

Lao PDR: Growing Momentum

In spite of its huge developmental challenges, Lao PDR is on an increasingly sustainable growth path with rising opportunities to build on reforms achieved so far. This small, landlocked nation of around 6 million people is fighting poverty, addressing social inequities, and building stronger capacity to manage its rich natural resources.

Lao PDR has been growing at a rate of 6.7 percent a year since 2001 while undertaking structural reforms in trade, private sector development, and public financial management. In 2007 growth reached close to 8 percent. Due to the impacts of the global financial crisis, GDP growth is expected to decline to around 5 percent in 2009, down from 7 percent in 2008.

Country Indicators	1992/93	2004/05	2007
GNI per capita (Atlas method, US\$)	290	460	630
Inflation (CPI, average annual rate, %)	6.3	7.2	4.5
External debt (% of GNI)	148.8	111.1	84.4
Poverty incidence (% below national poverty line)	46.0	33.5 (*)	N/A
Primary school enrollment (% of age group)	58 (1991)	84	118
Child mortality (under 5, per thousand)	163 (1990)	98	70
Population (millions)	4.4	5.6	5.9
Population growth rate (% per year)	2.5	2.0	2.1

Source: World Bank, *World Development Indicators* 2009.

(*) 2002/03.

The International Development Association (IDA), the World Bank's fund for the world's poorest countries, has supported the country's poverty reduction strategy and reform program, by taking an innovative and comprehensive approach to preparing the US\$1.45 billion Nam Theun2 Hydroelectric project. This has helped catalyze an emerging economic transformation and influence global players to support the country's broader development efforts.



COUNTRY ACHIEVEMENTS

A market-oriented economic transformation

Lao PDR is abundant in natural resources such as forests and biodiversity, land, water and minerals that support its economic expansion. It is also in a thriving neighborhood, at the center of the dynamic Mekong region. In 1990 this small, sparsely populated, landlocked country had begun its transition from a centrally planned to a market-oriented economy, but had uncertain prospects for rapid and sustainable economic development. The collapse of the Soviet Union saw it lose two-thirds of its yearly external aid resources. But, in its place, financing from IDA and other donors supported the country's transition.

The macroeconomic situation has improved in recent years, especially after the Asian crisis in 1997 due to reforms and strong economic growth driven by resource and non-resource sectors, Foreign Direct Investment (FDI) and exports.

Like other countries, Lao PDR faces the challenging task of dealing with the global financial crisis while maintaining macroeconomic stability. Although public external debt remains high (about 35 percent of GDP in Net Present Value terms at end-2008), the debt

service continues to be manageable. Private investment, especially FDI, has increased dramatically in the past few years due to a recent acceleration in regional and global integration efforts made by the government as well as some improvement in the legal framework and investment climate although much remains to be done in this area.

Significant progress on reducing poverty, but results have been uneven

The proportion of poor households fell from 46 percent in 1992/93 to approximately 33.5 percent in 2002/2003. Geography is a strong determinant: half of all poor people live in the North, and in some Northern provinces nearly three-quarters of the people are poor. Poverty is highest within ethnic groups. Also of concern, some of Lao PDR's indicators for the Millennium Development Goals (MDGs) are among the lowest in the East Asia and Pacific region. For example, life expectancy is 61 years compared to a regional average of 70; the primary school net enrollment rate is 84 percent compared to the region's 99 percent; and child mortality, at 98 per 1000, is more than double the regional average of 31.

Lao PDR has maintained a sound macroeconomic framework but domestic revenues (about US\$755 million or about 14.2 percent of GDP) are still not adequate for reaching

the MDGs. The country will need to achieve growth rates of 7 percent per year, and sustain this level up to 2020, if it is to overcome its poverty and social problems.

The government has designed a viable poverty reduction strategy in its carefully articulated National Socio-Economic Development Plan for 2006-2010 (NSEDP), and it is pursuing policy changes—including public finance, environment, investment climate, governance, and social management reforms—with vigor. The capacity to implement these reforms is perhaps the key bottleneck to more rapid results.

Nam Theun 2 hydro project, a catalyst for new engagement

Engagement with the international community is now much stronger than in previous years and IDA's involvement in the potentially transformational US\$1.45 billion, 1,070 megawatt Nam Theun 2 Hydroelectric (NT2) project has been a major catalyst for this. The NT2 project, in which the government has a 25 percent shareholding, aims to generate revenues for poverty reduction and environmental protection. Since 2001, an innovative IDA business approach to project preparation has not only made the NT2 project ready for

NT2 Hydro Project

The project allows Lao PDR to export electricity to Thailand, while also producing 75 megawatts of electricity for domestic use. It will generate US\$2 billion in government revenue over the life of its 25 year concession period—an average US\$30 million annually in the first 10 years, rising to average of US\$110 million over the subsequent 15 year period. This income represents a significant boost to current annual government revenues, which stand at just US\$400 million.

the country, but also the country ready for the project. In turn it has influenced global players to support NT2 and the country's broader development efforts. A window of opportunity exists for mobilizing greater support for the capacity development and concessionary financing that the Government of Lao PDR needs.

IDA CONTRIBUTIONS

IDA builds support alongside reform program

From 1977 to 2008, total IDA assistance for Lao PDR reached US\$914 million, including 16 percent in the form of grants. During this period, IDA was the third largest source of official development assistance to the country, after Japan and the Asian Development Bank. The average volume of IDA assistance over the past decade reached US\$37 million per year, augmenting government revenues by about 10 percent. The financing program included five policy support operations and a series of credits for rural development, forestry, transport, energy, telecommunications, education, health, and industry. Along with complementary support from other donors and multilateral institutions, this has helped the country lay the foundations for its infrastructure system, broaden access to better quality health and education services, and facilitate the transition from a centrally planned economy to a market one.

IDA and NT2—the trigger for change

Since 2001, IDA's engagement in the NT2 Project has triggered a qualitative change in the relationship between Lao PDR, the World Bank, and other development partners. The aim was to help launch Lao PDR on a sustain-

able development path and build international support for the country's development efforts as well as for the project. NT2 preparations saw the adoption of a new IDA business strategy. It centered on a Decision Framework (DF) as the basis for an 'up/down' verdict on support for the project. Comprehensive risk identification and mitigation strategies, and a range of 'due diligence' measures to assess the viability of the project, complemented the framework. The DF was founded on three pillars: 1) the government needed to implement a development strategy and program that would yield concrete results in terms of poverty reduction and environmental protection; 2) the project developer and the government needed to ensure that the technical, financial and economic aspects of the project and the design and implementation of safeguard policies were of a standard acceptable to IDA; and 3) the government was required to obtain broad support from international donors and civil society for the country's development strategy and the NT2 project itself.

As a result, IDA and Lao PDR formed a strong partnership on macroeconomic reform, poverty reduction, and sustainable growth, with technical support helping build domestic capacity. This partnership has had wider effects on the government's development planning and implementation. IDA and other donors are now contributing to the design and implementation of comprehensive sector strategies, for example in the education and transport sectors, where AusAID (Australia) is involved.

The project's second requirement involved traditional project-level 'due diligence', carried out in an evolving framework that nurtured partnership and engagement with all stakeholders, underpinned by transpar-

ency and disclosure. The third pillar triggered an unprecedented level of open consultation with the international community and local participants. Independent external oversight groups were established and extraordinary effort went into mobilizing official and commercial funds in support of the project. Commercial operations will start at the end of the year when power will be sold to Thailand and Lao grids. The environmental, social and revenue management outcomes are to be realized over a longer time frame that stretches through the 25-year concession period. The project continues to demonstrate steady performance despite the many challenges.

IDA supports NT2's new business approach

The World Bank Group used a range of IDA instruments to address the cross-sectoral complexities of the project and to support the new business approach. Three project instruments provided direct funding. A US\$20 million IDA grant—the Social and Environment Project (NTSEP)—helped fund a portion of the government's equity in the Nam Theun Power Company (NTPC) and the management of the social and environment impacts and independent monitoring and evaluation of the NT2 project. An IDA partial risk guarantee of US\$42 million covered a syndicated commercial loan to NTPC. MIGA guarantees of about US\$90 million for a syndicated commercial loan as well as an equity investment in NTPC covered political risks in Thailand (the external buyer of NT2 electricity) and Lao PDR.

NT2 approach brings new levels of consultation and openness

The quality of governance, management of public finances, and service delivery form the core of the broader dialogue, helping the

government to tackle deep-rooted impediments to growth while introducing a new level of consultation with civil society and development partners. The preparation of NT2 initiated irreversible changes in openness and participation and provided valuable experience to the government in negotiating future deals.

Separate IDA projects have also contributed to: spreading the benefits of electricity to the countryside; increasing opportunities for communities living in the NT2 area; supporting environmental and social goals, such as management of safeguard programs in the hydropower and other infrastructure sectors; biodiversity conservation; river basin management planning; raising public awareness in the broader Mekong region; reforms in public financial management and building capacity at the provincial and national levels.

Working with other donors and increasing aid effectiveness

Joint portfolio reviews with the Asian Development Bank and other bilateral donors have proved a useful foundation for improving IDA's own practices. Five Poverty Reduction Support Operations (PRSO), as well as individual IDA projects and multi-donor trust funds, have allowed for harmonized donor support and better alignment with government policies. The program of PRSOs focuses on three broad policy areas: public resource management; public expenditure policy; and sustainable growth. Besides working to improve capacity for better management of public resources and strengthen monitoring of state-owned companies, among other things, they have helped develop a legislative framework for a better investment climate and started reforming the structure of revenues, especially in forestry and customs.

IDA's impact in Lao PDR spans many sectors

Structural Reforms: The transformation from a centrally planned economy to a market one has made notable progress. The environment for investment and private sector development has improved. Foreign approved investment has gone from negligible amounts to more than 25 percent of GDP in 2007. The government's multi-year Public Expenditure Management Strengthening Program (PEMSP) has gained considerable momentum. New budget classification systems, independent external audits for large state enterprises and the restructuring of others, and a sharp reduction in arrears on salary payments to health care workers and teachers are among the impacts of policy reforms. These resulted from IDA support through policy lending and technical assistance.

Education: The now completed Education Development Project helped improve quality in seven provinces by developing a curriculum and new textbooks and teacher guides for primary and secondary schools. Under this project, 277 primary schools and 31 secondary schools were built. More than 3 million textbooks and 200,000 teacher guides were printed and distributed. The ongoing Second Education Development Project is focusing on increasing the primary school enrollment and completion in 19 poorest districts of 6 provinces. To date, drop out rates have gone down from 8.9 percent in 2004 to 7.9 percent in 2008 thus contributing at achieving universal completion of primary education.

Rural Development: The Agricultural Development Project assisted in reducing rural poverty by involving communities in increasing agricultural production. The project supported the rehabilitation of small-scale

irrigation systems and improvement of rural water supply and sanitation. The aims of the recently initiated Khammouane Development Project are two-fold: strengthening the planning process and public financial management associated with the decentralized delivery of services and infrastructure, including irrigation development support along the Nam Theun 2 (NT2) hydroproject downstream areas; and building local and provincial capacity to implement rural livelihood projects in more transparent and participatory ways.

Natural Resources and Environment: The Sustainable Forestry for Rural Development Project brings the country's priority natural production forests under participatory and sustainable management practices. This creates a partnership between the government and communities to foster stewardship of forests and their valuable resources. The policy gives local communities an equitable share in the revenue earned from the sale of forest products. Community participation will help ensure the protection of areas of social and cultural value, including sacred forests and other cultural assets. Community participation in land-use planning and in forest management also helps clarify land tenure and resource use rights. Two Land Titling projects successfully accelerated land registration through systematic registration, exceeding original targets.

Through the Lao Environment and Social Project, IDA is assisting the country to implement the National Policy on the Environmental and Social Sustainability of the Hydropower sector, improve the integrated management of selected river basins, and introduce a viable financing mechanism that will direct resources for community management of biodiversity.

Infrastructure: When the Third Highway Improvement Project started in 1996, Road 13—the backbone of the country's road transport network—was in serious need of improvement, with a gravel surface that limited speed to 35 km/h. At its completion, the project had upgraded a 200 km stretch resulting in savings in vehicle operating costs estimated at US\$39 million. Travel speeds rose to 80 km/h and the time to market fell from an average 5 hours to 3 hours.

The Road Maintenance Program, now in its second phase of implementation, is expanding the financing and management systems for the sustainable maintenance of the road networks in all 17 provinces countrywide. Road users' revenue collection (toll) is up from US\$ 3 million in 2002 to US\$ 20 million in 2008, helping cover 50 percent of the national road network's maintenance needs. About 83 percent of paved national road, 46 percent of provincial road network and 37 percent of district roads are now considered in "fair and good condition." In addition, 300 villages have been connected to improved rural roads passable year round. Due to IDA's support, nearly 23,000 km of roads are benefiting from improved periodic maintenance efforts.

The Provincial Infrastructure Project, completed in 2007, has helped reduce poverty and improve living standards in Oudomxay and Phongsaly Provinces by rehabilitating and upgrading basic infrastructure—including roads and water supplies—for about 52,000 people in 125 villages. New roads will help provide year-round access to a number of isolated rural communities. The project has also provided access to improved piped water supply for 21,700 people in two districts and

rural water supply that meets World Health Organization water quality standards for 71,400 people in 193 villages. The project has also improved sanitation and health behavior through education assistance provided in 181 villages, many of which are largely populated by ethnic groups.

An ongoing IDA-financed Rural Electrification project supports the successful development of the power sector, extending the electric grid to rural households in seven targeted southern, while also promoting off-grid renewable energy throughout the country. To date, about 19,300 rural households have been connected to the grid of Electricite du Laos (EdL) and about 37,500 households have gained access to off-grid technologies. Access to electricity is now 61 percent nationwide and distribution losses have been reduced from 19 percent in 1998 to less than 14 percent in 2008, resulting in additional greenhouse gas emissions reductions. The project also seeks to improve the financial performance of the power sector. As a result, EdL reported positive profits from its operations for the first time in 2007 and again in 2008.

Social Protection: The Poverty Reduction Fund is helping local governments and local communities collaborate to determine their most pressing development needs—whether they be bridges, schools, nurseries, clinics, community halls, communal water supply systems, or irrigation and drainage systems. This helps communities plan and manage the public investments that will address those needs. The Fund is empowering local communities and strengthening local institutions to support participatory decision-making and conflict resolution processes at the village

The Outside View

A 2008 client survey judged IDA's greatest contribution to be in the areas of poverty reduction, access to education, infrastructure, supporting efforts to increase and stimulate foreign direct investments and public financial management system strengthening. The survey singled out the Nam Theun 2 project in particular, as it ensures that appropriate environmental and social mitigation measures are in place and it provides needed financial and technical support.

and district levels, and ensuring the inclusion of women and the poor in decision-making.

Health: A Health Services Improvement project is improving the planning, budgeting and performance orientation of health services in eight provinces to improve the quality and use of health facilities. The objective is to improve the equity, efficiency and sustainability of health financing in order to raise the health status of the population, especially in poor and rural areas.

The ongoing Avian and Human Influenza Control and Preparedness project helps the Government of Lao PDR implement its national plan. The plan aims to minimize the threats posed to humans and the poultry sector by AHI infection and other zoonoses in Lao PDR. Efforts to prepare for, control, and respond to an influenza pandemic and other emerging infection diseases are underway, for example, by increasing community awareness through brochures and training. The launching of a compensation program to farmers for the loss of poultry—as a result of H5N1—and a community feedback hotline call service have helped increase early reporting.

CHALLENGES AHEAD

System-wide reforms and more investment needed

Besides addressing its low level of human development, the country needs to address other serious obstacles in order to achieve continued rapid and harmonious growth. These include weak capacity in the central and provincial governments, a fledgling private sector, inadequate physical infrastructure and unsound management of natural resources. A more enabling environment for business, a stronger domestic civil society, and a more effective media are also needed.

Some progress was made on these three fronts. A set of media, investment and Non Profit Association laws and decrees have been passed and are currently in the process of being enacted. A large part of recent growth has come from higher foreign investment in hydropower and mining. Future growth depends on continued investment in these areas—in a social and environmentally sound way—but also on promoting economic diversification.

The next 10 years will be critical

The agenda for reducing poverty and social inequities is formidable. The country's willingness to address these difficult issues while continuing its move to a market economy is embedded in strong and growing political commitment. The government is also beginning to address challenges in providing infrastructure and social services while dealing with the human and institutional capacity constraints that exist across the country.

The level of external financial and technical support is crucial, as it can allow the govern-

ment to implement its reform agenda and achieve its long-term development goals. Lao PDR is actively seeking international help and is looking at ways to increase the impact of aid, through the Vientiane Declaration on Aid Effectiveness.

Recent IDA successes in the country have demonstrated the benefits of a closer relationship with the international community, mediated by a multilateral organization such as the World Bank, and the environment is becoming increasingly favorable for these efforts.

Large, sustained in-flows of capital needed

The National Socio-Economic Development Plan for 2006-2010 outlines an ambitious program of reforms aimed at sustaining and accelerating economic growth and poverty reduction. Funding this program would require around US\$357 million per year in ODA and around US\$600 million per year in FDI, with national savings projected to cover only about thirty percent of the needs.

Currently ODA is estimated at around US\$200-250 million a year and FDI at approximately US\$500 million a year (most of it in the mining and hydropower sectors). Although the feasibility of attracting so much additional external financing needs to be examined, it is clear that Lao PDR needs large and sustained inflows of long-term capital from abroad.

Given the significance of ODA flows to the Lao PDR, and its limited capacity for dealing with multiple donors effectively, multilateral channels such as IDA provide a particularly useful vehicle for delivering assistance. Adequate levels of financial support—preferably on grant terms, as has been the case with

recent IDA flows—would facilitate better donor engagement and dialogue and help provide a continuum of support that includes investment lending, analytical and technical assistance, and regional and global access.

Among the country's vast financial needs, IDA resources are likely to be most productive in:

- Maintaining the momentum of structural reforms and building capacity;
- Improving the policy framework for private investment in natural resource projects;
- Strengthening the public financial management system as a cornerstone to improved governance, particularly in the context of decentralization;
- Strengthening management of the environment and improving social policies;
- Raising the government's capacity to deliver basic human services;

- Supporting economic integration programs to better link with the Greater Mekong Sub-region; and,
- Facilitating private sector investment in agriculture and industry.

Linking resources to results

The signing of the Vientiane Declaration on Aid Effectiveness (the local version of the Paris Declaration) by the government and 22 development partners—including some nontraditional regional donors—provides a framework for government and donors to cooperate to increase the impact of official development assistance and better measure results.

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<http://www.worldbank.org/ida>