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Background Note on

"Private Sector Development and Trade Capacity Building in the Lao People's Democratic Republic"

by Federico Bonaglia and Andrea Goldstein,

OECD Development Centre, Paris

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<u>Preliminary Draft – do not quote</u>

This document has been prepared by Federico Bonaglia and Andrea Goldstein of the OECD Development Centre on the basis of a data-gathering mission to Vientiane in August 2003. We thank Keovisouk Dalasane for outstanding research assistance and the local office of the Mekong Project Development Facility for logistical support. We also thank Alessandro Magnoli (World Bank), Christer Holtzberg (SIDA), Vincent Huynh (DREE), Sengxay Phousinghoa (IFC), and Eric Sidgwick (IMF) for providing us with valuable information. The note is aimed to inform the discussion and does not represent the official view of the OECD, the OECD Development Centre, or their Members.

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1. Geo-political Background

The Lao People's Democratic Republic (PDR) is a landlocked country with a population of little more than 5 million dispersed over 240 thousand square kilometres of mainly mountainous land, making it the country with the lowest population density in Asia.[1] It shares borders with four ASEAN countries (Cambodia to the south, Vietnam to the east, Thailand to the west, and Myanmar to the northwest) and China to the north. The country has three distinct regions. The North is dominated by mountains which average 1,500 meters above sea level. The Phou Luang (Annamite Chain) stretches from the southeast of the Phouane Plateau down to the Cambodian border. The plains region comprises large and small plains along the Mekong River, stretching between the Thai and Cambodian borders. The Mekong River flows through 1,835 km of the country from north to south. The population consists of 49 ethnic groups, in four main linguistic families: Lao-Tai, Mone-Khmer, Tibeto-Burmese, and Hmong-Ioumien.

Previously a Kingdom, Laos became the Lao PDR on 2 December 1975. The Lao People's Revolutionary Party (LPRP) is the country's main political institution and the administrative system works under the principle: "the Party leads and manages and the people are the masters of the nation". There are four tiers of administration – central, provincial and municipality, district, and *ban* (village). For administrative purposes, the Lao PDR is divided into 17 provinces and one prefecture (Vientiane), administered by a Governor. The provincial administration comprises representatives of the ministries of the central Government, whose role is to administer policies determined by the Government. Revenue is raised by the Government which makes payments to the provincial authorities.

The executive branch, formerly called the Council of Ministers, is now known as the government. It has 13 ministries: Agriculture and Forestry; Trade and Tourism; Communications, Post, Transport and Construction; Education; Finance; Foreign Affairs; Industry and Handicraft; Information and Culture; Interior; Justice; Labour and Social Welfare; National Defence; and Public Health. There are three ministry equivalent committees: the Prime Minister's Office; the Committee for Planning and Cooperation; and the Bank of the Lao PDR. After the promulgation of the Constitution on 15 August 1991, two general elections for the People's Supreme Assembly have been held. Following the February 2002 elections, the National Assembly re-elected as President General Khamtay Siphandone of the LPDR for a five-year term and approved a 23-member cabinet headed by Prime Minister Bounyang Vorachith.[2]

The Lao PDR is the second poorest country (after Cambodia) in East Asia and ranks low among the world's Least Developed Countries (LDC), both in terms of *per capita* income (US$ 326 in 2001) and human development (135th out of 175 countries considered by the UNDP human development index).[3] More than three quarters of the population live with less than US $2 a day. The country has little infrastructure. It has no railroads, a rudimentary road system, and limited external and internal telecommunications. Electricity and potable water are available in only a few urban areas and fixed-line telephone penetration is still below 1 per cent. The country has an infant mortality rate of 87 deaths/1,000 live births, with life expectancy being 54 years. The adult literacy rate stands at 66 per cent. In non-drought

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[1] The Lao PDR covers a total of 236,800 square kilometres, similar to the United Kingdom, which as a population 12 times larger.

[2] Ninety-nine percent of the 2.5 million eligible voters went to the polls. All but one of the 166 candidates was a member of the LPRP. The average age of candidates dropped by ten years to 51. Twenty percent of the candidates were women and sixty-four percent were university graduates, an increase in both categories. Vorachith, the former Minister of Finance, is widely regarded as a close student of Chinese economic reforms (Thayer, 2003).

[3] Data presented in this section are taken from the World Bank Development Indicators 2003 and UNDP Human Development Report 2003. If not otherwise specified, they refer to 2001. Lao PDR has come up in HDI ranking (140th in 1999 and 2000) overtaking Bhutan (136th), Bangladesh (139th), and Nepal (143rd).

years, Laos is self-sufficient overall in food, although rainwater brings uncontrolled flooding. Economic activity is heavily dependent on agriculture, accounting for 50 per cent of output, and remains concentrated in the central regions around Vientiane, the capital, where transport and communications infrastructure are more developed.

The Freedom House Report *Freedom in the World 2003*, places Laos amongst the most repressive regimes in the world, both in terms of political rights and civil liberties. Similarly, The Heritage Foundation places Laos as 2nd-last in terms of economic freedom.[4] According to these independent reports, the judiciary is subject to executive influence and courts provide citizens with little means of addressing human rights abuses and other grievances.

2. The New Economic Mechanism

In 1986 the Fourth Party Congress approved the *pean pang mai* (New Economic Mechanism) and private ownership has expanded considerably over the last 15 years. Laos was therefore the first centrally planned economy embarking on a transition path to the market. The government's economic strategy was developed further at the Sixth Party Congress in March 1996. The political report to the Congress emphasised the importance of both the state and private sectors and the need of promoting foreign direct investment.[5] Despite reaffirming the commitment to reform, the government adopted a cautious approach towards relinquishing state control over the economy. State enterprises maintain their role as the "mainstay of certain branches of production and services as well as the source of vital products". On foreign participation in the economy, the report stressed that foreign investment should be accepted only in priority areas where local capital and technological expertise is lacking (EIU, various years).

Under many respects, Laos remains a centrally planned economy and the ruling party holds tight control over the commanding heights of the economy. Economic policy is set according to five-year National Socio-Economic Development Plans (NSEDP). The NSEDP 1996-2000 aimed at (1) poverty reduction, especially in rural and multi-ethnic areas; (2) infrastructure development; and (3) human resource development. The fifth NSEDP (2001-2005) identifies sustained growth with equity as instrumental to eradicate poverty, in line with the objective – set in 1996 – to quit once and for all the status of a least developed country by the year 2020. The plan aims to reduce the incidence of poverty to less than one half of its current rate; to secure adequate rice and food supply for the whole country; to resolve the issue of slash-and-burn cultivation and eliminate opium and marijuana production by providing farmers with alternative livelihoods and income generation opportunities; to mobilize savings and encourage the SOE/private business growth; and to develop human resources along the industrialization and modernization paths.

In March 2001, the Lao government approved an Interim Poverty Reduction Strategy Paper (I-PRSP) which was endorsed by the IMF and World Bank in April. The document envisaged the completion of the full PRSP by August 2002. However, the government has requested additional time in order to complete its own National Poverty Eradication Programme document, based on the NSEDP 2001-2005, and to submit it for consideration as the full-PRSP by end-October 2003.

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[4] In a scale from 1 to 7, with 7 denoting lack of freedom, Laos got the worst score in terms of political rights and a 6 for civil liberties. Despite this negative judgement, Laos is not placed amongst the "worst of the worst" because some limited scope for private discussion is allowed for. Sources: http://www.freedomhouse.org/ and http://cf.heritage.org/index/indexoffreedom.cfm

[5] In industry, a number of sectors were singled out as priorities, including processing, energy and mining. With regard to processing, the importance of developing backward linkages to agriculture was stressed. In the services sector, tourism was highlighted as having great potential, particularly because of its capacity to generate foreign exchange. The report also reiterated the longstanding aim to exploit Laos' potential as a transport hub, particularly between Thailand and south-west China.

2.1. Privatisation

Lao PDR has made considerable progress in privatising state-owned enterprises (SOEs). There were 640 SOEs in 1989 and by 1995 549, the vast majority of them very small with fewer than 30 employees each, had been either liquidated or sold off. In recent years, long-term leases have been the preferred privatisation mode. There are currently only 93 wholly state-owned enterprises (of which 32 are considered as ‘strategic’), employing less than 1 per cent of total workforce and contributing around 15 per cent of total production. These include public utilities such as electricity and water, air transport, pharmaceutical factories, and various conglomerates controlled by the Ministry of Defence.[6]

Despite significant progress in selling state assets, there is still a pressing need for SOE restructuring. High capital intensity, coupled with financial mismanagement and weak government monitoring have led SOEs to excessive borrowing from state-controlled banks. The SOE sector accounts for one third of all loans extended by state owned commercial banks (SOCBs) and for more than 60 per cent of non-performing loans, contributing in a decisive way to the distress of the fragile Lao banking system.

Besides financial problems, the SOE sector poses increasing problems in terms of transparency and fair competition. According to a recent report, the three conglomerates under the jurisdiction of the Ministry of Defence, were responsible for disruptive operations in the forestry sector, due to their dominant position and the preferential treatment they receive in the allocation of logging, processing, export quotas as well as *de facto* exemptions from royalties payment (World Bank, 2001).[7]

In 2002 the government has agreed with the World Bank a plan for restructuring and strengthening SOEs. The plan comprises the sale of non-core assets belonging to the largest SOEs (such as Phudoi and Pharmaceutical Factory No.3) and tariff increases for utilities (such as the Nam Papa water company), as well as enhancing oversight and accountability. Little progress has been made since, mainly due to the lack of agreement on the extent of sales of non-core assets by the large conglomerates.

2.2. Trade liberalisation

In 1987, the government started an overall reform of the trading system, allowing private sector participation, rationalising the web of state trading companies, and eventually dismantling its monopoly of foreign trade in a large number of commodities. By 1992 only timber exports were subject to quantitative restrictions and only imports of rice and motor vehicles were subject to licensing. In recent years, most quotas have been eliminated and the tariff structure has been rationalized. Export taxes were eliminated in 1994, and the system of import tariffs was restructured in 1995 (see Box 1).[8]

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[6] These conglomerates are the Mountainous Region Development Corporation (Bolisat Phatthana Khet Phudoi, commonly referred to as BPKP or simply Phudoi, a 58 company conglomerate and the single largest holder of non-performing loans), the Agricultural Development Services Group (ADS), and the Development, Agriculture Forestry Industry Group (DAFI). They operate on a wide range of sectors, from tourism to agricultural development and dominate the forestry sector, and logging in particular.

[7] “Over time the three SOEs have grown increasingly independent and secretive, and are not monitored in any significant or transparent manner. There have been neither audits of SOE accounts nor of their operative performance. Internal financial control is supposed to be based on guidelines issued by MOF, but adherence to such guidelines has never been assessed.” (World Bank, 2001, pp. 30-31)

[8] Despite being free of formal restrictions, the Lao trade system is still characterised by a number of informal trade barriers, such as priority lists and excessively restrictive licensing requirements which limit imports of certain goods and are often imposed with a high degree of discretion (IMF, 1998 and 2000)

Along with external trade liberalisation, the government accomplished an overall reform of the foreign currency regime. The process started with the unification of the multiple exchange rates and the freeing of current account transactions and culminated in the adoption of a managed floated exchange rate in 1995. A new Foreign Exchange Decree Law has been submitted to the National Assembly and awaits approval. Furthermore, the government requested technical assistance from the IMF to review the exchange system and pave the way for accepting the obligations under IMF's Article VIII concerning discriminatory restrictions on current international transactions.

As far as international economic relations are concerned, the Lao PDR trades with more than 50 countries, has signed bilateral trade agreements with 19 countries and is granted GSP status from 35 countries. The country was accepted as a member of the Association of South East Asian Nations (ASEAN) in July 1997. Pursuant to the terms of its adhesion to the ASEAN Free Trade Area (AFTA), which it joined in 1998, Laos is gradually lowering its tariff barriers in line with the goal of complying with the tariff reduction schedule of the AFTA by 2008. The implementation of the Common Effective Preferential Tariff arrangement, which will reduce tariffs to between 0-5% on manufactured and processed agricultural products, will have a major impact on the Lao economy, since more 70% of Laos' formal trade is with ASEAN countries.[9]

The Lao PDR also has observer status within the World Trade Organisation and applied for full membership in 1997. A working party on accession was established in 1998 and the country submitted the Memorandum on its Foreign Trade Regime in March 2001.[10]

Laos enjoys preferential market access to the European Union (EU) in the form of generalised system of preferences (GSP) treatment, subject to Rules of Origin (RO) requirements.[11] With 2002 exports of US$ 133m, the EU is the second largest market for Laos after ASEAN (mainly Thailand and Viet Nam), and the first destination for garments exports (87 per cent of total merchandise export to the EU).[12] Lao garments producers, however, have often proved unable to take advantage of duty-free access to the EU market due to problems in meeting minimum local processing requirements. In 1997 Laos obtained a derogation to the RO, which allowed to export at a zero tariff rate garments produced from imported woven fabric or knitwear yarn, up to a certain quantitative limit. Thanks to its ASEAN membership, Laos also qualified in 1999 for the regional cumulation rule, which slackens RO requirements and extends GSP coverage to Lao exports produced from imported intermediate inputs originating from any ASEAN country.

The bilateral EU-Lao textile agreement, renewed in December 2001, grants garments exports duty- and quota-free access to the EU market as well as the GSP regional cumulation provisions (extended to SAARC and ACP countries since the late 1990s). Thanks to this preferential treatment, Lao garment

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[9] Due to lack of reliable data, it is difficult to estimate the magnitude of Laos trade with other ASEAN member countries. According to a recent ADB study, Laos trade with Thailand, Singapore, and Viet Nam accounted in 2001 for almost 83 per cent of all recorded trade (Kanokpan, 2002).

[10] In response to this Memorandum, three WTO members (US, EU and Australia) addressed 263 questions to the Lao authorities in 2002. The Lao Secretariat on WTO Accession recently submitted the answers for approval to its Government, which intends to forward them to the WTO by the end of 2003.

[11] The EU's GSP is a unilateral commercial concession allowing exports from developing countries to enter the European market a tariff lower than the normal customs tariff rate (i.e. the MFN rate). Special provisions for the LDCs allow for the total exemption of customs duties for industrial products and for a wide range of agricultural products. In March 2001 the EU introduced a new GSP scheme that allows for duty free import of all goods but arms and ammunition, from the LDCs into the EU. Bananas, rice, and sugar, considered sensible products, are temporarily excluded from this initiative.

[12] Data come from EU DG Trade website (http://europa.eu.int/comm/trade/issues/bilateral/dataxls.htm).

exports to the EU have increased by over 50 per cent between 1998 and 2000. Since 2001, Laos is also eligible to benefit from the Everything But Arms (EBA) initiative which extends duty- and quota-free access to all products originating in LDCs, except arms and ammunition. However, preferential market access does not seem to be enough to stimulate Laotian exports. In fact, according to the European Commission, in 2000 around 60 per cent of the Lao products that could benefit from the EU GSP did not actually used the system.

Finally, although the United States has had uninterrupted diplomatic relations with the Lao PDR since 1975, it does not grant it Normal Trade Relations (NTR) status.[13] This means that Laos does not enjoy Most Favoured Nation trading status and that its products face much higher tariff rates than those coming from NTR countries.[14] As a result, Lao exports to the US face the highest average tariff rates in the world – 45.3 per cent in 2001, compared with a global average of 2.4 per cent (Gresser, 2003). Laos' biggest export items to the U.S. by far are cotton sweaters, sweatshirts, and vests (HTS 611020). The non-NTR duty rate on these items is 45 per cent, while the NTR rate is only 5 per cent. In actual dollar terms, in 2001 Lao exporters paid US$ 1.8m to the U.S. Customs Services in order to sell US$ 3.9m worth of goods.

Obtaining NTR status is conditional upon reaching a bilateral commercial agreement with the United States and complying with the so-called Jackson-Vanik (JV) amendment to the 1974 Trade Act that requires non-market economies to allow their citizens to emigrate freely. Unlike most other countries without NTR, however, Laos is not subject to the JV amendment, since it was not considered a non-market economy when the amendment was passed.[15] In 1997, the United States and Laos concluded a bilateral trade agreement which calls for a reciprocal extension of NTR. The agreement will require Laos to open its markets to U.S. goods and services and to protect U.S. intellectual property rights. That agreement needs Congressional approval and has not yet entered into force.

[13] The US currently funds approximately US$ 10 million per year in MIA recovery, clearance of and education about unexploded ordnance (UXO), and counter-narcotics programs. Technically speaking, Laos is included in the Harmonized Tariff Schedule of the US in General Note 3(b) on the list of countries whose products are subject to column 2 (non-NTR) tariff rates. Currently, the US extends NTR/MFN status to all members of the WTO and most other countries. As of August 2003, besides Laos, only the countries of Cuba, North Korea and Serbia-Montenegro have been excluded from NTR. Despite not having legally lost their NTR status Iran, Iraq, Libya, are under full (Libya) or partial embargos (Iran and Iraq) and cannot freely export to the U.S. market. Cambodia received NTR in 1996, Vietnam and Afghanistan in 2002.

[14] NTR tariff rates range in most cases from zero to 10 percent. Non-NTR rates range from zero (for some natural resource goods, and agricultural products like tea and coffee that do not grow in North America) to around 90 percent for many light manufactured goods like clothes and toys (Gresser, 2003).

[15] Therefore, Laos could upgrade from its current non-NTR status directly to a permanent NTR status once the bilateral trade agreement is approved by Congress. On February 24, 2003, Secretary of State Colin Powell and United States Trade Representative Robert Zoellick sent a joint letter to Congress expressing the Administration' s support for extending NTR status to Laos and for bringing into force the 1997 agreement.

Box 1 Laos trade regime

The Lao PDR maintains a two-column tariff schedule using the HS 96 nomenclature for classification of goods. The import tariff structure maintains six tariff (*ad valorem*) rates, namely, 5,10,15,20,30 and 40 per cent. Low tariffs are levied on investment goods and inputs for industry, while higher tariffs applies to non-essential luxury goods. Preferential treatment is applied to investment goods under FDI (tariffs of 1 per cent), while tariff exemption are applied with regard to inputs for processing of exported goods. Yarn and textiles used for garment exports can be imported duty free. The median tariff in the Lao PDR is 5 per cent. The unweighted average of the tariff is 9.5 per cent, while the weighted average tariff is 14.7 per cent.

The government bans imports of certain goods on grounds of national security, public health, cultural socio-economic and environmental protection. These include weapons, right-hand-drive vehicles, animal parts, addictive drugs, certain medicines, certain cultural items, nominated agricultural products and dangerous goods.

Some sectors and products are strategic and potentially subject to state control and quantitative restriction. They include petroleum products, construction steel, cement, rice, vehicles, electricity, minerals, tobacco, timber products. Certain products are also designated as potentially subject to special control. They include food products, live animals and plants, fertilizers, cultural goods, communication products, medicines, chemicals, minerals, sporting guns and sports products. With respect to the importation of rice, the right to apply quotas is reserved for food security purposes, notably when necessary to support the minimum farm-gate price set by the Lao PDR in order to maintain the country's productive capacity of rice.

Licenses are required for most imports. Pre-shipment inspection is not used. Turnover and excise taxes, in addition to import duties, are payable on imports. Exemptions apply to goods imported for further transformation; to purchases of raw materials, production instruments, trucks and other production materials; and for transport vehicles used to provide services and for the spare parts for such vehicles.

Export licenses are required for all exports except garments and products on the AFTA Inclusion List of other ASEAN trading partners. Licenses are issued by the Municipal and Provincial trade offices of Minister of Commerce in consultation with line Ministries. Two to three days are required for export licenses to be processed which is valid for 90 days.

There are no prohibitions or restrictions on exports of agricultural products. Export duties are levied on electricity (20 per cent) and on coffee beans and livestock (5 per cent). Exports of certain products such as guns, archaeological and cultural artefacts, drugs and related products, logs and rough sawn timber and wild animals is forbidden. With respect to the export of rice, the right to apply regulation is reserved for food security purposes.

Source: Accession of the Lao People's Democratic Republic. Memorandum on the Foreign Trade Regime (WTO, 2001)

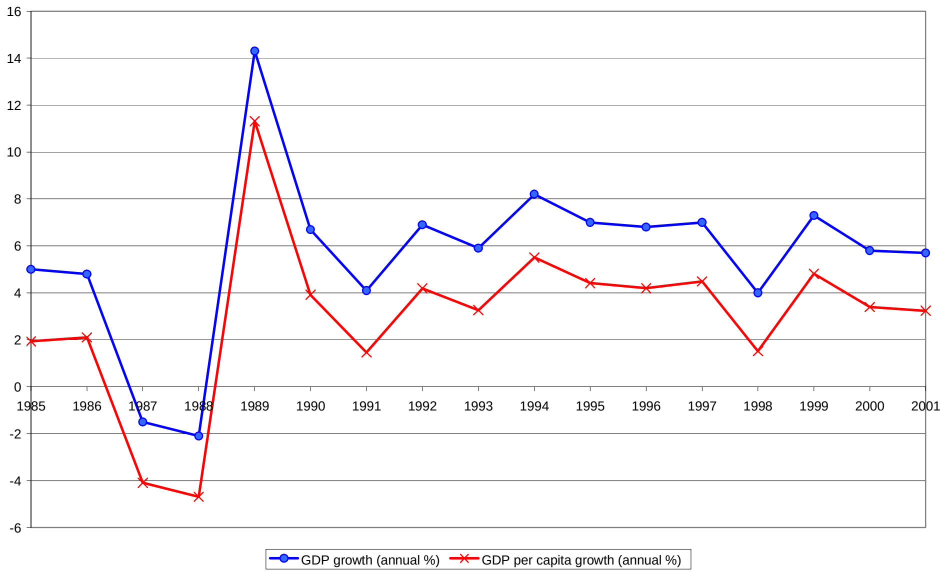
3. Growth performance in the 1990s and main macroeconomic challenges

3.1. *Growth performance*

Although not dramatic by regional standards, the Lao PDR embarked on a sustained growth path during the 1990s, with real GDP increasing on average by 5.8 per cent every year in 1990-97. This marked an improvement on the previous period, when the combined effect of droughts and fiscal shortfalls following large-scale reforms resulted in volatile and sometimes negative growth (see Figure 1). Agriculture growth, in particular, was led by extensive investment in irrigation and increased (albeit informal) cross-border trade in agricultural commodities with Thailand. In the industrial sector, construction and garments have been the fastest-growing industries, while tourism has also played an important role, contributing both to GDP growth and the balance of payments. Sustained growth contributed to reducing the percentage of the population living below the poverty line from 45 per cent in 1993 to 39 per cent in 1998. However, poverty reduction has not been uniform across regions– benefiting more the urban population living in the Central and Southern regions – and has been accompanied by rising inequality.

The 1997 Asian financial crisis wreaked havoc Laotian growth, mainly through a slowdown in economic activity in Thailand. Growth almost halved, year-on-year inflation rose to more than 150 per cent in the first quarter of 1999, approved foreign investment fell by almost 70 per cent in 1997-98 and the kip lost about 90 per cent of its value in the 18 months to August 1999. Since then the rate of economic reform has slowed down. Official figures put average real GDP growth over 1999-2002 at 5.7 per cent. Pressures on the exchange rate were contained in mid-2001 after the government moved to tighten up fiscal policy and maintain the stabilisation programme.

FIGURE 1 REAL GDP GROWTH (PER CENT, 1995 US$)



At 5.7 per cent, GDP growth in 2002 remained at the same level prevailing earlier in the decade. The service sector, including public administration spending and tourism, recorded high rates of growth, while agriculture growth remained subdued despite the good rice harvest. Industry remained the fastest growing

sector – with construction and garments playing a key role – expanding by 9.8 per cent. The most recent IMF projections set growth at 5.3 and 5.8 per cent in 2003 and 2004 respectively.

3.2. Macroeconomic challenges

Notwithstanding the success of the stabilisation programme, the Lao economy is still vulnerable. Two major and related macroeconomic challenges face Laotian authorities: strengthening the fiscal balance – the overall deficit was 8.2 per cent of GDP in FY ending on 30 September 2002 – and reducing the depreciation of the national currency – equal to 12.4 per cent and 15.6 per *vis-à-vis* the US dollar and the Thai baht, respectively, in 2002. Corrective measures taken by the government halted depreciation and the exchange rate stabilised at 10,660 kip per 1 US dollar during the first three quarters of 2003. The currency remains however vulnerable, due to the persisting deficits. On the positive side, the tight credit policy allowed foreign exchange reserves to increase, almost doubling between June 2002 and June 2003, up to the equivalent of 3.7 months of imports (IMF, 2003). After reaching 18 per cent in May 2003, inflation also started a declining trend and is expected to stabilise at 10 per cent by the end of 2003.

While having expenditures broadly in line with other ASEAN countries (20 per cent of GDP), Laos has considerably lower revenues (less than 12 per cent of GDP). Therefore, the large budget deficit has to be financed by grants and external concessional loans. Chronic budget deficits reflect the weakness of the tax administration, the failure in adopting revenue enhancing measures, and the high level of capital expenditures (60 per cent of overall expenditure, mainly related to large-scale irrigation projects to attain rice self-sufficiency).[16] The recent implementation of fiscal decentralisation in a context where provinces lack adequate capacity and monitoring is weak, contributed to worsen revenue mobilisation.[17] Collection of international trade taxes is a problem too, mainly because of porous borders and large exemptions that reduce the tax base. According to Fane (2003), almost 80 per cent of duty payable is foregone. Moreover, revenue from the forestry sector in inadequate. On the one hand, collection related to log royalties is far below the actual international value of timber logs – mainly because of lack of technical knowledge of public official in charge of log grading. On the other hand, collection related to export of sawn-wood is undermined by transfer pricing by vertically integrated foreign companies operating sawn-mills in Laos.[18]

In the medium term – by 2005 – the Government is committed to increasing its revenues to around 18 per cent of GDP and improve its public expenditure management. It is also determined to increase the share of spending in the social sector relative to GDP. Despite these efforts, revenue collection in the first six months of FY 2002/03 (to March 2003) fell short of its target by about 10 per cent. Significant increases in petroleum taxes (about 17 percent in kip value terms) in May-June should improve the outcome for the fiscal year. The authorities currently project that they will achieve 95 percent of the budget revenue target for FY 2002/03. On the other hand, the large volume of dollars and baht circulating in the country limits the role of monetary policy and exerts a strong pressure on the KIP. Foreign currency deposits account for

[16] Three major factors explain the weakness of the Lao tax administration. First, the assessment of tax liabilities depends to a significant extent on negotiations with tax payers; second, an inefficient tax sharing agreement considerably reduces incentive for additional tax collection at the province level; third, the use of outdated and overvalued exchange rates in customs import valuation to stem inflationary pressures undermine import duty collection. In 1998/99 the latter practice deprived the budget of an estimated 2.4 per cent of GDP in revenues (IMF Staff Country Report No. 3, January 2000). This negative feature has been corrected and the exchange rate used for customs duty valuation is now the current market rate as quoted by commercial banks.

[17] The government launched in 2000 a decentralisation policy aimed at increase self-financing of provinces and making budget formulation more participatory. Premature implementation led to major revenue shortfalls from the major surplus provinces. See IMF Country Report No. 02/65 for a detailed discussion.

[18] On these specific points see UNIDO (2002b) and the discussion in section 8.

at least 75 per cent of total liquidity and foreign currency is widely accepted for domestic transactions, making Laos one of the most dollarised economies in the world.[19]

The reform of the banking sector plays an important role in the strategy toward fiscal consolidation. Currently, three SOCBs and the Agriculture Promotion Bank dominate the system, although foreign banks and joint ventures also operate in Vientiane. In the past, SOCBs focused on lending to SOEs and built up a large amount of nonperforming loans (NPLs), which represent today more than 70 per cent of the total. Weak supervision and bad management allowed SOCBs to expand – despite the fiscal restraint – foreign-currency denominated credit, while at the same time reducing their foreign assets. Hence, the weakness of the kip threatens to worsen their already fragile position.

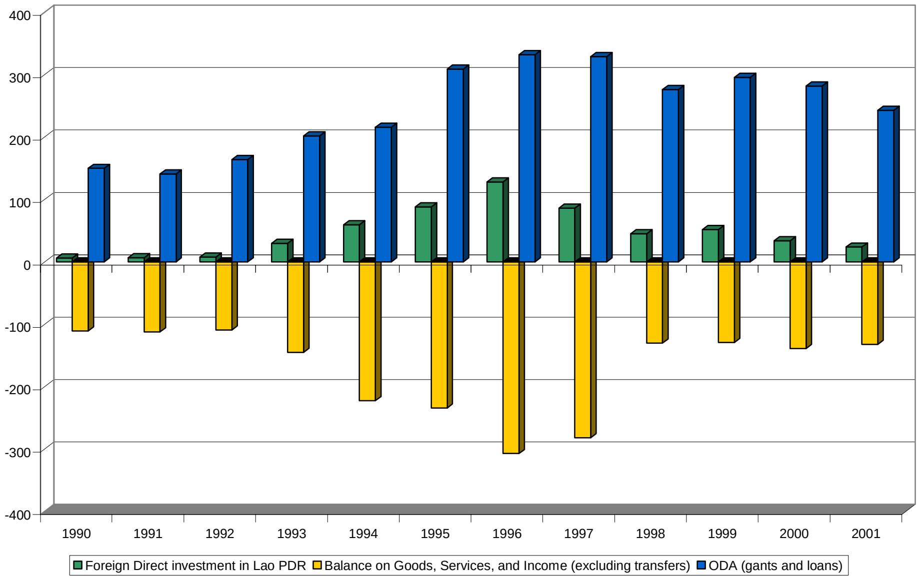
On the external front, despite the implementation of trade and investment liberalisation policies, Laos still has a very limited export base – while heavily depending on imports – and attracts few sizeable FDI. Therefore the country has recorded sizeable trade and balance of payments deficit, and is very dependent on external sources, in particular official development assistance (ODA, see Figure 2). Over the 1990-2000 period, the current account deficit (excluding official transfers) averaged more than 12 per cent of GDP, while ODA accounted on average for more than 17 per cent of GDP (peaking to 22 in 1998) and contributed to more than two-thirds of gross capital formation (source WDI 2003).[20] Despite being on a decreasing trend, the external deficit is still sizeable. In 2002 it reached US$ 198.7m (down from 217), while the current account deficit improved to about 6.3 per cent of GDP (3 per cent including official transfers) from 7.5 per cent (3.9). Foreign exchange reserves slightly strengthened and were sufficient to cover almost four months of imports of goods and services at year-end (IMF, 2003).

External debt, while large, is not particularly worrying. Laos is officially classified as a heavily indebted poor country, though official statistics overstate the seriousness of the country's foreign debt problem. In fact, nearly half of the debt is owed to the Russian Federation. This debt is recorded on the books at an unrealistic exchange rate and is not being serviced. In June 2003, governments of the Russian Federation agreed to renegotiate the debt, which will lead to a 70 per cent reduction in its book value, while the remaining US$ 387m will be reimbursed at preferential terms over a 33-year grace period.

[19] See Honohan and Shi, 2002, and IMF Country Report No. 02/61, March 2002. Currency substitution also narrows the base of the inflation tax and, were the tax base is already thin, exacerbates the inflationary impact of large fiscal deficits.

[20] Throughout the 1980s, Laos relied mainly on funding from the former Soviet bloc, Sweden and Vietnam, but the importance of DAC members, both bilateral and multilateral, increased during the 1990s. Total external assistance amounts to approximately US$250 million a year. The largest multilateral donor, the Asian Development Bank (ADB), lends around US$80 million annually with the World Bank providing US$40 million. In 2001, bilateral donors accounted for 57 per cent of total net ODA, with Japan alone providing twice the amount of all other bilateral donors.

FIGURE 2 BALANCE OF PAYMENTS (1990-2001)



Source: IMF, Lao PDR staff country reports (various years), UNCTAD FDI database, and OECD International Development Statistics database.

4. The structure of the economy

Table 1 provides a breakdown of GDP by industrial origin in 1993 and 2001. The agricultural sector still dominates Lao's economy, accounting for 51 per cent of value added (6 percentage points less than in 1993) and employing an estimated 80 per cent of the 2.4 million labour force. Since about 4/5 of the land is sloping and mountainous, arable land is limited. The FAO estimates that only 32 per cent of land is potentially suitable for agriculture. At present, only 6 per cent of total land area is used for agriculture and pasture: 3 per cent of land is cropped and another 3 per cent is grassland or permanent pasture. Bombing and defoliation by the US and guerrilla warfare during the Vietnam War decimated the country's agricultural productivity and potential but agricultural production expanded in the 1980s. Fertiliser application (4.2 Kg/ha) is amongst the lowest of the region (FAO, 2000). Agricultural production is still dominated by subsistence crop cultivation, with rice grown on over 80 per cent of the cultivated land. Apart from rice, major agriculture produces include fresh vegetables and fruits (pineapple, bananas, oranges), sweet potato, tobacco, coffee, cassava, and maize.[21]

[21] See FAO, Major Food And Agricultural Commodities and Producers, http://www.fao.org/es/ess/top/country.jsp

TABLE 1 LAOS REAL GDP BY INDUSTRIAL ORIGIN (KIP, CONSTANT 1990 PRICES)

	1993		2001	
	Kip millions	(%)	Kip millions	(%)
Agriculture	406	57.4	606	51.2
Industry	125	17.7	280	23.6
Mining and quarrying	1	0.2	6	0.5
Manufacturing	92	13.1	211	17.8
Electricity and water	10	1.3	34	2.9
Construction	22	3.1	29	2.4
Services	176	24.8	298	25.2
Wholesale and retail trade	59	8.3	114	9.6
Hotels and restaurants	6	0.8	25	2.1
Public wage bill	31	4.4	34	2.9
Other services	80	11.3	125	10.6
GDP at factor cost	707	100.0	1184	100

Source: IMF Staff Country Report, various years.

Industry accounts for 23.6 per cent of value added, with manufacturing representing almost 18 per cent and employing 4 per cent of the labour force. **Manufacturing** is the fastest growing sector during the last decade, with an average annual rate of 9.4 per cent. According to the 1999 Survey of Industrial Establishment (UNIDO, 2003) the major manufacturing sub-sectors are food and beverages (29 per cent of value added), garments (25 per cent) and wood processing (10 per cent).

- The **food and beverage sector** is dominated by one large firm, Lao Brewery. Although the weight of the coffee industry is increasing, it still remains modest and most coffee is exported not-roasted.
- The **garments and textiles sector** employs some 21,000 workers, mostly (80 per cent) women, and has expanded dramatically in the late 1990s following the granting of preferential market access by the EU. The sector encompasses 53 export oriented enterprises, mainly foreign owned (27) or joint-ventures (8), with Thai investors controlling more than 50 per cent of the sector.
- The **upstream forestry sector** contributes to little more than 3 per cent of GDP, despite 47 per cent of the country being forested.[22] The forest resources of Lao PDR are still rich in comparison with other Asian countries and they play very important roles in the economy, society and environment of Lao PDR and the Mekong River Basin.[23] **Wood products** account for more than 30 percent of the (recorded) total export revenue and the wood processing industry employs around 1 per cent of the labour force (22,000 persons). Wood exports from Laos have increased rapidly during the last decade, following deforestation in neighbouring countries and the decision of the Thai government to ban commercial logging of its forests in 1989. Demand for timber including plantation timber is rapidly growing both in Laos and neighbouring countries.

Hydropower represents one of the most important resources of the country. The ASEAN Centre for Energy estimates that Laos has a total hydro potential of about 26,500 MW (around half of the power potential of the lower Mekong Basin), which is still largely untapped. Thanks to its central location in the sub-region, and to the increasing electricity demand in countries such as Vietnam and Thailand, Laos could

[22] Forestry embraces all the fieldwork required to establish, regenerate, manage and protect forests and to harvest their products. Processing of forestry products is included into manufacturing.

[23] According to a National Reconnaissance Survey undertaken by the National Office of Forest Inventory and Planning (NOFIP) with technical and financial assistance from the Swedish International Development Authority (SIDA) the forest cover had decreased from 11.6 million ha (49.1 percent) in 1982 to 11.2 million ha (47.2 percent) in 1989.

become "the battery of Southeast Asia". Most of Laos' hydropower is indeed exported, mainly to Thailand.[24] However, the Lao power sector is still in its infancy. Of the estimated 18,000 MW of *exploitable* hydropower potential, only 627 has been harnessed so far – including the 214 MW Nam Thuen-Hinboun (worth US$ 260m) and the 126 MW Houay Ho (US$ 220m) power plants, both of which became operational in the late 1990s.[25]

Major developments are linked to the construction of the Nam Theun 2 (NT2) plant – the largest dam planned on the Mekong so far – a project that is expected to bring Laos an average export income of US$ 80m a year through the sale of 90 per cent of its capacity to the state-owned Electricity Generating Authority of Thailand. At an estimated cost of US$ 1.1b (roughly equal to 60 per cent of Laos' GDP), the project was expected to take-off in late 2003, after the signature of a power purchasing agreement. In July 2003, however, Electricité de France, the largest shareholder of the NT2 consortium, unexpectedly withdrew, casting serious doubts on the project's future. Reasons to explain the delays surrounding NT2 are lengthy and complicated, but have largely revolved around three factors: i) difficulty in securing political risk guarantees from multilateral development banks to support the considerable commercial bank credit required (over US$ 700m); ii) difficulties stemming from legitimate concerns over the human and environmental impact of the project, which necessitate the flooding of a large area of forested land and the relocation of some villages;[26] and iii) very lengthy negotiations on a power purchase agreement (PPA) with the intended customer, the Electricity Generating Authority of Thailand (EGAT). The hydropower sector could have an important impact on the construction industry, but this is still underdeveloped, so that infrastructure related to power generation and dams are built by foreign contractors.

Despite valuable mineral resources, **mining** in Laos is still limited and represents only 0.5 per cent of GDP. Laos' mining activity consists almost exclusively of gypsum, tin and barite. Other mineral commodities produced and consumed locally are coal, construction aggregates, gemstones, gold, limestone, rock salt, sand and gravel. According to the Asian Mining Yearbook geologic environments in Laos are favourable for discoveries of iron ore, potash, and rock salt, which were believed to be substantial. None of Laos' mineral production is of world significance. All mining activities are small scale and mostly owned and operated by the State-owned mining enterprises or by joint ventures of the State-owned companies and foreign companies (U.S. Geological Survey Minerals Yearbook, 2002). Important development are related to the Sepon gold and copper mineral, in southern Laos, where the Australian mining company Oxiana Resources opened its gold mine in February 2003 and plan to start exploitation of a copper mine in 2005. Exports are of gold, gypsum and copper should rapidly expand as the newly established mines become fully operational.

Tourism is the most important source of export revenue from services and has risen to the country's leading source of foreign earnings. The travel and tourism trade balance improved dramatically over the last decade, passing from a US$ 69m deficit in 1995 to a 25m surplus in 2003. Tourist arrivals increased seven times over the last decade, reaching 735,000 in 2002 and boosting revenues to US$ 113m (U$ 104m in 2001) (see Table 2). Laos is the third most visited country in the greater Mekong region. According to the World Travel and Tourism Council (2003), the travel and tourism industry (TTI) generates 3.5 per cent

[24] In 2000, 43% (683 GWh) of total production of electricity (1578.5 GWh, almost 100% from hydropower) was exported.

[25] In 2002 the Belgian company Tractebel, the energy arm of French utility Suez, took a controlling stake in the Houay Ho hydroelectric project in a deal worth $131 million.

[26] The NT2 project dates back to 1989 and received the green light from international financial institutions only after lengthy impact assessment studies. NT2 is the first project to comply with the World Bank's new mechanism of giving political-risk guarantees to private investors to boost their confidence in unstable countries like Laos by ensuring them a return on their investment should it run into difficulties.

of GDP and 65,077 jobs (2.7 per cent of total employment), while the broader travel and tourism economy is expected to total 7.8 per cent of GDP and 145,455 jobs.[27] Travel and tourism demand for Laos is expected to achieve a 6.0 per cent real growth in 2003, and 8.4 per cent real growth per annum between 2004 and 2013. Exports travel and tourism is expected to generate 19.6 per cent of total exports (US$ 119m) in 2003, growing (in nominal terms) to US$ 397m (equivalent to 23.9 per cent of total GDP) in 2013.

TABLE 2 LAO PDR – KEY TOURISM STATISTICS 1990-2002

Year	Number of Tourist Arrivals (thousands)	Change (%)	Revenue from Tourism US$ million
1990	14		n.a.
1991	38	161	2.2
1992	88	133	4.5
1993	103	18	6.3
1994	146	42	7.6
1995	346	137	24.7
1996	403	16	43.5
1997	463	15	73.3
1998	501	8	79.9
1999	614	23	97.3
2000	737	20	110.
2001	674	-9	104.
2002	735	9	113.4

Source: National Tourism Authority of Lao PDR, Lao Tourism

Growth in the travel and tourism economy is constrained by underdeveloped infrastructure and security concerns related to ambushes and bus bombings by anti-governmental rebels. Besides these domestic factors, the country suffered during 2003 the outbreak of SARS, with tourist arrivals down 30 percent during the first half of year (despite only one suspected case recorded there). The importance of infrastructure for tourism development is shown by the impact of opening of the Friendship Bridge over the Mekong River in 1998, which gave a major boost to overland travel from Thailand: in 2002, more than half of visitors came to Laos over the Friendship Bridge.[28]

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[27] "Travel and tourism industry" relates to the direct production-side of the 'industry', while "Travel and Tourism Economy" captures the broader 'economy-wide' impact, direct and indirect, of Travel & Tourism. See the World Travel & Tourism Council Internet site for details: www.wttc.org.

[28] Airport facilities have been improved too and airline seat capacity has been increased to reflect growing interest in the country. Japan financed the renovation of Vientane Wattay airport, and the Asian Development Bank funded the upgrading of Pakse and Suwanakhet airports. Besides Lao Aviation Bangkok Airways, Thai Airways International, Vietnam Airlines, PB Air and China Yunnan Airlines also operate services. There are now a total of about 6,500 airline seats a week into the country.

5. Trade performance

As seen above, since the early 1990s government policies have opened the national economy to market signals, including foreign trade, in the expectation that an export boom would improve the terms of Laos's progressive integration into the world economy. The initial opening of the economy brought about a dramatic increase in exports, which grew (in nominal terms) at 22 per cent yearly between 1990 and 1996 and doubled as share of GDP, reaching 18 per cent.

The supply response, however, has been weaker than expected. The marked increase in trade was achieved from a very low starting point (9 per cent of GDP) and was not base on a firm footing (mainly thanks to electricity exports, accounting for 34 per cent of BOP exports). Since the Asian crisis, export growth has remarkably slowed (2.3 per cent yearly up to 2002), while imports have not been curbed accordingly, perpetuating large trade deficits. Overall, Laos remains relatively closed to trade: trade (export plus import) in goods stood at 56 per cent of GDP over 1998-2002, low when compared with neighbouring Cambodia (80 per cent) and Vietnam (87 per cent).

Table 3 shows Lao PDR's export structure in 2001. Excluding electricity and based on partner countries import data, Lao exports amounted to US$ 248m, a 3 per cent growth over the previous year.[29] The annual growth in value between 1997 and 2001 was 2 per cent. The export basket is rather concentrated. Articles of apparel alone make up half of the country's exports. Wood and wood articles follow closely at more than 30 per cent. The six major exports alone contribute for 92 per cent of the country's exports. Despite being relatively well-endowed with mineral resources, the country is only marginally exploiting them. In 2001 Laos exported minerals only to Thailand (tin and zinc ores), for a total amount of US$ 4.6m.

[29] These data come from the UN COMTRADE database, which does not include exports of electricity and services. Mirror export data are only available for countries reporting to the database. Vietnam, which is as the first export market for Laos on the basis of Lao balance of payments data, does not report to that database and is therefore not included.

TABLE 3. LAO PDR EXPORT STRUCTURE IN 2001 (MIRROR STATISTICS, ALL PARTNER COUNTRIES).

Two-digit Product code	*Product description*	*Value US$ millions*	*Share in country's exports %*	*Annual growth in value between 1997-2001, %*	*Annual growth in value between 2000-2001, %*	*Annual growth of world exports between 1997-2001, %*	*Share in world exports, %*	*Ranking in world exports*
44	Wood and articles of wood, wood charcoal	80	32	8	3	-1	0.1	59
62	Articles of apparel, accessories, not knit or crochet	73	29	4	4	1	0.1	78
61	Articles of apparel, accessories, knit or crochet	53	21	4	6	2	0.1	75
09	Coffee, tea, mate and spices	11	5	-13	-35	-12	0.1	70
01	Live animals	5	2	267	-8	-1	0.1	54
26	Ores, slag and ash	5	2	32	82	0	0	81
	Top Six products	227	92					
	All products	248	100	2	3	4		154

Note: Lao People's Democratic Republic has not reported trade data in the COMTRADE database. Therefore figures are based on data from importing countries. Since Vietnam does not report to the COMTRADE system, trade with this country is not included. These figures do not include export revenue from hydropower and services such as tourism.
Source: authors' elaboration based on ITC 1996-2001 PC-TAS CD Rom (2003).

Table 4 shows major export markets for Laotian products. Thailand represents the major destination for Lao lumber, while Europe is the major market for clothing (especially male trousers and shorts, of cotton, not knitted), with the EU accounting for almost 90 per cent of the total. Trade between Laos and the European Union (EU) has grown considerably in recent years, mainly due to the granting of preferential treatment to garment exports. EU imports from Laos in 2002 were 27 times higher than in 1990. Europe is also the leading market for coffee, the third most important export item.

Official Vietnamese statistics suggest that bilateral trade is substantial. During the last five years, Vietnam has imported – on average – US$ 123m of merchandise from Laos, becoming its first export market (ADB, 2003). This figure is somewhat misleading, however, since more than 95 per cent of the total consist of re-exports of motorcycles parts. Recorded wood products imports, probably one of the most important goods exported from Laos to Vietnam, totalled US$ 36m.[30]

[30] Data come from the Vietnam's Trade Database managed by the Institute of Economics, available online for the years 1994-98 at http://www.vern.org.vn/TradeDatabase/Search/searchE.asp and UNIDO (2003b).

TABLE 4. MAJOR EXPORTS MARKETS FOR LAO PDR (US$ MILLION, 2001)

Apparel and Clothing (a)			*Wood and articles of wood (b)*			*Coffee, tea, mate and spices (c)*		
	Value 2001	Share %		Value 2001	Share %		Value 2001	Share %
World	125,279	100.0	World	79829	100.0	World	11355	100.0
France	50,236	40.1	Thailand	68129	85.3	Spain	2447	21.5
Germany	25,995	20.7	Japan	5331	6.7	Switzerland	2331	20.5
Italy	10,363	8.3	China	5150	6.5	France	1351	11.9
Netherlands	9,413	7.5	Ireland	771	1.0	Italy	1283	11.3
UK	8,741	7.0	Australia	92	0.1	Hungary	1159	10.2
USA	3,802	3.0	Malaysia	82	0.1	Germany	1057	9.3
Norway	2,980	2.4	UK	81	0.1	Belgium-Lux.	370	3.3
Finland	2,426	1.9	Hong Kong	73	0.1	Singapore	318	2.8
Spain	2,328	1.9	USA	64	0.1	Slovakia	263	2.3
Canada	1,564	1.2	Germany	49	0.1	Indonesia	203	1.8
Austria	1,555	1.2	Italy	7	0.0	Czech Rep	197	1.7
Japan	1,194	1.0				Poland	161	1.4
Sweden	1,031	0.8				Netherlands	109	1.0
Mexico	725	0.6				Thailand	53	0.5
Denmark	546	0.4				Finland	23	0.2
Belgium-Lux	456	0.4				Canada	21	0.2
Greece	433	0.3				China	9	0.1
Czech Rep	324	0.3						
Hungary	258	0.2						
Ireland	226	0.2						
Australia	148	0.1						
Switzerland	121	0.1						
Slovenia	111	0.1						
Poland	76	0.1						

Notes:

(a) includes "Articles of apparel, accessories, knit or crochet" (HS61), "Articles of apparel, accessories, not knit or crochet" (HS62) and "Other made textile articles, sets, worn clothing" (HS63). The single largest exports are "men/boys trousers and shorts, of cotton, not knitted" (HS620342), "men/boys shirts, of cotton, not knitted" (HS620520), "pullovers, cardigans and similar articles of man-made fibres, knitted" (HS611030) and "T-shirts, singlets and other vests, of cotton, knitted" (HS610910).

(b) includes "Wood and articles of wood, wood charcoal" (HS44). The largest exports are Lumber, non-coniferous not elsewhere specified (HS440799) and Okoumé, Obeche, Sapelli, Sipo, Acajou d'Afrique, Makoré (HS440722).

(c) includes "Coffee, tea, mate and spices"(HS09). The single largest export is Coffee, not roasted, not decaffeinated (HS090111).

6. SMEs

With the private sector being asked to play a larger role in economic development, small- and medium-sized enterprises (SMEs) have been the focus of increasing interest. According to the 1999 MIH/UNIDO Survey of Industrial Establishments, the latest available, there were 21,759 small companies (97.7% of the total number) and 372 medium ones (1.7%), employing 42,725 (45.5%) and 9,466 (10.1%) persons, respectively.[31] Even in the formal manufacturing sector (including rice mills), micro enterprises, i.e. those employing 9 or less employees, play a crucial role, as they account for 46 per cent of employment, 15 per cent of output, and 24 per cent of value added. Small establishment are predominantly in rice mills, where they account for the bulk of the sub-sector production, and textile weaving and furniture production, where, on the other hand, larger establishments are also very important in terms of turnover and employment.

Survey evidence on the performance of Laotian SMEs is unfortunately outdated, making it relatively more difficult to design and implement the appropriate policies. Based on a large sample of 2,799 enterprises in 97 *ban* and four urban markets interviewed in late 1995, Minot (1996) identified the following characteristics and problems.

- The SME sector is large, is growing rapidly, and is generating 10 to 20 times as many jobs per unit of capital as larger enterprises do.
- Although the SME density is higher in the cities, over three quarters of the SMEs are in the rural areas.
- Most owners were either farmers or government employees before starting their business. They are financed out of personal savings, retained earnings, and delayed payment to suppliers, with very few debts.
- SMEs have a high turnover ratio, with the pace of creation, growth and "death" of SMEs being unusually high.
- Management skills, repair, and retail trade are the skills that SMEs owners would like to acquire; they are unlikely to be trained in such skills, unless they receive some informal one from a family member or a friend.

Acknowledging that such constraints had not been overcome, cabinet started discussions in September 2002 of a decree to give the country a specific SME policy framework. To a large extent, this document reflects the conclusions of the integrated programme for industrial development, implemented jointly with UNIDO and widely discussed with stakeholders.[32] The decree, whose details are now being negotiated at the inter-ministerial level, focuses on six main policy areas.

- Improving the business environment
- Enhancing entrepreneurship
- Improving marketing skills
- Easing financial constraints
- Establishing and assisting business associations, notably by introducing appropriate measures granting them an autonomous legal status
- Encouraging entrepreneurial attitudes in society, including through the development of educational curricula.

[31] Although not strictly comparable, the survey by Minot (1996) reaches rather different conclusions, as the author indicates the presence of no less than 146,000 non-agricultural micro- and SMEs.

[32] More than 200 participants from the private and public sectors attended the ten regional workshops organised around the country (UNIDO, 2002a)

A key element in the strategy is the creation of a SME promotion committee, chaired by the Deputy Prime Minister, which should co-ordinate government policy in this area. Through the participation of private sector representatives, which will make up half of its membership, the committee is expected to ensure that policy design and implementation adequately reflect the latter's needs. A specialised agency is also to be created to provide business support services.

In fact, according to the 2003 World Bank *Doing Business* report, an average SME spends on average 198 days in meeting the legal obligations required to start operations, despite a relatively low number (9) of bureaucratic and legal procedures to incorporate and register a new firm ("entry forms"). This places Laos last in the region (see Table 5). In particular, obtaining a license requires 132 days, more than double the statutory pledge.

TABLE 5 STARTING A BUSINESS IN ASIA

Region		*Number of Procedures*	*Starting a Business Duration (days)*	*Starting a Business Cost (% GNI per capita)*	*GNI per Capita (US$)*
East Asia and Pacific	Cambodia	11	94	553.8	280
	China	11	46	14.3	940
	Hong Kong	5	11	2.4	24,750
	Indonesia	11	168	14.5	710
	Lao PDR	9	198	19.5	310
	Malaysia	8	31	27.1	3,540
	Mongolia	8	31	12	440
	Papua New Guinea	7	69	26.4	530
	Philippines	11	59	24.4	1,020
	Singapore	7	8	1.2	20,690
	Taiwan, China	8	48	6.1	13,300
	Thailand	9	42	7.3	1,980
	Vietnam	11	63	29.9	430
East Asia and Pacific average		8.9	66.8	56.8	5302
South Asia	Nepal	8	25	191	230
	Pakistan	10	22	46.8	410
	Sri Lanka	8	58	18.3	840
	Bangladesh	7	30	75.5	360
	India	10	88	49.8	480
South Asia average		8.6	44.6	76.3	464
Asia average		8.8	60.6	62.2	3958

Note: The survey examined commercial or industrial firms with up to 50 employees and start-up capital of 10 times the economy's per-capita GNI. Procedures are defined as a legal requirement that involves a separate interaction between the firm and an outside entity (e.g. officials, notaries) required to register a firm.

Source: World Bank *Doing Business in 2004: Understanding Regulation* (2003), available at http://rru.worldbank.org/doingbusiness/doingbusiness2004.aspx

7. Foreign Direct Investment

7.1 Regulations

Laos first promulgated a Foreign Investment Law in 1988, which was then amended in March 1994. In 1989 the government established the Foreign Investment Management Committee with the aim to centralise foreign investment approval procedures. The Chamber of Commerce and Industry, founded one year later, should assist the Committee in attracting new investment.

Three types of investment arrangements are possible: contractual or cooperative for investment in existing state or private companies, joint ventures to create new companies, and private ventures.[33] The law lays the bases of quite a liberal investment regime that allows foreign participation in most sectors of the economy, guarantees investors against confiscation and nationalisation – a principle formally stated in the 1991 Constitution, which protects the right to private ownership – grants them total freedom to manage their business and transfer financial resources abroad, and offers specific investment incentives. Foreigners can hold the majority, sometimes up to 100 per cent, of capital in firms operating in all sectors. The only screening conditions are that the investment must equal or exceed US$ 100,000 and that foreigners must own at least 30 per cent of the company. The only activities that remain excluded from foreign participation are those related to the environment, national security, public health and socio-cultural heritage. In the framework of the ASEAN Investment Area Agreement, Laos will grant national treatment to investment from other ASEAN partners by 2010 and to third countries by 2020.

Despite the repeated commitment to encourage foreign investment as a means of facilitating economic development, the implementing regulations of the 1994 law were approved only in March 2001. There are some obligations on foreign investors. First, they are to give priority to Lao citizens in employment.[34] Second, they are obliged to upgrade the skill of Lao employees. Third, non-residents are not allowed to own land; however foreign investors can obtain a lease and transfer it. Finally, foreign investors are obliged to open accounts in local and convertible currency with banks based in the Lao PDR, and company accounts have to follow the Lao PDR national system of accounting.

There remain some specific problems in the enforcement of the law. For instance, the 1994 law open in principle all sectors to foreign participation, while the business law lists specific areas restricted to domestic investment. These administrative obstacles have implied that the pledge of a maximum sixty days delay for the licensing process has not always been observed. Amendments to the foreign investment framework carried out in 2002 include streamlining approval procedures and simplifying the regulations and procedures for establishing businesses.

As in other countries, Laos also offers special tax incentives to promote investment. These incentives, which are summarised in Box 2, include, tax holidays, reduced corporate tax rates, exemptions from import duties on inputs and the carrying forward of initial operational losses. On the other hand, Laos has no free

[33] While being modelled on similar legislation adopted in Vietnam and China, the Lao Foreign Investment Law of 1988 established a more liberal regime, in so far as foreigners could invest in existing state or private companies. Thanks to this provision foreigners were entitled to purchase equity stakes in SOEs being privatised. In fact, equity sales to foreign firms has been the most common form of divestment of SOEs in Laos. In marked contrast to Vietnam, Laos has achieved a degree of integration between its FDI inflows and its privatization programme for state-owned enterprises, with a number of 'flagship' former state enterprises having been partially divested to strategic foreign investors over the last decade (Freeman, 2002).

[34] Where necessary and following approval of the FIMC, foreign investors can employ skilled and expert foreign personnel.

trade zone. Plans are currently underway for a free trade zone in Savannakhet Province along the East-West Corridor, on the Vietnamese border in South Laos. The East-West corridor will connect Danang (Vietnam) with Mawlamyine (Myanmar) through Savannakhet, Mukdahan, Khon Kaen, and Maesot (Thailand). The transport infrastructure in the East-West Corridor should be completed by 2005. Vietnam, Laos and Thailand have signed and are implementing a programme aimed at facilitating the transport of commodities and people across their borders. Moreover, Lao and Thai officials met in March 2003 under the auspices of the sub-committee for the mediation of business and investment disputes, a joint government body, to discuss bilateral business disputes involving companies from the two countries.

In light of the completion of the EWC, the Lao government decided to create in January 2002 the Savan-Seno Special Economic Zone Authority (SEZA), whose role is to undertake all the preparatory work for establishing the special economic zone and then work as a one-stop-shop for all investors willing to invest in the Zone and to provide them with all necessary facilities and assistance. SEZA also envisages to develop a service and logistic centre, providing packaging, handling and warehouse services, as well as financial and other business services. The government is planning to upgrade the existing domestic airport in Khanthabouly into an international airport in order to meet transportation requirements of passengers and goods. SEZA is targeting a wide range of manufacturing activities. In particular the government would like to attract labour-intensive agro-industries and activities (e.g. food processing and packaging) in the zone. In this respect, the Government planning to set up vocational schools and agricultural schools in the province. Lao and foreign direct investments in this Zone will be granted special privileges including fiscal incentives and duty-free privileges for import and export items and products. Regulations on the zone were submitted for approval by the Government and National Assembly in September 2003.

BOX 2 FOREIGN INVESTMENT INCENTIVES

Incentives offered to foreign investors include the following:

- Import duties on capital goods (i.e. equipment, machinery and vehicles) needed for the investment are set at 1%;
- Exports by certain sectors (namely clothing) are tax-exempt – although in practice relatively cumbersome administrative procedures must be put in place to receive the corresponding authorisation;
- Imports of raw materials and semi-finished products aimed at further processing and eventual export are duty-free;
- Corporate tax rate of 20% (the domestic rate being 35%) or a fixed 1% rate on total turnover (government is free to choose which one to apply) and a dividend tax of 10%. The corporate tax rate is further reduced to 15 percent for companies investing in lowlands and to 10 percent for companies in remote areas;
- Personal income tax at 10 per cent (against a domestic rate ranging between 5 and 40 per cent for Lao nationals and expatriates working for a Lao company),
- Provisions to carry forward losses for three years
- Tax holidays for profits stemming from investment in large projects such as mining, hydropower, and infrastructure).

If the proposed regulation for the Savan-Seno Special Economic Zone will be approved, additional incentives will be offered to Lao and foreign direct investments investors locating there. In particular these include:

- 10 year tax holiday for companies exporting more than 70 per cent of their production. After this period the profit tax rate is at 8 per cent.
- an extra two-year tax 50 per cent break on the profit tax if these companies supply more than 50 per cent of their input from the domestic market.
- possibility of employing up to 30 per cent of foreign employees (with respect to a standard ceiling of 20-25 per cent).

Source: Lao Department of Domestic and Foreign Investment (http://www.invest.laopdr.org)

7.2 Trends

Foreign investors have responded positively to the opening up of the country in the early 1990s and FDI has been a major source of support for the country's balance of payments (see Figure 2). During the 1990s FDI inflows increased uninterruptedly from almost nil to a US$ 128m peak in 1996. The 1997 Asian financial crisis drastically reduced FDI inflows in following years. In 2002, FDI only amounted to US$ 25m, a level comparable to 1993. The negative trend in FDI is also perceived in the strong reduction in the number of approved projects, which in 2000 (36) was one fourth of the 1993 figure.

In the period from December 1988 to June 2002, the Government approved 937 FDI projects (of which 68 in 2001 and 84 in 2002) for US$ 7.2b (see Table 6). The leading investor was Thailand with 41.3 per cent of the total, followed by the US with 21 per cent. EU investors account for a much lower share (1.2 per cent or US$ 82m). Laos is still the taillight of ASEAN LDCs in terms of attracting FDI.[35]

Since 2001 a sustained recovery seems underway – in 2002, 84 new licenses were issued for a value of US$ 494m. Its sustainability and the concrete realisation of such projects very much depends on critical developments in the hydropower sector (mainly the NT2 project) and in the mining sectors, as well as on economic conditions in major regional partner countries. The total amount of disbursed FDI, however, is substantially lower. The quality of FDI data is extremely poor and exact figures on the number of realised projects and disbursed capital are not available.[36] An informal survey conducted by the IMF in 2000 and covering half of pledged projects found that only 48 per cent of them were in operation and only 30 per cent of pledges had actually been disbursed. Based on balance of payments data, UNCTAD estimates that the stock of FDI in Laos amounts to US$ 600m only, i.e. a mere 8 per cent of the cumulated approved capital flows. This discrepancy is largely attributable to the licensing of a handful of large power projects during the first half of the 1990s, which together account for over 40 per cent of Laos' total stock of foreign investment pledges. For a variety of reasons, including a downward revision in Thailand's electricity consumption demand forecasts after the Asian economic crisis, and Bangkok's growing preference for independent domestic power producers, several of these power projects in Laos have failed to materialise, at least thus far.

[35] Myanmar leads, accounting for 62 per cent of total FDI going to ASEAN LDCs, followed by Cambodia (26) and Laos (12).

[36] On the one hand, official FDI figures also include the equity contribution of local partners in joint ventures projects, which is in many cases overstated; on the other, small-scale investment made by Lao expatriates or by Chinese and Vietnamese companies are not recorded. See Freeman (2001) on this point.

TABLE 6 FDI PLEDGES TO LAOS (1988-2002)

	Number of projects	*Approved capital (US$ million)*	*Share of total*
Hydropower	7	4,582	62.8
Telecom and transport	17	638	8.7
Hotel and tourism	52	630	8.6
Industry and handicraft	191	590	8.1
Wood industry	37	166	2.3
Mining and Oil	34	138	1.9
Agribusiness	94	130	1.8
Services	187	104	1.4
textile and garment	91	88	1.2
Banking and Insurance	12	84	1.1
Trading	132	73	1.0
Construction	39	68	0.9
Consultancy	44	9	0.1
Total	937	7,300	100.0

Source: Lao Department of Domestic and Foreign Investment.

The bulk of FDI flows goes into export-oriented activities and concentrates in the Vientiane region. The power generation sector alone attracted 63 per cent of approved capital, followed by telecom, hotel and garments, each accounting for about 8 per cent. Although FDI has played an important role in developing a number of key industries in Laos, most notably energy, telecommunications, banking and finance and garment, authorities are still confronted with the challenge of securing a larger, more diversified and less erratic inflow of foreign investment. An analysis of the driving forces behind the rise of FDI in the early 1990s suggests that such increase was mainly related to the combined effect of the untapped investment opportunities available in the country and the positive expectations foreign investors had towards Asia at the time of the opening up of the economy (Freeman, 2001). Laos – an almost unknown economy – offered to foreign investors an attractive privatisation programme and huge hydro-power potential to satisfy the rising demand for electricity of the region. As soon as the Lao privatisation programmes stalled and the investors' euphoria towards Asia cooled down in response to a gloomy growth outlook (which also meant reduced demand for electricity), foreign investment in the country dried up.

Specific investments of considerable size that are already starting to bear visible fruits in terms of job and hard currency creation, transfer of superior technology and management skills, and international competitiveness include the following:

<u>Wood processing</u>: In co-operation with private sector development arms of the World Bank and the Swedish International Development Assistance, IKEA, the Swedish retail company, opened a US$ 2.9m laminated-wood processing plant at Nabong, close to Vientiane, in November 2000. The timber is produced in two *Eucalyptus camaldulensis* plantations, owned by Burapha (a subsidiary of the Swedish forest company Silvi Nova) and New Zealand's BGA Lao Plantations, respectively. Both projects are financed by the Asian Development Bank. Eucalyptus is a fast-growing tree normally used for making pulp and paper but of very limited use for mass furniture production, partly because it was considered too unstable to work with when the trees are still young. Although IKEA has long been using teak, which is more suitable for making outdoor furniture, it found that logs taken illegally from the natural rainforests were sometimes slipped into batches of plantation teak logs. This was in contravention of the company's policy of requiring suppliers to use certified wood from well-managed, tightly-monitored plantations. For

this reason IKEA decided to support the Lao investment, providing technical assistance to improve the process to dry the wood and train inexperienced local workers.[37]

Mining: The late 1990s witnessed a renewed interest in the mining sector in Laos. Between 1999 and 2002 13 new licenses have been issued for gold, copper and potash, mainly involving Australian and Chinese investors.[38]

The Australian mining company Oxiana Resources purchased from Rio Tinto plc 80 per cent of the Sepon project in the southern province of Savannakhet in 2000. After completing exploration and an environmental and social impact assessment, Oxiana began operating the US$ 45m gold mine in January 2003. The company estimates that the gold deposits at are worth about US$1 billion. The gold project is Laos' largest mining operation and the first with foreign capital and modern mining technology. The International Finance Corporation (IFC) provided US$15 million in equity and US$30 million in debt finance to fund it. Under the term of the agreement, IFC would receive an undisclosed equity interest. [39] By early 2005 Oxiana plans to have a US$ 167m copper mine in operation too. The feasibility study for the Khanong mine was completed in late 2002. Construction work are scheduled to begin in late 2003.

The success of the Sepon project has precipitated other interests in the gold sector. A Chinese firm (Juajin) signed an agreement to prospect in the Luang Prabang province and a Vietnamese one has been granted a concession in Saysomboun. These would be very positive developments for the Lao mining sector. Despite Laos's geological promise, the almost 40 mining licences granted since the early 1990s have not resulted in major breakthroughs. According to government officials, a major problem in developing the mining industry is the difficulty in attracting professional companies.[40] That has probably something to do with the weak physical and legal infrastructure (including the 1997 mining law) and additional costs related to clearing up unexploded ordnance, which litters most parts of the country.

Food and beverages: Brasseries et Glacieres du Laos, the Lao Brewery Company, was established in 1973 by French investors and nationalised in 1975, becoming a state enterprise under the Ministry of Industry and Handicraft. The company holds a monopoly for beer production in the name of "Beer Lao", which accounts for 98 per cent of sales in the domestic market (imported beers face fairly high tariffs). The decision to open the company to private investors was taken in the early 1990s. The government saw privatisation as necessary step toward increasing and modernising production capacity (at the time the government envisaged to reach a 30 million litres yearly production target by the year 2000), in order to meet the increasing domestic demand for beer and keep its dominant position in the market. Attracted by the high profitability of a protected market characterised by low but constantly increasing consumption, a Thai joint venture between Loxley – a trading and project development company, whose business spans from telecommunications to consumer goods – and the Italian-Thai Development Company (ITD) – one of the largest construction companies in Thailand, which is also one of the main importers of beverages –

[37] Financial Times (2001).

[38] The Yunnan Geology and Mineral Resources Exploitation Group successfully finished a geological survey for kalium resources in the Vientiane province in 2003. Kalium is in large demand in China because it is an important raw material for potassium chloride, used in the production of agricultural fertilizers. The survey detected a rich reserve allowing an initial exploitation of 100 million tons and a maximum possible reserve of 10 billion tons.

[39] The apparent success of this project has precipitated other interests in the gold sector. A Chinese firm (Juajin) signed an agreement to prospect in the Luang Prabang province and a Vietnamese one has been granted a concession in the Saysomboun Special Zone.

[40] According to a Lao official with the Foreign Investment Management Cabinet "Ninety-five per cent of the [mining] companies that you have here are brokers and middle men. They don't have enough money to do the job and they try to sell their rights". See "Mining group blazes trail to mineral riches of Laos", Financial Times, 3 May 2001.

entered in 1993 into a twenty-year contract with the Laos government and created a company with a registered capital of US$ 20, with 49 per cent of the shares remaining in government hands.

Today the company is a joint venture between the government, holding a 50 per cent, Carlsberg Brewery Hong Kong, a subsidiary of Carlsberg Asia, with 25 per cent and TTC International Company (Thailand) with 25 per cent.[41]

The Lao Brewery is a modern brewery, recently upgraded through the addition of a new automatic brew house and packaging lines. Cambodia is the main market outside Laos. The company produces also the Tiger Head brand drinking water. For the first six months 2003, the company sold about 37 million litres of beer, 14.5 per cent more than last year and double the figure estimated in the six-month plan. Lao Brewery has invested about 80 billion kip (c.a. US$8 million) to further increase its capacity to about 85 or 90 million litres per year and is planning to open a new factory in the southern part of the country over the coming two years. External competition is expected to rise steeply once tariff barriers on alcoholic beverages (currently 30 per cent on beer and 40 per cent on spirits, ten percentage points lower than in 2001) are lowered in the framework of the AFTA.

<u>Telecommunication</u>: In 1996 the government established a joint venture between the state-owned Enterprise of Post and Telecommunications Lao (51 per cent) and the Thai company Shinawatra International, giving birth to Lao Telecom. The company has a 25-year license (with five-year exclusivity) to Build-Own-Transfer telecom infrastructure for projects under the Lao Telecommunications Master Plan.[42] At present, these include a GSM 900 cellular phone network in and around the capital, public call boxes in every province and district, a basic telephone network, international call services and Internet access service.

With the expiration of LaoTel’s exclusivity in October 2001, new telecom operators entered the Lao market. In early 2003 the Swedish company Millicom International Cellular launched Tango, the country’s fourth mobile telephony operator and the first to offer international roaming.[43] Tango, which obtained a 20-year license, has invested about US$ 10m and it plans to cover the country and to have about 200,000 mobile users by 2006.

8. Improving competitiveness in specific sectors

Industrial upgrading towards higher value-added activities is a compelling necessity and declared target for the Lao development strategy. According to Gereffi (1999) “upgrading is a process of improving the ability of a firm or an economy to move to more profitable and/or technologically sophisticated capital- and skill-intensive niches.” This section examines the opportunities for Lao firms to move up the value chain in specific sectors, such as agri-business, wood and garments.

[41] TCC International is a Thai owned holding company dominating the beer market in Thailand through Chang beer, which accounts for 60% of the local beer market, and also owns a 50% share in Carlsberg Asia.

[42] The company is controlled by the Thai Prime Minister Thaksin Shinawatra and is by far Laos’ biggest Thai investment partner.

[43] The other providers are Lao Telecom and ETL. A fourth competitor, Lao-Asia Telecom has not started operation yet.

8.1 Agriculture and agri-business

It is widely acknowledged that agricultural diversification and the modernisation of agro-food industries played a key role in the development process of Southeast and East Asia economies (Goletti, 1999). Thanks to improved agricultural productivity, these countries managed to achieve rice self-sufficiency and concentrated on diversification towards higher value products. Diversification not only contributed to meeting changes in food demand patterns, but also spurred rural industrialisation and had large spill-over effects thorough post-harvest activities such as storage, transportation, processing, and marketing. "Agro-industrialisation" comprises three related sets of changes: (1) the growth of agro-processing, distribution, and farm-input provision activities off-farm, undertaken by "agro-industrial firms"; (2) institutional and organisational changes in the relation between these firms and farms, such as increasing vertical coordination; and (3) changes in the farm sector, such as changes in product composition, technology, and sectoral and market structures (Reardon and Barrett, 2000).

The agricultural sector in Laos is still at an early stage of development and is characterised primarily by a subsistence form of farm production with rice as the staple food. Despite measures taken to improve the scope of markets as an allocative mechanism in the economy, the emergence of agricultural markets has been frustrated by the dominant role of the subsistence sector in the economy and the stagnation of rural incomes (Bourdet, 2000). It is estimated that – depending on the region – only between 35 and 75 per cent of rural households market goods, while at least 25 per cent are purely subsistence. Only 10 per cent of villages have a market and over 40 per cent are over 6 km far from a main road (UNDP, 2001). The lack of market and transport infrastructure is a major factor hindering the transition of the agricultural sector from subsistence to commercialisation, the first step towards agricultural diversification and rural industrialisation. In fact, successful agricultural diversification towards higher value-added products requires a commercialised agricultural system, adequate infrastructure development, and well functioning rural institutions, all conditions barely present in the country (Goletti, 1999).

Coffee is the major export crop in terms of value, with Europe being the main export market. The industry experienced little development since the French introduced coffee plants in the southern highlands of the country in the late 1920s. Production has risen steadily since the opening up of the economy, jumping from 600 metric tons (10,000 bags) in 1984 to 18,000 metric tons (300,000 bags) in 2001 (**FIGURE 3**). During the last two years the trend has been partially reversed, with production decreasing to little more than 10,000 tons. Robusta coffee accounts for eighty per cent of production. Despite a lower and more volatile price than Arabica, growers continue to prefer Robusta plants since they are more resistant to diseases, can be harvested for more years and grants higher yields.[44]

Despite government plans to emulate the Vietnamese miracle (from 4,100 tons in 1984 to almost 920,000 tons in 2001), the coffee industry remains very small by international standards. In 2003 Lao production accounted for a mere 0.14 per cent of the world production.

Lack of manpower combined with inadequate cultivation, harvesting and drying techniques reduce both quantity and quality of Lao coffee. Currently productivity is only about 500 kilograms per hectare, low when compared to a world average. With improved practices, including pruning fertilizing and weeding, yields could increase by 30-50 per cent (Arnold et al., 2003). Lao coffee beans have been recognised as good quality but still not up to international standards, which would require improved harvesting and drying techniques, as well as the establishment of a quality control system. Marketing is also a serious impediment to improve the prospects of the industry. Traditionally Lao coffee growers have sold their crops on the domestic market or to middlemen who shipped them to the former Soviet Union or another of

[44] The price of coffee has fluctuated considerably during the past years from a high of US$ 1500/ton in 1998 to around US$ 380/ton at the end of 2001 for Robusta beans.

Laos' communist allies for use in barter trade. Today most farmers sell directly to one of around 30 private export companies, which have formed an export association that fixes the coffee price annually, based on world prices.

The future for coffee exports is somewhat bleak. Prices are at historic lows and there are no signs of immediate end to the overcapacity in world coffee production.[45] Moreover, Laos faces direct competition with Vietnam, which also produces Robusta and is the second largest coffee exporter in the world. Without improvements in its logistics, it is unlikely that it can sustain a significant growth in exports (Arnold et al., 2003).

Value-addition would require switching to higher quality coffee, roasting and production of instant coffee. However, the characteristics of the international value chain make forward integration and upgrading extremely difficult. On the one hand, coffee importing is done by trans-national trading houses. Very high levels of working capital, accumulated market knowledge and reputation constitute high entry barriers to the trading function. On the other, coffee roasting and manufacturing of instant coffee is performed by food processing multinationals usually close to the consumption market (see Box 3)

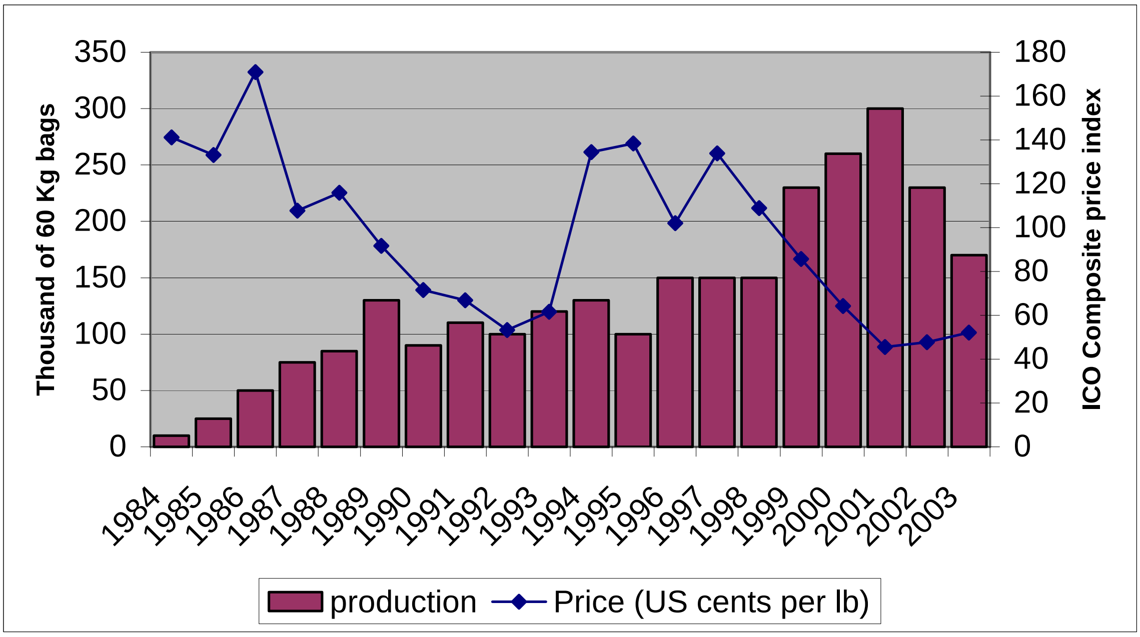
Upgrading towards roasting seems unlikely. Coffee roasting equipment in Laos is quite antiquated. The best roasting plant in Paksong, is "nothing more than a battered steel drum linked to a small motor which rotates it over an open charcoal fire. The only way [the roaster] can tell when the roasting is done is by sniffing the vapours the beans give off".[46] Moreover, while green coffee beans can be stored for long periods, roasted coffee rapidly goes stale. Thus green coffee has always predominated in international trade, and roasting has been done close to the point of consumption (Talbot, 2002). Therefore, the dismal status of logistics and roasting equipment represent a major obstacle towards forward integration.

Upgrading towards higher quality speciality coffee is slowly taking place. Despite the growers' preference for Robusta plants, an increasing number of farmers is converting to Arabica and organic shaded grown coffee production. In this context, Jhai Foundation is a promising but still small scale initiative involving some 100 small coffee growers that have joined forces with an American entrepreneur, Lee Thorn, who is determined to find a niche for Laotian coffee in the United States. The farmers are being trained to produce a high-grade, organic Arabica coffee for export, under the direct supervision of Jahi, which also pays "fair-trade wages", roughly five times what the farmers earn when they sold their crop to local traders. Similarly, the French-owned Lao Coffee Company, the largest coffee planter, roaster and exporter of Laos is exporting high quality, raw and roasted coffees. The coffee is certified organic by an the German institute CERT. Efforts to produce quality coffee are being acknowledged. In 2002 the the French *Centre de coopération internationale en recherche agronomique pour le développement* (CIRAD) judged Lao Arabica coffee to be one of the "12 best coffees in the world".

[45] Total production in coffee year 2001/02 (October-September) is estimated at around 113 million bags (60-kg bags) while world consumption is just over 106 million bags. On top of that, world stocks amount to some 40 million bags. Since the 1990s, global coffee production has been rising at an average annual rate of 3.6 percent but consumption has only increased at 1.5 percent, according to the International Coffee Organisation. Consequently, the price of coffee beans in 2001 plunged to their lowest level for 30 years.

[46] "Laos' fresh coffee hopes", BBC News, 29 March, 2002 (http://news.bbc.co.uk/2/hi/asia-pacific/1900686.stm)

FIGURE 3 COFFEE PRODUCTION AND INTERNATIONAL PRICE



Source: US Department of Agriculture, FAO Statistical portal and ICO. ICO Composite Indicator Price, prices in US cents per lb (1 lb = 0.45 KG)

BOX 3 THE INTERNATIONAL COFFEE VALUE CHAIN

Contrary to typical buyer-driven chains that are in "footloose" industries, the coffee value chain is rooted in the tropics (Talbot 2002). Coffee is a perennial tree that only grows in the Tropics. Consumption is concentrated in OECD countries. Supply and demand curves are rather inelastic, at least in the short run, and international prices tend to follow a long-term "boom and bust" pattern linked to the crop cycle. During boom periods a supply surplus will result in falling and then stagnating prices. Consequently, low prices due to overproduction generally have a negative impact on harvesting, encouraging farmers to switch to other crops, a factor which again permits world prices to rise.

Salient production characteristics

- The lifespan is around 40 years, but maximum yield occurs in trees between five and fifteen years old.
- There are little economies of scale in planting and harvesting, especially for the most prized coffee varieties which are grown in mountainous areas where machinery is unusable because of the steep slopes.
- Quality control is also key – coffee berries, for instance, ripe unevenly – and individual picking is therefore widespread.
- Harvesting however does not demand a skilled workforce, and production is performed by small self-employed farmers, often employing uneducated women and children, hired on short-term season contracts.
- Differently from cocoa, which produces intermediate products (cocoa butter and powder) that are inputs to other industries (mostly chocolate manufacturing, but also cosmetics), coffee is a final products.
- Green coffee can be stored for several years under proper conditions, while roasted coffee goes stale quickly. Thus most coffee is exported as green, decorticated, and graded bean, and roasting is done close to the point of consumption.
- Economies of scale arise in threshing, warehousing, roasting, transporting, and marketing.

Governance of the international supply chain
Five types of actors participate in the coffee supply chain: producers, processors/stockists, exporters, importers, and grinders/roasters. The governance structure can be described as international trader-driven up to the point at which green coffee enters the consuming markets. What provides the leeway to co-ordinate the chain is not so much proprietary know-how in process and product technology – as in producer-driven chains – or product design, advertising and marketing capabilities, and computer-based supply management systems – as in buyer-driven ones – but rather the ability "to procure continuously specific volumes and quality mixes for a number of processors [….] Entry barriers to the trading function are very high levels of working capital, accumulated market knowledge, and intangibles like reputation […] Chain governance by international traders tends to be loose and indirect. Prescriptions on commodity forms are much looser than in retailer/merchandiser-driven ones and while prescriptive grading classifications exist in most cases, these often turn out to have been constructed by larger direct producers rather than having been imposed by traders" (Gibbon 2001, pp. 351-2).

The incentives are therefore strong for concentration to rise in the trading node of the chain. In the mid-1990s five companies Neumann, Volcafé, Cargill, Esteve, and ED&F MAN – accounted for almost 50 per cent of world coffee trading, while a third of world roasting was done by four firms – Nestlé, Philip Morris, Sara Lee, and Procter and Gamble.

Source: Goldstein (2003).

8.2. Manufacturing

8.2.1. Value-added wood products

Within the forestry sector, a distinction is generally made between solid wood forest products and pulp and paper products. While wood industries comprise various conversions of wood into solid products,[47] pulp

[47] In terms of the Harmonised System (HS) classification these correspond to group 44 (wood and articles of wood, wood charcoal), group 45 (cork and articles of cork), and group 46 (manufactures of straw, esparto or other plaiting materials, basket ware and wickerwork).

and paper industries involve the conversion of fibre into pulp and further into a wide range of products like paper, packaging material, etc.[48] According to the degree of processing, solid wood products can be divided into primary products, i.e. those produced directly from raw timber input, like sawn wood, panels and boards, and secondary processed products, i.e. those using primary products as input for remanufacturing. Therefore, secondary processed wood products (SPWPs) include both intermediary products resulting from further transformation of sawn wood and other wood-based materials and final consumer products such as like doors and windows, and furniture. World trade of SPWPs products expanded at a rapid pace over recent years, despite volumes still being small compared to primary wood products (Descols, 2001). Expansion of furniture trade has particularly benefited from design advancements such as flat-pack or ready-to-assemble furniture that allow large shipments and global sourcing (Kaplinsky *et al.*, 2003).

TABLE 7 WORLD MARKET FOR SECONDARY PROCESSED WOOD PRODUCTS (2001)

Main exporters of wood products and wooden furniture					
Wood products			Furniture		
	US$ millions	Share in total		US$ millions	Share in total
Canada	1,963	12.8	Italy	4,849	19.3
China	1,591	10.4	Canada	2,239	8.9
Indonesia	1,042	6.8	Germany	2,148	8.5
USA	835	5.5	China	1,852	7.4
Germany	803	5.2	Poland	1,603	6.4
France	791	5.2	Denmark	1,399	5.6
Italy	725	4.7	France	1,037	4.1
Poland	568	3.7	Malaysia	995	3.9
Belgium-Luxembourg	559	3.7	Belgium-Luxembourg	895	3.6
Denmark	526	3.4	USA	795	3.2
World exports	15,306	100	World exports	25,178	100
Main importers of wood products and wooden furniture					
USA	4,778	0.30	USA	8,953	0.33
Germany	1,546	0.10	Germany	2,668	0.10
Japan	1,354	0.09	France	2,096	0.08
United Kingdom	1,053	0.07	United Kingdom	1,868	0.07
France	903	0.06	Japan	1,536	0.06
Italy	628	0.04	Netherlands	952	0.04
Canada	544	0.03	Switzerland-Liechtenstein	857	0.03
Belgium-Luxembourg	443	0.03	Belgium-Luxembourg	834	0.03
Netherlands	428	0.03	Hong Kong	737	0.03
Hong Kong	417	0.03	Canada	724	0.03
World imports	15,795	100	World imports	26,787	100

Source: UN COMTRADE (PC TAS CD-ROM 1997-2001)

Secondary wood processing and value addition is concentrated among a few number of OECD countries (Table 7). Asian producers, however, are gaining market shares. In 2001 China ranked second among world exporters of high value-added wood products and fourth among exporters of wooden furniture. That was the outcome of an impressive growth over the previous five year, averaging 10 and 14 per cent per

[48] These correspond to HS groups 47 (pulp of wood or of other fibrous cellulose material, waste and scrap of paper and paperboard), group 48 (paper and paperboard and articles thereof, paper pulp articles) and group 49 (printed books, newspapers, pictures and other products of printing industry; manuscripts).

year in the two respective segments. Indonesia followed in second position. Furniture is extremely important for Malaysia (the eight largest exporter, 4 per cent market share), and Indonesia and Thailand (3 per cent share each).

Where is Laos into this picture? These are sectors where Laos, rich in forest resources, with a relatively cheap labour force and a high level of traditional skills like carving, could have a comparative advantage. In fact wood products account for more than 30 percent of the total export revenue and have increased considerably in recent years.[49] A closer look at the trade statistics reveals however that more than 90 per cent of timber is exported at a very low level of value addition. In 2001 high-value added wood products only accounted for 6.5 per cent of wood exports (HS 44, "wood and articles of wood, wood charcoal"). Wooden furniture constituted the bulk of furniture exports (95 per cent), but furniture is only the ninth export item for the country, with a dismal 0.32 per cent share. Overall, SPWPs only account for 2.5 per cent of the total value of exports in 2001, down from 6.2 only few years earlier. These products are exported almost exclusively to three countries: Australia (furniture), Japan of and Thailand (other wood products). Most of the furniture products are only produced for the domestic market.

A recent study on the wood processing industry in Laos identified the major sources of weakness hampering the development of higher value-added products (UNIDO, 2002b).

- The government ban on log exports is not effective. Allocation of logging quotas is not administered in a uniform and transparent way. Illegal logging and smuggling remains widespread.[50]

- The capital-intensive primary processing industry dominates the wood sector. Installed capacity is excessive and productivity is very low, due to lack of technical and managerial skills and outdated equipment (leading to a high level of waste).[51] The combination of these two elements greatly reduces availability of input for downstream processing. Scarcity of raw material is aggravated by heavy wood consumption for energy generation. About 80 per cent of the domestic energy consumption is wood based, mostly in the form of fuel wood.

- The primary processing industry is almost entirely export-oriented and is not integrated downstream with the higher value-added secondary wood-processing industry. A large number of primary processing companies are directly or indirectly owned by vertically integrated foreign companies whose main interest is to use Laos as a source of cheap raw material.

[49] Exports to Thailand, the major destination of Laotian wood, have increased rapidly following the Thai government ban on commercial logging of its forests in 1989.

[50] According to official figures from the Department of Forestry, less than 50 per cent of the wood input volume (i.e. the log available for further processing) is exported. That would leave a large amount of raw wood available domestically for further consumption (and processing). In fact it is more realistic to assume that most of this balance is exported illegally (UNIDO, 2002b, pp. 19-20). Trade figure are not reliable. A recent World Bank report documented substantial unauthorized and illegal logging in protected areas. Similarly, even though logging quotas refer to the specific final use or destination of the timber, there are ubiquitous signs of unreported or underreported log exports to Thailand and Vietnam. There is no official information on the volumes imported from Laos by Vietnam. Rough estimates put this figure at least 100,000 cubic metres per year in the late 1990s (World Bank, 2001, p.33).

[51] Three large SOEs placed under the jurisdiction of the Ministry of Defence dominate the sector. These companies are granted preferential treatment and contribute very little in terms of paying royalties. Most companies operate at 30-50 per cent of the installed capacity.

- The secondary processing industry is made up of small and micro-enterprises, in many cases family based, whose production capacity is not adequate to participate directly in export oriented. The scarcity of raw material and its unreliable quality (due to the lack of proper drying) hinder the capability of these firms to work as sub-contractors for export-oriented companies. Moreover an old-fashioned and highly material consuming product design, combined with low levels of managerial and technical skills and low investment in equipment and machineries, greatly constraints the already limited market access for this sector. Technical training is not existent apart from sporadic training offered by technicians from machine suppliers while installing the equipment.

- Wood is not graded and certified according to international standards and sustainable forest management systems are not in place, limiting the access to OECD markets.

- Foreign investment in secondary wood processing based on natural forests is banned. The current legislation impedes foreign capital and knowledge to flow into secondary wood processing.

The UNIDO report concludes that despite heavy investment in the primary wood-processing sector, the Government's efforts to encourage modernisation and integration of secondary wood processing have not met expectations, mainly due to insufficient and intermittent raw material supply and the lack of investment into high value-added secondary processing.

At 47 per cent of total landmass, forest coverage in Laos is still large with respect to neighbouring countries such as Thailand (25 per cent) and Vietnam (30 per cent). However, deforestation is taking place rapidly – at an estimated 0.6-0.8 per cent yearly rate, which would imply that forest coverage will fall below 35 per cent by year 2020 – and much of the good quality wood has already been cut. Hence, the promotion of the plantation-based and secondary processing wood industries, will have to be carried out in face of shrinking wood resources. This will require substantial changes in the forestry regulatory framework, as well as political willingness and financial resources for enforcing it.[52] On one hand, the development of the sector requires large investment and technological upgrade that are not available locally. On the other hand, the tangled decision-making process and the inconsistent regulations concerning forestry management reduce transparency and favour discretionary rule. Opening up the sector to foreign investors without addressing these fundamental governance problems would probably results in little change for the sector.

8.2.2. Garments

The Lao garment sector, which rapidly developed in the early 1990s, accounts for 25 per cent of GDP and employs almost 20,000 workers, essentially women (around 90 per cent). It includes 53 export-oriented garment firms, of which 27 are foreign-owned (mostly Thai) and 8 are joint-ventures, generally with a minority Lao stake. The 18 Lao-owned firms mostly work for enterprises or agents in Thailand and Hong Kong or as subcontractors for larger Laos-based during peak periods. The sector also comprises 27 small firms only producing for the local market. Firms are mostly single-plant and undertake only "cut, make and trim" CMT operations, with cloth or fabric and all other input materials supplied by the parent company (in the case of the FDI and joint-ventures firms) or by middlemen working for foreign buyers (in the case of wholly Lao-owned firms). Almost none operates a full manufacture production modality, where local producers are responsible for purchasing input and delivering the final products ready for export.[53]

[52] The wood and timber companies infringe legislation, but the relevant agencies do not have the necessary enforcement resources. Often, it is not even clear who has, or whether anyone has, the mandate for action.

[53] The modality is also referred to as free-on-board (FOB) conditions, i.e. the price that a supplier is paid for a garment ready to be shipped. This price does not include freight and insurance costs for the garment

Production is concentrated in t-shirts and cotton trousers, using imported yarn. There is no backward linkage into primary textile production. Two textile companies exist in the country (the Lao Cotton State Enterprise and the Thai-owned Fair Vien Company, producing cotton denim the production of jeans) but they are small and cannot adequately supply the industry downstream. Production of more complex and labour-intensive garments such as shirts and skiing jackets is increasing, but still minimal.

In terms of exports, apparel and garments rank first, accounting for over 50 per cent foreign exchange revenue from merchandise exports. After experiencing impressive growth rates during the 1990s, garments exports have stagnated over the last three years. Europe (EU and Norway) grants Lao exporters preferential access and is the first market. Export to the US, the world's largest and fastest growing market, are severely hampered by the non-granting of Normal Trade Relations, which imply Laos exporters have to face non-MFN tariffs. The difference with respect to the MFN rate can be substantial, as Table 12 shows. For instance men or boys cotton trousers (HS 62034210), one of the biggest Lao export product, face a tariff rate that is sixty times higher than the applied MFN rate.

The negative impact of tariff must not be overlooked. The granting of NTR status to Cambodia in 1997 greatly contributed to the strong development of the export-oriented sector in general and of the apparel one in particular. Cambodian exports to the United States have grown from about US$ 6m of mostly unprocessed natural resources to US$ 1.1b of clothing, furniture and other products per year, with the US now representing 90 per cent of overall exports and 70 per cent of apparel exports from this country.

However, the lack of preferential access to the US only partly explains the different performance of garment exporters in Laos with respect to neighbouring Asian countries. In fact severe structural and regulatory weaknesses wreak havoc the competitiveness of Lao garments and could undermine the full realisation of benefits associated with greater market access. A survey conducted by UNIDO in 2001-02 identifies the major problems affect the industry (UNIDO, 2002c):

- The garment sector has not backward linkages. Textile production is negligible and inefficient. Hence, firm must import all fabrics for garments production. Given the landlocked nature of the country, the inadequate infrastructure and the cumbersome import procedures, lead times increase considerably.

- Lao firms do not have their own marketing activities, nor they have direct relations with downstream agents in the supply chain. They work as CMT subcontractors for middlemen based in Bangkok or Hong Kong or for larger foreign firms based in the country, which have little interest in favouring their upgrading along the supply chain.

- Labour costs are 'competitive' but productivity is very low. At US$ 25 per month (26 days and 8 hours per day) the legal minimum wage is among the lowest of similar garment exporting countries (see Table 11). However, the labour force is not skilled and productivity is low, as witnessed by high reworking level.

- Firms lack working capital. The majority of the companies have very little capital invested, in the range of US$ 0.3-1m. Considering the current status of the banking system, it is unlikely that these companies, which survive thanks to subcontracting in peak period, could finance much needed investment to modernise equipment, train workers, expand production and improve their marketing channels.

- Little or no vocational training is currently provided, neither by firms, nor by the formal educational system. Technical school exist, but offer courses that do not match the needs of the industry.

- Inadequate infrastructure and cumbersome customs procedures raise transport costs and increase delivery times. Trucks cover in 2-3 days the 670 kilometres from Vientiane to the port of Bangkok. Sealed containers have to pass an additional custom inspection at the Thai border. Regulation concerning handling and transportation implies that at the border trucks have to be unloaded and reloaded on Thai trucks. At present, Lao trucks are allowed into Thailand only within the province adjoining the crossing point. Carriage of Lao transit cargo through Thailand can be done only through designated and licensed road hauliers (only one is Lao). Lack of flexibility in working hours at customs also raise delivery time and cost since trucks cannot cross the border after 4 p.m..

- Legislation is inadequate. Import licenses are necessary for goods that were not included in the company annual plans, implying additional 2 to 4 weeks. Transport legislation limits the vehicle load limit for trucks operating in Lao PDR to 8.2 tons per axle versus 9.1 tons in Thailand and Vietnam, raising import costs. Surveyed firms also lamented that labour legislation is a major hindrance to increase competitiveness. In particular, legislation concerning maximum working hours and overtime hours conflicts with the need of the firm to work at full capacity with 8 hours shifts.

In a nutshell, low wages are not a sufficient condition to be competitive. Labour costs in neighbouring Cambodia only account for 15 per cent of the total input in production of denim jeans. A correct measure of competitiveness should incorporate not only direct wage costs, but also other indirect labour and non-labour costs (e.g. materials and accessories, shipping costs, implicit costs of red tapes and administrative delays, and so on). Benchmarking exercises for the garment sector try to incorporate this information. Comparable information is available for a large set of countries on the average wage and total labour cost per operator hour. At US¢ 12 per hour (i.e. US$ 1 per day), wages in Laos are amongst the lowest in the region. Unfortunately data on total labour costs are not compiled for Laos. The evidence from other countries suggests that total costs are between 1.1 and 1.8 times direct wage costs. Assuming total costs are 1.4 times wage costs, a Lao worker paid the minimum legal wage will still cost, overall, half than a Vietnamese or Cambodian worker. Moreover, the cost of electricity is considerably lower in Laos than in neighbouring countries.[54]

Despite that, Lao garments are less competitive than those produced in these countries, mainly because of the high incidence of transportation costs and red tapes, the absence of backward integration into textile production and the low productivity of the workforce. For a garment factory located in Vientiane as compared with a garment factory located close to Bangkok, the CIF price of equivalent garments when exported to Europe is 3-6 per cent higher.

Since the large investment required to develop an economically viable textile industry is not likely to materialise in the near future, and considering that, with the phasing out of the MFA, many "quota-jumping" foreign firms are going to relocate their activities, the immediate challenges facing the Lao garment industry are:

[54] Domestic tariffs are amongst the lower in the region. The state-owned Electricité du Laos charges residential customers from US¢ 0.5 to 3 per kWh, commercial customers between US¢ 3-4 per kWh, and irrigation customers a little over US¢1 per kWh (Economic Consulting Associates and Mercados de Energia, 2002).

- increase productivity of the workforce through better work practices, training and improved vocational education,
- reduce dependency on subcontracting and develop direct contacts with major foreign buyers,
- improve trade facilitation between Laos and neighbouring countries.

New and more stable business could be developed in sector where Lao firms can exploit to the fullest extent their comparative advantage. In particular, concrete opportunities exist in more complex garment production (e.g. babies and sports garments) as well as in further processing of garments (washing, dyeing, printing and finishing) that requires higher labour content, and also in sectors where traditional skills can be fruitfully employed. Concerning the latter, successful cases already exist in the silk weaving sector. Of course this latter have a lower employment generation potential, but these products command a higher price and they rely on rural production, having therefore a potentially higher poverty reduction impact.

9. Policy priorities for improving the competitive endowment

The previous analysis has shown that since the launching of the NEM in 1986 Laos has made considerable progress on the way towards a market economy. This process has gained momentum in the 1990s and started paying off in terms of higher growth as the country accelerated its insertion into the regional and global economy, although the Asian crisis of 1997-98 hit the country through its linkages with Thailand. Nonetheless, considerable obstacles remain, which manifest themselves through hard-to-surmount fiscal and trade deficits. The government is committed to tackle major bottlenecks, with support from bilateral and multilateral donors. In what follows, we highlight the most pressing policy priorities for improving the competitive endowment, in order to inform the discussion at the meeting.

The small-size of the Lao market, combined with administrative and operational obstacles – most notably poor human capital and infrastructure bottlenecks – limit the expansion potential of domestic firms and discourage foreign investors from bringing to the country badly needed capital and knowledge. Tax incentives can hardly offset these constraints. The government is now struggling to create a business-friendly environment and to tackle – with the technical and financial support help of international financial institutions, some of those obstacles.

9.1. Human capital development

Lao authorities face a major challenge to enhance enrolment and efficiency of its educational system. According to the national Human Development Report (UNDP, 2001) only half of the students enrolled at the primary level complete their schooling. The situation is particularly worrisome outside the capital region. In some provinces of the Northern and Southern regions more than 60 per cent of the population aged 6 or more has not completed any basic education. The primary school dropout rate is 12 per cent nationwide, but reaches 28 per cent in some regions. Despite considerable improvement in the last decade adult literacy is still low (68.5 in 1998 against 56.5 in 1990). Moreover improvements have not been evenly spread, neither geographically, nor across genders (still 45 per cent of adult women are illiterate)

The low skill base of a great majority of the population and the very small pool of people with the skills required for private business constitute a major hindrance to private sector development. As noted, literacy is very low, especially amongst women and in the peripheral areas that, through migration, contribute most to the workforce of garments exporters.[55]

Little evidence is available on skills endowments and training of the labour force. A survey on medium and large companies conducted in 1997 found that technical skills were very under-developed. Firms often had to start off new workers with the basics of work habits and even the simplest skills had to be taught. As regards managers, they were generally confident in their abilities in the main areas of business management – with the single exception of entry into foreign markets. Interviewers, however, did not always share managers' confidence, feeling that many "did not know what they did not know" (MDPF, 1997).

[55] According to the UNDP report, in 1995 about 44 per cent of residents in Vientiane were not born there, double than the national average. The internal flow of people from the regions to the capital has probably increased following the expansion of the garment sector in the late 1990s. Women, mostly from rural areas, represent 90 per cent of the workforce in this sector.

Author's own field interviews and the recent MIH/UNIDO industry survey suggest that the situation has not improved significantly.

Formal and informal vocational and technical training for workers as well as for managers are very limited, and almost non-existent outside the Vientiane Municipality. In general, vocational and technical training institutes suffer from inadequate recurrent budgets to carry out training, lack of training materials and equipment, as well as under-qualified teachers (UNIDO, 2002a). The difficulties experienced by enterprises to find semi-skilled and skilled workers also indicate that these institutes are not adequately providing the particular skills demanded by the manufacturing sector. One point in case is that the garment industry needs workers trained in industrial sewing, while the existing training institutes mainly provide training for household type of tailoring. Another example is the needs by the secondary wood processing industry that are not adequately met by the technical and vocational training institutes. Therefore, the enterprises themselves have to carry out the requisite training to produce semiskilled and skilled workers. On the other hand, enterprises report that Lao workers have good learning skills. Similarly, basic entrepreneurship training has not yet been incorporated into the education system and is only offered by a small number of private or development partner-financed initiatives (e.g. the Lao-Japan Centre or Lao-German Technical and Vocational Education and Training Project).

In 1998, the Government promulgated a Vocational Education Decree. According to this decree, businesses are required to pay a 1% training levy on their annual turnover into a Vocational Education Fund. This training levy has not yet been implemented. However, in April 2002, the National Training Council under this decree was established under the chairmanship of the Minister for Education.

9.2. Infrastructure, Telecommunications, Logistics

It is widely recognised that lack of territorial access to the sea, remoteness and isolation from world markets by inflating transportation costs and lowering effective participation in international trade negatively effect development and poverty reduction (UN, 2003).

Being a landlocked country, Laos badly needs to improve its transport infrastructure and interconnections with surrounding transit countries. The government acknowledges that the state of infrastructure lags behind other countries in the region and has therefore joined forces with the international community to improve the road network and airway connections.

There is no railway system in the Lao PDR. The road network has a very low density (0.076 km of road per square km) and less than a half is paved. This situation with the provincial road is worse. Only a small percentage is passable during the wet season.56 According to the Lao Expenditure and Consumption Survey conducted in 1997/98 (LECS 2), almost 40 percent of villages are more than 6 kilometres from a main road, half are inaccessible during the rainy season, one-quarter of the district centres lack year-round road access, and a quarter of provincial and local roads cannot be used during the rainy season . This not only makes it difficult to get outputs to markets, but also increases the import costs of essential consumer products and inputs such as fertilizers. Furthermore, since many villages are not connected to the power grid, lack of transport access also means lack of energy, since supply of fuel to run diesel generating set becomes impossible.

[56] The total length of the network is about 18,150 km of which 4,180 km were classified as national roads, 6,140 km as provincial roads and 7,830 km as local roads. The road network is made up of 3,300 km of paved roads, 5,300 km of gravel/laterite roads with the remainder being earth roads or tracks (Ministry of Communication, Transport, Post and Construction, 1997). Passenger transport by motor vehicles made up about 92 per cent of transport in 1998. Six per cent of passengers were transported by river and 1.5 per cent by air.

Table 8 presents the results of a recent study on the time and costs of container movements from Lao PDR to Europe and shows that alternative multimodal routes could reduce the present high door-to-door cost from Lao PDR to Europe (through Danang and Singapore) by almost one-third (Banomyong and Beresford 2000).

TABLE 8 TRANSPORT COSTS AND TRANSIT TIMES FOR LAO GARMENT EXPORTS

Route	*Distance (km)*	*Total transit time (days)*	*Total transport cost (USD)*	*Handling and customs charges (% of total)*	*Confidence index*
Via Danang (Vietnam) *Vientiane - Danang - Singapore - Rotterdam*	18 329	30/32	3 420	29.2%	2.7
Via Bangkok (Thailand) *Vientiane - Bangkok - Singapore -Rotterdam*	17 549	30/31	2 477	24.8%	2.9
Via Laem Chabang (Thailand) *Vientiane - Laem Chabang - Singapore - Rotterdam*	17 630	30/31	2 503	23.7%	3.1
Via Lad Krabang (Thailand) *Vientiane - Lad Krabang - Laem Chabang - Singapore - Rotterdam*	17 624	30/31	2 519	22.8%	3.0
Via Port Klang (Malaysia) *Vientiane - Lad Krabang - Port Klang – Rotterdam*	16 905	27/28	2 468	21.3%	3.0

Source: adapted from Banomyong and Beresford (2001)

Despite Laos' huge electricity production, the vast majority of households have no access to electricity. In fact, only a fraction of electricity production (57 per cent of total in 2000, equivalent to 895 GWh) is consumed domestically, the rest being exported, mainly to Thailand. Consumption is concentrated in urban areas, in particular in the Central and Northern provinces, while rural electrification is lagging behind.

Recent estimates highlight that most of the 2 million people living in sparsely populated rural areas are too remote from the grid to be connected in the foreseeable future (Economic Consulting Associates and Mercados de Energia, 2002). This study shows that only a fifth of villages and 34 per cent of households had access to electricity in 2000. True, the number of electrified households has almost doubled since 1995, but there still a long way to meet the 70 per cent target set by the government for 2010. Moreover, the nation-wide picture masks large regional disparities.[57]

Communication infrastructure is also inadequate. Lao Telecom estimates that less than four per cent of households have a telephone and less than half of districts have fixed telephone services. The GSM mobile

[57] In the Vientiane Municipality and neighbouring central provinces, which account for 70 per cent of national electricity consumption, 30 per cent of the villages and 45 per cent of the households are electrified (about 60 per cent in the capital city). In the Khammouane and Savannakhet provinces – accounting for 18 per cent of total consumption –the figure is 26 and 40 per cent respectively. In the Southern provinces – 10 per cent of total consumption – the figure drops to 17 and 35 per cent. The situation is considerably worse in the Northern provinces –which accounts for only 2 per cent of total consumption, mainly supplied by small diesel generators and pico-hydro turbines – where only 6 per cent of villages and 11 per cent of the households have access to electricity (Economic Consulting Associates and Mercados de Energia, 2002).

network covers half of the provinces and, since it is only available in major urban areas, less than ten per cent of the population is covered by a mobile signal (ITU, 2002).

In the two years to February 2003 fixed-line telephone users increased by 25 per cent (to 61,506) and mobile users by 83 per cent (to 55,165). The government's target is to reach five telephones per 100 people by 2009 (0.7 in 1999).

9.3. Business and trade support services

An increasing empirical evidence points to the important role business development services (BDS) play in strengthening a firm's competitive edge in both industrial and developing countries. The purpose of BDS is to reduce transaction costs, improve learning and build capacity within a firm (Pedersen, 1998). In so doing, they help firms to improve their access to resources, markets, and knowledge. A distinction is often made between "operational services"- i.e. those needed for day-to-day operations, such as information and communications, management of accounts and compliance with laws and regulations – and "strategic services" – i.e. those affecting the medium- and long-term performance of the enterprise. The latter are also referred to as "real" services in so that they "impact on structural features of company behaviour, and notably on their competitiveness" through knowledge and technology transfer and improvement of learning capabilities (Pietrobelli and Rabellotti, 2002).

BDS include access to finance, training, consultancy and advisory services, marketing assistance, information, technology development and transfer, and business linkage promotion. [58] They may be produced by profit-oriented organisations, civic organisations, and, especially in developing countries and for smaller firms, by donor organisations and NGOs.

Access to BDS is particularly critical for SMEs. On the one hand, SMEs lack capacity to produce their own services in-house and, very often, have little awareness and financial resources to purchase them on the market. On the other hand, a BDS market for SMEs does not always exist. Services suppliers have very little incentive to target smaller firms, due to higher transaction costs and perceived risks in identifying and offering their services to SMEs. Moreover, the information needed by SMEs is often generic with public goods characteristics, further reducing the profitability of its provision (Pietrobelli and Rabellotti, 2002, and Riddle, 2001).

Service institutions offering financial and non-financial services and profit-oriented providers have only marginally developed in Laos, and their outreach beyond Vientiane Municipality is extremely limited.

Professional services are open to foreign nationals, but some restrictions apply. For instance, foreign nationals with commercial presence in Laos can practice law as legal consultants, but cannot represent clients directly in the court. Similarly, financial services are not restricted to Lao nationals, but the establishment of foreign branches is limited to the municipality of Vientiane. Finally, to provide transport services, foreign companies should establish a joint venture with a Lao company.

[58] For the sake of simplicity, a broad definition of BDS is adopted here. In both the literature and policy debate on donor support to micro, small and medium enterprises, BDS are usually more narrowly defined to exclude financial services. For instance, Anderson (2001) defines BDS as "all external non-financial supports to micro and small enterprises that increase operational capacity, access to markets, management skills, financial efficiency and access to networks and information"(p. 5). For an overview on the policy debate and specific donors initiatives on BDS see the ILO dedicate webpage: http://www.ilo.org/dyn/bds.

A companion paper illustrates the infancy status of BDS use and provision in the country (Delasane, 2003). Very few private-for-profits providers exist and they specialise in accounting and legal services.[59] Public provision is hampered by lack of resources and experience – as in the case of the trade promotion Centre – and by lengthy political interference which hamper their operations – as in the case of the SME promotion agency, firstly proposed in the mid-1990s but still not in place.

9.4. Trade-related institutional capacity building

[to be completed]

Major priorities

- Strengthening and harmonising the legal framework
- Trade promotion organisation
- SMME promotion agency

The prospect of joining the Integrated Framework. Implications

[59] Two international consultancy firms are based in Laos, PWC and KPMG. They target only large (usually foreign-owned) firms and focus on legal and tax services.

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TABLE 9 FDI INFLOWS TO SOUTH AND EAST ASIA (1990-2002, $US MILLION)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Cambodia	0.0	0.0	33.0	54.1	68.9	150.7	293.7	168.1	242.9	230.3	148.5	148.1	53.8
	(0.0)	(0.0)	(0.3)	(0.3)	(0.3)	(0.5)	(1.0)	(0.5)	(1.1)	(0.9)	(0.8)	(1.0)	(0.4)
Laos	6.0	6.9	7.8	29.9	59.2	88.4	128.0	86.3	45.3	51.6	34.0	23.9	25.4
	(0.0)	(0.1)	(0.1)	(0.2)	(0.3)	(0.3)	(0.4)	(0.3)	(0.2)	(0.2)	(0.2)	(0.2)	(0.2)
Myanmar	161	238	172	105	126	318	581	879	684	304	208	192	129
	(1.3)	(1.7)	(1.3)	(0.6)	(0.6)	(1.1)	(1.9)	(2.6)	(3.1)	(1.2)	(1.1)	(1.3)	(0.9)
Thailand	2575	2049	2151	1807	1369	2070	2338	3882	7491	6091	3350	3813	1068
	(20.2)	(15.0)	(16.9)	(10.9)	(6.7)	(7.3)	(7.7)	(11.4)	(33.4)	(24.3)	(18.0)	(25.1)	(7.7)
Viet Nam	180	375	474	926	1945	1780	1803	2587	1700	1484	1289	1300	1200
	(1.4)	(2.8)	(3.7)	(5.6)	(9.5)	(6.3)	(6.0)	(7.6)	(7.6)	(5.9)	(6.9)	(8.5)	(8.6)
Brunei	3	1	4	14	6	583	654	702	573	748	549	526	1035
	(0.0)	(0.0)	(0.0)	(0.1)	(0.0)	(2.1)	(2.2)	(2.1)	(2.6)	(3.0)	(2.9)	(3.5)	(7.4)
Indonesia	1092	1482	1777	2003	2108	4346	6194	4678	-356	-2745	-4550	-3279	-1523
	(8.6)	(10.9)	(14.0)	(12.1)	(10.3)	(15.4)	(20.5)	(13.7)	-(1.6)	-(11.0)	-(24.4)	-(21.6)	-(10.9)
Malaysia	2611	4043	5138	5741	4581	5815	7297	6323	2714	3895	3788	554	3203
	(20.5)	(29.6)	(40.3)	(34.6)	(22.5)	(20.6)	(24.2)	(18.5)	(12.1)	(15.6)	(20.3)	(3.6)	(23.0)
Philippines	550	556	776	1238	1591	1577	1618	1261	1718	1725	1345	982	1111
	(4.3)	(4.1)	(6.1)	(7.5)	(7.8)	(5.6)	(5.4)	(3.7)	(7.7)	(6.9)	(7.2)	(6.5)	(8.0)
Singapore	5575	4887	2204	4686	8550	11503	9303	13533	7594	13245	12464	10949	7655
	(43.7)	(35.8)	(17.3)	(28.2)	(41.9)	(40.7)	(30.8)	(39.7)	(33.9)	(52.9)	(66.9)	(72.0)	(54.8)
ASEAN Total	12753	13638	12737	16604	20404	28231	30209	34099	22406	25029	18625	15211	13957
Bangladesh	3	1	4	14	11	2	14	139	190	180	280	79	45
	(1.1)	(0.4)	(0.8)	(2.5)	(1.8)	(0.2)	(1.2)	(10.7)	(22.1)	(19.6)	(36.9)	(13.9)	(4.0)
Bhutan	2	1	0	0	0	0	1	-1	0	0	0	0	0
	(0.5)	(0.2)	(0.0)	(0.0)	(0.0)	(0.0)	(0.1)	-(0.1)	(0.0)	(0.0)	(0.0)	(0.1)	(0.0)
Nepal	6	2	4	6	7	8	19	23	12	4	0	21	10
	(2.0)	(0.7)	(0.8)	(1.1)	(1.2)	(1.0)	(1.8)	(1.8)	(1.4)	(0.5)	-(0.1)	(3.7)	(0.9)
Pakistan	250	257	344	346	419	719	918	713	507	530	305	385	823
	(82.2)	(78.3)	(72.5)	(61.7)	(69.4)	(90.6)	(84.6)	(54.5)	(59.0)	(57.9)	(40.1)	(67.9)	(73.5)
Sri Lanka	43	67	123	194	166	65	133	433	150	201	175	82	242
	(14.3)	(20.4)	(25.9)	(34.7)	(27.6)	(8.2)	(12.3)	(33.1)	(17.5)	(22.0)	(23.0)	(14.4)	(21.6)
South-West Asia Total	304	328	474	561	604	794	1085	1308	859	915	760	568	1120
Asia Total	13057	13966	13211	17165	21007	29025	31294	35406	23266	25944	19385	15779	15077
of which Asia LDCs (%)	(4.9)	(3.1)	(3.3)	(4.7)	(4.3)	(3.2)	(6.5)	(15.7)	(27.9)	(22.5)	(38.9)	(20.1)	(6.4)

***Source*: ASEAN FDI statistics, based on balance of payments data.**

TABLE 10 EXPORT OF SECONDARY PROCESSED WOOD PRODUCTS

Group	*HS Product code*	*HS product description*	*Destination*	*1997*	*1998*	*1999*	*2000*	*2001*
Wood products	440910	Wood (lumber) continuously shaped coniferous (softwood)	Belgium-Luxemburg			89	24	
			Japan	1679	2279	1781	1630	635
			Thailand		17	36	174	173
	440920	Wood (lumber) continuously shaped non-coniferous (hardwood)	Japan	6272	3202	3711	4071	2581
			Thailand	2110	788	938	457	1048
			United Kingdom			16	71	
	441400	Wooden frames for paintings, photographs mirrors or similar objects	Thailand	167	145	202	138	146
	441820	Doors and their frames and thresholds, of wood	Thailand	232	99	128	62	106
	441830	Parquet panels, including tiles of wood	Japan	1222	389	286	302	208
			Thailand	101	29	12	7	9
	441890	Builder’s joinery and carpentry of wood n.e.s.	Japan	339	376	1260	821	229
			United Kingdom			229	101	
	442190	Wood articles n.e.s.	Japan	2	220	315	174	16
Wooden furniture	940161	Seats with wooden frames, upholstered n.e.s.	Russian Fed	56				
	940169	Seats with wooden frames, n.e.s.	Australia	0	39	69	119	371
			China	52				
			Denmark			130	8	
	940330	Office furniture, wooden, n.e.s.	Russian Fed	94				
	940340	Kitchen furniture, wooden, n.e.s.	Russian Fed	72				
	940350	Bedroom furniture, wooden, n.e.s.	China	64				
			Russian Fed	2557				
	940360	Furniture, wooden, n.e.s.	Australia	0	50	207	49	253
			China	103	5	3	0	0
			Denmark	0	117	34	8	42
			Japan	122	84	19	4	54
			Russian Fed	100	0	0	0	0
			Thailand	50	0	5	13	29

Source: ITC PC TAS CD-ROM 1997-2001.

TABLE 11 WAGE AND LABOUR COSTS IN GARMENT INDUSTRY IN ASIA

Average cost per operator	*India*	*Sri Lanka*	*Bangladesh*	*China Coastal*	*China inland*	*Pakistan*	*Indonesia*	*Malaysia*	*Laos (a)*	*Cambodia (b)*	*Thailand*	*Vietnam (c)*
Direct hour wage - local currency	18.08	26.99	13.69	3.3	1.88	15.02	3246	3.25	1206.72		47.16	
total cost per hour - local currency	27.68	38.24	15.09	5.75	3.43	20.29	4324.66	4.39	n.a.	n.a.	52.46	n.a.
ER to US$	48.93	96.2	59.6	8.28	8.28	59.99	8686	3.8	10056		42.14	
direct hour wage - US$	0.37	0.28	0.23	0.40	0.23	0.25	0.37	0.86	0.12	0.26	1.12	0.22
direct wage per month (8h*26days) - US$	77	58	48	83	47	52	78	178	25	55	233	45
total cost per hour - US$	0.6	0.40	0.25	0.69	0.41	0.34	0.50	1.16	n.a.	n.a.	1.24	n.a.
total cost per month (8h*26days) - US$	117.7	82.7	52.7	144.4	86.2	70.4	103.6	240.3	n.a.	n.a.	258.9	n.a.

Source: Werner International 2003, except a) UNIDO (2002), minimum legal wage , b) World Bank, and c) OXFAM (2001), minimum wage in foreign-owned and joint-venture based in Hanoi and Ho Chi Minh, the wage is $15 in state-owned companies.

TABLE 12 TARIFF BARRIERS REPORTED BY UNITED STATES OF AMERICA ON SELECTED IMPORTS (2002)

Product description	*Tariff ad-valorem*	*Tariff specific*
HS 440729: Lumber, tropical hardwood nes, sawn lengthwise >6mm		
MFN duties (Applied)	0%	
Non-MFN tariff		$1.27/m^3$
HS 440799: Lumber, non-coniferous nes		
MFN duties (Applied)	0%	
Non-MFN tariff		$1.27/m^3$
HS 610910: T-shirts, singlets and other vests, of cotton, knitted		
MFN duties (Applied)	17.4%	
Non-MFN tariff	90%	
HS 61102010: Sweaters, pullovers and similar articles, knitted or crocheted, of cotton, containing 36 percent or more of flax fibers		
MFN duties (Applied)	5%	
Non-MFN tariff	45%	
HS 61102020: Sweaters, pullovers and similar articles, knitted or crocheted, of cotton, nesoi		
MFN duties (Applied)	17.3%	
Non-MFN tariff	50%	
HS 61103010: Sweaters, pullovers, sweatshirts and similar articles, knitted or crocheted, of man-made fibers, cont. 25% or more by weight of leather		
MFN duties (Applied)	6%	
Non-MFN tariff	35%	
HS 61103015: Sweaters, etc., knitted or crocheted, of manmade fibers, containing 23% or more of wool or fine animal hair		
MFN duties (Applied)	17%	
Non-MFN tariff	54.5%	
HS 62034210: Men or boys trousers, overalls & shorts, not knitted or crocheted, of cotton, cont. 10 to 15% or more by weight of down		
MFN duties (Applied)	0.9%	
Non-MFN tariff	60%	
HS 62034220: Men or boys bib and brace overalls, not knitted or crocheted, of cotton, not containing 10 to 15% or more by weight of down, etc		
MFN duties (Applied)	10.4%	
Non-MFN tariff	90%	
HS 62052010: Men or boys shirts, not knitted or crocheted, of cotton, certified hand-loomed and folklore products		
MFN duties (Applied)	8.8%	
Non-MFN tariff	90%	
HS 62052020: Men or boys shirts, not knitted or crocheted, of cotton, nesoi		
MFN duties (Applied)	20%	
Non-MFN tariff	45%	

Source: TRAINS CD ROM (www.trademap.org).