Fiscal Policy for Macro Stability
Lao PDR Economic Monitor
November 2023

Part A: Macroeconomic Developments and Outlook
Key Messages

- Economic recovery continued in 2023, largely supported by the service sector. But it is slightly lower than expected constrained by macroeconomic instability.
- The Lao kip continued to depreciate in 2023, driven by debt pressures and external imbalances.
- Kip depreciation has in turn fed continued inflation (more so than higher international commodity prices).
- Domestic policies have contributed to weaken the kip (more so than external shocks, such as a strong US dollar).
- Low revenues and high public debt service have created macroeconomic imbalances (pressure on the budget and shortage of foreign exchange).
- Revenue reforms are critical, but these alone cannot restore fiscal/external sustainability unless underlying solvency issues are addressed through adequate debt restructuring.
Overall employment increased, but more workers left non-farm wage jobs

More workers became self-employed or migrated for better jobs

Children are not enrolled in school

Macroeconomic imbalances result largely from domestic policy environment

Laos experiences significant depreciation and inflation

Inflation and exchange rate depreciation are strongly correlated
Macroeconomic Imbalances

- External debt service
- Low FX reserves
- Low export receipts
- Low fiscal revenues

FX demand

FX supply

Domestic factors

- Stronger US dollar

External factors

- Higher international commodity prices

- Higher imports

- External debt

- Low fiscal revenues

- Low export receipts

- Low FX reserves

FX liquidity challenge amid high debt-service payments

Public and publicly guaranteed debt remains at critical levels

- Arrears + swap
- External publicly guaranteed debt
- Domestic public debt
- External public debt

Despite debt-service deferrals, repayment obligations are large

- Deferral
- Other
- Banks
- Bonds
- Multilateral
- Bilateral - Other
- Bilateral - China

% of GDP

Million US


Limited fiscal space for growth-enhancing expenditure

High financing needs despite improved fiscal balance and debt payment deferrals

Limited fiscal space undermine public investment on human capital

Persistent external imbalances
Tightened monetary and foreign currency management measures has limited and temporary impacts

Pressure on the parallel market reemerged

Some monetary measures (BOL bonds) have temporary impacts

Outlook and Risks

Gradual recovery

Outlook is dependent on debt renegotiation outcome

External public debt service profile
Significant Downside Risks

External
- **Debt renegotiation outcome** will have significant implications for fiscal space, debt sustainability, and economic stability
- Lower-than-expected growth in regional economies would mean lower external demand
- Escalated geopolitical tensions could potentially push up commodity prices

Domestic
- **FX liquidity risk** to meet external debt repayments, in a context of limited access to international capital markets and more pressure on the domestic market
- Limited fiscal space continues to constrain government investment in human capital
- Labor shortages could also undermine recovery prospects
- Climate shocks

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**The Vital Five**
Reforms to Secure Macroeconomic Stability in the Lao PDR

1. **CUT COSTLY TAX EXEMPTIONS TO RAISE PUBLIC REVENUE, PROTECT SOCIAL SPENDING**
   - Tax exemptions deprive the budget of much revenue every year, so less can be invested in human capital or used to service debt. Without investment in knowledge, skills and health, Laos will fall further behind.

2. **IMPROVE THE GOVERNANCE OF PUBLIC AND PUBLIC PRIVATE INVESTMENT**
   - Inefficient public investment is costly and public-private partnerships often create liabilities for the government.

3. **Restructure Public Debt Through Ongoing Negotiations**
   - High public debt levels undermine macroeconomic stability by constraining fiscal space, exerting pressure on the exchange rate, and jeopardizing banking sector stability.

4. **Strengthen Financial Sector Stability Through Legal and Regulatory Tools**
   - Vulnerabilities in state-owned banks may hamper private sector credit growth. This exposure to risk can have widespread impacts on the rest of the economy.

5. **Enhance the Business Environment via Effective Regulatory Reforms**
   - Burdensome processes and regulations raise business costs and reduce productivity, undermining investment and exports.
Part B: Improving Revenue Mobilisation

Key Findings

- Revenue performance has deteriorated considerably in past decade and is very low by regional and income standards.
- Low tax rates, a narrow tax base, and low compliance and enforcement have weakened tax revenue (which only reaches 60% of its full potential).
- Generous tax incentives have led to large revenue losses (e.g. corporate income tax gap estimated at 87%).
- Recent measures (e.g., VAT and fuel excise rate cuts) have further undermined revenue, while not providing much support to the most vulnerable.
- Tax revenue (11% of GDP in 2022) is well below the minimum recommendation of 15% of GDP.
- Low revenue is undermining fiscal sustainability, macroeconomic stability, and economic growth prospects.
Revenue performance has deteriorated in the past decade

Revenue performance has fallen since 2014, especially tax revenue

VAT, excises, and CIT (the largest sources of revenue) have underperformed

Revenue is very low by international standards

Revenue is very low compared to regional and income peers

Large gaps in corporate income, personal income, and value-added taxes
Key Reforms

- Restore the value-added tax rate to 10%. (Additional revenue would be over 1% of GDP.)
- Revise the Law on Investment Promotion to curb tax incentives to support the budget and increase inflows of foreign exchange (gradual but significant impact).
- Reform excise tax structures and increase rates (e.g. fuel) to generate revenue and produce health and environmental benefits.
- Strengthen compliance risk management by focusing on the administration of large taxpayers.

Most countries are rebuilding fiscal buffers after COVID-19.

Distributional Impact of Taxes

About 70% of VAT revenue is paid by the richest 20%

VAT burden (% VAT collected)

VAT burden (% household income)

VAT represents a greater share of income for richer households.
Improving domestic revenue is critical to help restore stability and boost growth-enhancing spending

Conclusion

• Revenue has been declining and is very low by international standards (low revenue undermines fiscal sustainability, macroeconomic stability, and growth prospects).

• There is significant scope to improve revenue collection (through tax policy and tax administration reforms).

• Increasing VAT and excise tax rates will have a small impact on inflation and poorest households, while generating significant revenue in the short term. (CIT exemptions need to be phased out.)

• Improving domestic revenue will help restore macroeconomic stability (coupled with debt restructuring) and support growth in the medium-term.