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The Lao People's Democratic Republic

Systemic Transformation and Adjustment

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II Setting of Economic Reform

The Country at a Glance

The Lao P.D.R. is a landlocked, largely mountainous country in the center of the Indochina peninsula. Rugged terrain and elevations separate the country from Myanmar to the northwest and China to the north, and much of the Annamite chain stretching along its eastern flank acts as a natural barrier to Vietnam. The Mekong River, however, has served traditionally as a connecting link to Thailand to the west and Cambodia to the south.

The country is characterized by pronounced ethnic, cultural, and linguistic diversity. Reflecting primarily the altitudinal stratification of settlement, one classification differentiates the Lao people roughly as Lao Loum ("valley Lao"), Lao Tai and Lao Theung ("mountainside Lao"), and Lao Soung ("mountaintop Lao"). The Lao Loum, often referred to simply as "Lao," originated in southern China and settled along both sides of the Mekong River and its principal tributaries. Forming the largest single group, with a share in total population estimated at between one third and one half, the Lao Loum have traditionally played a significant role in culture and politics.

With an area of about 237,000 square kilometers and a population estimated at some 4.5 million (Table 2), the Lao P.D.R. is as large as the former Federal Republic of Germany or the United Kingdom, but it is sparsely populated—particularly in the mountainous north and east—in comparison with neighboring countries or the rest of Asia. Most of the people live in farming areas in the lowlands. However, spurred by the Vietnam War and an extended period of internal political struggle, urbanization has been proceeding rapidly. Whereas just 8 percent of the population was urbanized in the mid-1960s, today about 20 percent of the Lao people live in cities, notably the capital of Vientiane, which contains roughly half of the urban population.

About 60 percent of the country is estimated to be covered with dense tropical forests, and only about 10 percent of its area is considered arable. Actual cultivated area is just under 15,000 square kilometers, including some 6,000 square kilometers classified as "shifting cultivation" land. The transportation system is generally weak, and major areas remain virtually inaccessible during the rainy season. Agricultural production is, therefore, still largely subsistence oriented. Furthermore, because only a fraction of the arable land is irrigated and most farmers lack access to improved inputs and essential technology, yields are low and depend heavily on the weather. Rice is by far the most important crop, accounting traditionally for over 80 percent of planted acreage. The country is, however, barely self-sufficient in food production and has repeatedly had to resort to imports.

The proportion of forests that are largely intact in the Lao P.D.R. is one of the highest in Asia. Forestry products were, therefore, traditionally among the few major foreign exchange earners. During the past 25 years, however, forest resources have declined rapidly. The rate of exploitation accelerated in the second half of the 1980s, when demand from neighboring Thailand for these resources rose steeply following that country's imposition of a logging ban. To reverse this trend, the Lao Government has recently reduced the number of logging permits drastically. (For a discussion of environmental issues in the Lao P.D.R., see Box 2.)

Combined with forestry, agriculture is estimated to employ 90 percent of the labor force and to account for 60 percent of GDP. Indirectly, agriculture accounts for even more of GDP, as much of the Lao P.D.R.'s small industrial sector processes agricultural products. Besides agricultural processing, the hydropower industry, which is another major foreign exchange earner, and the nascent garment industry, which thrives on foreign investment seeking to surmount textile quota hurdles, contribute significantly to the economy. The entire industrial sector accounts for little more than 15 percent of GDP.

In contrast to many other low-income countries with estimated GDP per capita of about $300, the Lao P.D.R. is well endowed with natural resources. It has untapped reserves of agricultural land, large forests, hydropower potential, and mineral resources that, when efficiently exploited, could contribute substantially to economic progress. However, the

Table 2: Economic and Social Indicators: Lao P.D.R. and Neighboring Countries

	Cambodia	China	Lao P.D.R.	Myanmar[1]	Thailand	Vietnam
Area (in thousands of sq. km.)	181	9,561	237	677	513	332
Agricultural land (in percent of total)	21	53	7	16	47	21
Population (in millions)	9	1,176	5	45	59	71
Density (persons per sq. km.)	51	123	19	66	115	214
Urbanization[2]	12	27	20	26	24	20
Agricultural employment (in percent of total)	...	56	86	65	57	72
GDP per capita (in U.S. dollars)	194	367	358	...[3]	2,102	166
Exports per capita	4	78	52	15	622	40
External debt per capita[4]	...	60	103	121	449	57
Share of state enterprises in nonagricultural employment (in percent)	...	39	6	5	13	19
Life expectancy at birth[5] (in years)	51	69	51	60	69	67
Infant mortality[6]	116	31	97	72	26	36
Child (under age 5) mortality[6]	169	38	158	100	31	44
Access to safe water[2]	...	78	29	33	72	50
Adult illiteracy[7]	65	27	42	19	7	12
Female illiteracy	78	38	67	28	10	16
Primary school enrollment ratio	...	125	101	102	114	103
			(Average 1990–93 growth, in percent)			
Population	2.5	1.2	2.9	2.2	1.5	2.3
Urban	4.8	2.2	6.3	3.4	4.4	3.2
Real GDP	6.8	11.4	5.7	3.6	7.8	7.4
Agriculture	3.9	0.9	-4.3	3.0	3.0	3.8
Industry	11.4	8.0	12.4	3.8	11.4	10.8
Consumer price index	123.3	8.1	9.8	28.5	4.4	39.8
Broad money	74.9	29.6	41.6	31.1	17.9	41.7
Exports (in U.S. dollars)	4.6	13.9	43.4	12.2	16.9	18.1
Real effective exchange rate[8]	...	-4.4	6.0	23.6	-0.4	3.9

Sources: Lao authorities; and World Bank and IMF staff estimates.
[1]Data refer to fiscal years starting April 1.
[2]In percent of relevant population.
[3]Per capita income was $1,232 at the official exchange rate and $66 at the parallel market rate.
[4]Excluding debt to the nonconvertible area.
[5]Based on 1992 data.
[6]Per 1,000 live births.
[7]Based on 1990 data; in percent of relevant population.
[8]Positive entry indicates appreciation.

country also faces very serious disadvantages. Its landlocked position, rugged terrain, low population density, and widely dispersed settlements generate high transportation and communications costs and render broad, equitable improvements in social and economic infrastructure expensive. Furthermore, the country continues to suffer from the adverse impact of the war, including the loss of lives and the exodus of a large number of skilled laborers. Therefore, the authorities face the difficult task of promoting economic development aimed at spreading benefits evenly throughout the country.

Brief Political History

The written history of the Lao P.D.R. begins in the fourteenth century with Fa Ngoun, called the Conqueror, who, with Khmer assistance, conquered the small states of the present-day Lao P.D.R. and much of northeastern Thailand. In 1353, he united these territories into the Lao kingdom of Lan Xang ("million elephants"), then one of the largest states in the region. Fa Ngoun established Buddhism as the state religion, but this had initially little effect on the animistic majority of the population. After years of

Box 2. Environmental Issues

Owing to the modest size of the industrial and mining sectors, environmental concerns in the Lao P.D.R. are chiefly related to the agricultural and forestry sectors, particularly in four areas: (i) forestry resource management; (ii) biodiversity conservation; (iii) land resource management; and (iv) water resource management.

Forestry resource management. The Government has been experiencing increasing difficulty in forest resource management as it has been unable to control effectively the depletion of forest resources. Although forest coverage in the Lao P.D.R. remains one of the highest in the world, forest depletion took place at unsustainable rates in the 1970s and 1980s, as wood extraction and encroachment by the farming population increased rapidly. In addition, returns from such depletion only partially accrued to the Government, owing to widespread illegal logging, clandestine exports, and inadequate pricing. Thus the Government, with World Bank assistance, now aims at striking a balance between sustainable wood production and environmental protection, particularly in areas in which watersheds and biodiversity are at risk.

Biodiversity conservation. Although the vast areas of intact forest in the Lao P.D.R. still allow one of the richest original habitats in the world, forest depletion had an increasingly damaging impact on the nation's rich biodiversity. Only recently did the Government approve legislation for wildlife protection and for the creation of a system of 17 protected areas, and the approach taken so far suggests that the legislation still relies primarily on command-and-control policies. The Government plans to place an increasing emphasis on providing proper incentives for the indigenous population to participate in conserving biodiversity. In order to secure the long-term support from the international community for conservation activities, the Government will consider steps to establish a conservation trust fund.

Land resource management. Even though the scarcity of land resources is not a pressing issue, use of land in the Lao P.D.R. is suboptimal. In the northern regions of the country (the uplands), population pressures on marginal land and the decrease of rotation periods are the root causes of land erosion and degradation of soil fertility. In the south, the lack of an integrated research and extension system constrains land yields to well below potential. Overall, irrigation facilities are not well developed in the lower uplands. The optimal regional and geographical specialization of agriculture—food production in the lowlands and tree plantations in the uplands—appears far away.

As in the case of forestry management, community-based resource management will be increasingly emphasized. At the same time, efforts will be made at the national level to provide policymakers with a better mapping of the overall land resources available, including the status of degradation and provisions for best land use. Concurrently, land legislation would allow a flexible allocation of land to farmers, based on land characteristics, labor availability, and possible uses, rather than maintain fixed upper limits.

Water resource management. The Lao P.D.R. is endowed with the highest per capita availability of renewable fresh water in Asia. However, with the development of hydropower schemes and increased urbanization, two serious problems may develop. First, the power projects may endanger the water catchment. Second, because of ineffective water management, coupled with insufficient resources devoted to water supply and sanitation, particularly in urban areas, water may become hazardous to public health. To deal with such potential problems, the Government is reviewing the overall environment assessment of hydroelectric projects and of comprehensive plans for water supply and sanitation improvements.

constant warfare that exhausted his people, Fa Ngoun was eventually driven into exile. His successor, a devout Buddhist, consolidated the administration, built schools and temples, and succeeded in making Lan Xang an important center of trade. Struggles with Siam and Burma began. Except for a brief period of anarchy and Burmese domination, however, Lan Xang's territory and power continued to grow until the end of the seventeenth century. Its rise culminated in the long reign of Souligna Vongsa, from 1637 to 1694, at times called the golden age of the Lao P.D.R.

After Souligna Vongsa's death, the kingdom disintegrated into three separate states: a kingdom based in Vientiane but under the suzerainty of Annam; an initially independent kingdom established at Luang Prabang; and a third kingdom, Champassak, which controlled the southern provinces along the Mekong but increasingly fell under the influence of Siam. After the occupation of Vientiane by Siam in 1778, both the kingdoms of Vientiane and Luang Prabang had to pay tribute, if only symbolic, to Siam. Later, the two kingdoms also had to pay tribute to the emperor of a rising Vietnam. The decline accelerated in the early 1800s as Vientiane engaged in a disastrous war with Siam, which eventually led to the destruction of the capital city, the forcible resettlement of its inhabitants, and the virtual depopulation of much of the central Mekong region. Additional Siamese campaigns also depopulated vast areas between the east banks of the Mekong and the Annamite chain.

After first recognizing Siamese suzerainty over the Lao region, France responded to a request by the court of Luang Prabang for protection toward the end of the nineteenth century by pressuring Siam to renounce all claims on territories east of the

Mekong. About 1900, France unified the administration of the main Lao principalities in Vientiane and allowed only the royal house at Luang Prabang to retain its title and prerogatives. Laos, as it was called, remained a French protectorate virtually through the end of World War II. At war's end, however, France recognized Sisavang Vong, who had been ruling Luang Prabang since 1904, as king of an autonomous Laos. In 1947, elections to form a constituent assembly were held, and the country's first Constitution was promulgated. Two years later, Laos became an independent associate state of the French Union and was eventually granted full sovereignty in October 1953.

From the onset, the newly independent country faced serious political and military difficulties. The Royal Government, headed by Prince Souvanna Phouma, encountered opposition from the Neo Lao Haksat (the Lao Patriotic Front), a dissident, communist-supported movement chaired by Prince Souphanouvong, a half-brother of Souvanna Phouma. The Pathet Lao, the military arm of the Patriotic Front, gradually seized control of the northeast provinces bordering North Vietnam, and, despite numerous attempts to reconcile the warring parties, Laos was de facto partitioned by the mid-1960s. As the Ho Chi Minh Trail ran through Pathet Lao territory, both sides were deeply drawn into the Vietnam War, and it was only in the context of the 1973 Paris peace agreement that a cease-fire in Laos was concluded. In April 1974, a new coalition Government was formed, and Prince Souvanna Phouma retained the post of Prime Minister while Prince Souphanouvong was appointed Chairman of the Joint National Political Council. However, in the ensuing months, the Patriotic Front steadily increased its power base by enlarging the Pathet Lao-controlled zone. Following the fall of Phnom Penh and Saigon in the spring of 1975, the Patriotic Front gained full control. When it won the elections in November 1975, King Savang Vatthana abdicated, and Prince Souvanna Phouma resigned.

Convening in December 1975, the National Congress of People's Representatives abolished the monarchy, changed the country's name from Laos to the Lao People's Democratic Republic, and elected a 45-member legislative body, the Supreme People's Council. Souphanouvong was appointed President of the Republic and of this council, and Kaysone Phomvihane, a leading figure of the Lao People's Revolutionary Party, became Prime Minister.

The Stage for Economic Reform

In the mid-1970s, the Lao economy shared many characteristics of centrally planned economies. However, certain special factors in the country's political and economic background both set the stage for economic reform and heightened its urgency.

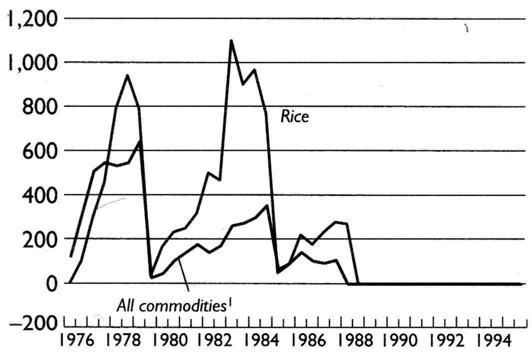
Inheriting a war-torn and extremely underdeveloped economy in 1975, the leadership was faced with the formidable task of reconstruction and development. The crisis was heightened by the abrupt termination of U.S. aid and the disruption of cross-border trade resulting from the economic blockade of neighboring Thailand, the country's major trading partner and a key source of basic foods. At the same time, the Government experienced various setbacks in implementing measures designed to lay the foundation of the "socialist transformation" of the economy. For instance, the introduction of taxation and the collectivization of agriculture met with considerable peasant resistance, and adverse weather compounded the agricultural problems. Furthermore, as regulations increased, traders, entrepreneurs, professionals, and capital fled abroad. At the same time, a growing fiscal deficit and rapid monetary expansion, coupled with acute shortages, resulted in high inflation. The balance of payments position also deteriorated, reflecting the limited export expansion and the total dependence on bilateral agreements for import financing.

Thus, the first few years of the communist regime—the second half of the 1970s—offered little respite from falling living standards, stagnant or declining production levels, growing financial instability, and increasing internal resistance. Recognizing the inadequacy, if not total failure, of the economic measures patterned on the model of other centrally planned economies, the Government initiated a gradual move toward comprehensive economic restructuring, without abandoning its Marxist philosophy or adopting multiparty democracy, to tackle the nation's serious economic problems. Indeed, consistent with Marxist orthodoxy, the capitalist system was accorded a special transitional role and was viewed as a necessary intermediate stage on the path to socialism.

Early Reform Years (1979–88)

In December 1979, faced with a steadily worsening economy and under pressure from its creditors, the Government took its first tentative steps toward economic reform. The new policies stressed the need for increased efficiency and production, and assigned an important role to market forces and the private sector. Among the most important measures implemented were the removal of various restrictions on internal and external trade, the substantial devaluation of the national currency, the kip, and the dramatic adjustment of official prices, especially agricultural ones. The authorities hoped to draw

Chart 1. Excess of Free Market Prices over Official Prices, 1976–95
(In percent)



Source: IMF staff estimates.
[1]Using the weights in the basket of civil service rations.

unauthorized activities back into official channels and to revitalize the state sector. By restructuring, in particular, the grossly distorted agricultural price system, they also hoped to lay the basis for the country's First Five-Year Plan (1981–85), which aimed at reaching food self-sufficiency and promoting a balanced and diversified agricultural structure.

However, it was with the introduction of the New Economic Mechanism (NEM) in 1985 that the reform process gathered momentum. Public enterprise reform was marked by the granting of operating autonomy to enterprises, which allowed them to determine production levels and product mix, investment, employment, and wages. Thus, the system of economy-wide production targets set by the Government was abandoned. Domestic and foreign private investors were given a major role in the economy. Private sector activity was allowed in most sectors, including rice production, and restrictions on internal trade were abolished.

In addition, the Government introduced changes in financial policy. Taken in isolation, these changes were hardly revolutionary, but they marked the beginning of a series of far-reaching policy reforms in virtually all relevant economic areas during 1985–88, as the country's development strategy shifted toward more of a market orientation and a liberalization of the economy.

Price Liberalization

The dramatic adjustments in official retail and wholesale prices, starting with a ninefold increase in the price for basic rice rations in April 1985 and continuing with an average 360 percent increase in most other controlled prices throughout the remainder of the year, initially changed little in the underlying system. Repeating essentially the pattern of the adjustment at the end of 1979, the 1985 price adjustments were just sufficient to bring official prices temporarily in line with free market prices. But as the latter continued to rise—fueled in part by the necessary increase in public sector wages—the gap between the two prices soon began to widen again (Chart 1).

The two-tier price system of market prices and generally much lower official prices continued to exist in 1985–89. The official prices were, in principle, set to reflect production costs plus margins, but owing to political and social considerations or inadequate accounting practices—including the application of a grossly overvalued official exchange rate—they often involved substantial subsidies. The subsidy element of the official price system grew even larger when vouchers redeemable at state shops were increasingly used for public sector payments in lieu of cash. For instance, during the period from mid-1985 to mid-1989, as much as 90 percent of public sector salaries and wages were paid in the form of so-called salary coupons that could be redeemed at state shops. Also, roughly 60 percent of official procurement purchases were made by issuing vouchers redeemable at state or cooperative shops.

The fundamental reform of public sector pricing came through a decree issued in June 1987. This decree abolished the practice of "cost plus" pricing for state enterprises by stipulating that prices had to be market determined and that, notwithstanding regional differences, there should in principle be but one price in a given market. More specifically, the decree stated that prices, except those of a few utilities, public services, and several key industrial products, should be freely negotiated between the parties to a transaction without interference from the Administration. As the basic consumer goods sold through state shops were not among the listed exceptions, the decree also signaled an end to the many related subsidies. However, in order to cushion the impact on civil servants and because an appropriate solution to their compensation still had to be formulated, the sale of subsidized goods to these employees continued until it was phased out over the period March–October 1988.[2]

The price reform also greatly affected agricultural procurement. After years of increasing use of barter

[2]Sales against salary coupons ended effectively in March 1989, when state stores were ordered to exchange the remaining coupons for cash. Many of the state stores were consequently closed.

transactions and payment with vouchers, procurement agencies had again to monetize their transactions. More significantly, however, the transition from cost plus pricing to market-oriented pricing implied substantial increases in procurement prices for most crops.

Trade Reform

Throughout the decade to the mid-1980s, the Government had sought to increase its control over domestic and foreign trade; as a result, the public distribution system had become increasingly dominant and exceedingly complex. At the national level, the Lao Trade Corporation was in charge of official external and wholesale trade, as well as rice distribution.[3] At the local level, procurement and distribution operations were handled by provincial offices in accordance with quotas established by provincial planning committees and at prices that, since 1982, partly reflected local conditions but also had to stay within limits set by the central authorities. At the retail level, the distribution system relied on an extensive network of state stores and cooperative shops that continued to expand through 1986.

Notwithstanding substantial unrecorded trade outside official channels, the state sector also dominated foreign trade. The state had reserved a monopoly on virtually all major exports and also on most imports, with the exception of imports made by so-called *sociétés mixtes* (joint public and private companies) or a few state enterprises that were authorized to retain a portion of their foreign exchange earnings. In view of the small share of free foreign exchange earned through untied exports, the allocation of foreign exchange turned inevitably into a complicated exercise that had to comply with the provisions of numerous bilateral trade and foreign assistance arrangements, leaving little room for flexibility.

In advance of the sweeping price reforms decreed in July 1987, the Government also liberalized the domestic and external trade system. In early 1987, the intricate web of state trading companies was consolidated, and administrative units were barred from engaging in, and interfering with, trade transactions. Shortly thereafter, provincial trade restrictions, most notably those relating to the movement of rice, were eliminated, and transportation, previously a monopoly of state and provincial enterprises, was opened to the private sector. Restrictions on foreign trade were also relaxed as, subject to licensing by the Ministry of Commerce, joint and private companies were permitted to trade and transport all but specifically listed "strategic" commodities.[4] Most of these restrictions disappeared during 1988 with the effective decontrol of prices and the liquidation of the Lao Food Corporation, which had monopolized the procurement of rice and shared its distribution with the Lao Trade Corporation.

Exchange Rate Reform

The exchange rate system for transactions in convertible currencies, like the implicit exchange rate system for transactions with the nonconvertible area, was complicated. With the introduction of two further rates in 1985 and early 1986, there existed seven different exchange rates. These included a symbolic official rate of KN 10 per U.S. dollar; a commercial rate of KN 95 per U.S. dollar, at which most transactions by state enterprises were made; and several rates close to the then-prevailing parallel market rate of roughly KN 400 per U.S. dollar, which applied to transactions by the *sociétés mixtes* or the prefecture of Vientiane.

Reform of the exchange rate system initially lagged behind other reforms. In September 1987, the number of exchange rates was reduced to four. While the overall spread between the highest and lowest rates was not narrowed, this first step brought the exchange rates applicable to most transactions very close to the parallel market rate. Reassured by the stability of the kip in the parallel market during the months following these initial steps—it even appreciated slightly—the authorities then moved quickly to unify, effective January 1, 1988, all rates at one very close to that prevailing in the parallel market.

Public Enterprise Reform

Prior to the adoption of the NEM in 1985, state enterprises were run along the standard model of a command economy, with virtually no room allotted for managerial flexibility or autonomy. Selling and input prices, salaries, investment, reinvestment, financing, product mix, and output targets were all determined by central or provincial authorities in accordance with the plan, the budget, or the stipulations of a supervisory ministry or provincial authorities. All operating surpluses, if any, and most of the depreciation allowances had to be transferred to the budget,[5] which, in turn, provided most of the

[3]Rice distribution was carried out jointly with the Lao Food Corporation, which was established in 1982.

[4]These commodities comprised a number of major exports that were initially reserved for state trading agencies so as to comply with bilateral trade contracts with the nonconvertible area.

[5]Because actual operating surpluses frequently diverged from the plan, these transfers were often effectively financed by the banking system.

financing for the necessary working capital and investment. As a result, little distinction was made between state and public enterprise assets, and virtually no incentive existed to improve financial performance, let alone earn a reasonable return on investment.

The first attempts to accord Lao state enterprise managers at least some degree of autonomy were made as early as 1983 at four of the most important centrally supervised enterprises.[6] Two municipal enterprises and another two enterprises under provincial supervision were added to the experiment in 1985. Initially, greater autonomy at these enterprises meant merely the permission to retain 40 percent of profits and, in the case of the Lao Wood Industry Corporation, also most of its depreciation allowances. But gradually greater autonomy was accorded to other public enterprises, which, in turn, were expected to become financially self-sufficient. By the end of 1987, roughly 75 percent of all centrally owned enterprises were thus granted a considerable degree of operational freedom, as long as they conformed with the two main targets established for each enterprise under the plan: output and payments to the budget. As funding through the budget for such enterprises had been discontinued by that time, the annual plans gained additional significance as the principal basis for justifying requests for credit from the banking system.

Fiscal Reform

Even though a tax system had been in place before the public sector reforms began, the principal source of domestic budgetary revenue used to be negotiated transfers from state enterprises. As increased financial autonomy was extended to a greater number of state enterprises, the revenue system had to be adjusted; accordingly, the authorities announced in a decree of June 1986 that the largely inoperative tax system would be overhauled and simplified.

The tax reform was implemented with the 1988 budget. Contrary to the initial intention, however, the new tax system turned out to be complicated and highly differentiated. Depending on the type of activity, the flat tax on commercial and industrial profits derived from domestic sales ranged from 20 percent to 85 percent, while profits derived from export activities were to be taxed at rates ranging from 0 percent to 80 percent, with some activities subject to a lower rate and others subject to a higher rate than the corresponding domestic activity. Like the profit tax, the turnover tax and the new import tariff system, which came into effect in March 1988, were highly differentiated, with rates ranging from 1 percent to 15 percent and from 1 percent to 70 percent, respectively. Moreover, wages and salaries of Lao citizens working for Lao employers remained untaxed, while the agricultural income and profits tax was maintained (although its rates were slashed again, to a yield-dependent rate of 4–5 percent in the case of paddy[7] and to 6 percent for all other agricultural production).

Parallel with the attempts to adjust the revenue system, efforts were made in 1988 to reorder expenditure priorities. As subsidies to civil servants and other consumer subsidies were gradually phased out, civil service wages were raised, although not in step with the resulting price increases. At the same time, and helped by an early retirement scheme and the introduction of separation payments, a substantial retrenchment of central government staff began.

Banking and Financial Sector Reform

Reform of the financial system lagged far behind those in other areas. In October 1988, the separation of central and commercial banking activities of the State Bank started. The Nakhoneluang Bank became autonomous, and two large branches of the State Bank in Vientiane were split off one year later as independent commercial banks. The process continued with the creation of several other commercial banks.

Interest rate policy, which was still within the authority of the Council of Ministers (the cabinet of the Lao Government), also changed little. In October 1988, the traditionally low deposit rates were raised by 20–50 percent, and the lending rates were roughly doubled. At this time, the authorities also abandoned the distinction between private and public sector with regard to credits and deposits and terminated the extension of preferential terms to the public sector. Most interest rates remained negative in real terms, and deposit rates, in particular, proved too low to enable the newly founded commercial banks to compete effectively with rates offered in the curb market.

Summary of Structural Reforms and Macroeconomic Developments

The implementation of major reforms during 1979–88 represented substantial progress in moving toward an open and market-oriented economy. The reforms helped to reactivate private sector activity and improve the quantity and range of goods available in the domestic market. The services sector was

[6]These were the tobacco and beer factories, the electricity company, and the Lao Wood Industry Corporation.

[7]Although the agriculture tax was generally progressive with respect to yield, its rate structure was highly regressive at both ends of the yield spectrum.

the quickest to respond to the improved incentives: private and public transport operators took advantage of the removal of internal trade restrictions, while enterprises involving handicrafts and consumer services (repair shops, tailors, and restaurants) quickly emerged as a result of the liberalization of private activities.

This favorable impact on macroeconomic performance was, however, largely offset by several adverse developments. In the late 1980s, the dismantling of the system of transferring surpluses of public enterprises to the budget caused a drop in revenues and an increase in government dissaving, while the decentralization of decision making was followed by local governments' action to provide large wage increases financed by bank credit. Accentuated by the effects of a prolonged drought in 1988, these developments triggered a surge in inflation, a large current account deficit, and the depletion of foreign reserves. The authorities were unable to manage the new system effectively because of the absence of the necessary policy tools, including indirect means of monetary management control and an adequate institutional framework.

Clearly, much remained to be accomplished in the transformation process, as subsistence farming and barter continued to characterize the agricultural sector and the public sector still dominated the monetized economy. Moreover, despite sizable public investments during the late 1970s and early 1980s, economic and social infrastructure remained inadequate, and the existing capital stock was poorly maintained and often obsolete. Domestic saving remained low, as the private sector made only limited use of the banking system. On the external side, exports, which covered only one third of imports, were narrowly based, while foreign reserves were low.

III Recent Macroeconomic Performance and Structural Reforms

Against the background summarized in the previous subsection, the Government adopted a major medium-term adjustment program in 1989, followed by another in 1993. This section summarizes the main objectives and reform strategy pursued during the period 1989–94, as well as the performance of the Lao Government under the programs. Sections IV–VII examine in greater detail economic developments in each of the major policy and reform areas.

First Medium-Term Structural Adjustment Program (1989–92)

Objectives and Reform Strategy

In mid-1989, the Government resumed a medium-term adjustment program with support under the IMF's structural adjustment facility (SAF) and a World Bank structural adjustment credit, with the objective of establishing domestic and external financial stability while implementing the structural reforms. Specifically, the program aimed to (i) achieve an average annual rate of real GDP growth of 5–6 percent; (ii) reduce the rate of inflation by 1992 to that prevailing in major trading partner countries (about 5–6 percent); and (iii) make progress toward balance of payments viability.

The 1989–92 program was framed to tackle a wide range of issues. To promote production, the program envisaged an improvement in producer incentives, accompanied by actions to rehabilitate productive enterprises and improve the socioeconomic infrastructure. In this connection, private sector investment was promoted by privatizing state-owned enterprises and introducing a legal framework for foreign direct investment, while public sector investment was undertaken by the Government with assistance from the donor community. The increased investment was to be financed by additional foreign resources and expanded public and private sector savings. To enhance domestic resource mobilization, the tax system was to be reformed, the finances of public enterprises improved, and financial sector reform initiated. To restrain demand pressures, the program emphasized the need to adopt cautious demand-management policies that entailed the elimination of bank borrowing by the Government and the curtailment of credit to state enterprises. Finally, to strengthen the external position, the exchange rate was to be managed flexibly, the trade and payments system further liberalized, and the contracting of new nonconcessional external debt strictly limited.

Policies and Performance

Macroeconomic Policies

With a view to achieving the medium-term macroeconomic objectives, the Government initiated a number of steps in macroeconomic policy areas. In the fiscal area, a fundamental reform of the tax system was begun to reflect the increased autonomy of state-owned enterprises, equalize tax treatment between the public and private sectors, and introduce tax incentives for foreign investment. On the expenditure side, priorities were substantially reordered. In particular, consumer subsidies and subsidies to civil servants and to enterprises were eliminated. The role of monetary policy was confined to limiting the state-owned enterprises' demand for credit and credit expansion by the banking system. In the external area, the official exchange rate was set generally at a rate close to the parallel market rate, while the trading system was rationalized further.

Macroeconomic Performance

A strong recovery of rice and electricity production in 1989 from earlier drought-stricken levels was followed by continued buoyant growth, apart from a small drop in rice production in 1991. At the same time, the relatively small construction and manufacturing sectors witnessed strong growth as domestic and foreign investors responded to the new opportunities opened up by the reforms. The pickup in output growth, along with the tightening of financial policies, brought about a dramatic reduction in the inflation rate (end-of-period basis) from about

82 percent in 1989 to about 10 percent in 1991. The rate fell further to about 6 percent in 1992, largely reflecting the continued pursuit of prudent demand-management policies and a bumper harvest. This improvement occurred despite a large increase in electricity tariffs and rents during the year (Table 3 and Chart 2).

The external position strengthened considerably during 1989–92. Early on, export receipts were boosted by a rebound in electricity sales to Thailand and growing timber earnings, and, in 1992, by a strong growth in garment exports. With buoyant exports and a slowdown in import growth (owing to tighter domestic financial policies and the underimplementation of capital expenditure), as well as higher private transfer flows attracted by a renewed confidence in the Government's policies, the current account deficit contracted by 2 percentage points of GDP. At the same time, stepped-up aid inflows from multilateral and bilateral donors more than offset the sudden loss in 1991 of financial assistance from the former Soviet Union. Although the overall balance shifted into deficit in 1991 as a result of temporary delays in program loan disbursements, a surplus position was restored in 1992. Gross foreign reserves of the banking system almost quintupled from $17 million at the end of 1988 to about $80 million at the end of 1992, equivalent to four-and-a-half months of total imports, although official reserves remained at only two months of imports. The increasing proportion of highly concessional debt and the improvement in exports facilitated a decline in the debt-service ratio from 20 percent in 1988 to under 15 percent in 1992.

Structural and Institutional Reforms

Agricultural decollectivization and price liberalization were the most important structural reforms introduced because they permitted a long-overdue adjustment of relative prices in favor of agricultural products. Also, contractual and leasing systems affecting land tenure were introduced.

Financial sector reform entailed the establishment of a two-tier banking system in June 1990, with the promulgation of the Central Bank Law establishing the Bank of the Lao P.D.R. as successor to the old State Bank. The central bank's instruments of monetary management were expanded gradually over 1989–92. During this period, the extension of banking services and improved management of commercial banks bolstered confidence in the banking system and were instrumental in mobilizing domestic savings, increasing financial intermediation, and attracting foreign capital.

State enterprise reform, together with privatization, required hard budget constraints on enterprises (which had previously monopolized bank credit) and severed the link between enterprises and the budget. In 1989, the Government announced its plan to privatize all but about a dozen strategic state enterprises.[8] During 1989–90, several enterprises were privatized on an ad hoc basis without sufficient regard to maximizing financial returns. Drawing on the lessons of that experience, a wider program of privatization, involving leasing arrangements, auctions, joint ventures, and improved bidding procedures, was adopted in 1991. Divestiture was rapid at the provincial level, with some larger provinces divesting (in many cases through sales to workers) over two thirds of the small enterprises under their jurisdiction; even though the privatization procedures adopted were less than optimal, this still represented significant progress. However, only limited progress was made in privatizing large and medium-sized state enterprises, where the procedural and administrative problems and the shortage of trained staff seriously hampered negotiations with foreign investors.

In the external area, the authorities built upon actions that had already yielded considerable benefits by further liberalizing the foreign trade system and the foreign investment regime. All exports and imports other than those on specified lists were freed from quantitative restrictions. As of the end of 1992, only timber exports remained subject to quantitative restrictions (for environmental reasons), and only imports of rice and certain types of motor vehicles still required quantitative licensing.

The Government also made some progress in institution building, although it was constrained by the lack of skilled staff and administrative delays. An important action was the promulgation of a new Constitution in August 1991, the first since 1975, which laid the foundation for the adoption of various business laws and important changes in the regulatory framework. The drafts of a number of such laws were prepared but still await enactment. In addition, the Government launched a major administrative reform in early 1992 aimed at streamlining decision making and reducing staffing, but progress has been slow.

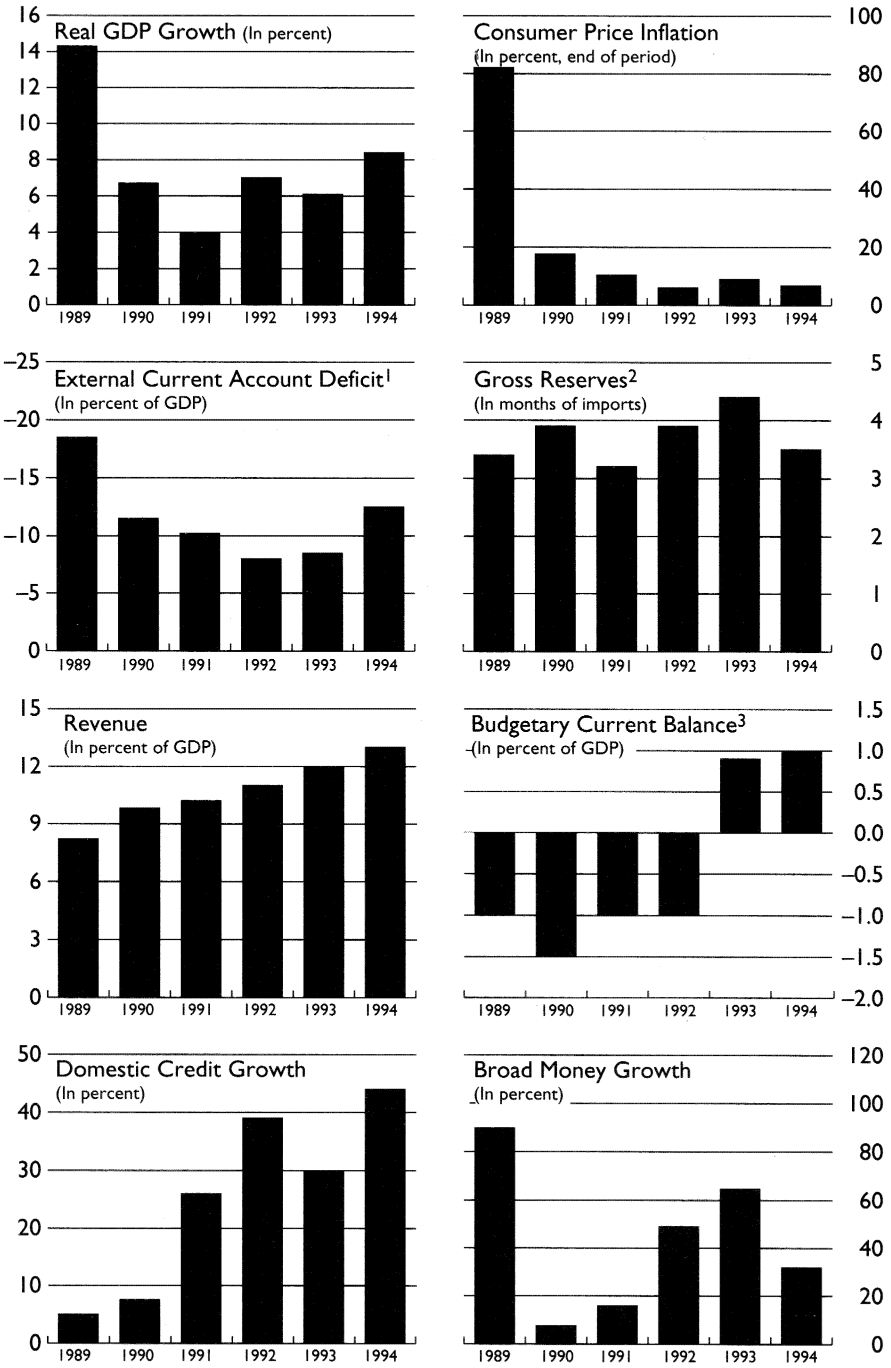
Second Medium-Term Structural Adjustment Program (1993–95)

Objectives and Reform Strategy

The objectives and basic strategy embodied in the first medium-term adjustment program for the pe-

[8]Subsequently (in 1995), the Government decided to keep 32 state enterprises in its hands.

Chart 2. Overall Macroeconomic Performance



Sources: Lao authorities; and IMF staff estimates.
[1]Excluding official transfers.
[2]Gross reserves of the banking system.
[3]Excluding grants.

Table 3. Economic and Financial Indicators

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
	(Annual percent change, unless otherwise specified)									
National income and prices										
Real GDP	6.9	9.2	–2.9	–0.7	14.3	6.7	4.0	7.0	6.1	8.4
Agriculture	7.4	9.4	–1.9	–4.2	10.8	8.7	–1.7	8.3	2.7	7.6
Industry	12.0	6.6	–16.0	–2.4	35.0	16.2	19.9	7.5	10.3	8.7
Real GDP per capita	4.0	6.2	–5.6	–3.5	11.0	3.7	1.0	4.0	3.1	5.3
Nominal GDP (in billions of kip)	76	124	210	235	427	613	722	848	986	1,159
Consumer price index (annual average)	106.0	37.1	6.0	14.4	59.5	35.7	13.4	9.8	6.3	6.7
Consumer price index (end of period)	136.8	15.0	9.8	13.0	82.1	17.7	10.4	6.0	9.0	6.8
External sector										
Exports, f.o.b.	22.4	2.6	12.9	–6.9	9.5	24.3	22.7	37.3	75.2	23.3
Imports, c.i.f.	19.3	–3.9	16.4	–24.9	29.7	–4.3	6.6	23.5	54.6	30.6
Nominal effective exchange rate	–2.8	–57.8	–2.1	–69.6	–37.3	–17.7	1.5	–3.5	–0.9	2.6
Real effective exchange rate	92.7	–42.2	1.8	–72.8	18.4	9.7	10.0	2.0	1.2	3.9
Kip per U.S. dollar (end of period)										
Official exchange rate	95	95	368	453	714	696	712	717	716	719
Parallel market rate	339	423	388	412	628	735	721	737	732	729
Government budget[1]										
Revenue and grants	91.0	64.3	5.8	93.1	27.4	60.1	27.8	17.4	26.5	30.6
Total expenditure	134.2	35.1	11.2	154.3	41.8	34.8	5.3	14.8	11.1	38.5
Current	129.1	56.6	8.3	75.0	42.4	74.9	17.3	23.1	9.5	20.5
Capital	139.2	15.2	14.9	248.7	41.4	10.7	–6.1	5.0	13.2	62.9
Money and credit[2]										
Net domestic assets	15.7	82.6	36.2	29.8	4.5	7.6	26.2	38.9	33.0	44.2
Broad money	35.6	70.0	79.0	37.1	89.7	7.5	15.8	49.0	64.6	31.9
Velocity (GDP/broad money at year end)	33.1	32.1	13.2	10.8	10.4	13.8	14.1	11.1	7.8	8.1
	(In percent of GDP)									
Government budget[1]										
Revenue and grants	16.2	16.2	10.2	17.5	12.3	13.7	14.8	14.8	16.1	17.9
Total expenditure	26.0	21.3	14.1	32.0	24.9	23.4	20.9	20.4	19.5	23.0
Budgetary current balance	1.1	3.0	1.9	0.2	–1.0	–1.5	–1.0	–1.0	0.9	0.8
Overall balance (cash basis)	–12.4	–6.5	–4.5	–19.8	–16.6	–14.4	–11.3	–11.7	–7.8	–11.0
External sector[3]										
Current account balance[4]	–5.6	–6.9	–9.8	–13.7	–15.8	–9.0	–4.3	–3.5	–2.2	–4.7
External debt outstanding[5]	9.6	13.1	14.9	34.4	32.5	35.7	32.9	34.8	36.2	36.8
Debt service [5]	0.8	0.8	1.0	1.7	1.6	1.1	1.2	0.8	0.7	0.7
	(In percent of exports)[6]									
External debt service[5]										
Including IMF	18.0	16.7	16.8	13.1	13.8	9.1	9.5	5.5	2.9	2.2
Excluding IMF	4.9	7.3	11.1	8.6	11.3	7.6	8.8	4.7	2.7	2.1
	(In millions of U.S. dollars)									
External current account balance[4]	–93.8	–90.6	–117.7	–79.2	–115.6	–77.8	–44.1	–41.0	–29.5	–72.5
Overall balance of payments	20.7	8.6	–11.3	–1.8	–4.3	–18.1	32.1	4.7	13.9	–10.1
Gross international reserves[7]										
(End of period)	25.9	32.6	21.2	29.4	59.8	64.8	57.2	85.8	150.9	158.2
(Equivalent months of imports)[6]	1.9	2.1	1.2	2.2	3.4	3.9	3.2	3.9	4.4	3.5

Sources: Lao authorities; and IMF staff estimates.

[1]Data from 1992 onward are adjusted to calendar-year basis from original fiscal-year (October–September) basis.

[2]1987 data are partly adjusted for a major change in the valuation of foreign-exchange-denominated assets and liabilities.

[3]Domestic currency values converted at official exchange rate (for commercial transactions). Data before and after 1988 are not entirely comparable, owing to massive realignment in the context of the exchange rate unification.

[4]Including official transfers.

[5]Excluding debt to the nonconvertible area.

[6]Exports of goods and nonfactor services.

[7]Including foreign exchange holdings of the banking system.

Box 3. Trade Taxation

Prior to 1988, the system of trade taxation consisted of (i) an ad valorem import duty levied on the c.i.f. value of imports, ranging from 5 percent to 200 percent, with numerous exemptions; (ii) a turnover tax levied on imports of state enterprises and trading companies, ranging from 5 percent to 25 percent; and (iii) an export duty levied on the f.o.b. value of exports, ranging from 10 percent to 40 percent (the lower rates applied to private sector transactions), with a number of exemptions. The large number and wide dispersion of tariff rates, together with the then-existing system of multiple exchange rates, nonmarket price determination of trade with the CMEA, and proliferation of exemptions, implied a highly distorted system of incentives for external transactions. Initial steps to rationalize the system of trade taxation were undertaken in 1988–89. Direct export taxes were replaced in 1988 by a system of taxes on profits accruing from exported goods, at rates ranging from 2 percent to 80 percent. At the same time, maximum import duty rates were lowered from 200 percent to 70 percent. The unification of the official exchange rates unified prices in trade with the convertible area, although nonmarket prices continued to apply in trade with the nonconvertible area.

In 1989, a new customs code was adopted, together with a revised tariff structure, with 12 rates ranging from 2 percent to 80 percent. The customs code simplified and strengthened the legal framework for external transactions. However, fixed valuation prices were maintained for many goods, trade with the nonconvertible area remained subject to differential taxation, and the tariff regime was characterized by a myriad of discretionary exemptions that could be granted by various ministries and levels of government.

During 1993–94, the trade taxation system underwent further rationalization. Early in 1993, the Government replaced the taxation of export profits with a simplified system of royalties (applying primarily to timber and electricity). In 1994, the Government adopted a new Customs Law, which strengthened the commitment to a market-based system based on international norms. Significantly, the law formalized invoice-based valuation and adopted a strict definition of allowable exemptions, thereby eliminating the scope for discretionary policy.

In early 1995, the Government adopted a new tariff structure on the basis of the Harmonized Commodity Description and Coding System that had been introduced in 1993. The new tariff structure reduced the number of tariff bands from 12 to 6 and lowered the maximum rate from 80 percent to 40 percent (exceptional tariff rates above 40 percent were limited to three goods categories). The current tariff structure implies a low level of protection in comparison with other countries in the region. On a simple average basis, the average import duty in the Lao P.D.R. is 14 percent, while corresponding levels are 44 percent in Thailand, 12 percent in Vietnam, 20 percent in Cambodia, and 43 percent in China.

riod 1989–92 remained valid for the successor program, which was supported by arrangements under the IMF's enhanced structural adjustment facility (ESAF) covering the years 1993–95. Accordingly, the program aimed at maintaining high rates of growth and further improving financial stability, but the authorities also recognized the need to address several institutional weaknesses encountered during the first program period. To this end, reorienting public sector operations and completing the establishment of an effective, centralized system of fiscal management were made key priorities. Strong emphasis was also placed on advancing to more comprehensive and genuine forms of privatization, strengthening the commercial basis of the banking system, and building an adequate legal and regulatory framework.

Policies and Performance

Macroeconomic Policies

Not surprisingly, given that the thrust of macroeconomic policies during the ESAF arrangement period remained broadly unchanged from that during the SAF arrangement period, the Government continued to pursue macroeconomic policies characterized by a cautious, demand-management approach. Against this background, the Government aimed at further mobilizing domestic savings during 1993–94, mainly by achieving a net saving from the government sector (compared with a net dissaving over the SAF arrangement period). Accordingly, the Government took further revenue measures and contained current spending. At the same time, the authorities maintained a relatively tight monetary policy by keeping real interest rates substantially positive. These cautious financial policies supported the stability of the nominal exchange rate.

Macroeconomic Performance

Macroeconomic performance during 1993–94 was, on the whole, again remarkable. Despite a weather-induced shortfall in agricultural production in 1993, real growth averaged about 7 percent during 1993–94. Broad money growth surged temporarily to about 65 percent during 1993 before falling to

32 percent during 1994. Owing to a considerable decline in velocity, which reflected rising real rates of interest and increasing confidence in the banking system following the opening of several foreign banks, inflation settled at about 6½ percent in both 1993 and 1994. Fiscal performance remained mixed during the period, as bottlenecks continued to weaken administrative capacity, but the external sector performed better than targeted in many areas as exports and foreign trade in general continued to grow strongly, foreign private capital inflows surged, and foreign assistance reached record levels.

Structural and Institutional Reforms

Considerable progress was again achieved in implementing structural reforms during 1993–94. The state enterprise sector, which in the Lao P.D.R. had never reached the significance that it had in many other former centrally planned economies, was rapidly reduced in size. As most of the enterprises were privatized through ad hoc leasing arrangements, the outstanding issue now remains to implement procedures for complete divestiture. In tackling the sensitive problem of further streamlining the bloated civil service, the authorities had to overcome a number of problems, including a disappointingly low rate of voluntary separation, poorly targeted incentives, and uncontrolled hiring at provincial levels. After a reclassification exercise in 1994 that downgraded a number of staff, especially in the higher echelons, the authorities began to identify redundant and unqualified staff for retrenchment. In the area of fiscal management, progress in strengthening administration remained limited. Revenues also fell short of expectations because newly introduced taxes, such as the land and registration taxes, were not immediately implemented and because ad hoc tax breaks were increasingly granted.

In contrast, substantial progress was made in reforming the financial sector. The opening of private sector banks during 1993–94 contributed to increased competition while the state-owned commercial banks were recapitalized in 1994. Additionally, with the commencement of regular treasury bill auctions and the opening in 1994 of a discount window, the central bank made further headway toward installing the instruments of indirect monetary management. Finally, the significant progress made in achieving external sector reform culminated in mid-1994 in the elimination of the last remaining restrictions on international current account transactions. To streamline customs administration, the Harmonized Commodity Description and Coding System was introduced in 1993, and, after the adoption of the Customs Law in late 1994, the Government approved for implementation in early 1995 a comprehensive tariff reform package that halved both the number of tariff bands and maximum rates while ending the practice of granting exemptions on an ad hoc basis. (Box 3 summarizes the reforms in trade taxation made from 1988 to 1995.)

Appendix III Legal and Constitutional Reform

Before the takeover in late 1975, the Kingdom of the Lao P.D.R. had the Constitution of 1947 and an essentially two-tier legal framework: civil affairs, such as family, dowry, inheritance, succession, land use, and related matters, were regulated by Lao tradition and customary law, while commercial business and administrative matters, legal procedures, and criminal justice were governed by laws closely following the French civil and criminal codes.[50]

With the proclamation of the Lao People's Democratic Republic on December 2, 1975 by the National Congress of People's Representatives, the monarchy was abolished. With it, the old legal system and the 1947 Constitution were also abolished. Given the resulting legal vacuum, the National Congress immediately elected a legislative body, the Supreme People's Council (later renamed the Supreme People's Assembly). However, over the next decade, the latter's role remained largely confined to ratifying decisions of the new Government, that is, the Lao People's Revolutionary Party. Lacking a new constitution, decrees and laws issued by the Prime Minister or a "Council of Government" started to fill the vacuum, but only a few such decrees and laws were issued through the mid-1980s. Moreover, decisions and resolutions taken within the party, albeit often not published, were considered binding for all citizens and thus became part of the legal system. Nevertheless, in many important areas, such as family or contract law, the legal framework remained largely undefined, and courts often had to follow prerevolutionary law. The situation was further complicated by the cessation of enforcement—without formal repeal—of previously introduced regulations and restrictions. Thus the emerging Lao legal system was difficult to interpret during 1975–85.

In the discussions on the Second Five-Year Plan preceding and during the Fourth Congress of the Lao People's Revolutionary Party in late 1986, the shortcomings of the legal system and the general lack of legal security were clearly recognized as major obstacles to market-oriented economic reforms and private sector activity, in particular, foreign investment. Consequently, the creation of an appropriate legal system was made a top priority. In February 1988, less than two years later, the Supreme People's Assembly (the first legislative body elected on a countrywide basis) passed an electoral law, and, in June of that year, three more major laws were issued that laid the foundation for a modern tax system, substantially liberalized the foreign exchange regime, and opened the country for foreign investment.

While plans for a new constitution dated back even further, to the Third Congress of the Lao People's Revolutionary Party in 1982, a constitutional commission to begin drafting was not formed until May 1984, under the guidance of a standing committee of the Supreme People's Council. In August 1991, a finalized draft was ratified by the Supreme People's Assembly.[51]

New Constitution

The Constitution[52] defines the Lao P.D.R. as a multiethnic (Article 1) people's democracy (Article 2), with a political system led by the Lao People's Revolutionary Party (Article 3).[53] In addition

[50]See Bogdan (1991); Norindr (1982); and World Bank (1994, pp. 98–101). Bogdan (1991, pp. 106–7) notes that in private civil suits the parties had the option to submit their case to a village chief or another local authority or to go to a state court.

[51]See Zasloff (1992, pp. 41–45). The Supreme People's Council, with 46 members appointed in December 1975 by the National Congress of People's Representatives, remained in office through May 1989. It was replaced at that time by the Supreme People's Assembly on the basis of national elections held in March 1989.

[52]The quotes in this section are taken from an undated Lao P.D.R. *News Bulletin*.

[53]In its Chapter I ("The Political Regime"), the Constitution is silent about the room for other, independent political parties. However, Article 31 in Chapter III ("The Fundamental Rights and Obligations of the Citizen") expressly grants the freedom of assembly and "to set up associations . . . which are not contrary to the law."

to the party, the Constitution acknowledges several other mass organizations, such as the Lao Front for National Construction and the Lao Federation of Trade Unions, whose role is to develop and protect the legitimate rights of their members (Article 7). Like all citizens, the party and all state and mass organizations must obey the Constitution and the laws (Article 10).

The Constitution guarantees a number of fundamental rights, including the right "to protect, preserve, and promote fine tribal customs and cultures" (Article 8), religious freedom (Articles 9 and 30), equality before the law (Article 22), equal and universal suffrage (Article 23), the right to education (Article 25), the right to work (Article 26), freedom of settlement and movement (Article 27), the right to bodily inviolability (Article 29), and freedom of speech, press, assembly, and association, insofar as it is not contrary to the law (Article 31).

The Constitution proclaims a multisectoral economy (Article 13), with all sectors encouraged to compete and cooperate with one another and all equal before the law (Article 14). Economic management is to be conducted "in line with the mechanism of market economy with adjustment by the state" (Article 16). The state protects "all forms of state, collective and individual ownership, as well as private ownership of domestic capitalists and foreigners" who invest in the country (Article 14), and this safeguard covers the right to govern, use, and transfer such property (Article 15). As to land, "which is property of the national community," the state ensures the right to use, transfer the right, and inherit it in accordance with the law (Article 15).

The Constitution establishes the National Assembly as the legislative and supreme organ of state power, with the right and duty to supervise the Administration and the judicial system (Articles 39 and 40) and to decide on fundamental national issues. The National Assembly is formed in general elections for a period of five years (Article 41) and convenes ordinarily twice a year (Article 43); between sessions, it is represented by a National Assembly Standing Committee elected from its members (Article 42). The National Assembly elects, with a two-thirds majority and for a five-year term, the President, who is head of state and commander-in-chief (Articles 54, 52, and 53(6)). The President's foremost rights and duties include promulgating the Constitution and the laws passed by the National Assembly; appointing or removing, subject to approval by the National Assembly or following a no-confidence vote (Article 61), the Prime Minister and the members of Government; and appointing, transferring or removing, on recommendation of the Prime Minister, governors of provinces and mayors of municipalities (Article 53).

Although subject to scrutiny by the National Assembly, the Constitution assigns far-reaching powers to the Government and the Prime Minister as its head (Article 60). The Government is, as stipulated in Article 56, the state executive organ that implements the Constitution, the laws, and presidential decrees, submits draft laws, development plans, and the annual budget for approval by the National Assembly, and manages and supervises the Administration (Article 57). In addition, the Government is vested with substantial legislative powers, inasmuch as Article 57 (4) entitles it explicitly to "issue decrees and decisions on the management of socioeconomic, scientific and technical fields; national defence and security; and foreign affairs."

The judiciary consists of a three-level system of People's Courts (Article 65) and Public Prosecutor Institutes (Article 72), as well as military courts and prosecutors. The People's Supreme Court, the highest judicial organ, scrutinizes the decisions reached by lower courts at the provincial, municipal, and district levels, as well as by military courts (Article 66). Both the President of the People's Supreme Court and the Public Prosecutor-General are appointed or removed by the National Assembly on recommendation of its Standing Committee (Article 40 (7)), whereas the vice-presidents and the judges at all levels are directly appointed or removed by that committee (Article 67).

System in Transition

Rather than adopt another country's legal framework and make adjustments as necessary, the Lao authorities chose to create their own legal system. By necessity, this eclectic approach implied a prolonged period of transition, characterized by an incomplete and possibly nontransparent system of laws. However, lacking extensive experience with a market-oriented economy, the authorities considered experimenting and learning essential in the process of developing an appropriate legal system. This approach in part explained why, after promulgation of the new Constitution and elections of the National Assembly members,[54] certain urgent legal building blocks continued to be introduced in the form of executive decrees before a corresponding draft law was presented to the National Assembly.

Although a written constitution did not exist before August 1991, numerous laws were, in fact, enacted by the two predecessors of the National As-

[54]The elections took place on December 20, 1992.

sembly. The more important among these were the electoral laws of February 1986 and August 1991; the Foreign Investment Code of July 1988, which has been superseded by the more liberal Law on the Promotion and Management of Foreign Investment of March 1994; the tax law and the law on foreign exchange transactions of July 1988; the criminal code of November 1989; the banking law of June 1990, through which the Bank of the Lao P.D.R. was established as the central bank within a two-tier banking system; and the labor law of November 1990, which was revised in April 1994. Several other laws regulating, among other things, contracts, enterprise accounting, property ownership, and inheritance were also introduced in 1990. While most executive decrees issued during this period provided regulations to implement earlier enacted laws, two decrees issued in 1991 stood out as major steps in the reform process: the Ministry of Trade and Tourism's Regulation No. 112 of February 1991 on the Establishment and the Operations of Export-Import Enterprises, which effectively opened foreign trade to the private sector, and the prime ministerial Decree No. 91 of December 1991 on State-Owned Enterprises, which established the financial and managerial autonomy of state enterprises and the Government's rights as owner or major shareholder.

While in its first two sessions the new National Assembly concentrated on establishing its own procedures, culminating in the National Assembly Law of February 1993, important new legislation continued to be issued through executive decrees.[55] These include the prime ministerial decree of February 1992 on the creation of a treasury; the December 1992 decree on land use and the November 1993 decree on forestry use, which extended important property rights while securing safeguards for the prudent utilization of the country's resources; the decree on land tax of March 1993; the decree on tariff reform of March 1993, which was a precursor to the customs code law of August 1994; the decree on enterprises issued in March 1993, which was eventually followed by the business law of August 1994; the decree on arbitration, the law on guarantees, and the enterprise bankruptcy law of November 1994; and the State Budget Law of August 1994.

Although the Lao P.D.R. has undoubtedly made substantial progress toward creating a legal environment conducive to its development goals, vital areas remain incomplete. Supported in part by technical assistance provided by the World Bank, work is currently under way on laws regulating secured transactions, procurement, mortgages, bank accounting and bank supervision, and negotiable instruments. While some of these laws are expected to come into effect during 1996, much remains to be done, in particular in developing the institutions and the regulatory capacity needed to translate the emerging legal framework into a well-functioning system.

[55]Since March 1993, the Ministry of Justice has published the texts of decrees, laws, and other important National Assembly decisions in Lao, French, and English in its monthly *Official Gazette (Journal Official)*.