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A synthesis of the

Vulnerability Profile

LAO PEOPLE'S DEMOCRATIC REPUBLIC

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Notes

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The $ sign refers to the United States dollar.

A hyphen (-) indicates that the data are either not available or not applicable.

Introduction

This paper presents a summary of the context in which Lao People's Democratic Republic is expected to graduate from the least developed countries (LDC) category, based on an assessment of the country's performance against the United Nations Committee for Development Policy's[1] graduation criteria, which is supplemented with additional indicators on potential areas of vulnerability. The findings highlight complementary support needed to mitigate country vulnerabilities, as informed by the structural and development trajectory of Lao People's Democratic Republic.

Areas of vulnerability based on LDC graduation criteria

The following section denotes the performance of Lao People's Democratic Republic in three criteria related to LDC graduation, namely income per capita, human assets index, and economic and environmental vulnerability. [2]

1. Income per capita criterion

Lao People's Democratic Republic reached the graduation criterion in 2018, reporting a gross national income (GNI) per capita of US$1,996, equivalent to 162 per cent of the graduation threshold (US$1,230 at the 2018 review). The country's per capita income from the graduation threshold increased by 66 percentage points between 2003 to 2015 and is expected to reach 198 per cent of the threshold in 2021. Sustained and rapid economic growth since 2003, driven by large investment in natural resources and infrastructure projects, has occurred alongside rising within-country inequality between rural and urban groups, as well as provinces, although the latter is decreasing. World Bank (2019)[3] reports increased inequality measured by average consumption per capita, which only grew at 3.3 per cent between 2012/13 and 2018/19, compared to 7 per cent gross domestic product (GDP) growth. If inequality had not risen, poverty would have declined by 10.5 percentage points, instead of only 6.3 percentage points. Remittances accounted for a 3.7 percentage point decrease in poverty reduction during that period. In 2018/19, 18.3 percent of the population were still living under the national poverty line (US$2.4 a day in 2011 purchasing power parity terms).

Overall, between 2012/13 and 2018/19 average consumption per capita has grown faster among the richest 10 per cent (4 per cent per year) compared to the poorest 10 per cent (2 per cent per year). With an estimated Gini Index of 38.8 in 2018/19, Lao People's Democratic Republic has one of the highest inequality levels in Asia, although the pattern of consumption is similar to other Asian countries, such as Indonesia, Thailand and Vietnam.

Due to COVID-19, real economic growth fell from 4.7 per cent in 2019 to -0.4 per cent in 2020. Without the pandemic, Lao People's Democratic Republic would have probably sustained a GDP growth of 6.7 per cent for 2020.

2. Human assets index (HAI)

Measured by the HAI, the human assets criteria are comprised of health and education indicators. Since 2000, the HAI showed a rising trend in absolute and relative value, reaching a level of 94 per cent of the threshold in 2009. Despite slight declines between 2009 and 2015, Lao People's Democratic Republic maintained levels consistently above 90 per cent, crossing the threshold level in the 2018 review by the Committee for Development Policy (CDP). Overall, three HAI indicators that make Lao People's Democratic Republic vulnerable are the prevalence of undernourishment (16.5 per cent of the population in 2017), low secondary enrolment ratio compared to primary enrolment, and high under-5 mortality ratio at 45 per 1,000 live births.

Between 2000 and 2009, improvements in mortality and nutrition accounted for 93 per cent of the HAI increase. Although the inclusion of the gross secondary school enrolment rate decreased the HAI in 2003, the improvements in adult literacy rates contributed to an increase in the HAI. In 2019, the secondary school enrolment ratio stood at 67.9 per cent for boys and 63.6 per cent for girls. However, between 2012 and 2020, the gender parity index and maternal mortality ratio were the largest contributors to HAI growth. Before the pandemic and its containment measures that restricted antenatal and postnatal care services, the latter stood at 185 per 100,000 live births in 2017, a 36.7 per cent decrease from 2010. Furthermore, COVID-19 is expected is exacerbate these challenges by reducing household health expenditures and, consequently, worsening health indicators, such as nutrition and sanitation access.

Without measures to strengthen health and education, the lack of human capital development and economic prosperity would decrease employment and labour productivity, affecting Lao People's Democratic Republic's competitiveness, structural transformation and development. In 2018, approximately 64 per cent of the labour force was engaged in agriculture, although this sector represented less that one quarter of GDP. This is in sharp contrast to mining and electricity that are the fastest growing sectors since the early 2000s. They grew to 11.2 per cent of GDP and 30 per cent of exports in 2015 but absorbed less than 1 per cent of the total labour force. However, mining and hydropower projects not only have very low capacity to absorb labour but have the potential to put at risk the livelihoods of the rural communities that account for the highest share of employment, causing social vulnerabilities to the population of Lao People's Democratic Republic.

1 Committee for Development Policy is a subsidiary body of the United Nations Economic and Social Council. The Committee is responsible for deciding which countries can be considered least developed countries.

2 UNCTAD Vulnerability Profile of Lao People's Democratic Republic, January 2021.

3 World Bank.2019. "Lao People's Democratic Republic Poverty Assessment 2020: Catching Up and Falling Behind." World Bank. Washington, DC

3. Economic and environmental vulnerability (EVI)

The EVI is a composite index measuring a country's structural vulnerabilities to external shocks. From 2000 to 2018, the EVI for Lao People's Democratic Republic has increased from 68 to 95 per cent of the graduation threshold. The country is expected to reach 119 per cent in 2021 and meet the graduation threshold for the first time. It is important to note that these figures are drawn from the old methodology of the EVI criterion before changes to certain indicators were made. A review conducted using the new methodology finds that Lao People's Democratic Republic would have met the graduation criteria in 2015 at 104 per cent of the graduation threshold. According to the provisional 2021 figures, three indicators namely "victims of disasters", "remoteness" and "share of agriculture" contributing 39 per cent, 26 per cent and 14 per cent of EVI, are the main sources of vulnerability in Lao People's Democratic Republic.

Lao People's Democratic Republic has experienced high frequency and intensity of extreme weather events and their consequences. In 2018, the country was hit by three natural disasters, including tropical storm Son-Tinh, affecting 10.5 per cent of the population with flooding damages worth 1.25 per cent of GDP. In 2019 and 2020, additional flooding affected 10,000 and 69,764 people, respectively. Damage and loss of livestock, crops, homes, and roads induced by natural disasters have taken a great toll on the country.

Remoteness is relatively inherent in Lao People's Democratic Republic as it is a landlocked country with limited infrastructure access and network for trade and investment. Trade is limited by weak road infrastructure, which is the dominant mode of border transport. Compared to peer ASEAN countries (the Association of Southeast Asian Nations), Lao People's Democratic Republic lags behind in logistics performance indicators, including postal services. Geographically, the country is well-positioned to create linkages between China and ASEAN countries, and transition to a well-integrated partner in the region. Lao People's Democratic Republic has invested heavily in the construction of infrastructure to better connect to its neighbours, including the US$5.9 billion investment in the construction of the Lao-China Railway under the Belt and Road Initiative.

Lao People's Democratic Republic faces an instability of exports rooted in the concentration of its trade in a few markets. While Lao People's Democratic Republic has made insignificant progress on product diversification, trade remains concentrated in three regional markets, namely China, Vietnam and Thailand. Moreover, although the emergence of mining and electricity is an important driver of economic and export growth, the growing dependence of the economy on natural resources entails new vulnerabilities not fully captured by the EVI, including risks from export concentration and export instability in the future. Lao People's Democratic Republic needs to expand its export-base in the manufacturing industry, integrate domestic firms into global value chains (GVCs), and keep pace with climate change and natural disasters.

Evaluation of vulnerabilities and policy entry points

1. Harnessing the nexus between structural transformation and export diversification

Lao People's Democratic Republic economic growth heavily relies on a natural resources-based and foreign direct investment (FDI)-driven development path. This pattern lowers export diversification, resulting in an even less diversified export base. The integration of Lao People's Democratic Republic in GVCs has remained at the lower rung of the value chain. Because of rising dependence on natural resource exports, the resource-based industries – electricity, mining and quarrying – contain very little domestic value addition. Compared to the mining industry, the strength of the electricity (and energy) sector is that its exports are more diversified by product and by export destination country. However, in 2019, based on GVC data, only 8.5 per cent of the overall energy generated serves as an input for domestic production activities. This strong export orientation of energy generation signals the lack of a critical input factor to production and potentially undermines dynamism in domestic productive activity. In 2018, 15 per cent of micro-enterprises still report "access to electricity" as a top business constraint.

Lao People's Democratic Republic's manufacturing sector has experienced remarkable growth over the past five years, especially through the expansion of high-skill and technology-intensive manufactured goods. Between 2015 and 2019, manufacturing exports have increased by 80 per cent, whereas total exports grew by 59 per cent. The labour-intensive manufacturing sectors apparel and clothing, footwear and furniture; have experienced comparably lower growth rates than the more technology intensive industries, such as machinery and transport equipment. To achieve sustained and inclusive employment-rich growth, it is crucial to increase productivity in labour-intensive sectors through strengthening the human capital base, especially through skills development and post-primary education. Moreover, the health of small businesses in Lao People's Democratic Republic has a significant impact on women's economic empowerment - which is recognized as one means for reducing poverty and increasing economic growth. Female participation in ownership is 45.5 per cent for small enterprises, but only 8 per cent and 9 per cent for medium- and large-enterprises, respectively.

2. Consequences for social development and environmental sustainability

The electricity generation and mining sectors have been the largest recipients of FDI, contributing positively to economic growth, export and budget revenue, despite a negative impact of real exchange appreciation. In 2019, electricity generation and the mining sector accounted for 76 per cent and 13 per cent, respectively, of all investments (domestic and foreign). In contrast, only 6 and 3 per cent of investments were realized in services and agriculture. In order to leverage large investments from multinational companies for sustainable growth and poverty reduction, Lao People's Democratic Republic needs regulatory oversight, employment creation and a promotion of social engagement by companies (e.g. in education, health, social schemes) across social groups and gender.

Despite the benefits of hydropower development, the concentration of investments in hydropower may exacerbate associated environmental and social risks, as seen by the loss of biodiversity and fisheries in the Lower Mekong Basin. The construction of dams and the manipulation of river systems alters ecosystems that communities are dependent on. Therefore, Lao People's Democratic Republic should shift towards sustainable energy generation using renewable energy sources such as wind and solar or penalise negative environmental and social impacts through a taxing mechanism.

3. The consequences of climate change and natural disasters

Natural disasters pose a threat to Lao People's Democratic Republic's GDP and the public finance n eeded f or a smooth transition post-graduation. The occurrence of natural disasters and external debt as a share of GDP present a positive correlation. In 2018, damage caused by natural disasters worth US$371.5 million contributed to a current account deficit, as imports and investment projects increased to sustain the economy. The government's domestic efforts and collaboration with international community successfully managed its recovery in 2018. Lao People's Democratic Republic should prioritise access to concessional funding at lower interest rates, as the high current debt limit recovery measures against natural disasters. However, the country still requires better risk disaster understanding, local capacity building, technical knowhow, strengthening of human resources and fiscal governance improvements as it prepares for increased natural disasters caused by climate change. Across the world, climatological and hydrological disasters are on the rise and Lao People's Democratic Republic is highly vulnerable to natural disasters due to the high share of people living in rural areas.

4. Financial consequences of vulnerabilities: domestic resource mobilization and debt sustainability

Domestic resource mobilisation is limited in Lao People's Democratic Republic. Government revenue is mainly comprised of value-added tax, excise tax and profit tax, which contribute 22 per cent, 20 per cent and 8.6 per cent, respectively, based on data obtained from the Ministry of Finance of the Lao People's Democratic Republic. Between 2012/2013 and 2018, tax receipts from natural resources-based activities, profit tax and exports duties declined, bringing their combined share to 14.7 per cent of total government revenue. From this, Lao People's Democratic Republic needs to create attractive tax incentives for profitable investment, and coordinate internal development priorities to enhance domestic resource mobilisation. FDI, official development assistance (ODA) and remittances should be leveraged to decrease public debt, grow social sectors, and reduce gaps between revenues and expenditures.

Constraints to domestic resource mobilisation have led to rising debt, despite improvements in fiscal deficits. Prior to COVID-19, Lao People's Democratic Republic was already dependent on government borrowing to finance economic activities and reported a 5 per cent net borrowing as a percentage of GDP, with public debt at slightly over 60 per cent of GDP. China, Russia and Thailand are among Lao People's Democratic Republic's largest sources of loans. While the pandemic is forcing countries to spend alongside decreasing revenues, Lao People's Democratic Republic is highly vulnerable to debt distress. Additionally, with high private external debt of 31.4 per cent of GDP (2019), mostly stemming from large investments in the hydropower sector, the country remains at risk of unsustainable debt development.

Concentration on the export of raw mining products poses risks of illicit financial flows. The sizeable cross-border intra-firms financial transactions make it challenging for Lao People's Democratic Republic's tax and customs authorities to monitor and govern these transactions.

Conclusion and policy recommendations

1. Promote enterprise development and strengthening business linkages

The private sector is a key driving force for job creation and income earning, which is the best way to reduce poverty. An enabling business environment is a prerequisite for robust private sector growth and job creation. However, Lao People's Democratic Republics business environment is weak and lacks incentives for firms to grow and become formal. In particular small and micro firms - that represent most of the business and where female participation is the highest – are not reaping the rewards of the strong economic growth, which reduces the scope for inclusive growth. Access to finance remains the biggest constraint for small- and medium-sized enterprises, followed by informal sector practices and access to electricity. The government can play an active role in facilitating better linkages between small and mid-sized enterprises (SMEs) and large firms. For instance, the Lao Trade Portal is an important source of market intelligence and information for importers and exporters. Enhancing business partnerships in the form of joint-ventures and business affiliation can promote technological process and skills transfer.

2. Enhance servicification and the digital economy.

Digital technologies should be maximised as tools to increase productivity and close gender gaps in information access. Barriers to mobile internet use, such as the lack of literacy, digital skills and affordability, as well as safety and security concerns should be addressed. The development of a broadband internet network is still low, as only few large state-owned enterprises dominate the domestic market. Due to reduced competition, internet service charges in Lao People's Democratic Republic are more costly than in other developing countries, such as Cambodia, Indonesia and Vietnam.

3. Boost domestic resource mobilisation using resource governance management

Stronger governance is required to manage the hydropower and mining sectors, whose growth is faster than administrative capacity. Lao People's Democratic Republic should close the gap between legal frameworks and rule implementation underpinned by resource management. Strong governance mechanisms would arise from an evaluation of the legal framework for natural resource exploitation, trade mispricing/transfer pricing and an understanding of commodity trading practices by authorities.

4. Addresse external vulnerabilities

Lao People's Democratic Republic should tackle challenges in environmental management and implementation, including limited human resources, skilled personnel and funding. Collaboration with bilateral development partners on the latter should be encouraged without neglecting national capacity building for environmental governance. Keeping the multi-faceted nature of vulnerabilities, Lao People's Democratic Republic could explore sectoral development programs that enhance productivity and investment, as well as private sector engagement.