

## **Lao PDR – Systematic Country Diagnostic**

### **Synopsis**

1. **Lao PDR has made important gains in its development in recent decades.** Incomes have risen, poverty declined, access to several key public services has improved and Lao PDR met a number of its Millennium Development Goals (MDGs). With an average growth rate of 7.8 percent per annum over the last decade, it was the second fastest growing economy in the Association of Southeast Asian Nations (ASEAN) region and the 13<sup>th</sup> fastest growing economy globally. Today, Lao PDR is a lower-middle income country with a GNI per capita of US\$1,730 in 2015. However, there is growing evidence of the importance for growth to be shared more equitably and to be less vulnerable, including on environmental degradation. The 8<sup>th</sup> National Socio-Economic Development Plan (NSEDP) 2016-2020 provides an important opportunity to introduce policies that may put Lao PDR on a path that more effectively reduces poverty and promotes shared prosperity in a sustainable manner and prepares Lao PDR to graduate from Least Developed Country (LDC) status.

2. **Lao PDR's asset endowments, geography and economic and social legacies have intertwined to shape a unique development experience of strong growth, limited inclusion and considerable risks to sustainability.** This reflects: i) relative abundance of natural resources; ii) landlocked and small size but part of a rapidly growing region; and iii) institutions that have not kept pace with the changes in the economy. This reinforced the already low human development outcomes as well as the high environmental cost of economic activity and vulnerability to shocks and disasters and amplified the pattern of limited inclusion and elevated risks. More specifically:

- **Lao PDR is rich in natural resources.** Its water resources represent a hydropower potential of up to 25,000MW, but are also rich in biodiversity and provide almost half of animal protein consumption of the population. The forest cover declined to around 40 percent in 2010 (from 47 percent in 1995), but is still among the highest in the region. There is no precise estimate of the value of the minerals; however, these are likely to be substantial, including in copper, gold, potash, bauxite etc.
- **Lao PDR is the only landlocked, the smallest and the most sparsely populated country in Southeast Asia.** While the rapid growth in the region fueled the demand for Lao PDR's natural resources, the difficult geography and low levels of human and physical capital lowered the country's competitiveness outside the few resource sectors and complicated the provision of public services, especially in remote and rural areas where a large part of the 49 non-Lao ethnic groups live.
- **While embracing market economy concepts, Lao PDR's governance arrangements to support the transition have been evolving very gradually.** The arrangements provide stability but rule of law is weak, the appetite to improve the regulatory quality is subdued and the ability to control corruption is constrained.

- **Human development outcomes have been improving very slowly.** The population of 6.5 million is rapidly increasing; but only one third of the work force has secondary education while over 30 percent of 2<sup>nd</sup> graders were unable to read a single word in 2012. Malnutrition, at 44 percent in 2012, has remained persistently high while the country is also an outlier on early marriages with 35 percent of girls aged 18 married in 2012. This reduces economic potential, reinforces malnutrition and increases health risks. Indicators are persistently worse for ethnic minorities while a gender gap remains in education and health.
- **Economic growth has come with a large environmental footprint.** The rate of depletion of natural resources is more than double compared to countries at a similar level of development which may put into question the ability of resources to continue propelling growth and providing important environmental services. In addition, the country is vulnerable to natural disasters and ill-prepared to deal with climate change and the future structural transformation (urbanization, migration, pollution).

3. **This Systematic Country Diagnostic (SCD) aims to identify interventions that would deliver sustained growth and edge Lao PDR towards ending extreme poverty and sharing prosperity.** To better inform the proposed interventions, the SCD attempts to answer three important questions: What is the nature of growth? How inclusive is it? and How Sustainable it is? and what are the underlying constraints?

Table 1: The twin goals of the World Bank Group

<b>End extreme poverty ...</b>	Reduce the percentage of people living on less than \$1.9 at 2011 PPP a day.
<b>... promote shared prosperity ...</b>	Foster income growth of the bottom 40 percent of the population in every country
<b>... in a sustainable manner</b>	Resource use should not prevent future generations from achieving a level of well-being at least as great. This implies that the total capital stock per capita (the sum of natural, human and physical capital relative to the population) should not decline. In other words, natural capital may decline in value as long as one or more of the other forms of capital increase so as to keep to total value at least as great. <sup>1</sup>

### *What is the nature of growth?*

4. **Lao PDR's GDP growth has been driven by a growing use of natural resources.** The mining sector expanded strongly in the 2000s as two large copper mines started operations while the installed capacity in the power sector surged from 640MW in 2000 to around 6,000MW by 2016 as Lao PDR welcomed investors to tap into its potential to meet growing demand in the region. The two sectors accounted for one third of growth in the last decade while natural resource-based exports (power, mining, and timber) reached

<sup>1</sup> However, the substitutability of natural capital with other forms of capital is limited by the essential environmental services they provide. An obvious example would be clean air. Another example may be a level of ecologically intact forest that is essential to maintain valuable biodiversity.

US\$3.5 billion in 2014 up from US\$0.9 billion a decade ago. The growth in the power sector also supported an impressive electrification improving livelihoods and supporting businesses.

5. **Competitiveness outside of natural resources is low.** Agriculture, where two thirds of the labor force is engaged, grew at 3.7 percent on average in the past decade, just slightly faster than growth in hours worked and mainly driven by an increase in acreage rather than productivity. There are signs of greater commercialization and diversification recently; however, subsistence rice farming dominates. Manufacturing growth was stagnant for most of the last decade. A few sectors emerged recently (parts and components) which are better integrated in regional supply-chains, albeit from a low base and largely confined to the special economic zones. Non-tradables fared slightly better. Investments in the power sector boosted construction, as well as growing public investment and foreign direct investment (FDI) in real-estate adding later on. Services expanded, but remain concentrated in traditional, low value-added activities.

6. **As a result of this growth pattern, few good jobs were created.** Most of the labor force of slightly above 3 million is economically active, mostly in subsistence agriculture (62 percent) or self-employed (20 percent). With agriculture providing an “employment of last resort”, the official unemployment rate is low; but, underemployment is high. Only 400,000 non-agriculture jobs were added between 2003 and 2013. Natural resources sectors are capital-intensive and created few jobs directly, and where jobs were created, in services, they were mostly in low-value added services. Manufacturing, the main engine of transformation in other East Asia and Pacific (EAP) countries, added only 6,000 jobs between 2008 and 2013, keeping employment in the sector at around 220,000.

7. **Competitiveness challenges stem from a difficult business environment, low human capital endowments and only gradually improving infrastructure.** There are too few firms and the few which do exist struggle to grow. High informality, a burdensome business environment that is discriminately enforced, and limited competition have prevented an emergence of a vibrant private sector. The infrastructure stock is largely in line with what is expected from the level of development; though some gaps still exist and a few critical upgrades are needed. Furthermore, where jobs are available, firms complain about an inadequate workforce and few applicants. The 2014 Lao PDR Development Report found that many workers lack foundational skills such as the ability to read. This mean workers struggle even in most basic jobs and teaching them more skills is challenging.

### *How inclusive is the growth?*

8. **Between 2002/03 and 2012/13, absolute poverty, based on the national poverty line, declined from 33.5 percent of the population to 23.2 percent.** This was driven by increasing human capital, access to land and creation of off-farm jobs. The proportion of working age adults with a secondary degree increased from 26.7 percent to 35 percent facilitating the transition to higher-paying wage jobs, and also allowing the few,

more educated, farmers to be more productive. Access to agriculture land in rural areas increased by 26 percent and 400,000 non-farm jobs were created.

9. **Still, growth can be more inclusive.** Given the high GDP growth rates, the pace of poverty reduction was modest when compared to regional peers. Each percent increase in GDP per capita contributed to a 0.4 percent reduction in poverty in Lao PDR, compared to a 1.2 percent reduction in poverty in Cambodia. Furthermore, inequality widened, with the Gini coefficient increasing from 32.5 to 36.2, as the gains for the bottom 40 percent were even lower than for the rest of the population. Inequality is still in the same range as Vietnam (Gini of 35.6 in 2012) and Indonesia (37.2 in 2013) but higher than in Cambodia (28 in 2011).

10. **A big part of the population is at risk of falling into poverty due by frequent shocks and the absence of a safety net and risk mitigation measures.** Half of the poor people in 2012/13 were not poor half a decade before. Households in agriculture are twice more likely than non-farm households to fall back into poverty due to their exposure to shocks from farm produce price fluctuations, loss of land and adverse weather. In addition, with fragmented health financing programs and limited health insurance coverage, health shocks and catastrophic out-of-pocket expenditures pose a significant risk. Low financial inclusion and the absence of safety nets limit the ability of households to mitigate risks.

11. **Non-monetary dimensions of welfare which drive poverty reduction in the long term are improving, but more slowly for the vulnerable and also define gender gaps.** Malnutrition remains persistently high, mainly caused by poor dietary diversity (driven by poor nutrition habits but also low education, especially among mothers) and lack of access to improved water and sanitation. The proportion of stunted under 5 year olds declined by only 4 percentage points over a decade, from 48 percent in 2001 to 44 percent in 2012<sup>2</sup> while poverty declined by more than 11 percentage points. *Consequently, Lao PDR failed to meet the MDG goal on stunting even as it achieved the goal of halving extreme poverty.* Access to basic services is improving, but remains unequal and is often of poor quality. Half of the bottom 40 percent had no toilet in 2012/13, compared to 26 percent without a toilet among the top 60 percent. Secondary enrollment, at 54 percent, is low, but even much lower among poor households (28 percent). Transport connectivity, proximity to schools and health centers are also lower for the bottom 40 percent, while 15 percent of villages – the most remote ones – have no access to electricity. Household air pollution, from unclean cooking sources, remains a major health concern, especially among the poor. Due to a culture of early marriages, teenage pregnancies are high, which is both a cause and consequence of high school dropout rates. This also contributes to high maternal mortality, which along with low literacy among women, is a defining feature of the gender gaps in the country.

12. **Ethnic minorities have seen slower progress in poverty reduction and are lagging in most human development aspects.** About two thirds of the poor in Lao PDR are ethnic minorities, even though they constitute a third of the population in the country. Poverty rates are highest among the MonKmer (42 percent) and Hmong (40 percent) at

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<sup>2</sup> Two surveys in 2015 reported information on the nutrition status. While both sources suggest a reduction in the stunting rates (according to one of the surveys to 35 percent, direct comparison is not possible).

nearly three times the incidence of poverty among the majority Lao Tai ethnic groups (around 15 percent). The majority of working age ethnic minorities (55 percent) have incomplete primary or no formal education, limiting their ability to productively participate in the economy. Less than 20 percent of ethnic minority households have a non-farm income, compared to 54 percent for Lao Tai households. Malnutrition, teenage pregnancies and school drop outs are the highest among ethnic minorities, further dimming their prospects.

### *How sustainable is the growth?*

13. **Growing public debt, risks in the financial sector as well as low buffers may test macroeconomic stability.** Under current policies the country is likely to return to high risk of debt distress while systemic risks in the financial system are high. Macroeconomic instability can ignite inflation, lower living standards and hurt public services delivery.

14. **The rapid rate of depletion of Lao PDR's natural resources puts into question the sustainability of the development path.** The rate of natural resource depletion is faster than in lower middle income countries, in Vietnam and in Cambodia. Deforestation rates were estimated at above one percent per annum until recently. These risks are further exacerbated by the impact of climate change which is increasing the frequency and severity of natural disasters. Continued environmental degradation will hurt livelihoods and create economic costs; the poor will be most affected as they have least options to mitigate risks.

### *Towards an agenda for the twin goals*

15. **For Lao PDR, accelerating progress toward the twin goals means maintaining the current robust growth rates; while increasing inclusiveness and lowering vulnerability.** The SCD employs a framework with three main pathways towards the twin goals, each addressing weaknesses identified in the diagnostics. Sustainably and efficiently managing the country's natural resources, including collecting and managing resource rents, (Pathway 1) is critical to delivering strong growth and getting resources to build Lao PDR endowments of human and physical capital. Drawing on Lao PDR's experience in reducing poverty, Pathway 2 focuses on boosting agriculture and improving the environment for the private sector to increase farmers' incomes and create non-farm jobs while Pathway 3 emphasizes improvements in human capital required to increase the ability of people to be able to grab those opportunities. Measures to address the high vulnerability of people in Lao PDR further informs Pathway 3. Strengthening institutions and governance is a critical cross-cutting challenge that affects progress in each of the three areas above. The proposed pathways can be easily mapped to the three main outcomes of the 8<sup>th</sup> NSEDP.

Table 2: Mapping the objectives of the SCD and the 8<sup>th</sup> NSEDP

8 <sup>th</sup> NSEDP	Systematic Country Diagnostic
Priority cross-cutting output (1 of 3): Enhance effectiveness of public governance and administration	Overarching priority: Enhancing institutional quality and creating a rules-based environment
Outcome: Sustainable management of natural resources and reduced impact of natural shocks and climate change.	Pathway: Sustainable and efficient management of natural resources
Outcome: Strong economic growth and lower vulnerability	Pathway: Unlocking the potential in non-resource sectors to create opportunities
Outcome: Enhanced human development, poverty reduction and access to quality education and health services	Pathway: Building the assets of people to be able to take on these opportunities and to mitigate risks and protect gain

*Pathway 1: Sustainable and efficient management of natural resources*

16. **With its relative abundance of natural resources compared to other assets, Lao PDR’s growth prospects in the near future will be closely linked to the resource sectors.** Australia, Canada and Chile are examples of high-income countries where natural resource and resource-intensive goods still account for a high share of exports. Malaysia and Costa Rica are examples that are on the verge of becoming high-income countries. The experience of these countries, documented in a recent World Bank report on development in resource-rich countries, underscores the importance of: i) using natural resources to advance integration; ii) getting a fair share of resource rents and iii) converting these into human and physical assets to open up opportunities outside of the resource sectors. The approach argues for stronger key economic institutions early in the development process.

17. **While Lao PDR has used its resources to advance integration and support growth, current practices may have contributed to excessive resource use which may undermine future growth prospects.** A more strategic and environmentally responsible use of natural resources can ensure that the resources are used in a sustainable manner and that social and environmental impacts are mitigated. The resulting stronger selectivity of hydropower and mining investments is likely to lead to fewer investments but with higher economic and social returns and with a noticeably smaller foot print in terms of land and water use. Integrated spatial planning can address competing demand on the country’s natural resources. Such a planning process should take into account that in some cases, conservation is a more attractive option than exploitation, especially until institutions to manage natural resources and rents are strengthened. Conservation can also open economic opportunities in more environmentally friendly sectors, such as nature-based tourism and clean agriculture. With improved management and protection of natural resources, Lao PDR will be well on its way to a greener and more resilient growth path. Stricter standards and strengthened monitoring and enforcement against pollution will also be important.

18. **Few sector specific interventions need to be addressed as a priority.** Reversing the process of deforestation and forest degradation is important. This would include stronger oversight arrangements over salvage logging and implementing the ban on illegal timber trade<sup>3</sup>; combating poaching and wildlife trafficking and preventing illegal mining. In parallel, a stronger capacity to manage forests and greater central-level management of conservation and protection forests can help. An integrated approach to water management would provide a more careful hydropower project selection process and identify operating rules that avoid conflicts between facilities and across water users, including transboundary priorities. While it may reduce the pace of hydropower expansion, it will still allow for sizeable growth and will better match the growth in installed capacity with infrastructure improvements and demand. In mining, an immediate priority is to improve the management of existing concessions (resolve overlapping land allocations and effective enforcement of regulations on environmental and social impacts). Next, putting in place a sound regulatory framework, including assurance for finder's right and simplified and transparent licensing, can encourage entry of reputable and socially responsible investors.

19. **Lao PDR should also do more to share more widely the benefits from natural resources use.** The country did not always put its resources to their best possible use, favoring in some cases short-term gains over long-term development; was able to convert relatively little of the resource rents into government revenues and didn't always invest these efficiently into human and physical capital. Revenue leakage and weak public financial management prevented the sharing of benefits across all population sub-groups. Doing more in this area would be critical to the successful functioning of the remaining two pathways.

*Pathway 2: Unlocking the potential in non-resource sectors to create opportunities*

20. **Meeting the goals of ending extreme poverty and boosting shared prosperity will mean an accelerated structural transformation, including a more productive agriculture and a vibrant private sector.** Increasing productivity of agriculture is critical to increase income of farmers, create jobs in agribusiness and agro-processing, reduce stress on the environment, and enhance nutritional outcomes. This will require a shift from a focus on rice self-sufficiency to competitiveness of rice-based farming systems, but also a focus on niche products. Expanding multi-purpose irrigation, improving availability of quality seeds and fertilizers and extension services can facilitate this shift, as well as increasing educational attainment of farmers. Improved food value chains, through greater availability of information, better rural roads and transport services, promotion of contract farming and improving access to finance, can accelerate commercialization and diversification.

21. **A more productive private sector can create more and better jobs.** This will facilitate further structural transformation and help those already making the transition out of primary agriculture but trapped in low productivity, often informal activities. Investing in infrastructure (through policies that encourage competition and address

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<sup>3</sup> The most recent Prime Minister Order No.15 from May 2016 appears to be a good start and to signal greater willingness to address this issue.

barriers to the flow of goods and services, closing gaps in infrastructure, especially on upgrading corridors, constructing the transmission level connections with potential electricity markets), and making it easier to do business (increasing transparency and predictability and streamlining procedures) can improve competitiveness and allow the private sector to invest in emerging business opportunities. Geography and some of the challenges outlined in the SCD may lower the likelihood of a large scale export-led industrialization seen in other EAP countries taking place in Lao PDR. Still, tourism, electricity, agriculture and labor markets offer opportunities for greater integration even today. Over time, improved human and physical capital will increase the areas in which Lao PDR would be able to participate in regional flows.

*Pathway 3: Building the assets of people to be able to take on these opportunities and to mitigate risks and protect gains*

**22. Households exit poverty by accumulating human capital and physical assets.**

This opens up opportunities for transition into better paid jobs – be it domestically or through migration – but also improve the prospects for those that remain in agriculture. Building skills begins with ensuring good nutrition status in the early years of life during which there is a limited window to maximize on each individual’s ability to reach her full potential. This includes: reproductive, maternal and child health services; nutrition specific and nutrition-sensitive services; parenting education and safe, nurturing, stimulating home environments; and early childhood education. Furthermore, this will require increasing the quantity and quality of education people receive, as well as improved access to and quality of health services, including preventive and primary care services that cater to emerging and non-communicable diseases. Aiming for improved access to basic infrastructure services will improve opportunities. While aspiring for universal coverage with water and sanitation facilities, interventions should prioritize high-stunting low-access areas as well as developing an information system on service coverage and functionality. More investment in local roads and improved road maintenance with strengthened disaster resilience can ensure universal year-round road access. Completing electrification will require innovative and low cost options for grid extension and scaling-up off-grid electrification. Dealing with unexploded ordnances (UXOs) will increase economic opportunities and lower risks to life.

**23. Building resilience and mitigating risks will be important for ensuring the sustainability of poverty reduction going forward.** Key areas include: i) increasing resilience to disaster risks and climate change, especially in agriculture since farming households are most exposed to unpredictable weather hazards, ii) introducing elements of a basic social safety net – especially on financial protection against health shocks; and iii) deepening financial inclusion to expand available options to cope with shocks.

**24. Coordinated and targeted interventions, based on realistic projections of future demand for services will be most effective.** Importantly, addressing key human development weaknesses (such as poor child nutrition and development in early years) requires a multi-sector approach involving interventions in a number of priority areas. Furthermore, the concentration of poor outcomes within ethnic groups raises the importance of targeted approaches and extensive outreach to generate demand for services. Finally, policies and interventions should be driven by the insight that, over the



long term, migration will likely be a pathway to economic integration for a big part of the population, especially the ones in remote and rural areas where economic opportunities will continue to remain limited while the ability to deliver public services constrained.

*Overarching priority: Enhancing institutional quality and creating a rules-based environment*

25. **Strengthened institutions will be critical for realizing opportunities through each of the three pathways.** While institutions is a much-used term, the experience of developed resource-rich countries points to the most important ones. It is the institutions that: i) ensure stable public finances and dampen volatility; ii) increase accountability of service providers and iii) ensure a level-playing field and promote competition.

26. **Most immediately, stronger institutions can reduce macroeconomic fragility.** Healthier fiscal accounts, underpinned by stronger tax base and more efficient public expenditures can stabilize public debt (as percent of GDP). Strong corporate governance of Electricité du Lao (EdL) will be important for fiscal solvency; but even more for the prospects of the power sector. Dealing with weak banks, adopting international practices in banking sector supervision and ensuring effective enforcement can lower risks in the financial sector. Beyond macroeconomic stability, reforms to enhance governance and provide a level-playing field can unleash the potential of the private sector, including by delineating the state from commercial activity (regulating conflict of interest, improving public procurement), reducing state fragmentation (clarify central-local government relations, build coordinating capacity) and introducing stronger mechanisms for check and balances (stronger role of the National Assembly and inspection agencies, improving transparency and budgeting).

*Prioritized agenda*

27. **While the list of development challenges is long, the SCD aims to identify the most critical factors for achieving the twin goals.** The prioritization was largely guided by the expected impact of the identified policies over the twin goals, defined to also include sustainability. Greater weight was given to policy areas that address constraints for lagging groups (such as ethnic minorities) and address gender gaps. The SCD prioritizes actions that require immediate attention, either because they address a pressing challenge (malnutrition, teenage pregnancies and rapid depletion of natural resources) or the long period it takes to yield results calls for early intervention (skills and improved governance). The prioritization was complemented by the findings of an extensive engagement process with a range of stakeholders, including representatives of the government, the business sector, non-profit organizations and development partners.

28. **In the Lao PDR context, a focus on the impact over the twin goals meant prioritizing policy areas that increase incomes in agriculture, create and facilitate transition to good non-farm opportunities and lower risks to sustainability of growth.** Agriculture growth is pro-poor, with the sector accounting for 44 percent of the poverty reduction between 2002/03 and 2012/13. Also, with productivity levels well below regional peers and almost two thirds of the population engaged in agriculture the remaining potential is large making this a top priority. Making more strategic and environmentally responsible use of natural resources a top priority reflects the criticality of the natural resource sector to growth as well as livelihoods. Furthermore, the 44 percent of

under-five year olds that were stunted in 2012 makes improving nutrition a top priority. More and better education improves the productivity of farmers and better prepares people to make the transition towards non-farm jobs. Both have been key drivers of poverty reduction in Lao PDR making this also a top priority. Lowering risks in the fiscal and financial sectors is a high priority as these could undermine growth and lead to instability that will impact delivery of public services and affect the vulnerable the most. Improving the business environment and investing in infrastructure have high pay-offs; however, benefits will be lessened in case there is no progress on the top priorities.

Table 3: Prioritized agenda for achieving the twin goals

TOP PRIORITIES	HIGH PRIORITIES	MEDIUM PRIORITIES
Promoting strategic use of natural resources and responsible management of the environment	Putting public debt on a sustainable path and maintaining financial sector stability	Improving access to and quality of health services for a healthy labor force
Increase agricultural productivity to support incomes	Making it easier to do business and create good jobs	Putting in place a strengthened disaster risk management
Improve nutrition - “Good hygiene, good food, good care”	Investing in infrastructure for growth and inclusion	Introducing elements of a basic social protection system
Improving quality of education and keeping girls in school		Improving inclusiveness of the financial sector
<b>Enhancing governance and creating a rules-based environment</b>		