Forging Ahead

Restoring Stability & Boosting Prosperity

PUBLIC FINANCE REVIEW

Executive Summary

Lao PDR 2023

THE WORLD BANK
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Executive Summary

The Lao PDR is facing unprecedented macroeconomic challenges, which jeopardize hard-won development gains. Over the past two decades, the country attracted considerable foreign investment and fostered regional integration, which contributed to a long period of high economic growth. Many human development indicators improved during the period 2000–2019, including child and maternal mortality, school enrolment, income poverty, and gender equity. However, economic growth was predominantly driven by large-scale investments in capital-intensive sectors, such as mining and hydropower, which created few jobs and entailed environmental costs. Moreover, many public investments were financed by external debt, gradually jeopardizing debt sustainability and macroeconomic stability. Long-standing structural vulnerabilities have been exacerbated by the impacts of the COVID-19 pandemic and adverse global macroeconomic conditions. Since 2021, the national currency has depreciated considerably, and inflation soared. This has had a large negative impact on living standards, with many households struggling to cope. Meanwhile, limited spending on education, health, and social protection is undermining human capital and thus economic growth prospects. Significant debt pressures, especially short-term external liquidity constraints, have pushed the country into debt distress.

This Public Finance Review identifies priority reforms to restore macroeconomic stability and boost prosperity. The objective of this review is to assess recent macro-fiscal performance, evaluate emerging fiscal risks, and propose policy reforms to secure fiscal sustainability, restore macroeconomic stability, and promote shared prosperity. This report is comprised of five chapters covering the main aspects of fiscal management:

- Chapter 1 evaluates recent **macroeconomic performance** while placing fiscal policy in the broader macroeconomic context.
- Chapter 2 assesses domestic **revenue mobilization** efforts and scope for reforms to enhance tax collection.
- Chapter 3 investigates the size and composition of **public expenditure**, as well as measures to increase its efficiency and effectiveness.
- Chapter 4 discusses reforms of **state-owned enterprises** with a view to improving their financial performance, operational management, and corporate governance.
- Chapter 5 documents the experience with **public–private partnerships** and provides recommendations to maximize value for money and reduce fiscal risks.

Based on the analysis across these chapters, the report identifies concrete policy options to restore macroeconomic stability, enhance revenue mobilization, increase spending efficiency, and tackle fiscal risks (Table E1).

Table E.1: Policy recommendations

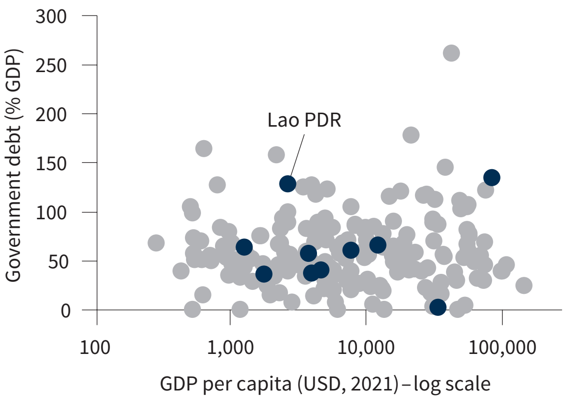
Recommendations	Lead(s)	Impact
Macroeconomic performance		
Negotiate a credible and transparent debt restructuring plan to restore debt sustainability and create fiscal space for growth-enhancing spending	MoF	Very high
Enhance revenue mobilization, improve spending efficiency, and curb fiscal risks to secure the sustainability of public finances	MoF, MPI	Very high
Develop a medium-term fiscal framework and approve a revised Law on Public Debt Management to improve fiscal and debt management	MoF	High
Adopt supportive monetary and exchange rate policies to help reduce macroeconomic vulnerabilities	BoL	High
Enhance bank monitoring and operationalize emergency arrangements to boost crisis preparedness	BoL	Medium
Revenue mobilisation		
Restore the value-added tax rate to 10 percent	MoF	Very high
Revise the Law on Investment Promotion to curb tax incentives	MPI	Very high
Reform excise tax structures and increase rates, particularly on beverages, tobacco, and fuel	MoF	High
Reform the land tax and prepare for the introduction of a property tax	MoF	Medium
Strengthen compliance risk management by focusing on the administration of large taxpayers	MoF	High
Public expenditure		
Reallocate spending toward education, health, and social protection to avoid a collapse in human capital	MoF	Very high
Strengthen spending controls to avoid the accumulation of further expenditure arrears	MoF, MPI	Very high
Report data for all spending units to increase budget transparency and accountability	MoF	High
Enhance budget preparation and execution, with a focus on procurement and public investment management, to improve the impact of public spending	MoF, MPI	High
Improve human resource planning to enhance the effectiveness of the civil service	MoF	High
State-owned enterprises		
Centralize and strengthen the state ownership and oversight function	MoF	Very high
Create a fiscal risk management unit within the Ministry of Finance	MoF	Very high
Broaden the ownership of state-owned enterprises (SOEs)	MoF	Very high
Professionalize SOE boards of directors to promote good governance and enhance performance	MoF	High
Disclose SOE performance reports to increase transparency and strengthen accountability	MoF	High
Public-private partnerships		
Upgrade the Decree on Public–Private Partnerships (PPP) to a law and develop related guidelines to strengthen the legal and regulatory framework	MPI	Very high
Enhance the capacity to prepare, procure, and manage PPP projects and improve inter-agency coordination	MPI, MoF	Very high
Establish clear institutional structures, responsibilities, and processes for assessing, approving, and managing PPP-related fiscal costs and risks	MPI, MoF	Very high
Mandate transparent and competitive procurement to maximize value for money	MPI	Very high
Establish a revolving project development fund to support project preparation and structuring	MPI	High

Source: World Bank staff.

Restoring fiscal sustainability and macroeconomic stability

Macroeconomic instability is undermining economic growth and threatening development prospects. Economic growth averaged 7 percent per year during 2000–2019, while the poverty headcount ratio declined from 25 to 18 percent between 2012 and 2018. However, the Lao PDR's capital-intensive, resource-based, debt-fueled growth model was already showing strains before 2020. Public debt levels increased rapidly, few jobs were created, and natural resources were depleted, thereby undermining sustained, inclusive, and resilient economic growth. Pre-existing macroeconomic vulnerabilities have been compounded by recent shocks, such as the COVID-19 pandemic and a deteriorating global economic environment. An unsustainable public debt burden is constraining fiscal space, exerting pressure on the exchange rate, and jeopardizing banking sector stability (Figure E.1). High inflation and sluggish economic growth are threatening living standards (Figure E.2). Fiscal space has been eroded, largely due to poor revenue collection and rising debt service payments, despite recent debt service deferrals. This has constrained the government's ability to provide meaningful support to households and businesses affected by the COVID-19 pandemic and high inflation. Large external imbalances persist, even as electricity exports grow steadily. Reserve buffers are precarious, with foreign currency shortages contributing to a rapid depreciation of the exchange rate. Fragilities in the financial sector are predominately linked to the weak balance sheets of the largest commercial banks and the kip depreciation. The Lao PDR is failing to transform its natural wealth into sustained prosperity, as it is not drawing adequate benefits from its mineral, water, and forest resources to invest in human capital.

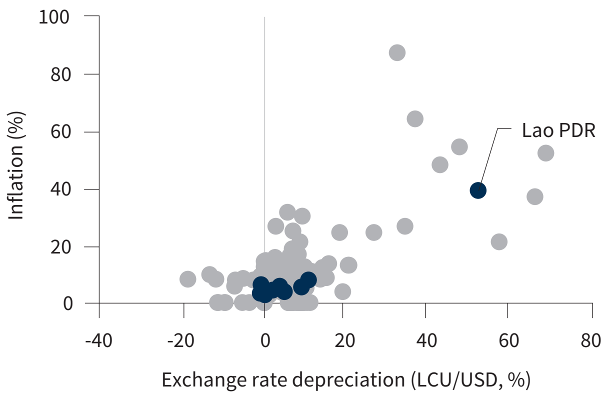
Figure E.1: Government debt (% GDP, 2022)



Source: International Monetary Fund and World Bank.

Note: Blue dots represent ASEAN countries.

Figure E.2: Inflation and depreciation (%, 2022)



Source: International Monetary Fund and World Bank staff calculations.

Note: Blue dots represent ASEAN countries. Annual values at end of period (i.e., December 2022).

Public debt has reached critical levels, jeopardizing macroeconomic stability, fiscal sustainability, and financial sector soundness. The Lao PDR is facing liquidity and solvency challenges owing to a very high debt burden, poor revenue collection, limited financing options, and low foreign currency reserves. These have pushed the country into sovereign debt distress. Public and publicly guaranteed (PPG) debt has surpassed 100 percent of GDP, one of the highest levels in the world. High debt service obligations have contributed to a rapid exchange rate depreciation since 2021, which has, in turn, aggravated the external debt burden. With revenue performance steadily declining over the years, an expenditure-driven fiscal consolidation has squeezed the fiscal space available for critical development expenditures (e.g., health and education). High public debt levels also exacerbate existing financial sector weaknesses, partly through the exposure of commercial banks to public debt. Economic growth is expected to benefit from a recovery in tourism, improved transport and logistics infrastructure (e.g., Laos–China railway and Thanaleng Dry Port), as well as mining and electricity exports. However, the macroeconomic outlook remains uncertain since it is contingent on continued debt service deferrals and the outcome of ongoing debt renegotiations, without which the economic situation would deteriorate further.

Fiscal pressures are amplified by sizeable contingent liabilities, which can further jeopardize macroeconomic stability. Large contingent liabilities arise from the operations of state-owned enterprises (SOEs) and public-private partnerships (PPPs). SOEs accounted for about 44 percent of total PPG debt in 2022, mostly in the energy sector, with some facing considerable financial difficulties. Given the country's debt overhang, the government may rely even more heavily on PPPs to boost large-scale infrastructure investments. However, these would likely entail significant fiscal commitments, contingent liabilities, and foregone revenues. Fiscal risks can exacerbate the public debt burden if they materialize.

Policy options

Negotiate a credible and transparent debt restructuring plan to restore debt sustainability and create fiscal space for growth-enhancing spending. Meeting current public debt service obligations is not achievable without a socially damaging compression of public expenditure. Hence, restructuring public debt is vital. Debt restructuring can be pursued through discussions with bilateral creditors or through multilateral channels. However, it is important that any agreement is credible and transparent. In the meantime, continued debt service deferrals are needed to relieve immediate liquidity pressures.

Enhance revenue mobilization, improve spending efficiency, and curb fiscal risks to secure the sustainability of public finances. Fiscal consolidation efforts should focus on improving revenue mobilization. However, there is a need to balance debt management and fiscal consolidation with public spending for long-term economic growth. Given the limited fiscal space available, it is critical to prioritize and improve the allocation of budget resources. Finally, improved governance arrangements are needed to stem the accumulation of contingent liabilities. The chapters on domestic revenue, public expenditure, state-owned enterprises, and public-private partnerships provide insights and recommendations on these topics.

Develop a medium-term fiscal framework and approve a revised Law on Public Debt Management to improve fiscal and debt management. It is important to establish a credible medium-term fiscal framework that provides a clear path toward fiscal and debt sustainability. This framework should include consistent and clearly defined targets for the entire public sector (e.g., strict fiscal rules, as well as limits on SOE financing and tax incentives for PPPs). Moreover, revising the 2018 public debt management law to strengthen the role of the Ministry of Finance in terms of debt and fiscal risk management would help avert a future unsustainable build-up of public debt.

Adopt supportive monetary and exchange rate policies to help reduce macroeconomic vulnerabilities. While there is limited scope for monetary and exchange rate policies to address the root causes of current macroeconomic challenges, they can still play a supporting role. These policies include greater exchange rate flexibility and measures to improve monetary transmission. Reducing distortions and improving confidence requires moving toward a unified market-clearing exchange rate while avoiding exchange rate restrictions. More transparent and effective policies can help build confidence in the Lao kip (e.g., improving transaction monitoring, data reporting, and communications). There is a need for continued tight monetary policies to support exchange rate stability.

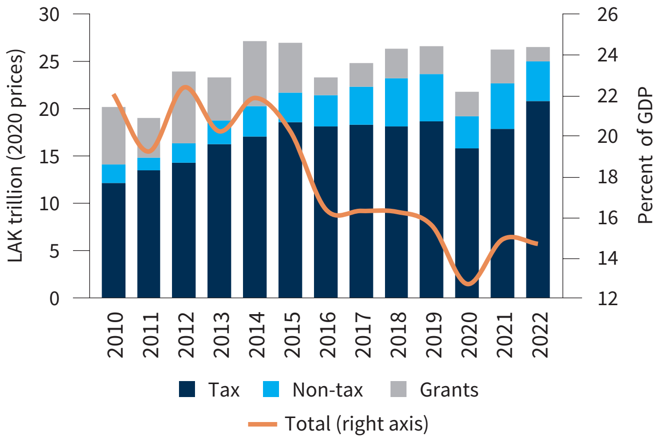
Enhance bank monitoring and operationalize emergency arrangements to boost crisis preparedness. Financial sector vulnerabilities can present considerable fiscal risks, as governments may have to inject capital into distressed banks to avoid systemic crises. Safeguarding financial sector stability requires enhancing the legal and regulatory framework, banking supervision, enforcement measures, financial safety nets, and crisis management. It is critical to have a fully operational emergency liquidity assistance facility and establish a crisis management framework. In terms of remedial action, the early warning system and regulations on early intervention and problem-bank resolution need to be fully implemented. There is also a need to establish a clear plan and timeline for gradually withdrawing regulatory forbearance measures, as well as strengthening the deposit protection scheme.

Boosting revenue mobilization

Revenue collection has deteriorated considerably in the past decade, constraining fiscal space and undermining fiscal sustainability. Revenue performance was a concern even before COVID-19, as total revenue declined from 22 to 16 percent of GDP during 2014–2019, owing to declines in tax collection and foreign grants (Figure E.3). Tax revenue fell from 14 to 11 percent of GDP during that period. Low tax rates, a narrow tax base, and weak compliance and enforcement have undermined tax collection. In particular, generous tax exemptions have deprived the budget of vital fiscal revenues and foreign exchange. Total revenue declined further to 13 percent of GDP in 2020, mostly because of the COVID-19 pandemic, although it recovered to 15 percent in 2022, partly supported by inflation. Revenue levels remain very low by regional and income standards (Figure E.4). In 2019, revenue-to-GDP and tax-to-GDP ratios ranked in the bottom 15 percent of the world, and these have deteriorated further since then. Recent measures, such as tax rate cuts and growing fragmentation in the management of large taxpayers, have further hampered revenue mobilization. At 11 percent in 2022, the tax-to-GDP ratio is significantly below the recommended minimum international benchmark of 15 percent.

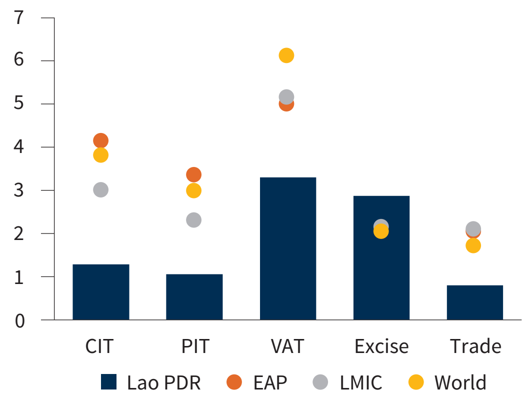
Revenue collection has relied heavily on consumption-related taxes, while limited income tax collection accounts for most of the performance gap. In 2022, about three-quarters of government revenue was collected through taxes. Indirect taxes accounted for most tax revenue, with the value-added tax (VAT) 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 only 23 percent of tax revenue in the same period. Tax collection has not kept pace with economic activity, with poor performance mainly driven by the corporate income tax (CIT). The revenue generated by the CIT declined from 2.7 to 1.4 percent of GDP during 2011–2019, albeit recovering to 1.8 percent in 2022. This remains among the lowest levels in the world. Generous tax incentives have been granted to attract foreign investment, but international evidence suggests that profit tax exemptions are highly inefficient. While economic growth has been predominantly driven by natural resources, government revenues accruing from the resource sector have been limited. Resource-related revenues, such as taxes, royalties, and preservation funds, account for a small share of total domestic revenue (averaging 8 percent in 2010–2022).

Figure E.3: Revenue (Lao kip and % GDP)



Source: Ministry of Finance and World Bank staff calculations.

Figure E.4: Revenue by type of tax (% GDP, 2016–20)



Source: International Monetary Fund and World Bank staff calculations.

Tax rates are relatively low and significant tax incentives have been granted, which undermines revenue collection. The CIT rate has been progressively reduced to attract foreign investment. The rate was cut from 35 to 28 percent in 2012, then to 24 percent in 2013, and finally to 20 percent in 2020. This rate is relatively low in international terms (albeit comparable to neighboring countries), which is a significant tax incentive by itself. Nonetheless, the Law on Investment Promotion provides several tax incentives (e.g., CIT holidays and reduced rates) ranging between 4–15 years, depending on the business activity and location. Concessions negotiated on a case-by-case basis provide even more generous terms. This approach to investment promotion is highly inefficient and creates large foregone revenues. The VAT rate of 7 percent is one of the lowest in the world, while some excise rates are also low by global benchmarks. Moreover, taxes levied on household consumption (e.g., VAT and excises) are found to be progressive, in the sense that they impose a larger burden on wealthier households.

Tax collection is reaching only about 60 percent of its full potential, implying that there is ample scope for policy and administration reforms. There is considerable potential for mobilizing additional domestic revenues. Tax collection can be increased by raising tax rates, expanding the tax base, enhancing tax compliance, and improving tax enforcement. When compared to taxation levels and (structural and institutional) determinants in peer countries during 2010–2016, the Lao PDR had an average tax potential of 21 percent of GDP, with the corresponding total tax gap at 8 percent of GDP. Estimates also suggest that only 13 percent of potential CIT revenue is being collected, largely due to tax exemptions that considerably reduce the tax base.

The administration of taxes has generally improved in recent years, but there remains considerable room to further enhance performance. The implementation of the Tax Revenue Information System (TaxRIS) provides a good platform for modernizing the tax administration. Nonetheless, the current system lacks critical features and staff are not using all functionalities. The approval of the Law on Tax Administration has strengthened the legal framework, but it is necessary to ensure the law is adequately implemented. Efforts to build the capacity of tax officials are also bearing fruit. However, developing a modern, efficient, and effective tax administration requires further improvements in processes, technology uptake, and staff capacity. This would also help build confidence in the tax administration (e.g., by reducing corruption risks).

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 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 the 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.

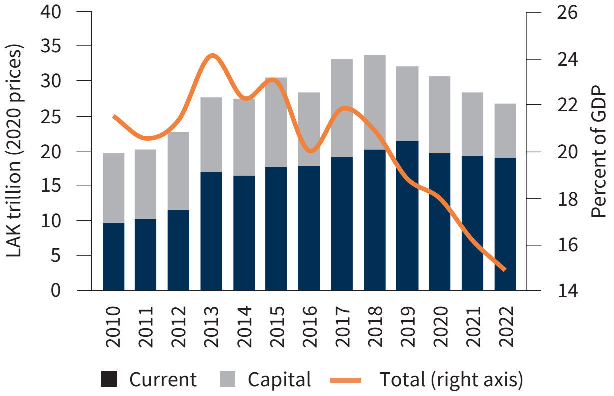
Reform the land tax and prepare for the introduction of a property tax to boost revenue collection. Property tax reform should follow a phased approach. First, land tax rates should be increased significantly to ensure the land tax becomes meaningful. The additional revenue should then be invested in enhancing the administration of land and land taxes, including the digital transformation of land and land tax management. Once tax administration has been improved, the land tax could be transformed into a property tax by including the value of improvements in the tax base.

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.

Enhancing the efficiency of public spending

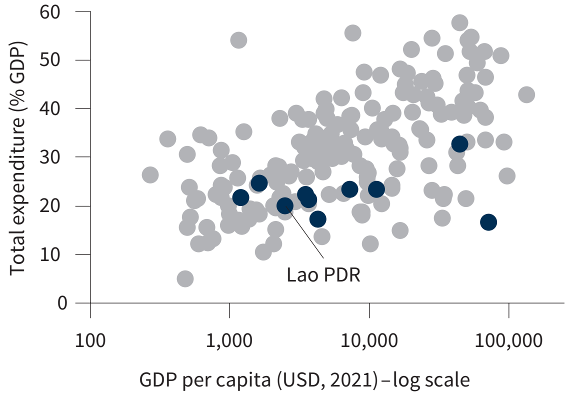
Government spending declined significantly in the past decade, raising concerns about spending adequacy and public service delivery. An expenditure-led fiscal consolidation is jeopardizing the quantity and quality of public service delivery. Expenditure declined from 24 to 15 percent of GDP between 2013 and 2022, fueling concerns that spending levels are insufficient to meet increasing needs (Figure E.5). Public spending is low when compared to regional and income peers (Figure E.6). With debt service obligations growing, non-interest spending will be further under pressure. Fiscal pressures are compounded by several challenges relating to public financial management, especially poor planning and weak commitment controls. Improving planning, budgeting, and implementation can enhance budget performance and thus improve the quality of public spending.

Figure E.5: Expenditure (Lao kip and % GDP)



Source: Ministry of Finance and World Bank staff calculations.

Figure E.6: Expenditure (% GDP, 2016–21)



Source: International Monetary Fund and World Bank staff calculations.
Note: Blue dots represent ASEAN countries. Vertical axis limited to 60 to improve readability.

Wage and capital expenditures account for most outlays, but low spending on operations & maintenance is undermining service delivery. The need to reduce fiscal deficits has compressed spending in many categories. Curbs on wage and capital spending have been particularly noticeable. Low recruitment can have a significant impact on public service delivery. Capital spending, which has been mainly aimed at developing power and transport infrastructure, has been affected by limits on new projects. Nonetheless, wages & salaries and capital still account for about two-thirds of total spending, partly reflecting policy priorities. Spending on operations & maintenance seems insufficient to meet existing needs. Large investments in public infrastructure need to be accompanied by rising budget allocations for cost-effective routine maintenance, while the purchase of goods is key to supporting staff in delivering quality public services (e.g., books, medicines, and medical equipment). Meanwhile, interest payments have increased, despite recent debt service deferrals. This has placed additional pressure on other spending items.

There is considerable scope for improving the efficiency, effectiveness, and equity of public spending. Budgetary resources do not seem fully aligned with stated policy priorities. For instance, public spending has declined for sectors directly influencing human capital, which is a central element of the Ninth National Socio-Economic Development Plan (NSEDP). The lack of prioritization of these sectors is concerning, especially given the impacts of COVID-19 on learning outcomes, and likely undermines public service delivery. The combined spending on education and health declined from 4.9 to 2.6 percent of GDP between 2013 and 2022, while spending on social assistance is negligible. Evidence suggests that spending on these sectors has a positive effect on poverty reduction and equity. Discretionary spending is relatively high, implying that there is scope for fiscal adjustments, assuming there is sufficient political will. However, the lack of comprehensive information (i.e., budget transparency) undermines an assessment of potential budget savings. In 2005, about 5 percent of total spending could not be allocated to a specific spending unit (e.g., ministry, organization, or province). That value increased to nearly 30 percent in 2020, largely due to the absence of reporting for several large ministries and organizations.

Policy options

Reallocate spending toward education, health, and social protection to avoid a collapse in human capital. There is scope for reallocating budget resources to improve efficiency and effectiveness. The lack of comprehensive reporting hinders and evaluation of potential savings, but there is likely scope within the wages & salaries and capital categories, while fiscal space could be increased through stronger revenue mobilization efforts and debt restructuring. Nonetheless, benchmarking suggests that the quality of spending in these sectors also needs to be improved. Therefore, there is a need for more and better spending on sectors that boost productivity and enhance economic growth.

Strengthen spending controls to avoid the accumulation of further expenditure arrears. Recurring expenditure arrears arising from sub-national investment projects are a significant concern. To clear these arrears, the government issued bonds amounting to nearly 10 trillion kip (5 percent of GDP) in 2021. However, an additional 23 trillion kip of potential arrears are undergoing a verification process, which could further threaten fiscal and debt sustainability. The implementation of the new Financial Management Information System (FMIS) could strengthen commitment controls and help avoid future arrears.

Report data for all spending units to increase budget transparency and accountability. Budget transparency has been gradually eroded by the absence of reporting for key ministries and other organizations. This undermines the ability to scrutinize the quality of public spending and likely affects decision-making, since it is not clear how unreported data is utilized in the budget process. Reporting data for all spending units is particularly critical at a time when fiscal pressures are compressing spending in areas fundamental for medium-term economic growth. Scrutinizing and publishing the reports of the State Audit Organization would also enhance transparency and accountability.

Enhance budget preparation and execution, with a focus on procurement and public investment management, to improve the impact of public spending. Embracing a medium-term budget perspective could facilitate strategic decisions and prioritization. Promoting transparent competition in public procurement will improve spending efficiency, while improving public investment management will enhance the quality and impact of capital spending. Setting up a centralized and robust public investment management monitoring system will be crucial. It is also fundamental to clearly allocate responsibilities for investment decisions and enhance transparency in decision-making (including for public-private partnerships).

Improve human resource planning to enhance the effectiveness of the civil service. Modernizing human resources management would help strengthen wage bill controls. Adopting a new human resource management information system would help reduce costs, while supporting planning and rightsizing. Professionalizing the civil service through a shift from personnel administration to talent management would also enhance public service delivery.

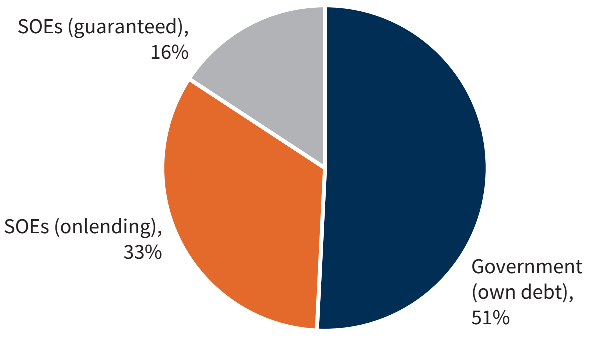
Managing liabilities from state-owned enterprises

State-owned enterprises (SOEs) have created large contingent liabilities, which threaten fiscal sustainability and macroeconomic stability. Unfunded policy mandates and poor governance typically generate considerable operational losses and heavy indebtedness. In the Lao PDR, some SOEs have benefited from sizable on-lending and loan guarantees from the government, often to support their involvement in public-private partnerships, notably in the hydropower sector. Many SOEs are highly vulnerable to shocks, such as exchange rate depreciation, in part due to their business models. Some operate in a competitive environment without a clear policy mandate, where the private sector can generally deliver similar goods and services more efficiently. Hence, there is a need to reassess their rationale, corporate governance, operational management, and financial performance.

There has been some progress in reforming the SOE sector, but many challenges remain. Since the mid-1980s, the number of SOEs has been cut considerably, their weight in the economy reduced, and their presence in non-strategic sectors curtailed or eliminated. However, past reforms have had mixed results, as illustrated by the financial difficulties currently faced by some of the largest SOEs. While there has been a renewed momentum for SOE reform since 2021, it is imperative to intensify the activities of existing SOE reform committees and fully implement their restructuring plans. Reform progress has generally been undermined by institutional weaknesses, low capacity, and political economy constraints. However, past experiences provide useful lessons.

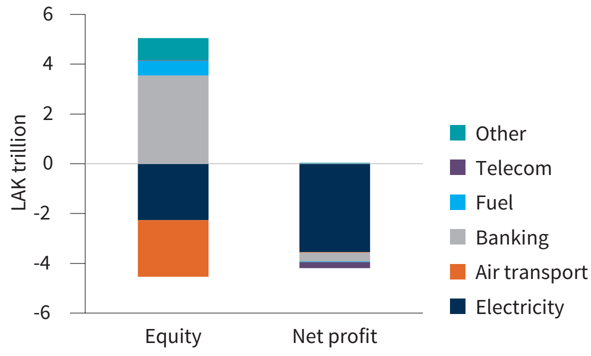
Deepening and accelerating reforms is critical to ensure that SOEs fulfill their policy mandates, operate efficiently, and do not generate undue fiscal risks. The SOE portfolio is relatively decentralized and spread over several economic sectors. Most SOEs do not consistently submit financial reports to the Ministry of Finance, which undermines a comprehensive assessment of the sector. Existing data suggests that profitability of the SOE sector is low and indebtedness high. Many SOEs are insolvent, with negative equity and persistent losses. The largest SOEs are highly indebted, thereby presenting a significant fiscal risk. In 2022, SOEs accounted for nearly half of total external public and publicly guaranteed (PPG) debt, most of which were in the energy sector (Figure E.7). The sectoral composition of key financial performance indicators raises concerns over the electricity, transport, and finance sectors, where EDL, Lao Airlines, and BCEL are the main actors (Figure E.8). There is a need to improve overall SOE corporate governance, operational management, and financial performance, as well as enhance transparency.

Figure E.7: External PPG debt (%, 2022)



Source: Ministry of Finance.

Figure E.8: SOE performance (Lao kip, 2021)



Source: Ministry of Finance and World Bank staff calculations.

Policy options

Centralize and strengthen the state ownership and oversight function to enhance SOE performance and promote efficiencies. The separation of the ownership and oversight function from the policy-making function enables greater objectivity and minimizes conflicts of interest. Moreover, it promotes greater consistency in the application of corporate governance standards across SOEs in all sectors. In fact, there is a need to empower and strengthen SOE oversight agencies, including through capacity building in monitoring and oversight.

Create a fiscal risk management unit within the Ministry of Finance to identify, assess, monitor, and mitigate contingent liabilities and other risks. It is important to assess the impact of SOE operational and financial performance on public finances. In this regard, there is a need to improve the identification, assessment, monitoring, and mitigation of fiscal risks, particularly of unforeseen SOE bailouts resulting from the realization of explicit or implicit contingent liabilities (including those related to public-private partnerships). A fiscal risk management unit needs to be created within the Ministry of Finance, which should cover all types of fiscal risks.

Broaden the ownership of SOEs to improve performance, accountability, and transparency. Listing SOEs on the stock exchange or converting them into joint ventures with the private sector has shown benefits in the Lao PDR and neighboring countries. These include improvements in reporting transparency (owing to requirements applied to listed companies), improved board composition (particularly for joint ventures), and increased availability of business management expertise. This restructuring modality can also generate revenues from asset sales and support market reforms by reducing the state's weight in the economy. However, these reforms require strong legal underpinnings, effective implementing institutions, and full transparency.

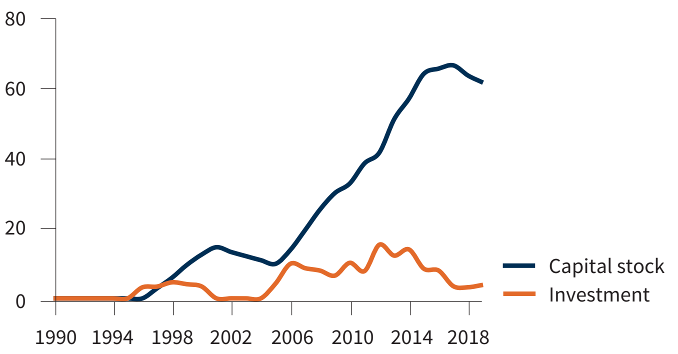
Professionalize SOE boards of directors to promote good governance and enhance performance. Boards of directors play a strategic function within SOEs, particularly in terms of supporting good governance. Their roles, composition, and functioning should therefore be reviewed and improved. For instance, there is a need to establish clear legal requirements for board autonomy and accountability, with roles and responsibilities clearly defined in law. Nomination and approval processes for the appointment of board members should be transparent while ensuring the inclusion of all necessary competencies and qualifications. In this regard, it is important to limit the numbers of public servants on SOE boards.

Disclose SOE performance reports to increase transparency and strengthen accountability. Many countries have taken steps to increase transparency through full public disclosure of SOE performance reports and fiscal risk statements. Actions have included (i) publishing SOE objectives and the extent to which these are fulfilled; (ii) mandating the adoption of International Financial Reporting Standards (IFRS) by SOEs; (iii) requiring SOEs to regularly disclose their financial and operational results using financial and nonfinancial performance indicators; (iv) requiring internal and external audits of SOE annual financial statements; (v) requiring the compilation and publication of aggregate reports on SOE performance and fiscal risks by oversight agencies; and (vi) increasing transparency on board member qualifications and remuneration. These reforms will support accountability and overall performance.

Containing fiscal costs and risks from public-private partnerships

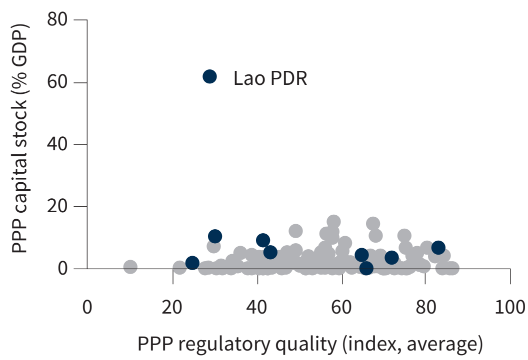
Substantial private sector finance has been mobilized through public-private partnerships, but projects have likely provided limited value for money and have increased fiscal costs and risks. No other country in the world has relied more heavily on public-private partnerships (PPPs) than the Lao PDR (Figure E.9 and Figure E.10). PPPs have been the preferred mechanism to exploit the country's large hydropower resources for several decades. More recently, limited fiscal space has increasingly led to the use of PPPs in other sectors, such as transport. However, weak governance structures (e.g., institutional, legal, and regulatory) and limited capacities to assess, prepare, and negotiate PPPs have likely resulted in suboptimal value for money for the public sector and end users. They have also led to an increase in fiscal commitments, contingent liabilities, and foregone revenues. There seems to be a large pipeline of mainly unsolicited PPP projects, which should be carefully scrutinized before contracts are awarded.

Figure E.9: Public-private partnerships (% GDP)



Source: International Monetary Fund.

Figure E.10: PPP capital stock (% GDP, 2019)



Source: International Monetary Fund and World Bank.
Note: Blue dots represent ASEAN countries.

PPPs can generate several benefits, but these are not automatic and depend on the fulfillment of certain conditions. Infrastructure development is necessary to support economic growth, but there is currently limited fiscal space to undertake significant investments. Mobilizing private sector capital through PPPs can help leverage limited fiscal resources for infrastructure development. They can also lead to a more efficient and effective delivery of infrastructure assets and services. However, PPPs are not 'free', as they need to be ultimately paid for by the public sector or end users. PPPs need to be carefully prepared, procured, and managed for potential benefits to be realized.

PPP arrangements can entail fiscal costs and risks that are often overlooked or underestimated. The private sector needs to be paid for providing public assets and services, usually through availability payments, user fees, or a combination of both. Governments may also need to provide direct and contingent fiscal support to help make PPP projects viable by mitigating some of the risks (e.g., demand, revenue, political, and early termination risks). Generous tax incentives are often provided, which entail large revenue losses and deprive the country of valuable foreign exchange. These fiscal costs and risks are often overlooked when assessing PPP arrangements, partly due to their complex nature and the longer time horizon (i.e., liabilities and revenues spread into the future). PPP projects should therefore be scrutinized by the same standards as public investment projects, such as efficiency, effectiveness, equity, and sustainability.

Policy options

Upgrade the Decree on Public-Private Partnerships to a law and develop related guidelines to strengthen the legal and regulatory framework. Upgrading the decree to a law would ensure that all PPP projects are implemented in accordance with the provisions of the law and the supporting implementing guidelines. The new law should include a definition of PPPs that is in line with international good practices. It should clearly specify the processes for implementing solicited and unsolicited PPP projects to ensure they are adequately identified, screened, prioritized, prepared, procured, and managed. The law should also assign specific responsibilities to relevant ministries and agencies.

Enhance the capacity to prepare, procure, and manage PPP projects and improve interagency coordination to help maximize value for money. Project appraisal can be improved by developing rigorous criteria, tools, and implementation guidelines to comprehensively assess economic and financial viability. It is vital to ensure that the existing PPP unit in the Ministry of Planning and Investment has both the authority and capacity to act as a center of excellence for PPPs in the country. In addition, smaller PPP coordination units should be established in key ministries likely to be active in the implementation of PPP projects. Finally, it is important to improve interagency coordination, since PPPs often entail the involvement of several public institutions. All stakeholders need to follow the established PPP processes.

Establish clear institutional structures, responsibilities, and processes for assessing, approving, and managing PPP-related fiscal costs and risks to improve their governance. Developing a robust framework to assess, approve, budget, manage, and monitor fiscal costs and risks can help mitigate risks. In this context, it is critical that a clear institutional structure is established to manage the fiscal exposure and budgetary implications of individual PPP projects. The Ministry of Finance should be responsible for oversight and gatekeeping functions, particularly with respect to assessing the impacts of PPP-related fiscal costs and risks from the perspective of long-term liability management, budget priorities and constraints, and macroeconomic management.

Mandate transparent and competitive procurement to maximize value for money. It is important to ensure that information on potential PPP projects is shared transparently with all stakeholders and that all PPP projects (including unsolicited proposals) are competitively tendered. Transparent and competitive procurement creates a level playing field for all bidders, which encourages private-sector investors to bid for projects. This benefits the public sector because a larger number of bidders usually entails greater competition, which can help maximize value for money. Competitive procurement should also be undertaken for the management of assets that will soon be transferred to the public sector, especially in the energy sector. Moreover, publishing PPP documents (e.g., PPP pipeline, appraisal studies, and reports on fiscal commitments) will promote greater overall transparency.

Establish a revolving project development fund to support project preparation and structuring. Project preparation and structuring can be time-consuming and expensive. It often requires the preparation of various studies and documentation that requires a highly skilled team. Given the current low capacity levels within the public sector, the PPP unit or implementing agency should hire transaction advisers to support key tasks. This could be supported by the establishment of a dedicated PPP project development fund. However, such funds need clear and transparent governance and funding structures.

Improving governance and institutions

Good governance and institutions are critical to supporting macroeconomic stability, while improved data and transparency can enhance evidence-based policy making. Improving governance arrangements and institutional capacities will support the management of public finances. Stronger oversight institutions can promote greater accountability. Institutions are also important in the design and implementation of regulatory reforms that reduce bureaucracy, enhance competition, and contribute to a more vibrant private sector. Improved governance and strong institutions are key to combating corruption, effectively managing natural resources, and stemming state capture, especially in a context of high resource rents. Improved data and greater transparency (e.g., expenditure arrears, SOE liabilities, and PPP-related fiscal risks) would help enhance policy making. Ensuring consistency, dissemination, and full implementation of legislation (e.g., coherent application and enforcement) would enable a faster move toward a rules-based economy that supports inclusiveness and promotes accountability.

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