

# Non-Equity Modes of Trade in ASEAN

Promoting new forms of trade between  
Japan and ASEAN

PAPER 4

MARCH

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Paper 4 / March 2020 / Non-Equity Modes of Trade in ASEAN: Lao People's Democratic Republic  
Promoting new forms of trade between Japan and ASEAN

# Non-Equity Modes of Trade in ASEAN

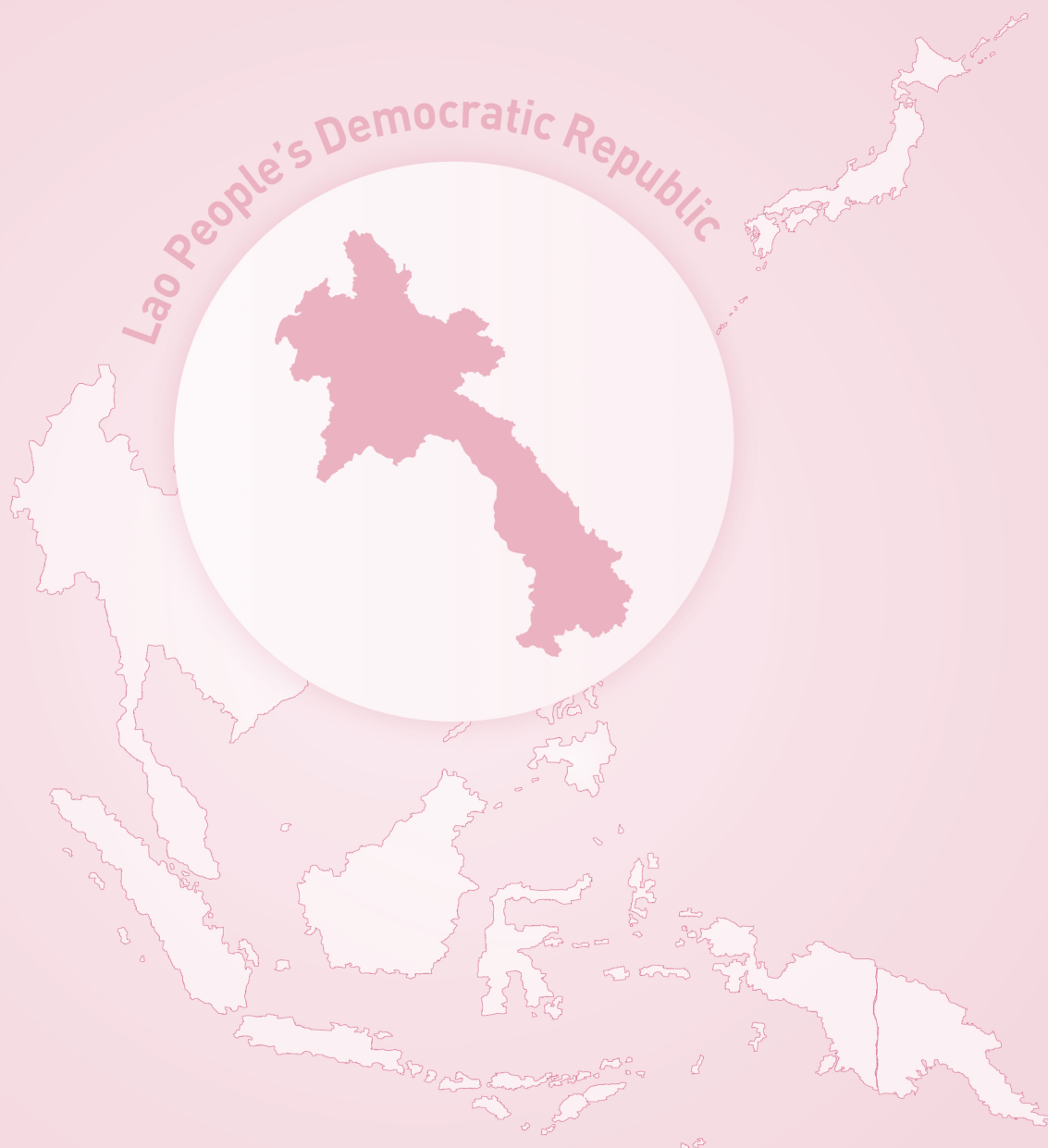
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## NOTES

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The following symbols have been used in the tables:

- Two dots (..) indicate that data are not available or are not separately reported.
- A dash (-) indicates that the item is equal to zero or its value is negligible.
- Use of a dash (-) between dates representing years, e.g., 2015–2016, signifies the period involved between the years, including the beginning and end years.

Reference to “dollars” (\$) means United States dollars, unless otherwise indicated.

There are ten papers in total. The other nine papers are being prepared simultaneously.

Paper 1. Brunei Darussalam

Paper 2. Cambodia (published in August 2019)

Paper 3. Indonesia

**Paper 4. Lao People's Democratic Republic**

Paper 5. Malaysia

Paper 6. Myanmar (published in March 2020)

Paper 7. Philippines (published in March 2018)

Paper 8. Singapore

Paper 9. Thailand

Paper 10. Viet Nam (published in December 2018)

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## KEY MESSAGES

- The use of non-equity modes (NEMs) of production has been increasing in the Lao People's Democratic Republic, including in exports of an estimated \$274 million in electrical machinery and \$132 million in garments.
- Lao firms are in the infancy stage of participation in NEMs, using subcontracting, management contracts and franchising, with the type of NEM varying by industry.
- In the garment industry, an important generator of employment in the country, outsourcing has given rise to subcontracting NEMs.
- The "Thailand Plus One" company strategy of Japanese transnational corporations (TNCs) provides opportunities for Lao companies to participate in NEM transactions with such companies and their subsidiaries. To realize these opportunities, the government needs to put more effort into developing infrastructure connectivity in the logistics network.
- International hotels are operated in the country through either management contracts or franchise agreements, or under long-term contracts through the leasing of land on which hotels are then built with equity investments. Local regulations prohibit land ownership by foreigners.
- The country should take advantage of the opportunities that foreign TNCs offer when they outsource the production of goods or services, or part of their production chains to the country.
- The government should assist in the development of NEM capabilities so that local firms can take advantage of appropriate TNC-driven economic synergies as competition forces TNCs to make continuous improvements in the quality and pricing of suppliers.
- In addition to upgrading the labour force and improving investment conditions, the government should strengthen the basic infrastructure and the science, technology and innovation infrastructure; improve coordination and connectivity between intermediary organizations, institutions and firms; and promote global integration.
- The government should consider implementing and strengthening the regulatory framework for NEM firms.





## 1. INTRODUCTION

Following theories on comparative and competitive advantage and on specialization that have attempted to explain the importance of international trade in economic development, various international bodies have promoted the internationalization of production to bring scarce capital and technology to poor and transition economies so as to assist them in the initiation of the processes of structural change from low to high value added activities. Consequently, global trade has grown by leaps and bound over the years. However, in many cases the accounts of trade between countries are represented by aggregate statistics on the basis of broad ownership patterns at different levels of product categories. Few studies have broached assessments of non-equity modes (NEMs) of ownership, where trade links appear in the form of supply chains or in many cases as part of the global value chains (GVCs) of transnational corporations (TNCs). NEMs tend to dominate such trade in industries such as clothing and electronics, and to manifest in the form of horizontal or vertical trade among TNC affiliates.

NEMs of trade in GVCs started gaining significance following the successful expansion of firms from Japan, the Republic of Korea and Taiwan Province of China. Unlike the Northeast Asian economies, Southeast Asian market economies such as Singapore, Malaysia, the Philippines, Thailand and Indonesia have strongly promoted foreign direct investment (FDI). Like these economies, the Lao People's Democratic Republic has also been strongly promoting FDI inflows. The role of NEMs can be complementary to that of FDI in the country. NEMs can become an important platform for generating foreign exchange, can provide strong linkages with FDI and the national economy and can act as a solid springboard for evolving national productive capabilities. Trade linkages between Japan and ASEAN members produce such elements.

As in the other ASEAN economies, trade linkages involving NEM firms are gradually spreading in the Lao People's Democratic Republic. They occur in the form of international subcontracting in manufacturing industries, such as garments and electronics; contract farming in agriculture and food processing; international franchising in fast food and retail stores and in hotels; variations of build-own-operate transfer arrangements and other concessions in infrastructure projects; and management contracts in international hotel chains, among others. With a view to the potential that NEMs offer for national economies, this study examines the Lao People's Democratic Republic in the overall framework of the ASEAN-Japan Centre project (box 1), particularly targeting NEMs in five industries: garments, food manufacturing, contract farming, retail chains and hotels.

### Box 1. The NEM project by the ASEAN-Japan Centre

Other than arms-length relationships, equity-holding is not the only means of exerting control over the international value chain. Companies also enter into a contractual relationship with other independent firms. This form of trade is gaining importance as global production and value chains are becoming more integrated. However, there exists a lacuna in the knowledge and research undertaken on this form of trade in ASEAN. It also calls for the formulation of an overall analytical framework to assess development impacts in order to propose a set of generic policies for dealing with this kind of transactions involved. The fundamental difference between equity and non-equity forms of operation relate to the question as to who holds equity: for NEMs, it is completely shared by local parties, especially private interests. Typically, the role of the state related to this partnership is limited to setting up the framework conditions within which local parties can freely negotiate the terms of their operations and cooperation with buyers and suppliers. By understanding better this phenomenon including the scale and scope of NEM operations and filling in a policy analysis gap the ASEAN-Japan Centre (AJC) seeks to provide ASEAN country governments with advisory support that they need to consider in order to fully benefit from these new forms of trade and its related investments.

.../

**Box 1. The NEM project by the ASEAN-Japan Centre (Concluded)**

In order to explain better the scale and scope of non-equity involvement in major industrial sectors, a case study methodology is used in this report. The reasons for taking this approach are two-fold: (1) balance-of-payments and supplementary statistics do not provide the details necessary to accurately measure cross-border NEMs of participation; and (2) the relevant microdata are fragmented and disconnected. Nevertheless, as much as possible, each case study builds on existing research and statistics.

New opportunities are opening up for ASEAN countries owing to changes in the conduct of TNCs, and to international innovation networks. While attracting FDI inflows and encouraging foreign TNCs to establish affiliates remain important options for ASEAN countries, governments need to review their current regulatory regimes in the context of new developments in this context. A key objective of this study is to offer policy recommendations (investment and industrial policies) that governments can consider in order to fully benefit from these emerging opportunities.

Resource-based products contributed significantly to overall Lao exports in 2016: copper accounted for 33 per cent of total exports, followed by electricity at 31 per cent (Bank of Laos, 2017). In contrast, imported products were concentrated in capital goods, such as machinery and vehicle equipment, raw materials and consumer products. As table 1 shows, electricity and minerals (\$1,450 million) were the chief exports in 2016. Vegetables and animal products followed, with an export value of \$707 million. Machinery and electric appliances (\$428 million) and refined copper and other metals (\$406 million) were next. Textiles have been among the most important manufactured export items, with their export value rising from \$86 million in 1990 to \$125 million in 2000 and \$222 million in 2016. Clothing and textiles became the leading item exported to Japan in 2013 due to wage increases in the Thai garment industry and the relocation of factories to the Lao People's Democratic Republic from other countries. Nonetheless, the major export destination of the country's clothing and textile exports remains the European Union (EU), thanks to the "Everything but Arms" clause (Rasiah, Vanthana and Latdavanh, 2011). Another industry that has been growing strongly in the country, albeit with few exports, is tourism. Its contribution to GDP amounted to 5.1 per cent in 2015, and in 2016 revenue from tourism was more than \$700 million (AJC, 2018). Agriculture has remained the largest contributor to GDP at 24.8 per cent and has accounted for the largest labour force (figure 1). These two industries are identified as NEM-related industries and subject to study here.

However, while exports have risen, imports have remained high for a number of items, such as machinery and electric appliances (\$1,370 million), vehicles and equipment (\$1,020 million), metals (\$700 million) and foodstuffs (\$496 million). It is in these industries that the expansion of NEMs can help ameliorate the problem posed by balance-of-payments imbalances, as NEMs can substitute for imports.

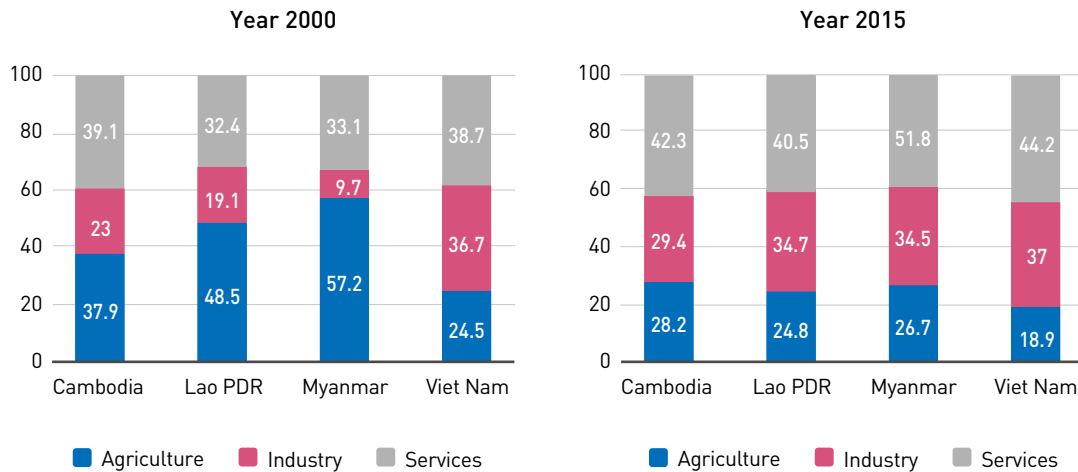
Table 1. Major Export and Import Products of Lao PDR, 2016

Industry	Export (CIF)			Import (FOB)		
	Export value (\$ million)	Share (%)	Export RCA (selected only)	Import value (\$ million)	Share (%)	Import RCA (selected only)
Electricity/Mineral	1 450	31	108	1 370	22	2.47
Vegetable/Animal products	707	15	24.3	1 020	16	3.35
Machines/Electric appliances	428	9	0.54	813	13	3.27
Refined Copper/Metals	406	9	14.5	700	11	3.78
Foodstuffs	382	8	3.4	496	9	2.2
Wood products	284	6	32.1	395	6	2.1
Textiles	272	6	9.9	322	5	4.5
Chemical products	221	5	32.4	211	3	1.1
Gold	207	4	1.8	138	2	1.7
Rubber	132	3	76.5			
<b>Others</b>	<b>211</b>	<b>4</b>		<b>755</b>	<b>13</b>	
<b>Total</b>	<b>4 700</b>	<b>100</b>		<b>6 220</b>	<b>100</b>	

Source: Global Trade Atlas/UN Comtrade.

Note: CIF = cost, insurance and freight; FOB = free on board, RCA = revealed comparative advantage.

Figure 1. GDP by sector, 2000 and 2015 (Per cent)



Source: Asian Development Bank, Key Economic Indicators 2016.

Deregulation and the rising importance of FDI inflows into the Lao People’s Democratic Republic are now well documented. Although national firms overwhelm foreign firms in Japan, the Republic of Korea and Taiwan Province of China, NEMs are active and form a strong, integral part of TNCs’ GVCs that has helped support their growth through integration with the U.S. and European markets. In Asia, the technological catch-up that facilitated the transformation of national firms from low to high value added activities was very much based initially on creative learning and incremental innovation from knowledge acquired and imported from Western and Japanese firms, in which TNCs have played a critical role (Amsden, 1991; Kim, 1997). Although this development is still not visible in the Lao People’s Democratic Republic, efforts can be made through the right strategies to stimulate the upgrading of NEMs in the country to follow the paths of NEMs in Japan, the Republic of Korea and Taiwan Province of China. This paper seeks to investigate whether there are signs that could be used to formulate policy-relevant recommendations to stimulate such a development by connecting Lao firms with TNCs, as well as GVCs, to promote NEMs in the country.

Participation by local firms in GVCs has already emerged in some ASEAN countries, including in the electronics industry and the textile and clothing industries. The expansion of outsourcing opportunities from TNCs can evolve only from sophisticated national innovation systems. Changes in intra- and inter-firm production linkages have resulted in transformations in the nature of control exerted by buyer TNCs and target markets. Because of the lack of studies that show the state of NEMs and the value chains of TNCs they connect with, this paper seeks to examine the nature of control in the value chains of local clothing and textile firms that are either selling to Japanese firms in the Lao People’s Democratic Republic or exporting to Japanese markets directly.

When analysing the factors that make locations attractive and conducive to NEMs, it is useful to be cognizant of the great overlap with the factors that contribute to FDI. As with FDI, locational determinants include political and social stability, sufficiently polished competitive policies, a literate labour force, good infrastructure, incentives for companies, smooth trading procedures and appropriate governmental macroeconomic policy. Hence, one can apply to NEMs the standard frameworks that have been used to evaluate FDI.

Several factors provide particular support for the development of NEMs in host countries (box 2). First, stable contract and commercial laws that are fair to all parties are important to strengthen the likelihood of the emergence of NEMs. Registration, licensing and protection of intellectual property rights are some of the regulations that must be in place.

Second, national and local authorities must introduce institutions to promote the emergence and growth of NEMs. For example, a wide scope of promotional activities and incentives must be introduced. Examples include specific conditions that induce TNCs to source from NEMs, such as financial incentives. Wherever possible, TNCs should be encouraged to participate in training and standards testing centres, which should also be opened for NEMs.

Instead of spreading all their resources across the country, TNCs should be encouraged to set up in selected locations where both basic and science, technology and innovation (STI) infrastructure can be developed. Such an effort will stimulate the spread of agglomeration economies, similar to the effect of special economic zones (SEZs).

Through either NEM modalities or TNCs, reliable regional enterprises are important to promote the growth of NEMs. Owing to locational specifics that include conditions such as working with a local labour force and the fact that foreigners are prohibited from owning land in the country, TNCs will seek local partners to expand their business. Large NEMs will also require small and medium-size enterprise NEMs to which to outsource complementary but dissimilar components and services. Local agricultural cooperatives can act as intermediaries to reduce business risks and raise product reliability (Barrett et al., 2010).

Another important factor is the phase of economic development and social capital to which the country has evolved. For example, consumer market scale and growth will be larger in more developed countries than in less developed countries. The same can be expected of social capital, which is important in solving problems that the market does not manage, especially when involving risky and uncertain investments. The provision of strong basic infrastructure—transport, energy and communication—can help lower transactions costs, and in that way reduce risks and uncertainty.

#### Box 2. Factors that will stimulate NEM Operations

When examining the factors that make national, regional and global locations attractive and conducive to NEMs, there is a need to address overlapping factors that stimulate FDI inflows. As with FDI, determinants of location choice include political and social stability, a literate labour force, good infrastructure, sufficiently efficient and competitive policies, financial incentives, smooth trading procedures and conducive macroeconomic policies. The Pakse-Japan Small and Medium Enterprises (PJM) Park in Champasak, which houses foreign small and medium-size enterprises, is very much a development zone driven by these attractions.

In addition to policy-related determinants that stimulate FDI, there are also many factors that can support NEM development in host countries. First, NEMs also depend on forms of contract-based TNC linkages in host economies, such as stable contract laws and commercial contract laws. For example, in franchises (e.g. Beard Papa's and Lao World) and contract farming (e.g. Tokai Tsukemono and its contract farmers), it is important to establish sufficient protection of intellectual property rights.

.../

**Box 2. Factors that will stimulate NEM Operations**

Second, as with FDI, facilitation measures for promoting businesses are very important for attracting NEMs. For example, promotion activities and financial incentives must be applied over a wide scope, such as when investment promotion institutions partner foreign franchisers with promising local companies. Access to capital procurement is also an important factor for regional enterprises that has strong potential for promoting NEM expansion.

TNCs must be given the opportunity to establish footholds from where they can support the growth and expansion of NEM businesses. These footholds can be a minimal commercial presence, such as purchasing and quality management organizations that provide support for outsourced manufacturing or logistics support operations that provide materials to franchise locations, as in the case of retail and quick service restaurant franchises.

The existence of reliable and capable regional enterprises, and the ability to network with them, are among the important factors essential to promote NEM operations. Most NEMs require local partners that are powerful, efficient and capable of taking on risks in complementary but dissimilar operations on behalf of TNCs. For example, if TNCs do not find it economical to produce their own machinery and equipment in integrated circuit assembly operations, their operations in particular locations become more deeply rooted when NEMs emerge to provide such services (Rasiah, 1994). Also, when TNCs do not enter contracts directly with individual farms, agricultural cooperatives can act as intermediaries to reduce business risk and provide reliability (Barrett et al., 2010).

Third, the degree of economic development and its association with social capital within a country are important in the promotion of NEMs. For example, consumer market scale and growth, and access to regional markets are as important to such NEMs as franchises and out-licensing as they are to FDI. Basic infrastructure provision and transport, energy and communication costs are all major areas of interest for both local and foreign companies.

Technological capabilities and the capacity to improve the quality and productivity of regional enterprises are critical to both TNC and NEM operations. Government policies targeted at improving such capabilities in national firms, as well as regulations to stimulate strong corporate social responsibility practices and minimum labour conditions, are also important to stimulate upgrading in TNCs and NEMs. Such initiatives also help expand the pool of NEMs available to network with TNCs. For example, the Malaysian government has introduced a law specifically concerning franchises and has implemented other measures to promote TNC participation in regional economies. For service outsourcing, the government of the Philippines has contributed to the promotion of the information technology and business process outsourcing industry.

Factors such as these have contributed to increasing the overall allure of ASEAN countries as sites for various types of NEMs. Box table 2-1 summarizes the major locational determinants of each mode.

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Box 2. Factors that will stimulate NEM Operations (Concluded)

Box Table 2.1. Locational determinants for FDI and NEMs

Relevant for FDI and NEMs	More relevant for FDI	More relevant for NEMs
<b>Policy framework</b>		
<ul style="list-style-type: none"> <li>• Economic, political and social stability</li> <li>• Competition policy</li> <li>• Trade policy</li> <li>• Tax policy</li> </ul>	<ul style="list-style-type: none"> <li>• Rules regarding entry and operations</li> <li>• Standards of treatment of foreign affiliates</li> <li>• International investment agreements</li> <li>• Privatization policy</li> </ul>	<ul style="list-style-type: none"> <li>• Stable general commercial and contract law</li> <li>• Specific laws governing NEM contractual forms (e.g. recognizing licensing, franchising contracts)</li> <li>• Intellectual property protection</li> </ul>
<b>Business facilitation</b>		
<ul style="list-style-type: none"> <li>• Reduction of hassle costs (e.g. cost of doing business)</li> </ul>	<ul style="list-style-type: none"> <li>• Investment promotion</li> <li>• Investment incentives</li> <li>• Provision of after-care</li> <li>• Provision of social amenities (e.g. quality of life)</li> </ul>	<ul style="list-style-type: none"> <li>• Facilitation efforts aimed at                             <ul style="list-style-type: none"> <li>- upgrading of technological quality, productivity standards of local firms</li> <li>- enterprise development, increasing local entrepreneurial drive, business facilitation</li> <li>- subsidies, fiscal incentives for start-ups</li> <li>- information provision, awareness-building on NEM opportunities with local groups</li> <li>- support for minimum standards of working conditions and CSR in local firms</li> </ul> </li> </ul>
<b>Economic determinants</b>		
<ul style="list-style-type: none"> <li>• Infrastructure</li> <li>• Market size and per capita income</li> <li>• Market growth</li> <li>• Access to regional and global markets</li> <li>• Country-specific consumer preferences</li> <li>• Access to raw materials</li> <li>• Access to low-cost labour</li> <li>• Access to skilled labour</li> <li>• Relative cost and productivity of resources and assets</li> <li>• Other input costs (e.g. transportation, communication, energy)</li> </ul>	<ul style="list-style-type: none"> <li>• Access to strategic assets</li> <li>• Created assets (e.g. technology, intellectual property)</li> <li>• Strategic infrastructure</li> </ul>	<ul style="list-style-type: none"> <li>• Presence of credible local entrepreneurs and business partners</li> <li>• Access to local capital</li> </ul>

Source: AJC.

Regional enterprise technology and quality improvement, active national-level measures aimed at improving productivity and supporting minimum labour conditions, and corporate social responsibility are important to stimulate FDI inflows, but they also increase the pool of potential NEM partners that can work with TNCs. In this respect, the Lao People's Democratic Republic can adapt the franchising laws in a manner similar to the way that the Malaysian and Philippines governments did for information technology (IT)-related industries, which resulted in the development of outsourcing services such as the call centre industry. The factors described above have contributed to increase the overall allure of countries as sites for various types of NEMs. Table 2 summarizes the major locational determinants of each mode.

The Lao People's Democratic Republic is landlocked, between China and Myanmar to the north, Thailand to the west, Viet Nam to the east and Cambodia to the south. However, the Mekong River flows through the country into Cambodia and Viet Nam before reaching the East China Sea. Economic development is still in its infancy as market reforms began only in 1987. The economy was the 121st largest in 2017, according to the International Monetary Fund (IMF 2017), and the country is categorized by the United Nations as a least developed country. The capital city, Vientiane, had a GDP per capita of \$5,052 in 2017, but the GDP per capita in the small town of Phongsaly in the north was a meagre \$874. Consequently, the government has focused on rural development and poverty reduction, spending more than 2 trillion (\$245 million) in 2016 and 2017.<sup>1</sup>

NEMs are expected to play an important role in the government's efforts to eradicate poverty and raise the standard of living. Although NEMs have emerged in all sectors of the economy – primary, secondary and tertiary – the task now is to stimulate their widening and deepening. In manufacturing, for example, machinery and electrical appliances, and textiles accounted for 9 per cent and 6 per cent of the country's exports, respectively, in 2016 (table 1). There were approximately 100 garment companies, exporting goods worth more than \$127 million and employing more than 30,000 workers. Garment manufacturing employed about 1 per cent of the labour force, with women younger than 25 dominating the company workforces.

Despite rapid growth in the secondary and tertiary sectors, the Lao People's Democratic Republic is still very much an agricultural economy, with agriculture accounting for about a quarter of GDP. Coffee is the most important agricultural product, with exports to more than 26 countries, amounting to \$67 million in 2016. Japan (25 per cent) and Belgium (20 per cent) were the main destinations in that year. That said, services has become the strongest and fastest-growing sector in the economy.<sup>2</sup> The government could accelerate the sector's orderly growth by developing basic infrastructure. For example, tourism will grow faster with improved air transport connectivity, retail trade and insurance services.

The next section explains the characteristics and scope of NEMs by type and introduces particular types that are distinctive in the Lao People's Democratic Republic. The following section discusses the opportunities and challenges expected for selected industries in the Lao economy. The paper finishes by drawing out policy implications for the government.

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<sup>1</sup> "Govt spends over 2 trillion kip on rural development", Vientiane Times, June 18, 2018.

<sup>2</sup> Its GDP contribution reached 41 per cent in 2015 (see figure 1).



**Table 2. Common forms of NEMs and examples of typical industries with NEMs in the Lao People's Democratic Republic**

Modality	Description (in the international context)	Typical industries	Company examples
Subcontracting	Agreement whereby a TNC contracts out to a host-country firm one or more aspects of product design, processing or manufacturing. Includes contract manufacturing and design outsourcing in the case of services and business processes.	Electronics	Vientiane Automation Products
		Garments	Yamaki, Santei-Lao
		Medical equipment	MANI
Contract farming/ contract mining	Agreement between a TNC buyer and host-country farmers or miners (including governments) that establishes conditions for the production and marketing of farm or mining products.	Agriculture	<ul style="list-style-type: none"> <li>• Dao Coffee (Dao-Heuang)</li> <li>• Sinouk Coffee (Chang Beer)</li> <li>• Adventure Agriculture</li> <li>• Tokai Tsukemono</li> </ul>
Licensing	Contractual relationship in which a TNC (licensor) grants to a host-country firm (licensee) the right to use an intellectual property (e.g. copyrights, trademarks, patents, industrial design rights, trade secrets) in exchange for a payment (royalty). Includes brand licensing, product licensing and process licensing (cross-licensing, intra-firm licensing).	Finance	<ul style="list-style-type: none"> <li>• Phongsavanh Bank (JCB)</li> <li>• NCC (VMoney)</li> </ul>
		Beverage	Pepsi-Cola (Lao Brewery)
Franchising	Contractual relationship in which a TNC (franchisor) permits a host-country firm (franchisee) to run a specified business modelled on a system developed by the franchisor, in exchange for a fee.	Restaurant	<ul style="list-style-type: none"> <li>• Texas Chicken, Café Amazon</li> <li>• Swensen's Ice Cream</li> <li>• The Pizza Company</li> <li>• Tammour</li> </ul>
		Convenience store	<ul style="list-style-type: none"> <li>• M-point Mart</li> <li>• Jiffy Mart</li> </ul>
		Education	<ul style="list-style-type: none"> <li>• Shichida</li> <li>• KiddyRoo</li> </ul>
Management contracts	Agreement under which operational control of an asset in a host country is vested in a TNC contractor that manages the asset for a fee.	Tourism and hospitality	Lao International Development (IHD)
Other	Concessions, lease agreements, build-operate-transfer arrangements, etc., in the context of public-private partnerships.	Electricity (Nam Ngiep 1 hydropower project)	Kansai Electric Power

Source: AJC.

## 2. CHARACTERISTICS AND SCOPE OF NEMs

The characteristics and scope of the different modalities vary, and hence, it is important to discuss each of them so that efforts to promote them are cognizant of their unique elements. Since NEM modalities have already emerged in a number of sectors in the country, a systematic discussion is provided in this section.

### 2.1 Scale and scope of NEM

It is clearer to explain NEM modalities through comparisons with TNCs' operations. NEMs can be compared with FDI from the perspective of TNCs' motivation. For example, contract farming is motivated by a search for resource-based agricultural outputs. Contract manufacturing and outsourcing or subcontracting are motivated by the desire to improve efficiency by reducing costs. Local characteristics offer NEMs the opportunity to enter into such captive activities. For example, the confinement of land ownership to nationals ensures that either access to such activities is undertaken through a lease from national owners or the farming itself is outsourced to NEMs. Licensing and franchising are motivated by the desire to expand markets. Whereas subcontracting is similar to FDI in that it consists of transferring resources, technology and expertise to contractors in the form of "packages", licensing and management contracts involve little transfer. Table 2 presents the different forms of NEMs that are dominant today. This section discusses the characteristics of the modalities in use in the country: subcontracting, contract farming and franchising.

The degree to which *subcontracting* accounts for overall production varies from industry to industry. The general value added breakdown between internalized operations and subcontracting in the toy, sporting goods, electronics and automotive industries is about 50 per cent. In pharmaceutical products it accounts for less than 50 per cent of the value added.

In Asia, subcontracting has grown significantly in the electronics, machine tool and automotive industries since the 1980s, as competition has driven firms to seek cheaper options by taking advantage of opportunities presented by NEMs in rapidly industrializing countries, such as Taiwan Province of China, China, Malaysia, Indonesia, Thailand, the Philippines and Viet Nam. Major electronics and automotive companies have dedicated themselves to research and development, product design and brand management, using electronics manufacturing services and cellular manufacturing to outsource component manufacturing. Of the top 10 electronics manufacturing services companies, seven are headquartered in East Asia. Some suppliers, such as Celestica, Flextronics, Foxconn, Astra-Honda, Astra-Toyota and Ingress, evolved to undertake component design so as to create a modular value chain (Sturgeon, 2002; Rasiah, 2004).

The use of subcontracting also has expanded into labour-intensive industries, such as the apparel, footwear and toy industries. From simple cut, make and trim (CMT) operations, subcontractors connected to clothing value chains have evolved to become intermediaries that handle a large section of the stages involved in the value chain – e.g. manufacturing and logistics throughout Africa, Asia and Latin America (Rasiah, 2007, 2012; UNCTAD, 2011).

Lao garment manufacturers participate in international subcontracting as subcontractors. Done Garment Factory, International Garments and Kianvilay Garments are local garment manufacturers that produce jackets and export to European markets. Foreign companies operating in the Lao People's Democratic Republic, such as Yamaki and Santei-Lao (both Japanese), are involved in subcontracting for foreign apparel makers.

Although the garment industry is the major industry in which NEM operations have emerged, they are also emerging in industries such as machinery and electronics, though still in the early stages. For example, an electronic wire harness assembler, Vientiane Automation Products, and a Japanese medical device manufacturer, MANI, have established subcontracting links.

Important developments are taking place in the country. The construction of SEZs and the implementation of the “Thailand Plus One” corporate strategy by Japanese companies have attracted foreign electronics manufacturing companies to relocate, using NEMs in manufacturing operations to complement those companies’ operations in Thailand. Electronic manufacturing companies, such as Daiichi Denshi (Japan), MMC Electronics Lao (Japan) and Jui-Fang Electronics (Taiwan Province of China) relocated their production operations to the Vientiane Industry Trade Area (VITA) park in 2012, 2014 and 2016, respectively. The relationship between Thai Yazaki and Vientiane Automation Products (VAP), which is explained in box 3, is an example of the Thailand Plus One initiative in the manufacturing of electronic wire harnesses.

Partly through international cooperation,<sup>3</sup> the Lao People’s Democratic Republic has been developing its human resources to strengthen local firms’ participation in GVCs, in contract farming, franchising and licensing.

*Contract farming* spanning international borders has evolved since colonial times. The nature of control has experienced considerable changes. From chain controllers with brand names, such as Chiquita and Del Monte, supermarkets have taken control of several agricultural value chains. For example, bananas, mangoes, rice and vegetables are now farmed by NEMs using supermarket brand names such as Tesco, Albert Hein and Giant. TNCs were already involved in contract farming in more than 110 developing countries as of 2010 and are involved in a diverse range of agricultural products (UNCTAD, 2011).

Contract agriculture is a tool for the efficient procurement of agricultural products because it makes it possible for TNCs to secure the necessary quantity and quality of products, farmed in arguably some of the best locations, at competitive prices. Farmers can also secure stable sales and improve their income, though they are often faced with pressures to reduce costs. TNCs demand high quality from contract farmers, who try to meet that demand because they can sell at prices higher than the price of shipping to the domestic market. In addition, the most sophisticated buyer TNCs offer farmers new technology and food sanitation procedures, raising the quality of farming and preparation by NEM farmers, including connecting them with new information from buyer TNCs.

Contract farming can offer large employment opportunities for small-scale farmers and harvesters. In 2018 Dao Coffee, which operates from Champasak, reported drawing on 1,000 families as coffee farmers to produce Arabica and Robusta coffee for export.<sup>4</sup> This employment has a reasonable impact in terms of reducing poverty. Although the total number of contract farms is hard to identify, individual projects can have several tens of thousands of participating farms. Such participation is emerging but limited to certain products (e.g. cucumbers for Tokai Tsukemono of Japan<sup>5</sup>; coffee for the TCC Group for export to Japan<sup>6</sup>).

<sup>3</sup> For example, at the request of the Lao government, since 2010 the Japanese government has implemented the project “Capacity Development of Business Persons through the Laos-Japan Human Resource Development Institute” in order to train business managers.

<sup>4</sup> Interview with the general manager and factor manager conducted on 26 July 2018.

<sup>5</sup> Tokai Tsukemono, a Japanese pickle maker which established a local subsidiary, has contracted out cucumber supply to contract farmers. The processed cucumbers are exported to Japan and marketed under the house brand as “Kyuri-no-kyuchan”, or Japanese pickles.

<sup>6</sup> TCC Group, which is a Thai conglomerate, has a 2,400 ha contract farm in the Bolaven Plateau. The company started growing coffee there in 2009. More than 70 per cent of the harvested coffee is exported to Japan through trading companies.

*Franchising* is a well-known business mode through which franchise holders contract out their established brand, including the technology, for a fee. In addition, they undertake the marketing of the brand. In return franchisees meet all the conditions imposed by the franchiser. Using this modality, franchisers can not only expand operations rapidly and efficiently, but also procure capital. This contract mode is common in the retail industry, including high street retail and goods stores, as well as in restaurants, hotels, business services and education. Examples include Pizza Hut and Caffè Bene. Crown Plaza and Summerset are examples of NEM hotels.

In addition to absorbing operations requirements, franchisees are also often exposed to ongoing support, training, management guidance, marketing and advice on administration and human resources. After gaining sufficient experience, a number of hotels have broken out from such franchising contracts to use their own brand names.

Licensing is the process of transferring the rights of a firm's products and services to the subcontractor for further production or sale. In exchange for a payment (royalty), the licensor allows the licensee to use an intellectual property (e.g. copyrights, trademarks, patents, industrial design rights, trade secrets) to access markets covered by the licensee. The international expansion of pharmaceuticals, consumer goods and electronics has often been based on licensing of contracts.

Examples of licensing contracts in operation in the country include Pepsi-Cola, the carbonated soft drink, which is manufactured by Lao Brewery Company Ltd under a licence agreement. In services, New Concept Consulting provides mobile lotto and e-gaming services, which it obtains through a licence agreement to use the VMoney platform for customers' online payment, and Japanese credit card company JCB has granted a license to Phongsavanh Bank to issue a JCB-brand credit card in the country.<sup>7</sup>



The analysis of NEMs is complex, since the web of directly owned, partially owned, contract-based and arm's-length forms of international operation of TNCs are entangled with overlapping operations, so that some of the distinctions between modes are blurred (UNCTAD, 2011). Thus, in this series of papers we limit the analysis to a select number of industries in which NEMs are important. This is especially necessary in the Lao People's Democratic Republic, where NEMs have expanded mainly since 2012, when the country's first SEZ opened in Vientiane and foreign investments and companies relocated there. The Thailand Plus One initiative has acted as a strong pull factor for Japanese companies in the machinery and electronics manufacturing industries.

NEMs have also been expanding in the country since the economy started to integrate into ASEAN, as well as since the formation of the ASEAN Economic Community in 2015, which has created strong opportunities for local firms to connect into TNCs' regional value chains. NEM operations identified for close assessment in this paper are summarized in table 3.

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<sup>7</sup> JCB website: <https://www.global.jcb/en/press/20121116153000.html>.

Table 3. NEM operations in major sectors, 2016

Sector	Primary		Secondary		Tertiary		
	Industry example	Coffee	Corn	Garment	Electrical machinery	Convenience store	Hotel
Product or service		Green coffee bean (Robusta coffee)	Livestock feed	Apparel	Trigger switch Car speaker Wire harness	Small retail business	Welcome, comfort, quality, trust and safety services
Number of companies (NEM-related estimation)	Lao Coffee Association (39 traders, 6 roasters, 5 producer groups) [Coffee producers for Thai companies are NEM]	More than 500 contract farmers for Laos Agro Industries [Corn producers for Thai, Vietnamese and Chinese companies are NEM]	116 factories (57 factories for export; 28 for both export and domestic; and 31 produces garment parts) [Most export products are NEM]	No specific associations [Most export products are NEM]	45 M-Point Mart Outlet, 21 Jiffy in PTT petrol station [M-Point and Jiffy are Thai convenience stores]	545 hotels and 1,982 guesthouses [3 major international hotel chains]	
Major companies (local partner/main franchisee)	Dao Coffee (Dao-Heuang Group) Sinouk Coffee (Chang Beer Group/Thai) TCC Group (Thai)	Laos Agro Industries Friend of the Upland Farmer	Yamaki Santei-Lao	Vientiane Automation Products	M-Point Mart (Big C) Jiffy (PTT-LDC)	Crown Plaza Amani Summerset	
Estimated export volume/Estimated export by NEMs)	23,659 tonnes \$67 million (\$7 million)	170,047 tonnes \$29 million (\$3 million)	\$165 million (\$132 million)	\$342 million (\$274 million) (\$666 million import)	\$6.7 billion [household final consumption expenditure]**	\$570 million travel and tourism	
Modality	<b>Contract farming/growing</b>	<b>Subcontracting</b>	<b>Franchising, licensing</b>	<b>Licensing, management contract</b>			
Number employed	123 producer groups in 7 districts (40,000) [Small and medium-size farmers make up about 80% of all coffee producers]	187,300 growers*	27,000 workers	10,000 to 15,000 workers	1,000 to 1,500	Over 167,800 (hotels and restaurants)	
Average export growth	15% increase from 2015	46% decrease from 2015	5% decrease from 2015	336% growth from 2012	Approximately 7% annual economic growth	47% growth in international tourism consumption from 2012 to 2016. Thailand is a dominant foreign value added contributor.	
Market/trade scale	Japan 23% Belgium 17% Germany 10%	Viet Nam 58% Thailand 41%	EU 85% Japan 6% United States 3%	Thailand 95% Viet Nam 2% Japan 1%	Thai capital convenience stores are dominant	Thailand 47% Viet Nam 23% China 12% Republic of Korea 4%	
Product/service scope	Planned production of 120,000 tonnes in 2020 and 280,000 tonnes in 2025	Planned production of 1.3 million tonnes in 2020 and 1.4 million tonnes in 2025. China will become a new market.	EU has stable demand, but some Japanese companies have interest in transferring their factories from China.	Thailand Plus One production More manufacturing production at SEZs	More international convenience chains have opportunities to enter.	More international hotel chains have room to enter local resorts.	

Source: AJC.

Note: Selected industries only; 2016 data unless noted.

\* 2010/2011 census.

\*\* Lao Expenditure and Consumption Survey 2012/13.

As discussed earlier, several examples of NEM exporters are found in the country. In the primary sector, coffee, rice and corn are produced and exported through contract farming and growing.<sup>8</sup> These farms are operated and managed by cooperatives of coffee-exporting companies affiliated with major local (e.g. Dao-Heuang Group) and Thai (e.g. TCC Group) companies.

Coffee and corn are major agricultural exports that play a vital role in employment, income generation and contribution to GDP, as well as in export for foreign currency earnings. Although most of these exports are undertaken directly by Lao farms, some are carried out through NEM modes. Japan is the largest destination for Lao coffee exports, worth \$16 million or 23 per cent of total coffee exports in 2016,<sup>9</sup> and some of these exports are through NEMs.<sup>10</sup> China is the largest destination for Lao corn exports, with 55 per cent of total corn exports in 2016.

In the secondary sector, the garment industry has been playing a major role in driving Lao exports and TNC subsidiaries since the country was opened to foreign investment. It fell to second place among industrial exports from the country in 2016 (table 1). As a major dollar earner, the industry accounted for 6 per cent of total exports (\$165 million) in 2016, with an estimated \$132 million of that (80 per cent) the share of NEMs. The Association of the Lao Garment Industry had 100 members in 2017, with 57 of them having export operations, mainly to the EU market.

Machinery and electrical appliances have grown rapidly to account for 9 per cent of exports in 2016 (table 1), overtaking garment exports. This expansion is largely a consequence of Japan's Thailand Plus One initiative, with production linkages between the Lao People's Democratic Republic and Thailand following the opening of SEZs in the former. Although machinery and electrical appliances still experienced a trade deficit between imports and exports, the export volume of electrical machinery from the country increased by 12.7 times between 2013 and 2016 to a record \$342 million. This expansion was partly due to relocations to the country by Japanese electrical machinery manufacturers, such as Nikon and DD-Lao. Under the Thailand Plus One business model, these electrical machinery companies operating in industrial clusters in Thailand transfer the labour-intensive parts of their production processes to firms located in SEZs in neighbouring countries, including the Lao People's Democratic Republic (Oizumi, 2013).

In services, the country is no exception to the global trend of rapid growth in IT services. The provision of various support services by ASEAN neighbours has already resulted in greater IT connectivity in the country. IT is expected to be a major focal industry for the growth of NEMs, which will not only stimulate the economic contribution of the industry to the national economy, but also, through its complementary support of other industries, stimulate dynamically the expansion of all industries.<sup>11</sup> As the IT industry develops, local firms must take note that the industry is more mature in neighbouring ASEAN countries. Hence, Lao NEMs face much competition if they are to develop enough to catch up in the IT value chain.

Tourism is another major revenue earner in the Lao People's Democratic Republic. According to the World Travel & Tourism Council (WTTC), in 2016 the direct contribution of travel and tourism to GDP in the country amounted to \$570 million, which accounted for 4.3 per cent of GDP. The industry also generated 397,500 jobs in 2016, which accounted for 2.4 per cent of total employment. Among the industry's contributions, hotels – and international hotel chains in particular – can best contribute to NEM operations through contract management.

<sup>8</sup> Coffee is by far the most lucrative item produced through contract farming in the country.

<sup>9</sup> UNCOM Trade.

<sup>10</sup> Coffee products produced by the TCC Group.

<sup>11</sup> See Rasiah and Oyeyinka (2005) for a lucid account of increasing returns generated by the IT industry.

In the extractives sector, copper and gold mining offer strong opportunities for the growth of NEMs as they are major exports, with gold accounting for 4 per cent of exports in 2016. TNCs dominate the mining of gold and copper. The Lao government should promote NEMs in smelting and downstream products, including jewellery.

## 2.2 NEM by modality: case studies

To understand better the operations of NEMs in the country, cases that have evolved successfully are reviewed here. A number of these NEMs are well integrated into TNC value chains.

### (1) Subcontracting: Garments

Clothing industries played a significant role in export-oriented industrialization in East Asia's early phase of rapid economic growth (Rasiah, 2012). Three of the Asian Tigers or Asian Dragons – Hong Kong (China), Taiwan Province of China and the Republic of Korea – benefited from massive garment exports from the 1960s until the early 1980s. They were accompanied later by ASEAN members Indonesia, Malaysia, Thailand and the Philippines, all of which benefited from the relocation of firms from the Asian Tigers and Japan. Since the turn of the millennium, two major developments have transformed trade in garments. First, China extended its grip on global garment exports – to about 40 per cent by 2010 – thereby reducing the space available for other countries (WTO, 2015). Second, the World Trade Organization (WTO) offered least developed countries, such as the Lao People's Democratic Republic, preferential access to major markets following the scrapping of the Multi-Fibre Arrangement in 2004 (Rasiah, 2012).

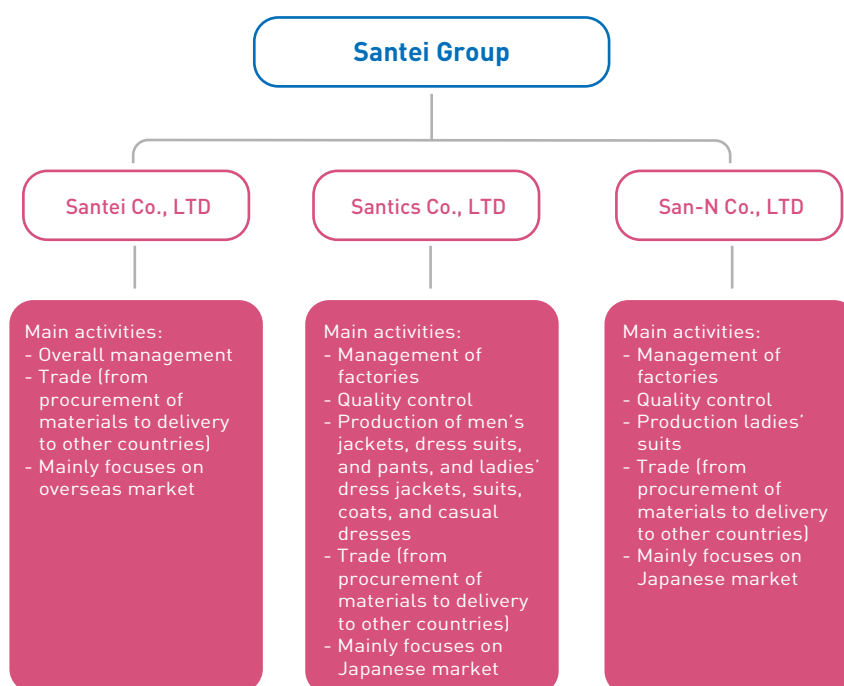
As in Viet Nam and Myanmar, the garment industry is dominated by CMT operations. In this form of contract work, a foreign buyer with the necessary financial and technical abilities pays contracting fees to a garment factory to perform the labour-intensive task of cutting fabric, sewing garments together according to design specifications and packing finished garments for export to international markets. The contractor handles the purchases of inputs, provides the subcontractor with the specifications to use to manufacture and buys the output, which it then supplies to major international buyers. The NEMs in such operations enjoy little value added until they begin upgrading in the garment value chain. Garment exports from the Lao People's Democratic Republic began in the middle of the 1990s. However, following a peak of \$219 million in 2011, exports have been falling due to labour shortages and a lack of upgrading.<sup>12</sup> On the basis of estimations by the Lao Garment Industry Association, NEMs account for about 80 per cent of Lao garment exports.

Although garment exports have gradually declined since 2010, the Lao government has actively promoted FDI inflows into the industry, especially in SEZs. In addition to low taxes, firms relocating to the country have also been allowed to lease land for setting up factories as well as access to power and other basic amenities. Hence, foreign firms are increasingly attracted to establish linkages with Lao NEMs. Santei-Lao is one beneficiary of such developments (box 3).

<sup>12</sup> Xaybandith Rasphone, chairman of the Association of the Lao Garment Industry, stated in the general meeting that labour shortages are a chronic issue for the industry that leads to decrease in export (The Nation, March 30, 2017).

**Box 3. Santei Group and Santei-Lao****Santei Group**

Established in 1963, Santei has evolved as a major maker of men's and women's apparel, expanding its production network internationally to several countries, including China, Viet Nam and the Lao People's Democratic Republic, following the rapid growth of mass retailing. In the 1980s, while still in its growth phase, the company decided to set up operations overseas. In China, Santei established a joint venture to produce men's suits in Hubei in 1985 followed by one in Shanghai in 1987, in Jiangsu in 1988 and in Zhejiang in 1991. In Viet Nam it did the same in Ho Chi Minh City in 1991. In 2008 Santei established Santei-Lao in Vientiane in order to diversify its country risk. Currently, with 630 workers, Santei-Lao produces 240,000 pieces of formal wear for men and women and 100,000 men's trousers annually in three factories in Vientiane (box figure 3-1).

**Box figure 3.1. Business model of Santei Group**

Source: Based on Santei Group report.

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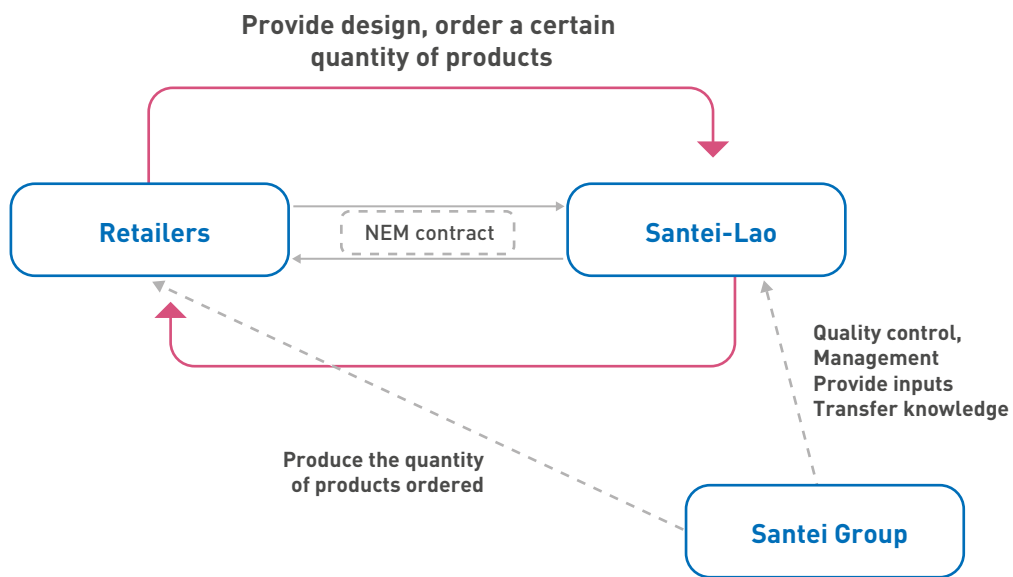


Box 3. Santei Group and Santei-Lao (Concluded)

**Santei-Lao**

Santei-Lao, which is a subsidiary of the Santei Group, is a joint venture between Japanese apparel maker Santei and a Lao investor. It manufactures men's and women's suits, jackets and coats under the extensive use of NEM contracts with Japanese apparel retailers.

Box figure 3.2. **NEM contracts between Santei-Lao and retailers**



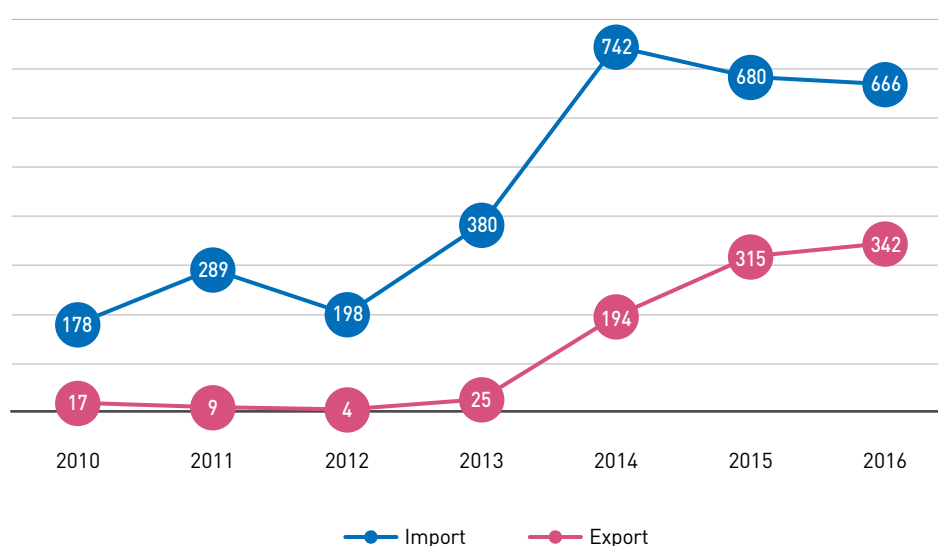
Source: Based on Santei Group report.

The relocation to the Lao People's Democratic Republic follows from the Santei Group's strategy to avoid the risks of overconcentration in China by using alternative locations to achieve complementary synergies: whereas Santei's China factories produce clothes that are in fashion, Santei-Lao produces clothes that are not much affected by trends. By producing low value added clothes in the Lao People's Democratic Republic, Santei-Lao can take advantage of the lower production costs that the country offers through its lower tax rate, lower wages and special financial incentives.

## (2) Subcontracting: Electrical Machinery and Equipment

Electrical machinery and equipment exports have grown rapidly, becoming the leading manufactured export in 2016. Much of this expansion has been due to the opening of SEZs, which have benefited from the Thailand Plus One initiative. The Lao government aimed to build 25 SEZs to create job opportunities for 50,000 people by the end of 2020.<sup>13</sup> Export manufacturers in electronics and related industries tend to operate in SEZs. With the establishment of more export processing zones and industrial estates, more foreign companies have entered the country. In electronics-related industries, export growth has continued to increase dramatically since 2014, and the import surplus in this industry has been decreasing (figure 2).

Figure 2. **Change in import and export amounts in HS (Harmonized Commodity Description Coding System) code 85 (electrical machinery and equipment and parts thereof), 2010–2016** (Millions of dollars)



Source: UN Comtrade.

<sup>13</sup> As of May 2018, there were 14 SEZs in the country. [https://www.asean.or.jp/ja/invest/country\\_info/laos/industrialestate/](https://www.asean.or.jp/ja/invest/country_info/laos/industrialestate/)

### ***NEMs in electrical machinery and equipment***

In the electrical machinery and equipment industry, Japanese companies are particularly visible, producing a wide range of products from wire harnesses to temperature sensors, charging resistors and coils through linkages with NEMs in SEZs. Daiichi Denshi, MMC Electronics, Lao Stanley, Asahi-Maxima (Lao), Tokyo Coil Engineering Lao and Nikon Lao are engaged in NEM linkages (table 4).

These companies moved to the Lao People's Democratic Republic in order to enhance their production efficiency and reduce costs. As in the linking of VAP with Thai Yazaki (box figure 3.2), Nikon Lao fulfils a complementary function for manufacturing processes in Thailand. These examples illustrate the Thailand Plus One model, in which Japanese companies operating in industrial clusters in Thailand relocate the labour-intensive parts of their production processes to SEZs near the borders with Thailand (Oizumi, 2013). Nikon Lao, located in the SEZ in Savannakhet Province at the border with Thailand and Viet Nam, produces DSLR camera parts that are shipped to Thailand for assembly into finished cameras at the Nikon factory in Rojana Industrial Park near Ayutthaya (Somphet, 2018).

**Table 4. Japanese electrical and electronics-related companies in the country**

<b>Company Name</b>	<b>Started</b>	<b>Location</b>	<b>Product</b>	<b>Mode</b>	<b>Subsidiary of</b>
Daiichi Denshi	2012	Vientiane (VITA Park)	Wire harnesses	Subcontracting	Daiichi Denshi Hong Kong
MMC Electronics	2014	Vientiane (VITA Park)	Temperature sensors	Subcontracting	Mitsubishi Materials
Lao Stanley	2004	Vientiane	Electronic applied products	Subcontracting	Thai Stanley
Asahi-Maxima (LAO)	2013	Vientiane	Resistors, coil	Subcontracting	JP Thai Asahi Electronics
Tokyo Coil Engineering Lao	1999	Vientiane	Coils	Subcontracting	Tokyo Coil Engineering
Nikon Lao	2013	Savannakhet (Savan-Seno SEZ)	Interchangeable lenses for cameras	Complementation of manufacturing process in Nikon Thailand	Nikon

Source: AJC.

### **(3) Subcontracting: Machinery parts and soccer balls**

Machinery and electrical appliances exports rose sharply to become the leading manufactured export in 2016. Although the Lao People's Democratic Republic has a small market, incentives and available land have made the country an attractive complementary location for suppliers that produce for bigger firms in Thailand. Manufacturers of other products, such as soccer balls, have established similar NEM-TNC linkages. Following are examples of such NEM operations.

#### ***Vientiane Automation Parts***

The Vientiane Electrical Engineering Company (VEEC) Group, founded in 2002, has a few NEM subsidiaries in the country (box 4). One of them, VAP, produces wire harnesses with technical assistance from Yazaki Thailand. VAP's assembled products are sent to Yazaki Thailand for inspection. VAP thus completes a part of the production process that is entrusted to Yazaki Thailand (box figure 4-2).

**Vientiane Equipment Factory**

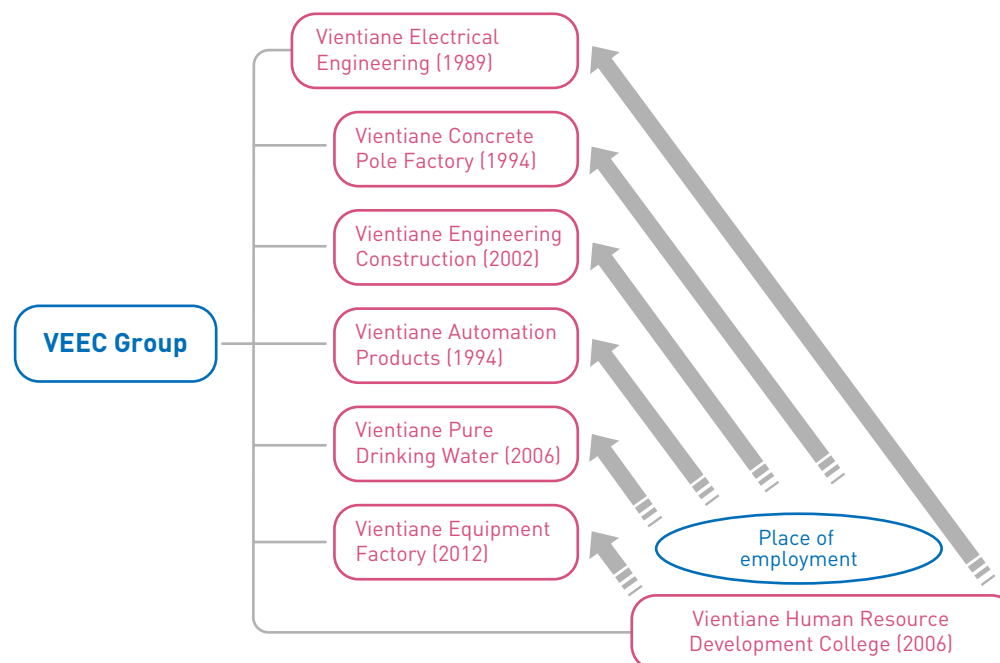
Vientiane Equipment Factory (VEF), founded in 2012, which is a subsidiary of VEEC (box 3), manufactures 70,000 footballs annually, with technical assistance from its buyer, Molten (box figure 4-3).

Recognizing the importance of skills development, the president of the VEEC Group, Bountheo Phommaseisy, has maintained a strong focus on employee training and vocational education. Consequently, VEEC Group opened in 2006 the Vientiane Human Resource Development College, which offers a three-year program with evening classes covering four courses: management, English, information technology and electronics. About 200 students study at the college, and many graduates are expected to work at the VEEC Group.

**Box 4. The VEEC Group**

The VEEC Group, founded in 2002, is made up of seven companies, which have more than 650 employees in total. The firm mainly specializes in the installation and construction of energy transmission and distribution facilities, electrical power plants and airports.

Box figure 4.1. **The structure of VEEC Group**

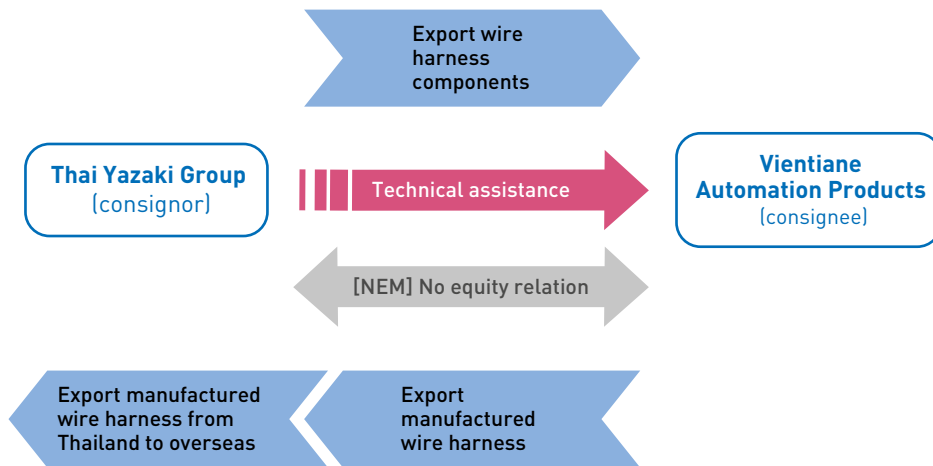


Source: Laos 100 Business Leaders (JETRO) and related materials (AJC).

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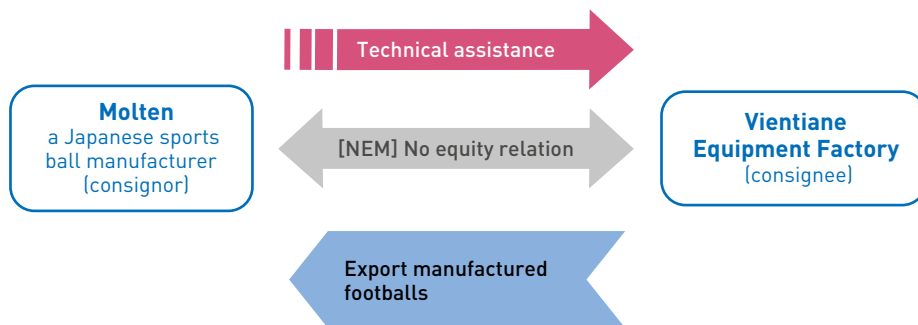
Box 4. The VEEC Group (Concluded)

Box figure 4.2. The relationship between Thai Yazaki and Vientiane Automation Products



Source: AJC.

Box figure 4.3. The relationship between Molten and Vientiane Equipment Factory



Source: AJC.

#### (4) Contract Agriculture: Farming

The prohibition of foreign ownership of land in the country has offered local farmers and land owners the opportunity to start NEMs to either lease the land for foreign cultivation or cultivate the land under contracts to supply farm products. Coffee and corn have become important platforms for contract farming, which has been assisted by the European tariff concession called Everything But Arms. The same arrangement has spread to contracting of agro-processing of fruits and jams (UNIDO, 2009). Vegetable and animal products accounted for 15 per cent of exports in 2016 (table 1). Coffee is by far the chief agricultural export. Examples of NEMs for coffee production include the Coffee Producers Cooperative (CPC) (discussed here), as well as the Thai-controlled CPC and the locally controlled Dao-Heuang.

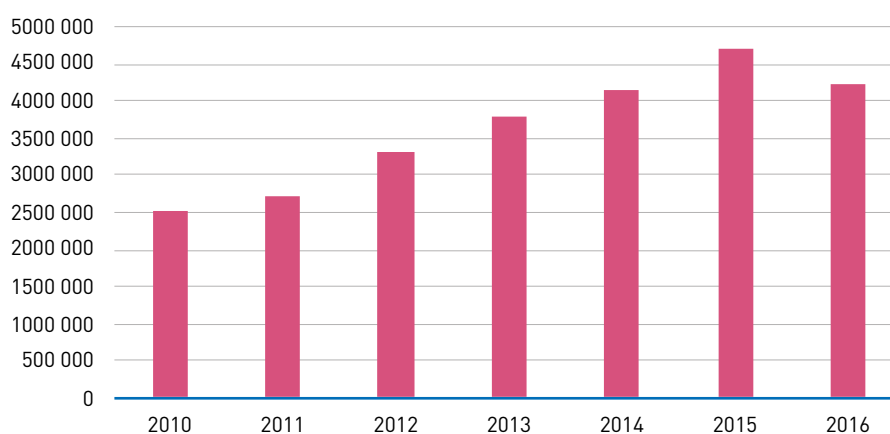
##### *Coffee Producers Cooperative*

The hilly highlands and two-season (wet and dry) climate dominating the southern province of Champasak have made it attractive for coffee farming, especially in the Bolaven Plateau. Founded in 2007 by the government, the CPC draws on 1,855 families in 55 villages who farm coffee (Lao, 2018). The successful harvesting of high-quality Arabica and Robusta coffee resulted in the cooperative raising exports of green coffee from 633 tons in 2012 to 1,000 tons in 2017. Each family handles on average about three hectares of the coffee farm. In fact, CPC coffee competes well with some of the best coffee in the world, though a glut in the market in July 2018 has resulted in the shifting of market destinations recently. The Asian Development Bank helped finance the construction of a training centre for the cooperative. The consistent production of high-quality green coffee has led the CPC to register intellectual property rights for its geographical indication with the WTO.

#### (5) Licensing and Management Contracts: Hotels

The Lao People's Democratic Republic has managed to attract tourists from all over the world. The number of foreign visitors has grown steadily (figure 3), especially after 2013, when the country was nominated as the World's Best Tourist Destination by the European Council on Tourism and Trade. Table 5 shows the number of hotels, guesthouses and rooms by province.

Figure 3. Number of tourist arrivals, 2010–2016



Source: Ministry of Information, Culture and Tourism.

Table 5. Number of hotels and guesthouses, and rooms, by province, 2016

Province	Number of hotels	Number of rooms	Major place
Attapeu	58	930	Attapeu
Bokeo	80	1 273	Ban Houayxay
Bolikhamxay	120	2 248	Pakxan
Champasak	224	3 788	Pakse
Houaphanh	67	877	Xam Neua
Khammouane	127	1 960	Thakhek
Luang Namtha	98	1 614	Luang Namtha
Luang Prabang	297	4 844	Luang Prabang
Oudomxay	101	1 764	Muang Xay
Phongsaly	64	720	Phongsali
Saravane	47	373	Saravane
Savannakhet	204	4 512	Savannakhet
Sakong	40	456	Sekong
Vientiane Capital	429	12 704	Vientiane
Vientiane Province	269	4 321	Muang Phon-Hong
Xaisomboun	38	336	Anouvong District
Xaiyabouli	150	1 846	Xaiyabouli
Xieng Khouang	114	1 947	Phonsavan
<b>Total</b>	<b>2 527</b>	<b>46 513</b>	

Source: Ministry of Information, Culture and Tourism.

In 2017, the government stepped up the promotion of Visit Laos Year campaign, aiming to reverse a decline in tourist arrivals in 2016 (figure 3). It laid out an ambitious goal of attracting 5.2 million tourists, with projected revenues of approximately \$910 million. Considering the current tourism infrastructure, especially the quality of the hotels and local airports, the target seems too ambitious. The WTTC reported that tourism contributed 14.2 per cent of the country's GDP in 2016, and it is forecasted to rise by 5.5 per cent per year to 13.4 per cent of GDP (\$3.4 billion) in 2027. This has led to the country being ranked 51st in the world in terms of long-term growth in tourism (forecast 2017-27).

A total of \$550 million of capital investment went to the development of hotel and tourism-related commercial complexes in 2016. That investment is expected to rise by 5.1 per cent per year to \$976 million in 2027. Among the developments are a Hilton and an InterContinental hotel (table 6).

The hotel industry has several appendage industries, such as online booking services, restaurant services, food and beverage services, linen services, and furniture and decoration industries, as well as transport services and tourism businesses. These linkages contribute to employment creation and industry development in the country,<sup>14</sup> which is why tourism has been identified as one of the priority sectors for development in many provinces: e.g., Vientiane, Luang Prabang and Champasak. Locations of most branded hotels are generally concentrated in Vientiane and Luang Prabang, where they cater to commercial demand and government requirements. International hotels have begun to

<sup>14</sup> According to the WTTC (2017), travel and tourism generated 118,000 jobs in 2016, while the total contribution to employment (including indirect effects) was 397,500 jobs.

operate in leisure destinations but these markets have been opened only recently and are not very well known among foreign travellers. The hotel industry has contributed strongly to employment and rural development because of its labour-intensiveness and its community-based activities.

**Table 6. Foreign investors opening international hotels (since 2014)**

Hotel brand	Hotel name	Opening year	Local partner
InterContinental	InterContinental Vientiane	2021	Lao International Development
Hilton	Double Tree by Hilton	2020	TPD Company Limited (TK Group)
InterContinental	Holiday Inn & Suites Vientiane	2019	BIM Group
Amari	Amari Vang Vieng	2018	Onyx Hospitality Group
Viet Nameese	Muong Thanh Luxury Vientiane	2018	Muong Thanh Group
InterContinental	Crowne Plaza Vientiane	2017	BIM Group
The Ascot	Summerset Vientiane	2014	LCD Global Investments (Singapore)

Source: AJC.

One of the most critical factors affecting TNCs' decision to choose NEMs in the Lao People's Democratic Republic is local regulations, which de facto favour NEMs over FDI. Hotel management and operations are constrained by land ownership limitations, thereby forcing foreign investors to take up management contracts, seek franchising or undertake long-term leases of land. However, even if the tourism growth ranking rises from 119th in 2017 to 51st by 2027 (WTTC, 2017), the country will still be far behind Thailand, Singapore and Malaysia, which ranked 4th, 21st and 22nd, respectively. Because the hotel industry in the country has the potential to grow further, the government must promote the involvement of foreign companies to stimulate FDI and NEM operations.

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As in other countries, international hotels in the Lao People's Democratic Republic are operated using different types of contracts and entry modes (table 7). Since the government does not allow foreigners to own private land, international hotels are operated either by NEMs through management contracts or franchise agreements, or through long-term lease of land in which hotels can be built with equity investments.

**Table 7. Hotel operations, by type**

Mode	FDI	Management contract	Franchise agreement
Example	Amari Vang Vieng	Crowne Plaza	Somerset Vientiane
Ownership of the land and hotel	Owns hotels	Without ownership	Without ownership
Management control	Direct control	Direct leadership by expatriates from headquarters	Management training through manuals
Contract fees	Not applicable	Higher (10% or more of profit)	Lower (less than 10% of profit)
Scale and speed of growth	Slow, smaller scale	Faster, medium scale	Very fast, larger scale
Hotel class	5-star hotel, independent hotel	4-star class	3-star class

AJC, based on Shinomiya (2016).



**Box 5. Construction boom in international hotels**

The hotel industry is one of the most important sectors contributing to the expansion of tourism in the Lao People’s Democratic Republic. According to the Ministry of Information, Culture and Tourism, the number of establishments has expanded constantly, with an average annual growth rate of 8 to 9 per cent. There are 2,527 establishments (545 hotels, 1,982 guesthouses) and 2,969 restaurants, which employ more than 167,800 people.

The country was recognized as the World’s Best Tourist Destination for 2013 by the European Council on Tourism and Trade. The government regards tourism as a priority sector for driving socioeconomic development this year is designated as “Visit Laos Year 2018”.

With the constant increase in foreign travellers, the country has begun to see the construction of international hotels. InterContinental Hotels Group (IHG) opened the Crown Plaza Vientiane in 2017. The hotel had a total investment of \$78 million, and IHG had a management agreement with the developer, BIM Group, a Vietnamese conglomerate. IHG proactively seeks to enter the Lao market, considering that “the country is well its own way to becoming one of the region’s busiest business and tourist destinations”.<sup>15</sup> IHG has announced that the openings of the Holiday Inn & Suites Vientiane in 2019 and the InterContinental Vientiane in 2021.

In general, IHG operates its hotels under three models (box table 5.1): a franchise model, a management model, and an ownership and lease model.

**Box Table 5.1. IHG’s operation models**

	<b>Franchise</b>	<b>Management</b>	<b>Ownership and Leased</b>
Ownership	Third party	Third party	IHG
Employees	Third party	IHG and third party	IHG

Source: IHG investor relations report, 2018.

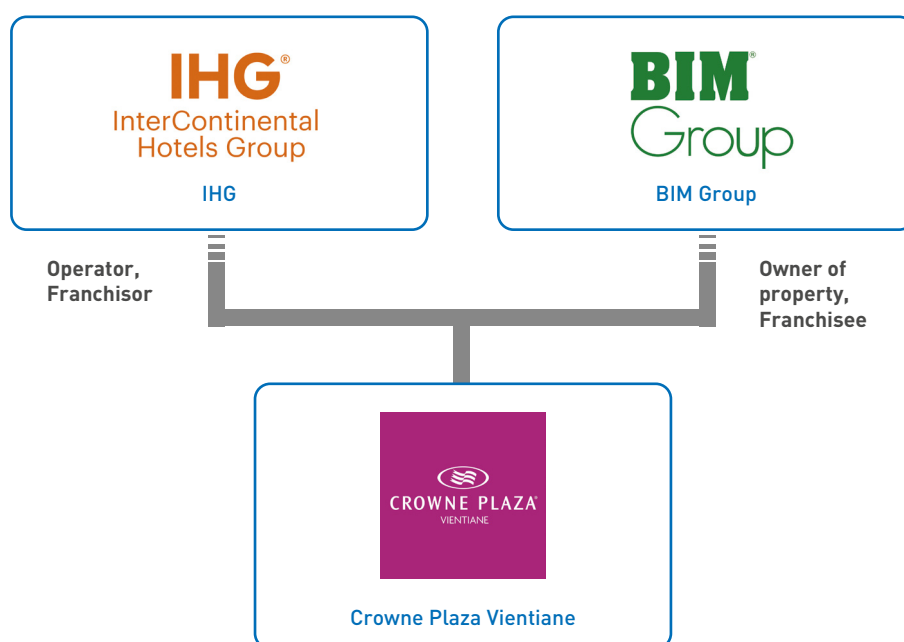
According to publicly available information retrieved from IHG’s website, the Crowne Plaza Vientiane is run by IHG under a mix of a franchise and a management model.

.../

<sup>15</sup> Leanne Harwood, Vice President, Operations, ING, South-East Asia & Korea <https://www.ihgplc.com/news-and-media/news-releases/2016/ihg-to-launch-intercontinental-brand-in-laos>

## Box 5. Construction boom in international hotels (Concluded)

Box figure 5.1. Management agreement between IHG and BIM group



Source: IHG annual report.

The possible fee system, services provided, term and renewal of the cooperation between IHG Group and BIM Group described here are based on IHG's investor relations report for 2018 and other relevant documents (box table 5.2).

Box Table 5.2. Possible fee system for a mixed business model, responsibilities, term and renewal

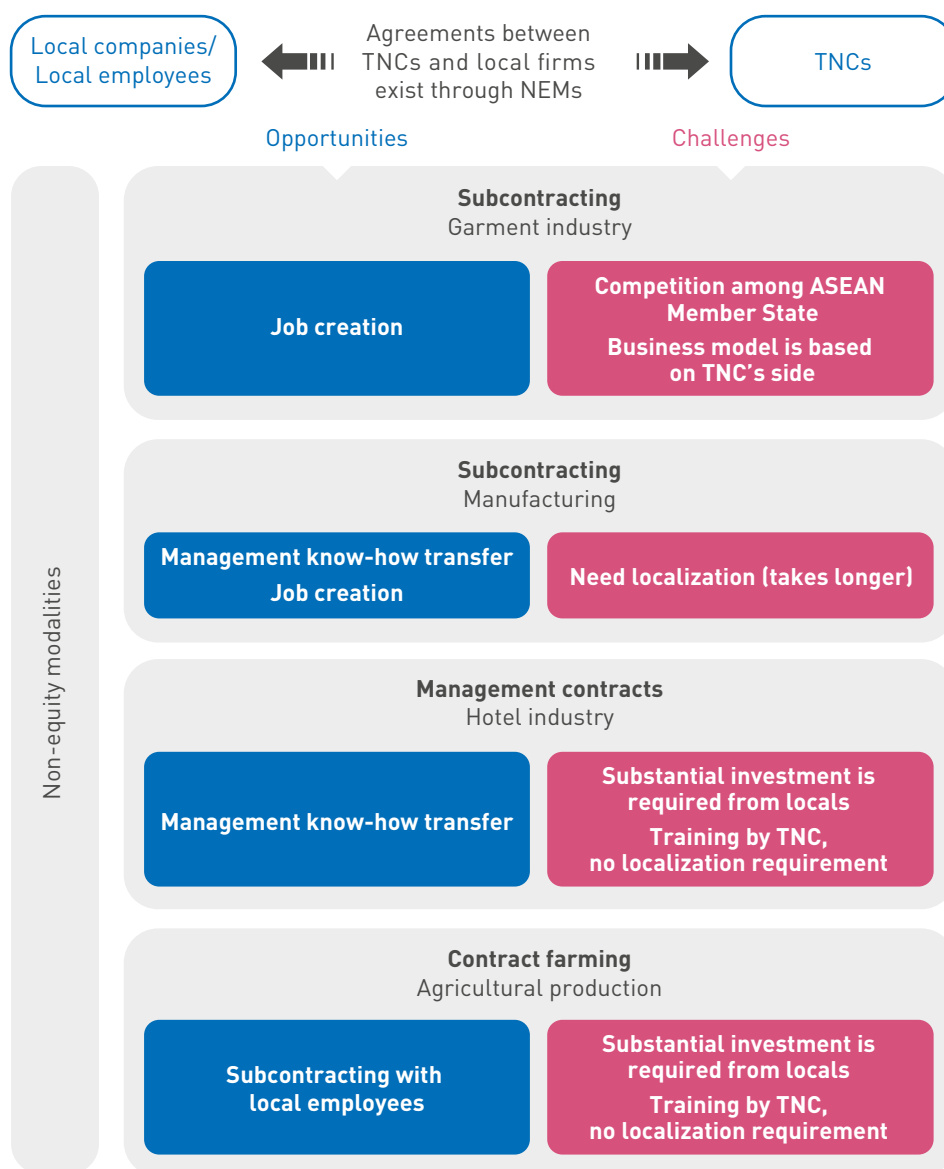
Fee charged by IHG Group	Services provided by IHG Group	Term and renewal
Franchise fee: - Application fee: \$50,000-\$100,000 - Franchise fee: 5-6% gross room revenues - System fund (marketing): 2.5% of gross room revenues Management fee: - Base fee: 1-3% of the hotel's total revenue - Incentive fee: calculated as a percentage of a hotel profitability measure Fee for running the Crowne Plaza Vientiane: - Operating costs - Capital expenditure	- BIM Group can use the Crowne Plaza brand name - BIM Group can benefit from a loyalty programme - Reservation system - Maintenance and repair - Hiring, training and supervising hotel managers and employees (general manager and financial controllers are from IHG) - Annual budget preparation - Local sales and marketing efforts - Financial analysis - Food and beverage services	- Franchise agreement - Management agreement - 15-20 year contract

Source: IHG annual report, 2018.

### 3. OPPORTUNITIES AND CHALLENGES

It is clear that NEMs have already started evolving in several industries in the Lao People's Democratic Republic. We focused on four industries where NEM participation is prominent, viz., garments (including the allied industry of sports equipment), electronics (including machinery and equipment), contract farming and hotels. This section provides an analysis of the opportunities and challenges that the country faces in promoting and absorbing potential benefits from NEMs (figure 4). Establishment of NEM agreements with TNCs offers Lao industries a number of economic opportunities; however, these agreements must be carefully crafted, as NEMs also bring a number of challenges for local firms.

Figure 4. Opportunities for NEMs



Source: AJC.  
Note: Major NEM industries only.

### 3.1 Ownership

NEM operations provide the host country and local firms with both opportunities and challenges. Even if business activities are not owned by foreigners, TNCs can still exert quasi-control over local firms through contracts by means of supply of important inputs, access to markets, required technology and income sources. If TNCs can find local firms that offer the same services as or better services than their existing affiliates, TNCs may establish contracts with local firms in the form of NEMs. TNCs can offer potential opportunities for local NEM firms in a wide range of industries, including agriculture, garments, electrical machinery, hotels and retail. However, it is important that local firms have a minimum level of management skills, autonomy and initiative, as well as technological skills and capacity since, unlike TNCs' support for their affiliates, TNCs' support for NEM partners cannot be taken for granted and TNCs can terminate contracts with local partners at any time. Garment firms engaged in CMT operations, for example, are often vulnerable to such dangers.

In the absence of direct operations by wholly or jointly owned foreign TNCs, national firms can also take advantage of potential opportunities, but these opportunities cannot be seized easily as the economic environment is becoming increasingly competitive. TNCs typically make their decisions about whether to produce in-house or to subcontract out components and intermediate inputs on the basis of a wide range of factors. One key factor is the existence or emergence of competent suppliers within the country. TNCs are likely to contract out supply to Lao firms if the TNCs benefit economically from outsourcing relative to producing in-house or importing. Such NEMs are more beneficial to host countries than TNC operations, as most of the profits arising from such linkages are most likely to stay within the host country. Santei-Lao, VAP and VEF are some of the NEM firms that took advantage of Santei's efforts to shift low value added activities from China and of the Thailand Plus One business model, which enabled several NEMs, including Lao Nikon, VAP and VEF, to supply Santei subsidiaries in Thailand. The same can be said of the NEM hotels of Crowne Plaza, Amari Vieng Vang and Somerset Vientiane.

However, such opportunities can be seized effectively only if the Lao firms acquire and develop the requisite capabilities to participate in such contract relationships. Such capabilities include management, inventory and quality control systems, and production technology. There is also a pressing need to sustain rapid technological upgrading among local NEMs so that they can remain connected to GVCs, as well as enjoy movement to higher value added activities. This is how Foxconn from Taiwan Province of China managed to transform its link with Apple from being an original equipment manufacturer to taking control of the design, research and development of the components it supplies to Apple (Sturgeon, 2002). And unless Lao NEMs succeed in remaining competitive – for example, in supplying materials to garment and electronics firms, and hotel franchising – TNCs may switch suppliers or terminate their brand recognition. In hotels, established brand holders have terminated contractual agreements with host-owners in several countries when the brand standards were not upheld. Examples include the termination of contracts by Park Hotel and Holiday Inn in Malaysia. Finally, franchise modalities are often vulnerable to the vicissitudes of volatile demand fluctuations. In industries such as garments, TNCs often engage a few suppliers simultaneously so that orders from successful competent firms are available to cover for orders terminated from unsuccessful firms.

## 3.2 Control

Although foreign firms have no direct ownership in NEMs, more often than not they are controlled by them. Control can take the form of buyer firms dominating pricing decisions, assessment of quality and determination of lead times. In CMT operations, Lao NEMs are completely reliant on buyers with respect to lead times, specifications used and materials sourced (Rasiah and Vanthana, 2014). Similarly, in hotels, franchise holders determine the terms and conditions under which NEMs must operate. The positive side of these conditions include the pressure imposed by TNCs on NEMs to upgrade. NEM firms that remain suppliers will remain exposed to the risk of contract termination whenever TNCs are not satisfied with their supplies or if more capable suppliers emerge. Such circumstances often arise when TNCs operate at the level of high value added activities that require their suppliers to upgrade and can also emerge when TNCs find other supplier bases in other countries to be more efficient. Nevertheless, NEM firms that successfully ride the wave of competition offered by major export markets and upgrade have the opportunity to move up the value chain – and in cases such as the Republic of Korea and Taiwan Province of China, to leapfrog incumbents. Samsung Semiconductor, which started memory chip production in 1975, and Taiwan Semiconductor Manufacturing Company, which started logic chip production in 1987, now lead their respective value chains (Rasiah and Yap, 2015). Infrastructure in the Lao People's Democratic Republic will require massive transformation to achieve such developments.

If buyer TNCs' subsidiaries are located in the Lao People's Democratic Republic to procure inputs from NEM firms, the control they exercise can be stronger than if those subsidiaries are located in other countries. In a number of cases such TNCs make efforts to train the workforces of host-country NEM suppliers; sometimes they invest in skills development centres to develop the host country's human resources or implement rooting strategies for their own expansion. The host-country government often plays a central role to initiate and coordinate such developments, as seen in Singapore<sup>16</sup> and Malaysia.<sup>17</sup> The garment and electronics industries in the Lao People's Democratic Republic can benefit from adopting such a framework. TNCs often adopt such a framework to strengthen their value chain globally.

Given that linkages with foreign TNCs can never be taken for granted, Lao NEM firms will have to take advantage of the opportunities to launch new businesses, which will then stimulate sales growth, job creation and exports. In order for them to do so, the government also needs to develop the science, technology and innovation (STI) infrastructure to stimulate entrepreneurial synergies. The STI infrastructure in the country should connect strongly with universities to stimulate start-ups in the garment and electronics manufacturing industries. However, the capacity of local NEM firms to enter such high-technology activities has remained a challenge.

<sup>16</sup> Singapore's Economic Development Board successfully played such a role (Rasiah and Yap, 2015a, 2015b).

<sup>17</sup> The Penang Skills Development Centre, a training centre established in 1989, is financed together with TNCs (Rasiah, 1995).

### 3.3 Relationships between NEM modalities and industries

Particular modalities are linked to particular industries in the country. There are TNC-owned subsidiaries in industries such as garments and electronics that enter contract agreements with customer firms outside the country or non-parent firms. In these cases, the subsidiaries create offshore outsourcing with these vendors. This modality creates opportunities for local employees to become integrated in the subsidiaries' business activities; however, it does not provide opportunities for building capacity in local firms. If local NEM firms have contract agreements with local subsidiaries of TNCs in the garments and electronics value chains, that creates outsourcing. Through this modality, local firms have potential opportunities to receive orders from customer TNCs located outside the country. TNC affiliates also have a modality through captive offshoring with their parent firms, which is done through FDI (non-NEM).

Different types of modalities are also observed in the hotel and retail industries. Most brand holders in the hotel industry use management contracts and franchising modalities. Indeed, throughout ASEAN, TNCs in the industry typically engage in these modalities, though there are also hotels that are owned jointly with foreign capital and managed directly by foreign hoteliers (e.g. Crowne Plaza). In the Lao People's Democratic Republic, there are a few four- and five-star hotels that have foreign equity. Examples include the Summerset Vientiane, Crowne Plaza and Muong Thanh Luxury Vientiane hotels.<sup>18</sup> Management contracts and franchising should be promoted, as foreign brand holders have demonstrated their strong global marketing ability to attract tourists worldwide to both the country and the country's hotels. However, because brand holders impose stringent conditions to protect their brands, national owners will need to maintain high operating standards to remain attractive to brand holders. To benefit from tourism synergies deriving from the promotion of NEMs in the hotel industry also requires that the government improve infrastructure (including IT support) and security throughout the country.

### 3.4 Localization strategies

Governments have often launched localization strategies when foreign TNCs are engaged in manufacturing for the domestic market. This is how Indonesia, Malaysia and Thailand initially promoted local suppliers in the automobile industry (Rasiah, 2009). However, such initiatives have been pruned since the launching of the ASEAN Free Trade Area in 1992 and the WTO in 1995. Nevertheless, governments can still promote linkages with national NEM firms without infringing the Trade-related Investment Measures instrument of the WTO, which prohibits differential trade treatment on the basis of ownership (Rasiah, 2006). Localization strategies ensure that the government can use its bargaining strength to impose conditions for TNCs to train national workers and to source from capable NEM firms, especially when the TNCs enjoy incentives or benefit from sales in the domestic market. The garment, hotel and related industries can be targeted for development of NEMs as suppliers, which can then also export once sufficient capabilities have evolved. Challenges include the need to stimulate human capital development and the need for local firms to undergo massive technological upgrading to meet international standards.

Foreign TNCs can outsource a part or the whole of any goods or services, or even part of their GVC stage, to a country when the government uses its leverage to call for national production or service. TNCs supplying the domestic market may seek NEM suppliers to reduce transport costs

<sup>18</sup> Information supplied by an official from the National Economic Research Institute (NERI), Vientiane, on 11 July 2018.

and to coordinate effectively the implementation of just-in-time inventory control systems, as well as smoothen the application of kaizen (continuous improvement) activities. This is why foreign TNCs have developed nearby suppliers in the electronics and automobile industries, though unless local capabilities are advanced, foreign suppliers often fill the void (Rasiah, 2014). In the garment and electronics industries, Lao NEM firms can improve the quality of their manufacturing of silk fibre, electronics parts (e.g. plastic injection moulding) and textiles, both to supply TNCs in the country and to export. National NEM firms should undertake initiatives independently to integrate their operations and activities with TNCs' overall production networks and GVCs.

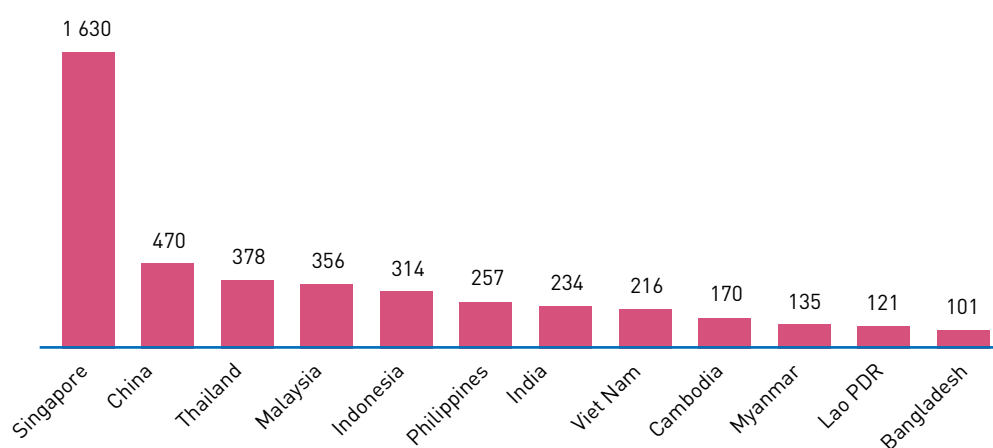
In the industries with franchising agreements, operations or activities may require a localization strategy – for example, in the retail industry – or may not – for example, in the hotel industry. In the retail industry, the final customers are mainly in the country, as is demand. Therefore, a localization strategy is required for TNCs in the retail industries. In the hotel industry, in contrast, TNCs; operations and activities are standardized at the international level and essentially the same as in other countries.

As TNCs may terminate their agreements with local contracting firms for more efficient suppliers, efforts to discourage crowding-out effects of this type require a profound localization strategy, both by TNCs and by local firms, even in NEM operations. To maintain their TNC relationships, local firms should undertake initiatives independently to integrate their operations and activities into TNCs' overall production networks and GVCs.

### 3.5 Labour issues

The nascent development phase of the Lao People's Democratic Republic offers access to lower-wage labour than in neighbouring countries. According to a survey by the Japan External Trade Organization (JETRO), the basic monthly salary of manufacturing workers in the country is \$121, which is three times lower than in Thailand and the lowest among the Mekong region countries (figure 5).

Figure 5. **Basic monthly salary for manufacturing worker in Asia-Pacific countries, 2016**  
(Dollars)



Source: JETRO (2017).

Although the cheap labour cost is very attractive, securing the labour force is another issue. Among the total population of 7.1 million, the working population – those age 15 to less than 65 – is 4.5 million, or 63 per cent of the total. The median age is 23 years (male, 22.7 ; female, 23.3) and 54 per cent of the population is younger than 25. By industry, more than 60 per cent of the working population is employed in agriculture – a high ratio, compared with Cambodia’s 27 per cent and Thailand’s 33 per cent (figure 6). In contrast, the share of the working population employed in manufacturing is less than 10 per cent. Thus, building a factory with a workforce of a large number, such as more than 1,000, would not be suitable. In this respect, small and medium would be the proper sizes of enterprises.

Figure 6. **Employment by sector in the Lao People’s Democratic Republic and neighbouring countries, 2017** (Thousands)

Country	Agriculture		Industry		Services		Total	
	Employment	Distribution	Employment	Distribution	Employment	Distribution	Employment	Distribution
Lao PDR	2 195	61.3%	346	9.7%	1 038	27.0%	3 579	100%
Cambodia	2 481	26.7%	2 510	27.0%	4 299	46.3%	9 289	100%
Myanmar	12 587	49.9%	4 180	16.6%	8 444	33.5%	25 211	100%
Viet Nam	23 014	40.9%	14 120	25.1%	19 182	34.1%	56 315	100%
Thailand	12 697	32.8%	8 732	22.6%	17 283	44.7%	38 712	100%

### 3.6 Opportunities and challenges facing national NEM firms

Local firms face a range of issues, from those related to contractual agreements to those related to industry characteristics and TNC strategies. Both opportunities and challenges can be found for each category, which can be grouped into issues of continuity, NEM characteristics, capacity-building and local firms’ initiatives and local embeddedness (table 8).

Local NEM firms will enjoy opportunities but also face challenges when they seek to strategically acquire TNCs’ know-how and technological skills by linking with them. They could also build capacity to deal with these challenges and even expand their businesses by using TNCs’ GVC networks. In addition, national NEMs can eventually use their supply experience with TNCs to export directly to foreign markets.



Table 8. Opportunities and challenges for local firms engaged in NEMs

Opportunities	Typical industries concerned	Challenges
<b>Continuity (footlooseness) problems</b>		
Easier to find TNC partners, both in and outside the country through, for example, matching events (since TNCs do not directly invest in the business).	Garment Electrical Machinery	Easier for TNCs to terminate contracts and long-term relationships are not guaranteed, if quality of services or goods do not meet TNCs' standards and if local firms in other countries are more competitive (e.g. strong competitors exist in the garment industry in Cambodia and Myanmar).
<b>NEM's characteristic issues</b>		
Easier to enter new market or new area even though demand are is present in the country. Skills, talents or resources that are available in the country but not required in the country can be usefully utilized outside the country.	Coffee Hotel	Demand and markets are outside the country (e.g. customers in hotel industry and for subcontracting products).  TNCs' demands may change with the interests and tastes of their clients (e.g. changes in trends of tourism destination, consumer's taste and home decoration tastes.)
<b>Capacity-building issues</b>		
Easier for local employees to work with the business activities because of low skills.	Garment Hotel Retail	Not easy for local firms to build capacity apart from receiving orders from customers as they receive only relevant know-how at most (e.g. upgrading value chain activities only through local firms' efforts is not easy).
<b>Initiatives and local embeddedness issues</b>		
Local firms adapt to foreign design and management and do not need to think about local values and localization strategies (quicker for local firms to make profit by using TNCs' business model).	Hotel	Local firms may lose their initiative, design ability and traditional values, apart from designing for limited products in the furniture industry (e.g. local firms may follow TNCs' business models in the hotel industry as they do not need to implement a localization strategy).
Franchise business operations need to be localized, so it takes longer for local firms to make profits. Therefore, they need initiatives for their operations or activities leading to embeddedness.	Retail Convenience stores	In the short term, franchisees or local firms may face difficulties in adapting TNCs' original strategy to local tastes and need to learn through experience before they become part of the community (e.g. in the retail industry, franchisees need to localize the TNCs' strategy to meet local demands of which TNCs are not aware).

Source: AJC.

## 4. POLICY IMPLICATIONS

Increasing intra-ASEAN trade and investment openness offers enormous opportunities for the Lao People's Democratic Republic despite some reversals in trade and investment practices, especially the current anti-trade policy stance of the United States. The remaining countries minus the United States under the Trans-Pacific Partnership agreement, or Comprehensive and Progressive Agreement for Trans-Pacific Partnership, have already forged ahead to deregulate trade. The ASEAN countries as a whole have become one of the most open and integrated regions in the world, with rapid expansion of trade and FDI inflows and outflows.

Within the overall policy framework of NEMs discussed earlier, the Lao government should consider evaluating the state of NEMs or NEM-related operations in the country so as to ensure it offers the foundation for their promotion in the country. If such an evaluation methodology does not exist in the country, AJC proposes the checklist shown in table 11. This proposal is based on the corporate code of conduct of the Tokyo Chamber of Commerce and Industry. It provides direction for the Lao government to confirm whether NEM agreements and their operations are in sync with international standards, taking account of foreign NEM clients, local NEM firms, local NEM firms' subcontracting firms and local employment.

Typically, firms owned fully or jointly by foreign TNCs that are reliant on export markets have been the most vulnerable to external shocks, as experienced in Malaysia, the Philippines, Singapore and Thailand during the global financial crisis of 2007-2008. More importantly, TNCs often repatriate their profits to their home countries. Lao NEM firms can help reduce the wholesale repatriation of profits as they are nationally owned firms. The development of resilient Lao NEM firms will also help expand the reservoir of domestic capital. Hence, the government should strongly consider the promotion of NEMs as a critical strategy for economic growth. This section discusses a number of the strategies that the government, TNCs and local NEM firms can take to facilitate the expansion of local NEMs in the Lao People's Democratic Republic, especially as a landlocked economy.

Fostering NEM firms can create more opportunities to link the country with neighbouring countries (e.g. Thailand, China, Viet Nam) through becoming part of value chains. Aiming at growth areas of the ASEAN region specifically is an important and reasonable growth strategy.

### 4.1 Enhancing the capability of local firms

The lack of training organizations in the Lao People's Democratic Republic has led to several TNCs launching their own initiatives to train workers. For example, the French firm Essilor, which was established in 2013 in Savannakhet to manufacture polycarbonate eyeglass lenses, has built a vocational training centre there to help Lao workers develop skills appropriate to new industrial needs (Somphet, 2018). The company also sends staff to train in Essilor Thailand for a period of two months in engineering, logistic procedures and human resource management. Other in-house training centres include the one financed by the Asian Development Bank at the CPC in Champasak.<sup>19</sup>

The spontaneous emergence of training centres shows the urgency for the government to institutionalize training as a major initiative. Local firms' capabilities in both technological and managerial skills should be enhanced so that they can meet TNCs' current and potential demands.

<sup>19</sup> Interview with the general manager of CPC on 26 July 2018 at the firm.

Once these necessary capabilities have been attained, firms can undertake more business initiatives or have more autonomy in their operations; they can find potential customers through networks; and independently from TNCs, they can create their own business activities in the long run.

To support access to learning and training on a wide scale, the government needs to provide support for several efforts:

- Implementing continuous internal training for employees within local firms. Local firms need to train their employees for higher job skills. Judging from the results of the interviews for this study, not all local firms implement continuous or regular training due to the costs incurred.<sup>20</sup> If there were some direct or indirect financial support for training, it would help local firms focus on internal training tailored to the needs of the firms themselves or to the demands of their client TNCs.<sup>21</sup>
- Establishing provincial learning centres where local firms can learn NEM operations or activities. Local firms need to be aware of changes and likely future demands in their industry rather than only focusing on current operations. The government can subsidise the centre and support the development of this awareness by facilitating connections between individual firms and industry. Such learning centres should cover all aspects of NEMs in forming, executing and evaluating contracts, as well as increasing knowledge about NEM operations.
- Creating a conducive environment for local firms to facilitate their globalization and localization strategies. Local firms need to familiarize themselves with TNCs' changing strategies and learn their customers' strategies. The government can offer support for different types of NEM strategies in different industries at the individual level, rather than offering support as an industry.

At the industry level, industrial or business associations and the government can work toward several goals:

- Creating an environment for competition and cooperation between local firms. Individual local firms need to have continuity in their operations or activities by enhancing their capabilities, and they need to compete among themselves. This implies that a number of potential local firms need to become competitive enough to participate as TNCs' partners or vendors. Therefore, the government needs to create a better environment for competing with and cooperating with each other so that NEM industries as a whole can become more competitive. In this environment, industrial and business associations can consult with the companies and offer them necessary capacity-building opportunities.
- Stimulating the upgrading of local firms to higher positions in GVCs. Shifts in demand by TNCs and changes in TNCs' strategies in the country derive mostly from TNCs' search for cost reduction. The government can promote local firms' capabilities explicitly through support for innovation and technical upgrading. Only then may they be partners with foreign TNCs in NEM operations. The CPC is on the brink of achieving its own geographical indicator, which should then offer the cooperative considerable opportunities to eventually become a major player in the green coffee value chain.<sup>22</sup>
- Putting in place an innovation policy for local firms to encourage and protect technologies required to perform as NEM operators. Competition to become TNCs' NEM partners is high. Some competitors may offer quality services at lower prices. Particularly if the services offered by local firms are standardized and do not require localization, competition will be much more

<sup>20</sup> Interview with Sitthipone Rashpone from NERI, Vientiane, conducted on 15 January 2017 by email.

<sup>21</sup> This was the case of the Malaysian electrical and electronics industry in the 1990s.

<sup>22</sup> Interview with the general manager of CPC on 26 July 2018 at the cooperative.

severe. Therefore, local firms need to be attractive enough to become a TNC's NEM partner. Innovations flourish only in the presence of intellectual property rights protection. The country is still underdeveloped in this respect, as the country is classified as stage 1 (the lowest development stage) in the World Economic Forum's Global Competitiveness Index. It is also pertinent for the government to identify and promote the geographical indicator so that products from its related farms in coffee, for example, can be traded at premium prices.

- Protecting local employees from unreasonably exploitative conditions can only help raise productivity. If the working environment or conditions in an industry are not healthy, local employees need to be protected by some labour policy for the industry.

## 4.2 Improving investment regulation

Although NEM firms are entirely owned by Lao citizens, stimulating NEM activities in the country requires refinement of regulations for attracting foreign and domestic investment. An active and vibrant environment where NEMs function alongside foreign firms and joint ventures will be important to foster rapid economic growth in the country. However, a 2016 report by Emerging Markets Consulting (EMC) and the Mekong Business Initiative (MBI) noted that regulations on the approval of licenses for small and medium firms are extremely cumbersome and often involve long delays. The government should rationalize approvals to be consistent with its practice for large firms, for which licenses are expedited quickly. In addition, since large foreign firms are primarily found only in resource-based and hydropower industries, it would be useful to attract similar foreign and joint-venture firms to play an active role in other critical sectors, such as IT and transport.

## 4.3 Promotion of skills and expertise upgrading

Economic development requires, inter alia, a massive upgrading of skills and expertise. Unfortunately, labour and skills shortages have hampered the activities of private firms in the Lao People's Democratic Republic (EMC & MBI, 2016). Interestingly, the 2016 study reports shortages in skilled, semi-skilled and unskilled labour. NEM firms and complementary foreign and joint-venture firms can certainly pursue upgrading strategies if the requisite skills and expertise are in place. The following recommendations can go a long way to make this possible:

- The government should build more schools and make primary education compulsory for children from age 7 to 12. Although this is the age group typically targeted for universal education, extending that to secondary schooling would be useful to ensure a strong supply of basic workers who are literate enough to at least perform unskilled jobs. This labour force can be trained to undertake semi-skilled and skilled tasks through learning by doing, in-house training and exposure to training in technical and vocational institutes. Foreign organizations – e.g. the Japan International Cooperation Agency and GIZ, the German development agency – can complement national institutes to strengthen skill-building activities.
- The country has seen significant emigration of skilled and professional personnel, especially to Thailand. Not only are the languages of the two countries close, some areas are still culturally close, with a long history of northwest Thailand being part of Laos. Efforts must be taken to bring these personnel back through attractive brain gain and brain circulation policies like those of the Republic of Korea, Taiwan Province of China and China. Whereas the government may consider Laotian immigrants for permanent resident and citizenship status, it should consider easing and simplifying work permits for foreign experts so as to strengthen firm management in the country.

## 4.4 Developing basic infrastructure

The NEM contribution in Lao exports, employment and revenue can grow only if the government develops the basic infrastructure where NEM firms operate. Ease of registration, access to finance and skilled personnel, and to water and power, and provision of security is important to lower the cost of doing business and to operate efficiently. Local administrative agencies must help solve the problems that these firms face. Hotels can benefit from an increase in tourist visits to scenic locations if the infrastructure is good. Access to the internet will also connect potential customers to hotels and the various tourist attractions that surround their locations. In the garment, electronics, coffee and corn, convenience store and hotel industries, NEM firms can enjoy low cost and quick access to essential services.

## 4.5 Developing science, technology and innovation infrastructure

Whereas efficient basic infrastructure is critical to raise the efficiency levels of firms, the development of STI infrastructure is critical to stimulate firms' participation in innovative activities, including information and communication technology (ICT) and biotechnology.<sup>23</sup> The country can start with ICT and biotechnology, offering complementary support for a wide range of industries. Not only current industries (such as silk, agricultural products such as coffee, tourism and electronics), but also future outsourcing industries (such as IT-BPO) could benefit strongly from this support. Given the landlocked nature of the country, this type of technology and innovation infrastructure should become important and useful for the country to develop.

The government has recognized the need to promote technological upgrading and consequently has set aside 1 per cent of investments to support the development of STI infrastructure (Somphet, 2018). This is a good move that should be accompanied by frequent appraisal to see that this development is followed by greater connectivity and coordination between the firms, cooperatives, universities, training centres and incubators in science parks as well as by legislative promotional instruments to ensure the maximization of economic synergies.

## 4.6 Promoting connectivity and coordination

The co-location of organizational support for NEM firms alone is not sufficient to stimulate technological upgrading. There must also be strong connectivity and coordination between the basic and STI infrastructure organizations, and the NEM firms. Whereas emphasis on basic infrastructure will enable the firms to execute efficient business practices with short lead times and low costs, the development of STI infrastructure – science parks, industry-university linkages, standards organizations – and the resulting good-quality technically skilled workers and university graduates will help in the stimulation and appropriation of innovation synergies among firms. These are critical for firms to upgrade technologically to enjoy participation in high value added activities.

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<sup>23</sup> For a detailed account of STI infrastructure in ASEAN member countries, see Rasiah (2018).

## 4.7 Promoting integration into global markets

NEMs can help ASEAN become more integrated. The ASEAN Economic Community offers low to zero tariffs in almost all product lines, and through ASEAN NEM firms enjoy preferential treatment in East Asian markets. In addition, Lao NEMs can also enjoy trade preferential treatment provided by developed countries. Efforts to maximize the use of such treatment include reducing bureaucratic red tape in custom controls involving trade, and registration of firms seeking to import and export. It is also important for the country to offer employment permits to foreigners who meet the requisite qualifications. The lack of professionals is a key problem faced by Lao firms.

## 4.8 Mainstreaming sustainable development

Adoption of the sustainable development goals by the United Nations provides opportunities for the government to shape the conduct of NEM firms to mainstream such goals. In particular, the goals related to workers and human rights, and to the environment are relevant. Environmental and labour standards have become important in bilateral trading relationships. The Lao People's Democratic Republic should observe the critical international labour covenants, which means it will have to allow unionization of workers and freedom of association, among other things.

Existing export-oriented garment firms, such as Alpilao and Anta Apparel in garment manufacturing, and the CPC in coffee production and farming, observe the standards imposed by TNCs and other buyers.<sup>24</sup> Nolintha and Jajri (2016) provided evidence that the technological capabilities of garment-exporting firms in the country are quite high. Similarly, established hotel brands also require their local hosts to observe such standards. Such monitoring by developed-country buyers has increased over the years. According to the UN's guidance,<sup>25</sup> human rights due diligence "should cover adverse human rights impacts that the business enterprise may cause or contribute to through its own activities, or which may be directly linked to its operations, products or services by its business relationship" (2011: 17).

Pressure on environmental standards have also mounted as problems of global warming and climate change grow. The Lao People's Democratic Republic has ratified the 2015 Paris Accord (and its subsequent time-deferred version of the Marrakech Proclamation in 2016) under the United Nations Framework Convention for Climate Change (Rasiah et al., 2018). Hence, the government should raise awareness, as well as work towards the formation of a major standards organization to coach and certify NEM firms.

The government should consider implementing and strengthening the regulatory framework for NEM firms so that they can successfully export, expand employment and upgrade technologically. This initiative should start with a profound evaluation of the critical policy pillars shown in table 9. This would be the first step for the government to decide whether it will establish a policy framework for NEM promotion and, if so, it will decide what, how and to what extent the government has to do.

<sup>24</sup> The garment firm interviews were conducted on 23 April 2018 in Vientiane, and the CPC interview was conducted in Champasak on 26 July 2018.

<sup>25</sup> United Nations (2011), "Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework", by the United Nations Human Rights Office of the High Commissioner. New York and Geneva.

**Table 9. Checklist for NEM agreements and operations to maximize benefits from and minimize costs with NEMs**

NEM policy of the Lao government	Compliance with laws	Whether there is an agreement on contract performance
		Whether there is an agreement on contract terms (durations)
		Whether there is an agreement on contract termination and its process
		Whether there is an agreement on contract arrangement (additional contract) and its process
	Respect for human rights	Whether there are rules on non-discrimination
		Whether there are rules on basic human rights
		Whether there are rules on harassment (power balance exists between local NEM firms and TNCs)
	Environmental consideration	Whether there are guidelines on air pollution by local NEM firms
		Whether there are guidelines on water contamination by local NEM firms
		Whether there are guidelines on environmentally friendly goods or services by local NEM firms
	Work environment	Whether there are employment rules (laws) on ages under the NEM agreement
		Whether there are employment rules (laws) on gender under the NEM agreement
		Whether there are guidelines on a safe and pleasant work environment for local NEM firms
		Whether there are employment rules (laws) on working environments under the NEM agreement
		Whether there are employment rules (laws) on working conditions under the NEM agreement
		Whether there are employment rules (laws) on working hours under the NEM agreement
		Whether there are employment rules (laws) on taking holidays under the NEM agreement
		Whether there are employment rules (laws) on treatment of absence under the NEM agreement
		Whether there are employment rules (laws) on maternity-related leaves under the NEM agreement
		Whether there are guidelines on provision of support system of childcare and nursing care
	For local firms' development	Whether there is a program which local NEM firms can take to improve their technology/capacity
		Whether there is a program through which local NEM firms' employees can learn
		Whether there is a program which local NEM firms can take to understand NEM policy
		Whether there is a program which local NEM firms can take to understand the business environment of the industry
	Subcontractors/suppliers	Whether there are guidelines for similar NEM policies for local subcontractors and suppliers

**Table 9. Checklist for NEM agreements and operations to maximize benefits from and minimize costs with NEMs** (Concluded)

For TNCs, required by the Lao government	Earning the trust of customers and consumers	Whether there are guidelines for TNCs to provide correct information on their products or services
	Mutual growth with partner companies	Whether there are guidelines for TNCs to respect free and fair trading rules
		Whether there are guidelines for TNCs to provide relevant information required for trading
	Coexistence with local communities	Whether there are guidelines for TNCs to develop relationships based on trust with local NEM firms
		Whether there are guidelines for TNCs to establish and maintain a good relationship with local community where local NEM firms are located

Source: Adapted from "Corporate Code of Conduct, the Third edition" of the Tokyo Chamber of Commerce and Industry (2013).



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ISBN 978-4-910293-07-3



ASEAN Promotion Centre on Trade, Investment and Tourism  
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