

Laos

Status Index (Democracy: 1.4 / Market economy: 1.3)		2.7		Management Index		2.8	
System of government	Autocracy	Population	5.4 mill.	GDP p. c. (\$, PPP)	1,620	Unemployment rate	n. a.
Voter turnout	n. a.	HDI	0.525	UN Education Index	0.63	Gini Index	37.0 (1997)
Women in Parliament	22.9 %	Population growth^a	2.2 %				
Largest ethnic minority	0.66 %						
Data for 2001 – if not indicated otherwise. ^{a)} Annual growth between 1975 and 2001. Source: UN Human Development Report 2003.							

1. Introduction

For Laos, the last five years were years of political inertia and economic stagnation. Real signs of steps forward in the transformation of the country towards democracy and market economy were scarce and fragile. To a large extent, the political evolution during the period can be traced back to the outcome of the Sixth Party Congress of the Lao People's Revolutionary Party (LPRP) in 1996. The congress resulted in a strengthening of the position of the members of the party opposed to the liberalization of the political system. The Seventh Party Congress, which was held in Vientiane in 2001, cemented this result with the old guard keeping a firm grip on power. An illustration of this is that General Khamtay Siphandone, 78 and one of the few surviving members of the Indochinese Communist Party founded by Ho Chi Minh in the 1930s, remained party chairman and State President.

Not surprisingly, in view of the political inertia, the commitment to market-oriented reforms remained weak during the last five years. The measures introduced in order to assist the transformation of the country toward market economy reflected for the most part external influences. The donor community exercised the strongest pressure, in particular the multilateral donors, the International Monetary Fund and the World Bank, who conditioned their financial support on the adoption of market-oriented measures and stricter budgetary and monetary policies. Another external factor was the Asian crisis that hit Laos through Thailand, its main trading partner and its largest foreign investor, and that obliged the country to implement reforms in order to tackle the macroeconomic consequences of the crisis and speed up economic recovery.

2. History and characteristics of transformation

During the second half of the 1980s Laos embarked on a comprehensive program of reforms, named the New Economic Mechanism (NEM). The main objective of NEM was to transform the country's depressed socialist economy into a market-oriented economy. Unlike what happened in many other countries that embarked on a similar transition towards market economy, democratic transformation and the opening up of the political regime did not accompany economic reforms in Laos. Perestroika without Glasnost has remained the motto of the Lao transition program. The LPRP has maintained a strict monopoly over political power. Each party congress since the start of the reform process has opposed liberal-democratic reforms and insisted that Laos should remain a one-party state.

Note that basically the same men managed socialism after the communist take-over in Laos in December 1975 and the transition away from a socialist economy after 1986. Kaysone Phomvihane, the historic leader and the dominant figure of the communist movement in the country since the 1950s, played a critical role as initiator and designer of the NEM. He also contributed to monitoring the implementation of the reforms until he passed away in November 1992. Note also that the transition process in Laos has run parallel with an increased role of the military in the top political leadership (party hierarchy and government). Today some two thirds of the members of the Politburo of the LPRP are current or former members of the Lao People's Army and the most prominent political posts are occupied by the military.

The program of transition from a socialist to a market-oriented economy was launched in 1986 and encompassed a variety of measures of both systemic and macroeconomic character that can be summarized under four main headings. The first concerns all the measures of a more microeconomic character that aimed at improving the structure of incentives and at encouraging the growth of private production. The second is trade liberalization that aimed at promoting the specialization of the country according to its comparative advantages and at integrating the country into the international economy, in particular the Southeast Asian region. The third is a less accommodating macroeconomic policy (that is less lenient budgetary and monetary policies) in order to secure price stability and reap the growth benefits of economic liberalization. The fourth heading covers the legal and institutional measures, which are necessary for the market economy to work.

The systemic changes have contributed to a significant transformation of the country's economic system towards a market system based on private ownership. Agriculture has been reversed to the private household system and co-operatives have been dismantled. Many state-owned enterprises have been privatized (or liquidated). Factor markets have been liberalized and foreign direct investments encouraged. Restrictions on internal trade have been removed. Business legislation has been modernized and a new constitution was adopted in 1991. The

role of the state in the economy has been redefined and made more limited. A market-adapted tax system has been introduced. Quantitative restrictions on foreign trade have been removed and replaced by lower import tariffs and export taxes on timber and other natural resources.

All these measures show that the country has engaged in an economic transition away from socialism and towards a market economy open to international competition. Not surprisingly, these measures improved resource allocation and spurred economic growth during the decade following the start of the reform process. However, the increased rate of growth has not been sufficient to achieve a substantial increase in living standards. This is in particular true for that part of the Lao population living in the countryside, since agricultural growth has been only slightly superior to population growth in rural areas. A main reason for this disappointing result is the very slow pace of transition from subsistence to market agriculture in Laos.

3. Examination of criteria for democracy and market economy

3.1 Democracy

The political order in Laos has only marginally changed over the past few years. Laos has remained a one-party state, with very limited opportunity for nonconformist and dissident voice. A certain form of political instability occurred in the late 1990s with the development of an internal strife between various factions of the LPDP, the regrouping and activism of the Lao opposition abroad and the revival of an ethnic conflict (with some Hmong insurgent groups) within the country. This instability did not threaten to a noteworthy extent the current political order, however. In the early 2000s, the internal strife in the party faded away and the Hmong rebellion lost intensity.

3.1.1 Political organization

(1) *Stateness*: The state monopoly on power is formally established throughout the whole of Laos. However, the population is scattered over large geographical areas, some of them mountainous, and therefore not easily accessible. Another factor that makes it difficult to maintain all-embracing state control is the ethnic diversity of the population with strong cultural and linguistic traditions and the absence among ethnic groups of a sense of national identity. Although all ethnic groups are formally Lao citizens, there remain wide differences in terms of access to education, health services and employment. All this contributes to preventing the development of a sense of national identity among minorities.

(2) *Political participation*: In Laos, there are no free democratic elections. Only candidates that are selected by the LPRP (or pre-approved by it) are allowed to

run for the five-yearly elections to the National Assembly. In the February 2002 elections, for instance, only one out of the 166 candidates (the Justice Minister!) was not a member of the LPRP. This is less than for the previous elections in 1997. The government claimed a 100 % voter turnout at the 2002 elections, which casts further doubt on the real tabulation of votes and the democratic nature of elections. Competing political groups are denied the right to stand for elections or the right to organize and demonstrate.

There is no state religion in Laos. Buddhism remains the religion of the majority of the Lao people, some 60 %. Over the past two decades, the LPDP has turned increasingly to Buddhism and its organizational structure in Laos (the Buddhist Sangha, the community of monks) to legitimate its monopoly of political power and promote Lao nationalism. Other religions are tolerated in principle. According to a recent Decree (No. 92 on July 5, 2002) "Lao citizenshave rights to participate in religious ceremonies at the temple or their own established churches and mosques". There remains, however, a huge gap between the legal rules and their implementation. Despite Decree No. 92 Christians continue to be denied certain civil liberties, like association rights, in particular in the southern provinces of Savannakhet and Attapeu.

(3) *Rule of law*: In October 1999, several students from the National University of Laos (at Dongdok campus) were arrested after demonstrating in front of the presidential palace in Vientiane for the establishment of multiparty democracy and the respect for human rights. Today, the arrested students are still in detention without trial in spite of a vigorous campaign by Amnesty International and other human rights organizations.

In October 2001, five European political activists (one of them a member of the European Parliament) demonstrated in front of the presidential palace in Vientiane to mark the second anniversary of the arrest of the students. The five were immediately arrested, sentenced to two years in jail and eventually deported from Laos following vigorous European criticism and threats to suspend European Union assistance to Laos. Still today the fate and whereabouts of the arrested students remain unknown.

The absence of a free and independent media combined with a weak civil society consolidates the monolithic structure of the Lao political system. The only existing newspapers, which are state-controlled, faithfully reflect government policy and are mainly concerned with Party propaganda, administrative matters, aid projects and collaboration between Laos and other socialist countries, in particular Vietnam. From time to time, the Lao government has expressed its concern over the development of the Internet in Laos.

The LPRP plays a central role in the political system. According to the 1991 Constitution, the LPRP is the "leading nucleus" of the political system. The LPRP selects the candidates to the National Assembly and, through the Assembly, the

members of the government after proposals from the State President (who is also the Party Chairman). The Party congresses also design the five-year economic plans that set the priorities for the government and shape its economic strategy. The role of the LPRP extends to the judicial system in spite of this being institutionally distinct from the executive branch.

The rule of law prevails according to the constitution but not in reality as widely illustrated by human rights organizations, in particular Amnesty International. There is actually no, or at best very little, protection from unjustified imprisonment and civil rights violations. The weakness of the civil society and the rudimentary organization of justice contribute greatly to the deficient rule of law in Laos. This is patent when it comes to corruption among civil servants. It is widely acknowledged that corruption has increased appreciably following the opening up of the economy and the augmentation of foreign investments. The historically well-rooted patronage system and the lack of transparency in government-business relations contribute greatly to this development.

Yet no corrupt officeholder has been prosecuted under the law in spite of the political report from the Sixth Party Congress in 1996 emphasizing the need for measures to “curb corruption among state employees”. Only adverse and temporary publicity has fallen on those suspected of corruption. An example of this is General Sisavath Keobounphan who was dropped from the Politburo of the LPRP in the early 1990s following rumors of corruption, but was reinstated in the party leadership and became Vice President in 1996.

3.1.2 Political patterns of behavior and attitudes

(1) Institutional stability: Political institutions are under-developed in Laos, reflecting the communist nature of the regime and, to a lesser extent, the scarce human and material resources of the country. The first constitution of the communist regime was adopted in 1991, long after the communist take-over in 1975. For more than one and a half decades the Lao political order was thus constitution-less. At the end of 2001, a committee was formed to propose revisions of the 1991 Constitution that will bring it more in line with the “socio-economic development of the country”. The work of the committee seems to have come to a standstill as a result of the opposition of conservatives within the LPRP. Today the one-party state is mainly challenged from abroad by a Lao opposition that is spread over different groups and continents, ranging from Hmong exiles in the U.S. to royalist in France and the transnational United Lao National Resistance for Democracy. Attempts are being made to unify these groups whose objective is to institute a multiparty democracy in Laos.

(2) Political and social integration: Laos has a poor landscape of interest groups and a weak civil society. The military network, which is made up of current and former members of the Lao People’s Army, constitutes the most powerful interest

group. The fact that it is the only organized, well-structured, and officially accepted network “outside” the LPRP explains its growing and today overriding influence on political life in Laos.

Another significant related interest group is the complex made up of the remaining state-owned enterprises (included the military ones) and the state-owned commercial banks. Unlike what could be seen in China or Vietnam, this complex did not oppose transition to market economy at the outset. This is presumably due to the relatively small size of industry in Laos as compared to neighbouring socialist countries. But the difficulty met in reforming the banking system and criticism from Party members against “uncontrolled and hasty privatisation” suggest that this interest group is more organized and powerful today compared to the early 1990s.

Other large organizations (the so-called mass organizations) like the Federation of Lao Trade Unions and the Union of Lao Women are the prolonged arms of the LPRP in the society and their leaders are recruited from the top leadership of the Party, mostly the Central Committee. They act on behalf of the Party (rather than on requests from workers and women) and are therefore no threat to the current authoritarian institutional order. The remaining social interests in the country, like peasants, private entrepreneurs, small traders, consumers, etc. are not organized and go largely unrepresented in the political arena.

3.2 Market economy

Between the start of the reform process in 1986 and the mid-1990s several important steps were taken in Laos to transform the socialist economy into a market economy open to international competition. Since then reform efforts have slowed down considerably following the growing influence in the party hierarchy and the government of the army and the members of the party opposed to comprehensive market-oriented economic reforms.

3.2.1 Level of socioeconomic development

A look at the key indicators of socioeconomic development suggests that the performance of Laos in terms of human development is poor and that the situation changed only slightly in the last few years. This is illustrated in the table on socio-economic indicators of modernization, which provides various indexes of human development. GDP per capita even decreased, partly as a result of the huge depreciation of the Lao currency in the late 1990s. The gender situation improved marginally during the same period. The percentage of women in the LPRP’s Central Committee, which is a more accurate way to measure women’s political empowerment in communist one-party states, actually decreased between the

Sixth and the Seventh Party Congresses. There is no woman in the highest political organ of the LPRP, the Politburo.

Table: Development of socioeconomic indicators of modernization

	HDI	GDI	GDP Index	UN Education Index	Political representation of women ^a	GDP p.c. (\$, PPP)
1998	0,484	0,469	0,48	0,50	8	1.734
2000	0,485	0,472	0,46	0,52	6	1.575

^a Percentage of women in the Central Committee of the Lao People's Revolutionary Party.
Sources: UNDP, Human Development Report, 2000, 2002.

It is likely that the stagnation of human development has been accompanied by an increased inequality of wealth and incomes. The most recent estimate of inequality in Laos pertains to 1997-1998, when the Gini index equaled 37 %. This is low when compared to most other countries in South-East Asia. Inequality in Laos, nonetheless, increased during the 1990s, parallel with a rather high rate of economic growth. In 1992-1993 the Gini index was significantly lower, 29 %. The reason behind this increase in inequality is that growth in Laos is concentrated to the service and industry sectors and to urban areas close to Thailand.

The transformation process due to the large role of subsistence agriculture has hardly affected rural and mountainous areas, in particular in Northern Laos. The trend observed during the 1990s has probably continued with, as a likely result, income inequality wider today than in the late 1990s but also closer to the level noticed in neighboring countries. An implication of this is of course that inequality between the provinces has increased as well with income per capita in Vientiane Municipality now being more than twice that of Laos on average.

3.2.2 Market structures and competition

The Lao economy is dominated by agriculture, which accounts for more than half of GDP. The large place of subsistence farming in agriculture means that the scope for markets and competition in rural areas is limited. Nevertheless the role of markets expanded during the 1990s following the abolition of most internal barriers to trade and the liberalization of agricultural prices. But agricultural markets are still segmented within the country because of the deficient transport infrastructure and the resulting high transaction costs.

In industry, the small size of the country and the pervasive role of the state in the industrial and banking sectors limit competition. Many public enterprises administered by the central government or the provinces were privatized (or liquidated) between the start of the reform process and the mid-1990s. The privatization process has slowed down markedly since then. Today the government argues that its objective is to retain only 32 enterprises in the public sector. In most industrial branches, the degree of competition is low with enterprises, state-owned or private, often benefiting from monopoly-like situations. This is, in particular, the case for the military-owned enterprises the activities of which have expanded and diversified (from timber concessions to cement production or road construction), encouraged by the Government's policy to make the Lao People's Army economically self-sufficient.

The competitive situation of the banking sector is similar to that noticed in the other sectors of the economy with non-competing state-owned commercial banks accounting for 70 % of the total assets of the sector. The interweaving of state-owned banks, state-owned enterprises, and government and LPRP officials contributed to the huge increase of bad (or non-performing) loans on the balance sheets of state-owned commercial banks in the late 1990s. Non-performing loans accounted in 2000 for some 70 % of the loans accorded by the state-owned commercial banks, mostly to state-owned enterprises. This contributed to the loss of confidence in the banking system and to the considerable depreciation of the Lao currency.

International competition increased between 1987 and 1997 as a result of trade liberalization, a main component of the NEM. During this period quantitative restrictions were removed, the tariff structure was simplified and tariff levels significantly lowered. There remained, however, numerous non-tariff barriers, mostly administrative hinders. The Asian crisis, the eventual contraction of exports, the decline in the volume of foreign direct investments, and macroeconomic instability in the late 1990s; all these factors led the government to again tighten trade controls. Today quantitative restrictions are imposed on a number of products such as motor vehicles, motorcycles, cement, fertilizer, petroleum, and from time to time rice. The imposition of import restrictions and the chronic lack of transparency of the Lao trade system lessen substantially the strength of international competition in the country.

3.2.3 Stability of currency and prices

The macroeconomic situation was very erratic in the last five years as a result of both external and internal factors. The Asian crisis played a critical role, but domestic factors also fuelled macroeconomic instability, as evidenced by the much higher inflation rate and larger exchange rate depreciation in Laos than in neighboring countries. Political inertia contributed greatly to the rapid deterioration of the macroeconomic situation, in particular in 1998 and 1999, by

delaying the adoption of a less accommodating macroeconomic policy and banking reform.

Between the end of 1997 and the end of 2002, the Lao currency, the Kip, depreciated massively, losing some 80 % of its value (plummeting from 2,135 to 10,650 kips per dollar). This is something of a world record in this period! The main reasons for the free fall of the Lao currency were the lenient monetary policy and the monetary financing of some budgetary expenditure.

An illustration of this is the large-scale irrigation project that was launched in 1997-1998 in order to achieve rice self-sufficiency. The project was defended by Khamtai Siphandone and was partly financed by the Lao central bank, which resulted in an upsurge of inflation in Laos. In 1998-1999 inflation in Laos averaged 109 %! With the assistance of the International Monetary Fund, the World Bank and the Asian Development Bank, the macroeconomic situation improved in the early 2000s. But the Lao currency continued to depreciate and in late 2002 inflation rose again, presumably as a result of a loss of control over budgetary expenditures in the provinces.

3.2.4 Private property

The reform of land rights introduced in the early 1990s focused on user rights rather than on formal private ownership. Land still belongs formally to the state but farmers have been given long-term tenure and they are allowed to pass on land to their children or to sell user rights. The differences between these rights and full formal property rights should therefore be regarded as limited. The protection of property rights has been improved further by the adoption of an inheritance law, a contract law and a property law. The institutions that can guarantee this protection are, however, underdeveloped, which means that the enforcement of property rights is still deficient and not free from political intrusion.

3.2.5 Welfare regime

Social safety nets in Laos are underdeveloped, reflecting the low level of per capita income in the country. Most households rely on subsistence farming and income from informal activities for their livelihood. Only in larger cities, in particular Vientiane Municipality and Savannakhet, is formal employment a significant source of income. Redistribution of income is more or less non-existent in Laos but some households, in particular in central and Southern regions, benefit from remittances from abroad. Corresponding figures for both regions are 35 % and 37 %, respectively.

The worst situation is found in the northern provinces of Oudomxay and Houa Phan, where no less than three out of four inhabitants live in poverty. Other features of poverty in Laos are that it is predominantly a rural phenomenon and that it mainly concerns ethnic minorities, households with low levels of education and households without access to public infrastructure (electricity, safe water and roads).

Laos can hardly combat poverty on its own because of the large scope and depth of poverty and the poor resource endowment of the country. One of the main objectives advanced by the Seventh Party Congress in 2001 was to eradicate poverty by 2020 after having halved it by 2005. This should be considered as unrealistic because raising growth and productivity in rural areas, which is necessary to reduce poverty, requires overcoming constraints such as low education, health and nutrition standards, and poor infrastructure, which can only be accomplished in the long term.

3.2.6 Strength of the economy

Economic growth in Laos, which has been moderately affected by the Asian crisis and the considerable deterioration of the macroeconomic stance, is largely de-linked from macroeconomic turmoil because of the predominant role of agriculture and subsistence farming in the economy. The Asian crisis and poor crisis management in the late 1990s mainly affected the urban population, which was more involved in the cash economy and more dependent on imported goods. The civil servants were most hit because their salaries did not increase in line with inflation. The impact on rural areas was less dramatic and some rural areas close to Thailand and more integrated in the cash economy might even have benefited from the huge depreciation of the Lao currency through boosted exports. GDP growth remained within the 5-6 % range in the early 2000s.

Table: Development of macroeconomic fundamentals (1998-2002)

	1998	1999	2000	2001	2002
Growth of GDP in %	4,0	7,3	5,8	5,7	5,7
Export growth in %	6,4	1,5	8,3	0,3	4,1
Import growth in %	-14,7	0,3	12,9	-1,6	-0,1
Inflation in % (CPI)	87,4	134,0	27,0	7,8	14,6
Budget deficit in % of GDP ^a	-12,9	-9,0	-8,3	-7,5	-6,4
Ratio of debt-to-GDP	84,5	80,0	70,1	70,1	72,6 ^c
ODA (% of GDP) ^b	25,9	25,1	19,9	21,5	21,5

^a Fiscal year, ending September 30. ^b Official development assistance inflows. ^c IMF projections.
Source: Lao authorities and IMF.

The failure of economic transition in Laos to reform the core of the socialist economic system, namely the interweaving between the state-owned (often military) enterprises, the banking system (including the central bank) and the one-party state contributed greatly to macroeconomic instability in the last five years. It also fuelled fiscal fragility, through its impact on both budgetary revenue and expenditure, and monetary instability. In Laos, some 80 % of the development expenditures are financed by foreign assistance, which allows a budget deficit of between 4 and 5 % of GDP and foreign debt of some 70 % of GDP. From time to time the loss of control over the budgetary situation has led to a monetary financing of part of the deficit, a revival of inflation and a flight out of the Lao currency.

3.2.7 Sustainability

A main objective of reform policy in Laos is to achieve a higher rate of growth and improved living standards in order to secure some political legitimacy to the political regime. Ecological considerations have only received limited consideration, in most cases initiated by the donor community (especially bilateral donors like Germany and Sweden) and environmental associations. Two examples illustrate this. The first concerns deforestation, with forest areas falling from 70 % to 40 % of Lao territory over the past fifty years. Uncontrolled logging, not the least by the military companies, has contributed to this development, which has only sporadically been a source of concern for the Lao authorities. Another example concerns the planned construction of the largest hydropower dam (Nam Theun 2) in Laos for the production of electricity to be exported to Thailand. The project received slight ecological consideration at the outset and it is only under the pressure of environmental organizations and some donors that the ecological sustainability of the project has been addressed.

Human capital endowment is poor in Laos. The average educational attainment of the population is low and a large share of the population lacks the basic skills needed to work in industry or the service sector. This outcome reflects the limited resources devoted by the Lao government to the education sector over a long period of time.

A complementary factor is the flight of skilled labor following the communist take-over in 1975. Public expenditure on education decreased from 3 % to 1.8 % of GDP between 1994-1995 and 1999-2000. During the same period, public expenditure on education decreased from 11.7 to 9 % of total government expenditure. Education expenditure has increased somewhat since, reflecting pressure from the donor community and greater emphasis placed on poverty alleviation. Education expenditures are significantly lower in Laos than in neighboring countries, and are biased in favor of primary education (55 % of education expenditure).

Higher education is less of a priority and only 8 % of education expenditure was devoted to higher education (and research) in the late 1990, as compared to 16 % in China and 22 % in Vietnam. It was only in 1995 that the government regrouped various institutions of higher education into the National University of Laos (NUOL), the only university in the country. The standard of education at NUOL is very low even if it has improved somewhat since 1995, reflecting the financial and technical engagement of the donor community, in particular the Asian Development Bank. In 2000, only 2 % of the teachers at NUOL had Ph.D. degrees, most often obtained from Vietnamese and Soviet Block universities. Research at NUOL is embryonic. By international standards the Lao educational system is performing poorly, which affects negatively the skills acquired and the human capital accumulated by the labor force.

4. Trend

(1) Democracy: The Lao state faces real problems of maintaining national unity and improving state identity because of the ethnic diversity of the country and the weak political legitimacy of the regime. One of the factors threatening national unity is the opposition by Hmong groups to the communist government. In the late 1990s, several ambushes were launched by the Hmong rebellion along the road between Vientiane and Luang Phrabang.

The intensity of the Hmong attacks waned in the early 2000s but on February 5th 2003, a new ambush killed 10 people, two of whom were tourists. The real motive and identity of the gunmen are still unknown, however. In 2000, the Lao government sought Vietnamese military assistance to face an escalation of the Hmong rebellion in the province of Xiang Khouang. Vietnamese troops were involved in the operation, which was denied by the Lao government.

In Laos all power structures continue to be tightly intermeshed and controlled by the LPRP. Political participation is limited to a minimum. A minor improvement could be noted in the elections for the National Assembly in 2002 when the number of candidates pre-approved by the Party related to the number of seats (166 candidates for 109 seats) increased compared to the 1997 elections. This gave voters a slight, albeit very limited opportunity to choose from different candidates. Public participation in development projects has increased somewhat under the pressure of the donor community, as illustrated by the public consultation and participation process organized in connection with the Nam Theun 2 hydropower project.

Foreign assistance has contributed to strengthening the formal legal framework, but it has not (or has only slightly) improved the rule of law because of limited resources for the judicial system and undue influences on law enforcement.

(2) *Market economy*: The development indicators show negligible improvement from an already low level of development. This also holds true for indicators of women empowerment and education attainment. The Gini index was last computed in 1997-1998 and it is not possible to assess its change during the period under examination. However, the uneven distribution of economic growth across sectors suggests that inequality has increased between provinces and households (and between the privileged LPRP hierarchy and the masses).

In Laos 31 % and 77 % of the population live on less than US\$1 and US\$2 a day, respectively. The institutional environment deteriorated markedly in the late 1990s, particularly in the areas of macroeconomic policy (fiscal policy, monetary policy, and exchange rate policy) and policy towards foreign direct investment. The macroeconomic situation recovered somewhat in the early 2000s but the underlying institutional and structural causes of macroeconomic fragility remained in place, which explains why macroeconomic instability resurfaced again in late 2002 and early 2003.

The deterioration of the macroeconomic stance had a limited impact on economic growth which remained at around 5 %. Two factors explain this discrepancy between the macroeconomic and growth outcomes. First, economic growth in Laos is de-linked from macroeconomic instability, at least in the short run, because of the great role of subsistence farming in the economy. After all, weather conditions matter more than stabilization policy for agricultural output. Second, it is known that official statistics in Laos overestimate agricultural production and growth, which means that actual GDP-growth is lower than the official rate. For 1999, for example, the IMF estimated real GDP-growth to be about 5 % that is more than two percentage points lower than the official figure (7.3 %).

5. Transformation management

5.1 Level of difficulty

Laos suffers from several structural weaknesses that tend to lock the country in a form of poverty trap and to obstruct the transformation of the country into a market economy and democracy. The poverty trap is made up of low real incomes, poor human capital endowment (mainly educational attainment), underdeveloped infrastructure, and huge inequality in human capital and infrastructure endowments across space. There is a kind of cumulative process where all the components of this poverty trap interact to keep the country in the group of low-income countries.

Poor human capital endowment and poor infrastructure result in low labour productivity and low levels of per capita production and income. In turn low levels of incomes limit the capacity to save and to invest and thereby the potential for improved productivity. This process is all the more critical in remote areas

(especially in Northern Laos) where low incomes limit the inducements to expand non-rural activities and to develop rural urban linkages.

The growing inequalities between the regions combined with ethnic fragmentation have contributed to fuelling social and ethnic tensions. From time to time, the top leadership has used ethnic discords and conflicts (real or potential) to justify the political and institutional standstill. The absence of political liberalization with power sharing, accountability and regional (ethnic) empowerment can be ascribed to other stumbling blocks of more structural and historical character.

One is the absence of civil-society traditions as illustrated by the fact that the overwhelming majority of NGOs active in Laos are foreign ones. Another is the low degree of participation in public life (for example only 1.5 % of the population adheres to the LPRP). A third is the lack of lasting historical experiences with effective rule of law. A last factor concerns the scarce human, administrative and material resources that impact not on the objective of democracy but on the speed of the possible democratic transformation and the building up of democratic institutions.

5.2 Reliable pursuit of goals

The party top leadership decides the long-term strategy of the Lao government most often in connection with the party congress. The Seventh Party Congress held in 2001 presented several economic objectives with some discussion of the accompanying measures. As expected, the Party took no steps towards multi-party democracy. The first economic objective was a long-term GDP growth of 7 %. The analysis of the measures necessary to achieve this objective was rather vague, with mention of continued market-oriented reforms (without going into details), the promotion of private activities, the mobilization of human resources, the improvement of transport infrastructure and the end of slash-and-burn practices in agriculture.

This growth objective should be considered out of reach because Laos has a predominantly agricultural economy (agriculture accounts for half of GDP) and agriculture is dominated by subsistence farming, which by its very nature does not grow or grows very slowly. The Congress put forward two other objectives, to triple per capita income by 2020 and to eradicate poverty by 2020 after having halved it by 2005. Both objectives should also be considered unrealistic given the rapid demographic growth, some 2.8 % per year. At that rate population will double by 2025. Further, rural poverty is the dominant form of poverty in Laos, and combating poverty in rural areas requires improving educational attainment, health and nutrition standards, and infrastructure, all measures that can only be carried out in the long term.

The Lao leadership seems not to have the capacity to design realistic objectives with appropriate accompanying measures. Economic policy in Laos for the most part consists of ad-hoc measures that are introduced in response to emergency situations and pressure from the multilateral donor community. Genuine domestic strategic considerations are seldom backed by a consistent and coherent set of reforms. This means that the encompassed measures and policies often counteract each other. For example, in the late 1990s, the monetary financing of the irrigation program in order to achieve rice self-sufficiency and combat poverty counteracted another objective of economic policy, namely macroeconomic (price and exchange rate) stability. The attainment of the latter objective was necessary to build an attractive investment climate and secure large inflows of foreign direct investment. The unreliability of the government in achieving macroeconomic goals incurs high politically induced risks for economic agents, deterring investment and affecting growth adversely.

5.3 Effective use of resources

The Lao government's use of personnel, financial, and organizational resources is far from optimal for economic development and transformation towards market economy. For historical reasons, personnel resources are scarce in Laos and they are often misallocated. Recruitment procedures for public jobs favor candidates that are members or close to the Party over candidates with appropriate skills.

Political considerations and clan patronage (including family connections) play a decisive role in the recruitment of high public servants but they also matter for more common public jobs in the bureaucracy. The existence of a patronage system with well-established clans implies that government reshuffles redistribute randomly qualified staff between ministries without consideration of merit and ability in the appointment to the post.

There are plenty of examples of inefficient use of financial resources in Laos: chronic and large budget deficits, high public debts, opaque planning and implementation of the government budget, and financial supports to the ailing and mismanaged public commercial banks and state-owned enterprises. This poor use of financial resources reflects to some extent the prevalence of an administrative organization, which is a legacy of the command economy period and is badly adapted to the transformation of the economy toward market economy. This applies to the central administration but still more to the provincial and district administrations, which have been allotted greater financial and economic autonomy since 2000.

One and a half decades ago, Laos embarked on a comprehensive program of reform whose main objective was the development of a private-based market economy open to international competition. Only parts of the program have been implemented as a result of the opposition of conservatives within the Party and

also misjudged structural obstacles to the rapid development of a market economy in Laos. The government has not been able to keep its own initial goal in areas such as the privatization of state-owned enterprises, the modernization of the banking system, macroeconomic stability, and private sector expansion. The difficulties met in transforming the Lao economic system and macroeconomic mismanagement have negatively affected the quality of state intervention, especially in the areas of education and other social sectors.

The deterioration of public services is likely to put severe constraints on future growth and development in Laos. A political economy reason for the poor quality of state intervention is the prevalence of patronage networks and the development of a kind of bargaining economy with powerful interest groups, often linked to the political leadership, capturing public decision-making. Opaque government-business relations, the absence of political competition, a weak civil society, and the lack of democratic references in the top leadership; all these factors interacted to bring to a halt, or at least to slow down significantly, the transition towards market economy in Laos.

5.4 Governance capability

Economic policy in Laos was late in tackling the consequences of the Asian crisis and in adapting the transformation program to the new economic environment. For that reason the crisis hit Laos more than neighboring countries. One reason for the delayed policy response was the ideological straitjacket that prevented the top Lao leadership from reacting rapidly and adequately to the crisis. Macroeconomic policy adapted eventually under the pressure of the donor community.

Another reason is the fear of powerful interest groups (like state-owned enterprises and banks, or the Lao People's Army) that were hit by the crisis and benefited from financial and other forms of assistance from the Lao government. The slow and poor decision-making of the Lao political players in dealing with economic turbulence illustrates for sure their limited adaptive learning capacities and low level of qualification. It also shows that the Lao government does not have enough authority to challenge vested interests.

The design and implementation of policies are often more the result of political-economy considerations than of an analysis of the expected effects of policies on resource allocation. In the case of Laos a factor that contributes significantly to this pattern is the lack of political competition and the weakness of the civil society.

5.5 Consensus-building

The Lao reform process has focused exclusively on economic reforms. There is no major political actor within the country, who advocates the introduction of multi-party democracy. The most vigorous opposition to political opening up is from the military network, which benefits from a kind of veto power due to its strong position in the party hierarchy. On the other hand there is a consensus among the main actors to move towards a form of market economy. This is considered necessary to improve the real incomes and the living standards of the population and thereby the legitimacy of the communist regime. It is also necessary to provide economic privileges to those interest groups close to the political leadership, for example timber concessions and trading rights for the military companies.

There are clear lines of ethnic, regional and religious cleavages in Lao society. Periodically, these lines of cleavage turn into tensions and in some case into armed conflicts. The Lao government (and the LPRP) has committed itself on repeated occasions to the notion that Laos is a multiethnic state. This is also formally acknowledged in the 1991 Constitution. Further, all religions are formally tolerated even if from time to time religious minorities have been denied certain rights.

Finally, the government initiated a process of decentralisation in 2000 to strengthen regional self-empowerment. There remain, however, wide differences in terms of access to education and social services and more generally in terms of geographical distribution of public expenditures. The government has not addressed the uneven distribution of public expenditure and services across space. On the contrary, the deterioration of public finances in the late 1990s led to a worsening of education and other services in some regions, in particular in remote areas, increasing the risk of escalation of ethnic and regional tensions in the country.

To some extent, the uneven distribution of public expenditure across space reflects ethnic fragmentation and the unwillingness of lowland Buddhist Lao, who constitute the majority of the population (60 %) and dominate the ruling elite, to act with solidarity with the non-Buddhist, most often animist people. This uneven provision of public goods (education, health, roads, etc.) in Laos impedes the accumulation of social capital and balanced social and economic development.

5.6 International cooperation

The collapse of the communist regimes in Central and Eastern Europe and the end of their financial assistance accelerated the reform process in Laos during the first half of the 1990s. The need to find alternative sources of assistance, combined with the ideological vacuum following the collapse of communism, obligated the

Lao leadership to accept the kind of market-oriented reforms advocated by the donor community, especially the IMF and the World Bank. The role of the multilateral donor community weakened markedly in the late 1990s parallel to the militarization of the political elite and macroeconomic mismanagement.

Relations with the multilateral donors resumed again in 2001 with the granting of a Poverty Reduction and Growth Facility by the IMF and the financing of infrastructure projects by the World Bank. Bilateral donors have also been involved in projects concerned with the transition towards market economy (in areas like tax collection, rule of law or administration reform). The potential positive impact of the huge foreign assistance to Laos (some 20 % of GDP) on the transformation process is, however, limited due to the poor quality of governance and the lack of a genuine commitment to market-oriented reforms on the part of the Lao leadership.

Deficient co-ordination among donors and absorptive capacity problems are also put forward to explain the low returns from bilateral foreign assistance. Since the early 2000s, the Lao government has made some efforts to regain some credibility among the international donors. One example of this is the drafting of a National Poverty Eradication Programme (NPEP) which is expected to receive the support of the donor community and give it the impression that the Lao government is a reliable partner.

From time to time, the bilateral donor community has expressed concerns over human right abuses, the Lao government secrecy and the democratic deficiency. Bilateral donors have, however, been reluctant to make full use of their economic influence to promote transparency, the rule of law and market-based democracy. The Lao government has successfully opposed political liberalization with the help of neighboring communist Vietnam, whose ideological and political influence in Laos is all encompassing. In the longer run, however, it is unclear whether the one-party state will survive membership in ASEAN and the inevitable exposition to other member countries' democratic institutions and modern media.

6. Overall evaluation

(1) Current situation: Laos in 2003 can be characterized as an authoritarian one-party state with uncertain state and national identity. The military and aged Party members, who are opposed to power sharing and multiparty democracy, strongly dominate the political elite and decide the reform agenda. No significant transformation of the political system is under way and the media are under the strict control of the communist party.

Public participation remains low and there is no network of independent associations between the society and the political system. The legal framework is still underdeveloped but there is now a constitution and basic national laws (civil,

criminal, business, labor, and family). The separation of power written down in the 1991 Constitution does not exist in practice, however. State powers in Laos are interdependent and highly dependent upon the LPRP. By the same token, the lack of personnel and financial resources, and undue influence upon judges and officials restrict considerably the scope and the effectiveness of the rule of law. The central and provincial administrations are badly adapted to market-based democracy and concepts like transparency and accountability are not integrated in public policy.

Today's Lao economy consists of a low-productive agricultural sector dominated by subsistence farming and poorly competitive industry and service sectors where market reforms have made critical inroads. Outside the agricultural sector, a form of bargaining economy has emerged, which combines imperfect competition in most sectors with a few firms accounting for a large share of domestic production, strong interest groups at the national and provincial levels (like the military-political network), a lack of transparency in government-business relations, a weak civil society and the one-party state with a strong influence of the communist party on economic policy. Consequences of this distorted market economy are the multiplication of rent-seeking activities, the strong role of political considerations in the conduct of economic policy, a stop-and-go fiscal stance and eventually financial and monetary fragility.

(2) *Evolution:* By large, the transformation towards democracy and market economy has stagnated in Laos during the period under study. The outcome of the Seventh Party Congress in 2001 cemented the firm grip on power of the conservatives and the military. Internal strife within the party, social and ethnic unrest, and activism of the Lao opposition abroad have challenged state and national identity but without consequence for the attachment of the top communist leadership to the one-party state.

During the lengthy preparation of the Seventh Party Congress some foreign observers noticed modest signs of political opening, which did not materialize in the form of changes in the party hierarchy or the government. Slight progress could be discerned, however, in the transformation of the legal framework and administration system, with the help and often under the pressure of the donor community. There remains, however, a huge gap between formal advancement and real implementation, especially when it comes to the rule of law and power sharing.

Market-oriented reforms slowed down markedly during the same period and this affected negatively the country's macroeconomic development. A first illustration concerns the reform of the banking system, that is the hardening of budget constraints and the re-capitalization of state-owned commercial banks, which was postponed several times. A second concerns the autonomy given the Lao central bank, which was never fully respected by the Lao government with, as a consequence, the maintained primacy of political considerations over monetary

stability. In the early 2000s, the Lao decision-makers could curb the worst macroeconomic imbalances with the help of multilateral donors. Eventually structural reforms were again put on the reform agenda

(3) Management: The management performance of the political leadership during the last five years must be considered poor. The transformation towards democracy was never put on the road and the slight improvements in democratic institutions that occurred during the period under study were, for the most part, introduced under the pressure of the donor community. The economic transformation process lost credibility in the late 1990s but regained some in the early 2000s. This was not sufficient, however, to significantly alter the opinion of the international community on the reliability of the Lao political leadership in economic matters.

There are numerous examples of a clear worsening of management performance over the past five years as compared to the period before: macroeconomic mismanagement, weak records in combating corruption, poor use of the huge foreign assistance to Laos, meagre achievements in improving educational attainment and health situation, and amplified social and ethnic tensions.

7. Outlook

The overall picture that emerges from an analysis of the transformation process towards democracy and market economy over the past five years is a rather negative one. There are no unchallenged signs of change towards a democratic system in Laos (multiparty and power sharing, accountability, transparency, and effective rule of law) and public participation remains embryonic. Only slight changes in the institutional efficiency of the government have occurred. Further, the transition towards market economy has proceeded very slowly, adversely affected by macroeconomic turbulence. Given the current situation in Laos, the strategic key tasks for democratic and market-economy reforms over the medium term are all the more encompassing and it is difficult to single out some of them.

However, real progress towards a market-based democracy can hardly be achieved without more effective rule of law, increased public participation at the national as well as local levels (provinces and districts), power sharing, freedom of the press, more secure property rights, increased competition from both domestic as well as foreign enterprises, and macroeconomic stability. All these are difficult to achieve mostly because the current leadership has no genuine commitment to such tasks and there are no political players within the country (and the LPRP) today, who can advance economic and still more political reforms. The prospects for Laos, in so far as developing a market-based democracy in the medium term is concerned, are therefore dim.