

# Development Finance for the 8th National Socio-Economic Development Plan and the Sustainable Development Goals in Lao PDR

**A DEVELOPMENT FINANCE AND AID ASSESSMENT**





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Australian Government

Department of Foreign Affairs and Trade





## **Authors**

This assessment was prepared under the guidance of the Ministry of Planning and Investment, Department of International Cooperation, with contributions from Zeljko Sevic, Sutherland Miller III, Jitendra Kumar Sinha, Thongdeuane Nanthanavone, Ashley Palmer, Marjolaine Nicod, Thomas Beloe, and Arounyadeth Rasphone.

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## **Asia Pacific Development Effectiveness Facility (AP-DEF)**

AP-DEF is a country-led regional platform, chaired by the Government of Bangladesh, which supports countries to implement their national agendas on Development Finance and Cooperation. The Facility is a platform for regional dialogue, cooperation, and sharing of country knowledge and experiences. It is responding to the growing demand from countries in Asia and the Pacific to establish evidence and analysis, and introduce policy and institutional reforms for managing the increasing complexity of domestic and international sources of finance for development. AP-DEF has its Secretariat at the UNDP Bangkok Regional Hub.

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## List of Acronyms

<b>ADB</b>	Asian Development Bank
<b>AMP</b>	Aid Management Platform
<b>ASEAN</b>	Association of Southeast Asian Nations
<b>BoL</b>	Bank of Lao PDR
<b>CPA</b>	Country Programmable Aid
<b>CPEIR</b>	Climate Public Expenditure and Institutional Review
<b>CSR</b>	Corporate Social Responsibility
<b>DAC</b>	Development Assistance Committee
<b>DFAA</b>	Development Finance and Aid Assessment
<b>DIC</b>	Department of International Cooperation (at Ministry of Planning and Investment)
<b>EU</b>	European Union
<b>FDI</b>	Foreign Direct Investment
<b>FOREX</b>	Foreign Exchange
<b>GAVI</b>	Global Alliance for Vaccines and Immunization
<b>GCF</b>	Green Climate Fund
<b>GDP</b>	Gross Domestic Product
<b>GEF</b>	Global Environment Facility
<b>GFATM</b>	Global Fund for AIDS, Tuberculosis and Malaria
<b>HDI</b>	Human Development Index
<b>IFC</b>	International Finance Corporation
<b>IFF</b>	Illicit Financial Flow
<b>IFI</b>	International Financial Institution
<b>INFF</b>	Integrated National Financing Framework
<b>INGO</b>	International Non-Governmental Organization
<b>IMF</b>	International Monetary Fund
<b>JICA</b>	Japan International Cooperation Agency
<b>LDC</b>	Least Developed Country
<b>LIC</b>	Low Income Country
<b>LMIC</b>	Lower Middle Income Country
<b>MDGs</b>	Millennium Development Goals
<b>MIC</b>	Middle Income Country
<b>MoF</b>	Ministry of Finance

<b>MoFA</b>	Ministry of Foreign Affairs
<b>MoNRE</b>	Ministry of Natural Resources and Environment
<b>MPI</b>	Ministry of Planning and Investment
<b>MTEF</b>	Medium Term Expenditure Framework
<b>MTFF</b>	Medium Term Fiscal Framework
<b>MTO</b>	Money Transfer Organization
<b>NCCS</b>	National Climate Change Strategy
<b>NEM</b>	New Economic Mechanism
<b>NERI</b>	National Economic Research Institute (at MPI)
<b>NGO</b>	Non-Governmental Organization
<b>NSCCC</b>	National Steering Committee on Climate Change
<b>NSEDP</b>	National Socio-Economic Development Plan
<b>ODA</b>	Official Development Assistance
<b>OECD</b>	Organisation for Economic Cooperation and Development
<b>OOF</b>	Other Official Flows
<b>PFM</b>	Public Financial Management
<b>PPP</b>	Public-Private Partnership
<b>RTP</b>	Round Table Process
<b>RTIM</b>	Round Table Implementation Meeting
<b>SDGs</b>	Sustainable Development Goals
<b>SEZ</b>	Special Economic Zone
<b>SMEs</b>	Small and Medium Sized Enterprises
<b>SOEs</b>	State Owned Enterprises
<b>SSC</b>	South-South Cooperation
<b>SWG</b>	Sector Working Group
<b>TOSSD</b>	Total Official Support for Sustainable Development
<b>TrC</b>	Triangular Cooperation
<b>TWG</b>	Technical Working Group
<b>UMIC</b>	Upper Middle Income Country
<b>UNCDF</b>	United Nations Capital Development Fund
<b>UNDP</b>	United Nations Development Programme
<b>UNFCCC</b>	United Nations Framework Convention on Climate Change
<b>WB</b>	World Bank
<b>WREA</b>	Water Resources and Environment Administration

## Foreword

This Development Finance and Aid Assessment (DFAA) was commissioned by the Ministry of Planning and Investment, with the support of the United Nations Development Programme (UNDP), the Asian Development Bank (ADB), the Government of United Kingdom, the Government of Australia and the Asia-Pacific Development Effectiveness Facility (AP-DEF). The aim of the DFAA is to provide an overall picture of the development financing context in Lao PDR, identify potential areas of alternative financing and partnerships, and provide insights into the types of policies and institutional arrangements which will be required to manage the full scope of development finance needed for achieving the goals set out in the 8th National Socio-Economic Development Plan.

The DFAA is timely not only given the juncture between the 7th and 8th NSEDPs, but also as Lao PDR looks ahead to LDC graduation and the implementation of the Sustainable Development Goals, as we will need to consider not only the potential changes to the types of available financing, but also how best to strategically utilize concessional financing and Official Development Assistance (ODA). While the study finds that levels of ODA are not expected to significantly decrease in the near future, overall trends in the region indicate that countries are well served to consider how to use this important source of development finance catalytically. This is important given that ODA can eventually be expected to decrease as a proportion of overall development finance sources. The DFAA offers an opportunity for discussion with current and new development partners on how to manage these transitions as we work toward common goals of achieving development impact in Lao PDR.

We look forward to working with all our national counterparts, development partners and other stakeholders to follow up on the recommendations outlined in this assessment. While the DFAA findings present an ambitious agenda for moving toward a more integrated approach to managing development finance in Lao PDR, we are committed to undertaking this work as we look ahead to meeting the commitments of the LDC graduation and the Sustainable Development Goals.

*June 2016*



**Dr. Kikeo Chanthaboury**

Deputy Minister

Ministry of Planning and Investment

# Executive Summary

## Background and Overall Findings

Lao PDR has begun implementation of the 8th National Socio-Economic Development Plan (2016–2020), with the objective of LDC graduation at its center. Lao PDR sees its graduation from LDC status as an opportunity to demonstrate the effectiveness of the country's public policies and economic performance and more effectively mobilize, manage, and deliver a wide range of development finance. In view of the changing development finance landscape, the Government has commissioned this Development Finance and Aid Assessment (DFAA) to facilitate a better understanding among stakeholders of the current and future flows of development finance, in the context of the 8th NSEDP, the 10-year National Socio-Economic Strategy (2016–2025), and the Sustainable Development Goals.

In order to achieve its national development goals and the SDGs, Lao PDR will need to draw on development finance from a range of sources and consider the implications of potential changes to the availability and concessionality of financing. The DFAA can catalyse thinking on how best to maximize the strategic allocation of specific finance flows which may be affected, such as grants and concessional loans, and consider how institutional arrangements within the Government may potentially be adjusted to prepare for management of a changing landscape of development finance.

The challenge of aligning finance flows with national development priorities and results is not unique to Lao PDR. Indeed, the outcome document of the 3rd International Conference on Financing for Development, the *Addis Ababa Action Agenda*, recognizes the need for more integrated approaches to managing public and private finance to achieve sustainable development and encourages the formulation of Integrated National Financing Frameworks.

In the context of Lao PDR, the need for such integration and a holistic overview of financing options is apparent when considering the financing estimates and requirements of the 8th NSEDP. The 8th NSEDP, newly endorsed by the National Assembly in April 2016, estimates the financing needs of the implementation of the plan, as seen in Table ES1. According to the estimates, the NSEDP will require over USD 27 billion. Over half will need to come from foreign and domestic private investment; this share rises to over three quarters when bank lending is included. The public sector- both Government investment and international public resources in the form of ODA- is expected to contribute just under one quarter of the total. These estimates illustrate the challenges of mobilizing and effectively utilizing the resources necessary for the NSEDP, particularly the challenge of aligning private sector investment with NSEDP goals.

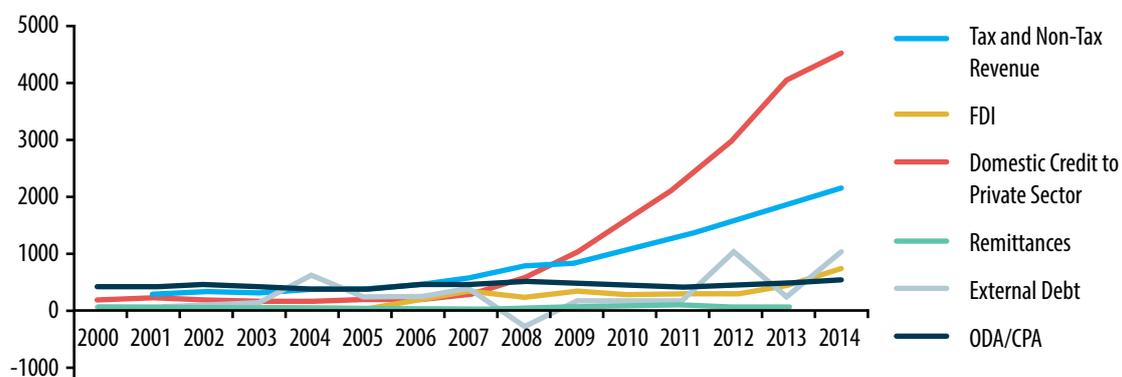
**Table ES1: Estimated Investment Requirements for the 8th NSEDP (in USD)**

Source	Total over Five Years	Share of Total (%)	Annual (approx.)
Government Investment/Revenue	3 billion	10.9	600 million
ODA	3.5 billion	12.7	700 million
Foreign and Domestic Private Investment	15.5 billion	56.1	3.1 billion
Bank Lending	5.6 billion	20.2	1.12 billion
<b>Total</b>	<b>27.6 billion</b>	100.0	

Source: MPI

In order to contribute to a comprehensive evidence base on existing resource flows in Lao PDR, the DFAA considered domestic and international, public and private sources of finance. Figure ES1 presents findings of the DFAA in terms of the volume and trends for those finance flows for which data was available. There has been rapid growth in domestic credit provided by the banking sector, growing from 10% of GDP in 2008 to 40% of GDP in 2014. External debt and borrowing is a large source of financing for the Government; while there is a great deal of variability in levels of borrowing from year to year, the *stock* of external debt reached over USD 5 billion in 2014. Public revenues, and specifically tax and non-tax revenue, has grown significantly in volume particularly since around 2011. Looking at the tax portion of public revenues, tax revenues have increased sevenfold over the past 14 years. FDI is also growing in volume: FDI in 2000 was USD 33.8 million, and in 2014 amounted to USD 720.8 million, which is over a twenty-fold increase. ODA continues to be a very important source of development finance for Lao PDR: since 2000 ODA has grown from USD 394 million to USD 525 million in 2014.

**Figure ES1: Development Finance Flows in Lao PDR, 2000–2014 (in USD mil.)**



Sources: World Bank, DIC/MPI, Bank of Lao PDR, OECD (calculations by the authors)

The Background Document for the 12th High Level Round Table Meeting organized in Vientiane on 27th November 2015 includes observations about economic growth and macroeconomic stability in the context of mobilizing various sources of development finance. These include a recognition of risks associated with the increasing dependence on natural resource exploitation and associated need to continue to diversify the economy. The importance of continuing to mobilize external grants and loans is noted, while also emphasizing the need to encourage investment by both the domestic and foreign private sector. This Background Document also mentions the need to “accurately identify investment proportion from the state budget and reflect actual development and ensure the highest effective use of the budget.”<sup>1</sup>

## Social and Economic Context

Lao PDR has been successful in attracting various forms of finance, which has resulted in an economic growth rate that has been one of the highest in the region, even in the years when many similar countries have not been successful in maintaining high rates of economic growth. However, both the Government and development partners (bilateral and multilateral) recognize that social development has not been

<sup>1</sup> Government of Lao PDR, Ministry of Planning and Investment/Department of International Cooperation, *12th High Level Round Table Meeting: Background Document*, November 2015, p 45.

as successful as economic development. Despite Government efforts to address the gap in the 7th NSEDP, there remains room for improvement. Hence, the 8th NSEDP pays particular attention to social development, together with sustainable development, rather than focusing disproportionately on achieving quantitative economic growth targets.

Therefore, Lao PDR will need to focus in the coming period on not only attracting increasing volumes of development finance, but also ensuring that the utilization of such finance is undertaken with a view towards investments which tackle the challenges of inequality and poverty that the country faces. Such an approach will require coherent policies and institutional arrangements to align key finance flows behind national priorities. Requisite reforms are complex; go beyond the remit of a single ministry or sector; and demand long-term commitment. An example would be the challenge of shifting from an economy reliant on natural resource-based exports towards one with more balance across other sectors and stronger pro-poor orientation, including prospects for creating decent jobs and livelihoods.

## An Integrated Approach to Leveraging Development Finance

The scope of reforms required for Lao PDR to develop and align finance flows for achievement of national development goals is significant, as the DFAA has shown that there is a great deal of inherent complexity. This complexity is not unique to Lao PDR, and has been the subject of discussion at the global level including at the 2015 *Financing for Development* international conference. What has emerged is the recommendation that countries develop Integrated National Financing Frameworks (INFFs) to respond to the SDGs and to articulate specific strategies for financing them.

As discussed in more depth in the DFAA report (see Box 2), INFFs are seen as long-term and ambitious endeavours with the INFF itself comprised of a number of building blocks, including, among others:

- A national development strategy/plan with well-articulated sets of priorities and results, including costed targets and indicators;
- Integrated planning and budgeting processes, that enable to link national priorities and results with medium term expenditure and budget frameworks and monitor progress;
- A resource mobilization strategy to meet the costs required by the national development strategy/plans;
- Financial management systems that allow government to better harmonize domestic and international public finance, as well as to leverage private sources of finance;
- Institutional arrangements in place that facilitate coherence among various policy areas and coordination across government for resource mobilization and prioritization of policy and institutional reforms, and
- An enabling environment in which a range of stakeholders can engage in the debate over the effectiveness and impact of finance in delivering the SDGs, thereby supporting transparency and accountability.

In the context of Lao PDR, it is important to note that progress has been made on some of these components. Not only is there a national development strategy outlining national priorities and results, but there has been an effort to identify associated financing needs. The DFAA is itself a contribution to a resource mobilization strategy. The Government has been working with both national and international partners for some time to introduce reforms which will improve the integration of the planning and budgeting systems including through medium term frameworks. There have also been investments in

institutional arrangements to promote transparency and dialogue with stakeholders, most notably through the Round Table mechanism “the national coordination process for aid and development effectiveness”.

While the results of these efforts should not be underestimated, the decision to develop and implement an integrated financing strategy will require political commitment across a number of institutions and with key development partners. Such a strategic approach implies more complex decision-making processes, which will need to be informed by data that at present is scattered across systems and institutions. In the context of Lao PDR’s ambition to graduate from LDC status by 2020, a core element of its financing strategy will certainly be to look at how to use ODA and concessional finance to maximum and strategic advantage in the near term, and to take decisions on its use with a view towards investing in long term benefits to the country. There is scope as well for improving coordination and data on synergies between ODA and other forms of external development cooperation such as public-private partnerships and South-South Cooperation (SSC).

Given the continuing importance of external development cooperation to the financing of the NSEDP, the experience and leadership of MPI/DIC, together with the Ministry of Finance, will be critical to defining how to most strategically allocate and manage external cooperation resources. However, managing the full ‘dashboard’ of development finance in Lao PDR will demand approaches which go beyond current systems of public sector budgeting and managing external resources. What will be needed are strategies where the systems for governing, allocating, and monitoring the use of individual finance flows are handled more holistically, so as to avoid duplication and maximize impact.

A key contribution of the DFAA is to not only present findings on trends for *individual* finance flows, but also to use those findings and analysis to formulate an overall picture of the development landscape. This includes attention to the *interface* between individual flows, and possible directions for prioritizing attention by the Government to some flows over others. In this connection, the DFAA recommends the following three strategic priorities:

- **First, leverage the private sector in support of achieving national development results.** The DFAA findings in this area demonstrate that the opportunities for leveraging the private sector towards development span both the domestic and international private sector contribution. Over three-quarters of the financing for the 8th NSEDP is expected to come from the private sector. It will be important to continue to promote an attractive investment climate for quality Foreign Direct Investment (FDI), but with recognition of the need to create an enabling environment for attracting FDI which contributes positively to social development and environmental sustainability. A key factor for attracting private sector investment which has been identified is the need for infrastructure investment. There is an opportunity to work with Southern partners here as key FDI investors (including in hydro sector) are neighboring and other Asian countries. Public-Private Partnerships (PPPs) may have an important role to play in improving infrastructure and the DFAA provides recommendations on PPPs (see recommendations for individual finance flows in Chapter 5).

At the same time, the DFAA also highlights the importance and opportunities for strengthening the domestic private sector, including support to Small and Medium Enterprises (SMEs) to be more productive and further tap into the export market. The DFAA discusses the trend in growth in domestic credit, largely resulting from the expansion of access to banks and financial instruments. There is an opportunity in this regard to support individuals in making productive use of these sources of credit, towards building livelihoods and business opportunities. However, more data is needed on the degree to which the expansion of the availability of domestic credit has translated into productive investment.

- **Second, ensure the efficient and effective spending of public revenues through the budget.** The DFAA findings include highlighting the considerable improvements made by the Government to increase levels of domestic public revenue collection including through both tax and non-tax revenue. Indeed, tax collection has increased nearly sevenfold over the past years. On the one hand, these efforts must continue, and the DFAA notes opportunities for further strengthening domestic resources mobilization. On the other hand, the issue is not just one of continuing to increase domestic revenue but also of ensuring that it is efficiently and effectively spent through the budget and in support of national development priorities and results.
- **Third, take a forward-looking approach to utilizing flows of external public finance, including ODA, SSC, and climate change finance.** The DFAA findings include discussion of the fact that there is not expected to be a significant drop-off in absolute amounts of these finance flows in the near future. They should therefore continue to be a strategic priority in the Lao PDR context, but with attention to exploring the complementarity between them and where each has added value. This relates also to the expected changes in concessionality as Lao PDR anticipates graduating from LDC status. For instance, while ODA has in the past been used to fill the fiscal gap and contribute to social sector spending, the increase in domestic public revenues can now be increasingly used for this purpose. It may in turn be more appropriate to utilize external flows towards infrastructure investment, which will improve the business investment climate. Given the likely change in the 'mix of money' available to Lao PDR, it will be timely to have more dialogue and analysis about whether these particular external finance flows are best used in the economic or social sectors and how they contribute to results. This is an area where a national coordination unit like Department of International Cooperation (DIC)/ Ministry of Planning and Investment (MPI) can make a significant contribution to the policy dialogue, but in order to do so it may need to strengthen its role in collecting, analysing and disseminating data around different finance flows.

In addition to these strategic priorities, Chapter 5 of this report also makes a number of recommendations, and includes a table with a summary of key recommendations related to the mobilization and effective use of *individual* flows of development finance.

## The Way Forward

Formulating an integrated financing strategy for the 8th NSEDP and its successors is a challenging and long term endeavour, yet there are immediate steps which can be taken towards this end. With the new Vientiane Declaration on Partnership for Effective Development Cooperation now approved, MPI/DIC together with its national and international partners will develop an attendant action plan to operationalize the Declaration. It is therefore proposed that DIC/MPI use the opportunity of dialogue with partners and across Government ministries to discuss the strategic priorities identified in the DFAA to inform the development of the Declaration's action plan. Consultations around the Declaration action plan will provide an opening for discussing how different forms of development finance can contribute to achieving national development goals, and the ways in which existing institutional coordination mechanisms, data collection systems and monitoring frameworks may need to be adjusted in order to bring about more integrated strategies for managing development finance.

In the medium and longer term, MPI, DIC, and the Ministry of Finance will need to define a program of institutional reforms to address the issues raised in the DFAA, and take forward its recommendations. Most of the required reforms are not confined to the mandate of a single ministry. The reforms required

for realizing an integrated financing strategy for the 8th NSEDP will need to be consulted, prioritized, implemented and monitored. As a foundation for the reform agenda, it will be necessary to identify strategies for bringing together key data on finance flows which are confined to different government areas, as well as related knowledge and analysis. A longer term approach to managing the different finance flows will also need to take into account the fact that alignment of non-public flows will present particular challenges to the government as these flows are not under direct control of the public sector and ways to influence their alignment will be more indirect, such as through the regulatory framework for private sector investment.

# Chapter 1. Introduction

## 1.1. Global and Regional Context of the DFAA

The development finance landscape has been rapidly changing with the economic growth and development of those countries that have traditionally been the recipients of development assistance. Developed countries have traditionally provided technical assistance in the form of advisory services, monetary assistance, or other forms of support to developing countries. However, as a country graduates from the least developed country status, the intensity, context and forms of the assistance change: Official Development Assistance (ODA) can be expected to decrease, while Other Official Flows (OOF) and economic cooperation flows will increase.

### Box 1: ODA in the Global Context

**Official development assistance (ODA)** is a term coined by the Development Assistance Committee (DAC) of the Organisation for Economic Co-operation and Development (OECD) to measure aid. It is widely used as an indicator of international aid flows. The OECD/DAC defines ODA as “those flows to countries and territories on the DAC List of ODA Recipients and to multilateral institutions which are:

- a) undertaken by the official sector (official agencies, i.e. government operating at any level and/or their agencies);
- b) executed with the promotion of economic development and welfare as the main objective; and
- c) packaged under concessional financial terms (for instance, loans must convey a grant element of at least 25% (calculated at a rate of discount of 10%) [As of 2018, new measures will be introduced; see below for information on changes made in 2014 to this criteria]

This definition distinguishes clearly between ODA, and other official flows (OOF). OOFs are public flows that do not meet the strict financial criteria – i.e. do not have a grant element or are not directly linked to or used for development.

The OECD/DAC is currently modernizing its statistical measurement framework to promote incentives for mobilizing and catalyzing development finance and to reflect the broader range of funding options now available to developing countries. Exploring ways to creatively leverage resources is crucial given the unprecedented scale of finance required to finance the SDGs. Statistical frameworks also need to be brought up-to-date with measures that can capture a wider range of financing trends, facilitate their analysis and provide greater transparency of finance available to developing countries.

In 2014, the OECD introduced a new statistical framework to measure ODA loans more accurately and credibly and to incentivize use of grants and highly concessional loans. Whereas in the past both grants and loans were included in ODA in their full face value, now only grants and the ‘grant portion’ of ODA loans are counted in ODA. The discount rate used in the calculation is differentiated by developing country groups – a loan to an LDC or other LIC will score more ODA than a loan at the same conditions extended to a MIC. Furthermore, higher concessionality thresholds have been introduced to fix softer terms and conditions to countries most in need. In the past, the threshold

for ODA eligibility was set at a grant element of 25%. Under the new system, loans to LDCs and other LICs must reach a grant element of at least 45% to be reportable as ODA, while LMICs will require a 15% minimum grant element and UMICs a 10% minimum grant element.

While ODA will remain a crucial part of international development cooperation, particularly for countries most in need, a much stronger role for finance beyond ODA, including private capital, is also needed. The OECD is proposing a new measure, currently being discussed, which is provisionally entitled: total official support for sustainable development (TOSSD). TOSSD aims to complement ODA by increasing transparency and monitoring important new trends that are shaping the international development finance landscape, including: i) the leveraging/catalytic effect of ODA, ii) the use of blended finance packages, and iii) the use of innovative risk mitigation instruments in development co-operation. TOSSD would incentivize broader external finance for development as a complement to developing countries' own domestic resources.

Sources: [www.oecd.org/dac/financing-sustainable-development/](http://www.oecd.org/dac/financing-sustainable-development/); <http://www.oecd.org/dac/stats/documentupload/ODA%20Before%20and%20After.pdf>; <http://www.oecd.org/dac/financing-sustainable-development/TOSSD%20BRAIN-STORM%20BRIEFING%20NOTE.pdf>

Until the early 2000s, ODA was a major driving force behind finance for development. However, the Monterrey Consensus,<sup>2</sup> agreed in 2002, embraced six areas of 'Financing for Development':

1. Mobilizing domestic financial resources for development;
2. Mobilizing international resources for development, including foreign direct investment and other private flows;
3. Encouraging international trade as an engine for development;
4. Increasing international financial and technical cooperation for development;
5. 'Forgiving' external debt, and
6. Addressing systemic issues, such as enhancing the coherence and consistency of the international monetary, financial and trading systems in support of development.

Since the 2000s, development finance has been seen to encompass private flows and domestically raised revenues, rather than focusing disproportionately on ODA flows. Currently, FDI to developing countries outstrips ODA by 4.5 times: in 2013, developing countries attracted USD 759 billion, or 61 per cent to total FDI.<sup>3</sup> However, it should be noted that since the 2007 financial crisis, the more developed countries' share of FDI has been growing, slowly but steadily. International trade is also playing an important role in facilitating development. It is estimated by the EU that between 2000 and 2008 GDP per capita in LDCs increased from USD 325 to USD 625, due largely to the benefits from trade and private finance inflows (see: EU, 2009).

The global development finance landscape has been changing over the last decade or two, and is increasing in complexity. Private and domestically mobilized sources of development finance are becoming increasingly important in facilitating economic growth and development in developing countries, enabling

<sup>2</sup> See for the full text: UN (2003)

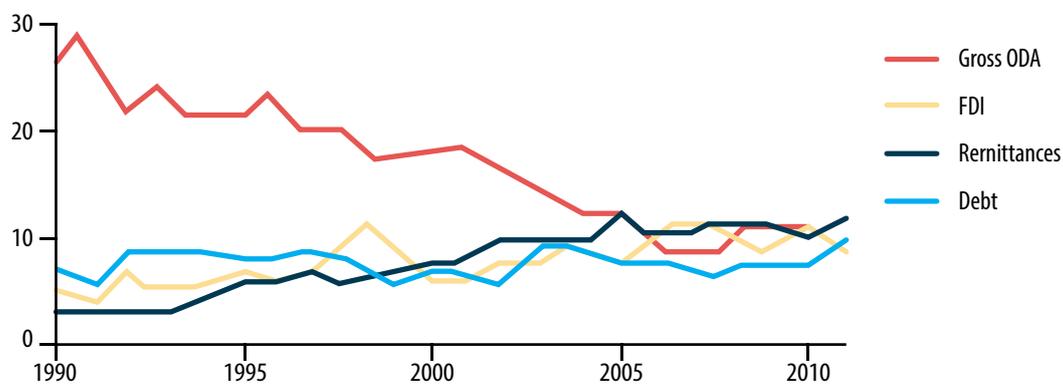
<sup>3</sup> See: the World Bank Development Indicators (Database). (<http://data.worldbank.org/data-catalog/world-development-indicators>)

graduation from LDC status.<sup>4</sup> Over the last 20 years, more than 30 per cent of countries on the DAC List of ODA Recipients have been removed due to their positive development performance. However, finding a good balance amongst various forms of development finance remains a challenge for many developing countries. Furthermore, evidence has shown that one solution cannot be applied across the board and expect the same success in different parts of the world. The contextual factors of a particular country have to be considered. Natural resource extracting countries have usually been better at mobilizing domestic resources, although natural resource wealth may guarantee high economic growth rates in the short-term, it does not necessarily bring about balanced and sustainable development in the long run. In short, a particular country must explore the most appropriate model for its socio-economic development.

Many of the development finance trends evident at the global level can be seen in the Asia-Pacific regional context as well. ODA continues to be an important source of development finance but is declining as a proportion of the envelope of international inflows to many countries in the region. South-South Cooperation, while difficult to define and quantify, is increasing. China is thought to be the biggest provider of SSC in the world; during 2010–2012, China provided a total of USD 14.41 billion in grants, interest-free and concessional loans, of which 30.5 per cent went to Asia.<sup>5</sup>

The regional development finance profile<sup>6</sup> is also affected by outflows, including illicit financial flows; IFFs from the Asia-Pacific were estimated at over USD 400 billion in 2011.<sup>7</sup> Domestic resources mobilization in the region is also increasing. The tax/GDP ratio in Asia-Pacific in the 2000s was 17.8 per cent, representing a significant increase from the 1990s rate of 12.9 per cent.<sup>8</sup>

**Figure 1.1: The Number of Asia-Pacific Countries for which each Resource Flow was the Largest, 1990–2011**



Source: Asia Pacific Effective Development Cooperation Report 2014

4 i.e. Less Developed and Low Middle Income Countries

5 *2nd White Paper on China's Foreign Aid*.

6 This section on regional development finance profile drawn from “*Strengthening Coherence between the Effective Development Cooperation and Financing for Development Agendas in Asia-Pacific*”, a background paper for a regional workshop of the same name, held in Manila in March 2015.

7 *Asia Pacific Effective Development Cooperation Report 2014*.

8 ESCAP/ADB/UNDP. *Making It Happen: Technology, Finance, and Statistics for Sustainable Development in Asia and the Pacific*. Asia-Pacific Regional MDGs Report 2014/15.

The Asia-Pacific region's financial strength is shaping a new profile of the region; actual figures are impressive:

- Over USD 7 trillion in foreign exchange reserves, more than USD 2.5 trillion in sovereign wealth funds and about USD 7.4 trillion of private savings.<sup>9</sup>
- Three Asian countries – China, India and the Philippines – received two-fifths of the USD 414 billion sent as remittances from migrants to developing countries in 2013.<sup>10</sup>
- The volume of operations of China Development Bank of USD 240 billion in 2013 dwarfs the USD 52.6 billion the World Bank disbursed last year.
- Outward FDI from countries in the region totalled USD 321 billion in 2011.

Indeed, it is very likely that a substantial part of public and private investment needed *in* the region to finance the SDGs will come from *within* the region. This may require some important changes in the present strategies to attract and manage them. For example, there is a large potential to use the region's savings, which are largely invested outside the region; using a small amount of 5 per cent of the currently available Asia-Pacific regional public savings could generate more than USD 350 billion in additional resources for financing sustainable development.

It is expected that the Asia Pacific region will continue to be the engine of global economic growth and increase its economic significance, with three of the world's four largest economies by purchasing power parity being in Asia: China, India and Japan. However favourable, this scenario is not going to ensure that problems are going to be easily resolved for most countries. On the contrary, as discussions on how to realize the post-2015 vision continue, it is important to analyse more carefully the main elements that countries will have to understand and master to unleash the potential of an increasingly complex and integrated resource landscape and effectively use all available finance sources to achieve national goals and priorities. This will not be an easy task and countries will have to develop their own strategies to manage the sources available, and to align each source's special characteristics to their own specific contexts.

For these development finance resources- domestic and external; public and private- to be attracted, absorbed, and effectively used, countries will need to have in place appropriate policies, institutions, and capacities to put available development finance to work for achieving national development goals. These challenges were discussed at the *3rd International Conference on Financing for Development* in Addis Ababa in July 2015, as the outcome document of the Conference makes reference to Integrated National Financing Frameworks (INFF), which are described in Box 2.

As an action-oriented diagnostic tool, the DFAA can support efforts to establish a baseline and roadmap for undertaking the reforms required for an INFF. In Lao PDR, the DFAA can catalyse dialogue and thinking on how best to strategically use existing financial resources to meet the development goals articulated in the 8th NSEDP. As Lao PDR looks ahead to graduating from LDC status, and considers implications in terms of changes to the availability and concessionality of financing, it is an opportune juncture to consider how best to maximize the strategic allocation of specific finance flows which may be affected, such as grants and concessional loans, and consider how institutional arrangements within Government may potentially be adjusted to prepare for management of a changing landscape of finance flows.

9 UN Economic and Social Council: *Fostering Sustainable Development in Asia and the Pacific*, Pattaya, Thailand May 2014.

10 UNDP, "Asia-Pacific Effective Development Co-Operation Report 2014."

### Box 2: Integrated National Financing Frameworks

To move ahead on the 2030 Agenda, countries will need to consider their current and future financing frameworks for delivering the SDGs. This Agenda requires both significant increases in resources as well as changes in the way existing resources are prioritized, calling for more integrated approaches to managing public and private finance to achieve sustainable development. Integrated National Financing Frameworks, as referred to in the *Addis Ababa Action Agenda*, can help governments develop “a holistic vision of fiscal planning and management that transcends traditional public financial management” by developing instruments to integrate private sector development in the national budget process and identifying incentives to align resources of private nature. As such, INFFs provide governments with a comprehensive overview of the various entry points and options available as well as an understanding of how to use them strategically.

Establishing INFFs represents an ambitious long-term endeavour. While such frameworks do not exist so explicitly in most countries, a number of on-going policy and institutional reforms in the area of public finance and results-based management provide countries with a good starting basis to build upon. An Integrated National Financing Framework can be seen to include the following building blocks:

- A national development strategy/plans with well-articulated sets of priorities and results, including costed targets and indicators
- Integrated planning and budgeting processes, that enable to link national priorities and results with medium term expenditure and budget frameworks and monitor progress
- A resource mobilization strategy to meet the costs required by the national development strategy/plans
- Financial management systems that allow government to better harmonize domestic and international public finance, as well as to leverage private sources of finance
- Institutional arrangements in place that facilitate coherence among various policy areas and coordination across government for resource mobilization and prioritization of policy and institutional reforms
- An enabling environment in which a range of stakeholders can engage in the debate over the effectiveness and impact of finance in delivering the SDGs, thereby supporting transparency and accountability

Source: UNDP/AP-DEF, “Development Finance Assessment (DFA): Linking Finance and Results to Implement the SDGs at Country Level- A Guide”, forthcoming (draft of March 2016)

## 1.2. Context and Objectives of the DFAA

In view of the changing global development finance landscape, Lao PDR sees its graduation from LDC status by 2020 as an opportunity to demonstrate the effectiveness of the country's public policies and economic performance and more effectively mobilize, manage, and deliver a wider range of development finance.

The Government has initiated implementation of the 8th National Socio-Economic Development Plan (2016–2020), with the overall objective of LDC graduation at its center. As such, the Government has commissioned this Development Finance and Aid Assessment (DFAA) with the aim to have a better understanding of the current and future flows of development finance, as it embarks on implementation of the 8th NSEDP and further defines its 10-year National Socio-Economic Strategy (2016–2025).

Initiated by the Government of Lao PDR, the DFAA has been supported by the Asian Development Bank, and UNDP Bangkok Regional Hub, and the UNDP Lao PDR country office. The DFAA consisted of four phases: (i) desk-based review and preparation for in-depth consultations, (ii) country in-depth consultations to introduce the assessment to stakeholders, to conduct interviews and to collect data, (iii) draft report and (iv) final approved report. Further detail on the DFAA process can be found in Annex 1.

The DFAA team was composed of four members (three international consultants, specializing in Public Financial Management [PFM]; Public Private Partnership [PPP] and Private Finance; and South-South Cooperation [SSC]; with the support of one national consultant). There was a designated focal point within the Government (from the DIC/MPI). The team focused on the analysis of major flows of development finance to and within Lao PDR- external and domestic; public and private- covering to the extent possible the individual flows depicted in the table below. The DFAA paid particular attention to PPPs and SSC at the request of the Government.

**Table 1: Dashboard of Development Finance Flows**

	Public	Private
<b>External</b>	<ul style="list-style-type: none"> <li>• ODA Grants and Loans</li> <li>• Other Official Flows (OOFs)</li> <li>• South-South and Triangular Cooperation</li> <li>• External Debt and Borrowing</li> <li>• Vertical Funds: Climate-related Finance and Vertical Health Funds</li> </ul>	<ul style="list-style-type: none"> <li>• Foreign Direct Investment (FDI)</li> <li>• Remittances</li> <li>• INGOs</li> </ul>
<b>Domestic</b>	<ul style="list-style-type: none"> <li>• Tax Revenues</li> <li>• Non-tax Revenues</li> <li>• Revenue from State Owned Enterprises</li> <li>• Mineral/Natural Resource-related Taxation</li> <li>• Public Private Partnerships</li> </ul>	<ul style="list-style-type: none"> <li>• Domestic Private Sector Investment</li> <li>• Domestic Philanthropy and Corporate Social Responsibility</li> </ul>

This DFAA report has also been structured to reflect findings and analysis of the four major categories of development finance depicted in the “dashboard” above.

# Chapter 2. Social and Economic Context

## 2.1. Overview and Country Context

Lao PDR is a South-East Asian Country bordering Cambodia, Myanmar, China, Thailand and Vietnam. Classified as an LDC, the Government has set the goal of meeting the LDC graduation criteria by 2020, and significant developments have been recorded, especially in the last half decade. Since 1989, the country has made increased attempts to join the international community and collaborate with international organizations. The first agreements with the IMF and WB were signed in 1989, and Lao PDR joined ASEAN in 1997. It is also a member of a number of specialized bodies of the United Nations and has forged trade agreements with the major countries in the world, most of which were signed in the early 2000s.

In addition to recording economic successes, a number of measures in the social sphere have been undertaken to improve the well-being of the population of the country. A summary of the economic and social context of the country is provided in subsequent sections of this chapter.

## 2.2. Social Context

Lao PDR is one of the 'youngest' countries in the world; more than one-third of its population is below the age of 15. It is also a very diverse country with 49 officially recognized ethnic groups (although some studies claim that there are over 60 ethnic groups). Ethnic groups, which make up less than half of the population, mainly live in highland areas. Lao PDR has been addressing the infrastructure and social gap between the lowlands and highlands, but the differences are still significant, especially in terms of access to basic public services.

Overall, the social development<sup>11</sup> of Lao PDR has progressed significantly. Life expectancy increased by 19 years between 1985 and 2013; it is around 66 years. Most of the Human Development Indicators (HDIs) have improved over time, especially those related to education. Aggregate spending on health has also more than doubled over the last two decades, from USD 37 in the 1995 to USD 84 in 2012.<sup>12</sup> Access to clean water and sanitation facilities has improved. The percentage of the population with access to clean water improved from 45.5 to 75 per cent from 2000 to 2015. Access to sanitation facilities improved from 28 to 75 per cent during the same period.<sup>13</sup> Literacy rates have also improved over time, although in recent years the figures have slightly fallen for men and improved significantly for women.<sup>14</sup> The primary school enrolment rate has also increased significantly and was 97.3 per cent in 2013.<sup>15</sup> Challenges remain, however, at the secondary and higher education levels, as places are limited, especially at university level.

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11 On social aspects of the development see: Friedman, 2006

12 ESCAP database

13 World Bank database

14 ESCAP database

15 ESCAP database

From the early 1990s into the 2000s, the GINI coefficient was around 34; by 2012 this had increased to 37.9,<sup>16</sup> showing that there is still significant inequality in income distribution which may hamper further economic growth in the future.<sup>17</sup> Although inequality may appear primarily a social problem, it will, in fact, become a serious economic issue to be tackled. Namely, lack of education and societal cohesion in the future stages of economic development will limit the country's capacity. Education and health challenges will be a major task for the Government to address in the next planning period, especially with a view to graduating from LDC status by 2020.

## 2.3. Economic Context

In the 1970s and early 1980s, Lao PDR operated under a centrally planned economic system. A 'New Economic Mechanism' (NEM) was introduced in 1986, which generally marked a shift from a centralized to a market oriented economy. This policy change was undertaken as a gradualist, step-by-step approach, leading to positive results, primarily in the economic sphere. The policy shift included price liberalization, wider private ownership (in addition to the existing 'personal ownership'), trade liberalization, and a more flexible foreign exchange market. Later, it was expanded to cover the approval of international collaboration (initially joint-ventures) which brought in foreign capital in a number of attractive economic sectors, and supported high economic growth.

During the past two decades, Lao PDR has recorded a very high growth rate. Over the last decade in particular, it has been one of the fastest growing economies in South-East Asia, recording growth of about 8 per cent annually. The key development goal of the Government is to graduate from LDC status by 2020 and further, to consolidate middle-income country status by 2030. To do so, economic growth must continue at a high rate. At the same time, the country will need to ensure that its development momentum is not stalled due to a lack of infrastructure, lack of an educated and trained labor force, an ineffective public administration, or inappropriate institutional and governance frameworks.

Exports and imports have been increasing steadily in recent years, although exports are predominantly driven by the mining sector and the export of minerals (and electricity), with final consumption goods recorded mostly on the imports side. Exports increased over six fold between 2004 and 2013, with imports growing threefold, with some minor annual oscillations.

During the 1990s and in 2000, Lao PDR battled with the problem of high and hyperinflation. However, since 2001, inflation has mostly remained at a single digit number, with the exception of 2003–2005, when inflation was 10.5, 15.6 and 10.5 respectively. In most years, the inflation rate was below growth rates, and in 2009, the country was very close to deflation. Despite good results, Lao PDR is still the country with the second highest inflation (after Vietnam) amongst the Mekong (Economic) Region members. Credit to the economy has been growing steadily over the years. From 2005 to 2012, the total credit to the economy increased over 12 times. Credit expansion was primarily in the private sector and only in early 2012 did the credit to SOEs grow, although it is still less than 5 per cent of total credit.

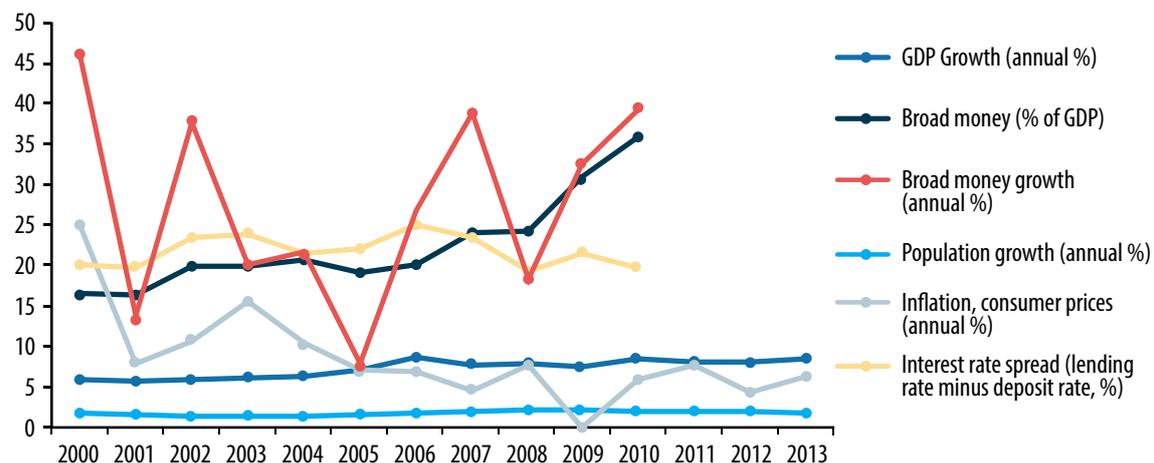
16 World Bank database

17 Recent study by OECD points out that OECD member countries, i.e. the advanced industrialized countries, have lost approximately 8.5 per cent in GDP growth from 1990 to 2010 due to increasing income inequalities (see: Cingano, 2014; see: *Wall Street Journal*, Tuesday, December 9, 2014, p. 3).

Lao *Kip*, the national currency, has been relatively stable since 2003/2004, with minor oscillations against the two major currencies – the Thai Baht and US Dollar. In the case of the Thai Baht it has been in the band of between 255 and 265 *Kip* per Baht, and in the case of the dollar, between *Kip* 8 and 10.6 thousand per USD. Central Bank interventions have usually been successful and the national currency has been kept steady with no adverse influence on growth and development. However, it should also be said that throughout the year, the *Kip* does fluctuate, which creates problems for planning and may increase inflationary expectations. As the FOREX market has relatively few major players, fluctuations under current economic conditions are controllable.

Lao PDR is improving its internal economic governance by focusing on raising domestic revenues and mobilizing domestic resources to support economic growth. Tax revenues have been increasing more or less steadily (with some fluctuations), and in 2014 were at 15.5 per cent of GDP. The Lao PDR budget has been in deficit for a number of years, and increasingly, spending has shifted from capital to current expenditures.

**Figure 2.1: Major Economic and Population Indicators for Lao PDR**



Source: World Bank-World Development Indicators Database

In sum, Lao PDR's economic progress has been significant and positive trends (usually with some minor fluctuations) can be reported across the board. This generally has led to the country meeting most of its Millennium Development Goals (MDGs), although some, in the social sphere (education and health) and for addressing problems of unexploded ordnance (UXO), have been difficult to achieve within the set timeframe.

## 2.4. National Economic Framework: Key Policies

### 2.4.1. National Planning/National Socio-Economic Development Plan Mechanism

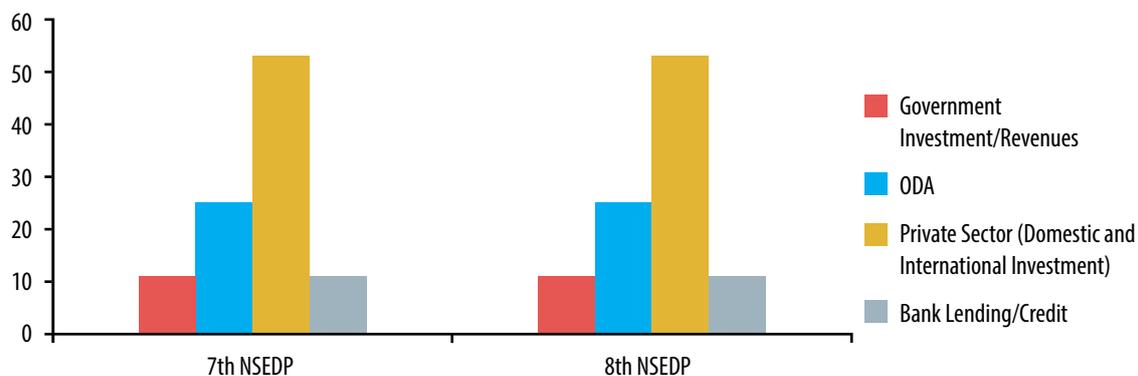
Over time, Lao PDR's National Socio-Economic Development Plan (NSEDP) has changed from the main instrument of the centralized, planned economy, into a platform for the coordination of national socio-economic policies. The current 7th and 8th NSEDPs have significantly contributed to the coordination of various economic policies and provided guidance to national institutions.

The current national planning process has involved setting development targets through a more consultative process with key stakeholders and local communities than had taken place in the past, when the Central Government was the sole player. The process is initiated by the Ministry of Planning and Investment (MPI) which is in charge of the 'physical' target-setting. The Ministry of Finance (MoF) is tasked with ensuring the budgetary side of the plan's feasibility and providing the necessary elements for financial decision-making. MPI draws on the expertise of the National Economic Research Institute (NERI), a leading national think-tank (despite being a directorate within the Ministry) that facilitates and coordinates the necessary background work in the planning process. The plan is approved and endorsed during the ordinary session of the National Assembly meeting. The National Assembly also has responsibility for monitoring the Government's implementation of annual and five-year plans.

Initially, Lao PDR was in favor of a shorter term planning cycle. In the late 1970s, immediately after the national revolution, one- to three-year plans were drafted. The first national plan covered 1976–1977, the second 1978–1980 and from 1981, a five-year standard cycle was employed. From 1986, with the launch of the NEM, the plans were less directional and instructional – more broad and guiding.

In the last 20 years, NSEDPs have focused on achieving a) targeted economic growth (approximately 8 per cent per annum), b) stability of foreign exchange, c) low inflation, d) targeted GDP per capita, e) primary school enrolment, and f) control of malaria, diphtheria, cholera and providing vaccinations to the general population. In order to achieve the planned results, sources of finance for the 7th and 8th NSEDP are shown in Figure 2.2 and summarized as follows. For the 7th NSEDP<sup>18</sup>: Government budget at 10–12 per cent; ODA at 24–26 per cent; domestic and international private investments 50–56 per cent; and bank credits at 10–12 per cent.

**Figure 2.2: Sources of Finance for 7th and 8th NSEDPs (% of total investment required)**



Source: Government of Lao PDR – 7th NSEDP documents and Background document for 12th High Level Round Table Meeting

Currently, the Government has entered the implementation period for the 8th NSEDP which covers the period 2016–2020 and focuses on preparing the country for graduation from LDC status. It is expected that the country will need approximately USD 27.6 billion and has estimated sources of finance as follows: Government investment/revenue at 10.9 per cent; ODA at 12.7 per cent; private sector at 56.1 per cent; and bank lending at 20.2 per cent.<sup>19</sup> The NSEDP will be in line with the longer-term national strategy that is almost concurrently being developed, which looks at Lao PDR becoming a lower mid-income country by 2030, or sooner.

18 7th NSEDP.

19 MPI: Background document for the 12th High Level Round Table meeting, November 2015.

### 2.4.2. National Budget and the Budgeting Process

The national budget process is the responsibility of the MoF, although the budget, as a legal Act, is enacted by the National Assembly, as the *de jure* supreme body in the country. The Law on State Budget (Art. 51) requires the national Government to review, prepare and submit the State Budget Plan to the National Assembly, at least 15 days before the beginning of the session. In practice, this usually happens in June, as the Law (on State Budget) requires the National Assembly to have a session at least three months prior to the end of the budgetary year, which in practice means that the session has to be held in June or July (Art. 52). Following the National Assembly's approval of the State Budget, the Government is obliged to enact a Decree on the execution of the State Budget (Art. 53). Although the Law on State Budget stipulates that economic type classification will be applied and the Decree on the implementation of the Law on State Budget, 2008 further elaborates on the classification, in practice, the Lao PDR State Budget is highly aggregated.

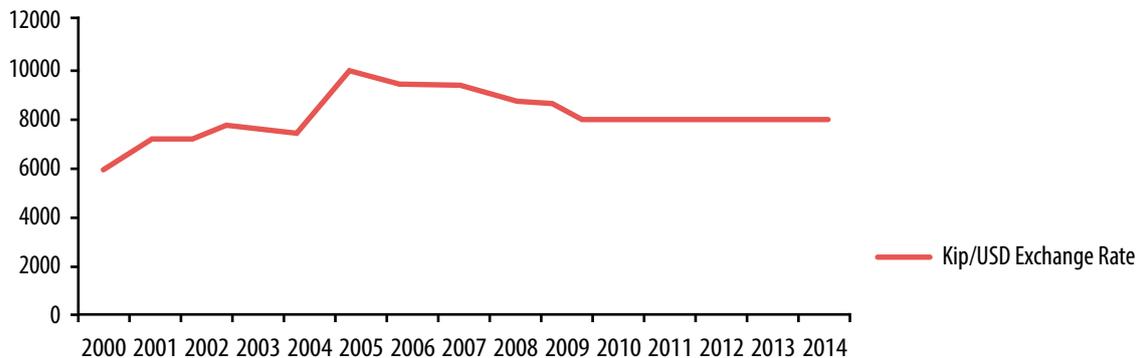
The economic planning function is performed by MPI. It prepares an investment plan, coordinates international aid and leads on the preparation of the NSEDP. In theory, the MoF should provide fiscal estimates for all documents, but it is not clear what the practice is and whether medium-term documents effectively reflect the annual budget.

The budget prepared the Government could be better consolidated to include all para-fiscal revenues and extra-budgetary funds. For instance, Road Maintenance and the Forestry Development Fund are included in the budget, whilst the other six funds are not. Data can be captured on a monthly basis and the MoF can supply data upon request. However, data is not published as a matter of course and the National Assembly receives reports only upon request.

A broader issue is the need for the Government to continue to take measures to strengthen the linkages between the planning and budgeting processes in order to utilize the national budget as a platform for aligning available financial resources with development results in the NSEDP. For discussion of reform efforts underway, see Box 5 in Chapter 2.

### 2.4.3. Monetary Policy

Monetary policy is the responsibility of the Bank of Lao PDR (BoL), as the central monetary authority. The BoL's objectives are: 1) to keep inflation under control (avoiding inflation surges); 2) foreign exchange stability (avoiding sudden large outflows of foreign currency), and 3) financial system stability (maintaining banking system solvency and preventing bank runs). Over the last 25 years, the BoL has had difficulties meeting these objectives. However, since 2005/2006 the situation has improved. Inflation has been more or less under control (with some minor surges in inflation) and the national currency has been kept around *Kip* 8,000 per USD in the last decade or so, again with some fluctuations.

**Figure 2.3: Kip/USD Exchange Rate, 2000–2014**

Source: Bank of Lao PDR

*De jure* the foreign exchange regime in Lao PDR is floating. As a result of the success in exercising external monetary stability, the *dollarization* in Lao PDR has receded in recent years (measured as a ratio between foreign currency deposits to broader money), although *de facto* currency competition is allowed in the country (payment can be exercised in another currency – USD, Thai Baht or even EUR – by physical persons).

In recent years, rapid credit growth has been a challenge for the BoL. Although the Bank has attempted to curb growth, it continued in 2013 and 2014, with growth of credit to the state-owned enterprises (SOEs) sector higher than that to private sector entities. This may lead to monetary instability in the future, depending on the loan delinquency level.

#### 2.4.4. Fiscal Policy

Fiscal policy is enacted by the Ministry of Finance. The Government is committed to better public financial management (PFM), continued fiscal reforms, and improvements in fiscal and customs collection. Overall, fiscal policies have been assessed as prudent, although on the expenditure side, there has been growth in some items which have shaken fiscal stability (the increase in the public sector wages bill in 2012). Fiscal deficit growth is moderate and the Government is committed to keeping the deficit within 2.5 per cent of GDP in the medium-term.

Fiscal policy results have been regarded as satisfactory by both the IMF and the World Bank (IMF, 2012; 2013; 2015; WB, 2012; 2013a; 2014b). Fiscal revenues have, in principle, been stable, and the Government continues to make efforts to strengthen PFM and improve the transparency of the budget.

Economic growth is still to be reflected in the proportionate growth in fiscal revenues. While fiscal revenues have grown over time, the introduction of new types of taxes has not always corresponded to a growth in revenues. It is necessary to ensure that, in future, reforms to the taxation system are looked at closely and improvements are made that will ensure that economic growth is reflected in the increase in Government revenues (primarily taxes). In addition, future reforms to the taxation system in Lao PDR should take into account not only the potential *quantity* of tax to be collected, but also consideration of issues of equity and the degree to which taxation supports overall socio-economic development of the country in the medium and longer term.

A further consideration is that the general tax model should recognize hydropower enterprises in a non-discriminatory manner, where exemptions are eliminated from primary taxes when the Government sets the key taxes and imposes a natural resources rent system. Currently, each investor in the hydropower and

mineral mining sectors has a specific contract where the rates have been fixed for a long period of time, quite often for more than 25 or even 40 years. In addition, all the contracts' rents have been defined on a discretionary basis, with a range of differential rates, which have been kept confidential. Practice has shown that a number of different models can give good results, but the bottom-line rule is that the fiscal approach has to be more transparent and less discriminatory, in line with international benchmarks and practices.

While foreign debt risk had been reduced from high to moderate by the IMF (see: IMF, 2012; 2013), recent concerns have been raised about Lao PDR's public debt. A recent report by ODI, however, has suggested that Lao PDR may be at risk of returning to a high-risk rating, given rising debt levels from USD 4.5 billion in 2012 to USD 5.1 billion at the end of 2013. It recommends that Lao PDR formulate a clear debt strategy with targets on key debt measures, which would aid the Government in managing its borrowing.<sup>20</sup>

## 2.5. General Context and the Development Finance Mix

In order for Lao PDR to achieve its national development goals, it will need to draw on development finance from a range of sources. There is no single model to define the optimal mix of resources. In fact, most likely, a combination of many sources will provide a basis for successful development, with the proportional representation from various resources changing over time, as the country progresses from one stage of the development to another.

In Lao PDR, the NSEDPs set the target for both domestic and international resources, including private flows that cannot be easily controlled. The NSEDP, in fact, requires each sector to define its own development policy and adopt development plans. Industrial policy, for instance, focuses on the further development of manufacturing and attracting international investment. Similarly, investments in hydropower and natural resource utilization require foreign investment and it is a priority to find an international partner and attract FDI.

As economic development accelerates, domestic sources of finance can be expected to play a more prominent role, with ODA decreasing over time (as a proportional of overall development finance flows) and, by the time the country has become an upper middle income country, perhaps ceasing completely. It can be a challenge for national authorities to manage this transition well, ensuring that growth and development are sustainable and that the achieved level of development will not be reversed in the face of the first major economic crisis. There are examples of countries that have achieved middle-income country status and then following external economic shocks were drawn back into the developing country pool.

The development finance mix (understood as the portfolio of development finance flows) will differ from country to country. In Lao PDR, in recent years, FDI has been an increasingly important source of development finance. With the change in the focus of leading international development partners (USAID, Australia, DfID, and others) from traditional ODA to support to business development, it is reasonable to expect that FDI and external private flows will play an increasingly prominent role in support to developing countries, including Lao PDR.

Chapters 3 and 4 will look in more depth at the current portfolio of development finance in Lao PDR, with Chapter 3 focusing on domestic sources (public and private) and Chapter 4 looking at external sources (public and private).

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20 Mustafa, S. and R. Greenhill (2016), *An Age of Choice? Lao People's Democratic Republic in the new development finance landscape*, Overseas Development Institute (ODI).

# Chapter 3. Domestic Finance

## 3.1. Domestic Finance

Domestic finance, including tax and non-tax resources, will be critical to meeting the goals outlined in the 8th NSEDP as well as for Lao's efforts to implement the Sustainable Development Goals (SDGs). As was recognized and discussed at the Financing for Development conference in Addis Ababa in 2015, improving domestic resources mobilization and ensuring adequate contribution of domestic finance to achieve national development goals will be key. In the context of the 8th NSEDP, the financing plan calls for Government investment to contribute an average of about USD 584 million annually, and notes the importance of ensuring adequate funding of the social sectors.<sup>21</sup> Looking across all development finance flows, it is important to note that domestic public revenues are unique in that they are arguably the flows which are most under the control of Government and can be directly programmed through the national planning and budgeting process. Yet discussion of domestic public revenues must look not only at potential measures for increasing the quantity of finance, but also at issues of efficiency of public expenditure.

### 3.1.1. Tax Revenues

There has been an increasing trend in tax collection in Lao PDR- nearly sevenfold over the past 14 years. In FY2014, the tax-to-GDP ratio was 15.5 per cent. This is slightly lagging behind the Asia Pacific regional ratio of 17.8 per cent in the 2000s. Indeed, while the increasing trend (the tax-to GDP ratio in FY2000 was 10.6 per cent) in Lao PDR is notable, there is scope for further increases in tax collection, including through improvements to harmonize the overall tax system.

**Table 2: Comparing Lao PDR Tax/GDP to Other Countries in the Region**

Country	FY2011	FY2012	FY2013	FY2014
Lao PDR	14.1	15.0	15.0	15.5
Cambodia	10.2	11.4	11.7	13.4
Vietnam	22.3	19.0	19.1	18.2
Thailand	15.9	15.1	16.5	15.3
Myanmar	3.7	3.8	6.3	9.2

Source: ADB, Key Indicators for Asia and the Pacific 2015, Country Profiles

In Lao PDR, there are currently fifteen different types of 'tax revenues' (see: Government Finance Statistics Annual Reports) which include: 1) Profit Tax; 2) Income Tax; 3) Land Tax; 4) Business Licences; 5) Minimum Tax; 6) Turnover Tax; 7) VAT; 8) Excise Tax; 9) Import Duties; 10) Export Duties; 11) Registration Fees; 12) Other Fees; 13) Natural Resources Taxes; 14) Timber Royalties, and 15) Hydro-Power Royalties.<sup>22</sup> Many of

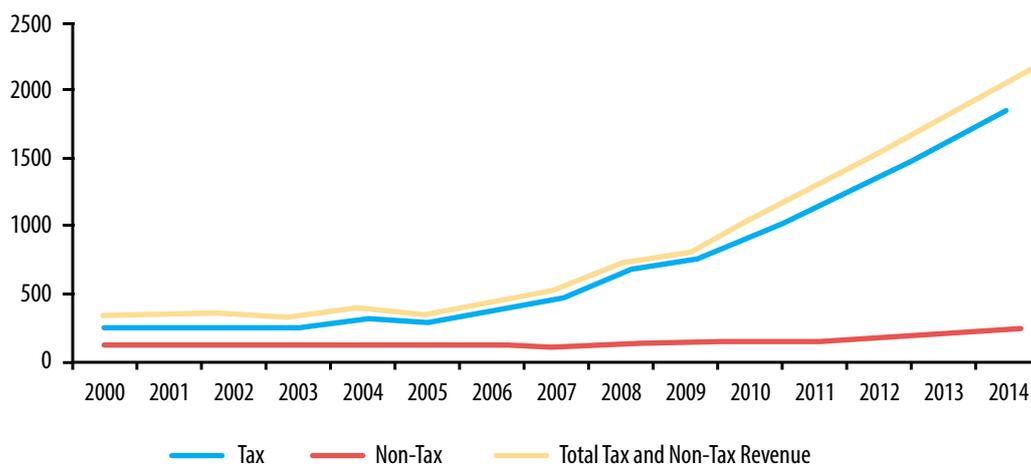
21 Government of Lao PDR, Ministry of Planning and Investment/Department of International Cooperation, "12th High Level Round Table Meeting: Background Document", November, 2015.

22 See: *Government Finance Statistics Annual Report*, various issues

these 'taxes' are fiscal revenues, but they are not necessarily taxes. The public finance definition of a tax is an involuntary levy imposed by the government to finance general government activities. There are a number of revenue items- including business licences, registration fees, and timber and hydropower royalties- which should be reclassified and reported as non-tax revenues.

Overall, tax collection in the country has improved over the years, from 1,642,139 million *Kip* in 2000/2001 to 14,665,700 million *Kip* in 2013/2014.

**Figure 3.1: Tax and Non-Tax Revenue in Lao PDR, 2000–2014 (in USD mil.)**



Sources: Government Finance Statistics Annual Report (various issues); Bank of Lao PDR Annual Reports (calculation by the author, Kip/USD Exchange Rate on 31st December)

The significant increase in tax collection is largely due to the reorganization of the tax function and establishment of the semi-independent Tax Revenue Department, and investment in Information Communications Technology. However, there is room for improvement, as the Government needs to improve the organization of tax collection, invest in education of the population on tax matters, and demonstrate value-for-money when it comes to providing public services across the country (and not necessarily only in the Vientiane Capital). It also has to ensure the simplification and harmonization of the overall tax systems. For instance, lump-sum tax is listed as a form of direct tax on the Tax Revenue Department Website<sup>23</sup>, and is not listed as a type of fiscal revenue/tax in the official government document – *Government Finance Statistics Annual Reports*.<sup>24</sup> A further area to be considered for reform would involve an effort to bring more individuals and companies within the tax net by registering those in the informal economy.

### 3.1.2. Non-tax Revenues

Unlike the increasing trend in tax revenues, in Lao PDR, non-tax revenues did not increase significantly as a proportion of public revenue between 2001–2014, as illustrated in Figure 3.1, although they have been growing particularly since 2012–2013, when new non-tax revenues were introduced. In 2012–2013, non-tax revenues in Lao PDR made up approximately 3.62 per cent of GDP. This is slightly higher than the

23 See: [http://www.tax.gov.la/Eng\\_WebPages/DirectTax.aspx](http://www.tax.gov.la/Eng_WebPages/DirectTax.aspx) [accessed Dec. 17, 2014].

24 Refer to the various issues of the *Government Finance Statistics Annual Reports*, used as a source for the WB and IMF databases

regional average of 2.5 per cent of GDP for developing Asian countries.<sup>25</sup> Improvements to the non-tax revenue classification regime to bring about more consistency would help the Government better predict how this public revenue source contributes to the overall development finance portfolio in the country.

Based on the *Government Finance Statistics Annual Report*, Lao PDR recognizes the following non-tax revenues: 1) Leasing Revenues; 2) Concessions; 3) Fines; 4) Administrative Fees; 5) Dividends; 6) Interest; 7) 'Overflight Fees'; 8) Irrigation Fees; 9) Forest Preservation Fund, and 10) Other Non-Tax Revenues.<sup>26</sup>

In recent years, non-tax revenue has grown, by about 33 per cent between 2011/12 and 2012/13, and by about 28 per cent from 2012/13 and 2013/14. In 2013/14, roughly 19 per cent of non-tax revenues were from the 'other' revenue category. It is fairly unusual that 'other' revenues are so highly represented, which suggests the need to revise the current revenue collection system. It is likely that non-tax revenues are being raised as payment for services and (public) goods received from public sector entities.<sup>27</sup>

In fact, until 2011/2012, the *Other Non-Tax Revenue* category was negligible, often reported as zero, yet it surged to make up 19 per cent of all non-tax revenues by 2013/14. It is difficult to explain such a change, except that new non-tax revenues were introduced, small in revenue capacity, but large in number and hence resulted in this surge.

In 2013/14, total non-tax revenues were 2,607,190 million *Kip*, or approximately USD 322 million, which is still relatively low, taking into consideration that the concession revenues, state enterprise dividends, and leasing revenues contribute to this amount. Similar to tax revenues, the main challenge remaining is that enterprises in the energy and mineral extracting sectors have individual contracts that provide them with a special tax regime.

### 3.1.3. Revenues from State-Owned Enterprises

It is difficult to establish the trend over time in the dividends from State Owned Enterprises (SOEs) in Lao PDR, although the *number* of SOEs has declined dramatically (by 75 per cent) since the early 1990s. In terms of recent figures of dividends from SOEs, in 2011–2012, they amounted to approximately 1.15 per cent of GDP. This is quite low, when compared to other countries in the region (for example, SoEs account for 33 per cent of GDP in Vietnam, 30 per cent in China, and about 25 per cent in India and Thailand).<sup>28</sup> Given the presence of SOEs in highly-profitable sectors in Lao PDR, there may be scope for more in-depth consideration of how to improve profitability by increasing competition and opportunities for the domestic private sector to engage in these sectors. Indeed, in discussing financing for the 8th NSEDP, MPI's background paper for the 2015 Round Table Meeting noted the need to "continue to improve, expand, upgrade efficiency and effectiveness of state owned enterprises to be strong and become basis for other sectors. Enterprises that are ineffective shall be terminated or shifted into other approach of doing business."<sup>29</sup>

State Companies, i.e. State-Owned Enterprises (SOEs) in Lao PDR are business entities that are fully owned and controlled by the State. Although the number of SOEs has been reduced by 75 per cent compared to the early 1990s (UNDP, 2006), the Government is supervising the highly profitable sectors, such as

25 ESCAP/ADB/UNDP. *Making It Happen: Technology, Finance and Statistics for Sustainable Development in Asia and the Pacific*. Regional MDG Report 2014/14, p. 29.

26 See: *Government Finance Statistics Annual Report*, various issues.

27 As confirmed during the site-visit to Lao PDR in November 2014.

28 OECD, *Policy Brief on Corporate Governance of State Owned Enterprises in Asia*, 2010.

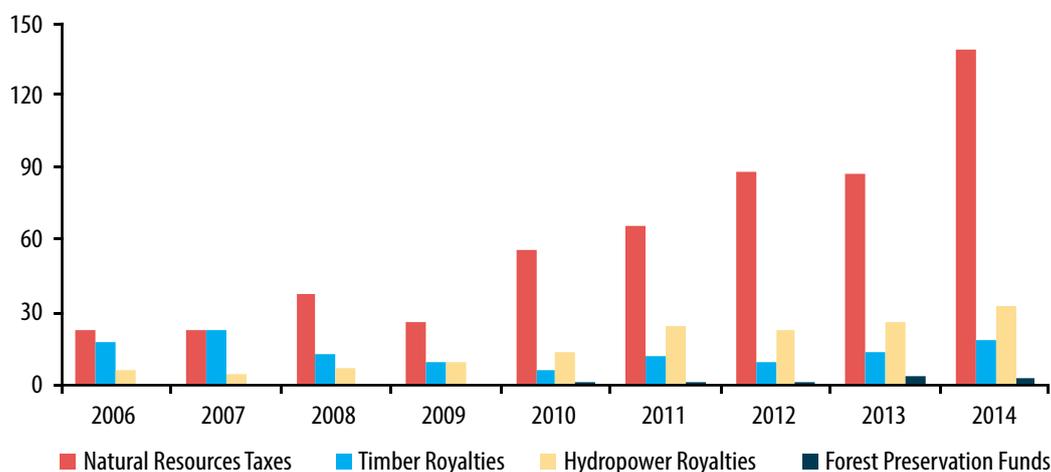
29 MPI/DIC Roundtable Background Document, pg. 45.

mining, energy, telecommunications, and banking and finance. It is very difficult to establish the efficiency levels of SOEs in Lao PDR. In most sectors there is limited competition, as joint ventures are usually the only competitor, and often the co-owner of the competitor is, in fact, the Lao SOE in the same branch of economy. Despite this advantaged position, dividends from SOEs are rather low, although until 2012–2013 they were the most significant source of non-tax revenues. In 2011–2012, dividends amounted to 763,952 million *Kip*, or approximately USD 95.5 million. Again, taking into consideration Lao PDR's economic growth and GDP, this is arguably a rather low sum to be collected from SOEs engaged in the most profitable industries. It is also possible that SOEs contribute to the Government in other ways – for instance selling products in the domestic market at subsidized prices, delaying price market corrections, or sponsoring Government activities directly.

### 3.1.4. Natural Resources Taxation and Revenue

Collection of natural resources taxes in Lao PDR has improved over the years and in 2013–2014 amounted to approximately USD 138 million. Over the last decade, the collection rate improved significantly, growing on an annual basis at a steady rate. Comparison with other countries in the region is difficult given the variation in natural resource endowments between countries. As a general matter however, it is well recognized that the wealth generated by extractive industries has the potential to contribute a great deal to the development of countries in the region. By the same token, natural resources are susceptible to rent-seeking and can strain institutional structures and the processes governing them.<sup>30</sup> Like other countries, Lao PDR will need to manage its extractive sectors, with attention to issues of transparency in both the generation and use of revenues.

**Figure 3.2: Natural Resource-Related Revenue and Tax Collection 2006–2014 (in USD mil.)**



Source: Bank of Lao PDR Annual Economic Report 2014

Lao PDR imposes a natural resources tax on the oil and gas industry (including shale exploitation), and enterprises that exploit rare and precious natural resources (metal and non-metal minerals, construction materials, peat, anthracite, etc.). Electricity (hydro-power concessions) is also subject to this tax, as are land concessions. Tobacco, coffee, tea and flower seeds are also subject to the natural resources tax, which is applied to the sale or export price and charged at a 25 per cent rate. In the case of timber products, the rate varies, depending on the quality and class of wood.

30 UNDP. *Asia-Pacific Effective Development Cooperation Report 2014*. P. 44.

Lao PDR has also announced an environment tax, which is imposed on both legal and physical persons involved in activities that are deemed to be damaging to the environment, people's health, and ecology. It is not clear what the rates will be and how the tax will be calculated and imposed (see Art. 57–58 (New Tax Law, 2012).

In contrast to the natural resources tax, hydropower and timber royalties have also grown but at a much lower rate. Hydropower royalties have grown, but do not correspond to the overall growth of the hydropower sector. Since 2008–2009 growth has intensified and amounted to about USD 33 million in 2013–14. One of the main reasons for rather low collection is that most players in the extractive industries have special individual contracts with the Government, which effectively limits their tax and other fiscal obligations.

Recently, the Forest Preservation Fund was launched, but the revenues have been rather modest, although important, as they allow investment in renewable resources. However, it is too early to assess the impact that the Fund will have on both the management of forests, and investment in the new renewable forest resources.

### Box 3: Timor-Leste Petroleum Fund

In 2005 Timor-Leste established a petroleum fund to manage resources from the petroleum sector. The Timorese economy is highly dependent on petroleum; in 2010 revenues from the sector accounted for 73 per cent of national GDP. The fund was established to prudently manage revenues from the sector, stabilize government revenue, and shield the economy from variations in prices and production.

The fund is structured such that transfers to the government cannot exceed a maximum Estimated Sustainable Income (ESI) without approval by parliament. To do this, the government must first undertake an audit on the impact of excessive withdrawals on the future ESI and justify the withdrawals. This has been an area of some debate; at its core lie questions about appropriate levels of investment and alternative sources of revenue.

The ESI model is based on the Norwegian Sovereign Wealth Fund model. However, levels of investment in Timor-Leste, a country with a recent history of conflict and without a long history of public investment, may be justifiably higher. On the other hand, there are risks of the economy overheating, of Dutch disease and limits to the absorptive capacity of government. Extending transfers beyond the level at which they can be used effectively risks a waste of resources and opportunities for corruption. There is an impetus therefore for improving budget execution and strengthening the capacities of public institutions to spend effectively.

The Timorese experience in managing its petroleum resources has been widely regarded as a success. In 2012 the assets of the fund amounted to USD 11.8 billion (about USD 10,700 for every person in Timor-Leste), and the fund successfully shielded the economy from fluctuations in international markets including shocks to international financial markets in 2008. Despite success of the fund, there are questions about diversification of the economy. Timor-Leste's economy is heavily reliant on the fuel sector and without development of non-fuel sectors, pressures on the Petroleum Fund as a source of revenue are exacerbated.

Source: Asia-Pacific Effective Development Cooperation Report 2014

Globally, as well as in the region, there is significant experience and lessons on the management of revenues from natural resources and extractive industries, including from the establishment of natural resources funds. Box 3 shares the experience from Timor-Leste's Petroleum Fund and Box 4 speaks more broadly to issues for consideration in looking at such funds as a potential instrument for managing natural resource revenue.

While the above sections look at specific characteristics, trends, and issues related to certain individual flows of domestic public finance in Lao PDR (tax, non-tax, SOEs, and mineral related revenues), at this juncture it is appropriate to make some overall observations about public revenue and expenditure in the context of the NSEDP goals.

First, while there may be targeted measures which can be taken to strengthen and improve management of individual flows (e.g. actions to further improve tax collection rates), the Government will also need to stay the course on more overarching Public Financial Management reforms aimed at improving the planning, budgeting, and monitoring processes to ensure efficient use of public revenues to achieve the development goals in the 8th NSEDP. Box 5 describes some of the reform efforts underway that are being supported by development partners.

Second, existing evidence and analysis suggests that the context of Lao PDR's high GDP growth, which has been driven by the natural resource sectors, poses challenges for how the Government manages its revenues in a way which is consistent with policy objectives of poverty reduction. A working paper by ADB<sup>31</sup> has provided very relevant insights in this regard. On the one hand, it notes that the proceeds from natural resource-based exports are accruing primarily to the Government, with the increase in Government revenue from 11 per cent to 19 per cent of GDP over the past 80 years due mostly to mining and hydropower revenues. At issue is how these revenues can be used to benefit the Lao people.

ADB's analysis points to a need for a more gradual rate of absorption of these resources into the domestic economy, and finds that the Lao PDR economy does have characteristics of 'Dutch disease', whereby the domestic absorption of natural resource revenues undermines competitiveness of other domestic industries. Policies to slow the rate of absorption, and instruments such as natural resources funds, could be an option, and would also give the Government more time to consider how best to use natural resource revenues wisely.

The paper – issued in 2013- also discusses the fact that the revenues available to the Government of Lao PDR are not being absorbed domestically in the form of increased spending on social sectors (health and education) or increased spending on rural areas including spending on agriculture sector, from which about 80 per cent of the population derives their income. [More recent data finds that in FY12/13 and 13/14 spending on education and health sectors expanded but this was due mostly to recurrent spending increases from the rise of the wage bill.<sup>32</sup>] This and other studies also observe that while Lao PDR has seen a significant decline in the rate of absolute poverty, this has taken place in a context of widening inequality: "on average, the poor have gained in absolute terms from economic growth, but the non-poor have benefited proportionately more."

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31 Menon, J. and P. Warr, "The Lao Economy: Capitalizing on Natural Resource Exports", ADB Economics Working Paper Series No. 330, January 2013.

32 See World Bank: *Lao Economic Monitor 2015*, p. 22.

#### Box 4: Natural Resource Funds

The Natural Resource Governance Institute (NRGI) and the Columbia Center on Sustainable Investment (CCSI) surveyed 22 natural resource funds worldwide, looking at issues of fund management, investment, transparency and accountability to the public, and the fiscal rules that govern them. While it is impossible to summarize the rich analysis and discussion in a short space, the project did have some headline findings and recommendations.

Key findings included the fact that natural resource funds are increasingly popular, with 34 of the 58 currently active funds having been established since 2000, with national authorities in over a dozen countries planning new funds. The project made clear recommendations to governments establishing or maintaining such funds:

1. Set clear fund objective(s) (e.g. saving for future generations; stabilizing the budget; earmarking natural resource revenue for development priorities)
2. Establish fiscal rules- for deposit and withdrawal- which align with the objective(s)
3. Establish investment rules (e.g. a maximum of 20 percent can be invested in equities) that align with the objective(s)
4. Clarify a division of responsibilities between the various authorities and managers of the fund, and set and enforce ethical and conflict of interest standards
5. Require regular and extensive disclosure of key information and audits
6. Establish strong independent oversight bodies to monitor fund behaviour and enforce the rules

Additionally, the findings included discussion on the relationship between such funds and the national budget process. It found that most governments permit domestic spending directly through their funds' choices of asset holdings rather than through the budget process. This has undermined parliamentary accountability and public financial management in some countries. The authors argue that, contrary to conventional wisdom, because of the risks associated with their existence outside the ordinary budget process, domestic spending of natural resource revenues should be made via withdrawals from the fund to the general or consolidated account, and can even be earmarked for specific health, education, infrastructure, or sector-specific projects to encourage spending on development priorities.

Source: Bauer, Andrew (ed.), "Managing the Public Trust: How to Make Natural Resource Funds Work for Citizens", Natural Resource Governance Institute and Columbia Center on Sustainable Investment, 2014.

What has emerged from this analysis is very relevant to decision making on expenditures in the Lao context of natural-resource based economy. First, there is a strong argument for slowing the absorption of natural resource-based revenues in order to allow considered decisions about their use with a view to the long term. Second, review of current expenditure priorities suggest a need for adjustment if social and poverty reduction goals are to be met.

### Box 5: Linking Finance to Results: Strengthening the Planning and Budgeting Processes through Public Sector Management Reforms

Assessments of Lao PDR's Public Financial Management (PFM) systems have pointed to the range of improvements required to effectively link the planning and budgeting systems in support of achieving national development goals outlined in the NSEDP. The 2010 Public Expenditure and Financial Assessment (PEFA), for example, discussed the ambitious reform agenda contained in the Public Financial Management Strengthening Program (PFMSP), encompassing reforms to budgeting, taxation, Treasury function, financial reporting, and procurement, among others. The PEFA report described an overall weakness in policy-based budgeting which precludes attempts to link financial resources with development outcomes. Analysis by ADB has similarly noted the problematic lack of strategic linkages between planning and budgeting, leading to the inefficient allocation of resources, as well as the need for more effective institutional coordination between key institutions involved in the planning and budgeting processes.

With the support of ADB, the World Bank, and other development partners, Lao PDR is in the process of strengthening the linkages between policy, planning, and budgeting, having recognized the need for a multiyear perspective on expenditure policy and budgeting in order to align with the development priorities identified in the NSEDP.

These reform efforts, while necessarily long-term and complex, are critical for ensuring that the national budget is the platform for linking public sector revenues and development results. Indeed, ensuring effective planning and budgeting systems will be central to the incremental process of formulating Integrated National Financing Frameworks (INFFs) as envisioned in the Addis Ababa Action Agenda, the outcome document of the *3rd International Conference on Financing for Development*, held in 2015. The DFAA proposed to contribute to this process in Lao PDR by providing an overview of the entire landscape of development finance, to inform current and long term thinking on managing the envelope of resources, and to complement ongoing work on Public Financial Management.

Sources: Public Expenditure and Financial Accountability Report 2010; ADB Country Partnership Strategy Lao PDR 2012–2016; ADB Technical Assistance Report: Support for Governance and Capacity Development, December 2015.

### 3.1.5. Public-Private Partnerships

Public-private partnerships (PPP) are a relative new concept in Lao PDR. The Government has been considering PPPs as a means to develop infrastructure and enhance service delivery to the population. It is well recognized that in Lao PDR the physical infrastructure needs improvement and there are a number of infrastructure projects where the Government would like to see private investors participating by developing the infrastructure and utilizing it under favorable conditions for a number of years, before it is transferred to the public sector. This focus on developing PPPs to invest in infrastructure is broadly in line with regional trends, which show that in Asia, 43 per cent of PPP projects were in the energy sector, followed by transportation with 27 per cent.<sup>33</sup>

33 ESCAP/ADB/UNDP. *Making It Happen: Technology, Finance and Statistics for Sustainable Development in Asia and the Pacific*. Regional MDGs Report 2014/15. P. 46.

While anecdotal reference claims that there are a number of PPPs across Lao PDR, there was little data to validate these claims. In fact, in both infrastructure and the social sectors, what is called PPP is, in fact, joint venturing where the Government invests in a project (often in kind) and usually a foreign partner makes the financial contribution. At present there are certain projects where public and private entities are partnering, but the modalities of their cooperation are more likely to contain some characteristics of PPPs, rather than operating as a PPP. The Government itself admits that across sectors there are a number of collaborative projects that may have some characteristics of PPP. It was expressed during the interviews that PPP is already operating in the hydropower sector and the health sector and Box 6 discusses the Nam Theun 2 hydropower project. Both the Asian Development Bank (ADB) and the World Bank have agreed to support the PPP efforts, especially in the infrastructure sectors (roads, hydropower, etc.).

### Box 6: Lao PDR Experience in PPP: Nam Theun 2

Lao PDR has experience in PPPs in the hydropower sector since 2009. The Nam Theun 2 hydropower station was established using the Build-Own-Operate-Transfer (BOOT) model of PPPs. The power station is managed by a single purpose company with the following ownership structure:

1. Électricité de France International (EDFI)	35%
2. Government of Lao PDR (GoL)/Lao Holding State Enterprise (LHSE)	25%
3. Electricity Generating Public Co. (EGCO), Thailand	25%
4. Italian-Thai Development Public Co. (ITD), Thailand	15%

The plant exports 95 per cent of the electricity produced to Thailand whilst 5 per cent is for domestic use. The concession period is 25 years from the start of operations. The estimated total cost is USD 1.45 billion.

As noted by the World Bank, “annual operational targets for supply - both to the Electricity Generating Authority of Thailand (EGAT) and Électricité du Laos (EDL) - have been exceeded during each year of commercial operations to date. In 2013, a total of 5,897 GWh (compared to a target of 5,354 GWh) were generated for EGAT and 378 GWh (compared to a target of 300 GWh) for EDL. All six generation turbine units are in operation. Revenues from the sale of electricity generated by NT2 to Thailand and domestically are flowing as planned.” (World Bank, 2014d, p. 10).

PPP requires robust regulation before it can become a significant driver of economic development in the country. The development of such regulation is necessary in order to ensure that the interests of the foreign party and that of the Government are protected and that the rewards are balanced with risks. Indeed, the Government has initiated a process, with the support of ADB, to formulate a policy framework for PPPs in the country. In December 2013 the document *Initial Conceptual Framework and Roadmap for Public-Private Partnerships in Lao PDR* (see: MPI, 2013) was developed, which provides a very broad definition of PPPs and recognizes the lack of any legal framework for PPP in Lao PDR.

With the help of the ADB, the Government is currently developing an overall framework to guide the development of additional PPPs, including supporting institutional capacity development. As noted by the Department of Investment Promotion, “In order to facilitate PPP initiatives, a task force unit called the PPP Unit has been established within the Department of Investment Promotion. The task force is responsible for initiating policy and legislation development and piloting PPPs on education and healthcare. The task force has worked closely with the government concerned agencies, ADB, international

organisations, civil society and the private sector.”<sup>34</sup> A Decree is also being formulated to govern PPPs, with the Government defining a PPP as having five essential characteristics:

1. “A medium- or long-term contractual arrangement between a Public Agency and a Private Body.
2. For delivery of a public service or infrastructure for which the Public Agency remains accountable.
3. Where the required service or infrastructure is specified as an Output.
4. Where significant risks are transferred to the private firm, making its private investment and financial returns linked to its performance.
5. That it is procured through a competitive procurement process.”<sup>35</sup>

Looking ahead, it is clear that PPPs can be a solution to certain development challenges, but determining the right kind of PPP – if a PPP model is appropriate at all – requires a careful process of matching a project to a particular PPP model. It also requires extensive upfront due diligence of the risks, potential public benefits, and associated costs, both financial and social. In the case of Lao PDR, the enabling environment for managing PPPs must be in place. This includes a legal framework that covers a range of issues and the capacity within government to procure and monitor a PPP tender up to international standards. As noted in Box 7, there are a wide range of interrelated legal and capacity issues to be addressed before issuing PPP tenders. A description of PPP modalities and risk considerations are included in Annexes 5 and 6. Box 8 presents an example of how one of Lao PDR’s development partners- Japan- is looking to support PPPs in the country.

#### **Box 7: Establishing the Enabling Environment for PPP Procurements**

The OECD and European Commission have each developed guidelines for developing PPPs. As part of these guidelines, they have developed a list of issues that must be addressed to support the development and implementation of a successful PPP. The issues identified are listed below.

- Legal capacity of the parties and the legal requirements of the state to provide services
- General legislation determining the role of the private sector in providing public services
- Legislation clearly setting the conditions for participation of foreign companies or financial institutions
- The existence of a legal basis for cost recovery mechanisms
- The ability to provide guarantees to the private contracting parties over the period of their involvement
- Clear land and property rights including intellectual property laws
- Clear land acquisition rules
- Planning permission requirements
- Licenses
- Transparency of national laws
- Administrative capacity to negotiate and follow the contracts
- Provisions for dispute settlement

34 <http://www.investlaos.gov.la/>

35 <http://www.investlaos.gov.la/>

- The role and requirements for any state finance participation
- Clear competition and antitrust legislation
- Clear labor and social security laws
- Clear tax and accounting liabilities
- Open and clear procurement procedures with very clear project specification requirements
- Rights to step in in the event of project failure and availability of alternative contractors
- Reputation (environmental, social) of the projects
- Credit standing of the public sector counterparty
- Certainty of the project cash flows to meet debt service requirements

Source: van der Geest, Willem and Nunez-Ferrer, 2011, p. 17.

### **Box 8: Japan's Approach to Supporting Infrastructure Investment in Asia**

Through its program "Partnership for Quality Infrastructure", Japan has announced in 2015 that it will be providing, in collaboration with the Asian Development Bank, approximately USD 110 billion (about a 30 per cent increase) for 'quality infrastructure investment' over a five year period. The Government of Japan has reached out the Government of Lao PDR in 2016 to discuss participation in the program.

According to program documents, the initiative intends to support infrastructure investment by bringing together a range of partners and financing sources, and by developing and strengthening mechanisms to attract private funding to infrastructure in Asia. Key program components include increasing Japanese ODA for infrastructure by 25 per cent and enhancing JICA's Private Sector Investment Finance, as well as utilizing new types of ODA loans to provide capital and guarantees for PPP infrastructure projects. The program also is considering new collaboration mechanisms between ADB and JICA to facilitate the use of PPPs for infrastructure investment. A third pillar of the program involves empowering the Japan Bank for International Cooperation to actively provide funding for PPP infrastructure projects with relatively high risk profiles, such as those without a guarantee from government to support payment obligations.

A second, but related Japanese program is the "Industrial Human Resource Development Cooperation Initiative". Through a public-private-academia collaboration, it will support industrial human resources development of 40,000 people in Asia over a three year period. The focus will be on sharing Japanese expertise, through vocational training and study programs in Japan, in areas such as PPP, management and planning skills, and training for government officials responsible for industrial policies.

Source: Program documents shared by Ministry of Planning and Investment, Department of International Cooperation

## 3.2. Domestic Private Finance

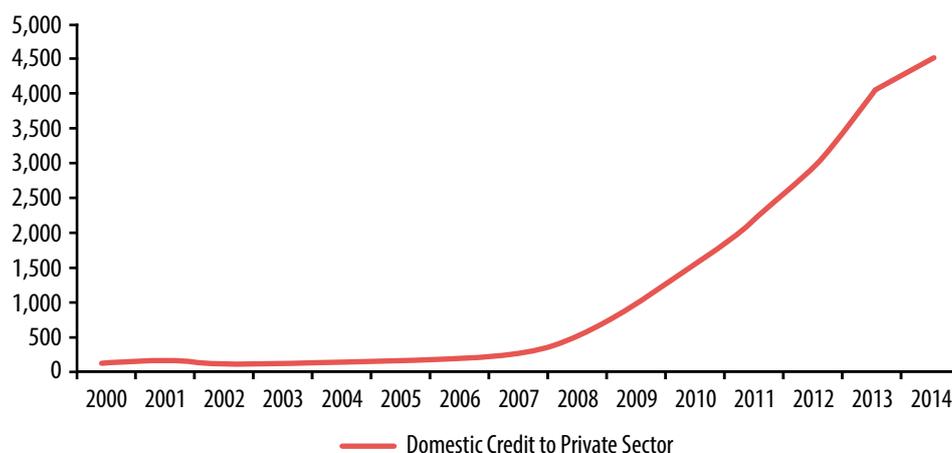
### 3.2.1. Domestic Private Sector Investment

The role of the private sector in contributing to development objectives is well recognized. In Lao PDR, as in many other developing countries, there has been a great deal of attention to the importance of attracting FDI (see section on FDI in Chapter 4). Equally important is the growth of the domestic private sector. This section will consider trends in domestic private sector investment, with a view to illuminating key factors which will enable the growth of the domestic private sector in Lao PDR to contribute to national development priorities. The ‘story’ to be explored, therefore, is one not just of aggregate growth, but one which must also consider issues of inclusivity, sustainability, and equity in how available finance is being invested and utilized.

A first aspect of the dynamics in the domestic private sector to be discussed is the trend of increasing availability of domestic credit and access to financial and banking services. Since the liberalization of the economy, the banking and financial sector in Lao PDR has grown significantly, both in terms of resource mobilization and physical expansion. While the branch network is still limited and many highland areas are underserved, the number of those who have been excluded from mainstream finance has been declining. Currently there are 32 banks operating in the country and over 120 micro-financial organizations.<sup>36</sup> The range of banking and financial services offered has been improving, and the increase in deposits in domestic currency generally demonstrates the trust of the public in the banking/financial system.<sup>37</sup>

Domestic credit has also increased significantly in recent years. The World Bank’s Investment Climate Assessment 2014 report found that domestic credit provided by the banking sector as a percentage of GDP has been growing at a “torrid pace”: Lao PDR experienced a 194 per cent increase in that share between 2000 and 2010. Nonetheless, it is important to qualify this trend by noting that domestic credit provided by the banking sector as a share of GDP was 26.5 per cent in 2010, making Lao PDR among the lowest among comparator countries looked at in the assessment (the highest, Vietnam, was 135.8 per cent).<sup>38</sup>

**Figure 3.3: Domestic Credit to Private Sector, 2000–2014 (in USD mil.)**



Source: Bank of Lao PDR Annual Economic Reports

<sup>36</sup> Bank of Lao PDR Annual Report, 2013.

<sup>37</sup> In 2013, deposits increased by 20.11 per cent. In 2011 and 2012 the growth was about 30 per cent and in 2010 it was approximately 84 per cent (Bank of Lao PDR, 2012; 2013; 2014).

<sup>38</sup> World Bank (2014f), *Lao PDR Investment Climate Assessment 2014: Policy uncertainty in the midst of a natural resources boom*, December 2014, p. 62.

At issue, however, is whether this increase in domestic credit and availability of financial services is being translated into investment in the domestic private sector. While access to financing has been identified as one of the main constraints to starting or expanding a business,<sup>39</sup> the World Bank has found that this financial constraint is weakening in Lao PDR. While in 2009 Lao PDR had one of the lowest shares of firms having a bank loan in the region, there was a 65 per cent increase between 2009 and 2012, situating Lao PDR closer to the 2009 regional average.<sup>40</sup> At the same time, a more nuanced picture emerges when considering relative access to finance based on firm size, with larger companies finding easier access to bank financing, and small, medium, and micro enterprises being more likely to turn to alternative sources including money lenders and family members.<sup>41</sup>

The challenge of promoting inclusive finance in the context of a domestic private sector characterized by a large proportion of SMEs is not unique to Lao PDR, as other developing countries in the region have also had to look at inclusive financing options. See, for example, Box 9 which discusses Vietnam's experience and Box 10 on Bangladesh's experience. Lao has received support from development partners, including UNCDF and ADB, on microfinance and improving rural access to finance.

Looking ahead to the period of the 8th NSEDP and beyond, there are a number of factors which will need to be taken into account if growth in the domestic private sector is to be aligned with principles and practical realities of promoting sustainable development in Lao PDR. For one, it is well recognized that while investment in natural resource-related sectors has contributed to continued high annual GDP growth rates, these sectors can pose risks to environmental sustainability efforts and do not tend to translate into high numbers of jobs being created. The long term policy planning will need to reconcile short term gains with longer term, pro-poor strategies. The latter will involve continued efforts to improve the business environment and access to finance for SMEs. It will also require, as noted in the 2015 Lao Economic Monitor, attention to raising agricultural productivity, given that the majority of the workforce is currently engaged in the agricultural sector. As lending is currently led by construction and commerce sectors, looking ahead, banks may want to evaluate carefully whether they are lending to the right mix of growth sectors vis-à-vis the priorities set out in the 8th NSEDP.

#### Box 9: Domestic Finance and Enterprise Investment in Vietnam

The Development Finance and Aid Assessment for Vietnam, published in 2014, found that one of the key challenges faced by the Government of Vietnam is related to mobilizing finance for the development of the domestic private sector. The DFAA found that a disproportionate share of lending from the Vietnamese banking sector goes to SOEs, despite their low investment efficiency, suggesting that a significant proportion of available credit in Vietnam is being poorly used.

At the same time, the domestic private sector is growing. Its contribution to GDP has grown faster than that of either SOEs or foreign companies. Yet private companies are still largely small and proprietor-financed, and they face a range of barriers in accessing credit from the financial sector. These include complicated procedures and strict collateral requirements, as well as the crowding-out effect of high SOE borrowing. As a result, the domestic private sector has limited capacity to higher value-added activities.

Source: Development Finance for Sustainable Development Goals in Middle-Income Vietnam (Vietnam DFAA), Vietnam Ministry of Planning and Investment, Hanoi, 2014.

39 For example, the *HRDME Enterprise Survey 2013 for Lao PDR* found that firms perceive lack of capital to be a significant constraint. Other constraints to accessing credit include complex application procedures, high collateral requirements, and high lending rates.  
 40 World Bank (2014f), p. 62.  
 41 GIZ, *HRDME Enterprise Survey 2013*, p 21.

### Box 10: Inclusive Business Finance in Bangladesh

There are various options for inclusive business finance in Bangladesh. Lending from formal banks has increased, as the economic importance of non-formal sectors and MSMEs is well recognized, including the contribution to employment generation. In 2009, the Bank of Bangladesh initiated a lending target of USD 3 billion to boost formal credit for MSMEs; by 2012 this target had more than doubled to USD 7.37 billion.

The Bangladeshi microfinance sector is also mature and there are thousands of Micro Finance Institutions (MFIs) working in the country, which provide mostly small, un-collateralized short-term loans. Credit services by MFIs include general microcredit, microenterprise loans, seasonal loans, and loans for disaster management. Interest rates vary between MFIs but are capped at 27 per cent per annum. Bangladesh also has an SME Foundation which has been set up to provide advice to MSMEs, in areas such as entrepreneur capacity building, market expansion for products, and guidance on establishing a new business.

Social enterprises are also emerging as an innovative inclusive finance source. They employ business approaches to address social and environmental problems. Bangladesh has a strong history of social enterprise, with national level organizations like BRAC and Grameen Foundation having used social enterprise as an effective tool to alleviate poverty. Social enterprises mobilize finance from High Net Worth Individuals, private equity, development finance institutions, and debt financing from public and private banks.

Source: Government of Bangladesh, Strengthening Finance for the 7th Five Year Plan and SDGs in Bangladesh: Findings from an Independent Development Finance Assessment, March 2016

## 3.2.2. Domestic Philanthropy and Corporate Social Responsibility

Private philanthropy, both internal and external, is still in the nascent phase of development in Lao PDR, but is growing slowly but steadily, although data on these flows is not well captured at present. The trend of upward growth of private philanthropy in Lao PDR is broadly in line with global and regional trends. The 2014/15 regional MDGs report found that “while other sources of development financing, particularly foreign aid, are under pressure, private philanthropy appears to be growing. In 2012, for example, while ODA to Asia and the Pacific was USD 33 billion, and South-South ODA was around USD 7 billion, private philanthropy finance was around USD 39 billion.”<sup>42</sup>

Corporate Social Responsibility (CSR) reflects some similar characteristics. Namely, while data on trends in CSR in Lao PDR is limited, regional upward trends suggest that CSR may be an area of under-tapped potential for contribution to development. CSR, a new concept for Lao PDR,<sup>43</sup> requires a certain level of economic development before it becomes a feature of a company’s corporate policy. Often, key initial motives for engaging in CSR are fiscal in nature, as the tax legislation allows certain expenses to be tax deductible. In Lao PDR, while appreciation of CSR is slowly being recognized in the corporate and business culture, it is still in a very early phase. In Lao PDR at the moment there is no legal framework or special tax regulations. The Government may want to consider integrating incentives in the existing tax

42 ESCAP/ADB/UNDP. *Making it Happen: Technology, Finance and Statistics for Sustainable Development in Asia and the Pacific*. Regional MDGs Report 2014/15. p. 44.

43 UNDP Lao PDR has supported the organisation of the first national forum on CSR in 2012. See more at: [http://www.la.undp.org/content/lao\\_pdr/en/home/presscenter/articles/2012/03/12/corporate-social-responsibility-csr-framework-is-vital-to-ensure-sustainable-and-equitable-development/](http://www.la.undp.org/content/lao_pdr/en/home/presscenter/articles/2012/03/12/corporate-social-responsibility-csr-framework-is-vital-to-ensure-sustainable-and-equitable-development/)

law and legal framework. It is well documented in other countries that companies which are afforded tax advantages are more likely to be actively engaged in CSR activities.

Looking ahead at ways to further incentivize CSR, Lao PDR may consider looking at models being adopted in other countries. In India for example, the Government has made it mandatory for companies to spend 2 per cent of profits on activities which include sustainable development priorities.<sup>44</sup> In Bangladesh, there are several developments on the CSR front, such as including CSR in the development of a new Industrial Policy, and the drafting of a National CSR Guideline involving collaboration of several ministries, NGOs and development partners. Bangladesh also has raised significant resources through “CSR Funds”: one-time donations for national events or disasters which are mandatory for all financial institutions and are managed by the Bangladesh Bank. Since 2011, over USD 250 million has been raised through this modality.<sup>45</sup>

Given the recent adoption of the Sustainable Development Goals, and discussion around financing at the *3rd International Conference on Financing for Development* in 2015, there has been significant attention to the role of the private sector in contributing to the achievement of the SDGs. As such, it may be opportune to look at deepening and expanding dialogue in Lao PDR with leading private sector corporations around the need for private sector contribution, and potential modalities and appropriate enabling policy framework in the Lao context. For such dialogue to be productive, there is a need for data and evidence of existing CSR initiatives in the country. Also of importance will be identifying common drivers and incentives between Government, private sector, and society, and working from that basis to find policy solutions to encourage private sector to investment in development. Such an approach would be in line with more modern and emerging understandings of CSR, which go well beyond viewing CSR as largely about charity and public relations, and focus more on a private sector entity’s responsibility to operate as a stakeholder in the longer term sustainable development agenda.

Indeed, a 2013 ESCAP report<sup>46</sup> noted that new ways of thinking about CSR require a shift in how business is done, towards adopting sustainability criteria- and due reporting- as an essential part of corporate strategy on which the long-term survival of the business depends. Furthermore, while there are multiple international instruments for evaluating corporate sustainability/responsibility, there is a need for convergence of these instruments to reduce reporting requirements and induce businesses to take sustainability seriously, as well as make it easier to report on their progress. The report also highlighted the importance of the role of Government to influence outcomes (such as the way licenses and contracts are awarded); develop local tools; and apply a certification mechanism. As policy-makers and stakeholders in Lao PDR consider locally appropriate measure to further incentivize CSR and overall concepts of sustainability in the private sector, these may be factors to keep in mind in promoting dialogue and action in this area of potential development finance.

44 ESCAP/ADB/UNDP. *Making it Happen: Technology, Finance and Statistics for Sustainable Development in Asia and the Pacific*. Regional MDGs Report 2014/15. p. 45.

45 Government of Bangladesh, *Strengthening Finance for the 7th Five Year Plan and SDGs in Bangladesh: Findings from an Independent Development Finance Assessment*, March 2016, pp. 52–54.

46 Economic and Social Commission for Asia and the Pacific (ESCAP), *From Corporate Social Responsibility to Corporate Sustainability: Moving the Agenda Forward in Asia and the Pacific (Studies in Trade and Investment No. 77)*, 2013, pp. 6–8.

# Chapter 4. External Finance

## 4.1. External Public Finance

External finance has played a major role in supporting economic development in developing and transitional countries, especially in the very early stages, when domestic resources may be limited or missing. External finance can help bridge the capital gap, as well as the skills/capacity gap, by bringing knowledge and skills into the country that are not found in the domestic labor market and supporting institutional reforms to create an enabling environment for sustainable capacity development.

In Lao PDR, the Round Table Process (RTP) serves as a national platform for promoting effective partnerships and mutual accountability of both Government and development partners on development cooperation. MPI/DIC, acting as a national secretariat for the Round Table Process, has been successful in supporting the RT process and especially the Round Table Implementation Meeting (RTIM). There are, however, some areas for potential improvement in the mechanism. For example, there are some inconsistencies with how the Sector Working Groups (SWGs)- which are primarily line ministry focused- are organized. Some line ministries engaged with SWGs have international development coordination units, whilst others do not.

While technical coordination of the RTP has been performed by DIC/MPI, it is not clear how policy coordination is executed. Steering committees may be established to implement national strategies, but they are often constituted with a mixture of technical and politically appointed staff. There is also room for improvement in defining the mandate and division of labor between the various institutional mechanisms related to the RTP. For instance, in some cases the RTM has performed duties which the steering committees could have performed. There have also been instances where issues have been raised to RTM and/or RTIM level that could have been addressed more effectively in other supporting fora (SWG, etc.).

Lao PDR signed the Vientiane Declaration on Aid Effectiveness with development partners in 2006. Based on the Paris Declaration on Aid Effectiveness, it is focused on the Lao PDR context and stipulates that the Government and development partners are responsible and accountable for their actions and committed to working together. The Declaration also ensures government leadership of the development agenda, on behalf of the people of Lao PDR, and is based on five principles: 1) increased country ownership of policy, implementation and priorities; 2) improved alignment of development partners' support to national policies and plans, and increased support to and use of national systems; 3) harmonization and simplification of development partners' procedures and activities; 4) endorsing principles of managing for results in order to ensure the effective use of resources and 5) both Lao PDR Government and development partners are accountable for progress.

In 2015, nearly ten years after the signing of the Vientiane Declaration on Aid Effectiveness, at the 12th High Level Roundtable Meeting in November 2015, Lao PDR and some of its development partners signed the Vientiane Declaration on Partnership for Effective Development Cooperation (2016–2025). This new Partnership Declaration notes progress made in implementing and localizing the 'core principles' of aid effectiveness since 2006, but explicitly recognizes the changing context of development finance and the need for systems and institutions which can effectively manage sources of development finance beyond

ODA. Specifically, the new Declaration discusses the need to strengthen domestic resources mobilization (public and private), south-south and triangular cooperation, and foreign direct investment. It also makes reference to the importance of strengthening and promoting inclusive partnerships, including with civil society, Southern partners, and private sector.

As a follow up to the signing of the new Partnership Declaration, the Government of Lao PDR (MPI) is in the process of developing a Country Action Plan, which will need to address the challenge of monitoring implementation of the new Declaration. The challenges notwithstanding, the underlying thinking of the new Declaration, and particularly its reference to the need to utilize all sources of financing for development is recognized:

*“Maximizing the synergies, taking advantage of the complementarities and building on the optimal interplay of all sources of financing and resourcing is essential to make this development effectiveness partnership a success. The manner and extent to which we align our resourcing and policy frameworks to achieving sustainable and inclusive development in Lao PDR is central to our common agenda moving forward.”<sup>47</sup>*

#### 4.1.1. Official Development Assistance (ODA): Grants and Loans

ODA to Lao PDR has increased since the early 2000s, reaching USD 525 million in 2014, up from a level of USD 394 million in 2000. According to OECD projections, ODA is expected to continue to remain steady in the coming years, increasing again up to USD 526 million in 2018 after falling to USD 477 million in 2015. This is in line with the commitment from OECD/DAC countries to prioritize Least Developed Countries, which was reiterated at the 2015 Financing for Development Conference in Addis Ababa. In terms of comparative performance, Lao PDR is the 10th largest beneficiary of ODA in Asia, well behind countries such as Cambodia (USD 795 million in 2014) and Nepal (USD 974 million in 2014)<sup>48</sup>. However, given its relatively small population size, Lao PDR fares better in terms of ODA per capita. With USD 64 per head, Lao PDR comes at the top of the list, behind Afghanistan, Bhutan, Mongolia and Timor-Leste. As a share of GNI at 4 per cent, Lao PDR is similar to most other countries that are important beneficiaries of ODA in Asia.<sup>49</sup>

In terms of composition, trends have not changed over the past 10 years. The majority of aid to Lao PDR is made up of grants, with only 4 per cent of aid provided as concessional loans. About a third of ODA comes from multilateral partners. The most important sectors include: economic infrastructure (16 per cent), governance and civil society (16 per cent), education (15 per cent) and health (11 per cent).<sup>50</sup> The 10 largest providers provided about 80 per cent of ODA to Lao PDR. ODA commitments in 2014 indicate that 32 different providers financed 1222 projects, suggesting fragmentation of resources across a large number of projects.<sup>51</sup>

While ODA was initially the most important source of funding, especially for social development and infrastructure, the relative levels of ODA has declined with the growth of external private finance flows

47 *Vientiane Declaration on Partnership for Effective Development Cooperation*, p. 9.

48 OECD-DAC Country Programmable Aid (CPA). Note: CPA is the portion of aid that providers can program for individual countries or regions, and over which partner countries could have a significant say. CPA is a closer proxy of aid that goes to partner countries than the concept of ODA.

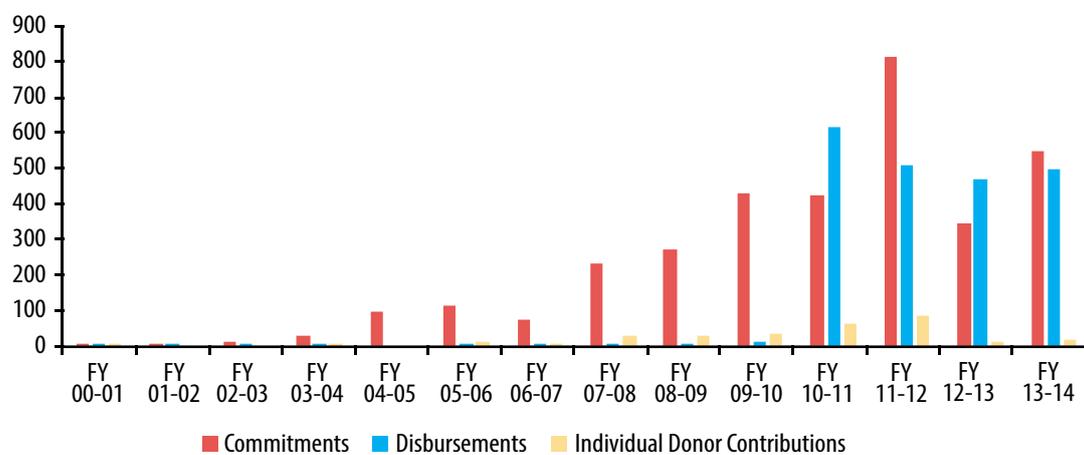
49 World Bank: World Development Indicators.

50 OECD-DAC: Country Programmable Aid database.

51 OECD reporting system.

(primarily FDI). This trend is likely to continue. As Lao PDR graduates from LDC status, it may no longer have access to priority funding from many DAC members that may consider focusing their resources on other less developed countries. However, at the same time, graduation from LDC status may open more opportunity for Lao PDR as it becomes eligible for non-concessional funding from both its bilateral partners using loan instruments (e.g. France, Germany, Japan and Korea) and multilateral agencies (e.g. Asian Development Bank and World Bank). As the country looks ahead to LDC graduation and considers its potential impact in terms of access forms of finance and the most appropriate allocation of existing forms of finance including ODA, it may be useful to learn from the experiences of other countries. Box 11 describes Vietnam's approach to managing these issues, which were discussed in the DFAA study completed in 2014.

**Figure 4.1: ODA Disbursements in Lao PDR- Historical Trend (in USD mil.)**



Source: Aid Management Platform; Lao PDR

#### 4.1.2. Other Official Flows (OOFs)

Other official flows include transactions by the public sector (either governments from OECD countries or multilateral agencies) which not meet the conditions for eligibility as ODA. This is either because they are not primarily aimed at development, or because they have a grant element of less than 25 per cent.<sup>52</sup>

Most donors with the exception of France and ADB do not provide OOFs to Lao PDR, which is eligible for concessional funding given its LDC status. OOFs have increased from USD 33 million in 2010 to 204 million in 2014,<sup>53</sup> of which export credits are very limited, representing less than USD 10 million every year. OOFs are likely to continue to grow, as data shows new commitments from IFC since 2013.<sup>54</sup> Also, as Lao PDR graduates from LDC status by 2020, the country may become eligible for non-concessional lending from a broader range of development partners. Last but not least, discussions under way in the OECD Development Assistance Committee on Total Official Support for Sustainable Development

52 This category includes, by definition: export credits extended directly to an aid recipient by an official agency or institution ("official direct export credits"); the net acquisition by governments and central monetary institutions of securities issued by multilateral development banks at market terms; subsidies (grants) to the private sector to soften its credits to developing countries; and, funds in support of private investment.

53 Source OECD, Geographical Distribution of Financial Flows to Developing Countries, 2016.

54 <http://stats.oecd.org>, Creditor Reporting System, accessed on 22 March 2016.

(TOSSD) may also have implications in the future regarding the type of resources that Lao PDR may be able to access (see Box 1 on the definitions of ODA and TOSSD in Chapter 1).

Analysis of data shows that most loans from China are OOF in nature, provided on non-concessional terms (see also section on South-South Cooperation). The management of such loans requires close attention given their potential impact on debt sustainability. ADB, for example, envisages public or public guarantee borrowing for high-revenues projects that will be able to generate resources to service their debt.<sup>55</sup> For additional discussion of debt sustainability, see the section on External Debt and Borrowing.

#### **Box 11: The Role of Development Assistance in Middle-Income Vietnam**

The DFAA study in Vietnam found that the role of development assistance in Vietnam has become increasingly unclear. As access to development finance from domestic and international sources has expanded, ODA is increasingly less significant as a source of finance. Vietnam's need is not necessarily for more development finance, but rather to use its existing resources more effectively, so as to maximize development results.

On the other hand, as long as Vietnam faces difficulties in making efficient use of its development finance, ODA enjoys significance beyond its dollar value. ODA provides a substantial share of the funds available for undertaking new policy initiatives, which are important as growth in Vietnam becomes less pro-poor in nature and the remaining poverty caseload increasingly difficult to tackle. ODA continues to play an important role in ensuring that development expenditure is equitable, including by directing more resources towards the poorest regions.

As soon as Vietnam reached MIC status, some bilateral donors began to phase out their aid programs. Though Vietnam now has access to a broader range of development finance options, it still displays many of the institutional challenges characteristic of low-income countries. ODA therefore still has an important role to play in helping Vietnam make the transition to its next phase of development.

It has been observed that the role of ODA in non-aid-dependent countries should be to leverage other sources of development finance. The DFAA found this to be true in Vietnam, but argued that the priority should be first and foremost about increasing the efficiency and effectiveness of other sources of development finance, rather than just maximizing their volume.

Source: Government of Vietnam (Ministry of Planning and Investment)/UN/EU, "Development Finance for Sustainable Development Goals in Middle-Income Viet Nam; Financing Viet Nam's Development: Meeting New Challenges", December 2014.

### **4.1.3. South-South and Triangular Cooperation**

South-South Cooperation (SSC) is a broad framework for collaboration between the countries of the South in the political, economic, social, cultural, environmental or technical domains.<sup>56</sup> It involves the mutual sharing and exchange of key development solutions – knowledge, experiences and good practices, policies, technology and resources – between and amongst countries in the global south. Triangular Cooperation

55 Asian Development Bank (ADB) (2013). 'Classification and Graduation of Developing Member Countries'. *Operations Manual*. OM A1/BP. Manila: ADB. <http://www.adb.org/sites/default/files/institutional-document/31483/oma1.pdf>

56 [http://ssc.undp.org/content/ssc/about/what\\_is\\_ssc.html](http://ssc.undp.org/content/ssc/about/what_is_ssc.html)

involves two or more countries in the global south collaborating with a third party, typically a traditional donor, emerging economy or multilateral organization, facilitating SSC exchange through the provision of resources.

South-South Cooperation (SSC) and Triangular Cooperation (TrC) are modalities of development cooperation which tend to be loosely and inconsistently defined; as such, it is difficult to quantify amounts of SSC/TrC from which Lao PDR benefits. In terms of regional trends, the Asia Pacific Effective Development Cooperation report notes “Asia-Pacific countries receive a growing volume of SSC in the form of financial assistance, technical assistance, knowledge sharing, and TrC. Much of this comes from other countries in the region- many recipients are benefitting from being in ‘good neighbourhoods’, where economic expansion in their neighbours is driving growing regional cooperation.”<sup>57</sup>

The history of SSC in Lao PDR context can be traced back to the late 1970s. Lao PDR became the Lao People’s Democratic Republic (Lao PDR) on 2nd December 1975. The 1977 Treaty of Friendship and Cooperation<sup>58</sup> between Lao PDR and Vietnam may be termed as the first South-South Cooperation treaty; it covered defence arrangements, delineation of the border and Vietnamese economic assistance to Lao PDR.

Lao PDR is a member of several regional associations and initiatives which offer potential for enhanced cooperation with neighbouring countries:

- In 1992, Lao PDR joined the sub-regional economic cooperation program known as the Greater Mekong Sub-region.<sup>59</sup> Lao PDR’s unique geographical position, being at the heart of South East Asia’s mainland, makes it part of some of the region’s major transport-economic corridors, namely, East-West, North-South, and Southern Economic Corridors.
- Lao PDR was admitted to ASEAN (the Association of South-East Asian Nations) in July 1997, was Chair in 2004–05 and is chairing ASEAN again in 2016.
- Lao PDR is a member of the Mekong River Commission and hosts its headquarters in Vientiane.

As an overall matter, South-South Cooperation is gaining significant momentum, with China, Thailand and Vietnam currently being the main partners to Lao PDR. India is also showing increasing interest as well and is likely to play a more prominent role in the coming years. SSC partners are focusing primarily on infrastructure development

Data on South-South Cooperation are not easily available. Information on projects funded by southern partners are not systematically included in the government’s Aid Management Platform.<sup>60</sup> For example, the database includes information on cooperation with India and Thailand, though it looks incomplete and does not seem to have been updated recently. A recent study estimates that Lao PDR is diversifying the range of its partners (including cooperation with countries such as Israel, UAE, Kuwait, Hungary, Turkey, and Russia),<sup>61</sup> with China, Thailand, India and Vietnam among Lao PDR’s most active South-South Cooperation partners (see Box 12).

57 UNDP. *Asia Pacific Effective Development Cooperation Report 2014*. p. 60.

58 The National Assembly of Lao PDR at <http://www.na.gov.la> downloaded on 17th November, 2014.

59 The Greater Mekong Region includes Cambodia, the People’s Republic of China (specifically Yunnan Province and Guangxi Zhuang Autonomous Region), Lao PDR, Myanmar, Thailand, and Vietnam.

60 <http://ppamp.mpi.gov.la/portal/>

61 Mustafa, S. and R. Greenhill (2016), *An Age of Choice? Lao People’s Democratic Republic in the new development finance landscape*, Overseas Development Institute (ODI).

### Box 12: Lao PDR's Most Important South-South Cooperation Partners

**China.** China has become one of Lao PDR's top partners, with its financial support being comparable to the amount of aid received from Japan, the largest OECD DAC donor. Commitments for grants and concessional loans have increased from USD 18 million in 2009 to USD 100 million in 2013. In addition, China provides non-concessional loans. While the details of this type of flows are not publicly available, several major hydropower and infrastructure projects receive financial support from China's Development Bank and Exim Bank.

**Thailand.** Lao PDR is the largest recipient of ODA from Thailand.<sup>62</sup> The government of Thailand provides assistance through two different agencies, the Thailand Development Cooperation Agency (TICA) and the Neighboring Countries Economic Development Cooperation Agency (NEDA). Between 2006 and 2014, ODA from Thailand amounted to USD 293 million. TICA's three year work plan with Lao PDR focuses on scholarships and training courses in Thailand and also includes 24 projects in education, public health, agriculture and environment/natural resources. NEDA projects focus on infrastructure and normally are based on a 30 per cent grant and 70 per cent loan element. For projects generating revenues, it will usually be fully funded through a loan with a 2.5 per cent interest rate.

**Vietnam.** According to Lao PDR's government sources, Vietnam's concessional disbursements to Lao PDR amounted to USD 24.86 million in 2005/06, making it the second largest bilateral donor at that time. Vietnam's support subsequently declined to reach USD 15 million in 2008/09. No information is available on grants and non-concessional loans from Vietnam.

**India.** The government of India provides mainly loans to Lao PDR through lines of credit for concessional loans extended by India's Exim Bank, whose conditions depend on the income level of the recipient country. These have totalled USD 160 million since 2004. Support from India includes one grant of USD 4 million to renovate the Wat Phou temple over an eight-year period. India also provides support for capacity development, including undergraduate and post-graduate scholarships and short-term training for civil servants through the Indian Technical and Economic Cooperation Programme. The ASEAN-India Cooperation Framework provided additional support to the establishment of the Lao-India Entrepreneurship development Centre in 2004 and the Lao-India Centre for English Language Training in 2007.

*Source: Mustafa, S. and R. Greenhill (2016), An Age of Choice? Lao People's Democratic Republic in the new development finance landscape, Overseas Development Institute (ODI).*

Lao PDR's partners of the South also play an important role as a source of foreign direct investment (see also section on FDI). According to MPI, from 1989 to 2011<sup>63</sup> Vietnam invested in 429 projects in Lao PDR with a combined value of about USD 4.9 billion, becoming the largest foreign investor in the country.<sup>64</sup> The second largest foreign investor is Thailand which invested in 742 projects with a combined value of about USD 4 billion during the same period. The third largest foreign investor is China with 801 projects and a combined investment value of about USD 3.9 billion. In the same timeframe, Malaysia invested in 99 projects with a combined value of USD 430 million, and India invested in 21 projects with a combined value of USD 161 million.

62 <http://www.tica.thaigov.net/main/>

63 Source: Vientiane Times, 13th Feb, 2013 available at <http://www.asianewsnet.net/Vietnam-tops-list-of-foreign-investors-in-Laos-42682.html>

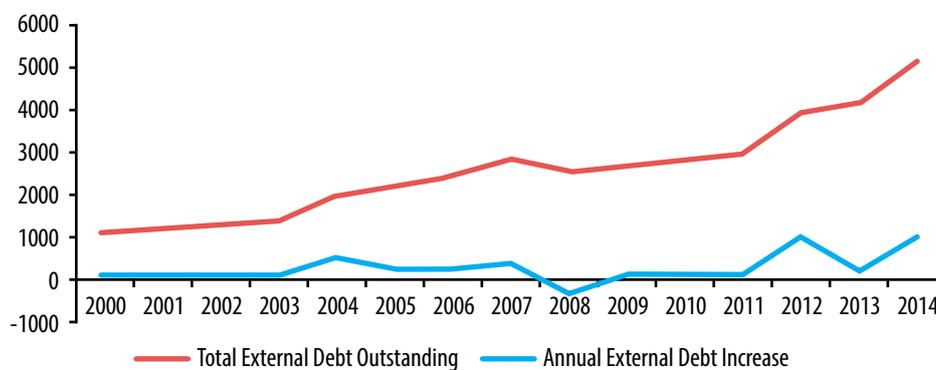
64 [http://www.vietnamconsulate-luangprabang.org/en/nr070521165956/news\\_object\\_view?newsPath=/vnemb.vn/cn\\_vakv/ca\\_tbd/nr040819103029/ns071211134730](http://www.vietnamconsulate-luangprabang.org/en/nr070521165956/news_object_view?newsPath=/vnemb.vn/cn_vakv/ca_tbd/nr040819103029/ns071211134730)

#### 4.1.4. External Debt and Borrowing

Public borrowing is an important tool that the Government of Lao PDR can use to fill fiscal gaps and finance the development priorities identified in the 8th NSEDP and the SDGs. As Lao PDR looks ahead to graduation from LDC to middle-income status, it will need to consider the ways in which its access to finance under different terms will change, as it can expect to have a decreasing degree of access to concessional loans from multilateral development banks and find that bilateral OECD-DAC members will increasingly target ODA to least-developed countries. At the same time, it may have better prospects for accessing international capital markets for borrowing. In looking at the full picture of various flows of development finance to and within Lao PDR, the DFAA provides an opportunity to stimulate a discussion on ways of financing fiscal gaps and the advantages and disadvantages of different resources, including strategies for managing public debt with different levels of concessionality.<sup>65</sup>

The *Age of Choice* study for Lao PDR recently published (April 2016) by ODI discussed the issue of public debt at some length. It noted that the Government has been very successful in mobilizing commercial financing for revenue-generating projects, particularly in the hydropower sector, since 2005. The Government has been able to access USD 1 billion or more, annually, on commercial terms, which has been critical given that concessional loans from traditional bilateral and multilaterals are limited in the sector. However, the technical assistance from partners such as the World Bank and ADB have been key to establishing a legal framework for the sector, including attention to environmental and safety issues.<sup>66</sup>

**Figure 4.2: External Debt (in USD mil.): 2000–2014**



Source: Bank of Lao PDR, Annual Economic Reports

At the same time, the data shows that Lao PDR has been taking on increasingly levels of external public debt, as seen in Figure 4.2. The ODI study noted:

“Lao PDR’s rising debt levels may constrain the country’s ability to continue to borrow to finance the NSEDP, and the lack of a clear policy on debt may also cause concern among financiers. Perception of risk and policy uncertainty will itself lead to lower credit ratings and higher borrowing costs. It has already been reported that China has restricted lending due to concerns on debt... Several donor interviewees raised concerns about rising debt levels. One interviewee reported that concern about public debt levels was informing the GoL’s focus on the private sector as a financing source, in which the risks are shared.”<sup>67</sup>

65 UNDP/AP-DEF: Development Finance Assessment Guidance Note (forthcoming 2016).

66 ODI, *Age of Choice* Study (2016), p 30–31.

67 ODI, *Age of Choice* Study (2016), p. 30–31.

Given this context, ODI recommended that Lao PDR formulate a clear strategy on debt, which includes publicly announced targets on key debt measures such as the ratio of external debt to GDP, and to Government revenue. Such a strategy would help the Government prioritize and manage borrowing.<sup>68</sup> The World Bank has also offered analysis around this issue. The *Lao Economic Monitor (April 2015)* observed the domestic portion of all public debt is relatively small compared to external public debt. It also noted steps being taken by the Government to strengthen capacity for debt management, including the deployment of a debt monitoring system (DMFAS), and a new presidential ordinance on public debt management. It concludes that “the authorities are taking steps to encourage a transparent public debate over debt and investment projects by publishing information in media and on the National Assembly website, but these efforts are starting from a very low base.”<sup>69</sup>

The concerns about external public debt levels will also affect Lao PDR’s ability to access another source of international finance, the international bond market. Because it has not been rated by the major credit rating agencies, the Lao PDR Government has not been able to tap into this source of international finance. This has resulted in, for example, SOEs having to borrow at non-concessional terms. As a result of the lack of rating, the Lao PDR Government has had to bridge the budget deficit and support economic development through other sources, such as bilateral financing. Looking ahead, Lao may consider pursuing a credit rating in order to tap into this source of development finance, as it could improve access to international capital markets and international commercial funding.

In 2013, Lao PDR did enter the bond market for the first time, with a 3-year unrated USD 50 million equivalent baht-denominated note; this is the first Thai baht issuance by a foreign government after the Thai authorities removed restrictions on the requirement that foreign issuers have an investment grade rating (see: World Bank, 2015).

In addition to external public debt held by the Government, the domestic private sector in Lao PDR has also looked to access international sources of financing through borrowing, as discussed in Box 13.

### Box 13: Access to International Finance for Lao PDR Domestic Private Sector

The International Finance Corporation (IFC), a member of the World Bank Group, has been providing lending to private sector businesses in Lao PDR, primarily medium and large-sized businesses, in sectors such as banking and finance, agriculture, hydropower and energy, forestry, and manufacturing.

IFC offers a range of financial products including loans, equity finance, risk management products, local currency finance, and trade finance. Loans from IFC’s own account typically have a maturity of seven to twelve years and are issued in leading currencies, although local currency loans are available. The IFC has a policy of only covering part of the cost of a project, to ensure the participation of other private investors, with IFC loans usually limited to 25 per cent of total project costs. Loans from IFC’s own accounts have generally been in the range of USD 1 million to USD 100 million.

Recent examples of IFC financing to private sector in Lao PDR included loans to companies in key sectors: telecommunications, tourism, banking, and power. Financing provided was in the form of loans, equity and guarantees, with the largest financing package (of examples given) provided to ACLEDA Bank Lao, in the form of loan (USD 8 million), equity (USD 4.2 million) and guarantee (USD 8.99 million) over the period 2009- 2015.

Source: Information provided to MPI/DIC (email correspondence) by Phongsavanh Phomkong, Head of Office, IFC, Lao PDR

68 ODI, *Age of Choice Study* (April 2016), p. 33.

69 World Bank, *Lao Economic Monitor (April 2015)*, p. 24–25.

## 4.1.5. Vertical Funds: Climate- Related Finance and Vertical Health Funds

### *Climate-Related Finance*

Tracking climate finance flows and how they contribute to the overall development of a country is a challenging task, as often, climate finance is part of the overall ODA block which requires a tracking system for both external and domestic resources. Currently, MPI has been able to only partly track climate finance through the Aid Management Platform (AMP) which only covers some years and is not fully reliable as many line ministries have not reported on the ODA/development flow received.<sup>70</sup>

In terms of data on international climate change finance in Lao PDR, the UNFCCC Global Environment Facility (GEF) reports that the country has accessed grant financing of USD 37 million from multilateral investment funds through 2013 with an allocation to formulate projects for an additional USD 7.3 million during the GEF 5 replenishment period through June 2014.<sup>71</sup> However, the amount of climate change finance mobilized is still a fraction of the amount that has been estimated to be required for the National Climate Change Strategy, which is USD 1.5 billion for mitigation and USD 900 million for adaptation.<sup>72</sup> In terms of vertical funds (see Box 14 for definition of vertical funds) which can be accessed to contribute to meeting this gap, the Green Climate Fund (GCF), which will reportedly make available USD 100 billion annually by 2020, is a clear opportunity. The Ministry of Natural Resources and Environment (MoNRE) has been designated as the focal point for the GCF, and UNDP is supporting Lao PDR in formulating proposals. The processes and requirements for accessing funding from the GCF are apparently quite technically rigorous and many countries, including Lao PDR, may have difficulties in meeting the requirements, especially without support from development partners.

Overall, it seems that one of the major challenges to Lao PDR is to define climate finance and develop the instruments to clearly link climate finance with the economic development agenda. It will also need to ensure that national capacity is developed to manage specific climate finance funds, both national and international. As Lao PDR looks at how to mobilize the necessary financing for climate change adaptation and mitigation, the 8th NSEDP and the National Climate Change Strategy can provide a framework, and utilize the institutional structures which have been established. This includes the national coordination body – The National Steering Committee on Climate Change (NSCCC), which is chaired by the Deputy Prime Minister. Vice-Chairs are the Ministers of Planning and Investment, Water Resources and Environment Administration (WREA), Ministry of Natural Resource and Environment (MoNRE), and Ministry of Agriculture and Forestry (MAF). Seven Technical Working Groups (TWGs) and a Secretariat support the work of NSCCC; there is also a Climate Office that collaborates with civil society, universities and other stakeholders groups.

Lao PDR has also created a number of specific funds related directly or indirectly to some aspects of natural resources and environment protection, such as: 1) Environmental Protection Fund; 2) The Forest and Forest Resources Development Fund; 3) Rural Electrification Fund; 4) Renewable Energy Fund; 5) Multilateral Trade Fund; 6) Public Management Trust Fund and 7) District Development Fund. National Funds have a Steering Committee consisting of Government ministers and senior civil servants, technical/expert committees, a secretariat and quite often, monitoring and evaluation and audit units. Their mandate usually enables them to manage both domestic and international resources. The manner in which they solicit and review proposals differs.

70 For instance, some Ministries have their own or sponsored databases, where data may differ to MPI's Aid Management Platform.

71 Global Environment Facility, Fact Sheet "Lao PDR and the GEF", available at [https://www.thegef.org/gef/country\\_fact\\_sheets?page=3](https://www.thegef.org/gef/country_fact_sheets?page=3)

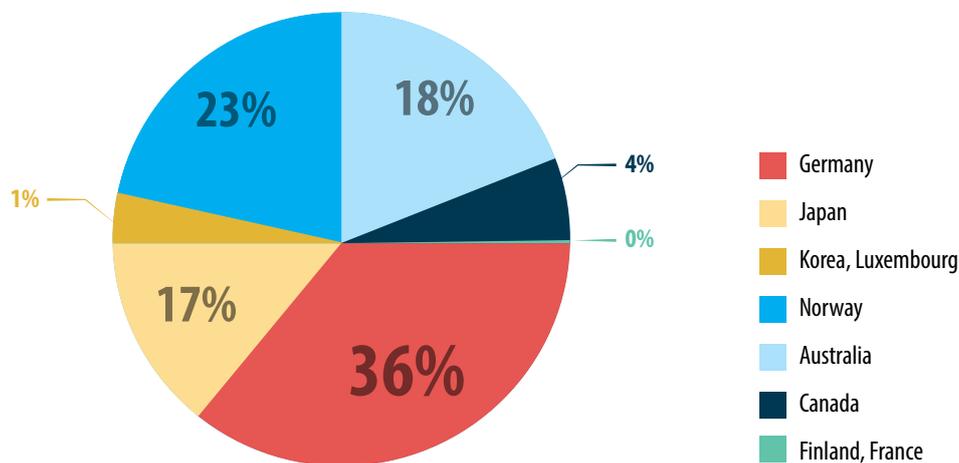
72 ODI, Age of Choice Study (2016) p. 21.

The Government of Lao PDR has identified the major strategic priorities for adaptation and mitigation in key sectors. MoNRE is preparing a National Action Plan which will operationalize the priorities. The Plan will not only respond to climate change issues, but will also be an instrument of economic development, where MPI will promote investments in the country and MoF will work towards ensuring that a set of climate change responsive financial instruments are available to potential investors.

The financial allocation for climate change goes through the State Budget, where development partners' commitments are coordinated via the Roundtable and Trust Fund finance is allocated by MoF through the regular budgeting process. It is expected that the 8th NSEDP will take a major step towards more responsible climate change finance by supporting the implementation of the National Climate Change Strategy – NCCS (promulgated in 2010).

Given its vulnerability to climate change, and the complexities of managing not only international climate change finance, but also getting a clearer picture of the amounts of domestic public finance contributing to the climate change response, Lao PDR may want to consider a Climate Public Expenditure and Institutional Review (CPEIR). A CPEIR is an innovative methodology which, in addition to reviewing the public expenditures of a country, also reviews its climate change plans and policies, institutional framework and public finance architecture and makes recommendations to strengthen them. A CPEIR can be a useful tool for national planning and budgeting, especially in terms of identifying and tracking budget allocations that respond to climate change challenges<sup>73</sup>. A CPEIR can make a significant contribution in terms of identifying strategies for Lao PDR to meet the challenges of managing climate change finance and linking allocations and overall decision making with the broader environmental, social, and economic priorities identified in the 8th NSEDP.

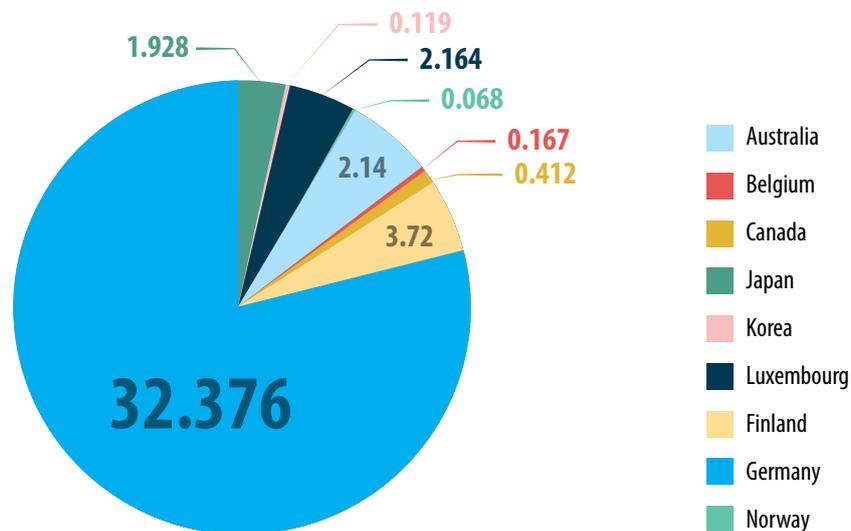
**Figure 4.3: OECD Data on Climate Mitigation Finance Commitments to Lao PDR, 2011**



Source: World Bank

73 <http://www.climatefinance-developmenteffectiveness.org/about/what-cpeir>

Figure 4.4: OECD Data on Adaptation Finance Commitments to Lao PDR, 2011



Source: World Bank

#### Box 14: Vertical Funds

Vertical funds are development financing mechanisms confined to single development domains with mixed funding sources. The primary examples are the Global Environment Facility (GEF), which was established in 1991, and the two vertical health funds, both created in 2000, the Global Alliance for Vaccines and Immunization (GAVI) and the Global Fund for AIDS, Tuberculosis and Malaria (GFATM).

Analysis of vertical funds as a development finance modality finds both positive and negative aspects. Vertical funds respond to an interest by donors to earmark funds for specific purposes, and may be favoured because they allow donors to fund distinctive and narrowly focused programs. Vertical funds have also been lauded for delivering ‘innovative multilateralism’. Despite having a limited number of donors, their governance systems can be inclusive of civil society and private sector. They also have a reputation for rapid delivery, as well as transparency and accountability.

However, distortions can arise from their sheer size and top-down nature, with the donor resources needing to be matched by human and financial counterpart resources in recipient countries, while drawing these resources away from national systems. A frequent criticism has been the lack of emphasis on capacity building in recipient countries.

While the development impacts delivered through vertical funds are significant and measurable, recipient countries will need to take actions to leverage the opportunities provided by vertical funds while minimizing distortions and ensuring that national institutions and systems are strengthened, rather than sidelined by these programs.

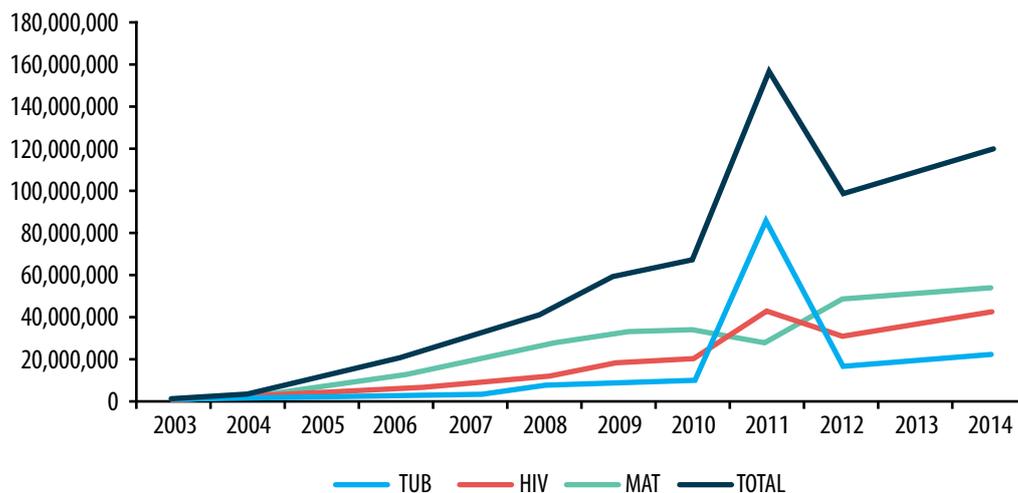
Source: Browne, S and R. Cordon, “Vertical Funds: Lessons for Multilateralism and the UN”, Future United Nations Development System, Briefing 25, January 2015.

### Vertical Health Funds

The Global Fund to Fight AIDS, Tuberculosis and Malaria (GFATM) committed USD 129.52 million to Lao PDR from 2003 to 2014; until now (the end of 2014), approximately USD 121.8 million has been disbursed—just over 94 per cent. Since 2003 the yearly allocation has steadily increased with some fluctuation in 2010–2012. Lao PDR has received similar levels of commitments to its neighboring countries: Thailand, Cambodia, and Vietnam all received commitments in the USD 100–500 million range during this period.<sup>74</sup> The other major vertical health fund, the Global Alliance for Vaccines and Immunization- GAVI- committed over USD 20 million to Lao PDR between 2001 and 2012. During this period there has been some year to year fluctuation in commitment levels but there is a declining commitment trend in 2014 and 2015 which is likely to continue with improvements in the health indicators in the country.

GFATM and GAVI resources are usually administered at the global level, with management entrusted to local entities. In the case of Lao PDR, the Ministry of Health (MoH) has created a separate unit to manage these funds. Neither of these funds has an in-country presence, but rely on domestic mechanisms to manage the funds locally.<sup>75</sup>

**Figure 4.5: Total Global Fund Transfers to Lao PDR**



Source: Global Fund Database

A review of Global Fund projects shows that projects related to AIDS have been, as a rule, well-reviewed and their performance scored high, compared to those related to malaria and tuberculosis. One of the explanations (given locally) was that AIDS programs are usually implemented in urban areas and hence relatively easy to monitor and report on, whilst malaria and tuberculosis programs are implemented in rural areas where it is difficult to capture data and assess the efficiency and effectiveness.

GAVI supports routine immunization against hepatitis B, Haemophilus influenzae type b (Hib) and pertussis (whooping cough), and one-off investments in immunization against measles, polio and yellow fever.<sup>76</sup>

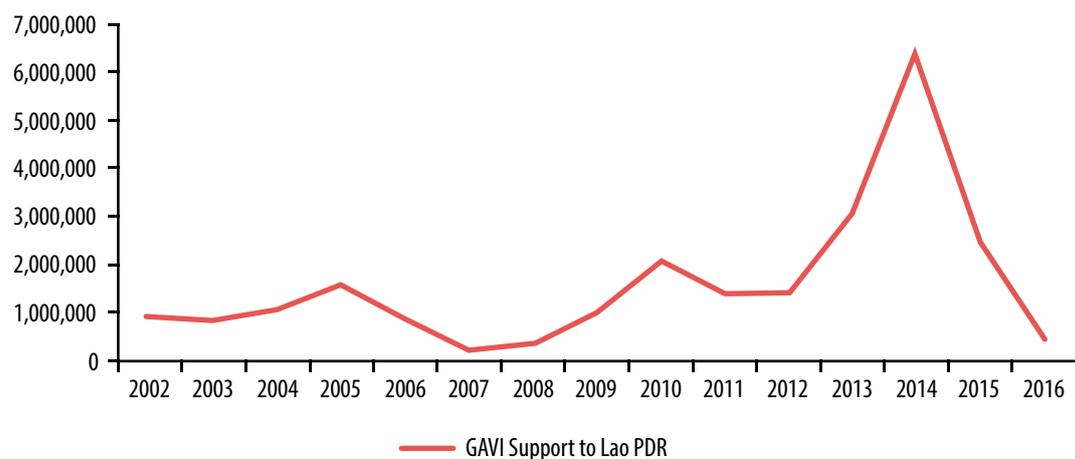
74 Global Fund Database.

75 See: Greenhill and Ahmed (2013), for the elaboration of the management mechanism.

76 See more at: <http://www.gavi.org/results/disbursements/#sthash.NYsNtP6x.dpuf>

Lao PDR has received over USD 20.5 million from GAVI from 2001 to 2012. Although no efficiency study has been conducted for Lao PDR, the disbursement report shows that the country has had the capacity to draw upon GAVI funds and utilize them in accordance with the Alliance financial guidelines. In 2002, a GAVI data audit was conducted by PwC, and no major concerns were recorded. The Expanded Programme for Immunization (EPI) is the national contact point. GAVI funds are allocated by the headquarters and with the improvement of the health situation they will be reduced. The committed funds for 2015 and 2016 show decline, which most likely will continue.

**Figure 4.6: GAVI Support to Lao PDR**



Source: GAVI/WB Development Indicators Database

Both the Global Fund and GAVI have distributed the monetary resources that they have planned, and the results achieved have been in line with these plans. No major issues were raised by national stakeholders except that sometimes the reporting procedures are cumbersome and time consuming. However, they were satisfied with the results that the country has achieved in terms of health improvement in these target intervention areas.

## 4.2. External Private Resources

### 4.2.1. Foreign Direct Investment (FDI)

FDI has played a prominent role in the economic development of Lao PDR in recent years. The country received USD 2.484 billion in FDI net inflows from 2000 to 2014. There has been a notable upward trend during this period as well: FDI in 2000 was USD 33.8 million, and in 2014 amounted to USD 720.8 million, which is over a twenty-fold increase.<sup>77</sup> By way of reference, in the Southeast Asia region, FDI increased from USD 45.5 billion in 2000 to USD 109.7 billion in 2012, more than doubling.<sup>78</sup> The major investors in Lao PDR are from Asian countries (Vietnam, China, Thailand, Korea, Japan and increasingly Malaysia). The major sectors that have attracted FDI have traditionally been mining and hydro-power generation, with

77 World Bank Development Indicators Database.

78 UNDP, *Asia Pacific Effective Development Cooperation Report 2014*, p. 18.

forestry in the north of the country. However, recently, the portfolio is broadening, with more investments in other sectors, especially service sectors, including tourism and health.

To be globally competitive in attracting FDI – particularly outside of the natural resource sector – continued improvement in the legal, regulatory, and administrative regime for investment is required. As noted by one observer, “Many of the reforms relating to improvements in the enabling environment for the private sector can be undertaken quickly and at a relatively low cost. For example, streamlining the regulatory and administrative regimes applying to *business* registration and investment approvals, continuing to streamline customs processes, and ensuring the consistent enforcement of tax laws and collection/compliance will send a strong and positive message to potential investors, both domestic and foreign.”<sup>79</sup> Land reform and completing titling is also a priority; it is estimated that only 30 per cent of land holdings in Lao PDR have been officially titled.<sup>80</sup>

In terms of targeting FDI, the Government of Lao PDR highlights several advantages. These include being at the center of the Greater Mekong Sub-region (GMS) and sharing borders with Myanmar, Cambodia, China, Thailand, and Vietnam.<sup>81</sup> Whilst continuing to highlight its natural resource base, especially its potential for increased hydropower, mining, forestry, and agriculture, the Government recognizes the need to diversify its investment base. The Government has cited steady growth rates in other sectors, including light manufacturing, construction, and services. Tourism may also play a more important role, and it could spur growth in other areas – transport, food production, etc. Tourism is being given more priority in the new national strategic development documents (8th NSEDP and new national development strategy until 2030). Agriculture and forestry have also attracted development finance, but have largely remained at the level of subsistence farming (small plots, intensive arable techniques, little or no use of fertilizers, etc.), with very small surpluses produced. Lao PDR, although a country with large agricultural potential, is, in fact, an importer of food, especially top end food. The Government has also identified agribusiness, tourism, textiles, garments, handicrafts, timber processing, and support industries for the mining and hydropower sectors as viable areas for both domestic and foreign investment.<sup>82</sup> The country also highlights its low labor costs, political stability and personal safety.

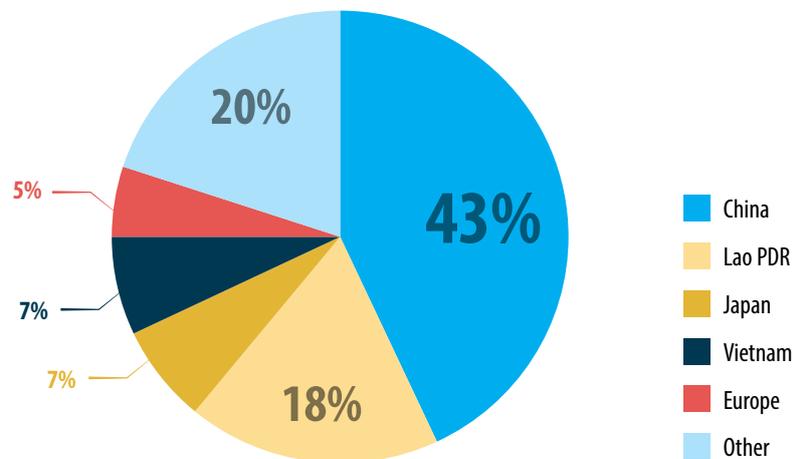
Lao PDR is home to ten special economic zones (SEZs) (at the time of writing this report), first developed in 2007, and is exploring the possibility of attracting private investment to develop other SEZs. Currently, 43 per cent of investors are from China, 18 per cent are local Lao investors, 7 per cent from Japan, 7 per cent from Vietnam, and 5 per cent are from Europe. The Government cites the total value of investment in SEZs as USD 1 billion.

79 Australia’s Statement at the Lao PDR’s 2014 Round Table Implementation Meeting, 14 November 2014, p. 2.

80 European Development Partners’ Statement at the Lao PDR’s 2014 Round Table Implementation Meeting (17/11/2014), p. 4.

81 The GMS countries are Cambodia, China (specifically Yunnan Province and Guangxi Zhuang Autonomous Region), Lao PDR, Myanmar, Thailand and Vietnam. The GMS covers 2.6 million square kilometers and has an estimated population of approximately 326 million.

82 *Annual Progress Report of the Trade and Private Sector Working Group 2013–2014 Fiscal Year*, 2014, p. 1.

**Figure 4.7: Investors in Lao PDR's Special Economic Zones**

At the policy level, the Government has prioritized improving the environment for trade and investment through, in part, advancing the level of trade integration regionally under the GMS and the ASEAN Economic Community (AEC) and globally post-WTO accession. Other goals include improving trade facilitation, the general business environment, and investing in trade-related infrastructure. Indeed, in the latest World Bank *Doing Business* report for Lao PDR, although the country's overall ease of doing business ranking had improved seven points, from 155 in 2014 to 148 in 2015, it still trails behind its neighbors as a desirable location for investment.<sup>83</sup> Malaysia, Thailand, Vietnam, China, Indonesia, and Cambodia all rank higher in the World Bank's global ranking. As noted in its latest country assessment of Lao PDR, "According to data collected by *Doing Business*, starting a business there requires 6.0 procedures, takes 92.0 days, costs 5.7 per cent of income per capita and requires a paid-in minimum capital of 0.0% of income per capita."<sup>84</sup> As noted by the Lao National Chamber of Commerce and Industry, "Laos ranked poorly in terms of closing a business, protecting investors (187th), obtaining credit (159th), paying taxes (119th) and dealing with trading across borders (161st)."<sup>85</sup> Several recent studies of the Laotian investment climate cite access to finance, a dearth of skilled workers, and high taxes and fees as major constraints to investment.

Trade and regional integration should be a driver of investment in Lao PDR. Exports are increasing steadily year on year but are concentrated in the power and mining sectors. The Lao PDR Government estimates that these two sectors accounted for 56 per cent of total exports in 2007,<sup>86</sup> by 2014 this had grown to 70 per cent of total exports.<sup>87</sup> Government data also confirms that trade is highly concentrated by destination. Thailand accounts for about 50 per cent of exports from 2005–10, followed by Vietnam, Australia and China. Thailand is also the source of approximately 75 per cent of Lao PDRs' imports, followed by China, Vietnam, and Japan.<sup>88</sup> Lao PDR has one of the highest female employment participation rates in the region and rapidly growing key export sectors such as clothing manufacturing, tourism and agribusiness all have high percentage female workforces.<sup>89</sup>

83 It should be noted that a country's overall ranking is a function of its performance against all other countries. As such, an improvement in ranking may not be a reflection of improved performance in the business climate but could reflect other countries lacking in attractiveness for investment.

84 World Bank, *Doing Business 2015, Going Beyond Efficiency: Economic Profile 2015 Lao PDR*, p. 17

85 GIZ (2014), HRDME Enterprise Survey 2013 for Lao PDR, p. 34.

86 Ministry of Industry and Commerce (2013), *Diagnostic Trade Study 2012 for Lao PDR*, p. 11.

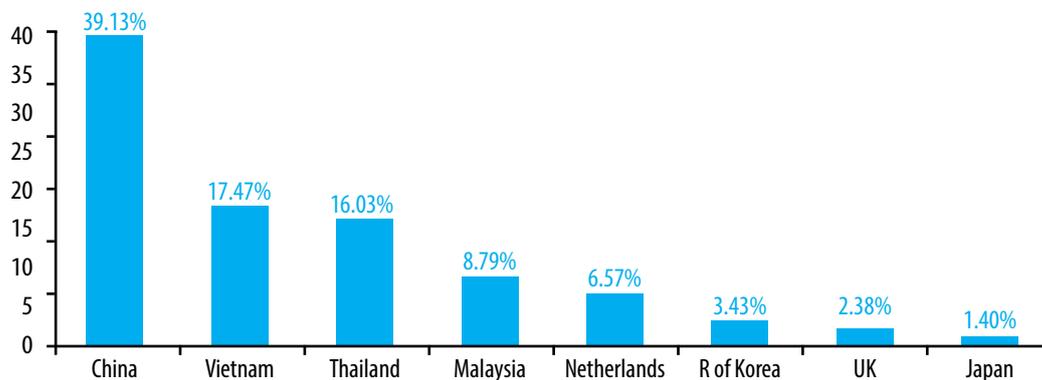
87 Bank of Lao PDR Annual Economic Report 2014.

88 Ministry of Industry and Commerce (2013), *Diagnostic Trade Study 2012 for Lao PDR*, p. 11.

89 *Annual Progress Report of the Trade and Private Sector Working Group 2013–2014 Fiscal Year*, 2014, p. 3.

However, the current state of Lao PDR's transport infrastructure is subpar. While this creates an opportunity for private investment, it also represents a challenge to the country's ability to take advantage of its status as the crossroads of the GMS. As noted by the ADB, "In general, the transport sector remains poor and discourages both domestic and foreign investments. A well-managed road network is one of the essential prerequisites for economic growth. Transportation costs are the most expensive in ASEAN nations and/or perhaps in Asia, because Laos has no access to the sea. Located at the strategic centre of the Mekong River, Laos can serve as an export-processing centre between South and South-East Asian nations. In order to realise such an advantage, infrastructure improvement is a priority issue."<sup>90</sup>

**Figure 4.8: FDI by Country (% of Total): 1989-2015**



Source: MPI

Lao PDR highlights market access as a major advantage. This includes the broader ASEAN market with more than 500 million inhabitants including the southern part of neighboring China. Lao PDR is a bridge between Vietnam and Thailand through the East-West corridor with a Special Economic Zone in Savannakhet, designed to be a major trade and service center. Lao PDR has signed unilateral trade agreements with 39 countries including several European states, Japan, Canada, Australia, India, China, and South Korea. It has also signed bilateral investment treaties with more than 27 countries in Asia and Europe.

As seen in Figure 4.8, for the period of 1989–2015, FDI has been dominated by Lao PDR's neighbors, notably China, Vietnam, and Thailand. Malaysia, Netherlands, and South Korea also rank in the top eight investors. While the investment response has been robust from countries in the region, this concentration in FDI from the region implies a lack of global diversification. It also emphasizes that Lao PDR remains overly reliant on natural resource-based FDI, which is prone to external shocks (both at the commodity and source of investment level), as well as to on-going environmental and social concerns related to concessions and land tenure conflicts.

The over-reliance on the natural resources sectors for attracting FDI is by now a well-recognized challenge in Lao PDR, and one which will have implications for the country's ability to promote sustainable development and meet the goals outlined in the 8th NSEDP and the SDGs. The challenge of attracting FDI in line with sustainable development goals is hardly unique to Lao and in fact is a focus as well in its neighbour, Vietnam. In fact, the Vietnam DFAA looked at this issue in some depth, noting:

90 ADB (2013), *Country Paper for Regional Workshop on Eco-Industrial Clusters*, p. 11.

“To get more development return from its FDI, Vietnam needs to attract higher quality investment and create more opportunities for Vietnamese companies to work with foreign-owned companies within international value chains. There is no one-size-fits-all strategy for achieving this. It calls for a package of linked interventions tailored to the needs of particular sectors and geographical areas. These must be based on detailed analysis of areas where Vietnamese have the potential to act as suppliers and partners to foreign firms, and of the bottlenecks and constraints they face in particular locations. This should inform the design of packages of interventions that address those bottlenecks, such as infrastructure investments, land allocation, access to finance, vocational training, tax incentives, and regulatory reforms.”<sup>91</sup>

In fact, the World Bank’s Investment Climate Assessment for Lao PDR for 2014 was entitled “Policy Uncertainty in the Midst of a Natural Resources Boom”. It presented the way forward for Lao PDR in stark but clear terms, concluding that policymakers face two possible paths, “business as usual, meaning the continuation of the current, principally natural resource based extraction model, or an alternative development approach that seeks to radically reform the business enabling environment improving transparency and predictability. For the latter path to be realized, the Assessment presents a number of policy actions, which cover a range of areas from changes to the taxation regime, modernization of the financial sector, and a public commitment to transparency in all aspects in which the state engages with the private sector.”<sup>92</sup>

Certainly the scope of reforms required are significant and long term and will require a great deal of commitment as well as resources. However, given the importance of FDI and other forms of private sector investment as a finance flow, the importance of leveraging this flow to meet the sustainable development objectives in the 8th NSEDP, including with attention to environmental and social goals, cannot be overstated. In this connection, the Government of Lao PDR may want to consider further leveraging other finance flows, in particular ODA, to continue to undertake this reform agenda.

#### 4.2.2. Overseas Workers’ Remittances and Diaspora Transfers

In Lao PDR, remittances have not significantly contributed to development finance (relative to other flows), as they have generally been less than 1 per cent of GDP (except in 2011, 1.34 per cent) for the period 2000–2013. As seen in Figure 4.9, this is low compared to other countries in the Asia region. Overall, the remittance figures for Lao PDR are lower than the average of LMICs, which was 4.3 per cent of GDP in 2011.<sup>93</sup> Despite the availability of some statistics on remittances, it is difficult to establish a firm number for remittance inflows to Lao PDR. The World Bank database states that USD 59.32 million was remitted to Lao PDR in 2013,<sup>94</sup> or 0.53 per cent of GDP.<sup>95</sup>

In the developing country context of Lao PDR, workers’ remittances and diaspora transfers can be an important source of development finance for many families and communities, even if they do not represent a high percentage of GDP compared to other countries. Remittances can act as almost an informal pension system, where through the overlapping generation model, the younger, work-active

91 Vietnam DFAA report, p 46.

92 World Bank, Investment Climate Assessment 2014 “Policy uncertainty in the midst of a natural resources boom”, 2014.

93 *Ibidem*.

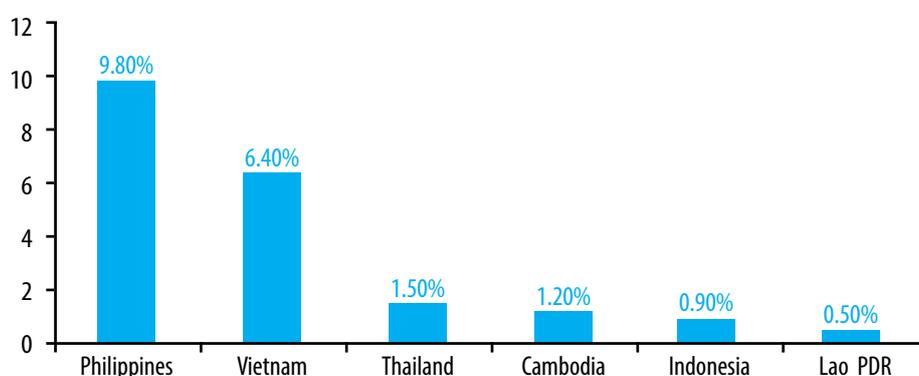
94 As of March 2016, 2013 is the most recent year for which data is available in the World Bank database for Lao PDR, although 2014 data is available for most other countries.

95 See: World Bank’s World Development Indicators Database.

population abroad supports the older generation at home. In the case of Lao PDR, as its development progresses, it is difficult to project the trend of migrant workers' remittances. Although theory suggests that they will decrease, it is also possible that they may grow as Lao PDR integrates better within the regional economic blocks (ASEAN, Mekong River, etc.). As such, the Government of Lao PDR may consider a number of potential actions to strengthen the enabling environment for remittance (and diaspora) inflows to the country.

Given that remittances are a very important finance flow- in absolute amounts and as a percentage of GDP- for a number of countries in the Asian region, Lao PDR may be able to learn from the experience of other Asian countries. Other DFAA studies, including those of Bangladesh and the Philippines looked in depth at the characteristics and opportunities for remittance flows to contribute to national development goals. A summary of key findings from the Bangladesh assessment is captured in Box 15.

**Figure 4.9: Remittances as a % of GDP in 2013**



Source: World Bank

#### **Box 15: Bangladesh's Experience of Harnessing Remittances for Development**

Migration and global diaspora resources have been an integral component of the development process in Bangladesh, and a key driver of social development for millions of people from low or marginal economic backgrounds. The eighth highest remittance receiving country in the world, growth on remittance flows has averaged about 20 per cent growth per year since the mid-1970's, and totalled USD 15.2 billion in FY 2015. The flow of remittance earnings is emerging as a crucial source of resources to improve rural and lagging economies in the country, as it has been estimated that 60 per cent of remittances accrue to the rural economy.

The economic performance of international remittances in Bangladesh is indicative of the success achieved by a number of government policies and support services, including (1) the creation of a dedicated Ministry (Ministry of Expatriates' Welfare and Overseas Employment) that promotes the interests of migrant workers; (ii) new banking institutions; (iii) effective diplomatic dialogue with host countries to open new markets and protect the rights and interests of migrant workers; (iv) tax exemptions and information sharing; and (v) the promotion of new microfinance institutions and mobile banking services. The main focus of government policy has been to expand the market for migrant workers, facilitating their working opportunities and providing adequate financial support.

There have also been attempts to ensure policy and institutional coordination, which are reflected in a range of policies and approved government documents, including the 7th Five Year Plan; the National Social Security Strategy; the Bangladesh Overseas Employment and Migrants Act (2013); and the Overseas Employment Policy (in process of finalization). Despite the wide range of successful policies and measures, there is recognition that much remains to be done to harness the full potential of both remittances and migrant workers. The DFA study identified the following areas for further attention:

- strengthen the technical, organizational, and financial capacity of the Ministry of Expatriates' Welfare and Overseas Employment (MoEWOE) and its subordinate bodies;
- focus on reducing the cost of remittances through the progressive bankarisation of remittance recipients, especially those from the poorest backgrounds and rural settings;
- improve the impact of remittances on savings and productive activities;
- further strengthen the diplomatic negotiation capacity to ensure the rights of migrants abroad; and
- enact comprehensive digitization of the migration process.

Source: Government of Bangladesh/AP-DEF, "Strengthening Finance for the 7th Five Year Plan and SDGs in Bangladesh: Findings from an Independent Development Finance Assessment", 2016.

### **Box 16: Channelling Remittance Inflows to Development in the Philippines**

Remittances of overseas Filipino workers have made a significant contribution to the growth of the Philippines economy; they have supported a rise in domestic consumption, contributed to the country's foreign exchange reserves, and promoted human capital investments among recipient households. In 2013, Filipino workers remitted USD 25 billion. The Government has taken various approaches to tap into this source of finance for development.

Since 1989, the Government's Commission on Filipino Overseas [CFO] has managed a program called "Lingkod sa Kapwa Pilipino" (LINKAPIL) to serve as the main channel for donations of overseas Filipinos who wish to help finance development projects identified by Local Government Units and NGOs. The program has garnered a positive response from overseas Filipinos because the CFO has remained transparent with its operations, making available information on project results and donation transmissions. In 2012, the majority of donations were for health-related projects.

Lessons from the LINKAPIL initiative suggest that the main factors for maintaining the support of overseas Filipinos include attention to the credibility and accountability of the intermediary institutions, the social worthiness of the projects to be funded, the efficient targeting of donations, and the impact of the projects on development outcomes.

Source: Government of the Philippines (National Economic and Development Authority)/AP-DEF, "Development Finance and Aid in the Philippines: Policy, Institutional Arrangements and Flows", 2014.

### Box 17: Global Experiences of Diaspora Bond Issuance

As developing countries are becoming more aware of the need to tap innovative development financing schemes, one such scheme which has been explored is the diaspora bond. The diaspora bond is a debt instrument sold by the national government to the diaspora community, or to citizens who work outside their home country, to help finance local development initiatives. Unlike other bonds, these are sold at a lower rate-of-return than the prevailing market rate, and are therefore sometimes described as bonds with a “patriotic discount”, as diaspora investors accept this lower yield out of concern for their home country.

A number of countries around the world have experience with these types of bonds, and the experience is mixed. Some countries have successfully raised funds for infrastructure investment, such as Ethiopia, where diaspora bonds helped the Government construct the Grand Renaissance Dam. In the Asia region, the Sri Lankan Development Bond has raised USD 580 million since 2001. India issued diaspora bonds following the balance of payments crisis in 1991 (USD 1.6 billion), following the imposition of sanctions in the wake of nuclear explosions in 1998 (USD 4.2 billion) and the India Millennium Deposits in 2000 (USD 5.5 billion). The issuance of these bonds were partly motivated by events where the diaspora communities responded out of sympathy or a feeling of solidarity with their home country.

Looking at the determinants of a diaspora bond, Akkoyunlu and Stern (2012) conducted an analysis of such bonds in nine countries. The results indicated that variables which positively impacted on the investors’ decision to buy diaspora bonds were (i) closeness indicator, which is measured in the amount of remittances per migrant; (ii) the sovereign rating; (iii) good governance; and (iv) war, which may have been caused by motives of solidarity in times of crisis.

Source: Government of the Philippines (National Economic and Development Authority)/AP-DEF, “Development Finance and Aid in the Philippines: Policy, Institutional Arrangements and Flows”, 2014.

At level of global dialogue on the potential role of remittances in financing development, there are multiple studies and analyses of migration issues and remittance trends at the global level, including recent interest attention to the issue at the *3rd International Conference on Financing for Development* in July 2015. The outcome document focuses on reducing the global average transaction cost of remittances to less than 3 per cent of the amount transferred by 2030.<sup>96</sup> For reference, the present global average cost of sending USD 200 was about 7.7 per cent in 2015.<sup>97</sup> While measure taken at the global level do have an impact at the national level, for the purposes of a country-level DFAA, there is perhaps more immediate relevance and potential for action around two key issues.

A first issue is to look at the extent to which remittances and diaspora transfers can be aligned with national development priorities and harnessed for development purposes. In exploring this issue, it is important to remember that, by nature, remittances are a *private* flow, so options for enhancing their development impact of remittances need to be considered in that context. With that said, there are options which have been explored by countries, including the setting up of financial instruments to which remittance stakeholders (remittance senders/workers and remittance recipients/families) can voluntarily contribute. These financial instruments include different types of diaspora bonds, as described in Box 17,

96 Addis Ababa Action Agenda of the Third International Conference on Financing for Development (2015), pg. 20.

97 World Bank, *Migration and Remittances: Recent Developments and Outlook (Migration and Development Brief 25)*, October 2015.

and more traditional fund-raising measures aimed at expatriate workers, such as the LINKAPIL program described in Box 16. Another approach is an incentive scheme to attract remittances, such as was tried by the Government of Pakistan in 2001. For a minimum remitted amount (USD 2,500–10,000), overseas Pakistanis were granted privileged access to benefits such as higher education and public housing.<sup>98</sup> Lessons from these types of instruments point to the importance of transparency and good governance in gaining the trust of potential contributors, meaning that successfully establishing such schemes will require investment in time and resources. Policy makers in Lao PDR will need to weigh carefully the potential benefits of such schemes against the effort required to establish and administer them.

Another area for consideration of policy makers wishing to strengthen the development impact of remittances, is the potential impact of improving the financial literacy of remittance recipients (generally families) and other types of support which can help recipients make the most productive use of remittance resources. Most remittances are used for consumption by the recipients, and investing in financial literacy can help in investment decisions that are sound, whether it be using remittances for education or health costs, small business expansion/ development, or savings.

A second issue to consider is whether there are measures that can be taken to ease transfers, making remittance services more cost-effective and reliable. Addressing this issue requires an acknowledgement of the fact that there are a variety of transfer mechanisms, both formal and informal. To gain an understanding of the specific mix of transfer mechanisms in Lao PDR will require further investment in establishing centralized data collection and reporting mechanisms for banks and money transfer organizations (MTOs). Obtaining an accurate picture of the remittance context in the country may also require undertaking surveys at the household level to determine types of remittance services being used, volume of informal remittances, and use of remittances. In terms of reducing the costs of remittance transfers, there are steps that can be taken. These include incentivizing more banking and financial institutions to offer services for remittance transfers; disseminating information to migrants on remittance services and options; enhancing coordination between banking/finance sectors and labor sector agencies; exploring opportunities for innovation in the use of technologies for financial transfers such as mobile banking; and continuing to expand banking service points to encourage transfers through the banking system rather than through MTOs (which are generally recognized to charge fees which are higher, regressive, and non-transparent).<sup>99</sup>

In conclusion, it is worth noting that an objective of the DFAA is to provide evidence on the relative strategic importance and potential of various finance flows. As such, given the *relatively* small amounts of annual remittances to Lao (as compared to other finance flows), policy makers will need to weigh carefully the potential benefits of strengthening remittance flows, including through the measures discussed above, as well as through strengthening the Office for Overseas Lao Affairs in MoFA, but also the opportunity costs of various actions given the strategic importance of some other flows as well.

98 OSCE, IOM, ILO, *Handbook on Establishing Effective Labour Migration Policies in Countries of Origin and Destination*, 2006, pg. 75.

99 OSCE, IOM, ILO, pgs. 73–77.

### 4.2.3. INGOs

International private philanthropy has grown over the last few years, although it is still relatively small in comparison to ODA and OOF. The leaders are foundations based in the US and EU countries, although most DAC countries have philanthropic foundations/funds<sup>100</sup> that are engaged in international projects. However, external philanthropic assistance in Lao PDR has been growing to some extent through INGOs. International NGOs operating in Lao PDR are registered with the Ministry of Foreign Affairs (MoFA), and while they are required to report on their financial activities, the reporting is incomplete.

International NGOs (INGOs) often make financial contributions to local NGOs in developing countries; Governments may often mistakenly assume that international and donor funds for NGOs crowd out donor funds for Governments. However, a 2009 survey of 39 countries revealed that fees and philanthropy contributed on average 50 per cent and 15 per cent respectively of NGO revenues, with only 35 per cent coming from Governments and official sources.<sup>101</sup> INGO and other international private philanthropic activity may be a potential growth area to harness for development activities in Lao PDR, but will be most effectively leveraged with concomitant attention to ensuring that both Government and INGOs/NGOs can operate with a minimum of duplication in provision of services. Another issue which may need attention is further exploration of the degree to which there may be a double counting of ODA flows which include allocations to INGOs/NGOs in Lao PDR, whereby the same resources can be mistakenly counted twice: once when NGOs report their funding sources, and a second time when the donor reports their total ODA grants and loans to a country. The imperative to clarify such issues of [potential] double counting stems from the overall need to understand the nature of existing development finance flows, with a view to ensuring their optimal impact by avoiding duplication.

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100 Lao PDR has directly (or indirectly through recipients in other countries implementing programs in Lao PDR) benefited from the Rockefeller Foundation, McKnight Foundation, McArthur Foundation, Asian Fund, amongst others (see data provided by the Foundation Center for the foundations registered and operating in the US).

101 See UNDP *Asia Pacific Effective Development Cooperation Report 2014*, p. 49.

# Chapter 5. Conclusions and Recommendations

## 5.1. Development Finance Flows in the Economic Growth Context of Lao PDR

### 5.1.1 Development Finance Flows and the 8th NSEDP

In the background document prepared by the Ministry of Planning and Investment for the 12th High Level Round Table meeting in 2015, estimates of the financing requirements for the 8th NSEDP are presented, as seen in Table 3. Based on these financing requirements, key observations include: (i) it is expected that the private sector (PPPs, private investment and bank lending) will contribute over three quarters (approximately 76 per cent) of the total, (ii) ODA continues to feature as a critical source of financing, and (iii) Government revenue is proportionally similar as a share of the total as compared to the 7th NSEDP financing.

**Table 3: Estimated Investment Requirements for the 8th NSEDP (in USD)**

Source	Total over Five Years	Share of Total (%)	Annual (approx.)
Government Investment/Revenue	3 billion	10.9	600 million
ODA	3.5 billion	12.7	700 million
Foreign and Domestic Private Investment	15.5 billion	56.1	3.1 billion
Bank Lending	5.6 billion	20.2	1.12 billion
<b>Total</b>	<b>27.6 billion</b>	100.0	

Source: MPI

These estimates are based on some important assumptions in terms of macroeconomic stability factors:<sup>102</sup>

- a budget deficit of not more than 5 per cent over each of the five years of the plan
- domestic budget revenue of 20–22 per cent of GDP needs to be mobilized
- total budget expenditure of less than 28 per cent of GDP
- public sector salaries not exceeding 45 per cent of domestic revenue
- GDP growth of not less than 7.5 per cent
- inflation managed at less than 6 per cent
- exchange rate stability
- foreign exchange reserves consolidated to at least five months of import coverage

102 Roundtable background document, pp 45–46.

In addition to macroeconomic factors, the Government has also made some broader observations about the context for economic growth and macroeconomic stability. These include a recognition of risks associated with the increasing dependence on natural resource exploitation and associated need to continue to diversify the economy. The importance of continuing to mobilize external grants and loans is noted, while also emphasizing the need to encourage investment by both the domestic and foreign private sector. The Background Document also makes mention of the need to “accurately identify investment proportion from the state budget and reflect actual development and ensure the highest effective use of the budget.”<sup>103</sup>

Against the backdrop of the financing needs identified by the Government for the 8th NSEDP, the DFAA has identified three strategic priorities which could be central to the formulation of an Integrated National Financing Framework for Lao PDR. In addition to proposing these strategic priorities, the DFAA identified ways in which select individual finance flows can be leveraged to contribute to financing needs. The DFAA also makes recommendations about potential next steps for taking forward the recommendations.

### 5.1.2 Recommendations for an Integrated Approach to Leveraging Development Finance

Lao PDR has been successful in attracting various forms of finance, which has resulted in an economic growth rate that has been one of the highest in the region, even in the years when many similar countries have not been successful in maintaining high rates of economic growth. However, both the Government and development partners (bilateral and multilateral) recognize that social development has not been as successful as economic development. Despite Government efforts to address the gap in the 7th NSEDP, there remains room for improvement. Hence, the 8th NSEDP will need to pay particular attention to social development, together with sustainable development, rather than focusing disproportionately on achieving quantitative economic growth targets.

A key conclusion of the DFAA therefore is the observation that Lao PDR will need to focus in the coming period on not only attracting increasing volumes of development finance, but also ensuring that the utilization of such finance is undertaken with a view towards investments which tackle the challenges of inequality and poverty that the country faces. Such an approach will require coherent policies and institutional arrangements to align finance flows behind national priorities. Requisite reforms may be quite complex; go beyond the remit of a single ministry or sector; and demand long-term commitment. An example would be the challenge of shifting from an economy reliant on natural resource-based exports towards one with more balance across other sectors and stronger pro-poor orientation, including prospects for creating jobs and livelihoods.

The scope of reforms required for Lao PDR to develop and align finance flows for achievement of national development goals is significant, as the DFAA has shown that there is a great deal of inherent complexity. This complexity is not unique to Lao PDR, and has been the subject of discussion at the global levels including at the 2015 *Financing for Development* conference. What has emerged is the recommendation that countries develop Integrated National Financing Frameworks (INFFs) to respond to the SDGs and to articulate specific strategies for financing them.

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103 Roundtable background document, p 45.

As has been noted earlier in the DFAA report (see Box 2), INFFs are considered long-term and ambitious endeavours with the INFF itself comprised of a number of building blocks, including:

- A national development strategy / plans with well-articulated sets of priorities and results, including costed targets and indicators
- Integrated planning and budgeting processes, that enable to link national priorities and results with medium term expenditure and budget frameworks and monitor progress
- A resource mobilization strategy to meet the costs required by the national development strategy / plans
- Financial management systems that allow government to better harmonize domestic and international public finance, as well as to leverage private sources of finance
- Institutional arrangements in place that facilitate coherence among various policy areas and coordination across government for resource mobilization and prioritization of policy and institutional reforms
- An enabling environment in which a range of stakeholders can engage in the debate over the effectiveness and impact of finance in delivering the SDGs, thereby supporting transparency and accountability

In the context of Lao PDR, it is important to note that progress has been made on some of these components. Not only is there a national development strategy outlining national priorities and results, but there has been an effort to identify associated financing needs. The DFAA is itself a contribution to a resource mobilization strategy. The Government has been working with partners for some time to introduce reforms which will improve the integration of the planning and budgeting systems including through medium term frameworks. There have also been investments in institutional arrangements to promote transparency and dialogue with stakeholders, most notably through the Round Table Mechanism.

While the results of these efforts should not be underestimated, the decision to develop and implement an integrated financing strategy will require political commitment across a number of institutions and with key development partners. Such a strategic approach implies more complex decision-making processes, which will need to be informed by data that at present is scattered across systems and institutions. In the context of Lao PDR's ambition to graduate from LDC status by 2020, a core element of its financing strategy will certainly be to look at how to use ODA and concessional finance to maximum and strategic advantage in the near term, and to take decisions on its use with a view towards investing in long term benefits to the country. There is scope as well for improving coordination and data on synergies between ODA and other forms of external development cooperation such as South-South Cooperation.

Given the continuing importance of external development cooperation to the financing of the NSEDP, the experience and leadership of MPI/DIC, together with the Ministry of Finance, will be critical to defining how to most strategically allocate and manage external cooperation resources. However, managing the full 'dashboard' of development finance in Lao PDR will demand approaches which go beyond current systems of public sector budgeting and managing external resources. What will be needed are strategies where the systems for governing, allocating, and monitoring the use of individual finance flows are handled more holistically, so as to avoid duplication and maximize impact.

A key contribution of the DFAA is to not only present findings on trends for *individual* finance flows, but also to use those findings and analysis to formulate an overall picture of the development landscape. This includes attention to the *interface* between individual flows, and possible directions for prioritizing attention by the Government to some flows over others. In this connection, the DFAA recommends the following three strategic priorities:

- **First, leverage the private sector in support of achieving national development results.** The DFAA findings in this area demonstrate that the opportunities for leveraging the private sector towards development span both the domestic and international private sector contribution. Over three-quarters of the financing for the 8th NSEDP is expected to come from the private sector. It will be important to continue to promote an attractive investment climate for FDI, but with recognition of the need to create an enabling environment for attracting FDI which contributes positively to social development and environmental sustainability. A key factor for attracting private sector investment which has been identified is the need for infrastructure investment. There is an opportunity to work with Southern partners here as key FDI investors (including in hydro sector) are neighboring and Asian countries. PPPs may have an important role to play in improving infrastructure and the DFAA provides recommendations on PPPs (see below in section with recommendations for individual finance flows and instruments).

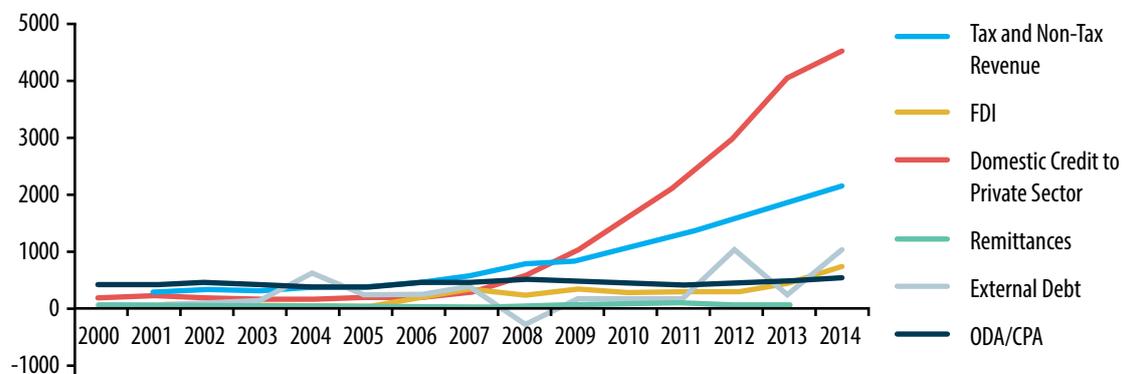
At the same time, the DFAA also highlights the importance and opportunities for strengthening the domestic private sector, including support to SMEs to be more productive and further tap into the export market. The DFAA discusses the trend in growth in domestic credit, largely resulting from the expansion of access to banks and financial instruments. There is an opportunity in this regard to support individuals in making productive use of these sources of credit, towards building livelihoods and business opportunities. However, more data is needed on the degree to which the expansion of the availability of domestic credit has translated into productive investment.

- **Second, ensure the efficient and effective spending of public revenues through the budget.** The DFAA findings include highlighting the considerable improvements made by the Government to increase levels of domestic public revenue collection including through both tax and non-tax revenue. Indeed, tax collection has increased nearly sevenfold over the past 14 years. On the one hand, these efforts must continue, and the DFAA notes opportunities for further strengthening domestic resources mobilization. On the other hand, the issue is not just one of continuing to increase domestic revenue but also of ensuring that it is efficiently and effectively spent through the budget and in support of national development priorities and results.
- **Third, take a forward-looking approach to utilizing flows of external public finance, including ODA, SSC, and climate change finance.** The DFAA findings include discussion of the fact that there is not expected to be a significant drop-off in absolute amounts of these finance flows in the near future. They should therefore continue to be a strategic priority in the Lao PDR context, but with attention to exploring the complementarity between them and where each has added value. This relates also to the expected changes in concessionality as Lao PDR anticipates graduating from LDC status. For example, while ODA has in the past been used to fill the fiscal gap and contribute to social sector spending, the increase in domestic public revenues can now be increasingly used for this purpose. It may in turn be more appropriate to utilize external flows towards infrastructure investment, which in turn will improve the business investment climate. Given the likely change in the 'mix of money' available to Lao, it will be timely to have more dialogue and analysis about whether these particular external finance flows are best used in the economic or social sectors and how they contribute to

results. This is an area where DIC can make a significant contribution to the policy dialogue, but in order to do so it may need to strengthen its role in collecting, analysing and disseminating data around different finance flows.

Figure 5.1 captures the overall findings of the DFAA by illustrating the relative proportion and trends in development finance flows; these three proposed strategic priorities address key development finance flows (FDI, domestic credit, public revenues, and ODA), particularly given risks identified with the high levels of external debt and the need to develop other finance flows in a balanced manner. The strategic priorities are also reflected in the *2016–2025 Vientiane Partnership Declaration on Effective Development Cooperation*, which prominently recognizes the important contribution of domestic resource mobilization, south-south/triangular cooperation and knowledge sharing, and ‘business as a partner for development’.

**Figure 5.1: Development Finance Flows in Lao PDR, 2000–2014 (in USD mil.)**



Sources: World Bank, DIC/MPI, Bank of Lao PDR, OECD (calculations by the authors)

### 5.1.3 Potential Contributions of Individual Finance Flows

#### Domestic Public Revenues

Experiences in other countries have shown that domestic resource mobilization will become increasingly critical as a country graduates from LDC status. At issue is not only the quantity of domestic public revenue raised but also the systems for decision making about its use. The following are broad areas for potential reform looking forward:

- i. Many, if not all LDCs experience problems with formulating effective and efficient PFM policies. The World Bank and ADB have supported PFM reforms in Lao PDR for a number of years, and the situation is improving, as detailed in Box 5 of this report. However, in order to better utilize public resources, the Government should strengthen the use of medium-term tools (MTEF/MTFF). A key priority should be to improve the efficiency and effectiveness of the use of resources over which the Government has the most control (such as domestic public revenues) by using the national budget as a platform and continuing to strengthen systems of planning, budgeting and budget monitoring, including considering the introduction of e-procurement.
- ii. The Government has made notable progress on increasing the collection of domestic tax and non-tax revenue as is evident from Figure 5.1. The DFAA has identified areas where the tax and non-tax

administration can be strengthened to bring more coherence and transparency and to generate additional revenues to fund the country's development priorities.

- iii. Review the allocation of domestic public revenue against national priorities including increasing allocations to social sectors. As the volume of public revenues increases, it will be important for the Government to look at whether they are being committed to the sectors and initiatives which will lead to achievement of the development goals in the 8th NSEDP. In order to address issues of social inequality in the country, the Government needs to further invest in education and health, ensuring that all social and ethnic groups are engaged.

### ***ODA, SSC and Climate Change Finance***

With implementation of the 8th NSEDP Lao PDR can continue to count on support from its traditional development partners; the contribution of ODA to the overall financing has been recognized, as shown in Table 3. ODA has been a very important source of development finance for Lao PDR over past decades, and will continue in the near future to be so, particularly in the social sectors, where many traditional donors are not only willing to provide financial support but can also bring global experience to bear in helping Lao meet its social development goals. The DFAA, in looking across all development finance flows, also provides an opportunity for reflection on how ODA can be utilized in concert with other flows, particularly other external flows such as SSC and climate change finance:

- i. Given the recognized importance of ODA to Lao PDR, there has been significant investment in creating institutions and mechanisms to manage it, including the Round Table Mechanism. What emerges from the DFAA is the opportunity to not only continue to strengthen this dialogue forum and partnership mechanism, but to expand its scope to help coordinate and manage other development finance flows. The Government of Lao PDR has signalled its interest in this approach with the issuance of the new Vientiane Partnership Declaration, which looks at the role of development cooperation beyond ODA. Building on this, and in the context of the start of implementation of the 8th NSEDP, it may be timely to look at ways to strengthen the Round Table mechanism to incorporate discussion of other finance flows and development partners.
- ii. Internally, within the Government, a similar review of institutional arrangements for managing external public finance may be in order. There are two aspects for consideration:
  - a. First, there is scope for improving coordination efforts between DIC as the leading coordination body at the technical level and other Ministries, Departments, and Agencies of the Government which are in some way managing finances and relationships with development cooperation partners in both the public and private sectors.
  - b. Second, as the implementation period for the new Vientiane Partnership Declaration begins, it may be timely to consider more strategic and innovative institutional arrangements for managing ODA and SSC and other forms of external development assistance. While any changes to mandates and institutional arrangements will need to be carefully considered, it has been observed that negotiations are taking place in different forums. For example, in addition to the Round Table process, negotiations with key non-traditional partners (China, Vietnam, India, and Thailand) happen through Joint Cooperation Commissions.<sup>104</sup> What emerges is a picture suggesting potential for bringing together some negotiation processes

104 As reported in ODI *Age of Choice* study, p 24–26.

and streamlining institutional arrangements to ensure that different forms of development finance are being used in synergy.

- iii. DIC also maintains the Aid Management Platform, a custom-made database that is intended to collect all information on foreign assistance to Lao PDR. It may be opportune to look at the current data coordination model. For example, the DFAA points to increasing trends and opportunities in areas such as climate change finance, South-South/Triangular Cooperation, and domestic/international philanthropy. These are areas where the potential for attracting more resources is well recognized, yet the challenges in finding hard data on current and past trends demonstrates the need for better understanding of the opportunities based on data.

### ***Private Sector: Domestic private sector, FDI and PPPs***

As noted above, the expected contribution of the private sector to the 8th NSEDP is significant. Providing detailed recommendations for improving the business and private sector investment climate in Lao PDR go beyond the scope of this study, and have been the subject of focused individual studies, such as the World Bank's Investment Climate Assessment, which provides specific recommendations on how the Government can affect a shift away from a private sector economy which is disproportionately reliant on natural resources and extractive sectors. While the DFAA does offer some specific recommendations, as below, for the domestic private sector, FDI and PPPs, two overarching points are emphasized as a chapeau:

- i. While there are potentially many specific reforms which could improve private sector investment (foreign and domestic) in Lao, it is recommended that the reform agenda be strongly informed by a litmus test of whether the expected outcome will contribute not just the quantity or volume of investment but will also further the progress on achieving NSEDP goals, including with attention to social and environmental impacts.
- ii. There are benefits to looking at the private sector more holistically rather than artificially 'siloining' reform efforts in the spheres of domestic, foreign, and PPPs. For example, there may be opportunities for strengthening the domestic private sector by identifying opportunities for Laotian companies to work with foreign companies, perhaps by incentivizing these type of joint ventures in the policy and regulatory regime. Similarly, as stated in one of the 'strategic priorities' it may be timely for the Government to consider further leveraging its current access to ODA and concessional finance to accelerate the needed reforms to the private sector enabling environment, taking a long term view of reforms required to address the volatilities and social/environmental disadvantages of the natural resources based economy.

### ***Domestic Private Sector***

Analysis of the enabling environment for the domestic private sector in Lao PDR has found that there are several areas which could be the focus of actions. Improving the overall business climate by accelerating legal compliance with the WTO should also enable further trade integration and private-sector growth, improving economic diversity and hence promoting economic resilience. As an overall matter, Lao PDR should continue to build a business environment that will include major project investment but also increasing support to micro and small and medium enterprise (SME) development:

- i. Work with commercial banks and the Bank of Lao PDR to conduct a review of lending to domestic private sector firms, with a view to determine (a) whether banks are lending to the right mix of sectors given the development priorities outlined in the 8th NSEDP and (b) the degree to which the

sharp rise in domestic credit is being translated into private sector investment which is in line with NSEDP goals. Such a review should lead to development of an action plan with policy and regulatory initiatives to promote domestic private sector growth in line with national development priorities.

- ii. Continue to work with development partners including UNCDF and ADB on programs to promote inclusive finance and improve access to finance for micro, small and medium enterprises.
- iii. Consider measures for reducing the potential crowding out of the domestic private sector by State Owned Enterprises, which are dominant in key profitable sectors. This may include review of the proportion of credit being provided to SOEs, potentially at the expense of credit to domestic private sector.

### **FDI**

FDI is a finance flow which is growing in Lao PDR and continues to offer growth potential. The following recommendations were developed as potential actions for attracting more FDI to Lao PDR. It bears worth repeating, however, that the Government will need to carefully weigh the risks and rewards of undertaking shorter term measures to attract more investment with the longer term benefits of a reform plan to attract quality investment in sectors outside the natural resource sectors.

- i. Improve investment and trade-related administrative procedures and regulations. There are opportunities to improve the enabling environment for investment and trade in Lao PDR and it seems appropriate for the Government to undertake a more detailed assessment of investment procedures and regulations with an eye towards developing a multi-agency action plan for reform which emphasizes improving the capacity of the Government to implement its revised regulations. Such reports as the World Bank's *Doing Business* highlight opportunities for reform but do not provide prioritized and specific recommendations for change. The Government may consider approaching USAID to conduct an Investor Roadmap or the Foreign Investment Advisory Service (FIAS) to undertake an Administrative Barriers Diagnostic.<sup>105</sup> Both of these projects employ a very similar methodology of process mapping to pinpoint inefficiencies that delay and deter investment and offer guidance for making specific reforms. A Roadmap or Diagnostic intervention would build on studies sponsored by donors in Lao PDR, including the World Bank's Investment Climate Assessment.
- ii. Review investment promotion themes. Some of the themes the Government uses in promoting Lao PDR as a favorable destination for investment should be revised. For example, Lao PDR cites its low labor costs, but wages are rising.<sup>106</sup> As noted by its Private Sector Working Group, "per capita GDP rose from USD 227 in 1990 to USD 1,460 in 2013, a more than six-fold increase, and it is projected that economic growth is projected to continue within a 7–8 per cent range throughout the next decade."<sup>107</sup> Furthermore, many in Government, the donor community, and private sector note that although labor costs may be low by international standards, Laotian labor is also relatively unskilled and its labor surplus is largely concentrated in the agricultural sector.
- iii. The availability of agricultural land, low cost electricity, proximity to large regional markets, abundance of forests and tourism potential, including eco and cultural tourism – which have the

105 FIAS is a part of the World Bank Group.

106 According to interviews, the Lao PDR minimum wage is approximately USD 85.7 per month.

107 *Annual Progress Report of the Trade and Private Sector Working Group for 2013–2014 Fiscal Year*, 2014, p. 2.

benefit of spurring growth in uniquely domestic sectors such as handicrafts, textiles, and local food products – are several attractive attributes of Lao PDR that are cited less often.

- iv. Review investment incentives. The efficacy of Lao PDR’s current investment incentives should be reviewed. There are those in the donor community who have questioned the need for ten-year tax holidays in the natural resource sector, citing strong and consistent demand for concessions in these sectors and very low land costs. Furthermore, when these investments come to the end of their tax holidays and they must begin paying the 24 per cent corporate tax rate, it is possible that some companies may close and reorganize to avoid the sharp increase in taxes. A lower tax rate and the elimination of negotiated tax holidays may make Lao PDR a more stable and transparent investment destination while increased revenues are paid to the state.

### **Public Private Partnerships (PPPs)**

As the Government has indicated an interest in prioritizing PPPs, the DFAA has gone into some detail about areas where the policy and institutional framework- and indeed general understanding and capacity to engage in PPP modalities- will need to be further developed in order to utilize PPPs to a greater extent in the coming period:

- i. Identify priority projects that may be appropriate for PPP models. Given the potential for export-driven growth in Lao PDR, the Government should identify a list of priority projects that will improve the country’s infrastructure for trade.
- ii. Ensure clear and needed public benefits. In considering the development of a PPP, the Government must ensure that a clear and vital public sector purpose is being served. This could include the provision of a needed infrastructure financed off-budget, free technology given to underserved students, cheaper public services, or skills development and commodity value-addition.
- iii. Carefully weigh the risks and rewards of a long-term partnership. Especially in infrastructure, PPPs are long-term commitments between the Government and a private sector entity. Whilst the private sector will assume the operational and financial risk during the period of performance, the Government must ensure that it can shoulder its responsibilities for usually 20–30 years. The public sector actor must enable the implementer to operate in a predictable, well-regulated manner throughout the term of the contract and also be the bridge between public perceptions and needs and the private sector operator. This is especially important in a country like Lao PDR where many large projects, and potential PPPs, involve resettlement and possible threats to livelihoods and the environment. “Partnership” is the central concept in a PPP and each side must adhere to the responsibilities as outlined in a well-articulated contract over the duration of service delivery. As such, extensive due diligence and long-term vision are required in designing a successful PPP.
- iv. Develop the capacity within Government to assess the quality of PPP partners. One of the critical assumptions of the PPP model is that the private sector can bring better management and more efficient operational skills than the public sector. This assumption must be validated in each country context. In Lao PDR the maturity and capacity of the domestic private sector is questionable. Especially given the long-term nature of PPPs, the Government must be able to evaluate the quality and durability of the private sector partner. This includes not only the financial strength of the firm, but also its management capacity, corporate social responsibility and record of service delivery.
- v. Learn from Lao PDR’s existing PPPs. Despite the potential benefits of traditional infrastructure PPPs, there is a learning curve for countries new to implementing such projects. Although not

prohibitive, countries with a relatively immature private sector may face challenges in attracting a sufficient number of qualified bids. The contracting process and resulting agreements are often complex, especially given that they must address the whole life cycle of the project. Given that Lao PDR has experience in implementing at least one PPP, it would be appropriate to take stock of its experience in designing, regulating, and monitoring the (semi-)private operator and derive what lessons learned could help future PPP development.

### **External Debt**

As shown in Figure 5.1, Lao PDR is clearly relying a great deal on external borrowing and debt to finance the NSEDP. While this source of finance is one which in principle can be used effectively, the Government will need to consider carefully the possible implications of being classified as having high debt risk. What is clear is that Lao PDR has been very successful at attracting commercial loans but now faces a situation of needing to service them. Looking ahead, the following may be considerations for improving the management of external debt:

- i. Formulate a clear strategy on debt, including publicly announced targets on key debt measures, such as the ratio of external debt to GDP and external debt to Government revenue.<sup>108</sup> There may be an opportunity to learn from other countries on how they have developed a debt strategy in an LDC-to-MIC country context.
- ii. Review the portfolio of external debt obligations in the context of the 8th NSEDP development goals and initiate discussions on strategies for balancing external borrowing in natural resource sectors such as hydropower projects with opportunities to borrow to fund development projects in other sectors which will realize more gains for sustainable development.
- iii. Consider opportunities for re-negotiating payment terms on existing non-concessional loans and/or improving commercial borrowing terms going forward. For the latter, this could include exploring the feasibility of pursuing a credit rating- weighing the possible advantages of improving borrowing terms against the transaction costs of the procedures for securing a credit rating from an internationally recognized credit agency.

### **Remittances**

Figure 5.1 shows that as a relative proportion of all development finance flows, remittances do not feature prominently in Lao PDR, although their importance to recipient families and communities should not be underestimated. Should the Government wish to take steps to strengthen remittances as development finance flow, the following recommendations could be considered, based on the experiences of other countries in the region:

- i. Explore options for establishing financial instruments to which overseas Lao (migrant workers and diaspora community) can voluntarily contribute, which will provide a source of finance for national development. While there are various types of financial instruments (diaspora bonds, traditional fund-raising measures, Government-sponsored incentive schemes), the appropriateness in the Lao PDR context will need to be considered carefully, including issues of capacity and overall human/institutional resource requirements for effectively rolling out such programs. A survey to assess potential interest among migrants/diaspora may be a first step.

108 This was the recommendation as stated in the ODI *Age of Choice* study

- ii. Strengthen the Office for Overseas Lao Affairs in MoFA to collect data on migration and remittances, as well as lead and coordinate all policies related to international migration and the migrant economy.
- iii. Provide support to remittance recipients, with a focus on the poor and those in rural areas, to improve financial literacy with a view towards encouraging more appropriate/productive use of remittance funds, whether through savings and/or investment decisions.
- iv. Undertake focused analysis on the cost of remittance transfers to Lao PDR, based on a survey of formal (banks, MTOs) and informal transfer mechanisms being used and the associated costs. Based on findings, identify strategies for reducing the costs of remittances.

## CSR

Corporate social responsibility is an area that is potentially quite untapped in Lao PDR. The Government may wish to elevate and highlight the potential contribution that CSR can make for achieving the goals in the 8th NSEDP, and emphasize CSR as a concept and approach which can bring together the interests of Government, private sector, and civil society. Initial actions could include:

- i. Promote dialogue on how CSR approaches can help Lao PDR align FDI as well as future private sector development with the social, economic, and environmental objectives of the 8th NSEDP. Such dialogue will need to look at how the concept of CSR can best be applied in the Lao context, including the type of incentives to which Lao's private sector investors are most likely to respond.
- ii. Undertake further analysis on potential policy options for encouraging CSR in Lao PDR, including reforms to the tax structure and legal framework for private sector investment, both international and domestic.

### 5.1.4 The Way Forward: Key Challenges and Next Steps

Formulating an integrated financing strategy for the 8th NSEDP is a challenging and long term endeavour, yet there are immediate steps which can be taken towards this end. First, with the new Vientiane Partnership Declaration now approved, MPI/DIC will need to develop an attendant action plan, by September 2016, to operationalize the Declaration. It is therefore proposed that DIC use the opportunity of dialogue with partners and across Government ministries to discuss the strategic priorities identified in the DFAA to inform the development of the Declaration action plan. Consultations around the Declaration action plan will provide an opening for discussing how different forms of development finance can contribute to achieving national development goals, and the ways in which existing institutional coordination mechanisms, data collection systems and monitoring frameworks may need to be adjusted in order to bring about more integrated strategies for managing development finance.

In the medium and longer term, MPI, DIC, and the Ministry of Finance will need to define a program of institutional reforms to address the issues raised in the DFAA and take forward its recommendations. Most of the required reforms are not confined to the mandate of a single ministry. The reforms required for realizing an integrated financing strategy for the 8th NSEDP will need to be consulted, prioritized, implemented and monitored. As a foundation for the reform agenda, it will be necessary to identify strategies for bringing together key data on finance flows which are confined to different government areas, as well as related knowledge and analysis. A longer term approach to managing the different finance flows will also need to take into account the fact that alignment of non-public flows will present particular challenges to the government as these flows are not under direct control of the public sector

and ways to influence their alignment will be more indirect, such as through the regulatory framework for private sector investment.

**Table 4: Key Recommendations for Lao PDR Emerging from the DFAA**

Area/Flow	Recommendations	
<b>1. Domestic Public Revenues</b>	1.1	Strengthen the use of medium-term tools (MTEF/MTFF) to improve the efficiency and effectiveness of the use of resources by using the national budget as a platform and continuing to strengthen systems of planning, budgeting and budget monitoring
	1.2	Strengthen tax and non-tax administration to bring more coherence and transparency and to generate additional revenues to fund the country's development priorities
	1.3	Review the allocation of domestic public revenue against national priorities including increasing allocations to social sectors to further invest in education and health and to ensure that all social and ethnic groups are engaged
<b>2. ODA, SSC and Climate Change Finance</b>	2.1	Continue to strengthen and expand dialogue forums and partnership mechanisms to help coordinate and manage other development finance flows
	2.2	Further improve coordination efforts between coordinating bodies both at the technical level and policy levels to manage financial flows and relationships with development cooperation partners in both the public and private sectors
	2.3	Consider more strategic and innovative institutional arrangements for managing ODA and SSC and other forms of external development assistance
	2.4	Further improve database system to capture more information on foreign assistance and to attract more resources
<b>3. Domestic Private Sector</b>	3.1	Conduct a review of lending to domestic private sector firms to development of an action plan with policy and regulatory initiatives to promote domestic private sector growth in line with national development priorities
	3.2	Continue to work with development partners including UNCDF and ADB on programs to promote inclusive finance and improve access to finance for micro, small and medium enterprises
	3.3	Consider measures for reducing the potential crowding out of the domestic private sector, including a review of the proportion of credit being provided to SOEs, potentially at the expense of credit to the domestic private sector
<b>4. Foreign Direct Investment</b>	4.1	Improve investment and trade-related administrative procedures and regulations to enabling environment for investment and trade in Lao PDR
	4.2	Conduct a more detailed assessment of investment procedures and regulations towards developing a multi-agency action plan for reform to emphasizes improving the capacity of the Government to implement revised regulations
	4.3	Conduct an investor roadmap or Foreign Investment Advisory Service to undertake an administrative barriers diagnostic
	4.4	Review investment promotion themes with specific strategies to overcome issues on labor supply and quality
	4.5	Tourism should be one priority area for further development and attraction of investment
	4.6	Review investment incentives where a lower tax rate and the elimination of negotiated tax holidays may make a more stable and transparent investment destination while increased revenues are paid to the state

Area/Flow	Recommendations	
<b>5. Public Private Partnerships</b>	5.1	Identify priority projects that may be appropriate for PPP models with potential for export-driven as well as to improve the country's infrastructure for trade
	5.2	Ensure clear and needed public benefits that could include the provision of a needed infrastructure financed off-budget, free technology given to underserved students, cheaper public services, or skills development and commodity value-addition
	5.3	Strategy, regulation, risk and rewards measurement systems should be developed to enable the implementer to operate in a predictable, well-regulated manner throughout the term of the contract
	5.4	Develop the capacity within Government to assess the quality of PPP partners as well as to manage PPP long term contracts
	5.5	Review and assess Lao PDR's experience with existing PPPs or similar/related models
<b>6. External Debt</b>	6.1	Formulate a clear strategy and measures on debt in the LDC-to-MIC-context, including publicly announced targets on key debt measures, such as the ratio of external debt to GDP and external debt to Government revenue
	6.2	Consider opportunities for re-negotiating payment terms on existing non-concessional loans and/or improving commercial borrowing terms going forward
<b>7. Remittances</b>	7.1	Explore options for establishing financial instruments to which overseas Lao (migrant workers and diaspora community) can voluntarily contribute, which will provide a source of finance for national development; a survey to assess potential interest among migrants/diaspora may be a first step
	7.2	Strengthen the Office for Overseas Lao Affairs in MoFA to collect data on migration and remittances
	7.3	Provide support to remittance recipients to improve financial literacy with a view towards encouraging appropriate/productive use of remittance funds
	7.4	Undertake focused analysis on the cost of remittance transfers to Lao PDR and identify strategies for reducing the costs of remittances
<b>8. Corporate Social Responsibility</b>	8.1	Promote dialogue on how CSR approaches can help Lao PDR align FDI as well as future private sector development with the social, economic, and environmental objectives of the 8th NSEDP
	8.2	Undertake further analysis on potential policy options for encouraging CSR in Lao PDR, including reforms to the tax structure and legal framework for private sector investment, both international and domestic

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## Annex 1: The DFAA Process

The assessment consisted of several phases: (i) desk-based review and preparation for in-depth consultations, (ii) country in-depth consultations to introduce the assessment to stakeholders, to conduct interviews and to collect data, (iii) draft report and (iv) final approved report.

**Team:** The DFAA team was composed of four members (three international consultants, specializing in Public Financial Management [PFM]; Public Private Partnership [PPP] and Private Finance; and South-South Co-operation [SSC]; with the support of one national consultant). There was a designated focal point within the government (from the DIC/MPI). The team focused on the analysis of major flows of development finance to and within Lao PDR- external and domestic; public and private- covering to the extent possible the individual flows depicted in the table below. Special attention was paid to PPPs and SSC at the request of the Government of Lao PDR.

**Table A1: Dashboard of Development Finance Flows**

	Public	Private
<b>External</b>	<ul style="list-style-type: none"> <li>• ODA Grants and Loans</li> <li>• Other Official Flows (OOFs)</li> <li>• South-South and Triangular Cooperation</li> <li>• External Debt and Borrowing</li> <li>• Vertical Funds: Climate-related Finance and Vertical Health Funds</li> </ul>	<ul style="list-style-type: none"> <li>• Foreign Direct Investment (FDI)</li> <li>• Remittances</li> <li>• INGOs</li> </ul>
<b>Domestic</b>	<ul style="list-style-type: none"> <li>• Tax Revenues</li> <li>• Non-tax Revenues</li> <li>• Revenue from State Owned Enterprises</li> <li>• Mineral/Natural Resource-related Taxation</li> <li>• Public Private Partnerships</li> </ul>	<ul style="list-style-type: none"> <li>• Domestic Private Sector Investment</li> <li>• Domestic Philanthropy and Corporate Social Responsibility</li> </ul>

**Phase 1:** During the first phase – desk-based review – the team consulted documentation relating to aid and aid management. DIC/MPI, UNDP Lao PDR, and UNDP Bangkok Regional Hub provided documentation to the team a month prior to the Inception Mission. The World Bank Development Indicators database and OECD Aid Statistics database were the main international sources of raw information, whilst IFIs operating in Lao PDR proved a very good source of analytical information, as well as many of the national government aid agencies operating in Lao PDR on a bilateral basis. DIC/MPI provided information from their Aid Management Platform and access to materials prepared for the Roundtable Consultation meeting held in November 2014.

The National Consultant (NC) has paid particular attention to the following:

- NSEDP and associated monitoring reports;
- Aid policy and related documents;
- Most recent budget documents;
- Organigrams of central agencies;
- World Bank and ADB Country Notes/Monitoring Reports;

- IMF Staff Notes;
- HDR reports, and
- MDG reports.

In many cases there was a need for triangulation, as the information (both qualitative and quantitative) differed between sources. Following a preliminary analysis of the information and documentation provided, the team conducted a detailed stakeholder mapping. A list of key stakeholders was drawn up in consultation with DIC/MPI, with the assistance of UNDP Lao PDR.

**Phase 2:** During the second phase – in-country consultations during an Inception Mission in November 2014 – the team met with over forty officials and stakeholders, representing a cross-section of Government Departments and development partners. Meetings were structured as open-ended interviews soliciting opinions on the state of development of Lao PDR, Lao PDR development results (including MDGs), ambition of the Lao PDR Government to graduate from an LDC status by 2020, and strategic development goals up to 2030. In the case of development partners the questions also looked at their past experience and engagement (primarily from the year 2000), as well as their planned support to Lao PDR until at least 2020. Stakeholders were also asked about their modalities of support and whether these are under review and may change in the near future (next five years). The emphasis on consulting a wide range of stakeholders proved important, as it allowed the team to gain an overview of development support activities.

**Phase 3:** This phase took place from late November 2014 to February 2015. Based on prior in-country consultations, the team prepared a draft DFAA report to share with stakeholders. In early January internal consultations were conducted within UNDP and the draft report was shared externally in mid-January. Based on the comments received, the team produced a second draft DFAA report, in preparation for the National Validation Workshop, held in February 2015. At the Workshop, stakeholders were invited to reflect on the report, and in particular the conclusions and recommendations, suggest changes and improvements, as well as to corroborate data reported in the study. During the National Validation Workshop, the Vice-Minister of MPI endorsed the DFAA report on behalf of the Government of Lao PDR.

**Phase 4:** The team revised the report, to include inputs received during the Validation Workshop and submitted the report to MPI/DIC in mid-2015. MPI/DIC then proceeded to share the report with stakeholders to invite comments, before undertaking in-house editorial revisions and quality control, with inputs from UNDP Lao PDR and the UNDP Bangkok Region Hub. The DFAA report was shared in draft form at the Roundtable Meeting in November 2015, following which stakeholders were invited to comment. A final round of revisions was made in early 2016, to reflect final inputs from MPI/DIC; to bring data sets up to date to the extent possible; and to strengthen and target the recommendations such that the DFAA could be used by the Government of Lao PDR in implementing the 8th NSEDP and taking forward the Vision 2025.

## Annex 2: Stakeholders Consulted

- *Arounyadeth Rasphone*, Director of Aid Effectiveness Division, Ministry of Planning and Investment
- *Ashley Palmer*, Governance and Development Effectiveness Specialist, UNDP Bangkok Regional Hub, Bangkok, Thailand
- *Audrey Maillot*, Attaché Cooperation, Acting Head of Operations, Delegation of the European Union, Vientiane
- *Azusa Kubota*, Deputy Resident Representative, UNDP CO Lao PDR
- *Clemency Oliphant*, First Secretary (Development Cooperation), Australian Embassy, Vientiane
- *Fongchinda Sengsourivong*, Deputy Director-General, Bank Supervision Department, Bank of Lao PDR
- *James Kovar*, Representative, USAID/Lao PDR, Vientiane
- *Leeber Leeboupao*, Director-General, National Economic Research Institute, Ministry of Planning and Investment
- *Malivanh Keomany*, Technical Officer, Fiscal Policy Department, Ministry of Finance
- *Manothong Vongsay*, Director General, Department of Investment Promotion, MPI
- *Manyvone Phonamath*, Technical Officer, External Finance Department, Ministry of Finance
- *Mark Miller*, Independent Consultant, Bangkok, Thailand
- *Michael Brady*, Senior Operation Officer, Forestry, IFC
- *Michel Goffin*, Chargé d’Affaires, a.i., Delegation of the European Union, Vientiane
- *Nathan Leibel*, CTA, Poverty Environment Initiative, UNDP/Ministry of Planning and Investment
- *Nils Christensen*, UXO Portfolio Manager/Head of UXO Unit, UNDP, Vientiane
- *Per Thiessen*, Global Finance Officer, The Halo Trust
- *Phanthakone Champasith*, Programme Manager (Trade) Development Cooperation, Australian Embassy, Vientiane
- *Phanthanousone Khennavong*, Technical National Consultant, Aid Coordination and Aid Development Effectiveness, UNDP/Ministry of Planning and Investment
- *Phaymany Heuangkamsay*, Acting Director-General, External Finance Department, Ministry of Finance
- *Phongsavanh Phomkong*, Head of Office, Lao PDR, IFC
- *Sengdavone Bangonesengdet*, Deputy Secretary General, Lao National Chamber of Commerce and Industry, Vientiane
- *Silavanh Vongphosy*, Assistant Resident Representative, UNDP Lao PDR
- *Sisomboun Ounavong*, Director-General, Department of International Cooperation, Ministry of Planning and Investment
- *Sisavanh Didraravong*, Director, Division of Macroeconomic Management Planning, Ministry of Planning and Investment
- *Somphone Phangmanyxay*, Deputy Director General, Ministry of Health

- *Soudalath Silaphet*, Country Officer, The World Bank Lao PDR
- *Soulinthone Leuangkhamsing*, Senior Economics Officer, Lao PDR Resident Mission, Asian Development Bank
- *Subir Datta*, Charge d' Affaires, a.i., First Secretary (Head of Chancery), Indian Embassy, Vientiane
- *Thomas Beloe*, Advisor, Governance, Climate Finance and Development Effectiveness, UNDP Bangkok Regional Hub, Bangkok, Thailand
- *Veunsavanh Svisay*, Deputy Director, Anti-Money Laundering Intelligence Unit, Bank of Lao PDR
- *Viengmala Phomsengsavanh*, Governance Program Specialist, Governance Unit, UNDP Lao PDR
- *Viengsamay Srithirath*, Country Officer, The World Bank Lao PDR
- *Zhao Wenyu*, Economic and Commercial Counsellor, Embassy of China, Vientiane

## Annex 3: Overview of Data Sources

Data for the DFAA study was drawn from various sources. Most data was provided by the Lao PDR Government, most notably the Ministry of Planning and Investment (MPI), the Ministry of Finance (MoF), and the Ministry of Health (MoH). From MPI, the Department of International Cooperation (DIC), the National Economic Research Institute (NERI) and the Department of Investment Promotion provided data. Data was collected in raw form, or by consulting published sources, such as *Government Finance Statistics Annual Report* (prepared by the MoF) and the *Lao PDR Statistical Annual* prepared by the Statistical Office. DIC provided access to their Aid Management Platform (AMP), and reports generated from it. The Bank of Lao PDR supplied data on the banking sector and microfinance institutions' performance. At the request of the Lao PDR Government, priority was given to national Laotian sources wherever possible.

International data sources were used as supplementary and as a control set. The primary source of data was the World Bank Development Indicators database, which in the case of Lao PDR provided data for most variables up to 2010 and for some data up to 2013. IMF has also published data on Lao PDR macroeconomic performance, which was used as a supplementary source. OECD International Development Statistics Database provided data on DAC countries' ODA and OOF to Lao PDR, as well as some other donors who report their ODA flows to OECD (e.g. Russia and EU member states, which are not members of the OECD). Data on vertical health funds (Global Fund and GAVI) was found on their websites and publications. The Open Aid Data database was also used to triangulate information and data. Data on international NGO activities was accessed online, from websites with project reports, although this provided an incomplete picture of INGO support to Lao PDR.

Secondary sources also provided data for the DFAA – most notably reports produced by the Government of Lao PDR, International Financial Institutions (WB, ADB, IMF, etc.), and third sector organisations (NGOs, charities, etc.). MPI/DIC provided access to materials prepared for the Roundtable Consultation meeting held in November 2014. Information/data was also collected through semi-structured interviews with a wide range of stakeholders, as well as from questionnaires.

In the case of conflict (which happened on occasion) between data sources, it was agreed with MPI/DIC that priority would be given to data provided by in-country Lao PDR sources.

## Annex 4: Examples of Financial Support Modalities in a South-South Context

### ***Asian Infrastructure Investment Bank (AIIB)***

The AIIB was established in December 2015 with 30 countries as founding members, and has been 'open for business' as of January 2016. Initially proposed by China, this new international financial institution is headquartered in Beijing and will focus on investing in infrastructure in the Asia region. The AIIB has an initial authorized capital of USD 100 billion.

According to the Asian Development Bank (ADB), the infrastructure investment needs in Asia could reach USD 750 billion annually during the period 2010–2020. The ADB's estimated lending approval each year of about USD 13 billion is simply not sufficient to support Asia's infrastructure financing needs.

The AIIB represents an important potential funding window for Lao to help meet its infrastructure investment needs. The bank will have similar responsibilities as other international banks, such as the ADB and the World Bank, but AIIB will mainly focus on Asian Countries.

### ***BRICS New Development Bank***

BRICS stands for Brazil, Russia, India, China and South Africa – which together represent a significant share of the world's production and population. BRICS has established the New Development Bank, with an initial subscribed capital of USD 50 billion and an authorized capital of USD 100 billion, aimed at financing infrastructure and sustainable development projects in the BRICS and other developing countries. BRICS also created a Contingent Reserves Arrangement (CRA), a fund with an initial authorized capital of USD 100 billion, which the BRICS countries will be able to use to forestall short-term liquidity pressures. As Lao PDR has cordial relations with BRICS member countries it can avail of this loan facility to finance its infrastructure, and socio-economic development projects at a concessional rate.

### ***South-South Exchange Trust Fund***

The South-South Exchange Trust Fund is a demand-driven multi-donor Trust Fund established to finance South-South experience exchange. The Fund is executed by the World Bank, leveraging its expertise, resources, and infrastructure. It was established in 2008 with support from contributing donors: China, Denmark, India, Mexico, The Netherlands, Spain, UK, Russia, and Colombia<sup>109</sup>. Donors pledged USD 10.3 million in support of the Trust Fund, which provides a simple and low cost mechanism for developing countries to share their knowledge and expertise in overcoming poverty.

The strategic objectives of the Trust Fund are (i) meet the immediate operational knowledge gaps of World Bank clients by catalysing the sharing of country experiences between practitioners; and (ii) document and disseminate lessons learned through a knowledge exchange library. Grants are disbursed

109 [www.worldbank.org/seetf](http://www.worldbank.org/seetf)

and implemented within 12 months. The knowledge exchange covers a wide range of topics including: Agriculture (fishing and forestry), Education, Finance, Industry and Trade, Public Administration, Law and Justice.

### ***IBSA Fund***

The IBSA Facility for Poverty and Hunger Alleviation (IBSA Fund) is a pioneering and flagship program of India-Brazil and South Africa (IBSA) which was established in March 2004 and became operational in 2006<sup>110</sup>.

The main objective of the IBSA Fund is to benefit other developing countries, particularly the Least Developed Countries (LDCs) and Post Conflict Reconstruction and Development (PCRD) countries around the world, in partnership with the UN. This is done by identifying replicable and scalable projects that can be disseminated to interested developing countries as an example of best practices in the fight against poverty and hunger.

While the Fund has no conditionality, the key principles of the IBSA Fund are that cooperation projects should be needs-driven as well as locally owned and managed to ensure the sustainability and continuity of development outcomes on the ground. IBSA underlines the importance of the capacity-building impact of its projects; favors local procurement, and promotes the use of Southern expertise.

This initiative of the Leaders of IBSA is supported and directed by their Governments and managed by the Special Unit for South-South Cooperation (SU-SSC) hosted by the United Nations Development Programme (UNDP). To date, the IBSA Fund portfolio has allocated 73.7 per cent of its distributed funds to countries classified as Least Developed, with the remaining 26.3 per cent going to other developing countries.

### ***Perez-Guerrero Trust Fund***

The PGTF was established in 1983 with a core capital of USD 5 million, which increased to USD 6 million in 2004 through a contribution from a G-77 member country. Only interest accrued on PGTF is used to support projects so as to keep intact the core capital.

PGTF provides catalytic financial support to cooperative projects carried out by three or more developing countries. Preference is given to projects that have the largest impact and country coverage. PGTF priority areas are food and agriculture, trade, energy, raw materials, technology, industrialization, finance and South-South Cooperation<sup>111</sup>.

The G-77, through the PGTF Committee of Experts and the Executive Secretariat of the G-77, has been responsible for project selection, approval and follow-up, as well as the mobilization of additional resources. UNDP has been responsible for the management of PGTF resources and for all administrative processes related to the implementation of approved projects, including the disbursement of funds to beneficiaries, administrative follow-up and financial reporting.

110 <http://www.ibsa-trilateral.org/about-ibsa/ibsa-fund>

111 [http://www.g77.org/pgtf/BandW%20Presentation\\_on\\_PGTF\\_updated\\_Sept\\_2014.pdf](http://www.g77.org/pgtf/BandW%20Presentation_on_PGTF_updated_Sept_2014.pdf)

### ***United Nations Fund for South-South Cooperation***

UNOSSC manages the United Nations Fund for South-South Cooperation (UNFSSC), which is included in the annual United Nations Pledging Conference for Development Activities. The Fund was designated by the General Assembly in 2005<sup>112</sup> *“as the main United Nations trust fund for promoting and supporting South-South and triangular cooperation”*.

Contributions can be open or earmarked for specific South-South and Triangular Cooperation initiatives agreed on between a contributing country and UNOSSC. An important activity that has mobilized resources through UNFSSC is the South-South Development Centre (SSDC) in China, for which UNOSSC supported the design and structure and established a Steering Committee.

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112 <http://southsouthconference.org/wp-content/uploads/2009/10/UNFSSC.pdf>

## Annex 5: PPP Modalities

A PPP is most often a partnership between government and the private sector to more effectively provide services and infrastructure needs traditionally met by the public sector. The philosophy behind PPPs is that private companies and the government bring different capabilities and allow for the spreading of risks, thus ultimately lowering costs and improving the likelihood that the project will be implemented.

There are multiple models for PPPs. Consistent with the ADB's framework for understanding PPPs, the most common ones include:

- **Design-Build (DB)/Build-Transfer (BT).** Under this model, the public sector contracts with a private entity to design and build a physical asset in accordance with the standards and contractual requirements established by the government. After building the asset, the government assumes responsibility for operating and maintaining it. Depending on the type of physical asset built, the period of performance is often quite long (20–30 years is typical), allowing for the private sector to recover its design and build costs and earn a return on investment (ROI).
- **Design-Build-Maintain (DBM).** Under this modality, the private sector designs and builds a physical asset in accordance with government specifications, but also maintains the facility on behalf of the government.
- **Design-Build-Operate (DBO)/Build-Transfer-Operate (BTO).** Under this model, a private company designs and builds a physical asset and once it is completed, the title is transferred to the public sector. The private sector will operate the facility for a specified period.
- **Build-Operate-Transfer (BOT)/Design-Build-Operate-Maintain (DBOM).** This modality requires a private entity to design and build a facility and then to maintain and operate it for a specified period of time. At the end of the maintenance and operations period, the physical asset is transferred back to the government. At the end of that period, the operation of the facility is transferred back to the public sector.
- **Build-Own-Operate-Transfer (BOOT).** A BOOT transaction involves the government granting the rights to a private company to finance, design, build, and operate a facility for a specified period of time. During the period of operation, the private sector owns the facility. Ownership of the asset is transferred back to the government at the end of the concession period and assumes both ownership and responsibility to operate the facility.
- **Build-Own-Operate (BOO).** Under this model, the private sector will finance, design, build, operate, and maintain an asset and retain ownership. The physical asset is not transferred back to the government.
- **Design-Build-Finance-Operate/Maintain (DBFO).** Under a DBFO, the private sector designs, builds, finances, operates, and/or maintains a physical asset under a long-term lease. At the end of the lease term, the facility is transferred back to the government, which will assume ownership and operational responsibility.

PPPs can also be used to provide services and the operation of existing facilities. Models include:

- **Service contract.** Under this arrangement, the government contracts out to the private sector the performance of a service it previously provided. Examples include waste disposal or advisory and support services for a government agency. Contracts are typically re-bid after a set period of performance so that new entities have the right to bid to provide the specified service. The period of performance for service contracts tends to be shorter, often three to seven years depending on the nature of the service provided, than for the models for building a physical asset.
- **Management contract.** A management contract is similar to a service contract except that the private sector partner is responsible for all aspects of operations and maintenance of the facility in question.
- **Lease.** Under a lease agreement, the government grants a private entity the right to use a physical asset or land. The private company must operate and maintain the facility or land in accordance with the stipulations of the lease.
- **Concession.** In a concession arrangement, the government grants a private company the exclusive right to utilize, operate, and maintain an asset or land over a long period of time under the terms stipulated in the concession agreement. The government retains ownership of the asset or land. The private sector partner retains ownership of any improvements made during the concession period.
- **Divestiture.** Divestiture involves the government selling off a state-owned asset, either wholly or partially, to the private sector. Usually, this is a one-time transaction but the governing contract may impose certain maintenance clauses on the private purchaser, usually related to any continued use of the asset for its intended purpose.

In recent years, “development” PPPs have emerged. Unlike the PPPs described above, although governed by an agreement between the public and private sectors, they tend to be voluntary in nature. Examples can include a computer manufacturer providing free hardware or software to underserved students in exchange for public relations benefits and to get a new generation accustomed to its products in the hope that they will become future customers. Another example includes attempts by companies to sell agricultural commodities to improve productivity across a value chain. This may involve providing inputs and training to farmers or fishermen to supplement whatever public extension services are offered.

## Annex 6: Risk Allocation Concepts for PPPs

At the heart of developing a viable PPP is an analysis and allocation of risks between the public and private sectors. In the infrastructure context, there is a consensus among international donors and practitioners that there are typically six major types of risks that must be analysed and allocated. These are:

- **Construction risk** – this includes the various commercial risks associated with the design and construction phase of a project. Typical risks include the cost of materials, the pace of project completion, and costs of environmental and social mitigation. Generally, construction risk is borne by the private sector, but government may have a role in ensuring that land devoted to the PPP is clear for construction.
- **Performance/availability risk** – this relates to ensuring that the end result of the PPP meets the contractual specifications. Generally, the public sector assumes the risk of ensuring that the private party builds the asset up to the agreed specifications and at the pace negotiated.
- **Residual value risk** – this relates to the valuation of the asset if it reverts back to government at the end of the concession period. With residual value risk, the maintenance and projected value of the asset is at issue. This risk is generally borne by the public sector, but the PPP agreement may have penalties for the private operator relating to maintaining the expected value of the asset at the end of the concession period.
- **Financial risk** – Financial risk is typically related to the interest rate on project financing and exchange rate fluctuations. This is typically a risk borne by the private sector, but the public sector also has an interest in ensuring that the PPP is financially viable.
- **Demand risk** – This is related to the chance that the actual use of the asset after completion is lower than expected. If the revenue stream of the project is below expectations, the project may become untenable. This is largely borne by the private sector, but the public sector also shares this risk in the case of a default and where the private operator cannot finance its maintenance and other obligations.
- **Legislative risk** – this refers to the chance that changes in legislation during the concession period could have an impact on the success of a PPP. In most cases, the concession agreement will attempt to shield the operator from exogenous changes in a country's legal regime.

Particularly in the developing country context, it may be relevant to consider two additional risks. These are:

- **Social risk** – this relates to the consequences of social upheaval related to resettlement of populations in areas where development takes place. In some cases, government may be responsible for brokering the removal of individuals and ensuring a level of security to allow for construction and operations to proceed. International best practice calls for a transparent process to remove residents from land allocated to a project and the project in question must clearly be in the greater public interest. Full, fair, and prior compensation for those relocated should be assured by the government.
- **Environmental risk** – particularly in a country like Lao PDR with abundant natural resources, rural livelihoods dependent on clean water, arable land, and natural habitats, ensuring that appropriate environmental mitigation clauses are enforced is a priority. This is a risk shared by the public and private sectors, but ultimately it is the state that assumes responsibility as the steward of its own environment and natural resources.

## Annex 7: Glossary of Terms

**Aid Activity** – Aid activities include projects and programs, cash transfers, deliveries of goods, training courses, research projects, debt relief operations and contributions to non-governmental organizations.

**Amortization** – Repayments of principal on a loan; does not include interest payments.

**Associated Financing** – The combination of Official Development Assistance, whether grants or loans, with any other funding to form finance packages. Associated Financing packages are subject to the same criteria of concessionality, developmental relevance and recipient country eligibility as tied aid credits.

**Claim** – The entitlement of a creditor to repayment of a loan; by extension, the loan itself or the outstanding amount thereof.

**Commitment** – A firm obligation expressed in writing and backed by the necessary funds, undertaken by an official donor to provide specified assistance to a recipient country or a multilateral organization. Bilateral commitments are recorded in the full amount of expected transfer, irrespective of the time required for the completion of disbursements. Commitments to multilateral organizations are reported as the sum of (i) any disbursements in the year reported on which have not previously been notified as commitments and (ii) expected disbursements in the following year.

**Concessionality Level** – A measure of the ‘softness’ of a credit reflecting the benefit to the borrower compared to a loan at market rate (*cf.* Grant Element). Technically, it is calculated as the difference between the nominal value of a tied aid credit and the present value of the debt service as of the date of disbursement, calculated at a discount rate applicable to the currency of the transaction and expressed as a percentage of the nominal value.

**Constant Dollars** – In DAC publications, flow data are expressed in US dollars (USD). To give a truer idea of the volume of flows over time, data can be presented in constant prices and exchange rates, with a reference year specified. This means that adjustment has been made to cover both inflation in the donor’s currency between the year in question and the reference year, and changes in the exchange rate between that currency and the United States dollar over the same period.

**Country Programmable Aid (CPA)** – Country Programmable Aid (CPA) reflects the amount of aid that can be programmed by the donor at partner country level. CPA is defined through exclusions, by subtracting from gross ODA aid that is unpredictable by nature (humanitarian aid and debt forgiveness and reorganization), entails no cross-border flows (development research in donor country, promotion of development awareness, imputed student costs, refugees in donor country and administrative costs), does not form part of cooperation agreements between governments (food aid and aid extended by local governments in donor countries), is not country programmable by the donor (core funding to national NGOs and International NGOs), or is not susceptible for programming at country level (e.g. contributions to Public Private Partnerships, for some donors aid extended by agencies other than the main aid agency).

**Development Assistance Committee (DAC)** – The committee of the OECD which deals with development cooperation matters. Currently there are 29 members of the DAC: Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, The Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, the United Kingdom, the United States and the European Union.

**DAC List of ODA Recipients** – The DAC list of ODA Recipients shows developing countries and territories eligible for receiving Official Development Assistance (ODA). The list is designed for statistical purposes, not as guidance for aid or other preferential treatment. In particular, geographical aid allocations are national policy decisions and responsibilities. The list is revised by the DAC every three years.

**Debt Reorganization/Restructuring** – Any action officially agreed between creditor and debtor that alters the terms previously established for repayment. This may include forgiveness (extinction of the loan), or rescheduling which can be implemented either by revising the repayment schedule or extending a new refinancing loan.

**Disbursement** – The release of funds to or the purchase of goods or services for a recipient; by extension, the amount thus spent. Disbursements record the actual international transfer of financial resources, or of goods or services valued at the cost to the donor. In the case of activities carried out in donor countries, such as training, administration or public awareness programs, disbursement is taken to have occurred when the funds have been transferred to the service provider or the recipient. They may be recorded gross (the total amount disbursed over a given accounting period) or net (the gross amount less any repayments of loan principal or recoveries on grants received during the same period). It can take several years to disburse a commitment.

**Evaluation** – The systematic and objective assessment of an on-going or completed project, program or policy, its design, implementation and results. The aim is to determine the relevance and fulfilment of objectives, development efficiency, effectiveness, impact and sustainability. An evaluation should provide information that is credible and useful, enabling the incorporation of lessons learned into the decision-making process of both recipients and donors. Evaluation also refers to the process of determining the worth or significance of an activity, policy or program. An assessment, as systematic and objective as possible, of a planned, on-going, or completed development intervention. Evaluation in some instances also involves the definition of appropriate standards, the examination of performance against those standards, an assessment of actual and expected results and the identification of relevant lessons.

**Export Credits** – Loans for the purpose of trade and which are not represented by a negotiable instrument. They may be extended by the official or the private sector. If extended by the private sector, they may be supported by official guarantees.

**Grant** – Transfers made in cash, goods or services for which no repayment is required.

**Grant Element** – Reflects the financial terms of a commitment: interest rate, maturity and grace period (interval to first repayment of capital). It measures the concessionality of a loan, expressed as the percentage by which the present value of the expected stream of repayments falls short of the repayments that would have been generated at a given reference rate of interest. The reference rate is 10 per cent in DAC statistics. This rate was selected as a proxy for the marginal efficiency of the domestic investment, i.e. as an indication of the opportunity cost to the donor of making the funds available. Thus, the grant element is nil for a loan carrying an interest rate of 10 percent; it is 100 per cent for a grant; and it lies between these two limits for a soft loan. If the face value of a loan is multiplied by its grant element, the result is referred to as the grant equivalent of that loan.

**Grant-Like Flow** – A transaction in which the donor country retains formal title to repayment but has expressed its intention in the commitment to hold the proceeds of repayment in the borrowing country for the benefit of that country.

**Imputed Multilateral Flows** – Geographical distribution of donors' core contributions to multilateral agencies, based on the geographical breakdown of multilateral agencies' disbursements for the year of reference.

**Loans (also: Credits)** – Transfers for which repayment is required. Only loans with maturities of over one year are included in DAC statistics. Data on **net** loans include deductions for repayments of principal (but not payment of interest) on earlier loans. This means that when a loan has been fully repaid, its effect on total net ODA over the life of the loan is zero.

**Long-Term** – Used of loans with an original or extended maturity of more than one year.

**Maturity** – The date at which the final repayment of a loan is due; by extension, a measure of the scheduled life of the loan.

**Multilateral Outflows** – Aid activities financed from multilateral development institutions' regular budgets. Projects executed by multilateral organizations on behalf of donor countries are classified as bilateral flows, since it is the donor country that effectively controls the use of the funds.

**Net Flow** – The total amount disbursed over a given accounting period, less repayments of loan principal during the same period, no account being taken of interest.

**Net Transfer** – a net flow minus payments of interest.

**Official Development Assistance (ODA)** – Grants or loans to countries and territories on the DAC List of ODA Recipients (developing countries) and to multilateral agencies which are: (a) undertaken by the official sector; (b) with promotion of economic development and welfare as the main objective; (c) at concessional financial terms (if a loan, having a grant element of at least 25 per cent). In addition to financial flows, technical cooperation is included in aid. Grants, loans and credits for military purposes are excluded. Transfer payments to private individuals (e.g. pensions, reparations or insurance pay-outs) are in general not counted.

**Official Development Finance (ODF)** – Used in measuring the inflow of resources to recipient countries: includes (a) bilateral ODA, (b) grants and concessional and non-concessional development lending by multilateral financial institutions, and (c) Other Official Flows for development purposes (including refinancing loans) which have too low a grant element to qualify as ODA.

**Offshore Banking Centers** – Countries or territories whose financial institutions deal primarily with non-residents.

**Other Official Flows (OOF)** – Transactions by the official sector with countries on the DAC List of ODA Recipients which do not meet the conditions for eligibility as Official Development Assistance, either because they are not primarily aimed at development, or because they have a grant element of less than 25 per cent.

**Partially Untied Aid** – Official Development Assistance for which the associated goods and services must be procured in the donor country or among a restricted group of other countries, which must however include substantially all aid recipient countries. Partially untied aid is subject to the same discipline as tied aid credits and associated financing.

**Private Flows** – Consist of flows at market terms financed out of private sector resources (i.e. changes in holdings of private long-term assets held by residents of the reporting country) and private grants (i.e. grants by non-governmental organizations and other private bodies, net of subsidies received from the official sector). In data presentations which focus on the outflow of funds from donors, private flows other than foreign direct investment are restricted to credits with a maturity of greater than one year and are usually divided into:

- *Foreign direct investment*: Investment made to acquire or add to a lasting interest in an enterprise in a country on the DAC List of ODA Recipients. “Lasting interest” implies a long-term relationship where the direct investor has a significant influence on the management of the enterprise, reflected by ownership of at least 10% of the shares, or equivalent voting power or other means of control. In practice, it is recorded as the change in the net worth of a subsidiary in a recipient country to the parent company, as shown in the books of the latter;
- *Private export credits*;
- *Securities of multilateral agencies*: This covers the transactions of the private non-bank and bank sector in bonds, debentures, etc., issued by multilateral institutions;
- *Bilateral portfolio investment and other*: Includes bank lending and the purchase of shares, bonds and real estate.

**Purpose of Aid** – The DAC statistics on the purpose of aid cover three dimensions: the sector of destination, the form or type of aid, and the policy objective(s) of aid. Data are collected on individual commitments in the Creditor Reporting System (CRS), and in the form of annual commitment aggregates in the DAC Questionnaire.

**Sector Allocable Aid** – As only a portion of aid can be allocated to sectors, when measuring shares of aid to specific sectors it is recommended to limit the denominator to aid that can be apportioned. Otherwise there is an implicit assumption that none of the aid unallocatable by sector benefits the specific sectors under review. Contributions not subject to allocation include general budget support, actions related to debt, humanitarian aid and internal transactions in the donor country.

**Short-Term** – Used of loans with a maturity of one year or less.

**Technical Cooperation** – Includes both (a) grants to nationals of aid recipient countries receiving education or training at home or abroad, and (b) payments to consultants, advisers and similar personnel as well as teachers and administrators serving in recipient countries (including the cost of associated equipment). Assistance of this kind provided specifically to facilitate the implementation of a capital project is included indistinguishably among bilateral project and program expenditures, and not separately identified as technical cooperation in statistics of aggregate flows.

**Terms of Repayment** – The terms of repayment of a loan may be the following:

- **Equal principal payments (EPP)** denotes a fixed schedule of equal instalments of principal adding up to the face value of the loan. Interest is charged on outstanding principal and the amount of individual service payments decreases with each payment of principal.
- In the **annuity** method, each service payment is established as an equal amount, within which the interest component declines with time while the principal component increases.

- **Lump sum** means the loan is repaid in a single amount (principal and interest) at maturity. If interest is paid at various earlier dates, then the repayment schedule is a particular case of equal principal payments and is reported under that category.
- If the type of repayment does not correspond to any of the three above, the code 'other' is used.

**Tied Aid** – Official grants or loans where procurement of the goods or services involved is limited to the donor country or to a group of countries which does not include substantially all aid recipient countries. Tied aid loans, credits and associated financing packages are subject to certain disciplines concerning their concessionality levels, the countries to which they may be directed, and their developmental relevance so as to avoid using aid funds on projects that would be commercially viable with market finance, and to ensure that recipient countries receive good value.

**Total Receipts** – The inflow of resources to aid recipient countries includes, in addition to Official Development Finance, official and private export credits, and long-term private transactions (see private flows). Total receipts are measured net of amortization payments and repatriation of capital by private investors. **Bilateral** flows are provided directly by a donor country to an aid recipient country. **Multilateral** flows are channelled via an international organization active in development (e.g. World Bank, UNDP). In tables showing total receipts of recipient countries, the outflows of multilateral agencies to those countries is shown, not the contributions which the agencies received from donors.

**Undisbursed** – Describes amounts committed but not yet spent.

**Untied Aid** – ODA for which the associated goods and services may be fully and freely procured in substantially all countries.

**Workers' Remittances** – Household income from foreign economies arising mainly from the temporary or permanent movement of people to those economies. Remittances include cash and noncash items that flow through formal channels, such as via electronic wire, or through informal channels, such as money or goods carried across borders. They largely consist of funds and noncash items sent or given by individuals who have migrated to a new economy and become residents there, and the net compensation of border, seasonal, or other short-term workers who are employed in an economy in which they are not resident.<sup>113</sup>

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113 Development Finance Assessment [Revised] Methodological Guidelines, draft March 2016, *forthcoming*.







