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**Summary Report and Outcomes of the Preparatory Consultation
to the 2018 Round Table Meeting: Fostering Productive
Capacities and Structural Economic Transformation in Lao PDR:
Implications for Graduation from the LDC category**

**29-30 August 2018
Vientiane, Lao PDR**

I. Background

Lao PDR is one of the world's 47 Least Developed Countries (LDCs), and the only landlocked developing country (LLDC) in the Southeast Asian region. Lao PDR has registered an impressive socioeconomic performance over the last two decades, outperforming many of its LDC and LLDC peers, and achieving average economic growth of around 7 percent since the early 2000s. The growth performance has contributed to improved incomes per capita, as well as significant poverty reduction and human development gains.

As a result, Lao PDR has made rapid progress towards the criteria for graduation from the LDC category. Its GNI per capita increased from about US\$ 350 in 2006 to almost US\$ 2000 in 2018. Similarly, its Human Assets Index has increased from 46.4 in 2003 to 72.8 at the 2018 review, and the Economic Vulnerability Index decreased from almost 60 in 2009 to 36.2 in 2018. Thus, in 2018, Lao PDR met two of the three criteria for graduation from the LDC category for the first time. It is broadly expected that – if current trends persist – Lao will meet all three criteria by the time of the next review in 2021, and thus be recommended for graduation in 2024. This would make Lao PDR only the second country (after Bangladesh) to achieve graduation by meeting all three criteria.

While Lao PDR has seen remarkable progress and is likely to graduate from the LDC category in the near future, it still faces a number of challenges. Firstly, the pace of poverty reduction achieved – while impressive – has not kept pace with the fast economic growth achieved at the national level. Secondly, poverty rates remain highly uneven across the country. Similarly, the country still faces challenges in reducing malnutrition and maternal mortality, and raising secondary school enrolment.

The more significant challenge, however, is to avoid being stuck in the low-income group of developing countries after graduation from the LDC category. Lao PDR's commodity export performance and human development achievements may have been enough to lead Lao PDR to graduate, but they by themselves are insufficient to make the transition to middle-income or higher-middle income status. Achieving this will require progress in structural transformation and export diversification. To date, there has been little progress towards structural transformation. Growth continues to be driven by the mining and electricity sectors, which account for less than 1% of jobs. In contrast, growth in the agricultural and manufacturing sectors has been sluggish, and the manufacturing sector's share in GDP remains smaller than in neighbouring countries, as well as than the group averages for LDCs and LLDCs. In addition, the concentration of Lao PDR's exports render the country highly vulnerable to changes in commodities prices. Continuing the current growth patterns therefore exposes the country to the risk of the 'middle-income trap'. These challenges call for renewed and determined efforts to accelerate sustainable and inclusive economic growth and development, including structural transformation and export diversification.

UNCTAD argues that achieving this requires the building of productive capacities. Conceptually, the notion of productive capacities is defined by UNCTAD as “the productive resources, entrepreneurial capabilities and production linkages which together determine the capacity of a country to produce goods and services and enable it to grow and develop” (UNCTAD, 2006). Thus, the definition stresses

three distinct but interrelated dimensions of productive capacities – productive resources, entrepreneurial capabilities and production linkages. These elements of productive capacities determine not only the overall capacity of a country to produce goods and services, but also which goods and services a country can produce and sell competitively. In many cases, productive capacities can only be built with deliberate efforts made by governments to direct the development of the economy; they will not always spontaneously arise over time. Structural economic transformation is also broadly defined to include the process of shifting productive resources away from low-productivity sectors such as agriculture and commodity extraction towards modern high-productivity sectors with extensive forward and backward linkages, such as manufacturing and technologically sophisticated production and exports.

Building on the above conceptual rationale and with a view to supporting landlocked developing countries, UNCTAD has undertaken a series of country case studies including on Lao PDR. The case studies clearly indicate that despite the challenges, the case for diversification and structural economic transformation remains more persuasive for LLDCs such as Lao PDR today than ever before. The study also underscores the importance of hooking into regional and global commodity value chains and the urgency for LLDCs to take advantage of their natural resources wealth by enacting sound development policies and strategies that put productive capacities and structural economic transformation at the center.

The consultation workshop was organized against the above-mentioned background, and it provided opportunities to deliberate on ways and means for Lao PDR to place fostering productive capacities and structural transformation at the center of domestic trade and development policies. It helped to understand the underlying development challenges facing Lao PDR and contributed to a better articulation of policy-oriented recommendations with a particular focus on fostering structural economic transformation and productive capacities, including diversification and technological sophistication of exports. The consultation also reviewed the national report on productive capacities in Lao PDR sponsored by UNCTAD as well as the performance of Lao PDR in UNCTAD's Productive Capacities Index. The workshop served as part of the UNCTAD Development Account Project on "Indices for benchmarking productive capacities for evidence-based policymaking in landlocked developing countries" of which Lao PDR is one of the beneficiary countries. The project aims to assist Lao PDR and other landlocked developing countries to identify where they stand now in fostering productive capacities and structural economic transformation. It particularly identifies key indicators that will assist in measuring and benchmarking productive capacities and the degree of structural economic transformation in Lao PDR and other comparable countries. With these objectives in mind, UNCTAD, and several experts and seniors officials drawn from various institutions of Lao PDR made a series of technically rich and substantive presentations. The findings and conclusions as well as policy recommendations from the UNCTAD study on Lao PDR served as background documents to the consultation workshop.

Specific questions addressed at the consultation include the following:

- a) How much progress has Lao PDR achieved towards internationally agreed goals including graduation and what are the policy options for accelerating progress?
- b) How will building productive capacities and promoting structural economic transformation contribute to Lao PDR's graduation from the LDC category?

- c) Where does Lao PDR stand now with regard to fostering productive capacities and structural economic transformation?
- d) What policies and strategies are needed in Lao PDR to accelerate structural transformation, productive capacity-building and inclusive growth?
- e) What is the role of development partners in Lao PDR's effort to achieve the SDGs, especially in the post-graduation environment?

II. Summary outcome: Key issues discussed, and priority areas identified for policy related actions by the Government of Lao PDR

At the consultation, participants assessed the progress achieved by Lao PDR towards internationally agreed development goals, including graduation from the LDC category. It was recognized that while Lao PDR had achieved broad progress on several socio-economic indicators, including per capita income growth and poverty reduction, the country still faced significant challenges with regard to structural transformation, export diversification and building productive capacities. While the prospect of a forthcoming graduation from the LDC category was evidence of the economic progress achieved, participants also noted that it brought a new set of opportunities of challenges to be addressed, including the potential loss of preferential market access and concessional development finance. However, it was noted that since 80% of exports of Lao PDR are destined for Thailand, China and Vietnam, Lao PDR has so far not fully utilized the preferential market access it enjoyed in economies such as the EU. Thus, the expected loss of preferences is unlikely to have a significant impact on the trade performance of Lao PDR. Furthermore, it was noted that concessional finance by multilateral institutions was still extended to low-income countries, as the multilateral financial institutions did not use the LDC category. At the same time, graduation also offers opportunities that should be capitalized on, including a boost in investor confidence. Competing in a post-graduation environment would likely require different development policies. If countries are to avoid the pitfalls of the 'middle-income trap' of being stuck in low-value added segments of global value chains, proactive policies are needed to encourage productivity gains, diversification and structural transformation.

In this context, assisting Lao PDR in fostering productive capacities and structural transformation aimed at improving the quality and form of economic growth; broadening the sources of growth, export earnings and government revenue; enhancing competitiveness and creating sustainable employment is critical. The notion of structural transformation should go beyond the traditional confines of commodity diversification and value addition but include enhancing the technological embodiment and sophistication of exports. It should also be seen as dynamic rather than static process. It occurs across sectors but also within sectors, given the right mix of domestic institutional framework, micro and macroeconomic conditions as well as global trade and economic circumstances.

The consultation on 'Fostering Productive Capacities and Structural Economic Transformation in Lao PDR: Implications for Graduation from the LDC category' was viewed as useful, valuable and timely by participants drawn from public and private as well as academic institutions of the country. In this

context, the concept of building productive capacities was seen as a helpful framework for identifying policies to support structural transformation. Measuring and benchmarking productive capacities and structural economic transformation - the exercise which UNCTAD is undertaking in landlocked developing countries (LLDCs) including Lao PDR - is a step in the right direction to inform development policy making processes. Participants also view statistics and indicators as important in policy formulation and implementation. These should be seen not only as a tool in policymaking process but also a "public good" and, hence, should be given due attention in national budget allocation.

There was a convergence of views and understanding that, drawing on practical policy lessons from successful developing countries and regions, the Government of Lao PDR can further improve its trade and development policies by undertaking policy actions in the following priority areas, which were identified at the two-day consultation workshop and through extensive bilateral consultations with key institutions.

These include:

- i.) **Mainstreaming the building of productive capacities:** Given the importance of building productive capacities for sustainable growth and development, including graduation from the LDC category, it is recommended the Government of Lao PDR place the building of productive capacities and structural economic transformation at the heart of domestic policy formulation and implementation.
- ii.) **Prioritizing productive capacities:** A brief assessment of the levels of productive capacities has shown that Lao PDR performs well in terms of private sector facilitation and natural capital. However, its scores on institutions, transport infrastructure, structural change and ICT are comparatively low. This suggests that Lao PDR's policy priorities in productive capacity-building include expansion of transport, energy and ICT as well as diversifying the economy from agriculture-forestry to industry are well-targeted. The consultation also took note of the Government's commitment to fully realize the rule of law in Lao PDR by 2020, which will make a key contribution to economic and social development. Encouragingly, productive capacities appear to have improved over time in several categories, above all with respect to human capital, ICT, institutions, structural change and private sector. As Lao PDR prepares for eventual graduation from LDCs category and aspires to meet the SDGs, it becomes indispensable for the country to address remaining challenges in fostering productive capacities and structural transformation.
- iii.) **Coordination/wholistic approach:** Placing productive capacities at the centre of national policy-making requires effective coordination among institutions and policies, to ensure that efforts in one field are supported and complemented by efforts in other areas. In this context, the establishment of the national inter-ministerial advisory committee at the highest political level to oversee the graduation of Lao PDR is critically important.

- iv.) **Making productive capacity building the focus of the development partnership:** Development partners should give consideration to supporting the efforts of the Government of Lao PDR to build domestic productive capacities, including through aligning their development assistance with national plans, and strengthening assistance to the productive sectors. In addition, development partners are encouraged to take measures to support the continued growth and development of Lao PDR beyond graduation from the LDC category, including through investment promotion, preferential tariffs and technical assistance.
- v.) **Graduating with Momentum:** Lao PDR may wish to consider its forthcoming graduation from the LDC category as a milestone on its development trajectory, rather than an end in itself. Focusing exclusively on meeting the criteria for graduation without a vision of its post-graduation development path heightens the risk of Lao PDR falling into a middle-income trap. It is recommended Lao PDR prepare for the post-graduation policy environment, and adjust its development policies accordingly.
- vi.) **Graduation as a catalyst:** It is important for the Government of Lao PDR to use its forthcoming graduation from the LDC category as a mobilizing factor to address the challenges still facing the country, including high economic vulnerability, on the road to achieving the SDGs.
- vii.) **Bilateral negotiations with trade partners:** In order to ensure a smooth transition, the Government of Lao PDR needs to consider entering into bilateral negotiations with key trade partners to continue benefiting from market access preferences in key export sectors affected by graduation for a transitional period.
- viii.) **ODA flows:** The impact of graduation from LDC status on Official Development Assistance (ODA) flows is expected to be minimal, because the bulk of ODA flows are not determined by LDC status. Furthermore, most ODA flows to Lao PDR are from regional and multilateral donors, which they get through bilateral and multilateral relations.
- ix.) **Development Finance:** In the event of a drop in ODA after graduation, it is strategically important for the Government of Lao PDR to continue to seek additional development finance from external sources, but also to build its capacity for domestic resource mobilization, including tax collection.
- x.) **Closing the gap:** Recognizing the remaining gaps in the graduation criteria, it is important for the Government of Lao PDR to address the areas where it is still lagging behind with regard to the Human Assets Index and the Economic Vulnerability Index, including, but not limited to, youth employment, maternal mortality, secondary school enrolment and malnutrition.

- xi.) **Human Capital/Education:** There is a need for the Government of Lao PDR to strengthen the training and higher education system, and to improve the alignment of skills taught with the needs of the private sector. Improving the average skills levels of the labour force will facilitate the absorption of greater number of agricultural workers in higher-productivity jobs in manufacturing and services. Measures to be considered include: Strengthening private sector participation in the creation of training curriculums (especially for technical and vocational education and training (TVET) institutions; Increasing public funding of education; Strengthening regular teacher training sessions; encouraging private sector job training programmes by MNCs and SME.
- xii.) **Human Capital/Health:** Despite significant achievements in expanding access to health care and reducing under-5 mortality, the service availability in many health centers remains severely limited. Greater investments and efforts are needed to render the health centers fully operational.
- xiii.) **Trade logistics:** Logistics services in Lao PDR are comparatively expensive due to the imbalance of trade between Lao PDR and its neighbours, as well as high costs related to customs clearance. To address this, the government could consider the establishment of logistics parks and dry ports at the main border crossings, which could integrate customs clearance, bonded warehousing, cold storage and tenant services. Furthermore, efforts should be made to encourage investment in the capacities of domestic freight forwarders, and to address discriminatory practices in transit countries.
- xiv.) **Transport infrastructure:** The poor quality of road connections between urban and rural areas, as well as the low standard of national roads in comparison to the regional neighbours are key constraints on development in Lao PDR. In this context, the Government of Lao PDR is encouraged to identify priority projects for funding and extend efforts to attract private investment in the road network through public-private partnerships (PPPs). This will require improving the legal and institutional framework for PPPs and establishing a PPP Development and Knowledge Centre within the Ministry of Planning and Investment and the Ministry of Finance. The Development and Knowledge Centre could be tasked to carefully study the successes and failures of PPP models, and identify best practices and successful experiences from other countries in the region for emulation in Lao PDR.
- xv.) **Improving productivity in agriculture:** The agricultural sector accounts for the bulk of employment in Lao PDR, and plays an important role in rural poverty reduction and achieving ensuring food security. In this context, greater efforts are needed to raise agricultural productivity, including through modernization of the sector. Core measures to be considered include extension of irrigation, use of higher-yielding varieties of seeds and fertilizers, as well as achieving economies of scale in farming through land consolidation. Improving farm extension services and access to finance for small farm

agricultural enterprises. Continued progress in the clearance of Unexploded Ordinance (UXO) will also be crucial to strengthening the agricultural sector.

- xvi.) **R&D, Technology and Innovation:** The development of science and technology should aim to provide the technologies and R&D that firms require for higher value adding activities. In this context, efforts should be made to reduce the price of internet access in Lao PDR, including through encouraging investment by the private sector as well as opening the sector to foreign competition. The newly created Ministry of Science and Technology (MOST) is an important step in the right direction, but will require further capacity-building support, so as to be able to effectively encourage R&D needed by private firms. Further investment is also needed in research institutions and universities to support expertise and improve facilities. Seed-funding and scholarships for overseas research fellowships can be used to enhance capacities. As is the case for training curricula, there is also a need to strengthen the private sector collaboration with universities and research institutes. The limited funds available to support R&D in Lao PDR should be effectively used, including through greater competition for funding and rigorous impact evaluation.
- xvii.) **Energy:** Given the central role of the energy sector in the economy of Lao PDR, the government could consider developing a detailed national energy policy that outlines its plans for expanding energy supply, to meet growing domestic and international demand. Furthermore, the government should work to improve the domestic transmission and distribution network for electricity, to reduce power loss. Options to be explored in this context include the separation of electricity transmission from distribution, and allowing foreign investment in the sector. Lao PDR may also stand to benefit from the creation of an energy management system (as is in place in neighbouring Vietnam). A further priority is the integration of border areas into the national electricity grid, as well as the introduction of an energy efficiency and conservation programme. Finally, it is recommended that a master-plan for renewable energy be created, including the development of wind- and solar energy, as well as the development of smaller hydro-power plants to serve rural areas and increase supply reliability.
- xviii.) **Private Sector:** The Government of Lao PDR could consider better leveraging the potential of the private sector in supporting the country's development process. This can include the identification of sectors of competitive advantage, and the incentivization of firms who have demonstrated their ability to achieve goals such as structural transformation, technological upgrading, employment generation, or poverty-reduction.
- xix.) **Coordination of Development Assistance:** The Lao PDR is encouraged to further review the current framework used for aligning donor support with national priorities in the round table process, including by considering to expand its scope to other development finance flows. Lao PDR could also consider further revising its Decree on the Management and

Utilization of ODA flows, so as to strengthen coherence and enhance transparency about the division of labour among government agencies. Similarly, the institutional arrangements for managing ODA internally could be revised so as to improve coordination among relevant departments, and to include management of finance from non-traditional donors such as China, India and Vietnam. Against the backdrop of falling development assistance from OECD DAC donors, there is also a need to develop a plan for mobilizing new sources of development finance, including south-south and triangular cooperation.

- xx.) **Mainstreaming trade into national policies and strategies:** Trade should be made an integral part of domestic development policies and strategies focusing on development outcomes rather than the processes of integration. In this context the ultimate test of success in trade mainstreaming should be whether it has led to the formulation of a coherent trade policy framework and whether it has fostered productive capacities and structural transformation. Experience has shown that for trade mainstreaming to be successful it is indispensable to put in place a credible mechanism for public consultations to solicit substantive inputs into trade policymaking. In sum, trade policy-making processes should be inclusive, forward-looking and pragmatic.
- xxi.) **Regional cooperation:** In view of the small size of Lao PDR's domestic market, Lao PDR stands to benefit from greater regional cooperation. This could include regional trade agreements, which should be designed to facilitate regional value chains, as well as regional cooperation on joint infrastructure projects.
- xxii.) **Diversification:** The diversification of production and exports away from the energy and mining sectors are key steps in achieving structural transformation and sustainable growth and development patterns. In this regard, Lao PDR is encouraged to pursue policies that promote diversification of production towards sectors with higher-productivity growth potential. One way of achieving this is to explore vertical diversification into products and services that are upstream and downstream from existing specializations.
- xxiii.) **Promoting integration into regional and global value chains:** Integration in to regional and global value chains offers significant benefits to local firms, including access to export markets, new technologies and skills. It also provides opportunities to capture higher value-added steps along the value-chain. In this context, Lao PDR is encouraged to develop strategies to support the private sector in integrating into regional and global value-chains, including through linkage programmes with foreign investors, as well as strategic support to sectors with foreign investment potential.
- xxiv.) **Statistics:** Participants noted the importance of effective collection and analysis of relevant statistical information to support evidence-based policy-making for development. In this context. It is recommended that Lao PDR strengthen the capacities of its national

statistical offices, to support collection and analysis of statistical data on building productive capacities.

- xxv.) **UN System support:** As Lao PDR approaches graduation from the LDC category, continued technical assistance and capacity-building from the international community and the UN system will be required. In this context, the UN Resident Coordinator in Lao PDR plays a crucial role in mobilizing all components of the UN system to provide targeted support to the Government of Lao in the run-up to graduation and beyond.