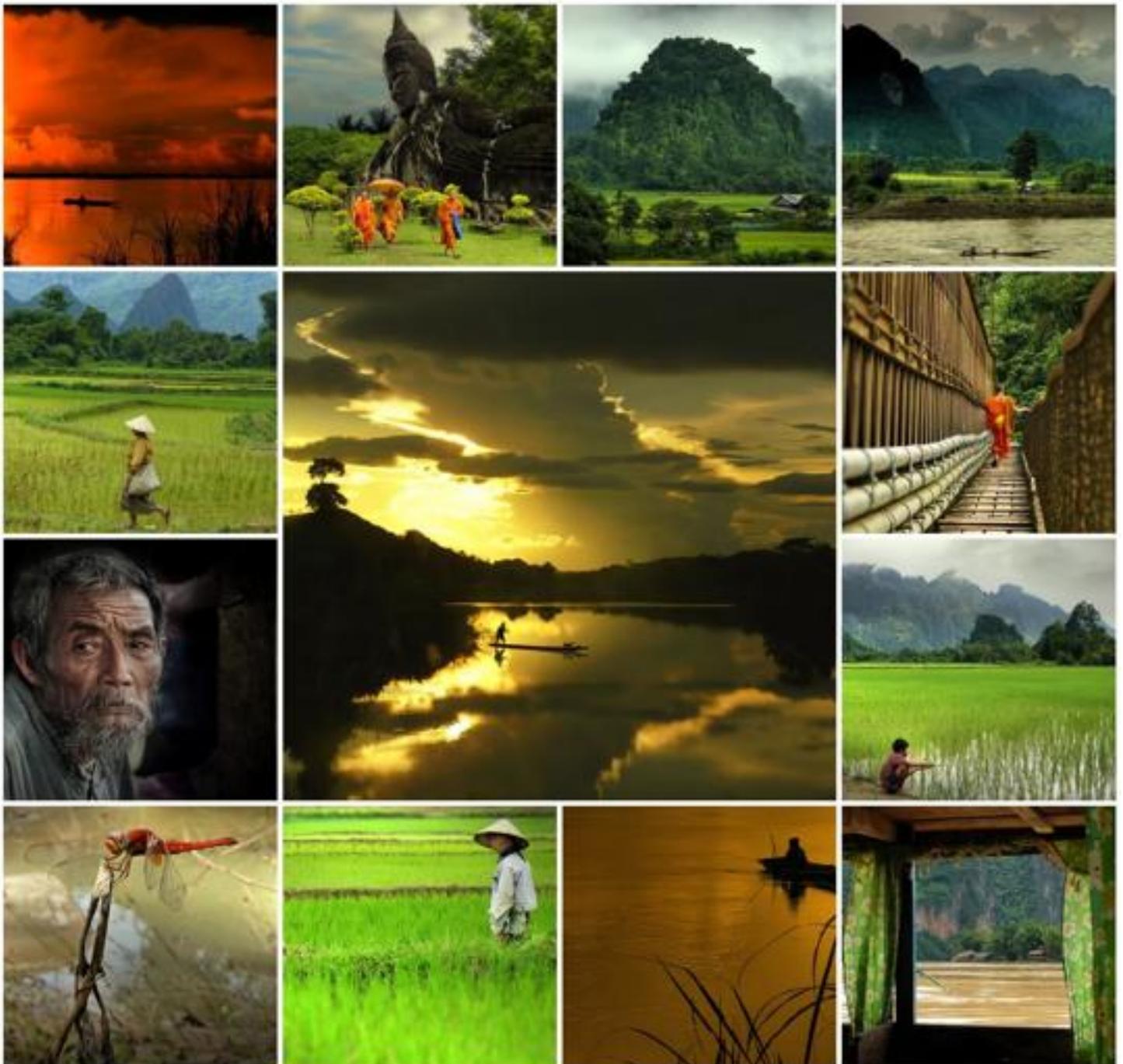


# International Poverty and Development Report



## Lao PDR 2010

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## Table of Contents

<b>Introduction</b> .....	3
<b>Definition of Development</b> .....	4
<b>How We Measure Development</b> .....	5
<b>Theories of Development</b> .....	7
Orthodox Liberal School.....	7
Radical School .....	9
Dependency Theory .....	9
The Planning School .....	11
Urban Bias .....	12
The Growth with Equity Model .....	12
<b>Laos 101</b> .....	14
<b>Current Development of Laos</b> .....	19
Land and Water.....	19
Agriculture .....	21
Economic Measures of Development .....	24
Financial Measures of Development.....	33
<i>The One Gap</i> .....	33
<i>The Two Gap</i> .....	36
<i>The Three Gap</i> .....	51
Social Measures of Development .....	63
Political Measures of Development .....	71
<b>Development Summary</b> .....	77
Current Development Summary .....	77
Development Finance Summary.....	78
Social Structure Summary .....	79
Political Structure Summary .....	79
<b>Development Potential</b> .....	81
<b>Conclusion</b> .....	83
<b>Works Cited</b> .....	84

## Introduction

The last time that Laos received significant attention from the United States was in 1973. A lot has changed since American B-52s stopped saturation bombing Laos<sup>1</sup>. Even so, most of the world cannot find the small nation on a map, let alone can state anything about Laos other than stereotyping it as an unimportant backwater. Although Laos is one of few remaining Communist states in the world and is one of the poorest countries in South East Asia, it has overcome numerous constraints and has established itself as one of the most dynamic and rapidly developing nations in the region. Bucking years of years of war and isolation, the government of Laos has since introduced itself to the world as one of the most environmentally pristine and culturally unique places to visit. The sleepy village life found near Laos's Luang Pabrang Buddhist temple is relaxing, but it is not reflective of the vast progress that Laos has made since its economic reforms of the late 1980s. More specifically, the Government, with support from foreign investors, has established Laos as the "battery of South East Asia," helping Laos maintain stable and high economic growth rates. In a similar vein, infant mortality rates have fallen, average life expectancies have risen, and social services provided by the government have expanded substantially.

Although Laos has made much economic, political, and social progress, numerous unfreedoms are still present in Laos that prevent most Laotians from securing their own unalienable rights of life, liberty, and the pursuit of happiness. Laos's development is only partially completed because its *perestroika* only involved certain sectors of the economy and largely ignored the political and social realm. Until economic, political, and social freedoms are further expanded to all Laotians, Laos cannot be considered truly developed. Only when all Laotians can decide exactly what they want to do with their lives and then be able to actively pursue that goal can Laos be considered truly developed. Therefore, freedom is both the end and the means of our policy proposal.

By removing the major sources of unfreedom in Laos, our policy proposal seeks to empower the middle class so that they can pursue their own happiness. By empowering the middle class, our hope is that this newly educated and skilled group will fill the needs of the

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<sup>1</sup> Laos was hit by an average of one B-52 bomb-load every eight minutes, 24 hours a day, between 1964 and 1973. US bombers dropped more ordnance on Laos in this period than was dropped during the whole of the second world war.

economy, polity, and society. By empowering the middle class, new doctors, teachers, and industrialists will fill Laos's hospitals, schools, and factories. A dynamic middle class will create positive externalities that a singular and narrowly focused policy proposal could never hope to achieve. A politically active middle class can even check the powerful government or seek increased representation. A robust and mobilized middle class will create small businesses, new jobs, and other entrepreneurial endeavors. Thus, our policy proposal will be broad in approach, involving sectors that range from agriculture to healthcare so that it can create an equally broad reaction: a well functioning middle class.

But before we can propose a policy that mitigates Laos's rampant unfreedoms, we will first have to thoroughly examine Laos's most urgent problems and recent development experience. Therefore in this report we will explore Laotian history, current development performance, problems, opportunities, potential for development, and lastly, we will introduce the means by which Laos can start mitigate its unfreedoms.

### **Definition of Development**

Without a working definition of what it means to be developed, it will be difficult to first address Laos's development issues and then secondly try to mitigate them. In our study of Laos, we are ultimately concerned with what people are capable of doing or being. In a Senian vein, we see "development as the process of expanding the real freedoms that people enjoy" (Sen). In a broad sense, we see development as freedom. Thus for the purpose of this report, freedoms are not only the primary ends of development, they are also among its principle means" (Sen). We see freedom as the ability to act according to one's own will unrestricted by the nature of their specific situation or the will of others. Thus, development is a process that enables people to choose what they want to do with their lives and then (more importantly) be able to pursue it. As Sen has stated, along the paths to development, major sources of unfreedoms, such as "poor economic opportunities as well as systematic social deprivation, neglect of public facilities as well as intolerance or over activity of repressive states," need to be removed. This definition of development urges us to focus not only on the accumulation of wealth, but also on human element as well when assessing Laos's development needs.

## **How We Measure Development**

Although many contemporary development theorists have divergent views about the weight of economic growth in the overall assessment of a country's level of development, most still include economic metrics like gross domestic product (GDP). According to Welzel, Inglehart, and Klingemann, "Socioeconomic development reduces restrictions on human autonomy, providing the objective means that enable people to pursue self-determination" (Welzel, Inglehart, & Klingemann). Hence why we believe economic growth is one of the prerequisites of freedom. An increase in income facilitates the attainment of basic human needs, such as the ability to purchase basic necessities like food, shelter, health care, and education. In our case study of Laos, we will evaluate the level of economic development based on the following indicators: total GDP, GDP per capita, GDP composition, labor force distribution, and recent trends in infrastructure. GDP composition and labor force distribution shows what percentage of GDP Laos's population is producing by sector. The labor force distribution shows how productive the population is when compared to GDP composition. This measure is important because it shows how productive Laotians are. By measuring Laos's productivity by sector, we will have a better understanding of what Laotians can purchase. This is an important measure of Laos's level of development because it shows what Laotians can buy to improve their standard of living. Basic infrastructure growth is also important to our definition of development because Laotians that are trapped in one place and have no way of communicating or traveling to areas outside their immediate surroundings do not have the same opportunities to do and be all that they can be.

Although economic indicators by themselves can not accurately measure Laos's current and recent levels of development, these economic metrics do have certain advantages. For example, using quantifiable data we can reliably compare Laos's recent trends in development with relative objectivity to other developing nations. On the other hand, economic growth indicators like GDP statistics do not provide the best picture of Laos's level of development because they do not account for other metrics that measure life expectancy and literacy rates. Economic growth alone will not give people self-determination; Empowering social change is also necessary. Many impoverished nations have experienced strong economic growth since the 1950's. However, improvements in human welfare and political rights have continued to lag behind economic growth. Social and economic development are both vital elements that given

enough time will afford people the basic capabilities to pursue what they want to do with their lives. Our measurement criteria will include, but is not limited to, the following indicators: The Human Development Index (which includes life expectancy, literacy rates, and income in terms of purchasing power parity), The Human Poverty Index (which indicates the proportion of people living below a particular poverty threshold as measured by HDI), GINI Coefficient, infant mortality rates, health and nutrition indicators, urban rural divide, and the percentage of GDP spent on schooling. We believe that these measurements will effectively compliment the aforementioned economic growth indicators to depict, more accurately, the recent level of development in Laos.

Our assessment of Laos's recent level of development cannot be considered sophisticated if political considerations are ignored. A political system that provides its citizens with the opportunity to actively participate in society is highly desired. Citizens should have the chance to build a strong and functioning civil society and exercise their political will. In Sen's article, he includes a discussion about a pluralist society in which citizens evaluate and then argue for what they want in a functioning marketplace of ideas. Hence we will measure the levels of unfreedoms present in Laos's political system using these two broad indicators: rule of law and the level of political participation. We will also take other interrelated considerations like discrimination into consideration in order to better develop a broad conception of Laos's political development. By utilizing these measures of development, we recognize that certain freedoms can exist even if Laos remains a communist state. According to our definition of development, political considerations are a basic requirement of being developed because without the rule of law or the right to organize Laotians cannot be all that they can be. This does not mean that we think a nation is not developed unless democracy is present, but rather that certain basic institutions should be present before a nation can be considered developed. Furthermore, a symbiotic relationship links Laos's economic, social, and political landscape. It is difficult to guarantee economic and social freedoms if the political structure of society is disregarded.

## **Theories of Development**

In order for Laos to eliminate its unfreedoms and achieve its development potential, it will first have to achieve certain requisites, which are required for development. These requisites vary depending on the developer's values and ultimate goals. Thus we will now outline requisites of development from the perspectives of the orthodox liberal school, the planning school, and the radical school. These theories provide us with a broad range of potential sources of development. Analysis of the current Laotian situation from the views of each of the schools will highlight specific causes for the current state of underdevelopment in Laos and recommend approaches to achieving development. Through a combination of the best economic and political reforms recommended by each of the schools, we will determine the proper requisites for Laotian development. The fulfillment of these requisites will set the base on which Laos's development will take place.

### **Orthodox Liberal School**

Orthodox theorists believe that development is a natural and law like process that will take place on its own. Additionally, government intervention will do more harm than good in the market economy. Therefore, the state should have very minimal involvement in the economy. Producers and consumers will make rational production and consumption decisions. These choices will ensure a "free market" economy is dictated only by the supply and demand of a product. When the domestic market is not in equilibrium, i.e. the supply of a particular product exceeds its demand, the producer should seek to export the product to an area where it is desired. The second major concept behind orthodox liberal thinking is comparative advantage and specialization. A country will produce products in which it has a comparative advantage, and then exchange the products for something that other countries can produce more efficiently through trade. According to this school, globalization stimulates specialization and allows resources to flow freely to places that generate the greatest returns. Trade deficits indicate capital inflows that will accelerate technology diffusion and development convergence. The third idea is that of modernization theory, which claims that there's a unilinear path of development for all nations.

From this basic outline, we can extrapolate in general that that societies move from traditional to modern and from rural to urban in orientation. As the society becomes educated, individuals experience cultural and value transformations. At this point, theorists like Lipset

would argue that these interrelated economic and social transformations lead to higher levels of democratization. As the economy develops and becomes increasingly complex, it becomes increasingly difficult to manage centrally. Thus the state expands so that the market can remain imbedded within the existing structure. Social services are extended and life expectancies begin to rise. Eventually technological innovations are applied to agriculture and people no longer have to live in the rural countryside on large plots of land. Peasants can now move to the city to work in a factory or go to school while enjoying a high level of material consumption. Poor countries are trapped in poverty not because of exploitation or transfer of wealth, but due to their slow progression on the path toward modernization. According to this theory, countries that focus on creating modern ways of thinking will have a good base on which to develop. Therefore, the goal of modernization is to emulate the current state of culture, society, policy, and economics in Western Europe and the United States.

In Laos, we see a pro-“free market” economy in which the communist government regulates and provides certain social services. Although domestic production and consumption of most goods and services are not subject to major government interference, healthcare and agriculture are two examples where the government does not follow laissez faire policies. In both of these cases, the government provides subsidies to citizens. In agriculture, the government helps farmers with irrigation subsidies and in healthcare, the government helps to fund hospitals and clinics. While some in the orthodox liberal school would accept government subsidies on healthcare, most would caution against the use of government money on private farms. Theorists claim that this spending will only delay the inevitable insolvency of these farms. When the farm takes more capital inputs than it produces in outputs, the farm is not efficient. Liberals would claim that this farm should be allowed to fail and the scarce resources used elsewhere.

Although it should be noted that to some, mainly political economists, that this inefficiency is not necessarily bad because it helps protect Laos from becoming overly dependent on external powers for the production of food. By relying on regional producers of rice, Laos has sacrificed a significant amount of sovereignty that cannot be accounted for in economic terms. In going down this path, Laos has put the well being of its population in the trusting and all stable hands of the market. If Laos was to accept that it does not have a comparative advantage in the production of sticky rice, and therefore it was acceptable to abandon this inefficient sector in

favor of another like timber, then the well being of typical Laotian would no longer be protected from the fluctuations of the market. A simple prolonged downturn in the economy could lead to the largest mass starvation in Laos's history if enough sticky rice cannot be imported. This dilemma of trade puts serious constraints on Laos's autonomous development. By pursuing a policy like this, regional producers of sticky rice will have serious political and economic leverage over Laos.

### **Radical School**

Political economists from the Radical School are more concerned with the shape of the process than its speed. To them, development is the means instead of the end, and the end is to enhance what people value. Unlike the Orthodox scholars, political economists do not see an automatic process in development and also do not believe in the Orthodox argument that there is a uniform Western development path that can be applied to all countries. According to the radicals, in an ideal world, a legitimate state would behave on behalf of the general interest of society and would promote ultimate equality. However, in reality, many states in the developing world simply uphold the interests of the ruling elites, creating a peripheral capitalism, which combines the worst features of both feudalism and capitalism. The weak bourgeoisies in those countries align with the aristocratic and monopolistic class to safeguard their private interests. Therefore, in order for development to take place, a dramatic change of social structure is needed, which will redirect the economic surplus to the hands of the progressive class.

### **Dependency Theory**

An offshoot of radical theory is dependency theory. According to this theory, the primary obstacle to development of the poor is their connection to the rich. Dependency theorists believe the current global economic system is exploitive and facilitates the transfer of wealth from the global South to the global North. Underdeveloped states that are situated within such a capitalist system will not be able to develop self-sustainably as they rely heavily on foreign assistance, in the forms of trade, grants, and loans, to achieve development goals. This assistance has deep consequences involving foreign control over the state and the economy. At its core, dependency theory is concerned about the relationship - positive or negative - between states in the global system. Dependency theory observes that the global south depends on their relationship with the north in order to develop. This means that poor countries can develop rapidly, but only as a reflection of others. Working from within this framework, autonomous growth is rather slow and

fraught with difficulties. Whereas modernization theorists saw the first world as a guiding example, some dependency theorists argued that the first world restricted the ability of the third world to emerge from poverty. The westernized elites of the third world would not lead their countries out of backwardness, but instead would conspire with the global North to keep most of the population impoverished while a few grew incredibly wealthy. Instead of investing their income on capital that would accelerate growth, these third-world bourgeoisies were conspicuous consumers and lived lavishly. By conspiring with the North, the third world elites remained in power and helped keep their country underdeveloped. By siphoning surplus away from the third world, the North further enriched itself.

In Laos, we see examples of the damage done by elite rule and dependency on foreigners. The elite in Laos are those associated with the communist party. On the surface, this party is focused on creating greater equality for the society, but they have not been able to achieve these goals. The communist party may allow some anti-communist ideas to be voiced among smaller groups or villages, but these ideas cannot be present in the national government since they undermine the authority of the Communist party. On the economic side of equality, the government has made some progress toward greater equality in society through its increased spending on rural agriculture, which employs about 80% of the country. This increased spending on irrigation techniques allows farmers to be more productive and increase their gross income. However, we have found cases that indicate that the government is not promoting overall equality. For instance, the government is subsidizing healthcare insurance pools. This idea sounds perfect on the surface, but upon further examination, one can see that the government does not subsidize enough so that the poor population can also participate in these pools. The insurance pools are also focused on urban healthcare, which tends to exclude the poorest sectors of the population that live in rural areas. Overall, the government is not representing the general interest as it claims to be, and the social surplus is not in the hands of a progressive class that is able to use it most efficiently.

According to dependency theorists, issues in Laos have arisen because of its dependency on the global capitalist system. Even though Laos has experienced trade surpluses, it exports low value added goods and imports high value added products. This pattern will not assist technology diffusion in the country, and will expose the country to potential trade deficits in the future. The

investments that Laos receives from the core countries will impede its development by creating a cycle of debt from which the country can never escape. Because of the political and economic implications of the growing stock of debt, Laos can never be free from foreign influences on which it is dependent. We see dependence mainly in analysis of the one and three-gaps. In the one-gap, Laos depends on about 8.75% of GDP in foreign capital investments to continue to grow at about 5% GDP growth per capita per year. In our analysis of the three-gap, we examined Laos's government revenues and expenditures and found that the country's spending depended heavily on loans and grants from foreign governments. Laos's dependency on foreign capital and grants creates dependency that may impede its development if it cannot secure external financing.

### **The Planning School**

The theories of the planning school are situated between the ideas of radical and orthodox liberal schools. The planning school's central belief is dirigism, which means that the state must steer instead of dominate the economy. Planners believe that there must be a healthy balance of state and market forces in economics. The market should be the principle actor, but the state must be ready to interfere with the market to maintain political and economic order, fight monopoly, and correct any failures and externalities. The state must also play the primary role in provision of social services, which are less attractive to private investors. This school claims that growth can be achieved by some strategic alliance of public and private interests.

The current situation in Laos is best examined through the lens of the planning school. We see the state allowing virtually free markets to function independently of the state. At the same time, we see the state providing or subsidizing basic social services such as education, infrastructure, and healthcare. The state's involvement in healthcare has allowed it to greatly decrease the numbers of tuberculosis and malaria cases reported. Through ITN's, deaths as a result of malaria decreased by about 80% from 1990-2007, and reported cases of TB have fallen to reach their millennium development goal.<sup>2</sup> However, at the same time, we do detect inefficiency in the state's steering of the economy, which is the major issue that we will try to address in our proposal.

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<sup>2</sup> WHO data

## Urban Bias

Lipton's theory of the urban bias states that, in developing countries, there is a tendency to place too much emphasis on urban development while neglecting the rural population. His argument is that since agriculture is so vital to developing societies, resources must be devoted to it. However, these resources could be devoted to the more productive large farm which is capable of providing food and raw materials to the urban centers but does not consume as many resources as the smaller family farms do. The excess labor created by an increased production on large farms, according to modernization theorists, should be sent to the city and employed in productive means. Lipton argues that, instead of using this surplus labor in industry, the labor is not used and goes to waste. Therefore, the urban bias causes significant damage to the rural poor. If this idea is expanded further to other sectors such as education, we see similar results. Resources of the state tend to be devoted to the urban areas or areas of great efficiency. However, these are not the areas where resources are most needed. By devoting resources to rural areas, the state could greatly improve the lives of those citizens.

In Laos, we see a much greater level of development and basic resources located in urban centers. However, almost 70% of the population lives in rural areas.<sup>3</sup> Naturally, if a disproportionate amount of resources are devoted to urban areas, rural areas will not have an equal base on which to develop. The example of healthcare in urban versus rural areas is particularly striking. 100% of urban residents have access to nearby hospitals and pharmacies. In contrast, 70% of rural families do not live within 3 km of the nearest hospital or pharmacy.<sup>4</sup> Within cities, all income levels receive comparable care, however, in rural districts, the wealthiest portion of this population tends to receive much better care while the poor in rural Laos are forced to rely on traditional forms of medicine as they do not have access to modern care. The disparities between rural and urban expenditures are great and are a major cause for the differences in level of care.

## The Growth with Equity Model

Despite its success in raising growth rates of GNP, the modernization theory of economic development has failed to address continued high unemployment, increased income inequality,

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<sup>3</sup> <https://www.cia.gov/library/publications/the-world-factbook/geos/la.html>

<sup>4</sup> <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTPOVERTY/EXTPA/0,,contentMDK:20204899~isCURL:Y~menuPK:443280~pagePK:148956~piPK:216618~theSitePK:430367,00.html>

and stagnation of real income levels amongst the poor. In Wezel, Inglehart, and Klingemann the authors demonstrate how socioeconomic development, cultural change, and democratization all constitute a coherent means of social change that is ignored by modernization theory. In comparison to the previously mentioned theories, the theory of socioeconomic development broadens peoples' choices by providing them with individual resources, cultural change gives people greater opportunity to express themselves in making independent decisions, and democratization provides rights and legal guarantees for freedom of choice in politics. Economic development brings urbanization, social mobility, and occupational freedoms. This emphasis on freedom of action tends to undermine the legitimacy of autarchies that repress human rights and are corrupt. In functioning democracies, instead of regime change, the participatory processes are further reinforced and people become more involved. Elites that make a mockery of the rule of law cannot exist in regimes like this. Thus client-patron relationships and corruption are minimized because elites are held accountable for their actions by an organized and powerful polity. In democratic societies like this, it is almost unheard of for governments or elites to "take a cut off the top" without political repercussions. That being said, unless the public can monitor those in office, elites will tend to do whatever they can get away with. Although effective institutions might guarantee civil and political liberties, if the population lacks the monetary resources to exercise those rights, then those rights become useless. At the same time, rising levels of income give rise to higher levels of self-expression, which in turn tends to promote effective democracy.

## **Conclusion**

From this analysis, we see that an amalgamation of theories is the best base for our study of Laos. We will pull ideas from other theories, as these theories will also provide valuable insight into Laos's development problems. By taking into consideration the requisites for development as outlined by each theory, we will determine our course of action for development.

## Laos 101

Laos is a small, mountainous, landlocked nation in the center of the Southeast Asian peninsula. It is about the size of Utah (236,800 square kilometers<sup>5</sup>) and is bordered by China, Burma (Myanmar), Thailand, Vietnam, and Cambodia.



Laos is largely mountainous with many elevations above 500 meters. The topography is typically characterized by steep terrain, narrow river valleys, and low agricultural potential (4% arable land). This mountainous landscape extends across most of the north of the country. Because of its mountainous geography and lack of development, Laos has few reliable transportation routes. The Mekong and Nam Ou are the only natural channels suitable for large-draft boat transportation. Smaller powerboats and pirogues provide an important means of transportation on many of the tributaries of the Mekong. Otherwise, travel is by ox-cart over level terrain or by foot. The steep mountains and

lack of roads have caused upland ethnic groups to rely entirely on pack baskets and horse packing for transportation.

Laos's population was estimated to be about 6 million in July 2004 and is growing at an annual rate of about 2.4%. The average population density is 21 per square kilometer, giving Laos the lowest population density in Asia. There are officially 68 ethnic groups in Laos. However, this number is likely well below the actual number of tribes in Laos as minorities tend to live in remote areas with minimal contact with people outside their immediate community. About 68% of all Laotians are Lao-Loum, or lowland Lao, a people related to the people of Thailand. On the hillsides live the Lao-theung, or slope dwellers. They account for 22% of the population. At higher altitudes are the Lao-soung, or mountain dwellers. They constitute 9% of

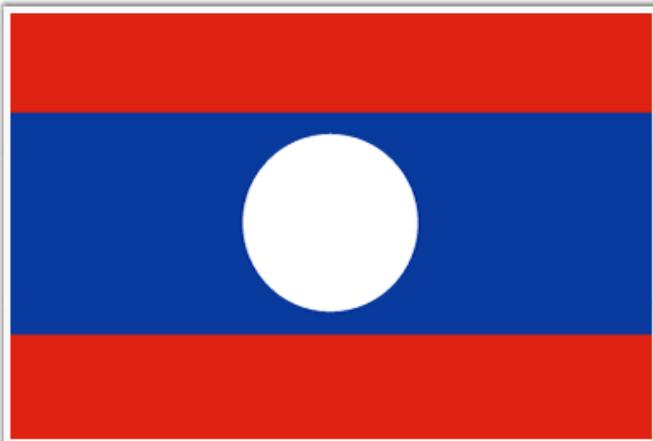
<sup>5</sup> <http://memory.loc.gov/cgi-bin/query/r?frd/cstdy:@field%28DOCID+la0006%29>

the population. Other important upland tribes, all with customs and religions considerably different from those of the lowland Lao, are the Ho, Kha, Kho, and Yao (Mien). Ethnic Vietnamese and Chinese account for 1% of the population.

Buddism dominates Laos' religious landscape with 67% of Laotians practicing Buddhists. Christians make up 1.5% of the population with animist and atheists taking up the remaining 31.5%. Despite global modernization, Buddhist thinking, attitudes and behaviors still profoundly influence much of Lao culture. It is impossible to understand Lao culture without having at least a basic understanding of the Theravada (Hinayana) Buddhist tradition. In many ways, the Lao people are not as collectivist or conformist as most of their East Asian neighbors.<sup>6</sup>

The official and dominant language is Lao. Midslope and highland Laotians speak an assortment of tribal languages. French, once common in government and commerce, has declined in usage, while the use of English, the language of the Association of Southeast Asian Nations (ASEAN), has increased dramatically in recent years.

Most of Laos is still covered in forests, with woodlands taking up 54% of the land. Arable, or farmable, land only accounts for 3% of total Laotian land. Timber, hydropower, gypsum, tin, gold, gemstones remain Laos's most important natural resources. Laos has a tropical monsoon climate. Its rainy season is from May through October, and it then has a cool dry season from November through February. From March through April, Laos is largely hot and



dry. Rainfall is not always adequate for rice cultivation even though Laos receives relatively high levels of precipitation. Such droughts often are regional, leaving production in other parts of the country unaffected.

From 1890 to 1953, Laos was a French colony and followed the governance

<sup>6</sup> <https://www.cia.gov/library/publications/the-world-factbook/geos/la.html>

<sup>7</sup> Culture of Laos - traditional, history, people, clothing, traditions, women, beliefs, food, customs, family, social, dress, marriage, men, life, population, rituals, History and ethnic relations <http://www.everyculture.com/Ja-Ma/Laos.html#ixzz0dm8sQozj>

rules set forth by the French colonial administration. In 1953 Laos became independent from foreign colonization and occupation. The new government soon found itself at war with the Communist Pathet Lao guerrillas that were backed by the Vietnamese Communist party. In 1975 the Pathet Lao won the civil war and consolidated their power into a one-party communist state. The country remained static for the next decade until the ruling regime began to relax controls on prices, encourage foreign direct investment, and privatized some state owned industries. Beginning in 1986, Laos began to adopt economic reforms that aimed to make the country more competitive economically. However, we will focus on more recent developments in Laos as our study of development is focused mainly on the modern Laos, not the Laos of 25 years ago.

In 1991, Laos adopted a new constitution that created a unicameral National Assembly composed of 115 elected members. However, there is only one approved party—Lao People’s Revolutionary Party (LPRP)—so voters must select from a list of pre-endorsed candidates. The current president is Lt. Gen. Choummali Saignason and the vice-President is Boun-Gnang Volachit. The central government controls various ministries that carry out tasks given by the Prime Minister, currently Bouasone Bouphavanh. <sup>8</sup>

The country’s estimated GDP measured by Purchasing Power Parity was \$14.60 million (based on 2009 USD) ranking Laos 134<sup>th</sup> globally, and \$2100 per capita respectively, ranking the country 186<sup>th</sup> globally. The estimated GDP growth rate in real terms for 2009 is 3%. Agriculture composes 39.2% of the GDP, industry 33.9%, and services 26.9%. In 2005, 80% of its work force was in agriculture and the rest was in the industry and services sectors. The Gini Index for the country for 2002 was 34.6, which indicates that income is comparatively equally distributed in the country. The estimated inflation rate based on Consumer Prices Index is 2.6%. Both central bank discount rate (7.67%) and commercial bank prime (24%) are surprisingly high, suggesting that capital is relatively scarce in Laos.

The country has a chronic trade deficit in goods. In 2009, the estimated value of imports was \$1.308 billion and value of exports was \$1.104 billion. Major trading partners include: Thailand, China and Vietnam. Trades and foreign investments are highly regulated. Main export products include low value-added commodities, such as wood products, coffee, hydroelectricity,

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<sup>8</sup> CIA – The World Factbook <https://www.ciz.gov/library/publications/the-world-factbook/geos/la/html>.

tin, copper, and gold. Main import products include: machinery and equipment, vehicles, fuel, consumer goods. In addition, an important source of revenue for Laos is remittances from migrant workers in Thailand, especially in the southern part of the country.

Laos's main agricultural products of the country include: sweet potatoes, vegetables, corn, coffee, sugarcane, tobacco, cotton, tea, peanuts, rice, water buffalo, pigs, cattle, and poultry. Rice cultivated on hilly areas feeds the majority of the population. The rural population consumes most of the food it produces, and the country imports additional food from Thailand <sup>9</sup>.

Laos has a rich natural resources base, including energy production and mining. Major industries include: copper, tin, gold, and gypsum mining, timber, electric power, agricultural processing, construction, garments, cement, and tourism. Logging and timber has been the largest industries among all and have been under the control of the state. Before the economic reforms of the late 1980s and early 1990s land was nationalized. Now, private ownership is recognized and a land-tilting program grants ninety-nine year leases and permits commercial transfer.

Laos is one of the Least Developed Countries according to the UN. The government began to decentralize the economy and encourage private enterprise in 1986, and economic growth has then taken place. However, 34% of the population is still living below the poverty line <sup>10</sup>.

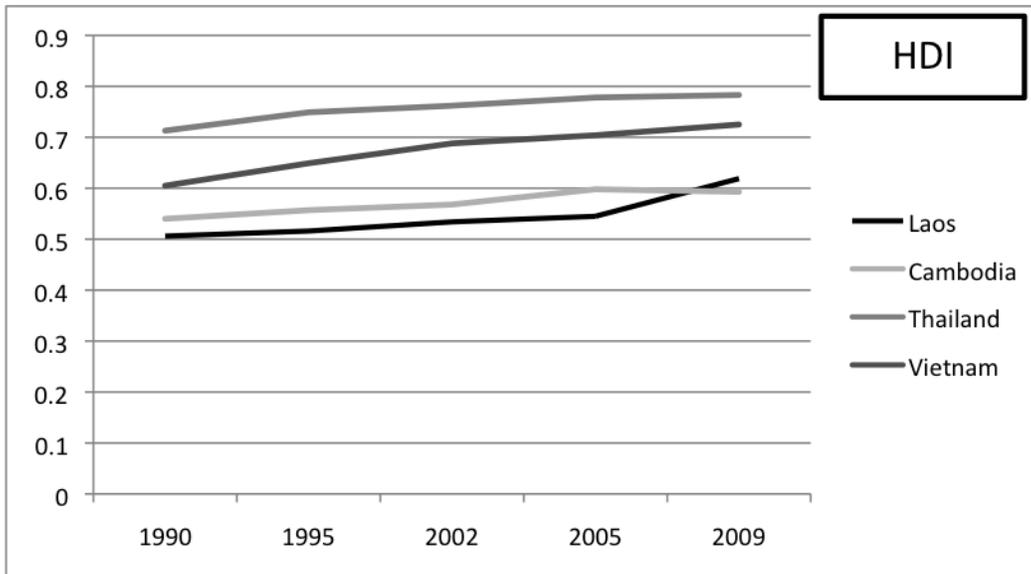
The Human Development Index is a measure of overall quality of life and is a good determinate of social development. It measures the relative healthiness of a country by creating an index composed of the country's average life expectancy, literacy rate, and GDP per capita using Purchasing Power Parity in US dollars. <sup>11</sup>

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<sup>9</sup> <http://www.everyculture.com/Ja-Ma/Laos.html>

<sup>10</sup> <http://www.asean.fta.govt.nz/laos-economic-situation/>

<sup>11</sup> HDI



*Figure 1*

*Figure 1* shows that the HDI of Laos has been increasing for the last twenty years; however, the HDI in Laos is still much lower than Vietnam and Thailand, indicating that the overall quality of life in Laos is much lower than the quality of life in the other two countries. However, Laos's HDI value is close to that of neighboring Cambodia.

## **Current Development of Laos**

Under this section, we will examine the current development status of Laos. In our analysis, we have decided to compare Laos to Cambodia, Vietnam, and Thailand over the past ten years because of their geographic proximity and similar level of development. Vietnam is an especially interesting comparison because, like Laos, it is also a communist state. To give added weight to certain metrics, we included the data for the United States because we wanted to show the enormous disparity between the most developed country in the world and some of the least.

In order to understand the current status, we need to first take a look at the basic attributes of land, water, and agriculture in Laos, which serve as the base for development. With a thorough understanding of these attributes, we will then be able to assess the level of development with respect to economic, social, and political measures.

### **Land and Water**

Laos has a tropical monsoon climate. Hence Laos experiences a rainy season from May through October, a cool dry season from November through February, and a hot dry season in March and April. Laos is dominated by a south-west monsoon which brings high rainfall, high humidity, and hot temperatures from May to October.

Laos's rainfall varies regionally. Its highest recorded totals (approximately 3,700mm 12 annually) are usually recorded on the Bolovens Plateau in Champasak Province. For comparative purposes, the temperate rainforest found in the Pacific Northwest records around 3810 mm 13 of rainfall annually. Laos's capital, Vientiane, receives around 1,700 mm 14 per year. However, these figures distort the fact that during some years Laos does not receive enough rainfall to cultivate rice. During these years, Laos might even only receive half or less than half of the average annual rainfall. Usually these droughts are only regionally focused so only parts of the country are adversely affected. Overall, Laos's rainfall is characterized by its high variability that brings frequent floods and droughts. In March and April along the Mekong River, temperatures may reach highs around 40 degrees Celsius 15. However in January in the

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<sup>12</sup> 145 inches

<sup>13</sup> 150 inches

<sup>14</sup> 66 inches

<sup>15</sup> 104 degrees Fahrenheit

highlands of Xiangkhoang, temperatures may reach a low of 5 degrees Celsius<sup>16</sup>. In the plains, Laos's average temperature stands around 26 degrees Celsius<sup>17</sup>. Generally speaking, Laos's mountainous regions experience a slightly lower average annual temperature.

Laos is a landlocked country that is surrounded by Burma, Cambodia, China, Thailand, and Vietnam. The Mekong River demarcates most of Laos's western border and historically it has been an important transportation network for Laotians. However, the Khone Falls on the Mekong River (in southern "panhandle" of Laos) are not navigable into Cambodia. The Khone Falls are the main reason why the Mekong cannot be used to travel to China or Cambodia via a sizeable vessel. But cargo ships can travel almost the entire the entire length of the Mekong (within Laos) throughout the year without obstruction. Yet small motorboats and human powered craft still remain an important source of transportation on many of the Mekong's numerous small tributaries. Historically speaking, the Mekong River has served as an important means of communication and transportation between the various cultures living within the Mekong river valley. However, the Laotian government severely restricts travel between Laos and its neighbors.

Steep mountains and river valleys characterize the topography of Laos. Elevations are abrupt and can reach more than 500 meters <sup>18</sup> above sea level and Laos's river valleys are very narrow. Laos's mountains extend across the northern corridor of the country, except for the plain that surrounds Vientiane. Rather bluntly, Laos's existing topography is not very conducive to agriculture. But Laos's southern "panhandle" is more suitable for cultivating rice and livestock because it is relatively flat. Numerous sources state only about eight percent of the total land in Laos currently can be considered arable.

Laos's natural resources include: timber, hydropower, gypsum, tin, gold, and gemstones. Traditionally Laos's forests have been its most important primary product because forests cover over fifty percent of the land.<sup>19</sup> However hydroelectric dams have become a recent and extremely important source of economic growth because the Laotian government recognizes that clear cutting has serious negative externalities.

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<sup>16</sup> 41 degrees Fahrenheit

<sup>17</sup> 79 degrees Fahrenheit

<sup>18</sup> 1,640 feet

<sup>19</sup> 1993 est.

## Agriculture

Since 40% of Laos's GDP comes from the agricultural sector (employing 80% of the country's labor force) it is critical that we examine the current agricultural situation in Laos. By analyzing the current situation, we can determine where improvements can be made. These improvements, in turn, will increase efficiency in agriculture which will greatly free people from farmland and enable them to pursue other sources of freedoms, such as education. Thus, a complex understanding of the status quo and development potential for the agricultural sector is crucial for our report.

Due its mountainous landscape, Laos's farmland is limited to around only 8.1% of the country's total surface area. As indicated in the table below, only 4% of total land area in the country is cultivated, 0.3% is used for permanent crop, and the rest is used as pastures.

<b>2003</b>	<b>Area (x 10,000 ha)</b>	<b>Percentage</b>
<b>Total land area</b>	2,368	100
<b>Farmland</b>	191	8.1
<b>Cultivated land</b>	95	4
<b>Permanent crop</b>	8	0.3
<b>Permanent pastures</b>	88	3.7

*Figure 2:* Source: FAO

Agriculture accounts for two fifths of the total GDP. Among this figure, rice accounts for about 40% and livestock accounts for about 30% respectively. Laotian agriculture is mainly subsistence farming rather than commercial production. As indicated in the chart and the table below, which summarize the major agricultural commodities in Laos for the year of 2007, rice makes up a large portion of the total outputs.

Rank	Commodity	Production (Int. \$1000)	Production (MT)
1	Rice (paddy)	496,450	2,710,050
2	Vegetables (fresh)	123,849	660,000
3	Tobacco (unmanufactured)	75,727	41,535
4	Chilies and peppers, dry	35,642	7,000
5	Maize	33,432	690,795
6	Coffee, green	2,7142	33,200
7	Groundnuts, with shell	16,174	35,070
8	Cassava	15,138	233,420
9	Sweet potatoes	10,698	126,465
10	Hen eggs, in shell	9,863	13,400

*Figure 3: Source: FAO*

Most farmers in Laos employ one a variant of these two techniques: the wet-field paddy system, practiced primarily in the plains and valleys, or the swidden cultivation system, practiced primarily in the hills. About 60% of the arable land in the country is cultivated by the wet-field paddy method, which is both sustainable and does not require the destruction of forests. However, the rest is cultivated by the swidden method, which causes a never-ending cycle of deforestation. Under this method, the land is cultivated for one year and left fallow for four to six years before becoming productive again. Swidden cultivation produces only 20 percent of the national rice harvest, yet it requires 10 to 15 times as much land per capita as wet-field cultivation due to the provision for fallow fields. Therefore the harvest for the households relying on swidden cultivation for subsistence often falls one to six months short of the families' annual rice requirements.

Since 1990, Laotian farmers have increased their use of fertilizer to enhance the productivity of their land as indicated in the graph below. However, when compared with Vietnam and Thailand, the consumption of fertilizer in Laos is still very low.

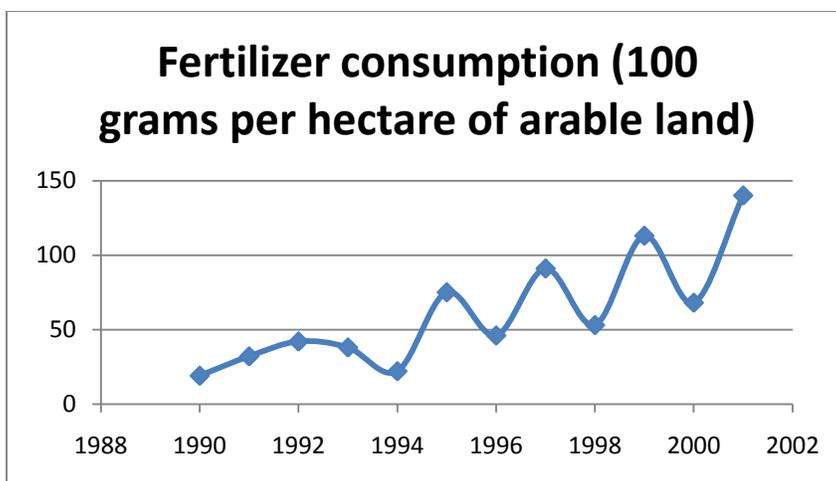


Figure 4

Country	Fertilizer consumption (100 grams per hectare of arable land), 2001
Laos	140
Cambodia	0
Vietnam	2867
Thailand	1061

Figure 5

The use of agricultural machinery, measured by tractors per 100 square km. of arable land, indicates the level of industrialization of the agricultural sector. Since 1990, the number for Laos has stagnated at 11, while the numbers for the other three countries have increased. This is due to the fact that the cost of mechanized tractors and fuel is far beyond the reach of most Laotian farmers who continue to use water buffalos for plowing. A comparison of the industrialization level of the agricultural sector in the four countries is found in the table below.

Country	Tractors per 100 square km of arable land, 2005
Laos	11
Cambodia	11
Vietnam	247
Thailand	261

Figure 6

Like many of its Southeastern Asian neighbors, Laos benefited from the Green Revolution. Financially supported by the Swiss Agency for Development and Cooperation, and led jointly by the Lao national rice research system and the Philippines-based International Rice Research Institute, the Revolution was able to increase rice production in Laos from 1.5 million tons in 1990 to 2.5 million tons in 2004, yielding an average annual growth rate of more than 5%. Households participating in the program have managed to more than triple their cash income. A third of Laos' lowland rice area is planted with improved varieties from this program. The average rice yields were pushed up 35 percent from 2.3 tons/ha in 1989 to 3.1 tons/ha in 2004 – well above the average yields of bigger neighbors such as Thailand<sup>20</sup>. Thanks to the Green Revolution, Laos is able to produce enough rice to meet local market demands and reduce reliance on imports for food. Hopefully, through further research and development, Laos will be able to establish rice exports as a sustainable source of revenue and help fuel economic growth, like what has taken place already in Vietnam and Thailand.

### **Economic Measures of Development**

The Gross Domestic Product (GDP) is a basic measure of a country's overall economic output. It reflects the market value of all final goods and services produced within the physical borders of a country in a year. Ideally, we would be more inclined to use the Gross National Product (GNP) as a measure of the economic growth in Laos as we are more concerned about the economic freedoms of Laotian nationals than about those of foreigners in the country. However, historical data for Laotian GNP are not complete or reliable. GDP is used only as an alternative. GDP can be calculated in three ways: the product approach, the income approach and the expenditure approach, all of which should yield the same results theoretically. Thus, GDP captures the productivity, income, and consumption of a country's economy. Of the various GDP figures, we choose Official Exchange Rate to measure the national strength and impact of Laos on the global economy. On the individual level, we favor Purchasing Power Parity, which will truly reflect the economic living standards of a country taking out the impact of inflation and currency exchange rate fluctuations. Since different countries have different population sizes, total GDP's relevance is significantly weakened in terms of indicating the economic freedoms of

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<sup>20</sup> [http://www.eurekalert.org/pub\\_releases/2006-03/irri-tgr031506.php](http://www.eurekalert.org/pub_releases/2006-03/irri-tgr031506.php)

an average individual in a nation and more difficult to compare to other nations since each nation will not have the same population or output capacity. Therefore, we also include GDP per capita in our analysis. We have chosen data on Laos from the period of 2000-2008 for our study. This choice in time period is significant because the effects of the Asian financial crisis in the late 1990's had a great effect on the country until 2000. The period from 2000-2008 allows us to examine overall trends in development of Laos which is important because of the variations in the business cycle that occur naturally from year to year.

For our study of the economic condition of Laos, we will examine GDP composition and labor force distribution by sector to better understand the productivity, efficiency and effectiveness of the Laotian economy. These measures will help explain the status quo of the Laotian economic growth. In addition to GDP metrics, we will examine Laotian infrastructure as we believe it is an indispensable building block as well as a direct outcome of the overall economic development.

We will begin our study by examining GDP. Even though total GDP is not the sole criterion, excluding it will lead to an incomplete measurement of Laos's economic development. Total GDP provides an informative picture of the Laotian economy on the national level. The estimated GDP (official exchange rate) for Laos in 2009 was \$5.721 billion. As shown in the following table, the Laotian economy is weak when compared with those of the benchmark countries. It was only 52% of the economy in Cambodia, 6% of that in Vietnam, 2% of that in Thailand, and 0.04% of that in the United States.

Country	GDP ( est. 2009, official exchange rate, in USD)
Laos	\$ 5.721 billion
Cambodia	\$10.9 billion
Vietnam	\$91.76 billion
Thailand	\$266.4 billion
United States	\$14.27 trillion

Figure 7

As discussed previously, GDP per capita is a more appropriate tool for measuring economic freedom at individual level. The estimated GDP per capita (PPP) for Laos in 2009 was \$2,100. In this measure, Laos was ranked the 186th out of 226 countries. The following countries had similar GDP per capita and world rankings:

Rank	Country	GDP per capita (2009, PPP)
181	Sudan	\$2,300
182	Papua New Guinea	\$2,300
183	Fed. States of Micronesia	\$2,200
184	Kyrgyzstan	\$2,100
185	Mauritania	\$2,100
186	Laos	\$2,100
187	Cambodia	\$1,900
188	North Korea	\$1,800
189	Tajikistan	\$1,800
190	Cote d'Ivoire	\$1,700
191	Senegal	\$1,700

*Figure 8*

We also compared the estimated GDP per capita of Laos for 2009 with those of the three neighboring countries previously mentioned and the United States, as seen in the table below.

2009 (est.) <sup>21</sup>	GDP per capita
Laos	\$2,100
Cambodia	\$1,900
Vietnam	\$2,900
Thailand	\$8,100
United States	\$46,400

*Figure 9*

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<sup>21</sup> CIA Factbook

Among the five countries, GDP per capita for Laos was slightly higher than that of Cambodia, ranking the 2<sup>nd</sup> lowest among the five. Yet, it is four times lower than that of Thailand. This confirms our aforementioned findings that Laotian economy as a whole is weak, but in terms of per capita, it is even worse.

To understand the recent trends in economic growth, we obtained the historical GDP per capita data based on Purchasing Power Parity (in constant 2005 international dollars) from the World Development Indicators database for the years between 2000 and 2008. We graphed the trends in the growth of GDP per capita for Laos, Cambodia, Thailand, and Vietnam as shown below. The data for the United States was not included on purpose as the large values of the United States will hinder the observation of minor trend changes in the figures for the four developing countries.

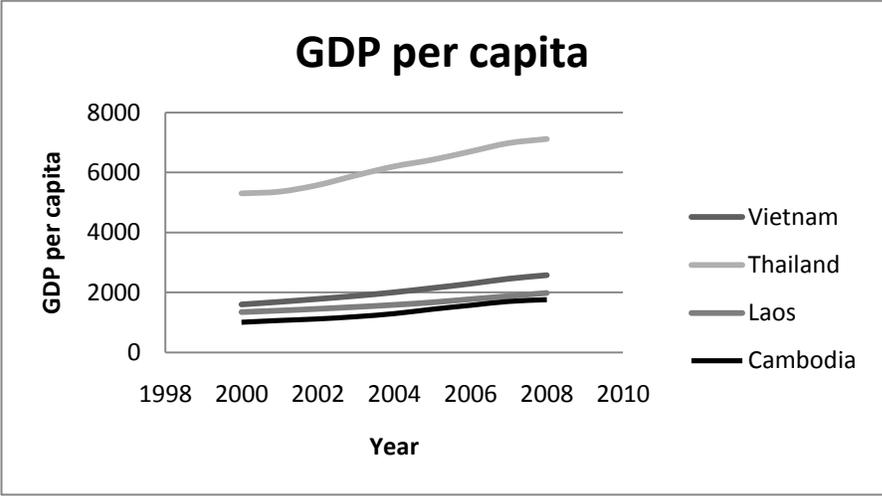


Figure 10

As indicated in the graphs above, the slopes for Laotian total GDP and GDP per capita are flatter than those for the other three countries. This implies that the economic growth in Laos is slower than that of the other three countries. The following table confirms this finding as it lists the GDP per capita growth rates across the four countries. For the period between 2004 and 2007, Laos constantly underperformed Cambodia and Vietnam in terms of GDP per capita growth. However, since the Laotian economy is in the primordial stage, it was less affected by the global economic downturn during 2008, whereas all other countries experienced a decrease in growth rate.

Country	GDP per capita growth rate (annual %)				
	2008	2007	2006	2005	2004
Laos	6%	6%	6%	5%	5%
Cambodia	3%	8%	9%	11%	8%
Vietnam	5%	7%	7%	7%	6%
Thailand	2%	4%	4%	4%	5%

Figure 11

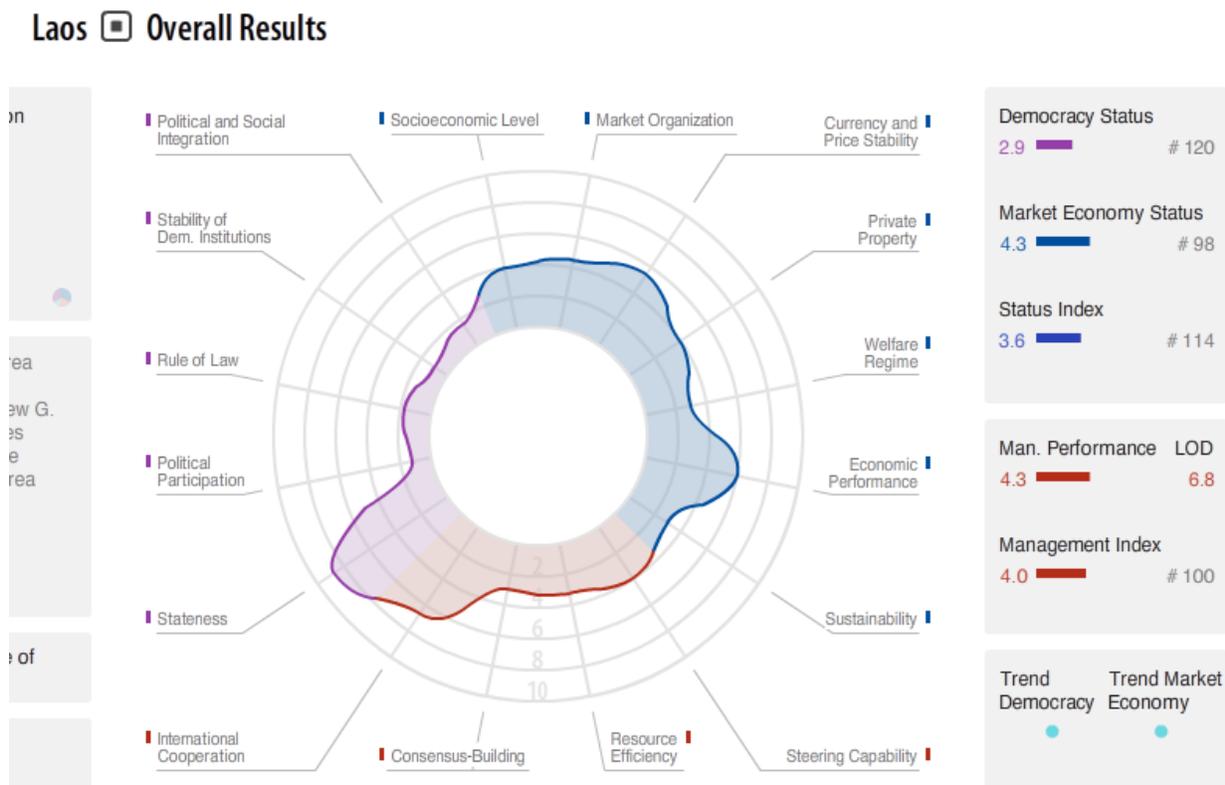


Figure 12: Bertelsmann-Transformation Index<sup>22</sup>

<sup>22</sup> “The Bertelsmann-Transformation Index is a global ranking that analyzes and evaluates development and transformation processes in 128 countries. It provides the international public and political actors with a comprehensive view of how each of these countries is progressing toward democracy and a market economy, as well as the quality of their political management. The BTI’s analysis assumes the goal of a consolidated market-based democracy. It analyzes the status of both democratization and market liberalization as it evaluates reformers’ actions, decisions and management within a particular setting.” (<http://www.bertelsmann-transformation-index.de/en/bti/>).

We also analyzed GDP composition and labor force distribution by sector to explore some possible causes for Laos' low GDP level and slow economic growth. GDP composition and labor force distribution are important for determining the efficiency of economy, the allocation of resources, and the productivity of workers. Not only do they provide insights about the causal factors of the status quo of the Laotian economy, but also indicate the country's potential to create more economic freedoms in the future. As shown in the table below, for the year of 2009, about 40% of Laos's GDP came from the agriculture sector, which is the highest of all the five countries studied. Industry also contributed a large portion of Laotian GDP, while the service sector only accounted for less than one third, the lowest among the four countries. Since, in Laos, the major component of agriculture is subsistence food and the major component of industry is logging and timber, it is quite obvious that the Laotian economy is not industrialized and is largely driven by low value added products. Furthermore, about 80% of the Laotian labor force is employed in agriculture, generating only 40% of GDP. Therefore, the majority of the labor (mainly farmers) are not productive and earn very little income. In a broader sense, Laos is not as efficient and effective as other countries in terms of utilizing human capital to generate output, or to increase income.

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Compiled by Bertelsmann Stiftung, the largest non-profit organization in Germany, which focuses on being both a think-tank and an agent for social change, the Bertelsmann Transformation Index is meant to be one all encompassing graph of one country's factors of development. Based on neoliberal ideals for development, each sector of the graph, Democracy, Management, and Market Economy is broken down into smaller indicators (16 overall). Each individual indicator (or points on the graph) is a compositional average of several questions that make up the indicator.

We have found the BTI to be a very useful measure of overall development. We will be referring to both the overall measure of development the BTI provides, as well as the specific rankings that are also included. Our one main concern with using the BTI is that it is only useful for comparing underdeveloped countries to one another, because no information is gathered for fully developed countries like the United States or Japan. For more information about what Bertelsmann Stiftung is and their goals and policies, visit <http://www.bertelsmann-stiftung.de/cps/rde/xchg/bst>

<b>2009 Composition by Sector<sup>23</sup></b>	<b>Agriculture</b>	<b>Industry</b>	<b>Service</b>
Laos	39.20%	33.90%	26.90%
Cambodia	29.00%	30.00%	31.00%
Vietnam	21.40%	39.90%	38.70%
Thailand	12.30%	44.00%	43.70%
United States	1.20%	21.90%	76.90%

*Figure 13*

<b>2009 Labor Force Composition by Sector<sup>24</sup></b>	<b>Agriculture</b>
Laos	80.00%
Cambodia	75.00%
Vietnam	55.60%
Thailand	42.60%
United States	0.60%

*Figure 14*

Basic infrastructure not only facilitates further economic growth, but also indicates the level of economic development already taken place in the country. If people do not have the ability to move and communicate freely, they will certainly be denied opportunities to do and be all that they desire. Therefore, infrastructure development is a measure that illustrates the potential for Laos to integrate with the globalized world economy and to gain international competitive advantages, according to modernization theorists; or, to build a sustainable, dynamic and well-articulated internal market, according to dependency theorists. Small towns simply cannot offer the same opportunities as cities can. Access to these cities is crucial to development. Also, infrastructure will allow access to other countries, which is particularly important with respect to exports and export promotion. Currently, Laos has an underdeveloped infrastructure, especially in rural areas. The road system is rudimentary and telecommunications are limited.

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<sup>23</sup> CIA Factbook

<sup>24</sup> CIA Factbook

However, electricity is widely available in both rural and urban areas. This oddity is largely because the Laotian government has recently been encouraging the hydroelectric sector to take advantage of the mountainous landscape of the country so as to export hydroelectricity and to become the “the battery of southeast Asia.” However, as a less industrialized country, Laos still produces and consumes much less energy than the rest of the world.

Roads are the dominant mode of transportation in Laos. However, the majority of the roads in the country are unpaved. As indicated in the graph<sup>25</sup> below, the percentage of paved roads has been decreasing over the years despite increased investment from the government and foreign investors.

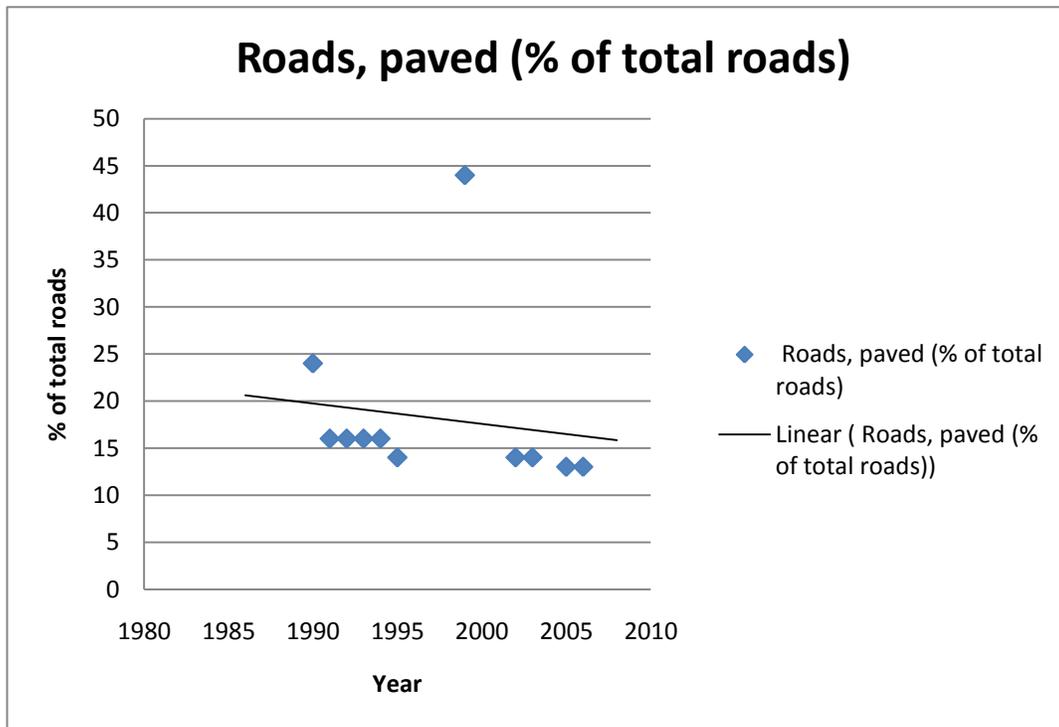


Figure 15: Source: World Development Indicators<sup>26</sup>

Most of the paved roads in Laos are in poor condition and are inaccessible during the wet season. Laos’s 4,600 km. of waterways are useful for transporting goods. However, large crafts may not be able to pass through waterways during the dry season. Air transportation in Laos is

<sup>25</sup> World Development Indicators

<sup>26</sup> We believe the data for 2000 is inaccurate as such a dramatic surge and decline in the percentage of paved roads within one year is unlikely.

limited due to the small number of airports (41 airports, 9 with paved runways). There have been proposals and studies completed for a trans-Asian rail link that would connect Laos to other countries in Asia, but no such railway exists at the time of this report.<sup>27</sup> Compared to most of the world, Laos’s communication infrastructure is again extremely limited. Only about two million people have telephones. Yet, there has been a dramatic increase in the number of mobile and fixed-line telephone subscribers since 2004 as illustrated in the graph<sup>28</sup> below.

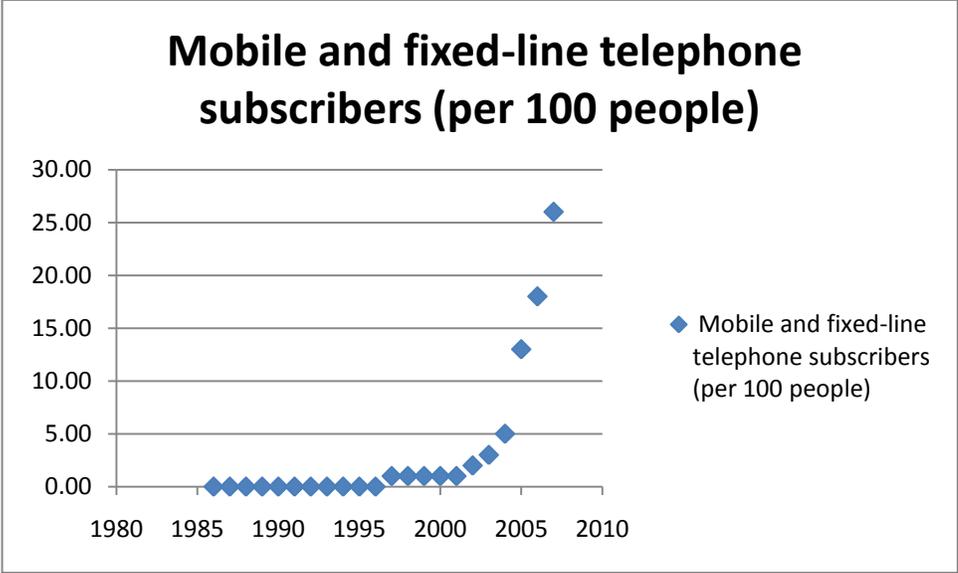


Figure 16

By the end of 2007, almost 26% of Laotians were subscribed to mobile or fixed-line telephones, while the figure stands at around 18% in Cambodia, 61% in Vietnam, 129% in Thailand, and 140% in the United States. In 2007, 2% of Laotians had access to the internet, while the figure was 0% in Cambodia, 21% in Vietnam, 20% in Thailand, and 74% in the United States. Even though there have been improvements in Laotian communication infrastructure, there is still a long way to go.

In conclusion, the Laotian economy as a whole is very weak and the growth rate is slower than those of the neighboring developing countries. Nevertheless, the situation worsens when GDP per capita is measured. The productivity, income, and consumption of an average Laotian are extremely low and are growing only very slowly. The Laotian economy is not very

<sup>27</sup> CIA World Factbook

<sup>28</sup> World Development Indicators

industrialized and is largely driven by low value added agricultural and industrial productions. An extremely large proportion of the labor force is tied in agriculture, which generates only 40% of GDP. Laos has underdeveloped transportation and limited communication infrastructures. Therefore, the average Laotian's economic freedom is restricted and affects his or her ability to pursue basic human needs.

### **Financial Measures of Development**

In this section, we will study the current financial status of Laos. We will conduct an analysis of the One, Two, and Three Gaps, and conclude that Laos's short-term financial situation is manageable, but the country may encounter problems in long term sustainability.

#### *The One Gap*

The Harrod-Domar equation strips Solow Growth Theory of its land, labor and efficiency components to yield a simple equation where the investment level determines GDP per capita growth. The given equation is  $\Delta\text{GDP} = I/K$  where K is the capital-output ratio and I is investment. By employing this equation, we are able to find the amount of investment necessary to achieve the targeted growth rate in any given year. If there is a discrepancy between desired investment and available domestic saving, there exists a disequilibrium, which is referred to as the one-gap.

Analysis of the one-gap is important for our policy proposal for Laos because it will help us determine if investment rates are adequate for desired GDP per capita growth. If the one-gap is large, it will tell us that Laos either is not saving enough or using these savings inefficiently. We must consider the implications of potentially increasing the one-gap if our recommendation includes additional capital investment in Laos.

Year <sup>29</sup>	Investment Rate (%) <sup>30</sup>	GDP per Capita Growth <sup>31</sup> (%)	K value
2001	27	3.8	7.1
2002	27	4.2	6.4
2003	28	4.4	6.3
2004	32	4.7	6.8
2005	34	5.0	6.8
2006	30	6.3	4.7
2007	38	5.9	6.4

*Figure 17*

From 2000 to 2007, Laos's domestic investment rate averaged 30.8%. Over this range, average GDP per capita growth was 4.9% giving us an average K value of 6.35. The average K value for a country is accepted to be about 5. A value of 6.35 indicates Laos does not employ efficient use of its investment capital. The government of Laos intends to achieve an annual growth of 8% in GDP per capita. We feel more comfortable with using the average GDP per capita growth rate for the past seven years, which is 5%, as the target since it smoothes out business cycles and serves as a better forecast for the long term economic situations in the country. With a goal of 5% growth in GDP per capita, according to Harrod-Domar, the country must average an investment rate of 31.75%. In 2007, the savings rate was 23% making the one-gap 8.75% of GDP. This gap must be filled by borrowing foreign capital or increasing domestic savings. Increasing domestic savings levels in Laos may be possible through cuts in consumption spending and using the excess capital for savings. If Laotians choose not to save to fill the 8.75% gap, Laos must receive foreign investments of that amount to fill the gap. This large gap is a concern to us as receiving foreign investment of 8.75% of GDP could create dependency or a debt trap. To fix this gap, Laos must be more efficient with or increase its domestic savings so such a large investment rate is not needed to sustain its current GDP growth. In the long run, Laos can also try to fill the gap through decreasing K, the capital-output ratio, by increasing worker or capital productivity. Technology and education improvements will both increase

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<sup>29</sup> WDI

<sup>30</sup> Gross capital formation as percentage of GDP

<sup>31</sup> GDP per capita. PPP constant international \$

productivity. However, Laos may still want to receive some amount of FDI since these investments will usually bring in technology that the country needs to further its development.

Given below is data on investment rates and GDP growth in 2007 in our benchmark countries. Thailand and Vietnam have similar K values, indicating similar capital efficiencies. Cambodia, however, makes more efficient use of its available capital. Laos should strive to use capital more efficiently so it will not need high savings and investment rates to sustain GDP growth.

Country	Investment Rate (%)	GDP per Capita Growth (%)	K value
Thailand	28	4.2	6.66
Cambodia	21	8.2	2.56
Vietnam	42	7.2	5.83

*Figure 18*

When Laos’s investment and GDP per capita growth rates are compared to other countries with similar GDP per capita incomes, we see that Laos sits nearly on the regression line. This placement indicates that Laos’s investment and GDP per capita growth rates are close to those which we would expect when given Laos’s current investment and growth rates. We chose to use countries with similar GDP per capita as we believe these countries have similar levels of development and will therefore give us similar returns on investment.

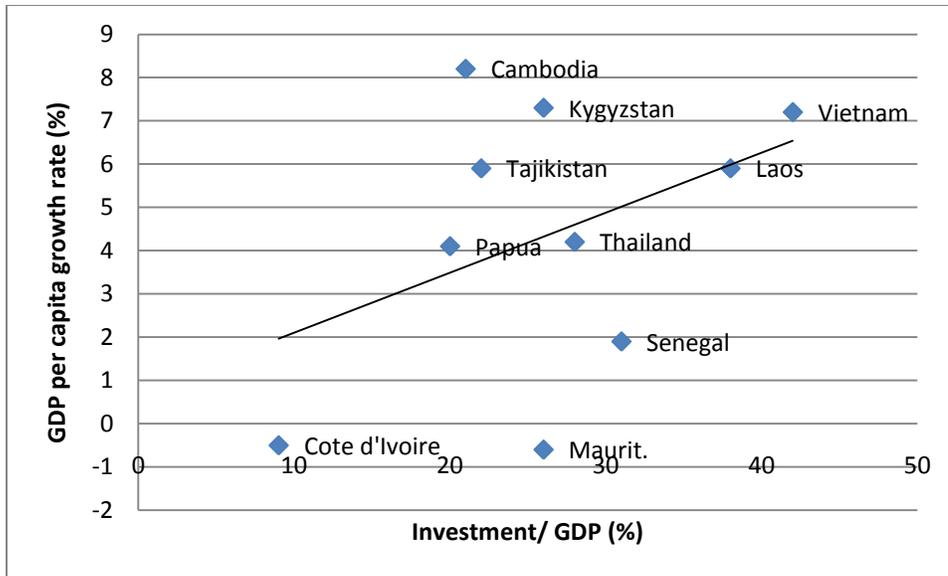


Figure 19

We have reservations about using solely the Harrod-Domar equation to determine necessary savings levels in Laos because over our time range, FDI jumped from 1%-8% of GDP. This 7% increase in FDI did not produce an increase in GDP we would have expected from the Harrod-Domar equation. Another problem is that this equation does not factor in the effects of depreciation on equipment. In reality, a 0% investment rate will actually cause about a -5% real GDP growth rate due to capital depreciation. This effect is not shown through this equation.

In conclusion, we believe the inefficient use of capital is the major reason that causes the One Gap in Laos, rather than an insufficient savings rate. This inefficient use of capital implies that although simply increasing investment rate will help to reduce the One Gap, given a current savings rate of 23%, we don't recommend further encouragement of savings, as it will restrict the consumption of the Laotian people. Instead, the country should look into means to decrease the K value through attempting a more efficient use of its available capital.

### *The Two Gap*

### Currency and Inflation

The Lao kip is not convertible to any currency outside of the Lao PDR. Because of this, the only reliable sources of foreign exchange information are those inside the country. The Bank of Laos has pledge to maintain the Kip's managed floating exchange rate at around 8,664.80 Lao

Kip to one USD.<sup>32</sup> The BOL sets the daily Kip/USD reference rate for commercial banks and exchange bureaus as the basis for determining the bid and asking price which is then allowed to float within the range of 0.25% of the reference rate. In addition, the Bank of Laos has encouraged commercial banks to maintain adequate reserves of foreign currencies. The Bank of Laos also permits foreign exchange bureaus to buy and sell currencies with the Bank of Laos. Laos’s international currency reserves currently cover 6.9 months of imports.

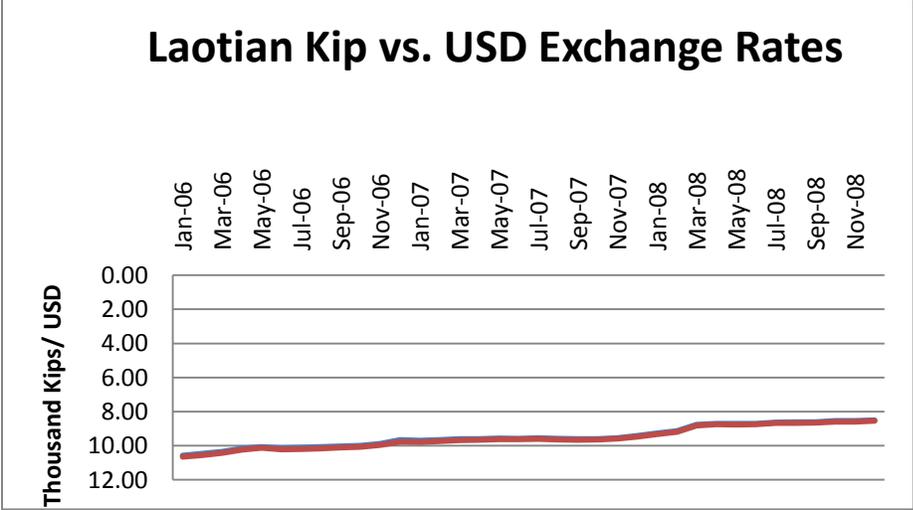
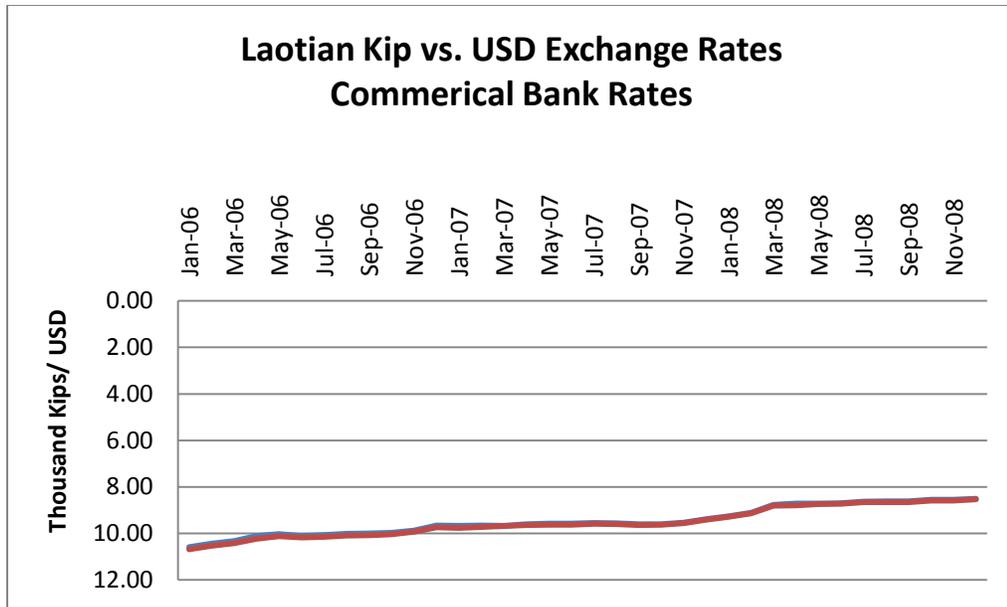


Figure 20

Last year the Kip appreciated against the dollar by 9.8%, this appreciation helped keep inflation rates in the single digit range and was significantly lower than its average economic growth rate. Overall, public and international confidence in the kip is up from the low of the late 1990’s when the economy experienced over 100% inflation and 500% depreciation.

<sup>32</sup> <http://www.oanda.com/convert/classic>



*Figure 21*

As of January 2010, the Bank of the Lao PDR has pledged to keep its existing monetary policy despite calls to devalue the Kip. According to the bank’s governor, leading representatives from the travel and garment industries urged the government to devalue the kip to enable the country to survive the world economic recession. Exporters wanted the kip to remain around 9,000 kip per USD because many exporters could not remain competitive with a higher valued kip.

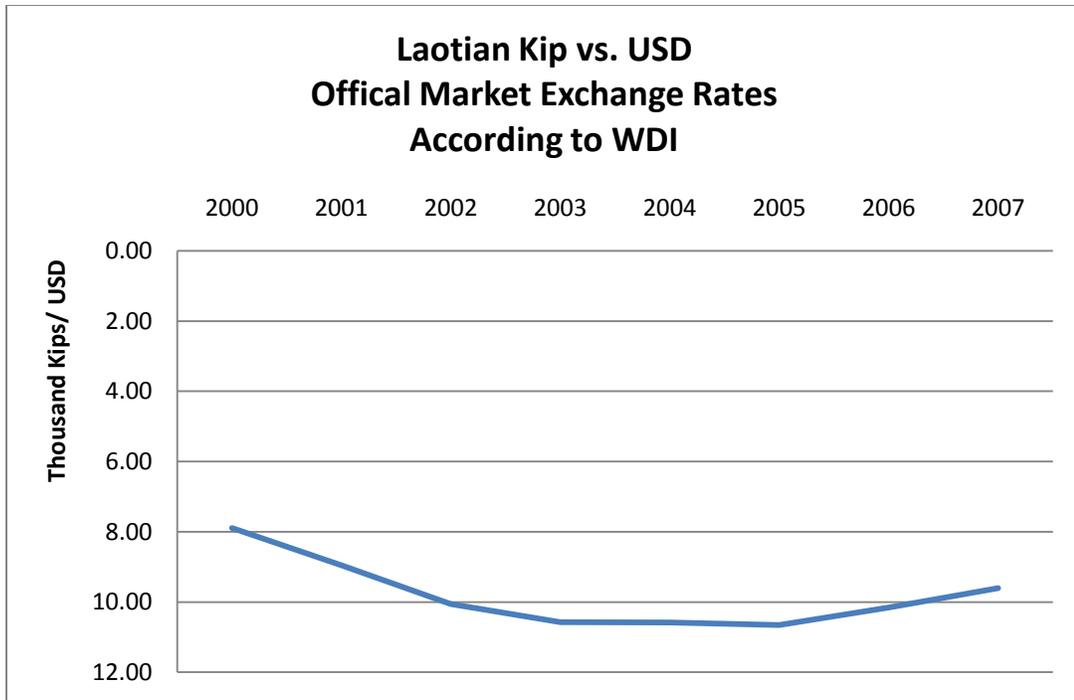


Figure 22

Exporters are usually paid in USD dollars but pay their operating costs and local expenses in Kip. Devaluation of Kip will enable the Laotian exporters to receive more income per unit sold abroad if they keep the nominal dollar price. On the other hand, if they decide to lower their nominal dollar price as a response to the devaluation, their products would become much more attractive in the global market. Currently, the undervalued Vietnamese Dong has added pressure on the Laos as the overvalued kip must compete with the highly competitive Dong.

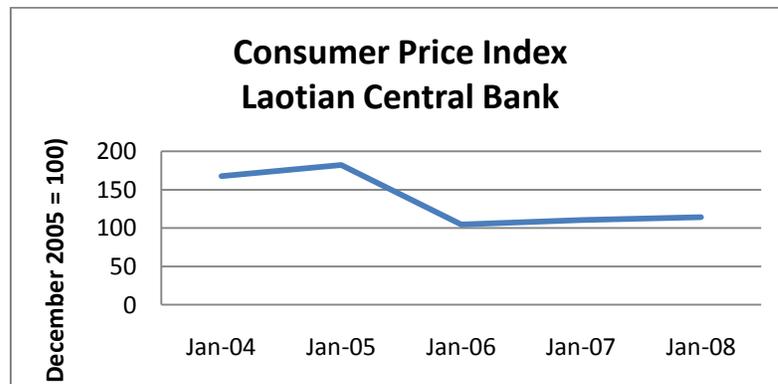


Figure 23

Laotian officials claimed that a devaluation of the kip would do more harm than good because devaluation would lead to inflation which could lead to a loss of confidence in the Kip and could also cause those that hold the kip abroad to sell it. Thus, the devaluation would be counterproductive to the government's attempt to get the Lao people to use the national currency.<sup>33</sup> But more importantly, the kip cannot be devalued because stability of the exchange rate and of the inflation rate is desired to ensure economic growth.<sup>34</sup>

The price of goods within Laos remained relatively stable. As indicated in the graph below, the inflation rate decreased dramatically since 2000, even though it rose slightly from 4.5% in 2007 to 7.5% in 2008. Compared to its neighbors, Laos's inflation rate remained slightly lower. The aggregate demand for housing and tobacco and alcoholic beverages were the major causes driving inflation. Laos's increased demand for oil and natural disasters like flooding also added to the rise.

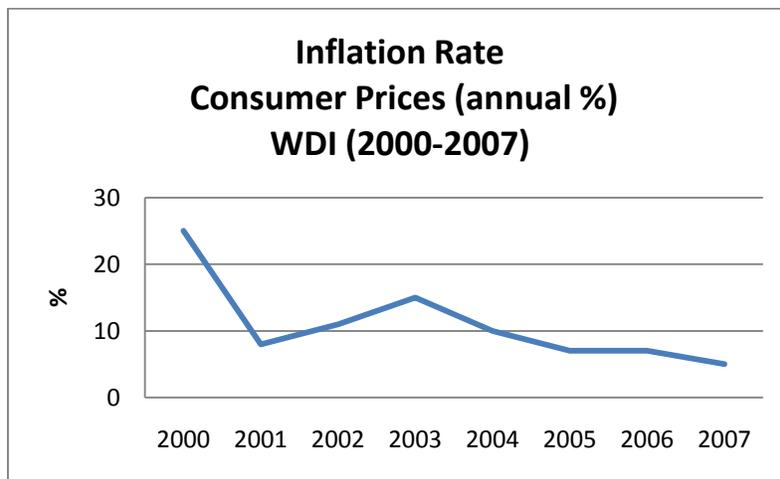


Figure 24

Despite experiencing relative stability in recent years, the kip cannot yet call itself a stable currency. After years of volatility the kip has in recent times remained fairly stable at around 10, 000 Kip to the US dollar. A popular travel book remarked, once you are outside of

<sup>33</sup> Although only the Kip is legally negotiable in everyday transactions, in reality three currencies are used for commerce: the kip, Thai baht (B) and US dollars (US). An estimated one-third of all cash circulating in Vientiane bears the portrait of the Thai king, while another third celebrates US presidents.

<sup>34</sup> <http://www.bol.gov.la/english/cbkk.pdf> Vientiane Times, 4 January 2010

Laos, no one, except perhaps other travelers on their way into Laos will want your kip, so spend it before you go. However, recent trends indicate that the tide may be turning in favor of Laos.

### Balance of Payments

Without first understanding Laos’s balance of payments, it will be impossible to identify the Two Gap. More specifically, Laos’s Two Gap is the difference between Laos’s desired import levels and available foreign exchange reserves. The following section will provide an in-depth explanation of the historic and current status of Laos’s balance of payments accounts.

In 2008, the balance of payments of Laos continued to record a surplus adding an additional 18.8% to its foreign reserves. By the end of the year, the official gross foreign reserves were valued to be USD 636.1 million and could cover 5.9 months of imports. The current account balance was in surplus of USD 183.2 million, which accounted for 3.5% of the total GDP. As indicated in Figure 25 below, Laos has experienced a steady increase in current account balance surplus since 2006.

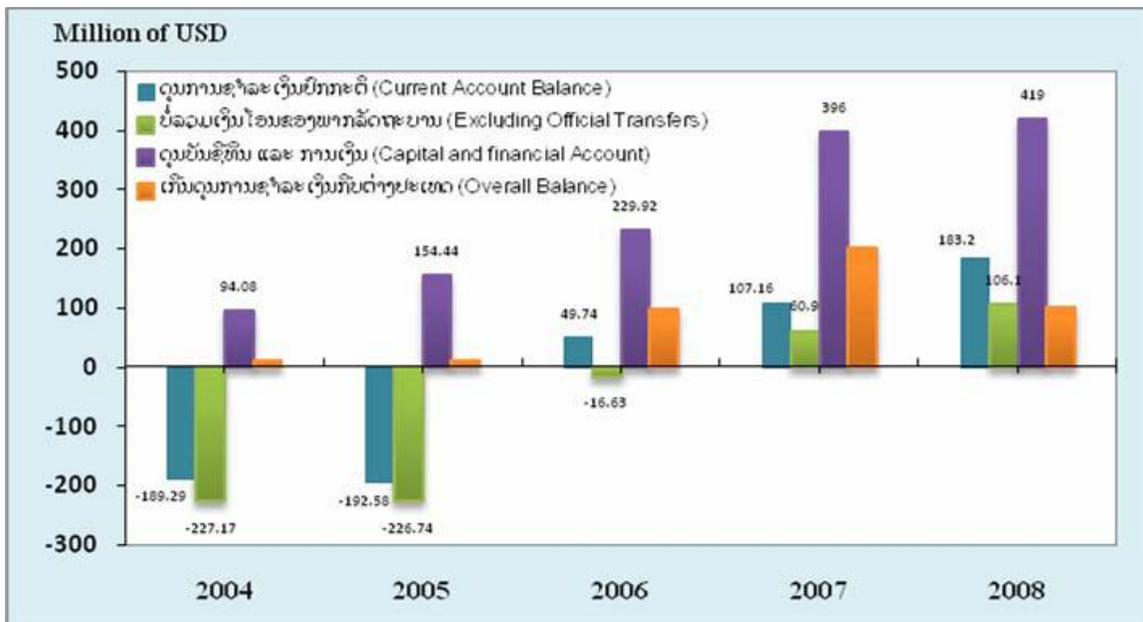


Figure 25: Balance of Payments Source: Bank of the Lao PDR

We will now highlight the factors that contribute to the overall surplus in Laos’s current account balance. In 2008 Laos experienced a trade deficit in goods. As indicated in Figure 26 below, Laos has imported more goods than it has exported since 2005. In 2008, the total export

of goods was USD \$1,084.90 million, which increased by 17.6% and accounted for 20.5% of the total GDP. The total import of goods was USD \$1,302.90 million, which increased by 22.4% and accounted for 24.6% of total GDP. Therefore, the total trade deficit in goods for 2008 was USD \$218 million, which accounted for 4.1% of Laos’s total GDP. The main reasons behind the deficit were the fact that Laos reduced its exports of wood products, coffee, and mining as well as increasing its imports of consumption in goods, raw materials, and electricity. It seems that Laos has imported goods so as to satisfy the consumption needs of its citizens and to produce its exports. Therefore, in order to sustain its exports, Laos has to rely on imports as raw material inputs and manufacturing equipment. Thus, the trade deficit in goods is likely to remain in the future.

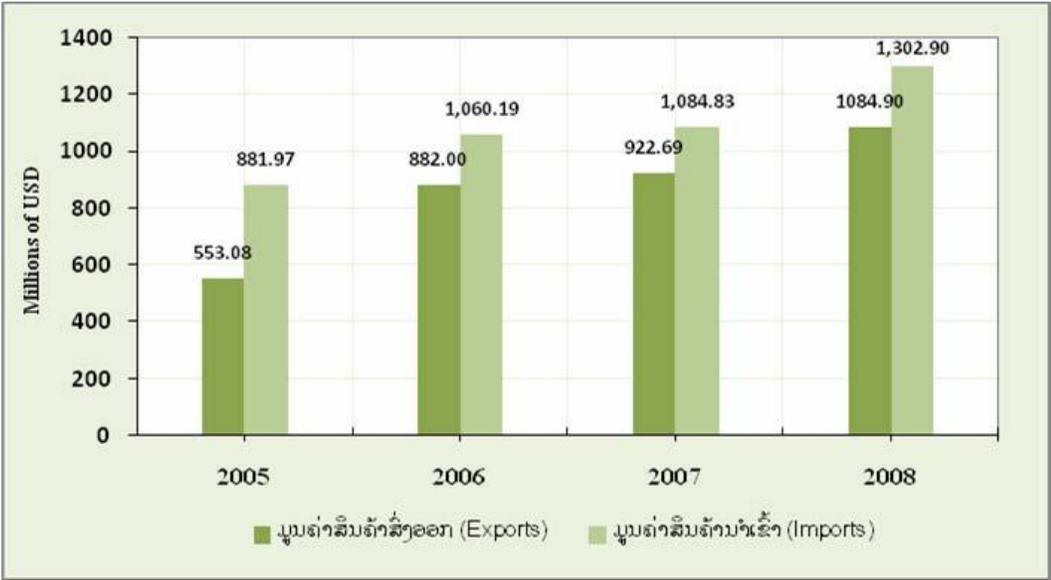


Figure 26: Imports and Exports Source: Bank of the Lao PDR

The services account continued to record a surplus of USD306.2 million, an increase of 51.5% from 2007 and accounting for 5.8% of the total GDP. Service receipts amounted to USD 414.3 million, 7.8% of the total GDP, while service payments were only USD 108.1 million. The surplus in Laos’s service account was mainly due to an increase in tourism, over-flight, and communication services. Particularly, Laos has discovered tourism as a new means of bringing in foreign currencies. As illustrated in Figures 27 and 28 below, revenues from tourism and number of tourist arrivals have skyrocketed since 2003.

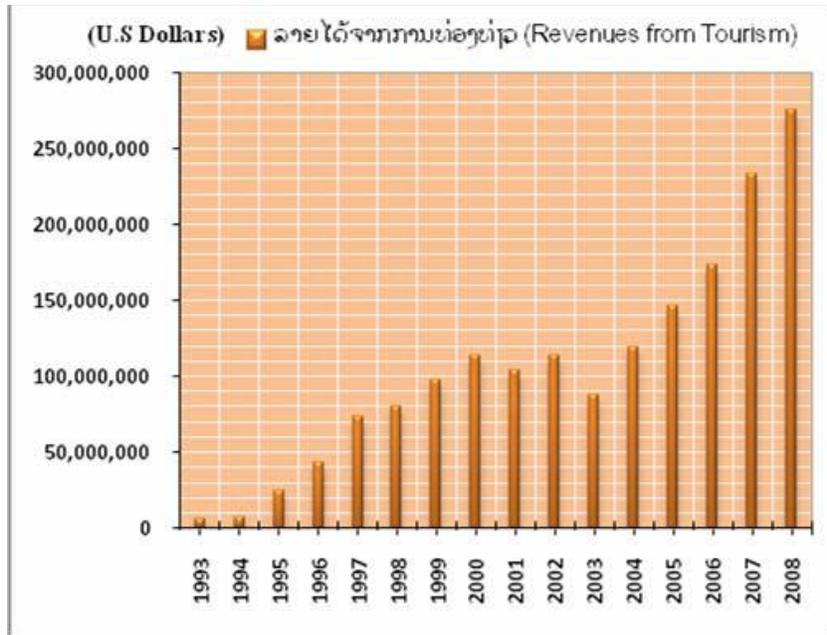


Figure 27: Revenues from Tourism

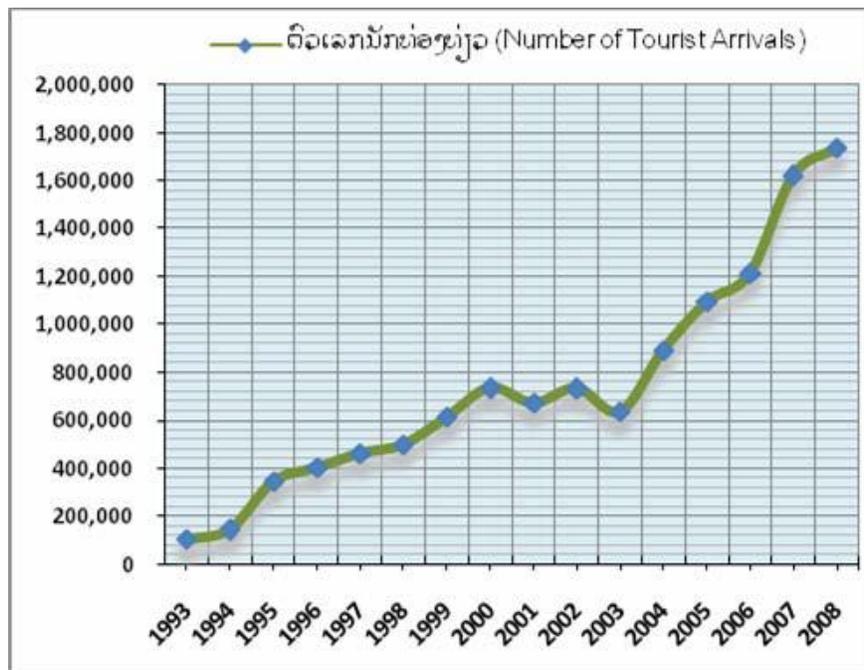


Figure 28: Number of Tourist Arrivals

In 2008, the factor income account recorded a deficit of USD 45.9 million. The continued repatriations of foreign investments were amounted to USD 78 million, which accounted for 1.5% of the total GDP, whereas income receipts from abroad were only USD 31.1 million.

Current transfers for the year of 2008 were valued at USD 140.9 million, an increase of 44.7% from previous year, of which USD 77.1 million was official grants, which accounted for about 1.5% of the total GDP. The top sources of official development assistance (ODA) to Laos in 2005 were Japan (\$65 million), France (\$21 million), Sweden (\$19 million), Germany (\$15 million), and Australia (\$12 million). China has been a major aid donor as well. Since the late 1990s, China has provided aids in the forms of grants (\$300 million), loans (\$350 million), pledges of trade and investments (\$876 million), technical assistance, and high profile public works projects<sup>35</sup>. The rest of the current transfers, amounting to 63.8 million USD, were from private sources. Worker remittance has been the major component of the private current transfers. In 2006, at least 200,000 Laotians worked in Thailand, sending back incomes of as much as US\$100 million, which accounted for approximately 5% of GDP<sup>36</sup>.

With deficits from trade in goods account and factor income account, and surpluses from services account and transfers account, the overall current account balance of Laos in 2008 was in surplus. As indicated in Figure 25 above, even when official grants are excluded, the overall current account balance was USD 106.1 million in surplus, which accounted for 2% of the total GDP.

In 2008, the Laotian capital and financial accounts were valued at USD 419.5 million, an increase of 5.9% and accounted for 7.9% of the total GDP. Foreign direct investment projects amounted to USD 650.82 million, a decrease of 42.76% from 2007. The actual FDI funds transferred and implemented were amounted to USD 227.8 million, which accounted for 4.3% of the total GDP and encountered a 29.6% decrease from the previous year as indicated in Figure 29 below.

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<sup>35</sup> <http://fpc.state.gov/documents/organization/99481.pdf>

<sup>36</sup> [http://www.vientianetimes.com/Stories/2006/11282006\\_remittance\\_of\\_lao\\_workers\\_contri.html](http://www.vientianetimes.com/Stories/2006/11282006_remittance_of_lao_workers_contri.html)

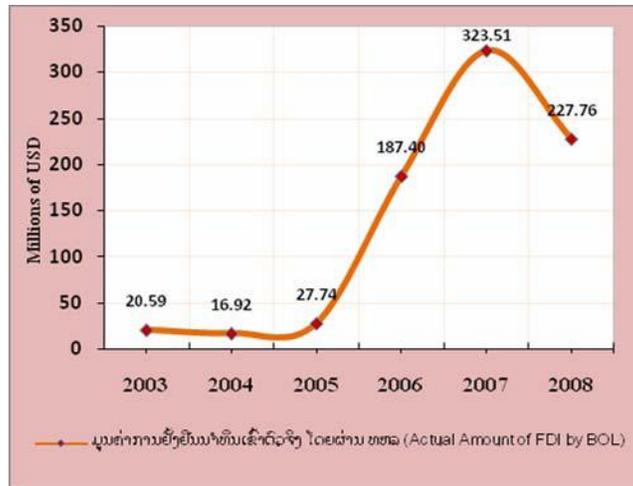


Figure 29: FDI Funds Transferred Source: Bank of the Lao PDR

As illustrated in Figure 30 below, Electricity Generation, Agriculture, Industry & Handicraft, Mining, Services, and Construction sectors received the most FDIs. According to Figure 31, the major investors of FDIs come from Thailand, South Korea, European Union, Taiwan, Japan, and Vietnam. The Laotian government aims to further promote FDI for the purpose of export in the following sectors: agro-processing, forestry, industrial processing, construction of infrastructure, and tourism.

Approved FDI by Sectors				
Years	2008	2007	2006	Total
Number of Projects	161	191	171	523
Total	650.8	1136.9	2700	4487.42
<b>Sectors</b>				
(Millions of USD)				
Electricity Generation	40	360.54	1777	2177.24
Agriculture	101.6	183.84	458.5	743.92
Mining	100.1	115.27	73.81	289.15
Industry & Handicraft	171.5	134.19	123	428.63
Trading	10.09	13.93	86.05	110.07

Construction	70.5	0	130.6	201.1
Services	36.81	181.19	12.1	230.1
Hotels & Restaurants	30.13	58.15	32.22	120.5
Telecoms	32.45	0	0	32.45
Wood Industry	20.99	56.96	1.01	78.96
Banking	28.2	25	0	53.2
Garment	5.11	5.52	3.89	14.52
Consultancies	3.46	2.32	1.8	7.58

Figure 30: Approved FDI by Sectors

2006	2007	2008	Country
0.4	18.19	9.88	Japan
1.25	0.94	0.36	North America
159.83	21.31	17.01	Europe
158.17	14.59	9.94	European Union:
1.66	6.72	7.07	Other Europe
5.3	1.68	42.97	ASIA
3.44	35.41	47.23	ANIES
1.2	14.58	46.93	South Korea(ROK)
0.01	0.14	-	Hong Kong
2.22	20.69	0.30	Taiwan(ROC)
10.56	100.41	47.67	ASEAN
-	-	0.38	Malaysia
-	10.15	0.29	Singapore
7.75	85.99	34.29	Thailand
2.81	4.05	12.50	Vietnam
0.54	2.37	6.26	AUSTRALIASIA
0.54	2.37	6.26	Australia
0	-	-	New Zealand
6.08	142.74	56.37	JOINTVENTURE COUNTRIES
-	-	2.48	Japan & France
-	-	-	USA & China
		1.30	China+Australia
-	-	-	Japan+Thailand+Korea
		11.76	France+Thailand
		4.00	Thailand+China

Figure 31: FDI Funds Transferred Through Banking System (Million US\$)

The errors and omissions of the Laotian balance of payments are extremely high with a value of USD 502.2 million for the year of 2008, which made up almost 9.5% of the total GDP. There are several possible reasons for this result and no sufficient information is available. However, officials suspect that the illegal drug trade within Laos is largely responsible for this gap.

With a surplus of 3.5% of GDP from current account and a surplus of 7.9% of GDP from capital and financial accounts, the total capital inflows reached 11.4% of GDP, which exceeded the One Gap of 8.75%. Therefore, we conclude that the foreign capital flows are currently adequate to cover the difference between the domestic saving rate and the required domestic investment rate. Compared to the rest of the developing world experiencing huge capital shortage, Laos seems to be in a good position. However, if the trade deficit in goods deteriorates in the future and increases in surplus of the services account fail to catch up, and/or if Laos experiences a downgrade in its credit and investment ratings, a capital shortage could result in which case Laos would have trouble importing necessary goods and achieving capital inflows at a low interest rate.

### External Debts

Laos relies heavily on external investment for its development needs. By the end of 2008, the total foreign debts outstanding were valued USD 2564.3 million, an increase of 5% from 2007 and accounting for 48.5% of the total GDP. Of all the external debts, 68.2% were concessional long-term debts in the form of multilateral debts from international financial institutions. The Asian Development Bank held 35.8% of the total loans, and the World Bank offered 24.7%. The rest, 31.8% was made up of bilateral debts, mainly from Russia, China, Thailand, and Japan. Figure 32 in the following graph depicts the recent situation regarding external debts in Laos.

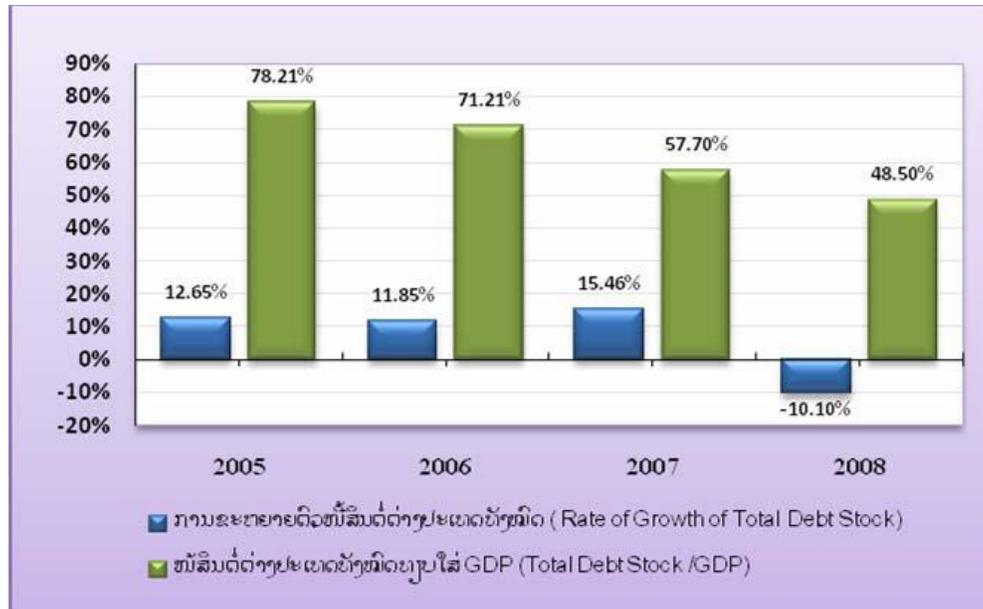


Figure 32: External Debts, Source: Bank of the Lao PDR

In the past few years, as a result of strong economic growth, appreciation of the Kip, and favorable external conditions, the debt to total GDP ratio has decreased. Comparing with other developing countries, the outstanding foreign debt level in Laos seems to be moderate. However, continuous reliance on foreign debt might pose serious development concerns for Laos in the future. As the country's current growth is maintained by external funds, its ability to repay those debts in the future becomes uncertain. The savings rate was only 23% of the total GDP, while external debt outstanding made up 48.5% in 2008. Liberals believe that capital inflows together with technology diffusion will generate growth and will help the country to enhance the abilities to repay the debts. However, this ideal scenario is not necessarily happening in Laos as the major exports of the country are low value added products, such as natural resources, garments, and wood products. The production of these products is not helped by increases in technology, which come from capital investment. Also these products are prone to price instability and declining returns. Nevertheless, if Laos can use the foreign capitals to fuel its production of electricity and truly becomes "the battery of Southeast Asia," the economic growth might be sustainable.

Currently, with debts that account for 48.5% of Laos's total GDP, Laos is not eligible for debt forgiveness. Soon the Laotian government will be under pressure to fulfill its obligations. It is possible that the government will direct a huge portion of the domestic resources away from social welfare and other services, where funds are most needed, to meet the debt obligations.

Laos could receive additional capital from international financial institutions, but these loans require structural adjustment shock therapy that can damage the country's fragile economic stance. The indebtedness of Laos has improved recently as a result of strong economic growth, appreciation of the Kip, and favorable external conditions. The country's ability to fully repay those debts and become independent eventually depends on the sustainability of the foreign capital driven economy, the potential of resisting the calls for devaluation of the Kips, and the continuity of favorable international conditions.

To determine if Laos's foreign debt is manageable and if its deficits are sustainable, we first examined Laos's One Gap, or the difference between desired investment rates and current savings rates, which is currently about 8.75% of GDP. As shown in the previous section, Laos's K value is relatively high (and therefore its use of capital can be considered inefficient) when compared with other countries.

Although Laos's sovereign debt level is much lower than some countries, it is still on the verge of becoming unsustainable. If Laos's foreign debt rises to figures that approach 60% of GDP, we believe that Laos will have to devote a significant sum of its savings and revenue to manage the debt's interest and principal repayments. This diversion of funds may mean sacrificing investment levels if external capital cannot be obtained. If a high rate of growth is deemed more important than an adequate standard of living, the government might increase taxes or detract from its social services to finance the growth and to service the debts. In any case, if anything goes wrong, (for example, if Laos experiences a natural disaster or its growth rates decline sharply) then it might demand even more external financing. If this situation takes place, it is highly unlikely that Laos will ever be able to recover from this cycle of debt. For these reasons, we find Laos's current debt level of 50% of GDP manageable under ideal conditions. However in the real world where simple arithmetic does little to guarantee the well being of Laos's future, we conclude that Laos's current level of foreign debt is not sustainable because at Laos's current rate of growth, it will take at least five decades to repay the loans even if there are no major disturbances. If Laos takes on more loans to finance its investments, then it is basically betting the well being of its people on the hope that its service and tourism sectors will remain strong. Due to surpluses from balance of payments, Laos' One Gap can be covered by foreign capital. However this does not mean that Laos's macroeconomic health is immune to

perturbations. It is likely that a small disturbance like price volatility in the commodities market could force Laos to expand external financing. In the end there are human faces behind these macroeconomic considerations. In the case of an emergency, Laos might not have little choice but to seek even more external financing to sustain its current growth levels.

### *Summary of the One and Two Gaps*

- Based on the Harrod-Domar model, Laos has an average  $K$  of 6.35 between 2000 and 2007, indicating inefficient use of capital. To reach a growth of 5% in GDP per capita, the one gap for the country in 2007 was 8.75%. Inefficient use of capital is the major reason that causes the One Gap in Laos, rather than insufficient savings rate. We recommend decreasing  $K$ , rather than increasing, to close the One Gap.
- The central bank maintains a managed floating exchange regime for the Lao kip. The foreign exchange rate for the kip has been stable over past a few years with slight appreciation. However, recently, the government has experienced calls for devaluation of the currency, and has denied the notion.
- The inflation rate in Laos has decreased since 2000 and experienced a rebound in 2008. Nevertheless, it still remains well below those of its neighboring countries.
- The balance of payments of Laos has been in surpluses since 2006. In 2008, Laos experienced deficits from trade in goods and in factor income account, and surpluses from services account and transfers account. The Laotian capital and financial accounts were also in surplus for the year. The One Gap can be covered by the inflow of foreign capitals.
- Laos relies heavily on external investment for its development. By the end of 2008, the total foreign debts outstanding accounted for 48.5% of the total GDP. Although the indebtedness has improved due to strong economic growth, appreciation of the Kip, and favorable external conditions, continuous reliance on external debts might pose development concerns in the future. The inflow of foreign capital hasn't helped the country to enhance its competitive advantages or its ability to repay the loans, as liberals would hope. The Laotians have traded in autonomy for the capital inflows and will be under pressure to fulfill these obligations in the future. In an ideal situation, the current level of foreign debt seems to be manageable. However, given the volatility and uncertainty of the future, the external debts are unlikely to be sustainable.

### The Three Gap

This section aims to quantitatively and qualitatively describe Laos's Three Gap, or the difference between Laos's current revenues and the required levels of government expenditure. Additionally, we will also determine if Laos's sovereign debt is manageable and sustainable. By highlighting the sectors of the Laotian economy and polity that currently benefit or could benefit from public funding, we will be able to determine the required levels of government expenditure that is necessary for sustained economic and social development.

### Current Government Budget

For the fiscal year of 2007 to 2008, the Laotian budgetary revenues (including foreign grants) were 7,708.3 billion Kip (\$875 million USD). This was an increase of 19.79% from the previous fiscal year. In total, these revenues accounted for 17.8% of Laos's total GDP. From 2007 to 2008, the government of Laos's total expenditure amounted to 9,065.7 billion Kip (\$1.03 billion USD) or 20.9% of the total GDP. As seen in the figure below, Laos has continuously experienced a budget deficit since the fiscal year of 2002 to 2003. By the end of 2007 to 2008, the budgetary deficit accounted for 3.1% of the total GDP. When grants are excluded, the fiscal deficit rose to 6.1% of the total GDP – an increase of 14.67% from the previous year.

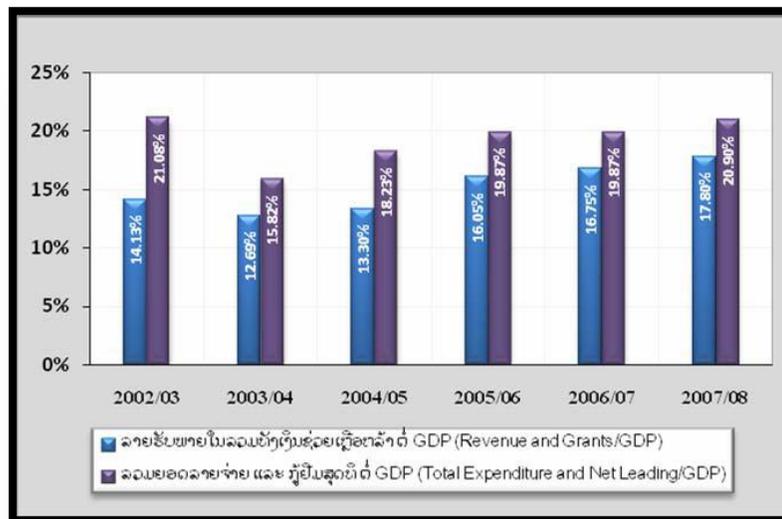


Figure 33

The GoL's two major sources of income come from taxes and grants. Collected taxes, which made up of 87.39% of the total revenue, amounted to 5,627.1 billion Kip (\$639 million USD). This was an increase of 19.2% (from the previous year) and accounted for 13% of the total GDP. Increases in Laos's profit tax, turnover tax, exercise tax, and import duties contributed to the overall increase in tax revenues. Non-tax revenues, which were composed of over-flight fees, dividends, and depreciation, rose by 30.91%, but only accounted for 1.9% of the total GDP. Figure 34 below depicts the sources of government revenue.

2004/05	2005/06	2006/07	2007/08	Items
2,803.11	3,641.12	4,720.66	5,627.09	A. Tax Revenues
307.20	458.87	918.63	1,321.60	Profits Tax
214.89	234.24	251.84	333.06	Income Tax
27.62	30.13	46.57	77.95	Land Tax
2.21	6.10	1.46	2.52	Business Licenses
12.79	22.17	19.27	21.50	Minimum Tax
673.47	887.13	1,045.99	1,228.52	Turnover Tax
522.83	800.33	998.70	1,190.01	Excise Tax
428.64	514.55	572.61	674.18	Import Duties
43.45	53.13	25.86	22.26	Export Duties
17.58	24.69	49.00	13.93	Registration Fees
94.80	217.55	273.81	316.52	Natural Resources Taxes
189.37	172.46	212.28	106.19	Timber Royalty Receipts
57.11	57.16	43.04	56.40	Hydropower Royalties
211.17	162.60	261.62	263.41	Other Fees
584.34	624.87	620.31	812.04	B. Non-Tax Revenues
44.23	36.11	29.92	27.22	Leasing Fees
8.08	7.36	8.66	17.92	Concessions
15.27	23.82	33.06	31.40	Penalties(Fine)
69.22	89.18	94.87	100.87	Administration Fees
177.82	174.78	156.67	293.34	Depreciation and Dividends
47.95	65.05	65.90	105.28	Interest
221.76	228.57	231.23	235.43	Over-Flight Revenues
-	-	-	0.545	Others
3,387.45	4,265.98	5,340.97	6,439.13	Total Tax and Non-Tax Revenues
12.07	15.41	6.91	34.26	Assets Sales
129.70	129.56	112.08	144.06	Amortization (Capital Return)
0.19	0.32	0.16	0.011	Pump Amortization
3,529.41	4,411.28	5,460.12	6,617.47	Total Revenue with Capital Return

Figure 34

As illustrated in the graph below, the Laotian budgetary revenues, especially tax revenues, have steadily increased since the fiscal year of 2002 to 2003. Even after accounting for inflation, the GoL’s revenues averaged a 15.9% real annual growth rate from 2004 to 2008. This phenomenal rate of growth is mainly due to the rise in revenues from foreign direct investments in mining, hydropower, and tourism.

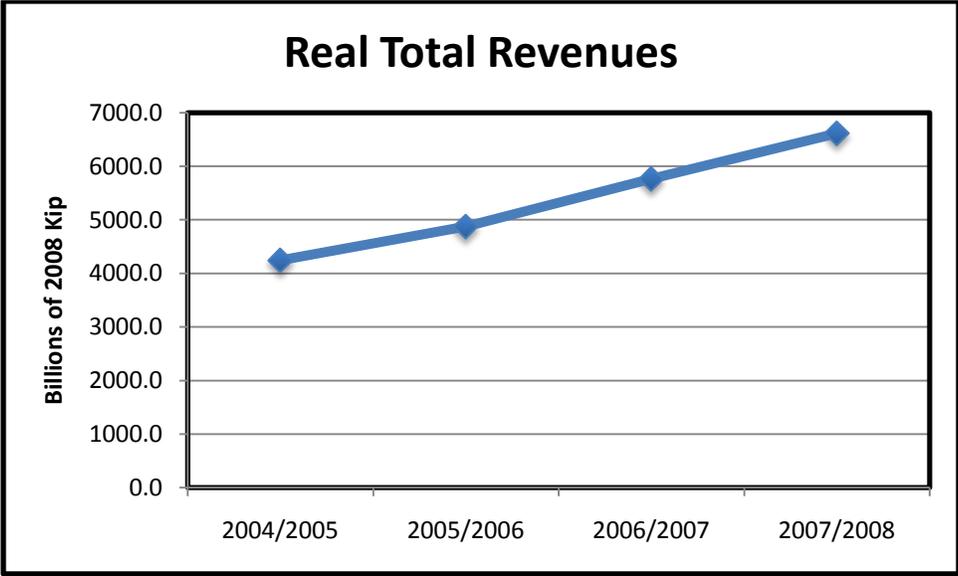


Figure 35

In the fiscal year of 2007 to 2008, total government expenditures increased by 18.79% and accounted for 20.9% of the total GDP. Current government expenditures increased to 59.83% of the total domestic expenditures with a 27.83% increase from the previous period. The three major accounts within Laos’s current expenditures include: wages and salaries, materials and supplies, and economic and social transfers. All three categories increased significantly from the previous fiscal year. The largest increase was in wages and salaries. This significant increase occurred because of the GoL recently introduced a new wage bill that aimed to increase wages for government workers.

Other current expenditures, which includes debt payments, interest payments and capital expenditure amounted to 1,143.22 billion Kip (\$130 million USD). Laos’s debt repayments accounted for 5.5% of the total expenditures, and its interest payments accounted for 4 % of its total expenditures. In general, about 2% of the total GDP is expensed for interest and debt payments, which is considerably low given Laos’s significant outstanding external debt. Total

capital expenditures accounted for 40.17% of total expenditures with an increase of 7.48% from the previous fiscal year. As demonstrated in the following graph, since the fiscal year of 2003 to 2004, current expenditures increased faster than capital expenditures, and total expenditures increased at an even more drastic rate.

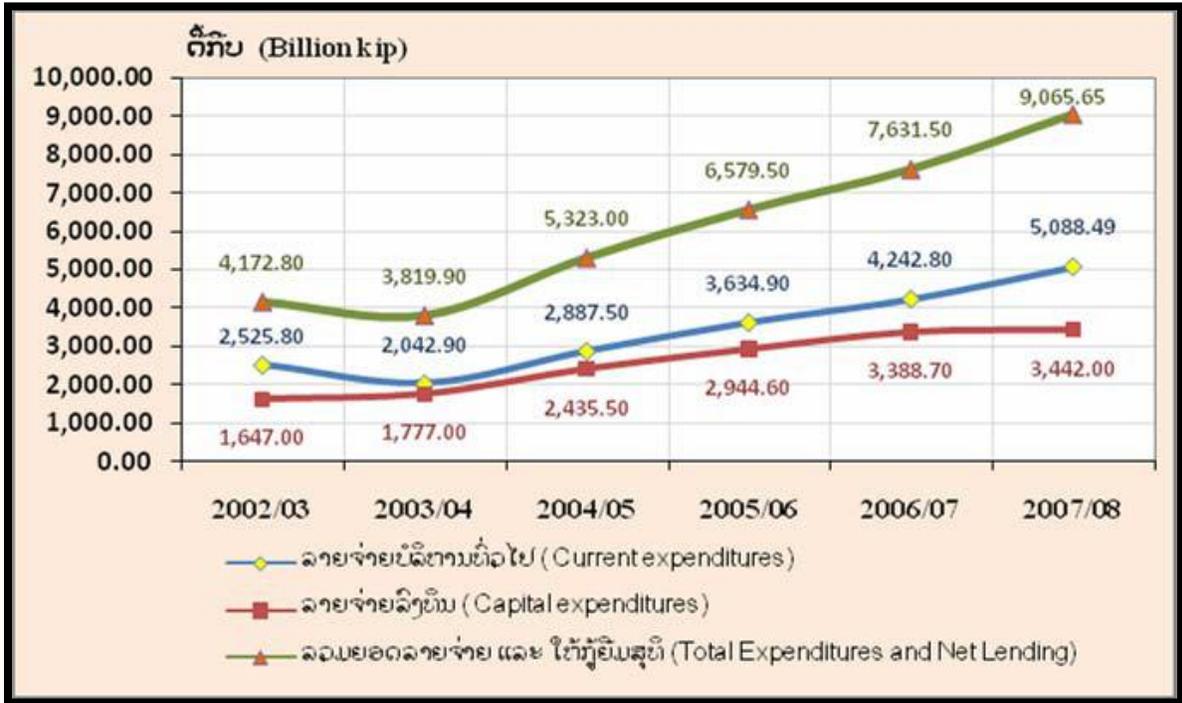


Figure 36

For the fiscal year of 2007 to 2008, Laos had a government budget deficit of 6.1% of its total GDP. Over 1,270 billion Kip (\$144 million USD), or 48.39% of the deficit was financed using grants. The rest of the deficit, which amounted to 1,357.34 billion Kip (\$154 million USD) accounted for 3.15% of the total GDP and represents Laos’s comparatively small Three Gap. To fill this gap, Laos used mostly foreign capital, which was received through project loans and debt forgiveness of these loans and grants.

Figure 37 below shows that Laos has increased its reliance upon foreign grants in order to cover its deficit over the past several fiscal years. While the amount for foreign financing has slightly decreased recently, it is still a significant percentage of the GDP. This confirms our

findings from our Two Gap analysis that finds that Laos' current development depends heavily on external sources for funding.

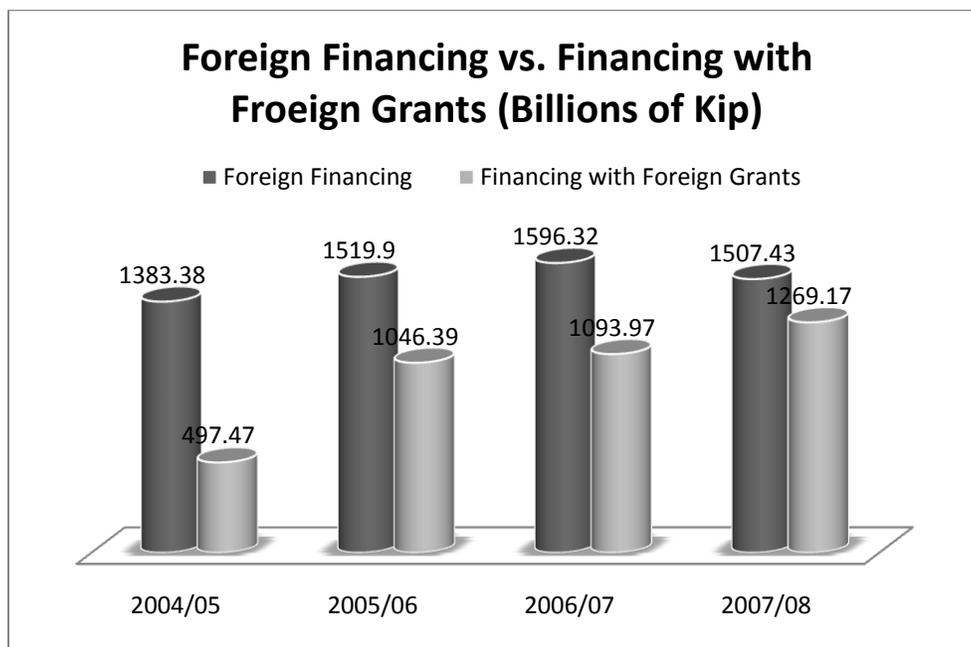


Figure 37

To summarize the 2007 to 2008 fiscal year budget:

Total Budget Revenue	7,708.3 billion Kip (\$875 million USD or 17.8% of the total GDP)
Total Budget Expenditures	9,065.7 billion Kip (\$1.03 billion USD or 20.9% of the total GDP)
Budget Deficit	1,357.34 billion Kip (\$154 million USD or 6.1% of the total GDP)

### Government Expenditure Analysis

Although the government has made much progress in regard to social, economic, and institutional indicators, numerous impediments to development are still present and require urgent government attention.

- Disparities in regard to economic growth and social development remain large depending on the geographic region and ethnic background of the population studied
- Protection of natural resources

- Unemployment and underemployment
- Rampant poverty, especially among the rural population
- Malnourished children
- Adequate maternal care

After considering these numerous obstacles to development, it becomes clear that the Government of Laos must take drastic measures to increase its current expenditures on: agriculture, forestry and natural resources, health, education, transportation networks, infrastructure, private sector development, and institutional development. Yet during the 2007 to 2008 fiscal year, the government decreased its public expenditures and claims that these cuts have not affected its ability to fund hospitals, schools, transportation networks, and the construction of new infrastructure. Figure 38 depicts the current expenditures of the GoL.

Composition	Amounts in Billions of Kip	% of Total Expenditure
Total Expenditure	7,562	100
Salaries, Allowances, and Operations	3,157	42
Debt Payment	692	9
Public Investment	3,708	49
ODA	3,191	42
Domestic Investment	517	7

Figure 38

### *Agriculture and Natural Resources Expenditures*

Laos’s agricultural sector remains a matter of concern because it is the main source of income for 80% of the labor force yet it still cannot provide enough food for the entirety of the population. Numerous shortages and constraints remain and can be effectively target through increased public expenditure. Large harvests from the cultivation of irrigated rice were not fully achieved due to irrigation systems that needed repair. Additionally these same farms lacked much needed fertilizer and credit to remain operating.

Agriculture spending as a share of total public expenditure declined from 2.3% to 2.1% of GDP over the past ten years, which may alarm readers after considering the fact that the majority of Laos's working population is employed in agriculture. However, provincial expenditures are not calculated as part of this budget. Some provinces spend up to 4,324 kip (50 cents) per capita on their agriculture sector to supplement government expenditures.

Most government spending provides funds for investments in irrigation equipment that foster increased rice harvests and decrease dependencies on other neighboring countries for sticky rice. However the problems with irrigation equipment are that it does not yield high economic returns especially when used on rice farms and that the rainy season destroys the irrigation infrastructure. The rain floods the areas where these systems sit and damages the irrigation systems, and these systems will have to be rehabilitated every three to four years if they lack proper flood protection. Both rehabilitation and flood protection are costly to the government and farmers. More important is the GoL's focus of funds on rice production. By producing alternative cash crops such as coffee, maize, or soybeans, the GoL could produce higher economic returns in the long run despite potentially high start-up costs. The government's priorities lie not in economic gains, but keeping the country's rural poor supplied with food. With a slightly different focus, the government could see beyond the immediate future and realize that larger and more efficient economic gains could be made by importing food for consumption and exporting other crops and then relocating farm workers in other more efficient sectors. Despite being inefficient, the GoL's investment in irrigation equipment, combined with increased spending on roads, has helped increase labor productivity in agriculture by about 33% over the past 20 years. Yet, the government's current expenditures could still be better utilized if these funds were diverted to more efficient sectors as described above.

### **Education Expenditures**

For the fiscal year of 2007 to 2008, the education sector received increased resources from the national budget and official development assistance (ODA). Public spending on Education reached approximately 12% of total public expenditure and approximately 19% of total ODA. As a percentage of GDP, spending on education represents less than 3% of Laos's GDP. Although it is steadily improving, public spending in this sector remains low when compared to countries in the region.

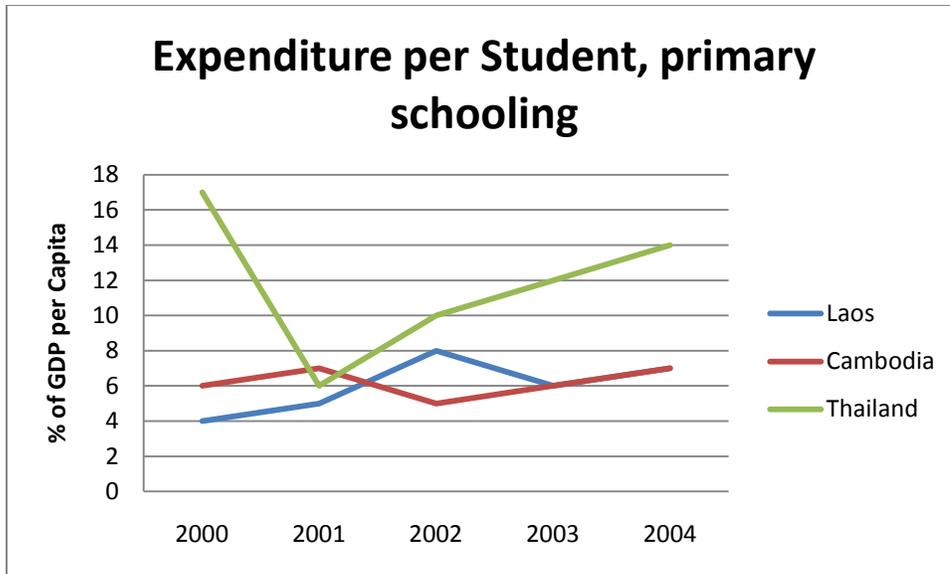


Figure 39

Currently, funds are being spent on building schools without taking into consideration the operating costs of maintaining a functioning school. Thus, the government needs to stop focusing on creating new structures so that it can maintain and then equip existing schools with competent teachers and textbooks. More importantly, the government's current level of spending on schools does not correlate with demand of the populous. In an endeavor to promote basic education, the GoL should allocate spending based on the specific need of the province so that poorer provinces get the majority of government funds. Overall, the government cannot cut back on educational expenditures because education is essential for advancing the development of the country. The government should spend more money on education in poorer provinces because these areas are in desperate need of qualified teachers and books. Most importantly, the GoL needs to pay primary teachers in the poorest regions of Laos more so that teachers (or educated professionals) in search of higher wages could help fill the desperate need for qualified instructors.

### Healthcare Expenditures

Public expenditure in healthcare represents 1.5% of the GDP and 7% of the total public expenditure in the 2007 to 2008 fiscal year. Notwithstanding these achievements, health care services are still far from satisfying the needs of the populous in quantitative and qualitative

terms. Health problems are still severe in remote and poor areas and much of the rural population still does not have access to the cities' abundant hospitals. The government currently spends about 7% of its budget on healthcare and 40% of the funds for healthcare come from donor assistance. Public and private health expenditures combined for only 1.5% of GDP and only 10% of that spending came from the government. The remaining came from households (60%) and donors (30%).

The rich benefit more from public health spending than the poor do because the best health facilities are mainly located in urban areas where the rich live. Generally speaking, the rural- poor rely on low-quality healthcare from the non-governmental sector. One reason for the low-quality health care is the simple fact that healthcare workers are paid low wages. Currently, the GoL is targeting poor in rural areas to receive donor assistance, but this effort does not help the poor in other areas who still will struggle to pay the costs of healthcare in urban areas. The GoL is also forming healthcare groups which pool people together so that they can receive lower premiums on health insurance. But the poor of Laos cannot afford to be in these pools despite the fact that the government subsidizes the pools.

The largest issue with government spending on healthcare is the efficiency of spending. Low wages in the sector hamper the country's availability to attract quality doctors who are needed to provide superb assistance. And again, health expenditures tend to be targeted towards the rich. Hospitals lack efficiency; health workers, on average, saw less than one patient per day because most of Laos's poorest families cannot afford to travel the great distances to the nearest hospital or afford to pay for their high cost.

### *Transportation Networks*

The GoL has greatly increased its expenditures towards the creation of new roads over the past ten years and has increased road networks from 23,000km to 32,600km. Despite this great increase in spending and the total number of new roads created, the rural poor still lacks adequate access to passable roads. In the north, only about 45% of households have access to roads (the average distance to the nearest road is roughly 8km). The public sector is solely responsible for financing road construction projects and maintenance since there is not enough road use to warrant private funding. Yet public expenditure in 2005 stood only at \$12 USD per

capita. Although this figure is greater than the amount spent on education (\$7), agriculture (\$9), and healthcare (\$5.50), it is still not enough. By attracting increased FDI, the GoL could supplement its finite budget by utilizing these capital rich firms to build and maintain the roads to their plants or firms. Also, by increasing the gasoline tax to above 150 kip per liter (1.7 cents per liter) additional funds could be raised to provide for increased road maintenance. Currently, 38% of road maintenance is paid for by the gas tax and 46% from donor contributions. Since donor contributions are expected to fall in the coming years, it is important for Laos to increase its gas tax to fund the roads.

In addition to the additional gas tax, the government must begin devoting more funding to the maintenance of roads instead of construction. There are already numerous roads and building more will not provide increased access for most of the population. The government currently spends 29% of road budget on maintenance, 46% on construction, and 25% on rehabilitation. Given the socioeconomic benefits from roads such as a 40-50% reduction in travel time, access to markets, and access to healthcare, Laos must continue to focus on funding roads. However, instead of increasing the number of roads, it must ensure that its roads are maintained despite mudslides and monsoons.

### **Other Expenditures**

One of the GoL's top priorities has been the increased promotion of jobs to decrease unemployment and underemployment levels. From 2006 to 2010, the government's efforts have generated over 100,000 new jobs. Most of these jobs were centered in the agriculture, forestry, and the fishery sector. Although this is an improvement, unemployment and underemployment still remain high and additional efforts are still needed to create diverse economic activities, stimulate investments in small businesses, and promote vocational training centers in order to create a situation that is more conducive to job creation.

Wages for civil service workers have not recovered from the Asian Financial Crisis of 1997. Their wages are still below 1990's rates. The GoL is working on a wage bill, which would increase wages of public sector workers that would likely cause a decrease in corruption. However, these wage increases could put pressure on the government to cut spending on certain programs. Specifically this wage bill should be focused on increasing the salaries of teachers and

healthcare workers. As shown in previous sections, the wages of these workers must be increased to encourage employment in these fields. Currently, an average Laotian teacher only makes about \$36 per month.

**Future direction with regard to the Macroeconomic Policy**

Sector	% Increase	% of GDP
Industry	15.2	33
Services	7	26
Agriculture	2.4	40.7

*Figure 40: Distributional GDP by sector*

Over the next year the GoL will introduce reforms to promote macroeconomic stability, foster investment and growth, and enhance efforts leading to poverty reduction. In this regard, the GoL currently plans to achieve:

- 8% of GDP annual growth (with Agriculture growing at 3%, Industry at 15.8%, and Services at 7%)
- Total Budget Revenue 7,069 billion Kip (13.9% of GDP) (\$803 million USD)
- Total Budget Expenditure 8,884 billion Kip (20.5% of GDP) (\$1 billion USD)
- Budget Deficit 4.2% of GDP to be financed by ODA
- Maintain Inflation Rate at less than 6%
- Increase Exports and Reduce Trade Balance Deficit to 5% of GDP
- Reduce Poverty Levels by another 3%
- Investment levels to reach 32% of GDP, Public Investment around 8% of GDP and Private Investment around 24% of GDP
- Increase Public Investment levels using domestic reserves, 688 billion Kip (approximately 69 million US\$) will be allocated
- Increase Public Investment Levels using ODA, 2,754 billion Kip (\$312 million USD) will be allocated

***Conclusion of the Three Gap***

- The budgetary deficit accounted for 6.1% of the total GDP.
- Two major sources of government income are taxes (87% of income) and grants.
- GoL's revenues have averaged a 15.9% real annual growth rate from 2004 to 2008.
- Government expenditure accounted for about 21% of GDP in 2008.
- The current expenditure account experienced an increase due to the passing of the wage bill that aims to raise salaries of government workers.
- Debt and interest payments accounted for 9.5% of total expenditures and 2% of GDP.
- Total capital expenditure accounted for 40.17% of total expenditure.
- The government financed the budget deficit through grants, mainly in the forms of ODA, and foreign capital, mainly project loans.
- In agriculture, Laos experienced a decline in public spending. Most new government investment in agriculture is in irrigation equipment for rice cultivation, which is not an efficient use of capital.
- Education accounted for 12% of total public expenditure. The government used its revenues to build new schools without allocating sufficient budget for operating costs of current schools.
- Healthcare accounted for 7% of total public expenditure. Major improvements have taken place in healthcare. However, rural poor still have limited or no access to quality health care due to lack of basic infrastructure and poor allocation of government budget.
- Spending in transportation averaged 25% of total public expenditure. Road networks experienced a 42% increase in the past ten years. However, a majority of the Laotian population still has limited access to roads. The government is the sole funder of roads.

About 38% of road maintenance is paid for by the gas tax, which is 1.7 US cents per liter.

- The government passed a wage bill which aimed to create incentives for employment in civil service. In order to tackle unemployment, the government has created 100,000 new jobs in the public service sector.

### Social Measures of Development

Social development is a very important component to our definition of development. We believe Laotians will not be able to achieve ultimate freedom without social development in the areas of poverty eradication, education, and healthcare. The following section will focus on the current condition of social factors in Laos and compare these conditions to those of our benchmark countries. As the reader will see, Laos tends to have greater social detriments to development than its peers. Additional government spending in these areas would help Laos to improve its current status and begin to catch up to our other benchmark countries.

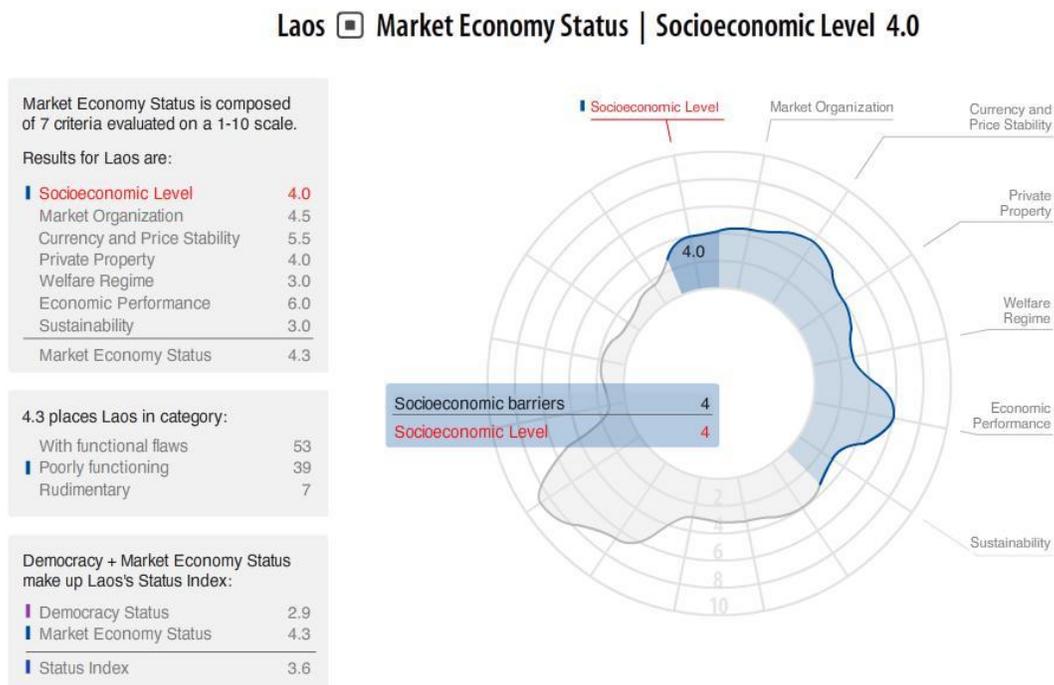


Figure 41: Bertelsmann-Transformation Index

This section of the BTI describes the socioeconomic barriers to development in Laos. This graph measures to what degree Laotians are excluded from society or economic opportunity because of poverty and inequality. According to the Bertelsmann Transformation Index, Laos's low scores are not because of the authoritarian government, but are instead a product of the culture and poverty of Laos. The government advocates equality for women and minority groups, but in reality, there are not enough resources to go around, and when there are shortages, the first people excluded are women and other marginalized members of society. For example, a Laotian family may wish to send both children to school, but when times get tougher, they will often send the boy to school and keep the girl home to save money and work the farm.

The Human Poverty Index measures poverty by three elements: the unweighted average of the percentage of the population without access to safe water, the percentage of underweight children for their age, and the percentage of the population below the income poverty line (50% of median household disposable income).<sup>37</sup> Measuring the HPI will help us determine overall poverty in Laos without relying simply on GDP per capita, which can be misleading due to wide income ranges.

Country <sup>38</sup>	HPI in 2007
Cambodia	27.7%
Vietnam	12.4%
Thailand	8.5%
Laos	30.7%

*Figure 42*

Laos has a similar HPI value when compared with Cambodia, but a much higher percentage than Vietnam and Thailand, indicating that Laos has a much greater percentage of citizens living in poverty.

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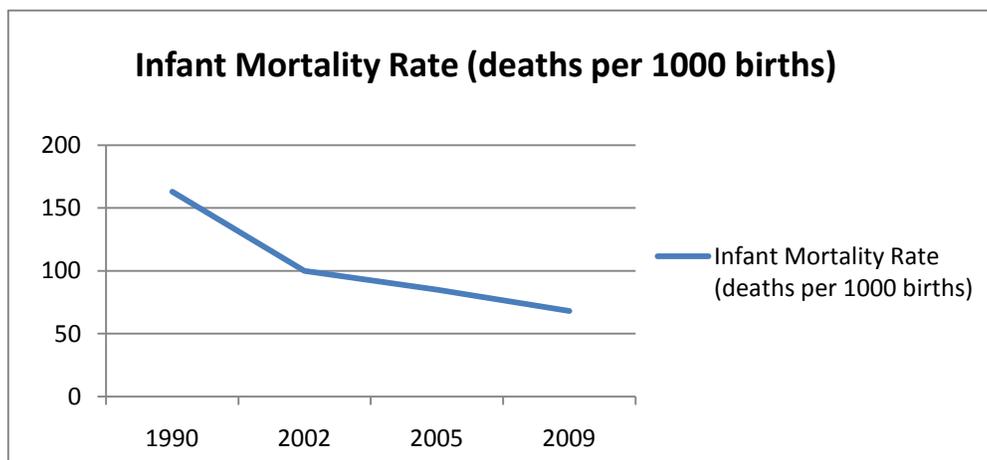
<sup>37</sup> HDI

<sup>38</sup> Data for US not available

Next, we will discuss healthcare in Laos. The purpose of using healthcare as a measure of development is that good healthcare will remove unfreedom of the deprivation of the right to live. Infant Mortality Rates are one measure of the quality of healthcare in Laos. As the reader can see in the figure below, Laos has the highest infant mortality rate among our benchmark countries. This high infant mortality rate is caused in part by minimal Laotian spending on healthcare, as we will examine soon.

Country	Deaths per 1000 Births
Cambodia	55
Laos	77
Thailand	18
Vietnam	23
United States	6

*Figure 43*



*Figures 44*

Although Laos has been experiencing falling infant mortality rates for the past twenty years, its current rate is still very high when compared with all other countries studied. Especially notable is the case of Cambodia. Cambodia and Laos both have similar development indicators in other respects, which suggests that Laos may have a worst post-natal care. Good

care during this stage of life is especially crucial to a baby since it depends on nutrients fed during this period to properly develop in later times. Also, young infants are more susceptible to infections and diseases than old persons and therefore must be given more care. According to Anand and Ravallion, a country must have adequate healthcare before it can begin to develop. Since Laos cannot provide basic health necessities to its citizens, it will be difficult to pursue other forms of development.

Despite poor healthcare, the average life expectancy in Laos has been rising for over twenty years, but it seems to be leveling off at nearly sixty-five years of age, which is well under the average seventy-eight year lifespan of a person in the United States.<sup>39</sup> As was the case with infant mortality, being deprived of the right to have a long, healthy life is a major source of unfreedom which currently plagues Laos. Since the average Laotian dies thirteen years younger than the average American, he will experience fewer healthy, productive years at work, decreasing the productivity of the nation.

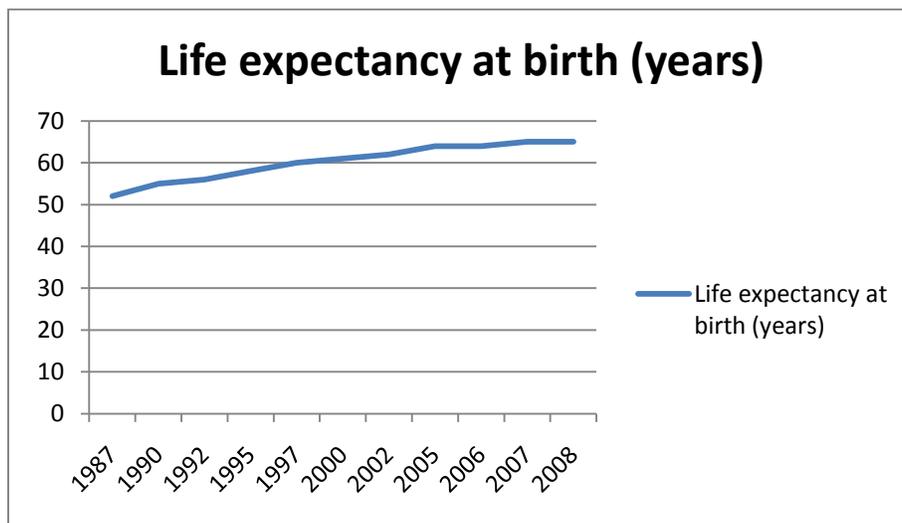


Figure 45

To measure childhood health and nutrition levels, we chose to examine the percentage of children less than five years of age that were underweight<sup>40</sup> for their age. In the year 2000, roughly 36% of children were underweight.<sup>41</sup> This indicator provides us with a general idea of

<sup>39</sup> WDI

<sup>40</sup> As measured by WHO standards

<sup>41</sup> WHO

how many calories the average Laotian child consumes. It is relevant to development studies because underweight children are often malnourished. Those children tend to underperform in school because their brain is often underdeveloped. This underperformance carries over into adolescence when that malnourished child becomes an unproductive laborer and unable to pursue career advancement.

Country	% of Children under 5 and underweight
Cambodia	28.4%
Laos	36.4%
Thailand	9%
Vietnam	20.2%
United States	1.1%

*Figure 46*

Laos, Vietnam, and Cambodia all struggle with low nutrition levels. The main food consumed in Southeast Asia is rice, which does not have a high nutritional value. Because Thailand has a much higher GDP per capita, it is able to afford higher quality foods with better nutritional properties. Because of these simple advantages, Thailand has achieved a percentage of children underweight that is over four times lower than that of Laos. Supplementing the rice with vitamins and minerals or more substantial foods could greatly help Laos in its quest toward social development.

In addition to infant mortality, life expectancy, and nutrition levels, a comparison of health expenditure will be useful in determining how Laos is currently performing with respect to healthcare.

Country	Health Expenditure per capita <sup>42</sup>	Expenditure as % of GDP
Cambodia	\$30	6%

<sup>42</sup> Measured in PPP 2006 US dollars. Data from 2006. WDI

Laos	\$24	4%
Vietnam	\$46	7%
Thailand	\$113	4%

*Figure 47*

As Figure 47 shows, Laos’s healthcare expenditures are significantly below those in our other benchmark countries. Laos could continue to improve its healthcare system through greater spending. Through this additional spending, Laos would have the opportunity to catch-up to our benchmark countries. As we will see in the next section, additional spending could also help Laos to bridge the urban/rural divide and be able to provide quality healthcare access to rural citizens.

An analysis of the urban-rural divide will help us determine the percent of people currently living in areas with access to healthcare, education, and diverse employment opportunities.<sup>43</sup> Citizens living in rural areas often have access to only minimal levels of these features which are usually only found in cities and are necessary to obtain a higher standard of living.

Country	Urban population %
Cambodia	22%
Laos	31%
Vietnam	28%
Thailand	33%
United States	82%

*Figure 48*

All of our benchmark countries have low urban populations when compared to the United States. Rural citizens do not have access to the same quality of healthcare, education, and employment opportunities that urban citizens have, and as a result, urban centers tend to

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<sup>43</sup> CIA

development more rapidly than do rural areas. People flock to urban areas to gain the advantage of the city: efficient production of social services and places of employment. It is important to note that although the United States has 18% of its population living in rural areas, there is a vast network of highways and airports that connect the population to urban centers.

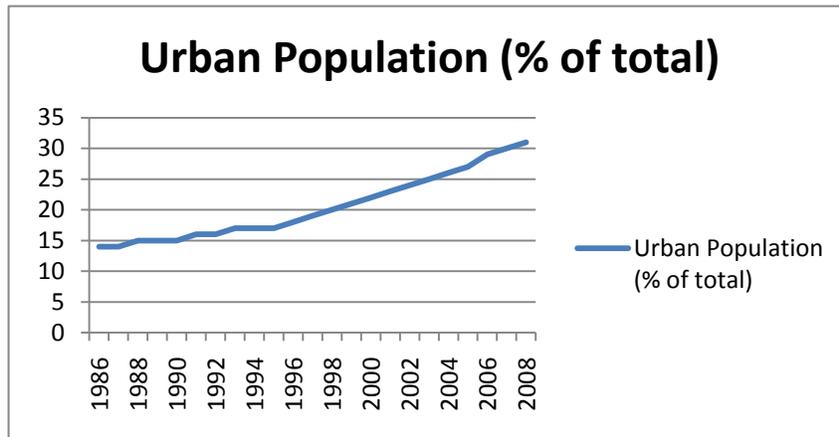


Figure 49

Laos has been experiencing rapid urbanization as people flock to cities to reap their benefits. During the 1980’s, Laos’s urban population was less than fifteen percent of the total population. Currently, this population is over thirty percent. We recognize that rapid urbanization does have drawbacks such as overpopulation in cities, but we believe that the benefits of having access to all that a city has to offer will likely outweigh the costs.

We measure the education expenditures of Laos as the public expenditure based on the primary education per pupil (measured by PPP to US dollars).<sup>44</sup> Education spending is important to our definition of development because a high level of quality education is one of the best ways in which to empower people and remove unfreedoms.

Country <sup>45</sup>	Public spending per pupil -- 2009
Laos	\$61
United States	\$9,963

Figure 50

<sup>44</sup> HDR

<sup>45</sup> Data for Cambodia, Thailand, and Vietnam not available

Laos's expenditures per pupil are astonishingly low when compared to the United States. Also, Laos only spends about three percent of its GDP on education which is less than developed countries which typically spend between four and six percent of GDP on education.<sup>46</sup> The quality of education on which Laos spends money is not high, as many materials are not distributed to rural areas.<sup>47</sup> The amount of spending on primary education is reflected in literacy rates as seen below.

Literacy rates are a measure of the quality of schooling that children receive.<sup>48</sup> The literacy rate is measured by the percent of people age 15 and over that are able to read and write.

Country	Literacy Rate – 2009
Cambodia	74%
Laos	69%
Thailand	92.6%
Vietnam	90.3%
United States	99%

*Figure 51*

People who cannot read or write tend to not be valuable workers. Their skills will not warrant high wages, and they could easily be replaced if they make a mistake or demand a higher wage. They will also have limited personal development and therefore limited capabilities to further pursue freedom.<sup>49</sup>

Country	GINI Coefficient (measured from 1992-2007)
Cambodia	40.7

<sup>46</sup> CIA World Factbook

<sup>47</sup> World Bank development report for Laos

<sup>48</sup> CIA World Factbook

<sup>49</sup> The GINI index is a measure of inequality in a society on a 0-100 scale with 0 being perfect equality and 100 being perfectly inequality.

Laos	32.6
Thailand	42
Vietnam	34.4
United States	40.8

*Figure 52*

Laos’s population receives relatively equal incomes compared to the other countries studied according to the GINI Coefficient listed above. We are not concerned with the level of inequality in Laos because some inequality in society is necessary to create incentives for innovation and hard work. Currently, the situation in Laos can be described as “equality in poverty.” We hope that throughout its development, Laos will build up a strong middle class, which is necessary for further development in its economy, society, and government.

In conclusion, Laos’s social development is similar to that of Cambodia, but falls far behind Thailand and Vietnam. Vast improvements could be made in Laos’s quality of life, target efforts against extreme poverty, education, and healthcare, which would greatly assist in the overall development of the country. These developments will help to bring Laos’s development indicators closer to those of Vietnam and Thailand and, ideally, the United States.

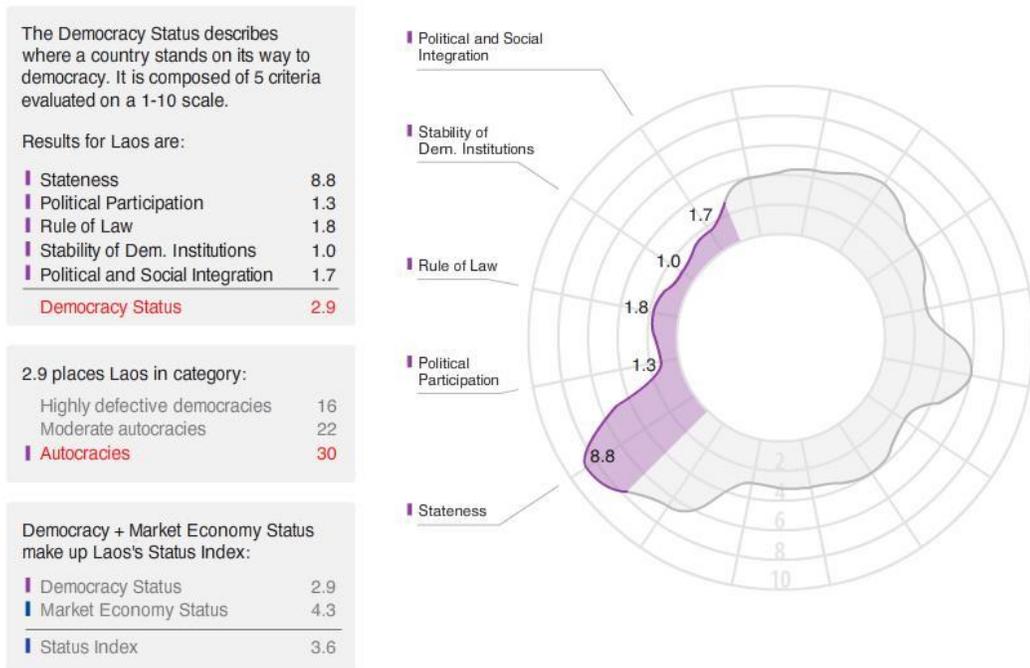
### Political Measures of Development

If Laos is politically developed, Laotians should be able to choose what they want to do with their lives and then be able to pursue it without over-interference from the state. Today Laos remains a single party authoritarian state and all political power in Laos is controlled by the Lao People’s Revolutionary Party (LPRP). Since the Laotian government is one of the most authoritarian regimes in the world, we see it as one of the major sources of unfreedoms that blocks Laos’s path to development. The following discussion will measure Laos’s level of

political development by highlighting its significant achievements and shortcomings in the political realm.<sup>50</sup>

The first metric of Laos’s political development is its rule of law. This is a broad measure of Laos’s level of political development because without an effective rule of law, the Laotian government is free to govern without regard for the law. Currently, Laos’s judicial system is developing rather slowly and is not transparent. Corruption by judges and other government officials is rampant at every level of governance. Recently Laos was ranked 151 out of 180 countries surveyed in Transparency International’s 2008 Corruption Perceptions Index.<sup>51</sup> Although there is technically a separation of powers between Laos’s National Assembly (the legislative branch), the government (the executive branch) and the judiciary- the judiciary remains basically an arm of the politburo. Thus it can be said that Laos lacks an effective system of checks and balances that keeps the executive branch from overstepping its bounds.

### Laos Democracy Status 2.9



<sup>50</sup> Transparency International

<sup>51</sup> Freedom House Political Freedom Index

Figure 53: Bertelsmann-Transformation Index<sup>52</sup>

Our second indicator of Laos’s level of political development measures political participation. Freedom of speech, although guaranteed in the constitution is basically non-existent, and freedom of religion is only limited to Buddhists. Voting in Laos is mandatory, and “voters” must choose from a list of candidates that were previously approved by the LPRP. In the 2006 National Assembly elections, only 2 candidates were elected that were not from the LPRP. Laotians are free to openly criticize the government as long as it does not evolve into a mass movement. The state controls the country’s three newspapers and one radio station through the Ministry of Information and Culture.

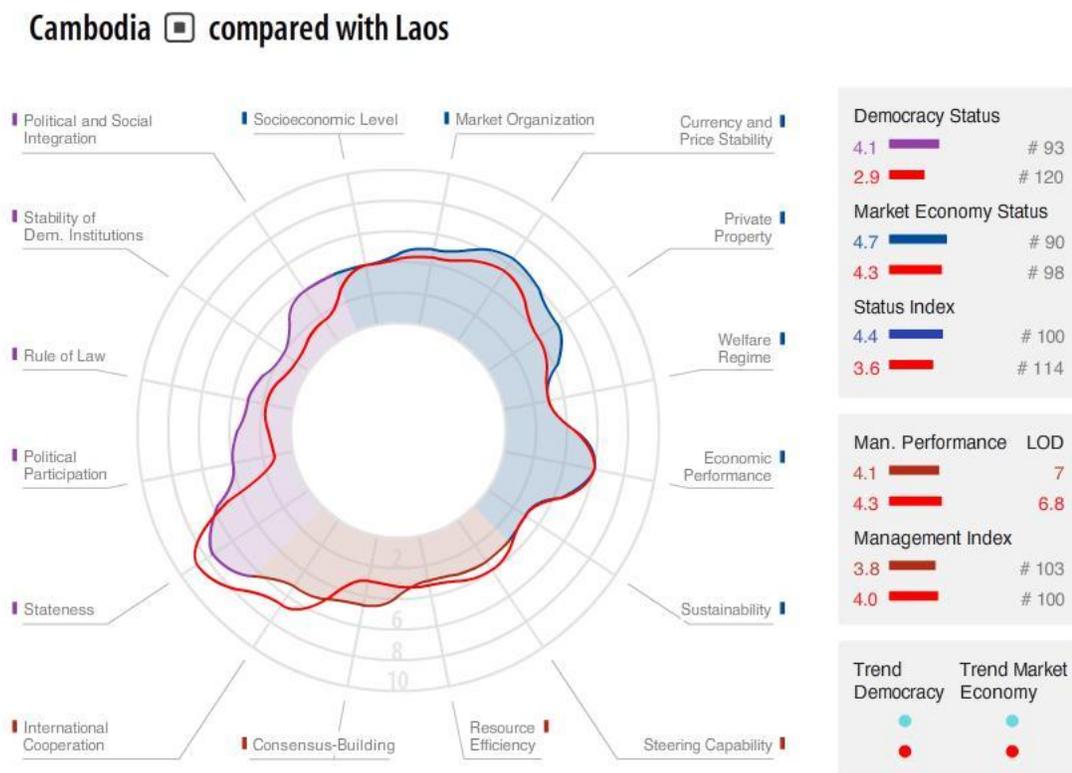


Figure 54: Bertelsmann-Transformation Index

<sup>52</sup> This close up of the Laos current “Democracy Status” is especially telling. Picture above, we see how little democratic freedom the average Laotian has, while at the same time we see just how powerful the government is. A Laotian citizen has practically no means to better his or her situation through the political process, while the Laotian government continues to maintain a stranglehold on all power.

The Laotian government also severely restricts one's freedom to assemble peacefully. Numerous laws prohibit participation in organizations that engage in demonstrations or public protests because these demonstrations are believed to create turmoil and social unrest. Laos currently has a small number of nongovernmental organizations, but they are prohibited from entering into politics and are heavily controlled by the state.<sup>53</sup> Laborers are allowed to organize into labor unions according to the constitution, however in practice unions are rarely formed because the laborers must first petition for permission to organize and it is usually not granted. Although strikes are also not prohibited, workers rarely stage walkouts or enter into collective bargaining agreements for fear of punishment. Political participation is representative of Laos's political development because without it one lacks the basic right to express his or her opinion. Once again, Laos's political level of development is low according to this measure.

■ compared with Vietnam

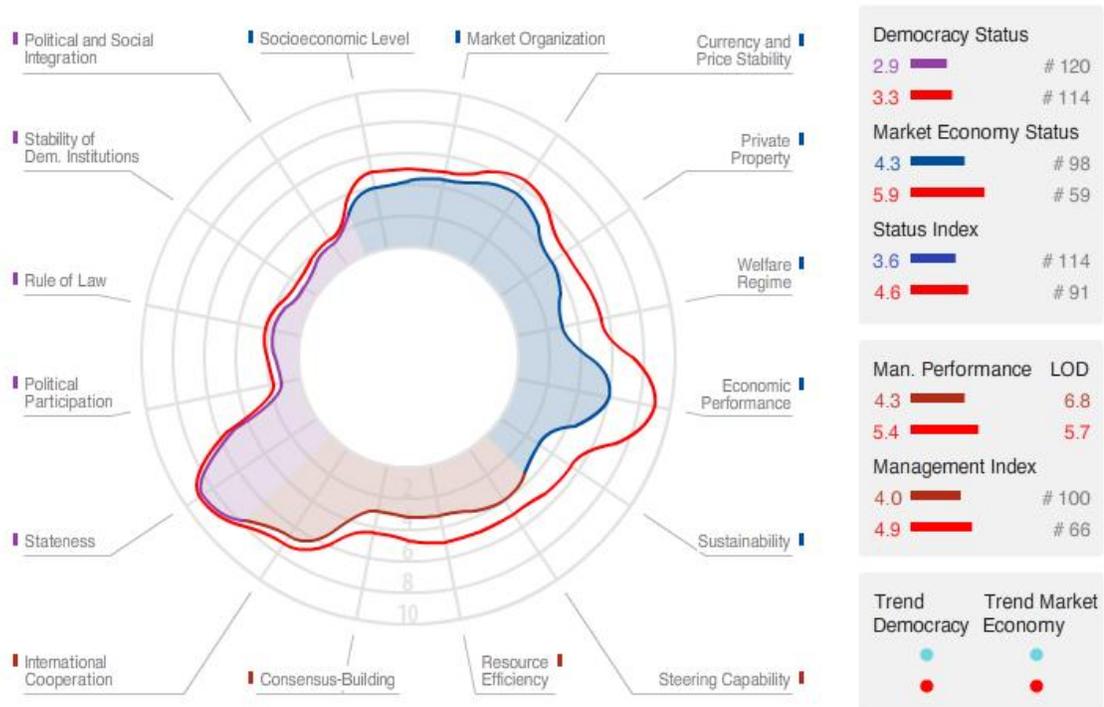


Figure 55: Bertelsmann-Transformation Index

<sup>53</sup> The Economist's Country Index

After applying our definition of development to Laos’s political system, e.g. what people are capable of doing or being, it seems clear that Laos’s level of political development is quite low compared to most of the world. Presently, most Laotians cannot choose what they want to do with their lives because of extreme government overreach. By evaluating Laos according to the aforementioned metrics, we recognize that the Laotian government is one of the largest impediments to development. However, we also recognize that it is highly unlikely that the regime’s intrusion into society will relax in the near future because the LPRP still receives support from the neighboring Vietnamese and Chinese communist parties. Until the next party congress in 2011, the politburo will continue to protect its privileged position by slowing reforms that aim to reduce corruption or improve transparency. There are several reasons for Laos’s slow growth in recent years, but the reasons are mainly political and structural in nature. For example, the senior ruling members of the government are unwilling to follow through with proposed economic and political reforms because they would lose power.

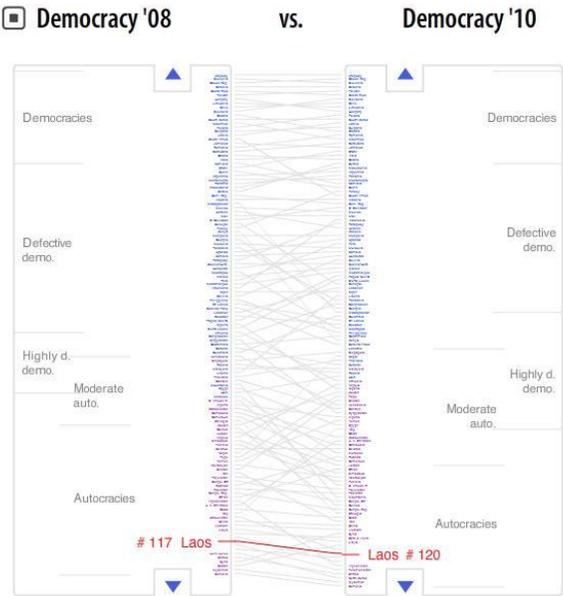


Figure 56: Bertelsmann-Transformation Index

According to our indicators, The Laotian government has made little progress towards a more democratic Laos within the past decade. More specifically, the LPRP has changed little since it consolidated power in 1975. Even after thirty-five years, the political structure in Laos

remains highly centralized and autocratic. Although Laos has had sustained periods of strong economic growth, this will have little impact on the political process because much of the wealth is concentrated in the hands of the ruling elites and party members. Many Laotian businesses in the industrial and service sectors do not lobby for democracy because they have been swayed by the government with the promise that they too will be able to share the spoils of economic growth. Like most of Asia, social relationships and networking remain highly entrenched in society and as long as this system remains, nepotism and graft will continue. As long as the LPRP remains in power, we should expect to see little evidence that suggests that political freedoms will improve in the years to come.

## **Development Summary**

Overall, Laos is progressing toward its development goals at a moderate rate. However, various forms of unfreedoms are still present and inhibiting its development. Ultimate progress will not be achieved in the country unless these various types of unfreedoms are removed. In our development proposal, we will seek ways to eliminate these deprivations of freedoms and empower the Laotian people to pursue their full potential. We will first summarize the current status of development in Laos and then identify our development priorities for the country.

### **Current Development Summary**

- Laos has a temperate tropical monsoon climate with widely varying yearly and seasonal rainfall totals.
- Laos is a landlocked country with waterways that are unusable for transportation because of seasonal changes in water levels and large waterfalls.
- The landscape of Laos is mountainous and not friendly to agriculture. Only 8% of Laos's land is arable.
- 80% of the work force is employed in agriculture, yet this sector generates only 39% of the country's GDP.
- The main crop grown in Laos is rice. Other crops include cash crops such as maize and coffee. There are two methods of rice cultivation: wet-field and swidden, the later of which is not sustainable.
- Industrialization of agriculture is very low. Because rainfall is an unreliable source of irrigation, the government has begun to subsidize irrigation infrastructure.
- Laos's major natural resources are timber and hydropower. 50% of the land is covered by forests that can be used for timber production. The country has numerous sites on which new dams could be built to generate hydropower.
- Overall, the Laotian economy is weak but improving.
- Laos's GDP per capita (PPP) has been growing at an average of 5% over the past seven years.
- Laos's GDP composition is 39% Agriculture, 34% Industry, and 27% Services.

- Infrastructure in the country is underdeveloped. Many Laotians have limited access to roads, telecommunications, and electricity. Large portions of the roads are unpaved.

#### Development Finance Summary

- Laos's One Gap was 8.75% in 2007 with a K value of 6.35. This K value indicates that inefficient use of capital is the major cause of One Gap rather than an insufficient savings rate.
- The currency is Kip, which follows a managed floating exchange rate regime.
- The exchange rate and inflation rate have remained relatively stable over the past few years.
- Since 2006, Laos has experienced overall balance of payments surpluses, trade deficits in goods, and trade surpluses in services. Sufficient capital inflows in the forms of grants, loans, and FDIs cover the One Gap.
- Laos relies heavily on external funds for development. Foreign debts outstanding accounted for 48.5% of the total GDP.
- The country's indebtedness has improved due to strong economic growth, appreciation of the Kip, and favorable external conditions.
- The budgetary deficit accounted for 6.1% of the total GDP.
- Two major sources of government income are taxes (87% of income) and grants.
- GoL's revenues have averaged a 15.9% real annual growth rate from 2004 to 2008.
- Government expenditure accounted for about 21% of GDP during this time period.
- The government financed the budget deficit through grants, mainly in the forms of ODA, and foreign capital, mainly project loans.
- In agriculture, Laos experienced a decline public spending. Most new government investment in agriculture is in irrigation equipment for rice cultivation, which is not an efficient use of capital.

- Education accounted for 12% of total public expenditure. The government used its revenues to build new schools without allocating sufficient budget for operating costs of current schools.
- Healthcare accounted for 7% of total public expenditure. Major improvements have taken place in healthcare. However, rural poor still have limited or no access to quality health care due to lack of basic infrastructure and poor allocation of government budget.
- Spending in transportation averaged 25% of total public expenditure. Road networks experienced a 42% increase in the past ten years. However, a majority of the Laotian population still has limited access to roads. The government is the sole funder of roads. About 38% of road maintenance is paid for by the gas tax, which is 1.7 US cents per liter.
- Accounting for increases in other expenditures, the government passed a wage bill which aimed to create incentives for employment in civil service. In order to tackle unemployment, the government has created 100,000 new jobs in the public service sector.

#### Social Structure Summary

- Laos scored poorly on HPI, which measures overall poverty.
- Although the infant mortality rate is high and the life expectancy rate is low, both measures are showing improvement.
- Laos's health expenditure by government and individuals is minimal, especially in rural areas, where about 70% of the population resides.
- Laos's low education expenditure per pupil correlates with low literacy rate.
- Laos's income distribution is relatively equal with a GINI Coefficient of .33.

#### Political Structure Summary

- Laos is a single party authoritarian state that is controlled by the Lao People's Revolutionary Party.

- Laos ranked 151/180 countries in Transparency International 2008 Corruption Index Report indicating high levels of corruption and a lack of transparency in the government.
- Laos lacks effective system of checks and balances because the judiciary is controlled by the executive bureau.
- Freedom of speech, although guaranteed in the Constitution, is basically nonexistent. Laotians are free to criticize the government as long as it doesn't evolve into mass movements.
- Freedom of religion is only limited to Buddhism.
- Laos currently has a small number of NGOs, but they are heavily controlled by the State and cannot enter the political arena.
- Social relationship and networking is highly entrenched in society.

## **Development Potential**

Our definition of development is the freedom to act according to one's own will unrestricted by the nature of their specific situation or the will of others. We see development as a process which enables the Laotian people to choose what they want to do with their lives and then, more importantly, to be able to pursue it. Upon assessment of the current development status and the development assets of Laos, we believe the best way to achieve maximum freedom for the Laotian people is through the creation of the fundamental elements that will enable a progressive middle class. Therefore, creation of this middle class is our development priority. This class will be made up of well-educated professionals, such as doctors, teachers, and engineers, who will be the major forces of economic, social and political development. As the society becomes educated, individuals experience cultural and value transformations. At this point, theorists like Lipset would argue that these interrelated economic and social transformations lead to higher levels of democratization. As the economy develops and becomes increasingly complex, it becomes increasingly difficult to manage centrally. Thus the state expands so that that the market can remain imbedded within the existing structure. Social services like education are extended and life expectancies begin to rise. Eventually technological innovations are applied to agriculture and people no longer have to live in the rural countryside on large plots of land. This advancement will help eliminate the rural-urban divide that is inhibiting Laotian development. Peasants can now move to city to work in a factory, go to school or receive quality healthcare all the while enjoying a high level of material consumption.

The aforementioned idea of creating the fundamental elements for a progressive middle class correlates our definition of development, which is to achieve ultimate freedom in Laos. This goal cannot be attained through a single development policy. Therefore, our proposal will take into account constraints on development, among which are unfavorable topography for agriculture, undeveloped human capital for productive work force, insufficient government revenues for public service, inefficient use of capital for public and private expenditures and investments, and the communist political system, which affects all sectors and activities within the country. Even when we consider these and other constraints, we still see the most pressing demand and greatest potential for development in the following areas: agriculture, healthcare, education, road networks, and budget allocation. Therefore, our final proposal will include policy recommendations aiming to tackle these sectors.

We choose these areas because we believe that development of them will be the best way to promote formation of the middle class and eliminate unfreedoms in Laos.

A developed agriculture sector will be an efficient provider of adequate food supply for the population. The surplus of agricultural products could be exported, which would reduce trade deficits in goods and provide new sources of income. Additionally, an advanced agriculture sector will free people from subsistence cultivation and allow them to pursue alternative lifestyles.

Healthcare in Laos has seen vast improvements in terms of disease control and prevention. However, the major problems lie in lack of education for healthcare professionals and inaccessibility of quality healthcare to the rural population. Only when all Laotian citizens can receive adequate healthcare, will they be able to rid themselves of unfreedoms and pursue their dreams.

A developed education sector will be able to provide the Laotian economy with a productive workforce as well as enable the individuals to advance their careers. Having a well-educated population will help Laos better achieve its other development goals, such as improving healthcare. In addition, education will ensure sustainable growth into the future, as knowledge will be passed down from generation to generation. Improvements in education are requisites for the formation of a politically active middle class. This new political force will be able to represent the interest of the general public and strive to determine their own future.

We believe developed road networks will enhance the articulation of the Laotian economy and polity because they will enable rural residents to trade their products, have access to advanced agricultural technologies, enjoy access to healthcare and education, and obtain the ability to organize social and political networks. Overall, freedom of movement will enable the Laotian people to pursue many other types of freedoms that they desire.

We also see an urgent need for the Laotian government to reform its budget allocation practices from inefficient spending to wise use of resources. Only through efficient use of social surplus by the government will Laos be able to achieve its development goals and improve the living standards of its citizens. Government reforms will help reduce nepotism and cronyism, increase government efficiency and effectiveness, and increase citizens' ability to open and

operate their own businesses. Currently, there are no monopoly regulations or protections for small businesses in Laos. Freeing Laotians to own and operate competitive small businesses will be a major force for creating and growing a strong middle class population.

## **Conclusion**

In conclusion, we have determined that there is a pressing need in Laos to build rural infrastructure, create efficient and productive agriculture, end inefficient government spending, promote education throughout the country, and to provide better access to healthcare. In order to address Laos's broad unfreedoms, we cannot focus on a singular and narrowly focused policy proposal. We must look beyond just improving Laos's poor transportation networks or underfunded schools. Thus we must look beyond a single sector of the economy and concern ourselves with the reorganization of society. By promoting the base from which an active and dynamic middle class can emerge from, our policy proposal hopes to empower a new class of Laotians to address Laos's numerous unfreedoms. By empowering a robust middle class, our policy proposal can address the sectors of the Laotian economy and polity that perpetuate unfreedoms. By creating a base from which a middle class can emerge, our policy proposal hopes that the Laotian people will be able to fill the key positions that will allow for sustained development. For example, currently Laotian hospitals and schools lack an educated and skilled staff. By addressing the unfreedoms that currently restrict the average Laotian from being all that he can do or be, our policy proposal aims to remove all the impediments that prevent someone from becoming a doctor or a teacher. From this progression, the new middle class will create positive externalities that can then address the broad range of unfreedoms currently present in Laos.

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