I. Introduction and Context

Country Context

Lao PDR has seen strong economic growth during the past decade, driven by the exploitation of natural resources and closer regional integration. The country is surrounded by some of the fastest growing economies in the world, and it has benefited significantly from external demand for tradables and increased foreign direct investment inflows. Real GDP grew at an average rate of 7.1 percent a year from 2001 to 2010 and is expected to increase to 7.5-8.0 percent during 2011-2015. In 2010, Lao PDR achieved a GNI per capita of US$1,010 and, as such, graduated from low income to (lower-) middle income country status. At this pace, Lao PDR is on track to achieve it's long term vision: to graduate from Least Developed Country status by 2020.

Impressive poverty reduction has also been achieved in Lao PDR over the past decade, but the country still lags behind the rest of the region in terms of achieving the Millennium Development Goals. According to national measures, poverty fell from 39.1 percent of the population in 1998 to 33.5 percent in 2003 and to 27.6 percent in 2008. Nevertheless, social indicators have not improved as expected with notably some population groups in remote areas lagging behind.

Against this background, Lao PDR GDP is going through a structural shift from agriculture to natural-resource based industry. Natural resource-based sectors have been growing very rapidly.
during the past decade, at an annual average of 20.7 percent in 2003-2010 (supported by mining and hydropower mega projects). As a result, the share of the sector to GDP almost tripled between 1998 and 2010, increasing to about 16.1 percent by 2010 from 5.9 percent in 1998. The share of non-tradables (services) to GDP grew more moderately, driven by increases in tourism and trade in recent years as well as expansion in infrastructure construction. Similarly, manufacturing (garments, wood and wood products, construction materials, light manufacturing, handicrafts, and, increasingly, food, beverages, and related processing) as a share of GDP has expanded, but at relatively slower rates.

Lao PDR continues to integrate more closely into the rapidly growing regional economy through implementation of commitments within ASEAN, the maintenance of relatively low tariffs, and through improved physical infrastructure and connectivity with neighbors. This has resulted in strong growth in cross-border flows of goods, services and investment. However, much of this has been driven by the growing external appetite for Lao PDR’s natural resources. Although the resources sector has brought significant benefits to Lao PDR’s economy in the form of higher economic growth, an increase in fiscal revenues, and infrastructure improvements, an over reliance on the sector as a primary source of economic growth poses serious risks to the sustainability of the country’s long-term development. There is a risk of increased volatility as the economy becomes more susceptible to external shocks driven by commodity price movements. In addition, the sector may not generate the kind of broad-based job and income creation needed to benefit a significant proportion of the Lao population.

Government’s broad direction of development is described in the 7th National Socio-Economic Development Plan (NSEDP), which outlines clear and specific objectives for increased international and regional integration as a means of achieving economic and social development targets. Accession to the WTO and implementation of commitments at the ASEAN level remains a high priority. A key challenge will be to follow through with fuller implementation of legal reforms enacted in recent years. This will be especially challenging in a post-WTO accession environment when reform momentum will inevitably begin to slow. Similarly, as trade and investment flows becomes increasing driven by the natural resource sectors, substantial efforts will need to be made to ensure that growth in the more labour-intensive non natural resource sectors is not stymied.

Sectoral and Institutional Context

Lao PDR has made significant reforms to the enabling environment for trade over the last five years and has deepened commitments at the regional (ASEAN) and global (World Trade Organization) level. A key priority over the next phase of the trade program will be to progressively shift from a pre to post WTO accession agenda, with an increased focus on implementation of reforms and following through of commitments at a level that directly benefits the private sector. Similarly at the ASEAN level, Lao PDR will need to deliver on its commitments in areas such as tariff liberalization and the construction of a national single window.

Even under fairly modest projections, Lao trade performance is likely to become increasingly skewed towards natural resource (hydropower and minerals) exports in the years ahead. While this presents tremendous opportunities, it also presents real risks to the economy in terms of lack of export diversification. Recent analytical work describes how lack of diversification can restrict economic growth through the early onset of diminishing marginal returns to a more limited range of export products, and through increased risk of terms-of-trade shocks. Cross-country research on the “natural resources curse”, actually finds that the core driver of the curse is not the presence of
natural resources per se, but the degree of export concentration. Similarly and with the right incentive structures for the private sector, diversified trade has the potential to act as the linking mechanism between GDP growth and income growth (and hence poverty reduction) in the Lao PDR.

There is growing evidence that export competitiveness in the non natural resource sectors is being eroded even before Lao PDR has begun to integrate into regional value chains in a significant way. Lao export flows in non-natural resource based sectors tend to be short-lived and rarely in sub-sectors offering scope for significant value addition. Similarly, exporting firms demonstrate substantially lower productivity compared to firms serving the domestic market. A not insignificant share of non-natural resource based exports are dependent on trade preferences associated with Lao PDR’s least developed country status. There are also increasing signs that the kip is overvalued. High logistics and trade facilitation costs, due in part to a landlocked supply chain, also tax competitiveness. While gains have been made in the efficiency of operations along Lao PDR’s key trade corridors, costs remain stubbornly high with imbalanced trade and a very high frequency of container empty running.

Accession to the WTO is a core policy objective and has acted as a driver of reform of the trade-related legislative framework. Lao PDR is now close to WTO accession and, among other areas, principles of national treatment have been introduced into Lao law and border clearance procedures simplified progressively. Efforts are being made to introduce automated information systems for customs clearance, along with more modern risk management techniques at the border to reduce clearance times and improve the efficiency of revenue collection. However, non-customs agencies have lagged behind and the costs of a landlocked supply chain taxes competitiveness. Encouraging steps have been taken to improve inter-agency border coordination through the establishment of a National Trade Facilitation Secretariat in 2010, and the approval by Cabinet of a National Trade Facilitation Strategy and Action Plan in 2011. Efforts are being made to publish information on trade-related processes and procedures as a part of related efforts to harmonize and simplify redundant border requirements. However, while much of the higher level legal framework now meets WTO norms in terms of transparency and non-discrimination, lower level technical implementation lags behind resulting in less-than-anticipated actual benefits to the private sector.

With an objective of graduating from least developed country status by 2020, Lao PDR will also need to focus increasingly on developing skills, and facilitating growth in productivity, value addition and the discovery of new tradable sectors of comparative advantage. Key bottlenecks remain in the trade enabling environment, not least with regard to the limited extent to which laws and regulations are implemented, the high costs associated with a poorly functioning and landlocked supply chain, an underdeveloped environment for trade in services, and the weak capacity of government to manage a modern, rules-based framework for trade facilitation.

As a Least Developed Country, Lao PDR has been an active participant in the global "Integrated Framework" process to support the effective participation of LDCs into the multilateral trading system. Priorities in this area have been articulated in the 2006 Diagnostic Trade Integration Study (DTIS), and in the 2012 DTIS Update. The country has a strong aid-for-trade system with a experienced and high capacity IF National Implementation Unit, part of the Ministry of Industry and Commerce's Planning and Cooperation Department. Development of the small and medium sized enterprise sector is a key priority for the government in the 7th NSEDP and the importance of...
reducing red-tape and regulatory impediments to business has been recognized as a key “breakthrough” area in the government's reform agenda. The 2006 DTIS led to the establishment of the NIU and subsequent formation of a Multi Donor Trust Fund - the First Trade Development Facility - with resources committed by Australia, the European Union and Germany, and administered by the World Bank with the objective of supporting the implementation of priorities outlined in the DTIS Action Matrix.

Relationship to CAS
The proposed operation forms a core part of the World Bank Group's new 2011-15 Country Partnership Strategy for Lao PDR, which in turn is closely aligned with the Seventh National Socio Economic Development Plan. The Second Trade Development Facility, will form a major part of efforts to achieve CPS Strategic Objective 1: "Improving Competitiveness and Connectivity", and in particular CPS Outcome 1.1: "Strengthening Government capacity to support growth diversification and competitiveness". Under the 7th NSEDP, the Government plans to have the non-resource sector contribute more than half of Lao PDR’s real GDP growth in the near term and 75 percent of GDP in the medium-term. To achieve these results, policies in Lao PDR will need to focus on creating a positive enabling environment that supports the development of the non-resource sectors.

The Second Trade Development Facility Project will build upon the results achieved under the First Trade Development Facility and forms part of an ambitious and integrated country trade program supported by the World Bank in partnership with Australia/AusAID, the European Union and Germany/GIZ. TDF-1 focused on trade facilitation reforms for non-customs agencies, successfully laying the foundations for a Lao National Single Window; core support to WTO accession negotiations, including technical capacity development for negotiations, legal reform with a priority on sanitary and phytosanitary measures, and accession impact evaluation; as well broader support to trade related research, and sector investments in competitive sectors.

The proposed operation is informed primarily by Government's 2012 DTIS Update, as well as by related analytical work undertaken by the World Bank and development partners, including the 2010 Lao Development Report (Country Economic Memorandum), the 2011 Lao Investment Climate Assessment and a series of trade-related analytical products prepared under the Trade Development Facility MDTF (Diversification/Product Space paper, Gender and Trade work program, Export Survival Study, ATIGA Tariff Reform Impact Study, Agribusiness work program, and the Trade and Transport Facilitation Assessment).

The Lao trade sector is increasingly seen, both within Lao PDR and internationally, as a good practice example of development partner coordination around a Government-led country reform program. TDF-2 will lay at the heart of a second phase Lao trade program, which also includes a complementary IDA Customs and Trade Facilitation Project, grants from the Japan Social Development Fund, Trade Facilitation Facility, Gender Action Plan and a large trade-related analytical program.

II. Proposed Development Objective(s)

Proposed Development Objective(s) (From PCN)
The proposed project development objective is to support the implementation of Government's trade and integration priorities outlined in the 2012 DTIS Action Matrix/Roadmap, and in particular to
contribute to improved export competitiveness and diversification of exports, focusing outside the natural resource sectors.

Key Results (From PCN)
The proposed project will contribute to the achievement of specific outcome level change indicators, across the three core pillars in the 2012 DTIS Action Matrix/Roadmap. Results are taken directly from the Government’s 2012 DTIS Update. Results monitoring will take place as part of a program based approach led by the MoIC during implementation of the 2012 DTIS.

(i) Conducive trade and investment environment established:
- Trade policy: legal and other commitments to international agreements, such as WTO and ASEAN implemented, with enhanced support systems in place including monitoring, communications and capacity building;
- Business environment: enhanced business environment with improved equality of opportunities for all businesses;
- Trade facilitation: system of more simple, transparent and cheaper import, export and transit procedures and processes development and implemented with involvement of the private sector;

(ii) Improved competitiveness, quality and value of agricultural manufacturing and service sectors:
- Firm level competitiveness: firm level quality and productivity support measures leading to enhanced competitiveness of the business sector, in particular SMEs;
- Sector level competitiveness: enhanced sector support and public private dialogue leading to increased employment and incomes for the poor in key agricultural, manufacturing and service sectors;

(iii) Improved aid for trade governance framework for mainstreaming trade and private sector development:
- Sustainable trade: measures to increase the extent to which trade growth benefits the poor through better integration into production processes with gender, poverty and environmental considerations systematically included and addressed in sector policy;
- Capacity development: sufficient institutional and management capacity built to formulate and implement trade related strategies and implementation plans;
- Trade mainstreaming: mainstreamed trade through improved national trade related planning and coordination consultation and implementation structures;
- Aid-for-trade governance framework: functioning governance framework for trade development, that is well resourced and makes use of a programmatic approach based on the principles of the Vientiane Declaration and a shared vision across public and private sector stakeholders;
- Monitoring and evaluation: a functioning monitoring and evaluation system that serves the needs for information on project and program levels and enhances results based management.

III. Preliminary Description

Concept Description
The proposed operation is a follow-on to the First Trade Development Facility, with a deepened focus on addressing the binding constraints to increased Lao integration into the regional and multilateral trading system. A highly selective approach has been taken with the identification of activities to be financed under the project, with a reduced scope allowing for a fuller engagement in selected areas. A number of feasible activities have been excluded from the project to ensure a focused operation with transactions costs minimized to the extent possible.
The project includes three main technical components, described below. The Trade Facilitation and the Trade Policy and Regulations components provide for follow-through implementation in existing areas under TDF-1 where existing implementation teams are moving to a second generation set of reforms. In contrast, the Diversification and Competitiveness component provides for a new engagement reflecting the increasing challenges that Lao PDR is facing in this area. Activity design is closely informed by the large amount of country trade-related analytical work that has been undertaken by the Bank and other donors.

(A) TRADE FACILITATION, TRADE POLICY AND REGULATIONS (Estimated cost: US$ 4.5-6.5 million)
This component, which builds on the success of trade facilitation and trade policy activities under TDF-1, will consist of a number of inter-related activities aiming to improve transparency, predictability and lower compliance costs associated with border agencies. Trade facilitation activities will focus primarily on inter-agency coordination and supporting the trade facilitation agenda of non-customs agencies. Investments financed under this component will be closely linked to and complement customs reform and modernization efforts including the ongoing Customs and Trade Facilitation Project, and the proposed Lao National Single Window Support Program financed by the World Bank. The trade policy aspect of the project will focus on the provision of essential and continued technical assistance in support of WTO accession related efforts, but increasingly shifting to a “beyond WTO” focus on implementation and follow-through of commitments at both the WTO and ASEAN level, including a strong emphasis on private sector engagement.

(i) Trade Facilitation Strategy/Action Plan implementation and national single window integration
Capacity building of the National Trade Facilitation Secretariat (reaching across multiple border agencies), and support to effective secretariat services and private sector participation in the trade facilitation agenda. To include continued support to the operations of the Lao Trade Portal/National Trade Repository (to ensure compliance with both GATT Article X and ATIGA Article XIII), but focusing on the next phase of integration of the Portal into a Lao National Single Window. To also include specific risk based approaches and support to border agencies as part of movement towards a Lao National Single Window (consistent with the ASEAN Single Window).

(ii) Non tariff measures review and rationalization
Activities to support efforts on simplification and harmonization of non tariff measures, including reviews of NTM regulatory objectives, consideration of alternative means of achieving NTM policy goals, compliance with international norms and support to business process re-engineering and re-structuring.

(iii) Trade in goods
Beyond WTO implementation of commitments as well as scaled up work on regional integration within ASEAN (ATIGA), including regulatory reform, technical capacity for negotiations, inter-agency coordination, impact analyses, implementation and dissemination of commitments. Activities to also improve understanding of preference utilization, negotiating capacity and private sector compliance with Rules of Origin.

(iv) Trade in services
An expanded program of work in services trade, similarly focusing on implementation of commitments beyond WTO, with ASEAN members (AFAS), including technical capacity, coordination, impact analyses and dissemination. A key focus will be on the movement of labor/natural persons, including linkages to the proposed skills and productivity activities under the Diversification and Competitiveness component.

(B) DIVERSIFICATION AND COMPETITIVENESS (Estimated cost: US$ 3.0-4.5 million)
This component will include a new set of activities aiming to support improved private sector capacity to compete in international markets, focusing on the non natural resources sector. Activities will adopt a “making markets work better for the poor” approach, aiming to facilitate more effective participation of small and medium sized enterprises in the international economy, and in particular support to women’s economic empowerment.

(i) Challenge facility / private sector matching grants fund
An enterprise/export competitiveness challenge fund to facilitate increased export discovery and survival in the private sector through direct 50:50 matching grants at the enterprise level. Grants will be open access and provided to finance business development activities that support increased current or future diversification and competitiveness. Complementary business development support will be provided to small and medium sized enterprises. Building off the marketplace model piloted by the Adolescent Girls Initiative/STEPS program, a gender window will also be included to facilitate increased participation by young entrepreneurs, in particular women.

(ii) Business membership organizations and public-private dialogue
A technical assistance facility to support capacity development and service upgrading among sectoral business membership organizations, as well as efforts to build capacity in public private dialogue and advocacy.

(iii) Skills and productivity / better factories
Building on the success of the Garments Skills Development Centre established under TDF-1, resources will be provided to further develop skills and productivity improvement activities in export manufacturing including a factory improvement initiative in line with “better factories” approaches focusing on improved working conditions and premium market access in the manufacturing sector.

(iv) Investment facilitation
Pilot activities to support the implementation of the new unified Investment Law, focusing on business process reform and restructuring of the enterprise registration process for general (non-concessional) investments. To include the establishment of an Investment Portal (using a similar approach to the successful Trade Portal) as part of efforts to improve transparency and predictability around investment/enterprise establishment procedures.

(C) MAINSTREAMING AID FOR TRADE (Estimated cost: US$ 2.5-3.5 million)
This component will provide for support to the next generation of work to further develop Lao PDR’s “aid for trade” governance framework as part of efforts to move to a full program based approach.

(i) Program based approach
Development of the Lao aid for trade governance framework, through investment in the IF National
Implementation Unit, support for trade-related inter-agency coordination, communications and secretariat services to the Trade and Private Sector Development Working Group. To also include the operation of a program-based results monitoring framework to manage the implementation of the 2012 DTIS Action Matrix/Roadmap.

(ii)  Research and policy analysis, coordination and network infrastructure
A scaled up trade-related research and policy program to further develop institutional capacity on trade related research and analysis, and to inform activities across the 2012 DTIS Action Matrix/Roadmap. To also include support to network and communications infrastructure across trade-related agencies. Links will be established with broader efforts to build statistical capacity in government, including via the proposed Statistics for Results Program.

IV. Safeguard Policies that might apply

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V. Tentative financing

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