LAO PDR ECONOMIC MONITOR

Reforms for Stability and Growth

Thematic Section:
More Revenues, Better Health – Implementing Health Tax Reforms in Laos

October 2024
Economic Policy
Global Practice
East Asia and Pacific Region

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Abbreviations

BCEL	Banque Pour Le Commerce Exterieur Lao Public
BOL	Bank of the Lao PDR
CAR	Capital adequacy ratio
CIF	Cost, Insurance and Freight
CIT	Corporate income tax
DALY	Disability Adjusted Life Year
DSA	Debt Sustainability Analysis
EAP	East Asia and Pacific
EDL	Electricité du Laos
GDP	Gross Domestic Product
ILA	Investment License Agreement
LAK	Lao kip
MOF	Ministry of Finance
NPL	Non-performing loan
NTM	Non-tariff measures
PPG	Public and publicly guaranteed
PPP	Public-private partnerships
SOE	State-owned enterprises
TCF	Tobacco Control Fund
VAT	Value added tax

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The Lao PDR Economic Monitor provides updates on macroeconomic developments and sectoral issues in the country. It is produced biannually and distributed widely to government agencies, development partners, the private sector, think tanks, civil society organizations, and academia.

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Executive Summary

Part A: Recent Economic Developments and Outlook

Despite a slight pickup this year, economic growth continues to be held back by persistent macroeconomic instability. Economic activity has benefited from continued growth in services, electricity and mining, agriculture, and in the manufacture of selected electrical and electronics. Nevertheless, depreciation of the kip and high inflation are eroding purchasing power, weighing on private consumption and pushing up costs for businesses. Labor-intensive businesses report facing staff shortages as Lao workers shift toward self-employment and migrate abroad in search of better paid jobs in response to economic difficulties at home.

Continued kip depreciation leads to high inflation and reduced spending on welfare. From January to September 2024, the official kip rate weakened by 19 percent against the US dollar and by 24 percent against the Thai baht, while parallel market rates weakened by 28 percent and 23 percent respectively. Given Laos' dependence on imports for many consumer goods, a weaker kip means higher consumer price inflation which has averaged 25 percent during the same period. Inflation tends to track the kip/dollar parallel exchange rate as markets base goods and services prices on parallel rate with a mark-up to cover the exchange rate risk. The impact of currency depreciation on private consumption is therefore significant. When the kip depreciates in the parallel exchange rate market by 1 percent, private consumption is estimated to decline by 0.6 percent, eroding both household welfare and domestic demand.

The government has maintained a tight fiscal policy stance, mainly through expenditure curbs, and this has restricted investment in human capital. Improved revenue collection, measured as a share of GDP, offset expenditure increases in the first half of 2024. Improved domestic revenue was largely driven by higher profit tax and value added tax collection, the latter after the restoration of the 10 percent VAT rate effective in May 2024. However, overall revenue capacity is still below that of regional peers, with generous tax incentives granted under investment agreements severely undermining the tax base. Public expenditure as a share of GDP also rose in the first half of 2024. Interest payments on debts have grown because of currency depreciation and higher interest rates, largely offsetting revenue gains and meaning that the fiscal space for social spending on human capital remains limited. Combined spending on education and health more than halved from 4.9 percent of GDP in 2013 to an estimated 2.3 percent in 2023. The combined recurrent budget allocation to the social sectors as a share of GDP, and as a share of total recurrent expenditure budget also declined in 2024..[1]

Public debt remains unsustainable, while domestic financing sources are under pressure. Laos is facing both solvency and liquidity challenges, owing to significant financing needs, limited financing options, low foreign exchange reserves, and depreciation pressures. Total public and publicly guaranteed (PPG) debt remained high at 108 percent of GDP at the end of 2023, or 116 percent of GDP if domestic expenditure arrears and a swap arrangement are included. The ratio of total public debt service (after deferrals granted by external creditors) to domestic revenue increased from 35 percent in 2017 to 57 percent in 2023, Without deferrals, the figure would have been 82 percent of domestic revenues). Debt service deferrals accumulated since 2020 amounted to about $2 billion by the end of 2023 (nearly 16 percent of GDP). Looking ahead, debt service obligations should average $1.3 billion per year in the medium term. Given lack of access to international capital markets, this will translate to more pressure on domestic financing sources, crowding out credit to the private sector and inducing further currency depreciation.2 A credible debt restructuring plan and improved debt management remain necessary if debt sustainability is to be restored.

1 Although the social sector budget allocation increased by 10 percent year-on-year in nominal terms, this allocation is expected to be lower than in 2023 due to higher prices. The 2024 budget plan includes recurrent spending by sector. Capital spending by sector was not available by the cut-off date for this report.

2 This assumes full repayment starting in 2024. Negotiations on deferrals are under way and could lessen financing pressure in the short term.

Although the current account shows a surplus, the foreign exchange market remains imbalanced, putting pressure on the exchange rate. There are two main reasons why a positive current account balance has not contributed to a better balance of foreign exchange demand and supply. First, imports are consistently underreported if compared to mirror data from partner countries. Second, only about 65 percent of official export proceeds entered the country's economy in the first half of 2024, with the remainder being retained offshore. The financial and capital account recorded a net outflow, mostly due to principal repayment of public and private debt. Foreign exchange reserve adequacy (excluding a swap arrangement with the Bank of China) remains below two months of imports, limiting the central bank's ability to meet international payment imbalances or address exchange rate shocks arising from high external debt service obligations and importers' demand for foreign exchange.

The Bank of the Lao PDR has tightened monetary policy and foreign exchange management regulations, aiming to mitigate depreciation pressures and improve foreign exchange liquidity. In 2023 and 2024, measures have included raising the policy interest rate, increasing reserve requirements, and issuing short-term bonds in the money market. However, the weak degree of influence on banks rates and high degree of dollarization hinder the effectiveness of policy interest rates while, despite increased enforcement efforts, compliance with repatriation and mandatory conversion requirements has been uneven. Faced with continued foreign exchange shortages, access to foreign currency is prioritized for essential goods such as fuel and medicine, as well as external debt settlements. This approach could prove counterproductive in the medium term, undermining business confidence about access to foreign exchange.

Macroeconomic imbalances are expected to persist and hinder growth prospects, unless there is debt restructuring and more progress on reforms. Real GDP will grow by an estimated 4.1 percent in 2024, due to expanding tourism, transport and logistic services, and investment in the power sector. On the supply side, these sectors are expected to sustain growth beyond 2024, but their contribution will be undermined by labor shortages and the higher costs that follow depreciation, inflation and high financing costs. High inflation will jeopardize real household incomes, thereby depleting family savings, consumption and human capital spending. Disposable income dynamics, lower external demand from trading partners, higher public financing needs, and higher financing costs are expected to moderate growth to 3.7 percent in 2025. This forecast assumes the government will fully service its public debt obligations, which amount to $1.5 billion for the year.

Fiscal space for development spending will remain constrained. Revenue is expected to increase gradually, owing to the recently introduced tax adjustments. However, total expenditure is likewise expected to rise along with higher interest payment obligations, although non-interest expenditure, especially on health and education, will remain contained. The baseline assumes no further deferrals on interest payments, which are expected to drive fiscal deficit in the next few years, while the primary balance (without interest payments) is a projected to remain positive.

According to the World Bank/IMF Debt Sustainability Analysis, public debt and external debt are rated as "in debt distress" and unsustainable. In business-as-usual scenario, currency depreciation would is expected to drive up the debt ratio, despite primary surpluses and positive real GDP growth in the near to medium-term. Public debt indicators for both solvency and liquidity would remain far above the indicative distress thresholds for two decades. Major economic vulnerabilities include significant financing needs, limited access to international capital, limited international reserves, increasing rollover risks, potential for additional exchange rate depreciation pressures and bank recapitalization, and substantial contingent liabilities.

Laos remains subject to significant domestic and external uncertainties. Key domestic risks include limited foreign exchange liquidity for debt service, which could worsen in the absence of deferrals, limited access to international capital markets, slow progress with structural reforms, and deteriorating balance sheets in major banks. Outmigration and labor shortages could threaten growth in sectors that need many workers. Externally, subdued global and regional economic growth could weaken external demand. On the upside, successful bilateral debt restructuring agreements could result in lower debt servicing obligations, thereby alleviating depreciation and inflation, and thus in turn reducing the constraints on growth.

Restoring macroeconomic stability requires a strong commitment to five critical reform areas: (i) curbing tax exemptions, and reforming excise taxes (for example on tobacco, alcohol, and fuel) to raise revenues and boost spending on social services; (ii) expediting ongoing debt renegotiations and strengthening public debt management; (iii) managing risks from contingent liabilities related to state-owned enterprises and public-private partnerships; (iv) strengthening financial sector stability; and (v) improving the business environment to promote investment and exports.

Table 1. Summary of key economic indicators

	2019	2020	2021	2022	2023	2024	2025
						Projections	
Real economy	Annual percentage change, unless otherwise indicated						
GDP growth	5.5	0.5	2.5	2.7	3.7	4.1	3.7
Inflation year-on-year	3.3	5.1	3.8	22.7	31.2	24.2	19.2
	Percent of GDP, unless otherwise indicated						
Fiscal balance	-3.3	-5.2	-1.3	-0.2	0.7	-0.9	-1.1
PPG debt	69.1	76.0	92.9	130.7	115.9	108.3	118.3
Current Account	-12.1	-5.9	2.9	-1.7	-1.6	-3.0	-3.6

Sources: Lao Statistics Bureau, Ministry of Finance, Bank of the Lao PDR, Ministry of Industry and Commerce, World Bank staff estimates and projections based on inputs from Lao authorities and trade partner data as of September 2024.

Part B: More Revenues, Better Health–Implementing Health Tax Reforms for Laos

Health taxes are excise taxes imposed on products that have a negative public health impact, e.g. taxes on tobacco, alcohol, and sugar-sweetened beverages (SSBs). These result in healthier populations and generate revenues for the budget even in weak tax administrations and low-capacity environments. On average, 0.6 and 0.3 percent of GDP are raised globally from tobacco and alcohol excise taxes, respectively.

Health excise taxes can improve public health and secure more tax revenue for Laos. To realize these gains, both tax structure and tax rates need to be revised. Laos collects 0.08 and 0.39 percent of GDP from tobacco and alcohol, significantly below regional average. Contrary to international best practice, it currently employs taxes levied in percentage on the Cost, Insurance and Freight (CIF)/producer price (an ad valorem tax), which is considered a poor practice from economic, health and tax administration perspectives.[3] Ad valorem taxes are easily evaded by under-declaring the value of production or the value of CIF to reduce tax liability. Ad valorem taxes are easily evaded by under-declaring the value of production or the cost, insurance and freight. The global trend is to move from ad valorem tax levied as percentage of a value to specific tax levied as a fixed amount on a cigarette pack.

An Investment License Agreement (ILA) with the tobacco industry has impeded the effectiveness of tobacco tax collection in Laos. A 25-year ILA that prevents the government from collecting all applicable taxes was signed by the government in 2001 with a joint-venture cigarette manufacturer. As a result, this and other tobacco industry players pay a preferential reduced tax rate as specified in the ILA. This results in at least 535 billion kip of annual revenue loss. The ILA is the primary reason for low cigarette prices (the lowest cigarette prices in the Asia-Pacific region), low tax revenue (0.08 percent of GDP versus 0.14 percent of GDP in Cambodia) and the resulting health and economic harm. The government should end the exemptions and privileges in the ILA at the date they are set to expire (2026) and not extend, nor replace nor restore in whole or in part, the tax concessions currently provided to tobacco companies. In absence of a government action and notification, the ILA will be automatically renewed for another 25 years.

[3] Ad valorem taxes mean a tax rate applied to a value as tax base (for example rate in percent on a value). A specific tax is a fixed amount of tax placed on a particular unit of goods (for example kip per unit).

In Laos, the latest excise tax reform approved in 2023 and effective Jan 1, 2024, is projected to have almost no impact on smoking prevalence and minimal impact of cigarette tax revenue in real terms. The 2023 tobacco, alcohol and non-alcoholic beverage excise rate increase are projected to have low impacts. This is primarily due to poor tax structure, low tax rates, and the presence of the ILA.

This report provides recommendations for reforming taxes on cigarettes, alcohol and sugar sweetened drinks. For cigarettes, a mixed tax structure with heavy reliance on the specific tax should be applied. The specific tax needs to be collected, and the rates should be increased annually to more adequate levels (see table 4 below for details) and adjusted annually for inflation and income growth to keep pace with real incomes at least until 2028. Tax needs to apply uniformly across different cigarette brands independent of their manufacturing costs (i.e. tax tiers should be removed) since they cannot be justified by differential harm caused by cigarettes with different cost of production. Once the new tax policy is firmly in place, the tax base of the ad valorem tax should move from production costs to retail prices since it will lead to further reduction in smoking prevalence and additional tax revenue while being significantly easier to monitor and enforce.

For alcohol, we recommend the use of a uniform fixed amount of tax (volumetric specific tax structure) set for each alcohol type (beer, wine, spirits).[4] Initially, tiers should be removed to aid tax administration. Once the new tax policy is firmly in place, a simple alcohol-strength tax tier structure could be considered since this will further reduce the amount of pure alcohol consumed.

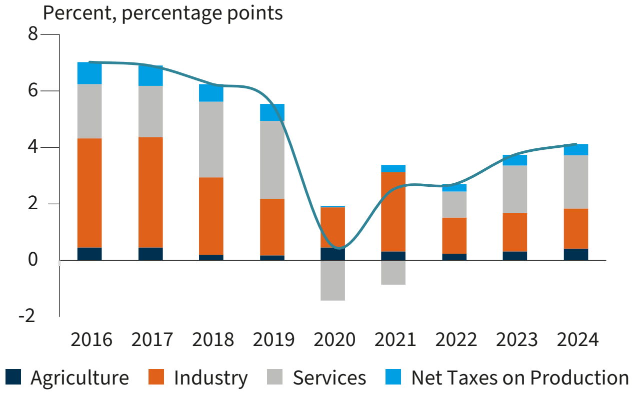
The proposed tax reforms would bring additional tax revenue of 2,225 billion LAK (~0.78 percent of GDP) within the first year (Table 4). In addition, the reform would reduce the smoking prevalence in Laos by 9.7% and prevent over 48 thousand premature deaths due to tobacco use. The proposed tax policy is conservative compared to lower-middle-income countries where, for example, the median excise tax per cigarette pack was 8,000 kip in 2020. The average excise tax per cigarette pack in Lao PDR was 476 kip in 2023. The proposed excise tax on beer is the same as currently applied in Viet Nam.

The proposed excise tax reform should be accompanied by steps to enhance tax administration, otherwise tax policy goals will be undermined. While efforts to modernise tax administration are ongoing, a longer-term development agenda is needed in areas such as digital tax administration and implementation of a track and trace system. Other actions to strengthen tax administration should also be considered, such as the use of technology to aid monitoring and enforcement, and licensing. In combination, the policy and administrative actions outlined above, in tandem with removal of the ILA, will help to provide the health and revenue impact direly needed in Laos.

[4] A uniform excise tax system corresponds to a unique excise applying to all alcoholic beverages.

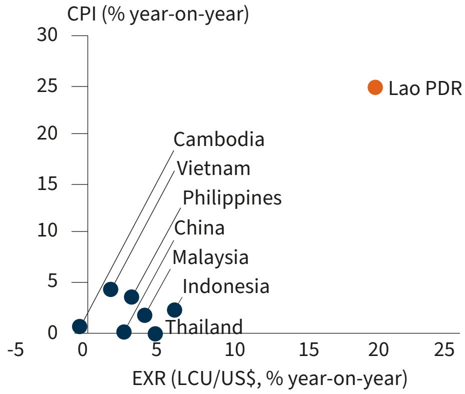
Lao PDR: Key Macroeconomic Indicators at a Glance

Growth prospect is restrained by protracted macroeconomic instability



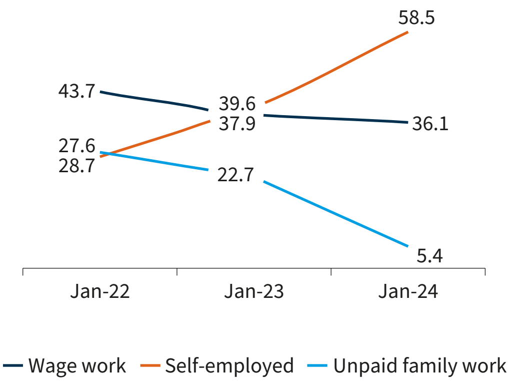
Source: Lao Statistics Bureau, World Bank staff estimates.

Inflation and exchange rates remained high (percent, average January–August 2024)



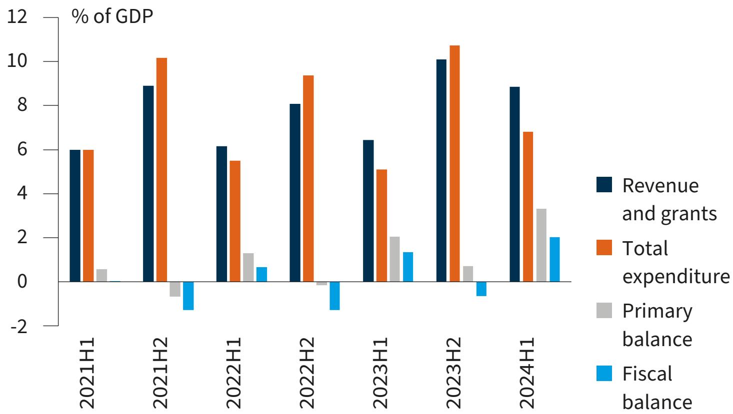
Source: IMF-IFS and Bank of the Lao PDR.

Economic difficulties push more people to becoming self-employment and migration



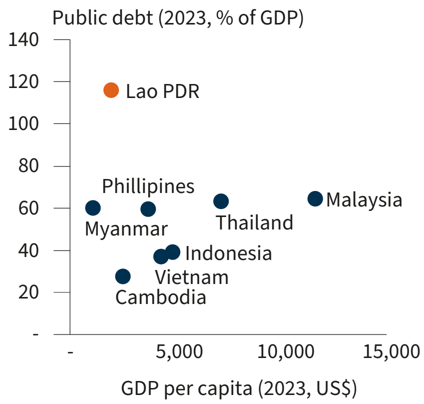
Source: World Bank Rapid Monitoring Phone Survey.

Fiscal performance improved in the first half of 2024



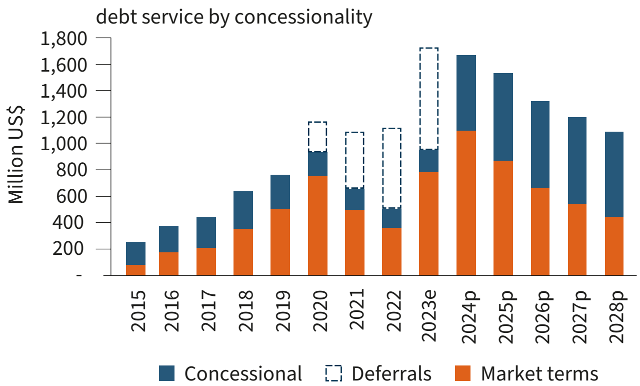
Source: Ministry of Finance.

Public debt levels are unsustainable, limiting fiscal space for social spending



Source: World Bank Macro Poverty Outlook October 2024.

External debt service obligations remain a hurdle



Source: Ministry of Finance.

PART A

Recent Economic Developments and Outlook

1. Regional Economic Context

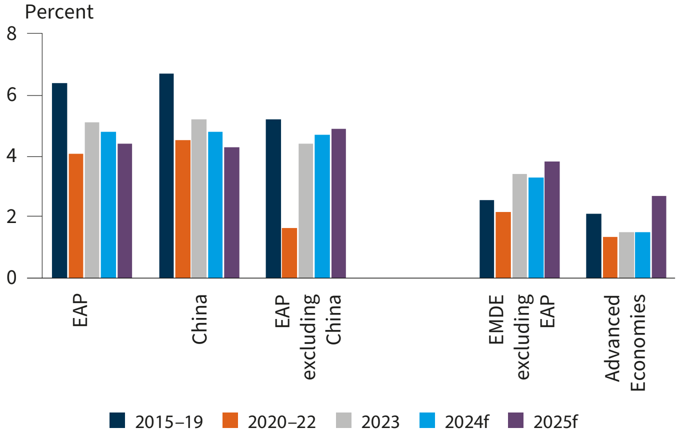
The regional economy is growing, but below both pre-pandemic level and its potential.

The East Asia and Pacific region's economic performance remains robust compared to peers, although growth is slower than it was before the pandemic and is potential. The region's economic growth is projected to be 4.8 percent in 2024, compared to an average growth of 3.3 percent in other Emerging Markets and Developing Countries (EMDEs) and 1.5 percent in advanced economies. Nevertheless, growth is lower than the pre-pandemic average of 6.4 percent from 2015 to 2019. China's economy is projected to grow by 4.8 percent and the rest of the region by 4.7 percent in 2024, slower than the 6.7 percent and 5.2 percent recorded during the 2015–19 period.[5] Growth in 2024 benefitted from increasing domestic consumption, recovering goods exports, and a rebound in tourism.

Economic performance across the region is affected by geopolitical, macroeconomic and policy uncertainty. Geopolitical risks have been aggravated by the conflict in the Middle East and are reflected in higher shipping costs and higher volatility in commodity prices. Trade protectionism has also risen. Heightened economic policy uncertainty abroad—for example, increased fiscal or trade policy uncertainty in the U.S.—could reduce industrial production and stock prices in EAP by up to 0.5 percent and 1 percent, respectively.

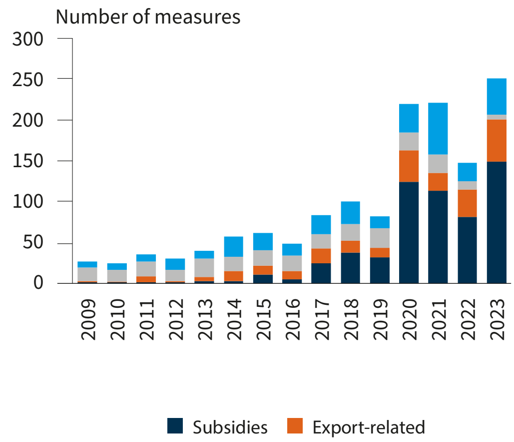
In 2025, growth across EAP is projected to slow to 4.4 percent, given an expected slowdown in China. Growth in China is undermined by near-term issues (high debt levels, low confidence and property sector weakness) and longer-term structural factors (for example, population aging and trade protectionism). However, growth in the rest of the region (excluding China) is expected to accelerate by 4.9 percent in 2025, supported by continued export recovery and the expected easing of global financial conditions.

Figure 1: Real GDP growth (percent)



Source: Word Bank EAP Economic Update October, 2024.

Figure 2: New trade-distorting measures in EAP



Source: Word Bank EAP Economic Update October, 2024.

[5] According to the EAP Economic Update (October 2024), regional growth has been highly influenced by China through trade channels. China's growth is estimated to have boosted developing countries' growth by around 1 percentage point annually during the 1995-2019 period, and by 0.67 percentage points annually during the period 2020-2023 when China's growth slowed down.

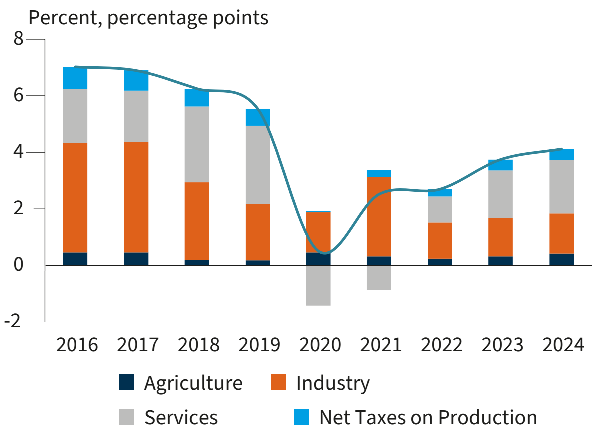
2. Recent Developments in the Lao PDR

2.1 Real Sector

Structural constraints undermine growth recovery potential.

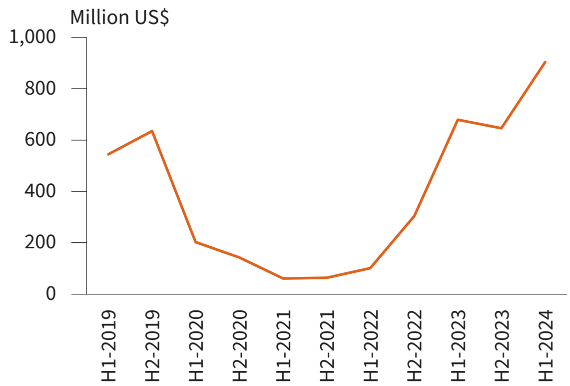
In 2024, economic growth remains steady, but persistent macroeconomic instability is weighing down on activity. Sectors including tourism, hospitality, transport, logistics, mining, agriculture, and electrical and electronics manufacturing, have contributed to this growth. A recovery in electricity generation, driven by increased rainfall, has further supported economic activity. Additionally, exports and foreign investment—primarily in the capital-intensive resource sector—have shown expansion. However, the depreciation of the kip and rising inflation are eroding purchasing power, negatively impacting consumption and driving up costs for businesses. Labor-intensive sectors are also grappling with workforce shortages, as economic difficulties push many workers to seek better-paying opportunities abroad.

Figure 3: Real GDP growth (percent)



Source: Lao Statistics Bureau, World Bank staff estimates.

Figure 4: Service export (million US$)



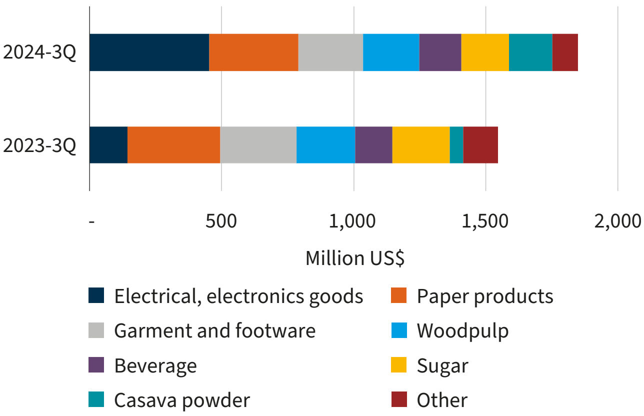
Source: Bank of the Lao PDR

The services sector, which accounts for one-third of GDP, is estimated to grow at 5 percent this year, benefiting from improved performance in tourism, hospitality and transport services. In the first half of 2024, the number of foreign visitors surged by 25 percent, reaching 2.1 million. Domestic tourism has also risen. Enhanced connectivity through the Laos-China Railway, which started operating in December 2021, has benefited transport and logistics services and facilitated increased exports and tourism, which have now surpassed pre-COVID-19 levels. However, the depreciation of the kip and persistent high inflation have driven up business costs and dampened consumption, resulting in a notable impact on wholesale and retail sales.

Industrial sector growth is primarily driven by growth in electricity generation, mining, and manufacturing goods such as electrical and electronic goods. Electricity generation, which accounts for about 10 percent of GDP, has rebounded thanks to improved rainfall, contributing to increased exports. The mining sector saw output growth in potash, while gold and copper output slightly declined - current mines are close to depletion while new sources are at an early stage of development. The manufacturing sector's performance has been mixed, with major contributions from electrical and electronic goods and cassava powder (Figure 5), while other manufacturing subsectors faced a slight contraction in real terms, partly affected by the high costs of doing business and labor shortages.

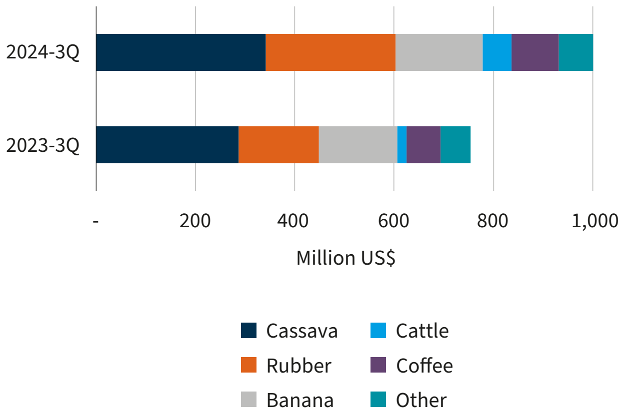
The agriculture sector has seen growth driven by strong demand for non-rice crops. In the first three quarters, agricultural product exports remained robust, particularly for cassava and rubber, with China being the primary destination (Figure 6).

Figure 5: Manufacturing exports (January–September 2024, million US$)



Source: World Bank staff estimates based on data from Ministry of Industry and Commerce and trade partners.

Figure 6: Agriculture exports (January–September 2024, million US$)



Source: World Bank staff estimates based on data from Ministry of Industry and Commerce and trade partners.

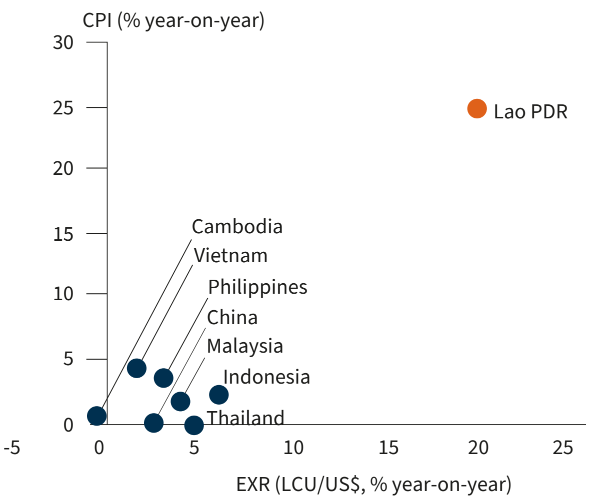
2.2 Inflation

Inflation remains elevated, driven by persistent kip depreciation and expectations.

Consumer price inflation has remained elevated throughout 2024, driven by ongoing depreciation and entrenched inflation expectations. Although headline inflation moderated from a peak of 41 percent in February 2023 to 22 percent in September 2024, it averaged around 25 percent between January and September 2024. Higher prices in food and non-alcoholic drinks, transport, restaurants and hotels are key contributors to inflation. Inflation in Laos remains much higher than in its regional peers, mostly driven by economic imbalances.

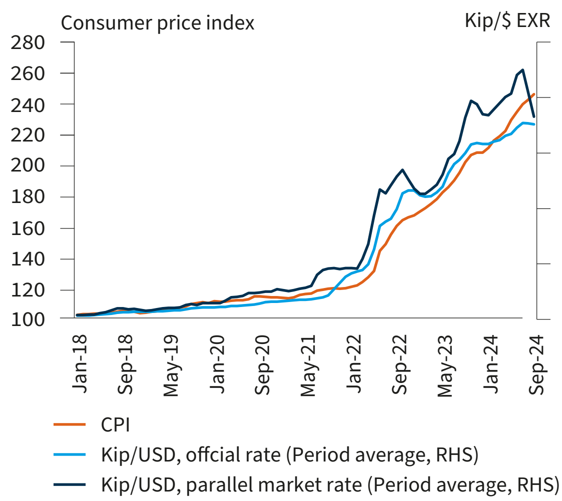
The exchange rate pass-through to inflation and welfare impacts is high. During the period 2017-2023, a 1 percent depreciation in the kip/dollar parallel exchange rate led to a 0.9 and 1.1 percentage point increase

Figure 7: Inflation and exchange rates (percent, average January–August 2024)



Source: IMF-IFS and Bank of the Lao PDR.

Figure 8: Exchange rates and inflation in Laos



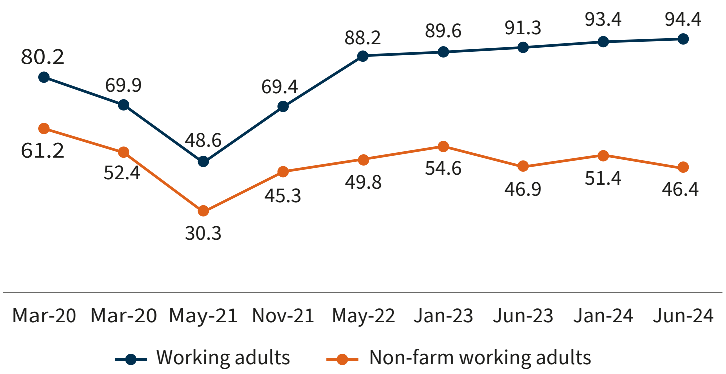
Source: Bank of the Lao PDR and Lao Statistics Bureau .

in headline inflation and food inflation respectively.[6] Markets tend to price goods and services based on parallel exchange rates, as many businesses anticipate further depreciation and thus set prices higher to cover the exchange rate risk. The impact of currency depreciation on household welfare is significant. A drop of 1 percent in the value of the kip in the parallel exchange rate market, affects both food and non-food prices, resulting in an estimated 0.6 percent decline in private consumption.[7]

2.3 Household Welfare and Employment

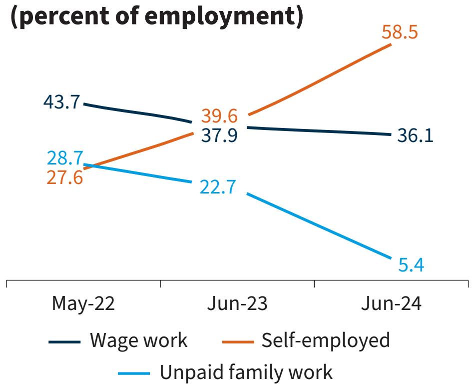
High inflation and currency depreciation have led to labor reallocation and outmigration. According to the World Bank Rapid Monitoring Phone Survey, employment picked up in the first half of 2024, with more women entering the workforce.[8] Between May 2023 and May 2024, average wages grew modestly by 8 percent, while business income rose by 15 percent, well behind the 26 percent rate of inflation over the same period. High inflation, currency depreciation, and slow wage growth have triggered a reallocation of labor from services to agriculture, and from wage and unpaid family employment to self-employment. Wage differentials between Laos and neighbouring countries have also widened, stimulating outmigration and causing labor shortages, especially in labor-intensive sectors.[9] The number of Lao documented migrants in Thailand was reported at 313,051 in June 2024, well above the pre-COVID-19 level of 277,618 in June 2019. Meanwhile, the number of total migrants (including unregistered migrants) is expected to increase.[10] Around 60 percent of migrants work in the services sector, followed by manufacturing (18 percent), agriculture (14 percent) and construction (7 percent). [11] Around 80 percent of migrants worked in manufacturing and services before migrating to Thailand, causing shortages in manufacturing and services in Laos.[12]

Figure 9: Employment (percent of respondents)



Source: Lao Statistics Bureau, World Bank staff estimates.

Figure 10: Occupational shifts (percent of employment)



Source: Bank of the Lao PDR.

High food inflation significantly affects food security and nutrition. Although phone surveys indicate that food security improved over the last year, nearly one-third of households face food insecurity and concern over food security has increased. Faced with high food prices, households are increasingly reliant on growing and gathering

[6] World Bank. 2024. Food Inflation Policy Note (Forthcoming)

[7] World Bank. 2024. Food Inflation Policy Note (Forthcoming)

[8] World Bank. 2024. Monitoring Household Welfare in the Lao PDR (Round 9 Survey)

[9] In October 2024, the monthly mminimum wage in Laos was raised to 2.5 million kip (approximately ($114),. The monthly minimum wage in Laos in Thailand is $245 (https://www.vdb-loi.com/laos_publication/lao-government-makes-significant-changes-in-minimum-wage/).

[10] International Organization for Migration. 2021. An Analysis of Migration Trends of Lao Migrants for Lao People's Democratic Republic in Two Selected Provinces: Savannakhet and Xayaboury. https://publications.iom.int/system/files/pdf/Analysis-MIG-Trends-Lao.pdf/ (Accessed 13 September 2024).

[11] Ministry of Labour, Thailand.

[12] International Organization for Migration survey, December, 2022.

their own food. More than half of interviewed families report reducing food consumption, with 94 percent of them cutting back on meat and fish consumption. This reduction in protein intake risks hindering progress in nutrition and child development in the longer term. Less than 3 percent of households report having received government assistance to help them cope with these challenges.

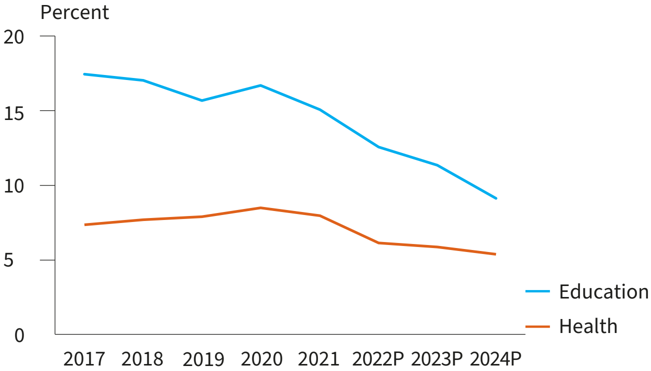
While private spending on health and education seems to have recovered somewhat, inflation continue to exert a toll. In June 2024, 31 percent of households reported having reduced education spending due to inflation, an improvement from the 36 percent reported in January 2024. However, 8 percent of school-age children were out of school, with the ratio increasing to 11 percent among children from low-income families. About one-third of households also reported having reduced spending on health care. Low private spending on human capital, coupled with low government spending on the social sectors, undermines long-term human capital development and economic growth prospects.

2.4 Fiscal Trends

The fiscal balance improved, supported by better revenue collection, while financing needs remain high.

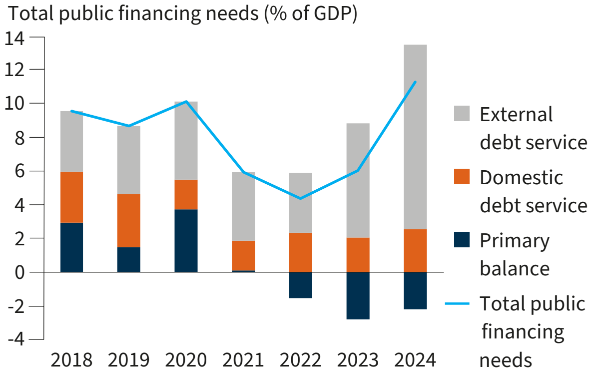
The government has maintained a tight fiscal policy stance but high gross financing needs are constraining priority spending. In the first half of 2024, the primary surplus and the overall balance improved to 3.3 percent and 2 percent of GDP respectively, as improved revenue collection offset expenditure increases. Despite these positive trends, gross financing needs remain large, potentially reaching 11.3 percent of GDP in 2024 (assuming full debt repayment), due to large debt repayments on bilateral and commercial loans. Financing sources for debt service are expected from fiscal revenues, bond issuances in the domestic capital market, repayments of on-lending from state-owned enterprises and domestic borrowing. Given lack of access to international capital markets, refinancing will continue to put pressure on the domestic financial sector, crowding out credit to the private sector. In addition, external debt payments will also exert pressure on the balance of payments and exchange rate.

Figure 11: Social sectors' current expenditure (% of total current expenditure)



Source: World Bank staff estimate based on data from Ministry of Finance.

Figure 12: Total financing needs (percent of GDP)



Source: World Bank staff estimate based on data from MOF.

Note: The financing needs during 2020-2023 reflected debt service deferrals. For 2024 no debt referrals are assumed.

Domestic revenue has improved due to economic recovery, new policy measures, and price and exchange rate effects, but extensive tax exemptions continue to erode the revenue base. Domestic revenue collection reached 8.3 percent of GDP in the first half of 2024, up from 6.2 percent in the same period of 2023. The primary contributors to this revenue growth were profit tax and VAT, supported by an expanded tax base, 10 percent VAT rate restoration, and favorable price and exchange rate effects.[13] Revenue policy measures implemented in 2023-24 included higher

[13] The government restored the VAT rate from 7 percent to 10 percent effective in May 2024.

excise tax rates on alcohol, vehicles, and tobacco, new export duties, and the return of the VAT to its pre-2022 rate of 10 percent. Although excise revenues increased, the gains were limited by a reduction in fuel excise rates and tax exemptions under the Investment License Agreement to the tobacco industry. (See also the Thematic Section of this report on health tax reforms). Following an increase in international fuel prices in 2022, the excise tax on fuel was reduced in 2022 from 31 percent to 10 for gasoline and from 21 to 0 for diesel. However, this measure forgoes large amounts of revenue and is poorly targeted. In addition, generous tax incentives granted under various other investment agreements continue to erode the tax base severely.[14]

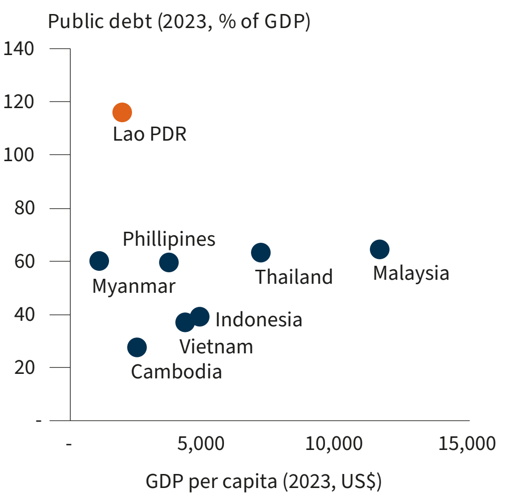
Public expenditure rose in the first half of 2024, owing to higher interest payments and public investment. Total expenditure rose to around 6.8 percent of GDP in the first half of the year. Interest payments increased due to greater servicing of commercial loans (which have higher interest rates) and exchange rate depreciation.[15] Interest payments would have been even higher in recent years without debt deferrals. Wage and salary spending remained stable as a share of GDP. Capital spending increased because of project loan disbursements and exchange rate effects. Domestic expenditure arrears continue to pose a challenge for expenditure and domestic debt management. Regarding the sectoral allocation plan for 2024, recurrent budget allocation to the social sectors increased by 10 percent year-on-year, but real spending declined due to high inflation, while the share of recurrent spending in social sectors in the total recurrent budget also declined from 17 percent in 2023 to 14 percent in 2024.[16]

2.5 Public Debt

Laos continues to face considerable public debt liquidity and solvency challenges

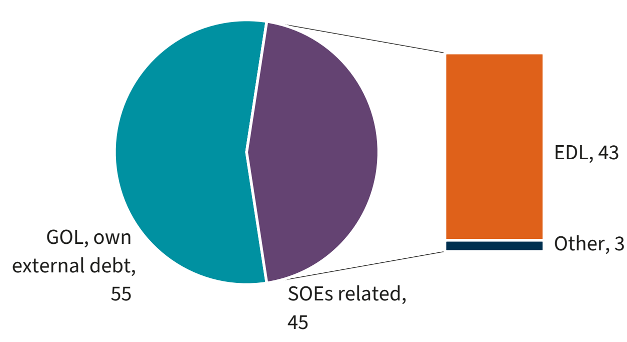
According to the Debt Sustainability Analysis, public debt and external debt are rated as "in debt distress" and unsustainable. Total public and publicly guaranteed (PPG) debt remain among the highest in the region, at 108 percent of GDP at the end of 2023, or 116 percent of GDP if domestic expenditure arrears and a swap arrangement are included. China accounts for about half of the external public debt stock in 2023, and of repayments scheduled for 2024–28 (averaging $1.3 billion per year). The energy sector, primarily through Electricité du Laos (EDL), has been a significant driver of external PPG debt accumulation, accounting for about 43 percent of external PPG debt in 2023 (41 percent of GDP).

Figure 13: Public debt stock (2023, percent of GDP)



Source: World Bank Macro Poverty Outlook October 2024.

Figure 14: External public debt stock (2023, percent share)



Source: World Bank staff estimate based on data from Ministry of Finance's 2023 Public Debt Bulletin.

14 See discussion in World Bank Public Finance Review: Forging Ahead and Lao PDR Economic Monitor October 2023, Fiscal Policy for Stability.
15 Partial debt payment deferrals in 2024 are reported, but the amount is unclear.
16 The 2024 budget plan includes recurrent spending by sector. Capital spending by sector is not yet available by the cut-off date for this report.

PPG debt is highly exposed to exchange rate risk. External PPG (debt denominated in foreign currencies) was recorded at 96 percent of GDP or almost 90 percent of total PPG in 2023, indicating high vulnerability to exchange rate depreciation. Nearly 60 percent of the external public debt stock was in US dollars, followed by Special Drawing Rights, Thai baht, and Chinese yuan. The continued depreciation of the Lao kip against major foreign currencies in 2024 has notably increased the debt stock and debt service. Additionally, despite easing global financial conditions towards year-end, relatively high interest rates earlier in 2024 are expected to affect debt service, as about 15 percent of total PPG debt has variable interest rates.

The domestic public debt stock as a share of GDP has been on the rise. The share of domestic debt in total PPG debt rose from 7 percent in 2019 to 12 percent in 2023. Bonds issued to clear previous investment expenditure arrears account for 47 percent of total domestic debt, followed by recapitalisation bonds (33 percent).[17] Despite steps to clear arrears, reported outstanding public expenditure arrears remain large, at 23 trillion kip (11 percent of GDP in 2022).[18] These arrears are not included in official debt statistics but constitute government liabilities. Domestic debt to GDP is forecast to increase further in 2024, as indicated by a 74% year-on-year increase in bank lending to the Government in June 2024.

Public debt repayments have risen in 2023-2024. Although debt negotiations are still ongoing, deferrals of debt servicing to China since 2020 had accumulated to about $2 billion (nearly 16 percent of GDP) by the end of 2023. The ratio of total debt service (after deferrals) to domestic revenue increased from 35 percent in 2017 to 57 percent in 2023 (without deferrals it would have been 82 percent of domestic revenues) (Figure 11).

High financing needs have put more pressure on domestic financial sources in a context of limited access to international capital markets.[19] The government turned to the domestic capital market to finance the deficit and to repay its debts by issuing Thai baht and US dollar and kip bonds on the Lao Securities Exchange. Bank lending to government also increased significantly (see the Financial Sector section).

In addition to direct public debt, contingent liabilities from state-owned enterprises and public-private partnerships pose fiscal risks. In 2023, SOEs accounted for 45 percent of total external PPG debt. EDL, the largest energy distribution company, experiences large losses as power is sold below cost-recovery prices.[20] Currency depreciation has exacerbated EDL's financial position, as the company earns revenue in kip but must repay its debt and import power in foreign currencies.

2.6 External Sector

Persistent external imbalances continue to put pressure on the exchange rate.

External imbalances persist and foreign reserve buffers are precariously low. The balance of payments showed a positive foreign exchange inflow of $142 million between January-June 2024, bringing foreign reserves, to $1.8 billion in June 2024. However, this reserve level was 6 percent lower than in June 2023. Excluding the swap facility of $900 million, net reserves are estimated to cover less than one month of imports, which is insufficient for stabilisation purposes.[21]

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17 According to the 2023 Debt Bulletin published by Ministry of Finance, bonds issued for repayment of expenditure arrears include investment and triangle bonds denominated in kip.

18 According to the Public Debt Management Law, arrears are not considered to be PPG debt. These only become a debt if (and when) settled through a bond issuance.

19 The August 2023 bond issuance in Thailand was significantly undersubscribed, while in September the TRIS ratings agency downgraded Laos' sovereign credit rating to BB+ with a negative outlook. This implies that further bond issuances in Thailand are unlikely to take place before 2026.

20 World Bank. 2023. Public Finance Review. Forging Ahead.

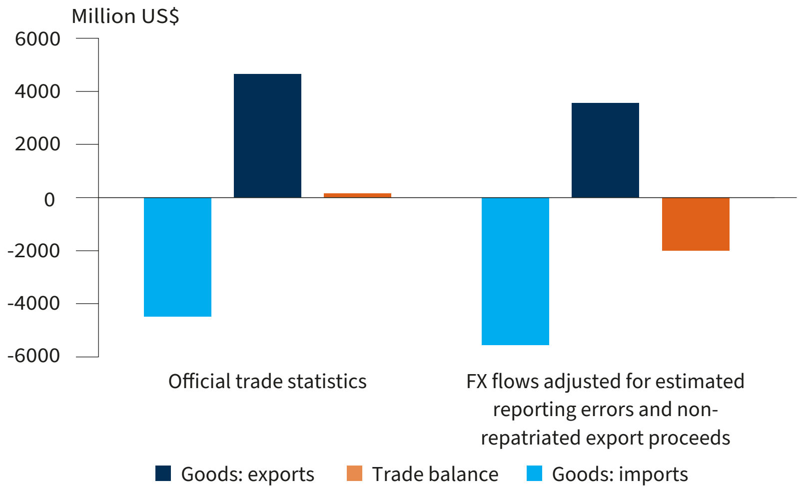
21 The Bank of the Lao PDR estimates reserve coverage of imports at around 4 months of due to differences in imports data. The PBoC announced a three-year swap agreement with the BOL for RMB6 billion (about US$900 million) in May 2020. According to the 2023 IMF Article IV, if the disbursements are tied to specific uses (e.g., facilitate trade with China), then they should not be counted as reserves. September 2024).

Official statistics show a lower current account surplus than last year. Exports of goods and services grew at a slower pace than did imports, resulting in lower net exports in the first half of 2024. Merchandise exports from January to June grew by 9 percent year-on-year, benefiting from agriculture, mining, electricity, and manufacturing of electrical and electronic parts, while robust tourism and transport boosted service exports. Despite the weakening kip, import growth was 24 percent year-on-year in the same period, driven by machinery equipment, vehicles, fuel and consumption goods. Net primary income outflows declined by 14 percent, likely reflecting lower interest payments on private debt and profit repatriation. Meanwhile, higher net secondary income reflects higher remittances from migrant labor and transfers. All in all, net exports more than offset net income payment outflows, resulting in a small current account surplus.

The financial account experienced net outflows in the first half of 2024 due to significant principal repayments on debt and other outflows from the banking sector, which more than offset foreign direct investment inflows. Foreign direct investment rose to about $680 million in the first half of 2024, mainly linked to investment in the power and mining sectors, and capital investment in the banking sector.

Despite a reported current account surplus, foreign currency shortages persist and exert pressure on the exchange rate. The reported current account surplus of $90 million in the first half of 2024 was driven by positive net exports and secondary income (remittances and transfers), which more than offset primary income outflows, including interest payments and income repatriation by foreign firms. For two main reasons, however, the positive official current account balance has not translated into a net inflow of foreign currency. First, mirror import data from trading partners suggest that Lao official statistics underreported imports by as much as 24 percent in the first half of 2024. Secondly, only about 65 percent of export proceeds entered the country's economy in the first half of 2024, while the remaining amount should have been part of financial account outflows.[22] Therefore, in terms of actual settlements, net outflows remain large (Figure 15).[23]

Figure 15: Trade balance and settlements (million US$)



Source: World Bank staff estimate based on data from the Bank of the Lao PDR, IMF DOTS and trade partners.

[22] The underreporting of financial outflows is likely captured by the large errors and omissions in the balance of payments data.

[23] The underreporting of imports are captured in errors and omissions in the balance of payments.

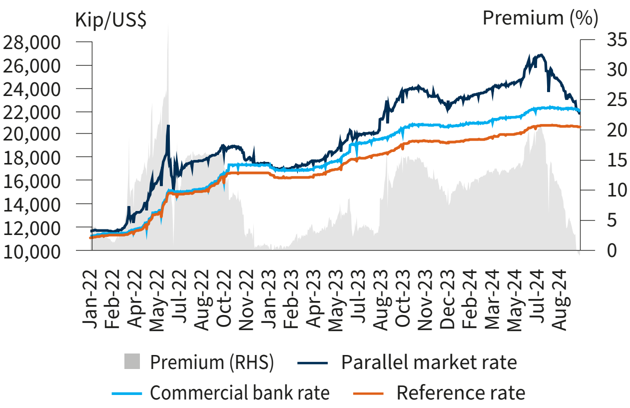
2.7 Exchange Rates

Kip exchange rates continue to depreciate, exhibiting some seasonality.

The kip continues to depreciate, despite some stabilization during June-September. From January to September 2024, the official kip rate weakened by 19 percent against the US dollar and by 24 percent against the Thai baht. Meanwhile, parallel market rates depreciated by 28 percent and 23 percent respectively. Limited foreign exchange liquidity at official rates has increased demand for forex in the parallel market, resulting in a premium.

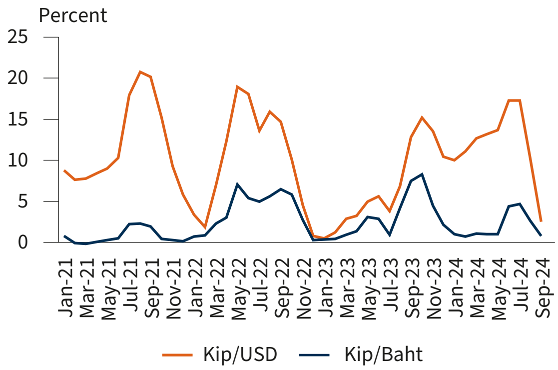
The average gap between parallel and official market rates from January to September was 12 percent, though this gap shrunk during June-September. This improvement appears to coincide with the introduction of a formal trading platform for banks, known as the Lao Foreign Exchange (LFX). The LFX platform seems to facilitate the transition of informal transactions into a formalized system, allowing the central bank to monitor forex flows, and track market rate movements.

Figure 16: Lao kip per US dollar



Source: Bank of the Lao PDR.

Figure 17: Exchange rate premium (percent)



Source: Bank of the Lao PDR.

The Bank of the Lao PDR has tightened monetary policy to contain depreciation pressures. Over 2023-24, the main measures included raising the policy interest rate; raising reserve requirements; and issuing short-term bonds in the money market.[24] As a result, reserve money contracted by 4 percent year-on-year, while the stock of BOL securities rose by 50 percent year-on-year in June 2024. However, a weak degree of influence on bank interest rates and high degree of dollarization hinder the effectiveness of increased policy interest rates.

To improve foreign exchange liquidity, the authorities have tightened foreign exchange management by introducing mandatory repatriation and conversion requirements. In March 2024, the central bank issued a notice stipulating mandatory ratios of export receipts for repatriation and conversion to kip.[25] However, implementation and compliance appear uneven. The BOL reported that 65 percent of export proceeds were being repatriated by mid-2024, and that its aim was to reach 70 percent by year-end. In the meantime, banks have also been instructed to sell a portion of their currency holdings to the central bank and prioritise the available supply of foreign exchange to importers of essential goods such as fuel and medicine. While these administrative measures may draw more foreign exchange receipts into the banking system in the short-term, they could be counter-productive in the medium-term, affecting business confidence, especially if firms face problems repurchasing foreign exchange. Some firms may be tempted to misreport their local and foreign currency holdings and may also become less compliant if their currency holdings in banks in Laos build up over time.

[24] Over 2023-2024, main measures included raising policy interest rate from 7.5 percent in February 2023 to 10.5 percent in August 2024; (ii) raising reserve requirements from 5.5 percent for kip and 8 percent for forex percent for forex to 8 percent and 11 percent in August 2024.

[25] The Bank of the Lao PDR Decision No. 333, dated 7 March 2024.

2.8 Financial Sector

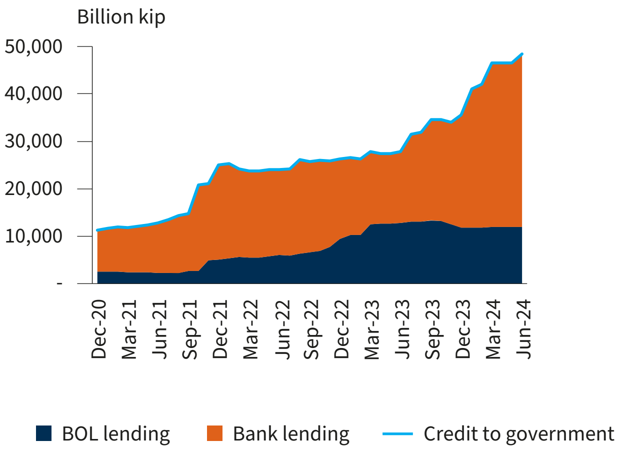
The financial sector continues to face vulnerabilities, including increasing exposure to public sector debt.

Depreciation has encouraged dollarization. With confidence in the kip low, foreign currencies are preferred as a hedge against depreciation. Broad money grew by 35 percent year-on-year in June 2024 from 27 percent a year ago, largely reflecting growth in foreign currency deposits and depreciation effects. As a result, the ratio of foreign currency deposits to M2 increased to 71 percent in June 2024, compared to 66 percent in June 2023.

Domestic credit accelerated in kip terms due to more lending to the government and the private sector, along with depreciation effects. Total domestic credit growth in kip (from both central and commercial banks to the private sector, state enterprises, and government) accelerated to 30 percent year-on-year in June compared to 22 percent a year ago, with rising lending from commercial banks. Net domestic credit from commercial banks to the government and to private and state-owned enterprises expanded by 35 percent year-on-year in June, of which about a third was due to the depreciation effect.

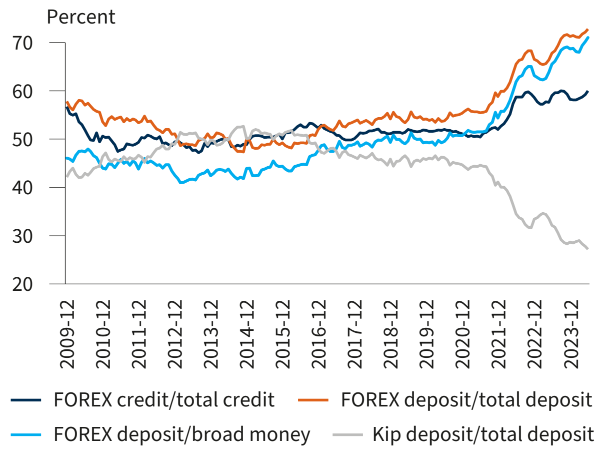
Credit to the government picked up significantly in 2024 as the authorities turned to domestic financing sources. Total lending to the government expanded by 74 percent year-on-year in June 2024, mostly from banks, through government bond holdings (bonds for paying off expenditure arrears, recapitalization bonds, deficit financing and loans). Higher reliance on the domestic banking sector will likely increase interest rates and crowd out the private sector. Foreign currency borrowing from domestic sources for external debt payments could further weaken the kip.

Figure 18: Exposure to government borrowing (billion kip)



Source: Bank of the Lao PDR.

Figure 19: Foreign currency ratios (percent)



Source: Bank of the Lao PDR.

While financial soundness indicators for the banking sector have improved on average, some specific banks remain vulnerable. Sector profitability increased in Q1 2024, reflecting better management of expenditure and a greater use of digital technology in banking services. The system-wide capital adequacy ratio rose to 18.5 percent in Q1 2024. However, the largest commercial bank, BCEL, which accounted for 33 percent of banking sector assets as of June 2024, still had a capital adequacy ratio below the regulatory minimum of 8 percent.

The Bank of the Lao PDR recently issued a decision to phase out regulatory forbearance measures. While some banks are gradually withdrawing forbearance measures, such as the freeze on loan classifications, on a case-by-case basis, the prolonged implementation of these measures and the practice of ever-greening loans could undermine credit discipline and create risks in the financial system. The recent central bank announcement that it will phase out these measures allows some exceptions. Several banks have accrued interest receivables worth more than 3 percent of total loans, indicating deteriorating asset quality. The ratio of non-performing loans to total loans remains below 2 percent, though this figure likely understates asset quality problems which may vary across banks.

3. Outlook and Risks

Box 1: Key assumptions for the baseline

The outlook (baseline) assumes that external debt service obligations will be fully met from 2024 onward, supported by state enterprise repayments relating to on-lending, some revenues and domestically issued bonds and domestic borrowing. This outlook assumes that debt service deferrals accumulated during 2020–2023 will not be paid during the forecast period. Though deferrals are reported for 2024, the amount is unknown. In the absence of a favourable agreement on bilateral debt restructuring, resulting in a lower net present value of debt, the pressure from debt service obligations is expected to persist. Debt pressure will likely mean that public spending that would support long-term growth by investing in human capital will be constrained. At the same time, pressure on domestic financing sources will increase and could crowd out credit to the private sector. Tourism and logistic services will continue to grow, albeit more slowly than during the immediate recovery after COVID-19, reflecting base effect and more moderate external demand. Oil and food price rises are expected to moderate, but structural constraints should maintain pressure on the exchange rate and hence on inflation. Revenue collection will gradually improve as revenue-enhancing measures are implemented and tax compliance improves. This should help maintain a a positive balance between government revenue and expenditures (excluding interest payments) in the medium term. High interest payments will keep the fiscal balance in deficit.[26]

Macroeconomic imbalances are expected to persist, hindering growth. Real GDP is projected to grow by 4.1 percent in 2024, driven in part by the recovery of tourism (especially from Thailand and China) and enhanced transport connectivity and logistics services, which will stimulate the service sector and economic activity. Continued investment in the power sector and increases in power production are anticipated. Mining sector performance will be constrained by depletion of resources and ongoing governance issues, as well as environmental and social safety issues. Growth is projected to moderate slightly from 2025 onward, reflecting a slowdown among major trading partners and underlying economic weaknesses. Persistent macroeconomic instability is expected to limit growth, keeping it below pre-COVID-19 levels.

Inflation is expected to remain in two-digits, reflecting persistent depreciation pressures. Although exchange rates appear to have stabilised over the past few months, high financing needs, coupled with imports, will continue to drive kip depreciation and hence domestic inflation and expectations.

High inflation is expected to continue to erode real household incomes, depleting savings, and reducing consumption and investment in human capital. As a result, many households are at risk of falling into poverty. Additionally, floods during the 2024 cropping season could further exacerbate food price increases and diminish farm income. These rising food costs will continue to undermine food security, particularly among the urban poor.

Fiscal space for development spending will remain constrained. Revenue is expected to gradually increase following tax reforms such as the restoration of VAT to 10 percent and tax administration improvements (for example, modernization and improved compliance), and as economic activity picks up. Priority policy actions that would have considerable revenue impact at this juncture include restoring the level of fuel excise duty and restructuring taxes on alcohol, tobacco and sugar-sweetened drink (See thematic section on health taxes). Total public expenditure is expected to rise, especially due to higher interest payment obligations and assuming no further debt deferral. Non-interest expenditure will remain relatively contained. The baseline assumes a primary surplus (excluding interest payments) in the next few years, but the fiscal balance is expected to deteriorate, reflecting full interest payments. Public spending on human capital is expected to remain restrained.

[26] A primary surplus means a positive balance between government revenue and non-interest expenditure.

Gross financing needs are high in 2024-25. Gross financing needs are estimated at 11.3 percent of GDP in 2024, assuming full repayments. External public debt service obligations average $1.3 billion per year over 2025–2028 (about 9 percent of GDP annually), keeping total public financing needs elevated. The financing strategy includes domestic revenues in foreign currency, repayments from state enterprises for on-lending, asset sales, and domestic borrowing and bonds (in kip and foreign exchange). As access to international capital markets is likely to remain constrained in 2025, when external debt service obligations are assumed to peak, pressure on domestic funding sources is expected to intensify.

Public and external debt are rated as "in debt distress" and unsustainable. According to the baseline scenario presented in the Debt Sustainability Analysis, currency depreciation will continue to drive up the debt ratio, despite primary surpluses and positive real GDP growth. Public debt indicators for both solvency and liquidity will remain very high and above the indicative distress thresholds for two decades. Major economic vulnerabilities include significant financing needs, limited access to international markets, limited international reserves, increasing rollover risks, the potential for additional exchange rate depreciation pressures and bank recapitalization, and substantial contingent liabilities.

External imbalances are expected to persist unless there are both major domestic reforms and a significant reduction in the net present value of Laos' bilateral debts. The current account deficit is expected to remain at around 3–4 percent of GDP, with high import demand and interest payments on external debt likely to offset improving exports and remittances. While implementation of repatriation and conversion requirements may appear to increase the supply of foreign currency in the banking system in the short-term, this policy may undermine business confidence in terms of access to foreign exchange, and may lead to misreporting. Net reserve adequacy, excluding the foreign currency swap, is expected to remain relatively thin, covering less than two months of imports.

This outlook is subject to significant domestic and external uncertainty. Domestic risks include tight foreign exchange liquidity (which could be exacerbated if debt repayment deferrals do not continue), limited access to international capital markets, slow reforms, and deteriorating balance sheets in major banks. Outmigration and labor shortages could threaten growth. Externally, subdued global and regional economic growth could weaken external demand. On the upside, successful bilateral debt restructuring agreements could result in lower debt servicing obligations and alleviate depreciation and inflation, thus in turn reducing the constraints on growth.

4. Policy Recommendations

Restoring macroeconomic stability requires a strong commitment to five critical reform areas: (i) raising public revenue to protect spending on education, health, and social protection; (ii) improving the governance of public and public-private investment; (iii) restructuring public debt; (iv) strengthening financial sector stability; and (v) improving the business environment to promote investment and exports. In addition, improving the availability, timeliness, and quality of data is essential for informing evidence-based policy making. Specific reforms are as follows:

(i) Raising public revenue to protect spending on education, health, and social protection

- **Review tax incentives and eliminate exemptions**
  Generous tax incentives deprive the country of vital fiscal revenues and foreign exchange. To better link incentives to investment, it is crucial that Laos moves from a profit-based to a cost-based tax incentive system. It also needs to rationalize incentive policies and reduce discretion when granting incentives. While the revised Investment Promotion Law was approved by the National Assembly in July 2024, secondary regulations are required to define clear approaches to fiscal incentives, and to strengthen the role of the Ministry of Finance. More importantly, the preferential taxes under the Investment License Agreement in the tobacco industry should be terminated immediately (see thematic chapter).

- **Reduce VAT exemptions.**
  Reducing and streamlining VAT exemptions, such as those for large-scale activities, would help widen the tax base. In the medium-term, VAT compliance can be improved by fully implementing the TaxRIS system, by

improving tax services and compliance incentives, by streamlining refund mechanisms, and through institutional and technical capacity building. Part of the additional revenue should be used to support the most vulnerable households through a targeted cash-transfer program, thereby mitigating the impact on poor households.

- **Reform excise tax structures and increase rates**
  Recent reductions in fuel excise rates have foregone large amounts of revenue. Restoration of the fuel excise would generate additional revenue, while reviewing the tax structure for tobacco, alcoholic beverages, and sugar-sweetened beverages would raise additional revenue and have positive health outcomes (See thematic section for more detail). This additional revenue could go towards healthcare, education, social protection and maintenance of infrastructure.

- **Reprioritize spending toward the social services**
  Reprioritizing public spending toward education, health, and social protection is critical for building human capital and thus improving economic growth prospects and reducing poverty in the medium term.

(ii) Improving the governance of public and public-private investment

- **Assess and manage contingent liabilities**
  Implementing a robust framework to assess, approve, monitor, and manage fiscal costs and risks related to public-private partnerships (PPP) and state enterprises would help limit the accumulation of direct and contingent liabilities. The planned upgrade of the decree on PPPs into a law provides an opportunity to incorporate good practice principles into the legal framework. This should be coupled with strengthening institutional capacity to prepare, procure, and manage PPP projects. In addition, it will be important to closely monitor expenditure arrears or payables that arise from public investment and recurrent spending in order to be fully aware of the implications on the budget.

(iii) Restructuring public debt

- **Expedite ongoing debt renegotiations and strengthen public debt management**
  Bringing ongoing bilateral debt negotiations to a successful conclusion in a substantive and transparent way would ease debt pressures, create fiscal space for growth-enhancing expenditure, and improve market confidence. In addition, it is critical that public debt management be strengthened by formulating a decree on implementation of the Public Debt Management Law that enhances the authority of the Ministry of Finance to manage the public debt, formulate a credible debt management strategy, and support capacity development.

(iv) Strengthening financial sector stability

- **Enhance bank supervision and operationalize emergency arrangements**
  Strengthening the deposit protection fund and employing an early warning system would help manage vulnerabilities in the financial sector. It is critical that regulations and procedures are put in place as the government may need to mobilize liquidity facilities and emergency liquidity assistance arrangements at very short notice.

(v) Improving the business environment to promote investment and exports

- **Improve the business environment**
  Creating a more conducive business environment by implementing electronic business registration processes, streamlining the operating licensing regime, and reducing and simplifying entry conditions would facilitate the entry and expansion of both domestic and foreign firms. In addition, trade would be facilitated by the streamlining of non-tariff measures and the promotion of electronic customs clearance.

5. Key Macroeconomic Indicators

	2020	2021	2022	2023	2024	2025
					Projections	
Real Economy	Percent change year-on-year					
Real GDP growth	0.5	2.5	2.7	3.7	4.1	3.7
Agriculture	3.2	2.3	1.6	2.4	3.0	3.0
Industry	4.0	7.6	3.3	2.5	3.7	3.1
Services	3.5	-2.1	2.5	5.5	5.0	4.5
Inflation (period average)	**5.1**	**3.8**	**22.7**	**31.2**	**24.2**	**19.2**
Fiscal Account	Percent of GDP					
Revenues	12.7	14.9	14.7	16.5	16.6	16.7
Domestic Revenues	11.2	12.9	13.6	14.7	14.9	15.1
Taxes	9.2	10.2	11.3	12.4	12.6	12.8
Non-tax	2.0	2.7	2.3	2.3	2.3	2.3
Grants	1.5	2.0	1.1	1.8	1.7	1.6
Expenditures	**18.0**	**16.2**	**15.0**	**15.8**	**17.5**	**17.8**
Current expenditure	11.5	11.0	10.6	10.5	12.1	12.3
Wages	6.2	6.0	5.4	4.7	5.3	5.4
Non-wage, non interest expenditure	3.8	3.8	3.4	3.7	3.7	3.8
Interest payment	1.5	1.2	1.8	2.1	3.1	3.1
Current expenditure without interest	10.0	9.8	8.8	8.4	8.7	8.9
Capital expenditure	10.0	6.5	5.2	4.4	5.3	5.4
Fiscal balance	**-5.2**	**-1.3**	**-0.2**	**0.7**	**-0.9**	**-1.1**
Primary balance	**-3.7**	**-0.1**	**1.5**	**2.8**	**2.2**	**2.0**
Public and publicly guaranteed debt	**76.0**	**92.9**	**130.9**	**115.9**	**108.3**	**118.3**
Selected Monetary Accounts	Percent change year-on-year					
Broad money	**16.3**	**24.0**	**36.9**	**33.3**		
Credit to the economy	**4.3**	**11.5**	**45.6 2**	**7.8**		
Balance of Payments	Percent of GDP					
Current Account Balance	**-5.9**	**-2.9**	**-1.7**	**-1.6**	**-3.0**	**-3.6**
Trade balance on goods & services	-1.3	1.7	-5.6	3.6	3.0	2.5
Gross international reserves	**1,821**	**1,737**	**1,480**	**1,677**	**1,942**	**1,981**
Months of G&S import cover	3.2	2.8	1.9	2.0	1.9	2.0
Memorandum items						
Nominal GDP (Billion kip)	171.7	182.6	217.1	279.5	332.8	383.1

Sources: Lao Statistics Bureau, Ministry of Finance, Bank of Lao PDR, Ministry of Industry and Commerce, World Bank Staff estimate, and projections based on inputs from Lao Authorities and trade partners' data as of 30 September 2024.

PART B

More Revenues, Better Health – Implementing Health Tax Reforms in the Lao PDR

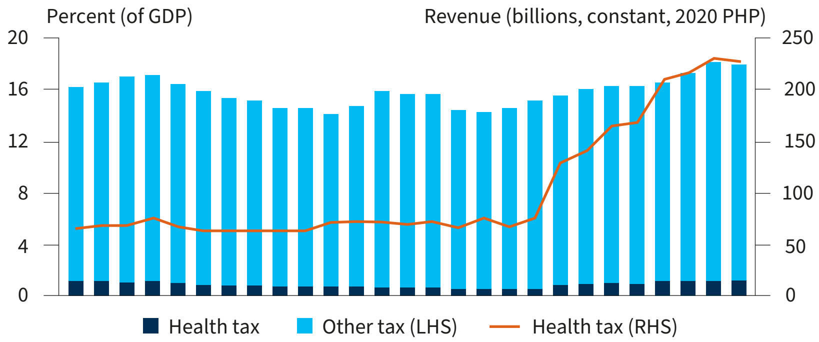
1. Context

The consumption of tobacco, alcohol and sugar-sweetened beverages (SSB) damages public health, and results in substantial economic loss in the form of lower productivity and higher health care expenditure.

Excise taxes on these products, often referred to as "health taxes", are government tools to increase the prices of these products and reduce their consumption in order to mitigate economic loss and raise revenues. Evidence based health taxes result in higher prices and healthier populations while generating important tax revenues, even in low-capacity tax administration environments. A review of scientific evidence reveals that a 10 percent increase in cigarette, alcohol, and sugar sweetened beverages prices leads to about 5 percent, 3 percent and 9 percent declines in demand for these products (Burton et al. BMC Public Health, 24:1286; 2024).[27] Health taxes are unlike other indirect taxes like VAT which are not able to change behaviour since they do not alter relative prices. Import tariffs do not serve the same purpose either, since they influence where something is produced rather than where it is consumed.

In the Philippines, higher alcohol and tobacco taxes have generated a dramatic increase in tax revenue since their introduction in 2012. When introduced with tax structure reforms, the health taxes contribution to total tax revenue increased from 1.4 percent to 2.2 percent (0.2 percent to 0.4 percent of GDP) for alcohol excise and from 2.0 percent to 4.2 percent (0.3 percent to 0.8 percent of GDP) for tobacco excise.

Figure 20: Alcohol and tobacco excise tax revenue in the Philippines, 1994–2020



Source: orld Bank 2023 Health Tax Knowledge Note: Unpacking the Empirics Behind Health Tax Revenue.

In most cases, SSB taxes generate significantly less revenue than do tobacco and alcohol taxes, averaging 0.07% of GDP. The lower magnitude of revenue is due to relatively lower tax rates and a more elastic price elasticity of demand. In the case of the UK, the implementation of SSB excise generated 334 million pounds (4.2 trillion kip) in the 2021/22 fiscal year. In South Africa, SSB tax generated 3.3 billion rand (2 trillion kip) in the 2018/19 fiscal year.

Health taxes are underutilized in Laos. They are generally applied to the producer price early in the supply chain and this practice reduces their effective value. Due to their low rates, health taxes do not act as a consumption deterrent. They also underperform as a source of revenue, despite their potential to bring additional tax revenue worth around 1 percent of GDP.

The tax reforms introduced on January 1, 2024 have had only marginal impacts both on revenue and public health. They focus on rate increases only, whereas the underlying tax structure also needs reform. In addition, the Investment License Agreement (ILA) with the tobacco industry renders the tax reform futile, since it exempts most of the tax base. As a result, the 2024 tax change was insufficient to counter the impacts of inflation resulting in a decline of the real excise tax revenue in the cigarette market (by 3 percent), and only a small increase in the real excise tax revenue from alcohol (by 3 percent) generating at best 0.054 trillion kip of new revenue, worth less than 0.02 percent of GDP.

[27] A Burton, R., Sharpe, C., Bhuptani, S. et al. The relationship between the price and demand of alcohol, tobacco, unhealthy food, sugar-sweetened beverages, and gambling: an umbrella review of systematic reviews. BMC Public Health 24, 1286 (2024). https://doi.org/10.1186/s12889-024-18599-3

Adopting structural reforms of health taxes consisting of a stronger role for specific tax, higher tax rates and applying taxes equally on all products could yield about 0.8 percent of GDP in additional tax revenue, doubling tax revenue from alcohol and tobacco in the first year of the reform. By 2027, the cumulative revenue gain would reach 1.3 percent of GDP.

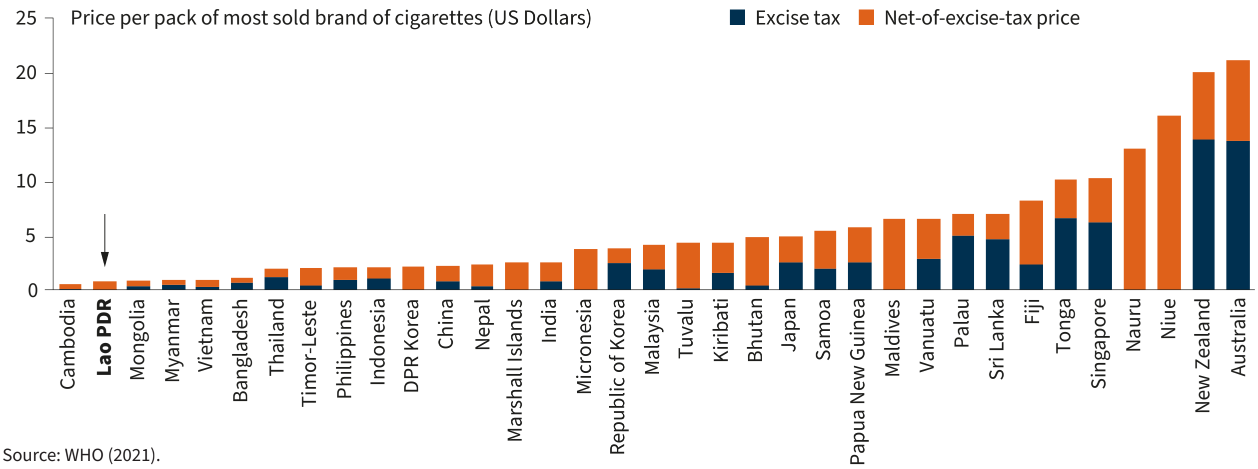
2. Assessment of Health Taxes

2.1 Tobacco Taxes

The use of tobacco is higher in Laos than in most Southeast Asian countries. More than 6,700 Lao people die every year due to tobacco-related illness, accounting for nearly 15 percent of all deaths in the country. Tobacco uses alone costs the economy about 2.3 percent of GDP through 240 billion kip in healthcare expenditure and 3.3 trillion kip in productivity losses.

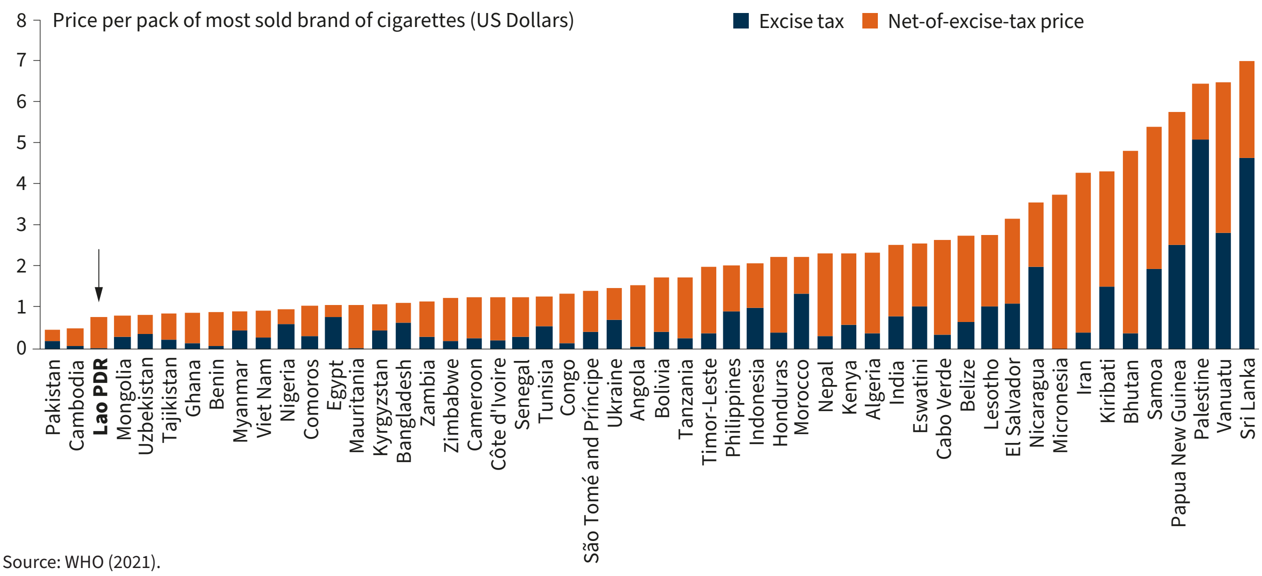
However, Laos has the second cheapest cigarettes out of 35 countries in the Asia-Pacific region (Figure 21). Figure 22 shows the price per pack to be dramatically lower than in most other lower-middle income countries.

Figure 21: Prices of most sold brand of cigarettes in Asia-Pacific region, 2020



Source: WHO (2021).

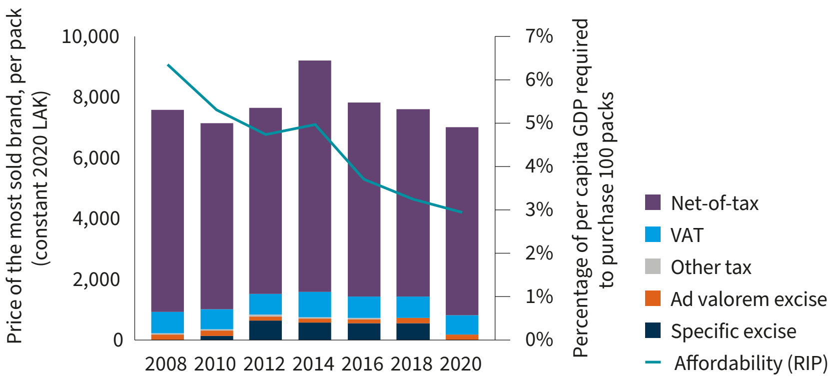
Figure 22: Prices of most sold brand of cigarettes in lower-middle-income countries, 2020



Source: WHO (2021).

The trends in cigarette prices and their affordability over time reflects the ineffectiveness of tax policy. The price of the most sold brand of cigarette in Laos between 2008 and 2020 with the price decomposed into the various tax and non-tax components in constant 2020 prices (Figure 23), shows an increase in real prices in 2014 in response to the Decree on the Tobacco Control Fund that imposed a specific tax of 200 kip per pack and 2 percent additional tax on the industry profit. However, this tax change, as well as the subsequent tax changes, had limited impact on cigarette prices in subsequent years, due to the Investment License Agreement (ILA) that grants the domestic industry preferential tax rates. Cigarette prices in Laos were twice as affordable in 2020 than they were in 2008 (Figure 23).

Figure 23: Price and affordability (right scale) of the most sold brand of cigarettes in Laos, 2008-2020



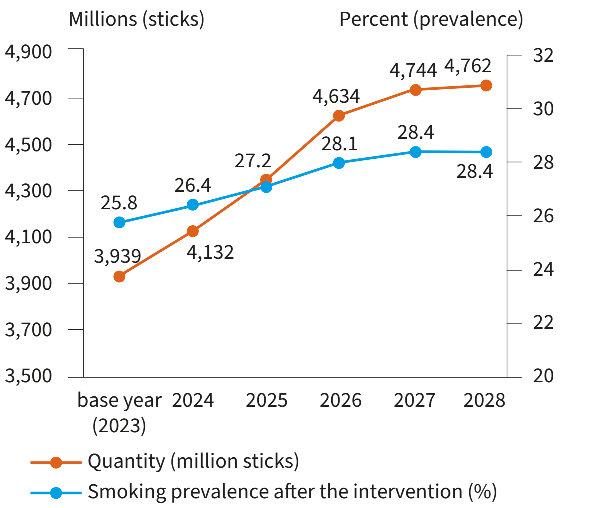
Source: World Bank GTP estimates using WHO (2021) and World Bank World Development Indicators data.

A key challenge in implementing tobacco taxes in Laos is the Investment License Agreement that exempts the tobacco industry from the application of the tax law, establishing a complex tax structure and a low tax rate. The current tax law calls for a 72 percent cigarette excise tax rate applied on value early in the supply chain, thus leaving a narrow tax base. This results in low effective tax (i.e. tax paid in kip). In addition, the industry (both firms covered and not covered by the ILA) is allowed to use a substantially reduced rate of 15 percent if the production cost is less than 1,500 kip per pack of cigarette 20 units, and 30 percent if production cost is either equal to or more than 1,500 kip per pack of cigarette 20 units. Moreover, companies do not comply with the specific tobacco tax of 600 kip per pack, citing the ILA. Such tax advantages, the presence of a tiered system and the use of an incorrect tax base result in low prices and small tax revenue while inviting tax avoidance and tax evasion.

Even though the government receives dividends thanks to the ILA, these values are dwarfed by the tax revenue foregone due to the ILA. For example, in 2022, the dividends and the royalties generated from the ILA reached 65.3 billion kip or $ 5.9 million, about 12.2 percent of the excise revenue foregone due to the ILA. In other words, government revenue would be at least 535.3 billion kip higher without the ILA (World Bank analysis using MoF data on income from tobacco industry, 2024).

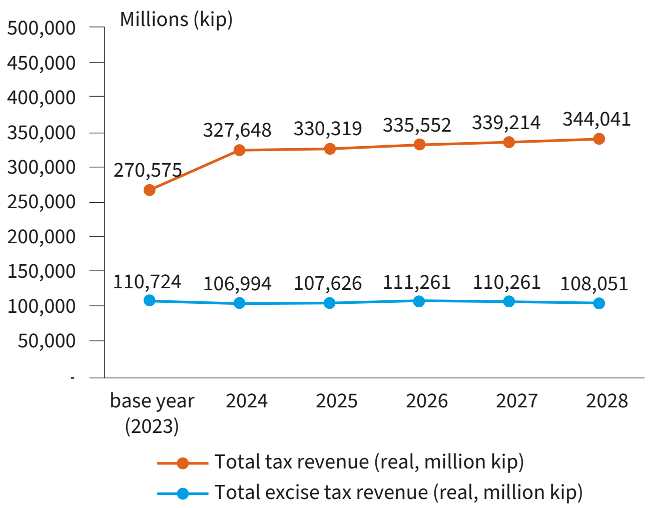
The presence of the ILA renders tobacco excise tax increases futile. For example, the recently adopted excise tax increases effective from January 2024, resulted in a very small tax increase applicable only to official imports. From 2023 to 2024, our model predicts a decline of 3 percent in real excise tax revenue while the total tax revenue goes up thanks mainly to the return of VAT to 10 percent (Figure 25). With no other tax policy changes, cigarette sales and smoking prevalence will keep increasing (Figure 24).

Figure 24: Cigarette sales and smoking prevalence in Lao PDR, 2023-2028 (status quo)



Source: World Bank GTP estimates based on Tax model developed for Lao PDR.

Figure 25: Total and excise tax revenue in Lao PDR (status quo)



Source: World Bank GTP estimates based on Tax model developed for Lao PDR.

The proposed health excise tax reform is based on simplifying tax structures and increasing rates moving towards international best practice (Table 2). Tax tiers need to be removed since cheaper cigarettes do not cause less harm than expensive ones. The result will be a mixed tax structure with heavy reliance on the specific tax, which is a fixed value that accounts for harmful ingredient in a product. The specific rates need to be increased annually and adjusted for inflation and income growth, so they become much less affordable and catch up with the prevailing tax rate in the region. Even after the proposed reform, the price of a cigarette pack will be the second cheapest in the East Asia & Pacific region using the 2022 data. The lowest price would be in Cambodia, but that is unlikely since Cambodia approved a substantial overhaul of its excise tax regime, scheduled to be implemented in 2025. This means that even the proposed tax reform is quite conservative providing the government with space for raising the tax rates even higher as needed.

Table 2: Cigarettes–proposed health tax reforms

	Cigarettes
Structure	Keep the existing mixed system, ensure that the ILA does not automatically renew in 2026.
Rate	**Ad valorem–**72 percent (as of Jan 1, 2024) **Specific–**Start with 800 kip per pack (600 kip excise tax + 200 kip to TCF) Increased by 800 kip annually at least until 2028. Applying tax stamp fee 500 kip per pack on all packs. ***Plus adjust all specific components annually for inflation and income growth***
Base	Volume for the specific tax, producer price for ad valorem tax

Source: World Bank GTP proposal.

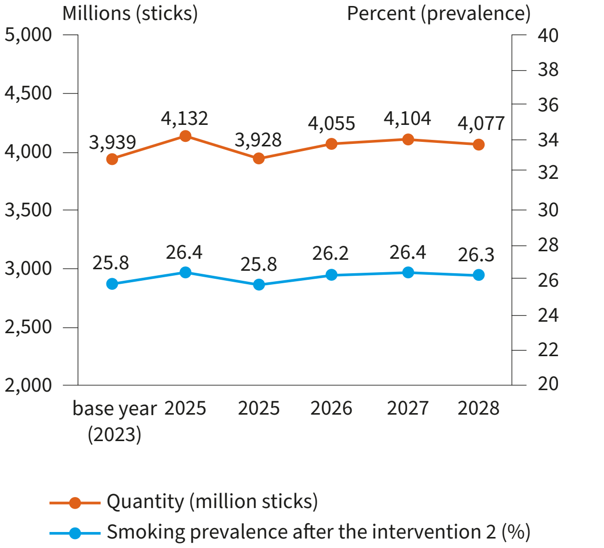
As soon as the new tax policy is firmly in place, the tax base of the ad valorem tax should move from production costs to retail prices, since it will lead to further reduction in smoking prevalence and additional tax revenue while being significantly easier to monitor and enforce. These recommendations are a conservative reform compared to the regimes in lower-middle-income countries where, for example, the median excise tax per cigarette pack was 8,000 kip in 2020.

These reforms would generate additional revenue and improve health outcomes. Figures 26 and 27 show the impact of the proposed health tax reform if implemented in 2025 on cigarette sales, smoking prevalence and tax revenue. The reform will manage to keep cigarette and smoking prevalence constant over time- a reverse of the current upward trend (Figure 26), which will also help to reduce health expenditure. The tax revenue (both excise and total) will be substantial. The predicted excise tax revenue is projected to quadruple in the first year of the reform (Figure 26). This is the impact of both removing the ILA and the increase in tax rates in 2025. The total revenue gain in 2025 represents about 0.24 percent of GDP.

This highlights the dual impact of excise taxes: this fiscal tool both controls the consumption of harmful products (cigarettes) and generates substantial tax revenue. This is possible due to the relatively inelastic nature of cigarette demand and the fact that the impact on consumption is concentrated among low-income users. Therefore, those who will continue to smoke cigarettes after a tax/price increase will be disproportionally those who are better off (i.e. those less price sensitive). The higher tax revenue will be primary fuelled by higher income groups.

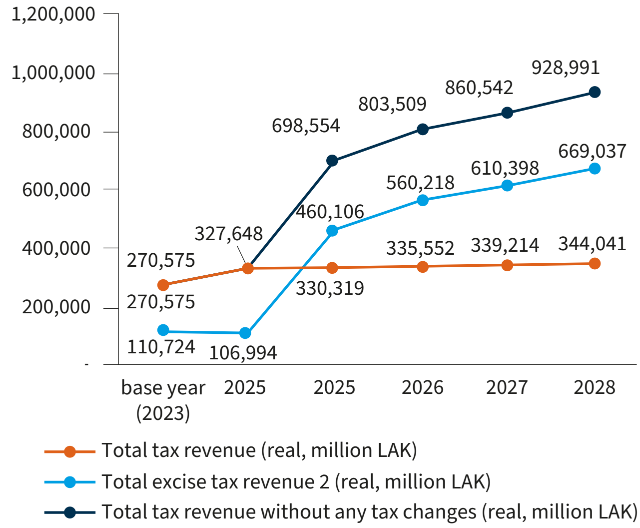
The current model uses a price elasticity of -0.4 for the premium and mid-price cigarette segment, and the price elasticity of -0.6 for the economy cigarette segment. These elasticities are from the literature on price responsiveness in LMICs since they do not exist for Laos due to data limitation.

Figure 26: Cigarette sales and smoking prevalence in Lao PDR, 2023–2028 (proposal)



Source: World Bank GTP estimates based on Tax model developed for Lao PDR.

Figure 27: Total (excise + VAT) and excise tax revenue in Laos, 2023–2028 (proposal)



Source: World Bank GTP estimates based on Tax model developed for Lao PDR.

2.2 Alcohol Tax

Mortality and morbidity in Laos due to alcohol use are higher than those in other lower middle- income countries (LMICs) and in Southeast Asia. Using globally comparable data (GBD, 2019), the consumption of alcohol causes over 33 deaths and the loss of 1,424 Disability Adjusted Life Years (DALYs) per 100,000 people in Southeast Asia. Even though DALYs lost attributable to alcohol use were falling in Laos until around 2010, this decline has stopped, and recently gone into reverse. The growing burden of alcohol use is part of the health transition from communicable to non-communicable diseases.

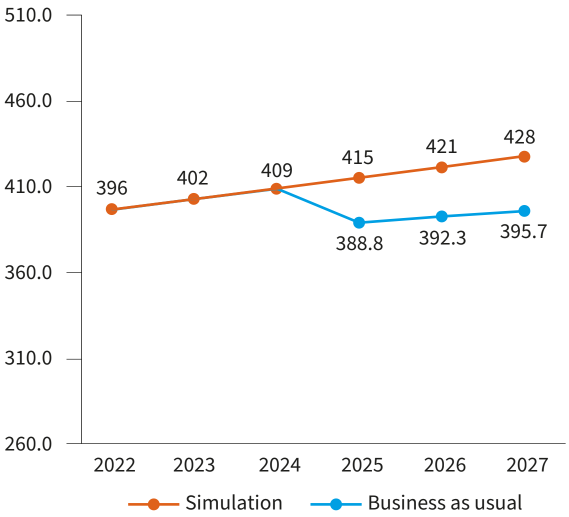
Currently, alcohol taxes in Laos are ad valorem applied to the ex-factory price (i.e., early in the supply chain) for domestically produced goods and the cost, insurance and freight value for imported goods.[28] Beers are charged at either 60 or 70 percent depending on alcohol content, while other alcoholic beverages are charged at 72, 90 or 110 percent depending on the alcohol content. For both beer and spirits, the higher the alcohol content the higher the rate. The challenges posed by the ad-valorem tax structure are nearly identical to those for tobacco, and result in lower prices, greater incentives for consumers to trade down to cheaper alcohol, incentives for firms to under shift tax increases (i.e. increase prices by less than the tax increase) and opportunities for tax evasion.

Specific taxes are preferable to ad valorem taxes and it is recommended that Laos reform its tax structure to adopt a specific tax. The World Bank recommends the initial use of a uniform volumetric specific tax structure for each alcohol type (beer, wine, spirits). Tiers should be removed to aid tax administration. Once the new tax policy is firmly in place, a simple alcohol-strength tax tier structure could be considered since this will further reduce the amount of pure alcohol consumed. The proposed excise tax on beer is the same as that currently applied in Viet Nam.

Recent tax increases have not had significant impacts on revenue or alcohol use. Figures 28 and 29 demonstrate that the recent excise tax increases effective from January 2024 have had a negligible impact on alcohol consumption and alcohol tax revenue ("business as usual" scenario), but that the proposed one-time tax increase described in Table 2 can both reduce alcohol consumption and substantially increase tax revenue ("simulation" scenario). The excise and total tax revenue from alcohol would increase by 60 percent and 43 percent in real terms in 2025, respectively. The reform would generate 0.43 percent of GDP in additional revenue while reducing the harmful impact of alcohol use. Given its sales volume, most of this revenue would come from beer.

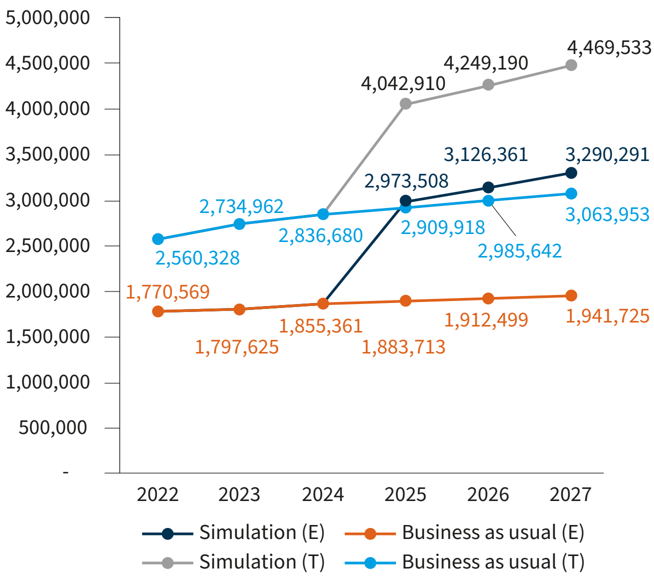
Similarly to the case of tobacco, the simulation demonstrates the dual impact of excise taxes: higher alcohol excise tax together with an improved tax structure reduces the consumption of alcohol and generates substantial tax revenue. This is possible due to the relatively inelastic nature of alcohol consumption. In this model, a price elasticity of -0.6 is used for all alcohol types in the absence of local evidence for price elasticity by alcohol types.

Figure 28: Alcohol sales (million liter)



Source: World Bank GTP estimates based on Tax model developed for Lao PDR.

Figure 29: Alcohol Excise (E) and Total (T) tax revenue (million kip, real)



Source: World Bank GTP estimates based on Tax model developed for Lao PDR.

[28] Note that one company uses ex-factory plus marketing and promotion costs as the base

Table 3: Alchohol–proposed health tax reforms

	Alchohol
Structure	Change to uniform volumetric specific tax by alcohol types *Remove tiers based on alcohol content to simplify tax administration*
Rate	Start with beer at 9,000 kip per liter; Wine at 70,000 kip per liter; Spirits at 72,000 kip per liter. *Plus adjust annually for inflation and income growth*
Base	Volume of beer, wine, and spirits

Source: World Bank GTP proposal

3. Policy Recommendations

Critical changes to the tax structures on alcohol, tobacco, and non-alcoholic beverages are needed to bring Laos in line with global best practice. Until these changes occur and the ILA ends, raising rates alone will not be sufficient to generate health and revenue gains.

The ILA with the tobacco industry, which is scheduled for automatic renewal in 2026 for 25 years, should be terminated immediately. The exemptions and privileges in the ILA lead to major losses of revenue and hamper the ability of the government to collect tobacco taxes.

The proposed tax reforms would generate additional tax revenue of 2,225 billion kip (~0.78 percent of GDP) within the first year and are summarized in Table 4.

Table 4: Proposed health tax reforms

	Cigarettes	Alchohol
Structure	Keep the existing mixed system	Change to uniform volumetric specific tax by alcohol types *Remove tiers based on alcohol content to simplify tax administration*
Rate	**Ad valorem–**72 percent (as of Jan 1, 2024) **Specific–** 800 kip per pack (600 kip excise tax + 200 kip to TCF); increased by 800 kip annually. Tax stamp fee -500 kip per pack *Plus adjust all specific components annually for inflation and income growth*	Start with Beer at 9,000 kip per liter; Wine at 70,000 kip per liter; Spirits at 72,000 kip per liter. *Plus adjust annually for inflation and income growth*
Base	Volume for the specific tax, producer price for ad valorem tax	Volume of beer, wine, and spirits
Tax revenue potential in one year	**683 billion kip**	**1,542 billion kip**

Source: World Bank GTP proposal *Note: Additional tax revenue (excise plus VAT, nominal)

The proposed tax reform is in line with the National Socioeconomic Development Plan Financing Strategy and The National Agenda on Addressing Economic and Financial Difficulties. The proposed policy is conservative - compared to tax rates in lower-middle-income countries where, for example, the median excise tax per cigarette pack was 8,000 kip in 2020. The average excise per cigarette pack in Lao PDR was 476 kip in 2023. The recommended excise tax on beer is the same as currently applied in Viet Nam. In addition, the reform has the potential to prevent close to 50,000 premature deaths.

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