# Economy, fdi and hydropower sector in laos

## Background:

Generally speaking, hydropower has various economical, environmental and social and strategic advantages. The hydropower is the largest renewable resource used for electricity and Hydropower is a significant source of electricity worldwide and will likely continue to grow especially in the developing countries. Thus it plays an essential role in economical development especially in many developing countries.

Like many countries the Lao People's Democratic Republic (Lao PDR) or Laos is in trend in receiving foreign investment mainly in hydropower sector which comparing by sector from 2000-2010 hydropower sector account more than 33% in total investment (MPI, Laos). Laos' nature and climate provide mammoth opportunities for the country to develop hydropower sector which in recent year there has been increased demand for electric power in the region of South-East Asia, however less than 2 percent of the hydropower potential has been developed in Laos over the past 30 years (Lao's National Statistic in 2007). During the last few years, the hydropower sector has played an important role in the speedy economic growth of the country recently has experienced, more than 70 hydropower projects are under development, and the hydropower sector makes up an significant part of the export industry in Laos.

As the government set the economic outlook from now the year 2020, the National Development Vision to the Year 2020 is to graduate from the status of being a least developed country and become sustainable development nation. To reach and achieve such vision, Laos needs the capital and invests in the human resource capacity, as Lao's Government lack of these things. Thus, the foreign investment especially in hydropower sector is playing an important role in increasing the government's revenue (capital generation), job creations and new business system introducing.

The hydropower sector is playing the significant role in the Lao's economic and social development, the investment law in 1994 introduced the huge incentives mainly tax incentives in order to attract more investment, the question is that are these incentives really work and attract more investment into Laos? Or how did the investment incentive policies effect to hydropower sector in Laos? Thus, the objective or thesis statement of this paper is to analysis the effective of incentive policies offered by government of Laos in attracting investment mainly hydropower sector into Laos. The scope of this paper is not go back beyond the investment law introduced in 1994, but it starts to introduce some basic information about Laos such as the basic information about population, land area, religions and so on (See the Laos at Glance in the table 1 below) and the investment incentive policies provided by the government of Laos.

Many scholars explained that, market size and cost of production is the key in attracting investment. Krugman (1991a) argues that the interaction of market, transport costs, and fixed investment costs determines the location of industry. In the Morisset's article (2003, p. 253), the impact of tax incentives on FDI is not obvious that it can help in promoting investment. In the past few decades the numerous studies of international investors have indicated that the investment incentive policies are not major factor in their investment location decision. More important factors such as infrastructure, political stability, labor and the cost of production, however in this study is going to explain and provide evidences that investment incentive policies provided by government are the key factor in attracting investment in the case of Laos.

Most of the data and information using in here are mainly from the concerning ministries in the Laos as essential. Thus, once again, the scope of this thesis is not covering all aspects of the economic development in country; it will focus only on the laws and regulations applied to foreign investment especially in hydropower sector. Furthermore, there is no any hypothesis test in this paper, as the objective of the paper is to analyze and examine the effective of the Strategic Investment Promotion for Laos. The main study shall be identifying the issues of using incentive policies and drawing out the strategic policies for recommendations.

In order to make this paper easy to read and complete, this paper is developed into four chapters. The chapter one is the introduction chapter, where the general information, thesis statement and scope of this paper are drawn. The second chapter is literature reviews related to the foreign investment policies. The third chapter will focuses on overview of Lao’s economy, FDI and Hydropower Sector in the economic and social development in Laos. In this chapter, the data and figures are illustrated in order to see how changing in hydropower sector in Laos through the policies and incentives offering, plus more specific study on the comparative study, which will focuses on the analyzing of the incentive and disincentive on foreign direct investment. The last chapter is conclusion and recommendations approaches. In this chapter, the policies recommendations are drawn. Then the last part of the paper is the references.

## Lao PDR at a Glance (Table 1)

Name

Lao People's Democratic Republic

Surface Area Population

total: 236, 800 sq km, land: 230, 800 sq km, water: 6, 000 sq km 1995 census: 4, 574, 848 (2007 estimate: 6, 677, 534)

Density

25 people per sq km

Land Boundaries

total: 5, 083 km

Borders

Myanmar 235 km, Cambodia 541 km, China 423km, Thailand 1, 754 km, Viet Nam 2, 130 km

Languages

Lao (official), French, English, and various ethnic languages

Climate

Tropical monsoon; rainy season (May to November); dry season (December to April)

Religion

Buddhist 65 percent , animist 32. 9 percent , Christian 1. 3 percent, other and unspecified 0. 8 percent (1995 census)

Time Zone

UTC+7

Currency

Kip (LAK)

Exchange Rates

As of October 6th, 2008 : 1 Dollar: 8560 Kips 1 Euro: 11680 Kips

GDP

39, 284 billion Kips (Nominal, 2007 estimate) 4. 1 US$ billion

GDP per Capita

604 USS (2006)

Source: Economic Research Department, MPI, Laos, 2007

# Chapter II: Literature Review

## Foreign Direct Investment Policy

Recently, many scholars try to explain and point out the factors for foreign investment location decision in developing countries. On the other hand there are many studies and articles related the FDI and its policies in developing countries. The developing countries try to develop their investment policies and strategic plan in order to attract the foreign investment

In the article of Shaukat Ali and Wei Guo (2005) explained the behavior of MNCs in China, with its huge potential market size as the most important factor for attracting FDI to China, with its large population, steady economic growth, trade integrations are the perfect combination in attracting FDI. The authors' further point out that the Chinese Government incentive policies are another important factor

In the article of Ekrem Tatoglu (2002), it is was found that market size, openness of the economy, and infrastructure of the host country had positive effect, but the lack of exchange rate and economic stability had negative effect but not significant, however to some extent, it has slowed down its efforts to receive much higher volume of foreign investment.

In the Morisset's article (2003, pp. 253) point out that the relation between investment policy such as tax incentives and FDI is not the most significant whether it can help the host country in gaining the foreign investment. Over the past few decades they are numerous studies from the international investors have indicated that investment policy such as tax incentives are not the most important factor for investment locations, more important factors such as infrastructure, labor and political stability. However it doesn't mean that the investment policy has no effect on attracting foreign investment, one of the good examples is the Ireland's tax incentives which have been recognized as key in attracting foreign investors over the past two decades. Moreover, there has been growing support evidence that investment policy influence the location decisions of companies within regional economic groupings, such as the European Union, North American Free Trade Area, and Association of Southeast Asian Nations.

No doubt that market size is important to foreign investment in deciding location but other factors such as the investment policy and institutional framework, are essential in influential a country's attractiveness to FDI. There are three forms of investment incentive policies: tax incentives, subsidies, export processing zones (EPZs). The investment policy can be favorable to foreign investment or unflavored to foreign investment in order to protect local industries

The effect of FDI will depend, in part, on the form that FDI takes. FDI directed to heavily protected industries or attracted by very costly incentives may have a low, or even negative, effect on growth and productivity, Attitudinal and empirical research on the effect of tax incentives on FDI has been inconclusive.

In the article of Hearnest (2007, pp. 25-30) dedicated that if the investment policy such as tax incentives may be good for a country. This is so if some conditions are contents. First, the investment policy must lead to an increased of inflow in FDI into that country by attracting FDI that would not come without the presence of the incentives. Second, these FDI should contribute to the country's development by offering returns to the country that more than offset (the returns) the foregone tax revenue in form of tax incentives granted to the investors. When trying to find out who should qualify for the tax incentives in Tanzania therefore, the work will focus on some types of investments that would not come to Tanzania without the presence of the incentives, but have the potential of contributing positively to the development of the country. As for who should not qualify, a focus will be on those investments that would come in any circumstance (in this case the absence of tax incentives).

FDI determinants that MNEs look for are the presence of economic, political and social stability; and rules regulating entry and operations of businesses. Others are standards of treatment of foreign affiliates; business facilitation (including, inter-alia, investment incentives and thereby tax incentives; market size, growth, structure and accessibility; raw materials, low cost but efficient labour force and physical infrastructure in form of ports, roads, power and telecommunication. Specific incentives may not be main determinants of a country's attractiveness to FDI. A country's general economic and political conditions, domestic market, natural and other resources may be more important than some specific incentives. However various incentives have been found to influence investments.

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In the conclusion for the literature reviews, there are both advantages and disadvantages by offering the investment incentives policy from the host countries to the foreign investors. However, most of the articles presented in there seem to support the investment incentives policy (tax incentives) offered by many developing countries. There is no doubt that this form of investment incentives are dominated in many developing from now and in the future, especially the ASEAN nations, particularly Laos. In this context, this paper will lead through the way that investment incentives are really strategic tools for FDI attracting in Laos.

# CHAPTER III: Overview of Economy, FDI and Hydropower Sector in Laos

## 3. 1 Current Lao's Economic Situation

As the Lao government set their development goal which aiming to free the country from being least developed country by the Year 2020, it ultimate goal is to graduate from the status of being a least developed country and become sustainable development nation. To achieve the goal, Laos needs the capital and human resource capacity, as Laos's lack of these things. Thus, the Foreign investment especially in hydropower and mining sector are playing an essential role in increasing the government's revenue (capital generation), job creations and so on.

Since the Lao's government started their economic liberalization, the " new economic mechanism" (NEM) in 1986, the Government of Laos has made the development of private sector and attraction of the foreign investment as the strategic priority, thus the implementation of investment policies are very important to investment especially in attracting foreign direct investment.

With the advantages such as political stability, natural resources, low labor costs, strategic location and incentive investment policies, both domestic and foreign investment has notably evidenced its contribution to the Lao's Social Economic Development. Generally the total (public and private) investment mobilized rose significantly from 21. 3 percent of GDP in 2001 to about 29 percent in 2005, and averaged at 27. 8 percent for the five-year period which mainly from FDI[1]. The foreign investment has provided further drive to Lao's economic growth. The government of Lao PDR provided good climate for investment, such as infrastructures, telecommunication, political stability, stable macroeconomic condition and law and regulation related to investment.

With the Lao's National Social and Economic Development Plan (NSEDP), Lao's government had achieved to maintain the economic prospect with an average GDP from year 2000 to 2010 approximately about 7. 73 percent (see figure 1), mainly benefiting from expanding natural resources within the country. By encouraging Foreign Direct Investment, Lao's economy has been gradually increased in many sectors, especially industry sector and services sector, which by 2009 had reached 70 percent of GDP. (See Figure 2 and 3)

Industrial sector has grown in recent year with rapid rate, accounted an average rate about 11. 3 percent per year. The mining industry increased by

33. 87 percent; tobacco 20. 75 percent; food processing 9. 17 percent; textiles 20. 11 percent; and garments 11. 15 percent. The services sector has been positively meet the requirements of production and trading, from 2001to 2005, the growth rate in total revenues from services sector accounted an averaged at 10 percent per year.[2]According to National Social and Economic Development Plan, in general Government of Laos (GoL) has performed well with its ambitious economic target and strong economic growth which grounding to free the country from the status of least-development country by 2020.

Figure 1: Lao's real GDP growth in percentage

Source: International Monetary Fund (IMF), World Economic Outlook 2010

Figure 2: Lao's GDP – composition by sector

Source: CIA World Fact Book

# Figure 3: Lao's GDP per capita compared by continent

Source: International Monetary Fund (IMF), World Economic Outlook 2010

In recent year the Government of Laos (GoL) continue to work hard and try to boost its foreign trade with the aim to increase more in export, the structure of their economic changed with the shares of the private sector and Foreign Investment in the economy have increased. In particular, Foreign Direct Investment has facilitated the creation of new products and increasing size of the markets including the entry of new markets. The number of foreign direct investments and private domestic in the past five years stood at 9. 7 billion USD, in which foreign direct investments accounted for 8 billion USD[3]. Thus, the private sector has become more and more essential in the economy of the Laos.

The Lao PDR has been headed for business in regional and global economic integration. It is vital to Lao’s economic with its potential in domestic and foreign investors to guarantee the benefits from the liberalization of trade. Being the member of ASEAN, ATFA and WTO applicant providing opportunity for the country in trade and attracting foreign direct investment increasing the market entry by reduced 98 percent of its tariffs (zero to five percent in 2008). However Laos faced the problem of trade imbalance, in the year of 2007 to 2008 the total trade was 2630. 9 million USD which number of export only 822. 7 million USD (see Table 2)

## 3. 2 Foreign Direct Investment and Hydropower Trends in Laos

Foreign direct investment is playing crucial role in Lao’s economy, with the implementation of Investment Law in 2004 which the Government of Laos (GoL) given huge investment incentive to foreign investors especially tax incentive, as the resulted in 2005 onward the FDI inflow has been significantly increased especially in mining sectors and hydropower sectors. In 2006 the FDI inflow raised up to 2, 699 million USD and in 2009 increased more than 4, 312 million USD (see figure 4 and figure 5).

## Figure 4: Foreign Direct Investment in Laos

Source: Raw data from Ministry of Planning and Investment, Laos

## Figure 5: Foreign Direct Investment by Sector 2000-2010(Jun)

Source: Raw Data from Ministry of Planning and Investment, Laos

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## 3. 3 Analysis Study of Investment Incentives and Disincentives in Laos

## 3. 3. 1 Investment Incentives in Laos

## Tax exemptions from some major industrial nations:

Lao receive the trade privileges from European Union such as GSP privilege. Currently, the receiving GSP is from 42 countries from EU, Japan, Canada, Switzerland, Vietnam and etc. Thus, the garment investment sector is still having comparative advantages in attracting many textile companies to invest in Laos. Mostly, investors are from Taiwan, Japan and Thailand. Furthermore, Laos has sign the Normal Trade Relations (NTR) with USA in December 2004. This is the signal for Laos to join the world trade system (membership of WTO is underway). Such membership leads confident for foreign investors doing business in Laos.

## Land-linked country:

This is going to be trade hub in the Southeast Asia region, which has access to ASEAN market with more than 500 million. Inhabitants including southern part of neighboring China, which adds up together reaching nearly 1 billion people, this is going to be the huge market in the world. Currently, the main roads reaching every corner of the international border pointed have been built. In the next five year, Laos can be the transit goods and connect Southeast Asia to the Northeast and Central Asia.

Abundant water resources, rich in mineral resources, and plentiful of productive land: Laos's government still enjoys receiving the application for the development of the hydropower dams and mining concession from foreign investors. These two sectors are main attractive sectors for foreign investors around the world. The abundant water resources help Laos to gain more major foreign investors to invest in the hydropower project, which lead Laos to be the electricity supplier or battery of Asia. Furthermore, unexploitations of mining areas are still existed and waiting for right foreign investors to invest in this sector.

Most of the mines are gold, copper, coal, tin, Zink and others. Thus, this is another sector that the Lao governments use to promote and attract foreign investors for investing. Moreover, there are plentiful of productive land for foreign investors to do the plantation projects for the industrial plantation such as sugar, palm trees, eucalyptus, and so on. Currently, many big paper companies are investing for the industrial plantation in Laos such as Oji paper factory (Japan), and Birla Pulp Company (India).

## Laos Economic Zone:

Savannakhet Province is a hub of trade and services in the Greater Mekong Sub-region (GMS). The province is linking Lao PDR with Thailand, and Vietnam on the Road No. 9. It is also all along the Road No. 13 which runs through Lao PDR, leading north into China and South into Cambodia. The construction of Road and bridge will progress develop Savannakhet as a trade and services zone in near future and will bring an expansion of markets which will create further business opportunities for all the economic sectors in Savannakhet province, thus Savannakhet Special Economic Zone (SSEZ) which linking neighboring countries in the Asian region with a total population of more than 500 million people and thus is a main centre for trade and services. The categories of business activities planned to be developing in the Savannakhet Special Economic Zone (SSEZ) include the following:

Export Processing Zone;

Free Trade Zone;

Free Service and Logistic Centre including tourism, banking and other activities.

## 3. 3. 2 Disincentive of Investment in Laos

Geographic condition (land locked country) and poor infrastructure: Laos has no border with the sea, thus this is only obstacle for the transportation. The cost of transport goods from Laos to the sea port in Thailand or in Vietnam is quite expensive and may take longer time for the goods to reach the destination due to the documentations and unforeseen events that can happen anytime. Furthermore, the infrastructure in Laos is not quite good especially the road condition in some places or provinces. These cause the transportation cost high and the return on investment or profit is not so high as expected.

However, with the support from the international financial organization such as ADB and World Bank, the Lao government has put the budget for the infrastructure development for the main route to the sea ports such as Road R3 connecting Thaiiand-Laos-China, the road No. 9 connecting Thailand-

Laos-Vietnam, Road No. 13 run through the whole countries from North to South of Laos. The vision of the government is to change Laos as Land-Locked country to the Land-Linked country. By achieving this goal, the cost of transportation will be reducing for sure.

Macroeconomic instability: Lao economic is not independent economic system. Directly and indirectly, the economic depends on the changing of the Thai and Vietnamese economic growth. Now, the Lao economic is more likely to depend to the Chinese economic as well now, as the major foreign investors is Chinese investors. The Lao currency (Kip) is none tradable currency, so it depends on the changing of the US dollars and Thai Baht. For instance, when the financial crisis occurred in 1997, supported that Lao can escape from this crisis, however, it hit hardly by the crisis as most of the commodities goods import from Thailand. Thus, when the global crisis hit Thailand, it will directly and indirectly hurt Lao economy.

However, Lao government has put more afford to monitoring the economic development in Laos and try to not depending on one country economy such Thailand. Now, the free flow of goods leads Laos to escape from the dependent economic from Thailand. Laos can gain access to the Vietnam and China market now.

Small market: Although the economy sounds goods in recent years, but the total expenditure of the Lao people is still low. Most of the markets in Laos are small in size and number of consumers. Most of the big spending on consumers is in the main city, but not in the rural areas. However, most of people in the city cross the border to Thailand in spending for the commodities goods. In recently, the good economic recovered and increasing in FDI inflow in to the country, Lao people spend more money in commodities and luxury goods. Thus, this is the good sign in increasing Lao people spending. In the near future, the Lao small market is going to graduate to the big market soon. Thailand. Now, the free flow of goods leads Laos to escape from the dependent economic from Thailand. Laos can gain access to the Vietnam and China market now.

## 3. 4 Comparative Study of Investment Law (1994 and 2004)

## 3. 4. 1 The Investment Law in 1994

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## 3. 4. 2 The Investment Law in 2004

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## Law on the Promotion and Management of foreign Investment in the Lao PDR (1994)

## Law on the Promotion of Foreign Investment In the Lao PDR (2004)

## Form

## of FDI

## - 2 forms of FDI:

a) A joint Venture with one or more domestic Lao Investors

b) A 100% foreign- owned enterprises

Exemption from import duties for intermediate components and raw materials imported for processing and re-export;

Uniform flat rate of 1% of import value of equipment, means of production, spare parts and other materials used in operation of investment projects;

No export duties on finished products;

Annual profit tax at a uniform flat rate of 20%

Special privileges, including reduction or exemption from theprofit-tax rate, are given based on the size of investments and the significant positive impacts that such investments have on the socio- economic development of Lao PDR;

## - 3 forms of FDI:

a) Business Cooperation by contract;

b) A joint venture with one or more domestic Lao investors (Foreign equity should not be less than 30% of total investment capital); or

c) A 100% foreign- owned enterprise

0% of import duties on production vehicles, machinery, equipment and raw materials

No export duties on finished products;

Profit tax is classified into 3 groups: 20%, 15% and 10% and profit tax exemption is offered for a certain period depending on activities, investment areas and size of investment

1) Zone One (area with no economic information infrastructure)

7 years profit tax exemption

thereafter a profit tax of 10%

2) Zone Two: (areas with certain level of economic infrastructures)

5 years profit tax exemption

3 years profit tax of 7. 5%

thereafter a profit tax of 15%

3) Zone Three ( areas with good infrastructure)

2 years profit tax exemption

2 years profit tax of 10%

thereafter a profit tax of 20%

## Other Incentives

Investment term is up to 30 years

Freedom to expatriate their earnings back home or to third countries

Right to employ foreign expatriates

Personal income tax at a flat rate of10%

Investment term is up to 75 years

Freedom to expatriate their earnings back home or to third countries

Right to employ foreign expatriates (not exceed 10% of the enterprise’s labor)

Personal income tax at a flat rate of 10%

Source: Ministry of Planning and Investment, Lao PDR

## Case Study of Foreign Direct Investment on Hydropower Sector in Laos

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## Chapter IV: Conclusion

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