Linking Laos, Unlocking Policies

Lao PDR Country Economic Memorandum[1]

The limits of the Laos growth model have become apparent

Following substantial economic growth and development over the last two decades, some of the limits of Laos's growth model are now apparent. Since 2000, the country has been among the fastest growing economies in the world, recording average annual growth of around 7 percent, mostly driven by the capital-intensive resource sector (mining and hydropower) and supported by infrastructure development. However, the drivers of growth have not been particularly inclusive. Strong GDP growth has not been reflected in widescale job creation. Poverty decreased, but at a slower pace than in other fast-growing economies in the region. Moreover, this growth has not been sustainable from an environmental perspective. Stocks of natural capital have been depleting, albeit at a slower rate since 2015, and many of the country's forests and water resources remain vulnerable.

Ongoing reliance on natural resources has also resulted in significant macroeconomic vulnerabilities. Up until 2017, resource exports and associated capital inflows led to an appreciation in the value of the kip. Combined with rising wages, this has undermined the competitiveness of non-resource export sectors and slowed their growth. At the same time, public debt has increased to critical levels driven by low rates of revenue collection, debt-financed investments in the electricity sector, the accumulation and subsequent clearance of spending arrears, and valuation effects associated with the recent kip depreciation. These investments, and the resulting debt service burden, have reduced fiscal space. This has left less room for investment in agriculture, education, healthcare, and other critical public services, which likely would have provided greater long-term returns through increased labor productivity. COVID-19 has exacerbated many of these economic and fiscal pressures. The country recorded its lowest GDP growth in three decades in 2020, and faces the risk that progress achieved against poverty in the past will reverse, especially for women and poor rural households.

In contrast to other land-locked countries, Laos' natural assets and location offer significant potential for a more sustainable and inclusive growth model

While the country is landlocked with high transport costs, the latter may soon change given growing interregional transportation infrastructure. Laos has the enviable advantages of considerable natural wealth, a young population, and a strategic location. It is endowed with significant natural capital including a mosaic of forests, biodiversity, minerals and land types, as well as access to water. The government has increasingly recognized that the value of environmental protection is greater than the value derived from uncontrolled resource extraction, and that achieving inclusive economic growth over the long term requires more sustainable use of these natural resources. Laos also has one of the youngest populations in the region, with potential for a substantial demographic dividend in coming decades.

Laos geographic location, with some of the world's fastest growing economies as neighbors, is a significant asset. Laos shares borders with five countries that account for over 17 percent of global GDP and over a fifth of the world's population. Most are rich, have open trading systems, booming markets and demand for labor and goods, and are involved in global value chains (GVCs). This means

[1] Please cite the work as follows: World Bank. 2022. *Linking Laos, Unlocking Policies: Lao PDR Country Economic Memorandum*. Washington, DC: World Bank. The full report is accessible at http://wrld.bg/tmsw50JmKGa

there is demand for Lao exports, plus cheap sources of imports, along with GVC and FDI opportunities right at the country's doorstep. These can help Laos to grow and to diversify its economy from mining and hydropower.

Laos is already reaping some of these benefits. Recent investment in export-oriented manufacturing special economic zones (SEZs) has facilitated exports in the electronics, telecommunication, and electrical equipment sector, and in the food industry. However, while at least some SEZs appear to have played a positive role in Lao economic development, the lack of data precludes a more careful and comprehensive evaluation of their impact, or that of related investment incentives on employment, productivity, and exports. Such an evaluation is necessary if the government is to continue to leverage these instruments to drive export diversification and job creation, particularly when fiscal space is tight.

Laos appears more policy-locked than it is land-locked: this needs to change for the country to realize its potential.

The government's land-linked vision is sound, yet a lack of progress on reform implementation is limiting the country's potential. The benefit of a strategic location is something that the government has understood, focusing its economic and social development strategy around trade, investment and establishing Laos as a bridge country within the region (the land-linked vision). Substantial investments are being made in railway and road infrastructure to realize this vision. However, regulatory reforms need to occur in tandem with infrastructure development. Reforms to improve transport, logistics, and the overall business environment are central to ensuring the investments in connectivity help the country benefit from new trade opportunities and diversify from natural resources. In addition, corridor projects that provide secondary road networks, along with adequate trade facilitation and logistics services, can help economic activity spread into rural areas, bringing important poverty reduction benefits while smoothing spatial inequalities.

More than creating new policy reforms, to accelerate change the government needs to prioritize its existing reforms and follow through with implementation. In 2019, Laos was ranked in the bottom 20 percent on all dimensions of Worldwide Governance Indicators, except for political stability. The domestic business environment remains unpredictable and restrictive, adding to the constraints of a small domestic market with bottlenecks in the labor market. Combined, these create formidable obstacles for Lao firms trying to compete regionally and internationally. The government needs to make significant strides in improving the business environment to allow productive companies to invest and expand, and to let efficient new firms enter the market and grow. Deeper forms of regional integration, such as through the Regional Comprehensive Economic Partnership, could also spur institutional and policy reform that improve the business and investment regime.

What can the Lao government do?

This Country Economic Memorandum (CEM) offers a set of policy directions that can help leverage Laos' strategic location and natural wealth to achieve more inclusive and sustainable growth (see Table 1 for a summary). The immediate priority is to restore the country's macroeconomic stability, as this is a precondition for the success of future structural reforms. The report then outlines ways in which the government could further use its strategic location and natural capital to improve the socioeconomic conditions of the young and growing population. Laos could continue moving toward upper-middle income status by sustainably capitalizing on its natural resources and diversifying the economy toward job-creating, export-oriented sectors (including agri-food, light manufacturing and services), thereby ensuring that the benefits of growth are shared more broadly.

Recommendations are prioritized as short, medium or long-term. Several of these recommendations are already being pursued by government and the links with the government's policy agenda as per the Ninth National Socio-Economic Development Plan (NSEDP 2021-2025) are indicated in Table 1.

Table 1 Main policy recommendations for sustainable and inclusive growth

Objective	Timeline for implementation	Responsible ministry or agency	Link with NSEDP 9 (outputs)
I. ENGINEERING A RETURN TO MACRO-FISCAL STABILITY			
1. Explore sources of external financing but limit new commercial borrowing to the amount necessary to service existing market term borrowing.	Short term	MOF	Outcome 1 (2)
2. Finalize ongoing debt negotiations with large creditors, giving appropriate consideration to debt sustainability and transparency.	Short term	MOF	Outcome 1 (2)
3. Strengthen due diligence and approval processes for new public investments, on-lending arrangements, issuance of public guarantees, and PPP proposals.	Medium term	MOF, MPI	Outcome 1 (2,3,5)
4. Mobilize domestic revenue by improving administration of large taxpayers, reviewing tax incentives and concessions (particularly for resource sector projects), and reducing the scope for discretion in taxation and revenue-sharing arrangements.	Medium term	MOF	Outcome 1 (2)
5. Consider the adoption of a medium-term fiscal framework to ensure that budget settings and new PPG borrowing plans (including SOE borrowing) are consistent with public debt sustainability.	Medium term	MOF	Outcome 1 (2)
6. Resolve balance sheet vulnerabilities in state-owned banks and reassess their role in the provision of credit to government and SOEs.	Medium term	MOF, BOL	Outcome 1 (2)
II. ENSURING THE USE OF NATURAL CAPITAL IS SOCIALLY AND ENVIRONMENTALLY SUSTAINABLE			
7. Review options to ensure the financial sustainability of EDL's payments to IPPs, and adjust electricity tariffs to ensure EDL's cost recovery, while protecting customers with less capacity to pay.	Short term	EDL, MEM, MOF	Outcome 1 (5)

Objective	Timeline for implementation	Responsible ministry or agency	Link with NSEDP 9 (outputs)
8. Optimize hydropower system planning and reorient new investment toward improving transmission and interconnection systems with neighboring countries.	Medium term	EDL, MEM, MPI	Outcome 1 (5) and outcome 5 (1)
9. Develop the potential to firm electricity supply through renewables rather than coal.	Medium term	MEM	Outcome 4 (2) and outcome 5 (2)
10. Resolve ongoing constraints to new mining investment, including by implementing the mineral licensing system and reviewing the beneficiation policy, while prioritizing the minimization of environmental impacts.	Medium term	MEM, MONRE	Outcome 1 (1,3)
11. Clarify and standardize licensing and land allocation processes and the legal framework to improve certainty for investors in environmentally-sustainable tree plantations and nature-based tourism.	Medium term	MAF, MONRE, MICT	Outcome 4 (1,2)
12. Prepare strategic environmental assessments to identify the cumulative longer-term effects of resource sector projects and manage trade-offs between different land uses.	Medium/long term	MONRE	Outcome 4 (1)
III. MAKING DOMESTIC MARKETS WORK FOR JOB CREATION			
13. Deepen business climate reforms to facilitate the entry and expansion of domestic and foreign firms.	Short term	MOIC, MPI	Outcome 1 (3,4)
14. Implement one-stop business registration service to cut the burdensome process and encourage formalization. Eliminate and streamline regulations for transparency and consistency in the tax and regulatory systems to curb informal practices.	Short term	MOF, MOIC, MPI	Outcome 1 (3,4)
15. Leverage remittances to support investment in agriculture and manufacturing. Allow remittances to be used in local public investment projects, decided by the migrants for their home village.	Short term	MAF	Outcome 1 (3)
16. Strengthen labor laws and enforcement to protect workers, male and female without jeopardizing firm competitiveness.	Medium term	MOES, MOLSW	Outcome 2 (2,3)

Objective	Timeline for implementation	Responsible ministry or agency	Link with NSEDP 9 (outputs)
17. Strengthen vocational training and employment services that allow qualified workers to find suitable jobs. Involve the private sector especially lead GVC firms.	Medium term	MOES, MOLSW	Outcome 2 (2,3)
18. Promote skill retraining and geographically targeted employment subsidies to foster employment in areas more at risk.	Medium term	MOES, MOLSW	Outcome 2 (2,3)
IV. LEVERAGING STRATEGIC LOCATION TO DIVERSIFY AWAY FROM NATURAL RESOURCES			
19. Advance trade policy reforms, with a focus on non-tariff measures to support quality upgrades in businesses.	Short term	MOIC, MOF	Outcome 5 (2)
20. Assess the effectiveness of SEZs and related investment incentives in attracting FDI, encouraging export growth and diversification, and creating jobs.	Short term	MPI, MOIC	Outcome 1 (5) and outcome 5 (4)
21. Facilitate SEZ backward linkages with domestic firms to help raise productivity, competitiveness, and resilience. Develop win-win deals with foreign lead GVC firms to develop downward services or training centers that also benefit other exporters or products.	Medium term	MOIC, MPI	Outcome 1 (5) and outcome 5 (4)
22. Improve the ability of businesses to satisfy core labor, environmental and governance standards to anticipate the increasing focus on social and environmental issues among buyers in overseas markets.	Medium term	MOIC, MAF	Outcome 5 (2)
23. Improve infrastructure and governance and promote competition in transport and logistics.	Medium term	MPWT	Outcome 5 (1,3)
V. BUILDING SKILLS AND CAPACITY FOR EFFECTIVE REFORMS			
24. Improve data and knowledge to support effective policy making.	Short term	All	Outcome 6
25. Develop comprehensive and inclusive communication strategy within each lead ministry and leverage feedback from stakeholders.	Medium term	All	Outcome 6

Note: Ninth NSEDP outcomes are as follows: Outcome 1: Continuous quality, stable and sustainable economic growth achieved; Outcome 2: Improved quality of human resources to meet development, research capacity, science and technology needs, and create value-added production and services; Outcome 3: Enhanced well-being of the people; Outcome 4: Environmental protection enhanced and disaster risks reduced; Outcome 5: Engagement in regional and international cooperation and integration is enhanced with robust infrastructure and effective utilization of national potential and geographic advantages; Outcome 6: Public governance and administration is improved, and society is equal, fair, and protected by the rule of law. Outputs are in parenthesis next to the corresponding outcome.