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SUSTAINING GROWTH

MAINTAINING MACROECONOMIC STABILITY

LAO PDR ECONOMIC MONITOR
June 2013

Sector Focus

Improving the Effectiveness and Transparency of Mining Revenues

Government Budget at a Glance

Public Spending on Health in Lao PDR

Net Economic Benefits of Sanitation Interventions

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Lao PDR

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Lao PDR Economic Monitor – June 2013 was prepared by the World Bank country team under the guidance of Sector Manager and Lead Economist for South-East Asia Region, Mathew Verghis and Senior Country Economists, Richard Record and Genevieve Boyreau. The team comprised of Keomanivone Phimmahasay and Somneuk Davading (recent economic developments and overall report), Saysanith Vongviengkham, Minh Van Nguyen and Leah April (public finance), Ratchada Anantavrasilpa (financial sector), Konesawang Nghardsaysone and Richard Record (private sector and trade facilitation), Morten Larsen (mining revenues), Saysanith Vongviengkham and Keomanivone Phimmahasay (government budget at a glance), Ajay Tandon (public spending on health), WSP Lao Team, U-Primo E. Rodriguez and Guy Hutton (economic assessment of sanitation interventions). The team would like to express its gratitude to the Government of Lao PDR (especially BOL, MOF, MPI/LSB, MEM, MOIC, MoICT, MAF and other ministries) and the Lao National Chamber of Commerce and Industry for providing essential inputs. We would like to also thank our World Bank colleagues: Vattana Singharaj, Meriem Gray and Toomkham Luanglath, for administrative support and dissemination of the Monitor.

“THE WORLD BANK TEAM APPRECIATES FEEDBACK ON STRUCTURE
AND CONTENT OF THE MONITOR”

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Executive Summary

The Lao economy is projected to grow at 8 percent in 2013. The hydropower sector (both completed projects in operation and projects in the construction/development phase), construction, food processing and services sectors remain the major contributors to this growth. In early 2013, Lao PDR's successful accession to the World Trade Organization (WTO) was an important step towards the establishment of a rules-based system of economic governance and a necessary part of efforts to diversify away from the resource sectors. Though medium-term growth projections remain optimistic, regional and global uncertainties may affect Lao PDR's ability to comfortably absorb macroeconomic shocks.

Overall inflation has risen considerably since the end of 2012, due to a notable increase in non-rice food prices. Though rice prices remain low, inflation rose due to a climb in meat prices, specifically the cost of beef, as a result of increased demand for internal consumption coupled with an insufficient local supply. Vegetable and other food prices have also risen. In response to rising food inflation, the Ministry of Industry and Commerce (MOIC) recently issued an order to temporarily suspend exports of livestock and divert them for local supply.

The fiscal deficit as a ratio to GDP is expected to widen in FY12/13. The fiscal deficit is expected to rise to 2.8 percent of GDP in FY12/13 from 1.3 percent in FY11/12 in part due to increased spending on public wage increases, and also as a result of an expected slower increase in total revenues (primarily due to lower grants after ASEM and lower mining revenues). Despite the completion of ASEM related infrastructure activities, the total spending for this fiscal year is likely to rise because of the significant increase in public wages and allowances, as reflected in the first quarter. The wage bill is expected to rise from FY12/13 estimates of 5.7 percent of GDP to almost 9 percent of GDP by FY14/15. Given the recent outlook on the uncertainty of commodity prices and the continued expansionary policy, financing this wage policy will require an increased debate on medium term fiscal sustainability. Furthermore, additional efforts to strengthen the non-resource revenue base are of critical importance in order to counter the effects of revenue volatility arising from swings in mineral prices that affect Lao PDR's natural resource revenues.

Low levels of external reserves call for the containment of aggregate demand. Despite a rebound in the second half of 2012 attributed to a slowdown in credit growth and commercial banks' recapitalization, foreign reserves coverage of imports reached its lowest level in the past eight years due to strong domestic demand. In addition, exchange rate management has contributed to fluctuations in the reserves level. This trend raises concerns over the country's resilience in absorbing any adverse shocks. Therefore, containing aggregate demand through fiscal and credit growth management is essential to maintain macroeconomic balances while exchange rate management needs to be measured given the pressures on reserves and competitiveness.

As the banking sector continues to expand and credit growth remains relatively high, bank supervision capacity needs to be strengthened. As the number of banks has risen, their total assets have increased concurrently, although the sector is still dominated by state-owned commercial banks. Commercial bank lending supported by continued growth in the construction, services and commerce sectors has been increasing and reached 34 percent of GDP in 2012. This trend is contributing to broad money growth and strong domestic demand. Against the backdrop of the credit and banking sector expansion, strengthening bank supervision capacity to improve reporting and the timely availability of banking sector data is essential for monitoring and managing the health of the financial sector.

Lao PDR's robust economic performance and expansionary fiscal policy calls for a bolder investment in social sector spending. Currently, public expenditures in priority areas such as health and education remain far below the Government's targets as outlined in the 7th NSEDP. Increased allocations to non-wage recurrent spending, which have already been underfunded, are particularly important for improving the efficiency of public asset utilization. In the health context, access to health care remains dependent on out-of-pocket spending while provision of health care is heavily supported by external sources of financing. In the context of the National Health Sector Reform Strategy for 2013-2025 and the time-bound commitment to achieving Universal Health Coverage (UHC) by 2025, greater investment and improvements in spending efficiency are essential to increase access to health care services.

Acronyms and Abbreviations

ASEAN	Association of Southeast Asian Nations	MAF	Ministry of Agriculture and Forestry
ASEM	Asia-Europe Meeting	MEM	Ministry of Energy and Mines
BOL	Bank of Lao PDR	MOIC	Ministry of Industry and Commerce
CB	Commercial Bank	MOF	Ministry of Finance
COD	Commercial Operation Date	MONRE	Ministry of Natural Resources and Environment
BOP	Balance of Payment	MPI	Ministry of Planning and Investment
CPI	Consumer Price Index	NA	National Assembly
DESIA	Department of Environment and Social Impact Assessment	NEER	Nominal Term Effective Exchange Rate
DOM	Department of Mines	NFA	Net Foreign Assets
EAP	East Asia & Pacific	NPL	Non-Performing Loan
EDL	Electricité du Lao	NSEDP	National Socio-Economic Development Plan
EIA	Environmental Impact Assessment	NT2	Nam Theun 2 Project
EITI	Extractive Industries Transparency Initiative	ODA	Official Development Assistance
EPF	Environment Protection Fund	OOP	Out-of-Pocket
ESI	Economics of Sanitation Initiative	PBM	Phu Bia Mining
EU	European Union	PPG	Public and Public Guaranteed Debt
FDI	Foreign Direct Investment	PO	Public Offering
FY	Fiscal Year	QOQ	Quarter on Quarter
GDP	Gross Domestic Product	REER	Real Effective Exchange Rate
GFIS	Government Financial Information System	RO	Right Offering
GOL	The Government of Lao PDR	SOCBs	State-Owned Commercial Banks
IMF	International Monetary Fund	SOE	State-Owned Enterprise
HC	Health Centre	UHC	Universal Health Coverage
IPP	Independent Power Producers	VAT	Value Added Tax
LDC	Least Developed Country	WB	World Bank
LNCCI	Lao National Chamber of Commerce and Industry	WEO	World Economic Outlook
LSB	Lao Statistics Bureau	WTO	World Trade Organization
LSX	Lao Securities Exchange	YOY	Year on Year
LXML	Lane Xang Mineral's Limited		
MCH	Mother and Child Health		

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PART I Recent Economic Developments

Global growth is expected to improve slightly in 2013 before rebounding in 2014-15. Global growth, influenced from prospects in developing economies, is projected at 2.4 percent in 2013 compared to 2.3 percent in 2012. The outlook for advanced economies, however, remains challenging. In Asia, economic performance experienced a slowdown in 2012 due to falling external demand and rebalancing in some economies. However, growth is expected to remain solid due to an improving external demand and a sustained domestic demand. Private demand has been stimulated through accommodative monetary policies, and fiscal policies in some economies. East Asia and Pacific (EAP) GDP growth in 2013 is projected to be 7.6 percent. ASEAN-5 economic performance is expected to remain robust at 6 percent due to a resilient domestic demand. China's growth is expected to accelerate due to robust consumption and investment as well as a recovered external demand. Thailand's growth is projected to return to her usual pace after completed reconstruction following the devastating flooding in 2012. Nevertheless, there remain some substantial external risks for Asia with the falling external demand from developed economies and internal risks arising from recent credit growth and accommodative financial conditions in some Asian economies. Despite these risks, Lao PDR is expected to benefit from sustained demand from its key trading partners (particularly China, Thailand and Vietnam) given their overall prospects in 2013. In early 2013, Lao PDR's successful accession to the World Trade Organization (WTO) is an important step towards the establishment of a rules-based system of economic governance and a necessary part of efforts to diversify away from the resource sectors. Lao PDR's country-level projections are based on the regional and global economic outlook from Global Economic Prospects, January 2013 and World Economic Outlook, April 2013, as summarized in Annex 1.

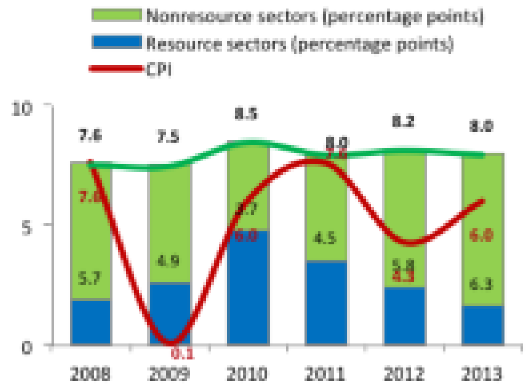
GROWTH AND INFLATION

The Lao economy is projected to grow at 8 percent in 2013. This anticipated growth remains strong as in years past and is driven by resource[1] and non-resource[2] sectors (Figure 1). The upward revision of 0.4 percentage points from November 2012's projection reflects recent data for cement and hydropower outputs. In addition to existing facilities, a new cement factory, in operation since 2012, has increased cement production capacity, in response to growth in the construction sector. Furthermore, the hydropower contribution to GDP will benefit from the completion[3] and development of several large hydropower projects including Hongsa Lignite, Sayaboury, Nam Ou, and Xepian Xe Namnoi projects, which also offer a positive spillover to the construction, food and services sectors (Figure 2). Food and beverages will continue to benefit from a robust domestic demand while expansion continues in wholesale and retail trade, tourism, transportation and the telecommunications and banking sectors. The agricultural sector has continued to rebound following a recovery from the floods in 2011.

Given uncertainties in the global economy and implications from regional economic developments, Lao PDR's average annual growth rate is projected to be 7.8 percent in the medium-term. This outlook assumes the continued success of active and planned hydropower projects. The non-resource sector is expected to maintain dynamic growth in the context of continued strong domestic consumption, sustained demand from key trading partners and active reform efforts to improve the enabling business climate. While the medium-term economic outlook remains positive, Lao PDR's ability to absorb macroeconomic shocks is relatively limited.

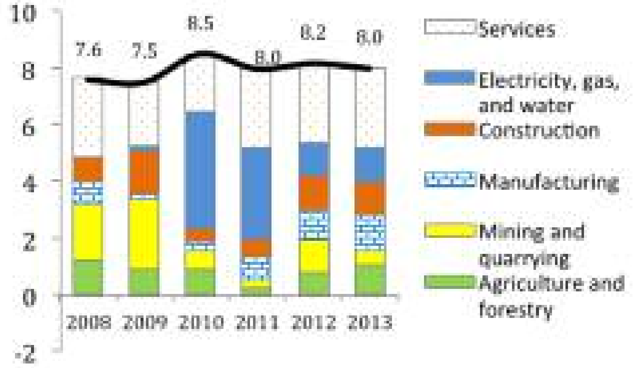
1 Hydropower and mining
2 Manufacturing, construction, food processing, banking and other services
3 Completed projects that will commence full operations in 2013 include Nam Ngum 5 and the Theun Hinboun expansion project.

Figure 1 Growth and Inflation (percent change)



Source: Government, LNCCI data and staff estimates and projections.

Figure 2 Real GDP Growth (at factor cost): Contribution by Sector (percentage points)

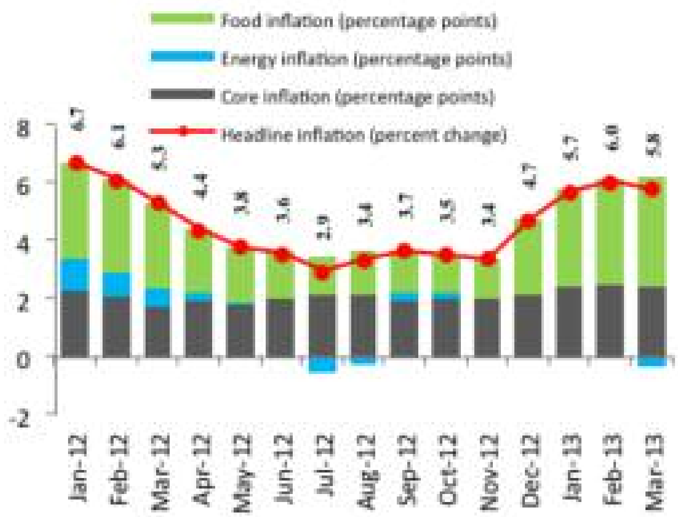


Source: Government, LNCCI data and staff estimates and projections.

Inflation

Overall inflation rose considerably since December 2012 due to a continuous rise in non-rice food prices. Headline inflation increased from 3.4 percent YOY in November 2012 to 5.8 percent in March 2013 primarily due to higher food inflation (Figure 3), which rose from 3.7 percent to 10.1 percent in the same period (Figure 4). A key driver of this effect is the significant climb in meat prices, followed by vegetable prices. Beef prices[4], in particular, rose by almost 40 percent YOY in February 2013 (Figure 5). This development is the result of a gap between an internal consumption demand and the limited supply associated with reported livestock exports to neighboring countries and scattered livestock rearing in the country. As a result, food inflation has increased. In response, the Ministry of Industry and Commerce (MOIC) recently issued an order[5] to temporarily suspend exports of livestock and divert them for local supply. The effect of this measure will be monitored. While energy inflation has remained low following an international price trend, core inflation has seen a moderate increase mainly due to the pressure from scheduled rising electricity tariffs[6] and restaurants and hotels' charges. Average inflation in 2013 is projected to rise to 6 percent compared to 4.3 percent in 2012.

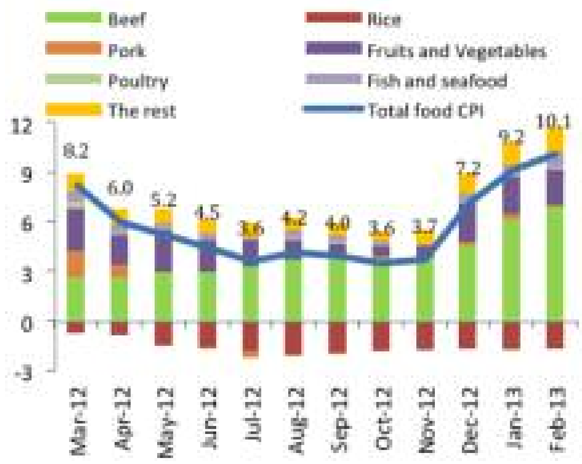
Figure 3 Monthly Inflation (yoy percent change)



Source: MPI (LSB) and staff calculations.

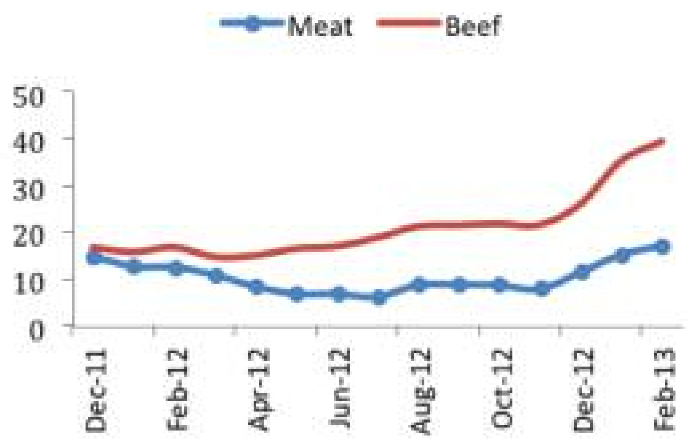
4 Beef accounts for 18 percent of total food items or 6 percent of the total consumption basket whereas vegetables account for about 10 percent and 4 percent, respectively.
5 MOIC order no. 650, dated 1 April 2013
6 According to Electricity du Lao PDR (EDL), electricity tariffs will increase by 5 percent annually from 2012 to 2015.

Figure 4 **Contributions to Food Inflation**



Source: MPI (LSB) and staff calculations.

Figure 5 **Beef and Meat Prices Index (YOY percent change)**



Source: MPI (LSB) and staff calculations.

GOVERNMENT'S REVENUE AND EXPENDITURE

Resource revenues from mining and hydropower increasingly influence the government budget. Fiscal deficit as a ratio to GDP in FY11/12 was 1.3 percent, 1 percentage point lower than the estimate in November 2012 due to outperformance in revenue collection and less-than-expected off-budget spending financed by direct borrowing from BOL. While the non-resource fiscal deficit declined slightly from 8.3 percent in FY10/11 to 8.1 percent in FY11/12, the non-mining fiscal deficit[7] experienced a more substantial decline, from 7.7 percent to 7.1 percent, respectively (Figure 6). This development highlights the role of resource revenue in financing the budget. A combination of higher grant receipts and 9 percent outperformance in domestic revenue (particularly tax revenues) brought the total revenue to GDP to 19.8 percent in FY11/12 from 18.5 percent in FY10/11. This was attributable to a combination of i) higher gold and copper prices in 2011; ii) higher revenue from hydropower projects and iii) certain non-resource revenues especially turnover tax, value added tax and income tax.

Total fiscal outlays as a ratio to GDP in FY11/12 fell more than expected due to a reduction in off-budget spending. Total expenditure as a ratio to GDP fell slightly from 21.3 percent to 21.1 percent in FY11/12 (Figure 6). The reduction in off-budget investment spending was attributed to direct borrowing from BOL that more than offset higher recurrent expenses including materials and supplies, wages, and expenditure that supported preparations for the 9th ASEM.

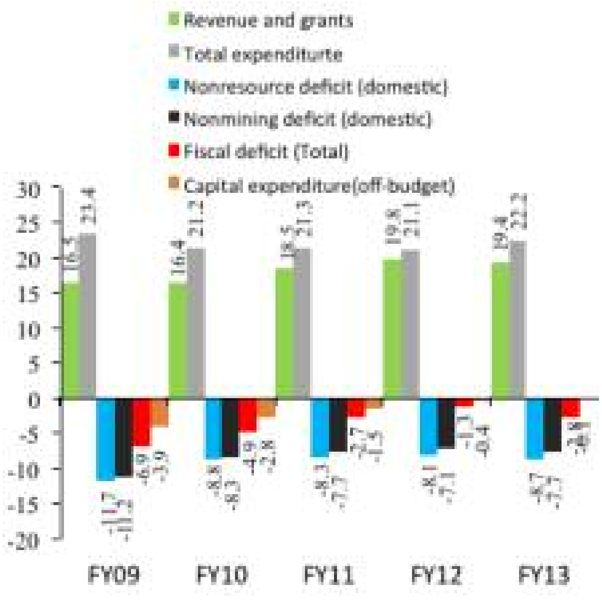
In FY12/13 an expansionary fiscal stance is expected as public sector wages increase and as mining revenues as a ratio to GDP decreased. The fiscal deficit is expected to more than double to reach 2.8 percent of GDP. The non-resource fiscal deficit is expected to rebound to 8.7 percent in FY12/13 while the non-mining fiscal deficit is likely to reach 7.7 percent. Total revenue as a ratio to GDP is expected to decline to 19.4 percent due to lower grants (back to pre-ASEM levels) and a lower mining revenue in 2012 as a result of a 10 percent fall in copper prices and higher mining production costs that partly offset the volume and gold price gains in 2012[8]. Nevertheless, non-resource taxes particularly VAT and excise taxes, have a positive performance outlook. VAT collection in Q1 rose by 35 percent YOY. This reflects the application of a flat 10 percent rate to those taxpayers who used to be subject to the 5 percent turnover tax and the increase in the number of VAT taxpayers from 2,300 to 4,100 units to date. Maintaining tax collection efforts on the non-resource base of the economy is critical not only to protect fiscal accounts from volatility, but also to diversify public revenue and avoid dependence on a limited number of megaprojects.

7 Non-mining fiscal deficit is the difference between hydropower and non-resource domestic revenue and total expenditure
8 Mining revenue monitoring is discussed further in Part II.1

Total spending is projected to climb in FY12/13 driven by the planned public wage and compensation increases. Despite the completion of ASEM related infrastructure activities, the total spending for FY12/13 is likely to rise to 22.2 percent of GDP from 21.1 percent in FY11/12. This increase is driven by a near 35 percent increase in public wages and allowances.[9] In FY12/13, wages and compensation are projected to account for about 61 percent of both recurrent spending and non-resource domestic revenue compared to 58 and 49 percent, respectively, in FY11/12. The effect of this policy is already reflected in Q1 where wages and compensation rose by 86 percent YOY accounting for nearly 40 percent (Figure 7) of the total expenditure compared to about 35 percent in Q1 last year (YOY). In addition, the share of non-wage recurrent expenditure (Figure 7) reduced further to 18 percent of recurrent expenditure in Q1 of FY12/13 compared to 20 percent in Q1 during FY11/12. This might reinforce the issue of underfunding for operation and maintenance expenditure for public assets. Given the recent outlook in uncertainty on commodity prices and a continued expansionary stance, financing this wage policy requires a careful assessment of its fiscal sustainability. Further discussion on the FY12/13 budget plan is presented in Section II.2.

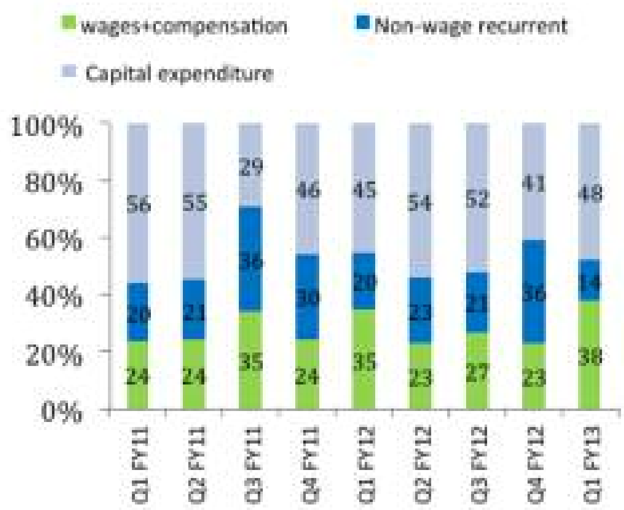
A trend of private pre-financing infrastructure projects is emerging. Many public infrastructure projects, such as roads and bridges, are pre-financed by private contractors citing development priorities of concerned regions despite limited budget allocations. This trend mirrors the increased lending taking place in the construction sector. These projects claim to be aligned with provincial or national NSEDP and plan to borrow future revenues for current spending to support their completion. If inappropriately managed such financing might generate contingent liability and liquidity squeeze for the future budget, contractors and the banking sector. Therefore, it is of crucial importance that the government understands the current size of active and planned pre-financing arrangements, and develops regulations and policies in order to optimize their management to avoid the accumulation of contingent liabilities.

Figure 6 Government's Fiscal Performance (percent of GDP)



Source: MOF and staff estimate and projection

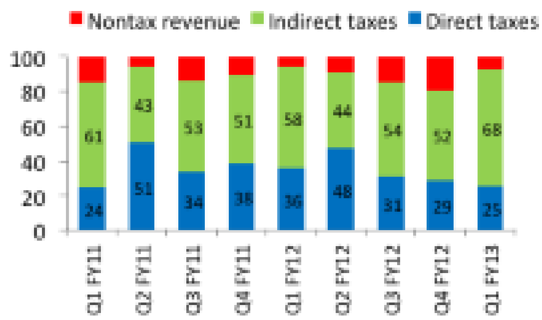
Figure 7 Quarterly Expenditures (percent of total expenditure)



Source: MOF and staff estimate and projection

9 In an attempt to improve living standards of civil servants, the government issued a decree to increase wages during 2013-2015 (No. 221/GOVERNMENT dated 30 May 2012).

Figure 8 **Quarterly Revenue Collection (percent of total domestic revenue)**



Source: MOF and staff estimate and projection

EXTERNAL SECTOR

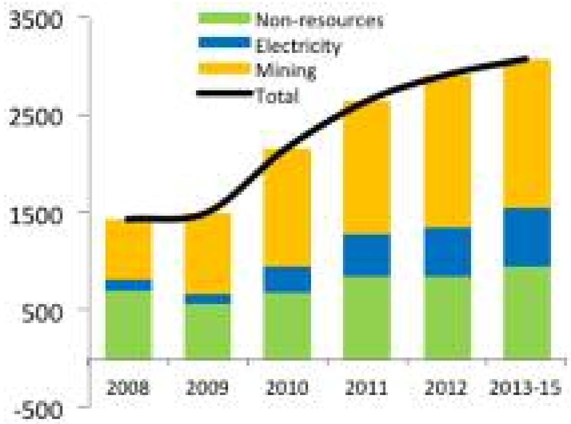
The overall balance of payments is expected to remain in a slight surplus as strong investment inflows offset a widened current account deficit. The overall balance is expected to remain in a surplus of 0.6 percent of GDP this year due to continued large investments in the resource sector, such as the Hongsa Lignite, Nam Ou, and Sayaboury power projects and continued capitalization of banks (Figure 19). Investment in the non-resource sector is expected to slow in 2013 after a robust acceleration in 2012. Economic activities following large infrastructure and service sector projects in Vientiane during 2012 are slowing down. The capital account surplus, that will mostly finance capital imports, is expected to rise from about 16 percent to 22.5 percent in 2013 (Figure 9).

The current account deficit is expected to widen due to robust resource sector imports. The total current account deficit is projected to worsen to 21.8 percent of GDP in 2013 from 15.5 percent in 2012. The causes for this are multi-factorial. Firstly, capital goods imports are projected to rise (Figure 12) by about 32 percent YOY largely to support construction of resource projects. Secondly, robust domestic consumption will continue to fuel demand for consumer goods imports, such as vehicles and fuel compared with slower growth in non-resource exports. However, nominal imports might increase at a slower pace compared to last year due to projected falling commodity prices for certain products and the high base effect in 2012. Non-resource exports experienced slower growth in the context of economic uncertainty in some trading partners (Figure 10). For instance, total garment exports fell by 16 percent YOY in value term and about 30 percent drop in volume term last year driven by the lower demand from the US market. Supply side constraints related to labor shortages and appreciation of the Kip has also played a role. Some firms have adjusted by turning to higher value added products while shifting to other markets such as Japan with a lower base. In addition, the net income outflow from the resource sector (interest payments and income repatriation from mining and hydropower sectors) is projected to climb this year. Nevertheless, the current account deficit will likely be offset by the capital account surplus yielding a slight surplus in the overall balance of payments.

Figure 9 **Balance of Payments (percent of GDP), 2008-13**

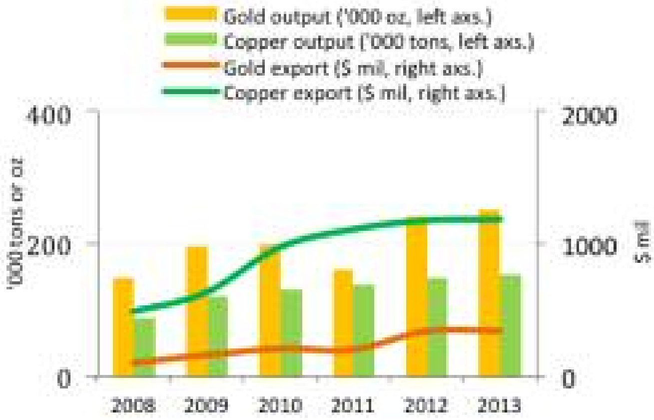
Source: BOL and staff estimates and projections

Figure 10 **Merchandise Exports (US$ million)**



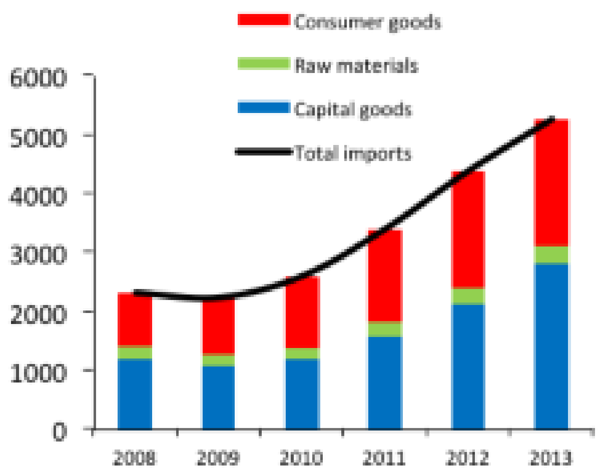
Source: Staff estimates and projections based on data from MOIC, LNCCI and partner countries

Figure 11 **Gold and Copper exports**



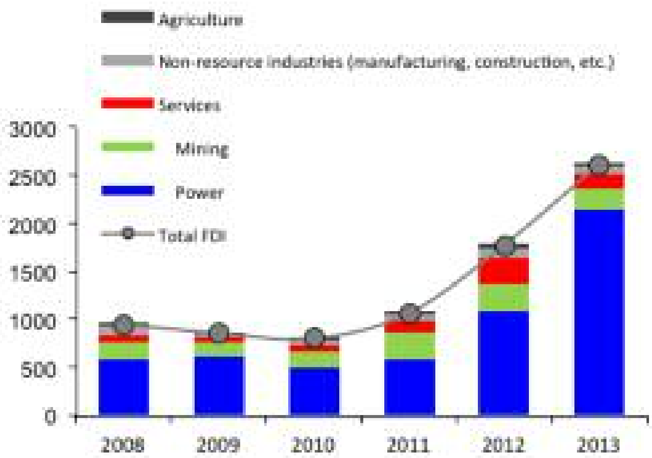
Source: Lane Xang Minerals Limited and Phu Bia Mining Companies, 2012 and staff calculations

Figure 12 **Merchandise Imports (US$ million)**



Source: Staff estimates and projections based on data from MOIC, LNCCI and partner countries

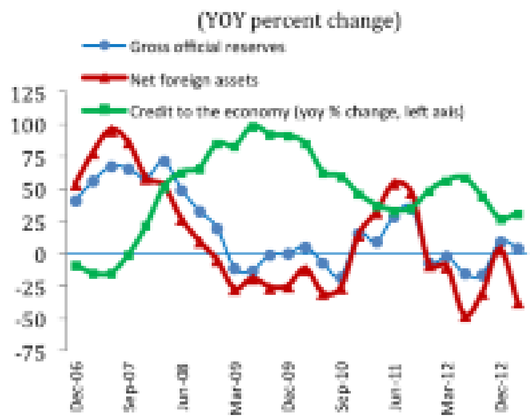
Figure 13 **FDI in Lao PDR (US$ million)**



Source: MPI and staff estimates and projections

Despite a recent end of the year rebound, low levels of external reserves call for a containment of aggregate demand. The balance of payments resulted in a surplus of 0.7 percent of GDP in 2012 helped by a slowdown in credit growth (particularly in foreign currencies) in the second half of 2012 and commercial banks' recapitalization and new registration (Figure 14). As a result, foreign reserves and net foreign assets rebounded in Q4 by 24 percent (QoQ) and 35 percent QoQ after continually falling since end 2011. However, the levels of reserves fell by 5 percent QoQ in Q1 2013 while net foreign asset fell significantly by about 30 percent QoQ attributed to a rebound in credit growth. Clearer policy intentions on containing aggregate demand and reserves management are welcomed. Reserves stood at US$ 700 million in March. The reserve level is expected to cover only 1.8 months of goods and services imports for 2013 or about 3 months of non-resource imports, which could be the lowest level over the past eight years. Reserves coverage compared to foreign currency deposits fell progressively from about 60 percent two years ago to around 35 percent in March 2013 (Figure 15). This trend signals concerns over the country's resilience in absorbing any adverse shock.

Figure 14 NFA and International Reserves



Source: BOL and staff estimates

Figure 15 Reserves Coverage (percent of total FOREX deposits)

Source: BOL and staff estimates

As the external balance has been increasingly influenced by the resource sector and non-resource imports, the development of non-resource sectors is important to broaden economic base and promote sustainability in the long term. The completion of Lao PDR's efforts to accede to the World Trade Organization (WTO) is an important step towards the establishment of a rules-based system of economic governance and necessary part of efforts to diversify away from the resource sectors (Box 1). Membership means that the country commits to follow the WTO principles of non-discrimination, transparency and predictability. To accede, substantial reform measures were needed to bring laws in line with WTO agreements on subsidies, price controls, trade restrictions, state enterprises, and other areas. WTO membership will contribute towards efforts of the country to diversify away from natural resource dependency, attract quality investment outside the resource sectors, create jobs, and reduce poverty.

Box 1: Lao PDR's accession to the World Trade Organization

What has happened?

- **Following the completion of accession negotiations in late 2012, Lao PDR became the 158th member of the WTO in February 2013.** The accession process required a series of **negotiations with members of the "working party"**, including answering several hundred questions from WTO members. It is the completion of a fifteen year process, with application first made in 1997. However, the year **2012 saw unprecedented progress** including the reaching of crucial agreements with the US and EU, and three meetings of the working party in Geneva.
- The **WTO General Council approved the accession protocol for Lao PDR's membership in October 2012.** This was the final agreement on exactly what Lao has done in terms of reform, and what Lao has agreed to do over the next 3-5 years. It includes a "working party report" and a "schedule of commitments". The National Assembly ratified the accession package in December 2012. Formal membership came into force 30 days after the ratified documents were deposited with the WTO Secretariat in Geneva.

What does it mean?

- **Lao is a least developed country** and so was allowed to receive **"special and differential treatment"** during the accession process, generally meaning that Lao did not need to make as deep commitments as other acceding countries and has been given more time to fully implement commitments.
- It means signing up to the WTO **core principles of non-discrimination, transparency and predictability** and ensuring that these principles are incorporated into Lao law. Plus a series of more specific reform measures to bring Lao legislation into line with the WTO agreements on issues such as subsidies, price controls, restrictions, and state enterprises.

- **The average tariff has been bound (so cannot be raised above) 18.8 percent.** This will not have a significant impact, as Laos will have to make deeper commitments to ASEAN member states by 2015. The WTO agreements cover both trade in goods and trade in services. **Market access commitments have been made in 10 service sectors allowing foreign access** (in for example, banking, telecoms, distribution, health, environment, tourism, construction, air transport). This means that there are limits on how the country regulates these sectors.
- **The terms of Lao PDR's accession package, including the extent of commitments made, are in line with other similar recently acceding countries** (such as Cambodia, Vietnam and Nepal).
- **While a surge in foreign investment resulting from accession is not to be expected, accession to the WTO is an important externally verified signal of reform and sustained commitment to reform. However, for Laos to fully benefit, commitments will need to be fully implemented.** This is a challenge as the reform pressure will be reduced once Lao is a WTO member and, other country experience suggestions, there will be a very real risk of backsliding.

What are the World Bank and Development Partners doing?

- **The World Bank and Development Partners have been supporting the Lao WTO accession process for more than four years under the Trade Development Facility** Multi Donor Trust Fund financed by AusAID, EU, Japan and GIZ . The Facility has supported the direct costs of negotiations - including the last five Working Party negotiations in Geneva, drafting of legal texts in key areas (especially on sanitary and phyto-sanitary measures), bilateral negotiations, technical assistance to the negotiating team (including the first and only full time lawyer in MoIC), and a series of sector impact studies in professional services, distribution services, financial services, transport and telecommunications. Similarly, it includes a substantial program on trade facilitation (including the launch of the Trade Portal - which allows Lao to meet WTO Trade Facilitation Agreement requirements on transparency and publication) and on customs reform, including the phase out of reference pricing and movement towards compliance with the WTO Customs Valuation Agreement. The second series of the PRSO was also instrumental in supporting a number of trade facilitation reforms required as part of Lao PDR's WTO accession process.

- **The World Bank and Development Partners have recently approved a Second Trade Development Facility (TDF-2), a follow on operation to support the "beyond WTO" agenda over 2013-17,** co-financed by AusAID, EU, GIZ and Irish Aid. This will support key aspects of the next phase trade program of MoIC, including post accession work on trade in goods, trade in services and trade facilitation.

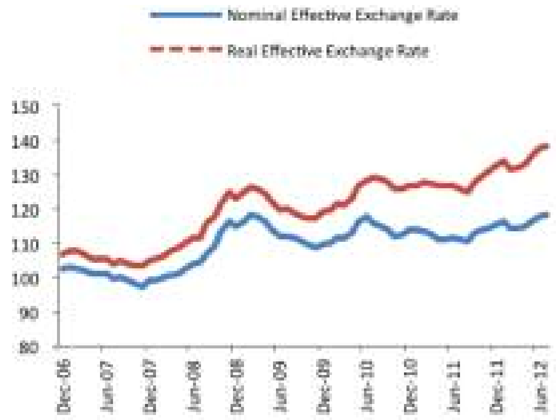
Exchange Rate

As the Bank of Lao PDR maintains exchange rate stability of the Lao Kip against major currencies, this should be balanced against reserves management and pressures on competitiveness. The effective exchange rate appreciated by 2.3 percent in nominal terms and by 4.3 percent in the real term from end-2011 to August 2012. This is the result of the combined Lao Kip appreciation against USD (by 3.2 percent during November 2012-March 2013) and Kip depreciation against the Baht in the same period (by 2 percent over the same period as the Baht continued to strengthen against the USD as a result of strong investment inflows into Thailand). The continued real appreciation of the exchange rate signals a loss of competitiveness of Lao PDR's exports which is consistent with the continued increase in domestic labor costs. Allowing some depreciation would relieve the pressure on reserves, and support competitiveness.

Figure 16 Kip Exchange Rate (Index Dec-2006 =100)

Source: BOL and Bank of Thailand and staff calculations

Figure 17 Nominal and Real Effective Exchange Rate (Index Dec-2006 =100)



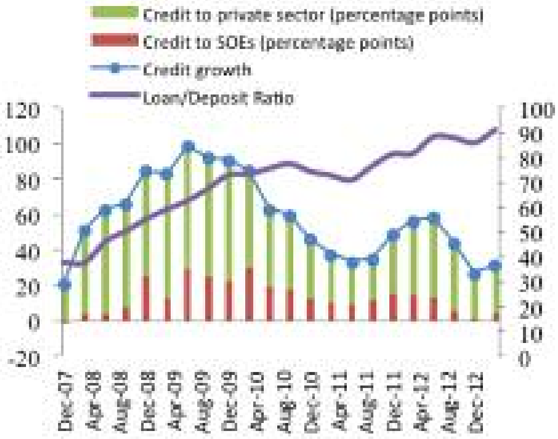
Source: IMF

Monetary Developments

Credit growth picked up by March 2012 and continued to stimulate domestic demand. After mid-2012, overall credit growth had decelerated to about 27 percent (YOY) in December due to the deceleration of BOL's direct lending (lending to SOEs line item) and lending to the private sector. This trend may be due to a base effect and a slowdown after an already high loan to deposit ratio of almost 90 percent in mid-2012. However, it rose by 31 percent in March due to a rebound in lending to SOEs, claimed to have been supporting the agriculture sector, and still robust lending to the private sector (Figure 18). Private sector credit growth has primarily come about as a result of increasingly buoyant growth in construction, commerce and service sectors (Figure 20). For instance, lending to construction significantly rose by 77 percent YOY in 2012, making it account for 17 percent of total lending to economy. Broad money grew by 12 percent YOY supported by strong deposits and credit growth. Therefore, managing domestic demand for example through BOL securities issuance might be an option to help remove some pressure on the external balance.

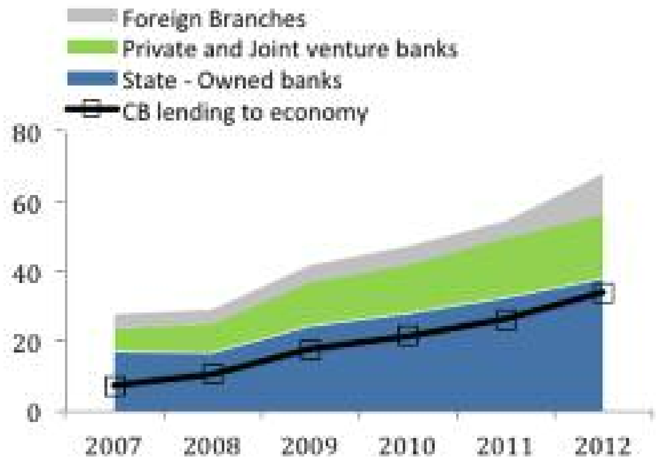
As the banking sector expands, bank supervision capacity needs to be strengthened. As the number of banks increased, their total assets increased significantly by 40 percent YOY in 2012. As a result, commercial banks' total assets substantially rose from about 40 percent of GDP in 2009 to about 68 percent in 2012 while their lending increased from about 20 percent of GDP to 34 percent in the same period (Figure 18). Currently, not all financial institutions can comply with the mandatory requirement to publish timely and audited financial statements as required by the Commercial Bank Law, making it difficult to assess the sector's financial health in a timely manner. The share of non-performing loans was reported to be 3.7 percent of total loans outstanding in mid-2012 but there are questions regarding the reliability of NPLs measurement, due to BOL's weak regulations, reporting and limited supervision capacity. Given this context, strengthening bank supervision capacity is crucial.

Figure 18 **Contribution to Bank Credit Growth (percent and percentage points)**



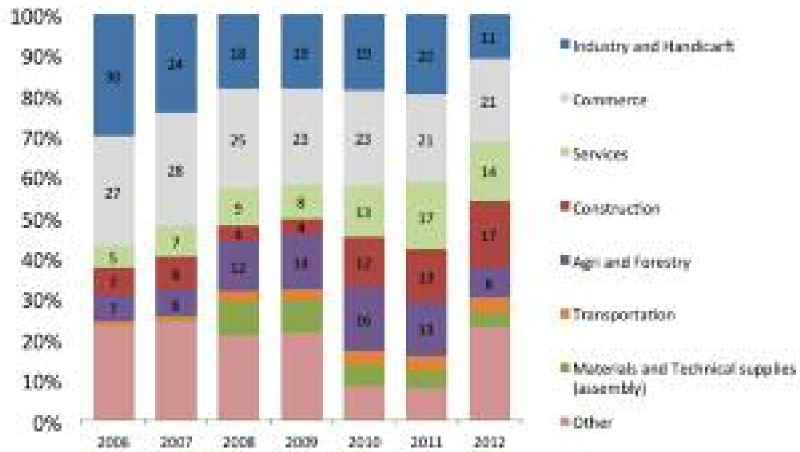
Source: BOL and staff estimates

Figure 19 **Banking Sector Assets and Credit (percent of GDP)**



Source: BOL and staff estimates

Figure 20 **Credits by Sector (percent in total lending)**



Source: BOL and staff calculations

PART II SECTOR FOCUS

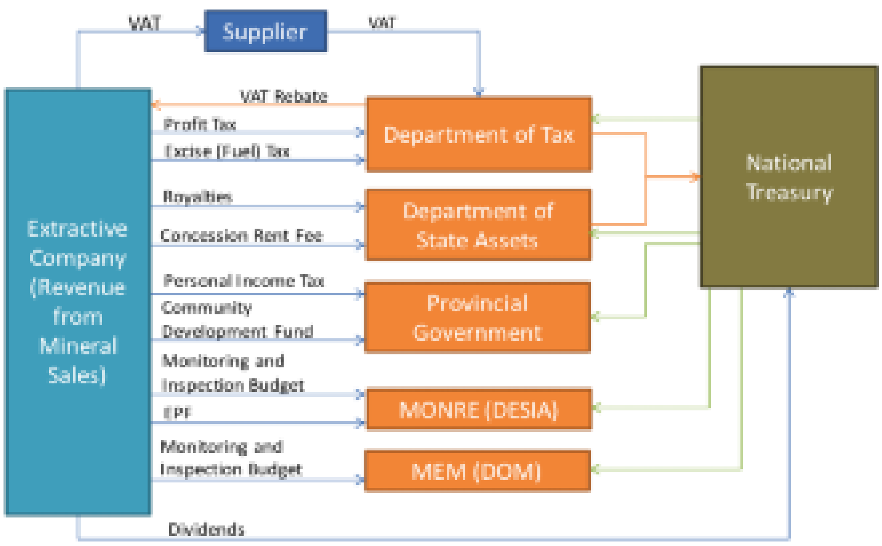
I. IMPROVING THE EFFECTIVENESS AND TRANSPARENCY OF MINING REVENUES[10]

The natural capital of Lao PDR including its agriculture, forests and increasingly its hydropower and mineral resources forms the backbone of the country's economy. The government aims to utilize this natural capital to drive socio-economic development through the generation of foreign direct investment (FDI), export earnings, government revenues, GDP growth, employment and skills development. Over the last decade significant investments have been made to develop the Lao mining sector. Of the 58 companies with active production agreements in Lao PDR, Phu Bia Mining's (PBM) copper-gold operation and Lane Xang Minerals Limited's (LXML) Sepon gold and copper mine are the most significant – accounting for over 90 percent of total national copper and gold production (Figure 10).

Mineral production has grown dramatically from modest production in 2003 estimated at some US$ 10 million to an estimated combined sales value of almost US$ 1.5 billion in 2012. The sector now directly contributes between 8-11 percent of the GDP and between 15–20 percent when indirect induced effects are accounted for. The significant increases in production have been accompanied by similar increases in government revenue in the form of: a) fees and service charges; b) taxes and royalties; c) dividends; d) duties and VAT; and e) funds and in-kind payments. Mining sector revenue now accounts for approximately 20 percent of total government domestic revenue. The two biggest operations, PBM and LXML contribute the bulk of these revenues – some US$200 - 300 million annually.
With this rapid increase in production and revenues a number of barriers to revenue collection and management have arisen including:

- *Limited monitoring and enforcement capacity* including a limited number of staff with an understanding of linkages between monitoring, inspection (of mine production) and revenue collection methods; limited capacity to audit production and revenue information supplied by companies; and limited capacity to follow up with companies that do not report on revenues.
- *Lack of information on revenues / payments from small to medium size operations:* There is currently little or no information available on the production levels, revenues and payments from small to medium size operations.
- *Difficulty tracking donations and sub-national revenue flows:* It is difficult to track and account for in-kind payments made directly to provincial and district governments.

Figure 21 Payment flows from extractive industries



10 This summary is based on a larger study undertaken by the World Bank in 2012 – Improving the Effectiveness and Efficiency of Mining Revenues in Lao PDR: An Initial Scoping Study for the Extractive Industries Transparency Initiative (EITI).

Transparency is recognized globally as a critical ingredient for best-practice management of the extractive industries sector. In terms of fiscal policy this means establishing an environment in which the objectives of policy and legislation are set based on clear and accessible data and information, made available and accessible on a timely basis. Transparency improves governments' ability to monitor and enforce existing legislation by creating certainty, stability and a level playing field for businesses.

In recent years Lao PDR has begun to take steps to increase the level of transparency, but in reality there is very limited reporting of mining revenues. In the mining sector, transparency (information disclosure) is legislated in the Decree on EIA (2010), EIA Guidelines (Draft, 2011) and the Public Involvement Guidelines (Draft, 2009). In practice, however, transparency within the sector is still very limited, particularly in relation to mining payments and revenues which are not part of the disclosure requirements stipulated above. Starting from FY12/13, the Budget preparation instruction requested revenue departments to separate mining, hydro and non-resource revenues in their budget plans in order to help monitor developments in each revenue sources. Currently, the Government publishes the summary of the budget in the print media and details in the national gazettes. However, the disclosed budget summary does not yet include detailed resource revenue information.

Key barriers to transparency in Lao PDR include:

- Limited capacity (governance, understanding mineral revenues, public sector financial management, accounting and auditing);
- Decentralised management of revenues;
- Lack of legal framework for disclosure;
- Practice of case-by-case negotiations of mining agreements, including fiscal terms, non-disclosure of these agreements;
- Limited systems within government for putting information into the public domain; and
- Lack of tradition or public expectation of transparency.

The EITI has the potential to support the government's mining sector reform efforts, both in terms of the reporting process itself and the collaborative framework provided by the EITI implementation process. The EITI is a voluntary global coalition, aimed at enhancing transparency and accountability. Countries implementing the EITI commit to publishing all payments made by oil, gas, and mining companies to Government, and all revenues received by the Government from those companies. Specific benefits to Lao PDR could include:

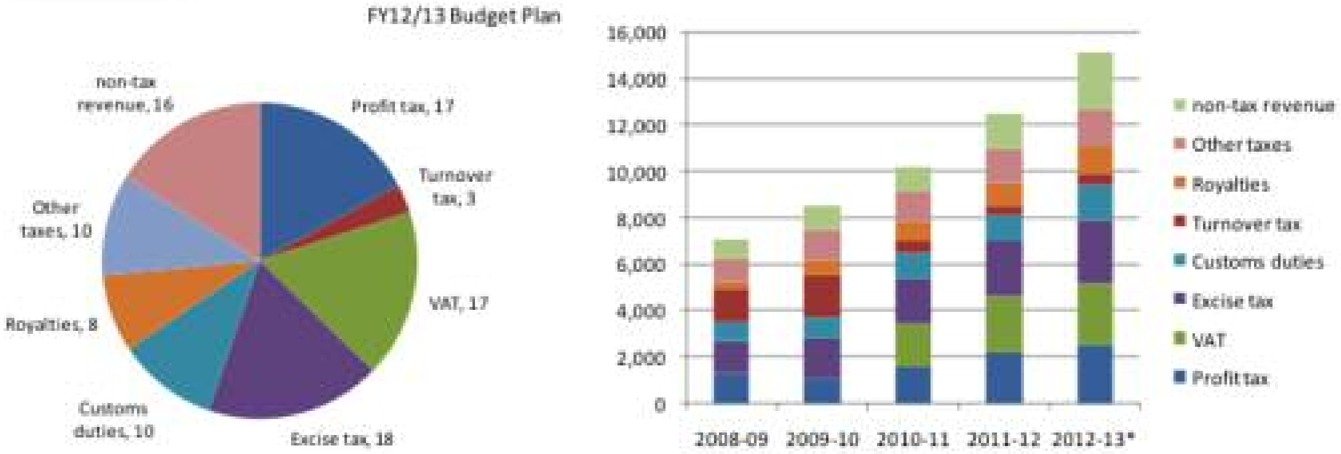
- Increased and better investment in mineral resource development;
- Possible identification and recovery of previously unaccounted-for funds;
- Increased trust between civil society, Government and extractive companies; and
- General improvements in budget monitoring and oversight

II. GOVERNMENT BUDGET AT A GLANCE

FY12/13 Budget Plan: A selective look

FY12/13 budget plan continues efforts to mobilize domestic revenue. A combination of profit tax, VAT, excise tax, customs and non-tax revenue is expected to constitute 70 percent of domestic revenue (Figure 22). Resource revenue is projected to account for about 22 percent of total domestic revenue. However, uncertainty in commodity prices in 2013 may affect the achievement of the government target. According to the NA resolution for the FY12/13 NSEDP and the Budget Implementation Instruction, the Government is following an expansionary fiscal policy, and thereby focuses its efforts to strengthen revenue administration by promoting VAT collection; strengthening technical revenue reporting and administration; and employing automation in revenue collection. In addition, incentives will be offered to local authorities to increase their efforts in revenue collection.

Figure 22 **Composition of Domestic Revenue in FY12/13 Budget plan**



Source: MOF and staff calculations

Total expenditure in FY12/13 is expected to climb due to the planned wage and compensation increases. With an aim to improve living standards of civil servants, the government plans to raise a salary multiplier in three consecutive fiscal years, which is equivalent to about 35-40 percent each year (Figure 23). At the same time, a once-off increase in compensation and allowances is also planned in FY12/13 in order to cover uniforms and basic living costs for civil servants. This raises its ratio to GDP from 1.5 percent of GDP to 2.4 percent in FY12/13. As a result, wages as a share to GDP is estimated to increase from 5 percent to about 5.7 percent this fiscal year. If this policy follows through until FY14/15, it is expected to progressively climb up to 7 percent in FY13/14 and will eventually reach almost 9 percent in FY14/15 (Figure 24). According to the Lao PDR's civil service pay and compensation study, wage bills of 8 percent of GDP or more can become problematic. Nevertheless, some countries experience two digits of wage share to GDP. Assessing the fiscal implications of this policy warrants close government attention. If the new policy is fully implemented, wages and compensation will therefore rise from about 8 percent of GDP this fiscal year to more than 11 percent in FY14/15. As a result, recurrent expenditure as a share of total expenditure would increase from 52 percent to 60.2 percent this fiscal year. Alternatively, if a conservative scenario of smaller increases for several years were considered[11], the ratio to GDP would remain relatively stable below 6 percent of GDP (Figure 24).

The wage and compensation increase policy will contribute to underfunding of non-recurrent expenditure. Even with a conservative scenario, non-wage recurrent expenditure, which covers maintenance and operating costs of created assets and facilities, would still be expected to decline from 5.2 percent of GDP in FY12/13 to 4.6 percent in FY14/15. With the wage increase policy, the ratio would be slightly worse at 4.4 percent in FY14/15, assuming the total recurrent budget envelope is not fixed. Compared to revenue outlook, the wages are expected to cover about 60 percent of non-resource domestic revenue (which is considered more stable) in FY12/13 and likely to reach almost 83 percent by FY14/15 (Figure 26). This would imply a smaller portion of revenue to cover other non-wage recurrent

11 Assume nominal wage increase by 10 percent each year

expenditures and capital expenditure. This raises concerns for fiscal sustainability and may require higher needs for expenditure financing from other sources such as the reserves fund, domestic and external borrowing and pre-financing from the private sector in the case of capital spending. On the other hand, in the conservative scenario, wages would account for about 31 percent of domestic revenue by FY14/15. Consequently, some resources could be freed up for other expenditures such as non-wage recurrent expenditure if a fixed ratio of capital spending to total expenditure was assumed.

Figure 23 **Wage Index Increase**

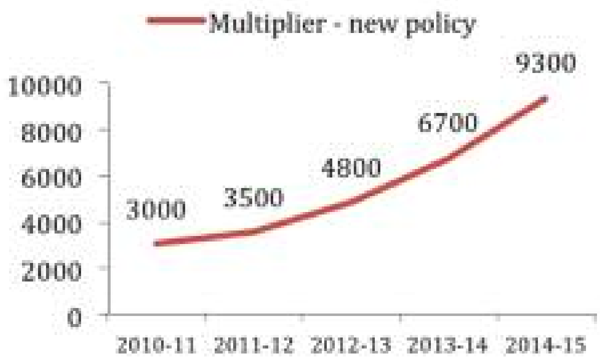


Figure 24 **Wages as Shares to GDP**

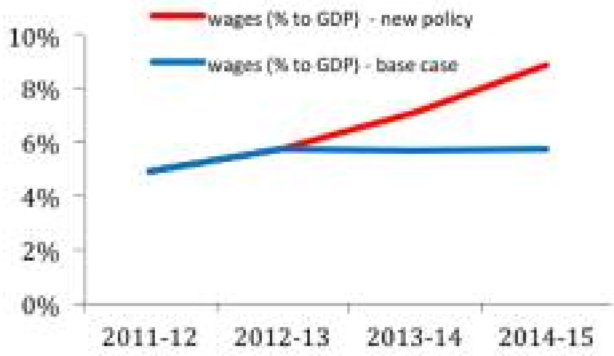


Figure 25 **Expenditure Scenarios**

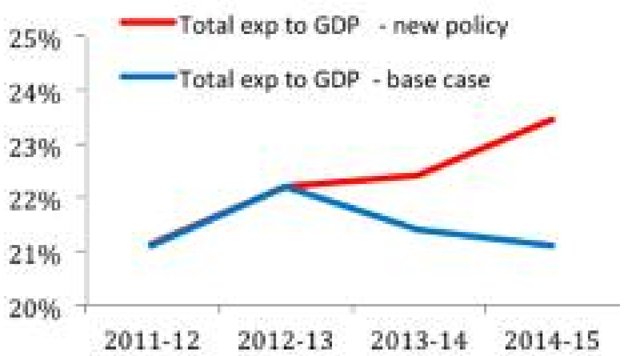
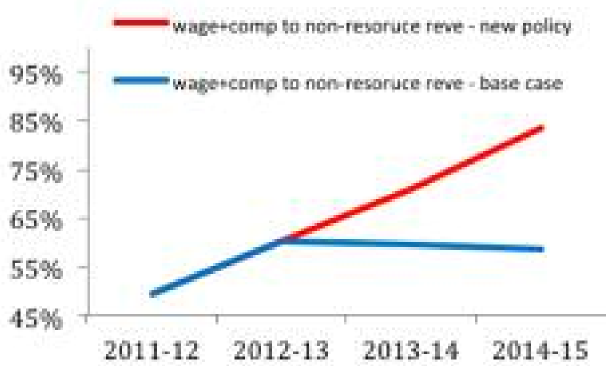


Figure 26 **Wages to Domestic Revenue (percent)**



Capital expenditure will increase in absolute terms but will account for a smaller share of total spending in FY12/13. The government plans to increase capital expenditure by 16 percent compared to the FY11/12 plan[12] but its share to total expenditure appears to decline to about 38 percent compared to 44 percent in the FY11/12 plan. This is partly due to the increased share in recurrent expenditure as mentioned above. The major source of public investment still comes from ODA, which accounts for about 68 percent of total capital expenditure. Most of public investment is expected to flow to economic sectors with a relatively smaller amount to the social sector (Figure 27).[13] While this trend may support growth, improving social sector financing remains a big challenge.

A strong high-level commitment was introduced to improve social sector planned allocations. For the FY12/13 budget, the National Assembly's Resolution14 in 2012 defined the allocation for the health and education sectors as 9 percent and 17 percent of total government spending, respectively. This top-down budgeting approach will only apply to health and education while bottom up budgeting is applied for other sectors. For these ambitious targets to be met, a bolder budget allocation is required. Figure 28 shows considerable gaps between the planned allocation to health and education in FY11/12 and the planned allocation for FY12/13.[14] While the increase in wages will attract human resources to the sector, the issue of non-wage recurrent underfunding would persist. If the total envelope remains stable, closing the gap between targets and planned allocations in health and education could be achievable by lowering allocations to other sectors, which poses a unique set of challenges.

12 This is based on government's budget presentation for FY12/13.
13 Based on the target allocation set in PM decree on Implementation of FY12/13 Budget and NSEDP, 30.2 percent of public investment to economic sectors, 34.5 percent to social sectors, and 35.3 percent to infrastructure and government assets such as buildings.
14 National Assembly Resolution, No. 089/NA dated 13 July 2012. Actual FY11/12 budget implementation information is not available yet.

Figure 27 FY12/13 Broad Sector Capital Spending Targets

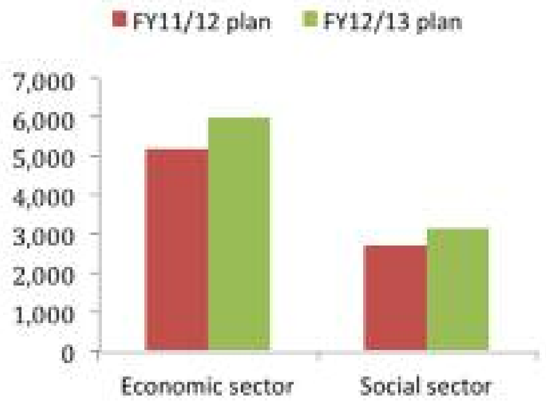
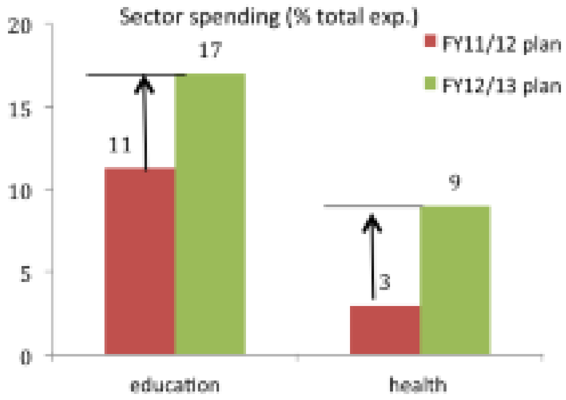


Figure 28 Gaps to Meeting FY12/13 Social Spending Targets



Source: FY12/13 Budget plan and NSEDP

Resource allocations over time[15]

Priority Sector Spending

The total spending of the four priority sectors (agriculture, public works and transport, education and health) has been fluctuating since FY06/07 (Table 1). The total actual spending of the four priority sectors as a share of the total expenditure declined from about 41 percent in FY06/07 to 27.6 percent in FY09/10. The government then planned to increase priority sector allocation to 39 percent in the FY11/12 budget plan due to a significant increase in spending within the public works sector. The capital expenditure of this sector increased from about 9 percent of the total actual spending in FY10/11 to about 19 percent in the FY11/12 plan partly to finance the growing infrastructure that was necessary to hosting ASEM and other notable events in recent years. The health sector encountered significant variability in spending, reaching a peak of 6.7 percent of the total expenditure in FY10/11 and subsequently suffering a substantial decrease to 2.9 percent due to a large decline in donor-funded capital expenditure in the FY11/12 plan. Education sector spending has remained relatively stable around 11 percent of the total expenditure in the past several years. Nevertheless, as a percentage of the total expenditure, the non-wage recurrent spending of all four sectors doubled in the FY11/12 budget compared to FY10/11, reserving additional budget resources for operational activities.

Main Sector Spending

Table 1: Total Government Spending by Major Sectors, from FY 2006/07 - FY11/12[16].

	FY07/08	FY08/09	FY09/10	FY10/11	FY11/12
	actual	actual	actual	actual	plan
Economic sector	20.5%	14.9%	12.3%	13.8%	25.9%
Agriculture and Forestry	4.8%	3.3%	2.4%	3.7%	5.1%
Energy and Mines	2.6%	0.6%	0.5%	0.6%	0.8%
Public works and transport	12.7%	10.6%	9.0%	9.2%	19.7%
Industry-Commerce	0.4%	0.5%	0.3%	0.3%	0.3%
Social cultural sector	19.3%	21.9%	20.3%	21.4%	17.5%
Education	11.0%	11.8%	11.8%	10.8%	11.3%
Health	3.0%	6.1%	4.3%	6.7%	2.9%
Information and Culture	2.5%	1.6%	2.0%	1.2%	1.4%
Labour-Social Welfare	2.8%	2.4%	2.2%	2.7%	1.9%
Others (total)	60.1%	63.2%	67.4%	64.8%	56.7%

Source: Official gazettes from FY06/07 - FY10/11 and the FY11/12 Budget Plan, MOF, Lao PDR

15 The figures presented are on budget spending and include external funded capital expenditures as published by MOF.
16 To keep classifications consistent FY11/12 expenditure data of only four agencies are included in the Economic and Social-Cultural Sectors. However, in FY11/12 spending of two and seven more agencies is added in the Economic and Social-cultural Sectors, respectively.

Changes in categorization in past annual budget presentations has yielded a mixed picture of actual and planned sector spending priorities. The public expenditure (on budget) is classified in three major categories namely 1) Economic Sector, 2) Social-Cultural Sector and 3) Other Organizations/Expenditures[17]. From FY06/07 to FY10/11, the "Social-Cultural Sector" spending share to total expenditure remained relatively stable around 21 percent while the "Economic Sector" spending share declined from 25.8 percent to 13.8 percent in the same period. However, this might not have represented the full scope of the "Economic Sector" because some of its capital expenditure was included in the "Other Organizations/Expenditures" category. The spending of the "Other Organizations/Expenditures" category has played an important role and accounted for a major share of the total spending from 52 percent in FY06/07 to almost 65 percent in FY10/11. This has likely acquired a significant portion of total expenditure since FY06/07 partly due to heavy infrastructure investments in facilities and in preparatory works for the regional sporting events such as Southeast Asian Games and ASEAN University Games and other notable events like the ASEM Summit in 2012.

However, the FY11/12 Budget Plan[18] structure looked slightly different. The allocation share of the "Other Organizations/Expenditures" category dropped to 56.7 percent while the "Economic Sector's" share rose significantly due to an increased allocation to the "Public Works Sector", specifically on capital spending. Inversely, the allocation to the "Social-Cultural Sector" declined by about four percent points in FY11/12 largely due to the significant decline in the "Health Sector" due to decreased donor-funded capital expenditure. The large share of the "Other Organizations/Expenditures" category has raised a concern of the general public and the development agencies working in the Lao PDR on transparency of public resource utilization.

	FY08/09	FY09/10	FY10/11	FY11/12
	actual	actual	actual	plan
(% of Total Expenditure)				
Published agencies	25.6	12.2	27.7	19.9
Other Organizations/agencies	16.4	15.4	14.2	24.0
Other Expenditures (Non-classified expenditure)	10.7	40.9	22.1	21.1
Local Level	33.1	19.3	23.5	22.0
Debt Repayment	14.2	12.2	12.5	13.0

Source: Official gazettes from FY06/07 - FY10/11 and the FY11/12 Budget Plan, MOF, Lao PDR

In an attempt to clarify non-classified expenditures, Table 1 presents outturned spending and budget plan data by sectors, of which the "Other or Non-classified Expenditures" category accounts for a large portion of the total spending. Table 2 presents outturned spending and budget plan data by the published agencies. At the central level, expenditure outturns of 20 agencies were published while data from the other 23 agencies were aggregated into so-called "Other Organizations/agencies". The local level spending and the debt repayment are classified as two separate items and the remaining item is "Other Expenditures" or "Non-classified expenditure" category. The detail breakdown of this "Non-classified" category shows that the capital spending accounted for 82 percent in FY09/10 and 70 percent in FY10/11. It was likely that some capital spending supported the big events mentioned above. As a result, the amount of the "Non-classified" Category remains around 20 percent of the total expenditure, which was lower than the proportion presented in the classification by sectors. Some changes to the FY11/12 budget plan structure were observed. The Published Agencies' spending declined to about 20 percent from 27.7 percent in FY10/11 whereas the spending share of Other Organizations/Agencies increased largely to 24 percent of the total expenditure compared to just 14.2 percent in FY10/11 outturn. This change might have resulted from the fact that some expenditure is not yet classified in the state budget plan. A clearer picture will prevail once the FY12/13 State Budget Plan is available.

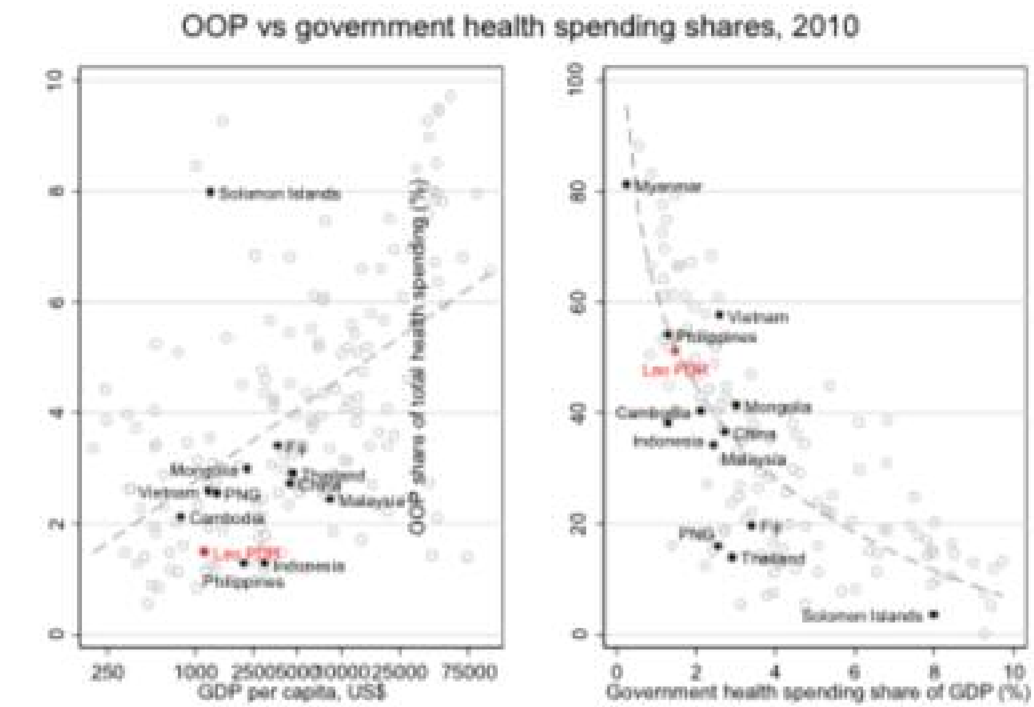
17 Previously, the spending data were classified into four categories, including the Security Sector. After FY2005/06, the budget data of the security sector was not published due to the lengthy bureaucratic procedures in obtaining publication permissions.
18 FY12/13 State Budget Plan is not available yet as of the time of the report.

III. PUBLIC SPENDING ON HEALTH IN LAO PDR[19]

Although economic performance has been robust in the past decade, improving social development outcomes, particularly on health, remains a challenge. Lao PDR continues to have some of the worst maternal and child health (MCH) outcome indicators, both globally as well as in the EAP region. At 357 per 100,000 live births, Lao PDR's maternal mortality rate is double that of Cambodia, almost eight times higher than that of Vietnam, and much higher than expected for its income level. Low levels of utilization of key maternal health services such as antenatal care, skilled birth attendance, institutional deliveries, and postnatal care, are key contributors to the problem. In addition, there are large inequalities in the utilization of health services by socio-economic status.

The high level of out-of-pocket (OOP) spending, estimated at 46 percent of total health expenditure, is a challenge to Lao PDR's health sector (Figure 29). The reliance on OOP payments represents a financial barrier to utilization of health services, contributing to extremely low levels of utilization, inequalities in access and health outcomes, and significant health-related financial risk. On the flipside, government spending on health, from both domestic and external sources, is very low (1.1 percent of GDP) even after adjusting for the country's economic status. Economically comparable neighboring governments in Cambodia and Vietnam spend more on health as a percentage of GDP than Lao PDR (Figure 29a).

Figure 29a (left) and Figure 29b (right)



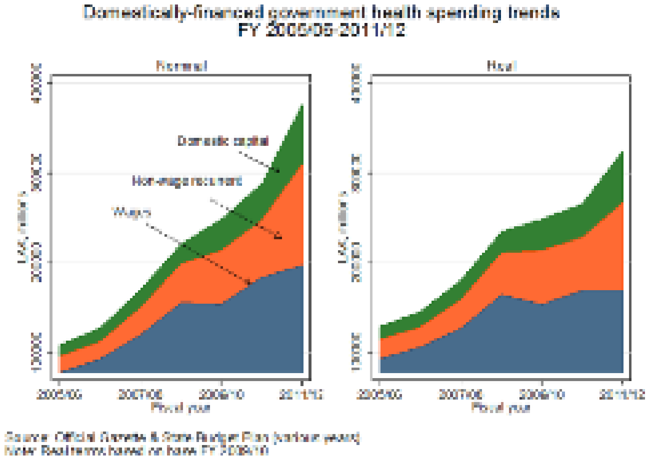
Source: WHO and WDI

Lao PDR is also very dependent on external sources of financing, which in some years (e.g., from FY07/08 to FY10/11) comprise a larger share of government spending on health than domestically sourced financing, but is inherently erratic (Figure 30). Meanwhile domestically financed government health spending, as a percentage of GDP has remained stagnant at about 0.5 percent of GDP in recent years. In absolute terms it has increased from 108.1 billion Kip in FY05/06 to 248.4 billion Kip in FY09/10, representing an average increase of 23.4 percent per year in nominal terms (Figure 31).

19 This is a summary of a World Bank report, Government Spending on Health in Lao PDR: Evidence and Issues. This report analyses overall trends in government health financing and expenditure patterns and discusses some of the efficiency and equity issues pertaining to current government health spending patterns, primarily covering fiscal years (FY05/06 to FY11/12. For more information, please contact Meriem Gray (Communications and External Affairs, World Bank Vientiane office, mgray@worldbank.org) and Ajay Tandon (Senior Economist and task manager of the report, atandon@worldbank.org). The report will be available at www.worldbank.org/lao.

Figure 30 Government Spending on Health Sector (percent of GDP)

Figure 31 Domestically Financed Public Health Spending

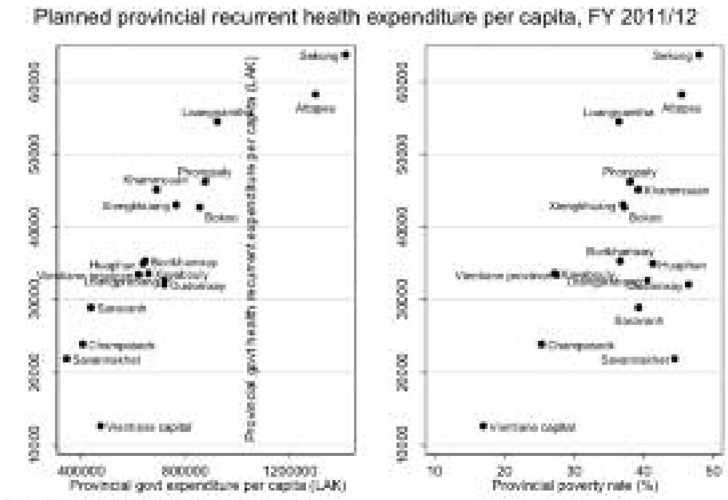


Wages account for a large but declining proportion of domestic government health spending, both in nominal and real terms (Figure 31). This trend may not hold as the government plans to raise wages and allowances during 2013-2015, with a 35 percent increase in wages for FY12/13, The increase in wage spending, in an attempt to improve the living standards of civil servants, is likely to strain non-wage recurrent spending required for operational costs and the purchase of health commodities.

In FY11/12, the budget health allocation stood at 2.9 percent, a significant decline from the previous fiscal year due to decreased external financing of health activities through the government budgetary system. In the NSEDP, the government has committed to increase its health expenditure to 9 percent of the total expenditure, implying roughly a three-fold rise compared to this planned spending. This ambitious target implies a contribution from both domestic and external funds and also raises a signal to the donor community that an increase in external health financing may be matched by a decrease in domestically sourced health spending if the total government health spending envelope remains fixed.

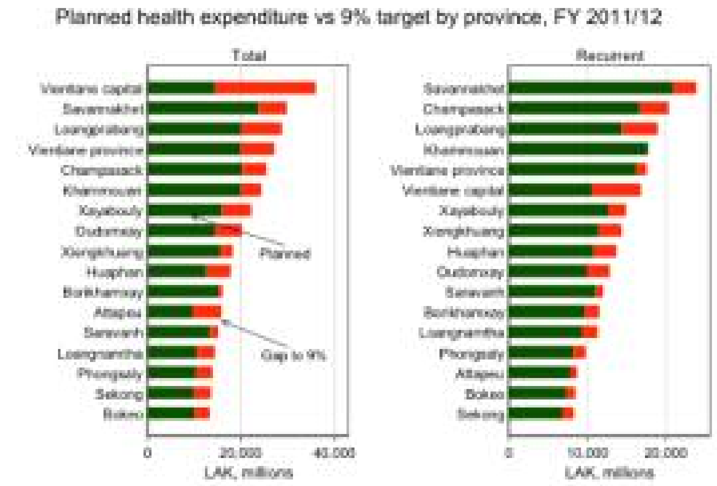
Most government health spending occurs at the central level. In FY09/10, less than a third of government health spending occurred at the provincial level. In addition to disparities in sub-national spending between the central and provincial level, individual provinces also differ in the share of total government spending dedicated to health: provinces with higher levels of overall government spending per capital tended to spend more on health. Per capita health spending was higher in more sparsely populated and poorer provinces such as Sekong and Attapeu as opposed to Champasack, Savannakhet, and Vientiane Capital (Figure 32). If the 9 percent target policy goal were applied equitably on a sub-national level, achieving it will be challenging. Some provinces, notably the more heavily populated ones, will have large expenditure gaps to bridge, both for total and recurrent expenditure (Figure 33).

Figure 32 Planned Provincial Recurrent Health Expenditure per Capita, FY11/12



Source: State Budget Plan & Epprecht (2008)

Figure 33 Planned health expenditure vs. 9% target by province, FY11/12



Source: State Budget Plan

Increasing and improving the effectiveness of existing government health spending is likely to be the most viable strategy for improving access to health care services and enhancing financial protection. As underscored in the National Health Sector Reform Strategy for 2013-2025, Lao PDR has made a time-bound commitment to achieving Universal Health Coverage (UHC) by 2025, ensuring that a vast majority of its population has access to an adequate service package and appropriate financial protection. It is expected that over 95 percent of the population will be covered by the prepayment scheme, and that OOP payment will be reduced to less than 30 percent of total health expenditure. Although the planned increases in government health spending are welcome, challenges remain in improving the effectiveness of increased spending. These include ensuring that the additional resources are used to improve access to and utilization of quality health services, especially in remote areas. Furthermore, additional domestically financed resources need to be made available to reduce both dependence on external funding and OOP spending for health. To attain these objectives, the government should consider an appropriate mix of both demand-side and supply-side incentives. While setting a target for budgetary outlays for health is a necessary step, the government needs to improve the efficiency of existing outlays, the measurement of which requires the monitoring of key population health outputs. These should include a specific focus on the level and equity of basic immunization rates, of skilled birth attendance, of institutional delivery rates, of need-based outpatient and inpatient utilization rates, and on adequate levels of financial protection from adverse health shocks.

The planned implementation of the free maternal and child health policy is a welcome step towards improving health outcomes in Lao PDR. Implementation of this policy will need to be complemented by improvements in the capacity of health facilities, not just in clinical and service availability terms, but also in terms of their ability to manage and allocate revenues appropriately. Current weaknesses include inconsistent implementation of user fee regulations and revenue management, variation in management practices, weak procurement practices for drugs, and inadequate service provision levels. In addition, the planned removal of user fees, as envisioned under the free maternal and child health policy, may not be sufficient to improve utilization and inequalities across the country. To achieve this, the government should consider additional demand-side incentives, especially in rural areas.

20 The Economics of Sanitation Initiative is a multi-country study launched in 2007 as a response by the World Bank's Water and Sanitation Program to address major gaps in evidence among developing countries on the economic aspects of sanitation. This paper is based on selected findings of the following study: Economic Assessment of Sanitation Interventions in Lao People's Democratic Republic. Rodriguez, U., Hutton, G. and Boatman A. World Bank, Water and Sanitation Program, 2013.

21 Economic impacts of sanitation in Lao PDR. Hutton G, Larsen B, Leebouapao B and Voladet S.World Bank, Water and Sanitation Program. 2009.

22 For more information on methodology and the study, please refer to Economic Assessment of Sanitation Interventions in Lao People's Democratic Republic. Rodriguez, U., Hutton, G. and Boatman A. World Bank, Water and Sanitation Program, 2013.

IV. NET ECONOMIC BENEFITS OF SANITATION INTERVENTIONS IN THE LAO PDR[20]

An additional challenge in achieving health improvement outcomes beyond low public spending on health is the lack of access to improved sanitation. Although the proportion of the population having access to improved sanitation facilities rose from 17 percent in 1995 to 63 percent in 2010, sanitation remains a major concern. Three of ten persons still practiced open defecation in 2010. Sanitation conditions were worse in rural areas, where about 41 percent of the population practiced open defecation and 8 percent of the population used unimproved sanitation facilities. Such lack of access to improved sanitation facilities imposes a heavy burden on society and may have cost implications for the economy.

In the above context, Economics of Sanitation Initiative (ESI) was initiated and has been implemented in two phases to date. Phase I of the ESI estimated the overall economic costs of poor sanitation in Lao PDR to be US$193 million per year at 2006 prices.[21] Translating to about US$34 per person per year, these costs are equivalent to about 5.6 percent of GDP. Phase II of the ESI, which supports the current study,[22] aims to provide evidence from cost-benefit analysis to relevant policy makers about alternative sanitation options in different contexts. Some key findings show that improved sanitation in all contexts can offer common benefits of access time savings and decreased health care costs.

Rural Areas: Highly Favorable Economic Returns on Pit Latrines - When Used

Figure 34 summarizes the benefit-cost ratios (economic return per currency unit invested) for the four rural sites.[23] It indicates that all of the sanitation options examined have a benefit-cost ratio that exceeds one, thus implying that the present value of economic benefits are larger than the economic costs. With an estimated economic benefit of at least 9 Kips per every Kip invested in the facilities, the most favorable results were found for shared wet pits and private dry pits. The study also found that it takes less than one year to recover the economic value of the initial investment costs for these facilities. Access time savings was the largest source of economic gains. Avoided health care costs were estimated to have the second largest contribution to net benefits. For the options presented in Figure 34, these represent at least 53 percent of the net benefits from improved sanitation.

Urban Areas: Favorable Economic Returns on Full Excreta Management Options

Figure 35 shows the benefit-cost ratios for urban areas. As with rural areas, all the sanitation options evaluated had benefit-cost ratios that exceed one. The most favorable results were found for wet pit latrines (shared and private) with benefit-cost ratios of about 6. For these facilities, it also requires less than one year to recover the economic value of the initial investment cost. As in rural areas, the largest sources of benefits were access time savings and avoided health care costs. For facilities examined, access time savings alone exceeded the annual costs of the facilities.

Sanitation Links to Tourism and Economic Development

Other key linkages of sanitation to economic development were examined in the study. A survey of 235 foreign visitors reveals that the general sanitation conditions need to be improved in Lao PDR. In Vang Vieng, availability of public toilets appears to be of concern. While a fifth of the respondents experienced gastrointestinal problems during their stay, close to half said that when outside their hotel, they could not find a toilet at a time of need. Those days of illness represent foregone earnings for the tourism industry.

About 17 business owners and managers operating in Vientiane Capital were asked to rate different aspects of sanitation in their areas of operation. On a scale of 1 (best) to 5 (worst), the most favorable average ratings were given to the water quality of rivers (2.4 points), air quality from human excreta (2.6 points) and pollution from low household coverage of sanitation (2.6 points). In contrast, the least favorable ratings were given to the presence of toilets in public places (4.2 points). While sanitation did not appear to be a serious consideration for firms in selecting their locations, the study found evidence that it has an effect on business operations. All respondents cited that poor water quality has a serious impact on their business, suggesting a direct link between poor sanitation and business operations.

23 Estimates of the other efficiency indicators are available from the full report of the study.

In summary, this study found that all sanitation interventions had benefits that exceed costs. The high net benefits from low-cost sanitation options, such as wet pit latrines in urban areas and all types of pit latrines in rural areas, suggest that these technologies should be at the center of national plans for sanitation improvements, especially where funds are scarce. It is worth noting that the net benefits of sanitation interventions also vary considerably from one site to the next.[24] This suggests a careful consideration of site-specific conditions when interventions are designed.

Figure 34 **Benefit-cost Ratios in Rural Sites**

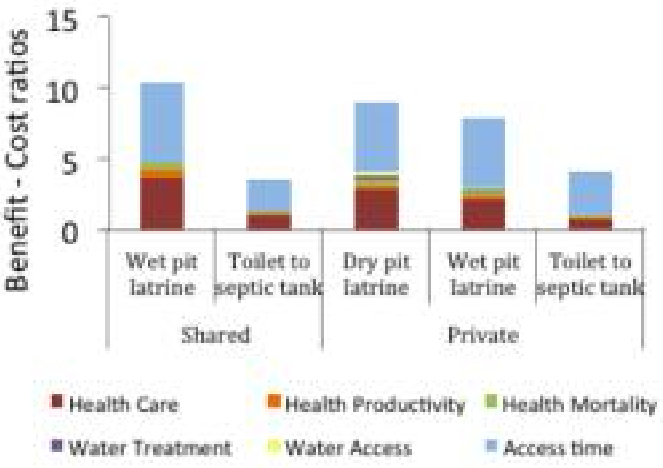
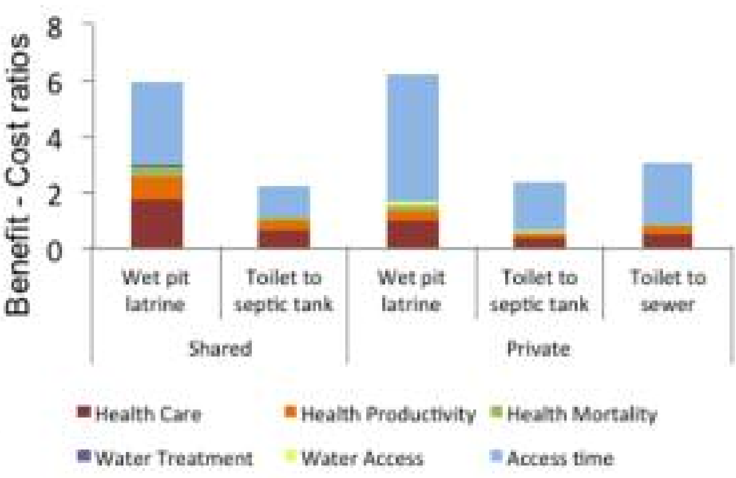


Figure 35 **Benefit-cost Ratios in Urban Sites**



ANNEX 3 – THE GLOBAL ECONOMIC OUTLOOK IN SUMMARY

(Percentage change from previous year, unless otherwise specified)

	2010e	2011f	2012f	2013f	2014f
Global conditions					
World trade volume	13.0	6	2.5	3.6	5.3
Consumer prices					
Advanced Economies /1	1.2	2.7	2.0	1.7	2.0
Emerging Markets and Developing Economies		7.2	5.9	5.9	5.6
Commodity prices (percentage change of USD terms)					
Non-oil commodities 3/	22.5	17.8	-9.8	-0.9	-0.9
Oil price (percent change) 2/	28.0	31.6	1.0	-2.3	-2.3
London Interbank Offered Rate (%)					
on USD Deposits	0.5	0.5	0.7	0.5	0.6
on Euro Deposits	1.0	1.4	0.6	0.2	0.4
Real GDP growth 3/					
World	4.1	4.0	3.2	3.3	4.0
Advanced Economies	3.0	1.2	1.2	2.2	2.3
United States	3.0	1.8	2.2	1.9	3.0
Euro Area	1.8	1.4	-0.6	-0.3	1.1
Japan	4.5	-0.6	2.0	1.6	1.4
Developing Asian Economies	7.4	8.1	6.6	7.1	7.3
East Asia and Pacific 4/	9.7	8.3	7.5	7.6	7.6
China	10.4	9.3	7.8	8.0	8.2
ASEAN-5		4.5	6.1	5.9	5.5

Source: *Source: IMF WEO April 2013, EAP Data Monitor Oct 2012*

Note:

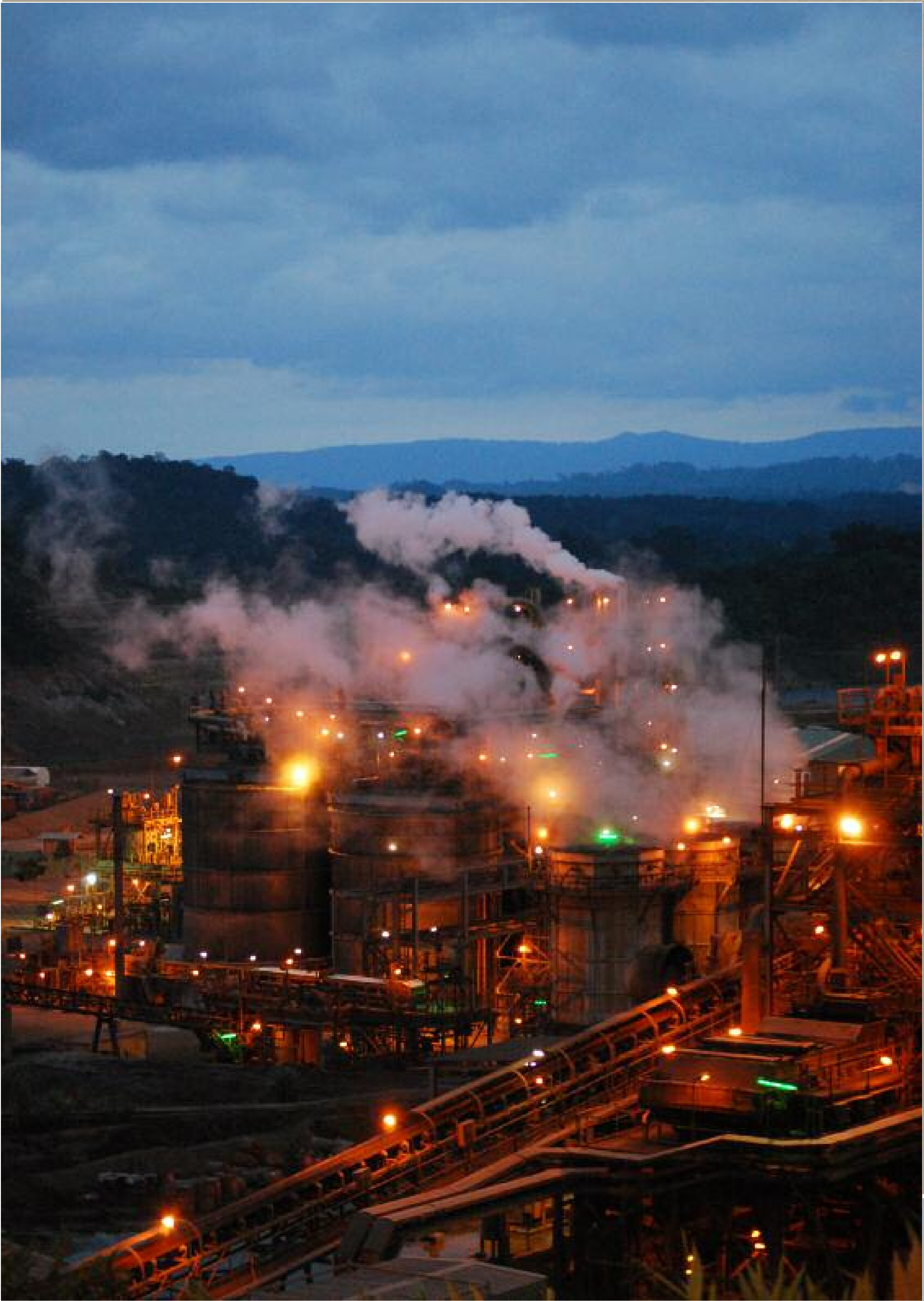
1/Canada, France, Germany, Italy, Japan, the UK, and the United States.
2/ Simple average of Dubai, Brent and West Texas Intermediate.
3/Aggregate growth rates calculated using constant 2005 dollars GDP weights.
4/ EAP Data Monitor Oct 2012

ANNEX 4 – LAO PDR AT A GLANCE

Lao PDR: Key Indicators

	2009	2010	2011	2012	2013
				Prelest	Proj
Output and prices (percent change, unless otherwise indicated)					
Real GDP	7.5	8.5	8.0	8.2	8.0
GNI per capita (in US dollars)	880	980	1100	1260	...
Consumer prices (% change, period-average)	0.1	6.0	7.6	4.3	6.0
Public finances (in percent of GDP) 1/					
Total revenue	16.5	16.4	18.5	19.8	19.4
Total revenue	...	16.2	18.5	19.7	19.3
Domestic Revenue	14.3	14.5	16.4	17.3	17.3
Domestic Revenue (non-resource)	11.7	12.5	12.9	13.0	13.5
Grants	2.2	1.9	2.1	2.5	2.1
Expenditure	23.4	21.2	21.3	21.1	22.2
Current	11.3	10.2	10.4	11.0	13.4
Capital and onlending	11.0	9.8	9.3	9.3	7.9
Overall budget balance (deficit)	-6.9	-4.9	-2.7	-1.3	-2.8
Overall budget balance (deficit, excl. mining)	-11.2	-8.3	-7.7	-7.1	-7.7
Overall budget balance (deficit, non-resource)	-11.7	-8.8	-8.3	-8.1	-8.7
Balance of payments (% of GDP, unless otherwise specified)					
Current account balance (CAB)	-9.8	-6.4	-10.4	-15.4	-21.8
Resource CAB	-0.2	4.8	4.1	1.1	-6.1
Non-resource CAB	-9.7	-11.2	-14.5	-16.6	-15.7
Trade balance (US$ million)	-734	-440	-762	-1,482	-2,258
o/w Resource (US$ million)	209	841	983	790	156
o/w non-resource (US$ million)	-943	-1,282	-1,745	-2,272	-2,413
Capital account balance	8.5	7.8	9.7	16.1	22.5
Overall balance	-1.3	1.3	-0.6	0.7	0.6
External public debt stock /4					
External public debt service	56.0	50.3	44.3	44.1	43.7
PPG debt service-to-exports ratio (in percent)	4.9	4.3	3.2	4.5	4.5
PPG debt service-to-revenue ratio (in percent)	10.8	11.0	7.5	9.6	9.3
Gross official reserves					
In millions of US dollars	633	730	679	740	807
In months of imports of goods and services	3.2	3.2	2.3	1.9	1.8
Memorandum items:					
Nominal GDP (billions of Kip)	49,673	59,310	66,293	74,754	84,010
Nominal GDP (millions of US dollars)	5,833	7,181	8,227	9,366	10,504
Exchange rate (kip/US$, average)	8,516	8,259	8,058	7,982	7,998

Sources: Staff estimates and projections based on data provided by the Lao authorities.
1/ Fiscal year basis (October to September).
2/ Includes payments on liabilities carried in from the previous budget years and arrears clearance.
3/ Excluding resource imports and exports
4/ DSA 2012 data



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