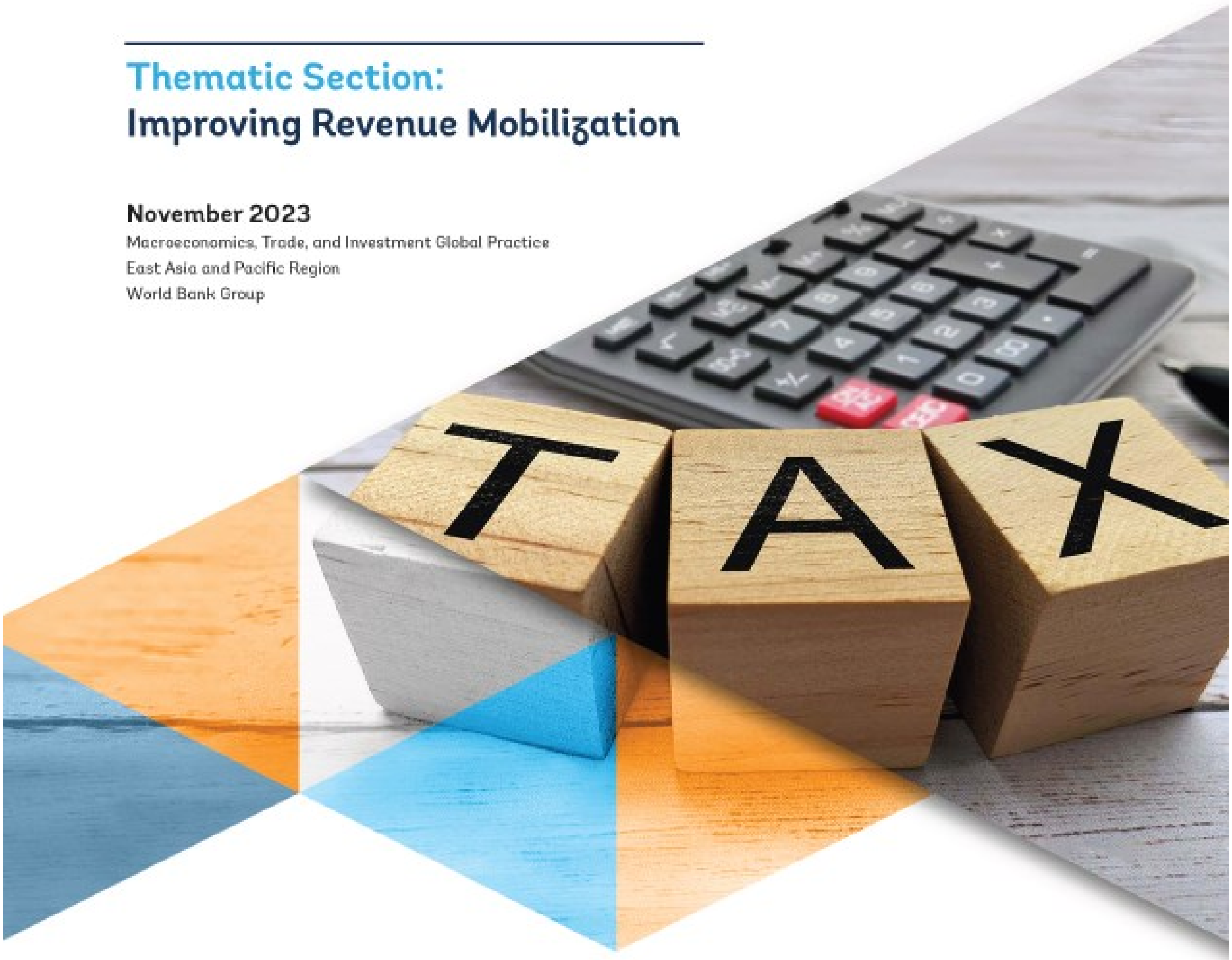
LAO PDR ECONOMIC MONITOR

Fiscal Policy for Stability

Thematic Section:
Improving Revenue Mobilization

November 2023

Macroeconomics, Trade, and Investment Global Practice
East Asia and Pacific Region
World Bank Group



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Acknowledgments

The *Lao PDR Economic Monitor November 2023* was prepared by a team led by Keomanivone Phimmahasay (Economist), Pedro Martins (Senior Country Economist) and Somneuk Davading (Senior Economist). This report comprises two parts. *Part A: Recent Economic Developments and Outlook*, was authored by Keomanivone Phimmahasay (Economist), Pedro Martins (Senior Country Economist), Somneuk Davading (Senior Economist), and Tanida Arayavechkit (Senior Economist). *Part B: Improving Revenue Mobilization* was authored by Pedro Martins (Senior Country Economist) and Viet Anh Nguyen (Senior Public Sector Specialist). The team received useful inputs from Konesawang Nghardsaysone (Economist), Ergys Islamaj (Senior Economist), Kim Alan Edwards (Program Leader), Michael Corlett (Senior Financial Sector Specialist), Vidaovanh Phounvixay (Financial Sector Specialist), Alounny Vorachakdaovy (Consultant) and Phetnidda Ouankhamchan (Consultant). We gratefully acknowledge the production and dissemination assistance provided by Boualamphan Phouthavisouk (Team Assistant) and Aiden Glendinning (External Affairs Officer).

The team worked under the guidance of Mariam Sherman (Country Director), Alex Kremer (Country Manager), and Sebastian Eckardt (Practice Manager, EEAM1).

The team would like to express its gratitude to the Government of the Lao PDR, particularly the Ministry of Finance, Bank of the Lao PDR, Ministry of Planning and Investment (including the Lao Statistics Bureau), Ministry of Industry and Commerce, Ministry of Energy and Mines, Lao Academy of Social and Economic Sciences (Macroeconomic Research Institute), line ministries, the Lao National Chamber of Commerce and Industry, several business associations, businesses and banks for sharing their valuable views and inputs.

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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Table of Contents

FIGURES

TABLES

Executive Summary

Part A: Recent Economic Developments and Outlook

Despite persistent macroeconomic instability, economic growth continued to recover in 2023, underpinned largely by a steady improvement in the service sector. GDP growth is forecast at 3.7 percent in 2023, slightly down from the projection in May 2023, primarily reflecting higher-than-expected kip depreciation and inflation, labour shortages, and unfavourable weather. Nevertheless, growth is still expected to have picked up in 2023, when compared to 2.7 percent in 2022, owing to tourism, transport and logistics services, and foreign investment. However, merchandise export growth has been muted, partly affected by higher business costs, labor shortages, and lower external demand.

The Lao kip continued to depreciate in 2023, driven by debt pressures and external imbalances. On the official market, the kip weakened by 30 percent and 35 percent on average against the Thai baht and the US dollar during January-October 2023, if compared to the same period last year. As banks continue to ration access to foreign currencies at the official rate, the parallel market premium has risen to about 15 percent for the US dollar and 8 percent for the Thai baht. While the US dollar has strengthened over the past few years, domestic structural imbalances have played a much greater role in driving depreciation. The large external debt service burden (despite deferrals of principal and interest payments) and rising imports continue to exert pressure on forex demand, while official reserves remain low. Recent monetary and foreign exchange management measures have included increases in the policy rate, reserve requirements, issuance of kip savings bonds, closure of foreign exchange bureaus, implementation of repatriation requirements for exporters and increased official exchange rate flexibility. However, since these measures are not addressing the root causes of depreciation, they have had only a limited and temporary impact in easing exchange rate pressures.

Kip depreciation has in turn fed continued consumer price inflation. On average, a 1 percent depreciation of the kip increases consumer prices by 0.5 percent. Therefore, inflation will remain high to the extent that depreciation pressures in the official and parallel markets persist. While the international prices of some imported goods eased, domestic inflation remained high at 26 percent in the year to November 2023. Food price inflation reached 26 percent, severely affecting poor households in rural and urban areas. Core inflation reached 26 percent in the same period.

Real household incomes have suffered from rising living costs. In a rapid phone survey with households conducted in June 2023, 54 percent of respondent households reported that their nominal income had remained stable or declined, implying a significant fall in real incomes. Households have coped with high inflation by scaling up food production, foraging, and reducing consumption. Half of the respondents spent less on health and education, which, coupled with lower public investment in these sectors, is undermining human capital accumulation and thus medium-term growth prospects.

Workers have migrated both domestically and internationally to seek higher wages and better employment opportunities. Labour shortages are due to significant outmigration in search of better jobs in Thailand, with an estimated 400,000 regular and irregular migrants crossing the border. Around 80 percent of these were previously working in manufacturing and services in Laos. Higher wages and better employment opportunities are the main reasons for migration. Despite the minimum wage in Laos rising to 1.6 million kip (about $79 per month) in October 2023, the Thai minimum wage is about three times higher.

Fiscal consolidation has been driven by expenditure tightening and more recently by some pickup in domestic revenue mobilization. Revenue collection was supported by higher economic activity and price effects that offset reductions in the value-added tax and fuel excise rates. The government has recently raised excise rates on vehicles, alcohol, and tobacco, and has introduced or raised export duties. In the meantime, it continues to tighten public expenditure, particularly capital spending. As a result, primary and fiscal surpluses were recorded in the first half of 2023. Nonetheless, gross financing needs remain considerable, owing to high external and domestic debt service obligations. Limited fiscal space has constrained the government's ability to invest in human capital.

Public and publicly guaranteed (PPG) debt remains at critical levels, undermining macroeconomic stability and development prospects. Laos is facing both solvency and liquidity challenges due to significant financing needs, limited financing options, low foreign exchange reserves, and considerable depreciation pressures. The PPG debt stock was estimated at 112 percent of GDP at the end of 2022. If domestic expenditure arrears and a currency swap are included, the PPG debt stock increases to about 125 percent of GDP. The energy sector, primarily through Electricité du Laos (EDL), has been a significant driver of debt accumulation, accounting for about 45 percent of external PPG debt in 2022 (45 percent of GDP). China accounted for about half of the external public debt stock in 2022 and for about half of external debt repayments scheduled for 2024–2027.

Debt service deferrals have provided short-term liquidity support, but future arrangements are uncertain. Deferrals of principal and interest owed to China amounting to about $2 billion (over 15 percent of 2023 GDP) have provided temporary relief between 2020 and 2023.[1] The ratio of debt service (i.e., principal and interest) to domestic revenue increased from 35 percent in 2017 to 43 percent in 2022, but it would have reached 72 percent in the absence of deferrals. Meanwhile, combined public spending on education and health has declined from 4.9 percent of GDP in 2013 to an estimated 2.3 percent in 2023.[2] Contingent liabilities arising from state-owned enterprises (SOEs) and public-private partnerships (PPPs) are a major source of fiscal risks. Limited external financing options will likely increase pressure on domestic financing sources and the exchange rate.

External imbalances remain high amid strong demand for imports and external debt service payments. Official statistics indicate that a current account surplus of almost $400 million was recorded in the first half of 2023 due to an improved services trade balance and lower net income payments. Tourism, transport and logistics services have contributed to a trade surplus, while overall merchandise exports were muted. Net income payments remained high, despite debt service deferrals. Although official statistics show an improvement in the current account surplus, when using trade partner statistics, which include imports under-recorded in Laos, the current account balance would be lower. Capital inflows remain limited, and access to international capital markets has been further restricted after a credit rating downgrade by a Thai rating agency in September. Moreover, only about 40 percent of export receipts enter the domestic banking sector, depriving the economy of vital foreign exchange.[3] Official reserve levels increased in June 2023 but remain inadequate.

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[1] The GDP ratio conservatively assumes that the current official exchange rate of about 20,000 kip per US dollar (October 2023) remains unchanged as of December 2023.
[2] Estimate for 2023 is based on Ministry of Finance 2023 Budget Plan.
[3] Bank of the Lao PDR reporting to the National Assembly in October 2023.

Economic growth is projected to gradually accelerate to an average of 4.2 percent in the medium term, led by the services sector and exports. This outlook assumes that the debt service deferrals accumulated between 2020-2023 continue into the medium-term. Economic growth is expected to benefit from a continued recovery in the services sector. External demand, coupled with improved logistics services and connectivity, is expected to help sustain some manufacturing and agriculture exports. The industry sector may also benefit from investments in the power sector and special economic zones. However, growth will be weighed down by structural weaknesses. Depreciation pressures are likely to persist, owing to high import demand, large debt service obligations, and the limited availability of foreign currency. Inflation is expected to remain in double-digits in 2024, partly due to continued depreciation pressures and high commodity prices. Addressing structural imbalances such as low foreign currency reserves, low revenue collection and a high debt burden would help restore macroeconomic stability and accelerate growth.

Household real incomes will likely be affected if inflation persists. The slow progress in poverty reduction is expected to continue, with per capita income growth likely to remain below pre-pandemic and regional peer levels in the medium term. This could cause greater divergence on poverty reduction and living conditions.

Debt levels will continue to constrain fiscal space in the absence of a debt restructuring agreement. Domestic revenue as a ratio to GDP is expected to increase slowly, supported by tax policy reforms and tax administration improvements. Grants as percent of GDP are expected to decline gradually as some donors phase out programs. Non-interest expenditure is likely to remain constrained due to pressures from large interest payments. The fiscal deficit is expected to rise, while the primary balance (excluding interest payments) is projected to remain in surplus in the medium term. Gross public financing needs will remain high due to substantial debt service obligations, averaging $1.3 billion per year over 2024 – 2027. While past deferrals have provided important liquidity support, there is a high degree of uncertainty on how they will affect the future repayment profile. Therefore, a successful conclusion to ongoing debt renegotiations and higher domestic revenue mobilization will be the key to restoring macroeconomic stability and creating fiscal space for critical growth-enhancing spending.

External imbalances are expected to persist, and thus continue to put pressure on the exchange rate. The current account deficit is expected to remain at around 3 - 4 percent of GDP as improvements in exports, tourism, and remittances are offset by higher import demand and interest payment obligations. External imbalances would continue to add to depreciation pressures.

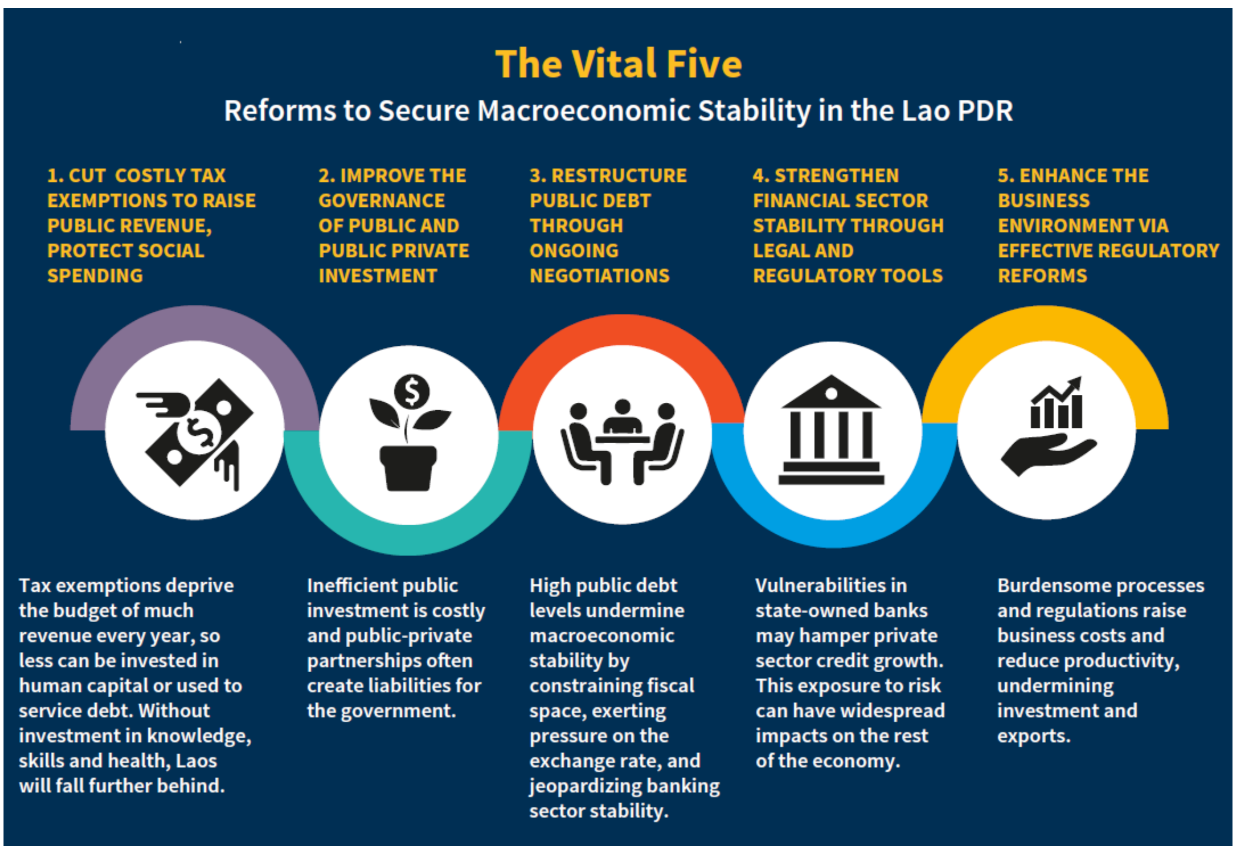
The outlook is subject to significant domestic and external uncertainty. Externally, subdued global and regional growth could lower external demand. Further financial tightening in advanced economies to address inflation could amplify depreciation pressures on the kip. Escalated geopolitical tensions could impact global commodity prices, which would also translate into domestic inflation. Domestic risks include further loss of foreign exchange liquidity due to external debt service obligations, slow progress with structural reforms, and a deterioration of bank balance sheets. In particular, the outcome of ongoing debt renegotiations with key creditors will have significant implications for both debt sustainability and macroeconomic stability. Delayed, untransparent and/or inadequate debt treatment could exacerbate instability and lead to prolonged expenditure curbs that will harm medium- and long-term growth prospects. Labor shortages due to out-migration could also undermine the recovery prospects of labor-intensive sectors, including agriculture, manufacturing, and services. Climate shocks such as El Nino could also hamper economic recovery.

Table 1. Summary of Key Economic Indicators

	2019	2020	2021	2022	2023	2024	2025
						Projections	
Real GDP growth	5.5	0.5	2.5	2.7	3.7	4.1	4.3
Inflation (period average)	3.3	5.1	3.8	22.7	31.4	15.2	8.5
Fiscal balance	-3.3	-5.2	-1.3	-0.2	-0.2	-1.6	-1.5
Current account balance	-12.1	-5.9	-2.9	-2.4	-2.9	-3.6	-3.7

Source: 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 October 2023.

Restoring macroeconomic stability requires a strong commitment to ambitious reforms in five crucial policy 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. Finally, while domestic reforms are critical, they are not sufficient to restore fiscal and external sustainability without addressing the underlying solvency issues through adequate debt treatment.



Part B: Improving Revenue Mobilization

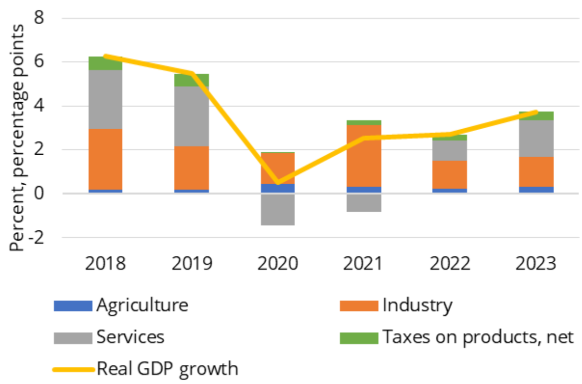
Improved domestic revenue collection is fundamental to supporting macroeconomic stability and creating fiscal space for growth-enhancing spending. For most of the 2010s, low revenue performance resulted in high fiscal deficits, despite expenditure tightening. In recent years, fiscal consolidation has been achieved through tight expenditure controls and interest payment deferrals. High fiscal deficits and large investments in infrastructure (often funded by government on-lending and guarantees) have led to significant external public debt accumulation. Low revenue collection constrains fiscal space for investing in basic public services (e.g., health, education, and social protection), especially in a context of growing debt service repayments. Moreover, generous tax exemptions, especially for large foreign investors, compound profit repatriation and add pressure on the exchange rate and hence to inflation (see discussion in Part A). Therefore, improved tax policy and tax administration are needed to boost revenue mobilization and thereby increase the fiscal space for growth-enhancing spending.

Revenue performance was a concern even before COVID-19, and revenue levels are low by regional and income standards. Total revenue declined from 22 to 16 percent of GDP during 2014–2019, owing to declines in tax collection and foreign grants. It subsequently dropped to 13 percent of GDP in 2020, affected by the COVID-19 pandemic, but recovered to 15 percent in 2022, partly supported by inflation. Revenue performance is low compared to regional and income peers. In 2022, almost 80 percent of total revenue was collected through taxes, while non-tax revenues accounted for 16 percent and grants for 6 percent.

Improved revenue mobilization could be achieved by: (i) restoring the VAT rate to 10 percent to immediately and efficiently raise considerable revenue; (ii) revising the Law on Investment Promotion to curb tax incentives and broaden the tax base; (iii) reforming excise tax structures and increasing rates, particularly on beverages, tobacco, and fuel, and (iv) strengthening tax administration and compliance risk management by focusing on the administration of large taxpayers.

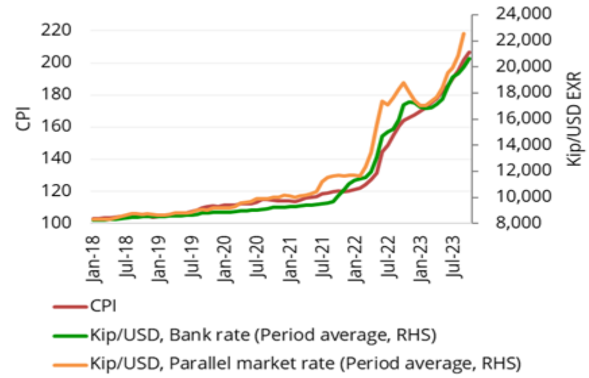
Lao PDR: Key Macroeconomic Indicators at a Glance

Growth has benefited from a steady recovery of the services sector,



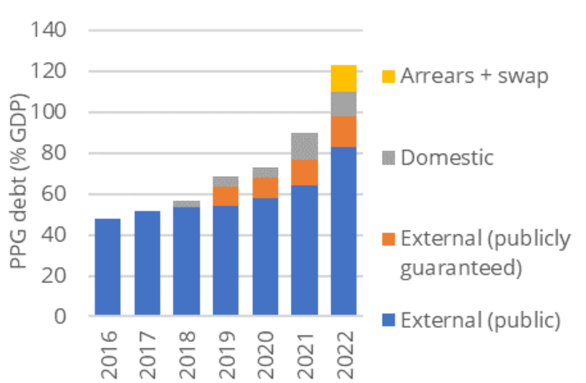
Sources: Lao Statistics Bureau and World Bank staff estimates.

Inflation has been largely driven by the depreciation of the Lao kip.



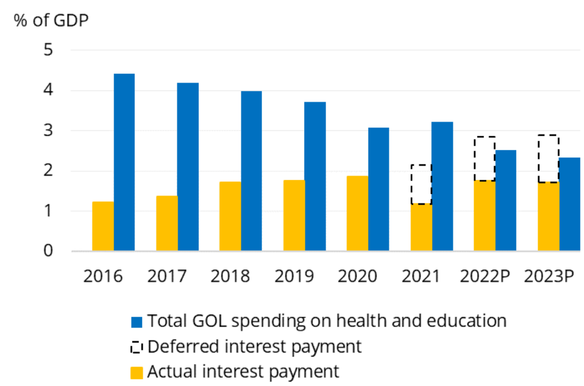
Sources: Lao Statitics Bureau and Bank of the Lao PDR

A growing public debt burden is fuelling macroeconomic uncertainty.



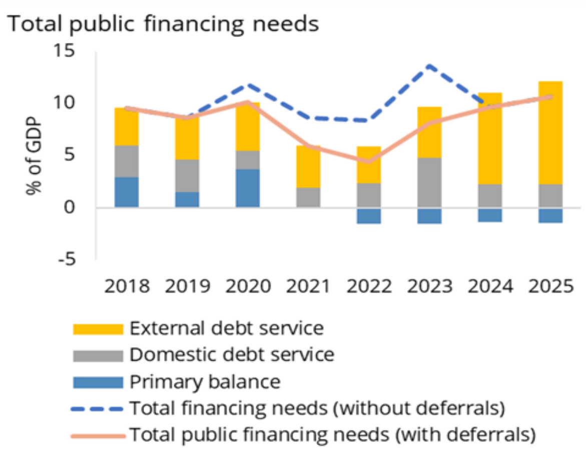
Sources: World Bank staff estimate based on MOF data

Limited fiscal space is constraining public spending on education and health



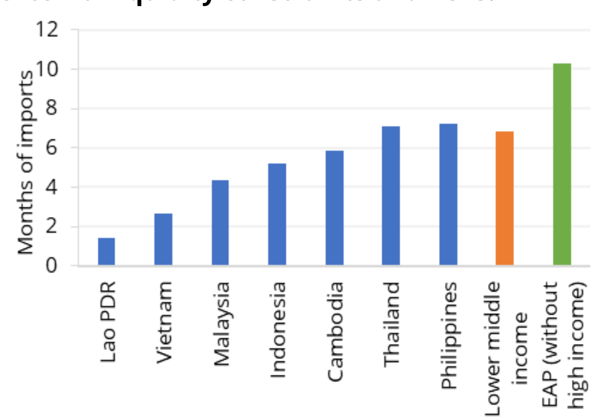
Source: Ministry of Finance and World Bank staff calculations.

Public financing needs remain high despite debt service deferral



Sources: Ministry of Finance, World Bank staff estimate.

Limited foreign reserve adequacy implies acute external liquidity constraints and risks.



Sources: Bank of the Lao PDR, International Monetary Fund Interntaional Financial Statistics.

Abbreviations

CAR	Capital adequacy ratio
CIT	Corporate income tax
EAP	East Asia and Pacific
EDL	Electricité du Laos
ELA	Emergency liquidity assistance
EMDE	Emerging market and developing economies
FDI	Foreign direct investment
ILA	Investment licensing agreement
NPL	Non-performing loans
NTM	Non-tariff measures
PPG	Public and publicly guaranteed
PPP	Public-private partnership
REER	Real effective exchange rate
SME	Small and medium enterprises
SOE	State-owned enterprise
VAT	Value-added tax

All dollar ($) amounts are US dollars unless otherwise indicated.

PART A

Recent Economic Developments and Outlook

1. Regional Economic Context

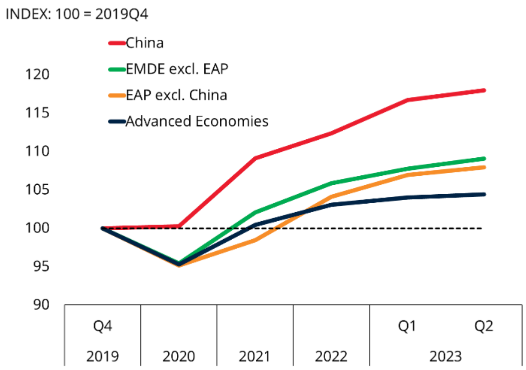
Economies in East Asia and Pacific have recovered

Economic activity in most developing East Asia and Pacific (EAP) countries has recovered from the pandemic shock. While output has surpassed pre-pandemic levels in most of larger EAP economies, recovery has been uneven across the region. The EAP region (without China) achieved stable growth in the first and second quarters of 2023 at an estimated 1.0 percent (q/q) amid weak external demand and moderating private consumption. China's economy slowed to 0.8 percent (q/q) in the second quarter of 2023, after growing by 2.2 percent (q/q) in the first quarter (Figure 1). The recovery of the EAP region benefitted from private consumption, although gradually winding down. Exports of both manufactured goods and commodities have contracted. Public investment and private investment also remain low.

Inflation had been declining across the EAP region, due to lower commodity prices, easing supply constraints and decelerating domestic demand. However, inflation ticked up in August as energy prices increased slightly and fed into higher transport costs, and food costs increased in some countries. Laos continued to suffer from high inflation compared to regional peers, largely due to sharp kip depreciation (Figure 2). To tackle inflation, policy rates in the EAP region have been raised starting in late 2022 but remain lower than in other emerging market and developing economies (EMDEs). Authorities appear to be balancing the need for monetary policy support against the risks of continuing inflation. China and Vietnam have reduced their rates in response to declining inflation and weaker growth. Meanwhile, fiscal policy is also less expansionary than in the last two years in most EAP countries as governments have reduced spending on COVID-19 support programs (Figure 3).

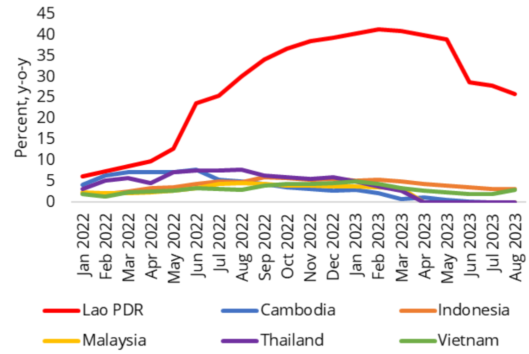
Economic growth in the EAP region is expected to remain robust in 2023-24, although lower than earlier projections. The EAP region is projected to grow by 5.0 percent in 2023, driven by China growth (5.1 percent in 2023 from 3.0 percent in 2022) while the rest of the region is projected to slow in 2023 (4.6 percent in 2023 from 5.8 percent in 2022). Regional growth is projected to moderate slightly to 4.5 percent in 2024, driven by a deceleration in China. Growth in China is projected to slow to 4.4 percent in 2024, as the bounce back from the re-opening of the economy fades and internal problems (such as elevated debt, weaknesses in the property sector, and structural factors) weigh on growth. Growth in the rest of the region is expected to edge up to 4.7 percent in 2024, as easing global financial conditions and the recovery in the global economy offset the impact of slowing growth in China.

Figure 1. Regional GDP growth



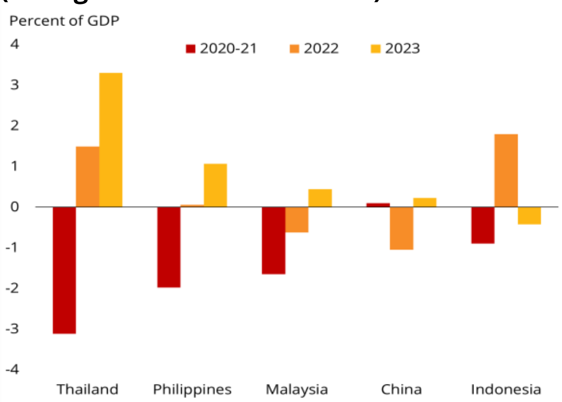
EAP: East Asia Pacific; EMDE: emerging markets and developing economies
Source: World Bank EAP Economic Update October 2023.

Figure 2. CPI inflation



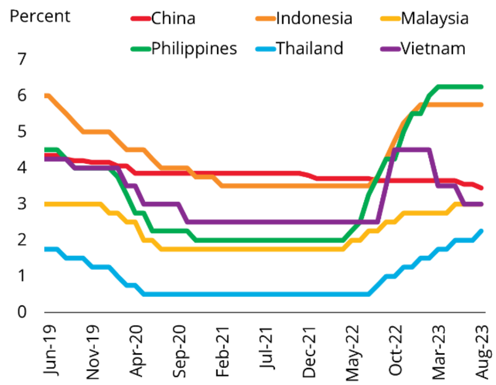
CPI: Consumer price inflation
Source: World Bank EAP Economic Update October 2023.

Figure 3. Less expansionary fiscal policy in 2023 (Change in structural balance)



Source: World Bank EAP Economic Update October 2023.

Figure 4. Tightened monetary policy, except in China and Vietnam



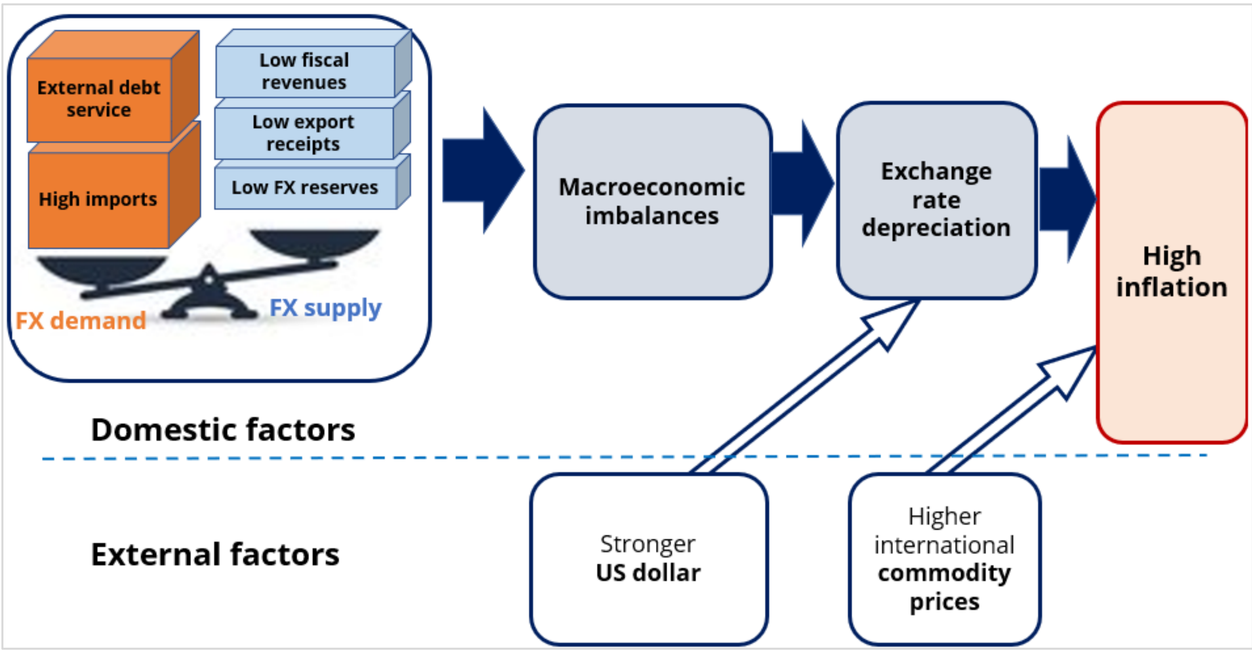
Source: World Bank EAP Economic Update October 2023.

2. Recent Developments in the Lao PDR

Fiscal and external imbalances and a high debt burden continue to strain the economy

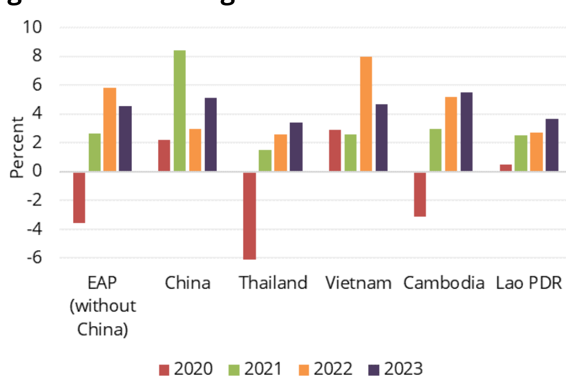
The post-pandemic economic recovery has been gradual, largely weighed down by domestic macroeconomic instability. Economic growth had been slowing over the last decade owing to the limitations of a resource-driven economic model and accumulated structural imbalances, aggravated by recent shocks (such as the COVID-19 pandemic in 2020) and a deteriorating global economic environment. The post-pandemic recovery has been slower than the regional average, largely due to long-standing structural imbalances. A history of high fiscal deficits and large investments in the power sector have led to an unsustainable debt burden. External debt service payments have risen due to the accumulation of non-concessional debt (with higher interest rates and shorter maturities), which has increased the demand for foreign exchange. At the same time, generous tax incentives for foreign investors have deprived the country of vital foreign exchange. These factors, coupled with high import demand in a context of low foreign reserves, have contributed to a significant foreign currency demand-supply mismatch (**Figure 5**). These imbalances have fuelled depreciation pressures, which in turn aggravate the public debt burden and pass through to high domestic inflation (Figure 5). High debt service obligations constrain the fiscal space available for investments in human capital, which are crucial for improving labor productivity and long-term growth. A slower recovery, coupled with inflation also means pressure on people's incomes and living standards.

Figure 5. Macroeconomic imbalances



Source: World Bank staff compilation

Figure 6. Real GDP growth

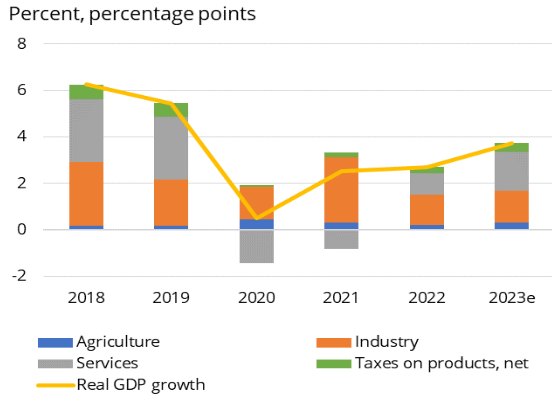


Sources: International Monetary Fund, World Economic Outlook October 2023.

2.1 Real Sector

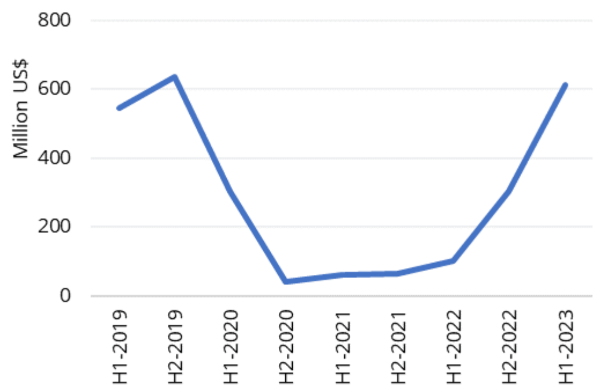
Despite macroeconomic instability, economic activity has benefited from a steady recovery of the services sector, which accounts for more than 30 percent of GDP. Tourism, transport and logistics services, and foreign investment have supported economic activity in the first half of 2023. However, merchandise export growth has been muted, while labor shortages are affecting construction and manufacturing. In tourism, the number of foreign visitors tripled to 2.5 million, mostly from the region, in the first nine months of 2023 compared to a year ago. However, that is still one-quarter below pre-pandemic levels. Transport and logistics services have benefited from railway and dry port operations. For example, the proportion of trade volume facilitated by the railway significantly increased in the first half of 2023, with exports (particularly ores and some agriculture produce) outweighing imports in volume terms. However, the kip depreciation and high inflation pushed up business costs and weighed down on consumption, which was reflected in a contraction of wholesale and retail sales in real terms in the first half of 2023.

Figure 7. Laos' Real GDP growth



Sources: Lao Statistics Bureau and World Bank staff estimates.

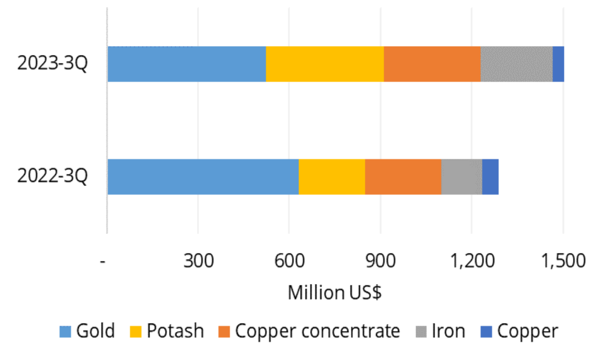
Figure 8. Services exports



Source: Bank of the Lao PDR.

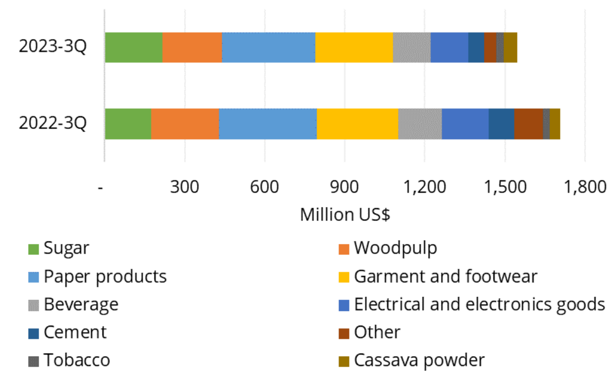
Industrial sector activity is supported by the mining sector, while electricity and manufacturing output remains subdued. The mining sector, which accounted for about 3 percent of GDP, saw output growth in copper, iron ore, and potash, while gold output slightly declined as existing reserves are gradually depleted. Overall mining export grew by 17 percent in the first nine months of 2023, also partly supported by higher gold price. After the rapid expansion of mining exploration concessions in the past few years, the authorities have put in place a moratorium on new mining concessions, partly due to concerns over compliance with regulations, social and environmental safeguards, and limited revenue collection. Electricity output, which account for 10 percent of GDP, was constrained by lower generation and exports in the first nine months of 2023 due to lower rainfall. High input costs, labor shortages, and lower external demand affected most manufacturing activities. Meanwhile, low wages in Laos, exacerbated by high inflation, encouraged more workers to migrate to Thailand where average wages are about three times higher. This trend is challenging for most labor-intensive sectors such as garment manufacturing and hospitality as about 80 percent of migrant workers leave to work in these sectors in Thailand. External and domestic factors contributed to lower manufacturing exports in the first nine months of 2023, particularly wood pulp and wood products, paper products, electronics, beverages, and garments.

Figure 9. Mining exports



Sources: Ministry of Energy and Mines, Mining companies, and Ministry of Industry and Commerce.

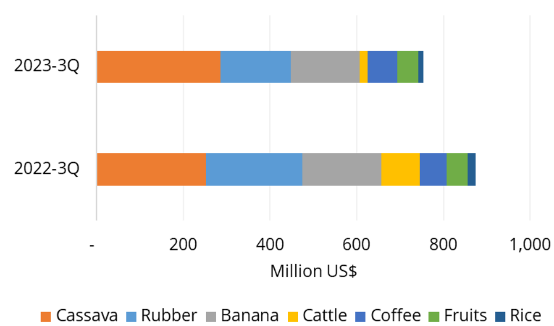
Figure 10. Manufacturing exports



Sources: Ministry of Energy and Mines, trade partners' import data.

Agriculture sector output is estimated to have picked up slightly, though partly undermined by high input costs and unfavorable weather. Global prices for agriculture inputs eased, but the costs of imported inputs remained high, owing to the sharp depreciation of the kip. Increased input costs have translated into higher local food prices. While domestic production is expected to increase as people move to more farm activities (see Household section), growth of main agriculture exports[4] contracted by 13 percent in the first nine-months of 2023, as higher cassava and coffee exports were offset by a decline in rubber, bananas, and livestock (Figure 12).

Figure 11. Agricultural exports



Sources: World Bank staff calculations based on Ministry of Industry and Commerce and trading partners' customs data.

2.2 Inflation

The depreciation of the Lao kip has translated to high inflation

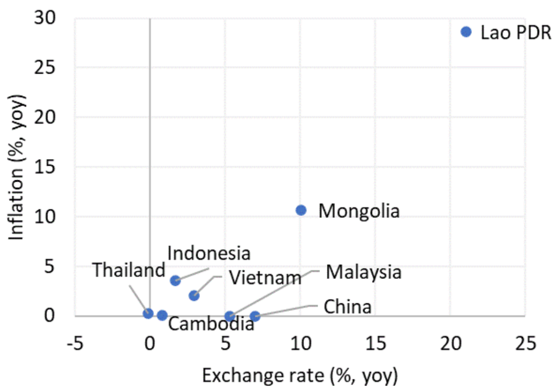
Consumer price inflation has remained in the double-digits, despite a recent moderation. Headline inflation remained high at 25 percent in the year to November 2023, despite the recent easing of international commodity prices. Inflation was much higher than in regional peers, reflecting a sharp depreciation (Figure 13). Although domestic inflation has moderated, compared to a peak of 41 percent in

[44] Main agriculture exports include cassava, rubber, bananas and other fruits, coffee, and cattle.

February 2023, this largely reflects a base effect. Consumer prices increased by 2.3 percent per month on average between May-November, compared to an average of only 1.5 percent per month between January–April 2023. Prices have increased across the board, reflecting high core inflation at 26 percent in the year to November 2023. Inflation in the food and non-alcoholic beverage category was 26 percent in November, down from 52 percent in April, while that for the transport and fuel category was at 22 percent, down from 33 percent in the same period. Food and transport price increases have been the main drivers of inflation, accounting for about two-thirds of overall inflation.

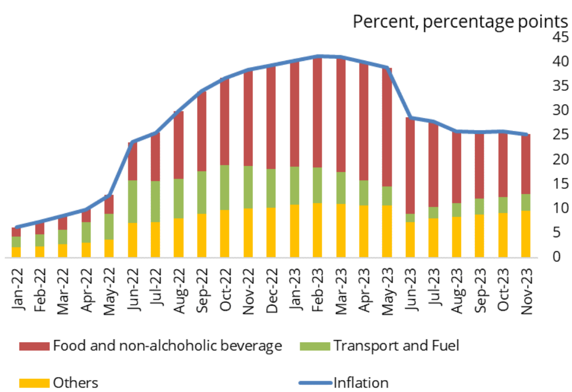
Consumer price inflation has been largely driven by the depreciation of the Lao kip. On average, a 1 percent depreciation of the Lao kip increases consumer prices by 0.5 percent.[5] Hence, a 20 percent depreciation will increase domestic prices by about 10 percent. Recently, the inflation rate is close to the depreciation level, which is by 21 percent against US dollar and by 29 percent against Thai baht in the year to October, partly explained by expectation effect as many businesses anticipate further depreciation particularly in the parallel market and set higher prices to cover exchange rate risk. Inflation will remain high in the absence of exchange rate stability.

Figure 12. Inflation among regional peers (August 2023)



Sources: Lao Statistics Bureau and, International Monetary Fund International Financial Statistics IMF IFS (August 2023).

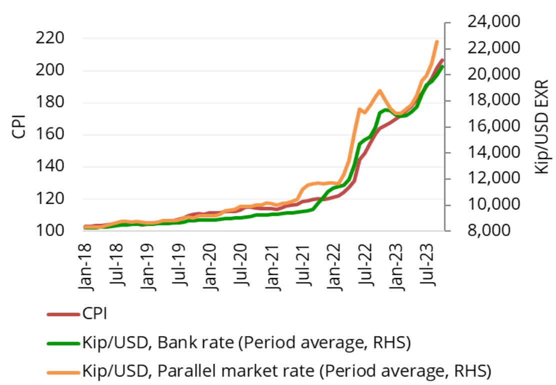
Figure 13. Consumer price inflation



Sources: Lao Statistics Bureau and World Bank staff calculation.

Figure 14. Inflation and exchange rates

[5] See International Monetary Fund Article IV 2023. The pass through might even be higher in recent times.



Source: Lao Statistics Bureau and Bank of the Lao PDR

2.3 Households

Steep kip depreciation and inflation have affected livelihoods and induced labor movements.

Strong kip depreciation and consumer price inflation have led to significant changes in the labor market. The latest World Bank phone survey shows that employment increased to 91.3 percent in the first half of 2023, from 89.6 percent in December 2022.[6] However, more workers have left non-farm wage jobs to become self-employed, including in farming., as wage income fails to keep up with inflation.[7] While the inflation rate was 39 percent in the year to May 2023, the average nominal wage grew only 5.7 percent, a fall of 33 percent in the inflation-adjusted wage. In contrast, the average profit from farm businesses rose by 42 percent during the same period. This labor movement has resulted in declining shares of wage employment from 44 percent to 38 percent, and non-farm employment from 57 percent to 51 percent.

High inflation has distributional impacts on household incomes. Average nominal household income rose by 12 percent between May 2022 and May 2023, with more than half of households that participated in the phone survey reporting that their income remained unchanged or declined during this period. At this rate, soaring inflation implies more than 25 percent fall in real incomes and purchasing power for many households.

Workers have migrated both domestically and internationally to seek higher wages and better employment opportunities. In June 2023, 11 percent of Lao households reported having at least one member migrate to another province during the previous 12 months while 5.3 percent of households reported to have one member migrated to a foreign country. Workers mostly migrate from Champasack, Vientiane Capital and Savannakhet provinces. Rural, low-income, and women-headed households were the most likely to report migration. According to the Thai Department of Employment, the number of regular Lao workers in Thailand was 226,000 in October 2023, while the total number (regular and irregular) could range between 300,000 and 400,000, more than one-third of non-farm employment in Lao PDR. Around 80 percent of migrants were previously working in manufacturing and services. Almost 60 percent of Lao migrant labor in Thailand work in the services sector, followed by manufacturing (20 percent),

[6] World Bank Rapid Monitoring Phone Survey of Households Round 7, conducted May-June 2023. Employment is defined as those who worked at least an hour in the last seven days before the interview date.

[7] Among the key drivers behind this trend are an increase in own-food production during the pandemic and high-inflation period, higher demand for agricultural exports, and higher returns in agriculture than in non-farm businesses or wage employment.

agriculture (16 percent) and construction (7 percent). Higher wages and better employment opportunities are the main reasons for migration. The rapid kip depreciation has widened the wage gap between Thailand and Laos. Despite the minimum wage hike in October 2023 to 1.6 million kip (about $79 per month), the minimum wage in Thailand is about three times higher than in Lao PDR.

Mounting food inflation has undermined food security. Food inflation remained high at 26 percent in the year to October 2023. Food insecurity worsened between May 2022 and May 2023, especially among urban families, who are more exposed to high food inflation. The proportion of urban households that experienced moderate to severe food insecurity increased from 34 percent to 42 percent.[8] In rural area, the food insecurity situation was relatively stable, despite remaining deeper and more widespread than in urban areas.

Households have adopted various coping strategies in response to high food inflation. Most households scaled up own-food production and foraging activities, switched to cheaper foods, or reduced food consumption. Low-income families were more likely than high-income households to engage in additional income generating activities, sell their assets, use credit purchase, or borrow from family and friends to cope with rising food prices. Of those households affected by inflation, 51 percent reported reducing both education and health care spending. These reductions were most common among low-income families. As a result, dropout rates remained high and school enrollment declined, especially among low-income households (Figure 16). Coupled with low government spending on the social sectors, investment on human capital is being hampered, which can severely undermine the economic prospects of an entire generation.

Figure 15. Employment

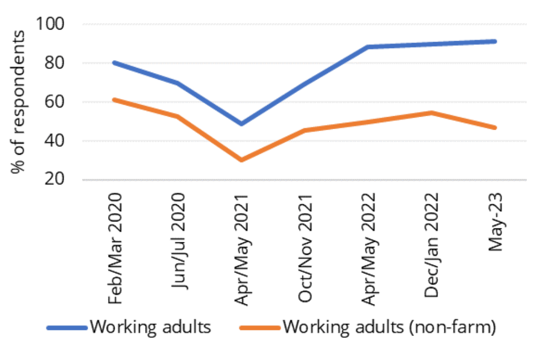
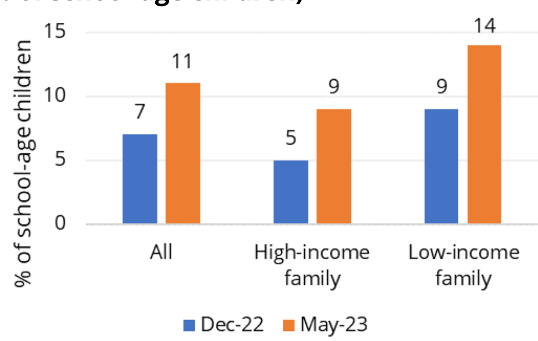


Figure 16. Children not enrolled in school (% of school-age children)



Source: World Bank's rapid monitoring phone survey of households Rounds 1–7

Note: Employment is defined as those who worked at least an hour in the last seven days before the interview date.

2.4 Fiscal Developments

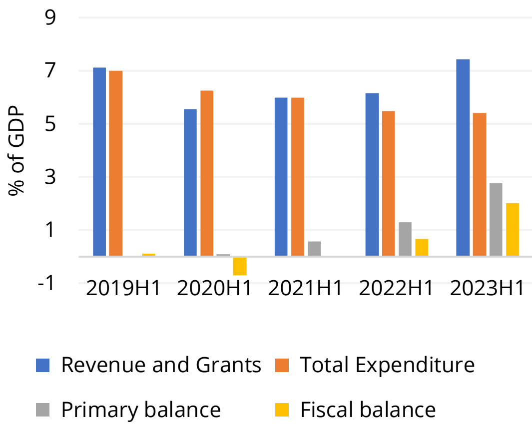
A fiscal consolidation has been driven by expenditure tightening and better domestic revenue collection

The fiscal deficit improved in the first half of 2023, owing to improved revenue performance and public spending containment, including deferrals of debt interest payments. The primary balance (which excludes interest payments) turned into a surplus of 2.8 percent of GDP in the first half of 2023, while the overall fiscal balance was in a surplus of 2 percent of GDP in the same period (Figure 17).

[8] Based on the Food Insecurity Experience Scale (FIES).

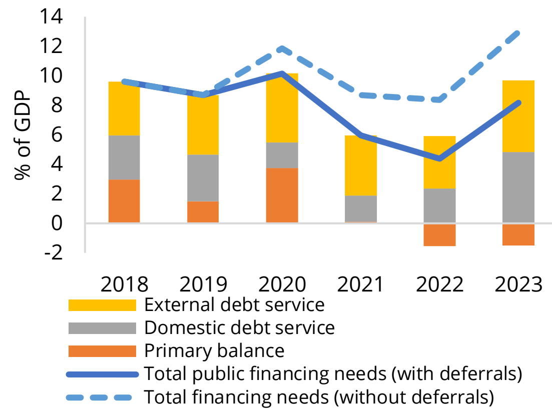
Nevertheless, total financing needs for the year 2023 are projected to remain high at around 8 percent of GDP, as debt repayments of both external and domestic debt (after deferrals) in 2023 still outweighed the primary surplus. The government expects to meet these needs largely through fiscal revenues, bonds issuances in domestic capital market (both in foreign and local currencies) and state-owned enterprise (SOE) on-lending repayments.

Figure 17. Fiscal performance



Source: Ministry of Finance.

Figure 18. Total public financing needs[9]



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

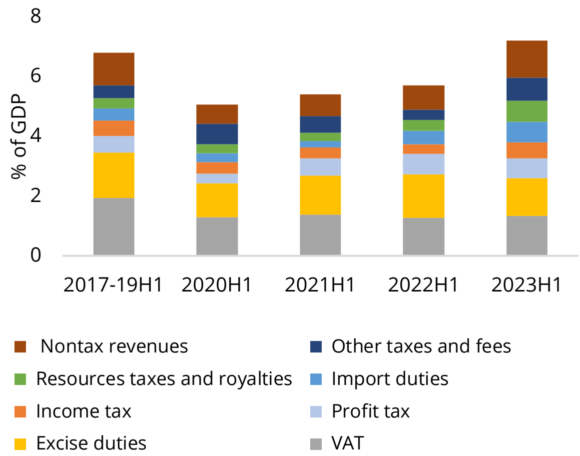
Domestic revenues improved substantially in the first half of 2023, supported by higher economic activity as well as inflation and a depreciated currency. Domestic revenue rose to 7.2 percent of GDP in the first half of 2023 from 5.7 percent a year ago., driven mostly by higher import duties, income tax, natural resource taxes, overflight fees and other non-tax revenues. Improved economic activity in tourism and mining has supported revenue collection, some of which were in foreign currencies. Meanwhile, the sharp exchange rate depreciation and general price increases have also benefitted revenue collection, which compensated for the lower value-added tax and fuel excise rates. To boost revenue, the government raised excise taxes on alcohol, vehicles, and tobacco, reformed the land tax, and introduced new and higher export duties. The government is also considering reversing the VAT rate to 10 percent.

Untargeted subsidies and generous fiscal incentives have resulted in large foregone revenues. To lessen the impacts of soaring international fuel prices, exacerbated by the strong kip depreciation in 2022, fuel excise rates were significantly reduced in mid-2022. Similarly, the VAT rate was reduced from 10 to 7 percent in January 2022, with the aim of supporting households, as well as improving tax compliance and expanding the tax base. Preliminary estimates suggest that these rate cuts have resulted in large foregone revenues: about $150 million between May-2022 and June 2023 for fuel excises, and 2 billion kip in 2022 (about 1 percent of GDP) for the VAT. These measures have predominantly benefited wealthier households, since the poor consume fewer products subject to VAT or excise taxes. In addition, corporate income tax (CIT) collection as a share of GDP remained at around the 2022 level, still low by regional benchmarks. Only

[9] This estimate of financing needs excludes deferred debt service payments until 2023. The baseline assumes continuation of payment deferrals in 2023,

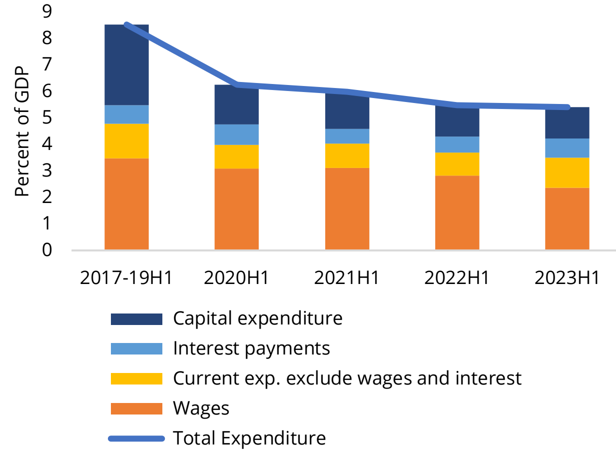
about 10 percent of the potential CIT revenue base is actually collected, which implies very large foregone revenues from tax exemptions.[10]

Figure 19. Domestic revenues



Source: Ministry of Finance.

Figure 20. Total expenditures



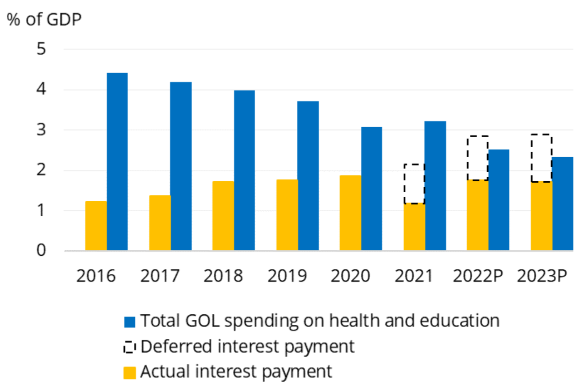
Source: Ministry of Finance.

The government continued to tighten public expenditure in the first half of 2023, amid pressing debt service payments. Total expenditure remained stable at 5.4 percent of GDP in the first half of 2023, much lower than pre-pandemic levels (Figure 20). High prices reportedly affected the construction costs of some public investment projects and the purchase of goods and services. New projects have either been cancelled or postponed. However, owing to the kip depreciation and higher domestic interest payments, interest payments remained at around 0.7 percent of GDP, in spite of payment deferrals. Although debt service deferrals have eased fiscal pressures in recent years, limited fiscal space has constrained the government's ability to provide support to poor households severely affected by rising living costs, as well as to invest in growth-enhancing expenditures. The combined spending on education and health declined from 4.9 percent of GDP in 2013 to an estimated 2.3 percent in 2023 (Figure 21). In addition, domestic expenditure arrears continue to pose a challenge for expenditure management.

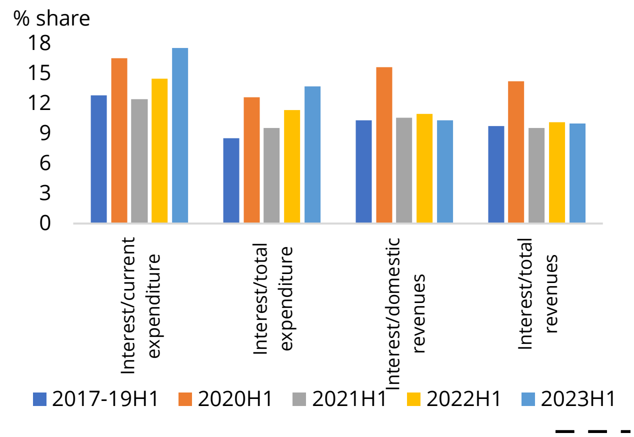
Figure 21. Human capital spending

Figure 22. Interest payments

[10] The revenue generated by corporate income tax (CIT), generally known as 'profit tax', declined from 2.6 to 1.4 percent between 2011 and 2019 and then to 1.0 percent of GDP in 2020. In 2019, the CIT-to-GDP ratio was the 9th lowest in the world and well behind regional peers.



Source: Ministry of Finance and World Bank staff calculations.



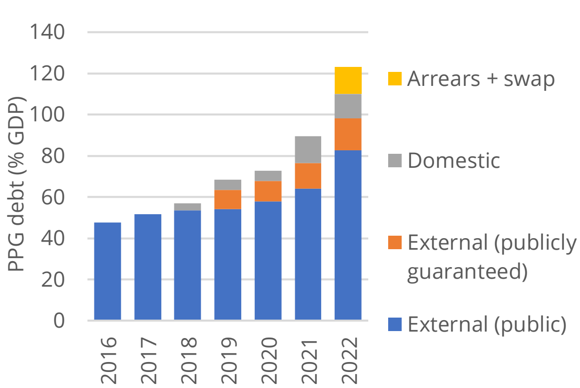
Source: Ministry of Finance, World Bank staff estimate.

2.5 Public Debt Dynamics

A weakened kip has significantly increased the public debt burden, with sustainability largely contingent on the outcome of ongoing debt negotiations.

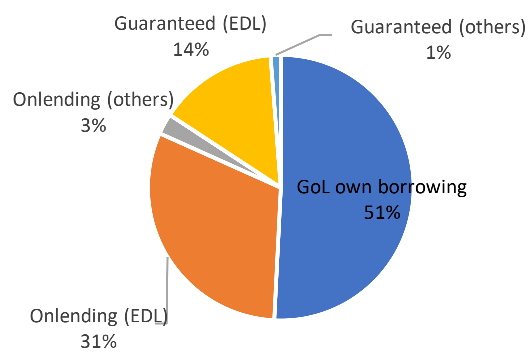
Public debt levels are unsustainable, which undermines macroeconomic stability and development prospects.[11] Laos is facing considerable liquidity and solvency challenges owing to a high debt burden, weak revenue collection, low foreign currency reserves, and limited financing options. Total public and publicly guaranteed (PPG) debt declined from $14.5 billion in 2021 to $13.9 billion in 2022, but as a ratio to GDP it increased from 89 percent of GDP in 2021 to 112 percent of GDP in 2022. If domestic expenditure arrears and the swap arrangement with the People's Bank of China are included, total PPG debt rises to 125 percent of GDP. The increase in 2022 was largely due to a weakened kip, which in turn worsens the debt service burden.

Figure 23. Public and publicly guaranteed debt stock



Source: WB estimate based on MOF data.

Figure 24. External PPG debt stock (%, 2022)



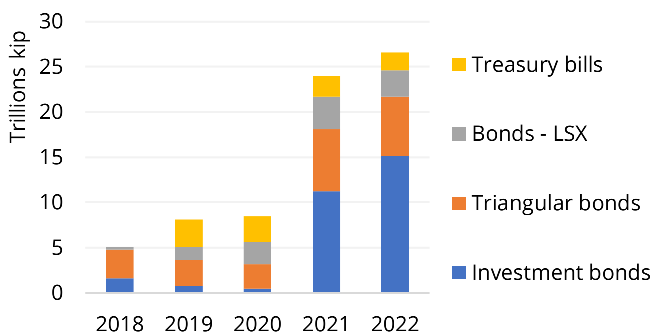
Source: WB estimate based on MOF data.

[11] The latest IMF-WB Debt Sustainability Analysis assesses Laos to be in debt distress with an unsustainable outlook under the Low-Income Countries Debt Sustainability Framework.

The PPG debt stock is mostly external and highly vulnerable to foreign exchange risks. External PPG debt accounted for 89 percent of total PPG debt in 2022 (or 99 percent of GDP), of which 75 percent was public debt, and 14 percent was publicly guaranteed SOE borrowing.[12] Debt denominated in US dollars accounted for 58 percent of external public debt, followed by Special Drawing Rights (15 percent), Thai baht (11 percent), Chinese yuan (9 percent), and the remainder in other currencies. Therefore, the continued depreciation of the Lao kip against major foreign currencies in 2023 had a considerable effect on the debt burden.

The domestic public debt stock increased in 2022 with the issuance of domestic bonds to recapitalize a state-owned bank. The domestic debt stock rose from 24 trillion kip in 2021 (13 percent of GDP) to 27 trillion kip in 2022 (12 percent of GDP), mainly due to the new issuance of investment bonds to clear domestic expenditure arrears and recapitalize a state-owned bank. Public expenditure arrears remained large with a reported amount of 23 trillion kip (11 percent of GDP in 2022). These arrears are under a process of audit and verification.[13]

Figure 25. Domestic debt stock



Source: Ministry of Finance.

Total public debt service payments have increased, despite deferrals from China during 2020-2023. Assuming that debt service to China is fully deferred in 2023, total public debt service payments (external and domestic) are estimated at 10 percent of GDP in 2023, of which external debt repayments account for about half. While the specific terms of these deferrals are not known, they will likely accumulate to about $2 billion by the end of 2023 (nearly 16 percent of GDP).[14] The pressure on revenue sources has heightened, with the ratio of total public debt service (i.e., principal and interest) to domestic revenue increasing from 35 percent in 2017 to 43 percent in 2022, although it would have reached 72 percent in the absence of debt service deferrals. More importantly, external non-concessional debt repayments account for 77 percent of total external repayments due in 2023 (after deferrals).

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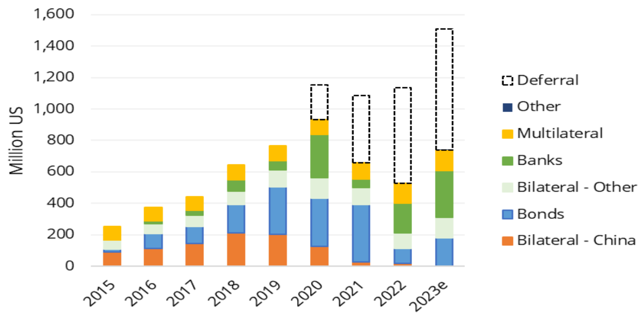
[12] Laos uses the currency criterion, which means that external debt comprises all debt denominated in foreign currencies, irrespective of where it is issued. Domestic debt comprises all kip-denominated debt.

[13] According to the 2022 Public Debt Bulletin, arrears are not yet considered to be PPG debt under the Public Debt Management Law. These only become a debt if (and when) settled through a bond issuance. The government reported completed public works (relating to capital investment) of about 33,000 billion kip, of which 10,000 billion kip were verified as arrears in 2021. The other 23,000 billion kip is currently undergoing an audit and inspection process by relevant agencies. The amounts verified and approved as arrears might be cleared through a combination of domestic bond issuances and future budget allocations.

[14] The GDP ratio conservatively assumes that the current official exchange rate of about 20,000 kip per US dollar (October 2023) remains unchanged by December 2023.

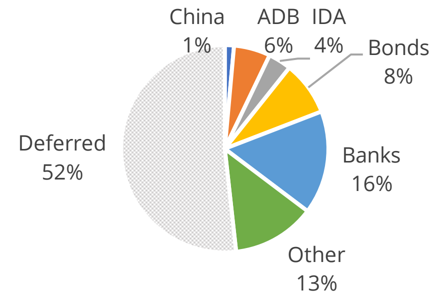
Figure 26. External public debt repayment due

A: By creditors (in million US$)



Source: WB calculations based on MOF data

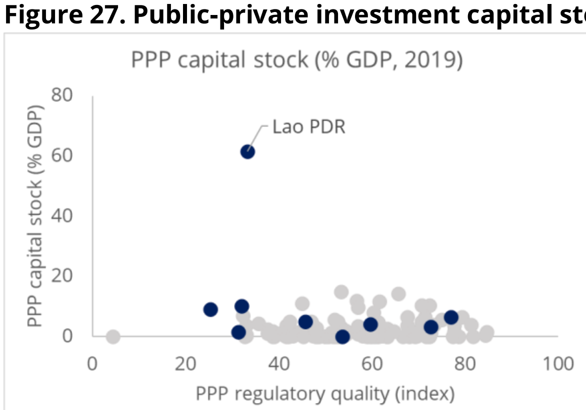
B: By creditor (in % share of total external debt service plan, 2022)



Source: World Bank estimate based on MOF data.

The operations of state-owned enterprises and public-private partnerships create fiscal risks through additional contingent liabilities. SOE debt accounted for 44 percent of total PPG debt in 2022 (in the form of on-lending and public guarantees), of which 42 percent was held by SOEs in the power sector (namely, EDL and Lao State Holding Enterprise). EDL alone accounted for 40 percent of total PPG debt in 2022 (or $5.6 billion). Unsustainable debt accumulation and large operating losses pose significant fiscal risks to the government. The continued currency depreciation has significantly affected EDL, which earns revenues in kip but has to repay its debts and import power in foreign currencies. In addition, Laos has a significant number of public-private partnerships (PPP), particularly in hydropower and transport. The PPP capital stock was estimated at 62 percent of GDP in 2019, by far the largest in the world. While PPPs have brought some benefits to the local economy, these are complex arrangements that can create significant fiscal costs and risks. The 2023 Debt Sustainability Analysis indicates that public debt is most sensitive to contingent liabilities shock.

Figure 27. Public-private investment capital stock



Source: World Bank Private Participation Investment database

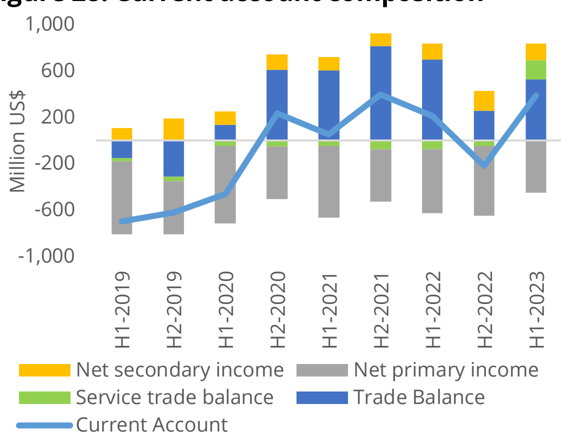
Access to international capital markets has been further restricted, which will increase the reliance on domestic borrowing to meet financing needs. The government offered bonds in the Thai capital market amounting to 3.6 billion Thai baht in August 2023 (about $100 million), but subscription only reached 22 percent. In September 2023, the Thai rating agency, TRIS, downgraded the sovereign (and EDL-GEN) credit rating to 'BB+' with a 'negative' outlook, which means that further issuances are unlikely to take place before 2025.[15] The government then turned to the domestic capital market to sell bonds to finance the deficit and repay its debts (amounting to $100 million, 3 billion Thai baht, and 3 trillion kip, respectively). Baht bonds were fully subscribed (mostly by banks), while the subscription of US dollar bonds has so far been lower. With limited access to international capital markets, pressure on domestic financing sources will increase.

2.6 External Sector

High demand for imports and debt service fuel external imbalances

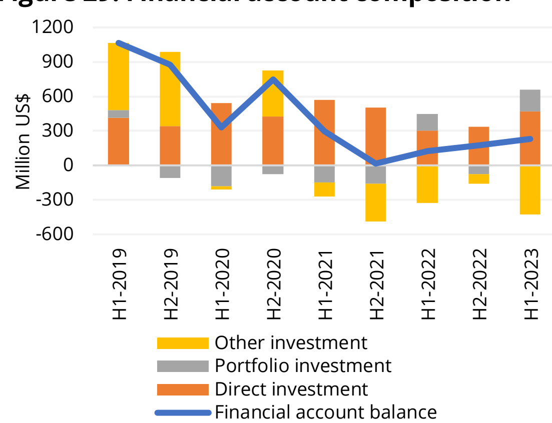
Despite an improvement in the trade balance, foreign exchange demand for imports and net income payments have intensified external imbalances. The net trade surplus in goods and services reached nearly $700 million in the first half of 2023, a 12 percent year-on-year increase.[16] This was supported by tourism and transport services, which partly compensated for stagnant merchandise exports and rising overall imports. Export of goods stagnated in the first half as an increase in mining offset declines in electricity, manufacturing, and agriculture. Only about 41 percent of total export proceeds were reportedly repatriated to the Lao economy in the first nine months of 2023, thus contributing to limited foreign exchange liquidity.[17] On the other hand, imports of goods rose by 4 percent year-on-year, mainly from equipment and construction materials, followed by vehicles and fuel. In addition, net income payments have exerted additional pressure, at $450 million in the first half of 2023, despite public debt service deferrals. Therefore, despite the improvement in the current account balance in official statistics, the associated net cash flows into the Lao economy are still in deficit, which places a persistent pressure on the exchange rate (Figure 31).

Figure 28. Current account composition



Source: Bank of the Lao PDR, World Bank staff estimate.

Figure 29. Financial account composition



Source: Bank of the Lao PDR, World Bank staff estimate.

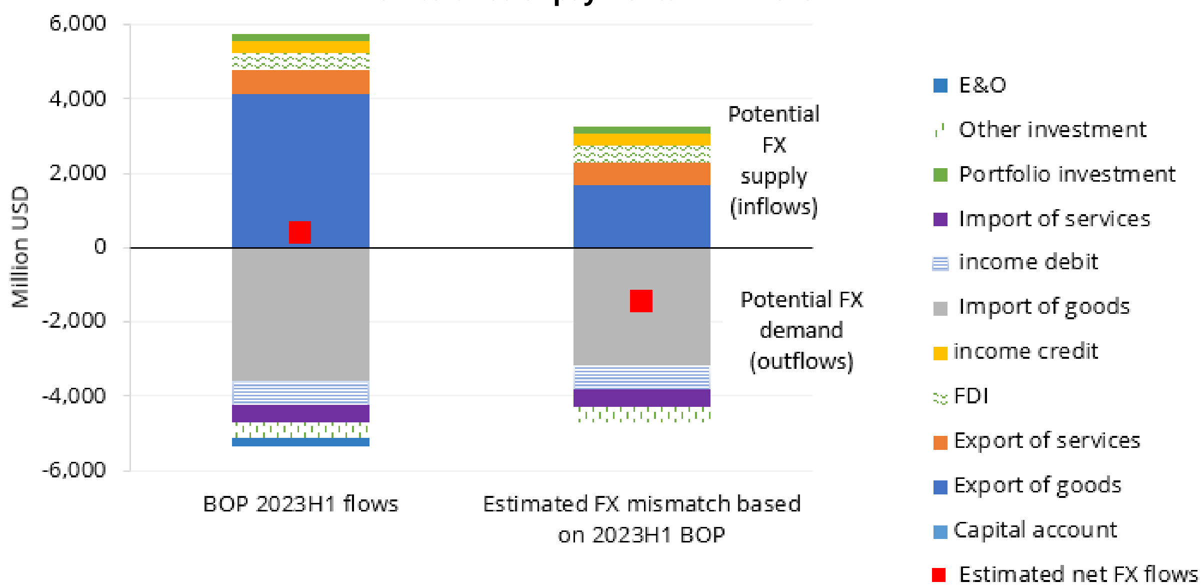
The financial account balance increased in the first half of 2023, owing to higher direct and portfolio investments. The financial account recorded a surplus of $230 million in the first half of 2023, double the level from last year, as foreign direct investment and portfolio investment net inflows outweighed other investment net outflows. Foreign direct investment rose to $470 million (or by 56 percent year-on-year)

[15] The downgrade reflected a significant deterioration in the serviceability of public debt, weak economic fundamentals, and the kip depreciation.
[16] However, the level could be lower when considering under-reported imports using trading partner data.
[17] The Bank of Lao PDR reporting to the National Assembly October 2023.

mainly supported by investments in power projects. Portfolio investment net inflows also rose partly due to EDL-Gen bonds in the first half of 2023 (3.1 million baht) for refinancing bonds due in July 2023. In the meantime, other investment experienced net outflows, partly due to principal repayments on external debt and outward flows by foreign bank branches.

Although the overall balance of payments improved in the first half of 2023, errors and omissions suggest large unaccounted outflows and hence low reserve buffers. The overall balance of payments recorded a surplus of $409 million in the first half of 2023, supported by current account and financial account surpluses. However, negative net errors and omissions suggest large unaccounted net outflows, mostly related to limited repatriation of resource exports, which could mean net income outflows and informal trade. As a result, gross official reserves buffers remain limited, despite increasing from $1.1 billion in December 2022 to $1.5 billion in June 2023, covering less than two months of imports of goods and services.

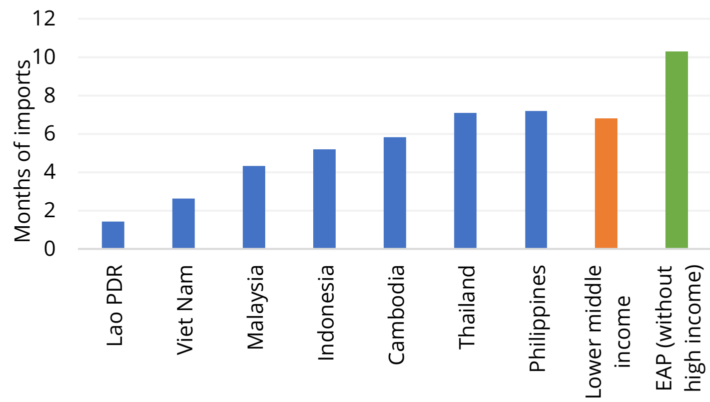
Figure 30. Indicative scenario of potential foreign exchange supply-demand imbalances on balance of payments in H1-2023



Source: World Bank staff assessment based on data from the Bank of the Lao PDR, Ministry of Finance, and other authorities and trade partners.

Note: FX denotes foreign exchange. Estimates of foreign exchange supply-demand are based on these assumptions: (i) 40 percent of the officially reported export proceeds are remitted back into the economy in the first half of 2023; (ii) goods imports adjusted for underreported imports and imports already financed by investment projects, (iii) a portion of export earnings retained offshores after financing imports are considered as unaccounted income outflows. and (iv) errors and omissions are negligible after these adjustments.

Figure 31. Foreign currency reserve adequacy (2022)



Sources: World Bank World Development Indicators

2.7 Exchange Rate

Structural imbalances continue to put pressures on the exchange rate

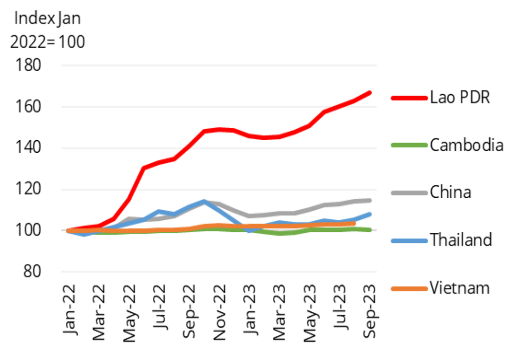
The kip continued to depreciate against foreign currencies in 2023, largely due to foreign currency demand-supply mismatches. The supply of foreign currency is limited in a context of high demand to finance imports and debt repayments, putting pressure on the exchange rate. On the official market, the kip weakened by 30 percent and 35 percent against the Thai baht and the US dollar on average during January-October 2023 compared to the same period last year. The depreciation pressures faced by the Lao kip were much stronger than in regional peers, implying that domestic factors account for most of this trend rather than a stronger US dollar. During 2021-2023, large debt service repayments seem to have coincided with stronger kip depreciation in the official and parallel markets.

Given limited foreign exchange liquidity, banks are prioritizing foreign exchange access for debt repayments and essential imports. Commercial banks are rationing the supply of foreign exchange by prioritizing customers and imports of essential goods, particularly fuel and medical goods. In October 2023, the pressure on the parallel market was strong, suggesting not only limited foreign exchange liquidity at the official rate, but also in the parallel market. The parallel market premium was 15 percent for the US dollar and 8 percent for Thai baht in October 2023. A high premium creates distortions that contribute to an inefficient allocation of resources across the economy.

Tighter monetary policy may have temporarily eased depreciation and inflationary pressures, but by itself cannot address the root causes. To mop up excess kip liquidity, the central bank issued kip bonds in June 2022 amounting to 5 trillion kip with a six-month maturity at 20 percent per annum. New bonds were subsequently issued in January, February and then in September 2023 to repay the maturing bonds, although offering a lower interest rate of 15 percent per year. Savings bonds seemed to have helped stabilise the exchange rate for only a short period. In addition, the policy rates were raised twice since mid-2022, from 3.1 to 6.5 percent in October 2022 and then to 7.5 percent in February 2023. However, these increases are undermined by weak monetary transmission mechanisms, as commercial bank deposit and lending rates have not responded to the higher policy rate. In September, the reserve requirement ratios for kip and foreign currencies were raised to 8 and to 10 percent from 5.5 and 8 percent, respectively.

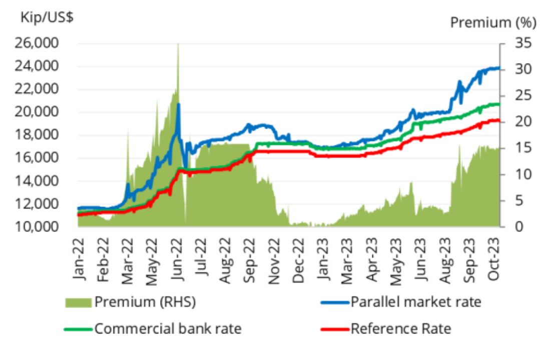
Foreign exchange management has also been tightened, with very limited impacts on the depreciation trend. Despite greater exchange rate flexibility, exchange rate controls were introduced by placing daily limits on foreign exchange transactions at banks, and all exchange bureaus were instructed to close in January 2023.[18] These measures had only a temporary impact on the exchange rate, and appear to have stimulated the parallel market. To improve foreign exchange liquidity, a revised law on foreign exchange management has been adopted. The law includes repatriation requirements, which require exporters and importers to register with the Ministry of Industry and Commerce and open specific accounts for their transactions.[19] While this measure was able to increase the repatriation rate of export receipts from 36 percent in 2022 to 41 percent by September 2023, these administrative measures could be counter-productive in the medium-term if businesses are reluctant to deposit in banks in Laos.

Figure 32. Official exchange rates
(An increase means depreciation. A decrease means appreciation)



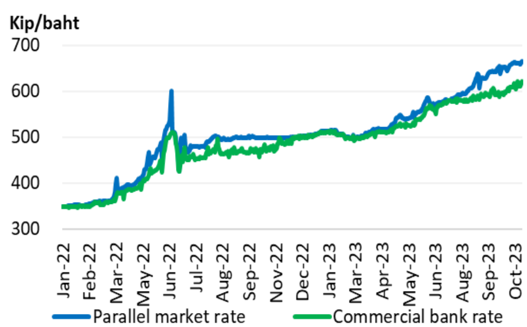
Sources: IMF IFS.

Figure 33. Kip/US$ exchange rates



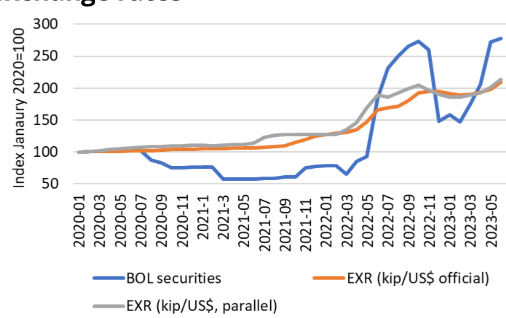
Source: World Bank staff calculation based on Bank of the Lao PDR data.

Figure 34. Kip/US$ official exchange rates



Source: World Bank staff calculation based on Bank of the Lao PDR data.

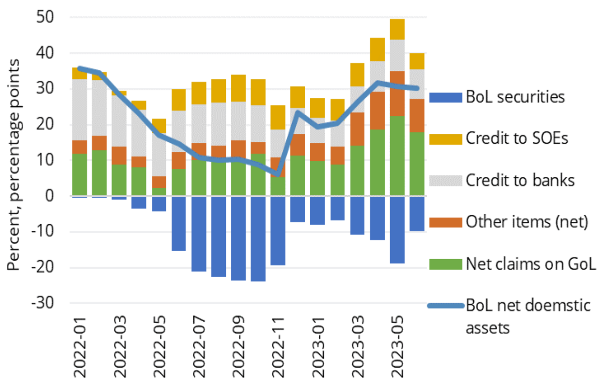
Figure 35. Bank of Lao PDR bonds and exchange rates



Source: World Bank staff calculation based on Bank of the Lao PDR data.

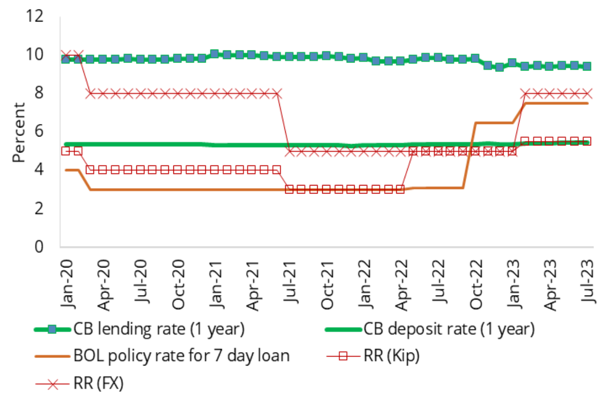
[18] The Bank of the Lao PDR has a managed float exchange rate regime. Banks set their exchange rates within a band around the BoL reference rate, which has been raised from ±4.5 percent in October 2022 to ±7.5 percent in June 2023.
[19] To implement the law, five regulations have been developed, including the PM Order No. 10 on foreign exchange management.

Figure 36. Bank of the Lao PDR's domestic assets



Source: World Bank staff calculation based on Bank of the Lao PDR data.

Figure 37. Monetary policy tightening



Source: World Bank staff calculation based on Bank of the Lao PDR data.

2.8 Financial Sector

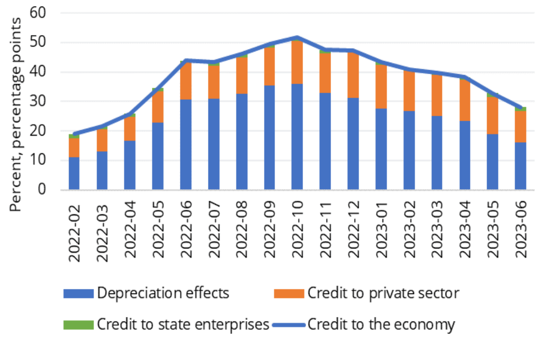
Despite improvements in some financial soundness indicators in the aggregate, vulnerabilities in the financial sector persist.

Credit growth in kip terms has moderated in the first half of 2023. Total credit growth in kip (to private sector, SOEs and the government combined) decelerated to 25 percent in the year to June 2023 from 48 percent a year ago, largely due to slower lending to all borrowers. Assuming a stable exchange rate as in 2021, the depreciation effect would account for almost 60 percent of the changes in credit outstanding between June 2022 and June 2023. Commercial bank lending to the economy (to private and state-owned enterprises) also expanded at a slower pace to 28 percent year-on-year from 44 percent during the same period, reflecting more prudent lending by banks and reportedly lower loan demand due to economic difficulties. Commercial bank lending to the economy mostly comprises lending to industry, commerce, service, and construction sectors.

While total credit growth to the government decelerated in the first half of 2023, the contribution of BOL lending to the government has remained substantial since 2022. BOL's liquidity supported the recapitalization bonds for restructuring two banks, Lao Development Bank and Agriculture Promotion Bank, and deficit financing. Total lending to the government rose to 11 percent of GDP in the year to June 2023, of which half was from BoL.

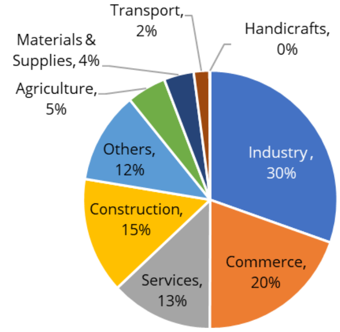
Broad money growth slowed, while reserve money accelerated in the first half of 2023. Reserve money grew by 39 percent in the year to June 2023, from 27 percent a year ago, reflecting commercial banks' growing deposit and required reserves deposits at the central bank. On the asset side, the BOL's net lending to the government rose. Broad money growth slowed to 27 percent in the same period, partly due to moderated deposit and credit growth, which is inflated by the depreciation of the Lao kip. As the kip loses value against other currencies, holding foreign currencies has been preferred as a hedge against depreciation expectations. This contributes to an increase in the ratio of foreign currency deposits to broad money, from 51 percent in January 2021 to 66 percent in June 2023.

Figure 38. Domestic credit growth[20]



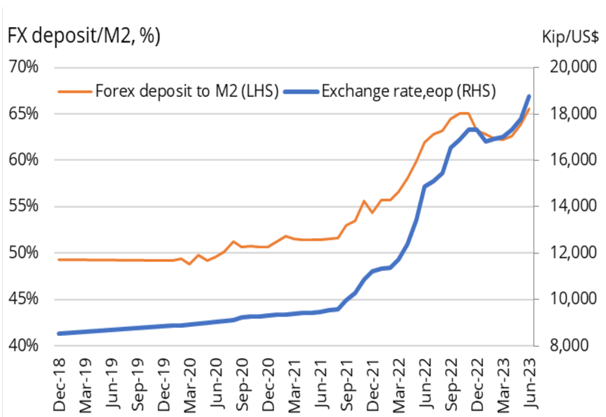
Source: World Bank staff estimate based on Bank of the Lao PDR data.

Figure 39. Bank credit by sectors in June 2023
(Percent share in commercial bank credit)



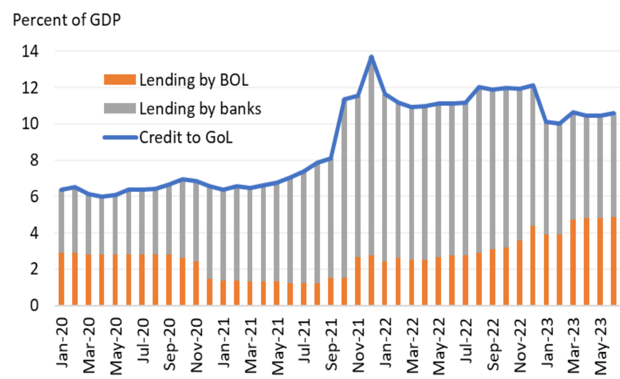
Source: Bank of the Lao PDR.

Figure 40. Foreign currency deposits



Source: Bank of the Lao PDR.

Figure 41. Exposure to government borrowing



Source: Bank of the Lao PDR.

Financial sector vulnerabilities persist, despite positive trends in system-wide averages. While the aggregate capital adequacy ratio (CAR) for the banking system seems comparable to regional peers, it masks significant variation in capital buffers and asset quality across banks. The CAR ratio increased to almost 20 percent in June 2023, reflecting the restructuring of two state-owned banks and capital increases of bank branches as per regulatory requirements. However, the largest commercial bank (BCEL), which accounted for 35 percent of banking sector assets in June 2023, still had a CAR lower than the regulatory minimum of 8 percent.[21]

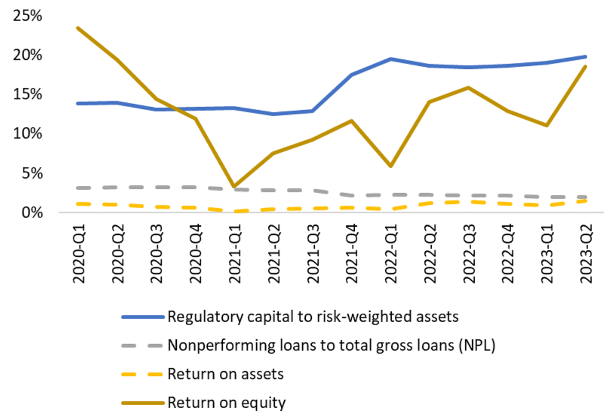
Reported non-performing loan (NPL) ratios slightly declined, but continued regulatory forbearance mask vulnerabilities. While some banks are gradually withdrawing forbearance measures to businesses on a case-by-case basis, the lack of a clear timeline to phase out these measures (such as the freeze of loan classifications) and the practice of ever-greening loans could undermine credit discipline and present risks

[20] Note: This illustration covers only lending by commercial banks to state-owned enterprises, and the private sector. The demonstrated depreciation effect controls for the exchange rate depreciation. The differences between the monthly actual kip-equivalent credits and estimated kip-equivalent credit amount assumes a constant kip/USD exchange rate as in January 2021 = 100.

[21] According to Interim Financial Information for the three-month period of Quarter 4 ended 31 December 2022. See https://www.bcel.com.la/bcel/bcelweb-datas/financial-info/quarter-rpt-unaudited/en/bcel_web_file_49_14797606d4f8dce5a9cffeb1fc6902cf.pdf

to the financial system. The largest commercial bank (BCEL) still has an NPL ratio above the system average. Several banks have significant accrued interest receivables.[22] Sector profitability remains low, despite an uptick in the second quarter of 2023 after the two bank restructurings. In this context, balancing the phasing out of forbearance measures and the health of bank balance sheets is important to minimize vulnerabilities in the financial sector while supporting the economic recovery.

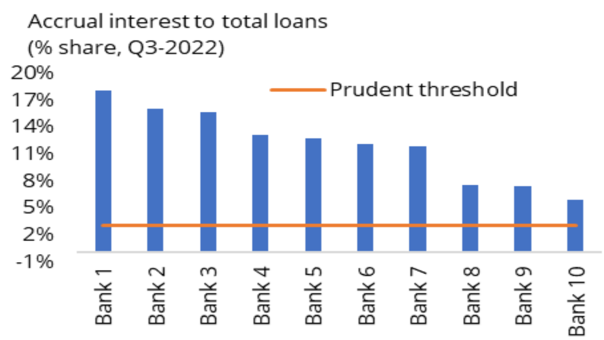
Figure 42. Financial soundness indicators



Source: Bank of the Lao PDR

Figure 43. Accrual interest to loans ratios

(Each bar represents a different bank, percent)



Source: World Bank staff calculation based on banks' financial reports as of Q3-2022.

3. Outlook and Risks

Box 1 Key assumptions for the baseline

The outlook assumes a gradual growth recovery, while macroeconomic stability remains a challenge. The outlook assumes that accumulated debt payment deferrals during 2020–2023 will not be paid during the forecast period as they are pending the conclusion of ongoing renegotiations. The baseline, however, assumes that external debt service obligations will be fully met from 2024 onward, which would keep public financing needs elevated. Therefore, pressures from debt service payment obligations in the next few years are expected to persist unless there is a comprehensive and favorable agreement on debt restructuring with the main creditors. The key channel is through compromised public spending on human capital that can support long-term growth and more pressure on domestic financing sources, which could crowd out the private sector. Tourism and logistics should continue to recover supported by external demand. Oil and food price rises are expected to moderate, but structural constraints are expected to maintain pressure on the exchange rate and hence inflation. Revenue collection gradually improves as revenue-enhancing measures are implemented and tax compliance improves. As debt service obligations remain high, expenditure controls continue to be considered to achieve fiscal consolidation in the medium term.

[22] This accrual interest to loans ratio provides an indication of how much interest has been accounted but is yet to be collected by the bank. It aims to highlight cases of deterioration of the loan portfolio that might not be captured solely by looking into non-performing loans. They reflect forbearance practices like those observed during the pandemic (COVID-19) where payments were deferred but accrual of interest continued.

GDP growth is projected to gradually recover to 3.7 percent in 2023 and average around 4.2 percent in the next few years. The gradual resumption of tourism, particularly from the region, and improved transport and logistic services will help stimulate economic activity. External demand, coupled with improved connectivity, would help sustain exports. The industry sector can benefit from investments in the power sector and special economic zones.[23] Meanwhile, the mining sector will be constrained in the medium-term due to depleted resources and the recent moratorium. Growth prospects will remain below pre-COVID levels as structural imbalances will continue to weigh on the recovery.

Inflation will remain in double-digits in 2024, albeit lower than in 2023, in part due to chronic depreciation pressures. Average annual inflation in 2023 is expected to reach 31.4 percent and will remain at two digits in 2024, though lower than in 2023. Global prices for key import products are projected to slightly ease in 2024, but depreciation pressures will continue to feed into inflation. High inflation will dampen real incomes and consumption and add to business costs. These factors could further incentivize labor migration to Thailand, which is already reported as a major constraint for the manufacturing and hospitality sectors.

High debt levels will continue to constrain fiscal space. Revenue is expected to gradually increase with inflation, economic activity, implementation of the land tax law[24] and tax administration improvements. Total expenditure is expected to increase, with non-interest expenditure relatively contained and interest payment elevated. The baseline assumes a primary surplus in the next few years, but the fiscal deficit is expected to increase, reflecting a higher interest payment due. External debt service obligations average $1.3 billion per year over 2024–2027 (about 9 percent of the 2023 GDP), keeping total public financing needs high. Large interest payments will continue to constrain the fiscal space for critical development spending on the social sectors in the absence of bold revenue reforms.

Financing needs will remain significant without continued deferral and hence stronger pressure on domestic resources. Recent credit rating downgrades have further restricted access to international capital markets. This increases pressure on domestic financing sources, which could crowd out resources for the private sector. Lower capital inflows (e.g., limited borrowing) also reduce the supply of foreign exchange, which translates into greater pressure on reserves and the exchange rate.

Box 2. Illustrative reform scenarios

Illustrative scenarios suggest that a combination of bold revenue reforms and significant debt restructuring would be necessary for restoring debt sustainability. Building on the baseline scenario of the 2023 Debt Sustainability Analysis, two additional scenarios have been developed: (i) "revenue reforms" and (ii) a "debt relief". The baseline assumes a business-as-usual scenario, with no external and domestic shocks, a gradual growth recovery, and a small primary surplus. An average real GDP growth rate of above 10 percent would be required to bring debt down to sustainable levels within 10 years, which is unfeasible in the current context. The revenue reform scenario assumes an immediate restoration of the VAT rate to 10 percent (2024), an increase and restructuring of excise taxes (boosting excise collection by 15 percent per year), and a phased elimination of corporate income tax (CIT) exemptions (doubling CIT collection by 2035 in relation to the baseline). The debt relief scenario assumes a reduction in the projected 2024 PPG debt stock by 20 percent compared to the 2023 baseline.

The baseline indicates that public debt levels will remain unsustainable over the next decade. In the absence of reforms, debt restructuring, and further shocks, debt ratios decline because of slight

[23] Pipeline power projects include Luang Prabang project (1460 MW), Nam Phak (128 MW), Nam Ngum 3 (480 MW).
[24] The Land tax law No. 35/NA was approved and endorsed by the National Assembly on 17 July 2023. https://www.laoofficialgazette.gov.la/kcfinder/upload/files/35%E0%BA%AA%E0%BA%9E%E0%BA%8A2023.pdf

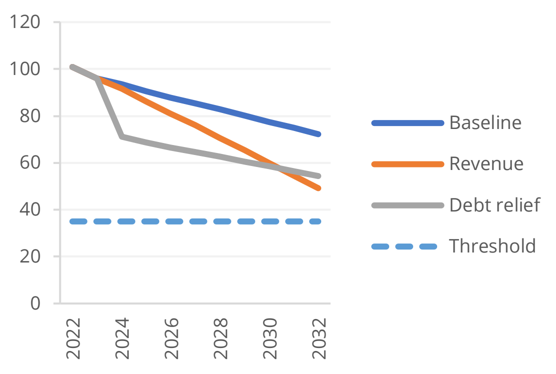
primary surpluses in the near-term and growth recovery. However, the debt stock and debt service levels would remain elevated and persistently breach sustainability thresholds. Debt service obligations would remain high above 100 percent of revenues for an extended period, which could severely compress other essential development spending. Gross financing needs increase considerably with assumed full repayments from 2023 onward. With limited access to international capital markets and external borrowing, strong pressure on domestic financing sources is expected.

Ambitious revenue reforms would help ease the debt burden, though debt levels would remain above sustainability thresholds over the next decade. A focus on tax policy reforms would significantly improve revenue collection. Improving revenue administration could also yield positive results, but would take longer to materialize. Key tax policy reforms include restoring the value-added tax rate from 7 to 10 percent and restoring excise tax rates on fuel. The impacts on the poor are expected to be limited, as the VAT and excises largely affect the non-poor (See Part B on Revenue Mobilization). The benefits of curbing tax incentives on investment projects would take time, but would substantially expand the tax base in the medium-term.

Debt restructuring would improve debt and fiscal outcomes, but the relief would need to be significant. A debt restructuring that significantly lowers the public debt stock would provide a clear path toward debt sustainability. For instance, a 20 percent write-off of PPG debt would significantly reduce the public debt stock and servicing requirements, but it would still be insufficient to achieve debt sustainability within 10 years. Nonetheless, debt restructuring would considerably reduce financing needs.

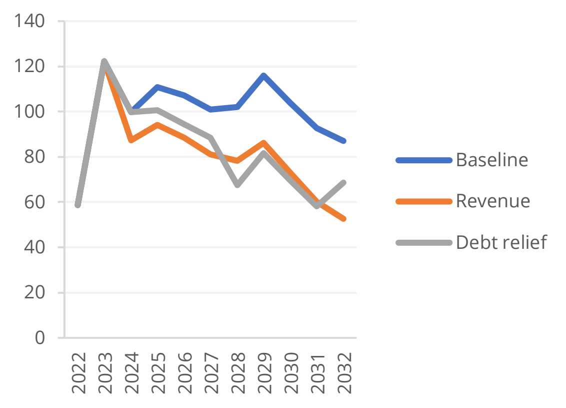
In conclusion, restoring debt sustainability and thus macroeconomic stability would require a combination of ambitious revenue reforms and debt restructuring. A credible debt restructuring plan would ease the debt service burden and reduce financing needs, while revenue reforms would provide a more sustainable source for financing and create fiscal space needed for supporting growth-enhancing spending (e.g., human capital investments).

Figure 44. Present value of total PPG debt (% GDP)



Source: World Bank staff projections.

Figure 45. PPG debt service (% revenue)



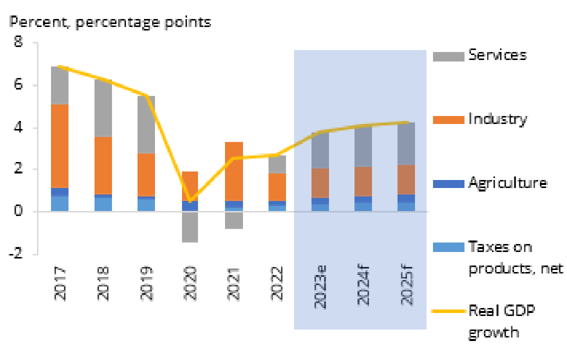
Source: World Bank staff projections.

External imbalances are expected to persist in the absence of critical structural and fiscal reforms. The current account balance is expected to remain at around 4 percent of GDP, as improvements in exports and remittances are offset by higher import demand and interest payments. Despite the requirement for exporters to repatriate export receipts, reserve adequacy is expected to remain thin (covering less than two months of imports) without substantial revenue reforms (e.g., curbing tax exemptions) and an improvement of the investment climate to promote re-investment opportunities with more backward-linkages in the local economy.

Household real incomes are expected to be affected by high living costs. Inflation has eroded purchasing power, thereby depleting household savings and reducing household consumption and human capital spending and placing many households at risk of falling into poverty. High living and food costs would continue to undermine food security, particularly for the urban poor. Slow progress in poverty reduction will likely continue. On a vulnerable recovery path, per capita income growth is likely to remain below pre-pandemic and regional peer levels in the medium term, thereby causing further divergence on poverty reduction and living conditions.

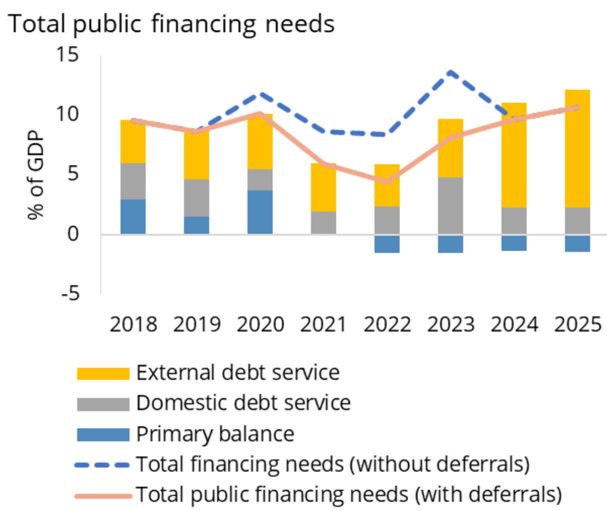
The outlook is subject to significant domestic and external uncertainty. Externally, subdued global and regional growth could lower external demand. Further financial tightening in advanced economies to address inflation could amplify depreciation pressures on the kip. Escalated geopolitical tensions could impact global commodity prices, which would also translate into domestic inflation. Domestic risks include foreign exchange liquidity risk to meet external debt service obligations, slow progress with structural reforms, and a deterioration of bank balance sheets. In particular, the outcome of ongoing debt renegotiations with key creditors will have significant implications for both debt sustainability and macroeconomic stability. A delayed, untransparent and/or inadequate debt treatment could exacerbate instability and lead to prolonged expenditure curbs that will harm medium- and long-term growth prospects. Labor shortages due to out-migration could also undermine the recovery prospects of labor-intensive sectors, including the agriculture, manufacturing, and services sectors. Climate shocks (e.g., El Nino) can also hamper the economic recovery.

Figure 46. Lao PDR GDP growth



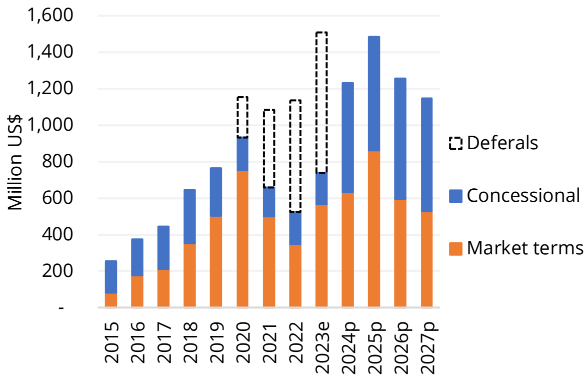
Source: Lao Statistics Bureau / World Bank staff estimate.

Figure 47. Public financing needs



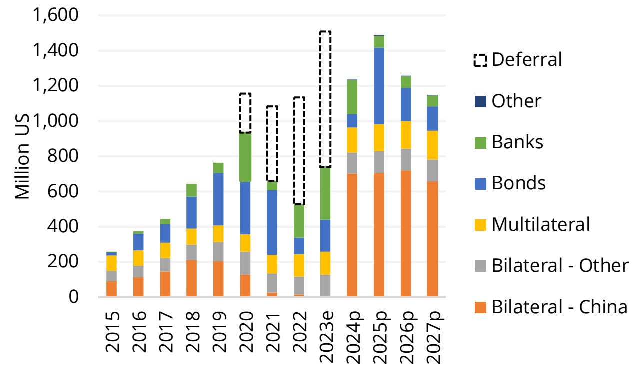
Sources: Ministry of Finance and World Bank staff estimate.

Figure 48: External debt service ($ million)



Source: World Bank calculations based on MOF data

Figure 49: External debt service ($ million)



Source: World Bank calculations based on MOF data

4. Policy Options

Restoring macroeconomic stability requires a strong commitment to ambitious reforms in five crucial policy areas: (i) raise public revenue to protect spending on education, health, and social protection; (ii) improve the allocation and efficiency of public expenditure; (iii) strengthen public debt management; (iv) strengthen financial sector stability; and (v) improve the business environment to promote investment and exports. In addition, improving the availability, timeliness, and quality of data is essential to inform evidence-based policy making. Specific reforms are as follows:

- Restore the value-added tax (VAT) rate to 10 percent and reduce VAT exemptions
  The VAT accounted for about 30 percent of total tax revenue in 2015–2021. In January 2022, the VAT rate was reduced from 10 to 7 percent. As a result, VAT collection only accounted for 24 percent of the total tax revenue in 2022. In addition, the VAT rate cut did not have a visible impact on inflation (as businesses do not seem to have passed the savings to consumers), while VAT compliance has not improved as expected. In 2022, VAT revenue amounted to 5.9 trillion kip with a 7 percent rate, so a 10 percent rate could have generated 8.5 trillion kip – representing a loss of about 2.6 trillion. In the first 6 months of 2023, VAT revenue was 26 percent higher than in the same period in 2022 – likely due to inflation. Therefore, the revenue loss in 2023 is expected to be even higher. VAT exemptions also result in a large amount of foregone revenues. Restoring the VAT rate 10 percent would be the most efficient way to generate additional revenue. If this reform was to be implemented in January 2024, it could generate more than 3 trillion kip in additional revenue. This should be coupled with improving the VAT refund mechanisms to reduce costs for businesses. Part of the additional revenue could be used to support the most vulnerable households through the targeted cash-transfer program, so that the tax rate increase does not exacerbate poverty and inequality. Reducing VAT exemptions, such as those for large-scale agricultural activities, would help widen the tax base and thus support domestic revenue mobilization.

- Review tax incentives and exemptions
  Broadening the tax base is critical to boosting domestic revenue mobilization. The corporate income tax (CIT) gap (i.e., the difference between potential and actual CIT revenue) is estimated at 87 percent, implying large foregone revenues from tax exemptions. Profit tax collection in 2022 was still below regional benchmarks. Large capital-intensive investments in energy, mining, and transport infrastructure have benefited from generous tax incentives, which deprive the country of vital fiscal revenues and foreign exchange. International evidence shows that tax incentives do not encourage foreign investment in the natural resources sector, since these are location specific.

To better link incentives to investment, it is crucial to replace the current profit-based tax incentive system (based on tax holidays and reduced rates) with a cost-based tax incentive system (based on accelerated depreciation and additional tax deductions). The ongoing revision of the Investment Promotion Law, led by Ministry of Planning and Investment, presents an opportunity to review fiscal incentive policies.

- Reprioritize spending toward the social sectors
  Improving the allocative efficiency of public expenditures is particularly important given the persistent fiscal constraints. Development spending has been declining as a share of GDP due to pressures from low revenues, rising debt service payments, and spending on other sectors and government organizations. This trend has undermined public service delivery. Reprioritizing public spending toward education, health, and social protection would be critical to building human capital and thus improve economic growth prospects in the medium term. It would also make public spending more pro-poor, thus helping to reduce poverty and inequality (see further discussion in the Thematic Chapter in Lao Economic Monitor May 2023).

- Expedite ongoing debt renegotiations to restore debt sustainability
  Liquidity and solvency challenges are due to rapid debt accumulation, particularly in the energy sector, and weak revenue collection. The current debt service schedule is not achievable without a socially damaging compression of public expenditure. Restructuring public debt is the basis for securing macroeconomic stability and support the economic recovery. 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 expenditures, and improve market confidence.

- 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) would help limit the accumulation of direct and contingent liabilities. Governments can choose to finance public assets and services through a PPP model, which may enable investments that otherwise could not be undertaken. However, PPPs may turn out to be more costly than traditional procurement if they are not carefully designed. Therefore, it is crucial to enhance the current legal and regulatory framework by upgrading the Decree on PPPs into a law and strengthening institutional capacity to prepare, procure, and manage PPP projects.

- Enhance bank supervision and operationalize emergency arrangements
  Protracted economic vulnerabilities and regulatory forbearance measures negatively impact bank balance sheets and threaten the sector’s ability to support the economic recovery. The rapid depreciation of the Lao kip places an additional stress on the highly dollarized banking sector. A bank failure could have considerable economic repercussions. Therefore, strengthening the deposit protection fund and employing an early warning system would help manage vulnerabilities in the 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 to manage sector weaknesses. An amendment to the Law on Commercial Banks, which was approved in principle by the National Assembly in July 2023, requires banks to increase capital, restrict foreign exchange operations, and strengthen dissolution and bankruptcy processes.

- Improve the investment climate
  Creating a 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. This would, in turn, contribute to improving productivity and economic growth. In addition, trade facilitation reform would benefit from streamlining non-tariff measures (NTMs) and promoting electronic customs clearance to facilitate trade. Such NTMs act as export restrictions. Improved transparency, harmonization, and mutual recognition of NTMs among trading partners would facilitate trade flows.

Table 2 Key Macroeconomic Indicators

	2019	2020	2021	2022	2023	2024	2025
					Projections		
Real Economy		Percent change yoy					
Real GDP growth	5.5	0.5	2.5	2.7	3.7	4.1	4.3
Agriculture	1.2	3.2	2.3	1.6	2.2	2.4	2.8
Industry	5.6	4.0	7.6	3.3	3.5	3.6	3.7
Services	6.9	-3.5	-2.1	2.5	4.6	5.3	5.4
Inflation (period average)	3.3	5.1	3.8	22.7	31.4	15.2	8.5
Fiscal Account*		Percent of GDP					
Revenues	15.6	12.7	14.9	14.7	14.9	15.1	15.2
Domestic Revenues	13.8	11.2	12.9	13.8	14.0	14.3	14.4
Taxes	10.9	9.2	10.2	11.5	11.7	11.8	11.9
Non-tax	2.9	2.0	2.7	2.3	2.3	2.5	2.5
Grants	1.7	1.5	2.0	0.9	0.9	0.9	0.9
Expenditures	18.8	18.0	16.2	14.9	15.1	16.7	16.7
Current expenditure	12.6	11.5	11.0	10.5	10.4	12.0	11.9
Wages	6.4	6.2	6.0	5.4	5.2	5.3	5.3
Non-wage, non interest expenditure	4.5	3.8	3.8	3.4	3.5	3.7	3.7
Interest payment	1.8	1.5	1.2	1.8	1.7	3.0	3.0
Current expenditure without interest	10.9	10.0	9.8	8.8	8.7	9.0	9.0
Capital expenditure	6.2	6.5	5.2	4.4	4.7	4.8	4.8
Domestic finance	2.6	2.0	2.0	1.8	1.8	1.9	1.9
Foreign finance	3.6	4.5	3.2	2.6	2.9	2.9	2.9
Fiscal balance	-3.3	-5.2	-1.3	-0.2	-0.2	-1.6	-1.5
Primary balance	-1.5	-3.7	-0.1	1.5	1.5	1.4	1.5
Selected Monetary Accounts		Percent change yoy					
Broad money	18.9	16.3	24.0	39.7			
Credit to the economy	7.4	4.3	11.5	47.9			
Balance of Payments		Percent of GDP					
Current account balance	-12.1	-5.9	-2.9	-2.4	-2.9	-3.6	-3.7
Trade balance	-7.9	-1.3	1.7	3.4	2.4	2.3	1.3
Export of G&S	37.6	35.2	42.1	65.3	74.6	76.6	74.1
Import of G&S	45.5	36.5	40.4	61.9	72.2	74.3	72.7
Primary and secondary income balances	-4.2	-4.6	-4.1	-5.5	-5.0	-5.6	-4.8
Primary income: net	-5.8	-5.9	-5.7	-7.8	-7.0	-7.6	-6.7
Secondary income: net	1.6	1.4	1.6	2.3	1.9	1.9	1.9
Gross international reserves	997	1,319	1,263	1,121	1,528	1,608	1,676
Months of G&S import cover	1.4	2.3	2.0	1.4	1.8	1.9	1.9
Memorandum items							
Nominal GDP (Billion kip)	162,657	171,705	182,584	217,108	262,262	293,324	321,668

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 October 2023.

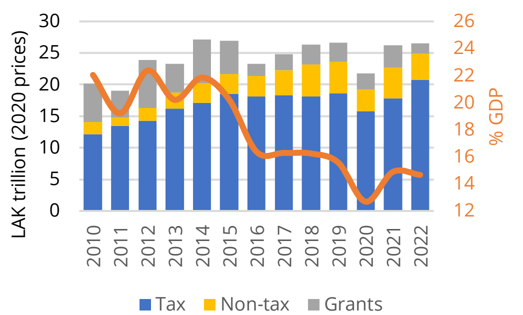
PART B

Improving Revenue Mobilization

1. Context

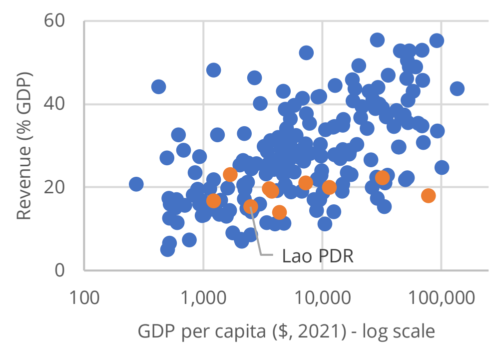
Improving domestic revenue collection is fundamental to supporting long-term macroeconomic stability and growth through investing in human capital. For most of the 2010s, low revenue performance resulted in high fiscal deficits despite expenditure tightening. In recent years, fiscal consolidation has been achieved through tight expenditure controls and interest payment deferrals. High fiscal deficits and large investments in infrastructure (often funded by government on-lending and guarantees) have led to significant external public debt accumulation. Low revenue collection constrains fiscal space for investing in basic public services (e.g., health, education, and social protection), especially in a context of growing debt service repayments. Moreover, low foreign currency revenues, particularly due to generous tax exemptions, add pressure on the exchange rate and hence inflation (See discussion in Part A). Therefore, improving tax policy and tax administration is critical for boosting revenue mobilization, which would help increase fiscal space for growth-enhancing spending.

Figure 50. Total revenue (in Lao kip and % GDP)



Source: Ministry of Finance and World Bank staff calculations.

Figure 51. Total revenue (% GDP, 2016–2021)



Source: International Monetary Fund and World Bank staff calculations.
Note: Orange dots represent ASEAN countries.

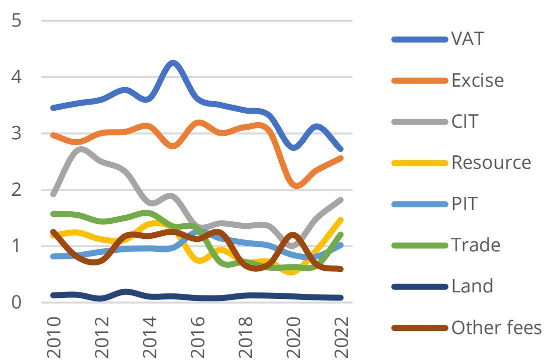
Revenue performance was a concern even before COVID-19, and revenue levels are low by regional and income standards. Total revenue declined from 22 to 16 percent of GDP during 2014–2019, owing to declines in tax collection and foreign grants. It subsequently dropped to 13 percent of GDP in 2020, affected by the COVID-19 pandemic, but recovered to 15 percent in 2022, partly supported by inflation. Revenue performance is low compared to regional and income peers. In 2022, almost 80 percent of total revenue was collected through taxes, followed by non-tax revenues (16 percent) and grants (6 percent).

Tax revenue has relied heavily on indirect taxes, particularly the value-added tax and excises. Indirect taxes accounted for most tax revenue, with the value-added tax (VAT) and excises representing 29 and 25 percent of total tax revenue in 2018–2022, respectively. These are consumption-based taxes levied on the purchase of goods and services. Direct taxes averaged 23 percent of tax revenue in the same period and were almost exclusively derived from the corporate income tax (CIT) and the personal income tax (PIT).

Tax revenue collection has not kept pace with economic activity, with collection reaching only about 60 percent of its full potential. Tax revenue fell from 14 to 11 percent of GDP during 2014-2019, before falling to 9 percent in 2020 due to COVID-19. Although tax revenue recovered to 11 percent in 2022, the tax-to-GDP ratio is significantly below the recommended minimum international benchmark of 15 percent. Tax collection is reaching only about 60 percent of its full potential, indicating there is ample scope for policy and administration reforms. When compared to taxation levels and (structural and institutional) determinants in peer countries, Lao PDR had an average tax potential of 21 percent of GDP, but could only collect an average of 13 percent of GDP in 2010–2016, implying a total tax gap of 8 percent of GDP. The tax gap has likely increased in recent years due to tax rate cuts.

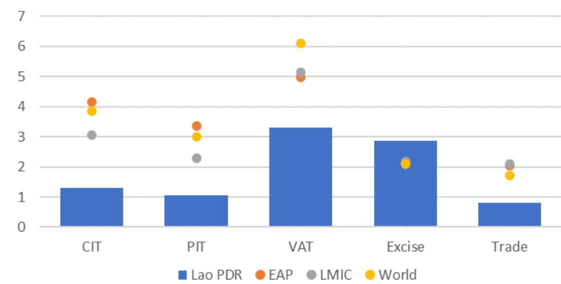
The relative decline in tax revenue is mostly accounted for by the underperformance of the corporate income tax and value-added tax. The poor performance of revenue collection has been observed across most types of tax. Corporate income tax (CIT) collection declined considerably since 2011, owing to steady reductions in the standard rate and widespread profit tax exemptions. The VAT has declined since 2015, likely also affected by tax exemptions. COVID-19 had a considerable impact on economic activity and, thus, tax revenue. In 2020, revenue collection declined for most taxes, especially excises, although 'other fees' partly offset this trend. Since then, a recovery in consumption and imports has underpinned tax collection improvements, although this is also linked to the exchange rate depreciation and higher (domestic and import) prices. Nonetheless, VAT collection declined in 2022, largely due to the VAT rate reduction from 10 to 7 percent.

Figure 52. Tax revenue (% of GDP)



Source: Ministry of Finance and World Bank staff calculations.

Figure 53. Revenue by type of tax (% of GDP, 2016–2020)



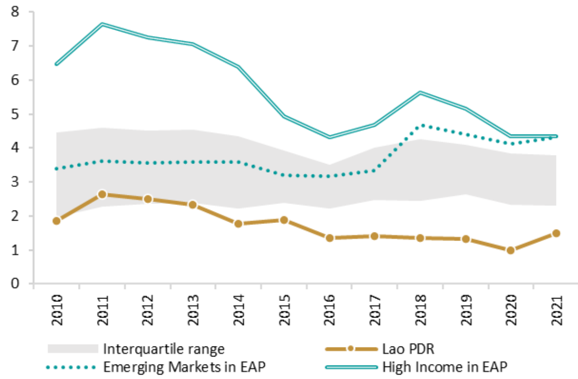
Source: International Monetary Fund and World Bank staff calculations.

2. Assessment of major taxes

2.1 Corporate income tax

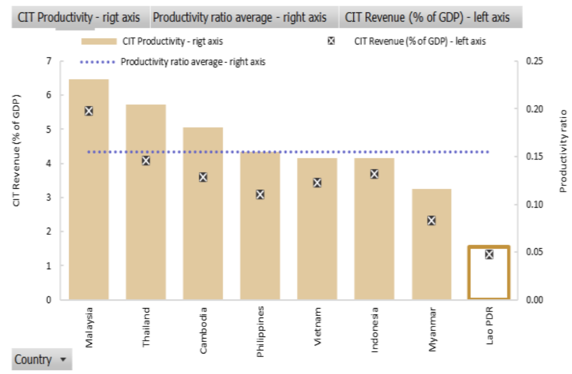
Corporate income tax (CIT) revenue and the CIT productivity ratio are the lowest in the region. CIT revenue steadily dropped from 2.7 to 1.0 percent of GDP during 2011–2020, although it recovered to 1.8 percent of GDP in 2022. However, it remains one of the lowest levels in the world. Very low CIT revenue collection is due to a combination of tax rate cuts and the widespread use of tax incentives (e.g., profit tax holidays). CIT productivity, measured as the ratio of actual CIT collection (as a percentage of GDP) to the highest statutory marginal rate, was also very low at 0.05. This ratio is significantly lower than the averages observed in the EAP (0.15) and other regions.

Figure 54. CIT collection (% GDP)



Source: International Monetary Fund and World Bank staff calculations.

Figure 55. CIT productivity ratio (2016–2021)



Source: International Monetary Fund and World Bank staff calculations.

The CIT rate has been progressively reduced, while additional tax incentives have been provided across several sectors. Companies registered in the Lao PDR (including foreign companies operating in the country) are taxed at a standard CIT of 20 percent, with some exceptions. The profit tax rate is 35 percent for mining companies and 22 percent for tobacco companies. Training and research centers are taxed at 5 percent, while activities using innovative or green technologies face a 7 percent tax rate. Companies listed on the Lao Stock Exchange pay 13 percent in the first four years. Microenterprises voluntarily registered in the VAT system only pay 0.1 percent, while small- and medium-scale entities newly registered in the VAT system pay 3 and 5 percent in the first 3 years, respectively. The standard profit tax rate was cut from 35 to 28 percent in 2012, then to 24 percent in 2015, and finally to 20 percent in 2020. Meanwhile, the Law on Investment Promotion provides tax incentives depending on the business activity and location, while concessions negotiated on a case-by-case basis provide even more generous tax benefits.

Poor CIT performance has its roots in the extensive use of profit tax holidays to incentivize foreign investment. The tax law allows the use of tax holidays, with the targeting criteria specified in the Law on Investment Promotion and the decree on its implementation. The duration of profit tax holidays varies by type of business activity and location, ranging between 4–15 years. The length of tax holidays for investments in concession activities and special economic zones (SEZs) is not detailed in the legislation. In practice, profit tax holidays (including their duration) are negotiated on a case-by-case basis. While these tax incentives are aimed at attracting investment, there has been no cost-benefit analysis to evaluate value for money.

Evidence suggests that firms do not rank tax incentives as the primary reason for choosing where to invest. The effectiveness of incentives largely depends on the investor's motivation for undertaking the investment. Surveys and empirical research often find that political stability, macroeconomic stability, the legal environment, and labor skills are the key determinants for foreign direct investment. Incentives can be more effective for attracting investors in traditional export-oriented sectors (efficiency-seeking) since these are largely driven by competitive cost advantages in the host country. By comparison, investors are less responsive to incentives when mainly serving the domestic market (market-seeking) or drawing on natural resources (asset-seeking). In the case of the Lao PDR, many large investment projects are location-based, as they rely on the presence of natural resources (e.g., minerals and rivers) or the country's geographic position in Southeast Asia (e.g., for transport and logistics services). Therefore, addressing barriers to investment should focus on regulatory issues (e.g., licenses, permits, and immigration requirements), infrastructure (e.g., utilities and roads), and the quality of the labor force (e.g., skills).

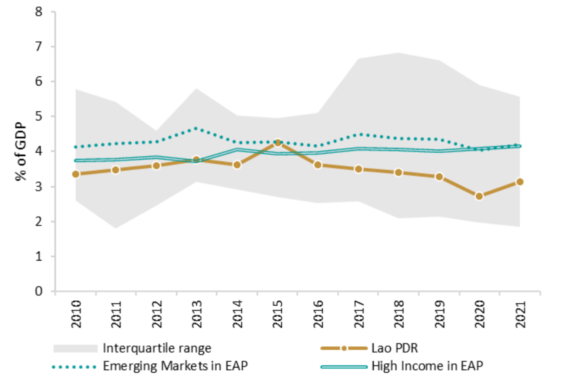
CIT gaps are estimated to be very high, indicating a very large amount of foregone revenues. The estimation of tax gaps is crucial for policy making since it provides a measure of the revenue gains that can be achieved with tax policy and administration reforms. Estimates suggest that the overall CIT gap amounts to 87 percent of potential revenue, which implies that only 13 percent of potential revenue is being collected. This is due to both tax policy (e.g., exemptions that reduce the tax base and a lower CIT tax rate) and tax administration issues (e.g., weak compliance and enforcement). The CIT gap is very high across most economic sectors, including those dominated by large companies operating in the formal economy. Agriculture and accommodation & food services, which are overwhelmingly informal, have CIT gaps above 95 percent. Mining, electricity, manufacturing, and transport & storage have CIT gaps ranging between 75 and 90 percent. At the other end of the spectrum, information & communication and financial & insurance services have CIT gaps below 40 percent. While informality may explain some of the gaps observed (by narrowing the tax base), measures of informality suggest that this does not account for most of the gaps. Hence, a large portion of the tax gap is likely caused by generous tax incentives and potentially base erosion and profit shifting (BEPS).

Profit tax exemptions should be phased out and replaced by cost-based incentives. International evidence suggests that profit tax exemptions are highly inefficient. This is because tax holidays do not explicitly target investment, with the amount of tax relief often being disproportionate to the investment. In fact, firms can benefit even when they are not investing. The incentive heavily favors firms with high profits, which least need government support. This contributes to high redundancy of expenditure on incentives since an investor anticipating high profits would likely have proceeded in any case. Also, host governments face the risk of losing substantial revenue when a firm earns extraordinary profits. In addition, CIT holidays facilitate aggressive tax avoidance, as profit from investments that do not qualify for exemption may be artificially transferred through related party transactions. Profit-based incentives should be replaced by cost-based tax measures (e.g., accelerated depreciation and investment tax allowances or additional deductions), which reward companies only if they invest. The tax relief provided is often set as a percentage of investment expenditure. Following good international practice, tax incentives should be consolidated in tax laws, with clear and transparent eligible criteria under the purview of the Ministry of Finance.

2.2 Value-added tax

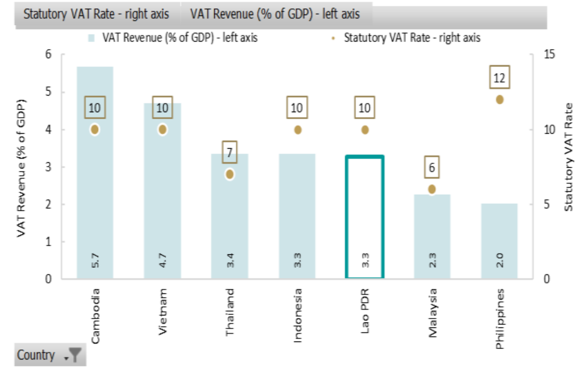
Value-added tax revenue is relatively low compared to most regional peers. VAT revenue dropped from 4.3 to 2.7 percent of GDP between 2015–2020, before recovering to 3.1 percent of GDP in 2021. This was partly due to the economic slowdown (including COVID-19) but also VAT exemptions on imports of capital goods related to some investment projects. VAT collection declined to 2.7 percent of GDP in 2022, owing to the reduction in the VAT rate from 10 to 7 percent, which more than offset higher consumer prices. Although the VAT accounts for a significant share of domestic tax revenues, VAT collection is comparatively lower than in most ASEAN countries. In fact, it was the lowest revenue among peers with the same VAT rate, implying that it is underperforming considerably. Thailand collected 3.2 percent of GDP from VAT, even with a rate of 7 percent.

Figure 56. VAT collection (% GDP)



Source: International Monetary Fund and World Bank staff calculations.

Figure 57. VAT rate and collection (2016–2021)



Source: International Monetary Fund and World Bank staff calculations.

The statutory VAT rate was reduced from 10 to 7 percent in 2022, significantly undermining tax collection. The VAT was introduced in 2010 at 10 percent, with some products being zero-rated. The 2021 amendment of the Tax Law introduced several changes to the VAT regime. The applicable VAT rate on the import of goods and services, supply of goods and services in the Lao PDR, and export of services was reduced from 10 to 7 percent from January 2022. The supply of goods outside a special economic zone (SEZ) by an enterprise registered for operation in the SEZ became subject to VAT. Activities currently exempted from VAT include electricity imports, electricity supplied to any electricity enterprise within the country, and electricity and minerals exported overseas or to SEZs.

The VAT regime includes numerous exemptions, which pose several drawbacks. VAT exemptions create economic distortions by benefiting some sectors more than others. Businesses unable to credit input VAT because they buy inputs from exempt businesses experience increased costs. On the other hand, if the exemption is applied at the end of the supply chain, it reduces VAT revenues. These negative effects of VAT exemptions make it important to examine the rationale for all exemptions.

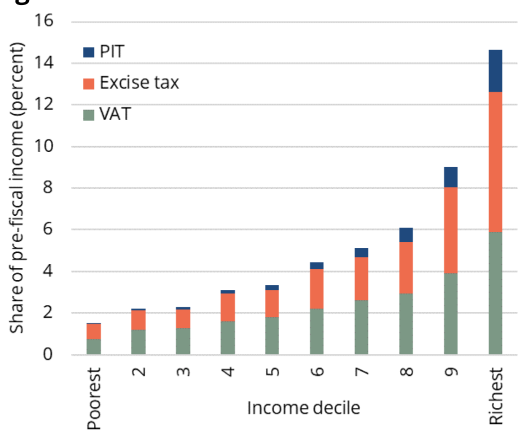
The recent reduction of the VAT rate has already had a negative impact on tax collection. The VAT rate was reduced from 10 to 7 percent in January 2022, with the declared aim of expanding the tax base (by providing a stronger incentive for tax registration) and providing temporary relief to ease the impact of COVID-19. At the same time, the authorities tried to balance this cut with excise rate increases for selected products. However, since the rate increases were small, applied on a very narrow tax base, and subject to exemptions, the revenue gains were not sufficient to compensate for the VAT reduction of 3 percentage points on most goods and services. The VAT revenue loss is estimated at about 1 percent of GDP in 2022, while there is little evidence of an impact on consumer prices. The 2021 revision of the Income Tax Law aims to promote formality by encouraging the SMEs to register for VAT through a favorable income tax regime. However, revenue increases through formalization will not be significant (as the experience of other countries suggests), since most VAT revenue comes from large (formal) taxpayers. Moreover, tax cuts may not necessarily lead to greater VAT registration due to other factors (e.g., additional costs such as bookkeeping).

Box 3. Distributional impact of VAT

Taxes levied on consumption impose a larger burden on better-off households, which implies that they are progressive. Although the standard VAT rate was 10 percent in 2018, poorer households faced much lower effective VAT rates due to large shares of informal consumption (e.g., self-produced food or services provided by unregistered vendors). For poorer households, a large part of VAT payments is the VAT component hidden in VAT-exempted and informal goods and services that use inputs subject to VAT (e.g., fuel). In total, VAT payments represent only 0.8 percent of the income of the poorest households, compared to 5.9 percent for the richest households, suggesting that the VAT is a progressive tax. Therefore, the VAT rate reduction introduced in 2022 has had a negative redistributive effect, meaning it did not proportionately benefit the poor. Excise taxes are found to be slightly more progressive than VAT, as better-off households spend more on goods and services subject to excise taxes. Spending on alcoholic beverages, tobacco, fuel, large vehicles, luxury goods, and recreation together constitute 23.5 percent of income for households in the richest decile, compared to 3.4 percent in the poorest decile. The amount of excise taxes paid represents less than 1 percent of the income of the poorest decile and 6.7 percent of the income of the richest decile.

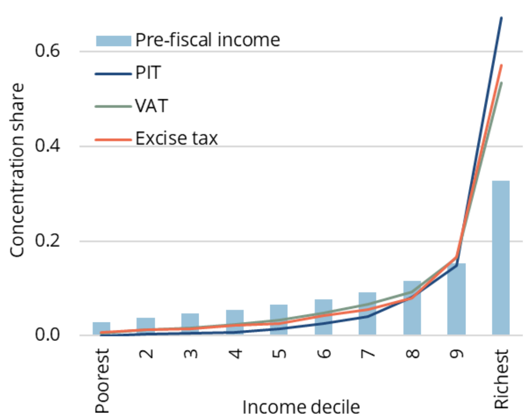
The government can use some of the additional revenues from reversing the VAT rate cut) to target support to poor households. Foregone revenue from VAT cuts is a tax expenditure. The government has a choice of either spending on tax expenditure or on targeted cash transfers. Because tax expenditure is a non-targeted policy, spending on targeted cash transfers is more cost-effective in terms of protecting vulnerable people against shocks. The cost effectiveness of a targeted cash transfer program depends on how accurate the targeting tool is in identifying the vulnerable and the most affected groups. In addition, the government can use the additional VAT revenue to support social spending, such as improving roads, schools, and hospitals, and increase benefits for teachers, doctors, and other civil servants to overcome the current economic difficulties.

Figure 58. Incidence of taxes



Source: World Bank staff calculations.

Figure 59. Concentration share of taxes



Source: World Bank staff calculations.

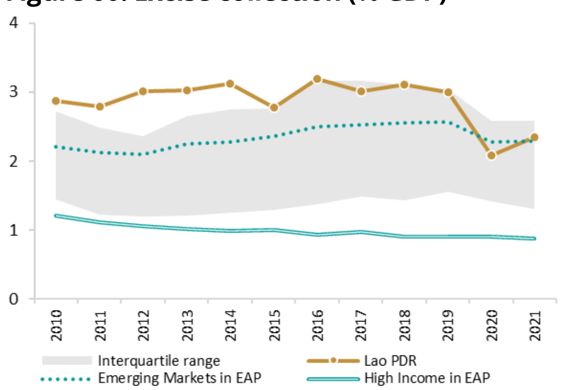
Several VAT exemptions should be reviewed for elimination, particularly those that are costly. While some VAT exemptions for public services (such as health care and education) could be retained, other exemptions should be removed. For example, agriculture and forestry are common exemptions in developing countries, largely because of the small scale of most agricultural activities and the low income of most people engaged in them. However, there are larger agribusinesses and forestry operations in the Lao PDR that generate substantial revenues. Subjecting these sectors to the standard VAT regime is highly advisable. Small farmers would not be affected by this change, as they would be under the VAT registration threshold of 400 million kip. Subjecting these goods to VAT could allow producers and traders to claim credit for input VAT, improving efficiency.

The management of VAT refunds needs to be improved to avoid negative impacts on businesses. The cost of VAT also falls on businesses when refunds are not processed in a timely manner. A significant improvement in the amended 2018 Law on VAT was that all VAT taxpayers with a net credit could claim a VAT refund. Previously, only exporters and large-scale investors were entitled to VAT refunds, and all other taxpayers had to carry forward the excess input credits. However, there are challenges with the administration of VAT refunds. All refunds are subject to examination prior to the VAT refund decision. Businesses have experienced substantial delays in obtaining refunds, sometimes of more than one year. The VAT refund process could be improved through the adoption of a risk-based approach, improvements in the TaxRIS system to support VAT management, and adequate budget allocations for VAT refunds.

2.3 Excise tax

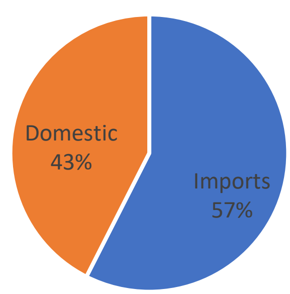
Excises comprise an important share of tax revenue, and collection is relatively high compared to regional peers. Excise revenue collection averaged 3 percent of GDP during 2010–2019, although it declined to 2.1 percent of GDP in 2020, partly due to the COVID-19 pandemic. This is reasonably high by regional standards. In 2022, revenue collection benefited from higher domestic and international prices, but this was partly offset by fuel excise rate reductions in mid-2022. Excises accounted for 23 percent of total tax revenues in 2021–2022. It is thought that most of the excise revenue accrues from vehicles and fuel, and thus collected from imports (Figure 3.23). The relative contribution of excises is high because the overall tax system generates relatively small revenue.

Figure 60. Excise collection (% GDP)



Source: International Monetary Fund and World Bank staff calculations.

Figure 61. Excise collection by source (%, 2022)



Source: Ministry of Finance and World Bank staff calculations.

Recent reductions in fuel excise rates have produced large foregone revenues, while the tax structure could also be improved. An ad valorem excise is levied on several fuel types. It is estimated that recent rate cuts have generated losses of over $160 million between mid-2022 and mid-2023. While these measures were introduced to protect consumers from inflation, these cuts have predominantly benefited wealthier households. In addition, fuel imports reported by the Lao PDR are much lower than those reported by trading partners (e.g., Thailand and Vietnam). This suggests that a significant amount of fuel is not being taxed, which generates considerable revenue losses. Finally, as the price of fuels fluctuates frequently, the resulting excise revenue may not correspond to the externalities produced by fuel consumption. An alternative is to apply a specific tax system on fuel, whereas the specific tax considers the costs of air pollution, carbon emissions, vehicle accidents, congestion, and road damage, among others.

The Lao PDR has among the lowest tobacco taxes and prices in the region. The excise tax on tobacco accounts for 11 percent of the retail price of the most sold brand in 2020, the lowest in the region. This is much lower than the WHO's recommendation that excise taxes on tobacco should account for at least 70 percent of retail prices. Furthermore, the Lao PDR has the second-lowest retail prices in both US dollar and PPP-adjusted terms. Concerningly, cigarettes have become considerably more affordable in recent years. The most sold brand was nearly twice as affordable in 2020 when compared to 2010. Data for alcohol and non-alcoholic beverages were not available to conduct a similar analysis.

The tax structures for tobacco, alcohol, and non-alcoholic beverages can be improved. Tobacco has a mixed tax structure with a specific tax of 600 kip per pack of 20 cigarettes and an ad valorem rate of 72 percent of ex-factory prices (for domestic production) or the cost, insurance, and freight (CIF) price (for imports).[25] However, most cigarettes qualify for a 15 percent tax rate due to an investment agreement. Alcohol and non-alcoholic beverage excises are ad valorem applied to the ex-factory price for domestically produced goods and the CIF price for imported goods. Alcohol taxes are based on alcohol content, with tiers employed for beer with alcohol content above or below 5 percent. The most recent rates for other alcoholic beverages employ tiers with alcohol content below 10 percent, between 10 and 23 percent, and greater than 23 percent. Ad valorem taxes are considered less effective than specific taxes. From a fiscal perspective, they are more difficult to collect, more prone to tax avoidance and evasion, and result in less stable and lower revenue streams. From a health perspective, they result in lower prices on cheaper brands, which promotes consumption and makes products more accessible to vulnerable populations (e.g., youth, poor, and people with alcohol use disorders). Furthermore, tax increases are less effective since they provide greater opportunities for users to trade down to cheaper products to avoid the tax increase. The global trend indicates that modern tax administrations are leaning toward a simplified specific excise tax structure with indexation to maintain the value in real terms for all three products.[26]

The weakness of ad valorem taxes is compounded by applying them early in the supply chain. Using wholesale/ex-factory price or CIF as a tax base invites tax avoidance and evasion, since this information is provided by manufacturers and importers that have an incentive to lower their tax liability. Using retail prices as the tax base is preferable because these can be verified independently by the authorities. However, this is still a less effective policy option compared to higher uniform specific taxes.

The current tax administration of the excise regime could be strengthened, especially for the cigarette market. A 25-year Investment License Agreement (ILA) signed in 2001 between the government and two tobacco companies established a joint-venture cigarette manufacturer. Under the ILA, the joint venture benefits from a reduced excise tax rate on tobacco products (15 percent of production costs if less than 1,500 kip per pack, and 30 percent if greater than 1,500 kip per pack) and exemptions from other taxes. Local tobacco companies are not complying with the mandatory contribution to the Tobacco Control Fund established in 2013.[27] The government should seek legal support to revoke or not renew the ILA. Furthermore, additional improvements would help manage or mitigate potential losses associated with the lack of compliance (e.g., strengthened audits, enhanced data inputs and analytics, and a revised system of physical excise stamps leveraging digital technology).

[25] Since the ad valorem tax is levied early in the supply chain, the excise collection as a share of retail prices is significantly lower. In 2022, the tax stamp fee was increased from 5 kip to 500 kip, but it appears to be collected unevenly.
[26] The indexation of specific unit taxes averts revenue erosion when the prices of excise goods increase. Unit rates can be indexed to inflation.
[27] The fund is supposed to receive 2 percent of the profit of tobacco companies and an additional 200 kip levied on each cigarette pack.

The list of goods and services subject to excise taxes could be reviewed for rationalization. While many goods are subject to excise taxation, their rationale is not always clear since many do not produce significant internalities or externalities. It is important to ensure that all goods and services in the excise list are worth the administrative and compliance costs that their collection entails. Excises can only be justified if they raise a reasonable amount of revenue and correct internalities or externalities.

3. Policy Options

Restore the VAT rate to 10 percent to immediately and efficiently raise considerable revenue. Restoring the 10 percent rate could generate at least 1 percent of GDP in additional revenue while having a limited impact on inflation or inequality. Part of the additional revenue should be earmarked to support the most vulnerable households through targeted cash-transfer programs. Moreover, VAT exemptions should be reviewed and streamlined, since they distort economic activity and can cause tax cascading. In the medium-term, VAT compliance can be improved through the full implementation of the TaxRIS, the improvement of tax services, and the enhancement of institutional and technical capacities.

Revise the Law on Investment Promotion to curb tax incentives and thus broaden the tax base. Profit-based tax incentives should be phased out and replaced by cost-based measures, such as investment tax credits and accelerated depreciation. Other tax incentives should also be restricted. The Minister of Finance should be the sole authority issuing tax incentives, particularly with a view to rationalizing the incentive regime and reducing discretion. These reforms would require a revision of the Law on Investment Promotion. In addition, improving monitoring of tax incentives would support better scrutiny of compliance and enable an assessment of their effectiveness.

Reform excise tax structures and increase rates, particularly on beverages, tobacco, and fuel, to provide additional revenue while supporting health, environmental, and social outcomes. Reversing the recent fuel excise cuts would generate considerable revenue while incentivizing a transition to green energy. Reviewing the tax structure for alcoholic and non-alcoholic beverages, with specific taxes replacing or being added to the ad valorem tax and moving the base to retail prices, could raise revenue and benefit health outcomes. Reviewing the scope of products included under the non-alcoholic beverage category to make it a true sugar-sweetened beverages tax would be advisable. Removing exemptions on the tobacco excise and raising the tax rate could produce similar results, while changing the base of the ad valorem tax from ex-factory to retail prices would facilitate monitoring and enforcement. Furthermore, all specific taxes should be indexed to inflation and income growth.

Strengthen compliance risk management by focusing on the administration of large taxpayers to increase revenue and enhance efficiency. Strengthening compliance risk management should start with the management of large taxpayers, given their importance to revenue collection and the scarcity of skilled staff within the tax administration. It is therefore necessary to re-establish a dedicated large taxpayer office and recentralize large taxpayer management. There is also a need to improve capacities in key functions, such as audit, taxpayer services, and data management and analysis.

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