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Lao People's Democratic Republic Issues in Public Economics

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Country Operations Division
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CURRENCY EQUIVALENTS

Currency Units: Kip National (KN)

Exchange Rate Arrangements

Currently the Lao PDR adopts a unified, market-related exchange rate. The unification process was initiated in 1986 when the commercial exchange rate of the Kip, one of the seven official rates, was devalued from 35 to 95 Kips per dollar. Then, in September 1987, the Government reduced the number of rates from seven to four, ranging from 10 to 350 Kips per dollar. In July 1988, all multiple exchange rates were eliminated and a single rate was announced at 400 Kips per dollar. The exchange rate has been periodically adjusted since to reflect market developments. The selling rate was 720 Kips per dollar as of mid-November 1988.

1. Official Exchange Rate

January 1980:	US$1.00 = KN 10
July 1988:	US$1.00 = KN 400
December 1989:	US$1.00 = KN 455
November 1989:	US$1.00 = KN 720

2. Commercial Exchange Rate

January 1982:	US$1.00 = KN 35
December 1986:	US$1.00 = KN 95
July 1988:	Abolished

3. Inward Remittances

July 1983:	US$1.00 = KN 108
July 1985:	US$1.00 = KN 270
December 1986:	US$1.00 = KN 350
July 1988:	Abolished

FISCAL YEAR

January 1 - December 31

ABBREVIATIONS AND ACRONYMS

ADB	-	Asian Development Bank
AP	-	Annual Plan
BCEL	-	Banque pour le Commerce Exterieur Lao
CIF	-	Cost, Insurance and Freight
EDL	-	Electricite du Laos
EPTL	-	Entreprise des Postes et Telecommunications du Lao RDP
FYP	-	Five-Year Plan
GDP	-	Gross Domestic Product
IFAD	-	International Fund for Agricultural Development
IMF	-	International Monetary Fund
IRCSID	-	International Center for Settlement of Investment Disputes
KN	-	Kip National
LAO PDR	-	Lao People's Democratic Republic
MCEER	-	Ministry of Commerce and External Economic Relations
MEPF	-	Ministry of Economy, Plan and Finance
MCTPC	-	Ministry of Communication, Transports, Posts & Construction
MGWh	-	Megawatt/hour
NEM	-	New Economic Mechanism
NGO	-	Non-Government Organizations
PFP	-	Policy Framework Paper
PIP	-	Public Investment Program
PTT	-	Post, Telephone & Telex
SPC	-	State Planning Committee
TCA	-	Tax sur le Chiffre d'Affaires
TPY	-	Tons per Year
UN	-	United Nations
UNDP	-	United Nations Development Program

FOREWORD

This report was prepared by a team led by Bernard Funck (mission leader) and comprising Klaus Lorch (state enterprises), Kenan Bulutoglu (fiscal resources), Beatrice Buyck (expenditure management) and Su-Yong Song (quantitative analysis). It also benefitted from contributions from Vilay Soulatha (national accounts), Henry Laurant, and Michel Cramer (state enterprises), as well as John Keating (forestry), Marianne Fay contributed to the final version of this report. The main mission visited the Lao People's Democratic Republic from November 14 to December 7, 1989. Finally, the report benefitted greatly from the findings of an IMF Tax Administration mission led by Jacques Baldet.

COUNTRY DATA SHEET: LAO PDR

Area: 237,000 sq km

Population (1988): 3.88 Mln
Rate of growth: 2.6 %

Density (per sq km ,1988): 16

Population Characteristics (1988)

Crude birth rate (per 1,000):	41.5
Crude death rate (per 1,000):	16.2

Health (1988)

Infant mortality (per 1,000):	110
Population per physician :	1,362
Population per nurse :	532

Income Distribution

% of national income

Highest 10 % :	N.A.
Lowest 20 % :	N.A.

Access to Safe Water (1975)

% of population - urban:	100
- rural:	32
- total:	41

Nutrition (1988)

Per capita calorie intake (cal/day):	2,391
Per capita protein intake (g/day):	64

Education (1988)

Primary school enrollment: (% of relevant age group)	94

GNP Per Capita (US$, 1988): 180 1/

GROSS NATIONAL PRODUCT (1988)

	US$ Mln	%	Annual Rate of Growth (%, Constant Prices) 1984-87	1988
GDP at Market Prices	533	100.0	2.9	5.3
Gross Domestic Investment	N.A.	N.A.	N.A.	N.A.
Gross National Saving	N.A.	N.A.	N.A.	N.A.
Current Account Balance	-55	-10.2	---	---
Export of Goods	49	9.2	8.1	7.3
Import of Goods	124	23.3	8.9	-7.8

OUTPUT, EMPLOYMENT AND PRODUCTIVITY (1988)

	Value Added US$ Mln	Value Added %	Labor Force Mln	Labor Force %	V.A. per Worker US$	V.A. per Worker %
Agriculture	122	60.6	N.A.	N.A.	N.A.	N.A.
Industry	28	13.8	N.A.	N.A.	N.A.	N.A.
Service	51	25.4	N.A.	N.A.	N.A.	N.A.
Total/Average	201	100.0	N.A.	100.0	N.A.	N.A.

GOVERNMENT FINANCE

	Central Government Mln Kip 1988	% of GDP 1984	% of GDP 1988
Current Receits	28210	8.9	13.8
Current Expenditure	26722	7.4	13.0
Current Surplus	1488	1.5	0.7
Capital Expenditure	22046	7.6	10.8

1/ Calulated in accordance with World Bank Atlas methodology.

MONEY, CREDIT & PRICES

	1985	1986	1987	1988	1989
	(Mln Kip)				
Money Supply (M2) (end of year)	2280	3876	15842	21715	41114
	(Percentage or Index Numbers)				
Money as % of GDP	2.5	2.6	9.9	10.6	11.4
Market Price Index (CPI) (1988=100)	52	71	75	100	153
Annual Percentage Changes in: Market Price Index (CPI)	--	35.0	6.6	32.6	53.1

BALANCE OF PAYMENTS

	1985	1986	1987	1988	1989
	(US$ mln)				
Exports of Goods	41	45	43	49	54
Imports of Goods	118	116	129	125	162
Trade Balance	-77	-71	-88	-76	-107
Service Balance	-4	8	9	-5	-8
Net Transfers (Private)	0	4	4	[illegible]	8
Balance on Current Account	-81	-59	-74	-74	-107
Official Transfers	47	26	24	36	40
Net MLT Borrowing	24	26	22	31	71
Disbursement	30	33	32	39	79
Amortization	6	7	10	9	8
Net Other Items	31	15	16	3	14
Increase in Reserves	-21	-9	11	5	-18
Net Official Reserves (End-Year)	15	24	14	15	n.a.

EXCHANGE RATE
(Commercial Rate)

	Annual average			
	1986	1987	1988	1989
US $ 1 = Kip	95	180	385	576
1000 Kip = US $	10.53	5.56	2.60	1.74

MERCHANDISE EXPORTS (AVERAGE 1986-1988)

	US$ Mlr	%
Hydroelectric Power	18.3	40.8
Logs & Wood Products	18.2	40.6
Coffee	3.8	8.5
Tin	[illegible]	1.8
Gypsum	[illegible]	1.5
Tota Exports	44.8	100.0

EXTERNAL DEBT, DEC 1988

	US$ Mln
MLT	408
ST	5
Total DOD	413
DEBT SERVICE RATIO (%) (1989)	[illegible]

IBRD/IDA LENDING (12/31/88)
(millions of US $)

	IBRD	IDA
Outstanding & Disbursed	0	88.3
Undisbursed	0	84.4
Outstanding inc Undisbursed	0	172.7

LAO PEOPLE'S DEMOCRATIC REPUBLIC

ISSUES IN PUBLIC ECONOMICS

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SUMMARY AND CONCLUSIONS

1. The Government of the Lao People's Democratic Republic (Lao PDR) has embarked since the Fourth Party Congress of 1986 upon an accelerated transition from a centrally planned to a market economy based on the mobilization of and competition between all economic agents, including the private sector. This ambitious policy has led to a thorough decentralization of economic responsibilities, the extension of financial autonomy to state enterprises and local governments, the liberalization of most prices (except public utilities) the adoption of a market-based exchange rate and the emergence of a still fledgling but already dynamic private sector. These bold and sweeping measures demonstrate the determination of the Government to foster a more rapid development of the country, by setting the appropriate framework for the efficient allocation of resources.

2. Despite severe external shocks, this policy has already shown signs of success in revitalizing economic activities. Real growth recovered in 1988 and 1989 to satisfactory rates of 5 and 9 percent, respectively. This recovery was driven primarily by private sector expenditure, but it is still fragile. The expansion of production in 1989 owes much to a bumper crop after two years of protracted drought. Transforming this rebound into long-term growth will require, above and beyond the maintenance of a supportive incentive framework, a fresh effort at developing the country's human and physical capital. It will also require a continued commitment to macroeconomic stability.

3. Economic tensions have unfortunately accumulated in 1989 as revealed by the acceleration of inflation from an average 7 percent in 1987-88 to about 50 percent in 1989, difficulties in tax collection, and the deterioration of the trade balance. These difficulties originate in a sharp decline in public savings and have been aggravated by the lack of coordination between domestic and external policies. This report demonstrates how deteriorating public sector performance has hindered macroeconomic stability and how this problem thwarts the development prospects of the country.

4. Many of the recent difficulties have their origin in the rapid reform process. They indicate moreover that the reform process must undergo consolidation, chiefly with respect to the role of the public sector in the economy. The objectives in this sector are clear: (i) additional public resources (fiscal revenues and state enterprise profits) need to be mobilized to support a higher level of development expenditure without compromising economic stability; and (ii) the efficiency of public resource allocation must be enhanced through the maintenance of an environment of market prices and positive real interest rates, on the one hand, and a closer scrutiny in the use of those resources which are directly controlled by the Government.

5. The four priorities for the consolidation of reforms are as follows: (i) deepening the enterprise reform to restore state enterprise profitability, (ii) enhancing fiscal resource mobilization, (iii) adapting the instruments of public expenditure management to the new role of the State in the economy, and (iv) strengthening government administration, without which none of the above will be achieved.

The Impact of Deteriorating Public Finances

6. For the public sector, the transition to a market system has its costs. The reforms have unveiled prevailing inefficiencies in the public sector (including overstaffing, weak management, obsolete techniques and sectoral misallocations, as well as the burden on the economy of the planning apparatus), which were previously hidden by price distortions. Administered pricing had the effect of capturing rents from the rest of the economy to the benefit of the public sector. The transition to a new system carries its own costs, however, in the form of investment in competitive technologies, severance payments to redundant employees, and adjustments to a new system of prices. An initial increase in public sector financing needs was therefore almost inevitable. The policies of leaving the usufruct of state enterprises to their workers and maintaining public tariffs constant in nominal terms, against a backdrop of inflation, have aggravated the emerging resource constraint. Finally, exogenous factors (lower export prices and a drought-related drop in production) have affected the largest source of public revenues: hydroelectricity. The authorities endeavored to offset these adverse developments by curbing government expenditure and by reforming the tax system to mobilize additional resources, mainly through indirect taxes. Despite this, public savings declined from 2.4 percent of GDP in 1986 to a negative 3.4 percent in 1989.

7. Impact on economic stability: Financing the ensuing deficit was the driving force behind the recent flare-up in inflation. While government expenditures were reduced in line with the available fiscal revenues and foreign aid -- and were even below these resources in 1989 -- the expansion of state enterprise financing requirements by about 4 percent of GDP was financed primarily through the banking sector thanks to a rapid increase in the domestic money supply. Faced with growing demand from state enterprises, the control of the authorities over monetary developments was weakened by (i) the infrequent adjustment of nominal interest rates and the consequent drop in real rates to sharply negative levels combined with (ii) the rapid accumulation of state enterprise arrears vis-a-vis the banks. This resulted in the rate of growth of the money supply accelerating from 37 percent in 1988 to 90 percent in 1989. While the demand for real money balances increased somewhat, thanks to the monetization of transactions, such rapid monetary espansion necessarily led to a surge inflation. The situation was worsened by the temporary ban on logging, a sector which formerly provided more than two thirds of the country's export earnings, destabilized the exchange rate and put additional pressure on the level.

8. Major policy changes addressing these causes of inflation were finally introduced during the summer of 1989. A major tax reform substantially improved revenue collection. The restoration of positive real interest rates and the introduction of a punitive rate on overdrafts reduced the expansion of credit to state enterprises, while substantial foreign borrowings and the recovery in wood and electricity exports stabilized the exchange rate. These policies were initally successful in generating a sharp disinflation. Starting from the last quarter of 1989, credit to state

enterprises started to grow again at excessive rates, causing a reemergence of inflation in early 1990.

9. Impact on growth: The supply response to the improved incentive framework is currently hindered by the severe shortage of basic public infrastructure and services. During the period of command economy, government development policy focussed on creating and subsidizing industrial state enterprises and on a small number of large-scale infrastructure projects. The operation and maintenance of existing facilities and provision of basic social services were notoriously underfunded. The badly deteriorated infrastructure and extremely low levels of human capital that now exist are the legacy of this policy. The success of the new policy course thus necessitates both a retrenchment of Government and a redeployment of its action towards satisfying the long-term needs of the economy. The recent squeeze on public resources has not permitted this. While redundant expenditures have been cut through, among others, a reduction in the civil service, the redeployment of government action has been thwarted because savings continue to be siphoned off into underperforming state enterprises.

10. The potential for sustained growth at a rate of about 6-7 percent per year in the early nineties exists. It will only be realized, however, if macroeconomic policies are geared towards the recovery of investment, operation and maintenance expenditure. This implies a complete turnaround in public sector performance, i.e., an increase in public savings from a negative 3.4 percent of GDP in 1989 to a positive 2.1 percent over the next five years. For Government, it means returning fiscal revenues to their historical levels of 13 percent of GDP, up from 9.5 percent of GDP in 1989. For state enterprises, the challenge is to turn their gross profit from a negative 1.1 percent of GDP in 1989 to a positive 1.7 percent over the same period. Vigorous efforts at restoring state enterprise profitability and mobilizing fiscal resources will therefore be required. But, the benefits of these efforts will only be seen if the allocation of public resources is improved. Thanks to the high concessionality of foreign flows, the country currently has a breathing space to build an efficient capital stock, develop domestic savings, and exports. If this opportunity is not seized, i.e., if foreign borrowings continue to support consumption and inefficient enterprises, the country will soon be caught in a debt trap where domestic expansion is stifled by the burden of foreign debt.

11. The landlocked position of the country adds another constraint to the engineering of sustained growth. While the domestic market is small and fragmented by the lack of communication infrastructure, the country's access to export markets is hindered either by natural barries (distance from the ports of Viet Nam) or by trade barries (high tariffs on agricultural good in Thailand and excessive transport costs for (transit trade). An improvement of the trade regine with the main markets of the region, which constitutes a natural outlet for Lao products would certainly improve Lao PDR's growth prospects.

Deepening the Enterprise Reform

12. Aware of the need to restore the efficiency and profitability of the enterprise sector, the Government has recently embarked upon a broad disengagement program from all "non-strategic" enterprises when private participation is limited to mixed enterprise and joint ventures. The following sectors are considered strategic: public utilities, banks, mining etc. construction, air and road transport. Each level of Government is now requested to prepare a list of enterprises considered privatizable. Actual disengagement programs have already been initiated in 1989 mainly by the Ministry of Industry and by the Prefecture of Vientiane. The latter, which has the largest portfolio of enterprises, disengaged itself from half of its enterprises during the latter half of 1989, through various techniques ranging from lease contracts to outright privatization. The scope, speed and unbureaucratic manner with which the disengagement process has been initiated is impressive. It is facilitated by the creativity and flexibility shown by the authorities as to the forms of disengagement. The broadening of the process should proceed with caution so as to preserve the interests of the State and of the country at large and prevent loss of its benefits through undervaluation of assets, the extension of privileges to private parties, or the use of disengagement forms, such as some forms of rental contracts, which do not provide incentives for the maintenance and expansion of the assets. Priority should be given to establishing clear, uniform and transparent procedures to be used nationwide. These would cover such areas as: valuation rules for the enterprise's capital contribution from private parties, the minimum number of bidders and announcements of the transactions; the authority of enterprise managers and officials to commit the Government; and the monitoring of privatization contracts.

13. The Government's disengagement policy will go a long way towards promoting economic efficiency and stability. Its main rationale is that a market economy can operate efficiently only if economic agents are guided by profit maximization. This principle should apply equally to those state enterprises which, for the time being, remain under the direct supervision of Government. In this case, the Government itself has to play the role of shareholder. At present, self-managed state enterprises have little incentive to act as profit maximizers. The outcome of such a system has been observed in other countries, such as Yugoslavia, Hungary and China: the potential surplus is increasingly absorbed in wage increases and bonuses which reduce enterprise savings and erode the profit tax base.

14. The principle that state enterprises belong to the nation and should be managed for its best interest, rather than to benefit one particular group, i.e., the enterprise employees, needs to be restated. In other words, autonomy has to be combined with accountability. A primary implication of this principle is that the disposition of enterprise after-tax profit should ultimately rest with the Government. Accordingly, the financial tutelle over state enterprise performance needs to be strengthened and exercised by a core economic agency (a planning and finance administration or a specialized agency), rather than by sectoral administration where more parochial interests may prevail. The rapid introduction of a new accounting system and the

monitoring of enterprise financial performance, through the centralization of summary accounting data, are two prerequisites for any improvement.

15. These initial steps should pave the way for the gradual introduction of performance contracts linked to profit-sharing arrangements. In the competitive sector, given the present price freedom, the relatively open trade regime and above all the limited administrative capacities, the performance criteria should be limited to a single summary indicator of performance: profitability (measured, for instance, by the ratio of gross profit to total assets). In cases where competition is still weak, an indicator of unit operating costs should be added to monitor potential abuses of monopoly situations. However, in public utilities, where prices are regulated, the latter indicator should be the main instrument of monitoring and rewarding financial performance. Its use should be combined with tailor-made indicators of volume and quality of service. The precise design of such systems needs to be developed through practical experimentation. It is therefore recommended to introduce, on a pilot basis, a performance evaluation system under the supervision of a single agency, before later generalization to the other agencies.

16. To restore state enterprise savings in the immediate future (i.e., before the performance evaluation systems can be generalized) and prevent any further erosion of the profit tax base, wage guidelines for state enterprises will need to be issued temporarily. These would limit average nominal wages to a maximum annual growth rate consistent with government inflation targets and defer all bonus payments until the enterprise accounts have been audited by the Government.

Mobilizing Public Resources

17. Improved public resource mobilization through an increase in the ratio of fiscal revenues to GDP is needed to restore public services. The June 1989 tax reform constitutes a major step in this direction. In addition to the elimination of the tax discrimination against exports, this new system should also be simplified to facilitate its administration. Major tax measures should: (i) reduce the number of wage tax schedules, exempt lowest incomes and align the marginal rates of all income taxes; (ii) reduce the profit tax rate to 35% and phase out overgenerous tax holidays; (iii) reduce the number of sales tax rates and introduce excise taxes on imports and local production of selected products, including beverages, luxury goods and petroleum products; and (iv) develop the revenue potential of local taxes (business and vehicle licenses, land tax, etc.) to alleviate the impact on local finance of the transition towards a unified general tax administration.

18. As general taxes and customs revenues will remain difficult to collect in the near future given the weak administrative apparatus, three other sources of revenues should be emphasized: financial revenues, public tariffs and user charges, and natural resource royalties. First, financial revenues from deposits, from a lending of foreign loans, participation in state enterprises and banks are the single largest untapped revenue potential. Charging and enforcing an adequate remuneration on these assets would generate in the short term more than a third of Government's 1990 revenue needs.

Second, public tariffs and other user charges for public infrastructure should be brought to the forefront of resource mobilization efforts. While all other prices have been freed and should therefore generally reflect scarcity values, public utilities prices, particularly water, electricity, and air transport, have remained unchanged. It is recommended that the attitude of Government towards public utilities evolve towards an active pricing policy according to scarcity values with a view to generating much-needed public resources. The same applies to public infrastructure, in particular roads and irrigation. Finally, the Government should rationalize the natural resource tax to further an efficient use of the country's greatest source of wealth. Pending the introduction of concession tendering, royalties are the best instrument for this purpose. To avoid inefficiency in the allocation of resources, and because the country cannot afford to divert resources from exports, they should be uniform for export and domestic uses. For the sake of administrative simplicity, these royalties should be limited to a small number of significant resources, i.e., minerals, wood and wood products and electricity. As regards to wood, the use of such royalties should be parallel with a strengthening of forestry manage-ment to prevent increased smuggling. The additional revenues that could potentially be collected through these three instruments are quite substantial, being equivalent to 60% of fiscal revenue requirement of 1990.

Enhancing Government Expenditure Management

19. The move away from a centrally planned economy requires a fundamental rethinking of the role of government expenditure and consequently of its management mechanism. The Government continues, for the moment, to use the planning and budgeting techniques inherited from the past, although physical planning does not serve any useful purpose anymore. These procedures were useful for microeconomic planning but not (i) to actively use public expenditure for macroeconomic management or (ii) to even program and monitor them effectively. The experience from many other developing countries shows the need to design planning and budgeting improvements as soon as possible, starting with the critical areas of immediate concern. These are: in the area of expenditure planning, to replace the existing physical Annual Plan with a rolling public investment programming system, as a first step towards a medium-term public expenditure program; in the area of budgeting, to revise the existing budget classification, to improve the budget coverage, and to strengthen, on the one hand, the preparation of the budget by issuing budget guidelines indicating expenditure priorities and options and, on the other, its execution through the introduction of financial control procedures, which are currently absent. The establishment of a clearer expenditure strategy should at the same time become an instrument of aid coordination. The country is receiving increasing attention from external donors, but its fragmented and diluted organizational framework hinders the effective mobilization and efficient use of these resources.

Strengthening Public Administration

20. The administrative decentralization of the country under the New Economic Mechanism has been pushed to an extreme, so that the costs of fragmented public action override the benefits of local accountability. Under

the present system, provincial governments collect all taxes from the taxpayers under their jurisdiction and are supposed to finance the major part of public expenditures for their areas (except, for instance, national roads, higher education, defense, etc.). They actually control about 60 percent of fiscal revenues. With the rest, the Central Government has to finance national expenditures and subsidize poor provinces, in the absence of any other inter-provincial equilibrating mechanism. Provincial admin istrations are under the full authority of governors, who are full rank ministers; they have no functional relations with their central counterparts. The costs of such a system are: (i) inefficient revenue collection; (ii) sub-optimal allocation of resources; (iii) fragmentation of sector policies and (iv) widening regional disparities. This even impairs continuity in the public service as local civil servants, teachers, and medical personnel, who often remain unpaid for months, are forced to seek other sources of subsistence.

21. Even in a federal system, there is no need to link revenue collection and allocation so closely. The current system should be restructured according to the following two principles. First, revenues should be collected by the administration which is most efficient at doing so. A single national administration would most likely be more efficient at collecting general taxes, and should therefore be created. The authority of local governments should be limited to local taxes, such as agriculture taxes, land tax, business licenses, etc., and to non-tax transfers from public enterprises under their supervision. Second, revenues should be shared according to the repartition of functions and competence among the various levels of Government, as determined politically. Consistent with the federal system, general taxes should be collected centrally and be earmarked for transfer to local governments according to the importance of their duties.

22. Experience from other reforming socialist economies clearly shows that decentralization must be pursued cautiously to forestall placing unacceptable constraints on central government policies. Price reform and dismantling of central planning will not have the desired effect if a powerful provincial apparatus stands in the way of an optimal allocation of resources and hampers the center's ability to exercise macroeconomic control. Therefore, at this stage of the reform process, a careful balance must be struck between areas in which decentralized decision-making can effectively replace central government controls and the need to create new instruments at the level of the national government to effectively manage the economy.

I. RECENT POLICY AND ECONOMIC DEVELOPMENTS

A. Introduction

1.1 The Government of the Lao People's Democratic Republic (Lao PDR) has undertaken since 1985 to move from a centrally-planned to a market-oriented system. This program of reforms, collectively known as the New Economic Mechanism (NEM), was first initiated on an experimental basis in 1985 with the granting of managerial autonomy to selected state enterprises. After this change of policy course was endorsed by the Party Congress in 1986, the experiment was turned into a comprehensive set of reforms, cutting across the whole spectrum of economic activities. The new system translated, among others, into a complete decentralization of economic decisionmaking, the granting of financial autonomy to most economic agents, the promotion of private sector participation, and the liberalization of most prices (except for public utilities) and the exchange rate. In contrast to other socialist countries' previous attempts at moving towards market systems, Lao PDR did not adopt a phased and gradual approach but boldly decided to achieve this major overhaul in a matter of months.

1.2 By proceeding so swiftly, the country has avoided the sequencing dilemmas which have plagued more gradual approaches to liberalization, in which market mechanisms and administrative regulations have led to market segmentation and aggravated rather than alleviated prevailing economic imbalances. But such a rapid transition has its drawbacks too: it strains financial structures and administrative capacities. A sudden price liberalization causes an immediate reallocation of profits across sectors and a deterioration of bank portfolios, for which banks are ill-prepared. If the institutional framework does not keep pace with the reforms (due, for example, to an absence of foreclosure procedures or undercapitalization), available options tend to be limited to two evils: large-scale defaults or bail-outs. Moreover, some reforms, such as tax reforms, require careful analysis because of their technical complexities or cross-sectoral implications. There is thus a trade-off between the speed with which such reforms are undertaken and the quality of their design and consistency. Finally, while the purpose of the reforms is to eventually curtail the involvement of Government in the economy, the burden on the government administration actually increases during the transition, as the implementation of sweeping structural changes adds on an additional administrative burden. In countries like Lao PDR, the latter strain is aggravated by the weakness and inadequate mix of administrative skills.

1.3 The country therefore bore the cost of such a rapid transformation in the form of a temporary loss of macroeconomic control in 1989. Economic tensions developed, as evidenced by accelerated inflation, difficulties in tax collection and the broadening of the trade deficit. As will be highlighted in this report, these tensions stem mainly from domestic resource mobilization difficulties and the consequent reduction in domestic savings available for productive investment. These difficulties indicate that the

reform process should now enter into a phase of consolidation. Such consolidation concerns primarily the role of the State and the public sector in a decentralized economy. Since microeconomic and physical planning has been abandoned, the Government has to redefine its instruments to enable it to manage the economy indirectly through the use of price incentives, taxes, credit and the direction of its expenditure program.

B. The New Economic Mechanism: An Overview

1.4 The New Economic Mechanism constitutes a wide array of reforms affecting not only the economic system but also the political organization of the country. It stems from the realization that the central planning system had created vast inefficiencies in the functioning of both the country's administration and its economy. While this report focusses on economic reforms, one should bear in mind that they were accompanied by a commensurate effort at decentralizing Government which put local authorities in charge of most government activities and gave them control over 75 percent of fiscal revenues. This section of the report gives an overview of the reform package and its content, while also indicating some concerns about the outcomes of the reforms. These concerns will be analyzed in the ensuing chapters.

1.5 The wide scope of the market-oriented reform was facilitated by the dominance of the agriculture sector, in which private operation had continued under the veneer of collective organizations. The initial attempt at collectivizing agriculture in the late seventies was soon abandoned due to its disastrous effect on production. The formation of cooperatives followed in the early eighties, with only mixed results. As land had never been formally collectivized - although most of the rice lands were exploited by cooperatives and state farms - the decision to make enrollment in cooperatives a voluntary matter led to the return of most agricultural production to family producers. Conversely, the marginal role of the industrial sector in the economy limited the power of its managers and the strength of entrenched interest in support of pro-industry regulations.

1.6 Exchange rate and price reforms. Perhaps the most far-reaching step taken by the Government has been the adoption of the "one market, one price" principle which calls for the elimination of the dual price system (official and parallel prices) for goods and foreign exchange and the determination of all prices by the market. Pursuant to that policy, the official rate is now maintained at the market level. Apart from the transactions at the official rate by the banks, Lao PDR has a large parallel market, which is tolerated by Government. The market is organized by private money changers and gold- and silver-smiths. The existence of this parallel market combined with limited administrative capacity prevent the use of foreign exchange control, other than the one which requires state enterprises to execute their foreign exchange transactions through the banking system. There is no obligation to remit foreign earnings. The process of unification of the multiple official rates was initiated in 1986 when the commercial exchange rate of the kip, one of the seven official rates, was devalued from 35 to 95 kip per dollar. Then, in September 1987, the Government reduced the number of rates from seven to four, ranging from 10 to 350 kip per dollar. The latter rate, applying to

commercial transactions, was set in line with the parallel market. In mid-1988, the Government adopted the principle of maintaining a unified, market-related exchange rate. The multiple exchange rates were eliminated and a single rate was announced at 400 kip per dollar in July 1988. The exchange rate has been periodically adjusted following parallel market developments with a view to maintain a slight premium between the official and parallel market rate. The selling rate was 720 kip per dollar as of mid-November 1989. The uniform exchange rate is being used for the valuation of foreign transactions and foreign assets/liabilities in the budgetary, monetary and national accounts.

1.7 Domestic prices of most goods and services are now market-determined. This fundamental policy reform was initiated in June 1987. Prices are negotiated freely between the different parties, and administrative bodies are strictly forbidden to interfere in the market mechanism. Procurement prices used by state trading corporations in agriculture have been aligned with market prices. Subsidies for agricultural inputs (e.g., fertilizer) were eliminated as part of the price rationalization. The prices of fuel, cement, machinery and vehicles, which had remained under central control after the June 1987 reform, were freed in March 1988. At the same time, the system of forced procurement of wage goods by the public sector at below-market prices for payment of salaries in kind was abolished. Starting from January 1988, these goods were procured at market prices. Selling prices and nominal wages were gradually adjusted to reflect the market value of wage goods. Consequently, prices of most traded goods are now set by the market. Only the prices of state monopolies, i.e., electricity, telecommunications, water and air transport, and ores, remain controlled by the Government.

1.8 Enterprise reform. The enterprise sector has undergone major changes aimed at enhancing the efficiency of the public sector and stimulating private sector participation. As a result of disappointment with the central planning system, the original thrust of the New Economic Mechanism was to decentralize economic decisionmaking through the introduction of self-management of state enterprises. Congruent with the new pricing system, most state enterprises were granted financial and managerial autonomy and the central planning apparatus was dismantled. Enterprise autonomy extends to the production level and product mix; financial management, including investment decisions; choice of suppliers and markets; output pricing as well as employment and wage policy.

1.9 State enterprises, which hitherto depended on budgetary resources to finance their investment, are now expected to rely increasingly on retained earnings. It was assumed that autonomous state enterprises would spontaneously generate profits for that purpose. Under the central planning system, once quantitative targets were established enterprises enjoyed virtually unlimited access to bank credit. Banks are now supposed to extend credit only on commercial grounds. Finally, operating subsidies to state enterprises have been officially abolished. However, the implementation of these principles remains problematic. While budgetary subsidies have largely disappeared, enterprise profits failed to materialize, and the banking system must now keep the sector afloat. As will be developed in Chapters II and III, this disappointing performance is due mainly to two factors: (i) the price

reform coupled with import competition revealed prevailing inefficiencies and (ii) enterprise autonomy unleashed wage escalation. Thus, because of inefficient pricing of labor and capital, enterprise reform has yet to achieve its objective of shifting resources towards more productive uses and of forcing internal efficiency improvements within firms.

1.10 The reform of the enterprise sector was broadened in 1987 and 1988 when the Government decided to promote private sector participation, even in state enterprises. The reforms allow private sector participation in all sectors of production, except those of "national importance," such as public utilities. The formation of various forms of economic associations, including mixed and private enterprises, was legalized in 1987. Private firms' and farmers have access to imported raw materials, machinery, transport and fertilizers and are allowed to borrow from the banking system. Small ventures have flourished since then, particularly in the areas of trade, handicrafts and other services as well as in some light industries. In agriculture, participation in agricultural cooperatives is voluntary and any preferential treatment of cooperatives and state farms has been eliminated. More recently, the Government has begun to disengage itself from state enterprises through a variety of techniques, ranging from the outright sale of assets to management contracts and leasing arrangements. Initial privatizations rested on unregulated initiatives taken by some agencies but a privatization law was enacted in March 1990 which sets the framework for formal guidelines for privatization in order to safeguard public interests; this will be elaborated in Chapter IV.

1.11 To attract foreign investors, the Government issued a liberal Foreign Investment Code in July 1988. It expects foreign investment to help the country exploit its natural resources, enhance the efficiency of existing activities, launch new ventures in non-traditional activities and improve the country's access to foreign markets. The new code has sparked some interest abroad, in particular in the wood processing, garment and mining sectors, and some joint ventures are already in operation. However, due to an inadequate legal framework for companies, poor infrastructure and the country's remoteness from world markets, this interest has not yet translated into substantial foreign involvements.

1.12 Trade reforms. The domestic trade sector was reformed in 1987 with a view to facilitating the inter-regional flow of goods and drawing more heavily on the resources of the private and cooperative sectors. Prior to that, the marketing system was complex and inefficient and featured extensive administrative interference in the direction and volume of domestic trade flows. In particular, farmers were not allowed to move rice across provincial borders. The movement of goods between provinces was generally limited to state companies. This policy aggravated the impact of natural barriers and poor infrastructure which hamper national economic integration. These restrictions were abolished in 1987. Domestic trade has been opened to private and cooperative traders and administrative bodies have been instructed not to interfere in trade. At the same time, the various state trading companies were restructured to enhance their efficiency. Others were dismantled, such as the government rice procurement company as a result of the abolition of the payment of wages in kind. Quantitative targets for the

procurement of certain goods by state trading companies are still centrally set, largely to fulfill official contracts with socialist countries. However, all procurement and distribution activities involving state companies must be based on contracts, with prices and other contract terms freely negotiated between the parties. This liberalization has led to a substantial increase in internal trade.

1.13 Important steps have also been taken towards foreign trade liberalization, which used to be almost completely monopolized by the state. On the import side, the Government views the increased availability of both producer and consumer goods as important in triggering the supply response and eliminating rents from parallel market transactions. To that effect, all economic agents, private or public, now have access to imported goods through licensed traders. The latter include state bodies but also a large number of mixed and private import-export companies which have been created since 1985. In most instances, these mixed companies constitute mainly a legal umbrella, under which private traders carry out wholesale foreign trade. No restriction applies to the range of goods they are entitled to import, although they commonly specialize in consumer goods. Imports are still subject to import licenses, which are reportedly easy to obtain. A new import tariff was introduced in March 1988 in the context of an overall tax reform. Tariffs were streamlined and coverage has been extended. In the past, the import tax played an insignificant economic or revenue role as imports were: (i) monopolized by the state, (ii) evaluated for tax purposes at a grossly undervalued exchange rate, and (iii) imports from socialist countries were exempted from tariffs. Under the tax reform, the tariff range has been narrowed from 0-200 percent to 0-70 percent, the zero rate applying to project imports and those financed by grants, and the higher rates (above 30 percent) to luxury and "sin" goods. Imports are now evaluated at the market exchange rate for tax purposes and tariff exemptions for socialist country imports have been removed.

1.14 The State monopoly on exports has largely been abolished. While it used to apply to all transactions, it is now in practice restricted to a small number of items (wood, coffee, tin and gypsum). Even for those items, State monopoly rights are in most instances delegated to trading agents. However, exports are still penalized by: (i) the non-deductibility of the sales taxes paid on inputs used in export products, in contrast to domestic sales and (ii) export surcharges on natural resources. As will be elaborated in Section G of this chapter, export liberalization policies unfortunately affect only a small segment, i.e., manufactures and agricultural producers, of the country's exports which continue to be dominated by hydroelectricity, a state sector, and forestry, where administrative regulations have been restored.

1.15 Fiscal reforms. The Government has gone through two major tax reforms in the last two years to adapt its revenue system to the requirements of a decentralized market-oriented system. Before March 1988, the main source of budgetary revenues came from the transfer to the budget of state enterprise operating surpluses. The reform of March 1988 introduced a proper tax system, including a profit tax, sales taxes, revamped import duties and agricultural production taxes, and it reduced the role of non-tax transfers. A second tax reform was enacted in June 1989 to tackle some of the flaws of the previous

reform, in particular the multiplicity of profit tax rates and the limited coverage of indirect taxes, and to introduce new levies such as a wage tax and an expanded natural resource tax. Unfortunately, it also included some discriminatory measures against exports and excessive complexities which should be eliminated.

1.16 In early 1988, forced procurement of wage goods at below market prices, equivalent to implicit taxation, was abolished. Wages were gradually adjusted accordingly and their payment in kind was eliminated in March 1989. Consistent with the principle of self-reliance inherent in the new policy, budgetary transfers to state enterprises, either as investment funds (with the major exception of public utilities) or subsidies covering operating losses, were terminated. In the same spirit, Government's overdraft facility with the State Bank of Lao PDR was eliminated. Finally, a major reduction in civil service employment was undertaken in 1988, which has affected an estimated 10 percent of government employees so far.

1.17 Fiscal policies have remained conservative, as expenditures were adjusted to the availability of fiscal revenues and foreign aid. Confronted with a resource squeeze, the Government substantially reduced its expenditure, both current and capital. The main causes of this resource squeeze are: (i) the change in the distribution of income caused by the reforms, particularly the decline in state enterprise profits, (ii) the reduced rents from hydroelectricity exports and (iii) the weakness of the tax administration. The origins and implications of the resource constraint will be examined in Chapters II and III.

1.18 Financial reforms. The Government has initiated a complete restructuring of the financial sector as well as the reform of monetary and credit policies. As regards the financial sector, the Government decided in March 1988 to separate the central and commercial banking functions of the existing single and multi-purpose State Bank. This process is currently under way. Three branches of the State Bank have already been transformed into autonomous commercial banks: the two branches in the capital and the Bank for External Trade (October 1989). A similar transformation of provincial branches into commercial banks covering several provinces is currently underway. One foreign bank opened in October 1989 (contacts are under way with other foreign banks), which should stimulate competition.

1.19 While credit policy used to simply accommodate the requirements of quantitative planning, it is now supposed to be guided by broad macroeconomic objectives through the use of a combination of quantitative controls, reserve requirements and interest rate regulations. A recent Decree of July 1989 establishes the principle that interest rates should be positive in real terms and that spreads should be positive for all maturities. Another decree of the same month dictates that bank credit should focus on short-term transactions, and that term investment should be funded only with long-term resources, either domestic or foreign. It also (i) restates that banks are not allowed to extend credit to any level of Government directly or indirectly (by financing tax payers' obligations) except under exceptional circumstances and with written request from the Chairman of the Council of Ministers, and (ii) authorizes the banks to request and foreclose on collateral. This potential

role of collateral in the development of financial intermediation is limited by the fact that most assets remain (land, state enterprises, but not houses) state property and are exploited under a system of usufruct, which provides a high degree of protection to its beneficiary but make the assets inalienable.

1.20 The banking system is still in transition: while the sound principles of the banks' arm's length relations with borrowers and autonomy from local government have been officially adopted, their effective implementation remains in doubt. Key to this problem is the practical impossibility of foreclosing on bad debts due to the absence of a legal framework for divestiture and in view of the political pressures for bailing out defaulting enterprises. Chapter II will elaborate on these points.

1.21 Economic impact. Despite these bold efforts at reviving growth, economic performance has only partially matched expectations. Overall growth revived in 1988-89 but inflation, which had steadily declined up to the end of 1988, has recently flared up. The next sections review the main economic developments in terms of production, exchange rate and prices, demand, public finance, external transactions. Chapter II will seek to identify the outstanding issues which underlie these performance problems. Chapter III will outline the medium-term outlook and agenda for public finance policies.

1.22 The review of economic performance necessitates a note of caution regarding the reliability of economic statistics and the dangers of comparing pre- and post-reform achievements. Given the weakness of the present data set in Lao PDR,[1] figures presented in this report constitute "educated estimates" rather than confirmed facts and should therefore be regarded as orders of magnitude. Secondly, quantitative data collected prior to 1987 are heavily influenced by the prevailing system of production targets, and probably reflect targets rather than actual outcome. As a result, the drop in production and private expenditure (which is calculated as a residual item) observed in 1987 should be seen in part as a "statistical adjustment" caused by the abandonment of quantitative planning. Finally, GDP is thought to underestimate private and informal activities; ratios to GDP therefore need to be interpreted in terms of their evolution rather than absolute level.

C. Production

1.23 After the 1987 decline, growth revived in 1988 and accelerated in 1989 (see Table 1.1). To some extent, the magnitude of the productive response to the reforms has been masked by a series of supply shocks, some exogenous (the protracted drought of 1987-88), some self-inflicted (the 1989 temporary ban on logging).

1.24 Growth in agriculture has been affected by adverse factors in rice cultivation and forestry, its two main subsectors, with livestock. Two years

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[1] The only official macroeconomic statistics available concern the budget, the balance of payments and the banking sector.

Table 1.1: GDP BY INDUSTRIAL ORIGIN
(in constant 1988 prices)

	1984		1985		1986		1987		1988		1989	
	(% GDP)	Growth Rate	(% GDP)	Growth Rate	(% GDP)	Growth Rate	(% GDP)	Growth Rate	(% GDP)	Growth Rate	(% GDP)	Growth Rate
Agriculture	(60.2)	-	(61.2)	11.0	(62.1)	6.7	(60.5)	-9.5	(59.6)	3.7	(56.8)	-3.9
Crops	(40.0)	-	(39.1)	6.8	(40.3)	10.7	(36.0)	-17.0	(34.8)	1.8	(35.9)	12.3
Livestock	(10.3)	-	(9.9)	5.4	(9.8)	6.5	(10.1)	-4.7	(9.9)	3.1	(9.9)	9.5
Fish	(0.7)	-	(0.6)	2.8	(0.6)	1.5	(0.4)	-31.6	(0.5)	25.8	(0.5)	0.0
Forestry	(6.7)	-	(9.1)	48.5	(8.8)	2.9	(11.6)	23.3	(12.1)	9.6	(8.2)	-26.3
Other	(2.5)	-	(2.5)	6.3	(2.5)	9.7	(2.3)	-14.8	(2.3)	2.3	(2.3)	11.5
Industry	(16.2)	-	(15.4)	3.8	(16.4)	14.2	(14.4)	-18.6	(13.6)	-0.6	(15.7)	28.2
Mining & quarrying	(0.3)	-	(0.3)	20.0	(0.4)	11.0	(0.3)	-22.3	(0.2)	-21.7	(0.3)	38.0
Manufacturing	(7.2)	-	(7.6)	15.0	(8.0)	13.4	(8.3)	-3.6	(7.4)	-5.9	(8.8)	28.6
Construction	(4.2)	-	(3.3)	-14.8	(4.3)	40.0	(3.1)	-33.2	(3.4)	16.5	(3.9)	24.0
Electricity, gas & water	(4.5)	-	(4.2)	2.0	(3.8)	-3.9	(2.7)	-33.5	(2.5)	-1.6	(2.8)	21.0
Services	(22.5)	-	(22.9)	11.3	(21.2)	-1.0	(24.8)	8.8	(24.9)	5.6	(25.6)	12.4
Transportation, storage & communication	(3.3)	-	(3.2)	5.5	(4.0)	31.9	(4.9)	14.8	(5.0)	7.1	(4.8)	5.3
Wholesale and retail trade	(8.5)	-	(8.6)	10.8	(8.8)	9.2	(10.0)	5.5	(8.4)	-11.3	(9.6)	24.3
Banking, insurance & real estate	(0.1)	-	(0.1)	3.2	(0.1)	91.8	(0.4)	279.3	(0.2)	-41.1	(0.3)	21.3
Ownership of dwellings	(1.3)	-	(1.2)	3.0	(1.2)	3.0	(1.3)	3.0	(1.3)	3.0	(1.2)	2.9
Public administration & defense	(5.7)	-	(4.9)	-5.2	(4.8)	3.9	(5.5)	7.9	(5.5)	4.3	(4.7)	-5.8
Non-profit Institutions	(3.5)	-	(4.7)	48.2	(2.2)	-49.9	(2.5)	3.3	(4.3)	82.1	(4.8)	23.5
Other services	(0.1)	-	(0.1)	10.4	(0.1)	37.4	(0.1)	14.6	(0.2)	34.6	(0.2)	3.7
Import duties	(1.0)	-	(0.4)	-58.4	(0.3)	-12.9	(0.4)	9.3	(2.0)	450.3	(1.9)	3.0
GDP at 1988 Constant Market Prices	(100.0)	-	(100.0)	9.2	(100.0)	7.2	(100.0)	-7.0	(100.0)	5.3	(100.0)	9.0

Source: World Bank staff estimates based on data provided by Lao PDR authorities.

of drought reduced rice output from 1.44 million tons in 1986 to 1.0 million tons in 1988, according to official figures. Most affected by the drought was lowland rainfed rice production while slash-and-burn cultivation, occurring in regions less affected by the drought, continued to expand unabated. Due to a return of normal rains in 1989, production is estimated to have increased by 24 percent.

1.25 Developments in the rice sector were largely offset by those in forestry. Pursuant to the objectives of the Second Five-year Plan to reach a production level of 600,000 cubic meters (cum), logging activities grew rapidly between 1986 and 1988. However, the Government became increasingly concerned about the economic and environmental impact of commercial exploitation and tried several times to restrain it through the imposition of administrative restrictions. An export ban was announced starting in January 1988. In anticipation of this ban, logging accelerated in 1987 and again in 1988 after the ban was postponed to January 1989. A total logging ban was finally implemented starting from the latter date, with case-by-case exemptions granted only by the Council of Ministers. This policy was supplemented by the imposition of logging royalties and export surcharges included in the June 1989 tax reform. As a result, commercial production had by and large come to a halt by mid-1989 apart from illegal logging and exports to Thailand to which this policy gave a boost. The Government has since authorized a selective return to logging, on the basis of production quotas extended to individual forestry enterprises. This reassessment was caused by serious concerns about the macroeconomic impact of abrupt policy changes. As wood exports represented on average 68 percent of export earnings (excluding border trade) in 1988, the impact of the ban on the external accounts was devastating, while its positive impact on the budget was only minimal. At the same time, it has made only a small dent in deforestation, given the fact that commercial exploitation represents only about 10 percent of the annual cut, the bulk of the environmental damage being caused by slash-and-burn rice production and particularly the encroachment of lowland farmers into forested areas. The return to selective logging by the end of 1989 permitted a substantial recovery in export earning.

1.26 More profoundly, the low agricultural growth reveals the difficulties of revitalizing a sector which had largely returned to subsistence activities, as a result of price distortions. In addition, the sector suffers from: (i) prolonged underinvestment, except in a few large-scale projects, resulting in obsolete equipment, ill-maintained facilities (e.g., irrigation, coffee trees) and (ii) weak support services (extension, nurseries, etc.). Finally, its capacity to trade profitably is reduced since the domestic market is highly fragmented by the lack of communication infrastructure (partly for want of maintenance). Furthermore, until this year fertilizer imports were minimal, as they were covered by a partial trade embargo by Thailand, and the type of fertilizer offered by the Soviet Union did not match the country's requirements. In these circumstances, the improved price signals have a limited impact on producers. The Government of Lao PDR has made great strides towards tackling these constraints; however, its success is likely to require longer-term efforts than might have been anticipated.

1.27 The case of Lao PDR also illustrates the difficulty of engineering sustained growth in small landlocked country, due to a difficult access to world markets. The latter is hindered by the natural obstacles to trade with or through Viet Nam (distance to the ports of this country), political disruptions in Cambodia and trade barries in Thailand. In the latter case, Lao exports of agricultural products are covered by heavy tariffs ranging from 30% (rice, cardamon) to 40% (livestock, coffee) and 60% (meat, tea). As regards transit trade through Thailand, which is in principle not subject to costum duties, it is conducted on the Lao and on the Thai side by monopoly transporters. This situation drives up transportation costs for transit by an estimated 40-50%. For geographical reasons, the Thai market is a natural outlet for Lao production. The benefits of a desirable improvement of the trade regime between the two countries would therefore certainly be very high.

1.28 Industrial growth has picked up lately, after a two-year drop in 1987-88. In the mining sector, the extraction of gypsum dipped in 1987 and then recovered strongly in the following years. As regards tin, the other significant ore being exploited, due to falling metal content and increasing metal losses in the concentration process, mechanized operations were shut down in mid-1988 and activities restarted on an artisanal basis only later that year. This allowed production to recover by more than 50% in 1989 after a decline of the same magnitude in 1988. Coal production expanded in 1989 as a small mine started to operate and supplemented traditional artisanal coal mining. New foreign ventures began to exploit precious stones in 1989. Manufacturing suffered from the statistical adjustment in 1987 (para 1.22) and was until mid-1988 handicapped by shortages of foreign exchange on the official market to procure raw materials and spare parts and by the increased foreign competition created by the liberalization of the trade regime. Since mid-1988, manufacturing output has picked up, especially in garments, construction, and consumer goods and parquet factories, reflecting the dynamism of domestic demand as well as foreign investments made in the sector after enactment of the foreign investment code. The construction sector benefitted from the surge in private demand for new buildings and renovation, a demand which had been suppressed for years. Finally, hydroelectricity production suffered during 1987 to mid-1989 from the impact of a protracted drought. The water level in the reservoir at Nam Ngum was so low that electricity generation dropped from 867.3 Mwh in 1986 to 532 Mwh in 1988. Thanks to good rains in 1989, annual production returned to full capacity towards the end of the year and is estimated at 685 Mwh for the whole year of 1989.

1.29 The service sector was the quickest to respond to the improved incentive framework brought about by the New Economic Mechanism. This dynamism has been particularly evident in transport, where private and public operators took advantage of the removal of inter-provincial trade barriers, in handicrafts and other services to the consumer due to the liberalization of private activities and the resultant mushrooming of repair shops, tailors, restaurants, shops, etc. This evolution is largely reflected in the rapid growth of "other services," which covers mainly private enterprise activities. Finally, service activities were boosted by the inflow of foreign technical assistance.

D. Price and Exchange Rate

1.30 The price liberalization and exchange rate adjustment resulted in a shift in the terms of trade between agriculture and industry in favor of the former (see Table 1.2). This is by far the most important policy success achieved under the NEM; it establishes the appropriate price structure for the resumption of agricultural production, a critical factor since the agricultural sector has the best growth potential and employs the vast majority of the population. Its immediate impact is to improve the distribution of income in favor of the rural areas, which is reflected in the income accounts of the private sector (Table 1.5). The major re-ordering in the relative price structure can be observed from the wide changes in the composition of GDP in current prices compared to its relatively more stable composition in constant prices (see Tables 1.3 and 1.4).

1.31 During the first two years of the reforms, the authorities were remarkably successful in controlling inflation. The inflation rate (annual average), as measured by the evolution of market prices in the capital, actually declined from an average of 30 percent in 1985-86 to 6.2 percent in 1987 and 7.1 percent in 1988 (see Graph 1.1 and Table 7.1, Statistical Appendix).[2] However, by the last quarter of 1988, market inflation had reached an annualized quarterly rate of 11.5 percent. This initial increase accelerated sharply during the second and third quarters of 1989, with annualized quarterly inflation rates of about 60 percent. Inflation subsided during the last quarter of 1989. Key reasons for the inflationary surge were the growing public enterprise deficit and the loss of a nominal anchor caused by the accelerated depreciation of the exchange rate. The dynamics of these large swings in inflation will be discussed in Chapter II.

1.32 The exchange rate followed a comparable evolution. After years of relative stability, the market exchange rate began to depreciate in mid-1988 and the movement accelerated along with price developments (see Graph 1.1). The official exchange rate for commercial transactions was first devalued in September 1987 from 95 kip to the dollar to 350 kip to the dollar, a level close to the market. All multiple exchange rates were finally unified at 400 kip to the dollar in July 1988, with the exception of the special exchange rate that serves to value transactions with the International Monetary Fund (IMF). The official rate was thereafter followed, with a slight lag in the evolution of the market rate. The evolution of the exchange rate is explained by the interplay of domestic and external policies: it remains stable when they are consistent and vice-versa. Against the background of an expanding public deficit, the liberalization of the export regime initially stabilized the market rate, then the reimposition of export restrictions on logs sent it plummeting. Again, these developments will be examined in the Chapter II which reviews public sector and financial policies.

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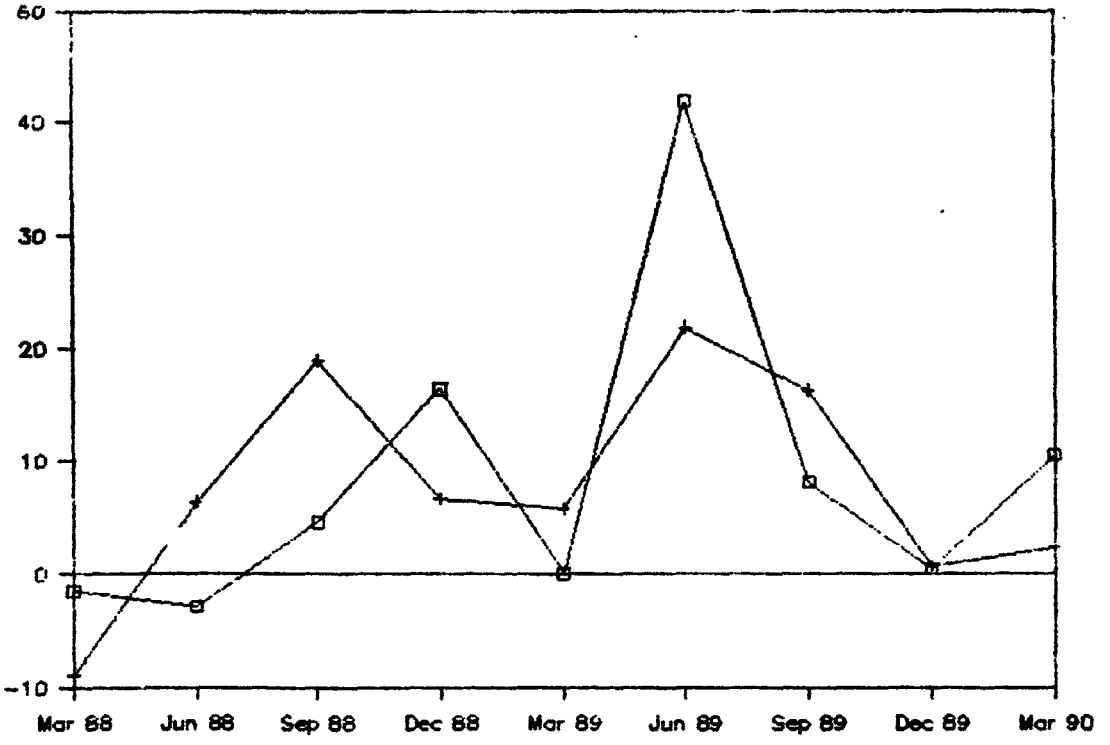
[2] The evolution of the consumption deflator shows the same pattern although the deceleration is slightly less due to the impact of the alignment of prices in State shops for public sector employees with the market level and the larger share of rice in the basket of the deflator.

Table 1.2: TERMS OF TRADE BETWEEN AGRICULTURE AND INDUSTRY (1985-89)
(1988 = 100)

	1985	1986	1987	1988	1989
Agricultural prices	35.6	53.5	69.1	100.0	150.3
Industrial prices	61.1	72.9	85.4	100.0	145.9
Terms of trade	58.3	73.4	80.9	100.0	103.0

Source: World Bank staff estimates based on data provided by Lao PDR authorities.

Graph 1.1: GROWTH RATES OF CPI AND EXCHANGE RATES



□ Grow Rate of CPI

\+ Growth Rate of ER

E. Private Expenditure

1.33 Over the period 1986-89, private expenditures were by far the most dynamic component of domestic demand (see Table 1.3). They declined much less than the other categories in 1987, and grew by 14.8 percent in 1989. This boom in private expenditure is clearly visible in the country in the rapid spread of durable consumer goods (bicycles, cars, electric appliances), mostly imported, the booming markets and the start of new houses and the renovation of existing ones. As a result, private expenditure gained about 1.5 percentage points of nominal GDP between 1986 and 1989 (see Table 1.4) to reach about 87 percent of GDP.

1.34 This increase was fueled by the rapid growth in private disposable income, which expanded from 86.1 percent of GDP in 1986 to 90.7 percent of nominal GDP in 1989 (see Table 1.5). Private primary income benefitted from the following developments: (i) the elimination of forced procurement at below market prices; (ii) wage escalation in state enterprises; and (iii) the supply response to the removal of restrictions for private activities. In 1989, private agricultural income also benefitted greatly from the bumper crop. Private purchasing power was further boosted by the inflow of transfers (i) from abroad, both from private sources (mainly expatriate nationals) and from official food aid, and (ii) from Government through severance payments made to departing civil servants.

F. Public Finance

1.35 On the other hand, during 1986-89, Government expenditures steadily declined in real terms, their share of GDP (in constant prices) dropping from 31.3 percent in 1986 to 19.4 percent in 1989 (see Table 1.3). This decline has equally affected public investment and public consumption. In 1989, the stabilization of Government investment and the expansion of state enterprise investments financed outside the budget, mainly for rehabilitation purposes, permitted some increase in public investment.

1.36 These developments have aggravated the already insufficient supply of public services, such as health, education, road maintenance, water supply, etc. During the first decade after the liberation of the country, Government concentrated its attention on creating, capitalizing and subsidizing enterprises as well as on a small number of large-scale projects, which absorbed most of the available public resources. Meanwhile, the provision of basic public goods, which are traditionally supplied by the public sector, was severely underfunded. The country's extremely low level of social indicators and the decay of road infrastructure are only two outcomes of this policy. While the recent decline in public expenditure corresponds in part to appropriate government disengagements, for instance through civil service retrenchment in areas where Government had no more role to play (as in quantitative planning), it also further weakened essential public services.

Table 1.3: GDP BY CATEGORY OF EXPENDITURE
(in constant 1988 prices)

	1984		1985		1986		1987		1988		1989	
	(% GDP)	Growth Rate	(% GDP)	Growth Rate	(% GDP)	Growth Rate	(% GDP)	Growth Rate	(% GDP)	Growth Rate	(% GDP)	Growth Rate
Private expenditure	(75.9)	-	(77.6)	11.6	(77.7)	7.4	(81.9)	-2.1	(81.9)	5.3	(86.3)	14.8
Public consumption	(19.7)	-	(20.6)	13.9	(18.4)	-3.9	(17.5)	-11.6	(16.7)	0.6	(14.3)	-6.7
Of which												
Government	(16.1)	-	(15.7)	6.7	(16.1)	10.0	(15.0)	-13.5	(12.4)	-12.9	(9.2)	-19.4
non-profit institutions	(3.6)	-	(4.8)	46.3	(2.3)	-49.2	(2.5)	2.2	(4.3)	81.3	(5.1)	29.9
Public investment	(18.0)	-	(16.7)	1.3	(15.7)	0.6	(14.6)	-13.3	(12.8)	-8.1	(12.7)	8.6
Of which												
Government	(17.5)	-	(16.2)	1.1	(15.2)	0.4	(13.6)	-16.6	(10.8)	-16.8	(0.2)	3.4
public enterprises	(0.5)	-	(0.5)	9.2	(0.5)	7.2	(1.0)	85.9	(2.0)	110.5	(2.5)	36.2
Total domestic demand	(113.6)	-	(114.9)	10.4	(111.8)	4.4	(114.0)	-5.2	(111.4)	2.9	(113.3)	10.9
Exports	(11.2)	-	(14.5)	41.5	(13.6)	0.5	(14.5)	-0.4	(13.6)	-1.6	(14.5)	16.0
Total final demand	(124.8)	-	(129.3)	13.2	(125.4)	4.0	(128.5)	-4.7	(125.0)	2.4	(127.8)	11.4
(Less) Imports	(-24.8)	-	(-29.3)	29.3	(-25.4)	-7.3	(-28.5)	4.6	(-25.0)	-7.8	(-27.8)	21.2
GDP	(100.0)	-	(100.0)	9.2	(100.0)	7.2	(100.0)	-7.0	(100.0)	5.3	(100.0)	9.0

Source: World Bank staff estimates based on data provided by Lao PDR authorities.

1.37 Government revenues. The reduction in government expenditures was due to a sharp decline in fiscal revenues compared to GDP (see Table 1.6). Key to this evolution is the change in the distribution of national income caused by the economic liberalization. The bulk of fiscal revenues are assessed on state enterprises' gross profit, which have been steadily declining as a share of GDP. On the other hand, the government share in the primary distribution of GDP increased thanks to the expanded role of indirect taxes. Overall, however, government revenues (including capital transfers) declined to 9.5 percent in 1989, down from 12.4 percent of GDP in 1986.

61.38 Government expenditures. As Government continued not to borrow domestically, except for short-term overdrafts, it was forced to decrease current expenditure due to constrained resources. The result was continued reduction in all categories of expenditure at constant prices by a cumulative 35 percent during 1986-89 (excluding transfers).

1.39 Reduction in government employment. In 1988, the Government initiated a program of civil service reduction and redeployment to reduce budgetary expenditures and decentralize government operations to the provinces. By mid-1989, government employment had been reduced to about 120,000 people, i.e., about 65,000 civil servants and 55,000 troops. While the size of the armed forces was maintained, the civil service was cut by about 10 percent. The retrenchment policy affected primarily the central administration where staffing in some areas dropped to alarming levels (e.g., in tax administration, state enterprise supervision, statistics, and investment programming). Although the cut in the civil service has affected an estimated 3.5 percent of the formal urban employment (industry, civil service and armed forces), no open sign of unemployment is currently visible. This is due to (i) the fact that, given the low public wages, a large number of government employees have a second occupation, on which laid-off employees were able to fall back, and to (ii) the dynamism of the private service sector. Moreover, the competition for new jobs is limited, since state enterprises have up to now retained most of their redundant labor. Departing employees are offered a lump sum severance payment representing the equivalent of their last month's salary including social benefits, multiplied by their years of service.

1.40 Until March 1989, when the Government eliminated its system of wage payments in kind, wages were defined in terms of a basket of goods, paid in kind as book entries in purchase books (referred to here as "coupons") usable in official shops. By October 1988, the prices of goods sold under this system were gradually brought in line with the market level. This allowed the dismantling of the Lao Food Corporation, which procured food sold under this system, and of the system itself by March 1989. Outstanding coupons were reimbursed in cash.

1.41 With the elimination of the system of payments of wages in kind, civil servants lost their protection against inflation. With the 1989 inflation surge, civil servants' average annual real wage dropped by about

Table 1.4: GDP BY CATEGORY OF EXPENDITURE
(in current prices)

	1984		1985		1986		1987		1988		1989	
	(% GDP)	Growth Rate	(% GDP)	Growth Rate	(% GDP)	Growth Rate	(% GDP)	Growth Rate	(% GDP)	Growth Rate	(% GDP)	Growth Rate
Private expenditure	(88.4)	-	(86.4)	71.8	(86.0)	60.4	(86.8)	8.4	(81.9)	21.1	(87.8)	87.5
Public consumption	(8.6)	-	(11.7)	139.9	(10.5)	44.6	(11.2)	14.2	(16.7)	92.1	(14.7)	58.9
Of which												
Government	(7.6)	-	(10.1)	133.3	(9.8)	56.9	(9.9)	7.8	(12.4)	61.6	(9.7)	37.8
non-profit institutions	(1.0)	-	(1.6)	191.5	(0.7)	-31.6	(1.3)	105.3	(4.3)	320.5	(4.9)	100.3
Public investment	(8.5)	-	(6.6)	80.9	(8.7)	61.8	(9.2)	48.6	(12.8)	77.0	(11.0)	51.9
Of which												
Government	(6.0)	-	(6.1)	81.4	(6.2)	61.9	(8.2)	43.3	(10.8)	67.3	(8.5)	39.3
public enterprises	(0.5)	-	(0.5)	75.7	(0.5)	61.1	(1.0)	114.9	(2.0)	156.5	(2.5)	119.8
Total domestic demand	(103.4)	-	(104.8)	78.0	(103.3)	58.7	(107.2)	11.6	(111.4)	33.3	(113.0)	78.4
Exports	(3.3)	-	(5.1)	169.0	(4.4)	40.0	(7.8)	90.3	(13.6)	122.9	(13.6)	75.7
Total final demand	(106.7)	-	(109.9)	80.9	(107.7)	57.8	(115.0)	14.8	(125.0)	39.4	(126.6)	78.1
(Less) Imports	(-6.7)	-	(-9.9)	157.7	(-7.7)	24.9	(-15.0)	110.2	(-25.0)	113.8	(-26.6)	86.9
GDP	(100.0)	-	(100.0)	75.7	(100.0)	61.1	(100.0)	7.5	(100.0)	28.3	(100.0)	75.9

Source: World Bank staff estimates based on data provided by Lao PDR authorities.

Table 1.5: SUMMARY OF PRIVATE SECTOR TRANSACTIONS, 1986-89
(% of GDP at current prices)

	1986	1987	1988	1989
Primary Income	85.9	87.3	80.0	87.3
Current transfers (net)	0.2	0.7	2.4	3.4
Received	0.5	1.0	2.6	3.6
From Government	-	-	0.1	1.5
From Rest of the World	0.5	1.0	2.5	2.1
Paid	0.3	0.3	0.3	0.2
To Government	0.3	0.3	0.3	0.2
Disposable Income	86.1	87.9	82.3	90.7
Expenditure	86.0	86.8	81.9	87.3
Net Financing Capacity	0.1	1.2	0.4	3.4

Source: World Bank staff estimates based on data provided by Lao PDR authorities.

Table 1.6: GENERAL GOVERNMENT BUDGET, 1986-89
(% of GDP)

	1986	1987	1988	1989
I. Revenue				
1. Tax revenue	1.2	1.2	10.4	7.4
Profits tax	0.1	0.1	3.0	1.6
Income tax	-	-	-	-
Agricultural tax	0.3	0.3	0.6	0.4
Business licenses	-	-	-	-
Turnover tax	0.6	0.6	3.6	3.0
Duties	0.1	0.2	3.2	2.3
Import	0.1	0.2	2.4	2.0
Export	-	-	0.8	0.3
Other	-	-	0.1	0.1
2. Non-tax revenue	11.3	11.3	3.3	2.1
Operating surpluses	9.3	9.7	0.3	0.1
Depreciation transfers	0.7	0.6	1.2	0.7
Other	1.2	1.0	1.9	1.3
3. Total revenue	12.4	12.6	13.8	9.5
II. Expenditure				
1. Current expenditure	10.1	10.0	13.0	11.1
Wages and salaries	3.2	3.2	5.5	5.4
Materials and supplies	6.6	6.7	6.9	4.3
Pensions	-	-	0.1	0.7 /1
Debt service	0.3	0.1	0.5	0.7
2. Capital expenditure	6.2	8.2	10.8	8.5
3. Total expenditure	16.3	18.3	23.8	19.6
III. Current Balance	2.3	2.6	0.7	-1.6
IV. Overall Balance	-4.4	-6.0	-12.1	-11.6

/1 Including severance payments

Source: Lao PDR authorities, staff estimates.

30 percent. In addition, given the difficulties in tax collection in early 1989, the payment of wages became erratic; by September considerable arrears had been accumulated which the Government endeavored to clear during the rest of the year. However, as the budgetary drain subsided, a selective wage increase was introduced in January 1990, bringing monthly wage levels to a range of US$11 to US$40, representing an average 34 percent increase in terms over a full year.

1.42 Insufficient operation and maintenance expenditures. Resource shortages resulted in further cuts in recurrent expenditures, particularly for roads, health and education. For roads, which play a vital role in integrating a large and sparsely-populated country, the 1988 budgetary allocation for maintenance was only one-eighth of the estimated minimum needed to maintain the poor standard of the existing network[3]. This will obviously have to be paid for through major rehabilitation projects, in the future, which cost far more than the accumulated "savings" in periodic maintenance costs. In the health sector, current expenditure declined from about US$2 per capita in 1986 to US$1.7 per capita in 1988 and were further eroded in 1989 (in constant prices at the 1988 exchange rate). This puts Lao PDR at the lower end of the range of current health expenditure per capita in low-income developing countries. Health conditions in the country are among the poorest in the world[4] and limit the potential of the population for a healthy and productive life. Government expenditure on education is particularly low compared to other low-income Asian country. Total expenditure in the sector represents only 2 percent of GDP compared to 3.1 percent in comparable countries.[5] Operational expenditures are even lower, representing half the relative levels of comparable countries (1.1 percent of GDP and 2.3 percent of GDP, respectively). This difference is largely due to the low level of teachers' salaries, equal to 90 percent of GDP per capita in primary schools and 110 percent at the secondary level, compared to 220 and 310 percent in similar countries. Teachers therefore often have other jobs so that the quality of education is poor and education levels low.[6]

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[3] Source: SWECO, National Transport Study, Interim Report, September 1989.

[4] The crude death and birth rates are high (at 15 and 44 per 1,000 population, respectively), fertility is high (6.8 children per woman of reproductive age), infant and under-five mortality are 117 and 193 per 1,000 live births, respectively, and life expectancy is only 50 years.

[5] It should be noted that international comparisons in terms of GDP entail an upward bias in favor of Lao PDR, where GDP estimates suffer from vast underrecording of private and informal activities.

[6] The literacy rate is equal to 44 percent, at best, compared to 60 percent on average in developing countries and 62 percent in Asia. The completion rate at the primary level is about 40 percent compared to 59 percent and 65 percent in developing countries and in Asia, respectively.

1.43 Decline in public investment. Despite a steady increase in foreign project aid, capital expenditure[7] has also been cut due to the lack of domestic resources. Capital expenditures declined in real terms by an estimated 16.6 percent in 1987, 16.8 percent in 1988 and recovered slightly by 3.4 percent in 1989. In view of the resource constraints, the authorities have given priority to the aid financed projects and canceled most of their self-financed investment except for selected road projects. In spite of this, they were not able to generate enough counterpart funds in 1989 to absorb all the available aid. As a result, the equivalent of US$10 million of disbursed project aid was accumulated with the banks, representing about 17 percent of the available project assistance.

1.44 At the same time, the local currency contribution for capital expenditures (excluding arrears) decreased from 3.3 percent of GDP in 1986 to 0.6 percent in 1989. Local currency resources come only from the current fiscal surplus and counterpart funds. The current surplus declined from 2.3 percent of GDP in 1986 to a negative 1.6 percent of GDP in 1989. This decline was initially offset by the increased availability of counterpart funds from balance of payment support provided by socialist countries[8] but the latter also dropped in terms of GDP in 1989. Starting from 1989, balance of payment support was also obtained from the convertible zone (an Asian Development Bank agriculture program loan and an IDA structural adjustment credit); as these resources were made available only in the latter part of the year, they could not be fully used to offset the shortfalls in fiscal revenues.

G. External Transactions

1.45 From 1986 to 1988, export growth (in real terms) weathered external shocks and provided a substantial contribution to GDP expansion (see Table 1.3). Exports of hydroelectricity, providing about two-thirds of export earnings in 1987 dropped from 683 Mwh to 373.5 Mwh in 1988 as a result of the reduced capacity of the Nam Ngum Dam. The drop in export volumes was

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[7] Capital expenditure includes Government self-financed investment and all foreign project aid (except investment lines of credit which are on-lent to the State Bank of Lao PDR without being recorded in the budget). It therefore covers investment expenditures of the Government itself as well as funds which are transferred (on-lent or granted) to other economic agents, which should strictly be considered a financing item.

[8] Counterpart funds are generated under bilateral trading arrangements with socialist countries. Under these arrangements Lao PDR is allowed to run a permanent trade deficit. The domestic counterpart of this deficit is a surplus for the state trading companies. Goods imported from socialist countries are sold in local currency on the domestic market at market prices and goods exported to these countries are procured at domestic market prices. Quantities are negotiated bilaterally with a view to ensuring that the local currency value of the sales of imported goods is structurally higher than the local currency value of the purchases of exported goods. The positive difference between these two amounts is transferred to the budget.

proportionally more important than in production volumes as domestic consumption continued to expand. The impact of the drought on export earnings was further aggravated by the reduction of the contractual price at which Thailand, the sole purchaser, buys Lao electricity, reflecting the evolution of the world market price of oil. This adverse development was more than offset, however, by the dramatic increase in wood and wood products exports and the rapid increase in manufactured goods exports, albeit from a negligible level. Easing of political tensions with Thailand and the consequent opening up of the border induced a sharp increase in border transactions, basically an exchange of logs and livestock from Lao PDR for Thai manufactured goods. Exports of non-factor services remained rather stable throughout these years. Overall, exports of goods and non-factor services in dollar terms grew by 8.6 percent a year between 1986 and 1988 (see Table 1.8).[9]

1.46 Due to the logging ban, the expansion was arrested during the first part of 1989, creating severe external tensions. The strong recovery in wood exports, which accompanied the relaxation of the restrictions on production and exports of these products coupled with the return of hydroelectricity exports to more normal level after the rainy season did offset this temporary shortfall, for the year as a whole: exports of goods are estimated to have grown by 9.3 percent in real terms in 1989.

1.47 The country's capacity to import depends on its export revenues and to a larger extent on the availability of foreign aid. As foreign assistance from the convertible zone (see Table 2.5, Statistical Appendix) responded positively to the policy changes in the country, so did its capacity to import. Consequently, the import coverage by exports (goods and non-factor services) decreased from 58 percent in 1986 to 53.1 percent in 1989. Imports of goods and non-factor services expanded over the same period (1986-89) at an annual average rate of about 5.3 percent in volume, with a sharp acceleration in 1989. This includes a 24 percent average increase in payments for non-factor services which reflects primarily the additional technical assistance received from the convertible zone.

1.48 The increasing openness of the country and its integration in the international trade system after years of isolation caused an increase in the share of both exports and imports in GDP (constant prices) (see Table 1.3).[10] However, the initial impact was, not unexpectedly, larger on the import side. The imbalance between exports and imports of goods and non-factor services therefore increased from 11.1 percent of GDP in 1986 to about 13.3 percent

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[9] For consistency, all transactions with the non-convertible zone are valued in this report at an exchange rate of US$0.55 per ruble until 1988 and US$0.45 per ruble thereafter, although the official exchange rate stood at US$1.563 per ruble in 1988.

[10] Due to the adjustment of the exchange rate in September 1988 from a grossly overvalued level to market level, comparisons of the shares of GDP in current prices are not meaningful.

Table 1.7: FINANCING OF CAPITAL EXPENDITURE, 1985-89
(constant prices of 1988, ratio in %)

	1985	1986	1987	1988	1989
Local/Foreign contribution	37.4	58.9	70.7	35.3	23.0

Source: World Bank staff calculation based on data provided by LAO PDR authorities.

Table 1.8: Balance of Payments

(in Mln US $)

	1984	1985	1986	1987	1988	1989
Trade balance	-60.5	-77.0	-71.3	-85.7	-75.5	-107.2
Convertible area	-29.3	-43.0	-39.0	-48.7	-48.6	-77.6
Nonconvertible area	-31.2	-34.0	-32.3	-37.0	-26.9	-29.6
Exports	34.9	41.3	44.9	43.3	49.2	54.4
Convertible area	30.0	34.6	39.4	33.0	41.8	47.2
Nonconvertible area	4.9	6.7	5.5	10.3	7.4	7.2
Imports	-95.4	-118.3	-116.2	-129.0	-124.7	-161.6
Convertible area	-59.3	-77.6	-78.4	-81.7	-90.4	-124.8
Nonconvertible area	-36.1	-40.7	-37.8	-47.3	-34.3	-36.8
Services and transfers (net)	28.3	42.9	39.5	36.4	37.1	40.2
Services (net)	-6.7	-3.9	8.2	8.5	-5.3	-8.4
Convertible area (net)	-4.9	-2.1	9.5	9.9	-3.7	-7.0
Receipts	15.0	21.3	24.3	26.2	23.2	30.6
Payments	-19.9	-23.4	-14.8	-16.3	-26.9	-37.6
Interest	-3.2	-2.5	-2.1	-2.7	-3.4	-4.3
Technical assistance	-12.9	-18.2	-9.5	-10.3	-21.4	-29.4
Other	-3.8	-2.7	-3.2	-3.3	-2.1	-3.9
Nonconvertible area (net)	-1.8	-1.8	-1.3	-1.4	-1.6	-1.4
Private transfers (convertible area)	2.8	0.0	3.7	3.5	6.7	6.3
Current account balance	-64.4	-80.9	-59.4	-73.7	-74.0	-107.3
Convertible area	-31.4	-45.1	-25.8	-35.3	-45.5	-76.3
Nonconvertible area	-33.0	-35.8	-33.6	-38.4	-28.5	-31.0
Capital account	72.1	92.1	77.4	69.0	87.2	140.6
Official transfers	32.1	46.9	27.6	24.4	35.6	40.3
Convertible area	26.7	45.4	26.0	23.0	34.0	38.0
Nonconvertible area	5.4	1.5	1.6	1.4	1.6	2.3
Capital inflows (net)	40.0	45.2	49.8	44.6	51.6	100.3
Convertible area	12.4	10.9	17.9	7.5	24.7	71.7
Long-term loans	6.8	7.6	14.3	4.0	15.5	59.7
Drawings	10.1	12.1	20.8	13.4	23.7	66.9
Amortization	-3.3	-4.5	-6.5	-9.4	-8.2	-7.2
Other	5.6	3.3	3.6	3.5	9.2	12.0
Nonconvertible area	27.6	34.3	31.9	37.1	27.0	28.6
Long-term loans	10.0	16.4	11.6	17.7	14.9	11.4
Drawings	10.6	17.6	12.3	18.3	15.6	12.2
Amortization	-0.7	-1.2	-0.6	-0.6	-0.6	-0.8
Bilateral arrangement	17.6	17.9	20.3	19.4	12.0	17.2
Errors and omissions	-13.7	9.6	-9.3	-6.6	-17.7	-15.5
Overall balance	-6.0	20.8	8.7	-11.3	-4.5	17.8
Changes in reserves	6.0	-20.8	-8.7	11.3	4.5	-17.8
Gross reserves	8.3	-14.7	-6.7	11.3	4.5	-25.3
Liabilities	-2.3	-6.0	-2.1	0.0	0.0	7.5

Source : Lao PDR authorities, Staff Estimates
Remark: See Chapter 1, Footnote 9.

of GDP in 1989. The changed composition of aid flows and reorientation of the trade pattern also changed the geographical composition of the trade deficit. While, before 1987, deficits with the convertible and non-convertible zones were more or less equivalent, the trade deficit with the convertible zone was about three times larger than that with the non-convertible zone in 1989.

1.49 The evolution described above resulted in a rapid increase in foreign debt, from US$323.1 million in 1986 to US$501.3 million by the end of 1989 (see Table 2.5, Statistical Appendix), the debt to exports (goods and non-factor services) ratio increasing from 4.7 to 5.9. As most foreign debt is contracted at highly concessional terms, the immediate impact on the debt service ratio has been limited. In addition, the country has benefitted from the renegotiation of its debt with its major bilateral partners: rescheduling with France, financing of debt obligations to Japan with additional grants, and deferment of all debt payments to the Soviet Union after the year 2000. The debt service ratio therefore increased only moderately from 13.3 percent in 1986 to 14.5 percent in 1989.

1.50 Due primarily to the accumulation of unused aid balances, the country accumulated US$17.8 million dollars in net reserves in 1989, after a decline in 1987.

H. Conclusions

1.51 The recent growth recovery needs to be consolidated. The sweeping reforms which have been undertaken under the New Economic Mechanism have greatly improved the incentive framework for development. They have already yielded positive production results. However, the return to normal weather conditions in 1989 provided the main impetus to growth. It has been accompanied by growing imbalances evidenced in the recent inflation and the deterioration of the external account. Transforming the rebound into sustained growth will require (i) tighter macroeconomic management and (ii) the development of new productive capacities, of basic infrastructure and of the country's human capital. However, little will be achieved without mobilizing domestic savings in support of development expenditure. What is now the public sector, i.e., the largest part of the modern sector, will continue to be a main agent in this process. Chapter III will show that, in order to play this role, the public sector will need to mobilize additional fiscal resources and to restore enterprise profitability. The current redefinition of the respective roles of the Government and the private sector in the economy, through the disengagement of the Government from the productive sector, will contribute greatly to these two objectives.

1.52 Furthermore, there is a pressing need to expand the country's export base. The best potential for rapid diversification is likely to be in agriculture: rice, livestock, coffee, tea, tobacco, etc. Investments are already underway in some of these subsectors to expand productive capacities. They need to be complemented by a more supportive tax system, in particular the elimination of any anti-export bias in the sales tax and natural resource taxes.

II. PUBLIC FINANCE AND MACROECONOMIC MANAGEMENT

A. Introduction

2.1 The sweeping structural changes outlined in the previous chapter have adversely affected the effectiveness of macroeconomic management. When authorities abandoned their direct control over resource allocation, they had to rely on yet untested instruments of indirect macroeconomic management. At the same time, the structural parameters on which macroeconomic policies are based (distribution of income, portfolio preferences, tax elasticities, etc.) were fluctuating as a result of the ongoing structural changes, causing problems of policy design and coordination. The recent flare-up in inflation is the clearest manifestation of these difficulties.

2.2 Management of aggregate demand has further been complicated by a number factors inherent to the nature of the Lao economy. With more than 90 percent of the exports concentrated on two products (wood and hydroelectricity) and more than 75 percent of its imports financed by foreign aid, the economy is highly vulnerable to external shocks (change in international prices, quantity restrictions, delays in aid disbursement, etc.). In addition, the control of the authorities over the liquidity of the economy is limited. Due to the wide circulation of foreign cash in the economy, there is a large scope for currency substitution, a phenomenon which magnifies underlying imbalances. Real shocks are therefore amplified by nominal factors. While the export expansion prompted by trade liberalization initially had a stabilizing impact, the restrictions imposed in 1989 proved highly destabilizing. Against this background of macroeconomic vulnerability, the capacity of the authorities to hold domestic credit expansion in check is blunted by (i) the highly decentralized central banking system and the close association between provincial branches of the central bank, provincial governments and state enterprises and (ii) the accumulation of arrears on bank credit.

2.3 In this context, the brunt of maintaining economic stability falls on public sector policies. The deterioration of public sector performance has unfortunately aggravated the underlying factors of instability. Public savings declined from 2.4 percent of GDP to a negative 3.4 percent between 1986 and 1989. This conflicted with the growing investment needs of the public sector. In Lao PDR, the transition to a market system requires both retrenchment of Government from production and a redeployment of its actions, to provide the basic public services and infrastructures which were neglected in the past. In addition, state enterprises need to modernize to survive foreign competition. However, the reforms have provoked a redistribution of the national income away from the public sector. Price liberalization and foreign competition, and the consequent change in the domestic terms of trade, have deprived it of its previous rents. The mobilization of private savings to finance the necessary public investments is hampered by the fact that (i) the private sector also strives to satisfy its long pent-up demand for consumption and housing and (ii) private sector confidence in the banks is limited, due to their endemic illiquidity. While Government endeavored to

Table 2.1: PUBLIC SECTOR CONSOLIDATED ACCOUNTS 1986-89
(% of GDP)

	1986	1987	1988	1989		1986	1987	1988	1989
		Resources					Uses		
A. Revenues	12.6	12.7	12.2	7.7	A. Current Expenditures	10.1	10.0	13.0	11.1
I. Fiscal Revenues	11.7	12.0	12.6	8.8					
1. Taxes	1.2	1.2	10.4	7.4					
1.1 Direct Taxes	0.5	0.4	3.3	1.8	1.1 Wages	3.2	3.2	5.5	5.4
- Companies	0.4	0.4	3.3	1.8	1.2 Goods and Services	6.6	6.7	6.9	4.3
- Individuals	-	-	-	-					
1.2 Indirect Taxes	0.7	0.8	7.2	5.6	1.3 Pensions	-	-	0.1	0.7
					1.4 Interest	0.3	0.1	0.5	0.7
2. Non Tax Revenues /1	10.6	10.8	2.1	1.4					
II. Public Enterprise Gross Savings	0.8	0.7	-0.4	-1.1					
B. Financing (net)	4.3	6.6	13.6	14.4	B. Capital Expenditures	6.7	9.2	12.8	11.0
2.1 Foreign (net)	3.6	7.4	12.6	14.1	2.1 Government	6.2	8.2	10.8	8.5
- official	3.3	7.0	10.9	12.2					
- private	0.2	0.4	1.7	1.9					
2.2 Domestic (net)	0.7	-0.8	1.0	0.3	2.2 Public Eterprises	0.5	1.0	2.0	2.5
C. Total	16.8	19.3	25.8	22.1	C. Total	16.8	19.3	25.8	22.1
Public Sector Gross Savings	2.4	2.7	-0.9	-3.4					

/1 excluding depreciation transfers.

Source: World Bank staff estimates based on data provided by LAO PDR authorities.

adapt its tax system to the new situation, and with some initial success with indirect taxes, the fall in state enterprise profits was so deep that consolidated public revenue mobilization dropped from 12.6 percent of GDP in 1986 to 7.7 percent in 1989. Government and state enterprises responded differently to the consequent resource squeeze: Government cut its expenditure, state enterprises turned to the banking sector. The accommodation of the latter's financing requirement has been the driving force behind inflation.

B. Problems of Aggregate Demand Management

2.4 Vulnerability to external shocks. Both the public sector and the balance of payments are extremely vulnerable to external shocks and for the same reasons: the high concentration of exports on two natural resources (hydroelectricity and wood) exploited by state enterprises and high dependency on foreign savings aid for the financing of imports and of the public sector. In 1986-88, wood and electricity represented on average 80 percent of export receipts. In these two sectors, Lao PDR is practically in a monopsony situation. While the wood sector contributes only marginally to public resources, due largely to its high inefficiency, the public revenues lost in hydroelectricity due to the drop in export volumes and prices represented more than 40 percent of 1989 consolidated public revenues. On the other hand, during the same year, disbursed foreign balance of payment support financed 33 percent of non-project imports and added another 47 percent to consolidated public revenues.

2.5 Fluctuations in these flows cause real shocks to the public sector and the balance of payments. If not offset by the recourse to foreign reserves or restriction in aggregate demand, they lead to inflation and the devaluation of the exchange rate. Since the country has adopted a floating exchange rate policy, only the second option is available. Unfortunately, the capacity of the authorities to manage aggregate demand through the control of liquidity is complicated for two reasons: the circulation of foreign money and the high decentralization of the central bank system.

2.6 Presence of foreign money. The circulation of foreign money in the economy facilitates currency substitution. Policy or exogenous shock which affects the market exchange rate can cause an erosion in the confidence in the local currency and lead to foreign exchange hoarding, i.e. currency substitution. The resulting decline in the demand for the domestic currency tends therefore to boost aggregate nominal demand for goods and services, adding to inflationary pressures. Only the evolution of the market rate, not the official rate, is critical in this, as it is on the free market that economic agents value their foreign currency holdings.

2.7 In such circumstances, the link between the supply of domestic money and inflation, while relatively strong, not as stable as in other countries (see Graph 2.1). This feature complicates the design of macroeconomic policies and undercuts the effectiveness of targeting quantitative aggregates, as the authorities do.

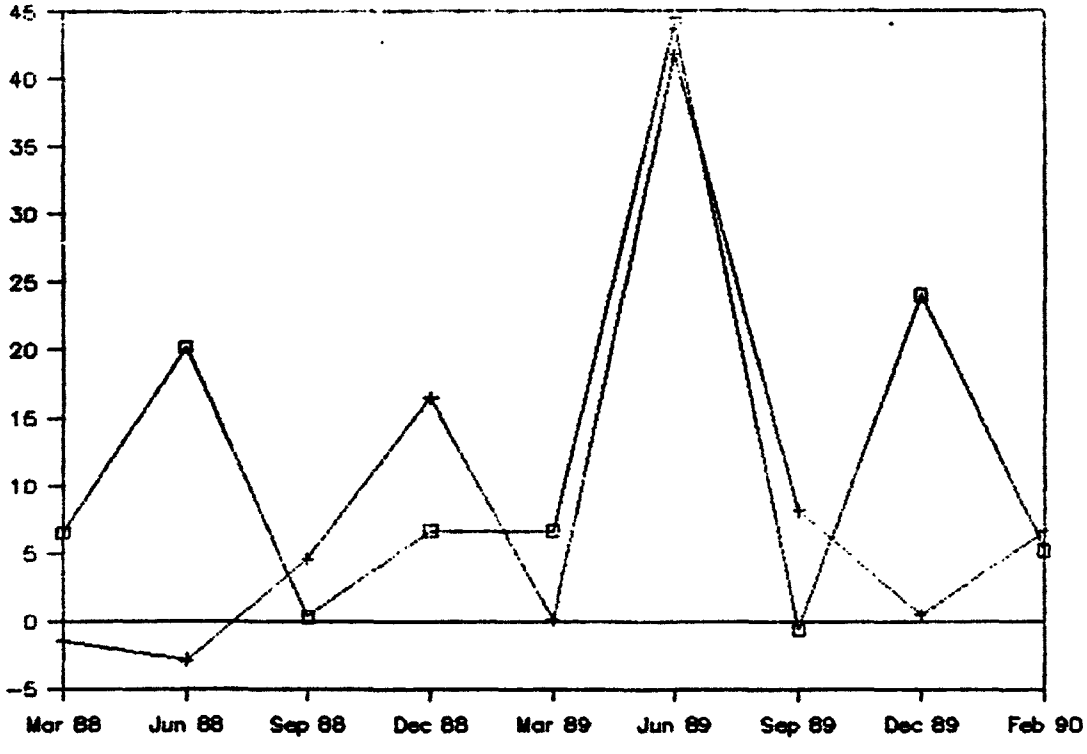
2.8 Institutional weaknesses in the banking sector. The very rapid expansion of credit to state enterprises points to institutional weaknesses in the relations between banks, state enterprises and local authorities. Like the rest of the country, the banking sector is organized on a provincial basis. Each province has its branch of the State Bank whose management is nominated by the provincial authorities. Provincial banks pursue their credit policy autonomously from the central authorities. The latter control them primarily by rationing the physical delivery of currency. Experiences in China show how the decentralization of the banking system complicates credit policy. Since regulated interest rates do not reflect the scarcity of savings, credit needs to be rationed. This is done mainly by informal persuasion. In a decentralized system this creates a cooperation dilemma. Macroeconomic control is a national issue but for local government it is someone else's problem. Each province tries to maximize its own income but hopes that other provinces will reduce their credit demand to prevent inflation. In China and in Lao PDR, central authorities have historically been relatively weak, in both case for geographical reasons (large size of the country or inaccessible terrain) and because consensus building between the central and provincial levels of Government is the main form of political decision making. The ensuing bargaining process tends to lead to excessive credit expansion if central authorities lack the clout to resist provincial demands or the instruments to forcefully curb them.

2.9 In addition, in Lao PDR bank autonomy vis-a-vis state enterprise supervisory agencies is still rather limited: the latter can compel the former to finance state enterprises, irrespective of financial performance. This problem was aggravated in 1989 when the accumulation of government arrears strained the enterprises' cash position. The Government is reorganizing the provincial banks, particularly through grouping into larger entities covering several provinces and the nomination of their management by the central authorities. These reforms, which would put state enterprises more at arm's length from provincial governments, should continue to receive high priority.

C. Public Savings and Distribution of Income

2.10 The main issue facing the economy is the lack of savings to finance its reconversion. The implementation of the reforms has been accompanied by a severe reduction in public savings. Consolidated revenues mobilized by the public sector dropped by 4.1 percentage points of GDP compared to their pre-reform level (see Table 2.1) due to the abandonment of administrative determination of prices and wages, trade liberalization and external shocks. At the same time, public financing needs were burdened by additional transitional costs, such as severance payments and the urgently needed modernization or rehabilitation of obsolete equipment, not to mention the financing requirements of establishing a new economic structure, through fresh investment in public services and emerging productive sectors. In the absence of substantial additional financial savings in the private sector, this decline in public savings is creating inflationary pressures.

Graph 2.1: DOMESTIC MONEY AND INFLATION



[] Money Supply Growth

\+ CPI Growth

2.11 The sources of this poor performance can be traced largely to previous inefficiencies in public resource mobilization and its heavy reliance on economic distortions benefitting state enterprises. Under the former system of central economic management, public sector resource mobilization used to depend primarily on: (i) the forced procurement of goods at below-market prices and exchange rates by Government and state enterprises, and (ii) the generation of gross operating surpluses in state enterprises, the size of which was determined partly by these forced levies and partly by direct controls over public sector wages. The vast inefficiency of the state enterprises was therefore concealed by price distortions. The economic rents so captured allowed state enterprises to hide operational inefficiencies (overstaffing, weak management, poor quality, etc.) and transfer their costs to the rest of the economy, through sub-optimal growth performance, and to future generations, through deferral of rehabilitation and modernization of productive capacities and infrastructure or overexploitation of natural resources (e.g., overlogging). As part of the New Economic Mechanism, the Government (i) has abandoned the first instrument - most prices and the exchange rate have been aligned with the market level, (ii) has lost any control over the size of enterprise surpluses by giving full autonomy to state enterprises, including the setting of wage levels and the disposition of profits. In addition, the most efficient source of public revenue, i.e., capturing of rents from hydroelectricity exports, was undercut by the decline in hydroelectricity production and prices.

2.12 These structural reforms have resulted in a fundamental changes in the distribution of income (see Table 2.2). The share of state enterprise in the primary distribution of income, i.e., the ratio of their gross profit (before tax) to GDP, has dropped from 10.3 percent of GDP in 1986 to 0.6 percent in 1989. A primary beneficiary has been the private sector, the share of which increased from 85.9 percent of GDP in 1986 to 87.3 percent in 1989. The Government's share in the primary distribution of GDP increased also, thanks to the expanded role of indirect taxes (Government primary income corresponds by and large to indirect tax receipts), and in particular the enhanced role of customs tariffs and the recent introduction of a broad-based sales tax.

Public Enterprise Savings[1]

2.13 While state enterprise profitability was declining so dramatically, they were requested to finance an increasing share of their investment through non-budgetary resources (see Table 2.3). Despite reduced tax and non-tax transfers to the Government, their gross savings turned negative in 1987 and continued to drop in 1989 to a negative 1.1 percent of GDP. Meanwhile, their investments gradually increased from marginal amounts to 2.5 percent of GDP in 1989. Inevitably, their financing requirements grew therefore from a mere 0.4 percent of GDP in 1986 to as much as 4.3 percent of GDP in 1989.

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[1] In this chapter, the definition of the public enterprise sector includes industrial and commercial enterprise as well as public utilities. Cooperatives and mixed enterprises, which are generally an umbrella for private activities, are excluded.

Table 2.2: INCOME ACCOUNT OF THE VARIOUS SECTORS, 1986-89
(Percentage of GDP)

	1986	1987	1988	1989
1. Private Sector:				
1.1 Gross primary income	85.9	87.3	80.0	87.3
1.2 Current transfers to (-) the other sectors	0.2	0.7	2.4	3.4
1.3 Disposable income (1.1+1.2)	86.1	87.9	82.3	90.7
(p.m. percentage changes at constant prices)	(n.a.)	-4.0	7.4	20.1
2. Public Enterprises:				
2.1 Gross primary income	10.3	10.6	2.9	0.6
2.2 Current transfers to (-) general government	7.5	-9.9	-3.3	-1.7
2.3 DIsposable income (2.1+2.2)	0.8	0.7	-0.4	-1.1
3. General Government:				
3.1 Gross primary income	1.9	1.8	9.0	6.9
3.2 Current transfers from other sectors	9.5	10.0	2.9	0.5
3.3 Disposable income (3.1+3.2)	11.4	11.8	12.0	7.4
4. Rest of the World:				
4.1 Gross primary income	0.7	1.3	4.3	4.9
4.2 Current transfers from the economy	-0.2	-0.9	-2.0	-1.4
4.3 Disposable income (4.1+4.2)	0.5	0.5	2.3	3.5
5. Statistical Discrepancy:	1.2	-1.0	3.8	-0.6
6. Gross Domestic Product	100.0	100.0	100.0	100.0
(1.1 + 2.1 + 3.1 + 4.1 + 5 or 1.3 + 2.3 + 3.3 + 4.3 + 5	100.0	100.0	100.0	100.0

Source: Staff calculation based on data provided by Lao PDR authorities.

Table 2.3: SUMMARY OF PUBLIC ENTERPRISE TRANSACTIONS, 1986-89
(% of GDP)

	1986	1987	1988	1989
1. Primary income (=Gross profit before tax)	10.3	10.6	2.9	0.6
2. Current transfers to Government	-9.5	-9.9	-3.3	-1.7
3. Gross savings (1 + 2)	0.8	0.7	-0.4	-1.1
4, Investments	0.5	1.0	2.0	2.5
5. Capital transfers to Government	-0.7	-0.6	-1.2	-0.7
6. Financing requirement (3 - 4 - 5)	-0.4	-0.9	-3.6	-4.3

Source: World Bank staff estimates based on data provided by Lao PDR authorities.

2.14 State enterprise profitability suffered from the pricing policy and trade reforms. In the competitive sector, the policy of liberalizing prices and floating the exchange rate combined with trade liberalization resulted in a reduction of gross margins. Most state enterprises could not adjust their selling prices sufficiently to recoup the increased cost of their inputs and wage payments. Industrial enterprises, handicapped by obsolete equipment and techniques, lacked the cost- and quality-competitiveness to match the increased competition from abroad, while in the service sector they were faced with a more dynamic private sector. This decline in profitability brought to light the fact that the former system of central economic management and regulation provided rents to state enterprises at the expense of the rest of the economy; the abandonment of forced procurement simply unveiled prevailing weaknesses.[2] On the other hand, the policy of maintaining domestic prices for public utilities fixed in nominal terms (except telecommunications) against a background of accelerating inflation had the same effect of reducing gross margins. However, due to the low supply of these services, the impact of this policy on aggregate savings was less than 0.5 percent of GDP.

2.15 In addition, the policy of freeing wages and leaving the disposition of after-tax profits to the workers has resulted in a decline in the distributive share of profits. Price and exchange rate liberalization were bound to cause a one-shot adjustment in the level of gross profits, corresponding to the transfer back of rents to the private sector. It does not explain the further decline in the state enterprise profitability which took place in 1989. This occurred because wages in state enterprises, once the corset of central regulations disappeared, started to accelerate and absorb an increasing share of the remaining gross income. This took the form either of straight wage increases or of distribution of profits as bonuses, depending on the circumstances. As a result, compensation (including bonuses) in public enterprises, which in early 1988 was comparable to that in the civil service, was more than three times the civil service level in 1989. Without external claim on their profits, state enterprises sought to maximize their own workers' income rather than ensure an adequate return on the assets entrusted to them by the nation. This phenomenon, reminiscent of other socialist countries such as China or Yugoslavia, will be further discussed in Chapter IV.

2.16 The combined effect of efficiency and distribution factors on state enterprise savings is estimated to account for more than 90 percent of the decline in state enterprise's gross profits.

2.17 State enterprise performances also suffered from the loss of rents on natural resources, caused by exogenous shocks. As described in Chapter I, this stems primarily from the cut in hydroelectric production caused by the drought, the reduced export price negotiated with Thailand in 1987 and the

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[2] Seen from another angle, however, such a system constituted an effective, if inefficient, vehicle to extract savings from the rest of the economy. It was grossly inefficient though, as the economy preferred to return to a subsistence level for want of incentives to generate a marketable surplus, which could only be sold at unremunerative prices.

absence of adjustment in domestic tariffs between 1986 and end-1989. The impact on Electricité du Lao PDR's (EDL) revenues was compounded by the change in the composition of electricity consumption in favor of the domestic sectors[3] which further reduced the average rate, and thus aggregate profits. Overall, EDL's net operating income declined from US$26.7 to US$7.9 million between 1986 and 1989. Also in 1989, the ban on logging caused a quasi-vanishing of rent extraction in forestry, a sector where state enterprises are preponderant. These losses are largely masked in the income accounts by the offsetting impact of exchange rate depreciation on nominal results.

2.18 Accumulation of arrears: On the financing side, the change in the distribution of income at the expense of state enterprises was reflected in the deterioration of bank portfolio and the accumulation of bank arrears. More than a third of the increase in bank credit to state enterprise during the first six months of 1989 was constituted by the accumulation of arrears. The latter constitute either (i) unrecoverable obligations of state enterprises which have been liquidated or dismantled or (ii) a bail out of defaulting debtors (see Box 2.1). Although no debt classification system exists, the total amount of irrecoverable claims might well be higher than the banking system's equity base. Thus, the solvency of the banking system seems in doubt. In addition, the accumulation of arrears combined with a restrictive credit policy also creates liquidity problems for the banking sector which faces difficulties in meeting its own obligations to depositors. This undermines the confidence of the population in the banking sector, and hence limits its capacity to mobilize financial savings. A major financial restructuring of the banking sector, consisting of relieving bank portfolios of their non-performing assets and recapitalizing the banking system through a fresh injection of equity, is needed to restore the sector's capacity to mobilize savings and allocate them efficiently.

Government Savings

2.19 Government savings have declined from 2.3 percent of GDP in 1986 to a negative 1.6 percent of GDP in 1989. This results from an erosion in tax revenues and an expansion in current expenditure, both in nominal terms. Contrary to state enterprises, Government adjusted to this by curtailing investment expenditure in order to maintain aggregate spending within the available envelope of fiscal resources and foreign aid.

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[3] Under existing contracts, Thailand is committed to buy whatever quantity of electricity is made available by EDL. The latter is determined as a residual once domestic consumption is satisfied. The expansion of domestic consumption, caused in part by the low tariffs, therefore tends to crowd out exports. As rates and profit margins are lower on the domestic market, this reduces EDL's profit.

BOX 2.1: THE PRACTICE OF BAILING OUT DEFAULTING ENTERPRISES

When a state enterprise in Lao PDR faces recurrent liquidity problems, a typical reaction is to gather representatives of the supervisory agency, the bank and the enterprise and define whether the enterprise's problems are due to "internal causes" (i.e., mismanagement) or "external causes" (i.e., all the other factors affecting enterprise profitability and liquidity). If the problems can be attributed to "internal causes," this would typically lead to managerial changes, supported by additional credit, or to the merging of the enterprise with a better-performing one. In case of "external causes," the bank is requested to extend additional credit to the defaulting enterprise. Disinvestment remains exceptional. Such procedures are not sound. The real criterion should be whether liquidity problems are caused by temporary cash-flow fluctuation or impaired solvency. While short-term cash flow problems should be buffered by the banks, solvency problems require stronger remedial actions, including managerial changes, restructuring or disinvestment. A wide array of external causes may affect enterprise solvency and require these stronger actions rather than ensuring the artificial survival by bank credit. In particular, when relative prices switch as dramatically as they have since the price and exchange rate reforms, the distribution of profits across sectors and enterprises is drastically modified. This is the very reason that these reforms are undertaken in the first place: to stimulate a reallocation of resources which reflects market preference and comparative advantages rather than the planner's own judgement. Without the kind of remedial action mentioned above, bailing out enterprises which have suffered from the switch in relative prices results in forcing scarce resources into the sectors which were previously benefitted by price distortions. Similarly, merging a performing enterprise with a non-performing one may be mere window dressing that does not address the underlying problems and solves them only in the books. These practices hinder the emergence of productive capacities in the profitable sectors where the best potential for long-term growth lies.

2.20 Government revenues. General Government revenues have declined from 12.4 percent of GDP in 1986 to 9.5 percent in 1989. Furthermore their composition has undergone a landmark change: the switch from non-tax to tax revenues (see Table 1.6 which includes capital transfers). While non-tax revenue amounted to more than 90 percent of Government revenue in 1986, this percentage dwindled to about 22 percent in 1989. Under the central planning system, Government revenues consisted primarily of the transfer to the budget of state enterprise operating surpluses. The introduction of a profit tax system reduced the potential take from state enterprises: a portion of their profits is left with state enterprises, in compensation for the curtailment of current and capital transfers from the budget. However, this effect was compounded by the erosion of the profit tax base. Due to shrinking profits, state enterprise's current and capital[4] transfers to the budget declined from 10.2 percent of GDP in 1986, under the former system, to 2.4 percent in 1989. Taking into consideration the impact of non-deductible import duties on intermediate consumption to use more comparable figures,[5] the decline in the state enterprise contribution to the budget is therefore estimated at an equivalent of 6.8 percent of GDP.

2.21 This negative impact was offset until 1988 by the emergence of indirect taxes (customs tariffs and sales taxes) as major source of fiscal revenues and foreign borrowing. Apart from non-deductible custom tariffs on intermediate consumption, revenues from indirect taxes are paid by the final consumers, i.e., they mobilize resources mainly outside the public sector. These revenues increased from 0.7 percent of GDP in 1986 to 7.2 percent in 1988. In 1989, though, the proceeds of indirect taxes shrunk back to 5.6 percent of GDP, due primarily to administrative difficulties in tax collection.

2.22 Government expenditure. Despite a continued decline in real terms (see Chapter I), current expenditure at current prices has expanded from 10.1 percent of GDP in 1986 to 13.0 percent of GDP in 1988 before dropping to 11.1 percent of GDP in 1989. This resulted from permanent and temporary factors. On the one hand, the abolition of the system of forced procurement at

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[4] Transfers of state enterprise depreciation funds to the budget are treated here as capital transfers. As they extinguish a debt vis-a-vis the Government, they should, strictly speaking, be treated as a financing item. However, the creation of this debt through the extension of investment funds from the budget to state enterprises cannot be isolated from Government's other capital outlays. Therefore, these transactions can only be treated as if they had no counterpart.

[5] Half the import duties are estimated to be collected on inputs consumed by state enterprises. Due to the overvalued exchange rate and generous exemptions, the proceeds of this tax were negligible in 1986 but rose to 1.0 percent of GDP in 1989.

administered prices and exchange rates represented a cost to the current budget equivalent to 4.9 percent of GDP in 1988.[6] On the other hand, severance payments made in 1989 to redundant civil servants represented an estimated 5.0 percent of the current budget.

2.23 Government capital expenditures underwent a comparable evolution. Despite a cumulative decline in real terms of more than 24 percent, their value at current prices grew from 6.2 percent of GDP in 1986 to 8.5 percent in 1989. Thus, while the current surpluses could finance about 26 percent of Government investment in 1986,[7] the latter was entirely covered by foreign aid in 1989.

Private Savings

2.24 Despite a 24 percent cumulative real increase in private disposable income between 1986 and 1989, the mobilization of additional net private savings to support public investment is hampered, due to three reasons: (i) the private demand for consumption and housing had long been suppressed by the fear that conspicuous spending would be source of trouble; this pent-up demand is now catching up; (ii) farmers have replenished their rice stocks in 1989, after the drought; and (iii) households are reluctant to deposit money with the banks, due largely to the risk consideration (see Box 2.2). No other financial instrument exists at present to mobilize private savings. An active curb market operates, though, but the transactions on this market are essentially internal to the private sector. As a result, the mobilization of private financial savings was made almost exclusively through the issuance of currency. The inflationary experience of 1989 has shown rapidly the limits of this instrument given the reluctance of the economy to accumulate real cash balances beyond a certain point.

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[6] = difference between (current expenditure in 1987/current GDP of 1987) and (volume of current expenditure of 1987*prices of 1988/current GDP of 1988).

[7] The calculation is at constant 1988 prices to net out valuation changes.

Box 2.2: PRIVATE DEMAND FOR DOMESTIC CURRENCY ASSETS

Three factors affect the attractiveness of local currency assets compared to other forms of investment (mainly foreign currency and real assets, such as livestock or rice stocks): their relative return, risk, and the transaction costs involved in using them. The recent return of bank interest rates to positive levels in real terms is a major step towards meeting the first criterion of ensuring that the return on bank deposits in local currency is at least equal to the one on alternative investments. The introduction in August 1989 of interest-bearing foreign currency accounts will require that real interest rates on domestic currency accounts be kept at levels that fully reflect real depreciation expectations, if currency substitution is to be avoided. Nevertheless, considerable risks remain associated with holding local currency assets. First, the volatility of the exchange rate adds a risk premium to them. The recent stabilization of the exchange rate will help reduce this premium. Second, holding bank deposits involves a considerable liquidity risk as banks are too often unable to face their obligations vis-a-vis their depositors, due to their own liquidity problems. This problem stems from accumulation of arrears (see para. 2.20) and physical restriction on the issuance of currency (see para. 2.10). The latter is due to the way the authorities endeavor to control liquidity. As seen above, one of their main instruments is to restrict the issuance of currency. When this constraint becomes binding, part of the demand deposits becomes illiquid and cannot actually be redeemed against cash. For instance, agricultural trading corporations may have bank deposits that they cannot mobilize in cash to purchase crops from the farmers who only accept this form of payment. This policy is a primary source of mistrust of the banking sector as supposedly sight claims on the banks can often not be turned into cash. A financial restructuring of the banking sector will be necessary to restore its liquidity position. Finally, the inconvenience of keeping transaction balances in kip should be reduced by introducing notes with larger denominations: currently, the largest note, which was introduced during the second quarter of 1989, represents only 500 kip, i.e., less than a dollar. Maintaining positive real interest rates, broadening the interest rate differential vis-a-vis foreign deposit and reducing the liquidity risks and transaction costs will initiate a virtuous circle where accumulated savings gradually under the form of precious metals, real assets and foreign currencies switch to local currency, supporting the exchange rate and enlarging the control of the authorities over liquidity, and therefore the effectiveness of their policies.

D. Public Deficit, External Shocks and Inflation

2.25 Financing the growing public sector deficit has contributed to recent macroeconomic instability. It has led to excessive supply of money and therefore excessive aggregate demand for goods and services. Before 1989, the rapid expansion in the money supply had been accommodated by a parallel increase in the demand for domestic money, stimulated by the deceleration of inflation and the relative stability of the parallel exchange rate. In 1989, while real external shocks (primarily the temporary ban on log exports) called for offsetting restriction in domestic policies, the public sector deficit continued to expand, causing a flare-up in inflation. The expansion in the public sector domestic borrowing requirement was curtailed during the second half of the year thanks to a tax reform, a dramatic increase in interest rates and the substitution of foreign borrowings for domestic borrowings. Inflation was reduced from a monthly rate of 7.4 percent during the second and third quarters of 1989 to a monthly 1.9 percent up to April 1990. However, while Government was building a strong net creditor position vis-a-vis the banks, liquidity growth and inflationary pressures continued to be fueled by credit to the enterprise sector.

The Expansionary Impact of the Public Sector Deficit

2.26 The growing public sector deficit has been financed thanks to a rapid expansion in domestic credit (netting out undisbursed aid balances) at a rate of about 48 and 71 percent a year in 1988 and 1989, respectively. As explained in the previous section, this deficit originates in the deterioration of state enterprise performance.

2.27 Conservative budget policy. The government sector has generally maintained a conservative stance by adjusting the level of its expenditures to the availability of fiscal resources and foreign aid. Government credit from the banking sector has remained virtually unchanged from year-end to year-end. However, during the second quarter of 1989, confronted with acute liquidity problems, the Government had to borrow Kip 5 billion from the central bank. This recourse to bank credit was reduced by k3.5 billion during the rest of the year, which contributed to the alleviation of inflationary pressures. In addition, the Government incurred arrears vis-à-vis a number of state enterprises, which also constitutes a form of domestic borrowing.

2.28 Growing state enterprise financial deficit. The main source of the public sector financial deficit lies with state enterprises. While the inflow of foreign investment funded part of their growing financial needs, they were financed in major part by the net recourse to the banking sector. The rapid expansion of credit to state enterprises was permitted by the decline in real interest rates. Moreover, as the authorities were endeavouring to implement a stricter credit policy, state enterprises increasingly financed their deficit by reducing their function of bank deposits (see Table 2.5).

2.29 Interest rate policy. In Lao PDR, wide changes in interest rates are necessary to influence credit expansion. Until the end of 1989, a rigid interest rate policy made this instrument ineffective. Until August 1989,

Table 2.4: MONETARY SURVEY (MILLIONS OF KIP, END OF PERIOD) 1986-89

	1985	1986	1987	1988	1989
1. Net Foreign Assets	146.0	238.0	286.0	1,530.0	31,747.0
1.1 Net foreign assets	259.0	326.0	10,948.0	13,281.0	42,645.0
1.2 Foreign liabilities	113.0	88.0	10,662.0	11,751.0	10,898.0
2. Domestic Credit	2,717.0	4,329.0	17,964.0	26,490.0	38,510.0
2.1 Government (net)	-273.0	-484.0	2,523.0	2,765.0	-2,539.0
2.2 Public enterprises	2,740.0	4,044.0	15,331.0	22,855.0	36,647.0
2.3 Private sector	250.0	769.0	110.0	870.0	4,403.0
3. Money Supply	2,280.0	3,876.0	15,842.0	21,715.0	41,114.0
3.1 Currency	635.0	1,047.0	2,091.0	3,486.0	16,842.0
3.2 Demand deposit	1,591.0	2,734.0	4,797.0	8,618.0	8,284.0
- private sector	301.2	517.5	908.0	1,093.0	4,522.0
- public enterprises	1,289.8	2,216.5	3,889.0	7,525.0	3,762.0
3.3 Time and savings deposit	54.0	95.0	60.0	136.0	14,818.0
- private sector	64.0	95.0	60.0	136.0	313.0
- public enterprises	-	-	-	-	14,505.0
3.4 Foreign currency deposits	n.a.	n.a.	8,894.0	9,475.0	1,170.0
- private sector	n.a.	n.a.	-	1,970.0	1,170.0
- public enterprises	n.a.	n.a.	8,894.0	9,278.0	0.0
4. Net Other items	584.0	691.0	2,404.0	6,304.0	29,142.0
Memo item: Money supply (in percent) GDP	2.5	2.6	9.9	10.6	11.4

Source: Lao PDR authority.

Table 2.5: SUMMARY OF THE FINANCIAL TRANSACTIONS OF THE DOMESTIC SECTORS, 1986-89
(% of current GDP)

	1986	1987	1988	1989
A. Public Enterprises				
New Assets	0.7	6.8	2.2	1.1
Currency	0.1	0.2	0.3	0.7
Demand deposits	0.6	1.0	1.8	-1.0
Time deposits	-	-	-	4.0
Foreign currency deposits	-	5.6	0.2	-2.6
New Liabilities	1.1	7.7	5.8	5.4
Bank credit	0.9	7.1	3.7	3.8
Coupons	-	0.2	0.4	-0.3
Foreign liabilities (net)	0.2	0.4	1.7	1.9
Surplus (+) or Deficit (-)	-0.4	-0.9	-3.6	-4.3
B. Private Sector				
New Assets	0.4	0.8	0.8	4.4
Currency	0.2	0.6	0.6	3.1
Demand deposits	0.1	0.2	0.1	0.9
Time deposits	-	-	-	-
Foreign cash	n.a.	n.a.	n.a.	n.a.
Foreign currency deposits	-	-	-	0.3
Coupons	-	0.2	0.4	-0.3
New Liabilities	0.3	-0.4	0.4	1.0
Bank credit	0.3	-0.4	0.4	1.0
Surplus (+) or Deficit (-)	0.1	1.2	0.4	3.4
C. Government				
New Assets	0.1	0.4	0.6	4.3
Bank deposits	0.1	0.4	0.6	4.3
New Liabilities	3.9	7.9	10.7	15.4
Foreign	3.9	5.7	10.0	15.1
Domestic bank	0.0	2.2	0.7	0.3
Deficit (-)	-3.7	-7.6	-10.1	-11.0
D. Non Profit Institutions				
Surplus (+) or Deficit (-)	-0.7	-1.3	-4.3	-4.9
E. Total 1/	-4.7	-8.6	-17.6	-16.4

1/ = Financial surplus of the rest of the world + statistical discrepancy.

Source: LAO PDR authorities, World Bank staff calculation.

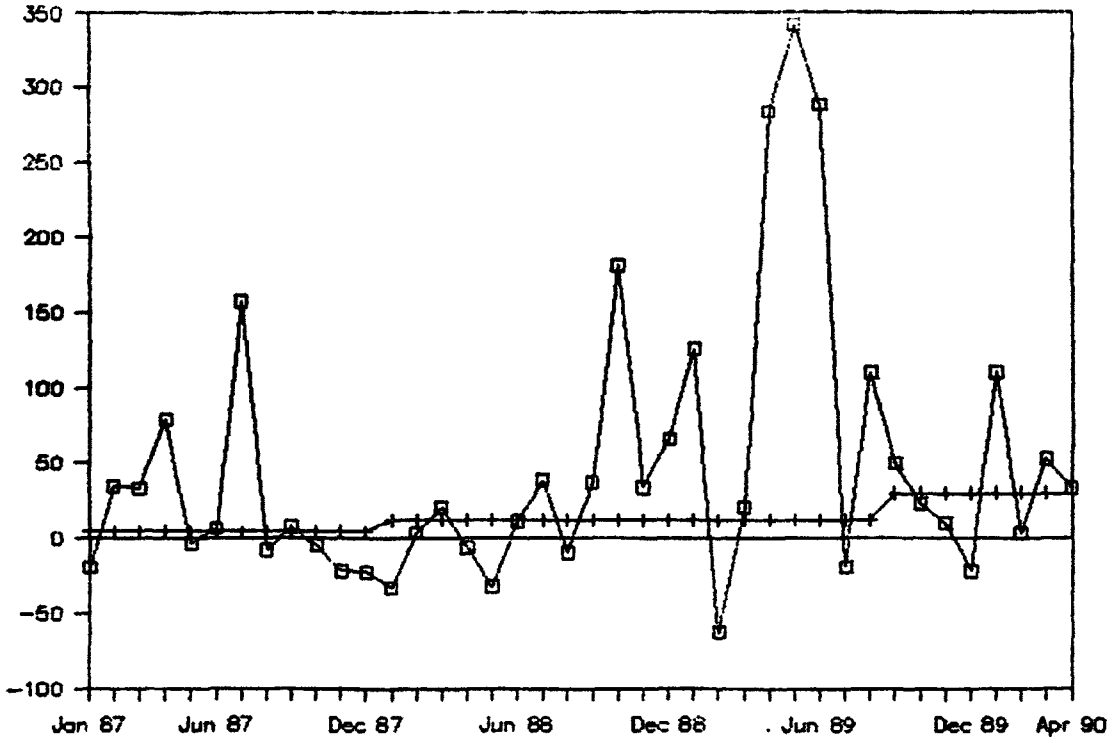
nominal interest rates were set directly by the authorities and adjusted infrequently. The level of real interest rates varied according to the level of inflation. As inflation decelerated with the introduction of the reforms, real interest rates became positive in 1987 (see Graph 2.2). When inflation accelerated in 1988-89, credit demand was fueled by a sharp drop in real interest rates. In August 1989, the authorities modified their interest rate policy and decided to set only minimal rates and to leave the actual determination of rates to commercial banks. The level of the minimum rates became higher than inflation as the latter subsided in the last quarter of 1989. The authorities also introduced a punitive interest rate of 1 percent a day on overdrafts. This measure was instrumental in reducing credit expansion.

2.30 Two factors blunt the effectiveness of interest rate policy. First, the accumulation of arrears is equivalent to automatic credit expansion. Therefore, credit policies influence only part of total domestic credit expansion. As long as this problem remains, the burden of the necessary restriction of credit will fall disproportionally on the best debtors, those with the best growth potential, and therefore hamper the productive response to the reforms. Second, state enterprises are not guided by profit maximization, therefore they react less to financial signals. It thus takes a large movement in interest rates to achieve a significant impact on total credit to the economy. The use of indirect monetary instruments to control aggregate demand needs therefore to be complemented by direct cash management, i.e. the adjustment of Government creditor position vis-à-vis the banking system and, when necessary, the use of foreign reserves.

2.31 Changes in the Demand for Money. While the authorities were attempting to regain control over credit expansion, state enterprises managed to avoid the intended liquidity squeeze by reducing their formation of bank deposits. Against a background of mounting inflationary pressures, the authorities attempted in 1989 to restrict the expansion of domestic credit. A 17 percent growth rate was targeted for domestic credit in local currency and domestic credit in foreign currency was limited to the availability of foreign exchange with the banking system, taking into account some increase in net foreign reserves. While new credit to state enterprise remained stable at around 3.7 percent of GDP, reduced their formation of new monetary assets from 2.2 percent to 1.1 percent of GDP.

2.32 The inflationary impact of a money supply growing at an annual rate of about 90 percent in 1989 was partly buffered by an increase in the transaction demand for money on the part of the private sector. The elimination of the system of payment of wages in kind broadened the use of the local currency, and therefore the transaction demand for it. However, the consequent increase in real money balance (Graph 2.3) was not commensurate with the runaway money creation of the first half of 1989. In view of the resulting inflation surge, a prolonged phase of restructive policies will be required before the confidence in the currency is fully restored and the demand for real money balances start growing again substantially.

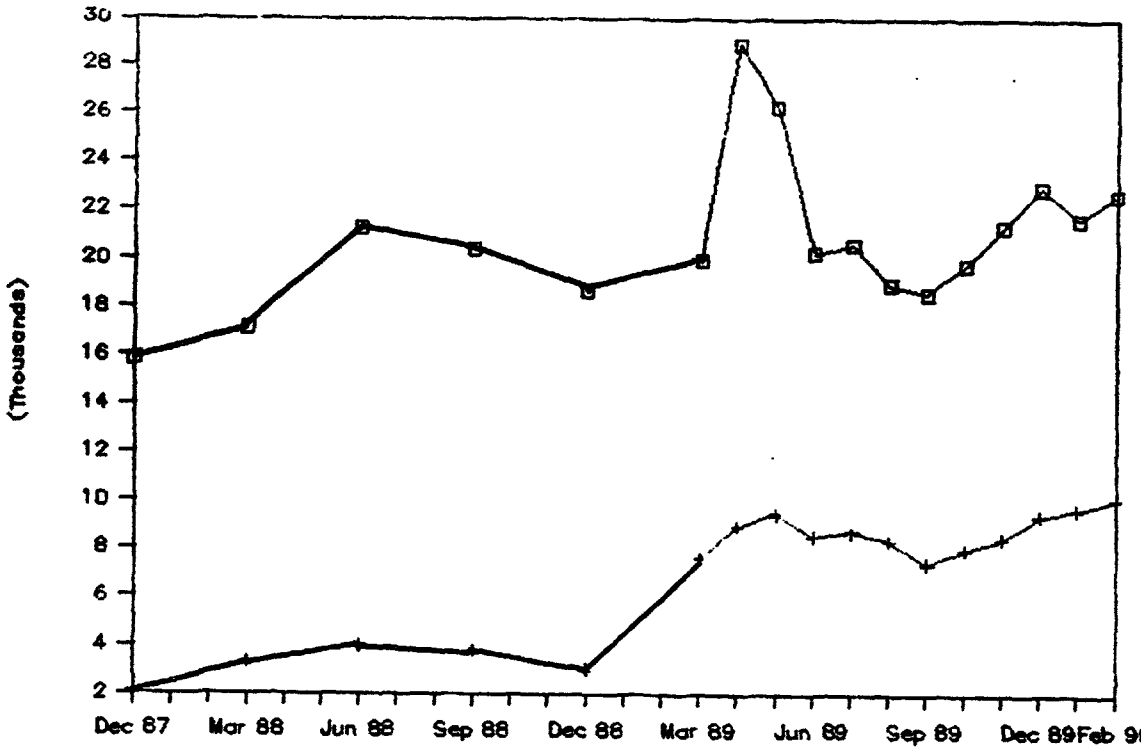
Graph 2.2: INFLATION AND NOMINAL INTEREST RATES
(Annualized Monthly Rates)



□ Annualized CPI

\+ Lending Rate

Graph 2.3: REAL DOMESTIC MONEY BALANCES
(En Constant Price of Dec. 1987)



□ Domestic Money

\+ Cash Only

The Impact of External Policies

2.33 In recent years, external policies have exercised a specific influence on price developments, by handling exogenous shocks to the economy. During 1987-88, the positive impact of export liberalization on the nominal exchange rate dampened the inflationary pressures of expansionary public sector policies. The reverse happened in 1989 when the export ban on logs dried up the supply of foreign exchange and drove down the nominal exchange rate. The recent inflation experience illustrates the need for a consistent use of external and domestic policy instruments. As a general rule, negative external shocks require a curtailment in the domestic money supply to allow for a shift in the domestic terms of trade in favor of tradables. Transitory fluctuations in foreign exchange earnings can be buffered through the use of reserves but more lasting shocks, such as those experienced in 1989, call for a restriction in the recourse of domestic sectors to the banking system, or in practical terms a reduction in the public sector deficit.

Lessons and Legacy

2.34 How to stabilize the economy. The manner by which the economy was temporarily stabilized provides useful indications for the design of future macroeconomic policies. The stabilization of the economy during the second half of 1989 was achieved through three policy instruments: (i) the June 1989 tax reform enhanced revenue collection, (ii) the interest rate reform restore real positive interest rates and (iii) foreign borrowing[8] stabilized the foreign exchange market. The combined impact of the tax and interest rate reform was to curtail the expansion of credit to the public sector: thanks to improved revenue collection, the Government was able to reduce its recourse to bank credit and reimburse part of its arrears, while credit state enterprise was temporarily stabilized. Meanwhile, the interest rate reform and foreign borrowing succeeded in restoring the confidence in the local currency assets and generating an increase in the demand for real money balances. The success of these policies was facilitated by a major increase in agricultural production in the fall of 1989, after two years of drought, which boosted supply as nominal demand was squeezed.[9] Their initial success was not consolidated, however, and by the end of the year, credit to state enterprise was expanding again at an excessive pace.

2.35 High real interest rates During the brief stabilized phases, real interest rate rose to very high levels. The persistence of high real interest rates is typical after a period of accelerated inflation, because inflationary expectations die hard. Until they do, high real rates are necessary to hold Graph 2.3

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[8] During the summer of 1989, the country started to receive balance of payment support from IDA, which helped stabilize the foreign exchange market and mopped up excess liquidity.

[9] Although no firm evidence is available in this regard, the adjustment of interest rate to positive levels in real terms is likely to have further contributed to the supply response, thanks to the release of stocks on the market.

aggregate demand in check. The real impact of such real rates on investment can be severe. The fact is that one way or another some categories of demand have to give. The alternative is clear: if investments are to be preserved, savings need to increase to alleviate the tension between the demand and supply of investable funds. This implies curbing consumption expenditures. As public consumption can hardly and should not be further reduced, the brunt needs to fall on private consumption, through higher taxes and wage restraints. Premature attempts at reducing real interest rate to lower level before inflationary expectations have been termed can only win the benefits of the stabilization efforts and unleash a fresh round of inflationary pressure.

2.36 Structural Changes in Financial Transactions. The macroeconomic developments reviewed above have resulted in major restructuring of the financing pattern of the economy, which is detrimental to growth and stability: financial flows have been redirected towards offsetting the reduction in state enterprise savings, rather than to productive uses. In addition the financing of state enterprise had to rely increasingly on the issuance of currency. This contribution was minimal until 1988 (see Table 2.5).[10] In 1989, however, the private sector dramatically increased its holdings of local cash, with savings in cash increasing from about 0.6 percent of GDP in 1987-88 to 3.1 percent of GDP in 1989, covering about 75 percent of state enterprise net borrowing requirement.

2.37 Confronted to the lack of fiscal resources, the Government was unable to absorb all the foreign assistance available, which in turn reduced its investment expenditure. Government financial requirements in 1989 were equivalent to 11.0 percent of GDP, but it received 15.1 percent from abroad and deposited the remaining 4.3 percent of GDP with the banking sector, which was reflected in an accumulation of reserve.[11]

2.38 As the authorities rapidly discovered, the financing of the economy through the issuance of currency rapidly reaches a limit in the willingness of the public to hold additional real cash balances. In addition to creating instability the recourse to this instrument to offset enterprise's declining savings, rather than to complement them undercuts, the economy's longterm growth potential. The accumulation of unused aid for lack of counterpart funds indicate further that there is no alternative to public resource mobilization, if the country is to realize this potential.

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10 Due do the existence of an active crub market, the magnitude of both new assets and new liabilities is likely to be underestimated in available statistics. As the transactions on the curb market are basically internal to the private sector, this should not affect the private sector net financial surplus.

11 Part of these deposits reflects the on-lending of lines of credit (from IFAD and IDA) underwritten by Government. The largest part of them, though, represents the accumulation of unused aid balances on special accounts. Part of this accumulation is a purely transitory phenomenon caused by a bunching of donor's disbursement towards the end of the year.

E. Conclusions

2.39 During the current transition period, the economy is prone to instability. External and domestic balances highly depend on a limited number of external flows - foreign aid and exports of hydroelectricity and wood - which are inherently unstable. Macroeconomic management is complicated by one-shot adjustments in economic behavior generated by policy reforms, such as the loss of economic rents by state enterprise or the recomposition of private portfolios after the elimination of wage payment in kind. As experienced in 1989, such adjustments provoke wide fluctuations in nominal aggregates. In the meantime, the control of the authorities over financial developments is limited by the accumulation of arrears, the decentralization of credit policy and the presence of foreign money in the economy. The onus of maintaining macroeconomic stability thus rests primarily with public sector policies.

2.40 The damage caused by this instability should not be overlooked. It does not simply affect the level of prices but it also affects the real economy. Accelerated exchange rate depreciation leads to currency substitution and capital flight while accelerated inflation increases demand for non-productive real assets (such as consumer durables, silverware, rice stocks, etc.) which provide a hedge against it. This in turn reduces the availability of savings for investment. Faced as it is with considerable investment needs, the country can ill afford this.

2.41 As indicated by the temporary stabilization of the economy over the fall of 1989, the authorities have basically two options to control aggregate demand: the control over credit to the economy and the management of their own cash position. As regards the former, the authorities can either adjust the interest rate at which the central bank rate refinances the commercial banks or adapt the level of the reserve requirements. The role of positive real interest rates in generating the sharp disinflation at the end of 1989 demonstrates the effectiveness of financial instruments. Both instruments operate only over time however. Moreover, given the large arrears they affect only part of domestic credit. Ample changes are therefore required to achieve the desired aggregate impact, which may expose the "good" debtors to a damaging stop-and-go process.

2.42 To smooth out short-term fluctuations in aggregate demand, the authorities are better advised to actively manage their cash position. To achieve this they can vary (i) their bank deposits, accumulating them when inflationary tensions appear and running them down when foreign exchange and goods markets indicate signs of deflation; or (ii) their foreign reserves when tensions result from temporary fluctuations on the foreign exchange market. Government has built up large deposits in 1989 that allow it to pursue the former policy. It has also accumulated some reserves; but since their amount is still limited, they should be used with great care. The active management of government deposits with the banks necessitates the strengthening of government expenditure programming and execution procedures in order to avoid their being offset by domestic arrears or leading to damaging across-the-board spending cuts, when restrictive action on liquidity is required. Recommendations in this respect are formulated in Chapter VI.

2.43 Improved short-term demand management will only be useful, though, if supported by resolute efforts at raising savings from their current low levels. The economic reforms have introduced a framework where performing

sectors have incentives to grow. More needs to be done to ensure that (i) this expansion in income be turned into savings, rather than consumption, and (ii) available savings are no longer siphoned off into non-performing enterprises. The restoration of positive real interest rates would certainly be conducive to these twin objectives. Since a substantial increase in private financial savings is unlikely in the short term, given the deep-rooted distrust of the banking sector, the public sector is called on to shoulder the brunt of the effort. Vigorous actions are thus required to curtail state enterprise deficits and restore government savings. The magnitude of the required resource mobilization effort will be defined in the next chapter.

III. THE FUTURE ROLE OF PUBLIC FINANCES: MEDIUM-TERM OBJECTIVES

A. Introduction

3.1 The potential for sustained growth exists in Lao PDR, but it will materialize only if macroeconomic policies are geared towards a recovery in investment. The New Economic Mechanism has greatly improved the framework for efficient economic decision making. However, recent growth performance benefitted to a large extent from the rebound in crop production after a protracted period of drought. The lack of physical and human capital still represents a major bottleneck to the productive response to improved incentives. Renewed resource mobilization efforts will be required to bring about the necessary level of investment. The scenario presented in Section B below is predicated upon the success of these efforts. Section C delineates the challenge facing the public sector and defines resource mobilization objectives. The nature of the necessary policy actions will be elaborated in the following chapters.

B. The Medium-Term Outlook

3.2 Growth is expected to accelerate in 1990-91 to rates of 6.8 and 11.3 percent, respectively, and to maintain its momentum thereafter with growth rates of about 6.5 percent per annum (Table 3.1). It is expected to be initially led by a recovery in exports and public sector investment.[1] The share of exports in GDP (at current prices) would increase from 11.1 percent in 1989 to about 18.0 percent during the early nineties, while the share of public investment would expand from 8.5 percent in 1989 to 14.5 percent during the same period. To permit this recovery, the growth private expenditures would first need to slow down to rates somewhat lower than the expansion of production. Macroeconomic projections are documented in Annex II.

3.3 Exports should initially pick up primarily due to a return to normal hydroelectricity production in Nam Ngum and the coming on stream of a second unit, at Xeset in 1992. Due to the continued expansion in domestic consumption, however, export volumes of electricity are not expected to return to their peak level of 1986. Exports of timber and wood are also projected to increase gradually. Initially, in 1990, they are projected to benefit from a reduction in log taxation. The improvement in forestry management structures should thereafter permit a return to the sustainable cut level. As the past

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[1] The concept of public sector will evolve in the medium-term (1990-95). As Government proceeds with its disengagement program, an increasing number of enterprises will become private or privately-managed. For reasons of consistency and comparability over time, the limits of the public sector are not modified in the projections presented below. It should therefore be understood that items such as "public enterprise investment" cover, in fact, investment expenditure incurred in sectors where state enterprise are currently predominant, whether or not this will still be the case in the future.

levels of commercial exploitation may have gone beyond that level, the past peak is not expected to occur. The impact of the ongoing rehabilitation and expansion of coffee plantations will start to be felt only after 1992 due to the long gestation period required. While prospects for the expansion of tin exports are limited (reserves and operational methods should be fundamentally reassessed and any expansion would require substantial investment, the financial viability of which is still uncertain), gypsum exports are projected to increase from 80,000 tons per year (tpy) to 180,000 tpy by 1995, assuming that the main purchaser, Viet Nam, will continue to be willing to absorb the transportation costs. Non-traditional exports will provide an increasing share of export earnings. These include livestock, precious stones, spices, garments and textiles, processed agricultural produce, etc.

3.4 To support the projected expansion of production, public investment expenditure both by Government (including all foreign project aid, except investment credit lines) and state enterprises would need to increase by about 21 percent a year in 1990-91. During the remainder of the projection period, Government investment growth would slow to an average rate of 11 percent a year while enterprise investment would continue to expand at an average rate of 14.2 percent. The financial conditions for this investment recovery to take place will be discussed in the next section. The supply constraints to such a recovery should be alleviated by (i) the international tendering of major civil works, which the Government has recently decided, (ii) the substantial inflow of foreign technical assistance and (iii) the weakening of the demand for new housing. The recent boom in private expenditure on consumption, housing, rice stocks would have to slow down to allow for the reallocation of exports and investment.

3.5 Thanks to improved export performance and continued donor support, imports could continue to grow faster than GDP during the early nineties, as they have done since 1987, assuming the necessary inflow of investment goods, spare parts and inputs. After 1992, the import growth rate would increasingly be outpaced by GDP growth. In dollar terms, the external current account (excluding grants) would continue to grow (Table 3.2), but it would plateau around 22 percent of GDP in 1991-93 and then decline to about 20 percent towards the end of the projection period. Donors would continue to finance the largest part of this deficit, with their disbursement increasing from US$136.6 million in 1989 to US$212 million in 1995. With the negotiation of a new five-year agreement (1991-95) with the Soviet Union bringing less favorable assistance to Lao PDR, the source of donor aid is anticipated to shift increasingly from the non-convertible to the convertible zone. Finally, a gradual phasing out of adjustment lending is assumed, starting from 1994.

C. The Challenge to the Public Sector

3.6 Public investment and O&M expenditures will need to increase substantially if the country's growth potential, outlined above, is to be realized. The achievement of this objective will require resolute mobilization efforts both on the fiscal side and on the state enterprise side. The magnitude of the challenge facing the public sector in the coming years is encapsulated Table 3.3. If the public sector is to achieve the level of

Table 3.1: PROJECTION OF GDP BY EXPENDITURE CATEGORY
(in constant 1988 prices)

	1989		1990		1991		1992		1993		1994		1995	
	(% GDP)	Growth Rate	(% GDP)	Growth Rate	(% GDP)	Growth Rate	(% GDP)	Growth Rate	(% GDP)	Growth Rate	(% GDP)	Growth Rate	(% GDP)	Growth Rate
Private Expenditure	(88.3)	14.8	(91.9)	13.8	(90.7)	9.9	(89.1)	4.7	(87.8)	4.9	(86.7)	5.1	(85.6)	4.2
Public Consumption	(14.8)	-6.7	(13.6)	1.2	(13.8)	13.2	(13.4)	3.4	(13.1)	4.2	(12.9)	4.7	(12.8)	4.7
of which														
government	(9.2)	-19.4	(9.2)	6.8	(8.4)	2.2	(8.2)	3.8	(8.2)	6.4	(8.1)	5.6	(8.2)	5.7
non-profit institutions	(5.1)	29.9	(4.4)	-8.8	(5.4)	36.3	(5.2)	2.9	(4.9)	0.7	(4.8)	3.2	(4.7)	3.2
Public Investment	(12.7)	8.6	(14.4)	20.9	(15.6)	21.1	(17.2)	16.9	(18.2)	13.1	(19.1)	11.6	(19.1)	5.6
of which														
government	(10.2)	3.4	(11.6)	21.3	(12.6)	21.5	(13.9)	16.8	(14.6)	12.4	(15.3)	11.4	(15.1)	4.3
public enterprises	(2.5)	36.2	(2.8)	19.6	(3.0)	19.3	(3.3)	17.3	(3.6)	16.0	(3.8)	12.4	(4.0)	11.1
Total Domestic Demand	(113.3)	10.9	(119.8)	13.0	(120.1)	11.6	(119.6)	6.2	(119.2)	6.0	(118.7)	6.1	(117.5)	4.5
Exports	(14.5)	16.0	(15.0)	10.5	(15.2)	12.9	(15.9)	11.8	(16.5)	10.2	(16.4)	6.1	(16.6)	6.8
Total Final Demand	(127.8)	11.4	(134.8)	12.7	(135.3)	11.7	(135.5)	6.8	(135.7)	6.5	(135.1)	6.1	(134.1)	4.8
(Less) Imports	(-27.8)	21.2	(-34.8)	33.9	(-35.3)	12.8	(-35.5)	7.3	(-35.7)	6.7	(-35.1)	4.6	(-34.1)	2.6
GDP	(100.0)	9.0	(100.0)	6.8	(100.0)	11.3	(100.0)	6.6	(100.0)	6.4	(100.0)	6.5	(100.0)	5.6

Source: World Bank staff estimates, based on data communicated by the Lao PDR authorities.

Table 3.2: PROJECTION OF BALANCE OF PAYMENTS (1989-95)
(in US Dollars)

	1989	1990	1991	1992	1993	1994	1995
Exports of goods	54	63	75	87	100	115	130
Imports of goods	-162	-210	-248	-276	-307	-338	-359
Trade balance	-107	-146	-173	-189	-206	-223	-229
Net service	-9	-11	-18	-21	-23	-23	-28
Net current transfers (private)	8	9	13	16	20	22	23
Current account balance	-107	-148	-178	-193	-210	-224	-235
Net long-term loans	71	73	90	101	113	123	132
Official capital grants	40	42	50	50	50	50	50
Net other items	14	28	39	44	43	44	41
Changes in net reserves	-18	5	0	-2	4	8	12
Memorandum items			(In percent)				
Current account (excl.grant)/GDP (%)	-17.2	-20.8	-22.1	-22.5	-22.0	-20.8	-19.6
Current account (incl.grant)/GDP (%)	-10.7	-14.9	-16.0	-16.7	-16.8	-16.2	-15.5
Debt/GDP (%)	83.4	84.6	87.3	91.4	94.1	96.1	98.5
Debt services/Exports (%)	14.5	13.1	13.9	12.9	12.4	12.2	12.3

Source: World Bank staff estimates.

investment required to sustain growth and absorb the foreign aid available to that effect, there needs to be a complete turn-around in public savings: they need to recover from their recent drop to a negative 3.4 percent of GDP to a positive 2.1 percent in 1995. Given the supply and financial constraints, the authorities will need to reinforce the care with which they assess public expenditure to make sure that the scarce public resources they mobilize areused efficiently. This section first identifies expenditure targets. In a second stage, it turns to the sources of financing and based on the expected foreign aid flows, derives the implications for domestic resource mobilization.

Expenditure Targets

3.7 Government current expenditure are projected to increase from 11.1 percent of GDP in 1989 to 12.3 percent of GDP in 1990 and then gradually to 12.7 of GDP throughout the rest of the period. This would allow for continued improvement in civil servants' real wages and increased expenditure on operation and maintenance. Civil servants' wages are projected to increase by 34.2 percent in real terms in 1990 to regain their purchasing power of 1988, and then to rise by an average of 5 percent in 1991-95. No increase in overall government staffing is envisaged, the existing gaps being filled through redeployment. No severance payments are projected beyond 1990. Expenditure on goods and services, including O&M outlays, are expected to recover in real terms in 1990 at a growth rate of 13 percent, then grow by 8 percent thereafter to keep up with investment expenditure. Due to the high concessionality of foreign aid, interest payments would remain relatively low over the period.

3.8 To realize the country's growth potential and absorb the available foreign aid, Government investment need to jump in two years from 11.1 percent of GDP in 1990 to 13.4 percent in 1992 and continue to expand to 14.5 percent of GDP in 1995. State enterprise investment (including privatized enterprises) is projected to increase from 2.5 percent of GDP in 1989 to 4 percent of GDP in 1995, with an increasing share of investment coming from non-government sources. Overall, the increase in capital expenditure would represent 4.7 percentage points of GDP between 1990 and 1995. Measures to ensure the efficiency of investment will be discussed in Chapters IV through VI.

Funding Public Expenditure

3.9 Recent developments. The capacity of the country to generate a local currency sufficient contribution to capital expenditure has declined dramatically. As indicated in Table 1.7, the ratio of local to foreign contributions to capital expenditure in constant price has declined dramatically from 58.9 percent in 1986 to only 23 percent in 1989. Not only does this decline directly affect the aggregate amount of investment but it also jeopardizes the country's absorptive capacity for foreign aid, which requires sufficient local currency resource for the local expenditure related to foreign-assisted projects. In 1989, substantial amounts of foreign aid were left unused for lack of counterpart funds. Another indicator further documents the current strain on the country's absorptive capacity. As of end

of September 1989, the Government owed Kip 657 million to construction companies from investments implemented on its behalf; this comprised more than 50 percent of the local cost of contracted works since the beginning of the year.

3.10 Future requirements. In the scenario presented here, the largest part of public sector expenditure will initially be financed by the projected inflow of foreign savings, but domestic resources will be required to cover an increasing share of expenditure, growing from 36.5 percent of total expenditure in 1989 to 54 percent in 1995. To reach that level, all forms of domestic resources will have to be mobilized: (i) fiscal revenues will need to return to their relative pre-reform levels, (ii) public enterprise profitability will need to be restored. In addition, the access to private savings is expected to increase thanks to the transfers of some state enterprises to the private sector. While recourse to domestic private savings is limited by the willingness of this sector to save and its own requirements, the relative contribution of state enterprise savings and fiscal revenues is more flexible.

3.11 Financing government investment. Government investment will continue to be largely dependent on foreign aid (see Table 3.4)[2]. The foreign contribution to capital expenditure[3] is expected to grow from 7.9 percent of GDP in 1989 to 10.9 percent of GDP in 1995. Future local currency requirements will be influenced by two factors: (i) the increased emphasis on the social sectors during the Third Five Year Plan (1991-95) will require relatively more local currency resources than in the past, as the local expenditure component of projects in these sectors tends to be larger than in other sectors; and (ii) the relative decline of Soviet aid will reduce the local resource requirement, as Soviet aid covers the import of goods only CIF Danang (Viet Nam), the heavy transportation costs to Lao PDR being incurred by the country and financed out of its own resources. Overall, a local contribution to government capital expenditure of about 25 percent (in constant 1988 prices), compared to an average of about 33 percent during 1985-88, is deemed to be the bare minimum, below which the country's absorptive capacity would be impaired.

3.12 The local currency contribution (including payment arrears) will therefore need to rise from 1.8 percent of GDP in 1989, to 3.2 percent in 1991, then stabilizing at its historical level of about 3.7 percent of GDP. Three sources of funds will contribute to this: (i) the current fiscal surplus (less table 3.4 amortization of foreign debt), (ii) the counterpart funds generated by donors' balance of payment support and (iii) the sale of Government participation in state enterprises to the private sector. While,

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[2] The Government is also projected to receive US$15.5 million from private sources in 1991-93 for the purchase of new airplanes, and US$6 million a year thereafter through the sales of participation in state enterprises to foreign investors.

[3] Equal to project aid less investment lines of credit and unused amounts accumulated with the banks.

Table 3.3: PUBLIC SECTOR CONSOLIDATED ACCOUNTS, 1990-95
(% of GDP)

	1990	1991	1992	1993	1994	1995
Resources						
1. Revenues	9.6	10.5	11.5	12.6	13.9	14.8
1.1 Fiscal Revenues	10.9	10.2	11.5	12.7	13	13.1
1.2 Public Enterprise Gross Savings	-1.4	0.4	-0.0	-0.1	0.9	1.7
2. Financing (net)	16.5	16.9	17.5	17.8	17.2	16.4
2.1 Foreign (net)	15.5	15.8	16.2	16.1	15.3	14.4
- Official	13.4	13.7	13.6	13.9	13.2	12.9
- Private	2.0	1.9	2.6	2.3	2.1	1.5
2.2 Domestic (net)	1.0	1.3	1.3	1.7	1.9	2.0
3. Total	26	27.4	29	30.4	31.1	31.2
Memo item: Public Sector Gross Savings	-2.7	-2.0	-0.8	-0.0	1.3	2.1

	1990	1991	1992	1993	1994	1995
Uses						
1. Current Expenditures	12.3	12.5	12.3	12.7	12.6	12.7
1.1 Wages	6.7	6.6	6.2	6.4	6.3	6.2
1.2 Goods and Services	4.4	4.4	4.6	4.7	4.8	5.0
1.3 Pensions	0.6	0.9	0.9	0.4	0.4	0.4
1.4 Interest	0.6	1.0	1.0	1.1	1.1	1.1
2. Capital Expenditure	13.8	15.0	16.7	17.8	18.5	18.5
2.1 Government	11.0	12.0	13.4	14.2	14.7	14.5
2.2 Public Enterprises	2.8	3.0	3.3	3.6	3.8	4.0
3. Total	26.0	27.4	29.0	30.4	31.1	31.2

Sources: World Bank Staff Estimates

Table 3.4: FINANCING OF GOVERNMENT CAPITAL EXPENDITURE (1989-95)

	1989	1990	1991	1992	1993	1994	1995
Foreign Contribution	7.9	8.4	9.2	10.0	10.5	10.8	10.9
Local Contribution	0.6	2.5	2.7	3.4	3.7	3.8	3.6
Current Fiscal Surplus	-1.6	-1.3	-2.3	-0.8	0.1	0.4	0.4
Counterpart Funds	3.6	5.0	5.0	4.0	3.4	2.9	2.1
Sales of Assets	0.0	0.0	1.0	1.0	1.0	0.8	0.8
Use of Bank Deposits	0.0	0.0	0.0	0.0	0.0	0.5	1.0
(Less) Amortization	-1.4	-1.2	-0.9	-0.8	-0.8	-0.7	-0.7
Total	8.5	11.0	12.0	13.4	14.2	14.7	14.5

Source: World Bank staff estimates.

it is assumed that Government will continue not to borrow from the domestic banks, a net reduction of Government deposits vis-a-vis the banks has been projected in 1994-95. Sale of State enterprises to the private sector is expected to provide the equivalent of 1 percent of GDP from 1991 to 1995. Counterpart funds for balance of payment support provided by foreign donors are the largest source of local currency resources. Adjustment lending will, however, be available only for a limited time, as it is meant to help the authorities until the fundamental reforms undertaken have borne fruit. The budgetary support so provided will represent about 5 percent of GDP in 1990-91. Over time, as the availability of counterpart funds gradually declines to an average of 2 percent of GDP in 1994-95, fiscal resources will have to supersede foreign budgetary support. The government should therefore pursue the objective of improving the current fiscal surplus from its low of -1.6 percent of GDP in 1989 to 0.5 percent of GDP by 1995. This will require that fiscal revenues are increased from 9.5 percent of GDP (1989 figure) to about 13 percent of GDP, an ambitious but not unrealistic objective given that this would only bring back fiscal revenues to their 1986-88 average level as a proportion of GDP.

3.13 Financing state enterprise investment. Given the overall availability of resources, the projected expansion in state enterprise investment will not be feasible without a drastic improvement of their profitability (see Table 3.5). In 1990-92, their aggregate retained earnings will need to return to the black so as to finance 42 percent of their own investment out of their retained earnings by the end of the projection period. The rest will be financed through private savings from domestic and foreign sources. The capacity of the sector to use private savings has been and will remain limited. Up to now, it has been constrained by the limited amount of financial savings mobilized through the banking sector, but even if this situation improves, the development of a dynamic private sector will require that an increasing share of these savings be directed to the private sector itself. On the other hand, it is anticipated that the privatization of state enterprises will improve their capacity to tap private financial savings, among others, through the issuance of equity. The contribution of private savings should therefore decline to 15 percent of investment between 1990 and 1995. The remainder (72 percent in 1990, 42 percent in 1995) will come from foreign sources.

Table 3.5: FINANCING OF STATE ENTERPRISE INVESTMENT (1989-95)
(% of GDP at current prices)

	1989	1990	1991	1992	1993	1994	1995
State Enterprise Gross Savings	-1.1	-1.4	0.4	0.0	-0.1	0.9	1.7
Private Domestic Savings	1.8	1.4	1.1	1.7	1.5	1.1	1.6
Foreign Savings	1.8	2.8	1.5	1.6	2.0	1.8	1.7
Total	2.5	2.8	3.0	3.3	3.6	3.8	4.0

Source: World Bank staff estimates.

D. Conclusions

3.14 Thanks to the low interest rates and long grace periods which the country can obtain on its foreign borrowings, the latter will not immediately engender an increase in the debt service ratio (Table 3.2). The authorities therefore have breathing space. It will only last a couple of years, though. During the second part of the nineties, the burden of servicing the current accumulation of foreign debt will start to be felt. Part of the present inflow of foreign borrowings has in effect financed an increase in consumption. This is not sustainable. If the country does not seize its present opportunity to built an efficient capital stock and develop domestic savings, it will eventually be caught in a debt trap, where a shrinking net transfer of foreign savings stifles domestic expansion.

3.15 The country has the potential to grow at a sustained rate of 6 percent per year in the early nineties. This will however require a strong recovery in public investment. Since private savings will be needed to support the still fledgling private sector, public savings will have to shoulder this effort.

3.16 To meet the challenge facing them, the authorities will need to strengthen all aspects of public resource management. Thanks to the impressive reforms already undertaken by the Government, this in general will not require dramatic changes in the direction of current policies. What is required is a consolidation of these policies that will provide Government with the means of action necessary to further its goals. The next chapters formulate recommendations in this respect in the following priority areas.

(i) Restoring state enterprise profitability. Low public enterprise savings are the main source of the current lack of investable funds. Urgent remedial actions are required first to restore them to positive levels, and then to increase them to 2.1 percent of GDP over the medium term. Such strategy will be developed in Chapter IV.

(ii) Mobilizing fiscal resources. To support necessary expenditures on investment and operation and maintenance, the level of fiscal resource mobilization must be brought back to its historical levels of 12-13 percent of GDP. Chapter V reviews the various ways by which this objective can be achieved.

(iii) Strengthening government expenditure management. In a context of scarce local resources, the management of public expenditure must be reinforced to ensure that scarce resources are allocated to their most beneficial uses. This requires a major revamping of budgeting and planning techniques, as elaborated in Chapter VI.

IV. ENTERPRISE REFORM FOR RESTORING PROFITABILITY

A. Introduction

4.1 The liberalization of product prices, wages, and the exchange rate, as well as the deregulation of domestic and external trade, exposed public enterprises in Lao PDR to unfamiliar domestic and foreign competition for which they were initially ill-prepared. They were stifled by rigid government supervision, inefficient due to their former monopoly positions and import protection, and hardly profit-oriented. Only capable and dynamic enterprises that seek profit, while abiding by some regulatory framework, would maximize economic welfare in an undistorted competitive environment. The challenge, then, was to introduce new systems of enterprise governance, ensure a minimum of regulation and resource mobilization by the state, and restructure enterprises and strengthen their capabilities. This chapter is focused on the change of enterprise governance, i.e., enterprise reform.

4.2 The Government of Lao PDR pursued a multi-faceted approach. First, it sought to retain enterprises under state ownership but to make them profit-oriented by giving them autonomy, financial self-sufficiency, and even control over the disposition of their profits. Second, it transferred other public enterprises partly or entirely to the private sector through leases, formation of joint ventures, or outright divestiture. Third, it encouraged private and foreign firms to enter the markets and win market shares from public firms.

4.3 The Government granted enterprise managers and employees far-reaching, albeit in practice not unlimited, autonomy in operations, borrowing and investment. Through the right to decide on wages and on profit distribution, including bonuses, they also got a concrete performance incentive. The State itself remained the sole owner, but its supervision of these enterprises became mostly formal. In other words, the enterprise staff obtained no legal claims on the enterprise assets themselves but gained almost unsupervised autonomy and profit participation in enterprises where they assume no liability. This report argues that this system contributed to the erosion of enterprise savings and at the same time to the risk of enterprise overinvestment, and hence to the massive increase of net financing needs of the public enterprise sector.

4.4 A privatization program was also recently introduced and is being pursued by some central ministries and local governments at a very rapid pace and with a variety of approaches. The Government has, however, encountered a number of difficulties in these speedy ad hoc privatizations including: limited administrative capacity in enterprise valuation, buyer search, negotiations, and contract follow-up; shortage of private savings and effective financial intermediation; and weaknesses of the legal framework. As a result, this first wave of privatizations is unlikely to lead to optimum allocation and to maximum divestiture revenue for the Government.

4.5 After a brief overview of the state enterprise sector and the policies for its reform in section B, section C will deal with the control of enterprises that remained state-owned, whereas section D will deal with the privatization of enterprises. The concluding section E of this chapter will

formulate recommendation to strengthen the process of privatization as well as the control of enterprises that will remain state-owned.

B. The Public Enterprise Sector and Its Reform: Brief Description

Background

4.6 By 1987, the modern industrial sector of Lao PDR comprised about 260 public enterprises (see Table 4.1) and virtually no private ones. Three quarters of the public enterprises were engaged in manufacturing, the others in construction, electricity, and mining. Seven out of every ten industrial public enterprises were under the supervision of the authorities of the 16 provinces and Vientiane Prefecture, whereas the others -- generally those of larger size -- were supervised by central government ministries. The Ministry of Industry was probably the largest supervisory body in terms of industrial sales and employment, whereas the municipal authority (Prefecture) of the capital city controlled the largest number of industrial enterprises. Not included in the list of the modern firms are cottage industries which have been controlled by cooperative or district authorities.

4.7 In agriculture, crop procurement was essentially controlled by provincial and national parastatals, and some production units were also operated by provinces or cooperatives. Public enterprises have also dominated the formal transport, wholesale, and external trade sectors; many trading activities were informal, though. The total number of state enterprises is not known exactly but is estimated to be four to five hundred.

4.8 In the first ten years under state ownership, the public industrial enterprises performed disappointingly in terms of productivity, growth, and financial results. These weaknesses could often be attributed to resource constraints such as shortage of capital, foreign exchange, and managerial expertise. Enterprise managers often came for only a short time from the supervisory administration, and little attempt was made to build a consistent career specialization in enterprise management. The weaknesses were also due, however, to inadequate autonomy, accountability, and incentives of enterprise management -- in short, the system of enterprise governance.

4.9 During its First Five-year Plan for 1981-85, the Government had sought to submit public enterprises to a strict central planning process. The investment, employment, import, output, exports, etc. of each public enterprise were to be determined through iterative review by provincial authorities, central ministries, and the State Planning Committee, although this system could not always be followed for lack of information or expertise. Somewhat greater management autonomy was initially tried in a few enterprises but soon suffered a setback. Such experiments were re-invigorated in 1985, again limited to a few companies. A new inter-ministerial committee steered those efforts.

The First Round of Reform (1986-88)

4.10 The enterprise reform process gained momentum after the Fourth Party Congress in November 1986 when a series of major reforms were introduced under the label of the New Economic Mechanism (NEM). A bit over a year after the Congress, the Party Resolution of January 1988 emphasized the objective of

Table 4.1: PUBLIC SECTOR INDUSTRIAL ENTERPRISES, 1987
(Numbers)

		Manufacturing	Mining	Construction	Electricity	Total
Administered by Provinces						
Prefecture	Vientiane	27	1	5	-	32
Province	Phong Saly	8	-	1	1	10
	Oudomsay	5	-	1	1	7
	Bo Keo	4	-	1	1	6
	Luang Namtha	6	1	1	1	9
	Luang Prabang	8	-	2	1	11
	Hua Phan	6	-	2	1	9
	Sayaboury	9	-	1	1	11
	Xien Khouang	4	-	2	1	7
	Vientiane	4	1	2	1	8
	Bolikhamsai	2	1	1	-	4
	Khammouane	8	-	1	1	10
	Savannakhet	10	1	3	1	15
	Saravane	13	-	3	1	17
	Sekong	2	-	1	1	4
	Champassak	14	-	1	1	16
	Attapeu	7	-	-	-	7
Subtotal		137	5	28	13	183
Centrally Administered						
Ministry of Industry		13	4	-	1	17
	Agriculture	14	-	-	-	14
	Construction	5	1	2	-	8
	Transport and Ports	2	-	6	-	8
	Commerce	-	-	-	-	-
	Defense	12	1	-	-	13
	Interior	5	-	-	-	5
	Education	3	-	-	-	3
	Health	2	-	-	-	2
Other organizations		3	-	-	-	3
Subtotal		59	6	8	1	74
Total		196	11	36	14	257

Source: State Planning Committee, Ministry of Industry, Vientiane Prefecture.

enterprise autonomy in the context of decentralized, democratic decision-making, together with greater reliance on market signals and management skills. As the State's past interference in operational management was recognized to have caused a lack of accountability and inefficiency, the State's role in enterprise control was revised to focus on policy guidance and general performance supervision instead of detailed operational control. Decree 19 of March 1988 broadly confirmed the autonomy of public enterprises.

4.11 Under the NEM, the economy was also opened up to private enterprise. The Party Resolution of January 1988 acknowledged the potentially useful contribution of the private sector during "the transition from a subsistence economy to a planned market economy." It advocated equal treatment of the public and the private economic sectors in commercial relations and in the law. The Party Resolution also mentioned the possibility of private and foreign participation in public enterprises. State enterprises unable to build the necessary financial, technical or managerial capabilities were expected to be turned into joint ventures with private or foreign parties, or transferred entirely to the private sector (including collectives). The various forms of privatization of economic activities in Lao PDR have since been commonly referred to as "disengagement" by the State.

4.12 The right of family enterprises and private enterprises (with profit sharing according to capital contributions) to enter into all activities subject to prior provincial licensing, but with reservations regarding national security and particular product monopolies, was confirmed by Decree 16 of March 1988. Private enterprises were allowed to sell shares to the public, including their own employees. They could now also borrow in foreign currency. A Foreign Investment Code allowed foreign investors to enter most economic sectors by way of subcontracting, joint ventures, or wholly-owned firms, subject to the approval of an Investment Board. The capital contribution of the foreign party should normally exceed 30 percent. The Code provided for tax exemptions on profit reinvested in the first three years, and possible tax reductions for enterprises that were technologically advanced, export-oriented, or based on local resources. Foreign parties were in principle entitled to repatriate capital, profits, and salaries, but for the latter two the firms apparently have to earn the necessary foreign exchange on their own (except possibly in prioritized import substitution projects).

The Second Round of Reform (1989 - Present)

4.13 Private initiatives rapidly picked up. The performance of state enterprises, however, deteriorated further as they faced increasing (import) competition and liberalized prices. Outright privatization, which had been mentioned by the Party Resolution in 1988, remained rare. Authorities therefore decided in 1989 to re-appraise and accelerate implementation of the NEM. A High Committee for Supervision of the NEM, comprising several ministers and chaired by the First Vice Minister and Minister of Finance, was created to lead new collective initiatives. Privatization of public enterprises was finally begun. Forms of such disengagement could vary from leases and management contracts to sale or liquidation. On an experimental basis, the Prefecture of Vientiane and the Ministry of Industry took the lead. The policy was officially endorced in early 1990 and is meant to gradually encompass all but "strategic" (power, water, mines, banks, etc.) sectors.

C. State Enterprise Control

The Concepts of Property and Autonomy

4.14 The enterprise reform is generally presented as the extension of "autonomy" to enterprises. Its concept is broader than that, however, as it encompasses the notions of self-reliance (enterprises are supposed to support themselves, without subsidies) as well as self-management (enterprise employees are supposed to take full responsibility in managing the assets entrusted to them by the nation). Decree No. 19[1] of March 1988 formally established the principle of state enterprise autonomy: state enterprises "are the property of the people, granted by the State for the management and use of workers to develop the business" (Article 1, free translation). In other words, the Decree introduces a distinction between the ownership of state enterprises, which rests with the people at large, thus with Government, and the usufruct of these enterprises, which is granted to their workers.[2]

4.15 This concept has formed the basis for the recent evolution in state enterprise-government relations as autonomy was extended to a growing number of state enterprises, which were deemed capable of management without direct government involvement. The rest of this section will explain how these principles were implemented in the public enterprise sector, what it implied for management incentives and responsibility, and what consequences this had for enterprise efficiency and growth.

The Autonomy of State Enterprise Management

4.16 The above-mentioned decree stipulates that an autonomous state enterprise is autonomous with regard to the elaboration and execution of its annual, five-year, and long-term plans and budgets, and gives the director the authority to adopt and implement them after endorsement by the staff committee. In practice, however, state enterprises submit their annual plans and budgets to their supervising agency for a priori approval. Multi-year planning is virtually unknown at the company level. Once its budget has been approved, an autonomous enterprise is free to manage its business without much

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1 Decree No. 19 of the Council of Ministers, signed March 12, 1988, "On the Right of Autonomy in the management of State Enterprises" (free translation).

2 This distinction already applied to real property (land and buildings) which, if formally nationalized, had remained privately used. In agriculture, for instance, land became state property but the farmers retained the right to use the land; collectivization, then, meant that a number of farmers "voluntarily" pooled together their land usufruct rights, rather than becoming employees of state farms and cooperatives. The same applied to buildings which continued to be privately used by their former owners, who retained the usufruct rights including the faculty to rent their properties. The usufruct rights are inalienable, which implies, inter alia, that they cannot be transferred from one beneficiary to another. While this provides a strong protection to the beneficiaries, it also prevents the emergence of a real estate market or the use of the assets as collateral, because the assets cannot be foreclosed on.

outside interference. A non-autonomous enterprise, by contrast, still needs a priori authorization even for the execution of its budget.[3] Surveyed managers of autonomous enterprises generally confirm the loose character of planning and supervision exercised on them, although in some instances, especially in the outer provinces, the planning exercise is still regarded as binding rather than indicative.

4.17 The operational freedom conferred on autonomous state enterprises is quite large. State enterprise managements set their own product prices in accordance with market conditions; only the rates that public utilities charge for electricity, oil and gas products, potable water, and air transport, to mention the most important, are still controlled by Government. In domestic procurement, public enterprises are entirely free. Purchases from abroad still have to go through the Lao Import-Export Company under the Ministry of Commerce, but this is regarded as a formality that does not affect companies' freedom of action. Public enterprises are entitled to retain their foreign exchange earnings although they have to deposit them in banks and to do all foreign exchange transactions with the banks (which means they cannot easily tap the inofficial foreign exchange market). Autonomous enterprises also have the authority to determine their borrowing and investment policy, although certain practical restrictions apply. For instance, the recourse to foreign financing requires government approval, and major investments need to be included in the annual plan, and so cleared with Government. Nonetheless, no prior approval is required for borrowing from domestic banks in spite of the fact that the State as owner of the enterprises might become liable in case of default.[4] State enterprises are free also to hire and fire labor as long as they respect internal procedures. They are similarly able to fix and adjust wages freely as long as they respect the legal scale of minimum wage levels[5]. To increase productivity and reduce absenteeism, some enterprises have even revised their wage system altogether and relied increasingly on piece-rate wages, or on bonuses linked, for instance, to the physical output of the work unit.

4.18 Autonomy has been awarded to the great majority of Lao state enterprises over a very short space of time. At end-1986 only 42 state enterprises were considered autonomous; by end-1988 this figure had increased

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3 This section considers only non-financial enterprises, omitting also the so-called Entreprises de Service Public which function like Government departments, having their expenses directly covered by the budget and remitting their revenues directly to it.

4 No formal system of state guarantee vis-a-vis residents exists at present in Lao PDR.

5 This requirement has received different interpretations, though. In some instance, enterprises were free only to grade and promote staff at any level along the scale (with the necessary agreement of the staff committee and especially its worker members) but had to pay precisely the minimum wage of the scale, whereas in other instances they could pay above the minimum wage for every given scale level. The minimum salary for state enterprise personnel (currently KN 8,000/month) is somewhat higher than that for general government personnel (KN 5,600/month).

to as many as 400 state enterprises.[6] Even public utilities are now autonomous, and the principles described also apply to them, with the exception of pricing freedom.

Financial Incentives

4.19 The incentives provided by the autonomy system foster high wages and high gearing ratios. The management of autonomous public enterprises is autonomous not only in operational, borrowing and investment decisions but also with regard to profit distribution; it can pay itself and the other staff a high share of the enterprise profits. While non-autonomous state enterprises pay all their after-tax operating profit to Government, autonomous public enterprises are entitled to the entire disposition of their after-tax profit. Decree No. 19 grants these firms the right to "use their profit as decided by the Assembly of Workers and Employees." State enterprises should replenish at least three funds with after-tax profits: (i) a contingent reserve; (ii) an expansion fund earmarked for investment; and (iii) a bonus fund. Earlier legislation, of which the latest was Decree No. 9 of 1985, had fixed the proportion of after-tax profits to be paid into each of these funds. Today, the distribution among the three funds is left entirely to the company's worker assembly. Not surprisingly, the bulk of profits in many autonomous public enterprises has recently gone into bonuses. In addition, management can raise salaries and wages to let the staff participate in the company's surplus even before profit is shown. The practice has apparently been so widespread, and the raises have been so high, that within two years state enterprise salaries have risen from approximate parity with civil service salaries to reportedly three to four times the latter.

4.20 Consistent with the usufruct system, the Government does not receive a profit-related dividend but a fixed payment. Strangely, however, this compensation of the owner is seen not as a remuneration but as a principal payment. Decree No. 19 (Article 3.2) states that "enterprises using capital from the State budget ..... must pay such capital back to the State completely..." Two systems of compensation for government investment coexist. Under the first system, autonomous state enterprises have to remit the funds set aside annually for depreciation of long-term assets (with a life

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6 The Government sought to ensure that only those enterprises obtain autonomy status that appear sufficiently capable. The criteria used for awarding autonomy were generally that the state enterprise (i) had attained a certain level of productive efficiency, (ii) possessed a clearly defined organizational structure, (iii) was in a position to interpret and respond to market demand, (iv) could reasonably be expected to attain financial self-sufficiency through internal generation of adequate funds for its current and investment needs, and (v) could document its capacity to contribute to fiscal revenue through tax payments. The rapidity of the autonomy process, however, might reflect the general nature of the above-mentioned criteria rather than excellent managerial capability. In fact, the uneven pace of the movement across the country, where some provinces still retain an unusually high proportion of non-autonomous enterprises, seems to indicate that varying degrees of commitment to the reform process rather than actual capability is driving the process of granting enterprise autonomy.

of ten years or more) to the supervising agencies, but retain the depreciation funds for assets with a shorter life. As the depreciation is commonly based on historical asset values, the recent inflation has vastly reduced the burden on enterprises resulting from the transfers. This system of depreciation funds transfer has been applied since the beginning of the decentralization process and therefore covers the largest number of autonomous enterprises. Another system was introduced after publication of the above-mentioned decree. Under this system, the assets of an enterprise are actually revalued, and then the enterprise and State negotiate a schedule for the payment to the Government of all the resulting asset value (irrespective of asset life) over a finite period of years, which is typically 7 to 10 years. The agreements are signed by enterprise management, the supervising agency, and the Ministry of Economy, Plan and Finance. This revaluation-based system imposes a bigger burden on enterprise liquidity because they include short-lived assets. Not surprisingly, this system has been generally resisted by enterprises that have been candidates for autonomy, and hence applies currently only to a handful of enterprises.

4.21 The company thus shifts gradually from equity finance through the State to loan finance through the financial system. When the company's annual contribution to reserves is small -- which is usually the case due to high wages and bonuses and to the transfer of depreciation allowances -- the enterprise thus draws down both its current assets and its equity; it shrinks. Eventually, it has to borrow funds to replenish or expand its asset base, which means that it increases its leverage.[7]

4.22 These compensation systems have created some confusion as to the intended outcome of the decentralization process, and in particular as to who would eventually own the enterprise. They should not: the enterprises remain State property. The legal terms are not very clear, yet the underlying concept appears obvious. The legal capital (or subscribed capital) of the enterprises is not transferred; i.e., the enterprises do not buy back their own capital from the State to become their own owner. Only the net worth (i.e., the book value of the equity) is being diminished through the payments to the State.[8] The firms may end up with a very low or even negative net worth, depending, inter alia, on their retained earnings during the reimbursement period. Yet, in any case the State remains the sole owner of

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7 This transformation has some benefits though. The importance of the State as enterprise owner is being reduced while the role of the financial system is strengthened; the enterprises could be exposed to the rigor of the financial markets if these worked efficiently. Moreover, higher leveraged companies should eventually be easier to sell to private parties whose funds are limited.

8 Another possible interpretation is to consider the transfers to the state as principal payments on an interest-free loan originally extended by Government. Even if this implies that the state never actually paid in the equity that it subscribed but that it gave only a loan instead, the state is still the sole owner of the company's capital. It has also been argued that the company employees become the new owners. This is obviously not the case. The transfers are paid out of the companies' own assets, not their employees' money. The usufruct system implies that employees are entitled to the product of the companies, not the companies' assets themselves.

the legal capital. The State retains the final claim on enterprise net worth, whatever its magnitude is and whichever way it has been constituted, including the accumulation of retained earnings under the system of enterprise autonomy.

4.23 The State thus also retains de facto the final liability for the enterprise if the net equity is negative, even after the State's entire initial contribution has been reimbursed. If the profits of the enterprise are appropriated by the employees through bonuses, the State does not enjoy an increase of the company's net worth that it owns, yet the State remains ultimately liable for the losses of the enterprise. In other words, the State bears risk but does not necessarily share in the benefits. In this situation, the accountability of the management to the owner -- the State -- is a highly critical issue.

Management Accountability

4.24 The accountability of company staff vis-a-vis the company owner is very limited. The management of autonomous public enterprises has two sources of authority. A state enterprise director manages the enterprise as "representative of the State and of the workers and employees" (Decree 19, free translation). He is nominated by the supervisory agencies, and elected by the Assembly of the Workers. Conversely, the Assembly can vote his dismissal, but must have it endorsed by these agencies. Enterprise managers are automatically dismissed after three years of losses. In practice, the influence of the agency and workers in such matter varies with their relative clout.

4.25 The director is supposed to have full authority over the enterprise management. Important decisions, such as on budget, planning, wages and employment, must nevertheless be cleared with a "Staff Committee," which acts as a permanent body of the Workers Assembly and is chaired by the director.[9] While the manager is supposed to have the final word in case of disagreement with the Staff Committee, in practice the latter has a veto power on management decisions, if only because it can submit the dismissal of the manager to Workers Assembly.

4.26 In this system, enterprise managers and workers share only the return on the enterprise assets, but do not bear the risks associated with the running of their enterprises. Enterprise managers are in principle liable for enterprise losses, but his has little practical implication. For example, if the company is liquidated they supposedly have to compensate the difference between the initial equity injection (taking into account depreciation) and the residual value. Interestingly, the reverse does not apply: the managers have no claim if the residual value exceeds the depreciation-adjusted equity. Managers' liability apparently applies only vis-a-vis the State as equity owner and not vis-a-vis creditors, which means that their liability is limited to the amount of state equity. However, foreclosure on managers' assets has

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9 The Staff Committee includes also the deputy director, the department heads, representatives of the labor unions, a representative of the Party cell if there is one inside the state enterprise (only the more important state enterprise have a Party cell), and representatives of the country's other mass organizations which most importantly include the union movement and women's and youth organizations.

reportedly never occurred. In practice, then, managers are accountable primarily to the workers who can dispose of them rather than to the Government to which they are nominally liable in financial terms.

The System of State Enterprise Supervision

4.27 Weak management accountability is aggravated by the fragmentation of the system of public enterprise supervision. Each state enterprise is assigned to one particular level of Government to which it then "belongs." It reports and pays all its taxes (direct and indirect) only to this government level. Within this government level, it is assigned to a sectoral agency. In practice, that agency is also charged with financial supervision since the Ministry of Economy, Plan and Finance (MEPF), which is theoretically the agency charged with financial tutelle over all state enterprises, now mostly confines itself to tax-related functions (assessment, collection, etc.). There are consequently more than 70 supervising agencies.[10]

4.28 While interference from the supervisory agencies in management decisions remain widespread, the financial supervision of autonomous enterprise is quite limited in content. Apart from administrative deficiencies, this reflects the absence of clarity as to the role of the State vis-a-vis its enterprises. Reporting is essentially formal and does not include any performance evaluation. There are no clear and uniformly applicable functional directives and formats for planning, monitoring, reporting, appointments and other functions within the authority of the supervising agency vis-a-vis the firms.[11] This is aggravated by inadequate accounting systems and data reporting. Another evidence of this limited oversight is that very small numbers of staff are assigned to state enterprise tutelle.[12] No supervising agency has an organizational unit to coordinate the supervision work done in the agency. Finally, another feature of the

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10 Most non-financial public enterprises are under the four following sectoral ministries and their provincial equivalents: Ministry of Transport, Communications, Posts and Construction, Ministry of Agriculture, Forestry and Irrigation, Ministry of Industry and Handicrafts; and Ministry of Commerce and External Economic Relations. District agencies have to be added. For example, the sectoral departments of Vientiane Prefecture have tutelle responsibilities over about 70 state companies, and the 8 districts in the prefecture area supervise another 25 state enterprises. Some supervisory functions are even entrusted to village administrations, although their exercise of these functions is usually supervised by the respective district administration.

11 In Vientiane Prefecture, for instance, where reporting is apparently less erratic than in some other places, enterprises submit a brief operational plan and an even briefer financial forecast consisting mainly of turnover and tax estimates, backed up by annexes showing the underlying prices and a few other variables.

12 Typically they are assigned on a part-time basis in addition to their other duties. The Ministry of Industry is among the few agencies that assign full-time staff to enterprise supervision, but this is only one single person.

supervision framework is the absence of any intermediary body such a Board of Directors between the supervising agency and the enterprise managers.

Impact on Enterprise Performance and Cash Flow

4.29 Decentralizing economic decisionmaking is crucial to revitalize growth. This principle is well understood by the authorities and constitutes the cornerstone of the New Economic Mechanism. Progress achieved in this area, in such a short period of time, is impressive. It indicates the resolve of the authorities to tackle head-on the structural problems of their country. However, the incentive and accountability framework for efficient enterprise operations is still incomplete and therefore unlikely to bring about the expected results.

4.30 It is well understood that decentralization of economic decisionmaking must be accompanied by free competition. Great strides have been made in this direction, in particular through domestic and foreign trade liberalization and through encouragement to private sector development and foreign investment. The freedom of enterprises in employment and wage levels has encouraged competition in the labor market. The banking sector is being restructured to allow for some competition in the credit market. Some barriers to competition still need to be dismantled, however. For example, small market size and poor infrastructure tend to create local monopolies in product markets; the implicit job guarantee of state enterprise workers that stems from their influence on enterprise management limits worker mobility.

4.31 The key reason for the disappointing financial performance of state enterprises, in particular the massive increase of their financing needs, lies in severe deficiencies in the framework of incentives and accountability. Enterprise employees do in fact have a strong incentive to raise productivity and meet market needs, because that allows them to pay themselves higher wages and salaries (before profit), higher bonuses (after profit), and perhaps other benefits that weak accounting practices and minimal supervision by government permit.

4.32 Yet, while the management and the collective of employees decide on wages and on profit allocation (between bonuses or retention) in the firm, they themselves are not the owners of the firms. Not surprisingly, then, employees prefer to maximize their wages and bonuses rather than profit retention in the firm. If the employees appropriate privately their enterprise income, they can choose individually between consumption or savings in real or financial assets, own the principal and return on their saving themselves, and can mobilize them at any time and at their convenience for private expenditure. On profits that are retained in the firm, by contrast, the employees have no claim, and on the returns generated by these retained earnings their claim is partial and hinges on their continued employment in the firm. The distribution of book profits as bonuses is even likely to eat up part of the companies' asset base: in spite of inflation and devaluation, assets are commonly valued at their historical cost.[13] Moreover, wage escalation even allows savings on the profit tax, which affects the Government's budget revenues.

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13 Until recently, accounting on a cash basis also made it difficult to build adequate reserves for future and contingent liabilities.

4.33 The equity base of the enterprises is further undermined by the repayment to the Government of its equity. As explained, autonomous enterprises are supposed to pay annually to the state amounts equivalent to their depreciation on long-term assets, or alternatively a fixed share of their entire revalued assets. Such a system might be consistent with central investment planning where resources are pooled for reinvestment and central allocation, but it loses its rationale once the State has pulled out of investment financing in productive sectors. Today, the system endangers the capacity of companies even to replace their worn-out assets, let alone expand.

4.34 The combined result of high wages, low profit retention, and substantial equity reimbursements is severe "undersaving" of the state enterprises. This undersaving is accompanied by incentives for "overinvestment" if the banking system is not in a position to enforce financial restraint on state enterprises. The emergence of a truly competitive financial market is still far-off in Lao PDR. One way for employees to increase their income is to borrow funds and raise the capital intensity of the production process. As long as investments generate a positive net profit, the consequent increase in labor productivity will be available for higher real compensations (wages and bonuses) while government-held equity goes unremunerated. Larger size might also give enterprises more clout in further borrowing, and perhaps later in demands for bail-out.

4.35 The erosion of enterprise liquidity and capitalization through excessive wages and bonuses could perhaps be limited by the directors' accountability vis-a-vis the government. However, in Lao PDR this responsibility covers only the maintenance of the asset value after depreciation. Directors are thus responsible for book losses, but have little incentive to generate profit or to maintain the real asset value when inflation erodes the historical book values. Moreover, the responsibility is hard to enforce due to weak accounting practices, understaffed and fragmented supervising administrations, and the limited personal assets of the directors, which would be needed to satisfy the state's claims. Concerned with election by the enterprise staff, the incentive for managers is rather to avoid unpopular decisions on employment, wages, and bonuses, and to borrow and invest to increase the income potential.

4.36 Hence, the undersaving of public enterprises explains their huge increase in net financing needs described in Chapter II. It appears that the usufruct concept that separates ownership from the use and profit of an asset has not worked out. Usufruct systems are probably more appropriate for agricultural land, from which the Government apparently borrowed the concept, rather than for assets as complex and vulnerable as enterprises. In other words, the transfer of the traditional concepts of an agricultural society to an increasingly modern industrial sector has not worked.

4.37 The records of Lao PDR, China, and similar economies show that there is no easy solution to running enterprises in a profit-oriented way while keeping them state-owned. The basis of the Chinese system is not the usufruct concept but explicit management contracts. The contracts stipulate, inter alia, the level of wages and bonuses, the magnitude of borrowing and investment, and social and "strategic" targets for a certain period of time. These contracts require effective supervision and accountability of the management, which the Chinese bureaucracy seems to be in a slightly better

position to exercise although it, too, is quite fragmented. More control allows it to limit the erosion of a company's net worth. Management cannot, however, be held responsible when contingencies like unforeseen price developments occur, which were not provided for in the management contracts. This, like state control over the banking system, softens the budget constraint of Chinese enterprises, resulting in a high net financing requirement there as well. Chinese enterprises also have less autonomy due to the highly incomplete scope of price liberalization in China, where profit seeking alone does not ensure economic efficiency because of huge price distortions.

4.38 The final section E of this chapter will discuss ways to strengthen the accountability of managers to the owner, i.e., the State. However, stricter control can alleviate but not remove the inherent problems of the usufruct system. This would ultimately require the development of private sector participation in these enterprises through various forms of State disengagement.

D. The Disengagement Process

Objectives of Government Disengagement

4.39 The Government of Lao PDR has now embarked upon a policy of privatization or "disengagement." The main objective of the disengagement policy pursued by the supervisory agencies is increased enterprise efficiency. The Government expects the following outcomes from this policy: (i) the mobilization of domestic savings and foreign capital for machinery and working capital; (ii) production and product technology as well as sectoral expertise; (iii) access to export markets and closeness to local markets; and (iv) stronger staff motivation, managerial performance incentives, and modern managerial skill. The supervisory agencies also hope to strengthen public finances, thanks to the proceeds of the disengagement and enhanced enterprise efficiency; this is the second most important objective of the disengagement.

4.40 While the disengagement process has evidently proceeded with extraordinary speed,[14] its contribution to the objectives being pursued could be undercut if the process is not streamlined. Problems have emerged as to the valuation of assets, the forms of disengagement and the extension of

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[14] Some conditions have facilitated disengagement. First, not many enterprises under the Prefecture of Vientiane were heavily indebted, and arrears could usually be settled before divestiture. Second, enterprise losses had rarely been very heavy, due in part to limited domestic competition. Third, the privatized enterprises are of small or medium size, and could hence be taken over by parties with limited capital and managerial expertise. Fourth, due to the replacement of most enterprise directors through the election process in 1988, the directors still had few entrenched interests in their enterprises.

privileges to private parties.[15] They stem primarily from (i) the limited administrative capacity for a broad privatization program, (ii) insufficient accounting standards and tax collection institutions, (iii) weak private savings and willingness to invest, and (iv) the underdeveloped legal framework for private activities.

Strategy and Implementation

4.41 Apart from the supervisory agencies concerned, two institutions are primarily involved in the disengagement process. A high-level interministerial committee, the High Committee of Supervision of the New Economic Mechanism, was appointed to provide leadership to government agencies in the reform process[16]. The High Committee prepares the policy and legal framework for the disengagement of public enterprises and advises similar NEM committees at the ministerial and provincial level. However, responsibilities still seem unclear, parti-cularly regarding decisions on specific disengagement proposals. Disengage- ments involving foreign parties as investors or contractors are subject to review by the Central (Foreign) Investment Board.[17] The tasks of the Investment Board and the High Committee overlap to some extent. Official approval for foreign investments is given by the Minister of Commerce (up to US$1.5 million), Minister of Economy, Plan and Finance (up to US$5 million), and Prime Minister (above US$5 million).

4.42 Before March, no explicit privatization guidelines had been defined by either the national government or the Prefecture of Vientiane, which has taken a pivotal role in disengagement. Supervisory agencies approach the issue pragmatically according to economic and political opportunities rather than following a fixed strategy and formal guidelines. For instance, priorities or limits as to the enterprises to be privatized had not been clearly delineated. A privatization Decree was issued in March 1990 which states disengagement is sought from "non-strategic" industries, i.e., excluding water and irrigation, telecommunication, electricity, banks, insurance, mining, etc. In the latter sectors, private sector participation will be sought only under the form of mixed enterprises and joint ventures. The Ministry of Industry and Vientiane Prefecture place priority on

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[15] Cases have arisen where fixed annual rents are very small compared to past enterprise profits and substantial inflation; machinery contributed by the private party appears obsolete and of lower value than originally stated; a quasi-monopoly over imports was granted one case (without imposing limits on prices); private parties turn out to lack financial and managerial capability; investments and maintenance are disputed under rent contracts; or public treasuries are concerned about tax and tariff evasion.

[16] The Commission is headed by the First-Vice Chairman of the Council of Ministers and is assisted by a secretariat of some 30 specialists drawn part-time from various ministries.

[17] The Board is chaired by the Chairman of the Council of Ministers and includes several ministers. It is supported by staff from the Ministry of Commerce, and linked to similar foreign investment committees in the provinces. The (Foreign) Investment Board generally refers cases that are new or controversial the to High Committee.

privatizing enterprises that are unprofitable, or use capital or labor inefficiently or fail to satisfy existing demand. In actual practice, however, comparatively efficient enterprises have also been privatized if there was a prospect of further enhancing their performance under private control. The choice between privatization forms has also not been formally determined but is decided case by case. In the Prefecture of Vientiane, more than one third of all signed privatization agreements are rent contracts. Management contracts with foreign parties have apparently not been concluded so far. Outright liquidation of unviable firms has also been rare. The terms of the privatization contracts do not follow fixed rules, either. Rent contracts, for example, vary in length from one year to fifteen years, and may even be unlimited in duration. In cases of private investment, profit-sharing and decision-making power does not always follow the respective capital contributions, sometimes because of limited financial savings of the private party, and sometimes in implicit recognition that the capital contributions are difficult to evaluate correctly. Some enterprises have been broken into parts to facilitate management and staff buy-outs, or because different private parties expressed interest in different parts of diversified enterprises.

4.43 The authorities have also been flexible in the choice of private partners. Former enterprise owners are given some priority. Among potential foreign partners, investors from Thailand have obvious advantages such as language and geographical proximity, relatively advanced technology and export experience, and a fast growing domestic market. Thailand therefore accounts for the majority of foreign privatizations although Lao expatriates may sometimes be involved. As Thai residents are restricted in their transfers of funds to purchase Lao enterprises, the lack of other foreign contacts may become a financial obstacle to extension of the disengagement process.

Problems in Privatization

4.44 The management of privatization in Lao PDR cannot benefit from prior domestic experience. The thin relevant capacity is dispersed in the various supervisory agencies, which often develop their own approaches without much cooperation among agencies. The High Committee of Supervision of the New Economic Mechanism provides guidance, but encourages experimentation with many different techniques. The Council of Ministers has requested agencies to draw up a classification of their public enterprises for a more systematic application of the most appropriate privatization techniques. The key agencies largely agree on a number of weaknesses at the different stages of the disengagement process and on the need to strengthen the tax administration and legal framework to support the disengagement process. These concerns are discussed below.

Box 4.1 The Scope of Disengagements in 1989

Since mid-1989, the pace of disengagement has accelerated. The Prefecture of Vientiane has taken a major role in this process and will later share its experience with other provinces and central agencies. The Prefecture is the major supervisory agency, overseeing about 70 enterprises which are mostly medium-scale enterprises employing from 30 to 300 staff, with annual sales of KN 20 million to KN 200 million. The enterprises are engaged in industry (35%), trade (22%), hotel and restaurant services (19%), communications, transport, and construction (17%), and other sectors (7%).

In November 1989, 34 enterprises under the Prefecture of Vientiane had already been either privatized or closed. Seven further privatizations had been initiated but contracts had not yet been signed. All hotels and restaurants had already or were soon to be privatized. In the manufacturing sector, privatization was completed for half of the firms, and initiated for another 20%. About 45% of all trading companies had been privatized, while in the other sectors, mainly concerned with infrastructure, privatization has been limited.

Of the 34 cases of disengagement, 12 (35%) were rent contracts, 11 (32%) were participation of private parties (in general foreign ones), thus forming joint ventures, 8 (34%) were full sales of enterprises to private investors, and 2 (6%) were closure and liquidation. In addition, and not included in these figures, a few public enterprises are working for foreign firms under subcontracts. In roughly one third of the privatizations, the private parties were former private owners of the enterprises; often they entered rent contracts. In about another third, other Lao individuals were involved, sometimes jointly with foreigners. The local parties had in several cases already managed the enterprises prior to privatization. More than one third of all privatization cases involved foreign parties. In most cases they came from Thailand, and entered joint venture agreements with the Prefecture.

In addition, the Ministry of Industry, which supervises some twenty-two public enterprises, has disengaged from 6 enterprises (among which two are under rental contracts). The Ministry plans to privatize another five or six companies in 1990, although it has encountered difficulties finding suitable private parties. Disengagements are reportedly also proceeding in agricultural trade, rice milling, wood processing, tourism, and export trade. The High Committee of Supervision of the New Economic Mechanism reports to be receiving 10 to 20 disengagement proposals every month.

4.45 Choice of the Most Appropriate Disengagement Form. The choice between full sale, sale of spun-off enterprise parts, joint private-public ownership, rent, closure, or liquidation may strongly impact on the costs and benefits of disengagements. The Government would be well advised to explore the various options systematically, before accepting the option preferred by the private parties interested in the enterprises. Rent contracts seem to be preferred due to: (i) the lack of sufficient private sector confidence in the major investments; (ii) a desire of the authorities to remain flexible in order to correct early privatization decisions; and (iii) a desire to enable enterprise management to accumulate financial savings to ultimately buy the firm it used to rent. However, rent contracts perpetuate some of the pitfalls of the current autonomy system with regard to, e.g., the lack of incentive for maintenance and self-financed investment. Under rent contracts where capital is still provided by the State, it is difficult to ensure proper maintenance and repair and thus to prevent the depletion of assets. Rental revenues can even be low compared with the potential revenues stream under continued public ownership. For instance, despite substantial inflation, there are ten-year rent contracts with fixed annual rents in kip. On the other hand, where the Government retains a passive or minority stake in the enterprise it participates only to a limited degree in the profits of the enterprise but may be fully liable for its losses if the private partners are unable to cover losses. Liquidation of unviable public firms and subsequent entry or expansion of private ones could be an important form of disengagement.

4.46 Search for and Assessment of Private Parties. In their disengagement policy, the authorities have used a number of approaches to attract and build private capital. They are open-minded with regard to the repatriation of Lao capital and earnings from abroad. Some private owners that take back their former enterprises are charged only for additional investments that the State has made since it took over the companies. Foreign investment, in particular in joint ventures, is encouraged and facilitated through the new economic policy. Private parties with limited savings -- often managers of the respective public enterprises, and at times even all their staff -- are offered minority ownership or rent of public enterprises, with the understanding that they could buy the entire company eventually with their accumulated profits.

4.47 While these approaches have facilitated the privatization process, they are not free of problems. The authorities have not always actively sought to create competition among interested private parties. Negotiations have often proceeded with one single party. This can cause high opportunity costs, and create an adverse public opinion. In addition, in an economy with little savings and weak financial intermediation, the highest bid for an enterprise does not always come from the party with the capacity to operate the enterprise most profitably. The choice of a private party hence depends largely on the capacity of the public administration to assess the managerial, technical, marketing and other capabilities of the bidders; it must resist the temptation to make the bid price the dominant, or exclusive, criterion. Finally, some private parties have obtained highly favorable conditions, which distorts competition with other local firms and attracts private buyers or renters that are not really capable, or motivated, to run the enterprises efficiently.

4.48 Valuation of Enterprises and Private Contributions. The authorities have had difficulties valuating their enterprises and the private parties' contribution. This has been due to a vague concept of capital, weak accounting systems of the enterprises, rapid devaluation and inflation, lack of information on current world prices (in particular of second-hand equipment pledged by a party), and the hurry in which the disengagements were carried out. Agencies often lack experienced accountants, and independent accounting firms do not exist. The agencies also lack staff capabilities for evaluating the future enterprise profitability under private versus continued public control, which would indicate the scope for negotiations.

4.49 Drafting and Negotiation of Contracts. Apart from some general clauses recommended by the Ministry of Commerce, model contracts are not available. In negotiations, authorities at times suffer from lack of experience, legal skills, and familiarity with international practice, in particular when dealing with foreign parties. Problems in the implementation of privatizations also stem from the potential risk of conflict of interest. Current enterprise staff, and particularly managers, play a major role in the process of individual privatizations. They have an obvious interest in resisting privatization if it jeopardizes their own income, and in seizing the company themselves at favorable terms.

4.50 Supervision of Contract Implementation. The implementation of disengagement contracts is not sufficiently controlled, especially with regard to the actual contributions of the private parties. Breaches have been reported, largely because the authorities are short of qualified staff to check and enforce the financial, technical and legal conformity with contracts.

4.51 Collecting Taxes on Private Enterprises. Disengagement raised severe problems of controlling tax evasion. Tax collection now relies on the good will of state enterprises and the control that the Government has retained over their management, in particular the authority of the supervisory agencies to nominate accountants. The same cannot be expected from a private company. The problem is amplified by a weak accounting system and poor accounting practices, and the absence of auditing. The rapid adoption of a new accounting system, the creation of an auditing capacity and the strengthening of the tax administration (see Chapter IV) are therefore a necessary complement to the disengagement process.

4.52 Legal Impediments to Privatization. The weakness of the existing legal framework of the Lao PDR may hamper the privatization process. First, a number of issues need to be clarified: how can an enterprise be privatized, who within the Government has the power to conclude a sale or to grant special benefits, what are the workers' rights, and what rights have the previous owners whose enterprise may have been nationalized without proper compensation in the mid or late seventies.

4.53 Second, the transfer from a command economy to a mixed economy requires the establishment of new rules governing the mixed and private sectors. Some of these rules have already been established; many, however,

are still missing. There is, for example, no law governing incorporation and operation of private companies, so companies have to be established on a purely contractual basis using foreign or pre-liberation models. Worse still, there is no law governing contracts. New laws are thus needed to regulate the private sector, particularly in the areas of general corporate law and business transactions. As for existing laws covering banking, investments, taxation, trade, economic planning, development and agriculture, their precise content is often difficult to establish due to the poor quality of the available translations and of the original Lao texts, which are mostly drafted by non-lawyers. There is also no official gazette, or systematic publication of laws and regulations; it is therefore difficult to determine what the law of the country is.

4.54 Third, the enforcement of existing laws is also weak. This is due to the absence of procedures for the settlement of commercial disputes and a lack of enforcement capacity. The courts do not handle commercial disputes, which up to now have been solved by the Government or on a transactional basis; proposals have been drafted recently to establish a commercial arbitration mechanism, but they provide for arbitration under the authority of the Ministry of Economy, Plan and Finance, which would not be acceptable to the private sector.

E. Recommendations

General Prerequisites

4.55 The enterprise reform initiated under the NEM, while in the right direction, has not yet fulfilled government expectations to stimulate efficiency and profitability. Government's recent initiative to disengage broadly from its enterprises and to rely on the private sector to manage these enterprises is highly welcome. If pursued so as to preserve the collective interests of the nation, this policy will contribute greatly to economic efficiency. Recommendations to strengthen this process are formulated below. The main rationale for these recommendations is that a market economy operates efficiently only if enterprise managers are guided by a profit objective and accountability for maintaining the asset value. This principle applies equally to enterprises remaining under state ownership.

4.56 The Government has recently appointed the High Committee for the Supervision of the NEM to appraise the results of the first phase of the enterprise reform and formulate policies for consolidating the process in a second phase. The broad mandate of the Committee and its supra-ministerial character are well suited to addressing the complex issues involved in the three priority areas of action: (i) strengthening government supervision over state enterprises; (ii) disengaging from a large number of enterprises; and (iii) developing the legal framework defining the rules for the enterprise sector.

4.57 Any improvement in the enterprise sector is predicated upon the adoption and generalization of a new accounting system to replace the existing one which is inadequate to measure financial performances. Improved accounts are indispensable to monitor, evaluate and sanction the performance of state

enterprises, to ensure realistic private accounts, and to permit the assessment of various taxes. With French Government assistance, the Government has developed a new accounting system and trained considerable numbers of accountants and bookkeepers in its use. By December 1989, however, the Council of Ministers had not yet approved the new system. It is recommended that the approval and actual installation of the system be given top priority.

4.58 The second step should be to improve the currently inadequate level of financial information on public enterprises. Due to shortfalls in the supervision of state enterprises, and the absence of any central coordinating unit, government officials are not able to obtain an adequate, complete and timely overview of developments in the state enterprise sector. This is a particularly critical problem at this time, when the progress and impact of reforms need to be closely monitored. It is recommended that standardized summary accounting data be collected in each relevant supervisory agency and passed to the agency in charge of financial supervision.

Strengthening the Control of State Enterprise

4.59 A priority objective of the Government should be to restore state enterprise profitability and savings. As seen above, the present institutional arrangements are not yet conducive to reaching this objective. To achieve it, the authorities need first to establish the principles that (i) state enterprises belong to the nation and have to be managed so as to yield the highest possible benefits to the public at large and not only to one particular group; (ii) enterprise managers are appointed by Government with this particular mandate and need to be supervised and held accountable accordingly; and (iii) the profit they generate is a public resource, the disposition of which rests with Government. In the medium term, enterprise profitability and savings should be ensured through new supervision mechanisms that promote management accountability through performance evaluation and performance-oriented incentives for managers and workers. Since the implementation of such a system will take time, restoring state enterprise in the immediate future should be achieved through wage and bonus guidelines, and the adjustment of administered prices.

4.60 The first and foremost implication of the above-mentioned principles is that the present system, under which state enterprises and their workers' collectives have control over the disposition of all after-tax profits, should be rescinded. These profits belong to Government, which should be able to decide on their final allocation among three possible uses: (i) rewarding enterprise managers and workers, (ii) accumulating earnings to finance enterprise expansion or to repay existing debts, or (iii) re-allocating them to other activities which have a higher return and priority. To make the latter option feasible a system of dividends needs to be introduced. It is further recommended that financial supervisory agencies be entrusted to (i) monitor and audit state enterprise financial performance, (ii) approve the final allocation of after-tax profit between reserves, dividends and bonuses, and (iii) approve major investments as well as changes in capital. Profit-sharing arrangements can serve to motivate managers to improve financial performance, but they should be explicitly specified instead of leaving profit

distribution to the management itself. Finally, the various forms of reimbursement of government participation should be terminated, as they decapitalize the enterprises. Government receipts from its ownership of state enterprise would henceforth be based on the return on its equity (or assets) rather than on its depletion.

4.61 In conjunction with this reform, a clearer distinction should be established between the State's role as owner and as regulator. Financial supervision, i.e., the exercise of State ownership rights, should be exercised in the last resort by one central economic agency (the Ministry of Economy, Plan and Finance or, alternatively, the inter-ministerial Supervisory Committee for Enterprise Reform, which is chaired by the Minister of Finance) whose mandate extends to the economy at large rather than narrower sectoral interests. For the time being, this authority could still be exercised through the current supervisory agencies but it should be established that in financial matters the Ministry of Economy, Plan and Finance (at the provincial and central levels) has the last word.

4.62 These two initial steps should pave the way for the gradual introduction of a performance evaluation system. In the competitive sector, the State's functions as enterprise owner should be limited to those exercised by a private holding company that owns several enterprises: setting enterprise objectives, appointing top management, evaluating performance, rewarding or penalizing managers accordingly, approving major investment decisions when they require external resources, and planning and coordinating across units and activities. Evaluation is tied to autonomy. All that managers need on a current basis are goals, autonomy to reach them, and incentives and accountability to do so most efficiently. Given the present price freedom and the relatively open trade regime, this goal should be unambiguous: profitability (indicated, e.g., by the return on assets).[18] The countries, like Pakistan, Korea or France where successes have been recorded in promoting an efficient state enterprise sector, use similar, although more complex systems where the Ministry of Finance or related bodies set financial targets for these enterprises, approve major financial decisions and leave actual operation to the managers it has appointed.

4.63 Public enterprise supervision should focus on two elements: profit targets and a multi-year investment and financing program. The first element should be introduced in the context of the annual submission of state enterprise plans and budget. On this occasion, each state enterprise manager should establish with the supervising agency a profit target for the year (with a multi-year perspective, if possible, to avoid overemphasis on short-

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[18] In cases where competition is limited, a second indicator needs to be monitored, i.e. unit cost, to avoid abuses of monopoly positions. Moreover, the use of profitability as the predominant target presumes that its measurement adequately reflects depreciation and revaluation of assets.

term profit at the expense of long-term profit).[19] In exchange, the tutelle would (i) commit itself to a profit-sharing system rewarding the satisfactory achievement of the target and (ii) give the management entire responsibility for achieving this target.

4.64 The reformed incentive framework of positive real interest rates and price freedom has improved the signals for investment decisions. However, if state enterprises are partly protected from financial market discipline, investment decisions will be biased towards projects which would further primarily the interest of management and workers but generate lower returns on investment than other alternatives. For instance, priority might be given to output expansion rather than long-term profit, or to projects with high capital intensity that do not correspond to the relative scarcity of resources but would make it possible to extend real wage increases to existing employees at the expense of a higher level of employment benefitting outsiders. Investment decisions can therefore not be left entirely to enterprise managers. Managers should submit their multi-year investment programs to the Ministry of Economy, Plan and Finance, which should assess competing programs and projects and rank them according to their expected return.

4.65 However, management of the enterprise's operations should be the sole responsibility of its managers appointed by the supervising agency, the mandate of which should be linked to the satisfactory fulfillment of profit objectives. The managers should be held accountable for their performance, but they should not be held personally liable vis-a-vis their owners or third parties, as they do not commit their own assets when they act as representatives of the owners. The latter remain liable for the way they manage their assets. Under this system the determination of wages, including the use of productivity bonuses, could be left to management under individual or collective bargaining systems. This managerial autonomy should be protected from any interference, including that from political bodies inside and outside state enterprises. While it is useful to consult enterprise staff in the framework of the existing Staff Committee on such things as work conditions, it should be confirmed that the role of this institution is a consultative one and does not impinge on managerial competence.

4.66 Profit targeting cannot serve as a basis for performance monitoring in the non-competitive sector, notably public utilities. Their profitability is beyond their control because their prices are determined directly by Government. In this case, it is recommended that the Government establish a basic wage scale that would apply to both the civil service and public utilities. In public utilities, work hardship or danger, and the level of skills required could be elements of basic wage differentiation. To stimulate workers productivity, enterprises should use productivity bonuses as is presently the case at EDL, based on quantitative indicators of production or volume of services. These indicators have to be tailored to particular

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[19] While it should be expected that targeted profit rates vary from one enterprise to another due in part to sectoral differences, central guidelines should ensure that they remain inside a broad band to avoid distortions in the allocation of resources.

circumstances. They can be usefully complemented by quantitative indicators of quality in order to avoid the risk that the expansion of services engenders serious problems of quality degradation, and by cost indicators so that output expansion is not achieved at the expense of cost control. Evaluation and reward of public utilities managers and higher-level staff should, in addition, take into account financial performance, which in the case of monopolies is best approximated by cost minimization indicators. Straight measurement of cost minimization should be balanced, to the extent possible, by a consideration of the additional costs of public service activities that management is requested by Government to carry out. While the basic wage scale would be common to all public utilities, the incentives systems would necessarily be enterprise-specific and established by each relevant authority, in accord with broad guidelines applying to all public utilities. Such guidelines should, for instance, establish that incentives cannot represent more than a certain number of months of basic salary to avoid unjustified wage differentials among utilities.

4.67 In view of the newness of the proposed performance monitoring and evaluation systems, it would be appropriate to introduce them first to one or a few supervisory agencies on a pilot basis. This test period would serve to elaborate and gain familiarity with performance monitoring procedures for later generalization to the other agencies.

4.68 To restore state enterprise savings in the immediate future (i.e., before the performance evaluation systems can be generalized) and prevent any further erosion of the profit tax base, wage guidelines for state enterprises will need to be issued. If the determination of wages and bonuses were left entirely to the discretion of enterprises, savings would continue to be absorbed by pay increases. Such a situation would, in addition, be inequitable vis-a-vis other economic sectors, especially the civil service, as it would allow state enterprise employees to raise their income by appropriating the revenue of public properties or even their asset value. Public enterprise compensations (wages and other benefits) should be submitted to strict quantitative guidelines, setting, for instance, a maximum growth rate for average compensation. All bonus payments should be deferred until the profit allocation principles outlined in para. 4.60 have been adopted, in order to protect enterprise savings against a pre-emptive raid. Thereafter, wage control in the competitive sector could be somewhat relaxed by allowing the enterprise wage bill (rather than individual salaries) to grow at the same pace as their turnover (the specific case of public utilities has been treated in para. 4.66). Such a mechanism would allow for real wage increases to reflect productivity growth. Wage guidelines should be used in the competitive sector until the performance evaluation systems have been generalized and the Government is satisfied that they are operating as expected. Also important for short-term improvement of state enterprise savings is the overdue adjustment of public utilities tariffs. This will be discussed in Chapter V.

Strengthening the Disengagement Process

4.69 Developing Disengagement Guidelines. While the March 1990 Decree on privatization provides a useful policy framework, explicit and coherent

central guidelines for disengagement would facilitate the disengagement activities of decentralized authorities, in particular by enhancing the effectiveness of staff with limited experience. Central guidelines would also reduce redundancies in the formulation of concepts and rules by different authorities, and allow the pooling of the best capabilities for formulating such concepts and rules. Moreover, they could aim, inter alia, at making privatization processes more transparent and decisions more objective in pursuit of the public interest. Such guidelines should be developed for all stages of the disengagement process, including the choice of privatization form, partner search and assessment, enterprise and offer evaluation, formulation and negotiation of contracts, and contract implementation. Mandatory regulations should be warranted for: ensuring minimum competition among bidders above a low amount; not granting monopoly rights or substantial duty protection from imports; restricting rental contracts over longer periods; and enforcing minimum enterprise evaluation standards.

4.70 Centralized control should take the form of more exacting approval ceilings on transactions and regular agency reporting. Central approval ceilings should be extended to cover assets transferred to domestic partners (not only foreign partners), including rental contracts. Permanent staff capabilities at the central level should be available to review applications beyond a minimum ceiling, including the evaluation of assets, partner contribution and projected outflow, and conduct site verification as needed. High-level interministerial review of the larger transactions or transactions involving privileges should be required. Periodic reports from agencies could usefully indicate: enterprises privatized and their past and present profits and sales, amounts of transactions and rents, asset value and main characteristics of enterprises projected to be privatized in the next six months, copies of all contracts and overall past and projected agency cash-flow from privatized enterprises. In addition, authorities could be careful to avoid contract terms that in the end jeopardize the returns to the state. For example, in an inflationary environment, rent payments should not be fixed over a long time, but be linked to the sales or profit performance of the enterprises, to the inflation rate, or to a foreign currency.

4.71 Overcoming Problems of Limited Capital Availability. In the effort to attract private parties, the pitfalls that have been pointed out earlier should be avoided. First, authorities should avoid granting import protection or local monopolies. Contracts under which the State would retain all (rent) or part of the equity need to be drafted and monitored very carefully. Second, the authorities could also attract more private sector interest by offering additional forms of disengagement. Management contracts would be one possibility. Another would be rent contracts with a fixed schedule of equity purchases over time by the renting party. Liquidation of inviable public enterprises and the sale of their assets to private buyers is another option.

Improving the Legal Framework

4.72 The establishment of a comprehensive legal and regulatory framework for economic activity is surely a long-term endeavor. The fast pace and high stakes of the disengagement process in Lao PDR call, however, for a number of urgent steps. These priority improvements should include, inter alia:

(i) defining the authorities qualified to commit the State in disengagement contracts; it should be clarified that disengagement procedures have to be carried out solely by government agencies, to the exclusion of enterprise managers or workers. Such involvement creates obvious conflicts of interest which need to be avoided. This is especially true when enterprise management or staff intend to bid for a purchase or rent contract;

(ii) developing economic legislation including, as a priority, (a) a company code defining the main characteristics of companies (rights and obligations of shareholders and managers, definition of shares, etc.) and clarifying the rights of enterprise staff and former owners; (b) contract laws establishing the requirements of validity, enforcement mechanisms, etc., and (c) labor legislation defining the nature of work contracts, the conditions of recruitment and layoffs, etc. This legislation should ensure strict equality between sectors and subject state enterprises to general commercial law; and

(iii) establishing mechanisms for settlement of commercial disputes. These could initially take the form of arbitration mechanisms, provided they are independent from Government. In addition, to foster foreign investment, the authorities should seriously considering adhering to international arbitration institutions, such as the International Center for Settlement of Commercial Disputes.

V. MOBILIZING FISCAL RESOURCES

A. Introduction

5.1 Enhanced public resource mobilization is a key condition to transform the recent growth upturn into sustained long-term growth. These resources are required to support the investment effort in basic infrastructure and social services and the long neglected maintenance of existing facilities. Unfortunately, the capacity of the authorities to support such effort has been endangered during recent years by a severe drop in fiscal revenues. As a percentage of GDP, they declined from 11.8 percent of GDP in 1986 to 9.4 percent in 1989 (see Chapter II). In the immediate future, they will need to be gradually restored to their previous levels, if medium-term growth objectives are to be fulfilled.

5.2 The June 1989 tax reform constitutes a major step in this direction. Apart from the tax discrimination against exports which need to be eliminated, this new system should be further improved with a view toward strengthening the tax base and facilitating its administration. As general taxes on income and consumption will remain difficult to collect in the near future given the weak administrative apparatus, more emphasis should be put on the considerable revenue potential of an improved exploitation of the national patrimony: Government portfolio of loans and participation in state enterprises, public infrastructure (roads, water distribution, telecommunications) and natural resources (mainly hydropower and forestry). This objective should now be brought to the forefront of resource mobilization efforts. After a brief review of the recent developments of the tax system in Lao PDR (Section B) this Chapter examines in turn three services of fiscal revenues and formulate recommendation to enhance their economic impact: taxes (Section C), financial revenues (Section D) and user charges (Section E).

B. New Policy of Economic Management and the Tax Reforms

5.3 In 1986, the Government of Lao PDR introduced a reform to improve the management of the economy. The reform was marked by swift and radical changes from previous central planning policy towards market orientation. The recent tax reforms have been both a sequel and an implementation tool of the new economic management policy.

5.4 In the eighties, until the introduction of the reform, the share of tax revenue in total government revenues declined sharply from one third in 1984 to less than one tenth in 1985 and the share of other revenues, particularly negotiated transfers of funds from state enterprises, climbed from 66 percent to over 90 percent. The Government rapidly and successfully reversed this trend by introducing a tax reform in 1988 and by further developing it in 1989. As a result, the share of tax collection in total revenue climbed to 80% in two years.

5.5 The tax reform represented a major improvement in eliminating some ambiguity about the state economic enterprises' obligation to contribute to the financing of general government expenditures. Before the reform, the contribution of public enterprises to government budget was determined through negotiation, in fact outright bargaining, between enterprises' managers and sponsoring government administration. In principle, the entire enterprise surplus, including depreciation funds, were siphoned off into a common pool and then reallocated to government expenditures as well as to enterprises' financing needs. Two important drawbacks of this system were that (i) public enterprises did not have much incentive to create a surplus; (ii) cash starvation caused by the centralization of surpluses straight-jacketed the management and resulted in cost overruns in production.

5.6 The surplus of public enterprises, as well as their tax contributions, went either to local government (province or district) or to central government; the prerogative of tutelle determined the government that had a right on such funds. This rule provided incentives for local government units to create new enterprises to broaden their revenue collection base. Provincial and district governments were particularly fond of creating trading companies to capture import-export rents or industries to farm forest products or exploit mines, to capture natural resource rents. The number of industrial firms is estimated to have increased roughly from 100 in 1976 to about 300 in 1985.

5.7 The previous system of pooling state enterprise savings was consistent with central planning. Under such system, where prices are set according to the planner's view on social values, savings are generally not generated in the sectors where they are needed for capital accumulation. Savings would, for instance, be low in a sector where, according to the planners objectives, prices are set at a low level to encourage consumption but where investable funds are needed to develop productive capacity. The budget is therefore used to channel resources from surplus sectors to deficit sectors. The result is a pattern of fiscal levies that varies from one sector to another. The rationale for such system disappears once the economy switches to a market system. In such system, the market generates a sectoral distribution of profits which reflects its preference and provides the necessary signals for the allocation of resources. The tax system needs therefore to be neutral in order not to disrupt the allocation of resources. The evolution to a neutral tax system took place in two stages. The reform of 1988 introduced a profit tax in lieu of the previous system of transfers of operating surpluses. The tax rates however continued to vary from one sector to the other (and between profits on domestic sales and on exports) which undermined the expected effect of the price reform on allocative efficiency. This point was rapidly understood by the authorities so that this system was only short-lived. It was abandoned in June 1989 in favor of a single profit tax rate.

5.8 As the new economic policy gave more autonomy to state enterprises to make them more responsive to market forces, the Government of Lao PDR introduced a tax reform in March 1988 (Decree 9) which established the objective and general rules of their compulsory contributions to the government. Uncertainties about state enterprises' obligation to contribute

to general government expenditures were greatly reduced by this reform. The Government went even further in the direction of restraining its tax powers and set the rule that all industrial enterprises, whether public, private or mixed, had to pay only one tax; either on production, retail sales, import, or export. Tax rates would be uniform for state enterprises, cooperatives, joint ventures and private sector and finally, they would be uniform within the same economic activity. However, profit tax rates varied not only across industrial sectors but also between profits out of domestic sales (20 to 80 percent according to the sector) and exports (50 to 80 percent according to the type of product). Services and construction were exempt from the profit tax but subject to a turnover tax, while industry was exempted from the latter. The government not only abandoned the procedure of negotiation of tax rates applicable to state enterprises with their management, it also set the tax rates fixed for five years.

5.9 Although an improvement over the previous practice of centralizing all surplus of enterprises before reallocating them, the reform of 1988 was still far from setting up an efficient mechanism of resource mobilization for financing the government budget. First, different rates applicable to different sectors distorted the allocation of resources in favor of lightly taxed sectors and prevented investments from going into sectors with highest returns. Second, the one enterprise one tax rule unnecessarily prevented the broadening of the base of both income tax and general sales (or turnover) tax. Third, and most important, the complexity of the system made it extremely hard to administer for an administration with little past experience in true taxation (as different from collecting negotiated transfers).

5.10 But the Government did not wait a long time to assess the results of the first reform. With tax collection foundering, it swiftly introduced the reform of June 1989, which greatly improved the tax system, as the Government dramatic improvement in tax collection performance shows. Major improvements concern in particular: (i) the broadening of the tax base, thanks to the diversification of the sources of revenue; (ii) the reduction in the tax rates (to 45 % for all business profits and to 3-20 percent range in the turnover tax); (iii) the generalization of tax withholding and of the ad valorem system to protect fiscal revenues against monetary erosions; (iv) the maintenance of low import tariffs will further Government strategy to restructure the economy according to its international comparative advantages. However, the discrimination against exports which has been introduced (under the form of (i) export surcharges on natural resources and agricultural produce, (ii) non deductibility of the sales tax on inputs for export sales as different from domestic sales) still conflicts with this objective. Apart from that, the four above-mentioned improvements strengthen the elasticity of the tax system and limit distortions to prices and economic decisions.

5.11 The new tax system provides the Government with the appropriate set of tax instruments. However, in view of the future fiscal requirement, further improvements are called for to step up revenue generation. Apart from the export regime, these are essentially technical measures to streamline the tax rates, strengthen the tax base and, above all, simplify the administration of the tax system. A good tax system does not mean automatic improvement in the government finance. The shortcomings of the tax administration, are too

widespread to be cured in a short period. The following review of the present tax system assesses its revenue potentials and its effects on development and makes recommendations to improve their enforcement or their economic and distributional effects.

C. The Tax System

(a) Some general principles

5.12 Taxation in Lao PDR needs to be based on the following considerations:

(a) Tax administration is weak. Therefore, each tax must be made as easy to administer and collect as possible. For the time being, this consideration need to supercede other objectives, if they require more sophistication;

(b) future economic growth will depend crucially on foreign exchange inflow from abroad. Any tax which discourages exports or foreign investment will also weaken economic growth and therefore also reduce the proceeds from the other taxes;

(c) the tax base is very narrow due to the small share of market activities and the preponderance of subsistence activities. Broadening the tax base is a priority; excessive tax rates would undercut the achievement of this objective. Initially, new activities such as market production in agriculture should be expected to contribute little to national fiscal resources. These activities need to develop on stronger economic basis before yielding more substantial fiscal revenues;

(d) the country is endowed with valuable natural resources such as hydroelectric potential, forest and some mineral resources. These resources are part of the national patrimony and should be exploited so as to benefit the nation at large, taking into account environmental concerns and long term resource management constraints. They generate economic rents, which belong to the nation and should be used to further national development objectives.

These considerations dictate what form of fiscal system can be efficiently implemented over the short and medium-term. Practically, it implies that Government should focus its attention on collecting primarily three sorts of taxes: (i) income taxes on the modern sector, but at moderate rates in order not to stifle its development; (ii) broad-based consumption taxes, which should be expected to represent the major part of Government revenues over the medium-term, as they reach taxpayers far beyond the modern sector; and (iii) taxes on natural resources to capture the rents inherent in their exploitation and promote their sustainable use. The collection of income taxes from the agriculture sector is currently very low; it represents less than 1 percent of the value added in this sector. Given the predominance of subsistence

activities in this sector, the collection of an income tax is originally difficult. In the short run, priority should be given to improved enforcement of existing taxes, while sales taxes on consumer goods mobilize additional resources from that sector indirectly.

(b) Review of the Major Taxes[1]

Corporate Income Tax (see Table 5.1, line 1.1)

Table 5.1: SHARE OF REVENUE ITEMS IN GENERAL GOVERNMENT REVENUES (%)

		1984	1985	1986	1987	1988	1989
1.	Tax Revenue	33.7	13.6	9.5	9.8	75.9	78.1
1.1	Profits Tax	5.1	1.7	1.1	1.0	22.1	17.1
1.2	Income Tax	0.3	0.1	0.1	0.1	0.1	0.2
1.3	Agricultural Tax	4.6	2.4	2.4	2.0	4.3	4.0
1.4	Business Licences	0.2	0.1	0.1	0.1	0.1	0.2
1.5	Turnover Tax	19.4	7.6	4.7	4.6	26.1	31.8
1.6	Duties	3.7	1.6	1.1	1.9	22.9	24.3
	(i) Import	3.0	1.2	0.8	1.6	17.2	20.8
	(ii) Export	0.6	0.3	0.3	0.3	5.7	3.6
1.7	Other	0.5	0.1	0.1	0.1	0.4	0.6
2.	Non-Tax Revenue	66.3	86.4	90.5	90.2	24.1	21.9
	(i) Operating surpluses	50.3	64.8	75.1	77.3	1.8	1.1
	(ii) Depreciation transfers	9.6	10.5	5.7	4.7	8.5	7.3
	(iii) Other	6.4	11.1	9.8	8.2	13.7	13.4
	Total Revenue	100.0	100.0	100.0	100.0	100.0	100.0

Source: Lao PDR authorities.

5.13 The major improvement in the corporate income tax (profit tax on legal persons) has been the adoption of a single rate instead of the previous range of sectoral rates or, even worse, the practice of tax assessment by bargaining. The tax rate on company profit stands now at 45% rate. It is assessed on companies' net profit and withheld on a quarterly basis. No

[1] This section benefitted greatly from the findings of an IMF Tax administration mission led by Mr.Tecyues Belder. The recommendations in this chapter are in line with the conclusions of this mission.

deductions apply but new establishments and rehabilitated enterprises benefit from a tax holiday for a duration of 1 to 5 years, as determined by the Minister of Economy, Plan and Finance.

5.14 This provides a relief to state enterprises relative to the previous practice of negotiated surplus transfers or to multiple tax rates. However, the increased autonomy of enterprises constitutes a threat to the base of corporate tax by rendering it prone to erosion. Since the tax reform, the state enterprises took advantage of their autonomy primarily to increase salaries and benefits of employees. Unless the Government takes the step of imposing basic salary limits in the public sector and regulate bonuses, growth of the company tax base (that is profits) is in jeopardy. Such measures are discussed in Chapter II.

5.15 The present rate of 45 percent is still on the high side, particularly for private companies and joint ventures. In developed as well as developing countries, the prevailing tax rates have typically lowered to 35-40% from the previous typical rates of 50%. In Thailand, the profit tax rates is 36 %; it is reduced to 30 % for export-oriented companies. On the other hand, tax holidays for new ventures are overly generous and risk to deprive the budget of the benefits of a more dynamic enterprise sector. In the case of foreign ventures, international experience suggests that generous tax breaks only marginally affect investors' behavior while unduly reducing the tax base. The principle of taxing all profits is a sound one. The government would therefore be well advised to follow foreign trend and reduce the normal rate to about 35% but to reconsider the tax holidays.

5.16 The adoption of a corporate income tax rate several percentage points below the top personal income tax rate would have another advantage; it would encourage the adoption of the legal status of corporate form of enterprise by personal businesses. A corporate tax rate of 35 percent would reconcile the revenue target with competitiveness and encouragement of corporate form of enterprise. However, to avoid the artificial proliferation of corporate enterprises for the purpose of producing sham invoices and transfer pricing, the imposition of a minimum tax (irrespective of profits or losses) of 1 or 2 percent on corporate enterprises turnover would be desirable.

5.17 Profits of legal persons are subject to a 45% tax; but there is no definition of legal persons. To determine whether a private business is a legal person a code of commerce is needed; this does not exist yet in Lao PDR. This lacuna should be filled to clarify the applicability of the various taxes to private enterprises that take the form of partnership based on contributions in capital shares.

5.18 A major weakness of the company profits tax as well as of the personal income tax that has persisted after the reform is the absence of clear, simple and precise rules for the determination of taxable profits. Assessment of business income necessitates the application of certain accounting rules and procedures. The tax reform decree gives certain rules on costs that are deductible from gross receipts. But a simplified set of accounting rules and forms of income and balance sheet statements is urgently needed to standardize the procedure of income determination in business.

Dissemination of accounting rules and practices is also a priority issue for the success of taxation of business profits on an actual basis.

Personal Income Taxes (see Table 5.1, line 1.2)

5.19 The reform of 1989 broadened the base of the personal income tax by taxing salaries, professional incomes and capital incomes. A year earlier, reluctant to levy income tax on salaries by sticking to the its self-imposed rule of one company one tax, the government considerably restricted the revenue potentials of the income tax by excluding to employees' incomes. This limitation has now been lifted. Personal income tax also covers the incomes on commercial and industrial activities (benefices industriels et commerciaux), self-employed professionals' incomes (benefices non commerciaux). Incomes from various forms of capital assets (rents on immovable property, interests and dividends) are also taxable. Agricultural incomes are subject to a separate tax (see below).

5.20 At the present stage of personal income tax reform, the Government has stuck by the schedular taxation (no aggregation of incomes from various sources) with distinct rate structures applicable to each category of income. The progression is in the range of 2-30 percent for salaries, and 10-40 percent range for business profits[2], 10 percent on dividends and 40 percent on gross rental incomes and on nominal interests. A proportional rate of 25 percent is applied to professional (non-commercial) incomes.

5.21 Although, in Lao PDR, schedular taxation is fully justified on grounds of administrative simplicity in a transitional period, this does not necessarily call for widely divergent rates on different categories of incomes. The present rate divergences between the top rates on the different income categories can and should be moderated for the sake of horizontal equity, providing better incentives to business and improving administrative efficiency. As regards wage incomes, the top rates should be identical to that of incomes from other sources. At the other hand, lower income should benefit from a zero rate tranche, as their contributive capacity at the current level of the tranche is virtually nil, and also because at such low rates the collection costs are larger than the tax revenues.

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2 Progressive rates are shown below:

Salaries		Industrial and Trade Profits	
Monthly Incomes	Rates	Annual Incomes	Rates
Less than 20 KK	2%	Less than 200 KK	10%
25 to 60 KK	5%	200 to 500 KK	15%
60 to 120 KK	10%	500 to 1000 KK	20%
120 to 200 KK	15%	1000 to 2000 KK	25%
200 to 300 KK	20%	2000 to 3000 KK	30%
over 300 KK	30%	3000 to 4000 KK	35%
		over 4000 KK	40%

KK : Thousand Kips.

5.22 As regards interest payments, bank interest should be exempted to avoid financial disintermediation. The competition from the curb market puts a floor under which depositors will not be willing to sacrifice their after-tax interest earnings. Therefore, the actual impact of the tax will either (i) to increase the lending rates, the tax being borne by the borrowers, or (ii) to reduce bank spreads if they cannot pass on the full cost of their deposits to their customers, due to interest rate regulations, which will in turn reduce the base of the profit tax on bank profits; or finally and more probably, (iii) to encourage disintermediation. In none of these cases will the beneficiary of the interest income bear the tax.

5.23 Although the reform has already attenuated the administrative burden through widespread resort to tax withholding and lump sum taxation on small business incomes, the administrative burden of implementing the various forms of income taxes should be further reduced. Conscious of the absence of standard accounting rules and paucity of accounting practices, the government relied heavily upon presumptive taxation (forfaitisation) to secure some meaningful revenue from business income taxation. Presumptive net profit rates are applied[3] to actual turnover volumes of enterprises whose annual turnover is below 3.6 millions Kips. This threshold for presumptive taxation is way too low and should be doubled to allow the administration to concentrate its energy on the medium and large taxpayers. Finally, the same accounting rules that apply to company profits are also applicable to personal business. To deal with the difficulty of compliance of small and medium size enterprises with standard accounting procedure, a simplified form of accounting is being proposed for the enterprises with an annual turnover between 3.6 millions and 7.2 millions Kips. Enterprises with a turnover above 7.2 millions Kips will comply with the standard rules of accounting.

Business Licences (see Table 5.1, line 1.4)

5.24 The 1989 tax reform did not reduce the importance of the licence tax (patente) which is paid up-front before going into or remaining in business; it has no connection with actual income obtained from business. However, the amount of capital engaged in business or annual turnover achieved in the previous years are used for the classification of taxpayers into one of the lump sum tax categories. Lump sum licence taxes on import-exports firms are levied according to five classes of business measured by the value of their capital and fourteen categories determined according to authorized imports and exports. Licence taxes on domestic trade firms are levied according to seven categories of turnover level.[4]

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[3] These net profit margins on gross receipts are tentatively set at 10 percent in manufacturing, 20 percent in trade and 30 percent in services. For a better approximation to real profits more detailed breakdown of trades should be established with presumptive profit margins derived from a sample of observations.

[4] The present lump-sum licence rates determined on July 1st (decision of the Minister of Finance No 309) are below.

5.25 The government's emphasis on the licence tax (patente) structure as a significant source of revenue is indicative of its concern about a failure to enforce the personal income tax effectively. However, even the enforcement of patente is defective. In fact a survey conducted in June 1989[5] revealed that among 7,333 trade and craft businesses active in Vientiane Prefecture only 4,276 paid patente and the rest remained untaxed. More than half (60 percent) of these enterprises were created in 1988 and in the first half of 1989 and 94 % of them were private. These figures indicate that the administration's failure to register emerging private enterprises for tax purposes is a serious problem. At present, as the income tax coverage is a limited proportion of the taxable population, business licence should be kept as a revenue source of provinces (or municipalities). Business licence tax register should also be used for the census of income taxpayers.

Turnover Tax (see Table 5.1, line 1.5)

5.26 A comprehensive tax on consumption is levied on domestic production, imports and wholesale of goods and on the sale of certain services. To prevent cascading, a tax credit is granted on taxes paid on material inputs in manufacturing activities. There are five turnover tax rates: 3, 6, 10, 15 and 20 percent. As mentioned above investment goods, certain intermediate goods (construction materials, electricity) and services that go into manufacturing (construction and transports) are taxed at 3 percent. Higher rates apply to finished and high income consumption goods. On some products tax rates are higher on imports than on local production. Finally, no tax refund (through zero rating) is available for exports.

A) Import-Export Activities

Class	Amount of Capital	Amount of Patente	Categories of Authorized Products
1	More than 200 KK	50 KK	1 to 14
2	150 to 200 KK	40 KK	1 to 12
3	100 to 140 KK	30 KK	1 to 10
4	50 to 100 KK	20 KK	1 to 7
5	10 to 50 KK	10 KK	1 to 4

B) Business Activities

Class	Annual Turnover	Transports and Manufacturing	Trade
1	More than 100 KK	15 KK	20 KK
2	50 to 100 KK	10 KK	15 KK
3	20 to 50 KK	70 KK	10 KK
4	10 to 20 KK	50 KK	70 KK
5	5 to 10 KK	35 KK	50 KK
6	2 to 50 KK	20 KK	30 KK
7	below 20 KK	15 KK	25 KK

K Kip.

[5] Elisabeth Goodridge, Avis general sur la reforme fiscale adoptee par la RDPL, 28 aout 1989, Annexe 4.

Table 5.2: TURNOVER TAX

Nature of Activity	Tax Base	Tax Generating Event
Imports	CIF value plus custom duties	Clearance through customs
Production	Wholesale price of products	Ex-factory delivery of goods
Sale of imported goods	Wholesale price of products	Delivery of goods
Supply of services	Value of supplied services	Execution of service contract

5.27 Due to its large base and potential simplicity, the turnover tax should be relied upon to generate considerable fiscal revenues. This potential should not be diluted by unnecessary refinements. Multiple rates create difficulties for the administration as well as for the taxpayers. Fewer rates would greatly reduce the administrative burden and the need to enumerate and define taxable products in the rate schedule. Lower rates would abate taxpayers' temptation to use fake invoices for crediting. In addition, higher rates that are applicable on imports of certain products relative to local production apparently confer a protective function to turnover tax, which blurs the protection pattern set up by custom duties. This practice constitutes an infringement to GATT rules, to no avail indeed given that tax paid on imported goods is normally deductible. To secure transparency in protection policy, as a matter of principle, identical rates should apply to both imports and local production and the function of protection of domestic production should be confined to custom duties.

5.28 It is therefore recommended to reduce the number of tax rates to only two: 5 and 10 percent. However, offsetting revenues should be generated by imposing a separate excise tax on certain mass consumption or high income (luxury) consumer goods and services such as fuel, tobacco, alcoholic beverages, cars, telephone services, in addition to the common rate of turnover tax.

5.29 The present system seriously discriminates against exports. It does not allow exporters to deduct the tax paid on inputs when production is sold abroad but it does when it is sold domestically. This adds to their costs and reduce their profit margin as they cannot pass it on to their prices, which are set on the world market. Since the destination principle of taxation

(zero tax rate on export products) is now widely used, Lao exports would be at a disadvantage against competitors who do not pay comparable taxes, if domestic taxes are not refunded to exporters. With given international prices of goods all domestic taxes of Lao would reduce net price received by Lao exporters. Given that lao exporters operate in highly competitive markets and sell labor-intensive products with low profit margin, the detrimental impact of such system can not be underestimated. Zero rating should apply to all exports to secure cash refund of taxes that went into their cost of production.

5.30 The possible cascading effect of a turnover tax has been carefully limited to a few instances. For example, no credit is granted to taxes paid on services purchased in the production process and for investment goods. The cascading of taxes on services purchased by a Lao manufacturing firm is not an important shortcoming at the present stage; it is justified at this stage by the difficulty for a weak administration to prevent likely abuses in crediting service taxes. Moreover, the low rate (3 percent) on the most important services that go into the cost of manufacturing (that is, transport and construction) attenuates the cascading effect. The inclusion of service tax into crediting chain can wait until the system becomes well established in manufacturing activities. The absence of crediting for investment goods, taxed again at the lowest rate of 3 percent, is also a necessary simplification in the first stage of application of a value added type turnover tax.

5.31 As in the income tax, a presumptive taxation (contractual system) is introduced to apply to small businesses (with a turnover lower than 3.6 millions Kips) as a safety valve to prevent non compliance and evasion in the common system. A useful function of presumptive taxation is to induce small business into the common system particularly by refusing them tax crediting. It also helps to improve the census of taxpayers which is essential in the implementation of broad based income tax and value added tax.

Custom Tariffs (see Table 5.1, line 1.6)

5.32 The structure of customs tariff[6] provides higher protection to the local production of finished consumption goods and lower protection or no protection at all to machinery and equipment and to most intermediate goods. Tax rates range from exemption for certain machinery and inputs to 70 percent for luxury goods. But tax rates for most finished products are around 20 percent and for machinery and intermediate goods around 5 percent. Tax base is the CIF value of products at the border and at the time of clearance of the product. Thanks to ad valorem rates and frequent adjustments of the foreign exchange value of Kip revenue remains buoyant despite the recent rate of domestic inflation.

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[6] Custom tariffs are part of a larger import/export tax. However, while exports are in principle subject to this tax, they benefit from a quasi total exemption. Revenues listed as export tariffs in the budget presentation in Table 5.1 correspond to export surcharge on the natural resource tax.

5.33 The most important issue concerning import duties is the control by the customs'administration of the declared values of imports. The administrative capacity of customs is too weak to carry out such verification effectively and too often has to rely only on importer's statements. Tariff structure also should be improved. Although moderate ad valorem rates constitute an asset by making custom duties buoyant, the protection structure can be improved, by limiting the dispersion of the tariff. There is no reason for granting low protection to cement (3 %), yarn (6%) and bicycle (5%) industries while imposing higher rates on garments or furniture (10% - 30%). Low tariff rates on petroleum products (15% on gasoline, 3% on diesel and 5-10% on other fuel) do not encourage enough the development of local energy sources. Only a limited number of products are subject to tariffs superior to 30%; these include mainly cars (50%), cigarettes (70%), tobacco and soft drinks (40%), alcoholic beverages (70%). These rates remain moderate by international standards. Taxation of goods accompanying travelers can be harmful to the development of tourist industry. Exemptions granted to civil servants to take into the country electrical consumer durable goods is an inducement for them for frequent travels abroad (simply across Mekong) to engage into the trade of these goods.

5.34 The wide open Lao border with Thailand imposes certain constraints on the structure of custom duties of Lao PDR. The country with higher duties (and consequently with higher prices) is candidate to attract smugglers across border. At present low prices of petroleum products in Lao PDR relative to those prevalent in Thailand constitute a source of potential illegal border trade. To the extent that smuggling goes from Lao PDR to Thailand the government of Lao PDR could obtain tax revenue from Thai citizens.

Land Tax (see Table 5.1, included in line 1.6)

5.35 The present real estate tax is applicable to real estate property that is not allocated to agriculture and thus excluded from the agricultural tax. Tax rates are determined according to the location of the property and area of land. There are three zones: 1) Vientiane Prefecture, Luang Prabang, Savannaketh and Champassak, 2) other provinces and 3) district centers. And within each zone four sites are determined according to the quality of access to roads. The construction value of buildings are not taken into consideration in the tax base. These features would encourage either land development in urban area or their allotment to agricultural use.

5.36 The introduction of a non-agricultural land tax by the reform of 1989 would have been a major step toward the resolution of the financing bottleneck of municipal services if tax rates had been based on the rental values of land. They are not; present specific rates (per square meter) are derisory and continue to erode with inflation. It is hard for local government to recover even the administrative costs with these rates. With some improvements, however, the land tax could become a solid source of finance for local governments, particularly for the supply of urban services. For this purpose, the land tax should be based on the rental value of land and assessment of these values should be carried out every five years with indexing of values to inflation in the intermediate years to assessments.

5.37 The success of non agricultural land tax depends on the updating of cadastral survey and register and on updating of specific rates. Experience in the developing countries showed that the adoption of an urban property tax is only a small step in the resolution of the financial problems of urban centers. The most important task is the conduct of an effective land survey permitting value assessment, and periodic updating of assessments. This is a worthwhile but costly undertaking, however, that could only be justified if tax rates were increased.

Tax on Natural Resources (see Table 5.1, included in line 1.6, except export surcharges included in line 1.5)

5.38 The tax on natural resources introduced by the Decree 47 essentially aims at capturing the rent element on natural resource based products. The Decree enumerates about three hundred products classified under thirteen categories: ferrous minerals, non ferrous minerals, construction materials, energy resources, land concessions for various purposes, forest products, ornamental products, wild life animals, plants and bulbs, agricultural products, tamed animals, non comestible products of animals (skins, bones etc.) metal waste and others. For each product, either one or two rates, specific or ad valorem, are given on their production (royalties) and some are subject to an export surcharges. In many cases, upper and lower limits of rates are given and the applicable rate to be determined by the administration depending on geographic location or type of product or exploitation.

5.39 The present coverage of the natural resource tax is overly cumbersome. Its implementation would require human resources (both in terms of number and skills) that exceed by far the capacity of the administration. The authorities would be better advised to concentrate on the small number of products which are likely to generate substantial rents: those for which concessions exist or could be introduced (forest, tin, coal, gypsum, precious stones) and hydroelectricity, which is a state monopoly anyway. Also for the sake of administrative simplicity, the redundant ad valorem and specific taxes should be merged.

5.40 For resources which can be submitted to a concession regime, taxation should be viewed as a temporary system, replaced over time by the auctioning of concession rights. It is virtually impossible to absorb natural rents by objective tax rates; no matter how many rates are devised for how many sorts of natural resources, there will always be certain products for which tax will either exceed rents or fall short of rental margins. Adjustment in time would be needed as fluctuations in demand for products modify natural rents. Therefore, it would be much more efficient and less cumbersome to work out the natural resource charges for each particular concession that gives access to the usufruct of natural resources. Competitive tender is the most efficient way of finding on a case by case basis the rental value of a concession that gives access to natural resources. The concept of concession rights was introduced in the tax system, with the recent reform; the rates envisaged are, however, ridiculously low.

5.41 Pending the introduction of such system, the current system of royalties on the main items listed above should be maintained. But the

imposition of export surcharges on wood, wood product, other forestry products (spices, locquer, seeds, etc), agricultural produce (coffee, tobacco, tea, cardamon) and livestock endanger the export potential of the country, as 1989 economic performance show (see Chapter 1) and introduce distortions in the allocation of resources. They should therefore be eliminated.

5.42 As regards timber and wood products, the government imposed an export tax and increased the royalty to such a level that no sector of the industry can be profitable at current market price. The government's aim is to stop forest logging and encourage salvage/clean up operations in the forest and landing areas. The macroeconomic impact of such policy, which hit the country's largest export earners has been dramatic (see Chapter 1). The initial impact on resource conservation is marginal as commercial exploitation represents only a small fraction of the annual cut and its long term impact will doubtless be detrimental. It is a fallacy to believe that by causing a cessation of logging, forests will better preserved. In fact the opposite is true where there is pressure on the forests from shifting cultivation, as is the case in Lao PDR. If the forests are perceived as having no value by the adjacent population, agricultural encroachment will intensify. At the same time, the Government, when attempting to protect natural resources, will have less to spend, therefore fewer personnel, less equipment and less to offer in the way of shared logging proceeds or employment in regeneration works.[7]

5.43 It is essential that the government ascribe a value to the commercial exploitation of forests to emphasizes their real worth and promote better utilization standards. These values should reflect the scarcity value of the various species of trees and encourage the use of lesser known species. All log purchaser should pay the same tax irrespective of uses and markets.

5.44 The level of economic rents per log, thus the appropriate level of taxation can be determined by comparing the FOB price the country can obtain with efficient production costs. Table 5.3 show the result of this calculation for a range of species representing the major part of Lao PDR production for sales on convertible currency market.[8] This is the value that the Government should place on their resource. By comparison the present resource tax and export surcharge range from $714 per cum for Deluxe wood to $45 per cum on lower quality hardwood. At present rate, only Deluxe timber and sawn wood is profitable on the world market, if efficiently produced. Profitability of the former is higher than on the latter. This is due in part to the structure of tariffs in Thailand which favor log imports against other

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[7] see Tropical Forestry Action Plan, FAO and alii, interim report, March 1990.

[8] FOB prices are calculated from in-country competitive prices for the major market of Japan, Taiwan, Thailand, South-West China and Vietnam, adjusted for freight, custom duties and handling costs. Using estimates of reasonably efficient manufacturing costs (not those prevailing in Lao PDR at present) and allowing for a fair profit margin, it is possible to calculate the rent that a specific species group and product should yield. Given the present production conditions, this estimate is likely to overshoot the actual level of the rent.

wood products[9]. On the other hand the domestic market for sawn wood and timber provides rents per log of $7 and $36 per cum respectively, against current tax levels of $59 to $66 per cum indicating the inability of the sector to absorb such punitive levels.

5.45 An alternative royalty structure (see Table 5.3) should be considered ranging from $700 per cum to 0 for low quality logs. For first acre, second grade wood remain slightly higher than the average rent to encourage selective harvesting. A 10 percent premium would be charged and a comparable discount be applied to small logs. Of course, a number of other characteristics influence the value of logs (species, level of defect, log form,distance to processing or export point, log length, etc) but due to implementation and control difficulties a relatively uncomplicated system should be preferred. While such royalty would be charged on foreign as well as domestic sales, it should be collected at the narrowest in the production process, i.e. the saw mills and export points, to facilitate its administration. The revenue from this royalty would range from $9.3 million at log removals of 238000 cum to $13.3 million per annum at 333000 cum. This represents 12 to 17 percent of 1990 revenue requirement. The introduction of a royalty system must go in parallel with the reinforcement of forestry management to avoid widespread snuggling to Thailand for tax evasion purpose.

5.46 Government policy vis-a-vis the forestry sector is motivated in part by the desire to induce provincial authorities to move away from their over reliance on forestry exploitation as a source of fiscal revenues and favor diversification to other agricultural produce. This objective is commendable but it will not be achieved if export surcharges are imposed on the very produce (tobacco, tea, cardamon, coffee, livestock) into which diversification is sought.

5.47 The natural resource tax also include an export tax on hydro-electricity at a rate of 70 percent of the export price. As hydroelectricity is a state monopoly, this is simply a device to transfer resource from EDL to the budget. The rate is way too high however, exceeding the gross profit margin on export sales. As that all of EDL's surplus comes from its foreign sales at the current low domestic tariffs, this leaves it strapped for cash and endangers even its most basic operations. EDL profit should be considered on a consolidated basis (export and domestic sales) and taxed accordingly. The easiest way would be simply to collect a reasonable dividend, that is if Government is confident that profit will not be eroded by cost slippages for tax evasion purposes. If it is not, the alternative would be to collect a royalty on all electricity sales, calculated on the basis of a target consolidated profit and taking into account a reasonable level of retained earnings.

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[9] After banning logging, Thailand revised its scale of import duties in December 1988 to favor the imports of unprocessed wood even more. Current duties range from 1 percent on logs, 2 percent on rough sawn wood to 60 percent on plywood (down from 10% and 24% on the former respectively). There does not appear to be any specific discrimination against Lao PDR's exports.

Table 5.3: RENT AND TAXES ON LOGS 1/
(US$/cm of log)

	Hardwood					Pine
	De Luxe A	De Luxe B	First	Second	Other	
1. Current Situation						
(i) Logs						
rent	712	245	9	-9	-15	-4
taxes 2/	714	263	109	86	45	62
(ii) Sawn wood						
rent	684	245	5	21	-43	-18
taxes 2/	544	237	97	80	52	78
2. Proposed Royalty	700	250	20	15	0	5

1/ De Luxe A: MayKhan Phi (Dalbergia)
De Luxe B: May Don (Pterocorpus)
First: May Nheng (Dipterocorpus alatus)
Second: May Bank (Anisoltera cochinchinensis)
Other: Mixed species
Pine: Pinus Merkusi

2/ Total tax including conservation tax, resource tax and export surcharges.

Source: Lao PDR: Forest Industry, Export Earnings and Tax Structure, mimeo World Bank 1990.

Agricultural Tax (see Table 5.1, line 1.3)

5.48 The reform of 1989 lowered the tax rates on agriculture. The government's decision to tax agricultural incomes separately from the personal income tax is in line with the economic reality of the country. Agricultural taxes are determined in fixed amounts of products per cultivated hectare. In tree farming, fish farming, animal husbandry and for certain cash crops (coffee, tea, tobacco, etc.) the tax rates are fixed as percentages of gross receipts (in the range of 5 to 6 percent). To encourage agricultural production, the reform of 1989 reduced agricultural tax rates and shifted the tax burden on non-food consumption products and on the income tax.

5.49 Farmers can pay their taxes either in cash or in kind; a majority of them prefer to pay in kind as transport and marketing costs are high. However, the government encourages cash payments because of difficulties and inefficiencies in transport, stocking and marketing. Actual revenues are therefore much lower than nominal rates might lead to believe, as Government has to shoulder these costs or, as happens generally, sell the products immediately at the end of the harvest when the market is already glutted. Fortunately, the government has no policy of stabilization and uniformity of rice prices throughout the year and regions. The option to pay in kind should be preserved, nevertheless, for horizontal equity purpose because it benefits those farmers who cultivate lands that are located far away from consumers' markets. Although agricultural tax is imposed on all farm products, in practice it is almost exclusively collected on paddy culture.

5.50 Government's present policy of encouragement of new agricultural products will be successful only if complemented with timely improvements in rural roads. Since cultivable land is not scarce relative to rural population, diversifi- cation would not be at the expense of rice output. The agricultural tax base can expand with the development of cash crops such as tobacco, coffee, fruits, and sugar cane. Development of dairy and meat products also has good potentials considering the availability of unexploited grazing land. But the expansion of the agricultural tax base with the diversification in farm products is at best a slow process and raising buoyant taxes on growing agricultural output would be a tour de force beyond the capability of even most determined administrations.

D. Tax Recovery and Administration

5.51 The merit of the tax reform has been to improve the cash flow position of the Treasury by securing revenue collection at an earlier stage of the production cycle. Under the previous system, fiscal resources were based mainly on state enterprise surpluses which only materialize at the end of the production process, i.e. after all other claims on enterprise revenues have been satisfied. A larger share of Government revenues are now collected before (e.g. turnover tax on inputs) or during the production process (e.g. income tax on wages, and anticipated payments on profit tax), while the role of the revenues collected after the end of the production cycle (e.g. transfers of depreciation) is reduced. The large use of withholding taxes also serves early generation of tax claims and payments. This reduces the

erosion of real tax revenues caused by delays in collection. The Government can therefore pay today's expenditures with today's tax claims, not with yesterday's.

5.52 The chronological and priority order of tax claims under the existing tax structure differs according to types of taxes. Enterprises pay import duties and turnover taxes on their raw materials or intermediary products before starting any production. Cascading turnover tax payments are prevented through a posteriori crediting of them on the taxes due on the output; not by granting tax exempt purchase privileges to the producer. The absence of payment deferral or tax installments secures early cash flow to the treasury during the production process. Crediting of positive balance of tax credit onto future tax obligations and absence of cash refund strengthens treasury's cash flow position.

5.53 As regards in the income tax, the widespread use of withholding secures early receipt of taxes from income sources instead of delaying the payment until the end of the period to which income is attributed. Placing the tax liability on the income payer rather than on the income recipient has accelerated tax recovery and facilitated its administration. The monthly withholding of income taxes are in chronological order after the taxes on inputs but before the sales tax (turnover tax). [10]

5.54 The agricultural tax of Lao PDR is due at the harvest time; thus the transfer of the tax is due earlier than would be the case with the income tax. Since it is paid at the harvest time either in kind or in cash without regard to the marketing of product, the claim of the treasury is collected earlier than in the case of the turnover tax. However, the payment in kind, which farmers prefer, diminishes the proceeds of the tax; much waste occurs in storage, transport until the ultimate stage of consumption or sale.

5.55 By the system of payments in installments in the current year on the basis of last year's income, collection of income tax on profits has also been advanced relative to payment upon declaration of the income after the end of the revenue period (see Table 5.2). Finally, assessment and payment of tariff duties and turnover tax on imports at the time of clearance of goods through customs has greatly improved the cash flow position of the treasury for imports constitute the largest tax base that is easily reached by the tax administration.

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[10] Note that when the enterprise is considered as a workers' cooperative workers' salaries becomes an advance payments on profits. Final assessment of the income tax would be carried out at the end of the period after determination of profits.

Table 5.4: THE ORDER OF TAX CLAIMS IN THE PRODUCTION PROCESS

Preparation of Production	Production Process	End of Production Process	Marketing	End of the Income Period
- Turnover tax on inputs - Resource tax incomes	Income tax - on salaries - on rental	Agricultural tax	- Turnover tax on products - Export tax	- Profits tax - Land tax
Ownership rights				- Dividends - Amortization

Upgrading the Tax Administration

5.56 After the expeditious tax reforms of 1988 and 1989, the major difficulty in resource mobilization is now the strengthening of the tax administration to enforce the tax system. This is not an easy task for the weakness of the tax administration is widespread and deeply rooted. First, the previous policy of management of the economy with central planning had practically abandoned the dependence on tax payments of enterprises to finance general expenditures. Instead it centralized all the cash flows of state enterprises into a common pool and allocated the funds from that pool both to the financing (investment) needs of enterprises and government expenditures. As a result, determination of government's claim on enterprises' output through tax assessment has become a secondary, even redundant, operation since even the surplus of enterprises was considered part of the common pool of financing. Fast turnover of civil servants and politically motivated appointments prevented the accumulation of professional experience in tax administration. The loss of tax assessment and collection culture was widespread; it affected central and provincial administrations, tax collectors and taxpayers.

5.57 Two other factors have contributed to the degradation of administrative capacities which are common to all administrations the abolition of all administrative hierarchies since 1988 (each civil servant is supposed to report directly to his minister) and the low level of salaries. The latter affects the effectiveness of tax and customs administration, probably more than any other public administration.

5.58 Another important factor in the present weakness of the tax administration is its fragmentation resulting from the extreme decentralization of the country. There are three tiers of government in Lao PDR:

(a) the Central Government;

(b) 16 provincial governments and a Prefecture which covers the city of Vientiane and the surrounding area;

(c) a number of district governments in each of the provinces. Each province (kheung) is divided into up to 15 districts (muong) which are further divided into subdistricts (tasseng) which administer from 5 to 10 villages (ban).

Provincial and district governments have approximately 12 departments that mirror the central government ministries (i.e. agriculture, finance, industry, etc.). Each province and the Vientiane Prefecture has its own Party Committee, headed by a Secretary, and an Administrative Committee headed by a Chairman. Sometimes, the Secretary and the Chairman are one and the same. The Chairman of the Administrative Committee is the President of the Province. Administrators are chosen by a Peoples' Assembly. The Chairman of the Administrative Committee is a member of the Council of Ministers; and since 1982 the Secretary of the Provincial Party Committee is automatically a member of the Central Committee. Historically, the provinces have always enjoyed a great deal of autonomy and power, culminating in 1986 with the decision by the Fourth Party Congress to make local governments completely selfsufficient. Provincial and district tax administrations are under governors of provinces and have no direct communication with the central tax administration.

5.59 More disruptively, local and central tax administrations share the taxpayers not the taxes. Apart from the consequent inefficiency in tax collection, this system engenders unacceptable distorsions in the allocation of public resources, both from an equity and from an efficiency view point. It has created gnawing regional disparities and an allocation of resources which does not reflect the country's overall priorities. Each level of Government applies the same taxes (income tax, turnover tax, custom duties and export taxes) to different groups of taxpayers and retain the full proceeds of these taxes: enterprises that are under the tutelle of the central government are taxed by the central tax administration; and the enterprises that are under local tutelle as well as all the local private enterprises are taxed by provincial or district government of their location. Given the existing repartition of taxpayers, the Central Government receives in effect only 25% of tax revenues out of which it has to finance its own operation and the deficits of the poorer provinces, for lack of any other regional equilibrating mechanism.

5.60 All direct and indirect taxes are therefore retained by the level of Government which collects them. This applies even to foreign trade taxes, with the only exception of export taxes on the so-called strategic goods. Import and export taxes as well as turnover tax on imports are collected by

the custom officers of the province of custom gate.[11] The exception to this rule is the practice in Vientiane where custom duties in the four ports (Mikena, Kolibosto, Thanatel, Thadeun) are collected by the central government customs officers and the customers of the prefecture assist the operations.[12] Custom duties on imports are shared between the province of the custom clearance gate which gets 2% and the province that has tutelage over the importer (98%). Export taxes are collected by the custom officers of the gate of export. In the case of strategic products exports (among which wood, ores, cattle, coffee, tea, etc.) 48% of taxes go to the central government, 50% to the province of the exporter, and 2% to the province of the gate, while receipts on non-strategic exports are shared by the export gate and exporter's province in the proportion of 2% and 98% respectively.

5.61 There is no reason to link so directly tax administration and the allocation of revenues. The present determination of tax authority with its revenue sharing component ends up with extreme revenue inequalities among seventeen administratively decentralized provinces; those in economically advantageous regions collect disproportionally high revenue relative to their population while those in undeveloped enclaves are put into financial starvation. No scheme or formula exists to correct the revenue inequality that emerges among provinces with the present pattern of tax collection prerogatives. The central government tries to fund the less developed provinces out of its own budget; this policy has been one of the causes of the drain on fiscal revenues. Another result of the present income sharing pattern is the encouragement of provinces and districts to create enterprises, as their proxy tax collectors, particularly in import and export business and exploitation of natural resources with a view of maximizing their revenue share.

5.62 There is no necessity of determining revenue shares of central and local governments by giving them powers on taxpayers or on taxes. On the other hand, taxes should be collected by the administration that can do it most efficiently. In the case of general taxes, a central administration is likely to be a more efficient one. Central tax administration should be divided into two parallel units: the administration that would be in charge of border taxes (customs) and the administration of internal taxes. Certain taxes collected exclusively by local governments, such as agricultural tax,

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11 Starting in March 1988 the tax was assessed at the gate of entry but actual perception was left to destination province. However, several importers sold imported goods after passing through the custom lines and never paid the duties. To prevent this abuse, all the gates received instructions to never let goods through the customs before collecting duties. This practice stopped the abuse but the provinces of importers did not receive their share of duties. The central government after taking effective control of Vientiane ports also neglected the payment of the share of importers' provinces. Central government revenues from foreign trade increased rapidly but this was partly through stopping the transfer of tax shares of importers' provinces.

12 Since the beginning of 1989 the custom officers of the prefecture have been excluded from custom clearance operations.

vehicle operating fees, non-agricultural land tax, should be retained by them because of their accumulated experience or their comparative advantage in the assessment and collection of them. On the other hand, revenue sharing should be determined according to revenue needs that emerge from the politically determined attribution of government functions to each level of government.

E. Revenues on Financial Assets

5.63 Financial revenues from ownership rights and other financial assets should be substantially expanded. They already constitute the largest part of Government non-tax revenues, which themselves represented 22 percent of total budgetary revenues in 1989 (including the transfers of depreciation funds which are considered here as revenues, in line with the current presentation of the budget). There are three main sources of revenues: (i) the receipts from the provision of public services by public administration and some state enterprise acting as quasi-administration; (ii) the transfers of depreciation funds from state enterprise and their equivalent; (iii) interest income on loans and deposits. The first item will be dealt with in the next section on user charges. This section focuses on the two latter.

5.64 As seen in Chapter III, the Government receives only principal payments on its participation in state enterprises but no return. This system need to be revised. Currently, autonomous state enterprises have the obligation to transfer their depreciation funds to the Government of tutelle. This policy amounts to a denial of the management responsibility of securing the continuity of the enterprise and prevents them from maintaining the value of the assets granted to them by the Government. Practically, it amounts to a gradual depletion of the national patrimony. Clearly this practice is in total conflict with the policy of granting more autonomy to enterprises. The management of enterprises should be given more freedom to use their depreciation allowances to secure maintenance and repair expenses. This policy need to be abandoned to avoid state enterprise decapitalization and the consequent decline in productive capacities, for want of renewal. In addition this revenue base is rapidly shrinking as transfer arrangements are stipulated in nominal terms and therefore eroded by inflation.

5.65 However, the nation as owner of these enterprise is entitled to a remuneration on its investment and to decide how to allocate it, whether by reinvesting in the same enterprise (retained earnings) or by redirecting this to other uses (dividend). Two consequences follow from this principle. First, management autonomy granted by the new economic policy to state enterprises should not obscure, or come to conflict with, the function of profit creation for their investments. The Government should monitor their savings as the custodian of the property rights of the nation. The recent record of the state enterprises in savings was quite dismal and calls for government intervention through the introduction of certain regulatory measures. To this effect, the Government should set up the principles of guiding salaries in the public sector. Salaries of state enterprises should remain within the general limits to be set up by the Government. Bonus

payments also should be within general limits and should not be paid before corroborating enterprises' performance through external auditing (see Chapter II).

5.66 Second, the after-tax profit remains a public resource. The allocation of the after-tax profit should rest with Government. To make this choice feasible, the principle of a dividend on Government participation should be introduced. It would then be up to the financial tutelle to decide whether, and in what proportion, after-tax profits need to remain with the enterprise or be transferred as dividend to Government and used in other enterprises or sectors (see Chapter III). Dividend revenues should replace the existing systems of principal payments as a source of fiscal revenues.

5.67 Interest revenues are a potentially major resource for the budget. On lending of foreign resources only began recently. Due to the existence of grace period (typically 5 years) only some of the 13 loans generate interest at present (multilateral funds on-lent to EDL). Grace period on on lending of foreign funds are not justified: they transfer the benefits of concessional terms to individual borrowers rather than to the country as a whole. The present stock of loans should generate $10.9 million a year in interest, i.e. the equivalent about 14 percent of 1990 revenue requirements. This source of revenue is bound to expand with the inflow of foreign aid. The government should make sure that future on-lent funds are charged a commercial interest rate.

5.68 Interest on on-lending to final borrowers are only part of the potential interest revenues. As seen in Chapter 1, the Government has also accumulated counterpart funds and special accounts with the banking sector. These funds should earn interest. At the current rate on saving deposits, Government deposits outstanding by end December 1989 should generate revenues to the tune of another kip 5 billion in 1990 on an annual basis, i.e. the equivalent of more than 8 percent of 1990 revenue requirement.

5.69 Finally, the budget has not yet benefitted from a traditional source of Government income: seigniorage. The seigniorage is the rent generated by Government monopoly right to print currency. In this process, the authorities issue interest free currency to finance interest-bearing credits. The difference typically accrue to Government. Until the reform of the interest rate policy in August 1989, it was used directly to offset the negative spread resulting from lending rates being lower than deposit rates, in other words to subsidize lending rates. It was also needed to compensate the loss of revenues on non-performing assets. Interest rate subsidies have now been abolished and the problem of non-performing assets should be tackled directly by restructuring bank portfolio. This restructuring would release even without Government borrowing from the central bank, about kip 5 billion,[13] i.e. the equivalent of more than 9 percent of 1990 revenue requirement, as seigniorage revenue for the budget.

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[13] (Average lending rate - transaction cost) X stock of currency in circulation.

5.70 The revenue potential of these instruments is thus quite considerable. Assuming that dividends provide the same level of resources as principal payments from state enterprises (in terms of GDP), financial revenues could have generated about 37 percent of 1990 revenue requirements.

F. User Charges in Public Services

5.71 In Lao PDR user charges are widely used. Their emergence and generalization, however, is due to the lack of budget funds and to the confusion of government departments output with that of state enterprises rather than to a clear perception of their economic advantages. In fact, the central planning procedure was a factor in the treatment of public services by the Government of Lao PDR like other marketable products; economic resources of government departments and state enterprises and their uses were consolidated in the same document. The government budget thus performed the function of a national budget of resources and uses. The merging of the needs and resources of enterprises with those of government departments obscured over time the proper role of government as the provider of public services financed by general taxes and overstretched its holding-like managerial function over state enterprises. The result has been the neglect, over time, of the public service functions of the government departments and priority funding of productive investments. Lack of funds combined with the assimilation of government departments'services to the products of state enterprises' contributed to the emergence and wide use of de facto (if not official) practice of user charges.

5.72 If properly devised, user charges on public services may yield several advantages. First, they reveal consumers' needs and ration resources to their marginal values. Second, they ensure the continuity of public services by securing cash flows needed as services are supplied. Third, when they reflect long term marginal costs, they are neutral on resource allocation while general tax financing creates disincentive effects through price distortions. Unless such concerns as income distribution, encouragement of more extensive consumption of services, (i.e., merit goods) or high transaction costs of the exclusion of non-payers justify free of charge delivery, user charges are a useful and efficient complementary tool for financing public services. However, as mentioned above, Laotian user charges were not devised according to strict economic principles; they mostly emerged to keep public services going under conditions of financial crisis. It would be useful to review the past practices of user charges in central and local government departments before determining their justified uses under the new economic management policy.

5.73 Like many other developing countries, the Government of Lao PDR carried out investments in public services without adequately ensuring that operating and maintenance expenditures of the capacity extension are available. One reason of boosting capacity inconsistently with operating and maintenance funds has been the availability of donor country funds for investments. Another reason has been the priority given to investments as a growth factor without paying equal attention to the funding of operating and maintenance expenditures. The past failures in capacity utilization

illustrate the importance of extending the capacity of public services as a function of the sustainable growth in recurrent expenditures rather than the other way round.

5.74 In Lao PDR user charges are collected on two distinct group of services; social services (such as education, health and drinking water) and services produced by use of infrastructure investments (roads, irrigation canals, utilities). While the low capacity to pay of the population hampers the significant extension of user chargers in the former, the potential is quite large in the latter.

(a) User Charges in Social Public Services

Education

5.75 Operation of primary and secondary education establishments is essentially a function of provincial and local governments. Construction of primary schools and junior secondary schools is the responsibility of local populations while senior secondary schools is the responsibility of provinces. Wide differences in per capita revenue collection among provinces lead to inequalities in the quality and availability of education services. The central government contributes to investment expenditures, mostly in the context of donor countries' projects and with the help of non-governmental organizations (NGO) and provides loans (de facto subsidies) to provinces unable to cope with local recurrent budget gaps.

5.76 Recurrent expenditures of the school system cannot be met in several provinces due to the lack of funding. Teachers remain more often than not unpaid for months. A mission in 1989 identified that 40 percent of the existing stock of 8,316 primary schools require rehabilitation or reconstruction, 50 percent of buildings need refurbishing, 10 percent of the existing 529 secondary schools require reconstruction and 30 percent of them need refurbishing.[14]

5.77 Users also contribute to the operating expenses of schools. Associations of pupils' parents provide help, mostly in the form of rice ration for the subsistence of teachers, who in certain provinces cannot get their salaries (less than 10 dollars a month) for sometimes nine months. Since 1988, parents have also been requested to purchase textbooks. As a consequence, the latter have by and large disappeared from the schools. The Government should instead study, the possibility of lending textbooks, at fees representing the expected life of books(3-4 years). Parents' willingness to contribute to school expenses is stronger in the senior secondary education than at junior level; and in the junior cycle of the secondary than in primary education. This behavior can be explained by the increase in the proportion of effective contributors in higher education levels which reduces the deterring force of free riders. This pattern indicates also the policy of appropriate user charges to implement in the education sector. In primary

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[14] J. Waechter, Infrastructure scolaire, Mission d'Identification, septembre 1989, mimeo, World Bank.

education, the government should finance a larger part of recurrent expenditures and should provide assistance to provinces that lack tax revenue sources. In needy provinces the timely payment of salaries of teachers should be guaranteed by the government. As the level of education goes up, parents' contribution should also go up. In higher education, only a fraction of students (talented but without family support) should be eligible for education without tuition.

Health

5.78 Health care services are organized from village to provinces in a pyramidal form: voluntary health workers for basic information and first aid at village level, a dispensary staffed by nurses sometimes with a physician assistant at the subdistrict level, a hospital with 40-50 beds in districts and 150 bed hospital at provincial centers. However, shortage of trained staff and operating funds hampered the setting up and functioning of this organizational blueprint.

5.79 In 1988, 41 percent of the reported health expenditures were coming from the central budget, 17 percent from provinces and 42 percent from external assistance. Two thirds of the external aid go to capital expenditures causing substantial recurrent cost obligations which the country cannot meet (Lao PDR, Population, Health and Nutrition Sector Review, June 1990, World Bank).

5.80 The possibility of easing of financial constraint in the health sector by users' contributions is limited. Starting with 1989, charges for medicines provided to outpatients in government facilities have been introduced to overcome severe budgetary constraints. Given the very limited capacity to pay of the population, its implementation raises considerable problems, however. A system of user charges on curative services could be introduced in the central hospitals to help the Ministry of Health to allocate more funds to preventive health services. The introduction of such user charges should be done only gradually, especially if combined with the payment of drugs, in order not to jeopardize the already weak access to health services. A prerequisite would be to improve the quality of the services. Economies can also be achieved by pruning unskilled and idle health workers in overstaffed medical centers. Consolidation of the existing health centers by providing adequate funds should be a priority over further dissemination of health centers.

(b) User Charges in Utilities

Electricity

5.81 The operating surplus of Electricite du Laos used to represent the Lao PDR's largest source of public sector revenues. It contributed up to $25.6 million to the budget in 1986. This surplus is disappearing rapidly. To begin with, the sale price for exports to Thailand declined from 4.4 UScent/KWh to about 3.05 UScent/KWh in 1987. Exports still account for more than 70% of EDL's sales. With the expansion of domestic consumption, the exportable surplus has started to decline, while the cost of distributing

power to the local market has kept increasing. Even with the coming on stream of a new facility in 1992 it will not permit exports to return to previous levels. In the meantime, domestic consumers are receiving increasingly large implicit subsidies (up to two cents of subsidy in foreign currency foregone by end of 1989). This level of subsidy is not sustainable.

5.82 Domestic electricity prices have been increased by an average of 75 percent in January 1980. The present price of electricity (kip 12.28/KWh for nationals), is still however only half the export price average, one third the level needed to ensure EDL's financial viability, and one fourth the long-term marginal cost of supply at low voltage. The subsidy of domestic consumption is even higher it appears because of high percentage of system losses (20 percent) in the local distribution grid. Withholding very high taxes on export revenues (70 percent) severely reduces EDL's cash flow. Tight cash flow prevents or delays EDL's implementation of certain operating and maintenance activities, which by their absence causes still further system losses. In addition, the current low electricity prices encourage inefficient substitution from petroleum products to electricity in industry and agriculture (i.e., irrigation with water pumps, particularly along the Mekong banks).

5.83 Electricity prices still need to be increased beyond the January 1990 tariff. This is essential if EDL is to generate enough income to finance, from internal cash generation, 20% of its investments in capacity expansion and meet its full operation requirements. Higher electricity prices are also needed to enable the collection of higher taxes on petroleum products without encouraging inefficient substitution. With the tariff introduced in January 1990, EDL's contribution to the budget will remain positive for another two years, although on a declining basis. From 1992 onward, though EDL is expected to begin incurring substantial losses. A rate equivalent to 3 UScent/KWh is needed to ensure EDL's financial solvency through 1994/95. An increase in the domestic tariff to about 4.5 US cent/KWh would ensure EDL's long-term financial viability and would produce a steady flow of about US$3 million per year in fiscal revenues through 1995. Erosion of EDL's fiscal contribution can only be prevented by raising the tariff to the equivalent of long run marginal cost - about US6 cents/KWh. The Government should seek to realize this objective without delay.

Water Supply

5.84 Five provinces have access to urban water supply: Vientiane, Luang Prabang, Savanaketh, Pakse and Lomsang. Five projects are in the way of realization: The construction of urban water supply facilities is clearly beyond the financial capability of provinces; either central government or donor countries' funds are needed. In Vientiane a 90 percent capacity utilization of the water supply plant has been reached; an extension project was prepared but financing was not secured. These projects should be adequately funded and quickly executed. Reportedly, poor health conditions in Lao is closely related to lack of sanitized water; potable water supply investments convey substantial benefits in terms of public health (Population, Health and Nutrition Sector Review, June 1990).

5.85 Water Company (Societe Centrale d'Eau) is in charge of the operation of Vientiane water supply facilities. It conducts studies and prepares projects for water supply in other towns. After construction of facilities, the operation and maintenance responsibility is transmitted with provinces.

5.86 Vientiane water is tapped from Mekong river. The largest cost component of the city water is chemical products used in water treatment (44%) followed by amortization costs (27%) and financial costs. Water loss in the network represents 23 percent of pumped water. Since the treatment and pump plant is used at nearly full capacity, an extension is urgently needed.

5.87 Water prices in Vientiane Province did not change since 1975 until the end of 1989, while costs increased considerably. The company's deficit was running at one million Kip per day since June 1989. New prices (up to 50 kip per cubic meter for households and 100 kip per cubic meter for commercial use) were approved at the end of 1989; they would cover operating expenses but would not create a surplus for new investments. Nonetheless, water charges should be frequently adjusted to operating and maintenance costs so that more funds can be allocated to service extension.

Irrigation

5.88 In Lao PDR, the utilization of the irrigation capacity is remarkably low; only one third of 30,000 irrigable land is actually irrigated. Several factors contribute to low capacity utilization. First, farmers do not possess the experience of paddy cultivation in dry season. Second, the lack of maintenance and the non-completion of tertiary canals reduce the effective capacity. Third, at times, the lack of fuel or power cause stoppage of service. Moreover, in the north, even in the wet season, some supplementary irrigation is needed in paddy culture due to strong soil percolation. There is also an economic reason: on certain remote lands the cost of irrigation is not covered by the value of product due to high transport costs. These difficulties in the remote or mountainous areas are clearly reflected in the fact that half of the effectively irrigated 10000 hectares is located in the Vientiane Plain.

5.89 In theory, water users from tertiary canals are supposed to be charged 120 kg of paddy per hectare. Water charges should be collected in kind and used to cover the costs of employees that operate the pumps, take care of canals, monitor irrigation work. These services are the responsibility of provinces or districts who set up irrigation units. In certain regions (as in Thanouan, Parkhien) farmers collectives assume the irrigation services starting from the primary canals. In practice, however, water charges cannot be collected because of unreliability of the water supply resulting from lack of operating and maintenance services, poor productivity of services or poor administrative motivation.

5.90 The effective collection of water fees is essential to the development of irrigated agriculture as the full cost of operating and maintaining only the existing irrigation schemes, not to mention expanding them exceeds by far Government budget capacity. The introduction of effective collection has

to go hand in hand with improved services. Enforcement effort should start with rehabilitated schemes. International experience shows the potential for using water user groups with collective responsibility to operate and maintain the secondary and tertiary canals and to raise among themselves the fees that are required for that purpose. The official tariff seems adequate for covering operating and maintenance costs, but would not create any surplus for major improvement of the system. Its generalization should receive first priority.

Road

5.91 Road construction and maintenance responsibilities are greatly centralized. Ministry of Communication, Transports, Posts and Construction (MCTPC) is responsible for the funding of the construction and maintenance of national roads. While in theory, the construction of other roads is the financial responsibility of provinces, in practice no funds are available. Roads are maintained on a contract basis by national and provincial Road and Bridge Maintenance Societies, but lack of funds results in roads in impassable condition. Some roads are being rehabilitated with international assistance from IBRD, ADB, SIDA, and USSR together with a small amount of local funding. The problem of road maintenance is just beginning to be addressed by MCTPC and the aid agencies.

5.92 The self-sufficiency in rice output was a priority of the government of Lao PDR since its first development plan (1981-85). Although this objective is almost achieved, difficulties of transport from surplus regions to deficit regions continue to dampen production incentives of growers while exasperating retail prices in certain markets. Low subsistence costs in rice growing regions have been a factor in retaining the population on the country side and preventing a rapid growth in urban areas.

5.93 The promotion of exports in the early stage of industrialization is likely to depend mostly on resource based products (hydro power, wood products, farm products, minerals, light industries). Export of such products depends greatly, except fcr hydro-power, on the improvement of transport conditions and road network in a land-locked country like Lao. Despite the high volume of investments to be allocated to hydropower investments (35-40% of the total) transport investments also will capture a budget of similar size (about US$300 million) in the period of the third plan.

5.94 Whatever the volume of foreign contributions to the realization of investments, the improvement of the Lao road network greatly depends on the volume of financing the Government can allocate to this sector. Table 5.5 below shows public expenditures in the transport sector in recent years.

Table 5.5: PUBLIC EXPENDITURES IN THE TRANSPORT SECTOR

	Actual expenditures 1986	1987	1988	Budget 1989
1. Government outlays on transports:	4,204	4,716	15,482	16,350
- Foreign aid & loans	2,404	2,869	12,240	13,850
- Local funds	1,800	1,847	3,242	2,500
Equivalent in million US$	44.3	49.6	38.7	32.7
2. Government outlays by mode:				
2.1 Roads	4,198	4,542	14,150	14,280
- Foreign aid and loans	2,404	2,598	10,920	11,800
- Local funds	1,794	1,844	3,230	2,480
2.2 River ports	6	174	1,332	2,070
Foreign aid and loans	0	171	1,320	2,050
- Local funds	6	3	12	20
3. Government outlays by source:				
3.1 National road construction	3,907	4,113	13,336	12,190
- Foreign aid and loans	2,404	2,698	10,920	1[illegible],630
- Local funds	1,503	1,415	2,415	1,560
3.2 National road maintenance	3,907	223	520	1,694
- Foreign aid and loans	0	0	0	1,170
- Local funds	166	223	520	524
3.3 Provincial road construction	8	18	30	40
3.4 Provincial road maintenance	90	160	230	320
3.5 Survey and design	27	28	35	36

Source: SWECO, National Transport Study, Interim Report, Sept. 1989 p. 3.5.

5.95 One of the investment priorities of the Government of Lao PDR has been to reduce the dependence of the country on transit transport via Thailand. Monopolistic practices of Thailand on Laotian transit transports was a factor in the development of an alternative access to seaborne transports. To that effect, a new road connecting Lao PDR to the port of Danang in Viet Nam was built. The transit monopoly power of Thailand has attenuated after this investment. Lao's sandwiched position between Thailand and Viet Nam provides it with a good potential of transit services in cargo traffic between the two countries. The development of this potential requires triangular cooperation and some important investments.

5.96 The share of the transport sector in the total government expenditures has remained around 40% in the period 1986-88 but, due to the devaluation of Kip, declined in US$ value from 44 millions in 1986 to 34 millions in 1989. The share of local financing in public expenditures in transport sector has also declined over the period from 43% in 1986 to 21% in 1988 with only 15% budgeted for 1990.

5.97 The central, provincial and district governments collect different types of revenue on the transport sector. The central government collects sales tax on fuel (10% on diesel, 20% on gasoline, and 10% on oil and lubricants), import duties on spare parts and tires (20%), import duties on vehicles (cars 60%, pick-up 15%, bus 10%, truck 1%, motorcycle 20%), turnover tax (5%) and profit tax (45%) on profits of national transport companies. Provinces receive, besides their import duty shares, the turnover tax (5%) and the profits tax (45%) on provincial and private transport enterprises and vehicle registration fees. Districts collect annual licence fees. Total revenue estimates from these sources are given below.

Table 5.6: TAX CONTRIBUTION OF ROAD USERS

	US $ million	Percent
Central Government	9.49	87
- Diesel tax	0.45	4
- Gasoline tax	1.53	1
- Tax on oils and lubricants	0.12	1
- Import duty on vehicles	2.60	24
- Import duty on spare parts	3.90	36
- Turnover and profit tax	0.89	8
Provincial Government	1.32	12
- Registration fees	0.01	0
- Turnover and profit tax	1.30	12
Districts	0.09	1
- Licence fees	0.09	1
Total	10.90	100

Source: SWECO, National Transport Study, September 1989, p. 3:6.

5.98 The local contribution to expenditure in transport sector has been far too low. Only one half of revenues collected from transport sector in 1989 was reinvested on to the sector; this investment accounted for only one-sixth of total investment expenditure in the sector including foreign aid and loans. However, for a country at on early stage of development there is a

great demand for transport network expansion on one hand, but on the other hand there is a small number of existing fleet from which transport user charges can be collected. Therefore, revenues from transport user charges usually are not sufficient to cover transport investment expenditure and allocation from central fiscal budget is required to fill this investment demand gap. In the case of Lao PDR, foreign aid and loan played a significant role in filling the gap.

5.99 Large initial investments are required to permit the development of road transportation, so that revenues/expenditure ratios comparable to other Asian countries will only be achieved over time. However, judging from international comparisons, the current level of road charges could easily be immediately increased by 50%. A comparison with some other Asian countries shows the undertaxation of road users in Lao PDR (see Table 5.7). In a land-locked, resource-rich country like Lao PDR, it is obvious that economic development greatly depends on the reduction of transport costs. Much of the costs stems currently not from the level of user charges but from the poor condition of the road network. The largest component of the sector related revenues come from import duties; spare parts contributing more than new vehicles. (This may indicate that the existing vehicle fleet is consisting of old and outmode vehicles that often require repair and maintenance). As mentioned above, petroleum products are undertaxed in Lao. As a result, gasoline prices are about 20 percent lower in Lao PDR than in Thailand, while gas oil is more or less at level with Thailand. The imposition of a separate excise on petroleum products to bring gasoline prices to Thai levels might generate the equivalent of $3-4 million. More resources should be generated by increasing licence fees especially on trucks, from their current low levels. Charging licence fees of $50 per car and $90 per truck (comparable to Philippines rates) would generate the equivalent of $1.4 million to the budget. Apart from generating revenues, such measure would also favor a more efficient use of the road network. Lorries are the main source (apart from rain) of road degradation but support few of the costs of the damage they create. Charging higher truck licenses according to axle load of the vehicles would be a way to recoup them. It would also confront road transporters with a more realistic price framework and influence the composition of the fleet in favor of less destructive vehicles.

Table 5.7: ROAD USER CHARGES IN ASIAN COUNTRIES (1987)

	India	Indonesia	Pakistan	Philippines	Lao PDR
	(in percentages of product prices)				
Fuel:					
Diesel	60	0	80	32	10
Gasoline	160	43	170	92	20
Import duty and sales tax:					
Cars (<1600cc)	50	130	150	110	60
Trucks (<12 tonnes)	25	5	30	30	1
Spare parts	70	20	110	30	20
Annual licence fees:			(in US $)		
Cars (<1600 cc)	40	260	30	50	5
Trucks (<12 tonnes)	100	310	380	90	5

Source: SWECO, National Transport Study, September 1989, p. 3:6.

5.100 The realization of highway investments of the Third Plan and maintenance of national road network would not be possible without setting up a strong highways administration and securing an undisturbed flow of funds to its budget. To accomplish this strategic task, the Government has probably no other alternative than setting up an autonomous National Highway Authority with a distinct budget and earmarked revenue. In order to ensure sufficient funding for transport network expansion, revenue earmarking is considered appropriate at this stage until after the network is maturely developed. An appropriate technical assistance program would be needed to upgrade the Highway Authority to required standards. As it is the case in the energy sector, the administrative capability must be much above the common Lao administration to program major transport investments, to monitor their execution and to set up an adequate operating and maintenance capacity.

Post, Telephone and Telex

5.101 Considering the poor state of both its postal and telecommunications (P & T) assets, which to a large extent are obsolete, the financial performance of EPTL's consolidated P & T operations have been surprisingly strong since its creation. However, while net income on domestic operations is getting squeezed between tariffs declining in real terms and costs increasing significantly due to inflation, it is international operations, which in spite of relatively poor-quality service, are carrying EPTL financially to a large extent. Domestic telecommunications tariffs have been adjusted only twice

since 1984, in October 1985 and in July 1988. The latter adjustment came late and both increased compensated too little (on average 200% in 1985 and only 50% in 1988) for major inflation and devaluation since 1985. Since mid-1988, the erosion of domestic telecommunications - and postal tariffs in real terms has continued. Thus, at present, most domestic tariffs are very low, compared to international standards. International telecommunications tariffs, while established in kip are indexed to the US term. The dollar value of International tariffs as last adjusted in July 1988, and its overall level has remained acceptable. To guarantee EPTL's profitability, tariffs adjustments averaging between 80% and 100% for domestic telecommunications are required. Moreover, tariffs should be reviewed on an annual basis to assure that EPTL will be in a position to generate enough cash flow to cover a significant percentage of the cost of expanding the domestic network.

G. Summary of Recommendations

5.102 Improved public resource mobilization through an increase in the fiscal revenues to GDP ratio is needed to generate more funds to restore and enhance the quality and volume of public services. The June 1989 tax reform constitutes a major step in this direction. Apart from the tax discrimination against exports which need to be eliminated, this new system should be further improved to facilitate its administration. Major recommended tax measures are:

- reduction in the number of wage tax schedules and the exemption of lower income and the alignment of the marginal rates of all income taxes;

- reduction of the profit tax rate to 35% and the phasing out of overgenerous tax holidays;

- reduction in the number of sales tax rates combined with the introduction of excise taxes on imports and local production of selected products, including beverages, luxury goods and petroleum products.

- Development of the revenue potential of local taxes (business and vehicle licences, land tax, etc) to alleviate the impact of the transition towards a unified general tax administration on local finance.

5.103 In the field of general taxes, the main challenge ahead lies in the strengthening of the administration. The current system should be restructured along the following two principles. First, revenues should be collected by the administration which is most efficient at doing it. Second, revenues should be shared according to the repartition of functions and competence among the various levels of Government, as determined politically. Because single national administration is most likely to be more efficient at collecting general taxes, it should be created. The competence of local governments should be limited to local taxes, such as agriculture taxes, land

tax, business licenses, etc, and to non-tax transfers from public enterprises under their supervision. Consistent with the federal system, general taxes should be collected centrally and be earmarked for transfer to local governments according to the importance of their attributions.

5.104 As general taxes and custom revenues will remain difficult to collect in the near future given the weak administrative apparatus, three other sources of revenues should be emphasized: financial revenues, public tariffs and user charges and natural resource royalties. Firstly, Government assets and monopoly rights (state enterprise dividends, seigniorage, remuneration on loans and deposits) should yield proper financial revenues. This is the single largest untapped revenue potential. Charging and enforcing a decent remuneration on these assets should generate in the short term about 40 percent of its revenue needs.

5.105 Secondly, public tariffs and other user charges on public infrastructure should be brought to the forefront of resource mobilization efforts. While all other prices have been freed and should therefore reflect more or less scarcity values, public utilities prices, in particular water, electricity, telephone and air transport have remained unchanged. Given the recent inflation their real value has declined sharply. Furthermore, private disposable income has greatly expanded thanks to the reforms, and so has its capacity to afford realistic tariffs. Some price increases have been adopted recently (water and electricity), but they fall short of the required objectives. In the case of electricity, domestic prices have dropped from 2 to 1.5 US cents per kWh from 1987 to early 1990. The fact that the long term marginal cost of producing low-voltage electricity is estimated at about 5-6 cents indicates the magnitude of the necessary adjustment, similar arguments apply to other public utilities. It is recommended that the attitude of Government towards public utilities evolve from refusing to subsidize them (in cash terms) to an active pricing policy according to economic values with a view of generating much needed public resources.

5.106 The same applies other to public infrastructures, in particular roads and irrigation. In the road sector, in addition to the above mentioned introduction of excise on gasoline, vehicle licence fees should be increase to secure additional resources for road maintenance. Given the preponderance of this sector for economic development, it is suggested that the revenues generated by these two measures be earmarked to a Highway Authority to be created for that purpose. Water user charges should be introduced in rehabilitated schemes and collected through water user groups.

5.107 Finally, the Government should rationalize the natural resource tax to further a rational use of the country's largest wealth. Pending the introduction of concession tendering, royalties are the best instrument to this purpose. To avoid inefficiency in the allocation of resources, and because the country can not afford to divert resources from exports, they should be uniform for export and domestic uses. Finally, these royalties should be limited to a small number of significant resources, i.e. minerals, wood and wood products and electricity in order not to overburden the administration.

5.108 The combined implementation of the recommendations concerning financial revenues, road user charges and electricity tariffs and logging royalties would be sufficient to generate about 60 percent of the revenue requirement of 1990, i.e. about 6.6 percent of GDP. Given their relative administrative simplicity, they should receive the highest priority.

VI. ENHANCING PUBLIC EXPENDITURE MANAGEMENT

A. Introduction

6.1 The opening up of the Lao economy to the world economy of market-oriented countries has direct implications on the way public expenditures are managed. The move away from a centrally-planned economy based on production targets and rigid controls requires a fundamental rethinking of the role of Government; if the Government is to create the conditions for the economy to grow, and to support it with well-administered and properly-funded services, established expenditure planning and management practices will need to be overhauled.

6.2 Under the NEM, much attention has been paid and progress made to establish a supportive framework of price and other incentives.These reforms are impressive. They must be complemented with the establishment and successful operation of a system of reformed public expenditure management. From an institutional and technical perspective, Lao PDR is at the crossroads between central planning and indicative planning. Firstly, the instruments and set-up for central planning have not been fully dismantled; at the same time the Government is not yet equipped with the appropriate mechanisms, administrative set-up and conceptual tools for public expenditure programming under a system of indicative planning. Secondly, the budget still lacks the instruments to effectively orient the composition of Government expenditure and manage their level as required for aggregate demand management. Thirdly, the decentralization of Government has been pursued to an extreme where the benefits in terms of administrative efficiency are outweighted by the fragmentation of public policies and a worrisome increase in regional disparities. Fourthly, the coordination of foreign aid has suffered from the the weakening of planning capacities. This chapter develops recommendations to strengthen each of these aspects of public resource management.

B. Expenditure Planning

From Control Planning to Indicative Planning

6.3 Following the proclamation of the Lao PDR in 1975, the Government tried to rebuild an economy devastated by war by introducing a command economy. To manage the economy, a highly centralized form of control planning was adopted, employing varying combinations of controls in an attempt to achieve a prescribed production pattern. Capital and labor were allocated with regard to centrally planned production targets. Planning was done with three different time horizons: a perspective plan until the year 2000,the Five-Year Plan (FYP), and the Annual Plan (AP). A State Planning Committee (SPC) was established, and civil servants were sent to countries of Eastern Europe, Viet Nam and the USSR to become acquainted with the system. Traditional socialist accounting (MPS) was introduced. The budget was the main instrument of financial control.

6.4 In the initial three-year plan (1978-80), the first Five-Year Plan (FYP) (1981-85), and the second FYP (1985-90), ambitious production and

consumption targets were established and resources were appropriated in physical quantities. The overall growth rate for the economy for the second FYP was set at approximately 10%, and individual sector performance requirements were equally elevated. The five-year plans were accompanied by lists of projects to be implemented during the plan period. These lists provided information on total cost, total expenditures prior to the period under consideration, global expenditure projections over the period, and sources of financing. Sector strategies were not elaborated; five-yearly policy guidelines issued by the Party Congress guided project selection decisions. The FYP contained relatively little text and analysis.

6.5 The Annual Plan was conceived as the operational planning document, to provide the link between planning and budgeting. Each Annual Plan contained a series of detailed output objectives and an investment plan. The investment plan listed projects by ministry, with estimated local expenditures during the previous year, local and external expenditures during the year under consideration, and sources of financing. Yearly policy guidelines issued by the Party dictated expenditure priorities. The Annual Plan provided assessments of progress both in physical and financial terms relative to the budgets set in the plan for the previous year. The reconciliation of projects to the financial resources available in the budget was made in the course of meetings of the Planning Allocation Committee. This committee comprised senior officials of sectoral ministries, the Ministry of Finance, and the SPC.

6.6 The SPC was a large organization, with six vice chairmen in charge of no less than 16 departments, including General Planning, Statistics, International Economic Relations, Culture, Training, Mekong Committee, Capital Investment, Agriculture, Industry, Finance, Pricing, Labor, Trade Planning, Communications, Transport, Materials and Equipment, Interior Affairs, and Defense. The SPC was responsible for converting resolutions and decrees of the Party and Council of Ministers into planning directives for technical ministries and local authorities, and reviewing and coordinating the Annual Plans prepared by technical ministries and local government planning departments, as well as conducting a semi-annual review of the implementation of the Annual Plans. Over the years, it had become the dominant development coordination agency of the Government, employing up to 300 persons.

6.7 As part of the planning apparatus, each technical ministry was expected to establish its own planning and statistics department, with responsibility for (a) coordination of development programs of the ministry, including those of the local authorities, and integration of programs into the ministry's Five-Year and Annual Plan; (b) identification and preparation of projects for bilateral and international assistance; (c) gathering and analysis of data, supervision and ex-post evaluation of programs and projects, and (d) preparation of the investment budget. Execution of investment projects was left to concerned departments and enterprises of the technical ministries, and the local authorities. The budget departments of the technical ministries prepared recurrent expenditure and revenue estimates.

6.8 By the mid-eighties, it was becoming increasingly clear that the system of control planning was not working. Implementation of the plans came up against a series of constraints which hindered the achievement of the targets. Five-year plan projections of GNP, domestic national income, and labor productivity increases were unrealized. For the most part, priority items of grain and food-consumer-export products were under production quotas.

The emphasis on regulating physical quantities of resources for final consumption, export or production did not result in an efficient allocation of resources. Besides, systems of central planning are complex; they require a high degree of knowledge of the structure and requirements of the economy and a relatively high level of skills to manipulate, none of which were available in Lao PDR. In 1986, the Government decided to move away from comprehensive administrative regulations of economic activities towards allowing a greater degree of economic autonomy within a market-oriented framework. In the context of the NEM a decision was taken to replace the system of control planning with indicative planning.

6.9 In a system of indicative planning, the Government no longer prepares a long-term blueprint for development of the whole economy with detailed quantitative targets for public and private investments and outputs. Analytical and planning efforts are concentrated on two essential tasks: (a) devising a sound public expenditure/investment program to support the economy with well-administered and properly funded services that the public sector is best suited to provide; and (b) establishing an appropriate macroeconomic framework, which is composed of a series of flexible interlocking policies--including fiscal, monetary, foreign exchange, trade, and wage policies--that affect all aspects of economic behavior. In other words, rather than adopting an interventionist approach the Government makes greater use of markets and prices while concentrating on programming of public rather than total investment. Emphasis is placed on devising a framework of price and other incentives to guide, not regulate, private activity and on designing an appropriate public investment/expenditure program.

6.10 A system of indicative planning, as described above, implies shifting the focus away from the interventionist fixed target concept of planning towards a much more flexible operational method of medium-term public expenditure planning, based on availabilities, not needs, thereby creating a framework within which policy and program trade-offs can be faced.

6.11 Indicative planning approaches may vary in detail but have several common elements: the coordination of macroeconomic analysis with public expenditure planning and budgeting over a three- to five-year horizon. The starting point is preparation of macroeconomic forecasts to provide a framework for making decisions, including those about feasible growth patterns for the economy and feasible annual levels of investment. This is followed by the identification of effective sector strategies that strike the right balance between direct intervention such as public investment and indirect means such as the policy environment, along with an assessment of the consistency among the various sector programs. Once a multi-year public investment program (PIP) consistent with the macro-framework is prepared, it must be phased for implementation in the form of programs that can be integrated with the annual budget. A fiscal plan should be developed, including revenue forecasts, estimates of resources available from domestic and external borrowing and grants; and projections of current expenditure including debt-servicing, defense, administration and recurrent expenditure on development.

Issues

6.12 At this time the Government is not equipped to meet these challenges. The Government continues to use the planning and budgeting instruments

described above: the FYP, the AP and the budget. Their outlay and context are virtually unchanged. Since the abolishment of the SPC, the planning functions of the central government are executed by the General Planning Office and the Capital Investment Office of the MEPF. There are no operational manuals which clearly spell out the responsibilities and the division of labor between the different institutional actors.

6.13 The present planning framework relies too much on a static long-term perspective. The Annual Plan, conceived as the operational planning document to provide the link between planning and budgeting, is a cumbersome exercise. The investment part of the Plan is prepared without projection of future capital costs, information on total project cost, recurrent costs after completion, or information on total expenditures prior to the year under consideration. It does not provide sufficient assessments of progress or prospects both in physical and financial terms relative to the five-year targets to serve as the operational framework of the FYP. The first part of the Plan which contains output and production targets no longer has operational relevance to the new system of economic management.

6.14 Nevertheless, the General Planning Section of the Department of Economic and Social Strategy and General Planning continues with the definition of production and output targets and the calculation of national accounts according to the MPS methodology but is not equipped with the skills required to conduct macroeconomic analysis, as is required under the New Economic Mechanism. Because these targets are no longer directive, the scope of its functions has been reduced to consolidation of the inputs of the technical ministries and the provinces, and its staff has been reduced from thirty to seven. The entire Department counts with a staff of twelve.

6.15 The Capital Investment Department now has a staff of only four full-time professionals. Its main functions consist of (a) global screening and review of the investment projects and annual plans prepared by the technical ministries; (b) preparation of the Annual Plan and the capital estimates for the budget; and (c) semi-annual reviews of the Annual Plan; (d) monitoring of plan implementation. With such a small professional staff, the Capital Investment Department is unable to assume its present role of global screening and review of the investment programs. Its staff is absorbed by ad hoc assignments, most of which consist of interacting with the international and bilateral donor agencies. In the absence of sectoral strategies and clearly established project selection criteria and evaluation techniques, donor preferences and availability of financing have become the dominant factor in the selection process. Cuts in the annual investment allocations are made across the board, rather than on the basis of an analysis of trade-offs between different expenditure patterns within and between sectors. Furthermore, it is not uncommon for projects to be presented to and approved by the Council of Ministers outside of the regular planning framework.

6.16 The planning functions of the technical ministries have remained unchanged, except with regard to the investment projects and plans of the local authorities. While sectoral ministries are endowed with much larger planning offices, they are constrained in the execution of their functions by the lack of data, equipment and analytical techniques and skills. Information on recurrent costs is not readily available for subsectors other than roads and engineering. Procedural manuals and guidelines are absent. There are no operational project and program monitoring systems. In the education sector,

for example, the main responsibilities of the Ministry of Education in the area of educational planning, programming and financing are the following:

(a) coordination of development programs of the Ministry, integration of programs into a global plan, identification and preparation of projects for bilateral and international assistance, liaison with the Capital Investment Department (for project approval, annual plan expenditures) and the Budget Department (recurrent expenditures); and

(b) gathering and analysis of data, supervision and evaluation of programs and projects, development of plans and preparation of overall investment budgets, and preparation of plans/models of primary and secondary schools.

6.17 Since 1986 local authorities are responsible for identification, appraisal and execution of investment projects falling under their jurisdiction. Annual plans should be sent to relevant technical ministries for approval, or screening for consistency with sectoral strategies. Projects with external financing remain under the control of the central government. Responsibility for execution of national and local projects rests with the technical ministries and the local authorities, respectively.

Priorities for Improvement

6.18 A first priority should be to introduce flexibility in the system, and to plan on an availability basis rather than needs. The FYP needs the support of an operational tool for allocating public resources on a medium-term basis. Investment decisions should be rationalized and prioritized and planning capabilities could thereafter be upgraded. Over the longer term, the medium-term investment program could thereafter be upgraded into a full-fledged expenditure program, as the administration develops its capacity to conduct macroeconomic and policy analysis.

6.19 (i) The Five-Year Plan. In a more open economy, the FYP no longer plays the pivotal role it played in a closely regulated system. This does not suggest that the FYP should be dismissed outright. It remains a useful framework for addressing certain long-term aspects of the development strategy, generate public support for national goals and foster interministerial coordination of policies and programs. A radically different approach to the FYP is required, however. Rather than developing a comprehensive detailed blueprint for the development of all or parts of the economy and attaching a fully phased investment program, the Government would be well advised to concentrate on: (a) developing effective sector strategies that strike the right balance between direct means of intervention such as public investment and indirect means such as the policy framework; (b) designing cost-effective global programs (not projects) within indicative resource envelopes to implement sector strategies; and (c) developing a simple macro framework, as a context for the sector strategies and programs. The sector strategy statements can help to (i) achieve consistency between macroeconomic sector targets and the prospects for individual sectors and (ii) clarify linkages to programs in other sectors.

6.20 (ii) The Medium-Term Investment Program. To serve a useful purpose, such a five-year plan needs to be complemented with an operational tool for allocating public resources on a medium-term basis. It is recommended here to

replace the existing Annual Plan procedure with a rolling public investment program (PIP), to be expanded into a full-fledged rolling public expenditure program at a later stage. A rolling multi-year PIP comprises the investment outlays which the Government plans to make over a given period. It is much more than a budgetary appropriation for capital outlays. It involves a ranking and prioritizing of projects according to specific criteria, and phasing outlays over the program period. The projections are reviewed and adjusted annually in light of actual expenditures and changed circumstances. It is designed to show previous expenditure on each project, as well as the balance of funding required to finish the project, and possibly its recurrent cost implications. The adoption of a PIP as the operational framework for the plans and programs contained in the FYP has many advantages over the Annual Plan:

- Transparency of investment decisions. Projects are seen in the light of their lifetime cost, and not simply in terms of spending proposed for the upcoming fiscal year. It allows the Government to have a clear understanding of the magnitude and composition of investment outlays, and of their implications for future resources and their utilization. It also provides a much clearer picture of the extent to which there is scope for new projects in the outer years of the program.

- Intersectoral balances. It encourages examination of relationships among similar projects or among projects in specific sectors and geographic areas, where now projects are by and large examined individually.

- Prioritization of investment decisions over the program period according to well-established criteria in the context of the development strategy and the indicative sector shares established in the plan.

- Flexibility in adjusting plans and programs. Rolling PIPs introduce the needed element of flexibility to make short-term changes quickly and efficiently. Experience to date, as well as the uncertainty of future prospects, suggest that investment programs need to be modified repeatedly as economic conditions, resource availabilities, and other circumstances change.

- Guide during implementation. It allows managers to keep track of where a project stands in its implementation cycle and flags delays in implementation of the program.

- Automatic link between planning and budgeting. Because the Five Year Plan is rolling, and its review and updating process has been institutionalized on an annual basis, year one can serve as the input into the capital budget cycle.

- Simplicity. It is a simple tool, used by many developing countries. It does not require sophisticated planning, and forecasting techniques.

Given the inherent uncertainty in forecasting exercises, the tradeoffs to be considered, and the iterations that would be required to achieve consistency,

it would be more feasible to formulate the PIP over a three-rather than five-year period.

6.21 (iii) The preparation of a policy document detailing the technical, financial, economic, and management criteria to be used in determining project priorities and conditioning financing approval, would help the Government rationalize and prioritize public investment decisions. The criteria for deciding on investment allocation within and between sectors typically include recurrent cost implications, availability of funds during the life of the project, gestation period, economic, financial and technical feasibility, employment impact, priority of the sector, rehabilitation and completion of existing investments, and strategic importance of the project.

6.22 (iv) Over the longer term, the medium-term investment program would lay the groundwork for a full-fledged expenditure program covering all public expenditure. Such an instrument would permit the extension of the programming horizon for current expenditure, which is just as useful as capital expenditure planning. A consolidated presentation of current and capital expenditure over the medium term would clarify the current and upcoming options and constraints and help improve the overall allocation of resources to all government levels. Although certain studies conducted by the staff and experts of external donors give valuable information on expenditure needs in education, health, agriculture and transport sectors, a more global review of the volume and functional and sectoral breakdown of public expenditures would help set expenditure priorities consistent with the Lao PDR's new economic policy, including a thorough review of recurrent expenditure implications of ongoing and proposed projects.

6.23 (v) Another long-term objective is the development of an in-house capacity to conduct macroeconomic and policy analysis. Long-term technical assistance is required to equip the Department of Economic and Social Strategies and General Department with the capability to construct economic scenarios based on a simple analytical framework in order to trace the relationships between key variables as they respond to reform efforts, interpret and monitor macroeconomic indicators, and conduct macroeconomic analyses of the impact of policy changes on the public expenditure program (e.g., the long-term budgetary implications of rapid growth in recurrent expenditure in certain sectors; the impact of eliminating producer subsidies or domestic price controls on certain sectors; or the consequences of eliminating certain distortions in the presence of others, etc.). Over time, the General Planning Office could therefore more effectively assume responsibility for the macro-framework of the Five-Year Plan and the PIP.

C. The Budget System

The Framework

6.24 The budget has been, and will remain, the principal instrument of financial control and short-term economic management. No hard and fast rules exist on the formats budgets should take, or procedures they should follow other than that they should promote transparency, allow effective execution and expenditure control, and facilitate fiscal planning. The budgetary process in Lao PDR does not yet fully respond to these requirements.

6.25 Budget preparation. The budget is divided into a current and a capital component and covers the central government and the local authorities. A cross-classification of expenditures is used (by nature and purpose); it is based on the IMF classification of public expenditures. Budgetary receipts are listed by source, but the Government is considering reclassification by type to facilitate analysis. Budgeting practices preclude the earmarking of revenues but transfer of accounts is allowed. There is no formal published budget document. Preparation of budget estimates is the responsibility of the Budget Department of the MEPF, which has a staff of seventeen. Budgeting is done on an incremental basis. The Lao fiscal year coincides with the calendar year; the preparation process begins in October. In the absence of clear guidelines or global ceilings from the MEPF, past expenditure patterns largely determined the size and composition of recurrent budget proposals prepared by line agencies. The format and classifications of line ministries and provincial budget proposals are compatible with those used by MEPF. The Budget Department makes a first series of global cuts across the board on the basis of a previously determined resource envelope and submits both versions (provinces and line agency proposals and MEPF revisions) to the Council of Ministers for consideration along with the budgets of the provinces. This is followed by a process of arbitrage. After global cuts have been agreed upon, further decisions are left to the discretion of the technical ministries. The Capital Investment Department of the MEPF is responsible for the capital estimates which it prepares on the basis of information contained in the line ministries' submissions for the Annual Plan.

6.26 Budget execution. The budget is executed on the basis of a global credit authorization by the Minister of Economy, Plan and Finance. The credit release is general and unconditional: spending departments are given full authority to commit funds as soon as the budget is approved. Expenditures are authorized by the line ministries. They decide how much is spent, and on what within the capital and current expenditure categories, and give spending authorization to their individual project managers. Spending authorization lapse at the end of the year but the ministry may in the course of the financial year reassign funds within expenditure categories. Payment authorizations are made by the Budget Department of the MEPF on a quarterly basis upon submission of provisional expenditure statements by the spending departments. In times of financial crisis, however, payment authorizations are made on a monthly or even ad hoc basis. Until recently, the State Bank acted as treasurer of the Government; it kept the public accounts and assumed responsibility for financial control. A Treasury Department has now been established in the MEFP but its functions and the role are yet to be clearly defined. There is no systematic monitoring or control of expenditure.

Issues

6.27 (i) The existing separation of the budget into current and capital components, rather than current and development or aid components in itself offers several advantages: It demonstrates the true investment proportion of government outlays in terms of physical capital formation and makes it easy to decipher the budget in national accounts terms. Also, by clearly separating expenditures for the creation of capital assets and their operation, it demonstrates the implications of large investment programs and specific projects on the budget. In other words, it allows meaningful planning of investment outlays (e.g., postponing or modifying projects that imply unaffordable recurrent costs). Unfortunately, Lao PDR does not exploit these

features, because its recurrent budget does not include a specific provision for O&M expenditures of projects.

6.28 (ii) A preliminary investigation of the budget nomenclature suggests that the existing classification of expenditures and revenues may not be satisfactory. The expenditure classification by nature and function does not appear to be internally consistent and uniform, or compatible with the accounting system nomenclature.

6.29 (iii) The budget coverage is inadequate. The budget is an incomplete record of public expenditure and revenues. In the first place, with exception of counterpart funds generated by foreign balance of payment support, aid received from donors does not pass through the budget. Direct payments made by donors to suppliers and contractors, aid in kind and grants for certain developmental purposes, including technical assistance, escape the budget. In consequence, the accounting system fails to capture fully investment expenditures. As a result, the full value of expenditure on projects is not reflected in the budget, which in turn obscures the recurrent dynamics of the capital investment program. If capital costs are understated, the main yardstick for estimating the operating costs of investment projects once the capital expenditure phase is completed is necessarily false. This problem is compounded by the fact that the budget does not include a provision for O&M expenditures.

6.30 (iv) Another important presentational deficiency is the lack of transparency: information on a capital project's total cost, progress towards completion and its implications on the government budget are not provided. In its present format, the budget recognizes only the current year's cost of projects. It is not possible to relate this to (a) the total estimated cost of the project; (b) the amount already spent in previous years (some information is given on the preceding year's expenditures, but there is no way of telling whether the project began in that year or many years earlier); (c) the amount required to complete the project; (d) its recurrent cost implications after completion. These are serious omissions, especially when a decision has to be made whether to approve the first year's expenditure allocation of a proposed project.

6.31 (v) The principles governing the distribution of budgetary resources are not clear. At present it appears that the major objective of the budgetary exercise is to decide on the division of resources between the current and the capital budget. Allocations for current expenditures are made using past expenditure patterns. For capital projects, outdated cost estimates in project documents tend to be used rather than a realistic estimate of current requirements. Line ministries are not given specific guidelines or global ceilings within which to determine expenditure priorities. As a result the budget preparation process is conducted on an incremental basis with cuts made across the board, without analysis and prioritization of expenditures in terms of national priorities, cost effectiveness or social impact.

6.32 (vi) In the absence of well-established project and other expenditure monitoring systems and sound expenditure recording practices, the Government has not been able to maintain a minimal degree of expenditure control. Fund releases and expenditure authorizations are not conditional on submitting project accounts or progress reports. Current procedures for expenditure

monitoring are inadequate for tracking and controlling total public expenditures. During the course of the budget year, the MEPF monitors its financial position by looking at its cash balance. The information on expenditures at a ministerial or local level which is sent to the MEPF is not processed in time to permit the data to be used to monitor the outcome and the status of the expenditure program. The discretionary expenditure authorization power of line ministries in the absence of clear accountability for the management for public expenditures may lead to misappropriation of funds and generates large expenditure overruns which account for a significant share of overspending in the current budget.

Priorities for Improvement

6.33 The Government is already undertaking to tackle the deficiencies of its existing procedures. Improvements will be made this year to the existing public accounting system, to make it more operational. The recently established National Treasury Department is in the process of taking over all Treasury-related functions from the State Bank. A posteriori financial control will be done by a new Financial Inspection Department. The Study and Research Unit of the Budget Department will be staffed. The Treasury Department will also take responsibility for funds release authorization, leaving the Budget Office the opportunity to concentrate on fiscal forecasting, budget preparation and implementation monitoring.

6.34 These actions will go a long way to improve the existing budgetary system, but further modifications are required if the budget is to serve as an effective mechanism for public expenditure allocation. It is suggested here that the Government improve its budgeting techniques and place greater emphasis on using the annual budget cycle as the primary tool for reviewing public resource flows to the various sectors. The main underlying weakness of the system today is perhaps the perception of the budget as an accounting exercise rather than an important means for expressing the Government's priorities in the public expenditure program. The objective is to develop a system whereby core and line agencies can be forced into considering spending alternatives within predetermined resource envelopes, and ensure that real priorities will be established and programs executed in a cost-effective manner.

6.35 This report does not argue in favor of comprehensive budgetary reform. In the experience of other countries, new systems have proven difficult to introduce; they require institutional capacities and techniques which are not within reach of the Government. The Government is best advised to stay with the existing system, and introduce certain changes highlighted below:

(i) Publicity. The budget includes some of the most important information which economic agents need. It is a policy statement by the Government indicating the means which will be devoted to the attainment of certain policy objectives. To serve its purpose of orienting economic activities, it must be published.

(ii) Budget Law. Before enacting the projects under preparation, the Government should examine the proposal for consistency with the overall legal framework, and evaluate the practical applicability of certain provisions such as investment expenditure authorization by

tranche or program, carry-overs of credits, and supplementary credit procedures. Also, to avoid misinterpretations, certain provisions need to be spelled out more clearly, especially those which pertain to financial control and expenditure authorization.

(iii) Budget Classifications and Configuration. A detailed study of the current budget nomenclature and the structure of the budget system is necessary to ensure internal coherence of the budget classification, its compatibility with the nomenclature of the accounting system, and usability with modern electronic data processing equipment.

(iv) Budget Coverage. The study mentioned under (iii) could also usefully include recommendations to improve budget coverage, including revenue and expenditures from external sources.

(v) Budget Guidelines. At present, the Budget Department does not issue annual budget guidelines to the line agencies. In other countries, the budget guidelines have developed into a strategic document that outlines the government's expenditure priorities for the coming year, advises ministries of the resource envelope within which to prepare their budget submissions, and provides technical information to allow ministries to estimate their costs for the coming year (e.g., the fill ratio for vacant positions, expected inflation rates for recurrent cost elements, etc.). This process accomplishes several objectives:

- It provides an opportunity for the political leadership to indicate priorities for the public expenditure program before the budget cycle begins, so that the final budget document reflects a sense of direction rather than representing a continuation of past trends.

- It provides ministries with enough information so that they can make realistic choices about the direction and composition of the expenditure program, rather than defending their submission on the basis of inputs (e.g., staffing ratios).

- It allows budget officials to establish guidelines that the ministries should take into account in making their submission (e.g., full funding for core projects, adequate provision for O&M, etc.).

(vi) Development of a methodology for the evaluation and forecasting of investment-generated recurrent expenditures. All technical ministries should calculate the O&M implications of their ongoing and proposed investment outlays. This information would permit the elaboration of aggregate recurrent expenditure estimates over a period of three to five years, revised and updated yearly. The aggregate estimates for a given technical ministry for a given budgetary year, once analyzed by the Capital Investment Department, would assist it in the preparation of the current budget.

(vii) Prior to changing existing public accounting system, the Government will want to be assured of the feasibility and practical applicability in the Lao context of the changes being prepared. Several of the proposed procedures appear to be unnecessarily cumbersome; others need to be further specified; additional work is

needed to make the budget and the accounting compatible and to ensure internal consistency of all provisions contained in the latter.

(viii) Expenditure reporting and recording practices must be improved if the Government is to monitor and control financial performance of its programs. A practical management information system could be developed based on information generated by the accounting system and other monitoring systems.

(ix) Engage in medium-term financial planning. In the short term, a large part of expenditures unquestionably will remain non-discretionary; over a longer period, however, choices may expand and options emerge concerning not only the composition and size of the public expenditure program but also between different totals and allocations of current and capital expenditures and their phasing. The introduction of a forward budget--a three-year indicative plan for central government expenditures, covering the three first years following the budget under implementation--can help Lao PDR think more systematically in terms of expenditure priorities within a projected resource envelope (e.g., revenue, external capital inflows). Such a medium-term financial framework could consist of:

- A three- to five-year estimate of the likely level of domestic and external resources, examined initially as percentage shares of GDP, and later, perhaps, converted into cash limits;

- Overall expenditure levels, consistent with fiscal deficit targets and expected financing;

- Projections of debt servicing;

- Indicative sector allocations, for both the recurrent and capital budget components;

- Analysis of the share of total expenditure going to wages and salaries to enable alternative assumptions on pay and numbers to be tested; and

- The recasting of the recurrent capital budget to enable recurrent costs of programs to be identified and projected.

(ix) As a first step the Government could develop budget restructuring scenarios, based on simple spreadsheet models of the current budget, projected forward three to five years. Incorporated in the projections are assumptions about: staff retrenchment, pay increases, salary decompression, restoration of other charges, parastatal restructuring, aid flows and domestic revenue growth. In addition, a number of arbitrary assumptions are made about limiting or increasing the shares of certain categories of budgetary expenditures. Both these and the underlying growth formulae can be varied to create and test other scenarios, and to illuminate the trade-offs between different fiscal strategies.

D. Decentralization of Revenue and Expenditure Assignments

The Framework

6.36 Administrative Organization. Lao PDR is a highly decentralized country. Historically, the provinces have always enjoyed a great deal of autonomy and power, culminating in 1986 with the decision by the Fourth Party Congress to make local governments completely self-sufficient. From an administrative perspective, the responsibility for planning, management, and allocation of their resources has been transferred from the center to the regional authorities, with the exception of projects financed from external sources, which remain under the control of the central government, and subjects which are considered to be of national interest (security, defense, national roads, etc.). Because of the existing tax system under which each level of government collects all taxes on taxpayers under its authority, and all revenues, except a portion of the export taxes, accrue to the authority which collects them, the decentralization policy instituted by Lao PDR is quite radical: local governments have been given not only the authority and responsibility, but also the control over resources to perform their new functions.

6.37 Before 1986, the provinces already had tax collection authority, but they drew on the central government budget for specific projects or needs. Budgets were appropriated by the Ministry of Finance to a sectoral ministry, which in turn, distributed the funds to the relevant local department. Equipment and materials financed by foreign loans and grants were imported by the State Trading Company and distributed to the provincial authority by the responsible ministry. Except for small projects, provincial governments would provide only transport, manual labor and other local inputs needed for project implementation. Salaries were paid by the central government.

6.38 The main problems with this system were the scarcity of qualified personnel at all levels and, above all, the communication problems. In the education sector, for example, schools were expected to send their programs and data to the towns for transmission to the higher level (district); the districts gathered all the information for transmission to the provincial offices, etc. Forms that should have been completed in the provinces, however, were received very late in Vientiane and often the data were not precise enough to give an exact idea of provincial realities. There was no direct communication between the ministry and the schools, towns and districts. Consequently, the ministry often was unaware of essential data, as for example, the number of villages without schools, the drop-out and repeater rates at various school levels, etc.

6.39 Rationale for decentralization. Supporting documentation of the decision of the Fourth Party Congress in 1986 to adopt such a radical decentralization policy is not readily available, but the rationale seems clear:

- As illustrated amply by the education sector, in a country which faces such enormous internal communication difficulties due to its woefully inadequate transport and telecommunications network, many functions that are the responsibility of central ministries or agencies are performed poorly because of the difficulty of extending central services to local communities. In such a set up, maintenance

of roads, irrigation channels and equipment, and other basic physical infrastructure is sometimes done better by local governments when they are given adequate funds and technical support--than by central agencies, which cannot easily monitor deterioration or breakdowns.

- Decentralization could increase the efficiency of central ministries by relieving them of routine, repetitive tasks, thus reducing these administrative burdens and allowing more time to plan and monitor programs that absolutely require central direction or control.

- And, finally, there are financial arguments: shifting part of the burden for support of public services to the local governments becomes an attractive alternative when the central government faces severe fiscal constraints.

In sum, decentralization is expected to lead to improved economic management, and contribute to optimal administrative and financial efficiency.

Issues

6.40 Five years after its introduction the policy is encountering serious problems. Rather than leading to increased government revenues, it has resulted in weakened control of the central government over its finances. Few provinces are self-sufficient, the others having to rely on central government resources to subsidize their deficits. Regional disparities are accentuated. Inter-governmental relations are deteriorating. The quality of services rendered to the population is deteriorating and regional investment decisions are not made in the context of a well-defined national and regional development strategy.

6.41 (i) Absence of national and regional development strategy. Relationships between local governments and sectoral authorities have broken down almost completely; budgets and annual plans are no longer sent to technical ministries for approval, or screening for consistency with the sectoral strategies. Often, they are submitted directly to the MEPF for submission with the central government budget to the Council of Minsters and the People's Assembly, with perhaps a copy to sectoral ministers for information. Sectoral ministries generally do not have information on investment activities in the province. Because of their integration in the Central Committee and the Council of Ministers, it is not unusual for provincial authorities to bypass the regular channels. Local governments generally lack suitably trained personnel and the technical capacity to formulate a regional development strategy or to identify, appraise and execute investment projects. As a result, it is not uncommon for those local governments which have sufficient resources for investment to commit these resources to unviable projects or low priority areas. According to the Ministry of Agriculture, the agriculture sector is generally neglected by provincial governments. Factories have been established and hospitals for which no recurrent cost financing is available.

6.42 (ii) Regional disparities. Most provinces, however, have little resources left for new investments. With the exception of Champassak, Savannakhet, and the Prefecture of Vientiane, provincial governments do not have the financial capability to cover their recurrent costs. Local public expenditure management and budgetary practices are generally deficient. While

budgets are balanced pro forma for submission to the MEPF, in reality most expenditure programs are grossly underfunded. For example, in Luang Prabang actual expenditures in 1989 exceeded estimated outlays by more than 100 percent; they exceeded actual revenues by approximately 30 percent. In the poorer provinces, not only roads, but virtually all government-operated infrastructure have deteriorated due to lack of maintenance, causing crippling bottlenecks; delays in the payments of civil servants' wages are common. In such circumstances, the continued diligence of public officers in certain provinces, in spite of the fact that they have not been paid for several months, is impressive. It is difficult to see, however, how public servants can devote themselves entirely to their official employment; in the case of teachers and medical personnel, the quality of service is becoming an issue of great concern.

6.43 (iii) Impact on the Central Government Budget. For the central government, instead of contributing to increased revenues, the local authorities are actually draining them: because of the absence of a regional equilibrating mechanism, the central government is forced to come to the automatic rescue of the poorer provinces without any form of control over how funds are dispersed by these provinces.

6.44 This situation is the direct result of the way in which the decentralization process was conducted: no consideration was given to the administrative capacity of the various provinces to carry out the responsibilities assigned to them, the amount of financial resources which would be needed to implement the functions transferred from the center, or the revenue-generating capacity of the respective local authorities. Detailed legal or procedural norms defining the respective powers and responsibilities of central and regional authorities do not seem to have been spelled out. The experience of Lao PDR clearly demonstrates that decentralization cannot be a quick-fix for administrative and financial problems. As with all managerial activities, the more successful decentralization efforts have been those that are thoroughly prepared and carefully implemented.

Priorities for Improvement

6.45 The existing situation of excessive local autonomy without accountability must be redressed, and the desirable level of decentralization determined. The challenge for Lao PDR is to find the proper balance between decentralized and centralized arrangements and to link them in ways that promote development most effectively. That optimal mix is not easily determined. Care must be taken not to re-establish full central control over finances which would overload the center, result in administrative bottlenecks, release of allocated fund problems and other negative aspects of the pre-1986 situation.

6.46 To redress the existing situation the Government should undertake the following steps:

(i) Assess the local finance situation of each province and evaluate the administrative capacity of individual provinces to undertake functions presently assigned to them.

(ii) Determine which functions will be reassigned to/transferred from the center and the amount of resources needed to implement the functions which are transferred from the center.

(iii) Establish a financial control mechanism over provincial expenditure and establish clear operational guidelines, legal norms and procedures governing the relationship between the center and the local authorities and proper communication channels.

(iv) Recentralize general tax collection and administration authority and develop incentives to increase local revenue mobilization and improve fiscal performances. A system of earmarking national funds, and transfers between provinces and between the center and the provinces, must be established. The distribution formula would take absorptive capacity, population size, fiscal capacity and effort of individual provinces into account. It should take the inequities between well-endowed and other areas into account and find a way to ameliorate provincial inequalities by favoring the poor, underpopulated areas and reward local fiscal efforts. Percentages of funds to be directed at investments must be specified.

(v) Upgrade the administrative capacity of individual provinces to carry out responsibilities which are assigned to them. In recognition of institutional weaknesses, technical assistance and training must be made available in areas such as accounting, formulation of development strategies, project proposals, etc.

E. Aid Coordination

The Framework

6.47 With the dismantlement of the planning apparatus, the Government has been deprived of a much needed instrument to coordinate its development strategy and thus aid flows. Formerly, requests for external donor assistance were processed by the SPC. Institutional arrangements and responsibilities for dealing with external aid are now widely dispersed and largely opaque. Requests for assistance from western bilateral donors, non-government organizations (NGOs), and the UN are collected by the Vice Minister for Economic Cooperation in the MCEER, cleared by the Prime Minister and formally requested by the Ministry of Foreign Affairs. His counterpart, the Vice Minister for Economic Cooperation with Socialist Countries deals directly with relations and aid from those countries. The MEPF also has an office for coordination with socialist countries, while its External Finance Department handles lending programs from multilateral sources. Technical ministries also deal directly with donors; the Department of Planning and Finance of the Ministry of Agriculture, for example, has a division of five people in charge of international cooperation. In the Ministry of Transport, foreign projects are handled by a Project Management Committee; its Economic Planning Department has a Division for Foreign Relations.

Issues

6.48 This set-up does not allow for proper aid coordination. The costs of operating without a clearly defined aid management strategy and a functional

aid coordination mechanism are high: Lao PDR is a "high aid inflow" country; with the opening up of the economy, the country is receiving increasing attention from western countries. The success of the NEM is, to a large extent, dependent on financial and technical assistance in all sectors; the Government can ill afford to waste scarce resources on low priority areas, or to duplicate efforts. The administration is overwhelmed by short-term missions and visitors. The administrative capacity is simply too weak to continue operating under the present conditions, where senior officials in core ministries are spending more time dealing with multilateral and bilateral donors than on managing the reform program, thinking about how policies should be developed, coordinating line ministry activities, and weighing the advantages and feasibility of recommendations made by the various external agencies and their compatibility with other reform measures. In other words, aid coordination and management is a prerequisite for economic management, and should be given urgent consideration.

Priorities for Improvement

6.49 To address these issues, the Government may want to undertake the following steps:

(i) Develop an articulate aid management strategy in conjunction with the planning exercise. This implies having a clear view on the areas and sectors in which to channel aid flows, their financial terms, the areas and projects slated for particular donors to support, and a capacity to control and design the scope of the projects.

(ii) Phase out multiple agency involvement in aid management and put a single structure in place in charge of collecting and centralizing data on external proposed and ongoing assistance, technical as well as capital, and coordinating requests to donors. Given the intimate link between planning and aid coordination, one possibility for the location of such a structure would be the Capital Investment Department of the MEPF, but the precise place where the Government decides to locate the structure is much less important than the fact that it addresses the situation soon.

(iii) Improve expenditure recording, which is now very deficient.

(iv) With specific reference to the field of economics and finance, it is essential that the Government develop a coherent coordinated approach to deal with assistance for complex and sensitive subjects such as the NEM and the systematic changes which accompany the reform program. A mechanism is needed whereby all the proposals made in the areas of finance, planning, and macroeconomic policy reforms would be examined by an interdepartmental MEPF task force, which studies the feasibility of recommendations, compatibility with other recommendations and their impact on other aspects of the reform program and the different sectors of the economy.

F. Administrative Capacity

6.50 Effective public expenditure management is as much manpower question as it is a policy or political one. Successful use of public expenditures as a policy instrument is largely a function of the appropriateness of the

organizational structures, the systems and practices, and the staffing of the implementing institutions.

Issues

6.51 Staffing. Perhaps the most decisive variable in determining the quality of public expenditure management is the quality of the civil service. This, in turn, is determined by its education standards, the level of pay scales, and other incentives to perform. Lao PDR suffers from a tremendous handicap in this respect. (i) While most professional staff working on expenditure management issues in the core ministries seem to have benefitted from a fair amount of technical training and a higher education, the vast majority was educated in eastern bloc countries and the skills they acquired are not applicable to the New Economic Mechanism. In addition, the Government lost a substantial number of staff as a result of the retrenching exercise it carried out in 1987. As a result, there is a critical shortage of skilled staff with theoretical or practical grounding in the management of an open economy; (ii) the salary level, although substantially increased this year, remains very low; (iii) the Government has no human resource development strategy or manpower development program.

Priorities for Improvement

6.52 (i) The critically short supply of qualified staff and skills is likely to become a major implementation bottleneck for the reform program. Intensive and systematic staff training is required. In the absence of a well-functioning national professional training institute for economy and finance, concrete, pragmatic in-service training programs, focussed on the development of operational skills are the best vehicle for administrative upgrading. In view of the scarcity of human resources, a phased approach is preferable concentrating in the short term only on high priority areas such as public investment programming, budgeting techniques, revenue and expenditure forecasting, and expenditure monitoring systems. It is recommended to conduct most training in the country, in a "hands-on" form, as skills acquired in overseas training programs tend to have less practical application. This form of training could be supported essentially through (a) recruitment of experts with coaching ability and clearly delineated responsibility for on-the-job training; and (b) workshops for core and line ministries to discuss and disseminate knowledge of systems and methodologies. Experience to-date in other countries shows that such seminars are an important vehicle for skill enhancement, consensus and commitment building.

6.53 (i) Over the medium to long term, the upgrading of the civil service calls for a more systematic civil service training plan, integration of training into career management, and improvement working conditions in the civil service. This includes appropriate personnel management systems, career development policies, and adequate performance incentives.

6.54 (ii) Administrative Structures and Systems. In recent years, government departments have been reorganized several times in an attempt to adapt the structures to the NEM. Very little information is available on the guiding principles for the reorganization process. Such continuing overhauling of governmental structures is highly destabilizing: it is necessary to put more permanent organization units for public expenditure

programming and management in place, with clearly defined functions and institutional links.

6.55 (iii) Other critical weaknesses to be addressed are: (a) the absence of well-established management systems, operating procedures and methodologies; (b) an inadequate information base for economic policy making and analysis; (c) lack of inter-departmental and overall coordination; and (d) lack of data processing equipment.

G. Conclusions

6.56 As indicated earlier, the move away from a centrally-planned economy to a more open system of economic management requires a fundamental rethinking of the role of government. It is a tremendously challenging undertaking with complex institutional and technical dimensions. However, the government of Lao PDR continues to use the old planning and budgeting instruments, and its expenditure control systems are woefully inadequate. Its decentralization policy is therefore running into serious implementation problems.

6.57 The task ahead as outlined in this chapter is huge. It is important to view the recommendations for changes in the expenditure planning and management system as an evolutionary process. Experience from many other developing countries illustrates the difficulty of implementing such reforms; to be successful efforts should be concentrated on a few critical areas rather than attempting more comprehensive changes. Even then it will not be a simple matter. To ensure that the required systematic changes do not overtax its administrative capacity, the Government should develop an action program of priority measures for the next three years to be supported by external donors. This could be the first phase of a long-term staged program of institution building.

6.58 Short-term priorities are (a) in the area of expenditure planning: to replace the existing Annual Plan procedure with a rolling public investment programming system; (b) in the area of budgeting: to examine and eventually revise the existing budget classification and structure; to improve the budget coverage, issue budget guidelines and improve budgeting techniques; (c) in the area of expenditure control: to improve reporting practices as well as the public accounting system; and (d) with regard to regional decentralization matters: to recentralize general tax collection and administration authority, determine the desirable level of decentralization, and clear operational guidelines and procedures, including a financial control mechanism.

6.59 Lao PDR is receiving increasing attention from external donors. It is essential that the country develop an articulate management strategy and structure, to deal with assistance for complex and sensitive issues such as the NEM.

6.60 But above all, the Government needs to address the skills gap issue, and embark on a massive, pragmatic training effort in high priority areas such as investment programming, budgeting techniques, reserve and expenditure forecasting and expenditure monitoring. This perhaps will be the most decisive variable in determining the long-term success and sustainability of the reform effort.

Estimation of GDP of Lao PDR

1. GDP of Lao PDR is estimated based on UNSNA methodologies.[1] Estimations are executed through 4 steps. First, GDP by industrial origin at constant 1988 prices is estimated. Second, GDP by expenditure category at current prices is estimated. Third, deflators for expenditure categories are estimated. Lastly, GDP by expenditure category at constant 1988 prices is estimated.

2. Throughout estimations, exchange rates of US$0.55 per rouble during 1984-88 and US$0.45 per rouble for 1989 (equivalent to the clearing rouble rate used in actual domestic transactions) are used to value transactions with the non-convertible zone, rather than US$1.563 per rouble (official rate which is used as accounting rate in BOP) or US$1.333 per rouble (accounting rate used by the Planning Department). This revision is necessary to ensure consistency between various economic accounts. It yields much more reasonable estimates.

GDP by Industrial Origin at Constant Prices

3. In general, output at 1988 prices are calculated first by multiplying physical output data by 1988 prices. Then, assumed ratios of intermediate consumption to output (IC/O) are applied to obtain value-added.

4. For agriculture, physical output data from the Ministry of Agriculture and State Statistical Center (SSC) and official prices from Economic Planning Office (EPO) and the market prices from SSC are used. EPO ratios of IC/O are applied for intermediate consumption. For example, 15% of IC/O ratio for paddy is used. Fish production is assumed to be 4.5 times of Nam Ngum Fishery Coop production.

5. For mining, quarrying and manufacturing, physical output data from the Ministry of Industry, SSC and EPO and price data from SSC and EPO are applied. There are no estimates for informal sector activities such as handicraft, small private rice mills, small private sawmills, etc. IC/O ratios for manufacturing from EPO range from 60% to 90%.

6. Government construction is equal to the local cost of public investment which is assumed to be equal to the local currency contribution, i.e. the sum of current fiscal surplus and aid in kind less amortization from general government budget. Private construction is assumed to be 30% of government construction. Deflator for total construction is composed of 50% of government construction materials prices and 50% of minimum wages. IC/O ratio of 50% from EPO is applied. For electricity, domestic consumption of

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[1] U.N., 1968, A System of National Accounts. Series F, No. 2, Rev. 3. New York, 1968.

Nam Ngum hydroelectricity is valued at the domestic price of 7 kips per kwh. The remaining is valued at 3 cents per kwh which is the export price to Thailand. An IC/O ratio of 20% from EPO is applied.

7. For goods transportation, total output is obtained by multiplying the number of ton/km of goods transported by the 1988 prices. Passenger transport is estimated on the basis of income earned per day by each vehicle, boat and airplane. For post, telephone and telegrams, the financial balance accounts of the post, telephone and telegram company are utilized. CPI is used as deflators.

8. For retail and wholesale trade, hotels and restaurants, the sum of 15% of the value from agriculture and 50% of manufacturing output and consumer goods imports are assumed to be gross output. IC/O ratio is assumed 80%. For banks, insurance and real estates, data from aggregate financial balance sheets of the State Bank are used. Deflators are proxied by CPI. For ownership of dwellings, the number of households are multiplied by an average of 5,000 kips rent per year in 1988. The IC/O is assumed to be 20%. For public administration and defenses, all the wages and salaries of the central, provincial and local government civil servants are utilized. Deflators are approximated by the minimum wage indices. Services of non-profit institution is proxied by foreign technical assistance. The import price index in kip is used as deflators.

9. Import duties deflated by import prices in kip are added to sum of value-added to obtain GDP at constant 1988 market prices.[2]

10. Estimates of GDP by industrial origin at 1988 constant prices are reported in Table 1.

GDP by Expenditure Category at Current Prices

11. Public investment is composed of government investment and investment by public enterprises. Government investment has two components: foreign cost and local cost. Due to valuation problems, foreign cost is calculated directly from the balance of payments; equal to project aid less lending of investment lines of credit; and local cost is estimated as the sum of current fiscal surplus and aid in kind less amortization in general government budget. It should be noted that in 1989 not all of foreign project aid and local currency resources translates into public investment due to huge increase of bank deposits. Investment by public enterprises is assumed 0.5% of GDP for 1984-86, 1% for 1987, 2% for 1988 and 3% for 1989.

12. Public consumption is composed of government consumption and non-profit institution consumption. Government consumption is calculated as the sum of wages and salaries and materials and supplies from general government

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[2] See para. 6.6 of Chapter VI, UN 1968, A System of National Accounts, Series F, No. 2, Rev. 3, New York, 1968.

budget. Non-profit institutions consumption represents foreign technical assistance.

13. Exports are composed of commodity exports, border trade exports and non-factor services exports. Imports are composed of commodity and non-factor services imports. In line with UNSNA methodology, duties on the imported goods and services which go directly as final uses should be added to imports.[3] In our estimates, 50% of import duties is added to imports.

14. Private expenditure is obtained as a residual. First, GDP at current prices are calculated from GDP at 1988 constant prices estimated from the previous step and GDP deflator from the following step. Then, public investment, public consumption, exports and imports are subtracted. In the absence of any information, there is no break-down between private consumption and private investment in our estimates.

15. Table 2 reports estimates of GDP by expenditure category at current prices.

Expenditure Deflators

16. There are two commonly used price indices. The Lapeyres price index weights the prices by quantities of the base year. On the other hand, the Paasche price index weights the prices by quantities of the current year. In our estimation, a chain-linked Laspeyres index which ensures the meaningful comparison of each pair of adjacent years is adopted.[4]

17. Public investment deflator is constructed as weighted average of local cost deflator and foreign cost deflator. Local cost deflator is composed of 50% of minimum wages and 50% of government construction materials. For foreign cost deflator, import price index in kip is applied.

18. Public consumption deflator is constructed as the weighted average of wages deflator, material and supplies deflator and foreign technical assistance deflator. For wages deflator, it is assumed that the number of government employees (both civilian and military) were constant for 1984-88. Hence, in effect, it is assumed that nominal development of wage bills are equal to deflator development. For 1989, severance payment is subtracted from wage bills and the observed 16% increase in nominal wages is used as deflator. Bases on information from the Budget Administration, the material and supplies deflator is composed of 20% of market CPI, 35% of official CPI and 45% of import prices of kip. Foreign technical assistance deflator is proxied by import price index in kip.

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[3] See paragraph 6.7 of Chapter VI, U. N. 1968, A System of National Accounts, Series F, No. 2, Rev. 3, New York 1968.

[4] See pp. 154-158, Microeconomic Theory, R. Layard and A. Walters, 1978.

19. For exports and imports deflators, exports and imports price indices collected by IMF in Kip are used. The private expenditure is a weighted average of the Vientiane market price index (40%), the state shop price index (10%) and the rice price index (50%) to reflect better rural and subsistence consumption. Finally, GDP deflator is constructed as chain-linked Laspeyres weighted average of expenditure deflators.

20. Estimates of expenditure deflators are reported in Table 3.

GDP by Expenditure Category at 1988 Constant Prices

21. GDP by expenditures category at 1988 constant prices are obtained by deflating current price series by corresponding deflators. The results are reported in Table 4.

Table 1.1: GDP BY INDUSTRIAL ORIGIN AT 1988 CONSTANT MARKET PRICES
(in million KIPS)

	1984	1985	1986	1987	1988	1989
Agriculture	107,776.7	119,657.0	130,082.1	117,784.3	122,169.1	126,875.9
Crops	71,613.7	76,350.1	84,515.3	70,106.6	71,379.6	80,161.7
Livestock	18,376.0	19,365.4	20,624.8	19,647.3	20,254.2	22,179.9
Fish	1,199.1	1,232.6	1,251.2	855.6	1,076.4	1,076.4
Forestry	12,028.4	17,861.4	18,871.2	22,644.3	24,823.2	18,287.0
Other	4,559.4	4,847.4	5,819.6	4,530.5	4,635.5	5,170.9
Industry	29,056.6	30,146.6	34,434.6	28,021.4	27,840.9	35,133.0
Mining & quarrying	557.8	669.5	743.2	577.2	452.2	623.9
Manufacturing	12,862.3	14,794.0	16,776.6	16,166.3	15,207.7	19,564.2
Construction	7,508.1	6,394.9	8,950.3	5,983.0	6,970.6	8,640.9
Electricity, gas, & water	8,128.4	8,288.2	7,964.5	5,294.9	5,210.4	6,304.0
Services	40,273.8	44,818.4	44,870.4	48,257.1	50,982.3	57,319.8
Transportation, storage, & communication	5,974.0	6,302.9	8,314.3	9,541.7	10,221.3	10,768.0
Wholesale and retail trade	15,258.3	16,898.6	18,446.3	19,451.7	17,256.7	21,452.2
Banking, insurance & real estate	109.4	112.9	216.5	821.2	483.4	588.5
Ownership of dwellings	2,370.5	2,441.3	2,514.2	2,589.3	2,666.7	2,744.0
Public administration & defense	10,150.0	9,621.8	9,996.0	10,783.5	11,250.0	10,599.3
Nonprofit institution	6,256.0	9,269.0	4,647.0	4,799.0	8,740.0	10,792.0
Other services	155.6	171.8	236.1	270.7	364.2	377.6
Import duties	1,875.0	779.9	679.1	742.5	4,086.0	4,206.6
GDP at 1988 constant market prices	171,982.1	195,401.9	209,566.2	194,806.3	205,078.3	223,535.3

Table 1.2: GDP BY EXPENDITURE CATEGORY AT CURRENT PRICES
(in million Kips)

	1984	1985	1986	1987	1988	1989
Export	1745	4694	6573	12506	27870	48960
Goods	1220	3096	4264	7790	18938	31334
Nonfactor services	525	1598	2309	4716	8932	17626
Import	-3546	-9138	-11409	-23979	-51258	-95792
Goods	-3339	-8871	-11035	-23225	-48027	-90259
Nonfactor services	-132	-205	-301	-594	-809	-1970
Public Investment	3394	6141	9939	14773	26149	39729
Government	3132	5679	9196	13175	22046	30712
Public enterprise	263	462	744	1599	4102	9017
Public Consumption	4514	10829	15661	17881	34343	52861
Government	3999	9329	14635	15775	25488	35120
Nonprofit institution	515	1500	1026	2106	8855	17741
Private Expenditure	46463	79822	128010	138703	167976	314922
GDP	52571	92349	148775	159884	205078	360679

Table 1.3: EXPENDITURE DEFLATORS (1988 = 100)

	1984	1985	1986	1987	1988	1989
Export	8.7	16.6	23.1	44.1	100.0	151.4
Import	8.0	15.9	21.5	43.1	100.0	154.2
Public investment	10.0	18.5	27.1	48.5	100.0	153.1
Public consumption	12.8	27.0	40.6	52.4	100.0	164.9
Private expenditure	35.4	53.2	78.3	89.5	100.0	161.4
GDP	29.4	47.3	71.0	80.1	100.0	161.4

Table 1.4: GDP BY EXPENDITURE CATEGORY AT 1988 CONSTANT PRICES
(in million Kips)

	1984	1985	1986	1987	1988	1989
Export	19987	28290	28437	28326	27870	32337
Goods	13974	18862	18450	17644	18938	20696
Nonfactor services	6013	9428	9987	10682	8932	11641
Import	-44318	-57324	-53150	-55597	-51258	-62103
Goods	-41736	-55651	-51407	-53849	-48027	-58516
Nonfactor services	-1645	-1284	-1403	-1377	-809	-1277
Public Investment	32217	32631	32830	28451	26148	28392
Government	31322	31654	31782	26503	22046	22803
Public enterprise	895	977	1048	1948	4102	5588
Public Consumption	35259	40176	38620	34143	34343	32052
Government	28829	30766	33840	29260	25488	20550
Nonprofit institution	6431	9410	4780	4883	8855	11501
Private Expenditure	135836	151629	162830	159482	167976	192857
GDP	178982	195402	209566	194805	205078	228535

Table 1: PROJECTION OF GDP BY INDUSTRY AT 1988 CONSTANT PRICES (1989-1995)
(1989 - 1995)

	1989	1990	1991	1992	1993	1994	1995
Agriculture	126876	134011	147937	156301	164653	173749	181738
Industry	35133	38701	44447	49249	54409	60213	66050
Services	57320	61524	68276	72385	76518	81015	85028
Import duties	4207	4537	5185	5482	5850	6070	6155
GDP at market prices	223535	238773	265847	283417	301424	321047	338965

Source: World Bank staff estimates.

Table 2: PROJECTION OF GDP BY EXPENDITURE CATEGORY
(in 1988 constant prices, in million Kips)

	1989	1990	1991	1992	1993	1994	1995
Export	32337	35731	40323	45076	49651	52705	56276
Goods	20696	23721	27271	30929	34169	36990	40206
Nonfactor services	11641	12010	13052	14247	15482	15715	16070
Import	-62103	-83184	-93851	-100721	-107495	-112678	-115552
Goods	-58516	-76381	-86941	-93163	-99329	-105105	-107393
Nonfactor services	-1277	-3768	-3478	-3880	-4245	-3424	-3919
Public Investment	28392	34337	41586	48619	54969	61360	64913
Government	22803	27651	33610	39266	44118	49160	51254
Public enterprise	5589	6686	7975	9353	10851	12200	13559
Public Consumption	32052	32444	36728	37986	39582	41431	43399
Government	20550	21954	22431	23275	24772	26149	27634
Nonprofit institution	11501	10490	14297	14712	14810	15282	15765
Private Expenditure	192857	219445	241062	252457	264717	278230	290028
GDP	223535	238773	265847	283417	301424	321047	338965

Source: World Bank Staff Estimates

Table 8: PROJECTION OF GDP BY EXPENDITURE CATEGORY
(In current prices, in million Kips)
(1989 - 1995)

	1989	1990	1991	1992	1993	1994	1995
Export	48960	71625	94674	115898	133806	149568	165437
Goods	31334	47550	64029	79265	92084	104971	118195
Nonfactor services	17626	24075	30645	36633	41723	44597	47242
Import	-95792	-171284	-228698	-271337	-304832	-330173	-352281
Goods	-90259	-157275	-211880	-250975	-281674	-307982	-327408
Nonfactor services	-1970	-7800	-8474	-10454	-12039	-10032	-11947
Public Investment	39729	73528	102075	130710	156047	181843	201204
Government	30712	58572	81612	104916	124459	144468	157623
Public enterprise	9017	14956	20463	25794	31588	37375	43581
Public Consumption	52861	80767	109744	124150	139921	154023	170314
Government	35120	59167	74905	84518	97923	109244	122252
Nonprofit institution	17741	21600	34839	39632	41998	44779	48062
Private Expenditure	314922	479519	604309	682216	752497	828295	904843
GDP	360679	534154	682104	781637	877439	983556	1089517

Source: World Bank Staff estimates.

Table 4: PROJECTION OF EXPENDITURE DEFLATORS (1988 = 100)
(1989 - 1995)

	1989	1990	1991	1992	1993	1994	1995
Export	151.4	200.5	234.8	257.1	269.5	283.8	294.0
Import	154.2	205.9	243.7	269.4	283.6	293.0	304.9
Public Investment	153.1	205.7	242.4	267.0	281.9	293.7	307.6
Public Consumption	164.9	248.9	298.8	326.8	353.5	371.8	392.4
Private Expenditure	161.4	220.5	252.2	271.4	285.4	298.8	313.0
GDP	161.4	223.7	256.6	275.8	291.1	306.4	321.4

Source: World Bank staff estimates.

Table 5: PROJECTION OF BALANCE OF PAYMENTS
(in million US) (1989 - 1995)

	1989	1990	1991	1992	1993	1994	1995
Exports of goods	54	63	75	87	100	115	130
Imports of goods	-162	-210	-248	-276	-307	-338	-359
Trade balance	-107	-146	-173	-189	-206	-223	-229
Net service	-9	-11	-18	-21	-23	-23	-28
Net current transfers (private)	8	9	13	16	20	22	23
Current account balance	-107	-148	-178	-193	-210	-224	-235
Net long-term loans	71	73	90	101	113	123	132
Official capital grants	40	42	50	50	50	50	50
Net other items	14	28	39	44	43	44	41
Changes in net reserves	-18	5	0	-2	4	8	12
Memorandum items				(in percent)			
Current account/GDP (%)	-17.2	-20.8	-22.1	-22.5	-22.0	-20.8	-19.6
Debt/GDP (%)	83.4	84.6	87.3	91.4	94.1	96.1	98.5
Debt services/Exports (%)	14.5	13.1	13.9	12.9	12.4	12.2	12.3

Source: World Bank staff estimates.

Table 6: PROJECTION OF EXPORTS AND IMPORTS
(in million US$)

	1989	1990	1991	1992	1993	1994	1995
Total Exports	54	63	75	87	100	115	130
Electricity	15	17	21	24	25	28	29
Timber & Wood	18	23	29	36	43	50	60
Coffee	6	4	4	6	9	10	12
Gypsum	1	1	1	1	1	1	1
Tin	2	2	3	3	3	4	4
Other	12	16	17	18	20	21	23
Border Trade	20	25	30	33	36	39	41
Total Imports	162	210	248	276	307	338	359

Source: World Bank staff estimates.

Table 7: PROJECTION OF EXTERNAL DEBT
(in million US$)

	1989	1990	1991	1992	1993	1994	1995
Convertible area LT debt	246.0	302.4	390.0	482.8	580.2	686.1	800.6
Nonconvertible area LT debt	250.6	274.5	301.1	325.1	348.1	370.9	393.6
Total LT	496.6	576.9	691.1	807.9	928.3	1057.0	1194.2
ST debt	4.7	4.7	5.4	6.0	6.6	7.2	8.0
Total debt	501.3	581.6	696.5	813.9	934.9	1064.2	1202.2

Source: World Bank staff estimates.

LAO PDR

COUNTRY ECONOMIC MEMORANDUM

STATISTICAL APPENDIX

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Table No.

Table 1.1: POPULATION (mid-1986)
(In thousands)

	Total
By Province	
Vientiane Prefecture	392
Phongsaly	128
Luang Namtha	101
Oudomsay	194
Bokeo	58
Luang Prabang	307
Houaphan	218
Sayaboury	232
Xiang Khouang	168
Vientiane	275
Bolikhamxay	126
Khammouane	221
Savannakhet	565
Saravan	194
Sekong	52
Champassak	419
Attopeu	72
Total	3,722
By Sex	
Male	1,824
Female	1,898
By Area	
Urban	557
Rural	3,167

Source: Lao PDR authorities.

Table 2.1: BALANCE OF PAYMENTS

(in Mln US$)

	1984	1985	1986	1987	1988	1989 June	1989 Actual
Exports	34.9	41.3	44.9	43.3	49.2	12.7	54.4
Convertible area	30.0	34.6	39.4	33.0	41.8	10.8	47.2
Nonconvertible area	4.9	6.7	5.5	10.3	7.4	2.0	7.2
Imports	-95.4	-118.3	-116.2	-129.0	-124.7	-82.2	-161.6
Convertible area	-59.3	-77.6	-78.4	-81.7	-90.4	-61.9	-124.8
Nonconvertible area	-36.1	-40.7	-37.8	-47.3	-34.3	-20.3	-36.8
Trade balance	-60.5	-77.0	-71.3	-85.7	-75.5	-69.5	-107.2
Convertible area	-29.3	-43.0	-39.0	-48.7	-48.6	-51.1	-77.6
Nonconvertible area	-31.2	-34.0	-32.3	-37.0	-26.9	-18.4	-29.6
Services and transfers (net)	28.3	42.9	39.5	36.4	37.1	17.6	40.2
Services (net)	-6.7	-3.9	3.2	3.5	-5.3	3.4	-3.4
Convertible area (net)	-4.9	-2.1	9.5	9.9	-3.7	3.2	-7.0
Receipts	15.0	21.3	24.3	26.2	23.2	13.8	30.6
Payments	-19.9	-23.4	-14.8	-16.3	-26.9	-10.6	-37.6
Interest	-3.2	-2.5	-2.1	-2.7	-3.4	-1.3	-4.3
Technical assistance	-12.9	-18.2	-9.5	-10.3	-21.4	-8.4	-29.4
Sundries	-3.8	-2.7	-3.2	-3.3	-2.1	-0.9	-3.9
Nonconvertible area (net)	-1.8	-1.8	-1.3	-1.4	-1.6	0.2	-1.4
Private transfers _a/	2.8	0.0	3.7	3.5	3.7	4.8	3.3
Official transfers	32.1	46.9	27.6	24.4	35.6	9.4	40.3
Convertible area	26.7	45.4	26.0	23.0	34.0	9.4	38.0
Nonconvertible area	5.4	1.5	1.6	1.4	1.6	0.0	2.3
Current account balance	-64.4	-80.9	-59.4	-73.7	-74.0	-51.9	-107.3
Convertible area	-31.4	-45.1	-25.8	-35.3	-45.5	-33.7	-76.3
Nonconvertible area	-33.0	-35.8	-33.6	-38.4	-28.5	-18.1	-31.0
Capital account	72.1	92.1	77.4	69.0	87.2	45.3	140.6
Convertible area	12.4	10.9	17.9	7.5	24.7	26.9	71.7
Long-term loans	6.8	7.6	14.3	4.0	15.5	25.3	59.7
Drawings	10.1	12.1	20.8	13.4	23.7	29.4	66.9
Amortization	-3.3	-4.5	-6.5	-9.4	-8.2	-4.1	-7.2
Private import/financing	5.6	3.3	3.6	3.5	9.2	1.6	12.0
Sundries	--	--	--	--	--	--	--
Nonconvertible area	27.6	34.3	31.9	37.1	27.0	18.4	28.6
Long-term loans	10.0	16.4	11.6	17.7	14.9	6.3	11.4
Drawings	10.6	17.6	12.3	18.3	15.6	6.9	12.2
Amortization	-0.7	-1.2	-0.6	-0.6	-0.6	-0.6	-0.8
Bilateral clearing arrangements	17.6	17.9	20.3	19.4	12.0	12.1	17.2
Errors and omissions	-13.7	9.6	-9.3	-6.6	-17.7	6.3	-15.5
Overall balance	-6.0	20.8	8.7	-11.3	-4.5	1.8	17.8
Changes in reserves _b/	6.0	-20.8	-8.7	11.3	4.5	-1.6	-17.8
Gross reserves	8.3	-14.7	-6.7	11.3	4.5	-1.5	-25.3
Liabilities	-2.3	-6.0	-2.1	0.0	0.0	-0.2	7.5

Source : World Bank staff estimates

Remark: Transactions with the nonconvertible zone are valued at an exchange rate of 0.55 Roubles per USdollar until 1988 and 0.45 roubles per USdollar thereafter.

Table 2.2: COMPOSITION OF OFFICIAL EXPORTS, 1984-89
(in million of US Dollars)

	1984	1985	1986	1987	1988	1989
Exports to the Convertible Area	30.00	34.60	39.40	35.10	42.00	47.20
Coffee	0.60	0.30	2.10	0.90	0.50	3.60
Hydroelectric power	25.10	25.70	29.80	13.70	11.33	15.00
Logs and wood products	3.70	5.60	5.50	19.50	20.76	15.60
Other exports	0.60	3.00	2.00	1.00	4.23	13.00
Re-Export					5.20	
Exports to the Nonconvertible Area	4.86	6.69	5.49	10.28	7.39	7.23
Coffee	2.85	2.89	2.50	2.99	2.38	2.34
Logs and wood products	0.46	1.97	0.81	4.72	3.27	2.61
Tin	0.46	0.39	0.99	0.67	0.73	0.99
Gypsum	0.35	0.49	0.77	0.81	0.39	0.41
Other exports	0.74	0.95	0.42	1.09	0.63	0.90
Total Official Exports	34.86	41.29	44.89	45.38	49.39	54.45

Source: Lao PDR authorities, staff estimates.
Remark: See Table 2.1 of Statistical Appendix

Table 2.3: COMPOSITION OF OFFICIAL IMPORTS 1/, 1984-89
(In millions of US dollars)

	1984	1985	1986	1987	1988	1989 June
Convertible Area	59.3	77.6	78.4	81.7	---	----
Cash Imports	35.30	38.30	41.10	55.60	54.09	23.16
Rice and other food	4.00	1.70	3.00	7.70	5.71	3.09
Petroleum products	10.80	10.60	7.80	6.40	5.33	3.87
Machinery and raw materials	10.30	11.10	12.30	14.80	8.83	1.23
Other imports	5.30	7.70	9.40	17.20	15.84	4.11
Private imports	4.90	2.20	3.60	4.50	9.15	1.60
Provincial imports	0.00	5.00	5.00	5.00	9.23	9.26
Aid-related imports						
Nonconvertible Area /a						
Cash imports	21.82	23.44	25.17	29.00	18.80	8.60
Aid-related imports	14.29	17.25	12.60	18.34	---	---
Total Imports	95.41	118.29	116.17	129.09		
Total cash imports	57.12	61.74	66.27	84.60	---	---

1/ Excluding border trade.

Source: Lao PDR authorities, staff estimates.

Table 2.4: EXTERNAL PUBLIC DEBT DISBURSED AND OUTSTANDING, 1985-89
(In millions of US dollars; end of period)

	Expenses as of 31.12.85	Expenses as of 31.12.86	Expenses as of 31.12.87	Expenses as of 31.12.88	Expenses as of 31.06.89
1.1 Suppliers' credits	3.00	3.00	3.00	0.00	0.00
1.2 Multilateral credits	77.40	92.60	103.50	121.30	130.87
BAsD	24.90	34.20	35.50	38.10	45.92
CEE	1.40	1.40	1.80	2.10	2.10
FIDA	0.50	0.70	3.40	6.40	6.69
IDA	31.80	39.80	48.30	62.80	65.52
OPEP	8.50	9.00	9.50	9.70	9.16
Fonds Fiduciaire	10.30	7.50	5.00	2.20	1.48
1.3 Bilateral credits	196.55	225.40	257.61	287.09	253.29
Convertible area	76.35	73.25	69.04	65.00	59.70
Germany	33.00	31.50	29.80	28.30	26.87
France	6.60	6.60	6.60	5.66	28.89
Japan	36.70	35.10	32.60	31.00	4.50
United Kingdom	0.05	0.05	0.04	0.04	0.04
Nonconvertible area	120.2	152.10	188.58	222.09	193.59
Total	276.95	320.95	364.12	408.39	384.16

Rates used for 1985: 1US$ = 0.96 SDR; 8.87 FF; 2.82 DM; 219.92 Yen
Rates used for 1986: 1US$ = 0.83 SDR; 7.08 FF; 1.8 DM; 154 Yen

Remark: see Table 2.1

Source: Lao PDR authorities, staff estimates.

Table 2.5: EXTERNAL AID DISBURSEMENTS, 1983-1989
(in millions of US Dollars)

	1983	1984	1985	1986	1987	1988	1989
Aid in Kind	14.28	3.86	7.58	4.70	7.03	9.52	0.64
Convertible zone	14.10	1.50	6.10	4.00	5.20	6.60	0.64
Nonconvertible zone	0.18	2.36	1.48	0.70	1.83	2.92	0.00
Project Aid	20.87	34.02	48.97	45.20	37.20	42.84	44.36
Convertible zone	10.10	22.40	33.20	33.30	20.90	29.70	37.69
Nonconvertible zone	10.77	11.62	15.77	11.90	16.30	0.19	6.67
Technical Assistance	11.35	14.66	20.03	10.77	11.71	9.98	0.69
Convertible zone	10.40	12.90	18.20	9.50	10.30	8.40	0.47
Nonconvertible zone	0.95	1.76	1.83	1.27	1.41	1.58	0.22
Total	46.50	52.54	76.58	60.67	55.94	61.84	45.69
Official Transfers	25.10	32.12	46.88	27.58	24.14	22.58	9.43
Convertible zone	25.10	26.70	45.40	26.00	23.00	21.00	9.43
Nonconvertible zone	0.00	5.42	1.48	1.58	1.41	1.58	0.00
Drawings	22.10	20.73	29.70	33.08	31.74	39.26	36.26
Convertible zone	9.50	10.10	12.10	20.80	13.40	28.70	29.37
Nonconvertible zone	12.60	10.63	17.60	12.28	18.34	15.56	6.89
Total	46.50	52.54	75.58	60.67	55.94	61.84	45.09

Source: Lao PDR authorities, staff estimates.

Table 2.6: FOREIGN DEBT SERVICE, 1984-89
(in million of US dollars)

	1984	1985	1986	1987	1988	1989
Debt Service	7.17	8.16	9.23	12.73	12.23	12.49
Capital	3.87	5.66	7.13	10.03	8.83	8.19
Interest	3.20	2.50	2.10	2.70	3.40	4.30
Convertible Zone	6.50	7.00	8.60	12.10	11.60	11.50
Capital	3.30	4.50	6.50	9.40	8.20	7.20
Interest	3.20	2.50	2.10	2.70	3.40	4.30
Bilateral Credit	1.90	2.10	2.90	5.50	4.00	4.70
Capital	1.20	1.40	2.20	4.40	3.10	3.60
Interest	0.70	0.70	0.70	1.10	0.90	1.10
Multilateral Credits	1.50	1.40	1.90	2.60	3.40	3.10
Capital	1.00	0.90	1.30	1.70	1.70	1.60
Interest	0.50	0.50	0.60	0.90	1.70	1.50
IMF	3.10	3.50	3.80	4.00	4.20	3.00
Capital	1.10	2.20	3.00	3.30	3.40	2.00
Interest	2.00	1.30	0.80	0.70	0.80	1.00
Nonconvertible zone	0.67	1.16	0.63	0.63	0.63	0.99
Capital	0.67	1.16	0.63	0.63	0.63	0.99
Interest	0.00	0.00	0.00	0.00	0.00	0.00

Source: Lao PDR authorities, staff calculation.
Remark: See Table 2.1 of Statistical Appendix

Table 2.7: INTERNATIONAL RESERVES, 1985-89
(In millions of US dollars; end of period)

	1985	1986 Dec.	1987 Mar.	1987 Jun.	1987 Sep.	1987 Dec.	1988 Dec.	1989 June
Gold	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60
Foreign exchange	25.33	31.79	27.33	31.72	32.01	20.60	16.13	17.65
SDR	0.01	0.16	0.02	0.01	0.01	0.01	0.00	0.00
Gross Reserves	25.94	32.55	27.95	32.33	32.62	21.21	16.73	18.25
Foreign liabilities /1	-11.26	-8.80	-8.40	-9.50	-9.50	-7.10	-1.81	-1.58
Of which letters of credit	(-9.20)	(-8.80)	(-8.40)	(-9.50)	(9.50)	(-7.10)	(-5.89	-
Net Official Reserves	14.68	23.75	19.55	22.83	23.12	14.11	14.92	16.67

/1 The banking system does not have liquid foreign liabilities in convertible exchange other than those which proceed from the IMF credit.

Source: Lao PDR authorities.

Table 2.8: EXCHANGE RATES, 1984-89
(Kip per US$; end of period)

	1984	1985	1986	1987	1988	1989 /1
Official exchange rate /2	10	10	10	10		
(Buying rate)					450	713
(Selling rate)					455	720
Exchange rate for the local expenses of embassies	35	35	35	35		
Commercial exchange rate	35	95	95	95		
Exchange rate for tourist receipts and inward remittanc to non-Lao nationals	108	108	108	350		
Rate for private remittances to Lao nationals	108	270	270	350		
Exchange rate for the Vientiane Export-Import Partnership Corp.	n/a	300	380	350		
Selling rate of the Prefecture of Vientiane - notes	n/a	n/a	390	390		
Exchange rate in the free market	258	424	400	390		
(Buying rate)					477	722
(Selling rate)					483	733

/1 Most recent data.

/2 The official exchange rate applies to financial transactions (loan disbursements and repayments of loans) with international organizations.

Source: Lao PDR authorities.

Table 3.1: GOVERNMENT BUDGET REVENUES, 1984-89
(in million of Kip)

	1984	1985	1986	1987	1988	1989
	Actuals					Est.
Tax Revenues	1,669	1,897	1,755	1,970	21,409	26,808
Tax on industrial and commercial profits	250	170	195	210	6,223	5,881
Tax on wages and salaries	15	11	14	18	22	75
Agricultural tax	228	250	450	400	1,213	1,358
Turnover tax	960	786	870	930	7,352	10,895
Of which: State enterprises	(453)	(424)	(530)	(580)	(5,730)	(7,700)
Business licenses	10	8	10	12	30	54
Tax on international trade	181	160	197	380	6,463	7,710
Import tax	(150)	(124)	(146)	(320)	(4,846)	(7,127)
Of which: State enterprises	(70)	(66)	(111)	(300)	(4,701)	(5,950)
Export tax	(31)	(36)	(51)	(60)	(1,617)	(1,224)
Of which: State enterprises	(24)	(30)	(45)	(55)	(1,596)	(916)
Other	25	13	19	20	106	196
Nontax Revenues	3,279	8,902	16,748	18,138	6,801	7,505
Operating surpluses of state enterprises	2,489	6,677	13,890	15,548	517	380
Depreciation allowances paid by state enterprises	473	1,084	1,050	950	2,411	2,510
Other	317	1,141	1,802	1,640	3,893	4,615
Total Revenues	4,948	10,299	18,503	20,108	28,210	34,313

Source: Lao PDR authorities.

Table 8.1: ECONOMIC CLASSIFICATION OF BUDGETARY EXPENDITURES, 1984-89
(millions of Kips)

	1984	1985	1986	1987	1988	1989
Current Expenditures	4,126	10,624	15,883	16,833	26,722	63,420
Wages and Salaries	580	2,5[illegible]	4,760	5,135	11,250	19,590
Materials and Supplies	3,419	6,810	9,875	10,640	14,238	32,550
Transfers	10	27	45	60	250	2,530
Debt Service	117	1,267	1,203	998	984	8,750
Capital Expenditures	4,259	10,182	11,732	11,842	52,628	59,601
Education	90	265	780	889	1,920	1,606
Health	170	600	714	748	1,257	258
Agriculture and forestry	1,010	1,549	1,993	1,936	6,710	5,249
Industry, energy and mines	1,366	1,558	1,208	1,276	8,510	19,705
Commerce and cooperatives	171	489	442	507	1,420	83
Transportation and communications	551	3,716	4,491	4,486	15,187	22,145
Public works	706	496	654	720	1,300	74
Others	195	1,511	1,450	1,280	16,324	9,481
Total	8,385	20,806	27,615	28,675	79,350	123,021

Source: Lao PDR authorities

Remark: By contrast with the rest of the report, expenditures financed by aid from freom the nonconvertible zone are valued at official exchange rates.

Table 4.1: MONETARY SURVEY, 1985-89
(In millions of kip; end of period)

	1985	1986	1987	1988	1989
Net Foreign Assets	147	238	286	1,530	20,468
Foreign assets	259	326	10,948	13,281	42,645
Foreign liabilities	-113	-88	-10,662	-11,751	22,178
Net Domestic Assets	2,133	3,639	15,560	20,186	20,648
Domestic credit	2,717	4,329	17,964	26,490	26,296
Net claims on Government	-273	-484	2,523	2,765	-14,753
Claims			-3,586	4,965	5,995
Deposits	-273	-484	-1,063	-2,200	-20,749
Public enterprises	2,740	4,044	15,331	22,855	36,647
Other enterprises	250	-691	-2,404	-6,304	4,403
Net other assets	-584	-691	-2,404	6,304	-5,648
Liquidity	2,280	3,876	15,842	21,715	41,114
Currency outside banks	635	1,047	2,901	3,486	16,842
Demand deposits	1,591	2,834	4,797	8,618	8,284
Time and saving deposits	54	95	60	136	14,818
Foreign currency deposits	n.a	n.a	8,894	9,475	1,170

Source: Lao PDR authorities.

Table 4.2: INTEREST RATES, 1985-89
(Percent)

	July 1985-Dec. 1987	Jan. 1988-Oct. 1988	Nov. 1988-Aug. 1989	August-Dec. 1989
Deposit Rates				
Private Sector	0	0	0	1.2
Demand deposits				
Savings deposits	5.4	7.2	7.0	24.0
Time deposits				
Three months	-	-	-	30.0
Six months	7.8	10.0	10.0	33.6
One year	9.6	14.0	14.0	36.0
Two-year	12.0	18.0	18.0	-
Three-year	15.0	18.0	18.0	-
Special certificates	-	-	-	72.0
Lending Rates				
For Agriculture, Industry and Transportation				
Overdraft	4.2-4.8	12.0	12.0	1 per day
Short-term (< 1 year)	4.2-8.4	12.0	12.0	32.4-42.0
Long-term (> 1 year)	3.0-4.2	8.0	8.0	24.0-33.6
For Trade				
Private	15.0	15.0	15.0	-
Public	6.1-7.8	15.0	15.0	-

Source: Lao PDR authorities.

Table 5.1: AREA, YIELD AND PRODUCTION OF MAJOR AGRICULTURAL CROPS, 1984-89

	1984	1985	1986	1987	1988
Area ('000 ha)					
Paddy	655.1	689.8	651.8	542.0	542.8
Rainfed lowland area	(360.3)	(396.3)	(385.0)	(356.7)	(311.3)
Irrigated area	(8.6)	(10.1)	(10.1)	(9.6)	(11.4)
Upland area	(286.2)	(283.4)	(256.5)	(195.3)	(213.5)
Vegetables	5.5	5.6	6.5	3.4	8.6
Maize	28.6	30.4	34.0	24.8	37.8
Cotton	7.2	7.5	8.4	5.7	6.6
Coffee	11.1	12.8	14.1	14.3	15.5
Tobacco	3.9	5.1	8.0	4.9	7.1
Root crops	11.9	12.4	15.0	16.6	27.8
Groundnuts	11.6	12.2	14.0	6.5	5.4
Mung beans	3.1	3.7	4.3	2.8	3.5
Soybeans	5.2	7.0	9.5	4.9	5.9
Tea	0.2	0.2	0.2	0.2	0.3
Sugarcane	2.0	3.0	4.0	3.8	-
Yield (ton/ha)					
Paddy	2.00	2.10	2.22	2.28	1.91
Rainfed lowland area	(2.55)	(2.57)	(2.81)	(2.66)	(2.20)
Irrigated area	(2.49)	(2.70)	(2.70)	(2.97)	(3.02)
Upland area	(1.32)	(1.35)	(1.32)	(1.23)	(1.32)
Vegetables	8.1	8.2	8.3	6.8	7.1
Maize	1.2	1.2	1.2	1.4	1.6
Cotton	0.7	0.6	0.6	0.7	0.6
Coffee	0.5	0.5	0.5	0.4	0.5
Tobacco	4.2	4.4	4.6	4.2	4.2
Root crops	8.1	8.1	8.2	7.1	6.7
Groundnuts	0.8	0.8	0.8	0.8	0.8
Mung beans	0.6	0.6	0.6	0.6	0.6
Soybeans	0.7	0.8	0.8	0.8	0.8
Tea	3.8	3.8	4.1	1.9	4.3
Sugarcane	27.6	27.7	28.0	29.0	
Production ('000 tons)					
Paddy	1,321.1	1,428.5	1,449.2	1,207.1	1,003.4
Rainfed lowland area	(919.3)	(1,019.9)	(1,081.9)	(950.7)	(686.1)
Irrigated area	(21.4)	(27.2)	(27.3)	(28.7)	(34.5)
Upland area	(380.4)	(381.4)	(340.0)	(227.7)	(282.8)
Vegetables	45.0	45.6	53.9	23.6	68.4
Maize	33.9	35.9	41.5	35.7	50.8
Cotton	5.1	4.7	5.3	4.0	4.3
Coffee	5.8	5.9	6.7	5.3	7.8
Tobacco	16.5	22.0	36.4	20.7	29.8
Root crops	96.6	100.0	122.5	120.1	220.2
Groundnuts	8.9	9.5	11.3	5.6	4.5
Mung beans	1.8	2.2	2.6	1.8	2.1
Soybeans	3.6	5.3	7.3	3.7	4.4
Tea	0.61	0.68	0.6	0.3	1.3
Sugarcane	54.5	83.1	112.0	112.8	

Source: Lao PDR authorities.

Table 5.2: LIVESTOCK, 1984-89
(Thousands of heads)

	1984	1985	1986	1987	1988	1989 (estimation)
Buffalo	936.7	974.4	979.1	1,032.0	1,040.7	
Cattle	543.9	576.0	646.3	703.0	764.1	
Pigs	1,359.7	1,433.0	1,279.7	1,420.0	1,267.9	
Sheep and goats	62.9	66.6	74.4	82.0	89.2	
Poultry	7,201.4	7,834.0	6,797.7	7,980.0	6,868.5	

Source: Lao PDR authorities.

Table 5.3: FORESTRY PRODUCTION, 1984-89

	1984	1985	1986	1987	1988
Logs ('000 m^3)	170	230	263	365	350
Of which:					
State forestry enterprises	62	106	107		
Provincial forestry enterprises	108	124	156		
Sawn wood ('000 m^3)	37	46	37	55	45
Benzoin (tons)	54	100	17		
Cardamon (tons)	204	352	157		
Rattan (m^3)	-	-	468		
Resin and others (tons)	-	-	430		

Source: Lao PDR authorities.

Table 6.1: PRODUCTION AND EXPORTS OF ELECTRICITY, 1984-89

	1984	1985	1986	1987	1988	1989 (Estimation)
Production (GWh)	890.9	906.6	867.3	566.6	532.0	684.6
Internal Consumption	133.9	97.1	128.1	117.4	144.3	149.6
Exports	709.7	716.2	683.0	387.2	373.5	478.9
Imports (US$'000)	696.0	794.0	838.0	634.0	702.7	653.1
Exports (US$'000)	26,861.0	29,424.0	29,912.0	13,700.0	11,090.0	12,141.0

Source: Lao PDR authorities.

Table 6.2: MINING PRODUCTION AND EXPORTS, 1984-89

	1984	1985	1986	1987	1988	1989 (Estimation)
Tin						
Production (tons)	430.0	520.0	559.0	501.0	245.0	384.0
Exports (tons)	400.0	451.0	500.0	500.0	245.0	384.0
Export earnings (US$'000)	1,600.0	1,935.0	1,301.0	1,424.0	854.6	830.9
Gypsum						
Production ('000 tons)	82.0	100.0	100.0	59.0	80.0	100.0
Exports ('000 tons)	70.0	70.0	90.0	50.0	60.0	80.0
Export earnings (US$'000)	1,915.0	2,300.0	1,669.0	810.0	988.0	1,575.0
Salt						
Production ('000 tons)	7.8	9.1	10.7	11.5	11.1	-
Coal						
Production (tons)	830.0	1,000.0	1,556.0	1,550.0	800.0	1,750.0

Source: Lao PDR authorities.

Table 7.1: INFLATION RATES
(market prices in Vientiane)

	1987		1988		1989	
	Monthly Rate	Annual Rate	Monthly Rate	Annual Rate	Montly Rate	Annual Rate
January	-1.8	n.a	-3.3	10.3	7.0	29.0
February	2.5	n.a	-0.3	8.0	-7.9	18.5
March	2.4	16.8	1.5	7.1	1.5	18.5
April	5.0	n.a	-0.5	1.4	11.8	33.2
May	-0.3	n.a	-3.2	-1.5	13.2	55.7
June	0.5	-2.3	0.9	-1.1	12.0	72.8
July	8.2	n.a	2.8	-6.1	-1.7	65.3
August	-0.7	n.a	-0.8	-6.2	6.4	77.3
September	0.6	1.2	2.7	-4.3	3.4	78.6
October	-0.4	n.a	9.0	4.7	1.7	66.7
November	-2.0	n.a	2.4	9.4	0.8	64.0
December	-2.1	12.0	4.3	16.6	-2.0	54.1
Annual Average		6.2		7.1		53.1
Memo Item:						
Consumption deflator		14.3		11.8		61.4

Source: Lao PDR Authorities, Staff Calculations.

Table 7.2: OFFICIAL PROCUREMENT PRICES, AND PRICES ON THE PARALLEL MARKET, 1984-89
(In kip per kg; end of period)

	1984	1985	1986	1987/1 (Nov)	1988 (Nov)	1989/1
Official Prices						
Paddy	12	14	14	-	-	-
Maize	12	14	14	-	-	-
Sweet potatoes	10	12	14	-	-	-
Vegetables	6	9	-	-	-	-
French beans	22	43	58	-	-	-
Fruits	8	12	14	-	-	-
Eggs	6	20	15	-	-	-
Pork (medium size)	96	170	111	-	-	-
Soybeans	-	25	-	-	-	-
Groundnuts	30	35	51	-	-	-
Salt	9	9	9	-	-	-
Tobacco	8	61.3	125	-	-	-
Coffee (small grain)	36	92	120	-	-	-
Tea	100	150	196	-	-	-
Sugarcane	1.6	1.8	1.8	-	-	-
Cotton	20	27	66	-	-	-
Cardamon (with shell)	350	1,110	1,200	1,200	1,200	983
Sticklac	60	85	110	150	150	200
Benzoin	800	1,368	1,440	900	900	1,550
Timber (hardwood per m^3)	4,500	4,500	10,500	-	-	-
Prices on the Parallel Market						
Ordinary rice	30	75.6	85	110	109	-
Glutinous rice	30	50.1	75	100	111	-
Maize	5	15	18	40	60	-
Vegetables	26	34	57	70	70	-
French beans	131	147	195	236	231	-
Fruits	5	7	30	42	49	-
Eggs (piece)	13	24	28	29	35	-
Pork	15	342	550	550	582	-
Soybeans	248	144	150	212	219	-
Groundnuts	107	152	196	210	259	-
Salt	10	19.2	40	40	40	-
Tobacco	267	314	659	636	645	-
Coffee	267	434	574	573	834	-
Sugarcane	131	7	10	35	50	-
Wood	15,500	35,000	44,500	44,500	62,500	-
Cardamon	-	-	-	-	-	-
Sticklac	-	-	-	-	-	-
Benzoin	-	-	-	-	-	-

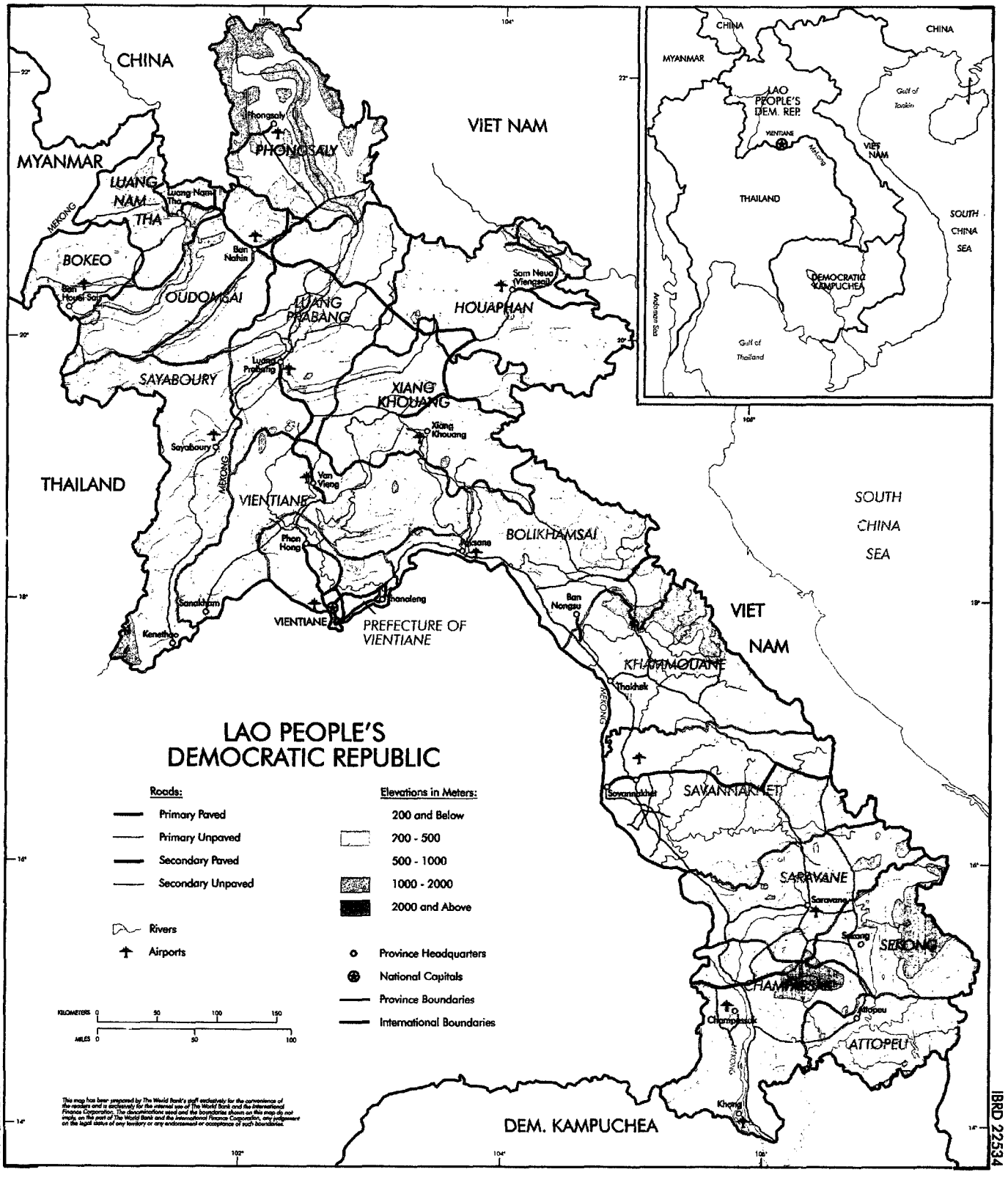
/a As part of the new economic mechanism, the Government no longer sets agricultural prices.

Source: Data provided by the Lao PDR authorities.

Table 7.3: FREE MARKET PRICES IN VIENTIANE, 1984-89
(In kip per kg; end of period)

	Unit	1984	1985	1986	1987	1988 June	1989 June
Food and Beverages							
Rice	kg	30	50	75	102	100	177
Pork	kg	300	575	550	550	550	1,200
Chicken	kg	300	625	665	550	625	900
Cooking oil	liter	130	130	270	300	300	400
Vegetables	kg	60	50	60	110	123	150
Sugar	kg	190	181	145	185	155	280
Condensed milk	can	170	250	190	175	160	180
Eggs	item	15	20	28	27	28	50
Fish	kg	280	645	820	735	1,000	1,200
Salt	kg	5	19	40	35	50	50
Beer	bottle	60	100	130	150	150	200
Clothing							
Shoes	pair	450	507	450	500	500	700
Skirts	item	700	917	875	1,000	1,100	1,000
Fabric	meter	450	370	265	400	400	-
Energy							
Gasoline	liter	60	90	140	140	110	700
Charcoal	kg	17	20	35	35	40	50
Battery	item	120	157	158	154	-	-
Construction Materials							
Cement	bag	-	1,800	2,200	2,100	2,000	2,250
Brick	item	-	4	8	7	-	10
Nails	kg	-	283	350	350	350	500
Other							
Rent	month	1,800	1,800	3,000	3,000	3,000	3,000
Bicycles	item	24,000	34,000	25,000	22,000	22,000	35,000
Cigarettes	pack	250	313	200	150	140	160
Pencils	item	15	30	30	40	30	50
Soap	item	120	176	170	160	150	180
Detergent	kg	130	213	200	260	175	350
Electric bulbs	item	110	150	170	165	170	200

Source: Data provided by the Lao PDR authorities.


LAO PEOPLE'S DEMOCRATIC REPUBLIC
CHINA
MYANMAR
VIET NAM
THAILAND
DEM. KAMPUCHEA
SOUTH CHINA SEA
PHONGSALY
LUANG NAM THA
BOKEO
OUDOMSAI
LUANG PRABANG
HOUAPHAN
SAYABOURY
XIANG KHOUANG
VIENTIANE
PREFECTURE OF VIENTIANE
BOLIKHAMSAI
KHAMMOUANE
SAVANNAKHET
SARAVANE
SEKONG
CHAMPASAK
ATTOPEU
MEKONG
Roads:
Primary Paved
Primary Unpaved
Secondary Paved
Secondary Unpaved
Rivers
Airports
Elevations in Meters:
200 and Below
200 - 500
500 - 1000
1000 - 2000
2000 and Above
Province Headquarters
National Capitals
Province Boundaries
International Boundaries
KILOMETERS 0 50 100 150
MILES 0 50 100
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