

Lao PDR Economic Monitor

Maintaining Economic Stability

Thematic section:

Constraints to Doing Business for SMEs

August 2019

Macroeconomics, Trade and Investment
East Asia and Pacific Region



WORLD BANK GROUP



ACRONYMS AND ABBREVIATIONS

ASEAN	Association of Southeast Asian Nations
BOL	Bank of Lao PDR
CB	Commercial Banks
CPI	Consumer Price Index
DB	Doing Business
EAP	East Asia and Pacific Region
EMDEs	Emerging Markets and Developing Economies
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
ICT	Information and Communications Technology
IMF	International Monetary Fund
LAK	Lao kip
LNCCI	Lao National Chamber of Commerce and Industry
MOF	Ministry of Finance
MW	Megawatt
NA	National Assembly
NPL	Non-Performing Loan
PPG	Public and Public Guaranteed Debt
SME	Small and medium-sized enterprises
VAT	Value Added Tax
WBG	World Bank Group
WEO	World Economic Outlook
y/y	Year on year

Regional Vice President:	Victoria Kwakwa
Acting Country Director:	Gevorg Sargsyan
Regional Director:	Hassan Zaman
Country Manager:	Nicola Pontara
Practice Manager:	Deepak Mishra

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The Lao PDR Economic Monitor August 2019 was prepared by a team comprising Keomanivone Phimmahasay (co-TTL, Economist), Somneuk Davading (co-TTL, Senior Economist), Chandana Kularatne (Senior Country Economist), Anthony Obeyesekere (Consultant), Jiamin Lim (Consultant), Mohammad Amin (Senior Economist) with inputs from Mombert Hoppe (Senior Trade Specialist), Konesawang Nghardsaysone (Trade Economist), Vidaovanh Phounvixay (Financial Sector Analyst) and Michael Corlett (Senior Financial Sector Specialist).

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The findings and interpretations expressed here are those of the authors and do not necessarily reflect the views of the World Bank Group, its Executive Directors, or the countries they represent.

The Lao PDR Economic Monitor provides updates on macroeconomic developments and sectoral issues in the country. It is produced biannually and distributed widely to government agencies, development partners, the private sector, think tanks, civil society organizations, and academia.

To be included in the email distribution list, please contact Souksavanh Sombounkhanh (ssombounkhanh@worldbank.org).

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Economic growth in Lao PDR is projected to rebound to 6.5 percent in 2019, up from 6.3 percent in 2018. This pick up is expected to be driven by growth of the construction sector supported by investments in large infrastructure projects, and a resilient services sector, led by wholesale and retail trade growth. The Government has remained committed to fiscal consolidation to contain public debt in the medium term by tightening public expenditure and improving revenue administration. The medium-term outlook remains broadly favorable, but subject to downside risks from heightened uncertainty in the global and domestic environments. Prolonged trade tensions among major economies could dampen growth prospects in Lao PDR's major trading partners, and spillover to the domestic economy through lower trade and investment, and reduced prices for key export commodities. The authorities may face difficulty in responding to such economic shocks given the low level of foreign currency reserves and significant external public debt. A priority is therefore to create fiscal space through improving tax policy and administration as well as build up reserve buffers to respond to shocks. Additionally, improving the business environment and reversing the decline in the global ranking of the ease of doing business, particularly for small and medium-sized enterprises, could also contribute to greater macroeconomic stability, job creation and poverty reduction.

Part I: Recent Economic Developments and Outlook

1. Economic growth in Lao PDR is expected to recover to 6.5 percent in 2019, from 6.3 percent in 2018. Despite continued fiscal tightening, the rebound in growth in 2019 is projected to be mainly driven by: (i) robust growth in the construction sector, driven by strong investment inflows to large infrastructure projects, including the Lao-China railway, of which civil work is reported to be around 70 percent completed by mid-2019; and (ii) a resilient services sector led by wholesale and retail trade growth associated with robust construction.

2. Continued fiscal consolidation contributed to a slowdown in the accumulation of public debt in 2019. Preliminary Q1-2019 estimates indicate the continued containment of investment spending. At the same time, improved revenue administration and modernization contributed to better performance in excise, profit, value-added taxes and non-tax revenues. This is expected to reduce the budget deficit to 4.3 percent of GDP in 2019 from 4.4 percent in 2018. As a result, the public debt to GDP ratio is an estimated 58 percent of GDP in 2019, slightly up from 57.2 percent in GDP in 2018. However, the public debt ratio to GDP is expected to decline to below 56 percent by 2021 and the risk of debt distress remains high. In this context, the Government of the Lao PDR (GoL) intends to borrow only on concessional terms for projects with high economic and social returns. The GoL also suspended public projects with low economic returns that have not yet started to disburse. Additionally, to further lower the need for external borrowing and strengthen supervision on dam safety, the GoL has instituted a moratorium on all new hydropower projects.

3. The current account deficit is expected to widen slightly to 12 percent in 2019 reflecting strong demand for imports related to investments in large infrastructure projects. During January-May 2019, exports earnings remained relatively stable as strong exports of crops and semi-processed products offset a decline in mining exports that were principally affected by lower metal prices. In contrast, imports grew slightly and the increase in demand for machinery and equipment more than offset the fall in the fuel imports. The current account deficit is mainly financed by foreign direct investment (FDI) associated with large infrastructure projects. Foreign currency reserves marginally picked up to US\$885 million in March 2019 from US\$873 million at end 2018. Nevertheless, foreign reserves buffers remain low at 1.2 months of total imports (or 2.4 months of non-FDI-related imports) in 2019. Therefore, building foreign currency reserves is a priority to provide a cushion against economic shocks.

4. External and domestic factors contributed to the depreciation of the Lao kip in the first half of 2019. The average kip exchange rate in the first half of 2019 weakened by 3.8 percent against the U.S. dollar and 4.7 percent against Thai baht compared to the average in the first half of 2018. Domestic factors include: (i) continued robust demand for foreign currency for imports and external debt repayments; and (ii) rising demand for foreign currency as a hedge against exchange rate depreciation. External factors include a strong U.S. dollar and Thai baht against regional currencies. More flexibility of the exchange rate within the band contributed to the narrowing of the premium between the official and parallel exchange rates to below 3 percent (on average) during January-June 2019.

5. Price pressure started to mount in the first half of 2019 while credit growth also slightly picked up. The average inflation rate in the first half of 2019 increased to 2 percent from 1.7 percent over the same period in 2018. This was driven by: (i) higher food prices, particularly rice prices, which increased by almost 13 percent due to the disruption in rice production after the 2018 floods; (ii) some increase in fuel prices; and (iii) the depreciation of the kip against the Thai baht and the U.S. dollar, which increased the price of imported goods. Core inflation remained around 2 percent driven by higher prices in housing and hospitality sectors. Fiscal tightening and still-moderate credit growth, despite a recent modest pickup early this year, also contributed to low pressure on inflation.

6. The short-to-medium-term growth outlook of the Lao economy is expected to remain broadly favorable supported by construction of large infrastructure projects and operation of power projects. Growth in the construction and service sectors is expected to remain robust in the short to medium term due to continued infrastructure investment. Overall investment will be supported by the ongoing construction of the Lao-China railway, the Vientiane-Vangvieng highway, and reconstruction and repair of infrastructure damaged by the 2018 floods. In addition, the upcoming completion of several large power projects, including the Sayaboury Hydropower Project, is expected to add an extra 2,200 MW of capacity. This is projected to boost generation capacity to almost 10,000 Megawatts by 2020, of which the majority is exported. In contrast, the contribution of the mining sector is expected to gradually decline as current investment matures without any new investment while the moratorium remains effective.

7. The medium-term fiscal framework is consistent with the path of fiscal consolidation set out by the GoL. The fiscal deficit is expected to decline to below 4 percent in 2021 from 4.4 percent of GDP in 2018. To achieve this deficit target, the GoL will focus on improving revenue mobilization and rationalize public expenditure. This fiscal consolidation, coupled with the recently approved public debt management law and upcoming debt management strategy, is expected to reduce public debt levels to below 56 percent of GDP in 2021 from an estimated 57.2 percent of GDP in 2018, reducing the debt repayment burden over this period.

8. The medium-term outlook is subject to increasing external and domestic risks. Heightened external risks include intensified and prolonged trade wars, heightened geopolitical uncertainty, and continued tightening of global financing conditions that could lead to disorderly financial market movements. The escalating trade conflict between China and the United States, with its adverse impact on regional growth, could in turn dampen trade and investment flows from key economic partners and lower economic growth in Lao PDR. Such disruptions could also adversely impact the price of key export commodities. A worsening trade balance would place downward pressure on the value of the kip and increase the cost of servicing debt. In addition, the high level of external debt against low foreign reserves buffers limits the GoL's ability to respond to economic shocks. Domestic risks include: (i) natural disasters that can adversely affect economic activities and create fiscal pressure; (ii) slower progress in implementing planned measures on the revenue and expenditure fronts, including slower progress on public financial management reforms, which could jeopardize the containment of the fiscal deficit and public debt; and (iii) a slowdown in momentum with respect to doing business reforms and economic diversification.

9. To mitigate these risks, the key priorities include fiscal consolidation and the improving the business environment to promote sustainable growth in the long-run. The GoL has undertaken important revenue and expenditure measures to support fiscal consolidation. However, revenue collection needs to be strengthened to ensure that necessary spending can be carried out while keeping the deficit under control. The approved public debt management law, which seeks to strengthen public debt management and the GoL's commitment to limit new borrowing, can help better manage risks associated with public debt accumulation. Speeding up the formulation of a public debt management strategy is a priority. Additionally, improving the business environment and reversing the decline in the global ranking in terms of ease of doing business, particularly for small and medium-sized enterprises, would also contribute to greater macroeconomic stability, job creation and poverty reduction.

Part II: Constraints to Doing Business for SMEs

1. Small and medium-sized enterprises (SMEs) constitute an important segment of the private sector in Lao PDR. SMEs in Lao PDR account for about 99 percent of all registered firms in the country and about 82 percent of employment. Therefore, they are critically important for the livelihoods of the Lao people. However, highlighting their as-yet-unrealized potential in Lao PDR, these firms are estimated to account for under 20 percent of GDP as compared with about 40 percent in Thailand, and 32 percent in Malaysia and the Philippines¹. Improving the performance and prospects of SMEs is one important way to raise incomes and the quality of jobs, while helping the GoL to move closer to its goal of graduating Lao PDR from Least Developed Country status.

2. Enterprise survey data suggest that formal SMEs are facing constraints in a range of areas – most notably access to finance, practices of informal competitors, and electricity. First, access to finance has become a more acute constraint over the past two years. This phenomenon could be a combination of persistent factors such as the more caution on risky lending by the banking sector, a lack of SMEs proper business and financial planning and management, low financial literacy, lack of variety of financial services offered to SMEs, especially in rural areas, and high interest rates. Second, practices of competitors in the informal sector – such as poor compliance with regulations combined with inconsistent enforcement by the authorities – result in an unfair disadvantage for formal firms.² Additionally, despite steady progress in the coverage of electricity in recent decades, the access and availability of power remains an issue that affects the operations of SMEs. Firms report facing issues such as substantial delays in setting up a connection and inconsistent electricity supply, with these challenges being most prevalent for small firms and firms in rural areas.

3. Addressing the aforementioned top constraints faced by SMEs is essential to unlock their potential. Importantly, improving access to finance for SMEs, a key constraint, could be improved by: (i) improving the capacity of SMEs in business planning, financial management and adoption of proper accounting practices; (ii) diversifying financial products and services offered by banks and non-bank financial institutions; and (iii) improving credit information coverage for financial institutions and supervision authorities to help better assess risks and promote access to finance. In addition, improving efficiency and reducing the costs of formal bureaucratic processes could be an incentive for formalization of informal firms. In effect, creating a level playing field for SMEs through the consistent enforcement of rules and regulations could reduce the challenges associated with informal competitors. Finally, investing in improving the efficiency of the energy distribution network and electricity connections can markedly reduce the impacts on the business operation for SMEs.

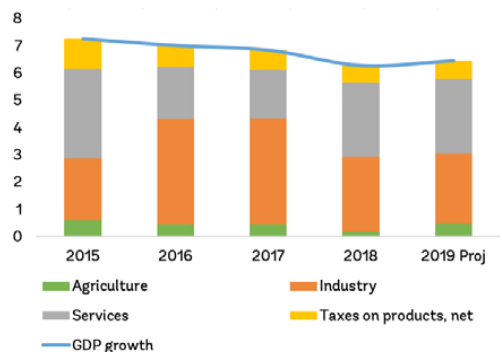
¹ World Bank Group (2017). “Systematic Country Diagnostic for Lao PDR”.

² Practices of competitors in the informal sector’ is one of 15 categories of business obstacles that firms can identify in the enterprise survey. This could refer to practices such as inadequate registration and “flying under the radar”; tax evasion; irregular adherence of complex regulations; and non-compliance with basic rules and standards.

The August 2019 Lao PDR Economic Monitor in Figures

Growth moderated to 6.3 percent in 2018, affected by the floods, but is still driven by the services and industry sectors

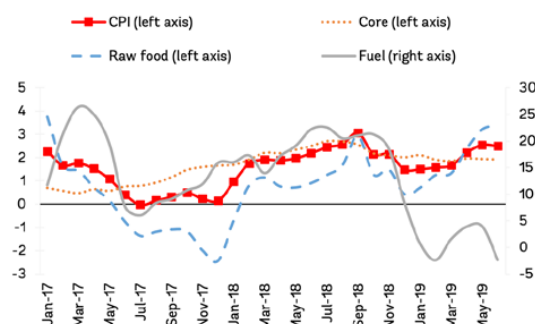
(Percent change)



Source: Lao Statistics Bureau

Headline inflation picked up in early 2019 due to an increase in food prices

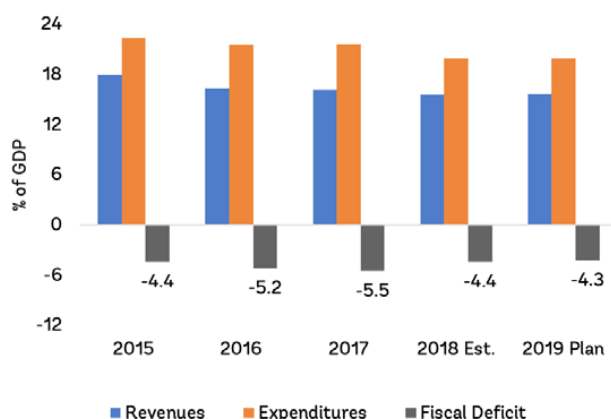
(Percent change)



Source: Lao Statistics Bureau

Expenditure controls have contributed to a lower fiscal deficit...

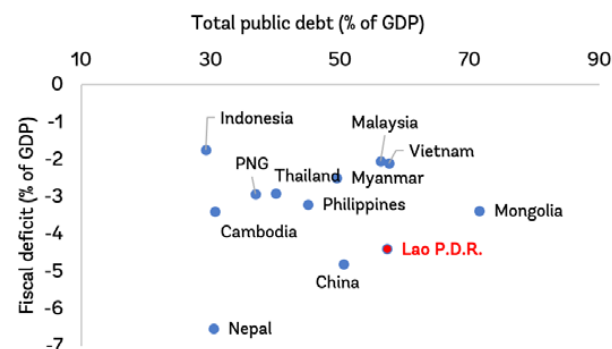
(Percent of GDP)



Source: MOF and World Bank staff estimates

...but public debt has remained relatively high compared to regional peers in 2018

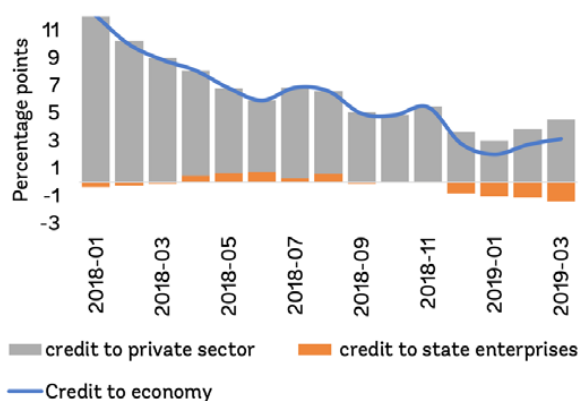
(Percent of GDP)



Source: MOF and World Bank staff estimates

Fiscal consolidation has also been linked to a slowdown in credit growth

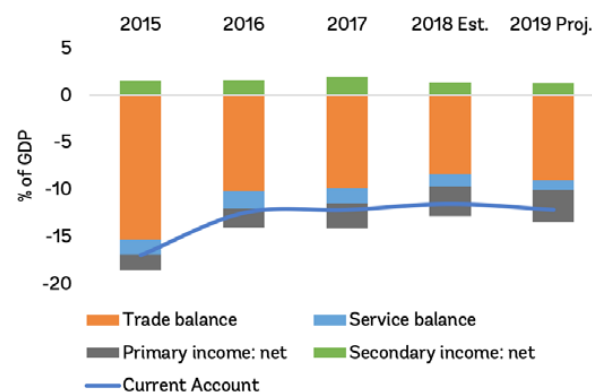
(Percentage points)



Source: BOL

The current account deficit remains high, but mostly financed by FDI

(Percent of GDP)

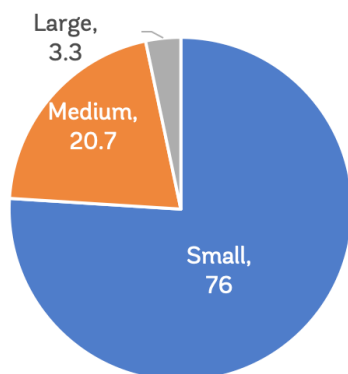


Source: BOL, trade partners' data and WB staff estimates

The August 2019 Lao PDR Economic Monitor in Figures

SMEs represent the majority of firms in the Enterprise Survey

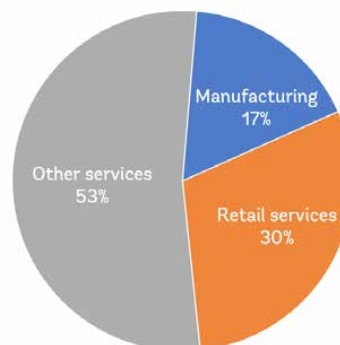
(Percentage share)



Source: WB Enterprise Surveys.

The majority of SMEs are in the services sectors

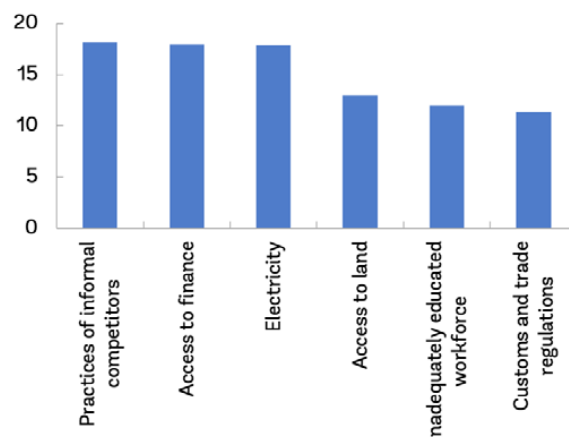
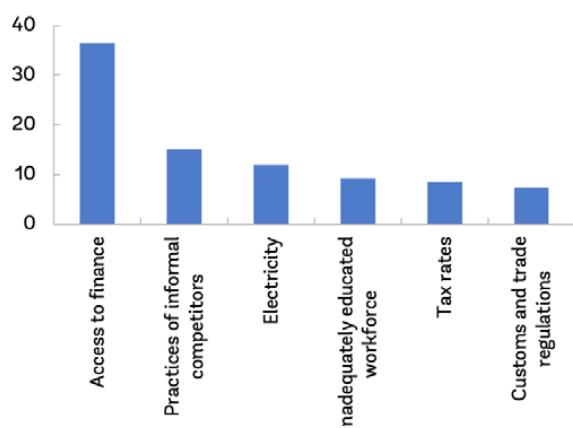
(Percentage share)



Source: WB Enterprise Surveys.

Main obstacles to the operations and growth of registered SMEs in Lao PDR include: (i) access to finance; (ii) practices of competitors in the informal sector; and (iii) electricity outages

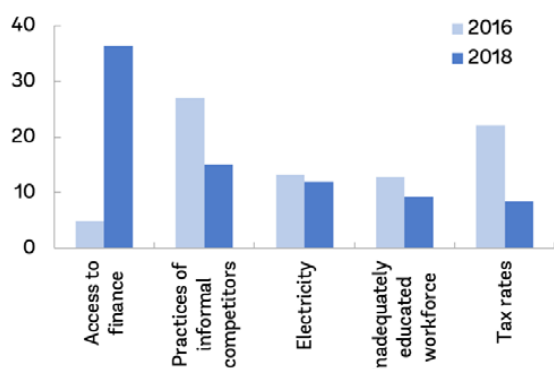
(Percent of firms)



Source: WB Enterprise Surveys.

Access to finance has recently become a more prominent obstacle

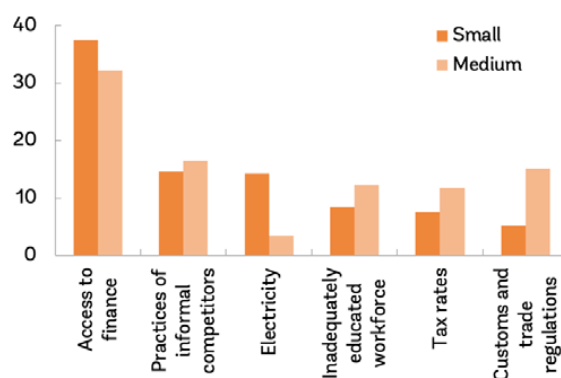
(Percent of firms reporting issue as biggest obstacle, 2016 and 2018)



Source: WB Enterprise Surveys

The constraints faced by small and medium sized firms are not always the same

(Percent of firms reporting issue as biggest obstacle, small- versus medium-sized firms, 2018)





Part I

Recent Economic Update



1.1. Recent Economic Developments

1. Economic growth

Economic growth is projected to rebound in 2019

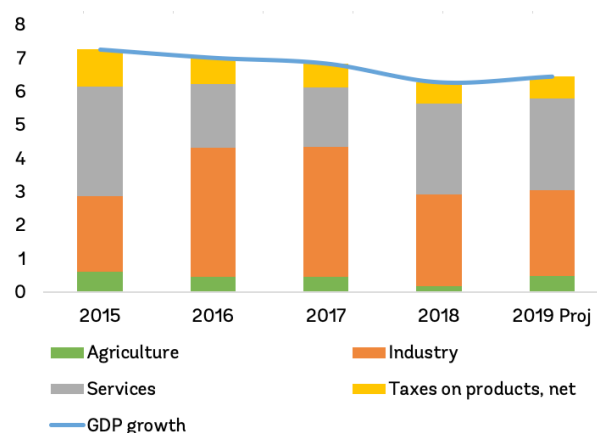
1. Economic growth is expected to recover to 6.5 percent in 2019 from 6.3 percent in 2018 (Figure 1). Despite continued fiscal tightening, the pickup this year is projected to be mainly driven by: (i) robust growth in the construction sector driven by ongoing robust investment inflows related to large infrastructure projects. These include the Lao-China railway³ (of which civil work was reported to be around 70 percent completed by mid-2019), and the Vientiane-Vangvieng highway⁴; and (ii) a resilient services sector led by wholesale and retail trade growth associated with robust growth in the construction which is partly supporting domestic consumption. The latter is also reflected in robust energy consumption in Q1-2019, which grew by 13 percent year-on-year, compared to only 7 percent y/y in Q1-2018. This was driven by the consumption in the commerce sector (24 percent y/y), household (14 percent y/y) and industry sectors (8 percent y/y). A rebound in agriculture post-2018 floods depends on the weather conditions and the control on pests and disease on livestock in the second half of 2019.

2. The industry sector, which accounts for 32 percent of GDP, is expected to remain resilient, despite some moderation. Similar

to 2018, the construction sector continues to expand supported by the ongoing construction of the Lao-China railway, the Vientiane-Vangvieng highway, and commercial and residential buildings, together with repair and reconstruction of infrastructure affected by floods in 2018. This is also reflected in an increase in machinery and equipment imports, especially from China, which grew by 26 percent y/y during January-May 2019. The growth in construction sector partly offset the impact of fiscal tightening and a slowdown in credit growth. In addition, several

completed power projects with total capacity of about 2000 MW are expected to start testing and partial operation in 2019 and to be fully operational in 2020.⁵ The manufacturing sector shows a mixed picture as electronic parts and components export growth declined in Q1-2019 affected by lower external demand from Thailand, but food and beverage processing and construction materials remain buoyant.

Figure 1: The services and industry sectors remain the main drivers



Sources: Lao Statistics Bureau and World Bank staff estimate

³ Construction started in 2017 and is expected to be completed by end-2021. As of July 2019, more than 70 percent of the civil work had been completed.

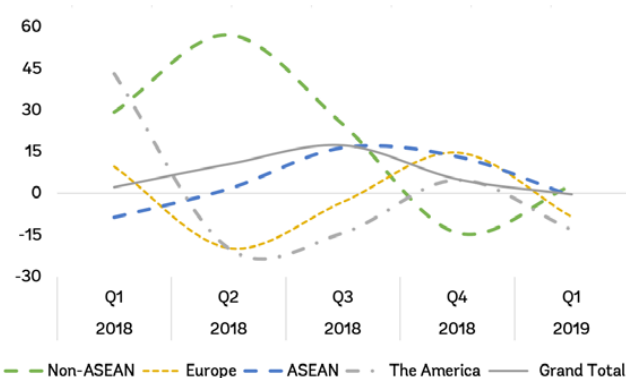
⁴ Construction of the Vientiane-Vangvieng highway, a build-operate-transfer project by Chinese investors, progressed, with more than 30 percent of civil work completed.

⁵ These include the Sayaboury Hydropower Project (1,285 MW), Nam Ngiep 1 (290 MW), Xe-Pian Xe-Namnoy (410 MW).

3. The growth in the service sector, which accounts for 42 percent of GDP, remains robust.

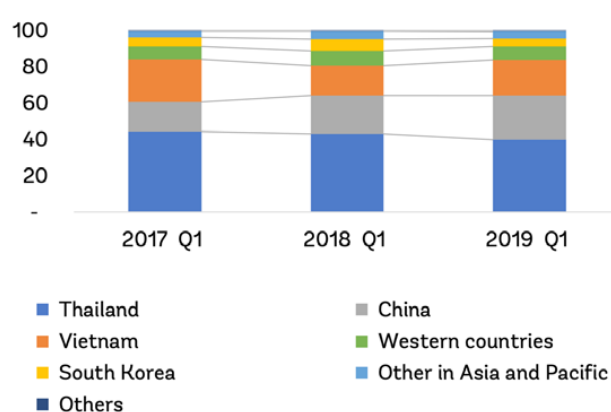
Similar to last year, wholesale and retail trade continues to benefit from robust construction and domestic trade flows, which rose by 13 percent y/y in the first four months of 2019. This is also reflected in the robust energy consumption in the commerce sector of 24 percent y/y in Q1-2019. Tourism appeared stable in early 2019. The total number of arrivals remained relatively stable in Q1-2019 compared to the same period last year (Figure 2, 3). Visitors from China increased notably (partly supported by the GoL's promotion of the Visit Laos-China Tourism Year in 2019), while visitors from Europe and North America declined in Q1-2019.⁶ To increase the competitiveness of the green tourism industry in Lao PDR, it is critical to invest in human capital in tourism management and hospitality and in tourism-related infrastructure in order to improve access to and the quality of tourism services.

Figure 2: Tourists arrival began to rebound in 2018 driven by non-ASEAN EAP visitors
(Percent y/y)



Source: Ministry of Information, Culture and Tourism.

Figure 3: Despite the recent slowdown, tourists from ASEAN still comprised the largest share in 2018
(Percent y/y)



Source: Ministry of Information, Culture and Tourism.

4. Subject to no prolonged weather-related shocks in 2019, the agriculture sector is expected to recover in 2019 after the impact from the flooding in 2018. The floods between July and September 2018 damaged more than 90,000 hectares of agricultural land, leading to a fall in rice output to 3.6 million tons in 2018 from 4 million tons in 2017. Ancillary infrastructure and services related to the sector, such as rural irrigation systems and road infrastructure were also adversely affected. The GoL reallocated some public spending in 2018 and additional reallocation in 2019 for the reconstruction of infrastructure and recovery of agricultural production. However, the pace of recovery for the year is subject to the weather conditions that affect the rice planting season and the control measures on the pests that affect maize plantation and pork swine disease. Despite these challenges, harvest of some crops remains resilient. In the first four months of 2019, coupled with higher external demand, the cassava harvest and export increased by 13 percent compared to a drop of 20 percent in the same period in 2018. Similarly, fruits exports, including bananas, also rose by 50 percent in the same period. In addition, rubber exports also increased by 10 percent in the same period despite some moderation in prices⁷.

⁶ Preliminary Q1-2019 data from Ministry of Culture, Information and Tourism.

⁷ based on trade statistics from Ministry of Industry and Commerce, trading partners' customs and IMF Direction of Trade Statistics.

2. Fiscal developments⁸

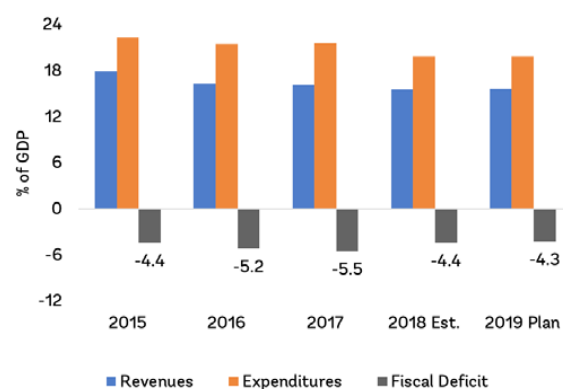
The fiscal deficit is expected to further narrow in 2019 due to tighter control of public spending and improvement in revenue

5. The GoL has remained committed to fiscal consolidation. Tighter control of spending lowered the fiscal deficit to 4.4 percent of GDP in 2018 from 5.5 percent in 2017. The 2019 Budget plan underscores the GoL's commitment to reducing the deficit further to 4.3 percent of GDP (Figure 4).⁹

6. Measures to control spending in 2018 were able to contain public spending. Total spending declined to 19.9 percent of GDP in 2018 from 21.6 percent in the previous year through the rationalization of investment and recurrent expenditures. At the same time, total revenue declined from 16.1 percent in 2017 to 15.5 percent in 2018 due to a decline in grants while domestic revenues remained stable at 14.5 percent.

Figure 4: Controls on the expenditures have contributed to the reduction in the fiscal deficit

(In percent of GDP)



Source: MOF and World Bank staff estimates.

7. The fiscal impact of the floods coupled with the general slowdown in economic activity in 2018 adversely affected tax collection. The widespread flooding is estimated to result in a 350-billion-kip loss in revenue due to the slowdown in business activity owing to the damage to transport infrastructure and the agriculture sector. The slowdown in general economic growth also contributed to the decline in tax revenue to 11.2 percent of GDP in 2018 from 12.0 percent in 2017. The “other taxes” category experienced the largest decline due to: (i) a reduction in timber royalties; and (ii) the decrease in associated charges related to the domestic retail fuel price to mitigate the impact of the sharp rise in global oil prices in 2018. Value-added tax (VAT) receipts (as a percentage of GDP) also declined in 2018 primarily due to the economic slowdown and partly owing to VAT exemptions on imports of capital goods related to some investment projects. Higher excise tax revenue due to the higher oil prices partially offset the decline in VAT tax receipts.

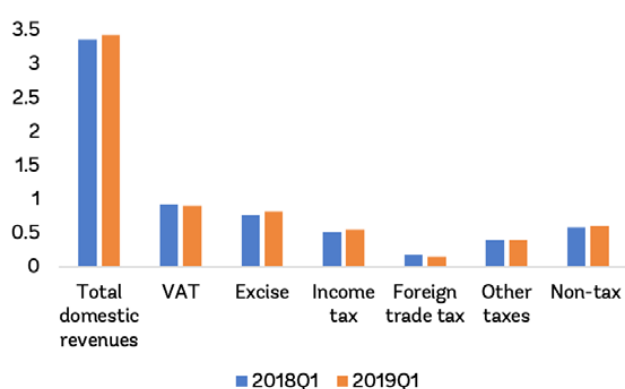
8. Domestic revenue is expected to improve slightly to 14.7 percent in 2019 from 14.5 percent in 2018. Strengthening tax administration continued to contribute to an increase in domestic revenues. Domestic revenues in Q1-2019 remained stable at 3.4 percent of GDP, but grew by 10 percent y/y in nominal terms compared to Q1-2018 (Figure 5). This was driven by the excise tax (partly due to still buoyant consumption growth), followed by the profit tax, the VAT and non-tax revenues. In contrast, there was a decline in trade taxes in nominal term over the same period.

⁸ This is based on information as of June 30th, 2019.

⁹ The budget plan for 2019 is based on the 2018 estimates prior to the release of the better than expected fiscal deficit numbers for 2018. It is likely that the fiscal deficit for 2019 will decrease further given the lower than expected preliminary 2018 fiscal deficit.

9. Since 2018, the Ministry of Finance recently undertook actions to improve revenue collection in line with the Tax Strategy Development Plan (TSDP). The TSDP stresses the importance of using Information and Communication Technology (ICT) to improve tax administration. For instance, the Tax Department recently adopted a Tax Revenue Information System (TaxRIS), which is expected to improve the efficiency of tax collection, enable systematic monitoring of revenue collection and allow for better management of the tax database.¹⁰ In addition, electronic payments were introduced to road, land and other taxes. To strengthen legal framework on VAT, the Tax Department amended the VAT law to provide a mechanism for better VAT administration. There is still room for improvement in revenue collection given the relatively low revenues to GDP ratio compared to regional peers with similar levels of GDP per capita (Figure 6).

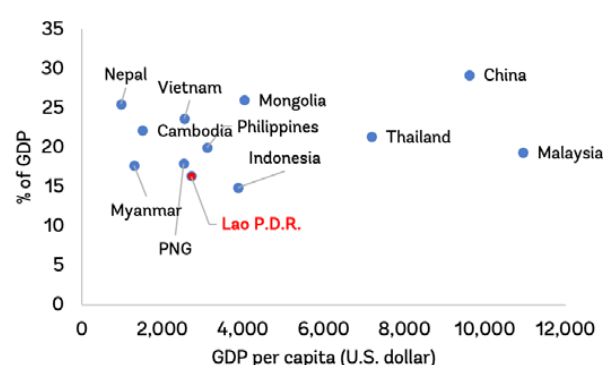
Figure 5: Revenue collection still improved across most revenue categories
(In percent of GDP)



Source: MOF

Note: VAT = value-added tax.

Figure 6: Revenues in Lao PDR are relatively lower than some of its regional peers
(In percent of GDP)



Source: IMF WEO April 2019.

Note: PNG = Papua New Guinea.

10. Measures to control spending have been successful in containing public expenditure.

Estimated Q1-2019 outturn indicates that total expenditure declined to 3.6 percent of GDP in Q1-2019 from 4.3 percent in Q1-2018 (or by a 10 percent reduction y/y in Q1-2019), driven by a 38 percent decline in capital spending (Figure 7). The public wage bill tightened further through an additional reduction in the number of new civil service recruits to 1,500 in 2019 from 3,000 in 2018. This will result in a decline in total number of civil servants. A wage index increase was also postponed. Nominal wage growth moderated to 4 percent y/y in Q1-2019 compared to 6 percent y/y in Q1-2018. The wage bill is projected to decline to 6.4 percent of GDP in 2019 from 6.6 percent of GDP in 2018. The GoL has also indicated to the National Assembly that from 2019 onwards it will focus on completing on-going projects and maintenance of existing infrastructure¹¹ while limiting new capital investments. Some existing budgetary funds will be reallocated to reconstruction of damaged infrastructure and agriculture caused by the floods in 2018¹². These actions have resulted in a reduction in capital spending in Q1-2019, particularly slower disbursement of loans and grants to finance capital spending. The capital expenditure is projected to further decline to 7.3 percent of

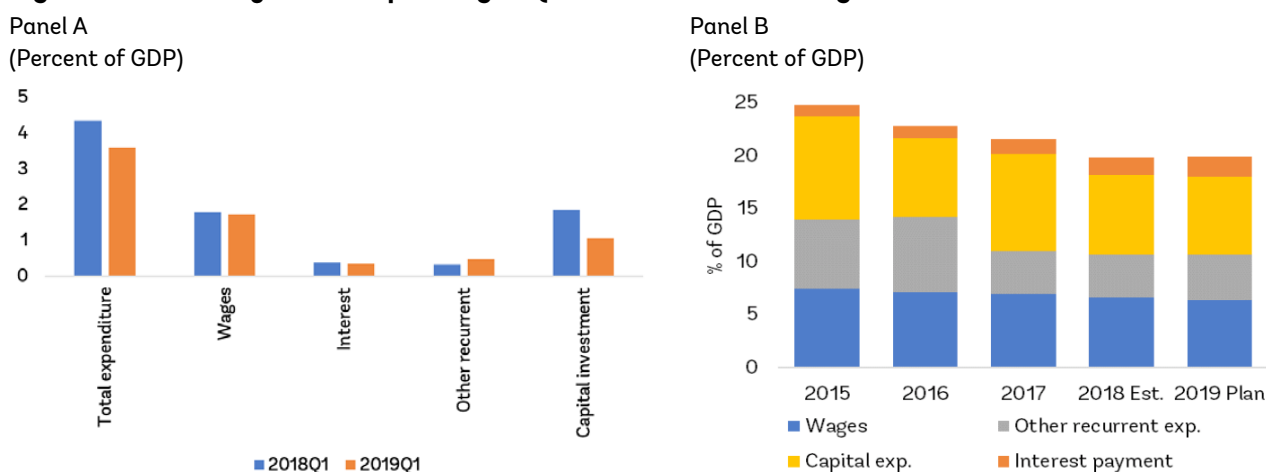
¹⁰ Finance Minister Notification No. 3532/MOF, dated 2 November 2018.

¹¹ The Government has indicated to the National Assembly that it will only focus on completing ongoing projects which have already begun to disburse.

¹² The Government reallocated 100 billion kip in 2018 budget and 500 billion kip in 2019 for reconstruction of affected infrastructure and agriculture.

GDP in 2019 from 7.5 percent in 2018. This is expected to leave more room for non-wage recurrent spending which is important for supporting service delivery.

Figure 7: Rationalization of spending in Q1-2019 and 2019 Budget Plan



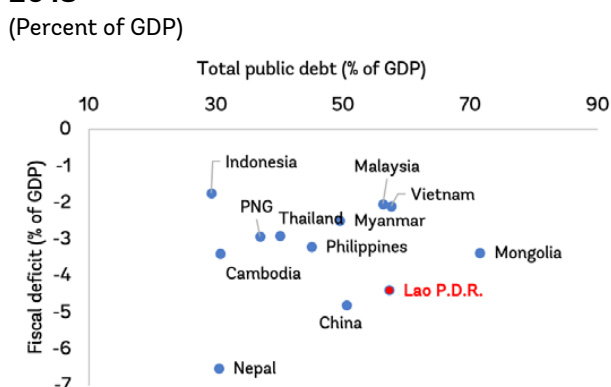
Source: MOF

Source: MOF

Fiscal consolidation has slowed the accumulation of public debt

11. Fiscal consolidation has slowed down the rate of public debt accumulation in 2019. The decline in the fiscal deficit has slowed the rate of public debt accumulation to 57.2 percent of GDP in 2018 from almost 56 percent of GDP in 2017, of which external debt accounts for a major share. This remains relatively high compared to regional peers, except, Malaysia, Mongolia and Vietnam (Figure 8). In this context, the GoL stated (in both the 2018 Public Debt Management Law and in its report to the National Assembly in June 2019) that it will borrow only on concessional terms for projects with high growth and social returns. The GoL also suspended public projects that have not yet started to disburse and are assessed to have a low economic return. In addition, the GoL has instituted a moratorium on all new hydropower projects, which will contribute to dampening external borrowing.

Figure 8: Lao PDR's estimated fiscal deficit and public debt for Lao PDR remained relatively high compared to regional peers in 2018



Source: IMF WEO April 2019, WB EAP Update April 2019, Joint IMF-WB Debt Sustainability Analysis

Note: PNG = Papua New Guinea

12. The slower accumulation of debt has contributed to a slowdown in interest payments in Q1-2019. In Q1-2019, interest payments accounted for 10 percent of domestic revenues compared to 11 percent in Q1-2018, or 13.7 percent of recurrent spending, down from 15 percent in the same period. Interest payments as a ratio of GDP declined to 0.3 percent in Q1-2019 from 0.4 percent in Q1-2018. However, the recent increase in the share of less concessional borrowing coupled with the increase in the debt-to-GDP ratio has pushed up debt service payments over the last two years. Although two-thirds of total external public debt is on concessional terms, the share of less concessional borrowing

slightly increased from 32 percent in 2017 to 35 percent of total external public debt in 2018 with most disbursements coming from existing loans. Consequently, interest payments, as a share of domestic revenue, increased from 10 percent in 2017 to 12 percent in 2018, or as a percentage of GDP, from 1.4 to 1.7 percent. Additionally, on average, the share of interest payments in Lao PDR to domestic revenues and recurrent spending was higher than that of Cambodia and Thailand in 2018, but below that of lower middle-income countries.

13. Notwithstanding the fact that public debt is primarily concessional, Lao PDR faces a high risk of debt distress. Lao PDR continued to be assessed at high risk of debt distress, as the projected ratios of total public and external public debt indicators continue to breach the indicative thresholds under the baseline cases. Additionally, the external debt indicators are particularly vulnerable to a sharp and significant depreciation of the exchange rate. However, risks are expected to be partly mitigated by guaranteed returns and export proceeds from the power purchase agreements for the power projects in which the GoL has equity participation.¹³

14. This underscores the importance of fiscal consolidation and improving public debt management. Fiscal consolidation has benefited from tightening expenditure while revenue collection continues to remain a challenge. With the reform actions in place, it is important to boost revenues in order to reduce the pressure on essential expenditure for service delivery and reconstruction after the severe flooding last year. By committing to focus its financing needs on concessional terms, the GoL intends to reduce, as a ratio of GDP, public debt and interest expenditure. Indeed, the recently approved Public Debt Management Law states that infrastructure and service delivery projects that do not generate high economic returns should be financed by more concessional borrowing. The subsequent formulation of a public debt management strategy along with capacity building will be a step to maintaining public debt sustainability in the longer term.

3. External sector

The current account deficit remained relatively high

15. Despite a decline in 2018, the current account deficit is expected to slightly widen to 12.1 percent in 2019 as imports are expected to grow somewhat faster than exports (Figure 9). In 2018, the improved trade balance helped to narrow the current account deficit.¹⁴ Buoyant export growth and the moderation in import growth (despite rising oil prices) narrowed the trade deficit from 9.9 percent of GDP to 8.4 percent of GDP between 2017 and 2018. However, during January-May 2019, imports from three major trading partners¹⁵ grew at 4 percent y/y. In contrast, export earnings remained stable compared to the same period last year.

16. Export earnings remained relatively stable owing to several factors. Lower metal prices adversely affected mining exports despite higher gold output in Q1-2019. Electricity exports remained

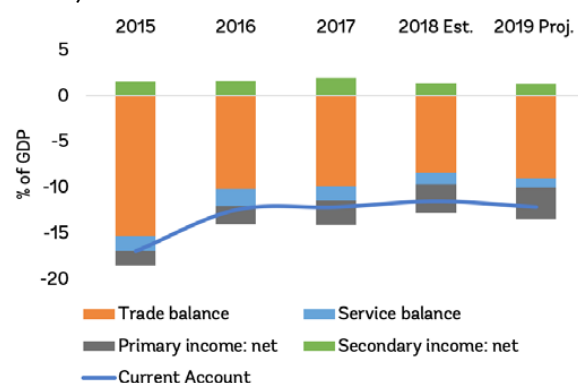
¹³ Over 90 percent of the electricity exports are under intergovernmental power purchase agreements that cover at least 25 years of export earnings.

¹⁴ The improvement in trade balance helped compensate for higher net income outflows. As a result, the improvement in trade balance brought down the current account deficit to 11.5 percent in 2018 from 12 percent in 2017.

¹⁵ Thailand, China and Vietnam account for 82 percent in 2018.

Figure 9: Stronger import demand and debt services are expected to contribute to higher current account in 2019

(Percent of GDP)



Sources: Ministry of Industry and Commerce; BOL; trading partners' customs data; UNCOMPTRADE; and World Bank staff estimates.

stable compared to last year. At the same time, manufacturing exports such as the electronic parts declined. This reflects the spillover effect of a fall in Thailand's exports partly due to the appreciation of the Thai baht. However, this trend was compensated by an increase in exports of rubber, crops (cassava and fruits) and wood pulp to China (about US\$ 80 million in the first five months of 2019 or seven-fold increase compared to the same period in 2018).

17. Import growth emanated primarily from machinery, equipment and vehicles to support construction of large projects. Imports of machinery and equipment, especially from China, rose by 26 percent y/y during January-May 2019. This was primarily driven by the construction of the railway, the highway and related investments. This partly offset the slowdown in import growth related to the completion of large hydropower projects construction. Fuel imports fell by 11 percent in value terms due to lower average oil prices during the first five months of 2019 compared to the same period in 2018, while the import volume remained fairly stable. Import growth is expected to remain buoyant during the year as the construction of large infrastructure projects continues.

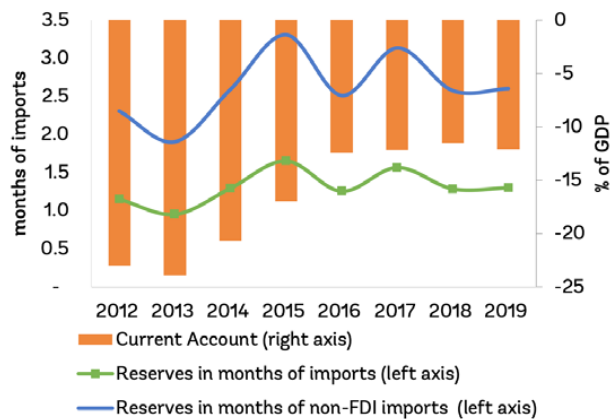
18. The high current account deficit in 2019 is expected to be largely financed by foreign direct investment. In 2018, FDI inflows remained at a historical high of 9.4 percent of GDP, financing a large part of the current account deficit. Inflows of FDI are expected to remain buoyant in 2019, owing to the construction of the Lao-China railway. About half of the foreign investment inflows are related to the construction sector, of which mostly relate to the construction of the railway line, which has a high import content, like other large investments.

Foreign currency reserves remain low although modestly increased in early 2019.

19. Robust FDI inflows have supported a slight increase in foreign reserves to US\$ 885 million in Q1-2019 from US\$ 873 million at end-2018, but they continue to remain relatively low (Figure 10, 11). At the end of 2018, foreign reserves buffers represented 1.1 months of total imports compared to 1.6 months in 2017. The downturn in reserves is due to external public debt amortization and interest payments in 2018. By end-2019, inflows of foreign investments and exports are expected to help boost foreign reserves to 1.2 months of total imports or 2.4 months of non-FDI-related imports. This level is considered low compared to regional peers. The generally low level of foreign currency

reserves is in part related to these factors: (i) limited export diversification; and (ii) a portion of foreign currency associated with export receipts remains outside the country. Building foreign currency reserves is essential to cushion against economic shocks.

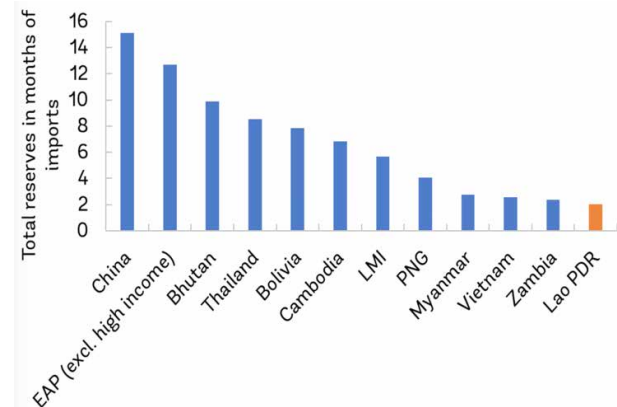
Figure 10: Foreign reserves have declined



Sources: BOL

Figure 11: Lao PDR has a low reserve adequacy ratio

(Percent of GDP)



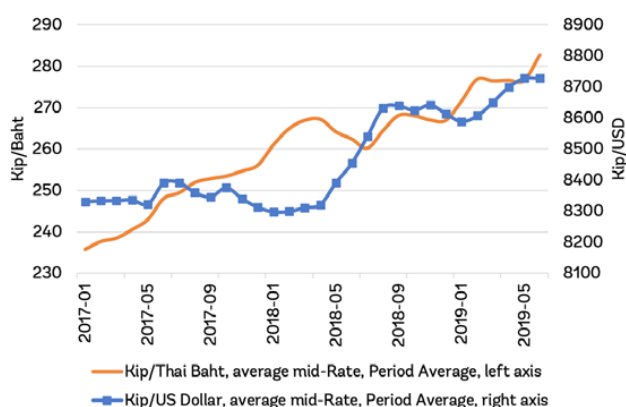
Sources: International Debt Statistics.

Note: LMI = Lower Middle Income Countries, PNG = Papua New Guinea.

The Lao kip depreciated against the U.S. dollar and the Thai baht

20. During January-June 2019, with the strengthening of the U.S. dollar and the Thai baht, the Lao kip depreciated against both these currencies. The Lao kip depreciated by 3.8 percent y/y against U.S. dollar and 4.7 percent against the Thai baht in the first half of 2019 (Figure 12). This follows the depreciation by almost 2 percent in 2018 of the official nominal kip/U.S. dollar reference rate and 7.8 percent depreciation of the official nominal kip/baht exchange rate. External and domestic factors have contributed to kip depreciation. Domestic factors include: (i) continued robust demand for foreign currency for imports and external debt repayments; and (ii) rising demand for foreign currency as a hedge against exchange rate depreciation. The external factor stems from the stronger U.S. dollar and baht against regional currencies (Figure 13). However, more exchange rate flexibility within the band contributed to the narrowing of the premium between the official and parallel exchange rates to below 2 percent during January-June 2019, on average.

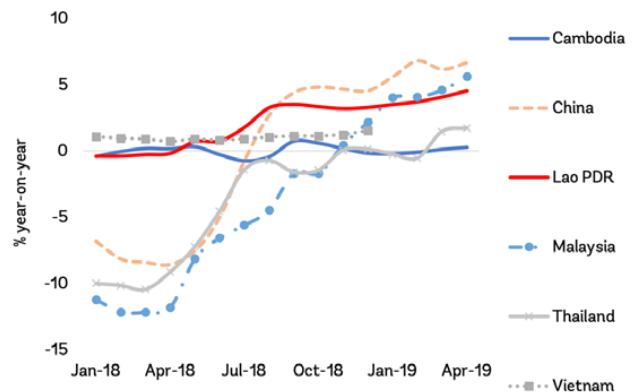
Figure 12: The kip continues to depreciate against the U.S. dollar and the Thai baht



Sources: BOL

Figure 13: The U.S. dollar strengthened against most regional currencies

(percent y/y)



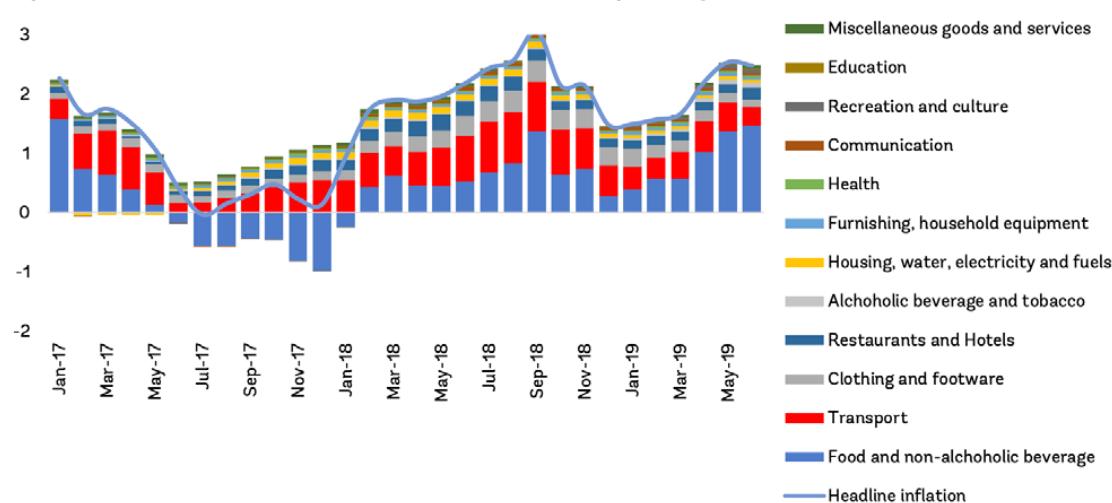
Source: IMF International Financial Statistics.

4. Monetary policy and price developments

Rising food prices coupled with a depreciating kip pushed up inflation

21. Price pressure started to pick up in the first half of 2019 while credit growth also slightly picked up. The average inflation rate in the first half of 2019 slightly increased to 2 percent from 1.7 percent over the same period in 2018 (Figure 14). This was driven by: (i) higher food prices, particularly rice prices which increased by almost 13 percent due to the disruption in rice production after the flooding last year; (ii) some increase in fuel prices; and (iii) the depreciation of the kip against the Thai baht and the U.S. dollar, which increased the price of imported goods. Core inflation remained around 2 percent driven by higher prices in housing and hospitality groups. Relatively contained inflation was partly due to fiscal tightening and moderation in overall credit growth despite a recent slight pickup. Credit growth slightly picked up slightly in Q1-2019 compared to end-2018, but was still lower than Q1-2018.

Figure 14: Headline inflation has risen driven by food prices



Source: Lao Statistics Bureau

Credit growth continues to moderate, but shows early signs of the recovery

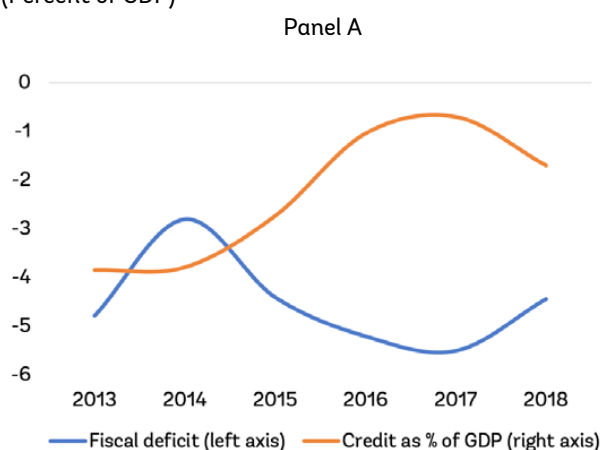
22. While the monetary policy stance remained unchanged compared to last year, credit growth picked up slightly in Q1-2019. Credit growth decelerated over 2018 partly due to fiscal consolidation, moderation in economic activity, non-performing loans (NPL) and more careful lending by banks (Figure 15). As a result, the ratio of total credit to GDP declined to 50 percent in 2018 from 52 percent in 2017. More recently, total credit growth to the economy (the private sector and state-owned enterprises) bottomed out at 2 percent y/y in January 2019, and picked up slightly to 3 percent in March 2019, although was still moderate compared to the same period in 2018 (Figure 16).¹⁶ One reason for the recent uptick in lending growth is related to the settlement of public investment arrears. Similarly, growth in credit to the private sector¹⁷ bottomed out at almost 4 percent in January and picked up to 5.5 percent in March, offsetting the decline in lending to state-owned-enterprises (SOEs).

¹⁶ However, the loan-to-deposit ratio dropped from 94 percent in at end-2018 to 91 percent in March 2019.

¹⁷ Credit to the private sector accounts for 84 percent of total loans.

Figure 15: The slowdown in credit growth is partly influenced by fiscal consolidation

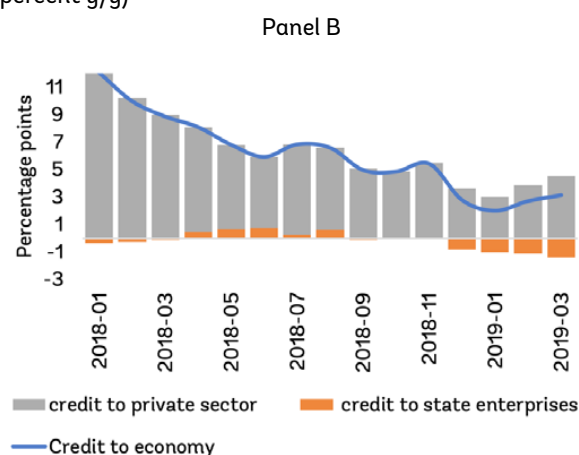
(Percent of GDP)



Sources: BOL

Figure 16: Credit growth remain low as lending to the private sector offset the decline in lending to SOEs.

(percent y/y)

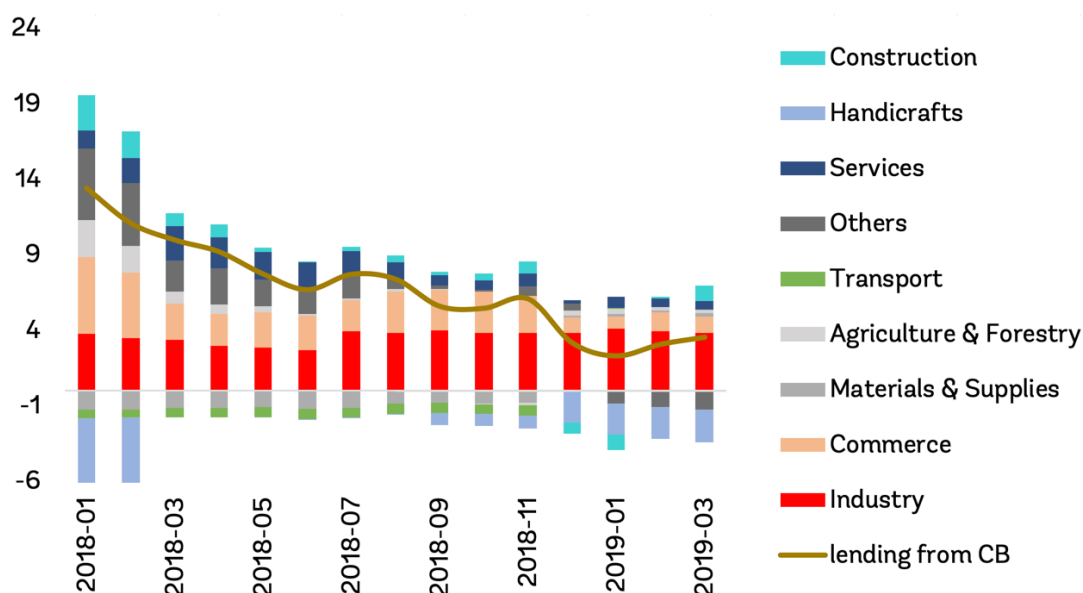


Sources: BOL

23. The recent uptick in growth in credit to the private sector is due to the continued buoyant growth in the industry and commerce sector.¹⁸ Despite remaining slower than last year, lending to the construction sector showed an early sign of recovery in Q1-2019 due to settlement of public investment arrears. Credit to the industry sector contributed almost 4 percentage points to total lending by commercial banks, while construction and commerce sectors contribute 1 percentage points each in Q1-2019 (Figure 17).

Figure 17: Lending to the industry, construction and commerce sectors mostly supported credit growth

(Percent and percentage points)



Source: BOL.

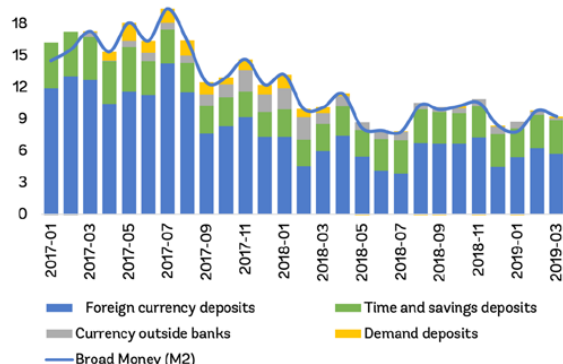
Note: CB = Commercial Banks.

¹⁸ Lending to these three sectors accounts for 60 percent of the total credit from commercial banks.

24. Broad money expanded slightly in Q1-2019, compared to end-2018. Broad money increased by 9.3 percent y/y in Q1-2019, which was marginally lower than the same period last year, but a pick up compared to 8.4 percent in Q4-2018. This reflects a higher proportion of foreign currency deposits and time and savings deposits (Figure 18). Higher foreign currency deposits and lending growth compared to local currency reflects higher dollarization with foreign currency deposits accounting for 54.5 percent of total deposits in Q1-2019, down from 53.6 percent in Q1-2018 (Figure 19). This partly reflects inflows of foreign currency related to foreign investment and an increasing demand for foreign currencies as a hedge against exchange rate movements (Figure 29). Such rates of dollarization are relatively high, though well below Cambodia's rate of dollarization of liabilities.

Figure 18: The pickup in broad money growth was driven by growing foreign currency deposits

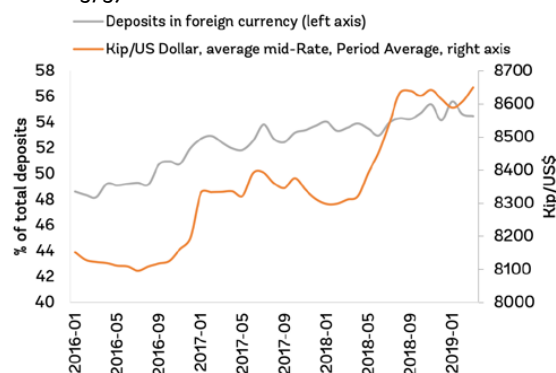
(Percentage points)



Sources: BOL

Figure 19: Increasing foreign currency deposits partly due to foreign investments and a hedge against kip depreciation

(Percent y/y)



Source: BOL.

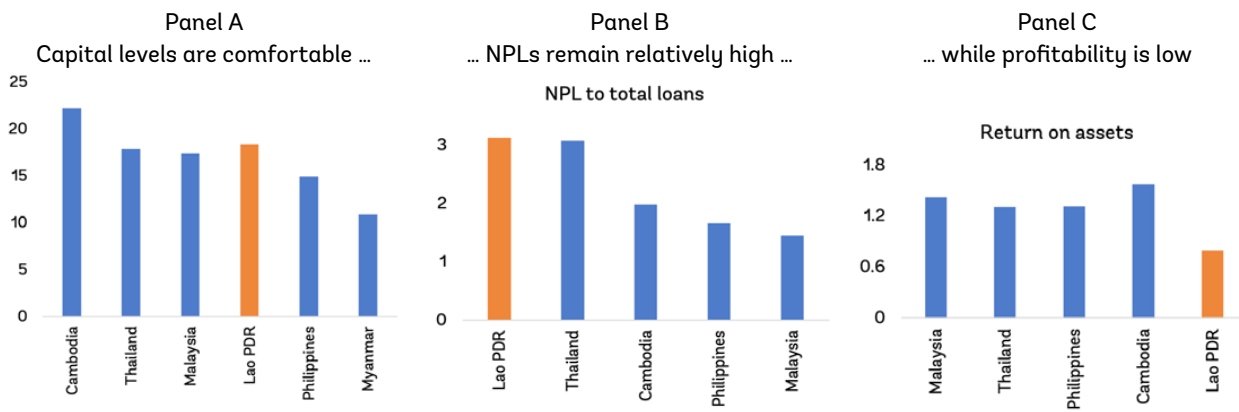
The banking sector is well-capitalized while profitability remains relatively low

25. The capital adequacy of the banking sector continued well above the regulator level. The regulatory capital to risk-weighted assets of the banking sector gradually improved from 15.8 percent in Q4-2017 to 18.3 percent at end 2018, which is above its selected regional peers, except Cambodia. In addition, Tier-1 capital to risk-weighted assets increased to 14 percent from 12.5 percent in the same period. Banking sector assets continued to grow at 8 percent in Q1-2019, slightly slower than a year ago as the increase in state-owned banks' assets offset the slowdown in other bank groups.¹⁹

26. However, the sector still faces relatively low profitability and high nonperforming loans compared to its regional peers (Figure 20). The return on assets gradually increased from 0.5 percent in Q4-2017 to 0.8 percent in Q4-2018. This level was still lower than in Cambodia (1.6 percent in Q4-2018), Thailand (1.3 percent) and Malaysia (1.4 percent). However, return on equity rose notably from 7.7 percent at the end-2017 to 11 percent at end-2018. This was higher than in Cambodia (9 percent) and Thailand (9.4 percent), but lower than in the Philippines (12.7 percent), and Malaysia (12.6 percent). The quality of the loan portfolio is mixed. Nonperforming loans was reported at around 3.1 percent of total loans, about the same level as in Thailand, but higher than in Cambodia (2 percent), the Philippines (1.7 percent), and Malaysia (1.5 percent).

¹⁹ However, the level of capital may differ among groups of banks, particularly for the two state-owned commercial banks, which are in the process of restructuring.

Figure 20: Financial Soundness Indicators



Sources: BOL for Lao PDR; Other countries from IMF International Financial Statistics.

Note: All data for Q4-2018. NPLs = non-performing loans.



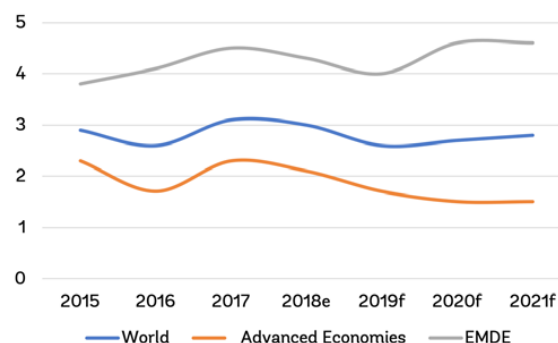
I.2. Outlook and Challenges

Box 1: Global and Regional Outlook and Risks

Global growth is expected to edge up to 2.7 percent in 2020 and 2.8 percent in 2021 (Figure 21). Slowing activity in advanced economies and China is expected to be accompanied by a modest cyclical recovery in major commodity exporters and in several Emerging Market and Developing Economies (EMDEs) affected by recent pressure related to financial market stress or sanctions. EMDE growth is projected to pick up from a four-year low of 4 percent in 2019—0.3 percentage points below previous projections—to 4.6 percent in 2020–21. This recovery is predicated on the waning impact of earlier financial pressure currently weighing on activity in some large EMDEs, and on more benign global financing conditions than previously expected. It also assumes no further escalation in trade restrictions among major economies and stability in commodity prices.

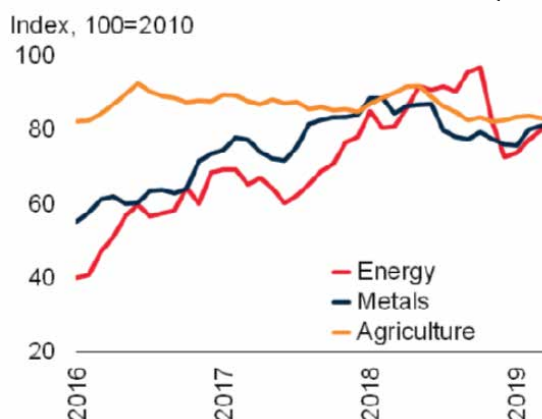
Global economic conditions are expected to remain challenging over the forecast period. A further escalation of trade tensions involving major economies could lead to a sharp increase in trade barriers and weigh on confidence and investment. Oil prices are expected to average US\$66 per barrel in 2019 and US\$65 per barrel in 2020, with high uncertainty around the outlook (Figure 22). Despite weaker demand prospects, metals prices are anticipated to stabilize in 2019 and 2020 due to modest supply growth and low inventory levels. Agricultural prices are expected to remain broadly flat over the next two years. The risk of financial stress in EMDEs could be exacerbated by increasing debt-refinancing needs. A sharp deceleration in major economies would have large spillover effects for EMDEs and increase the probability of a marked global downturn. Rising public debt levels are reducing the effectiveness of fiscal policy in EMDEs. Structural reforms, such as improvements in institutional quality, can help boost growth and reduce poverty.

Figure 21: Global real GDP growth (percent)



Source: WB Global Economic Prospects, June 2019

Figure 22: World commodity price forecast (Index=nominal U.S. dollars, 2010=100)



Source: WB Global Economic Prospects, June 2019

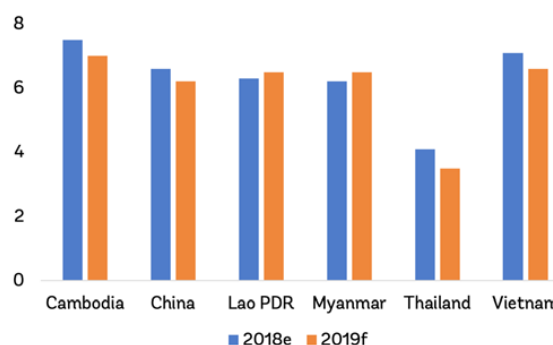
Growth in the East Asia and Pacific region is projected to slow from 6.3 percent in 2018 to 5.9 percent in 2019-20, and to ease further to 5.8 percent in 2021. This will mark the first time since the 1997-98 Asian financial crisis that EAP growth dropped below 6 percent. In China, growth is expected to decelerate from 6.6 percent in 2018 to 6.2 percent in 2019, and gradually decline to 6.0 percent by 2021, reflecting softening manufacturing activity and trade amid

domestic and external headwinds. In the rest of the region growth is also expected to moderate to 5.1 percent in 2019, before rebounding modestly to 5.2 percent in 2020-21, as global trade stabilizes (Figure 23). Risks to regional growth remain tilted to the downside and have intensified with the re-escalation of trade tensions. They include a sharper-than-expected slowdown in major economies, including China; an intensification of global trade tensions; and an abrupt change in global financing conditions and investor sentiment.

Risks continue to be on the downside. There is considerable uncertainty around the outlook for the global economy and the balance of risks remains firmly on the downside. Although unlikely in the near term, the simultaneous occurrence of a sharper-than-expected slowdown in China, the Euro Area, and the United States could trigger a significant downturn in global activity. The re-escalation of trade tensions could be highly disruptive to global activity amid the presence of complex value chains. The risk of severe and broad-based financial stress adversely affecting the outlook for EMDEs remains high amid elevated debt levels in many countries. Policy uncertainty and geopolitical risks remain high and could negatively impact confidence and investment in both affected countries and globally.

Source: WB Global Economic Prospects June 2019

Figure 23: Regional growth



Source: WB Global Economic Prospects, June 2019.

Note: e = estimate; f = forecast

27. The short-to-medium-term outlook of the Lao economy is expected to remain broadly favorable supported by electricity export and private investment. Growth is expected to pick up to 6.7 percent during 2020-21 due to a combination of factors: (i) an additional 2,200 MW of power generation and exports, mainly to Thailand, is expected by 2020 with the completion of several power projects;²⁰ (ii) the construction and services sectors, which will continue to be supported by the ongoing construction of the Vientiane-Vangvieng highway and the Lao-China railway; and (iii) reconstruction and repair of infrastructure damaged by the flooding in 2018. Coupled with still strong growth in key trade partners despite moderation, deeper regional integration and related reforms are expected to promote the non-resource sector development. Although growth prospects in China and Vietnam are projected to moderate slightly, they remain strong while Thailand's growth is expected to pick up. These will likely help support external demand. The agriculture sector is projected to rebound post-flooding while the services sector, particularly trade, is expected to remain buoyant with construction activities and imports. Tourism from the region is expected to pick up, partly with follow-on from the promotion of Lao-China Tourism Year in 2019. However, the contribution of the mining sector is expected to gradually decline as current investment matures without any new investment while the moratorium remains effective. The suspension of new hydropower projects to allow for a re-assessment of the performance of existing projects and their safety is also expected to limit the expansion of the hydropower sector in the near-term. Inflation is also expected to rise slightly.

28. The medium-term fiscal framework is consistent with the path of fiscal consolidation. The fiscal deficit is expected to decline to below 4 percent in 2021 from 4.4 percent of GDP in 2018. To achieve this deficit target, the GoL will continue to focus on improving revenue mobilization through the use of ICT and expanding the revenue base and undertaking public expenditure rationalization. Gains are expected to be realized from the implementation of an improved legal and regulatory framework including laws on tax administration, income tax and excise tax. Meanwhile, both recurrent and capital public expenditures are expected to be contained. The recruitment of new civil servants will be considered carefully after consecutive cuts in the last few years. The GoL has set a target for the public wage bill to decline to under 40 percent of domestic revenue by 2022 from 45 percent in 2018. The just concluded June 2019 National Assembly session reported measures of the postponement of new projects, a reduction in unnecessary recurrent spending, such as a limit on buying new vehicles; and improvement in the procurement process and methods in the purchase of goods and services to reduce costs. Additionally, the GoL reported to the National Assembly that from 2019 onwards it will focus on completing ongoing projects that have already begun to disburse and will limit new capital investments to disaster relief projects and maintenance of existing infrastructure. These actions are expected to contain capital expenditure over the medium term. Consequently, expenditure-to-GDP is expected to be contained to below 20 percent of GDP in the same period. This fiscal consolidation is expected to reduce the public debt level and debt repayment burden in the medium term.

²⁰ These include the Sayaboury Hydropower Project (1,285 MW), Nam Ngiep 1 (290 MW), Xe-Pian Xe-Namnoy (410 MW), and Don Sahong (260 MW).

29. Although remaining elevated, the current account deficit as a ratio to GDP is expected to gradually decline over the medium term. Exports are expected to benefit from upcoming power projects, manufacturing and a rebound in agricultural exports and tourism. As the implementation of Prime Minister Order No. 2, which aims to improve the business environment, gathers pace, it is anticipated that it will gradually facilitate more diversified investment in the non-resource sector. This will partly offset the expected rise in imports to support investment in the aforementioned infrastructure projects. Similar to historical trends, the current account deficit is expected to be largely financed by the investment inflows on these projects. In the medium term, after the completion of these investment projects, imports are expected to decline while exports pick up, hence narrowing the current account deficit (as a percentage of GDP). With the expected improvement in the current account balance, reserve levels are expected to accumulate in the medium term.

30. The medium-term outlook is subject to increasing external and domestic risks. Heightened external risks include prolonged trade protectionism, heightened geopolitical uncertainty, and continued tightening of global financing conditions that could lead to disorderly financial market movements. The escalating trade conflict between China and the United States has had impacts on regional growth through the value chain, which in turn can impact the trade and investment flows from key economic partners of Lao PDR. There are early signs of slowing demand for Lao PDR's manufacturing exports to Thailand as part of the regional supply chain due to declining Thailand's exports partly as a result of its currency appreciation. However, upside risks could be stronger demand for agricultural exports from Lao PDR to China, as already reflected in recent trends. Furthermore, commodity prices could be further impacted, which could further dampen mineral exports and GDP growth. Worsened trade balance could increase the pressure on the exchange rate and thereby increasing debt service costs. In addition, the high level of external debt against a low foreign reserve buffer limit the authorities' ability to respond in case of economic shocks. Domestic risks include: (i) more frequent devastating natural disasters which can damage economic activities and create fiscal pressure; (ii) slower progress in implementing the revenue and expenditure measures as well as current public financial management reforms which could derail the containment of the fiscal deficit and public debt; and (iii) a slowdown in momentum on doing business reforms.

31. To mitigate these risks, fiscal consolidation remains of the utmost importance, while improving the business environment will help promote more sustainable growth in the long-run. The GoL has continued fiscal consolidation, through both on revenues and expenditure measures. Revenue collection needs to be strengthened to reduce pressure on necessary spending. The generally low tax-to-GDP ratio is due to a combination of (i) low efficiency in tax collection (due to weak administration and modernization); (ii) a limited tax base and (iii) foregone revenues from exemptions to investment projects. This trend has challenged the GoL's needed investment in physical and human capital. Additionally, the recently approved public debt management law, which strengthens public debt management, coupled with an attempt to develop the domestic debt market, can help better manage risks associated with public debt accumulation. In the longer term, promoting sustainable growth through improving the business climate and trade facilitation is a priority for promoting and benefiting from opportunities that will arise from better physical connectivity upon the completion of the large infrastructure projects and deeper regional integration.

Table 1: Key macroeconomic indicators and projections

	2017	2018	2019	2020	2021
		Est.	Proj.	Proj.	Proj.
Real Economy	(Percent change y/y, unless otherwise stated)				
Real GDP growth	6.9	6.3	6.5	6.7	6.6
Inflation (annual average, %)	0.8	2.0	2.1	2.5	2.3
GNI per capita (Current U.S.dollar)	2,270	2,460
Fiscal Account	(Percent of GDP, unless otherwise indicated)				
Revenues	16.1	15.5	15.6	15.8	16.0
Domestic Revenues	14.5	14.5	14.7	15.1	15.3
Taxes	12.0	11.2	11.7	12.1	12.3
Non-tax	2.5	3.3	3.0	3.0	3.0
Grants	1.6	1.0	0.9	0.7	0.7
Expenditures	21.6	19.9	19.9	19.8	19.8
Current expenditure	12.4	12.4	12.6	12.6	12.6
Capital expenditure	9.2	7.5	7.3	7.2	7.2
Fiscal Deficit	-5.5	-4.4	-4.3	-4.0	-3.8
Total Public Debt	55.8	57.2	58.0	56.2	55.5
Balance of Payments	(Percent of GDP, unless otherwise indicated)				
Current Account Balance	-12.1	-11.0	-12.1	-11.8	-11.1
Gross Reserves (in US\$ million, eop)	1016	873	950	1,070	1,240
In months of prospective imports	1.6	1.1	1.2	1.4	1.7
In months of prospective non-FDI imports	3.1	2.2	2.4	2.7	3.2
Money and credit	(Percent y/y)				
Broad money	12.2	8.4
Credit growth	10.8	2.8
Other memo items					
GDP (nominal, billion US\$)	17.0	18.4	20.2	21.7	22.9

Source: Government of Lao PDR, trade partners, WB team estimate and projections, and Joint IMF-WB DSA 2019

Note: The Government's fiscal year (October-September) was changed to calendar year in 2017.

A woman with dark hair, wearing a light-colored striped sleeveless shirt, is working on a large industrial textile machine. She is looking up at a thick, blue, frayed fabric strip that is being processed by the machine. The machine has various metal components, including spindles and guides. The background shows a factory setting with shelves and other equipment.

Part II:

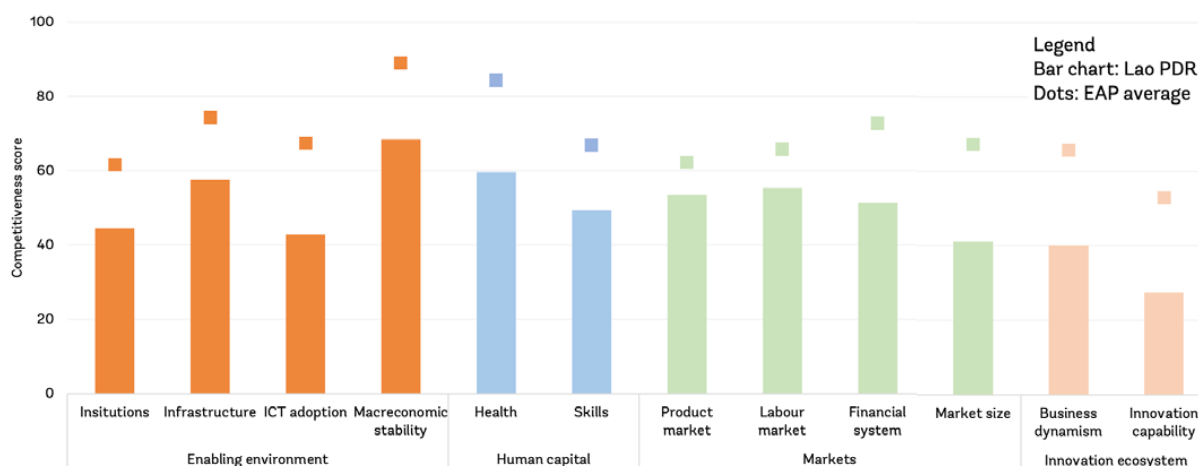
Constraints to Doing Business for SMEs

II.1. Introduction

1. Small and medium-sized enterprises (SMEs) constitute an important segment of the business sector in Lao PDR. Like in many other parts of the developing world, SMEs in Lao PDR account for about 99 percent of all registered firms in Lao PDR. However, it has been estimated that the share of SMEs in overall GDP is more modest at under 20 percent. This compares to about 40 percent in Thailand, and 32 percent in Malaysia and the Philippines²¹, possibly indicating the as-yet-unrealized potential of the sector in Lao PDR. Most SMEs are micro with fewer than 5 employees. Reinforcing the importance of SMEs in the country, the 2013 Economic Census conducted by the Lao Statistics Bureau found that SMEs accounted for 82 percent of total employment. Small and medium enterprises are therefore critically important for the livelihoods of the Lao people. Improving the performance and prospects of the sector is one sure way to raise incomes and the quality of jobs, while helping the GoL to move closer to its goal of graduating Lao PDR from Least Developed Country (LDC) status.

2. There is an urgent need to better understand the challenges facing businesses in Lao PDR and fast-track reforms that appropriately address them. Despite several reforms, the World Bank's Doing Business ranking for Lao PDR continues to decline from 134th place in 2015, to 139th in 2016, 141st in 2017, and 154th in 2018.²² This regression over time has possibly deterred private investment into the non-resource sectors and created the important diffusion of technologies and know-how that comes with it. Currently, competitiveness of the non-resource sectors is relatively lower than EAP regional average and the frontier, for instance in innovation and ICT adoption, market size and business dynamism (Figure 24). And yet, as Lao PDR continues to promote a market-based economy and foster the private sector to generate growth, raise incomes, and move more people out of poverty. To realize the full potential of private enterprise, it will be necessary to identify the chief sources of business concerns and activate reforms that alleviate these impediments while foster entrepreneurship and competitiveness in the economy.

Figure 24: Lao PDR Competitiveness Index



Source: Global Competitiveness Report 2018

Note: Higher score is better, score from 0-100. The frontier (100) corresponds to the goal post for each indicator and typically represents a policy target.

²¹ World Bank Group (2017). "Systematic Country Diagnostic for Lao PDR".

²² Comparisons of the Doing Business rank across years is not straightforward due to occasional changes in methodology and the number of countries in the dataset. Nonetheless, a deterioration in Lao PDR's comparative position over this period is evident.

3. The GoL recognizes the role of the private sector in driving economic development and has recently undertaken a number of reforms to further ease the doing business environment. Private sector development features prominently in the GoL's National Socio-Economic Development Plan 2016-2020. The GoL has also signaled its desire for a shift away from reliance on resource exploitation to drive growth and toward a more diversified economy with leading roles for agriculture, services, tourism and manufacturing. These latter sectors, however, are relatively more dependent on good business environment fundamentals, and have a much larger presence of SMEs. Consistent with this, the GoL has approved the SME Development Plan 2016-2020 and, more recently, the Prime Minister issued an official order (No. 12, dated 23 August 2018) which included a range of important reforms directed at private sector development, including in the SME arena.

This section presents a snap shot on SMEs from the World Bank's recent enterprise surveys. The section discusses results in two broad areas:

- a. The first area is firm performance, where labor productivity and labor costs are considered.** These results are based on responses by firms for the previous full financial year. Where financial statements are available, firms are asked to draw on these; otherwise, they are required to provide estimates. *All performance-related results in this thematic note are reported at the medians of the distribution (unless otherwise stated).²³ Furthermore, results are reported in 2009 U.S. dollar terms.²⁴* Employment, where it is used, is taken to be the number of full-time employees at the end of the last full financial year.
- b. The second area is business constraints.** These results are based principally on two types of questions: (i) a comparative question that asks firms to identify the *one biggest obstacle they face from a list of 15 potential obstacles*; and (ii) an obstacle-specific question that asks firms to *rate each of these 15 constraints on a five-point scale in terms of their individual severity*. While the comparative question does not give firms scope to indicate anything beyond the relatively most binding constraint that they face, the collection of 15 severity questions provides a means of capturing these broader concerns.²⁵ In both areas of analysis – performance and constraints – aggregated results are derived using special weights that account for the stratified sampling design and response rates. (Annex 1 presents information about characteristics of SMEs analyzed in this section)²⁶

²³ Averages are avoided because of their tendency to be skewed by outliers, including in some cases as the result of inaccurate recording or coding of responses.

²⁴ Currency amounts are deflated to their 2009 values (using the GDP deflator) and then converted using the 2009 USD exchange rate.

²⁵ A further discussion of these two question types is provided in 2.

²⁶ For more details on the survey and sampling design, see www.enterprisesurveys.org.

II.2. The performance of surveyed SMEs

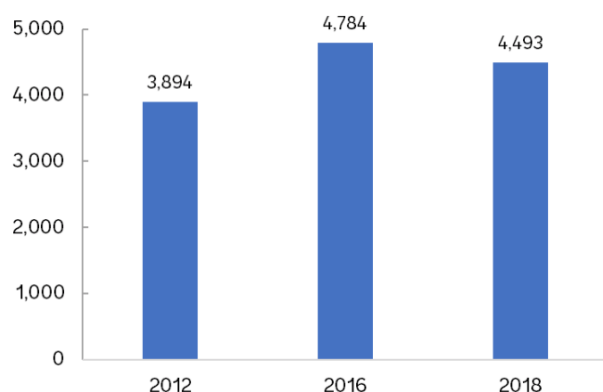
The increase in labor costs outpaced improvement in labor productivity, undermining the competitiveness of SMEs.

4. **The enterprise survey paints a mixed picture of the performance of Lao SMEs.** Looking across different measures and sectors, productivity has in most cases been flat or even declined since 2012.²⁷ Real wages too are also down over the period. The result, at least in the manufacturing sector, has been a small improvement in unit labor costs; but even here, it is despite a more recent uptick. While the enterprise survey offers some interesting insights, the reader would be prudent to recognize the significant data limitations of the survey.

5. **Sales per worker – one of the simplest measures of labor productivity – has risen only marginally since 2012.** Sales per worker (median) among SMEs rose by 23 percent between 2012 and 2016, but declined by 6 percent in 2018 to reach US\$ 4,493 in 2018 (Figure 25). This performance was not matched by all sectors. While there was a significant increase (79 percent) observed in the median firm performance in the other services sector over the six years,²⁸ declines were recorded in manufacturing (33 percent) and retail services (29 percent). While sales per worker can be a useful indicator, with fairly minimal data requirements, it has limitations for making comparisons across firms in different sectors and across different stages of the production process. An alternative measure of labor productivity is therefore value-added per worker, but data constraints entail that it can only be calculated for manufacturing firms.

Figure 25: Median sales per worker rose overall, but not in every sector

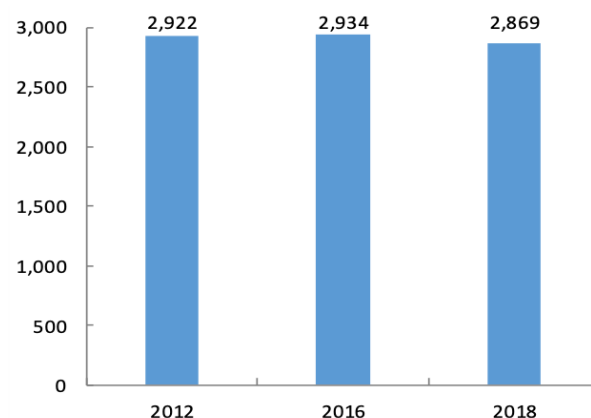
Sales per worker, 2009 U.S. dollar



Source: WB Enterprise Surveys.

Figure 26: Labor productivity in the manufacturing sector has been broadly flat

Value-added per worker, 2009 U.S. dollar, manufacturing only



Source: WB Enterprise Surveys.

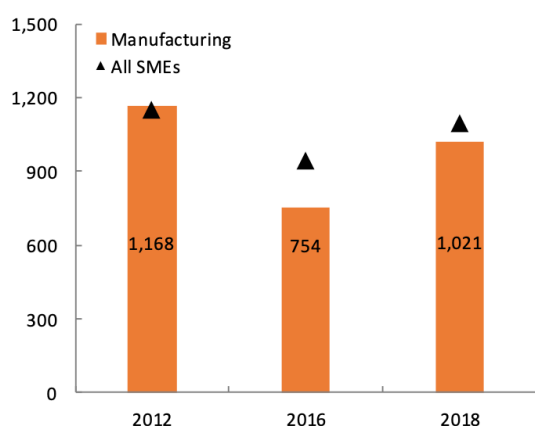
²⁷ Given that the same firms are not guaranteed to be surveyed each year, we are not necessarily measuring these indicators for a particular firm over time. Rather, as the survey in each year attempts to provide a representative picture of businesses in Lao PDR we are able to compare these indicators over time. However, due to high sampling variability in the Enterprise Survey, the trend over time for these indicators should be confirmed using other datasets before drawing definitive conclusions.

²⁸ Note, that this does not refer to a change in the performance of a single firm, but the difference in the calculated median of the distributions in 2012 and 2018.

6. An alternative measure of productivity, derivable for manufacturing firms, suggests that labor productivity has been broadly stable, notwithstanding a small recent decline. Value-added per worker is calculated for the manufacturing sector by subtracting the costs of raw materials and intermediate inputs from sales,²⁹ then divided by employment. Figure 28 demonstrates that productivity at the median has not changed materially between the three surveys. Overall, value added per worker among the surveyed manufacturing firms has remained at about US\$ 2900 over six years (Figure 28). It is surprising that these medians are significantly more stable than the sales per worker measure for manufacturing firms. In part, this is driven by differences in respective samples: some manufacturing firms do not provide the data necessary to calculate value-added, or otherwise reported extreme values that were judged unreasonable.

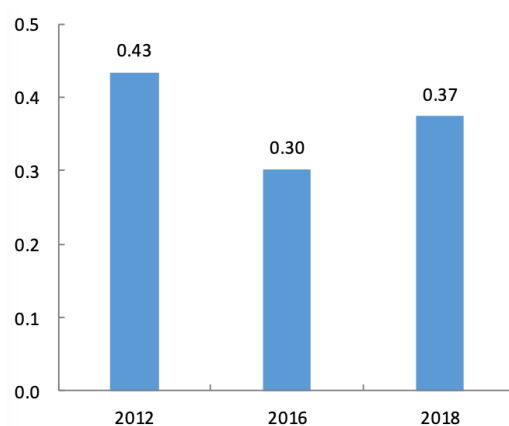
7. The cost of labor has recently increased. The implications of developments in labor productivity are most usefully considered while giving regard to the costs that firms incur in employing that labor. In manufacturing, as well as more generally, employee wage costs at the median declined substantially between 2012 and 2016. Two years later, in 2018, the median had recovered considerably but was still below the level observed in 2012 (Figure 27). Movements in the data will, in part, include the impacts of legislated minimum wage increases in 2011 and 2015, but it is not possible to disentangle these effects from those arising as a result of other drivers and sample variation.³⁰

Figure 27: Following a marked decline, wages appear to have bounced back
Total labor costs per worker (U.S. dollar, 2009)



Source: WB Enterprise Surveys.

Figure 28: Unit labor costs rose recently, but still lower than six years ago
Unit labor costs in manufacturing



Source: WB Enterprise Surveys.

8. The competitiveness of the SME manufacturing sector appears to have deteriorated since 2016 but is better than six years ago. A more holistic measure of firm competitiveness that captures both productivity and the cost of labor is unit labor cost. It is calculated by dividing the cost of workers by the output of workers. For a given firm, this reveals the labor cost associated with producing an additional dollar of output.³¹ To appreciate its significance, note that if labor productivity falls, but

²⁹ Data on raw materials and intermediate inputs is not available (and, often less relevant) for retail and other services firms.

³⁰ These increases should be reflected in the data, given that surveyed firms report results for the previous financial year (e.g. firms surveyed in 2012 would report labor costs for the 2011 financial year) and that minimum wage implementation usually takes place over time. Minimum wages were raised again in 2018, but this is outside the period captured by the surveys.

³¹ More specifically, unit labor costs are equivalent to the labor costs of an additional dollar of value-added per worker. It is a key measure of the cost-competitiveness of labor in the production process.

labor costs fall even faster, then the firm's unit labor costs would decline (implying, all else being equal, that the firm now incurs lower labor costs in producing a unit of output). Unit labor costs declined significantly from 2012 to 2016, but had risen again by 2018 (Figure 28). All else equal, higher unit labor costs could reflect increases in wages, stagnant productivity, or a rise in the labor intensity of production. It is not possible to disentangle these effects here, given the available data.

9. A more prosperous Lao economy will require higher wages, but productivity will need to rise at least commensurately in order to sustain (and, ideally, improve) the relative international competitiveness of Lao PDR's SMEs. The pace of labor productivity growth evident in the enterprise survey data for SMEs is largely unimpressive³² and coincides with a constraint to the private sector across the economy. Growth in GDP per employed person moderated in each year from 2013 to 2018 and was at a lower average pace than in each of Lao PDR's neighbors with the exception of Thailand. Recent increases in minimum wages have boosted social protection for low-wage workers, but robust productivity growth is necessary to ensure that wage increases are affordable, that unit labor costs do not rise excessively, and that employment growth is not impeded. However, many challenges exist which hold back the prospects for raising productivity to levels comparable to Lao PDR's regional peers. Addressing these issues will be an important start. It is to a discussion of these constraints, as highlighted by enterprise survey respondents themselves, that this report turns to next.

II.3. What are the major challenges facing SMEs in Lao PDR?

Access to finance, practices of competitors in the informal sector, and electricity supply are the top three obstacles facing formal SMEs in Lao PDR in 2018.

10. The Enterprise Surveys provides insights into the major challenges facing the respondent SMEs in Lao PDR. The survey asks managers whether certain areas of the business environment are constraining their business operations. Firms are asked to identify the "biggest" obstacle facing their business and the severity of each obstacle.³³ Aggregated responses on the biggest obstacle provide an indication of which constraints are the highest priority for firms across the country, whereas aggregated results on the severity of obstacles provide an indication of how broadly each obstacle is affecting the whole population of firms without necessarily being their foremost constraint. Box 2 explains how these responses are collected from firms and how they will be reported on in this thematic note.

Box 2: Tell me where the problem is?

Collecting and reporting data on business obstacles in the Enterprise Survey

The Enterprise Survey asks firms about the obstacles they face in two different ways.

The first way involves firms being presented with a list of 15 areas of the business environment and asked to identify which one is the "**biggest obstacle**" (see Table 2). Each

³² With the potential exception of sales per worker in other services.

³³ For the severity of each obstacle, firms are asked to rate each issue on a five-point scale, from "no obstacle (0)" to "very severe obstacle (5)". The firm is said to identify an issue as a serious obstacle if it has selected it as a "major obstacle" or "very severe obstacle".

firm must choose just one area from this list and cannot indicate any secondary or lower-order concerns. The order of the items is randomized so that it does not systematically bias respondents' choices. These responses are collated across all firms and then, for each of the 15 areas, the proportion of firms that identified it as their biggest obstacle can be reported.

The second way is to ask firms to rate how serious each of the 15 obstacles are, using a scale of zero (no obstacle) to 4 (very severe obstacle), as seen in Table 3. In this way, firms can provide an indication of their concerns (or lack thereof) with respect to every one of the 15 constraints. They do not need to choose between one or the other. This provides useful data on the broader set of problems that a given firm faces, rather than just the biggest one. In this thematic note, the perception of firms reporting a specific obstacle as either a 3 (major obstacle) or a 4 (very severe obstacle) are combined and defined as the proportion of firms reporting that obstacle to be a '**serious obstacle**'.

Both approaches provide useful and different insights into the most pressing obstacles that firms in Lao PDR must contend with.

Table 2: Source of the biggest obstacles

Question: By looking at the list of elements of the business environment can you tell me which one, if any, currently represents the biggest obstacle faced by this establishment?

Access to finance

Access to Land

Buisness licensing and permits

Corruption

Court

Crime, theft and disorder

Customs and trade regulations

Electricity

Inadequately educated workforce

Labour regulations

Political instability

Practices of competitors in the informal sector

Tax adminitration

Tax rates

Transport

Table 3: Source of the serious obstacle

Question: Using the response options on the card; to what degree is *[insert obstacle]* an obstacle to the current operations of this establishment?

0. No obstacle

1. Minor obstacle

2. Moderate obstacle

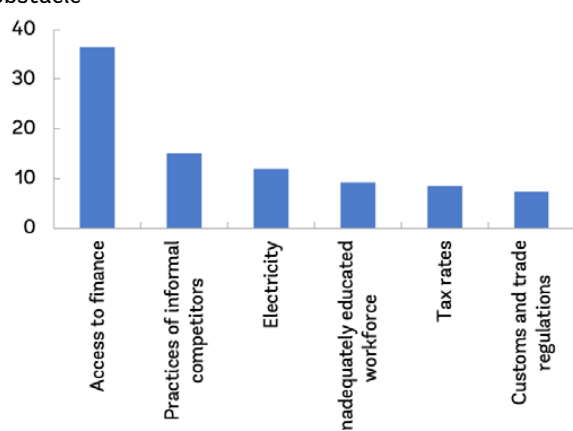
3. Major obstacle

4. Very severe obstacle

11. Access to finance, practices of competitors in the informal sector, and electricity, were cited by the respondent SMEs as the main constraint in 2018. Out of the 15 constraints, 36 percent of SME respondents cited access to finance as the “biggest” obstacle, followed by 15 percent of SME respondents cited practices of informal competitors, and 12 percent cited electricity as the biggest obstacle. When asked how severe each constraint is by rating from 0-5 scale, 18 percent of SME respondents cited access to finance as the serious obstacle, 18 percent cited practices of informal competitors, and 18 percent cited electricity as a serious obstacle.³⁴ One noteworthy point is that while 36 percent of respondent SMEs cited access to finance as the biggest obstacle, only 18 percent said that it is a very severe constraint (Figure 29).

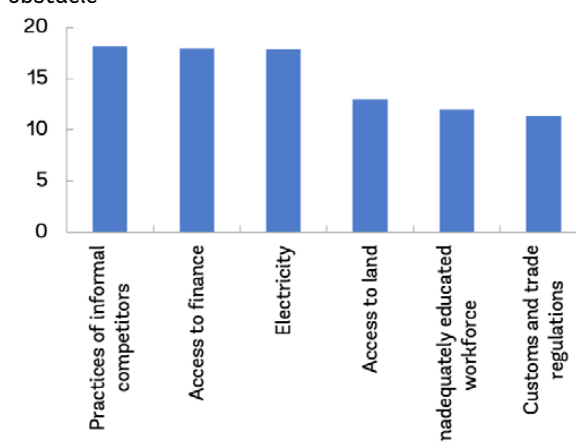
Figure 29: Both measures indicate that (i) access to finance, (ii) practices of competitors in the informal sector and (iii) electricity are the top three most prominent obstacles facing formal SMEs firms in Lao PDR.

Panel A: Percent of firms identifying issue as “biggest” obstacle



Source: WB Enterprise Surveys.

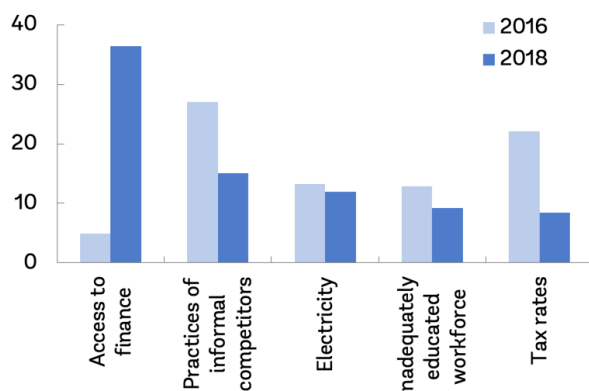
Panel B: Percent of firms identifying issue as “serious” obstacle



Source: WB Enterprise Surveys.

Figure 30: Access to finance has recently become a considerably more prominent obstacle

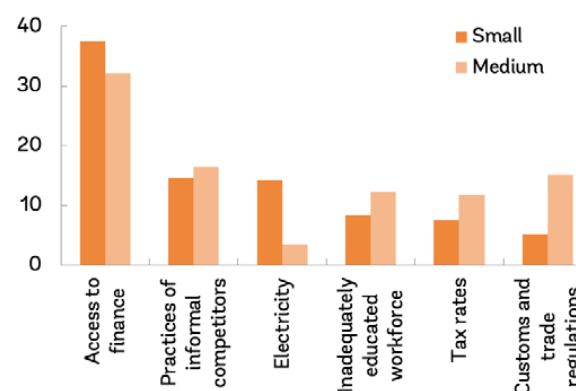
Percent of firms reporting issue as biggest obstacle, 2016 and 2018



Source: WB Enterprise Surveys.

Figure 31: The constraints faced by small and medium sized firms are not always the same

Percent of firms reporting issue as biggest obstacle, small- compared to medium-sized firms, 2018



Source: WB Enterprise Surveys.

³⁴ The stand-out result for access to finance, as evident in Figure 31, is explored in more detail in the following section.

12. There was a notable shift in SMEs' perceptions of the obstacles facing them between 2016 and 2018 (Figure 30). Access to finance appears to have become a significantly more prominent obstacle for businesses in the past two years, with the share of firms reporting it as a biggest obstacle increasing from 5 percent in 2016 to 36 percent in 2018. In contrast, practices of informal competitors and tax rates were much less frequently cited as firms' biggest obstacle in 2018 compared to 2016 survey. These trends are consistent with firms' perceptions of serious obstacles. However, one notable exception is that while the share of firms reporting transportation as their biggest obstacle remained largely unchanged over the past two years, the share of firms reporting it as a "serious" obstacle fell by around a third. This is likely to reflect improvements in the transportation network in Lao PDR during that period - indeed, the country's quality of trade and transport-related infrastructure score improved from 2 to 2.07 between 2016 and 2018.³⁵

13. While there are some similarities between the extent to which the constraints affect small and medium firms, there are also some differences (Figure 31). Both small and medium firms identified access to finance as their biggest obstacle in 2018, followed by practices of informal competitors. However, electricity appears to constrain small firms more than medium firms; small firms are around five times more likely to report electricity as their biggest constraint than medium-sized firms. In contrast, customs and trade regulations appear to constrain medium firms more than smaller firms. This could be because a larger share of medium firms are exporters and therefore are required to interact more regularly with custom and trade regulations.³⁶ Again, these trends are also broadly consistent with the serious obstacles data.

14. The following sections explore in greater detail each of the cited top three business environment constraints, that is, access to finance, practices of competitors in the informal sector, and electricity. The discussion examines how the constraints fit into the broader narrative on Lao PDR's domestic economic trends as well as how it compares in a regional context. The discussion will also offer insights on some of the factors that might be influencing firms to report those issues as a constraint. This will allow for a more nuanced understanding of the challenges facing the surveyed respondent SMEs in Lao PDR.

³⁵ This score is from the World Bank's Logistics Performance Index (LPI). The LPI ranking fell from 152 out of 160 in 2016 to 82 in 2018. The LPI is compiled using data from surveys of global freight forwarders and express carriers.

³⁶ Exporters are defined as firms that derive at least 10 percent of their annual sales from direct exports. In the 2018 enterprise survey sample, 17 percent of medium-sized firms were exporters compared to 7 percent of small firms.

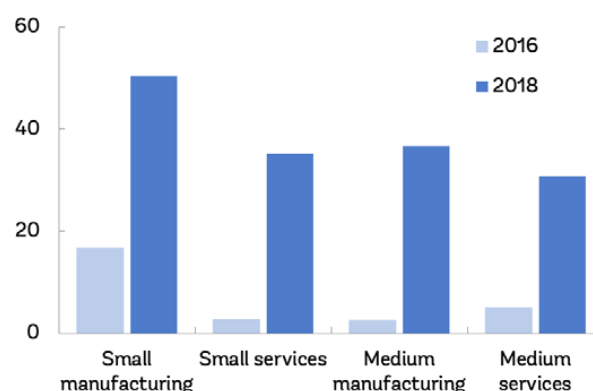
II.4. The leading constraints in detail: Access to finance

Access to finance appears to have recently become a considerably more prominent obstacle, but more so to small businesses.

15. Access to finance stood out as one of the top three prominent obstacles facing respondent SMEs in 2018. The survey data also suggest that access to finance has become a much more prominent issue for firms over the past two years (Figure 32), and this trend has been broad-based across different firm sizes and sectors. It was most frequently cited as the biggest constraint facing registered SME firms in the 2018 Enterprise Survey, with 36 percent of firms reporting it as such compared to only 6 percent in 2016. In line with this, access to finance was the second most cited “serious” obstacle facing businesses, with around 18 percent of firms reporting it to be so. Another notable trend is that, when compared to medium firms, small firms are more likely to report access to finance as their biggest obstacle, as well as a serious obstacle.³⁷

Figure 32: Access to finance has become a more prominent issue for small and medium-sized firms

Percent of firms reporting access to finance as their biggest obstacle



Source: WB Enterprise Surveys.

16. The current credit environment for businesses in Lao PDR appears to be less favorable than most other regional comparator economies. One indicator that provides insight into the state of Lao PDR’s credit environment compared to that in other countries is the Doing Business “Getting Credit” score.³⁸ On this basis, Lao PDR’s credit environment in 2018 was better than that of Myanmar, but less favorable than those of Cambodia, Vietnam, Malaysia, Thailand and Indonesia. According to the 2019 Doing Business report, the credit registry coverage (% of adults)³⁹ in Lao PDR is lower than the regional average: the share of adults covered by the public credit registry is 14.5 percent compared to the EAP average of 16.9 percent; Lao PDR appears to have no private credit bureau coverage (% of adults)⁴⁰ while the average across EAP is 23 percent. Both credit registry and bureau provide banks with the information for assessing creditworthiness of potential borrowers. They aim to reduce information asymmetry to help improve access to credit, improving borrower disciplines, support bank supervision and credit risk monitoring. The Enterprise Survey can also help shed light on this issue.⁴¹ Based on the latest survey data, formal SMEs in Lao PDR are more likely to report access

³⁷ The possibility exists that firms may blame difficulties in obtaining external financing on financial sector conditions even when the non-viability of their own investment projects may be the underlying reason behind their inability of these firms to access finance.

³⁸ The “Getting Credit” indicator is constructed using measurements relating to the legal rights of borrowers and lenders in collateral and bankruptcy laws, as well as the coverage and scope of credit information systems. On a global scale, Lao PDR ranks as 73rd out of 190 countries based on the “getting credit” indicator.

³⁹ Credit registry coverage (% of adults) means number of individuals and firms listed in credit registry as a percentage of adult population.

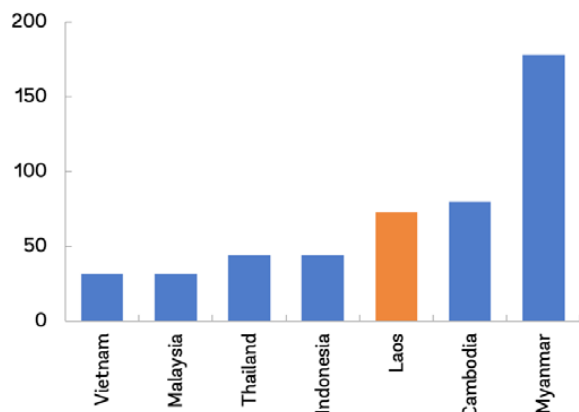
⁴⁰ Credit bureau coverage means the number of individuals and firms listed in largest credit bureau as a percentage of adult population.

⁴¹ There are several differences between the Doing Business survey and the Enterprise Survey. One notable difference is that the Doing Business survey is based on responses from local experts (lawyers, business consultants, etc.) and legal documentation, while the Enterprise Survey is based on firms’ perceptions.

to finance as their biggest obstacle, compared to firms in other countries in the region (Figure 34). Similar results emerge upon consideration of access to finance as a serious obstacle.

Figure 33: Lao PDR ‘Getting Credit’ ranking was less favourable than that for most comparator economies

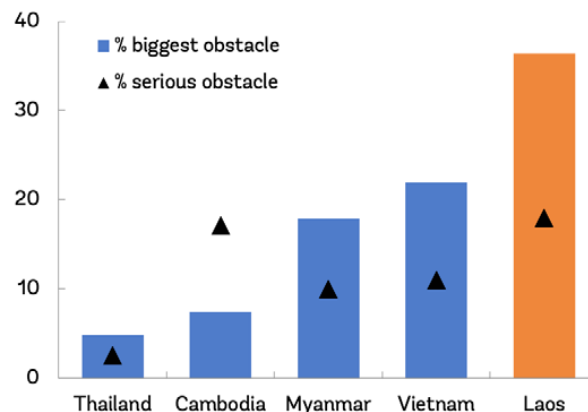
Doing Business ‘Getting Credit’ Ranking, 2018



Source: World Bank Doing Business Surveys.

Figure 34: Firms in Lao PDR are more likely to report access to finance as a constraint compared to neighbouring economies

Percent of firms reporting access to finance as a constraint



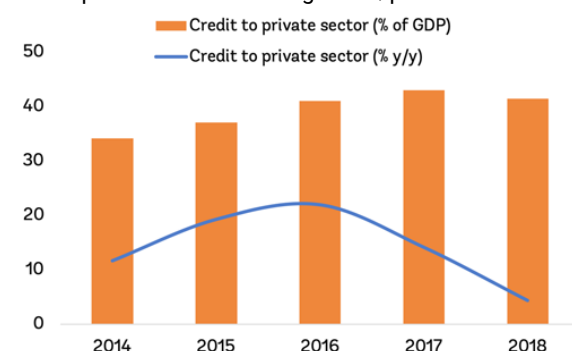
Source: WB Enterprise Surveys.

17. A protracted slowdown in credit growth may have contributed to SMEs perceiving access to finance as having become more of a challenge.

As discussed in Part A, annual growth in private sector credit slowed to around 5 percent in 2018, in line with a general slowdown in economic activity and significant fiscal consolidation efforts. The weakness in credit growth has been broad-based across sectors. In line with this, private sector credit to GDP has eased slightly over the past year (Figure 35).⁴²

Figure 35: A marked slowdown in credit growth has seen credit decline as a share of GDP

Annual private sector credit growth, percent



Source: BOL

18. Structural factors may also be preventing firms from accessing the financing that they require.

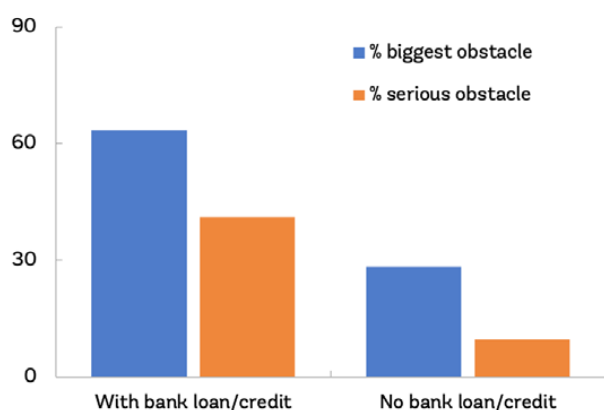
While there has been an increase in the number of banks and non-bank institutions over the past decade, the financial products and services that they offer are limited. There is a lack of supportive credit options for lending to SMEs. In addition, there are still relatively few that operate in rural areas. Microfinance institutions, which serve more in rural areas, have expanded considerably, but from a low base. There were 185 non-banks institutions in 2018, with recorded total lending of 0.6 percent of GDP. In rural areas, the limited financial knowledge and access to formal financial services remains a challenge; people lack the ability to expand their businesses by taking out loans or depositing money safely because there are limited financial services within reach.

⁴² Private sector credit to GDP eased slightly from 43 percent in 2017 to 42 percent in 2018, which follows a period of strong growth in private sector credit to GDP during 2012-17.

19. Firms that already had access to finance from financial institutions were more likely to report access to finance as a constraint.⁴³ For example, firms with a loan or line of credit from a financial institution were much more likely to report access to finance as their biggest constraint compared to firms without; around 60 percent of firms with a loan or a line of credit reported access to finance as their biggest obstacle, compared to around 30 percent of firms that did not have a loan or line of credit (Figure 36). On a related note, firms that are already using banks to finance working capital are much more likely to report access to finance as their biggest obstacle than firms that do not (Figure 37).⁴⁴ More firms with female managers tend to report this obstacle as most of them use internal finance and only a small portion of firms have a line of credit. Another finding of interest is that firms without a checking or savings account are more likely to report access to finance as their biggest obstacle.⁴⁵ Fewer firms with top female managers have saving accounts. One potential interpretation of this is that without a checking or savings account, financial institutions may find it more difficult to assess the financial health of these firms and are therefore more reluctant to lend.

Figure 36: Firms with a loan or line of credit are more likely to report access to finance as an obstacle.

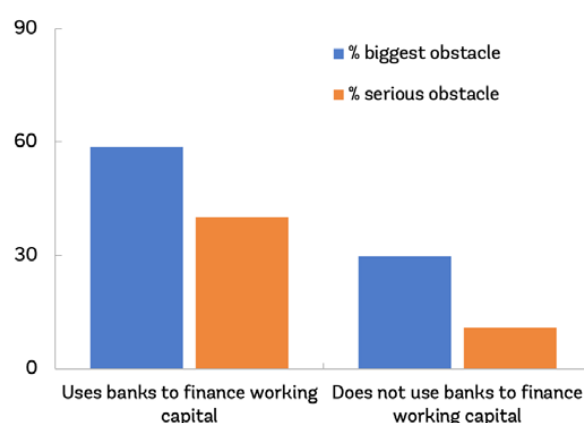
Percent of firms reporting access to finance as an obstacle



Source: WB Enterprise Surveys.

Figure 37: Firms that use banks to finance working capital are more likely to report access to finance as an obstacle.

Percent of firms reporting access to finance as an obstacle



Source: WB Enterprise Surveys.

20. Of the firms that did not apply for a loan but appeared to need one, those that reported access to finance as their biggest obstacle were more likely to cite unfavorable interest rates as their main reason for not applying.⁴⁶ One potential explanation for this is that the real lending interest rates in Lao PDR are fairly high compared to neighbors such as Thailand, Vietnam and China, but similar level with Mongolia, Myanmar and Cambodia (Figure 38). The high interest rates in Lao PDR reflects the higher deposit rates, which means relatively high cost of funds and pricing of risks. In addition, a small portion of firms reported high collateral value requirement and cumbersome process as an impediment. The introduction of an interest rate cap in 2015 also contributed to more

⁴³ These firms are also more likely to cite access to finance as a serious obstacle.

⁴⁴ Around 23 percent of firms use banks to finance working capital. Firms were also asked whether they use banks to finance their investments, but owing to a very small sample size, we do not report the results here.

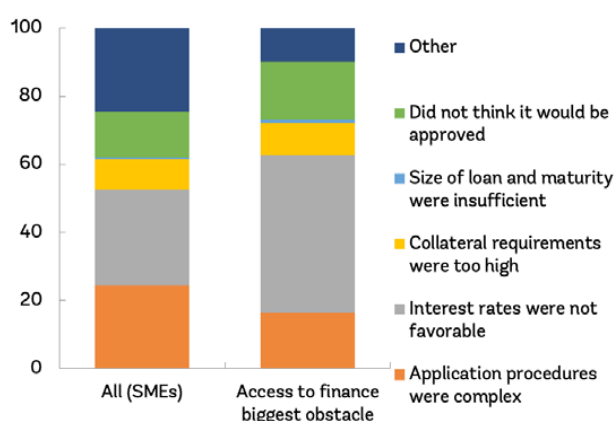
⁴⁵ Around 40 percent of firms without a checking or savings account reported access to finance as their biggest obstacle, compared to 34 percent of those with a checking or savings account.

⁴⁶ Here, as well as in Figure 40 and the following paragraph, we define 'SMEs that do not need a loan' to be those which specified that they did not apply for a loan and their main reason for not doing so was that they had sufficient capital.

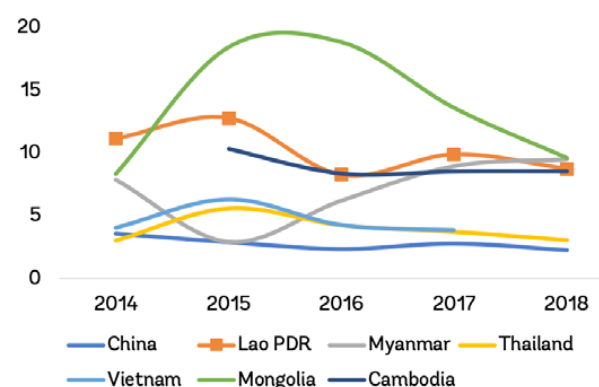
selective lending. However, the high interest rates also reflect high risks associated with potential SMEs borrowers due to their weak management practices, lack of proper accounting and business plans. The removal of interest rate caps in early 2019 may have given banks scope to price risk more appropriately, which may result in them being more willing to lend to SMEs.⁴⁷ Improving credit information about the financial behavior of borrowers will help banks and authorities to better assess risks of potential borrowers. At the same time, SMEs should also work on improving their business and financial plans to improve the creditworthiness and lower risks, which in turn will facilitate access to finance.

Figure 38: Most firms cited high interest rates and complex procedures as constraints to access to finance

Main reason for not applying for a loan; aside from already having sufficient capital; percent of firms



Real lending interest rates are high, but on par with some regional peers



Source: WB Enterprise Surveys.

Source: BOL

21. Low financial literacy is another factor that may be compounding the difficulties that firms face in accessing finance. Of formal SMEs that needed a loan but did not apply for one, around a quarter reported that their main reason for not applying was that the application procedures were complex. It may be the case that business managers with low financial literacy perceive the process of applying for a loan as too complicated and therefore are deterred from applying. Financial literacy in Lao PDR is comparatively low by global standards but is positioned around the middle among similar countries in the region. On the other hand, financial institutions may make the process of applying for a loan relatively more thorough and comprehensive if they do not have other reliable sources of information to judge a firms' performance.⁴⁸ This contributed to the difficulty of banks to appropriately assess and price the risks of the potential SME borrowers. According to the 2013 Economic Census by LSB, less than 10 percent of surveyed firms used proper accounting methods, about 10 percent used only basic accounting and the rest had no accounting methods. This could be a plausible explanation given that the coverage and scope of credit information systems in Lao PDR is considerably weaker than the regional average, as mentioned above.

⁴⁷ The interest rate caps were put in place in 2015. They were based on the following: (i) weighted deposit rates should be no higher than two percentage points above the rate of non-fuel inflation of the previous year; (ii) weighted lending rates should be no higher than four percentage points above deposit rates.

⁴⁸ According to cross-country survey data from the Asian Development Bank Institute, Lao PDR's financial literacy score is lower than that in China, Indonesia, Thailand and Vietnam, but higher than Malaysia, India and Cambodia. Survey data is used to construct the overall financial literacy score, which is based on three components: financial knowledge, financial behavior, and attitudes to longer-term financial planning.

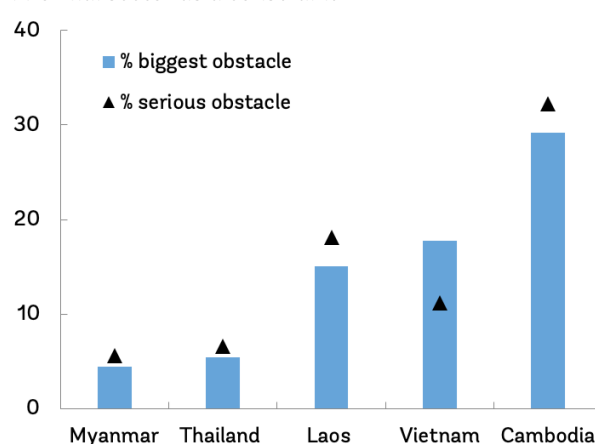
II.5. The leading constraints in detail: Informal Practices

Although practices of competitors in the informal sector became a less prominent a concern in 2018 compared with 2016, they remain among the top-three obstacles, particularly for medium-sized firms. Concerns about informal competitors include their lack of compliance with regulations, and inconsistent enforcement by authorities, which give informal firms an unfair competitive advantage.

22. There are two major types of informal practices that constraint competition and business environment in Lao PDR. First, practices of competitors in the informal sector and second, informal practices of formal firms. Practices of competitors in the informal sector are among the top three obstacles that SMEs face. The proportion of SMEs cited informal competitors declined from 27 percent in 2016 survey to approximately 15 percent of surveyed SMEs in 2018. This may have indicated some improvement in this front. However, the issue was still cited by 1 in every 6 firms as the top constraint. In this respect, Lao PDR sits about midway among selected regional comparators, with the issue being comparatively much less of a concern among SMEs in Myanmar and Thailand, about on par with those in Vietnam, and much more of a problem in Cambodia (Figure 39). In addition, 18 percent of SMEs reported the practices of informal sector competitors as a serious obstacle.

Figure 39: Concerns about informal competitor practices rank about midway compared to in neighboring countries

Percent of firms reporting practices of competitors in the informal sector as a constraint

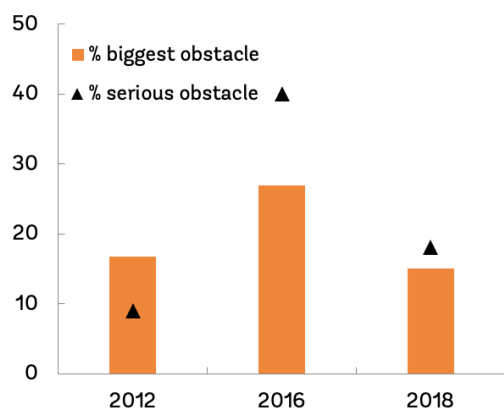


Source: WB Enterprise Surveys.

23. Practices of informal sector competitors were a less prominent concern in 2018 than in the recent past. The Enterprise Surveys conducted in Lao PDR this decade reveal that concerns about informal competitors escalated significantly in 2016, with 27 percent of SMEs reporting it as their leading constraint and 40 percent identifying it as a serious obstacle (Figure 40). While both indicators have subsequently decreased, the much larger decline was in identifying it as a serious obstacle. This means that, for many of the firms for which informal competitor practices were a serious problem in 2016, the issue may have now significantly subsided.

Figure 40: Firms' concerns about informal competitor practices have moderated recently

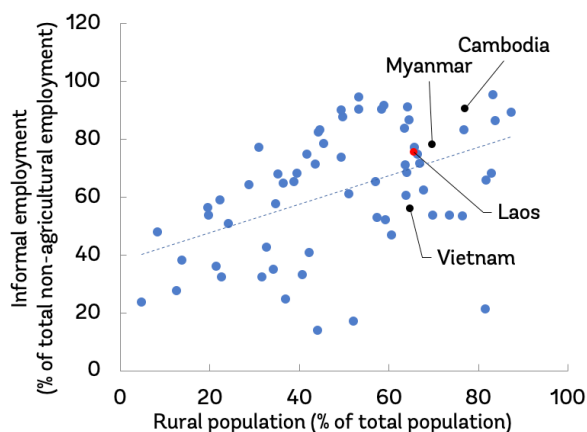
Percent of firms



Source: WB Enterprise Surveys.

Figure 41: Lower urbanization is correlated with higher levels of informal economic activity

Percent of informal employment in total non-agricultural employment; percent of rural population in total population



Source: World Development Indicators.

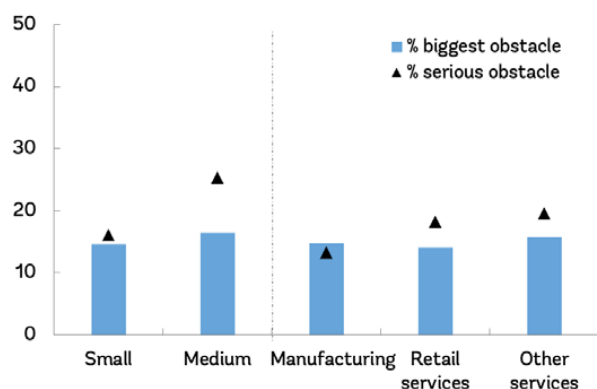
24. The practices of informal competitors pose a major problem to those in the formal sector may not be entirely surprising, particularly in developing parts of Asia where informal activity can represent a substantial share of the economy. In general, there is a positive correlation between the share of the rural population in a country and the prevalence of the non-agricultural informal economy (Figure 41). Considering employment outside agriculture, employment in the informal sector is estimated at around 78.5 percent, but it is almost 100 percent if consider either self-employed or employed in agriculture.⁴⁹

25. Perceptions on informal competitors as a constraint vary among different firm sizes and sectors. While similar proportions of small and medium-sized firms identified this issue as their biggest obstacle, serious concerns were relatively more prevalent among medium-sized firms (Figure 42). It may be the case that medium-sized firms, with their relatively more visible market presence (and, thereby, greater visibility to regulatory authorities), tend to have correspondingly greater concerns about the competitive advantage that informal competitors can exploit (through noncompliance and avoidance of those same authorities). From a sectoral perspective, firms in the services sectors were more likely to identify the practices of competitors in the informal economy as a serious constraint. This might be because formal firms in the services sector are more likely to be in direct competition with firms in the informal economy. The Enterprise Survey does ask firms whether they are in competition with unregistered or informal firms, and those that say yes (about 39 percent of all SMEs) are also much more likely to complain about the practices of these firms. More female-managed firms tend to report that they compete against unregistered firms. Moreover, services sector firms had a marginally higher propensity to report being in competition with informal firms (and the difference was even larger in 2016, as illustrated in Figure 43)

⁴⁹ ILO (2018).

Figure 42: More medium-sized and services-sector firms have serious concerns about their informal competitors

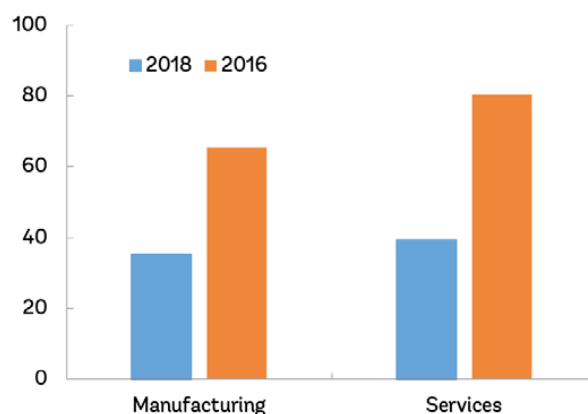
Percent of firms



Source: WB Enterprise Surveys.

Figure 43: Service-sector SMEs are more likely to report being in competition with informal firms

Percent of firms



Source: WB Enterprise Surveys.

26. Looking further into informality, there are four main types of practices that constrain to the business environment covers four areas.⁵⁰ These are: (i) inadequately registered businesses that “fly under the radar”; (ii) tax evasion, including those that are fully registered; (iii) irregular adherence of complex regulations; and (iv) a culture of non-compliance with basic rules and standards, particularly foreign-owned firms. Highly formalized firms claimed to be incurring higher costs and felt unfairly targeted by authorities, while unregistered or rule-flouting competitors were perceived to be escaping the same regulatory burden or official scrutiny. These informal practices may provide informal firms an advantage by avoiding obligations (such as regulations and taxes) that are more easily enforced upon formal businesses while registered and formal firms incur higher costs and feel unfairly targeted by authorities.

27. However, informal firms largely perceive themselves as not being in competition with formal firms. Evidence on informal firms, captured through a specially targeted enterprise survey in 2019, is illuminative while also raising further questions.⁵¹ Despite the elevated concerns about informal sector practices that are evident in the Enterprise Survey, informal firms in Lao PDR seem to be quite isolated from the formal sector both in terms of the distinct product markets they operate in, and the contractual arrangements they enter into. About 75 percent of informal firms report that there are no registered firms that provide the same good or service. This is likely to be the case when the choice of going informal is a survival strategy.⁵² Low-productivity firms may be forced into informal operations or, even if they operate formally, into employing informal workers because this reduces their costs.⁵³ Such “surviving” informal firms are likely to operate in very different markets and sell different products than formal firms. In addition, few informal firms enter into contractual agreements with formal sector firms for the sale of their output (less than 2 percent) and the purchase of inputs (less than 5 percent). This disconnect between the serious concerns that formal firms hold

⁵⁰ World Bank (2017). “Formal Informality: informal practices of formal firms as a key business constraint”

⁵¹ The 2019 Lao PDR Informal Sector Business Survey was conducted in early 2019, focused on the cities of Vientiane and Pakse. Key findings are reported in Box 3 as part of an extended discussion of Lao PDR’s informal economy.

⁵² La Porta and Shleifer (2014).

⁵³ Ulyssea (2018); Boly (2018).

about informal competitor practices and the informal firms' self-reported relative isolation is an unanswered question that warrants further investigation.

Box 3: Let's skip the formalities

A snapshot of the informal economy in two biggest cities, Vientiane Capital and Pakse

The share of informal economy in Lao PDR is one of the highest in the region. Unregistered informal firms account for about 78.5 percent of the total non-agricultural employment in the country, while total informal employment which includes informal employment in informal sector units, formal sector units and households equals 94 percent.⁵⁴ Anecdotal evidence confirms that informal businesses play large roles in many sectors of the economy, including manufacturing, construction, trade, and services.⁵⁵ Such a large informal economy can pose several problems by lowering productivity and growth in the economy

Lower productivity of informal relative to formal firms (henceforth, the productivity gap) is well established in the literature.⁵⁶ Studies focusing on developing countries find that labor productivity of informal firms is lower than that of formal firms by 30 to 216 percent.⁵⁷ Modest technological gains, reliance on unskilled labor, limited economies of scale, and restricted access to services, markets, and funding have been identified as key drivers of the productivity gap.⁵⁸ The analysis that follows uses firm-level data from the World Bank's 2019 Lao PDR Informal Sector Business Survey and the World Bank's 2018 Lao PDR Enterprise Survey of formal firms.⁵⁹ Reported statistics are for firms of all sizes.⁶⁰

The latest evidence on the performance of informal firms in two large cities in Lao PDR (Vientiane and Pakse) points to considerably lower labor productivity in informal firms compared to their formal sector counterparts. Median labor productivity of an informal firm in Lao PDR equals 1.8 million Lao Kip per month compared with 6.6 million for a median formal firm – a difference of about 73 percent. This gap is smallest for retail firms (61 percent) followed by other services firms (77 percent) and highest in manufacturing (80 percent); the gap is also smaller for firms in the capital city (68 percent) than in Pakse (in Champasack) (80 percent).

⁵⁴ LO (2018).

⁵⁵ EMC (2016).

⁵⁶ Loayza and Rigolini (2006); Oviedo (2009).

⁵⁷ Perry et al. (2007); La Porta and Shleifer (2008).

⁵⁸ Jovanovic (1982); Amaral and Quintin (2006); Galiani and Weinschelbaum (2012).

⁵⁹ The survey employed an innovative area-based sampling methodology and collected data on 361 informal sector firms in Vientiane and Pakse. For more details, see www.enterprisesurveys.org.

⁶⁰ However, of the 361 informal firms surveyed, only six had more than four employees.

There is substantial productivity variation across Lao PDR's informal sector firms.

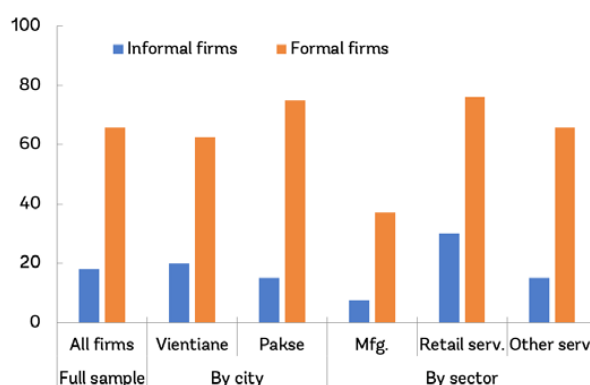
Labor productivity is found to be much higher for firms in the capital city of Vientiane than in Pakse; for retail firms followed by other services and then the manufacturing firms; for firms with owners who have completed post-primary education compared to those with owners who have not; and for relatively small firms in terms of the number of workers. One reason for the relatively higher productivity of the small firms could be that as firms become larger they become more visible and this in turn increases the cost of remaining unregistered.⁶¹

Another reason could be that as an informal firm becomes large, it may wish to formalize to reap the many benefits of being formal. Preparation for formalization can add to firms' costs due to the formalization of processes, improved bookkeeping, and to general record keeping, and even to a degree, registration fees incurred. These can reduce firm productivity by diverting resources and time away from production and towards pre-formalization processes. Thus, consistent with some of the findings in the literature, the informal sector in Lao PDR can hardly be considered as one monolithic whole. This is important in that it suggests that policies aimed at improving the productivity and incomes in the informal sector will depend on the type of informal firm under consideration.

Several factors could be driving the gap in labor productivity between formal and informal firms. Possible factors include extremely small size of informal relative to formal firms, differences in the quality of management, access to markets, and the business environment. Due to data availability, a direct comparison between the business environment experienced by informal and formal firms is limited to physical infrastructure availability (electricity and water supply) and access to finance. The data show that informal firms

Figure 44: Informality is characterized by lower labor productivity

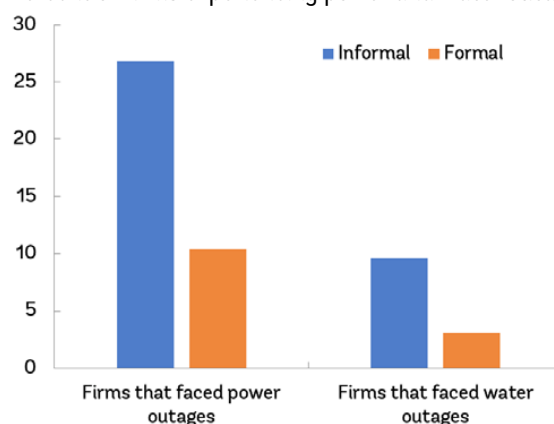
Sales per worker, per month, millions, Lao Kip



Source: WB Enterprise Surveys.

Figure 45: Informal firms experience poorer access to physical infrastructure

Percent of firms experiencing power and water outages



Source: WB Enterprise Surveys.

⁶¹ Amin and Islam (2015).

face poorer quality of power and water supply (Figure 45). That is, a higher proportion of informal firms experience power outages over the last month (27 percent) compared to formal firms (10 percent). The median informal firm endured 2.0 hours of power outages in the prior month, much longer than the 0.6 hours experienced by the median formal firm. While water outages seem to be a smaller concern for both types of firms, there is still a higher proportion of informal firms experiencing water outages in the last month (9.6 percent) compared to formal firms (3.1 percent)..

Seventy six percent of the informal firms in Lao PDR have one or more female owners. This is much higher than in the formal sector where 36 percent of firms have a female owner. Within the informal sector, the retail sector stands out with over 93 percent of the retail firms having a female owner compared with 42 of the manufacturing firms and 44 percent of the other services firms that do so. Controlling for the distribution of the informal firms across sectors, there is no statistically significant difference between firms with a female owner compared with the rest in monthly sales, number of workers, labor productivity, and profits and as a ratio of sales.

Informal firms also appear to be less connected with the financial system. Only 6.6 percent of informal firms have a bank account to run the business compared to the 55 percent of formal firms. Further, the use of external finance is comparatively less common among informal firms. Only 16 percent of them use external finance for day-to-day operations compared to 27 percent of formal firms. Of these 16 percent, 9.7 percent use moneylenders, 3.9 percent use banks, 3.7 percent borrow from friends and relatives, 1 percent use micro-finance institutions and 1.8 percent use other sources. We also observe that only 9.7 percent of informal firms have a loan for the business compared with 27 percent of formal firms that do so. One possibility is that informal firms may not need external finance perhaps due to limited investment opportunities available in the unregistered sector. However, close to 18 percent of the informal firms applied for a loan during the last year itself. Further, when asked if better access to finance is a benefit to them from registering, 60 percent of the firms replied in the affirmative. Thus, it is likely that informal firms are credit constrained.

Several areas of the business environment do not seem to adversely affect informal firms. They seem to face few problems regarding the fulfilment of agreements with suppliers and buyers, crime and paying bribes. When selling to customers during the last year, over 87 percent of the firms report that the agreements were fulfilled frequently without any problems or disputes while the remaining 13 percent reported that this happened only sometimes or never. Similarly, with suppliers, the agreements were fulfilled frequently without any problem for over 97 percent of the firms and less than 3 percent reported any problems. Crime is also low with only 5.6 percent of informal firms experiencing losses due to crime, while a lack of registration does not seem to invite scrutiny by government officials– fewer than 2 percent of informal firms report paying bribes to remain unregistered. A plausible reason for informal firms' limited interface with these business constraints could be that they are engaged in very simple production activities that do not require much support from the business environment. Problems with the business environment are more likely to surface when firms begin to access global supply chains, contract with customers and

suppliers overseas, engage in joint ventures with foreign businesses, and access business support services and development programs.

All considered, Lao PDR's informal sector is pervasive, eclectic, and characterized by low labor productivity. Compared to the formal firms, informal firms experience poorer access to physical infrastructure and greater difficulty in obtaining finance but are less impacted by a number of other typical constraints. A dual-economy view of informality might suggest that these firms operate largely separate from the formal sector and regulatory structures. While this may allow Lao PDR' informal firms to escape some of the problems associated with being informal, it does not make for a dynamic informal sector capable of exploiting available business opportunities in any meaningful way.

Source: WB Enterprise Surveys

Note: This Box was prepared by Mohammad Amin, Senior Economist.



II.6. The leading constraints in detail: Electricity

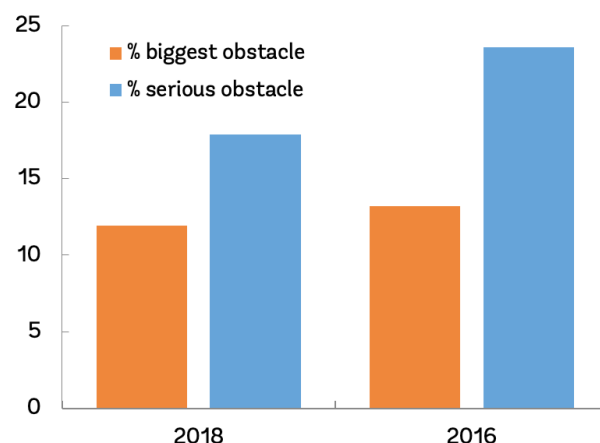
Despite substantial progress on electrification, Lao PDR places only midway among neighboring economies in terms of access to electricity. Inconsistent electricity supply is a problem for the formal and informal sectors, especially for small firms.

28. Electricity is another prominent obstacle facing businesses in Lao PDR, though concerns have moderated recently. Around 18 percent of

firms reported electricity as a serious obstacle, compared to 12 percent of firms reporting it as their biggest obstacle. Electricity was a leading concern among SMEs in 2016 and it remains so in 2018, although there appears to have been some limited improvement over that time (Figure 46). Despite improvements in electricity coverage across Lao PDR over time, there remains significant room for improvement, and firms report facing a range of related frictions such as relatively long delays in obtaining permanent electricity connections and inconsistency in supply after installation.

Figure 46: Electricity appears to be only marginally less of a constraint in 2018.

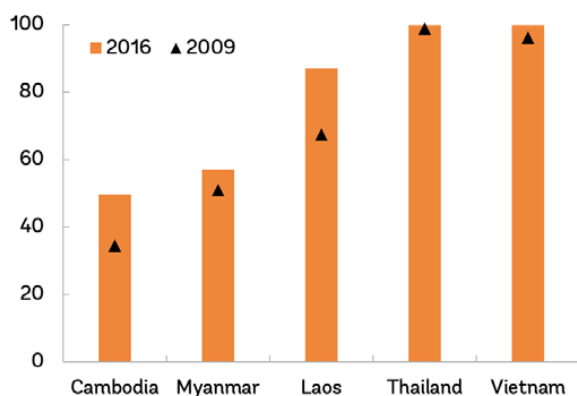
Percent of firms reporting electricity as an obstacle



Source: WB Enterprise Surveys.

Figure 47: Lao PDR ranks midway compared to neighboring economies on access to electricity

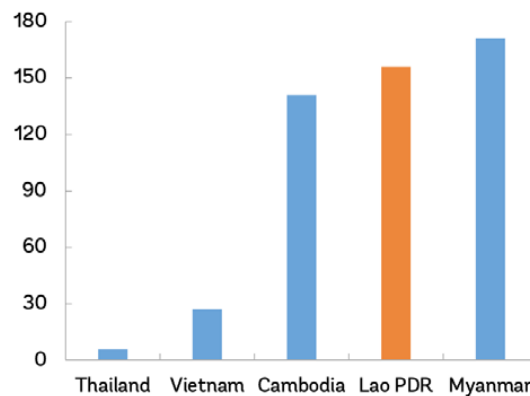
Percent of population with access to electricity



Source: World Development Indicators

Figure 48: Lao PDR ranks relatively poorly on “Getting Electricity” compared to its neighbors

Country rankings for the “Getting Electricity” index



Source: Doing Business Indicators

29. While access to electricity in Lao PDR has increased over the past decade, Lao PDR still ranks only mid-way among neighboring economies (Figure 47). Recent increases in national electricity coverage have been largely driven by improvements in rural areas, but the latter remain relatively underserved with the latest estimates placing urban coverage at 97 percent and rural coverage at 80 percent in 2016. When compared with its neighbors, national coverage in Lao PDR is lower than in Thailand and Vietnam, but significantly higher than in Myanmar and Cambodia.

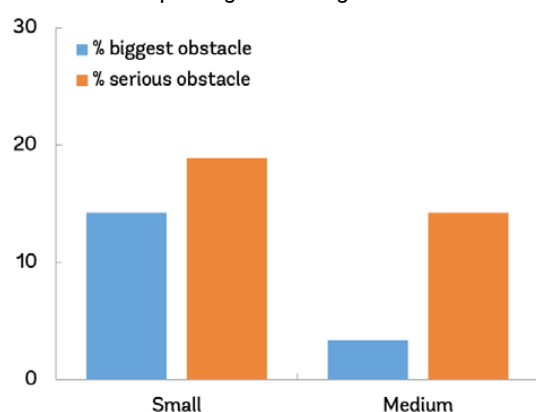
30. The process of obtaining an electricity connection in Lao PDR is notably lengthier and costlier compared to other countries in the region. Lao PDR ranks relatively poorly in the 2019 Doing

Business report in terms of “Getting Electricity”, with a poorer performance than all its neighbors, including two that have much lower levels of national electricity access (Figure 48).⁶² This points to the fact that the availability of grid access does not necessarily ensure that new connections are easy to obtain or that connections are reliable and affordable. For example, setting up an electricity connection takes on average 7 steps and 105 days in Lao PDR, compared to the EAP average of 4.3 steps and 65 days.⁶³ The most time-consuming parts of the process appear to be the site inspection, preparation of technical plan and completion of the external connection works, which can take around a month each. To address these issues, the Ministry of Energy and Mines announced in early 2018 that they plan to reduce the number of steps and length of time involved in the application process to install electricity.⁶⁴

31. Inconsistent electricity supply is a problem for respondent SMEs. According to the enterprise survey, around 78 percent of firms have experienced an outage in the past year. Those who experienced an outage in the past year were a lot more likely to report electricity as a constraint than those who did not. For the firms that experienced an outage in the past year, a mean of 0.3 outages per month was reported (that is, on average, an outage every 3 to 4 months), and these have resulted in estimated mean losses of around 1.3 percent of their annual sales. Poor quality of power supply was also found to be a considerable problem for informal firms according to a follow-up survey on the informal sector (See Box 3). One common way of mitigating the impact of grid outages is through the use of electricity generators, however these can be expensive and unviable for smaller businesses. Small firms were much less likely to own a generator compared to medium firms – only 3 percent of small firms owned a generator compared to around a quarter of medium firms. Reflecting this, small firms were more likely to report electricity as their biggest – as well as a serious – obstacle compared to medium firms (Figure 49).

Figure 49: Small firms are more likely than medium firms to report electricity as an obstacle

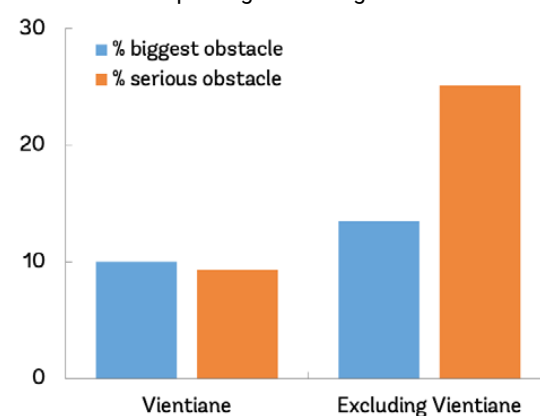
Percent of firms reporting electricity as an obstacle



Source: WB Enterprise Surveys

Figure 50: Electricity appears to be more of a constraint to firms operating outside Vientiane

Percent of firms reporting electricity as an obstacle



Source: WB Enterprise Surveys

⁶² The “Getting Electricity” index measures the process (steps, time and cost) required for businesses to obtain a permanent electricity connection for a newly constructed warehouse. It also takes into account the reliability of supply and transparent of tariffs index.

⁶³ These figures are based on the 2019 Doing Business report. The enterprise survey does have a question on the number of days required to obtain an electrical connection, but the sample size is too limited to draw inferences.

⁶⁴ They noted their target to reduce the number of steps from 6 to 5, and the application time length from 134 days to less than 50 days in 2018 and less than 40 days in 2019. Note that the Doing Business 2019 cites slightly different figures.

32. Electricity was a more prominent concern in provinces other than Vientiane, as the location of the capital, is by far the most urbanized part of Lao PDR, with only around one-fifth of its population living in rural areas compared rates of around 70 to 80 percent in the other regions surveyed by the ES.⁶⁵ It is commonplace in any part of the world for service delivery, including the provision of infrastructure, to be more complicated and costlier outside the capital city. It is therefore not surprising that SMEs find electricity to be more of an obstacle outside Vientiane (Figure 50), where electrical infrastructure is likely to be less widespread and reliable.

II.7. Policy Considerations

33. In summary, labor productivity of SMEs in Lao PDR is low compared to neighboring economies, according to enterprise survey data. Both indicators of labor productivity – sales per worker and value added per worker (for manufacturing firms only) – show that SME firms in Lao PDR rank relatively low compared to regional comparator economies. On the other hand, competitiveness of SMEs in the manufacturing sector in Lao PDR – as measured by unit labor costs – appears to be roughly in line with its regional peers, though this appears to have deteriorated over recent years.

34. Enterprise survey data suggests that formal SMEs are facing constraints in a range of areas – most notably in areas related to access to finance, practices of informal competitors and electricity. One of the stand-out issues – access to finance – appears to have become significantly more of a constraint in the past two years. This could be due to the recent slowdown in credit growth, in addition to other persistent factors such as limited coverage of formal financial services in rural areas, high real interest rates and low financial literacy. Another notable obstacle for formal SMEs was practices of competitors in the informal sector, though interestingly, informal firms largely perceive themselves to operate in isolation from formal firms. Additionally, despite steady progress in electrification in recent decades, electricity remains an issue affecting firms' operations. Firms report facing issues such as substantial delays in setting up a connection and inconsistent electricity supply, with these challenges being most prevalent for small firms and firms in rural areas.

35. The GoL has highlighted the importance of SME development as a driver of economic growth. SMEs account for a notable share of the economy – accounting for well over 95 percent of the number of businesses and more than three quarters of total national employment. Reforms targeted at SMEs have the potential to create a more accommodating and supportive environment for businesses to operate in, facilitating improved performance and growth, and raising the overall attractiveness of Lao PDR's investment climate. The two main government initiatives that have endorsed SME reforms in recent years are the GoL's medium-term strategy, as outlined in the National Socio-Economic Development Plan 2016-20 and the SME development Plan. These plans call stronger cross agency coordination and collaboration in designing policies to promote SMEs and creating feedback mechanism that allows adjustments in policy formulation.

⁶⁵ The other regions are Luang Prabang, Khammouane, Savannakhet and Champasak, where the share of rural population is 68, 78, 78 and 74 percent respectively.

36. Addressing the business constraints is essential to unlock potential of the private sector, including SMEs. Improving productivity would require further investment in human and physical capital,⁶⁶ strengthening institutions and linkages of SMEs to larger businesses and value chains. Improving efficiency and reducing costs of formal processes could be an incentive for formalization of informal firms. In addition, creating a level playing field for the businesses through consistent enforcement of rules and regulations in which firms can compete based on their business capacity will could reduce costs associated with informality. Importantly, improving access to finance for SMEs, as the most cited constraint, could be improved through (i) improving SMEs' capacity in business planning, financial management and adoption of standard accounting; (ii) diversifying financial products and services offered by banks and non-bank financial institutions and (iii) improving credit information coverage for financial institutions and supervision authorities to help better assess risks and promote access to finance. Table below include some measures to help improve competitiveness of SMEs, some of which are covered in the developments to varying extent.

⁶⁶ See further detail in World Bank (2019). "Lao Economic Monitor: Macroeconomic Stability amidst Uncertainty" Thematic Topic: Building Human Capital for Poverty Reduction".



Table 4: Policy considerations for improving business environment for SMEs in Lao PDR

	Potential key actors		
	SMEs	Banks	Authorities
Improving productivity			
Promote and support firms to invest in skills training by encouraging active labour market policies.	X		X
Establish a clear implementation action plan for each area of the reforms under Prime Minister's Order No. 2 on improving the business environment.	X		X
Promote links in value chains with larger businesses	X		X
Improve productivity through investment in human capital and skills development.	X		X
Invest in physical capital, improve maintenance of infrastructure, e.g., electricity, water supply, and transport, to ensure reliability and access.			X
Establish clear monitoring and evaluation and feedback mechanisms for the implementation of the SME development plan.			X
Facilitate the platform for SMEs to understand current and potential markets.	X		X
Improving access to finance			
Establish a coordination mechanism and a consistent approach to SME financing among different agencies involved in providing finance to SMEs (the financial sector, the Bank of Lao PDR (BOL), Lao National Chamber of Commerce (LNCCI), small and medium-sized enterprises, Ministry of Industry and Commerce (MOIC).			X
Develop a variety of financial products and services that cater to SMEs.		X	
Strengthen the capacity of SMEs to develop viable business and financial plans to improve their financial literacy, and improve business and financial management skills.	X		
Expedite the plan to improve the credit information centre and its capacity and coverage to include utility companies (electricity, water, telecom). Encourage more private sector participation.		X	X
Reducing informal practices			
Enforce regulations to create a level playing field for firms to compete. Establish clear operational procedures for relevant regulations to help SMEs navigate and facilitate agency coordination (e.g., one stop service, licenses processes, etc.).	X		X
Improve enforcement of laws and regulations. Make formal procedures efficient and transparent to reduce the cost of formality and reduce the inefficiency related to informality.	X		X

Table 4: Policy considerations for improving business environment for SMEs in Lao PDR

	Potential key actors		
	SMEs	Banks	Authorities
Reducing disruptions in electricity supply			
Continue the current upgrade of the distribution system.			X
Improve efficiency of the management of the distribution system.			X
Improve energy planning, particularly around seasonal changes.			X



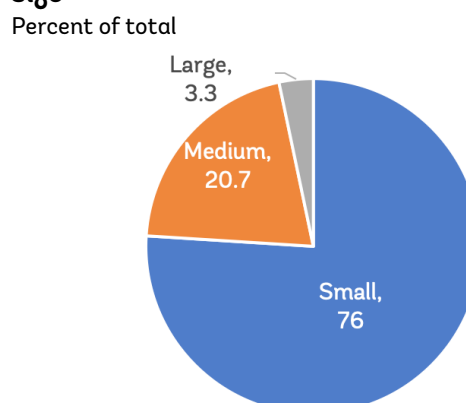
Annex I: Characteristics of respondent SMEs

1. This thematic note considers the results of 2018 World Bank enterprise survey for Lao PDR.

Respondents were interviewed over 2018, and the results are compared to those from the 2012 and 2016 surveys, and with the most recent surveys from neighboring economies: Cambodia, Myanmar, Thailand and Vietnam.⁶⁷ These enterprise surveys aim to capture a representative picture of the non-agricultural, formal business sector. The agricultural and informal sectors therefore remain largely excluded from the scope of this report.⁶⁸ This thematic note also confines consideration to the population of SMEs, which are defined as those

firms with permanent, full-time employment of no more than 20 employees, and those with between 21 and 99 employees, respectively (Figure 51).⁶⁹ Caution needs to be exercised in interpreting the survey results, particularly where multiple layers of interrogation are applied to the dataset leading to small sample sizes and large confidence intervals. The full sample for the 2018 Lao PDR Enterprise Survey comprises just 332 responding firms. Key characteristics of this dataset are 2018 summarized in Figure 51 and 52, using special weights that account for the stratified sampling design.

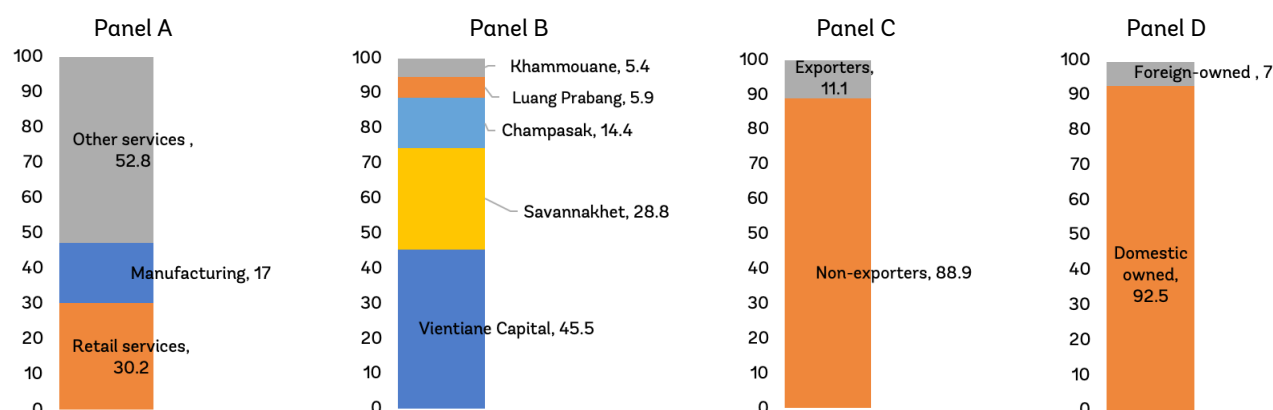
Figure 51: Proportion of the respondents by size



Source: WB Enterprise Surveys.

Figure 52: High-level characteristics of the dataset

Percent of total



Source: WB Enterprise Surveys.

* Firms where exports are greater than or equal to 10% of sales are classified as exporters

** Firms where foreign ownership is greater than or equal to 10% are classified as foreign-owned

⁶⁷ The most recent enterprise surveys for these countries are 2016 for Cambodia, Myanmar and Thailand, and 2015 for Vietnam.

⁶⁸ While informal firms are not captured in the scope of the typical enterprise survey, a separate 2019 Lao PDR Informal Sector Business Survey looked specifically at informal firms in Vientiane and Pakse. Some insights from this are presented in Box 3.

⁶⁹ The enterprise survey covers firms with at least 5 employees. In the survey, the size of firm is determined by the number of employees: small (5-19), medium (20-99), and large (100 or more). However, according to the Decree on SME classification (No. 25/GOL, dated 16 January 2017), the size of enterprise in terms of annual average full-time employees is determined by: micro (1-5), small (6-50), medium (51-99). This thematic note follows the approach taken in the Enterprise Survey, which is to treat these micro firms as if they were small.

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WORLD BANK GROUP

The World Bank Lao PDR
Xieng Ngeun Village, Chao Fa Ngum Road
Vientiane, Lao PDR
Tel: (856-21) 266 200
Fax: (856-21) 266 299
Website: www.worldbank.org/lao

The World Bank
1818 H Street, NW
Washington, D.C. 20433, USA
Tel: (202) 4731000
Fax: (202) 4776391
Website: www.worldbank.org