals of efficiency and equity need not be incompatible.

The two Fundamental Theorems perhaps constitute the essential pronouncements of NC theory in the sense that additional pronouncements do not much add to the analysis of the relationship

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<sup>5</sup> See, in particular, Hahn (1982a, 1982b).

<sup>6</sup> 1982a, p. 4.

between the market and economic efficiency. Efficiency springs from the competitive behavior of agents, an efficiency that is achieved by agents out of necessity and despite their greed.

Hayek (1988, 1989) is more philosophical on this matter. For him, human history shows that wherever markets were functioning people were freer, more equal and more prosperous, which shows the superiority of the “spontaneous” over the decreed order. Probably echoing Adam Smith’s view of the innate human propensity to barter and exchange for advantage, Hayek believes that the existence of markets spontaneously creates the conditions for efficiency, prosperity and equality. Free will and self-interest become the organic elements of economic man; if they are constrained, then ill consequences will follow. Consistently with this view, Hayek asserted, for instance, “. . . that any economic expansion resulting from ‘credit expansion’ must lead to an inevitable crisis subsequently . . .”<sup>7</sup> The free market, and only the free market, is efficient. In other words, the free market is a necessary and sufficient condition for economic efficiency and growth.<sup>8</sup>

NC theory is not very loquacious about income distribution. The second Fundamental Theorem states that competitive markets can achieve a more equitable income distribution, which is also Pareto-efficient. The simple one-good model of growth, which is often used by NC theory in its heuristic discourse on growth, shows a growth process that produces an increasing real wage rate and a falling rate of profit. This is a valid interpretation of a static model only if we see the growth process in the model as a historical movement that is reflected by capital accumulation or an increase in the capital-labor ratio over time. The distribution of income that results from this process is judged to be fair since competition inevitably leads to normal profits, these representing the reward for abstinence, entrepreneurship, risk taking, or any combination of these. Introducing technical progress does not substantively affect the results of the model.

The focus of NC theory, in either its pure or Keynesian variety, has traditionally been on allocative efficiency and has had little to

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<sup>7</sup> In Kaldor, 1983, p. 4.

<sup>8</sup> That is if growth is seen, as NC economists usually do, as an extension of efficiency rather than a separate process.

say about growth. This may sound an odd statement to make, considering the number and variety of NC growth models. However, growth in these models is usually portrayed as the outcome of an accumulation of inputs plus technical change, with results that much resemble those obtained in the static models. Technical change or progress is acknowledged to be an important source of growth, particularly in light of Solow's finding in his famous 1957 article that technical progress was the most important source of economic growth, accounting for more than half of the non-farm output growth in the U.S. between 1909 and 1949. Nonetheless, technical progress is not systematically explained or endogenized in the main body of neoclassical theory. Recent attempts at addressing this deficiency by making inducement mechanisms, such as learning-by-doing, integral to the analysis have still not changed the substance of NC growth models.

NC economists do admit that economics still has much explaining to do regarding the integration of technical progress in the main body of its analysis. It is Schumpeter, however, who, alone among all modern economists, has attempted a systematic analysis of technical progress as a process of innovation and diffusion taking place in a dynamic setting. He in fact looked down on the "trivial analysis" by the Keynesians and considered "... the historic mission of capitalism [to be]... the creative evolution of the economy through technological change linked to human greed".<sup>9</sup>

#### *Updating the pure neoclassical theory*

For the Austrian School, a radical branch of NC economics, the issues of perfect competition and probabilistic uncertainty are irrelevant. The Austrian school, which is mostly based on the writings of Friedrich Hayek and Ludwig von Mises, does bring to NC economics a fresh and critical dose of realism.<sup>10</sup> In that school's tradition, market imperfections and uncertainty are taken as given facts rather than circumvented. Agents act with imperfect information and face irreducible uncertainty. Moreover, the market process is a dynamic process of continuous entrepreneurial discovery of new information and opportunities, of learning and competition. Consequently, the

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<sup>9</sup> Goodwin, 1988, p. 145.

<sup>10</sup> See Kirzner (1997) for an informative survey on Austrian economics.

market becomes an open-ended process of rivalry and discovery instead of a static one distinguished by stable equilibria. It is for this reason that economists of the Austrian school do not find the quantitative empirical studies of the market to be useful or even feasible. Nonetheless, their policy recommendations are very close to, if not identical with, those given in the standard NC spirit. Thus, the substance of their outlook is that property rights should be enforced, free market entry guaranteed and, overall, that *laissez-faire* is the best economic policy.

In a similar vein, the NC Keynesians acknowledge the limitations of the pure NC model. These are mostly empirical in nature, relating to the absence of competitive and complete markets. The limitations are important because they may invalidate the two Fundamental Theorems on which the optimality of the market form of economic organization rests.

Market power, or the presence of monopolistic elements in general, implies that even if a Pareto-efficient equilibrium exists it may not be decentralized or achievable by the existing market process. The presence of public goods or of externalities, the latter being implicitly present in practically any imperfectly competitive market, will lead to the failure of the invisible hand.<sup>11</sup> Failure also occurs if there is a lack of inter-temporal markets, so that market expectations will dominate market exchange without there being a mechanism to coordinate inter-temporal decisions. In fact, “This was Keynes’s view”.<sup>12</sup> This is why the economics of information and missing markets has become an important item in the research agenda of NC economics. In the 1920s and 1930s, the theoretical limitations of the NC mainstream model were set by the economics of imperfect competition, via the works of Piero Sraffa, Joan Robinson and Edward Chamberlin. The emphasis seems to have recently shifted from the study of imperfect to that of incomplete markets. In any event, these theoretical limitations are recognized as invalidating the two Fundamental Theorems of Welfare Economics.

The theoretical limitations of the pure market model, however, are not taken by NC economists, of whatever persuasion, to imply a failure of their general propositions concerning the efficiency of

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<sup>11</sup> See Hahn (1982a) and Samuelson (1991).

<sup>12</sup> Hahn, *Ibid.*, p. 12.



markets. In many instances, it is claimed, not much damage is inflicted on the price mechanism if appropriate taxes, subsidies and property rights are applied.<sup>13</sup> If externalities are defined as arising only when interdependence among economic agents is not mediated through market transactions, then externalities can be remedied provided a market mechanism is devised in order to internalize them.<sup>14</sup> The example of tradable property rights is an illustration in point. Thus, Coase's Theorem states that if property rights are well defined, then market exchange leads to an efficient allocation of externalities.<sup>15</sup> Furthermore, market failure is not a sufficient condition for intervention in the market process as the net outcome of intervention may be a situation that is inferior to that obtained without intervention.<sup>16</sup>

Recently, perhaps unexpectedly, leading figures in the Keynesian NC tradition have advanced views that are associated more with the radical than the traditional wing of Keynesian economics. In a remarkable recent book, Hahn and Solow (1995) offer a systematic critique of new classical macroeconomics, and of pure NC economics in general. Specifically, they show that Keynesian results obtain in a monetary economy once any of the basic assumptions of the pure model is relaxed, and that even very simple alterations in the basic assumptions take the economy onto unstable paths. Thus, with successive introductions of non-probabilistic uncertainty, wage stickiness, and increasing returns to scale or imperfect competition, the basic model then generates deflation, persistent unemployment, multiple equilibria and instability. Indeed, simply with the introduction of uncertainty, perfectly flexible labor markets become destabilizing while wage stickiness emerges as a stabilizing factor against serious deflation. This is quite a fundamental criticism of the structural adjustment policies of the "Washington Consensus", especially since it comes from such a prominent strand of the mainstream camp of NC economics. In other words, Hahn and Solow's conclusion is that the pure NC model does not survive even simple and "realistic" changes in the assumptions of the model. Their overall view is that market equilibria are usually path-dependent, and that there is often room for stabilizing policies instead of just leaving it to the market.

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<sup>13</sup> *Ibid.*, p. 8.

<sup>14</sup> The definition is by Scitovsky (in Datta-Chaudhuri, 1990).

<sup>15</sup> Johansson, 1991, p. 89.

<sup>16</sup> See Krueger, 1990; Stern, 1991.

So what is the common ground on which pure and Keynesian NC economists stand? Essentially, it is the view that the market system possesses productivity and moral qualities that clearly outweigh its limitations and the qualities of any other system. In addition, it is a perfectible system that can be improved through well-designed policies. While the market system may not be sufficient, it nonetheless remains a necessary condition for efficiency and growth. Above all, the market system, with all its deficiencies, stands out among all known systems of social or economic organization because it is historically the most efficient and philosophically the most congenial with individual freedom.<sup>17</sup>

*Neoclassical theory and developing countries*

The issue of the free market versus intervention in the market mechanism is especially relevant in the case of LDCs, with their underdeveloped and inefficient institutions. The implications of NC theory for LDCs are straightforward, and a consistent NC economist may even question the validity of the existence of a special branch of economic inquiry called “development economics”, unless such a branch exclusively serves purposes of empirical investigation. The policy recommendation is simple: establish markets for all commodities and avoid intervention in the market process except in specific individual cases where the net effect of the intervention is expected to be clearly positive. This, in substance, is what the structural adjustment policies of the “Washington Consensus” advocate. In fact, for NC theory, the same prescriptions apply to all economies regardless of their degree of development.<sup>18</sup> The absence of markets leads to inefficiencies and, as Scitovsky claimed, complete and competitive markets lead to an optimal dynamic allocation of resources.<sup>19</sup> One should add, in this regard, that the recommendation to establish more markets is not exclusive to NC economists. The Latin American Structuralist School, including Raul Prebisch, stressed the importance

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<sup>17</sup> Hahn, *Ibid.*, pp. 7–9.

<sup>18</sup> The thrust of the structural adjustment policies that are advocated by the Bretton Woods institutions and the OECD (1987, 1989) falls in the realm of expanding the domain of markets so that the price mechanism governs increasingly more economic transactions.

<sup>19</sup> See Shapiro and Taylor, 1990, p. 862.

of removing institutional barriers to the free functioning of labor and capital markets.<sup>20</sup>

There are instances, however, when governments are deemed to contribute positively to economic growth in LDCs. For example, Stern (1991) states that growth theories have usually emphasized three determinants: capital accumulation, human capital and, finally, research, development and innovation. He notes that in some LDC countries, e.g. India in the 1960s and 1970s, the weaknesses of management, organization and infrastructure explain the lack of productivity of scarce capital despite the fact that these countries had managed to raise their savings rates. Governments can therefore promote growth by providing certain services such as infrastructure and education.

However, the consensus among NC economists is that government intervention is usually counterproductive, notwithstanding market failures. Krueger (1990) thus finds that there are also widespread government failures in development owing to corruption, rent-seeking activities and price distortions, all resulting from the fact that governments are neither selfless nor costless. She also believes that LDCs failed because of “postcolonial aggravated nationalism” that blinded them to the benefits that could have been reaped through the historical opportunity of integration in the hospitable international markets that developed during 1950–1980.<sup>21</sup>

Hayek (1988) has expressed the NC view better and more pointedly than many of his colleagues. Above all, according to him, no central mechanism can ever collect and process economic information as efficiently as the decentralized market. Moreover, governments are naturally inefficient and even counterproductive, for they have become charitable institutions distributing advantages to isolated interest groups whereas their revenues originate from a much larger number of taxpayers. This leads to an asymmetrical situation where benefits are visible and costs invisible, with the consequence that governments are constantly inclined to spend more for political purposes. Clearly, this type of behavior, and its consequences, would be more pronounced in LDCs where public institutions and the systems of checks and balances are relatively underdeveloped.

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<sup>20</sup> *Idem.*

<sup>21</sup> See Krueger, 1991.

The NC view is therefore that markets are the best form of economic organization for efficiency and growth, whatever the stage of development of the economy. If there is market failure and some markets are absent, markets may still be established now or in the future. Apart from the standard services that governments ought to provide, e.g. defense and law and order, only in limited and specific circumstances would government intervention contribute a net positive outcome. Above all, the rule is that free markets should dominate and spread in the domain of economic exchange.

*Post-Keynesianism, or the revival of classical political economy*

Post-Keynesianism is the only contemporary school that offers a systematic critique of NC theory. It knew a strong academic and political ascendancy in the 1960s and 1970s, matured in the 1980s, but came into relative obscurity with the political and economic collapse of the Soviet Union in the early 1990s. The collapse constituted a triumph and a confirmation of the validity of NC propositions, and made the Post-Keynesian critique lose much of its audience and appeal. However, independently of that momentous historical event, Post-Keynesianism was already suffering from an important drawback. What had brought its economists, with a rich variety of theoretical persuasions, together under the common label of “Post-Keynesian” has been more an opposition to mainstream NC economics than a unifying core of theoretical propositions that, on the other hand, NC theory has always enjoyed.

This state of affairs has recently started to change. Post-Keynesian (PK) economics is slowly regaining some of its earlier vigor, and is in the process of formulating a coherent theoretical framework that is rooted in the vision and works of Marx, Keynes and Sraffa.<sup>22</sup> The basic elements of the theoretical framework are, in many respects, those of the classical political economists, and these elements are identified below.

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<sup>22</sup> Indeed, the inside cover of *Contributions to Political Economy*, the annual supplement of the *Cambridge Journal of Economics*, a stronghold of Keynesianism and Post-Keynesianism, includes a policy statement noting that its articles will broadly fall in the tradition of the works of the classical political economists Marx, Keynes and Sraffa.

Two modern economists stand out among the Post-Keynesians, also known as Neoricardians: Piero Sraffa and Joan Robinson, with Sraffa (1926, 1960) providing the fundamental theoretical ammunition for the critique. Other major figures in the PK tradition include, again unrestrictedly, Paul Davidson, John Eatwell, Richard Goodwin, Nicholas Kaldor and Luigi Pasinetti. We first introduce the PK critique of the method and analysis of NC theory. The essentials of PK theory proper are then presented. A brief section follows on the policy implications of PK theory, particularly in an LDC context.

### *The Post-Keynesian critique*

The First Fundamental Theorem of welfare economics really is about the possibility, not actuality, of Pareto optimality. This is because of the very restrictive conditions for its applicability, including competitive and complete markets, no increasing returns, etc. Moving to the domain of actuality, “one cannot invoke the classical theory of the invisible hand in dealing with economies in which agents have market power”, and “externalities are implicit in any departure from perfect competition”. Then “. . . all market information will not be summarized by prices . . . and the outcome will, in general, not be Pareto-efficient”.<sup>23</sup>

So why is the invisible hand still called upon in support of analysis and policy? It is because markets, with all their limitations, are seen, economically and philosophically, as relatively superior to other forms of economic organization. However, this approach is constrained by the political considerations of the Cold War period, with its binary view of the economic world, either market or command. The issue of the adoption of the market plus some form of intervention has been systematically sidestepped by the academic community until the East Asian success stories forced, though still insufficiently, a new look on the issue of intervention in a market context.

The Second Theorem says that there are (n) Pareto efficient configurations for (n) initial endowments or wealth distributions. In other words, the issue arises whether some authority can initially impose a fair distribution of wealth, and then let the market work without loss of efficiency. However, this misses an important related

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<sup>23</sup> Hahn, *Ibid.*, pp. 6–7.

issue of actuality, for markets, though starting from an initially fair distribution, may be unable to sustain fair outcomes and, instead, would tend to produce outcomes that, over time, become less and less fair.

The opening shots of the so-called Cambridge controversy between the NC and the PK theories may be considered to have been started by Joan Robinson in her 1953–54 article.<sup>24</sup> The challenge had in fact begun much earlier with Sraffa's (1926) questioning of the logical and analytical validity of the partial equilibrium competitive price model, followed later by the more systematic and justly famous challenge that appeared in his 1960 seminal book *Production of Commodities by Means of Commodities*.

Sraffa subtitled that book “Prelude to a critique . . .,” emphasizing a reactive stand to a mainstream form of economic analysis, in addition to the laying down of foundations for its critique. The thrust of the book is to show that the edifice of NC theory rests on logically shaky foundations. Briefly, it shows that exchange values cannot be determined from knowledge of technology and cost conditions alone, and that the missing information (or equation) must be derived from the basic income distribution components, wages or the rate of profit.<sup>25</sup> Knowledge of distribution is thus logically prior to that of exchange values.

This critique has two important and far-reaching implications. First, the standard demand schedule for an input, say capital, which is derived from the marginal productivity of a physical capital entity that is “uncontaminated by market happenings”,<sup>26</sup> is a logically faulty notion. Marginal productivity must be in terms of values, not physical units, unless the model is a one-good model where inputs and outputs all are of the same unit, which would be equivalent to assuming away the problem of how value is determined. Second, value theory, to be logically consistent, requires prior information from distribution

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<sup>24</sup> This is in reference to a theoretical controversy that raged, particularly in the 1960s and 1970s, between the Keynesian/PK school in Cambridge, England (championed by Joan Robinson) and the NC school in Cambridge, Massachusetts (championed by Paul Samuelson and Robert Solow).

<sup>25</sup> Tastes/demand is usually seen by PK economists (though not explicitly in Sraffa's book) as a dependent and not an independent variable. It depends on production and income, and plays a role in the composition of output rather than its volume and prices (see more on this, later in this section).

<sup>26</sup> This happy phrase is Hahn's (1982b, p. 371).

between wages and profits, i.e. prior information on prices themselves that the theory is seeking to explain. This has led to the charge of circularity against NC economics. Finally, an inference of this critique has been that the missing information that would make value, and economic, theory coherent lies in the realm of history or politics, which implies that the distribution of political power is a major determinant of the distribution of income and wealth.

This PK critique in relation to the so-called missing equation, or the under-determination of the fundamental NC model, has understandably spawned numerous attempts from the NC side at closing the model. Moreover, some NC responses noted that the notion of marginal productivity is not essential to the theory, and that prices are determined at a “local” level of analysis or at sufficiently close equilibrium states to make the notion of marginal productivity logically stand.<sup>27</sup> Hahn has indicated that Sraffa is not wrong, but that all his propositions can be incorporated in NC theory as a special case and that the missing equation can be provided by the saving-investment equation.<sup>28</sup>

Of course, the NC and PK theories remain, in many substantive respects, far apart. We briefly present below the PK critique regarding some fundamental issues of method and analysis in the NC tradition.

a) *Demand and supply*

As Samuelson (1991) has noted, demand and supply analysis is fundamental to the theory of competitive prices. It is also implicit in the general equilibrium models, which are considered to be the most accomplished form of NC theorizing.<sup>29</sup>

In the NC benchmark model of the competitive market economy, “. . . the individual knows everything he needs to know once he knows prices”.<sup>30</sup> Prices constitute the critical variable that guides agents’ behavior and that makes economic events intelligible, and prices are themselves made intelligible by the demand and supply analysis. The

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<sup>27</sup> See Bliss, 1975, pp. 116–118.

<sup>28</sup> *Ibid.*, pp. 370–71.

<sup>29</sup> However, marginal concepts are not deemed essential to the theory according, for instance, to Austrian economics. For others, they can even be “optional extras” (Bliss, 1975, p. 37; see Chapter 5 in particular).

<sup>30</sup> Hahn, 1982a, p. 2.

description of an economy by agents' preferences, endowments and production technology is, of course, another way of saying that it is individual tastes and production costs, or the ultimate factors behind demand and supply, which fully explain economic facts. Indeed, behind the market price model is what Marshall called "... opposite but *independent* forces of supply and demand acting symmetrically to determine value in equilibrium".<sup>31</sup>

But the main formal point of the PK critique, as stated in the capital re-switching controversy that was started by Robinson's 1953–54 article, remains valid today, almost half a century later. The point was that specific values of capital, whether represented by capital-labor or capital-output ratios, are not necessarily uniquely associated with specific values of the interest rate. As a result, it is not possible to identify the standard downward-sloping and well-behaved price-demand for capital, or for any other input or factor category. Moreover, according to Goodwin, the NC price-market analysis is one of constrained maxima where the constraint is full employment.<sup>32</sup> Only when such a constraint is operative could the NC theory of value and output justify its emphasis on relative prices. Without full employment, constrained maxima become irrelevant.<sup>33</sup>

The NC response was defensive, proposing a less general price theory where there are as many own rates of return as there are assets.<sup>34</sup> NC theory thus ends up with a Walrasian general equilibrium model, which produces various rates of profit but offers no specific theory of profits and prices.<sup>35</sup> The limitations of the demand and supply apparatus as a general analytical framework for value theory further forces NC economics into a short-period equilibrium type of analysis. Unfortunately, such analysis lacks explanatory power and is unable to single out those major forces that a general theory is supposed to elicit as influencing prices and quantities and, hence, as being the fundamental parameters of a market mechanism.<sup>36</sup>

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<sup>31</sup> Bharadwaj, 1986, p. 27 (emphasis in the original).

<sup>32</sup> Goodwin, 1988, pp. 143–145.

<sup>33</sup> Notice that PK economists, for instance Pasinetti (1981), also use the assumption of full employment of resources to define equilibrium, but theirs is used in a different dynamic context with changing technologies and no emphasis on constraints.

<sup>34</sup> See Kurz, 1985, p. 21 on Hahn's 1982b counter-attack.

<sup>35</sup> See Robinson, 1971.

<sup>36</sup> See Kurz, 1985.



b) *Equilibrium*

Whether equilibrium is defined as a situation where all markets clear, of consistent choices or any other situation, it fulfills a basic function of making analysis tractable and systematic theorizing possible. Equilibrium theorizing is “. . . the core of the coherence of mainstream theory”.<sup>37</sup> The issue, however, is whether the adopted definition makes the analysis appropriate for answering relevant or interesting questions. As noted above, NC theory has increasingly reverted to short-period “local” equilibrium analysis. As such, its method may have become less suitable for long-run secular analysis, which is the traditional context of growth analysis.

But even if NC analysis is applicable to long-run problems, it still is based on a comparative-statics approach where little is known, or even claimed to be known, of what happens in between equilibrium situations. Ignorance of economic dynamics is generally admitted by NC economists. Hayek has stated that we really do not understand the mechanism of economic growth.<sup>38</sup> A fundamental proposition of monetarism is that we know little about how a change in money supply affects prices but that there is a strong and persistent long-run correlation between the two. Hahn (1982a, 1982b) has stressed that the demand and supply mechanism involved complex dynamics and that we needed to learn a lot about agents’ behavior and about the way the invisible hand moves. More recently, Hahn and Solow have emphasized the relevance of multiple equilibria and our general ignorance of economic dynamics.<sup>39</sup>

Equilibrium analysis in NC theory therefore leaves a lot of explaining to do. On the other hand, PK theory uses the equilibrium concept as one where a uniform rate of profit is established throughout activities. Equilibrium values may then be defined as centers of gravity with practical relevance and applications. In fact, the uniform-rate-of-profit equilibrium may be viewed, as classical economists did, as a center of gravity for competitive forces. Competition itself becomes a process of deployment of capital within and across activities rather than the traditional NC concept of price competition by many sellers in a given market that is defined in relation to a particular product.

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<sup>37</sup> Dow, 1997, p. 84.

<sup>38</sup> 1988, p. 6.

<sup>39</sup> 1995, p. 154.

For the classical economists, competition is a historical phenomenon that is perceived through the mobility of capital in time and space.<sup>40</sup> As such, the classical notion of equilibrium is an adequate concept for the analysis of contemporary economies in this so-called globalized world where capital is moving and competing, with fewer constraints, through conglomerates and multinational corporations.

c) *Efficiency and growth*

The market as an instrument for economic efficiency is the central tenet of NC analysis. It is supposed to provide, via price signals, rewards and penalties that constitute incentives for efficiency and a discipline against inefficiency. The NC results, however, crucially depend on the very restrictive assumptions of market completeness and competition. Failure in either of these assumptions severely limits the validity of the NC results.

By positing uncertainty as an irreducible fact of life, which Keynes did and then ended up with the “animal spirits” of the entrepreneur as the ultimate determinant of investment, markets can no longer be complete.<sup>41</sup> Information becomes not only an important resource but also one with no clear market boundaries. Coordination then becomes a possible alternative to the market. Moreover, even if a market for information exists, competitive equilibrium may still not exist. Arrow (1987) admits this possibility when technical information, which unlike other inputs can be often used, is acquired at a cost.

NC theory emphasizes relative prices in its value theory. Dropping the assumption of full employment undermines this approach.<sup>42</sup> Indeed, an assumption of less-than-full employment often is the natural and realistic one to make. For, given the modern fact of an ongoing technological progress, it is as if the production possibility frontier is ever receding with economic systems being continuously inside it. The economic problem becomes not one of allocation along the full-employment frontier but one of continuous movement towards it. In the same spirit, but for different reasons, Leibenstein’s concept of X-inefficiency, which results from a misuse rather than from a misallocation of resources, shows that allocative inefficiency is far less

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<sup>40</sup> See Clifton, 1977, 1983.

<sup>41</sup> See Davidson, 1991.

<sup>42</sup> See Goodwin, 1988.

serious an economic problem than other types of inefficiency. X-inefficiency may be due, for instance, to traditional educational systems, behavior and institutions, particularly but not exclusively in LDCs. In addition, externalities that are associated with technical change in LDCs may be so extensive and dynamic that they may no longer be liable to market mediation, especially since many agents are involved.<sup>43</sup> The general proposition in this respect is, as Kaldor has put it, that we cannot rely on market forces to ensure an optimal use of resources.<sup>44</sup>

With imperfect competition, businesses become price-makers and quantity-takers rather than competitive price-takers and quantity-setters, and efficient outcomes are then no longer certain.<sup>45</sup> NC economists admit that, without competition, externalities exist “almost by definition” and market efficiency does not necessarily hold. This was considered, since Marshall and Pigou, a *prima facie* case for intervention in the market. Nonetheless, the scope and benefits of the invisible hand are still believed by NC economists to outweigh its limitations.<sup>46</sup>

The focus of NC theory has traditionally been on allocative efficiency. Growth, on the other hand, is portrayed as the outcome of an accumulation of inputs and technical change, where the latter is deemed an important source of growth but is, nevertheless, still inadequately explained. Thus, structural change, in either consumption or production, is generally absent from NC growth models. These models usually exhibit steady growth, which effectively makes them an extension of their static counterparts, and of limited relevance for examining issues of secular growth.

In the basic NC growth model, which was formulated by Solow in 1956, factor substitutability was the essential element driving stable equilibrium growth.<sup>47</sup> John Von Neumann’s reaction to NC economics was to express skepticism regarding the validity of what he called “the marginalist approach” since it put too much emphasis on substitutability and too little on the forces that allow mutually

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<sup>43</sup> See Stewart and Ghani, 1991.

<sup>44</sup> 1983, p. 96.

<sup>45</sup> Kaldor, 1986, p. 193.

<sup>46</sup> Hahn, 1982a, pp. 7–9.

<sup>47</sup> Renelt, 1991, p. 2.

conditioned expansion.<sup>48</sup> Von Neumann's contrast between "substitutability", which is a technical state of affairs, and "forces" is insightful and interesting. In fact, marginalism, as a school of thought, came more in reaction to the threatening rise of Marxism than as an extension of classical or Smithian economics. The allocation of resources later replaced growth as the focus of analysis, and utility became the organizing principle in economic theory instead of labor as in classical economics, whether of the Smithian or Marxian variety.<sup>49</sup>

To conclude, the Post-Keynesians view NC theory as wanting in its formal structure and method, let alone in its view of the world and policy recommendations. In particular, they emphasize serious deficiencies in NC value theory, which is the foundation of all NC discourse. For instance, the PK fundamental critique that the NC's demand for capital does not, as it should, represent a monotonic relationship between the quantity of capital (represented by the capital-labor or capital-output ratio) and its price (the rate of interest) has not been effectively addressed to date. Moreover, and at a more general level of analysis, NC theory is too restrictive in its assumptions to have any justifiable claim to relevance or generality. As Schumpeter put it, the fundamental question is how capitalism generates change rather than how it restores stability.<sup>50</sup>

### *What Post-Keynesianism is*

Post-Keynesianism represents a paradigm shift with respect to NC theory. The shift is clear and distinguishable in terms of the specification of the economic problem, the method and analysis used in addressing it, and the policies proposed for its resolution.

The distinctions between NC and PK theories have so far been presented mostly in terms of formal logic, or the analysis that follows from that logic. Of course, there always are more or less satisfactory ways of addressing issues of logic. This is well demonstrated by the extensive debate and controversy regarding, for example, various issues in capital theory or the concept of equilibrium, its uniqueness and stability. In the final analysis, the dividing line between the two

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<sup>48</sup> Weintraub, 1990, p. 1193.

<sup>49</sup> See Pasinetti, 1981.

<sup>50</sup> Rosenberg, 1994, p. 50.

theories lies in what Schumpeter has called “the pre-analytical vision,” which is partly manifested by the questions that a theory poses, and by its original or axiomatic representation of reality.

In PK economics, production, not allocation, is the economy’s momentum. The distinction is crucial because the latter entails emphasis on scarcity and exchange, while the former raises issues of skills and growth. Scarcity implies limited resources and given technology, which calls for methods of optimization, while growth highlights problems of learning and technical progress. The NC pre-analytical vision of the economic problem as one of allocation right away defines growth out of the picture. That of PK theory, on the other hand, is one of dynamic growth, which in fact is an extension of Keynes’s concern with the mobilization rather than the allocation of resources.

By emphasizing exchange, NC theory uses the analytical tool of demand and supply, while PK theory poses the classical economists’ questions and uses their tools of surplus analysis. By stressing the importance of institutional considerations (history, social classes and power distribution) in the determination of the course of economic events, PK theory may well be adopting a less tractable method, one that is less prone to mathematical handling than that of NC theory, but it certainly is more informative and relevant.

Pasinetti insightfully draws the distinctions between the two theories.<sup>51</sup> The NC school poses the economic problem as one of scarcity and rationality, which is summarized by the problem of maximization of an objective function that is subject to constraints. The use of marginal concepts is central to the analysis because it is a corollary of the maximization principle. This analytical apparatus is, however, well suited to trading—as opposed to industrial—societies where the distinguishing characteristic of economic activity is the exchange of relatively scarce commodities. In fact, the general equilibrium models basically are models of a pure exchange economy where trade can be analyzed without any reference to production. In an industrial society, and indeed in practically all contemporary societies, the fundamental economic process is a process of growth that depends on how fast the society learns. Learning is identified with skills and has little to do with the issue of optimum choice. The problem is not one of choice of techniques, as in a given technical environment

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<sup>51</sup> 1981, Chapter 1.

with a given production function, but one of a change of techniques, as in a dynamic process of change with an open-ended avenue of technical progress.

Samuelson's comment on Sraffa's price theory illustrates well this contrast, if not divide, between the NC and PK theories. Samuelson sees Sraffa's system of equations as "... one subsector of the Arrow-Debreu system ...".<sup>52</sup> He then professes incredulity at the possibility that Sraffa could ever have believed prices to be determined by costs alone, rather than by demand and supply. For Samuelson, demand and supply is not a tool, it is *the* tool for economic analysis. Other tools or methods are simply and scientifically incomprehensible.

Of course, economic theory should be able to explain price movements, and the NC route is one of partial equilibrium demand and supply analysis in the context of "local" short-run equilibria. A PK, or better a classical, economist is not interested in a short-run context. Rather, he/she looks at the problem the way Sraffa (1960) did, as we explain below.

Start with a no-surplus or subsistence economy, i.e. one where aggregate output is just enough to replace the means of production and the necessary wages for human reproduction so that no residual or profit is left. In such an economy, there is only one solution, a unique set of prices that are solely determined by the technical conditions of production. These exchange prices allow the subsistence economy to reproduce itself with the same technical and price configuration, and any departure from the technologically determined relative prices would make the economy unviable or unable to reproduce itself.<sup>53</sup> Next, consider the more realistic case of an economy with surplus or profits. Now, the number of solutions, i.e. the number of sets of relative prices, that would allow reproduction are virtually unlimited since the relative-price outcome depends on the given technical conditions of production and on the virtually unlimited number of ways in which surplus can be distributed between wages and profits. Once a distribution parameter is known, then the level of

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<sup>52</sup> 1991, p. 570.

<sup>53</sup> A situation where actual prices are not the solution prices leads to some industries being in deficit (or losing) and others that are in surplus (or profitable). The deficit industries would eventually have to exit the market, which would undermine the survival of the whole economy since the surplus industries, by definition, purchase their means of production from the exiting industries.

prices becomes determinate. This is Sraffa's point, put simply without mathematics. Sraffa's apparently simple analysis, however, has uncovered fundamental propositions concerning the theory of value.<sup>54</sup>

Sraffa does not have recourse to tastes/demand, as this is a matter of "pre-analytical vision" or of making demand a dependent variable and not an argument in the theory of value. Moreover, as Pasinetti (1981) put it, tastes do play a role but only in the determination of the composition of output rather than in its volume and the level of prices. At heart, Sraffa's analysis is not one of an actual or growing economy: agents or their behaviors are not specified anywhere in his 1960 classic. Rather, the analysis is carried out in the domain of the possibility of constructing a logical theory of value, which is formulated in the context of a surplus-producing capitalist economy. His analysis has simply cleared the way for further logical and relevant analysis.

We can now summarize the basic elements of Post-Keynesianism; these are not mutually exclusive.

1. Uncertainty is an irreducible fact of life. Uncertainty is not an individualistic attitude towards the future that can be reduced to quantifiable probability distributions, as in NC theory. Here, uncertainty is just not knowing: the information that is required for a decision may simply not be available.<sup>55</sup> Uncertainty makes economic agents lose reference and seek to ground their decisions on a variety of considerations, including the cultural and political. With Keynes, these considerations are collapsed into the "animal spirits" of the entrepreneur. The PK story then becomes one where the rate of profit and the rate of growth are determined by a combination of the "animal spirits" and the rate of savings of capitalists, while technological conditions determine the wage rates.<sup>56</sup>

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<sup>54</sup> Some did not find Sraffa's analysis original enough. Hahn (1982b), for instance, has noted that any price from within or outside the system may be taken as a parameter that can "close" the system of equations. But the point is that the system of equations is determinate only through the subset of basic commodities, and fixing one price in the basic system is equivalent to fixing one of the distribution variables, wages or profits. Fixing a variable outside the basic system will not affect the structure and price solutions of the system. A basic commodity is one that enters directly or indirectly in the production of all other commodities. It may be thought of as an element of a basket of commodities that are commonly consumed by labor.

<sup>55</sup> See Aretsis et al., 1999.

<sup>56</sup> Evans, 1989, p. 167.

2. Money matters. Money is directly linked to uncertainty, for without uncertainty the demand for money is predictable to minimal amounts for simple transactions purposes, with the speculative part of the demand becoming irrelevant. When Keynes started to write *The General Theory* in the early 1930s, he in fact had in mind the task of working out what he explicitly referred to as a “monetary theory of production”. The idea was developed in 1933 into the article “On the Theory of a Monetary Economy”, in contrast to the then prevailing real-exchange theories.<sup>57</sup> Consequently, in *The General Theory*, the forces determining interest rates became those of the demand for and supply of liquidity rather than the demand for and supply of saving.

The NC representation of economic activity, particularly as fully developed in that basic reference of NC models, the Arrow-Debreu model of general equilibrium, has in fact little to do with a monetary, let alone modern, economy. For instance, the very restrictive assumptions of the model include what is technically referred to as the “irreducibility” assumption, which states that each individual must initially possess at least one good in amounts that exceed the subsistence level for that good plus at least subsistence amounts of every other good. Moreover, consumption sets that do not allow subsistence are excluded. These assumptions make the Arrow-Debreu model, as Koopmans put it, “best suited for describing a society of self-sufficient farmers who do a little trading on the side,” i.e. an unspecialized and a non-monetary economy.<sup>58</sup>

3. Economic systems are not natural systems. They are the products of human design, shaped by social and political institutions that affect economic decisions and developments in a significant manner. Douglas North defines institutions as “the humanly devised constraints that. . . define the incentive structure of societies and specifically economies”. This view of the economy as a system that is shaped by institutions is in contrast, for instance, to Samuelson’s statement that “In a perfectly competitive economy it does not really matter who hires whom”.<sup>59</sup>

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<sup>57</sup> See Dillard, 1989, in particular pages 604–5 and footnote 3.

<sup>58</sup> Rizvi, 1991, p. 2.

<sup>59</sup> Landesmann and Pagano, 1994, p. 199.



As products of human institutions, economic systems are therefore open systems, also called non-ergodic or non-deterministic systems. The implication is that the secular process of economic development is not fully informed by natural endowments and technical conditions of production alone but also, if not mainly, by institutional considerations such as the distribution of political power in society. Such distribution directly affects the distribution between wages and profits, e.g. through legislation protecting labor rights and entitlements, which itself affects economic values, incentives, and almost everything else in the economy.

4. Economic policy matters. Eatwell and Milgate (1983) note that an explanation of market failures through market imperfections is a misunderstanding of Keynes. Rather, the market is governed by systematic and objective forces that are independent of imperfections, including uncertainty. These forces vary in their workings and impact according to changes in the political, cultural and technological environments that characterize historical epochs. They can systematically bring about market failures in critical markets, such as employment, in contrast to NC economics that sees a tendency in the market mechanism to ensure full utilization of resources. In other words, market failures tend to occur independently of market imperfections, a structural characteristic that has often been taken, even by Keynesians, as a major cause of market failures. Economic policy can therefore be actively countercyclical—through demand management with fiscal and monetary policies—and growth stimulating.

PK theory also views competition differently from NC theory. Competition is capitalist rivalry in any sphere of production, and the basic condition for the operation of competition is free capital mobility.<sup>60</sup> As long as capital, however organized, is free to move, then “. . . the competitive process of the individual firm is directed more at securing the most favorable terms of growth than the most favorable terms of trade per se . . . Competition, as Mrs. Joan Robinson suggests, is therefore oriented around investment behavior and not market behavior per se”.<sup>61</sup>

An important corollary of economic systems being open systems is path dependency.<sup>62</sup> Feedbacks from economic actions or processes

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<sup>60</sup> See Clifton, 1977, 1983.

<sup>61</sup> *Ibid.*, 1977, p. 149.

<sup>62</sup> See Arthur, 1998.

engender path dependency. Diminishing returns are negative and increasing returns positive feedbacks. History reveals a strong degree of path-dependence in technical progress, in the sense that technical knowledge is by nature cumulative, depending much more on a sequence of events rather than on initial conditions.<sup>63</sup> In other words, collective or concerted action can reduce uncertainty and instability, and actively promote economic growth and development.

In sum, Post-Keynesianism has revealed fundamental inconsistencies and limitations in NC theory, which has benefited from this critique. The two schools now remain, as before, far apart. However, if PK theory is more relevant and fruitful than NC theory, it also has its own limitations. Whether we accept Keynes's "animal spirits" of the entrepreneur as determining the level of investment, or institutions and technical progress as crucial determinants of growth, these variables remain largely unexplained, something which leaves PK theory incomplete.

There is, however, an implicit dilemma in PK theory. The theory emphasizes the need for policy coordination, usually by government, to guard against market failures, yet it also acknowledges that governments represent the interests of particular social or economic groups rather than those of the society that they are supposed to serve. The dilemma can be resolved once Post-Keynesianism develops a theory of institutions, which play a critical role in its story. Some Post-Keynesians have resolved the dilemma by fully embracing a radical or Marxist view, which advocates a policy that serves the interests of the working class, these interests taken to be, in the end, those of the society as a whole.

#### *Development: a Post-Keynesian perspective*

The concept "development" became prominent in the economic literature after WWII, a confirmation of the still dominant idea of progress. In practice, development issues arose together with the independence of many new states, imposing itself as a need and a challenge. The aim then was "to achieve, in the span of one generation, the material standards of living that the industrialized West achieved in three generations or more, but without incurring in the heavy

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<sup>63</sup> See Rosenberg, 1994.

social costs they had to pay or inflicted on others”.<sup>64</sup> Now, more than two generations later, development policy has shifted toward poverty alleviation, which constitutes an implicit recognition of the failure of mainstream policies in the promotion of growth and development.

Mainstream NC or Keynesian theories, which, anyway, were designed to address issues that are pertinent to industrial countries, have not been successful in the identification of the major economic problems encountered by LDCs. In fact, developing countries continue to suffer from problems that often are the opposite of those that affect the industrial countries. LDCs mostly suffer from shortages of skills, capital and technology rather than from the excess capacity and associated demand management problems of Keynesian economics. Moreover, LDCs have to cope with problems unknown, or resolved long time since, in industrial countries, namely rural-urban migration and underdeveloped government and legal institutions. Keynesian economics may therefore appear to be less well equipped to deal with LDC-specific problems that, on the other hand, NC economics could pretend to address through the establishment of markets and the free operation of the price mechanism. For instance, implementing demand management tools in a context of inefficient, if not corrupt, public institutions could be counter-productive if not a recipe for economic disaster.

However, the economics of Keynes, and PK theory in particular, is in a position to provide a relevant and useful analytical framework for addressing development problems. Keynes's focus on issues of market failure in employment and, more generally, on the mobilization rather than allocation of resources is relevant to LDCs. Moreover, unlike NC theory, PK theory finds benefits in a systematic intervention by governments in order to prevent recessions and enhance physical and human infrastructure. It is not that markets are found by Post-Keynesianism to be naturally inefficient, but that failures in terms of efficiency, distribution and growth may be so extensive, particularly in LDCs, as to warrant that they be addressed by some form of intervention.

Once uncertainty and convexities, e.g. externalities, are admitted, planning can no longer be dismissed on grounds of efficiency.<sup>65</sup> Even

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<sup>64</sup> Sagasti, 1997, p. 1563.

<sup>65</sup> Chakravarty, 1990, p. 235.

no lesser economists than Jevons and Marshall, who are among those who laid the foundations of mainstream economics, considered that government regulation and even nationalization might be necessary.<sup>66</sup> Indeed, from a symmetrical perspective, markets can also be less free, less knowledgeable and less efficient in the transmission of signals to the consumer or in responding to them in LDCs.<sup>67</sup> Although the NC strictures against the significant and extensive inefficiencies resulting from government intervention in LDCs are often well founded and well taken, historical examples of successful intervention are also plentiful. The setting-up of marketing boards in Africa, with assured prices, greatly stimulated pre-war peasant production.<sup>68</sup>

More recently, the economic success stories of Southeast Asian economies owe much to the highly interventionist role of the state. Land reform in South Korea, Taiwan and Japan, before their industrialization drive, helped in the emergence of commercial and industrial middle classes.<sup>69</sup> The economic policy choice, however, should not necessarily be a binary one of total or no market. In South Korea, the state was interventionist in the domestic sector but pursued free trade abroad. The same may be said of Singapore and Japan, where corporations have long collaborated in “precompetitive research” and various organizations acted as intermediaries between research centers and industry.<sup>70</sup> This is an interesting illustration of a successful coordination response to uncertainty and market failure, and from a central authority that is not necessarily governmental.

However, if Keynesian anti-cyclical policies can avoid recessions, it does not necessarily mean that they will reduce income inequalities or stimulate growth. The two issues are related, but in an opposite manner to mainstream thinking. In fact, there is no evidence of a tradeoff between equality and efficiency, nor that economic development would necessarily bring about a reduction in inequality. This means that inequality issues need to be tackled directly. When capital markets are imperfect, as they usually are in LDCs, redistribution to the less endowed can be growth enhancing because it creates

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<sup>66</sup> Paul, 1979, pp. 281–282.

<sup>67</sup> Singer, 1987, p. 7.

<sup>68</sup> Kaldor, 1986, p. 95n.

<sup>69</sup> Datta-Chandhuri, 1990.

<sup>70</sup> Coghlan, 1991, p. 18.

opportunities, improves borrowers' incentives and reduces macro-economic volatility.<sup>71</sup>

Pasinetti (1981) provides an interesting and systematic attempt at identifying the fundamental determinants of long-run growth. The single most important determinant of growth is skills and learning, viewed in a growing economy with continuous technical progress, where technical progress ultimately means a labor-saving process and a changing composition of demand. For LDCs, the implication is straightforward and promising: they can just aim to adapt already existing and more productive techniques of production that were developed in the industrial countries. Growth then depends on the speed at which a society learns to be more productive by acquiring more skills. Whereas terms of trade are a concept that is particularly relevant to a zero-sum game, all countries can benefit from learning.

Already in late eighteenth century, Alexander Hamilton, one of the American "founding fathers", was advocating an active role for government in the protection of infant industries and in the unification of markets. Friedrich List made the same argument in Germany half a century later.<sup>72</sup> In the modern world of ever-expanding markets and fast-paced technical progress, it is skills and learning that have become the strategic elements of an economic policy for growth. Perhaps this is not such a novel idea since, about a century and a half earlier, the aforementioned List also had learning in mind when he was criticizing the advocacy by the classical school of a free market system since, he said, "... it attached too much importance to production and too little to productive power".<sup>73</sup>

### *The radical critique*

It is inappropriate, from a historical perspective, to speak of a radical critique of mainstream economics. It was in fact the other way round, for the rise to prominence of marginal utility theory towards the end of the nineteenth century was more in reaction to Marx's critique of economic theory in general, and to the then ambient

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<sup>71</sup> See Aghion and Williamson, 1998, particularly Part I by Aghion.

<sup>72</sup> Dorfman, 1991, pp. 578–9.

<sup>73</sup> Chakravarty, 1990, p. 233.

social unrest in Europe in particular, than an autonomous intellectual development.<sup>74</sup> The modern radical critique from the left came later and was directed against the dominant NC theory and mainstream economics in general. It is a critique that is largely inspired by the writings of Marx, which have marked the economic and political history of the twentieth century. If only for this, the Marxist view of the relationship between the market and economic development needs to be elaborated.

### *Capitalism and economic development*

Contrary to first impressions, the NC and Marxist schools of thought have in common a fundamental view of the impact of the market on economic development. NC theory considers that wealth can only be created by a risk-bearing private sector, and that the free market is the only source of material wealth.<sup>75</sup> Long before, Marx (1867) wrote effusively and in detail about the material contribution of capitalism to civilization and the superiority of this form of economic organization over the older social orders. Smith and Ricardo had already perceived, in the same vein but with less historical sweep, the revolutionary character of the emerging industrial class and its associated form, capitalism. Of course, Marx had made a clear and fundamental distinction between the market and capitalism. For him, the market has existed since immemorial times, wherein products are exchanged as use values. Capitalism, on the other hand, is a historically specific form of social and economic organization. It is based on private property and involves the exchange of commodities, as exchange values, for the purpose of making and accumulating more exchange values in order to generate a surplus called profit. Put very simply, the profit motive, which can exist only alongside its mirror entity waged employment, is the distinguishing characteristic of capitalism and the driving force behind an unprecedented accumulation of material wealth. Moreover, capitalism is itself a dynamic force in the sense that it will make capitalism spread across activities, in time and space.

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<sup>74</sup> For a stimulating review of the development of economic ideas during that period, see Pasinetti, 1981, pp. 11–14.

<sup>75</sup> Kaldor, 1983, p. 39.

The issue of the market and economic efficiency, as understood at the traditional micro or industry level, is not often addressed in Marxist writings or in the radical literature. However, the general efficiency and productivity of the market is implicit in Marx's view of the wealth-creating capacity and actuality of capitalism. Marx analyzed capitalism in a competitive environment, and it was one of his most successful predictions to foresee the dynamic evolution of competitive capitalism into a growing concentration and centralization of capital. Modern Marxist economists emphasize the inefficiency and waste of monopoly capitalism that, in advanced industrial societies, mainly takes the form of excessive advertising and military expenditures.<sup>76</sup> Moreover, the material progress that comes with capitalist growth is seen as accompanied by frequent economic crises that increase in intensity with the accumulation and centralization of capital. Thus, the material efficiency of capitalism coexists with a tendency to generate waste and instability.

Capitalism is also seen to generate a poor working class and an expanding "reserve army of the unemployed". More specifically, real wages are predicted to fluctuate around a socially accepted minimum, in addition to a growing polarization in incomes between the rich and the poor. The prediction of the growing poverty of the working class did not materialize in industrial societies, where real wages and standards of living continue to grow. Marx's predictions concerning the general poverty of workers and the skewed distribution of income and wealth, on the other hand, may be more applicable to LDCs than to industrial countries. However, the success of the latter may at least be partly explained by the poverty of the former. In addition, the improvement in the standard of living of workers in industrial societies may owe less to the market system per se and more to the countervailing power of organized worker unions and political parties, thus reflecting the view concerning the influence of "class struggle" on economic outcomes.

Marx successfully foresaw, and even perhaps underestimated, the unprecedented material productivity of capitalism. However, growth under capitalism is not the uneventful process that is described by mainstream economics. Financial crises and high rates of unemployment recur too frequently in too many countries to be discounted

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<sup>76</sup> See Baran and Sweezy, 1966.

as aberrations or adjustment phenomena. Moreover, sustained growth requires continuous technical progress, which takes the form of new products and processes of production. Few economists discussed technical progress in significant detail. Among the modern economists of the twentieth century, only Schumpeter gave it a critical role in his explanation of growth and development. Adam Smith identified technical progress with the division of labor, which is governed by the size of the market. Marx saw in capitalist rivalry the spur to technical progress, which would come about from the need to generate relative surplus value. Relative surplus value is surplus that is produced by a fall in real wages and/or by the introduction of labor-saving technology, as opposed to a lengthening of working hours that generates absolute surplus value. In fact, history shows that technical progress and labor-saving processes go hand in hand, producing sustained increases in labor productivity.

Overall, Marxists consider the NC theory of welfare as weak and misleading because preferences are not autonomous and because of the predominance of class power and action in affecting economic processes. Capitalism, as a form of economic and social organization, is further viewed not only as an unjust system but also as a historically transient one that would ultimately turn into socialism via recurring capitalist crises and intensified class struggle.<sup>77</sup>

### *Capitalism, between chance and necessity*

If there is wide agreement among radical leftists that capitalism is doomed to a tumultuous destiny and that it would and should eventually be replaced by socialism, there is nonetheless disagreement regarding the origin of capitalism and the appropriate strategy for achieving the sustained development that capitalism is deemed unable to produce.

The policies that are advocated in the Marxist literature on economic development follow directly from Marx's view of history. Since class struggle is the driving force behind social and economic development, it is in the domain of class or political power that development policies should be located. This view has had a strong modern academic support from Sraffa's analysis: since exchange values, and

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<sup>77</sup> Roemer, 1986, p. 201.



hence economic reality, cannot be understood from knowledge of production conditions alone, the exogenous missing element must be sought in the political or institutional domain. Thus, Post-Keynesians have balanced between two stands. The first is a standard Keynesian one, namely that the growth, stability and distribution performance of a market economy can be improved through systematic government intervention in the market process. The other is really of a Marxist inclination, one that believes the market economy to be doomed to continuous crises and polarization in the distribution of wealth, and that it should therefore be replaced with a more advanced or superior system of economic organization, namely socialism or some variety of it.

On one end of the Marxist spectrum of views is historical materialism, which sees in productive forces (i.e. human and physical capital) the primary cause of historical development, conceived as an inevitably progressive process where the original motor force resides in "... the consciousness properties of the human interface with nature".<sup>78</sup> History must and does follow ladder-like stages of development: primitive communism, slavery, feudalism, capitalism, socialism, and communism. Relations of production (i.e. relations of property and division of labor) may be such that they constitute obstacles to the further development of the productive forces but, inevitably, "... relations which advance productive power obtain because they would advance productive power".<sup>79</sup> The policy implication of this Marxist view of history is that capitalism is a necessary stage in the strategy for development. Thus, some Marxist writers were against what was considered an early establishment of socialism in the predominantly agricultural societies of the Soviet Union, and then China, where the productive forces were considered not to be developed enough for the institution of socialism. In Baran's (1957) phrase, socialism in underdeveloped societies becomes underdeveloped socialism. The recent economic and political collapse of the Soviet Union may be seen as a confirmation of that view.

There is a psychological first element or force in the materialist view of development that makes human consciousness the basis of history. The view is very different on the other end of the spectrum.

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<sup>78</sup> Laibman, 1984, p. 291.

<sup>79</sup> Cohen, 1983, p. 118.

The historian Robert Brenner (1977, 1986) has linked the birth of capitalism to a historical accident, namely the existence of conditions of separation of labor from its means of subsistence. These conditions arose by chance, not necessity. Brenner shows how increases in productivity and trade consolidated rather than weakened pre-capitalist economies in Eastern Europe. However, once capitalism is established, its dynamics of accumulation and expansion will start operating. In this regard, E.M. Wood (1996) notes that the capitalist market arose out of compulsion, a compulsion to maximize profits and accumulate, and that the market was not the natural opportunity it usually is presented to be. She further notes that it was the ideology of “improvement” of property in eighteenth century England, and not the Enlightenment idea of improvement of humanity, that drove productivity and the industrial revolution, which are at the origin of modern capitalism.

One of Brenner’s major findings is that “. . . pre-capitalist economies have an internal logic and solidity which should not be underestimated”.<sup>80</sup> This conclusion, as the rest of the book will show, provides a fitting description of the Lebanese experience.

### *Modernism versus Postmodernism in economics?*

It is interesting, and perhaps fruitful, to point to an alternative interpretation of the opposition between mainstream and PK economics, one that is subsumed in the current debate between Modernism and Postmodernism.

PK economics owes a great deal in its analysis to Sraffa. Sraffa had an intense intellectual debate with, and influence on the work of, his university colleague, the philosopher Wittgenstein.<sup>81</sup> Departing from an earlier and opposite view to that of Sraffa, Wittgenstein had reached the conclusion that there was no invariable standard or underlying essence of language by which the truth or falsity of propositions could be established. For him, the various uses of language do not necessarily share common essential qualities, and meaning depends on the context in which language is spoken. In other words,

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<sup>80</sup> Brenner, 1986, p. 53.

<sup>81</sup> See Andrews, 1996, for the Wittgensteinian interpretation of Sraffa and its bearing on Sraffa’s critique of NC economics.

“Nothing is hidden”. Similarly, Sraffa’s demonstration of the impossibility of finding the Holy Grail of an invariable standard of value may be viewed as questioning the existence of “real” or “equilibrium” prices—which he was loath to use anyway—that underlie observable market prices. For Sraffa, moreover, there is no simple rule governing changes in relative prices following changes in income distribution, and prices that obtain at any point in time are arbitrary in the sense of them depending on arbitrarily chosen standards of value. This view of prices stands in sharp contrast to the essentialist character of neoclassical theory and, indeed, to the still dominant form of “equilibrium” theorizing in economics.

This contrast between essentialist and relativist views of economic phenomena suggests a strong analogy, if not a direct correspondence, between the NC/PK debate and that of the Modernist/Postmodernist variety currently raging in various branches of the art, literature and the social sciences. In fact, as noted above, one can say that NC economics is an extension of the Enlightenment project (which is the basis of Modernism) and of its optimistic outlook of the world. Both the Enlightenment and Modernism have deep roots in the Newtonian view of the natural world as an orderly environment where the individual is the central force, and progress is the result of cumulative scientific investigation. It is indeed striking that David Hume, who was instrumental in the development of Enlightenment thought and was an acquaintance of Adam Smith, viewed self-interest and scarcity as the origin of justice and property (for without self-interest or scarcity justice is useless). Of course, self-interest and scarcity are the very same foundations of the NC view of the economic world.

In contrast, both the PK and Postmodernist perspectives reject the view that the natural world is intrinsically orderly and that reason and science alone are the basis of human progress. They both view history and the course of human progress as largely the result of the social context in which they take place. History is not the outcome of the natural progress of human reason, but is relative in that it depends on the social structure in which it develops. Again, it is ironic that the same champion of the Enlightenment, David Hume, who extolled the power of reason, nonetheless warned of the limitations of reason and of its harmful effects when used as the sole authority.<sup>82</sup>

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<sup>82</sup> Appleby et al., 1996, p. 73.

Grounded in skepticism, Postmodernism is difficult to categorize. However, its discourse shares views with both the right and the left. Among its core beliefs is the rejection of the idea of a rational, sovereign and independent actor, and of the idea of progress. This rejection situates it at the opposite end of rationalism. In the economic domain, and similarly to the view of the Austrian School, Postmodernism does not believe in the possibility of useful macroeconomic analysis. Indeed, it does not believe in the usefulness of theory but rather sees the world as an open system.<sup>83</sup> This effectively puts it in the radical camp of social theory.

### *An assessment*

The issue of the market and economic development is a complex one, encapsulating essential questions that have been raised by economic theory since Adam Smith. The views and answers relating to this issue may be grouped in three more or less homogeneous schools of thought called the neoclassical (NC), Post-Keynesian (PK) and Marxist schools.

The NC school, and mainstream economics in general, firmly believe in the fundamental efficiency and superiority of the market over any other form of economic organization. It claims that government interventions in the market process are often inefficient and counterproductive and that, despite market imperfections, markets can spread across activities and become competitively more efficient.<sup>84</sup> Externalities, it is further claimed, can be dealt with through a proper exchange of property rights. Moreover, studies of industrial organization use an operational concept of “workable competition” that is pragmatic and convincing in that practically competitive and efficient markets can and do exist. The argument about the drive to efficiency of numerous sellers in a given and well-defined market is quite strong and true on intuitive, logical and empirical grounds. However, NC analysis and its more relevant pronouncements refer to the narrow

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<sup>83</sup> See Dow, 1997.

<sup>84</sup> It is interesting to note that the NC view of governments as power and interest-driven institutions is not very different from that of the Marxists’ view, and stands in contrast to the attitude taken by PK economists, in general, concerning the welfare-increasing ability of governments.

domain of allocative efficiency. The bearing of this issue on LDCs and on technical progress and growth is, however, rather limited.

Mainstream economics, including NC theory, ends up with a two-legged support or justification of the market: the philosophical principle of liberty, and the historical evidence of the (relative) efficiency of markets. On the first one, liberty between the weak and the strong can be oppressive, and the choice need not be simply between *laissez-faire* and a command economy. Indeed, the historical record of the industrial societies of today is anything but a test case of *laissez-faire*. Furthermore, the collapse of the command economies of Central and Eastern Europe does not provide any empirical support to the economic superiority of the *laissez-faire* system. It merely provides important historical evidence on the economic inefficiency of the command system. Furthermore, it is precisely the case study of Lebanon that we use in this book to test the hypothesis that the *laissez-faire* system possesses superior advantages in terms of efficiency and growth.

Starting from irreducible uncertainty as a fact of economic life, Keynes concluded that there was no systematic tendency in a monetary market economy to achieve full employment. There is, consequently, a need for an equally systematic intervention by governments to remedy this failure. However, Keynes believed that, once full employment is achieved, the NC, or what he called the classical, propositions became valid again. In this context, PK economists range in their opinions from the traditional Keynesian view, that the market is an efficient but imperfect system that has to be managed more often than not, to the extreme position of Marx's evaluation of capitalism as an unmanageable and wealth-polarizing system that needs to be replaced with socialism.

The PK school has succeeded in identifying basic weaknesses in the analytical framework and arguments of the NC school. It has also brought back into the research agenda the need to incorporate dynamic and institutional considerations. The PK school, nonetheless, is still weakened by the absence of a coherent theoretical model and by its perennial hesitation, whether the market can be fundamentally improved or not. It is this distinction regarding the improvability of the market, rather than the ambiguous issue of the degree of efficacy of intervention in the market process, that should separate a PK from a NC economist.

The Marxist school has received a serious setback with the stark failure of the command economies of the Soviet Union and its satel-

lite countries in Europe. Some believe this setback to be a deadly one, in that the triumph of capitalism really constitutes the end of history, history being viewed as an ideological struggle that ends with the triumph and dominance of one ideology over the others. The triumph, however, may not be a decisive one. Economic slowdowns and crises, poverty and unemployment still mark the economic landscape all over the world. For this alone, radical political economy will surely make a comeback. After all, Marx's analysis is essentially concerned with the productivity and the future of capitalism and not the establishment and viability of command economies or socialism.

At the center of all these views is the question of the efficiency, and hence desirability, of the market as a medium or instrument for economic development. The following chapters aim to show, based on the example of the Lebanese economy, that the market can not only be inefficient but also retard development.

## CHAPTER TWO

### THE ROAD TO LAISSEZ-FAIRE: A HISTORICAL PERSPECTIVE

They were beautiful, do you remember?  
Marching tall and free  
And they were singing  
Holding the mast high, up high  
Not seeing it had no banner

Yannis Ritsos

Modern Lebanon was formally created in 1920 when “Le Grand Liban”, or Greater Lebanon, was established with its present boundaries under a mandate given by the Allies to France. A parliamentary constitution was modeled after that of the French Third Republic and promulgated in 1926. In 1943, Lebanon became fully independent with an area of 10.4 thousand square kilometers (a little more than four thousand square miles) and a population of 1.1 million. By the end of 1946, all foreign troops had evacuated the country.

Lebanon entered its modern era, soon after the end of the Second World War (WWII), with a radically transformed economic and social structure and very favorable economic conditions. Trade and a diversified industry were vigorous activities, significant foreign balances had been accumulated, and employment was apparently full.<sup>1</sup> The weakening of the feudal class, together with the emergence of a modern middle class, had already started in 1861 and culminated with the establishment of a parliamentary system in 1926. However, independence brought with it new political and economic challenges.

Arab nationalism, with its yearning for one borderless Arab nation, was a strong popular sentiment in the region. Lebanon’s population, which was then almost evenly divided between Christians and Muslims, was also divided between Arab nationalists and Lebanese nationalists, who were advocating an independent Lebanese entity. The existence of the new independent state was not the only contentious issue.

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<sup>1</sup> Britt, 1953, p. 8.

The form of the economic system to be adopted was also the subject of intense debate, especially since neighboring Syria, with whom Lebanon was then allied in a customs union, envisaged an active and important role for government in economic affairs. In contrast, Lebanon openly and explicitly opted for laissez-faire, an economic system that would be little interfered with by a political class whose legislative, executive and administrative powers were designed to be shared along sectarian lines.

This chapter introduces a historical background to the events that led to the adoption of the laissez-faire regime in Lebanon. It will also focus on aspects of industrial and capitalist development that will be further developed in the following chapters. First, we briefly go back to the nineteenth century to examine some salient political and economic events that were instrumental in the shaping of modern Lebanon's political and economic system.

*Early capitalism and industrialization in nineteenth century Lebanon*

Lebanon came under the rule of the Ottoman Empire in 1516 and, until its independence in 1943, had always enjoyed some measure of autonomy with its population of Christians, then a dominant majority, Druzes and a small minority of Muslim Sunnites and Shiites.<sup>2</sup> It was known as Mount Lebanon.

A prince, called Emir, ruled the land, assisted by local notables, called Sheikhs, whose principal economic function was to raise taxes from peasants on behalf of the Ottoman sultan. The feudal class of Emirs and Sheikhs lived off revenue from taxes and rent in kind. The peasants were landless but also metayers (sharecroppers) who gradually owned and acquired more land through accumulated surplus. The peasants' capacity to accumulate surplus was indicated by their ability to provide for subsistence, pay taxes and even get involved in some exchange of produce for money.<sup>3</sup>

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<sup>2</sup> See Collelo, 1989, p. 12.

<sup>3</sup> One estimate puts at 75 percent the share of appropriated product by taxation and similar forms of extraction (Saba, P., 1976, p. 2). While this estimate may appear inflated, it is nonetheless indicative of the existence of a significant agricultural surplus.



*The end of feudalism*

The economic history of modern Lebanon effectively began in the first half of the nineteenth century, when foreign trade in grain and raw silk was expanding under the stimulus of increased European and Egyptian demand. In 1840, French capital started the first modern textile factory. The cultivation of mulberry trees, a feeding source for the silk worm, expanded and became the basis of Lebanon's economic activity over a period of three-quarters of a century. A burgeoning local textile and handicraft industry began to develop, with local moneyed traders controlling and marketing the output. It was, however, the second half of the nineteenth century that witnessed the more momentous developments.

In 1841, 1845 and 1860, widespread destruction and sectarian killing occurred between Christians and Druzes. Some historians attribute these events and the sudden rise of sectarian animosity to instigations caused by European, Ottoman and Egyptian rivalry over the region, while others see it as the outcome of a deliberate design by the feudal lords to absorb the discontent of the heavily taxed peasants.<sup>4</sup> In fact, rebellions protesting excessive taxation had already erupted in 1820 and 1840, culminating in 1858–61 with a widespread peasant revolt that demanded the abolition of all feudal privilege while pillaging and burning feudal property. Whatever the cause of the subsequent sectarian and bloody events, a new administrative system was established in 1861 at the recommendation of an international commission composed of France, Britain, Austria, Prussia and the Ottoman Empire. Mount Lebanon then had less than half the area of Lebanon today, and a population estimated at 380,000 in 1867.<sup>5</sup> It was to be administered by a non-Lebanese Christian governor, assisted by an administrative council of members chosen by the heads of each religious community. This event marked an important turning point in the social and political history of Lebanon, for it represented a break with the previous feudal system of social administration in as much as it illustrated the rise to administrative, and hence political and economic, privilege of a new group of people who previously did not possess any feudal right or privilege.

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<sup>4</sup> See Hess and Bodman, 1954 and Saba, P., 1976.

<sup>5</sup> Courbage and Fargues, Vol. II, 1974, p. 16.

Other developments were also converging with this break with feudalism, setting the stage for the rise of that new dynamic form of economic organization, capitalism.

*The seeds of capitalism*

In the middle of the 1860s, a cadastral survey was completed for purposes of assessment of the tax base. This gave form and substance to private property in land, which was still the most important economic resource. The cadastral survey was to be later confirmed and legalized by the mandatory authorities in the mid-1920s. Both events were occasions for much redistribution of land in favor of big landowners, the Church in particular, at the expense of the peasants who were emigrating in large numbers at the time, thus leaving much unattended property behind.<sup>6</sup> Though agriculture was still the dominant activity, domestic and foreign trade flourished, together with handicraft production by peasant-artisans as a secondary family activity. However, the rise of the capitalist tobacco and textile industries disrupted artisan production. In the 1880s, some two hundred-village tobacco workshops were employing between two thousand and four thousand hired workers from peasant families. Moreover, some thirty capitalists employed around 4,200 wageworkers in the various stages of the cloth industry.<sup>7</sup>

Although the tobacco industry was dominated by the French Régie de Tabac, and French capital had started the silk industry in 1840, most manufacturing and trading capital quickly became local. Already, in 1827, 21 out of 34 commercial firms trading with Europe belonged to Lebanese nationals. In 1862, in the silk reeling industry, 33 out of 44 firms belonged to Lebanese who controlled 1,350 of the 2,200 pans in use.<sup>8</sup> At the eve of WWII, there were about 14,000 workers, of whom 12,000 women, in the silk industry alone.<sup>9</sup> Again, if the labor activity rate were assumed to have been around 25 percent,

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<sup>6</sup> Daher, 1983, p. 27.

<sup>7</sup> See Saba, P., 1976, pp. 16–17. If we assume a labor activity rate of 25 percent of the population (the average varied between 30 and 34 percent during 1950–1997; see Table A.II.3 in the Appendix), then those 4,200 wageworkers represented 6 to 8 percent of total employment.

<sup>8</sup> Issawi, 1964, p. 282.

<sup>9</sup> Owen, 1988b, p. 194.

these workers in the silk industry would have represented about 12 percent of the labor force, a figure that could easily exceed 20 percent if we include tobacco and other industries. Such a high proportion of labor in manufacturing proper would never be attained again.<sup>10</sup>

If the process by which foreign capital gave way to local capital and industrialization is not clear, the development of the human and physical infrastructure made a significant contribution to that process. Although manpower was mostly illiterate, the Lebanese had nonetheless acquired in the nineteenth century a reputation of being relatively literate and educated. Foreign missionaries had already established schools and universities, notably the American University of Beirut in 1866 and the French/Jesuit St Joseph's University in 1875. The Jesuits first arrived to Mount Lebanon in 1634 and established numerous schools, while the Lazarist religious order started Aintoura School in 1780, it being the first institution to extend secondary education.<sup>11</sup> More modest educational, and often informal, institutions were also being established across Mount Lebanon with many people acquiring the basic skills of reading and writing from the village priest, and some proceeding to local and foreign universities.

Lebanon thus became in the second half of the nineteenth century a commercial and intellectual center in the region, and a reasonably literate population became readily available for capitalist expansion. Moreover, capital was not in shortage, as indicated by the apparent wealth of traders and moneylenders and by the gradual control of indigenous capital over local industry. Indeed, the overall economic situation in the second half of the nineteenth century was one of relative economic prosperity amidst political peace. Before WWII, and according to Issawi, "Lebanon was one of the most equalitarian countries in the world, with very little abject poverty and very few rich people".<sup>12</sup> Although the assessment may be a generous one, particularly concerning the egalitarian distribution of wealth, the fact

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<sup>10</sup> Population was around 469,000 in 1913 (Courbage and Fargues, Vol. II, 1974, p. 16). Allowing for a higher participation rate, say 30 percent, would still keep labor in the silk industry at a relatively high 10 percent of the labor force. Allowing for a lower participation rate, of course, would entail a higher rate of labor absorption by industry.

<sup>11</sup> Iqbal, 1990, p. 313.

<sup>12</sup> Issawi, 1964, p. 287.

remains that Mount Lebanon was then widely known to be a peaceful and prosperous area that was also known for active tourism from neighboring countries.

Nonetheless, industrial capitalism did not really take off in Mount Lebanon, despite the availability of commercial and industrial capital, and of local and foreign markets for commodities throughout the Ottoman Empire and Europe. One reason for this failure may lie in the very nature of trade, which is a more forthcoming activity than industry, requiring less risk capital and a shorter planning horizon. The more important reason, however, may be that the Lebanese peasants did not constitute the necessary pool of potential waged labor since they were relatively autonomous and independent in terms of their direct access to their means of subsistence. In other words, the spread of industrial capitalism may have been checked by the resilience of independent production. We investigate this possibility in the next section.

### *The demise of industry*

In the mid-1880s, following a fall in silk prices that originated in the French market, local industrialists reacted by diverting capital to commerce and lending to small industrialists.<sup>13</sup> In other words, the industrialists' response to the challenge of falling prices was to reduce the scale of operations rather than modernize them or shift to other lines of production, despite the fact that capital and general demand conditions had remained favorable. On the other hand, the response was different and more positive after the end of WWII, when industry met the sharp fall in demand and the increase in foreign competition with a strategy of modernization of equipment.

The reason for the industrialists' failure to rise to the challenge may be found in the domain of the conditions of the labor market. A large number of peasant farmers who owned small plots of land and/or operated as metayers characterized agriculture, which was the dominant activity. Most of these farmers, and despite the mountainous and hard-terrain aspect of the land, were relatively independent in terms of their direct access to the means of subsistence.

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<sup>13</sup> Saba, P., 1976, p. 19.

They were mostly farm owners rather than sharecroppers.<sup>14</sup> They also had little contact with market exchange, either for their means of production or for their means of subsistence, except for the disposition of any surplus agricultural output in order to buy commodities for their own consumption rather than for exchange. This also meant that the scale of their operations was too small to allow a substantial surplus to be used by a potentially expanding industry or to contribute to the demand for local manufactures.<sup>15</sup>

Already, in the eighteenth century, many farmers formally owned their land. Agricultural surplus must have significantly improved in the second half of the nineteenth century as numerous farmers were buying land and guns, the former further consolidating their independent status.<sup>16</sup> By the latter third of the century, a more equitable distribution of land rights was achieved.<sup>17</sup> Moreover, the growth of the silk industry and of commercial relations with Europe led to a unique phenomenon in the area, which was that of a growing number of relatively wealthy small peasant landholders.<sup>18</sup> Moreover, there were parts in Mount Lebanon where a favorable land tenure system of “mugarasa”, a form of share cropping, allowed the peasant to acquire, within five to ten years, a quarter or half of the land.<sup>19</sup>

The economically independent condition of the peasant farmers was further reinforced, and hardship alleviated, by continuous remittances from emigrant relatives. Emigration and the associated remittances of funds to relatives in the home country has remained in Lebanon, since the middle of the nineteenth century, an important economic phenomenon. Between 1860 and 1914, more than 100,000, or about a quarter of the population, are estimated to have emigrated to Egypt, the Americas and West Africa.<sup>20</sup> A high population density, low agricultural productivity and a desire to escape Ottoman rule were the driving forces behind emigration. In any event, emigra-

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<sup>14</sup> See Tannous, 1949.

<sup>15</sup> See Owen, 1988b.

<sup>16</sup> See Buheiry, 1984 and Chevallier, 1971.

<sup>17</sup> See Migdal, 1988.

<sup>18</sup> Iqbal, 1990, pp. 310–311.

<sup>19</sup> Buheiry, 1984, p. 294.

<sup>20</sup> Issawi, 1964, p. 283. IRFED (c. 1962, Vol. I, p. 49) puts the figure of emigrants at 330,000, of which 210,000 emigrated between 1900 and 1914. This figure seems too high in relation to the population of Mount Lebanon, unless Beirut and other coastal cities are added to Mount Lebanon. Nonetheless, the extent of emigration was widespread and vast in its scale.

tion provided an outlet to “free labor” that could have been employed by a dynamic industry. Moreover, institutional and moral considerations of bad reputation prevented the drawing into waged employment of more women, who then constituted the dominant majority of the workforce in the silk industry.<sup>21</sup>

Feudalism therefore had become, in the second half of the nineteenth century, a weakened institution while peasant farmers gained in political and economic freedom. Private property became an established phenomenon, and farmers, though poor, were not destitute and most owned plots of land and complemented their income by handicraft production.<sup>22</sup> Though agricultural and handicraft activity were dominant, industry was a dynamic enterprise. The independent economic status of many farmers, emigration and the allure of a relatively quick and easily profitable commerce constituted serious obstacles in the face of a more significant industrialization process, initiated in 1840 by European industrial capital. As a result, modern capitalist relations remained marginal and industry missed its first historical opportunity for expansion.

*Industrial resurgence and the triumph of laissez-faire, 1920–1950*

If trade, and circulation activities in general, emerged dominant over industry in the early twentieth century, the proclamation in 1920, under the French mandate, of the Grand Liban consolidated this state of affairs. With the Grand Liban, the country now more than doubled in size with the addition of Beirut and other coastal cities, of the fertile plain of the Bekaa, and of the agricultural region of Akkar in the North. The mountain acquired a hinterland and a coastline but was now dominated by a capital, Beirut, which was a prosperous trading center. The population of the new Lebanon was then only around 600,000, depleted by massive emigration and deaths from famine.<sup>23</sup> The long-established silk industry was already dying

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<sup>21</sup> Owen, 1988b, p. 197.

<sup>22</sup> Chevallier, 1971, p. 154.

<sup>23</sup> Around 300,000 people died of starvation in Syria and Mount Lebanon, but mostly in Mount Lebanon, after a wave of locusts destroyed the grain harvest in the middle of an economic blockade imposed in 1915 along the eastern Mediterranean by the Ottoman governor (Courbage and Fargues, Vol. II, 1974, p. 19).

off from foreign competition, the introduction of new synthetic varieties, such as rayon, and from a lack of interest by local financiers or by the mandatory authorities, who adopted a policy of low tariffs that further stimulated commerce.<sup>24</sup>

However, a second historical opportunity arose for Lebanese industry between the late 1920s and the end of WWII. The opportunity came in the form of an increase in the supply of capital and labor, better infrastructure and protection through higher tariffs.<sup>25</sup>

### *The new economic environment*

Lebanon entered the twentieth century with a much-improved economic environment. By 1900, it had 415 kilometers of roads excluding the 111-km Beirut-Damascus road that was built by private French capital.<sup>26</sup> Taxation was light, boosting local demand, and the policy of low taxation and road building continued in the interwar period, as Beirut developed to become the leading port in the Eastern Mediterranean. In 1940, the first oil refinery was completed in the city of Tripoli. Education continued to spread but it was still provided, together with health services, by missionaries, charitable organizations, and public institutions. The improvement in physical and human infrastructure clearly owed much to non-market institutions and was mostly financed from outside market sources. Starting in 1924, the authorities gradually resorted to tariff protection, which provided an additional stimulus to industry.<sup>27</sup>

Significant developments were also taking place on the labor scene, which was witnessing a sustained expansion in the supply of labor. Emigration from Syria and Lebanon, of which Lebanon's share was a little more than half, had declined to an average of 2,000 a year in the 1930s after reaching a peak of 15,000 between 1900 and 1914.<sup>28</sup> The drop in the rate of emigration was mainly due to immigration restrictions in the countries of destination. As a result, the

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<sup>24</sup> See Owen, 1976.

<sup>25</sup> Bonné (1975), Nsouli (1953) and UN (1955), contrary to Owen (1976), mention a situation of higher tariffs in the context of an expanding Lebanese industry. It may be that higher tariffs were selective or that they were lowered and raised at various times during 1920–1939 since the UN document (p. 151) mentions a gradual increase in tariff protection after 1924.

<sup>26</sup> Issawi, 1982, p. 53.

<sup>27</sup> UN, 1955, p. 151.

<sup>28</sup> *Ibid.*, p. 150.

drain in Lebanese labor was greatly stemmed and many immigrants returned with some savings, though the extent to which these savings turned into capital cannot be determined. In addition, Armenians seeking refuge in Lebanon from massacres in Turkey swelled the domestic labor supply and depressed the wage level.<sup>29</sup>

Another source of supply to a potential industrial labor force was the internal migration from rural areas to urban centers, particularly Beirut. The rural-urban migration was much reinforced by the famine that erupted during WWI and that severely affected rural areas. People had to cut mulberry trees, originally used to raise silk cocoons, for fuel and thus were effectively forced to burn their capital.

### *The second industrial opportunity*

All these developments constituted a set of conditions that were favorable to industrial expansion. There was in fact a beginning in that direction. The number of industrial establishments increased from 400 in 1930 to 900 in 1939, at which time at least 20,000 workers were in factories and small workshops.<sup>30</sup> While the economic evidence on Lebanon during 1920–50 is sketchy, and sometimes inconsistent, it does nonetheless point to a strong rising trend in economic activity, particularly industry.

Following a severe reduction in the size of the labor force owing to the widespread famine during the First World War, there was a modernization of industry in Lebanon and Syria between 1913 and 1937. As Table 2.1 shows, factory-based work gradually started to replace a putting-out system, whereby payment was based on units produced by work carried out at home. In addition, the indicators point to a significant shift from the old industries, which were predominantly based on silk, to a new and more capitalist form of factory and wage-system of payment. It is interesting to note that, with the lower rate of participation of women in industry, the new industrial and more capitalist pattern of activity may have led to a fall rather than an increase in the overall labor participation rate. In other words, less rather than more labor may have then become subsumed by the more capitalist system of production.

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<sup>29</sup> Nsouli, 1953, p. 77.

<sup>30</sup> Idem. Subsequent surveys indicated that industrial employment exceeded 41,000 on the eve of WWII (see Table 4.1 in Chapter 4).



Table 2.1 *Industrial work patterns in Syria and Lebanon, 1913–1937*

	1913	1937 Total	Old <sup>b</sup>	New
Total no. of workers <sup>a</sup> (thousands)	310	204	171	33
Distribution of workers (%)	100	100	84	16
a) <i>Sex and age</i>				
Men	46	56	44	12
Women	43	32	29	3
Children	11	12	11	1
b) <i>Place of work</i>				
Factory	33	60	44	16
Home	67	40	40	
c) <i>Payment type</i>				
Wages	80	64	57	8
Daily	20	36	27	9

Source: Bonné, 1955, p. 300.

Notes: a- Workers include artisans. b- Old enterprises, mostly in the silk industry.

The 1930s witnessed a significant increase in capital investment in industry. The total tonnage of major industrial machinery imported into Syria and Lebanon quadrupled during 1934–38. The increase in the general tariff rate in 1926, and the subsequent introduction of protective duties, also may have contributed to the noticeable increase in domestic demand for industrial products in both Syria and Lebanon.<sup>31</sup> With the onset of WWII, circumstances became still more favorable to industry.

During WWII, Lebanese industry received an unexpected boost in demand through military expenditures by the Allied troops present in Lebanon, at a time when imports were being severely curtailed. Between 1940 and 1944, the Allied forces spent some £76 million in Syria and Lebanon, with Lebanon's annual share representing approximately 10 percent of its national income.<sup>32</sup> The two

<sup>31</sup> Bonné, 1955, pp. 291, 302.

<sup>32</sup> Lebanon's national income and trade shares were roughly equal to Syria's during that period. The exchange rate of the Sterling Pound was about 8.83 Syrian Lebanese Pounds (in January 1944). Lebanon's national income in 1945 may be estimated at some LL700 million (see Appendix III on national accounts). If we

countries enjoyed a cumulative surplus on their current account balance of 607 million Syrian Lebanese pounds between 1939 and 1945, or approximately 40 percent of their joint national incomes in 1945.<sup>33</sup> Moreover, the restrictions on the importation of machinery led to an increase in the rate of capacity utilization.

Detailed industrial statistics (in the 1955 UN document frequently cited above) reveal that, by 1946, a diversified industry had survived the decay of its dominant silk branch and started to include food processing, beverages, textiles, chemicals, printing, etc. The growth in food processing was an indicator of greater industrial linkages with agriculture, which had then diversified to the plantation of fruit and olive trees and was witnessing a surge in investment.<sup>34</sup>

The industrial resurgence, which occurred roughly between 1926 and 1945, confirmed the existence of a strong potential for sustained industrialization as the industry took good advantage of the new environment of protection and increased demand. The number of industrial establishments strongly increased, production became more diversified, and profits were reinvested to expand capacity or start new enterprises. These enterprises included refineries and manufacturers of glass, cardboard, textiles, food, metal products and industrial machinery.<sup>35</sup> Although there is no direct evidence regarding industrial employment at the time, most indirect evidence points to a strong expansion in industrial employment since the early 1930s until 1945.<sup>36</sup>

Soon after the end of WWII, Lebanese industry was subjected to the shock of the opening up to world trade, with the simultaneous disappearance of Allied expenditures and tariff protection. Data for the 1945–50 period are sparse, but the picture regarding industry is

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assume that Allied expenditures were evenly divided between the two countries, then these expenditures represented during each of the war years about ten percent of Lebanon's national income.

<sup>33</sup> UN, 1955, p. 151.

<sup>34</sup> "Before the Second World War, some 3,000 tons of chemical fertilizers were imported into Lebanon and Syria yearly. In 1947, Lebanon alone used 8,500 tons . . ." (UN, 1955, p. 154).

<sup>35</sup> IRFED, *Ibid.*, p. 207.

<sup>36</sup> See Table 2.1 above and Table 4.1 in Chapter 4. If we assume that industrial labor was distributed in Lebanon and Syria proportionally to their populations, then Table 2.1 would indicate a level of Lebanese industrial employment in 1937 that exceeded 80,000, a level that would be reached only thirty years later in the late 1970s.

one of a clearly falling level of industrial employment after the WWII boom.<sup>37</sup> Already, in 1948, the President of the Lebanese Society of Political Economy was lamenting the long commercial boom of 1840–1914, imputing its demise, however, to the protective policies of the mandatory authorities.<sup>38</sup>

*The triumph of laissez-faire*

The Lebanese economy performed well between 1920 and 1945. Despite the virtual disappearance of the silk industry, the fall in emigration and associated remittances, output significantly increased across most if not all economic activities. This positive economic performance was assisted by the larger market of the new Lebanon, good communications and education infrastructure and, as noted above, by the absence of capital shortages and a relatively high cumulative current account surplus. Financial savings accumulated, mostly in the form of French Franc and Sterling balances held by individuals and institutions.<sup>39</sup> Thus, by 1946, the economy was favorably set for an industrialization drive or, at least, for vigorous growth.

The government of the newly independent state was conscious of the challenges posed by the new economic environment. The Lebanese authorities chose *laissez-faire*, not only as a long-term policy for economic development but also as a national *raison d'être*.

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The 1937 industrial employment figure in Table 2.1 is derived from a survey-based report that was submitted to the League of Nations by the mandatory authorities. Chami (1981, p. 49) quotes the same report as mentioning that industrial employment was 41,000 in 1937 in only the three major cities of Beirut, Tripoli and Sidon. He further quotes other studies (a University of Paris thesis in 1951 by K. Bohsali) as putting total industrial employment in 1943–44, after the WWII boom, at more than 91,000! These figures are in marked contrast with a UN (1955, p. 151) estimate of only 20,000 at the outbreak of WWII. However, the UN estimate may have suffered from the exclusion of labor working at home and on a payment-by-piece basis.

<sup>37</sup> A 1950 survey by the Ministry of National Economy estimated industrial employment at approximately 22,000 (Nsouli, 1953, p. 82). The 1955 official industrial survey, with its estimate of more than 35,000 in total industrial employment, partly resolved the downward bias of the 1950 estimate. Although the two estimates are not strictly comparable, since they used different methodologies, the pattern that still emerges is one of falling industrial employment after WWII.

<sup>38</sup> Shehadi, 1987, p. 21.

<sup>39</sup> UN, 1955, p. 151. Savings included a large element of forced savings due to inflation as the Beirut cost of living index rose approximately six times between 1939 and 1945 (see Appendix IV).

The choice of laissez-faire came in the midst of several fundamental, often conflicting, developments that were affecting the political and economic environment of the country. Lebanon had emerged from WWII an independent state, with a revitalized industry and a financial surplus derived from active trade and speculation. In addition, there was little unemployment and the Treasury was in surplus.<sup>40</sup> Between 1939 and 1944, there was a fiscal surplus in every year with a cumulative total of about LL 23 million.<sup>41</sup> The picture is less clear, however, for the subsequent period 1945–50. An examination of some economic indicators, as in Table 2.2, reveals a mixed picture during a period of Lebanon's economic history on which little has been written.

Table 2.2 *General economic indicators 1939–1950*

	1939	1945	1946	1947	1948	1949	1950
Population <sup>a</sup> (thousands)	~ 1,000	1,147					1,443
Industry-main branches <sup>b</sup>							
a) Number of establishments			477		671		880
b) Number of employees			8,052		11,153		11,525
c) Capital invested (LL millions)			72		96		113
National income (LL millions)		~ 700			919	932	1,042
Cost of living index	100	607	553	500	492	461	426
Wholesale price index	100	1,038	889	797	775	635	589
Average exchange rate (LL/\$)				3.08	3.46	3.26	3.47
Trade deficit—Syria & Lebanon <sup>c</sup> (LLS millions)	39	87	181	279	405	405	
Gold & FX reserves <sup>d</sup> (\$millions)					74		39

*Sources:* See the corresponding Appendices and the notes below.

*Notes:* a- See Appendix I for population figures in 1945–1950. The population of about 1 million in 1939 is obtained by applying an average annual rate of growth of 2 percent between 1939 and 1945, a rate which is slightly lower than the average rate of 2.26 percent assumed by the UN for the period 1950–1955 (UN, 1988b, p. 288). b- The source is the UN (1955, p. 158n). It is not clear what is meant by “employees” and “main branches” of industry, which include food-processing, beverages, textiles, non-metallic mineral products, chemicals, wood products, printing and leather. c- The source is Saba, E. (1961, pp. 203–204). The data underestimate the deficit, without affecting its trend, because amounts are calculated at overvalued official exchange rates. d- Gold and foreign exchange reserves at end period. The source is UN (1955, p. 171n).

<sup>40</sup> Britt, 1953, p. 8.

<sup>41</sup> UN, 1955, p. 172.

Notwithstanding these considerations, national income did significantly increase between 1945 and 1950. The figures in Table 2.2 indicate an annual growth rate in real per capita income of 11 percent during the period. Industry exhibited a dynamic growth in terms of either the number of newly established enterprises or capital invested. Investment in the main branches of industry, whether deflated by the consumer or wholesale price index, more than doubled in real terms between 1946 and 1950, while employment increased at the much lower rate of 43 percent during the same period, thus indicating a significant increase in mechanization. Contrary to all the countries in the region, whose exports were essentially of agricultural origin, Lebanon's exports were, by the early 1950s, only 50 percent of agricultural origin and very diversified.<sup>42</sup> As this occurred with a majority of the population living in rural areas, it implies a relatively remarkable industrial performance.<sup>43</sup> Trade, particularly transit trade, also vigorously expanded owing to the enlargement and improvement of the port of Beirut and of its free zone.

Other evidence, however, reveals less favorable developments. Reports during the period in question mention a surge in consumption, financed from the surplus accumulated during the war years. In fact, gold and foreign reserves held by both private and public concerns fell sharply and were greatly depleted by the end of 1948.<sup>44</sup> The trade deficit, of both Syria and Lebanon—who were joined by a customs union until its breakup in March 1950—was mostly the reflection of the surge in consumption.<sup>45</sup> The war in Palestine exacerbated the adverse trade performance, and practically eliminated the market for Lebanese agricultural products and the income from Palestinian tourists.

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<sup>42</sup> UN, 1955, p. 163.

<sup>43</sup> Tannous (1949, p. 153) estimates the share of the rural population in the late 1940s at 75 percent while the UN (1955, p. 150) puts the urban population at over 40 percent. The definition of urban or rural population is not specified in either case.

<sup>44</sup> Britt, 1953, p. 8 and Saba, E., 1961, p. 106. It has to be noted that some of the loss in foreign reserves held by the Lebanese authorities is attributed to France's refusal in 1946 to honor its 1944 agreement to compensate Lebanon for any loss in its French Franc assets (held as cover of note issue) that would result from a devaluation of the French Franc vis-à-vis the Pound Sterling (Saba, E., 1961 and Yaffi, 1958).

<sup>45</sup> Lebanon's trade deficit, measured by its share in the early 1950s, represented during that period between 50 and 75 percent of the joint trade deficit.

These developments led to a rapid increase in unemployment.<sup>46</sup> IMF reports during the period also cite trade losses due to the fall in world and local prices and bank restriction of credit. Table 2.2 above clearly reveals a severe price deflation during 1945–50. In addition, bank deposits fell from LL 227 million at end 1945 to LL 181 million at end 1949. Even professional publications of the period were reporting a certain “marasme”, or a slackening of activity, and a fall in demand.<sup>47</sup>

Table 2.3 *Number of industrial establishments and employees, 1930–1950<sup>a</sup>*

	1930	1939	1950
Number of establishments	400	900	1,285 <sup>b</sup>
Number of employees		20,000	25 to 30,000 <sup>c</sup>

*Source:* UN, 1955, pp. 151, 158.

*Notes:* a- Employees and establishments are for all factories and workshops including craftsmen or artisans. b- The number of establishments in 1950 excludes handicrafts, public utilities and enterprises operating under concession agreements such as petroleum refineries and the tobacco monopoly. This underestimates the rate of expansion in industrial establishments relative to the pre-WWII period. c- The range estimate is for c. 1952.

Economic performance during 1945–50 may therefore have been mixed. National income was exhibiting strong growth, probably still driven by the gradually weakening impulse of the war boom. At the same time, accumulated surplus was being depleted, mostly on consumption, and foreign reserves were falling. Industry, though a secondary activity in relation to trade, with a share of some 10 percent of total employment, was still a dynamic activity, as illustrated by Tables 2.2 and 2.3 above that show a strong increase in the number of industrial establishments. It may be that, during 1945–50, only industry was still doing well or may have been less adversely affected than other activities. It was then that Lebanon chose the policy of laissez-faire as a national economic strategy.

<sup>46</sup> Several reports mention high unemployment rates around the late 1940s and early 1950s (Britt, 1953, p. 9 and UN, 1955, p. 158). Churchill's socio-economic study of Beirut estimated the unemployment rate in 1952–53 in Beirut at 10 percent (Churchill, 1954, p. 23).

<sup>47</sup> See UN, 1955, p. 169, and Chambre de Commerce Française Au Levant, 1948, p. 140.

Laissez-faire really began in November 1948, when most foreign exchange controls were formally relaxed. Although all controls were eliminated in 1952, the free foreign exchange market had been widespread and effectively in operation since 1948. The period 1946–54 also witnessed, in parallel, an intense intellectual debate, in articles, books and conferences, on the Lebanese identity and the leading role that Lebanon could play in its regional environment. The laissez-faire regime was then chosen as part of a well-formulated ideology regarding Lebanon's identity and calling.

The ideological argument that was used in support of the choice of laissez-faire went something like this. For centuries, Lebanon has been a pluralist, multi-confessional society of Christians and Muslims, with an established tradition of providing refuge to oppressed minorities.<sup>48</sup> Geographically located at the crossroads of three continents, it has long interacted to great advantage with both oriental and western cultures. History also shows that "private initiative" and free economic exchange, supported by this geographical and cultural advantage, have well served the Lebanese since Phoenician times. Moreover, free exchange and free movement are, the argument went on, naturally compatible with the traditions of the country and its geographical location. Governments, on the other hand and especially in that part of the world, are inefficient institutions that cannot adequately regulate or direct the private sector. The new system should therefore have as much freedom and as few constraints as possible, a free system that respects the pluralist traditions of Lebanese society.

This argument is mainly associated with the writings of the Lebanese businessman, politician and thinker Michel Chiha (1994). Politically, this meant that executive, legislative and administrative powers had to be fairly apportioned along sectarian lines, creating a balance among many social groups. Economically, it meant that laissez-faire was the obvious and natural choice of an economic system for a free and prosperous country.

The choice of the laissez-faire regime was in contrast with that of neighboring Syria, who was then stressing the role of government in the promotion of economic growth and development.<sup>49</sup> Indeed,

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<sup>48</sup> This section has heavily drawn on Shehadi's (1987) excellent review of the dominant economic and political figures and ideas that were instrumental, during that period, in the choice of the laissez-faire regime.

<sup>49</sup> See Al-Sibai, 1967.

this contrast in the orientation of basic economic strategy was one of the fundamental reasons for the breakup of the Syrian-Lebanese Customs Union. However, soon afterwards, regional political and economic upheavals in the late 1940s and early 1950s were to underline the validity of Lebanon's choice.

A succession of coups d'états erupted in many Arab countries, bringing with them political instability and radical changes in the political and economic regimes. The single most important economic consequence of these developments was the flight of private capital from these countries towards Lebanon. It all started with the displacement of Palestinians in 1948, many of whom came to Lebanon with their savings. At the same time, the elimination of competition from the well-developed Haifa and Alexandretta ports further enhanced the role of Beirut as a regional center for entrepôt and transit trade. Later, political uncertainty and the nationalization of private assets in Syria and Egypt resulted in further substantial capital inflow into Lebanon. In the case of Egypt, it was mostly the capital of Lebanese businessmen who had been established there since the turn of the century to escape Ottoman rule. The continuous inflow of private capital into Lebanon confirmed the importance of the benefits that a laissez-faire environment could bestow on the economy.

Clearly, it was a period when a proposal of a long-term industrial policy, as a principal element of a strategy for development, would have appeared inappropriate if not irrelevant. More important, laissez-faire was very suitable to the new middle class of entrepreneurs, merchants and middlemen that had emerged almost a century ago in the second half of the nineteenth century. The business and political classes could then plainly see the advantages and profits that could be realized from a laissez-faire regime.

### *The rules of the game*

Since Lebanon has no significant mineral or other natural resources, a system with a strong central authority was not called for to control the benefits from natural endowments. Agriculture is concentrated along a coastal narrow strip and in the large and fertile Bekaa valley, which lies between two chains of mountains running almost in parallel along the country, from north to south. Terracing of mountain slopes by farmers is prevalent, reflecting the labor-intensive system



of farming and the scarcity of agricultural land. The climate is Mediterranean and water resources are relatively plentiful, though insufficiently exploited, with many rivers and streams.

Laissez-faire is an economic policy regime that entails a system of private property and free exchange, with prices determined by market forces that operate under as few restrictions as possible.<sup>50</sup> Laissez-faire does not necessarily imply a capitalist economic organization or competitive markets, only a minimalist state that allows economic agents to operate freely within specific institutional rules of behavior. We shall describe these “rules of the game” by giving a description of the political and economic environment in which laissez-faire has been operating for more than half a century. This environment consists of the modus operandi of the Lebanese political system and of the factor and product markets.

### *The political setting*

Since 1943, Lebanon has operated as a parliamentary system whereby, by informal agreement, legislative and executive powers are divided along sectarian Christian-Muslim lines. The president is a Maronite Christian elected by Parliament every six years, the Speaker is a Shiite Muslim elected every year by the members of parliament (MPs), and the Prime Minister is a Sunni Muslim appointed by the President after consultation with the MPs who are themselves elected by universal suffrage every four years.<sup>51</sup> Civil service jobs also are roughly distributed along sectarian lines. Mostly, they are given as political favors and serve to consolidate the power and status of politicians. The political system itself may be thought of as an oligarchy where power is distributed among sectarian and regional leaders according to informal and tacitly approved rules. It is a traditional and conservative system since mostly it has served to concentrate and con-

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<sup>50</sup> The fact that laissez-faire is essentially a policy framework is underlined by its usual writing in the imperative “laissez” rather than in the neutral infinitive tense “laisser”. Indeed, for Adam Smith it was a program for the abolition of restrictive laws (Robinson and Eatwell, 1973, pp. 46–47).

<sup>51</sup> Following a new constitutional arrangement in 1989, the Speaker is elected every four years. The new Constitution has affected power distribution among the three top positions, weakening that of the President, but the political system has not much changed in practically all other respects.

solidate the power of the elite, i.e. to maintain the status quo. An outstanding example of the conservative character of the political system is that, by 1972 and in almost fifty years of parliamentary life, 359 MPs had been elected, of whom a little more than 300 have “inherited” their seat based on family ties.<sup>52</sup>

It was as if the same political and social contract was being continuously renewed. Access to political power also meant access to economic power through budget allocations, administrative appointments and association with private interests. *Laissez-faire* was not *laissez-aller*, though, for it implied specific obligations on the part of government, namely:

1. To safeguard what successive ministerial declarations always referred to as “private initiative”, which meant as little interference as possible in the market process.
2. To provide adequate infrastructure, which practically meant the provision of roads, communications and electricity in urban areas, notably in the capital Beirut and central Lebanon, where economic activity continues to be heavily concentrated. The objective of governments regarding infrastructure was less, in a developmental sense, the establishment of an efficient national infrastructure and more the provision of those basic services that are most needed by the business community in urban areas, predominantly in the capital Beirut.
3. To safeguard monetary stability, which is necessary for the inflow of private capital and for general economic stability. The principle of a “sound currency” was a principle seen by the founding fathers of *laissez-faire* in Lebanon as fundamental to the success of the system.<sup>53</sup> The monetary authorities largely succeeded in achieving this objective as the Lebanese pound, with a free-floating regime, became one of the most stable currencies in the world, fluctuating little between an average of LL 3.10 to the US dollar in 1947 and LL 3.43 in 1980. During that period, outlier exchange rates were few and lasted for relatively short periods. Detailed information on the financial system and the exchange rate is presented in Chapter 6.

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<sup>52</sup> Khalaf, S., 1977, p. 196.

<sup>53</sup> See Shehadi, 1987.

All governments unquestioningly adhered to the laissez-faire regime. Tariffs were imposed, but mostly for revenue purposes since direct taxation is relatively low and widely evaded by business enterprises. Licenses to import certain commodities may also be required, but are not a typical feature of the trade regime and can be easily obtained. Comparing the tariff and import duty system in Lebanon to other countries in the region, the UN observed that “. . . Lebanon has used import control only moderately and comparatively on a limited scale.”<sup>54</sup>

However, there was a period in 1958–64 during which the President, Fuad Chehab, had explicit objectives of building and consolidating state institutions in order to promote economic and social development. It was the only “developmental” period in the history of modern Lebanon, namely when economic and social development was set by the political regime as a major national objective. Various institutions were created for the civil service and the design and execution of major agricultural and road projects. A central bank was established in 1964, and the systematic and regular compilation and dissemination of national accounts data began in the same year.<sup>55</sup> Expenditure on education and pupil enrolment in government schools significantly increased. Preparation began for the design of a social security law; implementation, albeit deficient in several respects, began in the early 1970s.

Above all, the regime’s developmental view of the economy was best confirmed by its commissioning in 1959 the French consultancy firm IRFED to undertake, as a basis for a development strategy, a countrywide detailed socio-economic study of Lebanon.<sup>56</sup> Despite this developmental orientation, the government interfered little with the market. In fact, the important infrastructure and institutional achievement of Chehab’s regime may be seen as having provided a more efficient framework for the functioning of the market. To the extent

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<sup>54</sup> UN/ECWA, 1978, p. 35.

<sup>55</sup> In fact, the establishment of a fully-fledged Lebanese Central Bank could not take place before 1964 owing to a monetary agreement signed under the French Mandate in 1937 (Yaffi, 1958, p. 94).

<sup>56</sup> The acronym IRFED fully translates as the International Institute for Research and Training in View of an Integral and Harmonious Development. Henceforth, all references to IRFED, c. 1962, Vol. I, will be referred to as IRFED, unless otherwise indicated.

that the essence of a market or laissez-faire economy consists in the free movement of labor and capital, all Lebanese governments scrupulously adhered to that principle.

*The factor and product markets*

The factor and product markets in Lebanon operate freely, with the usual degrees of imperfection in structure and restrictive practices by enterprises.

Lebanon is a mountainous country with a high population density resulting in expensive land prices, particularly in urban areas. Attachment to land in a small country, and inheritance laws, which sometimes leave a small piece of real estate to a large number of heirs, have weakened the commodity characteristic of land, especially in rural areas. Land transactions are generally free, with some restrictions on ownership by non-Lebanese. As for capital, if laissez-faire or a free market system means anything it should above all mean a totally free foreign exchange market and the freedom of transfer of capital. In this regard, Lebanon has always had a free exchange market, and open current and capital accounts in its transactions with the rest of the world. These particular economic freedoms were first established in November 1948 and continue to be in force to date.

The establishment of any enterprise is a procedure that is subject to the usual regulations that operate in capitalist economies, with the usual natural and artificial barriers to entry. Foreign ownership of business enterprises is encouraged, with the proviso that the majority of the members of the board of directors of limited liability companies should be Lebanese nationals.

The labor market also is essentially a free market. The first labor legislation, which came into effect in 1943, was prompted by an expanding industrial activity and was mainly concerned with minimum wages and compensating for increases in the cost of living. It provided for equal pay for similar work by men and women.<sup>57</sup> Despite the minimum-wage legislation, many workers have been and continue to be paid wages below the prescribed minimum. More important, minimum-wage levels have always been significantly lower than

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<sup>57</sup> Al Shukhaibi, 1990, p. 8.

the urban subsistence levels and often at less than half that level (see Table 5.11 in Chapter 5). A comprehensive General Labor Code was promulgated in 1946; it set the general conditions of employment concerning wage earners only in trade and industry, to the exclusion of civil servants and workers in agriculture.<sup>58</sup> The general law of contracts and obligations, which provided for free contractual labor, had already been promulgated in 1932 but it did not allow for any protection to the worker vis-à-vis the employer. Subsequent legislation partly addressed this deficiency by setting limits to certain employment practices, such limits being very much to the advantage of the employer. A virtually unbridled power to “hire and fire” is vested with the employer, while allowing for severance pay usually equivalent to one-month pay for each year of service. Maximum weekly hours of work are 48 hours, with some exceptions. The minimum age of employment is eight years, a limitation borrowed from an 1874 French law.<sup>59</sup>

A social security scheme was established in 1965 and became operational in the early 1970s. It provided for partial medical insurance, payment of family allowances and a pension scheme, all against monthly contributions by both the insured and the employer. Regular salaried workers in agriculture were allowed into the scheme in 1974. The social security scheme was an advanced step in terms of raising the minimum social wage of labor, but it was mostly adhered to and effectively applied only by relatively large corporations. Administrative delays in payment to the insured and widespread non-payment of contributions by owners of enterprises undermined its effectiveness. By the end of 1974, the total number of subscribers to the scheme was estimated at around 340,000 workers, which represented about 45 percent of the employed. By the end of 2001, the number of subscribers increased to around 429,000, representing less than 30 percent of the employed.<sup>60</sup> These subscribers are the regular wage earners, working outside agriculture.

Finally, labor unions have been in operation since the turn of the century. However, despite occasional demonstrations of effective mobilization and negotiating powers, they remain relatively weak and dis-

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<sup>58</sup> Klat, 1959, pp. 69–70.

<sup>59</sup> Al Shukhaibi, *Ibid.*

<sup>60</sup> National Fund, c. 1983, pp. 67–73, and in *An-Nahar*, 21 March 2002.

organized. Estimates of the number of organized workers in 1952 ranged from 14 to 28 thousand out of a potential of 150 thousand union members.<sup>61</sup> Table 2.4 below provides figures on the level and evolution of union membership between 1949 and 2001.

Table 2.4 *Unions and union membership, 1949–2001*

Year	Number of Union Federations	Number of Unions	Number of Union Members
1949	1	34	18,837
1956	5	72	18,439
1961	5	101	21,568
1967	9	121	34,871
1972	14	141	50,708
...			
2001	37	210	58,690

Sources: Ministry of Labor and Social Affairs, in Chami 1981, p. 404; An-Nahar, May 1, 2002.

Union membership accelerated during the 1960s and grew at an average annual rate of 4.4 percent during the whole period, well above the population and employment growth rates. However, membership was distributed among a growing number of unions and union federations. In 1967, industry accounted for about one third of the total membership.<sup>62</sup> Moreover, total union membership, which was about 4 percent of the active labor force during the 1950s–60s, increased to only a little more than 6 percent in the mid-1970s. By 2001, they had become disorganized and lost much of their independence and influence, representing less than 4 percent of the employed. Labor union membership therefore has not been large or mobilized enough to have a significant impact on wages or the general standard of living of workers.

The stage is now set for an examination of the record of economic growth and development of Lebanon's laissez-fair regime. In many respects, this economic regime was a singular case, standing in sharp

<sup>61</sup> Lerner, 1958, p. 453.

<sup>62</sup> Khalaf, S., 1968, p. 127.

contrast against the economic regimes in force or soon to be implemented in the rest of the world: the industrial countries with their “mixed economies” and the developing countries with their various degrees of dirigisme or state intervention in the market process. Lebanon was in fact ready for an economic sprint, for “. . . by independence in 1943, [it] had the highest per capita income in the Arab East, the lowest rate of illiteracy, the best developed infrastructure and . . . the largest share of manufacturing within national income”.<sup>63</sup> We shall now see what laissez-faire made of these favorable conditions.

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<sup>63</sup> Owen, 1988b, p. 28.

## CHAPTER THREE

### GROWTH WITHOUT DEVELOPMENT

We have left undone those things  
Which we ought to have done,  
And we have done those things  
Which we ought not to have done

From a 1662 prayer book

Very few believed in the viability of the small new republic. The country had few natural resources and the sectarian basis of distribution of power was deemed unstable. However, the political system operated efficiently, especially by regional standards. Presidents of the republic have been regularly elected by Parliament except for a one-year hiatus in 1988–89, and parliamentary elections have been regularly held except during 1976–91 when mandates were successively renewed as war prevented the holding of elections. Moreover, the country clearly had the freest and most open society in the region, and the highest standard of living among the non-oil economies.

Until the onset of the war in 1975, many labeled Lebanon the Switzerland of the Middle East, and its impressive growth record was frequently emphasized.<sup>1</sup> Its literacy rate was deemed the highest in the Arab world and among the highest in the developing world. By 1970, a socio-economic development index for Lebanon, computed by the UN as part of a 1970 cross-country development profile, was over 70 while the index for Egypt and Turkey was 36 and 37 respectively, for Chile 65 and for Austria 90.<sup>2</sup> A World Bank report, published in May 1975, just as war was erupting, stated that “Lebanon is aiming for European living standards and should be compared with a European country in the lower income bracket”. Underlying this assessment was a remarkable financial performance. For instance, during 1951–82, the overall balance of payments remained positive

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<sup>1</sup> See Persen, 1958 and Issawi, 1964.

<sup>2</sup> UN, 1985, p. 469.



every single year, save for a negligible deficit in 1967, total government debt was practically nil in 1975 and then remained at moderate levels until the early 1990s. The inference was that, despite the country's poverty in physical resources, laissez-faire and skills were the cause of this impressive performance.

It is our contention, however, and it is indeed the thrust of this book that neither the growth nor the development record of laissez-faire is as impressive as it is claimed to be. We also argue that this record owes more to transitory and external favorable circumstances than to a productive base that is the result of a sustained production and participation of skills in the economy. It can further be shown that it was mainly non-market forces that were instrumental in the promotion of growth, whereas laissez-faire per se may be seen as having contributed little to, or even to have stunted, that process with little of the trickle-down-of-benefits effect that a market system is supposed to generate.

This chapter will present a general assessment of the growth and development performance in Lebanon, with emphasis on the 1948–74 period, when the laissez-faire system was operating in a relatively tranquil domestic environment. A more detailed assessment follows in the next two chapters. The first part reviews the record on growth and development. The second part analyzes the process of development by focussing on the generation of skills and the pattern of their absorption in economic activity. The last part examines the unexpected failure of capitalism, viewed as a dynamic form of economic organization, to develop in the market laissez-faire environment of the Lebanese economy.

### *The record of growth and development in Lebanon*

Economic development refers, in short, to two components, a growth component illustrated by a sustained increase in the per capita output of goods and services, and a social development component that includes various indicators such as housing, health and literacy conditions. Since income distribution is, for a given level of income, a good proxy for the degree of access by people to those development services, the process of economic development is then well summarized by the process of growth and distribution of income. In fact,

the grand economic theories, since the Physiocrats and until the last decades of the nineteenth century, were mainly concerned with the growth and distribution of output in a market economy, though the issue of development proper is a more recent one.

A summary of Lebanon's economic development between 1950 and 2002 is proposed in the following table of indicators.

Table 3.1 *Economic development indicators*

	1950	1964	1974	1987	1997	2002
<i>A- Economic indicators</i>						
Population, resident (000's)	1,443	2,090	2,705	2,767	4,005	4,251
GDP per capita (\$ current)	229	499	1,291	1,191	3,911	4,296
Growth per capita (% p.a.) <sup>a</sup>		2.9%	3.2%	0.2%	≤ 0.0%	0.2%
<i>Output structure (%)</i>						
Agriculture	20	12	9	9	6	
Industry <sup>b</sup>	14	15	18	16	15	
Services	66	73	73	75	79	
<i>Employment structure (%)</i>						
Agriculture	55		22		15-20	
Industry <sup>c</sup>	11		17		15	
Services	34		61		65-70	
<i>Demand structure (% GDP)</i>						
Consumption	88	99	98	102	105	
(o/w Private)	(81)	(88)	(89)	(97)	(89)	
Gross domestic investment	18	22	21	16	30	
Net exports	-6	-21	-19	-18	-35	
Gross domestic saving	12	1	2	-2	-5	
<i>Financial indicators</i>						
Public debt (% GDP) <sup>c</sup>	~ 0	≤ 1	≤ 1	16	92	161
Net foreign assets (% GDP) <sup>d</sup>	12	37	103	204	66	56
Average exchange rate (LL/\$)	3.5	3.1	2.3	225	1,539	1,508
CPI (% p.a.) <sup>e</sup>		1.9%	3.6%	18.1%	44.2%	1.2%
<i>B- Development indicators<sup>f</sup></i>						
Life expectancy at birth (years)	56	63	65	68	70	71
Infant mortality (per 000 births)	87	57	49	39	31	26
<i>Distribution: % of households who</i>						
Earn < average income	75		76		72	
Save	6		10		14	
<i>Education<sup>g</sup></i>						
Adult illiteracy (% population)						
Total	30-40		31	22	15	14
Female			42	31	20	

Table 3.1 (*cont.*)

	1950	1964	1974	1987	1997	2002
Gross enrolment (% age group)						
Primary		109	119		101	
Secondary		19	40		81	
Tertiary		6	24		27	
<i>Housing occupancy (% population)<sup>h</sup></i>						
Very high	22		56		46	
High to normal	51		32		30	
Low to very low	27		12		24	

*Sources:* Appendices I–IV; Badre, 1956; Chalak, 1983; Churchill, 1954; Gaspard, 1990; Lerner, 1958; PAL, 1972, 1998; Republic of Lebanon and FAO, 2000; République Libanaise, c. 1967–c. 1974, 1997, 1998a,b, 2003; UN, 1987, 1988b. Various issues of IMF, International Financial Statistics, UN, Human Development Report, UNESCO, Statistical Yearbook, and World Bank, World Development Report and World Development Indicators.

*Notes:* a- Average growth is between indicated years in GDP per capita in constant LL (1972–74) prices. Per capita growth during 1993–2002 is higher in constant \$ (2% vs. 0.7% in constant LL) owing to an average appreciation of the Pound vis-à-vis the \$ by about 1.3%. b- Industry is mining, manufacturing and utilities. The 1974 share is the average for 1973–74. Construction is added to services. c- Public debt is of general government, including annex budgets. It is the sum of net LL government debt plus gross government debt in foreign currencies; guaranteed debt is insignificant. d- Net foreign assets are of the banking system, including official gold holdings valued at market prices. The 1950 figure is for 1952. e- Consumer price inflation is between the indicated years. f- Indicators refer to the noted year  $\pm$  3 years. i- The 1964 and 1974 indicators are for 1960 and 1970, respectively. Adult illiteracy is for persons aged 15 years or more, with no schooling (1970) or who cannot read or write simple statements. g- Housing indicators are for Beirut 1951–52 and 1964, Lebanon 1970 and 1997. A very high occupancy status roughly corresponds to 2–3 persons per room, high-to-normal to 1–2 persons, and low-to-very-low to less than 1 person per room.

### *Growth and development performance: a first impression*

The indicators in Table 3.1 suggest a satisfactory economic performance. Between 1950 and 1974, real GDP per capita increased at an average annual rate of more than 3.0 percent. In particular, despite continuous and significant trade deficits, the overall balance of payments remained positive every single year between 1951 and 1982, except for one negligible deficit in 1967. It was also positive for most of the period 1983–98. By the end of 1992, two years after the end of the war, total government debt stood at less than 40 percent of GDP (including less than \$300 million in foreign currencies), and total foreign reserves held by the central bank stood at around \$4.6 billion, or about 80 percent of GDP. Private foreign debt has traditionally been small, mostly representing short-term trade credits.

The development indicators also show a satisfactory performance, although a very unequal distribution of income and the absence of

a notable industrial expansion produce a discordant note in an otherwise apparently overall positive picture. A relatively cramped housing situation is even more striking since a construction boom has been an almost constant feature of the Lebanese economy, growing at 6.6 percent a year, in real terms, between 1950 and 1974.<sup>3</sup> In fact, by the end of 1970, about 70 percent of all the housing stock had been built since 1945, and yet more than half the population was living in so-called “critical” or very high occupancy conditions. Thus, despite a continued construction boom, the majority of the population in 1997 was still living in overcrowded housing conditions.

Moreover, the development process has failed to allow the majority of the population to benefit from a minimal medical safety net. By 1997, only 14 percent of residents had adequate insurance coverage provided by the private sector, while an additional 28 percent had coverage from inadequate public sector social security schemes.<sup>4</sup> By mid-2003, the situation has practically remained unchanged. Fortunately, it is the various non-governmental organizations (NGOs) that partly compensate for the deficiency in social safety nets by operating institutions that provide basic services to practically all the disabled, elderly and orphans in the country. In fact, in 1999, NGOs were operating 650 of the total 750 dispensaries in the country.<sup>5</sup>

It is appropriate to recall at this stage that the Lebanese economy had started after WWII with unusually favorable conditions: a dynamic manufacturing sector, a strong financial condition, a relatively low illiteracy rate, and accommodating Arab markets for exports. In addition, a per capita annual income of \$250 in 1950 was practically at the top of the scale in the developing world.<sup>6</sup> These favorable conditions do not accord well with the absence of a strong economic and development performance. Clearly, this calls for a re-examination of the economic performance record.

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<sup>3</sup> FAO, 1959, II-13; Chalak, 1983, p. 11.

<sup>4</sup> République Libanaise, 1998b, p. 199.

<sup>5</sup> Al-Assir, p. 3.

<sup>6</sup> Per capita income in the Union of South Africa was deemed the highest, at \$256. See Badre, 1956, p. 31.

*The growth record re-examined*

The period following the end of WWII until the early 1970s was characterized by strong economic growth across the world. It was a unique performance for most countries of the world, compared to any other period of the century or even earlier. Lebanon's growth during that period was about equal to the average performance of the LDC group of countries. Indeed, over about a decade between 1963–65 (it being the earliest period for which GDP data are available for LDCs as a group) and 1972–74, the average annual rate of GDP growth in Lebanon was about 6.2 percent, and 3.6 percent in per capita GDP. That was quite an average performance since these rates are almost identical to the corresponding rates achieved by the LDC group during the same period.<sup>7</sup>

Other estimates lead to the same conclusion. Barlow (1982) has attempted a re-estimation of economic growth in the Middle East during 1950–1972 by using a regression of per capita GDP on physical indicators (per capita energy consumption, telephones and daily newspaper circulation) that have a high degree of correlation with purchasing-power-parity estimates. We add, in the same table below, alongside Barlow's estimates, the World Bank estimates of per capita dollar GNP for the same countries during the same period.

Table 3.2 *Per capita dollar GNP, Lebanon and other Middle Eastern countries*  
(Annual growth rates)

	<i>At constant purchasing power parity (Barlow)</i>	<i>At constant market prices (World Bank)</i>	
	<i>1950–72</i>	<i>1950–60</i>	<i>1960–73</i>
Cyprus	4.2%	3.7%	7.0%
Jordan	4.4%	9.2%	4.6%
Syria	2.8%		5.8%
Tunisia	3.1%		6.3%
Israel	6.0%	10.0%	8.9%
Turkey	3.4%	6.2%	6.6%
Egypt	1.7%	3.4%	4.0%
Lebanon	1.9%	3.7%	5.6%

Sources: Barlow (1982); the World Bank (1976).

<sup>7</sup> See IMF, IFS Yearbook 1991, pp. 162–163.

Whichever the estimation method, the ranking implied by the figures in Table 3.2 indicates a Lebanese economic performance that is less impressive than is commonly believed. Excepting Egypt, the average growth rate in Lebanon's per capita GNP in fact was distinctly lower than in any of the non-oil economies in the region during 1950–73.

These findings clearly call for an explanation. For how can one reconcile the numerous statements about Lebanon's relative high standard of living and outstanding growth performance, either in the region or among LDCs in general, with the reality of an average if not lackluster performance? The short answer is that most observers or visitors to the country usually restricted their observations to the capital Beirut and to the area of central Lebanon surrounding it. This region was much more developed than the rest of the country, as noted by the IRFED socio-economic survey of Lebanon in the early 1960s. The standard of living in Beirut or central Lebanon continues to be little representative of overall economic conditions in the country, as confirmed by the skewed distribution of income and wealth.<sup>8</sup> More specifically, Lebanon's income level in the late 1940s was distinctly higher than that of many neighboring or LDC countries.<sup>9</sup> However, most of the countries in the region have since been growing at faster rates than Lebanon, and with distinctly non-laissez-faire systems. What the figures in Table 3.2 therefore indicate is that, although per capita income in Lebanon during 1948–74 has remained higher than most, if not all, non-oil countries in the region, the gap was rapidly narrowing over time.

### *The distribution of income and wealth*

So laissez-faire in Lebanon was not the efficient or productive system that it was claimed or expected to be. In addition, the distribution of income and wealth remained strongly unequal and the level of labor skills modest. This is shown below and in the following sections.

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<sup>8</sup> See the following sections for more details on the distribution of income and wealth, and on comparative regional development.

<sup>9</sup> Bonné, 1960, pp. 36–7; Owen, 1988a, p. 28.

Table 3.3 *Distribution of income and wealth*<sup>a</sup>  
(Gini coefficients, unless otherwise indicated)

	1951–52	c. 1960	1966	1971	1985–86	1997
1– <i>Income</i>						
Lebanon		0.51		0.55		0.44
Beirut	0.61		0.51			0.41
2– <i>Expenditure</i> <sup>b</sup>						
	0.51		0.40		≥ 0.43	0.47
3– <i>Physical wealth</i>						
Cultivated land	0.52 <sup>c</sup>	0.69		0.63		
House ownership (% population)						
Lebanon				44%		68% <sup>d</sup>
Beirut	26%		17%			38% <sup>d</sup>
4– <i>Financial wealth</i>						
Bank deposits					0.83 <sup>e</sup>	0.68 <sup>f</sup>
Bank credit			0.98		0.90 <sup>e</sup>	0.89

*Sources:* 1– Chamie, 1971, p. 96; Churchill, 1954, pp. 58–59; IRFED, pp. 93–94; République Libanaise, c. 1968, p. 55. 2– Churchill, 1954, p. 64; République Libanaise, c. 1968, p. 55, 1998b, p. 237; GCLTU, 1987, pp. 49–52. 3– Bonné, 1960, p. 171; Churchill, 1954, p. 54; Daher, 1983, p. 175; PAL, 1972, p. 53; République Libanaise, c. 1968, p. 38; UNDP/FAO, 1980, p. 10 (Rapport de Synthèse). 4– Banque du Liban, Quarterly Bulletin, various issues.

*Notes:* a- Gini coefficients are relative to household distributions, except for the years c. 1960 and 1997 when they are for individual distributions. The mid-point of open-ended class intervals is determined based on the World Bank's method of linear interpolation (see Jain, 1975). b- Coefficients are all for Beirut except for 1997, which is for Lebanon. c- Late 1940s; d- For households; e- End 1986; f- End 2001; coefficient estimated from complete distribution, hence is not fully comparable to that of grouped distribution at end 1986.

It is important to note that the basis of calculation of the Gini coefficients in the table is inconsistent since the number of classes varies with the surveys. However, except for Churchill's survey of Beirut in 1951–52 that uses 67 classes for income and 28 classes for expenditure, the number of classes in the other cases varies between only 4 and 7, thus implying even greater inequality than the coefficients indicate.

If the interpretation of the evolution over time of Gini coefficients can be ambiguous, the levels themselves are indicative of a very non-egalitarian society, especially in the case of the availability of or access to financial wealth. Gini coefficients exceeding 0.40 usually start indicating strong inequality. Alternatively, one can say that the

emerging pattern of income and wealth distribution in Lebanon since 1951 does not provide any indication or empirical support for the existence of a significant improvement in the distribution of income or wealth.

In the early 1960s, IRFED estimated the distribution of income in Lebanon and found that half the population lived at or below the “poverty” level, while about a third of the population lived in a “middle” level of income, the remainder living in “comfort” and “ease”. Although poverty levels are not clearly defined in any of the surveys, it is noteworthy that this figure of approximately half the population living in “poverty” has consistently emerged in most of the surveys. Drawing together various income and expenditure surveys that were carried out in the capital Beirut or at the national level, we obtain the following summary on the evolution of income distribution between 1951 and 1997.

Any improvements, toward less inequality, in the distribution of income and wealth can only be characterized as modest at best. In 1997, half the population had a per capita monthly income from all sources of \$131, which is equivalent to about \$650 per household.<sup>10</sup>

Table 3.4 *Distribution of household income and expenditure*  
(In percent)

	1951–52 Beirut	c. 1960 <sup>a</sup> Lebanon	1966 Beirut	1971 Lebanon	1997 Lebanon
<i>% Households</i>					
			<i>% Income</i>		
Bottom 50	13	18	17	17	21
Next 40	36	38	39	35	40
Upper 10	51	44	44	48	39
	100	100	100	100	100
<i>% Households</i>					
Earning < average income	75		76		72
Spending < average expenditure	74		68		75
Who save	6		10		14

Sources: Chamie, 1977, p. 96; Churchill, 1954, pp. 24, 58–9; IRFED, pp. 91–3; République Libanaise, c. 1968, pp. 55–60, 1998b.

Note: a- The distribution is relative to per capita incomes.

<sup>10</sup> See République Libanaise, 1998, p. 71.



Saving levels, which stood at 1 to 3 percent of GDP before the war and at negative levels thereafter, are among the lowest in the world. Moreover, more than 84 percent of total savings were undertaken by 3 to 4 percent of households until the mid-1960s, and by 5 to 6 percent of households in 1997.<sup>11</sup> These findings cannot be reasonably reconciled with any proposition that laissez-faire produces over time a more egalitarian economy.

Our conclusion becomes more definite when the distribution of financial wealth is also taken into account. By the end of 1974, the top 5 percent of all beneficiaries obtained two thirds of all commercial bank credit, this share rising to around three quarters by the end of 1998.<sup>12</sup> In addition, as the above table indicates, only a minority of the population has deposits with banks, with only 14 percent of all households being in a position to save. Financial wealth therefore is much more unequally distributed than any other form of wealth, thus pointing to failure in the process of transformation of physical and human resources into financial wealth. What is also striking in this context is that it is in the financial domain, where the system's success has been more pronounced than elsewhere, that inequality has been the most pronounced.

An interesting finding emerges from the above-mentioned income surveys. Regional income disparities are less skewed than national ones: the Gini coefficients of income distribution within specific regions are significantly smaller (0.18 to 0.34) than those for income distributions at the national level (strictly exceeding 0.40). This suggests that urbanization and growth under laissez-faire seem to have exacerbated not only income but also regional distinctions.

### *Education, skills and culture under laissez-faire*

Education may be viewed as the single most important determinant of skills. We therefore take various levels of schooling as indicators of corresponding skill levels.<sup>13</sup>

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<sup>11</sup> See Churchill, 1954 and République Libanaise, 1998.

<sup>12</sup> See Banque Du Liban, Bulletin Trimestriel, nos. 11, 79.

<sup>13</sup> This intuitively reasonable relationship is indirectly supported by a study on Lebanese agriculture, which showed that, with a higher level of education, farmers were more likely to use new technology (Al-Haj and Yacoub, 1972, p. 549). In addition, other surveys showed a strong, though not unexpected, correlation between

The active population survey (PAL) of November 1970, with a sample of 30,000 households, was the most extensive manpower survey ever conducted in Lebanon. In particular, it supplied a record of educational and skill achievement in Lebanon in 1970, almost a quarter of a century after the establishment of *laissez-faire*. The PAL results were quite unexpected, revealing relatively high rates of illiteracy (defined as no schooling) that sharply stood in contrast with the widely held opinion of negligible illiteracy and high educational achievement in Lebanon. However, these results were hardly noted by observers.

The national illiteracy rate, which was estimated to be anywhere between 30 and 40 percent in the late 1940s, was, for the age group 10 and above, still standing at about 32 percent in 1970, with 22 percent for men and 42 percent for women.<sup>14</sup> Table 3.5 below presents detailed results concerning educational achievement.

Table 3.5 *Educational achievement by age group*  
(November 1970, in percent)

	<i>Age Group</i>			
	<i>6-14</i>	<i>15-24</i>	<i>15+</i>	<i>15+</i>
<i>Schooling Level</i>				(Males)
No schooling (illiterate)	25.5	16.7	36.4	(25.1)
Up to primary (semi-illiterate)	58.0	22.9	27.2	(33.5)
Primary finished	16.2	32.8	17.5	(18.7)
Total: Primary or less	99.7	72.4	81.1	(77.3)
Complementary	0.3	19.1	10.7	(11.6)
Secondary		7.9	5.8	(7.4)
University		0.6	2.4	(3.7)
Total	100	100	100	100

Source: PAL, 1972, pp. 84-85.

the level of education and income, particularly for groups with an education above the primary level (Schemeil, 1976, p. 29).

<sup>14</sup> Lerner, 1958, p. 452; PAL70, pp. 84-85.

There is an alternative way of assessing literacy achievement, which consists in examining the progress in literacy through its evolution in the three age subgroups of the age group 10 to 24. The illiteracy rate in 1970 in the subgroups 24–20, 19–15, and 14–10 was respectively 4.8 percent, 4.7 percent and 4.5 percent. In other words, no significant reduction in illiteracy was taking place, even during the heyday of *laissez-faire*.

Greater income and wealth are usually associated with a higher education level. Such a positive association existed in Lebanon, as the majority of individuals in the higher income groups had at least a secondary education.<sup>15</sup> Although education is a necessary condition, it is really the cultural environment that provides a better measure of the opportunity for access to higher incomes. It was IRFED's extensive socio-economic study that emphasized the deficiencies in Lebanon's general cultural environment as a major factor in its academic and development performance.

IRFED conducted in the early 1960s a national survey of the socio-economic conditions of 80 rural communities and of their regional capitals, in addition to those of the major urban centers. The conditions studied were in reference to income, health, housing and utilities, schooling, culture, entertainment and general social facilities.<sup>16</sup> More than 140 indicators were used to obtain a weighted numerical ranking with regard to general development conditions in urban and rural Lebanon. The grades 0 and 1 meant no development and serious underdevelopment, respectively; 2 was partial development or underdevelopment; 3 and 4 were good and high development conditions.<sup>17</sup>

The study estimated the general development average for Lebanon at 1.92; the center, mostly Beirut, two other cities and Mount Lebanon scored 2 or higher. The interesting result was that, while, as expected, the rural regions generally scored lower than the urban areas, it was culture, entertainment, and communal facilities that systematically scored below 1 while, equally systematically, schooling scored higher than 2.<sup>18</sup> In other words, although literacy was increasing, it was

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<sup>15</sup> See Table 6 in Schemeil, 1976, p. 29.

<sup>16</sup> The indicators for culture included literacy, schooling, newspaper reading, and access to public libraries.

<sup>17</sup> IRFED, Vol. II, p. 71.

<sup>18</sup> *Ibid.*, pp. 98–99.

increasing with little “cultural” content. In addition, the economic and cultural disparities were clearly wide between the rural areas and the center(s) in general. In fact, the only uniformly unfavorable development situation that IRFED elicited was the social and cultural conditions, in addition to poverty in sanitary equipment.

IRFED’s finding of high cultural underdevelopment in the rural areas, where 60 percent of Lebanon’s population then lived, ran against the traditional image of Lebanon as a cultural regional center. However, the fact that the capital Beirut was indeed a regional cultural center only serves to underscore the cultural and economic disparities that were actually prevailing among regions and people, instead of presenting Beirut as the reflection, manifestly incorrect, of general development conditions in Lebanon.

This economic and cultural poverty was accompanied by a geographical divide that is even more striking since it was taking place in a relatively small country. PAL’s population survey in November 1970 estimated urbanization, defined as agglomerations with 5,000 people or more, at 59 percent of the population. However, this figure is more misleading than illuminating. For, whereas 52 percent of the population lived in cities of 100,000 residents or more (including 44 percent in Greater Beirut alone), there were on the other end of the spectrum about 39 percent who lived in villages of less than 5,000.<sup>19</sup> The population distribution by size of agglomeration was really an inverted normal curve.

Most people, i.e. more than 90 percent of the total population, was almost equally concentrated in either very small agglomerations of less than 5,000 or in much bigger cities of 100,000 or more, the latter being effectively in the two largest cities of Beirut and Tripoli. The rural/urban divide was extreme, with practically no continuum in between, since only less than 10 percent of the population lived in the wide middle category of agglomerations with 5,000 to 100,000 residents. The divide was quite unusual since it was also taking place in a small country. Thus, by the early 1970s and in terms of several essential aspects of development, the Lebanese population had become two distinct populations.

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<sup>19</sup> PAL70, pp. 34, 39.

*Labor and skills in the development process*

The performance record so far considered may be viewed as an assessment of the productivity of a process from the output perspective, the output being labor with its characteristics of income and skills. We now consider labor as an input rather than output. We further take the analytical view that development is a process that essentially involves the drawing of labor into productive activity, where productive activity is one that is mostly carried out along capitalist rather than independent basis of production. In LDCs, as opposed to industrial countries, productive activity is mostly concentrated in industry.<sup>20</sup> We shall therefore focus on the allocation of labor and skills by capitalist and non-capitalist activity and, more specifically, according to whether labor is allocated to industry, particularly manufacturing.

The view that only the market is “productive”, in that free exchange for advantage carries with it the incentive to produce more and more output for further exchange, is central to all economic theory since Adam Smith. Marx’s analysis of capitalism was not incompatible with that view, although his was more specific and richer. For Marx, modern economic growth was the product of capitalism, a historically distinct form of social organization. Growth requires capital accumulation, and “. . . accumulation of capital is . . . increase of the proletariat.”<sup>21</sup> Thus, in a capitalist framework, growth essentially involves the bringing of more labor into the domain of capitalist activity, which implies the simultaneous operation of waged employment and production for profit. An essential condition for sustained growth then becomes the institutional requirement of the movement of an economy from a pre-capitalist to a capitalist form of organization.

Similarly, many if not most modern economists, also consider growth as a process involving a change in economic structure. For instance, for Kuznets, and Chenery et al. (1986), economic growth requires a shift from less to more productive activities, specifically a shift from agriculture to industry. So our view of what constitutes a

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<sup>20</sup> See Chapter 4, particularly its introduction, on the critical importance of manufacturing for development in LDCs.

<sup>21</sup> Sutcliffe, 1971, p. 315.

sustained process of growth or development is very much in the classical and modern tradition, namely it is one of a process of absorption of labor into activities, particularly industry, that are mostly carried out along capitalist lines of production. The process is more productive if it incorporates more rather than less skilled labor.

Capitalism is a system of social organization characterized by private ownership of the means of production, free market exchange, and by production for profit. The first two characteristics have practically existed since time immemorial, but it is production for profit that is relatively recent and is of the essence of capitalism. The extent to which production is carried out with waged labor can be taken as a proxy for the degree of capitalism in an economy. Production for profit can take place without extensive waged labor but, as noted below, this is possible in an extensive and sustained manner only in very advanced industrial countries.

A fundamental reason why we believe capitalist activity to be a productive one is scale. Only scale production can regularly supply increasing amounts of the material goods required by modern societies, for consumption and investment to expand production. And only capitalism, as opposed to an independent form of production, can increase the scale of production through its inherent tendency to keep reinvesting profits. Of course, it is logically possible to obtain a situation whereby independent producers, say engineers, craftsmen, doctors and teachers, are so skilled and use such advanced technology that their productivity can achieve the scale objective mostly along independent lines of organization, outside the institution of capitalism. However, such a combination of skills and advanced technology can be widespread only if the society in question is already economically so advanced as to be highly productive in wage and capital-goods producing activities—or in only some activities that allow it to trade for other products—that only very few, if any, advanced industrial countries can fit the description. In other words, by definition, this situation cannot apply to LDCs, for whom sustained growth implies scale production and scale production implies capitalist and mostly industrial production.

This work therefore adopts the view that sustained growth implies productive activity that is mostly carried out in industry because it is precisely this activity that easily lends itself to scale production and to the systematic application of science and technology. In this

context, industry is viewed as a dynamic activity for productivity and growth, and labor employed in capitalist industry is viewed as labor contributing to dynamic growth. The dynamic role of industry has been empirically confirmed by Kuznet's examination of the historical growth record, which showed that the rise in the share of the industrial sector in GDP has been accompanied by a significant acceleration of overall growth. This gave rise to the view of manufacturing as an engine of growth.<sup>22</sup> It is only later, when an economy becomes more industrialized and productive, that the share of industry starts to fall in favor of services.

*Skills: whence they came and where they went*

Structural change and development must, above all, entail the production of skills and an increasing absorption of those skills by the more productive and dynamic activities in the economy. This did not happen under *laissez-faire*.

Only two official and extensive national manpower surveys have been undertaken in Lebanon, the first in 1970 (PAL, 1972, thereafter PAL70) and the second in 1997 (PAL, 1998, thereafter PAL97). The relevant results are included in Table 3.6 below.

Table 3.6. *Employment structure by activity, and educational attainment*  
(In percent)

	1950	1959 <sup>a</sup>	1970	1997
<i>Employment in<sup>b</sup></i>				
Merchandise production	66	56	44	35
Intermediation		27	38	45
Human infrastructure	34	6	9	12
Personal services, other		11	9	8
	100	100	100	100

<sup>22</sup> Sundrum, 1990, pp. 27–28.

Table 3.6. (*cont.*)

	1950	1959 <sup>a</sup>	1970	1997
<i>Labor education level</i>				
Primary			80.0	45.2
Complementary			9.4	21.1
Secondary			6.3	17.4
University			4.3	16.2
			100.0	100.0

Sources: Appendix II; AUB, 1960; IRFED, c. 1962; PAL70, PAL97.

Notes: a- The 1959 employment structure in non-merchandise activity is an estimate based on limited data in AUB, 1960 and IRFED, c. 1962. Details can be found in Appendix II. b- Merchandise consists of agriculture, industry (mining, manufacturing and utilities) and construction. Intermediation consists of commerce, transport and communication, services to enterprises, financial intermediation and public administration. Human infrastructure consists of education and social services.

The most striking figure in Table 3.6 relates to 1970 when, after about a quarter century of *laissez-faire*, 80 percent of the employed had only a primary education at most. This finding should have undermined the notion, still prevalent today, that the strength of the Lebanese economy resided in its skilled manpower. Above all, it should have alerted policy makers to the serious deficiency in skills, and dominated any serious discussion about the future of Lebanon's economy. None of this happened.

No economy with such a low skill level and labor-allocation profile can exhibit dynamic growth, i.e. a long-term sustained increase in productivity and output. However, the situation appears to have improved since, by 1997, about a third of the employed had achieved at least a secondary level of education, as opposed to about 11 percent in 1970. Unfortunately, the quality of overall education and skills has manifestly declined in the intermittent war years of 1975–90. Indeed, general labor productivity currently stands at about half the peak level achieved in the pre-war period: the GDP level in 2002 was about the same as in 1974 despite a doubling of employment during the period. Underscoring this development is the fact, elaborated below, that the overall economic structure has changed very little.

It was largely the public sector and NGOs that have mostly contributed to the expansion in education in Lebanon. NGO schools are institutions that are mostly owned and run by various religious



organizations. They usually charge no or minimal fees. By 1973/74, close to two thirds of all school enrolment was taking place outside private paying schools, and the share was still more than half until the late 1980s. Following a brief dominance of private schools in the early 1990s, mainly owing to war damages to many government schools, the trend of majority schooling outside the strictly private domain resumed.

Table 3.7 *Enrolment in government, NGO and private schools*  
(In percent)

	1954-55		1973-74		1980-81		1993-94		2001-02
	Compl. & Second.	Total	Compl. & Second.	Total	Compl. & Second.	Total	Compl. & Second.	Total	Total
Government schools	25	46	51	40	53	40	40	31	39
NGO schools <sup>a</sup>				26		20		15	13
Private schools	75		49	35	47	40	60	55	49
	100	100	100	100	100	100	100	100	100

Sources: Bashshur, 1988; CRDP, 2000-2001; République Libanaise, 1995.

Note: a- NGO schools provide education mostly at the primary level.

Thus, the provision of education, at all levels, has been mainly undertaken by government or NGO institutions. However, the quality of education in these schools, particularly at levels lower than the secondary, is usually inferior to that in private schools. Moreover, at the national Lebanese University, a large number of students are part-time or absentee students who concentrate on law and non-technical studies, and only few of them expect to be able to compete effectively for the available well-paid jobs. These usually are the preserve of the graduates from the French and Anglo-Saxon institutions at home or abroad.

The allocation of labor by economic activity reveals, as expected, a declining share of labor in commodity production and a parallel increase in intermediation activities. However, the efficiency of this secular trend, usually observed in advanced industrial economies, requires a concomitant increase in the productivity of commodity production. This was not the case, either in agriculture, as later indicated in this chapter, or in manufacturing, as the next chapter will show. In fact, to date, commodity production continues to absorb a relatively small share of available skills.

Table 3.8 *Skill distribution by economic activity*  
(In percent)

<i>Worker education</i>	1970		1997
	<i>Complem. or higher</i>	<i>Secondary or higher</i>	<i>Secondary or higher</i>
<i>Activity</i>			
Merchandise production (o/w Industry)	15 (11)	11 (8)	17 (9)
Intermediation	50	50	50
Human infrastructure	32	37	28
Personal services, other	3	2	5
	100	100	100

*Sources & Notes:* See Table 3.6.

In Table 3.8, we identify skilled labor as labor with at least a secondary education level, that level of skills perhaps corresponding in 1970 to at least a complementary education level. The outstanding finding is that, contrary to the pattern of general labor allocation, as in Table 3.6 above, the pattern of absorption of skills reveals no marked changes between 1970 and 1997. This is particularly the case with respect to industrial and intermediation activities. The system has therefore been remarkably constant in the way it allocates its skills across economic activities. As such, it cannot be expected to produce a dynamic economic performance that requires structural change as a necessary condition.

This inability of *laissez-faire* to generate structural change also reflects, in part, its inability to strengthen and consolidate capitalism as a form of economic organization. This is the subject of the next section.

### *The underdevelopment of capitalism*

We classify employed labor as either waged or independent. The same classification was adopted by the two major manpower surveys, PAL70 and PAL97. Waged labor can be regular, with payment usually made on a monthly basis, or irregular, with a seasonal or discontinuous form of employment. Independent labor or activity refers to an opposite situation of absence of wages as the source of income.

Labor used along capitalist lines of organization is defined as waged labor. A stricter definition of so-called capitalist labor should perhaps exclude the irregular type of employment whereby labor suffers from a precarious status of work and participates in a discontinuous manner in the production process, thus adversely affecting productivity. Independent labor is unwaged labor working for revenue (residual of sales less expenses) rather than for wages. It is, of course, possible that independent labor will become, over time, labor working in a capitalist sphere of production. This transformation would provide an indication about the dynamism of capitalist activity.

Independent labor is found in agriculture, as farmers with family help, and in industry as artisans such as tailors, shoemakers, welders, etc. Independent labor in commerce mostly includes owners and family help in small retail outlets that are disseminated across the country. In services, taxi drivers, cooks and other house helpers, mechanics, electricians, plumbers, doctors, consultant engineers and lawyers working independently are all examples of independent labor.

Table 3.9. *Employment by work status and skill*  
(% of total employment)

	1951–52 (Beirut)	1959	1970	1997
Independent	} 46	32	24	25
Boss	}			8
7				
Family help	6	~ 7	7	2
Government waged <sup>a</sup>	~ 5	7	8	11
<i>Outside the "Waged in the private sector"</i>	57	46	47	45
<i>Waged in the private sector</i>	43	54	53	55
o/w –regular waged	33	39	30	35
o/w –regular waged & skilled <sup>b</sup>			9	16
o/w –regular waged, skilled & in industry <sup>c</sup>			1	1
Total	100	100	100	100

Sources: AUB, 1960; Churchill, 1954; IRFED, c. 1962; République Libanaise, 1972, 1998a.

Notes: a- Government employment includes the army and all those on the payroll of a specific Ministry, such as in the education and health sectors. b- Skilled labor is defined as labor with at least a complementary level of education in 1970, and with at least a secondary level of education in 1997. c- Industry is defined as mining, manufacturing and utilities.

The idea that capitalism, once established in the form of capital-labor relationship, has a momentum of its own that brings more and more labor and activities from the non-capitalist domain under its sway does not seem to have operated in force under *laissez-faire*. A remarkable stability is again witnessed in the share of waged and regular-waged labor in total employment. This stability, or at least the lack of an expansion in waged or regular-waged employment, is even more pronounced when considering the evolution of these waged categories in the private sector only. Similarly, the share of independent labor and bosses remained practically unchanged between 1970 and 1997, standing respectively at 25 and 8 percent.<sup>23</sup>

The category of labor that is both regular-waged and skilled may be viewed as a core capitalist labor category since it reflects the extent to which capitalism is based on a regular supply of labor that is skilled enough to provide establishments with the productivity and continuity that are essential for sustained growth. By 1997, and though registering a significant increase over 1970, still less than one in six workers could be qualified as belonging to this core category. At the same time, the regularly waged and skilled labor in industry represented only a little more than one percent of total employment.<sup>24</sup>

We can therefore say that, by 1997, and after about half a century of *laissez-faire*, capitalism had not succeeded in becoming a dominant form of economic organization. There is indeed little evidence pointing to significant structural change, which is best illustrated by skill generation and the absorption of skills by dynamic (e.g. industrial) or capitalist activities.

With an unremarkable growth record and stagnant capitalist activity and institutions, *laissez-faire* has proved to be a conservative force and system of economic organization. The question that now arises is why has capitalism failed to develop in the presumably congenial environment of an open *laissez-faire* economy?

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<sup>23</sup> For details, see Tables A.II.4 and A.II.5 in Appendix II.

<sup>24</sup> It is important to note, in this regard, that the above estimates are based on the official figures for total employment. In Appendix II on labor data, these figures are revised upward to allow for a larger activity rate for women, particularly in agriculture, and to compensate for the omission of a relatively large number of foreign, mostly seasonal or irregular, labor. Accounting for these omissions, which consist mostly of unskilled labor, would strengthen our conclusions.

*The market without capitalism*

The previous section has emphasized the absence of a dynamic capitalist activity in Lebanon, which indicates that independent activity has been quite resilient. This finding is taken as major reason for the lack of sustained growth and development, when this is viewed as a growing integration of labor and skills in industrial activities in particular. We shall presently elaborate the concept of economic independence by putting it in a specific theoretical context, and then present evidence on the evolution of independent economic activity in Lebanon. We then submit an interpretation of the reasons behind the continued survival of independent activity and attempt to correlate its survival with the performance of the Lebanese economy.

*Independent labor and development*

It can be argued that capitalism is the only historical form of economic organization that is associated with material reproduction on an expanding scale. However, independently of its potential to produce sustained growth and development and of the superiority of other forms of social organization in this domain, capitalism did bring about a radical and positive transformation in the productive forces of the societies in which it operated. In today's industrial societies, capitalism has at least proved to be an efficient vehicle for a historically unprecedented process of industrialization and growth. This performance has not been successfully duplicated in the vast majority of developing countries, and various theories have attributed this failure to a combination of factors, including imperialism, dependency, unfriendly market policies, market failures, etc.

How does capitalism drive accumulation and growth, particularly in a developing-country context? Two general strands of thinking provide an answer to this question. The first emphasizes the expansion of exchange and markets as the basis for growth and development; the second sees in capitalism, rather than markets as such, a revolutionary form of social organization that brings with it an autonomous process of capital accumulation. For Adam Smith, it was the size of the market that essentially governed specialization and accumulation, thus implicitly acknowledging a "natural" tendency for growth with market expansion. From this perspective, the potential for sustained growth is there, as a force, waiting to be unleashed

by favorable conditions represented by free markets and trade expansion. With its advocacy of structural adjustment policies that focus on market development as the principal instrument for sustained growth, the “Washington Consensus” is essentially in line with Smith’s view.

The second view points to the distinction between the market and capitalism in explaining the process of historical development, underlining the historical specificity of capitalism and the conditions that gave rise to it.<sup>25</sup> This view sees in the economic conditions of reproduction of labor—the terms under which it earns its livelihood—the defining characteristic of capitalism. Thus, the conditions that lead to the rise of capitalism are located in the domain of separation of labor from its means of subsistence rather than in a natural development of trade and market exchange. Capitalism requires the existence of free labor, i.e. labor separated from its means of subsistence, and this freedom puts labor under the necessity to sell its labor power, which becomes a commodity for sale against wages. Exchange value is then produced and results in a residual surplus value or profits that are realized in a market which, by virtue of its capitalist institutional setup, then drives enterprises to continue investing or accumulating capital ever more.

Not unlike Smith’s view of man’s “natural tendency to barter and exchange” for advantage, this second perspective sees in capitalism an inherent drive to accumulate. However, as E.M. Wood (1994) notes, capitalism, as a system of social organization, is not a natural system but one that has to be built and enforced. Once capitalism is established, the capitalist market then becomes an imperative rather than an opportunity, a compulsion to specialize and produce competitively. One can add that competition presents, in the capitalist context of production, a double condition of separation for both labor and capital that forces them to undertake market exchange. Under capitalism, labor is separated from its own means of subsistence, and capital is separated from its means of subsistence, namely labor and other means of production. This double separation becomes the condition that drives the process of exchange and the built-in compulsion to increase productivity.

Our concern here is to show that Lebanon, which was considered as a model illustration of a successful capitalist developing economy,

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<sup>25</sup> See Brenner, 1977, 1986.

was neither capitalist, in the sense of capitalism being a dominant and dynamic force of organization, nor successful. An implication of this assessment is that, had Lebanon become genuinely capitalist, it would have performed better in terms of growth and development. However, such is not the implication we wish to prove or disprove. Our main concern is to show that the institution of *laissez-faire* in developing countries is essentially a conservative institution that does not necessarily lead to structural change and sustained growth. In other words, *laissez-faire* is not a sufficient condition for growth and development.

We also wish to show that the Lebanon of *laissez-faire* was in many respects a non-capitalist market economy and that this characteristic may have been a major impediment to the utilization of its potential for growth and development. Now, a more capitalist Lebanon could have industrialized and developed more significantly than it actually did, provided appropriate policy actions were taken by a more active state. But this is an altogether separate issue.

#### *Independent activity in agriculture*

An economic agent is economically independent when he (or she) has direct access to his means of subsistence, and/or to the means of production of these means of subsistence, to the extent that he is under no necessity to sell his labor power. A situation of economic independence weakens the availability of free labor, which is a fundamental condition for the establishment of capitalism. Economic independence may be empirically assessed by examining the extent to which income, or the means of livelihood in general, is derived without recourse to the labor market. Agriculture is an important activity in this respect because it is a main source of food and livelihood in LDCs.

Most people working in agriculture in Lebanon have traditionally been, as elsewhere, at the bottom of the income ladder. Low incomes in agriculture are largely the result of low productivity, which is in part due to the mountainous nature of Lebanese topology and severe land parceling, through inheritance, into uneconomically small plots. This has led to a state of continuous and often rising emigration, and of internal migration of labor from rural to urban areas. Both the number of agricultural workers and their share in total employment have been in steady decline at least until the early 1970s, falling

from 55 percent in 1950 to 19 percent in 1970. However, since 1975, the trend has been one of stabilization, if not increase, in the share of labor in agriculture owing, in part, to the war and economic stagnation (see Table 3.1 above).

Farmers have usually faced adverse economic conditions, including high indebtedness and the monopoly power of traders who divided rural regions into exclusive zones for their purchase of agricultural products.<sup>26</sup> Trading margins on agricultural products averaged 83 percent of agricultural value added during 1964–70, and 88 percent during 1994–95.<sup>27</sup> In addition, farmers are often subjected to usurious credit conditions. For instance, during the 1950s, surveys indicated that annual real interest rates were approximately 14 percent, even exceeding 200 percent on loans to small and medium farmers.<sup>28</sup> Moreover, banks, despite strongly and consistently increasing domestic and foreign currency deposits, have been reluctant to lend in agriculture. Bank credit went mostly to large farmers and usually represented less than 3 percent of total credit to the private sector.<sup>29</sup>

Nonetheless, agricultural output did expand under the impetus of domestic urban demand and foreign demand, roughly maintaining a constant GDP share between 1964 and 1995. The expansion in output followed increased mechanization and fertilizer use. However, it was taking place with falling land productivity—expressed as yields in tons per hectare—for the large majority of crops.<sup>30</sup> In other words, agricultural development was not of a land-saving character, which is essential for growth, according to Kaldor (1986). The simultaneous increase in total agricultural output and stagnation in land productivity

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<sup>26</sup> In 1970, it was estimated that the three largest intermediaries in the marketing of apples, a major crop in Lebanon, controlled about a quarter of the market, while twenty-five intermediaries controlled more than two thirds of the market (Nasr, 1978, p. 8).

<sup>27</sup> See the input-output matrices in République Libanaise, 1997, c. 1972a and c. 1971.

<sup>28</sup> See, for details, Stevens, 1959, pp. 104–110, IRFED, p. 148, and Bonné, 1960, p. 171.

<sup>29</sup> See various issues of the Banque Du Liban's Quarterly Bulletins.

<sup>30</sup> See République Libanaise, Recueil de Statistiques, for the years 1964 and 1973. An examination of about 60 individual series of productivity per hectare for the period 1956–73 reveals a dominant pattern of either falling, stagnant or moderately increasing yields. Only apples and the industrial crop sugar beet, which enjoyed a government price support system, show a significant increase in yields, in the neighborhood of 9 percent per annum.



constitute strong evidence of excess labor or underemployment in agriculture. It also gives support to the view that the recorded increases in farmers' incomes were mostly due to an improvement in the domestic terms of trade for agriculture. In fact, the wholesale or retail price indices for foodstuffs have increased faster than the general index between 1950 and 1975 (see Table A.IV.3 in Appendix IV).

Other factors also supported rural incomes and compensated for the modest increases in productivity. Workers in agriculture have been able to supplement their incomes from various sources, thus strengthening the basis of their economic independence. Farmers usually exhibit a high degree of self-exploitation as most family members contribute to work in the fields. In addition, it has become customary for them to engage in more than one type of activity. Official and other agricultural surveys in the early and late 1960s indicated that more than half of the farmers in Lebanon worked in a secondary, usually non-agricultural, job.<sup>31</sup>

Economic independence, though at relatively low levels of income, has been a characteristic feature of people living off the land in Lebanon. Already in the 18th century, silk trade with Europe led to the rise of "small peasant landholders of a kind almost unknown elsewhere in the region".<sup>32</sup> This phenomenon has endured in the modern era. In the early 1950s, official Lebanese and US land surveys revealed the existence of few landless farmers, with an overwhelming majority (more than 95 percent) owning plots of less than two hectares, these plots constituting 70 to 75 percent of the total agricultural area.<sup>33</sup> Furthermore, most of the landless laborers rented land from large owners. A similar pattern of land ownership was confirmed by agricultural surveys conducted during the 1960s and 1970s, which indicated that around three quarters of agricultural land were directly exploited by their owners, who also owned the houses they occupied on the land.<sup>34</sup>

Greater self-exploitation, supplementary jobs and other sources of income did help workers in agriculture to remain economically independent, despite the poor wages and the low standard of living. In

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<sup>31</sup> République Libanaise, 1966, Annex No. 10, p. 2; Nasr, 1978, p. 9.

<sup>32</sup> Iqbal, pp. 310–11.

<sup>33</sup> UN 1955, p. 154n.

<sup>34</sup> Mallat, p. 38; PAL70, p. 53; Issawi, 1982, p. 149; UNDP/FAO, p. 11.

fact, many farmers could often rely on other reliable sources of income, in particular on transfers from relatives at home and overseas. The last section of this chapter examines the importance of transfers as a revenue source at the national level.

*Independent activity in industry and services*

The precariousness of incomes from sources outside permanent work led to significant migratory movements of labor within and outside Lebanon. Between 1965 and 1980, the rural-urban migration was responsible for 65 percent of urban growth, the highest rate of all Middle Eastern and Arab countries.<sup>35</sup> However, most of this mobile labor was absorbed by services rather than industry, as indicated by the rising share of services in total employment from 34 percent in 1950 to 65–70 percent in 1997 (see Table 3.1). Moreover, it is in services that 61 percent of total independent labor worked in 1997, up from 53 percent in 1970.

Numerous taxi drivers, street peddlers and the large number of small retail outlets are a feature of urban Lebanon, and of Beirut in particular. Financial barriers to entry into small operations have been relatively low. For instance, it was estimated in the 1960s that LL 5,000 (then about \$1,600), or a little more than the average annual per capita GDP, was sufficient as an initial capital to establish a grocery store. A survey of retail outlets in Beirut in 1968 estimated that about half the population of retail stores was located in Greater Beirut, and that about 80 percent of these stores were considered small-scale.<sup>36</sup> There was one retail store for 125 persons and average employment per store was 1.5 persons, thus pointing to a prevalence of excess capacity. Again, as in agriculture, this situation is addressed by a high degree of self-exploitation, usually illustrated by long working hours and the use of family help as labor. The free labor that moved from rural areas has thus moved from one independent status to another.

On the other end of the services spectrum were the professionals: engineers, doctors, lawyers and other professionals who are characterized by an independent form of organization that is supported by

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<sup>35</sup> Richards and Waterbury, 1990, p. 266.

<sup>36</sup> See Eid, 1969.

local demand from the higher income groups and by foreign demand, particularly from nationals of Syria and the Arabian Gulf countries. The less fortunate professionals always sought temporary work overseas or emigration as an outlet.

Industry did, however, manage to capture some of this migrating labor, as illustrated by the modest increase in its share of total employment. Quite a few manufacturing establishments are essentially hand-craft or artisan concerns, traditionally identified as those with less than five workers per establishment. The size distribution of manufacturing establishments in Table 3.10 below (and additional details in the next chapter) clearly show that such small-scale establishments did manage to survive and even increase their employment share, thus exhibiting an unexpected resilience.

Table 3.10 clearly shows that small or artisan industrial establishments, with a total of 4 workers or less (including owners and family help), continue to survive if not prosper. In a sense, the larger establishments have been partly responsible for the survival of the smaller ones. Subcontracting to smaller establishments is a common phenomenon in manufacturing, though its extent cannot be assessed. It involves specific jobs being undertaken on a sub-contractual basis, sometimes on the premises of the larger establishment where the owner of the small enterprise would perform the job with his small team of workers. This is similar to a modern putting-out system, with the small enterprise replacing the individual craftsman.

Table 3.10 *Manufacturing establishments, size and employment distribution*  
(In percent)

Workers/establishment	Number of establishments				Employment			
	1955	1964	1970	1998	1955	1964	1970	1998
Less than 5 <sup>a</sup>	77	78	81	74	33	33	42	40
5-9	13	11	}	17	22	13	}	25
10-24	7	7	}		12	16	}	9
25-49	2	2	}	2	4	10	}	33
50 or more	1	1	}		2	29	}	20
	100	100	100	100	100	100	100	100
Total number	7,946	9,558	15,669	22,025	50,827	67,476	94,620	141,923

Sources: Chami, 1981; Hamdan and Akl, 1979; Nsouli, 1966; PAL70; Republic of Lebanon, 1957; République Libanaise, c. 1966, 2000.

Notes: a- Employment in the "less than 5" category in 1955 and 1964 is estimated by assuming 2.7 as the average number of workers per establishment in 1955 and 3.0 in 1964 (see Nsouli, 1966, p. 7 in this regard). The average was 3.3 in 1970.

The legal ownership form of the relatively larger, or non-artisan, industrial establishments also underlines the underdeveloped capitalist basis of industry. By 1970, and in the population of industrial establishments of five workers or more, half the establishments were sole proprietorships, while another 40 percent were simple unlimited liability enterprises. Only about 6 percent were limited liability corporations.<sup>37</sup>

So the independent basis of labor and activity was quite widespread and resilient in Lebanon. Some labor in agriculture could resist the threat of separation from its means of subsistence, as incomes increased through more mechanization (made possible by a stable and appreciating domestic currency) and better terms of trade resulting from stronger urban and export demand. Various transfers from foreign or local sources provided another source of support to all forms of labor. A final resort was emigration to the Americas, Australia or Africa, where relatives were already established, or to the booming oil-rich Gulf countries. The next section examines the importance to labor of transfers and emigration as primary sources of support in avoiding joining the domestic waged category.

### *Transfers and emigration*

Those who live near or below the threshold of the socially acceptable level of income have to look for sources other than work to supplement their low wages or independent incomes. The following table provides information on the relative importance of these sources for households since the early 1950s.

Defining transfers to include income from property sale, financial assistance and other non-production income leads to transfers constituting around a quarter of total household incomes. Including with transfers part of wages in the public sector, where employment is often undertaken as an extension of political favors, raises the share of transfers to close to 30 percent of household incomes. Transfers are still a more important source of income in Lebanon than indicated by these figures. One reason is the immediate and extended family

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<sup>37</sup> Antonios, 1977, p. 26.

Table 3.11 *Sources of household incomes<sup>a</sup>*  
(In % of total household income)

	1951–52 Beirut	1966 Beirut	1997 Beirut	1997 Lebanon
<i>Work</i>	46	54	59	58
Wages-private sector <sup>b</sup>	39	44	49	46
Wages-public sector	7	10	10	12
<i>Supplementary income</i>	54	46	41	42
Interest and rent		22		19
Property sale <sup>c</sup>		12		7
Assistance <sup>d</sup>	}	12		9
Other <sup>e</sup>	}			7
Total	100	100	100	100

*Sources:* Churchill, 1954; République Libanaise, c. 1968, 1998b.

*Notes:* a- Household incomes are adjusted to exclude profits accruing to enterprises. They consist of wages, including wages imputed to independent workers, plus all types of supplementary incomes. b- Wages in the private sector are adjusted to include wages imputed to independent workers. The surveys usually present data on wage income and supplementary income, except for the 1966 survey, which amalgamated wages and non-agricultural profits. The allocation between wages and profits is assumed to be the same as for total GDP (see Table 5.7 in Chapter 5. c- Property sale is sale of real estate, durables, jewelry, etc. d- “Assistance” consists of financial assistance from family and relatives, and grants. e- “Other” mainly includes pensions and inheritance.

system, with its support network that is stronger in rural areas where kinship ties can include the sharing of capital tools and equipment.<sup>38</sup>

Workers’ remittances and other transfers from abroad are also an important source of supplementary household income, and these have usually been difficult to separate from other capital movements in the balance of payments. Taking as a proxy for this additional source of income the sum of net current transfers and short-term capital movements, we find that these have continuously increased from around 6 percent of GDP in 1951–52 to 16 percent in 1971–73. Thereafter, it has become more difficult to estimate these proxy figures in view of the large amount of “errors and omissions”, exceeding 20 percent of GDP in 2000–2002 (see Table 5.2 in Chapter 5).<sup>39</sup>

<sup>38</sup> Simonian and Yacoub, c. 1974, p. 9.

<sup>39</sup> A report by the heads of business enterprises estimated the total amount of transfers by Lebanese nationals residing abroad at more than \$900 million in 1974,

However, what Table 3.11 misses are the various sources of economic support that are available from outside the market mechanism. Thus, in 1999 and as noted above, it was the various NGOs that were providing the basic services to practically all the disabled, elderly and orphans in the country. NGOs were also operating 650 of the 750 existing dispensaries.<sup>40</sup>

Transfers weaken the condition of separation of labor from its means of subsistence and, hence, the pressures to enter the labor market. Transfers also dilute, through diffusion among a larger number of people, the magnitude of a given surplus, and therefore reduce its potential use for accumulation and growth. Based on the figures in Table 3.11 and the qualifications mentioned above, we believe that at least a third of total household incomes continue to originate outside the domain of market production.

And if employment opportunities or adequate incomes are not available, then labor would seek opportunities outside its country of residence, as indeed it has done for centuries almost everywhere. The data in Table 3.12 illustrate the strength of the emigration drive in Lebanon during 1900–74.

Table 3.12 is about overall Lebanese emigration and not only workers. The PAL70 manpower survey for 1970 estimated that about 95 percent of the emigrants were 15 to 65 years old, and that about

Table 3.12 *Lebanese emigration, 1900–1974*

<i>Period</i>	<i>Individuals Per annum</i>
1900–14	15,000
1921–39	4,400
1945–50	3,300
1951–59	2,850
1960–69	8,566
1970–74	10,000

*Source:* Chambre de Commerce et d'Industrie à Beyrouth, c. 1977, p. 18.

i.e. at around 26 percent of GDP (NBITD, c. 1988, p. 14). Recent estimates are less reliable in view of the very large "errors and omissions" in the balance of payments.

<sup>40</sup> Al-Assir, p. 3.

80 percent had left the country seeking jobs. Assuming this rate of 80 percent to apply to the period 1965–74, then the figures would indicate that the equivalent of 40 percent of the newly active population that entered the labor market during that period had emigrated for employment reasons. Moreover, as a World Bank study on manpower migration to the Middle East and North Africa reveals, the Lebanese migrants working in that region in 1975 were heavily drawn from the professional and skilled manpower pool.<sup>41</sup> Even more remarkable is the fact that emigration has started to accelerate since the early 1960s, thus coinciding with the period of accelerating growth in the country. Growth under *laissez-faire* in Lebanon was, at its best, accompanied by an increasing wave of emigration, consisting mostly of the skilled members of the work force.

A summing-up of this chapter leads to the following conclusions:

1. During the favorable period of 1950–74, the economic growth performance of *laissez-faire* was not as remarkable as it is usually claimed to be, whether in comparison to the performance of LDCs or of countries in the region. The development performance was mixed but significantly unfavorable in relation to the distribution of income and wealth, education or skills. This performance is all the more unsatisfactory since Lebanon had started, in terms of income, capital and skills, at a distinctly higher level than most countries in the region, or among LDCs in general, and in view of the economic potential that was afforded by a strong domestic and external financial condition that lasted over three decades.
2. If sustained development is defined as economic growth that is associated with increasing industrialization and a growing integration of skilled labor in capitalist economic activity, then Lebanon exhibited little sustained development. The *laissez-faire* experience mainly consisted in the drawing of unskilled and casual labor to the economic process while the more skilled group sought emigration.
3. This adverse growth and development record may be associated, at least in part, with the dominant non-capitalist or independent form of labor and economic activity. The Lebanese economic system was undoubtedly marked by extreme market and *laissez-faire* char-

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<sup>41</sup> Serageldin, et al., 1983, p. 77.

acteristics, which nonetheless did not make it a capitalist economy. It failed to produce more skills and industrialization, which are fundamental characteristics of sustained development.

4. The survival and resilience of the market without the spread of capitalism may be imputed to three factors: a favorable external environment, illustrated by strong foreign demand and capital transfers; the mechanization of production processes, made possible by a strong financial condition; and transfers, both domestic and from overseas, particularly for the lower-income groups. Transfers have been supported by the extended-family institution and by the emigration of workers.



## CHAPTER FOUR

### LAISSEZ-FAIRE AGAINST INDUSTRY

In the beginning was the deed

Goethe

The history of industrialization in Lebanon is one of missed opportunities. The first two opportunities were missed because of external developments, while the third and last one, which arose following the end of WWII, was thwarted by the newly adopted strategy of laissez-faire. This chapter is mainly a story of how laissez-faire can frustrate a potentially successful industrialization process.

Is industrialization necessary, or sufficient, for development? Industry—essentially manufacturing—has always enjoyed, particularly in developing countries, an allure that makes it synonymous with development itself. This entrenched perception is not misplaced. In fact, the benefits that are associated with industry are derived from the very nature of this activity, and the history of industrial societies underlines the critical contribution that industry has made to their advanced economic status.

With the progress of the industrial revolution, and as “manufacture” turned into “machinofacture”, the division of labor soon became the dominant system of work organization, concentrating material and human resources in a relatively small location, the workshop. The division of labor and the use of more machinery, with its systematic application of scientific principles to the organization of production, resulted in significant leaps in labor productivity that took the form of an expanding flow of products, for consumption and investment. Only manufacturing can produce the large volumes of merchandise for food, clothing and shelter that take by far the largest share of family budgets in developing economies. It is these productivity gains that lie at the heart of manufacturing being a natural leading activity for sustained growth.

For Adam Smith, the development of “commerce”, by which he meant what we today refer to as industry, was the way to increas-

ing the wealth of nations.<sup>1</sup> Industry is associated with wider and stronger linkages with other activities, and with higher income elasticity, than in agriculture and services. The historical record supports this observation: Kuznet's finding that the rise in the GDP-share of industry is accompanied by a significant acceleration of overall growth gave rise to the view of industry as an engine of growth. This view has been extended to the claim that high levels of income are even impossible without industrialization.<sup>2</sup>

Industry is a major vehicle for technological change and productivity growth. As such, it is more productive, leads to higher levels of income and provides a greater stimulus to economic exchange and production than other activities. The singular productivity of industry thus remains one of the few firmly established principles of economic analysis and policy. This is especially true since “[h]istorically, the rise in the share of manufacturing in output and employment . . . [is] among the best documented generalizations about development,” and “Manufacturing growth is one of the main sources of technological change.”<sup>3</sup>

Is industrialization feasible in a small country, like Lebanon? The issue is essentially one of technology—which determines the minimum optimal or efficient scale of production—and market size as represented by the level and structure of demand, i.e. the level and distribution of income. The conjunction of the minimum efficient scale of production and market size effectively determines, at a first level of approximation, the viability of a particular industrial activity. Fortunately for small-size economies, technological progress has today reached a stage where the industrial arts are associated with smaller minimum efficient scales than hitherto. Moreover, there is today a greater opening-up of markets for industrial exports, at both the regional and world levels. These trends strengthen industrial viability in relatively small economies.

Independently of these considerations, Lebanese industry, over time, has proved its viability while at the same time exhibiting signs of a strong potential for development. The constantly rising share of

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<sup>1</sup> Singer, 1997, p. 294.

<sup>2</sup> Sundrum, 1990, p. 27; Sutcliffe, 1971, p. 8.

<sup>3</sup> Chenery et al., 1986, pp. 1, 351.

manufacturing output, employment and exports until 1974, despite an appreciating currency and an open trading system, present strong prima facie evidence of viability and dynamism. Despite the small population size, income levels were relatively high, reaching in 1974 a per capita GDP of approximately \$1,300 (equivalent in the year 2002 to around \$4,700). In 1956, the per capita consumption of steel in Lebanon was more than 90 percent the level in Japan. It was also about seven times that of Turkey despite the fact that Lebanon's per capita income was only about 24 percent higher.<sup>4</sup>

Although a skewed income distribution in an open economy and a strong demonstration effect on consumption patterns have not been particularly favorable for industrialization, these drawbacks were alleviated, if not more than offset, by accommodating and relatively large Arab export markets. In addition, large minimum efficient scales of production, relatively to the size of the Lebanese market, were also partly offset by the large export markets and by a high degree of market concentration. After all, Singapore, which currently has a population of less than 4 million but a manufacturing GDP-share of 24 percent and a per capita GDP of approximately \$22,000, is a testimony to the diminishing constraint of size on industrial growth.

Industry in Lebanon has passed the survivor test, particularly during the difficult war period of 1975–1990, but it has failed to become a dynamic or leading sector. The analysis below explains the reasons behind this failure.

### *Industry in context*

This section presents a brief historical background to Lebanese industry and its demand and supply conditions.

#### *A historical background*

Lebanon's workshop industry was born around the middle of the nineteenth century. It started with the manufacturing of silk, based on locally raised silk cocoons. Capital for the new plants was mostly French, and the impetus came from foreign demand for silk. The

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<sup>4</sup> Bonn , 1960, pp. 36, 281.

first factory, for silk weaving, was established in 1840 by a Frenchman.<sup>5</sup> The activity soon became widespread and, just prior to WWI, 10 to 15 percent of the population lived off industrial activity that centered on silk. The introduction in the early 20th century of artificial substitutes for silk, and the emigration of labor, mainly to escape Ottoman rule, arrested this first industrial experience.

An industrial resurgence took place between the two world wars, constituting a second opportunity for an industrialization drive. It was occasioned by several developments, including a decline in emigration, an improved infrastructure that was laid down by the French mandatory authorities, and increased protection. In addition, reacting to a fall in the prices of agricultural products, businessmen started shifting capital investment from agriculture to industry. This new opportunity, which was further enhanced by the Allied expenditures during WWII, was well exploited by local industrialists. Businessmen had in fact started to import, since the early 1930s and at greatly reduced prices, second-hand machinery from bankrupt enterprises that were shut down by the depression in the industrial world. The importation of machinery continued throughout the decade and resulted in a significantly greater mechanization of manufacturing processes.<sup>6</sup> These developments led to the establishment of the foundations of a modern industry, which became more diversified and began relying less on a putting-out system of production and more on waged labor.

Although data for the period are often inconsistent, we attempt below a sketch of the evolution of industrial employment between the early 1930s and 1955, which gives an indication of the strength of the industrialization process during that period.

The data in Table 4.1 are derived from various sources and convey a general picture of the evolution of industrial employment, prior to and just after the establishment of *laissez-faire*.<sup>7</sup> Industrial employment

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<sup>5</sup> Nsouli, 1953, p. 74.

<sup>6</sup> NBITD, c. 1988, p. 31.

<sup>7</sup> Data until 1944 are mostly based on estimates made by the mandatory authorities. The 1955 data are derived from an official industrial survey by the Ministry of National Economy. Prior to 1955, data sources do not make clear the distinction between manufacturing and industrial employment. The figure for 1944 is obtained by adding 15,000 to the figure for 1937; this is based on an estimated additional employment of 15 to 20 thousand during the period (Chami, 1981, pp. 48–49). The range estimate for total employment in 1937 is based on population

Table 4.1 *Industrial employment 1931–1955*

	1931	1937	1944	1955
Industrial employment (thousands)	30	> 41	56	51
Total employment (thousands)		269–286	343	478
Industrial employment (% of total employment)		≥ 15	16	11

*Sources:* Table A.II.2; Bonné, (1955, p. 300); Chami (1981, pp. 48–9, 202); Republic of Lebanon (1957); UN (1955, p. 158).

*Note:* Employment in 1937 was greater than the reported 41,089 because the mandatory authorities restricted their survey to the three largest cities in the country (Chami, p. 49).

significantly increased since the early 1930s, particularly during the WWII years, stimulated by the expenditures of the Allied troops and the closure of the sea-lanes. These developments effectively created a situation of forced import substitution in a context of increasing demand. Local industry strongly expanded, taking advantage of the new favorable environment. One could therefore surmise that, by the mid-1940s and based on conservative employment estimates, Lebanon had then become, relatively to its population, at least as industrialized as it was to become at its growth peak 25 years later.

An adverse shock then hit Lebanese industry, following the end of WWII and the departure of all foreign troops in 1946. Military expenditures almost disappeared, foreign competition sharply increased, and industrial wages fell owing to a “large amount of unemployment”.<sup>8</sup>

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data from Courbage and Fargues (1974, Vol. 2, p. 21) and an activity rate assumed to be 30 to 32 percent, which is quite a realistic range (see Appendix II in this regard). Chami advances an estimate for total industrial employment of even more than 91,000 in 1943–44 (including 15–20 thousand associated with the presence of the Allied troops), which seems rather unrealistic. In any event, various sources converge in noting that industrial employment had greatly expanded from the 1930s until the end of WWII.

<sup>8</sup> See UN, 1955, pp. 157–8 and Nsouli, 1953. These references, particularly Moustapha Nsouli who then was the Director General of the Ministry of National Economy, present unique and detailed sources on developments in various branches of industrial activity between 1946 and 1953, just as the choice of laissez-faire as a fundamental economic strategy was being formulated and beginning to be implemented.

The new situation presented Lebanon with a challenge, but also with its third opportunity. The challenge, which came from a significant fall in demand and increased foreign competition, was further exacerbated in 1950 by the breakup of the customs union with Syria, which deprived industry of an important market for its products. The opportunity, on the other hand, consisted of a strongly favorable macro-economic condition, with no internal or external debt and continuous fiscal and balance-of-payment surpluses, the opening up of large Arab markets receptive to Lebanese products and, above all, a relatively modern industry with diversified output and export structures (food, textiles, non-metallic minerals, chemicals, metallic products, etc.)

For a while, the challenge was well met. Between 1946 and 1952, industrialists responded by renewing and modernizing their equipment, even calling on the services of foreign experts to raise productivity, as in textiles, biscuits, comestible fats and oils.<sup>9</sup> Industrial investment doubled and employment increased by about 50 percent in the major branches of food processing, textiles and non-metallic mineral products.<sup>10</sup> This time, the response was markedly more effective than in the 1880s, a period that witnessed the retreat of industrialists into commercial activity following the fall in silk prices. The authorities provided some incentives to industry through a reduction of duties on raw materials and machinery, and even raised protection by increasing the effective duty on competing imports to 25–30 percent.<sup>11</sup> With the increased demand from the Arab markets and the additional boost provided by the Korean War, the stage was set for a strong industrialization drive.

It was, however, at this juncture that a full-fledged laissez-faire strategy was implemented. Essentially, the strategy meant the full opening up of the economy, best illustrated by open external current and capital accounts and by a freely floating exchange rate. The free foreign exchange market was officially recognized in November 1948. While there were in the early stages some restrictions, e.g. the surrender of 10 percent of export proceeds at the official rate and the requirement on oil companies to purchase 80 percent of their local currency needs at the official rate, the market was to a large extent operating freely. In May 1952, all restrictions were officially

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<sup>9</sup> Nsouli, 1953, p. 81.

<sup>10</sup> UN, 1955, pp. 157–8.

<sup>11</sup> *Ibid.*, pp. 162–3.

cancelled, and the foreign exchange market then officially became fully free. Moreover, fiscal policy was to become, as it remains today, much less an instrument of economic management to affect incentives and more of a means to collect revenues in order to meet minimal current, capital and social expenditures that would ensure stability in the urban areas.

What follows is an analysis of industrial performance in a *laissez-faire* environment that rested on strong initial economic conditions and a sustained adherence to financial austerity. In other words, from a neoclassical or mainstream perspective, the economic set-up was ideal for growth and development.

Henceforth, in this chapter, the reference will be to manufacturing activity, excluding mining, energy and water. The excluded activities are relatively small and represented in the early 1970s only 1 percent of total employment and about 2.7 percent of GDP. Comments will focus on manufacturing activity as a whole, with little emphasis on the relative performance of its branches. The terms wages and salaries are interchangeably used.

#### *Cost and demand conditions*

##### a) *Natural endowments*

As previously noted, Lebanon possesses few mineral resources and its agricultural potential is modest. However, it has good water resources with many rivers and underground reserves. These resources have been little developed, pointing to a significant potential for increasing agricultural output and yields through irrigation schemes, which would provide a favorable basis for industrial development. The full western length of the country is a Mediterranean coastline, but both sea tourism and fisheries are also underdeveloped. The coastline and the small size of the country, though partly hampered by a chain of mountains along the center, should nonetheless facilitate the building of a modern road network that would reduce costs and extend the size of the domestic market. Again, this potential has not been developed.

##### b) *Labor and capital*

Although labor in Lebanon is considered relatively literate in a regional or developing—country context, skills have generally been in shortage particularly when viewed against the stated objectives of

rapid growth and membership in the developed-country group. By 1970, about 90 percent of the manufacturing workforce was unskilled, i.e. with a level of education not exceeding the primary level. The ratio improved in 1997 to 56 percent, but only a third of the employed in manufacturing had received a secondary education or higher (see Tables A.II.4 and A.II.5 in Appendix II). As the quality of education and exam standards have suffered during the war years in 1975–90, skills must therefore be at lower levels than those indicated by educational performance data for 1997.

The labor market for manufacturing has usually been in excess supply, or at best with little excess demand. This situation of excess supply has been fed by continuing labor migration to urban areas, where most of the industrial enterprises are located, and by the relatively weak expansion of manufacturing activity. Indeed, while in the early stages real wages in manufacturing increased at a higher rate than employment, the trend markedly slowed since the mid-1960s. Real wage growth was at an average annual rate of 2.8 percent between 1955 and the mid-1960s, slowing down to 1.3 percent between the mid-1960s and the mid-1970s (see Tables 4.3 and 4.5 below).

The abundance of financial capital is practically a parameter of the Lebanese economy, but not necessarily for industry. Until 1975, Lebanon's total (public and private) debt remained insignificant, and the balance of payments was almost continuously in surplus. In the developing world, funds in foreign currencies have typically been scarce and their use subject to constraints. In Lebanon, however, borrowers from commercial banks have always had the option to use credit in domestic or foreign currencies at interest rates that are close to the ones operating in industrial countries. Yet, most bank lending has been directed to short-term trade financing. Since 1964, bank credit to industry (mostly manufacturing) has ranged from 13 to 15 percent of total credit, roughly paralleling industry's share in GDP. Moreover, industrial credit is usually short-term revolving credit to finance imports and is mostly extended to relatively large enterprises rather than small or medium-sized ones. With limited bank credit and underdeveloped capital markets, industrialists usually relied on self-financing.<sup>12</sup> This reliance on self-financing implies, on the

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<sup>12</sup> See IRFED, p. 212; ECWA/UNIDO, 1978, p. 27; Banque du Liban, Quarterly Bulletin, various issues.



other hand, an adequate profit performance. In a 1973 general survey of credit markets in Lebanon, the World Bank's IFC noted that there was no identifiable credit shortage to business enterprises in general, but that this was not necessarily the case for small business firms and personal proprietorships.<sup>13</sup>

c) *Demand*

The demand conditions for industrial products were, at least until the onset of the war in 1975, relatively favorable. GDP per capita increased during 1950–74 at around 3.2 percent per annum and reached \$1,300 in 1974 (equivalent in the year 2002 to around \$4,700). GDP per capita in the year 2002 was approximately \$4,300. More important, though, is the large potential demand represented by accommodating Arab markets for Lebanese exports. The availability of Arab markets has diminished the scale constraint faced by Lebanese industry in general. On the other hand, a low-tariff open economy and a strongly unequal income distribution, with Gini coefficients exceeding 0.50 before 1975 and around 0.44 in 1997, are not congenial to demand for local manufactures. In addition, a pervasive demonstration effect has historically skewed the pattern of consumption towards imported manufactures.<sup>14</sup>

*Other structural elements*

Institutional and technical conditions that are particularly relevant to the supply side of manufacturing relate to infrastructure, technology and skills, taxes and tariffs, and ownership and concentration. Whereas these conditions significantly improved during the early years of laissez-faire, the drive to build a modern physical and institutional base soon petered out. It was boosted again, for a few years in the early 1960s, by the developmental policies of the Chehab regime.

a) *Infrastructure*

The condition of physical infrastructure in Lebanon significantly improved between 1948 and 1974, but much of the improvement

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<sup>13</sup> IFC, 1974, pp. 137–38.

<sup>14</sup> UNCTAD, 1969, p. 6; République Libanaise, 1998b, p. 71.

took place in the urban areas in the center of the country. Electricity production increased about twenty-five fold during the period, and the condition of international transport and telecommunications became among the best in the region. However, infrastructure was designed and built to serve mainly Beirut and the central region around it, and was geared to support commerce and services in particular. On the other hand, the condition of the internal road network, and of communications outside the center in particular, remains poor. This has further segmented the domestic market, curtailing its potential for expansion while rendering unattractive the location of enterprises in rural areas.

b) *Technology and skills*

The technical conditions of operation of Lebanese industry present a mixed picture. Owners and managers, particularly in the larger enterprises, are well educated, well traveled and receptive to the introduction of new techniques of production. As Sayigh (1962) has put it, the Lebanese entrepreneur is famous for his resilience, open-mindedness and cleverness. Industry, however, requires creativity more than cleverness, creativity in management and insight regarding market developments. Already in the late 1950s and the early 1960s, management conditions were noted to be overall deficient in Lebanese manufacturing.<sup>15</sup> Technical conditions improved, however, and there emerged since the mid-1960s islands of relatively large, mechanized, efficient establishments, e.g. in textiles, ceramics, cement, cables and chemicals, surrounded by thriving, less sophisticated establishments.<sup>16</sup> The desire to emulate and the capacity to adapt quickly new methods of production have frequently been noted as outstanding characteristics of managers and other types of labor in Lebanon. This advantage is largely offset, however, by relatively antiquated labor-management relations, including little focus on training and the absence, for most workers, of a reasonable expectation of upward mobility and a financially secure career.

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<sup>15</sup> Mills, 1959 and US, 1962, p. 27.

<sup>16</sup> UNCTAD, 1969, p. 2. We shall be using "establishment" and "enterprise" interchangeably, especially since the very large majority of enterprises operate only one establishment.

c) *Taxes and tariffs*

Overall, taxes related to business operations are small and do not constitute a significant cost element. Some tax exemptions were introduced in the late 1960s in order to encourage manufacturing, but administrative red-tape complications rendered these largely ineffective.<sup>17</sup> The low tax burden on businesses is largely due to the standard and tolerated practice of parallel bookkeeping and systematic tax evasion. Remarkably, prior to 1975 and later until the mid-1990s, government revenue remained stable at an average of 15 percent of GDP; income taxes represented only about one tenth of these revenues. By 2002, total government revenues improved to 22 percent of GDP, and taxes on income increased to a little more than 2 percent of GDP (see table 5.2 in Chapter 5).

Customs duties have always constituted the major source of government revenues, averaging more than 35 percent of revenues prior to 1975. However, sharply increasing government indebtedness has forced government to raise taxes, fees and improve collection. Moreover, a Value Added Tax (VAT) was introduced in 2002 at a rate of 10 percent.

Tariffs and other protective measures have been selective, on a case-by-case basis and have been, prior to 1975, the lowest in the region: in the early 1970s, the average nominal tariff rate was 18 percent while the average rate of total import duties was 21.5 percent.<sup>18</sup> In any event, the protective impact of tariffs on industry has been negligible, and although pressure has been exerted by manufacturers for a more effective system of protection, these efforts have been unsuccessful.<sup>19</sup>

d) *Ownership and concentration*

The capital of most enterprises is controlled by indigenous businessmen, and the bulk of industrial capital is of domestic origin.<sup>20</sup> The detailed foreign sector accounts, available only for the period 1964–72, show that the outflow of interest, rent and dividends averaged about 5 percent of gross private operating surplus.<sup>21</sup> This situation has not

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<sup>17</sup> Ibid., p. 37.

<sup>18</sup> ECWA, 1978, pp. 36–37.

<sup>19</sup> See Johnson, 1986, p. 146; UNCTAD, 1969, p. 36.

<sup>20</sup> UNCTAD, 1969, p. 38 and Murray, 1974, pp. 103–104.

<sup>21</sup> See République Libanaise, c. 1971 ans c. 1974.

much changed, especially since most foreign investments have gradually withdrawn from the country since the beginning of the war in 1975.

The dominant legal form of ownership of industrial enterprises is the sole proprietorship. Between 1955 and 1998, more than half the manufacturing establishments with five workers or more were proprietorships. Less than 10 percent of all establishments are limited liability partnerships or corporations, the rest being essentially unlimited liability proprietorships or partnerships. Based on all the industrial surveys since 1955, only 1 to 2 percent of all industrial establishments have the legal form of a limited liability corporation. It should be noted, however, that quite a few of the limited-liability corporations are closely controlled by family interests, which makes them, in many respects, similar to proprietorships.

As expected in a small economy, the degree of concentration is quite high, whether geographically or in terms of output. Based on official VAT data for 2002, it has been estimated that at least half the markets in Lebanon, with at least 40 percent of the total sales turnover value, may be considered to have monopolistic or oligopolistic structures. These structures are defined as a sales concentration ratio for the largest three establishments of at least 40 percent of the market.<sup>22</sup>

Although slightly decreasing over the period 1955–70, the share of Greater Beirut in the number of manufacturing establishments of five workers or more, employment or value added varied between 60 and 67 percent of the corresponding totals. The share of Central Lebanon, i.e. Greater Beirut and the rest of Mount Lebanon, averaged about 80 percent.<sup>23</sup> The most recent industrial survey for 1998 showed that the largest 20 establishments (representing 1 per mil of the total number of manufacturing establishments) produced 18 percent of the total gross output, while the largest 225 establishments (representing 1 percent of the total number) produced more than half the total output. This is high concentration, indeed, by any standard.

The high concentration in manufacturing must have reduced price competition and boosted profits, thus compensating for idle productive capacity. A survey for the period 1964–74 by the UN's Economic

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<sup>22</sup> See CRI, 2003.

<sup>23</sup> CERMOC, 1978, pp. 100–101.

Commission for Western Asia (1978) covering all major manufacturing branches led to estimates of capacity utilization ranging between 10 percent for matches and more than 80 percent for cement. Many of the reported rates stood at less than 50 percent. However, these estimates, which are based on an assumption of three daily work shifts, are unrealistic. Moreover, it is doubtful whether such low rates of capacity utilization in manufacturing are compatible with the manifest survival and profitability of enterprises, which many Lebanese industrial establishments exhibited over a relatively long period.

### *Manufacturing performance*

The following evaluation of manufacturing performance follows the standard industrial organization paradigm of structure-behavior-performance. The analytical focus will be on performance assessment, with some evaluation of behavior in terms of pricing, choice of techniques and competitive strategy. Performance is assessed in terms of productivity and investment.

The analysis of industrial performance covers the period 1946–1998. Emphasis will be put, however, on performance in the favorable conditions extending over more than a quarter century until 1974. In fact, manufacturing practically reached its peak, in terms of output and employment, by the mid-1970s. Although boosted for some years in the mid-1980s by the strong depreciation of the Lebanese Pound, manufacturing activity started to decline since the end of the war in 1990, in line with the beginning of reconstruction. The following sections evaluate the overall industrialization process, in particular the reasons for industry's failure to become a leading force for growth under *laissez-faire*.

### *The industrial series*

The data on manufacturing that are presented in this chapter and elsewhere have all been derived from major official industrial surveys.<sup>24</sup> The series in Table 4.2 below covers the main data categories for the period 1946–98.

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<sup>24</sup> The earliest surveys pertain to the years 1955 and 1964 (République Libanaise,

Table 4.2 *Manufacturing employment, output and wages, 1946–1998*

	1946–48	1955	1964	1970	1985	1998
<i>Manufacturing share in:</i>						
– total employment (%)	~ 9	11	11	15	15	~ 13
– GDP (%)	~ 14	12	13	14	15	14
<i>Number of establishments</i>						
o/w with ≥ 5 workers (%)	~ 6,300 20–22	7,946 23	9,558 22	15,669 19	18,879 32	22,025 26
<i>Employment</i>						
o/w – in (≥ 5) establ. (%)	32,400– 37,400	51,442	67,476	94,620	120,000	141,923
– and salaried (%) <sup>a</sup>	63–69	67 61	67 61	60 49	65 55	58 50
<i>Number of workers/establ.</i>						
in (≥ 5) establ.	5.1–5.9 17–18	6.4 19.1	7.1 21.4	6.0 18.4	6.3 12.7	6.4 14.3
<i>Gross output (GO)</i>						
(prices & index, 1972–74 = 100)	12	28	52	73	107	58 (\$4.0 bill.)
<i>Value added (VA)</i>						
(prices & index, 1972–74 = 100)	18	33	52	73	99	64 (\$1.7 bill.)
o/w in (≥ 5) establ.		78	76	70	76	80
<i>Wages (W)<sup>b</sup></i>						
(prices & index, 1972–74 = 100)	15	28	47	71	79	53 (\$0.7 bill.)
o/w in (≥ 5) establ. (%)		61	67	58	63	54
<i>Ratios</i>						
VA/GO	0.56	0.45	0.39	0.39	0.36	0.43
W/VA	0.39	0.40	0.43	0.46	0.38	0.39
W/VA in (≥ 5) establ.		0.32	0.38	0.38	0.31	0.26
LL/\$ nominal exchange rate	3.1	3.2	3.1	3.3	16.4	1,516
CPI (1972–74 = 100)	71.1	57.6	76.4	86.9	919	384,786

*Sources:* Badre, 1953, 1956; Badre/FAO, 1959; CERMOC, 1978; Chami, 1981; Hamdan & Akl, 1979; MASS, 1987; NBITD, c. 1988; PAL, 1972, 1998; Republic of Lebanon, 1957; République Libanaise, c. 1966, c. 1971, c. 1972a,b, 1995, 1998a, 2003; Rep. of Lebanon, 1995, 2000; UN, 1955. *Notes:* The dollar figures for 1998 are in current prices. a- Salaried workers are all those earning salaries on a fixed, seasonal or temporary basis. b- Wages include wages imputed to independent workers, based on their share in employment (see Table 4.4 below). This approach is adopted throughout the analysis.

1957 and c. 1966). The results of another official survey that was carried out for the year 1970 have not been officially released but have appeared in various publications and studies (Antonios, 1977; CERMOC, 1978; Chami, 1981; Hamdan & Akl, 1979; NBITD, c. 1988). Only the general rather than the detailed data of the officially sponsored survey for 1985 (MASS, 1987) are used since the results have not been properly reviewed and include some inconsistent estimates. More recently, two officially sponsored industrial surveys have been conducted for 1994 and 1998. Dr. Albert Badre, who supervised the first official survey of 1955, had already carried out a detailed industrial survey for the years 1948–1950 in the context of the first national income estimates for those years (Badre, 1953). His results apparently

The most recent industrial survey, for 1998, covered all manufacturing establishments, with the coverage of establishments with less than 5 workers extrapolated from a 1994 survey. Previous surveys for the years 1955, 1964 and 1970 covered establishments with only five workers or more.<sup>25</sup>

For the period 1946–70, we have estimated the data relative to small establishments (less than 5 workers) on employment, value added and wages. We have assumed 2.5 workers (the mid-point of the range (1–4)), per establishment in the period 1946–48; that number was approximately 3.0 workers in 1970. In addition, when value added and wages are available from the national accounts data, particularly for the years 1964 and 1970, the relevant data for small establishments are derived as residuals.

Despite the relatively strong expansion in investment and employment, manufacturing continues to be centered on the traditional branches of food processing, textiles and clothing. The combined value-added share of these branches has fallen from more than 60 percent in the early 1950s to around 35 percent today in the late 1990s, the drop occurring mostly in food processing. The distribution of employment by manufacturing branch roughly parallels that of value added (see Appendix Table A.III.7). However, since the 1940s, production has remained diversified, with the following currently accounting for largest shares in value added: non-metallic minerals, mainly cement (15%), metal products, excluding machinery (13%), furniture (8%) and chemicals (6%). The share of machinery

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under-estimated industrial output and employment as they were largely superseded by his later 1955 survey. However, his earlier results, at least from a structural point of view, are a very useful source of evidence. We have used those results in conjunction with various official (Ministry of National Economy) data on manufacturing that were reproduced in some detail in UN (1955) to provide estimates for the period from 1946 until the early 1950s.

<sup>25</sup> In the classification of industrial establishments by size, workers are defined in the 1998 survey as full-time salaried employees, including working owners and family help when these are paid regular salaries. Definitions are not as specific in previous surveys, but text and tables suggest that the reference is to full-time employees, including working owners and excluding occasional or seasonal workers. The definitions are broadly, though not necessarily fully, consistent across the surveys. However, we believe any element of inconsistency to be relatively small and that it would not materially affect our conclusions. Throughout this chapter and elsewhere, the term “workers” is used in the general sense of all those working in an establishment, owners and employees, on a regular or temporary basis.

and equipment, mostly electrical machinery and apparatus, has been gradually increasing over time but is only about 5 percent.

A relatively small share of manufacturing output is exported. It increased from 12–13 percent in the early 1950s to about 25 percent in 1970–74, but has fallen to 20 percent in the late 1990s. The structure of manufactured exports has roughly paralleled that of output. Nonetheless, manufacturing did exhibit some dynamic characteristics, pointing to a promising potential. Thus, while exports were mostly textiles in the early 1950s they currently are quite diversified: clothing, processed food, chemicals, jewelry and electrical machinery. In addition, unlike the situation in many other LDCs, Lebanese exports have been mainly manufactures. From 40 to 45 percent in the early 1950s, the share of manufactures in the early 1970s has risen to more than 70 percent of total merchandise exports. This share is currently around 90 percent. About half the exports are destined to Arab countries, the same ratio as in the early 1950s but down from two thirds in the mid-1970s.<sup>26</sup>

### *Productivity and linkages*

Chenery et al. (1986) have found that, in developing countries undergoing an industrialization phase of structural transformation, the share of manufacturing output typically increases by an average of 3.2 percentage points each decade. For Lebanon, the share of manufacturing in GDP increased from 10.5% in 1950 to 14.4% in 1972–74, falling to 13.5% in 1997. The rate of increase during 1950–74 was therefore 1.7 percentage points each decade, i.e. only about half the typical rate of increase in an LDC undergoing structural transformation towards industrialization.<sup>27</sup> On that count alone, there has been, during that period, little structural transformation in Lebanese manufacturing.

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<sup>26</sup> See Chaib, 1980; Fei and Klat, c. 1954; Banque du Liban, various Annual Reports.

<sup>27</sup> Averages are calculated for the period 1972–74 because manufacturing value added in 1974 may have been inflated by the inclusion of re-exports. Moreover, the increase in the share of manufacturing in GDP from 14% in 1973 to 15.5% in 1974 seems unlikely. However, using either single-year observations or period averages does not materially affect the trend in the data or our argument.



A poor productivity record cannot produce an effective structural transformation. Worker productivity (value added per worker at constant prices) increased at an average annual rate of only 1.8% between 1946–48 and 1972–74. Productivity growth, moreover, has been decelerating throughout the period from an annual rate of 2.6% to less than 1%. This modest productivity record is not surprising, given that the workforce has achieved only a basic level of education. Productivity in the late 1990s was still suffering from the effects of 15 years of war, standing at only 55 percent of its high level in 1972–74<sup>28</sup> (see Table 4.4 below).

This unimpressive performance was in contrast with two advantages that Lebanese manufacturing, and the economy overall, had long enjoyed: a strong mechanization of processes (more on that below) and large Arab markets for exports. This double advantage, when set against the small growth in labor productivity, in fact serves to highlight a situation of an even smaller growth in total factor productivity, thus confirming *laissez-faire*'s minor "systemic" contribution to industrialization.

The issue of total factor productivity (TFP) growth is now briefly discussed. An aggregate production function of the general form  $Q = A f(K, L)$  is assumed in manufacturing, where  $Q$  is value added,  $K$  and  $L$  are capital and labor inputs, and  $A$  is technical progress. The element "A" in fact embodies all those factors that affect output beyond the contributions of labor and capital accumulation. As a residual, it is more a measure of our ignorance of what truly drives productivity than a measure of technical progress *per se*.

Assuming constant-returns and Hicks-neutral technical progress gives the basic neoclassical growth accounting equation,<sup>29</sup>

$$Q \bullet = \alpha K \bullet + (1 - \alpha) L \bullet + \lambda \quad (1)$$

where  $(\bullet)$  indicates growth of the variable in question with respect to time, and  $\lambda$  is TFP growth.  $\alpha$  and  $(1-\alpha)$  are, respectively, the elasticities of output with respect to capital and labor. Using intensive

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<sup>28</sup> The sharp fall in labor productivity in 1998 may be exaggerated. With a continuing contraction in demand since 1996, greatly reduced rates in capacity utilization in manufacturing have significantly undermined labor productivity. Nonetheless, labor productivity has fallen relative to its peak in the mid-1970s, registering a fall of 30 percent in 1994 compared to its average level in 1972–74 (see Republic of Lebanon, 1995).

<sup>29</sup> See Chenery et al., 1986, pp. 17, 243–47 for details.

units, with  $q = Q/L$ ,  $k = K/L$  and  $v = K/Q$ , we obtain after manipulation the equation for calculating  $\lambda$ , in terms of either the degree of mechanization ( $k$ ) or capital intensity ( $v$ )<sup>30</sup>

$$\lambda = (1 - \alpha) q^\bullet - \alpha v^\bullet \quad (2)$$

or, alternatively,  $\lambda = q^\bullet - \alpha k^\bullet$  (3)

Whichever assumptions are used, the values obtained for  $\lambda$  are negative or relatively small. During the period 1948–74, labor productivity growth ( $q^\bullet$ ) was 1.8%, the output elasticity of capital ( $\alpha$ ) exceeded 0.85, and the growth of capital intensity ( $v$ ) was 1.5%, which gives a negative TFP growth of around  $-1\%$ . Alternatively, using Chenery et al.'s cross-country information, which gives a value for ( $\alpha$ ) of approximately 0.45 for countries in the same income category as Lebanon during roughly the same period of time, produces a TFP growth of only 0.3%. Finally, the same result of 0.3% is obtained if we use the additional neoclassical restrictive assumption that puts ( $\alpha$ ) as measuring capital's share in income, which was around 0.43–0.45 during the period.

In other words,  $\lambda$  was small under any of the various assumptions used, and its contribution to output growth was equally small. It should be noted, however, that during the subperiod 1964–74,  $\lambda$  had significantly increased to a range of 1 to 1.5%. Nonetheless, its contribution remained modest, at best ranging between 15 to 22% of output growth. This is well below the figures registered for most countries, since TFP has typically accounted for 30 percent of growth in LDCs and half the growth in advanced countries.<sup>31</sup>

This modest productivity growth, despite extensive capital accumulation, clearly points to a process with little structural change. Structural change is in fact the sine qua non condition for successful industrialization, sustained growth and development, as "... on both empirical and theoretical grounds—a period in which the share of manufacturing rises substantially is a virtually universal feature of the structural transformation".<sup>32</sup>

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<sup>30</sup> See the next section for the distinction between these two useful analytical concepts, and Table 4.4 below for the data on capital,  $k$  and  $v$ .

<sup>31</sup> *Ibid.*, p. 354.

<sup>32</sup> *Ibid.*, p. 350.

There has indeed been little structural change in manufacturing since its share in GDP increased little while the output structure remained concentrated in the traditional branches of food and clothing. Table 4.3 below confirms this conservative feature of the Lebanese economy by showing the cost and demand structures of manufacturing in 1969–70 and 1997, the latter year being the most recent for which input-output and final demand component data are available.

Table 4.3 *Manufacturing cost and demand structures, (1969–70)/1997*  
(Annual averages; in % unless otherwise indicated)

Manufactures: aggregate supply and demand (\$1.1/\$13.2 billion) <sup>a</sup>					
	1969–70	1997		1969–70	1997
<i>Aggregate supply</i>			<i>Aggregate demand</i>		
Domestic	53	47	Interm. consumption	32	33
Imports	47	53	Consumption	50	48
			Investment	9	13
			Exports	8	7
	<u>100</u>	<u>100</u>		<u>100</u>	<u>100</u>
Domestic manufactures (\$0.6/\$6.2 billion)					
<i>Supply</i>			<i>Demand<sup>c</sup></i>		
Output (prod. prices)	84	81	Interm. consumption	13	28
–intermed. inputs	(51)	(47)	Consumption	66	53
–value added	(33)	(34)	Investment	6	4
Trading margins <sup>b</sup>	16	19	Exports	15	15
	<u>100</u>	<u>100</u>		<u>100</u>	<u>100</u>
Imported manufactures <sup>d</sup> (\$0.5/\$7.0 billion)					
<i>Supply</i>			<i>Demand</i>		
Imports (CIF)	71	} 83	Interm. consumption	54	36
Customs duties	10	}	Consumption	32	43
Trading margins <sup>b</sup>	19	17	Investment	14	21
	<u>100</u>	<u>100</u>		<u>100</u>	<u>100</u>

Sources: République Libanaise, c. 1972a, 1997, 2003.

Notes: a- Dollar figures are current at market exchange rates. b- Trading margins are assumed evenly divided between domestic and imported manufactures. c- The demand structure is derived as a residual of aggregate demand less corresponding imports. d- Net of re-exports.

Notwithstanding that, in 1997, the economy may still have been in an accommodating stance following the end of the war in 1990, the demand for and supply of manufactures shows little structural change over a period of more than 25 years. Even the share of investment has remained relatively small despite the heralded reconstruction efforts by government. In fact, expenditure on reconstruction has been relatively modest, as Chapter 6 will show. Moreover, while the share of consumption in aggregate demand has slightly decreased, it has significantly increased as a share of imports.

Industrializing countries usually import a growing share of intermediate inputs and use these more intensively in industry.<sup>33</sup> This was not the case in Lebanese manufacturing, where the share of intermediate inputs in the aggregate demand for manufactures has remained relatively small, and has also fallen as a share in imports. At the same time, the cost structure reveals weak linkages between manufacturing and other domestic activities. In 1969–70, more than three quarters of inputs in manufacturing were diagonal elements, i.e. linkages within the same manufacturing branch. This share has remained practically unchanged in 1997, reflecting a constant situation of weak linkages.<sup>34</sup> Indeed, the indicator for forward linkages (the ratio of sales of intermediate manufactures to the total demand for manufactures) has remained stable at around 0.33 in 1969–70 and 1997.

With increasing mechanization, industrialists have introduced new machinery and production techniques. The ratio of value added to gross manufacturing output has been falling since the mid-1940s, indicating an increasing “modernization” and capital deepening in manufacturing. Despite this continuing increase in mechanization, the ratio of value added to gross output has stabilized at around 0.39 between the mid-1960s and 1985. However, this ratio has increased in 1997 to more than 0.42, pointing to a possible reversal from capital deepening.

Thus, a situation of weak and static density of linkages has meant that manufacturing would not produce strong spillover effects or inter-industrial externalities, which is a major source of productivity growth. This may explain, at least in part, the phenomenon of low TFP growth in Lebanese manufacturing.

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<sup>33</sup> *Ibid.*, pp. 54, 225.

<sup>34</sup> For the input-output data, see République Libanaise 2003 and c. 1972a.

*What happened?*

With low productivity in manufacturing and in the economy overall, it was practically impossible for Lebanon to become an industrial country. Yet, while manufacturing faced strong competition from imports in the open economic environment that is Lebanon's, it also benefited from critical advantages. In particular, restrictions were insignificant, capital abundant, the macroeconomic financial condition healthy and stable, and Arab markets welcoming. Manufacturing, with its slowly but steadily increasing share in employment, output and exports, exhibited some dynamic characteristics that could have sustained it on an industrialization path. In addition, although productivity was low, profitability was high (see below). Clearly, manufacturing in Lebanon had potential, but a potential that did not materialize. This section goes into more detail about the reasons behind this failure. Before doing this, some interesting, though often neglected, economic concepts need to be first introduced.

*A theoretical interlude: Pasinetti's dynamics of growth*

The concepts in question are introduced in Luigi Pasinetti's (1981) *Structural Change and Economic Growth*, which investigates the fundamentals of long-term economic growth in a framework of multi-sector dynamics. Pasinetti has introduced two original interpretations of capital intensity and mechanization, and the relevant indicators thereof. The application of these indicators to economic analysis puts many economic problems in a new perspective and brings insight into, among other things, price competitiveness and trade (see his Chapter IX in particular).

A good starting point, in what next is mostly a paraphrasing of Pasinetti's arguments, is the concept of capital. Contrary to consumer goods, capital goods are commodities that are produced for the production of other commodities. It pays to take this roundabout method of production because it is more efficient than a direct and more primitive method of production: with the produced capital goods, more output can be obtained from the original factors of production or less of the latter is needed to produce the same amount of output. A capitalistic method of production is therefore a process that uses a flow of labor and a stock of capital goods to produce a flow of final output. The view of capitalistic production as a roundabout

or indirect process of production is drawn from Böhm-Bawerk and Wicksell's theories of capital.

The fundamental concept of "roundaboutness" introduced by this view is, however, ambiguous. Given two methods of production, one is said to be more "roundabout" if it requires a higher stock of capital goods for given flows. But which flows are in question here, labor or output flows? The question is crucial, for the answer implies the use of either one of two different concepts (and corresponding indicators) according to whether one flow or the other is used: a capital-labor ratio ( $K/L$ ) or a capital-output ratio ( $K/Q$ ). Pasinetti refers to  $K/L$  as an indicator of mechanization and to  $K/Q$  as an indicator of capital intensity, two different concepts for two different purposes.  $K/L$  should be used in problems relevant to employment.  $K/Q$  is pertinent to issues of price formation, and hence comparative advantage in trade, and to the evaluation of the effects of investment on output. To bring out the relevance and importance of these indicators in economic analysis, it is necessary to sketch some major elements of Pasinetti's rich argument concerning economic growth.

Pasinetti seeks to determine the causes of long-run economic growth in an industrial economy. The qualifier "industrial" carries a specific and essential meaning, namely that the object of analysis is a producing economy where industry and technology are its dominant features, as opposed to a trading economy where scarcity and exchange govern its economic relations. Ricardo clearly made this distinction in the first two pages of his *Principles*. He emphasized the fundamental character of the emerging industrial society and the need to adopt an analysis that is compatible with that new character. However, this emphasis was neglected in the subsequent marginalist analysis, with its focus on scarcity. Thus, models that neglect land, i.e. circular-capital models, and, more generally, the dismissal of scarcity as a determining element of long-run growth, now appear as a natural and realistic methodological stand that is compatible with the nature of modern economic activity. This methodological viewpoint then becomes an essential generalization rather than a convenient simplification in the analysis of modern economies.

The basis of Pasinetti's theoretical structure is contained in his analysis of what he calls a "natural economic system", one that is viewed as independent of actual institutional set-ups and mechanisms. The natural system is designed to reveal the fundamental determinants and characteristics of a growing economy. Institutional relations

may then be added-on to the natural system to enrich the interpretation of economic reality.<sup>35</sup> This exercise is undertaken later in this chapter to interpret profitability in Lebanese manufacturing.

The best way to understand the properties of this natural system is to start from a set of final consumption and investment goods. These goods are produced by labor and capital. Pasinetti then introduces the concept of vertically integrated sectors, where a given sector is defined by association with a given final good. Each final good may be collapsed into labor units, and into units of capital expressed in physical units of productive capacity of that same final good. Vertically integrated sectors are concepts that can be empirically tested. In the final analysis, the reference point to start from becomes the vector of consumption goods that requires, directly and indirectly, a physical quantity of labor to produce it, including the labor required to produce the new investment goods that are necessary for an increase in consumption per capita over time. His is a labor theory of value where the natural rate of profit in sector  $i$ ,  $\pi_i$ , depends at equilibrium (defined as full employment of all resources) on population growth ( $g$ ) and on the growth of per capita demand in that sector ( $r_i$ ):

$$\pi_i = g + r_i$$

The natural rate of profit is natural because it is independent of the institutional set-up, and it arises out of the necessity to provide a higher level of per capita demand for a growing population. Growing population and per capita demand turn out to be the fundamental parameters of a growing economy. A growing demand is nothing but a shorthand expression for technical progress, which means, from a vertical integration perspective, labor-saving techniques and a concomitant increase in per capita incomes. The ultimate driving force of growth, trade and the pattern of relative prices, at the national and international level, is technical progress and learning. Technical progress and learning are reflected in labor productivity in the absolute and relatively among sectors. Demand, which includes “tastes” and plays an exogenous role, determines the composition of output, or relative quantities, whereas technology determines relative prices.

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<sup>35</sup> See his subsequent (Pasinetti, 1990), which develops fundamental ideas contained in his 1981 book.

We can now “add-on” institutional elements to the natural model in order to embark on the analysis of actual systems. In a capitalist economy, the owners of the means of production do not necessarily reinvest all their profits, i.e. they usually save part of their income, that share ( $S_c$ ) being

$$0 \leq S_c \leq 1$$

The new equilibrium rate of profit is

$$\pi = \frac{1}{S_c} (g + r)$$

This equilibrium rate is, for a given overall increase in per capita demand, a uniform rate of profit that arises in a capitalist economy maintaining full employment of labor and productive capacity. It is an equilibrium rate (perhaps better called a reference rate of profit) that varies according to the degree of market imperfection, capital mobility and utilization of resources.

Going back to the indicators  $K/Q$  and  $K/L$ , these can now be presented as follows. The capital-output ratio,  $K/Q$ , represents the “. . . proportion of the quantity of labor which must be kept ‘locked up’ in the capital stock to the amount of labor employed in direct production”.<sup>36</sup> It is independent of the numéraire, the wage rate, and depends exclusively on the state of technology in the sector itself and in the sector of capital goods for the original sector.  $K/Q$  is thus a measure of the capital intensity of the production process, relevant to issues of investment and price formation, showing in the latter case the incidence of capital charges on price.

$K/L$ , the capital-labor ratio, refers to another type of “indirectness”, the degree of mechanization, which is relevant for problems concerning employment. It is a function of the numéraire, the wage rate, and moves with the capital-output ratio only if there is no technical progress. In the more common occurrence of technical progress over time, or differences in technology over space, the two ratios need not move in the same direction. Rather, technical progress usually involves a higher degree of mechanization (more machines operated by each worker, or a higher value of capital stock per worker reflecting the higher wage rate, itself reflecting the growth in productivity), but

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<sup>36</sup> Pasinetti, 1981, p. 184.



capital intensity may remain constant if there is a constant proportion of locked up labor to direct labor. Although sectoral  $K/Q$  depends on technology alone and both ratios have a purely technical meaning at the sectoral level only, the two ratios are, at the general economic level, more complex concepts and depend, in their dynamic movement, on both technology and the composition of output or demand.

Pasinetti provides an interesting illustration that highlights the meaning and usefulness of these concepts. Consider a factory from a developing country A that imports equipment from the US. Physical capital per man is the same in both countries since the machinery is traded at international prices: A and the US have the same degree of mechanization in that particular sector. But if the wage rate in A is, say, one quarter that in the US, A's capital-output ratio for this production process is four times greater than the US's as the lower wage rate in A influences the price of the final output but not that of the machinery. The same physical capital and the same degree of mechanization represent, in this case, a much more capital-intensive process in A than in the US. The imported machinery used in A represents, at prevailing prices, more "locked in" labor in terms of A's direct labor than it does in the US because country A has a lower overall productivity than the US and a corresponding lower wage rate. The degree of mechanization in the sector is the same in both countries but the capital intensities are very different. Thus, while country A is overall less mechanized than the US, its exports may be more capital-intensive than the US's since the capital charges per unit of output, i.e. capital intensity, are higher in A.

### *Mechanization, capital intensity and productivity*

Pasinetti's concepts of capital intensity and mechanization help explain the process of industrialization in Lebanon. Table 4.4 below provides the relevant data.

Manufacturing in Lebanon was propelled by cheap capital and a cultural comparative advantage in the Arab markets.

Several indicators underline the situation of capital abundance in Lebanon, the most telling being a continuous surplus in the balance of payments for 35 years between 1948 and 1982.<sup>37</sup> In addition, the

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<sup>37</sup> The only exception was in 1967 when, following the failure of a major bank (Intra) and a regional Arab-Israeli war, the balance of payments turned into a very small deficit (\$20 million).

Table 4.4 *Mechanization, capital intensity and productivity in manufacturing*  
(Indices, prices and base 1972-74 = 100, unless otherwise indicated)

	1948-50	1964-66	1972-74	1985	1998	
Capital stock (K) <sup>a</sup> (100 = LL 1,736 M)	16	66	100	144	151	(\$4.6 billion)
Gross output (GO) (100 = LL 2,664 M)	~ 19	57	100	107	58	(\$4.0 billion)
Value added (VA) (100 = LL 1,039 M)	20	57	100	99	64	(\$1.7 billion)
Employment (L) (100 = 122,211 workers)	31	58	100	98	116	
o/w Independent	14%	15%	19%	19%	20% <sup>b</sup>	
Labor productivity (VA/L) (100 = LL 8,502)	65	97	100	101	55	(\$12,028)
<i>Mechanization</i>						
(K/L) (100 = LL 14,205)	46	113	100	147	130	(\$32,269)
(K/w) (100 = 514T man years)	30	74	100	201	229	
<i>Capital intensity</i> (K/VA)						
(K/GO)	~ 0.6	0.8	0.7	1.0	1.2	
LL/\$ exchange rate	3.4	3.1	2.7	16.4	1,516	
CPI (1972-74 = 100)	64	79	100	919	384,786	

Sources: See Table 4.2 above.

Notes: M = Million; T = Thousand; w = Average wage per worker. Dollar figures for 1998 are current values.

a- Capital consists of fixed assets plus 3 months' value of wages and intermediate products. Half the fixed assets roughly consist of land and buildings, and the other half of machinery and equipment. Current capital values are deflated by the average of the domestic CPI and import prices, the latter replaced since after 1974 by industrial country export prices. The 1948-50 and 1985 current figures are respectively in Badre (1953) and NBITD (c. 1988). The 1985 capital estimate for establishments with 5 workers or more is adjusted upward by 10% to cover establishments with less than 5 workers. The 1964-66 and 1972-74 figures are the average of minimum and maximum estimates made by the Ministry of National Economy (in CERMOE, 1978). Though these estimates also cover utilities, this upward bias is offset, at least in part, by the survey's exclusion of some manufacturing establishments. b- For 1997.

financial condition of the public sector remained strong for almost half a century until recently in the mid-1990s. By the end of 1974, net official foreign reserves stood at \$2.7 billion (equivalent to 79 percent of GDP or 1.5 years of imports), while total debt was practically nil. The net foreign assets of the banking system, deflated by the import price index, were increasing at an annual rate of more than 15 percent between 1950 and 1974. Even by the end of 1992, total government debt stood at 38 percent of GDP, with a relatively small foreign-currency component of less than \$300 million against \$4.5 billion in net official foreign reserves.

The situation of capital abundance reflected itself in low capital cost and in a Lebanese Pound that has remained strong and stable

until the mid-1980s. Thus, bank credit has always been extended without restriction regarding currency type, especially since the foreign exchange market is totally free. This was in sharp contrast with most developing countries where access to foreign exchange was often difficult or restricted, and where an economy's total financial surplus was practically associated with the available amount of foreign exchange itself.<sup>38</sup> In the mid-1960s, the average bank rate on LL advances stood at about 5.7%, corresponding to a real rate of 3%. In the mid-1970s, the average nominal rate of 8.3% was slightly less than the 3-month Eurodollar rate of 8.5% and corresponded to a real rate of 1% (see Table 6.3 in Chapter 6).

Based on the above, one can therefore say that there has been no shortage of financial capital in Lebanon. As for the businesses that obtained most of their financing needs from profits—and these businesses are numerous if not the majority—a relatively high rate of profit, usually exceeding 30 percent a year, ensured that capital supply would not be a constraint on investment (see Table 4.5 below).

This easy capital situation allowed a relatively rapid process of capital accumulation and mechanization in manufacturing, at least until the mid-1980s. In a sense, this mechanization was in compensation for a shortage in skills and the related low total factor productivity. In other words, capital was substituted for unskilled rather than for more expensive labor.

Mechanization, or the capital-labor ratio  $K/L$ , can be measured in value terms as so much money invested per worker. It can also be represented in man-years,  $K/w$ , a measure of the amount of labor that is commanded by capital, which is obtained by dividing the value of the capital stock by the average wage level. This preferable measure has long traditional roots in classical economic theory, and in Keynes's *General Theory*. It is also preferable to  $K/L$  because, as in our case, it sidesteps the difficult issue of the proper price deflator for  $K$  and the issue of inclusion of temporary or occasional workers in the labor series.<sup>39</sup>

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<sup>38</sup> See Fitzgerald, 1985.

<sup>39</sup> Although the labor series includes temporary and occasional workers, which may bias the mechanization indicator  $K/L$ , calculating mechanization in relation only to permanent labor in establishments with 5 workers or more does not materially affect our conclusions.

The period until the mid-1960s was characterized by a strong increase in capital accumulation (9.3% p.a.), a less strong increase in mechanization (5.8% p.a.) and a moderate increase in labor productivity (2.5% p.a.). Subsequently and until 1998, growth in each of these indicators continued decelerating except for a brief spurt in mechanization after the Israeli invasion of 1982, when it was believed that the war had then ended for good. The deceleration maintained the same pattern throughout the period, i.e. with growth in labor productivity well below the other growth rates. This lagging growth in labor productivity is itself a reflection of the moderate, if not absent, growth in total factor productivity that was discussed above.

During the peaceful period 1948–74, especially during 1948–64, industrial wages increased absolutely and in relative terms, but they had started from very low levels (Chapter 5 provides detailed information on wages in relation to subsistence levels). However, the significant increase in the factor price ratio ( $w/\pi$ ) in favor of wages was associated with a deceleration rather than an acceleration in the mechanization of processes, which is not in line with the traditional prediction of factor substitution following a change in relative factor prices (see Table 4.5 below). Clearly, the fast pace of capital accumulation, and associated mechanization, were largely in compensation for the poor skills engaged in manufacturing activity and were themselves the main source of growth in manufacturing.

Capital intensity, which measures capital charges per unit of output, remained low until at least the early 1980s. From 1.3 in the late 1940s, which, incidentally, was only slightly higher than the US's 1.2, it increased to 2.0 in the mid-1960s, mostly reflecting the strong mechanization that took place during the period.<sup>40</sup> Capital intensity then fell to 1.7 in the mid-1970s, which was mainly due to the strong appreciation of the Lebanese Pound against the US dollar. In fact, between 1948–50 and 1972–74, the Pound appreciated by an average of 1% a year, reducing by half the 2% annual increase in the prices of imports during the period. The low level of capital intensity also reflected, in part, improved investment efficiency that, however, largely took the form of an increased degree of capacity utilization. Capital intensity then sharply increased as of the mid-1980s, following the strong depreciation of the Lebanese Pound.

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<sup>40</sup> Badre, 1953, Monograph no. 3, p. 27.

In sum, capital cost or availability was not a constraint, save perhaps for the small enterprises where finance had to come almost exclusively from profits and the owners' funds. Indeed, in the mid-1960s, the source of most financing for industry originated from "parents, family or friends".<sup>41</sup> A favorable financial environment has permitted the mechanization of industry with imported machinery and equipment, thus offsetting, at least in part, the low productivity in the sector and the economy overall while enhancing the competitiveness of domestic manufactures. In addition, Lebanese entrepreneurs took full advantage of their regional comparative advantage. They obviously had a cultural edge over non-Arab exporters to the booming Arab markets. Indeed, factors other than cost may be equally if not more important for international competitiveness.<sup>42</sup> Thus, Arab countries were buying at least two thirds of Lebanon's exports by the mid-1970s, up from around half in the early 1950s.

#### *Capital accumulation under laissez-faire*

We now come to a crucial stage in our argument. If laissez-faire did impede, or at least did not foster, a process that would have made of Lebanon an industrial country, how did this impediment operate? The answer requires that we address the issue of behavior, particularly investment behavior.

#### *Consumption versus investment*

In a commerce and services-dominated economy such as Lebanon's, a question arises as to why businesses should invest in industry where technical management is more demanding and risk appears greater than in trading activities.

As Table 4.5 shows, manufacturing was quite a profitable activity. In an environment of financial stability and an appreciating currency, high profit rates meant that the enterprise's profits could substitute, if necessary, for bank or other sources to finance investment. This is indirectly confirmed by the resilience of the small establishments in terms of output and employment, and their relatively

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<sup>41</sup> Nsouli, 1966, p. 7.

<sup>42</sup> See Fagerberg, 1988.

Table 4.5 *Distribution, investment and profitability in manufacturing*  
(Indices, prices and base 1972-74 = 100, unless otherwise indicated)

	1948-50	1964-66	1972-74	1985	1998	
Capital stock (K) <sup>a</sup> (100 = LL 1,736M)	16	66	100	144	151	(\$4.6 billion)
Value added (VA) (100 = LL 1,039M)	20	57	100	99	64	(\$1.7 billion)
Wages (W) <sup>b</sup> (100 = LL 491M)	17	51	100	79	53	(\$0.7 billion)
Profits (Π) <sup>c</sup> (100 = LL 548M)	24	61	100	117	75	(\$1.0 billion)
Investment (I) <sup>d</sup> (100 = LL 180M)	≤ 17	~ 62	100		≥ 81	(\$0.4 billion)
Share in total investment	≤ 0.10	≤ 0.11	≤ 0.12		~ 0.10	
Wages share (W/VA)	0.39	0.43	0.47	0.38	0.39	
Investment share (I/Π)	0.23	≤ 0.33	≤ 0.33		0.36	
Profit rate ( $\pi = \Pi/K$ )	46%	29%	32%	23%	23%	
Investment rate (I/K)	≤ 10%	≤ 10%	≤ 11%		~ 8%	
Factor-price ratio ( $w/\pi$ ) <sup>e</sup>	0.38	0.99	1.00	1.11	0.63	

Sources: See Tables 4.2 and 4.4 above.

Notes: M = Million. The dollar figures for 1998 are current.

a- See Note (a) in Table 4.4 above. b- Wages for 1948-50 are from Nsouli (1953). They are weighted as 75% of the monthly LL120 for men plus 25% of LL50 for women. Wages for 1964-66 and 1972-74 are the sum of wages in establishments with  $\geq 5$  workers and wages in establishments with  $< 5$  workers, which are assumed to be at the minimum legal level. Many establishments pay even less than the legal minimum wage. Wages include, as throughout the chapter, wages imputed to independent workers. c- Profits are defined as value added less wages. d- Investment for 1948-50 is derived from Badre (1953); it is the average for 1949 and 1950. Investment for 1964-66 and 1972-74 is the maximum estimated by the Ministry of Planning (in CERMOC, 1978). e- The factor-price ratio is the ratio of (1972-74) indices of average wages and the rate of profit.

high rates of investment at least until the mid-1980s. Rates of profit achieved before 1975 averaged 35 percent, meaning that invested capital was on average recouped in less than 3 years.

The industrial worker, however, did not much share in industrial profitability. He, or she, in fact earned less than the worker did in any non-agricultural activity. Average wages in manufacturing have systematically been less than average wages in trade, services or even in government service. In the early 1960s, the average industrial worker earned LL 160 a month (then a little more than \$50) versus anywhere between LL 175 and LL 450 for a civil servant. An employee in commerce or finance earned considerably more than the industrial worker or the civil servant.<sup>43</sup> More significant, between

<sup>43</sup> IRFED, pp. 94-95, 220.

the mid-1960s and mid-1970s when the increase in per capita GDP was at an average annual rate of 3.4 per cent, the average real wage rate in manufacturing was increasing at only 1.2 per cent.

Profit rates fell during the uncertain and warring period from 1975 to 1990, accompanied by a redistribution against wages. That redistribution became particularly severe following the unprecedented monetary depreciation in 1987 (see more on this in the next chapter). Before 1975, the share of wages in value added ranged between 35 and 40 per cent. The high of 40 per cent, which was achieved in the period 1972–74, is a bit misleading since it reflected more an expansion in the output and employment of small establishments rather than an increase in wages. In any event, the acceleration in the rate of emigration and number of industrial strikes was testimony to the absence of a material improvement in the standard of living of workers.

The most telling indicator about business behavior is investment behavior, and the manufacturing investment rate remained low, never exceeding a third of profits until the mid-1990s.<sup>44</sup> It is at this point of the production cycle, namely at the point of investment decision, that the failure of *laissez-faire* in the process of industrialization is the most manifest. Industrialists, despite high profit rates and large export markets, put back as additional capital only a relatively small share of their profits. The rate of investment out of profits appears even smaller when put in the context of a Lebanese industry that relies little on bank financing and mainly on internally generated funds.<sup>45</sup> Viewed in relation to capital stock, the rate of investment has not exceeded the ceiling of 11 per cent. This translates into a significantly smaller amount of net investment, confirming the weakness of the industrialization process in Lebanon.

That investment behavior could not, and cannot today, produce a developed industrial sector. The process of mechanization did sustain industry by compensating for low labor productivity, but it is efficiency rather than capital accumulation that produces a high-

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<sup>44</sup> We conservatively used the maximum investment amounts for the periods 1964–66 and 1972–74, as estimated by the Ministry of Planning, which was then responsible for the compilation, estimation and dissemination of national accounts and other economic data.

<sup>45</sup> See IRFED, p. 212 and ECWA/UNIDO, 1978, p. 27.

growth performance. However, the small growth in total factor productivity was not indicative of an efficient industry.

The process of industrialization in Lebanon was driven by the opportunities of capital abundance and a relatively easy access to neighboring export markets. These advantages were unique in an LDC context. Unfortunately, this process has not been sustained by an internal process of productivity growth. Neither laissez-faire as a system, nor government as an agent of change, provided the basis or the incentives for productivity growth. The problem in Lebanon's laissez-faire system is not with the high profit rates per se, though these do not necessarily reflect high efficiency; it is with the low investment rate out of profits or in relation to capital, which reflects the absence of the incentives or appropriate signals that the market is supposed to generate in the first place. For industrialists, there was no compelling reason to invest substantially more risk capital. Using profits more for consumption than investment was the preferred option, which is a very non-capitalist behavior.

#### *Industrialization without capitalism*

We have established that, even in a financially favorable environment, laissez-faire does not necessarily sustain productivity growth and industrialization. This is an important finding, especially when set against the mainstream belief that a market economy with minimal constraints is, of itself, conducive to efficiency and growth. The reasons for this failure may be found in the social rather than the strictly economic domain. In fact, Lebanon's unremarkable performance may essentially be due to its underdeveloped capitalist structure. In other words, the failure in efficiency and industrialization may be the result of the failure of capitalism to develop in the Lebanese economy.

But capitalism does not arise spontaneously. Historically, it has arisen from specific conditions of separation of labor from its means of subsistence and/or the means of production of its means of subsistence. On the other hand, pre-capitalist or underdeveloped capitalist activities can be quite resilient because of a productivity that results from a favorable economic environment, which would weaken the pressure or necessity put on labor to become waged, i.e. to join capitalist activity. This argument is inspired by Robert Brenner's (1977, 1986) theory about the development of capitalism, already



referred to in the first chapter, and is applied below to Lebanon, and manufacturing in particular.

Perhaps the most telling indicator of the expansion of capitalism, as a system of organization and production, is the extent of the expansion of the system of waged labor, particularly the regularly waged or salaried category. While the industrial surveys since 1955 are not strictly comparable in this respect, the most extensive manpower survey for 1970 and 1997 (PAL70 and PAL97) revealed that total manufacturing employment was distributed as follows:<sup>46</sup>

In 1970,	19%	independent workers, versus	20%	in 1997,
	40%	daily or seasonal workers	14%,	
	13%	owners and their relatives	12%	
but only	28%	regularly-salaried workers	54%	
	<u>100%</u>		<u>100%</u>	

In other words, in 1970, about 59 percent (the independent and seasonal workers) were still outside the domain of regular capitalist activity, whereas only 28 percent were regularly salaried workers. Independent workers, or the self-employed, are the epitome of pre-capitalism and their endurance constitutes the most important obstacle to the expansion of capitalism. On the other hand, despite the still high share of independent workers in 1997, the almost doubling of the share of regularly-salaried workers suggests, notwithstanding statistical errors and omissions, an opposite trend that points to a strengthening of capitalist forces in manufacturing following the end of the war and the deterioration of economic conditions (more on this below). The significant increase in the number of regularly-salaried workers in 1997 should, however, be tempered by the omission from the survey of mostly temporary Syrian workers, who swelled employment in Lebanon in the 1990s, and by the fact that owners who are formally on the payroll are considered to be regularly-salaried workers (see Appendix II in this regard).

Another indicator of capitalism is the degree of survival of small establishments that, in principle, become relatively less important with the expansion of capitalism. This argument implies that scale and capitalism go hand in hand, which is largely true, especially in

<sup>46</sup> See République Libanaise 1998a, 1972.

LDCs. Table 4.6 below provides structural indicators on the evolution of scale and productivity in manufacturing since 1955.

All industrial surveys in Lebanon since 1955 have defined artisan establishments as those with less than 5 workers (excluding seasonal labor). However, “[m]ost enterprises with less than 10 workers, even many of those with up to 25 workers, are, in their set-up, production apparatus and management, artisan establishments.”<sup>47</sup> Indeed,

Table 4.6 *Scale and productivity in manufacturing*  
(% distribution by establishment size)

	1955	1964	1970	1985	1998
<i>Number of establishments</i>					
< 5 workers/establ.	77	78	80	74	74
< 10	90	89	93	92	95
< 25	97	97	98	98	98
<i>Employment (L)</i>					
< 5 workers/establ.	33	33	36	46	42
< 10	46	44	49	66	67
< 25	61	59	60	80	75
<i>Value added (VA)</i>					
< 5 workers/establ.	22	24	30		20
< 10	30	31	38		38
< 25	44	44	52		49
<i>Relative labor productivity (VA/L = 100)</i>					
< 5 workers/establ.	66	72	83		49
5–9	67	65	65		71
10–24	84	90	123		135
25–49	107	131	} 120		202
≥ 50	159	137			202
Average productivity	100	100	100		100
<i>Labor productivity (VA/L)</i>					
(prices, index 1972–74 = 100)	77	93	95	101	55

Sources: See Table 4.2 above.

Note: Distribution is cumulative, except for relative labor productivity, where productivity in each class is in terms of the average for the year, set at 100.

<sup>47</sup> Michel Chatelus, in a study on Lebanese industry in the late 1960s for the Ministry of Planning (in CERMOC, p. 3n).

Table 4.6 shows a remarkable vigor of artisan manufacturing on practically all fronts, no matter how artisan or small establishments are defined. By 1970, about half of manufacturing employment was in establishments with less than 10 workers, the share increasing to two thirds in 1985.

If anything, a fundamental characteristic of capitalism, at least beyond its early formative stage, is the existence of capital as a separate entity. By 1985, around 56 percent of all non-artisan establishments (with 5 workers or more) were proprietorships, practically the same share as in 1964. In a proprietorship, the enterprise does not constitute a separate legal entity and, as such, its wealth is confounded with that of the owner. In 1997, 83 percent of all enterprises were proprietorships while the share of limited-liability enterprises, whether partnerships or corporations, has remained small at around 7 percent of all operating enterprises.

If the so-called artisan establishments have endured, it is essentially because they were productive, owing to internal and/or external circumstances. During 1955–70, labor productivity in establishments with less than 5 workers continued increasing to a level of 83 percent of average labor productivity. This was the result of mechanization and favorable demand conditions. Until the mid-1970s, relative economic prosperity in Lebanon strengthened the independent workers and artisan establishments. In addition, small establishments can display flexibility and resilience that help them endure. For instance, many of these have tended to subcontract work from the larger establishments, often bringing their equipment and small teams of workers on the premises of the large establishment, a case of pre-capitalist entities feeding off the capitalist ones.

During the war period 1975–90, indications were that the smaller establishments prospered at the expense of the larger ones. In 1985, employment in establishments with less than 10 workers increased to two thirds of total employment, up from about half in 1970. The productivity of these establishments was sustained by new capital investment, particularly before the collapse of the Lebanese Pound in 1987 and the consequent dollarization of the economy.

Since the end of the war in 1990, with capital now more expensive than previously, manufacturing may in fact be entering a new historical capitalist phase. Two opposite forces are currently at work. One is economic and tends to weaken the resistance of the smaller

establishments. It takes the form of larger capital expenses, stronger foreign competition, and a prolonged recession, all in a context of stagnant productivity. Indeed, with an average capital-output ratio of 2.7 (compared to 1.7 in the 1970s) and an average labor productivity that is currently significantly below its 1972–74 level, small establishments can hardly compete, particularly in an economic recession with a fixed-exchange rate policy. The other force is technical and tends to favor the survival of the smaller establishments by making increasing returns arise with smaller minimum efficient scales of production (MES) than previously. Thus, the nature of technological progress and the evolution of the industrial arts may be now leading to smaller MES levels.

One can see in Table 4.6 that the highest level of labor productivity has become, over time, associated with smaller scales of operation. The highest productivity level, which was in 1955 in the ( $\geq 50$  workers) class of establishments, has moved, perhaps since the early 1970s but definitely by 1998, to the class of (25–49 workers) per establishment. An examination of average labor productivity in manufacturing branches, at the 2-digit ISIC level, confirms this general finding. The large majority of branches shows highest productivity at the (10 to 19 workers) establishment size, e.g. printed matter and furniture, the (20–34 workers) establishment size, e.g. basic metals and fabricated metal products, and the (35–49 workers) establishment size, e.g. food and clothing products.

In any event, substantial economies of scale are probably foregone when small enterprises dominate manufacturing. With reference to the manufacturing survey of 1998, and based on a calculation of MES as associated with those levels of output when average labor productivity is highest, it is estimated that value added in manufacturing would at least double if all enterprises operate at least at the MES level.

If economic prosperity helps the survival of the independent or pre-capitalist form of organization, economic difficulties represent a threat to their survival and expansion. Overall, it is now becoming more expensive and difficult to be an independent producer. The capitalist form of organization will likely spread more forcefully in manufacturing in the future.

*The moral of the story*

Mainstream economics, or its implied *laissez-faire* strategy, does not view industrialization or any other specific activity as the route to sustained growth. All routes are equally attractive, and the free market system itself should lead to optimum growth. However, this is contradicted by Lebanon's economic performance. Moreover, manufacturing should have been a leading dynamic activity owing to the experience that industrialists have acquired since the early 1930s, the modernization of equipment that took place right after the end of WWII, and the uniquely favorable macroeconomic, capital and export conditions that were prevalent for more than a quarter century.

*The conservatism of laissez-faire*

Manufacturing in Lebanon has displayed dynamic characteristics that could have served a more deliberate and ambitious industrialization program. Despite strong competition from imports, the value added and employment-share of manufacturing has steadily increased until 1975. Thereafter, during 1975–90 and over frequent episodes of armed conflict, industrialists successfully adapted their operations to very difficult conditions of operation. Nonetheless, new entrants continue to join the industry since, in 1998, around half of all the existing manufacturing establishments had been founded in the 1990s.<sup>48</sup>

However, entrepreneurship in Lebanon is mainly trade entrepreneurship that has a limited impact on efficiency and innovation. Moreover, Baumol (1990) rightly notes that it is not entrepreneurship, which is usually plentiful in most countries, that really matters for growth but rather its allocation between productive and unproductive activities. Entrepreneurship can be channeled into innovative techniques of production or into rent-seeking activities; it all "... depends heavily on the rules of the game—the reward structure in the economy—that happen to prevail."<sup>49</sup> The reward structure did not, and still does not encourage enterprise and industry, understood as the taking of risk for a relatively long period before an adequate yield is achieved.

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<sup>48</sup> See Republic of Lebanon, 1995.

<sup>49</sup> Baumol, 1990, p. 894.

The rapid pace of capital accumulation in Lebanon owes much to the country's relatively favorable geographical and political advantage in the area. That advantage has manifested itself with regular and significant capital inflows, and with receptive Arab markets to the export of labor and commodities from Lebanon. This advantage, however, is circumstantial and merely provides an opportunity for industrialization. It does not necessarily generate skills and productivity, which alone can drive sustained industrialization and growth. It is significant that this advantage is associated with rent rather than efficiency characteristics. Remembering the definition of rent as income to a factor that is fixed in supply, i.e. a factor that is not producible or renewable, then the profits and performance of manufacturing must be explained, in some large part, by rent characteristics.

The expansion of Lebanese industry was more of a linear expansion, in the sense that it was little rooted in skills and efficiency that make for sustained industrialization. The growth in manufacturing output, employment and exports, in absolute and relative terms, was more the result of an increase in inputs, particularly capital, than in productivity. There is little evidence of any significant growth in total factor productivity in Lebanese manufacturing, which is not unexpected in view of the relatively low level of skills employed.

This is not to say that laissez-faire works against industrialization per se. Rather, it is that laissez-faire is a conservative strategy that favors the status quo while industrialization requires deliberate and sustained policies towards that objective. This is best confirmed by the absence of a significant structural change in manufacturing, and indeed in all the economy, over a period of half a century. If laissez-faire favors the status quo and the more naturally forthcoming activity, commerce, it cannot, on the other hand and almost by definition, be congenial to an industrialization strategy, which is a dynamic process that disrupts existing structures.

Laissez-faire can be an activist policy, but in defense of the status quo or of the prevailing balance of power. The following is an illustration of this conservative characteristic. In September 1971, the Minister of Finance in a newly formed government proposed to raise customs duties on a range of imported goods, including many luxuries, in order to finance development projects. The measures were widely supported by the Industrialists' Association, but a notorious and widespread strike by Beirut merchants forced the government to rescind its decisions. There was a similar incident after the end

of the Korean war in 1953, when the authorities intervened over a period of two years in the foreign exchange market and stopped the appreciation of the Lebanese Pound vis-à-vis the \$ in order to avoid inventory losses by merchants, who had been stocking commodities during the Korean War.

*What could have been*

Setting industrialization as a goal requires the development of an industrial base. One of Chenery et al.'s (1986) main conclusions of their industrialization survey was that the development of an industrial base required a period of significant import substitution, and that that requirement was consistent with the arguments for supporting infant industries. As early as in the 1950s, the Lebanese authorities have discussed with private concerns the opportunity of establishing automobile assembly plants in Lebanon, but the issue of existing low tariffs was instrumental in the failure of the negotiations.<sup>50</sup>

Industrialization presupposes a learning of production, and the learning of production should precede the learning of consumption. In other words, the generation of skills and productivity should precede or accompany the improvement in the standard of living, which should reflect the productivity of the economy, lest growth becomes unsustainable. For the last half century, Lebanon has been distinguished with one of the lowest saving rates in the world. The aggregate saving rate has not exceeded 5 percent of GDP from the early 1950s until the mid-1970s, and it has become negative thereafter (see next chapter for details).

While both theory and history show that there clearly is a case for the protection of infant industries, the route to industrialization can be varied, depending on the circumstances of the country. Whatever the route taken, a purposeful central authority with a developmental outlook is needed for an effective industrialization strategy.

Singapore provides an example of what an appropriate industrialization policy can achieve.<sup>51</sup> For Singapore was, in the 1960s before it took off on its industrialization path, similar to Lebanon in many respects. It had a small population (less than 3 million until 1990),

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<sup>50</sup> Persen, 1958, p. 290.

<sup>51</sup> This section on Singapore heavily relies on Huff (1995).

and was a trade and services center for the region. It also enjoyed macroeconomic stability, had an equally small and even smaller investment rate than Lebanon's in the early 1960s, and was as "pre-capitalist" as Lebanon was in 1970, as the self-employed then constituted around 21 percent of the labor force versus 24 percent in Lebanon. Singapore, however, adopted a development strategy that focused on manufactured exports as the engine of growth. This was implemented following a few years of emphasis on the protection of infant industries and import substitution.

Singapore's strategy rested on three pillars. The first was the establishment of an educated workforce and a modern infrastructure to spur productivity and attract foreign investment. The second was a policy of government-enforced saving and guidelines for pay increases. This policy served many fundamental purposes: it provided the necessary affordable financing for building human and physical infrastructure; it supported macroeconomic stability; and it allowed labor to share in productivity increases and in the benefits of an efficient social security scheme, a situation that is conducive to higher labor productivity. In other words, this policy represented a fair and highly workable social contract that ensured the financing of the growth that would sustain labor's increasing standard of living. The third pillar effectively consisted in attracting the capital and experience of the more advanced economies by encouraging foreign direct investment in the manufactured export sector, using criteria like value added and skill content. The establishment of the other two pillars made sure that the benefits of foreign direct investment would be fully internalized and invested for long-term growth.

These three pillars, on which Singapore's development strategy rested, had to support each other for the strategy to work effectively. The outstanding feature of this strategy is that it relied, in all its essential aspects, on government policies that were designed to use the market, both domestically and externally, as an instrument to suit and achieve specific development objectives. The market was an instrument, not a master. Domestically, the strategy used the market only in part whereas, externally, the small economy operated within the international trade and investment rules of the market. The lesson remains, however, that in all the relevant aspects of Singapore's economic strategy, *laissez-faire* was an absent ingredient.

Singapore's strategy resembled, in many respects, the East Asian (Japan, South Korea and Taiwan) model of the developmental state,



which rested on a combination of an authoritarian regime, public-private cooperation, selective industrial policies and a relatively egalitarian distribution. However, this model, with its historically unique and specific ingredients, may not be reproducible in other developing countries with different historical and political contexts.<sup>52</sup> By any account, it is not an easy task to achieve public-private cooperation with regard to specific national economic objectives over a relatively long period. The moral is then to work, first, on building a national consensus on specific development objectives and, second, on showing and assuring the private sector of the benefits it could derive from adhering to the identified development strategy, the benefits deriving essentially from significantly increased productivity and sustained growth.

Lebanon had its first industrial opportunity in the 19th century with the flourishing of its silk industry. Foreign competition and the channeling of capital to trade, instead of a modernization of the productive base, led to the virtual disappearance of local industry. The second opportunity came during WWII in the form of increased labor supply, and inexpensive equipment imports from industrial countries. This favorable situation was reinforced by Allied expenditures and tariff protection. The response was first appropriate as a more mechanized and diversified industry emerged in the mid-1940s. The end of WWII and the opening up of the economy arrested the industrial boom. However, soon afterwards, regional political developments created an enduring situation of abundant capital, a strong financial condition and accommodating and growing Arab markets for exports. Those uniquely favorable circumstances constituted a third historical opportunity to turn Lebanon into an industrial country. However, the opportunity was lost amidst an apparent economic boom that came with the establishment of the new regime of *laissez-faire*, which effectively became the alternative to, if not the opposite of, a potentially successful industrialization strategy.

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<sup>52</sup> See Önis 1991.

## CHAPTER FIVE

### THE REPRODUCTION OF LAISSEZ-FAIRE

It is often assumed that an economy of private enterprise has an automatic bias towards innovation, but this is not so. It has a bias only towards profit.

E.J. Hobsbawm

If anything, mainstream economic analysis is essentially about incentives: to work, consume, save, invest, trade, etc. Given the right incentives, it is traditionally claimed, economic efficiency and sustained growth would follow. A set of conditions is supposed to provide the right context for the right incentives to operate. Chief among the conditions is a free market for all commodities, including factors of production. By adding minimal taxation, a stable macroeconomic environment, an open trade and capital account regime, economic performance should then be very close to the optimal level. Following the establishment of the laissez-faire regime, the Lebanese economy has largely met these conditions, particularly during the period 1948–74. The following is a detailed assessment of the extent to which Lebanon's economic performance has corresponded to the mainstream story.

The previous chapters have focused on the general pattern of development and then on industrialization under laissez-faire. This chapter evaluates performance by analyzing the structure, productivity and distribution characteristics of the overall economy. The findings are then integrated in a behavioral story that explains the process of reproduction of the laissez-faire system since the late 1940s. The analysis emphasizes the favorable period that lasted more than a quarter century until 1975. Performance during the war, including the financial crisis of the mid-1980s, and the strategy adopted in the reconstruction phase after the end of the war in 1990, are addressed in the next chapter.

We begin by a presentation of the main features of Lebanon's foreign trade and balance of payments, which are particularly relevant for an open and small economy. This is followed by an examination

of the structural changes that have taken place in output and employment, and of the associated changes in productivity and distribution. Finally, an analysis of the behavior of the principal economic agents or classes provides the explanatory link between production and reproduction. Since economic development, as distinct from economic growth, was extensively discussed in Chapter 3, this chapter will focus on economic productivity, growth and structural change.

### *The exchange economy*

Economic activity in Lebanon has usually centered on commerce and services. The distinguishing character of the economy has remained that of a trading society, in line with its history and that of the region. Trade, or commerce in general, is an activity that needs to be sustained more by external than internal stimuli, as opposed to an activity such as industry where improvements in production techniques can autonomously stimulate expansion.

### *Breathless: laissez-faire without support*

As a brief reminder of the institutional background, Lebanon has been since 1943 a parliamentary system where, by informal agreement, legislative and executive powers are divided along sectarian Christian-Muslim lines. This distribution of power is carried onto civil service appointments, most of which represent extensions of political favors that serve to consolidate political power. The political system operates as an oligarchy whereby power is shared among sectarian and regional leaders according to informal and tacitly approved rules. Despite frequent upheavals, this power-sharing system has shown remarkable endurance, since many members of today's political elite belong to the elite families since independence.

The performance of successive governments since independence is distinguished by the absence of economic programs, save the perpetuation of the laissez-faire regime. Indeed, the policy statements of practically all new governments have emphasized what has become a traditional refrain regarding the uncontested need to preserve and consolidate "private initiative".

However, during 1958–64, official economic policy took a different turn. The then new president, Fuad Chehab, had explicit objectives

of promoting economic and social development through the building of public institutions and the modernization of infrastructure across the country. It was the only “developmental” period in the history of modern Lebanon, namely when economic and social development was set as a national objective. Various institutions were created during that period, including for the reform of the civil service and the implementation of major infrastructure projects. A central bank was established in 1964, the systematic and regular compilation and dissemination of national account data began in the same year, and the education system and physical infrastructure were upgraded, particularly in rural areas. In a sense, an important contribution of Chehab’s regime may be in having provided a more efficient framework for the functioning of the market. In as much as the essence of a market or laissez-faire economy consists in the unhindered operation of free factor and product markets, including the unrestricted movement of capital and labor, all Lebanese governments have scrupulously adhered to that policy.

Lebanon’s liberal economic and political environment was unique among Arab countries. It proved to be a strong attractor of people and capital, against a background of political instability and economic dirigisme in most parts of the region. Indeed, to date, a regular inflow of Arab capital and from the Lebanese diaspora continues to provide laissez-faire with invaluable support.

Table 5.1 below provides an overview of the main economic and political events that constituted significant milestones for the Lebanese economy.

The laissez-faire regime could be said to have started with the official decree (dated November 6, 1948) authorizing the free foreign exchange market and formally relaxing most foreign exchange controls. Controls were eliminated in 1952 though, in practice, a widespread free foreign exchange market had been effectively operating since 1948.<sup>1</sup> The year 1948 is also a convenient starting point to our story since it presents distance enough from 1943, the year of independence, and from the end of WWII to have allowed institutional and economic accommodation to take place.<sup>2</sup>

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<sup>1</sup> See Saba, E., 1961.

<sup>2</sup> In addition, 1948 provides a statistically convenient beginning since it was the year when the national accounts were first estimated.

Table 5.1 *Economic and political milestones*  
(Annual averages; GDP per capita and CPI in %)

<i>Period</i>	<i>Growth</i> (GDP p.c.)	<i>Inflation</i> (CPI)	<i>Exchange rate</i> (LL/\$)	<i>Main events</i>
1948–52	7.5	–1.6	3.5	Influx of Palestinian refugees and capital. Breakup of customs union with Syria (1950). Korean War boom (1951–53).
1953–57	1.0	0.4	3.3	End of Korean War boom (summer 1953). Bank secrecy law (1956).
1958	–13.7	4.0	3.2	Civil disturbances (summer 1958).
1959–64	4.3 <sup>a</sup>	1.7	3.1	Chehab developmental regime; Capital inflow from Egypt and Syria.
1965–69	1.7	2.6	3.2	Intra Bank crash (1966). Suez canal closure diverts trade through Beirut. Israel bombs Beirut airport (1968).
1970–74	4.8	4.7	2.9	Oil boom in Gulf. Inflow of oil capital.
1975–81	–6.8 <sup>b</sup>	19	3.1	War begins (1975); extensive fighting during 1975–76; intermittent fighting thereafter.
1982		20	4.7	Israeli invasion (summer 1982).
1983–90	–5.6 <sup>b</sup>	88	236	Intermittent fighting and political instability. War ends (1990).
1992–97	2.5	11.8 <sup>c</sup>	1,644	Reconstruction
1998–2002	0.2	1.2	1,509	Public debt overhang

*Sources:* See Appendices III and IV.

*Notes:* a- Growth (in per capita GDP at constant 1972–74 prices) is for 1960–64 to exclude the year 1959 when GDP grew at more than 20% following the end of civil disturbances in 1958. b- Growth during the war years is for the periods 1975–80 and 1980–90; there are no GDP estimates for any of the years during 1981–86. The year 1991 is omitted, as it was an unusual transition year with an estimated GDP growth rate of 38% and an inflation rate of 50%. c- Inflation is for 1993–97 and is typical of the whole period when inflation substantially fell from 100 percent in 1992, 25 percent in 1993 and practically zero during 1999–2001.

From 1948 to 1975, the Lebanese economy was subjected to several shocks, mostly of the positive variety. The adverse shocks of the 1958 civil disturbances, the Intra Bank crash in 1966, and the Israeli and Palestinian involvement in Lebanon since the late 1960s had, overall, a brief and relatively limited impact on economic performance. This is best illustrated by the behavior of the exchange rate, the principal indicator about the state of confidence in the Lebanese economy. The exchange rate was on an appreciating trend vis-à-vis the US dollar during 1948–75, even reaching a historical high of LL 2.30/\$, as an average in 1975, despite the fact that the war had effectively started in April of that year. However, few could then have predicted that the early skirmishes would spread to such devastating consequences.

The positive shocks had a more lasting effect, and their most conspicuous manifestation has been in the form of capital inflows since the late 1950s. Escaping harsher economic and political climates, capital came from various sources and for different reasons, as transfers and capital from Lebanese working abroad, mainly in the oil-rich Arab Gulf region, and as capital fleeing political instability and economic restrictions in Egypt, Iraq, and Syria. While some capital was invested in manufacturing, the largest part fuelled a continuous real estate boom, mostly in Beirut and other parts of central Lebanon. Indeed, during 1951–75 (1951 being the year of the first detailed balance of payments) the balance of payments was in surplus every year except for a small deficit in 1967.

Lebanon's strong financial condition was supported by fiscal austerity. Fiscal surpluses were achieved most of the time and deficits were relatively small and infrequent. By 1974, net public debt was less than 1 percent of GDP. Even by 1987, it was still at the acceptable level of 15 percent of GDP (see Table 3.1). The Lebanese authorities have therefore consistently adhered to policies ensuring, or at least unwittingly entailing, macroeconomic stability, thus satisfying a fundamental tenet and requirement of mainstream economics for the success of *laissez-faire*.

However, as Table 5.1 shows, *laissez-faire* lacked the autonomous drive to resume satisfactory growth levels, which materialized only following positive external shocks. It was the influx of Palestinian capital since the late 1940s, and the demand occasioned by the Korean War in the early 1950s, that compensated for the sharp fall in demand after the end of WWII. With the end of the Korean

War in the summer of 1953, growth quickly petered out until the advent of the Chehab regime in late 1958. During the six-year Chehab period, significant spending on infrastructure and the modernization of the administration and public institutions provided a strong boost to economic activity. This developmental episode coincided with, and was strengthened by, the inflow of capital that was escaping nationalization of private assets in Egypt and Syria since the late 1950s.

Economic activity decelerated soon afterwards, and growth in per capita GDP fell from 4.3 to 1.7 percent in the second half of the 1960s. Although this was in part due to political instability, the economy was already losing steam with a sharp increase in unemployment and emigration of skilled labor in particular (see Appendix II and Table 3.12). Again, external events came to the rescue. The closure of the Suez Canal following the 1967 Arab-Israeli war diverted trade to Beirut port, and the growing oil income in the Gulf region boosted capital inflows. However, it was mainly real estate and intermediation activities in the center of the country that benefited from these developments.

Thus, the liberal economic and political regime in Lebanon derived its benefits mainly from the absence of a liberal environment in neighboring countries. This comparative advantage clearly appears in the structure and evolution of the country's external economic relations.

### *Trade and transfers: the balance of payments*

Table 5.2 *The balance of payments, 1951–2002*  
(Annual averages, in current \$ millions and % of GDP, unless otherwise indicated)

	1951–52	1964–66	1971–73	1985–87	2000–02	
<i>In current \$ millions</i>						
<i>Current account</i>		–2	–66	–51	–498	–5,444
Merchandise <sup>a</sup>	–87	–335	–508	–1,278	–5,319	
Exports	(32)	(132)	(413)	(553)	(810)	
Imports	(–120)	(–468)	(–921)	(–1,831)	(–6,129)	
Nonfactor services	63	199	336	–178	–36	
Factor (capital) services <sup>b</sup>	2	46	91	489	–62	
Transfers	20	25	30	468	–26	
<i>Capital account</i>	8	154	301	525	5,479	
Direct investment		16			1,032	
Private short-term capital		119		–312	–749	

Table 5.2 (*cont.*)

	1951-52	1964-66	1971-73	1985-87	2000-02	
Net public debt disbursement		4		92	1,527	
Errors & omissions		15		745	3,670	
<i>Overall balance</i>		6	88	250	27	35
Net foreign assets <sup>c</sup>	~ 41	521	2,207	6,731	10,304	
o/w commercial banks (%)	~ 10	46	38	33	21	
Nominal exchange rate (LL/\$)	3.7	3.1	3.0	93	1,508	
REER (1971-73 = 100) <sup>d</sup>	102	115	100	41	132	
<i>In % of GDP</i>						
Merchandise exports	9	12	19	15	5	
Merchandise imports	32	41	43	51	35	
Merchandise trade balance	-23	-29	-24	-35	-30	
Merch. & nonfact. services balance	-6	-13	-8	-40	-30	
Current account balance	-1	-6	-2	-14	-31	
Overall balance	2	8	12	1	0	
Current transfers -net	5	2	1	13	0	
Short-term (ST) capital -net	~ 1	11	~ 13	~ -9	-4	
Errors & omissions (e&o)	-	1	1	20	21	
Transfers, ST capital, e&o	~ 6	14	~ 15	~ 25	16	
External public debt <sup>e</sup>	Insignif.	Insignif.	Insignif.	9	80	
Net foreign assets	10	42	81	204	56	

*Sources:* Banque du Liban, Annual Report (various issues); Fei and Klat, c. 1954; IMF, IFS Yearbook (various issues); République Libanaise, c. 1973, c. 1974, 2003; UN, 1958, 1955; UNDP/FAO, 1980.

*Notes:* a- Merchandise is net of re-exports and of trade in gold, currency and films. Also excluded are purchases by tourists and foreign diplomatic institutions, which are included under services (travel). Exports are FOB and imports CIF. Exports include official estimates for drugs and other smuggled merchandise. Other official export estimates (on national-accounts basis) are significantly lower by about a third from the above BOP-based data (see UNDP/FAO, 1980, which includes both series). However, differences between the two series with respect to imports and the trade balance are relatively small (5 to 10%), so that the trade balance and trend are similar in both instances. The main reason for the higher BOP export estimates, which are adopted here, is mostly the adjustments for undervaluation and smuggled merchandise. b- Estimates of labor factor services are difficult to distinguish from remittances and other transfers. They are therefore added to transfers whenever they are separately identified. c- Net foreign assets are of the banking system at the end of the 3-year period. Gold official holdings of 9.2 million ounces have not changed since 1971 and are valued at market prices. Commercial bank net foreign assets do not include their foreign-currency deposits with the central bank. These deposits are at commercial rates and have ranged from about \$1 billion at end 1994 to \$5.5 billion at end 2002. d- The real effective exchange rate (REER) is based on the LL/SDR exchange rate and the relative CPI between Lebanon and the industrial countries, which are the major source of imports. Since the mid-1980s, these estimates are very close to the IMF's that are partly based on relative trade weights, with differences not exceeding 5 percent. e- "Insignificant" means approximately 1% of GDP or less. The external public debt is of general government and is at the end of the 3-year period. It is the gross debt in foreign currencies rather than debt to non-residents, which is difficult to estimate particularly since non-residents hold significant amounts of LL-denominated Treasury Bills. Private non-bank external debt is insignificant.



Few countries, if any, have had as open current and capital accounts and for as long a period as Lebanon since the late 1940s. Undoubtedly, the economy has benefited from this environment. The balance of payments (BOP) has been in almost continuous surplus, with a corresponding increase in the net foreign assets of the banking system.<sup>3</sup> Moreover, the floating exchange rate has remained remarkably stable until the early 1980s (see Table A.IV.6 in Appendix IV). Thus, the private and public sectors have enjoyed a strong financial condition with no debt overhang until the early 1990s. Then, public indebtedness began to rise.<sup>4</sup>

Although Lebanon's BOP continues to be dominated by transfers and capital flows, merchandise exports also have strongly increased, with an even more rapid increase in the share of manufactures. The latter has exceeded 70 percent in the early 1970s and is currently above 90 percent of total merchandise exports, with a noticeable increase in the share of metals, machinery and equipment (see Table 5.3 below). However, in terms of GDP, exports are still far below their pre-war level.

The merchandise export performance does not appear to have been much influenced by the behavior of the real effective exchange rate (REER). Even the improvement in price competitiveness by 16 percent between 1962–64 and 1971–73 is not sufficient to explain the more than doubling of merchandise exports during the same period. The suggestion here is that, in the absence of significant increases in productivity, the positive export performance may be more associated with Lebanon's privileged location in and cultural

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<sup>3</sup> The first BOP data compilation was for the years 1951 and 1952. During 1951–82 (and most likely since independence in 1943), there was only one deficit of about \$20 million in 1967. The BOP was in deficit during 7 years during 1983–2002, with surplus amounts largely exceeding deficits, though any surplus since the mid-1990s was due to external borrowing.

<sup>4</sup> Total public debt (net LL-denominated debt plus gross foreign-currency debt) of gross government started to increase since the late 1970s. It wildly fluctuated throughout the 1980s (between 15 and 66 percent of GDP) in line with the fluctuations of GDP and the exchange rate, though the foreign exchange part of debt remained modest at an average of \$250 million. During the 1990s, public debt reached a low of 38 percent of GDP at end 1992 after a sharp depreciation of the Pound during the year. Thereafter, it sharply increased to reach 161 percent of GDP at end 2002, about half of which being foreign-exchange debt.

Table 5.3 *The structure of merchandise trade<sup>a</sup>*  
(Annual averages, in %)

	1951-52	1964-66	1971-73	1986-87	2001-02
<i>Merchandise exports</i>					
<i>Manufactures (% of total)<sup>b</sup></i>	46	55	72	69	~ 90
– processed food products		12	10	6	18
– textiles, clothing products		13	17	16	7
– wood, chemical products		7	15	14	11
– metals, machinery		12	16	13	26
– other		11	14	20	~ 28
<i>Destination of exports<sup>c</sup></i>					
Arab countries	49	66	67	68	47
Industrial countries	39	18	15	17	33
Other	12	16	18	15	20
Total	100	100	100	100	100
<i>Use of merchandise imports<sup>d</sup></i>					
					1997
Consumption	43	39	41		41
Intermediates	44	51	49		42
Investment	13	11	10		16
Total	100	100	100		100

*Sources:* Banque du Liban, Annual Report and Quarterly Bulletin (various issues); Chaib, 1980; Fei and Klat, c. 1954; Salem, 1964; UNDP/FAO, 1980.

*Notes:* a- The choice of the post-1975 periods is mainly determined by the availability of data. b- The (1971-73) data are for 1971-72. c- The (1986-87) data are estimates. d- The (1951-52) data are for 1957 (in Salem, 1964).

links with the region than with productivity-based comparative advantage. These advantages are also enhanced by an active trading entrepreneurial class and, as noted in Chapter 4, factors other than cost can be more important in international trade.<sup>5</sup> Indeed, as Table 5.3 shows, two thirds of all exports went to Arab countries throughout the 1960s and 1970s, up from around half in the early 1950s. In other words, Lebanon's relative liberal system in the region, its linguistic and cultural links with the Arab countries, and its continuing ties with the Lebanese diaspora across Africa constitute a rent element that can explain a large part of the country's external performance. This economic advantage is also well manifested in the BOP's capital account.

<sup>5</sup> See Fagerberg, 1988.

Lebanon's open economy has traditionally played an important role as a transit and entrepôt trade center for the region. However, the impact has been felt mostly in the financial rather than economic domain, with an enduring dominance of the capital account over the outcome of the BOP, and an absence of a significant impact on investment and productivity. As Table 5.2 shows, the current account balance and that of goods and nonfactor services have remained negative most of the time, particularly after 1975. Prior to 1975, these balances have little improved, reflecting both relatively low productivity increases and high consumption rates. In addition, the details on the use of merchandise imports reveal stable consumption and slightly declining investment shares (see more on this in the following sections).

Consider the three main components of the capital account. Foreign direct investment mostly went to real estate in the center of the country, particularly Beirut; short-term capital flows went into commercial banks; and errors&omissions mainly consisted of unaccounted-for transfers and short-term capital inflows. The last two items constitute the major part of the capital account. Now, the joint component current transfers, plus short-term capital inflows and errors&omissions (all on a net basis) provides an indicator of the "rent" or "transfer" element in the BOP, as opposed to the "production" element represented by trade in merchandise and services, and direct investment. This indicator has increased from around 6 percent of GDP in the early 1950s to 16 percent in 1971–73, which is still the same level in 2000–2002.

This rent is not necessarily an adverse element in the context of growth and development. On the contrary, it has provided a unique financial opportunity that could have been used for a stronger and more durable industrialization process and, more generally, for the enhancement of the human and physical infrastructure. However, the steady and substantial inflow of financial capital from various sources has passed through the banking sector to be mostly exported as deposits with correspondent banks. Clearly, the context of *laissez-faire* has not been conducive to a more productive utilization of this capital. Indeed, as the next section shows, the Lebanese economy has manifested little evidence of structural change or productivity growth.

*Structural change under laissez-faire*

Structural change is not only necessary for growth, it is almost equivalent to it, particularly for developing countries. In industrial countries, structural change has meant a rise in the share of industrial output and employment, mostly at the expense of agriculture. It is only recently in the 1980s that the share of industrial employment in industrial countries has started to decline, reflecting a long-term and significant increase in industrial productivity. This productivity increase has led to a steadily increasing and relatively less expensive flow of merchandise. In industrial countries, services have started to dominate consumption patterns only at later stages of increased productivity and economic development. The large majority of developing countries, on the other hand, are distinguished by the absence of a dynamic manufacturing sector and by a pattern of structural change whereby employment is moving away from agriculture mostly towards services, without concomitant increases in industrial productivity. The result has been an economic structure that is relatively inefficient in the production of merchandise, which is the most important consumption element in household budgets in most developing countries.

*Growth without structural change*

It is remarkable how, outside agriculture, the structure of output in Lebanon has little changed over about a quarter century since 1950. It is as if the reduction in the output share of agriculture has been thinly spread among various other activities, thus keeping the non-agricultural structure practically unchanged.

Table 5.4 *The structure of output and expenditure<sup>a</sup>*  
(Annual averages, in % of GDP unless otherwise indicated)

	1950	1964-66	1971-73	1987	1997
<i>Merchandise</i>	32.3	24.6	23.3	23.4	19.8
Agriculture	20.2	11.6	9.3	8.7	6.3
Manufacturing	12.1	13.0	14.0	14.7	13.5
<i>Infrastructure</i>	9.1	10.3	8.9	8.8	14.4
Education <sup>b</sup>	5.0	4.5	4.5	4.0	5.0
Construction	4.1	5.8	4.4	4.8	9.4

Table 5.4 (cont.)

	1950	1964–66	1971–73	1987	1997
<i>Merchandise &amp; infrastr.</i>	41.4	34.9	32.2	32.2	34.2
Intermediation	36.1	42.8	43.4	45.7	32.1
Commerce	28.0	31.2	31.9	34.2	21.3
Transport & communication	3.5	8.1	7.7	2.8	5.3
Finance <sup>c</sup>	4.6	3.5	3.8	8.7	5.5
<i>Other</i>	22.5	22.3	24.4	22.1	33.7
Public administration	7.0	8.1	7.7	5.2	11.6
Housing	9.4	7.6	8.9		8.5
Energy & water	1.4	2.2	2.0	0.8	1.5
Other services	4.7	4.4	5.8		12.1
<i>Gross domestic product</i>	100	100	100	100	100
–in 1972–74 LL millions	1,946	4,489	6,739	7,812	6,547
–in current \$ millions	330	1,142	2,160	3,296	15,662
<i>Consumption<sup>d</sup></i>	88	90	89	102	105
Private	81	80	80	96	89
Public	7	10	9	6	17
<i>Domestic saving</i>	12	10	11	–2	–5
<i>Investment</i>	18	23	20	16	30
Private	15	19	17	14	23
Public	3	4	3	2	7
<i>Foreign balance<sup>e</sup></i>	–6	–13	–9	–18	–35
Exports of goods & nfs	28	35	41	33	11
Imports of goods & nfs	34	48	50	51	46

*Sources:* Badre, 1953; Bankers Association of Lebanon, Annual report, 1997–98 (in Arabic); Banque du Liban, Annual report (various issues); Chaib, 1985; Gaspard, 1990; République Libanaise, c. 1967, c. 1971, c. 1972a,b, 1997, 1998b, 2003; UNDP/FAO, 1980.

*Notes:* a- The choice of periods, particularly post-1975, is mainly determined by the availability of data. b- Education is valued at market plus subsidies. In 1950, it was 3.5% of GDP, to which should be added at least 1.5% to account for omitted subsidies. The figures for 1987 and 1997 are estimates. c- Value added by financial services in 1994–95 is an estimate based on banking data published by the central bank and the Bankers Association. d- Consumption data are on “residence” rather than “territoriality” basis (see Appendix III). Data are adjusted for expenditure by tourists and diplomatic institutions (see UNDP/FAO, 1980 for adjusted data). The adjustments essentially affect private consumption and the foreign balance, reducing them by 8 to 7% of GDP from the 1960s until the early 1970s, by 0% in 1987, and by 1% in 1994–95. e- The foreign balances for the periods 1964–66 and 1971–73 differ from those in Table 5.2 by about 1 percent of GDP owing to adjustments in moving to “residence” basis and rounding. The substantial difference between the foreign balances for 1985–87 and 1987, which is about 26 percent of GDP, is mainly due to the severe deflation that took place in 1987 following the unprecedented depreciation (83 percent) in the value of the Lebanese currency during that year.

Merchandise and physical/human infrastructure are activities that satisfy basic needs for consumption and growth in LDCs. For Lebanon, both the share of merchandise and the share of merchandise and infrastructure combined have been in a steady decline from 1950 until at least the early 1990s. Although this decline has taken place to the advantage of intermediation, no single activity has displayed a dynamic lead in terms of growth. Moreover, the share of merchandise and infrastructure combined, since the late 1960s, has remained practically unchanged at one third of GDP, a small share, by any standard, for these basic activities in a developing country.

Aggregate expenditure also reveals a remarkable absence of structural change. Despite the strong macroeconomic condition of the economy, investment or gross capital formation has been relatively weak except for a spike in the early to mid-1960s, reflecting the brief developmental period of the Chehab regime. Investment has averaged about 20 percent of GDP during 1950–74. Singapore, by comparison and with a slightly smaller population than Lebanon's, had an average rate of investment of 18 percent of GDP during 1960–66, 25 percent during 1966–69 and more than 40 percent during 1970–79.<sup>6</sup> Moreover, in Lebanon, investment has mostly been on construction, which averaged 64 percent of total investment during the period 1964–72, with a high degree of concentration in residential building in the center of the country.<sup>7</sup>

Domestic saving has stood at an even lower level than investment, in part reflecting the absence of structural change. The strong financial condition and high business profitability (see section 5.4 on this) have not positively affected saving, which averaged only 11 percent of GDP before 1975, compared to 23 percent for developing countries during 1964–74.<sup>8</sup> Since 1977, consumption has exceeded GDP every single year and it remains, to date and in relation to GDP, among the highest in the world.

The relatively high consumption levels have largely been supported by an appreciating Lebanese Pound. Consumer prices increased during 1950–74 at about the same annual rate of 2 percent as import

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<sup>6</sup> See Huff, 1995.

<sup>7</sup> See République Libanaise, c. 1971, c. 1974.

<sup>8</sup> See IMF, IFS Yearbook, various issues.

prices. In addition, consumer credit for the purchase of durable consumer goods became a widespread phenomenon, particularly in the 1960s when retail credit expanded against a background of a strong increase in local and foreign currency deposits with commercial banks. These deposits increased from around 19 percent of GDP in 1950 to 101 percent in 1974. Overall, direct bank consumer credit is estimated to have increased at constant prices at an annual rate of more than 10 percent during 1950–74.<sup>9</sup>

Clearly, *laissez-faire* Lebanon has been living beyond its means, in good times and bad, and the structure of consumption has remained, for almost half a century, out of synch with the structure of production. This state of affairs could only be maintained by a continuous balance of payments surplus, which Lebanon has been able to achieve for a relatively long period. This surplus, however, is due more to transfers or income originating outside the production sphere than to a productivity-based advantage. More important, what is relevant here is not the fact that the strong macroeconomic and financial condition of the economy is rooted more in rent advantages than in productivity improvements and, hence, that condition would not necessarily be reproducible or sustainable. Rather, what is relevant is the use to which the surplus, whatever its origin, has been put and the extent to which it has served to raise the productivity and growth potential of the economy.

The structure of employment, as shown in Table 5.5, mirrors the structure of output, with little structural change and the shift of labor from agriculture being mostly taken up by services. That, by itself, gives a first indication—to be confirmed in the next section—about the absence of notable sectoral productivity increases. Although manufacturing employment has shown a brief but strong expansion in the 1960s, the expansion quickly petered out despite the surge in exports during the same period. Increased local and foreign demand for manufactures was mostly met with increased capacity utilization. At the same time, the emigration of Lebanese workers was increasing at three times the 1950s rate, with a high concentration of professional and other skilled workers (see Table 3.12 in Chapter 3). By 1975, the Arab Gulf region had absorbed about 5 percent of the

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<sup>9</sup> Beydoun, 1970, p. 143, and Banque du Liban, *Bulletin Trimestriel*, various issues.

Table 5.5 *The structure of employment*  
(In % of total employment, unless otherwise indicated)

	1950	1960	1970	1974	1987	1997
Agriculture	55	44	26	22	20	15–20
Industry (o/w manufacturing)	11 (10)	12 (11)	16 (15)	17 (16)	16 (15)	15 (14)
Construction	5	6	8	8	8	11
Services (o/w public administration)	29 (4)	38 (7)	50 (9)	53 (9)	56 (11)	54–59 (11)
Total	100	100	100	100	100	100
Total employment (thousands)	411	558	702	762	855	1,500

*Sources:* See Appendix II

*Note:* The official active population survey for 1997 (République Libanaise, 1998a, or PAL97) has estimated total employment in 1997 at 1,246,000, which we have adjusted upwards to approximately 1,500,000 to account for unrecorded foreign labor. The impact of the adjustment is mostly on agriculture (up from 9 to 15–20%) and services (down from 65 to 54–59%). See Appendix II for details.

domestic workforce, more than three quarters of whom being of the professional and other skilled categories.<sup>10</sup>

In Table 5.4 above, the output structure has been arranged in a way to highlight the evolution in the share of merchandise and infrastructure, both human and physical. A corollary of that arrangement, that only merchandise production is “productive”, is not intended. Rather, the argument made in Chapter 3 is repeated, namely that sustained growth is unlikely to take place in a developing country without a sustained growth in the productivity of merchandise production. A growth strategy that promotes intermediation activity and services requires the widespread existence of skilled labor, which is of critical importance in these activities, for only then would productivity growth in these activities allow the acquisition of the necessary merchandise through trade. This condition, however, describes more the industrial and developed economies rather than LDCs. In other words, sustained growth and development in LDCs requires, as a necessary condition, a sustained increase in the productivity

<sup>10</sup> Serageldin et al., 1983, p. 77.



of merchandise production. This argument starts from the simple fact that, in LDCs in general, most consumption expenditure is on merchandise.<sup>11</sup>

Thus, if the process of growth and development requires structural change, then there indeed has been little growth and development in Lebanon during the favorable period between 1948 and 1974, since the economy has displayed little structural change. This productivity assessment, however, is carried out at a first level of approximation and needs to be extended by way of a more detailed analysis of productivity change. For, as Pasinetti (1993) notes, the fundamental force from which structural change springs is learning in production and consumption. This type of learning means technical change that takes, above all, the form of rising labor productivity.

*The productivity of laissez-faire*

Table 5.6 below shows average labor productivity by separate economic activity, normalized relatively to average productivity for each period. The table reveals the structural change in labor productivity, highlighting leading activities, if any, in relation to average productivity.

Average labor productivity, as illustrated by GDP per worker, was in 1987 at practically the same level as in 1971–73. Moreover, despite the end of the war in 1990 and major reconstruction work since 1993, it fell in 1997 to less than half its level in 1971–73.<sup>12</sup> Three factors explain this development. The first is related to the quality of the workforce. Since the early 1990s, a growing number of workers, who have graduated from much less favorable and training conditions during the war, started joining the workforce. This effect, which would likely last until the first decade of the new millennium,

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<sup>11</sup> For instance, household spending on food and clothing was about 40 percent in 1997, against 44 percent in 1966, with food taking up about the third of spending in both instances (see Appendix IV). In industrial countries in 1996, average household spending on food was about 11 to 12 percent, and spending on food and clothing was approximately 17 to 18 percent (see The World Bank, World Development Indicators, 1998, pp. 212–13).

<sup>12</sup> The fall in GDP per worker in 1997 relative to 1971–73 may be overestimated, mainly owing to excess capacity and price index problems. Regarding index problems, deflating current \$ values by industrial country prices (justified on account of an open economy and a high import level) brings the fall to around 22 instead of 55 percent. In any event, average worker productivity was, in the late 1990s, significantly lower than in 1971–73.

Table 5.6 *Labor productivity by economic activity*  
(In % of average productivity, unless otherwise indicated)

	1949–51	1964–66	1971–73	1987	1997
Agriculture <sup>a</sup>	37	33	39	44	36
Manufacturing	121	100	93	98	100
Construction	82	83	55	60	85
Commerce	255	240	213	180	97
Other services	191	126	117	108	152
Public administration	175	101	77	47	105
<i>GDP per worker</i>	<i>100</i>	<i>100</i>	<i>100</i>	<i>100</i>	<i>100</i>
–Index (100 = LL 9,219) <sup>b</sup>	50	78	100	99	46
–in current \$	818	1,824	2,955	3,855	10,441

*Sources:* See Tables 5.4 and 5.5.

*Notes:* a- The index of productivity in agriculture is the least reliable, particularly in the 1990s, owing to large differences and errors in various estimates for employment in agriculture. See Appendix II.

b- Index of GDP per worker at constant 1972–74 LL prices. 1971–73 = 100.

has been compounded by the swelling of the workforce with growing numbers of unskilled workers from Syria, Egypt, India and other Asian countries, particularly after the end of the war. Second, the period 1988–90 has witnessed intense fighting in major areas of Beirut that led to serious destruction, particularly of enterprises and areas that had hitherto been spared. Third, and not least important, the severe monetary depreciation and dollarization that erupted in 1987, after about half a century of relative exchange rate stability, has suddenly eroded financial assets, undermined the financial system, and done lasting damage to the economy. The episode concerning the financial crisis of 1987 will be discussed at length in the next chapter.

Until 1973, and excepting agriculture in the early 1970s, no separate activity has had any leading role relatively to other activities, which points to the absence of significant structural change. Of course, situations can obtain where most activities are expanding but at practically equal rates, high or low, so that no structural change is detected. Labor productivity has increased at an average rate of 3.2 percent during 1949–73. However, this is not an unusual rate since the quarter century following the end of WWII was a truly singular period in the world economy when strong growth characterized almost all economies in the world. In fact, the rate of 3.2 percent is lower than the 4 percent noted by Chenery et al. for a cross-country

sample of economies in the same income group as Lebanon, and for various periods during 1950–75. Moreover, labor productivity, in Singapore for instance, was increasing at an average rate of 4.7 percent during 1960–79.<sup>13</sup> On the other hand, manufacturing has displayed some productivity resilience after 1975. War conditions, and the fall in incomes, have created an environment of import substitution while, at the same time, stimulating demand for basic commodities such as food and clothing.<sup>14</sup>

Growth analysis, however, is better served by considering total factor productivity (TFP) rather than simple labor productivity. We shall estimate TFP growth over the period 1950–74, and use the standard equation for this exercise that was used in Chapter 4.

To recall, an aggregate production function of the general form  $Q = A f(K, L)$  is assumed, where  $Q$  is aggregate value added,  $K$  and  $L$  are aggregate capital and labor inputs, and  $A$  is technical progress.

Assuming constant-returns, competitive markets and Hicks-neutral technical progress gives the basic neoclassical growth accounting equation,

$$Q^\bullet = \alpha K^\bullet + (1 - \alpha) L^\bullet + \lambda$$

and

$$\lambda = Q^\bullet - \alpha K^\bullet - (1 - \alpha) L^\bullet$$

where  $(\bullet)$  indicates growth of the variable in question with respect to time, and  $\lambda$  is TFP growth.  $\alpha$  and  $(1-\alpha)$  are the elasticities of output with respect to capital and labor that become, under the indicated assumptions, equal to the income shares of factors.

As previously, and whenever possible, 3-year averages are used to reduce estimation errors. Thus, the beginning and ending periods are (1949–51) and (1972–74). The relevant data for the period are:

$$\begin{array}{ll} Q^\bullet = 6\% & \\ K^\bullet = 6.3\% & \alpha = 0.60 \text{ (0.55)} \\ L^\bullet = 2.6\% & 1-\alpha = 0.40 \text{ (0.45)} \end{array}$$

Therefore,  $\lambda = 1.2\%$  (1.4%)

<sup>13</sup> See Chenery et al., 1986, p. 236, and Huff, 1995.

<sup>14</sup> Contrary to widespread perception among external observers, war conditions in Lebanon during 1975–90 were focussed in time and space around Greater Beirut, except for relatively brief periods when fighting would intensify and spread to several parts in the country. Normal economic activity was often prevailing and many

The computation of the capital series for 1948–74 is discussed in detail in Appendix III. The factor shares refer to the shares of profits and wages, the latter including imputed wages to independent or self-employed workers (see the following section on factor shares).

Thus, TFP has been growing during 1949–74 at an average annual rate of 1.2 percent, or at an upper bound of 1.4 percent if the profits/wages shares are 55/45 rather than 60/40. This is significantly lower than an average TFP growth of 2.3 percent, calculated for various periods during 1950–75 for a cross-country sample of economies in the same income group as Lebanon. Moreover, Lebanon's TFP growth has contributed 20 to 23 percent to total output growth, compared to an average of 36 percent for the same group of economies.<sup>15</sup>

Lebanon's 1.2 to 1.4 percent TFP average growth rate is also significantly lower than that of the high-growth Asian economies during 1960–89, as calculated in the World Bank study (1993) of the East Asian "miracle". The World Bank study calculates for human capital, in addition to labor and capital inputs. In view of the very high contribution by human capital to growth that is noted in the study, this further underscores the relatively modest TFP performance by the Lebanese economy.

Finally, it should be noted that TFP growth, as calculated above, implicitly includes the effect of resource allocation from low to high-productivity sectors, which Chenery et al. estimate at about a quarter of calculated TFP growth.<sup>16</sup> Given the substantial shift, over the period under consideration, of labor from agriculture to service activities in urban centers, the conclusion must be that the contribution of TFP growth to Lebanon's already average growth performance has indeed been modest at best.

Why this lackluster productivity performance? There are two fundamental reasons: one is laissez-faire's failure to generate skills, the second is the allocation of the non-emigrating skilled labor to commerce and service activities rather than to merchandise production, which is more subject to increasing returns than commerce, or services in general. Thus, only 8 to 10 percent of the skilled labor force

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manufacturing concerns have relocated to relatively safe areas early since the beginning of the war.

<sup>15</sup> Chenery et al., 1986, p. 246.

<sup>16</sup> *Ibid.*, p. 254.

has gone into agriculture and manufacturing in 1970 and 1997, respectively.

Whether considering simple output growth, structural change or productivity growth, the evidence is clear that there has been little structural change in the economy, and either stagnant or modest growth in productivity. Therefore, on the strength of the Lebanese evidence, the proposition that *laissez-faire* is a sufficient condition for making an economic system a productive one, in terms of significant GDP or TFP growth, is not true. This conclusion is even more striking in light of the favorable circumstances of a strong macroeconomic condition, capital abundance and relatively large export markets that Lebanon has enjoyed over a period of more than a quarter century.

#### *Income distribution and the development of capitalism*

Following the assessment of the growth and productivity performance of the Lebanese economy, the investigation is now brought to a more detailed analytical level. This is done by first examining the factor distribution of income, including the profitability of private enterprise and the structure of wages. The extent of the development of capitalism in the Lebanese economy will then be assessed through the development of waged employment. The next section completes the analysis by focusing on the behavior of the main economic agents, a behavior that drives and shapes the integral process of growth.

#### *Income distribution and profitability*

Three income categories reflect Lebanon's institutional economic structure: the waged or salaried labor who earns wages, capitalists who earn profits, and the independent producers and the self-employed who earn independent income. The independent category consists of a heterogeneous collection of occupations, including farmers, street vendors, taxi drivers, artisan manufacturers, maintenance workers (electricians, mechanics, etc.), retail shopkeepers, lawyers, engineers and medical doctors. The range of their incomes and standards of living mirrors the diversity of their skills and other endowments, extending from the subsistence of the small farmer and urban street

vendor to the prosperity enjoyed by many in the medical profession. The income diversity within and among categories can be large, as illustrated by the relatively high Gini coefficients for the salaried population or for overall incomes (see Chapter 3).

Since it has not been possible to estimate independent income separately, this is included with wages through a process of imputation of average wages in proportion to the number of independent workers. The other two identified categories in Table 5.7 below are profits and taxes. Profits are defined as gross value added in the private sector less wages and taxes. They thus include the profit component of independent activity. The analysis focuses on incomes in the private sector—which usually exceed 90 percent of GDP—to single out the performance of private enterprise under laissez-faire, but also because a large part of wages in the public sector are effectively more in the nature of subsidies than wages with a value added counterpart.

Table 5.7 *Distribution of factor incomes*  
(In % of GDP)

	1950	1964–70	1987	1997
<i>Gross domestic product</i>	100	100	100	100
Less: public administration	–6	–8	–5	–12
=				
<i>Gross production income</i>	94	92	95	88
=				
Wages -private sector <sup>a</sup>	30	33	20	36
Profits	59	51	77	41
Net indirect taxes <sup>b</sup>	5	8	–2	11
<i>Memo</i>				
Wages -public administration	5	7	5	10

*Sources:* Badre, 1956; Gaspard, 1990; République Libanaise, c. 1971, c. 1972a, 1997, 1998a, 1998b, 2003; UN, 1955.

*Notes:* a- Agricultural wages are assumed to be 25% of value added in agriculture, as in the 1967 BOP survey (Medawar, 1969, p. 99). Wages include wages imputed to independent workers. Adjustment factors are 1.38 for 1997 and 1.44 for other periods, based on the employment distribution in PAL 70 and PAL 97. b- Net indirect taxes are indirect taxes less operating subsidies (extended by government, mostly for education and health services) and transfers from related businesses overseas, which are relatively small not exceeding 1% of GDP.

The data in Table 5.7 are all derived from surveys, particularly data for 1997 and 1964–70, which are derived from official sectoral accounts for households and businesses.<sup>17</sup> Profits include interest, rent and dividends. Rent and interest are included in profits since interest on monetary capital and rent paid by businesses are effectively distributed within the capitalist category. Interest, however, is netted out in Table 5.10 below.

Two characteristics stand out in the table: the relatively low share of wages and a corresponding high return on capital. A redistribution of income occurred strongly against wages in the war years, particularly in 1987, though a significant correction took place afterwards. The profit share fell sharply in 1997, though profits have been underestimated through the exclusion of dividends in the estimation of the return on capital. Nonetheless, the sharp drop in the profit share in the late 1990s took place against a background of an appreciating, then fixed, exchange rate policy, declining growth and public debt overhang. This is an unsustainable situation, as the next chapter will show.

Prior to 1975, wages in the private sector (including wages imputed to independent workers) have ranged between 30 and 33 percent of GDP, while profits were at least half of GDP. Income taxes have historically averaged less than 2 percent of GDP, with households paying more than half in the form of direct deductions from wages. Tax evasion by private enterprises is widespread; it is also an accepted and tolerated norm of behavior in Lebanon. Unofficial estimates in the early 1960s put the rate of tax evasion at 75 percent in private business and at 90 percent in the liberal professions. This is not an exaggeration since nominal tax rates have averaged 20 to 25 percent of private enterprise income, i.e. more than 10 percent of GDP.<sup>18</sup>

It is possible to calculate the average rate of profit by applying the identity (where  $\pi$  is profits and  $K$  the capital stock):

$$\text{Rate of profit} \equiv \pi/K \equiv (\pi/\text{GDP})/(\text{K}/\text{GDP})$$

In other words, the general rate of profit is equal to the ratio of the profit share in GDP to the capital-output ratio. During 1950–74,

<sup>17</sup> See République Libanaise c. 1971, c. 1972a, and 2003.

<sup>18</sup> See Issawi, 1964, p. 290n, on tax evasion. The nominal progressive tax rates have usually ranged from a minimum of 5 percent to a maximum 50 percent of private enterprise income.

the average capital-output ratio in Lebanon was equal to 2.4.<sup>19</sup> The same calculation cannot be effected for the period after 1975 or after 1990, for lack of a series on capital. Since profits have ranged between 50 and 60 percent of GDP during the period, the corresponding general rate of profit has then ranged between 21 and 25 percent. This means that capital investment in Lebanon, on average, has been fully amortized within 4 to 5 years. Private enterprise is indeed profitable under laissez-faire.

For comparative purposes, it is instructive to note that, during 1973–82, the GDP distribution in the major industrial countries was approximately two-thirds for wages, one quarter for profits and 8 percent for the self-employed.<sup>20</sup> However, again and as noted earlier, the issue is not whether profits are high or low but the extent to which profits are reinvested. The rate of investment out of profits would show the extent to which the market system adequately provides, as mainstream theory claims, a framework not only for profits but also for further growth. This issue, critical in our argument, is taken up at length below in the section on behavior.

#### *Subsistence and the structure of wages*

The distribution of factor incomes in Lebanon does not support the so-called Kuznets hypothesis. To recall, the hypothesis indicates that growth is associated with greater income inequality in the early stages of development, but smaller inequality subsequently with industrialization and urbanization. The implication is that the benefits of a market-led process of growth should eventually trickle down to the lower-income groups. Clearly, that was not the case in laissez-faire Lebanon, unless one expects egalitarian effects to emerge after periods longer than a quarter century. Indeed, the absence of an improvement in income inequality is largely due to the failure of the wage-component of income, i.e. the component associated with the market

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<sup>19</sup> See Appendix III for the capital stock series and sources. Average 1972–74 prices are applied. The ratio 2.4 should be reduced by a factor of 0.2 (or 20 percent of GDP) if only the private component of capital and output are taken into account, but would have to be augmented, also by a factor of 0.2, if capital investment includes working capital—the equivalent of 3 months' worth of labor and intermediate products. Thus, the private sector capital-output ratio, also accounting for working capital, is equal to 2.4.

<sup>20</sup> Maddison, 1987, p. 659.



mechanism, to catch up with other incomes. This is illustrated by a growth rate in average real wages of 3 percent during 1950–74, which is even smaller than the 3.2 percent average growth in the average product per worker (see below).

To complement the analysis of factor income distribution, we need to investigate the level or purchasing power of wages. This is done in Table 5.8.

Subsistence and poverty are not unambiguous concepts. Used interchangeably, they refer to income levels that satisfy, first, basic needs such as food and shelter. Over and above basic needs, subsistence income allows the worker a standard of living that is deemed just acceptable in a given society at a particular historical stage in its development.

All the subsistence income estimates in Table 5.8 are based on surveys of “poor” working class households, households with “limited resources”, etc. These estimates are here used to convey more of a general than precise order of magnitude about poverty levels, or the minimum incomes that unskilled workers earn from waged employment. As such, they provide a sketch of the evolution in the standard of living of workers and the desirability of waged employment.

The subsistence income estimates are conservative, in the sense that reference subsistence or poverty levels may actually stand at higher levels (with correspondingly more people living at or below those levels), and that the low-income groups may in fact be earning even lower incomes than estimated. For instance, Churchill’s (1954) socio-economic survey of Beirut estimated the average family needs “for a minimum of health and decency” at the monthly equivalent of \$113, which is about twice the estimate of the income level of a poor working-class family in the above table. Moreover, a 1974 UN study involving 200,000 waged workers noted that more than 70 percent of these workers, who were then registered in the National Social Security Fund and included few temporary workers, earned less than the social subsistence that is estimated for that year.<sup>21</sup>

To cite other surveys for comparative purposes, a study estimated the US purchasing-power-parity average poverty level in low-income LDCs at a consumption level of \$31 per person per month in 1985,

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<sup>21</sup> See UN/ECWA, 1977.

Table 5.8 *Subsistence and other wage indicators*  
(Monthly levels; indices (1974 = 100) based on 1972-74 LL prices)

	1951-52	1960	1966	1974	1987	1997
Subsistence/Poverty <sup>a</sup>						
Index (100 = LL 458)	75	74	88	100	87	43
In current \$	59	77	104	215	167	466
Subsistence expend. on food (%)	60	46	43		60	
Minimum wages <sup>b</sup>						
Index (100 = LL 252)	58	68	79	100	27	32
In current \$	25	39	51	118	29	195
Average wages <sup>c</sup>						
Index (100 = LL 517)	52	53	73	100	54	34-41
In current \$	46	62	97	242	119	400-480
Average wages (Subsistence = 1)	0.77	0.81	0.93	1.13	0.71	0.86-1.03
Wages structure <sup>c</sup> (Average wages = 1)						
Agriculture	0.22		0.32	0.33		0.50
Industry	0.84		0.78	0.66		0.93
Services	2.30		1.38	1.55		1.10
Minimum wages	0.54	0.63	0.53	0.49	0.24	0.46
<i>Subsist./poverty estimation</i>						
Coverage	Beirut	Beirut	Beirut	Lebanon	Beirut	Lebanon
Economic group	Poor working class	"Limited resources"	Lowest expenditure	Poor	Basic needs	Lowest Income
Sample size (no. of households)	277		2,500	2,200	Basic needs survey	16,330

Sources: Ecole Libanaise, 1952; IRFED, c. 1962, Vol. II; Milenkovic, 1987; République Libanaise, c. 1968, 1998b; Schemeil, 1976.

Notes: a- For households of 5 members. The estimate for 1987 is based on a basic needs survey, which assumes that spending on food represents 60% of total spending (see Milenkovic, 1987). The estimate for 1997 is derived from the Family Budget Survey for 1997, in which households in the lowest income group (\$195 or less) specified a minimum monthly expenditure requirement equivalent to \$466 (Rép. Lib., 1998b, p. 251). b- Legal minimum wages; often, these are not implemented, particularly in agriculture. c- Average wages are derived from GDP, wages share (adjusted for imputed wages to independent workers) and employment figures. Wages are for both the private and public sectors. The structure of wages is based on several observations on average wage levels: for agriculture (Berouti, 1973; Chami, 1981; Lerner, 1958; Medawar, 1969; Stevens, 1959; and US, 1962); for industry (IRFED, c. 1962; Nsouli, 1953; République Libanaise, 1970; and Schemeil, 1976); for services (IRFED, c. 1962; République Libanaise, 1970 and Recueil de Statistiques Libanaises, Année 1963; and Schemeil). The 1997 wage structure is directly estimated in the 1997 Family Budget Survey for 1997, but we exclude the relatively high salary component of resident workers working overseas (see Rép. Lib., 1998b, p. 63). In the few cases when no wage observations are available, these are derived as residual from average wages.

with a lower bound of \$23.<sup>22</sup> The study estimated the 95 percent confidence interval for countries in the Middle East to vary between \$16 and \$54. As Lebanon belongs to the group of middle rather than low-income LDCs, its average poverty level is likely to be near or above the \$31 level. Our estimate for 1987 was in fact about \$33 per person in a 5-person household, which is quite close to the mark.

Notwithstanding any statistical caveats, the most striking in these data is the low level of wage incomes in relation to subsistence levels. The national average wage remained below subsistence until 1974 and, except for services, wages in agriculture and manufacturing have also remained below subsistence, respectively averaging a third and about three quarters of subsistence income. Legal minimum wages, which are not strictly enforced, have also averaged about half the level of subsistence incomes. The legal minimum wage is a reference wage that is determined by government in light of price inflation and union demands, but it is also an operational wage since it is effectively applied in industry. It is not uncommon for some workers, particularly those on a seasonal or temporary status, to be paid less than the legal minimum wages. Clearly, for the large majority of workers, it did not and still does not pay to be waged in Lebanon.

Waged work therefore is not an attractive opportunity for many in the labor force. For some, it was not difficult to shift to independent occupations, such as being a small retail shop owner or taxi driver. Many have undertaken the shift, thus revealing a preference for the precarious, but often higher-earning, independent profession over the certainty of the low-earning waged employment. In other words, the level and structure of wages under Lebanon's system of *laissez-faire* have not been conducive to the development of waged employment. If the expansion of waged employment is synonymous with the development of capitalism, with its corollary sustained increase in productivity and growth, then the level and structure of wages in Lebanon remain unproductive.

Lebanon's experience further shows that the wage system is a flexible one, with wages increasing in good times but also falling in bad. The fall in wages can indeed be much steeper than the fall in productivity. Thus, during the financial crisis of 1987 when GDP was at about the same level as in 1974, and average worker pro-

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<sup>22</sup> See Ravallion, et al., 1991.

ductivity had remained roughly constant, average wages fell to around 54 percent their level in 1974. The gap has significantly narrowed since then, although labor productivity is currently around half its pre-war level. However, the deteriorating economic conditions over a period of about a quarter century since 1975 have perhaps undermined the basis for the survival of independent activity and, at the same time, created a favorable basis for the development of capitalist activity through the drawing of labor into waged employment.

*The development of waged employment*

The idea of capitalism not significantly developing in Lebanon despite the strong dominance of a market laissez-faire system has been a leitmotif in our analysis. It derives from the principle that capitalism is essentially different from a market system. The essence of capitalism is the sale of commodities in a market in order to realize surplus value, which is used to realize still more surplus value, and so on. This is the meaning of capital accumulation. In a non-capitalist market economy, market exchange takes place in order to acquire and consume use values rather than exchange values. The distinction is important, for capitalism carries with it the drive to accumulate and hence the potential for sustained growth, which is not necessarily the case in a system of free market exchange or underdeveloped capitalism.

Empirically, one can associate the development of capitalism with the evolution of waged employment. The various population and labor surveys that are at the basis of the tables in the previous sections provide an informative picture on the progress of waged employment in Lebanon. Employment data here are simply divided into two mutually exclusive categories, the waged and the rest. The waged consist of the regularly waged, i.e. those who usually are on a regular contractual employment basis, and the irregularly waged who include the seasonal, occasional workers and family help. The other employment categories consist of the independent or self-employed workers, and the bosses.<sup>23</sup>

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<sup>23</sup> For obvious reasons, there is a case for including family help, or at least a large part of them, with independent workers. They are, however, included with the irregular-waged as was done in IRFED for the year 1959. The share of family help in total employment in 1970 and 1997 was respectively 6.6% and 2.3%.

Table 5.9 *Employment by work status*  
(In % of total employment)

		1951–52 (Beirut)	1959	1970	1997
Independent	}	46	32	24	25
Boss	}			8	7
Family help		6	~ 7	7	2
Government waged		~ 5	7	8	11
<i>Outside</i>					
Waged -private sector		57	46	47	45
Waged -private sector		43	54	53	55
Regular		33	39	30	35
Irregular		10	15	23	20
<i>Total</i>		<i>100</i>	<i>100</i>	<i>100</i>	<i>100</i>

Sources: AUB, 1960; Churchill, 1954; IRFED, c. 1962; République Libanaise, 1972, 1998a.

Note: Government employment includes the army and all those on a Ministry's payroll, such as in the education and health sectors.

Table 5.9 confirms the endurance of independent employment until 1997, and a corresponding stability in the share of total waged employment in the private sector. Waged employment in the private sector has expanded throughout the 1950s, but it has then stabilized at around 55 percent of total employment.<sup>24</sup> At the same time, independent employment has shown a remarkable resilience, with practically a constant share of about a quarter of total employment.

Analytically, however, the regular element of waged employment is quite different from the irregular one. The first contributes regularly and cumulatively to production, while the precarious status and instability of the irregularly, usually unskilled, waged labor contribute much less to productivity and growth. In this sense, the regularly waged part of employment corresponds to core or developed capitalism. One can then say that, by 1975 and after about a quarter century of *laissez-faire*, regularly waged employment in the private sector, or core capitalism, represented less than a third of total employment.

<sup>24</sup> The number of waged workers has undoubtedly increased overall. Churchill (1954, p. 50) notes in the 1951/52 socio-economic survey of Beirut that 46 percent of heads of households, in a sample size of 1,617, were "owners", i.e. independent workers or bosses.

By 1997, the regularly waged part of employment appears, however, to have expanded after the bad times of the war. This development is understandable as recession and the collapse of the Lebanese Pound since the mid-1980s have raised the barriers to entry to independent activity, particularly in urban regions.

It is important to note, in this regard, that the total employment figures used in Table 5.9 are the original official estimates and not the adjusted employment figures discussed in detail in Appendix III. To recall, the adjustments, in particular, have taken into account underestimation of female employment in agriculture and the omission of a large part of foreign labor, particularly Palestinians and Syrians. It is not clear how taking these adjustments into account would affect the distribution between independent and waged employment. Whatever effect these adjustments may have on waged employment, it would surely consist of increasing the share of the independent and/or irregularly waged employment category, to which most of the omitted workers belong, at the expense of the regularly waged category.

In other words, the evidence strongly points to the resilience of non-capitalist activity and to the absence of dynamic capitalism in laissez-faire Lebanon. Whatever expansion has taken place in waged employment, it has been concentrated in the capital Beirut and in the irregularly waged category of employment. Our conclusion therefore is that capitalist development in Lebanon has been weak and marginal, encompassing a relatively large number of occasional and temporary workers.

These comments concerning the absence of dynamic capitalist activity under laissez-faire and the low level of wages beg the following questions. Why did capitalism not develop more forcefully, and how did workers cope with wages that often were below subsistence levels? The next section provides answers to these questions.

*Playing the game: behavior and the reproduction of laissez-faire*

The cumulative evidence has so far revealed that laissez-faire in Lebanon has exhibited an average economic performance, which becomes even less than average when set against the economy's favorable financial and regional conditions. An economic growth per person employed of around 3.2 percent, during the quarter century until 1974, was not extraordinary in itself or in relation to neighboring

or similar developing countries. Moreover, this growth has not been accompanied by significant increases in total factor productivity. The evidence also revealed the resilience of the independent or non-capitalist sector of the economy, and a corresponding failure of the capitalist sector to expand.

The analysis, however, has followed an approach similar to the traditional method of comparative statics, dwelling on the comparison of specific characteristics over time without making explicit the behavior of economic agents. This section proposes to address this issue by specifying the behavior of the principal economic agents, which are the four traditional sectors or institutions of businesses, households, government and the foreign sector.

*Life after profits: business investment behavior*

Does higher profitability lead to higher investment and growth? This issue of the relationship between profitability and investment is a classical and central issue in economic theory. It figuratively captures economic activity at the stage between the end of one cycle of production and the beginning of the next, i.e. at the moment of reproduction of the economy. It is a critical issue in our investigation about the performance of laissez-faire, and its suitability as an economic strategy for LDCs, for it shows the extent to which profits are reinvested in enterprises, let alone the form and efficiency of new investment. In other words, it shows the extent to which mainstream theory is validated in its view of market profitability as the necessary and sufficient condition for accumulation and growth.

Table 5.10 below is an extension of table 5.7 about the factor distribution of income. It gives indicators about the performance of businesses in terms of profits, and their behavior in terms of investment. To recall, businesses also include the independent workers or producers, after their incomes have been netted out of imputed wages so that their residual income becomes a profit-equivalent that becomes part of business profits. Independents are included in the business category because, although they are mostly self-employed who earn “revenue” as opposed to wages or profits, they nonetheless must make decisions concerning capital investment and the pricing of commodities they sell in the market.

Table 5.10 details the allocation of profits among various uses. Although interest on monetary capital is practically redistributed

Table 5.10 *Profitability and investment*  
(Annual averages in % of GDP, unless otherwise indicated)

	1950	1964-70	1987	1997
Gross Domestic Product	100	100	100	100
Less: public administration	-6	-8	-5	-12
=				
Gross production income	94	92	95	88
Wages -private sector	30	33	20	36
Profits	59	51	77	41
Net indirect taxes	5	8	-2	11
Profits <sup>a</sup>	59	51	77	41
Less: investment <sup>b</sup>	15	17	14	23
Less: interest cost	2	4	6	6
=				
Retained profits	42	30	57	12
Less: dividends <sup>c</sup>	11	9	14	
=				
Free capital	31	21	43	12
<i>Investment/profit ratio (%)</i>	25%	33%	18%	55%

*Sources:* See Table 5.7, and Banque du Liban, Annual Report and Quarterly Bulletin, various issues.

*Notes:* a- Profits include interest, rent and dividends and profits imputed to independent workers. b- Gross investment by the private sector only. c- Dividends are estimated at approximately 20% of profits (after interest cost but before investment), rent cost to business being estimated at about 3% of GDP. Since 1997 GDP has excluded dividends from profits, these are excluded from distribution.

within the business community in Lebanon, it is here viewed as the cost of working capital that is financed by banks. This approach is in line with actual business practices in Lebanon. Indeed, most fixed investment is undertaken by non-banks and is financed from the businesses' own funds. Businesses borrow from banks for their working capital needs, although working capital can also be financed from cash generated by sales. Commercial banks operating in Lebanon have infrequently lent to local businesses for fixed investment or on a long-term basis. Thus, profits are in fact distributed among three categories, investment, including working capital, dividends and a residual or free capital.

Clearly, businesses did not invest a large part of their profits. Until the early 1990s, the private sector in Lebanon invested only a quarter to one third of profits. Subsequently, after the end of the war,



the share of investment has sharply risen to 55 percent in 1997. However, this rise should be tempered by the fact that profits in 1997 have been underestimated owing, in particular, to the exclusion of dividends from their estimate. In addition, this rise is largely explained by the renewal of much of the capital stock in the private sector, especially in real estate, following the end of the war. In other words, the high share of investment out of profits in 1997 is atypical of private investment behavior in Lebanon.

During 1950–74, after allowance is made for investment and working capital finance costs, and after the distribution of dividends, residual “free” capital has ranged between 21 and 31 percent of GDP. It was at least 12 percent of GDP in 1997. Note that these estimates of free capital are fractions of GDP and not profits! If only half of this free capital were invested, then private fixed investment would have averaged an annual 30 percent of GDP throughout the non-war period of about 27 years since 1948. The Lebanese economy, and society, would have surely become radically different in terms of productivity and standard of living.

If anything, this investment outcome constitutes *laissez-faire*’s principal failure in Lebanon. It also shows the absence of an automatic link running from market profitability to investment and growth. The failure is compounded by the fact of negative real interest rates since, as the World Bank noted, “. . . interest rates have consistently been below the rate of inflation”.<sup>25</sup> *Laissez-faire*, or a market economy in general, can therefore reproduce itself at low rates of output with no incentive, or compulsion, emanating from the market to invest most of the profits and take the economy to higher levels of sustainable output.

How has this residual or free capital been used? Probably in conspicuous consumption, which is apparent in Lebanese society, and personal investments outside the domestic production sphere. Businessmen are guided more by levels than rates of profit. Thus, as output fell during the war years, profit margins were raised to compensate for lower sales, and hence achieve adequate profit volumes. In fact, the profit share in GDP did increase with falling output after 1975. The higher profits were necessary to maintain the living standards of business owners and ensure capital replacement, an outcome made

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<sup>25</sup> IFC, 1974, p. 3.

possible by the relatively high degree of concentration in Lebanese markets.

The Lebanese economy is indeed characterized by a relatively high degree of monopoly power. The high degree of geographical and output concentration has already been stressed in the previous chapter on manufacturing. A survey on the ownership by major business families of shareholding companies in Lebanon in 1973 estimated that the largest thirteen such families controlled 47 percent of total industrial capital, 30 percent of total bank assets and 24 percent of total capital in commerce, agriculture and service companies. Other reports stressed the widespread phenomenon of interlocking ownership in corporations in various activities.<sup>26</sup> In 2002, based on official VAT data, it has been estimated that at least half the markets in Lebanon, with at least 40 percent of the total sales turnover value, may be considered to have monopolistic or oligopolistic structures. These structures are defined as a sales concentration ratio for the largest three establishments of at least 40 percent of the market.<sup>27</sup>

An interesting illustration of business behavior is indirectly provided by Pasinetti's—also referred to as Cambridge—profit equation (see section 4.3.1 in Chapter 4):

$$\pi = 1/s_c(g + r)$$

where  $\pi$  is the rate of profit,  $s_c$  is the income saving ratio by capitalists (the savings they invest),  $g$  and  $r$  are respectively the growth rates of population and per capita demand. The sum  $(g + r)$  may be taken as equivalent to the rate of growth in national income or in GNP, while  $s_c$  represents the share of gross investment out of profits. Using our available historical evidence, we have  $(g + r) = 0.06$  and  $s_c = 0.25$  to  $0.33$  as average rates for the period 1950–74. Then  $\pi = 18$  to 24 percent.

The resulting average rate of profit of 18 to 24 percent may be interpreted as follows. Given a business investment rate representing a quarter to one third of profits, such a rate reflecting the “animal spirits” of capitalists and the standard of living they aspire to, given also a general annual increase in demand of 6 percent, then a rate of profit of 18 to 24 percent is the rate that needs to be realized in

<sup>26</sup> Hamdan and Akl, 1979, p. 63, and IFC, 1974, pp. 129–31.

<sup>27</sup> See CRI, 2003.

order to induce an investment in such volume as to lead to the full employment of all resources. Obviously, the lower the investment rate the higher is the rate of profit that is necessary to achieve full employment.

Now, Pasinetti's equation is one that obtains in a "natural economic system", which is independent of actual institutional mechanisms and where the competitive full employment condition is the equilibrium condition.<sup>28</sup> It is a reference rate of profit where, nonetheless, institutional parameters are partly reflected by  $s_c$  and by  $g$ . On the other hand, non-competitive markets and the unemployment of physical and labor resources are also parameters that characterize actual economic systems. Market imperfections and unemployment tend to increase the rate of profit through market power and lower pressure on wage inflation, while excess capacity tends to reduce it. The net effect of these institutional additions on the rate of profit is difficult to work out and varies with the situation on hand. However, the fact that the actual rate of profit has been estimated to range between 21 and 25 percent, and in view of the relatively high rates of unemployment that exceeded 10 percent since the late 1960s, then these data confirm the high degree of market imperfection in the Lebanese economy.

A typical business behavior can then be portrayed as follows. The businessman can realize high rates of profit (and at least satisfactory incomes for the independent workers) since costs are cheapened by a strong currency and low wages. The strong currency also affords a higher mechanization of processes and improved productivity. In addition, demand is supported by regional exports and profitability boosted by a high degree of market imperfection. In this context of high profitability that supports at least a satisfactory standard of living, the compulsion to take risks and raise the rate of investment is surely not strong.

Why was little foreign investment undertaken in agriculture and industry? Shouldn't the return on investments in these activities, as marginal productivity theory predicts, have risen and accordingly attracted investment funds? The answer is that investment in services, usually in the center of the country, raises the productivity of services relatively to other activities, particularly in the rural areas,

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<sup>28</sup> See Pasinetti, 1981.

and therefore tends to attract further investment in services. The process is reinforced by labor migration to urban areas, which provides a relatively cheap source of labor for the expanding services activities. Overall, skills are thus directed away from agriculture and industry, which then tend to be stuck in a vicious circle of low productivity and rewards.

This type of business behavior is associated more with trading rather than industrial or skill-driven societies. High rates of profit are not, of course, inimical to industrialization. However, a sustained and necessarily long-winded industrialization process is incompatible with a near-sighted investment outlook, and is unlikely to emerge when a relatively small share of profits is invested, and skills and productivity remain at modest levels. In such an environment, small rates of investment and TFP growth become self-reinforcing phenomena.

The distribution of factor incomes has shown that most wage earners are at the bottom of the earnings ladder and capitalists, though obviously at the top, invest a small proportion of their profits, thus weakening a crucial link in the growth process. This is in contrast with a fundamental but implicit principle that, in a market economy, good profit performance today should lead to increasing investment and productivity tomorrow. Our analysis has shown that this has not been the case in *laissez-faire* Lebanon.

### *Households as workers*

How did workers, with wages or independent incomes that were at or less than subsistence levels, react to that situation? If wage income is deemed insufficient, i.e. if wages do not exceed social subsistence levels, then the system is bound to reach a crisis, as happened in 1987 at the height of the monetary depreciation. Crisis forces changes, at least temporary ones, in the rules of the game. However, the pressure for change may be weakened if income from work is supplemented from other sources, domestic or external, in a way that allows the system to continue to reproduce itself. The story of waged work in Lebanon has consistently been one of a system where work does not pay for most of the workers and where transfers provide important supplementary incomes.

Formally speaking, a worker is confronted with the choice of becoming a capitalist, an independent or a waged worker. Success as a capitalist or a well-paid independent professional requires, in

addition to entrepreneurial skills, high educational achievement and social and political connections that constitute high barriers to entry.

Joining the lower end of the independent profession is, of course, a far easier enterprise since it requires fewer skills and less capital, especially in an environment of strong currency and financial condition. Hence, one can witness the proliferation in Lebanon of small independent entities in the form of retail shops, taxi drivers, mechanics and numerous other small independent enterprises, including the small farms in agriculture. For instance, a 1968 survey of merchandise retailing in Lebanon emphasized their small capital requirements and their large number, their excess capacity but also their attractiveness in relation to waged employment.<sup>29</sup> The ease of entry to this type of activity and other small independent professions, and the higher rewards it usually offers in relation to wages have been determining factors behind the survival and resilience of the relatively large category of independent workers in Lebanon.

For the remaining large group of workers, representing about two thirds of total employment, waged employment is the only open choice. For the majority in this group, the choice is unappealing since job opportunities are limited, wages low, and the status often irregular. Moreover, with the absence of unemployment benefits and limited medical, retirement and other benefits, workers actively sought jobs and higher incomes overseas. Indeed, since the early 1960s, and in parallel with the consolidation of *laissez-faire*, the mounting wave of worker emigration, particularly of the skilled, presents strong proof of *laissez-faire*'s failure to produce enough employment opportunities in the midst of a growing economy with an unusually strong domestic and external financial condition.

In the 1960s and 1970s, workers have emigrated mainly to the Arab Gulf countries where employment opportunities were relatively plentiful, but also to Africa, Australia and the Americas. The emigration rate has been constantly increasing since the early 1960s. According to the 1970 PAL survey, around 80 percent of the emigrants were economically active, which means that, at the rate of increase in the active population during 1970–74, the equivalent of about 20 percent of those newly joining the labor force were in fact emigrating.

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<sup>29</sup> See Eid, 1968.

Table 5.11 *Workers' response to working conditions*

	1951–52	1964–66	1971–73	1997
<i>Work</i>				
Workers/household <sup>a</sup>		1.5		1.5
<i>Transfers indicators (% GDP)</i>				
–Assistance to households <sup>a,b</sup>		8		6
–Other supplementary income <sup>c</sup>				5
–Net transfers and short-term capital <sup>d</sup>	6	14	16	17
<i>Emigration</i>				
Individuals/year	2,850	8,566	10,000	

*Sources:* Chambre de Commerce et d' Industrie à Beyrouth, c. 1977; Churchill, 1954; République Libanaise, c. 1968, 1998b, 2003.

*Notes:* a- For Beirut in 1966 and Lebanon in 1997. Assistance is in relation to household income, which is adjusted to exclude profits accruing to enterprises and the self-employed. It includes wages imputed to independent workers and all types of supplementary incomes accruing to all households. b- "Assistance" consists of financial assistance from family and relatives, and grants. c- "Other supplementary income" mainly includes pensions and inheritance. d- Net transfers and short-term capital are from BOP data. For 1997, it is the net foreign transfers, as in the recently adjusted national accounts for 1997. BOP data since the 1980s contain very large errors and omissions, exceeding 20% of GDP (see Table 5.2 above).

Those who were not in a position to find employment or better incomes overseas sought to supplement their incomes from other sources. Table 5.11 provides indicators about the importance of these sources. Within households, more people would seek employment. The average number of workers remained stable at 1.5 per household, although this figure is underestimated by the fact of labor emigration and collective family work in agriculture. Workers can also derive additional income from more than one occupation, although little information is available in this regard.<sup>30</sup> Another source of income is financial assistance, mainly from relatives, that has averaged at least about 6 percent of GDP. This figure does not truly reflect the importance of financial assistance to many households since it mostly accrues to the lower-income groups and represents a greater proportion of their incomes. Indeed, in 1997 and for the

<sup>30</sup> The 1997 household budget survey estimated that around 5% of the workforce derived supplementary income from a secondary occupation (République Libanaise, 1998b, p. 63).

bottom 40 percent of households, supplementary income from sources other than work represented 26 percent of their total income.<sup>31</sup>

The increasing importance of workers' remittances to family and relatives at home is closely associated with the historical phenomenon of emigration. Since it has usually been difficult to separate transfers from capital movements, or between inflows and outflows except for some years in the 1960s, we use net transfers and short-term capital movements as an indicator of the evolution of transfers into the economy. The fact of using this indicator on a net basis most likely makes it underestimate transfers. In any event, transfers have remained an important element of household income, especially after the beginning of the war in 1975.<sup>32</sup>

Transfers have supported workers' lives in ways that are not easily captured by statistical evidence. Nonetheless, observation shows that within-family financial assistance is quite widespread, e.g. working children helping retired parents who have modest or no pension. Religious institutions and other NGOs, in a confessional society such as Lebanon, play a conspicuous and active role in economic life, providing low-cost or free schooling, medical and elderly care services.<sup>33</sup> All these contributions to the market economy are in addition to those provided by government in the form of free education and limited health services. Transfers from domestic and external sources have therefore provided a strong support to the *laissez-faire* system by significantly supplementing the insufficient income levels of a quarter to a half of the population.

*The foreign sector: a financial relationship*

The foreign sector is a particularly influential element in the Lebanese economy, both because of the openness of the economy and its rel-

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<sup>31</sup> République Libanaise, 1998b, p. 224.

<sup>32</sup> During 1965–73, workers' remittances and grants-in-aid accounted for about 5 percent of GDP. If these amounts accrued to the poorer half of the population who received, at best, 15 percent of GDP, then overseas transfers would have represented about a third of the poorer-half's production income or a quarter of their total income. This estimate is compatible with the contribution of transfers by 20 percent of total income, which was estimated by IRFED for the late 1950s period (IRFED, c. 1962, vol. I, p. 95).

<sup>33</sup> Thus, in 1999, various NGOs were providing the basic services to practically all the disabled, elderly and orphans in the country, and were operating 650 of the 750 existing dispensaries (Al-Assir, p. 3).

atively small size. However, its impact has been manifest more in the financial than production domain.

To the foreign sector, Lebanon possessed several domestic and regional advantages: minimal economic restrictions, free capital movement, a tolerant political regime, and a bank secrecy law that restricted access to any information relating to bank depositors except in cases of prior consent or bankruptcy. The foreign sector found in *laissez-faire* Lebanon a platform for its regional trade operations and the recycling of regional capital. The strong capital inflows and BOP positions were being reflected in increasing foreign-currency deposits with commercial banks, but also in a relatively large share of these deposits being merely re-deposited with correspondent banks in Europe and the US (see the next chapter on the structure and performance of the banking sector).

The dynamic element in Lebanon's external economic relations, therefore, was associated more with the commercial and financial aspect of exchange than with direct investment and trade in goods and services. The sum of merchandise exports and imports, which is a measure of the degree of trade openness, increased from around 50 percent of GDP in the early 1950s to more than 60 percent in the mid-1970s, and then fell back to 50 percent in the late 1990s owing mostly to recession and a deteriorating financial condition. As for net foreign direct investment, it has usually been relatively small, averaging 2 percent of GDP in 1960–69 and 6 percent of GDP in 2000–02. These investments have mostly concentrated on the upper end of residential real estate in and around Beirut. Thus, gross foreign direct investment in real estate amounted to 7 percent of GDP in 2000–02.

Short-term capital inflows, which averaged more than two thirds of total capital inflows in 1960–69, were essentially bank deposits seeking the convenience, anonymity and relative safety provided by Lebanese banks. In other words, Lebanon's BOP surplus, which was at the heart of its strong macroeconomic and financial condition, has basically depended on transfers and similar elements, such as the proceeds from tourism that are associated with the country's location and its institutional characteristics.

Lebanon's financial and economic advantages therefore essentially derived from a geographical location and an institutional structure that provided better exchange facilities than the more restrictive regimes in the region. However, these are rent rather than productivity



advantages, and the rent income that Lebanon earned in fact represented windfall gains that took the form of a strong BOP position. Unfortunately, little of these gains have been put to productive use, say in enhancing physical and human infrastructure, which would have strengthened the potential for growth. The constraints that prevented the productive use of rent income did not originate from the foreign sector per se but from the very nature of the domestic laissez-faire system that, by definition, could not produce the incentives to act purposefully for growth and development.

Why was little foreign investment undertaken in agriculture and industry? The answer is again to be found in the same reasons that prevented local capital from being invested in these activities, as discussed above.

Finally, in the current fashionable context of spreading globalization and associated opening up of trade regimes throughout the developing world, it is important to stress a particular and immediate aspect of trade liberalization, which is the consumption demonstration effect. Consumption patterns are much more quickly imported into developing countries than production patterns, since the learning of production is, naturally, a more difficult enterprise. It is, however, this learning of more technologically advanced and more productive techniques of production that is necessary for stronger growth in developing economies. The point is that the adoption of imported, and usually more expensive, patterns of consumption is not inimical per se to growth in LDCs. Rather, it is that when learning in consumption is out of step with learning in production, which is necessary to raise productivity in order to pay for the more expensive new consumption pattern, the process becomes unsustainable. Macroeconomic instability would ensue, taking the form of a combination of unemployment, fiscal deficits and balance of payments crises.

*Government: subsidizing the market*

Laissez-faire is a moral program. For the Physiocrats, its purpose was to create a social organization that would mirror the “providential harmonious and self-operating physical order of nature”.<sup>34</sup> More than an efficiency vehicle, it is for its exponents a system that

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<sup>34</sup> Viner, 1961, p. 59.

derives its fundamental appeal from the “natural system of liberty”. Self-interest is viewed as an organic part of this natural system since self-interest is the *primum movens* of human action.<sup>35</sup> The corollary of this view is, according to the Physiocrats and Adam Smith, to limit government activity to domains where private enterprise cannot or would not go, e.g. justice and defense. Importantly, advocates of laissez-faire, at least the classical ones, have always associated the rationale of the system with the existence of competitive markets.<sup>36</sup> However, laissez-faire has recently become, particularly since the demise of Keynesianism in the 1980s, more activist in its stance, seeking the expansion of the market domain across activities and commodities, with little emphasis on the need for competitive markets.

Laissez-faire therefore is a program of minimalist government intervention and, by implication, of financial austerity. In this regard, governments in Lebanon have implemented laissez-faire as true believers would. Until war and political requirements forced them to play an unwitting Keynesian role, they have consistently adhered to the fundamental principles of laissez-faire, restricting their role to basic economic activities and the maintaining of fiscal discipline. In that, as Table 5.12 shows, they were quite successful.

Lebanon emerged from WWII with a healthy financial condition. Expenditure on development during 1945–54 was mostly financed by a Development Fund that was constituted from budget surpluses accumulated during the war and early post-war years.<sup>37</sup> However, except for a brief peak during the Chehab developmental period of 1958–64, government investment has been on a declining trend in terms of GDP or as a share of total expenditure. This investment stance was not dictated by financial considerations, for there was then a virtual absence of government debt and a consistently strong financial and foreign exchange position of either the government or the economy as a whole.

The Chehab regime during 1958–64 had an explicit developmental outlook. The commissioned IRFED socio-economic report underlined the serious deficiencies in the government’s economic and social

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<sup>35</sup> In this regard, it is interesting to note that Adam Smith did not look favorably at joint stock corporations since their managers would tend to promote their self-interest rather than that of the corporation (see Simon, 1997, p. 6).

<sup>36</sup> Viner, *Ibid.*, pp. 65–67.

<sup>37</sup> UN, 1955, p. 174.

Table 5.12 *Government and the economy*  
(Annual averages; debt and assets at end period)

	1949–51	1964–66	1971–73	1987	1997
<i>Government share in (%):</i>					
GDP	6	8	8	5	12
Employment <sup>a</sup>	4	8	9	10	11
Investment	~17	17	15	13	24
<i>Fiscal indicators (% of GDP)<sup>b</sup></i>					2000–02
Expenditure	9	16	15	19	41
Overall balance	Surplus	-2	Surplus	-15	-19
Public debt <sup>c</sup>	~ 0	" 1	" 1	16	161
o/w in foreign currencies	~ 0	" 1	" 1	9	80
Net foreign assets <sup>d</sup>	10	22	48	136	39
<i>Memo</i>					2000–02
Investment (% of expenditure)	35	25	20	13	10
<i>Taxes on (% of revenue)<sup>e</sup></i>					
-Income	11	10	10	7	11
-Income and wealth	16	19	19	9	16
-International trade	29	33	35	2	31

*Sources:* For the macroeconomic indicators, Badre, 1956, the official statistical publications, and Gaspard, 1990. For employment, see Appendix II. For the fiscal indicators, see Chaib, 1985, Rép. Lib., Recueil de Statistiques Libanaises, various issues, UN, 1955, 1958, and the Banque du Liban and Ministry of Finance publications and websites, <http://www.bdl.gov.lb> and <http://www.finance.gov.lb>, respectively.

*Notes:* a- Including military employment, which was about 2% of total employment in the 1960s and 1970s and is currently around 4%. b- Data are for general government (general budget plus annexes). They include transfers to public entities in deficit. c- Public debt is at end period. It is the sum of net LL government debt plus gross government debt in foreign currencies. d- Of the monetary authorities at end period; they do not account for domestic banks' deposits in foreign currencies at the central bank, which started in 1993–94 and reached about \$5.5 billion at end 2002. e- Percentages of general budget revenues, excluding annexes.

role. In addition, it noted that spending on infrastructure had been weak until the late 1950s and wondered about the incongruity of allocating to the Ministry of Agriculture only 2.5 percent of—an already small—general budget in a country where close to half the population lived off this activity.<sup>38</sup> Like the private sector, government focused its spending on the center of the country, i.e. Beirut and parts of Mount Lebanon, where only about half the population lived. Under Chehab, spending significantly increased on education and physical infrastructure, especially in rural areas. New public insti-

<sup>38</sup> IRFED, c. 1961, vol. 1, pp. 334, 338.

tutions were established, e.g. the central bank, a civil service board, a central statistical office, and a social security scheme that began a modest implementation in the early 1970s.

Overall, Chehab's brief action consolidated the laissez-faire system and made it more productive by upgrading its human and physical infrastructure, at very little cost to the private sector or to businesses in particular. Soon afterwards, public investment and expenditure started to decline. Consequently, the overall fiscal position remained mostly in surplus until 1975, and reasonably satisfactory until the late 1980s after about fifteen years of war. It is only since the early 1990s, with the beginning of reconstruction, that it began to deteriorate seriously.

The macroeconomic data relative to government can be misleading. Although the shares in GDP and employment have increased over time, a good part of public sector employment is a reflection of the government's role as dispenser of political favors to its constituent political elite. Many public sector employees lack the appropriate qualifications and/or undertake a limited amount of work, and accountability is often inexistent. It has been a common practice among Lebanese politicians to lobby for government jobs as favors to their supporters, who otherwise would be unemployed or have to contend with jobs that are less attractive or less well paid.<sup>39</sup> Whether in terms of financial or labor resources, Lebanese governments have rarely crowded the private sector. Rather, they have upgraded infrastructure and absorbed part of the rising unemployment. However, during the war years in 1975–90, the government has indirectly assumed, out of political necessity, an important Keynesian role of limiting recession by ensuring the regular payment of wages and, thus, a measure of social stability.

We have earlier underlined the conservative nature of laissez-faire, a characteristic that has emerged from the absence of structural change in the Lebanese economy over a period of half a century. Corresponding to this economic conservative nature is a practice whereby laissez-faire policy is an instrument that helps preserve the status quo, i.e. the existing balance of power. Two historical events illustrate this point well.<sup>40</sup>

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<sup>39</sup> See Johnson, 1986 and Kisirwani, 1974.

<sup>40</sup> See Yaffi, 1958 and Owen, 1976, respectively.

During the Korean war boom between the summer of 1950 and the summer of 1953, many Lebanese businessmen accumulated inventories through imports. Their reasons were precautionary and speculative, as international and domestic prices continued to increase. In 1951–52, the Lebanese Pound exchange rate fluctuated within the range LL/\$ 3.45 to 3.87. However, following the signature of the armistice in the summer of 1953, the Pound significantly appreciated while business stocks accumulated. As the Lebanese Pound continued to appreciate, heading below LL 3.20 to the dollar, a public outcry arose from the business community, warning of impending bankruptcies that would result from falling prices. The monetary authorities quickly intervened in the foreign exchange market, keeping the LL/\$ exchange rate above the LL 3.20 level for more than two years until early 1957.

The second event occurred in the summer of 1971, when the Finance Minister sought to raise import duties, mainly on luxury items, to finance economic and social development projects. The Industrialists' Association, which had been for years pressing the authorities for some trade controls against strong foreign competition, welcomed the proposed measures. However, the Association of Beirut Merchants strongly opposed them and held an unprecedented general strike that quickly led to the cancellation of the proposed new duties.

Throughout their modern history, Lebanese governments consistently ensured the unhindered operation of markets. They were, however, equally if not more diligent in intervening when the operation of the free market threatened the interests of the dominant interest groups. As such, government in Lebanon has been a genuine conservative force, in the true sense of the word.

#### *A summing-up*

Soon after independence and the end of WWII, Lebanon chose laissez-faire as its system of economic organization. The initial financial condition was strong and, in a singular manner, continued to be strong for about four decades. Few developing countries could hope for better favorable circumstances in their course of economic development.

Financial performance has been a success, with low indebtedness and almost continuous BOP surpluses until the early 1990s. This, however, did not carry onto economic performance, which has been average in terms of GDP growth, at best modest in TFP growth, and poor in income distribution and the creation of employment opportunities.

Laissez-faire has not succeeded in reducing the inequalities of income and wealth, or in enhancing labor skills through education. General labor productivity and wages remained low. Businesses compensated for low productivity by increasing the mechanization of their operations, supported by a strong currency. A high degree of market imperfection and accommodating export markets in the Arab region boosted profitability. Nonetheless, businesses invested little in relation to realized profits or to the potential afforded by the regional market.

Workers in the labor market were confronted with low wages, low in relation to subsistence or minimum standards of living. To use standard market analysis tools, these low wages were the result of a supply curve shifting to the right owing to rural-urban migration and weak labor unions, and of a demand curve shifting downward owing to low investment and productivity. In response to their low wage levels, workers sought emigration or independent work when possible, and financial assistance from various sources to supplement their low wage incomes.

The outcome has been an economic growth that is supported by increases more in capital inputs than productivity. The share of merchandise production continuously fell. Abstracting from the rural-urban migration, there has been little structural change in the economy for almost half a century. No single activity has become a leading dynamic activity. The distribution of factor shares changed little as wages remained close to subsistence levels, but emigration, independent work and transfers provided a leeway. Capitalism did not expand in such a self-sustaining economic environment.

The discrepancy between the performance of the financial and real sectors of the economy in fact highlights the limitations of laissez-faire as a program for economic development. Laissez-faire does indeed attract financial capital, especially when it is surrounded by more restrictive environments. However, nothing guarantees the transformation of financial capital into sustained productive investments

across the activities and regions in the economy. The success of the market-friendly policies in the East Asian economies has been well directed by the very visible arm of the authorities. Failing appropriate policies, a financial success can turn into just an intermediation success, with a limited impact on agriculture and industry and benefits accruing only to the few. There simply is no automatic linkage between financial opportunity and economic success.

The fundamental problem of the Lebanese economy is not the fact that its wealth has largely been based on resources with rent characteristics. For our purposes, this is immaterial. What matters is the performance achieved from using whatever resources are available, which makes the issue one of economic efficiency at the macro level of the whole economy. The problem does not lie in the source of the wealth produced, but in the fact that so little of it has been used to promote the development of skills and industry to lay the basis for a productive economy. The Lebanese case thus shows that there is no inherent tendency in a *laissez-faire* market economy to produce this desirable outcome.

## CHAPTER SIX

### FROM CRISIS TO RECONSTRUCTION

... But then, why the anguish? It is from seeing  
that the world does not change

Pablo Neruda

This chapter examines the performance of *laissez-faire* under adverse operating conditions, which culminated in 1987 with the unprecedented collapse of the Lebanese Pound after almost four decades of stability.

The structure and performance of the financial sector in a *laissez-faire* economy are examined. This is followed by an analysis of the behavior of financial agents in an open environment experiencing a monetary crisis. The second part of the chapter takes up the post-war period 1991–2002 and assesses the reconstruction program as a tool for growth resumption and economic development.

#### *Coping with war, 1975–1990*

This section presents an overview of the political and economic developments during the warring period of 1975–90. The period was marked by numerous and dramatic developments, including the participation of several foreign armies and armed groups in the fighting, the assassination of two newly elected presidents, one prime minister and several other major political figures. The most compelling outcome of these developments, however, has been the tens of thousands of civilian victims and the destruction of property on an extensive scale. The analysis will focus on the economic performance of *laissez-faire* against this unsettled background.

#### *Political milestones*

War erupted in Lebanon in April 1975. Largely haphazard and concentrated in Beirut, it gradually became more widespread and lethal



until the election, late spring 1976, of a new President. The six-year term of President Elias Sarkis was characterized by scattered and intermittent, but relatively short, periods of fighting that ended with a destructive and deadly Israeli invasion in the summer of 1982.

Briefly, for about a year in 1983, there was a surge of political and economic hope following a timely presidential election and promises of withdrawals of all foreign troops from Lebanon. Political pessimism, however, soon descended as fighting resumed, quickly followed by a new political *modus vivendi*. The next few years also were politically unstable but relatively quiet, meaning that armed conflicts were localized and short-lived, with economic activity often approaching normality. In fact, output gradually picked up and GDP growth during 1984–87 was positive, estimated at approximately 4 percent per annum.

While the political environment remained unstable and marked by scattered periods of intensive fighting, the fighting was largely confined to the lower half of the country, in Beirut and the South. Most enterprises, particularly in industry, which were mainly located in and around the capital, gradually moved to safer surroundings. Moreover, as most rural areas were spared the ravages of war, agriculture was less affected in terms of production than in the marketing and exports of its products.

In the summer of 1988, a new political crisis erupted with the approaching deadline of the presidential election. This was followed, over almost two years, by periods of intensive fighting within the so-called one Christian political camp, as well as among political camps, leading to serious disruptions in economic activity, major destruction of property and a growing wave of emigration. In 1989, a new constitutional arrangement, known as the Taif agreement (named after the city in Saudi Arabia where the agreement was brokered), was agreed upon by most political parties and, above all, by the relevant regional and international powers. The assassination of the new President, Mr. René Moawad, soon after his election, was quickly followed by the election of a new President, Mr. Elias Hrawi. The agreement failed, however, to win the approval of the then acting Prime Minister, General Michel Aoun. Intermittent but intensive fighting then resumed, followed by a prolonged period during which two “legal” governments were operating in practice. The unusual situation ended in October 1990, with the forcing out of General Aoun by the Syrian Army and the subsequent assertion of one official authority over the whole country.

Over the war period, government power had weakened and the tax base eroded in favor of numerous illegal ports that were scattered along the coastline of the country. Nonetheless, government succeeded in preserving a minimally functioning central authority and public administration. Although revenue from customs duties, its major source of income, dried up, wages in the public sector were regularly paid and subsidies of wheat and fuel maintained.<sup>1</sup> Citizens, however, were indirectly paying illegal taxes that were being levied on commercial transactions by the various militias. Overall, private enterprise could often operate normally except, of course, for the additional but major constraint of sporadic and sometimes intense and widespread fighting.

*The efficiency of laissez-faire*

There is little doubt that, during fifteen years of stop-go political crises and armed conflict, the economy performed reasonably well, displaying flexibility and a notable capacity of adjustment to uncertainty and difficult operating conditions. In attributing credit for such resilience, one can legitimately hesitate between the capacity of people at large to cope with adversity and the superiority of laissez-faire as a system of economic organization. In any event, given the circumstances, the laissez-faire system did largely contribute to maintaining economic activity and exchange with minimal disruption, and to the regular supply of commodities and the virtual absence of shortages. In particular, it was instrumental in the quick resumption of activity whenever fighting stopped.<sup>2</sup>

During the war period 1975–90, there were three instances when output sharply fell. The first was in 1976 when, as fighting spread for months to many parts in the country, output is estimated to have fallen to about one third of its level in 1974. The commercial center of Beirut, which concentrated the impulses of national economic

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<sup>1</sup> Thereafter, public sector and government will be used interchangeably, meaning “general government”, whose operations are reflected in the budgets of central government, including transfer “treasury operations”, and the annex budgets. The deficits of municipalities and public sector enterprises, such as Electricité du Liban, are financed through these budgets.

<sup>2</sup> It should be noted that warring factions had a vested political and financial interest in having the areas under their control regularly and sufficiently supplied with the necessities of life.

activity, was extensively looted and destroyed. A quick rebound followed in 1977 and, until 1981, output fluctuated around two thirds of its pre-war level.

The second sharp fall in output came with the June 1982 Israeli invasion that, in a trail of victims and destruction, reached the capital Beirut. Output may then have fallen by at least 30 percent, and probably much more, followed by another fall of about 15 percent in 1983. As in the past, economic activity quickly recovered, stimulated by an export upsurge following the significant depreciation of the exchange rate.<sup>3</sup> The third and last phase of intensive fighting and destruction took place in 1988–90, a period over which output is estimated to have fallen, on average, to half of its level in 1987.

Table 6.1 below brings together the main economic indicators for the period 1972–2002.

Table 6.1 *Economic indicators, 1972–2002<sup>a</sup>*  
(Annual averages; debt at end period)

	1972–74	1979–81	1985–87	1994–96	2000–02
Population (millions)	2.6	2.6	2.7	3.6	4.2
GDP (current \$ millions)	2,767	3,992	3,615	11,671	17,738
GDP Index <sup>b</sup>	100	66	103	84	96
Growth (%) <sup>b</sup>	6.9	5.5	4.0	6.2	1.2
CPI (% increase)	7.3	22.3	191	9.2	0.5
LL/\$	2.7	3.7	93	1,624	1,508
<i>In % of GDP</i>					
Merchandise net exports	19	15	15	5	5
Merchandise trade balance <sup>c</sup>	-24	-42	-35	-49	-30
Balance of payments	13	14	1	7	0
Fiscal overall balance	1	-16	-23	-18	-19
Public debt <sup>d</sup>	<0	34	16	77	161

Sources: Appendices I and III; Banque du Liban, Annual Report and Quarterly Bulletin, various issues; IMF, 1995; Ministry of Finance, Budget Statements.

Notes: a- Except for some financial indicators and estimates of macroeconomic aggregates, relatively few data are available for the periods 1975–76 and 1982–84. b- Index and annual growth of GDP at constant 1972–74 prices [100 = LL 7,186 million; base (1972–74) = 100]. c- The 1979–81 balance is for 1979–80. d- Public debt is of general government and is at end period. It is the sum of net LL government debt plus gross government debt in foreign currencies, including guaranteed debt.

<sup>3</sup> See Gaspard, 1990.

During 1975–90, industry, more than any other activity, displayed a flexibility and viability that is not uncommon in its long history. A survey of Lebanese industry in 1980 noted that 20 percent of industrial establishments had been founded since 1975, with more than 40 percent of these new establishments in the non-traditional branches of chemistry, metal and mechanical products and electricity.<sup>4</sup> By 1985, mechanization had significantly increased to compensate for an irregular labor supply and a fall in labor productivity. Relative to 1971–73, mechanization increased by 50 percent (see Table 4.4 in Chapter 4). As in the past, export markets, particularly the Arab markets, remained an important outlet for industry.

Merchandise exports, mostly composed of manufactures, sustained an average ratio of 18 percent relative to GDP, compared to 19 percent in 1972–74. However, in an attempt to maintain standards of living, imports were increasing at faster rates than exports, financed by significant transfers that kept the balance of payments in surplus during most of the period.

Employment stagnated. Between 1974 and 1987, rough estimates indicate that employment outside the public sector increased by about 11 percent, or about an annual average of 0.8 percent, a good part of the increase taking the form of occasional or irregular employment (see Appendix II). In parallel, labor emigration increased, with a heavy concentration in professional and skilled workers.<sup>5</sup> The outflow of skills was accompanied by an inflow of low-paid unskilled labor, with many factories employing low-paid foreign, mostly Arab and other Asian, workers.

Wages also fell, measured at constant prices or in terms of urban subsistence (see Table 5.8 in Chapter 5). The fall may be explained by the lower level of skills and productivity, and by the attempt by business owners to maintain profit volumes as output fell. Workers responded to the decline in their standard of living by a combination of more work, more working members in the household, and emigration. In this regard, the female participation rate increased from 20 percent in 1975 to about 27 percent in 1987, in part due to a secular trend but also in response to falling household incomes.<sup>6</sup>

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<sup>4</sup> See Gleizer, 1982.

<sup>5</sup> For details, see Serageldin, et al., 1983, p. 77.

<sup>6</sup> See UN, 1988b, p. 288.

Not unexpectedly, business investment declined during the war years. However, profit margins were raised in the face of uncertainty and to maintain enterprise owners' income levels in the face of falling output and demand.

The fiscal situation clearly deteriorated as government lost control over its revenues. However, we must note how unwittingly Keynesian Lebanese governments have been, during the 1975–90 period, through their deficit spending in the face of rapidly disappearing tax revenues. By ensuring the regular payment of wages and salaries, while continuing to provide basic infrastructure and administrative services, they have contributed, not insignificantly, to social and economic stability.

Developments on the exchange rate scene were more dramatic. From 1948 until 1993, uniquely among countries, the Lebanese Pound (LL) had consistently followed a floating-exchange rate regime. However, after almost four decades of stability, the exchange rate depreciated by an annual average of 80 percent over the two-year period 1986–87 (see section 6.3 below on this). After the end of the war and starting towards the end of 1992, the new government headed by Mr. Rafik Hariri introduced an exchange rate peg policy, the first in Lebanon's modern history. The peg policy was implemented following a sharp depreciation (65 percent) of the Pound during the first nine months of 1992. It was first an appreciating peg policy, as the nominal exchange rate of the Pound appreciated by an annual average of 3.4 percent from end 1992 to end 1998. The nominal exchange rate has since, and to date in November 2003, remained constant at LL 1,508/\$.

*Banks: the jewel in the crown*

We have seldom referred in our investigation to the financial or monetary aspects of *laissez-faire*. This lacuna is now addressed by analyzing the structure, performance and behavior of the banking sector.

The birth of *laissez-faire* can be traced to 1948, when free foreign exchange transactions and capital movement were officially sanctioned. The birth coincided with that of the Lebanese Pound, following the separation in the same year of the currency systems of Syria and Lebanon. Although the process became complete only in 1952, the

foreign exchange market and capital transfers already were largely free since 1945.<sup>7</sup> Capital markets, such as the stock market, and a few specialized banking institutions have played a limited role in the economy. Financial activity has always been identified with commercial banking activity, on which the analysis will focus.

*Banking structure and evolution, 1950–2002*

Practically all economic commentators have placed Lebanon's comparative advantage in services, and banking in particular. Beirut continues to be seen as a prominent regional financial center that has survived war and instability, maintaining banking secrecy and a substantial deposit base.<sup>8</sup>

The central bank, Banque du Liban (BDL), was established in 1964. As noted earlier, this belated establishment was due to a 1924 Convention, renewed in 1937, between Lebanon and the French mandatory authority whereby a French private bank, the Banque de Syrie et du Liban, would be the government's fiscal agent and retain the exclusive concession of note issue until 1964.<sup>9</sup> Until then, banks were subject to ordinary commercial law rather than to specific monetary regulations. Nonetheless, the authorities had already realized the importance of banks in attracting foreign capital since a Bank Secrecy Law was passed in 1956. The law was instrumental in contributing to a rapid growth in banks and bank deposits, especially since it was passed at the beginning of a long period of political instability and increasing economic controls in several neighboring Arab countries, including Syria, Jordan, Iraq and Egypt.

Banking growth was strong, as illustrated in Table 6.2 below. The number of commercial banks increased from 7 in 1945 to a high of 86 in 1966, just before a series of bank failures reduced the number to 74 by the end of 1974. At end 2002, the number of operating commercial banks fell to 53, following a series of mergers. Although the number of banks has been quite large relatively to the size of the economy, the banking sector has been characterized by a high degree

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<sup>7</sup> See Saba, E., 1961.

<sup>8</sup> Foreign-currency deposits in commercial banks were approximately \$30 billion at end 2002, representing 162 percent of GDP and \$7,000 per capita. About 80% of these deposits are in resident accounts.

<sup>9</sup> See for details Yaffi, 1958 and Salem, 1964.

of concentration. Currently, in mid-2003, the five largest banks control about half the volume of total deposits.

In the fall of 1966, Intra, the largest Lebanese bank, failed, also provoking the failure of a few other banks. A recession followed in 1967, which was further compounded by the sequels of the Arab-Israeli war in that year. The authorities, however, were quick at circumventing the impact of the bank failures. The economy then quickly rebounded in 1968, largely compensating for lost output in the previous year.

Foreign banks have dominated the banking market until the early 1980s, more so in terms of deposits than claims. In fact, by 1974, only the bottom three of the largest ten banks, in terms of deposits, were Lebanese-controlled.<sup>10</sup> The picture, however, needs to be qualified since, in the early 1970s, about 40 percent of the foreign banks were of mixed ownership, with Lebanese management control in many instances. It was not until the mid-1980s that foreign banks started to close or drastically reduce their operations, and that banks with a majority Lebanese ownership or control became dominant. At end 2002, only 11 out of 53 operating banks were foreign, with a corresponding minority share in deposits and claims.

One should not deduce from these observations that, at any point in time, foreign capital has actively dominated financial or economic activity in Lebanon. Foreign banks have in fact played a passive role that mainly focused, in addition to the management of correspondent relationships, on the collection and recycling of deposits. Few of the foreign banks have had branches outside Beirut and they regarded themselves as specialized wholesale bankers catering to the local banks rather than local borrowers. Their claims on the private sector have usually concentrated on a few relatively large and prime businesses. These prime businesses, few in number, also dealt with several other banks and were thus able to command a negotiating advantage.

The structure and evolution of the assets of foreign commercial banks indicate that their assets mostly were in the form of deposits with correspondents overseas, who usually are mother or sister branches. It should be noted, however, that this characteristic of a collector and recycler of deposits is a dominant characteristic of commercial banking activity in Lebanon rather than of foreign banks alone.

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<sup>10</sup> See ABL, 1974.

Table 6.2 *Banking and monetary indicators*  
(In % of GDP; annual averages of stocks, unless otherwise indicated)

	1950-52	1964-66	1972-74	1986-88	1994-96	2000-02
<i>Banking system</i>						
Net foreign assets	11	40	86	186	87	52
Claims on private sector <sup>a</sup>	24	65	65	38	56	87
Claims on the public sector—net	<0	-6	-10	11	32	97
Money <sup>b</sup>	35	88	111	105	128	198
Value added—financial services	4.6	3.5	3.8	8.7	5.0	
<i>Commercial banks</i>						
Net foreign assets <sup>c</sup>	~1	18	29	62	16	8
Foreign assets		46	51	87	35	49
Foreign liabilities		29	22	24	19	41
Claims on the private sector	24	62	64	38	55	84
Claims on the public sector—net	<0	0	-3	10	46	89
Deposits—private sector	20	72	94	100	121	192
% of deposits in foreign currencies	~12		27	82	60	70
Number of banks (end period)	~20	86	74	79	74	53
Concentration ratios (% deposits) <sup>d</sup>						
First 5 banks				29	44	48
First 10				42	66	70
First 20			75	71	87	89
Claims on (% of claims on private sector)						
Industry		13	17	9	12	13
Agriculture		6	3	1	2	1

Sources: Banque du Liban, Annual Report and Quarterly Bulletin, various issues; Bilanbanques 2000; Ecochiffres, 1989; IFC, 1974; IMF, IFS Yearbook, various issues; République Libanaise, 2003, and Recueil de Statistiques Libanaises, Année 1963; UN, 1958, 1955.

Notes: a- Resident private sector, for claims and deposits. b- Money is total LL and foreign-currency deposits of the resident private sector, plus LL currency in circulation outside banks. Pre-1964 data are estimates, based on total LL deposits, thus excluding resident foreign currency deposits but including LL non-resident deposits. c- Exclude domestic banks' foreign-currency deposits with the central bank. See note (d) in Table 5.12. d- 2000-02 data are for end 2001.



*Financial versus economic intermediation*

The development and modernization of banks, and the rapid growth in foreign-currency deposits, provided a unique opportunity to a developing country that, at the same time, had several location, educational and entrepreneurial advantages in the region. Financial resources were clearly not a constraint, and banks, as financial intermediaries, should have provided the transmission link between the supply of financial resources and investment. But this did not happen.

Considering the pre-1975 period, banks' contribution to growth was average, and far short of the potential role they could have played. Activity continues to be concentrated on commerce and short-term lending, mainly in the form of overdrafts and advances, and import letters of credit. At the height of their access to bank credit in 1972–74, agriculture and industry, which then had a 40 percent share in total employment and 25 percent in GDP, received only about 11 percent of total bank claims, domestic and foreign. Clearly, at least until the mid-1970s, the issue of the crowding-out of the private sector was irrelevant since net credit to government had been negative since independence.

Thus, banks operating in Lebanon were mainly financing imports, and recycling foreign funds to the major financial centers in Europe. As Table 6.2 shows, the foreign assets of the banking system, which mostly consisted of gold and deposits with correspondent banks, grew much faster than claims on the private sector. During 1964–74, commercial bank deposits with correspondent banks abroad averaged about 43 percent of total claims. Although this type of asset management that seeks high liquidity—represented by deposits with foreign correspondent banks—may be construed as prudent banking behavior, it singularly reflects at the same time the failure of the well-endowed banking sector to play a leading role in the economy, let alone the role of an engine of growth.

In parallel, most bank credit to enterprises was financing working capital. Funds for fixed investment mainly came from profits, own funds or, more generally, from outside banking sources. As an indicator of the weak linkages between banking and investment in the private sector, bank credit during 1950–74 represented, on average, less than the third of total private investment.<sup>11</sup>

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<sup>11</sup> This is calculated as the ratio of the change in bank claims on the private

Banking remains a profitable business. It is difficult, however, to supply reliable data in this regard since profit and loss statements are notoriously unreliable for all business concerns in Lebanon, including banks. However, an indirect proof of bank profitability has been the persistently strong demand for entry to the commercial banking sector, which was met by a freezing by the central bank of new license issue.

The claim that Beirut was a financial center was somewhat exaggerated, an exaggeration that has survived to date. By 1975, banking activity was still focused on short-term lending for trade and on the recycling of deposits. Financial instruments were elementary, and the interbank and money markets small. Yet, financial capital was relatively abundant, as illustrated by the volume of deposits or the net foreign asset position of the banking system in relation to GDP, or by the level of interest rates.

Indeed, prior to 1975, interest rates on LL deposits have generally been significantly lower than Eurodollar rates.<sup>12</sup> In addition, as Table 6.3 indicates, real interest rates on LL loans and deposits were on a declining trend until 1974. Bank credit could furthermore be utilized in any currency of choice by the borrower, a practice that holds to date, which is a reflection of a free exchange market and of a relatively easy capital situation.

Through its banking system, *laissez-faire* has therefore turned Lebanon into a net capital exporter. Instead of focusing on providing the crucial link between financial savings and domestic investment, banks continue to play the principal role of directing capital overseas. The following provides an illustration of this role. In 1972 and 1973, the Government of Algeria, the State Bank of India, and the World Bank placed various LL bond issues in the Beirut market. In other words, major governments and international institutions were borrowing medium and long-term money from a market that would not provide more than simple short-term financing for commerce to its domestic enterprises. These bond placements, which were then taken as proof of Beirut's emergence as an international money and capital market, were in fact stark illustrations of *laissez-faire's* failure in a domain where it was supposed to display its greatest strength.

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sector to private investment. It should be noted that bank claims include accumulated interest, which implies that bank contribution to investment is still lower than a third.

<sup>12</sup> IFC, 1974, p. 47.

Table 6.3 *Interest rates*  
(Annual averages, in % unless otherwise indicated)

	1950-52	1964-66	1972-74	1986-88	1994-96	2000-02
<i>Commercial banks</i>						
Interest on LL deposits <sup>a</sup>	3.0	3.0	4.3	17.2	14.3	10.4
Spread on LL advances <sup>b</sup>	+3.5	+3.0	+4.0	+17.2	+10.2	+6.9
Spread on \$ advances <sup>b</sup>				+7.0	+6.9	+5.6
3-month LL-TB yield	N.A.	N.A.	N.A.	27.1	16.4	11.1
13-week US TB yield			6.3	6.2	4.9	3.6
<i>Dollarization-commercial banks</i>						
\$ claims (%—on private sector) <sup>c</sup>			10	84	87	85
\$ deposits (%—nonbank deposits)	~12		27	82	60	70
<i>Memo</i>						
Inflation (CPI % increase)	-0.4	2.7	7.3	221.0	9.2	0.5
LL/\$ exchange rate						
-average	3.6	3.1	2.7	224	1,624	1,508
-end period	3.6	3.2	2.3	530	1,552	1,508

*Sources:* Banque du Liban, Quarterly Bulletin, various issues; IFC, 1974; IMF, IFS Yearbook, various issues; République Libanaise, c. 1973; UN, 1955.

*Notes:* a- Average nominal rates; rates for the 1950s and 1960s are estimates. Applied deposit rates in fact are lower, mainly because the value dates for new deposits are usually several days later than when funds are actually received. b- Bank spread is the difference between the average lending and deposit rates. Bank spreads are actually higher than indicated because of the effectively lower deposit rates (see note (a) above) and because of standard fees and commissions that are added to interest on outstanding borrowed funds. c- \$ claims are hard-currency claims, mostly in \$. The 1972-74 and 1986-88 data are respectively for 1973-74 and 1988.

### *Laissez-faire in crisis*

If anything, Lebanon's *laissez-faire* system has succeeded in producing exchange rate stability for almost forty years since the end of WWII, including 10 years of civil strife and fighting. Subsequently, however, the Lebanese Pound started to depreciate rapidly, culminating towards the end of 1987 with a dramatic loss of about 90 percent of its value over a one-year period.

In a totally open and small economy such as Lebanon's, inflation and dollarization quickly followed, the latter still embedded in the economy today. The episode was instructive, in that it witnessed the workings of speculative behavior in a free foreign exchange market with an effective bank secrecy law. This section focuses on banking

behavior during that episode. It is an attempt at telling the story of a crisis, the forces that drove it, the form it took and the lasting effects it produced.

### *The setting*

Following the Israeli invasion in 1982 and attempts at a final political settlement, hopes built up in the country that the war had finally ended. Expectations soon turned sour as fighting resumed, but a new political modus vivendi was soon established and fighting quickly subsided. Although political uncertainty returned, economic activity strongly picked up in 1984 and growth continued afterwards until 1987.

The resumption in growth since 1984 reflected, in part, improved political and security conditions, as goods and people started moving more freely than previously among various regions of the country. However, the fiscal situation started to deteriorate, exacerbated by the sharp fall in revenues while the government continued to pay its wage bill and maintain minimal public services. Various militias had started to collect in the regions under their control various taxes and customs revenues, the latter being the major source of government revenue, accounting for 35 percent of total revenues in 1971–73.

Although public debt continued to rise, it would not reach critical levels until the mid-1990s. By end 1986, it was only 67 percent of GDP and sharply fell in the next two years, partly because of the depreciation of the Pound. More important, the foreign-currency part of public debt remained small, not exceeding \$332 million and 10 percent of GDP until the end of 1993 (see Table 6.4 below). The LL-part of the debt has mostly consisted of Treasury Bills (TBs) with maturities ranging from 3 months to two years.

On the external front, the system received its first shock in 1983 and then in 1984, with a cumulative balance of payments deficit of around \$2 billion. Until then, the balance of payments had been for the past forty years practically in continuous surplus, except for a negligible deficit in 1967 and another one in 1976.<sup>13</sup> Afterwards, the

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<sup>13</sup> The deficits were \$20 million in 1967 and \$238 million in 1976, a year of intense fighting across the country.

situation improved as the system adjusted to the new environment. The trade deficit, which was at \$3 billion in 1983, continuously fell to \$0.7 billion in 1987. The overall external balance continued to rely essentially on workers' remittances and other substantial transfers, a good part of which coming in relation with the financing of the various militias fighting the war. At the same time, the net foreign assets of the monetary authorities, consisting of gold and foreign exchange, remained at relatively high levels, exceeding 100 percent of GDP until the end of 1991.

Therefore, the economic system had largely adjusted to the political shock of 1983 and 1984 before the onset of the crisis. In particular, growth had resumed since 1984, together with a sharp fall in the trade deficit and real wages.<sup>14</sup> Suddenly, real sector and financial developments appeared to lose all bearing on exchange rate developments.

*Going all the way: anatomy of a currency crisis*

Sometime in 1984, perhaps driven by the belief that no political settlement was in sight and that the political and economic situation could henceforth only deteriorate, banks started buying foreign exchange, mostly US dollars. The steady stream of LL liquidity, which was necessary for the purchase of dollars, was fed through the fiscal deficits. The risk of currency mismatch between assets and liabilities that this entailed for banks was deemed small since the expectations were strong that the Pound would continue to depreciate. It was a situation of self-fulfilling expectations since the process of buying dollars was simultaneously driving down the exchange rate and reinforcing the expectations of a further depreciation.

After maintaining a remarkable stability during 1948–80, with an average exchange rate of LL 3.1 to the dollar, the Pound first fell to an average of LL 5.0 in 1981–84. Then, in 1984, the depreciation started to accelerate. The exchange rate dropped to LL 18.1 at end 1985, then to LL 87 at end 1986. The year 1987 was the worst in terms of depreciation and speculative activity, with almost everybody

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<sup>14</sup> Relatively to their level in 1974, minimum wages at constant prices fell by 10 percent in 1984, 35 percent in 1985, and by more than 40 percent in 1986.

Table 6.4 *Crisis financial indicators*

(In % of GDP, unless otherwise indicated. Annual averages for flows, and end-period for stocks)

	1972-74	1979-81	1984	1985	1986	1987	1988
LL/\$ exchange rate -average	2.7	3.7	6.5	16.4	38.4	224.7	409.2
-end period	2.3	4.6	8.9	18.1	87.0	455.0	530.0
Fiscal balance	1	-8	-23	-33	-21	-15	-19
Public debt	<0	34	55	67	26	16	25
o/w in foreign currencies (%)		17%	6%	7%	23%	58%	32%
Balance of payments	13	14	-29	9	-8	1	17
Money <sup>a</sup>	118	223	196	183	104	98	112
o/w LL-component (%)	80%	63%	72%	68%	32%	11%	25%
<i>Monetary authorities</i>							
Net foreign assets (NFA) <sup>b</sup>	78	136	67	101	108	136	128
Foreign exchange (FX) reserves	37	36	11	26	13	10	26
FX reserves (\$ billions)	1.3	1.5	0.7	1.1	0.5	0.3	0.9
<i>The cost of money</i>							
3-month LL-TB yield (% p.a.)	N.A.	8.3	15.1	17.6	22.8	33.2	25.2
Bank LL-loan rate (% p.a.)	8.3	10.5	15.6	17.3	22.2	36.5	44.5
CPI Inflation (% p.a.)	7.3	22.3	17.6	64.0	104.9	403.6	155.0
<i>Memo</i>							
GDP (current \$ millions)	2.8	4.0	6.0	4.0	3.6	3.3	3.7
GDP growth (% p.a.) <sup>c</sup>	6.9	2.7	>> 0	2.0	3.0	7.0	

*Sources:* Banque du Liban, Annual Report and Quarterly Bulletin, various issues; IMF, IFS Yearbook, various issues; République Libanaise, Recueil de Statistiques Libanaises, Année 1963; UN, 1958, 1955.

*Notes:* a- Money is total LL and foreign-currency deposits of the resident private sector, plus LL currency in circulation outside banks. Money/GDP in LL values substantially diverges as of 1986, from the same ratio calculated in \$ values owing to the strong divergence between the exchange rate average and year-end values. The ratio is based on \$ values as of 1986, when the economy became mostly dollarized. b- Net foreign assets essentially consist of foreign exchange reserves and gold, valued at market prices. Foreign liabilities are relatively insignificant. c- 1979-81 average growth is for 1980-81. Output more than doubled in 1984, picking up from very low activity rates in 1982 and 1983, particularly during the Israeli invasion of 1982. Growth rates for 1985 and 1986 are estimates. See Appendix III.

joining in the daily routine of closely monitoring the fluctuations in the exchange rate. It ended with an exchange rate of LL 455 to the dollar, after briefly reaching a bottom level of LL 655 a few weeks earlier. Having already lost 79 percent of its exchange value in 1986, the Pound then lost an additional 80 percent in 1987. The following explains the mechanism of the depreciation during the period 1985-87.

Speculation against the Pound was started by banks rather than by LL-wealth holders in general, i.e. essentially bank depositors seeking

to protect the value of their wealth.<sup>15</sup> Indeed, the LL-component of money supply, mainly consisting of deposits in Pounds, was still at 68 percent by end 1985, down from 72 percent at end 1984. In other words, the process of currency substitution by depositors had not yet started although the Pound had already lost more than half its value in the course of 1985. It was only in 1986 that it started dawning on an increasing number of depositors that the Pound was irreversibly on a declining trend, and it was only then, by end 1986, that the LL-component in money supply sharply fell to one third.

The first simple route for banks in the speculative process was to use their LL reserves to buy dollars. The process would sometimes be reversed in profit-taking operations but, overall, speculation was strictly against the Pound. Banks' behavior during that speculative period was driven by the single objective of dollar accumulation, especially in an environment of a falling exchange rate and expectations of further falls. To be sustained, the process required a regular supply of both dollars and LL liquidity. LL liquidity was provided by the large public sector deficits. The dollar flow was supplied through the balance of payments, central bank use of its foreign exchange stock through intervention in the foreign exchange market, and by those who were playing the market or had to liquidate foreign-asset holdings in order to supplement their falling incomes.

Banks started to purchase dollars in large quantities, drawing down on their LL reserves that were regularly fed by the redemption of their TB holdings. Thus, whereas around 77 percent of the fiscal deficit in 1985 was financed by commercial banks through TB purchases, the ratio fell to 16 percent in 1986 and only 12 percent in 1987. By collecting their TB proceeds at successive maturity dates while renewing only a fraction of their previous subscriptions, banks had a steady increasing flow of LL liquidity. Some banks would also supplement their LL liquidity through the interbank market, which resulted in periodic surges in the interbank market rate, reaching, for instance, a maximum of 150 percent in 1987.

However, the most important source of speculation was bank credit. Banks would extend loans to preferred customers, and the proceeds

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<sup>15</sup> Currency speculation is defined as the buying and selling of currencies with the sole purpose of making a profit based on the expected movement of the exchange rate.

would be used to buy dollars, thus creating further downward pressure on the Pound. In successive episodes of profit-taking, some of the now higher valued (in LL equivalent) dollar holdings would be liquidated to repay the original loan, profits realized, sometimes shared with the bank, which would charge high interest rates anyway, and the whole process could then start afresh. The success of the speculative process required, finally, a depreciating trend in the exchange rate of the Pound, which was achieved by the cumulative and self-fulfilling momentum of the behavior described above.

It is not easy to provide direct empirical proof regarding speculative behavior. Speculation by banks, moneychangers and privileged bank borrowers was widely commented on in the local media. The following, however, provides indirect but substantive evidence. The distribution of bank credit to the private sector by economic activity had in fact started to change significantly. Until 1984, the share of credit to agriculture, industry and construction combined usually exceeded 30 percent of total credit to the private sector. The share fell from 28 percent at end 1985 to only 14 percent at end 1987. More telling was the noticeable change in the share of the category "various credits". That share, which, until 1984, had averaged about 14 percent of total bank credit to the private sector, increased to 19 percent in 1985–86 and to more than 30 percent at end 1987.<sup>16</sup> These various credits, during 1987, represented the equivalent of \$300 million. Their excess relative to the norm, or about \$150 million, could purchase in one year from \$600 to \$1,800 million, depending on a conservative assumption of a loan turnover ranging from one to 3 months.

There is other substantive, and more interesting, evidence concerning speculative activity against the Pound. This was the sudden emergence of the Euro-LL market. A Euro-LL deposit, similarly to Euro-dollars, is a LL-deposit held by a non-resident outside Lebanon. There obviously is no financial or economic reason for such deposits to exist, particularly in increasingly large amounts, since the Pound is not an international medium of exchange and was, anyway, on a depreciating trend since 1984. However, the amounts of Euro-LL deposits and loans had been increasing to several LL billions in offshore centers and European capitals where Lebanese banks had

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<sup>16</sup> See Banque du Liban, *Bulletin Trimestriel*, various issues.



branches or subsidiaries. This constituted a puzzle to many domestic and foreign observers who were closely following financial developments in Lebanon. However, its rationale was simple, as the following shows.

The Euro-LL was a phenomenon of brief duration. It coexisted with the episode of intense speculative activity, particularly in 1987, and operated in the following manner. To avoid detection by the regulatory authorities regarding their speculative operations, commercial banks in Lebanon started offering local customers on their LL deposits interest rates that were higher than the ruling market rates, with the proviso that these deposits would be booked with branches or subsidiaries outside Lebanon. The local depositor would benefit from the higher interest without any loss in convenience since he/she would, as usual, continue to have immediate access to funds from the local branch. Banks would then use the so-called Euro-LL deposits to extend Euro-LL loans to chosen customers, these funds being used to buy dollars. All the related transactions would take place in Lebanon but be booked overseas. Thus, banks would respond to official queries about dollar purchase orders that these orders were emanating from non-resident customers.

The appeal of the Euro-LL deposits to banks was in providing a mechanism for avoiding the cost of legal reserve requirements (since deposits were presumably non-resident and, at the time, not subject to these requirements) and in minimizing the risk of detection of their substantial speculative activities. The Euro-LL market was a bookkeeping exercise that was used as a medium of speculation.

How did the regulatory authorities, essentially the central bank, respond to these developments? Lebanon's central bank is a legally independent institution, and was one of the very few institutions that remained fully functioning throughout the war. By law, the Governor, who is appointed for six years, can be removed only in specific and exceptional circumstances. The central bank was clearly aware of the extent of the speculative activity and the gathering crisis. Its actions, however, were circumvented by two important limitations.

The first limitation was the Bank Secrecy Law, which prevented access to information regarding depositors and hence the possibility of gathering evidence on speculative activity. Moreover, whereas the central bank can regulate the asset, or loan, side of a commercial bank's balance sheet, the large number of operating banks, then 74, made timely regulation very difficult in overall difficult political cir-

cumstances. Nonetheless, legal reserve requirements, mostly in the form of interest-bearing TBs, were significantly increased and penalties imposed on a large number of non-complying banks. This led to an open and notorious confrontation between the central bank and the Association of Banks regarding these measures. Unfortunately, the overwhelming majority of the political class, whether in Government or Parliament, strongly supported the banks in this confrontation. The lack of political support to the central bank in its attempt to contain the crisis constituted the second, and more important, limitation that seriously curtailed the effectiveness of the bank's policies and ultimately allowed the crisis to unfold to its full limit.

In an open and *laissez-faire* economy such as Lebanon's, inflation dramatically surged. Consumer prices doubled in 1986 and increased further by more than 400 percent in 1987, the largest in the country's history. Dollarization of transactions quickly set in. Prices started being almost instantaneously adjusted to the exchange rate of the Pound, and often to the expected higher rate. The prices of a growing number of commodities also started being quoted, and paid, in foreign currencies while the wages of the large majority of salaried people were still being paid in Pounds, often at the old and lower exchange rate levels. Minimum monthly wages, which averaged more than \$200 in 1980–84, dropped to less than \$30 in 1987. As output growth was positive, a severe redistribution of income took place against the waged and salaried class. Independent workers, from the small retail shop owner to the medical doctor, also suffered a drop in incomes through a fall in demand. However, they were much less affected than waged workers owing to their price-setting countervailing power. Skilled workers actively sought emigration. Everybody became restive.

The process that started in 1984–85 continued well into 1987 and 1988. The drop in the real incomes of most people was rapid and sharp. An unprecedented general national strike, which brought together all the labor and professional unions, was massively followed in October 1987 against widespread opposition from the political class. A few days later, the depreciation trend dramatically reversed. The Pound began to appreciate, rising from a minimum of LL 650/\$ in October to LL 455/\$ at the end of the year, improving by more than 40 percent in less than two months. It was more than a simple market correction, confirming the economic and political unsustainability of the low exchange rate of the Pound. That rate was in

fact leading to a politically unmanageable and an economically unfeasible level of wages, as labor was gradually withdrawing from the labor market through emigration, strikes or featherbedding, i.e. deliberate inefficiency at work.

Although war ended in October 1990, the downward trend continued erratically until early 1992 when depreciation accelerated, taking the exchange rate to a historical low of LL 2,825 to the dollar in September of that year. Following widespread labor demonstrations, a new government was formed in October 1992, bringing for the first time to government as Prime Minister a wealthy businessman, Mr. Rafik Hariri. The stability of the exchange rate was soon announced as a primary objective of the new government. Thereafter, the Pound steadily appreciated against the dollar and then stabilized since the end 1998 at LL 1,508, which represents an annual appreciation in the nominal exchange rate of 3.4 percent during the previous six years. Nonetheless, dollarization remains strongly entrenched in the economy, and the risk of exchange rate instability that first started fifteen years ago in the mid-1980s today remains firmly embedded in the economic system.

### *Aftermath*

The speculative profits that were realized by banks and other speculators were very high. The declared net foreign assets of commercial banks reached a high of \$2.8 billion at end 1981, then declined to a minimum of \$1.5 billion at end 1984 and 1985 before rising to \$2.3 billion at end 1987.<sup>17</sup> The attempt to recoup their foreign asset losses may have been another reason that drove banks on a dollar-buying spree. Using their privileged position of money creators through credit, banks took advantage of the laissez-faire (and bank secrecy) system to build up their foreign assets, thereby precipitating and compounding, at an accelerating rate, an albeit existing financial and economic problem into an unwarranted monetary crisis out of all proportion to financial or economic reality. The crisis was unwar-

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<sup>17</sup> These figures underestimate the true foreign-asset position of banks. It is well known, even expected, that all commercial enterprises, including banks, under-report profits for tax purposes. It is also well known that most banks have hidden reserves, which can take the form of dollar positions that are booked as ordinary deposits.

ranted because it was incompatible with either output or financial developments.

At the time, mainstream economic and political opinion viewed the depreciation of the currency as the result of substantial budget deficits and a declining level of output. Local and international advice therefore focused on the need to reduce the public sector deficit. Much less useful advice was forthcoming, on the other hand, on practical ways of reducing the deficit in a country where political and security constraints clearly restricted government action in implementing fiscal adjustment policies. Moreover, officials of multilateral institutions and economic agents saw speculative activity against the Pound as a normal and rational free market activity.

In fact, output was increasing and had reached in 1987 a level that was at least as high as in 1974, the year preceding the onset of the war.<sup>18</sup> The year 1987 was an extraordinary year in that it witnessed a stabilization in the political and security environment, with people and goods moving more freely among various regions. Several economic indicators were clearly pointing to a sustained picking up in economic activity, particularly in agriculture and manufacturing. Greenhouses were proliferating across the country and a number of industrialists was complaining of labor shortages and wondering whether to expand capacity to meet growing export orders. Exports, particularly manufactures, were booming following the strong depreciation of the currency. In other words, this positive output performance since 1985 could not, of itself, explain or justify the strong depreciation in the exchange rate.

Public sector deficits are neither necessary nor sufficient for monetary depreciation. An increasing deficit may accompany an increasing level of output and be compatible with monetary stability as long as the additional monetary injection is willingly held in the asset portfolio of economic agents. On the other hand, a monetary depreciation can take place with or without a fiscal deficit, provided a given liquidity stock is transformed into an increasing flow through a higher turnover in an environment of adverse expectations about

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<sup>18</sup> Since 1980, there were no GDP estimates based on survey data. Using primary data, this writer estimated GDP for 1987 with the principal objective of determining whether output had in fact significantly fallen relative to pre-war levels, as banks and others were then claiming (see Gaspard, 1990).

the exchange rate.<sup>19</sup> The LL liquidity was itself quickly turned over several times as currency speculation became more widespread and pressing. As Hahn and Solow<sup>20</sup> note, a higher stock of money is neither a necessary nor a sufficient condition for higher money prices. In any event, the fiscal deficit strongly fell since 1986 in terms of GDP; it was also rapidly falling in dollar terms, from around \$1.4 billion in 1984 to less than \$0.5 billion in 1987.

Finally, the official holding of international reserves remained substantial. At end 1986, just before the acceleration of speculative activity, the net foreign asset position of the central bank was, at 108 percent of GDP, significantly higher than total public debt, which then stood at only 26 percent of GDP. That position also exceeded the total money supply in LL and foreign currencies combined (see Table 6.4 above). In other words, the strong official financial condition could not be reasonably construed as a reason to trigger a run from the Pound. On the other hand, the sharp fall in the foreign exchange reserves of the central bank since 1986 did precipitate the selling of Pounds and provide added justification to speculative activity. However, that came later, since the process of currency substitution had already started at least a year earlier.

There was a more serious, if less apparent, implication of the Lebanese monetary crisis. For if money is the most important claim to wealth, then speculative activity has engendered the destruction of wealth on an extensive scale. The crisis has sharply depreciated the currency, destroyed much LL-denominated wealth, introduced a lasting dollarization in the economy, and exacerbated the maldistribution of income and wealth. Since capital, as machinery and equipment, is mostly imported and fully paid for in foreign currencies, the capital-output ratio has significantly increased since 1987, and capital charges per unit of output have become to many businesses much more prohibitive than in the past. As such, the monetary crisis has led to a significant but unwarranted reduction in the potential for growth.

Until the mid-1980s, the exchange rate of the Lebanese Pound had been adequately reflecting local production and demand condi-

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<sup>19</sup> Indeed, one of Keynes's original contributions was the realization that the price of a commodity can change without transactions in the commodity actually taking place.

<sup>20</sup> Hahn and Solow, 1995, p. 149.

tions and balance-of-payment developments. In other words, output, the structure of incomes and demand, including transfers from overseas, were until then at levels compatible with the then prevailing exchange rate of the LL. This affirmation is especially valid since the private and public foreign debts were very small in relation to the net foreign asset position of either the private or public sector. However, with intensive speculative activity over a period of several months, the general perception that was holding for almost four decades since the creation of the Pound, namely that it was an acceptable medium of exchange and store of value, suddenly reversed. Equally suddenly, all LL-denominated assets and domestic labor lost much of their internal and international exchange values, and have since been unable to fully recover them.

Could the monetary authorities, in Lebanon or in other developing countries facing similar circumstances, have taken effective action to prevent the crisis from unfolding? Alternatively, was the problem one of policy or structure of the economy? Our inclination is more towards the latter. Money, as the general equivalent, is subject to a more sensitive reaction to adverse expectations than other commodities. This singular characteristic tends to amplify the effects of shocks, particularly exchange rate shocks in LDCs. When foreign exchange markets are free and small, as they are in most developing countries, adverse expectations about the exchange rate may easily become self-perpetuating and turn into widespread speculation against the local currency. This means that financial systems in developing countries potentially are more unstable than in developed countries. Putting constraints on the free operation of foreign exchange markets is rarely efficient and usually counterproductive. The solution is in the effective implementation of closer and more timely monitoring of banking operations, and in the setting of more stringent conditions of entry to the banking market, e.g. minimum capital requirements, management adequacy, etc. These issues are particularly relevant in developing countries where official and institutional stabilizers, such as bank regulations and bank management systems, usually are underdeveloped.

Laissez-faire, however, can reveal remarkable adaptive qualities in unfavorable circumstances. Thus, while growth and productivity were relatively modest in the very favorable conditions prevailing between 1946 and 1974, laissez-faire did display resilience and flexibility during the bad times of 1975–90. This was especially true in relation

to the resumption of economic activity whenever fighting stopped, and in relation to the supply of necessary finance for imports and working capital in general. Nonetheless, speculation by banks against the Pound, in an environment of adverse expectations about the exchange rate, quickly eroded the monetary stability that had lasted for about forty years and significantly reduced the incomes and wealth of the majority of people. Whereas financial strength is a major advantage of *laissez-faire* in ordinary times, a tendency for financial instability in adverse circumstances is a serious disadvantage that can undermine confidence and the potential for growth for many years.

### *Reconstruction, 1993–2002*

War ended in October 1990 with a military forcing into exile of then Acting Prime Minister Michel Aoun, who opposed the Taif Agreement and Syria's military and political control of Lebanon.<sup>21</sup> The beginning of the implementation of the Agreement started a new political era with a new system of power sharing of the three top political posts, with the President of the Republic losing prerogatives in favor of the Prime Minister and the Speaker of the House. As no fundamental aspect of the economic system had been in dispute, the system has remained unchallenged and unchanged. In fact, with the dissolution of the Soviet Union and the free market becoming the uncontested ruling principle or objective in the world, the *laissez-faire* system in Lebanon has suddenly become part of the actual mainstream. After fifteen years of war and destruction, the country was ready for reconstruction.

#### *A new beginning*

The first two years, 1991–92, were politically and economically difficult. A new political system had just been set in place, and extensive reconstruction needs became apparent in practically all domains

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<sup>21</sup> Failing a timely election of a new President in the summer of 1988, General Michel Aoun, Commander in Chief of the Army, was appointed Prime Minister. He subsequently disputed the legality of the Taif Agreement and of the newly elected president, Mr. Elias Hrawi, to whom he refused to cede power. For about two years until October 1990, when Aoun was forced out of power by the Syrian Army, there were effectively two governments operating in Lebanon.

of physical, social and legislative infrastructure. Starting from a low output level following the extensive fighting and destruction in 1989 and 1990, GDP strongly increased to \$5.5 billion in 1992. Although the LL/\$ exchange rate, the barometer of economic and political confidence in Lebanon, stabilized in 1991, it soon resumed a downward trend, sharply falling by 64 percent in the nine months ending September 1992. Angry labor demonstrations led to the resignation of the Government and the formation of a new one by Mr. Rafik Hariri, who then became the longest serving Prime Minister, from October 1992 to date (in November 2003), with only a 2-year interruption between October 1998 and September 2000.

Mr. Hariri set his government the primary task of economic reconstruction. He anchored his economic program in a stable-exchange rate policy and publicly stressed his commitment to defend that policy. This has resulted in the nominal exchange rate appreciating vis-à-vis the dollar from end 1992 to end 1998 by around 3.4 percent a year.<sup>22</sup> The government's first task was then to embark on reconstruction.

The government's reconstruction plan was detailed in an official document called "Horizon 2000, for Reconstruction and Development".<sup>23</sup> The plan was essentially a sectoral and regional expenditure program of \$14.3 billion, extending over the 10-year period 1993–2002. Overtaken by economic developments, the plan was quickly shelved into oblivion.

For the government, and most everybody else, restored peace was the occasion for the economy to regain its past glory. Rehabilitated and upgraded infrastructure was to be the catalyst for a strong recovery that would be driven, as in the past, by the private sector. Performance was then to regain its vigor, Lebanon its regional trade and financial center status, and standards of living their interrupted ascending trend. This vision was explicitly formulated in the indicative plan. The principal target was a doubling of per capita GDP relative to 1992, which would make Lebanon an upper middle-income country by 2002. In the near term, in 1995, in fact one year following the drafting of the plan, GDP was to reach its 1974 level,

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<sup>22</sup> The exchange rate has since stabilized at the rate of LL 1,508/\$, which remains effective to date.

<sup>23</sup> Republic of Lebanon, 1994.



an ambitious short-term objective considering it was still in 1992 at about 64 percent that level. The plan included other major objectives, in particular the sustainable growth of employment opportunities and a regionally balanced process of development, i.e. a greater focus of spending on regions outside Beirut and the center of the country.

These objectives implied specific behavior and performance by the private sector. Private investment was to be twice the rate of investment by the public sector, with an average total rate of investment over the period of 31 percent of GDP. Moreover, exports of goods and nonfactor services were to grow at twice the rate of GDP growth, i.e. at an average annual rate of 18 percent. As a result, average annual GDP growth over the 10-year period was expected to be 9.3 percent.

The financial targets were even more ambitious. On the fiscal front, a current surplus was to emerge as of 1995, and an overall surplus was to be achieved as of 2000. Total public sector debt was to peak in 1995 at 84 percent of GDP, and decrease thereafter to 39 percent by 2002—the debt situation at the time was in fact quite satisfactory, with total public sector debt standing at end 1992 at only \$2.4 billion, or 41 percent of GDP. Consumer price inflation was to fall quickly from 15 percent in 1993 to stabilize at 4 percent as of 1996. The real domestic interest rate was to remain at 3 percent throughout the period.

Those were the numbers, as projected in the plan's simulation exercise. At a deeper level, the plan reflected a specific view of the structure of the economy and its potential. It was as if those who drafted the plan saw the 15-year war as an interruption of an otherwise strong process of growth and development that was driven by Lebanon's private sector and Beirut's presumed advantage of a financial and commercial center. To make that process good again, it was therefore sufficient to rehabilitate and upgrade the infrastructure in order to clear the way for the private sector to regain its vigor and drive. Once this is done, Lebanon would reestablish its regional advantage in trade and finance, and autonomous growth would resume as in the past.

Unfortunately, the plan was more of a wish list than a reasoned economic program. It was given consistency by a simulation exercise and substance by a list of expenditures on a large scale. It included no assessment of the feasibility of the objectives in light of

the existing resources and structure of the economy, or of the economy's capacity to generate the anticipated growth in output and exports. Nor was there any institutional evaluation of the ability of the public sector, largely overstuffed and inefficient, to bring the fiscal balance into surplus, that early in exercise. With no program for significant economic or fiscal reform, growth soon petered out while spending continued unrestrained. Fiscal deficits began mounting, going hand in hand with an increasing public debt, taking it in the process to unprecedented high levels.

*From reconstruction to debt management*

The government's economic strategy effectively rested on two policies: ensuring a stable exchange rate and an ambitious expenditure program. Both policies have indeed been implemented, but the outcome has been quite different from what was projected. If anything, the period since 1992 has been distinguished by two outstanding trends: a sharply rising public debt and falling growth rates.

In a small and open economy such as Lebanon's, economic developments largely depended on growth and the financial condition being compatible with the policy of a stable exchange rate. In particular, fiscal policy had to minimize waste and apply the golden rule of allocating most of the proceeds from government borrowing to capital expenditure, mainly in the domain of physical and human infrastructure. Monetary policy had to ensure that the high interest rates would at least fall in line with improved stabilization. Structural reforms were needed to streamline public administration and containing waste (the widely used euphemism for corruption) and political patronage. Finally, growth had to be significant enough to support the rise in consumption and the debt reimbursement requirements. These basic rules are essential for creating a financially stable environment that would promote private investment, productivity, and reduce the burden of the public sector debt.

Table 6.5 below gives a summary of the major economic developments during the reconstruction phase.

Reconstruction's principal failure was on the growth front. During 1993–2002, the average annual growth in GDP was only 3.7 percent, less than the pre-war average of 6.2 percent. Growth per capita during the period was a mere 0.7 percent. Worse, the economy quickly became breathless, with the growth rate consistently decelerating

Table 6.5 *Reconstruction phase—macroeconomic indicators*  
(In % of GDP and annual averages for 1972–74, unless otherwise indicated)

	1972–74	1992	1994	1996	1998	2000	2002
<b>GDP</b>							
Current \$millions	2,767	5,843	9,601	13,694	17,036	17,345	18,264
Index (100 = LL 7,186 millions) <sup>a</sup>	100	66	79	88	93	95	98
Growth p.a. (%) <sup>a</sup>	6.9	4.5	8.0	4.0	3.0	0.0	2.0
<b>Balance of payments</b>							
Current account balance	13	1	12	6	-3	-2	9
Trade balance	-4	-48	-43	-33	-36	-29	-29
	-24	-55	-50	-45	-35	-29	-27
<b>Fiscal overall balance</b>							
Revenues	1	-11	-16	-20	-18	-23	-16
o/w income and wealth taxes	16	12	17	17	18	19	23
	3	1	3	3	3	3	4
Expenditures	16	23	34	37	36	42	39
o/w -interest	-	5	9	12	13	16	17
-investment	3	2	9	9	8	5	2
<b>Public debt<sup>b</sup></b>							
o/w in foreign currencies	< 0	41	51	77	101	134	161
	-	4	8	14	24	40	80
<b>Interest rate on TBs (%)<sup>c</sup></b>							
	N.A.	25.5	21.1	19.3	17.0	14.5	14.0
<b>Net foreign assets<sup>d</sup></b>							
	103	115	100	77	57	53	56
<b>CPI (% increase)</b>							
	7.3	99.8	8.0	8.9	4.5	-0.4	2.0
<b>Exchange rate (LL/\$ average)</b>							
	2.7	1,713	1,680	1,571	1,516	1,508	1,508

Sources: Banque du Liban, Annual Report and Quarterly Bulletin, various issues; Ministry of Finance, Budget Statements, various.

Notes: a- Index and growth of GDP at constant 1972–74 prices (100 = 1972–74). b- Public debt is of general government and is at end period. It is the sum of net LL government debt plus gross government debt in foreign currencies, including guaranteed debt. c- Nominal weighted yield on LL-TBs, weights being subscriptions in TBs with maturities of 3, 6, 12 and 24 months. d- Of the banking sector at end period.

since 1996 to 1 percent in 1999 and a standstill in the year 2000. Employment opportunities remained few and the unemployment level high. Despite the paucity of data on the labor market, senior officials have openly acknowledged the seriousness of the unemployment situation and the persistent wave of emigration of skills, particularly among the educated young.<sup>24</sup>

<sup>24</sup> The official 1997 manpower survey (République Libanaise, 1998a) estimates the unemployment rate at 8.5 percent. However, owing to a perception that a social stigma is attached to the unemployed, many of the unemployed, particularly among the young in their 20s, would report a status of university student. Hence, the number of respondents noted as students in the survey is unusually high compared, say,

To appreciate the extent of this failure, one needs to put it in context. Not only has growth started in the early 1990s from a relatively low level of output after several years of disruption, economic activity was also driven by extensive government spending and supported by a strong macroeconomic position, in particular a decelerating inflation rate, a low level of debt and a comfortable position in foreign reserves and net foreign assets.

It should be noted, however, that the apparently satisfactory external performance, since the mid-1990s, has been mainly due to external indebtedness and was in fact weaker than indicated. If we disregard external public debt disbursements and amortization, then the balance of payments has been in deficit throughout 1995–2002, except for a small surplus in 1996. In fact, during 1995–2002, the announced cumulative surplus of the balance of payments is \$1.3 billion, whereas it has been a deficit of \$5.7 billion if we exclude the external debt flows.<sup>25</sup> That has been an unprecedented weak performance for *laissez-faire*, on a front where it has systematically excelled in the past.

This weak growth and financial performance should have alerted the authorities to the existence of serious structural deficiencies in the system. However, officials attributed the weak performance to adverse political developments. The South of the country, occupied by Israel since 1978 until its liberation in May 2000, was the domain of almost continuous fighting and Israeli raids. Two extensive Israeli incursions took place in 1993 and 1995. These developments clearly had their impact on economic activity and expectations, though not to the extent usually claimed by the authorities. Most of the country and economic activity was in fact shielded from developments in a relatively small area in the South and, as in the past, activity would usually rebound to its previous normal levels, following fighting outbursts that usually lasted only a few days. The problem was in-house generated rather than driven by external developments.

Government failure was indeed systematic on all the major fronts of fiscal, monetary and structural reform policies. Fiscal deficits

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to the same rate in the only other manpower survey that was conducted in 1970. Unofficial estimates usually advance unemployment rates exceeding 25 percent, especially since many of those seeking emigration have difficulty obtaining employment or emigration visas.

<sup>25</sup> The comparative figures for the period 1993–2002 are an announced cumulative surplus of \$3.6 billion versus a deficit of \$3.9 billion.

remained high and public sector indebtedness rapidly increased, all driven by mounting current expenditure, particularly on interest (see Table 6.5 above). Moreover, despite falling price inflation and an appreciating exchange rate, nominal interest rates on the LL-TBs remained entrenched at relatively high levels. In fact, interest paid by government was even higher than indicated in the table above since the central bank also paid to commercial banks interest rates that were significantly above market, particularly in the secondary TB market, including swap transactions to reschedule TB maturities.<sup>26</sup> Moreover, very little was accomplished by way of structural reform.

Already since 1997, discourse about reconstruction began giving way to concerns about the high levels of the fiscal deficit and the public debt. However, it is only in 2001 that, alarmed by their mounting indebtedness and the gathering pressure on the Lebanese Pound in the foreign exchange market, the authorities then felt compelled to announce ambitious reform programs, particularly in the domain of privatization.

The Government's political efforts recently culminated with the receipt of substantial amounts of foreign aid. 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. In substance, aid consisted in about \$3.1 billion in soft loans that can be used to refinance foreign-currency debt at significantly lower interest rates, namely at about 5 percent rather than the then current 10 percent. The balance of \$1.3 billion was for loans for standard infrastructure investment projects, which the authorities, anyway, could have access to in the past. The domestic banks later joined the international donor effort by pledging a package of \$2 billion in TB financing at zero interest rate. In return, the Lebanese Government has undertaken to implement further fiscal consolidation and reforms, including, in particular, the privatization of the telecommunication and energy sectors.

The aid package practically meant a saving of about 25 percent of the annual interest cost of about \$2.2 billion, and for a limited period. Given that total net debt was \$31 billion at end 2002, and

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<sup>26</sup> Based on the central bank's data on these transactions in its Annual Report, and market information on the spread or margin paid by the central bank on these transactions, we estimate that the bank has paid close to \$1 billion in net interest, mostly to banks, during 1993–2002.

given the economic and political structural problems in the country, the risk remains that the aid package would prove to be of little effect. Nonetheless, following the announcement of the aid package, interest rates sharply fell from 14.6 percent yield on the 2-year LL-TB to 9.4 percent. The central bank significantly replenished its foreign exchange reserves through purchases in the market. While most reforms and privatization have been front-loaded for implementation in 2003, little had been accomplished by November.

*The economics and politics of debt*

The following table gives a summary and revealing picture of the allocation of public expenditure during a so-called reconstruction period.

Assuming that all investment expenditure went on reconstruction during 1993–2002, only a relatively small proportion, averaging 6 percent of GDP, was allocated to reconstruction activity. Moreover, in line with expenditure patterns prior to 1975, even a smaller proportion was spent outside the capital Beirut and central Lebanon. Interest on public debt cost a remarkable 38 percent of total expenditure, or about 15 percent of GDP.

Overall, about two thirds of government spending, representing about 25 percent of GDP, were allocated to interest cost and the wage bill. How much of that spending was excessive? While the

Table 6.6 *Cumulative government expenditure by economic category, 1993–2002*

<i>Economic category</i>	<i>\$ Billions</i>	<i>% of Total</i>
Interest on public debt	21.0	38
Wages and salaries	16.3	29
Goods and services	6.2	11
Transfers	3.3	6
Investment	9.2	16
Total	56.0	100

*Sources:* Ministry of Finance, Budget Statements, various years; Banque du Liban, Annual Reports and Quarterly Bulletins, various issues.

*Notes:* Figures are for consolidated general government and annex budgets. Allocation of annex budgets among categories is largely estimated. Wages and salaries include pensions and end-of-service payments. Total expenditure is in equivalent current dollars. Interest includes approximately \$1 billion paid by the central bank in the secondary TB market.

question may appear speculative, a reasonable estimate of government waste can nonetheless be provided if the practices during the 1990s are compared to those during the period prior to 1975 when *laissez-faire* was in a “normal” sustainable condition of waste, including no public sector indebtedness.

First, consider interest cost. It is important to note that although TB subscription occurs through weekly auctions, the TB market has in fact been more regulated through an unofficial understanding between the central bank and the major commercial banks than by independent supply and demand forces. This situation is facilitated by the oligopolistic structure of the banking industry, where the largest five banks averaged about 45 percent of total deposits during the period. Thus, although TB yields are in principle determined by auction, their evolution has exhibited few market characteristics, changing only intermittently. In fact, they have remained constant from October 1999 to December 2002!

The high-yielding TBs have been, at least until 1999, much in demand by local and regional investors. The strong demand was supported by relatively rapid price stabilization, and a stable exchange rate that was announced as a major commitment by government. This policy was effectively implemented by a gradual and almost predictable appreciation of the nominal exchange rate vis-à-vis the dollar by an average of 3.4 percent a year during 1993–1998; the rate has practically remained constant thereafter. Nonetheless, during 1993–2002, the weighted annual yield on LL TBs averaged 18 percent, corresponding to a high real interest rate of 11 percent over a 10-year period.<sup>27</sup>

We estimate that at least half the 18 percent rate on LL-TBs, amounting to about \$8.5 billion, was paid in excess of what the cost would have been in a normally operating market. As the weighted average interest rate on LL-TBs has been about 9 percent since early 2003, this rate reasonably and conservatively may be taken as a representative LL-borrowing rate by government during 1993–2002. Indeed, a 9 percent average rate would represent a healthy 4 percent spread or margin over the reference LIBOR rate for 6 months,

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<sup>27</sup> The 18% yield does not take into account the high interest rates—sometimes exceeding 40%—that have been paid by the central bank in the secondary TB market, but that are not accounted for in the budget.

which averaged about 5 percent during the period. It would be a healthy margin because Lebanon's financial situation was much stronger during the early 1990s than at present, and that rate would have entailed a significantly lower debt burden and less adverse fiscal performance, thus supporting the lower rate itself.

Government could therefore have saved \$8.5 billion in interest cost, merely on its LL-borrowing. One should also add a good part of the \$1 billion in excess interest paid by the central bank in the secondary TB market and swap transactions in order to support the exchange rate, and of the average 10 percent interest rate paid on borrowing in foreign currencies. This would make saving on all interest cost at least \$9 billion. Finally, applying a "waste" or a "corruption" rate of 20 percent on all the other categories would add a further \$7 billion, for a total wasteful spending of about \$16 billion.<sup>28</sup>

A waste of \$16 billion, including \$9 billion in interest cost, is large in absolute and relative terms (11% of GDP). It should be stressed that this waste estimate is not in reference to a perfectly efficient and waste-free public sector. Rather, it is in reference to the public sector operating in normal conditions, say with the threshold of waste that was ruling in the pre-1975 period when the financial condition was satisfactory and public debt was inexistent. In other words, the financial system of *laissez-faire* then was sustainable.

Government expenditure has therefore become a mechanism of money transfer to rentiers and to the politically privileged. Prior to 1975, the government's financial condition was strong and a minimalist government confined its policy to the perpetuation of *laissez-faire* and the support of the merchant class. In parallel, the political elite has been able to enjoy financial comfort, with administrative and political office often used as private property that yields income and that can be bequeathed to one's children. The arrangement,

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<sup>28</sup> A corruption rate of 20% is used by Leenders (2001) for investment expenditure in Lebanon. Several official annual reports by the Central Inspection Office note the huge discrepancy between actual and billed costs, for example in the construction of roads and schools, where billed costs often amounted to a multiple of actual costs. See also Leenders (2001) for documented illustrations of corruption practices. Moreover, the government wage bill was 7.1% of GDP in 1972–74, versus 10.4% during 1993–2002, i.e. about 47% increase in terms of GDP. Taking 1972–74 as the norm would therefore entail a waste rate in the wage bill in excess of 20%.



however, is becoming unsustainable because the transfer element in government spending has dramatically increased. The main beneficiaries now are, in addition to the political elite, banks rather than the merchant class.

Indeed, banks have become in the 1990s the main beneficiaries of the government's economic policy. Commercial bank capital accounts have increased from \$143 million at end 1992 to \$3.3 billion at end 2002. This capital increase has been fully financed from TB purchases as banks' net earnings from their TB purchases have strictly exceeded the increase in their capital accounts during the period. However, the cost of the government's economic policy to the whole economy has been much more serious than implied by the transfer of resources to banks.

The combination of high nominal interest rates and price stabilization, the latter mainly owing to the exchange rate peg policy, has produced a situation of high real interest rates that averaged 11 percent during 1993–2002. The impact of the high cost of money has mainly been a delinking of the financial sector from the real sector, and of economic opportunity from the majority of people and enterprises. In early 2001 and for the first time, claims by banks on the public sector exceeded claims on the private sector. Private investment has been falling for a few years and becoming more concentrated on working capital.

Laissez-faire has not been efficiently managed this time. Instead of ensuring financial stability, albeit with an unremarkable growth and development performance as it did in pre-1975, government has embarked on a so-called reconstruction program that effectively involved massive financial transfers to the political elite and banks. The mechanisms used have been fiscal spending and the interest and exchange rate policies. Still, the point of the argument is not about excessive spending or corruption as such, condemnable as they ought to be. Rather, it is about laissez-faire being the context or environment in which government policy essentially operates in support of the dominant economic force, the merchant class prior to 1975, banks since 1992, and the political elite always.

Why has laissez-faire been less efficient than previously? One important reason is the loss of independence. Since 1990, Lebanese governments have deferred, if not lost, much of their power to Syria, which effectively controls Lebanon's political institutions and security apparatus. Indeed, development, no matter how defined, is a

moral undertaking: to improve the material lot of people in a sustainable manner, and to make society more egalitarian. By relinquishing authority over one's affairs, one relinquishes responsibility and accountability, and hence the moral basis for decision making. Interestingly, the less autonomous an authority is the more strident it becomes in its claim to power and wealth, which is what has been happening in Lebanon since 1990.

## CHAPTER SEVEN

### CONCLUDING REMARKS AND POLICY RECOMMENDATIONS

Between the weak and the strong,  
Freedom oppresses but law sets free

Lacordaire

This book's main concern has been to answer the following question: is laissez-faire an efficient economic system? Based on the experience of Lebanon in 1948–2002, the conclusion is that laissez-faire is not especially efficient and may even be substandard in terms of growth and development. The findings and the implications of the analysis promise to be of interest to LDCs. Indeed, our story is one of an LDC economy that has operated in the advantageous context of open free markets, a relatively literate population, an abundant supply of capital and a dominant local ownership and control of resources. We summarize below our findings and propose some policy recommendations for a higher and more sustained path of economic development.

#### *Lebanon's growth and development experience*

Neoclassical theory, with its view of the efficiency and growth-inducing capacity of markets, would have predicted significant economic growth for the Lebanese economy. The outcome, however, has not been as expected.

From 1948 to 1974, Lebanon's economic performance was not the extraordinary one warranted by its advantageous conditions. Growth in per capita GDP was about the same as in developing countries overall, and even less than what was achieved by the neighboring non-oil countries in the Middle East. Performance becomes particularly unimpressive in light of the economy's unusually favorable initial economic conditions, the subsequent abundance of capital and the large Arab regional market that was available for exports.

Ownership of the ever-increasing financial resources was very concentrated and was directed by banks mostly to commercial activity and deposits with banks overseas. Manufacturing relied on self-finance and increased mechanization to substitute for its unskilled work force. It expanded nonetheless, taking advantage of receptive Arab markets, and modestly increased its share of value added and employment. However, domestic linkages were few and weak, with little evidence of growth in total factor productivity, and the expansion of manufacturing was not dynamic enough to make of Lebanon a new industrializing country.

The failure to enhance skills and to integrate them more in the domestic economy, especially in industry, is one of Lebanon's major failures. Skill is a relative concept, relative to the technology in use at the time and the growth strategy it is supposed to serve. In the late 1940s and relatively to other countries in the region or the developing world at large, Lebanon enjoyed what was then considered a literate population. Unfortunately, literacy did not significantly improve, nor did the majority of the work force acquire a level of education that is above the primary level. No serious development strategy can be accommodated with this education or skill performance.

Growth did not filter economic benefits down to a larger number of people. Income distribution remained skewed, and various surveys estimated that at least half the population continued to live in "poverty". The rural-urban divide was becoming very pronounced in terms of income, education and cultural facilities. About 92 percent of the population was, in 1970, evenly distributed between cities of 100,000 residents or more and villages of 5,000 residents or less, and only about 8 percent of the total population was living in the wide expanse in between.

Laissez-faire performed relatively better in the difficult circumstances of the intermittent and often widespread fighting that erupted in 1975. Between 1977 and 1980, output fell to about two thirds of its pre-war level, which it even exceeded in 1987. This economic resilience, however, depended much on transfers from overseas, and income distribution became more skewed, to the disadvantage of the waged workers. The intensive speculative activity against the Lebanese currency, which began in 1984 and culminated in 1987, led to a severe and unwarranted fall in real wages and in most household incomes. A more serious and long-lasting outcome of that speculative activity was the strong devaluation of LL-denominated assets,

an increase in the rate of emigration of skilled workers, and an economy that is still dollarized in 2003.

The integration of Lebanon's open economy into the expanding regional and world markets did not bring many benefits, after all. Neither did its export-orientation and strong macroeconomic condition, with a sustained surplus in the balance of payments and no public sector debt. These all are the critical elements that are stressed by the "Washington Consensus" and most mainstream writers as essential for building industrial competitiveness and for sustained growth.<sup>1</sup> The internal spillover effects in terms of income and linkages were few, the pace of industrialization modest and, importantly, the endowment in skills did not improve but declined in relation to the ongoing progress in technology.

Laissez-faire, however, proved to be good at adapting to changing circumstances. It allowed for the financial exploitation of opportunities and the absence of commodity shortages in times of war. In all circumstances, though, few have benefited from laissez-faire. Moreover, the cheapening of imports, through a strong domestic currency, and the dominant status of merchants with their political backing, led to a higher level of consumption than is compatible with the economy's productivity and growth.

With a share of consumption exceeding 90 percent of GDP, and more than 100 percent since 1975, Lebanon's relative consumption level is among the highest in the world. Instead of transforming the economy into one of skill and industry, Lebanon's advantage in terms of location and free markets has in fact subsidized consumption for the few.

After the war ended in 1990, Lebanon embarked on a reconstruction program, which effectively became a modest program of infrastructure upgrading that mostly centered around the capital Beirut, as in the past. During 1993–2002, government expenditures substantially increased to an average 38 percent of GDP, but the largest share went on interest cost (38 percent), wages and salaries (29 percent), benefiting banks and the political elite, while only 16 percent were allocated to investment.

Despite the substantial increase in government expenditures during 1993–2002, and a stabilization achieved through an exchange

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<sup>1</sup> See, for instance, Lall, 1990, pp. 64–66.

rate peg, growth quickly petered out since 1995. The average annual growth rate was only 3.7 percent during the period, versus 6.2 percent during the pre-war period. Fiscal deficits quickly mounted and public debt reached a record level of about \$30 billion at end 2002, or more than 160 percent of GDP.

*An interpretation of Lebanon's experience*

Two factors explain Lebanon's relatively poor economic development performance. The first is a negative and weaker interpretation than the second. It says that the market, as represented by the laissez-faire system, is not necessarily conducive to growth and development, even in a strongly favorable financial and trading environment. Market failure occurred in the provision of strong growth, an improved distribution of income and wealth, and in the generation of more and better skills. Moreover, it was non-market institutions, such as government, religious and non-government organizations, that provided the basic education services to the majority of people. There also was market failure in the generation of industrialization and of productivity growth in the economy overall. Therefore, the market has not been a sufficient condition for growth and development.

The second factor is one that concerns the institutional structure of the economy. It says that the capitalist form of economic organization, as illustrated by the extent of waged employment rather than free markets as such, never achieved a dominant position in the Lebanese economy. By 1970, only about 30 percent of total waged employment was regularly employed in the private sector, the ratio increasing to about 42 percent in 1997.<sup>2</sup> The anticipated capital accumulation and development that are expected under capitalism, therefore, may not have had the opportunity to operate in the first place. The non-capitalist or so-called independent, part of the economy in agriculture, trade and services has been an enduring

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<sup>2</sup> While it is still early to tell, the increase in regular waged employment is due, at least in part, to the severe economic crisis that has forced some of the independently employed to the waged ranks. Accounting for the large numbers of foreign, particularly Syrian, workers who mostly work part-time or in irregular fashion, of course, would significantly reduce the extent of the increase in the share of the regularly employed in the private sector.

phenomenon. Even the handicraft part of manufacturing increased its share in output and employment.

The increasing demand from the urban and export sectors made the resilience or progress of non-capitalist activity possible, allowing independent incomes to increase and independent activity to survive. Many of the lower-income groups, particularly in agriculture, were able to complement their low incomes and avoid joining the ranks of waged employment. This was made possible by domestic transfers and remittances from relatives at home and abroad, or through emigration. The favorable external environment made the coexistence of independent and capitalist activities sustainable.

This interpretation of the failure of capitalism to develop in Lebanon draws on Brenner's view of the origins of the rise of capitalism. Our findings support his view concerning the survival capacity of non-capitalist forms of organization. Brenner also believed that, once capitalism is already established somewhere, pressure then mounts on producers to become capitalist. In this regard, our findings suggest that, even with a dominant capitalist form of economic organization in the world, the necessity or compulsion for producers to become capitalist may still be not strong enough. This would particularly be the case in economies where the external environment provides a channel for the increase in the incomes of independent producers through increased demand and/or through the availability of transfers to support their low incomes.

Our line of reasoning raises a corollary question. Had capitalism been a dominant form of economic organization in Lebanon, would economic growth have been stronger and more sustained than it actually was? Hypothetical questions are not prone to testable answers. Nonetheless, the short answer is that output growth would probably have been larger, but economic development performance would not necessarily have been better. Capitalism does not contain an inherent tendency to produce equitable and extensive economic development. This requires the purposeful work of institutions in a developmental state.

Lebanese manufacturing provides an interesting illustration. Although it was largely organized along capitalist lines of production, Lebanese manufacturing was not the dynamic engine of growth that was able to bring significantly more labor and skills to its domain. In general, market failures in the domain of employment, skills and income distribution can be and are pervasive in capitalist economies. Industrial

Europe's economic system and performance is largely the product of a long struggle of its political parties and civil society, which produced the high levels of education and skills and effective social safety nets. The market served as a major instrument in this strategy, but it surely was not the *sine qua non* for Europe's economic performance.

*Policy recommendations*

So, what are the policies that can put the Lebanon, or developing countries in similar conditions, on a higher and more sustained path of economic development?

A comparison between Lebanon and successful industrial countries in Southeast Asia is instructive. Taiwan, for instance, and Lebanon share many similar characteristics. They both are open economies, export-oriented, with abundant capital and little control by foreign capital. They even share the characteristic of an old persevering political class. A salient difference between the two countries is that Taiwan has clearly opted for an objective of industrialization that has actively been supported by government policies.<sup>3</sup> Singapore, which has an even smaller population than Lebanon's, is here not relevant for comparison since its growth strategy has been all but one of *laissez-faire*.<sup>4</sup>

Hong Kong often is cited as the other *laissez-faire* economy. Lebanon and Hong Kong do share some characteristics. They both are small and have started from a relatively high-income level in their respective regions. Moreover, they both have played a leading role in services and *entrepôt* trading, and in being regional host to multinational corporations and a refuge for politically nervous money. Finally, both countries are usually portrayed as strongly outward-oriented, with economically passive governments.<sup>5</sup>

However, Lebanon and Hong Kong also are different in many important respects. Between 1960 and 1975, Hong Kong's waged employment averaged 82 percent of total employment while Lebanon has averaged about two thirds and, importantly, with less than half

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<sup>3</sup> See, on Taiwan, Van Dijk and Marcussen, 1990.

<sup>4</sup> For details on Singapore's growth strategy, see the last section of Chapter 4,

<sup>5</sup> See Wade, 1990, on Hong Kong.



of the waged being paid regular wages. Hong Kong also is practically a city-state with its very small agricultural base and, until recently, its strong political and trading links with Britain. Thus, Hong Kong is not, after all, such a good illustration of a *laissez-faire* type of a developing market economy.

A successful strategy for economic development must involve a sustained push by some central authority that would set economic development as a national objective. Government and the private sector can negotiate a developmental strategy, but they would first have to accept the principle that *laissez-faire* is not the adequate instrument of such a strategy. This is an important starting point that would clear the way for negotiating the following policies.

1. Provide free or moderate-cost quality education at government schools, colleges and universities.

This is a critical strategic objective, particularly for small economies. It also is a difficult objective to realize in view of its cost requirements. Obtaining an efficient quality educational system involves a long gestation period, and significant amounts of money are needed before the economic yield of improved education materializes. A more effective system of direct taxation, particularly on profits in view of their large share in GDP and very small contribution to government revenue, can alleviate this problem. While enterprise owners would clearly be reluctant to comply, it is difficult to envisage an economic strategy that would take Lebanon's economy to a higher path of growth without the private sector effectively contributing, in some way, to the financial resources required for that strategy.

In other words, a new "economic deal" is required between the public and private sectors. The private sector would agree to act as a major partner, largely through the payment of taxes and long-term and low-interest finance, in the development of the human and physical infrastructure. In exchange, government would undertake to upgrade and manage this infrastructure with minimum waste. For practical purposes, low interest means a real interest rate that is close to or even below the GDP growth rate.

2. Prioritize rural areas in development expenditures.

The main purpose of this policy is to integrate an already small market and thus provide a larger basis for increased investment and growth. Increased demand from rural areas usually benefits domes-

tic manufacturing and allows it to take advantage of greater economies of scale. Small national markets can be extended once we remember that size is more a matter of incomes than population.

In this regard, a critical project would be to develop modern road and communications networks in rural areas, which practically consist of all regions outside Beirut and the center. The aim is to take advantage of the small size of the country by making, in particular, transportation much quicker than at present. This would significantly reduce the high population density in Greater Beirut, drive up real estate prices in rural areas from their currently very low levels, and overall raise investments in these regions. It would also provide a basis for a better national integration of disparate areas in a small country.

As for education, financing would be provided by a better taxation system, but mostly by low-interest borrowing from the private sector. Again, the private sector would need to go beyond its traditional short-termism and consider the long-term benefits that would accrue to it and all the economy from the implementation of such a project. Surely, a government that paid during 1993–2002 about \$21 billion in interest cost, of which about half were excessive, would be able to finance essential projects, such as education and transportation, for economic development.

### 3. Industrialization should be a major policy objective.

The implementation of the first two sets of policies, regarding education and transportation, would make industrialization more feasible and profitable. The current state of the industrial arts, with a greater degree of computerization of operations, allows for smaller minimum efficient scales of production than was the case in the epoch of heavy industry. This should make the problem of scale less of a constraint.

The historically low level of wages and skills in industry is a problem. Better skills would raise productivity and wages, but the vicious circle needs to be broken earlier. Though currently in recession, industrialists have usually realized high rates and levels of profit. Like other profitable enterprises, they therefore are capable of attracting better talent, and of rewarding the existing one better. There is ample room for taking advantage of X-efficiency and scale economies in industry. Raising wages in line with productivity increases, or even to elicit better productivity, can significantly increase overall industrial

productivity. However, this is a job for industrialists rather than government.

Balassa (1990) finds that, excepting Hong Kong, all the successful industrial countries of Southeast Asia went through successive stages of industrialization including, first, an import-substitution phase based on unskilled labor and simple production processes that are not subject to large-scale economies. Another phase was the promotion of saving in relation to GDP. These two phases in fact refer to consumption behavior and concentrate, counterfactually, an important and endemic aspect in Lebanon's growth experience. Lebanon's high level of consumption in relation to GDP has already been noted. A tax or tariff system, emphasizing imported luxuries, serves several purposes by providing a source of financing for development expenditures and by promoting import substitution. It is important to pay attention, though, that the proposed tariff policy not turn the existing situation favoring the merchant class into one that protects the interests of inefficient industrialists.

### *Finale*

Can these policies be implemented? Yes. Lebanese governments, until the mid-1970s, have shown that they can at least avoid fiscal deficits, debt and bloated employment in the public sector. However, only a political authority intent on development can start the process and make it feasible. Markets are necessary for economic development, but, on their own, they are unlikely to sustain an economic development process and may even inhibit it.

Our strategy has focused on economic conditions, disregarding the political. This is an important omission for, in LDCs, political conditions often are the prerequisites of growth and development. In Lebanon, the first condition is that the country regains its autonomy from Syria. Since 1990, Syria has controlled the political process in Lebanon, including presidential and legislative elections, and government formation, thus overwhelming all aspects of the country's political and economic life. Subservience by any country's authorities to an external power cannot produce development, which requires autonomous decisions to be made solely with regard to the interests of the national community that the authorities are supposed to represent.

The second step is the establishment of effective democratic institutions, meaning regular, free and transparent elections, accountable governments, and efficient administrative and legal systems. A necessary condition for an efficient modern economy is the efficient operation of public institutions. It is only then that the economic strategy, as detailed above, would be able to work fully and deliver the desired process of economic development.

If anything, economic history tells us that all industrial nations have achieved their high standards of living through sustained and purposeful economic policy, rather than through letting market forces simply work themselves out. Successful markets in industrial nations have not originated as spontaneous opportunities; they were managed into success. Admitting the principle that economic development needs to be set as a national objective is a necessary first step towards development itself. This is all the more important for LDCs since belief is currently widespread and well anchored among politicians, businessmen and academics that a full-fledged market system, which really means *laissez-faire*, is the only efficient strategy for economic development. I hope that this work has succeeded in giving a more realistic reading of *laissez-faire*'s limitations. I also hope that our story will present all LDCs, which have now embarked or are planning to embark on an unfettered market path of economic development, with a picture of the likely shape of things to come.

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## STATISTICAL APPENDICES

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## APPENDIX ONE

### POPULATION

The only population census for Lebanon was conducted in 1932. The Lebanese population then was estimated at 793 thousand and the total de facto population at 855 thousand. The reluctance to conduct population censuses is due to a deep-rooted concern within the political class about upsetting the country's confessional balance. This confessional balance was reflected in an unwritten agreement (the so-called National Pact) made at the time of independence in 1943, whereby executive and legislative powers, and senior administrative posts, were to be allocated along confessional Christian/Muslim lines. A new constitution has been adopted following the end of the war in 1990, but the confessional basis of the distribution of political power remains intact.

The 1932 census figures, however, were underestimated as many Muslim Lebanese refused to take part in the census. Several population surveys that were later undertaken in the 1940s and 1950s produced estimates that were constrained by a variety of limitations. For instance, few of those early surveys explicitly defined or referred to the concept of economic residence, and some of them included emigrants who had been living overseas for a number of years. Later population and manpower surveys have seriously been limited by the omission of Palestinian and Syrian workers.

a) The Palestinian refugees living only in camps, whose number was a little over 100,000 in 1948 and 131,000 in 1970, have not been included in the estimates—though the omission is always acknowledged—except in the latest survey of 1997 (Courbage and Fargues II, 1974, p. 41; UN, 1955). Their number in 2003 may vary between 350,000 and 400,000.

b) A relatively large number of migrant Syrians have traditionally lived, without their families, part of the year in Lebanon, mainly working in agriculture and construction. Their number was around 75,000 in 1967. For 2002–03, estimates greatly vary between 200,000 and an unrealistic 1 million. A majority of these workers is employed occasionally or for a number of months every year. Their work duration often falls near the 6-month borderline that Lebanese manpower



methodology has used to separate resident and non-resident population or workers.

These issues will be explicitly addressed in Appendix II.

The first extensive and detailed population survey that was officially conducted on a national basis was relative to November 1970. It used a large sample of 30,000 households and adopted the concept of a resident population. This manpower survey will thereafter be referred to as PAL70 for “Population Active au Liban”.<sup>1</sup> The survey was held under the auspices of the Ministry of Planning. The resulting population figure of 2.126 million, as at 15 November 1970, was later adjusted upwards by about 9 percent.<sup>2</sup> Palestinian refugees living in camps and Syrian migrant workers were not included among the resident population. A second official survey, that we call PAL 97, was conducted in 1997 with a sample of 16,800 households.<sup>3</sup> The survey does not note any population category as having been omitted from the survey.

The population figures used in this book are based on the UN population series of the UN for the years 1950–1987, and on official estimates thereafter. It is the same series as that used by the World Bank, and is adopted for the following reasons:

a) The UN population series on Lebanon, which goes back to 1950, takes PAL as a reference estimate and adjusts it upward to 2,469 thousand for mid-1970.

b) The UN series uses the concept of “de facto” or present-in-area rather than resident population. However, the difference between the UN figure for mid-1970 of 2,469 thousand and the adjusted PAL figure of 2,315 thousand for mid-November 1970 (or 2,293 for mid-1970) is about 176 thousand. This difference reconciles well with the figure of 131,000 Palestinians living in camps in 1970.

c) The UN series is consistent with the first major national socio-economic study that was undertaken by the French mission IRFED in 1960–61. That study estimated the resident population in 1959 at around 1,626,000 Lebanese, plus 130,000 Palestinians living in camps, plus 20,000 non-Middle Eastern residents, plus “some tens of thousands” of Arab residents. This puts the resident population in 1959, according to IRFED, at some 1.8 million. The figure used by the UN for 1960 is 1,857 thousand.

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<sup>1</sup> République Libanaise, 1972.

<sup>2</sup> Courbage and Fargues, 1974.

<sup>3</sup> République Libanaise, 1998a.

The UN data therefore provide a continuous and realistic series that is consistent with the two major socio-economic and manpower studies of IRFED in 1959 and of the Ministry of Planning in 1970. Although the UN uses in general the “de facto population” concept, its series for Lebanon appears as if it is implicitly using the economic concept of a resident population since it coincides with the adjusted figures of IRFED and PAL, which are based on the economic concept of residence.

Finally, the 1945 population figure of 1,147 thousand is an official estimate by the Ministry of National Economy, which is not adjusted since few refugees or foreign workers need to be taken into account for that period.<sup>4</sup>

Table A.I.1 below provides estimates of the resident population and its growth rate until 1990, based on UN and World Bank data. Thereafter, the estimates are based on the official manpower survey for 1997.

Table A.I.1 *Population, 1945–2002*  
(Thousands, and average annual growth rates)

<i>Year</i>	<i>Population</i> (thousands)	<i>Growth</i>	<i>Year</i>	<i>Population</i> (thousands)	<i>Growth</i>
					2.3%
1945	1,147		1975	2,767	
		4.7%			-1.1%
1950	1,443		1980	2,618	
		2.3%			0.0%
1955	1,617		1985	2,618	
		2.9%			1.2%
1960	1,857		1990	2,779	
		3.0%			5.4%
1965	2,153		1995	3,608	
		2.8%			5.4%
1970	2,469		1997	4,005	
					1.2%
			2002	4,251	

*Sources:* République Libanaise 1998a; UN, 1988b; World Bank, World Development Report, various issues.

<sup>4</sup> IRFED, p. 46.

The high annual growth rate of 4.7 percent during 1945–50 is largely explained by the influx of Palestinian refugees since 1948. Moreover, the relatively high rates between 1955 and 1970 are mainly explained by an influx of Lebanese nationals from Egypt and of Syrian nationals following a change of regime and political instability in their respective countries. Finally, population has stabilized, or even declined, during the warring period of 1975–90, then strongly increased with the return of many nationals after the end of the war.

## APPENDIX TWO

### LABOR AND EMPLOYMENT

This appendix explains the derivation of the employment series.

The concept of labor force, defined as the number of persons aged 15 to 64 years, will be rarely referred to in this book. The concept of the economically active population is the more frequently used one; it consists of the effectively employed and unemployed population, including the occasional, seasonal and unpaid family workers. Labor activity obviously extends outside the age boundaries of the labor force, and refers to those who are working or seeking to work. As in the PAL manpower surveys, the employed population is the actually employed population, including the seasonal or occasional labor, although these may be unemployed during the time of the survey. All major studies on Lebanon, particularly those by the UN various agencies, have used the PAL early survey as a benchmark study for population and labor estimates covering periods before 1970 and after, until the second PAL survey was conducted for the year 1997. Also included in the manpower estimates are all persons in the armed forces, whose number has usually been relatively modest, standing at around 3 percent of the active population in 1964 and 1970, but around 5 percent in 1997.<sup>1</sup>

#### *The sources of manpower underestimation*

The manpower estimates in Lebanon have suffered from two major sources of underestimation: female activity and employment, particularly in agriculture, and foreign labor, mostly Palestinian and Syrian workers. Adjustments, though clearly imperfect, have been made to make the manpower series more consistent and representative of actual economic conditions.

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<sup>1</sup> See République Libanaise, 1966, PAL70 and PAL97.

The concept of labor activity or participation rate is used in relation to the total corresponding population.

*Female economic activity*

The first source of underestimation is female activity, particularly in agriculture, which is a major source of underestimation throughout the Middle East.<sup>2</sup> For Lebanon, the PAL70 survey admits that the actual female participation rate must significantly exceed the estimated 9 percent in rural areas.<sup>3</sup> For instance, a separate study conducted in the agricultural area of South Lebanon in 1973 estimated at 48 percent the share of female employment in total agricultural employment in the area, against PAL70's 21 percent in 1970. Total female agricultural employment in South Lebanon alone, which was put at 32,000 in the 1973 survey, well exceeded PAL70's 1970 estimate of 21,000 in all Lebanon.<sup>4</sup> Moreover, female participation in non-agricultural employment, in 1960, has been estimated by the UN at around 11 percent, whereas a field study that was conducted under the ILO supervision in 1961 has put that rate at around 17 percent for salaried employees in the private sector.<sup>5</sup>

In line with these findings, and to compensate for the underestimation of female participation and employment, we have adjusted upwards by half the total female employment figure for 1970, thus adding 47,000 to total employment. This increases the total female participation rate from 9.5 percent to 14.3 percent, against 22 percent in 1997. Our adjustments focus, first, on the 1970 estimates of PAL70, as these were benchmark estimates. These adjustments, as detailed below, are especially needed because the 1970 total employment figure of 538,000 was clearly in need of an upward adjustment since it turned out to be significantly lower than the Ministry of Planning's 1964 employment estimate of around 630,000, and IRFED's 1959 estimate of 580,000.

While the PAL97 survey for 1997 has acknowledged the underestimation of female employment, the error must have been significantly

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<sup>2</sup> Zurayk, 1985, p. 21.

<sup>3</sup> PAL70, p. 112.

<sup>4</sup> Courbage and Fargues, II, p. 72n.

<sup>5</sup> See ILO/Lacroix, 1962; République Libanaise, 1966; UN, 1988b, p. 289.

lower than in 1970 because of a better coverage and a lower overall employment in agriculture itself. PAL97 estimates total female employment in 1997 at 272,586 (22 percent of total employment), including 13,576 in agriculture (12 percent of employment in agriculture).

### *Foreign labor*

The second source of employment underestimation is foreign labor.

The PAL70 survey for 1970 acknowledges the omission from its employment estimate only of Palestinians living in camps, and of an important number of Syrian seasonal migrant workers who overwhelmingly worked in agriculture and construction.

The number of Palestinians living in camps has been estimated at around 131,000 in 1970.<sup>6</sup> We estimate their activity or employment rate at the same general rate of 32 percent (see below on this). This yields an additional resident Palestinian employment of 42,000, of whom at least a quarter worked in agriculture.

Accounting for the temporary Syrian workers is more difficult. The Ministry of the Interior has put the total number of Syrians at 280,000 in January 1970. The PAL survey has already accounted for about 104,000 as residents living in Lebanon. The detailed balance of payments survey for 1967 has estimated the number of temporary Syrian workers at a maximum of 75,000. The survey has further estimated 30,000 to be in agriculture, 21,000 in construction, and the balance in other activities. We adopt Medawar's estimates and maintain his 1967 maximum number of 75,000 for 1970.<sup>7</sup>

Our estimates of total unaccounted-for foreign labor of 117,000 represent about 17 percent of the adjusted total employment figure of 702,000 in 1970.<sup>8</sup> This is a relatively high but reasonable estimate, compared to the 10 percent figure for the 1950s, advanced by the Ministry of Labor and Social Affairs regarding the share of foreign labor in the registered workforce.<sup>9</sup> The estimate also is realistic in view of the increasing influx of temporary Syrian workers in the 1960s to the then booming construction activity.

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<sup>6</sup> Courbage and Fargues II, 1974, p. 41.

<sup>7</sup> See, for this paragraph and in succession, Courbage and Fargues II, 1974, pp. 41; PAL70, p. 69; Medawar, 1969, p. 99.

<sup>8</sup> Chami (1981, p. 205) cites a PAIRD (?) report which estimated unaccounted-for foreign labor in 1970 at 100,000.

<sup>9</sup> AUB, 1960, p. 36.

*Labor activity, employment and unemployment*

In light of the above, Table A.II.1 includes our estimates for the active population, employment and unemployment.

The employment estimates are obtained as follows:

*1945:* Employment is estimated at 350,000, based on the 1944 figure of 343,000. The UN's 1950 activity rate of 31.7 percent is used for 1945.

*1950:* Based on the UN's 31.7 percent activity rate (for 1945) and an unemployment rate of 10 percent, employment is then estimated at 411,000. The 10 percent unemployment rate is derived from Churchill (1954), an official socio-economic study of Beirut in 1952–53. This unemployment rate is in line with economic developments at the time, particularly after the influx of Palestinian refugees in 1948. While the situation was practically one of full employment in the mid-1940s, unemployment increased afterwards until the early 1950s (see section 2.2.3 in Chapter 2).

*1960:* Based on an American University of Beirut (AUB) manpower study, IRFED estimated employment in 1959 at 580,000, compared to a Ministry of Planning's 1964 estimate of 616,000.<sup>10</sup> Both estimates excluded the armed forces, which would make total employment

Table A.II.1 *Labor activity, employment and unemployment 1945–1997*

	1945	1950	1960	1970	1974	1987	1997
Population (thousands)	1,147	1,443	1,857	2,469	2,705	2,767	4,005
Activity rate (% population)	31.7	31.7	31.7	32.0	32.0	33.0	34.0
Active population (thousands)	364	457	589	790	866	913	1,362
Employment (thousands)	350	411	558	702	762	855	1,246 (1,500)
o/w in government		18	38	60	71	90	170
o/w military		5	11	15	17	27	60
Unemployment (% active pop.)	3.8	10.0	5.3	11.1	12.0	6.4	8.5
<i>Memo</i>							
<i>UN activity rate estimates</i>							
Male	56.2	48.2	42.9	44	44	44.8	
Female	6.9	7.6	10.2	11.5	14.6	15.4	
Total	31.7	28	26.7	27.9	28.9	29.6	

Sources: République Libanaise 1998a, 1972; UN, 1988b.

<sup>10</sup> IRFED, Vol. I, pp. 55–56, and CERMOC, p. 9.

around 590,000 and 630,000, respectively. The Ministry of Planning's estimate is more reliable since it is based on a wider and more systematic coverage than that of AUB/IRFED. Moreover, AUB/IRFED's estimate may be a little high since it would imply quite a low employment growth rate of 1.3 percent a year during 1959–64, which is the developmental period during the Chehab regime.

To obtain the employment level for 1960, we therefore adopt the Ministry of Planning figure of 630,000 for 1964 and then apply to that figure the average growth rate in employment of 2.7 percent for the period 1950–64, which is more typical of growth during 1959–64 than subsequent ones. This gives an employment estimate of 558,000 for 1960. The activity rate of 31.7 percent is maintained for 1960.

*1970:* Total employment is estimated at 702,000, which consists of the original PAL70 estimate of 538,000 plus the total adjustments of 164,000 that are detailed above (47,000 for female participation and 117,000 for foreign labor).

*1974:* Reliable employment estimates after 1970 and until 1997 are few. We assume a slight increase in the activity rate to 32 percent and a relatively small increase in the unemployment level, from 11 percent in 1970 to 12 percent, since labor strikes and emigration had strongly increased in the early 1970s (see Table 3.12 in Chapter 3). This produces a 1974 employment estimate of 762,000.

*1987:* Little information is available on employment levels in the 1980s. We assume that the activity rate has increased to 33 percent and use the employment estimate of 855,000 from a study undertaken by the UN.<sup>11</sup> The resulting unemployment rate of 6.4 percent is realistic in view of the picking-up in economic activity in 1987 and the absorption of some unemployment by the growing wave of emigration since 1975.<sup>12</sup>

*1997:* We start from the employment estimates of PAL97. As noted above, while there is still an underestimation of female participation, especially in agriculture, the error has substantially been reduced. A

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<sup>11</sup> ESCWA, 1989, p. 68.

<sup>12</sup> See Labaki, 1989, and Chapter 5.



more serious problem arises, however, from the underestimation of Syrian workers, whose numbers have greatly increased in the 1990s. The Prime Minister has publicly indicated in 1998 that the number of foreign workers in Lebanon ranged between half a million to 750,000 (i.e. 40 to 60 percent of the official 1997 employment estimate), which may be on the high side.<sup>13</sup> We believe, on the other hand, that the total number of foreign workers, including a large number of Arabs (Syrians, Egyptians, Sudanese, etc.) and other Asians (Indians, Filipinos, Sri Lankans) could exceed 400,000, at least half of whom are Syrians. We conservatively put the adjusted employment figure at 1,500,000, up from the official estimate of 1,246,000, which already includes foreign workers.

The 1997 estimates for the activity rate, employment and unemployment, in particular, are much less reliable than previous estimates owing to the complications brought by the relatively large number of Syrian and other foreign workers.

Given the adjustments we have made to the employment estimates, which are detailed above, we can now propose our estimates of the employment structure.

In terms of employment, the difference between industry and manufacturing has usually been one percentage point, which accounts for employment in mining, quarrying and utilities.

Table A.II.2 *Estimates of employment structure by economic activity*  
(In percentages)

	1950		1960		1970		1975	1987	1997
	ILO	ILO	IRFED	ILO	PAL70	UN	UN	PAL97	
Agriculture	55	38	55	20	19	17	12	9	
Industry	20	23	18	25	19	19	17	15	
Construction					7	7	15	11	
Services	25	39	28	55	56	57	56	65	
Total	100	100	100	100	100	100	100	100	

Sources: Hajj and Hamdan, 1989, p. 68; ILO, 1977, p. 60; IRFED I, c. 1963, p. 57; PAL70 and PAL97; République Libanaise, 1998a, p. 76; 1972, p. 114; UN/ECWA, 1981, p. 13.

<sup>13</sup> As-Safir local daily, 22 July, 1998.

Table A.II.3 *An alternative employment structure by economic activity*  
(In percentages, unless otherwise indicated)

	1950	1960	1970	1974	1987	1997
Agriculture	55	44	26	22	20	15–20
Industry o/w manufacturing	11 (10)	12 (11)	16 (15)	17 (16)	16 (15)	15 (14)
Construction	5	6	8	8	8	11
Services	29	38	50	53	56	54–59
Total	100	100	100	100	100	100
Total (thousands)	411	558	702	762	855	1,500

Sources: Table A.II.2 and details below.

The employment structure in 1970 is derived from the adjustments noted above, and the ILO structure for 1950 is maintained. The intermediate structure for 1960 is then estimated in light of the AUB and IRFED manpower studies for 1959. It should be noted, in this regard, that the 1960s were distinguished by a strong industrial expansion.<sup>14</sup> The estimates for agriculture are all adjusted upwards particularly in view of the underestimation of female and foreign labor employment in that activity. The sharp reduction in the employment share of agriculture during the 1960s is explained by an intensive rural-urban migration, which was precipitated by the influx of refugees from South Lebanon who were escaping Israeli raids towards the end of that period. PAL70 estimates the number of internal migrants at around one third of the resident population in 1970.

The warring and worsening economic conditions that prevailed after 1975, together with the sharp fall in real wages in the mid-1980s, induced people to go back to the more peaceful countryside. We therefore assume that the fall in the employment share of agriculture has decelerated after 1975. This is confirmed by the findings of a recent official agricultural census in 1997–98.<sup>15</sup> The census results indicated that total agricultural employment was in excess of 377,000, including family and waged labor, and the full-time equivalent of occasional labor, translating into at least 25 percent of total employ-

<sup>14</sup> See NBITD, c. 1988, and Chapter 4.

<sup>15</sup> See Republic of Lebanon and FAO, 2000.

ment. This figure seems excessive and significantly different from PAL97's estimate of 9 percent. The overestimation of the census may in fact be due to the inclusion among the employed of any person who has undertaken some agricultural activity during the period. In any event, we have opted for a middle estimate of 15 to 20 percent share of agriculture in total employment.

The share of employment in manufacturing and industry is derived from the industrial surveys, which are discussed in detail in Chapter 4. The share of employment in construction is based, first, on the adjusted manpower estimates for 1970, then on IRFED for 1960. Extrapolations are effected for the other years, except for 1997, in light of the UN estimates in Table A.II.2 and economic developments in the relevant period. The share of employment in services is calculated as a residual after the determination of the employment shares of the other activities.

Again, the employment structure as estimated in Table A.II.3 is supposed to convey general orders of magnitude, particularly for the non-industrial activities. However, one may raise the legitimate concern that, as the employment structure is altered in relation to the original estimates, the structure of output should also be correspondingly adjusted. However, since output and value added have mostly been estimated independently of employment, there is therefore no need to adjust the level or structure of output.

The following two tables present condensed results regarding employment structure by economic activity, work status and education, as estimated by the two PAL manpower surveys for 1970 and 1997.

Table A.II.4 *Employment structure by activity, work status, permanence and schooling, 1970*  
(In percent of total employment)

<i>Activity</i>	<i>Work Status</i>						TOTAL	<i>Work Permanence</i>			<i>Schooling achieved</i>					
	Independent	Boss	Waged-monthly	Waged-daily	Family help	Trainee & other		Permanent	Seasonal	Irregular	Illiterate	Less than primary	Primary	Complem.	Secondary	University
Agriculture	6.2	1.8	0.4	4.9	4.6	1.0	18.9	3.2	8.8	6.9	11.2	6.5	1.0	0.2	–	–
Manufacturing, mining	3.4	1.7	4.9	7.0	0.6	0.2	17.8	14.4	0.4	3.0	4.1	8.1	3.7	1.1	0.5	0.3
Electricity, gas, water	–	–	0.9	0.1	–	–	1.0	1.0	–	–	0.1	0.4	0.3	0.2	0.1	–
Construction	1.6	0.7	0.7	3.4	–	0.1	6.5	2.1	0.2	4.2	2.2	3.0	0.8	0.2	0.1	0.1
Commerce, hotels	6.9	2.2	5.1	1.8	1.0	–	17.0	15.2	0.3	1.5	3.7	6.4	3.3	2.0	1.2	0.5
Transport & communic.	2.3	0.1	3.4	1.2	–	0.1	7.1	6.1	0.1	0.9	1.7	2.9	1.1	0.7	0.5	0.2
Finance, serv. to enterp.	0.6	0.3	2.4	0.1	–	–	3.4	3.2	–	0.2	0.1	0.4	0.5	0.8	0.7	0.8
Other services	2.9	0.8	19.8	3.4	0.3	0.6	27.8	23.8	0.2	3.8	6.3	7.4	4.4	4.3	3.1	2.3
Undetermined	0.1	–	0.1	0.2	–	0.1	0.5	–	–	0.5	0.2	0.2	–	–	–	–
Total	24.0	7.6	37.7	22.1	6.5	2.1	100.0	69.0	10.0	21.0	29.5	35.2	15.2	9.5	6.3	4.3

Source: PAL, 1972 (PAL70).

Table A.II.5 *Employment structure by activity, work status, permanence and schooling, 1997*  
(In percent of total employment)

	<i>Work Status</i>						TOTAL	<i>Work Permanence</i>			<i>Schooling achieved</i>					
	Independent	Boss	Waged-monthly	Waged-other	Family help	Trainee		Permanent	Seasonal	Irregular	Illiterate	Reads & Writes	Primary	Complem.	Secondary	University
<i>Activity</i>																
Agriculture	3.7	0.7	0.5	3.3	0.9	–	9.0	2.8	4.2	2.0	2.6	1.7	3.2	1.0	0.3	0.1
Manufacturing, mining	2.7	1.4	6.2	3.3	0.3	0.2	14.1	12.1	0.4	1.6	0.8	1.4	5.7	3.5	1.9	0.9
Electricity, gas, water	–	–	0.5	0.1	–	–	0.6	0.5	–	0.1	–	0.1	0.2	0.1	0.1	0.1
Construction	3.3	1.4	1.7	4.5	0.1	0.1	11.2	6.6	0.4	4.2	0.7	1.1	4.3	2.8	1.5	0.8
Commerce	9.0	2.5	7.0	2.7	0.8	0.4	22.3	20.4	0.3	1.6	1.2	1.9	6.9	5.7	4.1	2.6
Hotels, restaurants	0.4	0.3	1.7	0.3	0.1	–	2.7	2.4	0.1	0.2	0.1	0.2	0.8	0.7	0.6	0.3
Transport & communic.	2.9	0.2	1.9	0.4	–	–	5.3	4.5	0.1	0.7	0.4	0.6	1.8	1.2	0.8	0.4
Financial intermediation	–	–	1.8	0.2	–	0.1	2.1	2.1	–	–	–	–	0.1	0.3	0.7	1.0
Services to enterprises	1.3	0.4	1.9	0.2	0.1	0.1	4.0	3.6	–	0.4	–	0.1	0.3	0.6	0.8	2.2
Public administration	–	–	8.3	0.2	–	–	8.5	8.4	–	0.1	0.3	0.4	2.1	2.3	2.0	1.4
Education	0.2	0.1	7.8	0.4	–	–	8.6	8.1	0.3	0.2	0.2	0.1	0.4	0.9	2.9	4.1
Health, social services	0.6	0.2	2.3	0.2	–	–	3.3	3.2	–	0.1	–	0.1	0.4	0.5	0.7	1.6
Domestic help	–	–	3.7	0.7	–	–	4.4	4.2	–	0.2	1.2	1.0	1.5	0.4	0.3	–
Other	0.9	0.3	2.0	0.4	0.1	0.1	3.9	3.4	0.1	0.4	0.3	0.2	0.9	1.0	0.8	0.7
Total	25.1	7.4	47.3	16.9	2.3	1.0	100.0	82.3	5.9	11.8	7.8	8.8	28.7	21.1	17.4	16.2

Source: PAL, 1998 (PAL97).

### APPENDIX THREE

#### THE NATIONAL ACCOUNTS OF LEBANON, 1945–2002

Until 1974, only two detailed studies have been undertaken on the national accounts of Lebanon. The first was by Professor Albert Badre (1956) for the years 1948–50, which then was regularly adjusted and updated until the year 1958.<sup>1</sup> The second was the official and more detailed estimates for the period 1964–74 that were undertaken by the Central Directorate of Statistics of the Ministry of Planning (DCS for Direction Centrale de la Statistique). However, only the preliminary estimates for 1974 have been released. These two series share the crucial characteristic of their reliance on primary data generated from sample surveys by economic activity and from detailed foreign trade statistics. The DCS statistics on national accounts and the balance of payments were derived from relatively large and extensive samples, starting with the 1964 detailed industrial survey, supplemented by periodic surveys of all activities and the foreign trade data series.

A family budget survey was undertaken for Beirut in 1966, and a detailed input-output table for 1964 was annually updated until 1970. It is not clear, however, whether the technical coefficients of production have been updated based on new primary data since these show an unlikely constancy over the seven-year period.<sup>2</sup>

Following the beginning of the war in April 1975 and under the auspices of the newly created Council for Development and Reconstruction (CDR), staff from the disbanded DCS managed during the relatively peaceful period in 1977 and 1978 to estimate the 1977 GDP. Chalak (1982) estimated for the World Bank the national accounts for the years 1978–80. No GDP estimation, based on primary data, was attempted during the 1980s until this author's estimate for the year 1987, which was followed by a UNDP estimate for 1988.<sup>3</sup>

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<sup>1</sup> See Badre, 1959, 1972.

<sup>2</sup> See, on the above, République Libanaise, from c. 1967 to c. 1974.

<sup>3</sup> See CDR, 1979, and Gaspard, 1990.

The central statistical agency was reorganized as the Administration Centrale de la Statistique (ACS) in the early 1990s. Work has restarted with GDP estimates and input-output tables for 1994 and 1995, along the same methodological lines adopted by the DCS in the 1960s and 1970s. In addition, family budget and manpower surveys covering all Lebanon were undertaken for the year 1997. In May 2003, the Prime Minister announced updated national accounts for the base year 1997, which adjusted 1997 GDP upward by 5.4 percent. We have applied the same adjustment rate of 5.4 percent to all the previous GDP estimates since 1992.<sup>4</sup>

### *Methods and sources*

The DCS methodology is derived, though not fully, from the UN's 1968 System of National Accounts (SNA68). Professor Badre's methodology for the accounts of 1948–50, though not fully detailed, is consistent with that of the DCS.

The DCS methodology is based on SNA68 and roughly uses the same approach and structure of accounts. However, it differs from it in two important respects:

a) DCS uses the concept of “territoriality” rather than residence: transactions are recorded according to their place of occurrence. The main implication of this approach is that the expenditures of tourists and foreign embassies, “non-residents” according to SNA68, are recorded by DCS respectively as consumption and as wages and salaries accruing to residents. SNA68 would record these expenditures as export proceeds. As a result, consumption was in 1964 approximately 10 percent higher than it would have been under the SNA68 approach. However, understandably, the overall effect on GDP is small, only about 1 percent, since it affects the allocation of expenditures within GDP more than the level itself. On the other hand, the national income and the Gross National Product (GNP) are identical in the two approaches.

Badre adopted an approach similar to that of DCS.

b) The more important difference between SNA68, on the one hand, and DCS and Badre, on the other, is the treatment of value

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<sup>4</sup> See République Libanaise, 1997, 1998a, 1998b and 2003.

added by financial services. DCS considers financial activity as any other activity, with net interest income and commissions treated as gross output, whereas SNA68 recognizes as output only services with explicit charges paid, thus eliminating the largest source of income, net interest, from financial value added. This approach is clearly inadequate for economies with a relatively important financial sector. The treatment of financial activity in the new SNA93, however, is compatible with the DCS methodology.

The two benchmark estimates, for 1950 and 1964, were based on sample surveys, though the official 1964 national accounts were much more detailed and provided a social accounting matrix, including an  $8 \times 8$  activity input-output matrix and an  $11 \times 7$  import matrix. Both estimates, however, suffer from relatively less reliable data on agriculture, and more so in the case of the 1950 estimate by Badre.

#### *Updating the national account series*

Though Badre's original estimates were for the years 1948–50, it is 1950 that he and others have used as a reference year. The 1950 estimate was of national income, or net national product at factor cost. Badre later frequently adjusted the 1950 estimate upwards until the year 1958, though the estimates for 1957 and 1958 were presented as provisional. Others used his estimates for further updates until 1962. The UN, citing private sources, provided a different series for 1957–1962, which was about 15 to 20 percent higher than Badre's, but these estimates were again frequently updated, particularly for later years in the series. To add to the confusion, the World Bank has published a GDP/GNP series for 1950–1964 where the 1950 estimate is about 50 percent higher than Badre's. The basis of the World Bank series is not specified.<sup>5</sup>

The official DCS series was regularly published for the years 1964–1973. After 1964, updates were based on sample surveys and foreign trade statistics. When the activities of the DCS were disrupted by the war in 1975, semi-official updates were undertaken for the years 1974–1976 by staff members of DCS, and these estimates were

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<sup>5</sup> See, on the above, Khalaf, 1971, p. 237n; UN, 1960, 1964, 1966, 1968; World Bank, 1976, p. 146.



adopted by international organizations such as UNDP/FAO, IMF, etc. An official CDR (1979) study produced 1977 national accounts estimates, based on a sample of more than 17,000 export and import declarations. A UN/World Bank (?) commissioned study by Chalak (1983) provided the estimates for 1978–1980. The IMF Economic Information System publishes estimates for 1981 and 1982 without specifying the source or basis of its estimation, though they are likely to be updates of Chalak's estimates. This author (1990) estimated GDP for 1987, based on limited sample observations by economic activity and expenditure group, and on foreign trade data and a family budget survey for Beirut in 1985–86. This was followed by a UNDP estimate of GDP in 1988, based on the same methodology as for 1987. The intense warring period of 1989–90 disrupted all further national accounts estimation efforts until the official dissemination by the new national statistical agency of a new GDP series, starting with the years 1994 and 1995. Based on the detailed accounts for these years, the authorities have only disseminated GDP estimates for each year from 1989 until 2002. In May 2003, detailed national accounts for the base year 1997 were disseminated, prepared with the assistance of the national statistical agency INSEE of France.

This book will use the national accounts estimates mentioned above, including the new official series since 1989. The GDP for each year since 1992 has been uniformly adjusted upwards by 5.4 percent, the rate of adjustment for the year 1997, which keeps unchanged output structure and the growth pattern since 1992.

For the period prior to 1964, Badre's original estimates for 1948–50 are maintained. However, as explained below, the estimates for 1951–58 are in need of adjustment.

#### *Adjusting the national account series 1950–1964*

The official national accounts series for 1964–74, and Badre's series for 1948–58, are generally consistent in terms of methodology. Badre, however, disregards income from triangular trade, which he recognizes as an important source of revenue in view of the widespread and traditional role that is played by Lebanese businessmen in this domain. This introduces a downward bias and an element of inconsistency with the 1964 official series, although the latter also has excluded some services from its estimates, e.g. consultancy.

Badre's updates until 1958 revealed a significant underestimation in the level, though not necessarily the growth pattern, of national income. However, the period 1950–57 was acknowledged by observers and in the relevant economic literature as a period of significant growth.<sup>6</sup> A striking example is the 1950–52 period, particularly the year 1951, which is represented in the series with falling output whereas it was distinguished by intensive economic activity owing to the Korean war boom. Moreover, in light of the official and more reliable 1964 national accounts, Badre's estimates implied unrealistic annual growth rates exceeding 20 percent in the early 1960s.<sup>7</sup>

One major reason for the underestimation may be Badre's use of the wholesale price index (WPI) as a deflator rather than the consumer price index (CPI). The WPI increased by an unlikely 6 percent during the period 1950–64, against 30 percent for the CPI during the same period. As explained in Appendix IV, the WPI reference basket of commodities became dated and unrepresentative since it included commodities such as wood for heating and silk-worm cocoons!

To address these problems, we shall adjust the 1948–63 series based on the following principles. The original benchmark estimates for 1950 and 1964 are kept unchanged, mainly because they are original estimates that were based on primary data generated by extensive surveys of all activities. Importantly, this approach will not significantly affect average growth during 1950–64, only its pattern for some intermediate years. For practical purposes, three separate periods are distinguished, and adjustments made moving backward from the year 1964. The adjustments are made using, first, Badre's estimates of national income at factor cost. The adjusted values then are converted to current values of GDP at market prices (see the next section on this).

#### a) 1961–1964

To address the issue of linking his updated estimates to the new 1964 series, Badre has advanced an estimate for the 1961 real national income, which, converted to current value by using the CPI rather

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<sup>6</sup> See, for example, Medawar, 1963, UN, 1955, and Yaffi, 1958.

<sup>7</sup> Badre, 1972, p. 179.

than the WPI index, gives a nominal value of LL 2,162 million. This adjusted estimate is adopted since it links well with the 1964 GDP, implying an annual growth of 7.7 percent in a notably expansionary period.<sup>8</sup> Using real national income estimates, we assume the same average rate of growth for each year between 1961 and 1964.

b) *1957–1961*

The period 1957–1959 was quite cyclical since major political and civil disturbances took place in 1958 over a period of several months, ending with the landing of US troops in Lebanon, who stayed only for a few months. Output in 1958 has been estimated in the Badre series to fall by about 13 percent, which we adopt. The period 1959–61 is noted for exhibiting strong growth following the beginning in late 1958 of the developmental Chehab regime. Lost output in 1958 was rapidly compensated, and Badre estimated that growth in the year 1959 “. . . was at least some 15 percent . . .” relatively to 1957, implying a typical average growth of about 7 percent for the period. An average annual growth of 7 percent is therefore assumed for the period 1957–61, excluding 1958 when output is estimated to have fallen by 13 percent.<sup>9</sup>

c) *1950–1957*

Badre’s estimated pattern of growth seems adequate for the period 1953–57, which he shows to be one of a continuously decelerating growth from more than 20 percent in 1953 to less than one percent in 1957. This is in line with the description of the period as one of business failures, following the end of Korean war in the summer of 1953.<sup>10</sup> The series, however, is distorted by an estimated 16 percent fall in output in 1951, at the height of the Korean boom. Adjustments therefore have been made to the 1951–1953 estimates, with some further adjustments to the estimates for the 1954–56 estimates in order to preserve Badre’s original pattern of growth.

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<sup>8</sup> See Badre, 1972.

<sup>9</sup> *Ibid.*, pp. 179–81.

<sup>10</sup> See Medawar, 1963 and Yaffi, 1958.

## d) 1945–1950

Badre's original estimates for 1948–50 are maintained. This implies an average annual growth rate of a little less than 15 percent between 1948 and 1950. This is not unlikely as the displacement of Palestinians since 1948, following the creation of the state of Israel, resulted in a significant influx of capital to Lebanon and the diversion of much Arab trade to the port of Beirut. To illustrate, real cash balances have increased by about a third between 1948 and 1950.<sup>11</sup> Growth during the period, however, is equally distributed between the years rather than attempt a separate estimate for each year.

The estimate of LL 700 million for 1945 is approximate and is based on Syria's national income in 1945 of 787 million Syrian pounds. Syria and Lebanon then had the same currency, and Lebanon's national income was 10 to 15 percent lower than Syria's in the early 1950's.<sup>12</sup> Based on this information, Lebanon's national income in 1945 is assumed to have been approximately LL 700 million.

Table A.III.1 shows the original and the adjusted estimates and growth rates for Lebanon during 1945–64.

Table A.III.1 *National income (NI) original and adjusted estimates*  
(In current LL millions and %)

<i>Year</i>	<i>Badre's NI series</i>	<i>Growth (%)</i>	<i>Adjusted NI series</i>	<i>Adjusted Growth (%)</i>
1945			~ 700	
1948	919		919	
1949	932	23.7	932	6.0
1950	1,042	20.5	1,042	23.6
1951	1,086	-15.9	1,221	8.0
1952	1,115	9.6	1,327	9.0
1953	1,168	18.1	1,328	7.0
1954	1,256	16.5	1,341	6.0
1955	1,374	8.3	1,403	3.0
1956	1,467	1.5	1,491	0.5
1957	1,503	0.5	1,593	0.2
1958	1,325	-12.7	1,448	-13.0

<sup>11</sup> Medawar, *Ibid.*, pp. 124–125.

<sup>12</sup> See Al-Sibai, 1967, p. 287, and UN, 1960, p. 48.

Table A.III.1 (cont.)

<i>Year</i>	<i>Badre's NI series</i>	<i>Growth (%)</i>	<i>Adjusted NI series</i>	<i>Adjusted Growth (%)</i>
1959			1,844	22.9
1960			2,036	7.0
1961			2,162	7.0
1962			2,366	7.6
1963			2,596	7.7
1964			2,861	7.7

*Sources:* Badre/FAO, 1959, pp. II-13; Badre, 1972, p. 179; Medawar, 1963, p. 142; Appendix IV.

*Notes:* Badre's growth rates are based on deflation by the WPI. The adjusted growth rates are based on deflation by the CPI, at constant 1966 LL prices (see Appendix IV for the price indices).

Note that the original Badre estimates for 1948-50 and the first official estimate in 1964 are kept unchanged. The resulting average annual rate of growth of the adjusted national income series during 1950-64 is 5.5 percent (and 6.6 percent during 1948-64). This is compared to Badre's estimate that growth ranged between 6 and 8 percent during the same period. The difference between the two estimates is mainly due to our use of the CPI rather than the WPI as a deflator. Using the WPI as a deflator for the adjusted series would have resulted in an average annual growth rate of 7 percent.

#### *Calculating the national account components*

Until 1964, most national account estimates used the concept of net national product at current factor cost. The 1957-1959 UN series was for GNP at current market prices. The official 1964 series used all national account concepts, with emphasis on GDP at current market prices. The establishment of a series of national account components requires a series on depreciation, indirect taxes, operating subsidies and net factor income from abroad. These have been derived for 1945-80 in the following manner:

a) *Depreciation*

The SNA68 method recommends the calculation of depreciation at replacement cost. Badre uses the historical cost data supplied by respondents to his survey. However, prices overall were falling during 1945–54, with the CPI falling by about a third. During the same time, the export unit values of industrial countries, who were the major exporters of equipment to Lebanon, were practically stable, which makes Badre's depreciation rate more at replacement than historical cost.<sup>13</sup> The depreciation amounts for 1950–1957 are derived from Badre (1972), where the depreciation rates are about 7 percent of national income. We apply the same rate to the adjusted estimates of national income since 1945. Given the estimated depreciation value in the official 1964 series, depreciation for 1957–1964 is obtained through a uniform compound rate.

The 1964–1977 official depreciation series is based on a method for calculating depreciation at replacement value according to the formula:

$$A = I [a/(a+t)]$$

where (A) is the amount of depreciation during a given year, (I) is gross investment, (a) is the rate of depreciation and (t) is the average rate of growth of investment in previous years. Various hypotheses concerning (a) and (t) lead to various close estimates of (A).<sup>14</sup>

Chalak (1983) also uses a similar method and arrives at estimates for the period 1974–1980.

b) *Indirect taxes*

Data on tax receipts prior to 1964 usually refer to receipts in the Ordinary Budget, thus omitting other tax receipts in separate annexes for budgets of autonomous government institutions. Therefore, some minor upward adjustments have been effected on published data for the period prior to 1964 in order to obtain a series for total indirect taxes, using various sources that provide detailed data. The data

<sup>13</sup> See IMF, IFS Yearbook, 1979, p. 70.

<sup>14</sup> See République Libanaise, Vol. 2, c. 1967, p. 59 for the methodology, and République Libanaise, Les Comptes Economiques, various issues, or UNDP/FAO, 1980, p. 19 for the estimates.

on indirect taxes for 1964–1973 are directly provided. However, for the period 1974–1980, only indirect taxes net of operating subsidies are reported.<sup>15</sup>

c) *Operating subsidies*

The operating subsidies in the official 1964 series mostly represent subsidies to government schools, hospitals and dispensaries. They are classified as a subsidy to education and health services. These subsidies amounted in the 1960s to about 90 percent of the budget of the Ministry of Education, and about 60 percent of the budget of Ministry of Health. We assume that these ratios remained unchanged during the period 1948–1964. Note that errors of estimation of indirect taxes and operating subsidies may cancel to some extent in the process of netting out. The sources of the data are the same as those for indirect taxes.

d) *Net factor income from abroad*

Net factor income from abroad should record the net income that accrues to resident factors of production from the rest of the world. Empirically, this is equal to net income from real and financial assets, including the remittances of those considered resident labor but who are temporarily working abroad. The last item is a major source of difficulty since it practically is impossible to determine whether labor working abroad is strictly resident or non-resident. Therefore, it has been very difficult to separate remittances between factor income and transfers.

Lebanon has always known important migratory flows. More than 100,000 Palestinian refugees poured into the country in 1948 and thousands of other Arabs, particularly Syrians, settled in Lebanon in the 1950s for varying periods. Moreover, thousands of Lebanese nationals emigrated overseas, maintaining a flow of transfers into Lebanon. Others worked more or less permanently in the Arab Gulf

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<sup>15</sup> The sources for direct taxes are, respectively, Askari et al., 1982, p. 153; République Libanaise, 1966, pp. 244–249; UN, 1955, p. 173; World Bank, 1967, Tables 10, 12 and 13. For indirect taxes, they are Chalak, 1983, p. 25; République Libanaise, Les Comptes Economiques, various issues; UNDP/FAO, 1980, p. 17.

countries, sending remittances that are at the borderline between factor income and transfers. The earliest balance of payments (BOP) detailed survey for the years 1951 and 1952, and subsequent more extensive ones during 1961–67, sidestepped the issue by amalgamating the remittances and transfers of workers and emigrants under short-term capital transfers in the capital account of the BOP, rather than in the current account of goods and services.<sup>16</sup>

Another difficulty stems from differences in estimates between the national accounts and BOP series. For instance, net factor income in 1967 is LL 141 million in the national account series and LL 188 million in the BOP survey. The difference may be explained, at least in part, by the two different methodologies used. As noted above, the national account series adopts the “territoriality” concept whereby embassies and international organizations are treated as resident producers and consumers of goods and services. However, factor incomes paid by these institutions amounted only to 1 percent of GDP in 1964.<sup>17</sup>

These issues are addressed as follows for the period 1948–64. The average annual rate of increase of factor income from wages and salaries, which was about 10 percent during 1964–1972, is used for the period 1948–64. The resulting estimates, which compare very well with those in the BOP surveys mentioned above, are then added to estimates of investment income, which are in Khalaf, N. (1971). We assume no factor income earnings in 1945.

The estimates for 1964–1973 were published as part of the official national accounts estimates and in UNDP/FAO (1980). However, the component amounts, wages and salaries and investment income, which are detailed in the separate external accounts, exceed by about 17 percent the reported total net factor income. This is addressed by proportionally adjusting the component amounts for the difference without changing the reported totals in the national account series.<sup>18</sup>

The only detailed estimates for the period 1974–1980 are in Chalak’s (1983) study of Lebanon’s national accounts for 1978–1980. Chalak elaborates on his method for calculating the separate com-

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<sup>16</sup> See Fei and Klat, c. 1954; Badre/FAO, 1959; Salem, 1964 and c. 1966, Medawar, 1969.

<sup>17</sup> See République Libanaise, Vol. 1, c. 1967, pp. 77, 107.

<sup>18</sup> See République Libanaise, c. 1974, pp. 10–11 and 22–23.



ponents of net factor income and explicitly distinguishes them from transfers. He adopts the SNA68 methodology, which partly explains the fact that net factor income more than doubles in 1974 (LL 520 million) relatively to 1973 (LL 250 million). Chalak's estimates are substantially higher than estimates for preceding years. Nonetheless, they will be adopted in view of a strong increase in various kinds of transfers into Lebanon since the beginning of the war in 1975.

Table A.III.2 *National account components*  
(At current market prices, LL millions)

<i>Year</i>	<i>National income</i>	<i>Depreciation</i>	<i>Indirect taxes</i>	<i>Operating subsidies</i>	<i>Net indirect taxes</i>	<i>Net factor income from abroad</i>		
						<i>Total</i>	<i>Wages &amp; sal.</i>	<i>Invest. income</i>
1945	700	49	50	3	47			
1948	919	64	57	7	50	13	12	1
1949	932	65	61	9	52	15	13	2
1950	1,042	73	57	10	47	17	14	3
1951	1,221	85	74	11	63	20	16	4
1952	1,327	93	84	12	72	25	18	7
1953	1,328	93	102	14	88	37	19	18
1954	1,341	94	125	14	111	44	21	23
1955	1,403	98	143	17	126	62	23	39
1956	1,491	104	162	20	142	38	26	12
1957	1,593	112	190	24	166	89	28	61
1958	1,448	121	180	27	153	70	31	39
1959	1,844	131	194	30	164	77	34	43
1960	2,036	142	210	33	177	93	38	55
1961	2,162	153	233	44	189	115	41	74
1962	2,366	166	253	55	198	113	45	68
1963	2,596	179	293	58	235	118	50	68
1964	2,861	194	316	62	254	109	46	63
1965	3,154	213	355	83	272	113	51	62
1966	3,460	235	385	85	300	128	50	78
1967	3,443	251	354	87	267	141	62	79
1968	3,862	264	400	97	303	155	70	85
1969	4,112	270	449	107	342	160	74	86
1970	4,411	275	464	120	344	165	81	84
1971	4,903	280	548	136	412	196	91	105
1972	5,796	310	632	143	489	230	109	121
1973	6,461	330	722	160	562	250	119	131
1974	7,496	370			791	520	90	430
1975	7,159	440			541	640	150	490
1976	4,330	460			50	740	200	540
1977	8,061	460			679	1,000	230	770
1978	8,590	580			600	1,290	280	1,010
1979	12,191	580			639	1,790	340	1,450
1980	15,580	700			620	2,510	400	2,110

Table A.III.2 (cont.)

Year	National income	Depreciation	Indirect Taxes	Operating Subsidies	Net indirect Taxes	Net factor income		
						Total	From abroad Wages&sal.	Invest. income
1987			37,082	59,107	22,025			
<i>LL billions</i>								
1997	20,647	1,572			2,580	691		

Sources: Table A.III.1; Chalak, 1983; Gaspard, 1990; République Libanaise, 2003, and Les Comptes Economiques, various issues; République Libanaise, Statistiques Libanaises, various issues, and 2003.

Table A.III.3 *The national accounts of Lebanon*  
(At current prices; LL millions until 1987, LL billions thereafter)

Year	GDP		GNP		National income factor cost
	market prices	factor cost	market prices	factor cost	
1945	796	749	796	749	700
1948	1,020	970	1,033	983	919
1949	1,034	982	1,049	997	932
1950	1,145	1,098	1,162	1,115	1,042
1951	1,349	1,286	1,369	1,306	1,221
1952	1,467	1,395	1,492	1,420	1,327
1953	1,472	1,384	1,509	1,421	1,328
1954	1,502	1,391	1,546	1,435	1,341
1955	1,565	1,439	1,627	1,501	1,403
1956	1,699	1,557	1,737	1,595	1,491
1957	1,782	1,616	1,871	1,705	1,593
1958	1,652	1,499	1,722	1,569	1,448
1959	2,062	1,898	2,139	1,975	1,844
1960	2,262	2,085	2,355	2,178	2,036
1961	2,389	2,200	2,504	2,315	2,162
1962	2,617	2,419	2,730	2,532	2,366
1963	2,892	2,657	3,010	2,775	2,596
1964	3,200	2,946	3,309	3,055	2,861
1965	3,526	3,254	3,639	3,367	3,154
1966	3,867	3,567	3,995	3,695	3,460
1967	3,820	3,553	3,961	3,694	3,443
1968	4,274	3,971	4,429	4,126	3,862
1969	4,564	4,222	4,724	4,382	4,112
1970	4,865	4,521	5,030	4,686	4,411
1971	5,399	4,987	5,595	5,183	4,903

Table A.III.3 (*cont.*)

Year	GDP	GDP	GNP	GNP	National income
	<i>market prices</i>	<i>factor cost</i>	<i>market prices</i>	<i>factor cost</i>	<i>factor cost</i>
1972	6,365	5,876	6,595	6,106	5,796
1973	7,103	6,541	7,353	6,791	6,461
1974	8,137	7,346	8,657	7,866	7,496
1975	7,500	6,959	8,140	7,599	7,159
1976	4,100	4,050	4,840	4,790	4,330
1977	8,200	7,521	9,200	8,521	8,061
1978	8,480	7,880	9,770	9,170	8,590
1979	11,620	10,981	13,410	12,771	12,191
1980	14,390	13,770	16,900	16,280	15,580
1987	740,743	762,768			
<i>LL billions</i>					
1990	1,973				
1991	4,132				
1992	10,009				
1993	13,826				
1994	16,126				
1995	18,996				
1996	21,513				
1997	24,108	21,528	24,799	22,219	20,647
1998	25,824				
1999	26,148				
2000	26,148				
2001	26,540				
2002	27,532				

Sources: See Table A.III.2.

Table A.III.4 *The national accounts of Lebanon*  
(At constant 1972-74 prices, LL millions)

Year	GDP	GDP	GNP	GNP	National income
	<i>market prices</i>	<i>factor cost</i>	<i>market prices</i>	<i>factor cost</i>	<i>factor cost</i>
1945	951	895	951	895	836
1948	1,501	1,427	1,520	1,446	1,352
1949	1,589	1,510	1,613	1,533	1,433
1950	1,946	1,866	1,975	1,895	1,771

Table A.III.4 (cont.)

Year	GDP	GDP	GNP	GNP	National
	<i>market prices</i>	<i>factor cost</i>	<i>market prices</i>	<i>factor cost</i>	<i>income factor cost</i>
1951	2,113	2,014	2,144	2,046	1,913
1952	2,304	2,191	2,343	2,230	2,084
1953	2,471	2,324	2,533	2,386	2,230
1954	2,647	2,452	2,725	2,529	2,363
1955	2,716	2,497	2,823	2,605	2,435
1956	2,788	2,555	2,851	2,617	2,447
1957	2,743	2,487	2,880	2,624	2,452
1958	2,434	2,208	2,537	2,312	2,133
1959	2,933	2,700	3,043	2,809	2,623
1960	3,117	2,874	3,246	3,002	2,806
1961	3,318	3,056	3,478	3,216	3,003
1962	3,575	3,304	3,729	3,459	3,232
1963	3,878	3,563	4,036	3,721	3,481
1964	4,191	3,858	4,334	4,001	3,747
1965	4,485	4,139	4,629	4,283	4,012
1966	4,791	4,420	4,950	4,578	4,287
1967	4,564	4,245	4,733	4,414	4,114
1968	5,141	4,777	5,328	4,963	4,646
1969	5,251	4,857	5,435	5,041	4,731
1970	5,597	5,201	5,787	5,391	5,074
1971	6,115	5,648	6,337	5,870	5,553
1972	6,870	6,342	7,118	6,590	6,255
1973	7,231	6,659	7,486	6,914	6,578
1974	7,457	6,732	7,933	7,209	6,869
1975	6,253	5,802	6,787	6,336	5,969
1976	2,653	2,620	3,131	3,099	2,801
1977	4,413	4,048	4,952	4,586	4,339
1978	4,143	3,850	4,773	4,480	4,197
1979	4,606	4,352	5,315	5,062	4,832
1980	4,729	4,525	5,554	5,350	5,120
1987	7,812	8,045			
1990	2,807				
1991	3,917				
1992	4,749				
1993	5,260				
1994	5,681				
1995	6,051				
1996	6,292				
1997	6,547	5,847	6,735	6,034	5,608

Table A.III.4 (*cont.*)

Year	GDP	GDP	GNP	GNP	National
	<i>market prices</i>	<i>factor cost</i>	<i>market prices</i>	<i>factor cost</i>	<i>income factor cost</i>
1998	6,711				
1999	6,782				
2000	6,809				
2001	6,911				
2002	7,029				

Sources: Table A.III.3, and Table A.IV.3 for the CPI deflator.

Table A.III.5 *The national accounts of Lebanon, an index series*  
(At constant 1972-74 prices, 1972-74 = 100)

Year	GDP	GDP	GNP	GNP	National
	<i>market prices</i>	<i>factor cost</i>	<i>market prices</i>	<i>factor cost</i>	<i>income factor cost</i>
1945	13	14	13	13	13
1948	21	22	20	21	21
1949	22	23	21	22	22
1950	27	28	26	27	27
1951	29	31	29	30	29
1952	32	33	31	32	32
1953	34	35	34	35	34
1954	37	37	36	37	36
1955	38	38	38	38	37
1956	39	39	38	38	37
1957	38	38	38	38	37
1958	34	34	34	33	32
1959	41	41	41	41	40
1960	43	44	43	43	43
1961	46	46	46	47	46
1962	50	50	50	50	49
1963	54	54	54	54	53
1964	58	59	58	58	57
1965	62	63	62	62	61
1966	67	67	66	66	65
1967	64	65	63	64	63
1968	72	73	71	72	71
1969	73	74	72	73	72
1970	78	79	77	78	77
1971	85	86	84	85	85

Table A.III.5 (cont.)

Year	GDP		GNP		National income factor cost
	<i>market prices</i>	<i>factor cost</i>	<i>market prices</i>	<i>factor cost</i>	
1972	96	96	95	95	95
1973	101	101	100	100	100
1974	104	102	106	104	105
1975	87	88	90	92	91
1976	37	40	42	45	43
1977	61	62	66	66	66
1978	58	59	64	65	64
1979	64	66	71	73	74
1980	66	69	74	77	78
1987	109	122			
1990	39				
1991	55				
1992	66				
1993	73				
1994	79				
1995	84				
1996	88				
1997	91	89	90	87	85
1998	93				
1999	94				
2000	95				
2001	96				
2002	98				

Sources: See Table A.III.4.

### *Capital stock*

The national accounts do not include capital stock estimates. However, Chalak (1983) has estimated capital stock values for the years 1973-80, based on the following equation:

$$K_{n-1} = (K_{n-1} - R_n) I_n + (V_n - D_n)$$

where:

K = capital stock in year n

R = unpredictable wear or loss (assumed to be nil in normal years)

I = ratio of investment-good prices over the previous year's  
 V = gross investment  
 D = depreciation

We provide K stock estimates for the period 1948–74. First, Chalak's K stock in 1974 of LL 16,400 million is adjusted for old unaccounted-for construction. Then, for 1948–63, when no investment series is available, investment is estimated at 18.5% of GDP for the period 1948–58 and 23% of GDP for the period 1959–63, which is in line with the substantial increase in investment during the Chehab era.

The official manpower survey for 1970 (PAL70) found that around 70% of residential construction standing in 1970 had been built since the mid-1940s. Since construction then represented around 60 percent of total investment, the adjustment for construction in 1970 then is about 26% [= (30% : 70%) × 0.6]. Applied to 1974, we estimate the adjustment to K stock to become 22%. Thus, the UN's estimate of 1970 capital at LL 16,400 is adjusted to around LL 20,000 million. The capital series is then estimated backwards to 1948, according to the above equation.

For the period 1964–73, the capital series is deflated by the UN's investment price deflator for Lebanon while the CPI is used for the period 1948–63.<sup>19</sup> The price deflator for the year 1974 is an estimate, based on trend and producer prices in industrial countries.

Table A.III.6 *Capital and the capital-output ratio*  
 (In current LL millions, unless otherwise indicated)

	<i>GDP</i>	<i>Investment</i>	<i>Capital</i>	<i>Capital-output ratio</i>	$P_t$ (1972–74 = 100)	<i>Capital ratio</i> (1972–74 prices)
1948	1,020	189	2,666	2.6	68.0	3,923
1949	1,034	191	2,678	2.6	65.1	4,117
1950	1,145	212	2,561	2.2	58.8	4,353
1951	1,349	250	2,944	2.2	63.8	4,611
1952	1,467	271	3,115	2.1	63.7	4,891
1953	1,472	272	3,093	2.1	59.6	5,192
1954	1,502	278	3,130	2.1	56.7	5,516
1955	1,565	290	3,370	2.2	57.6	5,848
1956	1,699	314	3,774	2.2	60.9	6,194
1957	1,782	330	4,242	2.4	65.0	6,529
1958	1,652	306	4,616	2.8	67.9	6,801

<sup>19</sup> See UNDP/FAO, 1980, p. 36.

Table A.III.6 (cont.)

	<i>GDP</i>	<i>Investment</i>	<i>Capital</i>	<i>Capital-output</i>	$P_I$	<i>Capital</i>
				<i>ratio</i>	(1972-74 = 100)	(1972-74 prices)
1959	2,062	474	5,124	2.5	70.3	7,289
1960	2,262	520	5,667	2.5	72.6	7,810
1961	2,389	549	6,019	2.5	72.0	8,361
1962	2,617	602	6,556	2.5	73.2	8,956
1963	2,892	665	7,165	2.5	74.6	9,608
1964	3,200	705	7,684	2.4	74.7	10,293
1965	3,526	793	8,264	2.3	74.7	11,070
1966	3,867	933	9,114	2.4	76.0	11,988
1967	3,820	770	9,809	2.6	77.5	12,657
1968	4,274	775	10,563	2.5	79.4	13,301
1969	4,564	882	11,772	2.6	83.9	14,030
1970	4,865	905	13,482	2.8	91.6	14,718
1971	5,399	1,069	14,622	2.7	94.0	15,557
1972	6,365	1,297	15,951	2.5	96.2	16,584
1973	7,103	1,465	17,541	2.5	98.9	17,731
1974	8,137	1,781	20,008	2.5	104.9	19,076

Sources: CERMOC, 1978; Chalak, 1983; UNDP/FAO, 1980; Table A.III.3.



Table A.III.7 *Value added and employment by manufacturing branch*  
(In establishments with 5 workers or more; in %)

<i>Manufacturing branch</i>	<i>Value added</i>						<i>Employment</i>					
	1955	1964	1970	1985	1998	1998 <i>All establ.</i>	1955	1964	1970	1985	1998	1998 <i>All establ.</i>
Food, beverages, tobacco	41.6	32.4	25.6	28.0	28.7	26.1	27.0	22.9	23.1	23.8	28.1	25.2
Textiles	10.2	7.7	20.0	22.7	2.3	2.4	17.7	11.7	27.7	21.9	3.1	3.2
Apparel	6.0	7.1	↓	↓	4.9	5.3	10.6	10.1	↓	↓	9.7	9.3
Leather & leather products	2.0	2.5	↓	↓	2.2	2.6	2.7	2.5	↓	↓	6.0	5.7
Wood products except furniture	1.4	2.5	7.0	7.9	1.5	3.1	2.2	4.4	10.6	13.6	2.7	6.1
Furniture	4.5	5.6	↓	↓	5.6	7.9	7.7	8.7	↓	↓	7.9	8.4
Paper & paper products	0.5	1.7	7.4	7.6	4.6	3.8	0.6	1.4	8.0	6.6	3.8	2.6
Printed & recorded matter	3.7	8.1	↓	↓	5.0	4.7	4.9	8.5	↓	↓	4.5	4.2
Rubber & plastic products	0.9	0.4	10.1	5.5	3.6	3.4	1.5	0.6	5.5	6.0	3.0	2.4
Chemical products	6.3	8.6	↓	↓	6.9	6.1	4.0	4.9	↓	↓	3.5	2.7
Non-metallic mineral products	15.0	13.7	16.9	9.7	15.9	15.4	10.5	12.8	10.9	12.4	11.9	11.7
Basic metals	0.1	1.3	12.2	2.1	2.1	1.7	0.1	2.0	1.2	2.4	0.6	0.4
Metal products	4.7	6.1	↓	15.9	10.3	10.9	6.2	6.7	11.9	11.6	9.2	12.7
Machinery and equipment	1.5	1.3	↓	↓	5.5	5.2	2.2	1.6	↓	↓	4.9	4.1
Other (mostly jewelry)	1.6	1.0	0.9	0.7	1.0	1.4	2.1	1.2	1.1	1.6	1.0	1.3
Total	100	100	100	100	100	100	100	100	100	100	100	100
Index, 1972–74 prices (1970 = 100)	50	77	100	146	100		63	82	100	142	152	

*Sources:* CERMOC, 1978; Chami, 1981; MAAS, 1987; Republic of Lebanon, 1957; République Libanaise, c. 1966, c. 1971, c. 1972a, 2000.

*Notes:* a- Employment consists of the regular salaried workers, including working owners and family members. b- Apparel includes footwear. c- Chemical products include petroleum and coal products. d- Value added is at constant (1972–74) prices.

## APPENDIX FOUR

### PRICE INDICES AND DEFLATORS

Only two official price indices have been compiled and disseminated between 1939 and 1974, a wholesale price index (WPI) and a retail or consumer price index (CPI).

The first consumer price index was established by the Ministry of National Economy and had June-August 1939 as a reference period. It consisted of 97 articles, divided into five categories: food, housing and water, lighting and heating, clothing and other (see Table A.IV.3 below for the weights). Prices were collected twice a week, and the weights were determined by the budget expenditure of a five-member family, including a housemaid, living in Beirut with a monthly income of LL 100. Clearly, the typical family in this index was at least in the middle-income category, as opposed to the low-income household that was to be selected for the 1966 CPI index. The index was discontinued in 1961. Between 1961 and 1966, the index was updated by the UN for the period 1960–64 and by the Central Directorate of Statistics for 1964–66.

A new CPI was compiled for 1966, based on an extensive family budget survey that was carried out in Beirut. The index comprised 238 articles that were divided into four general categories: food, clothing, housing and other (see Table A.IV.3 below for the weights). The weights were based on the expenditures of a low-income family with an annual income of less than LL 6,000 (then around \$1,900). A monthly CPI was disseminated every month until 1976. Since 1978, a private research institute, the Consultation and Research Institute (CRI), has been publishing the index, using the same weights with some minor changes to the commodity composition of consumption baskets. New updated weights for 1988 were produced by CRI, based on market surveys (see Notes in Table A.IV.4 below).

The earliest WPI series started in 1939, with an index for Beirut, and the Ministry of National Economy has published an index series for the period 1950–71. The index consisted of 91 articles, divided into six categories: food, raw materials, fuel, textiles, construction materials and other. Prices were collected twice a week. Weights

were determined by “consumption shares”, which were estimated from “a comparison of local production, importation and exportation of products”.<sup>1</sup> The index was discontinued in 1972.

ECWA of the UN estimated the WPI for the period 1970–74. However, the reliability of the index is questionable as it implies a negative rate of growth of around 6 percent per annum during the two years 1973 and 1974, which were characterized by a notable expansion in economic activity.<sup>2</sup>

Table A.IV.1 below shows the widely different growth patterns of the CPI and WPI.

Table A.IV.1 *CPI and WPI, 1945–1971*  
(Annual % increase)

	<i>CPI</i>	<i>WPI</i>
1945–1954	–4.3%	6.9%
1954–1959	4.3%	2.0%
1959–1965	2.0%	0.3%
1966–1971	1.8%	2.9%

Sources: See Tables A.IV.2 and A.IV.3.

The CPI suffers from three problems. First, it takes the lowest income group as a basis for calculating expenditure weights. Second, its rate of growth was smaller than that of the WPI during 1966–71, which is unlikely to occur over a number of years. Third, it assumes constant the prices of medical services, education, house repair and other services.

However, as a GDP deflator, the 1966 CPI is preferable to the WPI. First, the choice of the lowest income group as a representative group does not materially affect the CPI. In fact, the share of expenditure on food by the lowest income group is, at 43 percent, the highest among all income groups, and food prices have increased faster than the CPI general index. Thus, recalculating the general index for the period 1966–74, by taking the expenditure weights of the average income group, produces an insignificantly lower rate of inflation. Second, the WPI did become a dated index since it included

<sup>1</sup> République Libanaise, 1966, p. 186.

<sup>2</sup> UNDP/FAO, 1980, pp. 41, 43.

commodities such as wood for heating and silkworm cocoons. Third, the assumption of constant prices for some services does introduce a bias to the 1966 CPI index, especially since prices of services generally tend to increase more than prices of merchandise. Deflating the GDP series by the CPI leads to an average annual growth rate of around 6 percent during 1950–74, compared to a little less than 7 percent when deflating by the WPI.

The CPI-deflated GDP series therefore is more representative of economic developments in Lebanon than a WPI-deflated GDP series. Moreover, it is more appropriate to use a CPI as a deflator, rather than a WPI, in an economy where the GDP-share of consumption has exceeded 95 percent over the period 1950–74, and more than a 100 percent thereafter. In any event, adopting WPI as a deflator does not substantively affect our analysis or conclusions.

Of course, it would have been more appropriate to use an implicit deflator that is derived from price deflators for separate activities or expenditure categories. Only Chalak (1983), however, uses these price deflators for the period 1974–1980. His resulting implicit deflator is very close to the CPI for the whole period.

Table A.IV.2 *Wholesale price indices (WPI)*  
(1966 = 100)

	<i>Foodstuffs</i>	<i>Materials Raw</i>	<i>Materials Construct.</i>	<i>Fuels</i>	<i>Manufactures</i>	<i>Total</i>	<i>% Increase</i>
June 1939	11	19	13	19	8	15.4	
Dec. 1939	97	174	139	113	119	138.6	
1945	109	228	131	113	178	159.7	15.2
1946	103	183	89	107	154	136.7	-14.4
1947	97	122	73	93	121	122.6	-10.3
1948	92	106	78	90	100	119.5	-2.5
1949	90	103	76	86	98	98.0	-18.0
1950	90	102	75	85	97	90.9	-7.2
1951	111	146	91	83	134	112.7	24.0
1952	110	111	90	84	106	105.5	-6.5
1953	97	100	77	84	96	93.6	-11.2
1954	82	94	75	83	93	86.4	-7.8
1955	86	88	83	83	92	87.3	1.1
1956	95	88	84	87	94	91.8	5.2
1957	98	86	86	94	92	93.6	2.0
1958	99	86	84	98	92	94.5	1.0
1959	102	86	83	98	91	95.5	1.0
1960	102	88	75	99	87	93.6	-1.9
1961	104	89	75	99	87	94.5	1.0
1962	96	88	73	99	84	91.8	-2.9
1963	90	91	74	94	105	94.5	3.0

Table A.IV.2 (cont.)

	<i>Foodstuffs</i>	<i>Materials Raw</i>	<i>Materials Construct.</i>	<i>Fuels</i>	<i>Manufactures</i>	<i>Total</i>	<i>% Increase</i>
1964	99	90	74	97	109	96.4	1.9
1965	99	92	75	98	110	97.3	0.9
1966	100	100	100	100	100	100.0	2.8
1967	109	101	100	100	101	104.5	4.5
1968	105	104	99	103	101	103.6	-0.9
1969	110	110	109	105	110	109.1	5.3
1970	112	115	115	104	117	112.7	3.3
1971	119	117	115	104	115	115.5	2.4
1972	129	126	112	122	125	124.3	7.7
1973	150	147	131	143	145	144.9	16.5
1974	186	182	162	176	180	179.0	23.6
1975	206	202	179	195	199	198.3	10.8
1976	225	220	196	213	217	216.8	9.3
1977	268	263	234	254	259	258.6	19.3
1978	304	298	265	288	294	293.1	13.3
1979	372	364	324	353	360	358.5	22.3
1980	402	394	350	382	389	387.8	8.2

*Sources:*

*For 1939–1950:* Chambre de Commerce Française Au Levant, Bulletin, 1948, p. 163; Saba, E., 1961, p. 216; UN, 1955, p. 20.

*For 1950–1971:* République Libanaise, Recueil de Statistiques Libanaises, various issues.

*For 1972–1973:* Derived from individual commodity prices, listed in Recueil de Statistiques Libanaises, 1973, using weights from previous indices.

*For 1974–1980:* UNDP/FAO, 1980.

*Notes:* Total WPI is established by linking three consecutive series for 1939–1950, 1950–1971 and 1970–1989.

Table A.IV.3 *Consumer price indices (CPI)*  
(1972–74 = 100)

	<i>Food</i>	<i>Housing, Water</i>	<i>Lighting, Heating</i>	<i>Clothing</i>	<i>Sundry</i>	<i>Total</i>	<i>% Increase</i>
<i>Number of articles</i>	26	2	5	44	20	97	
1939	10	37	32	12	14	14	
1940							
1941							
1942							
1943	59	44	111	78	44	62	
1944	64	49	99	119	62	77	23.9
1945	71	48	93	127	69	84	8.4
1946	64	48	90	108	69	76	-8.9
1947	59	48	71	88	70	69	-9.5
1948	61	52	74	76	69	68	-1.6
1949	58	52	85	74	64	65	-4.2
1950	49	52	73	67	64	59	-9.6

Table A.IV.3 (cont.)

	<i>Food</i>	<i>Housing, Water</i>	<i>Lighting, Heating</i>	<i>Clothing</i>	<i>Sundry</i>	<i>Total</i>	<i>% Increase</i>
1951	55	55	73	73	66	64	8.5
1952	57	55	73	71	63	64	-0.2
1953	51	55	70	66	63	60	-6.5
1954	48	59	70	61	62	57	-4.7
1955	49	59	71	61	63	58	1.5
1956	54	68	74	61	63	61	5.9
1957	59	76	79	61	67	65	6.6
1958	60	85	86	61	73	68	4.4
1959	62	85	86	61	79	70	3.6
1960	64					73	3.2
1961	62					72	-0.8
1962	58					73	1.7
1963	61					75	1.9
1964						76	2.3
1965						79	3.0
1966	72	95		68	93	81	2.7
1967	77	96		65	95	84	3.7
1968	74	97		70	96	83	-0.7
1969	80	98		76	97	87	4.4
1970	80	98		78	97	87	0.0
1971	82	98		84	95	88	1.6
1972	89	99		89	96	93	4.9
1973	98	100		99	99	98	6.0
1974	113	101		112	105	109	11.1
1975						120	9.9
1976						155	28.9
1977	207	135		201	177	186	20.2
1978	211	151		257	213	205	10.2
1979	269	167		329	256	252	23.3
1980	330	190		395	306	304	20.6
1981	417	209		476	378	374	22.9
1982	484	243		535	511	448	19.8
1983	497	251		605	579	478	6.6
1984	589	275		644	716	560	17.4
1985	1,021	367		1,039	1,137	919	64.0
1986	2,160	708		2,303	2,136	1,883	104.9
1987	11,682	3,299		11,887	9,088	9,482	403.6
1988						24,179	155.0
1989						41,636	72.2
1990						70,281	68.8
1991						105,492	50.1
1992						210,773	99.8
1993						262,834	24.7
1994						283,860	8.0
1995						313,950	10.6
1996						341,891	8.9
1997						368,217	7.7
1998						384,786	4.5

Table A.IV.3 (cont.)

	<i>Food</i>	<i>Housing, Water</i>	<i>Lighting, Heating</i>	<i>Clothing</i>	<i>Sundry</i>	<i>Total</i>	<i>% Increase</i>
1999						385,556	0.2
2000						384,014	-0.4
2001						384,014	0.0
2002						391,694	2.0

*Sources:*

*For 1939–1960:* IRFED, vol. I, p. 84, Table No. 29.

*For 1960–1964:* Derived from UN, Selected Statistical Tables on the Middle East, 1965, Table VI-3 and République Libanaise, Bulletin Statistique Trimestriel, various issues.

*For 1964–1965:* Banque Du Liban, Rapport Annuel 1979–80.

*For 1966–1972:* République Libanaise, Recueil de Statistiques Libanaises, various issues.

*For 1973:* Partial indices only, The World Bank, 1975.

*For 1974–2002:* CRI and Banque du Liban, Rapport Annuel, various issues.

*Notes:* a- For 1960–63, the basis of estimation is expenditure by civil servants only. b- To link the 1960–64 and the 1964–1987 series, inflation in 1964 is assumed 2.3 percent, which is the average of the annual rates of inflation during 1961–63 (1.8 percent) and 1964–66 (2.8 percent). c- “Lighting and heating” has been included in “Housing” since the late 1950s. The weights are for the reference years 1939 and 1966. Their distributions are detailed in the table below.

Table A.IV.4 *Consumer price index (CPI) weights*

	<i>1939</i>	<i>c. 1959<sup>a</sup></i>	<i>1966</i>	<i>1988</i>	<i>1997</i>
<i>Coverage:</i>	Beirut	Beirut	Beirut	Beirut	Lebanon
<i>Income group:</i>	Middle	Low	Low	Low	Average
Food	37.8	46	42.8	58.5	33.9
Housing <sup>b</sup>	17.7	20	18.8	4.5	8.0
Utilities	4.8		4.9	3.8	7.3
Clothing	17.3	8	8.6	9.6	6.2
Health		6	7.2	7.0	8.6
Transportation		4	5.2	6.6	8.6
Education		10	3.9	2.0	13.1
Recreation			2.0	1.7	5.3
Miscellaneous	22.4	6	6.7	6.3	9.0
Total	100.0	100	100.0	100.0	100.0

*Sources:* See Table A.IV.3 above; CRI, 1989; IRFED, vol. II, p. 399; République Libanaise, 1998b.

*Notes:* a- The “c. 1959” distribution is from (IRFED, vol. 2, p. 400) and is derived from a Beirut “low income” household expenditure study by the official agency Conseil du Plan et du Développement Economique. The 1988 distribution is an attempt by CRI to update the weights following the serious monetary depreciation of the mid-1980s. b- Housing consists of rent, amortization, taxes, related durables, maintenance and repair. Utilities consist of water, energy, telephone and mail services. Health consists of medical services and medicine. Miscellaneous includes personal care, domestic help, tobacco (an average of 3 percent in 1966 and 1988), etc.

Table A.IV.5 *CPI comparative weights*  
1966/1997

	1966		1997	
	Beirut	Lebanon equiv.	Beirut	Lebanon
<i>Coverage:</i>	Average	Average	Average	Average
<i>Income group:</i>	Average	Average	Average	Average
Food	26.6	31.7	31.9	33.9
Housing	16.8	17.0	9.4	8.0
Utilities	3.2	3.6	6.7	7.3
Clothing	12.8	12.7	5.4	6.2
Health	6.1	6.8	9.4	8.6
Transportation	11.2	9.0	7.9	8.6
Education	5.9	5.8	14.1	13.1
Recreation	8.0	4.6	5.6	5.3
Miscellaneous	9.4	8.9	9.7	9.0
Total	100.0	100.0	100.0	100.0

*Sources:* See Table A.IV.4 above.

*Notes:* The 1966 weights for “Lebanon equivalent, average income” are the averages for the two income groups (LL 6,001–12,000) and (LL 12,001–18,000). These are just above the lowest income group of (less than LL 6,000), which is the basis of the 1966 CPI weights. These two income classes correspond to 54 percent of total household expenditure. They also include the average GDP per household in 1966, which was a little less than LL 10,000, to which should be added between 25 to 30 percent to account for other sources of revenue (see Table 3.11). In any event, the estimated national average spending on food in 1964 was estimated at 35 to 36 percent (see République Libanaise, c. 1967, vol. 1, p. 15). The other weights, for average-income Beirut in 1966 and 1997 were directly provided by the surveys.



Table A.IV.6 *Market exchange rates*<sup>a,b</sup>  
*LL/\$ and LL/SDR, 1947–2002*  
 (Annual averages)

	<i>LL/\$</i>		<i>LL/\$</i>	<i>LL/SDR</i>		<i>LL/\$</i>	<i>LL/SDR</i>
1947	3.07	1967	3.21	3.21	1987	225	290
1948	3.46	1968	3.16	3.16	1988	409	550
1949	3.26	1969	3.26	3.26	1989	497	630
1950	3.47	1970	3.27	3.27	1990	702	967
1951	3.73	1971	3.23	3.24	1991	928	1,271
1952	3.66	1972	3.05	3.31	1992	1,713	2,432
1953	3.42	1973	2.61	3.11	1993	1,741	2,431
1954	3.22	1974	2.33	2.80	1994	1,680	2,406
1955	3.24	1975	2.30	2.79	1995	1,621	2,457
1956	3.22	1976	2.91	3.32	1996	1,571	2,280
1957	3.18	1977	3.07	3.58	1997	1,539	2,119
1958	3.18	1978	2.96	3.70	1998	1,516	2,057
1959	3.16	1979	3.24	4.19	1999	1,508	2,061
1960	3.17	1980	3.44	4.47	2000	1,508	1,988
1961	3.08	1981	4.31	5.09	2001	1,508	1,920
1962	3.01	1982	4.73	5.24	2002	1,508	1,953
1963	3.10	1983	4.52	4.84			
1964	3.07	1984	6.51	6.67			
1965	3.07	1985	16.42	16.67			
1966	3.13	1986	38.37	45.01			

*Sources:* Banque Du Liban, Bulletin Trimestriel and Rapport Annuel, various issues; IMF, International Financial Statistics, various issues; République Libanaise, Recueil de Statistiques, 1963; UN, 1955.

*Notes:* a- The free foreign exchange market was officially authorized on November 6, 1948 (Decree no. 13532). b- Prior to December 1971, the SDR was fixed at 1 SDR = 1 US dollar.

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