LAO PDR Country Economic Memorandum

Leveraging Strategic Location and Natural Wealth for Inclusive and Sustained Growth

The limits of Lao PDR's growth model have become apparent

1. **Following substantial economic growth and development over the last two decades, some of the limits of Lao PDR'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 sufficiently inclusive. Strong GDP growth did not create as many jobs as expected. 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 several of the country's forests and water resources remain at risk.

2. **Ongoing reliance on natural resources has also resulted in significant macroeconomic vulnerabilities**. Public debt has increased to critical levels, rising by almost 20 percentage points of GDP since 2010, driven by low rates of revenue collection and debt-financed investments in the electricity sector. Up until 2017, resource exports and associated capital inflows also led to an appreciation in the value of the kip which, combined with rising wages, undermined the competitiveness of non-resource export sectors and slowed their growth. Public investments in mining and power have also reduced fiscal space and left less for investment in agriculture, education, healthcare, and other public services, which likely would have provided more 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, Lao PDR's natural assets and location offer significant potential for a more sustainable and inclusive growth model

3. **While the country is landlocked with high transport costs, that may soon change given railway and road infrastructure projects.** 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. It has become increasingly clear that the present value of future benefits from environmental protection is significantly greater than that of uncontrolled resource extraction. If exploited sustainably and at a slower pace, natural resources can still be robust drivers of long-term inclusive growth. Lao PDR also has one of the youngest populations in the region, with potential for a substantial demographic dividend in coming decades.

4. **Lao PDR's geographic location, with some of the world's fastest growing economies as neighbors, is a significant asset**. Trade with and investment from these countries can drive overall growth in Lao PDR, while helping to diversify the economy away from mining and hydro or coal power generation. Lao PDR 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 there is demand for Lao exports, plus cheap sources of imports, along with GVCs and FDI opportunities right at the country's doorstep. As such, Lao PDR can better partake in international value chains simply by letting location-driven market forces take place. Already there is some evidence of progress in this direction: for instance, 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.

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

5. **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 of Lao PDR has rightly understood, focusing its economic and social development strategy around trade, investment and establishing Lao PDR 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. 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.

6. **More than creating new policy reforms, the government needs to prioritize among existing reforms and follow through with implementation to see change accelerate.** In 2019, Lao PDR 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 already tough constraints of a small domestic market with bottlenecks in labor markets. 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 can also spur institutional and policy reform for improving the business and investment regime.

What can the Lao government do?

7. **This Country Economic Memorandum (CEM) offers a set of policy directions that can help leverage Lao PDR's strategic location and natural wealth to achieve more inclusive and sustainable growth** (see Table 1 for a summary). The immediate priority is to correct the country's macroeconomic instability, which, if not addressed, risks jeopardizing the impact of any future structural reforms. The report then offers ways in which the government can draw on its natural capital wealth in a more sustainable way. It shows that Lao PDR can continue to grow toward upper-middle income status by diversifying the economy into job creating, export-oriented sectors (including agri-food, light manufacturing, and services), ensuring that the benefits of growth are shared more broadly.

Table 1 - Main Policy Recommendations for Sustainable and Inclusive Growth

Objective	Timeline for implementation
1. 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
2. Negotiate credible and transparent debt restructuring with large creditors to reduce the debt service burden over the medium term.	Short term
3. Strengthen due diligence and approval processes for new public investments, on-lending arrangements, issuance of public guarantees, and PPP proposals.	Medium term
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
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
6. Resolve balance sheet vulnerabilities in state-owned banks and reassess their role in the provision of credit to government and SOEs.	Medium term
2. LEVERAGING ON NATURAL CAPITAL WHILE ENSURING SOCIAL AND ENVIRONMENTAL SUSTAINABILITY	
7. Renegotiate Power Purchase Agreements to reduce tariffs paid to IPPs and recalibrate take-or-pay clauses, and adjust domestic electricity tariffs to reflect costs.	Short term
8. Optimize hydropower system planning and reorient new investment toward improving transmission and interconnection systems with neighboring countries.	Medium term
9. Develop the potential to firm electricity supply through renewables rather than coal.	Medium term
10. Resolve ongoing constraints to new mining investment, including by implementing the mineral licensing system and reviewing the beneficiation policy.	Medium term
11. Clarify and standardize licensing and land allocation processes to improve certainty for investors in environmentally sustainable tree plantations and nature-based tourism.	Medium term
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

3. 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
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
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
16. Strengthen labor laws and enforcement to protect workers, male and female without jeopardizing competitiveness.	Medium term
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
18. Promote skill retraining and geographically targeted employment subsidies to foster employment in at-risk areas.	Medium term
4. Leveraging Strategic Location to Diversify into Export-Oriented Manufacturing, Agri-Food and Services	
19. Advance trade policy reforms, with a focus on NTMs to support quality upgrades in business.	Short term
20. Facilitate SEZ backward linkages with domestic firms to help raise productivity and competitiveness. Develop win-win deals with lead GVC firms to encourage downward services or training centers that also benefit other exporters or products.	Medium term
21. Improve and help firms satisfy core labor, environmental and governance standards to anticipate the increasing focus on social and environmental issues among buyers in overseas markets.	Medium term
22. Improve infrastructure and governance and promote competition in transport and logistics.	Medium term
23. Improve resilience along global value chains by attracting integrated production in garment and other component production	Long term
5. Building Skills and Capacity for Effective reforms	
24. Improve data and knowledge to support effective policy making.	Short term
25. Develop comprehensive and inclusive communication strategies within each lead ministry and use feedback from stakeholders.	Medium term