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The World Bank

Lao PDR
Economic Monitor

The World Bank Vientiane Office

MAY 2004

BACKGROUND

With an estimated per capita income of US$320 in 2003 (see Table 1), the Lao People's Democratic Republic (Lao PDR) is one of the poorest countries in the East Asia region. It is classified by the UN as a Least Developed Country (LDC). Nearly 77 percent of its population live on less than US$2 a day, and 29 percent below the national poverty line of $1.5 a day (in 2002/03 – down from 39 percent in 1997/98); its social indicators are among the worst in the region, and close to the average for Sub-Saharan Africa.

Lao PDR has a population of around 5.5 million and a land area of 236,800 square kilometres. It has significant natural resources like forestry, minerals and hydro-electric power. Agriculture remains the major sector of the economy, contributing around 51 percent of GDP and employing over 80 percent of the labour force; the industrial and service sectors account for the rest (23% of GDP for industry and 26% for services). Though landlocked, Lao PDR is in the center of the Mekong region, bordered by Thailand, Vietnam, Southern China, Cambodia and Myanmar.

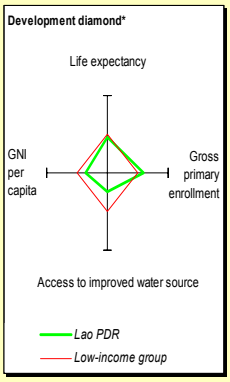
In the 1990s, Lao PDR has grown rapidly and reduced poverty significantly. Real GDP grew by 7 percent during 1992-97 period and by 5.8 percent a year during 1999-2003 period, with the intervening years adversely affected by the East Asian crisis. Exports also grew at a rapid rate over this period. Nevertheless, the country is still heavily reliant on external support; in 2002/03, donor funded programs accounted for 7 percent of GDP, 39 percent of total public expenditure, and 61 percent of the capital budget.

Transition. The Government introduced the "New Economic Mechanism" (NEM) in 1986, to begin the transition from a centrally planned to a market-oriented economy. Gradually, price controls were removed, farmers were allowed to work on their plots, the exchange rate system was unified, government's monopoly on trade removed, the number of state-enterprises reduced, and private firms allowed to be formed. Reforms stalled during the regional crisis, as Lao struggled with serious macroeconomic problems. With successful stabilization beginning in 2000, structural reforms picked up momentum in 2001/03.

Fighting poverty. In April, 2002, the Government of the Lao PDR finalized an Interim-Poverty Reduction Strategy Paper (I- PRSP). Using this and the five-year National Socio-economic Development Plan for 2001-05, the Government followed a consultative process to prepare the National Poverty Eradication Program (NPEP). The NPEP was presented to the donors' Roundtable Meeting in September 2003, approved by the National Assembly in October 2003, and reviewed and upgraded to a national strategy in early 2004. The final text takes the name of National Growth and Poverty Eradication Strategy (NGPS). It articulates Lao's development framework for poverty reduction, specifies the targets and goals that the country values and indicates the policies and public expenditure programs that will be needed to achieve those goals.

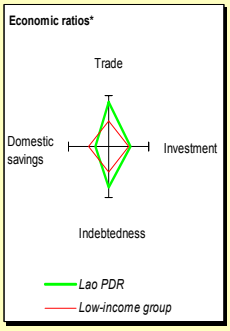
Table 1. Lao PDR, EAP and Low-income World: Comparing Development Indicators

POVERTY and SOCIAL	Lao PDR	East Asia & Pacific	Low-income
2002			
Population, mid-year *(millions)*	5.5	1,838	2,495
GNI per capita *(Atlas method, US$)*	310	950	430
GNI *(Atlas method, US$ billions)*	1.7	1,740	1,072
Average annual growth, 1996-02			
Population *(%)*	2.4	1.0	1.9
Labor force *(%)*	2.2	1.2	2.3
Most recent estimate (latest year available, 1996-02)			
Poverty *(% of population below national poverty line)*	39	..	..
Urban population *(% of total population)*	20	38	30
Life expectancy at birth *(years)*	55	69	59
Infant mortality *(per 1,000 live births)*	88	33	81
Child malnutrition *(% of children under 5)*	40	15	..
Access to an improved water source *(% of population)*	37	76	76
Illiteracy *(% of population age 15+)*	34	13	37
Gross primary enrollment *(% of school-age population)*	113	106	95
Male	121	105	103
Female	104	106	87



KEY ECONOMIC RATIOS and LONG-TERM TRENDS	1982	1992	2001	2002
GDP *(US$ billions)*	..	1.1	1.7	1.7
Gross domestic investment/GDP	..	..	22.1	..
Exports of goods and services/GDP	..	17.0	..	..
Gross domestic savings/GDP	..	..	..	..
Gross national savings/GDP	..	..	..	..
Current account balance/GDP	..	-4.3	-4.7	..
Interest payments/GDP	..	0.3	0.6	0.6
Total debt/GDP	..	170.0	142.6	158.6
Total debt service/exports	..	4.9	7.9	..
Present value of debt/GDP	..	..	74.0	..
Present value of debt/exports	..	..	235.5	..

	1982-92	1992-02	2001	2002	2002-06
(average annual growth)					
GDP	4.5	6.3	5.7	5.0	..
GDP per capita	1.8	3.8	3.3	2.6	..
Exports of goods and services	..	..	..	..	..



Source: World Bank, Economic Indicators of Development, 2003

ECONOMIC MONITOR – APRIL 2004 – Covering six months, up to end-April 2004. The Lao PDR Economic Monitor (the Monitor) is issued in Lao and in English, twice a year (Spring and Autumn) by the World Bank in Lao PDR. It reports on recent economic performance (Part I) and progress on the Government's reform agenda (Part II), and from this issue, donor activities in the relevant structural reform areas (Part III). The Monitor is prepared by Somneuk Davading and Alessandro Magnoli (Country Economist), under the overall supervision of Kazi M. Matin. For inputs and comments, we would like to thank Michael Markels , Renuka Vongviriyatham, and Amanda Carlier. We are also grateful to Mr. Sirisamphanh Vorachit (MOC) as well as other Lao officials for sharing their time and their views with the team. Our thanks also go to the staff in Bank's resident mission who provided support to the Monitor.

THE WORLD BANK TEAM WILL APPRECIATE FEEDBACK ON THE STRUCTURE AND CONTENT OF THE MONITOR.

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Acronyms and Abbreviations

ADB	Asian Development Bank
AFTA	ASEAN Free Trade Area
ASEAN	Association of Southeast Asian Nations
APB	Agriculture Promotion Bank
BCEL	Banque Pour Le Commerce Extérieur Lao
BOL	Bank of Lao PDR
BOP	Balance of Payment
BPKP	Bolisat Phattana Khet Phoudoi
BPO	Business Promotion Office
CEFT	Common Effective Preferential Tariff
CIC	Committee for Investment and Cooperation
COCI	Committee of Culture and Information
CPC	Committee for Planning and Cooperation
DDFI	Department of Domestic and Foreign
DOL	Investment Management
DONLUPAD	Department of Land Use Planning and Administration
CPI	Consumer Price Index
EAP	East Asia & Pacific
ECC	External NPL Collection Committee
EDL	Electricité du Lao
EU	European Union
FDI	Foreign Direct Investment
FINNIDA	Finland International Development Association
FMAC	Financial Management Adjustment Credit
FMCB	Financial Management Capacity Building Credit
FRP	Financial Recovery Plan
FY	Fiscal Year
GDP	Gross Domestic Product
GOL	The Government of Lao PDR
GTZ	German Agency for Technical Cooperation
HIPC	Highly Indebted Poor Country
IMF	International Monetary Fund
JICA	Japan International Cooperation Agency
LDB	Lao Development Bank
LMB	Lao Mai Bank
LNCCI	Lao National Chamber of Commerce and Industry
LTA	Lao Tourism Authority
LTC	Lao Telecom Company
LXB	Lane Xang Bank
MAF	Ministry of Agriculture and Forestry
MCTPC	Ministry of Communication, Transport, Post and Construction
MDG	Millennium Development Goals
MIH	Ministry of Industry and Handicraft
MOAF	Ministry of Agriculture and Forestry
MOC	Ministry of Commerce
MOE	Ministry of Education
MOF	Ministry of Finance
MOIC	Ministry of Information and Culture
MOFA	Ministry of Foreign Affairs
MOJ	Ministry of Justice
MOH	Ministry of Health
MOUR	Memoranda of Understanding
NA	National Assembly
NPL	Non-Performing Loan
NPV	Net Present Value
PM	Prime Minister
NSC	National Statistical Center
PEM	Public Expenditure Management
PER	Public Expenditure Review
PIP	Public Investment Plans
PMO	Prime Minister's Office
PPIAF	Public Private Infrastructure Advisory Facility
PRF	Poverty Reduction Fund
PRGF	Poverty Reduction and Growth Facility
RMFC	Rural Micro Finance Committee
SAMD	State Assets Management Department
SCB	Sate-owned Commercial Bank
SIDA	Swedish International Development Association
SOE	State-Owned Enterprise
STEA	Science, Technology and Environment Agency
TOR	Terms of Reference
UNDP	United Nations Development Programme
WASA	Water and Sanitation Authority
WB	World Bank
WTO	World Trade Organization

INTRODUCTION

In late 2003, economic performance has been positive: real GDP growth has fallen slightly to 5.5 percent, and the macroeconomic situation has improved over the last six months. The exchange rate has been flexible and relatively stable, and inflation, especially non-food price, has slowly begun to decline, helped no doubt by better fiscal control. In the first months of 2004, growth picked-up and is projected to reach 5.8 percent. Assuming continued inflows of foreign assistance, the balance-of-payments should not experience major problems. Exports are performing strongly and the current account deficit remains at around 6 percent.

The government has also been continuing its reform efforts. The National Growth and Poverty-Eradication Strategy (NGPS/PRSP), articulating a medium term program of reforms and public spending programs aimed at sustaining high growth and rapid poverty reduction, has been approved by the National Assembly in October 2003 and finalized by the Government in April 2004. Implementation of reforms, in respect to public expenditure management, state-owned enterprises (SOEs), banking, trade, and private sector development, has picked up momentum[1].

PART I – RECENT ECONOMIC DEVELOPMENTS

1.1 The Macroeconomic Situation

BACKGROUND

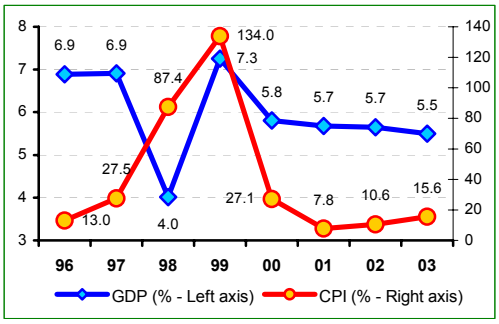
In the 1990s, Lao PDR grew at an annual average rate of 6.3 percent, and the incidence of poverty fell from 45 percent to 39 percent of the population in 1997-98 and to 29 percent in 2002-03. The crisis years of 1998 and 1999 saw inflation climb to an annual average of 110 percent and growth fall to 4 percent, but the resolution of the regional crisis stabilized the economy.

The economic situation for Lao PDR has been improving since. The adoption of a stabilization program since 2000 and the implementation of a phased program of reforms since 2001 – in public expenditure management, banking, state-enterprises, forestry, trade and private sector has contributed to this improvement. During the 2000-03 period, inflation has averaged 15 percent and GDP growth averaged around 5.6 percent annually. The 2002/03 revenue shortfall and the pick-up in inflation in the first half of 2003 has begun to be addressed by the Government.

Recent trends in economic policy. The Government has announced the introduction of a value-added tax (a date has not been set), and is expected to lower import tariffs in line with plans to join the ASEAN free-trade area (AFTA) by 2006[2]. Preliminary analysis of revenue performance in the first half of fiscal year 2003/04 (October-September) indicates that revenue collection, despite slippages in the first quarter, reached 42 percent of the annual target, a higher share than was achieved last year. Spending has been in line with budget, though there are pressures in the system for exceeding it.

Growth is strong. In 2004, real GDP is expected to grow at 5.8 percent, as a result of increased private investment, a modest recovery in tourism, and higher exports (due to faster world trade growth and improved access to US markets). Projected stronger growth in Vietnam, Thailand, and the EU - which together account for the majority of Lao exports - might play an important role. The Government has continued the efforts to improve the operating environment for businesses and the foreign investment framework (above all, streamlined investment approvals process for both domestic and foreign investors, including allowing provinces to approve

Figure 1. GDP Growth (%) and CPI (%)



Source: Lao authorities and WB staff estimates.

[1] After a year's delay, all seventeen specific reform actions for the release of the Financial Management Adjustment Credit (FMAC) second tranche have been completed.
[2] Laos has until 2008 to lower tariffs to below 5%, and reductions are taking place each year.

investment programs worth less than US$2m). In 2004-05 the government is planning further changes to ease the investment environment, including developing a special economic zone in Savannakhet province and reducing the barriers to the leasing of land by foreigners.

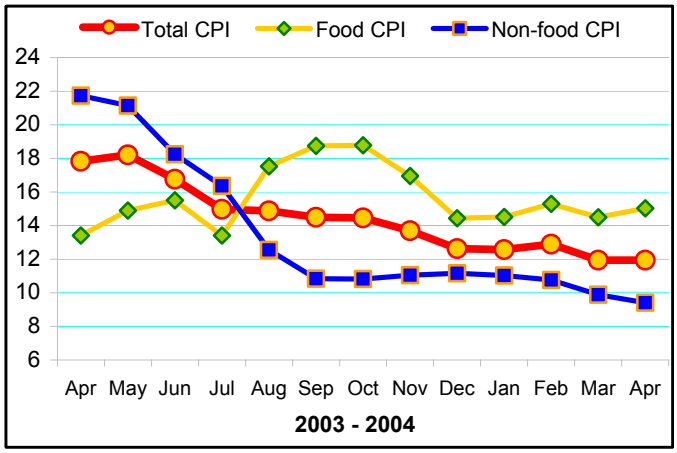
Agriculture is the engine of Lao growth. In 2003, growth in the agricultural sector was steady at 4 percent. Poultry farmers have been hit by the regional outbreak of bird flu. The main wet-season rice crop harvest – having avoided major flood and drought damage - has exceeded GOL expectations, but coffee producers have been hit by bad weather. To foster agricultural growth, needed changes are the development of rural infrastructure and easier access to rural credit for farmers. While illegal logging remains a problem, opium production has fallen. Exports of agricultural and forest products to neighbours have increased. The government has signed an agriculture agreement with Vietnam.

Industry is catching up. In 2003, the industrial sector has also grown fast, and - in 2004-05 – is expected to benefit from higher growth in the world economy and faster world trade growth, which should lift demand for Laos's merchandise exports. The garment manufacturing sector is growing in line with increased orders from the EU, and should also benefit from greater access to the US market once normal trade relations (NTR) status are granted (expected in 2004). Construction activity is being boosted by the rising number of infrastructure development projects, particularly road- and bridge-building and power generation. Energy co-operation with Vietnam has been stepped up with a proposed hydroelectric power station. The future of the proposed Nam Theun 2 hydroelectricity project (NT2) is clearer with: 1) the return of Electricité de France (EdF), a French state-owned energy company and a key developer; and 2) the agreement of the Thai state-owned energy company, Electricity Generating Authority of Thailand (EGAT) to buy electricity from NT2 from 2009. NT2, a US$1.1bn project is expected to have a significant impact on growth while construction is taking place. Mining has enjoyed progress in prospecting foreign-invested mining projects: new commercial interest in gold mining has surged following the success of the Sepon mine, an Australian-backed project. Lao and Thai officials have met to settle business disputes involving state and private firms from both countries.

Services are expanding. In 2003, the downturn in the tourism industry in the region and the country due to the outbreak of bird flu and SARS, has lowered growth in the service sector. While GOL has hosted the ASEAN Tourism Conference in Vientiane in January 2004 to promote tourism in the country and the region, the sector is recovering and is expected to grow faster in 2004, despite heightened security concerns, which prevent the tourism industry from achieving its full potential. The telecom services continues to grow as telephone penetration rates rise. Air travel with Vietnam, Myanmar and Cambodia has been liberalized. Transport links with Thailand have been liberalized in a bid to increase trade, and the Thai government has planned to finance the construction of two bridges.

Inflation is declining. Inflation, as measured by the total CPI, has been falling for the last 12 months ending April 2004, having risen in the first half of 2003 (see Figure 2). Non-food inflation has also been falling, and has come down to single digits as of April this year. This clearly reflects improved management of fiscal deficit and domestic credit growth. A stable exchange rate has helped too. However, there are cost-push pressures like *a)* rising world price for rice; *b)* scheduled increases in tariffs for domestic utility prices, including electricity and higher health-care costs, largely because of improvements in quality not captured in the data.

Figure 2. Food and Non-food CPI (%), 2002-04



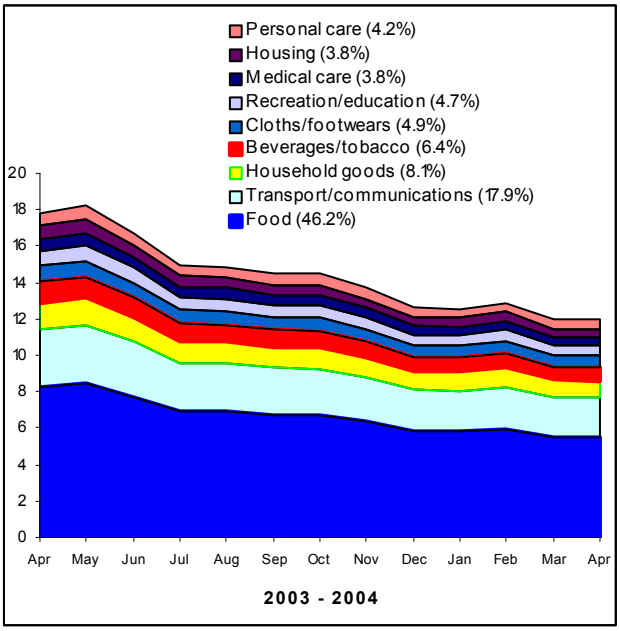
Source: Lao authorities and WB staff estimates

The effective measurement of inflation is hampered by the prevalence of foreign currencies (above 75 percent of the total money in circulation, compared to 35 percent in the early 1990s).

Decomposing inflation. The CPI is composed by nine components (consumer product groups). Six are the most relevant for this analysis, which together account for 86.2 percent of the total. These are: 1) food (which constitutes the 46.2 percent of CPI); 2) transport and telecommunications (17.9); 3) household goods (8.1); 4) beverage and tobacco (6.4), 5) housing (3.8); and 6) medical care (3.8).

- *Food (46.2 percent of CPI).* In terms of levels, during 2003 and in early 2004, the twelve-month CPI for food averaged 15 percent, and floated around 12-18 percent, with a peak of 18.8 percent in October 2003. Rice prices are on the rise, because of strong demand from Thailand. In terms of percentage changes, after a sharp decline in the Fall 2003, month-to-month CPI has resumed growth, reaching about 2 percent in February, March, and April 2004.

Figure 3. Decomposition of Non-Food CPI (% change)



Source: Lao authorities and WB staff estimates

- *Transport and telecommunications (17.9).* The CPI for transport and telecommunications - after peaking at 18-19 percent in March-May due to higher oil prices - decreased in April 2004 to about 6 percent. In terms of percentage changes, month-to-month trends are declining (see Figure 4).

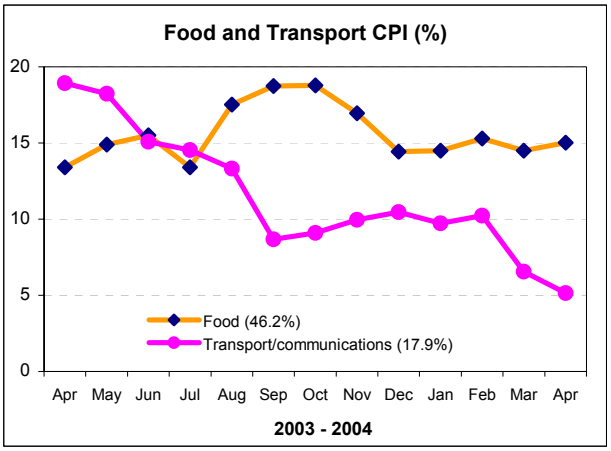
- *Household goods (8.1).* Household goods prices have gradually declined to about 6 percent after peaking in early 2003 (see Figure 4).

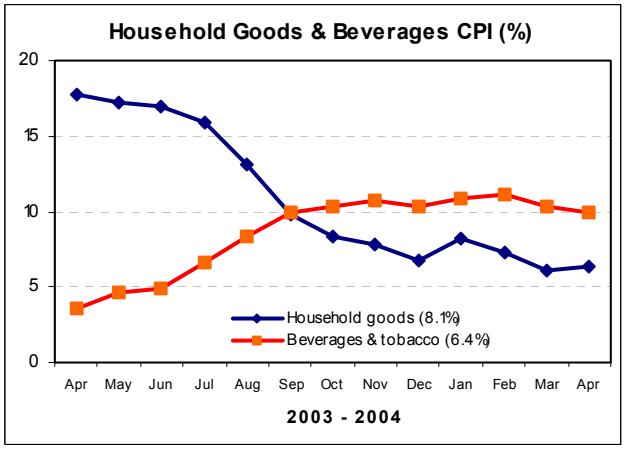
- *Beverage and tobacco (6.4).* The prices of beverages and tobacco increased from about 1 percent in January 2003 to 11 percent in February 2004, as a result of higher GOL taxes (see Figure 4). However, in March and April 2004 prices have been declining (to 9.9 percent in April 2004).

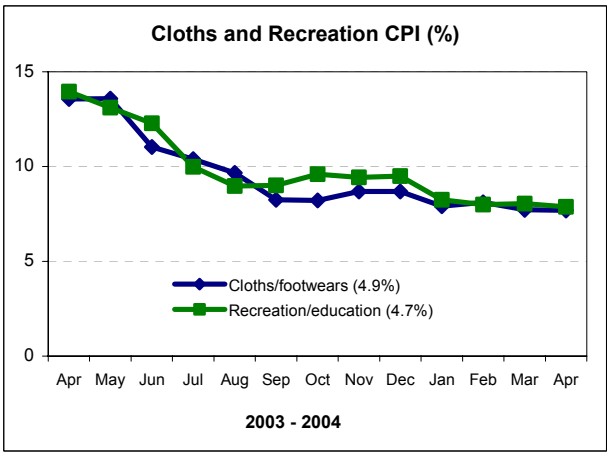
- *Housing (3.8).* The prices of housing also decreased during the rainy season (to 20 percent in April 2004) after peaking to 85-90 percent during the last dry season (November-April 2003). However, in terms of percentage changes, month-to-month CPI has been rising, from an average of 1.5 percent throughout 2003 to 2.5 percent in April 2004 (see Figure 4).

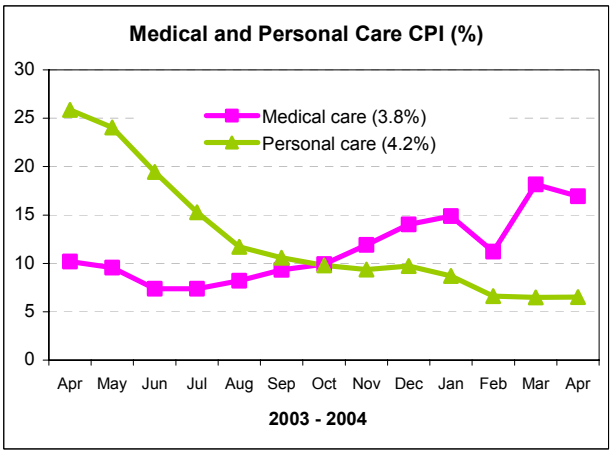
- *Medical care (3.8).* Costs are rising: while it is possible that SARS and the avian flu played a role, medical care prices in Lao PDR are on the rise - and will keep rising while the heath care system gets upgraded. Health services in Laos are getting rapidly upgraded from very rudimentary to fairly sophisticated. The availability in Thailand of a wide variety of medical services has been a major driver in this race to modernize. The costs of some of the new machines and lab facilities are many times greater than what was previously available in Laos. In terms of percentage changes, the medical care CPI is growing (see Figure 4), with some seasonality in the month-to-month numbers (last April it increased, in November and in December it rose again, to peak in March 04). From February to April 2004 the month-to month growth rate more than doubled - from 1.2 to 2.5.

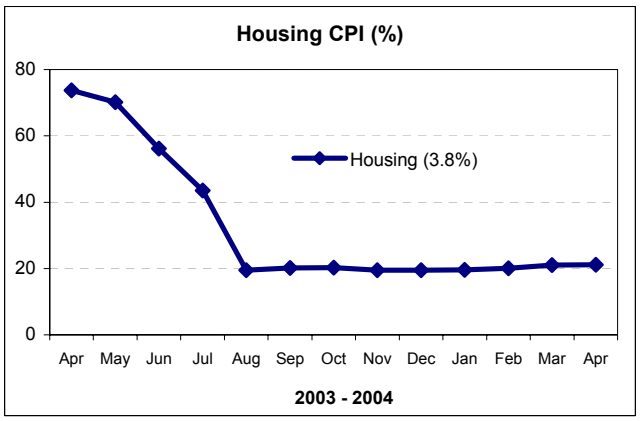
Figure 4. CPI breakdowns (year-to-year change), 2002-04







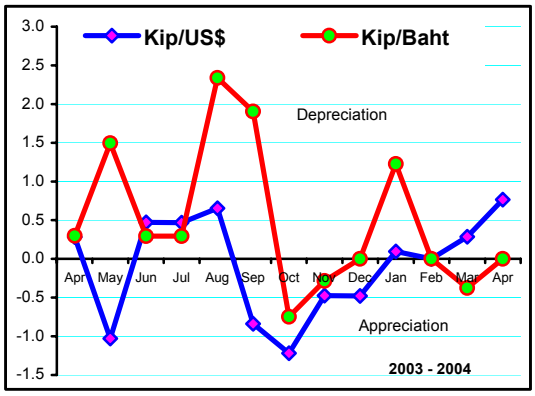




Source: Lao Authorities (NSC) and WB staff calculations

Exchange rate: stable. In 2003, the Kip fluctuated slightly against the US Dollar and the Thai Baht (between plus and minus one percent, except a 2.5 percent depreciation against the Baht in August), but overall has depreciated by an annual average of around 5 percent. However, towards the end of 2003 the Kip strengthened, to again depreciate mildly in early 2004, especially against the US dollar. In mid-January the Kip is estimated to have appreciated by around 2% year on year against the US dollar. Yet, the currency is vulnerable, as the main sources of exchange-rate weakness (the large budget deficit and the trade and current-account deficits) are not being reversed. Foreign-exchange reserves remain weak - in August 2003 reserves fell to US$170m, equivalent to four months of merchandise imports (based on estimated imports in 2003) - thereby limiting the Government's ability to defend the currency. In average the exchange rate levels are at about Kip10,600:US$1 and Kip250: 1Baht.

Figure 5. Lao exchange rate, 2003-04



Source: Lao authorities and WB staff estimates

Revenue performance: improving. After slippages in the first quarter of 2003/04, revenue collection exceeded target as of March 2004. Revenues reached 42 percent of the annual target, compared to 39 percent at the same time last year. Sustained revenue collection efforts – especially at the provincial level – would be necessary to ensure that the annual target is met.

Table 2. Budgetary operations

	2002/03	2003/04	2003/04
	Actual	(first half)	(plan)
		(billion Kip)	
Revenue & Grants	2,798	1,299	3,282
Revenue	2,345	1,184	2,817
Tax Revenue	1,928	986	2,406
Non-tax Revenue	417	198	411
		(percent of GDP)	
Revenue & Grants	13.1	5.3	13.4
Revenue	10.9	4.8	11.5
Tax Revenue	9.0	4.0	9.8
Non-tax Revenue	1.9	0.8	1.7

Source: Lao Authority (MoF). Estimates for first haft of 2003/04

Nevertheless, there is a secular downward trend in overall revenue collection as a share of GDP, for the following reasons: a) timber royalties falling by 1¼ percent of GDP from their peak in 2001/02 because of stricter enforcement of the log export ban; b) provincial collections remitted to the central Government's consolidated account is falling; c) the halving of the turnover tax on domestic products; and d) reduced import taxes.

Efforts have been underway to reverse this trend.[5] In 2003/04, the Government intends to improve the transfer and accounting of revenues, especially those of the central government, and by centralizing

[3] To address the revenue shortfall, in May 2003, the authorities implemented revenue and expenditure measures. In particular, petroleum taxes raised by 17 percent (effectively doubling the tax rate – this is expected to bring in additional revenue of 0.6 percent of GDP annually). However, while complying with the ceiling on bank credit to the government (see below), significant budget arrears were accumulated, on top of the stock of arrears that existed before. About two-thirds of these arrears is planned to be cleared by the end of 2003/04, mainly by the issuance of debt clearance bonds. This will also settle Government's obligations to the contractors who in turn had overdue obligations to the SCBs, thereby supporting bank restructuring.

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customs and treasury departments. Also the tax department is expected to be strengthened, and the large taxpayer unit expanded. The new Presidential Decree on Tax Incentives, intended for promoting private sector, could be costly in terms of lost revenue next year. The Government plans to prepare implementing regulations in a way that would minimize the revenue loss from this new decree. Future increase in government revenue will be partly offset by the loss of customs revenue as tariffs are lowered in line with AFTA commitments.

Monetary policy is still cautious. In 2003, despite the fact that commercial bank deposit rates remained far below lending rates, credit policy has been generally restrained, some repayments were made, credit appraisals were tightened, and net SCBs domestic assets have been slowly decreasing. This has been due largely to cautious bank lending practices that were put into place by BOL in an effort to stem increases in non-performing loans (NPLs). Additionally, the BOL has used indirect monetary instruments, such as the issuing of bonds. In 2004, broad money (M2) growth is expected to fall.

PART II – STRUCTURAL REFORMS

The Government of Lao PDR revived implementation of structural reforms in late 2001, to improve the management of public expenditures and state-enterprises (SOEs), enhance transparency of state-owned banks (SCBs), and achieve better natural resource management. Key objectives of the reform process are reducing waste and enhancing efficiency, as well as increasing the transparency and accountability of public resource use. If future increases in revenue from mining and hydro-power are to be used for improving social outcomes instead of financing losses of SCBs and SOEs, improvements in use of public resources will be critical. In addition, the Government is also continuing its reforms in the areas of trade and in private sector development, aimed at completing the transition to a market-economy, that Lao PDR initiated more than a decade ago. This part records the actions taken in these areas during 2003 and the first four months of 2004 (see the Boxes in the Annex for the actions that were taken in 2001 and 2002).

2.1 Public Expenditure Policy and Management

BACKGROUND

Since 2001, the government of Lao PDR revived its public expenditure reform, by reassessing its expenditure policies and its public expenditure management processes. With the share of revenues in GDP stagnating, and arrears accumulating, the spending choices are becoming more difficult and more critical, if the country's poverty reduction objectives are met. Phased payment of arrears is needed, as indeed, a better balance between recurrent and capital expenditure. Social spending needs to be made more efficient and certainly protected. More effective public expenditure management processes will be useful to ensure that the decisions are taken through accountable and transparent processes, and the allocations reach their destinations.

Public expenditure policy. Increases in capital expenditures, inconsistent with available recurrent budget, have been a chronic problem. In the 2003/04 budget, the Government planned to revert this trend, by raising current expenditures as share of the total spending.

Falling revenue over several years is reducing current spending. The lower share of revenue to GDP, relative to 2001/02 risks putting additional pressures on recurrent spending. Historically, the imbalance of recurrent spending relative to capital spending has led to irregular wage payments, especially in the provinces and general under-utilization of capacity.

Progress made by GOL. For the third consecutive year the Budget Department of the MOF is preparing a breakout of spending by sector, economic and administrative classifications at both the central and provincial levels. Data will shortly be available – by publication in the Official Gazette - for the 2002/03 outcome and the 2003/04 budget; a summary is presented in Table 3. There has also been progress in completing a census of budget arrears as of the end of September 2003, identifying type, level of government, creditor and age of the arrear. A plan to avoid arrears and to solve most of the stock quickly is being developed; this will help to ease the squeeze on current spending as well.

Table 3. Government expenditures

	2002/03 Actual	2003/04 (first half)	2003/04 (plan)
		(billion Kip)	
Total expenditures	**4,017**	**1,601**	**5,074**
Current Expenditure	1,647	776	2,245
O.W. Wages & Slaries	671	367	849
Capital Expenditures	2,370	826	2,829
O.W. Domestically-Financed	1,028	416	783
		(percent of GDP)	
Total expenditures	**18.8**	**6.5**	**20.7**
Current Expenditure	7.7	3.2	9.2
O.W. Wages & Slaries	3.1	1.5	3.5
Capital Expenditures	11.1	3.4	11.6
O.W. Domestically-Financed	4.8	1.7	3.2
Revenue & Grants	**13.1**	**5.3**	**13.4**
Deficit (including grants)	**5.7**	**1.2**	**7.3**

Source: Lao Authority (MoF). Estimates for first haft of 2003/04

Public Expenditure Management

Several actions were taken for improving transparency, improving procurement and in working towards a better balance between recurrent and capital spending. For measures taken so far please refer to the Annex – Box 1.

2.2 REFORM OF STATE-OWNED ENTERPRISES

BACKGROUND

Recent Trends. The objective of the government's SOE reforms is to enhance transparency, reduce waste and increase efficiency in order to promote their commercial viability and reduce their budgetary burden. Reforms implemented in the early 1990s reduced the SOE sector by closing down, leasing, merging and selling a large number of SOEs. The number of SOEs today are fewer, but more importantly, they play a significantly smaller role in Lao's economy in terms of its share in GDP and in its share in total employment. Nevertheless, several large SOEs have been generating a large share of the non-performing loans (NPLs) in the state-owned banking system, which risks the banking sector and ultimately needs to be funded by Government revenue.

The Government's recent SOE reform program initiated in 2001 has three thrusts: (a) improving transparency and governance of state enterprises, (b) restructuring those enterprises which have caused losses to the state and banks, and (c) rationalizing the regulatory and pricing environment for infrastructure SOEs, through tariff reform. Progress to-date has been relatively slow, but the momentum of SOE reform has picked up notably in the last nine months.

Actions Taken for SOE Reform in 2003

There has been significant progress during the last six months in moving the SOE reform and SOE restructuring agenda forward. The Government, especially the Ministry of Finance (MOF) and the Business Promotion Office (BPO), has demonstrated commitment to this program and marshalled the capacity to implement it. It has taken a long time to bring everyone on board this program – BPO, SOE management, relevant ministries, provinces – but the leadership appears to be committed to it. The challenge is now to sustain implementation of this program and for the donors to come forward and support continuation of SOE reforms.

Monitoring performance & classifying SOEs for reform. The MOF , especially the State Asset Management Board (SAMB), has in the last six months, completed its development of the data-base and the classification of all SOEs by performance. A system for collecting data and maintaining the data-base for annual monitoring of SOE performance has been established, based on the Implementing Regulations *to the Decree on Management of State-Invested Enterprises, Decree No.*

54/PM dated May 9, 2002. Technical assistance and training for state asset management bureau (MOF) officials at the central and provincial and for SOE directors has been fully implemented, and the process of collecting and analyzing financial and operational information on the 148 State owned enterprises operating in Lao is now complete. A set of technical criteria for assessing the performance of all SOE and a rating system using quantitative and qualitative information gathered to calculate a composite score for the financial performance of SOEs was developed. Key criteria used to assess performance included profitability, solvency, liquidity, debt management and operational activity; assessments of management capacity, business and industry experience, and viability of business plan were also taken into consideration. As a result of these efforts the Government has now completed its classification of all state owned enterprises into the following categorizes (i) performing well (ii) require restructuring/ improvement, and (iii) to be sold or liquidated. The Government has classified 31 SOEs (7 central and 24 provincial) for sale and liquidation, in addition to the 9 SOEs that are undergoing restructuring currently.

Ongoing Restructuring of 4 large SOEs. The BPO in the Prime Minister's office developed in December 2003, with the help of external consultants, detailed time-bound restructuring plans for Lao Airlines, BPKP, Pharmaceutical Factory No. 3,and Nam Papa Lao. Early this year these plans and their recommendations were adopted through two different instruments. The *Prime Minister's Notice* No. 059/CPMO dated 15 January 2004 adopted the key elements of the SOE restructuring plans, including key principles of such restructuring. The subsequent four *Implementing Guidelines/Instructions* issued to all relevant agencies on April 29 2004 by the Minister in the Prime Minister's office in charge of SOE restructuring set-out detailed actions, the institutional arrangements and agencies responsible for their implementation, transparent monitoring and evaluation procedures which include external audits and a specific timetable for 2004 and 2005 for their implementation. All 4 SOEs plan to have annual external audits by independent auditing firms, to assess their performance, to see what improvements are taking place and whether they are moving the SOEs to commercial viability. Some of the specifics in terms of actions that are covered in these Guidelines/Instructions in respect of each, are presented below.

Lao Airlines. Following changes in management and some financial restructuring, the Government conducted an in-depth analysis of the financial and operational situation, including tariffs, to develop restructuring options. This showed clearly that the Airlines is loosing money for several years, with the losses rising over time. Since the budget cannot finance these losses of the Airlines – without taking away taxpayers money from other important Government activities (e.g. road-building, schools, health clinics and so on), the best way to maintain a national airline for Lao PDR is to enter into a joint venture with a foreign airline, that can invest and eliminate losses. Various options for doing this, proposed in BPO restructuring plan, were subjected to extensive stakeholder consultations in December 2003 and in January 2004 in Vientiene, involving Lao Airline management, MOF, MCTPC, BPO, commercial banks, and other SOEs. Following those consultations and high-level meetings, the Government decided to propose conversion of Lao Airlines into a joint-venture entity with a foreign airline as a strategic partner, with Lao nationals owning 51 percent – but Government of Lao owning less than 51 percent. This is proposed, in the Implementing Guidelines, to be done by issuing new shares and diluting Government's holdings, and in the process obtaining the necessary investment from the foreign partner. The Implementing Instructions also set-out the process, the need of an external advisor to assist the Government in the transaction, as well as the decision to use cost-recovery commercial tariffs on all routes, except those that are financed by the Government for social reasons. The challenge now is to implement this major initiative of the Government quickly.

BPKP implemented an initial round of measures in 2002 i.e. reduced the number of activities from 58 to 9, reduced the size of the labour force and changed its management among others and then worked with BPO to assess its financial and operational performance in recent past. Based on that assessment and future potential, BPO developed a detailed time-bound restructuring plan, that suggested that it keep two core-activities as part of its ongoing operations and hive-off (i.e. sell or liquidate) the rest of its non-core activities. The time-bound restructuring plan was adopted under the Prime Minister's Notice No. 059/CPMO and the Implementing Instructions. The latter envisages continuation of only two core activities under BPKP – wood and wood processing, as well as construction. Most of the non-core activities are proposed for sale or liquidation, except the tourism centre which will be sold as a separate ongoing business to a non-state entity. The Instructions also specify actions for financial and operational restructuring of the two core business

lines, as well as annual monitoring of performance of the core-activities to ensure that they are viable.

Nam Papa Laos A detailed time-bound restructuring plan has been elaborated and a number of restructuring actions have already been implemented i.e. a water tariff increased, various cost reduction measures implemented including reduction in employment and management changed. The Prime Minister's Notice No. 059/CPMO dated 15 January 2004, and the Implementing Instructions/Guidelines together set out the main directions of restructuring as well as the specifics including further tariff increases, financial restructuring with debt-equity conversion and asset revaluation, and operational cost reduction in respect to material purchases and production and accounts receivables management, and a timeline for these actions in 2004 and 2005.

Pharmaceutical Factory 3, The Prime Minister's Notice No. 059/CPMO dated 15 January 2004 and accompanying Implementing Instructions constitute a detailed time-bound restructuring plan for PH3. Key measures include setting-up strict internal and credit control mechanisms, financial restructuring to enable the debt servicing of existing loans, refocusing of product-line along commercial lines; and seeking a joint venture arrangement with a regional pharmaceutical manufacturer to strengthen management capabilities and introduce new technologies. The Implementing Instructions also establish the institutional arrangements and responsibilities for the on-going reform actions as well as monitoring mechanisms.

Initiation of Restructuring of another 5 SOEs. Memorandum of Understanding (MOU) for Restructuring have been adopted for five additional SOEs, namely, DAFI, Lao State Fuel Enterprise, Lao Export-Import Trading Company, Bridge-Road Construction Company No. 13 and Agro-industrial Development Company (DAI). Detailed financial and operational information is now being collected in respect to these SOEs as a foundation for the development of the detailed multi-year restructuring plans, which will be completed by March 2005.

Tariff & Pricing Policies for Infrastructure. Most of the infrastructure services in Lao PDR -- electricity, water, telecommunications and aviation -- are provided by SOEs, though increasingly, more private providers are entering into these services. The Government, cognizant of the need to reduce budgetary subsidies to these services and to tap into the private financing of investments, have been moving to more appropriate tariffs and prices for such services. There has been a good deal of Government action in this respect over the last three years, and certainly very significant actions in the last six months cited below. These actions relate to: 1) actual changes in tariffs and in tariff structures and 2) articulating guiding principles for setting of tariffs and for changes in those tariffs. In particular, tariffs have been raised towards greater cost-recovery and policies and principles that would guide future tariffs and tariff changes have been adopted in respect of water, telecommunications and aviation, through Prime Minister's Notices approving the proposals made by MCTPC.

Water. In 2004, GOL introduced new water tariffs for Vientiane, a decision that has been overdue since mid 2002, generating a lot of the losses in Nam Papa Lao, one of the SOEs under restructuring. Implementation of the proposed tariff increases is being phased in two steps: March-June and July-December, 2004. Between March and June, new tariffs have increased by 50% for the first two user groups (households as well as government offices and commercial/industrial users); tariffs for embassies and foreign residential clusters were reduced by about 20 percent on average, as they were way above cost-recovery levels (see Table 4 below). The second round of adjustment will take place on July 1, 2004 in line with what is in the table below.

Table 4. Water tariff changes in Vientiane, 2004

Water users	Consumption Vol.(m3)	Old tariff Kip/m³	Mar-Jun 2004 Kip/m³	Mar-Jun 2004 % change	Jul-Dec 2004 Kip/m³	Jul-Dec 2004 % change
Group I. Households, government offices	0 - 5	219	285	30	350	23
	6 - 30	292	412	41	526	28
	> 30	336	546	63	706	29
Average		***282***	***414***	***45***	***527***	***27***
Group II. Commercial & industrial	0 - 10	691	899	30	1,210	35
	11 - 50	869	1,303	50	1,720	32
	>50	953	1,811	90	2,364	31
Average		***838***	***1,338***	***57***	***1,765***	***32***
Group III. Embassies, foreign residential	0 - 10	6,184	5,260	-15	5,260	0
	11 - 50	7,668	5,620	-27	5,620	0
	> 50	7,668	6,180	-19	6,180	0
Average		***7,173***	***5,687***	***-20***	***5,687***	***0***

Source: BPO, WASA & NAM PAPA Vientiane

In addition, a "water tariff policy" has also been recently approved by the Prime Minister's Office, which articulates clearly the principles guiding tariff-changes in Vientiane versus smaller towns and villages, and within the later what would guide subsidization of water supply to target groups and areas.

Electricity. In 2004, the electricity tariffs continued to be increased by 2.3% per month for all categories of users, except for embassies and international organizations - whose tariffs are fixed in USD (see Table 5 below).

Table 5. Electricity tariff changes, 2004

User categories	Minimum charge	Monthly increase	Months						
			Oct-03	Nov-03	Dec-03	Jan-04	Feb-04	Mar-04	Apr-04
	(Kip/month)								
1. Residential	650								
1-50 kw/month	-	2.3%	94	96	99	101	103	106	108
51-150 kw/month	-	2.3%	221	226	231	236	242	247	253
>150 kw/month	-	2.3%	637	652	667	682	698	714	731
2. Embassies, intern. organizations	4,500	Fixed	9.9 cent	9.9 cent	9.9 cent	9.9 cent	9.9 cent	9.9 cent	9.9 cent
3. Commercial and services	4,500	2.3%	689	705	721	737	754	772	790
4. Entertainment	4,500	2.3%	913	934	955	977	999	1022	1046
5. Government offices	4,500	2.3%	589	602	616	630	645	660	675
6. Irrigation	4,500	2.3%	246	251	257	263	269	275	282
7. Industrial, handicrafts, agriculture	4,500	2.3%	530	542	555	567	580	594	607

Source: Electricité du Lao (EDL)

Still, in Lao PDR electricity tariffs are very low when compared with other ASEAN countries (see Table below). Electricity tariffs are higher in Cambodia, Brunei, Philippines, Vietnam and Malaysia.

Table 6. Basic electricity tariff in the ASEAN Countries, As of 24 September 2003 (In US cents/kWh)

Country	Residential	Commercial	Industrial
Brunei Darussalam	2.88-14.42	2.88-11.54	2.88-11.54
Cambodia	9.17-17.03	15.72-17.03	12.58-15.72
Indonesia	1.69-4.60	2.77-5.65	1.71-4.38
Lao PDR	0.88-5.93	6.41-8.50	4.93
Malaysia	5.53-8.94	2.63-10.52	2.63-10.52
Myanmar	8.14	8.14	8.14
Philippines	3.15-10.71	3.68-9.85	3.35-10.84
Singapore	9.23	4.42-7.18	4.16-6.69
Thailand	3.41-7.47	2.94-7.47	2.94-7.13
Vietnam	2.92-8.17	4.24-13.96	2.83-13.96

*Source: ASEAN*energy.org.
Link at http://www.aseanenergy.org/publications_statistics/electricity_database/electricity-database.htm.

Telecommunications. The tariffs for telephone service in Lao PDR are generally supportive of growth in this sector, especially cellular service, though there remain considerable scope for making the regulatory environment more transparent and more predictable. At present MCTPC is not the only agency that make decisions about entry into this sector and its not clear that other agencies are following a given set of principles to make those decisions. Further private investment and further growth in services will depend on better and more predictable rules of the game in telecommunications. The fixed (i.e. traditional wire-line service) line service is still a monopoly in Lao PDR but the cellular/mobile service is quasi-competitive, and the latter not surprisingly has been service growing rapidly over the last few years, driven in part by foreign investments.

The tariffs for cellular service, are thus much closer to cost-recovery levels, with cost defined to include the needed investment-cost for providing the service, and thus the tariffs probably require relatively less attention of regulators, given existing capacity in Lao PDR. On the other hand fixed telephone service tariffs are distorted, and operates more like a monopoly. Domestic calls and line rentals are highly subsidized while tariffs for international calls are excessively high compared to neighboring countries; also tariff adjustments responds more sluggishly and administratively to market conditions. Thus increased attention to explicit policy guiding tariffs for these services is clearly more of a priority. The Government has accordingly revised and published fixed line tariffs and rentals several times, including one done in April 2004, as well as developed an explicit policy for setting telecom tariffs through a recent Prime Ministers Notice issued in February 2004.

In 2004, tariffs for local domestic calls were raised by 90 percent and for long distance domestic calls by 15 percent. The monthly fixed-line rental fee was increased by 60 percent. The various "types of calls" have also been simplified (see Table below). But the tariff for fixed line international calls has been reduced by 30 percent for all destinations. Nevertheless, the new tariff rates for fixed line service still deviate from cost recovery levels.

Table 7. Telephone tariff changes, 2004

No.	Type of calls	New tariff	
		(US$)	(Kip)
I.	**Fixed Phone**		
	(same tariff for all categories of customers)		
	Rental fee - monthly	1.500	16,000
	Local calls	0.020	200
	Long-distance calls		
	Between neighbour provinces	0.036	360
	Between non-neighbour provinces	0.041	410
II.	**Mobile Phone**		
	Rental fee - monthly	15.00	157,000
	Local call	0.030	300
	Long-distance calls		
	Between neighbour provinces	0.036	360
	Between non-neighbour provinces	0.041	410
	Prepaid (M-Phone):		
	Local call	0.070	700
	Long-distance calls	0.090	900

Source: Lao Authorities (MCTPC)

Aviation. The tariffs for Lao Airlines were grossly below cost-recovery levels for many routes and many services. There have been several revisions in the past, as indicated in earlier reports. However, with Lao Airlines moving towards a joint-venture with minority Government shareholding, and the Implementing Instructions issued in April 2004 confirming that tariffs will be on a commercial basis and cited in the business plan of the airline, the general principles for setting aviation tariffs in Lao is in place.

The challenge going forward will be the implementation of the approved policies on tariffs for the infrastructure services, especially in applying the guidelines promptly such that tariff adjustments do not lag significantly behind cost increases. Vigilance of the MOF and MCTPC will be thus be a critical part of the effectiveness of these new policy measures. Thus regular monitoring of tariffs and costs by MCTPC will remain important.

For SOE reform measures taken in previous years please refer to the Annex – Box 2.

2.3 Financial Sector Reform

BACKGROUND

The Lao banking system is the financial sector. It is small in absolute terms, with total system assets of approximately US$400 million, which is less than 25% of Gross Domestic Product (GDP). In the first phase of reforms in the late 1990s, Lao moved away from its mono-bank system, separating central banking from commercial banking and permitting joint-venture and foreign banks to operate in the country. In the mid-1990s, state-owned commercial banks (SCBs) had to be restructured and rehabilitated.

However, the SCBs accumulated significant non-performing loans since then. Thus restructuring those banks, improving regulation and supervision, supporting micro-rural finance and opening up the banking system have become key pieces of the current round of banking reforms initiated in 2001. The challenge is to get SCBs to run on more commercial principles, improving their lending decisions and enhancing their risk management practices. BCEL is the largest SCB. Two smaller SCBs were merged into a new SCB called the Lao Development Bank (LDB). Various changes in regulations were issued in 2001 and 2002 (see Box in the Annex). Today, the banking system comprises of three state-owned banks, including the Agriculture Promotion Bank (APB), three joint-venture banks, six braches of foreign banks, and one representative office. There are no domestic private banks.

Beyond the priorities of stopping losses in SCBs, resolving NPLs in SCBs and restructuring their operations on commercial lines, key next steps include developing a holistic medium term financial sector blueprint, with a ten-year vision, including a delineation of the role of private sector in the financial sector. Strengthening the legal framework and judicial capacity to enforce contracts on a fair and timely basis through a specialized commercial court is also being discussed as are improved accounting standards and practices, all part of its this round of reforms.

Financial Sector Reform in last six months. The Government of Lao PDR has also made considerable progress in respect of its financial sector reform program, which is led and managed by the Bank of Lao PDR. This comprises of actions to improve supervision of banks, restructure SCBs, especially NPLs and operate them on commercial lines, support rural-micro finance and open up the banking system further.

Supervision & Regulation of Financial System. The Financial and Banking Supervision Department (BFSD) is revising regulation no. 98/BOL on loan classification, regulation no. 178/BOL on foreign currency exposure, and regulation no. 3/BOL on lending limits. The new BOL 98 will remove the ambiguity on loan classification in the existing regulation, clarify the treatment of restructured loans, and introduce a proactive classification of NPLs beyond a simple aging classification. In addition, the revised regulation no. 3/BOL will establish an absolute limit on lending to single and group borrowers and remove BOL and BFSD from approval of large loans in excess of the prudential limit. These new regulations have been drafted and discussed in Government and in BOL and is expected to be effective before end of 2004. BOL has licensed three pilot commercial member-owned saving and credit unions (SCU). ADB provided seed capital of around 7,000USD for each SCU on top of $3,000 contribution from members of each SCU.

SCB Restructuring & Improvement. The SCB restructuring program has been progressing, albeit at a slow pace. Actions to restructure the three SCBs began in early 2002 and has been continuing since. The restricted credit regime has been in place and its been effective in slowing down the credit expansion. SCBs' credit risk assessment process has improved with the introduction of certification by the International Banking Advisors (IBAs), especially with regard to approval of lending to large accounts.

Efforts to improve quality of the portfolio of loans, enhance risk-diversification and make operations of SCBs autonomous have had uneven success. There was portfolio deterioration through 2002 (as confirmed by external independent audits of banks completed recently); but improvements in portfolio are evident during the second half of 2003, which is expected to be confirmed when audits for 2003 are completed later this year. There were also few "directed" or "policy" loans suggesting that banks were deciding, with the help of IBAs on a more commercial basis. Reductions in risk concentration were difficult to achieve and remains a weakness. Overall, a lot has been done to strengthen the health of SCBs, but more remains; the IBAs will continue to be important for further improvements in process. The NPLs have begun to come down but more resolutions will be needed.

*NPL Resolution***.** BCEL and LDB have identified the NPL resolution strategy (stock and flow) as well as action plans to address their largest flow NPL-accounts, which if successfully resolved, will reduce their NPLs further. The twenty largest NPL accounts of BCEL and the top thirty seven NPL accounts of LDB comprise a significant part of the troubled portfolio; banks are working with the Mekong Project Development Facility (MPDF), a multi-donor facility, to help restructure the operations and medium borrowers. The MOF has issued "triangle" restructuring bonds to banks, which are designed to resolve NPLs caused by government arrears. The first lot of around 100 billion Kip was issued in second half of 2003. The first coupon payment for these bonds are due in July 2004.

Agricultural Promotion Bank (APB) is undergoing restructuring, to transform it into a commercial entity. Under the plan, APB will have full management autonomy by June 2004. By end 2006, subsidized/policy lending will be phased out and APB will eventually fund itself wholly from public sources.

Law on Commercial Banks. The draft amendment of the Decree Law on Commercial Banks was submitted by BOL to the Ministry of Justice (MOJ) in early 2004. The proposed amendment aims at: (1) providing equal treatment of all banks under the law (all banks can be distinguished as "domestic" or "foreign" only, and face a similar legal regime and capital requirements), (2) improving corporate governance for both state and private banks by strengthening internal and external audits and administrative boards, (3) incorporating good banking decisions (to test and enhance decision making capability of owners and managers and strengthen on and off site supervision), (4) confirming GOL commitments with regard to SCB autonomy in decision making, interest rate setting and lending based on commercial principles. After review by MOJ, the draft Decree will be passed on to the Prime Minister's Office for approval.

Rural and Micro-finance. The policy statement, industry assessment and a time-bound action plan for the implementation of a rural and micro-finance reform were approved in principle by the Prime Minister's Office after a long process of consultation, including workshops for the provincial Deputy Governors. Regulations on the micro-finance industry have been drafted and are in the process of consultation with various stakeholders, including provincial authorities.

For financial sector reform measures taken in previous years please refer to the Annex – Box 3.

2.5 Trade Reform

BACKGROUND

Lao PDR has been integrating gradually into the world economy since 1989. The reform process accelerated after Lao PDR accession to the ASEAN and the joining of AFTA in July 1997. The highest current import tariff rate is 40 percent (compared to about 150 percent in 1995) and for most product groups is below 20 percent. The current tariff schedule has six tariff-rates: 5, 10, 15, 20, 30 and 40 percent, with un-weighted average tariff of 10 percent. Quantitative import restrictions remain. The country started to implement the AFTA Common Effective Preferential Tariff (CEPT) scheme in January 1998 and will complete the liberalization schedule by 2008: reducing its tariff on imports from ASEAN countries to 0-20 percent by 2005 and 0-5 percent by 2008. The Government has recently introduced one-stop services at customs border check-points to reduce bureaucratic procedures and provide better export and import services. Lao PDR has recently applied for the WTO accession and been working on the preparatory stage.

The Government of Lao PDR is continuing its gradual process of integrating with the world economy and the region. In March 2004, the first International Expo was held in Vientiane at the International Trade Exhibition and Convention Centre (ITECC), in which participated more than 200 companies from ASEAN countries and China. The event gave the Lao business community the opportunity to: *a)* promote products and services; and *b)* to engage in business discussions and build mutual trade relationships.

Recent Government Actions Towards Trade Promotion

[6] IMF advisor for bank supervisor saw further deterioration in 4Q 2003 from examination report.

- *PM Decree No.15 of February 04, 2004 on trade competition*. It will be effective on August 1, 2004, and has provided key principles to regulate monopolistic practices, and to promote fair competition and a level playing field for all players. The decree has identified the government agencies responsible for the monitoring of competition, and defined roles and responsibilities to ensure free market and guarantee the participation of various sectors of the economy.

- *Ministerial Guideline No.04/MOC of January 5, 2004 on promoting commodity production.* It has defined the following goals for the next few years: (1) meet domestic demands and substitute imports (especially food, raw materials, construction materials and other consumer goods that have potential), (2) increase exports, especially to ASEAN and other neighbour countries (of agricultural and forestry products, and wood), (3) maintain market dynamics, by favouring demands and supplies to support economic growth. This guideline also provides some significant implementation measures: (1) create awareness among Lao people at all levels of the importance of the transition from a self-sufficient economy to market-oriented one, (2) improve existing regulations and procedures to encourage the production of commodities and facilitate domestic trade and exports, (3) increase roles and participation of business communities from all economic sectors in the commodity production process, (4) attract more FDI for commodity production and leverage the Lao economic potential, especially in the area of natural resources and human capital.

Price Control. Although trade in Laos is gradually being liberalised, a number of products remain under government price control, especially those goods perceived as "strategic" (see Table 9).

Table 8. List of products subject to price control in 2003-2005 (14 items)

	Product Group	Items
Group 1	Energy	1 item: fuel & gas
Group 2	Construction materials	4 items: steel bars, cement, roof tiles and galvanized sheets
Group 3	Agricultural	2 items: fertiliser and animal foods
Group 4	Raw materials for production	1 item: raw materials for local production
Group 5	Foods	6 items: rice, sugar, beef, pork and eggs

Source: Lao Authority (MOC)

Tariff Preferences. As one of the least developed countries (LDCs), Lao PDR receives several tariff preferences, such as: 1) GSP from many developed and medium income countries (EU, Australia, Canada, Japan, New Zealand and former socialist countries); 2) ASEAN Integration System of Preferences (AISP) from Malaysia and Thailand; and 3) special tariff preferences from China and Korea (see table 2). However, many Lao exporters still face difficulties in making use of the preferences, because of a number of constraints, such as certification of products/origin, quality, transport costs, customs clearance and local capacity.

Table 9. List of tariff preferences given to Lao exports by other countries

Country/Region	Type of preference	Requirements
ASEAN • Malaysia • Thailand	ASEAN Integration System of Preferences (AISP) (tariff at 0-5%, Malaysia: for 12 items, Thailand: for 26 items)	Malaysia • At lest 40% originated in Lao PDR • Use of Form D and sealed with AISP stamp and notify Malaysian authority 1 month in advance. Thailand • Agricultural – materials used are 100% locally produced or a combination of local and Thai materials, not less than 60% of total value of materials. • Non-agricultural - materials used are 100% locally produced or a combination of local and Thai materials,

		not less than 40% of total value of materials. • Use of Form AISP and notify Thai authority 1 month in advance.
EU and other countries7	Generalised System of Preferences (GSP)	• Use of Form A • Lao origin (100%), or • Using materials from one of these countries, or • Materials from other countries (ASEAN, SAARC, ACP-EC) but were substantially transformed EU - (1) Garments –- Value-added is greater than the highest customs value of the products used originating in any one of the other countries of the regional group (2) For other products, base on list of working or processing required to be carried out on non-originating materials in order that the product made can obtain originating status. Australia – value of imported materials should not exceed 25% of factory cost Canada - value of imported materials should not exceed 60% of ex-factory price. Japan - value of imported materials should not exceed 50% of ex-factory price. New Zealand - value of imported materials should not exceed 50% of factory price. Former Socialist countries - value of imported materials should not exceed 50% of FOB price of products.
China	Tariff Preferences under ASEAN-China Agreement (for 202 items)	Tariff will be reduced to 0% by 2007
Korea, Republic	Tariff Preferences for LDCs (for 88 items)	• Lao origin (100%) • Use Form Certificate of Origin for Preferential Tariff for LDCs

Source: Lao Authority (MOC)

Trade Developments

In 2003, as compared with 2002, Lao exports increased by 17 percent (or to about US$366 m) and imports by about 8 percent (or to about US$508 m). From a medium-term perspective, the natural resource sector (mainly mining and hydropower) is seen to be the main driver of growth for Lao exports - while agriculture, manufacturing and tourism are significant for a longer-term development of the Lao economy.

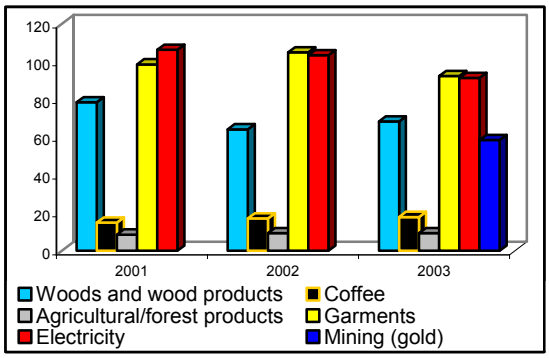
Strong exports. In 2003, export earnings have strongly accelerated:. Trade with China has recorded strong growth. Exports to ASEAN countries have been growing more rapidly. While tourism receipts remain depressed, the services sector continues to be robust. Imports have been growing faster than last year, but at a lower rate than export earnings. Thus, the trade and current account deficits are expected to be similar to last year. Strengthening demand in Thailand and Vietnam, key export markets, in addition to future greater access to the US market after NTR status has been granted, indicate that this positive trend in export growth might continue in 2004-05. However, competitiveness problems persist in the garment industry, which accounts for around 25-30% of total exports.

Composition of exports. The rapid growths in exports of mining products entailed a remarkable change in structure of Lao exports. In 2003, the share of mining products in Lao exports (mainly gold, copper, gypsum and coals) has increased significantly from a marginal level of 1.5 percent in 2002 to about 16 percent of the total in 2003, whereas shares of garments and electricity declined from 34-35 percent in 2002 to about 25 percent in 2003. Wood and wood products, and coffee remained unchanged, about 19 percent and 5 percent, respectively (see figure 5). In 2003, as compared with 2002, the Lao exports from mining increased more than ten-fold, while wood products by 7 percent,

[7] Countries providing GSP to Lao PDR include Australia, Austria, Belarus, Belgium, Bulgaria, Canada, Czech, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Japan, Luxemburg, Netherlands, New Zealand, Norway, Poland, Portugal, Russia, Slovak, Spain, Sweden, Switzerland, Turkey and U.K.

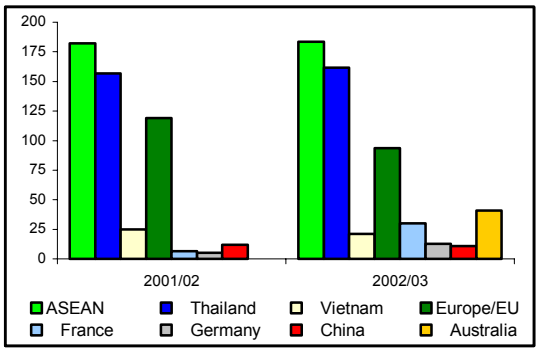
coffee by 5 percent, and agricultural and forestry products marginally by 1 percent. On the other hand, garments and electricity declined by 12 percent each.

Figure 6. Exports of Major Commodities (US$ m)



Source: The Lao authorities and WB staff estimates

Figure 7. Exports according to Country/ Region of destination (US$ m, FY)

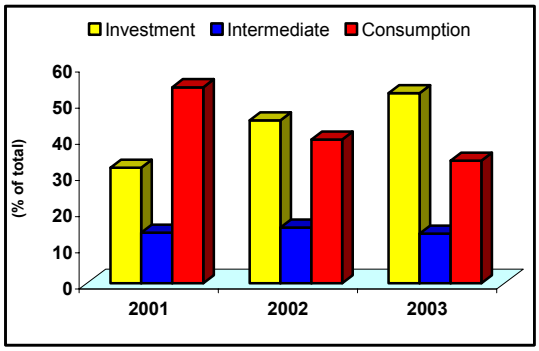


Source: The Lao authorities and WB staff estimates

Destination of exports. Over the last few years, Lao exports markets remained unchanged and concentrated in a few countries/regions: ASEAN (Thailand, Vietnam), China, Japan, Korea and the EU (France, Germany, Italy, Belgium, etc.). However, recent exports to Australia (mainly gold) have increased dramatically, from less than US$1m in 2002 to about US$60 m in 2003. When production of gold and copper will expand, exports to Australia will grow accordingly.

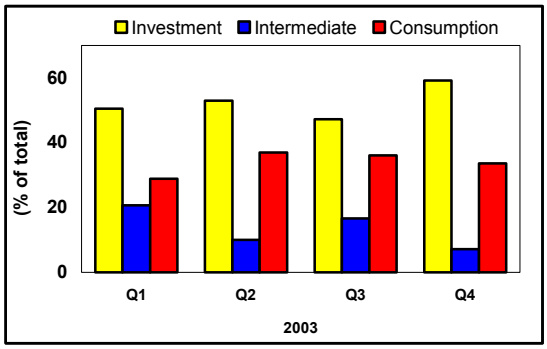
Composition of Lao imports[8]. Over the last three years, the overall trend of Lao imports shows a falling share of consumption (mainly fuel, food, cloths, and vehicles), from 54 percent in 2001 to 40 percent in 2002 and 34 percent in 2003, On the contrary, investment imports (mainly fuel, machinery and equipment) increased drastically from 32 percent in 2001 to 45 percent in 2002 and 52 percent in 2003 (see table 7). The intermediate imports (raw materials for garments and other industries) remain fairly stable at around 14-15 percent over the period. This change took place because of the Lao government's initiative of promoting domestic production and export growth through import substitution, which resulted in an increased use of local materials.

Figure 8. Imports of major commodities 2001-03



Source: The Lao authorities and WB staff estimates

Figure 9. Quarterly imports of major commodity, 2003



Source: The Lao authorities and WB staff estimates

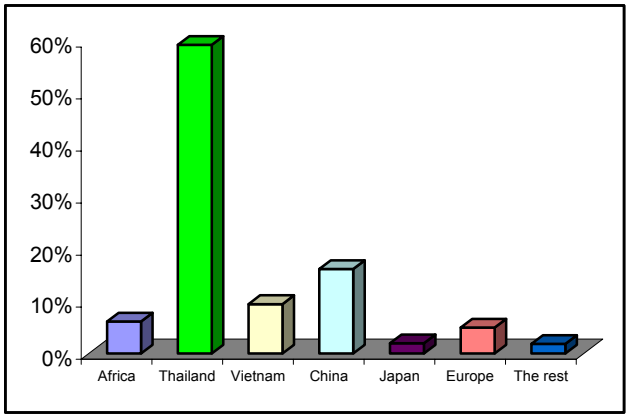
Investment imports are rising. In 2003, investment imports were higher than consumer and intermediate imports, and rose from 47 percent of the total imports in the first quarter to 59 percent in the last quarter. Consumption imports dropped consistently over the last three quarters of the year from 37 percent in Q2 to 34 percent in Q4. A similar trend is seen for intermediate goods, that

[8] Imports are classified into three main product categories: investment, intermediate, and consumption goods.

decreased significantly, from 21 percent in Q1 to about 7 percent in Q4 of the year (see table 8 above).

Provenance of imports. In FY 2002/03, Lao imports originated mainly in the following countries: Thailand (60 percent), China (16 percent), Vietnam (9 percent), Africa (6 percent) and Europe (5 percent) and other countries (see Figure 11). During the last few years, Lao imports from China and Vietnam grew rapidly, especially for consumer goods, foods, construction materials, fuel and project-based imports. A reverse trend is seen for the imports from Thailand: over the last few years, the overall value declined remarkably due to intensified competition from China, Vietnam and other neighbour countries. Despite this, Thailand still remains the largest trade partner of Laos.

Figure 10. Lao imports by country, FY 2002/03



Source: The Lao authorities and WB staff estimates

2.6 Private Sector Development

BACKGROUND

The Constitution of 1991 protects state, collective and private forms of ownership. During the 1990s an active program of legislation began to lay the foundation for the development of market based rules and institutions to support private sector development. The foreign investment legislation was passed in 1988 and a legal basis for land for use and transfer began to be established in 1992-93. Today all agricultural production and most of manufacturing production is in private hands; the industrial sector accounts for 5 percent of employment and state-enterprises cover only around one percent.

Nearly 97 percent of manufacturing units are small (less than 10 employees). Of the medium and large units, 35 per cent were privately owned by Lao citizens and 55 per cent were joint ventures with foreigners; the rest were owned by government (including provincial governments).

Foreign investments have been flowing into garments, wood processing, tourism, hydropower generation and more recently, mining. Between FY 2000/01 to FY 2001/02, foreign investment volume increased and approvals of investment increased tenfold (from US$42m to US$492m for the same period), largely due to mining and hydropower. The main foreign investors are from Thailand, Malaysia, Singapore, Vietnam (ASEAN), China, Australia, South Korea, Taiwan, France, the Netherlands and United States.

GOL continuously makes efforts to improve the investment climate in Lao PDR and organises high-level government missions to other countries (Japan, Korea) to promote and attract FDI to Laos. It has recently taken the following decisions to promote domestic private enterprises (SMEs) and improve overall investment process:

- PM Decree No. 42/PO of April 20, 2004 on Promotion and Development of Small and Medium Sized Enterprises, defines key policies and an action plan for SME promotion and development, including the establishment of SME Development Funds and supporting organizations (the SME Promotion and Development Committee and its permanent Office and Executive Committee). It also defines regulations, methods and measures needed to promote SMEs, the expansion of commodity production, and trade and service activities. The policy gives priority to creating an enabling regulatory environment, enhancing competitiveness, expanding markets (domestic and international), improving access to financing and developing both entrepreneurship and an entrepreneurial culture in the country.

- Consolidate the Domestic and Foreign Investment Laws, to harmonize investment regulations and procedures, improve investment registration process, provide fair treatment for all (both local and foreign) investors.
- Organize a regular business forum to encourage dialogue between the Government and the private sector. The forum shall create a better understanding of private sector development (PSD) issues in the country (in particular: key constraints and needs) and of which government assistance is needed to support the sector's growth.
- Undertake an Investment Climate survey and assessment in collaboration with the ADB and WBG.

For background on measures taken in previous years please refer to the Annex – Box 4.

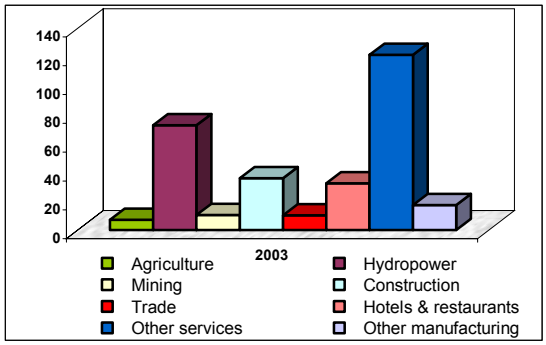
Foreign Direct Investment (FDI)

In general, in the Lao context, investments in hydropower and mining projects have huge impacts on magnitude of overall FDI in each year. At the moment of publication, data on actual FDI inflow was not available. Approvals are shown in the figures 9-10 below. In 2003 the approved FDI was about US$313m, considerably lower then in 2002.

FDI by Sector

In 2003, approved investments in services, such as trade, hotels and restaurants, construction and other services accounted for more than half of total FDI (about 53 percent), whereas Industry was at about 45 percent (construction, hydro and mining). For details, please see figure 10.

Figure 11. Approved FDI by sector (US$m)

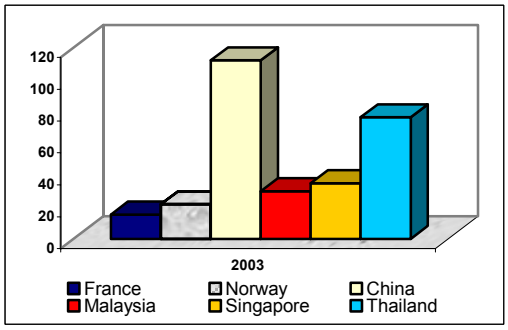


Source: Lao authorities

FDI by Country

In 2003, the key countries/investors in the approvals have been mainly China, Thailand, Singapore, Malaysia, Norway and France (see figure 11). As compared to 2002, approved investment from China, Singapore and Norway increased rapidly, as opposed to other countries, such as Vietnam, Australia, EU, ANIES.

Figure 12. Approved FDI by country (US$ m)



Source: Lao authorities

For background on measures taken in previous years please refer to the Annex – Box 5.

PART III – DONOR ASSISTANCE TO THE REFORM AGENDA

Lao PDR is still heavily reliant on external support; for example, in 2002/03, donor funded programs accounted for 7 percent of GDP, 39 percent of total public expenditure, and 61 percent of the capital budget. This part provides a overview of the donor activities, organized by thematic areas. Financial sector reform is the biggest recipient of funding, almost entirely provided by International Financial institutions (IFIs). Japan is the bigger bilateral donor.

3.1 Public Sector Governance

UNDP and other donors

- ***Strengthening the Legislative and Oversight Function of the National Assembly, LAO/02/M01*** **(UNDP - US$0.22m, 2002-03).**
  The project provides support to the National Assembly to strengthen its legislative process and oversight functions including enhancement of technical and managerial capacities of staff and members. The tasks include reviews of the NA human resource strategy, English language training and development and implementation of a gender mainstreaming strategy and action plans.

- ***Strengthening International Legal Instruments in Lao PDR, LAO/00/006*** **(US$.696m: UNDP – US$80,000 & Finland – US$616, 000. 2001-2003).** The project aims to strengthen the capacity of the Department of Treaties and Legal Affairs in the Ministry of Foreign Affairs. It intends to enhance dissemination, enforcement and reporting mechanisms relating to international obligations of Lao PDR. A further objective is to assist the Government of Laos in developing a sustainable, coherent and effective mechanism for the preparation, signing, ratification and implementation of Lao PDR's international obligations.

- ***Strengthening the Institutional Foundations for the Rule of Law, LAO/99/006*** **(US$0.489m: UNDP – US$431,000 and SIDA – US$58,000. 2000-03).** The project intends to assist the government of the Lao PDR in its efforts to strengthen the national judiciary. Given the government's objective to improve the capacities of national judges, the project's main goal is to set up a series of sustainable, material-based training programs, notably focusing on the needs of provincial and district court judges.

- ***Strengthening the Institutional Foundations for the Rule of Law (Assistance to the Office of Public Prosecutor), LAO/99/007*** **(US$0.52m: UNDP – US$374,000, SIDA – US$117,000 and CIDA – US$32,000. 2000-03)**. The project aims to strengthen the specialized legal skills of the Office of Public Prosecutor (OPP). Activities: (1) training of central and provincial level prosecutors in research techniques, interrogation and general legal issues, (2) enhancing information management capabilities at the OPP including development of a computerized information management system that will assist in data collection and compilation (statistics on the OPP's cases).

Norway

- ***Strengthening the Public Sector*** **(US$3.80m, 2001-03).** This project focuses on capacity enhancement for the national assembly, improvements in the legislative process, strengthening of the tax and customs authorities. The project also supports the preparation of environmental legislation and improvement of women's participation in this area.

3.2 Reform of State Owned Enterprises

World Bank (US$0.3m)

- ***Financial Accountability (IDF grant $0.3 m)***. This grant aims at improving Financial Accountability in SOEs and Private Enterprises. The project focuses on capacity building and introduction of international accounting and auditing standards and related training. The project also supports strengthening of LICPA and improvement of legal framework for

accounting and auditing particles. Efforts are currently underway to translate international accounting standards into local language.

3.3 Financial Sector Reform

World Bank (US$26.45m)

- ***Financial Management Adjustment Credit – FMAC (US$17.00m, 2002-2004).*** The FMAC will focus on three sectors to help solidify the macroeconomic stability achieved and strengthen the basis for further reforms. The program consists of three components closely coordinated with the IMF and ADB:

  The Public Sector. The public sector reform component aims to (i) improve budget planning, (ii) streamline budget execution and control, (iii) make the budget process more transparent, and (iv) better natural resource management.

  The SOE Sector. The state-owned enterprises component focuses on (i) strengthening oversight of financial and operational performance of SOEs, (ii) restructuring of enterprises, and (iii) rationalizing the regulatory framework. The power sector relevant issues are addressed in this component.

  Financial Sector. The financial sector component will support the launching of the Financial Sector Reform which seeks to (i) stabilize the financial condition of the state-owned commercial banks (SCBs), (ii) strengthen the SCBs to support broad-based economic growth and (iii) enhance rural micro finance for poverty alleviation.

- ***Financial Management Capacity Building Credit – FMCBC (US$9.45m, 2002-08).*** The FMCBC aims to provide a comprehensive and strategic framework for the capacity building activities to improve the financial management in Laos and to provide a credit for specific technical assistance and training activities within such framework.

IMF

- ***Poverty Reduction and Growth Facility - PRGF*** **(US$25m, 2001-03)*).***
  The PRGF is the IMF's concessional facility for low-income countries. This is intended to ensure that each PRGF-supported program is consistent with a comprehensive framework for macroeconomic, structural, and social policies to foster growth and reduce poverty. Under the PRGF-supported program, IMF provides support to the Lao government for strengthening macroeconomic performance and implementing structural reforms in the following key areas: (1) fiscal policy, (2) monetary and exchange rate policies, (3) external debt management policies, (4) banking and (5) SOEs reforms.

ADB (US$19m)

- ***Banking Sector Reform Program*** **(US$15.00m, 2002-05).** The objective of the program is to support the government (BOL, MOF) efforts to foster efficient intermediation of depositors resources and ensure a sound banking sector capable of supporting private sector growth and extending rural outreach. The goals will be achieved through an improved operating environment for banking, the immediate application of commercial principles in SOCB operations, and increased diversity in forms of rural financing.

- ***Strengthening Governance for Bank Sector Reform (US$4m, 2002-05).*** The project intends to support the Government's commitment to restructure and reform commercial banking in the Lao PDR. It will introduce sound commercial banking governance structures by engaging two resident international banking advisors (IBAs) for 3 years for each of the two state-owned commercial banks (SOCBs). An information technology (IT) upgrade will support these new governance structures by enabling improved financial reporting to management, shareholders, and the supervisory authority through more efficient and reliable processing of, and reporting on, transactions throughout the nationwide systems.

- ***Rural Finance Development Technical Assistance*** **(US$2m, from 2000).** The overall goal of the TA is to develop a sustainable, market-oriented rural financial system to contribute to poverty reduction. The key objectives the program are to: (1) strengthen the capacity of Bank of Lao PDR (BOL) to support sustainable rural financial development; (2) assist Agriculture Promotion Bank (APB) to build its capacity to expand outreach on a sustainable basis; introduce credit unions on a pilot basis.

UNDP and other donors

- ***Strengthening Fiscal Management*** **(Tax and Custom Administration Reform), LAO/96/005-LAO/02/U01. (US$2.9m: NORAD-$1.7m, UNDP-$0.9m and SIDA-$0.3m).** The overall objective of the project is to improve the government's ability to manage and collect revenue from the domestic economy in an efficient and responsible manner. The project is currently in the bridging, in which the MOF and development partners are reviewing the needs for further assistance. An assessment so far reveals that the advocacy works on fiscal policies should be more focused in addition to the on-going administrative improvements. Some achievements of the project so far are: separated administration of large taxpayers from medium-small ones, establishment of the Large Taxpayers Unit (LTU), simplified and computerized taxpayer registration and declaration at all major customs checkpoints, manuals, taxpayer Identification Number (TIN), modern "self-assessment" procedures, development of an audit policy, a procedures manual, methods to detect low level of filing and non-compliance by large taxpayers, training and seminars for taxpayers and business communities, streamlining tariff nomenclature and customs valuations; custom administration training and manuals; and production of trade statistics using the new system.

3.4 Trade Reform

UNDP and AusAID

- ***Support for Lao PDR's Integration into the International Trading System*** **(US$0.639m: AusAID – US$589,000 and UNDP – US$50,000. 1999-2004).** The main objectives of the this project are to provide technical assistance to GOL in the areas of WTO accession, improvement of economic and trade policy formulation and integration. The project has two components: (1) support for Laos accession to the WTO by providing technical expertise to review its policies, including preparation of Memorandum of Accession, establishment of a minister-level "National Steering Committee and its secretariat, identification of trade focal points in line ministries, and capacity building; (2) integration impact studies in the areas of laws and regulations, which should be changed to conform with WTO agreements, customs valuations, rules of origin, technical barriers to trade, quarantine, sanitary and phyto-sanitary measures and land transport policies.

European Union (EU)

- ***Support for Lao PDR's accession to WTO*** **(US$1.00m, 2003-04).** The objective is to help the Lao government prepare for the WTO accession, especially on capacity building. The project will help government officials understand better international trade, the role and requirements of WTO, revise legal and regulatory framework and develop university level courses on international trade for officials, lawyers, traders and students.

World Bank

- Regional workshops and seminars on trade and poverty, to assess the impact of both China's WTO accession and regional trade integration including ASEAN.
- Study on Lao foreign trade policies, to be completed in the context of the Integrated Framework (IF) exercise.

3.5 Private Sector, Tourism Development, and Land Reform

Private Sector Development

UNIDO

- ***Lao UNIDO Integrated Program* (US$1 million).** The Integrated Program for Lao PDR aims at alleviating the country's persistent trade deficit by strengthening productive capacities in the manufacturing sector. The main tasks of the phase one are to conduct subsectoral studies and produce medium-term strategy and action plans for industrial development in Lao PDR.

  Recently produced reports are: Composition and Evolution of Lao PDR's External Trade; Report on Food Processing Sector in Lao PDR: Product Innovation in the Food Processing and Packaging Sector in Lao PDR; Construction Materials Industry in Lao PDR: Product Innovation in the Construction Materials Industry in Lao PDR; Strategy for Development of the Wood Processing Industry; Artisan Craft Development; The Textile and Garment Industry in Lao PDR; Prospects for Further Integration of Lao PDR's Manufacturing Sector into ASEAN; Technical Report on the Industrial Land Development Program; Technology Needs Assessment in Lao PDR; International Experience of Promotion of SMEs: Small and Medium-sized Enterprise Development Framework; and, Proposal for Promotional Tools for Promotion of Foreign Direct Investment. In addition to that, some specialized background reports and short technical notes on various topics have also been prepared.

MPDF (IFC, WBG)

The main objective of the Mekong Private Sector Development Facility (MPDF) is to support the development of private, locally owned, small and medium enterprises in Laos (also in Vietnam and Cambodia). MPDF has three main programs: (1) *Company Advisory Assistance* (help local SMEs improve operations, develop new markets, strengthen management, and develop sound business plans), (2) *Business Development Programs* (strengthen the capacity of local institutions providing essential business services to SMEs in the areas of financing, consulting, training, and information services, (3) *Business Enabling Environment* (conduct research and prepares analyses on specific issues facing local SMEs and on the environment in which they operate, working closely with relevant government authorities and institutions).

Tourism Development

ADB

- ***GMS: Mekong Tourism Development Project* (US$10.9m, 2002-2007).**
  The Project will promote the development of the tourism sector in the lower Mekong River basin. In Lao PDR, It will improve tourism-related infrastructure in provinces of Champasak, Khammouane, Louangnamtha, and Louangphabang, support pro-poor community-based tourism projects in the rural areas of the country, facilitating private sector participation in tourism marketing and promotion, establish mechanisms to increase subregional cooperation, and facilitate the movement of tourists across borders. The project consists of four parts: part A, tourism-related infrastructure improvements; part B, pro-poor, community-based tourism development; part C, sub-regional cooperation for sustainable tourism; and part D, implementation assistance and institutional strengthening.

Land Reform

World Bank and AusAID (US$47.66m)

- ***The First Land Titling Project* (US$29m: WB-US$20m, AusAID-US$6m and GOL-US3$, 1997-2003).** The main objectives of the project were to foster the development of efficient land markets and to facilitate domestic resource mobilization in order to strengthen the long-term social and economic development in the country. The first LTP had six components: (1) development of the land policy and legal framework for land administration and management;

(2) implementation of an accelerated land titling program; (3) improvements in infrastructure, facilities and land administration systems; (4) improvements in land valuation; (5) support for institutional strengthening; and (6) studies on community land tenure and registration, definition of forest boundaries, cost recovery, land right issues on nationalized land and the socio-economic impact of land titling.

- ***The Second Land Titling Project (*****US$23.92m: WB-US$14.82m, AusAID-US$6.84m and GOL–US$2.27m, 2003-08).** The second phase of LTP aims at developing the land administration capacity to support the country's economic development and poverty reduction goals. The project would contribute to the government's National Poverty Eradication Program (NPEP). The objectives of the project are to (i) improve the security o f land tenure; (ii) develop transparent and efficient land administration institutions at the national and provincial levels; and (iii) improve the government's capacity to provide social and economic services through broader revenue base from property related fees and taxes.

ANNEX BOXES ON ACTIONS TAKEN IN PREVIOUS YEARS

Box 1. GOL Actions to Improve Public Expenditure Management

Measures taken in 2002

- Decree No. 57/PM on the Management of Public Investment, issued on May 22, 2002. The decree requires that PIP submissions for new public projects in excess of 1 billion kip in the FY02/03 budget include estimates of associated recurrent costs during the operating period. The rationale is that it will help Lao PDR correct the imbalance between investment and recurrent expenditures in the budget, which at present is heavily skewed towards the former, by clearly identifying recurrent cost requirements.
- FY 2000/01 outcome and FY 2001/02 budget published in April 2002 with classification by ministry, province, and services. The publication of the budget in the Official Gazette enhances budget transparency. However, the budget classification remains incomplete. The current budget nomenclature allows an economic classification and some functional accounts on an ad-hoc basis. The budget classification system needs to be revised to allow for the identification of administrative units and level of government (central, provincial, district) classification, and to be harmonized with the accounting nomenclature.
- The Government adopting the Accounting Regulations in July 2002 to implement Decree 20/PM on General Regulation of Public Accounting, to enhance financial accountability and transparency as well as internal financial control over revenues and expenditures. The regulations cover basic features of internal control that must be established and maintained in each ministry, province, district and agency, and also provide financial statements of the Government which are to be submitted to the National Assembly at the end of each FY.

Measures taken in 2003

- Increases in transparency was maintained for the second year by the publication of the FY 2001/02 budget outturn and FY 2002/03 budget-plan in April 2003 in the Official Gazette, with classification by ministry, province, and sectors, a summary of which is provided in Table 3.
- The Procurement Monitoring Office (PrMO) was established within the Ministry of Finance, to oversee the implementation of better procurement processes and to assist in related capacity building activities. The office is operational in its new premises. In addition, the office is revising the implementing regulations, which is expected to be completed by the end of the year.
- A methodology for estimating the recurrent costs has been developed for core construction projects in the PIP and was applied to actual PIP projects in the training of staff from CPC and MOF around middle of 2003. Of the 149 new construction-related projects in excess of 1 billion kip, (90 percent of new projects are construction-related), recurrent costs were estimated for 96 of them.

Box 2. GOL Actions on SOE Reform

Measures taken in 2001

- The Business Promotion Office (BPO) - was established in the Office of Prime Minister to centralize the restructuring of SOEs, and a Minister was named to head the office;
- Governance of the largest loss-making state-owned enterprise, Bolisat Phatthana Khet Phoudoi (BPKP) was transferred from the Ministry of Defense to the Ministry of Finance, with BPO charged with the restructuring of BPKP;
- Management audits were undertaken in Lao Aviation and BPKP, leading to change in top management of

[9] Each year through Notices to implement the general Decree No.205 of the Prime Minister issued on 11 October 2001 on this issue. Notice 203 of February 2003 defines the lists of prohibited imports and exports and these appear be relatively uncontroversial bans related to public safety and morals plus those related to logging & raw timber exports.

[10] Licensing of vehicles is now used only mainly as a registration device as importers can import as many as they want

[11] Under AFTA, Lao PDR is committed to move all the items from its Temporary Exclusion List (TEL) to the Inclusion list (IL) by the beginning of 2005 and to reduce the CEPT rates on all IL items to between zero and 5 percent by the beginning of 2008.

[12] The Land Law 01/97/NA (April 12, 1997) repeals a number of previous laws (1979, 1989, 1992) and serves as the new basis for land administration and management in Lao PDR, defining institutional responsibilities for land administration and registration (especially for eight categories of land in Lao PDR: agricultural, forest, construction, industrial, communication, cultural, water-area land and land for national defence and peace-keeping), and (2) sets out the basic rights and obligations of the land user.
PM Decree 22/PM of 1999 is on implementation of the 1997 Land Law.
Presidential Decree on Land Tax (03/PDR of August 12, 2000) provides new guidelines for land tax collection and management, with detailed tax rates for each type of land and its location.

Lao Aviation;

- Financial Recovery Plan (FRP) for EdL agreed with donors and its implementation was initiated;
- A new telecommunication law, passed in April 2001, laid the framework for telecom regulations, opening the sector to private participation, beginning November 2001.

Measures taken in 2002

- Decree No. 54/PM, May 2002, on Management of State-Invested Enterprises, and its Implementing regulations, Dec 2002, clarified the role and responsibilities of the Directors and managers of SOEs and their financial reporting requirements and provided guidance on capital investment in SOEs, procurement/transfer/replacement of assets, and the treatment of dividends, and; outlined sanctions for SOEs violating the regulations.
- Memoranda of Understanding (MOU) dated May 15, 2002 on the restructuring of BPKP, Lao Aviation, Nam Papa Lao, and Pharmaceutical Factory No. 3, setting out the broad parameters of the proposed restructuring, to be used as the basis for preparing detailed multi-year restructuring plans.
- Top management of BKPK and Pharmaceutical Factory No. 3 also changed to facilitate SOE restructuring.
- Letter of the Minister of Finance No. 618/MOF dated April 10, 2002 on new electricity tariff policy;
- White paper on water tariff policy; a draft 'Water Supply Authority (WASA) Charter' on Regulation of Water Supply Operations" is also under review. This is expected to give WASA the authority to function as the water supply sector regulator.

Measures taken in 2003

- Gradual increases in tariffs for Lao Airlines, electricity, water and telephone.

Box 3. GOL Actions in the Banking Sector

Measures taken in 2001

- Notice No. 90/BFSD dated March 19, 2001, requiring a commercial bank to make general provision from 0.5% to 1% of performing loans; Notice No. 209/BFSD dated June 15, 2001, reiterating that a commercial bank shall comply with Regulation No. 03/BOL, which set ceiling for lending at 60% of collateral value and for lending to a single borrower at 10% of the bank's capital, and a commercial bank shall comply with Regulation No. 98/BOL on loan classification, suspension of accrued interest income on a loan which becomes overdue for longer than 90 days, and restriction on new lending to a defaulted borrower;
- Instruction No. 176/BOL dated June 30, 2001, reiterating general reserve requirement and compliance with Regulation No. 98/BOL on loan classification;
- Notice No. 158/AMD dated July 3, 2001, which restricts SCBs to make a policy lending (for an infrastructure project, promotion of export and import substitute, and rice plantation) and focus on loan recovery;
- Instruction No. 195/BOL dated July 6, 2001 and letters to BCEL, LMB, LXB No. 263/BFSD dated August 6, 2001, which distinguish required provision on stock (subject to regulatory forbearance) and flow (in accordance with Regulation No. 98/BOL)i, reiterate SCBs to stop accruing interest income on NPLs, require SCBs to submit to BFSD a report on directed lending.

Measures taken in 2002

- Instruction 01/BOL dated Jan. 10, 2002 on notional capital, credit to large customers, and level of NPLs;
- Instruction No. 03/BOL dated March 14, 2002, which restricts SCBs to grow their risk portfolio if flow NPL ratio exceeds 15% and reduce the branch approval limits. This regulation is aimed to stop further deterioration of SCBs' assets;
- Notice No. 15/CIMD dated April 24, 2002, which gives clarification of Instruction No. 03/BOL;
- Notice No. 566/MOF dated March 31, 2002 on autonomy of SCBs. The objective of this notice is to ensure that SCBs have full autonomy in operating their banks on a commercial basis;
- The Rural and Micro Finance Committee (RMFC) was established on Feb.15, 2002 under Bank of Lao PDR (BOL) to make assessment of the rural and micro-finance industry, formulate a policy statement, and develop an action plan for the implementation of a rural and micro-finance reform program;
- The External NPL Collection Committee (ECC) was established under BOL with the mandate to support debt restructuring on a voluntary basis by SCBs and debtors; Signed Memoranda of Understanding for Restructuring (MOUR) for each SCB dated March 31, 2002, stating the basic principles under which the restructuring will be conducted;
- Two SCBs, Lao Mai Bank and Lane Xang Bank, were merged into the "Lao Development Bank" (LDB) and has been operating as such since the end of 2002.

Measures taken in 2003

- Governance Agreement between Bank of the Lao PDR, Ministry of Finance, each SCB, its Board of Directors, and the management was signed in March 20, 2003. The Agreement is aimed to restructure and strengthen SCBs.
- International bank advisors (IBA) were recruited by BOL to assist in restructuring and strengthening SCBs. IBAs have been working with SCBs since April 2003.
- Regulation No. 6/BOL replacing Regulation No. 98/BOL on loan classification and Regulation No. 5/BOL replacing Regulation No. 178/BOL on foreign currency exposure. Regulation No.3/BOL on lending limits is amended. The amendment improves and strengthens existing prudential regulations, which are currently ambiguous. BOL are reviewing the drafts, which may be implemented in 2004.
- Letter No. 17 and 18/BFSD, dated February 26, 2003, Letter No. 053/BFSD, dated July 30, 2003, Letter No. 092/BFSD, dated October 23, 2003 and Letter No. 120 and 121/BFSD, dated December 5, 2003 instructing BCEL and LDB to limit their net new lending since their NPLs exceed 15%. Letter No.17and 18/BFSD also requesting both SCBs to follow Instruction 01 and 03 closely since they exceeded the concentration limit without prior approval by BOL. These letters enforce SCBs to comply with the prudential regulation and restricted banking regime to avoid further deterioration in their portfolio.
- Notice No. 1760/PMO dated December 17, 2003 informing the MOF that the Prime Minister's Office endorsed in principle the rural and microfinance policy and action plan in December 2003. This will serve as the building blocks for developing rural financial services for the poor.
- The MOF has issued "triangle" bonds to SCBs, which are designed to resolve NPLs caused by government arrears. 120 billion kip was issued in July 2003 with one-year tenure and 11% semi-annual coupon. The second lot of 120 billion kip was issued in September 2003 with two-year term and 11% semi-annual coupon.
- The draft amendment of the Decree Law on Commercial Banks was approved by BOL and is being reviewed by Ministry of Justice in early 2004.

Box 4. GOL Actions towards Trade Promotion

Measures taken in 2003

- Coverage of import and export restrictions are significant13, but registered importers interviewed say that they are able to import as much as they want. Only in the case of cement and steel rods for construction, import controls appear to be binding. Notice 204 specifies that a license from the Minister of Commerce/provincial offices of MOC is needed to import the following:: Petrol and gas; Cars and parts for assembling vehicles of any type other than tractors14; Cement; Steel; Jewellery; any of 17 foodstuffs that include all meats, eggs and poultry, animal feeds, sugar, canned foods, food colouring or seasoning, soft and alcoholic drinks (including beer) and animal medicines; seeds; Videos, movies, gambling machines, satellite TV receivers and telecommunications equipment; Sporting guns.
- On AFTA, of the 1291 items on Lao's Temporary Exclusion List (TEL), 436 items were transferred to Inclusion List (IL) in January 2003, thereby putting 71 percent of all items and 45 percent of all dutiable imports by value in the Inclusion List [15].
- On September 18, 2003 the Lao and US governments signed the first US-Lao Bilateral Trade Agreement (BTA) in Vientiane, which will go into effect after the US Congress enacts legislation authorising normal trade relations (NTR) between the two countries.
- PM Decision No.14/PM of February 28, 2003 allowed the establishment of duty-free warehouses in Vientiane (near the friendship bridge) and Savannakhet (at Seno special economic zone) to facilitate the import processes.
- Supplementary Guiding Order No.530 of May 10, 2003, on business registration, has established sunset provision of two days for registration of local businesses in trade sector at one of the following three levels: central (MOC), provincial and district. However, the application must include: (1) an application form, (2) personal biography, (3) a statement of criminal records No.3, a copy of ID card and three pieces of 3x4 photo,

[13] Each year through Notices to implement the general Decree No.205 of the Prime Minister issued on 11 October 2001 on this issue. Notice 203 of February 2003 defines the lists of prohibited imports and exports and these appear be relatively uncontroversial bans related to public safety and morals plus those related to logging & raw timber exports.
[14] Licensing of vehicles is now used only mainly as a registration device as importers can import as many as they want
[15] Under AFTA, Lao PDR is committed to move all the items from its Temporary Exclusion List (TEL) to the Inclusion list (IL) by the beginning of 2005 and to reduce the CEPT rates on all IL items to between zero and 5 percent by the beginning of 2008.

(4) financial statement, (5) charter-by-law approved by trade agency (for entity as company only). Thus the application requirements remain quite time-consuming in terms of other formalities.

- Annex to the Supplementary Guiding Order No.530 (May 10, 2003) on business registration No. 538/MOC dated May 13, 2003 provides a division of business registration approval between different levels of government agencies: (1) MOC registers foreign companies (with registered capital from and over 200 thousands US$), enterprises dealing with imports of vehicles and fuel and exports of wood and wood products, state enterprises and joint ventures established at central level; (2) provincial trade authorities provide registration to foreign investors (with registered capital below 200 thousands US$), enterprises in agricultural, industrial and services sectors, trading firms, state enterprises and joint ventures established by local governments; (3) district offices can register and manage retail stores, shops, small super markets and other small services.

- Decree No. 125/PM of July 24, 2003 on organisation and operations of Lao National Chamber of Commerce and Industry (LNCCI) (replacing the decree No.175/PM of 20 August 1998 on areas of responsibilities of LNCCI) redefines the role, functional responsibilities, organisational structure and financial matters of LNCCI. LNCCI is an independent organisation that represents the business communities and acts as a bridge linking between the public and private sectors and brings together continuing dialogues between the government agencies and business communities. On behalf of its members, LNCCI negotiates with GOL and foreign partners on trade, industrial and services issues and establishes its representative offices abroad. It issues the certificate of origin to exporters and approves the establishment of business groups in the country. Being financially independent, LNCCI gets supports from its members (member fees), its own services (issuance of certificate, training and advisory services, trade exhibitions, etc.), the government as well as from individuals and local and international organisations.

Box 5. GOL Actions to Improve Private Investment Climate

Measures taken in 2001

- GOL took steps towards improving transparency and simplifying the investment registration processes. A number of websites (inter alia: www.invest.laopdr.org, www.moc.gov.la) have been set up to provide basic information about the country's legal framework, business and investment related laws, sector and industry information and other services.
- Decree No.46/PM March, 2001on the Implementation of the Law on the Promotion and Management of Foreign Investment provides basic guidelines for improving registration and speeding up approval processes for foreign investment. Based on this decree, total approval time for different types of projects has been reduced from 90-180 days to 45-60 days.
- On land, PM Decree 237/PM 2001 provides more clarity in the institutional setup and main functions and activities of the Department of National Land Use Planning and Development (DONLUPAD), which is responsible for the coordination of land-related policy[16] and inter-agency consultations on appropriate institutional arrangements.

Measures taken in 2002

- Further to Decree No.46/PM, Decision of the Chairman of CIC, dated 27 February 2002, has decentralized approval of foreign investment projects, extension of foreign activities and establishment of branches of foreign companies in Lao PDR. It defines four size-classes of foreign investment based on value: (1) equal or less than US$1m, (2) from above US$1m to US$5m, (3) from above US$5m to US$10m, (4) Above US$10m. Approval of FDI equal or less than US$1m can be done at the provincial level by all provinces. However, in large provinces, such as Vientiane Municipality, Savannakhet, Champasack and Luangprabang, the ceiling for provincial approval is US$2m and less).

[16] The Land Law 01/97/NA (April 12, 1997) repeals a number of previous laws (1979, 1989, 1992) and serves as the new basis for land administration and management in Lao PDR, defining institutional responsibilities for land administration and registration (especially for eight categories of land in Lao PDR: agricultural, forest, construction, industrial, communication, cultural, water-area land and land for national defence and peace-keeping), and (2) sets out the basic rights and obligations of the land user.
PM Decree 22/PM of 1999 is on implementation of the 1997 Land Law.
Presidential Decree on Land Tax (03/PDR of August 12, 2000) provides new guidelines for land tax collection and management, with detailed tax rates for each type of land and its location.

Measures taken in 2003

- PM Decree dated 23 April 2003, on roles and responsibilities of CIC at central and local levels. The decree provides local governments with new autonomy over investment and defines organisational structure, roles and responsibilities of CIC and other relevant line-ministries and agencies at central and local levels. It serves as a strategic guidance for CIC at all levels for decision-making process including approvals, promotion, management and monitoring of domestic and foreign investment. The effective implementation of the decree would contribute to the improvement of the investment environment in the country.
- Amendment of Lao constitution, especially with regard to chapter 2 on Social and Economic System. The new text states that GOL promotes every economic sector, including domestic and foreign investment, a modern industry, enterprises and services in order to accelerate economic growth of the country. The constitution further confirms the Government intention to guarantee interest in property and lawful capital of all investors.
- Publication of Quarterly Newsletter by DDFI. The government issued in July 2003 the first Quarterly Newsletter, to disseminate FDI information to investors and to promote foreign investment. The Newsletter provides recent updates on investment regulations (mainly on decentralized management and approval process at the central and provincial levels), tips for applications, investment incentives for various priority sectors and investment zones, and data on the cost of doing business in the country (business costs – land, office space, factory building, warehouse; and production costs – labor, utilities, i.e. electricity, water, fuel/gas, and telephone).
- PM established National Land Policy Committee (NLPC) on March 25, 2003, representing a number of line ministries/agencies involved in land administration and management, and providing an effective oversight mechanism to resolve policy issues as they arise and to facilitate the development of a comprehensive land policy framework. DONLUPAD is assigned as the secretariat of NLPC.

THE WORLD BANK OFFICE, VIENTIANE

Patou Xay, Nerhu Road
Vientiane, Lao PDR.
Tel: (856-21) 414209, 450010-11
Fax: (856-21) 414210
www.worldbank.org/laos

THE WORLD BANK

1818 H Street, N.W.
Washington, D.C. 20433
U.S.A.
Tel: (202) 473-1653
Fax: (202) 522-1560/1557
www.worldbank.org

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