

capitalists enabled them to convert the production to longer one and to earn profit. Marx admits capitalists have fund to convert the production period to longer one, but it is produced by laborers. Profit from the conversion therefore shouldn't belong to capitalists but laborers. In this sense, Marx argues the advance (fund to employ laborers —wage fund / variable capital—) is a mere pretence that deceives "bourgeois economists". For Marx's, Böhmer-Bawerk's argument just mirrored capitalist viewpoint. Here Marx doesn't care in this argument if profit accrues from the production period. According to Marx's labor theory of value, profit doesn't accrue because value isn't generated from production period; instead it accrues from social necessary labor. Meanwhile, Marx seemed to thought laborers have a right to acquire profit even if profit does accrue.

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Economic Reform in Transitional Economy: Lesson Learnt from Lao Experience

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Lao People Democratic Republic has gone through economic transformation and development period for almost 21 years. After two decades of reforms, experiences should have been accumulated and lessons should be learnt, particularly when both successful and depressing results have been observed. The paper discusses some reforming issues in order to provide a set of lessons and policy recommendations for current round of reforms which is more concerned with development issues than transformation from command to market

economy.

I. Overview

In general, Laos has gone through two phases of reforms: (1) economic reforms within the framework of centrally planned system and (2) transition to market economy. The first phase called ‘piece meal or *ad hoc*’ reform and was concerned with various reforming campaigns aiming at efficiency improvement or increasing production under existing economic system. This could be seen in Laos during late 1970s and first half of 1980s. The second phase actually transformed economic system itself, i.e. the launching of New Market Mechanism (NEM) in 1986. Reform began on a limited scale in the agricultural sector in 1979 after unsatisfactory results of cooperatives movement and natural disasters during 1976-77. The reform reached other sectors of the Lao economy by the second half of the 1980s through a comprehensive adoption of (NEM) in 1986 with the agenda on trade and price liberalization, state owned enterprise (SOE) reform, financial sector reform, etc. Since 1989, reforms had been carrying out gradually together with fiscal and monetary stabilization program which was strengthened during 1992-94 with strong bilateral and multilateral economic assistances. The reforms were slow down during the crisis period. From early 2000s, efforts and commitment to reforms regained. The on-going reforms today are more concerned with development under market mechanism and attempt to improve market efficiency and promote growth and poverty reduction. Summary of reform elements in periods before and after NEM is shown in table 1.

II. Characteristics of the Reform

The reform has three characteristics. Firstly, it is sparked by internal crisis – macroeconomic imbalance, and external pressure - economic reforms in neighbouring communist countries. Secondly, the transformation process is characterized by ‘trial and error’ practices rather than following certain blueprint.

Table 1: Chronology of Economic Reforms in Laos¹

Stabilization Program		Liberalization Program					
Fiscal policy	Monetary Policy	Agricultural Sector	Price/Exchange Rate (EXR)	Trade/Investment	State Enterprise and Private sector	Financial Sector	

¹ Period after 1979 refers to a ‘peace meal reforms’ and 1986/89 a comprehensive reform called NEM. Following crisis period from 1995 to 2000, next round of reforms resumed since 2001.

1979			- Collective system suspended but strengthened later -Permission of farmer direct sale to market, etc.	- Price and EXR control relaxed - Agricultural procurement price raised	- Partial removal of internal trade restriction - Abolition of subsidy at retail	- Easing restriction on private participation - Strengthening and reconstruction (merging) of SOEs (81+) - Granting limit autonomy to SOEs (85+)	
1986/89 NEM	- Expenditure control (88+) -Centralized tax and treasury administration (91+) - Revised national tax system (tax unification, etc.) (91) - New market-adapted tax system (91)	- Tightening monetary policy (containment and reduction of bank financing fiscal budget and SOEs) (89+)	- Co-operatives dismantled (87) -Land right strengthened (long term lease) (92+)	- Devaluation of EXR (87) - EXR unification (88) - Complete price liberalization except for some key utility prices, such as water supply, electricity, etc (88)	- Liberalization of good circulation within country (88+) - Foreign investment law (88) - Liberalization of foreign investment (88+) - Establishment of foreign investment management office (89) - Removal of quantitative import and export restriction (87-88+) - Removal of export tax and reduction of import tariff (88), but slightly increase in 1991	- SOE becomes fully autonomous, i.e. in terms of price, wage and investment (88) - Privatization of SOEs, excepted for strategic enterprises <30 small SOEs were privatized in 4 month from August to the end of 1989> (89+)	- Financial liberalization (88+) - Two-tier banking sector established (89+) - Central bank law (90) - Establishment of clearing house (90) - SOCBs recapitalized (94)
1995	- Expansionary fiscal policy (98)	- Credit expansion		- Adoption of Managed floating EXR system with devaluation of domestic currency (95+)	- Slightly increase in import tariff - Membership of ASEAN (97) and implementation of Common Effective Preferential Tariff (CEPT) scheme (98+)	- Privatization of SOEs was principally completed (97) - < However, it is still not clear whether the government will continue to privatize or nationalize the leased SOEs after their contracts expire >	- Liberalization of interest rate (97+)

2000 +	-Resuming expenditure control (00+)	- Adoption of stabilization program (00+) - Tightening monetary policy (issuance of high interest rate bond) (00)			- US-Lao Bilateral Trade Agreement signed (03) - Normal Trade Relation (NTR) was granted by the USA (04) - One-stop service at cross border checkpoint was introduced (03+) - Expiry of the Multi-Fiber Agreement (MFA) quota system (04) - On-going process for WTO accession	- SOE restructuring program initiated with a focus on improving transparency and governance, restructuring loss making large SOEs and tariff policy reform for infrastructure SOEs (01+) - Establishment of the Business Promotion Office (BPO) to centralize and manage SOE reform (01) - Telecommunication sector opened to private sector participation (01)	- Banking sector reform program initiated with a focus on restructuring two SOCBs (solving NPLs), enhancing transparency in SOCBs' operation and strengthening central bank supervision (00+) - The process to amend the Decree Law on Commercial Banks to ensure level playing field and lower barrier to entry and expansion of non-state owned banks is on going (05+)
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Source: Compiled from Bourdet (2000), Shimomura et. al. (1994), Ashad (2003), World Bank (2006) and various papers.

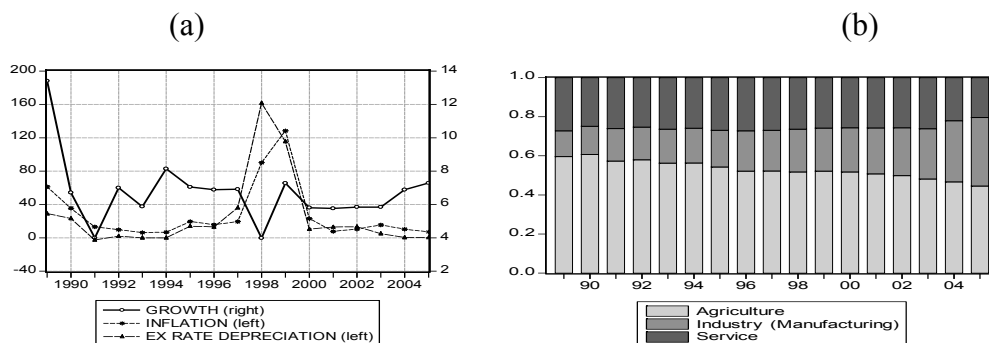
Thirdly, successful transformation in the first half of 1990s is partly explained by some preconditions endowed by Lao economy including a cushion against an output collapse and an abruptly cessation of socialist bloc aid. Moreover, short life of central planning system and existence of market economy, although not as supportive as in China and Vietnam, also contributed to an easier transformation to market economy.

III. Macroeconomic Performance and Productivity

The paper evaluates the reform by reviewing macroeconomic performance and productivity based on land, labor and investment. From a macroeconomic point of view, Lao has been successful in transforming to market economy, particularly during the first half of 1990s. Macroeconomic situation was considerably improved compared to that

before the reform. Economic structure has been gradually changed with industrial sector playing more important role in contributing to growth together with service sector (Figure 1).

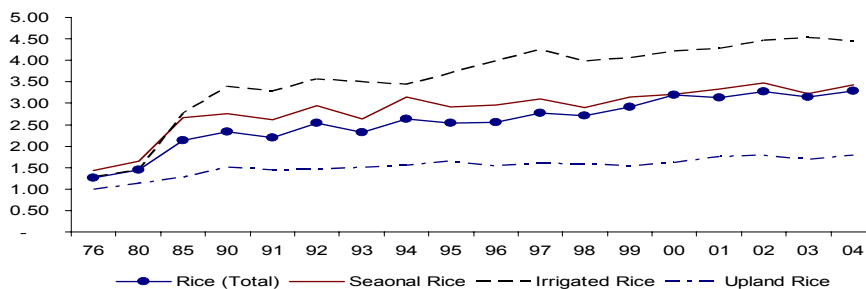
Figure 1: (a) Growth of GDP, price and exchange rate (b) GDP structure



Source: NSC and Bank of Lao PDR

However, shortly after the prosperous period, economic performance deteriorated. This was exacerbated by Asian financial crisis in 1997. After 2000, the economy has recovered with average growth rate of 5.8 per cent during 2000 to 2003, reaching 6.8 and 7.2 % in 2004 and 2005 respectively. Inflation declined a single digit in 2005 with stable exchange rate.

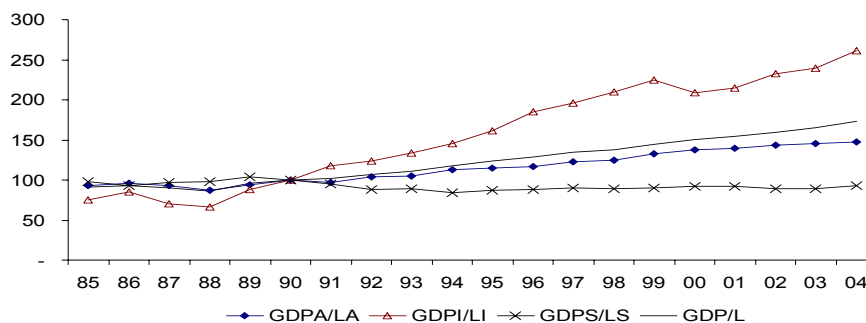
Figure 2: Rice Productivity (Ton/Hectare)



Source: Data from NSC

In terms of land productivity, rice production could give some insight. From Figure 2, there was an improvement in rice productivity after the partial reform in 1979 and NEM in 1986. Particular improvement was on irrigated rice production. Fluctuation in productivity was mostly explained by unfavorable weather condition. On the other hand, Figure 3 clearly shows overall improvement in labor productivity. The improvement in agricultural sector was comparatively much less than that of industrial sector. In contrary, service sector performance has been unimpressive through out the period, except some improvement during 1987 to 1990. The reforms have enhanced growth in industrial sector as a result of FDI inflow after NEM.

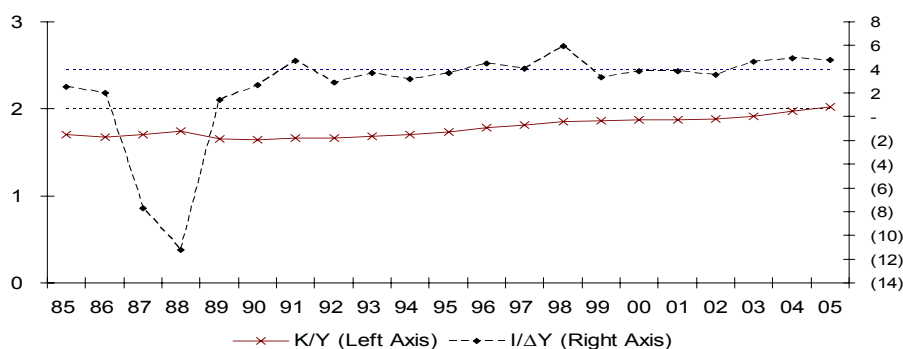
Figure 3: Labor Productivity in Agriculture, Industry and Service Sector (1990=100)



Source: Data from NSC, Ministry of Labor and Social Welfare and various papers.

Apart from labor and land productivity, there was also a loss and gain in investment efficiency after the reform. By estimating Lao capital stock and calculating Net ICOR (Incremental Capital Output Ratio) to measure investment efficiency, Figure 4 provides a comparative result. Gross ICOR was more fluctuated compared to Net ICOR, but both performed the same trend of a slight decrease in investment efficiency after 1990. By observing Net ICOR (K/Y), there might be some efficiency gains for the short period after the reform, especially during 1989 to 1994, with relatively low K/Y. After 1995, there was a loss in efficiency. This could be partly explained by the failure to maintain macroeconomic stability and a general upward trend of public investment on physical infrastructure in recent stage of development.

Figure 4: Gross ICOR (I/ΔY) and Net ICOR (K/Y)



IV. Some Issues on Economic Reforms and Development

To provide a set of lesson and policy recommendation, some issues are discussed. They are as follows:

1. Does Sequencing in Economic Reforms Matter?

In general, there are two main programs related to economic reforms. These are (1) stabilization program and (2) liberalization programs including price, trade and financial sector reforms. For the gradual approach, the first program generally precedes the second while the detail sector reforms under the second programs are put in orders to account for different adjustment speeds of goods and asset markets – e.g. current account liberalization precedes that of capital account of the balance of payment. There is a consensus among economists that fiscal and monetary stabilization is a necessary condition before embarking on financial liberalization¹.

Lao reform is quite different from a generalized sequencing discussed above. Figure 5 plots timeframes of the reforms in different area based on Table 1. Like China and Vietnam, Lao agricultural sector were subjected to the reform earlier even though not so significant. Restriction on price and trade control was also relaxed before fully liberalized in 1988. SOEs were subjected to some degree of adjustment and reconstruction before granted autonomy and privatized after NEM.

Figure 5: Timeframe of the Reform

Reform Area (NEM)	1979	1988	1995	2001
Agricultural Sector				→
Price and Exchange Rate				→
Trade and Investment				→
State Enterprise			-----	→
Financial Sector			-----	→
Stabilization Program	-		-----	→
Macroeconomic condition	-	+	-	+

Note: A dash line indicates partial or less significant reform.

Unlike the generalized sequencing, stabilization program was not in place before other reforming program. Instead it was introduced significantly at the same time when other

¹ See Mckinnon (1982), Edwards (1986), Fry (1997), Yang and Shea (1999). See also Nsouli, Rached and Funke (2002), Table 2 on page 11, summarizing schematic views of selected sequencing proposals by various authors. It was suggested that fiscal and monetary stabilization and institutional reforms should occur early in the reform process. However, timing of other reform areas is more controversial.

program started. This is because macroeconomic imbalance at the beginning of the reform process made it more than just a prerequisite but an urgent action needed. This follows the “Asian Approach” of economic reform suggested by Rana and Humid (1995) where microeconomic reform (price reform, enterprise reform and reform of the legal framework of enterprises) precedes macroeconomic reform (fiscal, monetary and foreign trade reform) which differs from the standard approach by World Bank and IMF. For Laos, unsatisfactory outcome due to the failure to follow the standard approach was more than offset by a successful outcome of a prompt action of stabilization program though lately introduced.

A merit of Lao type of reform is the consistency between agricultural reform and partial price and domestic trade reform in 1979, which contributed to increases in productivity in agricultural sector (Figure 2). What makes a more significant effect on farming communities after 1987 was a complete trade and price liberalization in according to the NEM, which brought private sector into competition with state enterprises in agricultural marketing, in the process transforming the incentive structure for agriculture when cooperative system was replaced by family based farming.

On macroeconomic point of view, the loophole in the sequencing economic reform is a discontinuity of reforms, particularly in state enterprise and financial sector. It took time for state-owned commercial banks (SOCBs) to be commercialized, phase out from policy lending and accumulate experiences on banking business. During this period faster enterprise reform is needed to lessen the cost of bank financing inefficient SOEs. Slow movement and insignificant reform of state enterprises after 1997 created a harmful effect on commercial banks. Relaxation in monetary and fiscal discipline together with a hit of Asian financial crisis exacerbated the situation and slowed down reforming progress in both sectors.

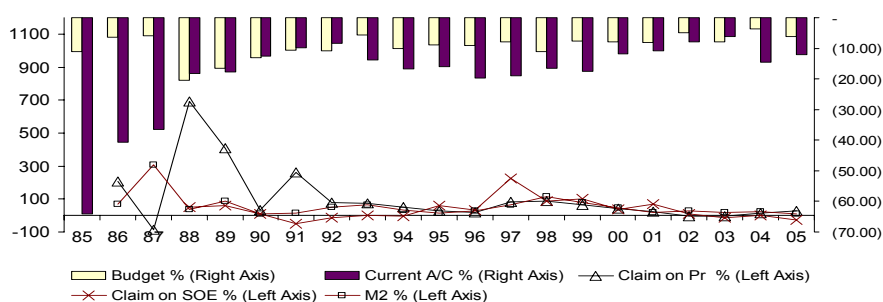
2. Macroeconomic Management under Market Economy

Failure to maintain macroeconomic stability was one of causes to emerging economic turmoil during the second half of 1990s. The situation was exacerbated by Asian financial crisis in 1997. As shown in Figure 5, this instability coexisted with a relaxation in monetary and fiscal policy. Fiscal expansion policy during that period further fueled inflation to the highest in 1999. On the monetary side, broad money growth was significantly noticeable during Asian financial crisis period. Bank financing SOEs speeded up from 1995 together with a sharp depreciation of exchange rate, after the abandonment of exchange rate anchor in 1995 (Figure 6). This led to financial difficulty of SOEs and then banking problems.

Importance of maintaining macroeconomic stability is also confirmed by successful corrective actions to contain inflation and stabilized exchange rate after the Asian financial crisis. Decreasing trend in M2 growth, claim on SOEs as well as budget deficit has contributed to recent macroeconomic stable environment (Figure 6, and also Figure 1a). Moreover, resuming in government’s commitment to economic reforms since 2000 has

contributed to period of recovery.

Figure 6: Share and Growth of Some Fiscal and Monetary Indicators



Source: Bank of Lao PDR, ADB and WDI.

3. Private Sector Development

Although SOE reform is crucial, the most important player in the market is private sector. Although there is acceleration in private sector activity since the introduction of the NEM in 1986, most of private enterprises remain small (Table 2).

Table 2: Number of Industrial/Handicraft Establishments¹

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Small	10,374	14,134	15,375	15,953	19,797	20,962	22,916	24,026	24,874	25,271
Medium	363	408	437	462	494	512	542	604	614	722
Large	89	110	119	99	108	95	116	112	119	207
Total	10,826	14,652	15,931	16,514	20,399	21,569	23,574	24,742	25,607	26,200

Note: Small enterprises (<10 workers), Medium (10-99 workers) and Large (>99 workers).

Source: Ministry of Commerce

Table 2 shows steady growth in small industrial enterprises establishments, and more modest growth in medium and larger enterprises. Of the medium and large enterprises only 35 per cent is owned by Lao private citizens, 55 per cent for joint ventures with foreigners and the rest owned by the government². Although the growth in small enterprises is encouraging, slow growth in the numbers of medium and large enterprises is a cause for concern since its growth is important to provide the scale needed to more effectively access and compete in regional and international markets. Currently government has put efforts to promote domestic and foreign private investments and improve the environment for doing

¹ This data excludes private firms engaged in agriculture, forestry, construction, trade, tourism, and other services.

² World Bank (2006).

business. This effort should be carrying on and speeded up in complimentary with the SOE reform.

4. Governance Issue

Successfully implementing any strategy to improve development outcomes will require Lao PDR to substantially improve its governance (World Bank, 2004). Issues where Lao PDR was identified to be weak cited by World Bank (2004) and UNDP (2004) includes accountability, corruption control and public sector effectiveness, poor revenue collection for domestic tax and customs duties, duplication of mandates, insufficient co-ordination, inadequate management rules and procedures and very low salaries which greatly weaken the ability of the public service to operate effectively.

Moreover, as mentioned in UNDP's paper, the rush towards fiscal decentralization¹ had a harmful effect on the central government's ability to manage the process, particularly the fiscal side, and to undertake national development plans and reforms. The fiscal decentralization, however, could enable provincial officials to challenge the central authorities' control in concealing important tax revenues (UNDP, 2004). Problems cited above are complicated and not easy to solve, particularly in the system where legal and institutional framework is underdeveloped. Therefore, the most important issue on the reforms is the soundness and consistency of policies. As long as policies and its sequence are good, the mentioned problem would be less severe. However, in order to ensure that reforming attempts and resources will translate into good development outcomes, reforming public administration for better governance is also required.

5. Challenges for Development under market system and globalizing world

In addition to the mentioned issues on economic reforms, Lao PDR is still facing with many constraints. These include poor physical infrastructures which make access from one commercial area to another very difficult, a small domestic market size and underdeveloped domestic commercial and market networks, and inadequate human resource development. In addition, many ethnic groups with cultural diversity may be a factor obstructing the rapid integration of the domestic market.

Moreover, in the globalization era, Lao is facing many challenges. These are classified into 3 main challenges (CPI, JICA, 2005). The first challenge is the transition from planned to market based economy. The challenge is on creating legal and institutional framework that are compatible to market economy, reforming and privatizing state-owned enterprises,

¹ The decentralization policy (Prime Minister Decree No. 1, issued in March 2000) is one of the major government reforms throughout the economic transition process which was devised with the aim to coordinate planning throughout the country. This decentralization process will set up the provinces into strategic units, the districts into planning and budgetary units, and the villages into implementing units. It divides responsibilities between the central government and the provincial, municipality, special zone and district authorities, which allow local services to be provided at lower costs than centrally provided ones (Ashad, 2003).

developing private enterprises and reforming monetary and fiscal systems, all of which are on-going and need to be speeded up. The second challenge is on the issue of social and economic development. This is concerned with the transition from traditional to industrial/modern economy. The challenge is on how to deal with issue of poverty eradication, population control, education, infrastructure improvements and the issues related to resources mobilization and industrialization. The final main challenge is related to global and regional integration. The challenge is related to issues on how to grasp benefits from the integration, especially in terms of increasing market, and mitigate losses from the treat of such integration.

V. Lesson Learnt and Policy Recommendation

In general, the economic reform in Lao PDR is successful in terms of a boost in growth, productivity and stable macroeconomic condition despite the declining trend of investment efficiency which is naturally happened during the first stage of development where investment in infrastructure outweigh productive investment. However, economic turmoil during the onset of Asian financial crisis period and issues discussed earlier could provide two lessons. One is the importance of putting reform components in a consistent order. The matter of reform is not to exactly follow proper orders of reforms suggested by sequencing literatures but Lao unique approach is acceptable as long as consistency and continuity of reforms are warranted and necessary action were put in place on the right time. The other lesson relates to an importance of maintaining macroeconomic stability through out reforming period. A delay in conducting reforms and fiscal and monetary stabilization program is an example that makes Lao economy vulnerable to shock, particularly during Asian financial crisis period.

Based on issues on economic transformation and development discussed earlier, some policy recommendations could be drawn as the followings:

(1) Maintaining macroeconomic stability is a precondition not only for the successful transformation of the economy but also for creating a favourable environment for the progresses of on-going reforms and private sector development. This is related to the consolidation of fiscal discipline and pursuing sound monetary policy.

(2) Private sector development together with restructuring of state enterprises (both SOEs and SOCBs) should be pushed further. On one hand, reforms in banking sectors should be more concerned with strengthening risk management capacity, and SOEs should be gradually privatized. On the other hand, private sector should be provided with the same playing field as of SOEs. Measures to promote private sector capacity in dealing with business and to create a more favourable environment for doing and entering businesses should be speedily promoted.

(3) Strengthening and enhancing trade reforms in line with regional and global integration should be kept up.

(4) Strong and continuous commitment to current reform agenda is crucial for the treatment of remaining inefficiency in management of market system.

(5) Creating legal and institutional frameworks that are compatible to market economy should be continued.

(6) Reforming public administration for better governance needs to be encouraged to ensure good outcomes from reforming and developing efforts.

(7) To enhance all reforming and developing attempts, constraints in terms of inadequate infrastructures and lack of capable human and domestic financial resource should be fundamentally addressed.

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