Fiscal Policy for Macro Stability

Lao PDR Economic Monitor

November 2023

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30 November 2023

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Part A: Macroeconomic Developments and Outlook

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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**.

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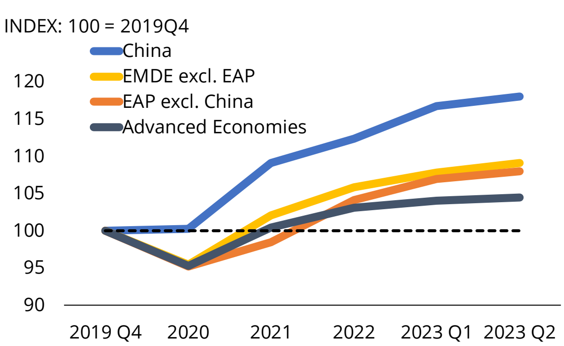
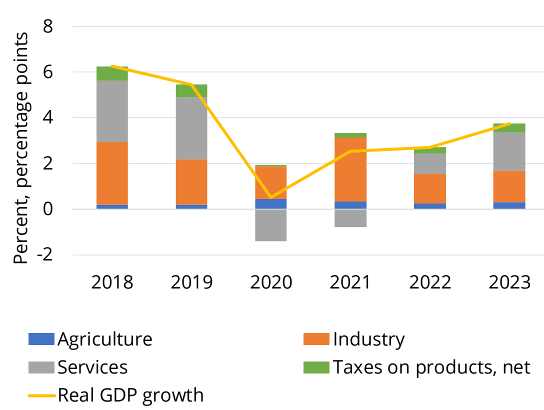
Continued growth recovery in Laos, but slightly lower than expected, undermined by macro instability

EAP economies have recovered



Laos GDP growth forecast at 3.7%, primarily driven by services



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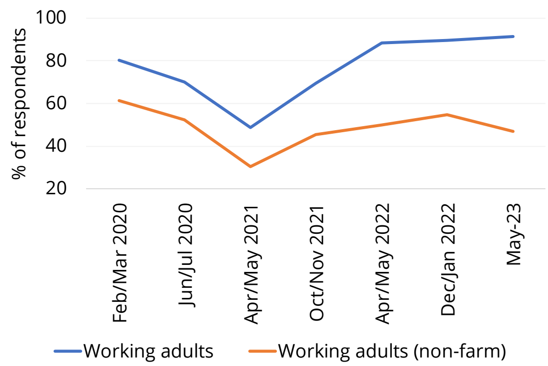
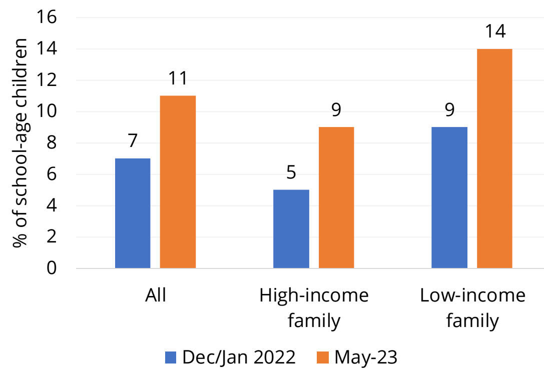
Overall employment increased, but more workers left non-farm wage jobs

More workers became self-employed or migrated for better jobs



Children are not enrolled in school



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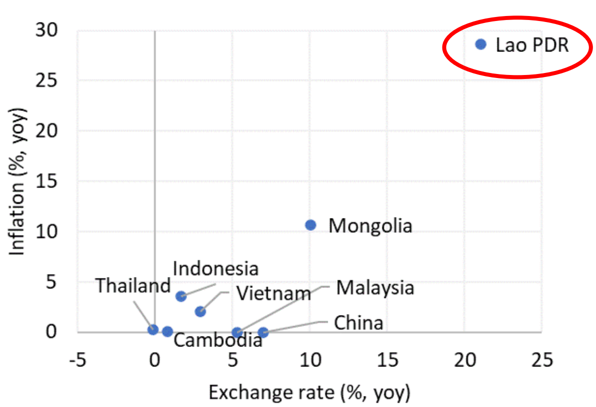
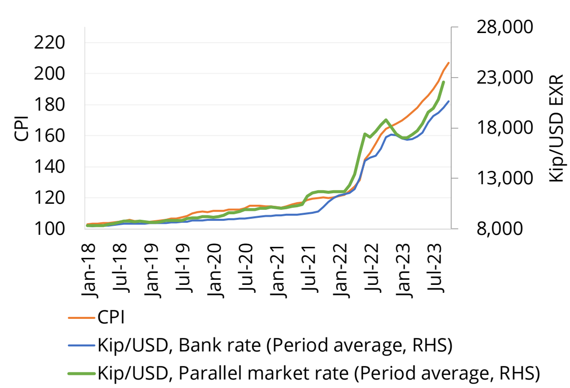
Macroeconomic imbalances result largely from domestic policy environment

Laos experiences significant depreciation and inflation



Inflation and exchange rate depreciation are strongly correlated



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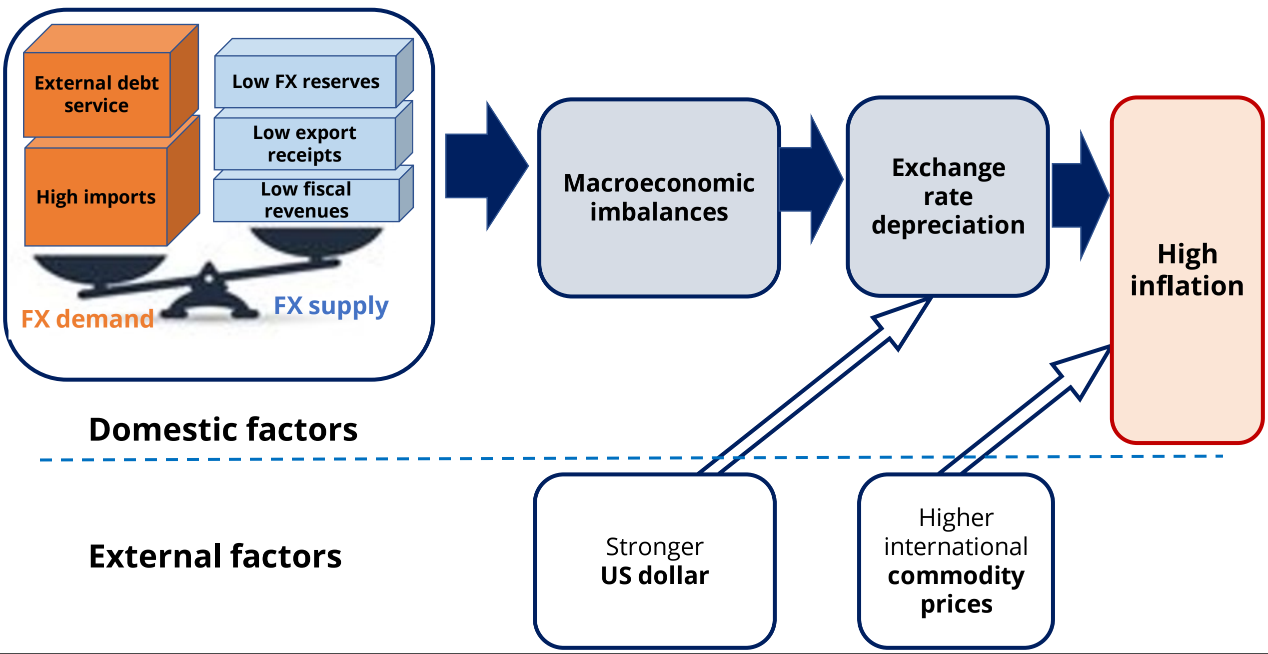
Macroeconomic Imbalances



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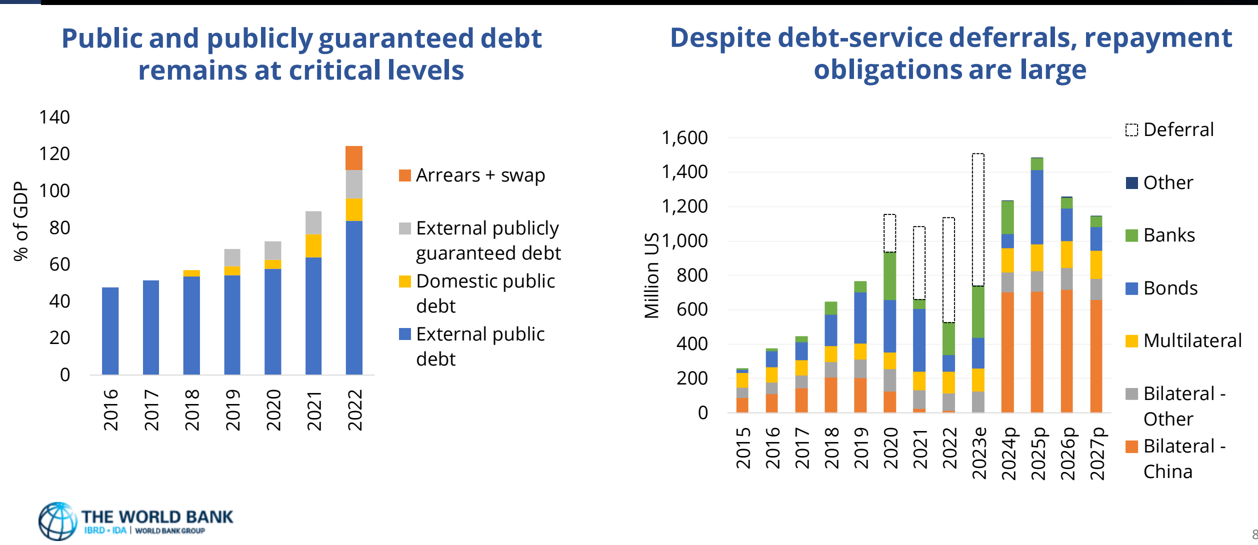
FX liquidity challenge amid high debt-service payments



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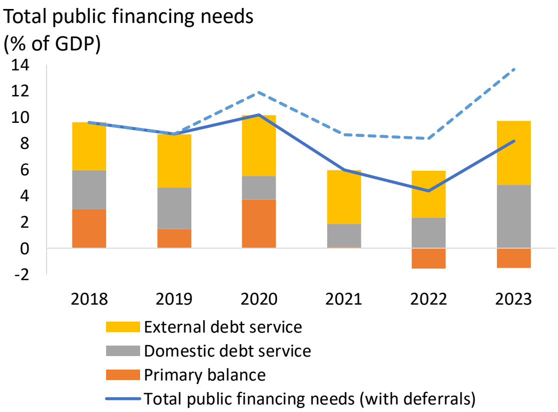
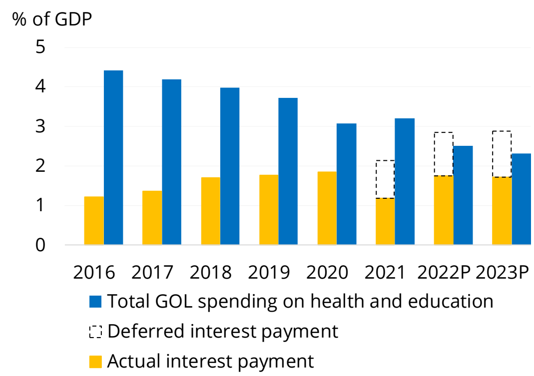
Limited fiscal space for growth-enhancing expenditure

High financing needs despite improved fiscal balance and debt payment deferrals



Limited fiscal space undermine public investment on human capital



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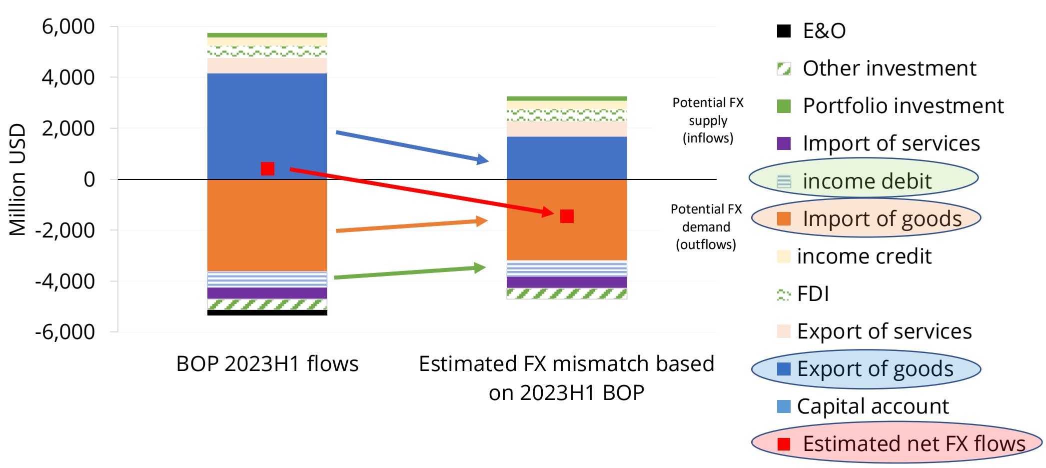
Persistent external imbalances



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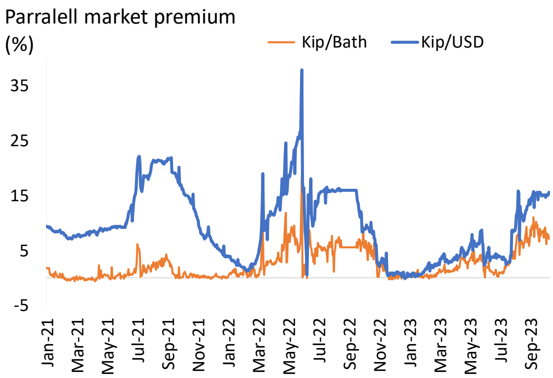
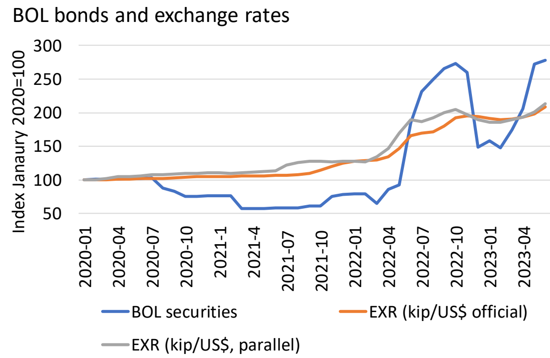
Tightened monetary and foreign currency management measures has limited and temporary impacts

Pressure on the parallel market reemerged



Some monetary measures (BOL bonds) have temporary impacts



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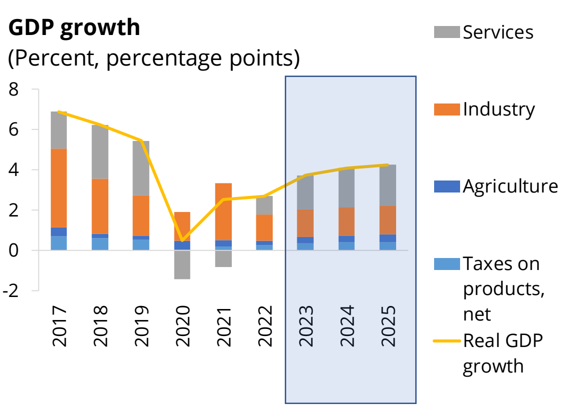
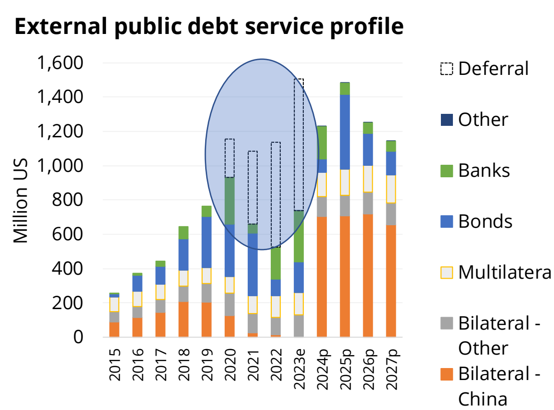
Outlook and Risks

Gradual recovery



Outlook is dependent on debt renegotiation outcome



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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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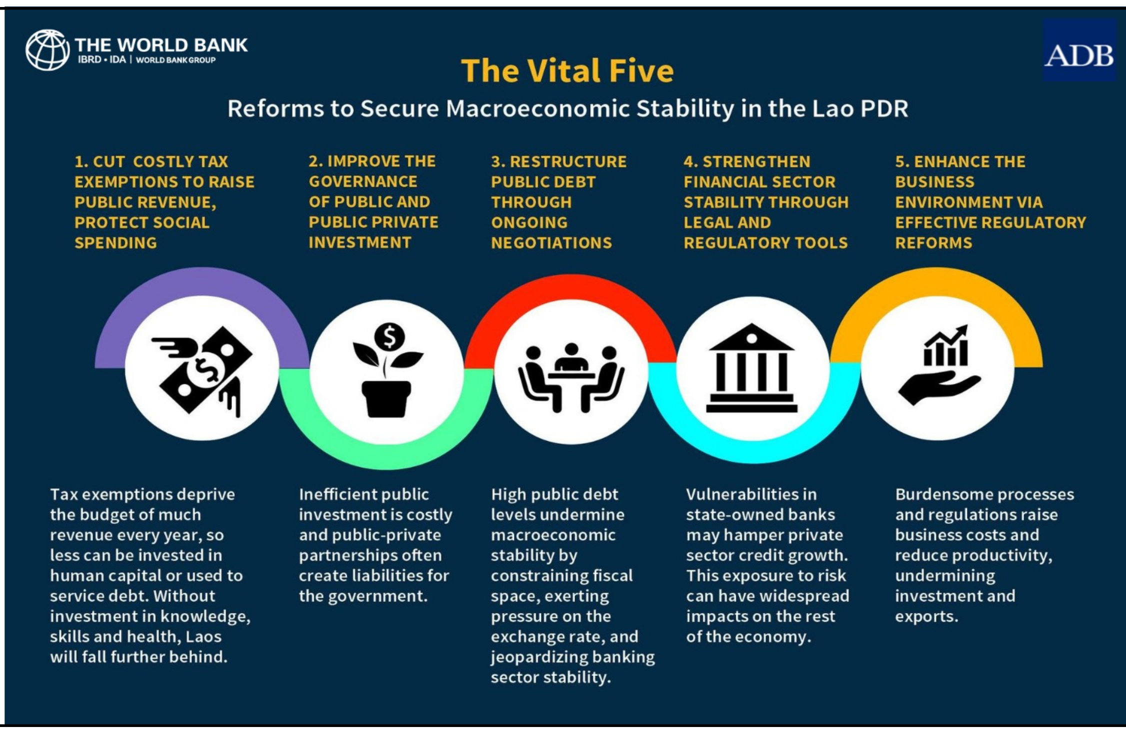

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Part B: Improving Revenue Mobilisation

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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.

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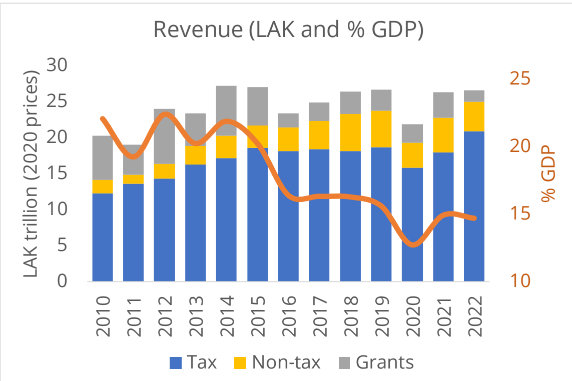
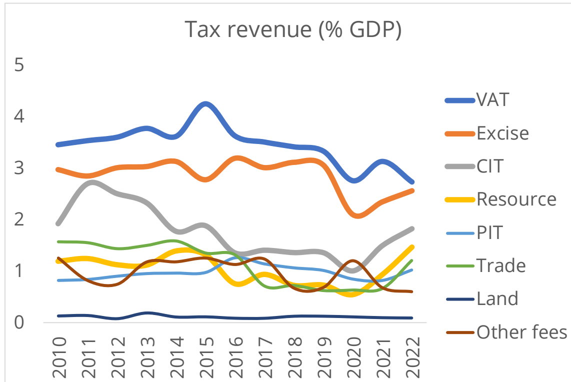
Revenue performance has deteriorated in the past decade

Revenue performance has fallen since 2014, especially tax revenue



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



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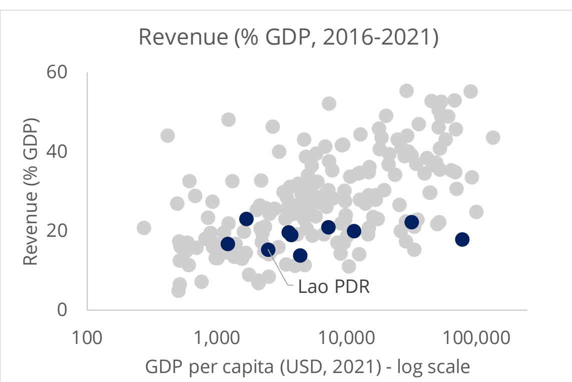
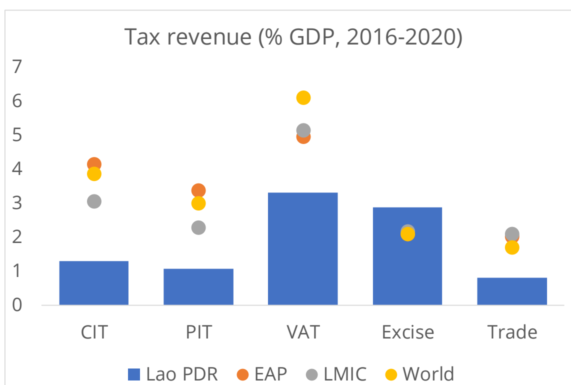
Revenue is very low by international standards

Revenue is very low compared to regional and income peers



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



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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.

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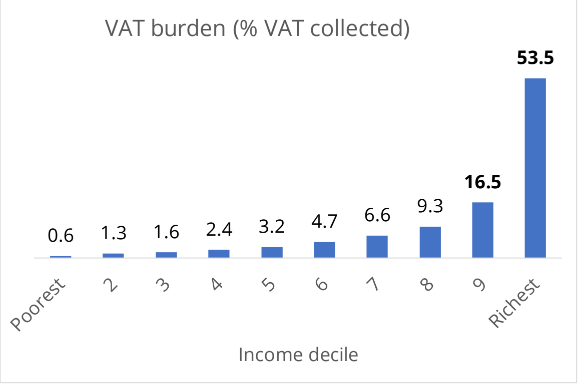
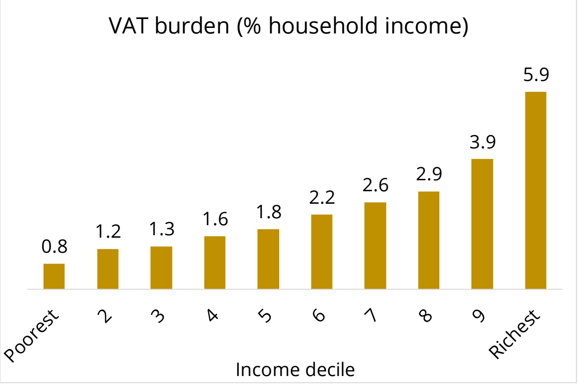
Distributional Impact of Taxes

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



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.