

**A STUDY ON THE ECONOMICS  
OF TRANSITION IN THE LAO PEOPLE'S DEMOCRATIC REPUBLIC**

**By**

**DOUANGCHAK, Bovonethat**

**THESIS**

Submitted to  
KDI School of Public Policy and Management  
in partial fulfillment of the requirements  
for the degree of

**MASTER OF PUBLIC POLICY**

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## ABSTRACT

### A STUDY ON THE ECONOMICS OF TRANSITION IN THE LAO PEOPLE'S DEMOCRATIC REPUBLIC

I.

II. By

DOUANGCHAK, Bovonethat

During the late of 1980s, it was the starting period of transition wave from the Centrally Planned to Market-Oriented Economy in almost former communist/socialism countries across the world. In this regard, the Lao People's Democratic Republic (Lao PDR) is one of them.

Basically the type of transitional strategies divided into two main approaches namely the "big-bang", and "gradualist" approach. The choice of transitional strategies is heavily based on the initial conditions and institutional building capacity. However, the choice strategy "big-bang" approach may be not conducted in the same way in other transitional economies, because this approach can be applied in different ways, depended on the level of current economic development and political environment.

This paper examines the process and approach of transitional strategies used, along with the economic performance, evaluation and development strategies. The initial conditions of the Lao PDR were different from the former socialist countries in the Eastern Europe. Then the choice on the speed and scope of the transition were heavily

influenced by initial conditions, political acceptance of the market mechanism, and availability of external technical and financial assistance.

In the long term, the main purpose in favor of transition in the Lao PDR is a desire to graduate from the ranks of the Least Developed Countries by 2020, and put on the path of sustainable development. In this perspective, transition and development issues should be conducted concurrently and complementally each other.

## **ACKNOWLEDGEMENTS**

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Secondly, I would like to express my sincere thanks for "Ambassador Special Fellowship" of KDI School that provided me financial assistance and all facilities, during 10 months of studying in Seoul, Korea. Otherwise, I have no chance to write this thesis.

In addition, I prefer to thank to all sources of information that I mentioned in bibliography at the end of this book.

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## ABBREVIATIONS AND ACRONYMS

IV. ADB - Asian Development Bank

V. AFTA - ASEAN Free Trade Area

ASEAN- Association of South East Asian Nations

BOL - Bank of Lao PDR

CPC - Committee of Planning and Cooperation

CPE - Centrally Planned Economy

EDL - Electricite du Laos

FDI - Foreign Direct Investment

FIMC - Foreign Investment Management Committee

GDP - Gross Domestic Product

GOL - Government of the Lao PDR

GSP - General System Preference

IMF - International Monetary Fund

Lao PDR- Lao People's Democratic Republic

LDCs - Least Developed Countries

MCTPC- Ministry of Communication, Transport, Post and Construction

- MNC - Multi National Corporation
- NEM - New Economic Mechanism
- SEZ - Special Economic Zone
- SOEs - State Owned Enterprises
- UNDP - United Nations for Development Programs
- WB - World Bank

## **CHAPTER I: INTRODUCTION**

### **1.1 Purpose of the thesis, and overview of the Lao PDR**

#### **1.1.1 Purpose of the thesis**

The purpose of a study the economics of transition in the Lao People's Democratic Republic (Lao PDR) is to research the process and approach of conducting the economic reform during the transition from centrally planned to market-oriented economy. In the long term, the main purpose in favor of transition is a desire to put the Lao PDR on the path of sustainable development. In this perspective, transition and development issues should be conducted concurrently and complementally each other.

As a result of geography and agrarian subsistent economy in the Lao PDR that different from the former socialist countries in the Eastern Europe, then the initial conditions of the Lao PDR has been different from others. The choices on the speed and scope of the transition were heavily influenced by initial conditions, political acceptance of the market mechanism, and the availability of external technical and financial assistance, as well as foreign direct investment. The initial conditions were characterized by agricultural dominance, low capital income, extreme poverty, rudimentary infrastructure and weak administrative capacity.

Although some scholars mentioned that the choice of transition strategy of the Lao PDR

was the big bang approach, it is not the same big bang approach like the Eastern Europe countries conducted.

To be selective, this thesis focuses on the macroeconomic stabilization that includes public finance and monetary policy; liberalization and privatization programs in the Lao PDR; those programs are the main components of transitional reform package. Besides, this thesis shows the economic performance in the Lao PDR from 1988 to 1999. To be successfully completed, the author would like to evaluate the economics of transition and place the tasks ahead in the Lao PDR. Moreover, the development effort in the past, evaluation of development issues will be described, including the development strategies will be complemented in this thesis.

### **1.1.2 Overview of the Lao PDR**

The Lao PDR is landlocked country and situated in the Indochina's peninsular, South East Asia, with the surface area of 236,800 square kilometers and population 5.2 million (year 1999), stretching 1,700 kilometers from north to south and between 100 and 400 kilometer from east to west. The Lao PDR borders the People's Republic of China at the north, the kingdom of Thailand at the west, the Union of Myanmar at the northwest, the Socialist Republic of Viet Nam at the east, and the Kingdom of Cambodia at the south. Although the Lao PDR borders with five dynamic neighboring countries, the Lao PDR

has historically been a relatively closed economy, exporting mainly primary goods, conducting extensive informal trade along its borders, and dependent mainly on Thailand for access to international market.

In terms of geographical area, two thirds of the country is mountainous, ranging from 200 to 2,800 meters above the sea level. This creates difficulties for communications and development. However, there is abundance of rivers, including a 1,800 kilometers stretch of Mekong River. In this perspective, the combination of mountains and rivers creates great potential for development of hydropower. By contrast, as a result of mountainous terrain, remote settlement and low population density are barriers to access to, and cost-efficient delivery of public service. In terms of demography, in 1999 population growth is 2.4 percent per annum. Population density is low with 21 persons per square kilometers, 85 percent of the workforce is employed in agricultural sector. The average household is 6.7 members. Moreover, the population of the Lao PDR is ethnically diversified; consists of 49 ethnic groups. This diversity enriches the culture, but also has implications for development.

Until recently, the structural reforms and sound macroeconomic management initiated in the Lao PDR under the New Economic Mechanism (NEM) in 1986 fostered a steady movement toward macroeconomic stability, production growth, particularly with

neighboring countries. Between 1992 and 1997, GDP growth averaged 7 percent per annum, giving the government of the Lao PDR (GOL) hopes that it would reach the goal of graduating from the ranks of the least developed countries (LDCs) by 2020. Unfortunately, after the financial crisis in 1997, the economic reform effort has slowed down and the macroeconomic environment has also worsened. Concurrently with the authorities pursued an expansionary fiscal policy with ambitious investment plans, particularly irrigation investment to achieve rice self-sufficiency, and this done without appropriate financing arrangement. Then inflation running at triple-digit levels, and exchange rate depreciated considerably. However economic reform and development in the Lao PDR should be kept going in order to overcome those challenges and achieve the main goal of transformation and sustainable development as expected.

## **1.2 Organization of the thesis**

- Chapter I: describes the purpose of the thesis and eye bird's view of the Lao PDR.
- Chapter II: reviews the initial conditions confronting the Lao PDR, based for the choice of transition strategy, and implementing the economic reform package such as economic stabilization, price liberalization, SOE privatization and restructuring.
- Chapter III: provides the economic performance during 1988-1999, evaluates the

economics of transition, and also places tasks ahead of transition of the Lao PDR.

Chapter IV: reviews the past effort of development, evaluates and clarifies the development strategies of the Lao PDR.

Chapter V: summarizes the study on the economics of transition in the Lao PDR.

## **CHAPTER II: BACKGROUND AND THE CHOICE OF TRANSITION**

### **STRATEGY.**

Since the founding of the Lao PDR in December 2<sup>nd</sup>, 1975, the centrally planned economy (CPE) was applied. Unfortunately, the economic growth from this economic system was not push the economic growth as expected, and then the GOL adopted the New Economic Mechanism (NEM) in 1986, by transforming the CPE to market-oriented economy, with a new hope to push economic growth and achieve the main goal of sustainable development.

Apart from that point, the GOL tried to conduct broad economic reforms, which have created the basic foundations of market-oriented economic system such as a market-based price system, privatization and dynamic private sector, liberalization of trade and payment systems, introduction a two tier banking system, a largely open foreign trade, and foreign direct investment's attraction. In this regard, the Lao PDR is fortunate not to face many difficulties that have confronted in the formerly CPE liked in the Eastern Europe countries<sup>1</sup>. The entrenched procedures, habits, constituencies, and political interference in production and distribution of output from the former CPE never took root in the Lao PDR.

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<sup>1</sup> See World Bank, "Lao PDR: Country Economic Memorandum", report No. 12554-LA, 1994, p. 37

There are three main reasons for this issue:

- 1) The Lao PDR experienced at most eleven years of CPE, much of it were unsuccessful.
- 2) With the economy being predominantly agrarian and the population very dispersed, there was a much smaller political constituency dependent on the socialist system.
- 3) Labor was not well organized and union did not exist, hence adoption of new market mechanism was less disruptive, compared to Eastern Europe countries.

However, there are both positive and negative in the initial conditions of the Lao PDR, as follows:

- **Positive elements**

- 1) The relative importance of agriculture (more than 60 percent of total output) has helped most Lao households to benefit from the initial price reforms.
- 2) Officials who were laid off from the state sector received adequate compensation packages from the government.
- 3) Redundant civil servants and employees of SOEs were quickly absorbed into the growing private sector.
- 4) SOEs in the Lao PDR have not served to the same extent the role of critical

provider of social services as in Eastern Europe countries.

5) The period under the CPE was only eleven years and much shorter than Eastern Europe countries.

6) The transition to the market has begun in 1986, under the guidance of the Lao People's Revolutionary Party.

- **Negative elements**

1) Weak institutional capacity.

2) Qualified government officials in conducting all forms of the economic reform were limited.

3) Poorly developed infrastructure.

4) A small domestic market, in terms of both population and purchasing power.

### **Initial conditions, of the Lao PDR in 1988**

- **Economic indicators**

Economic growth	-2.1
GDP (US\$ billion)	0.86
GDP per capita (US\$)	190
Total debt (percent of GDP)	204.5

\* Structure of the economy (percent of GDP)

- Agriculture	61.2
- Industry	11.2
- Services	26.0

• **Social indicators**

- Population (million)	4.5
- Urban population (percent)	20
- Population in absolute poverty (percent)	67
- Access to safe water (percent)	39
- Life expectancy at birth (years)	51.0

**Sources:** The BOL, IMF and the World Bank.

In general, the reform packages usually consisted of the following measures: macroeconomic stabilization, price liberalization, privatization, and easing trade and investment barriers and rationalization of the exchange rate. The implementation of the entire policy package within a short time period has been called the “big bang” approach. In this perspective, the Lao PDR conducted entire policy package, but just only partial of each component such as partial of privatization and decontrol of price. Therefore, the “big bang” approach that the Lao PDR conducted, is not the same “big

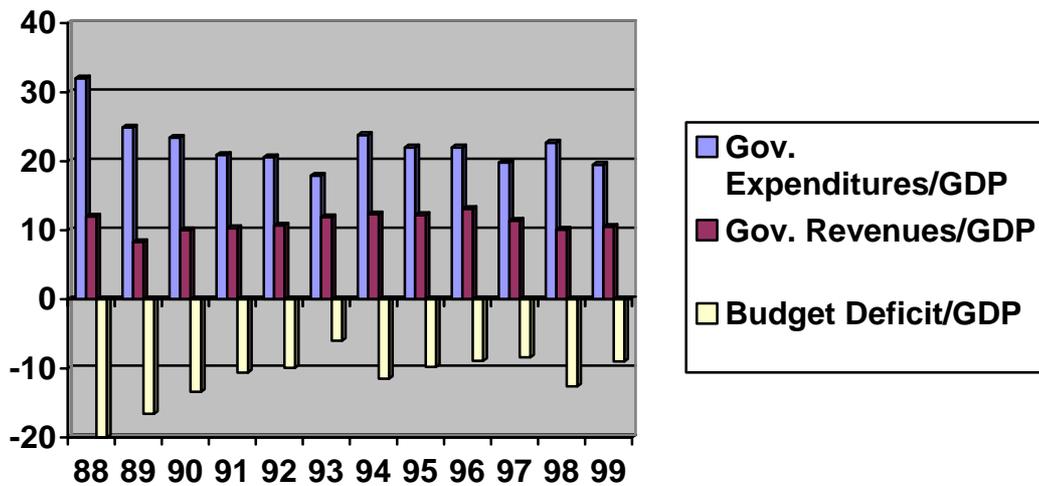
bang” approach with those Eastern Europe countries have applied.

## **2.1 Macroeconomic stabilization**

### **1. Public finance**

Since 1988, the public finance of the Lao PDR has been dramatically changed, two subsequent tax reform efforts in the late 1989. However, a comprehensive plan to restructure public finance of the GOL was launched in 1991, which eliminated the independent budgetary authority of the provincial administrations, and then the general budget was unified in 1992. The tax system has undergone substantial innovation. The expenditures control system has been centralized and discipline on expenditure was enhanced. The changes created a framework for securing fiscal sustainability.

Basically, revenues of the GOL are from power export (electricity); timbers; garments; agricultural products such as coffee, cardamom; import duties and grant aid from multilateral and bilateral assistance. In terms of expenditures, in general the GOL focuses on wages and salary of government officials, transport, agricultural, health and educational sectors. In this respect, government’s expenditures are traditionally more than government revenues. In 1988, the government’s revenues were only 12 percent of GDP; in contrast, the government’s expenditures were more than 30 percent (see figure 2.1).



**Figure 2.1:** Bar Chart of Government Expenditure/Revenue, and Budget Deficit from 1988 to 1999.

Since the initiation of the NEM reform program, the GOL has introduced several tax reforms measured aimed at shifting the revenue base of government away from its former dependence on state enterprise surpluses and transfers towards a mix of income, excise, property and trade tax.

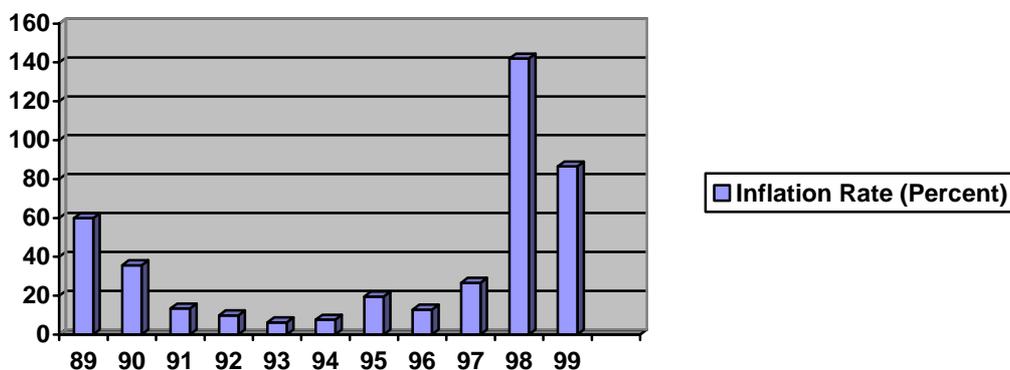
The major reform of the system in 1988 focused on replacing state enterprise transfers with a system of income and turnover taxes. In the process, state enterprises were given autonomy over production and pricing decisions. Two subsequent tax reform efforts in the late 1989 and 1991 aimed at expanding the revenue base and reduce distortions through establishing more uniform tax treatment across income sources. To this end, a National Treasury, within the Ministry of Finance was established in 1992 in order to

manage all government incomes and expenditures.

In terms of government expenditures, the progress with deficit reduction has been almost entirely achieved through lower capital outlays. The decline in the public investment program is a key policy concern. By contrast with capital expenditures, current government expenditures have been relatively steady as a share of GDP. In sum, the GOL has made good progress toward consideration in recent years. Nevertheless, the position of the public finance remains fragile, necessitating further reform.

## 2. Monetary policy

As a result of transition, the inflation in the Lao PDR is fluctuated (see figure 2.2). From 1988 to 1994, the inflation rate had reduced from 59.5 percent to 7.7 percent, but apart from that period, inflation has increased to peak level at 142 percent in 1998 due to the financial crisis in Asia, and then reduced to 86.5 percent in 1999.



**Figure 2.2:** Bar Chart of Inflation Rate from 1989 to 1999.

At the beginning of transition period, the GOL used the tight monetary policy aimed at limiting inflation and stabilizing the exchange rate of the Kip (Lao currency) relative to the US dollar. By and large, the bank of the Lao PDR (BOL) had been reasonably successful in achieving monetary stability. Inflation has come down from its peak level of almost 90 percent in August 1989, to single digit level during 1992-1994. The development of indirect policy instruments has been an ongoing process during the 1990s. Initially, the BOL relied on direct instruments, including instruction to reduce credit to state owned enterprises and moral suasion to limit and target credit expansion. Then an important step in the development of indirect instruments was the introduction in 1990 of a 5 percent reserve requirement. A credit window was opened at the BOL in 1992 and was replaced by a discount window in 1995. Several innovations were introduced in 1994 in an attempt to give new impetus to indirect monetary policy: the reserve requirement was double to 10 percent in March 1994. The successful control of monetary expansion and the gradual move to indirect policy instruments was interrupted in late 1994 and 1995.

Moreover, the Lao PDR was suffering from the financial crisis, begun in Thailand in July 1997. Due to Thailand was the main trading partner and biggest foreign investor in the Lao PDR, therefore the affect from the financial crisis was inevitable. Concurrently

with weak public finance's policy, and in part because the Lao authorities pursued an expansionary fiscal policy with ambitious investment plans, particularly irrigation investment to achieve rice self-sufficiency, and this done without appropriate financing arrangement. It entailed inflation peaked at level 142 percent in 1998 (see figure 2.2). In order to solve this problem, the GOL reapplied the tight monetary policy and trying to remove excess liquidity from the economy, and it became more active in late of 1998 and early of 1999. With renewed sales of the BOL and treasury bills to the public at interest rates of 30 percent, somewhat above bank deposit rates. Initial sales were successful and other new initiative to sell BOL bills at 60 percent interest rates in April 1999 proved extremely successful in stabilizing prices and the Kip, as they attracted investor from dollars back to Kip. As a result of this measure, the inflation rate was reduced from peak level at 142 in 1998 to 86.5 percent in 1999 and it expected to continue reducing in 2000.

## **2.2 Price liberalization**

In general, the process of liberalization is to allow prices to be determined in free market and lower trade barriers that had shut off contact with the price structure of the world market economy.

In retrospect, during 1976 to 1988, the foreign exchange system in the Lao PDR was

tightly restricted, and the multiple exchange rates then in use played little role in allocating resources in the economy. In addition, there was a complex system of exchange controls, accompanied by multiple official exchange rates. Four different official rates existed, mostly for official transaction, and there was a marked difference between official and parallel market rates at that time.

In keeping with its NEM initiatives, in mid of 1987 the GOL undertook price and exchange rate reforms and at the beginning of 1988 the four official exchange rates were unified simultaneously with price liberalization. In September 1995, the Lao PDR formally adopted a managed floating exchange rate system. Hence the market sets so far the prices for most products in the Lao PDR. However, the GOL maintains price surveillance of some strategic products, such as food staples and fuel.

Pricing policy is non-discrimination between imported product and domestically produced products. Moreover, the Lao PDR has lowered trade barriers such as no tariff quota system operate in order to be consistent with procedures of ASEAN Free Trade Area (AFTA), after the Lao PDR is full member of Association of South East Asian Nations (ASEAN) in 1997.

### **2.3 Privatization and SOE restructuring**

In the late 1980s, the state enterprise sector comprised approximately 640 enterprises and employed about 10 percent<sup>2</sup> (16,000 workers) of the non-agriculture labor force. In this connection, about two-thirds of enterprises were centrally managed under the line ministries, while the rest were managed by provincial and district levels' authorities.

The GOL considered that in order to accelerate economic growth, to fulfill its commitments to market-based reforms and international integration, strengthening the enterprise sector were required, both SOEs and private. Therefore, one of the components of the NEM reform program is privatization. In this perspective, the Lao PDR has gone further than most other ex-socialist countries in divesting most SOEs and reducing their drain on the budget. In general, the SOEs were privatized through foreign and private leasing, outright sale, joint venture agreements and employee management schemes.

During the initial phase of the program in 1989-1990, several small enterprises (about 100 enterprises) were privatized mainly through leasing contract in an *ad hoc* manner without clear procedures for evaluation or selection<sup>3</sup>. As a result, the progress in the privatization program has been slow and clarification of procedures has not been

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<sup>2</sup> See World Bank, "Lao PDR: Country Economic Memorandum", report No. 12554-LA. 1994, p. 21

<sup>3</sup> *Ibid*, p. 102

forthcoming. Although there have been a significant number of privatizations at the provincial level, only 15 percent of the centrally managed enterprises were divested at that time.

During 1991-1992, 37 enterprises under central supervision were privatized, 13 were small (less than 30 employees), 14 were medium sized (30-100 employees), and 10 were large sized (more than 100 employees). By 1997, most of the SOEs in the Lao PDR had been privatized, and in 1998, another 32 enterprises were scheduled for privatization.

In 1999, among 777 registered companies in the Lao PDR, only 7 percent were state-owned enterprises<sup>4</sup>. The economic significance of the state-owned sector in the Lao PDR is now similar to that in many market economies.

Moreover, the GOL will begin the restructuring process of five large SOEs. In this respect, three are large defaulting borrowers, such as the Mountainous Region Development Corporation (BPKP, shorten from Lao name), Nam Papa Corporation (water supply), and Lao Aviation; one large loss maker, Pharmaceutical Factory No. 3; and one large considered as a main revenue earner, Electricite du Laos (EDL).

Drafting of the restructuring plans of an additional five large defaulters will start by

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<sup>4</sup> See WTO. "Accession of the Lao PDR: Memorandum of Foreign Trade Regime", WT/ACC/Lao/3/Add.1, 2001, p.6.

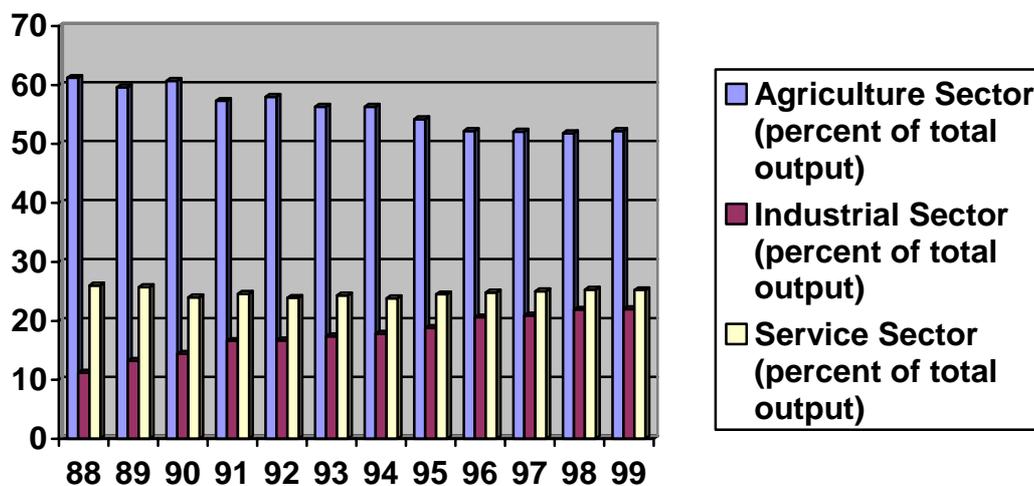
October 2002. The strategy are to convert and register the business as joint stock companies, appoint Boards and Directors, and agree on performance plans which set out commercial and financial objective.

## CHAPTER III: ECONOMIC PERFORMANCE DURING THE TRANSITION

### EVALUATION, AND TASK AHEAD

#### 3.1 Economic performance

During the transition economy in the Lao PDR, it is noticed that agriculture is the dominant source of production in the economy of the Lao PDR. It accounted for 52.2 percent of GDP in 1999. Industry contributed just 22 percent and service sector was around 25 percent. In this respect, there is a trend for the industrial sector to expand in the future.



**Figure 3.1:** Bar Chart of Share of Gross Domestic Product, from 1988 to 1999.

Since 1988, industrial sector has increased almost two times from only 11.2 percent of GDP to 22 percent in 1999. At the same time, the contribution of agriculture to GDP has fallen from 61.2 percent in 1988 to 52 percent of GDP in 1999, and the service sector is

fluctuated from 24 to 26 percent, between 1988 and 1999.

In terms of industrial sector in the Lao PDR is dominated by small-scale manufacturing, processing, construction and assembly plants, catering mainly for domestic consumption, and there is no heavy industry. In this regard, manufacturing contributes 75 percent of industrial output, garment production is a major export industry, and construction contributes 16 percent and mining, gas and electricity contribute only 8 percent of industrial output.

**Table 3.1:** Lao PDR-share of Gross Domestic product by sector (percent of total output)

Sector	88	89	90	91	92	93	94	95	96	97	98	99
Agriculture	61.2	59.6	60.7	57.3	58.0	56.3	56.3	54.2	52.2	52.1	51.8	52.2
Industry	11.2	13.2	14.4	16.6	16.7	17.4	17.8	18.8	20.6	20.9	21.9	22.0
Services	26.0	25.7	24.0	24.6	23.9	24.3	23.8	24.5	24.8	25.0	25.3	25.2
Import duties	1.6	1.5	0.9	1.5	1.4	2.0	2.1	2.5	2.4	2.0	1.0	0.6
Total	100	100	100	100	100	100	100	100	100	100	100	100

**Sources:** Bank of the Lao PDR, World Bank and IMF.

In addition, as for the economic indicators of the Lao PDR in 1999 compared to 1988, has improved dramatically for instance the economic growth has increased from -2.1 to 7.3 percent; economic growth in average during twelve years is around 6.3 percent; GDP per capita is also increased from US\$ 190 to 340; and percent of total debt percent of GDP has reduced from 204.5 to 143.8.

## **Economic and social indicators of the Lao PDR in 1999**

- **Economic indicators**

Economic growth	7.3
GDP (US\$ billion)	1.8
GDP per capita (US\$)	340
Total debt (percent of GDP)	143.8

- \* Structure of the economy (percent of GDP)

- Agriculture	52.2
- Industry	22.0
- Services	25.2

- **Social indicators**

- Population (million)	5.2
- Urban population (percent)	22.9
- Population in absolute poverty (percent)	39
- Access to safe water (percent)	90
- Life expectancy at birth (years)	54

**Sources:** Bank of the Lao PDR, World Bank and IMF.

**Table 3.2:** Lao PDR Key Macroeconomic indicators

Details	88	89	90	91	92	93	94	95	96	97	98	99
GDP growth	-2.1	14.3	6.7	4.0	7.0	5.9	8.1	7.0	6.9	6.9	4.0	7.3
Gov. revenues/GDP	12.0	8.3	10.0	10.3	10.7	11.9	12.3	12.2	13.1	11.4	10.1	10.5
Gov. expenditures/GDP	32.0	24.9	23.4	20.9	20.6	17.9	23.8	22.0	22.0	19.8	22.7	19.5
Budget Deficit/GDP	-20.0	-16.6	-13.4	-10.6	-9.9	-6.0	-11.5	-9.8	-8.9	-8.4	-12.6	-9.0
Current Account Balance/GDP	-17.8	-18.6	-11.7	-11.2	-8.8	-11.2	-6.3	-6.9	-12.0	-10.6	-5.6	-5.2
Inflation	-	59.5	35.7	13.4	9.9	6.3	7.7	19.6	12.8	26.6	142	86.5

**Sources:** Bank of the Lao PDR, World Bank and IMF.

### 3.2 Evaluation

#### (1) Privatization and SOE restructuring

During the transition, based on the performance of economic mentioned above, among other main components of economic reform package. It is noticed that the program of SOE's privatization and restructuring are more successful than the others. More than 600 state enterprises were privatized, there is only 32 state enterprises (see Table 3.3) that have to be further privatized and restructured.

**Table 3.3:** Lao PDR: Strategic Enterprises to remain State-Owned as of 1998

<b>Name of companies</b>	<b>Asset value (Kip millions)</b>	<b>Number of employees</b>
Prime Minister's Office		
1. Lao National Tourism	350	29
Ministry of Industry and Handicraft		
2. Electricite du Laos (EDL)	139,548	2688
Ministry of Commerce		
3. Lao Trade Import-Export Company	1,320	96
4. Magazin D'Etat Pour les Missions Etrangeres	1,413	40
5. Technical-Materials Supply Company	657	9
6. Vehicle and Spare Parts Supply Company	1,229	40
7. Lao (State) Fuel Company	4,914	254
Ministry of Communication, Transport, Post and Communication (MCTPC)		
8. Lao Water Supply Company	2,500	375
9. Lao Post Office Company	7,560	1,167
Ministry of Education		
10. Editing and Printing Enterprise	506	80
11. Educational Material Product Factory	114	6
Ministry of Culture and Information		
12. The Lao State Printing Enterprise	492	129
Ministry of Public Health		
13. Pharmaceutical Factories No. 2 and 3	4,258	339
Ministry of Labour and Social Welfare		
14. Employment Service Company	155	20
The Central Youth federation		
15. Youth Printing Factory	256	24
Ministry of Finance		
16. Lao National Lottery	2,459	36
17. Mountains Development Corporation (BPKP)	17,093	3,200
18. Development of Agro-Forestry Industry (DAFI)	19,865	872
19. Agro-Forestry and Service Company (Northern Wood Company)	17,179	784

Bank of the Lao PDR*		
20. Sethathirath Bank	3,920	99
21. Nakhoneluan Bank	995	74
22. Bank for Foreign Trade (BCEL)	4,496	141
23. Lane Xang Bank	2,338	208
24. Agricultural Promotion Bank	1,000	381
25. Lao Mai Bank	2,394	129
26. Pak Tai Bank	3,224	189
27. Aloun Mai Bank	663	53
Vientiane Municipality		
28. Bus Transport Service Commission	3,276	171
29. Vientiane Municipality's Printing Works	310	51
Luang Prabang Province		
30. Irrigation Company	378	49
31. Luang Prabang Tourist Company	133	28
Savannakhet Province		
32. Savan Wood Company	61	134

**Source:** IMF.

*\* In 1999, six of the state-owned commercial banks were consolidated into two banks.*

However, it was considered that it was still slow progress than planned pace due to the shortcomings in the institutional arrangement for privatization. In addition, another shortcoming of the privatization program to date has been the reluctance of government to relinquish ownership over the state assets, and consequently to rely almost entirely on leasing arrangements rather than outright sale.

The leasing approach that the GOL used, has several drawbacks such as:

- 1) It did not promote the mobilization of domestic and foreign investment in the modernization of the enterprise's productive capacity.

- 2) It encouraged lease holders to overuse and rapidly depreciate firm assets during the period of the lease in order to maximize their profits, and
- 3) It made supervision of the government's portfolio of state enterprises more complex and burdensome since each lease contract still requires monitoring.

Although there is some weak points related leasing approach, this program has made progress in cutting government spending and the chances for obtaining substantial from the sales, leading to improve better performance and increase the productivities, and building the competitive market economy.

### **(2) Price liberalization**

As for the liberalization is also satisfied at the certain level such as price liberalization allowed cost all price to be determined by market forces (except post and telecommunication services and air transport prices). The four official exchange rates were unified simultaneously with price liberalization, and the Lao PDR applied a managed floating exchange rate system since 1995. All of theses, it is recognized as progresses of price liberalization and it is considered as firm foundation for further price liberalization.

### **(3) Public finance**

The position of the public finance remains fragile, necessitating further reform.

Particularly, the GOL has to pay more attention how to increase the national revenue by further reforming the tax system, and expanding the tax base if possible.

In this connection, the main difficulty in raising tax revenue increased more rapidly is due to several factors. Chief among these is the lack of skills and institutional capacity.

Without adequately trained staff and monitoring capability enforcement is weakened and has resulted in implementation delays that have slow progress. Another factor is the

high share of agriculture in national income, as noted above, for which tax assessment is typically more difficult. Incomes are lower in agriculture and collection is logistically

more demanding and costly. As for the agricultural tax contributed around 1.1 percent in 1996 and reduced to 0.64 percent of total tax revenue (see Table 3.4), despite the

agriculture sector's covers more than 50 percent to GDP.

**Table 3.4:** General Government Revenue (in billion Kip), 1996-1999.

Details	1996	1997	1998	1999
<b>A. Tax Revenue</b>	<b>176.0</b>	<b>190.2</b>	<b>290.3</b>	<b>745.5</b>
Profits tax	20.7	25.6	33.4	80.4
Income tax	13.5	11.9	19.5	69.6
Agricultural/Land tax	2.1	2.4	3.1	4.8
Business licenses	0.1	0.2	0.3	0.3
Turnover tax	33.9	39.9	62.8	159.8
Excise tax	15.5	16.9	50.2	157.3
Import duties	40.6	45.7	51.5	98.5
Export duties	6.0	6.8	10.4	24.4
Registration fees	1.5	1.8	2.1	4.9
Natural resources tax	0.7	1.1	2.0	5.3

Timber royalties	34.6	31.7	36.8	89.5
Hydro power royalties	N/A	N/A	4.5	17.4
Other fees	6.6	6.2	13.9	33.3
<b>B. Non Tax Revenue</b>	<b>41.4</b>	<b>47.8</b>	<b>87.2</b>	<b>183.8</b>
Leasing fees	3.8	5.3	9.6	11.4
Concession	0.4	0.2	0.5	1.0
Depreciation and dividend	5.2	9.0	7.7	22.0
Interest	15.5	16.7	15.5	88.9
Over-flight	9.8	10.5	33.0	40.3
Penalties (fines fees)	N/A	N/A	6.9	8.8
Administration fees	N/A	N/A	3.6	11.3
Others	6.7	6.2	10.5	N/A
<b>Total Tax and Non Tax Revenue</b>	<b>217.4</b>	<b>238.1</b>	<b>377.5</b>	<b>929.2</b>
Asset sale	15.0	47.9	3.6	7.2
Capital return	5.0	8.9	10.4	24.1
<b>Total Revenue with Asset Sale</b>	<b>237.4</b>	<b>294.8</b>	<b>391.5</b>	<b>960.5</b>

**Sources:** Ministry of Finance and Bank of the Lao PDR.

However, maintaining the government expenditure to important sectors are necessary such as institution building, human capital investment, infrastructure, health, education, in order to push the socio-economic development, as expected. In addition, in monetary policy terms has to be further reformed and strengthen, because inflation during the last twelve years is highly fluctuated, then it proved that the monetary policy applied in the past was not the suitable yet.

### **3.3 Tasks ahead of transition**

#### **(1) Public finance**

The main issue that the GOL should focus on is to regain macroeconomic and financial

stability. That is the most immediate priority decisive action, needed to further tighten monetary and fiscal policy in order to stabilize the exchange rate and dampen inflationary pressures. Financial distress should be addressed in parallel with a broad sector-restructuring program to improve the BOL's ability to intermediate resources effectively.

In this connection, improving the public finance policy should lead to raise the efficiency of public expenditure decisions; encouraging the institutional capacity building; developing human resources in public finance sector; trying to link decisions more closely with broader development and poverty reduction objectives, and trying to bring domestic expenditures and revenues into greater alignment, eventually reducing fiscal imbalances. This required specific policy measures both to improve transparency and efficiency of public expenditure budgeting and execution, and including strengthen revenues, through additional tax reforms to increase the share of domestic direct and indirect taxes, and reduce reliance on trade tax, royalties, broaden the income tax base and strengthen administration of revenue collection and control. However, public expenditure patterns can increase, but should reflect the demands of a market economy as follows:

- Ensuring the provision of public goods and services that markets fail to

provide completely or efficiently such as defense, law and environmental protection.

- Facilitating the effective functioning of market by establishing a legal, institutional and policy environment conducive to private sector development. This includes maintaining macroeconomic stability by balancing the expenditures with expected revenue to avoid substantial budget deficits and to contain inflation.
- Alleviating poverty and pursuing broader social equity through income transfers, other measures of wealth redistribution, and expenditures that can raise the productivity of the poor people (such as education, health, and rural road), particularly ethnic minority groups, and women in the rural area.

## **(2) Privatization and SOE restructuring**

The GOL should continue privatizing and restructuring the rest SOE, in order to improve better performance and increase the productivities, and building the competitive market economy. To this end, further legal and institutional reforms will need to be pursued to enhance the state's ability to manage risk and execute SOE reform policy, need to improve the business environment and attract more foreign investment

and better accounting in the SOE sector.

### **(3) Liberalization**

As for price liberalization, the GOL should consider to further liberalizing the price that is not liberalized yet, such as post, telecommunication services and air transport prices, in order to stimulate the competitive capacity on those sectors and improve the quality of services in order to reach Lao people's satisfaction as a whole.

## **CHAPTER IV: DEVELOPMENT STRATEGY**

### **4.1 Past efforts of development**

During the transition in the Lao PDR, the GOL strongly intends to alleviate poverty through socioeconomic development programs by achieving average economic growth of around 7 percent per annum, increasing public expenditures and investments for social sectors (education, public health, and social welfare), and concentrating on rural infrastructure such as roads, irrigation, clean water supply and rural electricity, provision of food security, social services, and increasing income from commercial production.

In order to be selective the author prefers to cover four main parts namely: (1) poverty reduction, particularly in the rural area, (2) infrastructure development, (3) human resource development, and (4) foreign direct investment (FDI).

#### **(1) Poverty reduction**

The Lao PDR is a predominantly rural society, with over 77 percent of the population living in rural areas. The large majority of the Lao PDR's poor live rural areas, where poverty is widespread and varies significantly between regions. Then the GOL has attempted to raise living standards and reduce poverty of Lao people. In keeping with NEM, raising living standard in rural will require significant investment in rural area,

not only infrastructure, but also in support services, particularly agricultural sector, which remains by far the most important sector in the Lao economy.

During the last twelve years, from 1988 to 1999 the Lao PDR has achieved average economic growth of about 6.3 percent per annum, and can reduced the incidence of poverty from 67 percent to 39 percent of total population lived below the poverty line (see social indicator of the Lao PDR in 1999, in chapter III). However, the incidence of poverty varies significantly across region, as well as between urban and rural area, such as the incidence of poverty in the northern of the Lao PDR is highest covers 53 percent of the population compared with 12 percent in Vientiane prefecture<sup>5</sup>. In this perspective, the GOL considered that the public investment has a crucial role in generating income-earning opportunities and delivering social services to the poor, especially the hard-core of poor people living in remote and mountainous areas. Based on the public investment plan (see table 4.1 below), from 1996 to 2000 the GOL has increased the public investment on social sectors from 26.8 to 40.9, particularly in rural development investment has increased more than four times from 2.8 to 12.3 percent.

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<sup>5</sup> See ADB, "Development agenda: key features of the Lao PDR", report of Country Strategy and Program 2002-2004, 2001. p. 3.

**Table 4.1:** Composition of Public Investment Plan 1996-2000. (Unit: percent of total investments)

<b>Details</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>96-00</b>
<b>* Economic sectors</b>	<b>69.7</b>	<b>63.5</b>	<b>61.0</b>	<b>58.2</b>	<b>56.0</b>	<b>60.6</b>
- Agriculture and forestry	11.9	11.2	11.2	11.2	11.5	11.4
- Industry (no electricity)	4.7	5.1	5.4	5.4	5.2	5.2
- Electricity	10.7	8.9	8.8	9.3	9.8	9.5
- Transportation	32.2	29.1	27.3	24.4	21.5	26.1
- Telecommunications	4.3	4.5	4.1	4.1	3.9	4.1
- Other infrastructures	5.9	4.7	4.2	3.8	4.0	4.4
<b>* Social sectors</b>	<b>26.8</b>	<b>33.4</b>	<b>35.9</b>	<b>38.6</b>	<b>40.9</b>	<b>36.2</b>
- Education	9.9	9.1	9.4	10.0	10.3	9.8
- Public health	7.8	7.4	7.7	8.3	9.1	8.1
- Social welfare	4.4	6.6	6.7	6.9	7.0	6.5
- Rural development	2.8	8.4	10.1	11.3	12.3	9.7
- Culture	1.9	1.9	2.0	2.1	2.2	2.0
- Other	3.5	3.1	3.1	3.2	3.1	3.2
- Total	100.0	100.0	100.0	100.0	100.0	100.0
of which - Domestic funds	24.4	23.6	25.8	27.8	30.1	26.8
- Foreign funds	75.6	76.4	74.2	72.2	69.9	73.2

**Sources:** Government authorities and World Bank

## **(2) Infrastructure development**

Due to the initial conditions of the Lao PDR, particularly poor developed infrastructure, then roads have been the GOL's top expenditure priority and top public investment plan.

In this regard, development of the road sector, the dominant mode of transportation, is critical for national and regional integration and the overall socioeconomic development of the country. At the end of 1980s, the entire country's basic road network was a state

of total disrepair because lack of funds.

Since then the GOL has accorded high priority to the development of the transport sector with more than half of public investment allocated to the sector during 1990-1995.

Although the transportation is still high priority, (see Table 4.1) the share of public investment on the transportation has reduced from 32.2 percent in 1996 to 21.5 in 2000.

In addition, based on table 4.2 of government expenditure by functional classification, it is noticed that the proportion of government expenditure on transport/communication has increased from 19.9 percent in 1991 to 23.8 percent in 1995 of total government expenditures. After 1995, there was a tendency to decrease from 23.7 percent in 1996 to 19 percent in 1999. However, this proportion is still highest compared to other sectors.

**Table 4.2:** Government Expenditure by Functional Classification from 1991-1999.

Details	1991		1992		1993		1994		1995	
	% of	% of	% of							
	total	total								
	Exp.	GDP								
<b>* Economic Sectors</b>	<b>38.7</b>	<b>8.1</b>	<b>39.3</b>	<b>8.1</b>	<b>33.6</b>	<b>6.1</b>	<b>43.5</b>	<b>10.5</b>	<b>41.0</b>	<b>9.1</b>
- Agriculture	7.1	1.5	9.1	1.9	9.2	1.7	9.4	2.3	9.7	2.2
- Industry/Energy	11.6	2.4	8.3	1.7	4.9	0.9	4.2	1.0	7.5	1.7
- Transport/Communication	19.9	4.2	21.8	4.5	19.4	3.5	29.9	7.2	23.8	5.3
<b>* Social sectors</b>	<b>11.0</b>	<b>2.3</b>	<b>11.5</b>	<b>2.4</b>	<b>12.9</b>	<b>2.3</b>	<b>14.4</b>	<b>3.5</b>	<b>18.0</b>	<b>4.0</b>
- Education	7.5	1.6	8.5	1.8	10.5	1.9	9.9	2.1	12.4	2.7
- Health	3.5	0.7	2.9	0.6	2.4	0.4	4.5	1.1	5.6	1.2
* Others	50.4	10.5	49.3	10.1	53.5	9.7	42.1	10.2	41.0	9.1
<b>Total</b>	<b>100.0</b>	<b>20.9</b>	<b>100.0</b>	<b>20.6</b>	<b>100.0</b>	<b>18.1</b>	<b>100.0</b>	<b>24.2</b>	<b>100.0</b>	<b>22.2</b>

Details	1996		1997		1998		1999	
	% of	% of						
	total	total	total	total	total	total	total	total
	Exp.	GDP	Exp.	GDP	Exp.	GDP	Exp.	GDP
<b>* Economic Sectors</b>	<b>40.1</b>	<b>8.9</b>	<b>37.5</b>	<b>9.1</b>	<b>36.9</b>	<b>9.0</b>	<b>35.2</b>	<b>8.7</b>
- Agriculture	7.8	1.7	7.5	1.8	7.7	1.9	7.7	1.9
- Industry/Energy	8.5	1.9	8.0	1.9	8.2	2.0	8.5	2.1
- Transport/Communication	23.7	5.3	22.0	5.4	20.9	5.1	19.0	4.7
<b>* Social sectors</b>	<b>19.3</b>	<b>4.3</b>	<b>19.8</b>	<b>4.8</b>	<b>20.9</b>	<b>5.1</b>	<b>22.1</b>	<b>5.4</b>
- Education	12.4	2.8	12.4	3.0	12.7	3.1	13.0	3.2
- Health	6.9	1.5	7.4	1.8	8.1	2.0	9.1	2.2
* Others	40.6	9.0	42.8	10.4	42.3	10.3	42.6	10.5
<b>Total</b>	<b>100.0</b>	<b>22.2</b>	<b>100.0</b>	<b>24.4</b>	<b>100.0</b>	<b>24.3</b>	<b>100.0</b>	<b>24.6</b>

**Sources:** Ministry of Finance, Lao PDR and World Bank Staff estimate.

As a result of the public investment and government expenditure on transportation/communication sector, about 2,000 km of road (out of a total of about 21,627 km, of which 6,442 km are classified as national roads, 7,135 km as provincial roads and about 8,050 km as local roads) has been rehabilitated or substantially improved<sup>6</sup>.

### (3) Human resources development

In general, human resources development can pursue in many ways such as formal

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<sup>6</sup> See World Bank, "Memorandum of the President of the International Development Association to the Executive Directors on a Country Assistance Strategy of the World Bank Group for the Lao PDR", Report No. 19018-LA, 1999, P. 12.

education, non-formal education and informal education. To be selective, the author prefers to focus only on the basic education in the Lao PDR, because of the rate of illiteracy of 51 percent is still high in the Lao PDR. In this connection, poverty alleviation requires broadening access to good quality basic education.

Since 1975, the GOL has tried to expand the primary school and increase the quality of basic education to Lao people across the country and achieved in the certain level. In this regard, the proportion of government expenditures on education sector from 1991 to 1994 is around 9.1 percent of total expenditure (see table 4.2) or roughly 1.9 percent of GDP. This somewhat lowers than the average for other countries at comparable income levels. However, from 1995 to 1999 the proportion of government expenditure on educational sector had a tendency to increase from 12.4 to 13 percent of total government expenditure, or increased from 2.7 to 3.2 percent of GDP.

In this respect, the GOL considers that in order to push economic growth, human resources development, should be concurrently conducted. Therefore, the human capital investment should be improved and then the GOL has expanded the investment on education and public health sectors. Based on the table 4.1 from 1996 to 2000, the GOL has increased the public investment on education and public health sectors from 9.9 to 10.3 percent, and from 7.8 to 9.1 percent of total public investment, respectively. This

describes that the GOL has also placed a high priority on increasing the stock of human capital through education and training.

#### **(4) Foreign Direct Investment (FDI)**

FDI has considered being important factor to support the economic and social development. Then in keeping with its NEM initiatives, since 1988 the GOL has backed a policy of encouraging foreign investment in all sectors of the economy. In 1989 the law on Foreign Investment was adopted, setting out the regulations for foreign investment and establishing the Foreign Investment Management Committee (FIMC) to oversee FDI licensing and promotion.

The objectives of foreign investment policy under the law are to attract foreign capital from diverse sources in order to transfer appropriate technology; create local employment; promote Lao exports and their access to international market; generate revenues for the government through taxes, royalties, land rents; integrate into the broader economy; attract the capital inflow; and contribute to the overall development objectives of the country.

In this perspective, all sectors of the economy are open to investment and various incentives are provided. Investors can obtain a license through the “one-stop shop” of the FIMC, which is not term validated. Investors are eligible for a tax holiday from two

to four years, have special duty exemptions for export industries, are given full allowance for repatriation of profits, and are protected against expropriation under the law.

FDI has played an important role in the Lao PDR's transition to a market system and contributed to the country's rapid economic growth during the 1990s. Furthermore, in 1994, the law on Foreign Investment was revised in order to more open and liberal, generally friendly to foreign investors such as:

- All sectors are open to foreign investors, except for those detrimental to health, environment, culture, or public sector.
- Profits are taxed at a flat 20 percent, and expatriate staff incomes at a rate of 10 percent.
- Material and equipment that important for using of the investor can enjoy a special 1 percent import tariff.
- Investors can lease land and transfer leasehold interest and own improvements and transfer those ownership interests.
- Investors can repatriate earnings and capital in conformity with the law and regulation, which govern foreign exchange.

However, there are some obligations on foreign investors, such as they have to give

priority to Lao citizens in employment. When necessary and following approval of the FIMC, foreign investors can employ skilled and expert foreign personnel. In addition, foreign investors are obliged to upgrade the skill of Lao employees. Foreign investors are also obliged to open accounts in local and convertible currency with bank based in the Lao PDR and company accounts have to follow the Lao PDR national system of accounting.

In short, from 1988 to 1999, there are foreign investors from 34 countries registered over 760 investment projects in the Lao PDR, with a total value of over US\$ 7 billion. The number of projects rose very quickly from less than 40 projects per year during 1988-1990, to over 100 projects per year from 1994-1996. In both 1997 and 1998, because of financial crisis in Asia, about 60 projects were approved from the FIMC, and in 1999 only 43 projects were approved.

By value of investment, Thailand is the biggest investor in the Lao PDR with 41 percent of the approved total. The other leading investors are the United States with 22 percent, Korea with 9 percent and Malaysia with 4 percent. In this regard, the leading sector for foreign investors has been the hydropower sector, and followed by telecom and transportation, hotel and tourism, and industry and handicraft.

**Table 4.3:** Lao PDR Foreign Investment by sector, during 1988-1999 (unit: US\$ millions)

<b>Sector</b>	<b>Total projects</b>	<b>Value</b>
Agriculture	82	130.4
Textiles and garments	78	73.0
Industry and Handicraft	134	473.7
Wood industry	37	167.6
Mining, oil	33	139.5
Trading	112	67.6
Hotel, tourism	34	600.6
Banking, insurance	12	83.8
Consultancy	33	7.1
Services	146	65.8
Construction	39	64.8
Telecom, transport	16	637.7
Electric power	7	4,500.8
Total	763	7,012.4

**Source:** Foreign Investment Management Committee, Vientiane Lao PDR

**Table 4.4:** Lao PDR Foreign Investment by sources, during 1988-1999 (unit: US\$ millions)

<b>Country/territory</b>	<b>No. of projects</b>	<b>Value</b>	<b>Country/territory</b>	<b>No. of projects</b>	<b>Value</b>
Thailand	252	2,928.8	Germany	8	2.7
USA	44	1,490.3	Macao	1	2.5
South Korea	31	633.2	Canada	11	2.5
Malaysia	19	293.3	Finland	3	1.3
UK	18	69.2	Switzerland	3	1.1
Chinese Taipei	34	68.2	Sweden	7	0.9
China	68	63.0	Norway	3	0.9
Australia	44	41.8	New Zealand	3	0.9
France	86	37.4	Holland	4	0.8

Hong Kong	20	26.0	Denmark	6	0.5
Singapore	15	20.0	India	2	0.5
Russia	15	18.9	Austria	3	0.2
Japan	26	17.5	Ukraine	1	0.2
Viet Nam	19	10.6	Bangladesh	2	0.2
Indonesia	1	5.0	Cambodia	1	0.1
North Korea	1	3.3	Myanmar	1	0.1
Italy	6	3.2			
Belgium	6	2.7			
			Total	763	7,012.4

**Source:** Foreign Investment Management Committee, Vientiane Lao PDR

## **4.2 Evaluation**

### **(1) Poverty reduction**

As noted above, the Lao PDR's development agenda is to alleviate poverty while maintaining macroeconomic stability. In this connection, the development effort in the past showed that the GOL has succeeded to reduce the poverty in the certain level, such as population in absolute poverty has reduced from 67 to 39 percent of total population, and urban population has increased from 20 to 22.4 percent, from 1988 to 1999. All of this proved that the economics of transition in the Lao PDR push the economic growth and entails the poverty reduction in the Lao PDR.

Despite extensive reforms, rapid population growth at 2.4 percent still continues to erode gain in economic growth, and poverty is pervasive. This is consistent with the

United Nations Development Programme's (UNDP) human development index that gives the Lao PDR a rating of 0.484 and a ranking of 140 out of 174 countries, making the Lao PDR one of the poorest developing member country in the region. Low education, health and nutrition standards are major constraints to productivity growth.

### **(2) Infrastructure development**

Although the GOL put much effort to construct and repair the road network, it is not much improved. Only 40 percent of the national roads are in good or fair condition. Most of the provincial and district road networks consist of tracks, which are impassable during the rainy season. Therefore, continued improvements of road network are vital to transformation to a more market based economy. Better access to markets, as well as access to education, health, electricity and other services, is essential if the poor people in the rural area are to move beyond subsistence farming into more productive uses of labor, land and capital.

### **(3) Human resources development**

There is a tendency in increasing the proportion of public investment and government expenditure on educational sector, as noted above; this showed that the GOL considers development of human resources is also priority in transitional period. However, educational sector remains inadequately planned, under financed and under

professionalized. Most children in the rural area acquire some schooling but attendance is sporadic. In addition, the quality of instruction is relative poor, and nearly half of pupils who enter do not complete the primary cycle. Therefore, educational sector should be received more attention from the GOL by providing an adequate recurrent budget for the education sector, and providing the educational opportunity to all Lao people, particularly ethnic minority group and women in the rural areas. To ease the transition to more technologically advanced agriculture and toward a beginning industrial economy will require an increase in human capital by targeting the expansion and quality development of primary and non-formal education. However, giving priority to basic education does not mean ignoring other educational levels. Not only quality basic education but quality secondary and tertiary educations as well, are needed to maintain a viable education system and to achieve national, social, economic goals.

#### **(4) Foreign Direct Investment (FDI)**

Although the Lao PDR has attracted FDI in the certain satisfied level of more than US\$ 7 billion, there is around US\$ 2 billion in FDI commitments have been disbursed. To a large extent, this due to delays in the start-up of the large hydropower projects that were approved before financial crisis in Thailand, caused a drop in the projected demand for electricity imports in the northeast of Thailand. In addition, after financial crisis, the

trend of FDI in the Lao PDR has reduced, because of the worsening domestic economic climate such as economic instability and bureaucratic hurdles faced by investors as the reform process slowed.

#### **4.3 Government 's Development strategies**

The National Socioeconomic Development Plan of the GOL for 1996-2000 consisted of eight national priority programs, namely:

- 1) Food production (ensuring food security)
- 2) Stabilization/reduction of shifting cultivation (reducing slash and burn shifting cultivation)
- 3) Commercial production (moving from subsistence to commercialization)
- 4) Infrastructure development
- 5) Improved socioeconomic management and foreign economic relation (foreign investment)
- 6) Rural development
- 7) Human resources development
- 8) Service development

In this connection, the development strategy of the GOL could set out five general guidelines as follows:

- (1) Continued promotion of the market-oriented economy. The aim is to create a multi-sectoral economy with varied forms of ownership and production, services and distribution on market principles.
- (2) Development of agriculture, industrial and services sectors. Production in all sectors is to be fostered, services being developed to promote the regional role of the Lao PDR in this sector.
- (3) Development of regional economic structures. Development will be based on the principles that the economically stronger provinces will be able to assist less well-endowed provinces. Regional economic structures will be based on four areas. The north, where the strategy is to achieve food self-sufficiency and create a complete communication network and growing service sectors; the center, where the strategy is to make it the economic and political center of the country; the Savanhnakhet region in which all sectors are to be developed; and the south, where agriculture and forestry processing industries, as well as services, are to be developed.
- (4) Concentration on rural development. The strategy is to reduce revenue inequalities between the urban and rural population for equality and

social justice; to eradicate poverty in rural areas; and to help rural and mountain populations attain conditions for self-sufficient and market-oriented production, while strengthening village administration and preserving security and order in rural areas.

(5) Expansion of external economic cooperation. Closer economic integration with the Southeast Asian nations as well as the multilateral trading system to develop national advantages and potential are highlighted.

The strategic approach is to fight poverty through human development, rural development, and people's participation by focusing on (1) Agricultural and rural development, (2) education, (3) health, and (4) infrastructure development such as road construction and maintenance. Moreover, the Lao government has made a firm commitment to eliminate mass poverty and graduate the country out of the list of Least Developed Countries by the year 2020.

In this perspective, in order to create clearer pictures of development strategies of the GOL, the author prefers to clarify them and divides into two main parts, for instance the internal and external development strategies.

### **4.3.1 Internal development strategies**

#### **1) Agriculture versus Industry**

Although the changing composition of agricultural share contributed to GDP has been falling from 61.2 percent in 1988 to 52.2 percent in 1999, the agricultural sector is still the backbone of the Lao economy that providing more than half of total output and employing around 85 percent of the total work forces. In this respect, the GOL noticed the agricultural sector has the potential to become a substantial net exporter of food in the future. In this perspective, there are four concerns with agriculture explicitly in the development programs of the government's eight national priority program as mentioned above, namely: increasing food production, stabilizing and reducing slash-and-burn cultivation, promoting the production of commodities, and integrating rural development.

To accomplish this, the Lao PDR should transform the prevailing subsistence-oriented, low productivity, low input farming systems. Then developing rural infrastructure is a key priority, in particular investments in rural roads to provide access to markets.

In order to raise higher farmer incomes, Lao farmers should increase agricultural production that can be generated through two supply side improvements: (1) expansion of agricultural area where suitable agricultural land is still available and where labor

saving technologies are introduced, and (2) increased agricultural productivity through the adoption of better production techniques.

However, the industrial sector has increased almost two times from only 11.2 percent of GDP in 1988 to 22 percent in 1999, and has a trend to increase in the future because the GOL also supports the industrial sector, including the agro-industrial sector.

## **2) Voluntary saving versus involuntary saving**

In general, the rate of growth in the economy fundamentally depends on the rate of saving and investment (both physical and human capital investment), and on the efficiency of resource allocation for producing. In this connection, the author recognizes that as a result of GDP per capita of Lao people is relatively low, and then encouraging voluntary saving is rather hard to accomplish during this period. One way that the GOL can do is enhancing the involuntary saving, by further conducting reform the tax system as noted above in the public finance sector, in order to effectively collect the revenue as expected.

However, based on good experiences from other developing countries, voluntary saving is more sustainable compared to involuntary saving. Then voluntary saving of Lao people should be improved. As a result, in order to strengthen voluntary saving in the future, the GOL needs to place priority in four policy areas namely:

- Maintaining a stable macroeconomic environment
- Improving government mobilization
- Building up the capacity and efficiency of the domestic banking system, and
- Pursuing policy to reduce population growth.

### **3) Step by step strategy versus take off strategy**

Based on the development strategies of the GOL, particularly a firm commitment to eliminate mass poverty and liberate the country from under-development by the year 2020. This proves that the GOL are using step-by-step strategy. All of this is because of the initial conditions that were characterized by agricultural dominance, low capital income, extreme poverty, rudimentary infrastructure and weak administrative capacity. Moreover, the agricultural sector is still the backbone of the Lao economy that providing more than half of total output and employing around 85 percent of the total work forces.

### **4) Human investment versus transportation investment**

Due to the initial conditions of the Lao PDR, particularly poor developed infrastructure, then roads have been the GOL's top expenditure priority, and the road system has also attracted the largest share of donor funding. This has reflected the need to upgrade the extremely rudimentary road network in this sparsely populated country, to help link

dispersed domestic markets and create trade links to neighboring countries. Moreover, in order to be consistent with the Lao PDR's goal in transferring disadvantage of its landlocked position into an advantage by becoming a centrally-located land bridge connecting the large markets of Thailand, Viet Nam and China. Then the bulk of the GOL's planned investment until the year 2000 still accrue to the transport and communication sector, though it reduced from 51 percent in 1995, to 30 percent in 2000 (see table 4.1 Composition Public Investment Plan 1996-2000).

However, given the relatively under-developed human capital base, human capital building is also a priority. There is general agreement that the main way to increase the productivity of labor, and hence the demand for it, is to raise of "human capital" by fostering education, the acquisition of skill, better health, and improving nutrition. Therefore the GOL increases the share of education investment from 7 percent in 1995 to 10 percent in 2000, and the share of the health sector from 4 percent in 1995 to 8 percent in 2000 (see table 4.1 Composition Public Investment Plan 1996-2000) of total public investment. In addition, according to the decentralization plan (as mentioned in point 8) districts are to take on a key role as the principle units responsible for planning and budgeting. Many districts still lack the human resources to undertake these new functions. Then the human capital is really critical needs to huge amount of public

investment in the future.

### 5) Consumption goods versus investment goods

**Table 4.5:** Selected composition of imports from 1994 to 1998 (In million of US dollars)

Items	1994	1995	1996	1997	1998
Investment goods	146.1	189.3	277.0	226.8	226.7
Consumption goods	276.5	283.8	308.0	267.7	234.1

**Source:** IMF

According to table 4.4, during 1994 to 1998 the author notices that investment goods are lesser than consumption goods. This explained that the Lao PDR still enjoys using the consumption goods more than producing export goods, as a result the Lao PDR has traditional trade deficit for a long time. However, there is a trend that investment goods has increased, at the same time consumption goods has reduced, in particular in 1998 the amount of investment goods was nearly the same with consumption goods. This explains that the Lao society has a trend to change their behaviors from enjoying imported consumption goods to have the willingness to produce the commodities goods for export, by importing more investment goods.

## 6) Unbalance growth versus balance growth

**Table 4.6:** General Government Expenditures (Annual total, Kip billions)

<b>Ministries and sectors</b>	<b>1997</b>	<b>1998</b>
Public Health	8.8	17.3
Social Welfare	19.4	14.9
Education	31.0	37.4
Information and Culture	7.6	6.2
Agriculture and Forestry	10.7	17.5
Industry and Handicraft	43.6	45.2
CTPC	66.9	108.5
Commerce	0.2	0.4
Interior	15.3	17.3
Defense	49.2	53.5
Justice	0.4	0.5
Finance	1.4	1.9
Administration	24.5	17.9
Foreign Affairs	4.9	7.7
CPC	0.3	0.4
All Provinces	120.6	155.1

**Source:** IMF

Basing on the table 4.5, the expenditure of government is focused on Ministry of Communication, Post, Transport and Construction (CTPC), and Ministry of Industry and handicraft, at value of Kip 108.5 million and 45.2 million respectively. Therefore, the author concludes that the GOL using the strategy of unbalanced growth rather than balanced growth.

Moreover, as the author perceives one cause of unbalance growth is because of country's geography that two third is mountainous; the population is ethnically diverse

and consists of 49 ethnic minority groups. This diversity enriches the culture, but also implications for development. Then in area where land is relatively fertile and where communications are reasonable, farmers have been able to take advantage of the economic incentives enshrined from NEM. This is particular true for the villages situated along the Mekong valley, which further benefits from access to Thailand. But those in more remote areas, and these areas include the bulk of the country, have faced supply and marketing dislocations that have made production for the market difficult, and often impossible. Thus the reforms have, for the time being at least, widened spatial inequalities. Therefore, the incidence of poverty varies significantly across region, as well as between urban and rural area, such as the incidence of poverty in the northern of the Lao PDR is highest covers 53 percent of the population compared with 12 percent in Vientiane prefecture. This is also proved that there is unbalance growth in the Lao PDR.

#### **7) Current domestic firm versus new foreign firm**

The majority of foreign investment approvals have been awarded to wholly owned foreign investments is around 48 percent of total funds, with joint ventures accounting for slightly less is around 44 percent, contractual arrangements through various forms of licensing account for 8 percent. This explains that the trend of new foreign firms has increased because of FDI.

## **8) Centralization versus decentralization**

As a result of the GOL wants to facilitate greater people's participation in development, and then recently adopted a decentralization policy that focuses on provinces as "strategic units"; districts as "planning and fiscal units"; and villages as "implementing units". To this end, the GOL established the urban development administration authorities (UDAAs) to support decentralized urban development. Furthermore, the GOL has encouraged the devolution of decision-making and implementation responsibilities to the provinces to be more responsive to local needs. Therefore, capacity at the provincial level is an important issue and will need to be strengthened and better coordination between central ministries and the provinces that needs to be developed.

### **4.3.2 External development strategies**

#### **1) Domestic capital accumulation versus FDI**

Since the Lao PDR has chosen to follow the example set by the high growth economies of South East Asia in striving to make foreign direct investment as a key impetus for growth in the economy. Then FDI accumulation is more satisfied than domestic capital accumulation. On the other hand, because of GDP per capita of Lao people is relatively

low and then domestic capital saving in the past is also low.

## **2) Joint venture versus MNCs**

The majority of FDI approvals have been awarded to wholly owned foreign investment with 48 percent of total FDI, with joint ventures accounting for slightly less with 44 percent of total FDI. By the way, the GOL has recognized and support both types of investment.

## **3) Natural resources motivated FDI versus cost motivated FDI**

In general, textile and garment sector in the Lao PDR is satisfied and depended on low cost of labor and General System Preferences (GSP) from Europe. Due to these incentives, the textile and garment sector can attract FDI. As a matter of fact, according to the table 4.2, during 1988 to 1999, it is noticed that the amount of FDI in mining and oil was US\$ 139.5 million higher than the amount of FDI in textile and garment that reached only US\$ 73 million. Thus it explains that the natural resources motivated FDI is more attractive to foreign investors than cost motivated FDI. Although there is cheaper labor cost in the Lao PDR, it is unskilled labor.

## **4) Export-oriented versus import substitution**

Given the small size of the Lao PDR's internal market, then an inward-oriented strategy that emphasizes import substitution offers limited possibilities for growth. Along with

the poor transportation infrastructure, makes the effective size of the internal market even smaller. Therefore, the GOL issues the trade policies to push economic growth via export promotion, provide an appropriate environment for developing industries of comparative advantages, and also provide an appropriate environment for attracting needed skills and capital via FDI. With scarce domestic investment resources, rapid and sustainable economic growth for the Lao PDR is likely to come from increases in factor productivity rather than factor accumulation per se.

#### **5) Degree of open policy such as Special economic zone**

The Lao PDR has conducted the open policy since 1986, by liberalizing trade regime, attracting FDI in all form of businesses and so on. In this connection, the Special Economic Zone (SEZ) has also been planned to attract more FDI, and push the export-oriented growth and industrial sector. So far the GOL has finished the feasibility study of Special Economic Zone (SEZ) in the Savannakhet-Seno, central of the Lao PDR. The Japanese government supported this program. Moreover, Japanese investors have expressed interest in the SEZ in Savannakhet-Seno, in setting up a sugar mill similar to those in northeast Thailand, and furthermore electronic goods or car assembly plants could possibly emerge in the SEZ.

## **Chapter V: Summary of the study and comments**

The Lao PDR is in the process of making broad systemic reforms which have created the basic foundations of a market-oriented economic system: a market-based price system; a dynamic private sector; a two-tier banking system; and a largely open foreign trade regime are all in place. However, such process of transition from centrally planned to a market-oriented economy in the Lao PDR has not been smooth, confronted many challenges such as weak administrative capacity, under-developed infrastructure, poor human capital and low capital income; but there are clear signs that social and economic strong, and sustainable development will become true in the future, if the Lao PDR keeps conducting the economic reform package and social development.

Following on the NEM embarked in 1986, during the past 12 years, the Lao government has made substantial progress in macroeconomic performance with the continuation of strong stabilizing policies and setting foundation for structural reforms. This includes the public finance structure is improved, price deregulation, privatization of more than 600 SOEs, and opening up for foreign direct investment.

This because of the GOL recognized that the heart of the transition from CPE to market-oriented economy is the growth of the private sector and the withdrawal of government from direct production. Increasing a large part of distribution, pricing, credit, and other

economic decision should be left for markets to determine. Therefore, in order to complete the transition and sustainable development, strong participation of the private sector in the economy is needed and the requirement a firm commitment from the government to maintaining macroeconomic stability, strengthening institutional capacity, as well as fighting poverty through human resources development, infrastructure and rural development, and encourage all Lao people's participation to this commitment, in order to achieve the hope to graduate the Lao PDR out of the list of LDCs by 2020.

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