Lao PDR

Investment Climate Assessment 2014

Policy uncertainty in the midst of a natural resources boom

SUMMARY

Trade and Competitiveness Global Practice
East Asia and Pacific Region
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Photo by Jay Lawrence Till / World Bank, 2012

Summary

The World Bank undertakes periodic Investment Climate Assessments in order to provide policymakers with a better understanding of how the private sector is performing and where the principal constraints to increased private sector investment are to be found. These assessments are informed by Enterprise Surveys that follow a standardized approach and are conducted with the objective of providing detailed information on firm-level performance and constraints. So far, Enterprise Surveys have been conducted in more than 135 different countries and capturing data from over 130,000 individual businesses.

This is the third Investment Climate Assessment carried out in Lao PDR, and builds on findings from the previous assessments carried out by the World Bank in 2007 and 2011, each of which was in turn informed by an Enterprise Survey. This 2014 Investment Climate Assessment (ICA) is based on an Enterprise Survey undertaken across Lao PDR for the World Bank in late 2012. The survey covered nearly 400 formal private firms across six provinces, including small, medium-sized and large firms. Half of the businesses surveyed were in manufacturing and half in services. The World Bank Enterprise Surveys are the only firm-level data collected in Lao PDR that use stratified random sampling, and thus allow for results from the sample to be considered statistically representative of the entire Lao private sector. It is also the only Enterprise Survey in the country that captures detailed firm performance data on sales and cost of sales, from which aggregate estimates of firm level profitability and productivity can be computed.

The economy of Lao PDR has been growing rapidly based principally on the development of natural resource based industries. The transformation of natural wealth in terms of the country's mineral and water resources has propelled high rates of investment and economic expansion for more than a decade. Lao PDR has become a middle income economy and the country has achieved success in reducing poverty and delivering improved public services. The natural resource development process has also created spillover effects, mostly notably via strong expansion in the services and construction domestic private sectors.

However, Lao PDR's rapid growth has masked the costs of a still largely unreformed business enabling environment. In the absence of natural resources endowments, the country would not have been able to achieve the same sort of high rates of economic growth based on private sector activity in the agriculture, manufacturing and services sectors. Deeper investment climate reforms will be necessary to unlock the full potential of the Lao economy, to attract higher quality private sector investment in a wider range of diversified sectors, and to benefit more fully from natural resource development spillovers.

Inadequate workforce skills has emerged as the top constraint to private sector expansion in Lao PDR. Earlier ICAs saw "hard" infrastructure related constraints such as transport, energy and telecommunications as the most significant constraints. Over time, and in response to large scale investments in connectivity, these constraints have been overtaken by issues associated with "soft" infrastructure related issues. Other major constraints identified by firms include tax administration, practices of competitors in the informal sector, access to finance and corruption. Similarly, while the country's hard infrastructure has improved over recent years, underdeveloped regulatory governance still limits the quality of provision in the key backbone service sectors that are necessary for improved competitiveness.

In fact, while natural resource development has propelled strong rates of economic growth it has also concealed the costs of workforce education and skills that are at a level well behind that of comparable economies. Skill levels in the Lao labor force compare poorly with comparator countries on just about every metric, resulting in a workforce that is ill-equipped to contribute towards a more modern economy. Productivity in Lao PDR is estimated to be about half what would be expected for a country at this level of development. In addition, there has been almost no observable growth in labor productivity during the last decade.

While efforts have been made to improve the investment climate in Lao PDR, the costs of doing business remain high in relation to comparator countries at similar levels of development. Significant aspects of the investment climate remain characterized by a lack of transparency and predictability for investors. Much of the reform agenda has been driven by efforts to improve investment facilitation for natural resource sector investments and "mega projects", with more limited focus on diversified sectors that create more jobs. Similarly, natural resource investors have so far been more able to absorb high investment transactions costs given larger resource rents and economies of scale. The high costs of "doing business", as a share of business investment costs, have acted as a disincentive for small investors in diversified sectors of the economy. Even in areas where Lao PDR has implemented investment climate reforms, the gap with comparator countries has not been closed as reforms have been implemented elsewhere in the region.

Lao PDR, not unlike many other developing countries, suffers from a significant gap between the "de jure" legal framework and the "de facto" environment that enterprises experience on the ground. This means that there is a large gap between what is written in law, and what businesses actually experience on a day-to-day basis. It is not unexpected that the country, which is still in the midst of a major transition from a planned economy to a market economy, should experience substantial policy gaps. However, the result is a persistent and widespread problem commonly referred to as "lack of implementation" that results in inconsistent and unpredictable enforcement of laws and regulations.

In fact, the root causes of this problem are likely to be more complex and associated with the political economy of reform in a socialist state and a still unsettled consensus on the direction of reform. Much of the headline investment climate reforms have been driven by the desire to change the outward appearance of the country, including through accession to the WTO and commitments to ASEAN, but without a widespread understanding of the full implications of such commitments. This may have led to a partial reform syndrome with much more success in building the "form" of modern investment climate institutions than in building the "substance".

Meanwhile, labor costs have been rising rapidly in line with a growing economy, but without growth in productivity. Firms that compete on international markets (and are thus "price takers") such as manufacturers have become stuck in a low profitability, low productivity and low wage cycle, that has constrained growth. The same situation has not, however, acted as a brake on natural resource sector investments which are not labor intensive. Weak skills and poor productivity present a major barrier to private sector development in the diversified sectors, particularly in areas where knowledge acquisition, service delivery and learning-by-doing are important parts of the economic development process. Future growth will have to come from higher productivity and performance, not just in manufacturing but also in agriculture and services.

In addition, the rapid expansion of the mining and hydropower sectors, in an otherwise small economy, has put strains on the competitiveness of the non-natural resource sectors. While there are clearly large and obvious benefits to Lao PDR associated with the sustainable development of natural resources, including land, minerals, forest and water resources, this process has begun to seriously distort the wider economy—a phenomenon known as "dutch disease". Moreover, lack of transparency and predictability in the investment climate, as well as a unreformed regulatory environment for services, has hampered the emergence of higher value spillover effects from the natural resources boom.

Recent years have seen a compression of manufacturing profitability while construction and services profitability has expanded strongly. This could lead to an unbalanced development model with Lao PDR exposed to high systemic risks from sector specific shocks. Moreover, there is a risk that the country experiences high rates of growth, but without significant job creation or development in diversified sectors of the economy.

There are also early warning signs that the natural resource based development model is placing strains on governance. Businesses in Lao PDR are increasingly likely to report corruption as a constraint, and the volume and value of rent seeking payments appears to be growing, putting gains in terms of poverty and shared prosperity at risk.

The principle conclusion from this Investment Climate Assessment is that policy-makers in Lao PDR face two different pathways: business as usual, or radical change in the approach to private sector development (see chart):

- **Business as usual, meaning the continuation of the current, principally natural resource extraction model,** with limited growth in diversified sectors and a focus on "mega projects". While this approach is still likely continue to drive high rates of growth in the short to medium term, momentum will eventually slow. Moreover, growth rates that are generated by the capital-intensive hydro and mining sectors are unlikely to generate a lot of jobs. With approximately 90,000 additional young people entering the job market every year in the coming decade (four times as many as are currently employed in the hydro and mining sector), a strategy that creates more jobs is needed. In the longer term, there will be significant risks that incremental growth delivers fewer returns in terms of poverty reduction, and an undiversified economy will be vulnerable to sector specific shocks.
- **An alternative development approach that seeks to radically reform the business enabling environment improving transparency and predictability.** The objective would be to put in place an investment climate that can attract higher quality investors and investments, encourage substantially larger investments in skills upgrading in areas that the private sector needs, facilitating productivity growth and the creation of a lot more and better jobs in a wider range of sectors. The focus would be much less on putting in place the "form" of modernized institutions for private sector development, and much more on the actual "substance" of service delivery. This may mean less use of "first-best" institutional solutions, and more context-specific approaches that result in changes to the investment climate that can be observed at the enterprise level. While natural resource based development projects would still play a dominant role in the economy, much greater emphasis would be placed on facilitating higher productivity and performance in diversified and higher value manufacturing, agriculture and services. This would allow for Lao PDR to fully participate in regional production networks across an integrated ASEAN Economic Community.

Two possible future scenarios for Lao PDR

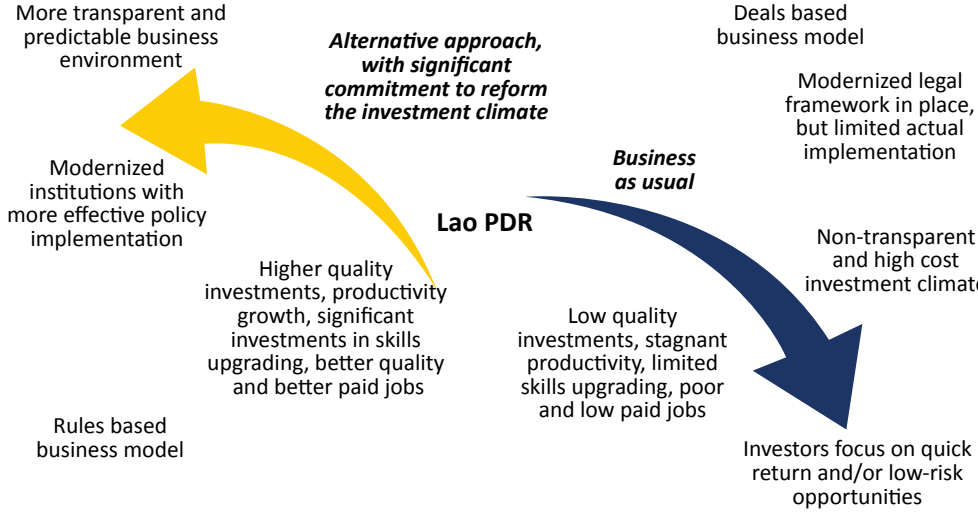
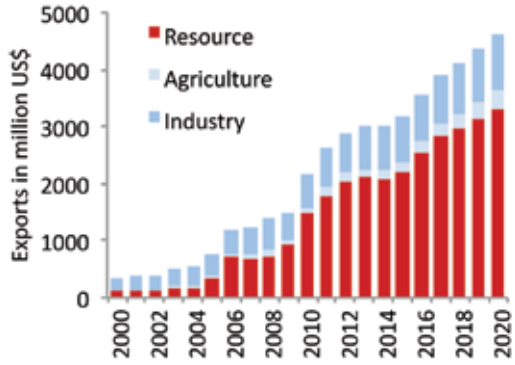


Photo by Remy Rossi / World Bank, 2013

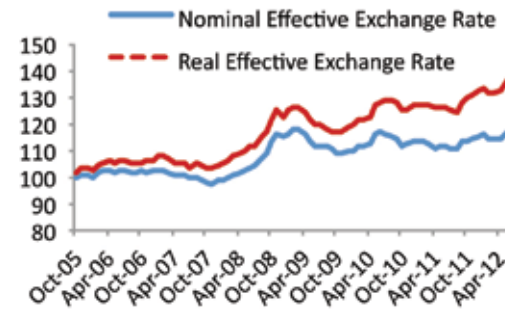
Lao PDR's investment climate in pictures

Natural resources account for the majority of Lao exports…



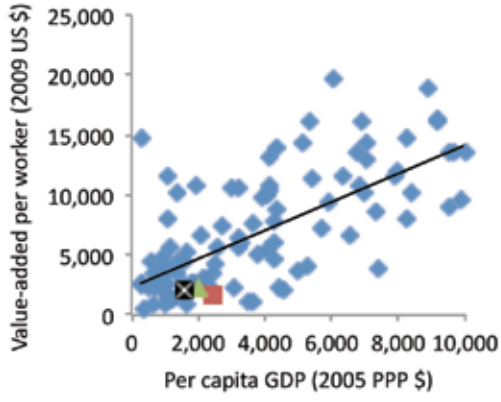
Source: World Bank staff calculations

…contributing towards a strong kip



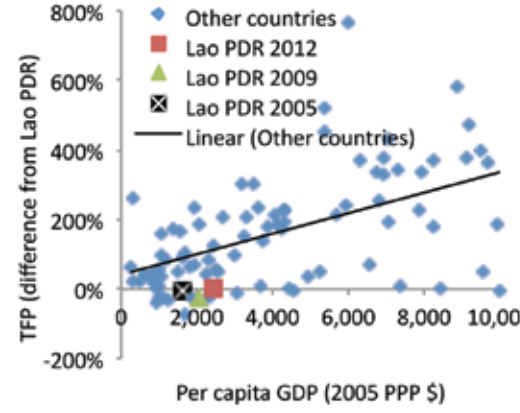
Source: World Bank staff calculations

Growth in value added per worker has been very weak…



Source: World Bank Enterprise Surveys

…and estimates of total factor productivity show a similar trend



Source: World Bank Enterprise Surveys

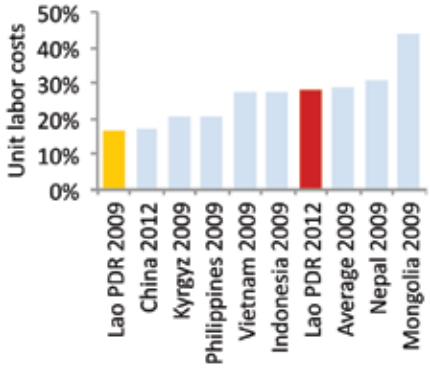
Manufacturing profitability has dwindled…

Source: World Bank Enterprise Surveys

…but services profitability increased markedly over the same period

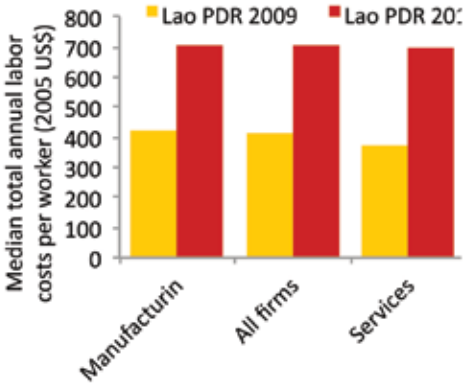
Source: World Bank Enterprise Surveys

Labor costs are rising rapidly…



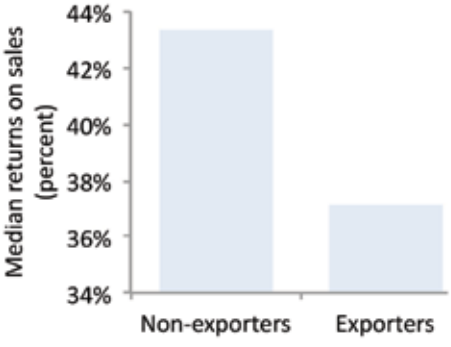
Source: World Bank Enterprise Surveys

…equally across sectors



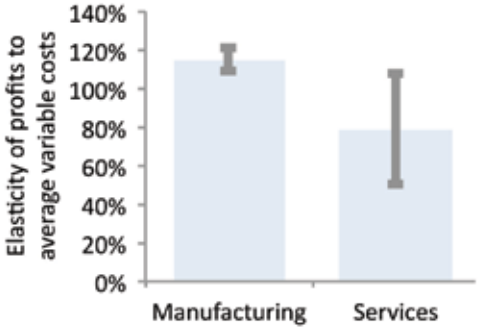
Source: World Bank Enterprise Surveys

Putting pressure on exporters in particular…



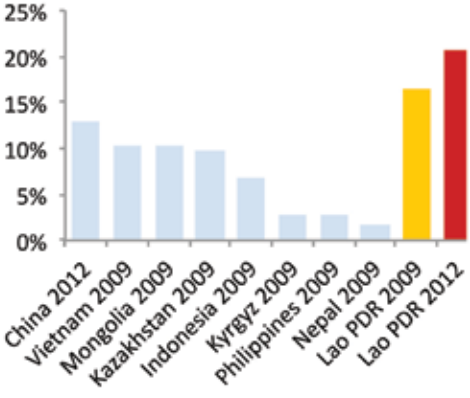
Source: World Bank Enterprise Surveys

…as well as manufacturers



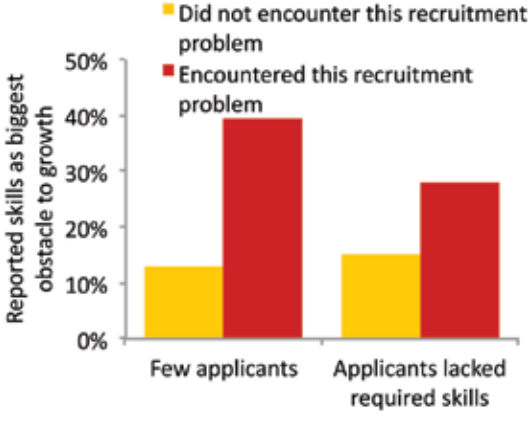
Source: World Bank Enterprise Surveys

Employers in Lao PDR are much more likely to complain about poor skills compared to in other Asian countries…



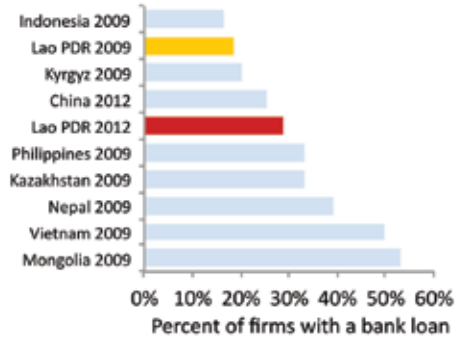
Source: World Bank Enterprise Surveys

…and in particular are complaining about few applicants and/or few applicants with the right skills



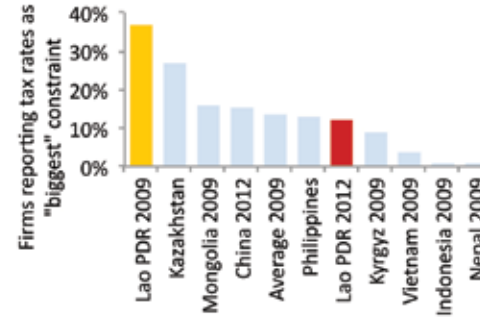
Source: World Bank STEP Employer Survey

Access to finance appears to be less of a problem than in the past



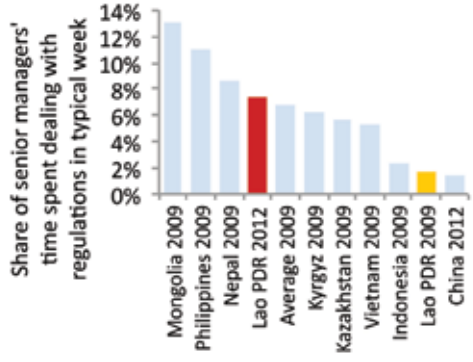
Source: World Bank Enterprise Surveys

Firms are now also less likely to identify tax rates as a problem



Source: World Bank Enterprise Surveys

However the compliance costs of tax administration remain very high…

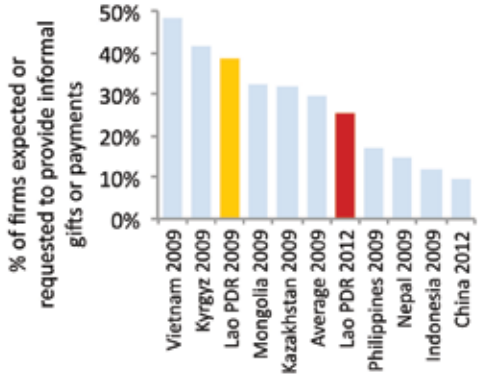


Source: World Bank Enterprise Surveys

…and firms complain about unfair competition from unregistered firms

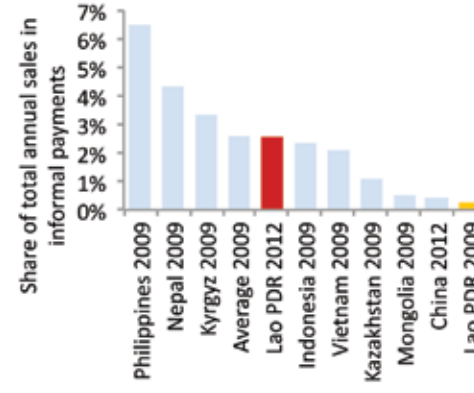
Source: World Bank Enterprise Surveys

Corruption is an increasing concern, and while the number of firms reporting that they make informal payments has gone down…



Source: World Bank Enterprise Surveys

…the cost has gone up dramatically



Source: World Bank Enterprise Surveys

Photo by Stan Fradelizi / World Bank, 2011


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Photo by Bart Verweij / World Bank, 2014