BUSINESS FORMALIZATION IN THE LAO PDR

SEPTEMBER 2016

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List of Tables, Figures, and box  
v  
Abbreviations  
vi  
Acknowledgments  
vii  
Executive Summary  
ix  
1 Introduction  
1  
2 History of reforms to encourage Private enterprise  
2  
3 Characteristics of the Private Sector  
4  
   Economic Overview  
   4  
   Size, Gender, and Formality  
   6  
4 Constraints on Private Sector Development  
9  
   Business regulatory environment  
   9  
      Laws and their Implementation  
      9  
      Business Registration, Licensing, and Permits  
      9  
      Regulatory Challenges for Foreign Investors  
      13  
      Enforcing Contracts  
      14  
   Taxation  
   15  
      Overview of Tax Regime  
      15  
      Taxation as a Constraint to Private Sector Development  
      16  
      Link between Taxation and Informality  
      17  
      Underlying Causes of Taxation Constraints  
      18  
      Recommendations  
      19  
   Markets for financial Services  
   20  
      Overview of Financial Services  
      20  
      Limited Access to Financial Services  
      21  
      Cause of Access to Finance Constraints  
      23  
      Impact of Access to Finance Constraints  
      24  
      Addressing Access to Finance Challenges  
      25
## Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Labor and Skills</td>
<td>26</td>
</tr>
<tr>
<td>Introduction</td>
<td>26</td>
</tr>
<tr>
<td>Extent of Labor Constraints</td>
<td>27</td>
</tr>
<tr>
<td>Impact of Labor Constraint</td>
<td>28</td>
</tr>
<tr>
<td>Causes of Labor Constraints</td>
<td>29</td>
</tr>
<tr>
<td>Current Initiatives to Address the Labor Constraint</td>
<td>31</td>
</tr>
<tr>
<td>Potential Reforms and Actions</td>
<td>31</td>
</tr>
<tr>
<td>5 Crosscutting Themes that Impact the Private Sector</td>
<td>33</td>
</tr>
<tr>
<td>Consultation on the Legislative Agenda</td>
<td>33</td>
</tr>
<tr>
<td>Public–Private Dialogue</td>
<td>34</td>
</tr>
<tr>
<td>Regional Integration and Private Sector Development</td>
<td>35</td>
</tr>
<tr>
<td>6 Conclusions and Policy Implications</td>
<td>37</td>
</tr>
</tbody>
</table>

### Appendixes

<table>
<thead>
<tr>
<th>Appendix</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Institutional Context of Business-Enabling Reforms</td>
<td>39</td>
</tr>
<tr>
<td>2 Key Initiatives in Support of Private Sector Development</td>
<td>41</td>
</tr>
<tr>
<td>3 Main Business Laws, Decrees, and Legal Instruments</td>
<td>50</td>
</tr>
<tr>
<td>4 Constraints Matrix</td>
<td>51</td>
</tr>
<tr>
<td>5 Ongoing Development Partner Support Programs in Private Sector Development</td>
<td>58</td>
</tr>
<tr>
<td>6 Study Methodology</td>
<td>64</td>
</tr>
</tbody>
</table>

### References

| References                                                                 | 71   |
Tables

3.1 Female ownership of enterprises, by Firm Size .......................................................... 7
4.1 Business Registration procedures ............................................................................ 10
4.2 Summary of the Main Business taxes ...................................................................... 15
4.3 Total Hours Worked in each Sector, as % of total Hours Worked by each Gender .... 67
4.4 Percentage of permanent Staff Who are Female ......................................................... 67

Figures

3.1 Structure of output and employment in the lao people’s Democratic Republic ....... 5
4.1 Credit to the private Sector .......................................................................................... 21
4.2 Percentage of Firms Complaining of no, or Few applicants, for a Job, by Skill level ... 27
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>ADB</td>
<td>Asian Development Bank</td>
</tr>
<tr>
<td>AEC</td>
<td>ASEAN Economic Community</td>
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<td>ASEAN</td>
<td>Association of Southeast Asian Nations</td>
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<td>DFAT</td>
<td>Department of Foreign Affairs and Trade</td>
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<td>DTIS</td>
<td>diagnostic trade and integration study</td>
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<td>ECCIL</td>
<td>European Chamber of Commerce and Industry</td>
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<td>ERO</td>
<td>Enterprise Registration Office</td>
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<td>ESDP</td>
<td>Education Sector Development Plan</td>
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<td>GDP</td>
<td>gross domestic product</td>
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<td>GIZ</td>
<td>Deutsche Gesellschaft für Internationale Zusammenarbeit</td>
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<td>GMS</td>
<td>Greater Mekong Subregion</td>
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<td>HRME</td>
<td>Human Resource Development for Market Economy</td>
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<td>IFC</td>
<td>International Finance Corporation</td>
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<td>INCHAM</td>
<td>India Chamber of Commerce</td>
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<td>Lao PDR</td>
<td>Lao People’s Democratic Republic</td>
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<td>LBF</td>
<td>Lao Business Forum</td>
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<tr>
<td>LFTU</td>
<td>Lao Federation of Trade Unions</td>
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<td>LNCCI</td>
<td>Lao National Chamber of Commerce and Industry</td>
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<td>LRYU</td>
<td>Lao Revolutionary Youth Union</td>
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<tr>
<td>LUNA</td>
<td>Lao PDR-US International and ASEAN Integration</td>
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<td>LWU</td>
<td>Lao Women’s Union</td>
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<td>MFI</td>
<td>microfinance institution</td>
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<td>MOF</td>
<td>Ministry of Finance</td>
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<td>MOIC</td>
<td>Ministry of Industry and Commerce</td>
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<td>MPI</td>
<td>Ministry of Planning and Investment</td>
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<td>PPD</td>
<td>public–private dialogue</td>
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<td>PPPD</td>
<td>provincial public–private dialogue</td>
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<tr>
<td>PRC</td>
<td>People’s Republic of China</td>
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<td>PSD</td>
<td>private sector development</td>
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<td>ROSCA</td>
<td>Rotating Savings and Credit Associations</td>
</tr>
<tr>
<td>SEZ</td>
<td>Special Economic Zone</td>
</tr>
<tr>
<td>SME</td>
<td>small and medium-sized enterprises</td>
</tr>
<tr>
<td>SOE</td>
<td>state-owned enterprise</td>
</tr>
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<td>UNCDF</td>
<td>United Nations Capital Development Fund</td>
</tr>
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<td>UNDP</td>
<td>United Nations Development Programme</td>
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<td>VAT</td>
<td>value-added tax</td>
</tr>
<tr>
<td>WTO</td>
<td>World Trade Organization</td>
</tr>
</tbody>
</table>
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LAO PEOPLE’S DEMOCRATIC REPUBLIC
PRIVATE SECTOR PROFILE

OUTPUT AND EMPLOYMENT 2013

Share of total hours worked
Share of value added

Construction, and Services
Mining, Electricity, Water, and Gas
Manufacturing
Agriculture

$1,646
per capita gross domestic product in 2013

55%
share of registered small enterprises owned by women

7.8%
average annual GDP growth since 2000

REGISTERED BUSINESSES IN LAO PDR

98,700
ARE SMALL ENTERPRISES

1,100
ARE MEDIUM-SIZED ENTERPRISES

200
ARE LARGE ENTERPRISES

1-19
EMPLOYEES

20-99
EMPLOYEES

100
OR MORE EMPLOYEES

CHALLENGES TO LAO PDR PRIVATE SECTOR DEVELOPMENT

1
Complex business registration

2
Arbitrary taxation

3
Limited access to finance

4
Labor and skills gaps
Executive Summary

Introduction

The macroeconomic performance of the Lao People’s Democratic Republic (Lao PDR) has been remarkably strong and stable over a sustained period of time. In the decade to 2015, the economy grew by an average of 7.8% per year, with annual growth never dipping below 7.0%. While this strong macroeconomic performance has helped reduce poverty and improve nutrition and health, private sector development (PSD) in the Lao PDR over the past decade presents, by its nature, some challenges to the goal of broad-based, inclusive, and sustainable economic growth.

Private sector growth has been largely concentrated in the resource-based industries of mining and hydropower. Large, mostly foreign-owned companies in these industries account for a large share of the country’s economic output, exports, foreign direct investment, and public revenues, but provide only a small share of total employment and few opportunities for small and medium-sized enterprises (SMEs). Beyond these two industries, the Lao PDR private sector consists mostly of smallholder agriculture and micro and small enterprises in manufacturing, construction, and services. Many of these smaller enterprises operate in the informal economy, and relatively few grow into larger, formal enterprises that would help the country diversify its economic base and ensure that the benefits of economic growth are spread more evenly across the whole population.

A major finding of this report is that many businesses remain informal, and struggle to grow into medium-sized and large businesses that are capable of providing decent work for large numbers of Lao PDR citizens.

Small and Medium-Sized Enterprises

The private sector in the Lao PDR is highly fragmented. Official figures for registered enterprises show that small enterprises (1–19 employees) comprise about 99% of all enterprises in the Lao PDR. The country has only about 1,100 medium-sized enterprises (20–99 employees) and 200 large enterprises (100 or more employees). While firms with fewer than 20 employees comprise a large share of total enterprises in many developing countries, the numbers for the Lao PDR are at the higher end of the spectrum.

Encouragingly, the share of registered small enterprises owned by women has been rising in recent years, from 44% in 2009 to 55% in 2012.
Not only are most registered firms in the Lao PDR small, they tend to stay small. Based on enterprise surveys conducted by GIZ in 2011 and 2013, only 6% of the small enterprises surveyed in 2011 had grown into medium-sized or large enterprises by 2013. Similarly, only 2% of the medium-sized enterprises surveyed in 2011 had grown into large enterprises by 2013, with 46% actually shrinking to small enterprises over the same period.

These statistics highlight a key challenge for PSD in the Lao PDR—small firms have difficulty growing into larger firms and achieving the scale necessary to improve their productivity and access to international markets.

Informality

Given the limited available research on the informal sector in the Lao PDR, it is difficult to estimate its share of the total private sector. Anecdotal evidence suggests, however, that informal businesses play large roles in many sectors of the economy, including manufacturing, construction, trade, and services. Many registered firms complain about the competition they face from informal enterprises. The World Bank’s Enterprise Surveys for the Lao PDR in 2012 found that 77% of firms face competition from informal firms, while 27% of firms cited the “practices of competitors in the informal sector” as their single biggest obstacle, making it the most commonly cited top constraint.

In addition to creating an uneven playing field, high rates of informality undermine the government’s fiscal policy by narrowing the tax base to concentrate revenue collection on a smaller number of tax-compliant firms, which strengthens the incentive to operate informally.

Informality presents a number of disadvantages for the unregistered businesses themselves. Most significantly, their access to finance is constrained by their inability to obtain a bank loan, forcing them to seek capital from alternative sources such as informal money lenders (often at very high interest rates) and family members. Constrained by a lack of capital, many informal businesses are unable to invest in new systems, equipment, and technologies, or to achieve the scale necessary to become internationally competitive.

In addition, informal firms have greater difficulty accessing global supply chains, contracting with customers and suppliers overseas, and engaging in joint ventures with foreign businesses. Closer to home, they have added difficulties accessing business support services and development programs.

While a firm may choose to stay informal for a wide variety of reasons, a key driver is the benefit of staying “under the radar” of government officials, particularly with respect to business registration, regulatory compliance, and taxation. By avoiding the substantial time and monetary costs of complying with these requirements, informal firms enjoy a competitive advantage over registered firms in their industry. This competitive advantage is a key dynamic of the private sector in the Lao PDR.

High rates of informality in the Lao PDR suggest that many firms perceive that the benefits of registration (including improved access to finance and global supply chains) are outweighed by the costs of registration and compliance with regulations and taxation.
Constraints on Private Sector Development

As the costs of business formalization are key constraints on PSD, they are the focus of this Lao PDR study.

**Complex business registration.** The three main components for registering a business are the enterprise registration certificate from the Ministry of Industry and Commerce (MOIC), the tax registration certificate from the Ministry of Finance (MOF) and the operating license from the relevant line ministry. While these registration procedures have been subject to some reform in recent years, many businesses still complain about the complexity of these procedures and the time it takes to register a business. The administrative burden of registering a business is a clear disincentive to formalization.

In 2008, the government sought to ease enterprise registration for most businesses by transferring responsibility from the Ministry of Planning and Investment to a “one-stop service” in the Enterprise Registry Office within the MOIC. However, the one-stop service exists in name only. In practice, businesses still have to go to the MOIC, MOF, and the relevant line ministry. The process is still complex and time consuming, particularly when obtaining operating licenses from line ministries and registering a business in the provinces. Foreign investors wishing to register a business are still frustrated by the time and complexity of the procedures, which can take up to 6 months.

An online business registry system piloted in Vientiane Capital does not appear to have been rolled out successfully. While an online registry system has the potential to make business registration faster and more transparent, any attempt to develop and implement such a system is likely to encounter resistance from departments and agencies that currently benefit from the discretion that individual officers have to collect informal fees and facilitation payments.

**Arbitrary taxation.** As in many developing countries, the tax system in the Lao PDR presents major challenges for the private sector, in addition to the amount of taxes businesses pay. These include lack of transparency, uncertainty about rates, and the administrative burden of keeping records and dealing with tax authorities. Many businesses complain of a general lack of transparency and consistency in the calculation and administration of the major taxes, including value-added, excise, and profit taxes. These inconsistencies are exacerbated by provincial tax officials’ different interpretations and requirements. Businesses also complain that the government’s current fiscal challenge has increased the intensity and unpredictability of tax negotiation and collection, with large, tax-compliant businesses experiencing the most intense pressures in their tax negotiations.

Any steps to address the problems facing the Lao PDR’s tax system must be taken with an understanding of why those problems exist and persist. Why does the country’s tax system lack transparency and consistency? Why are tax payments often determined case-by-case through negotiation, rather than through consistent application of relevant tax laws?

From the perspective of the tax department, issuing comprehensive tax guidelines that all businesses could rely on would run the risk of inadvertently creating loopholes with large consequences for tax revenue. For fear of “missing something” or “getting it wrong,” the tax department finds it safer to negotiate case-by-case rather than by laying out comprehensive tax guidelines.
Additionally, tax officials prefer negotiating lump-sum taxes because it gives them more discretion and hence enhances their ability to extract informal payments. Some businesses similarly prefer a negotiated approach because it reduces the administrative burden of maintaining accurate records for taxation purposes or because they possess the skills and connections to negotiate a tax liability below what they would pay under strict interpretation of the tax laws.

**Limited access to finance.** As is common in many developing countries, lack of finance severely constrains enterprises in the Lao PDR, particularly SMEs and those in agriculture.

Limited access to finance can hobble private sector growth in several ways. It constrains firms’ ability to expand, invest in new equipment and technology, gain access to foreign markets, and manage their liquidity efficiently. It can also hinder diversification of the Lao PDR economy by constraining growth in sectors where access to finance is particularly challenging (such as agriculture and agribusiness), while concentrating growth in such well-funded sectors as mining and hydropower. Finally, it can exacerbate the problem of the “missing middle” because if small enterprises cannot access the finance they need to expand their capacity and grow, they will not become medium-sized businesses.

There are many reasons why enterprises—particularly SMEs—and farmers are constrained in accessing credit. These include high rates of business informality, the inherent riskiness of lending to SMEs and farmers, low financial literacy, lack of financial products suitable for SMEs, high collateral requirements, the difficulty banks experience in repossessing collateral following default, and the information asymmetries between borrower and lender that arise due to a lack of reliable financial statements and the absence of a credit bureau.

When designing interventions to address constraints on access to finance, it is important to evaluate the extent to which these constraints arise from credit market failure or imperfection that can be rectified or, alternatively, reflect an efficient financial system that is identifying and pricing risk appropriately. A sensible first step in designing effective interventions is to conduct a comprehensive diagnosis of the finance sector in the Lao PDR and SMEs’ access to finance. This is currently underway by the United Nations Capital Development Fund via a program called Making Access to Finance More Inclusive for Poor People.

**Labor and skills gaps.** A clear finding of this study is that shortages of labor and skills are among the biggest constraints facing the private sector in the Lao PDR. Whereas a shortage of skilled labor is a challenge common to many developing countries, the Lao PDR also lacks an adequate supply of unskilled labor.

This finding is based on interviews conducted with large firms, SMEs, business associations, development organizations, and government officials, as well as on the latest data from a World Bank survey of firms. Nearly every interviewee highlighted labor shortages as one of the biggest constraints—and often the biggest constraint—on growth for their firm or, more generally, the private sector.

The underlying causes of labor shortages are interrelated and involve challenges with education, productivity, wages, and the migration of workers to Thailand.

As with many labor market issues, there are few quick fixes to the challenge of an inadequate supply of skilled and unskilled labor. While some potential interventions could partly alleviate this constraint, significant improvement will require longer-term planning and resources.
Interventions

The issue of business informality is critical to the development of the private sector in the Lao PDR, yet little is known about the nature of the informal sector, its extent, and the underlying drivers of informality. An estimate of the tax revenue lost as a result of unregistered businesses would help motivate policy makers to change. For this, comprehensive diagnosis is required.

Interventions should focus on alleviating the disincentives for businesses to formalize the time and monetary costs involved in business registration as well as the costs of their compliance with regulations and taxation. There may also be benefits in raising awareness among businesses of the negative consequences of not formalizing, and this requires a more in-depth understanding of these negative consequences.

The effort to create a genuine one-stop service for registering a business should be renewed. This will require a comprehensive review of the role of operating licenses in the Lao PDR’s regulatory framework, and the procedures involved in obtaining these licenses (particularly in the provinces). This is arguably the most important area of reform in business registration. However, achieving reform will be difficult given the incentives for line ministries to preserve their power and discretion.

Given the inconsistencies of business registration in the provinces, there is merit in benchmarking—at least in the large provinces—on their ease of registering a business. This would highlight best practice in provincial business registration procedures, and provide potential investors with valuable information for deciding where to locate their business.

There remains scope to further streamline specific steps in the business registration process, with a view to reducing the number of steps and shortening the time taken. The World Bank and other development partners are continuing to assist the government in this area.

Improving the transparency and consistency of tax administration would stimulate PSD and encourage businesses to join the formal sector. However, achieving success in tax reform will depend on the extent to which these reforms recognize, and can overcome, the incentives that have created a strong preference for negotiated tax assessments.

Interventions should support the development and rollout of practical implementation guidelines for the key business taxes (profit, value-added, and excise), similar to the guidelines on lump-sum taxation for SMEs that are currently being developed and piloted with the support of the World Bank. Other useful interventions would include establishing an online tax information portal (similar to the Lao PDR Trade Portal) and a low-cost mechanism by which businesses can dispute tax assessments. In the longer term, resolving the government’s fiscal challenge would create an environment more conducive to consistent and transparent taxation.

In terms of access to financial services, many government agencies and development partners are already active in this space. The challenge is to identify the most appropriate interventions and to build on them. The finance sector diagnosis being conducted by the United Nations Capital Development Fund should help to shape future interventions. Consideration should be given as well to supporting the implementation and rollout of the new online registry of movable collateral maintained by the Lao Registry Office for Security Interests in Movable Property. In addition, working with the Bank of the Lao PDR and
other stakeholders on existing initiatives to establish a legal framework, and supporting infrastructure development for innovative SME-friendly financial services (such as mobile banking) will help to deepen financial markets and improve SMEs’ access to financial services.

Shortages of skilled and unskilled labor are key constraints on many firms in the private sector for which there are few quick or obvious solutions. Long-term solutions will entail the reform of the country’s education and training systems, as well as broader reforms to improve the business environment and boost productivity and wages.
The macroeconomic performance of the Lao People’s Democratic Republic (Lao PDR) has been remarkably strong and stable over a sustained period. While this strong performance has contributed to reducing poverty and improving nutrition and health over the past decade, the nature of economic growth presents some challenges to the goal of broad-based, inclusive, and sustainable economic growth.

The government and other stakeholders have taken some positive steps in recent years to improve the business enabling environment and stimulate economic activity. Nevertheless, businesses in the Lao PDR continue to face major challenges in their attempts to grow, prosper, and take advantage of the opportunities provided by increasing regional economic integration.

This report assesses the key opportunities and challenges to private sector development (PSD), with a focus on why these challenges persist and what can be done to address these challenges and unlock the potential of the private sector. Many of these challenges relate in various ways to the highly fragmented and informal nature of the private sector in the Lao PDR. The underlying causes and consequences of informality are complex and interrelated. This report attempts to go some way toward understanding how informality constrains the Lao PDR’s ability to generate broad-based, inclusive growth, but further research on this important issue will be required.

Chapter 2 of this report provides a brief overview of the business enabling reforms that have been implemented in the Lao PDR. Chapter 3 analyzes the key features of the Lao PDR economy—including the informal sector—with a view to understanding the prevailing business and investment environment. Chapter 4 examines the factors that constrain the private sector’s ability to grow and prosper, and proposes measures to address these constraints. Chapter 5 considers a number of crosscutting issues that impact PSD in various ways. Chapter 6 concludes with some practical recommendations on reform priorities and implementation to improve the business and investment environment, stimulate private sector development, and generate broad-based inclusive economic growth for the people of the Lao PDR.
The Lao PDR’s transition from a centrally-planned to a market-oriented economy began about the same time as the Doi Moi reforms in Viet Nam. At the Fourth Party Congress in 1986, the Government of the Lao PDR announced reforms known as the New Economic Mechanism. These reforms represented the first tentative steps toward strengthening the role of the private sector and opening the economy to market forces, foreign trade, and investment.

Over the next decade, further reforms were gradually introduced to remove constraints on private production, establish a legal framework for commercial transactions, and privatize most state-owned enterprises.

Since the mid-1990s, closer economic ties to its neighbors and the global economy have provided the impetus for continued economic reforms, particularly in the areas of trade liberalization and competition. The Lao PDR joined the Association of Southeast Asian Nations (ASEAN) in 1997 and has since opened parts of its economy and lowered various tariffs as part of its commitments under the ASEAN Free Trade Area, the Common Effective Preferential Tariff scheme and more recently, the ASEAN Economic Community (AEC). Also in 1997, the Lao PDR applied to join the World Trade Organization—a process that took 15 years to complete, with the country finally becoming a member in 2013.

However, preparing enabling regulations and effectively implementing them has often been lagging. Although the legislative and executive branches of government have a strong drive to expedite business reforms to stimulate economic development and help the country reach middle income status by 2020, government staff generally lack capacity to implement reforms. At the provincial level, governors, who rank equal to cabinet ministers, can override national policy on business reform as well as the investments they approve.

While the private sector would benefit from business reforms, business owners are generally not pressing for reform. Large foreign enterprises, which usually invest in mega projects, are exempt from cumbersome regulations, as are large domestic investors that have close relationships with government. Although smaller domestic businesses would benefit most, they too are not pressing for reforms as they are largely unaware of them or of their power to advocate collectively through business associations.

In helping government and the private sector to improve their capacity to achieve regulatory and business environment reform, and meet the challenges of greater competition through the AEC, development partner support could play an important role.
3 Characteristics of the Private Sector

Economic Overview

In the decade to 2015, the Lao PDR economy grew by an average of 7.8% per year, with annual growth never dipping below 7.0%. As a result, per capita gross domestic product (GDP) increased from $476 in 2005 to an estimated $1,812 in 2015.2

Private sector growth has been largely concentrated in the resource-based industries of mining (copper and gold) and hydropower. While accounting for just 1% of total employment, mining and hydropower account for about 18% of total value added, one third of total GDP growth, two thirds of merchandise exports, two thirds of foreign direct investment, and 20% of government non-grant revenues (World Bank 2013a and IMF 2013). These industries are dominated by large, mostly foreign-owned companies with weak backward links to small and medium-sized enterprises (SMEs). In the mining industry, for example, Phu Bia Mining’s copper–gold operation (owned by a company incorporated in Australia) and Lane Xang Minerals Limited’s Sepon gold and copper mine (majority owned by an enterprise from the People’s Republic of China (the PRC)) account for more than 90% of total copper and gold production in the country (World Bank 2013).4 The hydropower sector is dominated by investors from the PRC and Japan.

As highlighted in Figure 3.1, over the past decade, there has been a dramatic shift in the structure of the Lao PDR economy, measured by each sector’s contribution to total value added. Mining and hydropower have grown in relative importance, while the share of agriculture has declined. Over the same period, however, the shift in the structure of employment has been more modest.

Beyond mining and hydropower, the Lao PDR’s private sector consists mostly of smallholder agriculture and micro and small enterprises in manufacturing, construction, and services. Many of these smaller enterprises operate in the informal economy and few of them grow into larger, formalized enterprises of the kind that would help the country diversify its economic base and ensure that the benefits of economic growth are spread more evenly across the population.

4 Note that gold production at Lane Xang Minerals’ Sepon mine has since ceased (in December 2013).
With economic growth concentrated in capital-intensive resource sectors, its flow-on effects on employment, consumption and equality have been somewhat limited. While GDP more than doubled in the decade to 2013, employment rose by just 20%. Consequently, growth in annual consumption per capita averaged 2% over the same period despite growth in GDP per capita rising by 6% on average. Moreover, this modest growth in consumption was not evenly distributed, with consumption by the richest 40% of households growing nearly twice as fast as consumption by the poorest 40% of households (World Bank 2016a). These figures highlight that the nature of economic growth in the Lao PDR presents some challenges to the goal of achieving broad-based, inclusive, and sustainable economic growth.

Nevertheless, it is important to recognize that strong economic growth has had a significant impact on overall poverty levels. The proportion of the population living below the national poverty line fell from 33.5% in 2002–2003 to 23.2% in 2012–2013 (World Bank 2014c).

Several enterprise-level surveys indicate that firms are not reaping the rewards of strong economic growth. According to the World Bank’s latest Lao PDR Enterprise Survey (World Bank 2016b), real annual sales growth and annual labor productivity growth declined by 22.4% and 22.0%, respectively. Annual employment growth also experienced a decline of 0.5%. Experiences were similar among firms in different sectors (manufacturing and services) and of different sizes (small, medium and large).
It should be noted that the World Bank’s *Lao PDR Enterprise Survey* only includes registered firms with at least five employees, and 59% of the surveyed firms have at least 20 employees. In contrast, the GIZ enterprise surveys include registered firms of all sizes (including those with 1 to 4 employees), and 85% of the surveyed firms have fewer than 20 employees. Consequently, results from the GIZ surveys arguably reflect the situation for SMEs more closely than results from the World Bank surveys.

In the 2013 GIZ survey, 41% of firms reported that their profit had increased compared to the previous year (down from 51% in 2011), while 31% of firms reported that their profit had decreased compared to the previous year (up from 24% in 2011). The percentage of firms reporting a profit increase was inversely related to firm size, with fewer micro and small firms reporting profit increases than medium and large firms (GIZ 2014).

In conclusion, it appears that the country’s strong rates of economic growth are masking some underlying weaknesses in the productivity and profitability of many private sector enterprises. This finding is consistent with the views expressed by many of the private sector owners and managers interviewed as part of this study; they felt that the business enabling environment need much improvement.

**Size, Gender, and Formality**

The Lao PDR private sector is highly fragmented and informal.

About 100,000 businesses are registered in the Lao PDR, with the precise number depending on the source of information. According to Ministry of Commerce figures, the number of businesses registered in the Lao PDR increased from 71,000 in 2012 to 97,000 in 2013. Statistics from the Ministry of Finance show that the total number of enterprises registered with the Tax Department was 95,000 in 2013 (GIZ 2014).

In the formal sector, small enterprises (1–19 employees) comprise about 99% of all enterprises in the Lao PDR. Only about 1,100 medium-sized enterprises (20–99 employees) and 200 large enterprises (100 or more employees) are registered in the entire country (DOSMEP 2010).

As highlighted in Table 3.1, various surveys indicate that about half of all enterprises have some level of female ownership, with female ownership highest in small firms and lowest in large firms. By sector, female ownership is highest in retail and/or wholesale trade and lowest in industry.

To control for the possibility that these sector-based gender differences merely reflect a size effect—since small firms are more commonly found in retail and/or wholesale trade than in industry—the table also shows female ownership by sector for small firms only. It confirms that even among small firms, females are more likely to own businesses in retail and/or wholesale trade than in industry.
Table 3.1  Percentage of Enterprises with Female Participation in Ownership, by Firm Characteristic

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td><strong>FIRM SIZE</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Small (1–19 employees)&lt;sup&gt;a&lt;/sup&gt;</td>
<td>51</td>
<td>46</td>
<td>58</td>
</tr>
<tr>
<td>Medium (20–99 employees)</td>
<td>33</td>
<td>17</td>
<td>49</td>
</tr>
<tr>
<td>Large (100+ employees)</td>
<td>18</td>
<td>8</td>
<td>39</td>
</tr>
<tr>
<td>All firms</td>
<td>48</td>
<td>43</td>
<td>53</td>
</tr>
<tr>
<td><strong>SECTOR</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Industry</td>
<td>33</td>
<td>16</td>
<td>N/A</td>
</tr>
<tr>
<td>Retail and wholesale trade</td>
<td>57</td>
<td>65</td>
<td>N/A</td>
</tr>
<tr>
<td>Other services</td>
<td>45</td>
<td>42</td>
<td>N/A</td>
</tr>
<tr>
<td>All firms</td>
<td>48</td>
<td>43</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>SMALL FIRMS BY SECTOR</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Industry</td>
<td>36</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Retail and wholesale trade</td>
<td>60</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Other services</td>
<td>45</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>All small firms</td>
<td>51</td>
<td>N/A</td>
<td>N/A</td>
</tr>
</tbody>
</table>

GIZ = Deutsche Gesellschaft für Internationale Zusammenarbeit, N/A = not available, USAID = United States Agency for International Development.

<sup>a</sup> The World Bank defines small as 5–19 employees.

Sources: Surveys by GIZ, the World Bank, and USAID.

While it seems clear that females are more likely to own smaller firms engaged in service-related activities, studies have not addressed the reason why female ownership is concentrated in this way. While it is beyond the scope of this study to evaluate the reasons for gender-based ownership differences, possible causes include:

- Female participation in post-secondary education is concentrated in business and hospitality courses, with low participation in industry-related fields such as electrical and electronics.<sup>2</sup>
- Sector-based gender differences may reflect possible differences in career interests and preferences.
- Females may experience unique constraints that inhibit or discourage their ownership of larger firms or firms in particular sectors.
- Women could be deterred from growing their business because of competing demands from family responsibilities and care.
Encouragingly, most studies indicate that female ownership of enterprises is on the rise. According to official statistics, the share of registered small enterprises owned by women rose from 44% in 2009 to 55% in 2012 (MOIC 2014). Similarly, the GIZ enterprise surveys reveal that the percentage of female owners increased from 36% in 2005, to 41% in 2009, to 48% in 2013. In the World Bank’s enterprise surveys, the percentage of firms with female participation in ownership increased from 39% in 2009, to 42% in 2012, to 43% in 2016. However, the slight increase to 43% in the 2016 World Bank survey is due to an increase in the weighting of small firms in that survey (compared to the 2012 survey). In the World Bank surveys, the percentage of female ownership actually declined from 2012 to 2016 for firms in each size category.

Not only are most registered firms in the Lao PDR small, they tend to stay small. Based on firm surveys conducted by GIZ, only 6% of small enterprises surveyed in 2011 had grown into medium-sized or large enterprises by 2013. Similarly, only 2% of medium-sized enterprises surveyed in 2011 had grown into large enterprises by 2013, with 46% downsizing to small enterprises over that time (GIZ 2014).

These statistics highlight a key challenge for private sector development (PSD) in the Lao PDR: small firms have difficulty growing into larger firms and achieving the scale necessary to improve their productivity and access international markets.

Given the limited available research on the informal sector in the Lao PDR, it is difficult to estimate the share of the private sector or the number of enterprises that operate informally. Anecdotal evidence suggests that informal businesses play large roles in many sectors of the economy, including manufacturing, construction, trade, and services. Many registered firms complain about the competition they face from informal enterprises. The 2016 enterprise survey by the World Bank found that 77% of firms face competition from informal firms (up from 42% in 2012). In the same survey, 27% of firms cited the “practices of competitors in the informal sector” as their single biggest obstacle (making it the most commonly cited top constraint), compared to 18% in 2012 (World Bank 2016b). These findings are consistent with complaints about “unfair competition” that business owners and managers voiced during consultations conducted for this report.

From an economy-wide perspective, high rates of informality create an uneven playing field that can place formal, tax-compliant businesses at a competitive disadvantage when compared to their unregistered competitors. In addition, high rates of informality have an adverse impact on the government’s fiscal position by narrowing the tax base and concentrating revenue collection on a smaller number of tax-compliant firms, which merely serves to heighten the incentive to operate informally.

For the unregistered businesses themselves, operating informally has a number of disadvantages. Most significantly, their access to finance is constrained by their inability to obtain a bank loan, forcing them to seek capital from alternative sources such as informal money lenders (often at very high interest rates) and family members. Constrained by a lack of capital, many informal businesses are unable to invest in new systems, equipment, and technologies, or to achieve the scale necessary to become internationally competitive.

In addition, informal firms have greater difficulties in accessing global supply chains, contracting with large customers and suppliers overseas, and engaging in joint ventures with foreign businesses. They also have added difficulties in accessing business support services and development programs.
While there are a wide variety of reasons why a firm may choose not to register, the key drivers of informality relate to the benefits of staying “under the radar” of government officials, particularly with respect to business registration and compliance with regulations and tax. By avoiding the substantial time, monetary costs, and uncertainties associated with these requirements, unregistered firms enjoy a competitive advantage over the formal firms in their industry. This is a key dynamic of the private sector in the Lao PDR.

A key question that has important policy implications is: why do firms operate informally? Is the answer that Lao PDR firms would like to become formal but are discouraged or prevented from doing so by complex and burdensome business registration processes? If this is the case, then it follows that policy interventions should focus on making it easier for firms to register their business.

Alternatively, do Lao PDR firms actively choose to remain informal after weighing the costs and benefits of formalizing? According to this view, firms do not want to formalize because the benefits of doing so (including improved access to finance and global supply chains) are outweighed by the costs of formalizing (including the initial costs of registering the business as well as the burden of complying with regulations, dealing with authorities, and paying taxes). To the extent that this is the case in the Lao PDR, simply making it easier for businesses to register may not be sufficient to cause large numbers of businesses to formalize. Rather than a narrow focus on streamlining the business registration process, a broader range of interventions may be necessary that seek to increase the benefits of formalizing (for example by improving formal firms’ access to finance) and address the underlying regulatory and taxation challenges that increase the costs for firms that operate formally.

These costs of becoming formal, and operating as a formal entity, represent key constraints to PSD. The following chapter examines the nature, causes, and consequences of these and other key business constraints.
Constraints on Private Sector Development

Business Regulatory Environment

Laws and their Implementation

While there is some room for improvement in the key business laws in the Lao PDR, the main challenge is the effective implementation, interpretation, and enforcement of those laws. A key concern of businesses and other stakeholders is that laws are often passed, but are not supported with the enabling decrees, regulations, capacity building, and administrative structures that are essential for those laws to be implemented effectively and to achieve their objectives.

This disconnect between the passing of laws and their practical implementation is a challenge common to many developing countries, including other countries in the Mekong region. Effective implementation often requires substantial resources, administrative capacity, and coordination between different levels of government—all of which tend to be lacking in developing countries.

In the case of the Lao PDR, a view expressed by some stakeholders is that the government sees laws as a “statement of good intentions” rather than something that it legally binding and enforceable. This mindset may in part reflect the Lao PDR’s recent history of passing laws that were required in order to become a member of organizations such as the Association of Southeast Asian Nations (ASEAN) and the World Trade Organization (WTO), and, more recently, to meet its commitments as part of ASEAN Economic Community (AEC) 2015. It may also reflect a desire to implement the suggestions of development partners and other international organizations. Finally, it may reflect a tendency for development partners to be more effective at advising on the development of new laws and amendment of existing ones, rather than supporting agencies in their rollout and implementation.

In discussions with the private sector for this report, the general consensus is that the legal framework governing the incorporation and registration of businesses is adequate, although there is always room for improvement. The main challenges in the business regulatory framework relate to implementation, interpretation, and administration of these laws.

Competition Law

In July 2015, the National Assembly passed the Law on Business Competition (No. 60/NA). The legislation establishes the building blocks of a comprehensive competition law regime, covering unfair trade practices, anti-competitive agreements, abuse of market power and the regulation of mergers. While this is a welcome development, the law needs to be supported with additional legislation and implementing regulations in order to become fully operational. This is an example of a law being passed to comply with regional commitments—in this case an AEC commitment to introduce competition policy by 2015—but without the supporting regulations and structures to give full effect to that law.
Business Registration, Licensing, and Permits

A business may be subject to one of three possible investment and business registration regimes: general business, concession business, and Special Economic Zones (SEZs).

Registration Procedures for General Businesses

Table 4.1 summarizes the main steps in registering a business in the Lao PDR, as described in the World Bank’s Doing Business 2016 survey (World Bank 2016c). In that survey, the Lao PDR ranks 153rd out of 189 economies on ease of starting a business (slipping eight places from its rank of 146th in the previous year). The six main procedures in registering a business take, on average, 73 days, compared to 87 days for Cambodia, 72 days for Myanmar, 48 days for Indonesia, 29 days for Philippines, 28 days for Thailand, 20 days for Viet Nam, 13 days for Myanmar, and 4 days for Malaysia. As in most neighboring countries, the average number of days it takes in the Lao PDR masks large variations depending on the type, location, and connections of the business.

Table 4.1 Business Registration Procedures

<table>
<thead>
<tr>
<th>Step</th>
<th>Procedure</th>
<th>Time to complete</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td><strong>Apply for Name Reservation Certificate and Enterprise Registration Certificate</strong>&lt;br&gt;Apply to Enterprise Registration Office (ERO) within the Ministry of Industry and Commerce (MOIC) to obtain Name Reservation Certificate and the Enterprise Registration Certificate</td>
<td>14 days</td>
<td>KN390,000 ($49)</td>
</tr>
<tr>
<td>2</td>
<td><strong>Register the Articles of Association</strong>&lt;br&gt;Register Articles of Association with State Assets Management Department in Ministry of Finance.</td>
<td>5-10 days</td>
<td>No charge</td>
</tr>
<tr>
<td>3</td>
<td><strong>Apply for Tax Registration Certificate</strong>&lt;br&gt;Apply to Tax Department for Tax Registration Certificate</td>
<td>14 days</td>
<td>KN125,000 ($16)</td>
</tr>
<tr>
<td>4</td>
<td><strong>Apply for content of company signage and company signage building permit</strong>&lt;br&gt;Apply for content approval and a building permit.</td>
<td>5-14 days</td>
<td>KN10,000 ($1.25)</td>
</tr>
<tr>
<td></td>
<td>(simultaneous with step 3)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td><strong>Carve a Company Seal</strong>&lt;br&gt;After ERO issues Enterprise Registration Certificate and a letter for seal carving, the enterprise submits these documents at Seal Carving Unit (MOIC) and Ministry of Home Affairs.</td>
<td>45 days (simultaneous with step 4)</td>
<td>KN120,000 ($15)</td>
</tr>
<tr>
<td>6</td>
<td><strong>Register Workers for Social Security</strong>&lt;br&gt;Enterprises with 10 or more employees register their workers for social security insurance at Social Security Office.</td>
<td>7 days</td>
<td>No charge</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td>73 days</td>
<td>KN645,000 ($81)</td>
</tr>
</tbody>
</table>

In 2008, the government sought to ease enterprise registration for general businesses and transferred responsibility from the MPI to a “one-stop service” in the Enterprise Registry Office within MOIC. The one-stop service is intended to enable enterprises to apply for business and tax registration at the same time.

While business registration procedures have had some reforms in recent years, many businesses still complain about the complexity of these procedures and the time it takes to register. The administrative burden of registering a business is a clear disincentive to formalization.

The main sources of frustration and priority areas for reform are outlined below.

**Business registration in the provinces.** While enterprises with an investment or registered capital of $5 million or more can register at the central level, smaller enterprises must register at the provincial level (or the municipal level, in the case of Vientiane Capital). Businesses complain that registration is generally more problematic, time-consuming, and expensive in the provinces than at the central level. Further research is needed to determine whether these problems encountered in the provinces stem from human resource capacity constraints or reflect provincial officials’ incentive to slow the process down in order to create opportunities for collecting informal facilitation payments.

**Operating licenses from line ministries and provincial departments.** The need for businesses to obtain an operating license from the relevant line ministry or provincial department diminishes the positive impact of the one-stop service for business and tax registration. The delays in obtaining an operating license discourage some firms from formalizing, and result in others opting to “partly formalize” (register with MOIC and the Tax Department but not register with the relevant line ministry).

One possible improvement to the current system would be copying the one used by concession businesses. Under this system, through the one-stop service, the Planning and Cooperation Department in each ministry or department follows up on the applications of enterprises.

**Carving the company seal.** According to the World Bank’s latest *Doing Business* survey (World Bank 2016c), it takes 45 days for approval of the design and carving of the company seal. However, the Ministry of Home Affairs has recently launched a hotline, which enables enterprises that pay additional fees to complete the procedures in 1–2 weeks. This initiative requires further monitoring to see if the shorter approval times can be maintained, and to investigate the extent of the additional fees.

**Registration Procedures for Concession Businesses**

A concession involves authorization from the government that allows a business to use the government’s property according to the terms and conditions of a concession agreement. Concession-related activities generally involve investments in telecommunications, communications, transportation, mining, electricity, and plantation agriculture. In the mining and electricity sectors, the investor will generally be required to offer the government a negotiated equity stake in the project company.

The Lao PDR amended its Investment Law in 2009 by combining the domestic investment promotion law with the foreign investment promotion law. In 2011, MPI issued a *Lao PDR Investment Guide Book*. 

(MPI 2011a) that explains the procedures for approval of concession businesses. The guidebook also specifies the incentives provided to foreign and domestic investors.

For concession business approval, the government established the Committee for Promotion and Management of Investment at the central and provincial levels. At the central level, the committee is chaired by MPI. The Investment Promotion Department acts as the permanent office for the committee and facilitates investment applications through a one-stop service unit. In the provinces, a similar organization is chaired by each provincial governor and the Vientiane Capital mayor. The efficiency of these committees results from their links with the planning and cooperation departments in all line ministries and provinces.

The procedures for obtaining an investment or business concession are similar to those for general businesses, as outlined above. Investors typically submit information relating to their business plan, feasibility studies, joint venture agreement, tax registration, and the proposed enterprise’s draft articles of association. The difference is that the application is made through MPI or the Provincial Planning and Investment Department.

In addition to the above procedures, the plan for the business concession’s import requirements has to be submitted to the Customs Department (Ministry of Finance). In accord with the Customs Department, investors must submit annual import plans. Timing for approval depends on the investment activities and the type of goods to be imported, with the official estimate being 20 working days.

The priority reforms to make it easier and cheaper to formally establish a concession business are outlined below.

Legacy impacts of the previous “first come first serve” approach to concessions. The policy of the government in the early 2000s was to open concession investments to all investors without thoroughly screening their status or experience in the proposed field of investment. Applications for concession businesses were processed and approved on a “first come, first served” basis. This resulted in a large number of mining and hydropower concessions being captured by speculators who hoped to on-sell the concession, rather than develop the project themselves. In response, in 2009, the government stopped issuing new mining and hydropower concessions until it reviewed all previously-awarded concessions. New concession business applications are now carefully considered on a case-by-case basis—which may lead to better investors being approved, but this also considerably slows the application process.

Complex application procedures for small concession projects. The same application procedures are required whether the concession is large or small, which makes the application process time consuming and very costly for small concession businesses. In the hydropower sector, the government, with assistance from the World Bank, is attempting to improve the situation by reducing the number of procedures and fees for small hydropower concessions of less than 15-megawatt capacity.

Registration Procedures for Activities in Special Economic Zones

As an investment incentive, the Foreign Investment Law allows for the establishment of SEZs and Specific Economic Zones. SEZs are intended to support development of new infrastructure and commercial facilities, and they provide highly favorable taxation and other incentives. In SEZs, business registration and other regulatory procedures are streamlined, and approvals can be obtained very
quickly. While it is not practical to mainstream such a streamlined regulatory approach for all businesses across the entire country, further research should be undertaken to identify lessons from SEZ business registration and meeting other regulatory requirements. These lessons could then be incorporated to improve the broader regulatory framework and make compliance easier for all types of businesses.

Specific Economic Zones are intended to develop existing infrastructure and facilities and they provide a lower level of incentives and support than SEZs.

There are currently 10 economic zones across the country, with the two most developed zones being Savan–Seno SEZ in Savannakhet and the Vientiane Industrial and Trade Zone. In recent years these zones have been successful in attracting high-quality foreign investors to establish factories and other facilities.

Regulatory Challenges for Foreign Investors

There are two main pieces of legislation that restrict foreign direct investment in the Lao PDR:

- List of Reserved Businesses for Lao Citizens, which prohibits foreign investment in a range of activities in areas such as manufacturing, construction, transport, tourism, finance, professional services, education, and health
- List of Conditional Businesses for Foreign Investors, which imposes additional equity restrictions and minimum capital requirements in a range of activities considered to be sensitive.

In general, foreign investors face many of the same difficulties and challenges that domestic businesses face in obtaining necessary approvals and permits. In addition, foreign investors who have registered their business in the Lao PDR are subject to various requirements if they decide to exit the country. As a result, small and medium-sized foreign investors often test the waters by commencing operations without formally registering their business.

A key constraint to the development of the Lao PDR private sector is the regime of foreign investment restrictions in key service sectors, including retail and wholesale, transport and logistics, and tourism.

Retail and Wholesale Trading

In a significant reform, the government has recently liberalized restrictions on foreign ownership of the retail and wholesale sectors (which were previously reserved for Lao citizens). Decision No. 1005/MOIC on Wholesale and Retail Businesses issued on 25 May 2015 permits foreigners to operate wholesale and retail businesses in the Lao PDR, albeit with stringent conditions and minimum capital requirements.

In addition, operations of the business must be in accordance with the Decision on Shopping Centers and Supermarkets No. 1950/MOIC, issued on 22 September 2015, which imposes additional conditions and minimum capital requirements for those types of retail businesses.

While the practical effect of these reforms has yet to be felt, it should become easier for foreign investors to acquire 100% ownership of large retail and wholesale enterprises. In the past, foreign companies were required to accept minority stakes in joint ventures or to distribute their goods to retail outlets through distributors or franchisees that were 100% owned by a Lao PDR national. These restrictions were a major disincentive for large companies such as Carrefour, Tesco, AEON, and Charoen Phokphand (CP Thailand) to invest in the wholesale and retail sectors in the Lao PDR.
Transport and Logistics

The restrictions on foreign investment in the transport and logistics sector are an impediment to the Lao PDR’s ambitions to become a “land-linked” country with competitive transport costs. Many exporters and trading businesses complain about the high transportation costs in the Lao PDR, which are partly caused by the highly protective nature of the industry.

Foreign participation is limited to a maximum of 49% ownership of a business in international freight and freight forwarding (domestic or international). There are no foreign investment restrictions on domestic freight, however no permits to operate such services have been issued to foreigners for a long time.

Under the AEC, Lao PDR has committed to the liberalization of the transport and logistics sector, agreeing to raise the foreign ownership threshold for any activity in the sector to 70%. It is not clear, however, precisely how and when these AEC commitments will be implemented in full.

Tourism

The tourism sector, being labor-intensive and dispersed throughout the country, offers great potential for inclusive growth in the Lao PDR. However, several restrictions on foreign investment constrain growth of the sector. While foreign investors can own 100% of a hotel or restaurant business, they can only own up to 49% of a joint venture in a guesthouse with fewer than 20 rooms. The latter restriction, which is covered by Regulation No. 1150/PM regarding the Establishment and the Management of Tourist Service Operators (25 October 1993), is intended to promote local ownership of small and medium-sized enterprises (SMEs) in the tourism sector.

The practical application of this restriction is not clear, however, with some officials limiting foreign ownership to 49% and others allowing up to 70%. In practice, many of the guesthouses in the provinces in the north of the country are owned by migrants from the People’s Republic of China (the PRC) and Vietnam. The restrictions are the same for tour companies.

Although the same regulation allows 100% foreign ownership of 3–5 star hotels, foreign investors must meet a minimum capitalization requirement of $500,000. Confusingly, 3-star hotels also appear on the list of businesses reserved for Lao citizens, which adds another layer of uncertainty.

Financial Services

In 2012, a new decree on microfinance allowed for foreign investment in deposit-taking microfinance institutions (MFIs) if the MFI is a joint venture with a local partner (Prime Minister’s Office 2012). However, the decree does not specify the maximum percentage of an MFI’s capital that foreign investors can own, but rather states that the investment is to be “in accordance with the proportions as defined by the Bank of the Lao PDR.” To date, no percentage has been defined by the Bank of the Lao PDR. As a result of this uncertainty, officials have been reluctant to allow foreign investments in deposit-taking MFIs.

Enforcing Contracts

The Lao PDR judicial system is not seen as an effective mechanism for resolving commercial disputes. Disputes—including those with government ministries or departments—are typically resolved through negotiation and persuasion, drawing on the connections of the persons involved.

According to the World Bank’s Doing Business scorecard, published in 2016, Lao PDR ranks 92nd out of 189 economies for ease of enforcing contracts, with the average time taken to enforce a contract being 443 days and costing 32% of the value of the claim. For most businesses, however, these figures mean very little because they rarely resort to the judicial system to resolve commercial disputes.
Taxation

Overview of Tax Regime

The main pieces of legislation governing taxation in the Lao PDR are the Tax Law, the Law on Value-Added Tax and the Investment Promotion Law (which contains provisions on tax incentives for eligible investors). Substantial changes to the tax system were introduced in October 2012 in an attempt to broaden the tax base and reduce the burden of tax compliance.

The main business taxes in the Lao PDR are summarized in Table 4.2.

Table 4.2 Summary of the Main Business Taxes

<table>
<thead>
<tr>
<th>Tax</th>
<th>Rate (%)</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit tax</td>
<td>24</td>
<td>Reduced rates apply to companies operating in Special Economic Zones or that have concession agreements with the government. Payable in advance on a quarterly basis.</td>
</tr>
<tr>
<td>Lump sum tax</td>
<td>3–7 of revenue</td>
<td>Alternative to the profit tax, available only to small and medium-sized enterprises with annual revenues less than KN400 million ($50,000). Tax rate depends on the sector and the amount of annual revenue. Tax payable is often negotiated case-by-case.</td>
</tr>
<tr>
<td>Value Added Tax (VAT)</td>
<td>10</td>
<td>All businesses with annual revenues of KN400 million ($50,000) are required to register as VAT taxpayers (optional for businesses below KN400 million).</td>
</tr>
<tr>
<td>Excise duties on imports</td>
<td>5–150</td>
<td>Payable by importer at the time of importing.</td>
</tr>
<tr>
<td>Personal income tax</td>
<td>0–24</td>
<td>(progressive) Applies to Lao nationals and foreigners working in the Lao PDR. Payable monthly by the employer.</td>
</tr>
</tbody>
</table>


Most businesses in the Lao PDR do not keep reliable accounting records. As a result, the amount of profit tax payable is often negotiated between the tax department official and the business, including businesses whose revenues are much higher than the upper threshold for lump sum taxation.

A recent survey of tax-registered businesses found that 70% of microfirms (1–2 employees) pay their taxes using the lump-sum system, compared to 56% of small firms (3–19), 31% of medium-sized firms (20–99) and 14% of large firms (100 or more) (GIZ 2014). The fact that significant numbers of medium and large firms report paying their tax as a lump sum—despite there being no legislative provision for doing so—highlights the common practice of negotiating profit tax on a case-by-case basis, rather than applying a rules-based profit tax regime.
**Taxation as a Constraint to Private Sector Development**

As in many developing countries, the tax system in the Lao PDR presents major challenges to the private sector in terms of transparency, certainty, and administrative burden (as well as the amount of tax paid). The private sector’s frustrations with the tax system stem from deficiencies in the effective implementation and rollout of the tax laws, rather than deficiencies in the tax laws themselves.

The payment and administration of taxation is a major concern for registered businesses. According to the latest GIZ Enterprise Surveys, about 40% of registered firms perceive high taxes and duties to be a “big” or “very big” constraint (GIZ 2014). In the World Bank’s Enterprise Surveys 2016, 22% of registered firms identified tax rates as their biggest obstacle, with the rate particular high for firms in the retail sector (34%) and where the top manager is female (32%) – keeping in mind that these two characteristics are positively correlated (World Bank 2016b).

The World Bank’s *Doing Business 2016* indicators, which indicate the tax and regulatory burden of medium-sized tax-compliant companies rank the Lao PDR 127th out of 189 economies on the ease of paying taxes. This compares to 70th for Thailand, 84th for Myanmar, 95th for Cambodia, and 168th for Vietnam (World Bank 2016b). The same survey highlights the large administrative burden of taxation, with businesses in the Lao PDR spending an estimated 362 hours per year on preparing, filing, and paying all taxes.

In consultations for this report, many businesses complained of a general lack of transparency and consistency in the calculation and administration of the major taxes, including value-added, excise, lump sum, and profit taxes. For example, with respect to VAT, most suppliers in the Lao PDR do not issue a VAT receipt. As a consequence, if a business purchases goods without a VAT receipt, the Ministry of Finance will charge that company the VAT amount, despite the VAT having already been paid by the supplier. This results in double collection of the VAT—once from the supplier and again from the purchaser.

On a more positive note, reforms are being implemented to simplify tax payments for SMEs. In 2012, the lump sum tax regime was introduced as a way of making it easier for SMEs to pay their taxes. SMEs with annual revenues below KN400 million ($50,000) pay a lump sum amount equal to a percentage of their annual revenues (3%–7%, depending on their revenues and their sector). The World Bank is currently supporting the tax department to train tax officials and roll out the new regime – first in Vientiane Capital and Luang Prabang in 2016, followed by nationwide implementation in 2017.

Businesses also complain that the fiscal challenge of the government, which peaked in 2013 and 2014, increased the intensity and unpredictability of tax negotiation and collection. In their negotiations with tax officials some businesses were asked to pre-pay taxes for the following year, had higher tax rates backdated for the previous 12 months, or had simply been given a substantially higher profit tax bill compared to previous years, despite having no commensurate increase in taxable income. While businesses of various sizes were affected by these actions, it appears to be large, tax-compliant businesses that experienced the most intense pressures in their tax negotiations.

The fiscal challenge has receded in recent years due to a combination of strengthened collection of profit tax and VAT, lower public investment spending, and restraint in public wages and recruitment. Nevertheless, public finances are expected to remain tight in the coming years, which may expose businesses to continued unpredictability in tax negotiation and collection.
These problems of tax transparency and consistency are compounded by the absence of an effective mechanism to deal with disputes over tax determinations. Businesses have to rely on their negotiation skills and their personal or professional connections if they are to challenge tax assessments, which they consider to be unreasonable or inconsistent with applicable tax laws and regulations.

Encouragingly, the government has embarked upon reforms to strengthen public financial management. A revised State Budget Law, to be implemented in 2017, strengthens the role of the National Assembly in budget oversight and enhances the system of budget allocation and budget targeting. In addition, the government is continuing to develop a long-term fiscal development strategy, which aims to strengthen the approach to revenue and expenditure management, debt management and budget financing.

**Link between Taxation and Informality**

The most direct impact of these tax challenges—aside from the actual amount of tax paid—is the additional time and effort that tax-compliant businesses devote to understanding tax requirements, preparing and filing all necessary documentation, and negotiating with tax officials.

This high administrative burden creates a strong incentive for registered businesses to negotiate payment of a lump-sum tax with tax officials. To the detriment of public finances, these officials similarly have an incentive to encourage case-by-case negotiation of a lump-sum amount, as it increases their discretion and hence their ability to extract informal payments.

As mentioned earlier, the high administrative burden also acts as a strong disincentive for businesses to formalize. By remaining outside of the formal economy, businesses can avoid the substantial costs of paying and administering taxes. This is a key contributor to the Lao PDR’s high rate of business informality, and the associated negative impacts relating to public revenue collection, access to finance, compliance with regulations, and protection of workers’ rights.

A major constraint to the development of a productive, efficient private sector in the Lao PDR is that the tax burden is not evenly spread across all businesses. Some businesses pay high taxes, some are able to negotiate much lower taxes, and others operate without paying any significant taxes. As a result, formalized, fully tax-compliant businesses operate at a disadvantage to their competitors that are either informal or able to negotiate special privileges. The biggest losers in this system include reputable foreign investors who prefer certainty and transparency and who wish to fully comply with tax laws, as well as other businesses (both foreign and local; large and small) that do not have the skills or networks to negotiate effectively with tax officials. The lack of equal opportunities reduces the quality of the whole private sector in the Lao PDR, and reportedly has resulted in some good businesses shutting down.
Underlying Causes of Taxation Constraints

Any attempt to address the problems with the Lao PDR’s tax system must be undertaken with an understanding of why those problems exist and persist. Why is the country’s tax system characterized by a lack of transparency and consistency? Why are tax payments often determined through case-by-case negotiation as opposed to the consistent application of relevant tax laws?

Despite the advantages of a rules-based taxation system, various stakeholders have strong incentives to prefer a flexible system based on negotiation. From the perspective of the tax department, issuing comprehensive tax guidelines that all businesses can rely on would run the risk of inadvertently creating loopholes that may have large adverse consequences for tax revenue. This fear of “missing something” or “getting it wrong” in a comprehensive tax interpretation means that it is safer from the tax department’s perspective to rely on case-by-case negotiations.

To some extent, inconsistencies in the interpretation and application of tax laws reflect the absence of implementing guidelines behind those laws. The effective development and rollout of implementation decrees and guidelines is a difficult, time-consuming, and expensive process. Guidelines need to be drafted and approved, an awareness campaign targeting taxpayers needs to be developed and funded, and tax authorities at both the central and provincial levels need to be trained. This process needs to be piloted in a small number of districts before it can be rolled out across the country—similar to what has recently been done with the lump-sum tax system for SMEs.

In addition, tax officials may not have clear guidance on how to interpret tax laws, including the substantial revisions to the tax laws that came into effect in October 2012. To the extent that genuine confusion exists within the tax department about how to interpret and apply the tax laws, inconsistencies are likely to persist.

As was mentioned earlier, tax officials have an incentive to prefer negotiation of lump sum taxes because it increases their discretion and hence their ability to extract informal payments. Some businesses also prefer a negotiation-based approach either because it reduces the administrative burden of maintaining accurate taxation records or because they possess the skills or connections to negotiate a tax amount below what would be payable under a strict interpretation of the tax laws.

It is important to recognize the difficulties of applying a rules-based business tax regime in a country where many transactions are settled in cash without invoices, few businesses maintain reliable accounting records—and even fewer have their accounts audited. In such an environment, some imprecision and discretion in the calculation of taxable amounts is inevitable.
Recommendations

Interventions and reforms to the tax system should focus on ways to reduce the administrative burden of paying business taxes and improve the transparency and consistency of tax collection. However, this is easier said than done, given the incentives of various stakeholders to prefer case-by-case negotiation, as well as the difficulty of applying a rules-based tax system in a cash-based economy where reliable accounting records are the exception rather than the norm.

The World Bank’s ongoing work with the government to support a nationwide rollout of the lump sum tax has the potential to significantly reduce the tax burden on SMEs, and thereby encourage more SMEs to formalize. The nationwide rollout will require substantial resources and expertise in terms of raising awareness among businesses and training tax authorities in districts all around the country. Similar initiatives could be implemented for other business taxes.

In an effort to improve the transparency of tax requirements for businesses, development partners could work with the Ministry of Finance to establish an online tax portal, similar to the Lao PDR Trade Portal (which was launched in 2012 and serves as a “one-stop-shop” for all information on regulations governing imports and exports). Currently, the tax department’s website (www.tax.gov.la) outlines the provisions of the tax legislation (in both the Lao and English languages), but does not serve as a comprehensive information portal containing news, guidelines, and practical advice for businesses on how to comply with tax requirements. As the share of businesses connected to the internet continues to increase, the potential audience for such an information portal could similarly increase in the coming years.

The ultimate success of such initiatives in improving the transparency and consistency of tax calculations will depend on the extent to which they recognize, and can overcome, the incentives that have created a strong preference for negotiation and flexibility.

A key deficiency of the tax system in the Lao PDR is the absence of an effective, low-cost mechanism through which businesses can dispute or challenge tax determinations they consider to be unfair or inconsistent with applicable tax laws. Development partners could work with the Ministry of Finance to help design and implement a low-cost tax dispute resolution mechanism, which would involve establishing some kind of administrative review board (independent of the tax department), and detailing the dispute resolution procedures. The challenges of establishing a mechanism that has both the capacity and the will to hear and resolve disputes in a cost-effective, timely, and independent manner, should not be underestimated—particularly as such a mechanism would run counter to the incentives of tax officials to maximize their discretion to determine tax amounts, and minimize scrutiny of their determinations.
Markets for Financial Services

Overview of Financial Services

Although the Lao PDR has 41 banks servicing a population of just 7 million people, the banking sector is highly concentrated, with the four state-owned commercial banks accounting for nearly two thirds of all loans.

Each state-owned bank has a specific lending focus, with Banque Pour Le Commerce Exterieur Lao (the largest bank) concentrating on large corporates, Laos Development Bank (second largest) focusing on SMEs, and the Agricultural Promotion Bank and Nayoby Bank focusing on the agriculture sector. ACLEDA Bank is one of the more active private lenders of credit to SMEs, with loans of less than $10,000 comprising about 85% of total active borrowers, and 33% of total loan value (data provided by ACLEDA Bank in May 2014).

The financial system in the Lao PDR is relatively underdeveloped compared to most other ASEAN members. Automated, real-time, interbank payments systems have only recently been introduced, and the use of retail card payment systems and ATM infrastructure provides only a limited degree of interoperability. Toward these, the operations of the central bank are being improved.

The regulatory framework needed to enable interbank payments is still being developed. A legal framework and interbank clearing systems are being developed. Electronic payments are limited to paying for mobile phone airtime top-ups and electricity and water bills. Market participants are not yet ready to launch large-scale, inclusive payment services alone; but broad mobile reach and some strong microfinance banks provide good foundations for development.

The Lao PDR banking sector experienced rapid credit growth from 2007 to 2013, averaging 52% per annum over the period. This resulted in the loan–deposit ratio rising from 38% in 2007 to 93% in 2013. Growth in credit eased to 14% in 2014 and 18% in 2018, with the loan-deposit ratio declining to 83%.

Rapid credit growth, combined with the limited capacity of the Bank of the Lao PDR to adequately supervise a large number of banks, led to some concerns about the financial stability of the banking system. Recognizing this, in May 2014 the Bank of the Lao PDR temporarily suspended issuing new bank licenses to entities that do not represent an existing bank or group of banking businesses that already have operations in foreign countries.

The microfinance industry is relatively small in the Lao PDR, with total loans of about $28 million at the end of 2014. More SMEs rely on informal sources of finance, including the traditional Rotating Savings and Credit Associations (ROSCAs). However, financing through ROSCAs tends to be short term and for small amounts.
Limited Access to Financial Services

As in many developing countries, in the Lao PDR, access to finance is commonly cited as a constraint by enterprises, and particularly by SMEs, farmers, and other agricultural enterprises.

In the 2014 GIZ Enterprise Surveys, 38% of firms rated lack of capital as a “big” or “very big” constraint, making it the biggest of 10 internal constraints for micro, small, and medium-sized firms, and the biggest constraint for large firms (along with lack of technically-skilled labor) (GIZ 2014).

More recently, however, there are signs that access to finance constraints may be diminishing in relative importance (compared to other constraints). According to data collected from the World Bank’s Enterprise Surveys, in 2016 only 5% of businesses cited access to finance as their biggest obstacle to growth, down from 13% in 2012 and 21% in 2009. In the 2016 survey, access to finance was the biggest obstacle for 13% of manufacturing firms but only 3% of services firms; and 5% of small firms compared to 3% of large firms. Interestingly, it was cited as the biggest constraint by 7% of firms with a male top manager, compared to just 3% of firms with a female top manager. (This may reflect a tendency for female managers to be found in services firms, as opposed to manufacturing firms.)

According to the 2016 World Bank Doing Business data, Lao PDR ranks 70th out of 189 economies on the ease of getting credit, representing a major improvement over the previous year’s ranking of 128 (World Bank 2016b). The introduction and strengthening of the online registry for moveable collateral (discussed below) was the main reason for the improvement in ranking.
According to the World Bank’s *Enterprise Surveys*, only 11% of small firms and 26% of medium-sized firms had a loan or line of credit from a bank in 2016. (The percentages are likely to be much lower for unregistered firms, given they are not legal entities and are even less likely to maintain reliable accounting records.) Similarly, the GIZ *Enterprise Surveys* found that only 16% of micro firms (1–2 employees), 25% of small firms (3–19 employees) and 36% of medium-sized firms used banks as an external source of finance.

Most of this lending to the private sector is to meet working capital needs, rather than to fund long-term expansion or investment. About 90% of bank lending has a maturity of less than 3 years, which may reflect the perceived riskiness of lending to businesses in the Lao PDR, difficulties in enforcing collateral obligations, and the fact that 80% of bank deposits have a maturity of less than 1 year (World Bank 2014d).

These factors may help to reconcile, at least in part, the apparent contradiction of firms complaining about access to finance constraints despite very high rates of growth in private sector credit since 2008. Much of this credit growth appears to have been in short-term lending in a limited number of sectors (including real estate and construction), rather than in supporting the long-term expansion of SMEs operating in the manufacturing, services, and agriculture sectors.

Access to finance constraints are particularly acute for farmers and others involved in agriculture. Banks are reluctant to lend to farmers, and typically restrict such lending to 9–12 month loans for seeds and fertilizer, at relatively high interest rates (15%–20% per annum). Development partners that support rural finance tend to focus their energies on very poor districts, as does Nayoby Bank. This means that farmers in other districts generally do not benefit from this type of support. As a result, farmers typically resort to informal lenders (often traders) who provide short-term lending at very high interest rates (3%–5% per month, which equates to 36%–60% per annum). 14

**Cause of Access to Finance Constraints**

One of the key themes of this study is the extent to which high rates of business informality constrain the development of the private sector in the Lao PDR. Nowhere is this more evident than in the area of access to financial services, including bank credit.

Firms that are not formally registered do not officially exist as business entities, and therefore cannot access formal credit markets. Owners of such businesses may be able to take out personal loans to support their business operations, but they are required to provide their personal land or buildings as collateral, which many are unwilling or unable to do. As a result, informal SMEs lack capital to invest, grow, and achieve the scale necessary to become internationally competitive and access foreign markets.

In addition to informality, there are other reasons why some businesses in the Lao PDR, and particularly SMEs and farmers, experience difficulties in accessing finance. (This section focuses on “involuntary exclusion,” as opposed to businesses that do not take loans simply because they do not need or want a loan.)
As in most countries, especially developing ones, one of the reasons why banks are reluctant to lend to SMEs and farmers in the Lao PDR is because these types of borrowers typically have higher rates of default. Compared to larger firms, SMEs in the Lao PDR tend to have unstable cash flows, large exposures to a few clients or sectors, ambiguous property rights, and inadequate systems for forecasting cash flows. In addition to these challenges, farmers can experience volatile cash flows as a result of commodity price fluctuations and adverse weather conditions.

In addition to the higher risks of lending to SMEs and farmers, banks also face higher transactions costs in evaluating, processing, and monitoring a large number of small loans. This higher cost, together with the higher risk of default, causes banks to charge higher interest rates, which reduces demand for credit; or banks limit their involvement in lending, which reduces the supply of credit to SMEs and farmers.

The reluctance of banks to provide credit to SMEs and farmers may reflect banks’ concerns about the risks of borrowers defaulting, and thus it could be a sign of an efficient financial market that recognizes and prices risk appropriately, rather a market imperfection or failure.

However, other factors constrain access to finance in the Lao PDR.

On the demand side, many SMEs and farmers lack the financial literacy required to understand the types of lending products that are available, how to develop a business plan, and how to go through the process of applying for a loan. They may also be discouraged from applying for a loan if they are uncertain about their future revenue stream, perceive that banks do not cater to their type of business, or are unable or unwilling to comply with the Lao PDR’s high collateral requirements (typically land or buildings worth three times the value of the loan, compared to two times in Cambodia and Viet Nam) (World Bank 2011).

One of the biggest challenges relates to the information asymmetries between lenders and borrowers. Many SMEs do not maintain reliable financial statements, which makes it very difficult for banks to understand the firm’s profitability, cash flows, and ability to meet loan repayments. Some banks are highly reluctant to lend to SMEs because of the lack of accurate and reliable information necessary to evaluate the risk of default.

These information asymmetries are compounded by the absence of a credit reporting system in the Lao PDR. There is no credit bureau in the country, which means there is no mechanism for financial institutions to share information on the creditworthiness of potential borrowers.

Banks typically require immovable assets (land and buildings) as collateral for loans—a key obstacle for many SMEs that do not own land or buildings of sufficient value. Even with fixed collateral, banks face the challenge of a lack of high-quality and trustworthy land valuation service providers in the country. This makes it difficult for banks to have confidence in the value of land put up as collateral and may explain the relatively high collateral requirements, which are equal to about three times the value of the loan.

Moreover, banks face major difficulties in claiming collateral in the case of default. It is very costly and time consuming for banks to take possession of collateral assets through the judicial system, which can take up to 5 years (World Bank 2014d). As a result, banks prefer to deal with nonperforming loans through negotiations with the borrower, rather than enforcing collateral obligations through the courts.
Impact of Access to Finance Constraints

This lack of access to credit and other financial services constrains private sector growth in several ways. It constrains a firm’s ability to expand, invest in new equipment and technologies, gain access to foreign markets, and manage liquidity efficiently. It can also hinder the diversification of the economy by constraining growth in sectors where access to finance is particularly challenging (such as agriculture and agribusiness) while concentrating growth in relatively well-funded sectors (such as mining and hydropower). Finally, it can exacerbate the “missing middle” problem to the extent that SMEs lack access to the capital needed to achieve scale and grow into medium-sized businesses.

While access to finance is particularly challenging for informal enterprises, the difficulties that even formal enterprises experience in obtaining bank credit diminishes the incentive for unregistered firms to formalize. Similarly, the lack of innovative financial services available in the Lao PDR (such as mobile banking) is another missed opportunity to encourage businesses to formalize. If informal firms perceive they are missing out on the benefits of the mobile payments systems available to formal firms, then they could be more likely to formalize. In other words, the access to finance challenges encountered by formal enterprises diminish the perceived benefits of formalizing.

Addressing Access to Finance Challenges

When designing interventions to address constraints on access to finance, it is important to evaluate the extent to which these constraints arise from credit market failure or imperfection that can be rectified. Alternatively, do these constraints reflect an efficient financial system that is identifying and pricing risk appropriately? A sensible first step in designing effective interventions would be to conduct a comprehensive diagnosis of the finance sector in the Lao PDR as well as SMEs’ access to finance. This is currently underway by the United Nations Capital Development Fund (UNCDF) via a program called Making Access to Finance More Inclusive for Poor People.

All stakeholders agree that improving SME access to credit and other financial services will contribute to the development of the private sector in the Lao PDR. Many development partners are working with the government, Central Bank, and commercial banks to improve access to finance for SMEs. These initiatives include the provision of risk-sharing facilities (where development partners accept some of the risk of SMEs defaulting, thereby encouraging banks to lend to SMEs), lines of credit to commercial banks, as well as measures to improve the capacity of commercial banks to understand SME needs, develop products suited to SMEs, and assess the creditworthiness of SMEs. Appendix 5 describes some of the ongoing development partner activities in this area.

Through the Law on Secured Transactions (2005) and the associated Implementing Decree in 2011, the Lao PDR has also taken steps to encourage the use of movable assets as collateral (such as motor vehicles, inventory, accounts receivable, and crops). Encouragingly, with the support of the World Bank, the Government of Switzerland, and the United States Agency for International Development, in 2013, the Ministry of Finance established the Lao Registry Office for Security Interests in Movable Property. The registry office provides a centralized computer registry where individuals and institutions can register their financial interest in moveable assets. Since the launch of the registry system in late 2013, more than $1.2 billion in loans had been granted with moveable assets as security by June 2016 (World Bank). With the necessary infrastructure now in place, the World Bank is working with Lao banks to enhance their moveable finance capacity and develop related financing products.

Beyond access to bank credit, there is a clear need to improve SME access to a broader range of modern financial services that have yet to be developed and implemented in the Lao PDR market. While the stability of the Lao PDR banking system is paramount, the Bank of the Lao PDR seems willing to work with development partners, commercial banks, and technology providers to create a legal and regulatory framework that strengthens the national payments system, supports innovative payment mechanisms (such as mobile banking), and encourages the introduction of SME-friendly financial products. The World Bank, UNCDF, and other development partners are actively involved in this space.
While development of innovative financial products and mobile banking platforms may not directly address SMEs’ lack of access to capital, these initiatives are an important aspect of financial inclusion. They will improve the efficiency and competitiveness of SMEs, as well as their ability to integrate into value chains. In the longer term, the development of new financial products that are attractive to SMEs will encourage more enterprises to formalize.

However, it is difficult to achieve momentum for reform of the legal and regulatory framework needed to support a robust payments system, because, in the short term, there are few tangible benefits visible to the officials charged with leading and implementing reforms. Measures that can produce shorter-term results may be needed, in parallel, to motivate and sustain commitment from directors.

Interventions should complement the ongoing work of the World Bank and UNCDF to strengthen the legal and regulatory framework for payments and secured transaction lending. This may involve additional support to the Bank of the Lao PDR to implement the payment system’s legal framework and improve the existing interbank and retail payments infrastructure, as well as support to the Ministry of Finance in effectively implementing and rolling out the new online registry for moveable collateral. Activities should be coordinated with the UNCDF to maximize effectiveness and avoid duplication. This may involve potentially partnering with a commercial bank to pilot and introduce new payment products.

More generally, to the extent that access to finance constraints reflect the underlying default risk of SMEs, business reforms in areas such as taxation, regulation, labor markets, and infrastructure will improve the overall risk profile of SMEs as well as their access to finance.
Labor and Skills

Introduction

A clear finding of this report is that labor shortages are one of the biggest constraints to the development of the private sector in the Lao PDR. These shortages relate to a lack of skilled labor (a challenge common to many developing countries) and also unskilled labor (which is less common among developing countries).

This finding is based on interviews conducted with large firms, SMEs, business associations, development organizations, and government officials, as well as the latest survey data on firms from the World Bank. Nearly every person interviewed for this study highlighted labor shortages as one of the biggest constraints—and often the biggest constraint—on the growth of their firm or the private sector more generally.

The underlying causes of these labor shortages are interrelated and involve challenges associated with education, productivity, wages, migration, and the overall structure of the Lao PDR economy.

As with many labor market issues, there are few “quick fixes” to the challenge of inadequate supply of skilled and unskilled labor. While some potential interventions could partially alleviate this constraint, significant improvement will require longer-term planning and resources.

Labor Market Characteristics

While labor force participation rates are almost equal for females and males, there are large differences in gender patterns of employment by sector. As highlighted in Table 4.3, females are more likely than males to work in wholesale, retail, and hospitality services. Females are also more likely to work in the garment sector, where females aged 16 to 25 comprise about 80% of the workforce but where management positions are dominated by males (World Bank 2012b). In contrast, males are much more likely than females to work in construction, mining, and transport.

<table>
<thead>
<tr>
<th>Sector</th>
<th>Female %</th>
<th>Male %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture, forestry, and fishing</td>
<td>71.7</td>
<td>72.9</td>
</tr>
<tr>
<td>Wholesale, retail and hospitality</td>
<td>12.3</td>
<td>5.4</td>
</tr>
<tr>
<td>Other services</td>
<td>7.3</td>
<td>10.3</td>
</tr>
<tr>
<td>Garments</td>
<td>2.8</td>
<td>0.3</td>
</tr>
<tr>
<td>Other manufacturing</td>
<td>3.5</td>
<td>4.7</td>
</tr>
<tr>
<td>Electricity, water, and construction</td>
<td>0.7</td>
<td>5.4</td>
</tr>
<tr>
<td>Mining</td>
<td>0.2</td>
<td>0.5</td>
</tr>
<tr>
<td>Transport</td>
<td>0.2</td>
<td>1.8</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Lao Expenditure and Consumption Survey 2012/13 (LECS 5).
The latest GIZ enterprise survey (2013) also provides an insight on the gender composition of employment in each sector. As highlighted in Table 4.4, females comprise 37% of the permanent staff of the 722 firms surveyed. Females comprise 77% of permanent staff in the garment sector, but only 16% of staff in electricity, water, and construction, and 18% of staff in mining. According to a recent gender study, average wages in the garments industry are lower than in other industries where male workers predominate (ADB and World Bank 2012).

Table 4.4 Percentage of Permanent Staff Who Are Female

<table>
<thead>
<tr>
<th>Sector</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Garments</td>
<td>77</td>
</tr>
<tr>
<td>Other services</td>
<td>47</td>
</tr>
<tr>
<td>Other manufacturing</td>
<td>42</td>
</tr>
<tr>
<td>Wholesale, retail, and hospitality</td>
<td>37</td>
</tr>
<tr>
<td>Transport</td>
<td>26</td>
</tr>
<tr>
<td>Mining</td>
<td>18</td>
</tr>
<tr>
<td>Electricity, water &amp; construction</td>
<td>16</td>
</tr>
<tr>
<td>All firms</td>
<td>37</td>
</tr>
</tbody>
</table>


The World Bank and USAID surveys also reveal information about female representation in management positions. Consistent with their ownership participation, females are more likely to hold management positions in small and medium-sized firms than in large firms. According to the latest World Bank survey, the top manager in a firm is female in 48% of small firms, 18% of medium-sized firms and 7% of large firms (World Bank 2016b). In the USAID survey, the percentage of senior managers (not just the top manager) who are female is 44% in small firms, 39% in medium-sized firms and 32% in large firms (USAID 2015).

**Extent of Labor Constraints**

**Unskilled Labor**

In contrast to most other countries in the Greater Mekong Subregion, the Lao PDR suffers from a shortage of unskilled and low-skilled labor. This shortage is experienced, to varying degrees, in all regions of the country and in all non-agriculture sectors.

According to the World Bank, 47% of firms in the Lao PDR complained that there were no or few applicants for unskilled jobs, compared to just 19% of firms in Viet Nam and 6% of firms in Yunnan Province (the PRC) (World Bank 2014b).

This shortage of unskilled labor affects firms in both the manufacturing and services sectors. The garment industry in the Lao PDR employs about 30,000 workers, or less than 1% of the country’s workforce. Despite these relatively small numbers, the industry faces a constant struggle to recruit and retain enough workers.

The Lao PDR’s entire manufacturing sector employs about 250,000 workers, or just 7% of the total workforce. With about 2.3 million Lao PDR nationals (two thirds of the workforce) working in low-productivity jobs in the agriculture sector, it would be expected that large numbers of workers from the countryside would migrate to urban areas to fill the demand for unskilled labor. However, the trend of rural–urban migration in the Lao PDR has been weaker than in comparable countries at similar stages of economic development.
Skilled Labor

A shortage of skilled labor is one of the top constraints for firms in the Lao PDR—and the problem appears to have grown worse in recent years. This finding is supported by available survey data on firms as well as industry consultations undertaken as part of this review.

Firms in the Lao PDR are constrained by an inadequate supply of workers with appropriate skills. This includes not only technical skills (such as engineering) and high-level nontechnical skills (such as accounting and management), but also basic foundational skills (numeracy and literacy) that are the building blocks of a productive workforce. For example, an assessment of adult literacy found that adults in the Lao PDR had the poorest literacy skills of all five developing countries surveyed. About one third of Lao PDR adults in urban areas are illiterate, compared to 17% in Bolivia, 14% in Sri Lanka, 5% in Viet Nam, and 1% in Yunnan Province (the PRC). Lao PDR adults with secondary education achieved similar literacy scores to adults from Viet Nam with only primary education (World Bank 2013b).

According to the World Bank’s Enterprise Survey (2016b), 13% of firms cited an inadequately educated workforce as their main obstacle to growth. This constraint was particularly prominent among large firms (33%), compared to medium firms (26%) and small firms (12%). In terms of sectors, the constraint was highest in “other services” (19%), followed by manufacturing (14%) and retail (2%). The constraint was much higher for firms where the top manager is male (17%) as opposed to female (9%).

Impact of Labor Constraint

A lack of skilled and unskilled labor limits private sector growth in several ways. Most directly, labor shortages make it difficult for manufacturing and services firms to take advantage of new opportunities to expand their activities or meet growing demand for their products or services. For example, many garment firms would like to be running more production lines and report having to turn away orders because they do not have sufficient machine operators (World Bank 2012). Some businesses interviewed for this study indicated they cannot expand their business or open new stores at the pace they would like because they cannot find enough supervisors or managers. Similarly, well-managed SEZs in good locations and with adequate supporting infrastructure (such as the SEZ in Savannakhet) have the potential to employ tens of thousands of Lao PDR nationals over the next few years, but their ability to fulfill this potential may be constrained by a lack of low-skilled workers.
In addition, difficulties in finding skilled labor mean that firms are forced to employ inadequately skilled workers. This negatively impacts firms’ productivity, profitability, and international competitiveness.

Labor shortages are contributing to dramatic increases in labor costs. According to the World Bank’s Enterprise Surveys, from 2009 to 2012, real labor costs per worker rose by about 65% in manufacturing firms and 80% in services firms. Combined with weak growth in value added per worker over that period—especially in manufacturing, which is more constrained in passing on rising labor costs—the median return on manufacturers’ sales has declined steeply from nearly 40% to less than 20%. At the same time, costs have risen strongly for services and manufacturing firms (from about 25% to more than 70%). Rapidly rising labor costs may harm the international competitiveness of Lao firms and make it more difficult to develop the non-resource private sector.

Finally, due to the shortage of local skilled labor, some firms, and particularly those in manufacturing and construction, recruit skilled labor from overseas (mostly Thailand and Vietnam, but also the PRC and the Philippines). While the use of foreign skilled labor can help firms to overcome one of their key business constraints, it also creates some language and cultural challenges for firms. From a broader perspective, the use of foreign labor does little for the long-term development of the country’s human capital.

**Causes of Labor Constraints**

**Unskilled Labor**

Compared to other countries in the Mekong Subregion, the Lao PDR has a relatively small workforce of about 3.5 million, comprising 2.3 million (66%) in agriculture; 250,000 (7%) in manufacturing; 900,000 (26%) in construction and services; and 20,000 (0.6%) in energy and mining.

With about two-thirds of the workforce stuck in low-productivity jobs in agriculture, and chronic labor shortages in other sectors of the economy, it is perhaps surprising that there has not been a large movement of labor out of agriculture and into manufacturing and services—at least not to the extent experienced in comparable countries at similar stages of development.

There are three reasons for this weak migration trend.

First, the low productivity of agriculture means that more workers are needed to stay on the farm. One of the key drivers of rural–urban migration flows in other countries has been dramatic improvements in agriculture productivity, which has freed up workers to move to the cities for work. In the Lao PDR, however, improvements in the productivity of agriculture have been more modest (World Bank 2014b).

Second, the financial incentives for workers to move out of agriculture and into Lao PDR manufacturing are not particularly strong due to low labor productivity—and therefore wages—in manufacturing. Labor productivity in the Lao PDR’s manufacturing sector is about three times that of its agriculture sector. By contrast, labor productivity in Thailand’s manufacturing sector was 15 times that of its agriculture sector in 1986 (the start of its decade-long, rural–urban migration boom), while in Vietnam it was about four times in the 1990s and six times in the 2000s (World Bank 2014b). This low productivity hinders manufacturing firms’ capacity to offer attractive wages. As a result, the wage premium in Lao PDR manufacturing does not appear to be large enough to incentivize people to move off the farm in sufficient numbers (World Bank 2014b).

Third, a large number of rural residents are leaving their farms, but a significant proportion of them are migrating south of the border. While farmers from northern Lao PDR generally migrate to Vientiane and other urban centers in the Lao PDR, many rural workers in central and southern Lao PDR are attracted by the higher wages offered in Thailand. A secondary-educated Lao farmer earning KN4,100 ($0.51) per hour can move out of agriculture and earn KN7,450 ($0.93) by staying in Lao PDR, or else move to Thailand and earn KN12,600 ($1.58). Given the similarities between the two neighboring countries in terms of
language, religion, and culture, compared to the typical migrant worker experience, migrants from the Lao PDR find it relatively easy to work and live in Thailand. While reliable data is lacking, the Ministry of Labor and Social Welfare estimates that about 300,000 nationals of the Lao PDR work in Thailand, of whom around one third are formally registered (ILO 2010).

While this trend of rural Lao PDR residents migrating to Thailand exacerbates the shortage of unskilled labor experienced by Lao PDR firms, it is important to recognize that this migration brings some benefits to the country in the form of remittances. Several studies estimate that 55% to 95% of Lao PDR nationals working in Thailand send remittances back home, with most of these studies estimating average annual remittances of $500–$700 per worker, or about $100 million–$150 million in total (Southichack 2014).

**Skilled Labor**

While unskilled labor shortages are driven by population, migration, productivity, and relative wages, the underlying causes of an inadequately skilled workforce relate to deficiencies in education, training, and labor market information.

Poor foundational skills (literacy and numeracy) are a function of a lack of early childhood education, the poor quality of primary and secondary education, and high dropout rates (particularly in rural areas) in primary school, and between primary and secondary school.

As foundational skills are the building blocks for higher learning, the low levels of literacy and numeracy make it difficult for postsecondary students to acquire the technical, vocational, and cognitive skills required for the workforce. These difficulties are exacerbated by the generally poor quality of vocational training and higher education, which is related to deficiencies in resourcing, teaching methods, teacher qualifications, and course curricula. In addition, there appears to be a mismatch between what students are studying and what employers are looking for, with an oversupply of university graduates with business degrees and an undersupply of university and technical and vocational education and training graduates with more technical skills (such as engineering). The lack of student demand for vocational training most likely reflects the low status of vocational training and blue collar jobs, as well as the lack of high-quality vocational training.

The absence of an effective labor market information system in the Lao PDR means that students, parents, education providers, and policymakers have an inadequate understanding of the types of occupations and skills in greatest demand. As a result, it is difficult for students to know which occupations and skills provide the best employment and career opportunities.

Finally, restrictions on the use of foreign workers make it more difficult for firms to cover the skills gaps that exist in the Lao PDR.

**Current Initiatives to Address the Labor Constraint**

The government recognizes the importance of improving education, skills, and human capital more generally, and human resource development is one of the three pillars of socioeconomic development. In the Seventh 5-Year National Socio-Economic Development Plan 2011–2015 (MPI 2011b), the government highlighted the need to continue with reforms in the national education system, including improving the quality of, and access to, education at all levels, and especially for ethnic groups and women. A draft of the Eighth 5-Year National Socio-Economic Development Plan 2016—2020 (MPI 2015) outlined the need to strengthen human resource capacity by improving workforce skills, increasing the number of technical experts and specialists, and enhancing the capacity of civil servants, the private sector and entrepreneurs.

The government has made some progress in expanding access to education, with increases in primary and secondary enrollment rates. Overall spending on education has been increasing in recent years.

Many development partners share the government’s commitment to improving education access and quality, and they support programs in these areas. Appendix 5 provides an overview of some of these programs.
Potential Reforms and Actions

While shortages of skilled and unskilled labor are key constraints for many firms in the private sector, there are few quick solutions to the problem.

Unskilled Labor

The lack of unskilled labor in the manufacturing and service sectors essentially derives from low labor productivity. As explained, low productivity in agriculture means that large numbers of workers are not released to look for work in other sectors, while low productivity in manufacturing (and to a lesser extent in services) means that the wages in these sectors are not sufficient to attract rural workers—either because they prefer to stay on the farm or because they migrate to Thailand for the higher wages.

Consequently, the long-term solution to the unskilled labor challenge is to improve productivity in agriculture (through greater use of high-quality seeds, fertilizers, equipment, and irrigation) and also in the manufacturing and services sectors (through a wide range of measures that improve the business environment, such as regulatory and taxation reform, transport and logistics, and access to electricity). Higher productivity will allow firms to offer higher wages, which will encourage unskilled workers to remain in (or return to) the Lao PDR, rather than work in Thailand.

In the shorter term, to the extent that some Lao PDR workers migrate to Thailand based on misinformation about the wages they can earn or the working conditions they will experience, there may be some benefits from launching an awareness campaign to ensure that Lao PDR nationals who live in the rural areas are fully informed about the work choices available to them in both Thailand and the Lao PDR. Such a campaign could involve provincial authorities, chambers of commerce, and development partners, and should target those provinces and districts that experience the largest migration to Thailand.

In terms of addressing labor shortages in the garment industry, authorities, industry representatives, and development partners could work to improve the attractiveness of working in the Lao PDR garment industry. This could involve interventions aimed at easing the transition to living in urban centers (such as provision of accommodation, transportation, and support services), as well as a monitoring and/or certification program that aims to improve working conditions and workplace relations.

Skilled Labor

The government and development partners recognize the need to address the country’s skills challenge through far-reaching reforms to all levels of the education and training system—primary and secondary education, vocational training, higher education, and workplace training.

It is beyond the scope of this paper to evaluate and recommend detailed reforms to each component of the country’s education system. Without downplaying the critical importance of those reforms to the long-term development of the country’s private sector, other possible interventions that could be considered in the shorter term include:

- Easing restrictions on the hiring of foreign workers—at least in those occupations where skill shortages are greatest;
- Considering tax incentives to encourage firms to provide workplace training for their employees; and
- Developing a labor market information system that estimates the supply and demand for different types of occupations, which will help students, educators, and employers make better-informed decisions and thereby help to reduce supply-demand mismatches.
In addition to the specific constraints identified in the previous chapter, several thematic issues have an impact on the private sector in a multitude of ways, both positive and negative.

**Consultation on the Legislative Agenda**

The government has introduced a large number of legislative reforms to comply with its commitments under the ASEAN and the World Trade Organization (WTO), and has prepared a Legal Sector Master Plan to achieve a full Rule-of-Law State by 2020. The evolving commitment to a Rule-of-Law State has advanced in parallel with the Lao PDR signing on to a range of important trade agreements, including the US–Lao PDR Bilateral Trade Agreement in 2005 and accession to the WTO in 2013.

A key concern of the private sector is the limited voice they have in influencing the country’s busy legislative agenda. Lao PDR does not have a tradition of social dialogue and still lacks some conditions for more effective social dialogue and consultation. While there have been some positive moves toward greater transparency and consultation in recent years, businesses still feel that they are not adequately consulted in the development of laws that have a significant impact on their operations. Moreover, there is often confusion about the timing of new laws, in terms of when they are expected to be passed, when they will come into effect, and whether they will apply retroactively.

In a positive development, the Law on Making Legislation was passed in 2012 (National Assembly 2012). This law mandates that all draft laws be published and allow for 60 days of public consultation, as well as the release of regulatory impact assessment notes. During the consultation period, interested parties, including business associations, can review the draft legislation and provide feedback.

In addition, the government ratified International Labour Organization Convention 144, which encourages tripartite and bipartite cooperation in drafting new laws concerning labor standards.

The best example of this new consultation framework operating in practice was the process for revision of the Labor Law in 2013. The government established a Tripartite Technical Committee comprising representatives from the Ministry of Labor and Social Welfare, Lao Federation of Trade Unions, and Lao National Chamber of Commerce and Industry (LNCCI). As a result of these consultations, a chapter regulating collective bargaining was added to the revised Labor law.

In addition, in 2013 the government launched an online Lao Official Gazette, which provides online access to all current laws in the Lao PDR. Laws can only come into effect 15 days after being published on the gazette. Moreover, ministry websites such as the Lao PDR Trade Portal (Ministry of Industry and Commerce) and the Tax Department’s website (Ministry of Finance) are increasingly listing all relevant laws and decrees.
While these initiatives have provided a solid framework for consultation and transparency regarding new laws, there are major shortcomings with the practical implementation of these requirements. For example, since the requirement came into effect, the 60-day time frame for public comments has not been adhered to for all new laws. In many cases, business associations are given little time to review draft laws and seek the views of their members. Even in the case of the Labor Law revisions, no regulatory impact assessment or cost–benefit analysis was conducted and officials from the Ministry of Labor seemed entirely unaware of the requirement to do so. Moreover, the tripartite committee for the Labor Law comprised 18 representatives from government and only one representative each for employers (LNCCI) and for workers (Lao Federation of Trade Unions).

In consultations for this report, the private sector expressed concern about the lack of effective consultation and transparency surrounding revisions to important laws, including the Enterprise Law, Value-Added Tax Law, and Land Law. Even when consultations have been undertaken, there is little evidence that concerns raised by the private sector have been incorporated into subsequent drafts of legislation.

It is hoped that this new framework for consultation and transparency will, over time, create a shift in the mindset of ministry officials responsible for drafting legislation. It may take some time for officials to grow accustomed to engaging in genuine dialogue on proposed legislative changes, and to appreciate the benefits of doing so. Gradual improvements in the level of consultation and transparency should lead to better business laws that take into account their impact on private sector development.

Public–Private Dialogue

Just as consultations on the proposed legislative agenda are essential to improving the legal and regulatory framework, there is also need for an effective mechanism for public–private dialogue (PPD) on the broader range of concerns and frustrations of the business community.

In the Lao PDR, the primary PPD mechanism is the Lao Business Forum (LBF) and the related working groups.

The LBF was established by the Ministry of Planning and Investment in 2005, with support from the World Bank Group’s International Finance Corporation. The LBF’s purpose is to facilitate a structured and ongoing dialogue between the government and the business community (both foreign and domestic companies) to improve the business environment. The LBF allows enterprises to exchange ideas, identify constraints, and determine how these could be realistically addressed. Leaders believe that the most productive and reliable way to identify such constraints and possible solutions is through PPD that encourages open discussion within the structure provided by the LBF.
PPD offers the private sector a unique opportunity to express policy and regulatory concerns to decision makers within the government and to obtain direct feedback. PPD also encourages and facilitates initiatives from both the government and the private sector on policy issues that will ultimately contribute to improved private sector development (PSD) and remove impediments to business. PPD provides a voice not only for large companies but also for SMEs.

The LBF works through two primary structures: a formal semiannual forum and a series of private sector working groups. The LBF secretariat, which is responsible for overall coordination and facilitation, was transferred from the IFC to the LNCCI in 2010.

Feedback from the private sector suggests that the LBF is not providing an effective mechanism for genuine dialogue between the public and private sectors. In addition to capacity and resourcing challenges associated with the transfer of the secretariat to the LNCCI, the twice-yearly forums are seen by many businesses as formal “talkfests,” with little scope for genuine discussion and debate. Not surprisingly, much of the substantive dialogue is intended to take place in the working groups and subgroups, but even here businesses do not feel that their concerns are being listened to and channeled up the chain to decision makers. Many issues raised in the LBF have remained outstanding for more than 5 years.

The declining prominence and effectiveness of the LBF is evidenced by fact that the Prime Minister’s Office and a number of line ministries are organizing their own parallel PPD conferences.

A comprehensive review of PPD mechanisms in Lao PDR is needed, which may include reforms to the LBF in order to improve its relevance and effectiveness.

Regional Integration and Private Sector Development

Increasing global and regional integration has been an important driver of the Lao PDR’s business reform agenda over the past decade, as well as creating new opportunities for business and investment. With the establishment of the ASEAN Economic Community (AEC) in December 2015, there is a diversity of views about the likely impact of this milestone event on the Lao PDR’s private sector. Some stakeholders highlight the exciting opportunities presented by closer regional integration through the AEC, while others are more worried about the threats posed by increasing competition from abroad in goods, services, labor, and investment. Based on discussions with representatives of the private sector undertaken for this report, the majority appear to believe that the AEC will not have a significant impact on the business environment in Lao PDR, at least not in the short term.

The details and likely consequences of the AEC for the region as a whole, as well as for individual members, have been analyzed exhaustively in previous studies (Basu Das 2013). The consensus seems to be that member states are behind schedule in implementing their commitments in readiness for the AEC and, as a result, the AEC commenced at the end of 2015 in name only. Member states still have plenty of work to do in 2016 and the years beyond to make the AEC into a single, integrated economic community. Importantly, the enabling rules, regulations, and institutions of each member state will need to be amended to give practical effect to AEC commitments. Implementation of this type of supporting regulatory infrastructure is the very thing that the Lao PDR has struggled to do effectively in the past.

The real impact of closer integration of the ASEAN economies is more likely to come from market forces, than from the signing of intergovernmental agreements or the passing of new laws. Adoption of new technologies, reengineering of supply chains, improvements in transport and communications infrastructure, and the growth of large, outward-looking businesses that have the scale to operate regionally will be the main drivers of closer integration within ASEAN. Regional business forums, such as the ASEAN Business Advisory Council and various affiliated “ASEAN Plus” councils, also have an important role to play in laying the practical foundations for businesses to operate regionally. The legislative and regulatory reforms envisaged under the AEC blueprint will facilitate and support, rather than drive, these business and investment trends.
In addition to the AEC’s initiatives, the Asian Development Bank has been a big supporter of the Greater Mekong Subregion (GMS) initiative, which seeks greater cooperation among the six economies of the Mekong Basin, namely Cambodia, the Lao PDR, Myanmar, Thailand, Viet Nam, and Yunnan Province and Guangxi Zhuang Autonomous Region (the PRC). The activities of the GMS Business Forum focus on improving cross-border trade and transport facilitation in the economic corridors, and developing private sector initiatives to implement the Cross-Border Transport Agreement.

While the short-term impact of the AEC on private sector development is likely to be muted, the emergence of a genuine regional economic community over the medium term will impact the private sector in a multitude of ways. The extent to which these forces will provide an opportunity or a threat to the Lao PDR’s private sector depends, in part, on how quickly Lao PDR businesses can adapt to increasing regional competition for goods, services, labor, and investment. This gives added importance to addressing the constraints to private sector development identified in this report so that businesses in the Lao PDR are encouraged to formalize, invest in new technologies and production processes, become more productive, and achieve the scale necessary to take advantage of the opportunities provided by closer regional integration.
The issue of business informality is critical to the development of the private sector in the Lao PDR, particularly in the context of the opportunities and threats posed by increasing regional integration through the AEC. Despite its importance, policymakers and development partners have to date relied largely on piecemeal and anecdotal evidence to understand the nature, extent, and underlying drivers of informality. Further work needs to be done to understand why so many businesses in the Lao PDR choose to remain informal, and the consequences of doing so. Understanding the root cause of informality, and in particular, whether it reflects the difficulty of formalizing, or the perception that the costs of operating formally outweigh the benefits, will help the government and its development partners focus their reforms and interventions on the most critical issues.

Interventions should focus on improving the cost–benefit equation of operating as a formal enterprise. On the cost side, this includes not only the time and costs associated with registering a business, but also the ongoing compliance and administrative burdens associated with regulations, taxation, and dealing with government authorities. On the benefits side, improving access to financial services (including credit and innovative payments systems) and other business development services for formal enterprises will increase the perceived benefits of formalizing.

A renewed focus on creating a genuine, one-stop service for registering a business is needed. This will require a comprehensive review of the procedures involved in applying for operating licenses from line ministries. However, reforms will be difficult to achieve, given the vested interests that line ministries have in preserving their influence. There is scope too for further streamlining the steps in the business registration process so that it takes less time to register a business.

In the area of taxation, interventions should focus on supporting the development and rollout of practical implementation guidelines for the key business taxes (profit, value-added, and excise), similar to the guidelines on lump sum taxation for SMEs currently being developed and piloted with support of the World Bank. Other useful interventions include the establishment of an online tax information portal (similar to the Lao PDR Trade Portal) and a low-cost mechanism through which businesses can dispute tax determinations. In the longer term, resolution of the government’s fiscal challenge will create an environment more conducive to the consistent application of tax requirements.

Many government agencies and development partners are already engaged in efforts to improve access to financial services, especially for SMEs. These initiatives, taken together, tackle the full spectrum of possible causes of access to finance challenges in this country, including the weak national payments and interbank settlement systems, the high default risks of SMEs, the low capacity of banks to evaluate the credit worthiness of SMEs, the lack of SME-friendly financial products such as mobile banking, and the low capacity of SMEs to develop business plans and apply for bank loans.
Rather than leaping into this already-crowded, access-to-finance space with bold new initiatives, it may be more effective to support existing programs that appear to be best able to tackle the root causes of the problem, including the ongoing work of the World Bank and the UNCDF.

Although the Lao PDR’s shortage of skilled and unskilled labor does not fit within the broader narrative of informality, this in no way detracts from its importance as a constraint to private sector development in this country. Indeed, labor issues are arguably the single biggest constraint to the private sector’s ability to grow, diversify, and compete internationally. The underlying causes of these labor challenges are complex and interrelated. Unfortunately, there are few quick solutions to these challenges. Long-term solutions will require reforms to the country’s education and training systems, as well as broader reforms that improve the business environment and increase productivity and wages.
The Lao People’s Revolutionary Party (LPRP) and the government made a paradigm shift at the Ninth Party Congress in 2011. A resolution from the Central Committee specified the need to strengthen state-owned enterprises (SOEs), including injecting private capital, and possibly listing SOEs on the Lao Stock Exchange, as well as supporting the private sector by improving the business enabling environment, and opening additional sectors for private investment.

In terms of the institutional context of business enabling reforms, the LPRP is the main driver of economic policy in the country. The LPRP’s approach to private sector development (PSD) is reflected in the Eighth National Economic and Social Development Plan.

The National Assembly also plays a key role in the legislative and broader reform agenda. The Economic Commission of the National Assembly has established a unit to conduct follow-up consultation on new laws and make sure that private sector comments are addressed and laws are amended accordingly. One example of the influence of the National Assembly is that of preparing the Improved Labor Law. After the Labor Law was passed by the National Assembly in December 2013, a number of issues affecting employers and investments were raised. The National Assembly halted the submission of the law to the President’s Office and asked the tripartite bodies to renegotiate on the specific issues raised by the private sector through Lao National Chamber of Commerce and Industry and the international chambers of commerce. The renegotiations were undertaken, and the issues raised by the private sector were addressed.

At the national level, the Government Office or the Prime Minister’s Office coordinates the actions of all ministries and provincial public administration bodies. The Prime Minister’s Office organizes cabinet meetings where current issues are addressed, including PSD issues. Private sector issues are usually proposed to cabinet meetings by the Ministry of Industry and Commerce (MOIC).

In the government, almost all ministries and national committees are more or less involved in PSD. The MOIC is the main driver of PSD, with its mandate covering almost all aspects for PSD, including:

- Development of trade legislation by the Department of International Trade Policy, which was deeply involved in proposing amendments and new legislation to promote trade and the private sector, in line with the Asian Free Trade Agreement and other free trade agreements. The department was the main player in preparing the Lao PDR for World Trade Organization (WTO) accession;
- Registration of “general business” enterprises at its one-stop service unit. This unit provides service for tax registration, business licensing with line ministries concerned, and issuing company stamps. Licensing of trade companies, including wholesale and retail enterprises are under the MOIC;
- Dissemination of information on trade and private sector development through the Lao Trade Portal managed by the Department of Import–Export;
- Promotion of small and medium-sized enterprises (SMEs) under the Department of SME Promotion;
- Promotion of industry under the Department of Industry;
- Promotion of the export of Lao products and Lao brands by the Department of Export Promotion;
- MOIC co-chairing the Working Group on Trade and [the] Private Sector with the European Union and the Embassy of Germany.
The Ministry of Planning and Investment (MPI) also plays an important role in PSD. The MPI is in charge of the Lao Business Forum, which is the main platform for public–private dialogue. The ministry has a coordinating function but cannot influence the decision of line ministries on issues related to PSD. As MOIC is now taking on more functions in registering enterprises and promoting the private sector, the MPI’s role in PSD will be limited to the registration of concession businesses. The MPI is mandated to coordinate official development aid. As a means of relieving poverty, a number of development agencies recently changed their support toward development of the market economy, including trade and PSD. Therefore the MPI will need to enhance support for the private sector.

The Ministry of Finance is the other important driver for PSD. The ministry has reformed the customs and taxation system to facilitate integration with the Association of Southeast Asian Nations (ASEAN). These important changes were the introduction of the value-added tax and the Automated System for Customs Data Management (ASYCUDA).

The National Committee for Special Economic Zones under the Prime Minister’s Office could also be considered a potential driver for PSD, particularly through the success of the Savan–Seno Special Economic Zone and Savan–Park.

Official mass organizations such as the Lao Women’s Union (LWU), the Lao Revolutionary Youth Union (LRYU), the Lao Front for Reconstruction (LFR), and the Lao Federation of Trade Unions (LFTU), play a role in PSD. The LFTU takes part in tripartite consultations on labor issues with the government and the LNCCI. The LWU and LRYU recently increased their support to PSD by establishing, respectively, the Lao Women’s Business Association and the Lao Youth Business Association. The two associations have branches at the provincial level, and the Lao Youth Business Association is playing a regional role by representing the Lao PDR in the ASEAN Youth Entrepreneur Association.
APPENDIX 2
Key Initiatives in Support of Private Sector Development

**Government**

With publication of the “New Mechanisms” in 1987, the government has engaged in economic reforms to move the country from a centrally-planned to a market-oriented economy. The Lao PDR joined the Association of Southeast Asian Nations (ASEAN) in 1997 and further enhanced efforts to integrate its economy with Southeast Asia and the world. Although market-oriented economic policy was launched in the late 1980s, it was not until the early 2000s that the necessary legal framework was developed. The 8th Resolution of the Lao Revolutionary Party, and the 6th National Economic and Social Plan in 2005, mentioned development through market economy mechanisms and the role of the private sector in developing the country.

The paradigm shift made by the ruling party and the government came with passage of the 9th Resolution of the Lao Revolutionary Party in 2011. On 30 November 2012, a resolution from the Central Committee addressed the condition of enterprises operating in the Lao PDR and outlined the direction for improving the country’s business environment. The resolution specified the need to strengthen SOEs so that they could acquire private equity and list on the stock market; the need to support private sector production and services by improving relevant legislation and procedures as well as the business environment; and opening additional sectors for private sector investment. On 26 March 2013, Resolution No. 5 of the Central Committee of the Party further outlined directives to promote the private sector in the Lao PDR. The resolution highlighted the importance of the Lao National Chamber of Commerce and Industry and business associations in managing and promoting the country’s private sector and SMEs. This was in line with the requirements of the ASEAN Economic Community and the World Trade Organization.

The new policy for private sector development (PSD) is highlighted in Resolution No.5, dated 26 March 2013. While there is no specific PSD strategy, PSD is specified in the Industry and Commerce Strategy 2025 and Vision 2030 of the Ministry of Industry and Commerce.
Development Sector

A large number of development partners led by the World Bank Group support PSD in the Lao PDR. The focus is on improving the business environment and the regulatory framework for trade to comply with the requirements for WTO accession, the ASEAN Economic Community (AEC), and specific bilateral trade agreements and investment treaties. The MOIC, the European Union, and the Embassy of Germany co-chair the “Donor–Government” Trade and Private Sector Working Group. The programs initiated with the different development partners are as follows:

World Bank

In 2006, the government, with support from the World Bank and other development partners conducted a Diagnostic Trade Integration Study (DTIS). This study strongly emphasized the need to build competitiveness, and further the objectives associated with international and regional integration. According to the DTIS, the five priority areas where external trade-related technical assistance and reform efforts should be concentrated are: (i) export competitiveness; (ii) trade facilitation; (iii) the business environment; (iv) trade policy, trade agreements, and global opportunities; and (v) trade opportunities for the poor. To implement the government’s trade and PSD agenda, MOIC and the development partners established the Trade Development Facility as the principal mechanism for financing implementation of the DTIS Action Matrix. The World Bank leads this multidonor trust fund (MDTF). Initial commitments to the MDTF were made by the European Union and Australia in 2008. Germany joined the MDTF in 2012. The World Bank administers the MDTF, and in accord with the World Bank’s objective to improve the Lao PDR’s competitiveness and connectivity, the World Bank provides additional resources to supervise the project. In addition, the World Bank country program supports the Customs and Trade Facilitation Project and the SME Access to Finance Project.

International Finance Corporation

The International Finance Corporation’s (IFC) support is improving businesses’ access to finance by investing in financial institutions that onlend to private enterprise, and by advising local companies, especially SMEs, on how to develop affordable and commercially-viable products and services. IFC has worked to strengthen the country’s financial infrastructure by helping the government to develop the Law on Commercial Banks and other regulations that improve the quality of loans and access to credit information.

In addition, IFC has a program to develop private sector participation in the country’s power generation and distribution sector, and provides advice on structuring public–private partnerships in power generation, and especially those for small-scale hydropower schemes. For this IFC program, a working group on hydropower has been established under the Lao Business Forum (LBF). IFC helped to initiate the LBF and is involved in efforts to improve legislation related to the business environment. This includes the improvement of tax laws such as the VAT law, and the regulations for licensing businesses.

Asian Development Bank

The Asian Development Bank’s (ADB) PSD assistance is through regional projects under the Greater Mekong Subregion umbrella, including developing the transnational North–South and East–West economic and transport corridors, which have boosted trade, tourism, and investment in the country.

ADB has supported a private sector and SME development program since 2007 that comprises developing institutional capacity to formulate and implement SME policy and improve access to finance, the investment climate, trade policy and capacity, and macroeconomic stability in support of private sector growth. The SME program is also supported by a grant from the Japan Special Fund.
Australia

The delivery of Australian aid to the Lao PDR, through the Government of Australia's Department of Foreign Affairs and Trade (DFAT), is governed by the Aid Investment Plan Laos: 2015–16 to 2019–20.

Following consultations with program partners, Australia has recently consolidated its aid to focus on three main areas – basic education, human resource development, and trade and business environment reform. Australia has raised the proportion of the program devoted to basic education and trade and business environment reform, in recognition of development needs and Australian aid policy priorities.

DFAT support for trade and investment reform, including the extensive reforms that accompanied WTO accession, is expected to have economy-wide benefits. The World Bank-led MDTF has had DFAT funding since 2008.

Current DFAT-sponsored initiatives include:

- **Trade Development Facility – Phase 2 (TDF2)**
  Value: $5 million  
  Start Date: 1 January 2013 to 30 June 2017 (Phase 2–TDF2)

  TDF2 is a government-executed project financed by the multidonor trust managed by the World Bank. The project aims to deepen the focus and sustain advances made by the first phase of the TDF and, in particular, address the constraints facing the Lao PDR in integrating into the regional and multilateral trading system. TDF2 also aims to enhance the capacity and competitiveness of the country’s private sector.

- **Greater Mekong Subregion Transport and Trade Facilitation**
  Value: $6 million  
  Start Date: 1 November 2010 to 30 June 2016

  Through improving connectivity and cross-border management, transit procedures and exchange of traffic rights, the overarching goal of the project is to help the Greater Mekong Subregion (GMS) become more integrated as a production base. To improve cross-border trade, the project’s priorities were determined by GMS ministers in 2010 under the GMS Trade and Transport Facilitation Program of Actions, which was updated in 2013, and supports regional efforts to build cooperation among Cambodia, the Lao PDR, and Viet Nam, (and more recently Myanmar). To date, through the expansion of traffic rights and improvements to cross-border management and transit procedures, the initiative has led to shorter clearance times at selected border crossings and/or trading routes.

- **International Finance Corporation Sustainable Hydropower in the Mekong Countries**
  Value: $6 million  
  Start Date: February 2014 to 30 June 2017

  The DFAT–IFC partnership has focused first in the Lao PDR, before reaching further into Cambodia and Myanmar, where assessment of the rapidly expanding hydropower sector is critical to river health, ecosystems, livelihoods, and energy security for the region.
Germany

The German development program, GIZ, is implementing a number of projects in two priority areas: rural development and sustainable economic development. One of the main projects in the economic development area is the Regional Economic Integration of Laos into ASEAN, Trade and Entrepreneurship Development (RELATED) project, scheduled to run from 2014 to 2017. The RELATED project seeks to assist the government in managing the regional integration process, improving the regulatory and procedural environment for regional trade, and support the private sector to benefit from the AEC. Another project is the Support to the Initiative for ASEAN Integration (IAI) project, running from 2015 to 2017. This project assists Cambodia, the Lao PDR, Myanmar and Viet Nam to reduce the barriers to trade and investment in services sectors, with a focus on tourism and health sectors. GIZ also has projects that seek to improve access to finance in rural areas and strengthen aspects of vocational education and training.

Japan

Under Japan’s bilateral cooperation program, its contribution to PSD in the Lao PDR is intended to achieve sustainable economic growth by strengthening ASEAN connectivity, including developing infrastructure such as roads, bridges, and airports; improving investment and trade logistics; developing an industrial park that will encourage investments from Japan in the Lao market; rectifying disparities in access to electric power within Lao PDR; and enhancing power export through expanding electric power generation in a safe and stable manner. Japan recently established a representative office of the Japan External Trade Organization in Vientiane, which provides assistance to investors from Japan in the Lao PDR, and helps local companies that want to export to Japan.

Switzerland

The Swiss State Secretariat for Economic Affairs (SECO) has supported PSD in the Lao PDR by advising the government on integrating the country into the regional and international trade system. The focus of the Swiss trade promotion program has been on building the trade promotion capacities of SMEs, the competitiveness of export-oriented SMEs, and the environmental sustainability of the export-oriented SMEs under SECO’s Cleaner Production Centre program. Also, SECO contributes to IFC’s Mekong Private Sector Development Facility, which is a multidonor facility established to reduce poverty through sustainable PSD. Recently, SECO funded a 3-year program (2012–2014) entitled “Enhancing sustainable tourism, clean production and export capacity in Lao PDR,” which was implemented by four agencies: the International Labour Organization, the International Trade Centre, the United Nations Conference on Trade and Development, and the United Nations Industrial Development Organization. The main objective of the project was to develop a competitive tourism industry in the Lao PDR, while at the same time strengthening organic agriculture and handicrafts (especially silk production).
United States

The United States Agency for International Development has been supporting PSD through the Lao PDR–US International and ASEAN Integration (LUNA) project. Now in its second phase (LUNA II), the project is building the capacity of the government to comply with, and fulfill, commitments made under three trade agreements (WTO, AEC, and the US–Lao Bilateral Trade Agreement). Luna II is also working on improving economic governance and rule of law, and laying the foundation for a modern market economy. In addition, LUNA II seeks to help Lao PDR integrate further into the global trading system, improve the market economy, finalize its WTO accession commitments, and further develop its electronic gazette. LUNA II will provide training on the global trading system, enhance understanding of trade opportunities, and improve capacity for dialogue on trade reform. Government officials will receive training on best practices in legal reform and development of laws and policies, as well as how to comply with international and regional trading obligations. Businesses will receive training on how to take advantage of the trading system and advocate for reforms that improve the environment for business in the Lao PDR.

Business Associations

Business associations in the Lao PDR include the Lao National Chamber of Commerce and Industry (LNCCI), 15 provincial chambers of commerce and industry, 7 international business association and chambers, and 25 business associations.

LNCCI

The Lao National Chamber of Commerce and Industry (LNCCI) was established in 1989 as a unit under the MOIC. In November 2009 the organization became a nongovernment body that represents employers and state-owned and private enterprises registered in the Lao PDR. Prime Minister’s Decree No. 316/PMO, dated 20 November 2009 defined the objective, role, and duties of the LNCCI as an association to promote business and support the development of trade and investment in the country. According to Decree 316/PMO, all companies registered in the Lao PDR are required to be members of the LNCCI. Today the chamber has more than 1,000 members who are represented through provincial chambers of commerce and industry, as well as business associations, business groups, and foreign chambers of commerce.

The roles and activities of the LNCCI are to:

- Represent both public and private enterprises in public–private dialogue with the government in order to develop a favorable business environment for trade and investment in the country. The LNCCI is the main dialogue partner with the government in the LBF and provincial public–private dialogues, and organizes and facilitates dialogue under these two platforms as well as other formal platforms for public–private dialogue;

- Represent both foreign and domestic employers in the country. An LNCCI vice president chairs the Lao Employer Activity Bureau. The LNCCI represents employers in the tripartite negotiations on labor and social welfare issues with the Ministry of Labor and Social Welfare and the Lao Federation of Trade Unions;

- Represent the business sector in consultation on new or improved laws and regulations. The LNCCI’s role is to send out draft laws and regulations and seek comments on them from provincial chambers of commerce and industry, foreign chambers of commerce, business associations, and individual enterprises, and to report on the comments to government authorities concerned;

- Issue certificates of origin for general export products. The MOIC issues these certificates for
goods under the General System of Preferences;
• Organize trade and investment shows in-country and abroad;

• Organize and participate in trade and investment missions and forums in trade partner countries as part of official government delegations and also co-organize trade investment missions and forums from abroad with the government authorities and foreign chambers of commerce;

• Work toward global and regional economic integration. The LNCCI is a member of the ASEAN Business Advisory Council and all the affiliated “ASEAN Plus” business councils and forums. The most important business councils are: the East Asia Business Council, the China-ASEAN Business Council, the EU-ASEAN Business Council, the Russia-ASEAN Business Council, the Australia-ASEAN Business Council, the ASEAN New Zealand Business Council, and the ASEAN-India Business Council. A key forum is the Asia-Pacific Business Forum organized by the United Nations Economic and Social Commission for Asia and the Pacific; and

• Provide assistance and service to members, especially SMEs, with regard to information dissemination and training. The LNCCI has a Trade Information Center that provides information on WTO and AEC laws and regulations, as well as market information on WTO member countries.

The LNCCI’s mandate is large and complex, and therefore the chamber is constrained by its lack of capacity and resources to operate and organize all of the activities specified. Among the challenges obstructing the progress of LNCCI activities are the following:

• The government requires that businesses become members of the LNCCI, but the chamber has difficulty setting up a procedure to register members at the central and provincial levels. LNCCI membership is still only 1,000 enterprises. This adversely affects the revenues of the chamber, as well as its capacity to conduct its mandated PSD activities.

• Both the public and private sectors are not used to the process of consultation. The public sector still wants to act without consulting the private sector. A large number of private enterprises still think that the government should do everything for them and are not interested in participating in the activities of the LNCCI and business associations. Also a large number of entrepreneurs benefit from special privileges and monopolies so they are not willing to join the chamber, which is moving toward implementation of the rule of law. The LNCCI does not have adequate time to disseminate information on draft laws and regulations and gather comments from the private sector. Also, the private sector lacks experience in providing comments on proposed legislation. Both of these problems mean that the LNCCI’s attempts to give the government useful feedback have not been very successful.

Foreign Private Associations

In the early 2000s, the government authorized the establishment of foreign chambers of commerce and business associations. However, these foreign private sector associations must be approved by both the LNCCI and the MOIC. The Ministry of Foreign Affairs also must approve the establishment of a foreign business association. In practice, application is made with supporting letters from the international organization concerned such as the European Union and country embassies.

•
The major foreign private associations are:

- The European Chamber of Commerce and Industry in Lao PDR (ECCIL) was established in 2011 with the merger of the French, German, and Swedish chambers of commerce and industry. The ECCIL has been very active in providing information on the business climate in the Lao PDR through both studies and workshops. The ECCIL chairs the Lao Business Forum (LBF) Working Group on Banking, Finance, and Insurance and the LBF Working Group on Crosscutting Issues (in particular, enterprise registration, taxes, and labor issues). In collaboration with the LNCCI, the ECCIL is the main organizer of the EU–Asian Business Forum.

- The Japan Chamber of Commerce and Industry in Lao PDR was established to support enterprises from Japan investing and trading in the Lao PDR. The chamber is supported by JETRO and is responsible for providing information on the investment climate to companies interested in investing in the Lao PDR. Every year, in collaboration with the LNCCI and the Embassy of Japan, the Japan Chamber of Commerce and Industry organizes a Lao–Japan Investment Forum and a Japan Week.

- The India Chamber of Commerce in Lao PDR (INCHAM) was established in 2010. The INCHAM supports companies from India investing in the Lao PDR and organizes investment workshops as well as trade missions from, and to, India. The INCHAM chairs the LBF Working Group on Agriculture and Agribusiness.

- The Australia–New Zealand Business Association was established in 2005 to support companies from Australia and New Zealand that invest in the Lao PDR. The Australia–New Zealand Business Association has organized a number of business and investment forums with the Embassy of Australia and it chairs the LBF Working Group on Energy and Mines and participates in the Working Group on Banking, Finance, and Insurance.

- A number of business associations have been established through bilateral cooperation. These are the Lao–People’s Republic of China Business Association, the Lao–Viet Nam Business Association, the Lao–Thai Business Association, the Lao–Philippines Business Council, and others. These operate on a diplomatic level but also organize business and investment workshops and visits. However, their activities depend on the bilateral agreements between the Lao PDR and the respective government.

Business Associations

The LNCCI has 25 affiliated business associations. These have a mandate to promote businesses in specific economic sectors and subsectors, and also provide services to members that are similar to the services provided by the LNCCI, but focus on the needs of specific sectors or professions. Prominent associations include the Lao Garment and Textile Association, Lao Coffee Association, Lao Handicraft Association, and Lao International Freight Forwarder Association.

A number of business associations have been created by government institutions. These serve the public interest in publicly-controlled sectors such as road transport, as well as those related to specific national associations such as those for women and youth. Examples include the Lao Youth Business Association, Lao Women’s Business Association, and Lao Public Transport Association.

Business associations face more problems than the LNCCI because of their status as social associations under Decree No. 115/PMO. There is a perception that the government is more interested in controlling the management and operation of business associations than it is in facilitating their success. Many government officials, especially those in the provinces, regard the private sector and their business associations as a source of revenue. For example, the Hotel and Restaurant Association of Luang Prabang (HRAL) was established under the Department of Tourism, not the LNCCI. The HRAL collected compulsory annual membership fees that are far higher than the fees collected by the Lao Hotel and Restaurant Association. The dues paid to the HRAL were never used for member-related services; instead the dues financed the activities of the Tourism Department in Luang Prabang. Decree 115/PMO put an end to this practice, but hotel owners in Luang Prabang are still reluctant to join the HRAL.
APPENDIX 3
Main Business Laws, Decrees, and Legal Instruments

<table>
<thead>
<tr>
<th>Name</th>
<th>Year</th>
<th>Type</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Law (Amended)</td>
<td>2011</td>
<td>Law</td>
</tr>
<tr>
<td>Business Competition Law</td>
<td>2015</td>
<td>Law</td>
</tr>
<tr>
<td>Value added tax Law (Amended)</td>
<td>2014</td>
<td>Law</td>
</tr>
<tr>
<td>Land Law (Amended)</td>
<td>2014</td>
<td>Law</td>
</tr>
<tr>
<td>Labor Law (Amended)</td>
<td>2013</td>
<td>Law</td>
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<tr>
<td>Enterprise Law (Amended)</td>
<td>2013</td>
<td>Law</td>
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<tr>
<td>Industrial Processing Law (Amended)</td>
<td>2013</td>
<td>Law</td>
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<tr>
<td>Accounting Law (Amended)</td>
<td>2013</td>
<td>Law</td>
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<tr>
<td>Securities Law</td>
<td>2012</td>
<td>Law</td>
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<tr>
<td>Insurance Law (Amended)</td>
<td>2011</td>
<td>Law</td>
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<tr>
<td>Customs Law (Amended)</td>
<td>2011</td>
<td>Law</td>
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<tr>
<td>Electricity Law (Amended)</td>
<td>2011</td>
<td>Law</td>
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<tr>
<td>Mineral Law</td>
<td>2011</td>
<td>Law</td>
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<tr>
<td>Telecommunications Law (Amended)</td>
<td>2011</td>
<td>Law</td>
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<tr>
<td>Decree Regarding Implementation of the Law on Investment Promotion</td>
<td>2011</td>
<td>Decree</td>
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<tr>
<td>Decree Regarding Import and Export Management</td>
<td>2011</td>
<td>Decree</td>
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<tr>
<td>Secured Transactions Decree</td>
<td>2011</td>
<td>Decree</td>
</tr>
<tr>
<td>Law on Intellectual Property (amended)</td>
<td>2011</td>
<td>Law</td>
</tr>
<tr>
<td>Law on Economic Dispute Resolution (Amended)</td>
<td>2010</td>
<td>Law</td>
</tr>
<tr>
<td>Securities and Exchange Decree</td>
<td>2010</td>
<td>Decree</td>
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<tr>
<td>Environmental Impact Assessment Decree</td>
<td>2010</td>
<td>Decree</td>
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<tr>
<td>Law on Investment Promotion</td>
<td>2009</td>
<td>Law</td>
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<tr>
<td>Construction Law</td>
<td>2009</td>
<td>Law</td>
</tr>
<tr>
<td>Decree Regarding Goods Import Licensing Procedures</td>
<td>2009</td>
<td>Decree</td>
</tr>
<tr>
<td>Decree on State Land Leases and Concessions</td>
<td>2009</td>
<td>Decree</td>
</tr>
<tr>
<td>Contract and Tort Law (Amended)</td>
<td>2008</td>
<td>Law</td>
</tr>
<tr>
<td>Instruction Regarding Implementation of [the] Declaration for Enterprise Registration in Accordance with the Enterprise Law</td>
<td>2008</td>
<td>Instruction</td>
</tr>
<tr>
<td>Amended Forestry Law</td>
<td>2007</td>
<td>Law</td>
</tr>
<tr>
<td>Decision Regarding the Importation of Foreign Laborers to Work in the Lao PDR</td>
<td>2007</td>
<td>Decision</td>
</tr>
<tr>
<td>Order on the Implementation of the Enterprise Law</td>
<td>2006</td>
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</tr>
<tr>
<td>Secured Transactions Law</td>
<td>2005</td>
<td>Law</td>
</tr>
<tr>
<td>Regulation Regarding the Reservation and Approval of Enterprise Names</td>
<td>2000</td>
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</tr>
<tr>
<td>Financial Leasing Decree</td>
<td>1999</td>
<td>Decree</td>
</tr>
<tr>
<td>Law on Water and Water Resources</td>
<td>1996</td>
<td>Law</td>
</tr>
<tr>
<td>Law on Bankruptcy of Enterprises</td>
<td>1994</td>
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<td>Property Law</td>
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