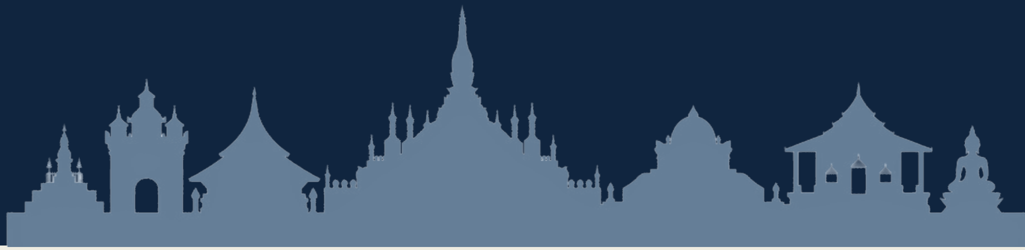
# Public Finance at a Crossroads

## Fiscal Reforms to
## Restore Stability and Boost Shared Prosperity



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Launch of the

Public Finance Review and Fiscal Incidence Analysis

Lao Plaza Hotel, Vientiane

6 December 2023

# Outline

1. **Macro-fiscal issues**: macroeconomic performance, revenue mobilisation, and public expenditure.

2. **Distributional impacts** of fiscal policy (i.e., taxes and spending) on households.

3. **Fiscal risks** related to state-owned enterprises and public-private partnerships.

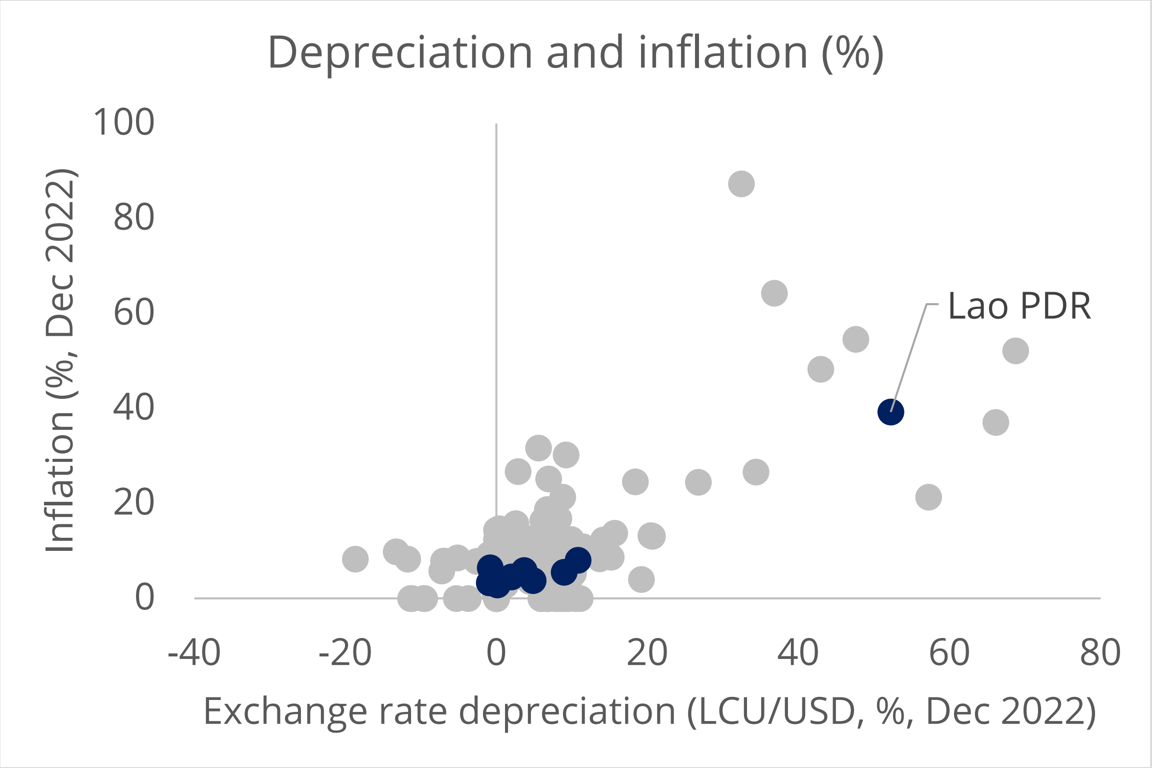
# Macro-fiscal issues

# Main findings (macroeconomic performance)

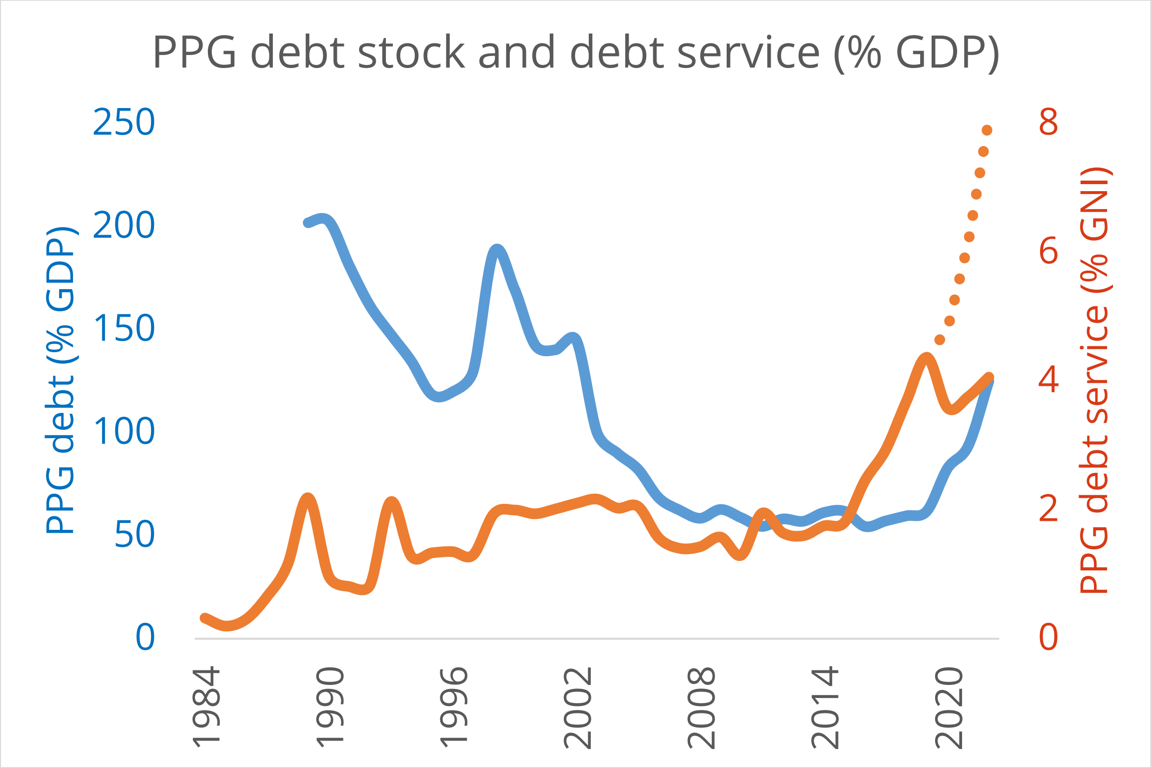
- Economic growth **decelerated** during 2013-2019, suggesting that growth model is not sustainable (i.e., financed by debt, created few jobs, depleted natural resources).
- External shocks (e.g., Covid-19, strong US dollar, high commodity prices) have exacerbated pre-existing fiscal and external **imbalances**.
- Inflation mainly driven by kip **depreciation**, largely caused by previous domestic policy choices.
- High **public debt** and low **revenue** have created macroeconomic imbalances (e.g., shortage of foreign exchange, limited fiscal space, and financial sector vulnerabilities).
- **Fiscal risks** (e.g., contingent liabilities) can exacerbate the fiscal and debt burdens.

# Macroeconomic indicators have worsened considerably in recent years, mainly due to previous policy choices

## Inflation increased rapidly and the kip depreciated strongly in 2022




## Public debt service has never been higher before, despite recent deferrals

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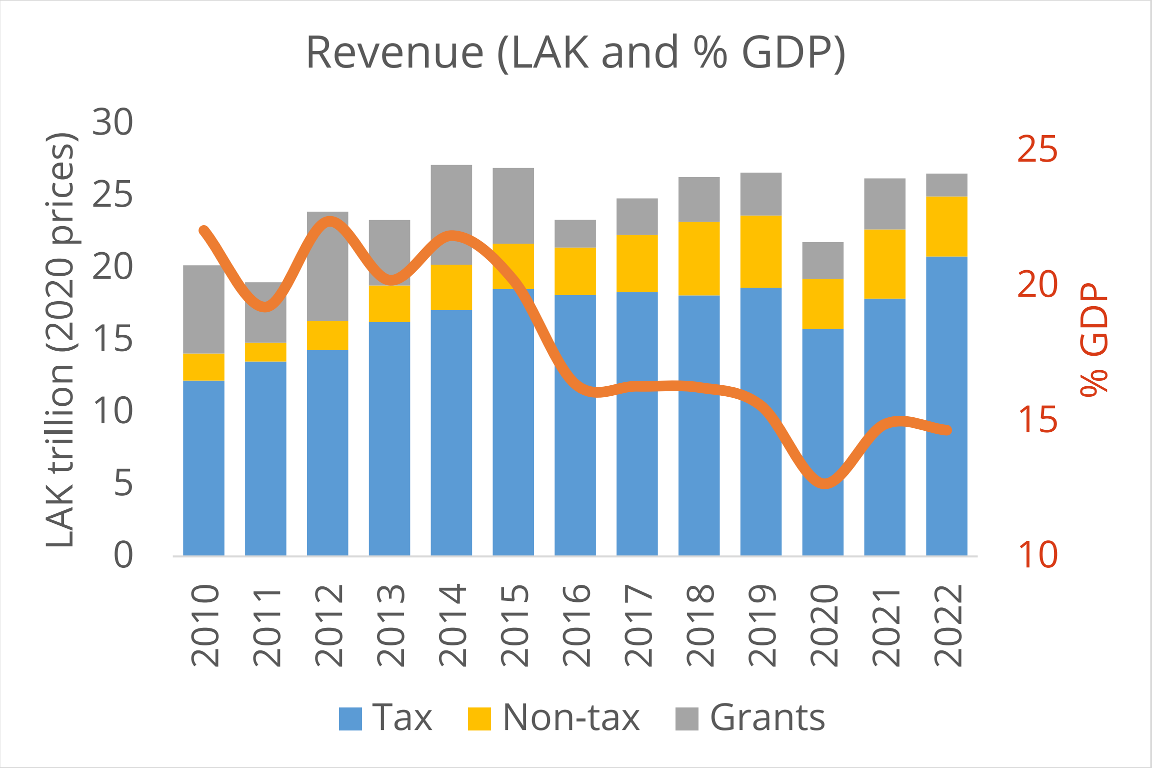
# Main findings (revenue mobilisation)

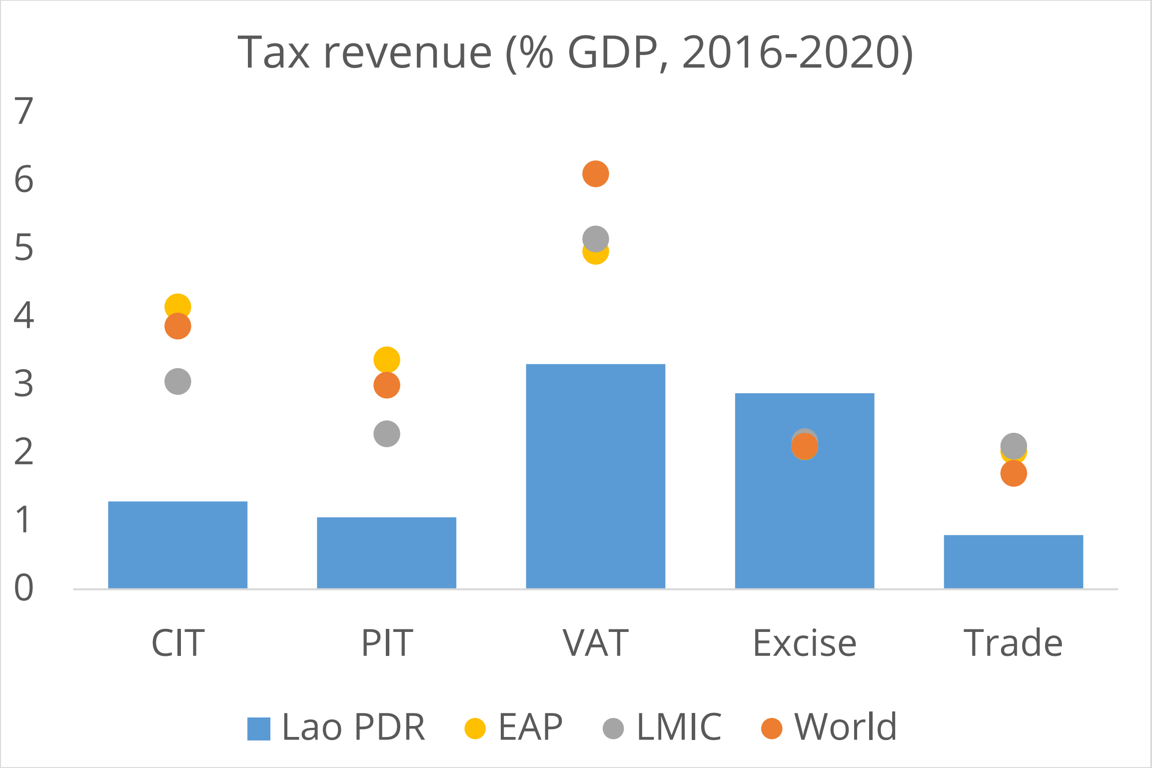
- Revenue **performance** has deteriorated considerably in past decade and is very low by regional and income standards.
- Low tax rates, a narrow tax base, and low compliance and enforcement have weakened **tax revenue** (which is only reaching 60 percent of its potential).
- Generous tax **incentives**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

# Revenue performance has deteriorated in the past decade, and is low by international standards

## Revenue performance has fallen since 2014, especially tax revenue




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

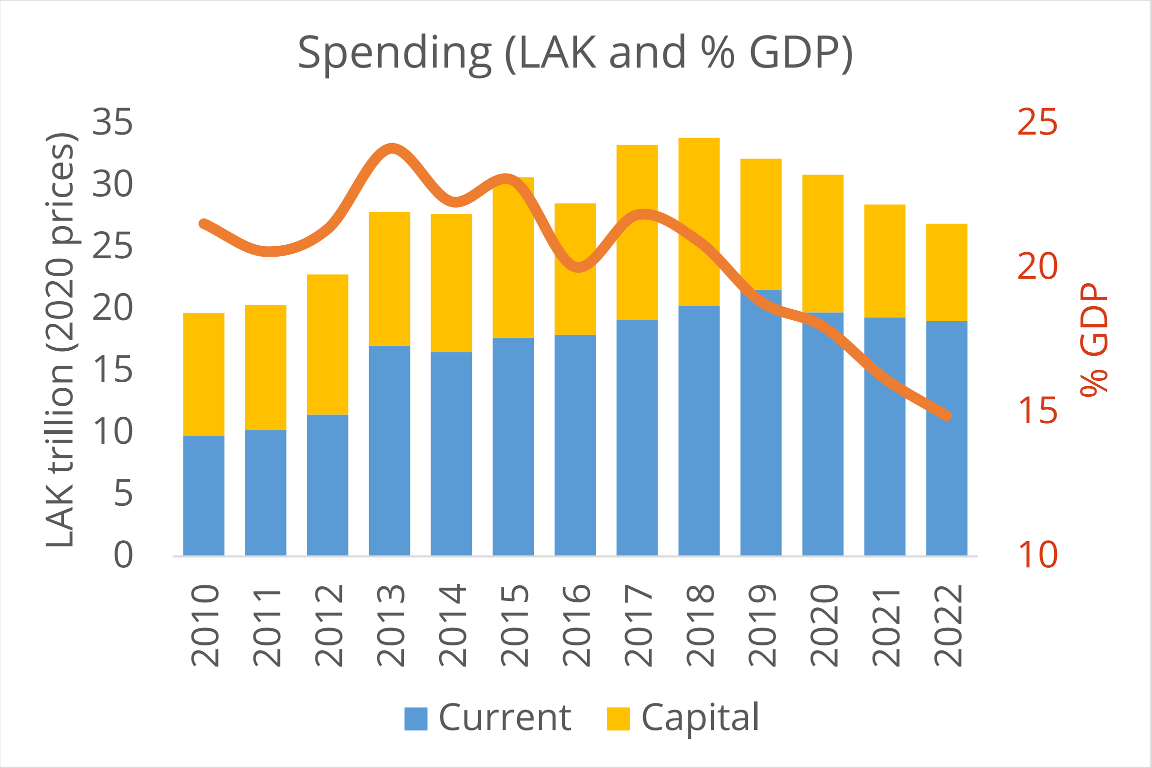


# Main findings (public expenditure)

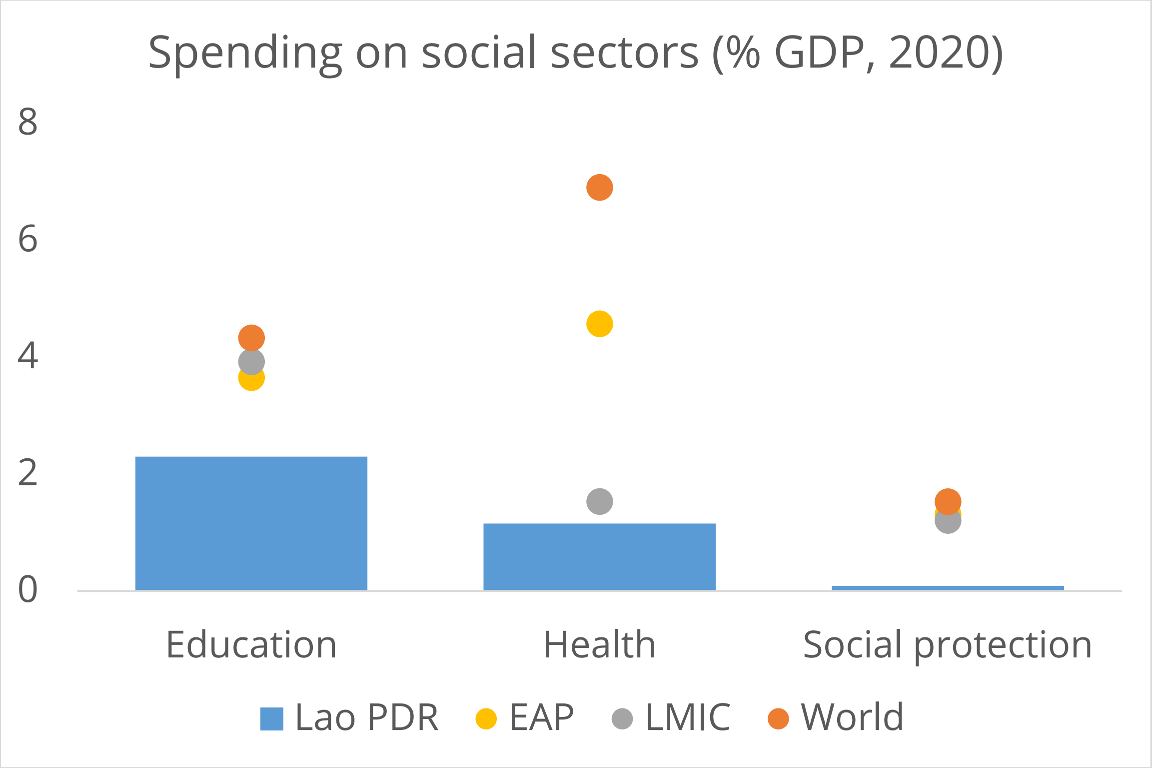
- Public spending has **declined** significantly in the past decade, raising concerns about public service delivery (quantity and quality).
- Growing **debt service** payments (despite deferrals) have reduced fiscal space for growth-related spending (e.g., human capital).
- Challenges related to **public financial management** weaken impact of spending and threaten fiscal sustainability (e.g., weak commitment controls).
- Lack of comprehensive **reporting** undermines transparency and evidence-based policy.
- Budgets not aligned with NSEDP **priorities** (e.g., spending on education and health declined from 4.9 to 2.6 percent of GDP during 2013-2022).

# Public expenditure has declined considerably in the past decade, raising concerns about public service delivery

## Spending has fallen significantly since 2013, due to low revenue performance




## Social spending is low when compared to regional and income peers

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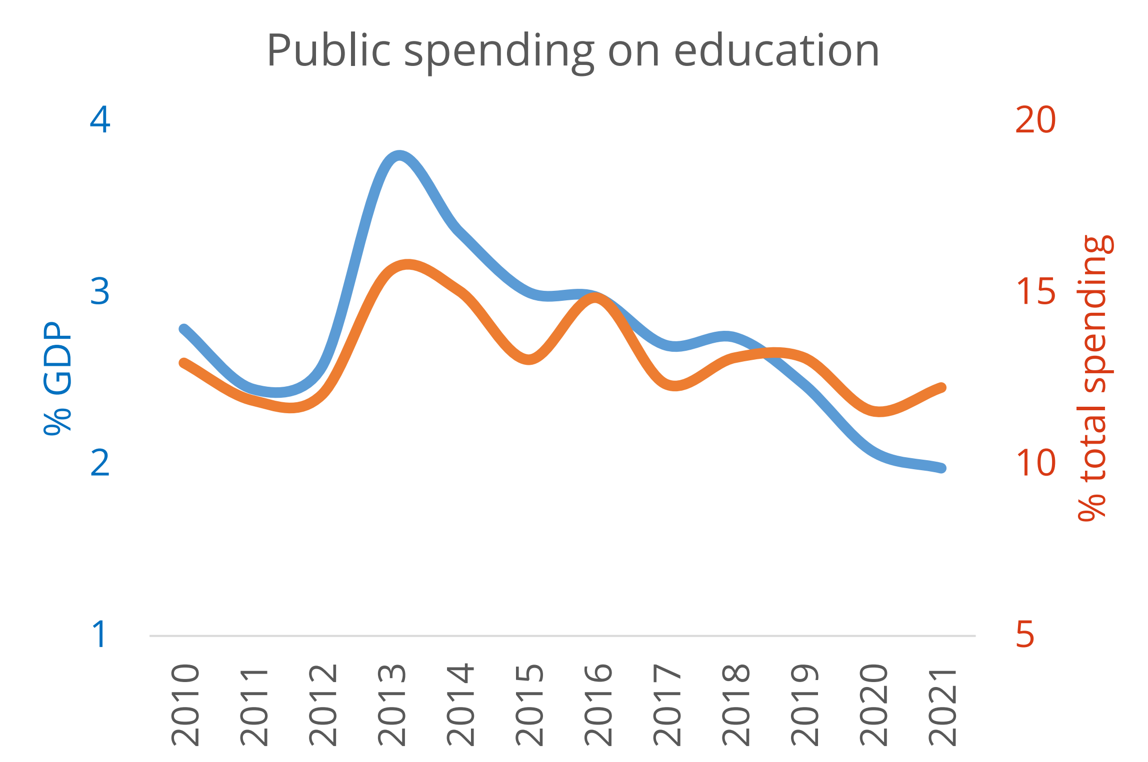
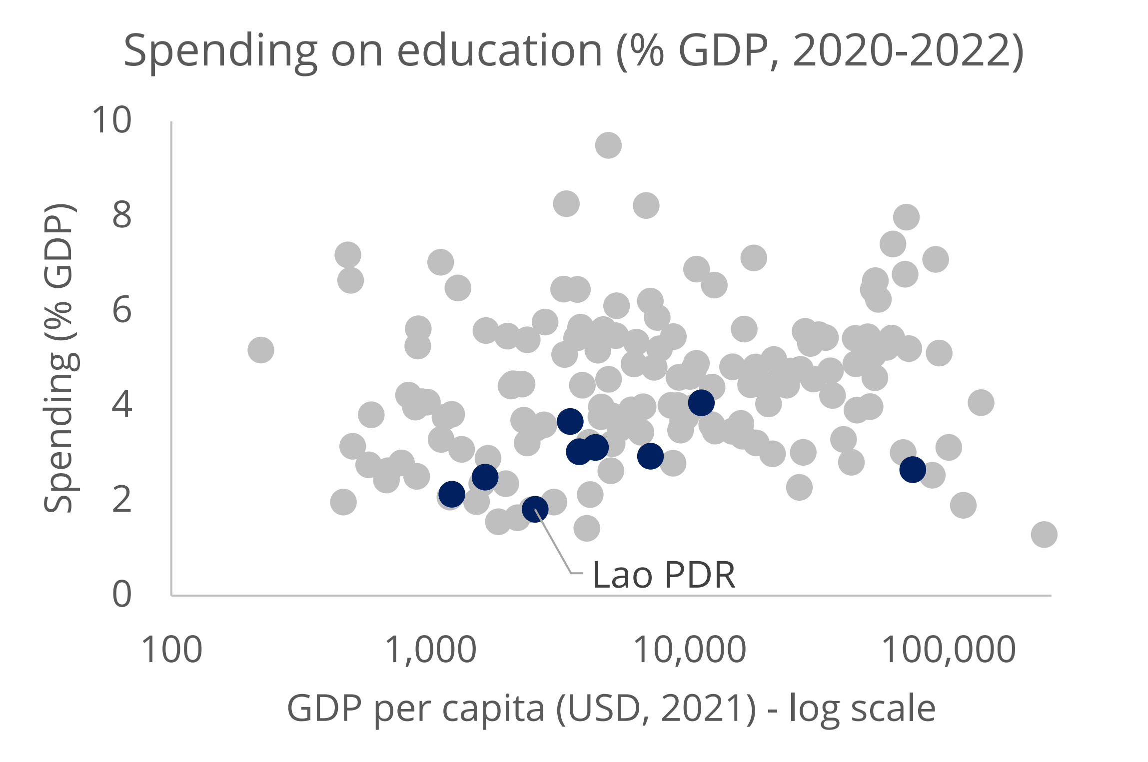
# There is a need for more and better spending on social sectors, especially education

## Despite being a stated priority, spending on education has declined since 2013




## Public spending on education is one of the lowest levels in the world

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# Recommendations (macro-fiscal)

Urgent reforms are needed to stabilise the economy and stimulate growth:

1. Negotiate a credible and transparent **debt restructuring** plan to restore debt sustainability and create fiscal space for growth-enhancing spending.
2. Restore the **value-added tax** rate to 10 percent. (Additional revenue would be over 1 percent GDP.)
3. Revise the **Law on Investment Promotion** to curb tax incentives to support the budget and increase inflows of foreign exchange. (Gradual but large impact.)
4. Reform **excise tax** structures and increase rates (e.g., fuel, beverages, and tobacco) to generate revenue and produce health and environmental benefits.
5. Reallocate spending towards **education**, **health**, and **social protection** to avoid a collapse in human capital.

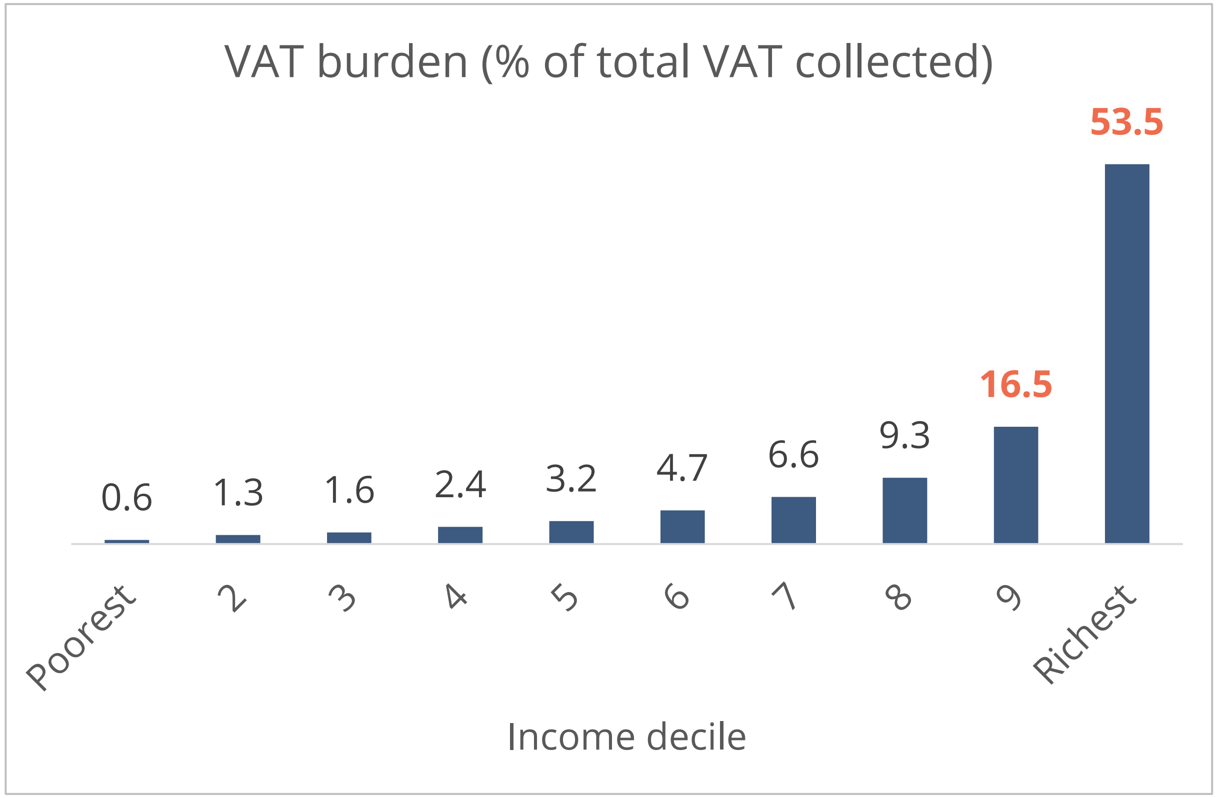
# Distributional impacts

# Main findings (distributional impacts)

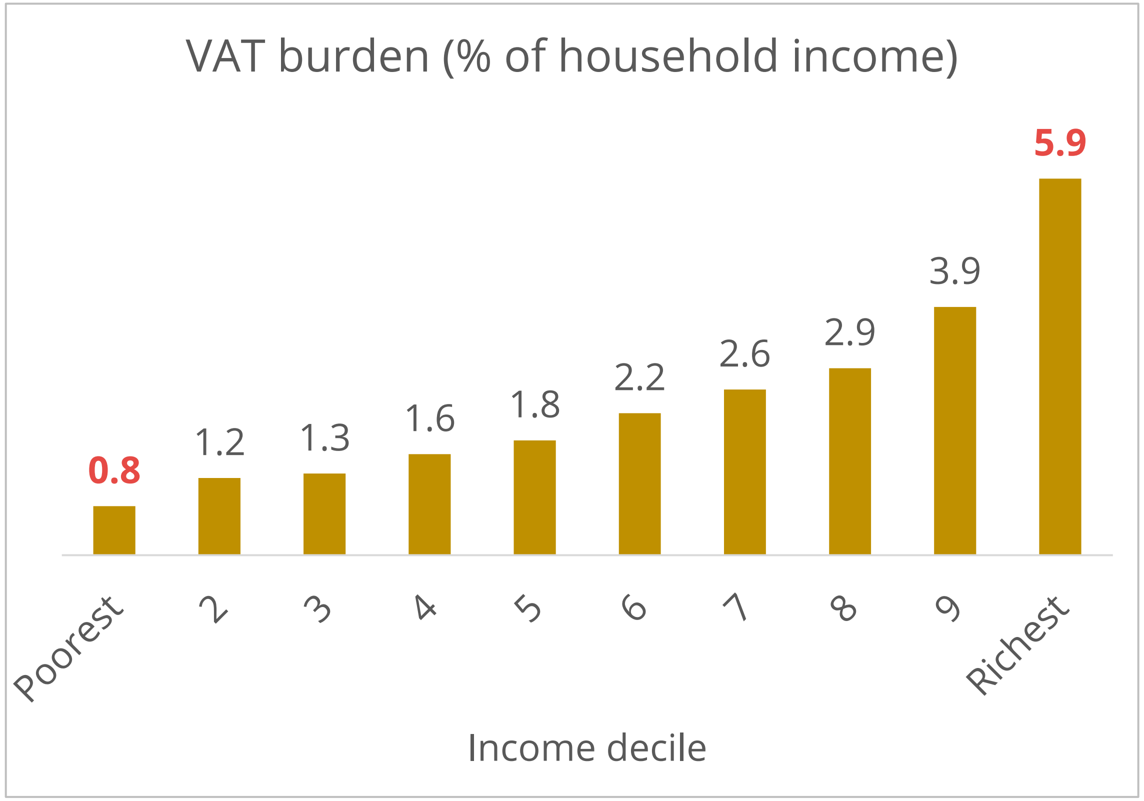
- **Personal Income Tax (PIT), Value Added Tax (VAT)** and **Excise Tax** in Laos are progressive, placing larger burden on better-off households than low-income households.
- **Recent tax cuts** (e.g., VAT and fuel excise rate cuts) have led to forgone revenues and increased inequality, with limited impact on poverty reduction
- Benefits from **health and education spending** are progressive, representing greater shares of income for poorer households.
- **Recent declines** in health and education spending have therefore worsened inequality
- Despite being progressive, the impacts of taxes and social spending on improving **household welfare and reducing poverty and inequality** are low due to weak revenue collection that results in low social spending.

# VAT imposes a larger burden on better-off households, due to high informality among poorer households

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




## VAT represents a greater share of income for richer households

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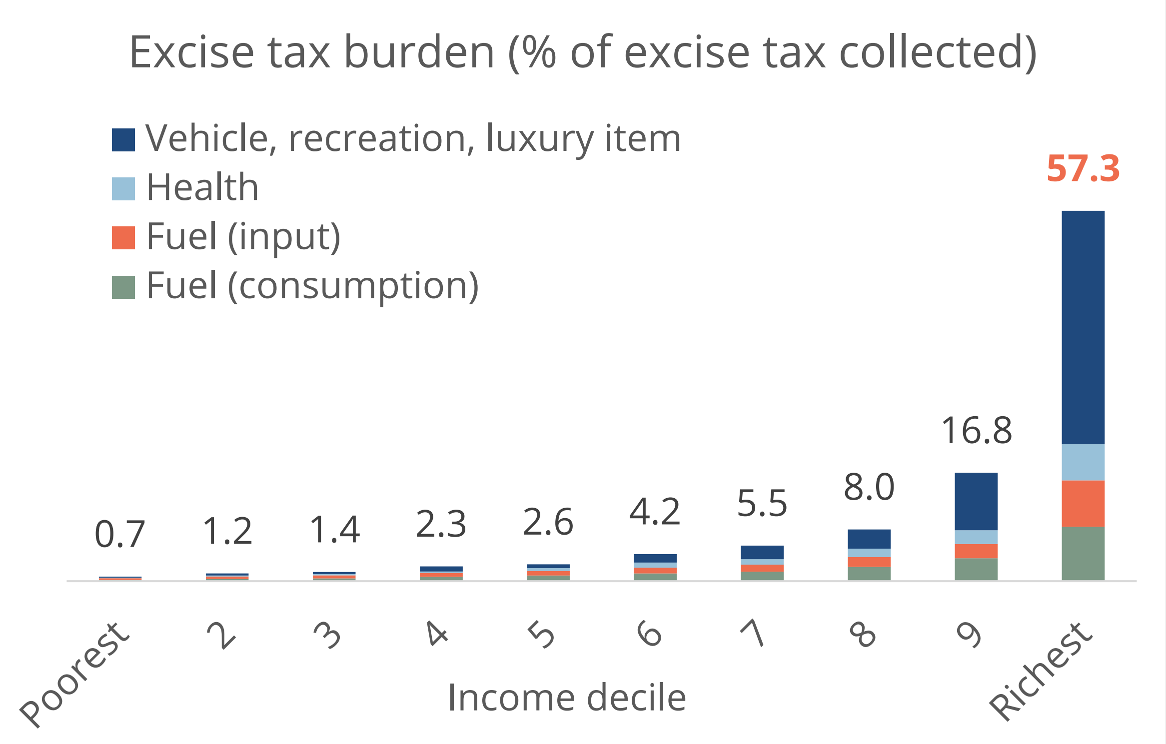
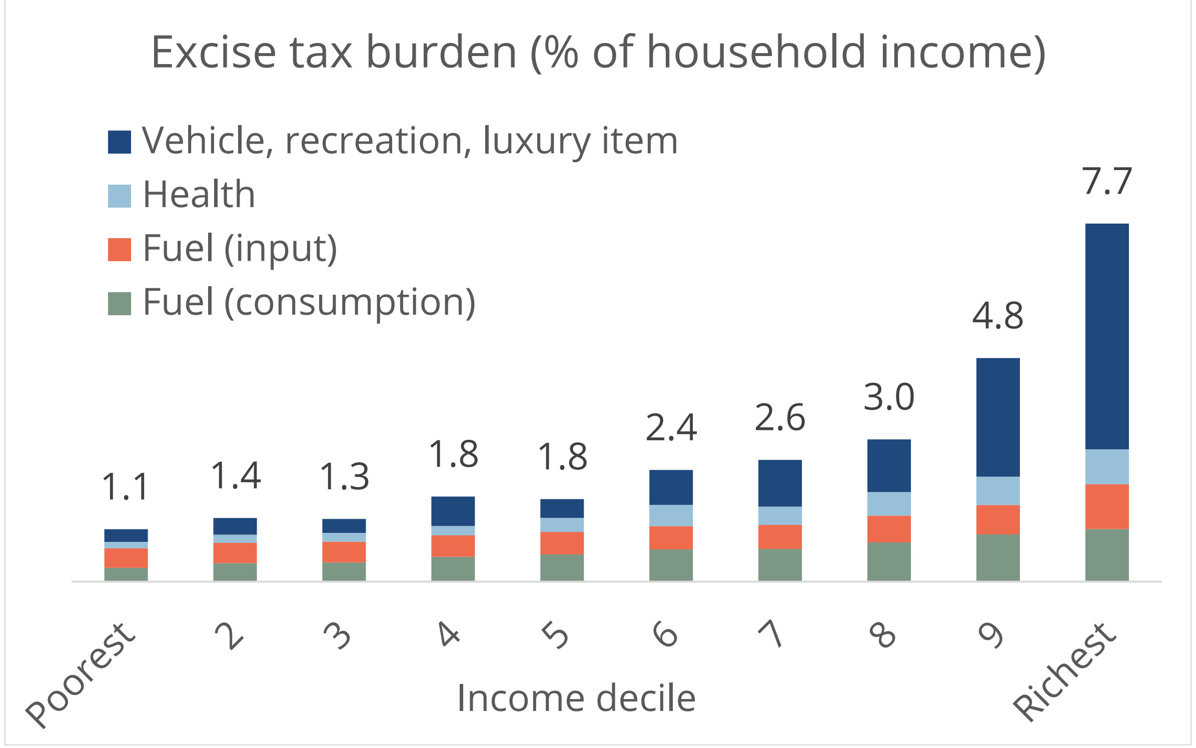
# Excise taxes also impose a larger burden on better-off households than on poorer households

## 57% of excise tax revenue is paid by the richest 10%




## Excise tax on vehicles, recreation, and luxury items are more progressive than fuel and health taxes

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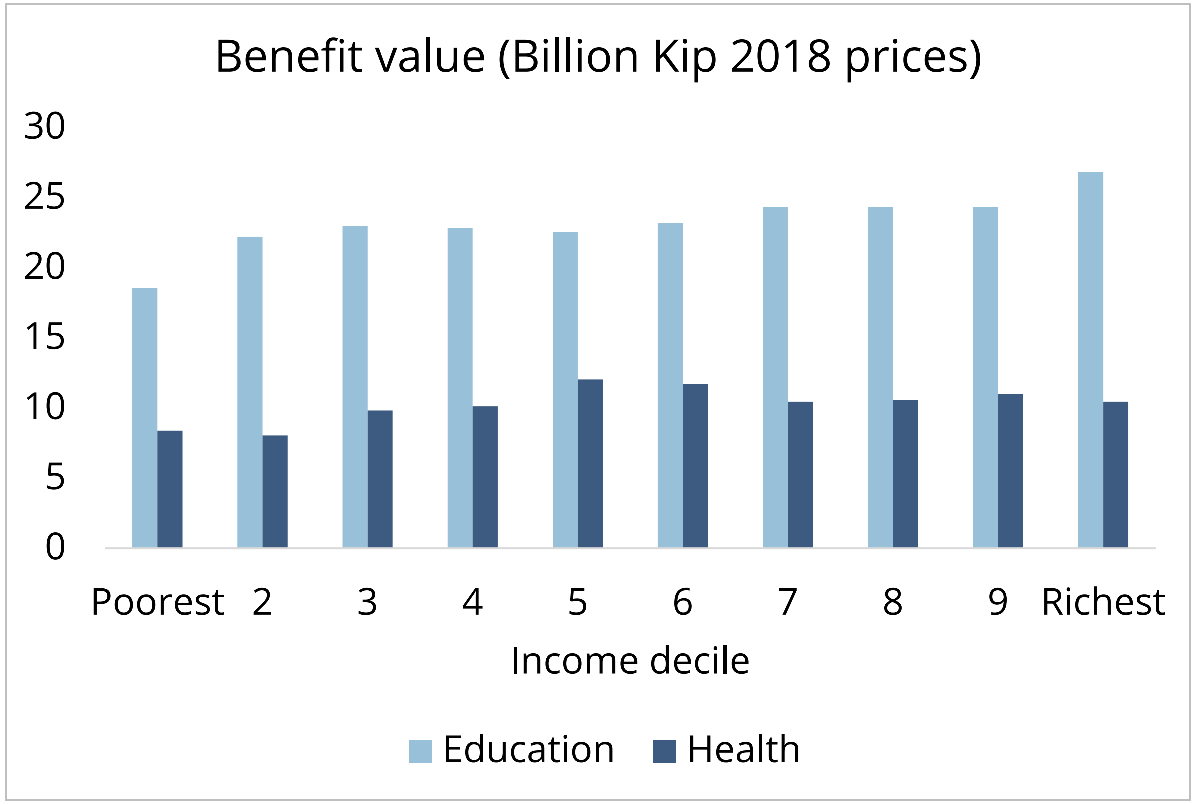
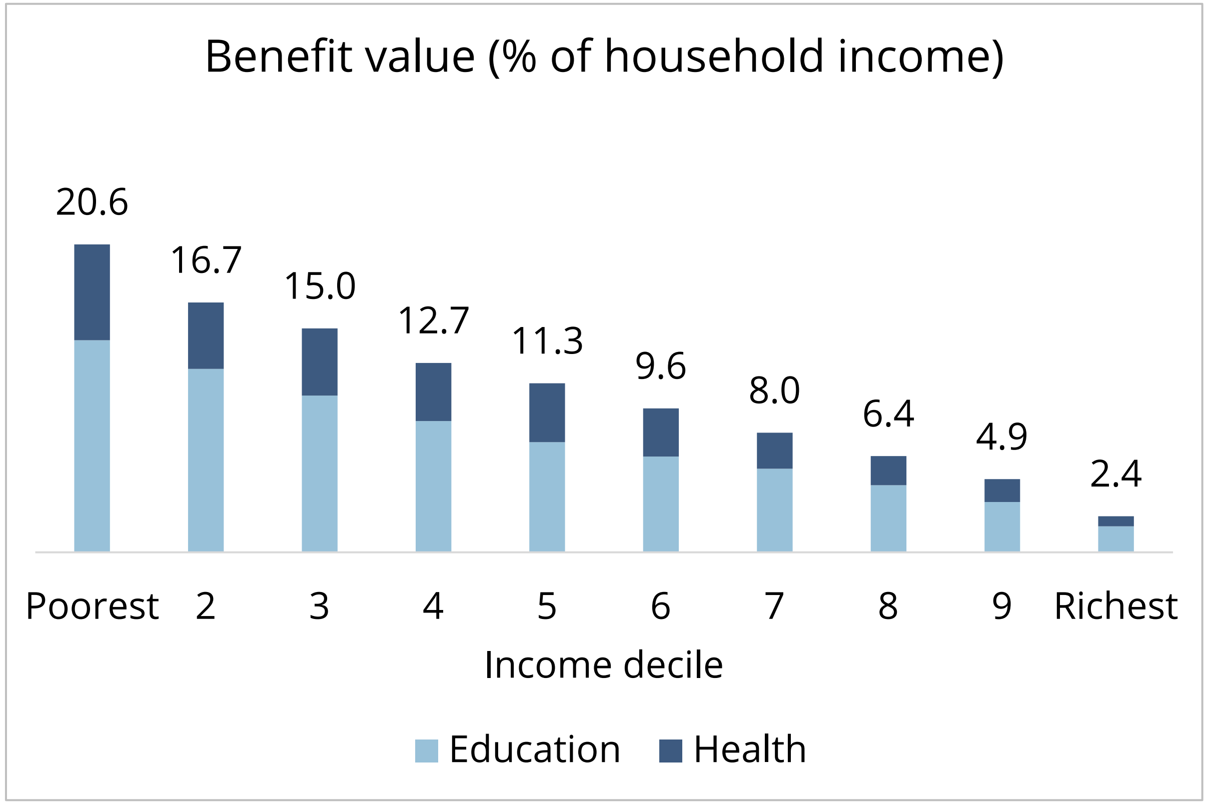
# Poorer households benefit more from health and education spending, relative to their income

## Benefit value of social spending is greater for better-off households…

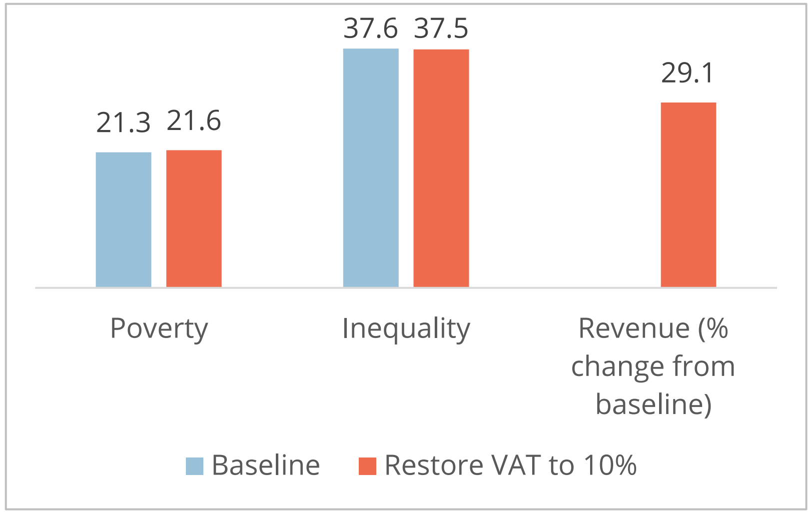


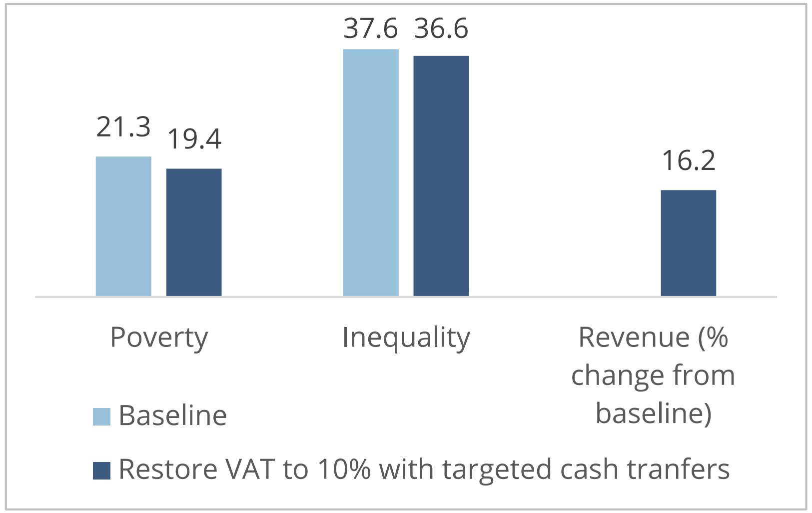

## …but it represents a greater share of income for poorer households



# Recommendations (distributional impacts)

1. Restore the **value-added tax** rate to 10 percent would increase revenue and reduce inequality, while placing low tax burden on poor households.
2. Raising **health taxes** (beer, cigarettes, and sugar-sweetened beverages) would generate revenue with small impacts on poverty and inequality.
3. Larger fiscal gains and inequality reduction can be achieved through health taxes as households **internalize the negative externalities** of consuming these products
4. .**Tax and Spend**. Combining tax reforms with increased social spending (targeted cash transfers, health and education) would generate revenue as well as reduce poverty and inequality

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# Fiscal risks

# Main findings (state-owned enterprises)

- There has been **progress** in reforming the SOE sector (e.g., reducing number and weight in economy), but many challenges remain.
- SOE **portfolio** is relatively decentralised and spread over several economic sectors.
- SOEs do not consistently submit financial **information** to the Ministry of Finance, which hinders a comprehensive performance assessment of the sector.
- Poor **governance** and unfunded mandates have created large liabilities for the government, which threaten fiscal sustainability and macroeconomic stability.

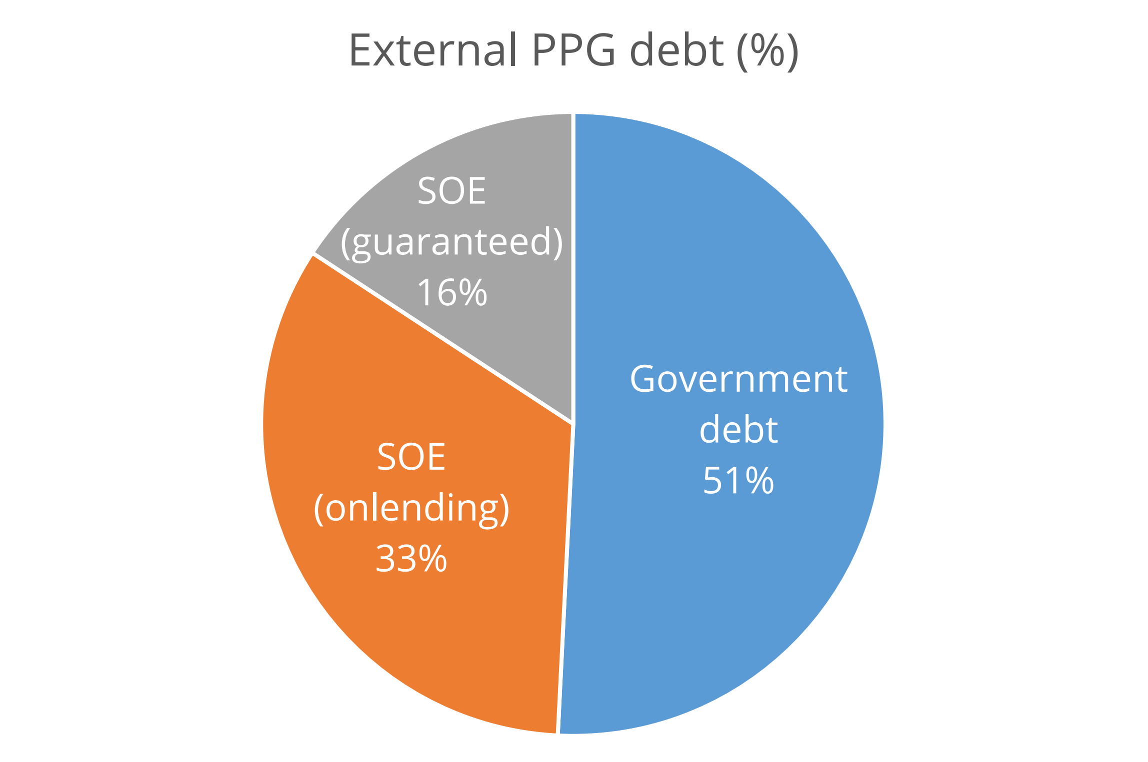
# Main findings (public-private partnerships)

*A PPP is a long-term contract between public and private sector entities, whereby the parties share the responsibility and risk of delivering a public asset and/or service.*

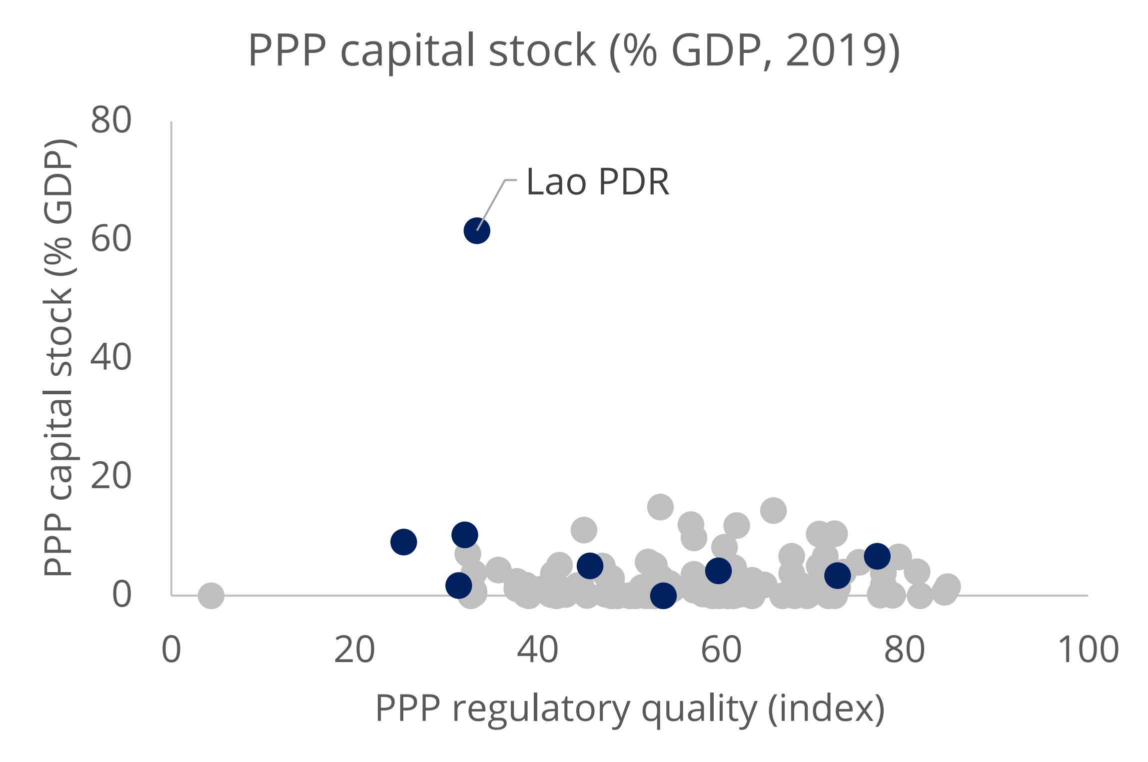
- Significant private sector **finance** has been mobilized through PPPs (e.g., hydropower and transport).
- PPPs can generate benefits (e.g., efficiency) but they are **not 'free'** as they increase fiscal costs and risks.
- Most PPPs have been **unsolicited** (i.e., proposed by private sector) and awarded through **direct negotiation** (rather than competitively tendered).
- Weak governance arrangements and low institutional capacities have likely yielded limited **value for money**.
- There is a large **pipeline** of projects, which should be carefully assessed to protect public interest.

# Fiscal risks associated with SOEs and PPPs are high, which should be carefully monitored and mitigated.

## SOE indebtedness is high, while profitability is generally low (or negative)




## PPP capital stock is very high, despite low regulatory and institutional capacities



# Recommendations (fiscal risks)

1. Establish clear institutional structures, responsibilities, and processes for assessing, approving, and managing **fiscal risks**.
2. Create a fiscal risk management **unit** within the Ministry of Finance.
3. Broaden the **ownership** of SOEs to improve performance, accountability, and transparency.
4. Upgrade the Decree on PPPs to a **law** to strengthen the legal and regulatory framework.
5. Mandate transparent and competitive **procurement** for PPPs to maximise value for money.

# The Vital Five

## Reforms to Secure Macroeconomic Stability in the Lao PDR

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### 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.

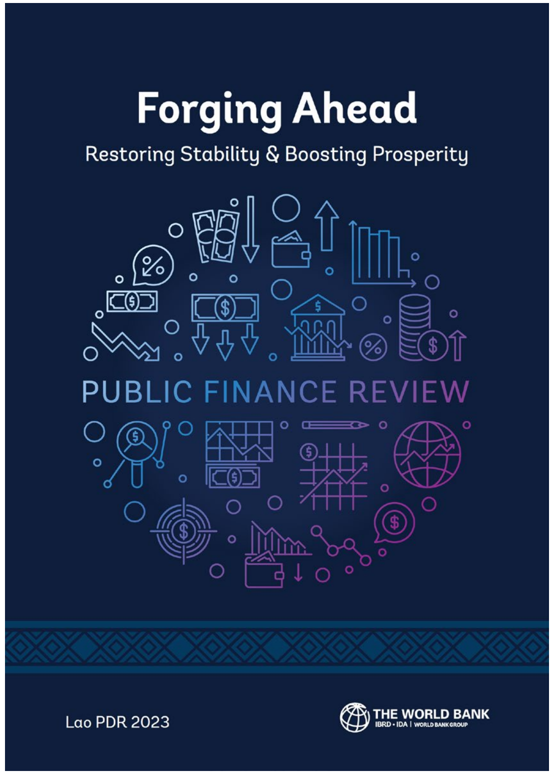
### 5. ENHANCE THE BUSINESS ENVIRONMENT VIA EFFECTIVE REGULATORY REFORMS

Burdensome processes and regulations raise business costs and reduce productivity, undermining investment and exports.

# Reports

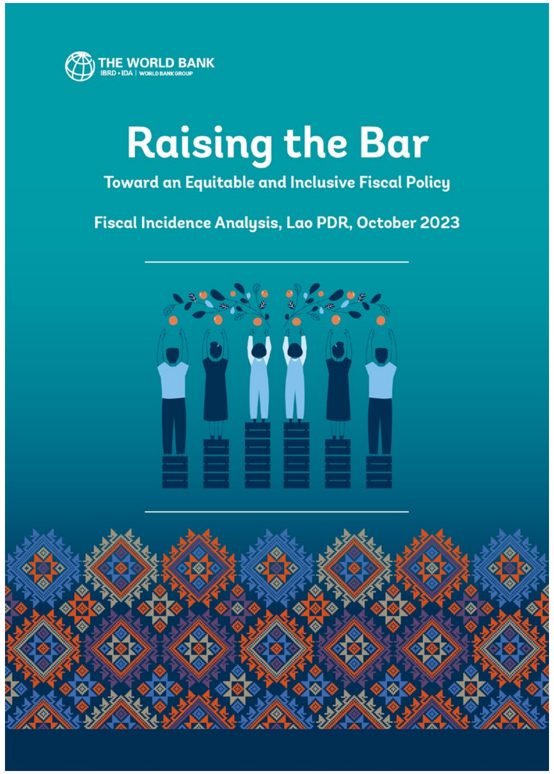
Forging Ahead:
Restoring Stability and Boosting Prosperity

Public Finance Review




Raising the Bar:
Towards an Equitable and Inclusive Fiscal Policy

Fiscal Incidence Analysis

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