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Forging Ahead

Restoring Stability & Boosting Prosperity



PUBLIC FINANCE REVIEW

Lao PDR 2023

THE WORLD BANK
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Restoring Stability & Boosting Prosperity

Lao PDR 2023

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Contents

Abbreviations viii

Acknowledgements ix

Executive Summary x

Introduction 1
Background 2
Development progress 2
Governance and institutions 3
Public Finance Review 4

1. Macroeconomic Performance 6
1.1 Background 7
1.2 Economic growth 9
1.3 External and monetary sectors 11
1.4 Fiscal sector 16
1.5 Conclusion and recommendations 27

2. Revenue Mobilization 30
2.1 Background 31
2.2 Trends and composition 32
2.3 Assessment of major taxes 38
2.4 Tax administration 48
2.5 Conclusion and recommendations 51

3. Public Expenditure 55
3.1 Background 56
3.2 Level and composition of spending 57
3.3 Quality of spending 70
3.4 Public financial management 75
3.5 Conclusion and recommendations 78

4. State-Owned Enterprises 81
4.1 Background 82
4.2 Performance of the SOE sector 87
4.3 Recent reforms and current plans 95
4.4 Legal and institutional framework for SOE oversight 96
4.5 Remaining challenges 97
4.6 Conclusion and recommendations 98

5. Public–Private Partnerships 101
5.1 Background 102
5.2 Key elements of PPPs 103
5.3 PPPs in the Lao PDR 112
5.4 Conclusion and recommendations 120

Figures

Figure E.1: Government debt (% GDP, 2022) xii
Figure E.2: Inflation and depreciation (%, 2022) xii
Figure E.3: Revenue Lao kip and % GDP) xiv
Figure E.4: Revenue by type of tax (% of GDP, 2016–2020) xiv
Figure E.5: Expenditure (Lao kip and % GDP) xvi
Figure E.6: Expenditure (% GDP, 2016–2021) xvi
Figure E.7: External PPG debt (%, 2022). xviii
Figure E.8: SOE performance (Lao kip, 2021) xviii
Figure E.9: Public-private partnerships (% GDP) xix
Figure E.10: PPP capital stock (% GDP, 2019) xix

Figure I.1: Governance indicators (percentile rank) 3
Figure I.2: Corruption in public transactions 3
Figure I.3: Scope of the public sector 5
Figure I.4: Public Finance Review outputs 5
Figure I.5: Public Finance Review structure 5

Figure 1.1: GNI per capita (Atlas method, $) 8
Figure 1.2: Achievement of NAAEFD targets (%) 8
Figure 1.3: GDP growth (% and contributions) 10
Figure 1.4: GDP growth (%, 2010–19) 10
Figure 1.5: Contributions to real GVA growth (%) 10
Figure 1.6: Value added growth (%, 2010–19) 10
Figure 1.7: Current account (% GDP) 12
Figure 1.8: Current account (% GDP). 12
Figure 1.9: Financial account (% GDP) 12
Figure 1.10: Balance of payments (% GDP) 12
Figure 1.11: Reserves ($ million and months of imports) 13
Figure 1.12: Reserves (months of imports, 2018–21) 13
Figure 1.13: Exchange rate (kip per foreign currency) 14
Figure 1.14: Effective exchange rate (index) 14
Figure 1.15: Consumer price inflation (%). 15
Figure 1.16: Consumer price inflation (%) 15
Figure 1.17: Credit growth (% and contributions) 16
Figure 1.18: Credit to the private sector (% GDP, 2018 – 21) 16
Figure 1.19: Fiscal balance (% GDP) 17
Figure 1.20: Fiscal balance (% GDP, 2015–19) 17
Figure 1.21: Deficit financing (% GDP) 18
Figure 1.22: Financing needs (% GDP). 18
Figure 1.23: PPG debt (% GDP) 19
Figure 1.24: Government debt (% GDP, 2022) 19
Figure 1.25: External public debt by lender (% GDP) 19
Figure 1.26: External public debt by currency (%, 2022) 19
Figure 1.27: External public debt service (% GDP) 20
Figure 1.28: External public debt service ($ million). 20
Figure 1.29: Liquidity and solvency thresholds 21
Figure 1.30: Present Value of total PPG debt (% GDP) 21
Figure 1.31: Present value total PPG debt (% GDP) 23
Figure 1.32: PPG debt service (% revenue) 23
Figure 1.33: GDP growth (%) 25
Figure 1.34: Consumer price inflation (%). 25
Figure 1.35: Poverty and inequality 25
Figure 1.36: Exchange rates (index, 100 = 1988). 25
Figure 1.37: Public debt stock and service. 25
Figure 1.38: External balances 25

Figure 2.1: Classification of government revenues 32
Figure 2.2: Revenue (Lao kip and % GDP) 33
Figure 2.3: Revenue (% GDP, 2016–21) 33
Figure 2.4: Tax revenue (% of GDP) 33
Figure 2.5: Tax revenue (% of GDP) 33
Figure 2.6: Tax revenue (% of GDP, 2016–21) 34
Figure 2.7: Tax revenue (% GDP) 34
Figure 2.8: Tax revenue (% GDP, 2016–21) 34
Figure 2.9: Revenue by type of tax (% of GDP, 2016–20) 34
Figure 2.10: Non-tax revenue (% GDP) 35
Figure 2.11: Non-tax revenue (% GDP, 2016–21) 35
Figure 2.12: Incidence of taxes 36
Figure 2.13: Concentration share of taxes 36
Figure 2.14:. CIT collection (% GDP) 38
Figure 2.15: CIT productivity ratio (2016–21) 38
Figure 2.16: PIT collection (% GDP) 41
Figure 2.17: PIT productivity ratio (2016 – 21) 41
Figure 2.18: VAT collection (% GDP) 43
Figure 2.19: VAT rate and collection (2016–21) 43
Figure 2.20: VAT revenue, productivity, and c-efficiency 43
Figure 2.21: VAT productivity and c-efficiency (2016 – 21) 43
Figure 2.22: Excise collection (% GDP) 44
Figure 2.23: Excise collection by source (2016–21) 44
Figure 2.24: Trade taxes collection (% GDP) 46
Figure 2.25: Property taxes collection (%) 46
Figure 2.26: Natural resource taxes and royalties (% GDP) 47
Figure 2.27: Resource and non-resource revenue (% GVA) 47
Figure 2.28: Domestic revenue by department (2016, % GDP) 48
Figure 2.29: Domestic revenue (2016, % GDP) 48
Figure 2.30: Domestic revenue (% GDP) 48
Figure 2.31: Domestic revenue (2016, % GDP) 48
Figure 2.32: Firms identifying tax as constraint (%) 50
Figure 2.33: Burden paying taxes 50
Figure 2.34: Tax burden and post-filling 51
Figure 2.35: Corruption in tax collection 51

Figure 3.1: Expenditure (Lao kip and % GDP) 57
Figure 3.2: Expenditure (% GDP, 2016–21) 57
Figure 3.3: Budget execution (Lao kip and %) 58
Figure 3.4: Budget revisions (Lao kip and %) 58
Figure 3.5: Expenditure (% GDP) 59
Figure 3.6: Expenditure (% GDP) 59
Figure 3.7: Expenditure (2020, % total) 59
Figure 3.8: Current spending (% GDP, 2016–21) 59
Figure 3.9: Expense (% current expenditure, 2021) 60
Figure 3.10: Capital spending (% GDP, 2016–21) 60
Figure 3.11: Momentum (percentage points) 61
Figure 3.12: Force (percentage points) 61
Figure 3.13: Fiscal rigidity (% GDP) 62
Figure 3.14: Fiscal rigidity (% total) 62
Figure 3.15: Wages & salaries (% GDP) 62
Figure 3.16: Allowances (% GDP) 62
Figure 3.17: Wages (% GDP, 2016–21) 63
Figure 3.18: Wages (% total spending, (2016–21) 63
Figure 3.19: Operations and maintenance (% GDP) 64
Figure 3.20: Purchasing of materials (% GDP) 64
Figure 3.21: Financial expenditure (% GDP) 64
Figure 3.22: Interest payments (% GDP) 64

Figure 3.23: Subsidies & transfers (% GDP) 65
Figure 3.24: Miscellaneous & contingencies (% GDP) 65
Figure 3.25: Capital spending (% GDP) 66
Figure 3.26: External capital spending (% GDP, 2020) 66
Figure 3.27: Domestic capital spending (% GDP) 66
Figure 3.28: Construction spending (% GDP) 66
Figure 3.29: Administrative units (%, 2004–5) 67
Figure 3.30: Administrative units (%, 2020) 67
Figure 3.31: Expenditure by level (% total) 68
Figure 3.32: Expenditure by level (% total, 2020) 68
Figure 3.33: Central spending (% GDP). 69
Figure 3.34: Central spending (% GDP, 2020) 69
Figure 4.35: Local spending (% GDP) 69
Figure 4.36: Local spending (% GDP, 2020) 69
Figure 3.37: Expenditure by sector (% GDP) 70
Figure 3.38: Expenditure by sector (% GDP, 2020) 70
Figure 3.39: Efficiency and effectiveness 70
Figure 3.40: Allocative efficiency (education) 71
Figure 3.41: Allocative efficiency (health) 71
Figure 3.42: Spending on social sectors (% GDP, 2020) 72
Figure 3.43: Spending on social sectors and interest (% GDP) 72
Figure 3.44: Allocative efficiency (capital) 72
Figure 3.45: Spending effectiveness (education) 73
Figure 3.46: Spending effectiveness (health) 73
Figure 3.47: Rate of return on total capital (percentage points) 74
Figure 3.48: Rate of return on public capital (percentage points) 74
Figure 3.49: Education and health spending (% GDP, 2019) 74
Figure 3.50: Incidence of spending. 74
Figure 3.51: Main phases of the budget cycle 76
Figure 3.52: Results-driven planning and budgeting 76
Figure 3.53: PEFA scores 80

Figure 4.1: SOE reporting and performance (2017) 88
Figure 4.2: External PPG debt (%, 2022) 88
Figure 4.3: Registered capital (%, 2021) 90
Figure 4.4: Equity and net profit (Lao kip, 2021) 90
Figure 4.5: Total assets and liabilities (%, 2021) 90
Figure 4.6: Revenue and Expenses (%, 2021) 90
Figure 4.7: Overview of the power sector 92

Figure 5.1: Typical PPP project structure 104
Figure 5.2: Flow of funds in a PPP arrangement 104
Figure 5.3: Types of PPP contract samples 106
Figure 5.4: How PPPs can address Infrastructure challenges 108
Figure 5.5: Number of projects (1990–2022) 113
Figure 5.6: Investment (1990–2022, USD billion) 113
Figure 5.7: PPP value (% GDP) 114
Figure 5.8: PPP capital stock (% GDP, 2019) 114
Figure 5.9: PPP regulatory quality 115

Tables

Table E.1: Policy recommendations. xi
Table 1.1: Fiscal risk matrix 21
Table 2.1: Revenue responsiveness to GDP growth (2010–2019) 35
Table 2.2: Statutory tax rates (%, 2022) 37
Table 2.3: PIT basic exemption (2021) 41
Table 2.4: Selected excise rates (%) 44

Table 3.1: Fiscal rigidity 61
Table 3.2: Expenditure (% central level) 68
Table 4.1: SOE portfolio 87
Table 4.2: Average financial performance of the SOE sector (trillion kip, unless otherwise stated) 88
Table 4.3: Average financial performance of 41 SOEs (2016–2018) 89
Table 4.4: Aggregated financial performance of 23 SOEs (billion kip, 2021) 90
Table 5.1: Differences between public procurement, PPPs, and privatization 105
Table 5.2: Lifecycle of a PPP project 107
Table 5.3: Examples of fiscal costs and risks related to PPPs 112
Table 5.4: Institutional PPP approval requirements 116
Table 5.5: List of PPP projects (1990–2022) 123

Boxes

Box 1: Distributional impacts of fiscal reforms 23
Box 2: Past episodes of macroeconomic instability 24
Box 3: Definitions 40
Box 4: SOE origins, challenges, and reforms 84
Box 5: Regional experiences 85
Box 6: Main sectors of activity 89

Abbreviations

BCEL	Banque Pour Le Commerce Extérieur Lao Public
BOT	Build-Operate-Transfer
DSA	Debt Sustainability Analysis
DSRI	Department of State-Owned Enterprise Reform and Insurance
DSSI	Debt Service Suspension Initiative
EDL	Électricité du Laos
EGAT	Electricity Generating Authority of Thailand
FMIS	Financial Management Information System
GFIS	Government Financial Information System
GFS	Government Finance Statistics
HIPC	Heavily Indebted Poor Countries
ILA	Investment License Agreement
IMF	International Monetary Fund
IPP	Independent Power Producer
JBIC	Japan Bank for International Cooperation
JICA	Japan International Cooperation Agency
LHSE	Lao Holding State Enterprise
LNRE	Lao National Railway State Enterprise
MAF	Ministry of Agriculture and Forestry
MEM	Ministry of Energy and Mining
MLSW	Ministry of Labor and Social Welfare
MoE	Ministry of Education and Sports
MoF	Ministry of Finance
MoH	Ministry of Health
MPI	Ministry of Planning and Investment
MPWT	Ministry of Public Works and Transport
NAAEFD	National Agenda on Addressing Economic and Financial Difficulties
NSEDP	National Socio-Economic Development Plan
PBoC	People's Bank of Management
PFR	Public Finance Review
PIMS	Personnel Information Management System
PIP	Public Investment Plan
PPA	Policy and Performance Actions
PPG	Public and Publicly Guaranteed
SAO	State Audit Organization

All dollar amounts are US dollars unless otherwise indicated.

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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

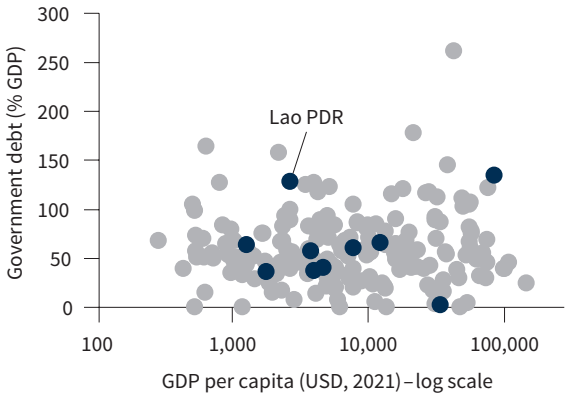
Recommendations	Lead(s)	Impact
Macroeconomic performance		
Negotiate a credible and transparent debt restructuring plan to restore debt sustainability and create fiscal space for growth-enhancing spending	MoF	Very high
Enhance revenue mobilization, improve spending efficiency, and curb fiscal risks to 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

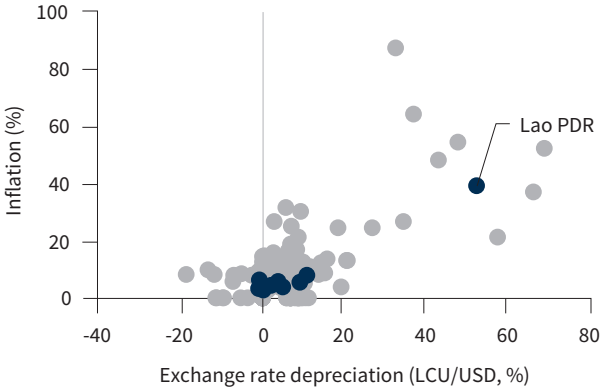
Macroeconomic instability is undermining economic growth and threatening development prospects. Economic growth averaged 7 percent per year during 2000–2019, while the poverty headcount ratio declined from 25 to 18 percent between 2012 and 2018. However, the Lao PDR's capital-intensive, resource-based, 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.

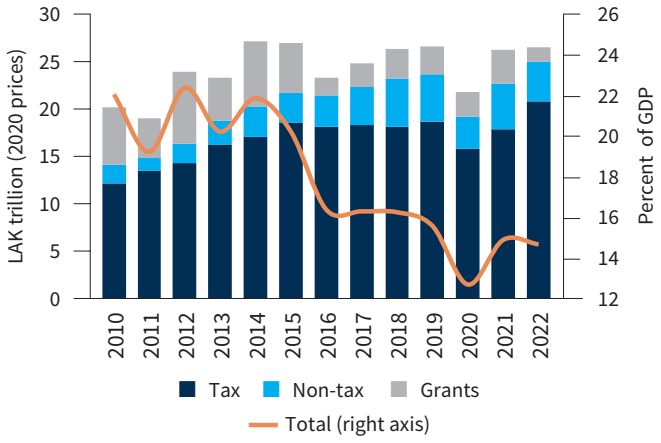
Enhance bank monitoring and operationalize emergency arrangements to boost crisis preparedness. Financial sector vulnerabilities can present considerable fiscal risks, as governments may have to inject capital into distressed banks to avoid systemic crises. Safeguarding financial sector stability requires 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.

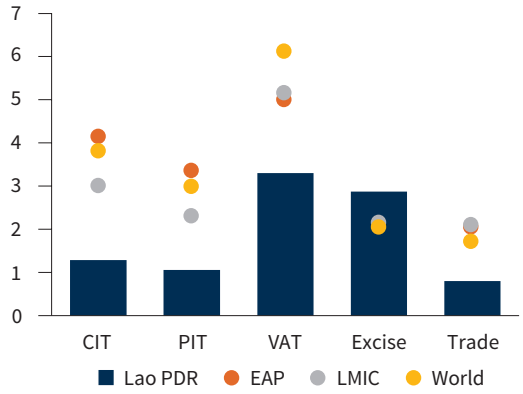
Revenue collection has relied heavily on consumption-related taxes, while limited income tax collection accounts for most of the performance gap. In 2022, about three-quarters of government revenue was collected through taxes. Indirect taxes accounted for most tax revenue, with the value-added tax (VAT) 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.

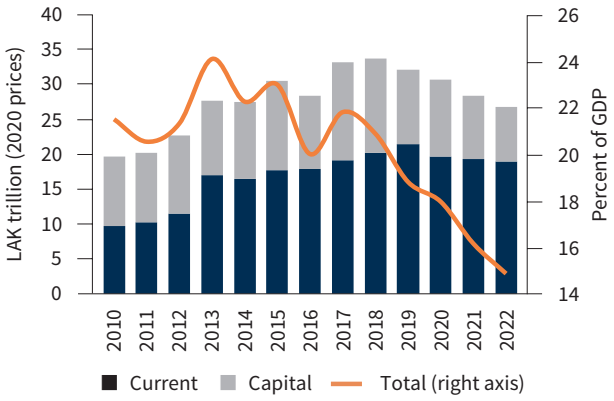
Reform the land tax and prepare for the introduction of a property tax to boost revenue collection. Property tax reform should follow a phased approach. First, land tax rates should be increased significantly to ensure the land tax becomes meaningful. The additional revenue should then be invested in 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

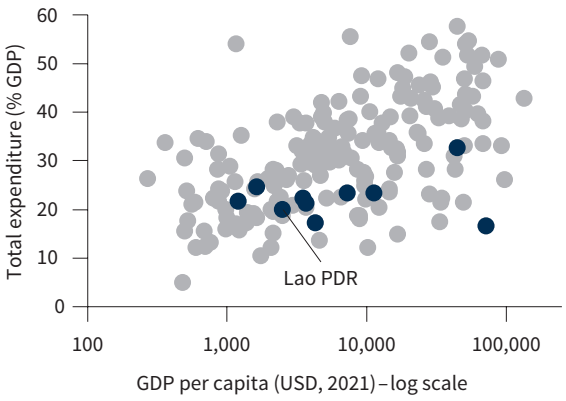
Government spending declined significantly in the past decade, raising concerns about spending adequacy and public service delivery. An expenditure-led fiscal consolidation is jeopardizing the quantity and quality of public service delivery. Expenditure declined from 24 to 15 percent of GDP between 2013 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.

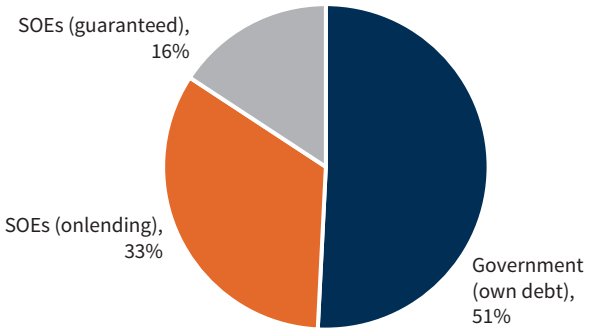
Managing liabilities from state-owned enterprises

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.

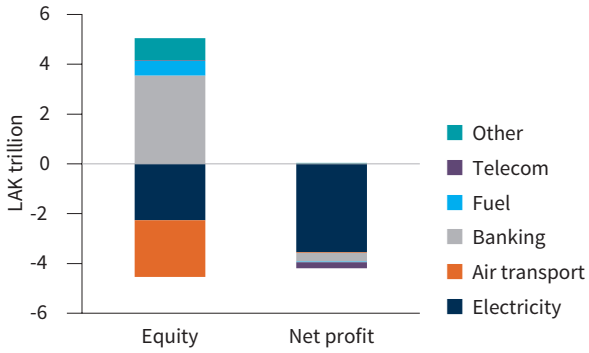
Deepening and accelerating reforms is critical to ensure that SOEs fulfill their policy mandates, operate efficiently, and do not generate undue fiscal risks. The SOE portfolio is relatively decentralized and spread over several economic sectors. Most SOEs do not consistently submit financial reports 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.

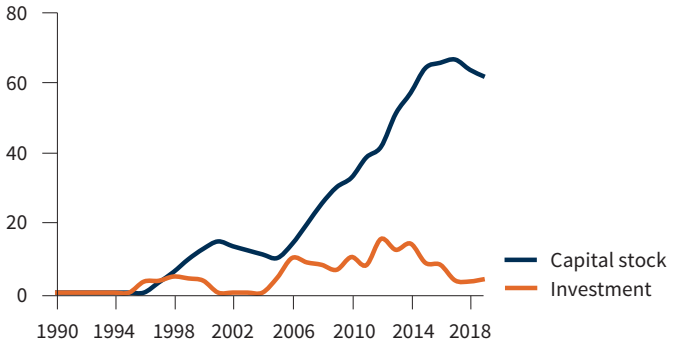
Professionalize SOE boards of directors to promote good governance and enhance performance. Boards of directors play a strategic function within SOEs, particularly in terms of supporting good governance. Their roles, composition, and functioning should therefore be reviewed and improved. For instance, 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

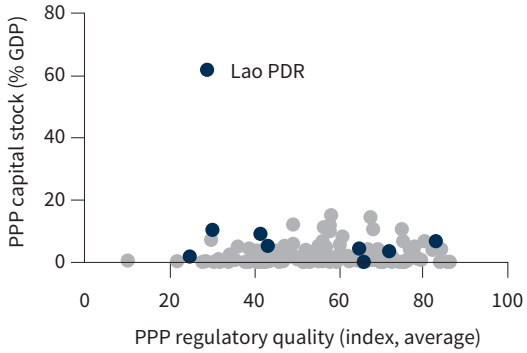
Substantial private sector finance has been mobilized through public-private partnerships, but projects have likely provided limited value for money and have increased fiscal costs and risks. No other country in the world has relied more heavily on public-private partnerships (PPPs) than the Lao PDR (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.

Introduction



Introduction

Background

The Lao PDR is a country with vast natural resources that has enjoyed significant political stability. The Lao People's Democratic Republic (Lao PDR) is the only land-locked country in Southeast Asia, sharing borders with Thailand (west), Myanmar (northwest), China (north), Vietnam (east), and Cambodia (south).[1] It is one of the most sparsely populated countries in Asia, with 7.5 million people inhabiting about 230,000 square kilometers of land area. Most of the population lives in rural areas and relies on subsistence agriculture. The country's diverse topography (which includes rugged mountains, plateaus, and lush valleys) has contributed to rich biodiversity and cultural diversity, but it also has implications for livelihoods and connectivity (e.g., difficult access to remote rural areas). The country lies in the Lower Mekong River Basin and is endowed with vast natural resources, such as water (critical for fisheries, irrigation, and hydropower), minerals (e.g., copper and gold), and forests. Tourism has significant potential, especially eco-cultural tourism. The country has a tropical monsoon climate with distinct (rainy and dry) seasons, which impacts agriculture, hydropower generation, and the risk of natural disasters. The Lao PDR has a rich cultural heritage influenced by Buddhism (the predominant religion), while traditional customs and beliefs play an important role. The Lao PDR has been a single-party socialist republic governed by the Lao People's Revolutionary Party since 1975. The country has close historical, political, and economic ties with Thailand and Vietnam, while China has become an important trade and investment partner in the past two decades. The country has enjoyed a long period of political and social stability.

Policymakers have set an ambitious vision for the country in key development plans and strategies. The Ninth National Socio-Economic Development Plan (NSEDP), which covers the period 2021–2025, builds on the National Socio-Economic Development Strategy (2016–2025) and the National Vision to 2030. The NSEDP defines the long-term socioeconomic development objectives for the Lao PDR. These include graduating from the Least Developed Country category by 2026, moving toward becoming an upper-middle-income country, and achieving the Sustainable Development Goals by 2030.[2] The NSEDP identifies six priority outcomes: (i) continuous quality, stable, and sustainable economic growth; (ii) improved quality of human resources; (iii) enhanced well-being of the people; (iv) enhanced environmental protection and reduced disaster risks; (v) engagement in regional and international cooperation and integration through robust infrastructure and effective utilization of national potentials and geographical advantages; and (vi) public governance and administration. The government has recently approved the Ninth NSEDP's Financing Strategy, covering 2023–2025. During an extraordinary session in August 2021, the National Assembly approved National Agendas to be implemented by 2023 to address two pressing issues: economic and financial difficulties, and illicit drug control.

Development progress

Despite significant achievements in the past few decades, several socioeconomic challenges remain. The Lao PDR has been classified as a lower-middle-income country since 2011. Access to basic services has increased, especially electricity, clean water, and improved sanitation facilities. Many human development indicators improved during the period 2000–2019, including child and maternal mortality, school enrollment, income poverty, and gender equity. While there has been considerable progress in improving many socioeconomic outcomes, the Lao PDR remains a nation with relatively weak human and institutional capacities, large infrastructure gaps, and a high dependence on natural resources. Child stunting and low learning outcomes are particularly concerning. Malnutrition continues to undermine physical and cognitive development, with stunting affecting over 30 percent of children under five. Educational outcomes are also poor, with low attainment in harmonized test scores (365 within a range of 300–625) and high learning poverty (as 98 percent of 10-year-olds cannot read and understand a simple text by the end of primary school). A child born in the Lao PDR just before the COVID-19 pandemic will only be 46 percent as productive when she grows up as she could be if she enjoyed a complete education and full health, which is lower than regional and income peers. Many socioeconomic indicators have recently deteriorated because of the impact of the COVID-19 pandemic (e.g., learning outcomes).

[1] Southeast Asia comprises Brunei, Cambodia, Indonesia, Lao PDR, Myanmar, Malaysia, Philippines, Singapore, Thailand, Timor-Leste, and Vietnam. These countries are often identified as regional peers. All but one (Timor-Leste) are part of the Association of Southeast Asian Nations (ASEAN).

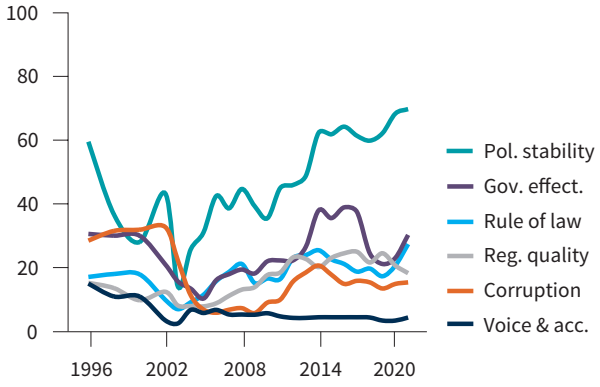
[2] The Lao PDR also aspires to become the 'battery of Southeast Asia' and transform itself from a landlocked to a land-linked country.

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. However, 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. Debt pressures are unprecedented (especially short-term liquidity) and have pushed the country into debt distress. Macroeconomic instability, limited fiscal space, and financial sector vulnerabilities are endangering hard-won development gains and may weaken the population's confidence in public institutions.

Governance and institutions

Weak governance and institutional capacities undermine macroeconomic and fiscal management. Macroeconomic stability is often hampered by weak institutions, systems, and processes. Unclear legal frameworks, lack of internal controls, poor rule enforcement, and limited checks and balances lead to a suboptimal allocation and management of public resources. While most governance indicators have improved since 2005, many have stalled or deteriorated in recent years (Figure I.1). Political stability increased over the past two decades and ranked in the top 30 percent of the world in 2021.[3] Except for voice & accountability, other governance indicators improved from around 2005 until the mid-2010s, after which they either stagnated or declined. Government effectiveness has broadly worsened since 2017, reflecting a decline in public administration performance. Corruption remains a significant challenge, with control of corruption declining since 2014.[4] Data collected from enterprises shows that corruption is pervasive (Figure I.2).[5] Corruption undermines economic and social development by creating inefficiencies (e.g., distorting markets, discouraging investment, and wasting public resources), eroding the rule of law and justice, and damaging public trust.[6] The rule of law improved

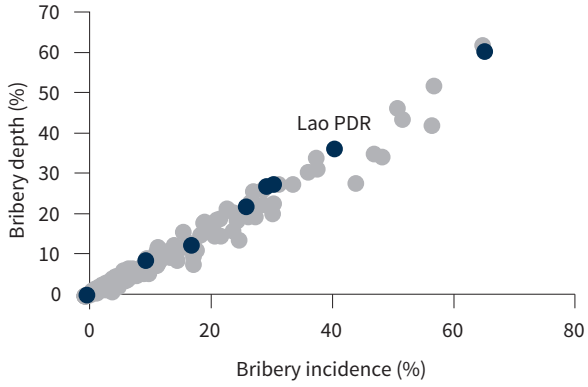
Figure I.1: Governance indicators (percentile rank)



Source: World Bank Worldwide Governance Indicators.

Note: Estimated scores provide very similar trends.

Figure I.2: Corruption in public transactions



Source: World Bank Enterprise Surveys.

Note: Blue dots represent ASEAN countries.

[3] For information on the methodology, refer to the World Bank's Worldwide Governance Indicators.

[4] Cross-country research shows that 'grand' corruption distorts the decision-making process regarding public investment projects, and that higher corruption is associated with: (i) higher public investment; (ii) lower government revenues; (iii) lower expenditures on operations & maintenance; and (iv) lower quality of public infrastructure. See IMF working paper "Corruption, Public Investment, and Growth".

[5] 'Bribery incidence' measures the proportion of firms experiencing at least one bribe payment request, while 'bribery depth' measures the share of public transactions where a gift or informal payment was requested. Public transactions include six different types of interactions with government officials: applying for electricity and water connections, obtaining operating and import licenses, obtaining construction permits, and dealing with taxes.

[6] In 2022, the State Inspection and Anti-Corruption Authority estimated that over $700 million were lost to corruption since 2016. Meanwhile, it is critical to expedite the implementation of the Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) framework.

in recent years but remains weak. The government has made efforts to institutionalize state rule through laws and regulations, but few laws are widely known or consistently applied, while compliance and enforcement remain weak. After a steady improvement, regulatory quality stalled and then declined, which is a concern for the private sector. Key governance risks with fiscal implications include tax and customs administration, ad hoc granting of tax incentives, royalties (from the hydropower, mining, and forestry sectors), public procurement, public investment management (e.g., unclear accountability on decisions relating to public-private partnership), and state-owned enterprises (e.g., embezzlement and vested interests). Improving governance and institutions is therefore key to enhancing macroeconomic and fiscal management.[7]

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 macroeconomic management, public service delivery, the business environment, and natural resource management. Strong coordination among public institutions is key to promoting macroeconomic stability, mobilizing domestic resources, and delivering effective public services. Stronger and more capable 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. Institutions also play a role in building resilience to shocks. Improved data (in terms of quality, coverage, and timeliness) and greater transparency (e.g., expenditure arrears, SOE liabilities, and PPP-related fiscal risks) would help enhance evidence-based 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.

Public Finance Review

This Public Finance Review covers macroeconomic stability, government revenue, public spending, and fiscal risks. The key objective of this Public Finance Review (PFR) is to assess recent macro-fiscal trends (e.g., revenue, expenditure, deficits, and debt), shed some light on emerging fiscal risks, and propose key policy reforms to secure fiscal sustainability and restore macroeconomic stability. Macroeconomic instability has been largely induced by fiscal and public debt decisions (e.g., tax exemptions and on-lending to state-owned enterprises) and a lack of coordination with monetary policies. Poor revenue mobilization has reduced fiscal space, and it is therefore critical to collect additional resources. Assessing the quantity and quality of public expenditure is crucial to improve the efficiency and effectiveness of spending, particularly in a context of limited fiscal space. Emerging fiscal risks relating to state-owned enterprises (SOEs) and public-private partnerships (PPPs) are a growing concern despite limited availability of relevant financial information. Overall, this PFR aims to strengthen the evidence base for decision-making on macro-fiscal management issues.

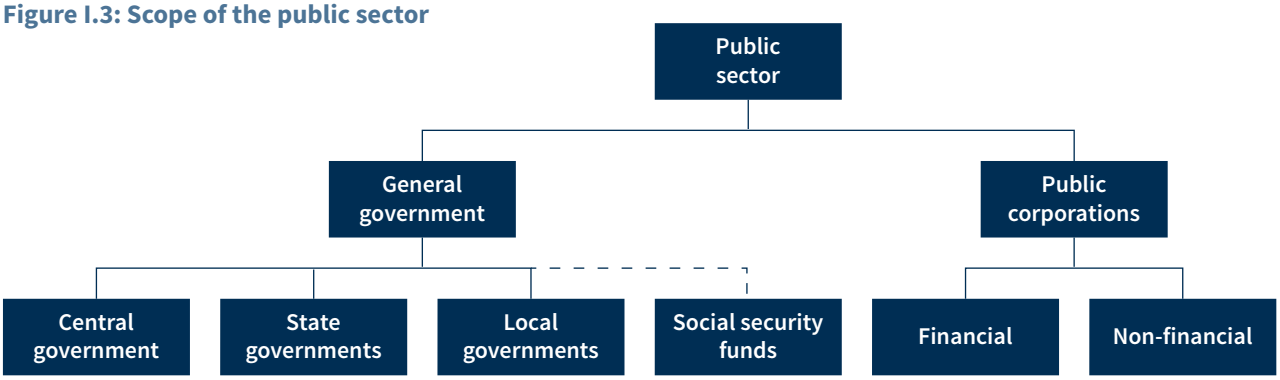
This PFR covers issues relevant to the entire public sector despite information gaps and data challenges. The compilation and presentation of data on public finances should follow established international standards, such as the 2014 Government Finance Statistics (GFS) Manual produced by the International Monetary Fund (IMF). In the GFS, the public sector consists of all institutional units controlled (directly or indirectly) by the government (Figure I.3). The general government sub-sector comprises central, state, and local governments, and each of these may have budgetary units, extra-budgetary units, and social security funds. Social security funds can also be treated as a separate sub-sector (see dashed line). The public corporation sub-sector includes financial corporations (e.g., state-owned banks and the central bank) and nonfinancial corporations (e.g., state-owned enterprises). In the Lao PDR, most publicly available data refers to the budgetary central government, which includes ministries and provinces. Provinces are part of the central government (as first-tier budgetary units) since they do not fully meet the criteria of autonomy, but rather act as deconcentrated entities with service delivery functions.[8] There is

[7] The Lao PDR ranked particularly low in terms of institutions in the 2019 Global Competitiveness Index (119th out of 141 countries), with a score far below the EAP average. Product market was the best ranked pillar (77th), partly due to low taxes. Within the institutions pillar, most challenges related to public sector performance, transparency (i.e., incidence of corruption), checks and balances (e.g., budget transparency), corporate governance (e.g., conflict of interest regulation and shareholder governance), and social capital (which relates to social cohesion). Most of these indicators ranked in the bottom 20 percent. Security and property rights fared better.

[8] While there has been progress in administrative and representational devolution (e.g., locally elected assemblies), fiscal decentralization is not on the agenda. See the 2018 Public Expenditure and Financial Accountability (PEFA) assessment.

limited information on the social security fund and public corporations, and hence, there is no consolidated public sector balance sheet.[9] This PFR has dedicated chapters on SOEs and PPPs, despite information gaps and a lack of comprehensive data, since they often entail large risks for public finances.

Figure I.3: Scope of the public sector

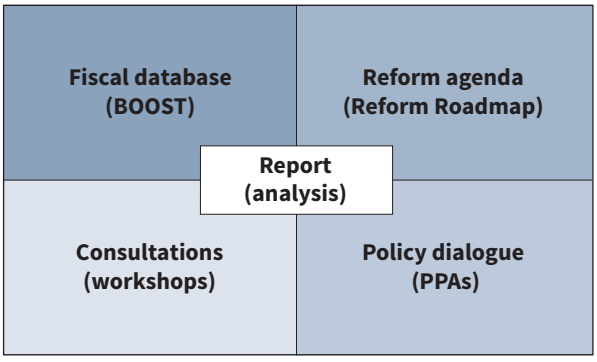


Source: International Monetary Fund.

This report is the result of a productive collaboration between the World Bank and the Government of the Lao PDR. The PFR work was undertaken in close collaboration with the Ministry of Finance, and it also benefited from an engagement with the Ministry of Planning and Investment, among other public institutions. It builds on the 2011 Public Expenditure Review and the 2018 Public Expenditure Analysis. This programmatic activity involved several missions with the objective of collecting information, better understanding fiscal dynamics, and strengthening institutional collaboration. Beyond this report, a BOOST database was developed to facilitate the analytical work, while its evidence and recommendations have fed into the World Bank's Reform Roadmap and several Performance and Policy Actions (Figure I.4). Several stakeholder consultations were undertaken before publication.

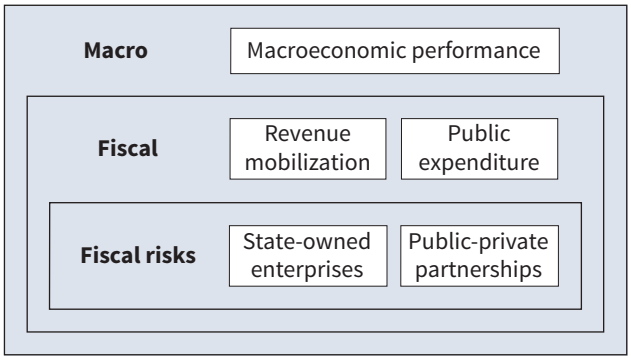
This report comprises several chapters framed as standalone (yet interconnected) building blocks. This report is organized as follows (Figure I.5): Chapter 1 provides an overview of key macroeconomic trends to offer a timely reflection on recent macroeconomic performance while placing fiscal policy in the broader macroeconomic context. Chapter 2 assesses recent domestic revenue mobilization efforts by reviewing trends, policies, and institutional developments to gauge revenue performance and scope for reforms. Chapter 3 evaluates the size and composition of public expenditure according to different classifications, as well as its efficiency and effectiveness. Chapter 4 (on state-owned enterprises) and Chapter 5 (on public-private partnerships) provide some insights on fiscal risks, which can further undermine fiscal sustainability if they materialize.

Figure I.4: Public Finance Review outputs



Source: World Bank staff.

Figure I.5: Public Finance Review structure



Source: World Bank staff.

[9] Quasi-fiscal operations are activities often undertaken by public corporations (e.g., central bank, state-owned banks, and state-owned enterprises) that affect the overall public sector balance sheet without affecting the budget deficit. These quasi-fiscal operations can have similar fiscal policy impacts on the economy and should be carefully monitored.

1

Macroeconomic Performance



1. Macroeconomic Performance

The macroeconomic situation has become critical, with urgent reforms and public debt restructuring needed to stabilize the economy and stimulate growth. Economic growth has steadily decelerated since 2013, highlighting the limitations of a growth model that has been capital-intensive, resource-based, and debt-fueled. Poverty has been reduced, but at a slower pace than in regional peers, while inequality has increased. Pre-existing macroeconomic vulnerabilities have been exacerbated by the COVID-19 pandemic and a deteriorating global economic environment. Fiscal, external, and financial imbalances have fueled macroeconomic instability, with a sharp exchange rate depreciation and high inflation severely affecting households and businesses. The Lao kip depreciated, from about 9,700 to over 20,000 kip per US dollar between September 2021 and September 2023, while consumer price inflation reached 41 percent in February 2023. Public debt levels have risen rapidly, putting a considerable strain on public finances and the broader economy. Public and publicly guaranteed (PPG) debt surpassed 100 percent of GDP in 2022, one of the highest levels in the world. Large external public debt service obligations (averaging 9 percent of the 2022 GDP during 2023–2027) pose considerable fiscal and external risks. Contingent liabilities associated with state-owned enterprises (SOEs) and public-private partnerships (PPPs) are a major concern. Poor revenue collection and rising debt service payments have eroded fiscal space, leaving the country vulnerable to economic, health, and environmental shocks. External imbalances have led to foreign currency shortages, which have triggered a sharp currency depreciation and, thus, high inflation. The banking sector is highly vulnerable to risks associated with public sector liabilities. Unsustainable public debt levels, limited fiscal space for development spending, and a fragile banking sector are, in turn, undermining economic growth, private sector development, job creation, and poverty reduction. Navigating domestic and external challenges requires a positive outcome from ongoing debt renegotiations and the implementation of ambitious reforms to increase domestic revenue, enhance the quality of public spending, strengthen financial sector stability, and improve the business environment.

Main recommendations: (i) negotiate a credible and transparent debt restructuring plan to restore debt sustainability and create fiscal space for growth-enhancing spending; (ii) enhance revenue mobilization, improve spending efficiency, and curb fiscal risks to secure the sustainability of public finances; (iii) develop a medium-term fiscal framework and approve a revised Law on Public Debt Management to improve fiscal and debt management; (iv) adopt supportive monetary and exchange rate policies to help reduce macroeconomic vulnerabilities; and (v) enhance bank monitoring and operationalize emergency arrangements to boost crisis preparedness.

Chapter structure: The chapter starts with an overview of the current macroeconomic framework and key policy objectives. It then assesses the main challenges to economic growth and stability, including long-standing structural imbalances. The remainder of the chapter is devoted to fiscal and debt sustainability, analyzing recent trends and discussing different scenarios to frame policy options for the future. The chapter concludes by summarizing the evidence and providing key policy recommendations.

1.1 Background

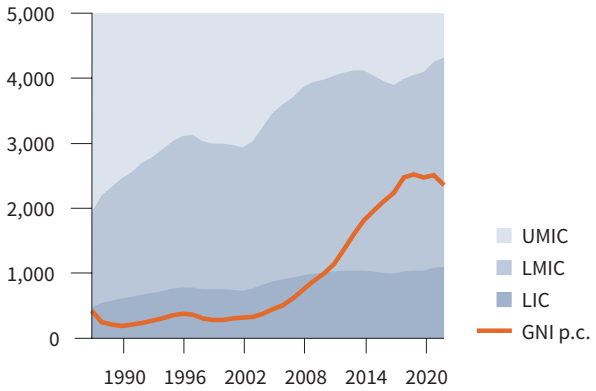
Policymakers have announced several macroeconomic targets in key national plans and strategies. The Ninth National Socio-Economic Development Plan (NSEDP) covers the period 2021–2025. Among the NSEDP's key targets is an average GDP growth rate of (at least) 4 percent, which is significantly lower than pre-pandemic levels. To secure fiscal and monetary stability, the NSEDP sets targets for revenue (at least 17 percent of GDP), expenditure (at most 18 percent of GDP), and the budget deficit (average of 1 percent of GDP).[10] The NSEDP also calls for restructuring public debt, limiting inflation to 6 percent, limiting money supply growth to 20 percent, keeping the exchange rate within a ±5 percent band against the US dollar, and increasing foreign exchange reserves to cover three months of imports. More recently, the National Agenda on Addressing Economic and Financial Difficulties (NAAEFD), which covers the period 2021–2023, was adopted to tackle macroeconomic vulnerabilities jeopardizing the country's development prospects.[11] Among its key targets is a ceiling on public debt (64.5 percent of GDP).

[10] Additionally, domestic revenue should be (at least) 15.8 percent of GDP, capital expenditure 5.6 percent of GDP, and the budget deficit should not exceed 2 percent of GDP.

[11] The National Agenda aims to avert a severe economic crisis and support the achievement of the NSEDP.

Progress toward the achievement of most targets has lagged, owing to limited reform efforts and significant macroeconomic instability. Stated policy objectives are consistent with restoring fiscal and debt sustainability, but the achievement of NSEDP and NAAEFD targets is largely off-track (with several reversals).[12] For instance, gross national income per capita (measured in US dollar terms) declined in 2022, owing to the weakening of the Lao kip (Figure 1.1). GDP growth and fiscal deficit are on track to meet the NAAEFD 2023 targets, although the growth target is arguably low at 4 percent (Figure 1.2). Domestic revenue, current account, foreign reserves, and exchange rate premium are lagging, while public debt increased significantly rather than declined. There are also concerns over financial sector stability indicators (e.g., nonperforming loans and capital adequacy ratios), as regulatory forbearance measures mask vulnerabilities in the banking system. Macroeconomic instability and slow progress on structural reforms have jeopardized progress toward the achievement of many targets. The World Bank and the Asian Development Bank have recently produced a Reform Roadmap to support the implementation of the NAAEFD.[13]

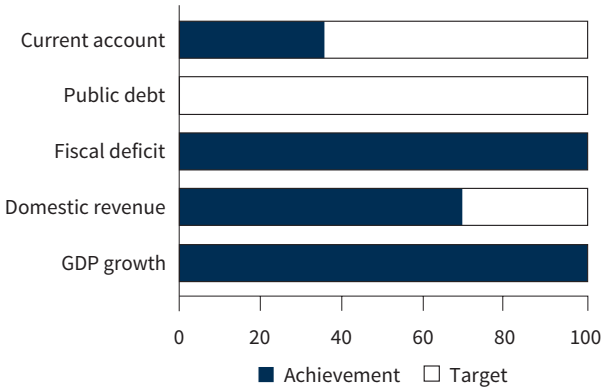
Figure 1.1: GNI per capita (Atlas method, USD)



Source: World Bank.

Note: UMIC upper middle-income country, LMIC lower middle-income country, and LIC low-income country.

Figure 1.2: Achievement of NAAEFD targets (%)



Source: Bank of the Lao PDR and World Bank staff calculations.

Note: Values are the ratio of current progress (difference between 2022 data and baseline) to expected progress (difference between the target and baseline).

Macroeconomic stability is an essential precondition for accelerating economic growth and enhancing living standards. Macroeconomic stability requires sustainable fiscal and external balances, manageable debt levels, and a sound financial sector, all of which are key to supporting a stable exchange rate and low inflation. Hence, stability relies on good macroeconomic management and supportive structural reforms that strengthen the functioning of important markets and sectors. Macroeconomic stability is known to be a necessary condition for sustained economic growth, which underpins improvements in the well-being of the poorest and most vulnerable people. In contrast, persistent macroeconomic instability can jeopardize development gains by reducing real incomes and increasing inequities. Macroeconomic imbalances, financial sector vulnerabilities, high inflation, and disruptive currency depreciations have negative impacts on job creation and other economic opportunities by raising uncertainty, disincentivizing investment, and undermining the efficient allocation of resources across the economy.

Fiscal policy has undermined macroeconomic stability, mainly through high budget deficits and large debt accumulation. Fiscal policy can promote economic growth, stability, and equity through targeted measures within the limits of fiscal prudence. The Ministry of Finance plays a central role in defining and executing Lao PDR's fiscal policy, although the Ministry of Planning and Investment oversees tax incentives and the capital budget. Over time, generous tax exemptions have been granted to large foreign investments, which has considerably undermined the revenue base. Poor revenue performance contributed to large fiscal deficits, while external borrowing (including on-lending to state-owned enterprises) also added to fiscal pressures. Coordination and consistency between fiscal and monetary policies have been low, with an unsustainable fiscal policy stance undermining financial sector soundness (through a growing exposure of banks to the public sector) and exchange rate stability. Recent fiscal consolidation

[12] An evaluation of performance against past five-year plans showed that the country met only one-third of the targets set under the Seventh NSEDP (2011–2015) and one-fourth set under the Eighth NSEDP (2016–2020). See the World Bank's Country Economic Memorandum.

[13] The Reform Roadmap is focused on five critical policy areas: (i) domestic revenue mobilization; (ii) expenditure efficiency; (iii) public debt management; (iv) financial sector stability; and (v) business environment.

efforts have been centered on expenditure controls, which will likely damage medium-term growth prospects. Current fiscal rules include a ceiling on the annual budget deficit (5 percent of GDP) and outstanding total debt (60 percent of GDP), although these are not strictly obeyed.[14] Overall, fiscal policies have largely been inconsistent with their stated objectives.

Monetary and exchange rate policies have been shaped by the consequences of fiscal policies, while their effectiveness is hampered by persistent structural imbalances. The stated objectives of monetary and exchange rate policies are to secure price stability and stimulate economic growth. These policies are managed by the Bank of the Lao PDR (BoL) with the stated goal of reaching GDP growth of 7 percent (or higher) and maintaining single-digit inflation below the GDP growth rate.[15] The monetary policy framework is a mixed regime of monetary targeting and an exchange rate anchor.[16] The BoL influences the money supply by setting policy and reserve requirement rates, issuing bonds, buying government bonds, and providing credit to the public sector. Nonetheless, the effectiveness of monetary policy measures is often hindered by weak transmission mechanisms. While the 'de jure' exchange rate regime is a managed float, the BoL operates a 'de facto' crawl-like arrangement in an effort to keep the Lao kip within a narrow margin relative to the US dollar (±5 percent of the previous year's average). Commercial banks are currently required to keep their buying and selling rates for Lao kip to US dollar transactions within 7.5 percent of the daily reference rate, while foreign exchange bureaus have been closed.[17] De facto exchange rate restrictions have increased, including the rationing of access to foreign exchange and hard ceilings on transactions. Recent efforts to stabilize the exchange rate and reduce inflation have been hampered by persistent structural imbalances (fiscal and external).

1.2 Economic growth

The Lao PDR was one of the fastest-growing economies in the world until the COVID-19 pandemic, despite a steady deceleration since 2013. The Lao PDR experienced rapid economic growth in the 2000s and 2010s (Figure 1.3). GDP growth averaged 7.2 percent per year in the period 2000–2019, making it one of the fastest-growing economies in the East Asia and Pacific (EAP) region and in the world (Figure 1.4). Nonetheless, growth gradually decelerated from 8.0 to 5.5 percent between 2013 and 2019, largely due to emerging structural constraints. GDP growth fell to 0.5 percent in 2020, its slowest pace in three decades, because of the economic impacts induced by the COVID-19 pandemic.[18] Growth recovered to 2.5 percent in 2021 and 2.7 percent in 2022, but it is not expected to return to pre-COVID-19 levels in the medium-term.

Economic activity has been notably driven by the mining and electricity sectors, with related services also playing an important role. The mining sector attracted considerable foreign investments in the 2000s owing to high global demand for copper and other mineral exports (e.g., gold). Meanwhile, the electricity sector also benefited from significant investments in power generation, which aimed to exploit the country's hydrological resources. As a result, mining and electricity have been the key drivers of economic growth, with positive spillovers for construction and some related services (Figure 1.5 and Figure 1.6). Construction also benefited from large investments in transport and logistics infrastructure (e.g., Laos–China railway and Thanaleng Dry Port) to facilitate trade. From an expenditure perspective, growth has been predominantly driven by investment and exports. However, new sources of growth need to be found, particularly given the declining potential of mining and hydropower.[19]

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[14] Fiscal rules constrain policy (by setting limits on budgetary aggregates) to secure fiscal discipline and debt sustainability. These can comprise budget balance, debt, expenditure, and revenue rules.

[15] The central bank is not independent from the government. According to the 2018 amendment of the Law on the Bank of the Lao PDR, BoL is a state agency equivalent to a ministry. BoL serves as the secretariat of the government for the areas of monetary stability, supervision of financial institutions, and payment systems. Central bank independence typically enhances policy credibility (and thus effectiveness) by ensuring that decisions are based on economic, rather than political, considerations.

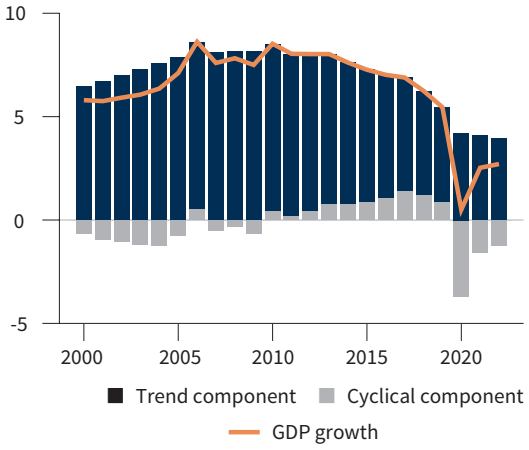
[16] See IMF 2021 Annual Report on Exchange Arrangements and Exchange Restrictions.

[17] In 2021, the US dollar exchange rate band was ±0.25. The 'official' exchange rate is calculated as the weighted average of the previous day's interbank rates and rates of commercial banks, and this rate is used to set the daily reference rate.

[18] The values for 2020–2022 are World Bank estimates, which differ from those published by the authorities.

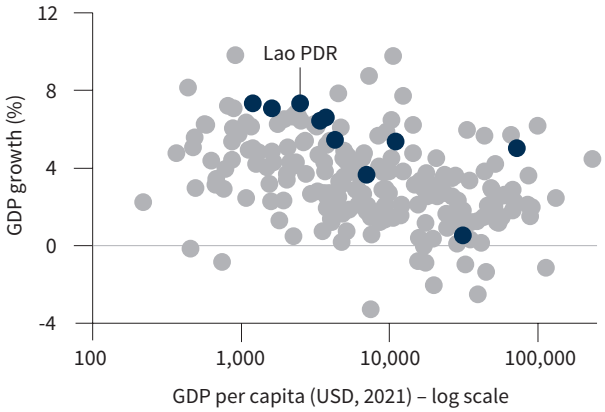
[19] Even if external demand for power increases, further investments in the electricity sector are increasingly constrained by limits to the amount of power technically recoverable (and the related social and environmental costs). Known reserves of minerals (particularly copper and gold) are also thought to be depleting.

Figure 1.3: GDP growth (% and contributions)



Source: Lao Statistics Bureau and World Bank staff estimates.

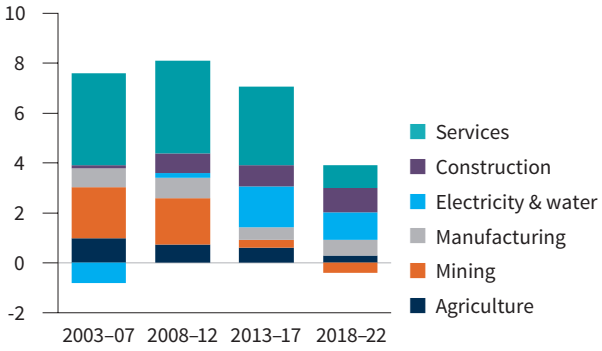
Figure 1.4: GDP growth (%, 2010–19)



Source: World Bank and staff calculations.

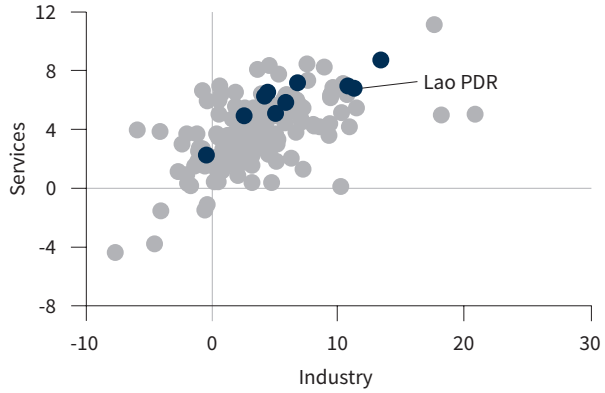
Note: Blue dots represent ASEAN countries. Vertical axis restricted to -4 to improve readability.

Figure 1.5: Contributions to real GVA growth (%)



Source: Lao Statistics Bureau and World Bank staff estimates.

Figure 1.6: Value added growth (%, 2010–19)



Source: World Bank and staff calculations.

The current growth model has clear limitations, as reflected in the large accumulation of public debt, limited job creation, and rapid depletion of natural resources. The steady deceleration of GDP growth underscores the limitations of the Lao PDR's capital-intensive, resource-based, debt-fueled growth model, which has proven to be economically, socially, and environmentally unsustainable.[20] The mining and electricity sectors are capital intensive and thus not able to generate significant employment, while the domestic private sector outside these sectors has been hampered by an unfavorable business environment. Economic growth has created limited job opportunities, undermining structural transformation, which is essential for sustained and inclusive growth. Unemployment rose from 4 to 16 percent during 2012–2018, while migration increased (especially to Thailand). Growth also came at a high environmental cost, as the construction of hydropower dams damaged river ecosystems and negatively impacted agriculture, fisheries, and biodiversity. Finally, (foreign) public debt levels increased considerably, partly to support investments undertaken by the state-owned power utility company (Électricité du Lao).[21] The Lao PDR has struggled 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.

[20] The World Bank's Systematic Country Diagnostic (SCD) argues that key risks to macroeconomic stability, the inclusiveness of growth, and environmental degradation have materialized in the past few years.

[21] Revenue collection has underperformed, despite the potential for considerable natural resource revenues, owing to generous tax incentives. This has also contributed to foreign exchange shortages, as foregone revenues deprive the country of valuable foreign currency (and budget resources).

The poor quality of economic growth has weakened progress in reducing poverty and achieving shared prosperity. Increases in average incomes have not been commensurate with the pace of growth, partly because growth has not been inclusive.[22] The proportion of the population living under the national poverty line declined from 25 to 18 percent between 2012 and 2018, but it remains high. Meanwhile, income inequality increased and became one of the highest in the EAP, as rapid growth has been mostly jobless. The poverty headcount ratio using the $3.65 per day international poverty line was at 33 percent in 2018, which is much higher than regional peers.[23] Over the period 2012–2018, a 1 percent increase in GDP per capita was associated with a 0.52 percent decline in the poverty rate, less than half the impact Vietnam experienced during the same period. Gains in household income and consumption were modest, especially at the lower end of the distribution. Poverty improvements were mainly driven by rising incomes in the agricultural sector and migrant remittances rather than jobs in the manufacturing or modern services sectors, which are typically associated with structural transformation. A more inclusive growth pattern is required to improve development outcomes.

COVID-19 and high inflation have further undermined living standards, highlighting the economy's vulnerability to shocks. COVID-19 containment measures (e.g., internal movement restrictions and border closures) severely impacted the services sector and disrupted supply chains during 2020–2021. International commodity prices increased considerably in early 2022 when Russia invaded Ukraine. High fuel and fertilizer prices have undermined the economic recovery, with high inflation (mostly driven by exchange rate depreciation) having a considerable negative impact on living standards. Given limited fiscal space, the authorities have not been able to provide much-needed support to households and businesses affected by these shocks.[24] In the absence of an adequate social protection system, economic shocks will continue to undermine private consumption.

1.3 External and monetary sectors

Balance of payments

The current account deficit has narrowed since 2015 as an improving trade balance more than offset rising primary income outflows. The current account balance has improved considerably in recent years, partly supported by electricity exports, but rising debt repayment obligations intensify external imbalances. Exports of goods and services rose steadily during 2013–2019, reaching 56 percent in 2022 (Figure 1.7). This was driven by electricity and mining, as well as manufacturing and agriculture, but also the sharp depreciation of the Lao kip in 2021–2022. Imports of goods and services increased during 2007–2015, supported by the construction of large FDI projects, but subsequently eased as some of these were completed. The COVID-19 pandemic led to a severe contraction in imports (e.g., fuel, steel, and travel) in 2020, but the economic recovery and higher import prices raised imports to 50 percent of GDP in 2022.[25] The trade balance (of goods and services) improved considerably, from a deficit of 16 percent of GDP in 2015 to a surplus of 5 percent in 2022 (Figure 1.8). However, the primary income deficit deteriorated from 1 to 8 percent of GDP during 2014–2022, reflecting rising interest payments on loans.[26] The deficit would have been even higher in the absence of considerable deferrals on external public debt service since 2020. The significant improvement of the current account balance masks imbalances, as only about one-third of export proceeds enter the domestic banking system.

The financial account balance has deteriorated considerably since 2015, owing to a reduction in all types of investment. Lao PDR's vision of becoming the 'battery of Southeast Asia' and a 'land-linked country' has drawn large investments to hydropower and connective infrastructure. However, net foreign direct investment (FDI) declined from 10 to 4 percent of GDP during 2017–2022, albeit with some volatility (Figure 1.9). This partly reflects the completion of some large investment projects (e.g., expressway and railway) and perhaps a lower appetite for

[22] Moreover, the exchange rate appreciated by 26 percent between 2005–2013, likely improving the purchasing power of households. This suggests that the impact of economic growth on poverty reduction might have been even more limited than usually thought. The forthcoming Lao Expenditure and Consumption Survey (LECS) will shed further light on this, given the recent depreciation.

[23] This poverty line (measured in 2017 power purchasing parities) is the standard for lower-middle-income countries.

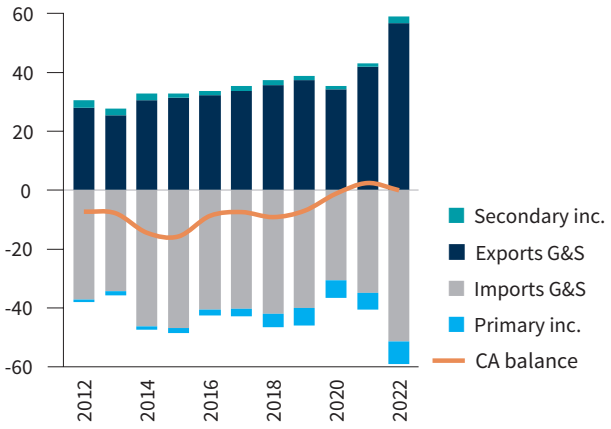
[24] Government efforts relied primarily on monetary and financial instruments. The BoL reduced policy and reserve requirement rates and instructed financial institutions to defer principal and interest payments, restructure debt, and provide new loans to affected enterprises. More recently, fuel excise and VAT rates were reduced.

[25] The Covid-19 pandemic led to a sharp decline in tourism and workers' remittances, despite an improvement in the goods trade balance (as imports declined faster than exports).

[26] Interest payments relate to public, SOE, and private debt. Income repatriation (e.g., FDI dividends) is comparatively smaller.

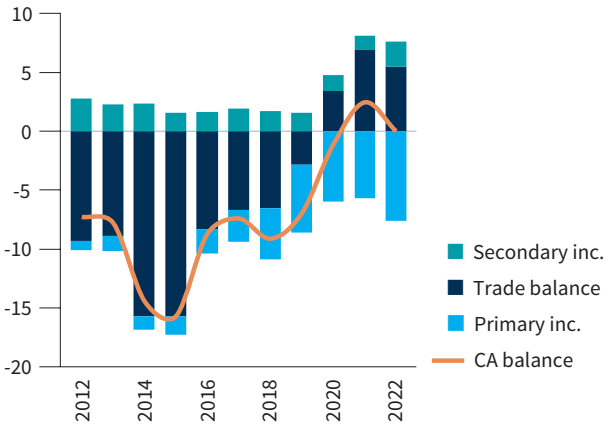
additional electricity projects. Net portfolio investment inflows (which are mostly associated with debt securities) were positive and significant until 2018, after which they became either negative or negligible. This partly reflects limited market access (for new bond issuances) and the repayment of maturing bonds. 'Other investment', which mainly includes other debt instruments (e.g., lending) and mostly relates to banks and government, has also been volatile but showing a clear downward trend. Overall, the financial account has steadily recorded lower net inflows. This has likely had an impact on economic growth, which decelerated during this period, as well as the supply of foreign exchange, thus contributing to exchange rate pressures.

Figure 1.7: Current account (% GDP)



Source: Bank of Lao PDR and World Bank staff calculations.

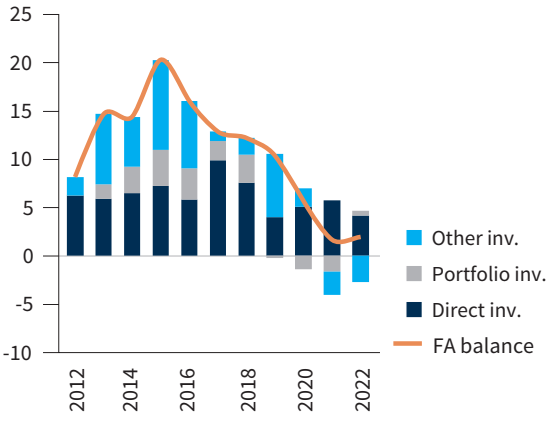
Figure 1.8: Current account (% GDP)



Source: Bank of Lao PDR and World Bank staff calculations.
Note: Trade balance includes goods and services.

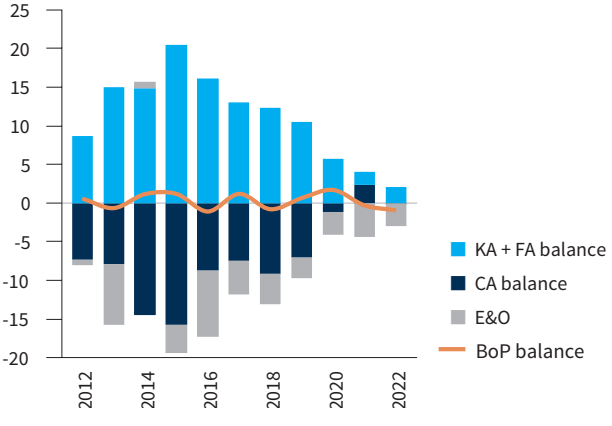
The balance of payments position has been volatile, while large errors & omissions suggest large unaccounted outflows. Net financial inflows have progressively declined from 20 to 4 percent GDP during 2015–2022, while the current account deficit improved from 16 to virtually 0 percent of GDP during the same period (Figure 1.10). In recent years, lower FDI, external borrowing, and tourism-related service exports have reduced the supply of foreign exchange. Errors & omissions have been consistently negative and sizable, suggesting large unreported outflows. The improved current account balance has led to recent balance of payments surpluses, but this data masks deeper structural imbalances. A large proportion of exports proceeds are retained abroad (depriving the country from vital foreign currency), while imports are likely underestimated (according to mirror data from trade partners).[27]

Figure 1.9: Financial account (% GDP)



Source: Bank of Lao PDR and World Bank staff calculations.

Figure 1.10. Balance of payments (% GDP)



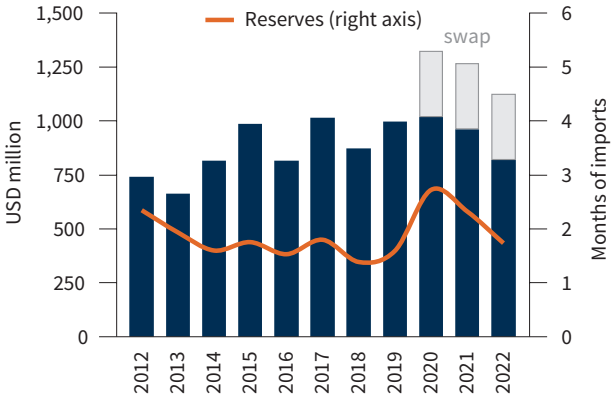
Source: Bank of Lao PDR and World Bank staff calculations.

[27] The BoL estimated that only 33 percent of total export proceeds came to the Lao PDR. The gap for electricity exports was much larger than for mining. Errors & omissions likely capture export proceeds retained abroad, informal transactions (e.g., trade and remittances), and illicit financial flows.

Reserves

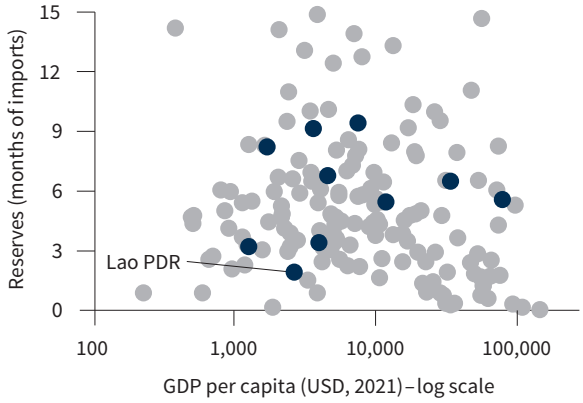
Official reserves are very low and cannot adequately cover import needs or debt service obligations. Gross foreign exchange reserves have been gradually depleted since 2007, as measured in months of imports, although a swap line with the People's Bank of China (PBoC) provided a boost in 2020 (Figure 1.11).[28] Reserves stood at $1.1 billion in December 2022, below two months' import cover, which is considerably below prudent thresholds (Figure 1.12).[29] Growing primary income outflows (e.g., interest payments) and lower investment inflows have had an impact on foreign exchange availability, while an improving trade balance has not fully offset these trends. Despite strong export performance, most export proceeds do not enter the domestic banking system as they are retained abroad. Low reserve levels limit the central bank's ability to support the exchange rate and banks with weak dollarized balance sheets, while constraining the government's capacity to meet external debt service obligations.

Figure 1.11: Reserves (USD and import cover)



Source: Bank of Lao PDR and World Bank staff calculations.

Figure 1.12: Reserves (months of imports, 2018–21)



Source: Bank of Lao PDR and World Bank staff calculations.

Exchange rate

The Lao kip appreciated significantly until the mid–2010s, mainly because of large capital inflows targeting natural resources. A resource-based growth model triggered a steady nominal exchange rate appreciation against the US dollar between 2005 and 2013, which undermined the development of labor-intensive activities outside the resource-based sectors (Figure 1.13). Between 2003 and 2016, the real effective exchange rate (REER) appreciated by about 80 percent (Figure 1.14).[30] This appreciation was mainly driven by large capital inflows to exploit natural resources, such as mining (e.g., copper and gold) and electricity (i.e., hydropower). Foreign exchange inflows mainly comprised foreign investment and external debt, and to a lesser extent official grants and workers' remittances. Large foreign exchange inflows tend to produce a 'Dutch disease' effect, whereby the appreciation of the real exchange rate (usually linked to the development of natural resource exports) undermines the development of traditional exports (e.g., manufacturing) by making them less competitive. This constrains their growth and partly explains why a large and diversified manufacturing base has not developed.[31]

The kip has depreciated rapidly in recent years, predominantly due to external imbalances. The Lao kip has been weakening against most currencies since 2016, with a sharp depreciation experienced since mid-2021 (Figure 1.13). Between September 2021 and September 2023, the kip depreciated by 106 percent against the US dollar and 71 percent against the Thai baht (using average commercial bank rates). This has been largely due to structural

[28] In 2020, PBoC and BoL agreed to a three-year swap arrangement amounting to 6 billion Chinese yuan (about $900 million). Monetary data implies that about $300 million were disbursed in 2020, which are counted as gross reserves. Given the lack of details published (e.g., information on whether funds are earmarked for specific purposes), there is some uncertainty about how to accurately account for it in terms of reserves and public debt.

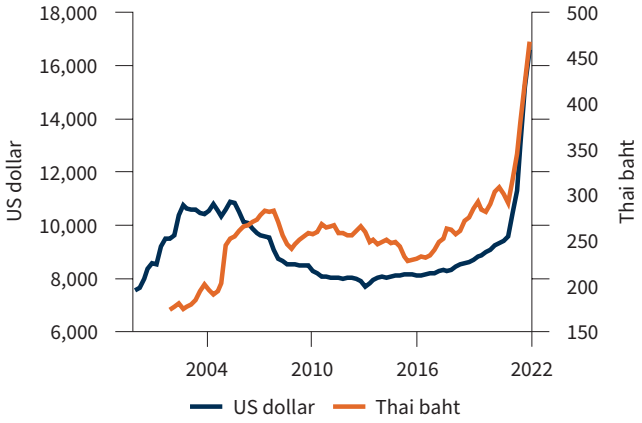
[29] A standard rule of thumb is to maintain reserve levels at about 3 months of imports, but a prudent reserve adequacy level for the Lao PDR might be even higher given its level of development and existing vulnerabilities. It should be noted that BoL calculates reserve coverage by excluding FDI-related imports.

[30] The REER measures the value of the kip against the currencies of major trading partners (as a weighted average) in real terms.

[31] The share of manufacturing in total GDP stagnated at about 9 percent compared to an average of 20 percent for regional peers. Manufacturing only accounts for 20 percent of exports by value, and this lack of export diversification exacerbates the country's vulnerability to volatile commodity prices. The sector has been shedding jobs, with employment mostly driven by public sector jobs.

factors (e.g., high financing needs, limited availability of foreign currency, and low reserve buffers) and, to a lesser extent, the strengthening of the US dollar against most world currencies.[32] The BoL attempted to stem depreciation pressures by using monetary policy instruments to support the value of the kip (e.g., issuing kip-denominated savings bonds, raising interest rates, and increasing reserve requirements), while widening the exchange rate band (thus allowing greater exchange rate flexibility). The BoL has also closed foreign exchange bureaus and revised the foreign exchange management law (which includes repatriation and surrender requirements) in a bid to attract more foreign exchange to the formal banking system. However, the recent depreciation can be seen as an inevitable adjustment, as the kip appeared to be significantly overvalued.[33] Meanwhile, the sharp depreciation has fueled inflation (through higher import prices), increased external debt servicing costs, and exacerbated currency mismatches on bank balance sheets.[34] Persistent external imbalances will continue to put pressure on the exchange rate. Lack of confidence in the kip can potentially accentuate the dollarization of the economy.

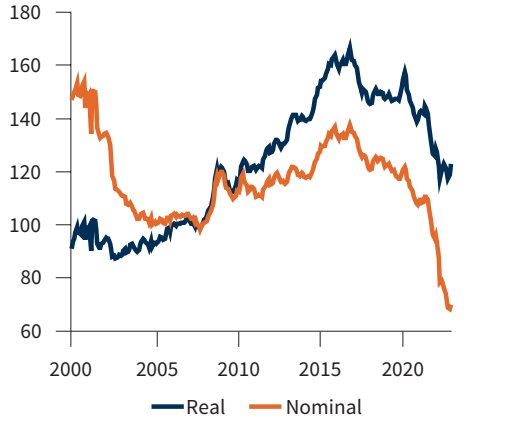
Figure 1.13: Exchange rate (kip per foreign currency)



Source: International Monetary Fund and Bank of Thailand.

Note: Quarterly data up to 2022-Q4.

Figure 1.14: Effective exchange rate (index)



Source: Bruegel.

Note: Monthly data up to December 2022. Index equals 100 in December 2007.

Inflation

High consumer price inflation has undermined living standards and negatively impacted businesses. Inflation was relatively low and stable from 2004 until 2021, but the recent exchange rate depreciation and high commodity prices (e.g., fuel and fertilizers) have increased domestic prices (Figure 1.15 and Figure 1.16). Average consumer price inflation reached 23 percent in 2022, and it is projected to be above 30 percent in 2023. Given the significant reliance on imports, food and transport prices rose considerably. However, domestic price increases have been broad-based, also affecting non-tradable goods. The government reduced tax rates in 2022 and attempted to enforce price controls on several basic goods (e.g., rice and pork).[35] Additional depreciation pressures, a possible monetization of the deficit, and supply shocks could sustain domestic inflation in the medium-term. High inflation affects the purchasing power of households, especially the most vulnerable, as well as business costs and public expenditure (e.g., through higher procurement prices).[36] Real interest rates are strongly negative, which creates a disincentive to hold kip and thus supports dollarization. Inflation has contributed to an increase in domestic revenue (in nominal terms), but it has made the purchase of goods and services more expensive.

[32] The parallel market rate started to depreciate considerably in June 2021, with the parallel market premium rising to about 30 percent in September 2021. At this point, the BoL widened the US dollar exchange rate band from ±0.25 to ±1.5 percent, which enabled a faster adjustment that reduced the premium. This band was subsequently increased to ±4.5 percent in October 2022, and ±7.5 percent in June 2023.

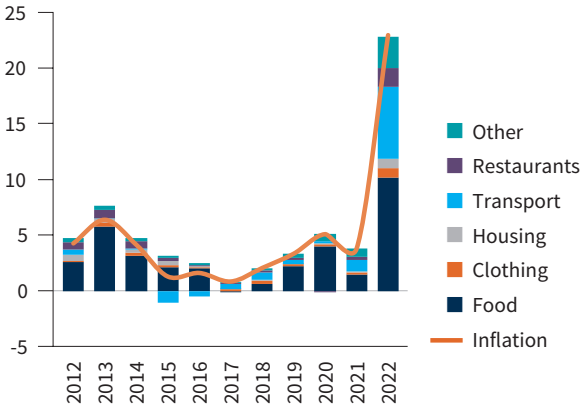
[33] The real effective exchange rate was estimated to be overvalued by 44 to 49 percent at the end of 2016 (IMF 2017 Article IV report). Nonetheless, evidence suggests that exchange rate movements tend to have asymmetric impacts on exports, partly because a depreciation will only promote export competitiveness if adequate productive capabilities and a favorable investment climate are in place.

[34] The strong exchange rate depreciation has considerably increased the kip value of liabilities denominated in foreign currency (e.g., public debt, corporate debt, and bank liabilities).

[35] Tax cuts tend to benefit the non-poor and create large foregone revenues, which undermined fiscal sustainability. Targeted social protection would be a more efficient and effective policy response. There were nationwide fuel shortages in April-June 2022, owing to a combination of fuel price caps and limited foreign exchange availability at the official rate.

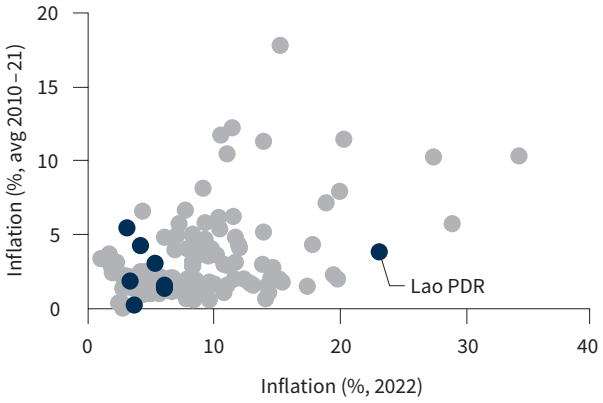
[36] The World Bank's Rapid Monitoring Phone Surveys indicate that 43 percent of households experienced declines in real incomes, and thus had to reduce spending on food, education, and health care. Poverty levels may have increased.

Figure 1.15: Consumer price inflation (%)



Source: LSB and World Bank staff calculations.

Figure 1.16: Consumer price inflation (%)



Source: World Bank and staff calculations.

Financial sector

Monetary policy has been tightened, but weak transmission mechanisms undermine its effectiveness. Money supply (M2) growth gradually decelerated from about 30 percent in 2011–2012 to 8 percent in 2018. However, M2 growth has accelerated rapidly since then, reaching 37 percent in 2022, although mostly due to the revaluation of foreign currency deposits. BoL has recently raised the policy rate, increased reserve requirements, and issued kip-denominated savings bonds to stem the currency depreciation and, thus, inflation pressures. The policy rate was reduced from 4 to 3 percent at the outset of COVID-19 (March 2020), but it was subsequently increased to 6.5 percent in 2022 and 7.5 percent in early 2023.[37] Despite these recent changes, commercial bank interest rates have remained broadly unchanged (likely due to excess liquidity), and real interest rates deeply negative. During 2022–2023, reserve requirements were increased to 8 and 10 percent for the kip and foreign currencies, respectively.[38] Finally, the BoL issued kip-denominated savings bonds in 2022–2023 (with a maturity of 6 months and interest rates of 15–20 percent per year) to reduce kip liquidity and thus shield the value of the local currency. However, these measures have had a limited impact on exchange rate trends.

The financial sector is relatively underdeveloped and dominated by banks with some level of state ownership. The non-bank financial sector is rudimentary, with a limited range of financial products. The financial sector remains dominated by state-owned banks (SOBs) despite the recent restructuring of the Agricultural Promotion Bank (APB) and the Lao Development Bank (LDB). The largest commercial bank is the state-owned Banque Pour Le Commerce Extérieur Lao Public (BCEL), which accounts for about 40 percent of deposits in the banking system. Domestic credit growth decelerated over the years, with the increase in 2022 mostly explained by asset revaluations (Figure 1.17). Access to credit continues to be identified as a top constraint for enterprises, and rising financing needs from the public sector could crowd out private sector borrowing. Domestic credit to the private sector is relatively low by regional and international standards (Figure 1.18).[39] Credit to the government increased considerably in 2021 and 2022, mainly due to the issuance of domestic bonds to clear expenditure arrears and recapitalize banks. The BoL provided direct credit to the government in 2020, purchased government bonds from banks in 2021, and increased financing to banks.

Financial sector weaknesses have been aggravated by the COVID-19 pandemic, prolonged regulatory forbearance, and the recent exchange rate depreciation. Most businesses were significantly affected by COVID-19 containment measures and faced difficulties in repaying loans. More recently, the sharp exchange rate depreciation has severely impacted businesses that earn revenues in kip but must make payments in foreign currencies (e.g., to import inputs and repay debts). Financial soundness indicators appear to be relatively healthy, but they mask considerable vulnerabilities. For instance, reported nonperforming loans (NPL) are low, but

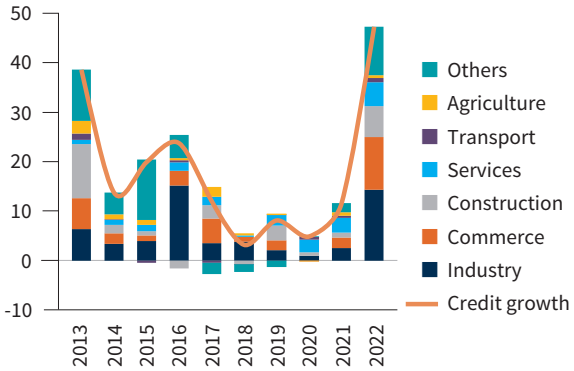
[37] The policy rate (which is a short-term lending rate) was set at 20 percent between 2002 and 2007, but it was gradually reduced to 4 percent by 2010. The rate remained broadly unchanged for a decade, despite small changes in 2015–2017.

[38] The reserve requirement declined from 5 to 3 percent for the kip and from 10 to 5 percent for foreign currencies between 2017–2021.

[39] Credit to the private sector averaged 42 percent of GDP during 2018–2021, compared to 44 percent in lower-middle-income countries and 160 percent in the EAP region.

are believed to be understated due to a lax enforcement of regulatory standards, the practice of evergreening problem loans, and COVID-19 forbearance measures (i.e., frozen loan classifications).[40] Accrued interest receivables are high in several banks, indicating considerable forbearance. The average capital adequacy ratio (CAR) of the banking system conceals significant variation across banks. For example, BCEL had a capital adequacy ratio of 6.3 percent in December 2022, below the prudential minimum (8 percent). Profitability is generally low, as measured by return-on-equity and return-on-asset indicators. Weaknesses in the banking system have been compounded by macroeconomic instability, regulatory forbearance, and exchange rate pressures on bank balance sheets. These can lead to capital shortfalls in banks and significantly hamper domestic private sector credit growth, and thus undermine economic activity.

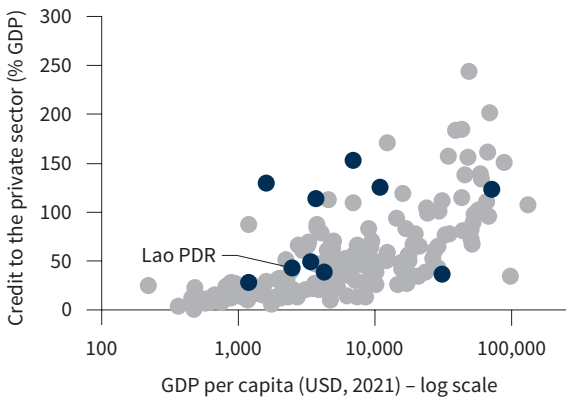
Figure 1.17: Credit growth (% and contributions)



Source: BoL and World Bank staff calculations.

Note: Credit to the economy includes SOEs.

Figure 1.18: Credit to the private sector (% GDP, 2018 – 21)



Source: World Bank and staff calculations.

The banking sector is highly vulnerable to risks associated with public sector liabilities, while bank recapitalization needs present an additional fiscal risk. The exposure of commercial banks to the public sector is considerable. Banks provide direct financing to the public sector through government bond purchases and loans to SOEs, and indirectly through central bank borrowing from commercial banks to finance fiscal deficits. This is likely to crowd out credit and foreign exchange to the private sector. SOBs are particularly vulnerable to public sector risks, but so are other banks through the financing of public investment projects (directly to the government or through contractors). Banks are exposed to private contractors on public projects since expenditure arrears can give rise to NPLs and even force defaults. Domestic public debt has been growing in the past few years, mostly due to the issuance of triangle and investment bonds to resolve expenditure arrears and recapitalize banks.[41] A deterioration of the fiscal position will likely exacerbate existing financial sector risks and impact credit growth. Balance sheet weaknesses in the largest commercial (state-owned) bank pose a significant threat to financial stability and compound fiscal risks (e.g., recapitalization needs).[42] A financial or banking crisis could obliterate people's savings, disrupt financial flows, create large fiscal costs (bailouts), and undermine long-term trust in the sector.

1.4 Fiscal sector

1.4.1 Fiscal deficit

Fiscal deficits were high until 2020, owing to deteriorating revenue performance and despite expenditure tightening. Total revenue (which includes grants) gradually declined from 22 to 16 percent of GDP during 2014–2019

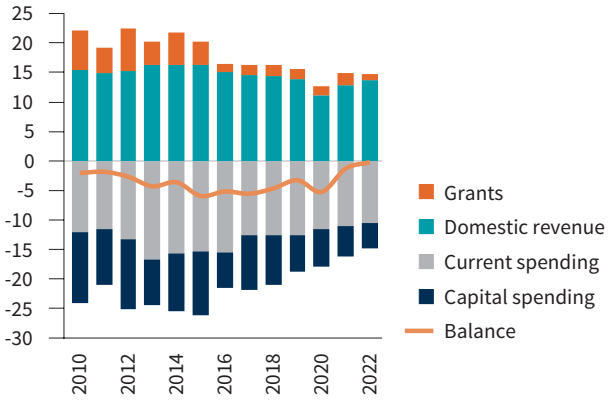
[40] At the onset of Covid-19, measures were enacted to encourage a continued flow of credit. These included lowering reserve requirements and introducing regulatory forbearance (such as credit moratoria, restructuring loans, and freezing loan classifications). As a result, banks may not be adequately provisioning for expected losses, and could face capital shortfalls as they recognize losses when forbearance measures are unwound, in addition to strong exposure to exchange rate risks.

[41] About 23 trillion kip of potential domestic arrears are being verified. In February 2023, the National Assembly authorized the issuance of bonds to clear 8 trillion kip of arrears. Two SOBs were recapitalized before being restructured in 2021–2022.

[42] Public sector borrowing contributes to currency mismatches in bank balance sheets, especially when the government has the right to repay foreign-currency loans in kip.

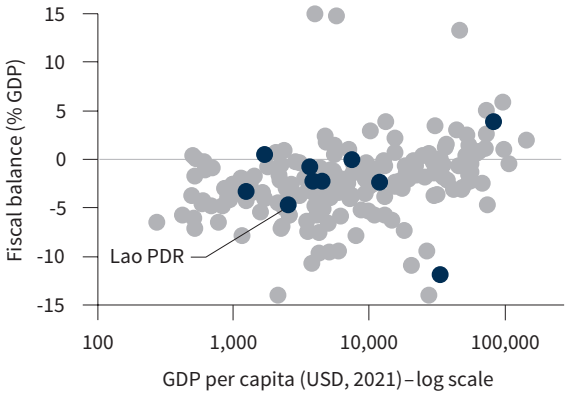
(Figure 1.19).[43] Revenue further decreased to 13 percent of GDP in 2020 due to the COVID-19 pandemic, after which it recovered to 15 percent in 2022. These trends reflect both lower grants and sluggish tax revenue.[44] As a consequence of poor revenue collection, fiscal consolidation has been achieved through tight expenditure controls and interest payment deferrals. Expenditure decreased from 26 to 15 percent of GDP during 2015–2022, owing to curbs on both recurrent and capital spending. Wage bill controls and the postponement of new public investment projects aimed to minimize the fiscal deficit. However, debt service payments have increased, despite deferrals during 2020–2022. The fiscal deficit averaged about 5 percent of GDP in 2015–2020, although it declined considerably in 2021–2022 due to strong expenditure curbs. However, there are sizable expenditure arrears that have not been included in the fiscal accounts. Pre-COVID-19 budget deficits where high compared to regional and income peers (Figure 1.20).

Figure 1.19: Fiscal balance (% GDP)



Source: MoF and World Bank staff calculations.

Figure 1.20: Fiscal balance (% GDP, 2015–19)



Source: IMF and World Bank staff calculations.

Limited fiscal space has constrained the ability to fund socioeconomic priorities and adequately respond to shocks.[45] The country has been impacted by several external shocks, including natural disasters (e.g., dam collapse in 2018), health emergencies (e.g., COVID-19 pandemic), and high international commodity prices (e.g., fuel). However, the government has not been able to provide meaningful support to households and businesses affected by these shocks.[46] Given limited fiscal resources, policy responses initially relied on bank forbearance measures and then tax cuts (e.g., reduction of fuel excise and VAT rates), which can jeopardize financial sector stability and fiscal sustainability. Tax cuts are inefficient, as they do not target the most vulnerable (in fact, they tend to benefit the better-off) and generate large foregone revenues. Moreover, spending on the social sectors (e.g., health and education) and capital expenditure have declined, which undermines economic growth prospects.[47]

Fiscal deficits have been largely financed by external borrowing and, to a lesser extent, domestic banks. The government ran large fiscal deficits until 2020, which were predominantly financed through foreign lending (Figure 1.21).[48] In fact, a significant proportion of capital spending has been financed by external project loans. Nonetheless, domestic financing has also been significant. This has mainly comprised borrowing from commercial banks, treasury bills, and asset sales. Fiscal policy can have significant repercussions on monetary aggregates and the balance of payments. Gross financing needs are very high, representing a key source of

[43] The fiscal year ran from 1 October to 30 September until 2016. From 2017 onwards, the fiscal year coincides with the calendar year. For the purposes of this chapter, the last year will be mentioned in the text (e.g., 2015-16 will be 2016).

[44] Donors gradually shifted their support from grants to loans as the Lao PDR graduated to lower-middle-income country (LMIC) status. Grants declined from 7 to 2 percent of GDP between 2012 and 2022. Generous tax incentives provided to large investors and a weak tax administration have undermined revenue performance.

[45] Fiscal space can be defined as the availability of budgetary resources to conduct effective fiscal policy. Governments can create fiscal space by raising revenues, reducing lower-priority spending, and borrowing (e.g., loans and bonds) as long as it does not compromise fiscal sustainability and macroeconomic stability.

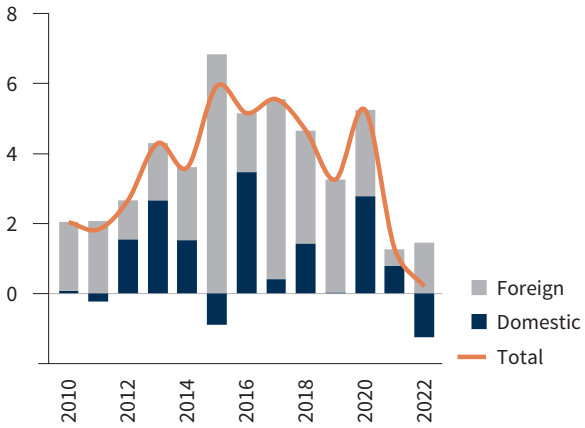
[46] Additional spending or forgone revenue accounted for less than 0.1 percent of GDP between March 2020 and September 2021, one of the lowest levels in the world. Cambodia, Vietnam, and Thailand have spent the equivalent to 1, 6, and 15 percent of GDP, respectively. See the IMF COVID-19 database.

[47] The Lao PDR is one of the poorest countries in the region and has low levels of human capital. Despite high development needs compounded by the COVID-19 pandemic and high inflation, spending on education, health, and social assistance compares poorly with regional and income peers.

[48] There are considerable data discrepancies on deficit financing as financing instruments do not add up to the fiscal deficit.

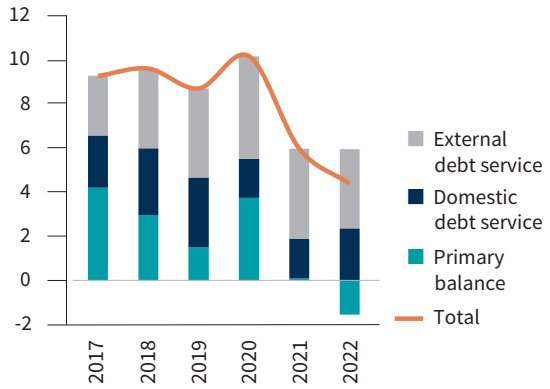
macroeconomic risk (Figure 1.22). Domestic expenditure arrears (mostly arising from off-budget investment projects) misrepresent the fiscal deficit and contribute to public debt accumulation through related bond issuances. SOE quasi-fiscal activities and PPPs are not included in the fiscal accounts, but they also threaten fiscal and debt sustainability.

Figure 1.21: Deficit financing (% GDP)



Source: MoF and World Bank staff calculations.

Figure 1.22: Financing needs (% GDP)



Source: MoF and World Bank staff calculations.

Intergovernmental fiscal relations are being developed, but fiscal discipline at the local level is a major concern. Local governments are not legally independent from the central government, as their finances are part of the national budget planning and execution process.[49] Provincial authorities fulfill some government functions at the sub-national level, such as the provision of basic public services (e.g., education and health).[50] They have the fiscal authority to levy taxes (e.g., land tax) and are de facto entitled to spend some of the revenues they collect according to their own plans and policies, while cash shortfalls are covered by the central government. Available data suggests that provinces collected 23 percent of domestic revenue and executed 31 percent of public spending during 2015–2019, accounting for about 50 percent of the fiscal deficit. Moreover, off-budget projects at the sub-national level have generated a large amount of expenditure arrears.

1.4.2 Public debt

Debt stock

Public debt has reached critical levels, driven by strong government borrowing and a sharp currency depreciation. The public debt stock increased from 57 to 96 percent of GDP between 2018–2022, according to official statistics.[51] Although external debt has recently stabilized in nominal US dollar terms, the debt burden deteriorated rapidly in 2021–2022 because of large domestic bond issuances and severe currency depreciation. In 2022, the public debt stock mainly comprised external debt (87 percent), 40 percent of which was on-lent to state-owned enterprises (mainly Électricité du Laos).[52] Domestic debt amounted to 12 percent of GDP, which is predominantly held by the banking sector and government contractors (through investment bonds), but also the central bank. Publicly guaranteed debt, an explicit contingent liability, accounted for 16 percent of GDP.[53] Hence,

[49] See the 2018 Public Expenditure and Financial Accountability (PEFA) assessment.

[50] In this report, the term 'provinces' comprises the 17 provinces and the Vientiane Prefecture.

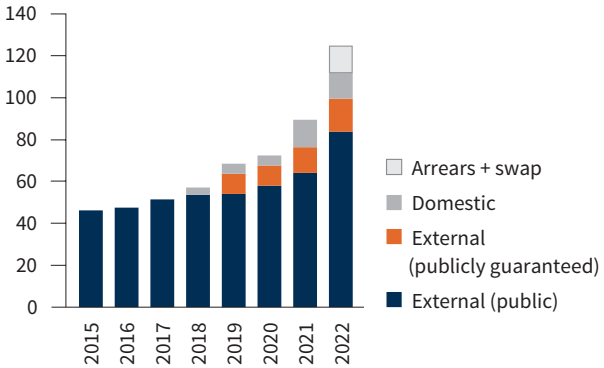
[51] Public debt covers debt owed by the central government, while public and publicly guaranteed (PPG) debt includes debt guaranteed by the central government. Domestic debt was not reported before 2018, and publicly guaranteed debt was not reported before 2019.

[52] The Lao PDR uses the currency criteria, which means that external debt includes domestic debt issued in foreign currencies.

[53] As of 2022, SOE debt guaranteed by the government was mainly held by EDL, and Lao Airlines to a lesser extent. Non-guaranteed SOE debt is an implicit contingent liability (e.g., the large borrowing by the Lao National Railway State Enterprise).

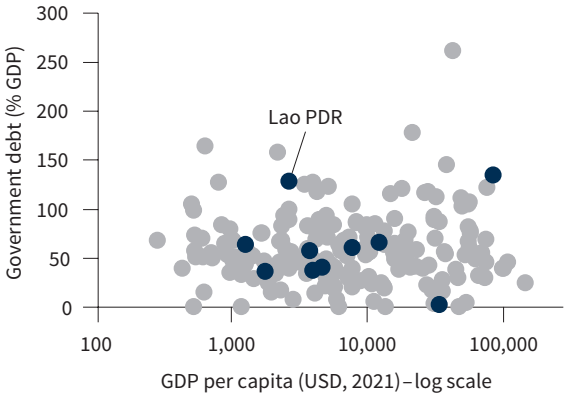
public and publicly guaranteed (PPG) debt amounted to 112 percent of GDP in 2022, of which 44 percent of GDP was related to SOEs (through on-lending and guarantees).[54] Including domestic expenditure arrears and a swap arrangement with PBoC raises PPG debt to 125 percent of GDP in 2022 (Figure 1.23). Gross public debt has become one of the highest in the world (Figure 1.24).

Figure 1.23: PPG debt (% GDP)



Source: Ministry of Finance and World Bank staff calculations.

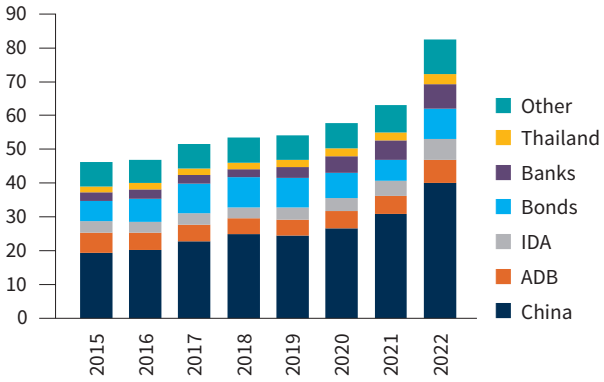
Figure 1.24: Government debt (% GDP, 2022)



Source: International Monetary Fund and World Bank.

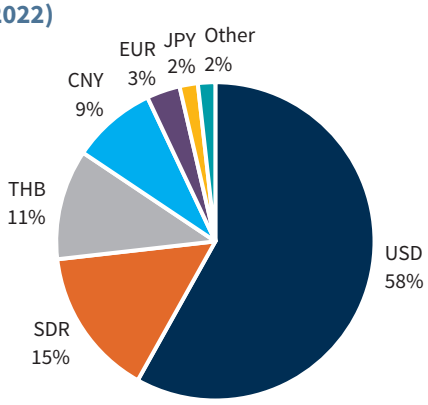
External public debt is mostly concessional, from bilateral institutions, and denominated in US dollars. External debt increased from 46 to 84 percent of GDP over the period 2015–2022 (Figure 1.25). Although most debt is contracted on concessional terms, market-based lending increased rapidly from 33 to 42 percent during 2015–2019 and stabilized at 40 percent in recent years. Most debt relates to bilateral loans (63 percent), followed by multilateral lending, foreign-denominated bonds, and commercial bank loans. Nearly 50 percent of external debt is owed to China. Debt is mainly denominated in US dollars (58 percent) and has a fixed interest rate (84 percent) (Figure 1.26).[55]

Figure 1.25: External public debt by lender (% GDP)



Source: MoF and World Bank staff calculations.

Figure 1.26: External public debt by currency (%, 2022)



Source: MoF and World Bank staff calculations.

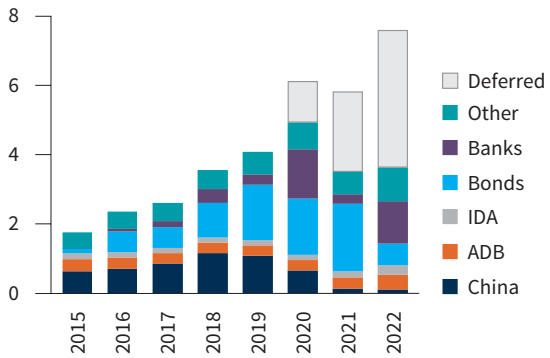
[54] The stock of PPG debt is taken from the Ministry of Finance's 2022 public debt bulletin and nominal GDP is based on World Bank estimates. The 2023 WB-IMF Debt Sustainability Analysis estimates PPG debt at 129 percent of GDP in 2022. The latter is a projection based on 2021 values and a broader definition of debt. Domestic expenditure arrears and a swap arrangement are classified as PPG debt under the Guidance Note on the Bank-Fund Debt Sustainability Framework for Low-Income Countries (LIC-DSF), but not under the current legal framework in the Lao PDR.

[55] Sovereign bonds were issued mainly in the Thai bond market. The government temporarily lost market access in 2020 before resuming in 2022. Multilateral loans contracted on market terms comprised less than 1 percent of external debt.

Debt service

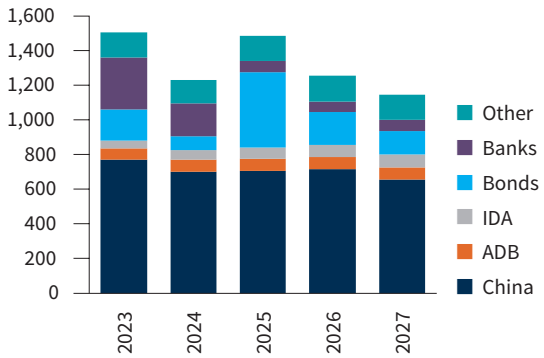
Most public debt service relates to borrowing at market terms and is mostly owed to China. Total public debt service obligations are high and growing. In 2022, principal and interest repayments amounted to 6 percent of GDP (including both external and domestic debt) despite significant deferrals. External debt service payments have been considerably below planned amounts, as deferrals to China in 2020–2022 accumulated to about $1.3 billion by the end of 2022, 8 percent of the 2022 GDP (Figure 1.27). These have provided temporary relief, but liquidity pressures have intensified with the sharp depreciation of the Lao kip.[56] Borrowing from private lenders is typically associated with higher interest rates and shorter maturities when compared to official lenders. Attempts to issue dollar-denominated bonds abroad in 2020–2021 were canceled or postponed, a sign of constrained access to international capital markets. The Lao PDR's sovereign credit rating was downgraded by Fitch, Moody's, and TRIS during 2020–2022, reflecting concerns about rising financing pressures.[57] A successful Thai baht bond issuance in March 2022 paved the way for future issuances in Thailand, although a bond issuance in 2023 was significantly undersubscribed. The authorities have stated that they aim to meet current financing needs through increased revenue, asset sales, external borrowing (including bonds), and domestic borrowing.

Figure 1.27: External public debt service (% GDP)



Source: MoF and World Bank staff calculations.

Figure 1.28: External public debt service ($ million)



Source: MoF and World Bank staff calculations.

Debt service requirements are unsustainable in the absence of a successful outcome from ongoing negotiations with major creditors. Assuming no further deferrals, external debt service obligations are estimated at over $1.3 billion per year during 2023–2027, about 9 percent of the 2022 GDP (Figure 1.28). This is higher than gross foreign reserves ($1.1 billion as of December 2022). Over half of these external public debt service obligations are due to Chinese lenders. The outcome of ongoing bilateral debt renegotiations is a critical unknown that has a strong bearing on debt sustainability and, thus, the economic outlook, through its impact on public finances, external accounts, and investor confidence.

Debt sustainability

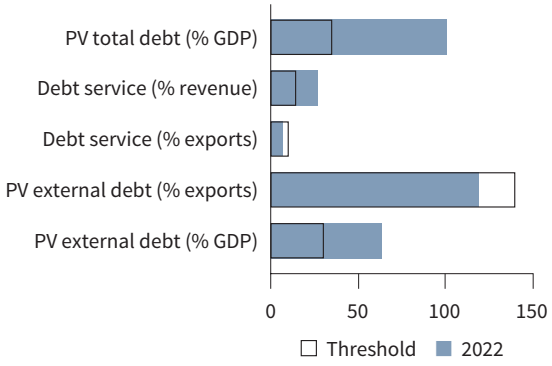
The Lao PDR is in debt distress, and its public debt levels are unsustainable.[58] The Lao PDR is facing both liquidity and solvency challenges owing to a high debt burden, poor revenue collection, limited financing options, and low foreign currency reserves. The public debt stock and debt servicing requirements have surged in recent years, edging the country into sovereign debt distress. Most debt ratios breach the indicative debt thresholds for a country with low debt carrying capacity, except for those relating to exports (Figure 1.29). However, only a fraction of export proceeds enters the domestic banking system to boost the supply of foreign exchange, which can be misleading. In the absence of revenue reforms or debt restructuring, debt levels are expected to remain above sustainability thresholds for many years (Figure 1.30).

[56] The specific terms and conditions of these deferrals (e.g., repayment period) are subject to ongoing negotiations.

[57] Moody's and Fitch downgraded to Caa2 and CCC respectively in 2020. The Thai Rating and Information Services (TRIS) downgraded the Lao PDR's sovereign rating to BBB- in 2021. Several attempts to issue international bonds during this period were unsuccessful due to limited interest and transparency. There were concerns over debt sustainability, slowing growth, low foreign exchange reserves, and tight foreign exchange liquidity.

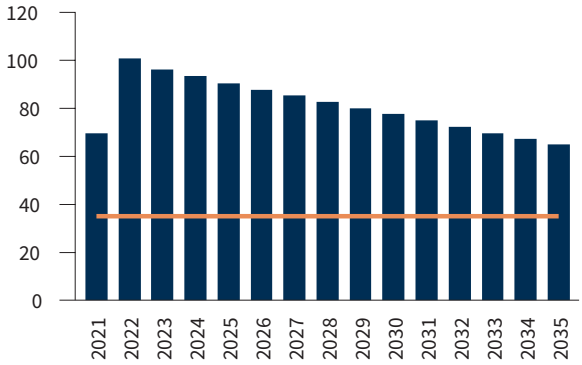
[58] In May 2023, the authorities consented to the publication of the 2023 Debt Sustainability Analysis (DSA), which is jointly conducted by the World Bank and the IMF.

Figure 1.29: Liquidity and solvency thresholds



Source: IMF and World Bank (2023 DSA).

Figure 1.30: Present value of total PPG debt (% GDP)



Source: IMF and World Bank (2023 DSA).

1.4.3 Fiscal risks

Fiscal risks can exacerbate the fiscal and debt burdens, and thus compound macroeconomic vulnerabilities. A fiscal risk is an exposure of public finances to an uncertain event that, if realized, may contribute to deviations from expected fiscal outcomes. Fiscal risks can impact public finances (e.g., deteriorate the fiscal balance) and limit the scope of fiscal policy to stabilize the economy and support economic growth. Therefore, it is crucial to identify, assess, disclose, monitor, and manage fiscal risks to secure fiscal sustainability and macroeconomic stability. This should entail a comprehensive assessment of the likelihood and potential impact of a range of risks, including macroeconomic shocks, financial crises, bailouts of public enterprises, commodity price shocks, and natural disasters. A better understanding of fiscal risks and effective risk management supports fiscal credibility and the sustainability of public finances. The World Bank and the IMF have developed diagnostic tools to identify direct and contingent liabilities and map them into a fiscal risk matrix (Table 1.1).[59]

Table 1.1: Fiscal risk matrix

Liabilities	Direct (actual)	Indirect (contingent)
Explicit (legal)	• Foreign and domestic sovereign debt (loans contracted and securities issued by central government) • Current budget expenditures (current fiscal year) • Future budget expenditures (legally binding over the long term – e.g., civil servant salaries and pensions)	• Guarantees for borrowing and obligationsmof SOEs • Guarantees for private investments (PPPs) • Guarantees for borrowing and obligations of SNGs • Guarantees for trade and exchange rate risks • State insurance schemes • Unexpected compensation in legal cases related to disparate claims • Reconstruction of public assets
Implicit (moral)	• Future recurrent cost of public investments • Future public pensions* • Social security schemes* • Future health care financing*	• Defaults of SOEs on non-guaranteed debt and other obligations • Liability clean-up in entities being privatized (e.g., public corporations) • Bank failures (support beyond state insurance) • Environmental recovery, natural disaster relief • Defaults of SNGs on non-guaranteed debt and other obligations • Failures of nonguaranteed pension funds, or other social security funds

Source: Adapted from World Bank (1998).

Notes: * If not required by law. SNG stands for sub-national government. State insurance schemes include deposit insurance, private pension funds, crop insurance, and flood insurance.

[59] These include the World Bank's Fiscal Risk Assessment (FRA).

There are significant direct and contingent liabilities, but their quantification has been undermined by a lack of transparency. There are many state-owned enterprises (SOEs) in the Lao PDR, most of which are loss-making and have large liabilities. For instance, Électricité du Laos (EDL) has made significant investments that have been predominantly funded through on-lending and guarantees from the government. Other large SOEs include Lao Airlines and BCEL, a state-owned bank. The Lao PDR has relied extensively on public-private partnerships (PPPs) to finance public infrastructure development. The government participates in PPPs largely through SOEs, such as EDL, EDL-Gen, and Lao Holding State Enterprise in the energy sector. The Lao PDR has also made major transport infrastructure investments, including the Laos–China railway and the Vientiane–Vang Vieng expressway. While the government is pursuing SOE reforms, the country's debt overhang may lead to an even stronger appetite for PPPs to boost large-scale infrastructure. The large accumulation of contingent liabilities creates additional fiscal risks that can heighten the already large fiscal and debt burdens. Chapters 4 and 5 of this report cover the two main sources of fiscal risks in the Lao PDR: SOEs and PPPs.

1.4.4 Scenarios

Scenario analysis provides valuable insights into the impact of different reform options and debt renegotiation outcomes. This section assesses the impact of different scenarios on debt sustainability. The baseline projection is the same as in the 2023 Debt Sustainability Analysis (DSA), which is complemented by two scenarios: (i) 'revenue reforms', which comprises an immediate restoration of the VAT rate to 10 percent (2024), an increase of excise taxes (boosting excise collection by 15 percent per year), and a phased elimination of CIT exemptions (doubling CIT collection by 2035 in relation to the baseline); and (ii) 'debt relief', which encompasses an immediate (2024) reduction in the PPG debt stock (equal to 20 percent of its 2023 value). Moreover, the real GDP growth rate necessary to bring the present value (PV) of PPG debt down to sustainability levels in the next 10 years is also calculated. The result (over 10 percent a year) indicates that the Lao PDR cannot 'grow out' of its debt situation. The 2023 DSA already included a contingent liability stress test, which applied a 47 percent of GDP shock.[60]

In the baseline, public debt levels remain unsustainable throughout the projection period. In the absence of reforms, debt restructuring, and further shocks, debt ratios decline because of (small) primary surpluses in the near-term and robust economic growth (Figure 1.31). 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, debt levels would remain elevated and persistently breach sustainability thresholds. Debt service obligations would remain high and crowd out all but the most essential government spending (Figure 1.32).[61] Gross financing needs increase considerably, owing to the assumption that full external debt service resumes in 2023, which need to be financed domestically due to limited access to international markets.[62] If large contingent liabilities were to materialize, the debt burden would be overwhelming, which would likely induce a public financing crisis, leading to a very large exchange rate depreciation, extremely high inflation, and a protracted economic recession.

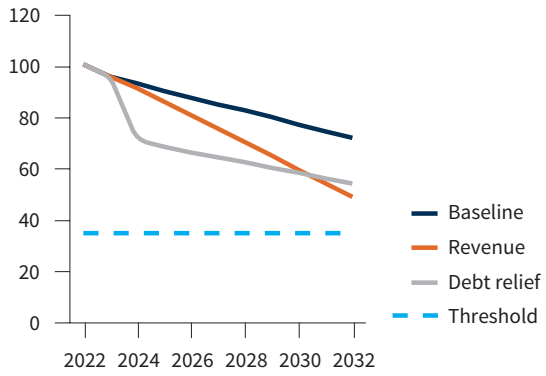
Enhancing domestic revenue mobilization would help ease the debt burden, but debt levels would remain unsustainable in the next decade. Tax policy reforms are needed to significantly (and sustainably) increase domestic revenue (see chapter on revenue mobilization). This would entail reversing recent cuts to the VAT and fuel excise rates. These measures would immediately and efficiently generate much-needed revenue. There is evidence that the VAT is a progressive tax, as it predominantly affects the non-poor (Box 1). Moreover, the government should rationalize tax incentives, although its impact would be gradual due to the

[60] The contingent liability shock is large, since it takes into consideration the very large PPP capital stock, the precarious financial situation of large SOEs (e.g., EDL), likely bank recapitalization needs, and potential additional expenditure arrears.

[61] Debt service projections are less linear than debt stock trends due to the different maturities of debt instruments. This adds an additional challenge to the government's debt management strategy.

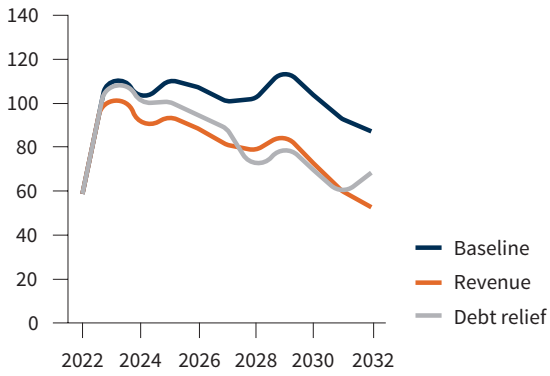
[62] Without further deferrals, no monetary financing, and no additional sources of finance (e.g., asset sales), it is assumed that financing needs are met by domestic banks, which can crowd out private credit. This could lead to rising domestic financing costs and shorter maturities, which would increase rollover and refinancing risks. This could entail a deterioration of bank asset quality and trigger liquidity shortages with a spiral of depreciation and inflation.

Figure 1.31: Present value of total PPG debt (% GDP)



Source: World Bank staff projections.

Figure 1.32: PPG debt service (% revenue)



Source: World Bank staff projections.

need to 'grandfather' (i.e., honor) existing agreements. This scenario would improve the fiscal balance and enable a faster reduction in debt burden indicators when compared to the baseline. However, debt ratios would remain above sustainability thresholds in the next decade. Tax administration measures are also important, but typically take much longer to impact revenue collection.

Debt restructuring would significantly improve fiscal and debt outcomes, but the relief would need to be significant. Given the need to service a large public debt stock, revenue reforms alone will not be sufficient to alleviate the debt burden in a decisive way. A debt restructuring that significantly lowers the public debt stock would provide a clear path toward debt sustainability. For instance, a 20 percent write-off of PPG debt would significantly reduce the public debt stock and servicing requirements, but it would still be insufficient to achieve debt sustainability within 10 years. Nonetheless, debt restructuring would considerably reduce financing needs.

Restoring debt sustainability will require significant fiscal reforms and a successful debt renegotiation. Macroeconomic outcomes depend on assumptions relating to reform implementation and debt renegotiations. In the baseline, a debt overhang (i.e., the inability to finance new growth-enhancing investments) will have a considerable impact on economic growth prospects. However, adjustment options are limited since the primary surpluses required to reduce debt below risk thresholds within a few years are not politically feasible or socially desirable. Even if critical reforms to enhance revenue mobilization are undertaken, debt sustainability would still hinge on a successful conclusion of ongoing debt renegotiations (Box 2).

Box 1: Distributional impacts of fiscal reforms

Fiscal reforms can have significant distributional impacts, which should be carefully considered. The Commitment to Equity (CEQ) methodology assesses the distributional impact of fiscal policies on household and individual welfare. It disaggregates income into stages that include or exclude fiscal interventions to analyze the impact of each intervention on poverty and inequality. This generates several income concepts used to further understand the effect of fiscal policies on welfare (see the World Bank's Fiscal Incidence Analysis entitled "Raising the Bar: Towards an Equitable and Inclusive Fiscal Policy").

Restoring the VAT rate to 10 percent would have a strong impact on revenue, while the tax burden placed on low-income households would be low. The VAT is progressive in the Lao PDR, which means that poorer households face lower effective VAT rates than richer households, due to larger shares of informal consumption. At the current rate of 7 percent, VAT payments represent 0.6 percent of the income of the poorest households (i.e., bottom decile), increasing to 4.3 percent for the richest (i.e., top decile). Restoring the VAT rate to 10 percent would increase the tax burden to 0.8 percent of income for the poorest decile, compared to 5.9 percent for the richest decile. About 80 percent of the additional VAT revenue would be paid by the richest three deciles. Therefore, restoring the VAT rate would considerably improve revenue collection while reducing inequality. The Gini index, a measure of inequality, is estimated to decline by 0.13 points.

Box 1: Distributional impacts of fiscal reforms (continued)

Raising health taxes would generate additional revenue, with larger fiscal gains achieved through reducing the health care burden in the long term. In the absence of behavioral responses to higher prices, increasing the excise tax on beer (to 9,000 kip per liter), on cigarettes (to 5,700 kip per pack), and on sugar-sweetened beverages (to 2,000 kip per liter) would enhance revenue collection, albeit to a lesser extent than restoring the VAT rate to 10 percent. Increasing the excise tax on beer would also reduce inequality, as richer households tend to spend larger shares of their income on beer. However, consumers tend to adjust their behavior by reducing their consumption in response to higher prices. While the immediate impact of health tax increases on revenue collection could be lower with behavioral responses, larger fiscal gains are expected through reducing long-term health care spending as households internalize the negative externalities of consuming these products. Moreover, inequality is expected to further reduce with behavioral responses. Poorer households are more responsive to the higher prices after excise increases, reducing their consumption by more and so bearing relatively less burden of tax increases, as well as benefitting more from better long-term health and productivity and lower out-of-pocket health expenditures.

Targeted cash transfers are an effective tool to protect vulnerable households. Targeted cash-transfer programs provide financial assistance to low-income households to support their livelihoods and protect them from shocks. The government has a proxy means test (PMT) targeting tool in place to identify potential beneficiaries, although efficiency and accuracy of the tool can still be improved. Based on the PMT tool, providing 336,000 kip (in 2018 prices, equivalent to 10 percent of the annual poverty line) to the poorest 20 percent of the population would cost the government around 480 billion kip, but help reduce inequality by over 0.8 Gini points and reduce poverty by 2.4 percentage points.

Targeted cash transfers are also an effective tool to alleviate the negative impact of high inflation on malnutrition. COVID-19 and high inflation have eroded human capital through increasing malnutrition, disrupted learning, and school dropout, with a higher incidence among low-income households. A conditional cash transfer program (CCT) to promote maternal health and children's nutrition was rolled out in 2021 in the four northern provinces (Phongsaly, Huaphan, Oudomxay, and Xieng Khuang). Evidence shows that while the nutrition situation has worsened due to the impact of COVID-19 and high inflation, the negative impact on nutrition was lower among CCT beneficiaries. Creating fiscal space for the CCT program would help mitigate the negative impacts of economic shocks on household livelihoods and human capital investment, especially among low-income households who tend to underinvest in their children's nutrition, health, and education.

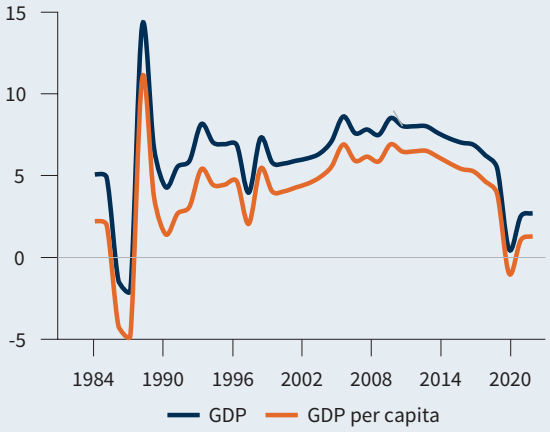
Combining the proposed tax reforms with targeted cash transfers to vulnerable households would generate significant revenue while reducing poverty and inequality. Using part of the additional revenue generated by the proposed tax reforms to provide cash transfers to vulnerable households would have considerable impacts on revenue and livelihoods. The VAT and excise tax rate increases, when combined with targeted cash transfers amounting to 336,000 kip to the poorest 20 percent of the population (as identified by the PMT tool), would help raise fiscal revenue by 16.2 percent of net fiscal revenue in the baseline, while reducing inequality by 1.0 Gini index points and poverty by 1.9 percentage points.

Box 2: Past episodes of macroeconomic instability

The Lao PDR has experienced economic difficulties throughout its history, and lessons from the past can be drawn to restore macroeconomic stability. The current levels of macroeconomic instability are not unique in the country's history. The economy has experienced high public debt levels, large external imbalances, sluggish growth, high inflation, and a weakening currency at different points in time over the past 40 years, particularly in the late 1980s and the late 1990s. The legacy of a centralized economic system, mixed reform efforts, and external shocks have underpinned periods of considerable economic volatility. The 1997 Asian Financial Crisis was a major factor affecting economic performance, albeit briefly. Recent shocks (e.g., the COVID-19 pandemic and high inflation), coupled with muted policy responses, are likely to induce deep scarring that may undermine economic prospects for many years to come.

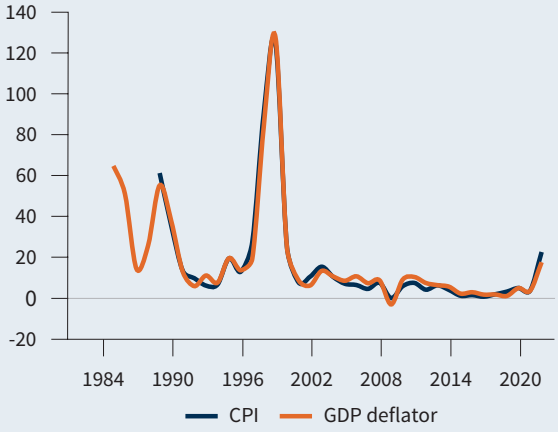
Box 2: Past episodes of macroeconomic instability (continued)

Figure 1.33: GDP growth (%)



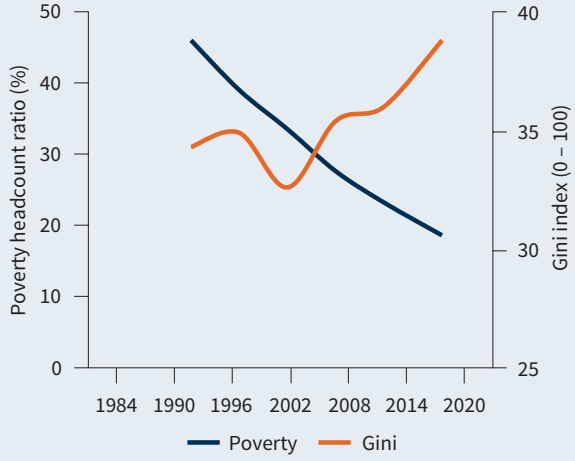
Source: World Bank and staff calculation.

Figure 1.34: Consumer price inflation (%)



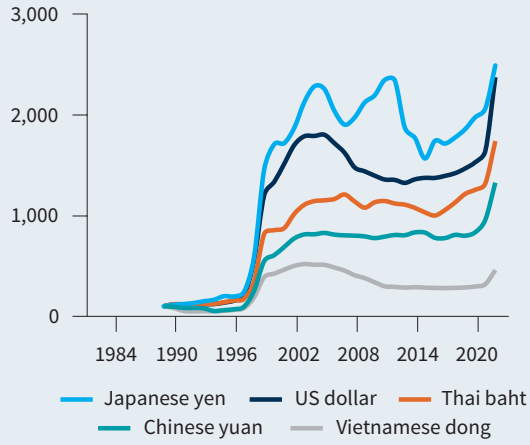
Source: World Bank and staff calculation.

Figure 1.35: Poverty and inequality



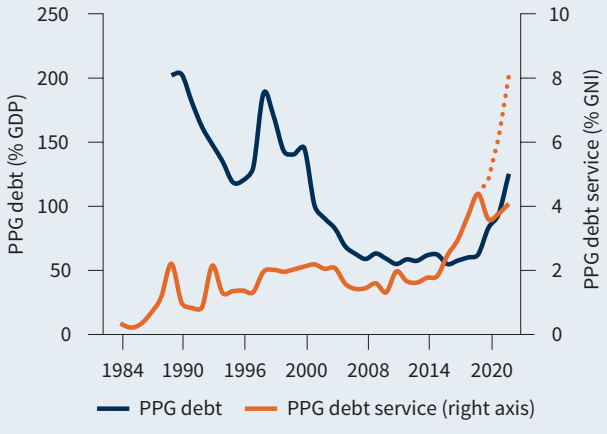
Source: World Bank and staff calculations.

Figure 1.36: Exchange rates (index, 100 = 1988)



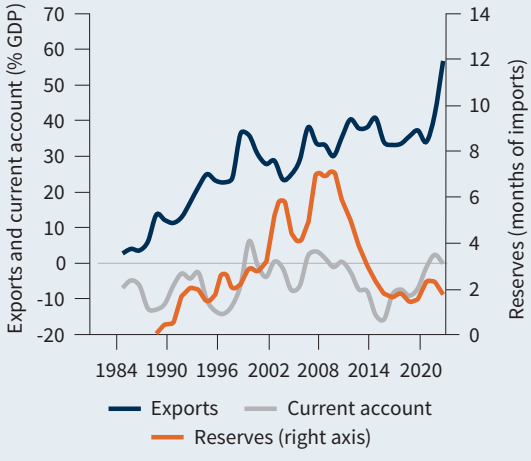
Source: International Monetary Fund and World Bank staff calculations.

Figure 1.37: Public debt stock and service



Source: International Monetary Fund and World Bank staff calculations.

Figure 1.38: External balances



Source: World Bank and staff calculations.

Box 2: Past episodes of macroeconomic instability (continued)

The first decades after independence were marked by experimentation with central planning. In the first decade after the establishment of the Lao People's Democratic Republic (PDR) in 1975, the government employed a command economy that did not meet its development objectives. By 1985, the manufacturing sector was struggling, exports fell to a fraction of imports, external debt increased rapidly, and many state-owned enterprises required budget subsidies. Early reforms to encourage trade, devalue the currency, and adjust agricultural prices failed to stem the tide.

An economic reform program was initiated in the mid-1980s, marking the beginning of a transition from a centrally-planned to a market-oriented economy. The government introduced the New Economic Mechanism in 1986, a far-reaching set of reforms aimed at granting a greater role to markets. Major reforms included liberalizing international trade and foreign direct investment, allowing private sector activity in most sectors, abolishing regulated prices for most goods (in favor of market-determined prices), and allowing greater autonomy in SOE management. Prior to 1986, central and provincial authorities determined output, prices, salaries, and other targets for state enterprises. Public expenditures were funded by SOE profits (if any) and depreciation allowances transferred to the state budget as revenue, though transfers were often financed by the banking system. Tax systems were in place but largely inoperative. The fiscal reform launched in 1988 attempted to decouple the state budget from state enterprises by simplifying the tax code and using it to collect revenue.

Inflation and public debt surged in the late 1980s, partly because of poor reform design and implementation. The decoupling resulted in a short-run decline in government revenues, while decentralization allowed local officials to increase wages. Severe droughts in 1987–1988 compounded economic challenges. Government debt increased to over 200 percent of GDP in 1988 and stayed above 100 percent for many years. Nearly half the population was living in poverty in 1992. In 1989, the World Bank and the International Monetary Fund (IMF) provided loans to bolster reforms and support medium-term macroeconomic stabilization.

Macroeconomic stability was temporarily restored in the early 1990s as reform momentum grew. As the country emerged from drought, robust economic growth was underpinned by reforms under the Third NSEDP (1991–1995). The government divested many small enterprises, although progress was more limited with medium- and large-sized SOEs. An IMF structural adjustment program aimed at achieving high growth, reducing inflation, and addressing external imbalances was coupled with government efforts to establish an effective centralized system of fiscal management. Consumer price inflation declined from about 60 percent in 1989 to less than 10 percent during 1993-1994. Financial sector reforms included the opening of private banks, while external sector reforms included allowing enterprises to be completely foreign owned and lowering trade tariffs. However, revenues remained below expectations because of slow reform implementation and 'ad hoc' tax incentives. The civil service remained oversized, while weak governance and corruption also undermined reform progress.

The 1997 Asian Financial Crisis had a significant impact on the economy. The Lao PDR joined the Association of Southeast Asian Nations (ASEAN) in 1997 to further its strategic objectives of transitioning to a market economy, reducing poverty, and improving human development. However, the 1997 Asian Financial Crisis had a severe impact on the country, particularly given its close economic relationship with Thailand, where the crisis began. The currency collapsed against the US dollar and the Japanese yen, partly due to limited foreign exchange reserves. Economic growth fell to 4 percent in 1998, while consumer price inflation escalated to 91 percent in 1998 and 125 percent in 1999. Government debt increased considerably in 1998. However, many of the negative impacts from the Asian Financial Crisis proved to be transitory. Economic growth accelerated, and inflation eased. External debt, about half of which was owed to Russia, declined. This was largely due to Russia writing off 70 percent of the balance in 2003 and allowing the government to service the remaining debt over a period of 33 years at a preferential interest rate. Nonetheless, high fiscal deficits persisted.

Box 2: Past episodes of macroeconomic instability (continued)

Several parallels can be drawn to past macroeconomic crises, but current liquidity pressures are unprecedented and require bolder solutions. As in the past, the country is currently experiencing significant uncertainty in key macroeconomic areas (e.g., public debt, inflation, and exchange rate). Limited foreign exchange reserves failed to avert a very sharp currency depreciation during the Asian Financial Crisis, while the collapse of commodity prices following the 2007–2008 Global Financial Crisis highlighted the vulnerabilities of a resource-based growth model (e.g., government revenue highly dependent on commodity prices). Despite these challenges, the government averted debt defaults, opting instead for bilateral relief from major development partners, particularly Russia in the early 2000s. Later, the country did not seek debt relief through the Heavily Indebted Poor Countries Initiative, even though it was eligible. Instead, it accepted new offers of aid from Japan. Likewise, the country has recently shunned relief under the Debt Service Suspension Initiative, instead engaging in direct discussions with key bilateral creditors. However, current debt service obligations are much higher than in the past, partly due to a larger share of non-concessional debt, which is associated with higher interest rates and shorter maturities.[63] These unprecedented liquidity pressures suggest that, more than ever before, deep economic reforms and a comprehensive debt restructuring will be needed to restore macroeconomic stability.

1.5 Conclusion and recommendations

Macroeconomic instability is undermining economic growth and threatening development prospects. Economic growth averaged 7 percent per year during 2000–19, while the poverty headcount ratio declined from 25 to 18 percent between 2012 and 2018. However, 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 – 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. High inflation and sluggish economic growth are threatening living standards. 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 struggling 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.

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 (coupled with rising debt service obligations) 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 highly 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.

[63] PPG debt amounted to 145 percent of GDP in 2002, which is higher than current levels. However, debt service payments are much higher now than in 2002 . Without debt service deferrals, these would amount to about 8 percent of GNI in 2022.

Fiscal pressures are amplified by sizeable contingent liabilities, which can further jeopardize macroeconomic stability. There are large contingent liabilities arising 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, most of which were 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.

Restoring macroeconomic stability will require comprehensive reforms and debt restructuring. Critical macroeconomic challenges include unsustainable public debt levels, limited fiscal space, foreign exchange rationing, low reserve buffers, and growing financial sector risks. These have been exacerbated by recent shocks and underscore the need for urgent reforms. There is a need for continued tight fiscal and monetary policies to avoid a further deterioration in fiscal and external balances. However, scenario analysis suggests that even with key reforms supporting revenue mobilization, debt servicing obligations would remain unsustainable. Hence, an agreement with major creditors on a credible debt restructuring will be critical for the country's economic outlook. This needs to be complemented by structural reforms, including measures to safeguard financial sector stability and improve the business environment.[64] Improved governance and data would greatly assist all these areas.

Negotiating a credible and transparent debt restructuring plan would help 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 to secure macroeconomic stability and support the economic recovery. Debt restructuring can be pursued through discussions with bilateral creditors or through multilateral channels. The G-20 Common Framework aims to provide comprehensive debt relief for developing countries, while there are ongoing debt renegotiations with large bilateral creditors. Bringing these bilateral negotiations to a successful conclusion, or applying for debt treatment under the Common Framework, would ease insurmountable debt pressures, create fiscal space for growth-enhancing expenditures, and improve market confidence. A combination of debt restructuring and primary surpluses (driven by enhanced revenue mobilization) would limit financing needs and lower debt service obligations to sustainable levels. 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.

Enhancing revenue mobilization, improving spending efficiency, and curbing fiscal risks is critical to securing the sustainability of public finances. Macroeconomic instability has been largely fueled by unsustainable fiscal policies. Low tax rates and generous tax exemptions have deprived the country of vital budgetary resources and foreign exchange, while high fiscal deficits and large debt accumulation have contributed to weaken the kip and thus intensify inflation pressures. Fiscal consolidation is necessary to avert the accumulation of additional public debt, but the focus should be on improving revenue mobilization. There is also a need to balance debt management and fiscal consolidation with critical 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 to maximize the impact of public spending. Finally, contingent liabilities present significant risks that can further undermine fiscal and debt sustainability. Improving governance arrangements is crucial to stem the accumulation of unwarranted contingent liabilities, while risks need to be identified, assessed, mitigated, monitored, and reported. The chapters on domestic revenue, public expenditure, state-owned enterprises, and public-private partnerships provide key insights and recommendations on these topics. These fiscal reforms ought to be coordinated with other macroeconomic and structural policies, such as those pertaining to the monetary sector, exchange rate, financial sector, and the business environment.

Developing a medium-term fiscal framework and approving a revised Law on Public Debt Management are key to improving fiscal and debt management. The lack of a solid macro-fiscal framework and a sustainable fiscal strategy undermine planning and inter-government coordination. It is, therefore, crucial to establish a credible medium-term fiscal framework that provides a concrete path toward fiscal and debt sustainability. This framework should include consistent and clearly defined targets for the entire public sector (e.g., strict fiscal

[64] Business environment reforms (e.g., streamlining regulations, enforcing rules consistently and transparently, and adopting measures to enhance competition) would help attract sustainable and impactful investments, as well as promote exports. This is fundamental to address persistent structural imbalances, especially foreign exchange shortages. Investing in basic education and skills would be key to attracting foreign investment in labor-intensive sectors. However, the government should refrain from providing costly tax incentives, as these create large foregone revenues that undermine fiscal sustainability.

rules, as well as limits on SOE financing and tax incentives for PPPs) to help restore macroeconomic stability. It should also comprise reliable revenue projections and growth-enhancing budget allocation rules. Moreover, revising the 2018 public debt management law to clarify and strengthen the roles and responsibilities of the Ministry of Finance in terms of debt and fiscal risk management would be critical to avert a future (unsustainable) build-up of public debt.

Adopting supportive monetary and exchange rate policies would help reduce macroeconomic vulnerabilities. Macroeconomic instability mainly stems from previous fiscal and debt policies (e.g., large deficits and on-lending to SOEs), and a lack of coordination with monetary policies. Coupled with external imbalances, these have induced a large exchange rate depreciation that has pushed inflation to record highs. 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 by complementing fiscal reforms. These include greater exchange rate flexibility and measures to improve monetary transmission. A high parallel market exchange rate premium creates distortions and corruption risks, while exchange rate restrictions often exacerbate imbalances. 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 (e.g., no deficit monetization).

Enhancing bank monitoring and operationalizing emergency arrangements will 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 will require enhancing the legal and regulatory framework, banking supervision, enforcement measures, financial safety nets, and crisis management. The Bank of the Lao PDR (BoL) has limited capacity to be a lender-of-last-resort, due to a high degree of financial dollarization and low foreign exchange reserves. Therefore, it is critical to have a fully operational emergency liquidity assistance facility and establish a crisis management framework to ensure interagency cooperation and coordination. In terms of remedial action, the early warning system and regulations on early intervention and problem-bank resolution need to be fully implemented. Strengthening prudential regulations and improving supervisory capacity will help prevent and manage bank vulnerabilities. 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.

2

Revenue Mobilization



2. Revenue Mobilization

Improving domestic revenue collection is fundamental to restoring macroeconomic stability and boosting growth-enhancing spending. 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. Tax revenue fell from 14 to 11 percent of GDP in 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 even foreign exchange. Revenue collection has heavily relied on indirect (consumption) taxes and is very low by international standards. 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. At 11 percent in 2022, the tax-to-GDP ratio is significantly below the recommended minimum international benchmark of 15 percent. Tax rates are among the lowest in the region, while tax administration inefficiencies also undermine performance. Tax collection is only reaching about 60 percent of its potential (due to suboptimal tax policy and administration), implying that there is vast scope for revenue-enhancing reforms that need not undermine economic growth or living standards. However, recent measures have further hampered revenue mobilization (e.g., tax rate cuts and growing fragmentation in the management of large taxpayers). Poor revenue performance jeopardizes fiscal and debt sustainability, as well as broader macroeconomic stability. Improving tax policy and tax administration is critical for boosting revenue mobilization, which would help increase fiscal space for growth-enhancing spending and meet growing debt service obligations.

Main recommendations: (i) restore the value-added tax rate to 10 percent; (ii) revise the Law on Investment Promotion to curb tax incentives; (iii) reform excise tax structures and increase rates, particularly on beverages, tobacco, and fuel; (iv) reform the land tax and prepare for the introduction of a property tax; and (v) strengthen compliance risk management by focusing on the administration of large taxpayers.

Chapter structure: The chapter starts by providing a brief overview of the tax system, after which it assesses key revenue trends and performance. It then presents a more in-depth assessment of major taxes, supported by key metrics and benchmarking to regional and income peers. The chapter also covers tax administration issues before concluding with recommendations for enhancing tax policy (including widening the tax base) and strengthening tax administration.

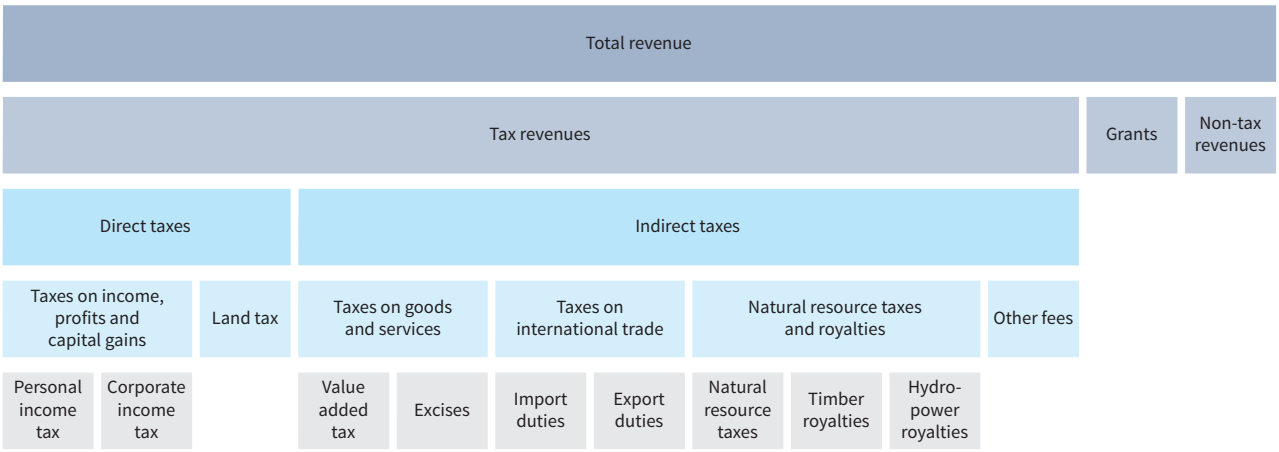
2.1 Background

There is an urgent need to revisit the current revenue mobilization strategy, especially due to mounting macroeconomic challenges. Rising public debt service obligations have sharply increased financing needs, despite significant deferrals in 2020–2022. Coupled with limited access to international capital markets and low foreign exchange reserves, this has contributed to a severe exchange rate depreciation and thus high inflation, jeopardizing macroeconomic stability and economic growth. Poor revenue performance has intensified these pressures, despite strong curbs on public spending. Generous corporate tax exemptions and tax rate reductions have undermined fiscal sustainability and macroeconomic stability. The erosion of fiscal space increases the country's vulnerability to economic, health, and environmental shocks, while threatening economic growth prospects through under-investments in education, health, and infrastructure.

The stated policy objective is to achieve a domestic revenue level of about 16 percent of GDP by 2025, but this will require major reforms. Collecting adequate levels of fiscal revenue is key to supporting the implementation of national development priorities. The Ninth National Socio-Economic Development Plan (NSEDP), which covers the period 2021–2025, sets targets for total revenue (at least 17 percent of GDP) and domestic revenue (at least 15.8 percent of GDP). Proactive reforms are required to meet these targets. In 2022, total and domestic revenue reached 15.0 and 13.3 percent of GDP, respectively. Tax revenue collection averaged only 10 percent of GDP since 2018, while research suggests that a minimum tax-to-GDP ratio of 15 percent is necessary to support economic growth. Below that threshold, economic activity is likely impacted by poor financing of basic public services crucial for growth, such as education, health, and infrastructure (including maintenance). Broadening the tax base, setting tax rates at reasonable levels, and improving the efficiency of revenue collection are key to enhancing domestic revenue mobilization.

The state budget is funded by multiple sources of finance, but the tax framework is the ultimate foundation. Public spending is mainly financed through government revenues and borrowing, and to a lesser extent, asset sales and capital returns. Revenues are typically classified by the nature of the source. Tax revenue is by far the main source, followed by non-tax revenues and foreign grants. Direct taxes are levied on incomes, profits, and capital gains on both individuals and corporations, together with the land tax (Figure 2.1). Indirect taxes are levied on the consumption of goods and services (value-added tax and excises), as well as on international trade. Natural resource taxes and royalties (e.g., from timber and hydropower) are also indirect taxes. Non-tax revenues mainly relate to fees, user charges, fines, and interest. Grants are provided by a range of development partners, such as bilateral and multilateral institutions. In the Lao PDR, social contributions are not considered to be part of government revenue.

Figure 2.1: Classification of government revenues



Source: World Bank staff.

Notes: The sum of tax and non-tax revenues is often referred to as domestic revenue.

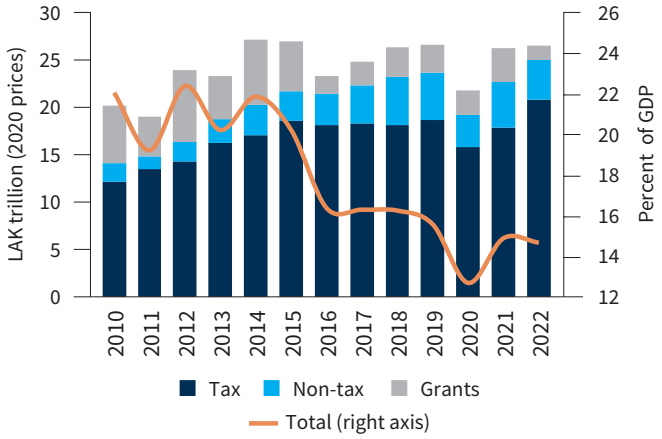
A well-functioning tax system should fulfill certain attributes, such as adequacy, efficiency, and equity. Some of the desired features of a tax system include revenue adequacy (to fund basic public services), efficiency (in revenue collection), equity (through income redistribution), simplicity (of the tax system), and stability (to avoid economic instability). However, trade-offs require careful attention and may need complementary policies. For example, reducing tax rates may benefit some consumers and businesses in the short-term, but can eventually undermine living standards and the business environment by weakening the provision of basic public services (e.g., education and infrastructure). Some reforms can efficiently collect a significant amount of revenue (e.g., VAT rate increase) but may need to be accompanied by measures to protect the most vulnerable households. Evaluating and balancing different priorities will be critical.

2.2 Trends and composition

Revenue collection has deteriorated considerably in the past decade and is low by regional and income standards. Total revenue fell from 22 to 16 percent of GDP during 2014–2019, owing to declines in tax collection and foreign grants. It subsequently dropped to 13 percent of GDP in 2020, but it recovered to 15 percent in 2022 (Figure 2.2). In 2022, about three-quarters of government revenue was collected through taxes. Tax revenue steadily declined from 14 to 11 percent of GDP in 2013–2019, falling further to 9 percent of GDP in 2020 due to the impacts of the COVID-19 pandemic. While tax revenue bounced back to 11 percent in 2022, this was largely aided by inflation (and despite some tax rate cuts). Non-tax revenue averaged 2 percent of GDP during 2010–2022. Grants showed considerable volatility before falling significantly in 2016, partly due to the country's graduation to lower-middle-income status. Total revenue is very low when compared to regional and income peers (Figure 2.3).

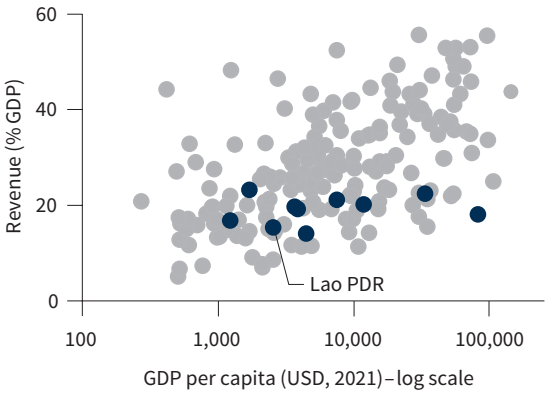
Tax revenue has relied heavily on indirect taxes, particularly the value-added tax and excises. Indirect taxes accounted for most tax revenue, with the value-added tax (VAT) and excises representing 29 and 25 percent of total tax revenue in 2018–2022, respectively. These are consumption-based taxes levied on the purchase of goods and services. Direct taxes averaged 23 percent of tax revenue in the same period and were almost exclusively derived from the corporate income tax (CIT) and the personal income tax (PIT).

Figure 2.2: Revenue (Lao kip and % GDP)



Source: Ministry of Finance and World Bank staff calculations.

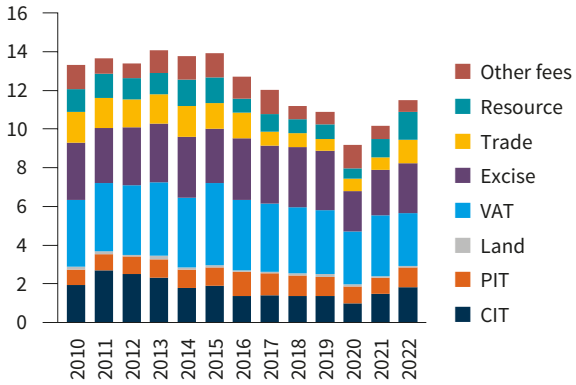
Figure 2.3: Revenue (% GDP, 2016–21)



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

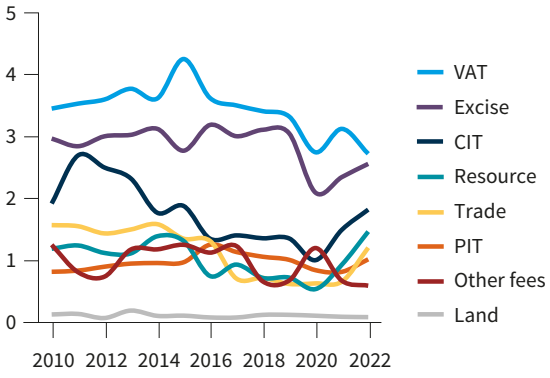
The relative decline in tax revenue is mostly accounted by the underperformance of the CIT and VAT. The poor performance of revenue collection has been observed across most types of tax (Figure 2.4 and Figure 2.5). The CIT declined considerably since 2011, owing to steady reductions in the standard rate and widespread profit tax exemptions. The VAT has declined since 2015, likely also affected by tax exemptions. COVID-19 had a considerable impact on economic activity and, thus, tax revenue. In 2020, revenue collection declined for most taxes, especially excises, although 'other fees' partly offset this trend. Since then, a recovery in consumption and imports has underpinned tax collection improvements, although this is also linked to the exchange rate depreciation and higher (domestic and import) prices. Nonetheless, VAT collection declined in 2022, largely due to the VAT rate reduction from 10 to 7 percent.

Figure 2.4: Tax revenue (% of GDP)



Source: Ministry of Finance and World Bank staff calculations.

Figure 2.5: Tax revenue (% of GDP)



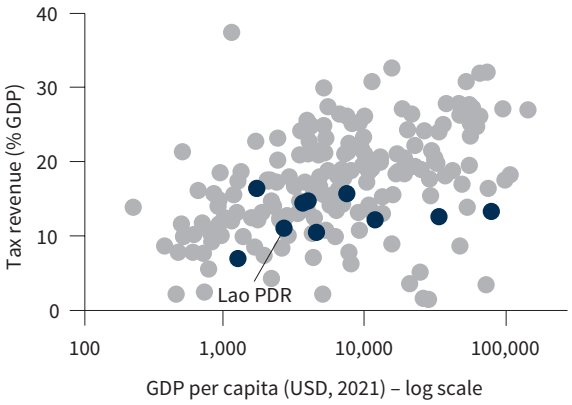
Source: Ministry of Finance and World Bank staff calculations.

Tax revenue collection is considerably lower than regional and income averages. The tax-to-GDP ratio is significantly lower than most regional and income peers (Figure 2.6). While the EAP region is generally known to have low tax rates (and thus tax collection) compared to other regions in the world, tax revenue in the Lao PDR is not only lower by international standards but also by regional standards. Moreover, tax revenue collection has been deteriorating in contrast to many countries in the region. Before 2016, tax revenue was at the lower end of the interquartile range in the EAP region, and it dropped significantly since then (Figure 2.7).

The tax system relies heavily on consumption taxes, with limited income tax collection accounting for most of the gap to international benchmarks. Taxes on (corporate and individual) income account for most of the shortfall in revenue relative to other countries in the region (Figure 2.8). CIT collection amounted to 1.4 percent of GDP in 2018, less than half the average collected in EAP countries and LMICs (Figure 2.9). Despite large foreign investments, CIT revenue is low because of generous profit tax exemptions. PIT collection is also relatively small due to lower average incomes and higher informality (i.e., low share of wage and salaried workers in total employment). VAT

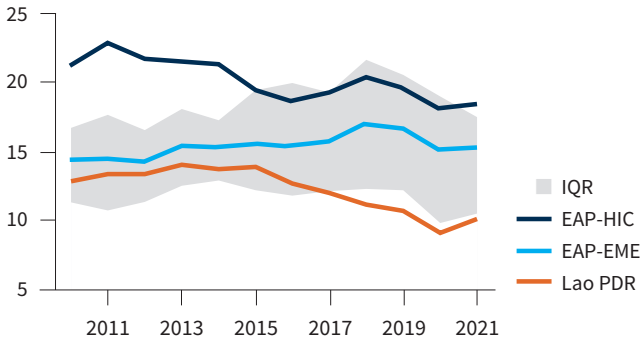
revenues are sizable, but still low by international standards. Taxes from international trade are also much lower than peer countries, likely due to exemptions for large investment projects. Among the main taxes, only excises perform comparatively better.

Figure 2.6: Tax revenue (% GDP, 2016–21)



Source: International Monetary Fund and World Bank staff calculations.

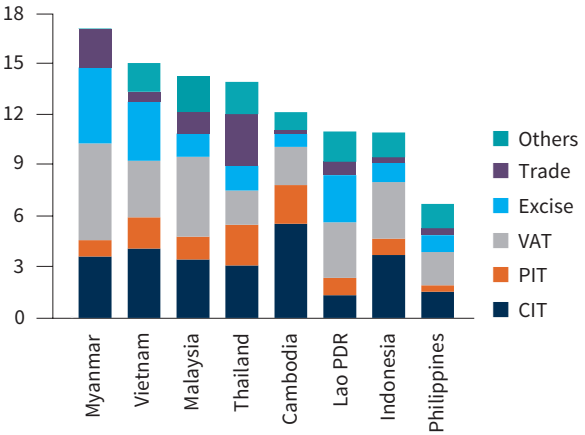
Figure 2.7: Tax revenue (% GDP)



Source: International Monetary Fund and World Bank staff calculations.

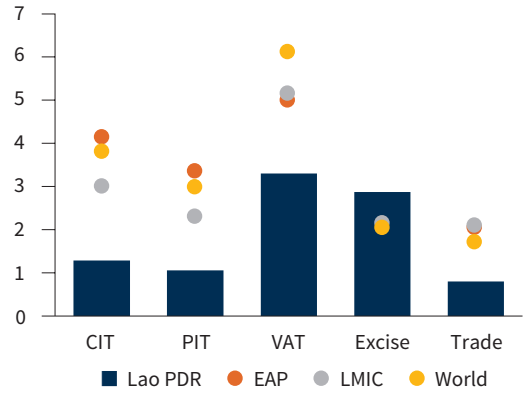
Note: IQR: interquartile range, EAP-HIC: East Asia and Pacific, high-income countries, EAP-EME: East Asia and Pacific, emerging market economies.

Figure 2.8: Tax revenue (% GDP, 2016–21)



Source: International Monetary Fund and World Bank staff calculations.

Figure 2.9: Revenue by type of tax (% GDP, 2016–20)



Source: International Monetary Fund and World Bank staff calculations.

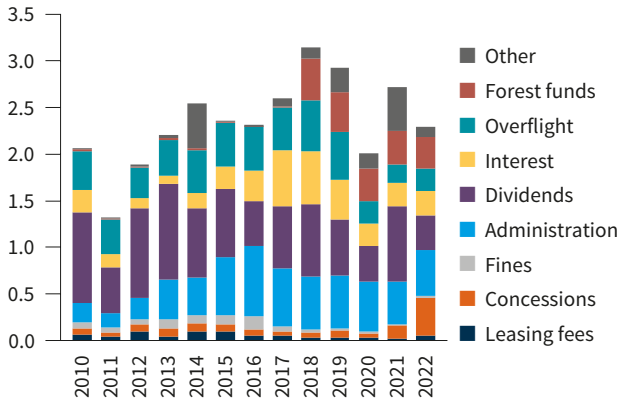
Non-tax revenue collection is sizable, but it remains below regional standards. Non-tax revenue mainly relates to fees, user charges, fines, interest, and dividends. For instance, this includes administration fees (e.g., registration and document processing), dividends from corporations where the government holds equity, interest from on-lending to SOEs, and charges relating to the use of Lao PDR's airspace (overflight rights).[65] Non-tax revenue averaged 2.3 percent of GDP during 2010–2022 (Figure 2.10). Forest Preservation Funds significantly increased to 0.4 percent of GDP since 2018, while concessions rose to 0.4 percent of GDP in 2022. In ASEAN countries, the Lao PDR's non-tax revenue was higher only than the Philippines and Indonesia (Figure 2.11).

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, are relatively small. Their combined (tax and non-tax) revenue averaged about 8 percent of total domestic revenue in the period 2010–2022 (or 1 percent of GDP), which is much lower than the combined share of forestry & logging, mining & quarrying, and electricity in total gross value added (about 20 percent).[66] These revenues have been undermined by tax incentives, volatile international commodity prices, and depleting reserves (e.g., copper).

[65] Asset sales and capital returns (e.g., loan repayments from SOEs) are not reported under revenue as they are included in net financing in GFS-compatible fiscal accounts.

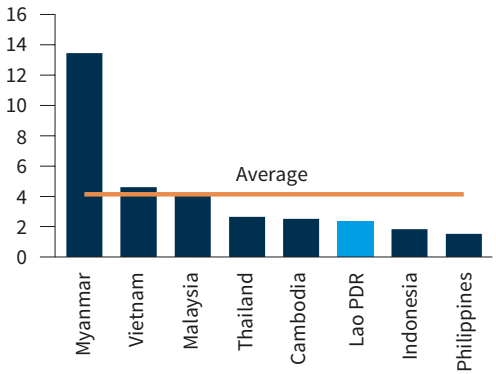
[66] Resource exploitation is also taxed through CIT, trade taxes, and VAT, but these likely yield limited revenue due to generous exemptions.

Figure 2.10: Non-tax revenue (% GDP)



Source: Ministry of Finance and World Bank staff calculations.

Figure 2.11: Non-tax revenue (% GDP, 2016–21)



Source: IMF and World Bank staff calculations.

Note: Non-tax revenues (mainly from SOEs in the energy sector) account for most revenue In Myanmar.

Tax buoyancy

Tax revenue collection has not kept pace with economic activity, with poor performance mainly driven by the CIT. Tax buoyancy (or tax elasticity) assesses whether growth in tax collection has been keeping pace with economic growth over time. A buoyancy coefficient of 1 would suggest that a 1 percent increase in GDP leads to an average rise of 1 percent in revenue collection, implying that revenues grow at the same pace as economic activity. The buoyancy for the period 2010–2019 for all combined tax revenues stood at 0.69, meaning that tax collection performance has been low in relation to economic growth (Table 2.1). Tax buoyancy is above 1 for PIT and excises, while for the VAT, it is nearly 1. However, the buoyancy for CIT, trade taxes, and natural resource taxes & royalties is low or even negative. This is mainly due to the impact of tax exemptions for large projects (including those in mining, electricity, and transport), along with the reduction of the CIT rate, trade liberalization, and volatility of commodity prices. Strong reforms are needed to mobilize adequate revenues since these need to increase much faster than economic growth to reach stated policy objectives, as well as regional and international benchmarks.

Table 2.1: Revenue responsiveness to GDP growth (2010–2019)

Tax	Bouyancy
Tax revenue	**0.69**
Personal income tax (PIT)	1.51
Corporate income tax (CIT)	-0.03
Land tax	0.74
Value-added tax (VAT)	0.98
Excises	0.10
Trade taxes	-0.47
Import duties	*-0.36*
Export duties	*-2.34*
Other fees	0.67
Natural resource taxes & royalties	-0.15

Source: World Bank staff calculations.

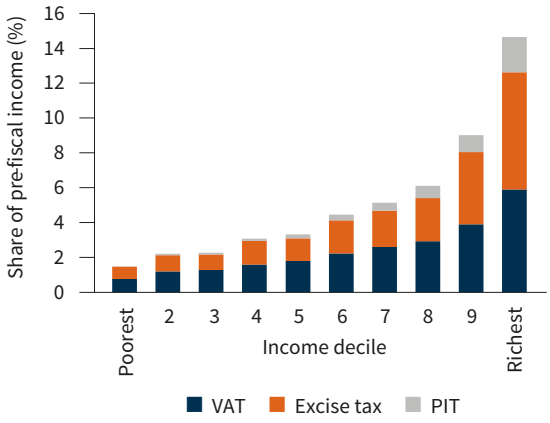
Distributional impact

Taxes levied on consumption impose a larger burden on better-off households, which implies that they are progressive. Although the standard VAT rate was 10 percent in 2018, poorer households faced much lower effective VAT rates due to large shares of informal consumption (e.g., self-produced food or services provided by unregistered

vendors). For poorer households, a large part of VAT payments is the VAT component hidden in VAT-exempted and informal goods and services that use inputs subject to VAT (e.g., fuel). In total, VAT payments represent only 0.8 percent of the income of the poorest households, compared to 5.9 percent for the richest households, suggesting that the VAT is a progressive tax (Figure 2.12). Therefore, the VAT rate reduction introduced in 2022 has had a negative redistributive effect. Excise taxes are found to be slightly more progressive than VAT, as better-off households spend more on goods and services subject to excise taxes. Spending on alcoholic beverages, tobacco, fuel, large vehicles, luxury goods, and recreation together constitute 23.5 percent of income for households in the richest decile, compared to 3.4 percent in the poorest decile. The amount of excise taxes paid represents 1.1 percent of the income of the poorest decile and 8.2 percent of the income of the richest decile.

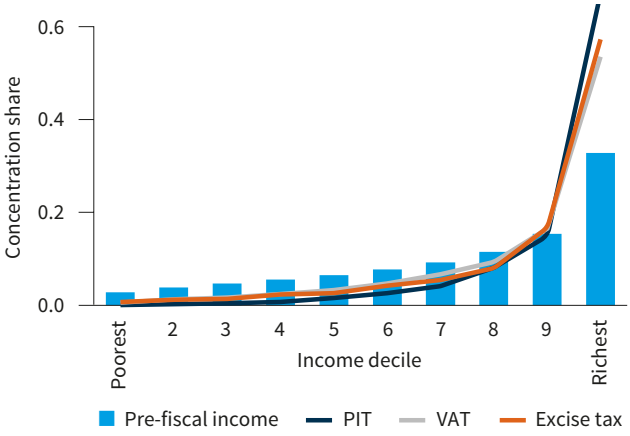
The PIT is progressive and imposes a relatively small burden on households. PIT progressive rates and the minimum income threshold, combined with high rates of informality among poorer households, mean that the PIT is structurally progressive. The amount of PIT paid increases with household income. The richest households account for 67 percent of total PIT payments, more than double their share in total household income, while the contribution of the poorest households is less than 0.1 percent (Figure 2.13). However, overall PIT revenue collection and its burden on households are relatively small due to the high prevalence of informality. Among PIT taxpayers, PIT payments represent around 2–5 percent of their income. Broadening the tax base through formalization and increasing PIT rates (especially for the top income brackets) could support revenue collection without placing a heavy burden on low-income households.

Figure 2.12: Incidence of taxes



Source: World Bank staff calculations.

Figure 2.13: Concentration share of taxes



Source: World Bank staff calculations.

Tax revenue potential

There are several methods to estimate a country's domestic revenue mobilization potential. There are various factors affecting domestic revenue collection, pertaining to both tax policy and administration. Domestic revenue can be considerably below its potential due to suboptimal tax rates and the proliferation of exemptions (which relate to tax policy), as well as low compliance and limited capacity to collect revenue (which relate to tax administration). It is therefore crucial to identify the most binding constraints to prioritize reforms. A simple method of estimating the amount of additional tax revenue that could be potentially collected is to compare a country's tax-to-GDP ratio with that of other countries with similar characteristics, such as the level of economic and institutional development. This can be undertaken through a simple benchmarking exercise, including tax productivity, VAT c-efficiency, or through an empirical exercise.[67]

'Tax effort' measures a country's effort to raise tax revenues, while the 'tax gap' is often driven by both policy and administration weaknesses. Tax potential (or taxable capacity) provides a reference point for the maximum amount of revenue that could be collected through tax policy changes or improvements in the efficiency

[67] Tax productivity (or tax collection efficiency) is calculated as the ratio of tax revenue as a share of GDP to the standard tax rate. This measures efficiency in both tax policy and administration, and it is often computed for the CIT, PIT, and VAT. VAT c-efficiency is measured as the ratio of actual VAT revenues to the product of the standard rate and final consumption.

of collection given a country's socioeconomic factors (e.g., a country's specific macroeconomic, demographic, and institutional features). Tax effort is the ratio between actual tax collection and tax potential, which measures a country's effort to raise tax revenues. The tax gap is the difference between tax potential and actual tax collection, and it comprises the 'policy gap' and 'compliance gap'. The policy gap quantifies the extent to which tax collection is affected by policies that reduce the tax base and tax rates. Examples include tax exemptions and reduced rates, which reduce tax liabilities and thus revenue. The compliance gap conveys the extent to which poor tax administrative capacity and active tax avoidance may explain the gap between potential revenues and actual collection.

Tax collection is only reaching about 60 percent of its full potential, implying that there is ample scope for tax policy and administration reforms. Tax effort was estimated at about 0.6 during 2010–2016, meaning that tax collection was lower than the average tax yield for countries with similar characteristics. Hence, there is considerable potential to mobilize additional domestic revenues. Tax effort is affected by the tax structure (e.g., tax rates and tax base), as well as tax administration and compliance. Tax effort can be increased by raising tax rates, expanding the tax base, and improving tax compliance and enforcement. When compared to taxation levels and (structural and institutional) determinants in peer countries, Lao PDR had an average tax potential of 21 percent of GDP, with the corresponding total tax gap at 8 percent of GDP – as tax revenue averaged just over 13 percent of GDP in 2010–2016.[68] The tax gap has likely increased in recent years due to tax rate cuts.

Tax rates are low when compared to regional and income peers, which considerably undermines revenue collection. The standard CIT rate (20 percent) is low in international terms (Table 2.2). This rate already represents a significant tax incentive, but tax exemptions further hamper the effective tax rate. The PIT top marginal tax rate (25 percent) is also below most regional and income peers. The VAT rate of 7 percent places the Lao PDR among the countries with the lowest VAT rates in the region and the world. Recent trends suggest that countries in the region are raising VAT rates. For instance, Indonesia raised its rate to 11 percent in April 2022.

Table 2.2: Statutory tax rates (%, 2022)

	CIT (standard)	PIT (top rate)	VAT (statutory)
Cambodia	20	20	10
Indonesia	25	30	10
Lao PDR	**20**	**25**	**7**
Malaysia	24	30	6-10
Myanmar	25	25	5
Philippines	30	35	12
Thailand	20	35	7
Vietnam	20	35	10
Asia	21	28	12
Latin America	27	32	14
Africa	27	33	16
OECD	23	42	19
World	24	31	15

Source: International Monetary Fund, PwC, and KPMG.

Note: In Myanmar, a 5 percent rate on certain goods and services is considered turnover tax rather than VAT. Malaysia levies a 10 percent sales tax and a 6 percent services tax.

[68] See the World Bank's Tax Revenue Dashboard.

2.3 Assessment of major taxes

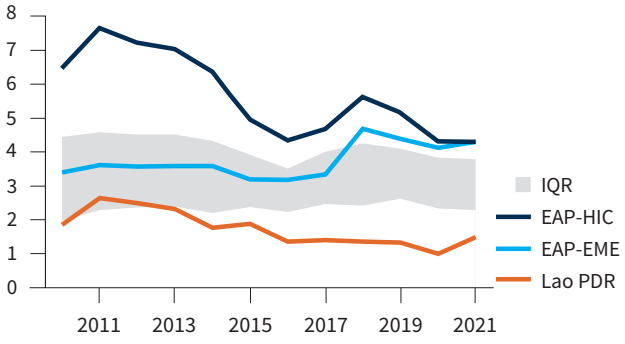
2.3.1 Income taxes

Corporate income tax

The CIT rate has been progressively reduced, while additional tax incentives have been provided across several sectors. Companies registered in the Lao PDR (including foreign companies operating in the country) are taxed at a standard rate of 20 percent, with some exceptions. The profit tax rate is 35 percent for mining companies and 22 percent for tobacco companies. Training and research centers are taxed at 5 percent, while activities using innovative or green technologies face a 7 percent tax rate. Companies listed on the Lao Stock Exchange pay 13 percent in the first four years. Microenterprises voluntarily registered in the VAT system only pay 0.1 percent, while small- and medium-scale entities newly registered in the VAT system pay 3 and 5 percent in the first 3 years, respectively. The standard profit tax rate was cut from 35 to 28 percent in 2012, then to 24 percent in 2015, and finally to 20 percent in 2020. Meanwhile, the Law on Investment Promotion provides tax incentives depending on the business activity and location, while concessions negotiated on a case-by-case basis provide even more generous tax benefits.[69]

CIT revenue collection and CIT productivity ratio are the lowest in the region. CIT revenue steadily dropped from 2.7 to 1.0 percent of GDP during 2011–2020, although it recovered to 1.5 percent in 2021 (Figure 2.14). It has increased to 1.8 percent of GDP in 2022, but it remains one of the lowest levels in the world. Very low CIT revenue collection is due to a combination of tax rate cuts and the widespread use of tax incentives. CIT productivity, measured as the ratio of actual CIT collection (as a percentage of GDP) to the highest statutory marginal rate, was also very low at 0.05 (Figure 2.15). This ratio is significantly lower than the averages observed in the EAP (0.15) and other regions.

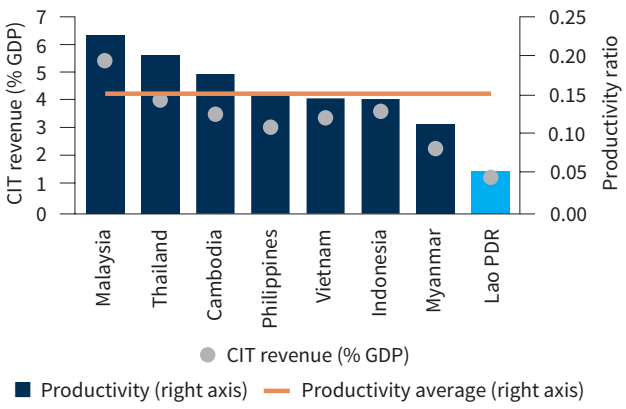
Figure 2.14: CIT collection (% GDP)



Source: International Monetary Fund and World Bank staff calculations.

Note: IQR: interquartile range, EAP-HIC: East Asia and Pacific, high-income countries, EAP-EME: East Asia and Pacific, emerging market economies.

Figure 2.15: CIT productivity ratio (2016–21)



Source: International Monetary Fund and World Bank staff calculations.

CIT gaps are estimated to be very high, indicating a very large amount of foregone revenues. The estimation of tax gaps is crucial for policy making since it provides a measure of the revenue gains that can be achieved with tax policy and administration reforms.[70] Estimates suggest that the overall CIT gap amounts to 87 percent of potential revenue, which implies that only 13 percent of potential revenue is being collected.[71] This is due to both tax policy (e.g., exemptions that reduce the tax base) and tax administration issues (e.g., weak compliance and enforcement). The CIT gap is very high across most economic sectors, including those dominated by large companies operating in the formal economy. Agriculture and accommodation &

[69] Additional benefits are often granted to individual companies as part of concession agreements.

[70] It is not possible to estimate the CIT gap with microdata because of the limited scope of the CIT return form. This report uses income data from the national accounts following the IMF's RA-GAP methodology. The tax base is derived using 2020 value-added by sector, adjusting for the share of value-added that is earned by labor, land, and capital, as well as other deductible expenses (e.g., depreciation). Therefore, these CIT gap estimates are merely indicative.

[71] This exceeds the CIT gap estimated in an earlier analysis by the IMF, which found foregone revenues ranging 78–82 percent when excluding the agriculture and natural resource sectors.

food services, which are overwhelmingly informal, have CIT gaps above 95 percent. Mining, electricity, manufacturing, and transport & storage have CIT gaps ranging between 75 and 90 percent. At the other end of the spectrum, information & communication and financial & insurance services have CIT gaps below 40 percent. While informality may explain some of the gaps observed (by narrowing the tax base), measures of informality suggest that this does not account for most of the gaps. Hence, a large portion of the tax gap is likely caused by generous tax incentives and potentially base erosion and profit shifting (BEPS).

Poor CIT performance has its roots in the extensive use of profit tax holidays to incentivize foreign investment. The Law on Income Tax allows the use of tax holidays, with the targeting criteria specified in the Law on Investment Promotion and the decree on its implementation.[72] The duration of profit tax holidays varies by type of business activity and location, ranging between 4–15 years. The length of tax holidays for investments in concession activities and special economic zones (SEZs) is not detailed in the legislation. In practice, profit tax holidays (including their duration) are negotiated on a case-by-case basis.[73] While these tax incentives are aimed at attracting investment, there has been no cost-benefit analysis to evaluate value for money.

Evidence suggests that firms do not rank tax incentives as the primary reason for choosing where to invest. The effectiveness of incentives largely depends on the investor's motivation for undertaking the investment. Surveys and empirical research often find that political stability, macroeconomic stability, the legal environment, and labor skills are the key determinants of FDI.[74] Incentives can be more effective for attracting investors in traditional export-oriented sectors (efficiency-seeking) since these are largely driven by competitive cost advantages in the host country. By comparison, investors are less responsive to incentives when mainly serving the domestic market (market-seeking) or drawing on natural resources (asset-seeking). In the case of the Lao PDR, many large investment projects are location-based, as they rely on the presence of natural resources (e.g., minerals and rivers) or the country's geographic position in Southeast Asia (e.g., for transport and logistics services). Therefore, addressing barriers to investment should focus on regulatory issues (e.g., licenses, permits, and immigration requirements), infrastructure (e.g., utilities and roads), and the quality of the labor force (e.g., skills).

Profit tax exemptions should be phased out and replaced by cost-based incentives. International evidence suggests that profit tax exemptions are highly inefficient. This is because tax holidays do not explicitly target investment, with the amount of tax relief often being disproportionate to the investment. In fact, firms can benefit even when they are not investing. The incentive heavily favors firms with high profits, which least need government support. This contributes to high redundancy of expenditure on incentives since an investor anticipating high profits would likely have proceeded in any case. Also, host governments face the risk of losing substantial revenue when a firm earns extraordinary profits. In addition, CIT holidays facilitate aggressive tax avoidance, as profit from investments that do not qualify for exemption may be artificially transferred through related party transactions. Profit-based incentives should be replaced by cost-based tax measures (e.g., accelerated depreciation and investment tax allowances or additional deductions), which reward companies only if they invest. The tax relief provided is often set as a percentage of investment expenditure. Following good international practice, tax incentives should be consolidated in tax laws, with clear and transparent eligibility criteria under the purview of the Ministry of Finance.

The need to reform tax incentives is high, given the upcoming global minimum corporate tax. More than 130 countries have agreed to start implementing a global minimum tax (GMT) rate in 2024.[75] The agreement aims to achieve a global minimum effective tax rate of 15 percent for multinational enterprises (MNEs) with a global turnover above 750 million euro.[76] The GMT does not directly obligate countries to adopt this rate, but it creates a strong incentive to raise CIT rates.[77] Countries that continue employing tax holidays and reduced rates are effectively giving

[72] The 2009 Law on Investment Promotion introduced a range of tax incentives (e.g., profit tax holidays, reduced royalty rates, and import duty waivers on machinery, equipment, and raw materials) in selected sectors (e.g., mining and power generation). The duration of tax holidays in special economic zones (SEZ) is negotiable. The law was revised in 2017 to reduce the degree of discretion, but it is not clear how strictly this is being implemented. The law is currently under review.

[73] The Law on Investment Promotion allows for incentives beyond those stipulated by the law, which require approval of the National Assembly.

[74] See World Bank Global Investment Competitiveness Report 2020.

[75] These countries are members of the of the OECD Inclusive Framework on Base Erosion and Profit Shifting (BEPS). The G20 has endorsed this agreement.

[76] Even a small company operating in the Lao PDR that is a part of an MNE with a global turnover above the threshold will be subject to GMT.

[77] The first rule allows countries where the parent company of an MNE is taxable to impose a top-up tax on the profits of any foreign subsidiaries paying an effective tax rate of less than 15 percent. If the home country of the parent company chooses to impose a CIT rate of less than 15 percent, then the second rule allows the host country where the MNE subsidiary carries out its business activities to charge top-up taxes on the subsidiary.

away their taxing rights to FDI exporting countries or countries where MNE subsidiaries operate. Moreover, MNEs will no longer benefit from these tax incentives because there will be one or several countries that will bring their effective tax rate to 15 percent. Countries that provide generous tax incentives and do not act upon the GMT could lose out when other countries introduce domestic tax rules to top up under-taxed profits. Several countries in the region are advancing implementation (e.g., Australia, Japan, Korea, Malaysia, and New Zealand). Thailand and Vietnam are also considering the adoption of GMT for effectiveness in 2024.

The Income Tax Law does not provide a legal foundation for international taxation. There are no 'transfer pricing' rules or 'thin capitalization' rules in the 2019 Law on Income Tax, and there is no definition of a 'permanent establishment' (Box 3). There is no legal provision to require taxpayers to use arm's length pricing, or provide the authority for the MoF's tax department to audit the transfer pricing of MNEs or impose penalties to deter taxpayers from non-compliance. MNEs tend to shift profits more easily out of countries without transfer pricing legislation. Currently, all ASEAN countries have adopted transfer pricing legislation, except for the Lao PDR and Myanmar. As a result, Lao PDR is facing the risk of CIT tax base erosion due to non-arm's length (i.e., artificial) prices charged on transactions between related parties or excessive interest deductions.[78] There is also no provision for direct taxation of digital businesses operating outside the country but generating profit from the country's market.

Box 3: Definitions

Transfer pricing refers to the prices and other conditions used in transactions between related parties (e.g., goods, services, and capital). Although it is a legitimate practice for MNEs, it can be used to artificially shift profits between the members of an MNE (toward low tax jurisdictions) to lower overall tax obligations.

Thin capitalization is when a company is financed through a very high level of debt (compared to equity), which significantly lowers taxable profits because debt usually creates an interest expense that is deductible. Many countries have taken steps to counter this practice.

Permanent establishment is a term used in tax treaties between countries to define tax liabilities in each jurisdiction.

Arm's length pricing refers to the pricing of transactions between unrelated persons subject to normal market forces. Transfer pricing rules typically substitute 'arm's length pricing' for the actual pricing in transactions between related persons, for the purpose of computing taxable profit.

Personal income tax

The PIT regime has the feature of a dual income tax system, which includes a progressive tax schedule for labor income and a flat rate tax for capital income. Personal incomes are subject to a progressive PIT regime with rates ranging from 0 to 25 percent. The PIT is applied to all income earned in the Lao PDR from salary, wage, benefits in kind, and other remuneration, both for Lao nationals and expatriates, regardless of the length of their employment and stay in the country. The basic exemption for an employee earning a salary or wage income is 15.6 million kip. In 2021, the PIT exemption was higher than Myanmar's but lower than other regional peers in US dollar terms (Table 2.3). The threshold of the top PIT rate of 25 percent is 780 million kip, with a ratio of 32 (to GDP per capita). Domestic-source income from dividends, interest, capital gains, rent, and royalties is subject to withholding at different flat rates. Foreign-source capital income is currently exempt from taxation.

[78] While there is no data to quantify the tax erosion risk to revenues, some research indicates that this can be high. For instance, a study found a significant trade mispricing in Lao exports of copper concentrate and coffee beans during the period 2012–2017 (see "Commodity Trade Mispricing: Evidence from Lao PDR").

Table 2.3: PIT basic exemption (2021)

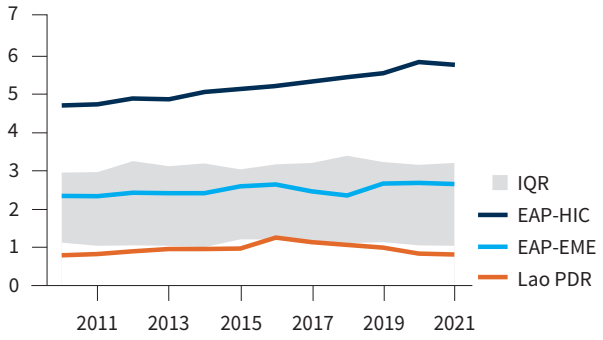
Country	PIT (%)	GDP pc (USD)	Exchange rate (avg.)	Exemption threshold			Highest threshold		
				LCU ('000)	USD	Ratio	LCU ('000)	USD	Ratio
Cambodia	20	1,625	4,099	15,600	3,806	2.3	150,000	36,597	22.5
Indonesia	30	4.333	14,308	-	-	-	5,000,000	349,451	80.7
Lao PDR	**25**	**2,536**	**9,698**	**15,600**	**1,609**	**0.6**	**780,000**	**80,430**	**31.7**
Malaysia	30	11,109	4	20	4,827	0.4	2,000	482,707	43.5
Myanmar	25	1,210	1,614	2,000	1,239	1.0	30,000	18,587	15.4
Philippines	35	2,70	49	250	5,076	1.5	8,000	162,421	46.9
Thailand	35	7,006	232	150	4,691	0.7	5,000	156,362	22.1
Vietnam	35	3,756	23,160	-	-	-	960,000	41,451	11.0

Source: PwC and World Bank staff calculations.

Note: PIT is the statutory top rate. The hyphen (-) indicates there is no zero percent tax bracket.

PIT collection is lower than most peer countries, while the PIT productivity ratio is also low. PIT collection steadily increased from 0.8 to 1.3 percent of GDP in 2010–2016 but gradually declined to 0.8 percent of GDP in 2021 (Figure 2.16). Despite increasing to 1.0 percent of GDP in 2021, it remains one of the lowest levels in the region. PIT productivity, calculated as the ratio of actual PIT collection (as a percentage of GDP) to the highest statutory marginal rate, provides a measure of tax efficiency. PIT productivity is estimated at 0.035, which is low when compared to peer countries (Figure 2.17). This suggests that PIT collection efficiency is low. This is partly due to a narrow tax base (due to a focus on payroll rather than income, profits, and capital gains) and high levels of informality.

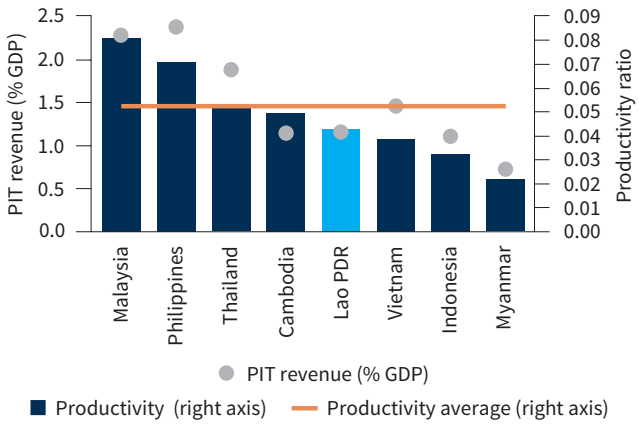
Figure 2.16: PIT collection (% GDP)



Source: International Monetary Fund and World Bank staff calculations.

Note: IQR: interquartile range, EAP-HIC: East Asia and Pacific, high-income countries, EAP-EME: East Asia and Pacific, emerging market economies.

Figure 2.17: PIT productivity ratio (2016 – 21)



Source: International Monetary Fund and World Bank staff calculations.

The 2019 Law on Income Tax has addressed several weaknesses of the PIT regime, but further improvements are needed. Taxes on labor income are now paid on a monthly basis but only reconciled annually. This helps deal with the volatility of monthly income and the risk that taxpayers artificially smooth their income to avoid the higher tax rate (e.g., year-end bonuses). The new law also simplified the tax rate schedule from six to five tax brackets, which can help improve compliance. However, tax brackets are not indexed to inflation. This may result in 'bracket creeping', as inflation erodes real wages and wage earners are subject to higher tax rates. Given low average incomes and higher informality when compared to other countries in the region, reforms should focus on enhancing efficiency and fairness. For instance, the PIT system could be simplified through a further reduction of the number of tax brackets (from five to four), which could help improve the efficiency of the PIT regime. In addition, tax brackets should be indexed to inflation to avoid bracket creeping.

2.3.2 Consumption taxes

Value-added tax

The statutory VAT rate was reduced from 10 to 7 percent in 2022, significantly undermining tax collection. The VAT was introduced in 2010 with a 10 percent rate, with some products being zero-rated. The 2021 amendment of the Tax Law introduced several changes to the VAT regime. The applicable VAT rate on the import of goods and services, supply of goods and services in the Lao PDR, and export of services was reduced from 10 to 7 percent from January 2022. The supply of goods outside a special economic zone (SEZ) by an enterprise registered for operation in the SEZ became subject to VAT.[79] Activities currently exempted from VAT include electricity imports, electricity supplied to any electricity enterprise within the country, and electricity and minerals exported overseas or to SEZs.

The VAT regime includes numerous exemptions, which pose several drawbacks. VAT exemptions create economic distortions by benefiting some sectors more than others.[80] Businesses unable to credit input VAT because they buy inputs from exempt businesses experience increased costs. On the other hand, if the exemption is applied at the end of the supply chain, it reduces VAT revenues. These negative effects of VAT exemptions make it important to examine the rationale for all exemptions.

VAT collection is relatively low compared to most regional peers, and so is VAT productivity and c-efficiency. VAT revenue dropped from 4.3 to 2.7 percent of GDP between 2015–2020, before recovering to 3.1 percent of GDP in 2021 (Figure 2.18). This was partly due to the economic slowdown (including COVID-19) but also VAT exemptions on imports of capital goods related to some investment projects. VAT collection declined to 2.7 percent of GDP in 2022, owing to the reduction in the VAT rate from 10 to 7 percent, which more than offset higher consumer prices. Although the VAT accounts for a significant share of domestic tax revenues, VAT collection is comparatively lower than in most ASEAN countries. In fact, it was the lowest revenue among peers with the same VAT rate, implying that it is underperforming considerably (Figure 2.19). Thailand collected 3.4 percent of GDP from VAT, even with a rate of 7 percent. Moreover, VAT productivity and c-efficiency have also been relatively low (Figure 2.20 and Figure 2.21). VAT productivity (0.35) and c-efficiency (0.64) were lower than the EAP average (0.44 and 0.67, respectively).

The recent reduction of the VAT rate has already had a negative impact on tax collection. The government reduced the VAT rate from 10 to 7 percent in January 2022, with the declared aim of expanding the tax base (by providing a stronger incentive for tax registration) and providing temporary relief to ease the impact of COVID-19. Meanwhile, the authorities tried to balance this cut with excise rate increases for selected products. However, since the rate increases were small, applied on a very narrow tax base, and subject to exemptions, the revenue gains are not sufficient to compensate for the VAT reduction of 3 percentage points on most goods and services. The VAT revenue loss is estimated at about 1 percent of GDP in 2022, while there is little evidence of an impact on consumer prices.[81] The 2021 revision of the Law on Income Tax aims to promote formality by encouraging SMEs to register for VAT through a favorable income tax regime. However, revenue increases through formalization will not be significant (as the experience of other countries suggests), since most VAT revenue comes from large (formal) taxpayers. Moreover, tax cuts may not necessarily lead to greater VAT registration due to other factors (e.g., additional costs such as bookkeeping).

Several VAT exemptions should be reviewed for elimination, particularly those that are costly. While some VAT exemptions for public services (such as health care and education) could be retained, other exemptions should be removed. For example, agriculture and forestry are common exemptions in developing countries, mainly because of the small scale of most agricultural activities and the low income of most people engaged in them. However, there are large agribusinesses and forestry operations in the Lao PDR that generate substantial revenues. Subjecting these sectors to the standard VAT regime is highly advisable. Small farmers will not be affected by this change, as they would be under the VAT registration threshold of 400 million kip. Subjecting these goods to VAT could allow producers and traders to claim credit for input VAT, improving efficiency.

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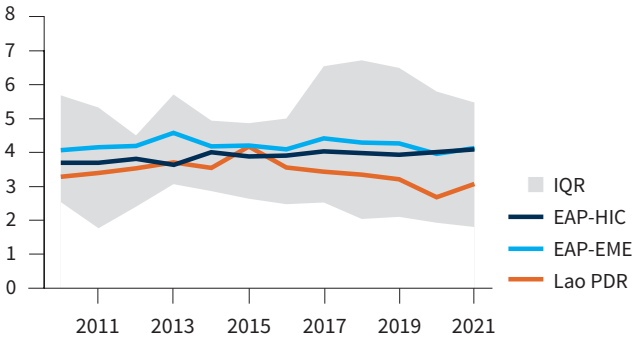
[79] Previously, only the supply of services outside a SEZ by a SEZ registered enterprise was subject to VAT.

[80] It is challenging to estimate foregone VAT revenues. For instance, VAT paid by businesses at importation (to customs department) is deducted from output VAT collected (by tax department), so there is a need to combine different data sources. Also, not all VAT exempted at the importation is revenue foregone. For example, large infrastructure projects are entitled to VAT refunds, since input VAT will be accumulated while output VAT is zero (in the development phase), so the VAT exemption at importation is merely to support cash flows and avoid VAT refund claims.

[81] There was no discernible impact on the consumer price index. Even if the VAT rate reduction was fully passed on to consumers, consumer prices would only be reduced by 3 percent, while VAT revenues are immediately cut by 30 percent. Limited revenue contributes to depreciation pressures, which are much more impactful on consumption.

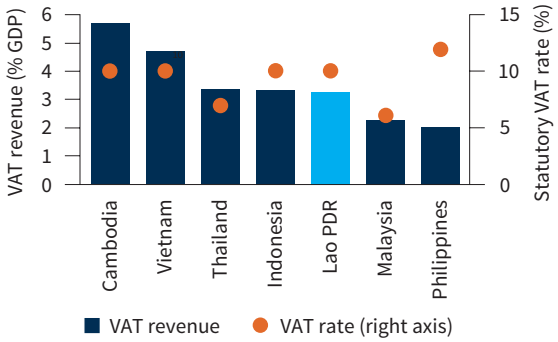
The management of VAT refunds needs to be improved to avoid negative impacts on businesses. The cost of VAT falls on businesses when refunds are not processed in a timely manner. A significant improvement in the amended 2018 Law on VAT was that all VAT taxpayers with a net credit could claim a VAT refund. Previously, only exporters and large-scale investors were entitled to VAT refunds, and all other taxpayers had to carry forward the excess input credits. However, there are challenges with the administration of VAT refunds. All refunds are subject to examination prior to the VAT refund decision. Businesses have experienced substantial delays in obtaining refunds, sometimes of more than one year. The VAT refund process could be improved through the adoption of a risk-based approach, improvements in the TaxRIS system to support VAT management, and adequate budget allocations for VAT refunds.

Figure 2.18: VAT collection (% GDP)



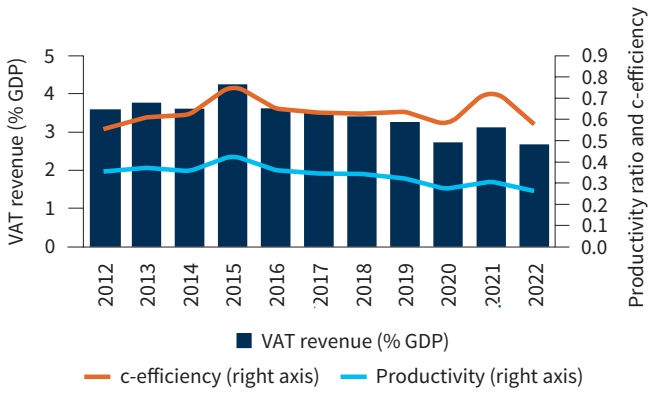
Source: International Monetary Fund and World Bank staff calculations.

Figure 2.19: VAT rate and collection (2016–21)



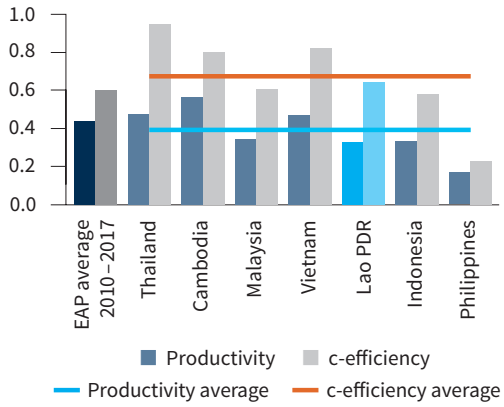
Source: International Monetary Fund and World Bank staff calculations.

Figure 2.20: VAT revenue, productivity, and c-efficiency



Source: Ministry of Finance and World Bank staff calculations.

Figure 2.21: VAT productivity and c-efficiency (2016–21)



Source: Ministry of Finance, USAID, and World Bank staff calculations.

Excise tax

Excises are levied on several products and services, mainly through ad valorem taxes. Excise taxes are applied to a wide range of domestic and imported goods and services, which are paid at importation and by domestic producers before releasing the products for distribution. Most excises use an ad valorem rather than a specific tax structure, with rates ranging from 3 to 110 percent. Some tax rates have fluctuated considerably over time, through both increases and reductions (Table 2.4). Fuel excise rates have gradually increased through time, despite some volatility, although they have been recently cut as a response to higher international fuel prices and exchange rate depreciation. Excise rates on vehicles (e.g., motorcycles and transport vehicles) vary significantly according to their engine volume. Alcoholic and non-alcoholic excise rates have increased marginally in the past 10 years. Tobacco has a mixed tax structure, with both ad valorem and specific taxes. However, some of these taxes are subject to reduced rates or exemptions under investment agreements. Moreover, some rates are levied at the early stages of the supply chain, which results in low effective tax rates.

Table 2.4: Selected excise rates (%)

	Product	2012	2019	2022
Fuels	Gasoline (super)	25	35	40
	Gasoline (normal)	20	30	31*
	Diesel	10	20	21*
	Kerosene (for aircraft)	10	8	8
Vehicles	Motorcycles (depending on engine volume)	10–25	25–100	28–110
	Transport vehicles (depending on engine volume)	-	25–90	26–102
	Speed boats, yachts, motorboats	15	20	25
Beverages	Alcoholic beverages (depending on alcohol content)	60–70	50–70	62–70–80
	Beer (depending on alcohol content)	50	50	20–60
	Non-alcoholic beverages (e.g., soft drinks, sodas, fruit juices, etc.)	5	5	7
	Non-alcoholic beverages (energy drinks)	10	10	12
Tobacco	Cigarettes	60	50	57**
	Tobacco (shredded)	60	35	42

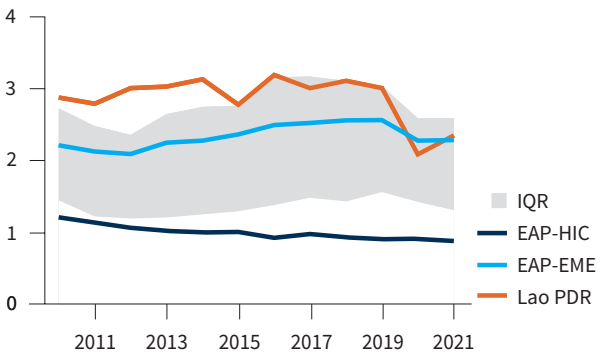
Source: Ministry of Finance, DFDL Co. Ltd. and VDB-Loi Co. Ltd.

Note: * Rates were significantly reduced in mid-2022 to 16 percent for normal gasoline and 0 percent for diesel. ** The rate can be reduced to 15 or 30 percent under an investment agreement. Some of these products are also subject to a specific tax per unit (e.g., cigarettes).

In most countries, excises are limited to a narrow set of goods with inelastic demand or negative internalities and externalities. Inelastic demand for a good makes its taxation convenient because the increase in consumer prices caused by the excise does not reduce demand to a significant degree.[82] Moreover, the negative internalities and externalities of some goods mean that their consumption has negative effects on the consumer and society. For example, fuel consumption creates pollution, tobacco creates health problems, and alcohol creates both health problems and anti-social behavior.[83] Taxing these goods more heavily than normal goods discourages their use (increasing overall social welfare) while also generating sizable revenues. However, the current tax level and tax structure are not sufficient to reduce the negative effects of these products and support revenue mobilization.

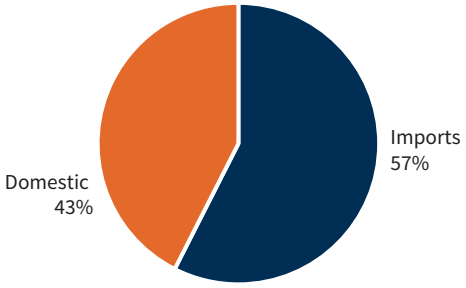
Excises comprise an important share of tax revenue, and collection is relatively high compared to regional peers. Excise revenue collection averaged 3 percent of GDP during 2010–2019, although it declined to 2.1 percent of GDP in 2020, partly due to the COVID-19 pandemic. This is reasonably high by regional standards (Figure 2.22). In 2022, revenue collection benefited from higher domestic and international prices, but this was partly offset by fuel excise rate reductions in mid-2022. Excises accounted for 23 percent of total tax revenues in 2021–2022. It is thought that most of the excise revenue accrues from vehicles and fuel, and thus collected from imports (Figure 2.23). The relative contribution of excises is high because the overall tax system generates relatively small revenue.

Figure 2.22: Excise collection (% GDP)



Source: International Monetary Fund and World Bank staff calculations.

Figure 2.23: Excise collection by source (2016–21)



Source: Ministry of Finance and World Bank staff calculations.

[82] Nonetheless, raising taxes too much could lead to lower revenue collection, due to a higher incentive to evade tax.

[83] 'Health taxes' are excises applied to products such as tobacco, alcohol, and sugar-sweetened beverages that cause health-related problems to individuals and society more broadly. These are one of the most cost-effective ways to reduce consumption of unhealthy products while raising much-needed revenue.

Recent reductions in fuel excise rates have produced large foregone revenues, while the tax structure could also be improved. An ad valorem excise is levied on several fuel types. It is estimated that recent rate cuts have generated losses (i.e., foregone revenues) of over $160 million between mid-2022 and mid-2023. While these measures were introduced to protect consumers from inflation, these cuts have predominantly benefited wealthier households. In addition, fuel imports reported by the Lao PDR are much lower than that reported by trading partners (e.g., Thailand and Vietnam). This suggests that a significant amount of fuel is not being taxed, which generates considerable revenue losses. Finally, as the price of fuels fluctuates frequently, the resulting excise revenue may not correspond to the externalities produced by fuel consumption. An alternative is to apply a specific tax system on fuel, whereby the specific tax considers the costs of air pollution, carbon emissions, vehicle accidents, congestion, and road damage, among others.

The Lao PDR has among the lowest tobacco taxes and prices in the region. The excise tax on tobacco accounts for 11 percent of the retail price of the most sold brand in 2020, the lowest in the region. This is much lower than the WHO's recommendation that excise taxes on tobacco should account for at least 70 percent of retail prices. Furthermore, the Lao PDR has the second-lowest retail prices in both US dollar and PPP-adjusted terms. Concerningly, cigarettes have become considerably more affordable in recent years. The most sold brand is nearly twice as affordable in 2020 when compared to 2010. Data for alcohol and non-alcoholic beverages were not available to conduct a similar analysis.

The tax structures for tobacco, alcohol, and non-alcoholic beverages can be improved. Tobacco has a mixed tax structure with a specific tax of 600 kip per pack of 20 cigarettes and an ad valorem rate of 57 percent of ex-factory prices (for domestic production) or the cost, insurance, and freight (CIF) price (for imports).[84] However, most cigarettes qualify for a 15 percent tax rate due to an investment agreement. Alcohol and non-alcoholic beverage excises are ad valorem applied to the ex-factory price for domestically produced goods and the CIF price for imported goods. Alcohol taxes are based on alcohol content, with tiers employed for beer with alcohol content above or below 5 percent. The most recent rates for other alcoholic beverages employ tiers with alcohol content below 10 percent, between 10 and 23 percent, and greater than 23 percent. Ad valorem taxes are considered less effective than specific taxes. From a fiscal perspective, they are more difficult to collect, more prone to tax avoidance and evasion, and result in less stable and lower revenue streams. From a health perspective, they result in lower prices on cheaper brands, which promotes consumption and makes products more accessible to vulnerable populations (e.g., youth, poor, and people with alcohol use disorders). Furthermore, tax increases are less effective since they provide greater opportunities for users to trade down to cheaper products to avoid the tax increase. The global trend indicates that modern tax administrations are leaning toward a simplified specific excise tax structure with indexation to maintain the value in real terms for all three products.[85]

The weakness of ad valorem taxes is compounded by applying them early in the supply chain. Using wholesale/ex-factory price or CIF as a tax base invites tax avoidance and evasion, since this information is provided by manufacturers and importers that have an incentive to lower their tax liability. Using retail price as the tax base is preferable because these can be verified independently by the authorities. However, this is still a less effective policy option compared to higher uniform specific taxes.

The current tax administration of the excise regime could be strengthened, especially for the cigarette market. A 25-year Investment License Agreement (ILA) signed in 2001 between the government and two tobacco companies established a joint-venture cigarette manufacturer. Under the ILA, the joint venture benefits from a reduced excise tax rate on tobacco products (15 percent of production costs if less than 1,500 kip per pack, and 30 percent if greater than 1,500 kip per pack) and exemptions from other taxes. Local tobacco companies are not complying with the mandatory contribution to the Tobacco Control Fund established in 2013.[86] The government should seek legal support to revoke or not renew the ILA. Furthermore, additional improvements would help to manage or mitigate potential losses associated with the lack of compliance (e.g., strengthened audits, enhanced data inputs and analytics, and a revised system of physical excise stamps leveraging digital technology).

The list of goods and services subject to excise taxes could be reviewed for rationalization. While many goods are subject to excise taxation, their rationale is not always clear since many do not produce significant

[84] Since the ad valorem tax is levied early in the supply chain, the excise collection as a share of retail prices is significantly lower. In 2022, the tax stamp fee was increased from 5 kip to 500 kip, but it appears to be collected unevenly.

[85] The indexation of specific unit taxes averts revenue erosion when the prices of excise goods increase. Unit rates can be indexed to inflation.

[86] The fund is supposed to receive 2 percent of the profit of tobacco companies and an additional 200 kip levied on each cigarette pack.

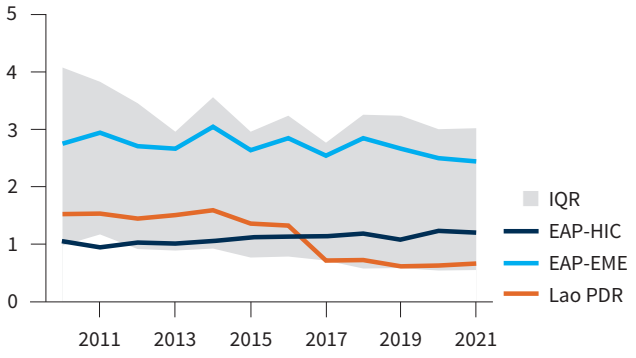
internalities or externalities. It is important to ensure that all goods and services in the excise list are worth the administrative and compliance costs that their collection entails. Excises can only be justified if they raise a reasonable amount of revenue and correct internalities or externalities.

2.3.3 Other taxes

International trade taxes

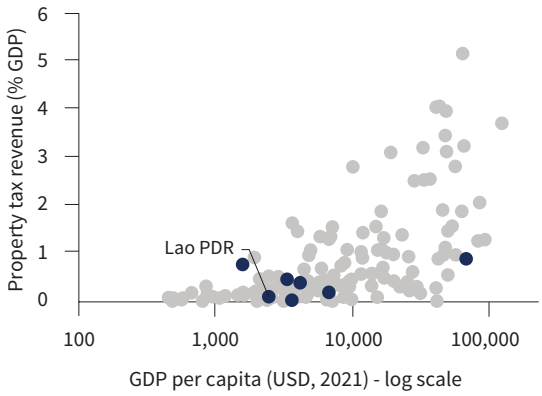
Revenues from trade taxes have been on a declining trend over the last ten years. Most trade taxes are derived from import duties. Revenue from trade taxes averaged 1.5 percent of GDP between 2010 and 2016 and sharply declined to about 0.7 percent of GDP since 2017 (Figure 2.24). This value increased to 1.2 percent of GDP in 2022, owing to rising imports (driven by higher prices), but it remains one of the lowest in the region. Trade tax rates have been reduced trough time. The average tariff rate applied (weighted mean) declined from 14 to 1 percent between 2000–2020, partly due to growing regional integration (particularly in ASEAN) and the World Trade Organization accession in 2013. However, this does not explain the performance gap to other countries in the region. Instead, generous tax incentives for large investments have significantly undermined trade tax collection.

Figure 2.24: Trade taxes collection (% GDP)



Source: International Monetary Fund and World Bank staff calculations.

Figure 2.25: Property tax collection (% GDP)



Source: IMF and World Bank staff calculations.
Note: Blue dots represent ASEAN countries.

Land and property taxes

Effective land tax rates are low, which considerably undermines revenue collection. The land tax exhibits low non-buoyant revenues, as tax amounts are determined by land type and size rather than land value. This is accompanied by rising tax inequity across land tax parcels and high economic and administrative inefficiencies. The unit tax rates are very low and have not been updated since 2007. Considering that land prices are rising rapidly, especially in urban areas, the effective tax rate for commercial and industrial land is estimated to range from about 0.005 to 0.01 percent. For instance, commercial land parcels in the Saysettha District (in Vientiane Capital) are estimated to pay an effective tax rate of 0.01 percent (maximum of 300 kip/m^2 on land valued at 3 million kip/m^2), while industrial land has an effective tax rate of 0.006 percent. In the same area, residential land owners pay an effective tax rate of 0.003 percent (80 kip/m^2).[87]

The revenue collected through the land tax is very low, but there is potential to enhance revenue mobilization. The land tax generated revenue equivalent to about 0.1 percent of GDP in 2021. This is very low by international standards, as similar taxes have generated 0.3–0.6 percent of GDP in low- and middle-income countries and up to 2–3 percent of GDP in several advanced economies (Figure 2.25). In 2016–2019, land tax collection ranked the second-lowest in the region (only behind Vietnam, where land tax rates are very low) and much lower than the average for the EAP region. These benchmarks suggest there is considerable potential to increase land tax revenues.[88]

[87] An analysis of land taxpayers in one village in Saysettha District shows they were paying a median land tax of 100,000 kip per year, with individual land tax bills ranging from 12,000–1,664,000 kip per year.

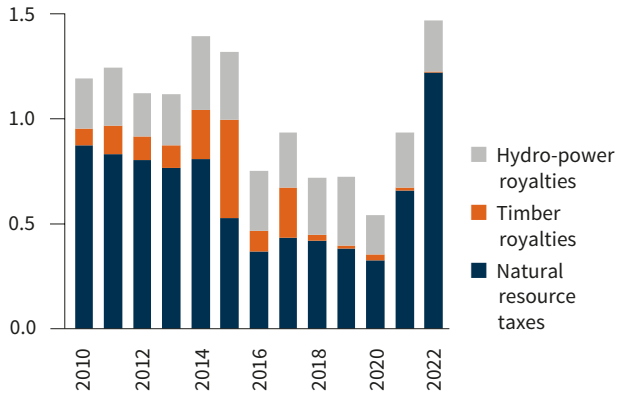
[88] Revenue could possibly double to 0.16 percent of GDP within 3–5 years, and perhaps double again to over 0.3 percent of GDP within 10–12 years.

To improve revenue mobilization, the unit rates should be revised and subsequently adjusted on a regular basis. Based on international norms, the effective tax rate should range between 0.1–0.2 percent for residential constructed land and between 0.3–0.5 percent for non-commercial/industrial constructed land. This would require a revision of the current unit rates, followed by adjustments on a periodic basis (e.g., every 3–5 years). These unit rates should be calibrated to the underlying absolute real land values. Capturing the absolute and relative changes in the underlying real land values would improve revenue buoyancy and the yield of land taxes. It would also improve taxpayer equity across land parcels and the cost efficiency of the land tax administration. Developing and implementing an adequate land valuation system will be key to supporting tax collection.

Natural resource taxes & royalties

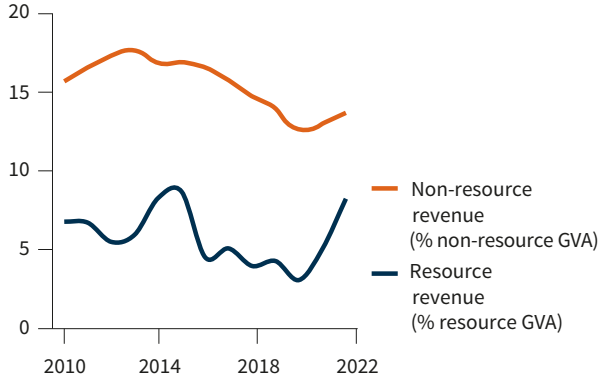
Revenue from natural resources has recently increased, but it remains low considering the weight of the sector in overall economic activity. Natural resource taxes & royalties declined from 1.4 to 0.5 percent of GDP during 2010–2020, but they have subsequently risen strongly to 1.5 percent of GDP in 2022 (Figure 2.26). Natural resource taxes mainly relate to mining activities. These revenues have increased partly due to a sharp exchange rate depreciation, since they are mainly collected in foreign currency, as well as higher production. Timber royalties were sizable in the mid-2010s, peaking at about 0.5 percent of GDP in 2015, but have recently become negligible.[89] Hydropower royalties have been relatively stable, at about 0.3 percent of GDP. However, this is very small compared to the level of investment and revenue generated by the hydropower sector. Overall, revenue collection has not kept pace with the exploitation of natural resources (e.g., mining and hydropower) and their contribution to economic growth, largely due to widespread and generous tax incentives (Figure 2.27).

Figure 2.26: Natural resource taxes & royalties (% GDP)



Source: Ministry of Finance and World Bank staff calculations.

Figure 2.27: Resource and non-resource revenue (% GVA)



Source: Ministry of Finance and World Bank staff calculations.
Note: Resources include forestry, mining, and electricity.

There is a need to undertake a comprehensive review of the regimes for natural resource revenues. The weak performance of natural resource revenues can be explained by the volatility of commodity prices, the complexity of tax arrangements, and the generous tax incentives provided by investment promotion policies or negotiated concession agreements. Domestic revenue improved significantly in the period 2003–2014, partly as strong commodity prices (e.g., copper and gold) led to significant investments in mining. Lower commodity prices and dwindling production have undermined revenues in recent years. Moreover, it is difficult to conduct a detailed assessment in the absence of relevant data on tax incentives. Given the importance of the sector to the economy, a comprehensive review of the legal framework and implementation arrangements of natural resource revenues is warranted to inform a reform agenda.[90]

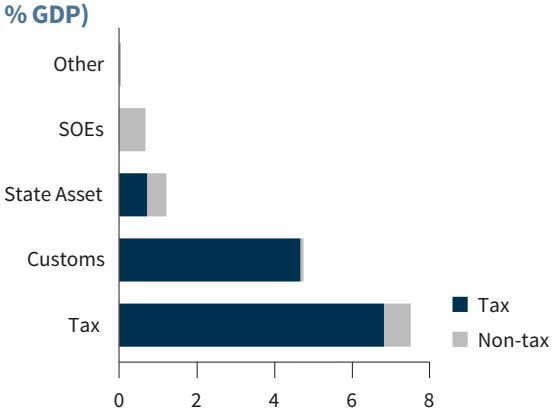
[89] This decline might be related to the rise in Forest Preservation Funds. Despite new legislation, policies, and plans to promote economic development through socially and environmentally sustainable forest management, illegal logging remains a challenge. There remain risks associated with the land allocation process (i.e., granting concessions).

[90] The government was expecting to collect significant revenues from cryptocurrency mining and trading, but these have not materialized.

2.4 Tax administration

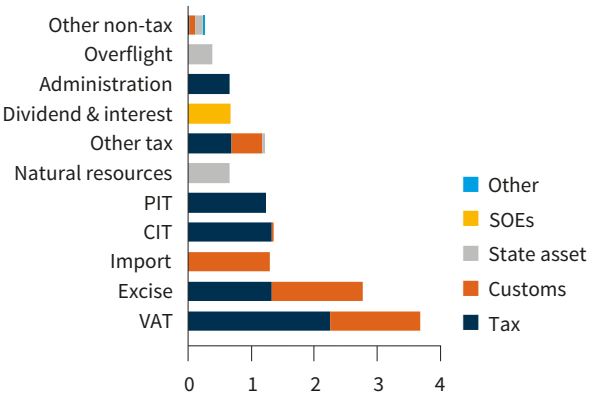
Domestic revenue is collected by several departments of the Ministry of Finance, but transparency has declined. Budget transparency has deteriorated in recent years, as the amount of information published in the state budget implementation reports has been considerably reduced, particularly for revenue. Detailed information on revenue collection ceased to be published in 2017 (e.g., disaggregation by province and department). Data for 2016 suggests that the MoF's tax and customs departments collect most of the revenue, although the state asset and SOE departments still collect important amounts (Figure 2.28). The tax department collects most income taxes (i.e., CIT and PIT) and administrative fees, as well as part of VAT and excises (Figure 2.29). The customs department collects VAT and excises at the border (levied on imports), as well as import duties. The state asset department receives natural resource revenues and overflight fees, while the SOE department collects dividends and interest from corporations with state equity. More granular information would be critical to evaluate tax performance over time.

Figure 2.28: Domestic revenue by department (2016, % GDP)



Source: MoF and World Bank staff calculations.

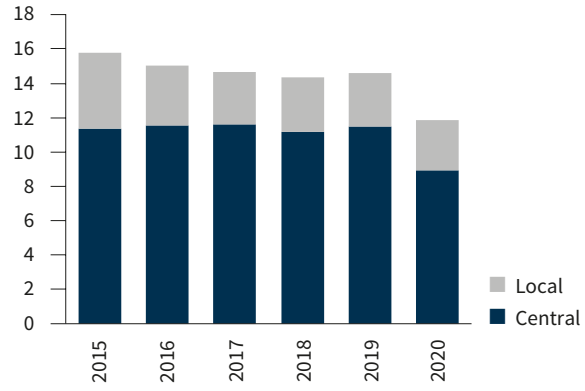
Figure 2.29: Domestic revenue (2016, % GDP)



Source: MoF and World Bank staff calculations.

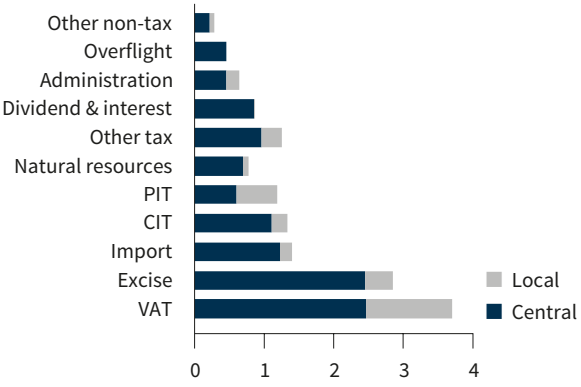
A significant amount of revenue is collected at the sub-national level, but further decentralization may create challenges. Most domestic revenue is collected at the central level, but local authorities have been collecting considerable amounts (Figure 2.30). There have been different waves of decentralization and recentralization of revenue collection over the past few decades. Local authorities collected significant amounts of PIT and VAT in 2016 (Figure 2.31). There has been a recent move to place many large taxpayers under the responsibility of provinces, with a view to support self-sufficiency. However, this can create inefficiencies and weaken existing controls.

Figure 2.30: Domestic revenue (% GDP)



Source: MoF and World Bank staff calculations.
Note: Data includes asset sales and capital return.

Figure 2.31: Domestic revenue (2016, % GDP)



Source: MoF and World Bank staff calculations.

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 to modernize the tax administration, particularly with the aim of improving the efficiency of tax

collection, reducing leakages, and increasing revenue. Nonetheless, the current system lacks critical features (e.g., automated late filing/payment notice, automated risk analysis, and data analysis capabilities) and staff are not using all functionalities. The approval of the Tax Administration Law has strengthened the legal framework, but it is crucial to ensure that the law is adequately implemented. Efforts to build the capacity of tax officials are aimed at increasing operational efficiency. However, developing a modern, efficient, and effective tax administration requires further improvements in processes, technology uptake, staff capacity, and transparency.[91]

There is no strategic planning function at the central level, which likely undermines tax performance. Strategic plans should cover all aspects of the tax administration and must be revisited regularly, since the operating environment is not static. There is a division in the MoF's tax department responsible for planning, but it has not yet performed activities typically performed by a modern tax administration. Effective strategic planning would enhance operational performance and facilitate the allocation of scarce resources to areas that pose greater compliance risks. This should cover all core business activities and take into consideration the environment in which the tax administration operates.

The tax department has not yet adopted a comprehensive risk management framework. A risk-based audit approach has been piloted in the past several years. A risk-based analysis unit has been established, but the concept of risk management is limited to the audit function at headquarters and the Vientiane Capital tax office, although there is a plan to expand implementation to other provinces. There is a need to develop and implement a comprehensive compliance improvement strategy and the related annual compliance improvement plans across tax administration functions.

Recent changes are likely undermining compliance risk management, particularly for large taxpayers. It is critical to adequately manage the special risks that large taxpayers pose (e.g., by ensuring consistency of treatment for a corporation that has subsidiaries and branches in different provinces). Centralizing the management of large taxpayers in a single unit would significantly improve tax compliance and efficiency. International evidence shows that, on average, large taxpayer offices or programs employ less than 10 percent of total revenue staff and collect over 50 percent of revenue.[92] Most tax administrations in advanced economies and the EAP region have dedicated large taxpayer offices (LTOs).[93] However, current arrangements are limited in the Lao PDR. The MoF's revenue management division at headquarters previously assumed the management responsibility of about 400 large taxpayers, but this has been undermined by the reallocation of responsibilities for many taxpayers to provinces. Recent organizational changes (e.g., the split of the revenue management division) represent a further deviation from good international practices.

Tax audits can increase compliance, but there is a significant gap between current and good international practices. Tax audits are undertaken for several reasons, such as detecting and redressing individual cases of non-compliance. They also promote voluntary compliance by increasing the probability of detection and penalties for non-compliant taxpayers. Moreover, they enable the gathering of information on the performance of the tax system and the evasion techniques used by taxpayers. Finally, audits provide an opportunity to educate taxpayers on their legal obligations and bookkeeping requirements, thereby improving future compliance. However, there is currently a significant gap between current audit processes and good international practices. For instance, there is no structured approach to audit planning and implementation, and no systematic cross-checking using third-party information (e.g., customs data). Moreover, tax inspectors are routinely rotated from and to non-audit functions, which is not efficient.

Audit strategies need to be developed within the context of compliance risk management. Compliance risk management is a structural process for the systematic identification, assessment, ranking, and treatment of tax compliance risks. The tax administration should seek to maximize voluntary compliance (e.g., through taxpayer assistance and education programs), but it must also have effective enforcement strategies to deter, detect, and address non-compliance. The level of scrutiny and intensity of audit activity should depend on the level of risk to revenue, which is related to the segment where the risks occur. Segments may be based on business size (e.g., large taxpayers), industry (e.g., mining), or the type of tax (e.g., corporate income tax). Different types of audits are appropriate for different objectives, aiming to focus tax audits on taxpayers that pose a higher risk to revenue.

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[91] Using the World Bank's Tax Administration Index tool would provide a brief assessment of the revenue administration.

[92] IMF Revenue Administration Fiscal Information Tool (RA-FIT).

[93] See the OECD report "Tax Administration 2015" and the ADB report "A Comparative Analysis of Tax Administration in Asia and the Pacific".

Modern tax administrations are increasingly using technology to support audit operations. Tax administrations are leveraging new technologies to combine automated audits with comprehensive ones (e.g., to detect fraud). This allows increases in audit coverage and risk perceptions, as well as a better allocation of resources. Higher compliance rates are often achieved when information from third-party sources is systematically matched with the information contained in tax returns. Tax administrations are increasingly using big data to effectively monitor compliance with tax obligations. Recent advances in artificial intelligence are already being deployed in this area.

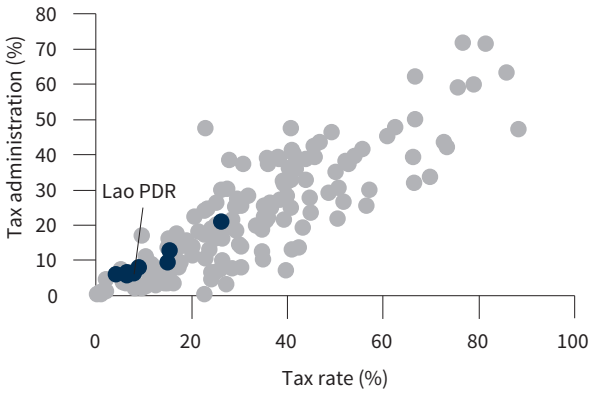
Taxpayer services can improve tax compliance, but there is currently no dedicated unit or strategy to deliver these services. Taxpayer services can be defined as a set of strategic initiatives to assist taxpayers in complying with their tax obligations. These often comprise outreach and tax education programs. Taxpayer services and information can be tailored by taxpayer segments, based on attitudes and the underlying factors of non-compliance. Tax administrations often set service delivery standards and measure performance (e.g., time to answer taxpayer inquiries, process tax refunds, and resolve disputes). While some services are currently provided to support the rollout of TaxRIS (e.g., e-filing and e-payment), there is no dedicated unit or strategy to provide services in support of voluntary compliance.

The collection of taxpayer data is insufficient, and there is limited access to third-party information. Tax returns provide limited information for compliance and analytical purposes. For instance, the CIT return form is one-page long and only includes eight data fields. It does not provide information on financial performance (e.g., turnover, investment, and depreciation) or relevant information to estimate the cost of tax incentives (e.g., income subject to CIT and exempted income). In comparison, the CIT return form in Cambodia is 20 pages long and has over 100 data fields. The absence of relevant information precludes assessments of tax policy (e.g., estimation of tax expenditures). Moreover, the MoF's tax department does not have access to third-party information, except for customs data. Even then, customs data is rarely used for systematic cross-checking. Therefore, it is crucial to improve data collection, integration, and analysis to strengthen evidence-based policy making.

Adequate staff levels and capacity are critical to perform the different functions of a modern tax system. An efficient and effective tax administration requires a solid regulatory framework, clear processes, suitable technologies, and adequate staffing. While capacities are low, the transition to electronic filing and payment provides an opportunity to reallocate staff resources. The staff levels needed in return processing will decline with the increasing uptake of electronic processing. With appropriate training programs, staff can be re-trained to work in other functions currently under-resourced, such as taxpayer services, debt management, or even audit.

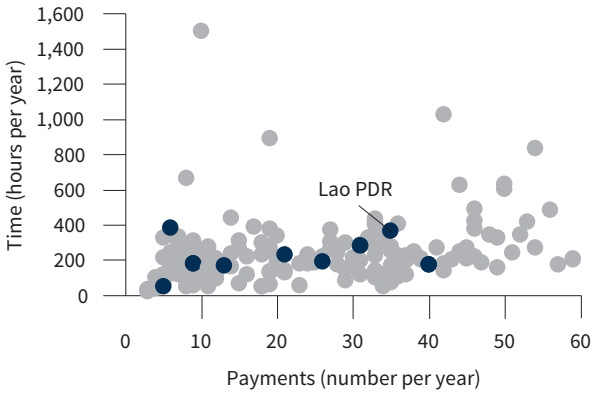
The tax administration places a significant burden on business, while corruption is a major concern. Only a small proportion of firms identified tax rates or tax administration as a major constraint to their business (Figure 2.32). The former is not surprising, owing to low statutory tax rates and the widespread granting of reduced rates and exemptions. However, complementary evidence suggests that businesses need to make a significant number of tax payments per year, which require a considerable amount of time to prepare, file, and pay (Figure 2.33). The total tax and contribution rate is relatively low as a share of profits, but the post-filing score is also low,

Figure 2.32: Firms identifying tax as a constraint (%)



Source: World Bank Enterprise Surveys.
Note: Blue dots represent ASEAN countries.

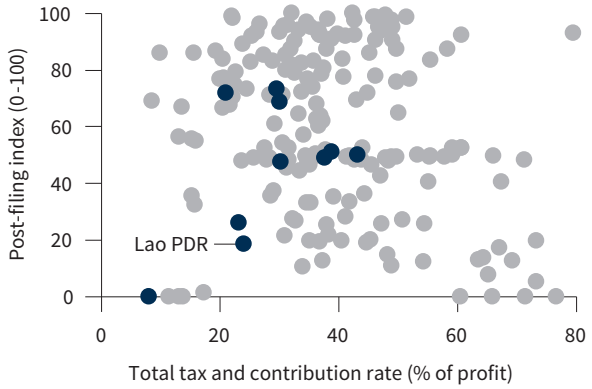
Figure 2.33: Burden of paying taxes



Source: 2020 Paying Taxes.
Note: Horizontal axis restricted to 60 to improve readability.

suggesting challenges with VAT refunds and CIT corrections (Figure 2.34). Most firms (85 percent) were visited or required to meet with tax officials, with an average of three visits per year, which is higher than regional and income averages. Concerningly, a significant proportion of firms (35 percent) were expected to give gifts in such meetings, the eighth largest value of 155 countries (Figure 2.35). Accelerating the modernization of the tax administration (e.g., through further digitization and adoption of a risk-based approach) would help reduce bureaucracy, as well as mitigate corruption and tax fraud.

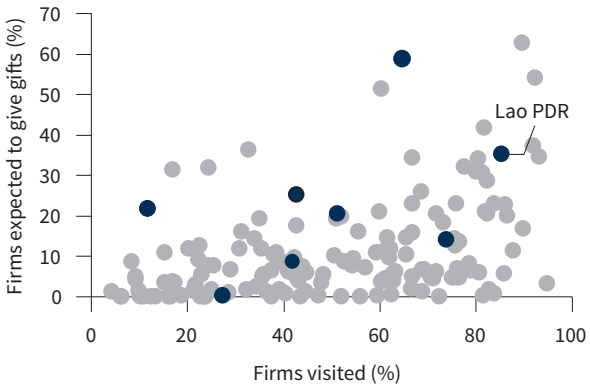
Figure 2.34: Tax burden and post-filing



Source: 2020 Paying Taxes.

Note: Horizontal axis restricted to 80 to improve readability.

Figure 2.35: Corruption in tax collection



Source: World Bank Enterprise Surveys.

2.5 Conclusion and recommendations

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. Tax revenue fell from 14 to 11 percent of GDP in 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 from 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. 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. These trends have reduced fiscal space for critical public spending, while threatening fiscal sustainability.

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 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 23 percent of tax revenue in the same period and were almost exclusively derived from the corporate income tax (CIT) and the personal income tax (PIT). Tax revenue collection has not kept pace with economic activity, with poor performance mainly driven by the 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).

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, 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 PIT top marginal tax rate (25 percent) is also lower than most regional and income peers. 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 only reaching about 60 percent of its full potential, implying that there is ample scope for policy and administration reforms. Tax effort was measured at about 0.6 during 2010–2016, meaning that tax collection was lower than the average tax yield for countries with similar characteristics. Hence, there is considerable potential to mobilize additional domestic revenues. Tax effort is affected by tax structure (e.g., tax rates and tax base) as well as tax administration and compliance. Tax effort 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 to modernize the tax administration, particularly with the aim of improving the efficiency of tax collection, reducing leakages, and increasing revenue. Nonetheless, the current system lacks critical features (e.g., automated late filing/payment notice, automated risk analysis, and data analysis capabilities), and staff are not using all functionalities. The approval of the Tax Administration Law has strengthened the legal framework, but it is crucial to ensure that the law is adequately implemented. Efforts to build the capacity of tax officials are also bearing some fruit. However, developing a modern, efficient, and effective tax administration requires further improvements in processes (which should be standardized and transparent), technology uptake (e.g., automation), and staff capacity. This would also help build confidence in the tax administration (e.g., by reducing corruption risks).

Bold tax reforms are needed to ensure that revenue levels are adequate to sustainably finance growth-enhancing public spending and debt service obligations. Poor revenue performance significantly impacts fiscal space and the availability of foreign exchange, thus jeopardizing fiscal and debt sustainability, as well as broader macroeconomic stability. Moreover, a modern tax system should raise revenues efficiently and equitably. A prioritized and sequenced set of tax reforms (relating to both policy and administration) should be pursued in the coming years. Measures to expand the tax base, diversify revenue sources, and improve compliance are key to generating sufficient domestic resources to meet large financing needs (e.g., social spending and debt servicing).[94] However, strong political commitment and ownership is needed.

Restoring the VAT rate to 10 percent would immediately and efficiently raise considerable revenue. The current rate of 7 percent (introduced in 2022) is one of the lowest in the world, which severely undermines revenue mobilization. Restoring the rate to 10 percent could generate at least 1 percent of GDP in additional VAT revenue while having a limited impact on inflation or inequality.[95] Part of the additional revenue should be earmarked to support the most vulnerable households through targeted cash-transfer programs.[96] Even at this level (10 percent), the standard VAT rate would remain very low by international standards. Moreover, VAT exemptions should be reviewed and streamlined, since they distort economic activity and can cause tax cascading. For instance, exemptions for large-scale agricultural and forestry activities (e.g., businesses larger than 400 million

[94] Research shows that large tax revenue increases are associated with reforms of indirect taxes and exemptions, often supported by tax administration reforms, with sustainability hinging on reforms in the key compliance areas (risk-based audits, registration, filing, payment, and reporting). There is also evidence that tax reforms require major political consensus and that these tend to occur following major economic crises. Successful reforms tend to broaden the tax bases by significantly curbing exemptions and other special treatments.

[95] Even if this increase would fully translate into higher consumer prices (leading to a 3 percent increase, albeit in a context of high inflation), this would need to be set against a counterfactual of limited revenue mobilization that fuels further exchange rate depreciation pressures and thus domestic inflation. Moreover, the VAT is a progressive tax, from a distributional perspective.

[96] Even if only 10 percent of the additional revenue was allocated to a cash-transfer program, the budget for social assistance could be doubled from the current 0.1 percent of GDP.

kip) should be eliminated. Finally, adopting and implementing legislation to extend the scope of VAT to cover cross-border digital services could generate additional revenue. In the medium-term, VAT compliance can be improved through the full implementation of the Tax Revenue Information System (TaxRIS), the improvement of tax services, and the enhancement of institutional and technical capacities.

Revising the Law on Investment Promotion would help curb tax incentives and broaden the tax base. The current tax incentive system is predominantly based on tax holidays and reduced rates (relating to corporate income, value-added, import duties, and royalties), which are a costly and inefficient means of encouraging investment. 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 (in line with international best practice), particularly with a view to rationalizing the incentive regime and reducing discretion. While special incentives currently need to be approved by the National Assembly, stricter requirements should be adopted (e.g., ex-ante cost-benefit analysis). These reforms would require a revision of the Law on Investment Promotion. In addition, improving the monitoring of tax incentives would support improved scrutiny of compliance and enable an assessment of their effectiveness. The creation of a centralized tax incentive database/repository in the Ministry of Finance would enable the authorities to estimate foregone tax revenues and undertake cost-benefit analyses. The corporate tax return form should include relevant information to better monitor and assess tax incentives, while exempt businesses should still submit CIT returns. Meanwhile, undertaking an assessment of the largest concession agreements would provide a tentative estimate of foregone revenues and an evaluation of the legal scope for revision. Finally, the introduction of anti-avoidance rules against profit shifting (i.e., transfer pricing rules) and other international taxation frameworks should also be considered to protect the tax base. This should also include provisions for direct taxation of the digital economy to embrace this growing component of the economy.

Reforming excise tax structures and increasing rates, particularly on beverages, tobacco, and fuel, could 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 of 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. Overall, reforming structures and raising excise rates on products with negative (health, environmental, and social) internalities and externalities could generate several positive outcomes.[97] These tax policy reforms ought to be accompanied by improvements in tax administration to avoid leakages (e.g., tax evasion). This can be achieved by accelerating digital transformation (e.g., introducing a track and trace system) and other reform opportunities (e.g., audit). Given existing knowledge gaps (e.g., market size, prevalence, price dispersion, price/income elasticities), it is imperative to improve data collection and analysis to support evidence-based policy reforms.

Reforming the land tax and preparing for the introduction of a property tax would be key to boosting 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. The National Assembly has recently approved the new Land Tax Law, which changes the tax base from size to value of the land. This will help raise effective tax rates and thus improve the fairness of the property tax regime. Developing and implementing an adequate land valuation system will be key to supporting tax collection.

Strengthening compliance risk management by focusing on the administration of large taxpayers would increase revenue and enhance efficiency. Improving tax administration is crucial to increase revenues and 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.

[97] Some of these goods can be considered luxury or non-essential. Taxing goods typically consumed by the wealthy can generate considerablerevenue and promote equity (which could strengthen social cohesion), particularly given the difficulty of taxing high incomes and assets.

It is therefore critical to re-establish a dedicated large taxpayer office (LTO) and recentralize large taxpayer management. There is also a need to improve capacities in key functions (e.g., audit, taxpayer services, and data management and analysis) and then expand to other areas. This program should take into account the implementation of the TaxRIS and the issue of staff redundancy associated with automation. Moreover, it would be important to broaden e-services offerings through an integrated ICT solution, which could be done by expanding TaxRIS to include more sophisticated tax administration features. A modern IT system would allow the tax administration to adopt efficient and effective business processes and facilitate business continuity. The use of big data and artificial intelligence can play a key role in modernizing tax administration.

3

Public Expenditure



3. Public Expenditure

Enhancing the quality of public spending is crucial for rebuilding human capital and accelerating economic growth, particularly given pressing fiscal constraints. Government expenditure levels have declined from 24 to 15 percent of GDP between 2013 and 2022, largely because of poor revenue performance, and are very low by international standards. An expenditure-led fiscal consolidation has compressed spending in many categories, jeopardizing the quantity and quality of public service delivery. While public expenditure has had a positive impact on economic activity, there is limited fiscal space to support a strong and sustained recovery. With debt service obligations growing, non-interest spending will remain under pressure. Expenditure trends on education and health are worrying, especially since the economic, health, and social impacts of COVID-19 have drastically eroded human capital. The combined spending on education and health fell from 4.9 to 2.6 percent of GDP during 2013–2022, which would have been less than interest payments in the absence of large debt service deferrals. Fiscal pressures are compounded by several challenges relating to public financial management, with poor planning and weak commitment controls appearing to be major weaknesses. Institutional fragmentation is also a concern. Despite limited fiscal space, there is scope for fiscal adjustments, particularly to reprioritize and reallocate resources across and within categories. More and better spending on growth-enhancing sectors is crucial to enhance medium-term economic prospects, but the lack of comprehensive information (i.e., budget transparency) undermines an assessment of potential budget savings. Overall, fiscal discipline is essential to secure fiscal sustainability, while improving the quality of public spending is critical for rebuilding human capital and accelerating economic growth, as well as for reducing poverty and promoting inclusiveness.

Main recommendations: (i) reallocate spending toward education, health, and social protection to avoid a collapse in human capital; (ii) strengthen spending controls to avoid the accumulation of further expenditure arrears; (iii) report data for all spending units to increase budget transparency and accountability; (iv) enhance budget preparation and execution, with a focus on procurement and public investment management, to improve the impact of public spending; and (v) improve human resource planning to enhance the effectiveness of the civil service.

Chapter structure: The chapter starts by providing a brief overview of aggregate expenditure trends, followed by a detailed analysis of the composition of spending. Subsequently, it discusses issues related to the efficiency, effectiveness, and equity of public spending. Granular analysis is based on data published in state budget implementation reports for the period 2011–2020. The main public financial management, bottlenecks are highlighted. Key recommendations are presented with a view to improving the impact of public spending while securing fiscal sustainability.

3.1 Background

The five-year National Socio-Economic Development Plans guide the preparation of sector plans and state budgets. The planning process is led by the Ministry of Planning and Investment (MPI) and is articulated through five-year National Socio-Economic Development Plans (NSEDPs). These plans include aspirational targets for several economic indicators, but it is unclear to which extent the underlying assumptions are based on a consistent macroeconomic framework. The NSEDP provides guidance for the state budget prepared by the Ministry of Finance (MoF) and sector plans.[98] The NSEDPs are not fiscally constrained, which puts pressure on MoF to increase revenue.[99] Plans are seldom revisited to reflect new developments, while the availability and reliability of timely and comprehensive budget data also pose challenges.

The budget planning process is established in the State Budget Law, although it is not always strictly complied with. The State Budget Law, which was revised in 2015 and 2021, provides a sound basis for the budget process based on a budget calendar with sequenced activities. However, substantial delays are often experienced, which

[98] Lao PDR has a dual budgeting system, whereby the recurrent budget is under the responsibility of the Ministry of Finance (in coordination with line ministries), while the elaboration of the capital budget is under the mandate of the Ministry of Planning and Investment.

[99] The recently approved NSEDP Financing Strategy outlines useful qualitative approaches to mobilizing resources for development, but it is not intended to define an expenditure framework.

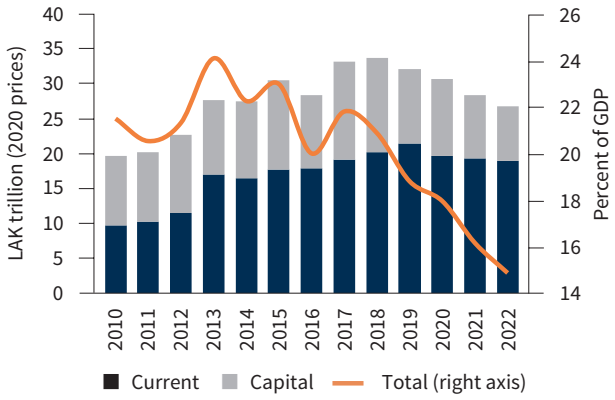
undermines the process. In recent years, the MoF has been working toward implementing the law's provisions to strengthen the medium-term orientation of the budget. Aggregate expenditure ceilings for the budget year were approved by the government and issued for the fiscal years 2021, 2022, and 2023. In April 2023, the government adopted a new prime ministerial decree on budget planning, which implements the law's provisions for the preparation of a state budget policy statement and medium-term budget plans with ceilings (for the next budget year and indicative allocations for the two outer years) for budget entities. The decree also sets out a detailed budget planning process.

Fiscal accounts have shortcomings in terms of data availability, coverage, and quality.[101] Fiscal data is compiled and reported on a cash basis. The current Government Financial Information System (GFIS) does not cover the entire public sector and is not yet deployed at the district level, which leads to delays in consolidating information. Public spending is recorded with the support of a chart of accounts, which comprises an economic classification (by appropriation category) and an administrative classification (by institution).[102] However, there is currently no functional classification to enable an accurate analysis of spending by sector, such as education and health. This is approximated through spending undertaken by related administrative units (i.e., ministries and provinces) and may thus not include relevant spending that takes place under other spending units. A new chart of accounts is being finalized, which will improve the comprehensiveness of recording and reporting of public spending. Some spending items are likely misclassified, such as externally financed recurrent expenditures recorded under capital spending. Budget data is not reported for all ministries and organizations, which considerably undermines budget transparency, while large expenditure arrears and extra-budgetary funds are also a concern.

3.2 Level and composition of spending

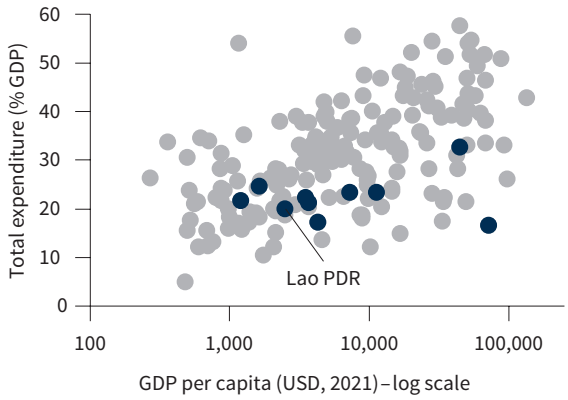
The level of government spending has declined considerably and is very low by international standards. Total public spending has been falling in real terms since 2018, but the decline is even more pronounced as a share of GDP (Figure 3.1).[103] Expenditure declined from 24 to 15 percent of GDP between 2013 and 2022. This spending compression was mainly caused by weak revenue performance and the need to avoid high fiscal deficits. The level of aggregate public spending is lower than most regional and income peers, especially considering that it was even lower in 2022 (Figure 3.2). Given population growth and large needs associated with the impacts of COVID-19, the decline in spending is likely undermining public service delivery. There are concerns about spending adequacy, particularly in sectors that have a lasting impact on economic growth, poverty, and equity.

Figure 3.1: Expenditure (Lao kip and % GDP)



Source: Ministry of Finance and World Bank staff calculations.

Figure 3.2: 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.

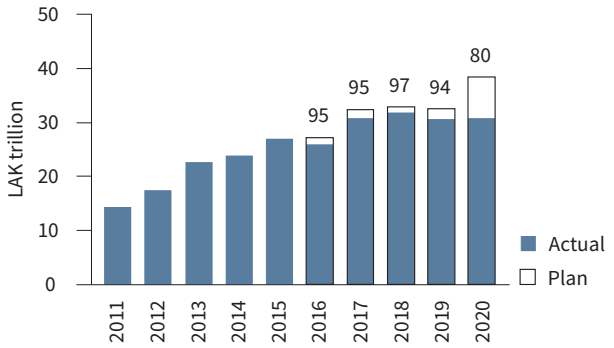
[100] Data quality refers to accuracy, completeness, reliability, relevance, and timeliness.

[101] Detailed data has been compiled from the yearly state budget implementation reports published in the official gazette. Given the lack of access to the raw data from the GFIS, this chapter relies on a newly compiled fiscal database drawing on the digitized hardcopies of these detailed reports.

[102] The fiscal year ran from 1 October to 30 September until 2016. From 2017 onwards, the fiscal year coincides with the calendar year. For the purposes of this chapter, the last year of the old fiscal year will be mentioned in the text (e.g., 2015-16 will be 2016).

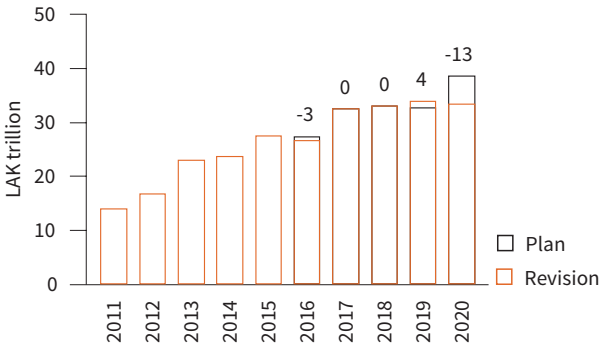
Budget execution has been relatively high, but the large accumulation of expenditure arrears undermines budget performance. The lack of a (credible) fiscal framework and a medium-term perspective on planning and budgeting contributes to a weak linkage between policy and the budget. To assess budget execution, a focus on the initial (rather than the revised) budget is warranted since it is likely to provide better insights into the credibility of the budget process and implementation capacity. Systematic over- or under-budgeting can reflect poor planning, budgeting, or implementation. For instance, there might be a weak link between planned activities and the proposed budgets, or an inability to adjust initial budget requests to the approved allocation. Budget execution averaged 95 percent between 2017 and 2019, although it dropped significantly in 2020, likely due to COVID-19 (Figure 3.3). High execution rates partly reflect the large share of wage expenditure (which are typically simple to execute), but the data masks challenges in the capital budget, namely expenditure arrears. Large arrears have been accumulated, largely due to off-budget projects in the context of weak commitment controls.[103] Improving planning, budgeting, and implementation is key to enhancing budget performance. For instance, plans should be realistic and adequately costed, budgets should be aligned with stated priorities, and implementation should be improved through public financial management reforms (e.g., commitment controls, procurement, internal controls, and treasury operations).

Figure 3.3: Budget execution (Lao kip and %)



Source: MoF and World Bank staff calculations.

Figure 3.4: Budget revisions (Lao kip and %)



Source: MoF and World Bank staff calculations.

Budget revisions have been relatively small, except in 2020, when the COVID-19 pandemic affected budget implementation. The initial budget approved by the National Assembly can undergo modifications, usually through a 'budget adjustment' that revises the budget in case of higher/lower-than-expected revenue collection, policy changes, or unexpected events. For instance, if revenue collection is 5 percent or more below target, then the Ministry of Finance can request the government to propose an adjustment of the budget plan to the National Assembly. While this flexibility enables the budget to respond to changing circumstances, it can also undermine the credibility of the budget as a statement of government policy, if adjustments are due to poor planning and budgeting or are politically motivated. In the Lao PDR, the need for budget adjustments seems to stem from the overestimation of revenue, which is linked to poor revenue forecasting. The budget was revised downwards in 2020, as the COVID-19 pandemic affected budget execution owing to revenue shortfalls and implementation challenges (Figure 3.4).

3.2.1 Economic classification

The decline in public spending has affected most categories, particularly wage and capital spending. The economic classification comprises the following divisions (numerical codes in brackets): wages & salaries (60), allowances (61), materials & supplies (62 and 66), subsidies & transfers (63), financial (64), miscellaneous & contingencies (65), and capital (67).[104] Public expenditure increased up until 2013, reaching a peak of 24 percent of GDP (Figure 3.5). This was mostly driven by large hikes in capital spending and wages & salaries. Capital spending reached 11 percent of GDP in 2012, while wages & salaries reached 9 percent of GDP in 2013 (Figure 3.6). However, public expenditure has been falling in relative terms since 2013, especially wages & salaries and capital expenditure.

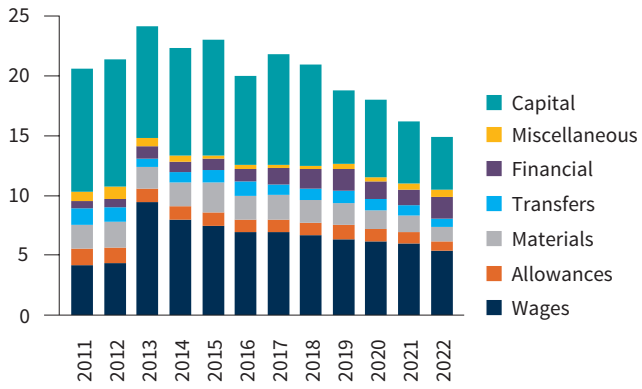
[103] Expenditure arrears have been identified as a major weakness of the public financial management (PFM) system. See the 2018 Public Expenditure and Financial Accountability (PEFA). These arrears mainly relate to sub-national investment projects that, although approved by the planning authorities (e.g., MPI and National Assembly), have not been included in state budgets. The existence of large expenditure arrears undermines an accurate assessment of budget execution, since these imply over-execution.

[104] Materials & supplies includes operations & maintenance (division 62) and purchasing of materials (division 66).

Curbs on wages & salaries (e.g., wage freeze and lower recruitment), capital spending (limits on new projects), and other recurrent expenditures (e.g., purchase of goods and services) have been necessary due to declining revenue, limited access to finance, and emerging expenditure arrears. However, financial expenditure (mainly interest payments) has been increasing, despite recent debt service deferrals, which is further compressing fiscal space. In the absence of these deferrals, interest payments would have surpassed 3 percent of GDP in 2022.[105]

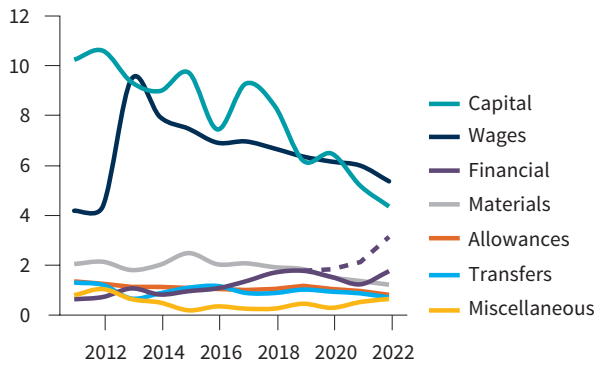
Wage and capital expenditures continue to account for most outlays, despite recent declines. The relative weight of each category can provide an indication of the overall fiscal strategy. Wage and capital spending have been the largest categories despite some volatility (Figure 3.6). Wages & salaries rose sharply to 39 percent of total spending in 2013, declining to 35 percent in 2022. Capital expenditure has gradually fallen from 50 to 32 percent of total spending between 2012 and 2022. Nonetheless, wage and capital spending still accounted for about two-thirds of total expenditure in 2022. Wage expenditure is dominated by salaries, while capital spending is mostly financed through external sources such as loans and grants (Figure 3.7).

Figure 3.5: Expenditure (% GDP)



Source: MoF and World Bank staff calculations.

Figure 3.6: Expenditure (% GDP)

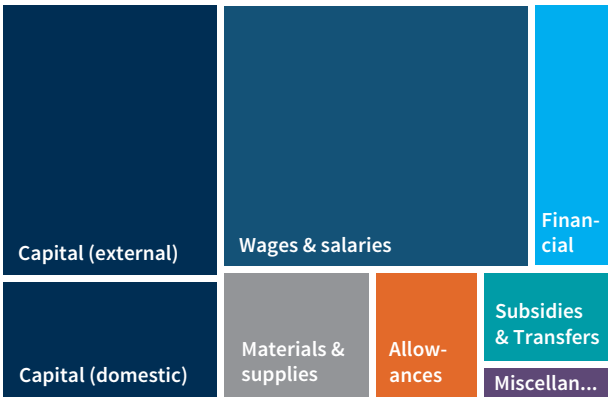


Source: MoF and World Bank staff calculations.

Note: Dashed lined represents financial expense in the absence of external debt service deferrals.

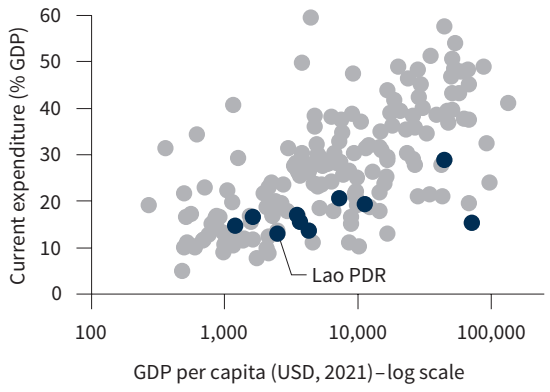
Recurrent spending is low by international standards, and it is likely undermining public service delivery. Recurrent spending is typically associated with expenditures necessary for the basic functioning of the government and public service provision. Spending restraint, particularly on wage expenditure, has led to a relative decline of recurrent spending from 17 to 11 percent of GDP between 2013 and 2021, which is low by regional and income standards (Figure 3.8). However, there is significant variation across categories. Spending on wages accounts for a

Figure 3.7: Expenditure (2020, % total)



Source: Ministry of Finance and World Bank staff calculations.

Figure 3.8: Current spending (% GDP, 2016–21)



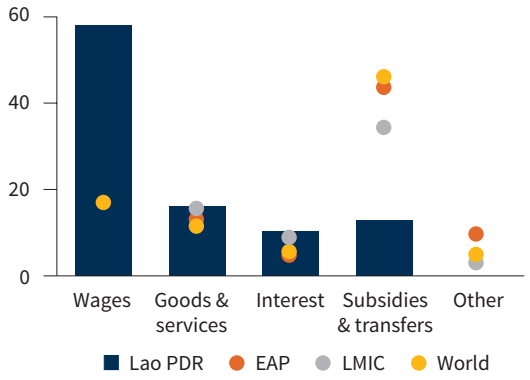
Source: International Monetary Fund and World Bank staff calculations.

Note: Vertical axis limited to 60 to improve readability.

[105]This is based on data from the MoF's public debt bulletin. There are discrepancies across official sources. The budget implementation reports state 2.6 trillion kip in 2020, compared to 3.2 trillion kip in the public debt bulletin. This might be due to a recording issue (e.g., timing), as fiscal data reported by the MoF shows 2.3 trillion kip in 2021, compared to 1.6 trillion kip in the public debt bulletin.

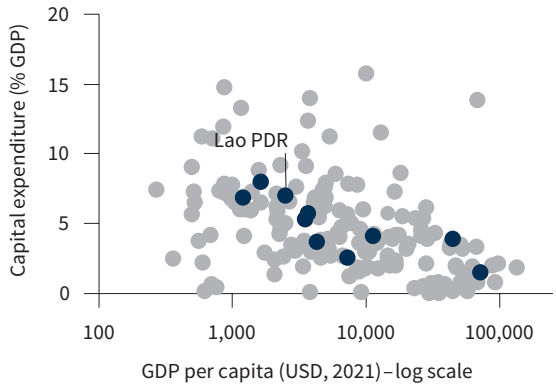
very large proportion of current spending, although most is not directly related to basic service delivery (Figure 3.9). Expenditure on goods & services is low, at under 2 percent of GDP, compared to a world average of 4 percent of GDP. Interest payments are deceptively low as they have been nearly halved due to debt service deferrals. Subsidies and other transfers (e.g., grants and social benefits) typically account for a large share of current expenditures globally, partly owing to fairly developed social protection systems. Overall, there are concerns that declines in recurrent spending are undermining public service delivery, particularly education (e.g., lack of teaching materials) and health (lack of medicines and medical equipment).

Figure 3.9: Expense (% current expenditure, 2021)



Source: World Bank and staff calculations.
Note: Aggregate data represents the median.

Figure 3.10: Capital spending (% GDP, 2016–21)



Source: International Monetary Fund and World Bank staff calculations.
Note: Vertical axis limited to 20 to improve readability.

There has been a strong prioritization of capital spending, despite recent declines. Capital spending peaked in 2012, when it accounted for half of total expenditure (11 percent of GDP). This reflected a strong focus on public investment to promote economic development, particularly to develop power and transport infrastructure.[106] The relative decline in capital spending (observed since 2012) coincided with a steady deceleration of GDP growth and a build-up of public debt, highlighting the unsustainability of the economic growth model. Despite declines in recent years, capital outlays remain higher than many regional and income peers (Figure 3.10).[107]

An analysis of fiscal force and momentum provides further insights into the drivers of public spending. Decomposing expenditure growth into its key drivers can provide insights into recent dynamics. The approach used here is based on the concepts of 'momentum' and 'force'. Momentum relates to the contribution of a particular spending item to the percentage growth in total spending in a given time period, while force measures the percentage point change in spending between years. Force and momentum convert expenditure shares and growth rates into units that can be added to equal total expenditure growth (momentum) or acceleration in growth (force), highlighting the most important items of expenditure. The force measure is additive, meaning that components add up to 'acceleration', and is also comparable across time and budget categories. Force can help identify relatively small budget items that are growing fast (i.e., small size but large acceleration), or items growing at a modest pace but are still driving trends owing to their large size (i.e., small acceleration but large size). Cases where both size and acceleration are large are of particular concern.[108]

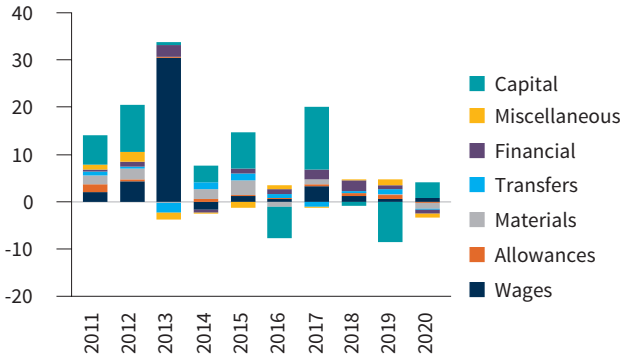
Spending growth has been mainly fueled by a positive momentum in wage and capital expenditures. Wage and capital spending accounted for most spending growth (momentum) between 2011 and 2020 (Figure 3.11). In terms of the overall force, most items cancel each other out (Figure 3.12). The large changes in momentum and force for capital spending may imply some weaknesses in public investment management, especially regarding planning. A rapid (and volatile) scaling up of public investment may fail to deliver strong economic growth if it creates significant inefficiencies.

[106] However, some recurrent expenditures may be recorded under capital spending, particularly if they are externally financed. Capital spending may include allocations for clearing expenditure arrears.

[107] These values do not include the large investments made by state-owned enterprises and public-private partnerships.

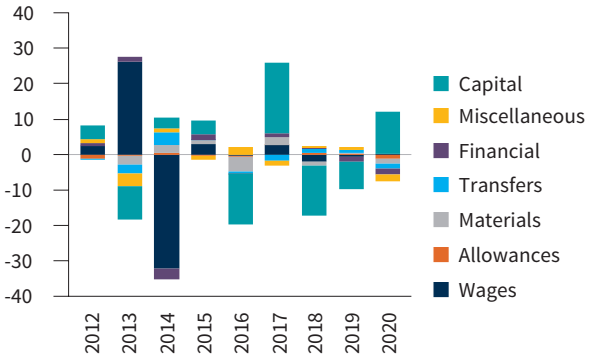
[108] The approach is similar to assessing drivers of economic growth, whereby it is not just the growth of a component that matters, but also its weight in overall output.

Figure 3.11: Momentum (percentage points)



Source: Ministry of Finance and World Bank staff calculations.

Figure 3.12: Force (percentage points)



Source: Ministry of Finance and World Bank staff calculations.

An analysis of budget rigidities can help fiscal consolidation efforts by shedding light on discretionary spending items. Budget components vary within a spectrum of flexibility since not all can be easily modified by the authorities in the short-term. Having a clear understanding of the budget items driving expenditure growth, and how inflexible they are, can support policymakers in anticipating fiscal pressures. Budget items that cannot be reassigned without entailing a high cost are generally said to be 'rigid'. Budget components classified as rigid are thus not subject to the immediate discretion of the authorities. For the analysis, a typology of expenditure rigidity is applied to the economic classification (Table 3.1).[110] Civil servant basic salaries and interest payments on public debt fall under the high rigidity category, since these cannot be easily reduced. The other components of wages & salaries, allowances, and subsidies & transfers are classified as medium rigidity. Lastly, spending on materials & supplies, miscellaneous & contingency, and capital is categorized as low rigidity (or discretionary spending).

Table 3.1: Fiscal rigidity

Rigidity level	Appropriation category (budget item)
High	Wages & Salaries (basic salary), Financial
Medium	Wages & Salaries (general allowance and social assistance benefits), Allowances, Subsidies & Transfers
Low	Materials & Supplies, Miscellaneous & Contingency, Capital

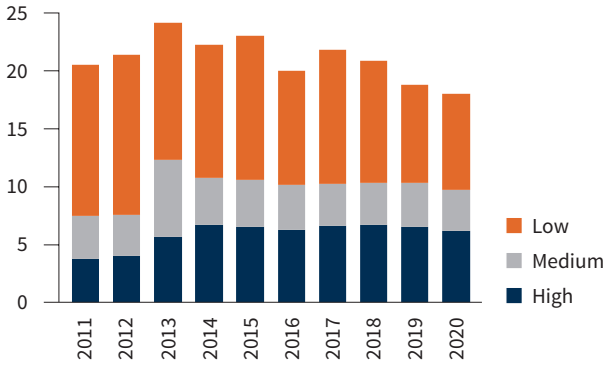
Source: World Bank staff.

Note: Spending on social assistance appears to be reported under wages in the Ministry of Labor and Social Welfare.

Discretionary spending is high, albeit declining, suggesting that there is scope for fiscal adjustments. A significant share of public expenditure comprises items classified as having low rigidity (Figure 3.13). On the other end of the spectrum, high rigidity expenditures averaged 34 percent of total expenditure in 2020 (Figure 3.14). The combined share of high and medium rigidity expenditures in total spending has risen over time. Given the need to secure fiscal sustainability, and in the absence of public debt restructuring or stronger revenue mobilization efforts, a fiscal adjustment would likely need to be driven by a further compression in capital spending – which would undermine economic growth prospects. An increase in the share of rigid expenditures, particularly those legally binding (e.g., interest payments), limits the scope for reprioritizing budget allocations. At present, the relatively low degree of budget rigidity suggests that there is some scope for consolidating and reallocating budget resources across categories to improve efficiency and effectiveness. However, there are some risks in wages & salaries and allowances (owing to inflationary pressures), financial expenditure (due to rising debt service obligations), as well as other categories.

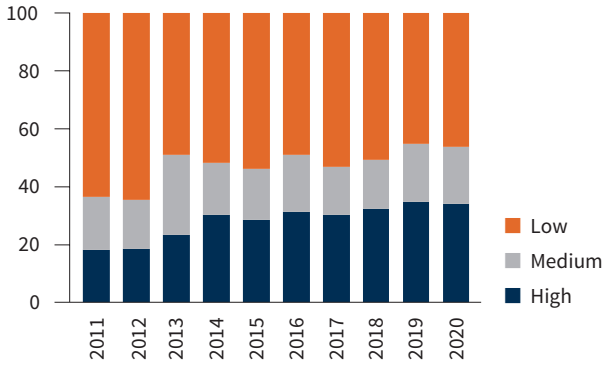
[109] The definition of expenditure rigidity that is used in this analysis follows a conceptual framework from the literature, which lists the broad categories by rigidity level. Herrera and Olaberria (2020) define budget rigidities as "institutional, legal, contractual, or other constraints that limit the ability of governments to change the size and composition of the public budget, at least in the short term".

Figure 3.13: Fiscal rigidity (% GDP)



Source: MoF and World Bank staff calculations.

Figure 3.14: Fiscal rigidity (% total)



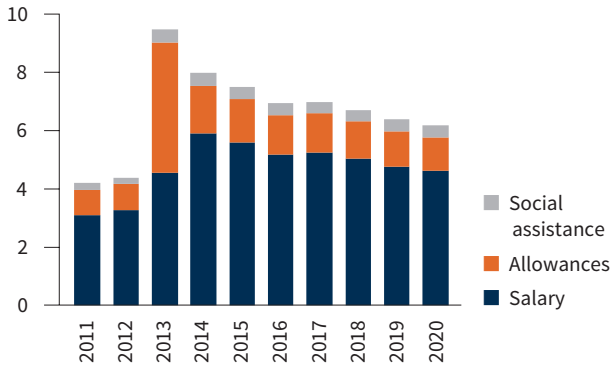
Source: MoF and World Bank staff calculations.

Wages & salaries and allowances

Spending on wages & salaries increased considerably in 2013, although it has been declining since then. Wage expenditure more than doubled to over 9 percent of GDP in 2013 (Figure 3.15). This increase was largely due to a sharp rise in allowances that were subsequently converted to wage increases. Most wage expenditure relates to the payment of salaries, but allowances also account for a significant amount. Spending on social assistance (related to civil servants) is comparatively smaller. Since 2013, modest salary index increases and curbs on recruitment have contributed to a steady decline in the wage bill in relative terms. The execution rate of this spending category has been relatively high, as expected, averaging about 94 percent in 2016–2020. The education and health sectors typically account for a large proportion of wage expenditure, given the large number of teachers and health staff required to deliver basic public services to the population. General public services (i.e., administration), public order & safety (i.e., police), and defense (i.e., army) are also thought to account for a significant share, but data is not reported for these sectors or their ministries.

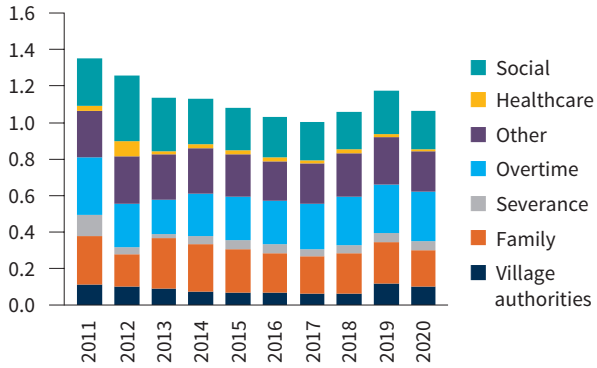
There are a range of allowances, which differ from those included in wages & salaries. This category differs from the allowances included under wages & salaries because it mainly relates to benefits, such as family, 'extra work', 'other' (mainly study-related), and social allowances. Although these partly relate to civil servants, they also include allowances to village authorities (e.g., chiefs) that should probably be better classified as transfers. In fact, the IMF's Government Finance Statistics (GFS) includes some (but not all) allowances under wage expenditure. Overall, allowances declined as a share of GDP until 2017, after which they appear to have increased (Figure 3.16).

Figure 3.15: Wages & salaries (% GDP)



Source: MoF and World Bank staff calculations.

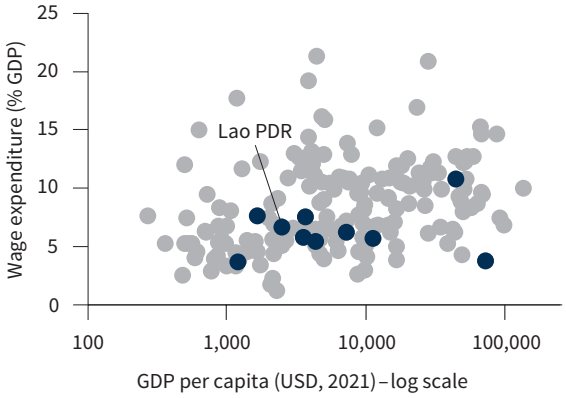
Figure 3.16: Allowances (% GDP)



Source: MoF and World Bank staff calculations.

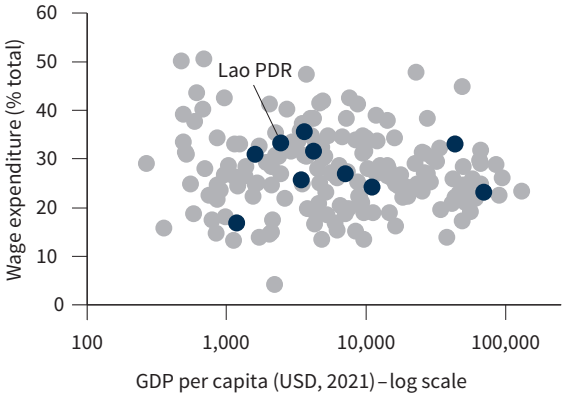
The wage bill is broadly in line with that of regional peers, but its share of total spending is relatively high. Spending on wages (including some allowances) averaged about 6 percent of GDP in recent years, which is around the average for regional peers (Figure 4.17).[110] This partly reflects recent efforts to contain the wage bill, which peaked at 9 percent of GDP in 2013.[111] Nonetheless, wages & salaries still account for a relatively large share of total spending (Figure 3.18). High inflation is severely undermining the purchasing power of civil servants, which will put pressure on the wage bill, as the government may have to increase salaries to retain (qualified) essential workers.

Figure 3.17: Wages (% GDP, 2016–21)



Source: International Monetary Fund and World Bank staff calculations.
Note: Vertical axis limited to 25 to improve readability.

Figure 3.18: Wages (% total spending, 2016–21)



Source: International Monetary Fund and World Bank staff calculations.

Public employment is relatively high, and there are concerns over its composition. Public sector employment grew significantly from 7 to nearly 12 percent of total employment between 2005 and 2017, of which about two-thirds were men. Official statistics reported 176,151 civil servants in 2021, including more than 74,000 teachers and about 16,250 medical staff.[112] However, these numbers exclude many public sector workers because major employers are not included in the personnel information system (e.g., police and armed forces). Estimates suggest there were over 367,000 public sector employees in 2022, implying that teachers and medical staff only account for one-quarter of total public employment.[113] Recent curbs on recruitment may have affected key service delivery sectors. The government target is to reduce civil servants from 2.3 to 1.8 percent of the population (it was 2.8 in 2019). This will likely put pressure on public service delivery, particularly since the commitment does not include jobs outside the personnel information system. Moreover, low average pay (and even volunteering) may undermine staff morale and productivity, particularly given the impact of high inflation on the cost of living.

Materials & supplies

Spending on operations & maintenance is not in line with the needs related to service delivery and the preservation of public assets. Most expenditures in this category pertain to utilities & purchasing and, to a lesser extent, external services (Figure 3.19). Utilities & purchasing includes costs related to fuel, electricity, and water, as well as purchasing of equipment (e.g., pedagogical and medical), uniforms, and office supplies. External services include repairs & maintenance, rental, and telecommunications. Overall, it is concerning that spending in this category has been declining, since it is likely affecting the quality of public services. For instance, limited budgets for teaching materials and medical equipment undermine the provision of education and health services. Moreover, given the fast accumulation of public infrastructure assets, limited provisions for maintenance costs can limit their usage and value.[114] Spending

[110] It should be noted that IMF data includes some allowances (division 61) in wage expenditure, but not all. Small states tend to have high wage-to-GDP ratios, often above 10 percent of GDP, partly reflecting diseconomies of scale in the provision of public services.

[111] The wage index, which is used to calculate public sector wages, increased from 1,800 kip in 2005 to 6,700 in 2014, and is currently at 7,350.

[112] Around 6,600 were contract staff and 14,500 were volunteers, of which 7,900 were volunteer teachers and 3,000 volunteer medical staff, partly to fill vacancies in remote areas.

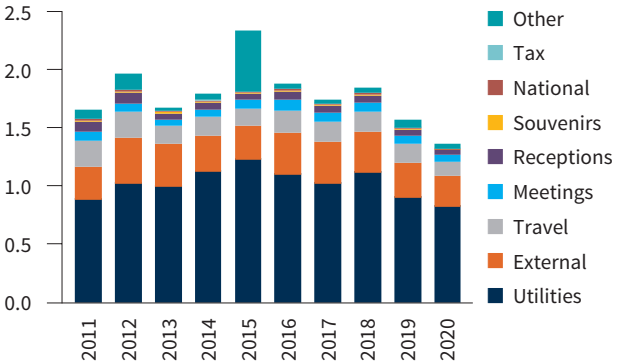
[113] The 2015 Population and Housing Census shows that 347,000 people were government employees, while an additional 38,000 were employed in state enterprises.

[114] Increases in capital spending (e.g., construction of public infrastructure) ought to be accompanied by an increase in (related) recurrent costs, to avoid a fast depreciation of the public capital stock and ensure that infrastructure remains fully functional.

on the maintenance of roads and bridges appears to be a fraction of construction and rehabilitation.[115] Adequate spending on routine (preventive) maintenance would avert higher costs in the future and sustain service delivery standards, especially owing to existing vulnerabilities to extreme weather events.[116]

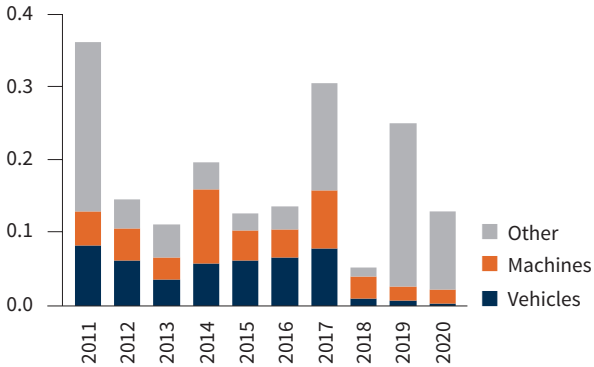
Purchasing of materials is a relatively small category, but it is quite volatile. Spending on materials relates to the purchase of fixed assets for administration (Figure 3.20). Trends show a containment in the purchase of vehicles since 2017 while spending on machines and equipment has also declined. Other fixed assets for administration (e.g., computers and furniture) are often the largest item, although showing significant volatility.

Figure 3.19: Operations & maintenance (% GDP)



Source: MoF and World Bank staff calculations.

Figure 3.20: Purchasing of materials (% GDP)

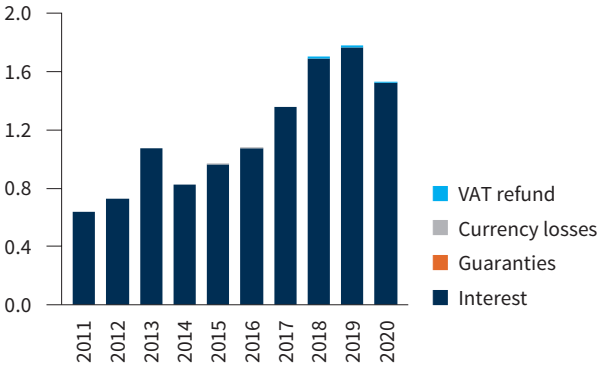


Source: MoF and World Bank staff calculations.

Financial

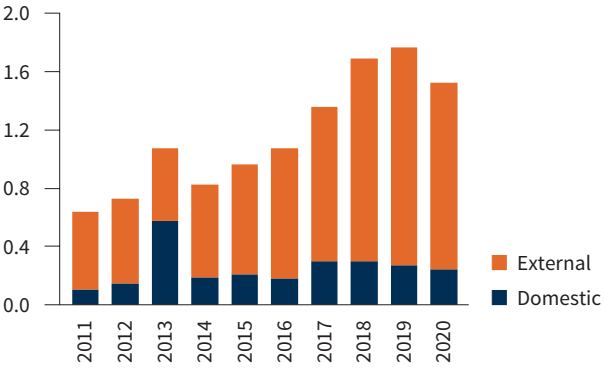
Financial expenses have increased considerably, although recent debt service deferrals have provided temporary relief. Most financial expenditures relate to the payment of interest on the current public debt stock (Figure 3.21). These payments have grown significantly over time.[117] This is due to the fast accumulation of public debt, in part to finance large public investments in infrastructure (e.g., power and transport). Most interest payments are related to external debt (Figure 3.22).[118] The sharp depreciation of the Lao kip in 2021–2022 has increased the domestic currency value of these payments, although sizable debt service deferrals by China have provided

Figure 3.21: Financial expenditure (% GDP)



Source: MoF and World Bank staff calculations.

Figure 3.22: Interest payments (% GDP)



Source: MoF and World Bank staff calculations.

[115] In 2020, spending on maintenance (and minor repairs) of roads and bridges was reported at 500 million kip [62.20.02.05], compared to 807 billion kip for construction [67.80.02/03] and 596 billion kip for rehabilitation [67.90.07.02/03].

[116] Public asset databases (e.g., roads, buildings, etc.) that are updated, interconnected, and fed into a performance management system can enhance the planning of routine maintenance and limit the need for emergency maintenance and rehabilitation.

[117] Data from the MoF's public debt bulletin implies a value of 1.8 (rather than 1.5) percent of GDP in 2020. The 2020 budget implementation report lists 3.7 trillion kip as 'plan', but only 2.6 trillion as 'actual'. In 2020, debt service deferrals were mainly on principal repayments rather than interest. The discrepancy might be due to a recording issue (e.g., timing).

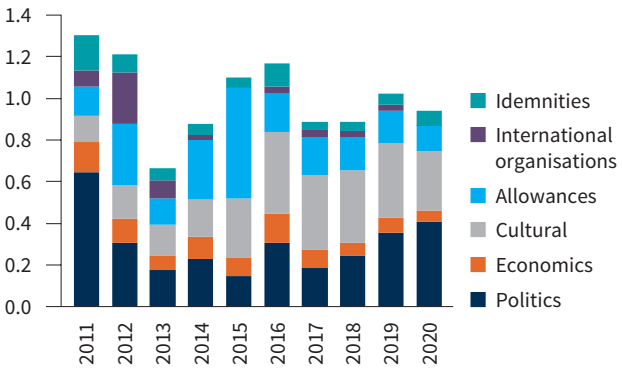
[118] The hike in domestic interest payments in 2013 was linked to short-term borrowing undertaken to pay the large increase in wage expenditure.

temporary relief, which has accumulated to 8 percent of GDP by the end of 2022. Without debt restructuring, interest payments will lead to a significant reduction in fiscal space and further squeeze the budget available for critical sectors. In the absence of debt deferrals, interest payments would have surpassed the combined spending on education and health in 2022. Financial expenditure (particularly interest payments) is a key driver of budget rigidity, while recent deferrals may come at a (large) cost in the future.

Subsidies & transfers

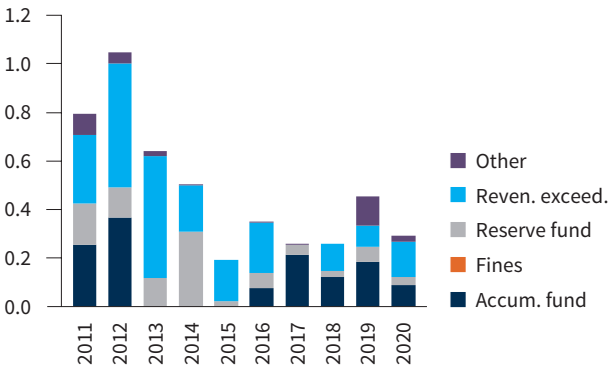
Subsidies & transfers, which mainly relate to political and cultural & social activities, have remained broadly stable. Spending on subsidies & transfers averaged 1 percent of GDP since 2011 (Figure 3.23). This category includes subsidies and transfers related to political activities, economic subsidies (e.g., promotion of goods production), cultural & social activities (e.g., preventive healthcare and education quality), allowances (e.g., technical extension), contributions to international organizations (e.g., membership fees), and indemnities (e.g., natural disasters). In recent years, the allocation for political activities has increased, resulting in a squeeze on cultural & social activities.

Figure 3.23: Subsidies & transfers (% GDP)



Source: Ministry of Finance and World Bank staff calculations.

Figure 3.24: Miscellaneous & contingencies (% GDP)



Source: Ministry of Finance and World Bank staff calculations.

Miscellaneous & contingencies

Spending on miscellaneous & contingencies has declined over time and is relatively small. Miscellaneous categories are typically used for expenses that cannot be mapped to an existing category in the chart of accounts, while contingencies are 'set asides' to cover unexpected expenditure needs.[119] Spending on miscellaneous & contingencies declined from 1.0 to 0.3 percent of GDP between 2012 and 2020 (Figure 3.24). However, it increased to over 0.6 percent of GDP in 2022. A key component is 'expenditure for revenue exceeding plan', which relates to bonus payments for budget units exceeding revenue targets.[120] The budget law provides for reserve funds to meet contingencies and urgent requirements (e.g., defense, security, mitigation of natural calamities, and epidemics), which comprises contributions to the state accumulation fund, as well as government and local reserve funds.

Capital

There has been a strong focus on public investment, most of which has been funded by external sources. This category is associated with the creation of tangible capital assets. The capital budget is prepared by the Ministry of Planning and Investment, in coordination with line ministries and provinces, and is based on public investment plans (PIPs). As in many East Asian economies, public investment has been seen as a key ingredient for accelerating economic growth, although it should be noted that public investment excludes investments undertaken by SOEs and PPPs.[121] Capital spending has been declining as a share of GDP (Figure 3.25). Most

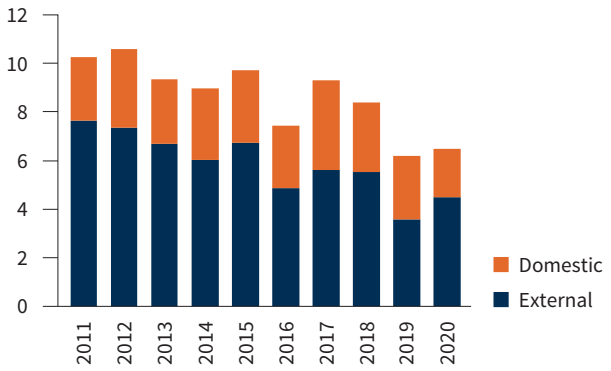
[119] High spending on miscellaneous categories may be due to a misuse of the classification or limitations in the chart of accounts.

[120] Since excess revenue from provinces is often not recorded on time, those amounts are reported under domestic financing (like a cash balance) and expenditure (bonus payment) in the following budget year.

[121] There are concerns that some recurrent spending is likely misclassified as capital spending (particularly if related to donor-executed projects), while this category may also include expenditure arrears (from sub-national investment projects).

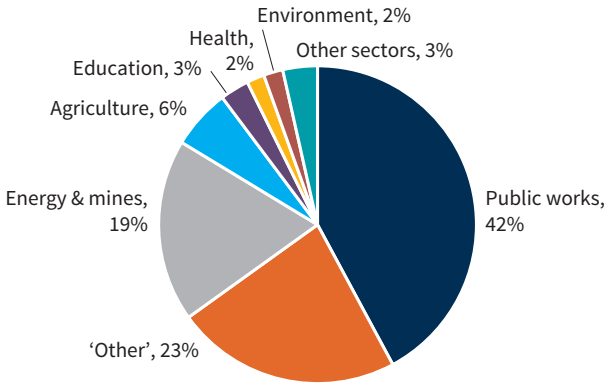
spending is financed externally through grants and loans. In 2020, the public works & transport and energy & mines sectors accounted for 42 and 19 percent of total external capital spending, respectively (Figure 3.26). This implies that most externally funded capital spending is devoted to transport and energy infrastructure. However, investments in several key sectors have lagged, particularly agriculture, education, and health.

Figure 3.25: Capital spending (% GDP)



Source: Ministry of Finance and World Bank staff calculations.

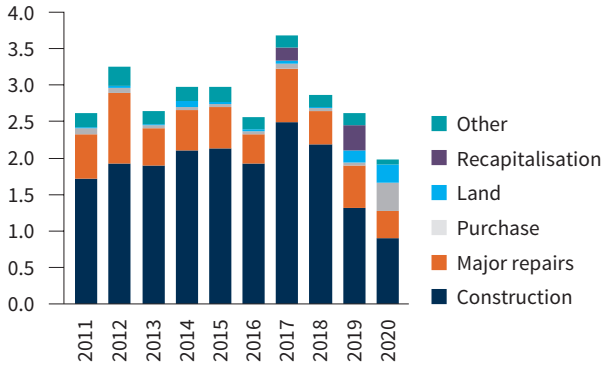
Figure 3.26: External capital spending (% GDP, 2020)



Source: Ministry of Finance and World Bank staff calculations.

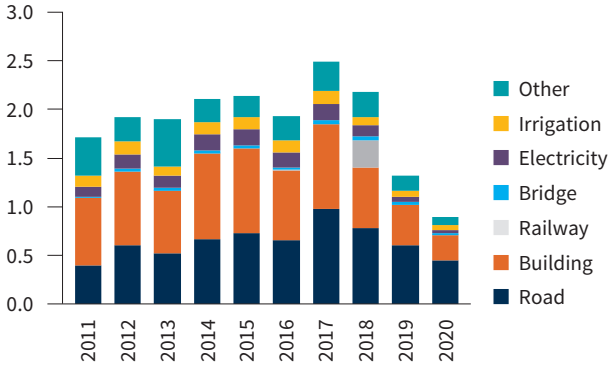
Domestic capital spending has mainly comprised construction expenditure. Although most capital expenditure relates to foreign capital, official data only offers a detailed disaggregation of domestic capital spending. Most of this has been associated with construction expenditures, followed by major repairs – mainly related to roads (Figure 3.27). In recent years, spending on land compensation increased, while there were two SOE recapitalizations and a large purchase of telecom equipment. Most construction expenditures relate to roads and buildings (Figure 3.28). Overall, domestic capital spending has steadily declined during 2017–2022, owing to growing fiscal pressures. A deteriorating fiscal position (underpinned by poor revenue mobilization efforts) has led to recent limits on new capital projects, which will likely further reduce the capital budget.

Figure 3.27: Domestic capital spending (% GDP)



Source: Ministry of Finance and World Bank staff calculations.

Figure 3.28: Construction spending (% GDP)



Source: Ministry of Finance and World Bank staff calculations.

Capital spending is likely underreported due to off-budget projects, but future spending is likely to be constrained. Large expenditure arrears mostly arise from sub-national off-budget investment projects. In 2021, the government issued bonds amounting to nearly 10 trillion kip to clear some of these arrears (5 percent of GDP), while an additional 23 trillion kip are undergoing a verification process. The amounts verified and certified might be cleared through a combination of domestic bond issuances (which increase domestic public debt) and future allocations in the capital budget.[122] The resources available for new capital projects are limited, owing to the backlog of ongoing projects and potential allocations to clear arrears. This may create an incentive for budgetary units to generate and underreport their own resources. It is therefore important to reassess spending needs and prioritize projects, which may require delaying or even canceling (non-priority) projects.

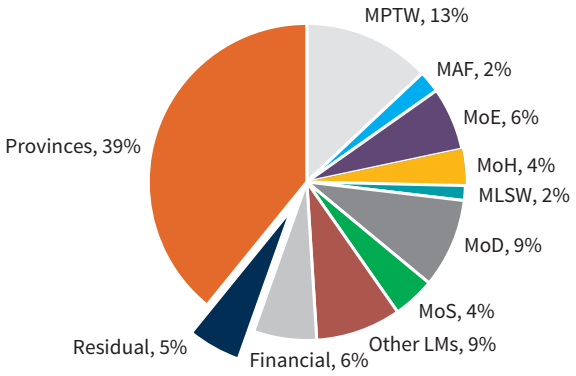
[122] In the past, the Ministry of Planning and Investment (MPI) has requested spending units to allocate a significant share of their public investmentplan (PIP) allocation to clear arrears (up to 30–35 percent in 2017).

3.2.2 Administrative classification

The assessment of institutional spending over time is made difficult by changes in administrative units and a lack of comprehensive reporting. The administrative classification disaggregates spending by relevant public institutions, such as ministries, other public organizations (e.g., National Assembly), and provinces.[123] Changes in government structures have led to some ministries splitting or merging, while some institutions were created or eliminated. For the analysis, adjustments were made to provide consistent insights on key spending units. The focus is on the Ministry of Public Works and Transport (MPWT), Ministry of Energy and Mining (MEM), Ministry of Agriculture and Forestry (MAF), Ministry of Education (MoE), Ministry of Health (MoH), and Ministry of Labor and Social Welfare (MLSW). Moreover, the reporting is not comprehensive, with spending from several important ministries and organizations aggregated and reported in a category called 'Others'.

Budget transparency has been gradually eroded by the absence of reporting for key ministries and other organizations. In 2005, central government spending was reported for 15 ministries and organizations, accounting for 81 percent of the total at the central level. In 2020, central government spending was reported for 19 ministries and organizations, but those only covered 48 percent of the total. This means that over half of spending at the central level cannot be attributed to a specific spending unit. These values remain high when considering total spending (i.e., including the 18 provinces) and excluding financial expenditure (mainly interest payments, which are made at the central levels but not allocated to a specific administrative unit). While this 'residual' accounted for only 5 percent of total spending in 2005, that value increased to nearly 30 percent by 2020 (Figure 3.29 and Figure 3.30).[124] This significantly undermines budget transparency and the ability to scrutinize the quality of public spending. Moreover, it also undermines decision-making, since it is not clear how unreported data is used in the budget process.

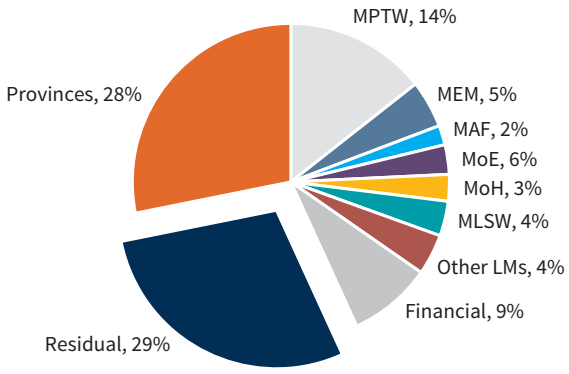
Figure 3.29: Administrative units (%, 2005)



Source: Ministry of Finance and World Bank staff calculations.

Note: 'Residual' excludes financial expenditure and relates to ministries and organizations not reported. LM stands for line ministries.

Figure 3.30: Administrative units (%, 2020)



Source: Ministry of Finance and World Bank staff calculations.

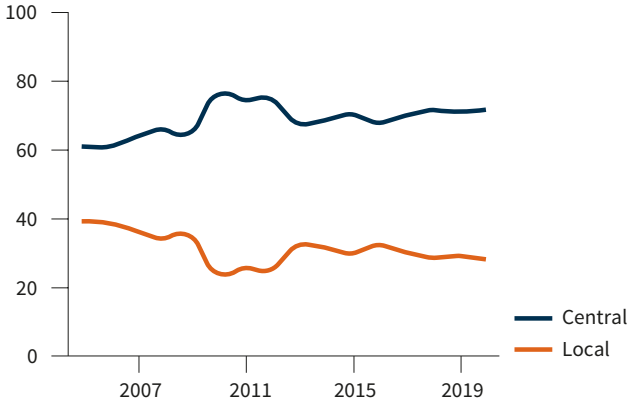
Note: 'Residual' excludes financial expenditure and relates to ministries and organizations not reported. LM stands for line ministries.

There is a significant level of fiscal decentralization, with about 30 percent of spending executed at the local level. In 2005, nearly 40 percent of spending was executed at the local level, but that value has gradually declined to 28 percent in 2020 (Figure 3.31). These trends and magnitudes do not change significantly when excluding financial expenses from central spending. Most spending at the local level relates to wages (Figure 3.32). Capital spending is predominantly executed at the central level, partly because foreign-financed projects are recorded and managed at the central level. Provinces only execute domestically-financed capital projects. Additional decentralization of budget responsibilities and plans for self-sufficient units may contribute to further institutional fragmentation and should be carefully considered.

[123] In this report, the term 'provinces' includes the Vientiane Capital prefecture.

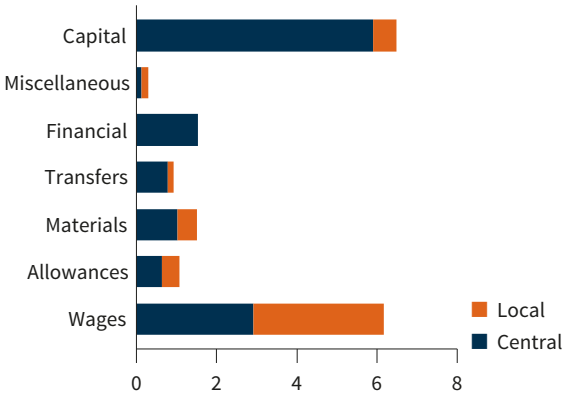
[124] In 2020, 'residual' spending (i.e., 'others' excluding financial expenditure) accounted for 40 percent at the central level. At the local level, spending is reported by sector for each province, but 38 percent cannot be allocated to a specific sector.

Figure 3.31: Expenditure by level (% total)



Source: Ministry of Finance and World Bank staff calculations.

Figure 3.32: Expenditure by level (% total, 2020)



Source: Ministry of Finance and World Bank staff calculations.

At the central level, most spending is not reported for individual ministries or organizations. In 2005, about 21 percent of spending at the central level was undertaken by the Ministry of Public Works and Transport, followed by the Ministry of Defence (15 percent), Ministry of Education (11 percent), Ministry of Public Security (7 percent), and Ministry of Health (6 percent) (Table 3.2). From 2006 onwards, spending was no longer reported for the Ministry of Defence and the Ministry of Public Security, likely included in the category 'Organizations and administrative office' (admin.) from 2006 until 2015, and then in 'Others' from 2016–2020. Over 50 percent of spending at the central level is unallocated to a specific ministry or other public organization, although 12 percent of this can be attributed to financial expenditure (mostly interest payments) executed through the Ministry of Finance, even if it is not part of their budget.

Table 3.2: Expenditure (% central level)

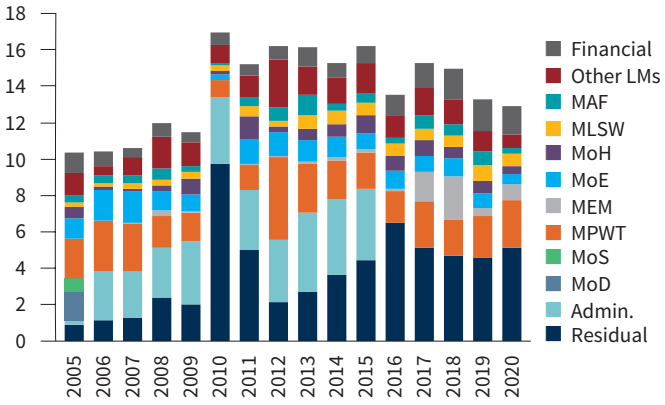
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
'Residual'	9	11	12	20	18	57	33	13	17	24	27	48	33	31	34	40
Admin.	2	26	24	23	30	22	21	21	27	27	24	..	..	..	..	..
MoD	15	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..
MoS	7	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..
MPWT	21	27	25	15	14	5	9	28	17	14	12	13	17	13	17	20
MEM	..	..	1	3	0	0	0	1	1	1	1	1	10	16	3	7
MoE	11	17	16	9	8	2	9	8	7	7	5	7	6	7	6	4
MoH	6	1	1	2	7	1	8	2	4	5	6	6	6	4	5	4
MLSW	2	2	3	3	4	2	4	2	5	5	4	5	4	4	6	5
MAF	4	4	4	5	3	1	3	4	7	3	3	3	5	4	6	3
Other LMs	12	5	9	15	11	6	8	16	10	9	10	9	10	9	8	6
Financial	11	8	5	6	5	4	4	4	7	5	6	8	9	11	13	12

Source: World Bank staff calculations.

Note: 'Residual' excludes financial expenditure (i.e., interest payments), which is not allocated to a specific spending unit. Data from 2005 to 2016 relates to a different fiscal year (October to September).

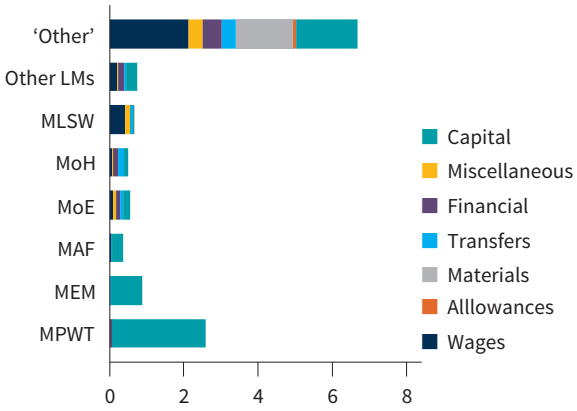
The proportion of central government spending allocated to social ministries is very limited. Despite some volatility, the Ministry of Public Works and Transport remains the main spending unit reported at the central level (Figure 3.33). The Ministry of Energy and Mines had significant allocations in 2017 and 2018, while the Ministry of Agriculture and Forestry averaged 0.5 percent of GDP in 2013–2020. The combined spending of the Ministry of Education and Ministry of Health (at the central level) has gradually declined from 1.9 to 1.0 percent of GDP between 2015 and 2020. Apart from capital spending executed by the Ministry of Public Works and Transport and the Ministry of Energy and Mines, most other spending is not allocated to a specific spending unit (Figure 3.34). The large proportion of wages in 'residual' may include wages for general administration, police, army, and the party – if these are mostly paid at the central level.

Figure 3.33: Central spending (% GDP)



Source: Ministry of Finance and World Bank staff calculations.

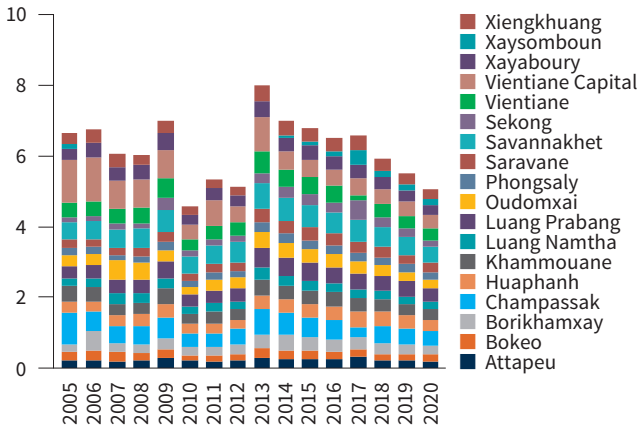
Figure 3.34: Central spending (% GDP, 2020)



Source: Ministry of Finance and World Bank staff calculations.

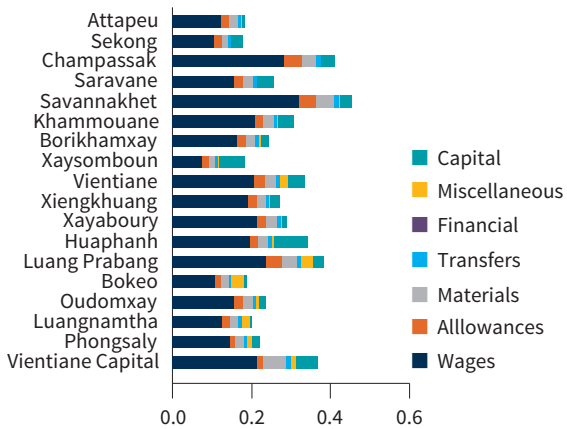
Spending levels vary significantly across provinces, but budget allocations do not seem to reflect specific needs. The hike in overall spending in 2013 and its subsequent decline are also noticeable at the sub-national level (Figure 3.35). No province stands out significantly in terms of spending, although Vientiane Capital did account for a disproportionately large share until 2013. In 2020, spending ranged from 0.18 percent of GDP in Sekong to 0.45 percent of GDP in Savannakhet (Figure 3.36). In per capita terms, it ranged from about 66,500 kip in Vientiane Capital to 2,900,000 kip in Xaysomboun. Most spending relates to wages. Budget allocations appear to be predominantly based on political decisions, rather than following a predefined formula (e.g., based on population, land area, poverty levels, or spending capacity). There is no evidence of targeting. Budget execution may not always follow the declared priorities of the central government, since the (functional) allocation of the provincial budgetary resources is flexible.

Figure 3.35: Local spending (% GDP)



Source: Ministry of Finance and World Bank staff calculations.

Figure 3.36: Local spending (% GDP, 2020)



Source: Ministry of Finance and World Bank staff calculations.

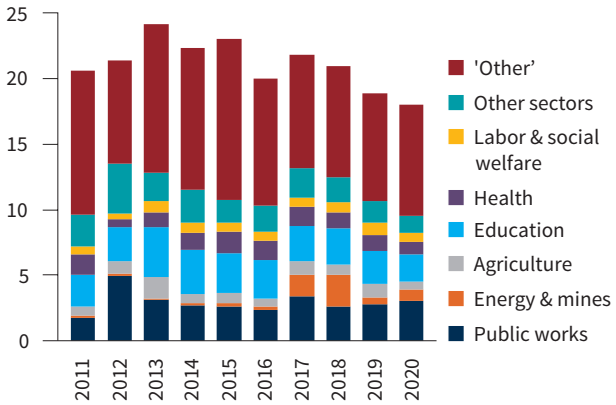
Despite the lack of a functional classification, existing data suggests that spending on the social sectors is very limited. A functional classification consolidates spending in key areas of interest (i.e., sectors), which is particularly pertinent for policy making. The administrative classification does not accurately map spending into typical sectors, as relevant spending can be undertaken across several administrative units (e.g., ministries). Hence, the absence of a functional classification makes it difficult to reliably track total spending on education and health.[125] Nonetheless, available data suggests that spending on critical social sectors is limited (Figure 3.37).[126] For instance, the combined

[125] Spending on these sectors could potentially be underestimated if significant education and health expenditures are undertaken by unrelated spending units. The classification of the functions of government (COFOG) classifies government expenditure into ten categories: general public services; defense; public order and safety; economic affairs; environmental protection; housing and community affairs; health; recreation, culture and religion; education; and social protection.

[126] In the state budget implementation reports, spending by sector comprises central government spending by ministry and related sub-national spending. For instance, the education sector comprises the Ministry of Education (central level) as well as provincial and district education offices (local level).

spending on education and health declined from 4.9 to 2.6 percent of GDP between 2013 and 2022, and is now one of the lowest levels in the region and the world (e.g., the combined average in ASEAN countries is nearly 6 percent). It is important to develop a functional classification that is built bottom-up (by program and activity) rather than top-down (by institution) to provide a more accurate representation of spending. In addition to financial expenditure, a large proportion of wage and capital spending is not allocated to a specific sector (Figure 3.38).

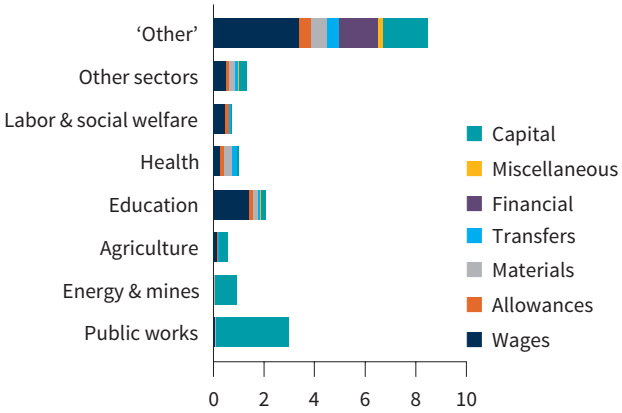
Figure 3.37: Expenditure by sector (% GDP)



Source: Ministry of Finance and World Bank staff calculations.

Note: 'Other' is the difference between total spending and the aggregated spending of all sectors reported.

Figure 3.38: Expenditure by sector (% GDP, 2020)



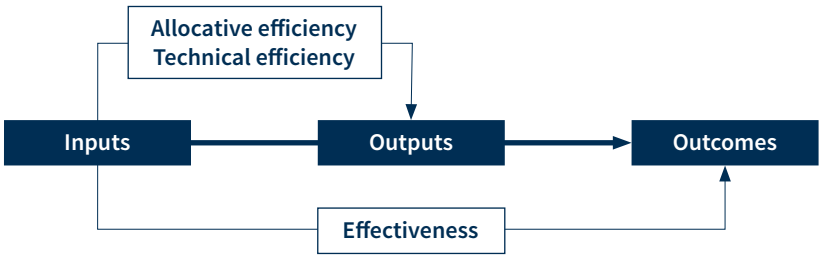
Source: Ministry of Finance and World Bank staff calculations.

Note: 'Other' is the difference between total spending and the aggregated spending of all sectors reported.

3.3 Quality of spending

Assessing the efficiency, effectiveness, and equity of public spending suggests that the use of budget resources can be improved. Improving the efficiency and effectiveness of government spending is key to ensuring that public resources have a strong impact on service delivery. For this, it is essential to evaluate how spending units translate their budgets into physical inputs (e.g., staff and infrastructure), then into outputs (e.g., years of schooling or outpatient visits), and finally into outcomes (e.g., test scores and child survival rates). Efficiency analysis evaluates how inputs translate into outputs, while effectiveness relates to how inputs translate into outcomes (Figure 3.39). Moreover, it is also important to consider the distributional impact of spending (to promote shared prosperity) and reflect on the future demand for basic public services.

Figure 3.39: Efficiency and effectiveness



Source: World Bank staff.

3.3.1 Efficiency

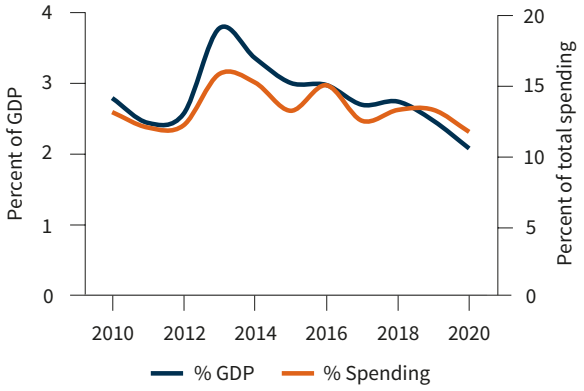
Given the mounting fiscal pressures, it is crucial to enhance the efficiency of public spending. The concept of efficiency relates to how inputs translate into outputs, and often includes two sub-dimensions: (i) allocative efficiency, which evaluates whether the distribution of inputs (both across and within sectors) is conducive to achieving desired outputs; and (ii) technical efficiency, which assesses whether a certain output is achieved with the least possible amount of inputs.[127] Identifying sources of inefficiency is key to ensuring that scarce public

[127] Efficiency entails consistency of aggregate spending allocations (across and within sectors) with policy priorities and cost minimization.

resources are not wasted. Given fiscal constraints, it is pertinent to uncover potential savings to create fiscal space for more productive spending. In fact, recent research suggests that governments can reduce income inequality by simply changing the composition of public spending while keeping total expenditure constant.[128]

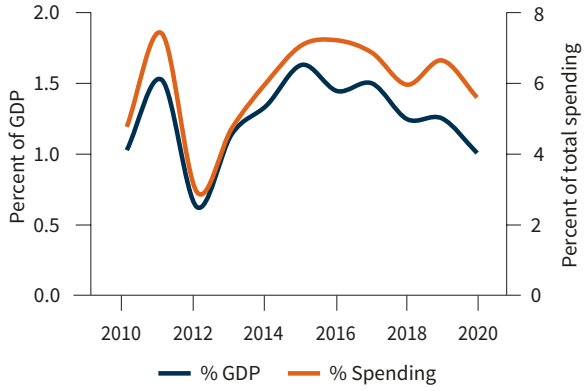
The allocation of budgetary resources can be considerably improved, particularly when considering stated policy objectives. The Ninth National Socio-Economic Development Plan (NSEDP), which covers the period 2021–2025, is an ambitious plan to realize the government's medium-term vision for the country. The NSEDP outlines six outcomes related to economic, human capital, well-being, environment, integration and connectivity, and governance dimensions.[129] However, development spending has been under pressure from declining revenues and rising debt service obligations, jeopardizing spending adequacy. Moreover, budgetary resources do not seem fully aligned with policy priorities. For instance, public spending has declined for sectors directly influencing human capital outcomes, both as a share of the total budget and as a share of GDP (Figure 3.40 and Figure 3.41). A renewed focus on the social sectors will likely require budget increases across different spending categories (e.g., wages, goods & services, and capital). If this additional spending cannot be financed through stronger revenue mobilization, then spending on 'others' (i.e., unreported sectors) should be deprioritized, particularly since it is unclear how these expenditures are contributing to stated socioeconomic objectives.

Figure 3.40: Allocative efficiency (education)



Source: Ministry of Finance and World Bank staff calculations.

Figure 3.41: Allocative efficiency (health)



Source: Ministry of Finance and World Bank staff calculations.

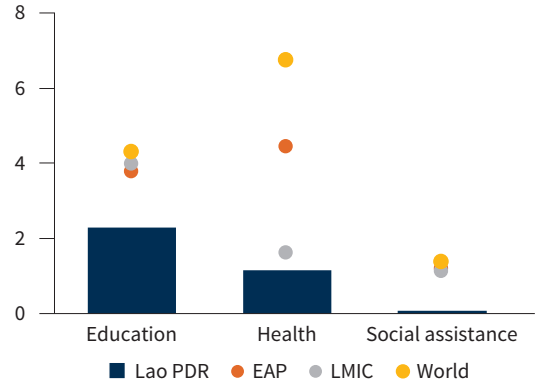
The lack of prioritization of the social sectors is concerning, particularly given the impacts of COVID-19 on learning and health outcomes, and it is undermining public service delivery. Public spending on education, health, and social assistance is very low by regional and income standards (Figure 3.42). It is also considerably below international benchmarks. For instance, the Education 2030 Framework for Action recommends that governments allocate between 4 to 6 percent of GDP and 15 to 20 percent of their budgets to education. While the government has committed to achieve an education spending target of 18 percent of the total budget, the current value is only around 13 percent. Meanwhile, development spending is being squeezed by poor revenue mobilization and rising interest payments. The combined spending on education and health declined from 4.9 to 2.6 percent of GDP during 2013–2022, which would have been less than interest payments in the absence of large debt service deferrals (Figure 3.43). Reprioritizing public spending toward education, health, and social protection would help ensure that scarce fiscal resources are allocated efficiently in the pursuit of stated policy objectives. Rebuilding human capital is critical to improving medium-term growth prospects, as well as reducing poverty and inequality. The allocation of spending within sectors (internal efficiency of spending) and the technical efficiency of spending are also important, but they are beyond the scope of this Public Finance Review.[130]

[128] See the IMF report "Reallocating Public Spending to Reduce Income Inequality: Can It Work?"

[129] The NSEDP identifies six priority outcomes: (i) continuous quality, stable and sustainable economic growth; (ii) improved quality of human resources; (iii) enhanced well-being of the people; (iv) enhanced environmental protection and reduced disaster risks; (v) engagement in regional and international cooperation and integration through robust infrastructure and effective utilization of national potentials and geographical advantages; and (vi) public governance and administration. The lack of a functional classification makes it difficult to compare spending with stated government priorities.

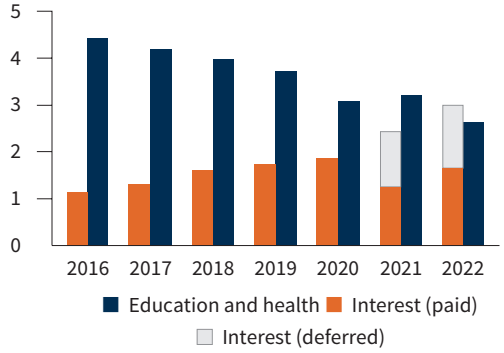
[130] For a detailed analysis on the education sector, see the World Bank's report "Preventing a Lost Decade in Education in the Lao PDR".

Figure 3.42: Spending on social sectors (% GDP, 2020)



Source: World Bank and staff calculations.

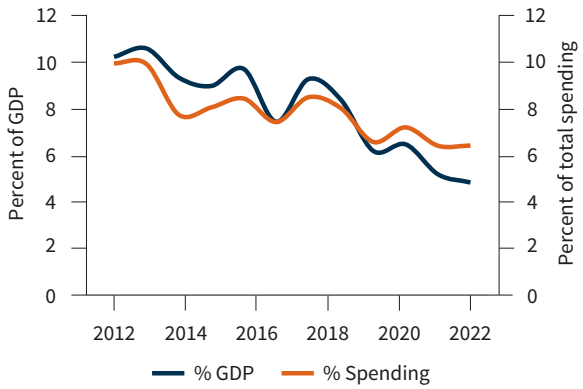
Figure 3.43: Spending on social sectors and interest (% GDP)



Source: Ministry of Finance and World Bank staff calculations.

Infrastructure development remains a key policy priority despite a gradual decline in capital spending. An important policy challenge is to ensure that the composition of spending is efficient, from an allocative point of view, to yield maximum economic and social benefits. The construction of public assets (e.g., transport) can generate considerable gains, especially in countries with large infrastructure gaps. Capital spending has steadily decreased as a share of GDP and as a share of total spending, even if it remains high by international standards (Figure 3.44).[131] This decline has been partly due to growing fiscal pressures, stemming from lower revenue collection and rising interest payments. However, there has been a strong focus on public-private partnerships, initially in hydropower but more recently on transport infrastructure, which masks the full involvement of the public sector in infrastructure development.[132] Nonetheless, without strong investments in human capital, the return on physical capital investments will likely be limited. This may require a rebalancing from the prevalent focus on large-scale infrastructure toward more selective and impactful spending. Hence, there is a need to prioritize projects with high socioeconomic returns. Higher selectivity with a focus on impact should also be the criteria for selecting PPPs.

Figure 3.44: Allocative efficiency (capital)



Source: Ministry of Finance and World Bank staff calculations.

[131] However, capital spending is likely underreported due to off-budget projects.

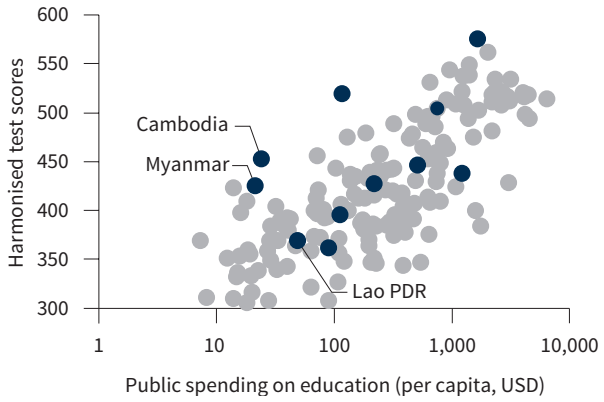
[132] PPPs can be seen as frontloading of capital spending, since the private sector typically provides the initial financing that is subsequently paid for by the government or end-users.

3.3.2 Effectiveness

Assessing the effectiveness of public spending is vital to ensure that the use of public resources achieves desired impacts. Measures of spending effectiveness evaluate how inputs translate into outcomes (i.e., the attainment of intended objectives). At the aggregate level, fiscal multipliers can provide insights into the extent to which fiscal policy is effective in stimulating economic activity. At the sectoral level, basic tools can be used to evaluate how inputs (i.e., spending) translate into outcomes (e.g., learning and healthy living).

While it is critical to allocate additional resources to the education and health sectors, the effectiveness of public spending also needs to be enhanced. Public spending on education is low by international standards (Figure 3.45). However, mobilizing additional resources will not be sufficient to significantly improve outcomes. There is also a need to enhance the effectiveness of spending. For instance, Cambodia and Myanmar spent less on education in per capita terms during 2010–2019, but had better outcomes as measured by harmonized test scores. Public spending on health is also low by global standards, albeit not to the same extent as education (Figure 3.46). Spending effectiveness can also be improved in the health sector. Cambodia allocated a similar amount of resources per capita during 2010–2019, but had significantly better outcomes as measured by the probability of survival to age 5, while Myanmar had similar outcomes with less spending. Given expenditure levels per capita, better education and health outcomes could be achieved.

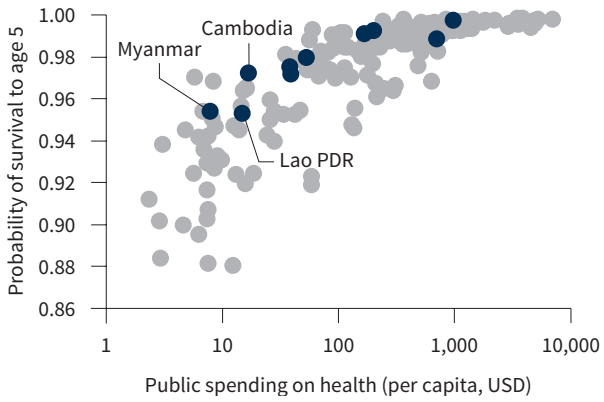
Figure 3.45: Spending effectiveness (education)



Source: World Bank and staff calculations.

Note: Latest data and average spending for 2010–19.

Figure 3.46: Spending effectiveness (health)



Source: World Bank and staff calculations.

Note: Latest data and average spending for 2010–19.

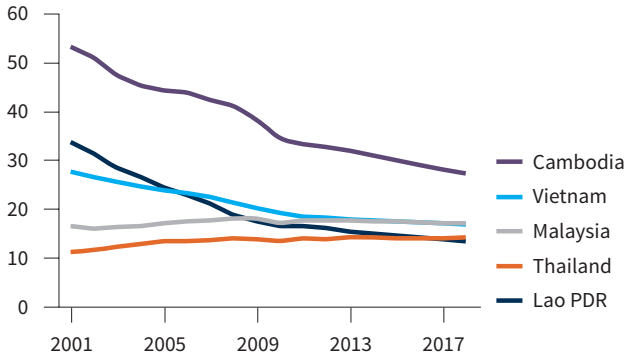
The rate of return on public capital has been relatively strong, but public investment management can be improved. Economic theory postulates a strong relationship between capital spending and economic growth. Public spending can engender an endogenous process of (private) capital accumulation, productivity growth, and economic dynamism required to accelerate and sustain economic growth.[133] The rate of return on capital (RoRK) measures the change in output brought about by a unit change in the capital stock. The return on total (public and private) capital has declined over time and is now below many regional peers (Figure 3.47). However, the return on public capital has been relatively strong, albeit mostly financed by external borrowing (Figure 3.48).[134] Nonetheless, there remains considerable scope for improving public investment management through a more judicious assessment of needs, particularly given existing fiscal pressures.[135] Overall, the selection of future investment projects (including public-private partnership projects) should rely on robust cost-benefit analysis and prioritize growth-enhancing cost-effective infrastructure. This is key to ensuring that public expenditure addresses supply-side constraints and supports medium-term economic growth.

[133] The lack of information on externally-financed capital spending undermines a more in-depth assessment (e.g., effectiveness of road spending). Nonetheless, while the road network has expanded (closing gaps in remote areas and lack of all-weather roads), there are growing concerns about quality, owing to inadequate maintenance and a bias toward large projects.

[134] The capital stock is estimated through the perpetual inventory method, with initial capital calculated through two methods: (1) initial-year gross fixed capital formation, and (2) 'rule of thumb' for capital output ratio. See the World Bank's Rate of Return to Capital (RoRK) tool.

[135] Lao PDR ranked 65th (out of 71 low- and middle-income countries) in a Public Investment Management Index produced by the IMF. See "Investing in Public Investment: An Index of Public Investment Efficiency."

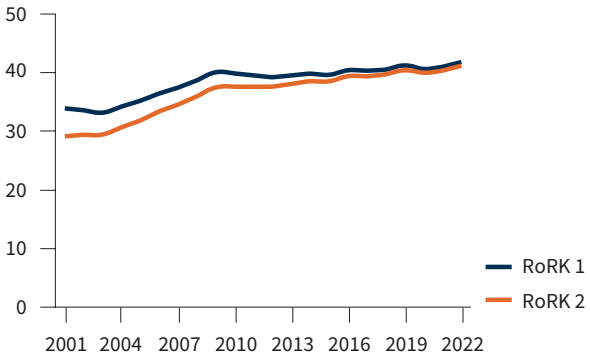
Figure 3.47: Rate of return on total capital (p.p.)



Source: World Bank and staff calculations.

Note: p.p. stands for percentage points.

Figure 3.48: Rate of return on public capital (p.p.)



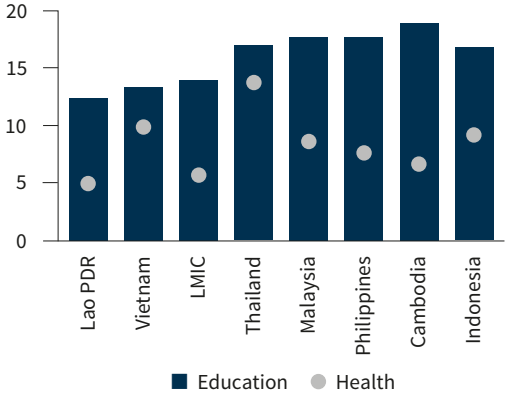
Source: Ministry of Finance and World Bank staff calculations.

Note: p.p. stands for percentage points.

3.3.3 Equity

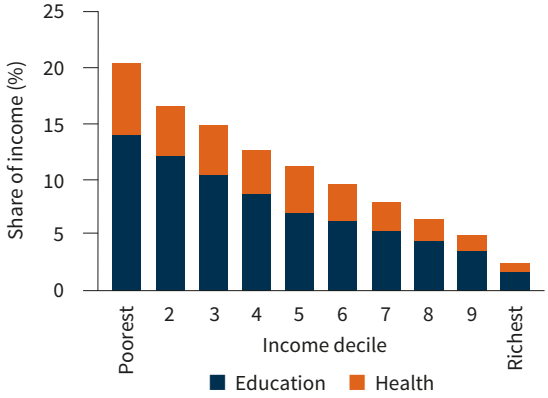
The impact of public spending on poverty and inequality is limited owing to the low levels of social spending. Fiscal policy is often deployed to stabilize the economy (e.g., cushion the impact of shocks), support economic growth, and reduce poverty and inequality. Scrutinizing the distributional impact of public spending is key to a better understanding of the latter.[136] Among lower-middle-income countries (LMICs) with available data, the Lao PDR ranked 16th out of 20 countries in terms of the inequality-reducing effect of the fiscal system and 15th out of 18 countries in terms of the poverty-reducing effect. Low levels of social assistance transfers do not provide sufficient income support to poor households to help them escape poverty or protect them from falling into poverty. During 2018–2021, despite the need to safeguard the poor and vulnerable during COVID-19, social assistance accounted for less than 0.1 percent of GDP. This is well below the spending levels in Cambodia (0.9 percent in 2015), Vietnam (1.6 percent during 2015–2016), and Thailand (1.6 percent during 2018–2020). Spending on education and health are also low compared to regional and income peers (Figure 3.49). While richer households tend to benefit more from public spending on health and education, due to different utilization rates and service types, the benefit represents a greater share of income for poorer households (Figure 3.50). The recent declines in health and education spending have, therefore, worsened inequality.

Figure 3.49: Education and health (% public expenditure, 2019)



Source: World Bank.

Figure 3.50: Incidence of spending



Source: World Bank staff calculations based on the Commitment to Equity Framework 2018.

Stronger investments in lagging regions would support greater equity in education and health outcomes. There are significant spatial disparities in terms of inputs, outputs, and outcomes within the country. This is particularly evident regarding access to (and quality of) public services and socioeconomic outcomes. Aligning sub-national spending to existing needs can therefore enhance equity in economic and social outcomes. For instance,

[136] See the World Bank's report "Raising the Bar: Towards an Equitable and Inclusive Fiscal Policy". The report conducts an analysis using the Commitment to Equity (CEQ) methodology.

budget allocations to provinces and districts could follow a formula comprising key dimensions (such as population, land area, poverty levels, and spending capacity) to enhance the spatial efficiency and effectiveness of spending. The 2025 Population and Housing Census presents a major opportunity to collect and use geospatial data for public service delivery. Since dwellings and basic public services will be geographically tagged (e.g., schools and health centers will be referenced by location), several tools can be then deployed to support planning and budgeting processes – and thus the quality of spending.[137]

3.3.4 Sustainability

Demand for public services will likely increase due to demographic, epidemiological, and income factors. Demographic and epidemiological trends are expected to raise the demand for public services. A demographic transition tends to raise the demand for education, placing pressure on the education system.[138] A rising burden of non-communicable diseases places pressure on health systems to adapt and provide prevention and treatment services. Moreover, public expenditure levels (as a share of GDP) tend to increase with a country's income level. This is partly because citizens demand more and better public services, such as higher education, specialized health services, and pensions. In the absence of additional resources, the quality of public service delivery can be expected to deteriorate.

Financing transitions will place further pressure on the budget, especially given poor domestic revenue performance. The Lao PDR graduated from the World Bank's low-income country (LIC) group in 2011 and is scheduled to graduate from the United Nations' Least Developed Country (LDC) category in 2026. As income levels increase, financial assistance from development partners tends to decline, at least in relative terms. Financing transitions, particularly in the education and health sectors, may thus reduce the availability of external resources and increase budget pressures, which are already strained by poor revenue performance and rising debt service obligations. Declining development assistance would need to be offset by domestic financing sources to maintain the same level of spending. Nonetheless, it is equally important to improve the efficiency and effectiveness of public spending. A reprioritization of the overall state budget could yield more human and physical resources for the social sectors without impacting fiscal sustainability.

3.4 Public financial management

Public financial management has gradually improved over time, but significant challenges remain. The 2018 Public Expenditure and Financial Accountability (PEFA) assessment identifies key strengths and weaknesses of the public financial management (PFM) system (see Annex, Figure 3.54). Emerging strengths include a more solid treasury and cash management system at the central level, and the increasing automation and integration of PFM processes (e.g., tax). Weaknesses are linked to the limited credibility of the budget (as an instrument to achieve policy objectives), lack of a medium-term perspective on budgeting, and weak links between strategic development plans, sector plans, and annual budget allocations. Budget monitoring is hampered by the manual consolidation of expenditures below provincial level and the absence of systems to track resources available at the service delivery level. The absence of a unified chart of accounts to track expenditures by functional classification hinders informed decision-making. Fiscal data consolidated by the National Treasury relies on manual processes that may affect reliability. The Government Financial Information System (GFIS) has limited coverage and functions, which affects timely and comprehensive budget execution reporting. The internal and external audit functions are not sufficiently resourced to mitigate the control weaknesses identified.

Improving public financial management systems would help enhance aggregate discipline, strategic allocation of resources, and efficient service delivery. Sound public financial management systems are essential to support domestic revenue collection and more sustainable and effective public expenditure. The weak fiscal position, accumulation of public debt, and emergence of expenditure arrears imply there is significant scope to improve public financial management. Improvements are needed along the entire budget cycle

[137] See the World Bank's Public Expenditure Review for Timor-Leste (chapter 6 on Digital Information).

[138] Lao PDR has one of the youngest populations in the region (60 percent of the population were under 25 in 2015). However, seizing a demographic dividend requires a healthy and educated labor force. Investments in education and health can support a more productive workforce and thus enhance economic growth. Recent phone surveys conducted by the World Bank show that households are cutting back on education and health spending as they cope with high inflation. The rising level of school dropouts is a growing concern.

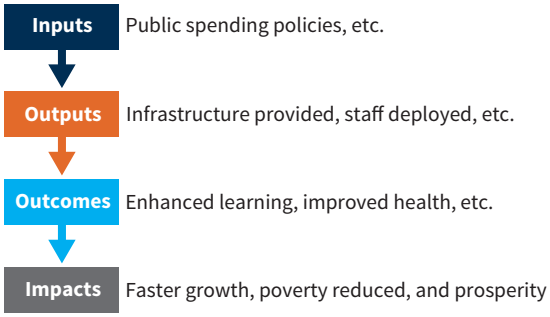
(Figure 3.51). There is a need for a more credible fiscal envelope, strengthening the medium-term perspective, adherence to budget ceilings, continuing the implementation of a Treasury Single Account, improving core government systems, implementing the revised chart of accounts, publishing timely and accurate budget information, and strengthening the capacities of the State Audit Organization and the National Assembly. Ensuring that planning and budgeting processes are results-based is key to accelerating economic growth and reducing poverty and inequality (Figure 3.52).

Figure 3.51: Main phases of the budget cycle



Source: World Bank staff.

Figure 3.52: Results-driven planning and budgeting



Source: World Bank staff.

Implementing the Decree on State Budget Planning would help enhance the quality of public spending. To implement key provisions of the 2015 State Budget Law (revised in 2021) and improve the budget formulation process, the MoF began to develop a Prime Minister's Decree on State Budget Planning in early 2020. The decree mandates the use of a State Budget Policy Statement as a driver of the budget planning process.[139] It defines the budget timelines and processes, as well as the responsibilities of relevant parties (notably MPI and MoF, responsible for the capital and recurrent budget, respectively) to ensure the submission of a credible state budget. The decree requires the government to issue ceilings for the next budget and indicative allocations for two outer years for the budget units (including ministries and provinces) to prepare their medium-term budget plans. The successful implementation of the decree would contribute to improving the efficiency and effectiveness of public spending.

Implementing the new Financial Management Information System would help strengthen spending controls. The existing GFIS is limited in its capability to provide the technological backbone of a core Financial Management Information System (FMIS). The GFIS covers only a subset of functionalities required for a fully functioning budget execution system, since bank reconciliation is not yet in place and district offices are not included in its coverage. The GFIS has no commitment control function. In its absence, government entities enter into commitments without confirmation of budget availability, which results in payment arrears. There is no interface for data exchange between GFIS and other government systems.[140] The implementation of the new FMIS, based on a revised chart of accounts, is expected to provide comprehensive and timely data for planning, monitoring, and decision-making. It will help strengthen spending controls (and thus minimize the accumulation of arrears) and improve the comprehensiveness and reliability of the government's financial statements.

Modernizing human resources management would help strengthen strategic decision-making and wage bill controls. The wage bill accounts for a very large share of recurrent spending. Improving human resource management, which requires comprehensive information on civil service headcount and composition, is critical to enhance public service delivery. The government's ability to manage human resources is hampered by a Personnel Information Management System (PIMS) that has considerable limitations. The PIMS is estimated to cover less than 25 percent of the public sector workforce, as major employers (e.g., police and armed forces) and employment regimes (e.g., contract and casual workers) are outside the system. The PIMS also has limited functionalities in key areas such as recruitment, performance appraisal, and training. Moreover, its architecture cannot be extended to

[139] The State Budget Policy Statement comprises five sections: (i) macroeconomic projections; (ii) five-year rolling fiscal framework; (iii) rolling medium-term state budget; (iv) annual state budget plan; and (v) fiscal risks.

[140] Other key information systems include the Automated System for Customs Data (ASYCUDA) of the Customs Department, the Tax Revenue Information System (TaxRIS) of the Tax Department, the Debt Management and Financial Analysis System (DMFAS) of the Public Debt Management Department, and the Personnel Information Management System (PIMS).

become a modern solution that goes beyond a recording system to one of engagement, analytics, and innovation. Adopting a new human resource management information system with expanded coverage and functionalities would help reduce costs for employee management and preparation of payrolls, while supporting planning and rightsizing. Professionalizing the civil service through a shift from personnel administration to talent management would also be important.

Implementing a Treasury Single Account would improve cash management, modernize treasury operations, and help minimize borrowing costs. The transition toward a Treasury Single Account (TSA) is incomplete. While the Bank of the Lao PDR (BoL) and commercial banks provide daily information on the balances of all accounts under the control of the National Treasury, these are not consolidated in a single account at the end of each day. In addition, some earmarked fund accounts and all donor fund accounts are kept outside the TSA. Consequently, the National Treasury is working on a weekly cash cycle, resulting in cash rationing (including delays in salary payments) and taking on expensive short-term borrowing.[141] The implementation of a TSA will improve cash management, modernize treasury operations, and help minimize borrowing costs by preventing cash shortages and making better use of idle balances.[142]

Scrutinizing and publishing the reports of the State Audit Organization would enhance transparency and accountability. Comprehensive and reliable external audits are essential for promoting transparency and accountability in the use of public funds. The government's annual financial reports are submitted to the State Audit Organization (SAO), which then submits a report to the National Assembly. The president of the SAO makes a formal presentation of the main conclusions and recommendations, which is broadcast and disseminated. However, there are no in-depth hearings of the SAO findings by the National Assembly, and when the SAO report is presented, the National Assembly does not summon the representatives of the audited agencies whose findings have been highlighted. In addition, the reports are not published on the SAO website and are not publicly available. SAO reports should be scrutinized by the National Assembly and published to enhance transparency and accountability.

Promoting transparent competition in public procurement would improve spending efficiency. Open, transparent, and fair procurement processes can ensure an efficient use of public resources, especially since this is an area often prone to abuse. While the legal framework for public procurement has been strengthened, its implementation is limited, and capacities are weak.[143] The 2017 Law on Public Procurement provides the foundation for public procurement. An implementing instruction was adopted in 2019, tools were developed (such as a procurement manual, standard bidding documents, templates, and procedures for complaint handling), and capacity building was provided. However, there is no data on the application of the various procurement methods stipulated in the law. Hence, the implementation of the law is not systematically monitored, thereby providing opportunities for using procedures outside the law. Establishing a mechanism to collect and disclose information, and to monitor and enforce the implementation of the law in procurement operations by government entities, is important to enhance competition and reduce inefficiencies.

Improving public investment management is essential to enhance the quality and impact of government spending. Public investment management suffers from limitations in planning capacity, inadequate application of pre-feasibility and selection criteria, incomplete costings, and fragmented implementation monitoring.[144] Detailed guidelines are available at the central level, but the management of public investments is decentralized to line ministries and provinces, with no standardized quality assurance for evaluations and no pre-feasibility studies. Setting up a centralized and robust public investment management monitoring system will be crucial. Meanwhile, government line ministries and provinces should follow their five-year investment budget plans as a reference for infrastructure development. It is also fundamental to clearly allocate responsibilities for investment decisions and enhance transparency in decision-making, including for public-private partnerships. Given existing fiscal pressures, prioritizing infrastructure projects with high economic and social returns (and financing these at concessional terms) would be key to securing fiscal sustainability and improving spending effectiveness.

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[141] The reconstituted TSA Committee is currently reviewing three options for a TSA mechanism and is expected to develop a roadmap for implementation.

[142] Inefficient cash management can lead to negative carry (e.g., if government deposits at commercial banks are relatively high compared to public domestic debt). Some deposits are kept outside the control of the National Treasury.

[143] This is reflected in the very low scores on the PEFA Indicator PI-24 on Procurement Management and its sub-indicators (e.g., monitoring, methods, public access to information, and complaints management).

[144] This is reflected in the low scores on the PEFA Indicator PI-11 on Public Investment Management and its sub-indicators (e.g., economic analysis of proposals, project selection, project costing, and project monitoring).

3.5 Conclusion and recommendations

Government spending declined significantly in the past decade, raising concerns about spending adequacy and public service delivery. Weak revenue performance and limited access to finance have forced an expenditure-led fiscal consolidation that 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 currently insufficient to meet increasing needs. Public spending is low when compared to regional and income peers. With debt service obligations growing, non-interest spending will be further under pressure. Limited fiscal space has undermined the government's ability to protect households and businesses from recent shocks (e.g., COVID-19 and high inflation). Fiscal pressures are compounded by several challenges relating to public financial management, with poor planning and weak commitment controls appearing to be major weaknesses. Improving planning, budgeting, and implementation can enhance budget performance and thus improve the quality of public spending.

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, which partly reflects the government's 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 a significant level of fiscal decentralization to the provinces.

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 key 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. Public spending on education and health has declined in real terms and is very low by international standards. Evidence suggests that spending on these sectors has a positive effect on poverty reduction and equity. Hence, there is significant room to improve the allocation of budgetary resources across categories and spending units. Discretionary spending is relatively high, implying that there is scope for fiscal adjustments, if there is political will. However, the lack of comprehensive information (i.e., budget transparency) undermines an assessment of potential budget savings.

Reallocating spending toward education, health, and social protection is key to avoiding a collapse in human capital. The combined spending on education and health declined from 4.9 to 2.6 percent of GDP between 2013 and 2022. This is very low by international standards. Spending on social assistance is negligible. COVID-19 and high inflation have eroded human capital, which may undermine economic prospects for an entire generation. Meanwhile, demand for public services is expected to increase due to demographic, epidemiological, and income factors, while financing transitions (i.e., decline in development assistance) will place further pressures on the budget. In the absence of additional domestic resources, the quality of basic public service delivery will deteriorate considerably. However, the relatively low degree of budget rigidity suggests that there is scope for reallocating budget resources across and within categories to improve efficiency and effectiveness. The lack of comprehensive reporting hinders an 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.[145] A reprioritization of the overall state budget could yield more human and physical resources for the social sectors without impacting fiscal sustainability. Nonetheless, benchmarking suggests that the quality of spending in these sectors also needs to be improved (e.g., improved spatial and group-based targeting). Therefore, there is a need for more and better spending on sectors that boost productivity and enhance economic growth.

[145] For instance, it is not clear which budgetary units (e.g., ministries) or sectors are responsible for spending much of the wage and capital budgets. Without detailed information, it is difficult to identify spending items that could be cut or deprioritized.

Strengthening spending controls would help 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 accumulation. The new FMIS is also expected to provide comprehensive and timely data for planning, monitoring, and decision-making. Moreover, implementing a Treasury Single Account would improve cash management, modernize treasury operations, and help minimize borrowing costs.

Reporting data for all spending units will increase budget transparency and help promote accountability. Budget transparency has been eroded over the past two decades. 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 (e.g., Ministry of Defence and Ministry of Public Security). These trends significantly undermine budget transparency and thus the ability to scrutinize the quality of public spending. Moreover, this also 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. Moreover, scrutinizing and publishing the reports of the State Audit Organization would also enhance transparency and accountability. Comprehensive and reliable external audits are essential for promoting transparency and accountability in the use of public funds.

Enhancing budget preparation and execution, with a focus on procurement and public investment management, will improve the impact of public spending. Budget preparation and execution can be improved. The recently approved Prime Minister's Decree clearly defines timelines, processes, and the roles of different entities. It also sets out a medium-term budget perspective to facilitate strategic decisions and prioritization. However, these reforms need to be fully implemented. Moreover, promoting transparent competition in public procurement will improve spending efficiency. While the legal framework for public procurement has been strengthened, its implementation is limited and capacities are weak. Finally, improving public investment management is essential to enhance the quality and impact of capital spending. This ought to include public-private partnerships, which should be seen as a procurement option for public projects rather than a financing instrument. 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.

Improving human resource planning will enhance the effectiveness of the civil service. The government's ability to manage human resources is hampered by a Personnel Information Management System (PIMS) that has considerable limitations. For instance, the PIMS is not comprehensive (because major employers and employment regimes are not recorded) and has limited functionalities (e.g., recruitment and performance appraisal). Modernizing human resources management would help strengthen wage bill controls. Adopting a new PIMS would help reduce costs while supporting planning and rightsizing. Professionalizing the civil service through a shift from personnel administration to talent management would also be critical to enhance public service delivery.

Annex: Public Financial Management

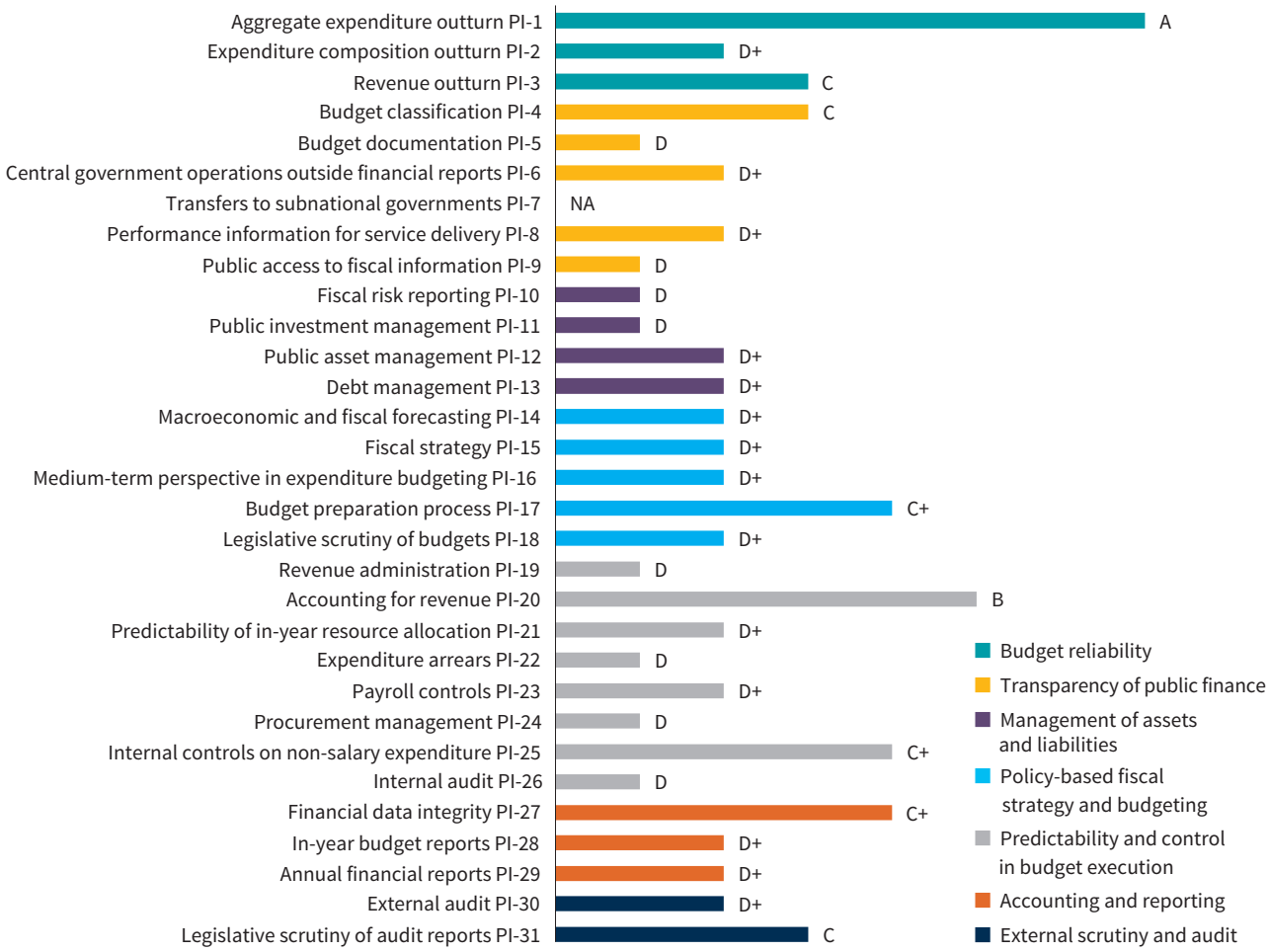
The Public Expenditure and Financial Accountability (PEFA) framework enables a comprehensive diagnostic of public financial management systems. PEFA assessments follow an established methodology to measure performance across different areas relating to public financial management (PFM): budget reliability, transparency, asset management, budget preparation, execution controls, accounting, and audit. The PEFA framework is based on the stages of the annual budget cycle and evaluates the strengths and weaknesses of PFM systems using a letter-grade scoring system.[146] Quantitative indicators are used to measure 94 characteristics (known as dimensions) across 31 components (indicators) in seven broad areas of activity (pillars).

[146] The scoring system is as follows: (A) high level of performance that meets good international practices, (B) sound performance in line with many elements of good international practices, (C) basic level of performance, and (D) less than the basic level of performance.

PEFA assessments evaluate the impact of PFM performance on the three main fiscal and budgetary outcomes. Good public financial management is crucial to link available resources, delivery of services, and achievement of government policy objectives. Strong PFM systems ensure that revenue is collected efficiently and used appropriately and sustainably. Hence, a good PFM system is an enabling element of the following three desirable fiscal and budgetary outcomes: (i) 'aggregate fiscal discipline', which requires effective control of the total budget and management of fiscal risks; (ii) 'strategic allocation of resources', which involves planning and executing the budget in line with government priorities aimed at achieving policy objectives; and (iii) 'efficient service delivery', which requires using budgeted revenues to achieve the best levels of public services within available resources.

The 2018 PEFA assessment shows that most dimensions are not aligned with international standards. The 2018 PEFA assessment for the Lao PDR reveals that only 8 out of the 31 indicators showed a basic alignment (or better) with good international practices, represented by a score of C or above (Figure 3.53). However, 22 indicators scored below C, suggesting weak performance. Out of the 94 dimensions, 43 dimensions were scored at C or above, 48 were scored D, and three were not scored. Nonetheless, these results need to be contextualized, since some reforms that would lead to higher scores in the short-term may not be pertinent for the country. It is, therefore, crucial to develop a prioritized and sequenced reform plan that aims to maximize the impact of PFM reforms on public finance outcomes.

Figure 3.53. PEFA scores



Source: PEFA 2018.

4

State-Owned Enterprises



4. State-Owned Enterprises

Deepening and accelerating reforms of state-owned enterprises (SOEs) is critical to ensure that they fulfill their mandates, operate efficiently, and do not generate undue fiscal risks. SOEs have been established worldwide for different purposes, such as addressing market failures, supporting national strategic interests, and promoting socioeconomic objectives. However, many SOEs are inefficient and struggle to meet their policy mandates. This has led to considerable operational losses and heavy indebtedness, which have jeopardized fiscal and debt sustainability. The Lao PDR has made some progress in reforming its SOE sector throughout the years. 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, the results of past reforms have been mixed, and several challenges remain. Reform progress has been undermined by institutional weaknesses, low capacity, and political economy constraints. 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 prevents a comprehensive assessment of the sector. Available data suggests that many SOEs have negative equity and generate persistent losses, and the largest ones are highly indebted, presenting a significant fiscal risk. Aggregate financial performance indicators raise concerns over the electricity, transport, and finance sectors, where EDL, Lao Airlines, and BCEL are key actors. 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. While there has been a renewed momentum for SOE reform since 2021, it is crucial to intensify the activities of SOE reform committees and implement their reform plans. Overall, there is a need to improve SOE corporate governance, operational management, and financial performance, as well as enhance transparency.

Main recommendations: (i) centralize and strengthen the state ownership and oversight function; (ii) create a fiscal risk management unit within the Ministry of Finance; (iii) broaden the ownership of SOEs; (iv) professionalize SOE boards of directors to promote good governance and enhance performance; and (v) disclose SOE performance reports to increase transparency and strengthen accountability.

Chapter structure: The chapter starts by describing the rationale for SOEs, briefly reviewing the global experience, and summarizing past reforms in the Lao PDR. The following section evaluates the recent financial performance of the SOE sector. The chapter then discusses recent reform efforts and existing plans, including changes to the legal and institutional framework. The final section provides key recommendations to improve the financial performance, operational management, and corporate governance of SOEs.

4.1 Background

4.1.1 Definition and role of SOEs

In this chapter, 'state-owned enterprise' is defined as a corporate entity recognized by law that is at least partially owned by the government. There is no universal definition of an SOE since definitions differ across countries, often anchored in national SOE-related legislation. However, there are some common features, such as (i) having its own separate legal status; (ii) being at least partially controlled by a government unit; and (iii) predominantly engaging in commercial activities.[147] The recent Decree on SOEs defines them as business units in which the state is the only investor or a joint venture with other parties, including pre-existing enterprises acquired by the state. Hence, an SOE is any corporate entity recognized by Lao law as an enterprise in which the state has some level of ownership. Typically, SOEs are independent commercial entities that generate most of their income from selling goods and services. They do not depend on transfers from the government to cover most of their costs and are usually able to borrow on their own account.

The characteristics of SOEs and their rationale vary considerably across and within countries. SOEs vary in terms of size, sector of activity, and the degree of state ownership. Some are fully owned by the government, while others

[147] A government unit may exert significant influence over corporate decisions in an entity even when only holding a minority stake (e.g., through golden shares or indirect ownership). See the IMF Fiscal Monitor April 2020 and OECD Guidelines on Corporate Governance of SOEs.

have mixed ownership (i.e., both public and private owners). SOEs can be owned at either central or sub-national government levels. SOEs provide goods and services in many economic sectors, including utilities (e.g., gas, electricity, and water), finance, transportation, telecommunications, mining (e.g., oil), manufacturing, and construction. SOEs have been created for several reasons, sometimes linked to market failures that lead to a suboptimal (or lack of) provision of important goods or services (Box 4 and Box 5). These reasons include natural monopolies (due to high initial costs), under-provision of essential public goods (due to non-rivalry and non-excludability), and externalities (positive or negative). Other purposes include supporting national strategic interests (e.g., control over natural resources, or national defense), and promoting socioeconomic objectives (e.g., employment).

Despite the motives for their existence, country experiences illustrate drawbacks that need to be carefully considered. Many countries rely on SOEs to provide public services, as well as foster economic and social development.[148] However, some SOEs struggle to meet (often multiple) policy mandates and are inefficient.[149]Some operate in a competitive environment without a clear policy mandate, where the private sector can generally deliver similar goods and services more efficiently. The separation of ownership (government) and control (SOE management) may create conflicts of interest and moral hazard (i.e., the principal-agent problem), which can lead to inefficiencies and mismanagement.[150] Moreover, some receive excessive government support and are vulnerable to vested interests.[151] It is therefore important to use SOEs pragmatically, by clarifying their policy mandates and regularly assessing their rationale, corporate governance, management, and financial performance.[152] It is crucial to ensure they fulfill their mandates, provide good value for money, and do not burden the state budget.

SOEs play a large role in several sectors of the Lao economy, including energy, finance, transportation, telecommunications, mining, and water. Over the years, some SOEs have made significant contributions to the country's economic development. Through SOE activities, access to electricity and improved water sources expanded considerably, transport and telecommunications infrastructure increased, and domestic credit to the private sector grew. SOEs also provide essential products to society, including construction equipment, pharmaceuticals, medical equipment, and educational materials. Nonetheless, SOE investments and operations have entailed large fiscal costs and led to a considerable rise in contingent liabilities.

4.1.2 Historical trends and recent reforms

SOE reforms have been pursued in several phases since the mid-1980s, with some positive results. Most enterprises were nationalized in the second half of the 1970s, but weak performance, partly due to a centrally-planned economic system, led to granting a greater role to market forces. SOE reforms started in the mid-1980s, as part of broader economic reforms under the New Economic Mechanism.[153] Similar reforms were initiated by China in 1979 and Vietnam in 1986, although the Lao PDR had fewer and smaller SOEs. SOE reforms can be categorized into four distinct phases. The first phase focused on giving greater operational autonomy to SOEs, while the second phase placed an emphasis on privatization.[154] In the third phase, SOEs were subject to a more comprehensive reform effort that went beyond ownership. A fourth phase has recently started. Overall, past reforms have reduced the dominance of a (largely) inefficient SOE sector and gradually paved the way for an emerging private sector. However, progress on SOE reform has generally been undermined by institutional weaknesses, low capacity, and political economy constraints. Moreover, the recent financial difficulties faced by the larger SOEs cast a shadow on previous efforts, while providing important lessons for future reforms.

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[148] SOEs are prevalent in the provision of public services (e.g., electricity, water, and transportation) and financial services.

[149] They often face competing objectives, such as profit maximization (especially if listed) and socioeconomic objectives. Non-commercial mandates (e.g., social objectives) are often not adequately compensated, leading to indebtedness.

[150] This may happen when the government (i.e., the principal) does not have the capacity or information required to oversee SOE performance effectively.

[151] Government support may include direct financial support (e.g., subsidies and capital injections), tax exemptions, below-market financing, and guarantees. It can lead to financial stress (if it is insufficient to cover the cost of pursuing their policy mandates) or give them an unfair competitive advantage over private firms (if it is excessive). It can also help sustain SOEs with unsustainable business models and thus undermine fiscal sustainability. Unwarranted political interference and rent-seeking may constitute additional challenges.

[152] This requires developing institutions and processes to evaluate SOE performance and regularly assessing whether an SOE is the best way to achieve a given policy goal.

[153] See "Trial and Error in State-Owned Enterprises Reforms in Laos".

[154] In a broad sense, privatization does not involve divestment of state ownership or asset sales as it also includes leasing and joint ventures.

Box 4: SOE origins, challenges, and reforms

SOEs rose to prominence in the 1950s and 1960s, as they became widespread in most parts of the world. The origins of SOEs are often traced back to the early 20th Century, following the nationalization of key industries in Europe. With the end of colonialism, many countries in Africa and Asia created SOEs, often to support certain ideologies (e.g., nationalism or socialism). It is estimated that, by the early 1980s, SOEs accounted for 8 percent of output in advanced economies and 15 percent in developing countries.[155]

By the 1970s and 1980s, it had become clear that SOEs were associated with significant challenges. SOEs were found to often perform worse than private firms, both financially and in terms of service delivery. Inefficiencies were partly driven by poor corporate governance, owing to ineffective ownership or conflict of interest.[156] Moreover, lack of competition in a sector (e.g., monopoly) meant that inefficient and unproductive SOEs could still be viable, while soft budget constraints (owing to explicit or implicit government support) created moral hazard. SOEs also had multiple (and sometimes unclear) policy mandates that were difficult to reconcile. Weak governance also led to the use of SOEs for personal and political benefit. Some SOEs became a heavy burden on public finances, threatening fiscal sustainability, and were crowding out resources required for the emergence of a dynamic private sector (e.g., credit and access to markets).

SOE reforms attempted to tackle these challenges, partly through corporatization and (partial or full) privatization. SOE reforms have been mostly aimed at increasing efficiency and easing the burden on public finances.[157] SOE reforms worldwide from the 1980s and 1990s focused on transferring SOE ownership to the private sector, fostering competition in markets where SOEs operated, imposing hard budget constraints on SOEs, and improving performance monitoring. Many SOEs around the world are no longer fully owned by the government, as mixed ownership has become more prominent, even if governments have often chosen to retain a majority stake.[158] Some countries also pursued corporatization. This involved placing SOEs under the same commercial laws as private firms, giving them the legal status and the management structure of a corporation. Many SOEs now have shareholders and a board of directors, though they can still be fully owned by the state. These reforms were partly driven by the transition to market economies that followed the dissolution of the Soviet Union. Nonetheless, the experience of China, Singapore, and other countries has somewhat renewed interest in the role of SOEs. Privatization efforts continued in the 2000s, often improving revenue, creating a lower fiscal burden, and enhancing public service delivery. However, most successes were in commercially attractive sectors, such as telecoms, trade, manufacturing, and among smaller enterprises. Some SOEs proved difficult to privatize, particularly natural monopolies. There were also failures due to vested interests and bad transactions, and efficiency gains were not always shared equally among stakeholders.

Reform efforts have continued throughout the world, but SOEs remain widespread. Over the last 20 years, the SOE reform agenda has broadened, deepened, and increased in sophistication. The main directions of SOE reform programs now typically include: (i) strengthening and centralizing the state ownership function; (ii) continuing privatization where appropriate and ensuring equitable treatment of all shareholders in mixed ownership companies; (iii) improving SOE performance management; (iv) reimbursing the costs of SOE public service obligations; (v) professionalizing SOE boards of directors; (vi) ensuring competitive neutrality between SOEs and private enterprises; and (vii) enhancing transparency and disclosure, as well as financial and fiscal discipline for SOEs.

[155] IMF Fiscal Monitor April 2020, and Occasional Paper 137.

[156] Unlike private firms, SOEs are owned by the government on behalf of citizens, which undermines accountability and generates limited incentives to innovate and improve efficiency. Conflict arises when a government entity is both the owner and the regulator (or policymaker).

[157] Governments may try to raise fiscal revenues and reduce expenses (e.g., direct subsidies) by selling equity in SOEs. However, doing so when facing solvency pressures may lead to a 'fire sale' of state assets.

[158] This is likely due to the intention to privatize gradually and keep a presence in sectors seen as strategic. Political feasibility may also have played a role, especially owing to negative attitudes toward foreign ownership and the existence of vested interests.

Box 5: Regional experiences

SOE origins and experiences vary considerably across the region, and often reflect economic, social, and political factors. The prevalence of SOEs differs significantly across countries in Asia.[159] For instance, SOEs account for a significant (albeit declining) share of GDP in Vietnam (30 percent) and China (25 percent), but they are less significant in Cambodia, the Lao PDR, and Thailand (10 percent). They have diverse origins, from supporting political ideologies (e.g., nationalism and socialism) to facilitating economic strategies (e.g., industrialization).[160] Reform efforts have typically been driven by financial motives (e.g., decline in foreign assistance and growing burden on public finances) rather than an intrinsic desire to promote efficiency and productivity. Political economy considerations partly explain the slow pace of reforms in some countries. Recent reform trends include: (i) reduced ownership through partial divestment to allow private sector involvement (e.g., equitization in China and Vietnam), (ii) improved corporate governance to enhance efficiency (e.g., professionalization of management, introduction of performance targets, and adoption of international accounting standards); and (iii) improved oversight (e.g., centralization) and transparency. Below is a summary of the experiences of China, Thailand, and Vietnam.

China. SOE reforms started in the late 1970s, as the country moved toward a market-oriented economy by giving SOEs greater autonomy in decision-making. In the 1990s, many SOEs were transformed into joint-stock companies, and performance-based incentives were introduced. Several SOEs were restructured, and some were listed on the stock exchange. In the early 2000s, the focus was on improving efficiency and competitiveness, which entailed restructuring, professionalization of management, and adoption of international accounting standards. In the mid-2010s, the government promoted mixed ownership, although many challenges persist. While SOEs remain important in the economy, reforms have increased their access to capital and knowledge, which helped improve their efficiency and competitiveness, even leading to their internationalization. A core component of China's reform strategy has been the inclusion of private shareholders in the ownership structures of SOEs. A declared aim of this policy is to maximize efficiency by improving corporate governance.

Thailand. Thailand started privatizing some SOEs in the 1980s, such as the Electricity Generating Authority of Thailand (EGAT), to increase efficiency and reduce the fiscal burden. In the 1990s, a commission was established to oversee the restructuring of SOEs and improve their performance (through greater transparency, accountability, and competition) and an office was created to monitor and evaluate SOE performance. Reforms continued with several legal instruments aimed at improving corporate governance (e.g., appointment of independent directors, performance-linked pay, and establishment of audit committees). There are around 55 SOEs, of which 46 are fully owned by the state and seven are publicly listed. They operate in many sectors of the economy. Line ministries are responsible for sector policies, but the Ministry of Finance is the shareholder for all SOEs, which it supervises through its State-Owned Enterprise Policy Office. Recent reform priorities include enhancing SOE competitiveness and more efficient provision of essential public services, reducing fiscal risk, and improving transparency and accountability in public spending. Thailand's accession to international trade agreements has spotlighted the need to ensure SOE competitive neutrality.

Vietnam. Reforms started in the 1980s by giving SOEs greater independence, applying stricter budget constraints, and experimenting with joint ventures with foreign companies. SOE reforms accelerated in the 1990s, with many SOEs sold to private investors (privatization) or converted into joint-stock companies (equitization).[161] In the early 2000s, the focus was on restructuring and equitizing large and inefficient SOEs in strategic sectors, such as energy and telecommunications, and improving transparency and accountability. In the mid-2010s, there were also efforts to strengthen the legal framework and increase private participation. About 4,000 SOEs were equitized between 1998 and 2008. The number of SOEs fell from 3,281 in 2010 to 2,200 in 2021 through divestments and closures, although they continue to play a significant role in the economy.[162]

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[159] Different definitions, accounting standards, and valuation methods undermine cross-country comparisons, even in terms of size and sectoral distribution.

[160] The efficiency and profitability of Singapore's SOEs are often explained by the country's external openness (due to its small size) and, thus, the need to be competitive in international markets. A preference for listing SOEs in the stock exchange, professional management with limited state interference, and intolerance for corruption are often cited as reasons for success.

[161] In Vietnam, equitization is the conversion of an SOE into a public (joint stock) company or a corporation by dividing ownership into shares. SOEs in Vietnam are subject to the same laws as private enterprises.

[162] Although nearly 97 percent of SOEs have been equitized, only 8 percent of their stocks are held by private investors.

The first phase of SOE reforms in the Lao PDR focused on granting greater managerial autonomy, aiming to improve their efficiency and financial performance. The first wave of reforms took place in the second half of the 1980s, roughly 1986–1989. SOEs were mostly transformed into autonomous or commercialized SOEs, with the authority to determine production and investment levels, wages, and prices. Government subsidies and capital transfers were largely discontinued.[163] These reforms aimed to improve SOE operations in terms of service delivery and financial performance, with the state retaining full ownership. Complementary reforms included the removal of price controls (with a few exceptions) and trade liberalization. However, privatizations were limited to mainly small enterprises. The separation of the central and commercial banking functions of the state bank also occurred during this phase. Despite these efforts, SOE expenditures increased considerably, supported by significant bank loans, compounding the financial burden on the government and increasing the vulnerability of the banking system.

The second phase built on the lessons of the first and focused on the privatization of SOEs. The second wave of reforms occurred in the 1990s, mostly in 1990–1997. These were mainly motivated by a need to reduce the growing burden of SOEs on public finances, a consequence of the first wave of reforms, particularly with the loss of financial support from the Soviet Union. The aim was to transfer the ownership of SOEs to the private sector, except those operating in strategic sectors (such as electricity, water, and telecommunications), which were to be restructured. However, most privatizations occurred in small and medium enterprises (SMEs) operating in peripheral services sectors, such as hospitality. SOE reforms focused on leasing, merging, selling, and closing many SOEs. In this period, more than 500 enterprises (out of 640) were privatized, although mostly through leasing and predominantly at the provincial level.[164] Privatization proceeds were limited, partly owing to their small size. Despite a very large reduction in the number of SOEs, the remaining ones still caused financial stress. Meanwhile, foreign banks were allowed to operate as joint ventures. State-owned banks had been accumulating large nonperforming loans (owing to policy-driven lending) and had to be restructured and recapitalized, with the problem persisting until the 2000s. The 1997 Asian Financial Crisis undermined reform efforts for the rest of the decade.

The third phase focused on aspects beyond the ownership of SOEs, such as restructuring, the institutional and legal framework, and corporate governance. The third wave of reforms mainly happened in the 2000s. The focus was on restructuring inefficient SOEs, improving transparency and governance (such as through stronger financial reporting requirements), and rationalizing the regulatory and pricing environment. These reforms were broader and more complex than the earlier waves, aiming to improve the efficiency of the larger and more strategic SOEs without complete privatization. The reform led to the liquidation of a few large loss-making SOEs, especially big conglomerates in the forestry sector, such as Bolisat Phatthana Khet Phoudoi and DAFI Group, and other smaller SOEs. Reforms also promoted an increased role for the private sector by spinning off parts of large SOEs, such as Électricité du Laos (EDL), to create EDL Generation Public Company (EDL-GEN) and by listing the Banque pour le Commerce Exterior Lao Public (BCEL) and EDL-GEN in the newly founded Lao Stock Exchange. There was also a significant reduction in domestic credit to SOEs, partly a consequence of the 1997 Asian Financial Crisis. Nonetheless, the results of this wave of reforms were mixed. Despite some improvements in revenues, rates of return remained low. By 2012, 99 SOEs were classified as 'inefficient' compared to 27 'efficient' and 6 'highly efficient'. Joint ventures were found to be more efficient and profitable than other ownership types. The pace of reform slowed in the 2010s, partly owing to the 2007–2008 Global Financial Crisis and perhaps a reluctance to deal with the larger SOEs.

A fourth phase has recently started, with a comprehensive SOE reform program. The role and importance of SOEs have changed significantly over time. Hundreds of SOEs have been either privatized, divested, sold, closed, or dissolved in the past decades to reduce the fiscal burden, improve efficiency, and enhance public service delivery. SOEs have exited some competitive sectors, while their presence has been significantly reduced in others (e.g., finance). However, this fourth wave of reforms was instigated by the serious economic challenges facing the country, as reflected in the 2021 National Agenda on Addressing Economic and Financial Difficulties. Some SOEs played a pivotal role in the accumulation of public debt (particularly EDL), while recent shocks (e.g., COVID-19, a deteriorating external environment, and a sharp exchange rate depreciation) have further compounded their financial stresses. However, the level of political commitment to reform appears to be high and there is ample scope for undertaking progressive reforms to improve the governance and financial performance of SOEs. Section 4.3 provides a summary of the measures taken over the past couple of years, as well as future reform plans.

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[163] See IMF Occasional Paper 137.

[164] Fixed-term leasing only changes the management structure, not the ownership structure, and only for a limited period (say 15 years). Although perhaps more politically acceptable, this mode of privatization discourages long-term investments and entails a high administrative burden. Between 1989–1994, 64 centrally managed SOEs were privatized out of about 200 in 1989. In 1989, SOEs employed about 16,000 people, which was about 10 percent of non-agriculture labor force. See IMF Occasional Paper 137.

4.2 Performance of the SOE sector

Many governments expect SOEs to fulfill multiple policy mandates while performing efficiently. Evidence tends to suggest that profitability and productivity are lower in SOEs than in private firms, especially when the government has a majority stake. This might be partly due to the cost of pursuing policy mandates for which many are not reimbursed (e.g., providing affordable public services, often below cost-recovery, and promoting employment). In the Lao PDR, this mainly pertains to electricity, air transport, and banking services. However, operational inefficiencies arising from poor SOE corporate governance also play a key role. Mixed ownership tends to deliver higher profits and efficiency, suggesting that private involvement can be beneficial. Moreover, improved governance (e.g., control for corruption) reduces gaps in performance and productivity in relation to private firms.

SOE's financial performance and the realization of risks can have significant fiscal impacts. Governments often provide support in the form of capital injections and recapitalization, especially for SOEs operating in the electricity, transport (e.g., airlines and railways), and finance sectors. SOE debt can pose considerable fiscal risks, even in the absence of explicit guarantees. In addition, SOEs may have considerable obligations to private entities through joint ventures, power purchase agreements, and public–private partnerships. The materialization of these contingent risks, in both financial and nonfinancial SOEs, can have significant impacts on the economy (e.g., limited credit growth and suboptimal investments).

The SOE portfolio in the Lao PDR is relatively decentralized and spread over several economic sectors. There were 162 SOEs in 2021, of which 111 had an active status; 60 at the central level and 54 at the local level (Table 4.1). The remaining 51 SOEs were either inactive (29), lacked information (18), or were newly established (4). The overall total does not include 13 SOEs that were dissolved or liquidated and 7 SOEs that were privatized or restructured. Data for 2017 shows that the government held more than 50 percent of the share capital in most SOEs. The fact that most SOEs were still wholly owned by the government signaled a preference for full control. However, there are a significant number of SOEs where the government has a minority stake, particularly at the central level. This is mainly the result of partial share sales, as the authorities have favored the retention of partial ownership, perhaps due to a reluctance to fully privatize. Recent and planned reform efforts indicate the intention of the government to divest its position in small fully-owned SOEs, apart from strategic SOEs. SOEs are present in several economic sectors, including electricity, water, mining, construction, agriculture, transport (e.g., road, rail, air transport), telecommunications, and finance (especially banking). However, some sectors and sub-sectors only have SOEs with a state minority stake, such as mining, beverages, tobacco, and insurance.

Table 4.1: SOE portfolio

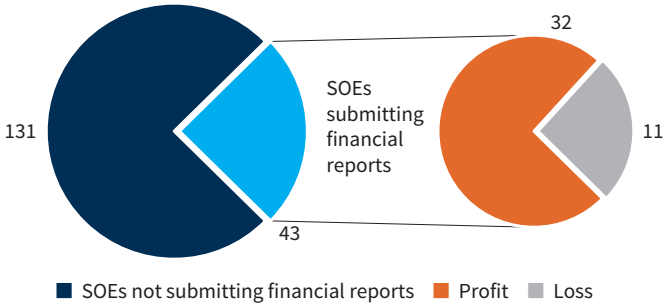
State ownership	2017			2021		
	Central	Local	Total	Central	Local	Total
Majority (> 50%)	54	69	123	40	44	81
of which whole (100%)	48	65	113	..	..	..
Equal or less than 50%	38	13	51	20	10	30
Other (inactive, unknown, or new)	..	..	..	..	..	51
Total	**92**	**82**	**174**	**..**	**..**	**162**

Source:Ministry of Finance.

Note: Data is not fully comparable across years due to changes in categorization (i.e., 'other').

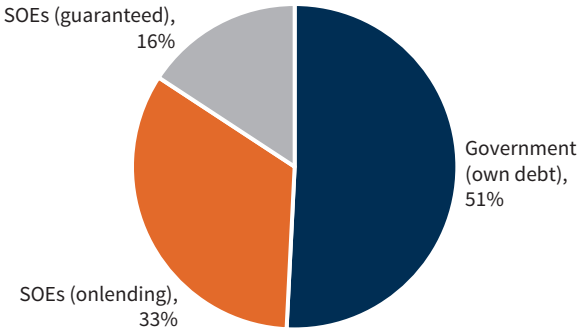
Most SOEs do not consistently submit financial reports to the government, and there is uneven compliance with reporting standards. Comprehensive financial information for most SOEs is not published except for a few SOEs listed on the stock exchange. There is limited information publicly available on their financial performance or fiscal impact. In 2017, only 43 SOEs submitted financial reports to the Ministry of Finance (i.e., 131 SOEs, or more than 75 percent of the total, did not submit their financial reports). Out of those 43 SOEs, 11 were reportedly loss-making (Figure 4.1). Reports are often submitted with significant delays, and few comply with international financial reporting standards (IFRS). Comprehensive and timely financial information on SOEs is needed to assess and mitigate fiscal risks. 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 4.2).

Figure 4.1: SOE reporting and performance (2017)



Source: Ministry of Finance.

Figure 4.2: External PPG debt (%, 2022)



Source: Ministry of Finance.

Profitability of the SOE sector is generally low or even negative, while indebtedness is high. The SOE portfolio included 178 SOEs in 2018, about 0.1 percent of the total universe of enterprises (Table 4.2). Their total registered capital was 28 trillion kip, amounting to 6 percent of the registered capital of all enterprises in the country (471 trillion kip). Their total assets were valued at 185 trillion kip (equivalent to 96 percent of GDP), and the total value of their liabilities was 147 trillion kip (equivalent to 78 percent of GDP).[165] The value of liabilities is likely to have increased considerably in 2021–2022, owing to the sharp depreciation of the Lao kip. Average net profit was low in 2016–2018 and negative in 2021. Collectively, the SOEs' average contribution to government revenues over the period 2016–2018 was 504 billion kip per year, while in 2021, the profit tax and dividends amounted to 526 and 67 billion kip, respectively.

Table 4.2: Average financial performance of the SOE sector (trillion kip, unless otherwise stated)

Indicator	2016–2018	2021
SOEs (number)	178	111
Registered capital	28.0	..
Assets	184.8	204.7
Liabilities	147.5	..
Revenue	31.5	30.3
Expenses	31.1	33.2
Net profit	0.4	-2.9

Source: Ministry of Finance and World Bank staff calculations.

Note: The sample for 2021 only includes active state-owned enterprises.

Financial performance varies considerably across levels of state ownership. Data for a group of 41 SOEs shows that SOEs that were fully owned by the government were collectively incurring losses and were the most indebted (Table 4.3). Profitability indicators (return ratios) were the lowest in the sample, while liquidity and solvency indicators (debt ratios) were the highest. The ratio of expenses to revenues was also the highest. Joint ventures, which are SOEs where the government holds less than half of the shares, were making similar loss margins, although they were less reliant on debt – and thus had lower repayment risks. Only mixed SOEs (government ownership ranging from 50 to 99 percent) were collectively showing commercially acceptable returns and debt ratios.[166] Overall, this raises questions about the performance of fully owned SOEs, particularly in terms of profitability, indebtedness, and efficiency. However, the sample may not be representative, and there might be considerable heterogeneity within each category, with results driven by a few larger SOEs (Box 6).

[165] Liabilities include accounts payable (i.e., future obligations beyond debt), such as accrued expenses and trade payables.

[166] In a recent financial evaluation conducted by the Ministry of Finance, fully-owned SOEs are considered to be ineffective and classified as weak in terms of profitability and liquidity, while other majority-owned SOEs are highly effective and minority-owned SOEs are effective.

Table 4.3: Average financial performance of 41 SOEs (2016–2018)

State ownership	Number of SOEs	Return on Assets (%)	Return on Equity (%)	Debt-to-Equity ratio	Debt-to-Assets ratio	Expense to revenue ratio
Whole (100%)	29	0.5	7.4	4.4	0.7	1.1
Mixed (50–99%)	5	14.5	25.5	0.3	0.3	0.8
Joint venture (<50%)	7	8.8	13.5	1.8	0.4	1.0

Source: Ministry of Finance.

Note: The sample includes 41 state-owned enterprises for which data was available.

Box 6: Main sectors of activity

SOEs remain key actors in many economic sectors across the world despite variations in ownership structures, corporate governance, efficiency, profitability, and productivity. It is good practice to publish aggregate reports by sector on the financial performance and positions of SOEs. The OECD regularly publishes data provided by its member states according to the following economic activities: (i) primary sectors (e.g., agriculture and forestry), (ii) manufacturing, (iii) finance, (iv) telecoms, (v) electricity & gas, (vi) transportation, (vii) other utilities, (viii) real estate, and (ix) other activities. SOEs often dominate the electricity sector, particularly transmission (network) and distribution (access), since these tend to be natural monopolies. However, it has proven difficult to balance access and affordability with a sustainable business model, often because tariffs are set below cost-recovery, which undermines investments and operations. The need for cost recovery is also important in the water sector. Cost-recovery, in the absence of direct financial support, can help improve the quantity and quality of service provision and ensure sustainability. Progressive tariff structures and social protection (e.g., cash transfers) can help shield the poor from high costs. Ground transportation (e.g., buses and trains) is often provided by SOEs in advanced economies, especially at the sub-national level, to ensure affordability while reducing congestion and pollution. However, these are less common in developing countries, where private operators dominate (e.g., small buses). SOEs in the mining sector are also common, particularly to exercise control over oil and gas exploration. Finally, state-owned banks still play an important role in many countries, often justified by the need to address market failures and promote economic development, through both commercial banks (that provide corporate and retail services) and development banks (that lend to development-related projects). This chapter proposes a sectoral classification for future consolidated reports.

Financial performance also varies considerably across economic sectors. Recent data on 23 SOEs for 2021 indicates that the group, in aggregate, is incurring losses and faces insolvency (Table 4.4). The main contributor to the losses is the electricity sector, followed by the banking and telecommunications sectors. In fact, most sectors are incurring losses. The aggregate insolvency of the group is mostly due to the high negative equity of the electricity and transport sector SOEs. The assets and liabilities of these 23 SOEs are considerable, representing 115 and 109 percent of GDP, respectively.

The sectoral composition of key financial performance indicators raises concerns over the electricity, transport, and finance sectors. While there is some heterogeneity within each sector, the aggregate values provide useful insights (Figure 4.3). For instance, the electricity, finance, and transport sectors have a strong impact on the finances of the overall SOE sector. The electricity and transport sectors had negative equity in 2021, while equity in the finance sector was positive (Figure 4.4).[167] Net profits were strongly negative, mainly driven by SOEs in the electricity sector. Assets and liabilities are dominated by the electricity and finance sectors, while it is unsurprising that the largest shares of revenues and expenses are accounted for by these same sectors, given their weight in the overall sector (Figure 4.5 and Figure 4.6). However, the fuel sector is also significant. Return on assets (ROA) were strongly negative in the telecoms sector.[168] The ROA in the electricity sector was also negative, but its debt-to-equity ratio cannot be interpreted due to negative equity. These insights support a reform focus on the largest SOEs, particularly EDL, BCEL, and Lao Airlines.

[167] The latter is largely because of the privatization of the Agricultural Promotion Bank and the Lao Development Bank, which turned large negative equity positions into positive equity in 2021. BCEL has had positive equity consistently, at least in the past few years.

[168] It should be noted that Lao Telecom is not part of the sample.

Table 4.4: Aggregated financial performance of 23 SOEs (billion kip, 2021)

Indicator	Electricity	Transport	Finance	Fuel	Telecom	Others	Total
Registered capital	7,045	182	2,039	611	138	381	10,396
Equity	-2,267	-2,277	3,165	593	-167	889	-65
Assets	82,772	2,114	91,641	1,340	2,532	1,955	182,353
Liabilities	85,038	4,391	88,476	747	2,699	1,124	182,476
Revenue	9,798	248	4,267	3,841	6	828	18,989
Expenses	13,357	273	4,392	3,859	261	797	22,939
Net Profit	-3,558	-26	13.5	-125	-255	32	-3,951
Profit margin	-36	-10	-3	0	-4,486	4	-21
Return on Assets (%)	-4	-1	0	-1	-10	2	-2
Return on Equity (%)	157	1	-4	-3	152	4	6,085
Debt (% Equity)	..	..	2,795	126	n/a	127	..

Source: Ministry of Finance.

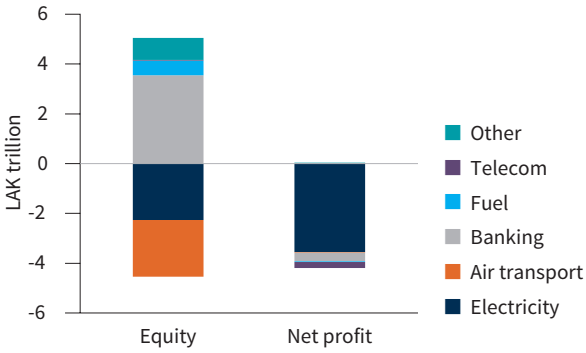
Note: The sample includes 23 state-owned enterprises, most of which the state has a stake of 51 percent or more. Transport mainly reflects air transport. The debt-to-equity ratio is not meaningful for sectors with negative equity. There are some inconsistencies due to inaccurate reporting.

Figure 4.3: Registered capital (%, 2021)



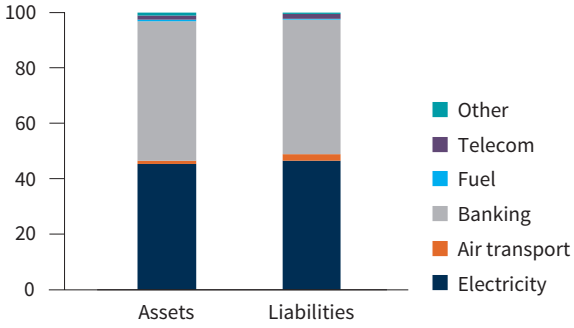
Source: Ministry of Finance.

Figure 4.4: Equity and net profit (Lao kip, 2021)



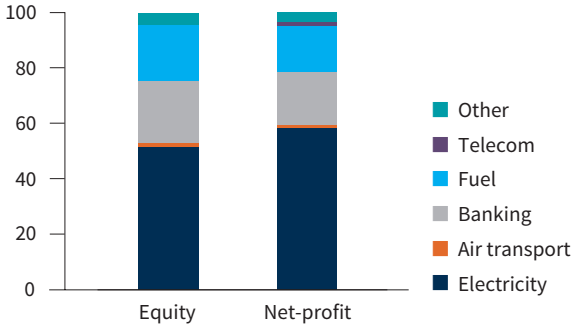
Source: Ministry of Finance.

Figure 4.5: Total assets and liabilities (%, 2021)



Source: Ministry of Finance.

Figure 4.6: Revenue and Expenses (%, 2021)



Source: Ministry of Finance.

SOE operations have resulted in substantial fiscal costs and risks, which undermine fiscal sustainability. Major fiscal costs have arisen from budget transfers and unpaid or reduced dividends and taxes. Fiscal risks emerge from SOEs' high indebtedness and persistent operational losses. Explicit contingent liabilities comprise government on-lending and guarantees. A large portion of the Lao PDR's public and publicly guaranteed debt is from the energy sector, especially from EDL (40 percent).[169] While the MoF has the overall responsibility for the management of the SOE portfolio, the MoF does not have accurate and complete performance information on all SOEs, including their financial position, assets, and employment levels. This reflects weaknesses in SOE governance and monitoring processes. There is currently no framework for identifying, assessing, monitoring, or disclosing SOE performance information, which is necessary for evidence-based policy making. In addition, there is a need to review the rules governing the financial support that SOEs receive from the government.

Building a comprehensive dataset on SOEs is crucial to support decision-making. There is a need to strengthen ownership, accountability, and oversight capacities. The lack of consolidated and accurate information on SOE's financial performance and positions undermines the ability to provide a reliable overview of the SOE sector, undertake an assessment of risks and potential impacts, and inform key decisions that have fiscal implications (e.g., on-lending, guarantees, budget transfers, and recapitalizations). There is also limited information on the financial relations between the SOE sector and the state, and between SOEs (including banks). Data to be regularly collected as part of an upgraded SOE performance monitoring system should include assets, liabilities, equity, revenue, expenses, and profit, as well as fiscal relations with the government (e.g., payment of taxes, duties, royalties, and dividends; loan reimbursements to the state and expenditures reimbursed by the state; transfers and subsidies; arrears). Recent efforts, particularly through the approval of the Decree on SOEs, aim to address these shortcomings by enabling the collection of comprehensive and timely financial information on SOEs to assess and mitigate fiscal risks.[170]

4.2.1 Électricité du Laos (EDL)

Électricité du Laos is a key SOE, but there are three other SOEs in the energy sector. The SOEs in the energy sector comprise Électricité du Laos (EDL), EDL Generation Public Company (EDL-GEN), Lao Holding State Enterprise (LHSE), and EDL Transmission Company Ltd (EDL-T) (Figure 4.7). EDL was established in 1961 to generate, transmit, and distribute electricity. It is still the single buyer and sole distributor of power in the domestic market. EDL was commercialized in the first phase of SOE reforms, but it was placed on the strategic list of SOEs in the second phase and, thus, not subject to privatization. EDL was one of the five major SOEs targeted for reform under the third phase through restructuring.[171] During this period, reforms focused on tariff adjustment, resolution of arrears, and reduction of system losses. In 2010, EDL-GEN was created and most of EDL's generation assets and stakes in independent power producers (IPPs) were transferred to the new SOE. EDL-GEN has its own generation facilities and sells electricity to EDL. EDL-GEN also holds shares in IPPs who produce for the domestic market and export. LHSE's role is mainly to hold shares in IPPs that export power overseas. The government holds 100 percent of the shares in EDL and LHSE. EDL currently holds 51 percent of EDL-GEN's shares, while private investors hold the remaining 49 percent.[172] In March 2021, a concession agreement was signed between the government and China Southern Power Grid Ltd. to establish EDL-T as a joint venture that may take the leasing concession of the existing 230 kV transmission assets from EDL. EDL-T is expected to make sizable investments in power transmission and interconnectivity to enhance regional power trade.

Despite impressive achievements in expanding electricity access and service coverage, EDL is facing deep rooted financial and operational challenges. Mega investments in infrastructure have led to a considerable expansion of generation capacity and improved access to electricity, in line with the country's vision of becoming the 'battery of Southeast Asia'. However, these investments were largely financed by external debt and through

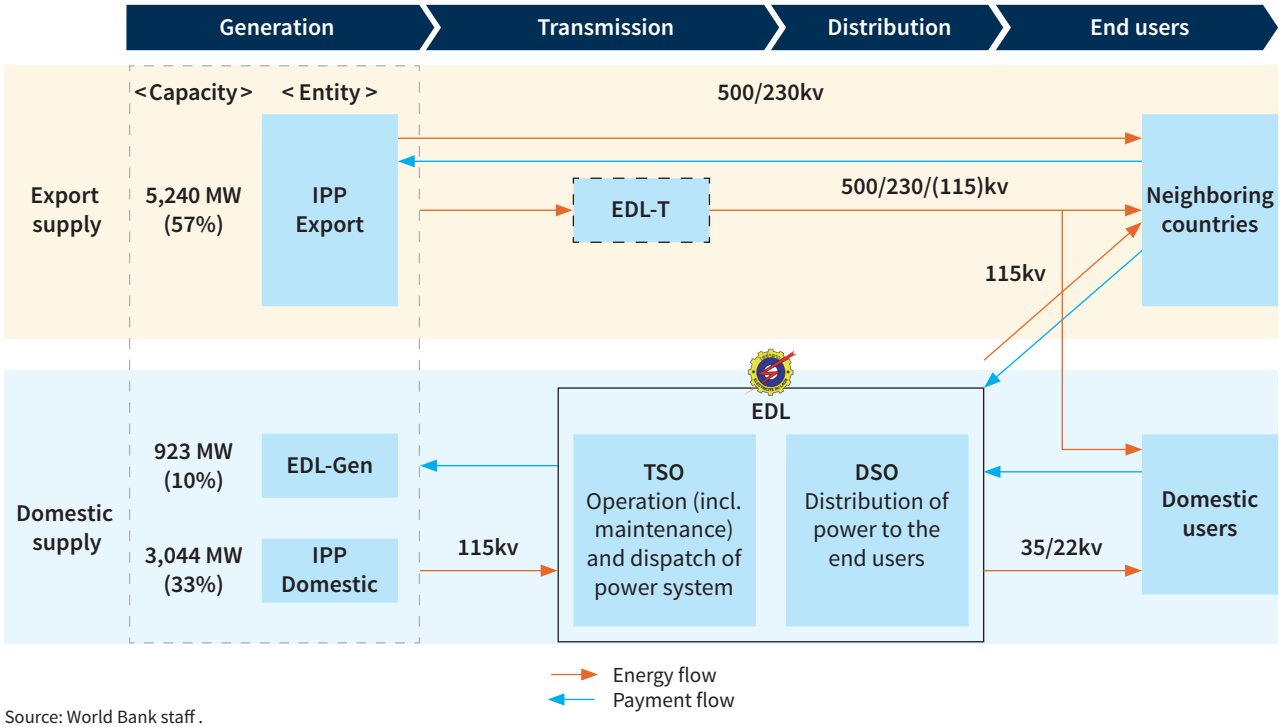
[169] It should be noted that government decisions (e.g., regarding investments and prices) often affect the financial performance of EDL.

[170] Nonetheless, the decree could benefit from an implementing instruction to strengthen and enforce the mandate of the MoF's Department of State-Owned Enterprise Reform and Insurance to collect, analyze, and disseminate data. The weak exercise of oversight functions (due to limited capacity, ownership, or accountability) may undermine compliance.

[171] EDL financial and efficiency challenges are not new. Domestic tariffs were often set below cost-recovery, there were significant payment arrears from government entities, currency mismatch (depreciated income in kip and debt servicing in US dollars), and high distribution losses due to poor infrastructure.

[172] In February 2021, 24 percent of EDL shares in EDL-GEN were transferred to Phongsubthavy Road–Bridge, Building and Irrigation Construction Sole Co., Ltd., reducing its stake from 75 to 51 percent.

Figure 4.7: Overview of the power sector



Source: World Bank staff .

public-private partnerships, while the sector faces significant structural challenges.[173] For instance, the country has substantial excess generation capacity during the wet season, but insufficient capacity during the dry season. Tariffs are below cost recovery, and EDL is burdened with unfavorable take-or-pay obligations. EDL's financial management systems are weak, and the gaps in corporate governance and the broader power sector institutional arrangements resulted in negative operating margins and the accumulation of a growing debt burden. Since EDL is fully owned by the state and its debt is either on-lent or guaranteed by the Ministry of Finance, EDL's large liabilities represent a clear fiscal risk. Public and publicly guaranteed (PPG) debt relating to EDL amounted to $5.7 billion in 2022, about 45 percent of GDP (or 40 percent of total PPG debt).[174] On-lending accounted for $3.9 billion, while guaranteed debt reached $1.8 billion.

Weak accounting practices and corporate governance, coupled with gaps in staff capacity and IT systems, represent a major challenge. Accounting weaknesses include delays in compliance with various national regulations and accounting policies, and with international financial reporting standards (IFRS). Technical challenges and weak staff capacity are preventing an effective utilization of IT systems. As a result, the recording of accounting transactions, approvals, and financial reporting is mostly carried out manually, resulting in inefficiencies and risks of human errors. Benchmarking EDL against international practices of regional peers revealed inadequacies, such as inadequate board composition and oversights, absence of internal control frameworks, and insufficient public disclosure, including of its financial reports.

Although power sale revenues have grown in recent years, the average cost of power purchases from IPPs also increased. Revenues from power sales grew at an average of 8 percent per year during 2015–2019, while the average power purchase cost from IPPs increased by 11 percent in the same period. As a result, gross profit from power sales was very low, around 13 percent between 2015 and 2019. Profitability is estimated to have deteriorated even further in 2020–2022, mainly because of high IPP costs and foreign exchange losses. The cash burden will continue to increase as large debt service obligations persist.

[173] It should be noted that the government is partly responsible for factors that have contributed to EDL's financial situation and prevent its ability to improve its condition. These include: (i) tariffs set below cost-recovery levels by law without regulated mechanisms to compensate EDL; (ii) power-purchase and concession agreements signed by ministries; (iii) regulatory requirements to adopt local accounting standards instead of international accounting standards; (iv) EDL staff salaries set by the government significantly below the private sector average, which prevents it from attracting and retaining skilled human resources; (v) controls over EDL data disclosure.

[174] See the MoF's 2022 public debt bulletin.

The liquidity and solvency situation is concerning, particularly due to limited capacity to meet short-term obligations. Liquidity and solvency can only be assessed through the company's financial position during 2015–2019, since recent financial reports are not publicly available. The current ratio, calculated as current assets over current liabilities and reflecting the company's capacity to meet its obligations due within a year, decreased to a low level of 0.1 in 2019. This means EDL had only 10 percent of cash available to fulfill its short-term debt obligations. In addition to this short-term liquidity issue, the company's debt-to-equity ratio was high at 3.9, resulting in a shortage of cash to repay debt service obligations.

EDL's vulnerable financial situation has been further compounded by the sharp depreciation of the Lao kip in 2021–2022. Financial performance forecasts have significant limitations due to the lack of reliable financial data, However, a sharp decline in the value of the Lao kip causes IPP payments and debt service obligations to rise steeply, since these are denominated in US dollars. The Lao kip depreciated by 8 percent against the US dollar in 2021 and 47 percent in 2022. While these payments will be made in US dollars, EDL's main source of revenues are, or at least set, in Lao kip.

A return to profitability would require critical reforms to improve corporate governance, management, and financial performance. Reforms would require adjusting tariffs to cost-recovery levels, improving governance arrangements, and enhancing the regulatory framework. These would need to be complemented by corporate actions to optimize power purchase costs and debt financing, as well as significant improvements in financial management and corporate governance systems. In January 2023, EDL announced measures recommended by its reform committee to deal with the company's growing debt burden and to ensure the strength of its business and the sustainability of its operations. They included institutional reform, including rationalization of its operating procedures and staffing, revising the electricity tariffs in ways fair to producers and consumers, negotiating electricity trading agreements with suppliers and investors, and restructuring outstanding debts.

4.2.2 Lao Airlines

Lao Airlines was created in the late 1980s to serve as the national carrier, and it has grown over time. Lao Airlines was created in 1989 and became fully commercial in 2005. Since its creation, the airline has had mixed results. The accumulation of losses forced a restructuring in 2009, which mainly comprised debt write-offs. Between 2011 and 2019, Lao Airlines increased the size of its fleet to 11 aircraft, its network to 23 destinations served, and its organizational structure to 959 employees.[175] This was a time of strong regional growth in airline travel. The Lao PDR's aviation market was growing at 16 percent per year, higher than ASEAN peers but similar to Cambodia and Vietnam. In 2019, 19 airlines from seven countries operated in the Lao PDR. The two SOEs (Lao Airlines and Lao Skyway) had a combined share of 52 percent of seats, four Thai airlines had 20 percent, and four Chinese airlines 11 percent. Despite strong market growth, Lao Airlines' capacity was limited by competition within the region. During the height of the COVID-19 pandemic, travel restrictions reduced the number of airlines operating in the Lao PDR to 7, all operating at less than 20 percent of capacity.

Measured against most operational indicators, Lao Airlines was not performing well when the market was buoyant. Aircraft utilization and load factors were below the average for regional competitors, even before COVID-19, and some costs were higher (e.g., maintenance). The airline was incurring operating losses despite strong market growth, while the COVID-19 pandemic severely curtailed the airline's operations in 2020–2021, leading to further financial difficulties. During the pandemic, Lao Airlines kept essential workers, unlike other airlines, which restructured to adapt to reduced demand. Pre-pandemic results show that the airline did not perform well in 2019 when the market was buoyant and attractive.

Lao Airlines is a highly leveraged company and is a major contingent liability to the government. The airline has substantial negative equity and low liquidity levels, which forced the airline to postpone or underpay its financial obligations, increasing its outstanding debt. The impact of COVID-19 worsened its financial situation. Despite new working-capital loans, it is not possible to rebalance accounts without downsizing and additional capital injections. Lao Airlines has accumulated significant debts, of which $154 million are guaranteed by the government. While opportunities remain to restructure some of these liabilities, most debts cannot be repaid from the current revenue

[175] Furthermore, Lao Airlines increased its maintenance and operational staff capability, attained IOSA certification, and became an IATA member, moving toward the international standard.

streams and are thus deemed unsustainable. A reform committee was established in 2022 to prepare a reform plan for the flagship carrier, which includes financial restructuring, seeking a joint-venture partner, and improving operational efficiencies. The development of rail infrastructure in the north of the country is expected to reduce demand for domestic air travel from Vientiane to the North, which will likely affect Lao Airlines. The domestic market is small, and the presence of two domestic carriers is unlikely to be justified.

4.2.3 Banque pour le Commerce Extérieur Lao Public (BCEL)

State-owned banks continue to dominate the financial sector in the Lao PDR despite several waves of reform. The banking system evolved from a mono-bank system to a two-tier banking system in 1988. Commercial banking activities were separated from the central banking function, and three branches were spun off as independent state-owned banks. Four more state-owned commercial banks were created during 1990–1991.[176] The banking sector was gradually reformed in the mid-2000s, and the sector was opened to foreign banks. In 2007, two joint-venture banks, two private banks, and six foreign bank branches entered the market. The share of state-owned banks in terms of assets gradually declined from 65 to 48 percent between 2012 and 2021 and then further to 35 percent with the privatization of the Agriculture Promotion Bank (APB) and the Lao Development Bank (LDB) in late 2021 and early 2022, although the government retained a 30 percent share in both banks. The Banque Pour Le Commerce Extérieur Lao Public (BCEL) is the largest commercial bank. Currently, the banking sector consists of one state-owned commercial bank (BCEL, 34 percent of total bank assets), five joint-venture banks (including APB and LDB, 19 percent of assets), and several private and foreign bank branches (42 percent of assets). BCEL holds stakes in the three joint-venture banks: Lao-Viet Bank, Banque Franco-Lao, and Lao China Bank (25, 30, and 49 percent, respectively).[177]

The financial performance of state-owned commercial banks has been weak, mainly due to directed lending to SOEs, and characterized by repeated bailouts and ineffective reorganizations. Credit to SOEs averaged over 40 percent of total credit to the economy in 2000–2004, declined sharply in 2005, and has steadily declined since 2011 to around 13 percent from 2020 onwards. SOEs were a major source of nonperforming loans in the 1980s and 1990s. In the 1990s, the banks' main problem was direct lending to SOEs, which dominated economic activity. In 1994, the government recapitalized state-owned commercial banks at a cost of around 2 percent of GDP. However, the recapitalization was not accompanied by any operational restructuring or a reduction in state interference, and nonperforming loans (NPLs) reached high levels again by the late 1990s. By 2001, three-quarters of BCEL's loans were nonperforming, and the bank had a capital deficit of 4 percent of GDP. In 2001, the government launched a comprehensive bank reform program, including recapitalization. After long delays, reforms began in 2003, including restricted lending to SOEs, although it only lasted a year. State-owned commercial banks were recapitalized through the issuance of triangle bonds. The persistent recurrence of nonperforming SOE loans reflected mainly the absence of a repayment culture, state interference in pricing, and protracted weaknesses in their operations. Government arrears to contractors on public projects have been a significant and persistent problem, as these contractors subsequently default on their loans to state-owned commercial banks.[178]

BCEL is the largest bank in the Lao PDR, accounting for a significant proportion of loans and deposits. BCEL was established in 1989 as a state-owned commercial bank. In 2011, BCEL became the first bank and legal entity in the Lao PDR to be listed on the Lao Securities Exchange, with the Ministry of Finance retaining 70 percent of the total shares. Unlike many SOEs, BCEL (and EDL-GEN) are subject to stringent listing rules requiring an annual external audit, and disclosure of its financial position and performance data. It is also subject to the corporate governance requirements applied to listed companies. The government currently holds 60 percent of the shares in BCEL, while 10 percent is held by a strategic partner (Compagnie Financière de la BRED), and 30 percent is held by domestic and foreign investors. BCEL accounts for slightly over one-third of banking sector assets, credit, and deposits, a dominant position relatively unchanged since its inception.

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[176] All seven state-owned commercial banks were under the management control of the Bank of the Lao PDR and each was assigned a geographical area of coverage. See World Bank and Asian Development Bank "The Banking and Financial Sectors of Lao PDR".

[177] BCEL also has significant investments in other local economic entities, including BCEL-Krung Thai Securities Company Limited (70 percent), Lao-Viet Insurance Joint Venture Company (35 percent), the Lao National Payment Network Company Limited (20 percent).

[178] Following several years of weak performance, the government sold 70 percent of its shares in the Agricultural Promotion Bank and Lao Development Bank in late 2021 and early 2022. The transactions were facilitated by bond issuances equivalent to about 9.3 trillion kip (or 5 percent of GDP) to clear accumulated losses and recapitalize.

BCEL's financial performance weakened during the COVID-19 pandemic, and its capital level is below the regulatory minimum. The capital adequacy ratio (CAR) was 6.3 percent at the end of 2022, down from 7.4 percent at the end of 2021, which is below the regulatory minimum requirement of 8 percent and indicates that the bank is undercapitalized. BCEL reported a nonperforming loan (NPL) ratio of 3.4 percent at the end of 2022, but the real figure is likely higher after considering ongoing regulatory forbearance policies, which include a freeze on loan classifications, and the possibility of 'evergreening'. Return on assets (ROA) fell from 0.71 percent in December 2019 to 0.24 percent in December 2022. BCEL generously applied regulatory forbearance measures to its portfolio during the COVID-19 pandemic. Regulatory forbearance measures comprised interest and principal moratoria, a freeze in loan classification, and an extension of maturities to around 30 percent of its portfolio, a much higher share than most other banks. BCEL will be highly exposed to the possibility of a future increase in NPLs when forbearance measures are phased out. BCEL has significant accrued interest receivables, a sign of generous extension of forbearance. Loan loss provisions are unlikely to be sufficient to cover expected losses.

BCEL's exposure to fiscal risks is significant, while liquidity concerns could have a systemic impact on the economy. BCEL holds a considerable and growing amount of government debt. Net government credit provided by the banking sector accounted for 8.9 percent of GDP in 2021, up from 3.7 percent of GDP in 2020. These government debt holdings are concentrated in three banks, including BCEL (2.9 percent of GDP), Industrial and Commercial Bank of China (2.3 percent), and the recently privatized Lao Development Bank (2.1 percent). The high exposure of banks to the government increases the likelihood of shock transmission between the two sectors. Moreover, BCEL has significant exposure to SOEs, particularly in the industrial sector. The share of industrial services companies increased from 22 to 51 percent of the overall loan portfolio from 2015 to 2016 and has remained at about 50 percent since then. Although publicly available information lacks detail, it seems that this increase is partly related to public investments in the hydropower sector.[179]

4.3 Recent reforms and current plans

In recent years, SOE reform has again become a high priority on the government's policy agenda. The priority conferred on SOE reform is reflected in the National Agenda on Addressing Economic and Financial Difficulties (2021–2023). This broad agenda sets forth the government's priorities to tackle the country's difficult macroeconomic situation. There are five core components, one of which is to "promote frugality, tackle extravagance, enhance effectiveness of investment-expenditure, and address domestic-foreign debt." Within this component, measures foreseen are to "reform management and business operations of state enterprises and enterprises with government shares/stakes". These measures include developing a strategy for SOE reforms, closing SOEs, strengthening SOE management, improving transparency, and improving the monitoring of SOE performance.

Improving SOE effectiveness is also a priority in the Ninth National Socio-Economic Development Plan (2021–2025). The document states that the plan "prioritizes the management and development of state-owned enterprises (SOEs) so that they can be economically strong and efficient, reduce substantial liabilities, support a sustainable economic base, and generate income for the country". Under Outcome 1, which is "continuous quality, stable and sustainable economic growth", the government has identified five outputs, one of which is "enhanced efficiency and effectiveness of state-owned enterprises and collective economy". This includes improving legislation aimed at managing and developing SOEs more effectively, undertaking SOE reforms, and ensuring transparency and efficiency. SOE reform is therefore critical to the realization of the Ninth NSEDP objectives of stable and sustainable economic growth, efficient public administration, and improved public services.

Important elements of the current SOE Reform Plan (2021–2025) include reforms within 31 of the largest SOEs. The SOE Reform Plan was approved by Government Resolution No. 10/GOV, dated 15 October 2021. These reforms include the appointment of reform committees to plan and implement organizational and financial restructuring and to implement changes to the boards of directors and boards of management. Under the plan, some large SOEs (such as EDL) would remain 100 percent under state ownership. Lao Airlines, Agro-industrial Development Company (DAI), Lao Export-Import Trading Company, and the Lao State Fuel Company would be converted to joint ventures with the government maintaining ownership of 51 percent or more of the shares. EDL-GEN would maintain its present form as a public company listed on the Lao Stock Exchange and would be separated from EDL.

[179] In 2016, BoL loaned BCEL about $200 million for the purpose of providing credit to "certain government-backed hydropower projects".

SOEs operating in production, trading, and service sectors will be considered for joint ventures with the private sector. Some steps have already been taken to sell stakes or dissolve SOEs. Two state-owned banks (LDB and APB) were converted into joint ventures in late 2021 and early 2022, with the state retaining only 30 percent of the shares, though both required MoF to issue bonds to clear accumulated losses and increase capital before the sale.[180] The government sold 51 percent of its shares in Entreprise de Postes Laos, as well as 49 percent of its shares in Lao Enterprise Service of Transit and MSIG Insurance Laos. Two persistently loss-making SOEs would be closed (Inter Lao Tourism Company and DAFI), and a third would be dissolved and become a technical unit under the Lao Women's Union (Lao Cotton State Enterprise). By mid-2022, the proceeds from the sale of shares resulting from the ongoing SOE reforms had already amounted to 1,037 billion kip. However, it is important that partial and full divestitures involve a transparent and competitive tendering process to secure fair market value and avoid governance risks.

Enterprise-level reforms continued their momentum during the second half of 2022. EDL's restructuring plan was endorsed by the Party in September 2022. It includes improving its organizational structure, enhancing budget planning and accounting standards, revising tariffs for non-residential users, modernizing the billing system, revising the power purchase plan with two power projects, negotiating a debt restructuring plan with creditors, completing a manual of internal controls and audit, and measures to improve staff performance evaluation. A new restructuring plan for the Lao State Fuel Company includes organizational restructuring and business consolidation, revising market regulations governing the fuel business, improving accounting standards, and strengthened risk assessment. The Board of EDL-GEN has been restructured. The government has decided that Lao Airlines will become a joint venture with the private sector, and its reorganization will focus on human resources, finance and accounting, business operations, and aviation operations. Two of DAFI's factories will be repurposed.

4.4 Legal and institutional framework for SOE oversight

There have been recent improvements to the legal and regulatory framework governing the ownership and oversight of SOEs, but further changes are needed to bring the framework closer to international good practice.

Ministry of Finance Instruction 2526 was a positive step intended to clarify the roles, mandates, responsibilities, and qualifications required of SOE boards of directors. The instruction, dated 28 September 2020, requires women board members to account for at least 10 percent of board membership of fully owned SOEs, which is a first step in achieving gender balance. It specifies the methods of selection of board members, confirms the role of boards of directors in overseeing SOE restructuring, and also requires the setting up of SOE board committees on management, internal audit, risk management, recruitment, and good corporate governance and defines their roles. It appropriately grants the board's autonomy in appointing the SOE directors and in overseeing the operations of the enterprises. The instruction specifies the qualifications required for board members (e.g., qualifications in accounting, finance, law, and other managerial specializations) and the personal qualities required (such as honesty). It also requires board members to have had training in board membership.

However, in some other respects, the instruction is not fully in line with good international practice in the determination of board composition. The instruction does not place limits on the number of civil servants on boards, nor does it restrict the appointment of ministers on boards, nor staff of supervisory agencies to be on the boards of SOEs which they supervise. It stipulates that boards can include full-time SOE employees without stating that employees should be appointed as employee representatives, and it does not require boards to include independent directors. Instead, it refers to the appointment of public servants as board presidents and deputy presidents and leaves the door open to the appointment of boards composed entirely of civil servants, including individuals with a potential supervisory role over the board or who are SOE insiders. The trend in international good practice is to limit the number of public servants on boards, to avoid conflicts of interest, and to require a minimum number of independent directors. The Instruction also gives few details on the processes to be employed in the selection and appointment of board members.

An MoF Decision gives the Department of State-Owned Enterprise Reform and Insurance (DSRI) a broad mandate to oversee all aspects of the SOE reform program and of the operations and finances of SOEs. The decision, dated 17 December 2021, defines the roles, duties, organizational structure, and procedures of the MoF's

[180] These amounted to about 5.4 trillion kip for LDB and 3.9 trillion kip for APB, totaling 9.3 trillion kip.

DSRI. It defines in detail the responsibilities of four divisions within DSRI: Planning and Development, Management and Evaluation of SOEs, SOE Reform, and Insurance Management. The coverage of DSRI's mandate is in line with many of the accepted functions of a central SOE oversight unit in a Ministry of Finance. It empowers DSRI with a mandate to disseminate plans and policies, monitor the performance of the SOEs, their boards, and their directors, monitor the implementation of business plans, and create and manage a database on SOE performance. However, the Decision does not give DSRI the right or the obligation to prepare and publish regular comprehensive reports on individual and aggregate SOE performance, finances, and fiscal risks. Despite the roles assigned to DSRI, their fulfilment is impeded by capacity constraints within DSRI and inadequate SOE compliance with information reporting requirements.

Decree 322 on State-Owned Enterprises describes and gives effect to government policies on SOE reform. Points covered in the decree, dated 2 September 2022, include the forms of SOEs and the criteria and the procedures for their establishment and funding, the roles, rules, and compositions of their boards of directors, the setting up and operation of reform committees for key SOEs, and the rights and duties of the MoF and other entities in overseeing SOE operations and finances. It covers and endorses many of the points covered in the MoF Instruction and Decision described above but with some improvements. One improvement (in Article 22) is that it gives the possibility of appointing external directors as board members if they have the necessary expertise, with the agreement of the shareholders. In addition, Article 47 mandates SOEs to submit quarterly, six-monthly, and annual financial statements to DSRI, while specifying deadlines for their submission. It also specifies that DSRI must consolidate and record this information in its database. Article 35 states that SOEs require approval from the Ministry of Finance before accessing sources of finance, while Article 44 requires SOEs to comply with standard accounting systems.

However, the Decree could be strengthened in some areas to bring it more in line with international good practice. Like the Instruction and the Decision, Article 22 does not require boards to include independent directors, and Article 62 (on the rights and duties of the MoF) does not give MoF the duty to prepare and publish an annual report on aggregate and individual SOE performance and fiscal risks. While requiring SOEs to use standard accounting systems, it does not require the use of International Financial Reporting Standards (IFRS). Another weakness in the Decree is in Article 62.10, which gives the MoF the power to appoint civil servants from MoF and line ministries to be members of SOE boards. International good practice is to minimize the number of civil servants on SOE boards and to avoid creating a conflict of interest that would occur by appointing a staff member of a supervising agency to be a board member of an SOE that it is supervising. The decree also makes no mention of the DSRI. Inclusion of the DSRI in the decree as the MoF's unit responsible for supervising the SOEs would help strengthen DSRI's mandate.

4.5 Remaining challenges

The authorities are cognizant that there remain several challenges. The key SOE reform challenges identified in the Minister of Finance's report to the National Assembly in June 2022 included: (i) unclear policy and regulations governing pledging of SOE assets as security for bank loans, lack of clarity in SOE oversight relationships between line ministries and the MoF, inadequate systems for performance monitoring of SOEs; and (ii) enterprise-level challenges such as poor management of SOE finances including the payment of bonuses despite poor performance, nepotism in appointments, lack of qualified or professional managers, appointment of government employees to posts requiring business experience, and lack of understanding of their duties by boards of directors.

Despite the reform progress underway, additional challenges include the absence of consolidated and detailed performance reporting on the SOE sector. This absence not only prevents transparency in SOE operations, but also makes it unfeasible for the government to carry out an accurate analysis of SOE sector performance, or the explicit and implicit impact of SOEs, in aggregate or individually, on public finances. Such detailed data is needed to pinpoint and diagnose with accuracy the causes of the problems within SOEs, to identify and quantify fiscal risks, and to devise and target policy actions needed to resolve or mitigate these problems. It is also needed to monitor and assess the impact of policies implemented so they can be fine-tuned as necessary. The authorities are aware of these problems and have been actively taking steps to strengthen data collection and reporting.

The monitoring of SOE performance has been undermined by technical and capacity issues. Central SOEs are supervised mainly under the mandate of line ministries in collaboration with the MoF as shareholder. There is also inadequate compliance by many SOEs in submitting their financial statements to the MoF, which in turn does not have a framework to monitor, assess, and disclose SOE performance or monitor their governance.[181]

[181] Software developed in 2015 was expected to be an important tool for DSRI in monitoring and updating SOE performance, but the software did not operate well and DSRI has not used it since 2018.

The profitability of many SOEs has deteriorated in recent years. SOEs are increasingly having difficulty meeting their debt servicing and operational commitments.[182] While external shocks have played a role (e.g., impact of the COVID-19 pandemic and the sharp exchange rate depreciation), most of these challenges arise from a continued over-extended and unprofitable involvement in non-strategic commercial activities. Inefficiency and poor financial performance also affect SOEs operating in strategic sectors.

The problems are also a result of governance challenges affecting the entire SOE sector. These include the overlapping and sometimes conflicting supervisory responsibilities between the MoF and line ministries and the fact that many boards of directors and SOE management teams are composed mainly of public servants and SOE insiders without adequate inclusion of the independent business management expertise needed to bring about and sustain effective service delivery and financial viability.

4.6 Conclusion and recommendations

State-owned enterprises have created large contingent liabilities, which threaten fiscal sustainability and macroeconomic stability. SOEs have been established worldwide for different purposes, such as addressing market failures, supporting national strategic interests, and promoting socioeconomic objectives. However, some governments expect SOEs to meet (often multiple) policy mandates and perform efficiently without being fully reimbursed for the cost of non-profitable public services. In addition, poor SOE corporate governance arising from moral hazard and conflict of interest (i.e., the principal-agent problem) often leads to inefficiencies and mismanagement. Unfunded policy mandates and poor corporate governance typically generate considerable operational losses and heavy indebtedness, which jeopardizes fiscal and debt sustainability. 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. SOE reforms started in the mid-1980s as part of broader economic reforms under the New Economic Mechanism. Since then, 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 (e.g., EDL, Lao Airlines, and BCEL). While there has been a renewed momentum for SOE reform since 2021, it is crucial 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 important lessons for shaping the current and future reform agenda.

Deepening and accelerating reforms is critical to ensuring 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. Despite the absence of consolidated performance reporting, existing data suggests that profitability of the SOE sector is low and indebtedness high, even if performance varies considerably across economic sectors and levels of state ownership. Many SOEs are insolvent, with negative equity and persistent losses. The largest SOEs are highly indebted, presenting a significant fiscal risk. The sectoral composition of key financial performance indicators raises concerns over the electricity, transport, and finance sectors, where EDL, Lao Airlines, and BCEL are key actors. There is a need to improve overall SOE corporate governance, operational management, and financial performance, as well as enhance transparency.

The current reform agenda can benefit from international experiences and best practices, as well as from own past experiences. The Lao PDR has had a long experience in SOE reform and currently has an active SOE reform agenda. While reforms need to consider a country's context, needs, and priorities, there are common principles

[182] Some SOEs have large liabilities denominated in foreign currencies (e.g., EDL and BCEL), which entail a considerable foreign exchange risk, especially since the government and central bank do not have access to the amounts that would be required for a bailout.

and good practices that have emerged and have been increasingly adopted across countries. These can inform and shape the future direction of the SOE reform program. The key elements typically include (i) centralizing the state ownership function; (ii) allowing or increasing private participation in SOEs while ensuring equitable treatment of all shareholders in mixed ownership companies; (iii) ensuring competitive neutrality between SOEs and private enterprises; (iv) improving SOE performance management (including financial discipline); (v) professionalizing SOE boards of directors; (vi) enhancing transparency and disclosure; and (vii) reimbursing the costs of SOE public service obligations. Moreover, (external and domestic) debt restructuring is likely to be needed for the most indebted SOEs.

Centralizing and strengthening the state ownership and oversight function can enhance SOE performance and promote efficiencies. There is a global trend toward centralizing SOE ownership and oversight. Many countries have created a central coordination unit for SOEs or even vested SOE ownership in a single entity. This is increasingly regarded as good international practice, since it typically correlates with better outcomes in terms of SOE financial and operational performance. The main benefits are the separation of the ownership and oversight function from the policy-making function, which 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. Centralizing also enables the pooling of funds and specialized capabilities, which is particularly important in countries with scarce human and financial resources. In fact, there is a need to empower and strengthen SOE oversight agencies, including though capacity building in SOE monitoring and oversight. In particular, this would enable DSRI to strengthen its role in SOE performance management and monitoring, reporting, and transparency, using a broad range of indicators of financial, operational, and governance performance, as well as fiscal impact. Achieving this requires setting targets and performance contracts for SOEs, which would entail employing a range of financial and nonfinancial performance indicators to ensure that SOEs remain financially sound and meet their targets. An effective SOE performance monitoring system is critical to support the Ministry of Finance in its SOE oversight role.

Creating a fiscal risk management unit within the Ministry of Finance is key to identifying, assessing, monitoring, and mitigating 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 (see Table 1.1). Building the capacity to assess and manage fiscal risks will assist ongoing reform efforts and serve as part of an early-warning and mitigation system for risks arising from potential SOE financial problems. Building a comprehensive dataset on SOE performance is crucial to support fiscal risk assessment and management.

Broadening the ownership of SOEs can improve performance, accountability, and transparency. Increased private participation in SOEs (e.g., through listing on stock exchanges, various types of joint ventures, or even full divestiture) is often associated with improved financial discipline, enhanced operational performance, and reduced political interference. 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 that was previously lacking. This restructuring modality can also generate revenues from assets 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. For instance, divestitures should follow a transparent and competitive tendering process to secure fair market value and avoid governance risks. Moreover, SOEs should operate on a level playing field with private companies (competitive neutrality) by ensuring that they do not receive preferential treatment in terms of exemptions (from general laws, tax codes, and regulations), access to finance (e.g., debt and equity), access to inputs (e.g., energy, water, and land), and access to procurement opportunities or other services from the government. Some countries have no special laws for SOEs but apply the same laws to SOEs as they do to private enterprises (e.g., Vietnam). Finally, SOEs may need to be reimbursed for the costs of their non-profitable public service obligations, including requirements to deliver essential public services for a price below efficient cost-recovery.

Professionalizing SOE boards of directors is essential for promoting good governance and enhancing performance. Boards of directors play a significant 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 (e.g., required skills and experience, appointment of independent directors, gender balance, and avoidance of conflicts of interest). In this regard, it is important to limit the numbers of public servants on SOE boards. Specialist board committees should be created to oversee critical aspects of SOE performance (e.g., audit, risk management, and remuneration) and board member performance should be regularly monitored and evaluated. Finally, training in corporate governance principles and practices would generate significant benefits. This would aim to improve the competencies of board members and senior managers and could even be used as a pre-requisite for all board member appointments.

Disclosing SOE performance reports will 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, with details of funding for any public policy objectives; (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, including by the supreme audit agency; (v) requiring the compilation and publication of aggregate reports on SOE performance and fiscal risks by SOE oversight agencies; and (vi) increasing transparency on board member qualifications and remuneration. These reforms will support accountability and overall performance.

5

Public-Private Partnerships



5. Public-Private Partnerships

While the Lao PDR has been successful in mobilizing significant private sector finance through PPPs, 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. 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. PPPs can provide access to private sector finance to implement public projects, but PPPs are not 'free' as they need to be ultimately paid for by the public sector or end users. The government has participated directly and indirectly in PPPs (e.g., through state-owned enterprises) and is thus exposed to their performance. PPPs can also improve the delivery of public assets and services (when compared to traditional public procurement), but these potential benefits can only be achieved if projects are carefully prepared, tendered, and managed. In some cases, fiscal support might be needed to ensure project viability, which may include direct commitments (e.g., availability payments and viability gap funding), contingent support (e.g., payment guarantees), and tax incentives. In the Lao PDR, weak governance structures and limited capacity to assess, prepare, and negotiate PPPs have likely resulted in suboptimal value for money. PPPs have led to an increase in fiscal commitments, contingent liabilities, and foregone revenues. It is critical that PPP-related fiscal costs and risks are carefully identified, assessed, and managed throughout the project lifecycle. The success of PPPs partly hinges on the establishment of a strong institutional, legal, and regulatory framework. If not adequately prepared, procured, and managed, PPPs may impose an additional burden on the budget and thus undermine fiscal sustainability.

Main recommendations: (i) upgrade the Decree on Public-Private Partnerships to a law and develop related guidelines to strengthen the legal and regulatory framework; (ii) enhance the capacity to prepare, procure, and manage PPP projects and improve interagency coordination; (iii) establish clear institutional structures, responsibilities, and processes for assessing, approving, and managing PPP-related fiscal costs and risks; (iv) mandate transparent and competitive procurement to maximize value for money; and (v) establish a revolving project development fund to support project preparation and structuring.

Chapter structure: The chapter starts by providing a brief introduction to PPPs, covering definitions, key features, potential benefits and limitations, and risks. It then offers insights on the Lao PDR's experience with PPPs, including an overview of the current institutional, legal, and regulatory framework. The chapter presents two PPP project case studies to highlight some of the strengths and weaknesses of the current framework with a view to improving the governance of PPPs. It then concludes with recommendations to ensure that future PPP projects deliver strong benefits to the public without exacerbating the fiscal and debt burdens.

5.1 Background

Infrastructure development is important to supporting economic growth, but there is currently limited fiscal space to undertake significant investments. More and better infrastructure can promote inclusive and sustainable development, particularly if it generates high economic and social returns while safeguarding the environment. The Lao PDR has made large investments in infrastructure over the past two decades.[183] The Ninth National Socio-Economic Development Plan (2021–2025) acknowledges the need to build resilient infrastructure to improve connectivity with a view to facilitating trade and investment (i.e., transforming the country from land-locked to land-linked).[184] The country also aims to become the 'battery of Southeast Asia' through large investments in hydropower. However, there is currently very limited fiscal space to invest in new infrastructure assets owing to poor revenue mobilization and high spending needs (e.g., debt servicing). This places a strong emphasis on the need to improve the efficiency and effectiveness of public investment. In this context, the government may, whenever possible and desirable, leverage limited public resources for infrastructure development through public-

[183] This includes both public investment projects and public-private partnerships (PPPs) projects. Many PPPs have been implemented since the early 1990s, mostly build-operate-transfer (BOT) projects in the energy sector.

[184] See the World Bank's Country Economic Memorandum entitled "Linking Laos, Unlocking Policies".

private partnerships (PPPs). However, demand for PPPs should be mainly driven by a desire to enhance spending efficiency rather than an attempt to override fiscal constraints. PPPs are not 'free' and mainly enable the public sector to spread capital spending over a long period or place the funding onus on end users. In fact, PPPs can turn out to be more costly than traditional procurement methods over the lifecycle of the asset. Therefore, PPPs should be regarded as a procurement option, within the broader public investment management system, rather than a financing mechanism.

5.2 Key elements of PPPs

5.2.1 Definitions

A PPP is a long-term agreement between the public and private sectors to deliver an asset or service typically provided by the public sector. There are different types of private sector engagement in public infrastructure development. Although there is no universal definition, there are some common elements that characterize PPP projects. The term PPP usually refers to a long-term collaborative arrangement (defined and mediated by a legally binding contract) between a public sector entity (e.g., government agency or public corporation) and a private sector entity (e.g., company or consortium) whereby the parties share the responsibility and risk of delivering a public asset or service (e.g., hydropower dam, or electricity supply). The private sector typically provides financing and expertise (to design, construct, and operate the project), while the public sector usually retains asset ownership and some level of oversight and control.[185] The long duration of PPP contracts creates an incentive for the private sector party to integrate service delivery costs into the design of the project, potentially optimizing the trade-off between initial investment and future costs (e.g., construction and operation & maintenance costs) through a 'whole-life' approach. The private sector recoups and remunerates their investment through regular government payments or user fees. Hence, PPPs are a mechanism to procure public infrastructure assets and services using private sector resources, which can deliver infrastructure more efficiently and attract additional finance to reduce infrastructure gaps.[186]

Definitions vary across countries and are often anchored in domestic legislation. Definitions matter because they determine which investment projects should follow the PPP regulatory framework. The PPP Knowledge Lab defines a PPP as *"a long-term contract between a private party and a government entity, for providing a public asset or service, in which the private party bears significant risk and management responsibility, and remuneration is linked to performance".* Specific definitions can usually be found in national PPP decrees or laws, often reflecting the legally authorized contractual arrangements between the public and private sectors for delivering infrastructure assets and services in that country. The definition of a PPP in the Lao PDR is contained in Article 2 of the PPP decree, which states that a PPP is: *"A partnership between public and private parties, written in English as Public-Private Partnership (PPP), can be a joint investment between public and private entities or a partnership where the investment capital is borne entirely by a private party into a public project such as a newly established project, a project to improve existing infrastructure or a project to provide public services, including to develop tourism, agriculture, energy, mining and others under a joint-venture agreement within a certain period of business operation time in compliance with the rules of law."* It should be noted that this definition does not mention risk transfer, nor the importance of linking remuneration to performance. Adopting a clear definition of PPP in line with international good practices is the basis for ensuring all relevant investment projects follow the appropriate regulatory framework.

PPPs differ from traditional public procurement as the private sector assumes responsibility for delivering several project functions on a long-term basis. In conventional public procurement, the public sector usually takes responsibility for nearly all project functions, and financing is typically provided by the public sector.[187] Typically, public procurement involves a single transaction where the government purchases goods or services through a tender process. Hence, the provision of a public asset or service may involve several separate contractual arrangements.

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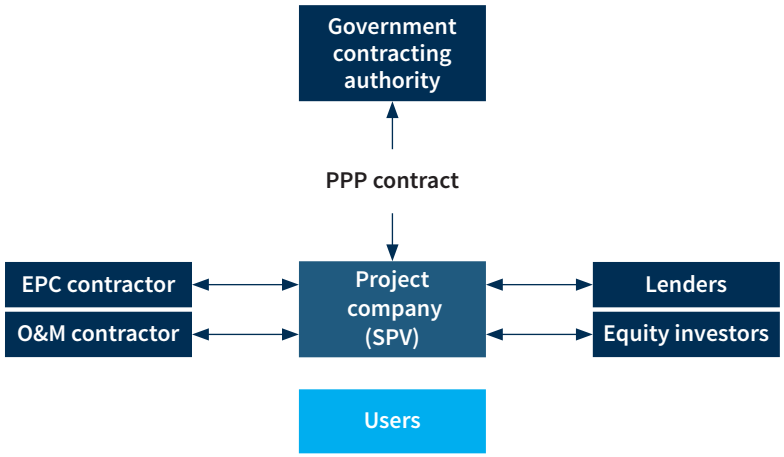
[185] The economic rights to exploit an asset might be more relevant than asset ownership.

[186] Sectors that typically receive PPP investments include transport (e.g., roads, railways, ports, and airports), energy (e.g., electricity generation, transmission, and distribution), water and waste (e.g., water treatment and distribution, and solid waste management), and information and communications technology (e.g., land and submarine cables). There have also been PPP investments in social infrastructure (e.g., schools, hospitals, and social housing).

[187] Main project functions include: (i) design, (ii) build, (iii) finance, (iv) operate, and (v) maintain. The build function may entail the construction of a new asset, or the rehabilitation or extension of an existing asset.

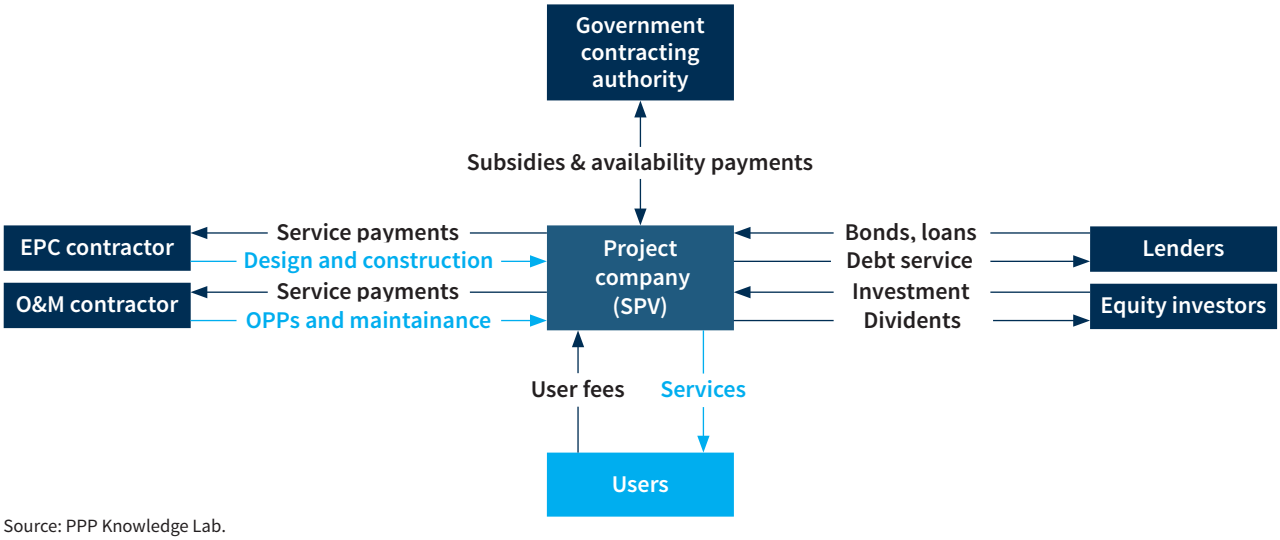
However, an important characteristic of PPPs is that they combine several functions into a single large contract, known as bundling.[188] The private sector entity usually establishes a special-purpose vehicle (SPV) to manage the project and assumes responsibility for delivering several project functions on a long-term basis (Figure 5.1).[189] While public procurement may also entail some level of bundling, there is limited transfer of responsibility and risks to the private sector. Under a PPP, the private party is accountable for project performance and bears significant risk and management responsibility, even if the project functions transferred to the private sector vary from contract to contract. Poor performance under the contract could lead to contract cancellation. While the upfront financing is (mostly) provided by the private sector, the public sector or end users will ultimately pay for the project as the private sector will seek returns on their investment (Figure 5.2).

Figure 5.1: Typical PPP project structure



Source: PPP Knowledge Lab.

Figure 5.2: Flow of funds in a PPP arrangement



Source: PPP Knowledge Lab.

PPPs entail greater involvement and responsibility of the private sector, but they do not encompass privatization. PPPs can be placed within a spectrum that ranges from traditional public procurement to privatization, with the transfer of increasing responsibilities and risks to the private sector (Table 5.1). In public procurement, project financing is provided directly through the government budget and project risks are mostly

[188] PPP contracts delineate the functions allocated to the private sector, which will vary according to the type of asset and service involved, as well as public sector preferences for private sector involvement (in terms of responsibility and risk).

[189] The SPV enables the segregation of all assets and liabilities linked to the private provision of services.

borne by the public sector, except design and construction risks (e.g., cost overruns).[190] The construction price quote is often the most important criterion in evaluating bids, and the procurement process places limited emphasis on the operational phase. In a PPP, financing is provided by the private sector, with project costs (including financing, construction, and operations & maintenance) expected to be recovered through availability payments or user fees.[191] The contracting authority provides broad (output) specifications, leaving the private sector to provide the best solution to meet them. PPPs entail a longer-term form of private engagement, with risks shared among the parties. Several criteria can be considered in the bid evaluation process, including price, risk allocation, technical and financial capacity, proposed financial arrangements, ability to address environmental and social issues, and reliability of the planned technical solutions. Privatization is not regarded as a PPP since it typically involves the permanent transfer of a public asset or the responsibility for delivering a service to the private sector.[192] In this case, the public sector may continue to regulate the asset in terms of service quality and tariffs, but almost all risks are borne by the private sector.

Table 5.1: Differences between public procurement, PPPs, and privatization

	Public procurement	PPP	Privatization
Financing	Public	Private	Private
Impact on government budget	Immediate and negative (due to upfront costs)	Moderate and negative (depending on payment mechanism; often spread over the duration of the agreement)	Positive (due to privatiszation proceeds and elimination of future liabilities)
Risks	Borne mostly by the public sector (except design and construction risks)	Shared between parties (depending on negotiation)	Borne fully by the private sector
Public sector involvement in the project	Extensive (most stages of the project cycle)	Moderate (e.g., output specifications, procurement and monitoring)	Limited (mainly as a regulator)
Relation with private sector	Short term	Long term (duration of the agreement)	Long term (mainly as a regulator)
Suitability	Projects with high socio-economic returns but limited commercial viability	Projects with high socio-economic returns and commercial viability	Projects with proven long-term commercial viability

Source: World Bank staff.

5.2.2 Types of PPPs and project lifecycle

There are several types of PPP contracts, but there is no international standard nomenclature. The terminology used to describe PPP contracts varies across countries, with no consistent standard for naming and defining them (Figure 5.3). Some nomenclatures focus on the project functions allocated to the private party, while others focus on the legal ownership and control of assets. An example of the latter is the build-operate-transfer (BOT) contract, which entails the creation of a new public asset and involves the transfer of responsibility for several functions (e.g., design, build, and operate) to the private sector over a long period. In many cases, the private sector provides the financing for the project and owns the underlying project assets until they are transferred to the public sector at the end of the contract. There are several contractual types related to BOT, such as build-transfer-operate (BTO),

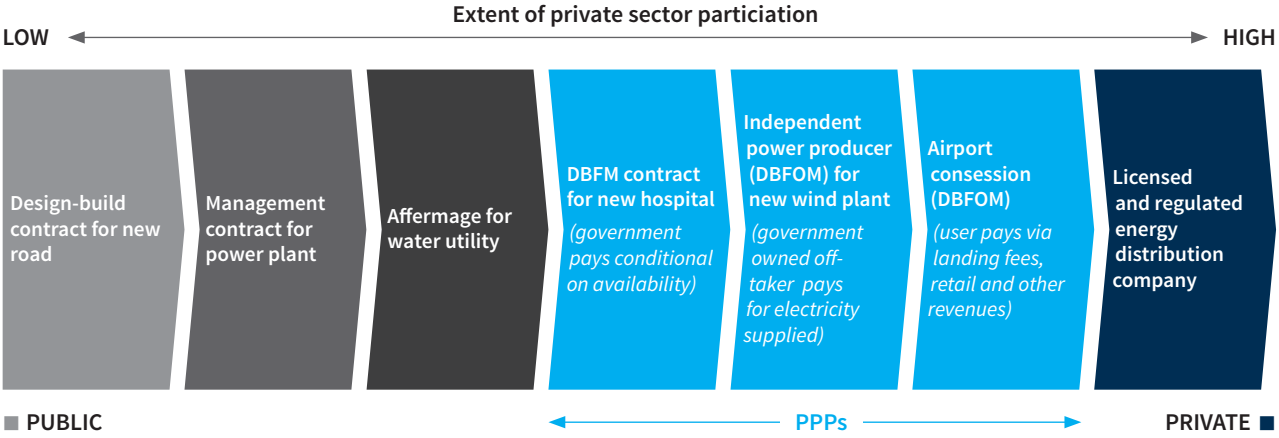
[190] Under a build contract, the contracting authority provides detailed design (input) specifications, while under a design and build contract the private sector is responsible for both the design and construction of the project. In both cases, the private sector is liable for construction-related risks (e.g., cost and time overruns, and commissioning risks), but the public sector typically bears all other risks. Moreover, if a cost overrun is caused by a variation order from the contracting authority, then the cost is borne by the public sector.

[191] PPP contracts define the payment mechanism through which the private sector is paid for providing the public asset or service, which should be linked to performance. This can come through user fees (e.g., road tolls and energy tariffs), availability payments (where the government makes a regular payment), or a hybrid approach (i.e., a combination of user fees and availability payments).

[192] Under a PPP, public assets typically remain under the ownership of the government or, if they are temporarily owned by the private partner, transferred back to the public sector when the term of the contract expires.

whereby asset ownership is transferred once construction and commissioning is complete. BOTs and BTOs are also generally referred to as design-build-finance-operate-maintain (DBFOM) contracts. These contract types are typically the most complex, especially in terms of oversight of the award, implementation, and operation. In all these cases, the private party is accountable for project performance and bears significant risk and management responsibilities. In return for bearing these responsibilities and risks, the private investor is often paid a regular service fee by the government or collects fees from end users for the duration of the contract. Most PPPs undertaken in the Lao PDR have been classified as BOT projects, predominantly in the electricity generation and road sub-sectors (see Annex, Table 5.4). State-owned enterprises in the energy sector have been involved in PPPs, which often involve power purchase agreements with take-or-pay clauses (i.e., a commitment to buy a pre-agreed amount of electricity or pay a fine).

Figure 5.3: Types of PPP contract (examples)



Source: PPP Knowledge Lab.

Note: DBFM stands for design-build-finance-maintain, DMFOM stands for design-build-finance-operate-maintain.

The lifecycle of a PPP project depends on who initiates the process and the procurement method. The public sector can proactively identify, prepare, and procure PPP projects through a solicited process, or the private sector can identify a project and propose it through an unsolicited process. Irrespective of whether a project originates from a solicited or unsolicited proposal, the assessment process should be the same. The lifecycle of a PPP project is generally considered as having four main phases (Table 5.2): (i) identification; (ii) preparation; (iii) procurement; and (iv) implementation. Solicited projects typically arise from a robust project identification process (ensuring they are aligned with national and sector priorities) and are prepared as part of a competitive procurement process. In unsolicited projects, the public sector might be at a disadvantage in assessing and negotiating the project due to information asymmetry.[193] In the Lao PDR, most PPP projects have emerged from unsolicited proposals and awarded through direct negotiation. In the absence of robust frameworks and processes to ensure unsolicited projects are carefully assessed and competitively procured, these may result in limited value for money and increased fiscal risks. Therefore, solicited and unsolicited projects should follow the same review and approval process and be tendered transparently and competitively.

Project identification (phase 1). The primary objective of this phase is to determine public investment needs and priorities, and to identify projects that are (i) aligned with existing national and sectoral plans, (ii) able to generate significant economic and social benefits, and (iii) affordable. This process should apply to all public investments and thus be part of the broader public investment management system. Once projects are prioritized and selected, and typically integrated into a public investment plan (PIP), their potential to be procured as a PPP can be assessed. This requires the careful screening of projects to determine their suitability to be procured as a PPP.[194] By identifying potential PPP projects upfront, the public sector can ensure that it allocates scarce resources to those projects that have strong potential to be procured as PPPs. Most screening tools examine a

[193] Unsolicited projects are often awarded through direct negotiation. Even if they are tendered, the project proponent may be provided with some bidding advantage, which undermines competitiveness and transparency.

[194] There are several tools available to help governments screen PPP projects, including the PPP Project Screening and Analytics Tool (PSAT) developed by the World Bank.

project's suitability to be structured as a PPP by assessing the economic and social benefits, strategic importance, legal and investment environment, market interest, fiscal exposure, potential for private sector innovation, and the project's ability to generate value for money.

Table 5.2: Lifecycle of a PPP project

Lifecycle	Solicited proposal (competitive tender)	Unsolicited proposal (competitive tender)	Unsolicited proposal (direct negotiation)
Identification	• Identify projects (NSEDP-PIP) Select priority projects Screen as PPP *	• *Receive proposal from private sector*	• *Receive proposal from private sector*
Preparation	• Structure (identify and allocate risks) • Appraise (feasibility, viability, VfM, fiscal)	• Structure (identify and allocate risks) • Appraise (feasibility, viability, VfM, fiscal) • Decide on proposal **	• Structure (identify and allocate risks) • Appraise (feasibility, viability, VfM, fiscal) • Decide on proposal **
Procurement	• Request for proposals • *Receive proposals from private sector* • Review and select proposal • Award contract	• Request for proposals • *Receive proposals from private sector* • Review and select proposal • Award contract	• Direct negotiation • Award contract
Implementation	• Manage contract (monitor delivery and risk)	• Manage contract (monitor delivery and risk)	• Manage contract (monitor delivery and risk)

Source: World Bank staff.

Note: Structuring and appraising might be weak or nonexistent for some unsolicited proposals (gray).
* If not suitable for public–private partnership, it can follow traditional procurement. ** If rejected, project does not proceed.

Project preparation (phase 2). During this phase, the implementing agency needs to define and structure the project it wants to implement as a PPP. This will include a description of the physical facilities to be constructed, the technology to be used, the outputs to be provided, and the end users. Once a project has been clearly defined, design parameters and outputs to be provided should be clearly specified. The project should then be assessed for feasibility across similar dimensions used to initially screen the project for PPP suitability. However, at the project preparation stage, it is important that these assessments are now undertaken based on detailed feasibility studies (e.g., technical, legal, economic, social, and environmental) and financial analyses. At this stage, the PPP structure can be clarified through discussions with potential private sector bidders and can be adjusted in response to such discussions. The main objectives of this stage are to ensure the project is economically viable, bankable (i.e., able to raise finance), affordable, and generates value for money.

Project procurement (phase 3). The implementing agency prepares for the tendering of the project, including preparing expressions of interest, requests for qualification, and requests for proposal. The requests for proposal should include an initial draft of the PPP contract and other project agreements, in line with national laws, that set out the obligations and requirements that private sector investors are expected to meet. Bids are submitted and evaluated based on transparent criteria, and the successful bidder is awarded the project. It is important that the procurement process is structured in a transparent manner that encourages competition, as the competitive tension between bidders will help maximize value for money (e.g., ensure that expected costs are not inflated and profits underestimated). Most governments use a competitive selection process to procure PPP contracts as the best way to achieve transparency and value for money.

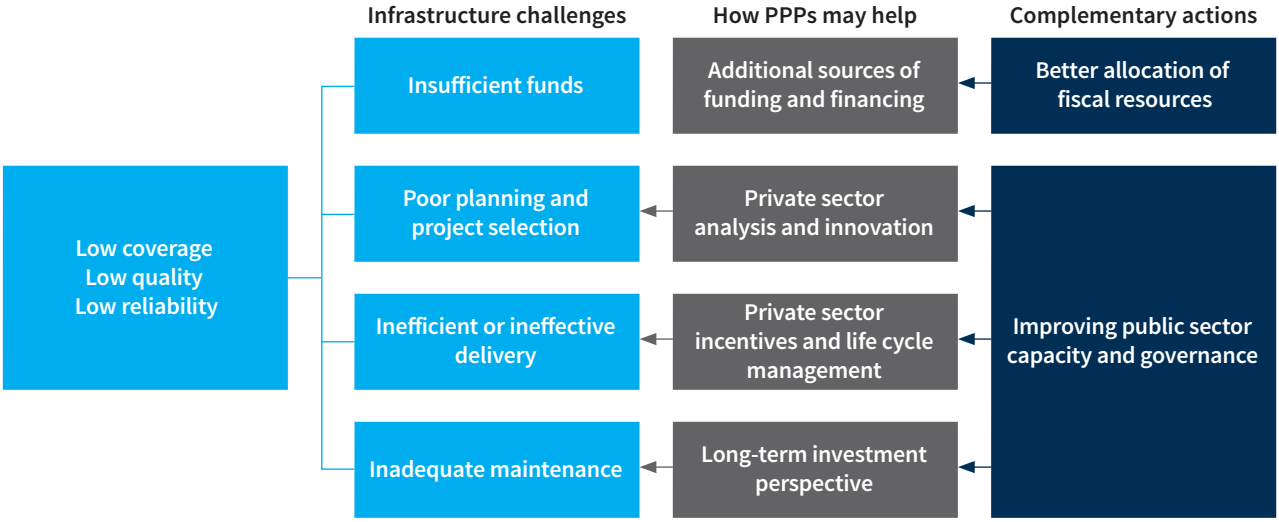
Project implementation (phase 4). During this phase, the project company (established by the successful bidder) implements the project, which typically includes final design, construction, operation, and maintenance. During the implementation phase, the implementing agency should establish a project management unit to ensure that the project company implements the project in accordance with the project agreement and national requirements (e.g., social and environmental legislation). In the case of non-compliance, the project management unit should apply the contractual remedies (including payment penalties) set out in the agreements. At the end of the contract, the underlying asset is often returned to the public sector and, as such, it is important that the project agreement sets out the conditions for hand back to ensure that the asset is still 'fit for purpose'.

5.2.3 Potential benefits, limitations, and risks

Potential benefits

PPPs can generate several benefits, but these are not automatic and depend on the fulfillment of certain conditions. Procuring public assets and services through PPPs can potentially yield considerable benefits when compared with traditional procurement. For instance, PPPs can help mobilize private capital for public infrastructure investment, leverage private sector expertise, and create strong commercial management incentives. PPPs can help close infrastructure gaps and enhance the delivery of public assets and services (Figure 5.4).[195]

Figure 5.4: How PPPs can help address infrastructure challenges



Source: PPP Knowledge Lab.

PPPs can provide access to private sector finance to implement public projects that otherwise would not be possible due to insufficient funds. Fiscal and borrowing constraints can limit the government's ability to undertake additional infrastructure projects through traditional public procurement. PPPs can provide additional financing to help close infrastructure gaps and improve service delivery. This alternative source of finance may include private sector investors, commercial banks, development banks, multilateral organizations, and institutional investors (e.g., pension funds and insurance companies). However, it should be noted that PPP projects will ultimately be paid for by the public sector (e.g., government or state-owned enterprise) or end users through user fees. In that sense, PPPs are not 'free' and mainly enable the public sector to spread capital spending over a long period (or place the funding onus on users) by attracting private financing for public infrastructure projects. Therefore, the availability of private financing to invest in public projects should not be the main reason for implementing a PPP.[196]

PPPs can improve project design and appraisal by harnessing private sector skills and resources, which may strengthen project selection. Poor project preparation and selection can result in under-used assets and poor service delivery at a high cost. This is often due to poor planning and coordination, inadequate analyses (e.g., cost-benefit analysis), or political economy issues (e.g., politics or vested interests). PPPs can help improve project selection by harnessing the due diligence of private sector investors, especially since their profits depend on accurate appraisals (e.g., cost and revenue forecasts).[197] PPPs can also enable better access to private sector

[195] The private sector may benefit from collaborating with the public sector by generating profit opportunities (through availability payments or user fees) and accessing long-term investment opportunities (as government contracts can generate business, provide certainty and security, and improve the company's image).

[196] The decision should involve a careful assessment (e.g., cost-benefit and value-for-money analyses). This is because PPPs may generate fiscal costs (including foregone revenues) and risks not well understood at the time of the agreement.

[197] A public sector entity might have an incentive to overestimate demand. Subjecting proposed projects to private sector scrutiny can enhance project selection (e.g., help identify projects not economically viable). PPPs can create an incentive mechanism to align public interests (e.g., adequate public service delivery) and private interests (i.e., profit). However, conflicts may arise if incentives are not carefully designed, with profit maximization potentially leading to reduced service quality or higher user fees (e.g., the private sector may have an incentive to inflate costs).

expertise (specialized knowledge), experience, technology, and skills, which can benefit the project. However, these gains can only materialize if the preparation and selection process is effective and competitive.

PPPs can lead to a more efficient and effective delivery of public assets and services. The delivery of assets and services by the public sector might be constrained by limited capacity and weak management incentives. Compared to traditional public procurement, PPPs can improve the construction of assets and enhance service delivery through the output-based approach of PPPs. This provides an incentive for the private sector to take a long-term (whole-life) approach to the design, construction, and maintenance of the project, which can entail considerable cost savings and efficiency gains.[198] A successful PPP will identify and combine the strengths of all parties, both in terms of technical and managerial skills, as well as financial resources. However, potential gains depend on preparing, procuring, and implementing the PPP properly.

PPPs can improve the maintenance of public assets, which helps protect their value and lifespan. Public sector infrastructure assets are often inadequately maintained due to poor planning, procurement constraints, or limited budgets allocated for maintenance, as political economy tends to bias public spending toward new assets over maintenance. Inadequate maintenance increases lifetime costs, shortens the lifespan of the asset, and decreases benefits. Infrastructure asset deterioration usually entails high rehabilitation costs, while poor quality infrastructure is also costly to operate and maintain and may adversely impact the safety of users. Regular preventive maintenance is cost-effective since it preserves assets at serviceable standards at a reduced lifecycle cost. PPPs create incentives to prioritize asset maintenance, since they often bundle construction (or rehabilitation) and maintenance into a single contract. This creates an incentive for the private party to build the asset to a high quality standard upfront and establish an efficient maintenance regime, reducing the need for maintenance in the future and, thus, reduce the whole-life cost of the asset. If project revenue is contingent on service performance (e.g., to attract users who pay fees or meet quality requirements for availability payments), then the private entity has a strong incentive to carry out adequate maintenance.

Potential limitations and risks

While PPPs can generate benefits, they have several limitations that need to be carefully considered. Procuring public assets and services through the PPP modality has some disadvantages when compared to traditional procurement. Potential limitations include higher costs (as they can be more expensive than traditional procurement), lack of transparency (if there are non-disclosure requirements), complexity (e.g., in the design and negotiation), inflexibility (given their long-term nature), limited accountability (due to fragmented roles and responsibilities), misallocation of risks, conflict of interest, and political economy (e.g., vested interests). Some of these may lead to excess returns for the private sector at the cost of the public sector or end users.[199]

PPPs can create significant fiscal costs and risks, while undermining fiscal and debt transparency. PPPs often require government support to ensure their financial viability.[200] This support can be in the form of direct fiscal commitments (e.g., availability payments and viability gap financing), foregone revenues (e.g., tax exemptions), and contingent liabilities (e.g., minimum revenue guarantees, payment guarantees, and termination payments).[201] Foregone revenues and contingent liabilities can be sizable but difficult to assess and monitor. If contingent liabilities do materialize, they can significantly exacerbate fiscal and public debt burdens. Moreover, PPPs are also often associated with a lack of transparency, since they may be subject to limited information disclosure, and difficult to understand due to their complexity. PPPs can, therefore, bypass public financial management controls, such as prudent fiscal rules (e.g., budget deficit and public borrowing ceilings). This may occur when policy makers are under pressure to deliver infrastructure and decide to exploit the limitations of cash basis budgeting and narrow definitions of public sector debt. Future payment commitments, foregone revenues, and fiscal risks are unlikely to be adequately captured in budget documentation. It is therefore important to closely monitor PPP-

[198] For instance, the infrastructure can be designed to reduce operation and maintenance costs over the life of the project, especially if revenue is linked to performance.

[199] Moreover, limited ability to assess and negotiate PPP projects may lead to mispricing, whereby the private sector earns excess returns due to long concession terms, high user fees (e.g., tariffs and tolls), generous government support (e.g., tax and royalty exemptions), and inadequate risk allocation. This is a particular concern for PPPs not tendered competitively.

[200] It is important to assess if the economic and social benefits generated by the project outweigh the costs of the project, including any support provided by the government.

[201] PPP availability payments are not very different from the repayment schedule of traditional public procurement financed by debt. If PPPs are treated as being off-balance sheet, and fiscal costs and risks are not adequately captured elsewhere, then PPPs may not be consistent with prudent public financial management.

related costs and risks (e.g., through a centralized database) and gradually include their assets and liabilities in the government balance sheet (like the assets and liabilities of state-owned enterprises).

PPPs cannot improve planning and may even distort investment priorities. PPPs cannot eliminate poor planning and project selection, since the public sector remains responsible for strategic planning (including coordination across sectors) and selecting projects and the procurement method. In fact, PPPs may even distort investment priorities, with low-priority projects selected on the basis that they can be implemented through PPPs. Projects initiated by the private sector (i.e., unsolicited proposals) may not be aligned with national development strategies and investment priorities, and they may further exacerbate weaknesses in planning and coordination. The long-term commitment of PPP contracts creates a degree of inflexibility that may lead to planning challenges that might be costly to overcome.[202] PPPs can also provide an opportunity for corruption, which leads to inefficiencies and may bias project selection.[203]

PPP projects are time-consuming and costly to prepare, and not all projects are suitable to be procured as a PPP. PPPs are significantly more complex and incur higher transaction costs than traditional procurement methods (e.g., legal, financial, and technical advisory costs). They are more demanding, in terms of both time and skills. Considerable financial and human resources need to be allocated at the outset, with the risk that some projects may eventually prove to be unsuitable for procurement as a PPP.[204] Many of the potential benefits hinge on the ability of the implementing agency to adequately prepare, procure, and manage the PPP project over its lifetime, which can be a challenge when public sector capacity is low. However, not all projects are suitable to be procured as PPPs (e.g., because of public reluctance, excessive complexity, inability to transfer risks, and lack of affordability from the government or end users' perspective).[205] Therefore, it is essential that governments adequately identify and screen projects to assess their suitability for a PPP before committing significant resources to their preparation and implementation.

Value for money and risk allocation

PPP projects need to demonstrate higher value for money when compared to traditional public procurement. Value for money means achieving the optimal combination of benefits and costs in delivering the services that users want. Value for money is usually determined by using both qualitative and quantitative approaches.[206] To assess whether a project is suitable for implementation as a PPP, it needs to demonstrate that it can achieve higher value for money for the public over the life of the project when compared to other procurement structures, especially traditional public procurement. A project is generally regarded as being suitable for a PPP if the net present value (NPV) of the overall risk-adjusted costs of the project is lower than the NPV of the overall risk-adjusted costs to the public sector of implementing the same project using a traditional procurement approach. Hence, the government needs to undertake a comparison between the estimated whole-life costs of the project under a PPP method and traditional procurement (known as the 'public sector comparator'). The results of this analysis will then allow the government to assess and support the rationale for implementing a project under a PPP in terms of value for money for the public sector and end users.

One of the main drivers of value for money is the appropriate and fair allocation of risks to the party that is best able to manage them. PPP value drivers are the mechanisms that can be used to improve value for money, of which risk transfer is a key one.[207] Risks associated with PPPs vary across countries, sectors, and projects. However, there are several risks commonly associated with infrastructure PPPs, such as design, construction, revenue, demand, operational, economic (e.g., interest rate, exchange rate, and inflation), political, environmental, social, legal, and regulatory. The basis on which these risks are allocated between the public and private sector will be driven by

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[202] It is difficult to adapt to changing circumstances, especially when they are difficult to anticipate (e.g., fall in user demand).

[203] PPPs are vulnerable to 'agency' problems, since the public sector makes decisions on behalf of citizens, taxpayers, and end users. This issue is compounded by the large amounts typically involved, which can lead to corruption and even the failure of PPP projects. Hence, there is a need for evidence-based public decision making, as well as greater transparency and accountability.

[204] Efficiency gains should outweigh these additional (preparation) costs.

[205] Moreover, user fees may face social and political resistance in sensitive sectors (e.g., education and health), while there are often environmental concerns.

[206] Qualitative factors include the extent to which the procurement can generate competition and the ability of the private sector to introduce innovation.

[207] These include risk transfer, whole-life costing, upfront commitment to maintenance, focus on service delivery, innovation, asset utilization, mobilization of additional funding, and accountability.

several factors, including the type of project, the commercial viability of various risk allocation scenarios, as well as the objectives and desired outcomes of the government in procuring the project as a PPP. If the public sector takes on too much risk, it can adversely impact value for money.[208]

Poor project preparation can significantly undermine value for money. Careful project preparation is important to maximize value for money and increase the probability of a successful procurement. However, governments sometimes do not have the necessary resources or experience to prepare projects that are bankable and provide value for money. For instance, the implementing agency may accept too much risk during PPP negotiations, some of which it may not be equipped to adequately manage. Therefore, to minimize risks and maximize value for money, it is essential that governments carefully assess and structure PPP projects through the preparation of appropriate studies (e.g., feasibility, and environmental and social impact), as well as undertaking a robust financial analysis (e.g., cost-benefit and value-for-money analysis), before deciding to implement a project as a PPP. If the government does not have the capacity or experience to undertake these studies, it is necessary to hire professional advisers to support the project preparation process.

Competitive and transparent procurement is critical to maximizing value for money. Even if PPP projects are properly prepared, it is essential that they are then competitively and transparently tendered, negotiated, and managed to ensure that the targeted value for money is achieved. A competitive and transparent procurement process helps maximize value for money by creating competitive tension between bidders. In fact, one of the main weaknesses of unsolicited proposals is that the original proponent is often given a bidding advantage that may include the right to match the price of the winning bidder (i.e., a Swiss challenge), a price advantage, or a points advantage. Providing such bidding benefits to the original proponent often weakens the competitive tension and, thereby, the value for money proposition, as many bidders may decide not to bid for the project on the basis that the original proponent has been given an unfair bidding advantage. Poor project preparation and procurement (e.g., direct negotiation) can lead to suboptimal technical design, high user fees (e.g., tariffs and tolls), long contract duration, excessive government support (e.g., guarantees, availability payments, and tax incentives), and a risk allocation that favors the private sector.

Fiscal commitments, contingent liabilities, and foregone revenues

Although the private sector often provides the financing for PPP projects, the public sector can still have significant financial exposure to the project. The private sector is usually responsible for financing, constructing, and operating a PPP project, and thus assumes a considerable share of the risks. However, the public sector often has considerable financial exposure to the PPP project, which arises from any direct or indirect financial support that it may have agreed to provide to the project and its investors and lenders. PPPs may entail a range of fiscal costs and risks (Table 5.3). Fiscal commitments are liabilities arising from direct financial support by the public sector to the project as stipulated in the PPP agreement. For example, a government may agree to pay a monthly availability payment to the project company in return for constructing and operating a road, subject to that road being 'available' in accordance with the terms of the contract.[209] Contingent liabilities give rise to a potential fiscal commitment since the occurrence, value, and timing of the payments are contingent on certain events that may or may not happen. Examples of contingent liabilities include government payment guarantees (explicit or implicit) linked to financial commitments made by public corporations (e.g., take-or-pay clauses in power purchase agreements) (see fiscal risk matrix Table 1.1).[210] Other contingent liabilities include minimum revenue guarantees, which are only triggered if revenues fall below a certain pre-agreed level, or termination payments if the contract needs to be terminated due to a force majeure event or default of one of the parties. Foregone revenues can also be considerable, with an impact on the budget and even the availability of foreign exchange, especially when tax incentives are overly generous. Therefore, the public sector needs to carefully manage PPP-related fiscal costs and risks, not only on a project-by-project basis but also on a PPP portfolio perspective.

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[208] Prior to procurement, implementing agencies need to carefully assess project risks and develop a provisional risk-allocation and risk-mitigation matrix as part of the project preparation process.

[209] The fiscal costs of PPPs (including foregone revenues) are seldom reflected in budget documentation, particularly in countries with cash-basis accounting.

[210] Take-or-pay obligations provide revenue certainty for the private sector, as the public sector absorbs the demand risk and, often, the foreign exchange risk (if the values are denominated in foreign currency).

Table 5.3: Examples of fiscal costs and risks related to PPPs

Type	Description
Fiscal commitments (direct liabilities)	Contractual obligations where the payment commitments from the government is known, although there may be some uncertainty about the exact value and timing of the payments.
Direct fiscal support to the project itself	**Availability payments:** a regular payment (usually monthly) made by the government over the life of the project, conditional on the availability of the service or asset. **Output-based payments:** payments made by the government based on per unit of service. **Viability gap funding:** a payment made by the government to reduce the capital costs of a project to ensure that a project that is economically feasible but not commercially viable can proceed.
Cost of related investments and associated works	**Resettlement cost:** payment by a government to relocate and compensate project affected persons. **Right of way acquisition:** a government may sometimes need to acquire rights of way so that the project company can deliver the project. **Project related works:** a government may agree to pay for some shared infrastructure (e.g., access roads to a solar park facility).
Contingent liabilities	Contractual obligations where payment depends on some uncertain future event occurring that is mostly outside the control of the government and where the occurrence, value, and timing of any payment is not known in advance.
Guarantees to mitigate particular risks	**Demand or tariff guarantee:** a government undertaking whereby the government commits to a certain level of volume or revenue (minimum revenue guarantee) to the project company. If the volume or revenue is not achieved, then the government is obliged to compensate for the financial shortfall. **Force majeure:** these payment obligations are typically shared between the project company and the government.
Payment guarantees	**Payment guarantees:** these materialize in case of a payment default by a public sector contractual counterparty. Payment guarantees are typically required by lenders, where there is uncertainty in the offtaker's capacity to fulfil its contractual payment obligations.
Termination payment commitments	**Termination payment commitments:** these will vary depending on the nature of the termination event.
Foregone revenues	
Tax incentives	**Tax incentives:** these may include tax exemptions (on profits and imports) and reduced royalty fees.

Source: World Bank.

5.3 PPPs in the Lao PDR

5.3.1 History of PPPs and their performance

Significant economic reforms have been undertaken since the mid-1980s, including the promotion of foreign investment. The government adopted the New Economic Mechanism in 1986 to develop a market-oriented economy in the Lao PDR. The provision of public assets and services has traditionally relied on financing from the government budget and foreign development partners, although the private sector has been playing an increasing role. PPPs have provided a vehicle for foreign direct investment (FDI) in public infrastructure assets and services, while the government has participated directly and indirectly in PPPs (e.g., through SOEs).[211] Most PPP projects

[211] PPPs include independent power producer (IPP) projects. Large SOE investments in power generation, transmission, and distribution have been mainly funded through on-lending and guarantees from the government (amounting to 48 percent of GDP in 2022).

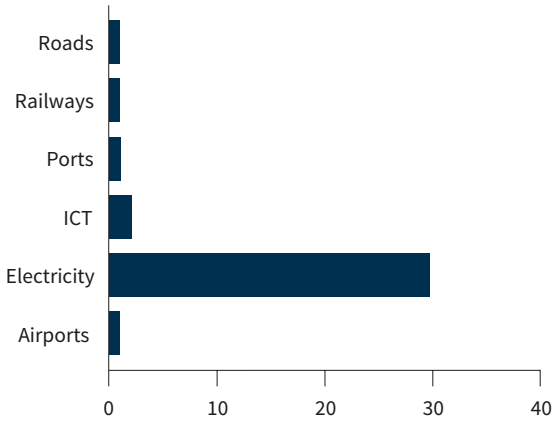
have been directly negotiated, awarded, and implemented on a concession model under the 1989 Law on Foreign Investment and its subsequent revisions. A dedicated PPP unit was established in 2018 in the Ministry of Planning and Investment. It was only in December 2020 that a specific legal document dedicated to PPPs was approved (i.e., the PPP decree).

The current definition of a PPP in the Lao PDR context is unclear, which undermines the use of the current regulatory framework. A lack of clarity and understanding of PPPs has meant that many projects that should be classified as PPPs are not, while projects that have been classified as PPPs are not really PPPs. For example, IPPs in the hydropower sector are often regarded as purely private investments rather than a form of PPP, which potentially undermines the public interest, since they create important public assets (i.e., hydropower plants) that should be carefully managed. In addition, PPPs have been predominately viewed as financing vehicles, rather than as mechanisms to improve service quality and efficiency, thereby weakening the potential benefits that can accrue from PPPs.

The Lao PDR has a long history of PPP projects, mostly BOT projects in the energy sector, but increasingly in the transport sector as well. There is no consolidated database on PPP projects in the Lao PDR with essential project details, such as name of project, type of project, location, implementing agency, sponsors, status, project costs, as well as information on fiscal commitments, contingent liabilities, and foregone revenues. The World Bank's Private Participation in Infrastructure (PPI) project database reports 35 PPP projects that reached financial closure in the period 1990–2022 in the Lao PDR.[212] The earliest project recorded in the PPI database is the Tha Ngone Bridge Project, which reached closure in 1993. However, the database does not capture all projects that have benefited from private sector participation and may not be fully accurate, since it relies on public disclosure.[213] Most of the reported projects procured since 1990 have been in the electricity generation sector and procured on a BOT basis (Figure 5.5). In recent years, there has been significant private sector investment in other sectors (e.g., railway and dry port), with the Laos–China railway project standing out in terms of value (Figure 5.6). While the Vientiane-Boten expressway is currently not in the database, the section from Vientiane to Vang Vieng (which is already in operation) is estimated to have cost around $1.3 billion, with the three remaining sections expected to cost an additional $6 billion. There appears to be an ambitious pipeline of mostly unsolicited PPP projects, mainly relating to railways and roads.[214] Since the interest in PPPs is likely to remain strong, partly owing to limited fiscal space, it is crucial to strengthen the PPP enabling environment. In particular, projects should be aligned with national strategies and plans, and should not be implemented without careful preparation, procurement, and contract management.

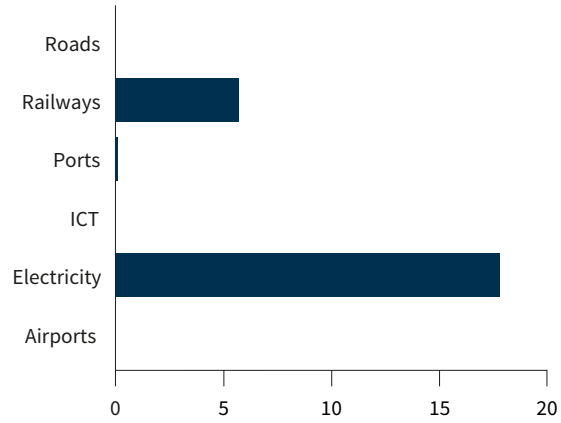
Many of the existing projects were procured on an unsolicited basis, which can undermine value for money. Available information suggests that many of the 35 PPP projects reported originated from unsolicited proposals,

Figure 5.5: Number of projects (1990–2022)



Source: World Bank.

Figure 5.6: Investment (1990–2022, USD billion)



Source: World Bank.

[212] The PPI database includes four types of projects: management & lease (not PPP), brownfield, greenfield, and divestiture (not PPP). For the Lao PDR, all but one (a management contract for an airport) are PPP projects.

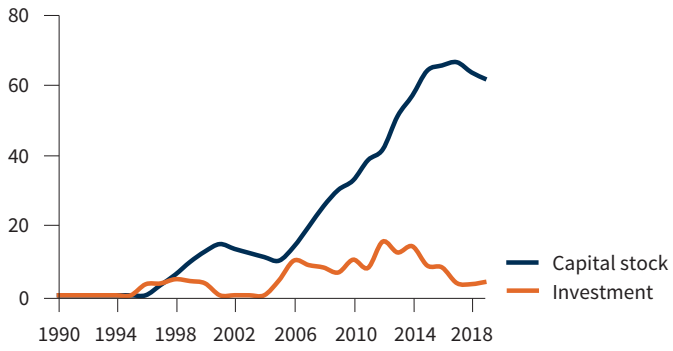
[213] There are over 80 hydropower dams in the Lao PDR, which suggests that many PPPs have not been captured in the database.

[214] Planned projects include several expressways (from Vientiane to Hanoi, Vientiane to Pakse, Vang Vieng to Boten, Boten to Bokeo) and railways (from Vientiane to Pakse, and Thakek to the border with Vietnam).

which probably circumvented the already weak PPP regulatory framework.[215] It is likely that projects initiated by unsolicited proposals (often procured on a direct negotiation basis) did not benefit from a robust feasibility analysis and were not tendered through a transparent and competitive bidding process. This can significantly undermine the project's affordability proposition and value for money, while also undermining planning synergies.[216]

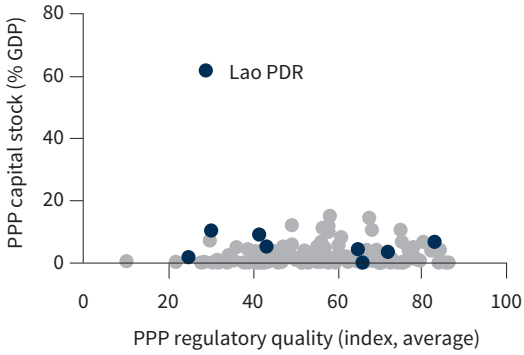
The PPP capital stock is very large by international standards, raising concerns about the size of existing fiscal commitments and contingent liabilities, as well as foregone revenues. PPP investments averaged about 10 percent of GDP per year between 2006–2016 (Figure 5.7). Large PPP infrastructure investments have considerably increased the PPP capital stock, which peaked at 66 percent of GDP in 2017. In 2019, the relative size of the PPP capital stock was far larger than in any other country in the world, while the quality of PPP regulatory practices was comparatively low (Figure 5.8). Therefore, there is an urgent need to develop a robust framework to quantify and manage PPP-related fiscal commitments and contingent liabilities, as well as quantify and assess foregone revenues from tax and royalty exemptions.[217] This will be key to better managing PPP-related fiscal costs and risks.

Figure 5.7: PPP value (% GDP)



Source: International Monetary Fund.

Figure 5.8: PPP capital stock (% GDP, 2019)



Source: International Monetary Fund and World Bank.

PPP performance is relatively low, suggesting that there is significant scope to improve governance arrangements and capacity. The regulatory framework and institutional arrangements for PPPs are not in line with internationally recognized good practices for project preparation, procurement, and contract management. PPP performance scores are low when benchmarked against averages for regional and income peers, especially for project preparation (Figure 5.9).[218] This is concerning, since it is during this stage that the project is defined, structured, and assessed for its suitability to be procured as a PPP. Therefore, it is critical to improve the regulatory framework and institutional capacities to properly prepare PPP projects to ensure that the right projects are selected to be procured as PPPs, and that the projects are adequately structured so that they are bankable, affordable, and provide value for money.

Strengthening the overall enabling environment for PPPs is critical to supporting private sector capital mobilization. To encourage and support private sector participation in the provision of infrastructure outside the energy sector, it is important to strengthen the ecosystem for PPPs. This would require: (i) strengthening the current legal and regulatory framework for PPPs so that there is a clear legislative framework and process for PPPs; (ii) identifying and socializing a pipeline of bankable PPP projects; (iii) ensuring transparency throughout the tender process; and (iv) mandating competitive procurement.

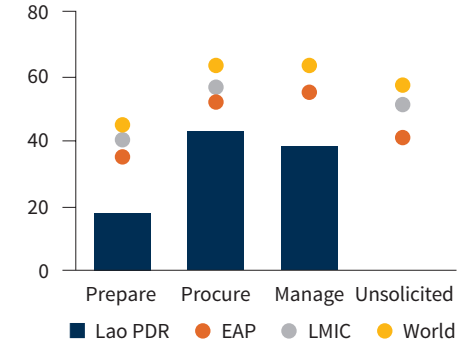
[215] This estimate is likely to be severely underestimated, since most BOT projects in the energy sector are known to have been unsolicited, particularly given limited capacity in the public sector. For instance, the Nam Ngiep 1 Hydropower Project (which is one of the case studies in this chapter) is listed as solicited, when that is not the case.

[216] PPPs can improve project management and enable the public sector to focus on planning, strategic policy, regulation, and monitoring. However, planning can be undermined if most PPPs are unsolicited and not part of a public investment plan. It is vital to scrutinize and prioritize PPP project proposals to ensure they are consistent with existing public investment plans.

[217] The PPI database shows there is substantial public participation in financing PPP projects. In the energy sector, some of this is likely through EDL, EDL-GEN, and Lao Holding State Enterprise (LHSE).

[218] The benchmarking results are based on responses from the relevant PPP units in each country. In the case of the Lao PDR, there was no response to the questions on unsolicited proposals.

Figure 5.9: PPP regulatory quality (index)



Source: World Bank.

5.3.2 Legislation, regulations, and institutions

The successful implementation of PPP projects relies on a sound legal and regulatory framework that promotes good governance and clearly defines roles and responsibilities. A PPP framework comprises policies, rules, procedures, and institutions that define how PPPs are identified, assessed, selected, prioritized, budgeted, procured, monitored, and accounted for. The framework should also define the public sector institutions responsible for each of these tasks, while promoting accountability, transparency, access to information, participation, fairness, and integrity. This can help ensure that PPP projects are aligned with the government's development strategy, maximize economic and social returns (while preserving the environment), and do not generate unnecessary fiscal risks.

Legal and regulatory framework

The current PPP legal and regulatory framework in the Lao PDR comprises several laws and decrees. The general legal and regulatory framework for PPPs comprises the Investment Promotion Law, the State Investment Law, the Public Procurement Law, the Decree on the Controlled Business and Concession List, and the Decree on Public-Private Partnerships. PPPs may be further regulated through sector-specific laws and regulations, such as the Electricity Law, which contains several provisions relating to the assessment, award, and contract terms of projects relating to transmission and generation.

Until the PPP decree came into force, PPP projects were implemented under different laws. Until January 2021, when the PPP decree came into effect, most PPP projects were implemented under either the Investment Promotion Law or the Electricity Law. However, neither of these laws specifically addressed PPPs, and thus were not drafted to reflect the unique characteristics of PPP projects. Therefore, the government instructed the Ministry of Planning and Investment (MPI) to prepare a PPP decree that specifically addressed PPPs. In particular, the PPP decree was drafted to provide clarity on the processes and the roles and responsibilities of the various parties to a PPP contract in terms of project preparation, procurement, and project management. The PPP decree also provided clarity on the sectors open for PPPs, the type of acceptable PPP investment structures, the processes for approving unsolicited proposals, and the types of government support that can potentially be made available.[219]

While the PPP decree does provide more clarity, there are several areas that could be further clarified and strengthened. The decree is only an implementing regulation that must be read in conjunction with the Investment Promotion Law, State Investment Law (which governs the use of state funds), and the Public Procurement Law (in circumstances where the PPP project provides services directly to the state). Given that a decree is subordinate to a law, this means these laws take precedence in case of inconsistencies. Moreover, no complementary policies and guidelines have been produced to support the implementation of the decree. This, coupled with scarce financial and human resources, limited understanding and experience of PPP concepts and processes, and the absence of a specific pipeline of PPP projects, has severely constrained the use of the relevant legislation in support of PPPs.[220]

[219] The decree mentions two forms of partnerships: (i) partnerships with public financial contributions; and (ii) partnerships where investment capital is borne entirely by private parties.

[220] Given the current lack of clarity of what constitutes a PPP in the Lao PDR, it is important to provide a clear definition of PPPs that is in line with international definitions. This would ensure that all relevant projects are prepared and implemented in accordance with the relevant laws and regulations governing PPPs.

Most PPP projects are still being procured outside the process specified in the PPP decree. Despite the introduction of the decree, most PPP projects are still being procured on a negotiated basis outside the processes and approval mechanisms set out in the decree. Most of these projects originate from unsolicited proposals. These often receive approval from senior government officials before being passed to the relevant line ministry or agency to finalize the contract and support implementation. However, most line ministries and agencies do not have the capacity or resources to accurately assess the technical and financial aspects of PPP projects, which means the public sector may: (i) take on fiscal risks that it cannot afford or manage; and (ii) allow the private sector to generate excessive returns. In this context, it is crucial to develop a framework to properly manage unsolicited proposals and ensure that line ministries and agencies have the capacity and resources to assess and prepare PPP projects.

To overcome the inherent weaknesses of PPP-related decrees and regulations, some countries in the region have approved PPP laws. Vietnam initially used a decree to govern the use of PPPs. However, inconsistencies between this decree and other legislation (e.g., laws) created uncertainty over the authority and relevance of the decree. To address these issues, the National Assembly ratified a PPP law in June 2020. In November 2021, Cambodia enacted a PPP law to replace the 2007 Law on Concessions. It is understood that the Lao PDR is planning a new PPP law to be submitted to the National Assembly in late 2024. The main objective of the new PPP law should be to ensure that all projects are processed in accordance with the requirements of the law.

Institutional framework

PPP projects need to be approved by the Prime Minister's Office and may require additional approvals. Under the PPP decree, projects require approval from one or more public entities, depending on several factors (Table 5.4). All PPP projects, with very few exceptions, must be approved by the Prime Minister's Office. Projects under $300 million only require approval from the Prime Minister's Office if no funding from the state budget is required and there are no significant social and environmental impacts.[221] In other circumstances, projects may need approval from a Provincial Assembly or the National Assembly.

Table 5.4. Institutional PPP approval requirements

Criteria for approving authority	Prime Minister's office	National Assembly	Provincial Assembly
Project investment value	Not more than $300 million	More than $300 million	
Requirement for state funding	No funding from the budget is required	If state funding exceeds 20 billion kip	If funding does not exceed 20 billion kip
Requirement for the conversion of conservation or national protected forest, the diversion of water flows or resettlement	No requirement for conversion of conservation or national protected forest or the diversion of water flows and resettlement of more than 500 households	If project requires the conversion of conservation or national protected forest, the diversion of water flows or the resettlement of more than 500 households	If the project requires the conversion of degraded or barren forest land
Others		Moderate (e.g., output specifications, procurement and monitoring)	

Source: World Bank staff based on the Decree on Public–Private Partnerships.

Responsibility for PPPs has been mainly assigned to the Ministry of Planning and Investment (MPI). The MPI, through the Investment Promotion Department and its One Stop Service Office, is responsible for administering the foreign investment framework and reviewing investment applications in accordance with the Law on Investment Promotion. In particular, the department is responsible for screening projects, providing summary reports to the government, and implementing activities to promote private sector investment, including PPPs. Within MPI's Investment Promotion Department, the Public-Private Partnership Division has been established to help manage the PPP program. However, the division is currently understaffed given its responsibilities and obligations.

[221] This restriction does not find support in the Investment Promotion Law and may not be enforceable.

The preparation and successful implementation of PPP projects requires dedicated and experienced resources. The development, procurement, and management of PPP projects is very different to those projects procured through traditional public procurement. PPP projects require a certain set of skills and experience to ensure they are structured in a way that is bankable, affordable, and maximizes value for money. Therefore, it is important to strengthen the capacity and resources of the Public-Private Partnership Division, so that it can fully support ministries and agencies to identify, screen, prepare, procure, and manage PPP projects.

In addition to MPI, the Ministry of Finance has an important gatekeeper role to play in the approval process for PPP projects. The role of the Ministry of Finance is particularly important with respect to assessing, approving, and managing fiscal costs and risks that may arise from PPP projects. However, while the Ministry of Finance is part of the Committee for Partnerships Promotion and Management, the PPP decree is relatively silent on the specific roles and responsibilities of the Ministry of Finance in terms of assessing and managing PPP-related fiscal costs and risks (e.g., foregone revenues).

It is of central importance to develop a robust framework to manage PPP-related fiscal costs and risks. Given the fiscal constraints the government is currently facing and the fact that these constraints have partially been driven by liabilities arising from past PPP projects, it is essential that the government establishes a robust institutional framework and process that systematically assesses and manages both historic and future PPP-related fiscal costs and risks.

5.3.3 Case studies

Case studies can offer important lessons for future PPPs, while regular assessments should be undertaken by all ministries that implement PPP projects. This sub-section presents two case studies of PPP projects that have been implemented in the Lao PDR to help shed some light on the strengths and weaknesses of the current PPP enabling environment. It mainly assesses PPP processes and capacities, rather than the intrinsic quality of the project (such as its technical and financial aspects).[222] The authorities provided access to documentation for both projects, which were a vital source of information. This was complemented by stakeholder interviews. While the Ministry of Energy and Mines (MEM) and Électricité du Laos (EDL) appear to have developed some capacity to assess the technical and financial aspects of PPP projects in the energy sector, the implementation of PPP projects in the transport sector is much more recent. Since the Vientiane–Vang Vieng Expressway Project was the first PPP contract that the Ministry of Public Works and Transport (MPWT) negotiated, it is understood that the ministry is currently assessing the lessons that can be learned. In fact, ex-post assessments of existing PPPs can be extremely beneficial.

Nam Ngiep 1 Hydropower Project

This PPP project is a BOT arrangement for the construction and operation of a hydropower plant. The Nam Ngiep 1 Hydropower Project involves the construction and operation of a 290-megawatt hydropower generation facility at the Nam Ngiep River in the provinces of Bolikhamxay and Xaysomboun. Like many other hydropower projects, it is a BOT arrangement. The project started as an unsolicited proposal in the early 1990s, but when the memorandum of understanding with the original developers expired, the government approached the Japan International Cooperation Agency (JICA) to conduct a full feasibility study into the project's social and environmental impacts, as well as its technical and commercial aspects. After many years and several studies, the Nam Ngiep 1 Power Company was established to develop the project with Japan's Kansai Electric Power Company (Kansai) having a 45 percent share, the Electricity Generating Authority of Thailand (EGAT) having a 30 percent share, and the Lao Holding State Enterprise (LHSE) having a 25 percent stake.[223] The concession period is 27 years, after which the assets will be transferred to the public sector. The construction of the project started in late 2014 and was completed in September 2019. The project's costs were around $870 million, and the electricity being generated is sold to EGAT (95 percent offtake) and EDL (5 percent offtake) under a power purchase agreement

[222] For instance, it does not evaluate the adequacy of government support, take-or-pay clauses, or user-fee levels. It also does not assess economic, social, and environmental impacts.

[223] The LHSE is a state-owned enterprise that holds government shares in power projects. If SOE debt is on-lent or guaranteed by the government, it is classified as public and publicly guaranteed (PPG) debt. If SOE debt in not guaranteed by the government, then it is an implicit contingent liability. This case study does not assess the underlying power-purchasing agreement.

[224] See LHSE website.

signed with the Nam Ngiep 1 Power Company. During the 27-year operating concession, the project is expected to contribute more than $600 million to the Lao PDR through royalty fees, taxes, and dividends paid to LHSE.[224] Set out below are some of the lessons from this case study.

The importance of building the necessary capacity to assess the technical and financial aspects of a project to ensure value for money is being achieved. While MEM and EDL have built up some capacity to assess the technical and financial aspects of independent power producer (IPP) projects (e.g., costings), this capacity needs to be enhanced. In-house technical and financial capacity is critical to properly assess private sector proposals to ensure that the project provides value for money to the public sector and the government is not enabling excessive returns to the private sector. If such capacity is not available within a particular ministry or agency, then resources should be made available to hire external advisers that have the necessary skills and experience.

The importance of preparing bankable contract templates. Preparing standard contract templates for an IPP/PPP project on a sector-by-sector basis can help expedite the procurement and signing of PPP contracts, as both the implementing agency and private sector proponent will then be familiar with the terms and conditions of the agreement. However, it is important that such standard contracts have been structured based on feedback from the private sector and are viewed as being bankable by investors and lenders. While MEM and EDL have developed standard contract templates to try and expedite the project development process, these templates have often been viewed as not being bankable due to the underlying risk allocation, which undermines their usefulness in terms of expediting the procurement process.

The importance of ensuring that PPP projects are planned and procured on a portfolio basis rather than on a project-by-project basis. While coordination in planning and investment is important in all sectors, it is particularly crucial in the energy sector to ensure that (i) the demand and market for the power being generated by an IPP is identified ahead of time to avoid the risk of having excess capacity (as is currently the case); and (ii) the transmission and distribution network is in place to transport the electricity generated to demand centers. While this project is dispatching 95 percent of its energy to EGAT in Thailand, many other IPPs are having challenges in dispatching their capacity.

The importance of stakeholder consultations and disclosure. It is important to ensure the government and the project company have robust consultations with all stakeholders during the project preparation and implementation stages. It is also crucial that the project company is required to provide timely and accurate information to the government and other stakeholders. The requirement to provide information should be specified in the concession or project agreement. The type of information that needs to be disclosed may vary depending on the stakeholder. For instance, the government's project management unit will require detailed performance and financial reports, while the public and other stakeholders not party to the contract will only need high-level (non-confidential) information. The Nam Ngiep 1 Power Company provides very detailed information on the status of the project in a dedicated website, including monthly environmental management reports.[225]

There are benefits of having international investors and development partners participate in a project. This project benefited from the involvement of Kansai and EGAT as investors, and the Asian Development Bank (ADB) and Japan Bank for International Cooperation (JBIC) as lenders to the project. The involvement of international investors not only brought considerable international experience to the design, construction, and operation of the project, it also helped to catalyze international financing from a group of Japanese and Thai banks. This commercial financing was also supported through the commitments of both ADB and JBIC to the financing, as their involvement gave additional confidence to the commercial banks that (i) the environmental and social impacts of the project would be well managed; and (ii) if there were any problems with the project, ADB and JBIC would have more authority and influence than the banks to help solve these problems. Looking forward, the government should encourage international investors to bid on PPP projects, which can help bring in international expertise as well as much-needed commercial bank financing. However, for international investors and banks to support projects in the Lao PDR, it is important that projects are well prepared and bankable, and that the government commits to a transparent and competitive bidding process.

[224] See LHSE website.

[225] See Nam Ngiep 1 Power Company website.

Vientiane–Vang Vieng Expressway Project

This PPP project is a BOT arrangement for the construction and operation of an expressway. The Vientiane–Vang Vieng expressway is the first of four sections of the Laos–China expressway, which will run between Vientiane and Boten in Luang Namtha. The expressway has been developed as part of China's Belt and Road Initiative and is the first expressway to be built in the Lao PDR. This section is 113.5-kilometers long and 23-meters wide in a two-way four-lane configuration. It features several bridges and a tunnel, with eight toll gates along the way. The expressway runs parallel to the existing National Road 13 North. The project was initiated under an unsolicited proposal by China's Yunnan Construction and Investment Holding Group, which holds a 95 percent shareholding in the project, with the remaining 5 percent held by the government. The total cost of the expressway was around $1.3 billion. Construction started in 2018 and the expressway was officially opened in December 2020. The expressway has cut the traveling time between Vientiane and Vang Vieng from around 3.5 hours to about one hour. This is a BOT project under a 50-year concession agreement, with revenues relying entirely on tolls collected from road users. It is understood that the government was not required to provide financial support or other contributions to the project, aside from providing the necessary approvals. In particular, the costs of land acquisition and resettlement were factored into the capital costs of the project. Set out below are some of the lessons from this case study.

The importance of having the necessary time and resources to adequately assess the technical and financial proposals. As this project originated from an unsolicited proposal, the Ministry of Public Works and Transport (MPWT) had not prepared or studied technical proposals (e.g., cost estimates) for this expressway prior to the unsolicited proposal being submitted. Given the very short negotiation period, the ministry was under pressure to assess the proposal and negotiate the concession agreement without having the necessary technical and financial resources. Having the necessary skills and experience to assess the technical and financial proposals is particularly important in the case of an unsolicited proposal, to ensure that the proposed costs are reasonable and that the proponent is not making excess profits through the road tolls and length of the concession. In addition, it is important for the government to carefully assess the tax benefits and royalty exemptions requested by the project developer to avoid unnecessary foregone revenues.

The importance of ensuring that the unsolicited proposal is submitted with a robust feasibility study that has detailed traffic studies, costings, and alignment options. It is understood that the feasibility study prepared by the developer only presented one alignment (i.e., route), when it would normally be expected that two or more alignment options would be presented with associated costings. This highlights the importance of putting in place clear guidelines that set out the minimum technical (as well as financial) information required for an unsolicited proposal to be accepted for review.

The importance of having a risk allocation and concession contract template, together with appropriate legal resources, to support the negotiation over the concession contract. As MPWT had not entered into a PPP contract before, it did not have a contract template that could be used as a basis for negotiation. In addition, they did not have sufficient funding to hire a legal firm that had experience in negotiating such contracts. The concession contract is a binding legal agreement that sets out the terms and conditions, as well as the rights and obligations, of the public and private sectors under the project. It is therefore critical to have access to experienced professionals and sector experts (e.g., lawyers, engineers, and financial advisers) that can thoroughly review and support the investment committee to negotiate the PPP contract.

The importance of ensuring adequate consultation with all stakeholders including project affected parties. Given the expedited timetable to negotiate and implement the project, there was insufficient time to engage with the various stakeholders, including at the local level. This lack of consultation caused some issues with the implementation of the project (e.g., some residents were unhappy that parts of the expressway alignment cut across existing roads or paths). It is vital to undertake adequate and timely consultations with various stakeholders, and that the project developer puts in place a robust grievance redress mechanism to deal with any issues and complaints that may arise.

The importance of monitoring the project's performance during construction and operation. Given the expedited timetable for implementation, the developer mobilized and initiated construction very quickly. As a result, there was a delay by the government in putting in place a monitoring framework, and when an engineer was appointed, construction was already relatively well advanced. Although the government has a 5 percent equity stake, it has limited influence in the day-to-day management of the concession. Putting in place a robust monitoring and reporting framework is critical to ensure that the government is provided with timely and detailed

reports on construction and operational performance. This requirement on the project developer to provide project reports needs to be clearly laid out in the concession agreement.

PPPs are not 'free', even when the public sector does not provide any direct or contingent financial support to a project. It is critical to carefully assess the costs of technical and financial proposals (particularly in terms of the tolls being charged, as well as the tax and royalty exemptions being sought) to ensure that projects are providing value for money to the public. While the government may not have provided direct or contingent financial support to the project, and even received a small equity stake at no cost, the project is not 'free' as the end users must pay for the project through (rising) tolls over the term of the concession. The government may also be foregoing revenue through the various tax incentives that it may have granted.

5.4 Conclusion and recommendations

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. 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.[226] There seems to be a large pipeline of mainly unsolicited PPP projects, which should be carefully scrutinized before contracts are awarded.

PPPs can generate several benefits, but these are not automatic and depend on the fulfillment of certain conditions. Investing in infrastructure is key to supporting 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 arising from projects (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 using the same standards applied to public investment projects, such as efficiency, effectiveness, equity, and sustainability.[227]

Several reforms should be undertaken to strengthen PPP governance and capacities, taking into account lessons learned from other countries. It is important to enhance the overall ecosystem for PPPs by creating a robust enabling environment to support the development of a successful PPP program that delivers value for money. The Lao PDR can benefit from the experience of other countries in the region, such as Thailand, Malaysia, Indonesia, and Philippines, to help develop a successful and fiscally sustainable PPP program. However, mixed experience with PPP projects across the world suggests that PPPs are not a panacea.[228]

Upgrading the Decree on Public-Private Partnerships to a law and developing related guidelines will strengthen the legal and regulatory framework. The current PPP decree needs to be read in conjunction

[226] For instance, some hydropower projects have provided limited revenue to the government due to generous tax incentives, have not improved service delivery in the country, especially in the case of export-oriented projects, and have created large contingent liabilities for the government (e.g., through take-or-pay clauses in power purchase agreements involving state-owned enterprises).

[227] For instance, there is a need to assess distributional impacts (equity) and ensure that the demand for the proposed services is sufficient (sustainability).

[228] See the PPP Knowledge Lab's reference guide, where several successful and unsuccessful case studies are presented.

with several other laws relevant to PPPs, such as the Investment Promotion Law, State Investment Law, Public Procurement Law, and Electricity Law. Since a decree is subordinate to a law, these laws take precedence in case of inconsistencies, which weakens the effectiveness of the decree. These inconsistencies create uncertainty and have resulted in many PPP projects being procured outside the decree. Therefore, it is critical to upgrade the decree to a law to 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.[229] The law should also assign specific responsibilities to the relevant ministries and agencies. In particular, the law should assign responsibility to the Ministry of Finance to determine whether the project generates value for money; assess, approve, and budget for any government support that is provided to the project (including tax incentives); and monitor the performance of the project to manage fiscal risks. In addition, implementing regulations should be prepared to support the implementation of the new law (e.g., regulations with respect to identifying PPP projects, managing unsolicited proposals, and monitoring PPP-related fiscal costs and risks).

Enhancing the capacity to prepare, procure, and manage PPP projects and improving interagency coordination will help maximize value for money. Given the weak performance across the lifecycle of PPP projects, it is critical to strengthen the capacities to prepare, procure, and manage PPP projects across all levels of government. Project appraisal can be improved by developing rigorous criteria, tools, and implementation guidelines to comprehensively assess economic and financial viability.[230] Capacities can be enhanced through workshops, knowledge sharing by regional peers, and access to PPP resources (e.g., online materials). 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.[231] In addition, smaller PPP coordination units should be established in ministries that are likely to be active in the implementation of PPP projects (e.g., Ministry of Public Works and Transport). This will help build PPP capacity at the sector level, as well as reduce some of the workload on the central PPP unit. Finally, it is important to improve interagency coordination, since PPPs often entail the involvement of several public institutions (e.g., line ministries, state-owned enterprises, Ministry of Planning and Investment, Ministry of Finance, Prime Minister's Office, and National Assembly). It is critical that all stakeholders follow the established PPP processes.

Establishing clear institutional structures, responsibilities, and processes for assessing, approving, and managing PPP-related fiscal costs and risks is key to improving their governance. If fiscal commitments, contingent liabilities, and foregone revenues are not carefully assessed and monitored during the lifecycle of the PPP project, they may create a significant fiscal burden. This includes financial commitments made by state-owned enterprises (e.g., take-or-pay clauses in power purchase agreements), as well as generous tax incentives (e.g., profit tax and import duty exemptions). Developing a robust framework to assess, approve, budget, manage, and monitor fiscal costs and risks can help mitigate this. In this context, it is important that a clear institutional structure is established to manage the fiscal exposure and budgetary implications of individual PPP projects. Clear reporting requirements for all relevant stakeholders also need to be in place. The Ministry of Finance (MoF) 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. To support them in this role, the MoF should establish a standardized methodology for quantifying fiscal costs and risks to guide implementing agencies in their reporting and to help the MoF in preparing its analyses.[232]

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[229] Detailed guidelines should be issued for processing unsolicited proposals, since it is critical to ensure these are economically and financially viable. Unsolicited proposals should be assessed and approved using the same framework as solicited proposals, and they should be competitively tendered.

[230] It is important to carefully assess technical and financial proposals (e.g., project costs and returns required) to ensure that the public entity is not enabling excess returns to the private sector (e.g., through an overly lengthy concession, large availability payments or tariffs, unfavorable take-or-pay clauses, or generous tax incentives). The PPP unit or implementing agency should also develop a robust monitoring framework to ensure that the private sector entity is complying with all its obligations under the PPP contract.

[231] The roles and responsibilities of the central PPP unit need to include: (i) developing a clear policy and strategy for PPPs; (ii) preparing relevant legislation and guidelines to support the preparation and implementation of PPPs; (iii) developing and socializing a pipeline of priority PPP projects; (iv) providing technical support to ministries and agencies; (v) developing standard templates (e.g. request for proposal, contract, and risk allocation templates); (vi) assessing and commenting on PPP proposals; and (vii) providing PPP capacity building through workshops and trainings.

[232] The MoF could consider using the PPP Fiscal Risk Assessment Model (PFRAM), which is an analytical tool jointly developed by the International Monetary Fund (IMF) and the World Bank to assess potential fiscal costs and risks arising from PPP projects.

Mandating transparent and competitive procurement is crucial to maximizing 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 soon will 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.

Establishing a revolving project development fund would support project preparation and structuring. Project preparation and structuring can be time consuming and expensive. It often requires the preparation of various studies (e.g., feasibility, technical design, demand, environmental, and social impact) and documentation (e.g., requests for proposal and contracts) 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 (e.g., technical, financial, legal, environmental, and social) to support key tasks. This could be supported by the establishment of a dedicated PPP project development fund. Successful PPP project development funds have been established in Indonesia and Philippines. However, it is crucial that any such fund has a clear and transparent governance and funding structure.

[232] The MoF could consider using the PPP Fiscal Risk Assessment Model (PFRAM), which is an analytical tool jointly developed by the International Monetary Fund (IMF) and the World Bank to assess potential fiscal costs and risks arising from PPP projects.

Table 5.4: List of PPP projects (1990–2022)

Year	Project	Type	Sector	Contract (years)	Gov. Support	Private (%)	Invest ($)	Award method	Main revenue	UP
1993	Tha Ngone Bridge Project	BOT	Roads	15	..	50	..	..	..	Yes
1993	Houay Ho	BOT	Electricity	30	..	80	220	CB	..	No
1996	Lao Telecom (M-Phone)	BROT	ICT	25	..	49	92	..	..	Yes
1996	Theun Hinboun	BOT	Electricity	30	..	40	665	..	..	Yes
2002	Vimpelcom Lao	M	ICT	20	..	78	9	..	..	Yes
2005	Nam Theun 2	BOT	Electricity	25	..	75	1,250	DIN	PPA	Yes
2006	Nam Ngum 2	BOT	Electricity	25	..	71	760	DIN	PA	Yes
2006	Xekaman 3	BOT	Electricity	29	..	85	310	DIN	PA	Yes
2008	Nam Ngum 5	BOO	Electricity	..	..	85	200	..	..	Yes
2008	Nam Nhone	BOT	Electricity	..	..	100	5	LS	..	Yes
2010	Hongsa Coal Plant	BOO	Electricity	25	PG	80	3,710	DN	PPA	No
2010	Nam Lik 1-2	BOT	Electricity	25	PG	92	150	DN	PA	Yes
2011	Nam Long	BOT	Electricity	..	PG	100	14	..	PPA	Yes
2011	Xekaman 1	BOT	Electricity	30	PG	70	442	DN	PPA	No
2012	Nam Tha 1	BOT	Electricity	..	PG	75	317	LS	PA	No
2012	Nam Kong 2	BOT	Electricity	..	PG	100	71	LS	PPA	No
2012	Nam Ngiep 1	BLT	Electricity	..	PG	75	982	..	PPA	No
2012	Xe Katam	BOT	Electricity	..	..	75	120	LS	PPA	No
2012	Nam Ngum 3	BLT	Electricity	27	PG	77	1,200	LS	PA	No
2012	Nam Kong 1	BLT	Electricity	..	PG	80	168	..	PPA	No
2012	Xekong 4	BOT	Electricity	..	PG	80	600	LS	PPA	No
2012	Xekong 5	BOT	Electricity	..	PG	100	..	LS	PPA	No
2012	Nam Mang 1	BOT	Electricity	..	..	100	..	LS	PA	No
2012	Nam Khan 2 and 3	BOT	Electricity	..	PG	85	430	LS	PA	No
2012	Nam Ou 1-7	BOT	Electricity	..	PG	100	2,000	LS	PPA	No
2012	Xekaman 4	BOT	Electricity	..	PG	100	..	LS	PPA	No
2014	Nam Ngiep 1	BOT	Electricity	27	PG	75	980	LS	PA	No
2014	Xe-Pian Xe-Namnoy	BOO	Electricity	..	..	93	1,046	..	User fees	No
2017	Don Sahong Hydropower	BOT	Electricity	..	..	80	500	..	..	Yes
2017	Nam Theun 1	BOT	Electricity	27	..	85	1,300	LS	PA	Yes
2017	Xe Namnoy 2 and Xe Katam 1	BOT	Electricity	..	..	100	50	LS	PA	Yes
2019	Laos–China Railway	BOT	Railways	..	..	70	5,700	DN	User fees	No
2019	Nam Che 1	n/a	Electricity	25	..	100	49	..	PA	Yes
2022	Thanaleng Dry Port	BOT	Ports	50	..	100	92	..	..	Yes

Source:World Bank (PPI Database).

Note: Build, operate, and transfer (BOT); Build, rehabilitate, operate, and transfer (BROT); Management contract (MC); Merchant (M); Build, own, and operate (BOO); Build, lease, and transfer (BLT); Not available (..); Payment guarantee (PG); Competitive bidding (CB); Direct negotiation (DN); License scheme (LS); PPA/WPA payments (PPA); Purchase agreements or transmission fees with public entity(ies) (PA); Unsolicited proposal (UP). Information may not be accurate, since it relies on publicly available information.



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