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Report No: 63200-LA

# LAO PDR
# Public Expenditure Review

**June 30, 2011**

**Poverty Reduction and Economic Management Department**
**East Asia and Pacific Region**
**The World Bank**

## CURRENCY EQUIVALENTS

(Exchange Rate June 17, 2011)

| | | |
|---|---|---|
| Currency Unit | = | Kip |
| 8,000 kip | = | US$1 |
| US$ | = | SDR 1 |

## FISCAL YEAR

October 1 – September 30

## ABBREVIATIONS AND ACRONYMS

| | |
|---|---|
| AFTA | ASEAN Free Trade Agreement |
| APB | Agriculture Promotion Bank |
| ASEAN | Association of South East Asian Nations |
| AusAID | Australian Agency for International Development |
| BCEL | Banque pour le Commerce Exterieur Lao |
| BOL | Bank of Lao PDR |
| CFAA | Country Financial Accountability Assessment |
| COA | Chart of Account |
| CTPC | Communications, Transport, Post and Construction |
| DGA | Development Grant Agreement |
| DOFI | Department of Forest Inspection |
| DPs | Development Partners |
| DSA | Debt Sustainability Analyses |
| EC | European Commission |
| EDL | Electricity Du Laos |
| EPF | Environment Protection Funds |
| ESDP | Education Sector Development Framework |
| FDI | Foreign Direct Investment |
| FMCBP | Financial Management Capacity Building Project |
| FY | Fiscal Year |
| GDP | Gross Domestic Product |
| GFIS | Government Financial Information System |
| GFS | Government Finance Statistics |
| GOL | Government of Laos |
| IDA | International Development Association |
| IFA | Integrated Fiduciary Assessment |
| IMF | International Monetary Fund |
| IT | Information Technology |
| Lao PDR | Lao People's Democratic Republic |
| Lao TIS | Lao Tax Information System |
| LDB | Lao Development Bank |
| LTSP | Lao Transport Sector Programme |

| | |
|---|---|
| MDGs | Millennium Development Goals |
| MIGA | Multilateral Investment Guarantee Agency |
| MPI | Ministry of Planning and Investment |
| MPWT | Ministry of Public Works and Transport |
| MW | Megawatts |
| MTEF | Medium Term Expenditure Framework |
| MTFF | Medium Term Fiscal Framework |
| NGPES | National Growth for Poverty Eradication Strategy |
| NPL | Non-Performing Loan |
| NSEDP | National Social Economic Development Plan |
| NTPC | Nam Theun Power Company |
| NT2 | Nam Theun 2 |
| NZ OAG | New Zealand State Audit Office |
| ODA | Official Development Assistant |
| PACSA | Public Administration and Civil Service Authority |
| PEFA | Public Expenditure and Financial Accountability |
| PEMSP | Public Expenditure Management Strengthening Programme |
| PER | Public Expenditure Review |
| PETS | Public Expenditure Tracking Survey |
| PFM | Public Finance Management |
| PFMSP | Public Finance Management Strengthening Programme |
| PIMS | Personnel Information Management System |
| PIP | Public Investment Programme |
| PM | Prime Minister |
| PPG | Public and publicly guaranteed |
| PRSO | Poverty Reduction Support Operations |
| RMS | Revenue Management System |
| SAO | State Audit Organization |
| SDR | Special Drawing Rights |
| SNG | Sub National Government |
| SOCB | State Owned Commercial Bank |
| SOE | State Owned Enterprise |
| TSA | Treasury Single Account |
| UNICEF | United Nations Children's Fund |
| VAT | Value Added Tax |
| WHO | World Health Organization |
| WREA | Water Resources and Environment Administration |

| | |
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# EXECUTIVE SUMMARY

ES.1. This Public Expenditure Review starts by looking at the country's macro-fiscal performance in Chapter 1, it examines the implementation of the Nam Theun 2 (NT2) Revenue Management Arrangements (RMA) by which the government committed itself to continued strengthening of PFM and the selection of "eligible" pro-poor and environmental conservation projects to be funded from NT2 revenues in Chapter 2, and takes stock of issues relating to expenditure prioritization and centralization of tax, treasury, and customs department in Chapter 3 on Public Finance In this way, the PER responds to the commitment made to stakeholders in the hydropower dam project that implementation of the RMA would be reported on in successive Public Expenditure Reviews (PER).

ES.2. The PER then reviews the intergovernmental fiscal arrangements, as they have evolved since the new organic Budget Law was promulgated in 2006. Currently, central, provincial and district governments are considered deconcentrated elements of a single level executive. In practice provincial governors enjoy considerable autonomy, causing variation in the implementation of national policies. The government, however, is moving towards a more transparent, rules based intergovernmental fiscal system. PER-IFA-2007 provided some initial analysis and comments on such a transformation. Chapter 4 looks in greater detail at the current system of revenue and expenditure assignments and transfers, and how they work in practice. It then discusses the challenges in designing a new system of inter-governmental relations with reduced vertical and horizontal imbalances.

Chapter by chapter, the main messages of the PER are the following.

**Macro Fiscal Performance (Chapter 1)**

ES.3. Macroeconomic performance in Laos strengthened after the early 2000s with **economic growth averaging 7.7 percent during 2005-2010**. Growth was broad based with solid contributions from both the resource (minerals and hydro) and non-resource sectors.

ES.4. Progress on poverty reduction continued with the **poverty headcount falling** from 33 percent of the population in 2002/03 to an estimated 27 percent in 2007/08. [1]

ES.5. The Lao economy performed relatively well during the **global financial crisis**, largely due to the quicker than expected recovery of commodity prices and expansionary fiscal and credit policies. GDP growth is estimated to have accelerated to 8.4 percent in 2010.

[1] The poverty headcount fell from almost half the population in 1997/98 to one-third in 2002/03, reducing the share of the population in poverty by 30 percent, Lao PDR, Poverty Assessment, From Valleys to Hilltops—15 Years of Poverty Reduction, Report No. 38083-LA, World Bank, Washington DC, September 2006.

ES.6. Booming exports (especially from mining) have narrowed the **current account deficit** to about 9.3 percent of GDP in 2010 from 13.6 percent in 2009. Capital inflows, mostly FDI, have been robust and more than financed the current deficit, despite a decline in flows as a result of the global financial crisis and increased profit repatriation, from 12.4 percent of GDP in 2009 to 10.1 percent in 2010. Foreign reserves have built up in recent years, but still cover only about 3-4 months of imports.

ES.7. With large mining and hydro operations coming on-stream the **government's revenue situation** strengthened considerably. Supported by tax policy and administration reforms, non-resource tax revenues regained ground since the lows of 2005. Given the uncertain nature of resource revenues and reduction in trade taxes as a result of trade agreements, however, reforms to broaden the tax base need to be fully implemented. This will require thorough preparation to ensure that the institutional arrangements are in place and functioning well. The revenue to GDP ratio remains low, at an estimated 13.3 percent in 2010.

ES.8. Growing government revenues meant the end of cash rationing and the associated disruptions to government programs and public services. Both wages as well as non-wage recurrent expenditure have grown as a proportion of GDP.

ES.9. While externally financed capital spending has fluctuated[2], **domestically financed capital outlays** remained constant. The balance between capital and recurrent spending in priority sectors appears to have improved somewhat, but data weaknesses do not permit a conclusive assessment.

ES.10. Higher revenue collection combined with better expenditure controls helped reduce the **overall fiscal deficit** up to 2008. In 2008/09 the fiscal deficit widened considerably, to 6.7 percent of GDP, due to the global crisis and increased public investment, but closed to an estimated 4.6 percent of GDP in 2009/10. The ratio of external public debt and publically guaranteed debt to GDP continued to decline, from 112% of GDP in 2001 to around 55% in 2009, aided by significant currency appreciation.

ES.11. Though the country still faces a high risk of **external debt** distress, the debt burden is expected to trend down in the medium term. In the near term, however, rising public expenditures, both on and off-budget, and the quasi fiscal operations of the BOL will lead to a rise in domestic debt. And Lao PDR's external debt dynamics will remain sensitive to the performance of the resource sector.

ES.12. Concerns, raised in the last PER, about the build-up of government arrears and contingent liabilities related to **SOEs and SOCBs** are being addressed. Arrears have been largely extinguished, and SOCBs have undertaken some reforms and been recapitalized. Continued reform is necessary, and they will need to be monitored closely, as vulnerabilities remain.

[2] Subject to the caveat that government data may not be capturing the full extent of donor financing. This issue will be further investigated in the course of the next phase of the PER.

ES.13. The overall **legislative framework for the budget** and particularly that for inter-governmental fiscal arrangements has been strengthened. Yet it is early to see the effects on the ground of these improvements and a considerable unfinished agenda remains to make such a framework operational.

**Nam Theun 2 and Revenue Management (Chapter 2)**

ES.14. Under the Nam Theun 2 Project,[3] the Government committed to establishing **revenue management arrangements** (RMA) designed to improve the effectiveness and reach of public spending and delivery of services. NT2 revenues over the life of the project, from royalties, company tax on profits, and dividend payments on its equity, are estimated at $1.9 billion. In the initial years, revenues will be modest as NTPC repays its debt, and then build more rapidly. An effective and transparent expenditure management system is essential if NT2 revenues are to be used to achieve poverty reduction and environmental management goals. Thus the RMA aim at both effective use of NT2 revenues and levering broader PFM reform.

ES.15. Significant progress in modernizing the PFM system has been achieved in a relatively short period of time, in accordance with the **Public Financial Management Strengthening Program** (PFMSP), and its predecessor program, supported by wide range of development partners. The legislative framework has been overhauled, a degree of disclosure and transparency is now evident, budget timetables are now somewhat better aligned with budget execution and an independent audit framework is in place. Budget planning and preparation now precedes the presentation to the National Assembly although public disclosure lags considerably.

ES.16. Fragmentation of **cash balances** across agencies and levels of government has been addressed through a central treasury account, a pre-cursor to a planned "treasury single account" framework. A new budget nomenclature has been designed and implemented in conjunction with an upgrade to the GFIS and all 38 ministries and 17 provincial treasury offices in the country have live/real-time connections through this system.

ES.17. The centralization of revenues—**treasury, customs and tax functions**—has provided relief to cash management and allowed for most arrears to be identified and cleared while preventing the emergence of further large scale arrears. Consequently budget execution is reportedly running more smoothly on the basis of quarterly cash allocations and corresponding execution reports being prepared used for monitoring progress.

ES.18. **The State Audit Office** has undergone major restructuring and a serious effort is underway to develop it as a modern independent audit agency. In accordance with its new mandate it has been submitting reports to the National Assembly more or less within the required six months of year-end.

[3] Presented to the Board of the World Bank on March 31, 2005 and that of the Asian Development Bank on April 4, 2005.

ES.19. In mid-July 2009, the Parliament approved the **allocation of NT2 first-year revenues** of kips 50 billion to programs in education, health, rural roads, rural electrification, and environmental management. Some residual concerns remain, mainly regarding the challenging agenda of preparatory work that must now be undertaken to ensure that the reporting and monitoring requirements, including performance indicators for each program, are developed and in place ahead of formal reporting by Government of NT2 revenue after the revenue start flowing – June 2011. Another concern is whether the RMA objective of ensuring spending on the selective programs will be additional, since calculation of baseline spending is difficult to do in Lao PDR, given lags in expenditure data becoming available, and, until recently, deficiencies in the classification system.

ES.20. However, limited progress has been made on developing performance indicators for programs, and the overall capacity on monitoring and evaluation remains weak. Over the short-to-medium term, there will be need to focus on these issues.

ES.21. Overall, the PER concludes that the Government has narrowly met the **NT2 RMA readiness criteria** but there will be need to continue focusing on two areas: (i) allocations of revenues to eligible expenditure programs between sector department and line agencies; and (ii) developing performance monitoring indicators for sectors broadly as well and NT2 'eligible' programs narrowly.

ES.22. The discipline of implementing these arrangements rigorously will serve the government well once the revenue flow from the project becomes significant and should ensure that all public resources are effectively targeted, spent, and reported.

ES.23. The more critical but broader challenge for public expenditure management is to gradually move away from the focus on use of NT2 revenues and priority areas to a greater focus on use of overall government funds that is based on similar guiding principles.

**Public Financial Management (Chapter 3)**

ES.24. This chapter examines in depth two aspects of Public Financial Management in Lao PDR. The first is expenditure prioritization. The second is progress with the centralization of revenue administration.

ES.25. **Expenditure prioritization** has long been a weak feature of the Lao PFM system. The recurrent budget process is incremental, and while the National Socio-Economic Development Plan (NSEDP) articulates the government's overall development objectives well, the link between the plan and the development budget is weak, and the latter is not well coordinated with the recurrent budget. For example, while the social and productive sectors are assigned high priority in the plan, this is not reflected in the sectors' share of the recurrent budget, which amounts to no more than 20%, with three quarters of recurrent budget spending allocated to administration, including debt servicing.

ES.26. There are several causes why expenditure prioritization is weak in Lao PDR. The first has to do with the way the plan is prepared, and particularly the lack of a well articulated fiscal framework, the second is budget fragmentation, and the third is institutional practices.

ES.27. The **NESDP**, on its part, is neither costed nor fiscally constrained, and thus provides little real guidance on overall budget priorities. It will be important for the next plan, due to start in October 2011, to include a realistic fiscal plan based on availabilities, not needs, providing the main sector spending ministries clear resource envelopes for each year of the plan period.

ES.28. This requires the early development of a **Medium Term Fiscal Framework** (MTFF) and its companion, the Medium Term Expenditure Framework (MTEF). Work on the latter was recently suspended, and resources shifted to the MTFF. Difficulties with the MTEF, in the PER's view, stem from attempting an inappropriate and out-of-sequence "baseline" MTEF, coupled with insufficient attention to data deficiencies and other structural differences, from more advanced countries.

ES.29. Leading sector ministries have carried out **strategic plans**. While these are useful to depict possibilities, they are not resource constrained, and so trade-offs between different priorities and levels of allocation are not considered. Thus they help to reinforce incremental annual budgeting. A MTEF would greatly help planning at the sector level, particularly as resource led growth increases both the demand for government spending, and the revenues flowing to the government.

ES.30. Effective expenditure prioritization also requires **a comprehensive budget**. Some progress can be recorded, following the centralization of revenues. DP general budget support, by definition, is "on-budget", as is also loan financed project spending. It is estimated about half of grant financed project spending is included in the budget, with the rest managed by Development Partners (DP) outside the budget system, and may include technical assistance and aid in kind.

ES.31. The budget continues to be fragmented by the existence of **statutory funds** enjoying earmarked revenues. Some of these are fully managed as part of the overall budget. For others, only a transfer into the fund from the budget is shown in the budget estimates, and reporting on their transactions is limited. The continued existence of several of these funds should be reviewed as Lao PDR moves towards a Treasury Single Account.

ES.32. The Ministry of Finance (MF), Ministry of Planning and Investment (MPI) and the Public Administration and Civil Service Agency (PACSA) need to coordinate better in ensuring the plan supports annual budgeting, and that projects included in the Public Investment Program (PIP) realistically estimate their operations and maintenance costs on completion. Both MF and MPI need to work closely in advising the Cabinet on the overall fiscal envelope (including DP financing) for the annual budget, and in determining the MTFF and the MTEF. PACSA need to work more closely with MF in approving additional positions, against which staff can be recruited, and strengthen its

capacity to evaluate organizational structures and staffing levels of ministries, departments and agencies.

ES.33. Expenditure priorities potentially could be diluted during budget execution by the use of **reserve funds**, which could potentially amount to as much as 7% of total budgeting expenditure, though probably much less in practice. Procedures and rules for the operation of the two main reserve funds should be reviewed against international practice, which recognizes the need for the executive to respond quickly to emergencies, but set a much lower limit on discretionary spending.

ES.34. As noted also in Chapter 3, the role of the **National Assembly** in reviewing both proposed budgets and their implementation has been growing, strengthening executive accountability. Likewise, the State Audit Organization has been building its capacity. The next step would be for the National Assembly to institute formal arrangements to follow up on SAO audit findings.

The **centralization of all government revenues**, as mandated by the 2006 State Budget Law, is proceeding well and resulting in improved revenues flows and better cash management, contributing to a reduction in arrears. A formal cash management unit should be established in the MF.

ES.35. A further source of budgetary fragmentation is the continued existence of **"technical" revenues"** collected directly by line ministries. Progress is being made improving the reporting of such revenues, though it is estimated that the budget currently records only about one-third of actual ministry collections. Once the Treasury Single Account (TSA) has been implemented, the Ministry of Finance will have a powerful tool to control these revenues.

ES.36. The long run solution to the tendency of governors to allocate and spend without regard to national policy guidelines is a system of formula driven fiscal transfers (discussed in Chapter 4). In the meantime, the government is promoting the use of expenditure norms in key sectors such as education and health. This is supported, and could be reinforced by greater coordination between the budget department of the MF and their counterparts at the provincial government level, and by a stronger review of draft provincial budgets by the center. A review of existing rules on budget delegation to provinces would be useful.

**Intergovernmental Fiscal Arrangements (Chapter 4)**

ES.37. Lao PDR continues to move towards a more transparent, rule based system of intergovernmental fiscal transfers and clear assignments, to replace the hitherto *ad hoc* negotiated budget process. This began with the State Budget Law of 2006, and has been followed by the re-centralization of the treasury function, and customs and tax administration, and the introduction of spending norms (mandated minimum spending levels) for the provinces in health and education.

ES.38. Assignment of expenditure responsibilities in the State Budget Law, however, requires further clarification and streamlining of functional responsibilities. In particular,

there is a need to make clear the functions that the center will retain and implement, those that it will continue to finance but delegate responsibility for implementation to sub-national governments, and those it will decentralize fully, but retain regulatory oversight. An early lead in this was given by the Ministry of Education in 2002, and this initiative should be resuscitated.

ES.39. Expenditure norms, initially for non-wage expenditures, in education and health have been developed by the Ministry of Finance to guide budget preparation and execution. This will need to be extended to other major sectors and cover staffing as well, at the same time clarifying functional responsibilities.

ES.40. The State Budget Law specifies absolute categories for revenue sharing, though relative shares still have to be agreed. Currently, local governments do not have authority to set rates for the taxes they benefit from directly. The Ministry of Finance is designing an equalization grant system based on expenditure needs, though has not yet determined the size of the grant. Design of a conditional grant system still has to be undertaken, and both have to be coordinated with expenditure norms.

ES.41. In planning the work ahead, the government will need to set priorities and determine the sequence for introduction. The starting point should be the re-issue of the original Ministry of Education instruction, and its adaptation to health. A formula index that takes account of population, poverty and land, for the allocation of shared taxes will be superior to one based on the derivation principle.

ES.42. Further work includes introduction of an equalization grant for worse-off provinces, based on an expenditure norms and revenue capacity, and, later, expenditure norms for other sector down to the district level. In the medium term, the government should consider granting some tax autonomy at the provincial level, a distinct assignment of revenues for the provinces and districts, and the full-fledged introduction of conditional grants for recurrent purposes.

**Main Recommendations**

ES.43. The main recommendations of the PER are:

- **Budget Planning and Classification**
  - Increase budget coverage to capture all overseas development assistance and technical revenues from agencies.
  - MF issue indicative budget ceilings to ministries and agencies with the Budget Circular.
  - Integrate the recurrent, investment and personnel budgeting processes.
  - Follow the budget calendar as stipulated in the Budget Law.
  - Improve budgeting especially for the social sectors by improving coordination between central and local budget departments as well as respective sector ministries.

- Introduce full GFS consistent functional classification in the chart of accounts and to implement this classification uniformly across the general government.

- Develop a medium term fiscal framework to guide preparations of the budget.

- **Budget Execution**

  - Complete implementation of the consolidated single account within the National Treasury and ensure technical revenue accounts are captured within the fiscal reporting system.

  - Ensure all transactions are entered into ex-ante into the budget execution and reporting system, and that the practice of ex-post transaction entries is phased out.

  - Ensure arrears on utilities are monitored and settled within the year, especially on electricity.

- **Fiscal Reporting**

  - Report the structure of budget using standard GFS economic and functional classifications. Currently more than 70 percent of expenditures are lumped together into "administration, including debt service".

  - Prepare budget execution reports with variance analysis for major expenditure categories.

  - Expand coverage of fiscal reports by including ODA and technical revenues across the country.

  - Publish procurement monitoring reports, as required under the Public Procurement Law.

- **External Audit**

  - Expand coverage of the financial audit to all agencies under the general government – central and provincial levels – whilst improving quality.

  - Publish findings of the audit reports and actions taken by agencies to address audit concerns.

# CHAPTER 1 MACRO-FISCAL PERFORMANCE

## A. INTRODUCTION

1.1 Lao PDR's macroeconomic performance has changed markedly compared with the period analyzed in the last PER.[4] During 2004-10 Lao PDR experienced a resource-related boom and bust cycle, while in the years before 2004 the country was recovering from the after effects of the East Asian crisis. While resource sectors were buoyant, non-resource GDP growth was also robust. From a public finance perspective, a rapid increase in revenues allowed greater spending on previously compressed public expenditures, at least until 2007/2008. Within a short space of time, however, Lao PDR has been exposed to the challenges posed by the volatility of resource-related revenues, with copper prices falling and domestic revenue growth easing in 2008/2009. Nevertheless, the impact of the recent global economic crisis on the Lao economy was less than initially expected. It was felt through the slowdown export earnings (resource and non-resource, particularly agriculture), reduced FDI inflows and tourism income. Despite these adverse effects, the real growth remained at 7.5 percent in 2009 supported by the recovery of commodity prices and expansionary fiscal and credit policies. Growth of 8.4 percent is expected to be recorded for 2010.

1.2 During the period under review, Lao PDR has made steady progress on a public finance reform agenda, addressing to varying degrees several weaknesses noted in the last PER. Revenue and expenditure administration has been strengthened and the government has shown prudence in spending the revenue boom. The 2008/2009 downward pressure on revenues combined with expenditure expansion, especially off-budget, has, however, put a strain on fiscal balances. While this policy stance has helped sustain aggregate demand in the face of slowing economic activity, it can only be temporarily pursued and is being phased out. Barring these short-term events, given the growth prospects in the resource and non-resource sectors, and recent reform efforts, Lao PDR is well positioned to continue to build on the gains of recent years to ensure fiscal sustainability.

1.3 This chapter begins with a review of recent macroeconomic developments and the short-run challenges that the government is facing due to the knock-on effects of the global financial crisis. It then assesses progress made in confronting the three challenges identified by the last PER: (a) mobilizing revenues, (b) improving expenditure allocation, and (c) ensuring debt sustainability in the medium to long-term. In the following analysis, as in the last PER, aggregate revenue and expenditure data are based on IMF classification, whereas expenditure data by sector or province are based on Lao PDR's official gazette.[5] In assessing the above challenges this note finds that while a number of these have been successfully addressed, new ones have arisen.

1.4 Thus while overall revenue performance has benefitted before the global crisis from the boom in international commodity prices as well as the coming on-stream of large resource projects, these have pointed to new vulnerabilities, namely the volatile nature of such revenues

[4] Lao PDR Public Expenditure Review Integrated Fiduciary Assessment, Report No. 39791-LA, World Bank, May 2007.

[5] IMF's classification as presented in its Article IV Staff reports is closer to GFS, than that in the official gazette.

and the consequent complexities for fiscal management. Not only does this imply the need for fortifying the government's capacity to better manage such volatility, it also points to the challenge of implementing broad based tax reform for strengthening the non-resource tax base. For Laos this means building on the success of tax reforms of recent years, and fully implementing the long delayed value added tax.

1.5 Implementation of the new Budget Law, passed in 2007, has under-pinned many of the fiscal reforms that have taken place in the past two years and which are covered in greater detail elsewhere in this report. Going forward a key medium term challenge is to strengthen center-provincial relations, including inter-governmental fiscal arrangements that ensure that national priorities are reflected in budgetary allocations and disbursements. This requires better revenue sharing arrangements and a need to move to a norms-based transparent system of allocation of inter-governmental transfers. Initial efforts on this front covering the health and education sectors can serve as useful pilots in this regard.

1.6 The need to strengthen the allocation of public expenditure, both among economic categories and across sectors, remains an important issue in Laos. Within economic categories, the concerns have been the size of the wage bill and the capital-recurrent balance. While this note analyses emerging expenditure trends and notes certain improvements in recent years, the data do not permit conclusive assessments. In addition there are a number of extra budgetary statutory funds which operate largely outside the discipline of government procedures and monitoring.[6] These will also constitute an important medium term challenge for the government which needs to bring all these activities onto the budget or halt them. Fortunately, the extensive public financial management reforms which are currently underway do hold the promise of considerably improving fiscal data collection and dissemination. Such information would be essential in quantifying the government's efforts at improving the equity and efficiency of public expenditure.

1.7 The ratio of external public and publicly guaranteed debt to GDP declined from 112 percent in 2001 to around 55 percent in 2009, aided by real exchange rate appreciation. The ratio is projected to further reduce to about 51 percent in 2011. This includes the rise in domestic debt from the quasi-fiscal and off-budget activities. But the debt burden is projected to ease thereafter as fiscal adjustment is pursued over the longer term. The projected decline in the debt-GDP ratio is also helped by a pick-up in GDP growth as the construction of new large resource projects resumes, rising incomes boost consumption and non-resource sectors expand. Robust GDP growth, in the medium to long term is expected to be sustained by a deepening of reforms to create an enabling environment for business development. However, Lao PDR's external debt dynamics will remain sensitive to the performance of the resource sector.

1.8 The last PER had cautioned about growing government arrears and raised concerns about the contingent liabilities of SOEs and SOCBs. Good progress has since been made in addressing both issues. Arrears have been largely extinguished while SOCBs have undertaken reforms, significantly cleaned up their balance sheets, and in return have been recapitalized by the government. Nonetheless their capital position is not strong. This point to the need to monitor

[6] These are the Road Maintenance Fund, Poverty Reduction Fund, Forestation Fund, Social Welfare Fund, Social Security Fund for Public Sector, Environment Protection Fund, and the SMEs Development and Promotion Fund.

these entities closely while maintaining the momentum of efforts to reform their operational and governance practices.

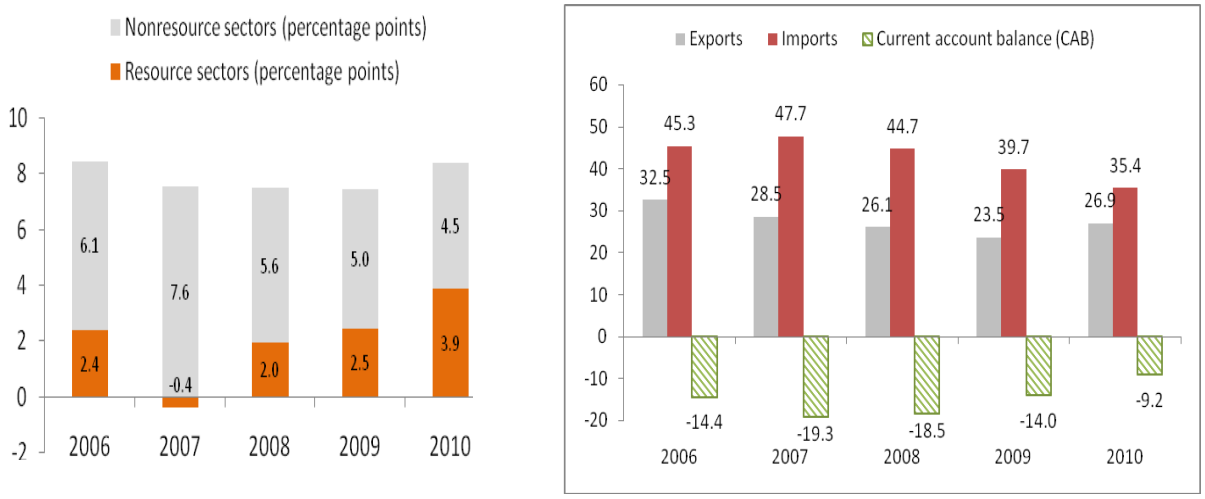
## RECENT MACROECONOMIC DEVELOPMENTS

1.9 *Overall performance of the economy:* Lao PDR experienced a period of solid growth during 2005-10, with real GDP growth averaging 7.7 percent (Figure 1a). Resource sectors have played an increasing role in driving the growth. However, the recent global financial crisis caused some concerns on the potential impacts on Lao PDR. But the Lao economy performed relatively well during the crisis, largely due to the quicker than expected recovery of commodity prices and expansionary fiscal and credit policies, which have acted as a fiscal stimulus and boosted domestic aggregate demand

1.10 Real GDP growth averaged around 7.5 percent in 2008-09. Growth still remained robust, driven by the rapid expansion in the natural resource sectors, contributing about 2.8 percentage points to this growth. Large hydro and mining projects, through their direct and indirect impacts on economic activity, were key contributors to growth—the Nam Theun 2 (NT2) hydroelectric power project, whose construction commenced in mid-2005 and which begun exporting electricity in early 2010; and two foreign-owned gold and copper mining companies which began operations in 2004-05 and reached high capacity utilization by 2007.

1.11 Real GDP is projected to accelerate to 8.4 percent in 2010. This growth is driven by rapid expansion in the natural resource sectors (mainly electricity exports from the NT2, steady growth in agriculture, construction and a rebound in processing industry and tourism. The resource sectors (hydropower and mining projects) contribute around 3.9 percentage points to this growth, including 3 percentage points from NT2. The remaining 4.5 percentage points come from non-resource sectors.

**Figure 1: (a) GDP growth (% pa) (b) Export ($mn) and Current Account Balance (% GDP)**




**Source: World Bank Staff estimates.**

1.12 **The booming exports (especially from mining and power sectors) have narrowed the current account deficit to about 9.3 percent of GDP in 2010 from 13.6 percent in 2009.** Total exports grew at an average rate of 21 percent per annum in value terms during 2004-09, with resource-based exports rising by 36 percent per annum. Resource exports (hydropower and mining) have taken a significantly increasing share in total exports, reaching more than 60 percent in 2009 (Figure 1b).Exports earnings were sustained in nominal terms in 2009, due to the relatively low exposure of the economy to the collapse in demand in industrialized countries, while demand in the region remained robust. Lao exports performed well in 2010 supported by increased regional demand, the operational start of new hydropower projects, and favorable commodity prices. Exports have increased (in nominal terms) by about 40 percent in 2010 (or US$2 billion) supported by resource exports (electricity grew by 140 percent and copper and gold together by 48 percent) while imports have grown by about 11 percent driven mainly by the non-resource sector: the non-resource current account deficit is estimated to deteriorate in 2010 to 20.6 percent of GDP, due to fast rising imports (consumer and some investment related goods) above the pace of expansion of non-resource exports across sectors (agriculture by 13 and garments by 15 percent, driven by demand from China, Thailand, Vietnam and the EU (garments)). Main Lao exports of goods include minerals/metals (mostly copper and gold), hydro-electricity, garments, wood and wood products, and -- agricultural products while imports contain investment goods (machinery and equipment, construction materials, etc.), fuel, raw materials for garment industries, agriculture and processing industries, and various consumer goods.

1.13 **Net capital inflows are estimated to decrease by 2.3 percent of GDP in 2010.** Capital inflows, mostly FDI, have been robust and more than financed the current deficit, despite a decline in inflows in the midst of the global crisis. The economy has been reliant on FDI in the past few years, most of which has flowed into the resource sectors. FDI inflows increased substantially until 2007 before a notable slowdown in 2009 and a decline in 2009 due to the crisis. FDI is estimated to remain at a similar level in 2010 compared to 2009. A large proportion of inflows are expected to finance the mining and hydropower projects. . The net flow of capitals is estimated to decline to 10.1 percent in 2010 from 12.4 percent of GDP in 2009 due to a temporary plunge in foreign investments in the resource sectors (especially hydropower) and a large increase in income transfers by resource projects (repatriation of profits of around US$ 367 million compared to about US$ 135 million in 2009). Outside the resource sector, foreign investment is expected to flow to construction and services (mainly tourism).

1.14 **Foreign reserves have built up over years, although with some fluctuations.** Foreign reserves have built-up, rising from 228 million dollars in 2004 to 636 million dollars by end-2008 (3 months of imports). Gross reserves at the end of 2009 were stable at around $633 million. These have been supported by IMF's SDR on equivalent to $65 million and the BOL's issuance of foreign currency denominated bonds to commercial banks. However, foreign exchange reserves dropped sharply by 12 percent (yoy) in the second quarter of 2010, recorded at $558 million due to, among other factors, reduced flows of investment following completion of large projects.

1.15 *Inflation:* Since the end of 2009, inflation has picked up relatively quickly due to the recent rebound in energy and food prices. The headline inflation was 4.8 percent in May 2010 in which 2 percentage points came from food prices, 1.6 percentage points from energy and the

remaining from the core inflation. Demand side pressures also began to play a role as credit growth climbed to 63 percent by mid-2008 and to about 90 percent in end 2009, though from a relatively low base. Before then, the sharp fall in fuel prices in 2009 largely contributed to the historically low inflation of about 0.1 percent average in 2009, after the sharp global rise in food and fuel prices in 2008.

1.16 *Exchange Rates:* The kip was allowed to strengthen against the U.S. dollar and the Thai baht, in the face of large capital inflows but also to offset inflation pressures. After a period of pronounced appreciation, the kip nominal exchange rate against the US dollar was relatively stable over the last year. The *de facto* peg against the depreciating US dollar caused a depreciation of Kip against Thai baht last year until early 2010.

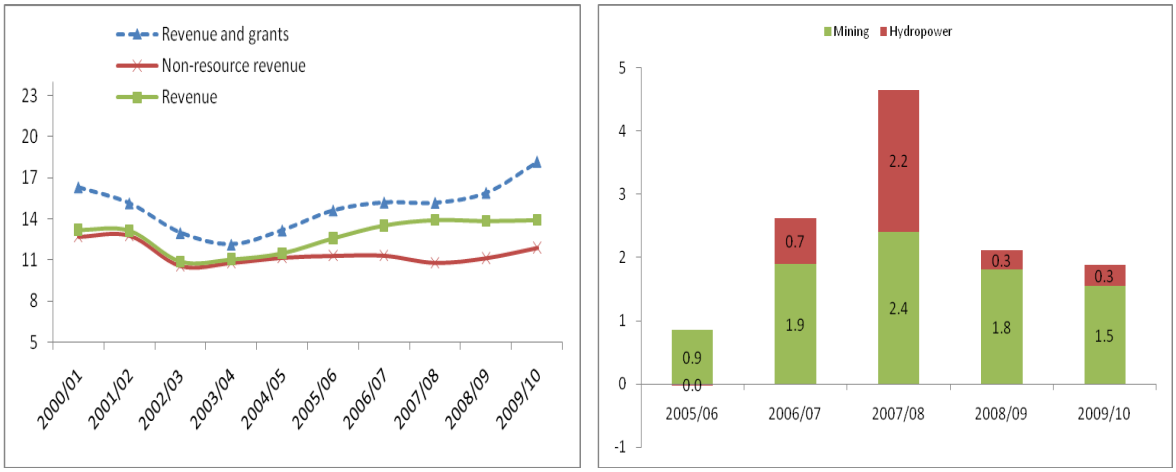
1.17 *Fiscal Balance:* The fiscal deficit has increased in recent years, mostly on the account of off-budget spending to provincial projects financed by the Bank of Lao PDR. The fiscal deficit widened significantly in FY2008/09 (6.7 percent of GDP) due to the pressures from the global crisis and expansion in public spending related to public investments combined. Public outlays grew rapidly to about 22.6 percent of GDP in FY2008/09 from 18.1 percent in the previous fiscal year. This included off-budget spending through the BOL's lending to finance local infrastructure projects, which accounted for about 3.8 percentage points of the FY2008/09 deficit. Revenue shortfalls also contributed to the widening of the budget deficit in this fiscal year, particularly from resource and non-tax revenue. The fiscal situation is expected to improve in 2009/2010, with the fiscal deficit in 2009/10 decreasing to 4.6 percent of GDP, and total revenues expected to increase by around 2.2 percent of GDP. The on-budget deficit in 2009/10 is projected at about 1.9 percent of GDP. In response to the macroeconomic pressures emanating from such expansionary policies, the government decided in September 2009 to phase out quasi fiscal operations of the BOL by extending credit only to committed projects, to stop any new commitment over new projects, and to slow the pace of credit growth. The fiscal deficit has remained slightly above 3 percent of GDP on average from fiscal years 2003/04 to 2007/08. Revenue increased steadily and exceeded targets three years in a row up to FY2007/08. Expenditure also rose steadily over the years in response to the growing demand for development and provision of public services.

1.18 *Growth of Aggregate Demand:* The main short-term challenge that Lao faces is related to the rapidly rising aggregate demand which is causing fast import growth and a loss in net foreign assets. Credit growth has been growing fast over the last 2 years, and net foreign assets in the banking system declined markedly in 2009. Credit was growing 90 percent year on year as of end December 2009 and 85 percent in March 2010 (slightly down from the record high of 98 percent growth at the end of June 2009). An important contribution to credit expansion (22 percentage points) came from the BOL's direct lending to local projects to finance public infrastructure and associated imports. This direct lending has been financed through BOL sales of US denominated and, to a less extent, Kip-denominated bonds to commercial banks. This "swap" of banks net foreign assets for domestic credit and imports has therefore translated into a notable growth in broad money (31 percent year over year by end 2009 and 29 percent by March 2010), and a fall in net foreign assets (-12 percent by March 2010). The government has committed to phasing out this off-budget lending, which brought down credit growth to 46 percent by end 2010.

## GOVERNMENT REVENUES

1.19 With large mining and hydro operations coming on-stream the government's revenue situation has strengthened considerably since 2004/05. The bulk of the increase in the revenue to GDP ratio in this period came from resource revenues (Figure 2).[7] While non-resource revenues (tax and non-tax) have remained roughly flat between 2004/05-2008/09 at about 11 percent of GDP, resource revenues increased from 0.7 percent of GDP to 2.7 percent. The main increase in resource revenues stemmed from copper followed by gold exports, both of which benefited not only from increased production but also a boom in prices. Government revenues from mining and hydro power include royalties, corporate (profit) tax and dividends (since it also holds an equity stake) and income tax. Profit taxes have been the chief contributor in the case of mining as the government has been able to capture the upside of rising prices. In the case of hydro projects, given the high level of debt financing, their taxable profits are considerably reduced by hefty debt service payments.

**Figure 2: (a) Total & Non-resource revenue (% GDP) (b) Resource Tax revenue (% GDP)**



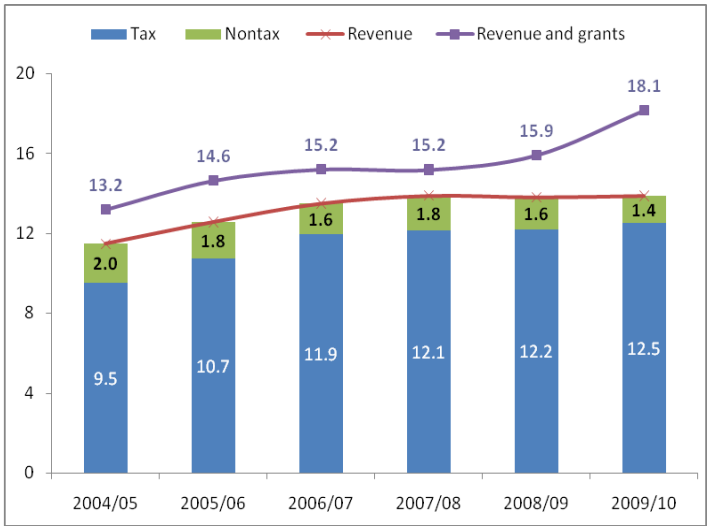

*Source: World Bank Staff estimates.*
*Note: Preliminary estimate for FY2009/2010*

1.20 *Total Revenues:* Despite a shortfall in domestic revenues due to the global crisis, total public revenues have remained stable in 2008/2009 as a share of GDP. The revenue to GDP ratio declined slightly from 13.9 percent of GDP in 2007/08 to 13.8 percent in 2008/09 while overseas development assistance rose from 1.3 percent of GDP to 2.1 percent at the same time, thereby offsetting the shortfall in domestic revenue. Tax revenue increased from 12.1 percent of GDP in 2006/07 to 12.2 percent in 2008/09 driven largely by higher profit from mining (mining sector's earning in 2008) and income taxes (mainly from increased public wages and also minimum wage for the country). However, the GoL's domestic revenue is estimated to increase by 21 percent (in nominal terms) in FY2010 due to higher tax collection, especially from VAT, resource royalties and customs duties. However, the revenue to GDP ratio has slightly declined to about 13.3 percent in FY2010 compared to 13.8 percent in FY2009 due to the rapid GDP growth.

[7] Resource revenues include those from hydro power and minerals. Timber royalties are included in "non-resource" revenues.

1.21 *Tax Revenues:* Supported by reforms, tax revenues have regained ground since the lows of 2005, (Figure 3). The main reforms implemented were the Tax Law of 2005 which widened the tax base and the introduction of VAT in 2010. VAT was introduced in January 2010 after its postponement in 2009 due to uncertainties of the global economic environment. Preliminary indications suggest that VAT collection is higher than the turnover tax it replaces[8]. Nevertheless, it is still too early to make a judgment on the overall revenue impact of VAT introduction. Efforts were also made to reduce leakages in revenue collection by requiring traders to disclose the identities of purchasers, standardizing tax forms, and introducing an electronic filing system for large tax payers.

**Figure 3: Tax Revenue 2004/05-2009/10 (% GDP)**



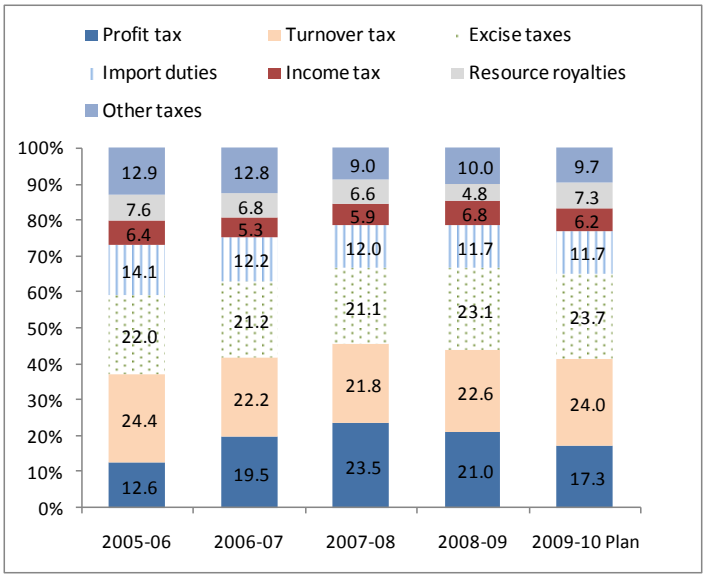

*Source: World Bank Staff estimates.*

1.22 Other reasons for the rise in revenues are linked to movements in commodity prices and as such are mainly exogenous rather than reforms-induced. Receipts from timber royalty, though by now a small share of total revenues, increased in 2006/07 because part of the allocated quota that remained uncut in the previous year was brought forward and the administered price of timber rose in line with the international price. Importantly, fluctuations in oil prices led to variability in associated revenues, through collections from excise taxes and import duties levied on oil products. Revenues from oil consumption went up following the sharp rise in oil prices before 2008, after moderating in the first half of 2008 when the government froze the dutiable price of oil to shield customers from the price increase. In 2009, with oil prices coming down significantly the government introduced an additional excise on oil to shore-up revenues. More recently, declining oil prices reduced revenues from fuel consumption taxes. Road fees (or fuel levy), which doubled, in steps, from 150 kip per liter in 2004/05 to the current level of 300 kip, were another key contributor to the increase in 2006/07. Receipts from the fuel levy are dedicated to the *road maintenance fund.*

[8] Data of five month VAT collection from 20 large tax payers shows that VAT collected from these taxpayers is 38% higher than the turnover tax revenue collected from them for the period in 2009.

1.23 In terms of the structure of tax revenues, the profit, turnover (to be eventually fully replaced by VAT) and excise tax have remained the key contributors (Figure 4). The share of the turnover tax is expected to increase in this fiscal year, partly due to the introduction of the VAT. The share of the excise tax also increased to more than 23 percent of tax revenue in the recent year. This increase could be due to the offset for lower import duties, which in turn resulted from lower imports during the crisis and the lower tariff rates for some imported products under ASEAN. A notable increase of the profit tax was recorded from 2005/06 until 2007/08 before declining further to about 20 percent in 2008/09. It is expected to decline further to about 14 percent in 2009/10.

**Figure 4: Structure of tax revenue, 2005/06 and 2009/10 (plan)**




*Source: World Bank Staff estimates.*

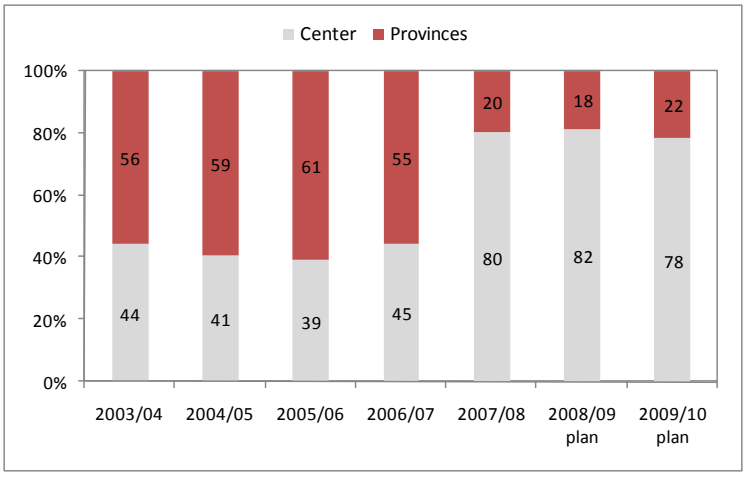
1.24 *Tax Policy and Tax Administration:* The shortcomings in the areas of tax policy and administration highlighted in the last Public Expenditure Review (PER) are being addressed. The PER noted that government revenues fell by 2 percentage points of GDP between 2001 and 2005. This happened at a time when recovery after the knock-on effects of the 1997 East Asian Crisis had set in, and thus the decline in revenues could not be attributed to slow economic activity. This decline partly reflected lower timber royalties following the government's decision to impose an export ban on unprocessed logs. Lower taxes and dividends from SOCBs and SOEs also contributed as their finances were rationalized. But the main reasons for the poor revenue performance lay chiefly with weaknesses in revenue administration and the erosion of the revenue base related to tax incentives.

1.25 A fragmented revenue administration in which provinces had responsibility for collecting a major share of the central government's revenues had been the most significant impediment to greater revenue mobilization. A decree passed in 2000 (PM 01) increased provincial autonomy in collecting revenue. It shrank the number of firms administered by the central *large taxpayer unit*—from 723 to 50—as firms were transferred to provincial tax offices and it put customs posts under the control of the provinces. The center was left with only limited authority over provincial tax offices and its capacity to oversee their operations was weak. This revenue

structure not only hampered efforts to improve tax administration but also delayed the implementation of major reforms, such the VAT.

1.26 But this is now changing: the Government has made considerable progress in putting in place an appropriate legislative framework for better managing budgetary resources. It has started implementation of the Budget Law of 2007 which focuses on centralization of the Treasury Department, the Customs Department, and the Tax Department. The Government has adopted the Treasury Single Account framework requiring all spending agencies to transfer control of their bank accounts to the centralized national treasury. To date, the Ministry of Finance (MOF) has managed to gain control over all provincial treasury accounts, major extra-budgetary fund such as the road fund, and bank accounts of line ministries. Revenues collected by the tax and customs departments are deposited into these bank accounts. Approximately 80 percent of total public finances flow through these accounts[9]. The remaining 20 percent represent bank accounts held by spending agencies collecting technical (non-tax) revenues. To bring these revenues on budget, the MOF has recently issued decisions on technical revenue management and transfer of technical revenue accounts from commercial banks and the BOL into the Treasury. The consolidation of these accounts into Treasury has already started and the MOF plan to fully complete this process within a year. Improvement in public finance management has produced tangible results. Domestic revenue to GDP ratio increased from 12.6 percent in 2005/2006 to 13.8 percent by 2008/09.[10] Improvement in revenue collection and enhanced expenditure controls have allowed the Government to fully fund budget expenditures and to start settle arrears on utilities.

**Figure 5: Center-Province shares in Revenue**




Source: Lao PDR Official Gazette, various issues.

[9] Subject to the caveat noted in footnote 2.

[10] This increase in revenue effort is a combination of public financial management reforms as well as high commodity prices.

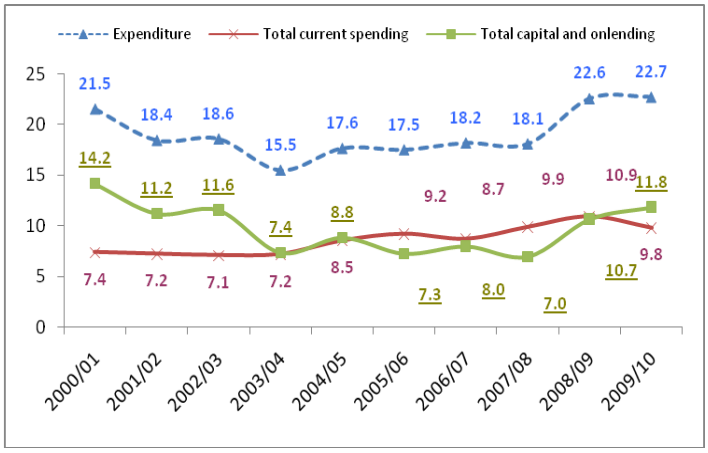
1.27 Given the uncertain and volatile nature of resource revenues and possible reduction in trade taxes under trade agreements, reforms to broaden the tax base need to be fully implemented. The long delayed introduction of the VAT started in January 2010. It is estimated that there are about 4,000 business units that are identified as VAT Taxpayers and up to now 48% of them have reportedly been registered. By midyear, about 500 Taxpayers had submitted their VAT returns monthly and currently all returns are processed manually. Relevant IT applications (Lao TIS VAT) are being developed to facilitate VAT implementation and reduce burden on staff's workload. The Tax Department has planned to "go live" with Lao TIS VAT implementation at the center in the second half of 2011 and roll it out to other two provinces in 2012. Both staff size and capacity need to be strengthened in order to better service the VAT Taxpayers. Moving forward, there is a need to complete registration of all VAT tax payers and enforce compliance by them. Enhanced efforts need to focus on tax payer education and communication.

1.28 Lao is a signatory to the ASEAN Free Trade Agreement (AFTA) under which nearly all tariff lines have to be reduced to under-5 percent by 2015. Apart from the potential benefit of the VAT in reducing distortions caused by the turnover tax, the VAT is also one way to make up for the lost tariff revenue as it will be levied on imports as well. The issue of tax and customs exemptions that are eroding the tax base, especially for provinces still needs to be fully addressed.

## GOVERNMENT EXPENDITURE

1.29 *Recurrent Expenditure:* Since 2005 the rapid rise in revenues has allowed an increase on previously compressed recurrent expenditures (Figure 6). The previous PER found that the decline in revenues combined with a fall in aid inflows between 2001 and 2005 led to a compression of expenditures. The decline in aid flows was reflected in the considerably lower level of capital expenditure by 2003/04. On the recurrent side, the resource squeeze was mainly felt on non-wage expenditure.

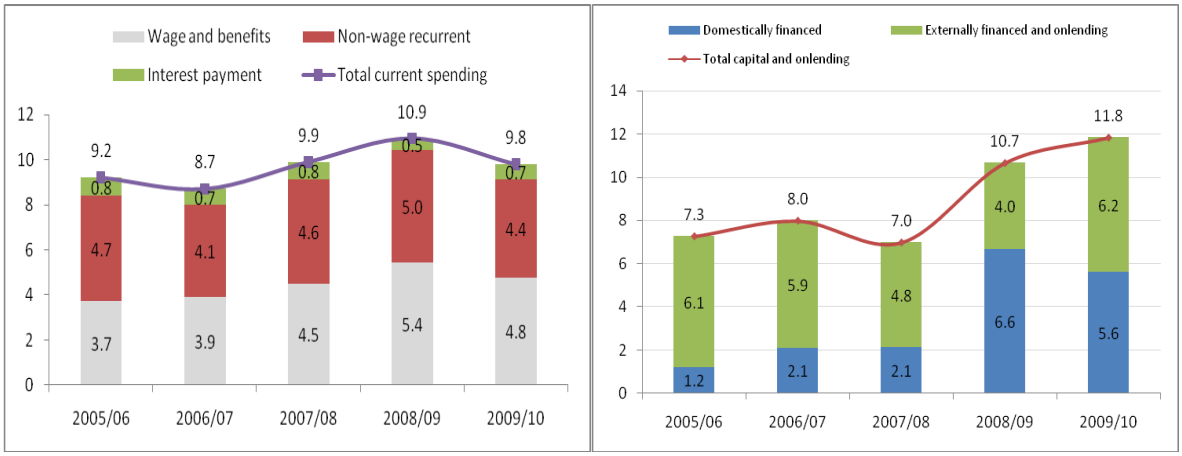
**Figure 6: Total Expenditure, Current and Capital Expenditure (% GDP)**




*Source: IMF and Bank Staff estimates.*
Note: Preliminary estimate for 2009/10

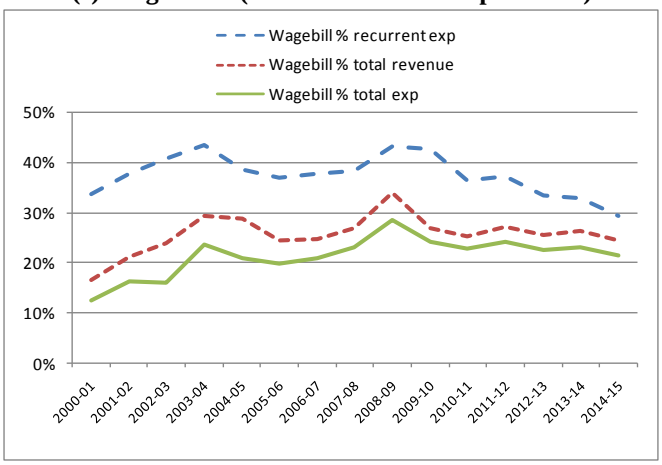
1.30 *Government Wage Bill:* Both wages as well as non-wage recurrent expenditure have grown as a proportion of GDP (Figure 7a). The share of wages in recurrent expenditure had risen during 2001-04 and fell during 2005-2006. Since FY2006/07 the share has picked up gradually. Government wages were increased by an average of 12 percent in October 2006, by a further 26 percent in October 2007, and another 20 percent in October 2008. A minimum wage increase of 20 percent was announced in February 2009. The previous PER assessed that there was a case for increasing public service wages based on international comparisons and the fact that wages had been declining in real terms. A cautious approach was suggested, however, and one that maintained an appropriate balance between the wage bill and the pressing need to increase non-wage operations and maintenance spending. The Medium Term Fiscal Framework (MTFF) prepared in the last PER recommended that the wage bill be realigned with revenues and that the ratio of wages to revenues be kept broadly unchanged. This has largely been the case until 2006/07, until which point the wage bill stayed below 30 percent of revenues. In 2007/08, however, the wage bill began to creep up, and by 2008/09, the wage bill had risen to almost 40 percent of revenues. The 2009/10 had planned budget and forward projection figures suggested that GOL had recognized the importance of reigning in the wage bill back to around 27 percent as a share of revenues, but this implementation must be monitored closely.[11] Any plans for additional across-the-board wage increases should be viewed with some caution. As a result of tightened wage policy, the wage expenditure as a share of GDP is estimated to fall to 4.5 percent in FY2010 from 5.4 percent in FY2009.

**Figure 7: (a) Recurrent expenditure (% GDP)** **(b) Capital Expenditure (% GDP)**




[11] According to preliminary results of the 2010 Civil Service Pay and Compensation Review, the current compensation levels of civil servants are, for the most part, relatively adequate in comparison to the private sector and state-owned enterprises

**(c) Wage Bills (% of revenue and expenditure)**




*Source: IMF and Bank Staff estimates.*

1.31 *Capital Expenditure:* On the side of capital spending, while externally financed expenditure fluctuated, domestically financed capital outlays were buoyant (Figure 7b). As a result total capital expenditure increased markedly. The sharp increase in capital expenditure in 2008/09 and to a lesser extent 2009/10 is in large part due to off-budget spending quasi-fiscal operations of the BOL directed at provincial expenditures, including expenditures related to the SEA games and the 450th anniversary of Vientiane capital city.[12] As a result, domestically financed capital investment is expected to decline from 6.6 percent in FY2009 to 5.6 percent in FY2010 following the phase out of off-budget spending.

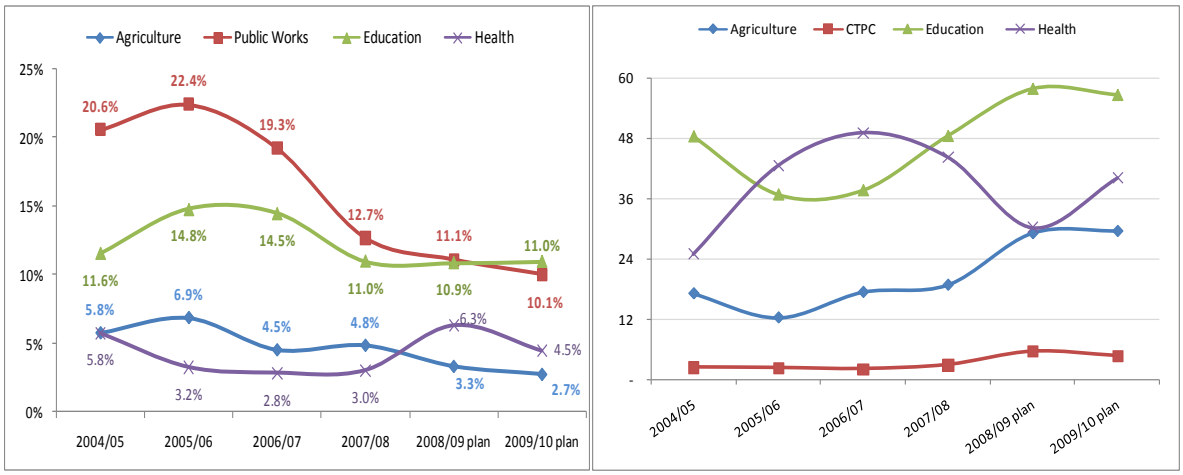
## SECTORAL ALLOCATION OF EXPENDITURE

1.32 *Priority Sectors of Agriculture, Public Works, Education and Health:* At the sectoral level the falling share of expenditure budgeted for infrastructure (MPWT)[13] stands out (Figure 8a). Four data-related caveats are in order. First, the latest year for which outturn data are available is 2007/08. Since then only budgetary allocations are available. Second, data are compiled along administrative or ministerial lines, as opposed to a functional classification. As a result, elements of expenditure that belong to a certain function (e.g., education or health) may be spread across different ministries or agencies and are not entirely captured within its associated administrative classification. Third, as noted earlier, what is classified as externally or donor financed capital expenditure may in practice include elements of recurrent spending. Fourth, to the extent that donor financing is off-budget, it is not reflected in the data used here. With these data caveats in mind, the declining allocation budgeted for infrastructure chiefly reflects falling donor funded capital expenditure. Capital expenditure forms the bulk of expenditure in the infrastructure sector. In the health sector, on the other hand, its rising budget share in 2008/09 planned budget reflects an increase in donor financed capital expenditure.

[12] The stadium construction for the games has been financed through an asset (land) sale and is thus not debt-creating.

[13] Ministry of Public Works and Transport.

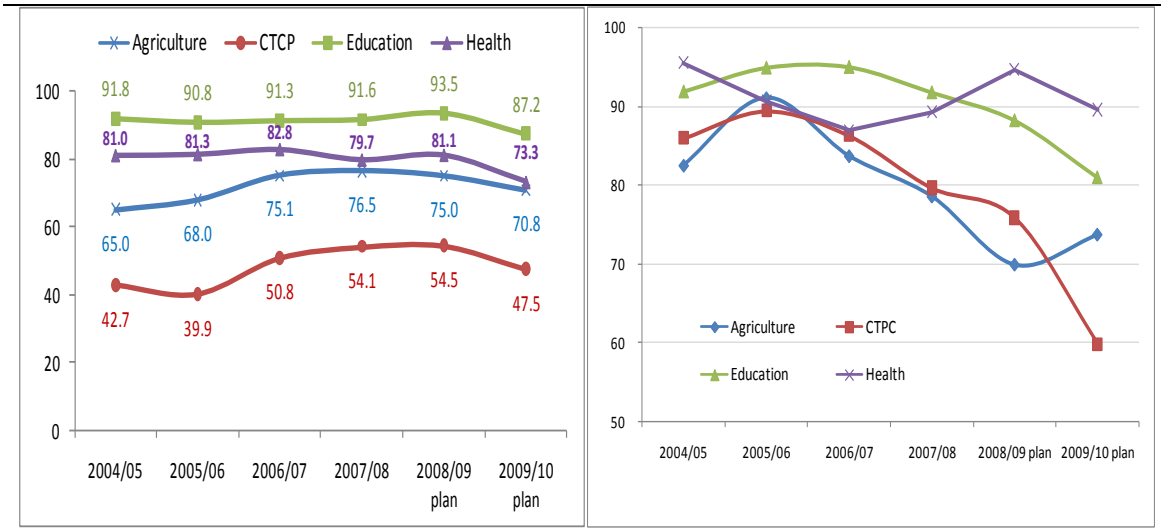
**Figure 8: (a) Sectoral shares in total expenditure (b) Shares of current expenditure within sectors**




*Source: Lao PDR Official Gazette, various issues.*

1.33 The imbalance between current and capital spending has remained, largely due to the country's needs for infrastructure development. A concern noted in the last PER was that there was insufficient allocation to recurrent expenditure relative to capital expenditure in the priority sectors. No doubt, in a low-income country, greater capital expenditure is needed to develop priority sectors, but within the given expenditure envelope the imbalance with recurrent spending was leading to deteriorating service quality. The lack of adequate recurrent financing led to delays in salary payments, shortage of supplies at health centers, shortage of text books and teaching materials, and inadequate attention to road maintenance. As Figure 8b shows, there appears to have been progress on this count. Between 2004/05 and 2007/08, the four years for which sectoral data on outturns is available, recurrent expenditure share decreased for health but increased in other three priority sectors. Based on 2008/09 and 2009/10 planned budget data, the share of recurrent in total sectoral allocation is expected to increase for health and slightly level off for other three priority sectors. Since 2006/07, however, the government has attempted to correct the imbalance between recurrent and capital expenditure in terms of the budgeted amounts, especially in education. Within recurrent expenditure, the upward trend in the share of wages appears to have flattened out, leaving more room for non-wage spending (Figure 9a). Since sector-wise estimates of actual expenditures are not available for 2008/09 yet, it is not possible to provide a definitive answer.

**Figure 9: (a) Share of wages in current expenditure (b) Donor-funded capital expenditure within sector**

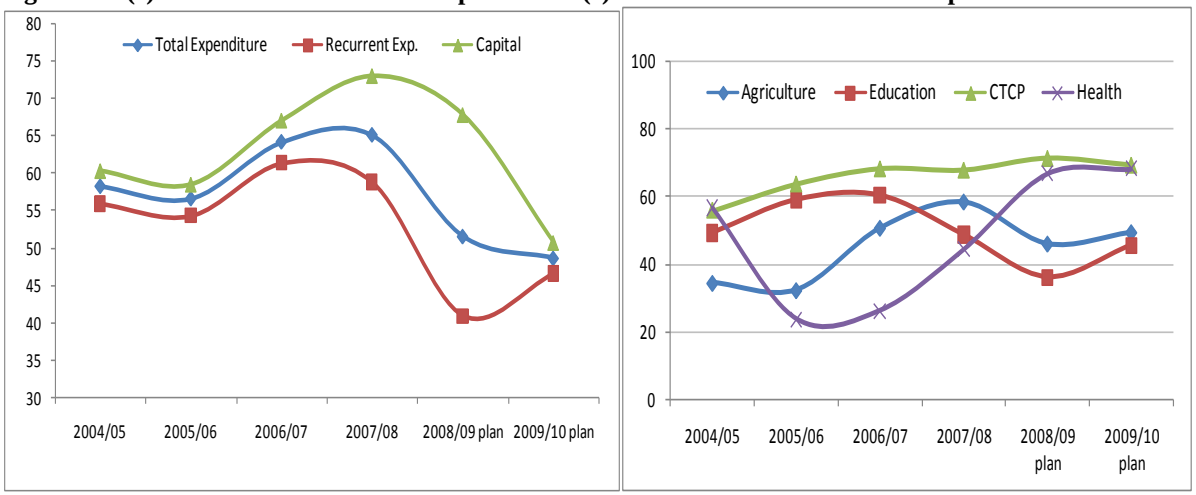



*Source: Lao PDR Official Gazette, various issues.*

## CENTER-PROVINCE ALLOCATIONS

1.34 The center's share in overall expenditure (excluding debt service) increased between 2001/02 and 2007/08 (Figure 10a). These trends were driven by an increase in the center's share of domestically financed capital expenditure, but and to a lesser extent an increase in recurrent spending. However, the shares drop dramatically in the 2008/09 and 2009/10 budget plan, partly due to the unclear classification of an additional category as "others" cited in the official Gazette. Sector shares in health and education increase steadily, while education and public works decline.

**Figure 10: (a) Center's share in Total Expenditure (b) Center's share in Sectoral Expenditure**

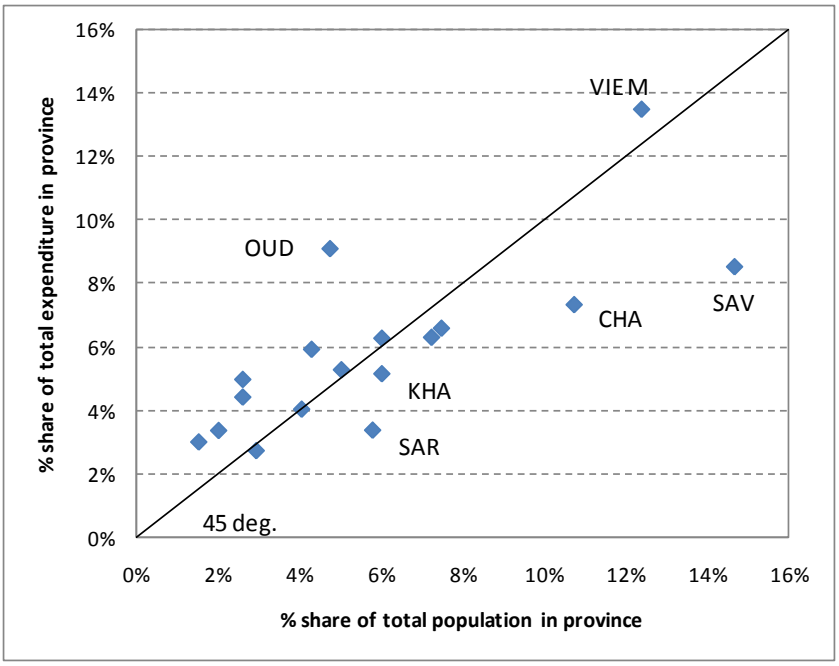



Note: The ratio of budget allocation for the central level in 2008/09 and 2009/10 plans excluded the "other" category in the *Official Gazette*, for comparison purpose.
*Source: Lao PDR Official Gazette, various issues.*

1.35 *Fiscal Relations prior to 2007:* Center-province fiscal relations in Lao PDR prior to the 2007 Budget Law were not conducive to sound fiscal management. Sub-national authorities have extensive fiscal and functional responsibilities including primary and secondary education, primary and secondary health, water supply and reticulation, non-national roads and other transport infrastructure; agriculture support and extension; and environmental management. The new fiscal structure introduced by decree of 2000 (PM 01) was based on an "upward revenue sharing" system in which most revenue was collected by the provinces. Rich provinces were to transfer surplus revenues to the center to fund both central government expenditures and transfers for the "deficit" provinces. Rich provinces had little incentive to give to poorer provinces, however, and revenue sharing became solely a matter of *ad hoc* negotiation between the province and the center.

1.36

**Figure 11: Provincial share of expenditure in relation to population**




Note: Each diamond represents a province. Data are for 2006/07.
*Source: Lao PDR Official Gazette, various issues.*

1.37 Figure 11 plots the share of a province in Lao PDR's total population against the share of expenditure allocated to that province. It shows that population size is an important determinant of provincial expenditure. If all the provinces had been on the 45 degree line that would have signified full equality of per capita allocation of expenditure across provinces. The fact that they are not, implies that other factors such as geography, cost of service provision, level of development and the negotiating power of each province have played a role.[14] While there is

[14] Criteria such as geography, the age structure of population, poverty rates, revenue raising capacity of the province, and other factors that impact the cost of service provision should play a role in determining the level of transfers. Achieving equity in per capita allocations without consideration of these factors will, nearly always, not be the most equitable or efficient outcome. Determining their influence on expenditure allocation is, however, beyond the scope of the current note.

some balance in relation to population size, this does not imply that the allocation of expenditure within the province has conformed to national priorities. Provincial authorities have had the power to transfer funds within and across expenditure items, and they also have the power to determine spending at the sectoral level. As a result of this discretionary power by the provincial governors, there has been a disparity in resource allocation between provinces and a lack of alignment with national priorities.

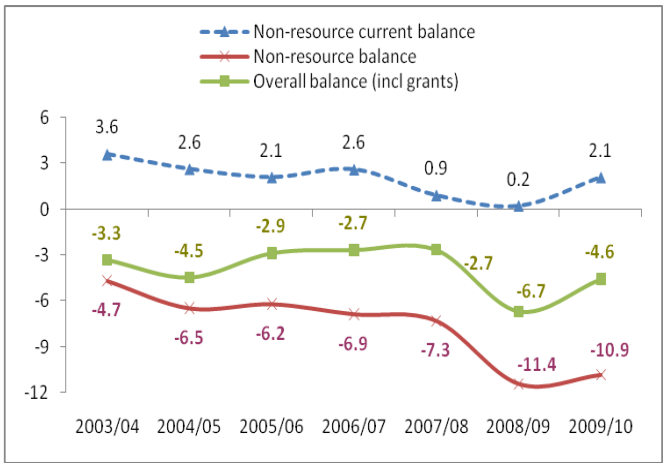
1.38 *Fiscal Relations under the 2007 Budget Law:* The new Budget Law aims to address some of the weaknesses in the current intergovernmental fiscal framework that stem from the decentralized management of public finances without adequate monitoring and control mechanisms. A key element of the Law is the development of a robust revenue sharing framework that would allow aligning policies with budget allocations. Progress has been made on adopting a system of spending norms to guide the allocation of the provincial budget for health and education. The norms would serve as mandatory requirements for minimum spending per capita for allocating fiscal resources for the sectors in the FY2010/11 Budget. Even in FY2008/09, for the first time, the Minister of Finance mandated specific allocations of health and education budget that provinces must follow. While this allocation was not based on norms that account for sector specific factors and cost differences, it represents a very important policy change which will allow the central government to ensure that provinces adequately provision for spending on these priority sectors. More progress in this area remains a priority.

**FISCAL BALANCE**

1.39 *Overall Fiscal Balance:* Higher revenue collection combined with improved expenditure controls helped reduce the overall fiscal balance from 4.5 percent of GDP in 2004/05 to an estimated 2.7 percent in 2007/08 (Figure 12). As noted earlier, however, the combined effect of a slowdown in the growth of revenues and higher expenditure, particularly off-budget spending, in 2008/09 led to a sharp deterioration in the fiscal balance to 6.7 percent of GDP. Before the global crisis, the Government had resisted the temptation to spend additional revenues, and maintained expenditures at their budgeted levels. The Government also strengthened centralized oversight and control over bank accounts in the provincial treasuries, which improved the overall fiduciary environment and curtailed leakages of funds. Government deposits rose to over 2.8 trillion kip by March 2010 and a State Accumulation Fund to save resource revenues also become operational.

1.40 *Non-Resource Fiscal balance:* The non-resource deficit, arguably a better indicator of the government's fiscal stance, deteriorated, particularly in the past two years. The increase in expenditure was fueled by the inclusion of off-budget spending (Figure 11). However, the non-resource current balance has remained positive, but on a declining trend from 2006/07 before picking up again in 2009/10. This implies an improvement in non-resource revenue in recent years.

**Figure 12: Fiscal balances (% GDP)**




Note: Includes off-budget items.
*Source: World Bank Staff estimates.*

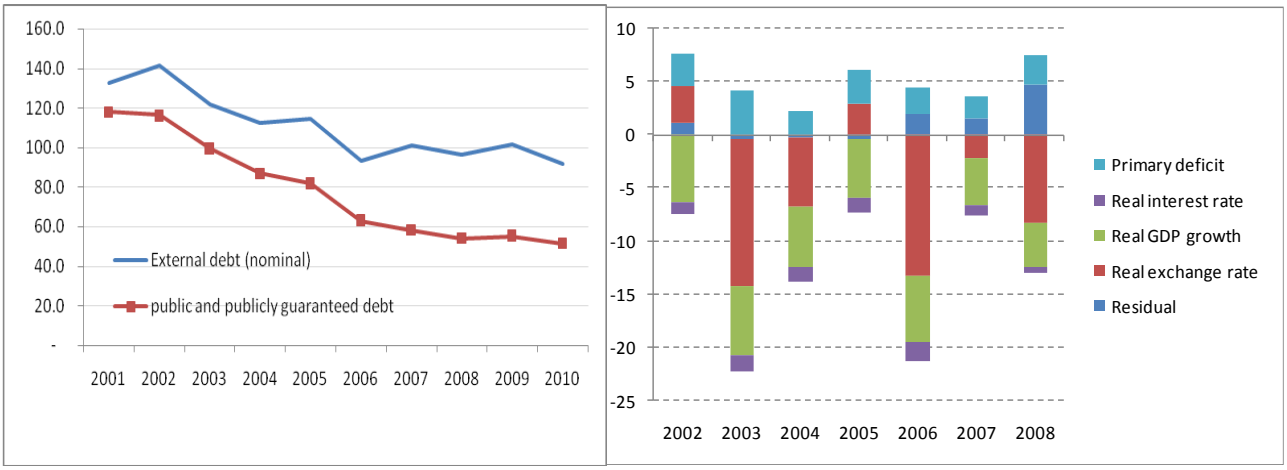
## PUBLIC DEBT AND CONTINGENT LIABILITIES

1.41 *Aggregate Public Debt:* The total public debt-GDP ratio (external and domestic) in Lao fell sharply from 112 percent of GDP in 2001 to 61.6 percent in 2009 (Figure 13a). Public and publicly guaranteed (PPG) debt is predominantly external amounting to 55.4 percent of GDP in 2009. Since the bulk of Lao PDR's external public debt is concessional, its present value at 43.4 percent of GDP in 2009 is considerably less than its nominal value.[15] But relative to exports, even the present value exceeds 100 percent.

1.42 The decomposition of annual changes in the debt-GDP ratio is presented in Figure 13b. The sharp decline in debt-GDP over the last 6 years was not attributable to fiscal (primary) surpluses. The main drivers of the reduction in debt-GDP ratio were real exchange appreciation and real GDP growth. Lao PDR is not unusual in this respect—over this period these two factors were also the main drivers of debt reduction for several developing countries.

[15] Only about 2 percent of PPG is on non-concessional terms. It mainly consists of debt contracted by public entities for hydropower development and electricity generation, including to finance equity stakes.

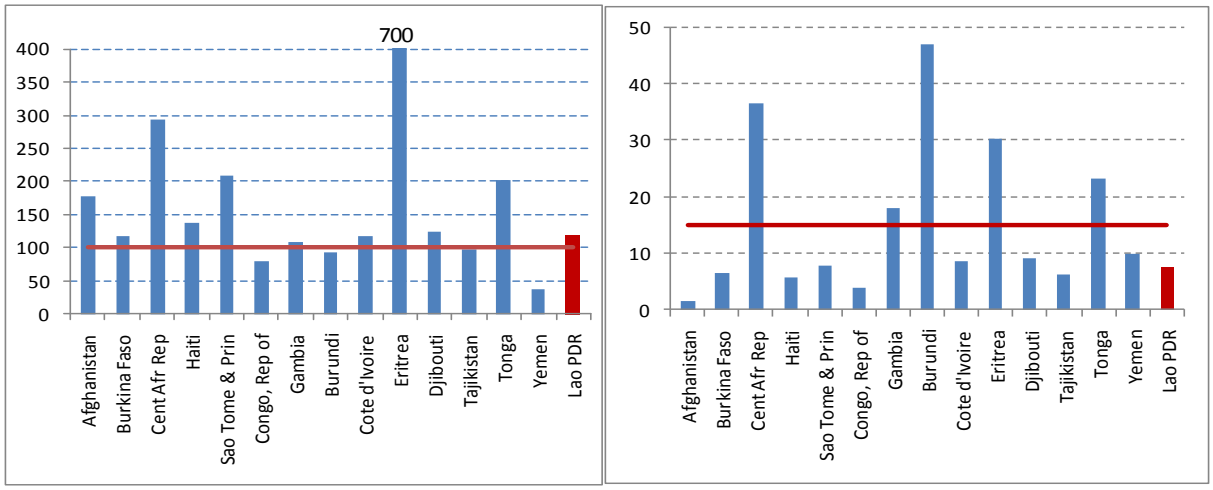
**Figure 13: (a) Total external debt and public external debt (% GDP) (b) Contribution of various factors to change in debt GDP (% GDP)**




*Source: World Bank-IMF Joint Debt Sustainability Analysis, 2009.*

1.43 Lao PDR is characterized as a country that faces a high risk of external debt distress. This rating is based on Lao PDR's stock of public and publicly guaranteed debt, as opposed to debt servicing. In other words, it is Lao PDR's debt stock indicators expressed in present value terms that breach a pre-determined threshold while debt service indicators are below their chosen thresholds. The debt threshold breached in the case of Lao is the ratio of the present value of debt to exports (100 percent). Figure 14 shows Lao PDR in comparison with these thresholds and other countries that are also classified as having a high risk of debt distress.

**Figure 14: (a) Present Value of Debt to Exports (%) (b) Debt Service to Exports (%)**




*Source: World Bank-IMF Joint Debt Sustainability Analyses, various.*

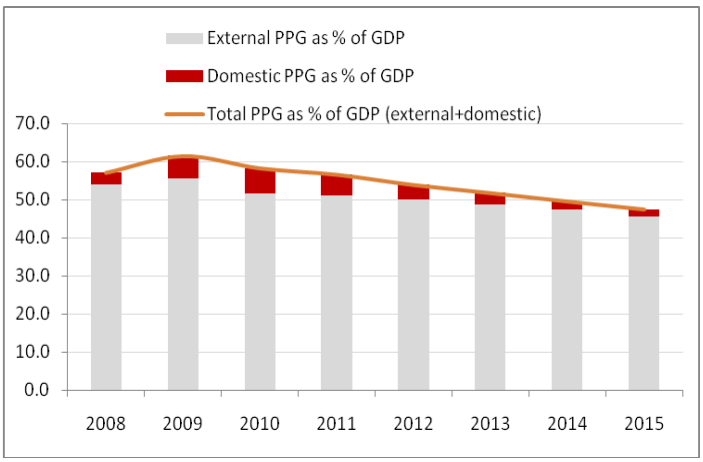
1.44 *Domestic Public Debt:* Domestic public debt comprises mainly treasury bills and bonds issued to recapitalize state owned banks. At end-2009, the stock of recorded domestic public debt amounted to 6.1 percent of GDP. However, increasing off-budget public investment by

lower levels of government and quasi-fiscal operations led to a sizable increase in the domestic debt in 2009 and 2010. Under a baseline scenario developed for the joint Bank-Fund DSA, in the absence of fiscal measures, revenue shortfalls and higher expenditure lead to a large domestic financing requirement which cannot be met through a drawdown in government deposits that were built-up over the last few years. Domestic debt rises to around 8-9 percent of GDP in the medium term and stabilizes at that level in the long term.

1.45 *Domestic and External Public Debt:* The total public and publicly guaranteed (PPG) debt is projected to peak at 58 percent of GDP in 2010 but the debt burden will ease thereafter. The ratio is expected to have declined slightly to about 56 percent in 2010. The near term debt dynamics are driven by the impact of the global crisis on growth and fiscal revenues. But as fiscal adjustment is pursued over the longer term—in part by constraining domestically financed development expenditure in the face of rising domestic debt—PPG debt begins to decline (Figure 15). The decline in the debt-GDP ratio is also helped by a pick-up in GDP growth as the construction of new large resource projects resumes, rising incomes boost consumption and non-resource sectors expand. Robust GDP growth, in the medium to long term is expected to be sustained by a deepening of reforms to create an enabling environment for business development.

1.46 Lao PDR's external debt dynamics are highly sensitive to the performance of the resource sector. Large resource-related projects now account for more than 10 percent of GDP, with this share expected to nearly double over the medium term. Under the baseline, the global crisis is assumed to delay the near-term investment pipeline by 2 years, but leave unaffected construction of future planned projects. In addition, profitability is expected to rebound in the medium term as global demand and commodity prices strengthen. Under a less positive scenario, lower growth would lead to a deterioration in debt dynamics. In addition, the volatile nature of mining revenues will be a challenge that the government will need to address, perhaps through the adoption of a rule on the utilization of such revenues.[16]

**Figure 15: Projected Evolution of Public and Public Guaranteed Debt**




*Source: IMF and Bank Staff estimates.*

[16] Issues related to the management of resource revenues have been covered in the Lao Development Report.

1.47 *Arrears:* Concerns highlighted in the last PER about government arrears and contingent liabilities related to SOEs and SOCBs are being addressed, but vulnerabilities remain. With the government facing acute funding shortages during 2003-05, it started to accumulate arrears, especially with Electricité du Lao PDR (EDL). This trend was, however, reversed. The stock and accumulation of arrears between government agencies and EDL has been considerably reduced, and is planned to be fully settled in 2010/2011. An "Action Plan for Financial Sustainability of the Power Sector" was adopted. The Government has endorsed an EDL tariff increase annually and significantly reduced the stock of arrears accumulated up to FY2005/06, and stayed on track with mutual clearances of arrears. Budget allocations for electricity consumption by government agencies have been increased to fully cover electricity consumption and ensure that no new arrears are being accumulated.

1.48 *State Owned Enterorises (SOEs)*: In comparison with other transition economies, the SOE sector is relatively small with less than 15,000 employees, and hence risks related to their performance are thus also of a smaller magnitude. In 2008 total losses of SOEs reduced to about 14 billion Kip (0.2 percent of Government's revenue), and indications are that SOE performance, though still weak, has actually improved since then. Out of 13 SOEs undergoing a restructuring effort, seven have generated profits during 2008-09, with profit margins more than doubled from 661 billion to 1.3 trillion kip. The government needs to address operational weaknesses of SOEs recently identified by independent audits, but also needs to define its vision for the SOE sector. This entails defining strategic SOEs while withdrawing from non-strategic ones, corporatizing strategic SOEs, strengthening state-assets management, and enhancing shareholder functions of the MOF.

1.49 *State Owned Commercial Banks (SOCBs)*: Contingent liabilities from the operations of SOCBs and quasi-fiscal operations of the Bank of Lao PDR are a concern. The risk management capacity of the banks as well as BOL's supervisory capacity, though improving, is weak. The legacy of directed lending has impaired a move toward market based loan decisions. In the past the banks have lent to SOEs, small and medium enterprises, and agriculture on less than commercial terms. As of end-2009 two of the three SOCBs had a positive capital position, and only one is at the regulatory minimum. Fortunately, the size of the banking sector relative to GDP – measures by the ratio of broad money over GDP - at about 32 percent is still low. The government could use the current low level to its advantage and put the sector on a strong footing. Otherwise, not only will the budget start feeling the pinch from the cost of poor credit decisions, it will prevent the development of a vibrant banking sector that is critical for sustaining a high rate of growth.

1.50 Credit growth, including Bank of Lao's direct lending to local projects (recorded as credit to SOEs in the BOL balance sheet), reached 90 percent in December 2009. Lending to the public sector has been the main driver of credit growth. As a consequence the share of the public sector in total credit increased to 23 percent in 2009 compared with 16 percent at end-2007. Total lending as percent of GDP increased from 9 percent in 2007 to 23 percent in 2009, while lending to local projects increased from 1.2 to 4.8 percent of GDP. However, Credit growth has slowed by end-2010 due to the phasing out of the BOL's direct lending to local government projects and the slowdown of private credit. The credit growth decelerated y-o-y to about 46 percent in December 2010.

1.51 The government has in recent years attempted to clean-up the balance sheets of SOCBs at moderate fiscal costs. Total non-performing loans (NPLs) were reduced from 21.2 percent in 2006 to 3.18 percent December 2010, mainly through write-offs. Recapitalization was conditional on Governance Agreements (for Banque pour le Commerce Extérieur Lao (BCEL), Lao Development Bank (LDB) and Agriculture Promotion Bank) covering financial, credit and operational policies, as well as reporting and disclosure requirements. The banks were regularly audited by international accounting firms. In 2006 and 2007, BCEL received a capital injection of 227 billion kip ($26.7 million), and LDB received 123 billion kip ($14.5 million), in the form of bonds, the total for both banks amounting to [around 1 percent of 2007 GDP]. The third large bank, Agriculture Promotion Bank (APB), was split in two to better account for and to distinguish between policy interventions and commercial transactions. In 2008, MOF recapitalized the APB in the amount of 87.50 billion kip ($10.3 million [around 0.2 percent of 2008 GDP]), upon successfully meeting assigned performance targets.

# CHAPTER 2 : NAM THEUN 2 REVENUE MANAGEMENT

## A. BACKGROUND—THE NAM THEUN 2 PROJECT

2.1 The Nam Theun 2 (NT2) hydroelectric power project aims to generate revenues, through environmentally and socially sustainable development of the Nam Theun River hydropower potential, to be used to finance priority poverty reduction and environmental management programs. The use of NT2 revenues for these purposes was envisioned in the Decision Framework agreed between the Government of Lao PDR and the World Bank in 2001 and subsequently reiterated through the Government Letter of Implementation Policy in 2005. In turn, the Government and the Bank undertook to review the performance on the revenue management arrangements for the project, in periodic public expenditure reviews. This entails assessing both the implementation of the revenue management arrangements themselves, and broader PFM reforms, because of the former's integration into the Government's overall management of public finances.

2.2 The project has three components: (a) a hydropower facility that includes a mid-size dam, associated reservoir and power generation and transmission equipment; (b) management of the social and environmental impacts of the project which include resettlement, covering provision of basic infrastructure and social services and design and delivery of livelihood programs; and on the environmental side, mitigation measures, adaptive wildlife management programs, water quality monitoring and management, flood control measures and riparian release measures; and (c) a Monitoring and Evaluation framework which covers (i) supervision of physical implementation of the hydropower component; (ii) independent review of key project components by professional experts; (iii) systematic monitoring of the technical, environmental and social safeguards components of the project during construction and operation by a professional firm; and (iv) an international advisory group to advise the President of the World Bank and its senior management on project implementation, including NT2 revenue management arrangements.

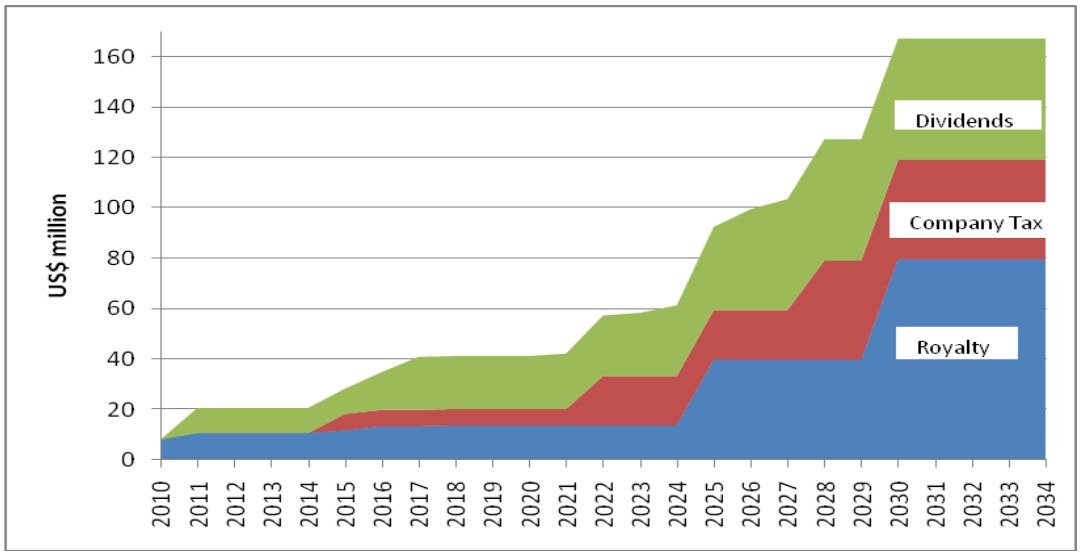
2.3 The overall cost of the project is estimated at about US$1.25 billion net of contingencies. On the World Bank Group side the project is being financed through three separate instruments, totaling just over US$150 million equivalent. This comprises a US$20 million IDA grant for the NT2 Social and Environmental Project; an IDA partial risk guarantee covering US$42 million of principal for a syndicated loan to the commercial operator; and MIGA guarantees of US$91 million for a syndicated commercial loan to and an equity investment in the commercial operator, covering political risks in Laos and Thailand. The Asian Development Bank (ADB) is also a significant co-financier of this operation through a US$50 million direct loan, a US$42 million Political Risk Guarantee, and a US$20 million public sector loan to the Government. The project was presented simultaneously to the Boards of both institutions in March-April 2005 and following approval, construction commenced in the second half of 2005. A large number of multilateral, bilateral and commercial financiers also worked together to achieve the financing package for NT2.[17]

[17] These included Agence Française de Développement, Proparco , the European Investment Bank, the Nordic Investment Bank, export credit agencies including Compagnie Française d'Assurance pour le Commerce Extérieur,

2.4 The NT2 hydropower project will have an installed capacity of 1,070 Megawatts (MW) of which 75 MW will be for domestic use in Laos with the remaining 995 MW to be sold to Thailand under a long term power purchase agreement. The hydroelectric facilities are to be operated by a commercial entity, the Nam Theun Power Company (NTPC), under the terms of a 25 year Concession Agreement. The Government of Laos is a 25 percent equity holder in NTPC. The project remains largely on track and commercial operations were expected to commence in February 2010, about 60 days later than originally planned.

2.5 Over the life of the project the government will receive an income stream estimated at some US$1.9 billion. The projected annual income stream is presented in Figure 1. The government will benefit directly from three separate income streams—royalties, company tax on profits, and dividend payments on its equity—which will increase steadily over the 25 years of the concession agreement, slower at first while NTPC repays its debt and more rapid in the latter years. It will also receive indirect benefits through the payment of personal income taxes by both foreign and local personnel working on the project. These resources have the potential to be deeply transformative if they are effectively targeted and spent. Therein lies the challenge.

**Figure 16: Estimated Revenues from Nam Theun 2, 2010-2034**




*Source: Estimates based on NTPC presentation to Government of Lao PDR, Vientiane, April 2009.*

## A. Rationale for the Revenue Management Arrangements

2.6 Effective revenue and expenditure management is central to the achievement of the NT2 project's development objective: "to generate revenues that will be used to finance spending on priority poverty reduction and environmental programs in Lao PDR through environmentally and socially sustainable exploitation of NT2's hydropower potential." The Revenue Management Arrangements (RMA) governing the allocation and use of revenues received from the NT2 project were conceived with the broad needs of public expenditure management in the country in

Guarantee Institute for Export Credits of Norway, Export Kredit Namnden of Sweden, and Export-Import Bank of Thailand, together with a consortium of 14 international private commercial banks.

mind. The RMA under NT2 were designed to serve as stimulus for achieving that broader objective. The basic principles agreed to with respect to the utilization of NT2 revenues—for purposes of poverty reduction and environmental management—are not only consistent with government strategy and development plans but also critical to the long term development of Laos and certainly essential if the government goal to exit least developed country status by 2020 is to be realized.

2.7 The approach therefore adopted in the design of NT2 revenue and expenditure management arrangements focuses on strengthening of national public expenditure management systems as effective revenue and expenditure management was considered central to the achievement of the NT2 project's development objective. This would also serve a broader and more fundamental development purpose, since an effective, transparent expenditure management system would be essential for the country to use its limited resources effectively in support of its poverty reduction and development objectives.

2.8 The government has taken the need to develop an effective and transparent system of public expenditure management quite seriously. In 2005 it put in place its Public Expenditure Management Strengthening Program (PEMSP) for the period 2005-09, subsequently succeeded by its Public Financial Management Strengthening Program (PFMSP) in 2008. The PEMSP was designed to cover the key expenditure management functions: (a) fiscal planning and budget preparation; (b) treasury, accounting and reporting; (c) the development of information systems; and (c) the legislative framework for public expenditure management. Capacity building was also a prominent part of the program, with particular emphasis on training to support program implementation. Implementation of the program was scheduled to allow the government to make significant progress towards meeting international benchmarks for public expenditure management by 2009-10, the year in which NT2 was scheduled to be commissioned.

2.9 A number of development partners have designed their assistance programs to support the government in this endeavor. The ADB for example has provided assistance to the State Audit Organization and to strengthening financial management systems in the social sectors while the European Union has focused on public financial management capacity. The World Bank for its part has supported the government program through the Financial Management Capacity Building Project (FMCBP), free standing technical assistance and a series of annual *poverty reduction support operations* (PRSOs) which have been critical in establishing policy benchmarks for progress on this agenda. AusAID, the European Union, Swiss Development Cooperation, the Swedish International Development Agency also established a multi-donor trust fund administered by the World Bank to support the Government's PFMSP.

2.10 A critical partner for the government in its ambitious efforts to reform and establish a modern system of public expenditure management has been the Government of Vietnam which has longstanding political and ideological ties to Lao PDR.[18] Before proceeding with public expenditure management reforms the Government of Laos consulted the Government of Vietnam under the terms of the Strategic Co-operation Agreements on Economics, Culture, Science and Technology for the 2000-05 and 2000-10 periods. In addition to endorsement of its nascent plans in this area Laos also obtained an offer of direct agency-to-agency technical assistance for

[18] Dating to the 25-Year Lao-Vietnamese Treaty of Friendship and Cooperation signed in 1977.

its endeavor. This collaboration has been a critical success factor in the progress that Laos has made with respect to PEM and Public Financial Management (PFM) reforms.

## B. PFM SYSTEMS AND CAPACITY IN LAOS

2.11 This section will outline the status of public expenditure management in Laos with a focus on public financial management systems given they are critical ingredients to effective public expenditure management. The first part of this will provide an overview of the situation in the early-to-mid 2000s as a back drop to the subsequent assessment of the current situation.

### PFM THEN - 2002

2.12 Public expenditure management was considered weak, ineffectual and in considerable disarray. Indeed a public expenditure review and country financial and accountability assessment in 2002 identified serious weaknesses in Lao PDR's systems for budget preparation, budget execution and control.[19] Among many shortcomings the review found that the expenditure management system failed to achieve any of the Highly Indebted Poor Country initiative public expenditure management benchmarks. Despite attempts to revise the budget classification system and chart of accounts, it was largely impossible to link resources to specific functions and programs.

2.13 These problems were further compounded by the decentralization of responsibility for budget preparation, which allowed for differing interpretations of policy priorities. An unsurprising result was one of significant disparities in per capita resource allocations to priority sectors between provinces. Incomplete reporting by provinces and some agencies prevented budget reconciliation from taking place. Treasury operations and cash management were likewise hampered by multiple accounts, lack of commitment controls and weak cash planning mechanisms. This contributed to arrears to suppliers and delays in salary payments.

2.14 Revenue retention at provincial level exacerbated the cash constraints faced by the central administration and resulted in delays in transfers to the poorest provinces. Consolidated year-end financial statements were not published on an annual basis nor were budget execution reports published. The newly established State Audit Organization (SAO) was constrained in relation to its broad mandate due to its limited resources and its audit reports were not published. Despite some progress a number of these concerns were reiterated in a subsequent review published in 2007, but which covered events through 2005.[20]

### PFM NOW - 2009

2.15 Since that time, however, the situation with respect to public financial management has changed markedly as a result of the government's PFMSP and the collective support from the

[19] Lao PDR Public Expenditure Review and Country Financial Accountability Assessment, Report24443-LA, Joint Report of the World Bank, International Monetary Fund and Asian Development Bank, June 28 2002.

[20] Lao PDR Public Expenditure Review and Integrated Fiduciary Assessment, Report39791-LA, Joint Report of the World Bank, International Monetary Fund and Asian Development Bank, May 15, 2007.

donor community. Indeed a 2009 review of PFM systems in Laos[21] expressed positive surprise at the progress that has been made in such a short time, relative to the starting point and limited technical and managerial capacity, while recognizing that there still remains considerable work to be done to achieve the goals that have been set—to reach broad international standards.

2.16 This section is a summary review of PFM systems and capacity. More detailed analysis is provided in other chapters of this PER focusing on these issues as well as in the recently concluded Public Expenditure and Financial Accountability (PEFA) Assessment.

### HIGHLIGHTS OF RECENT IMPROVEMENTS IN PFM SYSTEMS

2.17 The principal changes that have contributed to improving and strengthening the PFM system since the PER of 2007 are:

- **a new budget law** centralizing revenues and improving the timeliness of the budget cycle;
- **improved budget execution** and an end to the previous cash rationing due to better and more realistic revenue forecasting and management and the centralization of revenues at Treasury;
- **improvements to budget nomenclature and chart of accounts** to make them compatible with the IMF's system of Government Finance Statistics (GFS);
- **substantial progress on the development of a Government Financial Information System (GFIS)** which will enable more timely and reliable reporting on budget execution to be fully implemented from FY2009/10; and
- **a new State Audit law** and associated strengthening of the SAO which has resulted in the SAO submitting audit reports to the National Assembly in the June session, as stipulated within the Audit Act.

2.18 Work is also underway on a Public Finance Management Project through which a *government finance management information system* will be developed building on the GFIS, with implementation planned for 2014/5. Other ongoing work seeks to improve cash forecasting and management through development of a single treasury account. Work to develop a Medium Term Expenditure Framework (MTEF) encountered problems due to the choice of a methodology which gave priority to developing baseline budgets in pilot ministries. The effort has now been shifted to the building of an aggregate Medium Term Fiscal Framework (MTFF), generally agreed to be the first steps in developing a MTEF based approach to budgeting. For a further discussion of why initial efforts to develop a MTEF were unsuccessful, see Chapter 2, and especially the box on MTEFs.

### IMPROVEMENTS IN BUDGET PLANNING AND PREPARATION

2.19 **New Budget Legislation**. A new State Budget Law passed in December 2006 replaced the 1994 Law. The main changes were: (a) centralization of customs, tax and treasury revenues into

[21] Study on Public Finance Management System, The European Commission's Program for Laos, Project No. 2008/171-935, January 24, 2009.

the central treasury account, enabling the center to controls funds in local treasury accounts. While extra budgetary accounts with their own PFM arrangements remain they are intended to be absorbed into the accounting system and managed by the Treasury. The budget includes all capital expenditure and in principle all donor funding is part of the budget; (b) a new more timely budget timetable. Previously the budget was presented some time after commencement of the fiscal year. It is now presented to the National Assembly in June for approval by end-July, two months before the fiscal year commences, although the formal budget is at a high level of aggregation.[22] thus further reform of the budget cycle is warranted, in order for the detailed budget to be presented to Parliament ahead of the the start of the fiscal year; (c) six monthly revision of the budget; (d) improvements in budget transparency. Article 50 sets out the documentation required to be submitted to the National Assembly which includes final budget execution statement of the previous year and an (interim) report on current year execution, as well as information on public debt and the Public Investment Program (PIP); (d) determination of a new allocation of revenues between central budget and local budgets to clarify central and local financial arrangements; (e) audited public accounts now being required within six months of end of year, to be sent to National Assembly 15 days prior to its opening session; and(f) requirement for a medium and long term budget;[23]

2.20 **Capital/Recurrent Split**. The Ministry of Planning and Investment (MPI) is responsible for the development of the capital portion of the budget which includes related donor financed recurrent expenditures. The Ministry of Finance (MOF) advises MPI of the available domestic budget funding for is the capital component of the budget in April each year and MPI then prepares the PIP, which covers all capital expenditures, financed domestically as well as by donors. The PIP covers budget year plus one (but is published in Lao only) and is presented as part of the budget documentation.

2.21 The 2007 PER referred to poor coordination between recurrent and capital expenditures but it could not be determined whether this had improved. In discussions MPI indicated it recognized the historical over emphasis on capital expenditures to the detriment of recurrent expenditures. It attributed some of this to the priorities of provincial governors and some to the priorities of development partners (responsible for financing more than 80 percent of the capital budget). As part of an effort to increase recurrent non-salary expenditures in the social sectors for FY2010/11 MOF is planning to mandate minimum allocations for the health and education budgets that provinces are required to adhere to. Greater effort is required to advance the agenda around establishing a system of spending norms to guide inter-provincial transfers and expenditure allocations at subnational levels.

2.22 **Chart of Account and Budget Nomenclature**. The existing budget nomenclature did not include functional classification and it mixed administrative and economic classification despite being overly detailed. It was also incompatible with the IMF's GFS system. A new budget classification system has been developed that is compatible with GFS requirements. The new Chart of Accounts has a robust structure and the classification system utilizes economic, organization-

[22] Line ministries then work to prepare quarterly expenditure plans for the Ministry of Finance. In this sense there is no detailed budget publicly available at the outset of the fiscal year.

[23] Article 47.1, specified in more detail in National Budget Law Implementation Decree Article 12.

al, locational, project and source of funds data. There are cross-walk tables to map the budget classification to GFIS functional classification for reporting purposes. Lao PDR does not allocate budgets by function at this time. It was used in the preparation of the 2008/09 budget. The COA has been implemented with the new GFIS which went live nationwide on October 1, 2009. Continued implementation and post-live stabilization of GFIS is expected to continue in 2010.

### IMPROVEMENTS IN BUDGET EXECUTION

2.23 **Treasury Single Account and Cash Management**. The new Budget Law provides for the principle of paying of all revenues into a consolidated fund. The Government has made significant progress in this regard by: (i) consolidating the management of all revenue accounts with the fully centralized National Treasury; (ii) conducting a survey of bank accounts held by government agencies in order to determine which accounts should be rationalized; (iii) changing business processes to ensure that Treasury Offices nationwide solely execute expenditures based on requests by spending agencies; and (iv) Treasury managing all the Designated Accounts for donor projects executed by government (including IDA) and as well as management of the extra-budgetary funds (including the Road Fund). However, agencies generating technical revenues still control some bank accounts and these are supervised by respective line ministry. Looking ahead the focus will be on developing a system to manage these bank accounts electronically, to improve cash sweeping, zero-balancing accounts, and thereby enhancing cash management ability.

2.24 **Budget Realism**. The 2007 PER commented unfavorably on unrealistic budgets and the need to resort to cash rationing.[24] *De facto* budget authority or prioritization thus rested with Treasury officers, leading to distortions of expenditure priorities. While aggregate fiscal discipline was achieved there was considerable variation in the composition of actual expenditures compared with budget. Since 2007, however, revenues have grown strongly and along with improved revenue forecasting and the centralization of revenues under the new Budget Law mentioned above (central treasury now receives all national revenues some of which were previously withheld by provinces) there has been no resort to cash rationing. The Treasury Department has now absorbed the provincial treasuries into its organizational structure as part of the ongoing re-centralization of revenue. Treasury Department asserts that no additional expenditure arrears have arisen in the past three years with the exception of some arrears to the state electricity authority, which is because of inadequate budgetary allocations for this category of expenditure. The Ministry of Education Finance Department has indicated that budget execution rates have been at least 95 percent over the past three years, and was 98 percent in 2008/09.

2.25 **Financial Management Information Systems**. The GFIS has been developed in house at the Ministry of Finance, with support from the Bank's Financial Management Capacity Building Project (FMCBP) to provide on line real time connectivity. The updated GFIS, incorporating the new Chart of Accounts went live nationwide on October 1, 2010. The updated GFIS has integrated budget preparation and execution functionality, and ability to generate in-year budget execution reports. However, it does not include commitment controls at this time.. The GFIS incorporates project codes, including projects to which NT2 resources have been committed by the Government.

[24] p. 41, para. 41-43.

2.26 The proposed Integrated Financial Management Information System (Treasury Modernization Project) will eventually replace the GFIS and will constitute an integrated financial management information system covering all Treasury offices nationwide as well as at ministries and central agencies and will support budget execution, accounting and reporting. It will be interfaced with the tax, customs and debt management systems as well as a commitment control module. This will be a large and complex project with implementation commencing in 2013.

2.27 **Managing Budget Execution**. Budget execution reports are currently prepared by spending units themselves. They receive a quarterly allotment of funds from the Budget Department and can compare payment requests they have sent to the Treasury with this funding. Based on these MOF compiles quarterly budget execution reports. The new GFIS is capable of providing budget execution reports at all levels of government.

### IMPROVEMENTS IN BUDGET MONITORING AND REPORTING

2.28 **Public Accounts**. The new Budget law requires the public accounts to be audited within six months of the end of the financial year. Public Accounts have been produced for the last two years at least, although the audit report to the National Assembly has been presented somewhat later than the new six months requirement, but not significantly so. The public accounts focus on budget execution but apart from this there is no public disclosure on the informational content of the public accounts.

2.29 **Audit Arrangements**. There has been significant progress since 2007 in strengthening the SAO. The new State Audit Law 2007 enhances its independence by having it report to the National Assembly rather than the Prime Minister as previously. Following the peer review carried out by the New Zealand State Audit Office (OAG) significant technical assistance has been provided by NZ OAG and the ADB. There has been a doubling of staff numbers and regional offices outside Vientiane have been opened. An Action Plan 2009-20 has been developed which focuses on building its capacity and defining its resourcing requirements.[25] Its resources and capacity remain relatively limited, however, and it covers only about 10 percent of the state budget each year.

## C. KEY ELEMENTS OF THE RMA

2.30 The revenue management arrangements developed for use of NT2 revenues cover four main areas or pillars: the first deals with the allocation of NT2 revenues within the government budget, specifying both the principles to be used in the allocations as well as the criteria for selection of programs. The second element focuses on PFM and details the flow of funds through the budget and specifies how these resources are to be utilized including the specific actions to be undertaken in relation to managing disbursements, unutilized balances and sanctions formal-performance within programs. The third concerns the reporting requirements for these public funds to ensure that there is transparent and timely information available on the in-year progress of the programs as well as on program outcomes and audit requirements. The fourth and final element of the RMA cover monitoring and consultation which is to be conducted mainly through

[25] State Audit Organization of the Lao PDR Action Plan for the years 2009 through to 2020, undated report, copy obtained March 2009.

periodic public expenditure reviews, and public expenditure tracking surveys in collaboration with the government equity financiers in NT2—the ADB and the World Bank.

2.31 **The allocation of NT2 revenues** are to be undertaken as part of the government's regular budget planning and preparation process. Within that process, programs "eligible" to receive NT2 revenues are to be consistent with government development priorities as specified in its national development plan (the National Growth and Poverty Eradication Strategy, 2000-05) and its successors (presently the National Socio-Economic Development Plan, 2006-10). Eligible programs are to be initially selected from the following sectors: (a) Basic health; (b) Basic education; (c) Rural roads; and (d) Specific environmental protection, conservation and poverty reduction programs. Selected programs are to have a significant and verifiable poverty reduction impact, provide public goods, services and infrastructure to the (rural) poor, and/or a significant and verifiable conservation or environmental impact. These programs and projects are to be ongoing and are to receive additional financing from NT2 revenue, with clearly specified rules to determine additionality of resources (Box 1). Eligible programs may finance recurrent or capital expenditures. Eligible programs and their financing are to be publicly disclosed through the State Budget and published MTEF documents.

**Box 1: Additionality under the RMA**

1. Under the concept of *additionality*, programs eligible for NT2 revenue are to receive a budgetary allocation in excess of the general increase in the overall budget in the particular year. On the surface this principle is laudable as it is designed to ensure that effective programs that are targeted at the poor, or deliver social goods or services or improve environmental management or strengthen conservation—would receive an increasing share of overall budgetary resources and over time this would result in a change in the structure of the budget in favor of such spending programs.

2. There are, however, potential difficulties with implementing additionality as it was conceived, requiring base line expenditures to be first determined for each eligible program. These are to be the greater of:

(a) budgeted expenditures in the previous year expressed in real terms for the comparator year;

(b) average expenditures in the three previous years, again expressed in real terms for the comparator year; and

(c) eligible programs' percent share of budgeted and actual total expenditures, excluding expenditures related to debt servicing, in the previous year.

3. The following issues arise as a result of this:

- As actual expenditures are presently only available with a lag of two years or more, that is, for 2006/07, it will not be possible to utilize spending outturns to determine baseline spending, rather these will have to be based on budgetary allocations.
- Moreover, as the classification system that has been employed until FY2008/09 is based on the older nomenclature it may not be able to identify eligible program spending prior to 2008/09, unless the allocation is to projects, which has been under implementation previously, because project coding structure has not required modification.
- Under certain unusual economic circumstances, not unlike those currently being experienced, the additionality criteria could result in some non-eligible area or program having to take a cut in nominal terms over the previous year, certainly an unintended consequence. For example in the event that overall nominal spending has to be cut.

4. The need to be pragmatic in this matter suggests that in the first instance one should rely on planned spending as a proxy for outturns, and perhaps if eligible program spending cannot be identified for prior years due to classification issues, then one may need to rely on only one or two of the criteria in determining additionality. In a larger sense, the difficulties in generating accurate estimates of baseline spending have dogged the efforts to develop a MTEF, pointing to a need to rethink MTEF methodogy.

2.32 **The Flow of Funds** specify the institutional and public financial arrangements for NT2 revenues: these are to be held in a dedicated Treasury account at the Bank of Lao which will directly receive payments from NTPC and Lao Holding State Enterprise.[26] Monthly disbursements are to be made from the NT2 Revenue Account to the Central Treasury Account, in line with budget allocations and the pace of execution in eligible programs and for the repayment of debt

[26] Lao Holding State Enterprise is the holder of the state's equity share in NT2 and will be responsible for remitting dividend payments to the government.

incurred by government for acquiring its equity in the project. An annual financial statement of the NT2 revenue account will provide a statement of balances, transfers and receipts to be disclosed. Finally, funds may be withheld from eligible programs by the Minister of Finance in the event of non-compliance with financial or audit requirements, major financial control failure, slow budget execution, etc. The Minister of Finance may also re-allocate funds during the year between eligible programs to ensure efficient budget execution and may re-authorize unutilized balances from one year to the next.

2.33 **Reporting** will require in the first instance that eligible programs be identified through a published statutory chart of accounts and budget nomenclature. Thereafter that quarterly budget execution reports provide summary expenditure data for eligible programs in a timely manner, to be complemented by year-end financial statements. An annual program of internal audits of eligible programs is to be conducted, led by the MOF's Inspection Department. Findings concerning compliance, financial management, control weaknesses and irregularities in the use of funds are to be published together with recommended actions/sanctions to address these as appropriate. The SAO is to conduct an audit opinion with respect to: (a) the NT2 Revenue Account; (b) the financial statements of eligible programs; and (c) compliance with government's financial management and procurement procedures. SAO audits are to be conducted in line with appropriate international standards. This will in turn require a significant capacity building effort by SAO specific guidance for which is also provided through this element of the RMA. The MOF will publish a detailed annual report on eligible programs—covering expenditures, financial compliance, reporting and summary program performance in terms of objectives and performance indicators.

2.34 **Monitoring and Consultation** will comprise three specific elements. The first is a rolling cycle of PERs and Public Expenditure Tracking Surveys (PETS) exercises to be undertaken in collaboration with the government's equity financiers and other development partners as may be appropriate. The main purpose of the PERs is to assess progress in implementation of the NT2 RMA, strengthening of PEM systems, efficiency and effectiveness of public spending and following commissioning of the dam, the impact of eligible program expenditures and the effectiveness of expenditure management and control arrangements. The second element is for a formal annual review on implementation progress of the RMA, with a final review to be conducted six months prior to commissioning of the dam. The final element calls for an annual review between the government and equity financiers to be held after commissioning of the dam.

## D. NT2 RMA READINESS ASSESSMENT

2.35 This section reviews progress made with respect to the commitments made under the RMA in order to arrive at an overall readiness assessment. Under the Development Grant Agreement for the NT2 project, there are a number of specific legal covenants (5) that touch upon the RMA. Under the DGA, however, in addition to the specific legal covenants, the *Project Appraisal Document* which contains the full detail of the RMA is also considered part of the overall legal agreement. Hence the entire RMA forms part of the legal commitments entered into by government.

## ALLOCATION OF NT2 REVENUES

2.36 Under the **Allocation of NT2 revenues**, the first element specifying that allocation be determined through the expenditure planning and budget process for the overall allocation of public resources is being adhered to as is the subsidiary requirement that NT2 revenues to be available to the budget for financing eligible programs be net of debt repayment in respect of government's equity acquisition in the project.

2.37 **Identification and revision of eligible programs** requires that government would prepare a list of possible eligible programs consistent with its identified priorities in the National Growth and Poverty Eradication Strategy (NGPES) and successors (NSEDP) and would thereafter maintain the list revising it as appropriate, publishing the same by the start of FY2008. While that date was not met this did not result in a material delay to the program, fortunately. From March – June 2009, MOF conducted three workshops with the Ministry of Planning and Investment and sector ministries for determining eligible programs for FY2009/10. During consultations with NTPC, it was brought to the attention that commissioning of NT2 would be delayed to April 2010 due to technical reasons, and therefore revenues would start flowing from May/June 2010. The total expected revenues for FY2009/10 are kips 50 billion (equivalent to US6.5 million).

2.38 Based on the interagency discussions, the MPI allocated kips 50 billion to eligible sectors (detailed below) to the Parliament in July 2010. The Parliament approved this allocation. The following are details that have been obtained regarding the proposed eligible programs:

- **Education** has been allocated kips 17.5 billion to finance four projects. these are: (a) a training program for 9th Grade teachers (8,000) that would facilitate expansion of basic education to 10 years in Laos; (b) text book provision for students in Grades 1-4, that would increase the proportion of students with textbooks from about 10 percent to 100 percent; (c) improving the buildings of secondary schools;; and (d) provision of black boards, chalk, and sports supplies. The proposals have clear objectives and could be scaled up or down to take account of resource availability. This proposal appears to meet the eligibility criteria established under the RMA.

- **Health** has been allocated kips 10 billion to finance a project on quality improvement of mother and child services and surgery at targeted poor districts. The project has thre main components; (i) improving the skills of health service personnel; (ii) subsidies for the poor in districts and villages; and (iii) upgrading facilities of health centers. Based on the information available, it is understood that the proposal does meet the eligibility criteria.[27] Specifics of the project interventions will need to be discussed with the Ministry of Health and the Ministry of Planning and Investment.

- **Rural electrification projects** have been allocated kips 6 billion to finance electrification of rural villages in Savannaket, Luang Prabhang, and Champasak. The rural electrification program in Laos has been very successful at providing electricity connectivity to rural villages and improving livelihoods. This proposal appears to meet the eligibility criteria established under the RMA.

[27] Once more complete information becomes available this will need to be confirmed.

- **Rural road maintenance and construction** has been allocated kips 15 billion to finance rural road construction in Savannaket, Saravan, and Sekong provinces, and to maintain rural roads throughout the country. It is understood that the proposed program targets four southern provinces, on the grounds that the generally poorer northern provinces are the focal points for a significant and integrated program of donor assistance. Districts and communities are selected on the basis of how under-served they presently are. The selection criterion is 10 hours or more travel time to the nearest road. Presently on a national basis an estimated 20 percent of the population is considered not to be served by any roads. This proposal meets the eligibility criteria established under the RMA.

- **Environmental Management and Conservation** has been allocated kips 1.5 billion to support renovation of a laboratory at the Water Resource and Environmental Agency (WREA) and to establish another three WREA offices in districts. These proposals are consistent with the eligibility.

2.39 Overall, the allocations are consistent with the RMA and eligibility criteria. It is worth noting that no allocations have been made to the Poverty Reduction Fund and the Environment Conservation Fund at this time. Indeed MOF has expressed apprehension to allocating NT2 revenue to these. In part this is related to the recent performance and management arrangements of some of these. But there is a bigger issue at play here—namely that these arrangements are inconsistent with the overall thrust and principles of the NT2 RMA—which are to utilize country systems (Box 2).

2.40 While the government has made good progress on determining eligible programs there is one aspect of the RMA which has lagged. This is the need for clearly defined objectives, performance indicators and systems to be in place for monitoring performance in terms of the volume and quality of services provided with established mechanisms for program performance evaluation, involving key stakeholders at or close to field level in place, and administrative and financial management arrangements also in place that would allow reporting requirements to be met. The government strategy has been to select the eligible programs first and thereafter to require the respective sector staff to prepare the other aspects. The clear danger with this approach is that it will be easy to underestimate the effort and time required to develop the reporting and monitoring regime and to implement it. However, now that the eligible programs have been identified, the focus of work has to move to the monitoring and evaluation system for eligible programs.

2.41 The additionality requirement under the RMA was designed to ensure that eligible programs benefitted from increased allocations over and above that warranted by the general budget increase. Consequently there are three separate criteria which have to be satisfied in order to determine base expenditures and then the minima above those. In practice these criteria appear excessive and onerous especially when measured against the reality of the situation on the ground in Laos where it is not yet possible to obtain actual expenditure for any specific categories prior to two fiscal years earlier. Nonetheless these guidelines will form good guideposts for determining allocations. The recommendation would be to ensure that the overall share of government recurrent allocations to sectors receiving NT2 revenues increase over time.

2.42 **Documentation of NT2 allocation of funds** requires publication of these in an annex to

**Box 2: Extra Budgetary Funds**

1. There are a number of statutory (8) extra budgetary funds in Laos, each operating under its own governance arrangements and receiving budgetary resources but not being directly accountable to the MOF. These are (a) Environment Protection Fund; (b) Poverty Reduction Fund; (c) Poverty Reduction Fund for Poor Districts; (d) Reforestation Fund; (e) Road Maintenance Fund; (f) SME Development and Promotion Fund; (g) Social Security Fund for Public Sector; and (h) Social Welfare Fund. Summary revenue and expenditure of these funds are reported in the *public investment program* submitted to the National Assembly by the Ministry of Planning and Investment but this document is only produced in the Lao language.

2. According to the latest available budget documents (based on the official gazette) in 2006/07 the eight statutory funds together constituted the equivalent of 5 percent of expenditure under the State Budget that year. This is a significant source of extra-budgetary spending. When combined with retained *technical revenues* (user-fees) which are of unknown quantum, they pose considerable risks to the overall fiscal position as there is no effective oversight. There are thus no institutional mechanisms in place to provide the government with an overview of the overall fiscal position.

3. These are effectively unreported government operations with considerable potential to impact the fiscal bottom-line. Although the new Budget Law has provisions which make clear that all extra-budgetary funds are to be brought on to the budget, there appear to be no mechanisms or plans for such activity. It is recommended that government study this issue, to determine the extent of the problem and to develop a time bound plan to bring these entities on-budget.

MTEF documents and in the state budget. As noted earlier, it has been recognized that efforts to develop an MTEF have run into difficulty,[28] and afforts have been redirected towards first preparing a MTFF. And the government has published the list of NT2 programs (presented earlier) in the capital budget documents presented to the National Assembly by the Ministry of Planning and Investment.

[28] In addition to the technical requirements of an MTEF, there are other prerequisites for a successful effort to develop an MTEF including involvement of political decision makers, good budget information systems and data, capacity to manage these at the center as well as sectoral capacity across the breadth of government.

**FLOW OF FUNDS**

2.43 Treasury **NT2 revenues are to be deposited in a dedicated NT2 Revenue Account** held and managed by Treasury at the BOL. All institutional arrangements for this are in place, facilitated by the revised Chart of Accounts, which includes on the source of funds side revenue from NT2. MOF and NTPC have been in recent discussion on details of the account and magnitude of expected NT2 revenues in 2009/10: these are expected to be in the range of US$6-8. MOF will need to continue to consult regularly NTPC regarding magnitude and timing of revenue flows.

2.44 **Transfer of NT2 revenues from "NT2 Revenue Account"** to the Central Treasury Account is to take place on a monthly basis in line with budgetary allocations to eligible programs and the pace of budget execution, and debt service payments coming due on the borrowings undertaken for government's equity participation in NT2. Arrangements consistent with this, governed by the new Budget Law and its implementation decree are in place.

2.45 **Annual financial statement of NT2 Revenue Account** is to be prepared to report on balances, transfers and receipts, in consultation with the SOA, which has audit responsibility for NT2. The new chart of accounts and upgraded GFIS should allow for this to take place once it is fully functional. The templates for this are expected to be prepared in the June to October 2009 period.

2.46 **Withholding of NT2 funds in the "NT2 Revenue Account"** in exceptional circumstances such as cases of serious, financial control failure non-compliance with financial reporting, inspection, audit, or slow budget execution. Arrangements for this are in place and the Minister for Finance has the necessary authority to withhold funds under the appropriate circumstances. Similarly, procedures are also in place to allow for **reallocation of NT2 revenues during budget execution** between eligible programs to ensure efficient budget execution should the need arise and such re-allocations will be reflected in published quarterly budget execution reports. Appropriate procedures are in place governing the **application of "NT2 Revenue Account" balances** from one fiscal year to the next, consistent with additionality requirements.

**REPORTING**

2.47 **Budget and accounting registers for eligible programs** need to be able to clearly identify all eligible programs following a detailed administrative/organizational or program classification in order to track the application of NT2 revenue. The new chart of accounts and budget nomenclature has incorporated the unified project codes which clearly identify NT2 financed projects and this will allow for this once eligible programs have been selected. The revised chart of accounts was used in the preparation of the 2008/09 and FY2009/10 budget as required.

2.48 **Reporting on budget execution for eligible programs** through quarterly budget execution reports beginning in FY2008/09 has taken place. These first ever quarterly budget execution reports were produced utilizing the upgraded GFIS and new chart of accounts but they did not report on eligible programs as these had not yet been identified. Nevertheless this should not have any material effect on program implementation. Similarly the MOF Inspections Department has established procedures for **reporting on internal control in eligible programs** to be undertaken through a program of internal audits of eligible programs and publication of a summary report of

findings and measures taken to address these. The updated GFIS which went live in October 2009 incorporates the new chart of accounts with the project codes identifying NT2 financed projects. The system has the ability to generate financial reports. The challenge will be to devise a mechanism for reporting non-financial information together with the financial information. The onus of non-financial reporting on progress with eligible programs remains with sector ministries.

2.49 The SAO is to conduct and publish an annual **audit of "NT2 Revenue Account"** and eligible programs. In doing so it is to provide an audit opinion with respect to: (a) the statement of receipts and transfers of the NT2 Revenue Account; (b) financial statements of eligible programs including compliance with government's financial management and procurement procedures; (c) application of funds under eligible programs. The SAO is also to provide and publish a summary of audit findings and the management response. To this end the SAO has been included in training on the new chart of accounts and budget classification system. The SAO will have to meet **audit standards** for financial audits and performance audits.[29] In order to be able to respond effectively the SAO has undertaken a comprehensive restructuring and prepared a detailed action plan with an emphasis on capacity development following an audit peer review exercise organized with the New Zealand Audit Office as required under the RMA.

2.50 The MOF will publish an **annual report on implementation of NT2 revenue management arrangements** detailing the allocation of revenues, actual expenditures, compliance with reporting and financial management requirements by beneficiary programs, and corrective actions taken as required. The report is also to provide summary information with respect to objectives and performance indicators of eligible programs. The financial reports have been programmed within the GFIS already but more consultation is required with sector ministries/agencies on non-financial reporting. This needs to be the focus of the work in the coming months.

### MONITORING AND CONSULTATION

2.51 **Implementation of PER and PETS** began with the PER that was concluded in 2006 and published in 2007. A second PER, the present one, commenced in 2009 which assesses, among other items, progress in implementation of the NT2 revenue and expenditure management arrangements. A PETS with a focus on the health sector was undertaken in 2006 and concluded in 2008. A follow up PETS is planned, possibly to examine common cross-sectoral issues at sub-national levels. The government's PEMSP, now the PFMSP, has made good progress in strengthening public expenditure management systems and remains on track with the support of the broad donor community. The PER and PETS are on a two-year cycle under the NT2 RMA. However as there is significant on-going technical assistance and implementation support work on-going continually, it would be recommended to move the PER and PETS to the regular three-four year cycle or as required. This will ensure that analytical work demand and needs led, rather than simply to meet a criteria under the RMA.

[29] As established by established by the International Organization of Supreme Audit Organizations and the International Federation of Accountants.

2.52 Annual consultations have taken place between government and NT2 equity financiers and a **review of status prior to commissioning** is expected to take place shortly, six months ahead of commissioning of the dam. The government has established an NT2 RMA implementation committee within the MOF to ensure that this remains on track. In keeping with the RMA, the government remains committed to maintaining the **annual consultations with NT2 GOL equity financiers** after commissioning of the project to review progress in implementation of the revenue management arrangements and the impact of NT2 financed expenditures.

### SUMMARY ASSESSMENT

2.53 The RMAs were designed to foster reform of Lao PDR's country systems for public expenditure management, with a strong emphasis on public financial management systems and the revenue side as well. This was done through specific requirements for the tracking of spending, monitoring and reporting for special programs—the eligible programs—which were to receive additional resources from NT2. The benchmarks that were established and agreed by which to measure progress with this agenda were "stretch goals". Yet the government has made commendable progress with respect to a rich and complex reform agenda.

2.54 Despite some shortcomings (related to taking a wrong turn on the MTEF) the government remains broadly on track with respect to its commitments under the RMA for NT2. The government has met the spirit of the RMA and it has largely met the original objectives of the RMA—a more robust country wide system has been put in place for public financial management and many other aspects of public expenditure management have also been strengthened.

2.55 But there are also many challenges facing the continued advancement of this agenda. The issue of identifying incremental expenditures for eligible programs will not be as simple as originally envisioned and will require a pragmatic approach. Another important issue is that much of the new PFM architecture is now being "road-tested". Hence implementation difficulties should not come as a surprise.

2.56 A notable challenge in achieving the RMA benchmarks will be developing an effective monitoring and reporting system. This will require performance indicators to be developed and agreed upon for each eligible program, and then baseline indicators generated. The government has decided that this will take place after selection of eligible programs and the burden of this work can be expected to be significant and given the prevailing timelines for budget preparation and presentation, there remains some risk that this will not be achieved.

2.57 Parallel efforts will also need to be made to ensure the progression and implementation of spending norms to improve inter governmental resource allocations as part of a broader effort to reform inter governmental fiscal arrangements. The focus in this respect needs to be strengthening the link between government's policy priorities and their translation into budgetary allocations.

2.58 Looking to the future, government needs to continue to place its efforts to implement the RMA but this should be done with the knowledge and clear understanding that the overall objective is to improve country systems across the board. Once country systems are sufficiently

strengthened in every respect—allocation of resources, flow of funds, monitoring, reporting and audit—the RMA in respect of eligible programs will become redundant.

# CHAPTER 3 PUBLIC FINANCIAL MANAGEMENT

## A. INTRODUCTION

3.1 This chapter discusses two inter-related issues in Public Financial Management (PFM) which have not been analyzed in any depth in other PFM analysis in Lao PDR. The aim is to provide analytical advice to the government as it reviews and recalibrates the Public Finance Management Strengthening Program (PFMSP) over the medium term. These are the key issues of:

- **Expenditure prioritization**. This issue is addressed in only general terms in Public Expenditure and Financial Accountability (PEFA) assessments. It is a weak feature of the Lao PFM system, an attribute common to most countries at Lao's state of development. The budget is input based. Although a national development plan, the National Socio Economic Development Plan (NSEDP) exists and is intended to guide budget preparation, its link with the budget appears weak. The starting point for improved expenditure prioritization is the development of set of essentially top down medium term expenditure envelopes, in the form of a MTEF, though using a different approach to the one so far attempted. In turn, the MTEF should be consistent with an overall Medium Term Fiscal Framework (MTFF), which can be created quite quickly, and progressively refined.

- **Progress in centralization of revenue administration involving the state Treasury, Customs and Tax Administrations**. Major steps have been taken by Government and this is a major reform with significant opportunities for improving fiscal transparency, expenditure prioritization and cash management. This has not been covered in any detail in other reports and it is therefore important to review recent progress in this area.

3.2 Most other issues concerning PFM in Lao PDR have been well documented and analyzed. A PEFA assessment has been being finalized in collaboration with the government. The Bank's analysis of Lao's ability to adhere to the Nam Theun 2 (NT2) Revenue Management Arrangements (RMA) is also important as these arrangements use the country PFM systems—budgeting, accounting, reporting and auditing. Details of the NT2 RMA assessment are contained in Chapter 3 of this Public Expenditure Review. In addition both the European Commission and the Asian Development Bank (ADB) for their own program management purposes completed reviews of PFM in Laos in 2009.[30] The World Bank published a Public Expenditure Review/Integrated Fiduciary Assessment (PER/IFA) carried out in conjunction with the ADB and IMF, in 2007. This followed a combined Public Expenditure Review/Country Financial Accountability Assessment (PER/CFAA) in 2002.[31]

[30] Diagnostic Review Report on PFMSP, Asian Development Bank, July 2009; Study on Public Financial Management System, Final Report, European Commission January 2009.

[31] Lao PDR, Public Expenditure Review/Integrated Fiduciary Assessment, World Bank, 2007; Public Expenditure Review/Country Financial Accountability Assessment, World Bank, 2002.

## B. EXPENDITURE PRIORITIZATION

### FUNCTIONAL CLASSIFICATION OF EXPENDITURES

3.3 The development of the new Chart of Accounts (implemented since 2008/09) and the GFIS now makes it possible to partly construct *ex-post* spending reports on a functional basis through use of bridging tables but this only provides an approximation of expenditure by function and does not overcome the problem that one administrative unit may be carrying out more than one function. There is, however, currently no comprehensive functional classification of the budget available in Laos. Expenditure is classified by ministries/sectors at the central level and by sectors at the provincial level. Article 23 of the 2006 Budget law provides for a classification based on 9 sectors.[32] The presentation in the 2008/09 budget breaks down both the central budget and the summary of provincial budgets differently under three main headings—*economic sector* (agriculture and forestry, energy and mines, public works and transport, industry and commerce), *socio cultural sector* (education, health, information and culture and labor-social welfare) and *other*. The latter category included defense and security expenditures which are now reported only as a single line of expenditure representing a reduction in fiscal transparency. Further the budgets of the 17 provinces are classified under 14 slightly different sectors with justice, planning, finance and provincial administration being additional separate sectors. The reason for this variation in sector definitions between the central and provincial budgets is not known. Nonetheless it is important to understand that this inconsistency prevents a clear picture of the consolidated budget from emerging and thus reduces understanding of the budget.

3.4 A full functional classification covering both recurrent and investment expenditures at both the central and provincial levels would highlight and encourage the authorities to think more about broad issues of prioritization when developing the budget and should be included in the updated medium term PFMSP implementation plan. This would also be consistent with the provision in the new Budget Law that Laos will move to a "true" functional classification.

### THE PATTERNS OF EXPENDITURE PRIORITIZATION IN LAOS

3.5 While the 2007 PER/Integrated Fiduciary Assessment suggested a lack of a pro-poor focus in many areas of budget expenditure the government has identified national priority sectors and programs[33] and 47 very poor priority districts, which is intended to influence budget allocations. The 2007 PER/ Integrated Fiduciary Assessment noted, notwithstanding serious deficiencies in the data, that expenditures in education and roads appeared to be reasonably efficient and equitable, but expenditures in agriculture and health much less so.

3.6 Examination of the sectoral breakdown of recurrent budget allocations for the period 2007/08-2009/10 is instructive (Table 1).

[32] Education, health, economy, socio-cultural, science, environment, public administration, national defense and security, social welfare and other sectors).
[33] Paragraph #45, World Bank 2007.

**Table 1: Sectoral Composition of Recurrent Government Spending, 2007/08-2009/10**

| | 2007/08 | | 2008/09 | | 2009/10 | |
|---|---|---|---|---|---|---|
| | Allocations | Percent | Allocations | Percent | Allocations | Percent |
| Administration, incl. debt service | 2,852.7 | 72.7 | 3,890.0 | 75.6 | 4,096.0 | 74.2 |
| Social Sectors | 713.6 | 18.2 | 820.3 | 16.0 | 995.2 | 18.0 |
| Health | 151.2 | 3.9 | 191.6 | 3.7 | 222.5 | 4.0 |
| Education | 562.5 | 14.3 | 628.7 | 12.2 | 772.8 | 14.0 |
| Productive Sectors | 109.5 | 2.8 | 157.4 | 3.1 | 157.7 | 2.9 |
| Roads | 35.8 | 0.9 | 61.6 | 1.2 | 58.1 | 1.1 |
| Agriculture | 73.7 | 1.9 | 95.8 | 1.9 | 99.6 | 1.8 |
| Other | 259.2 | 6.6 | 274.7 | 5.3 | 274.2 | 5.0 |
| Total Government Recurrent Budget | 3,925.0 | 100.0 | 5,142.4 | 100.0 | 5,523.1 | 100.0 |

*Source: Official Gazette, various issues.*

3.7 A pattern of public expenditures emerges that show a low and fluctuating share of total recurrent expenditures in the social sectors of education and health. The Ministry of Planning and Investment (MPI) indicated in March 2009 that the social sector share of total expenditures was to be increased to 30 percent, with 30 percent going to the economic sector and 40 percent to infrastructure, mainly roads although it was unable to provide comparative figures for previous years.

3.8 The table, which is based on published sources, shows three quarters of recurrent spending allocated to debt service and "administration". The latter can be assumed to be all categories of government spending other than on the social and productive sectors, and thus includes the security sector. In the interests of budget transparency, the Government should publish how this major share of the recurrent budget is allocated. In the first place, compared to other countries, the share of the recurrent budget going to "administration" is unusually high. Secondly, if there is to be a shift in total spending towards the social and productive sectors, this will need to be reflected in a similar shift in recurrent budget allocations. But the figures show that, while social and productive sectors grew over the three year period by 33%, spending on administration grew by 45%. The drivers of this spending should be more evident.

3.9 Expenditures also show a decline in the proportion of non wage bill recurrent expenditures more recently, in 2009/10. Based on regional comparisons Laos does not have a large number of civil servants. Despite this the civil service wage bill has grown from around 42 percent of recurrent expenditure at end 2000/01 to around 68 percent at end 2009/10, from 2.7 percent of GDP in 2000, to 5.5 percent in 2007 to just under 9 percent in 2009. This reflects

both increased salary levels and increased civil service numbers. A recent World Bank review[34] identified poor establishment controls as a reason for this growth. The overall effect has been to crowd out non wage recurrent expenditures.

3.10 MPI has indicated that it recognizes that historically there has been an excessive emphasis on capital expenditures to the detriment of recurrent expenditures. It attributes some of this to the previous power and independence of provincial governors to implement expenditure policies which did not reflect national priorities, utilizing revenues retained at the provincial level. It may also reflect the influence of DPs given that the bulk of investment expenditures are financed by DPs. The issue was highlighted in the 2007 PER. The low domestic revenues as a share of GDP also make it a difficult issue to resolve.

3.11 The recent centralization of revenues combined with efforts to develop a new system of inter-governmental fiscal relations, which will include minimum expenditure norms, can be expected to significantly reduce such actions by provincial governors and to improve resource allocation at the provincial level.

3.12 As part of a move to increase recurrent non-salary expenditures in the social sectors beginning in 2008-09 there was a requirement for provinces to allocate a certain minimum level of resources to health and education services through budget norms. A trigger for the Fifth Poverty Reduction Support Operation (PRSO) was that the Ministry of Health and Ministry of Education together with the provinces develop such a system of budget norms as a basis for revenue sharing and expenditure allocations for application commencing in 2010/11. The National Assembly has also been pressing for the adoption of norms for the allocation of provincial and district recurrent expenditures.

### THE NATIONAL SOCIO-ECONOMIC DEVELOPMENT PLAN

3.13 The Government's broad objectives are set out in the 5 year (2006-10) NSEDP which is managed by MPI. A new five year plan covering 2011-15 is presently under preparation. The current NSEDP lists targets for broad social indicators and Millennium Development Goals (MDGs) and discusses issues and proposed strategies for the various sectors in some detail. Each ministry has its own five year plan consistent with the NSEDP which is approved by its Minister and these form the base from which the NSEDP is constructed. The NSEDP covers projects to be financed by public expenditures as well as private sector activities.

3.14 The NESDP is, however, neither costed nor fiscally constrained and thus provides little real guidance on overall budget priorities. As a result, the link between the plan and the annual budget is very weak. In marked contrast to this situation it is notable that the individual plans of the Ministries of Education and Public Works are costed – though they also are not fiscally constrained.

3.15 The National Assembly reviews and approves in June each year an annual statement on the NSEDP prepared by MPI. This document includes proposed total expenditures under the Public Investment Plan for the upcoming year. The discussion of the implementation of the plan

[34] World Bank, Lao PDR Civil Service Pay and Compensation Review; Attracting and Motivating Civil Servants, Draft February 15, 2010.

in the ongoing year covers actual activities under the Public Investment Plan for only the first 8 months of the year (October 1 to May 31) and planned activities for the remainder of the year, reflecting the need for the document to fit in with the timing of sittings of the National Assembly.

### PFM REQUIREMENTS FOR IMPROVING PRIORITIZATION

3.16 Improving expenditure prioritization is generally considered to require the following PFM components:

(1) *A comprehensive budget* under which all funding bids are considered together at the same time. This requires that any extra-budgetary funds be at least small and that if separate investment and recurrent budgets exist that they be integrated into a single budget process. Good prioritization also requires that such a budget be implemented as passed with limited in-year opportunities for changing priorities, especially in a non-transparent way—for example, through resort to cash rationing or the misuse of budget reserve funds.

(2) *Some dialogue as part of the budget process on the likely results* or impacts of competing budget expenditures and an analytical capacity within the budget office and line ministries to use such information in budget planning and review. Again for Laos and other countries it is unrealistic and undesirable at this stage to propose a move to formal performance budgeting. Pragmatic and *ad hoc* analysis through PERs and PETS as envisaged in the NT2 RMAs should assist in improving the dialogue and the information base. Sector strategies and plans as discussed below under Section 3 should also form part of this dialogue.

(3) *A medium term perspective in the budget process.* Developing and implementing a useful MTFF or Medium Term Expenditure Framework (MTEF) in countries at Lao's stage of development could improve annual budgeting somewhat. However, the effort has proven problematic in Laos, principally because a faulty approach has been taken and the initiative needs to be relaunched, and used to link the annual budget more closely to the plan.

These components are now discussed in turn.

### THE BUDGET IS RELATIVELY COMPREHENSIVE

3.17 The Lao budget is reasonably comprehensive and this is improving further as a result of the recent centralization of revenues, discussed above. The 2006 Budget Law stipulates that all government revenues are part of the unified budget, including DP funding. Article 6 of the Law states that all revenues and expenditures shall be fully centralized and accounted for in the national budget and that no revenues shall be retained outside the budget system. Further no separate funds may be established without proper authorization. The budget is also a unitary one covering all levels of government—central government and its 14 ministries, 17 provinces, 143 districts, etc.

3.18 There are presently, however, eight separate statutory funds (which are provided for in the National Budget Law Implementing Decree of 2008) with earmarked revenue sources whose expenditures are approved by boards under arrangements that are different than those governing the Budget. These funds are the Road Maintenance Fund, Poverty Reduction Fund, Poverty Re-

duction Fund for Poor Districts, Reforestation Fund, Social Welfare Fund, Social Security Fund for Public Sector Employees, Environment Protection Fund and Small and Medium Enterprise Development and Promotion Fund.

3.19 The 2009 European Commission report estimates that total spending under these funds is equivalent to just over 5 percent of the total budget. The Finance ministry directly controls the accounts of these entities and disburses funds only upon request of the respective board. A few of the funds operate outside of the national accounting and treasury system. In the case of the Poverty Reduction and Environmental Protection, Funds World Bank agreement is also required with regard to the proposed expenditures and they are separately audited by external (private sector) auditors.

3.20 Two of the funds (roads and forestry) are fully managed as part of the overall budget aggregates with their total expenditure being included in the budget allocation approved by the National Assembly, whereas for the other funds only the transfer from the budget is shown as a single line appropriation and approved by the National Assembly. There is limited *ex post* reporting on their transactions, the only reporting being publication of Road Fund transactions in the press.

3.21 The other six funds are relatively small and therefore cannot be considered to compromise overall budget comprehensiveness. The existence of these funds is, however, inconsistent with the provisions of the Budget Law.[35] Given the development of the Treasury Single Account discussed below it is intended that all these funds will in due course be included in the national accounting and treasury system.

3.22 Some revenue retention by sector ministries and provinces still occurs, which compromises budget comprehensiveness but this is being addressed by the revenue and cash centralization arrangements discussed below. The actual amount of the technical revenues is not known. However, anecdotal evidence suggests that in the technical revenues reported in the budget plan account for only one-third of what are actually collected by agencies. Measures are being made to ask the sector ministries to fully report the technical revenues, while they are still granted the full spending authority. Hopefully, in the next few years, the full picture of the technical revenues will be known.

3.23 Over the years, donor funding has been increasingly brought on budget. Partly this is due to the increase in general budget support, which, by definition is "on budget". Development projects financed by loans are included in the budget and reported on by MPI. The situation of grant financed projects is more ambivalent, and it is estimated that about 50% of projects financed by bilateral grants is reflected in the budget. The rest, which includes technical assistance and aid in kind, is implemented largely outside government systems.

### BUT THERE IS INSTITUTIONAL FRAGMENTATION

3.24 There is also some institutional fragmentation in that while overall budget planning is the responsibility of MOF, MPI also plays a significant role. Cabinet determines the overall fiscal

[35] The statutory funds consist of Road Maintenance Fund, Poverty Reduction Fund, Forestation Fund, Social Welfare Fund, Social Security Fund for Public Sector, Environment Protection Fund, and SMEs Development and Promotion Fund.

envelope (including DP funding) for both recurrent and investment expenditures based on advice from MOF, but MPI (International Cooperation Department) also provides input through its advice on available DP funding. MPI then prepares the Public Investment Program (PIP) which covers all investment expenditures financed domestically as well as by donors. The actual amount of the technical revenues is unknown. But it has been estimated that what reported in the budget plan is just one thirds of what are actually collected. Measures are being made to ask the sector ministries to fully report the technical revenues, while they are still granted the full spending authority. Hopefully, in the next few years, the full picture of the technical revenues will be known. The PIP covers the budget year plus one but is published only in the Lao language and although presented to the National Assembly as part of the budget documentation is not publicly available. The PIP includes some recurrent as well as investment expenditure as it includes special projects which may have recurrent expenditure components. The PIP also operates in part as a fundraising plan for financing by DPs.

3.25 The PIP is governed by the new Law on Public Investment (2009)[36] which requires public investments [37] to be consistent with the policies, strategies and goals of the NSEDP and delegates authority for appraisal to MPI, ministries or provinces depending on the cost of the project. It covers investments funded by DPs. Although Article 10 requires that it cover human resource development, this is not discussed further anywhere in the Law.

3.26 The 2007 PER refers to poor coordination between recurrent and capital expenditures. It is not clear the extent to which this has improved since then. Total costs of investments are defined in Article 16 but the definition does not include ongoing operating or maintenance costs, so there is no explicit requirement in the PIP Law to identify or consider them in project costing and evaluation. As discussed below this issue appears to have been addressed in the 2009/10 Budget circular but it would be desirable to formally address this in a more permanent basis.

3.27 As discussed below there is formal provision for collaboration between MPI and MOF through the budget drafting committee provided for in Article 36 of the Implementation Decree.

### AND A SEPARATE SYSTEM OF STAFF BUDGETING

3.28 Another aspect of fragmentation of the budget concerns staff budgeting. The staff allocation system provides for regular annual increases in the number of staff with allocations of additional staff made by the Public Administration and Civil Service Authority (PACSA). At the beginning of each 5 year planning period ministries indicate their expected or needed staff increases over the 5 year period. PACSA establishes yearly hiring quotas in consultation with sector ministries and these are incorporated into the five year plans prepared by each ministry and combined into PACSA's 5 year plan. For the current 5 year planning period the total increase in civil service numbers in the PACSA plan is 29,000.

3.29 Actual or budgeted annual increases in civil service numbers appear to be the result of a different process. PACSA issues an annual circular on staffing needs known as the "Staff Quota Instruction" requesting bids from ministries and provinces for additional staff, based on net increase after retirements and other sources of attrition. Once it receives the envelope for staff

[36] Law on Public Investment No. 08/NA, 26 November 2009.
[37] The Law does not apply to investments by state enterprises.

numbers provided by the MOF Budget Department it distributes the increases to ministries who in turn allocate the new staffing.

3.30 In 2008/09 a total of 7,000 additional staff were provided across the entire civil service compared with requests totaling 14,000. In 2009/10 the relevant figures were 10,160 and 30,000 respectively.

3.31 The criteria used by PACSA in allocating these staff increases are unclear. Judgments are apparently made based on workloads as well as policy priorities. In deciding these allocations PACSA is guided by the NESDP and other indications of government priorities. For example it is currently giving priority to the education sector (5,000 additional staff) and has previously given priority to agriculture. In 2009/10 it also by-passed the line ministries by making additional staffing allocations directly to districts. Reflecting a judgment that districts have been neglected in past staffing allocations it allocated 14 additional staff to each of the 143 districts. Apart from this one occasion, PACSA leaves the allocation decisions to each line ministry although ministries must report to PACSA on how they have allocated the additional staff. PACSA maintains a central data base of all civil servants and is currently piloting a new integrated personnel management information system known as the PIMS.

3.32 This is clearly a resource allocation or priority determination exercise and thus should be fully aligned with overall priority determination through the budget process. As MOF develops its sector knowledge and the ability to better prioritize government expenditures this function could be transferred to MOF, leaving the detailed allocation of staff to each ministry and province. PACSA's role would evolve to the development and monitoring of wage and personnel policies including classification, grading, ethics, etc. across the civil service. Alternatively, PACSA's capacity to evaluate organizational structures and staffing could be strengthened, and coordination between it and the Ministry of Finance could be deepened.

3.33 This problem is reinforced by the misalignment of staff and budget allocations at the provincial and district levels. For education and health the budgets of district education and health services are included in the budgets of the provincial departments of education and health but staffing decisions are made by the provincial governors—who may decide to allocate new staff to other activities. This reflects a tendency to see staffing primarily in manpower terms, not by positions. If MF/PACSA determine that more teachers are justified, then this should result in increased positions for teacher recruitment, not general recruitment. A stronger staff inspection role by the center seems needed.

### AND SOME POSSIBILITY OF CHANGING PRIORITIES DURING THE YEAR?

3.34 It is important that sound budget priorities not be circumvented either by cash rationing because of an unrealistic budget or by other changes during the year such as misuse of budget reserve funds. Unrealistic budgeting and cash rationing have been an issue in the past, as identified in the 2007 PER/IFA. The 2010 PEFA assessment, however, notes relatively good scores for the indicators of aggregate expenditure and revenue out-turns compared with the budget for the three years 2005/06 to 2007/08.

3.35 Article 39 of the Budget Law Implementation Decree provides for a mid-year review of the budget, to take account of changes in policies or revenue collections. Any changes require the approval of the National Assembly. The Article also provides, however, that some additional expenditures may be approved by the government provided they "would not materially affect the national budget", subject to reporting such increases to the National Assembly.

3.36 Article 33 of the Budget Law Implementation Decree provides for central and local reserve funds of between 3 and 5 percent of total revenues to meet contingencies and urgent requirements such as national disaster prevention and control, defense, security, epidemics and urgent matters that could not have been foreseen. At the central level Article 10 of the Budget Law provides that use of the reserve requires the approval of the Prime Minister but there appears to be no provision for explicit reporting of such use to the National Assembly. To the extent that the reserve fund is not used, its unutilized balances are transferred to the State Accumulation Fund discussed below.

3.37 Furthermore, Article 34 of the Implementation Decree provides that 2-3 percent of the annual budget shall be transferred to the National Reserve or State Accumulation Fund to be used in nationally important and urgent activities such as responding to a financial crisis. Article 11 of the Budget Law requires that the use of the fund be approved by the National Assembly as proposed by the government. The Prime Minister may, however, authorize use of the fund in an emergency, subject to reporting this to the National Assembly. The Reserve Fund balance is returned to the budget at the end of the year.

3.38 It does not appear, however, that either the budget reserve or the accumulation fund is used to bypass good prioritization. Despite this benign conclusion it is important to review both the size of reserve funds and whether the procedures for their use are appropriate. Most countries have provisions for emergency spending at the discretion of the head of government, but tend to limit the amount to not more than 1-2% of total budget spending (a 5-8% range for reserve funds is unusually high). Within that amount, the head of government should have the discretion to declare an emergency and use the funds, but should report immediately to the legislature, and, perhaps, seek replenishment. The existence of two apparent reserve fund mechanisms is unnecessary.

### BUDGET DIALOGUE ON DESIRED EXPENDITURE RESULTS

3.39 The budget process in Laos is largely based on inputs with no explicit discussion of outputs or outcomes. This is understandable for a country at Laos' stage of development, but there should be informal discussion of what ministries expect to achieve with their budgets during discussion of budget proposals with the central management agencies.

3.40 For investment expenditures MPI issues a "call circular" several months before the commencement of the fiscal year on October 1, to line ministries and provinces seeking prioritized bids. As the circular does not set any resource ceilings the resulting bids are always many times higher than the available funding. Article 29 of the Implementation Decree requires MPI to study and propose priority investment projects.

3.41 In practice it appears that MPI issues block allocations to line ministries and provinces, and then largely allows them to determine their priorities within these resource envelopes. For line ministries MPI may rely on the sector strategies which some ministries have developed such as the Education Sector Development Framework (ESDF). There is no formal requirement to outline objectives, outcomes or outputs and information is required only on proposed expenditures and revenues. Article 19 of the Implementation Decree requires that allocation of investment expenditures be based on norms that take account of population, poverty level, geographic conditions, accessibility and socio-economic potentials. This makes explicit the policy intention to have a pro-poor focus.[38]

3.42 The budget circular issued by MOF[39] contains a general requirement that the expenditure proposals take account of the objectives and priorities of the NSEDP, and refers to 11 priority programs and 111 projects defined by the government. There is, however, no explicit requirement to document any such connection or to provide information on likely outputs, outcomes or impacts, only a general requirement to prioritize and allocate resources to various (undefined) sectors and localities. Article 19 of the Implementation Decree requires that norms for the allocation of current expenditures be based on numbers of civil servants and mandates and responsibilities, thus suggesting an input based approach. This is appropriate given the stage of budget development in Laos.

3.43 There is no provision in the budget circular for explicit bidding for new recurrent expenditures, except for the separate staffing exercise managed by PACSA discussed above. An explicit provision for new policy bids covering both recurrent and investment expenditures (akin to the NT2 eligible programs exercise) would contribute to expenditure prioritization as well as improving the link between investment and recurrent expenditures.

3.44 Extensive internal consultation in developing the total budget is provided for in Article 36 of the Implementation Decree which provides for a budget drafting committee comprising MOF, MPI and other agencies to examine and discuss expenditure proposals in depth for each sector. Following this work consultations between ministers and provincial governors on programs and projects are also provided for.

### DEVELOPING SECTOR KNOWLEDGE TO IMPROVE PRIORITIZATION

3.45 Reflecting its responsibility for the preparation of the NSEDP and the annual report on NSEDP and the prioritization of projects under the PIP, MPI has a good understanding of sector objectives and expenditure issues. As noted above it has some analytical tools which it applies in prioritizing bids but details of these are not known. By contrast the MOF Budget Office appears to have limited knowledge about sector issues. There are four designated budget review officers in the MOF with whom sector ministries are encouraged to develop a dialogue. Strengthening this capacity is a key requirement to strengthening the prioritization of the recurrent budget. It appears that good analytical capacity may exist within line ministries, particularly

[38] The 2009-10 circular appears to require attention to be paid to the ongoing costs of public investments by incorporating these into the public investment projects but the translated version of the circular is somewhat unclear on this point.

[39] Minster of Finance's Instruction on Public Budgeting, No: 0666/MOF, April 2, 2009.

those where the planning and budgeting functions are integrated, such as the Ministry of Education.

### IMPROVING COORDINATION WITH THE PROVINCES

3.46 A long standing practice which undermines coherent priority setting has been that of governors allocating resources, both capital and recurrent, staff and money, to spending purposes not always in harmony with central priorities. The long term solution is a system of formula based fiscal transfers, and this is discussed in greater length in Chapter 4. In the short run, the Government has been promoting expenditure norms to guide budgeting in sectors like education and health. What is also needed is greater coordination between the Budget Department of the Ministry of Finance in the center, and their counterparts in the provinces. There also could be stronger review of draft provincial budgets by the center, with, perhaps, sanctions to provinces which use budget resources in ways that run contrary to national policies. Here, it might be useful to review the existing rules on budget delegation to provinces, both for preparation and execution, and see whether they could be tightened, pending the creation of a formal system of fiscal decentralization.

### A MEDIUM TERM PERSPECTIVE AND SECTOR STRATEGIES

3.47 Article 47 of the State Budget Law specifies the adoption of a medium and long term finance strategic plan to be approved by the National Assembly. The NT2 RMA also envisages the development of an MTEF to guide the definition of eligible program and assist in determining additionality under the NT2 RMA. Article 12 of the National Budget Law Implementation Decree requires MOF to take the lead in developing a 3-5 year budget plan broken down by sector and setting out priorities, with all government organizations developing their budget in line with the approved medium term budget. Assuming that the budget figures referred to are indicative figures, this in effect mandates an MTEF.

3.48 Although these requirements are provided for in the Budget Implementation Decree they have not yet been implemented.

3.49 In principle well prioritized and costed sector strategies, developed by and with strong ownership of line ministries and the support of DPs, can be an important tool in prioritizing expenditure within a sector. This is with the important proviso that they be constrained by a top down resources envelop, consistent with the aggregate resources picture, set before sector planning begins by the central allocation agencies (effectively MF, MPI and PACSA) and approved by the prime minister.

3.50 A number of ministries have developed sector strategies and each ministry also has a five year plan approved by the Minister, but the extent to which these are related is not clear. As mentioned above work has been undertaken on developing sector MTEFs with technical assistance from ADB but this has occurred in the absence of an overall framework that sets medium term envelopes for the main sector ministries, within which they can prepare their sector strategies and determine priorities.

3.51 Some sectors are in relatively good shape: for example, there is a Strategy for Transport Sector Development 2008-10 (and direction for 2011-15) and the Lao Transport Sector Program

(LTSP), all of which are consistent with the Five Year Plan of the Ministry. There is good liaison in this sector between GOL and DPs. This strategy is costed and includes assumed funding from NT2 of around US$10 million annually for three years. However, these plans have been arrived at on a "needs" rather than "availabilities" basis, due to the absence of a simple whole-of-government MTEF.

**Box 3: Medium Term Expenditure Framework (MTEF)**

MTEFs have been widely recommended as a mechanism to help countries escape from the incrementalism inherent in traditional annual budgets, to improve the realism of sector planning, to make policy fiscally sustainable, and to lay the basis for further refinement of the planning and budget system. They can also strengthen the links between national plans and annual budgets, and between the capital and recurrent parts of a dual budget system.

Results have not met expectations in many countries, Laos included. The main reason is the adoption of inappropriate MTEF models, drawn from more advanced countries which typically have better developed costing systems, stronger econometric forecasting capacity, and unified budgets, often already in program format.

It is helpful to see the development of a medium term approach to budgeting in countries like Laos in three stages: (i) creation of a Medium Term Fiscal Framework (MTFF); (ii) introduction of a simple top down planning MTEF; (iii) development of a baseline MTEF using bottom-up cost information. Laos seems to have reversed this sequence, jumping to unconstrained sector plans and trying to create a baseline MTEF in a few pilot ministries in a setting where information on costs is sketchy and historical spending data are lagged. Many have therefore concluded that attempting a MTEF is premature.

Establishing a medium term approach to budgeting remains vitally important for Laos. First, to ensure budgets better reflect government priorities in a fiscally sustainable way as the country faces the challenge of managing public spending in an era of rapid natural resources driven economic growth. Second, to achieve compliance with NT2 RMA commitments and State Budget Law requirements.

- A MTFF is an aggregate 3-5 year framework, typically the overall spending envelope for all ministries, net of debt servicing. It will include estimates of domestic revenues, derived either from econometric modeling or borrowed from the fiscal frameworks developed for Laos by the IFIs. It will have estimates of likely donor funding on an 'availabilities' (not needs) basis, derived from consultations with DPs. And it will be expressed in constant base year prices.

- A planning MTEF is the breakdown of the MTFF into spending shares for the main sector ministries. In the first year of the MTEF it will largely reflect existing shares. In the outer years shares will be adjusted to accommodate desired shifts in spending priorities and the expected recurrent arising from completing development projects. In a dual budget setting, the MTEF may be divided into capital and recurrent components. MF and MPI would take the lead in developing the planning MTEF, which would be approved by Cabinet, and form the basis of the annual budget call circular. The planning MTEF would be a central part of the macro-fiscal chapter of the National Plan, and would be updated and published with the annual budget.

- A baseline MTEF, which is more bottom up, could be developed once the planning MTEF is well established, and cost data have been strengthened. This could be done on a pilot basis, starting with ministries which have begun strategic planning. The aim would be to estimate more precisely the cost of delivering existing services, and whether there is any headroom for expanding them or introducing new policies and programs in the future.

Given that the IFIs have already developed forecasts of the main macro-fiscal aggregates, a simply MTFF effectively already exists. This could be used as a basis for developing a planning MTEF for the next national development plan and for the next cycle of the budget call circular. As local econometric modeling capacity grows, the MTFF could be refined. Once the planning MTEF foundations have been laid, Laos could resume its efforts with estimating service delivery baselines.

3.52 In the education sector there have been many competing plans and strategies, covering aspects of the sector. The Education Sector Development Framework (ESDF) covering the period up to 2015 has recently been costed and prioritized after discussion with DPs. Although the plan has been approved by the Prime Minister, MOF has indicated that the level of required funding—which indicates a financing gap of US$253 million over a five year period including a gap of US$37 million in 2009-10—is not affordable. To place some perspective on theseIn the health sector plans develop by non-funding agencies such as WHO and UNICEF tend to be fiscally unconstrained. Despite this more meaningful plans and strategies exist at sub-sectoral levels, such as child and maternal health and nutrition.

3.53 In the environment area the Environment Protection Fund (EPF) whose secretariat is based in MOF appears to have undertaken considerable planning and preparation and has produced a draft Strategy Paper on use of NT2 revenues (January 2009) . Five year plans have been developed covering environmental protection including a national climate change strategy and action plan by the newly established Water Resources and Environmental Agency (WREA) and environmental monitoring of hydro power.

3.54 This brief survey of selected sectors suggests that the practice of preparing plans which are not affordable, or indeed which may not even be costed appears to be widespread. Despite this apparent lack of realism such plans are regularly put to the Prime Minister for approval, which is granted. Clearly there is a need for all sector ministry plans, covering both investment and recurrent expenditure, to be considered within an overall government medium term expenditure framework.

### A ROLE FOR THE NATIONAL ASSEMBLY IN IMPROVING PRIORITIZATION

3.55 The Budget Law (Article 27) delegates major responsibilities to the National Assembly in budgeting matters. Parliament is required to approve the NSEDP, the annual report on the NSEDP, the annual budget including the PIP and any amendments to the budget arising from the mid-year review. Under the new budget timetable Parliament now has some two months to review the draft Annual Budget law before the commencement of the fiscal year. It has a role in reviewing the medium and long term finance strategic plan required by Article 47 of the State Budget Law but not yet implemented, as discussed above.

3.56 Although the Assembly in practice approves these documents without change, these roles provide potential opportunity to challenge and discuss policies and priorities. It is understood the National Assembly is increasingly doing this, with the support and encouragement of the government leadership. According to the EC report the government has declared strengthening of the National Assembly as a key priority in promoting good governance. According to the 2010 PEFA assessment the Assembly's Economic, Finance and Planning Committee is consulted when the general budget strategy is being developed and before it is submitted to the National Assembly. It has limited if not inadequate time, however, to consider the details of revenue and expenditure proposals once the budget is presented.

3.57 The State Audit Organization (SAO) reports to the National Assembly on the annual public accounts, providing a formal audit opinion on them. Its reports on the 2006/07 and 2007/08 public accounts were tabled later, but not significantly so, than the new Budget Law requirement

of 6 months after the end of the fiscal year. There are presently no formal arrangements for the National Assembly to follow up on any SAO reports although the SAO is proposing to report to the Assembly on the follow up of its 2008/9 findings.

### C. CENTRALIZATION OF REVENUE COLLECTION AND TREASURY SINGLE ACCOUNT

3.58 The new organic Budget Law passed in December 2006 centralized all government revenues including those of sub-national governments (SNG) by providing for a National Treasury to receive and disburse all public funds. Article 6 of the Law states that all revenues and expenditures shall be fully centralized and accounted for in the national budget and that no revenues shall be retained outside the budget system. MOF instruction 2160 of September 2007 outlines the details and time line for implementing this and a draft National Treasury Law has been developed but not yet adopted.

3.59 The 17 provincial treasuries have been integrated into a new National Treasury. The Law also provides for the centralization of tax and customs administration and staffing into national tax and customs administrations. These new arrangements have been gradually introduced over the past three years.

3.60 Article 30 of the Budget law requires the Tax and Customs Departments to each prepare an annual revenue collection plan and to provide this to MOF. This is designed to make the heads of the national tax and customs administrations accountable for the full collection and remittance of these revenues to the National Treasury and to improve cash and revenue forecasting.

3.61 All this is a significant change from previous arrangements under which provincial treasuries were under the control of provincial governments and made payments for SNG expenditures with no central oversight. In addition provincial treasuries reported directly to the provincial governor who could divert both local and national revenues to unbudgeted purposes. This compromised the ability to execute the budget in line with the plan. In addition the center did not receive timely information on provincial expenditures nor was there timely remittance of national revenues collected at the provincial level. This exacerbated the cash constraints faced at the central level and resulted in delays in transfers to the poorest provinces.

3.62 Under the new arrangements all revenues collected by provincial treasuries are allocated to either a national or provincial account. The new Budget Law (Articles 37-9) specifies which revenues belong to the central budget and which belong to the provincial budgets and which are to be shared between the two levels. On shared revenues the Implementation Decree provides for the government to decide the sharing proportions from time to time. A draft decree specifying the division of the shared revenue sources between the center and the provinces has been submitted to the Prime Minister for approval. Under this, all central payments require the approval of the National Treasury. The heads of provincial treasury offices may make provincial payments for relevant expenses but this information is now automatically available to the National Treasury which can review them *ex post* against budget allocations. Provincial payments for certain expenditures that are to be made from provincial revenues can be made directly by the relevant provinces with the center covering any deficits. Any deficits are to be subsequently recouped.

3.63 As the 2009 EC report observes, it can be expected that provinces will be more likely to support and cooperate in this revenue centralization if there is a clear system of revenue sharing which yield predictable revenue flows to them. This should occur once the draft decree specifying the division of shared revenue sources between the center and the provinces is signed and once the allocation of funds to provinces based on expenditure norms commences. The transfer system is expected to be based on expenditure norms for key sectors such as education and health and to allow for horizontal imbalances across provinces. There may also be provision for general untied grants to the provinces.

3.64 In making these changes the grading, number and skills of provincial treasury staff has been enhanced. There is still some non observance, however, of the new system by provincial treasury staff reflecting in part the need for further training. For example the 2010 PEFA assessment notes that at the level of individual spending units expenditures may be paid directly in cash without reaching any bank account.

3.65 These new arrangements have the following benefits:

- They improve the liquidity and cash management of the National Treasury by ensuring that moneys are not withheld by provincial treasuries;
- They improve national budget Implementation for the same reason;
- They improve the transparency of provincial budget implementation;

3.66 While the Treasury has not been able to quantify the benefits of the new arrangements in terms of improved revenue flows and cash management, reduction in interest costs or increase in interest earnings, it seems clear that cash and revenue forecasting have been improved. Cash management and planning has improved significantly and now progressed to the stage where cash allocations are made on a six monthly basis. This is in marked contrast to the previous situation, characterized by cash shortages, compounded by weak cash management and planning with adverse consequences for budget execution.

3.67 Presently cash management is being conducted by the Budget Department at MOF, the result of its historical role in the early reforms. This is not, however an appropriate role for the Budget Department and there is therefore a need to clearly delineate cash management responsibilities. A formal cash management unit should be established within the Treasury Department of MOF.

3.68 Further work remains to be done to fully establish a treasury single account (TSA). Technical advice in the establishment of a TSA is being provided by a peripatetic consultant. This work includes an inventory of government bank accounts currently held at state commercial banks. A considerable number of central government bank accounts are still held at state commercial banks, being mainly to receive user charges or other revenues collected directly by ministries. All such accounts have been identified and the new budget law clearly requires them to be closed and their revenues paid into the TSA. Some ministries are, however, resisting their closure. An inventory of provincial bank accounts has also been completed in readiness for their incorporation into the TSA. In addition, the 8 extra budgetary funds discussed above operate outside the Treasury system and will be brought into the TSA.

3.69 The Treasury now makes most payments for civil service salaries and for payments to suppliers by electronic transfer to bank accounts. It needs to utilize some retail banking services, however, to make payments in rural areas where the Bank of Laos has no branches and therefore requires commercial agency arrangements with state commercial banks. These will be developed based on a zero balance approach or the ability to sweep such accounts on at least a daily basis.

3.70 The World Bank has assessed that sustainable centralization will require 3-4 years of significant change management and political support. The 2009 European Commission report comments that the action plan or road map envisages a comprehensive piloting phase followed by a comprehensive nationwide rollout phase with the full process being completed no earlier than 2012.

# CHAPTER 4 INTERGOVERNMENTAL FISCAL ARRANGEMENTS

## A. INTRODUCTION

4.1 The People's Democratic Republic of Lao has had a history of recurrent cycles of administrative and fiscal decentralization and re-centralization since its establishment in 1975.[40] That experience left Lao PDR with an unbalanced intergovernmental fiscal system, with weak central fiscal institutions and quite dominant provincial powers. This has made it difficult to implement central policies and programs seeking to increase the overall efficiency of public expenditures and to address serious disparities in access to basic public services across the national territory. However, over the past three years Lao PDR has made consistent progress toward a better footed system of intergovernmental relations. In particular, important progress has been made in moving away from an *ad hoc* negotiated budgeting system with local governments to a more transparent rule-based system. This process got started with the approval of the State Budget Law in 2006 and more recently with the required strengthening of several central government budget institutions including the re-centralization of the Treasury Function and the Customs and Tax Administration. Other progress benchmarks include the approval of mandated minimum spending levels for the provinces in education and health in 2008-09 and the approval of a revenue sharing formula for the shared taxes pool likely to be used in FY 2010-11.

4.2 Challenges remain in the current design of intergovernmental fiscal arrangements in Lao PDR. The assignment of expenditure responsibilities in the State Budget Law is still too vague. This area will require considerable effort in clarifying and streamlining functional responsibilities. The full development of an intergovernmental fiscal system will be completed as and when Laos moves to a system of elected provincial and district councils, which can hold sub-national executive administrations accountable for their use of transfers and locally raised revenues. In the meantime, it will be important to move forward with the implementation of the new legal framework. In addition, ways need to be found to strengthen the participation of central government sector ministries in the preparation of provincial budgets, to ensure a more even application of government sector policies across the country, particularly in the social and economic sphere.

4.3 The Ministry of Finance has started to formulate expenditure norms for the two most important deconcentrated sectors: education and health. Other sectors, including agriculture, communication, transport, construction, and administrative services would follow in later years. The plans are to use those norms for budget formulation purposes (and later on for the equalization grant) and at least for the time being not to make them compulsory for budget execution. The planned expenditure norms would at first cover only non-wage current

[40] Properly speaking Lao PDR has had and has at the present time a deconcentrated system of intergovernmental fiscal relations as opposed to a decentralized system. This is due to the fact that the country remains politically highly centralized with all sub-national authorities being appointed and being accountable only to the central authorities as opposed to being elected by local constituencies. In this report the term decentralization will be loosely utilized to refer to Lao PDR experience with intergovernmental relations when in a more strict sense the correct term would be deconcentration. Using the term decentralization has the advantage of connecting more directly with the terminology commonly used in Lao PDR in this context.

expenditures. This is a serious limitation that needs to be overcome. The most significant inter-provincial disparities in expenditures and in the level and quality of services are associated with the staffing for those services, such as in the case of teachers and health workers; by allowing a phasing in period of several years needed for the adjustment of personnel levels it may be possible to include wage expenditures in the basic sector norms. At any rate, some important obstacles remain for accomplishing the work of formulating sectoral expenditure norms. Prior to the determination of the norms, it will be necessary to clear up the assignment of expenditure responsibilities, to implement the functional classification of the budget, and to address the hard issue of incomplete budget coverage due to expenditures financed with ODA and "technical revenues" (revenues from fees and charges paid especially by users of education and health services).

4.4 In the area of revenue assignments, the Budget Law now clearly specifies what revenue sources are assigned 100 percent to the central governments, those that are assigned 100 percent to local governments, and those to be shared between the central and local levels at a rate to be defined by the central government. The revenue autonomy of local governments remains limited because they do not have any discretion to set rates for those taxes from which they receive 100 percent of revenues. On the other hand, some progress has been made in the definition of a formula to be used in the allocation of the taxes shared by the central and local governments. This formula is a weighted index of population, poverty, and land area. The actual pool of revenues to be shared remains at the discretion of the center, but plans are to calibrate this percentage so that the most well-off provinces have "sufficient" financing to cover their expenditure needs in conjunction with their own (100 percent assigned) revenues. The other constraint in the definition of the sharing rate is that all provinces will be held harmless in terms of the revenues they received in the past (no province will experience a cut in funding).

4.5 At present there are significant horizontal disparities across provinces in the provision of public services. A good portion of these horizontal disparities are expected to remain even after the implementation of the revenue sharing formula, which contains some equalizing elements (the use of the poverty index as one of the variables in the formula). In order to address the horizontal fiscal disparities, the Ministry of Finance is at the initial stages of designing an equalization grant system. This grant system would provide further central support for the poorer provinces, which otherwise would be expected to receive not enough funding from their "own" (100 percent) taxes and the revenue sharing transfer to cover their expenditure needs. Conceptually, the equalization formula would use measures of expenditure needs based on the definition of sectoral budget norms, as discussed above. The issues of determining revenue capacity and how to determine the pool of funds for equalization are much less advanced conceptually. Nevertheless, the harder challenge for the otherwise very desirable introduction of that equalization grant system is the determination of expenditure budget norms. To date there has been little progress made in the definition and implementation of a system of conditional grants. This reflects in large part the reality that the line ministries, which would be in charge of managing those grants with particular sectoral objectives, remain weak in budgetary terms vis-à-vis the provincial administrations. The only exception may be for capital grants administered by the Ministry of Planning and Investment (MPI).

4.6 The Government of Lao PDR faces a complex and challenging reform agenda. It will therefore be important to set priorities and the right sequence of reforms in the intergovernmental

fiscal system. The reform agenda in the short run should concentrate on re-issuing the Ministry of Education Instruction with "financing" responsibilities and replicating this Instruction for Health. These norms should be kept simple (e.g., kip per student") and should be calibrated over time for affordability on the basis of budget outturn figures by functional classification subcategories.. The choice of a formula index for the allocation of shared taxes based on population, poverty index, and land area is more desirable than using the derivation principle and this should be retained. In addition, work should be started on the introduction of an equalization grant for worse-off provinces based on the existence of a positive fiscal gap measured by the difference between expenditure needs (based on expenditure norms and revenue capacity, including own (100 percent) revenues and revenue sharing).

4.7 Other issues that the Ministry of Finance is properly pushing back to the medium term, in terms of the reform agenda, are the clarification of expenditure assignments and introduction of expenditure norms for other sectors (agriculture, transport, etc.), down to the district level. Over the medium term the government should consider granting some level of tax autonomy to set rates for some taxes at the provincial level, a distinct assignment of revenues to the provinces and the districts, and the full-fledged introduction of conditional grants for recurrent purposes.

4.8 This chapter first presents expenditure figures for total and local spending in the most recent years for which outturn data are available. Next it reviews the vertical structure of government and the territorial and administrative organization. Following this, it examines the current arrangements for expenditure assignments and the ongoing work on the definition and computation of expenditure norms. It also reviews revenue assignments, the degree of revenue autonomy present in the new Budget Law, and a proposed new revenue sharing formula. It then looks at the current system of transfers and the ongoing work to define a new equalization grant system. The final part of the chapter contains a set of recommendations and discusses the proper sequencing of the reforms in the near and medium terms.

## ANALYSIS OF SUB NATIONAL GOVERNMENT SPENDING

4.9 Currently, the share of sub-national spending in total government spending is about one third, somewhat lower than a decade or so ago.. In 2007, the most recent year for which data are available, the share of local budget expenditures in the overall State Budget expenditures was 32 percent, but notably this share has not been stable over time. Over the period 2000-07 both local expenditures and central level expenditures have continuously increased, but the central component of total budget expenditures has increased faster (Table 2, Figure 17). As a result, there has been a downward trend in the "level of decentralization" as measured by the share of local budget expenditures in total (central plus local) expenditures. This share started the decade in 2000 close to 39 percent and reached a peak in 2001 at 48 percent. Since then, as illustrated in Figure 1.B the local share in total expenditures has declined unsteadily to the 32 percent figure for 2007. Thus, over the period there has been a significant re-centralization of government expenditures in Lao PDR.

**Table 2: (a) Lao PDR Central Government and Local Government Total Expenditures, FY 2000-2007 (million kip)**

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007* |
|---|---|---|---|---|---|---|---|---|
| Central + Local | 3,547,760 | 3,598,755 | 4,409,574 | 4,172,319 | 5,619,255 | 6,943,863 | 8,099,758 | 8,884,000 |
| Local | 1,376,955 | 1,731,742 | 1,971,434 | 1,553,263 | 1,938,665 | 2,593,167 | 2,462,618 | 2,817,296 |

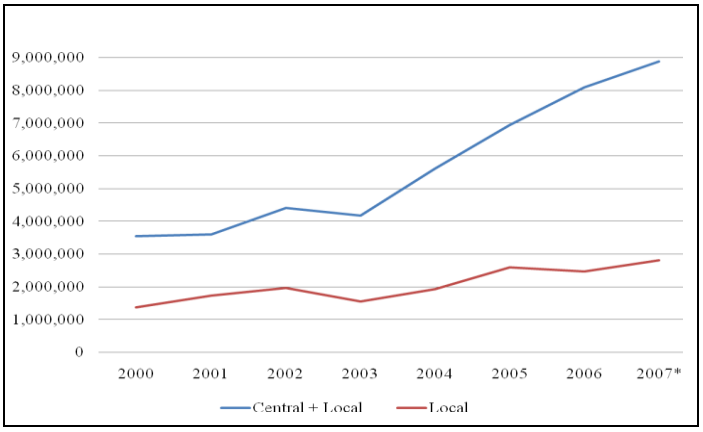
*Note:* * Estimate
*Source:* Lao PDR Official Gazette Database FY2000-2007

**(b) Lao PDR Local Government Total Expenditure as a share of total Central and Local Government Expenditures, (FY 2000-2007 (%)**

| 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007* |
|---|---|---|---|---|---|---|---|
| 38.8 | 48.1 | 44.7 | 37.2 | 34.5 | 37.3 | 30.4 | 31.7 |

*Note:* * Estimate
*Source:* Lao PDR Official Gazette Database FY2000-2007

**Figure 17: Lao PDR Central Government and Local Government Total Expenditures, FY 2000-2007 (million kip)**




*Note:* * Estimate
*Source:* Lao PDR Official Gazette Database FY2000-2007

4.10 However, these figures about the level of expenditure decentralization must be interpreted with caution. First, public expenditures financed with international funds (ODA) are generally not recorded in the executed budget figures, and ODA financing can represent upwards of 25 percent of total public expenditures.[41] Second, the recorded budget figures do not include either expenditures financed with the so-called "technical revenues" representing fees and charges paid by service users, which may be quite significant in sectors such as education and health. The share of budget expenditures at the local level should also be interpreted with caution with respect to the actual level of fiscal autonomy enjoyed by sub-national governments. While provincial governments have considerable discretion in prioritizing expenditures and executing budgets, in fact there is little autonomy available to provincial governments on the revenue side of the budget.

4.11 A more disaggregated account of the evolution of expenditure trends at the local level versus total (central plus local) expenditures for the most important functional components in local budgets: agriculture, communications and transport, education, and health is illustrated (Table 3). While expenditures in agriculture have decreased in nominal terms over the period 2000-07, they decreased faster at the local level. In the case of communications and transport (CTPC), expenditures have increased at both the central and local level, but much more rapidly at the central level, making the share of local governments decline markedly since 2001. The same trends are basically repeated for education, although the decline in the local share has been less pronounced and with a few peaks and valleys. Note, however, that in nominal terms local expenditures on education have more than tripled in the period 2000-07. The share of local governments in health expenditures shows even more volatility than in education, but it fell from 80 percent in 2000 to less than 50 percent in 2007. In contrast to the case of education, local health expenditures in nominal terms barely moved in the 2000-07 period. The evolution of local shares in the four categories of functional expenditures is illustrated in Figure 18. Overall, the evidence above illustrates that the *de facto* re-centralization of government expenditures in recent years has occurred across the board covering all sectors where local governments have traditionally played an important role.

[41] IDA reports that ODA to Lao PDR is estimated around US$ 200 to 250 million per year.

**Table 3: (a) Lao PDR Central and Local Government Expenditures for Selected Functions, FY 2000-2007 (million kip) (b) Local Government Total Expenditures as share of Total Central and Local Government Expenditures for Selected Functions, FY 2000-2007 (%)**

| | Agriculture | | CTPC | | Education | | Health | |
|---|---|---|---|---|---|---|---|---|
| | State + Local | Local | State + Local | Local | State + Local | Local | State + Local | Local |
| 2000 | 589,018 | 509,317 | 809,951 | 157,720 | 260,961 | 151,759 | 131,398 | 105,227 |
| 2001 | 409,229 | 349,801 | 574,477 | 382,121 | 386,126 | 240,590 | 179,956 | 114,930 |
| 2002 | 509,116 | 424,154 | 984,713 | 486,940 | 436,317 | 244,132 | 254,626 | 173,099 |
| 2003 | 286,206 | 184,306 | 842,888 | 326,101 | 457,482 | 283,676 | 180,409 | 114,832 |
| 2004 | 323,125 | 212,277 | 1,156,076 | 512,826 | 649,091 | 330,203 | 324,091 | 141,057 |
| 2005 | 476,782 | 323,477 | 1,557,177 | 569,606 | 1,026,721 | 423,051 | 225,617 | 172,065 |
| 2006 | 365,283 | 180,392 | 1,560,941 | 501,037 | 1,173,212 | 468,738 | 229,142 | 169,082 |
| 2007* | 391,045 | 192,155 | 1,255,296 | 416,159 | 1,130,942 | 536,625 | 351,968 | 170,831 |

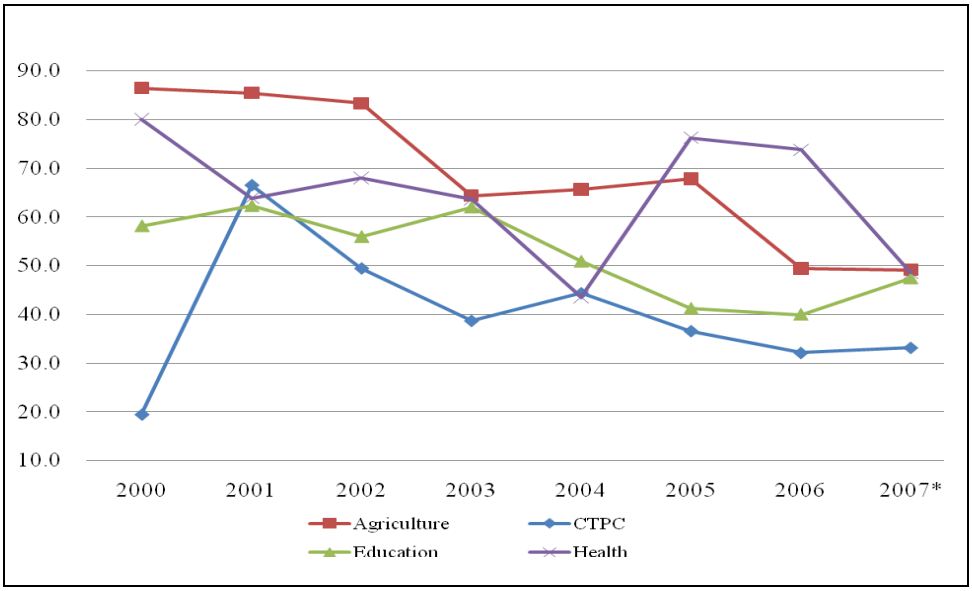
*Note:* * Estimate
*Source:* Lao PDR Official Gazette Database FY2000-2007

**(b) Local Government Total Expenditures as a share of Total Central and Local Government Expenditures for Selected Functions, FY 2000-2007 (%)**

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007* |
|---|---|---|---|---|---|---|---|---|
| Agriculture | 86.5 | 85.5 | 83.3 | 64.4 | 65.7 | 67.8 | 49.4 | 49.1 |
| CTPC | 19.5 | 66.5 | 49.4 | 38.7 | 44.4 | 36.6 | 32.1 | 33.2 |
| Education | 58.2 | 62.3 | 56.0 | 62.0 | 50.9 | 41.2 | 40.0 | 47.4 |
| Health | 80.1 | 63.9 | 68.0 | 63.7 | 43.5 | 76.3 | 73.8 | 48.5 |

*Note:* * Estimate
*Source:* Lao PDR Official Gazette FY2000-2007

**Figure 18: Lao PDR Local Government Total Expenditures as a Share of Total Central and Local Government Expenditures for Selected Functions, FY 2000-2007 (%)**




*Note:* * Estimate
*Source:* Lao PDR Official Gazette Database FY2000-2007

## I. VERTICAL STRUCTURE AND TERRITORIAL AND ADMINISTRATIVE ORGANIZATION

### CURRENT ARRANGEMENTS

4.12 The Lao PDR Constitution, in its Article 75, states that the government is divided into three levels of local administration (provinces, districts, and villages). However, the vertical structure of governments receives quite different treatment in the State Budget Law of 2006 and the Law on Local Administration of 2003. While the Law on Local Administrations defines (Article 59) two levels of budget for local finance, the province and the district,[42] the Budget Law subsumes all sub-national tiers into a general "local" category of government. What this means is that for the purpose of budget revenues and expenditures all three tiers are consolidated at the provincial level. This treatment diminishes, as discussed further below, the autonomic budget role of the lower tiers, and therefore it reduces also the potential gains from decentralization.[43]

4.13 There are currently 16 provinces plus Vientiane Capital, sub-divided in turn into 141 districts and municipalities, and 11,293 villages (Table 4). Provinces and cities are headed by

[42] The village is defined as basic revenue collection unit, with its expenditure tasks to be defined by the district
[43] By recognizing only two levels of government (central and local) the 2006 Budget Law follows, for example, the current practice in Vietnam and it deviates from the 1994 Budget Law which explicitly addressed the provincial and district levels. However, the lack of locally elected councils in Lao PDR as discussed further below means that the potential losses in decentralization benefits are likely to be smaller due to a complete lack of horizontal accountability to local residents.

governors, while municipalities are headed by mayors and districts and villages by chiefs. These heads of local administration are not elected, but appointed by higher level authorities.[44] Provincial governors are appointed by the President upon the Prime Minister's recommendation for a five year term and can be reappointed for an additional term. Similarly, district chiefs are appointed for five-year renewable terms by the Prime Minister on the recommendation of the governor. In Lao PDR there are no sub-national (provincial, district, village) legislative organs or councils elected or appointed.

4.14 The functions of provincial, district and village administrations are rather generally defined in the Law on Local Administration. For example, the provincial administrations are given the responsibility to manage political, economic, and socio-cultural affairs and human resources; to protect, preserve and utilize natural resources, the environment and other resources. They are also to manage local defense and security affairs as assigned by the central government. The Budget Law is more specific but still vague about the functional responsibilities of provincial (local) governments (Section 3).

[44] In Lao PDR the only elected organ is the parliament or National Assembly.

**Table 4: Local Administration in Lao PDR**

| Region | Province | Population 2005 | Surface area (km2) | Pop. Dens (pers/km2) | No. of districts | No. of villages |
|---|---|---|---|---|---|---|
| **North** | Phongsaly | 165,947 | 15,601 | 10.6 | 7 | 629 |
| | Luang Namtha | 145,310 | 9,051 | 16.1 | 5 | 422 |
| | Oudomxay | 265,179 | 11,425 | 23.2 | 7 | 771 |
| | Bokeo | 145,263 | 7,669 | 18.9 | 5 | 382 |
| | Luang Prabang | 407,039 | 19,714 | 20.6 | 11 | 1,175 |
| | Houaphan | 280,938 | 17,186 | 16.3 | 8 | 846 |
| | Sayaboury | 338,669 | 16,359 | 20.7 | 10 | 548 |
| **Total Northern** | | **1,748,345** | **97,005** | **18.0** | **53** | **4,773** |
| **Center** | Vientiane Municipality | 698,318 | 5,691 | 122.7 | 9 | 492 |
| | Vientiane Province | 388,895 | 17,950 | 21.7 | 12 | 581 |
| | Xiengkhouang | 229,596 | 16,811 | 13.7 | 7 | 514 |
| | Bolikhamxay | 225,301 | 15,580 | 14.5 | 6 | 362 |
| | Khammouane | 337,390 | 16,761 | 20.1 | 9 | 803 |
| | Savannakhet | 825,902 | 21,679 | 38.1 | 15 | 1,543 |
| **Total Central** | | **2,705,402** | **99,374** | **27.2** | **61** | **4,375** |
| **South** | Champassak | 607,370 | 16,140 | 37.6 | 10 | 908 |
| | Sekong | 84,995 | 7,665 | 11.1 | 4 | 256 |
| | Saravane | 324,327 | 10,478 | 31.0 | 8 | 708 |
| | Attapeu | 112,120 | 9,520 | 11.8 | 5 | 209 |
| **Total Southern** | | **1,128,812** | **43,803** | **25.8** | **27** | **2,081** |

*Source:* Martinez-Vazquez et al. (2006), and City Population sources (http://www.citypopulation.de/Laos.html)

4.15 The organizational structure of provinces includes the provincial cabinet and the local, de-concentrated divisions of the line-ministries. The structure is replicated at the district level. Article 10 of the Law establishes the principle of dual accountability of the local divisions of line Ministries to the provincial administration and to the national Ministry. In particular, the local divisions of the line ministries are to act as the secretariat to the province or city and to the ministry or ministry-equivalent organizations in the particular functional area of responsibility. Quite unique to Lao PDR, too, line ministries in practice appear to have little control and authority over the local divisions, the governor being the one in control. This is in large part due to the fact that it is the governor that exercises control over the personnel of the local divisions. Also according to Article 14 of the Law on Local Administration the governor has authority to "appoint the directors of the local divisions of the line ministries," and to "appoint, transfer, or remove the chief and deputy chief of the provincial or city cabinet." Provincial governors also have authority to set salary scales for all those public employees.[45] In practice, the dotted line of accountability of provincial staff to Headquarters Ministries is a weak one.

### MAIN POLICY ISSUES IN THE VERTICAL STRUCTURE

4.16 A notable feature of the current vertical structure arrangements in Lao PDR is the absence of local councils, and in particular local elected councils that can serve as a counterbalance and increase the accountability of local executives. Even though the current system is designed to provide for vertical accountability within the structure of government, the international experience is clear that the fuller gains of decentralization can be realized onlywhen local executive decisions are subject to the scrutiny and potential criticisms of local councilors who represent the interest and needs of local constituencies. These gains are realizable even in single party regimes as in the case of Vietnam. In the medium to longer term the Law on Local Administration should be reformed to incorporate a legislative branch of government at the local tiers that have budgetary authority (provinces and districts.)

4.17 A second important issue is the desirable de-bundling of local budgets. Although the Law on Local Administration identifies separate budgets, functions and revenue sources for the provinces and the districts, the State Budget Law of 2006 places districts and villages completely under the hierarchy of provincial governments without any explicit rules as to how provincial governments are to behave in fiscal matters vis-à-vis districts. Even though this approach may be convenient, it lacks logical appeal. For the same reasons that the State Budget Law of 2006 seeks transparency and explicit rules to regulate the fiscal relations between the central government and the provinces, there will be a need to explicitly regulate the fiscal relations between the provinces and the districts. At present there is little information on how the provincial governments share resources and distribute responsibilities with district governments. For example, the current concerns in the Ministry of Finance for a more equal distribution of resources across provinces could be extended to the distribution of resources across the districts within each province. The explicit regulation of provincial-district fiscal relations should be part of the medium to longer term agenda for decentralization reform in the Lao PDR.

4.18 A third issue concerns the minimum efficient size for economies of scale and administrative capacity of districts. Even though the average size is over 30,000 there is significant variation in the size distribution and some districts may be too small for the efficient production and delivery of services. This is an issue that should be revisited in the medium term. Although the forced

[45] The authority to create new permanent civil service positions remains centralized in the State Manpower Agency. However, effectively governors can exercise local patronage by appointing temporary workers.

amalgamation of smaller districts is an option, other solutions are also available based on the international practice, ranging from cooperative agreements or associations of local governments for the delivery of certain services requiring some minimum efficient scale to contracting with private firms for the delivery of those services.

4.19 A final issue is the need to rebalance the presence and authority of line ministries in their deconcentrated territorial offices at the provincial and district level. One can imagine how hard or even impossible it could be for central authorities to implement programs and control the execution of central government policies throughout the national territory in education, health, etc. if public employees in theory subordinated to the central authorities in no way respond to them. Ideally, at some stage in the future, there would be a separation between the deconcentrated personnel of the line ministries in the territories and the decentralized personnel under local authority each carrying out their functional responsibilities emanating from a clear assignment of competencies for expenditures for the central and local governments. Until that time, the rebalancing of authority under double subordination to the line ministries and the provincial governments will require providing the central authorities with some say in or control over the appointment or removal as well as wage compensation and training programs for the territorially deconcentrated public employees. A way should be found to involve both the line ministries and the central management agencies of finance and planning in the preparation and vetting of provincial budgets, to ensure that national policies are carried out appropriately at the sub-national level.

## II. ASSIGNMENT OF EXPENDITURE RESPONSIBILITIES AND DEFINITION OF EXPENDITURE NORMS

4.20 This first most important step in the design of a system of intergovernmental fiscal relations is a clear and stable assignment of expenditure responsibilities to the different levels of government. The second and related step is the approximate quantification of expenditure needs that follow from the assignment of expenditure responsibilities in the first step. Without having a clear idea of what local governments are responsible for and the funding needs associated with those responsibilities, it will make little sense to try to design a system of local budget financing including the assignment of tax revenues, revenue sharing, and the formulation of equalization transfers and others.

4.21 This section examines the current assignments of expenditure responsibilities and the ongoing work on expenditure norms. It concludes with an analysis of the main challenges facing the government in this area of reform.

### THE CURRENT ASSIGNMENTS IN THE LAW

4.22 The expenditure assignments in the 2006 State Budget Law at the central level (Article 17) and at the local level (Article 18) are opaque for the most part, repeating the same entries in both articles, using a mix of economic (recurrent expenditures, salaries, interest, capital investment, etc.) and functional classification (defense, security forces.) criteria of budget classification (as opposed to a strict use of functional classification, such as education, health services, national defense etc.) to define central government and local government expenditure responsibilities. There is no clarity either as to which functional responsibilities may be exclusive for one level of government and which may be concurrent or joint responsibilities. Given the repetition of the language used in Articles 17 and 18, one may conclude that, for the most part, functional responsibilities are intended to be concurrent or joint, but then there is no guidance as to what attributes of each responsibility (e.g., regulation, financing, and implementation) are to be performed by each level of government. By comparison, the previous assignments in Decree 192/PM of 1999 and reproduced in Table 5 had

many of the same defects but somewhat more helpful in anticipating how functional responsibilities were to be distributed among different levels of government.

### THE DE FACTO EXPENDITURES BY GOVERNMENT LEVEL

4.23 Even though, clearly, there are no formal expenditure assignments at the present time in Lao PDR, there are expenditure assignments *de facto* as reflected in the actual expenditures at the sub-national level. This section reviews the composition of sub-national budgets from an economic classification perspective, with the caveats that the budget data may not fully reflect expenditures financed with ODA funds or those financed with "technical revenues" (funds from fees and charges), which can be significant in sectors such as health and education. An effort also is made to analyze the functional composition of sub-national expenditures. Here, the main additional caveat is that the data on functional expenditures do not come from a true functional classification of the budget, which does not exist at the present time, but rather from aggregating expenditure data by budget organization. This means that, for example, education expenditures outside education agencies (for example, in the defense establishment) are not recorded as such but rather as some other kind of expenditures (in the example, as expenditures on defense.)

4.24 It is also important to note that the budget data for 2006-07 for the most part reflect the expenditure assignments prior to the 2006 Budget Code. An examination of the distribution of provincial government nominal expenditures (mean value, minimum and maximum values, and coefficient of variation) by economic classification for 2006-07, the most recent year for which data are available, while Table 6 shows the same items as percent of total expenditures. The size of total budgets differs across provinces with the largest being five times that of the smallest. On average, about 57 percent of the budget is spent on recurrent budget items and the remaining 43 percent on capital expenditures. The dominant item in recurrent expenditures is salaries, which on average represent 35 percent of all expenditures (Figure 19). This is a relatively modest figure by international standards even if it increases to over 45 percent when the 'compensation and allowance' item is added. This still leaves Lao PDR in the lower tier distribution in the international experience.[46] There is, however, significant variation across provinces in the economic composition of budgets. For example, salaries represent from 16 percent of total expenditures to a maximum of close to 47 percent. There is larger variation in the case of capital expenditures, with this item representing up to 72 percent of total expenditures in one province and only 28 percent in another. The largest variation is, as to be expected, for "other unforeseeable expenditures."

[46] See Martinez-Vazquez and Yao (2009)

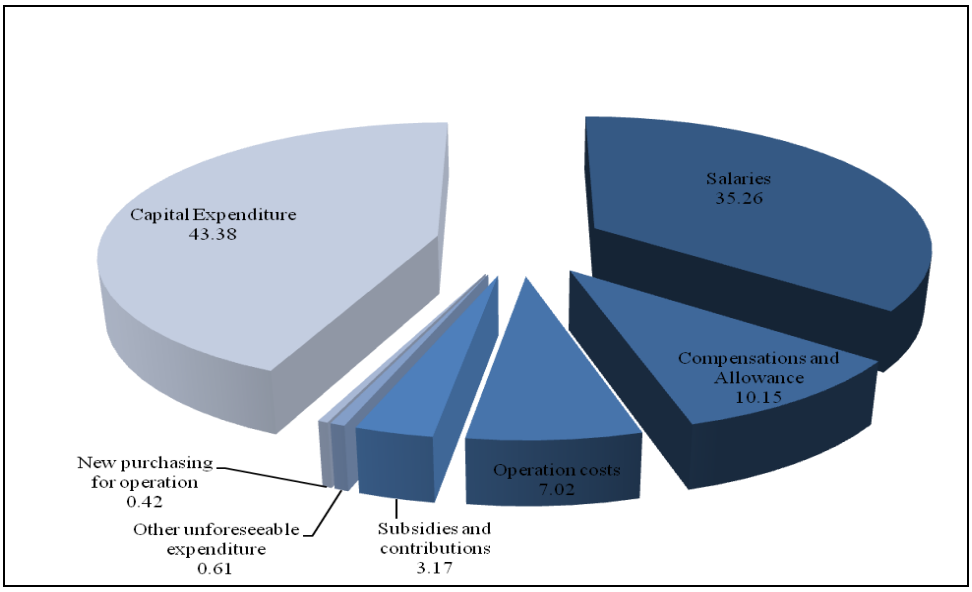
**Table 5: Current Expenditure Assignment in Lao PDR under the 2006 State Budget Law**

| Central Government* | Local Level** |
|---|---|
| 1. Current administrative expenditures<br>- Administrative costs of government organizations, Lao Front for National Construction and central level mass organizations;<br>- Expenses of defense and security forces under the central level's management;<br>- Participations and contributions to international organizations;<br>- Repayment of interest on the Government's domestic and foreign debts;<br>- Expenses of government funds managed by the central level (broken down into region and line in accordance with the budget nomenclature);<br>- Expenses of government administrative-technical agencies managed by the central level (distinguished by region and line in accordance with the budget nomenclature);<br>- Expenses of government funds;<br>- Expenses of government reserves; | 1. Current expenditures<br>- Administrative costs of government organization, Lao Front for National Construction, mass organizations and other equal ranking agencies at local level;<br>- Expenses for defense and security forces managed by the local level;<br>- Repayment of domestic loan interest;<br>- Expenses of government funds managed by the local level (distinguished by region and line in accordance with the budget nomenclature);<br>- Expenses of administrative-technical agencies managed by the local level (distinguished by region and line in accordance with the budget nomenclature);<br>- Expenses of local funds;<br>- Expenses appropriated into the government reserves; |
| 2. Expenses in public investments managed by the central level, including investments in the construction of infrastructure, participation funds to grant and loan financed projects, business equity | 2. Investments managed by the local level include investments in the construction of infrastructure, participation funds to grant and loan funded projects; |
| 3. Repayment of domestic and foreign loan principal | 3. Repayment of domestic loan interest |
| 4. Repayment of previous year's debts | 4. Repayment of previous year's debts; |
| 5. Other planned expenditures<br>- Price and interest rate subsidies in accordance with the Government's policies;<br>- Reloan costs;<br>- Expenses of aid grants;<br>- Other expenses set by laws and regulations. | 5. Other planned expenditures<br>- Expenses of assistance grants;<br>- Other expenditures provided by laws and regulations. |

*Note:* *Article 41 of the National Budget Law; ** Article 42 of the National Budget Law

4.25 The "functional" classification of local expenditures is presented for 2006-07 as percent of total by main category in Table 6, although it needs to be recalled that, properly speaking, these figures do not reflect a full functional classification of the budgets but rather an approximation using organizational structure. It is nevertheless informative besides 'administration' which represented 34.3 percent of the local budgets, the two largest spending categories of local governments are 'education' with 19 percent and 'CTPC' with 19 percent. Far behind are the categories of 'agriculture' with 7.6 percent and 'health' with 7.1 percent. Even lower is 'social welfare' with 4 percent, energy with 2.8 percent and culture with less than 1 percent. Quite notable and surprising is the variation shown across provinces for most of these categories, which may reflect different expenditure needs and priorities for provincial governments, but it would seem to also indicate some data aggregation issues. For example, the share in local budgets of 'CTPC' ranges from 3.75 percent to 50.9 percent. Even in the cases of 'education' and 'health' the variations are very large (4 to 32 percent and 2 to 15 percent, respectively). These variations would appear to be too large just to be based on the different expenditure priorities of provincial governments. Some other large variations as in the case of 'energy' may be due to location or geographical issues. The overall composition of the local budgets for 2006-07 is illustrated in Figure 19.

**Figure 19: Lao PDR Provincial Government Non-Interest Expenditures, Economic Classification, FY 2006/2007 (% of total)**



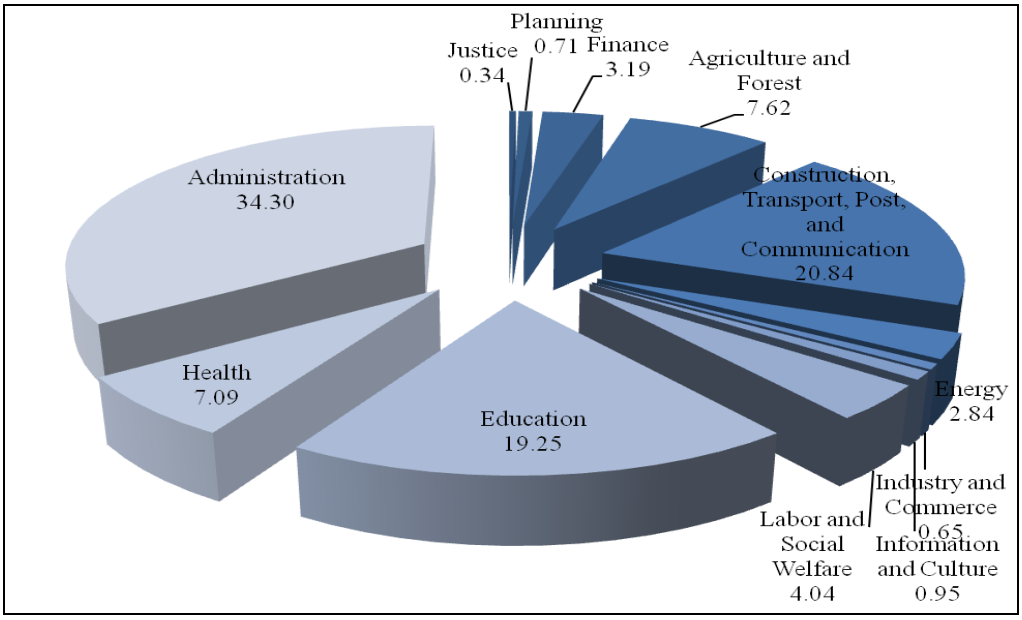

*Source:* Official Gazette, Lao PDR 2006/07

**Table 6: Lao PDR Provincial Government Non-Interest Expenditures, Functional Classification, FY 2006/2007 (% of total)**

| | Mean | Minimum | Maximum | Coefficient of Variation |
|---|---|---|---|---|
| Justice | 0.34 | 0.17 | 0.55 | 0.32 |
| Planning | 0.71 | 0.35 | 2.23 | 0.65 |
| Finance | 3.19 | 1.27 | 5.90 | 0.40 |
| Agriculture and Forest | 7.62 | 1.69 | 20.39 | 0.67 |
| Construction, Transport, Post, and Communication | 19.01 | 3.74 | 50.91 | 0.73 |
| Energy | 2.84 | 0.00 | 34.03 | 2.84 |
| Industry and Commerce | 0.65 | 0.30 | 1.80 | 0.60 |
| Information and Culture | 0.95 | 0.37 | 1.65 | 0.38 |
| Labor and Social Welfare | 4.04 | 0.65 | 8.56 | 0.57 |
| Education | 19.25 | 3.94 | 32.66 | 0.44 |
| Health | 7.09 | 2.15 | 15.10 | 0.52 |
| Administration | 34.30 | 22.24 | 53.89 | 0.28 |

*Source:* Official Gazette, Lao PDR, 2006/07

**Figure 20: Lao PDR Provincial Government Non-Interest Expenditures, Functional Classification, FY 2006/2007 (% of total)**




*Source:* Official Gazette, Lao PDR, 2006/07

## POLICY ISSUES AND PLANNED REFORMS IN EXPENDITURES ASSIGNMENTS

4.26 Local governments in Lao PDR play an important role in the delivery of many public services, as *de facto* at least they are assigned the responsibility to deliver public services in key areas such as education, health services, agriculture, and infrastructure and communication.

Although there is not much disaggregated information, the responsibilities that are in practice assigned at the local government level would seem to be typically "local" services in that they have a local dimension in service benefits. This *de facto* assignment of expenditure responsibilities seems to broadly follow the subsidiarity principle and to respect other standard principles of expenditure assignment. There are, however, a number of shortcomings in the current assignment of expenditure responsibilities that need to be addressed as a first priority for successfully moving forward the system of intergovernmental fiscal relations in Lao PDR.

4.27 The first and foremost important issue is the lack of an adequate formal assignment of expenditure responsibilities. As the preceding notes, the 2006 State Budget Law is vague and unclear regarding which functional areas and public services are the responsibility of the central and local governments. Articles 41 and 42 of the Budget Law (which should specify the functional assignments) are a mix of economic, organizational and rarely functional assignments, which overlap even in the language used. The Implementing Decree of the Budget Law of 2008 (Articles 17 and 18) does not clarify but rather reproduces the language in Articles 41 and 42 of the Budget Law.

4.28 The formal expenditure assignments would appear to rule out the possibility of exclusive assignments at different levels and instead most, if not all, functions are considered concurrent or joint responsibilities. Although the existence of exclusive responsibilities is desirable from the viewpoint of accountability (i.e., citizens know who to go to if services do not work properly), concurrent responsibilities may be acceptable or even necessary in some cases. The Budget Law, however, fails to consider the multi-dimensional nature of expenditure assignments and leaves the assignments for concurrent or joint responsibilities confused. One way to introduce clarity in the case of concurrent responsibilities would have been to specify explicitly in the law the attribution of competencies for the regulation, the financing, and the implementation of each concurrent responsibility. For example in the education sector, one needs to identify which level does what in, for example, primary education; that is what functions and expenditure responsibilities are assigned to the center and to the local governments. Specifically, in terms of logistics and using the same primary education example, the assignments need to clarify the following: (i) which government entity is in charge of school construction, school repair and maintenance; (ii) for school materials, who should provide school furniture, books and other materials; (iii) for school administration, who is training, hiring and supervising the teachers; (iv) who is responsible for the overall supervision of primary education quality and will publish the access indicators, etc. It is interesting to note that precisely for the case of the education sector the Instruction of the Ministry of Education for Decentralization in the Education Sector of 2002 (Number 1500/MOE) largely does that,[47] and much before the approval of the State Budget Law in 2006.

4.29 An additional drawback of the current formal expenditure assignments is that all three sub-national tiers of government are thrown together in Article 24 of the State Budget Law, as the "local government." Presumably the reason for this is to allow flexibility at the provincial level to set those assignments. But it is doubtful that the advantages associated with that flexibility outweigh the disadvantages associated with the arbitrariness, confusion, and inefficiencies accompanying the unclear assignments among provinces, districts, and villages. This is an aspect that even more strongly characterizes Lao PDR intergovernmental system as a deconcentrated system as opposed to a decentralized system.

[47] As discussed elsewhere in this report, the Instruction of the Ministry of Education is, however, silent on the matter of the financing responsibilities of different levels of government.

## QUANTIFYING EXPENDITURE NEEDS USING EXPENDITURE NORMS

4.30 Over the past year, several exercises have been conducted within the Ministry of Finance exploring different ways to define expenditure norms for the education sector and the difficulties associated with expanding that work to other sectors such as health.[48] This work has rightly exploited the idea that an adequate initial or base estimate of the budget norm, say for education, can be based on the actual aggregate local expenditures in the sector and the number of clients.[49] Different measures of capacity should not be used in the definition of norms because they do not capture need necessarily and because they are subject to manipulation by the local authorities. Overly complex schemes also need to be avoided; the composition and structure of budget norms should be as simple and transparent as possible. These issues are discussed next.

### *Choices and Policy Issues in the Definition of Norms*

4.31 Expenditure norms allow a transparent linkage between expenditure assignments and funding sources including own revenues, revenue sharing and transfers so that local governments have the resources needed to provide the expected services. They also allow the computation of expenditure needs in the allocation of equalization grants.

4.32 There are two basic ways to construct the expenditure norms. One approach can be called "bottom up," starts the identification of minimum service levels to be achieved by local governments and the costing of those standards. Two modalities are possible within the "bottom up" approach. A better modality here is to frame the defined minimum service levels in financial terms in relation to the corresponding client base as a cost-adjusted per-client expenditure norm. In some measure, this modality seems to have been used in a recent exercise by the Lao PDR Ministry of Education in setting the standards to be the fulfillment of the Millennium Development Goals for the country. A second modality is to quantify the cost of a series of inputs needed to obtain certain output or outcome. Assuring that "local expenditure needs" are connected to service standards and driven directly by the number of clients for local government services is preferable to defining these indirectly through the number of inputs used to provide a range of services whose ranking in terms of priorities and "enforcement" is largely undefined. It is clearly not a trivial task to take the variety of inputs associated with any service standards and reduce the standard expenditure norms that are defined in per-client financial terms.

4.33 A second approach to defining budget expenditure norms is a "top-down" approach that frees itself from costing inputs or the targeting of pre-established levels of service delivery outside the budget framework. Under this approach, the national government through a priority-setting process that cuts across sectors (generally through Cabinet discussions) determines sectoral resource envelopes that take into account the local government component making sure that the resulting budget needs are feasible within the available budget resources. These envelopes may be further subdivided into programmatic envelopes of national and local government expenditures. The local government programmatic allocations are then divided by the aggregate number of clients served, often adjusted for different costs of service delivery in different areas, generating an expenditure

[48] See Lepain (2009-July; 2009-August; 2009-September) and "Aggregated Budget Norms for Non-Wage Expenditure", (2009) Mimeo.

[49] Although actual enrollments are used in these exercises as the client base for education, it is more desirable for equity and efficiency reasons to use the number of eligible clients, as approximated by population of school age in the jurisdiction.

norm that is used as a means of computing expenditure needs for local governments and which can be factored in, for example, the equalizing transfer formula for local governments. This approach does not explicitly use service delivery standards but these may nevertheless enter into the process at later stages by adjusting the sectoral or programmatic envelopes to make certain standards affordable. The advantage of this approach is the relative simplicity of the process, both in terms of decisions and data requirements and also because of the fact that it ensures that budget viability, feasibility of the budget norms and therefore, that the enterprise is financially responsible.

4.34 Both approaches have obvious advantages and disadvantages. It would, however, seem that in the current environment a "top-down" approach may be better fitted to the institutional environment and fiscal realities of Lao PDR.[50] Whatever approach is used it must be clear that the definition of expenditure norms does not need to be taken to mean that the expenditure norm in turn will necessarily become prescriptive for local governments. These expenditure norms can be used - as notional norms- only for computational purposes in the calculation of revenue adequacy including the formulation of equalization transfers. If expenditures norms were actually used in a prescriptive fashion the entire system of intergovernmental finance would run the risk of essentially being transformed from an unconditional source (such as own revenues, revenue sharing, and potentially the equalization grant) to a series of conditional or sectoral grants (defined by the expenditure norms).[51] And in a larger sense, expenditure norms should be for guidance rather than prescriptive, since in poor countries there is often a large gap between declared policies are the resources available to implement them.

## III. REVENUE ASSIGNMENTS

### CURRENT REVENUE ASSIGNMENTS

4.35 By comparison to the previous revenue assignments in the Budget Law 1994, the new State Budget Law of 2006 represents positive advancements in some areas, specifically clearer definition of assignments, but also retrocession in some other areas, for example, the lack of separate revenue assignments for provinces and districts.

4.36 The revenue assignments in the 2006 State Budget Law distinguish three types of revenue sources: taxes assigned 100 percent at the central level, taxes assigned 100 percent at the local level, and shared taxes between the central and local governments. [52] The lists of taxes under each category areas are shown in Table 7.

4.37 The tax revenues assigned 100 percent to the central government include trade taxes (export tax and import duty); turnover on Value Added Tax (VAT) and excises on imports; profit taxes on

[50] Having said that, it needs to be noted that an effort must be made to relate the top-down expenditure norms to actual local expenditure needs (as determined by some accepted level or standard of service) and this should be an integral part of the discussions setting the sectoral/programmatic trade-offs made at the cabinet level. The danger will be of falling into a blind incremental basis across sectors disconnected from desirable national policy objectives, such as attaining the Millennium Development Goals.

[51] Note that somewhat of an intermediate position is feasible by leaving the budget norms as notional (as opposed to obligatory or prescriptive) but introducing some minimum level of per client sectoral expenditures. In fact this is the approach that has been adopted very recently by Lao PDR in the areas of education and health at the local level.

[52] Lao PDR follows the nomenclature used in Vietnam's Budget Code. What is called "taxes assigned 100 percent at the local level" in other transition countries is called "local or sub-national own taxes." The advantage of the approach used in Lao PDR and Vietnam is that it does not create false perceptions that local governments may have any degree of autonomy over these taxes, such as control over tax rates.

import activities, and income tax on dividends and capital gains from the sale of shares. A variety of fees also accrue 100 percent to the central budget including, registration fees and road fees.

4.38 The tax revenues assigned 100 percent to the local government level include the personal income tax and the land tax. Several fees and non-tax revenues also accrue 100 percent to local budgets.

4.39 Shared taxes between the central and local governments include all turnover or VAT receipts on domestic activities, excise taxes on domestic commercial manufacturing, profit tax and minimum tax collected from domestic businesses, and dividends from publicly owned enterprises. The Budget Law specifies that the sharing rates for all these revenues will be determined by the central government from time to time. Presumably the central government has been sharing these revenues on a derivation basis at individualized sharing rates high enough to fill the budget gap in each of the provinces. The plans are to switch next year to a tax-sharing formula based on an index with three components: population, land area and percent of the population living in poverty. Within this framework, the overall pool of funds to be shared with local governments would be fine tuned so that the better off or richer provinces will have sufficient funding for their budgets from revenue sharing funds and their 100 percent assigned own revenues. Poorer local governments for which total funding from revenue sharing and their own 100 percent assigned revenues are insufficient to cover their public expenditure needs would receive (in the future) an equalization grant. This is discussed further in the next section.

4.40 As pointed out above, a significant change in revenue assignments in 2006, and one that parallels the changes introduced also for expenditure assignments, is that revenue assignments are now stated only for the central government and the provincial (or combined local) level. The previous State Budget Law (1994) included explicit revenue assignments at the district level. The new Budget Law (2006) (Article 21) gives the provinces discretion to set the revenue assignments for the districts and villages.[53]

4.41 Until recently all tax collections in Lao PDR were completely decentralized. Over the course of 2009, the central government centralized most of the activities of domestic taxation and customs, but it does appear that there will continue to be a *de facto* dual subordination of tax administrators to the central administration and the local authorities. This means that local officials still can have an influence on the effective collection effort for all kinds of taxes. Thus the 2006 Budget Code (Article 26) has a "budget revenue collection promotion policy" which allows local governments to retain their own revenues collected in excess of the budget plan and share in any of the revenues collected in the locality for central taxes or shared taxes in excess of budget plans.[54] These funds must be dedicated to public investments and the actual share retained for the case of central and shared taxes is decided by the central government.

### LOCAL GOVERNMENT REVENUES

4.42 The distribution of actual collections from the different revenue sources of local governments for 2006/07, the most recent year available, are shown in Table 9 in million of kip. It is important to note that these revenue figures for 2006/07 for the most part reflect the revenue assignments of the 1994 Budget Code as opposed to that in the 2006 Budget Code.

[53] Unlike the case of Vietnam, no minimum levels of revenues are established for districts or villages.
[54] Revenue targets are defined at the central level, together with expenditure ceilings.

4.43 For 2006/07, indirect taxes (turnover, excises and import duties) represented 62 percent of total local revenues, with direct taxes (income tax, profit tax and land tax) representing only 17.3 percent. The balance went to fees and charges at 6 percent and non-tax revenues at 14.5 percent Among indirect taxes, the turnover tax was the most important, representing close to 29 percent of total revenues. It is interesting to note that among the taxes assigned 100 percent to local governments in the 2006 State Budget Law, the income tax represented only 6.8 percent of total revenues in 2006-07 and the land tax 2.2 percent (Figure 21). Thus for the new revenue assignments in the 2006 Budget Code, it is to be expected that the bulk of local government revenues will come from shared taxes as opposed to 100 percent assigned taxes. This is not a significant issue presently as there is little consequence to the distinction between 100 percent assigned taxes and shared taxes due to the lack of any form of tax autonomy or local government discretion.

**Table 7: Lao PDR Revenue Assignments under the 2006 State Budget Law**

| Central Government Revenues Apportioned in Full (100%) to the Central Budget | Local Level Budget Revenues Apportioned in Full (100%) to the Local Level | Shared Revenues Revenues Apportioned between the Central and Local Levels |
|---|---|---|
| 1. Custom duty and tax revenues<br>1.1 Import-export duties<br>1.2 Taxes<br>- Turnover or value-added tax, excise tax, profit tax on imported goods;<br>- Income tax on dividends, sale of shares and other immovable assets of enterprises and organizations;<br>1.3 Fees<br>- Official documents registration fees;<br>- Visa fees;<br>- Road fees;<br>- Other fees.<br><br>2. Non-tax revenues<br>2.1 Revenues from assets and government technical service fees<br>- Revenues from the sale of wood;<br>- Charges on natural resources except rock, gravel, limestone, sand, black soil and laterite;<br>- Royalties;<br>- Concession fees;<br>- Overflight fees;<br>- Rent of state-owned buildings other properties;<br>- Sale of the Government's assets and shares;<br>- Fees for technical services provided by other government agencies.<br>2.2 Revenues from fines and seized goods<br>2.3 Revenues from investments by the Government<br>- Loan interest;<br>- Repayment of loan principal;<br>2.4 Revenues from transfer of state properties | 1. Customs duty and tax revenues<br>1.1 Taxes<br>- Personal income tax, income tax on dividends sale of shares and other immovable funds of enterprises;<br>- Land tax.<br>1.2 Fees<br>- Official documents registration fee;<br>- Other fees.<br>2. Non-tax revenues<br>2.1 Revenues from assets and technical service fees<br>- Charges on natural resources for rocks, gravel, limestone, sand, black soil and laterite;<br>- Royalties;<br>- Concession fees;<br>- Rent of state-owned properties such as buildings, land and other assets;<br>- Fees on technical services provided by the other government authorities;<br>2.2 Revenues from fines and seized goods<br>2.3 Revenues from investments by local authorities<br>- Loan interest;<br>- Repayment of loan principal.<br>2.4 Revenues from transfer of government properties<br>2.5 Revenues from government funds | 1. Turnover or value-added tax on domestic manufacturing, trading and service businesses<br>2. Excise tax collected on domestic commercial manufacturing<br>3. Profit tax and minimum tax collected from domestic businesses<br>4. Dividends from enterprises with investment from the Government.<br>The revenue apportionment ratios shall be determined by the Government from time to time. In the event a locality is apportioned revenues in excess of the annual expenditure plan approved by the National Assembly, the Government shall set specific revenue norms for that locality. |

**Table 8: Revenue Assignment in Lao PDR on the Basis of the 2006 State Budget Law (continued)**

| Central Government<br>Revenues Apportioned in Full (100%) to the Central Budget | Local Level<br>Budget Revenues Apportioned in Full (100%) to the Local Level | Shared Revenues<br>Revenues Apportioned between the Central and Local Levels |
|---|---|---|
| 2.5 Revenues from government funds<br>- Poverty Reduction Fund;<br>- Environment Protection Fund;<br>- Road Maintenance Fund;<br>- Forests and Forest Resources Development Fund;<br>- Social Insurance Fund;<br>- Other government funds.<br>2.6 Revenues from fund raising and contributions by individuals, juristic entities and organizations<br>2.7 Revenues from foreign assistance grants<br>- Bilateral assistance grants;<br>- Multilateral assistance grants.<br>2.8 Other revenues indicated in laws and regulations. | 2.6 Revenues from fund raising and contributions by individuals, juristic entities and organizations<br>2.7 Revenues from foreign assistance grants<br>- Grants from foreign countries;<br>- Grants from international organizations.<br>2.8 Other revenues set by laws and regulations | |

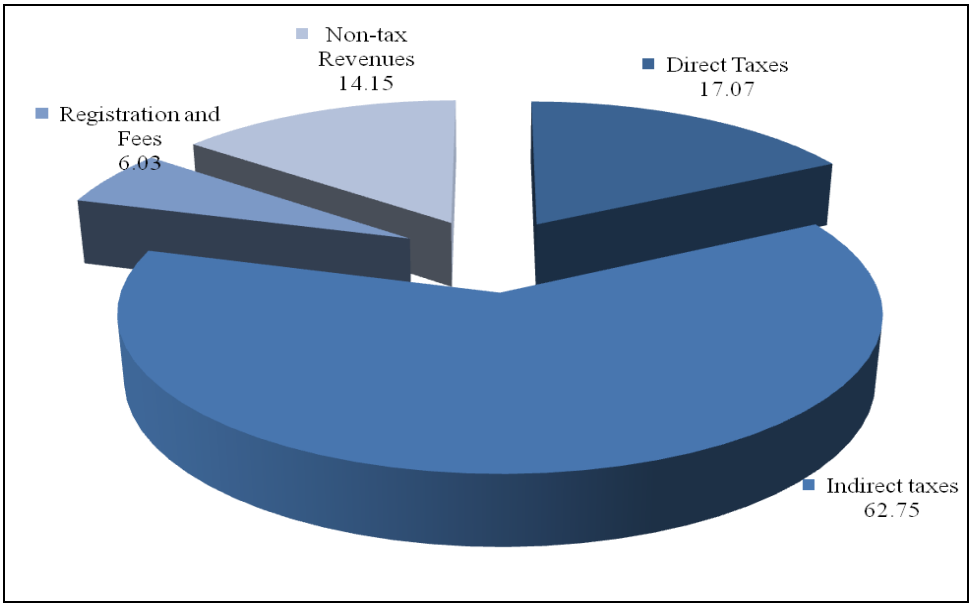
*Source:* State Budget Law, 2006

**Table 9: Lao PDR Provincial Government Revenues, FY 2006/2007 (million kip)**

| | Mean | Minimum | Maximum |
|---|---|---|---|
| Total Revenue | 177,993 | 15,237 | 1,040,450 |
| Revenue from customs and taxes | 162,845 | 13,206 | 1,017,207 |
| Direct Taxes | 22,604 | 3,456 | 101,425 |
| Profit Tax | 9,647 | 1,285 | 45,116 |
| Income Tax | 10,000 | 978 | 43,588 |
| Land Tax | 2,160 | 265 | 8,026 |
| Business Licensing | 82 | 9 | 464 |
| Minimum tax | 875 | 0 | 7,989 |
| Indirect taxes | 129,389 | 8,591 | 809,443 |
| Turnover tax | 45,080 | 4,209 | 296,743 |
| Excise tax | 33,611 | 367 | 310,183 |
| Import Duties | 33,683 | 240 | 182,927 |
| Other taxes and duties[1] | 17,015 | 211 | 210,813 |
| Registration and Fees | 10,852 | 719 | 106,339 |
| Registration and Fees | 1,286 | 59 | 11,532 |
| Fees | 3,204 | 84 | 18,569 |
| Tax stamp | 126 | 11 | 590 |
| Communication fees | 1,005 | 16 | 13,445 |
| Visa fees | 7,259 | 33 | 48,821 |
| Other fees | 2,718 | 4 | 13,381 |
| Non-tax Revenues | 15,148 | 1,919 | 51,936 |

*Note:* [1] Mainly Natural Resource Duties.
*Source:* Official Gazette, Lao PDR, 2006/07

**Figure 21: Lao PDR Provincial Government Revenue, FY 2006/2007 (% GDP of total)**




*Source:* Official Gazette, Lao PDR, 2006/07

## MAIN POLICY ISSUES IN REVENUE ASSIGNMENTS

4.44 The lack of any meaningful degree of revenue autonomy (in the sense of being able to increase revenues at the margin by changing tax rates) by local governments. The issue of tax autonomy is a difficult one for many governments, especially those in unitary political systems and in particular, in Lao PDR where historically excessive autonomy of the wrong kind not in the very distant past. In looking ahead, however at how to improve the decentralization system in the medium term and in trying to inject the system with a degree of horizontal accountability, the issue of local revenue autonomy is an important one.

4.45 The benefits of fiscal decentralization in terms of greater expenditure efficiency can arise only if local governments become accountable and are able to respond to the needs and preferences of citizens or taxpayers. The most effective way to provide budgetary accountability and responsiveness is by granting local governments a meaningful degree of tax autonomy. Through local tax autonomy taxpayers become more aware of the costs of services and local officials' actions are subject to closer scrutiny by taxpayers. Not all forms of tax autonomy are desirable. For example, it may be counterproductive for the development of the market economy to allow sub-national governments to introduce their own taxes or be able to modify the structure of existing taxes. The former can lead to highly inefficient or distortionary choices of taxation and the latter may increase compliance and administration costs and make domestic commerce more difficult.

4.46 The simplest and best form of revenue autonomy would be in the future to let local governments select tax rates for at least one significant source of revenue, probably between minimum and maximum rates established by the National Assembly. For example, this could be done for the land tax or even for the personal income tax. The exercise of some degree of tax autonomy at the local level has some other benefits besides promoting accountability and efficiency. In particular, providing a meaningful degree of tax autonomy at the local level is the simplest and most effective way to address the issue of vertical imbalances (the mismatch between expenditure responsibilities and funding made available to different levels of government, an issue that is

discussed in the next section). It is important to note that greater tax autonomy at the local level may also generate other unexpected problems, such as an increase in horizontal disparities among local governments. But there are tools, for example, equalization transfers, that can be employed to deal adequately with these issues. (These issues are also discussed in the next section.)

4.47 Another issue in revenue assignments relates to change in approach that the 2006 State Budget Law brought about. By eliminating explicit revenue assignments at the district level it has moved the intergovernmental finance system toward less transparent and predictable arrangements. Even though this approach may provide provincial governments with greater budget flexibility and the ability to adapt to the particular circumstances in the province, including higher levels of equalization across districts, clearly, the lack of concrete revenue assignments also imposes costs on local governments. Under these circumstances, one should expect that accountability to local residents will be lower and local officials will be subject to less revenue certainty and predictability, which makes budgeting and planning over time much less efficient. As well, the lack of explicit revenue assignments may lead to unfair outcomes and abuses with smaller poorer jurisdictions being marginalized and ignored. The lack of concrete assignments at the district levels would serve as incentives for revenue mobilization and for increased tax collections; the practical lack of clear rules regarding revenue assignments in effect provides provincial administration the authority to claw back any increased revenues or even enhanced expenditure efficiency by district governments.

4.48 A third set of issues has to do with the mechanisms that can be used for tax sharing. The present plans are to introduce a formula driven revenue sharing mechanism perhaps the 2010/11 budget. This is a positive move as the alternative that has been used until now, fundamentally the derivation principle, carries significant problems. The derivation principle (splitting revenues between the central government and the sub-national jurisdiction where revenues are actually collected), introduces several distortions, which are particularly acute for the VAT and the enterprise or corporate profit tax.

4.49 In the case of the VAT, the general use of the derivation principle leads to an unfair distribution of resources since the VAT can be credited and debited in different and far-flung local jurisdictions. For example, even if an enterprise has production facilities (not independent units) in other jurisdictions, VAT is paid exclusively in the jurisdiction where the headquarters of the enterprise is located. Thus the jurisdictions which benefit are those more likely to hold enterprise headquarters (e.g., Vientiane) where it is more likely that the headquarters of enterprises will be located.

4.50 In the case of the corporate income tax (profit tax), the sharing of this tax with local governments is also complicated by how apportionment of the revenues is carried out in practice. Most commonly the effective sharing of the CIT by the central government with the provinces is by the place of registration or the headquarters of the enterprise. This can be a source of unfairness since enterprise activities, and consequently the consumption of local public services, many times take place in jurisdictions other than the one where the enterprise is registered. Thus, the use of the derivation principle, as opposed to a formula, to apportion the profit tax would again tend to benefit the wealthier jurisdictions. Although some remedies do exist and are practiced in a few countries, such as apportionment formulas based on the distribution of assets, sales and so on, the use of formulas based on objective characteristics is a superior preferred alternative.

4.51 The sharing of excise taxes may also lead to problems with unfair apportionment if these taxes are paid at origin by the factory rather than at destination where the concerned commodities are

purchased and consumed. Again, the use of a formula for the distribution of these tax revenues will also take care of this problem.

4.52 A last set of issues has to do with the use of fees and charges at the sub-national level. Local fees and charges are important from a revenue assignment viewpoint because in effect they provide local governments (or their implementation units) with some degree of revenue autonomy. Sub-national governments have discretion to set fees for water, sewerage, and solid waste disposal services. Often, fees and charges are insufficient to cover the cost of service delivery for basic services. In the overall context of revenue assignments, however, this source of revenue continues to be rather small outside the so called "technical revenues" or fees charged in the education and health sectors. There is little available information on the importance of technical revenues but it appears that it has been growing fast in recent years. In the case of education, parents now contribute to the costs of schooling by paying a school fee which increases with several options. Fees and charges are also common in health services.

4.53 The judicious use of charges and fees can increase efficiency and reduce waste in government operations. There is, however, also a downside to this policy, especially for social services when user charges are not based on ability to pay. The otherwise desirable use of user charges requires that government policies pay more attention to service coverage of the poor, in particular what implications this may have for access by the poor to basic services in education and health.

## IV. THE SYSTEM OF TRANSFERS

4.54 A system of transfers is needed in any system of intergovernmental fiscal relations to address the presence of a vertical imbalance as well as horizontal imbalances. A vertical imbalance usually is present because revenue resources and expenditure obligations of the different tiers of government may not match in an aggregate sense. Typically, central governments tend to have revenue resources that exceed their expenditure obligations while in the aggregate the reverse is true for local governments, with expenditure obligations exceeding their own revenue resources. This vertical gap is typically addressed through a system of transfers, including revenue sharing, from the central government to local governments.

4.55 Horizontal imbalances can also be present because among local governments there can be fiscal disparities concerning differences in expenditure needs and fiscal capacity. In general, governments with relatively low levels of economic activity can collect less in own taxes. These same governments may have relatively larger expenditure needs because of higher costs of delivering services (for example, because of mountainous terrain or relatively younger or older populations).

4.56 This section examines the evidence concerning the existence of vertical and horizontal disparities in Lao PDR using the most recent available data for 2006/07, then describes the current system of transfers, and concludes with a discussion of the policy challenges in this area of the intergovernmental relations system.

## THE EXTENT OF VERTICAL AND HORIZONTAL FISCAL DISPARITIES IN LAO

### *Vertical Imbalances*

4.57 Vertical fiscal balance exists when there is a broad correspondence between the expenditure responsibilities assigned to each level of government and the fiscal resources available to them to carry out those responsibilities. Even though it is always hard to attain vertical balance, the most effective solution is to provide some degree of tax autonomy or discretion to each level of government. A typical representation of the two sides of the budget is given in Box 1. The most common source of vertical imbalance is a lack of own revenue sources at the local level.

| **Box 4: Vertical Fiscal Balance** | |
|---|---|
| Revenue Capacity = Expenditure Needs | |
| **Regional Revenue Sources**<br>[1] Own taxes and other revenue sources<br>[2] Shared tax revenues<br>[3] Intergovernmental transfers<br>a. Equalization grants<br>b. Other recurrent transfers<br>c. Capital transfers | **Expenditure Responsibilities**<br>[4] Own expenditures (responsibilities)<br>[5] Delegated expenditure responsibilities |

4.58 Conventionally, the vertical fiscal imbalance is measured in two different ways. The first approach is to look at the surplus or deficit position of each consolidated level of government, before borrowing but after all revenue sharing and transfers has been implemented. One might conclude that the level of government that runs relatively the largest deficit, does not have its expenditure needs met appropriately. Although this measure has the benefit of being easily understood, there are a number of problems with this approach (local governments generally are not allowed to run current deficits, presence of waste or inefficiencies, etc.).

4.59 A second way to measure vertical fiscal imbalance is to examine the share of local government expenditures financed with sources of revenues under the control of local governments. By construction the coefficient of vertical imbalance takes values between zero and one, with values closer to zero indicating a larger vertical fiscal imbalance. There are, however, disagreements on how exactly to define those resources under the control of local governments. In a strict sense "sources of revenues under the control of local governments" are taxes for which the local government has authority to change tax rates or tax bases. In a looser sense, the definition could include 100 percent assigned taxes and all other unconditional sources including revenue sharing and other unconditional grants, such as equalization grants, as long as besides being unconditional those sources are stable over time.

4.60 In the case of Lao PDR the required information to compute the different measures of vertical balance is not available, though the most recent budget data available at the provincial level for 2006/07 provides some approximate answers, noting, however that the data for 2006-07 may not be reflective of the budgeting and funding changes that have followed after the new 2006 Budget Law.

4.61 To get a better understanding of this issue, the PER examined the share of local government expenditures financed with sources of revenues under the control of local governments. Under the strict definition of own source revenue, it would seem that there is a very significant vertical

imbalance in Lao PDR. This is so because local governments do not have any discretion or control over tax rates or any other aspects of the taxes assigned to them. If own source revenue is defined more widely to include all sources of unconditional funding, this gives a very different answer of vertical balance for local governments. The same answer of sufficient vertical balance for local governments in the aggregate is reached by using the first definition based on the budget deficit. As shown in Table 10, total revenues aggregated at the provincial level in 2006-07 were 3,025 thousand million kip while total expenditures aggregated at the provincial level were 2,462 thousand million kip. This puts the aggregate budget balance for local governments in a surplus of over 500 thousand million kip.

4.62 If the balance between revenues and expenditures is examined by province, the story is different again. There are seven provinces with larger revenues than expenditures in fiscal year 2006-07, a couple of provinces roughly in balance and all the rest with expenditures exceeding revenues. It is interesting to note that only two provinces, Savannakhet and Vientiane Capital, represent over 55 percent of all provincial revenues (Table 11). By comparison, on the expenditure side those two provinces represent about 22 percent of all provincial expenditures. Many of the provinces, especially small ones in budget revenue terms, end up representing a higher share of expenditures; for example Oudomxay province represents only 1 percent of all aggregate provincial revenues but 9 percent of all aggregate provincial expenditures. This means that besides experiencing vertical balance in the aggregate sense, there is also a great deal of redistribution across local governments. But, is this redistribution across provinces enough to significantly reduce horizontal disparities? The PER looks next at the issue of horizontal imbalances in the Lao PDR budgetary system.

**Table 10: Lao PDR, Total Provincial Revenues and Non-Interest Expenditures (million Kip)**

| | Revenues FY 2006/07 Share % | Expenditures FY 2006/07 Share % |
|---|---|---|
| *Total* | *3,025,877* | *2,462,618* |
| Attapu | 42,584 | 78,751 |
| Bokeo | 54,683 | 108,903 |
| Borikhamxay | 172,383 | 102,205 |
| Champasak | 258,703 | 187,685 |
| Houaphan | 32,947 | 130,791 |
| Khammouan | 171,718 | 126,371 |
| Luangnamtha | 79,092 | 123,881 |
| Luangprabang | 65,152 | 153,560 |
| Oudomxay | 32,637 | 223,799 |
| Phongsaly | 15,237 | 63,322 |
| Saravan | 60,129 | 84,509 |
| Savannakhet | 692,401 | 210,995 |
| Sayabouly | 75,032 | 152,288 |
| Sekong | 19,222 | 74,685 |
| Viengchan | 157,176 | 161,713 |
| Vientiane Capital | 1,040,450 | 332,022 |
| Xeingkhouang | 56,329 | 147,140 |

**Table 11: Lao PDR, Total Provincial Revenues and Non-Interest Expenditures (% of total)**

| | Revenues FY 2006/07 | Expenditures FY 2006/07 |
|---|---|---|
| *Total* | *100.00* | *100.00* |
| Attapu | 1.41 | 3.20 |
| Bokeo | 1.81 | 4.42 |
| Borikhamxay | 5.70 | 4.15 |
| Champasak | 8.55 | 7.62 |
| Houaphan | 1.09 | 5.31 |
| Khammouan | 5.67 | 5.13 |
| Luangnamtha | 2.61 | 5.03 |
| Luangprabang | 2.15 | 6.24 |
| Oudomxay | 1.08 | 9.09 |
| Phongsaly | 0.50 | 2.57 |
| Saravan | 1.99 | 3.43 |
| Savannakhet | 22.88 | 8.57 |
| Sayabouly | 2.48 | 6.18 |
| Sekong | 0.64 | 3.03 |
| Viengchan | 5.19 | 6.57 |
| Vientiane Capital | 34.39 | 13.48 |
| Xeingkhouang | 1.86 | 5.97 |

### *Horizontal Imbalances*

4.63 The assignments of revenue sources and expenditure responsibilities in force in 2006-07 produced significant horizontal imbalances across the provinces. Table 14 shows per capita revenues and per capita expenditures by province for that fiscal year. On the revenue side there is much wider variation than on the expenditure side. This is again an indication of a significant degree of equalization performed through the budgetary process that year.

4.64 On the revenue side, the average (across provinces) per capita revenues were 417,870 kip but with a wide range in values, from a minimum of 91,820 kip per capita in Phongsaly province to a maximum of 1,489,940 kip per capita in Vientiane capital, a multiple of over 16. It is also evident that indirect taxes experience generally wider differences than direct taxes, as measured by the coefficient of variation.

4.65 On the expenditure side, the average (across provinces) per capita expenditures were 522,750 kip, with a range in values from a minimum of 255, 470 kip per capita in Savannakhet province to a maximum of 878,700 kip per capita in Sekong province. This is a multiple of 3.4, which is still high by international standards but much smaller in comparison to the 16 fold difference across the range of per capita revenues.

4.66 Capital expenditures show higher variation than recurrent expenditure items. In the case of capital expenditures, the difference between the maximum and minimum provincial per capita values is 8 fold; for salaries that difference is less than 3 fold. Even though these figures need to be interpreted with caution, analysis reveals quite significant differences across provinces in the levels

of expenditure per capita in some fundamental services. For example, for education the difference between the maximum and minimum values is over 15 fold. Of course, these differences may reflect special circumstances and spending programs, but nevertheless are disturbingly high.

4.67 Thus all the information above taken together tells a story of very large disparities in revenue resources across provinces. After the budget system gets implemented which includes the positive transfers to the relatively poorer provinces and negative transfers from the richer provinces, the fiscal disparities as measured in expenditures per capita decrease quite significantly but they still remain relative high, especially for specific types of expenditures, such as education expenditures per capita. Therefore, even though the budget system, as implemented in 2006-07, is equalizing, it does not appear to be equalizing enough. There is no easy benchmark for how unequal the fiscal system remains at the provincial level because we lack, for example, a measure of per capita income by province. Nevertheless, at the aggregate provincial level per capita income is likely to be highly negatively correlated with the measure of "poverty headcount. The different elements of statistical evidence discussed above indicate that there is room in the intergovernmental system of finance for stronger, more effective equalization mechanisms.

**Table 12: Lao PDR, Total Provincial Per Capita Revenue and Non-Interest Expenditures (000 kip)**

| | Revenues FY 2006/07 | Expenditures FY 2006/07 |
|---|---|---|
| *Total* | *538.22* | *438.03* |
| Attapu | 379.80 | 702.38 |
| Bokeo | 376.44 | 749.69 |
| Borikhamxay | 765.12 | 453.64 |
| Champasak | 425.94 | 309.01 |
| Houaphan | 117.27 | 465.55 |
| Khammouan | 508.96 | 374.55 |
| Luangnamtha | 544.30 | 852.53 |
| Luangprabang | 160.06 | 377.26 |
| Oudomxay | 123.08 | 843.96 |
| Phongsaly | 91.82 | 381.58 |
| Saravan | 185.40 | 260.57 |
| Savannakhet | 838.36 | 255.47 |
| Sayabouly | 221.55 | 449.67 |
| Sekong | 226.16 | 878.70 |
| Viengchan | 404.16 | 415.83 |
| Vientiane Capital | 1489.94 | 475.46 |
| Xeingkhouang | 245.34 | 640.86 |

**Table 13: Lao PDR Per Capita Provincial Government Non-Interest Expenditures, Economic Classification, FY 2006/07 (000 kip)**

| | Mean | Minimum | Maximum | Coefficient of Variation |
|---|---|---|---|---|
| Total Expenditure | 522.75 | 255.47 | 878.70 | 0.40 |
| Salaries | 169.42 | 89.92 | 255.51 | 0.27 |
| Compensations and Allowance | 50.24 | 24.45 | 89.55 | 0.37 |
| Operation costs | 34.79 | 20.03 | 64.72 | 0.34 |
| Subsidies and contributions | 16.15 | 9.71 | 31.77 | 0.41 |
| Other unforeseeable expenditure | 2.67 | 1.27 | 4.88 | 0.34 |
| New purchasing for operation | 2.12 | 0.91 | 3.65 | 0.40 |
| Capital Expenditure | 247.35 | 75.02 | 607.10 | 0.66 |

*Source:* Official Gazette, Lao PDR, 2006/07; City Population (data on population for 2005)

**Table 14: Lao PDR Per Capita Provincial Government Non-Interest Expenditures, Functional Classification, FY 2006/07 (000 kip)**

| | Mean | Minimum | Maximum | Coefficient of Variation |
|---|---|---|---|---|
| Total Expenditure | 522.75 | 255.47 | 878.70 | 0.40 |
| Justice | 1.72 | 0.87 | 4.05 | 0.47 |
| Planning | 4.03 | 1.43 | 15.64 | 0.95 |
| Finance | 15.43 | 5.74 | 33.03 | 0.41 |
| Agriculture and Forest | 35.90 | 8.03 | 83.86 | 0.62 |
| Construction, Transport, Post, and Communication | 110.36 | 11.56 | 383.14 | 0.97 |
| Energy | 21.15 | 0.00 | 287.19 | 3.25 |
| Industry and Commerce | 3.53 | 1.04 | 15.83 | 0.96 |
| Information and Culture | 4.81 | 1.78 | 14.10 | 0.59 |
| Labor and Social Welfare | 19.65 | 2.71 | 52.44 | 0.60 |
| Education | 95.52 | 17.86 | 281.22 | 0.59 |
| Health | 33.04 | 9.74 | 57.81 | 0.44 |
| Administration | 177.63 | 71.54 | 343.24 | 0.46 |

*Source:* Official Gazette, Lao PDR, 2006/07; City Population (data on population for 2005)

## THE CURRENT SYSTEM OF TRANSFERS IN LAO

4.68 Lao PDR does not have a well developed system of transfers. The 2006 State Budget Law identifies (Articles 43 and 44) two types of transfers: those for general support and those for targeted support.

4.69 The general support transfers, which in the conventional terminology can be associated with unconditional grants, are provided "to balance local budgets." This transfer is the traditional negotiated gap filling budget transfer based on the Soviet era budgeting system, which is sometimes referred to as "regulating" transfers.[55] Although this general support transfer has an equalization goal, the transfer lacks transparency and objectivity; recipient local governments do not know how much they qualify for, because for example they cannot look at a formula but instead they must negotiate the amount of the transfers with the central authorities and rely on their bargaining abilities to achieve a good outcome.[56]

4.70 The targeted support transfers are intended to facilitate the implementation of specific central government policies, including recurrent and capital expenditure programs. They are also implemented to deal with natural disasters and other emergencies. In the conventional intergovernmental finance typology these would be known as conditional grants. There is little information available on how important these grants are in practice. The information available is that conditional grants implemented by line ministries and other central agencies are small or non-existent.

## POLICY ISSUES

4.71 Significant policy issues need to be addressed to advance the system of transfers in Lao PDR. Having a better understanding of fiscal imbalances, both vertical and horizontal, at the local government level in Lao will be instrumental for the adequate re-design of the transfer system. Therefore it will be important to replicate and expand the above analysis with the most recent data possible.

4.72 In terms of vertical imbalance in the aggregate between the central and local governments, the current system has performed adequately because of the ability of central authorities to reset the level of funding for local governments through negotiations and (at least conceptually) the use of negative transfers from richer provinces to the central budget. In moving from a discretionary and opaque system of intergovernmental allocation of funds toward a more transparent and rule-based system, central authorities will lose in the future some of the (undesirable) degrees of freedom such as individualized bilateral negotiations and with that some of the flexibility to reach budget targets.

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[55] This also means that provinces in a surplus budget position need to transfer a share of their resources to the central government. In terms of transfer of funds from provinces to central government, Vientiane Capital, Champassak and Savannakhet are the major providers.

[56] Expenditure ceiling and revenue targets are defined at the central level based on the relative needs and wealth of the provinces. The difference between revenue collection and expenditure cap is expected to be transferred to the central government. In case the provincial government's revenue collection exceeds the expenditure target but does not meet the revenue target, they are instructed to reduce expenditure and maintain the same transfer level to central government. The incentive provided by the central government to achieve this goal is that provinces are given the opportunity to retain some percent of any excess of the revenue target set ex-ante by the central government. In the new 2006 Budget Law, local governments are allowed to retain all the collection over the target in the case of 100 percent assigned local taxes and a share of all other taxes (central and shared taxes).

So it will be important that more systematic and careful budget preparation precedes allocation of funds. As discussed above, the plans of the central authorities for the immediate future will be to address the question of vertical balance through: (i) the assignment of tax revenues as in the 2006 State Budget Law; (ii) the fine tuning of the index formula for shared revenues so that the most well-off local governments would have sufficient financing with own 100 percent tax revenues and shared revenues; and (iii) the introduction of an unconditional equalization transfer for the worse-off local governments (see below). These three measures plus an increased use of conditional grants (also below) should produce an adequate vertical balance between the central and local governments. Within such framework there will no longer be a need for negative transfers from the better-off local governments to the central budget, as also discussed below. However, it should be possible now, to define within the context of a new equalization grant system a "fraternal arrangement" whereby the relatively richer local governments contribute some funds according to explicit objective rules to the equalization fund to distribute to the relatively poorer local governments. In such a new system, bilateral bargaining and negotiations between the Ministry of Finance and local governments would vanish.

4.73 In terms of horizontal disparities among local governments, the current approach has failed to eliminate what appear to be very large disparities in expenditures per capita among local governments. The current negotiated system significantly reduces potential disparities but in actuality still leaves large gaps in the access and availability of local public services across local governments, as listed above. There are many reasons why this may be the case, such as different bargaining capacity of smaller and poorer local governments. Whatever the reason, however, substantial policy action would seem to be required in this area. The current plans are to develop a formula-driven transparent and objective equalization grant system based on the fiscal gap between expenditure needs and potential revenues to improve the position of the relatively worse-off local governments. Carrying forward those plans would go a long way to address horizontal fiscal disparities in Lao PDR in a way that would parallel the approach used in many other countries, including the neighboring country of Vietnam. How to approach the design of a modern equalization grant is addressed in the recommendations section below and also extensively in several notes in the appendix.

4.74 Finally, in order to introduce a comprehensive modern system of transfers, Lao PDR still will need to strengthen and in many cases introduce a new a system of conditional transfers. Beyond being able to address natural disasters and other exceptional circumstances, the central government can use the conditional grants through line ministries and other agencies to pursue national priorities such as education and health outcomes, or to address spillovers or externalities across subnational boundaries. The success or failure of particular central government programs will hinge many times on how effectively the central authorities may be able to engage local governments in supporting those policy actions. The most effective way other central governments around the world have found is to transfer earmarked resources for those activities through the conditional grants. Using matching arrangements for the transfers of the funds (the central government contributes x percent if local governments contribute (1-x) percent) can increase the leveraging and effectiveness of the transferred funds since local governments are given a specific incentive to contribute their own funds to the particular program. Given that the State Budget Law (Article 43) prohibits any kind of borrowing by local governments, conditional capital grants take on a particular importance in the

current system of intergovernmental finance arrangements in Lao PDR.[57] This should involve the restructuring of MPI's implementation of the capital budget which could be interpreted or easily converted to conditional grants

## V. CONCLUSIONS AND RECOMMENDATIONS

4.75 The current system of intergovernmental fiscal arrangements in Lao PDR can best be characterized as a deconcentration model (as opposed to a decentralization one), because local governments are only accountable to the central government authorities. This situation is accentuated by appointment of local officials. In contrast to other countries where local officials are elected, in Lao PDR local officials are appointed which accentuates the situation. In practice, the fiscal relations among the different tiers at the sub-national level have become in some ways less transparent and objective, at least on paper, with the passage of the State Budget Law of 2006, because all sub-national tiers of government (provinces, districts and villages) are addressed as a whole instead of individually. In practice, provincial and city governments are assigned funds to support district budgets, while in turn districts are assigned similar functions to support the villages. But little is known about the actual processes and the outcomes that follow below the provincial level since all the reporting, at least the data which was provided for this report are aggregated at the provincial level.

4.76 The approval of the State Budget Law (2006) and its Implementation Decree (2008) are, however, also positive steps because they will enable the transition in Lao PDR toward more rule-based intergovernmental fiscal arrangements, at least between the center and the provincial governments. It is also very positive that some critical steps have been taken in strengthening central government institutions by re-centralizing the Treasury function and the Customs and Tax Administration. These reforms will be instrumental in moving forward with a modern approach to intergovernmental fiscal arrangements. The mandated minimum spending levels for the provinces in education and health approved by the National Assembly for 2008/09 also represents a positive step in aligning national policies and priorities with local government budgeting practices.

4.77 At the present time, the fundamental pillars of the intergovernmental finance system (expenditure assignments, revenue assignments, and transfers) in Lao PDR are unequally developed.

4.78 The weak link in the current system of intergovernmental finance is the lack of clarity in the formal or statutory expenditure assignments. In this sense the 2006 State Budget Law would need to be amended after a careful exercise in analyzing what the actual expenditure assignments—in a functional sense-- are in practice and how they should be modified. The principles and practical guidance for the reform in expenditure assignments are explained in the methodological appendix of this report. Although clarifying expenditure assignments and putting them into law is both a difficult and time-consuming exercise, the fact is that there is already a good practice in Lao PDR on how to do this as documented by the 2002 Ministry of Education Instruction on expenditure assignments for that sector. It therefore follows that such work should commence with the education sector with an established time table to expand the work to other sectors that are significant in local budgets, such as health, agriculture, transport and communications, and so on.

[57] In the medium term allowing local borrowing under strict rules and supervision of the Ministry of Finance should be considered. But given the many other priority issues that will need to be addressed in intergovernmental fiscal arrangements, the issue of local borrowing is not further addressed in this report.

4.79 It is also positive that there is a clear vision within the central government about the need to quantify expenditure needs by using some form of per capita or per client expenditure norms. The idea should be to use these budget norms for the notional definition of local budgets and quantification of expenditure needs in the equalization transfers as opposed to using them as compulsory mandates for budget execution by local governments. The definition of budget norms is also an involved demanding exercise,[58] which in fact faces numerous serious obstacles, including the lack of a clear assignment of expenditure responsibilities, the lack of operational functional budget classification, and incomplete budget coverage of ODA and "technical revenues." The work has begun within the Ministry of Finance of defining per client expenditure norms with the plans being coverage first of the education and health sectors. Such programmed sequenced approach starting just with a few sectors in the definition of budget norms is desirable given the existing obstacles that the central authorities will need to overcome. A decision will need to be made on the scope of the sectoral budget norms as to whether they will apply to all current expenditures or just to non-wage current expenditures. For many reasons discussed in this report it is essential that the norms cover all current expenditures including wages and salaries. Otherwise there is a significant risk that adoption of using will accomplish including the scope of equalization according to expenditure needs. Because readjusting the levels of public sector employment across jurisdictions can be demanding and disruptive, there should be a phasing-in period of some years to allow for the necessary changes in staffing.

4.80 The status of revenue assignments as reformed in the 2006 State Budget Law is in most reports an improvement over what existed previously. The Budget Law clearly identifies taxes whose revenues are assigned 100 percent to the center, those taxes whose revenues are assigned 100 percent to the local governments, and those taxes whose revenues are to be shared between the central and local governments as determined by the central authorities. While this is definitely a good start, future reforms of tax assignments will need to consider how to introduce some degree of autonomy to set the rates of some local taxes, for example the land tax, and to introduce distinct explicit revenue assignments for the provinces and the districts. The issues to consider in the reform of revenue assignments in the medium term are discussed in the methodological appendix to this report.

4.81 Another issue concerning revenue assignments which needs to be addressed is that of income certainty and stability in the way shared tax revenues are to be split between the central and local governments. In this area the Ministry of Finance is planning for the introduction (tentatively in FY 2010/11) of a revenue sharing formula based on three criteria: population, poverty, and land area. Additionally, although the pool of shared revenues to distribute to local governments would remain at the discretion of the center, the plans are to calibrate the percentage put into the pool for distribution based on two principles: (i) the pool of funds will be set so that the most well-off provinces will have "sufficient" financing to cover their expenditure needs in conjunction with their own (100 percent assigned) revenues and fees and charges; (ii) a 'hold harmless' clause will ensure that no province will experience a reduction in their funding. These plans would go a long way to introduce more transparency, certainty, and stability in the process of revenue sharing. At a later date, it would be desirable to fix the percentage of funds to be allocated for revenue sharing in order to increase budgetary certainty and transparency at the local level. But clearly, the measure will help

[58] The technical appendix in this report reviews the different methodologies available for defining expenditure norms, and in particular per client based norms. Practical steps for their calculation are also discussed in the technical appendix in the methodological discussion of equalization grants.

move Lao PDR from the present ad hoc negotiated budgeting system to a more transparent and rule-based system.

4.82 The status of the system of transfers is again much less evolved. The current practice is to use the old form of budget gap filling grants negotiated in an ad hoc manner. Explicit formula-based equalization grants are non-existent and conditional grants are incipient or non-existent. The 2006 Budget Law, however, does provide for the introduction of modern equalization unconditional grants and also conditional grants, even though these are not the precise terms used in the law.

4.83 The Ministry of Finance is at a conceptual stage considering the introduction of an equalization formula-driven grant for those relatively poor provinces which would have resources to cover their expenditure needs through their own revenues and shared revenues. The plans are that the equalization formula will use measures of expenditure needs based on the development of a system of expenditure norms, as discussed above. The conceptual design and discussion of what measures of revenue capacity would be used in the formula are less advanced. There has not been much discussion either on the determination of the pool of funds for distribution of the equalization grants, but one clear possibility would be to use some of the funds from the shared taxes revenue pool.

4.84 There is little question that the Lao PDR intergovernmental system of fiscal relations is very much in need of a modern equalization grant system and that the conceptual design that is emerging on this issue is on the right track. The methodological appendix to this report discusses at length the different approaches that can be taken in the design of the new equalization transfers, including the quantification of expenditure needs and revenue capacity.

4.85 The methodological appendix also discusses the nature and different uses of conditional grants. As previously noted above, some of MPI's implementation of the capital budget could be converted to the provision of capital grants.

4.86 All of the above provides a dense and ambition agenda for reform of Lao PDR systems of intergovernmental fiscal relations. It will be important to clearly articulate a road map describing the sequencing and content of the reform process so that there is continuity and clear vision of the task in the years ahead. As has been observed over these past years, an agenda for decentralization reform takes a long time to implement. It is also understood that full decentralization has a political dimension, in the sense that sustained accountability requires the creation of elected councils to oversee provincial and district governments. In the meantime, there is a need for an internal position paper at the Ministry of Finance which sets a strategy and benchmarks to be met on the way forward, together with an implementation plan containing a sequence of steps that need to be taken so they are consistent with the overall medium term reform strategy. That roadmap should include:

- In the short term, re-issue the Ministry of Education Instruction on expenditure assignments in the education sector adding a clear statement for the assignment of "financing" responsibilities

- In the short term, replicate this Instruction for the health sector in the short run and for other sectors (agriculture, transport, etc.) in the medium term in combination with the sectoral strategies in each area of functional assignment.

- In the medium term make sure that expenditure assignments extend to the district level.

- In the short term start with the quantification of per client bottom-down expenditure norms for the education and health sectors and later on expand to others (agriculture, transport, water). As explained in the appendix, an "all other expenditures" per capita category can be used for those sectors for which expenditure norms are yet to be defined. Keep the computation of expenditures norms simple: for example, "kip per student in primary education" perhaps adjusted for geographical cost differences.

- In the medium term, as horizontal accountability mechanisms are developed, reform revenue assignments to introduce autonomy to set certain rates (e.g., land taxes). Also in the medium term (as part of tax modernization) review tax assignments for vehicle taxes, business license fees, etc. and clarify tax revenues to be assigned exclusively (100 percent) to districts and not only provinces .

- The choice of a formula based on population, poverty index, and land area is more desirable than using the derivation principle for the allocation of shared revenues. This approach should be fully developed in the short term. To bring more certainty for budget formulation at the local level, the percentage for determining the pool of funds should be kept stable for several years. In the medium term, a revenue sharing formula should also be introduced by provinces for sharing revenues with the districts.

- In the short term design an equalization grant for worse off provinces based on the difference between their expenditure needs and their revenue capacity, where revenue capacity should include own (100 percent) revenues and revenue sharing. Plan for the determination of a pool of funds for equalization purposes that is stable and large enough to significantly close the fiscal gap. In the medium term implement the equalization grant for the provinces and extend the approach of using formula-driven equalization grants between the provinces and districts.

- In the medium term introduce sectoral conditional grants to be administered by line ministries (education, health, etc.) for pursuing central government program objectives after sectoral strategies are developed for the most important areas of public expenditures. In the medium term also introduce a system of formula driven conditional capital grants. Keep the conditional grant system simple with a small number of conditional grants with clear objectives and in assessing the needs for public infrastructure, consider the important potential role to be played by sub-national borrowing under strict rules and central monitoring.

## STATISTICAL APPENDIX

**Table 15: Lao PDR: Government Expenditure, 2000/01-2008/09**

| | 2000/01 | 2001/02 | 2002/03 | 2003/04 | 2004/05 | 2005/06 | 2006/07 | 2007/08 | 2008/09 |
|---|---|---|---|---|---|---|---|---|---|
| *Sector expenditure as share of total expenditure* | | | | | | | | | |
| Agriculture | 16.6 | 11.4 | 11.5 | 6.9 | 5.8 | 6.9 | 4.5 | 4.8 | 3.3 |
| CTPC | 22.8 | 16.0 | 22.3 | 20.2 | 20.6 | 22.9 | 19.3 | 15.2 | 14.6 |
| Education | 7.4 | 10.7 | 9.9 | 11.0 | 11.6 | 15.1 | 14.5 | 13.8 | 14.3 |
| Health | 3.7 | 5.0 | 5.8 | 4.3 | 5.8 | 3.3 | 2.8 | 4.1 | 8.3 |
| *Recurrent % of total expenditure* | | | | | | | | | |
| Agriculture | 3.8 | 6.6 | 5.4 | 13.4 | 17.0 | 12.2 | 17.3 | 16.7 | 29.4 |
| CTPC | 2.3 | 2.8 | 1.8 | 2.4 | 2.3 | 2.2 | 2.0 | 2.9 | 5.2 |
| Education | 61.1 | 47.8 | 39.0 | 53.9 | 48.3 | 36.8 | 37.7 | 51.3 | 60.7 |
| Health | 36.4 | 33.5 | 20.4 | 36.4 | 24.9 | 42.5 | 49.1 | 51.4 | 31.1 |
| *Wage expenditure % of recurrent expenditure* | | | | | | | | | |
| Agriculture | 58.2 | 61.0 | 63.5 | 65.7 | 65.0 | 73.0 | 75.1 | 76.5 | 70.0 |
| CTPC | 23.7 | 36.8 | 37.1 | 41.7 | 42.7 | 40.0 | 50.8 | 54.1 | 45.3 |
| Education | 62.0 | 63.4 | 64.9 | 73.4 | 91.8 | 90.8 | 91.3 | 91.6 | 87.6 |
| Health | 59.1 | 65.2 | 69.1 | 75.3 | 81.0 | 81.3 | 82.8 | 79.7 | 78.1 |
| *Share of foreign funded in capital expenditure (in percentage)* | | | | | | | | | |
| Agriculture | 27.7 | 21.1 | 35.3 | 66.9 | 82.5 | 91.1 | 83.7 | 85.3 | 67.2 |
| CTPC | 82.7 | 56.9 | 68.4 | 67.4 | 85.9 | 89.4 | 86.3 | 81.0 | 75.2 |
| Education | 66.7 | 59.2 | 76.1 | 81.9 | 91.8 | 94.8 | 94.9 | 91.0 | 88.1 |
| Health | 78.7 | 75.2 | 88.3 | 91.5 | 95.5 | 90.6 | 86.9 | 86.0 | 95.0 |
| *Central % of total expenditure by sector* | | | | | | | | | |
| Agriculture | 13.5 | 14.5 | 16.7 | 35.6 | 34.3 | 32.4 | 50.6 | 50.5 | 45.9 |
| CTPC | 80.5 | 33.5 | 50.6 | 61.3 | 55.6 | 63.4 | 67.9 | 66.7 | 71.0 |
| Education | 41.8 | 37.7 | 44.0 | 38.0 | 49.1 | 58.8 | 60.0 | 52.1 | 36.1 |
| Health | 19.9 | 36.1 | 32.0 | 36.3 | 56.5 | 23.7 | 26.2 | 53.0 | 66.7 |

*Source: Official Gazettes, various issues.*

**Table 16: Budget Execution, 2000/01-2003/04**

| Lao PDR: Budget Execution, 2000/01-2003/04 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| (million kip) | | | | | | | | |
| FY | 2000/01 | | 2001/02 | | 2002/03 | | 2003/04 | |
| | Plan | Out-turn | Plan | Out-turn | Plan | Out-turn | Plan | Out-turn |
| **Total Expenditure (total)** | 3,540,990 | 3,547,760 | 4,035,000 | 3,598,755 | 4,700,002 | 4,409,574 | 5,619,966 | 4,172,319 |
| **Recurrent Exp. (total)** | 1,014,290 | 989,053 | 1,174,000 | 1,142,102 | 1,294,800 | 1,403,455 | 1,864,019 | 1,636,279 |
| Non-wage Recurrent Exp.(total) | 592,200 | 573,322 | 323,000 | 311,617 | 314,800 | 407,618 | 631,279 | 726,704 |
| **Capital Expenditure (total)** | 2,005,261 | 2,071,693 | 2,273,000 | 1,926,485 | 2,710,002 | 2,525,808 | 2,942,736 | 1,777,008 |
| Foreign Funded (total) | 1,200,001 | 1,200,001 | 1,256,000 | 931,428 | 1,650,001 | 1,499,456 | 2,158,910 | 1,169,322 |
| Domestic Funded (total) | 805,260 | 871,693 | 1,017,000 | 995,057 | 1,060,001 | 1,026,352 | 783,826 | 607,685 |
| **Exp. as a result of revised plan** | | | | | | | | |
| | | | | | | | | |
| **Central Level** | | | | | | | | |
| | | | | | | | | |
| **Total Expenditure (central)** | 2,250,747 | 2,170,805 | 2,276,435 | 1,867,013 | 2,814,422 | 2,438,140 | 3,784,175 | 2,619,056 |
| **Recurrent Exp. (central)** | 679,394 | 629,863 | 766,979 | 691,648 | 805,944 | 850,228 | 1,224,318 | 879,124 |
| Non-wage Recurrent Exp. (central) | 431,640 | 384,903 | 199,330 | 166,028 | 176,040 | 231,752 | 457,951 | 448,463 |
| **Capital Expenditure (central)** | 1,049,914 | 1,053,928 | 921,456 | 645,197 | 1,320,478 | 1,107,600 | 1,746,646 | 981,121 |
| Foreign Funded (central) | 838,152 | 838,152 | 685,906 | 477,862 | 988,949 | 898,691 | 1,398,920 | 727,334 |
| Domestic Funded (central) | 211,762 | 215,776 | 235,550 | 167,336 | 331,529 | 208,909 | 347,726 | 253,788 |
| **Exp. as a result of revised plan (central)** | | | | | | | | |
| | | | | | | | | |
| **Local Level** | | | | | | | | |
| | | | | | | | | |
| **Total Expenditure (local)** | 1,290,243 | 1,376,955 | 1,758,565 | 1,731,742 | 1,885,580 | 1,971,434 | 1,835,791 | 1,553,263 |
| **Recurrent Exp. (local)** | 334,896 | 359,190 | 407,021 | 450,454 | 488,856 | 553,227 | 639,701 | 757,156 |
| Non-wage Recurrent Exp. (local) | 160,560 | 188,419 | 123,670 | 145,589 | 138,760 | 175,866 | 173,328 | 278,241 |
| **Capital Expenditure (local)** | 955,347 | 1,017,765 | 1,351,544 | 1,281,287 | 1,389,524 | 1,418,208 | 1,196,090 | 795,886 |
| Foreign Funded (local) | 361,849 | 361,849 | 570,094 | 453,566 | 661,052 | 600,765 | 759,990 | 441,989 |
| Domestic Funded (local) | 593,498 | 655,917 | 781,450 | 827,721 | 728,472 | 817,443 | 436,100 | 353,898 |
| *Source: Official Gazette, various issues.* | | | | | | | | |

Table 17: Budget Execution, 2004/05-2006/07

| **Lao PDR: Budget Execution, 2004/05-2007/08** | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| (million kip) | | | | | | | | |
| FY | 2004/05 | | 2005/06 | | 2006/07 | | 2007/08 | |
| | Plan | Out-turn | Plan | Out-turn | Plan | Out-turn | Plan | Out-turn |
| **Total Expenditure (total)** | 6,006,999 | 5,619,256 | 7,006,133 | 6,943,863 | 7,913,000 | 8,099,757 | 8,884,000 | 9,721,277 |
| **Recurrent Exp. (total)** | 2,404,160 | 2,198,190 | 2,322,733 | 2,847,791 | 3,197,000 | 3,168,488 | 3,925,000 | 4,562,243 |
| Non-wage Recurrent Exp.(total) | 799,160 | 822,496 | 704,053 | 1,197,759 | 1,170,000 | 1,171,770 | 1,429,000 | 2,066,243 |
| **Capital Expenditure (total)** | 2,769,999 | 2,435,471 | 3,618,400 | 3,106,576 | 3,353,000 | 3,398,340 | 3,442,000 | 3,642,034 |
| Foreign Funded (total) | 2,226,999 | 1,967,402 | 3,225,000 | 2,703,945 | 2,836,000 | 2,846,456 | 2,754,000 | 2,959,135 |
| Domestic Funded (total) | 543,000 | 468,069 | 393,400 | 402,631 | 517,000 | 551,884 | 688,000 | 682,899 |
| **Exp. as a result of revised plan** | | | | | | 290,329 | | |
| | | | | | | | | |
| **Central Level** | | | | | | | | |
| | | | | | | | | |
| **Total Expenditure (central)** | 4,035,273 | 3,680,590 | 4,655,565 | 4,350,696 | 5,496,189 | 5,637,139 | 5,473,946 | 6,850,847 |
| **Recurrent Exp. (central)** | 1,485,504 | 1,227,896 | 1,205,405.6 | 2,469,585 | 1,899,110 | 1,828,696 | 1,521,085 | 2,679,313 |
| Non-wage Recurrent Exp. (central) | 613,660 | 631,205 | 474,902.0 | 1,721,052 | 909,230 | 903,792 | 695,367 | 1,725,612 |
| **Capital Expenditure (central)** | 1,716,929 | 1,467,100 | 2,385,160 | 1,881,111 | 2,234,079 | 2,275,514 | 2,435,861 | 2,654,534 |
| Foreign Funded (central) | 1,352,729 | 1,255,963 | 2,180,960 | 1,659,905 | 1,959,579 | 1,970,035 | 2,080,156 | 2,285,292 |
| Domestic Funded (central) | 364,200 | 211,138 | 204,200 | 221,206 | 274,500 | 305,478 | 355,705 | 369,241 |
| **Exp. as a result of revised plan (central)** | | | | | | 290,329 | | |
| | | | | | | | | |
| **Local Level** | | | | | | | | |
| | | | | | | | | |
| **Total Expenditure (local)** | 1,971,726 | 1,938,665 | 2,350,567 | 2,593,167 | 2,416,811 | 2,462,618 | 2,817,856 | 2,870,430 |
| **Recurrent Exp. (local)** | 918,656 | 970,294 | 1,117,327.0 | 1,367,701.7 | 1,297,890 | 1,339,792 | 1,830,158 | 1,882,930 |
| Non-wage Recurrent Exp. (local) | 185,500 | 191,290 | 229,151.0 | 466,203.2 | 260,770 | 267,978 | 333,432 | 340,631 |
| **Capital Expenditure (local)** | 1,053,070 | 968,370 | 1,233,240 | 1,225,465 | 1,118,921 | 1,122,826 | 987,698 | 987,500 |
| Foreign Funded (local) | 874,270 | 711,439 | 1,044,040 | 1,044,040 | 876,421 | 876,421 | 673,843 | 673,843 |
| Domestic Funded (local) | 178,800 | 256,931 | 189,200 | 181,425 | 242,500 | 246,405 | 313,855 | 313,658 |

*Source: Official Gazette, various issues.*

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