Chapter 3

Well-Coordinated Policies

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Chapter 3
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Even well-intended policies may not efficiently produce expected results without support of relevant well-coordinated policies and their effective implementation. In some cases, the combination of well-intended but inconsistent policies may lead to worse outcomes. For example, a policy aiming to promote a cluster of the electronics industry would not be fruitful if high tariff rates are imposed against the import of electronic parts and components. This argument also holds for the development of hard and soft cross-border infrastructure, which aim to enhance connectivity. A cross-border bridge would not efficiently generate expected cross-border movements of goods, investment, and people without user-friendly rules, regulations, and operation. Furthermore, most policy targets would not be achievable without sufficient human capital specifically educated to carry them out. For example, construction and electrical engineers are indispensable for a successful energy industry. This chapter discusses well-coordinated policies by assessing interrelationships among these related policies.

3.1. Industrial Promotion Policies and International Trade Policies

The aim of industrial promotion policies in Lao PDR is to foster diversified industries that will help achieve the country's objectives of industrialisation and modernisation. In brief, industrial promotion policies include the following five goals: (1) To promote small and medium-sized enterprises (SMEs), which presently account for 97 percent of manufacturing activities. Although SMEs have significantly contributed to job creation, businesses in this sector are usually unorganised and not very competitive, and therefore their capacities need to be enhanced (MOIC, 2014). (2) To promote and develop import substitution products of selected goods to reduce overdependence on imports. (3) To push forward export-oriented industries with high value-added products, such as electronic products and garments. (4) To develop human capital to integrate with and compete in the global economy.

Historically, industrial development in Lao PDR has occurred in the three development periods: (i) nationalisation or collectivisation between 1976 and 1985, (ii) preparation for the New Economic Mechanism between 1986 and 1990, and (iii) implementation of the New Economic Mechanism since 1991. The adoption of the New Economic Mechanism is also widely known as Lao PDR's transition to a market economy.

To create a level playing field and facilitate conditions favourable to industrial development in Lao PDR, the government enacted the Business Law in 1994. All types of businesses, categorised by ownership (i.e. private, state-owned, union-owned, and joint-venture enterprises) were treated equally subject to this law. The private sector was encouraged to participate in various industrial fields of the economy, but not in those designated as sensitive–for instance, fuel, electricity, water, telecommunications, timber, mining, medicine, and the alcohol and tobacco industries. The introduction of the Industrialisation and Modernisation Strategy (2001–2020) in 2002 and the current revision of the 10 Year Development Strategy (2016–2025) endorsed by the National Assembly in April 2016, which reflects the changing international and domestic environments, make clear the government's intention to develop the industrial sector as an engine of growth in the economy. At present, in addition to tens of garment factories, there are 15 processing factories with an investment value of more than 50 billion Laotian kip, including maize drying, Jatropha extraction, rubber and sugar factories, as well as beverage companies' factories established by, for example, Beer Lao Ltd, Lao Asia-Pacific Brewery Ltd, and Lao Indochina Tropicana. These factories have contributed to job creation and income increases for over 160,000 people.

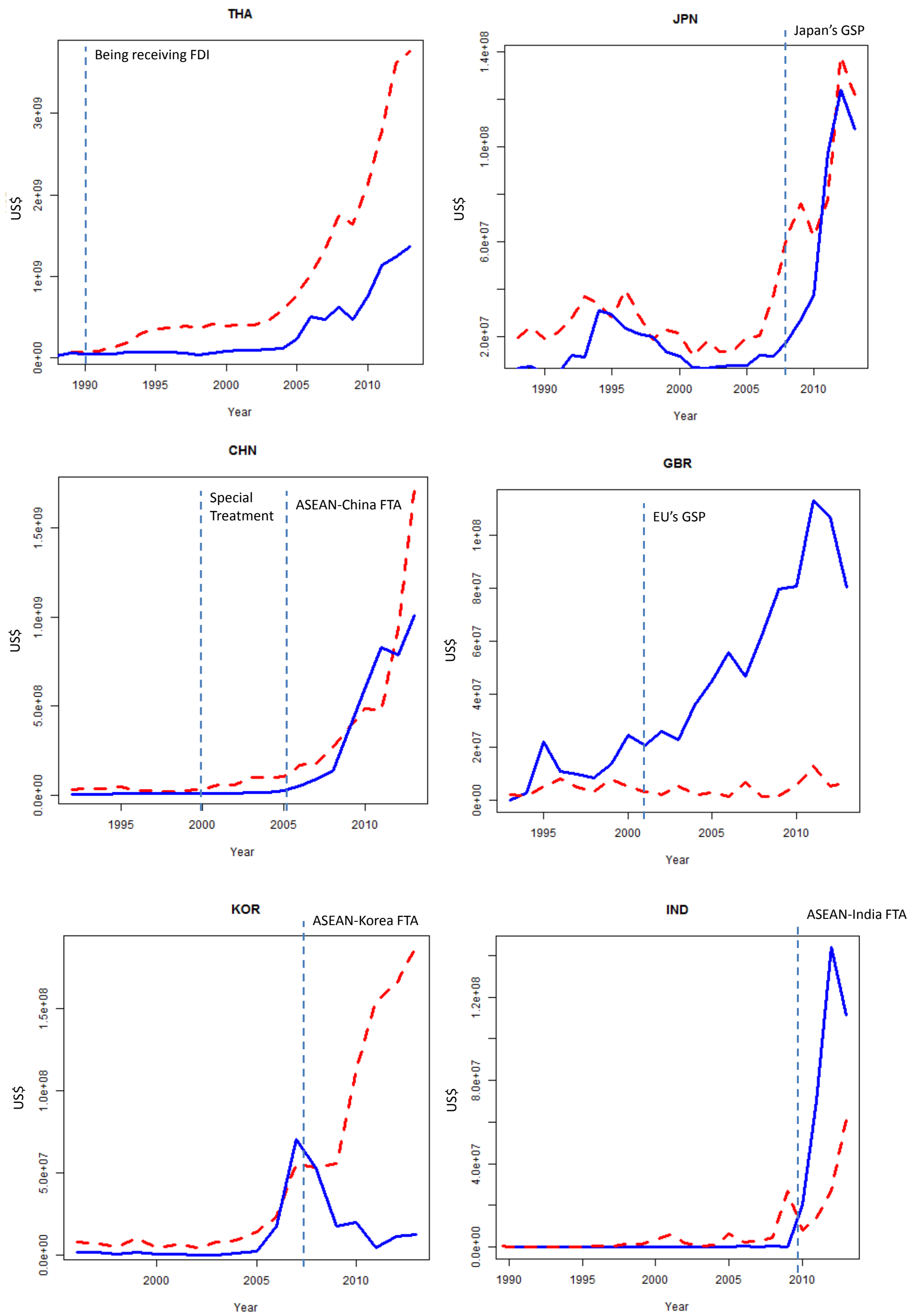
In fact, the government links the achievement of its Vision 2030 to the attainment of an annual gross domestic product (GDP) growth rate of 8 percent from the present to

2030, on the basis of total investments of around 30 percent of GDP in each year. More than 50 percent of the investment is expected to come from foreign investors. To this end, Lao PDR has made huge progress in introducing trade and investment liberalisation policies, following successful examples in advanced Southeast Asian countries. For example, the government abolished, in practice, a tax on loss-making enterprises (1–2 percent of total sales) in the mid-2000s by revising the tax law in 2015. The tax on loss was a special measure introduced to secure fiscal revenue, which had declined sharply in the aftermath of the Asian financial crisis in 1997. Various incentives such as the profit tax exemption period and customs duty drawbacks were introduced in conjunction with the development of Special and Specific Economic Zones (SEZs).

More importantly, the government has devoted continuous efforts to securing preferential and favourable tariff arrangements through bilateral and multilateral frameworks. This includes the free trade agreements (FTAs) with Thailand (1991), Association of Southeast Asian Nations (ASEAN)–China (2004), ASEAN–Republic of Korea (2007), ASEAN–Japan (2008), ASEAN–Australia–New Zealand (2010), and ASEAN–India (2010), as well as Lao PDR's accession to the World Trade Organization (WTO) in 2013, and several generalised schemes of performances (GSPs). These arrangements undoubtedly contributed to the dramatic increase of foreign direct investment (FDI) flows from an annual average US$18 million during 2001–2005 to about US$367 million from 2011–2014 (World Bank, 2015). Furthermore, the high-level Regional Comprehensive Partnership (RCEP) under negotiation is expected to promote the efficient formation of supply chains throughout East Asia, which would also benefit Lao PDR's industrial development.

Since most industries in Lao PDR not only require imports of inputs but also aim at external markets, they are closely related with international trade. Figure 3.1 shows how international trade in Lao PDR is strongly influenced by FTAs and GSPs.

Figure 3.1. FTA/GSP and Export in Lao PDR



FTA = free trade agreement; GSPs = generalised schemes of preferences; THA = Thailand; JPN = Japan; CHN = China; GBR = Great Britain; EU = European Union; KOR = Korea; ASEAN = Association of Southeast Asian Nations; IND = India.
Source: Computed by authors (ERIT) based on COMTRADE.

Exports to major European Union (EU) economies (e.g. the United Kingdom [UK]), Japan, China, and India increased after FTAs or GSPs had entered into force. Exports to the UK increased irrespective of the trend of imports from the UK, whereas the increase of exports to Japan was accompanied by an increase of imports from Japan. It is a well known fact that exports of garment products account for the bulk of recent increases in exports to the UK and Japan. At the very least, obtaining GSPs from the EU and Japan have benefited the development of the garment industry in Lao PDR. In addition, exports of minerals to China and India increased after the conclusion of FTAs with these countries, which were made within the framework of ASEAN.

The conclusion of this section is that industrial development policies are not likely to function without necessary and appropriate international trade policies. This is especially the case for a small economy such as Lao PDR that needs to import many inputs from other countries and have access to much larger markets beyond its own border.

3.2. Hard and Soft Infrastructure Development

Many hard infrastructure have been introduced in Lao PDR since the beginning of the 1990s. National Road No. 13, running from the north to the south, and several East–West national roads had been repaired, upgraded, and constructed by the beginning of the 2000s. To date, four Mekong Friendship Bridges (from the First to the Fourth Bridge) linking Lao PDR's populated areas to Thailand were opened sequentially in 1994, 2006, 2011, and 2013. Another Mekong Friendship Bridge linking the northern part of Lao PDR to Myanmar was completed in 2015. International border gates, through which formal international trade is carried out, have also been installed. Although these infrastructure have significantly increased cross-border movements of goods, investment, and people, there is still a lot of room for further improvements. As a reference, the Comprehensive Asia Development Plan (CADP) 2.0 formulated by the Economic Research Institute for ASEAN and East Asia (ERIA), which drew up a comprehensive list of prospective infrastructure development projects, such as roads, bridges, railways, airports, and others, would be very useful for an assessment of what infrastructure developments are needed in Lao PDR.

The number of people crossing the First Mekong Friendship Bridge at the most popular entry point in Lao PDR was about 1.15 million in 2014, which amounts to about 3,000 people per day. The number of vehicles entering Lao PDR via the Second Mekong Friendship Bridge was less than 100,000 in 2014, including 30,000 trucks of several sizes, which translates to only about 82 trucks a day on average. These figures are much lower than what these cross-border infrastructure can handle. We can compare this finding in an international context by looking at similar cross-border bridges in other regions. For instance, more than 20 million people crossed a bridge linking the southern part of Sweden to the capital city of Denmark in 2014 and about 19,000 vehicles crossed the same bridge every day. The number of heavy goods vehicles passing through Switzerland was more than 1 million in 2014.

Nevertheless, while hard infrastructure are a prerequisite, they would not produce expected results without the necessary soft infrastructure prepared. Soft infrastructure can be regarded as anything relevant to rules and regulations applied to the way hard infrastructure are operated in reality. Hence, we need to keep in mind that both hard and soft infrastructure are indispensable for ensuring connectivity, which facilitates economic activities within and across the country.

3.3. Human Capital Development

Assessing the current development of the Lao PDR economy, we find that many important positive trends in economic and social aspects have emerged, including more rapid economic growth, greater poverty reduction, and improved education. Lao PDR recorded an annual average economic growth of 7 percent from 1996 to 2015.

GDP per capita increased from US$319 in 2001 to US$1,857 in 2015. The poverty rate also decreased, from 33.5 percent in 2003 to 27.6 percent in 2008, and 23.2 percent in 2013. Life expectancy increased from 49 years in 1980 to 69.4 years in 2015. The adult literacy rate increased from 66 percent in 2010 to 81.3 percent in 2015. These trends clearly demonstrate human capital accumulations, which in turn will stimulate future growth.

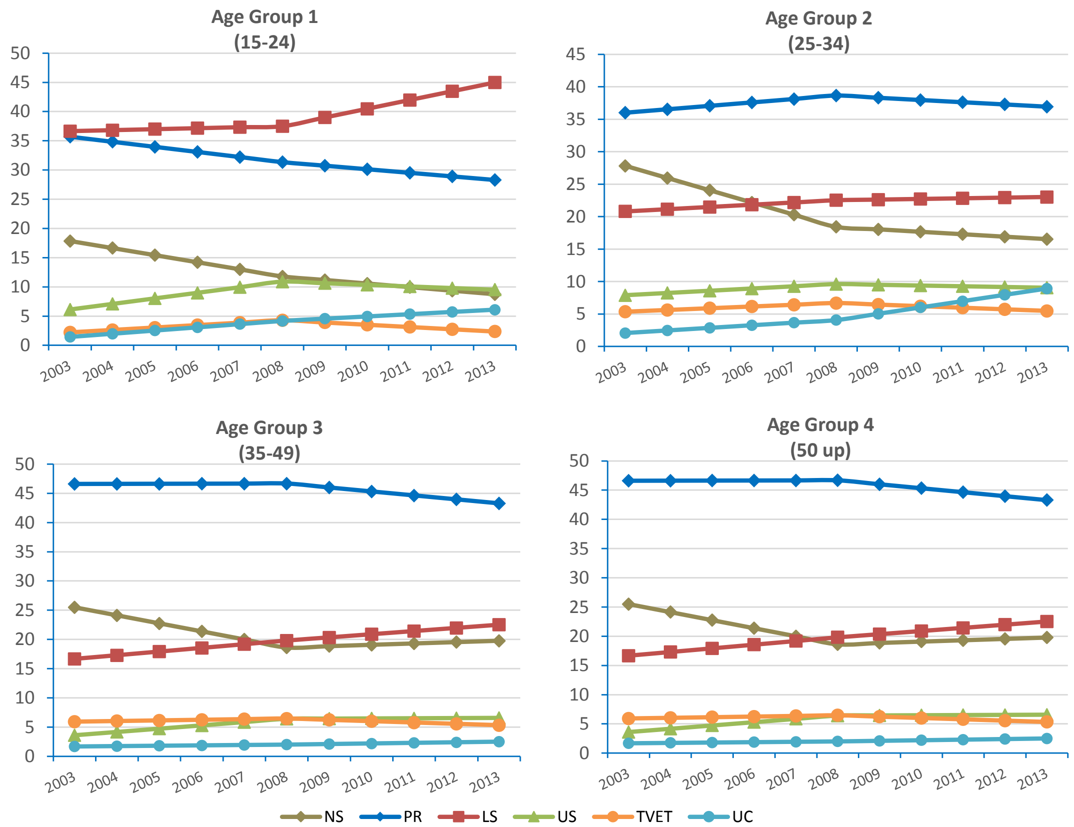
In 2015, Lao PDR's population was 6.4 million people, with an average growth rate of about 2 percent per year. When we compare the share of educational attainments to total workforce among four age groups between 2000 and 2013, we can see that the young generation today has better access to basic education than the older generations did (see Figure 3.2.). For the youngest group (15–24 years), those with lower secondary education made up the largest group throughout 2000–2013, whereas the population in the other age groups had the largest share of primary education. For the age groups 15–24 and 25–34 years, the share of those with college and vocational education increased steadily. Based on the current trend of increasing educational attainment, future Lao workers are expected to be much more educated than the current workforce.

The latest assessment for the human asset index (HAI) conducted in 2015 demonstrates that Lao PDR has moved beyond least development country (LDC) status. The HAI indicators include the under-5 mortality ratio, the prevalence of undernourishment in the total population, the adult literacy rate, and the secondary school gross enrolment rate. Lao PDR improved its performance for all the HAI indicators from the previous assessment in 2012.

Based on information provided by Child Mortality Estimates, which is the web-based data source used for assessing the under-5 mortality rate in the HAI calculation, the under-5 mortality rate is estimated to have decreased from 71.4 percent in 2013 to 66.7 percent in 2015. The latest data on the prevalence of undernourishment in Lao

PDR's overall population shows a declining trend (FAO, 2015). The adult literacy rate also improved, from 72.7 percent in 2005 to 79.9 percent in 2015 (UNESCO, 2015). Furthermore, according to the latest millennium development goal (MDG) assessment in 2015 (GOL and UN, 2015), the secondary school gross enrolment rate also increased from 50.5 percent in 2013 to 64.6 percent in 2015.

Figure 3.2. Educational Attainment of Workforce by Age Group



NS = no schooling, PR = primary school; LS = lower secondary school; US = upper secondary school; TVET = Technical and Vocational Education and Training; UC = University or College.
Source: Author's (NERI) calculation based on LECS III, IV, and V.

However, in spite of these improvements in social indicators related to the HAI, Lao PDR did not exceed the HAI reference point stipulated in the 2015 Commission on Population and Development assessment. The HAI of Lao PDR was 60.8 in 2015, which is about 92 percent of the HAI threshold (i.e. the HAI must be higher than 66 to qualify). With respect to the human development index (HDI), Lao PDR ranked 139th out of 187 countries in 2013. The HDI index improved from 141st position in 2010, but the country's rank remains low.

These findings indicate there are many challenges in human capital development that need to be addressed, as also pointed out in the 8th Five Year Plan (2016–2020). Low educational attainment is considered highly correlated with low wages and limited labour market opportunities, which result in lower productivity and higher poverty (World Bank, 2013). Although there has been substantial progress in educational attainment since the beginning of the 21st century, the average primary school completion rate remains below the desired target. According to the above-mentioned latest MDGs review, Lao PDR achieved a net enrolment ratio of 98.5 percent, which meets the MDG target related to enrolment. However, the completion rate of grade 5 has remained low, at around 78 percent, still far below the 95 percent target for 2015.

As the review also pointed out, this low completion rate is caused mainly by the fact that most children drop out in the first school year or do not progress to the next grade level. This implies that children are likely to lack readiness to start school and have limited access to early childhood education services. More precisely, the possible reasons for dropping out could be a lack of well-equipped schools, limited capacity of teachers, direct and opportunity costs of schooling for families, insufficient funding to support investments in improving the quality of education, and others. The completion of primary school is constrained by these factors and, therefore, early-year primary schooling is a key bottleneck in the country's basic education system.

Moreover, despite steady progress in increasing the enrolment rate in primary and lower secondary school (Table 3.1), there is concern that a large proportion (30 percent) of children did not continue their study to the upper secondary level, which might negatively affect the overall education level of the future population (GOL and

UN, 2013).

Table 3.1. Enrolment Rate in Basic Education
(% of population in relevant age group)

	1992	1995	2000	2005	2012	2013	2014
Primary education	58.8	65.2	77.3	84	95.2	96.8	98
Lower secondary education	28.9	39.3	53.3	62.7	64.7	69	74.4
Upper secondary education	11	17.4	34.6	36.8	34.7	37.3	41.3

Note: The enrolment rate for primary education is net enrolment. The enrolment rates for lower and upper education are gross enrolment.
Source: Reported by Government of Lao PDR (GOL) and the United Nations (2013).

The mismatch between demand and supply of skilled labour – both in terms of quantity and quality – is another prevailing issue in Lao PDR. The Lao PDR government and its development partners such as international development banks have dedicated great efforts to improving vocational education and training by investing their resources in revamping the Technical and Vocational Education and Training (TVET) system. Higher education systems have also been undergoing reforms since 1995. This resulted in an increase in the number of higher education and vocational schools from 55 units in 2000 to 163 units in 2014 (Table 3.2).

Despite such efforts, the vocational education system fails to produce workers at a quality level that employers find satisfactory and are willing to properly reward (World Bank, 2013). This reflects the fact that an improvement in the quantity and quality of

Table 3.2. Number of Higher and Vocational Education Units in Lao PDR

	2000	2005	2010	2011	2012	2013	2014
University	1	3	5	5	5	5	5
College	5	25	99	108	108	111	111
TVET	49	47	39	39	48	47	47
Total	55	75	143	152	161	163	163

TVET = Technical and Vocational Education and Training.
Source: Lao Statistics Bureau.

higher education has not kept up with evolving labour market needs, which suggests that the focus of the education system itself is the root cause of this mismatch. According to the World Bank (2013), the focus should be not only on increasing quantity (i.e. increased enrolment, higher labour participation rates, etc.) but also on improving quality to enhance the workforce's basic skills (such as cognitive skills) and equipping tertiary students with relevant, job-specific technical skills.

A recent study on job matching of TVET graduates in Lao PDR, which is a case study of Pakpasak Technical College, suggests that the mismatch occurred in vocational education, not the whole TVET system, and the causes of the mismatch are job selection pressure by family, the unavailability of relevant jobs, the personal preferences of workers who dislike their field of study, a preference on the part of jobseekers for working places close to their homes, wishing to have much leisure time in their private lives, and a desire to secure tenure jobs (Onphanhdala and Thongsavath, 2015). A lack of accurate, consistent, and up-to-date labour market information is another reason for the mismatch. This makes it difficult for the relevant authorities to design a vocational and skills training curriculum that satisfies present and future needs in the labour market.[2]

The challenges of human development have also been a reflection of commonly known issues of low labour productivity. Table 3.3 shows a comparison of labour

[2] This argument is based on the technical report to the 38th ASEAN Confederation of Employers (ACE), Chief Executive Officers (CEOs) and Board of Directors (BOD) Meeting held on 12 January 2013.

productivity between Lao and Thai workers in various sectors in 2010. In the manufacturing and agricultural sectors, the Thai workers were 3.6 and 6.5 times more productive, respectively, than the Lao workers.

Table 3.3. Lao and Thai Workers' Productivity in 2010

Sectors	Productivity (US$/worker)		Thai/Lao (x more productive)
	Lao	Thai	
Agriculture, forestry, and fishing	517	1,875	3.6
Mining and quarrying	17,049	201,279	11.8
Electricity and water supply	14,081	45,433	3.2
Manufacturing	2,324	15,160	6.5
Construction	2,786	3,106	1.1
Services	2,333	8,182	3.5
All sectors	1,167	6,799	5.8

Note: Productivity = Real GDP (US$)/Number of employees.
Source: Author's (NERI) calculation based on Thai data from Office of the National Economic and Social Development Board (GDP) and National Statistical Office, Ministry of Information and Communication Technology (Labor) and Lao data from Lao Statistic Bureau.

Demand for skilled labour continues to increase, and the gap between demand and supply of skilled labour is filled by the inflow of foreign workers. The main finding from a recent study of skilled labour employment conducted by the Asian Development Bank (ADB) (2015a) was that multinational enterprises (MNEs) in Lao PDR employ a common strategy of sending staff holding high-level positions from their headquarters to their subsidiaries in Lao PDR. Since the existing pool of local workers does not yet possess the necessary knowledge and technical know-how, it is difficult for local personnel to substitute for foreign personnel at the same work level. In mid-level management jobs, however, local personnel may be able to substitute for foreigners in areas such as marketing and administration, if they can successfully upgrade their job skills (ADB, 2015a).

Deepened regional integration makes human capital development even more critical for the development of Lao PDR. The ASEAN Economic Community (AEC) envisioned by the AEC Blueprint advocates removing not only barriers in trade of goods and services between member states but also barriers in labour mobility, from the end of 2015. This gives rise to opportunities as well as challenges in terms of human resource development. Labour mobility will be promoted through memoranda of understanding on mutual recognition between member states of nationally endorsed education and training qualifications. This will put some useful pressure on Lao PDR to build up its human capital, and this mobility will also increase the pool of human capital available for economic development.

The changing age structure of Lao PDR's population, the so-called demographic dividend, is another opportunity for Lao PDR to benefit from human capital development. This change indicates that the proportion of the population of working age will increase, which implies that Lao PDR will be able to depend on a higher number of workers than the current level. Lao PDR's population is expected to see robust population growth, at a projected rate of between 1.7 percent and 2 percent from 2015 to 2050.[3] More precisely, the current official projection shows an increase in Lao PDR's population from 1.71 million in 2015 to 1.91 million in 2030, and to 10.25–10.72 million in 2050. Over the period of the 8th Five Year Plan, the number of school-aged children (5–14 years old) is projected to decrease by 3.7 percent, whereas the working-age population is expected to increase by 10.6 percent and the elderly population by 10.1 percent. The working-age population is expected to start to still slowly rise in 2050.

In line with the above discussion, we present the following policy suggestions for human capital development:

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[3] This estimate is provided by the Lao Statistics Bureau. A population census was completed in 2005 and a further decennial population census was undertaken in 2015, with preliminary results expected in the first quarter of 2016.

- Human capital development should start before the schooling stage to ensure that the later stages of education produce a capable and competent workforce that can be utilised for further industrialisation. Lao PDR needs to ensure, therefore, that basic literacy skills are provided through expanding and strengthening early childhood development and education.
- Given the current quality of the education and training system in Lao PDR, job-relevant skills for industrial development can be enhanced through collaboration between training institutions and firms, particularly through internship programmes and on-the-job training. In addition, the government can implement the human capital training programmes provided by international agreements concluded between ASEAN and other partner countries (e.g. human resource training programmes formulated by the ASEAN Economic Ministers–Ministry of Economy, Trade and Industry of Japan (AEM–METI) Economic and Industrial Cooperation Committee [AMEICC]).
- At the same time, firms should be provided with incentives to encourage knowledge transfer at the firm level, which upgrades Lao workers' skills and increases the opportunities to substitute for foreign workers in high-skilled positions.
- To fully benefit from the comparative advantage of the demographic dividend, job-relevant, specific technical skills and high-quality jobs should be provided to the growing working age population.

3.4. Nurturing an Efficient Financial Sector

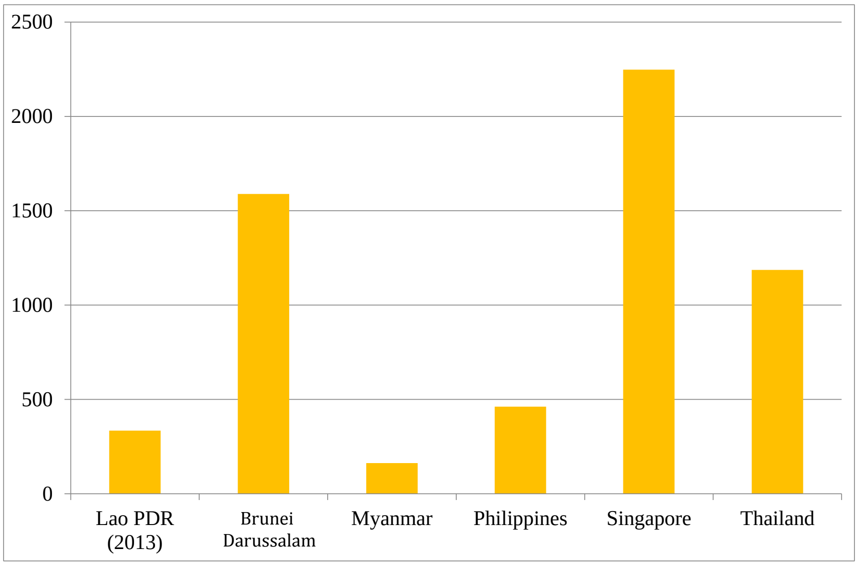
The 8th Five Year Plan (2016–2020) set a target for investment of about one-third of GDP, or about US$27 billion for the five-year period. FDI and private domestic investments are expected to cover about half (54–58 percent) of this target amount. They have continuously been the biggest source of development financing in Lao PDR since the beginning of the 2000s. There is nevertheless a significant change in the 8th Five Year Plan as to how finance is planned for development in Lao PDR. The planned target for investment that should be financed by financial institutes has been raised from 10–12 percent of total investments in the 7th Five Year Plan (2011–2015) to 19–21 percent in the 8th Five Year Plan. In relative terms, this change amounts to doubling credit provided by financial institutions in development financing.

The role of financial institutions' credit has been growing, with the financial sector exceeding the target set in the 7th Five Year Plan. Although credit from financial institutes had been expected to account for 10–12 percent of total investments (or US$15 billion) between 2011 and 2015, the actual result was about double this target. Indeed, the target was subsequently realigned with this new reality. At least nine new, mostly foreign, banks have been established since 2010. Credit from these new banks played a significant role in the rapid increase of bank credit during the period of implementation of the 7th Five Year Plan.

For banks to be able to lend, money must be deposited with them in the first instance. Saving with banks, including the holding of bank accounts, is still in the early stages in Lao PDR. In 2013, there were 335 bank accounts per 1,000 persons in Lao PDR (Figure 3.5). This is higher than Myanmar (162.9) and close to the Philippines (461.9), but far lower than in more industrialised countries such as Thailand (1,186.5) and Singapore (2,247.8).

Although the number of banks in Lao PDR, including foreign banks from industrialised and neighbouring countries, has increased steadily in recent years, the bulk of their lending has concentrated on real estate transactions. Financing real estate requires less sophisticated financial knowledge because the availability of properties would work as collateral.

Figure 3.3. The Number of Bank Accounts per 1,000 Persons



Source: World Bank Database.

This is very different from the operation of financing firms, which requires expertise that is usually specific to particular industries. Nurturing the financial sector with diversified lending capacities is indispensable for industrial development in Lao PDR.

Nonetheless, the experience of an industrialised country such as Japan shows that the lending capacity of financial institutes is not sufficient. Lending to infant industries generally involves high risk, as SMEs often do not have sufficient assets to offer as collateral to secure large amounts in loans. National or public financial institutes may be required to facilitate a quicker lending process while minimising the risk to private lenders. Furthermore, as an instrument for nurturing efficient financial sectors, we can consider the establishment of a National Credit Guarantee Association, which would be expected to enable SMEs to borrow from banks. (For details, see the analysis of the finance sector discussed in Chapter 6.)

3.5. From Resource Curse to Resource Blessing

The energy and mining sectors have been Lao PDR's two most important engines of growth since the 6th Five Year Plan (2006–2010). Exports of electricity and minerals were about US$570 and US$1,286 million, respectively, in 2014 (Bank of the Lao PDR, 2015). Lao State Holding Enterprise (LSHC), a state corporation of Lao PDR primarily involved with the financing of the energy industry, was established in 2006 and has large stakes in nine major power projects in the country, such as the Namtheun 2 Power Company and Hognsa Thermal Electric Power. LSHC often involves foreign partners. Since the revenue and management of the energy sector are devoted to LSHC, it not only reinforces bargaining power vis-à-vis the regulatory authority, but also facilitates the effective use of the large revenues as its disposal for development purposes. LSHC's investments in energy projects are still mostly funded by loans from international development banks such as the World Bank and ADB. Such loans also function as channels of official development assistance (ODA) that can be used in business-oriented investments.

Similar state enterprises do not exist in the mineral sector. This may be due to the fact that although income from the mineral sector is much larger than that from the energy sector, in absolute terms direct revenue for the government from the mineral sector is still smaller than from the energy sector. However, the mineral sector will become increasingly important for the Lao PDR economy, as can be seen from the number of approved FDI projects in the sector. Establishing a similar mechanism in the mineral sector is important and should be recommended. The establishment of special funds based on temporary but high revenue from the mineral sector is required. Such funds will not only secure revenue from the mineral sector but will also be used for necessary infrastructure investments, and the effective use of such funds will also reduce the risk of suffering the so-called Dutch disease, which phenomenon suggests that an expansion in the resource sector weakens the manufacturing sector (Insisienmay et al., 2015).

Mineral resource development in Lao PDR is still in its early stages. Larger-scale commercialised mines only began operating in 2005. There has not been much evidence so far of a so-called resource curse (which means that countries rich in resources stagnate) in Lao PDR. The Laotian kip appreciated from 2007 to 2014 at an annual average rate of three percent (ADB, 2015b). Insisenmay et al. (2015) found weak evidence of symptoms of the 'Dutch disease' in Lao PDR and they proposed five treatments to cope with it: (1) invest the revenue from resource exports in infrastructure and education; (2) reduce import barriers against capital and equipment imports; (3) establish a natural resource fund and a foreign exchange equalisation fund; (4) modernisation and technological upgrading through economic integration; and (5) establish a comprehensive bank for efficient trade and investment activities.

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