

Lao PDR: Growing Momentum

Despite huge challenges, Lao People's Democratic Republic (PDR) is on an increasingly sustainable development path with growing opportunities to build on reforms achieved so far. This small, landlocked nation of less than 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 6.5 percent a year since 2001 while undertaking structural reforms in trade, private sector development, and public financial management. Growth reached 7 percent in 2005 and is expected to be around 7.3 percent in 2006.

Country Indicators	1992/93	2004/05
GNI per capita (Atlas method, US\$)	290	460
Inflation (CPI, average annual rate, %)	6.3	7.2
External debt (% of GNI)	148.8	111.1
Poverty incidence (% below national poverty line)	46.0	28.7
Primary school enrollment (% of age group)	58 (1991)	84
Under-five child mortality rate (per 1,000)	163 (1990)	98
Population (millions)	4.4	5.6
Population growth rate (% per year)	2.5	2.0

Source: World Bank, *World Development Indicators*.

The International Development Association (IDA), the World Bank's fund for the world's poorest countries has supported the country's poverty reduction strategy, taking an innovative approach to project preparation in the ground-breaking case of the US\$1.45 billion Nam Theun 2 Hydroelectric Project. This has helped catalyze an emerging economic transformation and influence global players to support the country's broader development efforts.



COUNTRY ACHIEVEMENTS

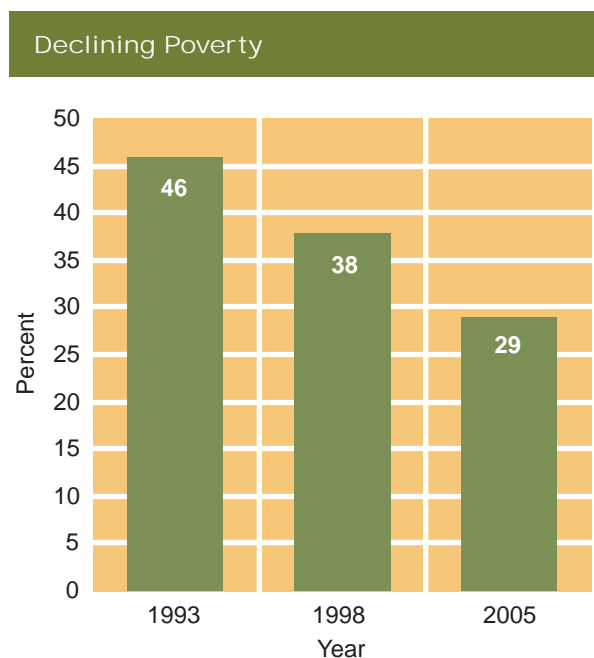
A market-oriented economic transformation.

Lao PDR has abundant natural resources supporting mining, hydropower and forestry. It's also in a good 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. In its place, financing from IDA and other donors supported the country's transition.

Spillovers from the Asian crisis of 1997 set the economy back, but Lao PDR's economy regained its stability. Much of the country's improved performance has come from vigorous non-traditional horticultural and garment exports by the private sector, but also from timber. External debt, which remains a concern, dropped from 83 percent of GDP in 2004 to 77 percent in 2005. Openness to foreign trade and investment, freer domestic prices, the creation of family farms, sales of state-owned production and marketing units, and a single exchange rate have all built a stronger platform for the economy's expansion.

Significant progress on reducing poverty, but results have been uneven.

The number of poor households fell from 46 percent of the total in 1992/93 to approximately 29 percent (or 137,500 households) in 2004/2005. But a lot depends on geography. 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.



Source: World Development Indicators.

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 55 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 1,000, is more than double the regional average of 37.

Lao PDR has maintained a sound macroeconomic framework but domestic revenues (about US\$400 million or below 12 percent of GDP) are still inadequate 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 2006-10 (NSED). 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.

A new partnership with the international community.

The country's engagement with the international community is much stronger than in previous years. Since 2001, 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 shift. The NT2 project, in which the government has a 25 percent shareholding, aims to generate revenues for poverty reduction and environmental protection.

Nam Theun 2

The Nam Theun 2 Hydroelectric (NT2) Project, approved by the Bank's Board of Directors in 2005, will allow Lao PDR to export electricity to Thailand, while also producing 75 megawatts of electricity for domestic use.

It will generate annual government revenues of US\$30 million (nominal) on average in the first ten years, rising sharply to US\$110 million (nominal) in 2020-34. This income represents a significant boost to government revenues, which stood at just US\$400 million in 2005.

Through a public expenditure management program and various capacity-building initiatives funded by IDA, the government is improving its ability to manage revenues and to implement projects once NT2 begins operations in 2010.

Through an IDA grant for social and environment mitigation and an IDA partial-risk guarantee (as well as a MIGA guarantee) the World Bank is committed to ensuring that the project is developed in an environmentally and socially sound way and that revenues generated are used to finance priority poverty reduction and environment protection projects.

As of early 2007, more than half of the households being resettled had moved to their final resettlement sites, which were chosen by the villagers. The rest of the 1,200 households will finish moving by mid-07. The resettled villagers are benefiting from improved household infrastructure, roads, schools, and a comprehensive livelihood package that will allow them to develop more sustainable livelihoods.

More information on Nam Theun 2 is available at <http://www.worldbank.org/laont2>

Global players have rallied to support NT2 and the country's broader development efforts. A window of opportunity exists for mobilizing further support for Lao PDR.

IDA CONTRIBUTIONS

From 1977 to 2006, total IDA assistance for Lao PDR reached US\$839 million, including 9 percent in the form of grants. During this period, IDA was the third largest source of official development assistance to the country, ranking behind 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 four 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 to a market economy.

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 sustainable 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, centered on a decision framework that has had wider effects on the planning and implementation of aid in Lao PDR.

For example, in order to prepare for NT2, the government was asked to implement a development strategy and program characterized by concrete performance on poverty reduction and environmental protection. IDA's strong partnership with the government on macroeconomic reform, poverty reduction, and sustainable growth, implemented through technical support for building domestic capacity, is helping achieve this.

Increased domestic capacity means that IDA and other donors can take a more sophisticated approach to development. As a result, they have been able to design comprehensive sector strategies, for example in the education sector, where Sweden's SIDA is involved.

Project approval was also conditioned on the design and implementation of World Bank safeguard policies. This project-level 'due diligence' was carried out in an evolving framework that nurtured partnership and engagement with all stakeholders, underpinned by transparency and disclosure.

A third pillar of the decision to support NT2 required that the government obtain broad support from international donors and civil society for the country's development strategy and the NT2 project itself. This 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.

The preparation of NT2 initiated irreversible changes in openness and participation and provided valuable experience to the government in negotiating future deals.

The quality of governance, management of public finances, and service delivery now form the core of the broader dialogue in Lao PDR, helping the government to tackle deep-rooted impediments to growth while introducing a new level of consultation with civil society and development partners.

Providing multi-faceted support.

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 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. The Multilateral Investment Guarantee Agency (MIGA), part of the World Bank Group, provided guarantees of about US\$90 million for a syndicated commercial loan and an equity investment in NTPC which covered political risks in Thailand (the external buyer of NT2 electricity) and Lao PDR.

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 provided a useful foundation for improving the Bank's own practices. Three Poverty Reduction Support Operations (PRSOs), 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 to a market economy has made notable, but slow, progress. The environment for investment and private sector development has improved. Private investment has gone from negligible amounts to more than 11 percent of GDP, overtaking public investment. 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 (for example, Lao Airlines) and the restructuring of others (one-third of the 14 non-performing enterprises that were identified), 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 Sector Development Project helped improve quality in seven provinces by developing a multi-lingual 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.

Rural Development: The Agricultural Development Project is helping to reduce rural poverty by involving communities in increasing agricultural production. The project supports the rehabilitation of small-scale irrigation systems and improvement of rural water supply and sanitation. The recently completed District Upland Development and Conservation Project has helped enhance the livelihoods of communities, while protecting biodiversity in an adjacent protected area.

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

Infrastructure: When the Third Highway Improvement Project started in 1997, Road 13—the backbone of the country's road transport network—was in serious need of improvement, with a gravel surface that limited speeds to 35 km/h. The project upgraded a 200 km stretch of the road, resulting in savings in vehicle operating costs of about US\$39 million. Travel speeds rose to 80 km/h and the time to market fell from an average 5 hours to an average 3 hours. The project developed a sustainable road maintenance framework, exceeding its own targets by 60 percent and leading to the periodic maintenance of 23,000 km of roads.

The Provincial Infrastructure Project is helping to 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 is also bringing low-cost water and sanitation services to about 42,000 people in 165 rural communities, many of which are largely populated by ethnic groups.

The Southern Provinces Rural Electrification Project has **tripled access to electricity in 10 years** from 15 to 46 percent of the rural population, servicing 51,805 households in 721 villages through extensions of the grid, and another 6,097 households (in remote areas) through off-grid systems. Distribution losses dropped from 19 percent in 1998 to 16 percent in 2003, even as total electricity consumption rose. Altogether, a series of IDA credits since 1993 has supported electricity to 98,800 households, or almost 21 percent of the households that receive electricity.

Social Protection: The Poverty Reduction Fund is helping local governments and local communities collaborate to determine their most pressing development needs and 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 and district levels, and ensuring the inclusion of women and the poor in decision-making.

Over three years of activities, more than 1,200 subprojects have been selected, completed and implemented by poor communities in nearly 2,000 villages. So far, the Poverty Reduction Fund has helped more than **900 villages gain access to clean water**. More than 240 schools have been built in remote villages, almost 2,000 km of roads have been upgraded, and more than 40 bridges linking different villages are in now place.

Health: The objective of the Health Services Improvement project is to assist Lao PDR in improving the health status of its population, particularly the poor and rural population by

improving the performance and financing of health services.

The ongoing Avian and Human Influenza Control and Preparedness Project helps the government of Lao PDR implement its national plan. This plan aims to **minimize the threats posed to humans and the poultry sector** by AHI infection and other zoonoses in Lao PDR, to prepare for control and to respond to influenza pandemics and other emerging infectious diseases.

Efforts to increase community awareness have taken place and work is ongoing to prepare a decree and compensation guidelines that would encourage early reporting of disease outbreak and compliance with culling orders.

Under the Health System Reform and Malaria Control Project, health facilities at provincial, district and community levels were renovated or built, 10 malaria control stations were built, awareness activities were undertaken and at least 4,300 staff trained. The project contributed to increasing access to basic health care for vulnerable groups and reduced the incidence of malaria cases.

Land Titling: An important element of the government's policy to move toward a market economy is the development of efficient land markets. The Land Titling Project is working to provide landowners with official titles of ownership to their land. Titles serve as collateral for bank loans, which help expand businesses or establish new ones, even facilitating larger project investments, such as apartment buildings. The involvement of the Lao Women's Union has played a key role in **informing women of the benefits and risks of land titling**. As a result, compared

to provinces not included in the project, the number of titled land parcels registered jointly and in the names of women exceeded the number registered in the names of men only.

REMAINING CHALLENGES

The next 10 years will be a critical time for Lao PDR to pursue reforms and attract more investments.

Pursuing systematic reforms.

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

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 socially and environmentally sound way—but also hinges on promoting economic diversification.

The agenda for reducing poverty and social inequities is formidable. The country's willingness to address these difficult issues while moving to a market economy is embedded in strong and growing political commitment. While the investment climate for the private sector has improved, it is still unsatisfactory. 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.

Attracting large and sustained flows of capital.

A high level of external financial and technical support will be crucial to allow the government 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.

Linking Resources to Results

The Vientiane Declaration on Aid Effectiveness (the local version of the Paris Declaration) was signed in November 2006 by the government and 22 development partners—including some non-traditional regional donors.

It provides a framework for government and donors to cooperate to increase the impact of official development assistance and better measure results.

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

The National Socio-Economic Development Plan (2006-10) 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 Official Development Assistance (ODA) and around US\$600 million per year in Foreign Direct Investment (FDI), with national savings projected to cover only about 30 percent of the needs. Currently

ODA is estimated at around US\$200-US\$250 million a year and FDI at approximately US\$500 million a year (with most of it flowing to 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 Lao PDR with the Greater Mekong Sub-region.
- Facilitating private sector investment in agriculture and industry.

Learning from the past to improve project outcomes.

Assessments of IDA projects and programs conducted by the Independent Evaluation Group (IEG) of the World Bank over the past five years have covered key development areas. They include projects for the development of upland agriculture, forestry, land titling, highways and road maintenance, rural electrification, health, financial management, and a structural adjustment credit. In general, they indicate that projects with tangible physical outcomes and strong capacity building components have been satisfactory or moderately satisfactory in meeting their development objectives and have made substantial contributions to domestic project and program management capacities.

Recent projects have performed better than older projects, reflecting improvements in IDA preparation, donor coordination, and country commitment. But outcomes from complex undertakings, such as the financial management and structural adjustment initiatives, have been unsatisfactory. IDA programs need grounding in solid analytical work to exploit the synergy between policy reform and investment during this period of systemic transformation in Lao PDR. Greater effort at building domestic capacities to design, undertake, and monitor the effects of this analytical work is essential, since ownership of the reform program is a key success factor—as well as the root cause of occasional failures.

In 2003, a client survey judged IDA's greatest contribution to Lao PDR to be in the areas of financing, donor coordination, and capacity

development. It singled out IDA involvement in infrastructure development, the financial system, environment, regulatory reform and energy development as priorities.

Improved models for working with decentralized entities, increased focus on outcomes rather than narrow performance benchmarks,

and better use of partnerships with other donors are some of the areas that internal and external reviews suggest for deeper examination by IDA in Lao PDR.

April 2007.

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