

Lao PDR Economic Monitor

Macroeconomic Stability amidst Uncertainty

Thematic section:

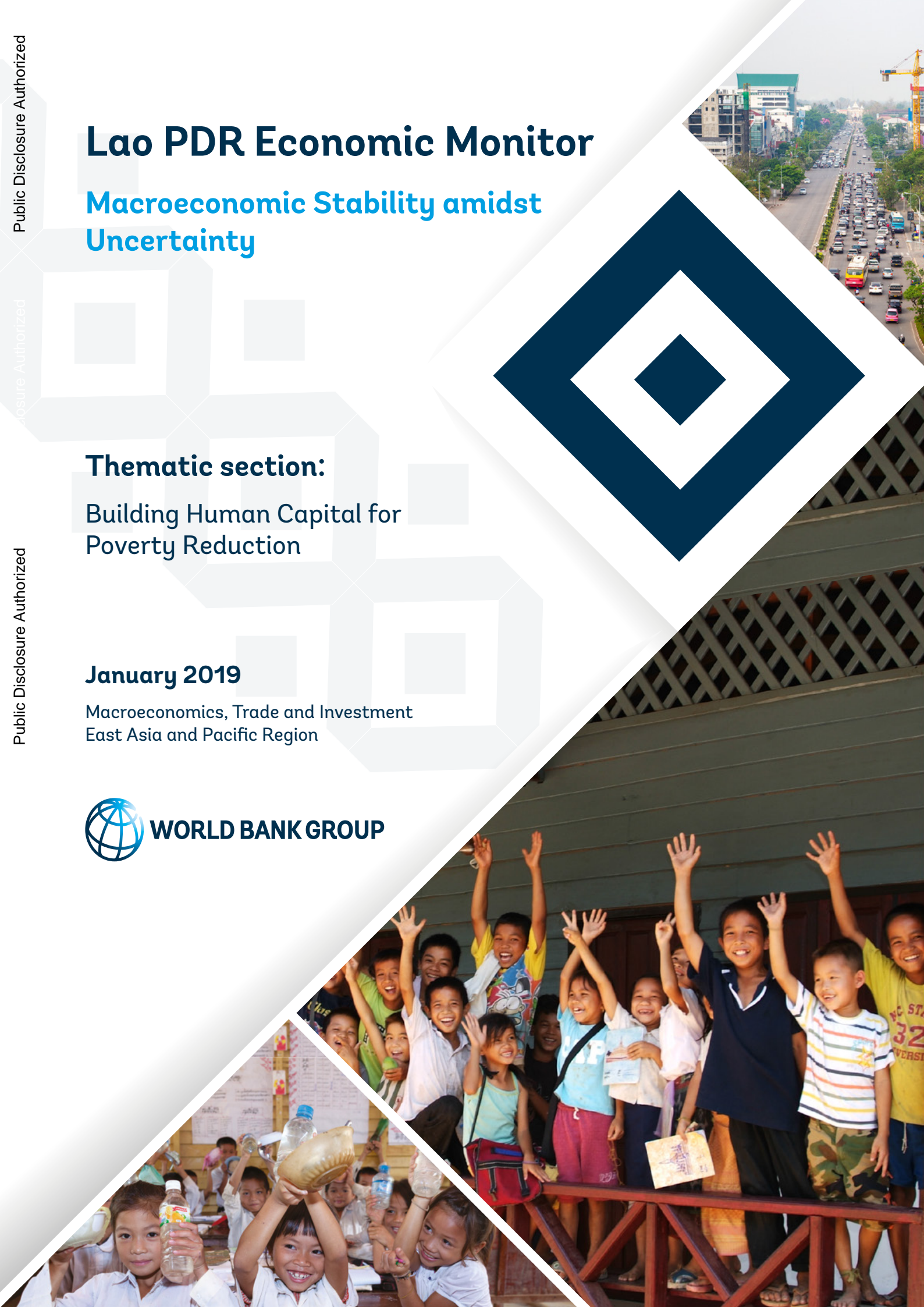
Building Human Capital for
Poverty Reduction

January 2019

Macroeconomics, Trade and Investment
East Asia and Pacific Region



WORLD BANK GROUP



ACRONYMS AND ABBREVIATIONS

AEC	ASEAN Economic Community
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
ESEA	East and Southeast Asia Region
GDP	Gross Domestic Product
ICT	Information and Communications Technology
IMF	International Monetary Fund
LAK	Lao kip
LMI	Lower Middle-income Countries
LNCCI	Lao National Chamber of Commerce and Industry
MOF	Ministry of Finance
MW	Megawatt
NA	National Assembly
NPL	Non-Performing Loan
PDNA	Post-disaster needs assessment
PPG	Public and Public Guaranteed Debt
PPP	Purchasing Power Parity
REER	Real Effective Exchange Rate
VAT	Value Added Tax
WBG	World Bank Group
WEO	World Economic Outlook
yoy	Year on year

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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.

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Recent Economic Developments and Outlook

1. Although decelerating from 6.9 percent the previous year, economic growth in 2018 is estimated to remain robust at 6.5 percent. The slowdown in growth in 2018 has been partly due to a combination of the following domestic factors: (i) the severe floods that hit the country during July–September 2018, which adversely affected agricultural production and damaged infrastructure in several provinces; (ii) the weak performance of the mining sector despite higher commodity prices; and (iii) continued fiscal consolidation, which contributed to slower credit growth. These downside factors offset the gains from the industry sector driven by the expansion of construction activities and electricity exports, coupled with robust growth in wholesale and retail trade.

2. There is evidence of increasing job creation between 2010 and 2017. According to the 2017 Labor Force Survey¹, wage jobs are estimated to have gradually increased since 2010. This has resulted in 28 percent of households situated mostly in urban areas reporting an increase in income. As a result, ownership of consumption goods among the more affluent households increased faster than in poorer, mainly rural, households. Therefore, while poverty is still expected to decline modestly, inequality is likely to have increased.

3. The government intends to remain on the path of fiscal consolidation, with the deficit estimated to decrease to 4.7 percent of GDP in 2018 from 5.3 percent in 2017, owing to some improvement in revenue collection and expenditure restraint. Improved revenue performance has been primarily driven by higher excise revenues due to increasing oil imports coupled with a higher price of oil. Other drivers include an increase in income taxes, dividend earnings, and other non-tax revenues. Strengthened revenue administration, such as the use of electronic tax payment platforms, has also supported revenue mobilization for certain tax types. Public outlays have been rationalized through tighter control of the public wage bill and downward adjustment of non-wage current spending. These measures offset higher interest payments and the increase in capital spending financed by external loans. Fiscal consolidation is estimated to have slowed the accumulation of public debt in 2018, though not enough to reverse the rising debt-to-GDP ratio, which is estimated to increase from 60.1 to 60.6 percent of GDP between 2017 and 2018.

4. The current account deficit is estimated to narrow in 2018, with the support of higher net exports. Key exports have driven the increase in export earnings: electricity, due to more generation; and minerals, due to relatively higher metal prices despite flat output; and the manufacturing of electronic parts for export. These helped compensate for the decline in agricultural exports due to the impact of floods, and lower agriculture commodity prices such as rubber. Import growth slowed due to a moderation in the import of consumption goods despite higher oil imports. As a result, the current account deficit is estimated to decline to 11 percent in 2018 from 12.1 percent in 2017, with the improvement in the trade balance. However, foreign direct investment (FDI) inflows and external borrowing remained inadequate to finance the current account deficit. This, together with

¹ The labor survey was conducted in 2017 and published in 2018

repayments of debt obligations, contributed to a reduction in reserves. Reserves were recorded at US\$812 million in October 2018 and are estimated to remain at that level at year end. At that level, the reserve buffer is expected to remain relatively thin covering 1.1 months of total imports in 2018 compared to 1.5 months in 2017.

5. Increased pressure on the local currency has led to a depreciation of the exchange rate in 2018 and an upward shift in the exchange rate band. The official nominal kip/U.S. dollar reference rate has depreciated by almost 2 percent (yoy) in 2018, while the kip/baht exchange rate depreciated by 7.8 percent. Similarly, the real effective exchange rate for the first seven months in 2018 depreciated by 5.6 percent. The pressure on the kip emanates from both domestic and external factors. Domestic factors include (i) the restrictions placed on the purchase of foreign currency at commercial banks, (ii) and rising demand for foreign currency as a hedge against exchange rate depreciation. External factors include (i) a general strengthening of the U.S. dollar against emerging market economies' currencies, and (ii) higher demand for foreign currency for external debt repayment. The increased flexibility of the exchange rate within the band, a more active interbank market, and moral suasion by the Bank of Lao PDR resulted in the spread between the official and parallel market exchange rates narrowing to below 2 percent (on average) in 2018, which is below the annual average spread of 2.5 percent for 2017.

6. Rising core inflation coupled with higher food and fuel prices during most of 2018, and the depreciation of the kip against the currencies of its major trading partners, contributed to higher inflation in 2018. Core inflation picked up from 0.9 percent to 2.3 percent yoy between 2017 and 2018 due to higher prices, particularly for household furnishings, clothing and footwear, and restaurants and hotels. This contributed to the higher headline inflation rate, which was in line with regional trends. In addition, the headline inflation rate was also driven by (i) rising domestic retail fuel prices of 19 percent yoy; (ii) a rise of 1.2 percent in fresh food prices partly due to the temporary disruption of food supply after the flooding; and (iii) depreciation of the kip against the Thai baht and the U.S. dollar, which resulted in higher import prices by an estimated 3.9 percent in 2018. As a result, the headline inflation was 2 percent in 2018 compared to 0.8 percent in 2017.

7. While the policy interest rates remain unchanged in 2018, credit growth has continued to slow in 2018. Commercial bank lending to the private sector and state-owned enterprises declined from 12 percent yoy in October 2017 to 5 percent in October 2018 due to the moderation of economic activity and tightening fiscal spending. As a result, total credit to GDP is estimated to slightly decline to about 51.5 percent in 2018 from 52 percent of GDP in 2017.

8. In the near term, growth is expected to remain robust. Growth in 2019–20 is expected to remain robust on the back of large hydropower projects expected to begin commercial operation during 2019–20 and continued infrastructure investment. Further, the medium-term fiscal framework envisages a fiscal consolidation path that aims to stabilize and eventually put public debt on a more sustainable path. The budget deficit is expected to decline over the medium term from 4.7 percent in 2018 to 4.3 in 2019 and to below 4 percent in 2020 following revenue improvement and expenditure rationalization. The reduction in the fiscal deficit coupled with the positive impact of a more measured public borrowing strategy, in the wake of the recently passed Public Debt Management Law, is expected to reduce the public debt-to-GDP ratio over 2019–20.

9. The risks to this outlook continue to weigh on the downside. Domestically, notwithstanding the efforts undertaken by the government to consolidate the fiscal position, the fiscal deficit and public debt are at risk of remaining elevated if there is limited progress on domestic revenue mobilization coupled with increased expenditure on infrastructure projects, rising payments on debt service and disaster relief efforts owing to weather-related shocks. In addition, key downside risks to growth include a delay in the construction and operation of other pipeline power projects following the breakdown of the saddle dam of the Xe-Pian Xe-Namnoy project, which triggered tighter supervision over safety. The risk of prolonged flooding may also dent growth in the agriculture sector. Furthermore, external risks include escalating and prolonged trade protectionism, heightened global and regional geopolitical uncertainty, and continued tightening of global financing conditions that could lead to disorderly financial market movements and adversely impact global demand and commodity prices.

10. Addressing the domestic risks associated with macroeconomic challenges remains a key priority, while building human capital can boost productivity and long-term growth. Regarding fiscal and public debt management, the authorities should maintain reform momentum and make further progress as planned through enforcement of the current fiscal measures and maintaining fiscal discipline. Promoting sustainable growth through investing in human capital and improving the business climate, particularly in the non-resource sector, should support job creation and promote inclusive growth.



Thematic Section: Building Human Capital for Poverty Reduction

11. The Lao PDR has room to improve its citizens' skills, health, knowledge, and resilience – that is, its human capital – to make them more productive, flexible, and innovative. Using elements of the Human Capital Index (HCI), developed by the World Bank under the Human Capital Project, the report sets out to answer three questions: (i) Why does human capital matter in the Lao PDR context? (ii) What is the status of human capital indicators? and (iii) How can Lao PDR make further progress in boosting human capital?

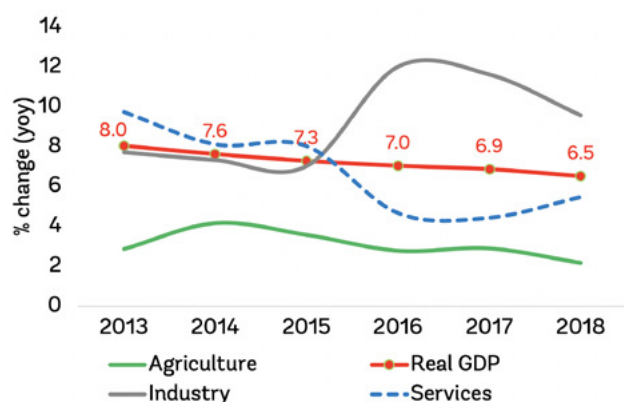
12. In Lao PDR, the HCI improved by 10 percent from 0.41 to 0.45 between 2012 and 2017 but remains lower than is expected for its income level. What this means is that when a child born today in Lao PDR grows up, she will only be 45 percent as productive as she could be if she enjoyed complete education and full health care. Evidence shows that, despite progress, Lao PDR displays significant gaps in human capital outcomes and lags behind when compared to regional peers, leaving the country poorly prepared for achieving sustainable and inclusive growth. Moreover, compared to the average HCI attained by lower middle-income countries and East Asia and Pacific countries, Lao PDR still performs poorly. In the region, Lao PDR's HCI was 0.45 in 2017 compared to 0.47 for Myanmar, 0.49 for Cambodia, 0.6 for Thailand, and 0.67 for Vietnam.

13. In Lao PDR, stunting levels remain relatively high and the quality of education remains relatively low. Although the proportion of children under five years of age who are stunted decreased from 48 percent to 33 percent between 2000 and 2017, it remains relatively high compared to other lower middle-income countries. Those children who are stunted are at risk of cognitive and physical limitations that can last a lifetime. In education, while children in Lao PDR can expect to complete 10.8 years of schooling by age 18, the quality-adjusted learning is relatively low at 6.4 years, implying a learning gap of 4.4 years. Moreover, access to quality education and health and, consequently, educational and health outcomes, have significant variation across (non-mutually-exclusive) characteristics of geographic location, ethnicity, income, and gender.

14. A combination of systemic and sector-specific interventions is needed to enhance human capital development in Lao PDR. Given limited fiscal space, systemic and sector-specific interventions will require prioritization of areas and population groups where education and health outcomes are relatively poor, that is, in rural areas among the non-Lao Tai population, who are usually at the lower income deciles. Interventions should be targeted at the poor and underserved ethnic groups to have the greatest likelihood of reducing disparities in health, education, and labor market outcomes. In many cases, this will require social and behavior change to stimulate demand for and consumption of these services as a large part of the unserved population are ethnic groups in remote areas.

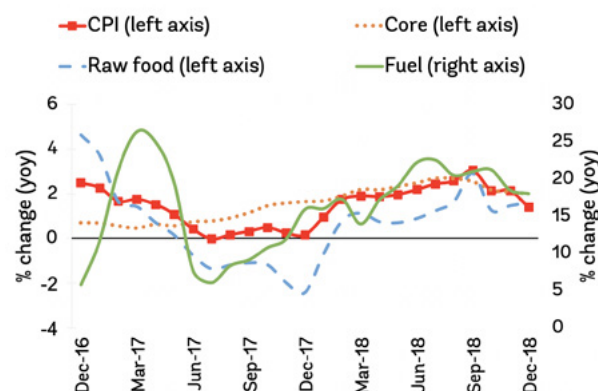
The January 2019 Lao PDR Economic Monitor in figures

Growth remained robust despite the recent floods...



Source: Labor Statistics Bureau.

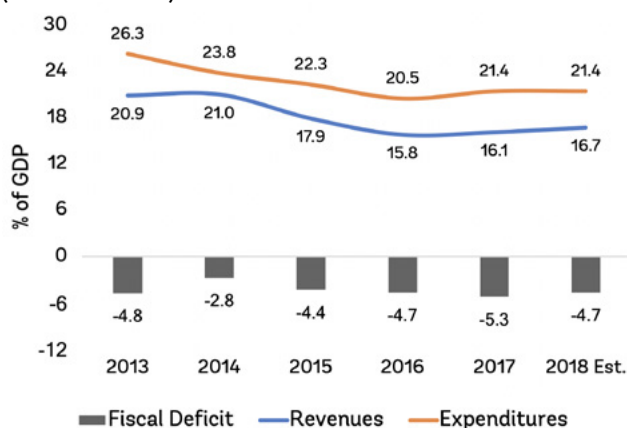
Headline inflation has risen, but declined toward year end



Source: Labor Statistics Bureau.

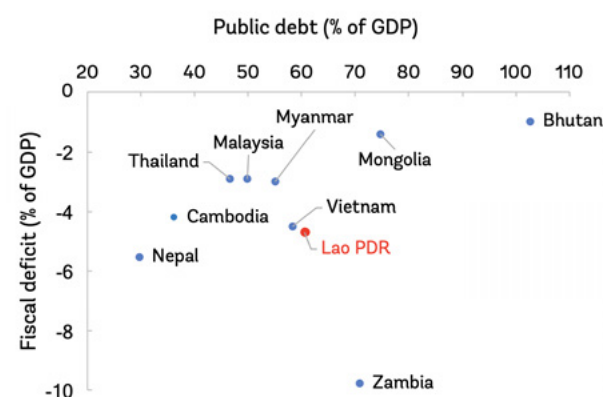
The fiscal deficit remains high but is expected to decline in 2018, following a fiscal consolidation plan

(Percent of GDP)



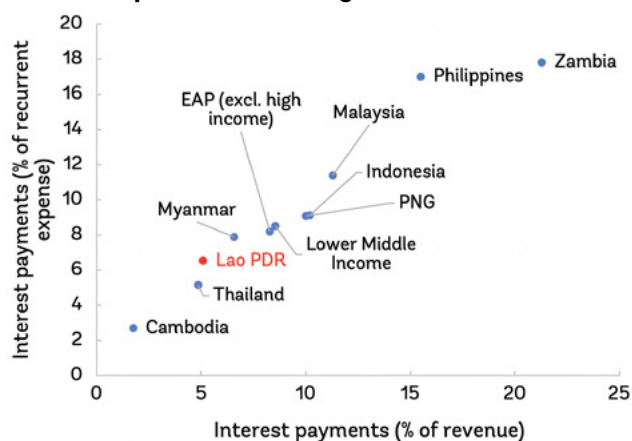
Source: MOF.

Despite a recent fall, the persistent fiscal deficit still results in high public debt in 2018
(Percent of GDP)



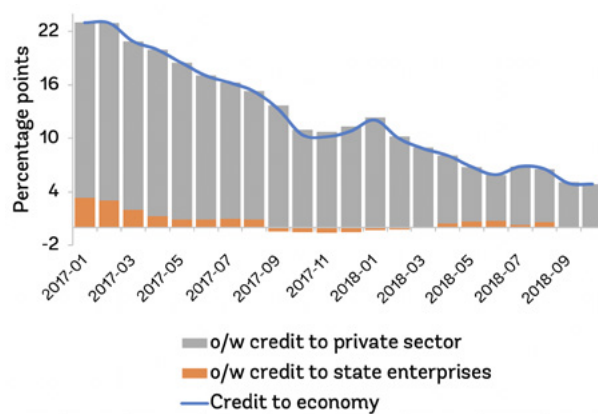
Sources: MOF; IMF WEO October 2018.

Lao PDR's debt services ratios to revenues and recurrent spending have risen, but remain below some comparators, average 2014–16



Sources: MOF; WDI; and International Debt Statistics.

Credit growth has continued to slow in 2018

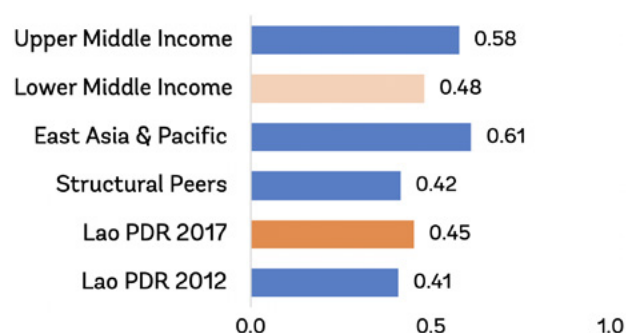


Source: BOL

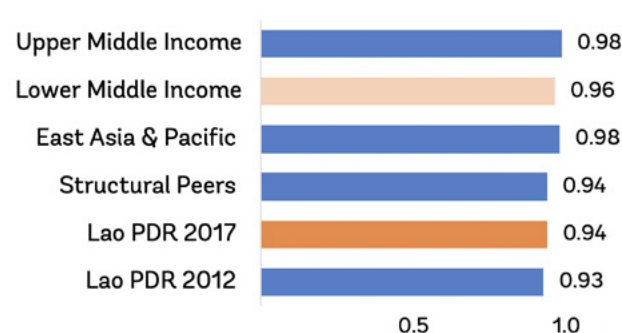
Thematic topic: Building Human Capital for Poverty Reduction

Lao PDR has improved over time in relation to human capital components, but this progress is relatively lower than what would be expected for its income level, particularly on stunting.

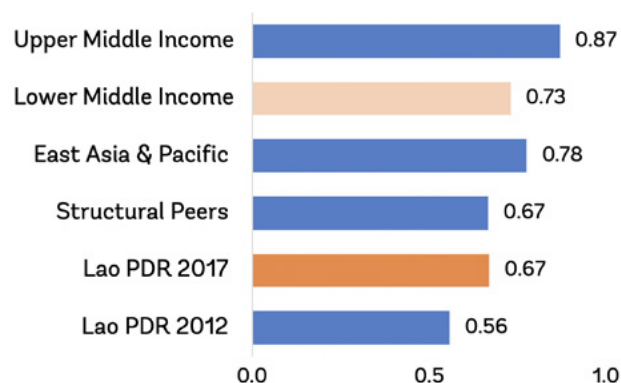
Human Capital Index (HCI)



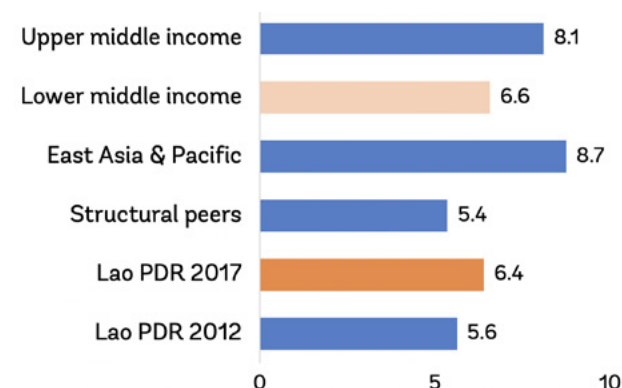
Probability of Survival to Age 5



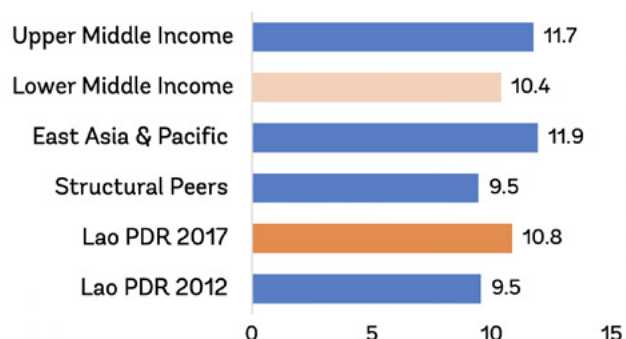
Fraction of Children Under 5 Not Stunted



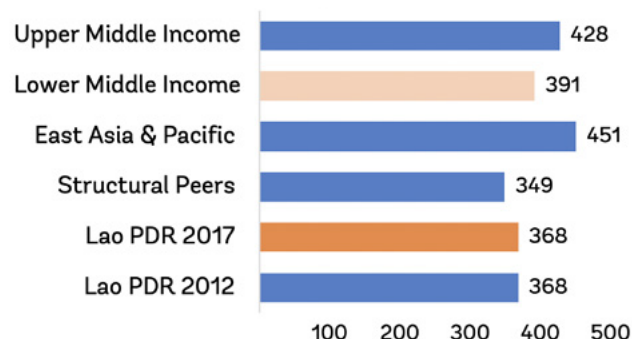
Learning-Adjusted Year of School



Expected Years of School



Hamonized Test Scores



Source: World Bank Human Capital Project.

Note: *The data on harmonized test scores for Lao PDR for 2017 assume the level in 2012 due to the lack of more recent data.

A construction site under a cloudy sky. A large yellow tower crane is prominent on the right side. In the foreground and middle ground, there are several vertical structures made of rebar (steel reinforcement bars) standing on concrete bases. A yellow excavator is partially visible on the left. The scene is industrial and shows active construction work.

Part A

Recent Economic Update

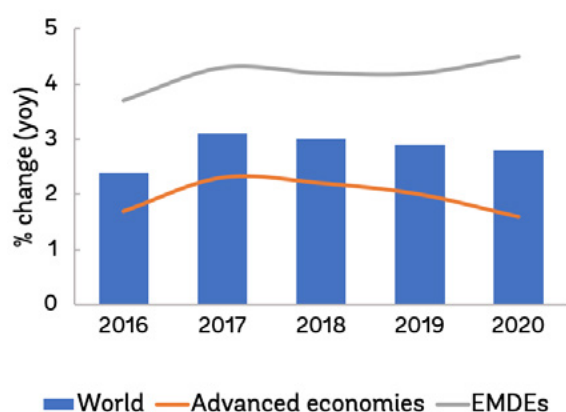
A.1. Recent Economic Developments

1.1. Economic growth

The external economic environment is less favorable

1. The global economic environment has become less favorable, with the recovery in trade and manufacturing activity losing steam (Figures 1 and 2). Global real GDP is estimated to edge down to 3 percent in 2018 from 3.1 percent in 2017, as economic slack dissipates, major central banks continue to roll back accommodative monetary policy, and global trade and investment growth weakens as trade tensions remain elevated. Growth in advanced economies is estimated to slightly decelerate to 2.2 percent in 2018 from 2.3 percent in 2017. Similarly, growth in emerging markets and developing economies (EMDEs) moderated to an estimated 4.2 percent in 2018 from 4.3 percent in 2017, due to deteriorating external conditions and heightened policy uncertainty. In contrast, growth in developing East Asia and Pacific (EAP) remains robust, despite the moderation to 6.3 percent in 2018 from 6.6 percent in 2017.

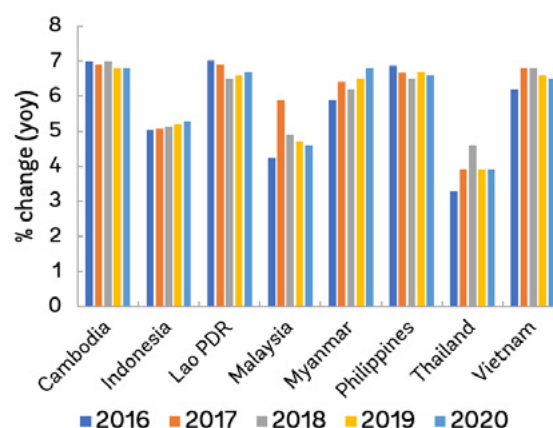
Figure 1: Global GDP growth expected to moderate



Source: World Bank.

Note: EMDEs = emerging markets and developing economies.

Figure 2: Similarly, growth in Lao PDR continues to moderate, but remains strong compared to its regional peers



Source: World Bank East Asia and Pacific Economic Update October 2018.

Lao PDR's economic growth continues to moderate in 2018, but remains relatively robust

2. Real GDP growth in Lao PDR is estimated to moderate to 6.5 percent in 2018 from 6.9 percent the previous year (Figure 3). In addition to the more subdued external economic environment, the slowdown in growth has been partly due to a combination of the following domestic factors: (i) the severe floods that hit the country during July–September 2018, and adversely affected agricultural production and damaged infrastructure in several provinces; (ii) weak performance of the mining sector; and (iii) continued fiscal consolidation, which in turn contributed to slower private sector credit growth. Industry sector growth also moderated due to slower growth in electricity output compared to the high base in the previous year, when new large projects entered full operation (Figure 4).

3. The industry sector continued to be the main driver of growth in 2018 despite some moderation (Figure 4). Although growth in industrial output is estimated to remain robust at 9.6 percent in 2018,

it is lower than the previous year (12 percent). Within industry, the power sector is estimated to grow by 15 percent yoy in 2018 compared to more than 30 percent the previous year. Despite this moderation, the power sector is a key driver, contributing 1.9 percentage points of total real GDP growth. Greater rainfall in 2018, which allows for more power generation, coupled with the addition of an extra 300 megawatts (MW) from three medium hydropower projects, are responsible for the buoyant growth in the power sector.² The construction sector is expected to add 1.5 percentage points to total growth, supported by the ongoing construction of the Lao section of the Kunming-Singapore railway, several hydropower projects, commercial and residential buildings, and repair and some reconstruction of infrastructure affected by the recent floods. In contrast, for the first three quarters of 2018, performance of the mining sector remained weak. Copper output was at a similar level over the same period in 2017, while gold output dropped by 11 percent yoy over the same period. Weak performance of copper and gold production is related to low ore grade. However, higher average metal prices in 2018 helped support nominal growth and export earnings.

Figure 3: Growth remained robust despite the recent flood...

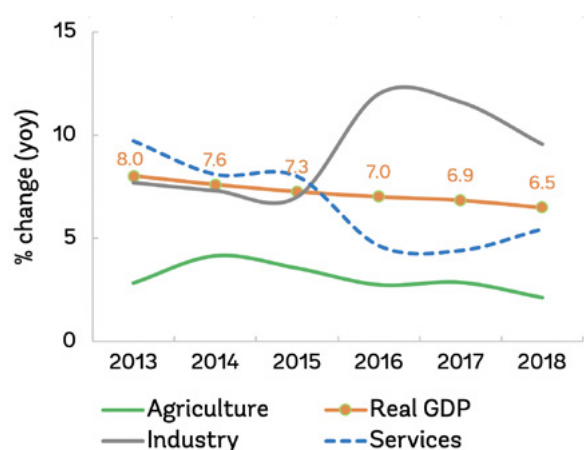
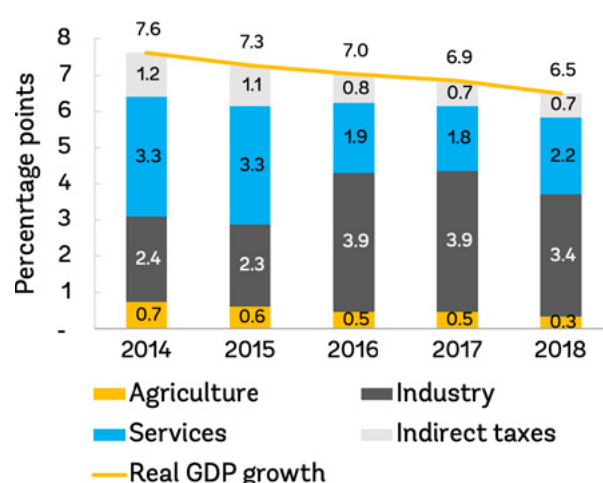


Figure 4: ...driven by the industry and service sectors



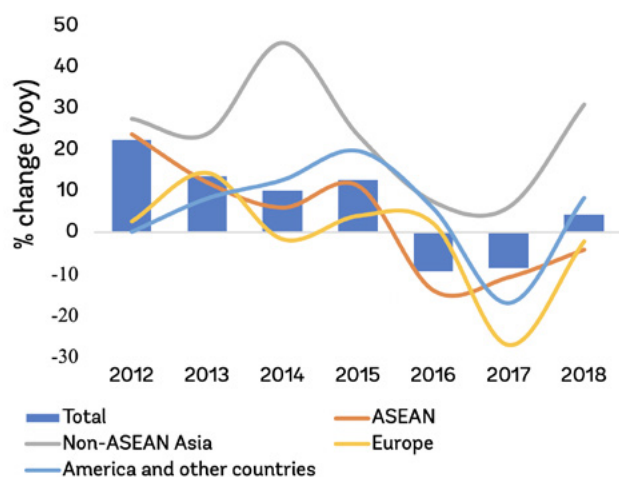
Sources: Lao Statistics Bureau and World Bank staff estimates.

4. Service sector performance picked up mainly due to the expansion of wholesale and retail trade and the gradual recovery of tourism. The service sector is estimated to grow at 5.5 percent this year compared to 4.4 percent last year, contributing 2.2 percentage points to GDP growth. Wholesale and retail trade benefited from the expansion of construction activities and gradual recovery of the tourism sector. This is also reflected in the energy consumption of the trade sector, which grew by 13 percent yoy in Q3-2018. Tourism sector performance is estimated to rebound slightly in 2018 following the regional trends, which are amplified by the Government of Lao PDR's marketing campaigns (Visit Laos Year 2018). Total tourist arrivals increased by 3 percent in the first three quarters of 2018, as the decline in the number of visitors from neighboring countries (Vietnam and Thailand) and Europe was compensated by a notable increase of visitors from non-ASEAN nations (China, the Republic of Korea, Japan, Australia, the United States, and Latin America). Despite the recent downturn in the number of ASEAN visitors, the share of this group remains notably high and accounts for about 65 percent of the total arrivals in 2018 (Figures 5 and 6). Given the changing composition of tourist arrivals to Lao PDR, a proper understanding of different target markets and

² These include Nam Tha 1 (168 MW), Nam Kong 2 (66 MW), and Nam Phay (86 MW).

corresponding positioning of Lao PDR can assist the country in realizing its tourism potential. In the longer term, to promote the competitiveness of green tourism in Lao PDR, it is critical to pursue further policy and regulatory reforms and capacity strengthening for tourism management and promotion, as well as further improving tourism access to and quality of services.

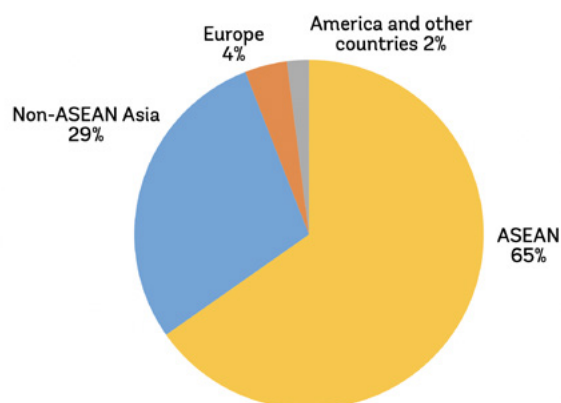
Figure 5: Tourist arrivals began to rebound in 2018 driven by non-ASEAN EAP visitors



Source: Ministry of Information, Culture and Tourism.

Figure 6: Despite the recent decline, tourists from ASEAN still comprised the largest share in 2018

(Percent share)



Source: Ministry of Information, Culture and Tourism.

5. In 2018, growth in the agriculture sector was adversely affected by the recent flooding and lower prices of some key commodities. Agriculture sector growth moderated to about 2.1 percent this year compared to 3.3 percent last year due to the impact of the flooding in Q3-2018. Consequently, the agriculture sector is estimated to contribute 0.3 percentage points to GDP growth in 2018 compared to 0.5 percentage points the previous year. Agriculture output growth, especially for rice, vegetables, rubber, and banana, is expected to slow due to both the flood and lower prices of some key agricultural commodities such as rubber. In particular, key subsectors, such as rice, plantation crops, and fishery, as well as ancillary infrastructure and services related to the sector such as rural irrigation systems and road infrastructure connecting farmers to market, were negatively affected by the flooding during July–September 2018 (see Box 1).

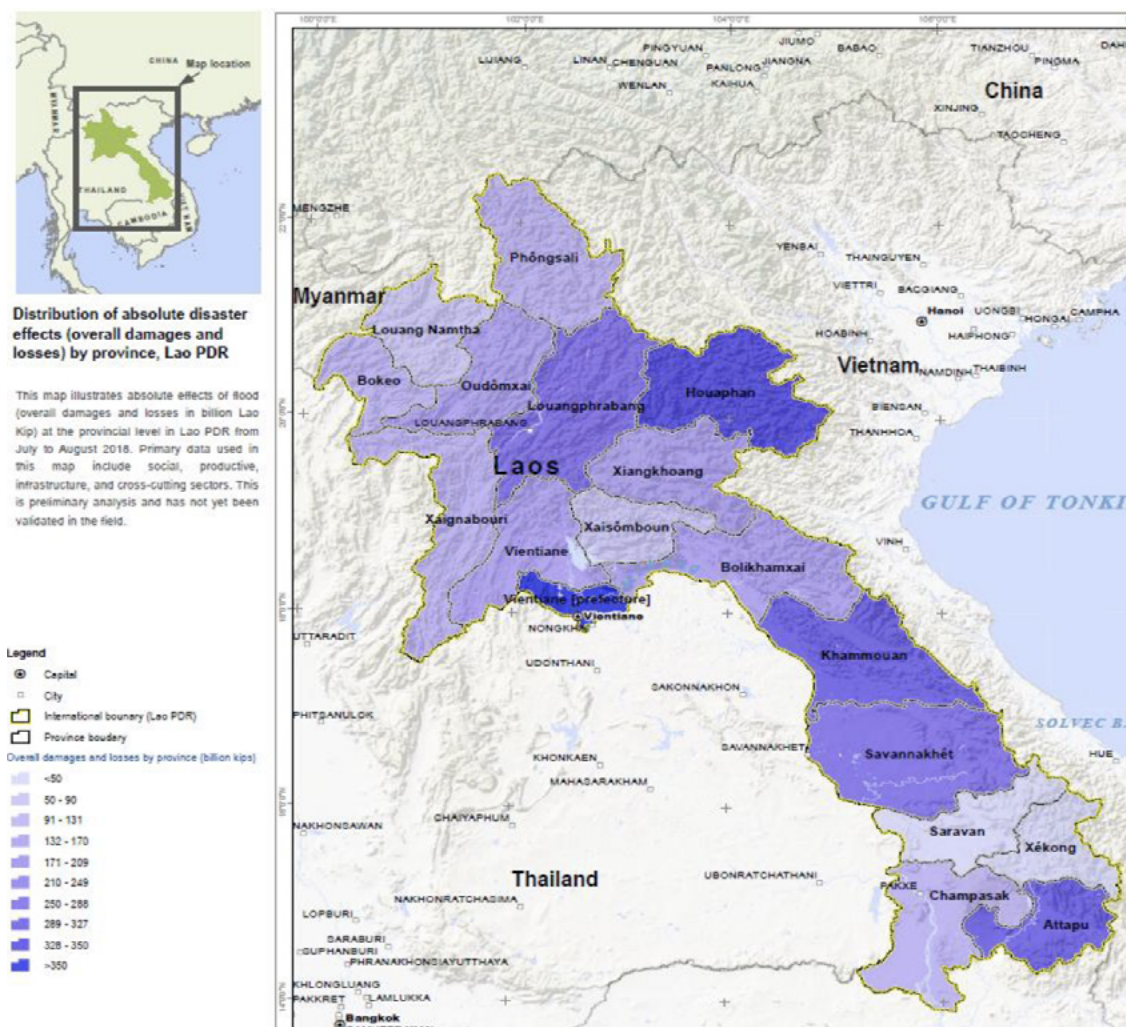


Box 1: Economic impact of the July–September 2018 flooding on the economy

Lao PDR was severely affected by floods and heavy rains during July–September 2018.

On July 18–19, tropical storm Son-Tinh caused heavy rains and flooding in 55 districts covering 13 provinces. The areas that were most affected by the flood include Vientiane Capital, Houaphanh, Khammouane, and Attapeu provinces (Map 1). Flooding in Attapeu province was exacerbated by a breach in the Xe-Pien Xe-Namnoy hydropower saddle dam, which caused an unprecedented flash flood in Attapeu Province that severely affected many lives. In this context, a post-disaster needs assessment (PDNA), led by the government, was conducted covering the impacts on 17 provinces and Vientiane Capital.

Map 1: Distribution of absolute disaster effects (overall damages and losses by province, Lao PDR)



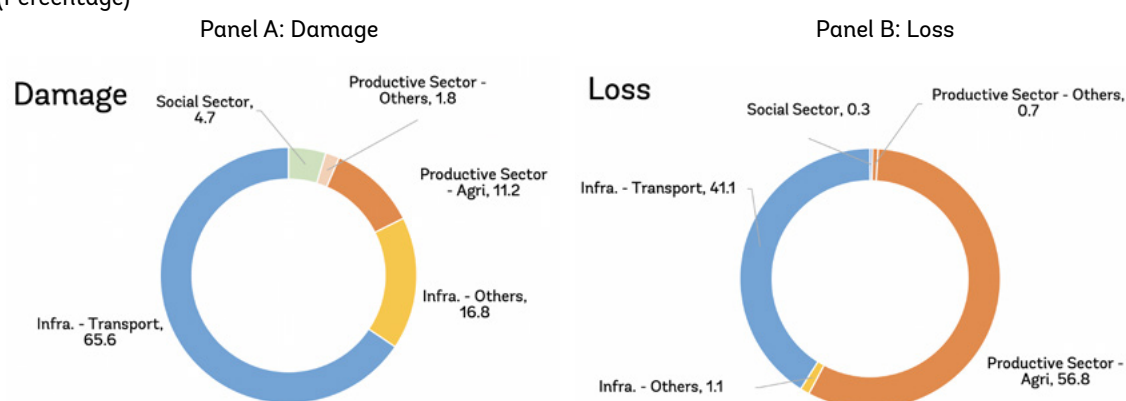
Source: UNITAR, Lao PDR, 22 October 2018

The PDNA estimated the total impact of the floods (damage and loss) on the economy at about 3,167 billion kip (around US\$372 million), of which the total damage accounted for 1,253 trillion kip (around US\$147 million) and the loss totaled 1,914 trillion kip (around US\$225 million). These costs are equivalent to 2.1 percent of losses in GDP in 2018. This

makes the overall impact of the recent floods more significant than the two previous flood events in 2009 and 2011.

The damage and loss due to the floods vary across sectors. The agriculture (mostly crops, livestock, fishery, and irrigation) and infrastructure sectors (mainly land transport followed by water transport infrastructure such as waterways) were the most damaged, accounting for 94 percent of the aforementioned total damage. This damage is estimated to cause the biggest losses in the agriculture and transport sectors (57 percent and 41 percent of total losses, respectively) (Figure 7).

Figure 7: Distribution of damage and loss
(Percentage)



Source: Lao PDR PDNA report (December 2018).

Note: Based on the PDNA guidelines, damage is estimated in terms of the replacement value of both public and private domain physical assets damaged or destroyed, built to the same standards as prevailed before the disaster. Losses are estimated based on the changes in economic flows resulting from the temporary absence of the damaged assets or disruption to access to goods and services in terms of reduced revenue, higher operational costs, and actions taken to reduce risk.

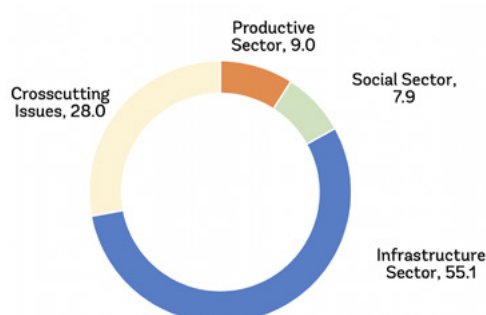
In addition to the impact on economic losses, there is an added fiscal burden, further challenging the government's fiscal consolidation efforts. The floods are estimated to affect the budget in terms of foregone revenues and reprioritization of the expenditure toward the affected regions. As a result, these impacts contribute to an estimated budget deficit of 4.7 percent of GDP in 2018, compared to the pre-flood estimate of 4.3 percent.

At the household level, the floods have had serious implications for people's livelihood and well-being. Unless adequately addressed, loss of income from the destruction of farms and microenterprises, coupled with the disruption of social services, can exacerbate existing nutrition, health, and education challenges. As a relatively significant share of the population is just above the poverty line, disasters such as these can affect the livelihood and move vulnerable groups back into poverty. Establishing a social protection system and prioritizing the recovery of social service provision can help lessen the impacts on the poor.

The short-, medium-, and long-term needs for flood recovery resources are considerable.

Total recovery and reconstruction needs are estimated at around 4.4 trillion kip (around US\$520 million). The needs are higher than damage and losses since they include, first, the application of a “build back better” approach to the reconstruction of damaged infrastructure that improves the weather-resilient consideration and reduces risks; and, second, the resumption of production, service delivery, and access to goods and services. Reconstruction of the infrastructure sector (mostly land and water transport infrastructure) is expected to account for about 55 percent of the total needs followed by crosscutting issues that account for 28 percent. The latter primarily pertains to the need for clearance of unexploded ordinance due to their possible relocation after the floods, to ensure the recovery of livelihood activities (Figure 8).

Figure 8: Summary of total needs for recovery and reconstruction
(Percent)



Source: Lao PDR PDNA report (December 2018).

Signs of more job opportunities, but further human capital development needed to realize potential

6. There is evidence of increasing job creation between 2010 and 2017, but disparity is likely to have persisted. According to the 2017 Labor Force Survey,³ wage jobs are estimated to have gradually increased since 2010,⁴ resulting in 28 percent of households situated in mostly urban areas reporting an increase in income. At the same time, the median monthly income, including cash and in-kind transfers, for employees in rural areas was 1.7 million kip (equivalent to US\$203) compared to 1.9 million kip (equivalent to US\$227) in urban areas. This reflects limited formal wage employment opportunities and the lower skill level among rural communities. As a result, possession of consumption goods among better-off (mainly urban) households increased faster than in poorer (mainly rural) households. A gender gap is also notable. The earnings of female employees were reportedly 0.5 million kip (equivalent to US\$59) per month less than men, which partly reflects socioeconomic constraints for women in obtaining formal wage employment. Therefore, while poverty is still expected to decline modestly, inequality is likely to have increased between 2012 and 2017.⁵

³ The latest survey available.

⁴ Reported average gross monthly income of an employee, including primary income in cash and in-kind payments and secondary income, was about 2.5 million kip (about US\$297 at the exchange rate of 8,352 kip/US\$ in 2017) and the median was 1.8 million kip (about US\$ 215).

⁵ Based on the last survey in 2012/13, the Gini coefficient measuring consumption inequality was 36.2. An increase in the Gini coefficient suggests higher inequality in the society in terms of consumption.

7. Despite continued growth in job opportunities for certain subsectors, a lack of skilled labor and relatively low labor productivity remains a challenge at a broader level. Overall labor productivity growth has been slowing and is still lagging the regional average (Figure 9). The moderate growth in overall labor productivity is related in part to the limited availability of skilled labor, reflecting the relatively lower level of educational attainment (Table 1). This is confirmed by the enterprise survey finding in 2016 that a lack of skilled labor is one of the top constraints for doing business in Lao PDR. This underscores the importance of improving productivity through building human capital and skills as a factor in fostering diversification and improving the distribution of income. The thematic topic (in Section B) will explore the status of human capital in Lao PDR and how the country can further build its human capital.

Figure 9: Labor productivity growth in Lao PDR has been slowing

(Percent)

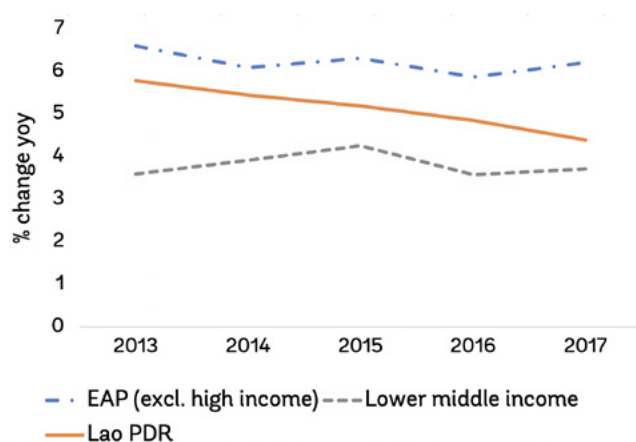


Table 1: Most of the labor force has acquired up to lower secondary education

(Percent)

	Male	Female	Total
No formal education	9	6	13
Up to lower secondary education	68	69	67
Upper secondary education	4	4	3
Vocational education	14	15	13
University and upper	6	6	5

Source: Lao PDR Labor force survey 2017.

Source: World Development Indicators.

Note: Number measured as GDP per person employed (in constant 2011 PPP dollars).



1.2. Fiscal developments

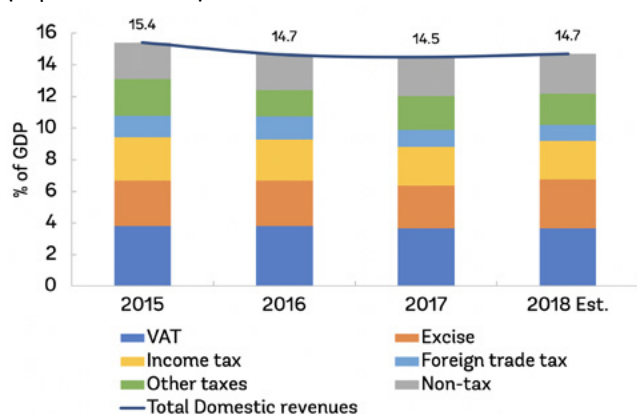
The fiscal deficit is expected to narrow in 2018 due to improvements in revenue collection and tighter control of public spending

8. The fiscal deficit is expected to fall in 2018 supported by some improvement in revenue mobilization and tighter control of public spending. Total revenue is estimated to rise to 16.7 percent of GDP in 2018 from 16.1 percent the previous year due to an improvement in domestic revenues and grants. Based on preliminary information up to Q3-2018, despite the foregone revenues due to flooding, domestic revenue for 2018 is estimated to rise to 14.7 percent of GDP from 14.5 percent over the same period in 2017 (Figure 10). The improvement in revenue performance has been mainly driven by higher excise tax revenue due to increasing oil imports coupled with the higher price of oil. Other drivers include an increase in profit and income tax as a result of improving tax administration. Dividend earnings and other non-tax revenues remained resilient. This improvement in revenue offset the decline in revenue receipts from trade and value-added taxes, partly due to exemptions on imports of capital goods related to some investment projects. Grants as a ratio of GDP are estimated to increase to 2 percent from 1.6 percent in the same period, partly due to inflows related to post-flood assistance.

9. Much needed regulatory reforms and the modernization of revenue administration are expected to improve efficiency. For instance, electronic tax payments through the banking system introduced for road tax payment since end-2017 has resulted in a six-fold increase in road tax receipts from about 10 billion kip to almost 60 billion kip in 2018. An electronic payment system for land tax was also launched in December 2018. This should be coupled with measures to promote access to and compliance with the system. In addition, the tax department recently adopted a Tax Revenue Information System (TaxRIS), initially in five pilot provinces and the Tax Department at the central level. The adoption of TaxRIS is expected to improve the efficiency of tax collection, to enable systematic monitoring of revenue collection and to better manage tax database. In addition, the legal framework is also being strengthened with the approved value-added tax law. These measures are necessary given that Lao PDR revenue performance remains below its structural⁶ and regional peers (Figure 11).

Figure 10: Excise tax collection is expected to boost domestic revenue collection

(In percent of GDP)

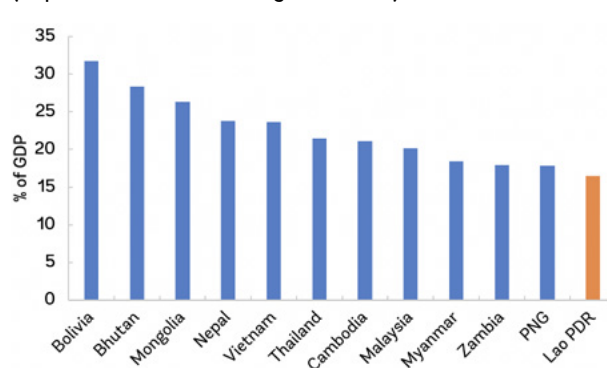


Source: MOF and World Bank staff estimate.

Note: VAT = value-added tax.

Figure 11: Revenues in Lao PDR are lower than its structural and regional peers

(In percent of GDP, average 2016–17)



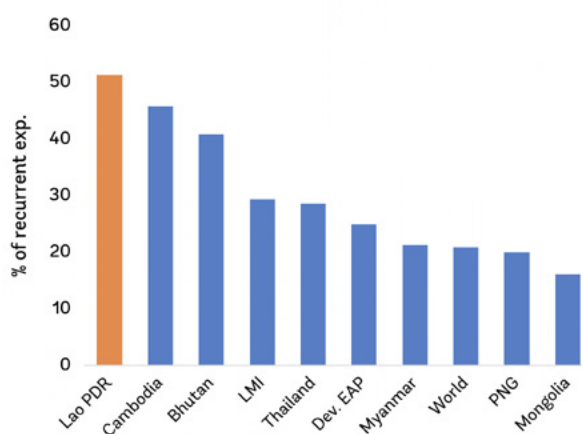
Source: IMF Government Financial Statistics.

⁶ See Box 4 for the definition of structural peers

Expenditure rationalization has contained public spending as a ratio to GDP, although debt service payments continue to rise

10. Measures to control spending in 2018 are estimated to have contained public spending as a percentage of GDP at the 2017 level. To contain the fiscal deficit, the wage bill and other recurrent spending continues to be tightly controlled. Authorities have reduced the new staff intake from 5,000 in 2017 to 3,000 in 2018 and placed a freeze on the public wage index. Taking into account retirements, this will limit the increase in the total number of civil servants, which already accounts for a relatively high percentage of the population (about 5.3 percent) compared to the average for lower middle-income countries (around 3 percent). As a result, the wage bill is estimated to decline to slightly below 7 percent of GDP in 2018, from almost 10 percent of GDP in FY2012/13.⁷ Despite this declining trend, wages still account for a relatively high share of recurrent expenditure and revenues compared to regional peers (Figure 12). At the same time, non-wage recurrent spending and transfers were cut.⁸ These measures helped keep recurrent spending (excluding interest payments) at around 11 percent of GDP in 2018 compared to 13 percent of GDP in FY2015/16.

Figure 12: Civil service wage spending in Lao PDR appears high compared to structural and regional peers



Source: World Development Indicators.

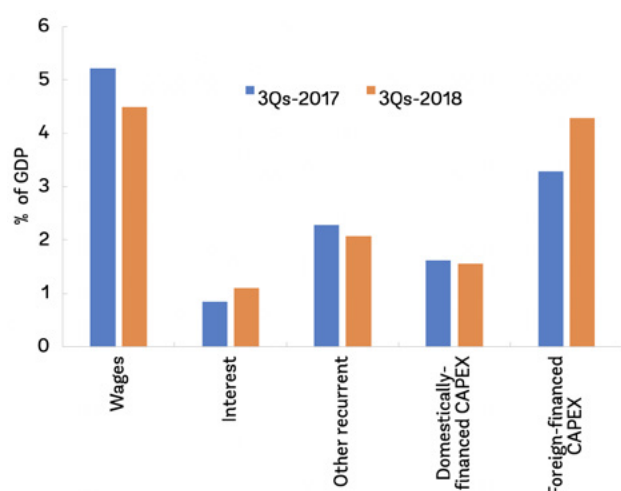
Note: Dev. EAP = developing East Asia and Pacific; LMI = lower middle income. PNG = Papua New Guinea

11. However, the gains from rationalizing domestically-financed spending (excluding interest expenditure) have been offset by an increase in foreign-financed capital spending (Figure 13). While domestically-financed capital spending has been contained, foreign-financed capital spending in the first three quarters of 2018 rose to 4.3 percent of GDP from 3.3 percent over the same period in 2017. The increase in foreign-financed capital spending is due to investment in infrastructure projects. In 2018, domestically-financed capital expenditure underwent some reprioritization, including the reported 100 billion kip to the flood-affected areas, which was primarily for recovery of agricultural inputs and infrastructure.

⁷ The budget year was changed from the fiscal year (October-September) to calendar year starting from 2017.

⁸ Reducing non-wage recurrent spending has the unintended consequence of putting pressure on already underfunded operational expenditure to ensure adequate public service delivery.

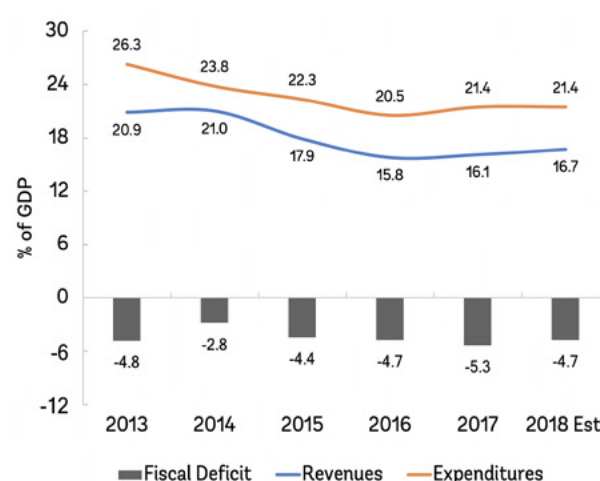
Figure 13: Adjustment in recurrent spending offset the increase in debt service and foreign-financed capital spending
(Percent of GDP)



Source: MOF.

Note: The budget changed from fiscal year (October–September) to calendar year in 2017.

Figure 14: The fiscal deficit remains high but is expected to decline in 2018
(Percent of GDP)



Narrowing fiscal deficit slows public debt accumulation

12. Fiscal consolidation is estimated to slow the accumulation of public debt over the medium term, though not yet enough to reverse the debt-to-GDP ratio in 2018 (Figure 14). The fiscal deficit is estimated to narrow to 4.7 percent of GDP in 2018 from 5.3 percent in 2017. Despite this estimated decline in the fiscal deficit in 2018, the cumulative impact of relatively high, successive fiscal deficits over the recent past has pushed the debt-to-GDP ratio upward. Public debt is estimated to rise from 60.1 percent of GDP to 60.6 percent of GDP between 2017 and 2018, which is relatively high compared to regional peers, except Bhutan, Mongolia, and Zambia (Figure 15).⁹

Figure 15: The estimated fiscal deficit and public debt for Lao PDR remained high compared to regional and structural peers in 2018
(Percent of GDP)



Source: IMF World Economic Outlook October 2018.

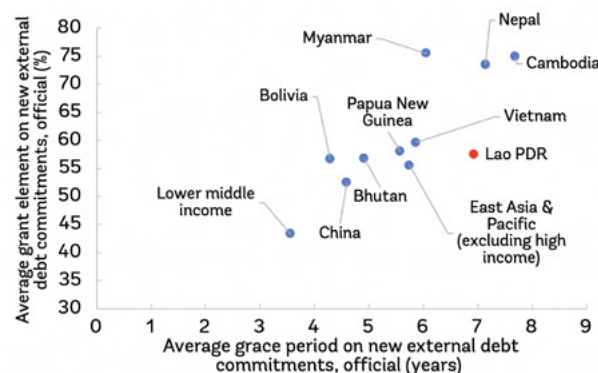
13. Public debt is mostly external and denominated in U.S. dollars. In 2017, public external debt accounted for 82 percent of total public debt (50.5 percent of GDP), with domestic debt (primarily Treasury bonds and bills) accounting for the balance (10.1 percent of GDP) in 2017. According to International Debt Statistics data, Lao PDR's external debt is mostly denominated in U.S. dollars (63 percent of total external debt), a higher share than Vietnam's (56 percent), Nepal's (52 percent), and Papua New Guinea's (55 percent), but still below the average for developing EAP countries (75 percent) and lower middle-income countries (71 percent). For countries such as Lao PDR with a relatively

⁹ Both Mongolia and Zambia are defined as Lao PDR's structural peers (see Box 4).

high public external debt ratio, this means that a sudden and significant depreciation of the Lao kip is a key risk to public debt sustainability.¹⁰ To mitigate the foreign exchange rate risk, toward the end of 2018, the Ministry of Finance began the process of issuing domestic bonds through the Lao Security Exchange in an effort to develop the domestic debt market and mitigate risks associated with external debt.

14. While the Lao PDR debt portfolio is relatively more concessional compared to its peers, the proportion of concessional debt to total external debt has declined. The majority of Lao PDR's external debt is concessional, with both a relatively high average grant element (57 percent) and average grace period (7 years) compared to the other lower middle-income-country group averages (43 percent and 3.6 years, respectively) and some structural peers (Figure 16). Nonetheless, the proportion of less concessional borrowing has increased, mostly to finance equity investment in projects that are expected to generate an economic return, such as those in the power sector.

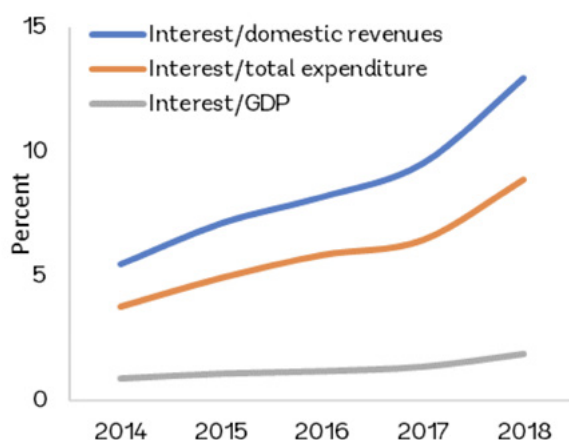
Figure 16: The borrowing terms in Lao PDR are still relatively more concessional compared to its peers



Source: *International Debt Statistics*.

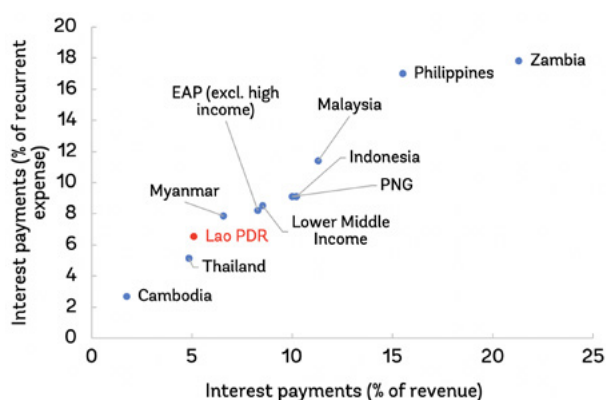
15. The relatively high debt level and increasing share of less concessional borrowing have pushed up debt service payments. Interest payments are estimated to nearly double as a share of domestic revenue from 7.1 percent in 2015 to an estimated 12.9 percent in 2018, or as a percentage of GDP from 1.1 percent to 1.9 percent over the same period (Figure 17). On average, the share of interest payments in Lao PDR to domestic revenues and recurrent spending was higher than that of Cambodia and Thailand, but lower than that of lower middle-income countries (Figure 18). For comparison, the estimated interest spending in 2018 is almost as high as the planned public expenditure in health, and about half the expenditure in education.

Figure 17: Lao PDR's debt services ratios to revenues and recurrent spending have risen...



Sources: *World Development Indicators*, *International Debt Statistics*, and *Ministry of Finance*.

Figure 18: ...but debt services remain below some comparators, average 2014–16



Sources: *World Development Indicators*, *International Debt Statistics*, and *Ministry of Finance*.

¹⁰ This represents a foreign exchange rate risk whereby a sharp and sustained depreciation of the Lao kip against the U.S. dollar would increase public debt service payments.

16. Notwithstanding the fact that public debt is primarily concessional, Lao PDR faces a high risk of debt distress. Based on the previous Debt Sustainability Analysis published in March 2018, Lao PDR was assessed as at high risk of debt distress, as the projected ratio of debt service to revenue breached the indicative threshold. However, risks are expected to be partly mitigated by returns to power sector projects that have been financed by external borrowing.

17. This underscores the importance of fiscal consolidation and improving public debt management.

Given that the projected increase in the ratio of debt service to revenue drives this assessment, it would be prudent to reduce the proportion of commercial borrowing and total debt levels to reduce the pressure on debt services and/or improve revenue performance in the near future. Considering this, the government commits to fiscal consolidation, amidst rising fiscal pressure from the recent floods by focusing efforts on robust revenue collection and/or reducing non-productive public expenditure. By committing to focus its financing needs on concessional terms, the Government of Lao PDR 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.



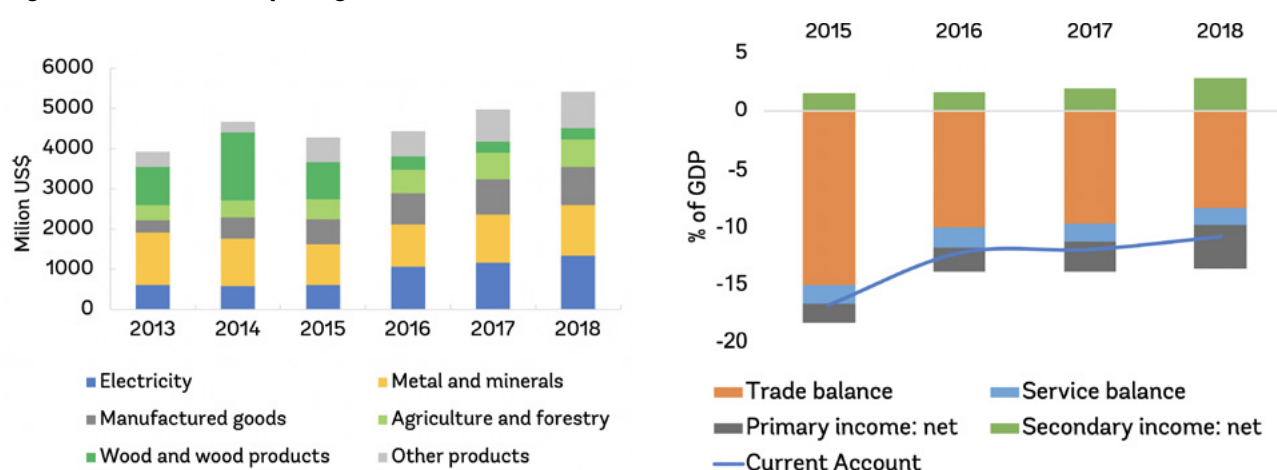
1.3. External sector

A lower trade deficit in 2018 is expected to help narrow the current account deficit

18. Robust export growth continued into 2018 but at a slightly slower pace. Lao PDR exports are estimated to reach US\$5.4 billion in 2018. This represented an increase of 9 percent in 2018, slightly lower than the 12 percent export growth in 2017. In 2018, exports that have driven the increase in export earnings were electricity due to more generation, minerals due to higher metal prices despite flat output, and manufacturing exports due to an increase in capacity. Electricity exports to Thailand climbed by 23 percent in the first three quarters of 2018 due to greater generation capacity supported by heavy rainfall this year. Mining exports are estimated to rise slightly to US\$1.26 billion in 2018 supported by the copper and gold price effect, given that output remained flat. Exports of manufactured goods, including electronic parts, are estimated to continue expanding, despite slight moderation due to a high base for expansion in recent years, particularly from the Special Economic Zones. These trends in export growth in 2018 further supported the rise in non-resource exports.¹¹

19. In addition, in 2018, gains in these sectors compensated for weak agricultural exports (Figure 19). Agricultural export growth decelerated, with growth in crop production estimated to significantly decline due to the flooding, while the growth of some commodities such as rubber are expected to slow due to lower rubber prices, which were also affected by the international trade tension. In addition, despite rising trade tensions between the United States and China, Lao PDR's exports to China during January–October of 2018 rose by 30 percent yoy. Therefore, potential impacts on trade and investment flows due to the trade tensions are expected through their impact on the Lao PDR's trading partners and volatility in commodity prices, such as rubber, metal, and oil prices. Any adverse impact of the trade tensions on other countries will also negatively affect FDI flows into Lao PDR.

Figure 19: Robust export growth contributed to a lower current account deficit in 2018



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

20. Despite higher oil prices, the moderation in import growth narrowed the trade deficit to an estimated 8.5 percent of GDP in 2018 from 9.9 percent in 2017. Merchandise imports grew at an

¹¹ Non-resource exports have risen rapidly in recent years, with their share in total exports increasing to reach slightly over 50 percent of total exports for the first time in the last decade.

estimated 5 percent yoy. In 2018, fuel imports and imports of capital goods remained buoyant. Fuel imports rose by an estimated 40 percent this year, reflecting continued buoyant demand, despite higher oil prices. Similarly, imports of capital goods and construction materials also picked up, partly to support construction of the Lao section of the Kunming-Singapore railway (which was reportedly 40 percent complete by Q3-2018), pipeline power projects, and other infrastructure projects. In contrast, increasing import substitution for some products such as cement, completion of some construction projects, and slowing growth of imports of some consumption and household goods have contributed to the moderation in import growth.

21. The improved trade balance helped to narrow the current account deficit to 11 percent of GDP in 2018 from 12 percent the previous year. The improvement in the trade balance is expected to compensate for the rising net income outflows owing to outflows in remittances and debt service outlays. Despite this reduction in the current account deficit, it remained relatively high. The current account deficit was mostly financed by FDI inflows and external borrowing, with the balance covered by foreign reserves.

22. Despite some moderation, FDI inflows grew at 11 percent yoy in the first three quarters of 2018, reaching US\$1.1 billion. Almost 40 percent of the inflows are related to the construction sector, particularly the construction of the Lao section of the Kunming-Singapore railway line, which has a high import content. This helps offset the decline in investment in the mining sector (as the key mines mature) and the power sector (with the completion of some power projects). China remains the largest investor accounting for almost half of the FDI inflows, followed by Thailand, which accounts for almost 30 percent.

Declining foreign currency reserves owing to a myriad of factors

23. Despite a narrowing trade deficit, foreign currency reserves remained relatively low at US\$812 million in October 2018 (Figure 20). By year end, reserves are estimated to remain at the October level, representing a US\$200 million decline of total foreign exchange reserves over the year. Estimated total foreign exchange reserves at the end of 2018 translated to 1.1 months of total imports or 1.6 months of non-resource sector imports or 2.2 months of non-FDI--related imports compared to 1.5 months, 2.1 months, and 3 months in 2017, respectively (Figure 21).¹² The reserve buffer is expected to remain relatively low due to structurally weak export growth in the non-resource sector and debt service payments. This decline in reserves was due to (i) a drawdown of government deposits primarily for external debt service payments, (ii) some intervention in the foreign exchange market to manage the volatility of the currency (notwithstanding a more flexible currency), and (iii) financing the continuing current account deficit.

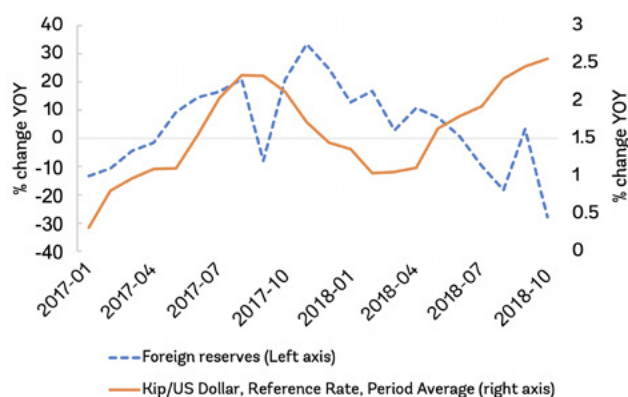
Kip depreciates against U.S. dollar

24. Increasing pressure on the local currency has led to an upward shift in the exchange rate band, resulting in a depreciation of the exchange rate in 2018. The official nominal kip/U.S. dollar reference rate depreciated by almost 2 percent yoy in 2018, while the kip/baht exchange rate depreciated by 7.8 percent (Figure 22). Similarly, based on available information, the real effective exchange rate for

¹² The total foreign exchange reserves estimate for end-2018 is around 25 percent of foreign currency liabilities in banks or 17 percent of foreign currency deposits.

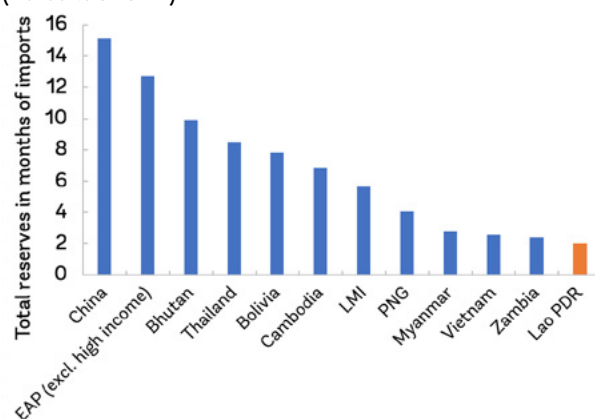
the first seven months in 2018 also depreciated by 5.6 percent. The pressure on the kip emanates from both domestic and external factors. Domestic factors include (i) the restrictions placed on the purchase of foreign currency at commercial banks, and (ii) rising demand for foreign currency as a hedge against exchange rate depreciation. External factors include (i) a general strengthening of the U.S. dollar against emerging market economies' currencies (Figure 23), and (ii) higher demand for foreign currency for external debt repayment. The increased flexibility of the exchange rate within the band, a more active interbank market, and moral suasion by the Bank of Lao PDR resulted in the gap (spread) between the official and parallel market exchange rates narrowing to below 2 percent (on average) in 2018, which is below the annual average spread of 2.5 percent for 2017.

Figure 20: Foreign reserves have declined
(Percent yoy)



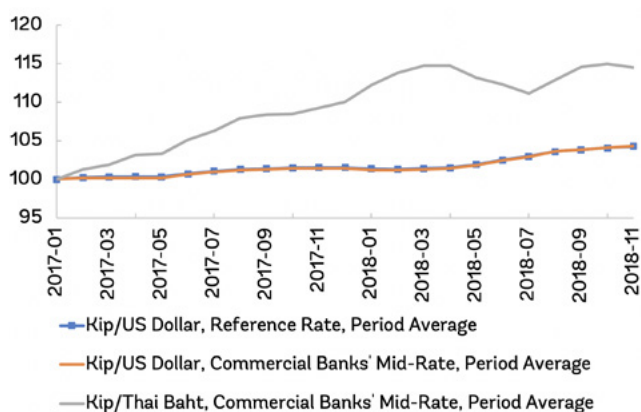
Sources: BOL.

Figure 21: Lao PDR has low reserve adequacy ratio, 2017
(Percent of GDP)



Sources: International Debt Statistics.

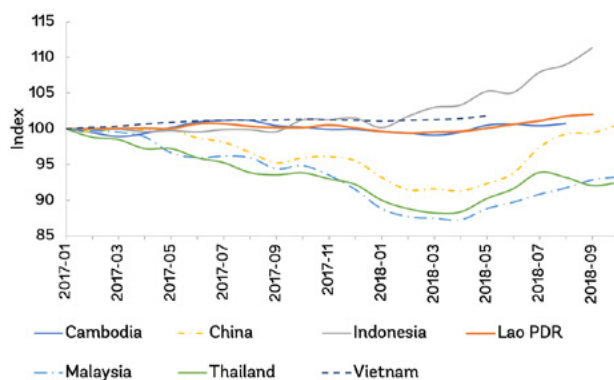
Figure 22: The kip has depreciated against the U.S. dollar and the Thai baht
(Index kip-US\$ Jan 2017 = 100)



Sources: BOL; World Bank staff calculations.

Note: An index increase means local currency depreciates against the U.S. dollar.

Figure 23: The U.S. dollar strengthened against most regional currencies
(Index local currency/US\$ Jan 2017 = 100)



Sources: IMF International Financial Statistics.

Note: Index increase means local currency depreciates against U.S. dollar.

1.4. Monetary policy and price developments

Rising oil and food prices coupled with a depreciating kip pushes up inflation

25. Rising core inflation coupled with higher food and fuel prices during most of 2018, together with the depreciation of the kip against the currencies of Lao PDR's major trading partners, contributed to higher inflation in 2018. Core inflation is estimated to pick up from 0.9 percent to 2.3 percent yoy between 2017 and 2018 due to higher prices for household furnishings, clothing and footwear, and restaurants and hotels. The headline inflation rate has edged upward, similar to regional trends, to an estimated 2.1 percent in 2018, up from 0.8 percent the previous year (Figures 24 and 25). The headline inflation rate was driven by (i) rising domestic retail fuel prices of 19 percent yoy; (ii) a rise of 1.2 percent in fresh food prices due to the temporary disruption on food supply after the flooding; and (iii) the depreciation of the kip against the Thai baht and the U.S. dollar, which resulted in an increase in import prices by an estimated 3.9 percent in 2018.

Figure 24: Headline inflation has risen, but declined toward year end

(Percent yoy)

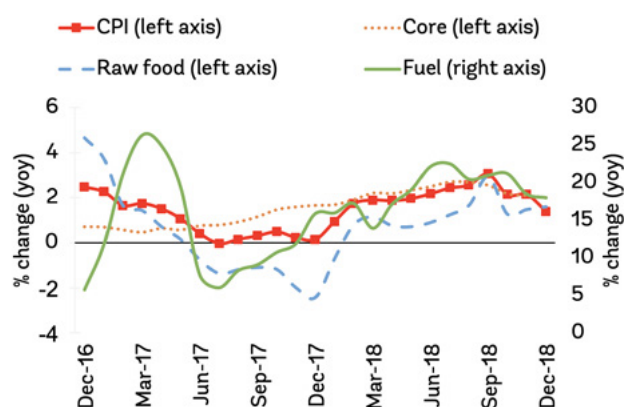
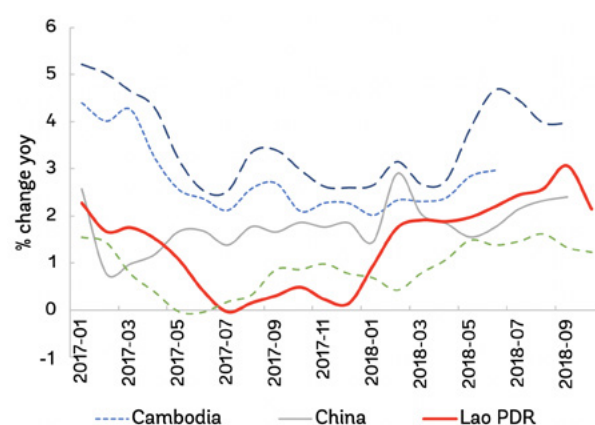


Figure 25: Inflation is rising in neighboring countries

(Percent yoy)



Sources: Lao Statistics Bureau and IMF International Financial Statistics database.

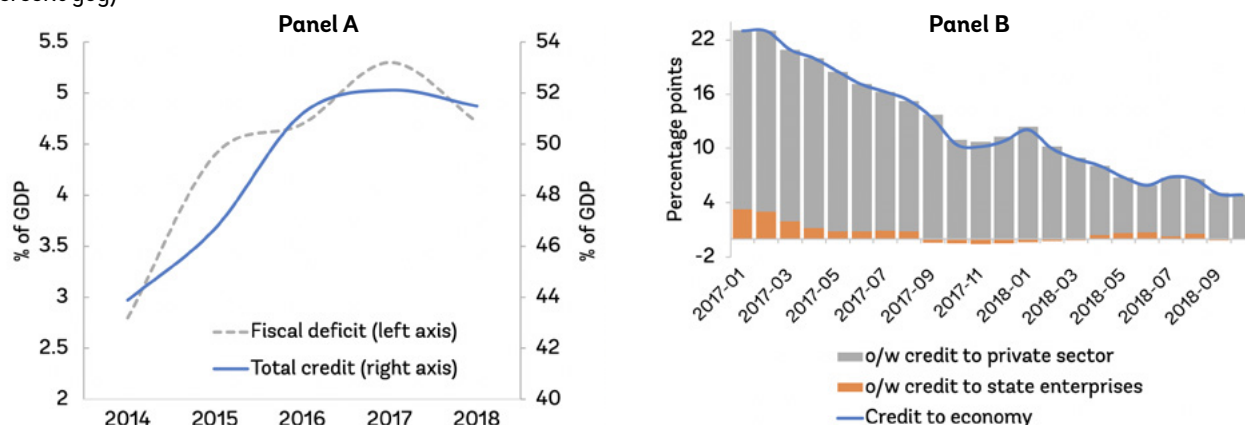
Credit growth continues to decelerate

26. While the policy interest rates remain unchanged in 2018 after the drop at the end of 2017,¹⁴ credit growth continued to slow in 2018. Bank lending to the economy (the private sector and state-owned enterprises) declined to 5 percent yoy in October 2018 from 12 percent a year ago, driven by a moderation in lending to the private sector, which accounted for 83 percent of total credit (Figure 26 and 27). This implied that real credit growth was only at about 3 percent yoy, mainly associated with the moderation of economic activity and a tightening of fiscal spending. Lending in kip grew at 2 percent yoy in October 2018 compared to 18 percent at the same time last year. In contrast, the pickup in foreign currency lending is partly driven by the lifting of restrictions on foreign currency lending in mid-2018 and banks' available foreign exchange liquidity. Total credit to GDP is estimated to slightly decline to about 51.5 percent in 2018 from 52 percent of GDP the previous year.

¹⁴ The policy rates set by the Bank of Lao PDR have remained unchanged since their reduction in November 2017. The policy rates were reduced by 25 basis points – from 4.25 percent to 4 percent – for one-week loans to commercial banks, by 30 basis points – from 5.3 percent to 5 percent – for more than one-week loans, and by 63 basis points – from 10.6 percent to 10 percent – for loans of more than 14 days up to one year.

Figure 26: Credit growth moderation has been driven by fiscal tightening, contributing to decelerating lending to the private sector

(Percent yoy)



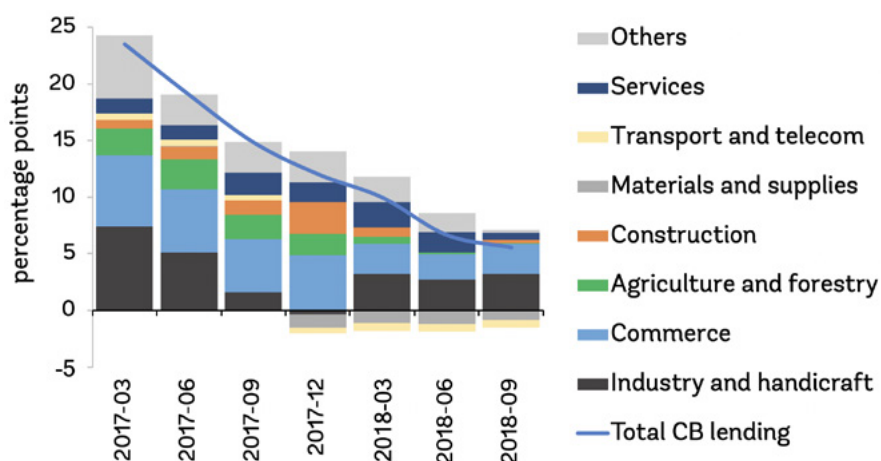
Source: BOL

27. Credit growth to the industry and commerce sectors remains robust despite some moderation from 2017.

Credit growth to the industry and commerce sectors slowed, but was still high at 11 percent and 14 percent yoy, respectively, by Q3-2018. This represents a moderation in credit growth compared to the same period the previous year of 28 percent and 21 percent growth, respectively, for the two sectors (Figure 27). These two sectors account for half of bank lending to the private sector (industry accounted for 30 percent, commerce accounted for 20 percent). This helped compensate for the deceleration of lending to the transport, raw materials, and construction sectors.

Figure 27: Lending to the commerce and industry sectors continued to drive credit growth

(Percent and percentage points)



Source: BOL.

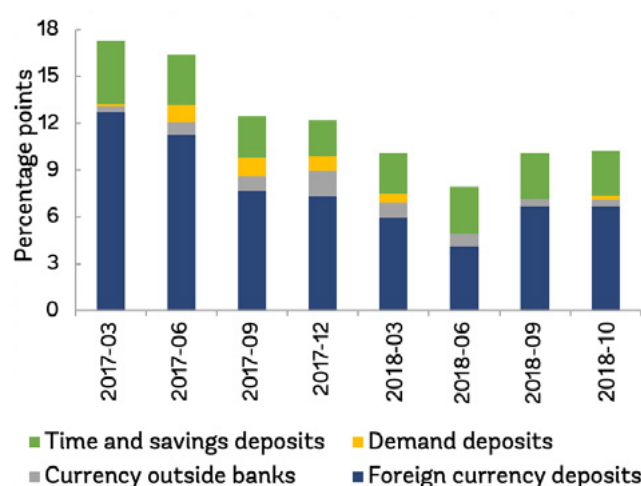
Note: CB = Commercial Banks.

28. Broad money growth moderated in the first half of 2018 and picked up in the third quarter.

Broad money growth slowed by October 2018, largely reflecting the slower growth in foreign currency deposits, currency circulation outside banks, and demand deposits (Figure 28). At the same time, the growth in deposits in commercial banks moderated toward midyear to 8 percent and picked up in the third quarter to 11 percent yoy, reflecting growth in foreign currency deposits. The trend of increasing dollarization of the deposit portfolio continued, with foreign currency deposits growing by 14 percent yoy in October compared to 7 percent yoy for local currency deposits. This led to foreign

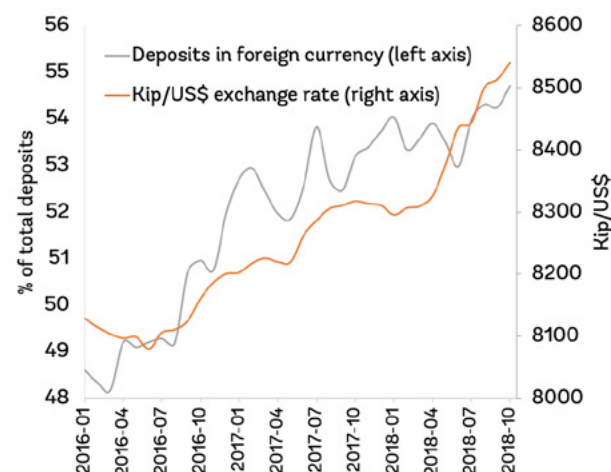
currencies accounting for 55 percent of total deposits from about 50 percent two years ago. This reflects (i) the continued implementation of the interest rate caps on kip deposit and lending rates, (ii) holding of foreign currency deposits as a hedge against exchange rate movements (Figure 29), and (iii) the slight increase in the deposit rate for U.S. dollar deposits. Such rates of dollarization are quite high, though well below Cambodia's rate of dollarization of liabilities.

Figure 28: The pickup in broad money growth was driven by growing foreign currency deposits
(Percentage points)



Source: BOL

Figure 29: Increasing foreign currency deposits as a hedge against kip depreciation
(Percent yoy)



Source: BOL

A well-capitalized banking sector is facing a weakening portfolio and low profitability

29. The banking sector remains well capitalized compared to regional peers despite a slowdown in economic activity. Regulatory capital to risk-weighted assets rose to 18 percent in September 2018 from 16 percent at the end of 2017, well above the minimum requirement of 8 percent. In addition, Tier-1 capital to risk-weighted assets increased to 14 percent from 12.5 percent in the same period. However, there continue to exist some state-owned commercial banks with relatively low capital adequacy. These state banks are now undergoing internal restructuring. Banking sector assets grew at 11 percent in Q3-2018, slightly faster than a year ago, but much slower than a few years ago due to fiscal tightening, and the moderation in consumer demand and economic activity, in general.

30. However, the sector still faces relatively low profitability and high nonperforming loans compared to its regional peers (Figure 30). The return on assets gradually increased from 0.5 percent at the end of 2017 to 0.7 percent in Q3-2018. This is about the level in Vietnam, but still lower than in Cambodia (1 percent in Q2-2018) and about half that in Thailand (1.4 percent) and Malaysia (1.5 percent). Return on equity rose notably from 7.7 percent at the end of 2017 to 9.4 percent in Q3-2018. This is higher than in Cambodia (5.8 percent), slightly higher than in Vietnam (8 percent), but below that in Thailand (9.9 percent), the Philippines (12.6 percent), and Malaysia (13.4 percent). The quality of the loan portfolio is mixed. Nonperforming loans for the sector have trended upward slightly, reported at around 3.1 percent of total loans, about the same level as in Thailand, but higher than in Cambodia (2.4 percent), the Philippines (1.8 percent), and Malaysia (1.6 percent).

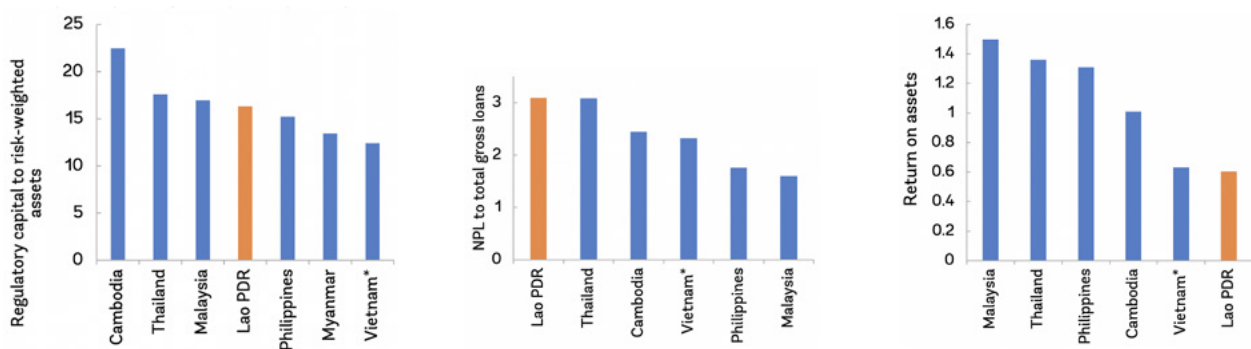
Figure 30: Financial Soundness Indicators

(In percent)

Capital levels are comfortable ...

... NPLs remain relatively high ...

... while profitability is low



Sources: Bank of Lao PDR for Lao PDR; IMF Financial Soundness Indicators for the rest.

Note: All data for Q2-2018 (except Vietnam* for Q2-2017). NPLs = nonperforming loans.

31. In response, the Bank of Lao PDR (BOL) is in the process of improving the regulatory and supervisory framework. The recently approved Bank of Lao PDR Law allows the BOL to move toward risk-based supervision. This law provides an opportunity for the BOL to take into account good international practices, including on management of the BOL, relations with market participants and the government, modernizing the instruments of the central bank, and improving the BOL's ability to regulate banks. There has been progress on developing a cost-efficient payment system through the establishment of the Automated Clearing House. Reflecting an anti-money-laundering effort during 2017, the Lao PDR was also delisted from the grey list and is in the process of preparing a national risk assessment.

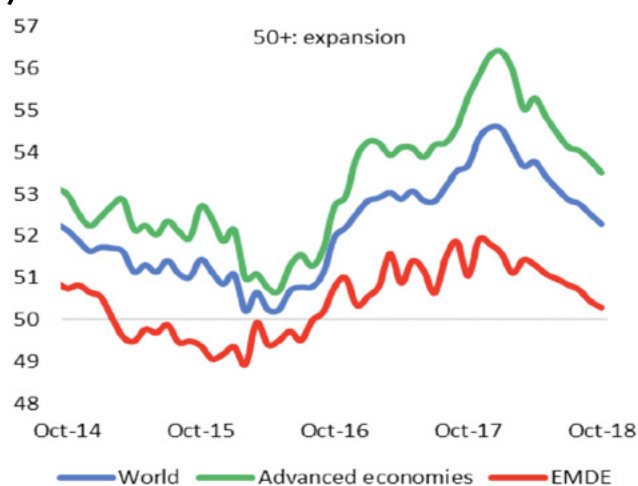


A.2. Outlook and Challenges

The near-term outlook remains broadly favorable, but risks are significant

32. The slowdown in global economic growth is expected to continue into 2019 and 2020, decelerating to 2.9 and 2.8 percent, respectively. This reflects moderating advanced-economy growth, which is projected to decelerate from 2 percent in 2019 to 1.6 percent in 2020. This moderation emanates from a softening of global trade and investment as capacity constraints become binding, tightening financing conditions with the continuation of monetary policy normalization, and rising trade tensions. The steady downward trajectory of the Purchasing Managers' Index from October 2017 to October 2018 for both advanced and EMDE economies is a harbinger of lower real GDP growth in the near future (Figure 31). Moreover, the EAP region is also expected to gradually moderate from 6.3 percent in 2018 to 6 percent in 2019 and 2020. The slowdown in regional growth reflects a structural slowdown and weaker exports amid rising trade tensions between China and the United States, and a projected deceleration in China's growth in the medium term in line with its continued economic rebalancing. Growth in the rest of the region (excluding China) is expected to remain steady at around 5.3 percent in the medium term.

Figure 31: Manufacturing Purchasing Managers' Index (PMI)



Source: World Bank.

Note: EMDEs = emerging markets and developing economies.

33. Despite the recent moderation in economic growth and the continued slowdown in global growth in 2019, Lao PDR's medium-term prospects are expected to remain favorable, with GDP growth projected to rebound slightly to 6.6 percent in 2019 and 6.7 percent in 2020. The growth in 2019–20 in Lao DPR is driven by a combination of ongoing construction of the Lao section of the Kunming–Singapore railway; reconstruction and repair of infrastructure damaged by the flooding in 2018; expansion of electricity outputs and exports from some power projects, with a total installed capacity of about 2,200 MW¹⁵ by 2019–20; and a rebound in the agriculture sector post-flooding. While the moratorium currently in place continues, the contribution to economic growth from the mining sector is expected to gradually decline as current investments mature. Diversification

¹⁵ 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).

through boosting growth of the non-resource sectors will require an improvement in the business environment. The Lao PDR dropped further in the Doing Business Ranking, from 141 in 2018 to 154 in 2019, reflecting the relatively slow momentum in business climate reforms (see Box 2).

Box 2: Doing Business in Lao PDR in 2019

The Lao PDR's Doing Business (DB) ranking slipped to 154 in the 2019 report from 141 in the 2018 report (Figure 32). The issuance of Prime Minister's Order No. 2 in February 2018 demonstrates the high-level commitment to addressing these challenges. However, translating the Prime Minister's vision into effective implementation has proved challenging. The deterioration in ranking implies that the reforms still need to keep pace with other countries in order to maintain an attractive environment for investors. In the 2019 Doing Business Report, the most improvement compared to regional peers are in the following areas:

- Trading across borders through the streamlining of the customs clearance process, using electronic systems to enhance customs administration and inspections for exports and imports. As a result, Lao PDR's ranking for this DB indicator improved from 124 in the 2018 DB report to 76 in the 2019 report.
- The getting credit rank improved to 73 in the 2019 DB Report from 77 in the 2018 DB Report due to the broader coverage of the credit registry.

The areas that need significant attention include starting a business, enforcing contracts, dealing with construction permits, and protecting minority investors. These are associated with more required processes and time, and with higher costs involved (Figures 32 and 33).

Figure 32: Lao PDR Doing Business ranking compared to other ASEAN nations

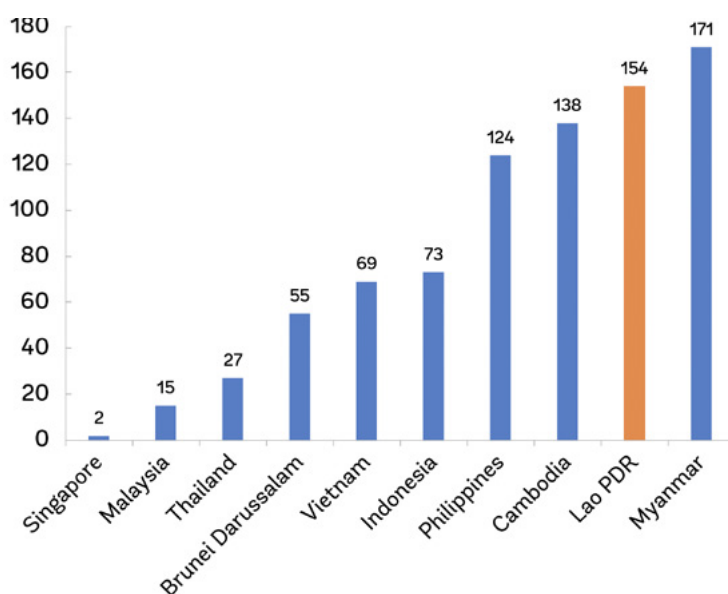
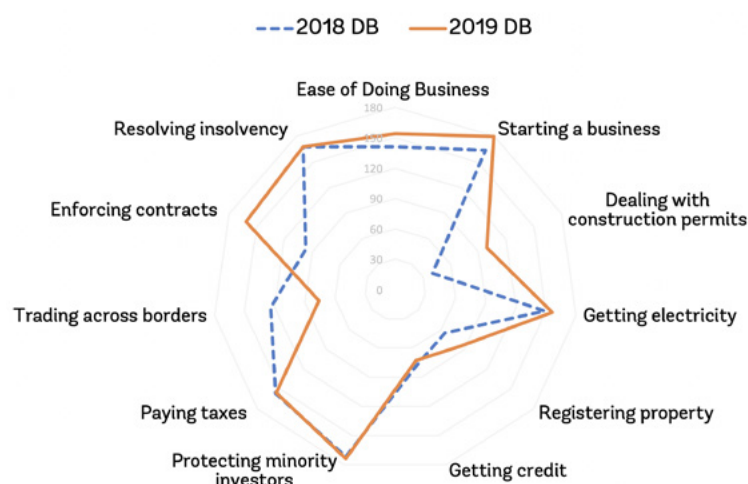


Figure 33: Changes in Lao PDR Doing Business rankings



Note: The line closer to the center means an improvement in rankings.

To improve Lao PDR's DB score and ranking, more ambitious reforms will be required, together with full implementation across all levels of government, which is essential. An important priority is creating a level regulatory playing field for businesses by streamlining procedures and documents, developing clear and consistent procedural guidelines to enhance the predictability of rules and regulations, and ensuring accountability of both investors and regulators across the reforms related to areas assessed in Doing Business.

Specific key measures include (i) establishing an institutional mechanism to formulate needed reforms; (ii) implementing and enforcing reform plans, and eventually monitoring and feeding through the feedback loop for policy adjustments; (iii) investing in and incentivizing reforms; and (iv) strengthening enforcement of reform plans across implementing agencies.

The authorities should engage the relevant stakeholders and the public at large when reforming the business environment and then communicate the changes to them both effectively and in a timely manner. For instance, in the area of starting a business, concrete steps could include removing some of the lengthy steps and documents, publishing a clear list of steps to start a business and the maximum time entrepreneurs should expect for each step, reducing the number of documents for business registration, rationalizing the fee schedule, and informing the public about these changes.

Source: Doing Business Report 2019.

34. The medium-term fiscal framework envisages a fiscal consolidation path that aims to stabilize and eventually put public debt on a sustainable path. The budget deficit is expected to decline over the medium term from 4.7 percent in 2018 to 4.3 in 2019 and to below 4 percent in 2020 following revenue improvement and expenditure rationalization. The revenue improvement is expected to come from strengthening both tax administration through the use of ICT, and the legal tax framework through the recently approved value-added tax law and upcoming laws on tax administration, and excise and income taxes under preparation for submission to the National Assembly in 2019. Public expenditure will be contained by limiting both the number of new recruits and wages. The new civil service quota will be further cut to 1,500 in 2019, and the public wage index increase will be postponed further. The government is expected to slow new borrowing, particularly non-concessional borrowing. These measures, together with implementation of the Public Debt Management Law (passed in mid-2018), are expected to result in a decline in the debt-to-GDP ratio over the medium term.

35. The current account deficit is expected to remain high in the coming years. This reflects projected imports to support construction of infrastructure projects, and higher oil prices. Exports are expected to benefit from upcoming power projects, the continued positive trend in manufacturing exports, and a rebound in agricultural exports and tourism. This will partly offset the expected rise in imports to support investments in infrastructure projects. The external balance is expected to improve in 2020 as import growth retreats after the completion of these projects.

Table 2: Key macroeconomic indicators and projections

	2015	2016	2017	2018	2019	2020
Real Economy				Est.	Proj.	Proj.
Real GDP	7.3	7.0	6.9	6.5	6.6	6.7
Consumer Price Index (average)	1.3	1.6	0.8	2.1	2.1	2.5
Fiscal Accounts*						
Revenues	17.9	15.8	16.1	16.7	16.2	16.8
Expenditures	22.3	20.5	21.4	21.4	20.5	20.4
Fiscal Deficit	-4.4	-4.7	-5.3	-4.7	-4.3	-3.6
Total Public Debt	57.7	58.5	60.1	60.6	60.3	59.5
External Balance						
Current Account Balance	-17.0	-12.4	-12.1	-11.0	-12.1	-11.8
Other memo items						
GDP (nominal, billion Kip)	117.3	129.3	140.7	152.4	165.5	181.1

Sources: Ministry of Finance and Lao authorities, World Bank.

Note: *The fiscal year (October–September) changed to calendar year starting from 2017. The government's fiscal framework envisages a similar adjustment in the overall fiscal deficit, through an assumption of stronger emphasis on expenditure consolidation. This medium-term fiscal framework envisages a similar path of fiscal deficit through (i) stronger revenue performance because of implementation of the planned revenue policy and administration reforms, and (ii) a more gradual adjustment in expenditure to accommodate the needs for service delivery.

36. The medium-term outlook is subject to external and domestic risks. External risks include escalating and prolonged trade protectionism, heightened global and regional geopolitical uncertainty, and continued tightening of global financing conditions that could lead to disorderly financial market movements. These risks are likely to adversely impact global demand and commodity prices. Moreover, despite the temporary standoff from December 2018 on the further

imposition of trade barriers, the probability of escalating trade tensions and restrictions between China and the United States could have more consequences on regional growth through the global value chains. Tightening global financing conditions and the pace of U.S. interest rate normalization could lead to a further slowdown of capital inflows and lead to weaker regional currencies against the appreciating U.S. dollar. This will increase the cost of debt servicing for many countries in the region, including Lao PDR, particularly where policy buffers are limited. Domestic risks are primarily two-fold: (i) a failure to implement the fiscal consolidation plan, which can adversely affect fiscal and public debt sustainability; and (ii) a slowdown in momentum on doing business reforms.

37. Addressing the domestic risks associated with macroeconomic challenges remains a key priority, while building human capital can boost productivity and long-term growth, and lead to further poverty reduction. Regarding fiscal and public debt management, the authorities should maintain the reform momentum and make further progress as planned through enforcement of the current fiscal measures and fiscal disciplines, as mentioned above. Promoting sustainable growth through investing in human capital and improving the business climate, particularly in the non-resource sector, should support job creation and consequently engender inclusive growth.





Part B:

Building Human Capital for Poverty reduction

The special thematic topic focuses on human capital development in Lao PDR. Human capital development, which pertains to the development and improvement of skills, health, knowledge, and resilience, allows people to be more productive, flexible, and innovative. Using elements of the Human Capital Index (HCI) developed by the World Bank under the Human Capital Project, we seek to answer three questions in relation to human capital development: (i) Why does human capital matter in the Lao PDR context? (ii) What is the status of human capital indicators? and (iii) How can Lao PDR make further progress in boosting human capital? Evidence shows that, despite progress, Lao PDR displays significant gaps in human capital outcomes and lags behind regional peers, leaving the country poorly prepared for achieving sustainable and inclusive growth.

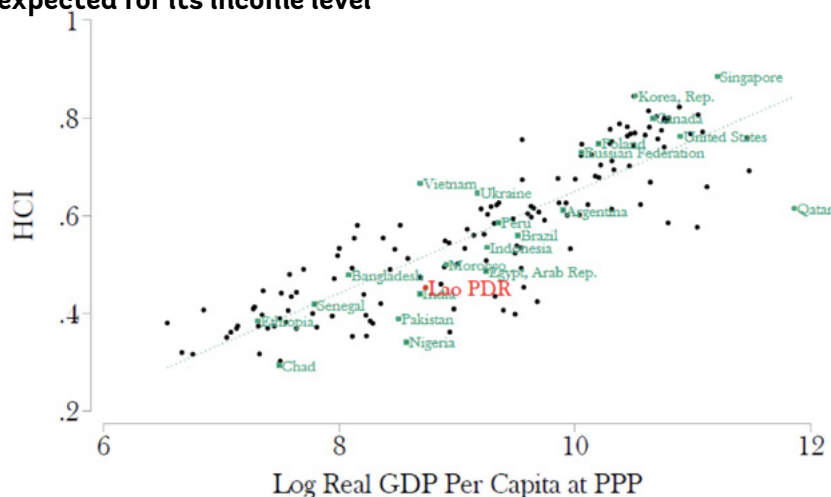
B.1. Why does Human Capital Matter in the Lao PDR Context?

Better human capital brings higher income growth and lower poverty

1. There is a relationship between poverty reduction and access to social services associated with human development outcomes. Poverty reduction in Lao PDR over the last two decades has been impressive, with the proportion of the population living below the national poverty line falling by nearly 50 percent, from 45 percent to 23 percent in the 20 years between 1992 and 2012.¹⁶ However, the incidence of poverty is estimated at 40 percent in rural areas compared to 10 percent in urban areas. This indicates that poverty, along with lack of access to social services, remains entrenched in remote and highland areas even though improvements have been observed. These areas continue to be characterized by poor access to sanitation¹⁷ and publicly provided social services, especially secondary schools, hospitals, and health centers. In addition, infrastructure in remote areas is particularly limited, and many communities are inaccessible during the annual rainy season. It is these remote, poorly serviced, rural areas that have lower human development outcomes as well compared to urban centers, which have access to better social services.

2. A higher level of human capital development is associated with a higher per capita growth rate and consequently a lower poverty rate (Figure 34). Human capital is a salient driver of sustainable growth and poverty reduction, particularly as the nature of work has evolved. Job creation, stimulating productivity growth, and improving the quality of jobs in the non-farm sector are key to reducing poverty in Lao PDR. One way to reduce poverty is for people to attain a higher level of education, which allows them to transition into better-paid jobs and/or increase their productivity in their current job. In addition, a healthier society, allows for a more productive economy, which increases household labor income and enables households to transition out of poverty. If human capital development is focused on the bottom 40 percent of the population, this would additionally result in promoting equality of opportunity, thereby reducing income inequality and the vulnerability of individuals living just above the poverty line.

Figure 34: the HCI for Lao PDR is lower than what would be expected for its income level



Source: World Bank HCI Project

¹⁶ As discussed in Section 1.1, according to the 2017 Labor Force Survey, with the increase in wage jobs and median income due to robust economic growth, the poverty rate is expected to have continued to decline post-2012.

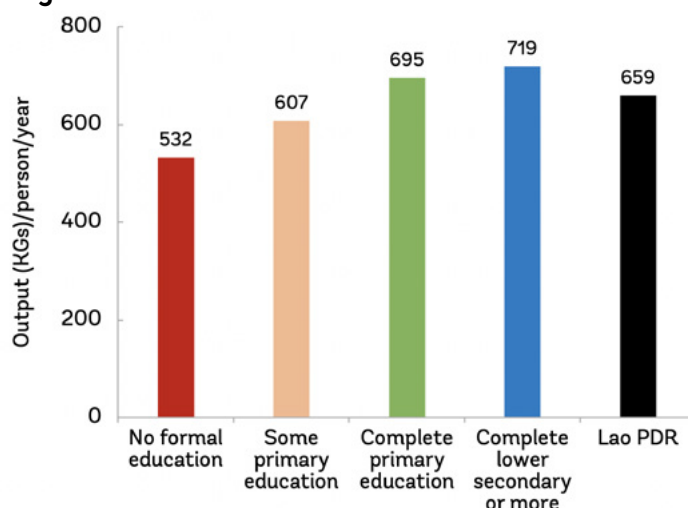
¹⁷ For example, about 60 percent of households in remote rural villages do not have a toilet.

3. In Lao PDR, as in many countries, higher levels of education are associated with a lower probability of living below the poverty line.¹⁸ In 2012/13, the poverty rate among those with no formal education was 47 percent compared to 4 percent for those with a university degree. In addition, the least educated, conditional on ethnicity and wage compared to non-wage employment, have the lowest probability of transitioning out of poverty and the highest probability of entering into poverty.¹⁹ In particular, averaging across job type and ethnicity of the head of household, the risk of falling into poverty of a non-poor household decreases from an average of 50 percent where the head of household has no formal education to 8 percent where the head has upper secondary school education.

4. In Lao PDR, rising educational attainment increases the productivity of farm employment, allows households with farm employment to diversify their source of income, and enhances the opportunity for individuals to transition into higher wage, non-farm employment.²⁰ Specifically:

- (i). **More educated households produce both more rice per person and more rice per area planted.** Controlling for land terrain, households headed by someone with completed primary education or above produce 30 percent more rice per person and enjoy average rice yields that are at least 26 percent higher than households headed by someone without any formal education (Figure 35). Households with more education also have a higher degree of commercialization. At least 56 percent of households headed by a person who completed primary education or more sold rice on the local market compared to 40 percent among those headed by someone with no formal education. In Lao PDR, productivity gains in this sector are associated with higher education attainment up to completion of primary education. Therefore, given that a large majority of Lao population will remain in the agriculture sector in the foreseeable future, increasing the educational attainment of those in the farming sector will contribute to higher productivity in the sector and thus raise agriculture incomes, consequently lifting people engaged in agriculture out of poverty.

Figure 35: Better education results in higher labor productivity in the agriculture sector



Source: Poverty report based on Lao Expenditure Consumption Surveys 4-5.

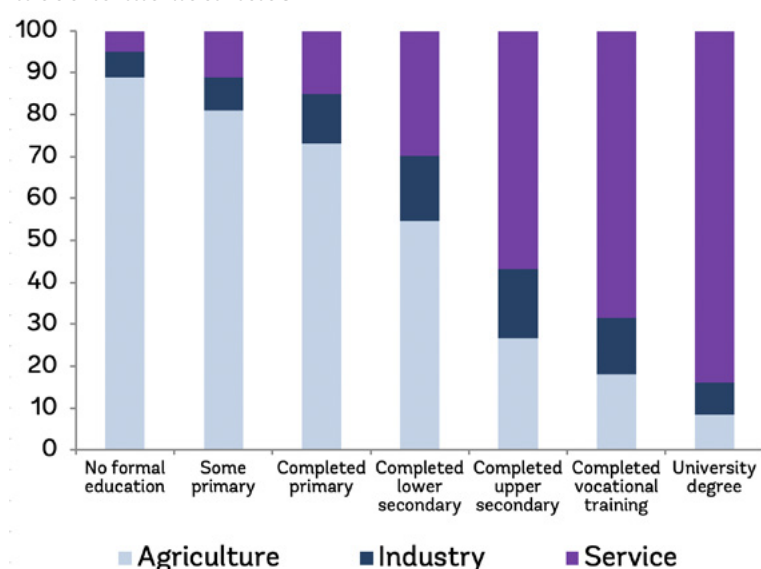
¹⁸ In Lao PDR, the average years of schooling of the labor force in 2010 was 5.1, with only 10 percent of the workforce completing upper secondary, and 5 percent having either vocational or tertiary degrees. (See Lao PDR Systematic Country Diagnostic, World Bank, 2017.)

¹⁹ The likelihood of moving out of poverty for an agricultural, non-Lao Tai household with at least one person with post-primary education was at least 80 percent, compared to the 47 percent chance faced by a similar household without anyone with formal education.

²⁰ Among farming households, those with a non-farm wage income were 12 percent more likely to escape poverty.

- (ii). **People with higher levels of education are more likely to transition into (and engage in) higher-earning, non-farm employment activities.** More education facilitated transition into higher-earning non-farm economic activities, with the highly skilled moving out of agriculture completely and the low skilled diversifying their income sources away from agriculture. The odds of having primary employment in the non-farm sector increase from 11 percent for people with no formal education to 27 percent for people who have completed primary education, to 45 percent among those who completed lower secondary education. Those with vocational training or a university degree have the highest likelihood, at 82 percent and 91.5 percent, respectively, of being in a non-farm primary economic activity, which is most likely to be in the service sector (Figure 36). Such people were likely to have spent limited time on farming. Among farming households, those with a non-farm wage income were 12 percent more likely to escape poverty. The increase in education attainment was especially critical in facilitating the transition to non-farm incomes, with the highly skilled moving out of agriculture completely.

Figure 36: More education facilitated transition into better rewarding non-farm economic activities



Source: Poverty report based on Lao Expenditure Consumption Surveys 4-5.

5. However, earning a non-farm wage income did not improve the chances of escaping poverty among low-skilled non-farming households, indicating that individuals with a relatively low skill set have difficulty escaping poverty. This is particularly relevant to Lao PDR, where the majority of individuals engaged in farming lack the requisite skills and training necessary to transition from poor farming into non-poor, non-farming good jobs. People with lower education in Lao PDR who are engaged in non-farm work tend to be self-employed, earning low returns within a small household business, which they supplement with farming income. Only the transition out of agriculture to higher-paying jobs (mostly in the service sector) is sufficient to lift people out of poverty, which highlights the need for training to upgrade skills when transitioning into the non-farm sector. Thus, people either attain an adequate level of education, so they never become part of the working poor in the first place, or they resort to supplementing non-farm wage income with farming income if they lack the requisite skills to get higher-paying jobs.

6. Improving health outcomes in Lao PDR, particularly child malnutrition, is also key to reducing poverty and supporting growth. Ensuring that children enter healthy life and receive adequate nutrition in the first 1,000 days of life is the foundation for skills development and employment opportunity. Child malnutrition (and stunting) are responsible for significant cognitive and productivity deficits in the population, particularly among the poor and those with limited access to services. This constrains the opportunities for individuals to improve their livelihoods, and contributes to shortfalls in workforce capability in the labor market.

7. Using elements of the Human Capital Index (HCI) developed by the World Bank under the Human Capital Project, the special thematic section focuses on human capital development in Lao PDR (see Box 3). This section determines the status of human capital indicators for Lao PDR compared to both the regional benchmarks and its peers (Box 4). This section focuses on aspects of the HCI pertaining to measures of health and education for Lao children as the measure of opportunities for the next generation, with special attention to child stunting and mortality, expected years of schooling, harmonized test scores, and learning-adjusted years of schooling.

Box 3: What does the Human Capital Index measure?

The Human Capital Index (HCI) measures the amount of human capital that a child born today can expect to attain by age 18, given the status of health and education that prevail in the country where she lives. The HCI is designed to highlight how improvements in current health and education outcomes shape the productivity of the next generation of workers, assuming that children born today experience over the next 18 years the educational and health opportunities and risks that children in this age range currently face.

The HCI has four components: (1) survival from birth to school age, measured using under-five mortality rates. This reflects the reality that children born today need to survive until the process of human capital accumulation through formal education can begin; (2) expected years of learning-adjusted schooling, which aims to measure the educational attainment by combining the quantity and quality of education. The quantity of education is measured as the expected number of years of school a child can expect to attain by age 18 given the prevailing pattern of enrollment rates across grades. The quality of education reflects ongoing work at the World Bank to harmonize test scores from major international student achievement testing programs; (3) the rate of stunting for children under age five. Stunting is broadly accepted as a proxy for the prenatal, infant, and early childhood health environment, and so summarizes the risks to good health that children born today are likely to experience in their early years; and (4) the adult survival rate, defined as the proportion of 15-year-olds who will survive until age 60, which reflects the range of health outcomes that a child born today might experience as an adult. Adult survival rates are estimated based on prevailing patterns of death rates by age and are reported by the United Nations Population Division for five-year periods. For this reason, the adult survival rate is imprecisely estimated in countries

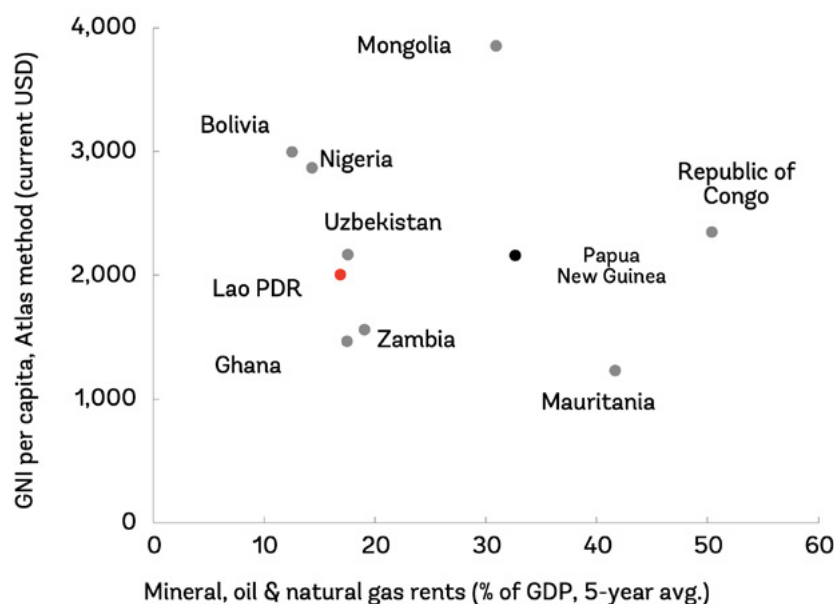
where vital registries are incomplete or nonexistent. The five-year data are interpolated to arrive at annual estimates. The measurement of adult survival rates requires data on death rates by age.

Source: World Bank Human Capital Project.

Box 4: Defining a set of comparator countries for Lao PDR

Whilst Lao PDR, a lower-middle income country, is situated in the East and Southeast Asia (ESEA) region, the structure of the economy not typical of the region. In contrast to all ESEA countries, Lao PDR, after Mongolia, is the most sparsely populated country, having less than 30 persons per km² and more dependent on extractive resources than all countries in the ESEA region. This section therefore benchmarks Lao PDR against other lower middle-income countries with significant endowments of mineral and/or petroleum resources. According to the World Bank's definition for 2017, lower middle-income economies are those with a GNI per capita between USD 1,026 and USD 4,035, calculated using the World Bank Atlas method. Countries with a significant amount of mineral and/or petroleum resources are categorized as those countries where the ratio of mineral and petroleum rents to gross domestic product (GDP) are greater than or equal to 10 percent. This classification yields the following set of comparators 'peer' countries which will be frequently referred to in this section: Bolivia, Republic of Congo, Ghana, Mauritania, Mongolia, Nigeria, Papua New Guinea, Uzbekistan and Zambia.

Figure 37: Defining a set of structural peers: Countries with similar per capita incomes and resource rents in 2014



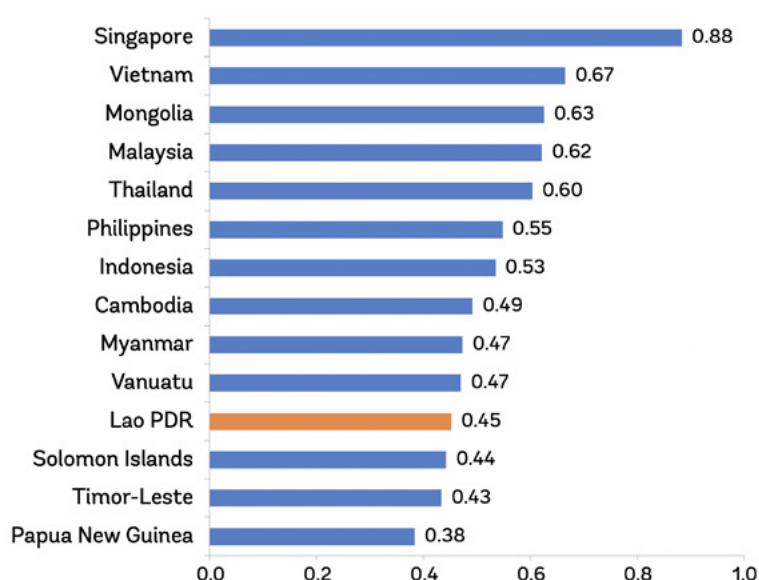
Source: World Development Indicators

B.2. What is the status of human capital indicators?²¹

Lao PDR has improved over time in relation to human capital components, but this progress is relatively lower than what would be expected for its income level

8. In Lao PDR, the Human Capital Index PDR improved by 10 percent, from 0.41 to 0.45 between 2012 and 2017, but is still lower than expected for its income level. What this means is that when a child born today in Lao PDR grows up, she will be only 45 percent as productive as she could be if she enjoyed complete education and full health care. While the country has made progress in terms of delivering some basic education and health services, such as working hospitals and schools, the quality of the services is poor. Moreover, compared to the average HCI attained by lower middle-income countries and EAP countries, Lao PDR performs poorly (Figure 38). In the region, Lao PDR's HCI was 0.45 in 2017 compared to 0.47 for Myanmar, 0.49 for Cambodia, 0.6 for Thailand, and 0.67 for Vietnam.

Figure 38: Despite progress over time, Lao PDR's HCI still lags other countries in the region, 2017

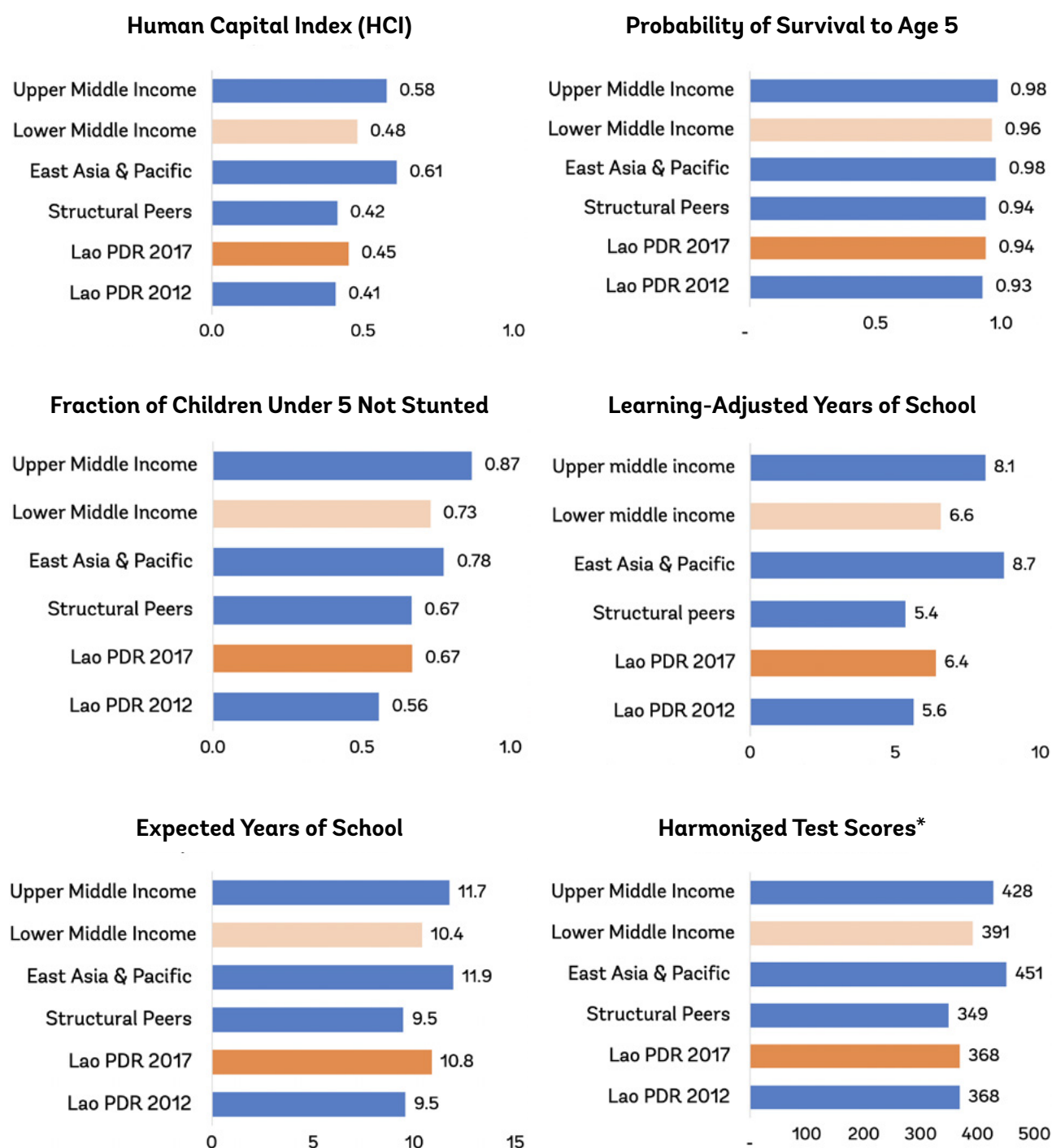


Source: World Bank Human Capital Project.

²¹ This section compares the performance of Lao PDR HCI indicators with other lower middle-income countries, and regional and structural peers. Lao PDR's structural peers are defined in Box 4.



Figure 39: Lao PDR has improved over time in relation to human capital components, but this level is relatively lower than what would be expected for its income level



Source: World Bank Human Capital Project.

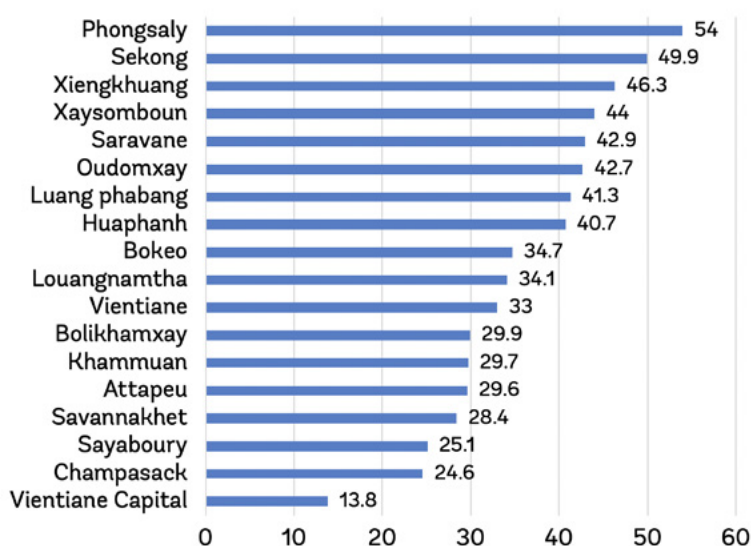
Note: *The data on harmonized test scores for Lao PDR for 2017 assume the level in 2012 due to the lack of recent data.

Stunting

9. In Lao PDR, compared to other lower middle-income countries, stunting levels among children remain stubbornly high at 33 percent. The proportion of children under five years of age who are stunted decreased from 48 percent to 33 percent between 2000 and 2017. Those children who are stunted are at risk of cognitive and physical limitations that can last a lifetime. The improvement, though commendable, is insufficient for Lao PDR to reach the average attained by lower middle-income countries and other EAP countries (Figure 39). Compared to its structural peers, the rate of stunting for children under five years of age in Lao PDR is equivalent to the average, and does better than only the Republic of Congo, Nigeria, Papua New Guinea, and Zambia within this group.

10. Despite the significant improvement in the stunting rate, there is a large and persistent variation across geographic regions and across ethnolinguistic and income categories. Comparing different regions, the stunting rate for children under five years of age is higher for rural areas (37 percent) than urban areas (22 percent), and highest in the Phongsaly Province (54 percent) and lowest in Vientiane Capital (14 percent), which also happens to be the most urbanized region (Figure 40). There is also significant variation in stunting across income levels, with the stunting rate among children in the poorest quintile (48 percent) over three times the rate for children in the richest quintile (14 percent). In addition, the stunting rate is the highest for the Hmong-Mien ethnic group (50 percent), which is more than double the rate for the Lao Tai ethnic group (23 percent).

Figure 40: Large and persistent variation across geographic (rural compared to urban), ethnolinguistic, and income categories



Source: World Bank HCI Project

11. In Lao PDR, one of the causes of under-five mortality and stunting is malnutrition.²² Prior to birth, insufficient nutrition intake of mothers during pregnancy increases the risk of infant mortality and

²² The UNICEF Conceptual Framework on Undernutrition, originally designed in 1990, identifies basic, underlying, and immediate causes of malnutrition. The basic causes address systemic challenges including social, cultural, economic, and political that contribute to an unequal distribution of resources.

can have lifelong effects on the immune function and cognitive outcomes.²³ Childhood malnutrition originates from insufficient intake of certain food types to meet the body's requirements.

12. In Lao PDR, poor nutrition (and hence stunting) is related to the poor quality of diet rather than food insecurity. Analysis of the Lao Expenditure Consumption Survey (LECS) 5 shows that although a typical household in Lao PDR has sufficient access to food to cover their required calorie intake, diversity in diet is low, with rural households consuming on average only three of the nine major food groups. The following factors are significant in determining the degree of malnutrition among children:

- (i). **Poor sanitation and hygiene.** High chronic exposure to large quantities of fecal bacteria results in anatomical changes to the structure of the small intestine, which affects a child's ability to both absorb and use nutrients, which in turn leads to stunting. In Lao PDR, while approximately 78 percent of households have access to "basic" drinking water, over 83 percent of households had E. Coli contamination in their source of water. Only 65 percent of rural households have access to basic sanitation, and as many as 32 percent of households practice open defecation. There are also large regional variations, with 47 percent of households in Phongsaly practicing open defecation (LSIS 2017).²⁴
- (ii). **Unaffordability of certain foods.** Lack of affordability is a major factor in the inadequate nutrient intake for children. Sixty-one percent of households reported unaffordability as a major constraint to diet diversity in the Lao Social Indicator Survey (LSIS) 2017, with significant variation by province.²⁵
- (iii). **Poor feeding practices.** Even when food is available (and therefore affordable) in the household, a significant proportion of children under two years of age are not fed important food groups. This is particularly the case for children 6 to 23 months old who are fed fewer food groups than children 24 to 59 months old. For instance, the CNP Baseline Survey (2010) shows that while 74 percent of mothers in the sample consumed foods and vegetables rich in vitamin A, only 45 percent of babies 6 to 23 months old did. More concerning is that only 60 percent of babies 6 to 23 months old consumed foods and vegetables rich in vitamin A, even when their mothers consumed them, while the corresponding share is 90 percent for children 24 to 59 months old. The same applies to fresh foods, other fruits and vegetables, eggs and legumes, and nuts, reflecting an inappropriate practice of late and suboptimal complementary feeding for children under two years old.

13. Mother's education, gender, cultural and social norms all affect feeding practices and, therefore are closely correlated with stunting. The likelihood of being stunted is at least 10 percentage points higher among children conceived by women below the age of 18. As nearly all teenage pregnancies

²³ In four of the poorest provinces, nearly 20 percent of infants are born with low birthweight, while UNICEF estimates that over 5,000 infants die every year due to nutrition-related factors.

²⁴ Estimates show that the probability of stunting among 6 – 23-month-old children is 14 percentage points higher when the share of the population practicing open defecation in the village increases from 25 percent to 100 percent, but no correlation is found between incidence of diarrhea and stunting.

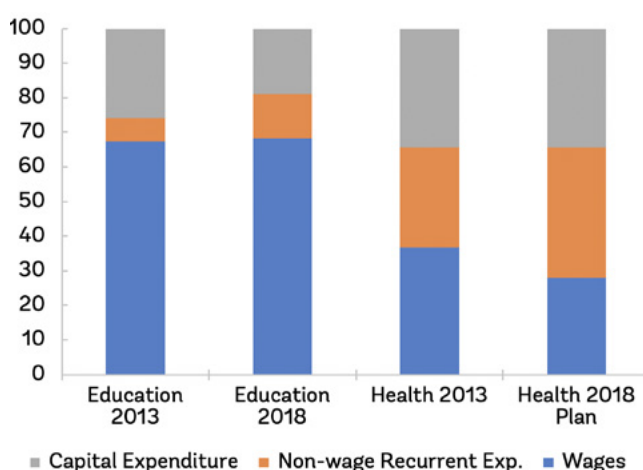
²⁵ Only 55 percent of households in Lao PDR can afford a nutritious diet (WFP 2017) and affordability of a nutritious diet varies by province (83 percent in Vientiane versus 5 percent in Sekong, for example)

are a result of early marriages,²⁶ stunted children are mostly prevalent among less educated girls residing primarily in rural areas.²⁷ In addition, social norms have influenced dietary practices of mothers during pregnancy. For instance, mothers have reported that they are encouraged by influential family members to restrict food intake during pregnancy, so they can have smaller babies and easier deliveries, and that food restrictions often continue through the delivery and breastfeeding period. Pre- and postnatal services can help to counteract such social and cultural norms.

14. Poor feeding practices are prevalent where pre- and postnatal services available and accessible to women are limited, which is particularly acute in the remote rural areas. The LSIS 2017 found that only 52 percent of pregnant women from the poorest wealth quintile received prenatal care from a trained health professional, and over 36 percent of pregnant women living in rural areas received no prenatal services. The issues of the availability of, and accessibility to, health services in Lao PDR are related to the limited capacity of health personnel, the limited availability of drugs and equipment, and poor connection to communities, particularly in rural areas, which adversely affect women's ability to access both preventive and curative care. For instance, nationally, 67 percent of health center staff have not received training in nutrition, so they lack the capacity to provide nutrition counseling.²⁸ In addition, health centers lack sufficient tools, nutrition supplies, and human resources to provide adequate diagnosis and response.²⁹ As a consequence, health center staff tend not to recognize stunted children, and in fact many regard stunting as normal, particularly in localities where stunting is highly prevalent. In addition, the skilled health professionals staff are unevenly distributed across provinces, further compounding the inequity of access to health services among localities. For instance, the density of doctors to population in Vientiane is four times that in rural areas.

15. Relatively low government spending, weak budget implementation, and the complex health budgeting mechanism limits the availability of health services and results in relatively high out-of-pocket spending. Despite the significant decline of out-of-pocket spending as a share of total health expenditure from more than 60 percent in 2000 to 45 percent in 2016, and a recent increase in operation expenditures for health (non-wage recurrent expenditure) from the recent budget plan (Figure 41), out-of-pocket payments remain the largest source of financing for health in the country, and deter health service use by the poor. Much of current public spending is still allocated to wages and

Figure 41: Non-wage recurrent spending for sectors remains low compared to total recurrent expenditure



Source: MOF

²⁶ Nutrition in Lao PDR: Causes, Determinants and Bottlenecks, World Bank, 2016.

²⁷ Early marriage remains widely accepted, particularly in rural areas, leading to high numbers of teenage pregnancies, as evidenced by the fact that Lao PDR has the highest adolescent birthrate in the region. About 94 out of 1,000 births are to girls aged 15 to 19 (UNFPA 2016) compared to the regional East Asian average of 47 out of 1,000 births.

²⁸ For example, only 34 percent of health workers in the Northern region provide counseling on breastfeeding, while only 24 percent of health center workers in the Southern region provide advice on hygiene and sanitation.

²⁹ Only 66 percent of health centers surveyed had the equipment to measure children's weight and height.

capital spending, some of which are more dependent on external assistance. This continues to affect the operationalization of health centers and, in particular, limits the ability of health professionals to combat stunting. The complex budget process and weak implementation lead to inadequate and unreliable services, particularly of frontline health service delivery.³⁰

Child Mortality

16. Lao PDR has made significant progress in lowering the child mortality rate, but lags behind the average for many other comparator countries. The probability of survival to age five increased from 89 percent in 2000 to 94 percent in 2017.³¹ However, the probability of survival to age five is slightly below the average for the lower middle-income countries and the EAP region, and at the average of its structural peer group (Figure 38).

17. Several factors adversely affect the survival rate for children under five years of age. Infant mortality, which contributes to under-five mortality, is adversely affected by the limited number of assisted births, particularly in rural areas. For instance, only 34.1 percent of rural households' deliveries are assisted by a skilled birth attendant compared to the national average of 64.4 percent, and the regional average in rural areas of 90 percent. Unsurprisingly, limited access to maternal health care also results in inadequate health care for children—about 90 percent of rural women did not receive postnatal care. In addition, insufficient fetal growth due to limited nutrition intake during pregnancy increases the risk of infant mortality and can have lifelong effects on the immune function and cognitive outcomes. The incidence of low birthweight varies considerably across provinces in Lao PDR; it is above 19 percent in Saravane, Attapeu, Bokeo, and Khammuane, but less than 10 percent in Vientiane province and Phongsaly. Further, notwithstanding the steady improvement in immunization coverage since 2010,³² less than 50 percent of children are fully vaccinated across the country, with fewer still in the northern provinces (LSIS 2017). The percentage of fully immunized children age 12 to 23 months for the poorest income group was about 32 percent compared to 65 percent among the richest income group (MOH; LSIS 2017).³³

18. Lao PDR currently lacks social protection programs that explicitly address poverty, which is a key basic cause of undernutrition. While most countries in the region and beyond have invested significantly in recent decades in developing targeted programs to support the poor and the neediest, Lao PDR has not.³⁴ According to the Labor Survey 2017, out of 4.8 million working-age population, only 0.8 million people (16 percent) were covered by a social protection scheme. Overall spending on social protection is around 1.7 percent of GDP, far below neighboring Vietnam at 6.7 percent and

³⁰ See Managing Transition: Reaching the Vulnerable while Pursuing Universal Health Coverage, World Bank, 2017.

³¹ There have been significant declines in under-five mortality rates from 201 per 1,000 live births in 1980 to 71 per 1,000 live births in 2013. This sharp reduction in child mortality means Lao PDR has moved closer to achieving the United Nations Sustainable Development Goals.

³² According to the latest available World Health Organization-UNICEF estimates, immunization coverage rates increased for DTP3 (diphtheria-tetanus-pertussis) from 74 percent in 2010 to 82 percent in 2016, and the coverage of single measles vaccination at nine months increased from 64 percent in 2010 to 76 percent in 2016.

³³ A gender gap in immunization coverage could exist and can be a potential source of concern; however, the current immunization data are not gender disaggregated. Gender differences, therefore, cannot be assessed.

³⁴ See the latest World Bank publication on the "State of Social Safety Nets," 2018.

the East Asia average of 5.7 percent. Social protection programs are fragmented, small scale, and financed mainly by development partners. The Poverty Reduction Fund is one of the few programs that focuses on poverty reduction through a community-driven development approach. In addition, in the health sector, Health Equity Funds were introduced to promote the use of health services by the poor through fee exemptions and reimbursements for transportation and food under certain conditions. The Health Equity Funds have been fully integrated into the National Health Insurance program, which was introduced in 2017 to expand service coverage and improve financial protection. However, safety net programs have been fragmented and provide coverage to only a limited proportion of the population.

Educating ourselves

19. Lao PDR has made significant progress in improving both the quantity and quality of education and educational outcomes. There was also an improvement in years of schooling and learning-adjusted years of schooling between 2012 and 2017 (Figure 38). Children in Lao PDR can expect to complete 10.8 years of schooling by age 18, but when adjusted for the quality of learning, learning-adjusted years of schooling is estimated at only 6.4 years, with a learning gap of 4.4 years. This is also reflected in about 83 percent of working-age people (aged 15 to 64) with completed secondary education,³⁵ which affects their ability to develop skills and productivity at work..

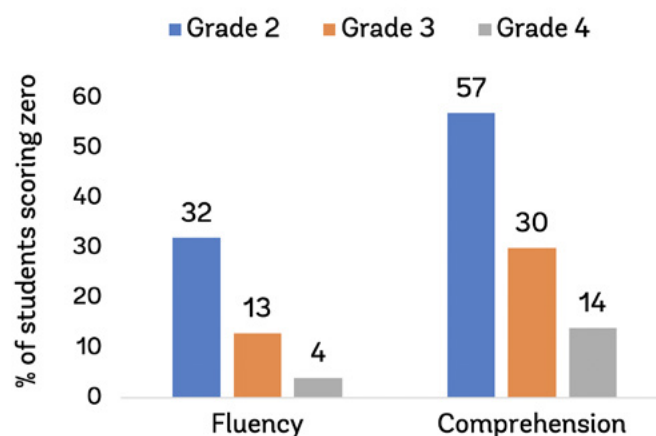
20. However, Lao PDR does relatively worse in terms of quality of education, in contrast to years of schooling, when compared to its peers. While the educational attainment in years of schooling in Lao PDR is both above most resource-rich countries and the average for lower middle-income countries, it does worse than the average learning-adjusted years of schooling with respect to lower middle-income countries (Figure 38). Moreover, the number of years of schooling Lao PDR is closer the EAP regional average. However, the quality of learning, which is measured by learning-adjusted years of schooling, is lower than that of the EAP region average. This is reflected in the fact that, in Lao PDR, the early grade reading assessment found that almost one-third of students in grade 2 scored zero on fluency and 57 percent scored zero on comprehension (Figure 42). Limited operational expenses (non-wage recurrent spending) (Figure 39) and on teaching and learning materials, equipment, and teacher training also contribute to the slow improvement of education quality.³⁶

21. Women still have lower literacy rates, especially among the poor. The literacy gap between males and females is 23 percentage points, and girls constitute the majority of those who have never been to school. Although gaps in enrollment have closed and the net enrollment of girls equals that of boys in both primary and secondary education, the gap still persists in access to tertiary education. Although the legal framework provides equal rights to men and women, customs and traditions may limit implementation in some cases.

³⁵ Labor Force Survey 2017

³⁶ Improving educational quality is based on ensuring effective and sustainable institutional alignment across several factors, such as effective spending, improving teacher quality, enhancing the readiness of students to learn, and regular assessment of learning outcomes. See *Growing Smarter: Learning and Equitable Development in East Asia and Pacific*, World Bank, 2018.

Figure 42: Learning outcomes are poor



Source: World Bank 2014.

22. The typical out-of-school child lives in a rural area without access to a road, is poor, and is more likely to be non-Lao Tai. This implies that, similar to access to quality health services, access to quality education and, consequently, educational outcomes, vary significantly across (non-mutually exclusive) characteristics of geographic location, ethnicity, income, and gender. For instance, early childhood education participation is 55 percent among urban children of the same age group compared to 15 percent of rural children. In addition, the completion of education to grade 5 is lowest among children living in rural areas without road access, children in the poorest quintile, and children of mothers with no education.

23. Lao PDR has a relatively high dropout rate. The dropout rates are relatively high with only 77.5 percent of pupils starting in grade 1 reaching the last grade (5) of primary education. Moreover, the transition to secondary education is relatively low, with only 44.7 percent of children enrolling in secondary education, compared to 77.1 percent in the EAP, on average. Once again, the dropout rate (before completing primary school) for poor, non-Lao Tai girls living in rural areas is highest at around 16 percent. In addition, for boys in the same category, it is lower (10 percent), implying a gender disparity. Poor educational outcomes, which limit the school enrolment and completion rates in Lao PDR, may be attributed to:

- (i). **Relatively higher direct cost in concert with the higher opportunity cost of schooling vis-à-vis the lower return on education creates a vicious cycle of perpetually lower educational outcomes among households living at the lower income deciles.** A primary reason for the high dropout rate among poorer households is the cost of education and need to work to support their families, indicating that cost (both direct and opportunity cost) is a constraint to continuing schooling. The cost of attending school can be relatively high for a poor family, which mainly refers to ancillary costs, that is, the cost of uniforms, food, and transport. In terms of opportunity costs, a large proportion of children contribute to household chores and economic activity. As they get older, the potential value of children to their households increases. This appears to be especially true for girls.
- (ii). **Capacity constraints, both human and physical capital, within and around schools, limit access to quality educational services.** Limited school infrastructure, equipment, teacher training, maintenance, and materials adversely affect the quality of schooling. The lack

of school infrastructure is acute in Lao PDR, with almost 57 percent of all primary schools and 70 percent of primary schools in the poorest districts not offering all five grades of primary education. For instance, 40 percent of children who left school after completing grade 3 were studying in a school that did not offer grade 4, while 30 percent of children who left after grade 4 had no grade 5 to go on to. In addition, almost half of the schools in Lao PDR have a roof that leaks, only slightly more than half of the schools have a water supply, only 20 percent have electricity, and fewer than half of the schools have toilets. Modern appliances (phones, ICT) are even more limited (World Bank 2012a). As with access to health care, access to schooling is limited due to poor road access, which limits the ability of children to reach schools, with the percentage of children who have never attended school rising for rural areas with no road access to a school.

- (iii). ***Underfunding and poor prioritization of aspects of the education sector have led to the low quality of services provided by this sector.*** Spending on education as a percentage of GDP was only 2.7 percent in the 2018 budget plan, on par with some countries in the region (Cambodia), but low compared to lower middle-income countries and most of the selected peers (Bolivia, Botswana, Nepal) and other countries in the region (Thailand, Vietnam). A major portion of expenditure has been taken up by wages and capital spending, leaving low non-wage recurrent expenditures (such as school materials, equipment, teacher training). This implies that households must pay nonmandatory fees for schooling, which may affect access to education for children from poor families.



B.3. How can Lao PDR make further progress in boosting human capital?

A combination of systemic and sector-specific interventions are needed to enhance human capital development outcomes.

24. There are both sector-specific and systemic interventions that need to be undertaken to improve health and education outcomes. More specifically, sector-specific interventions to reduce child mortality and reduce stunting include improving primary health care facilities to support preventive health care and early disease detection; educating the population to change dietary habits; ensuring local market availability of key foodstuffs or, otherwise, supplements; complementary efforts in support of water, sanitation, and hygiene (WaSH) services; and delivery of quality maternal and child health services including immunization, pre- and postnatal care, safely delivery availability, and essential newborn care to ensure maternal and child survival.

25. Sector-specific interventions to improve learning-adjusted outcomes include providing early learning/early childhood education opportunities to develop children's language, cognitive, and social skills; teacher training; continued assessment of learning outcomes; increasing the availability of educational tools and materials in schools; and continuous assessment of learning outcomes and teacher performance.

26. Systemic interventions fall under four broad avenues to improve service delivery, and thereby human capital development, in Lao PDR: (i) increasing the quantity and quality of spending; (ii) mitigating capacity constraints; (iii) improving planning, monitoring, and evaluation; and (iv) improving the functioning of the decentralized institutional service delivery mechanism.

Increasing the quality of public spending

27. Ensuring adequate non-wage recurrent spending and improving the quality of expenditure related to human capital development and related services, would support improved human development outcomes. Spending needs to be prioritized, particularly for operation and maintenance, directed toward service delivery in rural and remote areas given significant urban-rural disparities in access. Alternative models of service delivery, including co-delivery of public services with partners from the private and nonprofit sectors under an adequate governing framework, should be more frequently considered, as it can lead to quality improvements alongside a lighter fiscal burden. Disrupted cashflows mean that regular activities, including outreach beyond urban areas, are not funded consistently. Improvements to the public financial management system constitute one avenue for improving the quality of public spending. Improvements need to be undertaken in four key areas: (i) the credibility and links between the planning and budgeting processes, (ii) the comprehensiveness and transparency of recording and reporting in the budget by functional classification of budget expenditure, (iii) the control of budget execution, and (iv) corrective measures in financial management.

Mitigating capacity constraints to service delivery

28. Capacity constraints hinder service delivery at the national level, and the problem is even more severe at lower levels of government. The challenges are myriad, including human resource

constraints (for example, inadequate staffing levels and an inability to source appropriate skills), technical difficulties, lack of supplies, and shortages of ancillary services to enable service delivery. Conditions vary across provinces, and between rural and urban areas, with rural capacity especially constrained due to difficulties in both hiring (and keeping) employees and maintaining infrastructure in rural areas. Basic supplies for schools and health care facilities can often end up mismanaged and poorly distributed, making it difficult for corresponding services to be provided. Slow and laborious public procurement processes need to be reformed (streamlined, but with transparency and accountability improvements) to encourage greater private sector support for service delivery, from supplying inventory to maintaining infrastructure.

Improving planning, and monitoring and evaluation

29. Planning, and monitoring and evaluation, although improved in recent years, continue to be constrained by a lack of data. These activities are hampered by data fragmentation, old and poor-quality data, lack of data sharing among government entities, and inconsistencies among different data sources and between national and international data. Basic questions such as whether national sector expenditure, workforce, or infrastructure have increased or decreased in recent years, cannot be readily answered. This can significantly change the narrative around particular issues and therefore affect the ability to adequately plan, budget, and implement policy. The Lao Statistics Bureau should be supported to expand its capacity so that major gaps in the collection and availability of national statistics are addressed and steps taken to encourage and streamline information and data sharing across government.

Improving the functioning of the decentralized institutional service delivery mechanism

30. The pace of decentralization and devolution of service delivery responsibilities to the district and provincial levels has exceeded the speed at which subnational systems are able to adapt. There is poor performance in several areas crucial to decentralization. Cashflow and accountability issues continue to hinder provincial service delivery. Better institutional arrangements need to be implemented to overcome ineffective integration within and among agencies at different tiers of government. Funds directed to the district level have had mixed results: successes have been idiosyncratic, with many projects established but not staffed or maintained. Improvements are needed in public investment management, to ensure delivery and ongoing maintenance of essential infrastructure, and public financial management, for improved credibility and execution of the overall public budget.

31. Addressing human capital development using both a sector-specific and systemic approach in the face of a limited resource envelope will require prioritization to areas and population groups where education and health outcomes are relatively poor, that is, in rural areas among the non-Lao Tai population who are usually at the lower income deciles. Interventions should be targeted at the poor and ethnic minorities to have the greatest likelihood of reducing disparities in health, education, and labor market outcomes. In many cases, this will require social and behavioral change to stimulate demand for, and consumption of, these services, as a large part of the unserved population are ethnic groups in remote areas. Media campaigns; outreach activities; interpersonal contacts, especially at the village level; and social transfers can help.

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