The Impacts of Trade Facilitation in Greater Mekong Subregion on SME Exporters of the Lao PDR

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Abstract

The importance of trade facilitation and reducing the time to trade is gaining increasing recognition. Significant efforts are being made in the Greater Mekong Subregion (GMS) to promote improvements in this area of economic integration. The Lao PDR, landlocked and surrounded by other GMS economies, is by far the most dependent on the GMS for its trade. Several studies all pointed out that being landlocked should not be a serious problem for the Lao PDR because of border agreements, trans-border coordination of logistics and infrastructure provision and other trade facilitation measures. Nevertheless, this paper want to argue that trade facilitation has costs of its own. And, while the present arrangements appear to work satisfactorily for large exporters, SME exporters, who face higher fixed costs of trade facilitation, will be adversely affected. This paper will investigate in more detail of regulatory reform of Laos, especially with respect to its weak formal institutions and governance structures. There is ambivalence towards the private sector as we recognized that enterprise reform is central to the transition from a planned to a market economy. We expect to find that, in the interim period of transition from plan to market, because fully reformed sectors are co-existing with partially reformed, the costs of facilitation will be exacerbated and, therefore, the SME exporters may face high hindrance in seeking outside markets.

Keywords: trade facilitation, Greater Mekong Subregion (GMS), regulatory reform, transition economy, private sector’s right to development

New Economic Mechanism in Laos

Faced with declining living standards and mass poverty, the Lao leadership began to follow Vietnam in reforming economies from the mid-1980s (Bourdet, 2000). Vietnam's *doi moi* (literally 'renovation') was replicated in Laos under the banner of the so-called 'New Economic Mechanism' (NEM). Laos also began to cautiously re-open diplomatic relations with non-communist Southeast Asian states, although it would be another decade before it formally joined ASEAN in 1996.

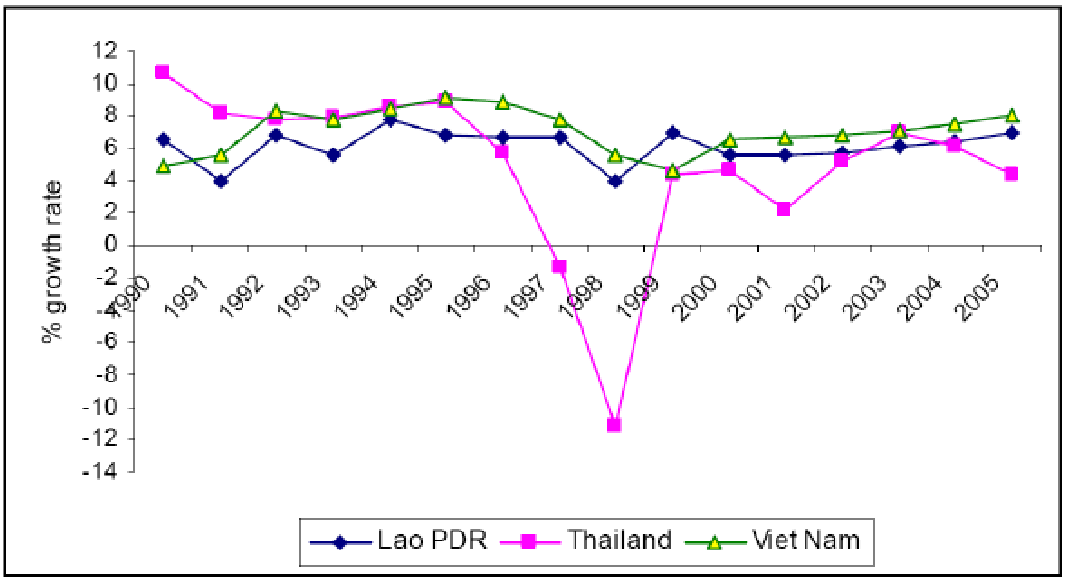
Under the NEM, reform has been gradual and reasonably consistent with three broad phases. In the first and most important phase, approximately 1987-1994, most trade barriers were relaxed, almost immediately, private companies were permitted to trade domestically and internationally, and much of the transport sector was opened up to private sector. In June 1987, the government removed price controls, except for utilities, public services and several 'strategic' products, *e.g.*, cement and steel. It also permitted some trade to be conducted at exchange rates closer to the informal market, leading to the unification of the multiple exchange rates in January 1988. State-owned-enterprise (SOE) reform commenced, but with few privatization. In October 1988, the government began to divest commercial banking functions from the State Bank of Lao PDR. Tax reforms were introduced in the 1988 budget. Civil service salaries were increased and staff numbers reduced. Large aid flows from the West resumed, and these in turn allowed the country to run very large current account and fiscal deficits.

In the second phase, 1995-99, trade reform continued and there was the continuing of SOE reform. The reforms were stalled by the inter-related events of serious macroeconomic problems and the East Asian economic crisis. There was a temporary loss of macroeconomic control, a brief period of hyperinflation, and a large nominal exchange rate depreciation. The severe contraction and exchange rate turmoil in several neighboring countries in 1997-98 also put the reform momentum on hold. A third phase has been evident since 2000, with the restoration of macroeconomic stability, continuing reforms, and the emergence of significant natural resource booms.

Nevertheless, there was very little political reform. Laos remains a single-party state, under the control of Politburo of the Lao People's Revolutionary Party, the LPRP, which exercises its authority formally through the country's National Assembly. Senior officials are required to be members of the LPRP, which perpetuate itself through a mixture of authoritarian rule and patronage. The media is heavily controlled and civil society is largely absent. Ethnic minorities, mainly living in the border regions, are often oppressed. There has been some decentralization of political authority, introduced in the late 1980s as part of the NEM. Power was devolved to the provinces rather than villages, and the strongest regional sentiments were felt in the country's three main regions, the north, center and south. Initially, significant financial resources, including foreign trade and several taxes, were devolved to the regions. As local service provision became more uneven from the late 1990s, however, the central government attempted to re-centralize its fiscal powers, particularly under the budget law of 2006.

Economic Recovery and Growth

Laos is one of the poorest countries in Southeast Asia, with a very low GDP per capita and human development index (HDI) ranking.[1] However, since 1990, when rudimentary but plausible national accounts have been prepared, its economy has grown on average at about 6% per annum, somewhat slower than Vietnam and less erratic than Thailand (Figure 1). With population growth of about 2%, this implies an annual per capita growth rate of 4%, and per capita income more than doubling since the reforms commenced. This is the first period of sustained growth in the country's recorded history. The economy slowed in the wake of the 1997-98 Asian economic crisis but growth remained positive. There was non-financial contagion since Laos was then still a mainly agrarian economy, little connected to global financial markets, and with little short-term external debt. The crisis impacted mainly through the real sector effects of declining export demand, particularly as Lao trade patterns were heavily concentrated within East Asia, in part as a result of the continuing U.S. trade blockade established in 1975.



[1] Among the four low-income mainland Southeast Asian states, Laos' 2008 per capita GDP was estimated to be US$ 837, compared to US$ 651 and US$ 1,052 for Cambodia and Vietnam respectively. No Plausible estimates for Myanmar are available. In HDI rankings, Laos is number 130, very similar to two of its neighbors, Cambodia (131) and Myanmar (132), but is lower than Vietnam (105).

Figure 1 Economic Growth, 1990-2006, Laos and Neighbors (%)

Source: Bird and Hill (2010).

The process of economic growth has resulted in steady structural change since 1990. Most sectors of the economy have performed well. Agricultural growth has averaged slightly more than 4% per annum, mainly through increased crop yields; crops, mainly rice, constitute 58% of agricultural output. There has also been some diversification into maize, fruit and vegetables. The irrigation and road networks have been expanded, thus raising yields and lowering marketing costs. Barriers to inter-provincial trade have been relaxed, and there is less emphasis on local food self-sufficiency.

Industrial output has grown rapidly since 1990. The largest sector, manufacturing, has averaged 12% growth per annum, more than doubling its share of GDP to 20%. Food and beverages constitute 75% of this output, while garments are the major manufactured export. Electricity production has averaged 11% growth, and its share has also doubled. About 97% of power generation capacity is hydro, mostly for export. Mining output has grown very rapidly, by 25% per annum from a small base. Most of the increase has occurred since 2003, when the major Sepon copper and gold mine production commenced. Services output has grown at an average annual rate of 6.6% since 1990, a little faster than the economy as a whole. The increases have been broad based: domestic and international trade flows have been liberalized, while transport and communications have grown quickly, with tourism a major source of growth.

There are three main features of the country's external account. First, there has been rapid growth of all forms of international transactions in response to the more liberal policy regimes. Over the period 1990-2006, for example, foreign trade as a percentage of GDP more than doubled, from 37% to 78%.[2] This trade growth has been driven by both policy reform and increased exploitation of the country's natural resources.

Second, the country continues to run large balance of trade, current count and fiscal deficits, mainly financed by foreign investment and aid. Excluding official transfers, Lao current account deficits in the past decade have been in the range of 10-20% of GDP. Several factors explain this unusually high figure. There is a large merchandise trade deficit, generally 10-15% of GDP, with imports at least 50% more than exports, and sometimes double. Net foreign income is also a large negative item, mainly in the form of income accruing to foreign investment in the country and interest on private external debt. This deficit is financed by large capital transfers, in

[2] It should be noted that these figures exclude the extensive unofficial border trade, mainly with Thailand.

the form of foreign investment, long-terms loans and grants, and private transfers, much of it remittances. Annual foreign aid flows are large, in the range of 6-10% of GDP. With Laos' least developed country status, most aid is highly concessional. Grants constitute 30-40% of the total, with the remainder being low interest loans. As a consequence of this high aid dependence and recent foreign borrowings, Laos is a highly indebted country. External debt is equivalent to 92% of GDP. However, three-quarters of this debt is public, and almost all of it is long-term, low interest borrowings from the international financial organizations, principally the Asian Development Bank and the World Bank.[3]

Third, for such a small economy, foreign exchange earnings are moderately diversified, a factor that renders the country a prospect of durable growth. Apart from aid and investment, there are several sizable foreign revenue flows. Annual receipts from garments and tourism now each exceed US$150 million in most years. Remittances are poorly documented, but are estimated to be about US$100 million per annum, from the approximately 5% of the population working either full time or intermittently in Thailand. This mobility is facilitated by a long and porous international boundary, slight ethnic-linguistic differences, and unskilled wage differentials of at least 4:1. Copper, gold, timber and other natural resource exports now exceed US$ 100 million per year. Finally, electricity exports have risen rapidly, and now also exceed US$ 100 million.

The mining and electricity exports have originated from a few large investments. Garments and tourism are, by contrast, more labor-intensive and the benefits more widely diffused through the workforce. Growth has been rapid in both, especially tourism. Arrivals have risen by 45% per annum since 1990, from a very low base. The neighboring countries are the dominant source, with Thailand and Vietnam accounting for 55% and 15% respectively. Although small, garment exports began to rise quickly from the early 1990s, boosted by special market access arrangements under the then Multi Fibre Agreement (MFA), especially to the European market (Rasiah, 2009). Several foreign firms have relocated from Thailand, to take advantage of export quotas and lower wages. That dependence on Thailand resulted in a downturn in exports in 1997-98, but growth later resumed until affected by the 2008-09 global recession.

GMS, Trade Facilitation and Laos

[3] Commercial debt constitutes just 6% of total public debt. One curious historical legacy is that most of the 20% of public debt that is bilateral, i.e., owed to other governments, is with the Russian Federation, and was mainly contracted in the 1980s. The figure is thought to be vastly inflated by conversion at the unrealistic official exchange rate that prevailed under the USSR. It is thought unlikely that it will ever be repaid.

As trade is an important driver of growth and infrastructure is a necessity for trade, infrastructure development has a key role to play in economic development. This has long been recognized in the Greater Mekong Subregion (GMS).[4] The transport sector is one of the first areas of cooperation under the GMS Cooperation Program which began in 1992.[5] At the beginning, national boundaries in the region were, for all practical reasons, closed and most of the region's infrastructure was of very poor quality (see, *e.g.*, Ishida, 2007). The program set out to open borders and improve connections to make trade easier, enhance development and strengthen the region's ability to compete in global economy.

In 1995, the GMS adopted the Transport Master Plan which identified priority transport links—mostly road projects—designed to generate the greatest and fastest improvement in connectivity. This was an important step in producing economic opportunities in the region by, *e.g.*, significantly reducing travel times and costs. Thus, the GMS countries have transformed from self-sufficiency to increasing interdependence with more convenient transport facilities.

The other important trade facilitation measure is the Cross-Border Transport Agreement (CBTA) established in 2003 to ease movement of people and goods across borders in the GMS. The agreement includes facilitating border-crossing formalities, exchanging commercial traffic rights, establishing transit traffic regimes and setting infrastructure standards and regulations on crossing vehicles. The CBTA further strengthened the transport corridors in reducing travel times and logistic costs.

The GMS could be traced back to the Mekong Commission since 1957 which included four downstream countries of Mekong. However, impeded by wars, the Mekong basin did not have any realistic cooperation in the subsequent 30 years. Therefore, the 1992 involvement of the ADB was the beginning of practical development (ADB, 2005a, b). Almost 320 million people live in the GMS which is strategically located, bridging South, Southeast and East Asia. While the Mekong region is widely expected to be one of the fastest growing areas in the world, economic development continues to elude some countries in the region where poverty remains as significant problem (ADB, 2005a).

Populations range from under 6 million in Laos to over 90 million in the combined Yunnan-Guangxi region of the PRC. The economies also are diversified with a GDP of US$ 3.4 billion in Laos compared with over US$206 billion in Thailand, about 60 times as large. GDP per capita ranges from US$ 500 or under in Laos, as well as Cambodia and Myanmar, to over US$ 3,000 in Thailand (see Table 1). Overall, the

[4] The GMS comprises Cambodia, Lao PDR, Myanmar, Thailand and Vietnam, as well as Yunnan Province and Guangxi Zhuang Autonomous Region of the People's Republic of China (PRC).

[5] The GMS Economic Cooperation Program is an Asian Development Bank (ADB)-supported comprehensive program.

GMS remains a relatively poor region.

Table 1 Selected Aggregate Indicators for the GMS, 2006[1]

	Population (mil.)	GDP (US$bil.)	GNI per capita (US$)	Intra-GMS share of total exports[1]		Intra-GMS share of total imports[1]	
				No PRC (%)	PRC (%)	No PRC (%)	PRC (%)
Cambodia	14.2	7.3	490	2.5	3.6	2.5	3.9
Lao PDR	5.8	3.4	500	17.9	20.7	19.6	22.6
Myanmar	48.4	--	281[2]	36.3	43.2	35.9	43.1
Thailand	63.4	206.3	3,050	3.0	13.8	3.1	14.0
Vietnam	84.1	61.0	700	1.7	10.3	1.8	10.6
PRC Total	1,311.8	2,644.7	2,000	2.1		2.2	
PRC GMS[3]	92.3	75.4	702	n.a.		n.a.	

Note: n.a.: not available.

[1] data of year 2004.

[2] World Bank (2008a).

[3] Yunnan and Guangxi: Population 2003, GDP 2004, GDP per capita 2005.

Source: World Bank (2008b).

There is also variation in intra-regional trade patterns wherein the PRC plays a role (see last two columns of Table 1). The highest dependency on the region is found in Myanmar where over 35% of its imports and exports are sourced within the GMS. The PRC appears to play a small but significant role, increasing those shares by about 7%. Laos and Cambodia do not appear to be overly dependent on the PRC with their intra-GMS trade shares changing little whether the PRC is included or not. The two economies most dependent on trade with the PRC appear to be Thailand and Vietnam.

There are also variations in physical measures in the GMS. Land area ranges from under 180 million km^2 in the case of Cambodia to over 650 million km^2 for Myanmar (Table 2). Population density ranges from 25 people per km^2 in Laos to over ten times this density in Vietnam. It is notable from Table 2 that the poorest countries—Cambodia, Laos and Myanmar all have limited road networks, with less than 15% of roads paved. There are also countries with relatively low population densities and limited resources to provide rural populations with access to markets and the accompanying opportunities. Movement by rail in the region is also fairly limited. If we calculate the road density, we can find that the population density for all GMS countries is well above road density, with the exception of Laos where both population and road densities are very low. The gap in road networks has a direct impact on the GMS's ability to attract investment. The changing nature of global production patterns has affected economic development both within and outside GMS with, especially, transport service availability and quality playing crucial roles. Variations in logistic costs among countries stem from differences in quality and cost of infrastructure services, including customs procedures and institutional quality. Opportunities of trade expansion and foreign direct investment increase with improved trade facilitation and road transport services.

Table 2 Selected Geographic, Population and Infrastructure Indicators of the GMS, 2006

	Land area (mil. Km^2)	Population density (per km^2)	Rural pop. (%)	Roads (mil. Km)[1]	Paved roads (%)[1]	Rail lines (mil. Km)[1]
Cambodia	176.52	80.4	79.7	38.3	6.3	0.7
Lao PDR	230.80	25.0	79.0	31.2	14.4	--
Myanmar	657.55	73.6	68.7	28.0	11.4	--
Thailand	510.89	124.2	67.4	57.4	98.5	4.0
Vietnam	310.07	271.3	73.1	222.2	25.1	2.7
PRC	9,327.49	140.6	58.7	1,930.5	81.6	62.2
PRC GMS[2]	630.80	150.4		288.8		5.0

Notes:

[1] PRC 2005; Cambodia 2004; Lao PDR 2003; Vietnam roads and rail lines 2004, paved roads 1998, PRC GMS sourced from National Bureau of Statistics of China (2007).

[2] Yunnan and Guangxi, sourced UNESCAP (2008), average population density calculated from 2000 data.

Source: World Bank (2008a).

Trade Facilitation, Costs, and SMEs in Laos

Trade facilitation, as generally stipulated, refers to a set of policies that reduce the costs of importing and exporting. In defining the term in this way, we are consciously taking a broad approach to the type of policy measures it includes (see, *e.g.*, Wilson *et al.*, 2005). On one hand, we include customs formalities, administrative procedures and regulatory transparency directly linked to trading processes. This is essentially what has been covered in the current WTO negotiations on trade facilitation. On the other hand, we also include a broad range of measures such as infrastructure, institutional transparency and good governance, and domestic regulations (Wilson, 2005).

Essentially, everyone stands to gain from making the process of trade easier.

Governments gain because efficient border procedures make them able to process more goods and improve control of fraud, thus increasing government revenue. Businesses gain because if they can deliver goods more quickly to their customers they would be more competitive. And consumers gain because they are not paying the costs of lengthy border delays. If a truck is stuck at the border for a week, ultimately the consumers is paying for its being off the road and unproductive during that time. Studies indicate that even modest reductions in trade transaction costs, such as lengthy border procedures, translate into significantly increased trade. Taking into account how trade facilitation measures to reduce transaction costs affect different sectors of the economy and different types of traders, OECD research shows that developing countries stand to gain two thirds of total world welfare benefits from trade facilitation. But if trade facilitation were to be undertaken by OECD countries alone, developing countries would stand to lose (OECD, 2005). Therefore, developing countries would show higher trade gains because of the relative inefficiency of their current systems and because agro-food and small and medium enterprise (SME) trade, which are most severely affected by inefficient procedures are central for the economy of these countries.

On the other hand, trade facilitation can have costs of its own. For developing countries in particular, improving an inefficient customs system may place multiple demands on limited resources. Furthermore, governments will have to fund some of the reforms before they see any benefit in terms of increased revenue and trade, although initial benefits can then be used to pursue further reform. A particular cause for concern is the fact that it is difficult to say how much effective trade facilitation would cost, or how much reform governments would have to undertake before they started reaping the benefits.

The changing nature of global production patterns has affected economic development both within and outside the GMS depending on, among other things, transport service availability and quality. Variations in logistics costs among countries stem from differences in the quality and cost of infrastructure services, including customs procedures. Let us take some instances in the following.

Document preparation is a large stumbling block, taking as long as 33 days for exports from Laos but still as many as nine days for Thailand and 14 days for the PRC (Stone and Strutt, 2010: 163; World Bank, 2008a). Also, Nathan Associates (2007) found that transporting goods by road between Lao PDR and the Thai border cost shippers four times more than the international norm (including Asia). The function of the customs department is to facilitate and never to restrict desirable trade. However, in Indochina, poverty has led to the corruption and bribery of customs officers at the checkpoints. In some cases, it is cheaper to pay "facilitation fees" than to accept the arduous task of dutifully completing import/export forms. Another problem is the non-alignment and non-standardization of customs documentation. The problem is more pronounced in Vietnam where freight forwarders have their own (non-standard) forms. The concept of bonded goods is also not fully applicable in these countries as some goods can be held for a month at the customs warehouse before clearance is given. Despite calls for greater integration, improvements in trade facilitation measures have not taken place. Simple technical issues like commodity classification systems, design of forms and even the coordination of customs opening and closing times, and extensive red tape have resulted in problems of compliance and delay. There is a need to streamline such procedures to improve the efficiency and effectiveness of border procedures, contributing to greater logistics fluency in transshipment (Goh, 2000: 10-11).

Foreign third party logistics (TPLs) may want or choose to invest in or form joint ventures with influential local partners to infuse new capital, technology and knowledge. This will help in opening up new distribution routes for road transport. For companies that want to move goods (raw materials, work-in-process and finished goods) in and out of Indochina, there is a need to consider some standardization to facilitate loading and unloading of shipments to and from overseas destinations. This harmonization of the specification of pallet standards would need to be driven by MNCs in collaboration with their TPLs. This will again help to reduce unnecessary handling (de-kitting and re-packing) of pallets during transit or modal transfer. Similarly, MNCs should look for TPLs that can provide a one-stop fee (including logistics facilitation) to minimize unnecessary delays at the point of entry into or exit from the country concerned. TPLs should also agree to harmonize customs procedures to reduce cross-border delays. However, some delays are unavoidable due to the different prevailing clearing procedures. For time sensitive goods, managers, MNCs and TPLs should seriously consider air transport for international routes and use road transport extensively for goods movement within Indochina. Further, Vietnam represents a strategic production and distribution location to the neighboring countries in Indochina due to its better developed logistics infrastructure, through the highway, rail, air and the inland waterways system. Therefore, managers, MNCs and TPLs who desire to distribute finished goods into Myanmar, Cambodia and Laos should consider the following key Vietnamese cities (Hanoi for entry into North Myanmar and Laos, Danang into South Laos and North Cambodia, and HCMC into Cambodia) as key entry points in the supply chain into Indochina. The main transport modes would be by road and inland waterways or by air into the capital/provincial cities. TPLs should also seriously study how to organize port activities efficiently and to improve container-handling facilities at the key seaports of Danang, Haiphong, Ho Chi Minh City (HCMC) and Yangon. Potential savings in cargo handling and transport costs realized at these ports will make physical distribution more competitive and reduce the unduly long lead time. New managers should also be made to realize this (Goh, 2000: 12).

Therefore, while being land-locked is not a serious obstacle to Laos, Challenges remain to be overcome, One is the Laos' border infrastructure need to connect back to the hinterland, particularly so that the country's agricultural and tourism potential may be realized. This requires both better rural infrastructure, particularly roads, and the removal of minor commercial harassment by local police and customs officers. The second is to facilitate the access of smaller newcomer exporters to the trans-border arrangements. The present protocols appear to work satisfactorily for existing large exporters, who have well-established relationships with the customs services and Thai freight-forwarders, and whose scale enables them to employ low-cost containers, which are sealed after the ex-factory customs inspection. However, the system is much more complex for firms whose exports are small or irregular. These firms need to consolidate loads to achieve the lower costs of the larger containers. The market for this service remains under-developed, raising costs and delaying shipment. Moreover, customs procedures remain slow and costly for these firms. Ironically, the expensive "friendship" bridge across the Mekong linking Laos and Thailand is estimated to have saved only 45 minutes due to these customs complexities (Bird and Hill, 2010: 23). Moreover, the lack of "consolidation points" along the border adversely affects SME exporters, who therefore face high fixed costs of trade facilitation.

Concluding Remarks

The preliminary conclusion we draw from the text is that SMEs in Laos could take not much advantage from GMS integration due to high costs of trade facilitation. Economic growth in Laos in the past two decades have rendered enterprises, public or private, ample opportunities to participate in markets and to interact with foreign counterpart. Furthermore, the integration program of Greater Mekong Sub-region provides a good prospect for businesses in member countries to export their products and services to international markets through intra-regional logistics networks. No one would deny nowadays that private businesses, especially those of transition economies, are the key players in promoting and assuring a country's sustained growth. SMEs, with their agility and low-costs production, in such land-locked countries as Laos could be proved as very crucial for the country to penetrate into other markets. However, SMEs in the country may, on one hand, not recognize the potential and even the right to development they are entitled in contributing to their country's economic progress. On the other hand, they also face relatively large barriers arising from high costs in trade facilitation measures in trans-border transportation compared to large enterprises which are better equipped to avoid the facilitation costs.

It is undeniable that the transition from plan to market involves a complex interplay of economics and politics, with fully reformed sectors and policies co-existing uneasily with the partially reformed. In the interim period, the messy policy regime may be effectively operational, but it may also hinder more vulnerable sectors in the economy, especially SMEs who could have been bogged down in intertwined bureaucratic procedures. As we discussed in the text, Laos can take advantage of its proximity to larger, fast-growing economies such as Thailand and Vietnam. Furthermore, Laos has been a large recipient of international aid flows, generally on concessional terms. However, for the country, and businesses therein, to benefit from these two advantages, it has to seize the opportunities by reforming at home. That is, the benefits are conditional on successfully reforms. Moreover, these benefits should not be overstated. With weak bureaucracies, Laos struggles to meet the myriad demands from international communities. From the viewpoint of this paper, SMEs in Laos may need further assistance in overcoming hurdles they encounter in many bureaucratic messes.

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