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LAO PDR

Public Expenditure Review Integrated Fiduciary Assessment

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EASPR



East Asia and Pacific Region



**The World Bank
International Monetary Fund
Asian Development Bank
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CURRENCY EQUIVALENTS

Currency unit = KIP
1 USD = 10,500 KIP

FISCAL YEAR

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WEIGHTS AND MEASURES

Metric System

ACRONYMS AND ABBREVIATIONS

ADB	Asian Development Bank
AFD	<i>Agence Française de Développement</i>
AFTA	ASEAN Free Trade Area
AIDS	Acquired Immune Deficiency Syndrome
ASEAN	Association of South-East Asian Nations
AusAID	Australian Government's Overseas Aid Program
BOL	Bank of Laos
BOT	Build, Operate, and Transfer
CFAA	Country Financial Accountability Assessment
COA	Chart of Accounts
COTS	Commercial-Off-The-Shelf
CPI	Committee for Planning and Investment
CPIA	Country Policy and Institutional Assessment
CTCP	Construction, Transport, Post, and Communication
DAFO	District Agriculture and Forestry Office
DCTCP	Department of Construction, Transport, Post, and Communication (provincial)
DDG	Deputy Director General
DFRC	Division of Forest Resources Conservation
DHUP	Department of Housing and Urban Planning
DOE	Department of Environment
DOR	Department of Roads
DPT	Diphtheria-Pertussis-Tetanus vaccine
EC	European Commission
EDL	Electricité du Laos
EFA	Education For All
EIA	Environmental Impact Assessment
EMIS	Education Management Information System
EMMU	Environment Management and Monitoring Unit
EPF	Environmental Protection Fund
ERI	Environment Research Institute
ERR	Economic rate of return
EU	European Union
FAOSTAT	Food and Agriculture Organization Statistical Database
FDI	Foreign Direct Investment
FM	Financial Management
FMCBC	Financial Management Capacity Building Credit
FPD	Fiscal Policy Department
FY	Fiscal Year
GDP	Gross Domestic Product
GER	Gross Enrollment Ratio
GEF	Global Environment Facility

GFIS	Government Financial Information System
GFMIS	Government Financial Management Information System
GFS	Government Finance Statistics
GLIP	Government of Lao Letter of Implementation Policy
GNI	Gross National Income
GNP	Gross National Product
GOL	Government of the Lao People's Democratic Republic
ha	Hectare
HH	Household
HIPC	Highly Indebted Poor Countries Initiative
HIV	Human Immunodeficiency Virus
H&P	Hygiene and Preventive
HSIP	Health System Improvement Project
ICT	Information and communication technologies
IDA	International Development Association
IFA	Integrated Fiduciary Assessment
IFC	International Financial Corporation
IFI	International finance institution
IFMIS	Integrated Financial Management Information System
IMF	International Monetary Fund
INTOSAI	International Organization of State Audit Institutions
IRI	International Roughness Index
JBIC	Japan Bank for International Cooperation
JICA	Japan International Cooperation Agency
Kip	Lao currency
Lao PDR	Lao People's Democratic Republic
LAK	Lao KIP
LECS III	Lao PDR Expenditure and Consumption Survey III
LEnS	Lao Environment and Social Project
LTU	Large Taxpayer Unit
MAF	Ministry of Agriculture and Forestry
MCTPC	Ministry of Construction, Transport, Post, and Communication
MDG	Millennium Development Goal
M&E	Monitoring and evaluation
MFA	Multi-Fiber Arrangement
MIH	Ministry of Industry and Handicrafts
MOD	Ministry of Defense
MOE	Ministry of Education
MOF	Ministry of Finance
MOFA	Ministry of Foreign Affairs
MOH	Ministry of Health
MTEF	Medium-term Expenditure Framework
MTFF	Medium-term Fiscal Framework
NA	National Assembly
NAFES	National Agriculture and Forestry Extension Service
NAFRI	National Agriculture and Forestry Research Institute
NGO	Non-governmental Organization
NGPES	National Growth and Poverty Eradication Strategy
NORAD	Norwegian Agency for Development Cooperation
NPA	National Protected Area
NSC	National Statistical Center
NPV	Net present value
NRM	Natural Resources Management
NSEDP	National Socioeconomic Development Plan
NT2	Nam Theun 2 Project
NT2RMA	Nam Theun 2 Revenue Management Arrangement
NTFP	No-Timber Forest Products
NTPC	Nam Theun 2 Power Company
NTSEP	Nam Theun 2 Social and Environmental Project
OCTCP	Office of Construction, Transport, Post, and Communication (district)

ODA	Official Development Assistance, Overseas Development Assistance
O&M	Operation and maintenance
OOP	Out of pocket
OPCS	Operations Policy and Country Services
PACSA	Public Administration and Civil Service Authority
PAFO	Provincial Agriculture and Forestry Office
PDR	People's Democratic Republic
PEE	Public Environment Expenditure
PEM	Public Expenditure Management
PEMSP	Public Expenditure Management Strengthening Program
PER	Public Expenditure Review
PES	Payment for Ecological Services
PETS	Public Expenditure Tracking Survey
PFM	Public Financial Management
PFO	Provincial Finance Office
PHO	Provincial Health Office
PIP	Public Investment Program
PIU	Project Implementation Unit
PMO	Prime Minister's Office
PRGF	Poverty Reduction and Growth Facility
PrMO	Procurement Monitoring Office
PRSC	Poverty Reduction Support Credit
PRSO	Poverty Reduction Support Operations
PRSO 2	Poverty Reduction Support Operations 2
PRSP	Poverty Reduction Strategy Paper
PSIA	Poverty and Social Impact Analysis
PSTEO	Provincial Science, Technology and Environment Office
RMF	Road Maintenance Fund
RMP-2	Road Maintenance Program 2
SAMB	State Asset Management Board
SAO	State Audit Organization
SCB	State Commercial Bank
SEM	Strengthening Environmental Management
Sida	Swedish International Development Agency
SME	Small and Medium Enterprise
SOE	State-owned Enterprise
STEA	Science, Technology, and Environment Agency
SWAp	Sector-wide Approach
TB	Tuberculosis
TSA	Treasury Single Account
TVET	Technical and Vocational Education and Training
UN	United Nations
UNDP	United Nations Development Program
US\$	US dollar
VAT	Value-added Tax
WB	World Bank
WHO	World Health Organization
WMPA	Watershed Management and Protection Authority
WPRO	Western Pacific Regional Office of the WHO

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EXECUTIVE SUMMARY

(i) **The key challenge of the Lao People's Democratic Republic (Lao PDR) is to make full use of both physical and human assets to accelerate growth and improve the living standards of the population.** To achieve the country's development goals, laid out in the sixth National Socioeconomic Development Plan (NSEDP) and the National Growth and Poverty Eradication Strategy (NGPES), improvements in public financial management and public expenditure policy - aimed at increased efficiency, equity, and accountability - will be critical. This report assesses the current situation and provides a way forward.

(ii) **Public spending has made an important contribution to growth and poverty reduction, particularly in priority poorest districts, during the last five to seven years.** Overall poverty declined from 46 percent in 1992-93 to 33 percent in 2002-03, with much of this decline coming from the priority poorest districts between 1997-98 and 2002-03. Also, improvements in road infrastructure and increases in education enrollment were greater in priority districts than in other districts.¹

(iii) **However, the scope for increasing public spending is limited by the country's ability to generate additional revenue.** In 2005, total expenditure stood at only 15.9 percent of GDP, which seems inadequate to achieve the goals set out in the NSEDP. Donor assistance has also fallen by more than 5 percent of GDP between 2001 and 2005 and is unlikely to rise much in the foreseeable future. Next year, to increase tax revenue collections, the GOL plans to implement the value-added tax (VAT), contingent on improvements in central control of tax collections.

(iv) **Reorienting public expenditures is key to increasing efficiency and equity.** Though serious deficiencies in the available data (Box 1) made the analysis difficult, this report finds evidence that public expenditure allocations in education and roads were reasonably efficient and equitable, while expenditures in agriculture and health were much less so. Since 2001, there have been improvements in the balance between capital and recurrent spending, but inadequate non-wage recurrent spending remains an outstanding issue, especially in the health and education sectors. Intra-sector reallocations (for example, a reallocation in favor of basic education and preventive health care) are key to increasing both the efficiency and equity of public resources.

(v) **The reform of center-province fiscal relations is crucial both to increasing total tax revenue and to reorienting public spending, especially in education and health.** With the provinces collecting around 60 percent of total revenue and spending 45 percent of total expenditure, strengthening central government control over both revenue administration and Treasury operations in the provinces - to the extent of agreeing on revenue sharing arrangements and expenditure assignments - will be *sine qua non* for success. For example, in the education and health sectors, provincial expenditure is more than 70 percent of total spending. The GOL is currently engaged in an internal dialogue to develop consensus on these issues - and on what actions can be taken to address them.

(vi) **Going forward, the timely implementation of the Government's multi-year Public Expenditure Management Strengthening Program (PEMSP) will be key.** The successful implementation of PEMSP will: (i) contribute to increased efficiency in the use of tax revenue

¹ For details, see *Lao PDR: Poverty Assessment Report*, World Bank Washington DC 2006

and donor resources; (ii) strengthen the overall transparency and accountability of public spending; and (iii) meet the GOL's specific commitments for using revenue generated by the Nam Theun 2 (NT2) project. To date, the GOL has done a commendable job of implementing the PEMSP. Progress is particularly noticeable in: (i) revising the chart of accounts and budget nomenclature to better track and classify spending; (ii) extending the GOL's financial information system (GFIS) to ensure reliable reporting and recording; and (iii) strengthening the Treasury system.

(vii) **The GOL has made progress in identifying the priority sub-sectors that can receive NT2-generated revenues for poverty reduction and environmental conservation.** The earlier NGPES had selected basic education, rural roads, and basic health as priority sub-sectors, and the NSEDP has not modified that selection. To date, the basic education and rural roads sub-sectors appear to be best prepared to become 'eligible.' These two sub-sectors as well as the Poverty Fund and the Environment Fund are expected to be ready to use NT2 revenue by 2010.

(viii) **What follows summarizes the main findings of the individual chapters of this PER/IFA.** The main policy recommendations are presented in Table 1 and are discussed more extensively in each chapter.

A. Findings and Diagnostic

A1. Macro-Fiscal Framework

(ix) **In 2001, Lao PDR emerged from a major economic crisis, and its economic performance has been encouraging ever since.** In particular, the 1997-2000 crisis entailed: (a) a collapse in funding for key social sector programs, which undermined education and health services; (b) a decline in the real wages of civil servants, which - despite an increase in 2001 - remained well below their pre-crisis levels; and (c) insufficient funding for operation and maintenance (O&M) costs and counterpart funds for donor projects, which led to accumulating domestic arrears. The GOL managed to restore macroeconomic stability and has maintained it by applying fiscal and monetary discipline and by reducing contingent liabilities. Robust growth was accompanied by a decline in poverty, mainly generated by public spending in roads and irrigation. Finally, while donors began funding recurrent expenditures, the GOL started tackling capacity building issues, took actions (Box 10) to improve its Public Expenditure Management (PEM), and established priority districts for public spending.

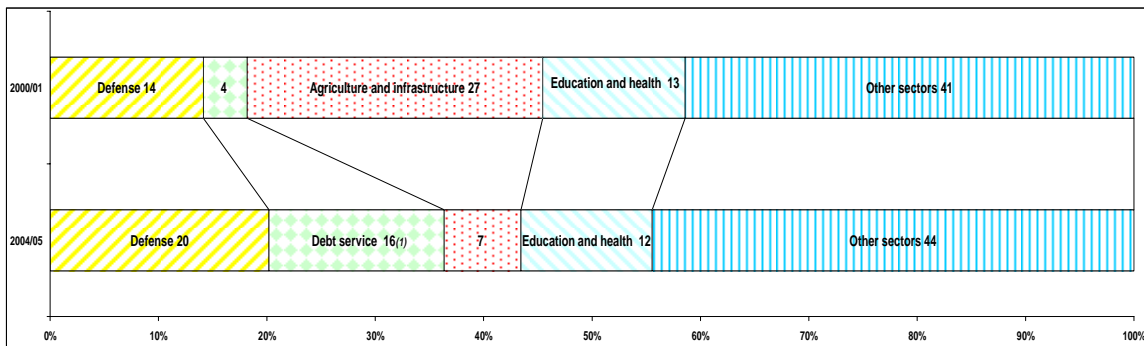
(x) **Lacking clarity and accountability, the existing center-local institutional setting hampered further progress.** Between 2001-04, the Governors' *autonomy without accountability* gave the provinces ample budgetary autonomy. This autonomy hampered revenue mobilization and sharing and hindered expenditure assignments. Provinces collected approximately 60 percent of total revenues, 90 percent of which were retained and assigned to local spending. At the same time, provincial expenditures increased as a share of the total budget from 39 percent to 45 percent. Self-governed - and wide - variations among provinces in sectoral spending *undermined the implementation of the GOL's public expenditure policy*, hindered the achievement of key NGPES/NSEDP objectives, and compromised service delivery. Since allocations tend not to follow stated policy priorities, budget management and control remain key PEM issues.

(xi) **Revenues and donor-inflows declined, greatly reducing spending.** Between 2001-05, *revenues fell* by over 2 percent of GDP, due largely to a decline in royalties from logging. Lower revenues combined with *lower aid inflows* (declining in the same period from 11 percent to 6½

percent of GDP) resulted in a significant *squeeze on spending*. Total expenditures fell during this period from 20.7 percent to 15.9 percent of GDP, largely reflecting the decline in donor-financed expenditure. Domestic spending also declined, from 12.8 percent to 11.0 percent of GDP.

(xii) **In addition, increased outlays in both the wage bill and external debt service put spending in “priority sectors” under rising pressure.** Spending on wages and salaries rose from 2.7 percent to 3.6 percent of GDP. Much of the increase went to the Ministry of Defense (MOD). Consequently, the decline in domestic spending fell disproportionately in the area of non-wage outlays. It resulted in severe shortages of funds for routine operations and an accumulation of domestic arrears. Between 2002 and 2005, the debt service to revenue ratio rose from 15.3 percent to 21.7 percent, close to the indicative threshold for debt distress. Lao PDR’s debt indicators are significantly above the indicative thresholds for countries with weak institutional settings (as measured by the Country Policy and Institutional Assessment or CPIA).² Nevertheless, the overall burden remains manageable.

Figure 1. Lao PDR: Priority Sector Spending under Pressure, 2001-05
(% total public expenditure)



Sources: Lao PDR Official Gazette and IMF staff estimates.

Note: 1. Includes debt repayment, net lending and contingency.

(xiii) **As a result, donor and private sector financing have “substituted” GOL funds in “priority sectors.”** Since 2001, the combined effect of a decrease in revenues and an increase in both debt service and defense spending has crowded out priority sector spending. Domestic spending on agriculture and infrastructure was cut much more deeply than education and health, which remained broadly constant as shares of total discretionary domestic spending. This decline in domestic spending has led to a *substitution* of GOL funds by donor and private sector funds. Donor funds increasingly have been financing priority sectors. The private sector has funded agricultural extension, road building, and health and water user fees.

A2. Public Financial Management

(xiv) **The PEMSP was adopted.** In 2005, through the approval of the Ministry of Finance (MOF) and the Prime Minister’s Office (PMO), the GOL adopted a detailed five-year PEMSP. It provides a framework within which to:

- Implement NGPES policies to improve PEM
- Prioritize and sequence a program to strengthen PEM

² At the end of 2005, the stock of external debt was estimated at \$2.1 billion (75 percent of GDP) with a net present value of \$1.5 billion.

- Mobilize and coordinate external assistance in support of GOL-led PEM strengthening initiatives, while ensuring technical consistency and appropriate sequencing and avoiding duplication of efforts.

The PEMSP is structured in five components: (a) *fiscal planning and budgeting*; (b) *budget execution, accounting, and reporting*; (c) *local government*; (d) *legislative framework*; and (e) *capacity building*. The MOF “PEMSP steering and implementing committees” are in charge of its implementation and coordination.

(xv) **Fiscal planning and budget preparation display four key problems:** (a) a lack of realism in the fiscal forecasts, leading to unpredictable spending by way of arbitrary cash rationing; (b) no mechanism for ensuring that provinces reflect national priorities in their budget plans; (c) a budget process that is fragmented institutionally and by type of expenditure; and (d) an overly compressed budget cycle. Other problems include the continuing off-budget funds, deficiencies in the budget nomenclature, little systematic monitoring and evaluation of budget execution, procurement planning that is not integrated effectively into the budget preparation process, and the short-term horizon of the budget process. Recent GOL actions have made budget targets for revenues more realistic and have expanded the period over which the budget is prepared. A revised chart of accounts and budget nomenclature is being developed and is expected to be completed in 2007.

(xvi) **Budget execution, accounting, and financial reporting also show four main problems:** (a) weak authority and capacity of the Treasury offices at each level of government; (b) weaknesses in the Treasury’s financial control, accounting, and reporting system; (c) a lack of effective implementation of the public procurement framework and of monitoring procurement performance and outcomes; and (4) deficiencies in public financial accountability and transparency. Other problems with budget execution, accounting, and financial reporting include the lack of commitment controls and weak cash management, both especially at the provincial level. The GOL has taken actions aimed at reporting and recording spending in real time, such as strengthening Treasury functions and stabilizing and extending the GFIS.

(xvii) **The current (1994) Budget Law is inconsistent with the significant decentralization that has occurred in Lao PDR since 2001.** The system of central-local fiscal relations suffers from a number of structural weaknesses, including the provinces’ extensive control over revenue, the way these revenues are shared (by the surplus provinces) with the center, and the negotiated block transfers that are used to fill the fiscal gaps of the deficit provinces. The law does not specify clearly and appropriately the roles and responsibilities of different departments and levels of government in the budget process, or the roles and responsibilities of the National Assembly. Therefore, provinces and districts assumed a crucial role in national PEM. In recent years, sub-national expenditures as a share of the total budget notably increased (from 28 percent in 1998 to 45 percent in 2004). However, institutions and capacity for local expenditure management have not grown at the same pace as decentralization. The new budget law, aimed at addressing many of the issues identified above, was approved by the National Assembly in November 2006 and preparation for its implementation is underway.

(xviii) **Local capacity needs to be strengthened.** While the GOL is paying more attention to capacity building by mobilizing donors and hiring advisors, Lao PDR has an acute shortage of staff with public financial management (PFM) skills. These skills range from public expenditure analysis and planning and Treasury administration to procurement, accounting, auditing, and financial information and communication technologies (ICT). Skills are particularly poor at the

local level. Capacity building mechanisms are inadequate. Donor-funded capacity building has been uncoordinated.

A3. Sectoral Spending

Agriculture

(xix) ***Agriculture remains the most important sector in Lao PDR.*** In 2003 agriculture still contributed approximately half of total GDP and provided employment to 80 percent of the workforce. Over the last decade, agricultural growth averaged nearly 5 percent per year and was the most important driver in reducing rural poverty. Produced mainly in lowland rain-fed areas, rice is the single most important crop and accounts for approximately 60 percent of total agricultural GDP. Livestock, including fisheries, accounts for 35 percent and forestry for approximately 7 percent respectively. The GOL promotes food security by improving the often-inefficient subsistence farming of poor households. It also provides the necessary public goods to strengthen farmers' competitiveness and creates a more market-oriented environment for agriculture by investing in - and operating - physical and productive infrastructure, promoting agricultural research, and providing effective extension services and rural credit. Redressing the emerging spatial inequalities between lowland and upland areas is the next challenge.

(xx) **During 2002-04, the agricultural budget - after donors' inflows - decreased from 2.3 percent to 1.1 percent of GDP and fell from 13.3 percent to 8.4 percent of government spending.** Given the GOL's emphasis on promoting national rice self-sufficiency, irrigation remains the most important recipient of public resources. Capital expenditures, primarily donor-funded, account for more than 90 percent of total sector expenditure. Capital funds are not disaggregated into subcategories and are reported only as aggregate capital expenditures. Capital funds remain biased toward physical investments, without appropriate allocations to meet recurrent spending requirements, particularly allocations for O&M. Irrigation investments are targeted primarily at the Mekong Corridor.

(xxi) **Public agriculture spending is efficient but not equitable. While the effectiveness of public spending is difficult to evaluate, between 2000 and 2004, rice production increased in area and yield.** Yet access to irrigation schemes increased only slightly and was heavily biased toward non-poor farmers in non-priority districts. Overall growth in the irrigated rice yields fell from 13 percent in 2000 to 3 percent in 2004. However, yields in the priority districts were considerably lower. Additionally, due to the continued focus on irrigation construction in a few lowland provinces, only a small part of available public resources reaches the rural poor in remote upland areas. Access by the rural poor to a range of essential services and infrastructure is severely constrained. These essentials include agricultural and forestry extension services, including information on products and prices, livestock vaccination, and other public support to strengthen agriculture; road infrastructure; markets to sell agricultural produce; and social services.

Road Sector

(xxii) **The road sector carries approximately 75 percent of freight and 93 percent of all passenger traffic and is the dominant mode of transportation in Lao PDR.** Despite playing this important role, the network is vulnerable during the rainy season. Only 53 percent of the national roads and 3 percent of the local roads are paved. More than 10 percent of all district centers and over 40 percent of villages have no year-round road access. The GOL is committed to providing the necessary transport infrastructure for all the people of Lao PDR. The government

has developed a spending policy geared at allocating investment to improve road access to remote areas, fostering border trade, and providing a conducive environment for economic development in the less-developed provinces. The Ministry of Construction, Transport, Post, and Communication (MCTPC) manages the road network in an integrated manner and follows streamlined procedures. However, the institutional capacity for implementation, especially at the sub-national level, remains weak.

(xxiii) **From 2002–04, public expenditure on roads - including donor assistance- increased from 3.2 to 3.3 percent of GDP and rose from 18.7 percent to 24.7 percent of government spending.** The total over the last five years amounts to roughly US\$400 million, of which approximately 80 percent was funded by donors. Road expenditure is heavily concentrated on national roads, especially construction works. However, there is evidence that increasing attention is being given to road maintenance and provision of rural roads. With revenue from the fuel levy, the Road Maintenance Fund is increasingly funding road maintenance. Nonetheless, the fund is still far from fully meeting the country’s needs.

(xxiv) **Public spending on roads is efficient and equitable.** The unit costs of road works are reasonable compared with other low-income countries, and ex-post economic rates of return from major road investment projects are high. However, the GOL should make more effort to increase the efficiency and cost-effectiveness of road spending in two ways: (a) by strengthening institutional capacity for implementation at the local level and (b) by promoting market competition and private sector participation in the delivery of road works. Between 1997 and 2002, access to roads increased across the country, rebounding from the collapse of the previous five years, especially in priority districts. Compared with 1997 levels, by 2002 access to all-year roads, distances to hospitals, length of tarred roads, and electricity supply had all improved dramatically.

Education

(xxv) **After the public expenditure collapse of the late 1990s, education outcomes improved across age and poverty groups.** Between 1997 and 2002, primary and secondary enrollments continued to increase, driven heavily by increased female enrollment. Literacy rates increased nationwide, but priority districts improved more than the national average. At primary age (basic education), literacy almost doubled from 31 percent to 58 percent. The increase in the secondary age groups was more modest. In addition, keeping children in school long enough to complete primary and secondary schools is proving difficult. Public-private partnerships can increase investment in post-basic education. However, the GOL has an important “stewardship” role to play in:

- a. Maintaining oversight of the sector’s strategic development
- b. Monitoring and evaluating progress
- c. Operating a quality assurance system that holds public and private providers accountable
- d. Continuing to fund the sector in ways that benefit the poor.

(xxvi) **During 2002-04, the education budget decreased from 2.2 percent to 1.8 percent of GDP but rose from 12.6 percent to 13.4 percent of government spending.** Indeed, public educational expenditure, although it has rebounded since the crisis, is still very low. Investment spending has reached as high as nearly half of total public expenditure, and by 2004-05 foreign funds accounted for over 90 percent of educational investment. If both budgets had been spent effectively, the rapidly rising foreign investment should have been matched by substantial increases in the recurrent federal budget. However, this matching did not materialize. The

declining percentage of the recurrent budget now going to basic education - and its recent rapid increase in upper secondary, technical/vocational education, teacher education, and higher education - stands in stark contrast to the GOL's declared policy of focusing on basic education and the achievement of the goals of the Education For All (EFA) initiative.

(xxvii) **Public spending in education is efficient but not equitable.** There are widespread disparities in educational access and outcomes, based on income, ethnicity, and geographic area of residence. Children of wealthier households account for much of the higher enrollment rates but receive the lowest primary subsidy. However, the high Gross Enrollment Ratio (GER) rates, even for richer students, could be a sign of significant inefficiencies in primary schooling. If so, this would require the GOL to focus on increasing efficiency. At the same time, disadvantaged groups have more limited access to publicly provided education. While children from all quintiles participate in primary schooling, quite clearly the children of wealthier households account for much of the enrollment in lower and upper secondary education. Furthermore, there are signs of divergence within the female population, with a widening schooling gap between rural Lao-Tai and non-Lao-Tai women and between rural and urban women. Provinces are key actors in both the financing and the delivery of education services but are not accountable to the central administration.

Health

(xxviii) **Despite recent progress, the public system has been unable to deliver adequate health services.** During 1995-2000, health outcomes improved only in the non-priority districts. Given the lack of progress in extending health coverage, the progress in overall outcomes related to child and maternal mortality was remarkable. Maternal and under-five child mortality rates fell by more than 20 percent, and life expectancy increased by five years. However, the coverage of key maternal and child health interventions is low, and the immunization rate is on a worryingly worsening trend. Public services dominate the sector with a significant level of decentralization to the provincial level. The GOL's roles are to: (a) ensure the provision of "public goods," that is, health services that would not be provided if left to the market; (b) ensure that the poor will not face financial barriers to accessing essential health services and protect the population from the adverse impact of catastrophic health care costs; and (c) correct health sector "market failures." However, government services are underused, and a significant share of outpatient health care is privately delivered.

(xxix) **From 2002-04, total government health expenditures decreased from 1.0 percent to 0.7 percent of GDP and from 5.9 percent to 5.3 percent of government spending.** Total (public and private) health spending in 2002 was only \$8.7 per capita, equivalent to 2 percent of GDP, a very low level compared with other Asian countries. Capital expenditures account for a substantial share of government health expenditures, roughly 40 percent in 2003-05. Per capita government health spending varies considerably across provinces and districts. Lao's public health sector wages are among the lowest in the world, and salary increases are among the lowest across sectors. Provinces are key actors in both the financing and delivery of health services but are not accountable to the central administration. Coverage of key primary health services varies widely among provinces, reflecting their autonomy.

(xxx) **Public health spending is inefficient and inequitable.** Gaps are emerging between the poor and non-poor and between the Lao-Thai and the other ethnic groups. Indeed, more favorable outcomes are found in urban areas and among the more well-off segments of the population. Lao PDR has overspent on capital investment (it has more hospital beds per 1,000 people than any other country in the region), but its health facilities remain significantly underused. Budget

execution rates are especially low for capital expenditures. In 2003-04, the execution rate, including for donor funding, was below 50 percent. Low execution is particularly problematic at the provincial level. Statistically, public spending does not correlate with such factors as income, poverty, or health needs. Overall, the richest quintile captures 27 percent of public subsidies for health services, compared with 13 percent for the poorest. Public subsidies to central hospitals are heavily biased in favor of the richest quintile. The majority of the poor are ethnic minorities who live in remote mountainous areas. Effective mechanisms to protect the poor from unaffordable health care costs are lacking, especially for the poor who do not live in the 47 priority districts.

Environment

(xxxix) **Population growth and unchecked economic activities brought about a noticeable deterioration of natural resources and environmental quality.** Between 2000-04, forest cover was reduced from 47 percent to 43 percent of the total land area. Alarming, it is being further reduced by an average of 53,000 ha per annum, with even higher deforestation rates in priority districts. Widespread soil erosion, especially in the uplands, and shorter fallow periods lead to declining agriculture productivity. Increasing hydropower development puts additional pressure on water resources. Human use of once remote protected areas is leading to a decline in biodiversity. Evidence shows that the unchecked exploitation of natural resources can lead to rapid depletion and degradation, damaging interrelated ecosystems. The GOL needs to manage the use of natural resources and ensure sustainability when tapping the country's potential by: (a) using the Environmental and Social Impact Assessment (EIA) to identify possible risks and mitigation measures; (b) monitoring and enforcing the implementation of the EIA findings; and (c) conserving and protecting the environment to ensure sustainable use, while (d) increasing pro-poor measures.

(xxxix) **Between 2002-05, public environment expenditures, which account for only 0.7 percent of total public expenditure, declined by 36 percent.** This sharp reduction was due to a drop in foreign grants. The amounts of recurrent and capital expenditures have been quite stable. Foreign aid makes up more than 90 percent of public environment expenditures. More than 90 percent of public environment expenditures has been made by only two key agencies, the Ministry of Construction, Transport, Post, and Communication (MCTPC) (36 percent) and the Science, Technology, and Environment Agency (STEA) (58 percent), which is a part of the Prime Minister's Office.

(xxxix) **Public spending on the environment needs to be more effective.** In environment, recurrent expenditures have not been able to keep up with capital expenditures, with the former accounting for only 4 percent of the total. Furthermore, approximately 60 percent of total recurrent expenditures go to wages and salaries. Other operating expenses explain the remainder. However, during the last four years, there has been an upward trend in recurrent public environment expenditures, a manifestation of the commitment by the GOL to increase recurrent expenditures.

B. "Way Forward": Conclusions and Recommendations for the GOL

B1. Medium-term fiscal framework (2005-10)

(xxxix) **The sixth National Socioeconomic Development Plan (NSED) calls for faster economic growth, a higher GDP per capita, and a further reduction in poverty by 2010.** The NSED also sets targets for eradicating illiteracy, lowering mortality rates, and raising life expectancy, especially among the poor. To meet these challenges, the GOL needs to:

- a. Mobilize revenues by recentralizing the tax and customs administration, establishing a mechanism for revenue sharing and intra-governmental transfers, and introducing a VAT system with a single rate
- b. Ensure the sustainability of the macrobudgetary framework by restraining the growth of the wage bill in line with that of revenues and contracting only concessional debt
- c. Increase the efficiency of both expenditures and service delivery
- d. Increase the direct revenue allocated to priority sectors and areas by maintaining domestic expenditures on non-priority sectors as a share of GDP
- e. Increase the participation of the private sector in service delivery by lifting restrictions on private provision of services
- f. Enhance resource monitoring and accountability by improving fiduciary mechanisms.

(xxxv) **Given the ongoing squeeze on available resources, the first and main priority in the period ahead is to enable Lao PDR to meet its development needs within a sustainable fiscal framework.** Assuming that the NSEDP policy agenda is successfully implemented, then economic growth could reach 6-7 percent between 2006 and 2010. Prudent fiscal and monetary policies, underpinned by the continued avoidance of monetary financing of the budget deficit and restrained credit growth, should keep inflation down to approximately 5 percent over the medium term. The overall fiscal deficit is projected to remain at roughly 3 percent of GDP. Revenues are projected to rise from 11.6 percent to 12.8 percent of GDP; higher commodity prices and greater natural resource rents should offset the fall in tariff revenues. Primary expenditure is likely to remain broadly unchanged at roughly 16 percent of GDP. Total donor support is projected to rise only modestly in US\$ terms, implying a decline in aid inflows to the budget from 6.5 percent in 2005-06 to just under 5 percent of GDP by 2010. This framework assumes no bank financing of the deficit.

(xxxvi) **The medium-term fiscal framework (MTFF) hinges on (a) increased revenue mobilization and sharing and (b) improved expenditure assignments, which in turn require a broader review of center-province relations.** While higher mining royalties and taxes will help, non-resource revenues also need to be increased. Introducing a VAT is still the main tax policy reform over the medium term, but its implementation hinges on reforms to recentralize authority over the tax and customs administration. Such reforms will require a broad review of center-province fiscal relations, particularly with regard to three issues. First, the review should consider the assignment of revenues and expenditures between the center and provinces, the establishment of a mechanism for revenue sharing and intragovernmental non-earmarked transfers, and the increasing of central control over Treasury operations in the provinces.

(xxxvii) **Second, the GOL should (a) stop crowding out "priority sector spending" by pursuing a cautious approach to increasing commitments on wages and salaries and (b) contain future debt service by restricting borrowing.** Since past low levels of priority public spending contributed to poor social outcomes, the *ongoing pressures on disposable expenditures* raise concerns about Lao PDR's ability to meet the Millennium Development Goals (MDGs). The country would do well to restrain growth in the wage bill to realign it with that of revenues. The MTFF presented in this review has the wage bill rising to 4.2 percent of GDP by 2010, an increase which would keep the ratio of wages to revenues broadly unchanged. The GOL could make better use of the resources within the wage bill to raise the compensation of teachers and health workers. While this policy may be politically difficult, it would create more incentives for people to enter the education and health professions, especially in remote rural areas. The GOL also should contain future debt service by restricting borrowing.

Figure 2. Expenditure Projection by Wages and Non-wages

(% GDP) (Excludes externally financed expenditures and interest spending)

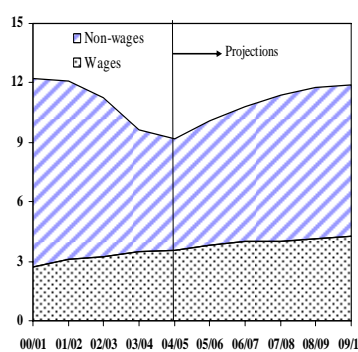


Figure 3. Expenditure Projections by Priority and Other Sectors

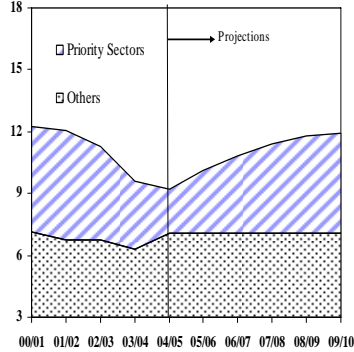
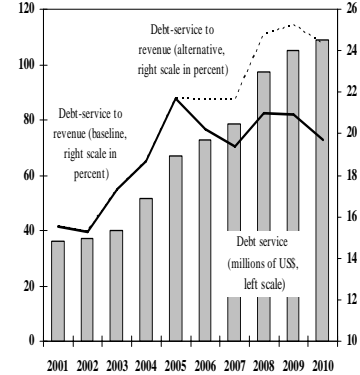


Figure 4. External Public Debt Service



Sources: Lao PDR Official Gazette (various issues), Lao PDR Ministry of Finance, Bank of Lao, and IMF staff projections 2000/01 to 2009/10.

Note: Projections start from 2005/06.

(xxxviii) **Third, the GOL needs to increase the effectiveness of its public expenditure policy.** To achieve the NSEDP objectives and to improve service delivery to poor and vulnerable groups, the GOL needs to: (a) align expenditure policies more clearly with NSEDP priorities and (b) rationalize allocations by taking into account the efficiency of public spending in priority sectors. The future financing requirements for the social sectors and public infrastructure alone will average 9.1 percent of GDP a year. Provided that progress is made in mobilizing revenues, the government should have the scope to significantly increase the budget allocations for its spending priorities. For example, if expenditures on non-priority sectors were kept constant as a percentage of GDP and any revenue gains were devoted to increasing priority sector allocations, expenditures in priority sectors could be raised from 6.5 percent to 8.5 percent of GDP by 2009-10.

B2. Public financial management: Large agenda on a tight calendar

(xxxix) **For Lao PDR to achieve its growth and poverty reduction goals, it will be critical to strengthen public expenditure management.** If the goals are to be achieved, it is imperative that the GOL and donors are strategic and selective in phasing and prioritizing PEMSP actions. In fiscal planning and budget preparation, budget execution and control, and accounting and financial reporting, most attention should be focused on the fundamental problems identified above. The PEMSP should be used to promote a high-level dialogue on central-local fiscal relations. More attention needs to be paid to capacity building. The Nam Theun 2 Project Revenue Management Arrangements (NT2RMAs) need to be fine-tuned to fit the revised and rephased PEMSP.

(xl) **First, the top priority is to strengthen the fiscal planning that underpins the annual budget process based on reliable forecasts.** The GOL also should ensure that the detailed budget is ready for approval by the National Assembly in October, with a budget cycle starting much earlier in the year. It should strengthen the monitoring and evaluation (M&E) of budgets to ensure that budgeting is based on sound policy analysis that involves all stakeholders. A simple

mechanism should be developed urgently to *ensure that provinces allocate resources to national priority sectors in their budget plans.*

(xli) **Second, it is important to reassert the authority of the central Treasury over provincial treasuries.** This is a complex political issue that cannot be rushed and will require extensive dialogue and commitment. Further work is needed to ensure that the GFIS is fully functional and to establish regular, timely, and accurate budget execution reporting. To this end, the MOF should approve a reporting format and develop a tool to extract the necessary data from the GFIS. For procurement, the challenge will be to put into operation the new systems for managing procurement and monitoring performance and outcomes.

(xlii) **Third, the PEMSP needs to focus on public financial accountability and transparency.** A new Audit Law for the State Audit Organization (SAO) is being drafted and aims to strengthen the SAO's independence by requiring it to report to the National Assembly. However, the inspection and review responsibilities of government agencies need additional clarification. Progress in executing approved strategic plans using the new audit methodologies needs to be made to provide effective audit oversight of public expenditures.

(xliii) **Fourth, the PEMSP should promote a high-level dialogue on central-local fiscal relations in Lao PDR.** This is a highly political issue and raises fundamental questions about the distribution of authority among levels of government and the distribution of resources between the more prosperous urban centers and the poorer upland provinces. However, these issues cannot be ducked if Lao PDR is to achieve growth and justice and to reduce poverty.

(xliv) **Fifth, budget allocations among provinces must be based on more realistic revenue forecasts.** The development and implementation of new reporting formats and standardized payment procedures at the local level should be part of the GFIS roll-out and the development of in-year budget execution reports and the new Chart of Accounts (COA). However, their implementation depends on progress in strengthening the authority of the Central Treasury to enforce these new procedures. The Central Treasury should also take steps to strengthen the transparency and accountability of institutions at the local level; for example, provinces should be required to publish their budgets and end-year accounts and to post these on public notice boards outside all offices.

Sixth, the PEMSP should support the ongoing revision of the Budget Law and Treasury Decree. These actions require dialogue at the highest level and cannot be a purely technocratic exercise. Although not included in the PEMSP, a new audit law is being drafted to strengthen the role of the state audit and to clarify its responsibilities. Regarding procurement, it will be critical for the implementation of the improved legislative framework to ensure the early finalization and adoption of the standard bidding documents and procurement manual and to build the capacity of the procuring agencies to apply the new procedures.

(xlv) **Finally, capacity building needs to accelerate.** The PEMSP envisages establishing a PFM Capacity Building Committee, conducting a needs assessment and capacity building strategy, and developing and implementing PFM capacity building plans. Progress in these areas has been insufficient. The PEMSP capacity building plan is a first step in strengthening coordination among donors. As a next step, the GOL should establish a multi-donor trust fund to support the PEMSP.

(xlvi) **The 2005-06 Public Expenditure Review/Integrated Fiduciary Assessment (PER/IFA) assesses the progress made and the planned steps that would achieve the Nam Theun 2 revenue management arrangements (NT2RMA).** This report highlights the status of PEMSP actions that have a more immediate bearing on achieving NT2RMA (as cited in the

Annex of GOL Letter of Implementation Policy, GLIP for NT2), as well as the actions needed to develop the priority sub-sectors that can be made eligible to use revenue from NT2. These requirements are that: (a) NT2 revenue be used for a number of “eligible” sub-sectors satisfying eligibility criteria; (b) expenditures financed by NT2 revenue are “additional” to what is being spent from the budget; (c) financial management and reporting arrangements are adequate to track spending in real time; (d) the State Audit Organization has the capacity to audit “eligible” spending adequately; (e) regular monitoring and consultations are carried out; and (f) all reports are published (Box 9).

(xlvi) **Based on current plans and the progress so far, the government expects to be ready to use NT2 revenue in 2010.** A yearly flow of NT2 revenues of approximately US\$20 million is expected between October 2009 and September 2010; by then, a number of “eligible” sub-sector expenditures will be ready to use that revenue. To date, the policy dialogue for satisfying NT2RMA requirements has progressed furthest on the subject of the *basic education sub-sector*, followed by *rural roads*. This dialogue has focused on: (i) defining the sub-sectors; (ii) developing a medium-term spending plan; (iii) identifying performance indicators to monitor impact on poverty reduction and environmental conservation; and (iv) reviewing the key PEMSP actions taken so far and to be taken that will ensure that adequate financial management and reporting arrangements are in place for the “eligible” sub-sectors. During the fiscal year 2007 and 2008, concerted efforts are needed to ensure that the selected sub-sectors meet the eligibility requirements by 2009-10. *In 2010, NT2 revenues can be allocated to and spent on the basic education and rural roads sub-sectors, the poverty fund, and the environment fund.* Additional priority sub-sectors will become eligible in subsequent years.

B3. Sectoral Spending

(xlviii) **To improve the delivery of social services and to integrate capital and recurrent expenditures, the GOL has estimated the cost of implementing the NGPES/NSEDP priority programs.** Over FY05/06 to 09/10, in the four priority sectors designated by the GOL (agriculture, transport, health, and education), the GOL estimated that total implementation would cost approximately \$2.25 billion. Excluding agriculture, the other sectors later adjusted their projections upwards, bringing the total to \$2.77 billion. These estimates are approximately double the current sectoral allocations. The need to make substantial adjustments midstream reveals difficulties in medium-term planning and prioritizing.

(xlix) **In agriculture, salary payments are a declared priority.** Hence, this is a concern as wages and salaries already account for 30 percent of the total projected budget. In 2006/07, capital investments will decrease to 60 percent, half of which will come from foreign sources. The implementation of agricultural programs could be hampered if the practice of under-funding approved budget plans continues. Financing plans to address the Ministry of Forestry and Agriculture’s (MAF’s) NT2-related expenditures (and debt) as well as the provincial debt need to be included in the medium-term plan.

(1) ***The first and most immediate priority at the central level is to make a more focused allocation of resources by addressing capacity constraints in agriculture expenditure management. Second,*** there is a strong rationale for allocating more public funding to agriculture as a major engine of rural poverty reduction, for distributing public funds more appropriately between richer and poorer provinces, and for making more focused allocations of centrally controlled resources to poorer provinces to achieve the desired development outcomes. ***Third,*** capacity constraints for planning, monitoring, and analyzing public expenditure are the major issue at the MAF in the short-term.

(li) **In the road sector, financing existing needs will be a major challenge for the GOL.** Total maintenance and rehabilitation needs (unconstrained by the budget) for the national and provincial roads are estimated to be US\$460 million over the next 10 years. Moreover, the GOL faces an enormous task to finance the expansion of basic road access to connect all district centers and a large number of villages. Additional financing sources are much needed to fill the financial gaps. One additional source expected in the near future is the NT2 revenue, especially for that portion of road expenditure that has little prospect of being financed by users or by private financing.

(lii) **The main challenges include the sustainable financing of road maintenance, providing all-weather basic road access to all district centers and a large number of villages, and upgrading existing roads to meet the growing traffic demand.** The amount of financial and human resources available are not adequate to meet all of these competing demands, and this situation will continue into the near future. *Second*, the GOL should focus on increasing the efficiency and cost-effectiveness of road spending and in increasing its efforts at mobilizing financial resources, especially from users. *Third*, the GOL should promote market competition to extend the efficiency gain from private sector participation in the delivery of road works.

(liii) **In education, the NGPES and the National EFA Action Plan set the priorities for the levels of education in this order:** (a) primary; (b) lower secondary; (c) non-formal and adult education, especially skills development; (d) teacher training; (e) upper secondary; (f) preschool; (g) tertiary; and (h) technical and vocational training. A related objective is to increase recurrent expenditure deriving from investments to ensure the long-term sustainability of education development, to improve quality and increase efficiency, and to promote equity. If revenue inflows allow, it is also proposed to increase teachers' base salary by 2 percent per annum, with the ratio of the average salary to GDP per capita remaining constant at approximately 0.87. In the aggregate, there would be a total funding gap of US\$12.9 million for the period of the overall plan in relation to the MOF's preliminary envelope for education. Filling this gap will depend chiefly on donors' willingness to invest.

(liv) **The top priority is to increase the proportion of national resources allocated to education and to timely pay teachers' salaries.** *Second*, at the provincial level, the real problem is the lack of an information system through which data are routinely reported to Ministry of Education (MOE) and used to monitor allocation and performance. Financial allocations to provinces take place within the framework of decentralization but are not supported by procedures for adequate reporting and monitoring. *Third*, without urgent action on teachers' conditions (including salaries), Lao PDR will continue to experience a shortage of teachers, especially in the poor and remote districts, and the goals of the EFA initiative and the MDGs will not be achieved. *Finally*, the problem of separate recurrent and capital budgeting must be jointly tackled by the MOE and the donors.

(lv) **In health, there will be a significant gap in financing recurrent spending.** The GOL's projections for health public expenditure exceed its available resource considerably. Estimates suggest that the funding gap for staff and salary increases alone would be approximately US\$14 million by 2010, even assuming that the promised levels of external funding are delivered. An additional gap will exist for non-wage recurrent spending. Filling this gap will require increased donor funding. In addition, user fees are likely to play an increasingly important role in financing government health services but may make these services unaffordable to the poor.

(lvi) **The immediate priority is to increase resources to public health programs and to improve how they are allocated.** Priorities include ensuring adequate resources for non-wage recurrent expenditures on Hygiene and Preventive (H&P) programs, which are front-line health

services at the district level, and for improving the performance of health personnel (for example, incentive packages). **Second**, the GOL should improve targeting the poor to ensure that they have access to essential health services and are protected from catastrophic health expenditures. **Third**, low execution rates, notably at the provincial level, call for strengthening financial management systems to ensure transparent execution and effective monitoring of public spending. **Last**, it is important to harmonize and align government and donor programs to health sector front-line priority areas.

(lvii) **In the environment, the 2002–05 declining trend in public expenditures is expected to be reversed.** External grant support is expected to increase public environment expenditure by 5 to 21 percent in the next fiscal year and by 15 to 27 percent thereafter. In addition, the GOL and donors have recognized community participation in natural resources management as one of the most effective ways to allocate the benefits from public environment expenditures to the people, especially the poor. Lessons learned from sectoral projects have shown that communities and the poor are able to share the benefits from participating in natural resources management (NRM) if the GOL helps communities to build their capacity and to feel empowered in partnership with local and international partners.

(lviii) **The immediate priority is to monitor the effectiveness of public environment expenditures.** Indeed, a more systematic and disaggregated approach is needed to record and separate the environment expenditures and their impact at the national and provincial levels. **Second**, recurrent expenditures need to be increased to ensure the sustainability and effectiveness of capital expenditures and grant funding. **Third**, the NT2 experience— - one of the largest programs anywhere on Payment for Ecological Services (PES) - should be applied to other types of natural extraction projects. The NT2 project has set out an unprecedented range of comprehensive environmental and social safeguards. **Last**, the NT2 revenues will be used only to fund poverty reduction and environmental conservation measures.

B4. Bridging data gaps and future analytical work

(lix) **More disaggregated data are needed to (a) further understand expenditure patterns and (b) improve public policy.** The depth of this PER/IFA has been constrained by a lack of data. District expenditure data are needed to assess the effectiveness of the NSEDP priority district program. Before recommendations can be made about inter- and intra-sectoral reallocations, subsectoral cost/benefit analyses are required. The identification by the GOL of the NT2-eligible programs is a key step toward implementing the NT2 agreements in the PEMSP framework. Before being normative about the “right” capital/recurrent balance, it is also important for the GOL to reveal the recurrent expenditure that is mis-classified in the Public Investment Program (PIP). When cross-analyzed with output indicators, better expenditure data also would enable a better understanding of both (a) the barriers to access created by user fees and (b) the incentives for delivering services in remote areas.

B5. Implications of donor spending

(lx) **Donors should target financing to priority subsectors, strengthen coordination with the GOL and other stakeholders, and fund recurrent expenditures through budget support.** In 2002-05, although donors reduced their total inflows, they increased their financing of recurrent costs. In general, donors’ support to the GOL reform program should be more closely aligned with NSEDP priorities, such as, in health care, providing rural delivery instead of additional urban inpatient facilities. Donors also should target an adequate inflow of technical assistance, especially in the PFM area.

Table 1. Summary of Policy Recommendations

<i>1. Macro-Fiscal Framework</i>	
1.1 Revenue strategy	<ul style="list-style-type: none"> • Recentralize tax and customs administration and establish credible mechanism for revenue sharing and intragovernmental transfers as well as clearer assignment of revenues and expenditures between center and provinces • Introduce VAT system by 2009 with single rate, broad coverage of goods and services, and minimum exemptions
1.2 Wage bill	<ul style="list-style-type: none"> • Restrain growth in wage bill in line with that of revenues to keep the ratio of wages to revenue broadly constant • Keep employment growth under tight control and focused on the needs of priority sectors
1.3 Priority sector spending	<ul style="list-style-type: none"> • Align public sector spending to strategic objectives laid out in sixth national development plan • Devote revenue gains to increasing priority sector allocations by keeping domestic expenditures on non-priority sectors broadly constant as share of GDP
<i>2. Public Expenditure Management</i>	
2.1 Relationship between the center and the provinces	<ul style="list-style-type: none"> • Agree on center-local revenue-sharing arrangements, intragovernmental transfers, and expenditure assignments
2.2 Fiscal planning and budget preparation	<ul style="list-style-type: none"> • Strengthen fiscal planning underpinning annual budget process, which should be based on reliable forecasts • Revise budget cycle to make it less compressed • Establish system of minimum per capita allocations to priority sectors for provinces
2.3 Budget execution, accounting, and financial reporting	<ul style="list-style-type: none"> • Reassert authority of central Treasury over provincial Treasuries by recentralizing tax and customs • Make GFIS fully functional • Effectively implement revised public procurement rules and regulations • Finalize, approve, and enact new Audit Law for SAO
2.4 Local government financial management	<ul style="list-style-type: none"> • Promote high-level dialogue on central-local fiscal relations • Base budget allocations to provinces on more realistic revenue forecasts • Strengthen transparency and accountability of local institutions by posting budgets and end-year accounts on public notice boards in provinces
2.5 Financial legislation and regulatory framework	<ul style="list-style-type: none"> • Finalize, approve, and enact Budget Law and Treasury Decree • Finalize and adopt standard bidding documents and procurement manual
2.6 Capacity building	<ul style="list-style-type: none"> • Establish PFM Capacity Building Committee • Conduct needs assessment and elaborate, adopt, and enact capacity building strategy
2.7 NT2RMAs and rephased PEMSP	<ul style="list-style-type: none"> • Revise and reprogram PEMSP, and adapt NT2RMAs to revised and reprogrammed PEMSP (with PEMSP, not NT2RMAs, as focal issue)

<i>3. Agriculture</i>	
3.1 Resource allocation	<ul style="list-style-type: none"> • Increase allocation of public funds to agriculture, specifically for agricultural extension and research to support commercialization and diversification • Involve the MAF more closely in budget formulation led by the MOF and Committee for Planning and Investment (CPI)
3.2 Agriculture information system	<ul style="list-style-type: none"> • The MAF should collect, organize, and analyze data on agricultural and rural development expenditure carried out by central and subnational authorities and private sector • Strengthen consultation, information exchange, and data access among the MOF, the CPI, and the MAF through regularly scheduled interactions • Provide better information on local arrears levels as well as locally generated revenues
3.3 Equity	<ul style="list-style-type: none"> • Allocate more resources to most disadvantaged provinces (those with highest number of priority districts) • Carry out analyses on alignment of provincial expenditures with national priority programs to ensure consistency
<i>4. Roads</i>	
4.1 Resource allocation and use	<ul style="list-style-type: none"> • Prioritize preservation of existing road assets over expanding asset base • Update medium-term transport development strategy • Refine and improve process for road expenditure prioritization, including appropriate use of economic criteria
4.2 Resource mobilization	<ul style="list-style-type: none"> • Increase effort and political commitment to bring fuel levy to level that makes the RMF sustainable • In providing rural “basic-access” roads, complement NT2 revenue sources with contribution in kind (such as labor) or cash from rural communities
4.3 Private sector participation	<ul style="list-style-type: none"> • Promote private sector participation in delivery of road works and encourage market competition to achieve efficiency gains • Corporatize and privatize state-owned construction enterprises and expose them to market competition
<i>5. Education</i>	
5.1 Resource allocation	<ul style="list-style-type: none"> • Direct additional spending, including that to come from NT2 revenues, to meet EFA and MDG basic education targets • Improve allocation of resources, notably to improve package for education personnel, including salary review and non-financial incentives
5.2 Education information system	<ul style="list-style-type: none"> • Improve comprehensiveness and reliability of Education Management Information System (EMIS) and integrate it fully in planning and budgeting • Collect, analyze, and disseminate data on education expenditure in provinces by program and educational subsector
5.3 Equity	<ul style="list-style-type: none"> • Allocate more resources to priority districts so that expenditure matches “need” (defined as the gap in each district between current status and EFA/MDG targets) • Ensure that NGPES priorities are reflected in budget allocation • Develop new approaches to attract and retain non-Lao-Tai students in education system, especially girls

<i>6. Health</i>	
6.1 Resource allocation	<ul style="list-style-type: none"> • Increase public resource allocation for public health programs, notably from domestic sources • Align budget planning and monitoring with key functions of public health sector (stewardship, public health, delivery of preventive and clinical health services) • Develop more transparent, need-based formula for budget allocation at both central and provincial levels • Ensure adequate resources for non-wage recurrent expenditure of H&P programs and human resources (for example, monetary and non-monetary incentive packages) • Ensure that NT2 revenues finance health care for the poor
6.2 Health information system	<ul style="list-style-type: none"> • Improve budget recording system to permit reliable analyses of health expenditure by level of care, program, and economic function
6.3 Equity	<ul style="list-style-type: none"> • Target the poor through demand-side financing by ensuring sufficient resources, developing appropriate targeting mechanisms, and selecting cost-effective, performance-based methods to pay health care providers • Improve targeted use of external financing and align government and donor programs in health
<i>7. Environment</i>	
7.1 Resource allocation and use	<ul style="list-style-type: none"> • Increase funds (including from NT2 revenues and Environmental Protection Fund, or EPF) to environment, especially to natural-resource-intensive sectors such as hydropower and mining. • Increase recurrent expenditures by gradually increasing number of qualified staffs at provincial level. To monitor progress, set a target, for example, 8 percent of Public Environmental Expenditure (PEE) in 2010 • Require proponents of natural extraction projects to allocate part of expected revenues to environmental conservation and management
7.2 Environment information system	<ul style="list-style-type: none"> • Develop system to collect and monitor PEE data at national and provincial levels by building disaggregated database at departmental and divisional levels. Examples would be in the Department of Environment (DOE) and the Environmental Research Institute (ERI), and in Environment Management and Monitoring Units (EMMUs) and the Division of Forest Resources Conservation (DFRC) respectively. Pilot system in three provinces before rolling over to all provinces • The STEA and the MOF should collaborate to establish consistent and reliable baseline to monitor both outcome and impact of NT2 revenue use on environmental programs
7.3 Equity	<ul style="list-style-type: none"> • Ensure transparent, efficient use of NT2 revenues to finance poverty reduction and environmental conservation programs as defined in the NGPES and the NSEDP • Ensure equitable allocation of benefits proceeding from natural resources use (preventing them from going only to elites)

1. MACRO-FISCAL FRAMEWORK AND INTERSECTORAL ALLOCATIONS

Lao PDR's recent economic performance has been encouraging. The economy has enjoyed a period of macroeconomic stability, underpinned by fiscal and monetary discipline. Growth has been robust, driven by both the gradual integration of Lao PDR with its fast-growing neighbors and an expansion in its mining and hydropower sectors. Over the last decade, poverty has significantly decreased. .

However, many challenges remain. Progress in strengthening fiscal management has been slow and uneven. The fiscal position is still fragile. Public debt is high. Weak revenue collections in recent years have severely strained the budget, especially because the debt service burden also has risen. Another pressing need is to address a broad array of expenditure issues, including raising civil service wages, providing additional resources for key social sectors, and increasing spending on operations and maintenance. The country's infrastructure needs to be substantially upgraded. Reforms to enhance revenue mobilization and to strengthen expenditure management will be essential to improve public sector outcomes and to ensure that the medium-term fiscal outlook is sustainable.

On the revenue side, there is a broad consensus that efforts need to focus on strengthening tax and customs administration (essential for moving ahead with the VAT). On the expenditure side, the priority is to ensure that public spending is allocated more efficiently and more closely in line with the strategic objectives laid out in the sixth NSEDP. Making progress on this front will require reforms to strengthen the planning and execution of the GOL budget. Progress in all of the above areas will depend on strengthening central government's control over revenue administration and Treasury operations in the provinces, which, in turn, will entail a comprehensive reform of intragovernmental relations.

1.1 INTRODUCTION

1. **Chapter 1 discusses the medium-term fiscal framework (MTFF) needed to address Lao People's Democratic Republic's main development challenges.** The main emphasis continues to be revenue mobilization. It is critical given Lao PDR's high public debt and substantial development needs. However, this chapter also will discuss some of the key expenditure policy issues confronting the authorities and highlight the sustainability and risks of the medium-term outlook.

2. **The chapter is structured as follows:** (a) section 1.2 reviews recent economic developments, focusing on the government's efforts to consolidate the economy's recovery from the crisis in the late 1990s; (b) section 1.3 presents a medium-term fiscal framework and discusses the main challenges and risks involved in the medium-term fiscal outlook; and (c) section 1.4 concludes and summarizes the main recommendations.

1.2 RECENT ECONOMIC DEVELOPMENTS: RECOVERY FROM CRISIS

3. **In early 2001, when the GOL was formulating its fifth development plan, Lao PDR was just emerging from a major economic crisis.** The crisis stemmed from a breakdown in macroeconomic management that compounded the contagious effects of the Asian crisis in the late 1990s. The GOL managed to restore macroeconomic stability by 2001, but the costs of the crisis were high. A sharp compression of recurrent spending resulted in a collapse in funding for key social sector programs, undermining much of the country's earlier progress in improving education and health services. Civil service wages were also hard hit. Despite a significant increase in 2001, real wages were still well below their pre-crisis levels. Domestic spending was insufficient to fund operation and maintenance (O&M) costs and counterpart funds for donor projects. One consequence was a build-up of domestic arrears.

4. **Against this background, fiscal reforms focused on the following key priorities:**

- *Mobilizing revenue* to support continued macroeconomic stability and provide additional resources for key expenditure priorities
- *Reallocating budget expenditures* to address the bias toward capital outlays and correct the heavy emphasis on economic over social sector spending
- *Ensuring a sustainable fiscal framework* by prudently managing debt and containing contingent liabilities in the state-owned commercial banks (SCBs) and state-owned enterprises (SOEs)
- *Strengthening budget management and control to improve budget outturns.* There also was a push for greater transparency and accountability in the budget process, which was also important to donors, because high fiduciary risk was a major barrier to increasing levels of donor support.

5. **At the central government level, making progress toward these objectives has proved to be more difficult than expected, partly due to the central-local relationship.** Central revenue mobilization proved especially difficult (Table 2 and Figure 5). Between 2001 and 2005, instead of rising, revenues fell by over 2 percent of GDP. This decline partly reflected lower timber royalties following the GOL's decision to impose an export ban on unprocessed logs. A rationalization of the finances of the SCBs and SOEs also contributed by reducing taxes and dividends from the state sector. In addition, the revenue base was eroded by tax incentives.³ However, there is broad consensus that a fragmented revenue administration in which the provinces have responsibility for collecting a major share of the central government's revenues has been the most significant impediment to greater revenue mobilization. The current revenue structure not only has hampered efforts to improve tax administration but has also delayed the implementation of major tax reforms, such as the introduction of a VAT (Box 1). At its core, this question of revenue structure is a governance issue concerning the control of - and accountability for - public resources.

³ These included a reduction in turnover tax rates for domestic producers in 2003 and ad hoc exemptions on excises (such as tobacco).

6. **The tax administration is strongly decentralized, and declining provincial revenues are affecting the national fiscal position.** Fewer than 4 percent of tax administration employees are located at headquarters, and only 16 percent of large taxpayers are managed centrally. Provinces collect two-thirds of the national revenues, but their revenue effort is lagging behind budgeted performance. The use of unreported off-budget revenues and tax exemptions is hampering the national revenue performance. The data collection process and classification systems are weak (Box 1).

Box 1. Are Lao PDR Data Reliable?

Data collection processes and classification systems are weak. As discussed in this chapter, the Lao PFM system does not comply with international standards. Additionally, given the autonomy enjoyed by local authorities, provinces tend to underreport collected revenues and omit reporting actual expenditures. District expenditure data generally are not available. Therefore, expenditure data are (a) not fully comparable with those of other countries and (b) often inconsistent between the central and the local levels. Donors contribute to this situation because they record all outlays as capital expenditures in the Public Investment Plan, even when they finance recurrent spending.

The GOL and donors use different data. Different GOL agencies and donors do not harmonize their data sets. For example, the Ministry of Finance and the line ministries report different data on sectoral spending as a share of GDP. Often, donors work with a third figure. Additionally, these databases are not internally consistent.

Current data do not assist decision-making. The public administration information systems need to be strengthened. Indeed, weaknesses in the data system prevent authorities from making informed decisions. Intergovernmental data inconsistencies weaken the reliability of the GOL's decision-making. To make and implement its policies, the GOL will need accurate information, for example, on (a) the balance between recurrent and capital spending and (b) expenditures in priority districts or in specific social programs (primary education).

Source: World Bank, 2006.

7. **Despite difficult circumstances, the GOL maintained fiscal discipline during this period.** Apart from a brief hiatus in 2002-03, the government has kept tight control over the cash budget deficit, especially with regard to the domestic budget, which it has kept in broad balance to avoid any recourse to monetary financing of the budget. This commitment to fiscal discipline has played an integral role in the restoration of macroeconomic stability in Lao PDR in recent years.

Box 2. Central-local Relations: The Impact of the 2001 Decentralization Decree

Over the last 30 years, Lao PDR's policies on intergovernmental fiscal relations have experienced several swings. These swings have reflected ongoing tensions between the center and historically powerful provinces - whose governors hold large fiscal responsibilities - over the control of public resources. After a period of decentralization in the 1980s, the GOL reasserted central control over fiscal management in 1991 with the introduction of a new Constitution. The new Constitution, which laid the foundation for a national budget, was based on the concept of a unitary, "deconcentrated state." This concept lasted until 1997 when the GOL gave provincial governors wide responsibilities for fiscal management. This devolution was reinforced in 2001 by Prime Ministerial Decree 01 (PM 01).

All provinces have interpreted PM 01 as a mandate to take on greater responsibility for revenue administration and budget management in their jurisdictions. However, the original objective of PM 01 was to "establish provinces as the strategic unit, districts as the planning unit, and villages as the implementing unit." The decree was meant to develop a "bottom-up" approach to budget planning.

Nevertheless, the effect of the decree has been to increase the provinces' autonomy in collecting revenue. PM 01's two main operational implications are that (a) it shrank markedly the number of firms administered by the central large taxpayer unit (LTU) - from 723 to 50 - as firms were transferred to provincial tax offices and (b) it put customs posts under the control of the provinces. The new fiscal structure 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.

The fiscal structure introduced in 2001 hampered provincial revenue collection and weakened the possibility for the Lao fiscal system to develop. Rich provinces have little incentive to give resources to poor provinces. More fundamentally, the fragmentation of tax and customs administration is inherently inefficient and incompatible with the introduction of the modern tax systems required for a VAT, particularly in a developing country with weak institutions. The system also is vulnerable to tax competition to boost local trade and economic activity. These structural weaknesses are exacerbated by the center's limited authority over provincial tax offices and its weak capacity to monitor their operations.

The 2002 Public Expenditure Review/Country Financial Accountability Assessment (PER/CFAA) recommended recentralizing customs duties and increasing the responsibilities of the central large taxpayer unit. In general, the review recommended that responsibilities for tax administration be aligned more closely with revenue assignments and, where necessary, revenue-sharing arrangements be put in place. More concretely, it proposed that the responsibility for collecting customs duties be shifted back to the center and a significant portion of firms back to the central large taxpayer unit.

However, there has been only limited progress on this front over the past three years: center-province fiscal relations need to be redefined. This redefinition will require, among other factors, a national consensus on the appropriate revenue and expenditure assignments between the center and the provinces and a credible mechanism for revenue sharing and intergovernmental transfers. Appropriate accountability mechanisms for such a decentralized structure also will need to be put in place to ensure that sub-national governments have an appropriate mandate for managing public resources.

Sources: IMF, 2006, Villaincourt, 2001.

Table 2. Lao PDR: General Government Operations
(% of GDP, unless otherwise specified)

	2000-01	2001-02	2002-03	2003-04	2004-05
Revenue and grants	16.3	14.5	13.0	12.1	12.4
Revenue	13.2	13.1	10.9	11.0	10.9
Tax	10.7	10.6	8.9	9.1	9.1
Resource ¹	1.7	2.4	1.3	1.1	1.3
Non resource	9.0	8.2	7.6	8.0	7.7
Non-tax	2.4	2.5	1.9	1.9	1.9
Grants	3.1	1.3	2.1	1.1	1.4
Expenditure	20.7	18.4	18.6	15.5	15.9
Domestic expenditure	12.8	13.2	11.7	10.9	11.0
Wages ²	2.7	3.1	3.2	3.5	3.6
Interest	0.9	0.8	0.6	0.9	0.9
Other ³	9.2	9.3	7.9	6.5	6.5
Donor-financed expenditure	7.9	5.3	7.0	4.6	4.9
Overall balance	-4.4	-4.0	-5.7	-3.4	-3.5
Financing	4.4	4.0	5.7	3.4	3.5
Domestic financing (net)	1.7	0.5	0.4	-0.2	0.2
Foreign financing (net)	3.1	3.3	5.1	3.6	3.3
Discrepancy	-0.4	0.3	0.1	0.0	0.0
Memorandum items:					
Nominal GDP (fiscal year, billions of Kip)	15,197	17,719	21,549	25,555	29,313
Priority sector expenditure					
Share of total expenditure (%)	47.1	47.4	54.4	46.7	40.0
Share of domestic expenditure (%)	40.1	40.3	38.6	30.5	19.6

Sources: Lao PDR Official Gazette, various issues; and Fund staff estimates, 2006.

Notes:

1 Includes taxes and royalties from timber, hydropower, and mining sectors.

2 Includes salaries, compensations, and extra work allowances.

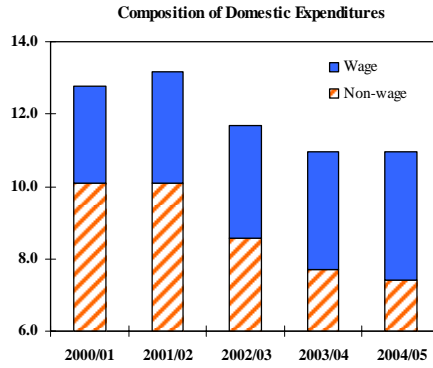
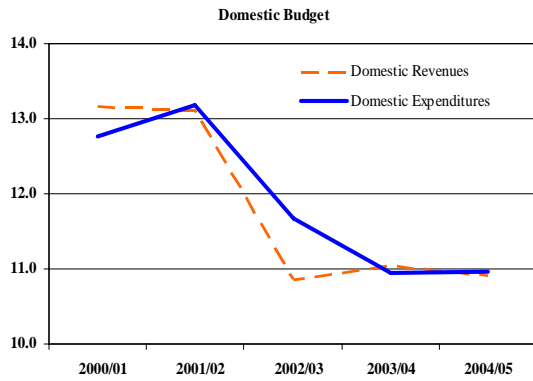
3 Includes discrepancy of 0.8 percent of GDP in 2003-04.

8. **However, the decline in revenue, combined with lower aid inflows, has resulted in a significant squeeze on spending, especially on non-wage outlays.** Between 2001 and 2005, total expenditure fell from 20.7 percent to 15.9 percent of GDP, largely reflecting a decline in donor-financed expenditure. However, domestic spending was also compressed, falling from 12.8 percent to 11.0 percent of GDP. Spending on the wage bill rose from 2.7 percent to 3.6 percent of GDP during this period, with much of the increase devoted to the Ministry of Defense (Figure 5). As a result, non-wage expenditure came under particular pressure. Some reorientation of spending toward wages and salaries was warranted, as there was scope to cut domestic capital outlays. However, with revenues under-performing, the increase in the wage bill caused non-wage spending to be overly compressed. Thus, the GOL continued to run significant domestic arrears and has experienced acute shortages of funds for routine operating expenses.

Figure 5. Lao PDR: Recent Fiscal Trends, 2001-05
 (% of GDP unless otherwise indicated)

Revenues have fallen sharply since 2001, resulting in compression of domestic expenditure...

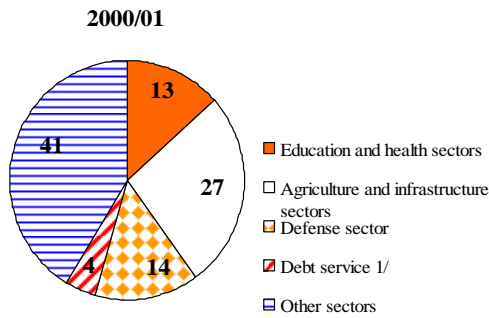
...with spending on wages rising, nonwage expenditure came under particular pressure.



The brunt of this decline in domestic expenditure has been borne by priority social and economic sectors...

... whose share of domestic spending has fallen from 40 percent to 20 percent.

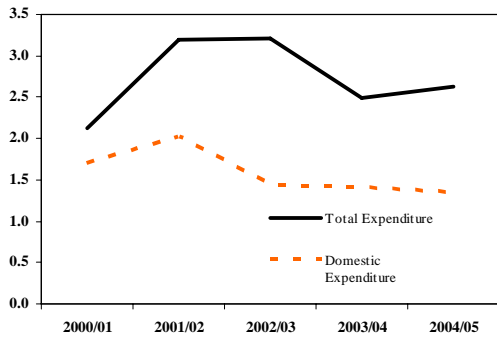
Share in domestic expenditure (%)



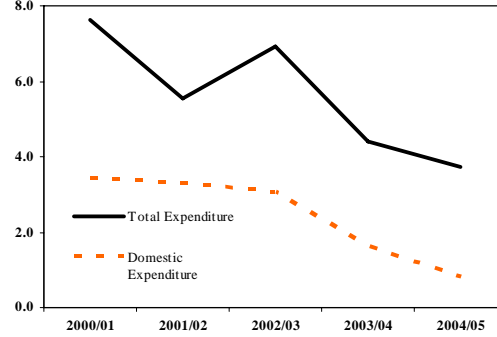
Total expenditure in health and education has increased only modestly, despite higher donor inflows...

...and lower domestic spending also has led to lower total outlays in agriculture and infrastructure.

Spending in priority social sectors



Spending in priority economic sectors

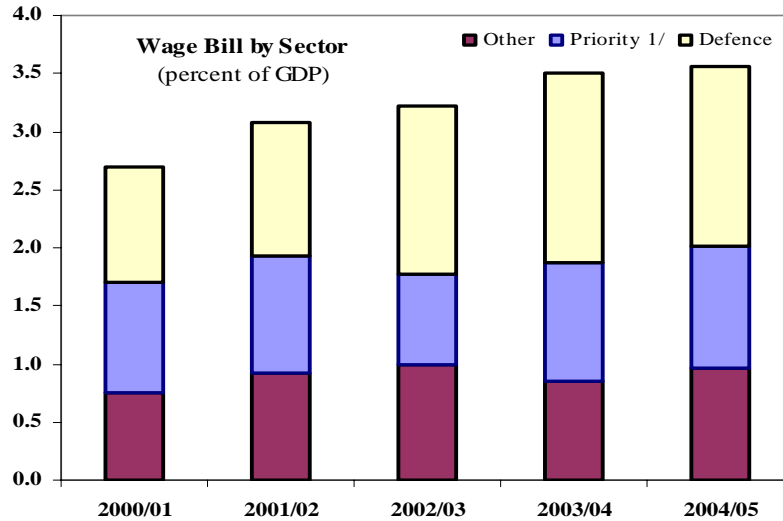


Sources: Lao PDR Official Gazette, various issues; IMF staff estimates, 2005

Note:

1 Includes debt repayment, net lending, and contingency.

Figure 6. Wage Bill by Sector, 2001-05
(% of GDP)



Sources: Lao PDR Official Gazette, various issues; IMF staff estimates, 2006.

Note:

1 Priority includes agriculture, infrastructure, education, and health.

9. **Priority sector spending was hindered by provincial autonomy.** Lao PDR is one of the most decentralized countries in the region (Figure 7), and most of the spending in priority sectors is executed by the provinces (Table 3). However, they lack the administrative, legal, and technical capacity to be held accountable to central authorities. Equally important, they also lack bottom-up mechanisms through which local preferences can be expressed and translated into expenditure priorities. As a result, the governors' *autonomy without accountability* has entailed wide variations in sectoral spending among provinces

Figure 7. Expenditure, Sub-national Level, 2006 (%)

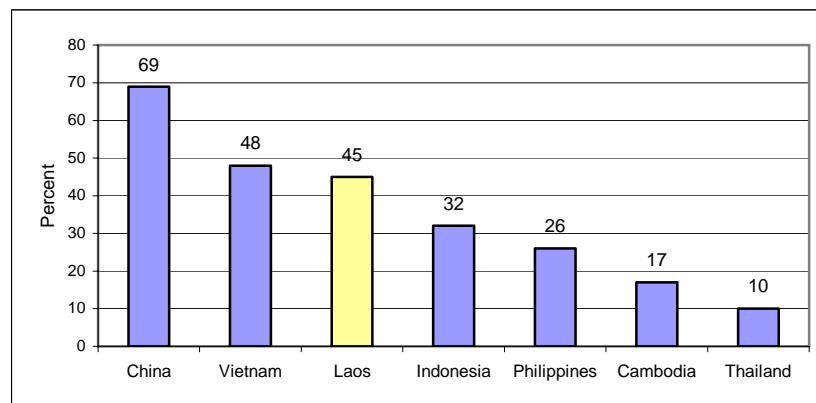


Table 3. Revenues and Expenditures, Administrative Classification, 2002-03 (%)

	<i>Aggregate revenues</i>	<i>Aggregate Expenditures</i>	<i>Educ. expenditures (w/o ODA)</i>	<i>Health expenditures (w/o ODA)</i>
<i>Center</i>	40	56	22	27
<i>Provinces</i>	60	44	78	73

10. **Some progress has been made in increasing social spending as a result of increased donor outlays.** (Table 4). Between 2001 and 2005, total expenditure on education and health rose from 2.1 percent to 2.6 percent of GDP. However, the increase in donor funding partly offset a reduction in domestic outlays in these sectors, which fell from 1.7 percent to 1.3 percent of GDP. Total spending on agriculture and infrastructure also fell as donor funding and domestic outlays in these key economic sectors both fell sharply. While the decline in domestic spending in these priority sectors partly reflected the general squeeze on the domestic budget, the share allocated to these sectors also declined, crowded out by higher debt service and increased outlays for the Ministry of Defense.

Box 3. Expenditures in the Priority Districts

No institutional mechanism is in place in the national budget to target priority districts. The government seems to channel resources to the neediest districts by (a) favoring the poorest districts' projects in the prioritization meetings at the provincial level and (b) directing donor funding to the poorest areas. However, the central government has set no minimum allocations for priority districts.

Nevertheless, perception data and results from the poverty analysis suggest that public spending in priority districts has increased and is effective. Evidence from the Poverty Assessment, Public Expenditure Review, and fieldwork in the provinces shows that social indicators in the priority sectors are improving beyond the national average.

A proper analysis of public expenditure in the priority districts is not possible due to the poor quality of local information systems. The current system may allow the collection and analysis of sectoral expenditure at the provincial level but not at the district level. As a result, linking public expenditure in the priority districts (or any other district) with poverty is not feasible.

In the next years, it will be necessary to improve monitoring mechanisms for district expenditure to assess the effectiveness of the government's poverty strategy. Provincial line agencies should start screening their expenditure by district to enable better targeting in the poverty strategy programs. The new Budget Law (under preparation) will set *binding minimum allocations* to be spent in the priority sectors by the provinces, but it remains unclear whether the new budget will facilitate monitoring district expenditure.

Source: World Bank, 2006.

11. **Although public debt has been declining as a share of GDP, it remains high.** At the end of 2005, the stock of external debt is estimated at \$2.1 billion (75 percent of GDP) with a net present value of \$1.5 billion.⁴ At these levels, Lao PDR's debt indicators are significantly above the indicative thresholds for countries with weak institutional settings, as measured by the World Bank's Country Policy and Institutional Assessment Index (Table 3). Concessional borrowing from the Asian Development Bank (ADB) and the World Bank accounts for the bulk of the increase in public debt since 2001. While the external debt service burden has remained manageable due to the high degree of concessionality of the

⁴ The stock of domestic public debt is small (1.5 percent of GDP).

borrowing, the debt service to revenue ratio rose from 15.3 percent to 21.7 percent between 2002 and 2005, bringing it close to the indicative threshold for potential debt distress.

**Table 4. Lao PDR: Composition of General Government Expenditure
(% of GDP, unless otherwise indicated)**

	2000– 01	2001– 02	2002– 03	2003– 04	2004–05 <i>Est.</i>
Total expenditure	20.7	18.4	18.6	15.5	15.9
Domestic	12.8	13.2	11.7	10.9	11.0
Wage	2.7	3.1	3.2	3.5	3.6
Non-wage	9.6	9.0	8.1	6.1	5.6
Debt service ¹	0.6	1.1	0.4	1.3	1.8
Donor	7.9	5.3	7.0	4.6	4.9
Education and health	2.1	3.2	3.2	2.6	2.6
Domestic ²	1.7	2.0	1.4	1.5	1.3
Wage	0.8	0.9	0.7	0.9	0.9
Non-wage	0.9	1.1	0.8	0.6	0.4
Donor	0.4	1.2	1.8	1.1	1.3
Agriculture and infrastructure	7.6	5.6	6.9	4.6	3.7
Domestic ²	3.4	3.3	3.1	1.8	0.8
Wage	0.1	0.1	0.1	0.1	0.1
Non-wage	3.3	3.2	3.0	1.7	0.7
Donor	4.2	2.2	3.9	2.8	2.9
Defense	1.8	1.8	2.3	2.5	2.2
Domestic	1.8	1.8	2.3	2.5	2.2
Wage	1.0	1.1	1.4	1.6	1.5
Non-wage	0.8	0.7	0.8	0.9	0.7
Donor	0.0	0.0	0.0	0.0	0.0
Other	8.6	6.7	5.8	4.4	5.5
Domestic	5.3	4.9	4.5	3.8	4.8
Wage	0.8	0.9	1.0	0.9	1.0
Non-wage	4.5	4.0	3.5	2.9	3.8
Donor	3.3	1.8	1.3	0.7	0.7
Debt service¹	0.6	1.1	0.4	1.3	1.8
Memorandum items:					
Nominal GDP (Fiscal year, billion of Kip)	15,194	17,726	21,549	25,555	29,313

Sources: Lao PDR Official Gazette, various issues; IMF staff estimates, 2006.

Notes:

1 Includes debt service, on-lending, and debt repayment.

2 Excludes non-budgetary revenues (such as user fees in the health sector), and the data may differ from those presented in other sectoral chapters in this PER.

Table 5. Lao PDR: External Public Debt Indicators, 2005 (%)

	<i>Indicative threshold</i>	<i>End-2005</i>
NPV of debt in % of		
<i>GDP</i>	30 ^a	52
<i>Exports</i>	100	171
<i>Revenues</i>	200	475
Debt service in % of		
<i>Exports</i>	15	8
<i>Revenues</i>	25	22

Source: IMF Lao PDR 2005 Article IV staff report.

Note: In 2004, Lao PDR fell into the "poor performer" category in the World Bank's Country Policy and Institutional Assessment Index.

12. **Contingent liabilities are an additional risk to the fiscal outlook.** The GOL has committed to issuing Kip 634 billion (2.4 percent of GDP) in bonds to recapitalize the two largest SCBs.⁵ However, this only partly covers their capital requirements, which were estimated at 5 percent of GDP at the end of 2004. Given the limited progress that has been made in restructuring the SCBs - and the possibility of further non-performing loans - a further deterioration in their capital position cannot be discounted. Although data are limited, there also is evidence that the GOL is running significant domestic arrears. Arrears to the electricity utility EDL are estimated to be running at approximately \$3.5 million (0.1 percent of GDP) a year, and sizeable arrears are reported to government contractors.⁶ The fiscal outlook is further clouded by the increase in the number of extra-budgetary funds in recent years (Table 6). The fiscal implications of these funds are not clear as only limited information on their operations is available.

Table 6. Lao PDR: Extra-budgetary Funds (2006)

	<i>Start date</i>
<i>Old Funds</i>	
Road Maintenance Fund	...
Contribution Fund for Poverty Reduction	...
Social Welfare Fund	...
<i>New Funds</i>	
Fund for Poor District Elimination	2003–04
Afforestation Fund	2003–04
Social Insurance for Public Sector	2005–06
Environmental Protection Fund	2005–06

Source: Lao PDR Ministry of Finance, 2006.

⁵ Banque pour le Commerce Extérieur du Lao and Lao Development Bank.

⁶ Between 2002 and 2005, GOL issued bonds of Kip 34 billion (0.1 percent of GDP) in settlement of its arrears to contractors who had non-performing loans at the SCBs.

13. **As is discussed more in Chapter 2, Lao PDR still experiences considerable weaknesses in budget planning and execution.** Budget planning remains poor, hampered by a lack of realism in budget forecasts, a lack of mechanisms to ensure that provincial budgets reflect national priorities, a fragmented central budget process, and a highly compressed budget cycle. In addition to poor planning, budget execution suffers from the weak authority and capacity of the Treasury and deficiencies in the systems for financial control, accounting, and budget reporting. The proliferation of GOL bank accounts, especially at the provincial level, has complicated budget management. These problems have severely impeded efforts to improve fiscal management. Insufficient fiscal transparency, due primarily to poor budget reporting, also remains a pressing concern.

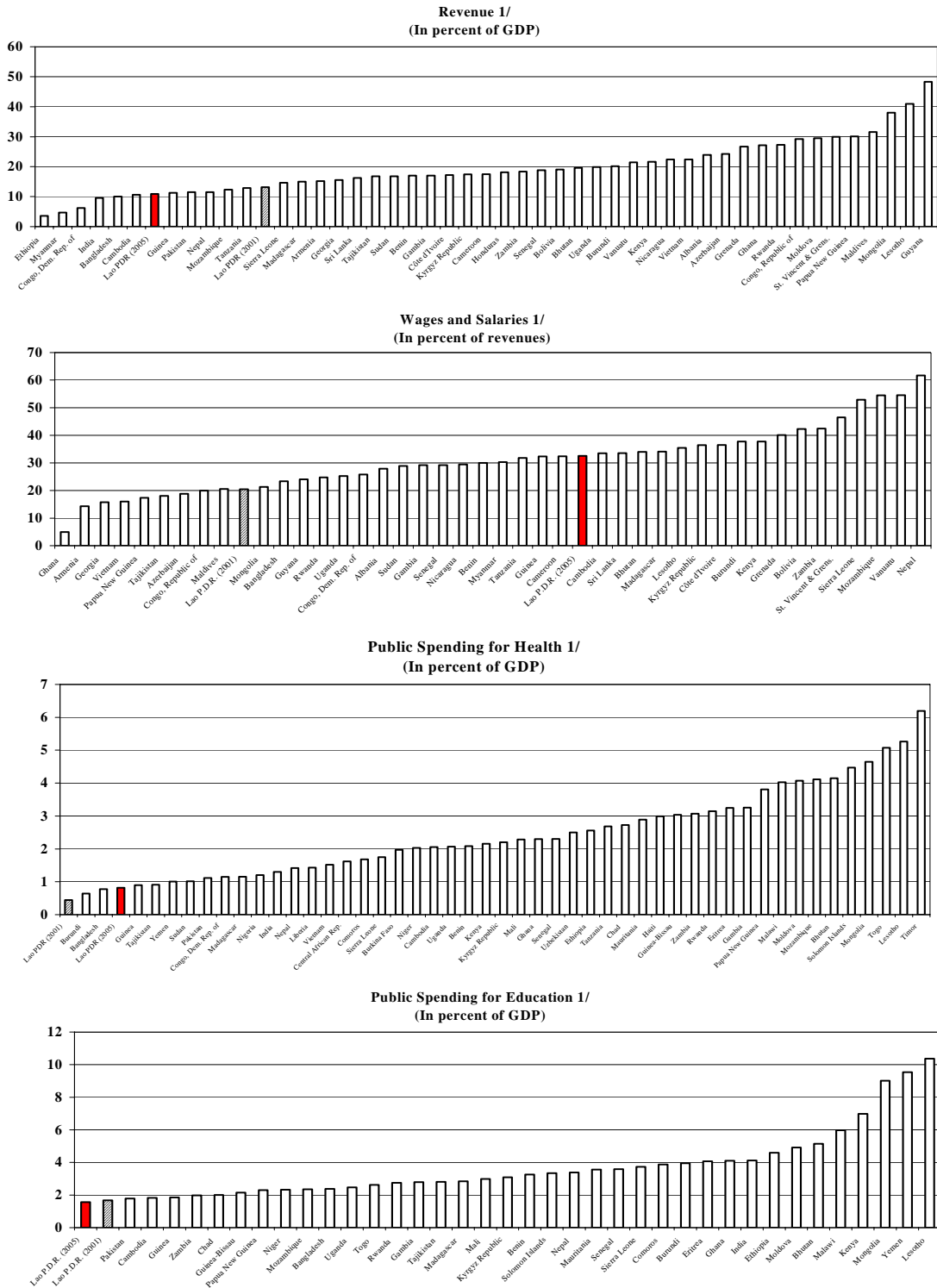
1.3 Medium-term Outlook

1.3.1 Principal challenges

14. **The main priority in the period ahead is to enable Lao PDR to meet its development needs within a sustainable fiscal framework.** This priority will require more forceful steps to address the underlying weaknesses in the GOL's fiscal position. The main challenges are:

- *Mobilizing revenues.* Lao PDR's revenue effort is among the lowest in the region (Figure 3). While this partly reflects constraints imposed by the dominance of agriculture in the economy, the country has considerable scope for improving tax policy and administration. To realize these gains, the issue of the control over local public revenues must be addressed. Recent experience - combined with Lao PDR's capacity constraints - argues for caution over the revenue outlook.
- *Increasing the efficiency of expenditure.* Two efficiency issues must be addressed: (a) ensuring an expansion of the wage bill that is prudent and allows sufficient resources for other priority needs and (b) reorienting domestic spending toward the priority sectors identified in the GOL's NGPES. Improving the management and accountability of provincial budgets will be key in this regard as they account for almost half of total expenditure.
- *Ensuring progress toward debt sustainability.* In addition to mobilizing revenues, this step will require a prudent public sector financing strategy involving (a) continuing efforts to mobilize grants and highly concessional loans and (b) ensuring that new funds are allocated to the projects with the highest economic and social return.

Figure 8. International Comparisons of Key Fiscal Indicators



Sources: World Bank, World Development Indicators 2005; IMF country reports (various years); and IMF staff calculations.

Note:

1 Data include Poverty Reduction and Growth Facility (PRGF)-eligible economies or low income economies with per capita GNI less than \$825.

1.3.2 Projected framework

15. **The medium-term fiscal framework (MTFF) presented in this chapter assumes that the policy agenda outlined in the sixth national development plan will be successfully implemented.** In addition to maintaining sound macroeconomic policies, the plan stresses the need for stepped-up efforts to implement in core structural reforms, such as mobilizing budget revenues and strengthening SCBs. These reforms will be critical for sustaining macroeconomic stability over the medium term. It also recognizes the need for progress to be made in improving the investment climate to provide a sound foundation for sustained and broad-based economic growth.

16. **Under such a scenario, between 2005 and 2010, economic growth is projected to be 6-7 percent.** GDP growth would continue to be buoyed by activity at the two large mining projects (Oxiana and Pan Australian) and the construction of the NT2 dam. Growth also would be supported by an expansion in agriculture, tourism, and small-scale manufacturing driven by trade reforms and improvements in the investment climate. The stimulus from these sectors is projected to offset slower growth in the garment industry following the expiration of the Multi-Fiber Arrangement (MFA) quota system. Over the medium term, prudent fiscal and monetary policies, underpinned by continued avoidance of monetary financing of the budget deficit and restrained credit growth, are expected to keep inflation down to approximately 5 percent.

17. **The medium-term fiscal framework and resource envelope are both set out in Table 7.** The overall fiscal deficit is projected to remain at approximately 3 percent of GDP, consistent with the need to ensure debt sustainability over the medium term and the availability of concessional donor funding. The fiscal consolidation would be driven largely by an improved revenue raising effort, with revenues projected to rise from 11.6 to 12.8 percent of GDP. Primary expenditure would remain broadly unchanged at approximately 16 percent of GDP, with interest payments increasing from 1.0 to 1.1 percent of GDP.

18. **Total donor support (loans and grants) is projected decline gradually to just under 5 percent of GDP over the medium term, reflecting a relatively modest increase in aid disbursements in US dollar terms.** While this percentage is not substantially lower than donor inflows in recent years, it is well below the levels earlier in the decade when donor support was close to 9 percent of GDP.⁷ Only a conservative estimate for general budget support (1 percent of GDP) has been included in the framework. Ideally, donor support in the period ahead should focus increasingly on funding non- wage recurrent expenditures - or, indeed, be provided in the form of budget support - rather than on capital spending. However, mobilizing such support will depend critically on the government taking steps to increase transparency and accountability in the budget process and to pursue reforms in governance. The framework includes some domestic bond issues for the recapitalization of the SCBs but, consistent with the low inflation objective, assumes no bank financing of the deficit.

⁷ Donor inflows are projected to rise temporarily to 6-7 percent of GDP in 2005-06 and 2006-07, reflecting a bunching of project disbursements.

Table 7. Lao PDR: General Government Operations 2006-10
(% of GDP; unless otherwise indicated)

	<i>Projections</i>				
	2005– 06	2006– 07	2007– 08	2008– 09	2009– 10
Revenue and grants	13.1	13.4	14.1	14.5	14.2
Revenue	11.6	12.0	12.7	12.8	12.8
Tax	9.8	10.2	10.9	10.9	10.9
Resource ¹	1.6	1.8	2.5	2.4	2.3
Non resource	8.2	8.3	8.4	8.5	8.7
Non-tax	1.8	1.8	1.8	1.8	1.8
Grants	1.5	1.4	1.4	1.8	1.5
Expenditure	17.1	17.3	17.4	17.5	17.2
Domestic expenditure	11.6	12.0	12.5	12.9	13.0
Wages ²	3.8	4.0	4.0	4.2	4.2
Interest	1.0	1.1	1.1	1.1	1.1
Other ³	6.7	6.9	7.4	7.7	7.7
Donor-financed expenditure	5.5	5.3	4.9	4.6	4.2
Overall balance	-4.0	-3.9	-3.3	-3.0	-3.0
Financing	4.0	3.9	3.3	3.0	3.0
Domestic financing (net)	0.0	0.0	-0.1	0.0	0.4
Foreign financing (net)	4.0	3.9	3.4	3.0	2.6
Memorandum items:					
Wages and salaries					
Share of revenue (%)	33.0	33.1	31.8	32.6	33.2
Share of domestic expenditure (%)	33.2	33.2	32.3	32.2	32.7
Priority sector expenditure					
Share of total expenditure (%)	45.4	47.8	48.8	49.4	49.1
Share of domestic expenditure (%)	26.5	31.4	34.6	36.7	37.3
External financing (US\$ million)	199.1	204.0	206.0	225.9	215.8
Grants	44.3	45.5	49.1	69.3	61.6
Loans	154.8	158.4	156.9	156.7	154.2
External public sector debt	72.1	71.5	69.1	66.7	63.5
Nominal GDP (fiscal year, billion Kip)	33,222	37,103	41,441	46,077	51,782

Sources: IMF staff projections, 2006.

Notes:

1 Includes taxes and royalties from timber, hydro, and mining sectors.

2 Includes salaries and benefits, compensations, and extra work allowances.

3 Includes on-lending, debt repayment, and contingency.

1.3.3 Revenue Strategy

19. **The medium-term fiscal framework hinges on successful efforts to increase revenue mobilization.** Part of the increase will be driven by higher mining royalties and taxes - mainly from the Oxiana gold and copper mine - that are projected to raise resource revenues from 1.3 to 2.3 percent of GDP.⁸ Non-resource revenues also are projected to rise by 0.9 percentage points, reflecting progress in tax reforms and efforts to strengthen tax and customs administration. These reforms also will need to offset revenue losses from tariff

⁸ Royalties and taxes from timber, mining, and hydropower projects.

reductions under Lao PDR's ASEAN Free Trade Area (AFTA) obligations, estimated at 0.5 percent of GDP (absent any reduction in leakages in customs collections).

20. **To achieve the projected increase in revenues, progress will need to be made in several areas. Introducing a VAT is still the main tax policy change in the medium term.** A full-fledged VAT with a single rate, broad coverage of goods and services, and restricted exemptions would address many of the weaknesses in the existing turnover tax. The authorities plan to introduce a VAT in early 2009. Preparations are underway, and a number of issues have been resolved, including the decision to create a single rate VAT at 10 percent. However, a detailed plan for its implementation has yet to be adopted. This plan will have to address, among other things, reforms to tax and customs administration that will be necessary for the VAT to be implemented successfully. In the shorter run, a number of other tax reforms have revenue potential. These include a further reform of the turnover tax to bring it closer into line with the VAT.⁹ There is also scope for rationalizing and simplifying the structure of excise taxes. To assist ongoing efforts to increase tax compliance, the possibility of reducing the very high rates on some products (for example, vehicles) also should be explored.

21. **The main challenge will be to introduce reforms to recentralize authority over the tax and customs administration.** As discussed, the current system of "upward" revenue sharing in which the provinces are responsible for collecting major taxes is inherently incompatible with efficient tax administration. This system also is a major impediment to proceeding with the VAT. To make progress on this front, the administration of major national taxes (such as customs and the VAT) must be centralized. This will require reforms to establish: (a) a clearer assignment of revenues and expenditures between the center and the provinces and (b) a credible mechanism for revenue sharing and intragovernmental transfers. These two reforms would lay the foundation for the provinces to cede control over administering major taxes to the center.

22. **The first step in achieving the reversion of tax administration to the center will be to improve central oversight over provincial operations.** In the customs area, the top priority should be to ensure greater oversight by the Customs Department in running the major customs posts along the lines envisaged in the new Customs Law. On the tax side, the top priority should be to re-establish a tax identification number system in the major provincial tax offices that would form the basis of a new tax reporting system. As elaborated in Chapter 2, to ensure that revenues are reported accurately and remitted to the center in a timely manner, it will be necessary to increase central control over Treasury operations in the provinces.

1.3.4 Wage bill

23. **The government needs to ensure that the wage bill does not absorb an excessive share of government revenues.** With the rise in spending on wages and salaries in recent years, the wage bill –to revenue ratio has increased significantly to over 30 percent. This increase has placed Lao PDR toward the upper end of the ratios found among low-income countries. Furthermore, the uncertainties in the revenue outlook and the broad array of spending pressures on the budget - from a rising debt-service burden to depleted non-wage

⁹ The next steps are to align the rates of turnover tax on domestic and imported goods, reduce exemptions, and ultimately adopt a single rate for the turnover tax.

budgets for priority sectors - argue for a cautious approach to increasing (potentially irreversible) commitments on wages and salaries.

24. **Provinces' hiring autonomy poses a risk in the wage bill.** The center - through the Public Administration and Civil Service Authority (PACSA) within the Office of the Prime Minister - establishes ceilings for numbers of provincial staff. However, de facto, provinces hire staff without consulting the center, which is what is largely driving the current inflation in the public sector wage bill. In addition, through the appointment of "temporary workers," provincial governors occasionally circumvent centrally established civil service restrictions.

25. **Consequently, it is proposed that the GOL should keep the growth in the wage bill in line with that of revenues.** This control should ensure that the GOL maintains an appropriate balance between the competing needs of enhancing civil service salaries¹⁰ and increasing resources for operation and maintenance (O&M) and pressing infrastructure and non-wage recurrent spending needs. By the end of the decade, under the proposed framework, the wage bill is estimated to rise to 4.2 percent of GDP. This figure would keep the ratio of wages to revenues broadly unchanged. To ensure efficient use of these resources, the government should keep employment growth under control and focused on the needs of the priority sectors. To this end, the framework assumes an employment freeze in non-priority sectors and 2 percent growth in the priority sectors.¹¹ This strategy would be consistent with an average real increase in total compensation of approximately 10 percent per year. This scenario is contingent on revenues remaining on track.¹² Ensuring a prudent expansion of the wage bill would enable the GOL to make additional resources available for non-wage outlays without jeopardizing fiscal sustainability (Figure 9).

¹⁰ Civil service salaries have only partly recovered to their mid-1990 levels in real terms. Preliminary analysis by World Bank staff suggests that a substantial gap remains relative to private sector salaries, especially at higher-grade levels.

¹¹ This would imply total employment growth on the order of 0.5 percent annually from 2006-07 onwards. These projections include an assumed annual drift of 2 percent, reflecting the general upward tendency in wages associated with structural increases (as employees progress higher up the grade ladder) and merit pay increases.

¹² A lower revenue effort would require a proportional scaling back of spending on wages and salaries.

Figure 9. Expenditure Projections by Wages and Non-wages
(% of GDP. Excludes externally financed expenditures and interest spending)

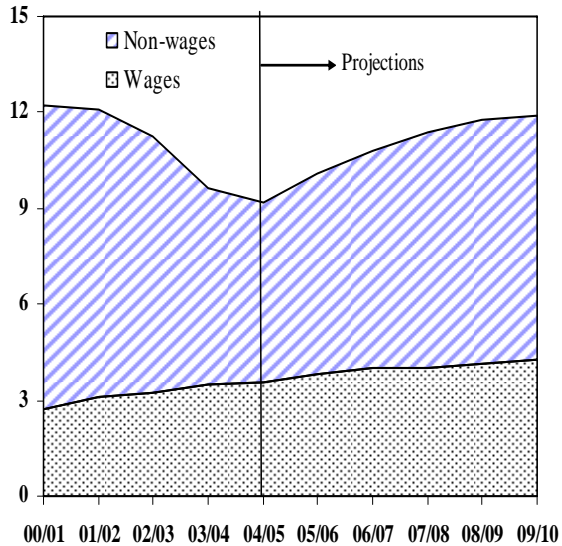
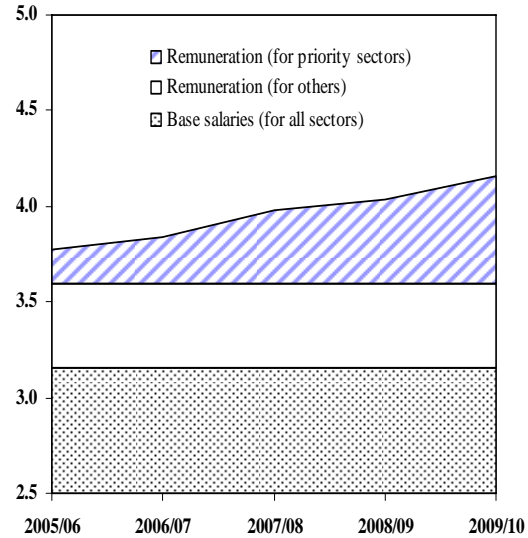


Figure 10. Total Compensation Projections by Priority and Other Sectors, 2005-10



Sources: Lao PDR Official Gazette (various issues); IMF staff projections, 2006.

26. **The GOL could make better use of the resources within the wage bill to increase the compensation of teachers and health workers.** While raising the wages and salaries of teachers and health workers faster than the rest of the civil service may be politically difficult, there is scope for targeting benefits more effectively, for example, by giving allowances for working in remote areas. For example, if the GOL kept the increase in basic wages and salaries in line with real GDP (at annual rate of 6-7 percent), then it would have resources to increase benefits for teachers and health workers at a substantially faster rate (25-30 percent per year in real terms) within the same envelope.¹³ This would translate into an annual increase in total compensation (wages, salaries, and benefits) of 15-20 percent in real terms for these employees. In addition to stemming the severe erosion of wages in priority social sectors, this approach would give citizens greater incentives to enter the education and health professions, especially in remote rural areas (Figure 10). In addition, the government would be wise to consider these issues within the context of a broader review of the civil service (Box 4).

¹³ This assumes that benefits for other civil servants also would grow in line with GDP.

Box 4. Lao PDR: Civil Service Wages and Employment

More data on wages and employment are needed to determine the magnitude of the increase in the wage bill as well as the number of civil servants in the medium term (FY2006-10). The extent to which the wage bill might increase would depend on the increase in the number of government officials. In other words, the larger the increase in the number of officials, the less room there would be to increase the wage bill. To determine the appropriate increase in employment and wages that would yield an efficient civil service, data on the number of civil servants and their corresponding wages are needed. Currently, data exists only on the number of central and local civil servants and average base salaries by grades (Box Table 4.1). Data on employment, the number of employees being promoted and leaving the civil service, and their grades are not systematically collected. Moreover, there are no employment data by rural and non-rural location. Civil servant performance measures do not exist. In addition, there are no data on the military and police employment and wages.¹⁴ Due to the lack of data, the ability of the government and other stakeholders to make policy recommendations on civil service reform is impaired.

In addition, to meet the needs in the priority sectors, the wage bill needs to be allocated more efficiently and transparently. The optimal policy would be a transparent and merit-based system of salaries and a monetized benefits system. Targeting increases in salaries and benefits to selected groups instead of providing an across-the-board increase would increase the wage bill in the priority sectors. However, given the short-term constraints that Lao PDR faces, the GOL could also use the benefits system to introduce in the wage structure the much-needed incentives for better performance in priority sectors. However, in the longer term, a more transparent and performance-based system of compensation in which benefits are monetized is preferable.

Box Table 4.1: Civil Servant Base Salaries per Month, FY2006

<i>Grades</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>	<i>6</i>	<i>Weighted average</i>
Average salaries* (Kip)	264,240	311,040	386,640	491,040	624,240	937,500	396,166
(US\$)	24	28	35	45	57	86	36
							Total
Number of employees	4,082	21,536	42,277	27,724	281	148	96,048
of which Central	232	942	2,970	7,218	210	120	11,692
of which Local	3,850	20,594	39,307	20,506	71	28	84,356

Sources: GOL and WB 2006.

Note: * = "Civil servant" excludes military and police officials.

1.3.5 Priority Sector Spending

27. **Low public spending in key sectors has contributed to poor social outcomes and has raised concern about whether Lao PDR can meet its Millennium Development Goals.**¹⁵ Despite sizeable donor contributions, public expenditures on health and education in Lao PDR are very low relative to those in other low-income economies. Partly as a result, Lao PDR is ranked 133 out of 175 countries on the basis of its human development indicators, most of which lag far behind those of other countries in the region. At the same time, low levels of spending in key economic sectors such as agriculture and infrastructure

¹⁴ Other than the rough estimate of 100,000 military and police officials, there is no other information on their employment. Their total wage bill is computed by subtracting the civil servants' wages from the total wage bill.

¹⁵ Although Lao PDR has made good progress in reducing poverty, it lags behind on four other MDGs: maternal health, child malnutrition, universal completion of primary education, and environmental sustainability.

threaten to undermine the progress that Lao PDR has made in reducing poverty and regional integration.

28. **The GOL’s recent exercise to “cost” the implementation of the NGPES has highlighted the substantial cost of implementing the plan.** Preliminary results from the costing exercises suggest that it would cost a total of \$2.25 billion, or 125 percent¹⁶ of the total expenditures of the last five years, to implement the NGPES (Box 5). For the social sectors and public infrastructure alone, financing requirements would average 9.1 percent of GDP a year, equivalent to approximately 109 percent of total revenues and grants (in nominal terms) in 2004-05. Given the outlook for revenues and donor support, it is unlikely that these financing requirements will be fully met over the next five years.

Box 5. NGPES Costing

The government of Lao PDR intends that the country will lose its status as a least-developed country (LDC) by 2020. The government articulated the development strategy to achieve this goal in the National Growth and Poverty Eradication Strategy (NGPES). The NGPES Costing Exercise was undertaken to estimate the implementation costs of the priority programs in the four priority sectors designated by the GOL: agriculture, transport, health, and education.

The preliminary costing exercise estimated the total implementation cost of the priority sectors programs at approximately \$2.25 billion from FY05-06 to FY09-10. These costs comprise \$253 million in health, \$571 million in education, \$420 million in agriculture, and \$1,004 million in transport. All sectors, excluding agriculture, later raised their projections for a revised total of \$2.77 billion. The revisions indicate the difficulties that the ministries face in planning and prioritizing within the budgeting process for the medium term. The revised needs are approximately double current sectoral allocations.

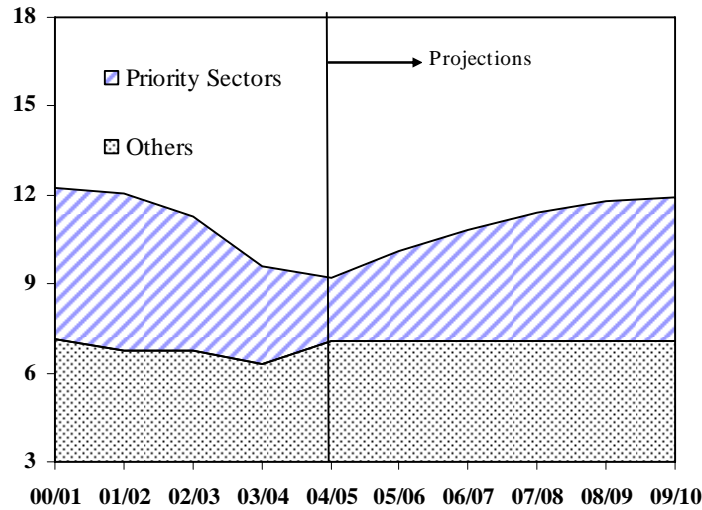
Prioritization would help to channel scarce available resources toward the most urgent needs. However, the line ministries carried out prioritization unevenly. The draft 5Y Plan uses the non-prioritized NGPES Costing results to estimate the total national financial needs for the upcoming period.

Sources: Government of Lao PDR and World Bank, 2006.

29. **To address this challenge, the composition of domestic spending will need to be adjusted to allocate more resources to the priority sectors.** Readjustment is particularly important as donor funding is projected to decline (as a percentage of GDP) over the medium term. To illustrate the gains that could be made in the next five years, the medium-term framework has kept expenditures on non-priority sectors broadly constant as a percentage of GDP. If the projected revenue gains were devoted to increasing priority sector allocations, domestic expenditures in priority sectors could be raised from 2 percent of GDP in 2004-05 to 4.75 percent of GDP by 2009-10 (Figure 11). This increase would bring the share of domestic spending on priority sectors back up to approximately half of the domestic budget. Under such a scenario, total expenditures in priority sectors could be raised from 6.5 percent of GDP in 2004-05 to 8.5 percent of GDP by 2009-10. In addition to addressing the issue of low compensation in the priority sectors, this strategy would yield additional resources to meet non-wage recurrent needs in education and health and investment needs in infrastructure and agriculture.

¹⁶ In nominal terms, planned expenditures used for 2004–05.

**Figure 11. Lao PDR: Expenditure Projections by Priority and Other Sectors, 2000--10
(% of GDP)**



Sources: Lao PDR Official Gazette (various issues); and IMF staff projections.
Note: Excludes externally financed expenditures and interest spending.

1.3.6 Key risks to the outlook

30. **The projected medium-term fiscal framework is sustainable but is subject to significant risks.** While external public debt will remain at elevated levels in the medium term, the main debt stock indicators are projected to be on a downward trend. The debt service indicators are also projected to ease with respect to revenues. This relatively favorable outlook hinges on the following key assumptions: (a) that robust GDP growth will be sustained, which in the longer term will depend on improving Lao PDR's investment climate; (b) that the mobilization of revenues will progress; and (c) that public borrowing will be restrained and on concessional terms.

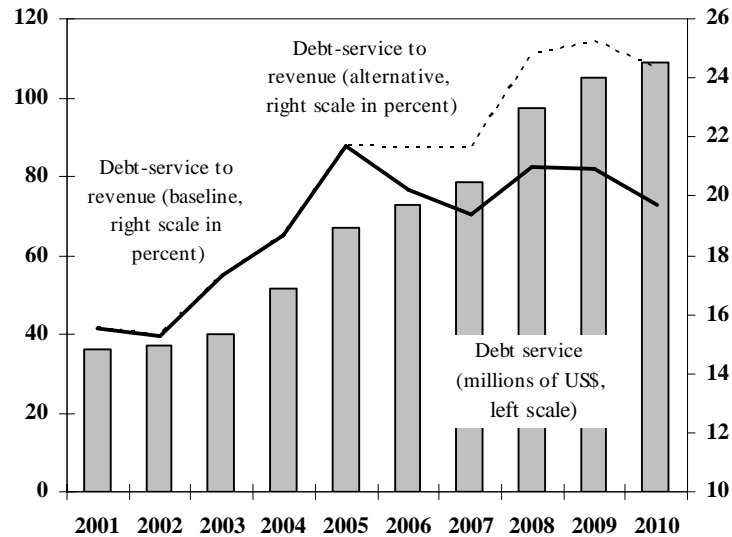
31. **The main risk is on the revenue outlook.** Even under a relatively optimistic scenario, in which revenues rise by 1.75 percentage points over the next five years, debt service indicators remain high (Figure 7). Increased mining royalties and taxes will boost revenues.¹⁷ However, the scenario hinges on an acceleration of reforms to domestic taxes, which will require making progress on the sensitive issue of center-province relations. The absence of such reforms further delaying the introduction of a VAT. Consequently, non-resource revenues would decline further over the medium term as AFTA tariff reductions are implemented, broadly offsetting the increase in resource revenues. If revenues were to continue unchanged at 11 percent of GDP, the fiscal outlook would be less benign, with the debt service ratio rising significantly.

32. **Such a revenue shortfall also would have negative consequences for expenditure.** The GOL's track record of fiscal discipline in recent years is likely to be a bulwark against a

¹⁷ The outlook for mining revenues also is subject to some uncertainty. While they are based on conservative commodity price assumptions, the parameters for profit taxes had to be estimated, as they are confidential. Another assumption is that the provinces will fully remit these revenues to the center.

return to monetary financing of the deficit. Instead, if revenues were to perform poorly, the most likely outcome would be further expenditure compression. There would be limited room to raise civil service wages and increase resources for priority sectors, such as education and health. O&M expenditure would also be squeezed, possibly resulting in an accumulation of domestic arrears to SOEs and others.

Figure 12. Lao PDR: External Public Debt Service



Sources: Lao PDR Ministry of Finance, Bank of Lao PDR, and IMF staff projections, 2006.

Note: Projections start from 2006.

33. **Furthermore, constraining fiscal space with this weak revenue effort could create pressures to increase public sector borrowing.** In a slow reform scenario, an increase in donor aid is unlikely. If anything, the supply of aid may diminish. Therefore, any increased borrowing would have to come from non-concessional sources. A combination of lower revenues, higher borrowing, and a decline in the average level of concessionality in new borrowing would give rise to the possibility of debt distress. Increased borrowing could take subtler forms. The most obvious would be quasi-fiscal activities, such as directed lending at the SCBs, which has been the primary source of the high levels of non-performing loans at these banks.

34. **There also are risks stemming from a potential accumulation of contingent liabilities.** The SCBs' capital deficiency is estimated to be 5 percent of GDP. However, this amount could increase if progress is not made in restructuring these banks. Despite some improvement in recent years, the SOEs' financial position generally remains weak. (Many still face pressures to be involved in businesses that are not entirely commercially viable.) Finally, considerable uncertainty remains about the true stock of domestic arrears and the financial position of the off-budget funds.

1.4 MAIN CONCLUSIONS AND RECOMMENDATIONS

35. **The immediate priority of the GOL is to strengthen fiscal management.** Doing so is critical for ensuring continued macroeconomic stability, an essential ingredient for growth.

Stronger financial management is also critical for increasing resources for public spending programs that are essential for achieving sustained progress in alleviating poverty.

36. Strengthening fiscal management will require, among other things: (a) mobilizing revenues; (b) increasing the efficiency of expenditure; and (c) ensuring progress is made toward debt sustainability. Failure to make progress on these challenges will jeopardize the sustainability of the fiscal framework and render the fiscal outlook less benign. Failure would have negative consequences for priority expenditures and increase pressure to raise public sector borrowing.

37. The following key recommendations emerge from the analysis undertaken in this chapter:

- **Revenue mobilization:** (a) Recentralize tax and customs administration and establish a credible mechanism for revenue sharing and intragovernmental transfers as well as a clearer assignment of revenues and expenditures between the center and provinces and (b) introduce a VAT system, with a single rate, broad coverage of goods and services, and minimum exemptions by 2009.
- **Wage bill:** (a) Restrain the growth in the wage bill in line with that of revenues to keep the ratio of wages to revenue broadly constant; (b) limit discretionality in staff hiring decisions in the provinces; and (c) keep employment growth under tight control and focused on the needs of the priority sectors.
- **Priority sector spending:** (a) Align public sector spending with the strategic objectives laid out in the sixth national development plan and (b) devote revenue gains to increasing priority sector allocations by keeping domestic expenditures on non-priority sectors broadly constant as a share of GDP.

2. CORE SYSTEMS: PUBLIC EXPENDITURE MANAGEMENT

Achieving socially inclusive development in Lao PDR will require sustained efforts to improve public expenditure management (PEM), because its existing capacity and institutions remain weak, which is frustrating efforts to achieve growth and reduce poverty. Since 2002, the GOL has taken various actions to improve its PEM (Box 10), and the MOF has taken the first steps in establishing and starting to implement a highly ambitious and compressed agenda, the Public Expenditure Management Strengthening Program (PEMSP). The PEMSP, which covers FY2005-FY2009, was approved by the Prime Minister's Office in January 2005. While some initial progress has been made in implementing aspects of the strategy, progress has been slower than originally anticipated. If the PEMSP goals are to be achieved, a careful prioritization of the numerous proposed actions is needed, as well as a systematic assessment of the detailed practicalities of implementation. PEM is a "whole of government" activity. Thus, there will need to be commitment and action not just by MOF but also by every branch and level of government. In particular, the PEMSP should be used to promote a high-level dialogue on central-local fiscal relations in Lao PDR. The NT2RMAs also need to be fine-tuned to fit the revised and re-phased PEMSP.

2.1 INTRODUCTION

38. **This chapter discusses public expenditure management (PEM) in Lao PDR within the context of the PEM Strengthening Program (PEMSP).** The focus is on prioritizing an extremely ambitious agenda and on identifying practical steps by which progress can be made on the strategically most important actions. Section 2.2 focuses on fiscal planning and budget preparation; (b) section 2.3 tackles budget execution, accounting, and financial reporting; (c) section 2.4 turns to local government financial management; (d) section 2.5 reviews financial legislation and the regulatory framework; (e) section 2.6 focuses on capacity building; and (f) section 2.7 concludes and summarizes the main recommendations.

2.2 FISCAL PLANNING AND BUDGET PREPARATION

39. **A reliable PEM starts with sound fiscal planning and budget preparation.** A good budget, the foundation stone of sound PEM, should be prepared within a realistic fiscal envelope. Subject to this constraint, it is as close as possible to a financial mirror of a nation's socioeconomic development strategy.

2.2.1 Current status

40. **Lao PDR has numerous challenges with fiscal planning and budget preparation, but four of these are fundamental and require earliest attention.** These four challenges are: (a) a lack of realistic fiscal forecasts, (b) the lack of a mechanism to ensure that provinces reflect national priorities in their budget plans, (c) the fact that the budget process

is currently fragmented institutionally and by type of expenditure, and (d) the budget cycle is overly compressed.

41. **The first challenge is the lack of realism in the central and provincial fiscal forecasts on which the budget is prepared.** Each year, the National Assembly (NA) has approved a budget based on a revenue forecast that external observers (including the IMF and the World Bank) have warned is unrealistically high. Each year, a significant portion of these revenues has failed to materialize. As a result, the budget has become increasingly irrelevant as a planning tool. The MOF is quite capable of preparing a realistic fiscal forecast. The problem is governance - specifically the pressure felt by the MOF to assume improvements in revenue collection that are not matched with tax policy changes or revenue administration strengthening measures. More revenue collection requires changing tax policy and taking tough steps to strengthen revenue administration. Even then, revenue growth will be gradual.

42. **Poor fiscal marksmanship has not resulted in aggregate fiscal indiscipline** as the GOL has found ways to reduce spending when planned revenues do not materialize. However, spending can be reduced only by *cash rationing*, which seriously distorts resource allocation not only in the budget but also across the economy. Priorities are distorted. Education, health, and non-wage recurrent expenditures are often squeezed below budgeted amounts. Arrears are built up, including to SOEs and other enterprises. These companies consequently are loss-making and unable to invest and grow and run up non-performing loans with state commercial banks.

43. **Cash rationing weakens the authority of the Lao PDR leadership by transferring *de facto* authority to Treasury officers.** Thus, Treasury officers - rather than the National Assembly and elected politicians - end up deciding which invoices to pay and which to add to accounts payable. Revised budgets are a sensible attempt to ensure that the reallocations are at least approved by the National Assembly at midyear. However, it would be far better if the original budgets were realistic. The time saved on not having to prepare a revised budget then could then be used to start the next year's budget preparation process earlier.

44. **The second challenge is the lack of a mechanism to ensure that provinces reflect national priorities in their budget plans.** Lao PDR has a highly decentralized system of public expenditure management. Forty-five percent of the budget or more is assigned at the sub-national level. Because of the governors' *autonomy without accountability*, provincial administrations have extensive discretion over the use of these resources. Among other things, this authority allows for wide discrepancies among provinces on per capita expenditures in priority sectors such as education and health.

45. **Decentralization can bring many benefits, but it *requires* mechanisms to connect local and national priorities and strong accountability to local people.** Lao PDR has an NSEDP, an NGPES, and national priority sectors and programs. Nevertheless, the provinces' budget allocations diverge substantially from the country's national priorities. Lao PDR has no specific purpose grants or ring-fenced minimum allocations for national priorities. Due to provincial control, central sector ministries and the MOF have almost no influence over how resources are allocated among sectors and programs. Instead, governors' offices in the provinces make these decisions. Donor-funded projects are often the nearest thing that central ministries have to a specific purpose grant or other mechanism for delivering national priorities at the local level.

46. **Challenge number three is a budget process that is fragmented institutionally and by type of expenditure.** Lao PDR has separate finance and planning functions at the central and local levels and is dependent on donors to provide a large proportion of project aid. Coordination between capital and recurrent expenditures remains weak. The responsibilities of the MOF and the Committee for Planning and Investment (CPI) are not clearly delineated, and the government has established no formal mechanisms by which they can work jointly. The CPI takes inadequate account of recurrent cost implications in investment appraisals. The proportion of capital expenditure is strikingly high, notably in the health sector. For example, the number of Lao PDR's hospital beds compares favorably with that of richer countries, but its health workers do not receive their salaries on time.

47. **The existing project aid management and expenditure classification does not enable balancing capital and recurrent spending.** Ring-fenced arrangements for project aid mean that the GOL has little real control over project grant resources. Although the United Nations (UN) recently established mechanisms for GOL-donor dialogue, most project funds are managed off budget. Furthermore, the GOL tends to be passive in accepting most donor proposals, even though these carry counterpart contributions and ongoing recurrent cost implications. Since 2002, donors have started financing the recurrent costs implicit in their projects, so the capital-recurrent balance has improved. However, the Public Investment Program (PIP) still classifies the donor-financed recurrent component of donor-funded projects as "capital." This ongoing misclassification does not permit an accurate assessment of the total recurrent expenditures. Only a small amount of aid is provided in the form of budget support through Poverty Reduction Support Operations (PRSO) and other vehicles. In the future, the GOL should develop arrangements to improve the reporting and recording of donor-financed expenditures. Mongolia's system (Box 6) is worth examining.

Box 6. Reporting Donor-financed Expenditures in Mongolia

Mongolia receives an average of US\$110 million each year as foreign-financed development expenditures and approximately US\$20 million as program loans and grants. In 2001, the GOL established a centralized debt management unit at the Treasury Department in the Ministry of Finance. The GOL also deployed a debt management and recording system. By capturing information on foreign-financed project and program loans, this system has reduced data inconsistencies and improved reporting on loan funds.

However, information on foreign grants remains sketchy because of project special accounts and donors making disbursements directly to vendors. The GOL has been discussing with donors the need to shift all special accounts into the consolidated Treasury Single Account (TSA), which has been in operation since 2003-04. With the deployment of a Government Financial Management Information System (GFMIS) in 2005 based on unified and consistent chart of accounts, it is now possible to track funds flows at the item and program levels. With a view toward using the TSA for foreign-financed development expenditures, donors are reviewing the checks and controls within GFMIS. It is expected that, as donors use the GFMIS, it will be significantly easier to access grant information.

Sources: Government of Lao PDR and World Bank, 2006.

48. **The fourth challenge is the overly compressed budget preparation cycle.** Only a very high-level two-page budget plan is approved ahead of the October 1 fiscal year start date (Table 8). Budget details are not finalized until February and are not published until close to the end of the fiscal year or even after it is over (too late to guide spending). The National Assembly does approve the final detailed budget. Allocations to priority sectors are reported to the National Assembly and the public in the National Gazette when it is too late to do

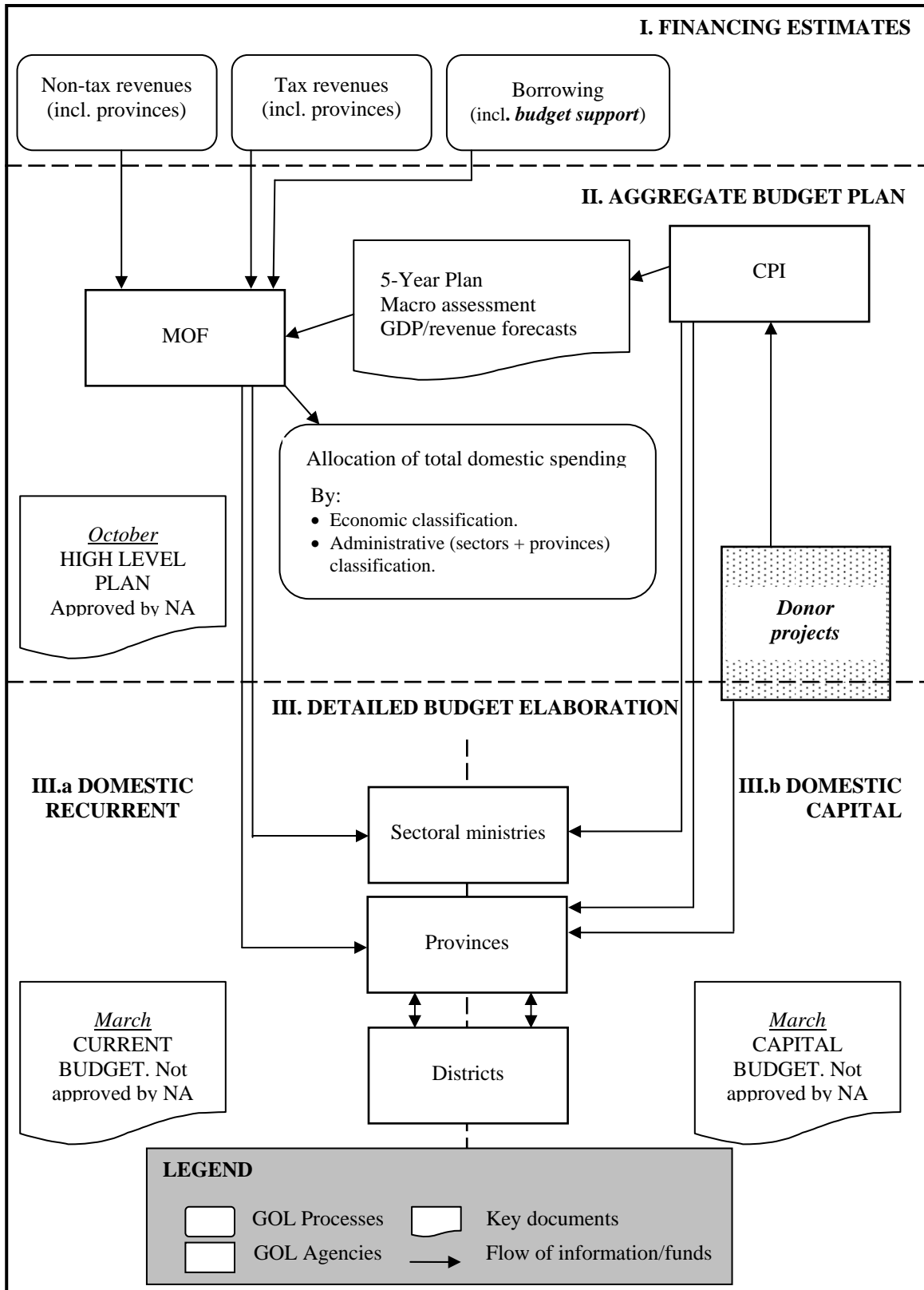
anything about them. The compressed budget cycle leaves almost no time for dialogue among the MOF, sector ministries, and provinces. The budget is not published in time for there to be any substantive dialogue with non-GOL partners. The budget process is far from transparent, and there is little participation by mass organizations, donors, business, the media, and stakeholders other than the GOL.

Table 8. Lao PDR: Budget Cycle

<i>Month</i>	<i>Existing budget cycle</i>	<i>Improved budget cycle?</i>
November		Fiscal Policy Department prepares revenue estimates for budget
December		The MOF prepares “high-level” state budget framework The MOF sends notice of target revenue and expenditure increases to sector ministries and provinces
January		Sector ministries and provinces submit outline budget proposals to the MOF The MOF compiles “high-level” budget based on submissions from ministries and provinces
February		The MOF submits draft “high-level” budget plan to the GOL
March		The GOL submits “high-level” budget plan to March/April session of the National Assembly March/April session of the NA approves “high-level” budget plan
April		The MOF informs sector ministries and provinces of their “high-level” budget envelopes and requests detailed budgets to be finalized within these constraints.
May	Fiscal Policy Department prepares revenue estimates for budget	Sector ministries and provinces prepare detailed budgets
June	The MOF prepares a “high-level” state budget framework The MOF sends notice of target revenue and expenditure increases to sector ministries and provinces	The MOF receives final submissions from sector ministries
July	Sector ministries and provinces submit outline budget proposals to the MOF The MOF compiles “high-level” budget based on submissions from ministries and provinces	The MOF receives final submissions from provinces
August	The MOF submits draft “high-level” budget plan to the GOL	The MOF consolidates final detailed budget
September	The GOL submits “high-level” budget plan to September/October session of the National Assembly September/October session of the NA approves “high-level” budget plan	Final detailed budget is submitted to September/October session of the National Assembly (ahead of start of fiscal year on October 1) Final detailed budget is published in the National Gazette (ahead of start of fiscal year on October 1)
October	FISCAL YEAR BEGINS The MOF informs sector ministries and provinces of their “high-level” budget envelopes and requests detailed budgets to be finalized within these constraints	FISCAL YEAR BEGINS
November	Sector ministries and provinces prepare detailed budgets	
December	Final submissions are received from sector ministries	
January	Final submissions are received from provinces	
February	The MOF consolidates final detailed budget	
March	Final detailed budget is submitted to the NA and published in the National Gazette (six months into fiscal year)	

Sources: Government of Lao PDR and World Bank, 2006 .

Figure 13. Budget Process and Flow of Information and Funds



Sources: Government of Lao PDR and World Bank, 2006 .

49. **Other problems with fiscal planning and budgeting in Lao PDR include:**

- *Continuing off-budget funds at the central and provincial level, including retained “technical revenues” (user charges) and various statutory and non-statutory funds.* The absence of such expenditures means that neither the budget nor financial reports reflect the true GOL fiscal position or the actual allocation of resources between priorities. On the provincial side, local authorities seem to make extensive use of off-budget funds, which they do not report to the central administration.
- *Deficiencies in the budget nomenclature,* which remains overly detailed, does not include a functional classification. The nomenclature also muddles administrative and economic classifications in a way that is not compatible with the IMF’s internationally recognized “Government Finance Statistics” (GFS) classifications.
- *Little systematic monitoring and evaluation (M&E) of performance information* to feed back into budget planning.
- *Procurement planning is not integrated effectively in the budget preparation process.* Budgetary allocations are based on annual procurement plans, which do not provide realistic cost estimates and expenditure forecasts. Insufficient local funds to cover contractual commitments and the frequent reallocation of budgets of the procuring entities during the fiscal year often result in not being available to make contract payments on time.
- *The short-term horizon also is an issue.* A Medium-term Expenditure Framework (MTEF) was included in the NGPES, but it was more of an aggregate fiscal framework than an expenditure framework and did not include expenditure breakdowns by ministry, province, central/local level, sector, or sub-sector.

2.2.2 Strategy, Progress, and Emerging Issues

50. **First, Component A of the PEMSP should address the most pressing and fundamental problem, which is the lack of realism in the one-year fiscal forecasts.** The biggest effort should be made in strengthening the fiscal planning that underpins the annual budget process. Until the annual budget process is based on reliable forecasts, it would be premature to focus significant efforts on long-term forecasting. The MOF could develop a simple macro-fiscal framework to project revenues for the year ahead. However, the main challenge is to make decision-makers more aware of the benefits of realistic budget planning. In addition, the MOF could consider establishing a marginal contingency reserve in every budget. The reserve would remain unallocated in the budget and would be drawn down only in the event that revenues exceeded forecasts.

51. **Second, Component A of the PEMSP should emphasize developing annual budgets based on NGPES priority sectors.** Doing so would be a recognition of: (a) the benefits of linking the priority-oriented and forward-looking NGPES with the budget process, (b) the revenue management arrangements required by the international financial institutions (IFIs) under the NT2 Project (page 56), and (c) the need to integrate the analysis of current and capital budgets as a basis for allocating resources for service delivery in NGPES priority sectors more coherently. Although some progress has been made,¹⁸ the budget nomenclature

¹⁸ The GOL has described various “programs” as NGPES priorities, has carried out work to “cost” the NGPES priority programs, and Public Expenditure Tracking Survey (PETS) have been launched.

and Chart of Accounts (COA) still do not include functional or program classifications. Moreover, the NGPES priority programs have yet to be defined to correspond to the budget nomenclature and the COA, so that they can be operationalized without program classifications. The GOL's Government Financial Information System (GFIS) will not support program coding or performance information, but it can support sector and sub-sector coding. The GOL should define its NGPES priorities at the sectoral and sub-sectoral levels and not as programs. It also should track the resources for NGPES priorities that are allocated in budget plans and delivered in budget execution. These expenditures need to be tracked using the systems that are available or that can be developed in a reasonably short time.

52. **Third, the MOF in consultation with sector ministries and provinces should develop and pilot a system of provincial budget allocation norms for the NGPES/NSEDP priority sectors.** These norms should be developed in a participatory way and should adopt a simple and transparent approach consistent with the principles of decentralization. A first step, agreed under the PRSO program, would be to establish minimum per capita allocations for basic education and basic health. Having minimums in place would ensure that all provinces allocate at least these amounts to these national priorities. In the medium term, once revenue collection has been considerably improved, the MOF might consider introducing a system of earmarked grants to fund targeted expenditures in the priority sectors.

53. **Fourth, the GOL should revise the budget cycle to ensure that a detailed budget is ready for approval by the National Assembly every October.** To this end, the GOL should ask the National Assembly to approve the high-level budget plan in its March session each year, six months before the start of the fiscal year. Following six months of elaboration and dialogue with provinces and sector ministries, the National Assembly would then approve the detailed budget in its October session (Table 8).

54. **In the longer term, an MTEF will be an important tool for planning and budgeting in Lao PDR.** The country's short-term budgeting horizon is a deficiency, and the progress that has been achieved so far is valuable, both as capacity building and as an end in itself. However, moving beyond the current very simple MTEF would be premature at this stage and might divert attention from more pressing and fundamental problems associated with the annual budget cycle.

55. **In addition to these priorities, the GOL should build on the progress it has already made to strengthen the monitoring and evaluation (M&E) of budgets.** Good M&E is vital to ensure that budgeting is based on sound policy analysis. The establishment of joint GOL-donor Public Expenditure Reviews (PERs) itself is an important step toward better evaluation of the GOL's spending and toward greater transparency and accountability in the use of public funds. The GOL has decided to keep the PETS and the PERs participatory, focused, and regular. The involvement of the "whole of government" in the PER/IFA is a practical first step toward ensuring better coordination across sectors. The involvement of the CPI and the MOF will help to ensure better coordination of plans and budget analysis and of capital and recurrent spending. The involvement of donors will also ensure better coordination of donors with one another and with the GOL's NGPES and NSEDP.

2.3 BUDGET EXECUTION, ACCOUNTING, AND FINANCIAL REPORTING

56. **Although better budget planning is necessary for better budget execution, it is not sufficient.** A badly prepared budget cannot be executed well; however, even a well-prepared budget can be badly executed. An important step in strengthening budget execution in Lao PDR is to eliminate the cash rationing necessitated by the lack of fiscal realism in the budgets approved by the National Assembly. However, given the long time horizon needed to strengthen public expenditure management, parallel efforts are needed to strengthen budget execution, accounting, and financial reporting in the shorter term.

2.3.1 Current status

57. **There are many challenges in the areas of budget execution, accounting, and financial reporting in Lao PDR, but four are fundamental and require the earliest attention.** They are: (a) the weak authority and capacity of Treasury offices at each level of the GOL; (b) the weaknesses of the Treasury's financial control, accounting, and reporting system; (c) ineffective implementation of the public procurement framework and a lack of monitoring of procurement performance and outcomes; and (d) deficiencies in public financial accountability and transparency.

58. **The first problem is the lack of authority and capacity of Treasury offices at each level of the GOL.** In effect, provincial Treasury officials report to the governor of the province, not to the central Treasury. Formally, the Treasury offices at provincial level are departments of the central Treasury and report both to the Director of the Treasury at the MOF and to the provincial Governor. In practice, the provincial Governor has much greater influence over the provincial Treasury office than does the Director of the Treasury, in part because the staff is hired at that level. This undermines the authority of the central Treasury to enforce the budget as approved by the National Assembly and undermines the unity of the state. Provincial Treasuries retain revenues intended for the central government, thus exacerbating cash constraints at the center.

59. **There is also duplication in the assignment of responsibility for payment approval and budget execution reporting.** The Treasury Department of the MOF, including its offices at provincial level, is responsible for validating, authorizing, and recording payments requested by ministries, departments, and spending units. However, both the MOF Budget Department and the provincial budget departments check invoices and report on budget execution. This is an unnecessary duplication. It both undermines the central Treasury's authority and distracts the central Budget Department from its core responsibility of budget planning and monitoring.

60. **The second challenge is the weaknesses of the Treasury's financial control, accounting, and reporting system.** Until 2005, Treasury reports have been almost entirely paper-based, with provincial information becoming available late if at all. The GOL has made good progress in establishing a unified COA – the underpinning of Treasury financial control, accounting, and reporting - to be used at every level of the GOL and consistent with the budget nomenclature and the GFIS to automate the capture of data against the unified COA. However, both the COA and the budget nomenclature need to be simplified and rationalized. They currently mix up administrative and economic classification concepts and have no functional (sectoral) classification. The nomenclature and the COA contain

numerous additional divergences from the IMF's internationally recognized and comparable GFS conventions, such as treatment of amortization above the line, and international accounting standards and practices.

61. **Budget execution reporting remains weak.** The lack of agreement on a reporting format for budget execution, together - until recently - with the lack of automation has made it difficult to use the GFIS to generate regular, timely, and accurate reports on budget execution. The reports currently prepared by the Treasury are paper-based and limited in coverage, accuracy, and timeliness.

62. **The *third* problem is the lack of effective implementation of the public procurement framework and the monitoring of procurement performance and outcomes.** In recent years, significant progress has been made in laying the foundations for an effective procurement system. The GOL has adopted new and improved rules and has created an office dedicated to establishing procurement policy and procurement monitoring practices (the Procurement Monitoring Office or PrMO). However, clear processes do not exist for: (a) managing procurement operations; (b) monitoring procurement outcomes and collecting and publishing such information; and (c) ensuring the application and enforcement of the improved rules.

63. **The *fourth* problem is deficiencies in public financial accountability and transparency.** The State Audit Organization (SAO) is mandated to audit all public sector operations, foreign-aid loan and grant investment projects, budget support, and state-owned enterprises. The SAO is responsible for auditing the GOL's consolidated annual financial statements and for providing an annual report to the National Assembly. However, the MOF provides no timely statements for audit. Due to the SAO's resource and capacity limitations, the audit coverage of public expenditures is very limited. The SAO does not publish its audit results. The SAO reports to the GOL, not to the National Assembly, so audit reports are neither published nor subject to legislative oversight.

64. **Other problems with budget execution, accounting, and financial reporting include:**

- *A lack of commitment controls.* Although the GFIS includes some mechanisms to track accounts payable, the GOL has few effective mechanisms to prevent the build-up of arrears to suppliers. The line ministries have made progress in paying the salaries to teachers and health workers more promptly but largely because of exhortation. The GOL is committed to preventing any further build-up of new arrears to Electricité du Laos, but this commitment may not be sustained without realistic fiscal planning that avoids cash rationing. Provincial short-term cash rationing has led to a build-up of arrears to contractors.
- *Weak cash management.* Cash management in Lao PDR is undermined by the large number of central Treasury bank accounts in which balances are kept and by poor cash planning. The limited data available on Treasury balances at the provincial level means that the MOF has little basis on which to prepare meaningful cash plans. The fragmentation of bank accounts makes bank reconciliation difficult and results in needless borrowing to fund local deficits in which idle balances are available elsewhere.

2.3.2 Strategy, Progress, and Emerging Issues

65. **This PEMSP component places primary emphasis on the need to strengthen the Treasury's authority;** its financial control, accounting, and reporting system; and the GOL's framework for public procurement. These priorities are strategic and appropriate. The GOL has made gradual progress in the first year of the implementation of the PEMSP, but major challenges remain.

66. **First, it is important to strengthen the authority and capacity of the Treasury.** In the NGPES, this would require the rapid approval of a strategy to restructure Treasury functions, rationalize budget execution functions, and amend Treasury decrees. However, progress has been slow. The GOL clarified in the November 2005 Budget Circular the division of responsibilities for budget execution between the Treasury and Budget Departments. Henceforth, expenditure approvals will be left to a greater extent to the Treasury. The Budget Department will play a more strategic planning and aggregate monitoring role. However, additional work is required to operationalize this new principle.

67. **Moreover, it is important to reassert the central Treasury's authority over provincial Treasuries.** Rather than centralizing the Treasury, there is a need for the GOL to clarify and strengthen the authority of the Treasury to enforce more accurate execution and reporting of the budget at every level. Strengthening should include ensuring that the provinces remit revenues to the center while the center transfers funds from those provinces that have a surplus to those provinces that are running a deficit. Clarifying and strengthening the Treasury's authority is a complex political issue that requires extensive dialogue and commitment if it is to be resolved. This issue raises fundamental questions about the distribution of authority among the functions and levels of the GOL. More significantly, the issue raises questions about the distribution of public expenditure between the more prosperous urban centers and the poorer provinces. The GOL is considering addressing this issue in the revisions to the Budget Law as well as through a Treasury Decree.¹⁹

68. **Second, the GFIS is extremely new, and more implementation work is required before the system will be fully functional. The GFIS needs to incorporate the new COA and strengthened commitment controls.** The accuracy of data entry and coding requires further verification and strengthening. Capacity, communication links, and business processes all need to be developed further to ensure better reporting between provinces and the center using the GFIS. The internal control framework, audit records, and system security all need strengthening. The revision of the COA began late but now is on track.²⁰ Changes to the COA need to be informed by dialogue and consultation with the users of government financial information. The COA revision needs to proceed in parallel with the work on budget nomenclature.

¹⁹ In addition to amending laws and practices, ways need to be found to reduce the sources of tensions between provinces and the center. In some cases, the retained surplus-province revenues in question may be more notional than real retained resources—yet another adverse impact of unrealistic revenue forecasting. More realistic revenue forecasting as part of the budget process could substantially reduce grievances and build common ground by bringing the expectations of all provinces more into line with reality.

²⁰ The MOF established a COA revision committee and appointed an international consultant to assist in the process. The consultant prepared an inception report, a process and work plan for finalizing and approving the new COA, and an implementation strategy.

69. **The GOL needs to do additional work to establish regular, timely, and accurate budget execution reporting.** The PEMSP supports a number of actions. These include: (a) devising and rolling out new monthly and quarterly report formats, procedures, and plans at each level of the GOL and (b) implementing the approved formats for the consolidated (whole of government) financial statements. The GOL needs to ensure that this work is incorporated into the development of the new GFIS. The MOF should approve a reporting format and develop the processes needed to extract the necessary data from the GFIS. This will be an important step toward more timely and informative reporting of in-year budget execution and toward the achievement of the NT2 revenue management arrangements.

70. **Third, the GOL has made initial progress in strengthening the legal and institutional framework for procurement management under the PEMSP.** Applying procurement rules and mechanisms for monitoring and oversight is key to effective budget execution, and a sound framework for implementation is being established. The GOL is developing standard bidding documents and a national procurement manual. Their early adoption together with appropriate capacity building is required to facilitate the application of the procurement rules. The GOL has decided to establish an M&E system to measure the performance and outcomes of the public procurement system, and it has recently carried out a baseline assessment and has developed a performance monitoring tool.

71. **The challenge will be to put the new systems to manage procurement and monitor performance and outcomes into operation.** Ensuring the application in practice of the improved procurement rules and standardized procedures will require a sustainable capacity building program and an effort to change the management of the procuring agencies and the PrMO. Ensuring that the new rules will be applied will also require the implementation of the M&E mechanisms. Other key measures that will be required in the short term include providing adequate international standards for technical specifications, restricting use of less competitive methods such as limited bidding, requiring the publication of contract award information, and developing a procurement website.

72. **Fourth, a notable deficiency of the PEMSP is that it pays little attention to public financial accountability and transparency.** The MOF does not prepare or publish timely budget execution reports. The absence of this information limits the accountability of government and transparency in the use of public funds. Approximately six months after the end of the financial year, the MOF publishes an annual budget execution report in the official gazette as part of the annual budget publication. However, a multitude of reports are not being prepared and presented to the SAO for audit as required by Ministerial Decision 1301/MOF of 2002. These include annual financial statements incorporating a financial position statement, a statement of assets and liabilities, a statement of receipt and payments for all sector ministries and provincial administrations, and budget execution reports for the whole of government. The GOL should implement these accounting regulations.

73. **Approved strategic plans using the new audit methodologies need to be implemented to ensure effective audit oversight of public expenditures.** The SAO is developing more comprehensive audit plans and audit methodologies in line with international auditing standards and is training staff accordingly. The MOF has prepared a five-year strategic plan and is drafting a new Audit Law for the SAO and aims to strengthen the independence of the SAO by having it report to the National Assembly. However, the inspection and review responsibilities of the GOL agencies need more clarification.

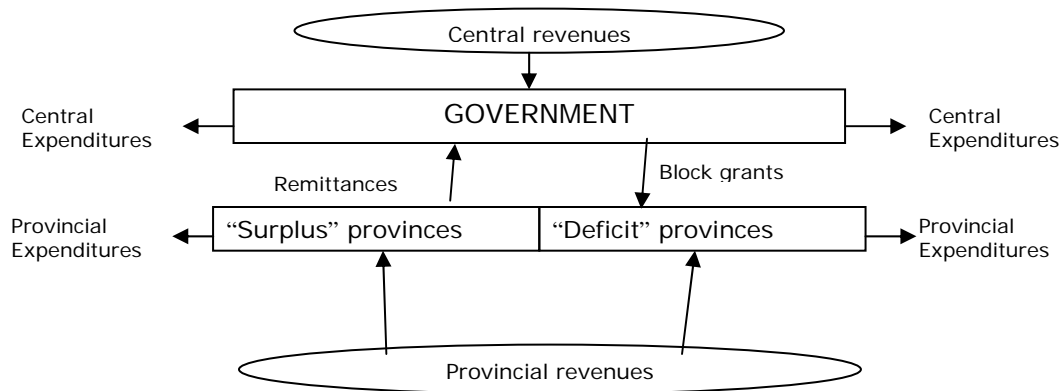
74. **None of this work is formally incorporated into the PEMSP work program or capacity building plan.** As agreed, as part of the SAO's NT2 revenue management arrangements, a peer review needs to be completed to provide a baseline assessment of the quality of the audit of public expenditures and the capacity to provide effective audit coverage and to provide a plan for continued development of an independent external audit function.

2.4 LOCAL GOVERNMENT FINANCIAL MANAGEMENT

2.4.1 Current status

75. **Lao PDR is one of the most decentralized countries in the East Asia Region.** Sub-national administrations raise most of the country's fiscal revenues, spend just under half all budgeted resources, and deliver most services in key sectors (education, health, transport infrastructure, and rural development). After China, Lao almost ties with Vietnam in terms of the proportion of its total public expenditures for which provinces are responsible.

Figure 14. Overview of Intergovernmental Fiscal Structure



Source: Government of Lao PDR and World Bank, 2006.

76. **Local authorities collect revenues and execute expenditures.** The central administration is in charge of redistributing revenues from surplus to deficit provinces. Figure 14 portrays the central-local fiscal system in Lao and shows that most of the revenues collected by the provinces are retained to fund their own expenditures. Provinces in surplus remit a part of that surplus to the center, which also collects its own assigned revenues. Provinces running a deficit receive unconditional block grants from the central government. The provinces do no borrowing.

Box 7. The Budget Process in Provinces and Districts

The budget process at the provincial-district level reproduces the central-provincial model. At the central level, the Committee for Planning and Investment (CPI) allocates the public investment program (PIP) across line ministries and provinces. Subsequently, the Ministry of Finance allocates recurrent expenditures based on number of staff rather than on specific recurrent needs generated by PIP projects. Similarly, at the local level, the provincial planning unit allocates investments across line agencies and districts, and the provincial finance office provides the recurrent budget.

In all provinces, budget planning and execution are undertaken mostly by provincial line agencies rather than districts. Provincial line agencies *de facto* act for the districts. In the budget planning process, the provincial line agencies consolidate the districts' needs into a sectoral PIP request for the province. In the implementation of the budget, provinces allocate resources to provincial sectors, which in turn finance specific projects. Districts receive a small allocation to cover their administrative needs but do not play a direct role in the implementation.

Sources: Government of Lao PDR and World Bank, 2006.

77. **Provinces and districts gradually have assumed a more crucial role in national public expenditure management.** The increase in sub-national expenditure as a share of the total budget in recent years (from 28 to 45 percent between FY1996-97 and FY2002-03) has been significant. Provinces and districts also collect 60 percent of total revenues. Insofar as this provides the budgetary space for increased expenditure on priority sector activities for which the provinces have lead responsibility, this is in line with the GOL's strategy.

78. **However, institutions and capacity for local expenditure management have not proceeded at the same pace as decentralization. The system of central-local fiscal relations in Lao PDR suffers from a number of structural weaknesses.** Decentralization can result in service delivery that is more responsive to local needs and local conditions and is more efficient and effective. However, this result is likely to be the case only if there are strong central institutions to govern central-local relations as well as strong institutions and capacity at the local level. In Lao PDR, there are structural weaknesses in the extensive control that the provinces have over revenues (Chapter 1), the way in which revenues are shared (by surplus provinces) with the center, and the negotiated block transfers that fill the fiscal gaps of the deficit provinces (Box 8).

Box 8. Intergovernmental Reform in Lao PDR

Chapters 1 and 2 mention central-local fiscal relations in Lao in connection with several problems: low revenue performance, wide and erratic expenditure variations in the priority sectors, and poor budget execution and financial reporting. These challenges all arise from underlying weaknesses in the *structure* of the intergovernmental system in Lao. This system is characterized by two core features: (a) extensive provincial autonomy, combined with extremely weak systems of accountability and (b) poor public finance and administrative systems at the provincial level and between the center and provincial administrations.

The provinces play an important role in Lao PDR. They raise 60 percent of revenue, are responsible for nearly half of all expenditures, and have primary responsibility for service delivery in priority sectors (health, education, and roads). Thus, it is unlikely that many of the problems elaborated in Chapters 1 and 2 will be tackled successfully unless there is significant reform in the structure of central-local relations and substantial strengthening of the functional systems necessary for basic administration. In this context, two basic challenges need to be met. The first concerns the central-local *fiscal* structure and the systems within it, and the second concerns *accountability relationships*.

On the fiscal side, the most fundamental reform required is a shift away from the current system of extensive provincial control over revenues, characterized by upwards-sharing (from surplus provinces) to the center and negotiated gap-filling transfers (to deficit provinces). The more desirable model is one in which the center raises most revenues, which then are shared with the provinces via a system of formula-based fiscal transfers distributed on rational and equitable grounds to fund sub-national fiscal gaps. Since this would constitute a major change from the current system, a process of extensive dialogue and technical work led by central government will be necessary to achieve it.

Intermediate steps include introducing budget allocation norms to guide provincial budgeting for the priority sectors, developing a system of earmarked transfers to support targeted expenditures, expanding the authority of the center over provincial treasury departments, introducing greater central control over the customs departments, and rolling out the GFIS. Some of these reforms are already underway, but it is important that others are started.

If the benefits of decentralization are to be realized, **a strongly decentralized system of government requires robust bottom-up accountability** between sub-national entities and their constituents as well as strong oversight and accountability institutions at the central level. In Lao, the central-local system is very weak in both of these dimensions. In the medium to long term, the GOL also will need to introduce accountability reforms.

Sources: Government of Lao PDR and World Bank, 2006.

79. Local government financial management includes two major challenges:

- a. *Public financial management and procurement skills/capacity remain weak at the local level.* Capacity needs assessments have highlighted the lack of even basic numeracy skills among personnel at some local levels of government. Meanwhile, new systems and processes that are now being developed will place new demands on the limited number of skilled staff at the local level.
- b. *While rudimentary accountability institutions exist at the central level, they are nearly nonexistent locally.* Provincial assemblies or local people's councils do not exist. Local-level expenditures are seldom audited, and there is little transparency or accountability to communities. Upward accountability to central government also is quite limited, particularly in light of the weak central Treasury.

2.4.2 Strategy, Progress, and Emerging Issues

80. **First, there should be more progress in changing the basis of resource allocation across provinces as part of the dialogue on revising the Budget Law.** The basis for allocating resources across provinces should be reviewed as part of the Budget Law revision. In addition, budget allocations among provinces need to be built on more realistic revenue forecasts if they are not be undermined by the reality of budget execution. The PRSO program is addressing the PEMSP intention to establish “indicative allocations” for priority sectors in the provinces. During PRSO2 negotiations, the GOL committed itself to preparing and issuing to all provinces a guideline on minimum per capita allocations for recurrent spending on health and education. Preparing this guideline will require the GOL to consult closely with the provinces and with the relevant sector ministries.

81. **Second, faster progress needs to be made in developing and implementing new reporting formats and standardized payment procedures at the local level.** This work will be conducted as part of the GFIS roll-out and the development of in-year budget execution reports and the new COA. However, its implementation depends on what progress is made in strengthening the authority of the central Treasury to enforce these new procedures. (The PEMSP does not address local-level financial accountability and transparency.) Simultaneously, the GOL should take steps to strengthen the transparency and accountability of institutions at the local level. As a first step, provinces should be required to publish their budgets and end-year accounts and to post these on public notice boards outside all offices.

2.5 FINANCIAL LEGISLATION AND REGULATORY FRAMEWORK

2.5.1 Current status

82. **The current Budget Law, approved in 1994, predates the significant decentralization that has occurred in Lao PDR over the past decade.** The law and subsequent implementing guidelines and regulations do not clearly set out expenditure and revenue assignments or define central-local fiscal relations. They do not specify clearly and appropriately the roles and responsibilities of different departments and levels of government in the budget process, nor the roles and responsibilities of the National Assembly. They also enforce a budget cycle that is overly compressed.

83. **The accounting and reporting legislative framework needs to be reviewed and updated to be consistent with the accounting regulations and procedures of Ministerial Decision 1301/MOF of 2002, which provides the basis for improving financial management and accountability.** Decree No. 20/PM is the main decree governing the accounting systems that are required to support the effective implementation of the Budget Law. Ministerial Decision 1301/MOF of 2002 assigns responsibilities for annual budget execution and provides accounting regulations and procedures covering revenue, expenditures, cash advances, inventories, fixed assets, payroll, accountable forms, losses and deficiencies, safe custody of public monies, retained revenue, recording and monitoring of commitments, end-of-year closure of the fiscal year, internal control systems, and internal auditing as well as the format and timing of the GOL’s annual financial statements.

84. **The legislation and regulatory framework supporting the SAO need to be strengthened.** Decree 24/PM of February 2004 sets out the responsibilities for and the activities of the state audit. The state audit also is conducted in accordance with Decree No. 159 PM of August 26, 1996, which outlines the objectives of state auditing, the principles of audits and auditing standards, and a code of ethics for auditors. However, the role of the state audit needs to be strengthened, with the SAO becoming an independent body reporting to the National Assembly.

85. **The legislative framework for procurement is broadly consistent with internationally recognized good practices.** In 2004, the GOL passed a new procurement decree and implementing rules and regulations that included significant improvements. Nevertheless, these have not yet been implemented in full. It also issued the charter of the PrMO as a division within the MOF to be the primary agency responsible for procurement policymaking and oversight. However, the PrMO's authority and capacity to carry out its functions remain weak.

2.5.2 Strategy, progress, and emerging issues

86. **First, it will be necessary for the GOL to revise the Budget Law and Treasury Decree.** A revision of the Budget Law is being prepared, with early drafts suggesting some progress. Early drafts also indicate that the final draft may address important issues regarding the budget cycle; the powers, roles, and responsibilities of key legislative and executive bodies in the budget planning and execution process; and central/local fiscal assignments and transfers. A revised Treasury Decree also is being prepared.

87. **It is imperative that the Lao leadership encourage dialogue about these matters and that the dialogue is not just a technocratic exercise.** The GOL has established a Budget Law Revision Committee with representatives from throughout the GOL. This committee should receive strong engagement by the leadership as well as carry out extensive consultation with regional and other international partners and donors. The GOL should implement decrees and draft regulations in parallel with the law to ensure that the law and decrees are consistent and can be implemented quickly.

88. **Second, a new audit law should be written to strengthen the role of the state audit and to clarify its responsibilities and reporting relationships.** This law is currently being drafted, but it is not yet clear to what extent it will address the independence and authority of the SAO or the important issue of the publication of audit reports. These reports need to be published to establish independent review and oversight of public expenditures in combination with scrutiny of audit results by the National Assembly.

89. **Third, implementing new procurement legislation remains a key challenge** (see above). Private sector companies need to be given the information that they require to become effective participants in the public procurement system. Keeping companies informed would enable the GOL to get its procurement needs met competitively and cost effectively. It will also be necessary to restrict the use of less competitive methods such as limited bidding, to require the publication of contract award information, and to allow the use of electronic means for procurement whenever technology permits. The GOL needs to

strengthen the PrMO's capacity and authority to enable it to carry out its regulatory and oversight functions effectively.

2.6 CAPACITY BUILDING

2.6.1 Current status

90. **Lao PDR has an acute shortage of staff with public financial management skills, and current capacity building mechanisms are inadequate.** The skills that are in short supply range from public expenditure analysis and planning to Treasury administration to procurement, accounting, auditing, and financial ICT. Skills shortages exist at all levels but particularly at the local level. Capacity building mechanisms are inadequate. On the GOL's side, the MOF has three training schools but their faculties are weak, they teach an outdated curriculum, and the schools operate with limited resources and facilities. There has also been little coordination of donor-funded capacity building. Although many donors are providing support in the area of PFM (including from the ADB, the European Commission, the IMF, the JICA, Sida, and the World Bank), the coordination among these donors is insufficient.

2.6.2 Strategy, progress, and emerging issues

91. **First, faster progress is needed in building PFM capacity.** This component of the PEMSP involves establishing a PFM Capacity Building Committee; conducting a needs assessment and capacity building strategy; and developing, implementing, and monitoring PFM capacity building plans. In May 2005, a PEMSP Capacity Building Assessment and Program Design was completed with support from the European Union. The Capacity Building Adviser was recruited in April 2006, but implementation has been limited since. The Capacity Building Committee has yet to be established, and the capacity building strategy has yet to be developed. The GOL clearly needs to pay more attention to this important component and to speed up its implementation.

92. **Second, the PEMSP capacity building plan is a first step in strengthening coordination among donors.** As a next step, the GOL would like to establish a multi-donor trust fund to support the PEMSP. Both the EC and the World Bank have indicated their willingness to contribute to such a trust fund. This capacity building should be linked to the roll-out of the new Budget Law, of the new reporting formats, of the COA, and of the GFIS, and should emphasize learning by doing as much as classroom teaching.

2.7 ACHIEVING NT2 REVENUE MANAGEMENT ARRANGEMENTS

93. **This section highlights the PEMSP actions that have a more immediate bearing on Nam Theun 2 Revenue Management Arrangements (NT2RMA),** as cited in the Annex of the GOL Letter of Implementation Policy (GLIP) for the NT2 Hydroelectric Project. These are the requirements listed in that document:

- a. NT2 revenue is to be used for "eligible" sub-sectors that satisfy eligibility criteria, and these were selected by the NGPES and subsequently left unchanged by the NSEDP (2006-10), the successor to NGPES.

- b. The budget classification system is to be revised and financial management and reporting arrangements enhanced so that expenditures on the “eligible” sub-sectors can be monitored and reported adequately and accurately.
- c. The computerized Government Financial Information System (GFIS) is to be stabilized and upgraded so that it is able to track spending on “eligible” sub-sectors in real time.
- d. The capacity of the State Audit Office (SAO) is to be strengthened so that it can audit independently and adequately the public accounts prepared by the MOF, including “eligible” spending of NT2 revenue.
- e. Regular monitoring, evaluation, and consultation will be undertaken by the MOF.
- f. All public financial and monitoring reports will be published by the MOF.

94. **The government’s current plans and the progress to date in implementing the PEMSP suggest that these requirements can be met starting in fiscal year 2010.** For Lao PDR, FY2009 refers to the period between October 2009 and September 2010. The flow of NT2 revenue is expected to be approximately only US\$20 million in the first year. In that year, the government will be able to allocate and spend NT2 revenue on the *basic education sub-sector*, the *poverty fund*, the *environment fund*, and either the *rural roads sub-sector* or the *basic health sub-sector* (depending on which progresses the most in meeting the “eligibility criteria”). These areas will be able to absorb most of this fund. Additional priority sub-sectors will become eligible in subsequent years as the revenue flow increases. The NT2RMA requirements will be met when the relevant sub-sector expenditure programs are developed and when planned actions under the PEMSP are implemented. Specifically, the following actions will be important in the next few years.

95. **Sub-sector expenditures must be selected and actions taken to meet the “eligibility” criteria.** The first NGPES selected spending in several sub-sectors as high priorities from the point of view of poverty reduction and environmental impact. These included *basic education*, *basic health*, *rural roads*, *the poverty fund*, and *the environment fund*. These sub-sector expenditure priorities have not been modified by the National Socioeconomic Development Plan (NSED) for 2006-10, which is the successor to the NGPES in terms of poverty reduction policy; additional sub-sectors may be added in subsequent years.

96. **Before the selected sub-sectors can be ready to use NT2 revenue, a good deal of sector dialogue and discussion will be needed among the sector agencies and ministries** to define its content clearly and show how these sub-sectors have performed in terms of poverty reduction and environmental conservation. In addition, the MOF would have to take key PEMSP actions to strengthen financial management and reporting tools as well as monitoring and evaluation arrangements for all public spending including for eligible sub-sectors. This planned preparation, dialogue, and discussion must result in agreement and decisions that meet the requirements in the GLIP Annex. To date the policy dialogue and discussion for satisfying these requirements has progressed the furthest in the *basic education sub-sector*, with rural roads coming next. Thus, there will have to be concerted efforts during fiscal year 2007 and 2008 to ensure that these sub-sectors meet the eligibility requirements by 2009-10. Box 9 provides the specific steps and actions that will have to be taken to make the *basic education sub-sector* fully eligible to use NT2 revenue.

Box 9. Satisfying NT2 Eligibility Criteria for the Education Sector

The Ministry of Education and relevant agencies, in collaboration with the MOF and the CPI, plan to take the following steps over the next few years to make *basic education* eligible to use NT2 revenue in FY2010:

- Develop in FY07 a more precise definition of the basic education sub-sector (primary and lower secondary), including details of spending components covered by this sub-sector; define the objectives and indicators of performance for service delivery and outcomes for the sub-sector; and establish mechanisms for continued monitoring, evaluation, and consultation.
- Prepare in FY07 a medium-term projection of total spending (recurrent and capital) in the sub-sector, including “additional” NT2 spending, that will improve service delivery and educational outcomes, and increase poverty-reduction impact. (Recent analysis suggests that there should be more spending on non-salary recurrent spending in basic education, specifically on teacher upgrading and textbook revision, printing, and distribution and on strengthening the Education Management Information System (EMIS). Most of this spending should be in the 47 priority districts. This shift of emphasis should be part of the medium-term expenditure plan in basic education.)
- Approve by the end of FY07 the new budget format consistent with revised budget nomenclature (BN) and modified Chart of Accounts (COA) with procedures to allocate the government’s budget by individual sub-sectors, such as basic education, all in close collaboration with the MOF (details on the MOF’s steps below). (For example, for education, the spending agency is Ministry of Education/Provincial Department of Education, the function is education services, the sub-function is basic (primary and lower secondary) education, and the specific spending items are wages and the development, printing, and distribution of textbooks. Investment projects will comprise the construction of schools.)
- Complete by the end of –FY07 stabilizing, upgrading, and improving the connectivity of the Government Financial Information System (GFIS), which was rolled out to 39 ministries and 17 provinces in FY06 (see below for details on PEMSP steps to complete this).
- Adopt in FY07 appropriate processes and checks in districts for education that can ensure that the manual paper system of authorizing/recording spending at the district level (which will continue until 2011) is reported and is fully captured in the GFIS reports.
- In FY08, use basic education as a pilot eligible sub-sector in budget preparation, allocation, and execution, using revised BN and the COA as well as the upgraded GFIS to start generating data on actual basic education expenditures (quarterly and annual). These data can then be used as a baseline to establish which additional expenditures would qualify using NT2 revenue in FY10.
- Adopt and agree in FY08 relevant budget norms or other mechanisms to ensure that provinces follow national sub-sector priorities.
- Prepare and publish in early FY09 the annual FY08 financial report on education. The contents should comprise basic education and quarterly budget execution reports on the education sector including the basic education sub-sector through FY09.

Source: Government of Lao PDR and World Bank, 2006 .

97. **Dialogue across sector ministries and agencies will have to be significantly enhanced in 2007 to meet the eligibility requirements in time** not only for basic education but also for other sectors. The government has already constituted a dedicated group of officials comprising representatives from the MOF and respective sector ministries to identify specific sub-sector expenditures within the NSEDP priority sectors. This group will also consult the country’s development partners in defining the components of eligible expenditures more clearly, in developing sub-sector performance indicators for monitoring outcomes, and in taking the necessary sectoral policy actions. By the end of 2007, it is critical that the initial list of “eligible” sub-sectors is finalized and approved by the government, so

that further actions can be taken to ensure that these sectors can meet the eligibility requirements.

98. **The government will need to develop an effective revised budget classification system:** The current Chart of Accounts (COA) and budget nomenclature are not compatible with the Government Financial Statistics (GFS). Also, there is no functional classification of the budget that allows for a sectoral breakdown of the budget. This is a critical element of the NT2RMA. Using with external consultants, the government has already started revising the CoA and realigning the budget nomenclature to be compatible with the GFS. It was expected that this work would be completed by March 2007. In parallel with this COA revision, the government is developing a consistent functional classification system of the budget that will make it possible to identify expenditures by sub-sector. It is expected that the functional classification of the budget will be approved by mid-2007.

99. **A comprehensive training program on the new COA and functional classification system will need to be devised in 2007 and initiated in all government agencies.** This will ensure that ministries and provinces can plan their budgets according to the new classification system and that the eligible expenditures are clearly reflected in the budget for 2008/09. At the same time, the coding structure of the Government Financial Information System (GFIS) needs to be modified to ensure that it reflects the revised COA and the revised functional classification of the budget.

100. **The computerized financial management system needs to be strengthened and upgraded.** A very significant step was taken during FY06 when the Government Financial Information System (GFIS)²¹ was rolled out in all 39 ministries and 17 provinces. This GFIS is not a *fully* integrated budget execution system linked to a payments system. Thus, different departments are responsible for requests for payment, payment vouchers, expenditure authorizations, and payment issuances. After all authorizations are entered in the system, as the rules require, the final check or bank transfer is issued and *entered* in the system. The 17 provinces and 39 ministries cannot make payments or issue checks without completing the GFIS authorization trail. Once all authorizations for each payment-transaction are entered in the system, *they leave a trail that can be audited later*. The GFIS also incorporates the *Crystal* reporting tool, which can rapidly generate financial reports at the level of specific items, budget execution reports, and cash management reports for both operational and monitoring purposes.

101. **The government has initiated an upgrade²² of the GFIS to address these problems.** When completed, the system will be able to satisfy the transparency, financial management, and accountability requirements stipulated in the NT2RMA. The upgrade is being financed by the World Bank's Financial Management Capacity Building Credit (FMCBC). Completion is expected to take another 12 months, with the bidding documents

²¹ The GFIS has many of the core functions of an integrated solution: undeletable transaction trails, recording and staged expenditure authorization controls, and reporting ability.

²² The GFIS is performing at a very low level for the following reasons: (a) it uses outdated servers that require long downtimes and have a high risk of sudden failure; (b) connectivity between provinces and the MOF is poor and unreliable; (c) officials in ministries and provinces have inadequate IT training and knowledge of public financial management; and (d) appropriate and much needed expenditure management processes are not yet in place.

expected to be finalized in mid-2007. Most of the functionality of the upgraded GFIS will be operational by the end of 2007.

102. **A fully integrated financial management information system (IFMIS) that connects all treasuries with payments linked to authorizations and all expenditures made in real time will not be available until 2011.** Although preparation will begin earlier, the upgraded GFIS is expected to migrate to the COTS-IFMIS from 2010. At that time, the system will be fully integrated and functional for all government financial transactions.

103. **Another requirement will be to establish the additionality of spending from NT2 revenue;** Once eligible sub-sector expenditures have been clearly delineated, the revised COA and the 2008/09 Budget will show the baseline allocation of spending for all eligible sub-sectors. The GFIS will record and report actual spending on basic education for 2008-09. To achieve "additionality," it will be necessary to show that, in FY2009/10 onwards, spending on eligible sub-sectors will comprise actual spending in 2008-9 (in other words, baseline spending) using the revised budget classification, plus the additional spending on the same sub-sector from the NT2 revenue.²³

104. **Regular and effective monitoring and evaluation tools will also be needed.** The government has committed itself to conducting a Public Expenditure Review's (PER) every two years and Public Expenditure Tracking Surveys (PETS) on a two-yearly cycle jointly with its development partners. The first such PER has been completed and is awaiting the government's comments before finalization and publication. Work on the PETS has advanced significantly – the survey and data analysis have been completed and the report is being written,, with the final document expected in mid-2007. The PER and PETS will continue to be the government's most important monitoring and evaluation tools, as they will make it possible to assess the reforms, they will highlight any issues that may need addressing, and they will yield information that can be used to update the public finance management framework.

105. **The government has been undertaking other complementary reforms that will facilitate compliance with and monitoring of the NT2RMA, including:**

(a) In June 2006, the MOF established an inter-departmental committee to oversee the effective implementation of reforms needed to comply with NT2 RMA.

(b) The budget calendar has been decompressed significantly. The National Assembly approved the budget on time this fiscal year, and, for first time in many years, revenue collection has exceeded targets.

(c) The government is in the process of reforming central-local fiscal relations, which will be critical for the effective implementation of eligible sub-sector programs, given that a large share of the expenditures under those programs will be made in provinces and districts.

²³ For example, assume that in FY2008/09 allocations and actual spending for basic education were US\$10 million. In 2009-10, if NT2 revenue of \$5 million is allocated to basic education, then total spending on basic education in 2009-10 should be at least \$15 million in other words, the spending from NT2 revenue is wholly additional to the baseline level of spending.

106. **External audits by the State Audit Office (SAO) need to be strengthened.** The government is committed to ensuring the independence of the SAO by requiring it to report to the National Assembly and to enhancing the capacity of the SAO to carry out audits effectively. For the purpose of the latter, an independent INTOSAI member will conduct an Audit Peer Review of the SAO audits by on a two-yearly cycle starting this year. This Audit Peer Review will allow the government to review current audit practices and subsequently putting together a comprehensive audit capacity development plan for the SAO. The Audit Peer Review was expected to commence in 2006 but has been delayed. It is critical that this process be speeded up so that the Audit Peer Review can commence in early 2007, and so that the capacity building plan can be developed thereafter. The Asian Development Bank is providing the SAO with technical assistance to increase its capacity.

107. **Timely and accurate financial statements and monitoring reports should be published.** The revised Budget Law that has been approved by the Parliament mandates comprehensive disclosure of the budget and all financial statements. The Minister for Finance constituted a Budget Law Implementation Steering Committee on November 29, 2006. A subcommittee has been established to prepare the formats for the disclosure of budget information. It is expected that this subcommittee will finalize these forms by the end-mid-2007.

108. Once the formats are finalized and approved by the Minister for Finance, there will be need to: (i) develop a tool to extract this information from the GFIS by September 2007; (ii) pilot the budget execution report for the first quarter of FY2007/08; and (iii) make the necessary adjustments within the GFIS to ensure the effective and timely capture of information. This will only be possible if the appropriate stabilization and upgrading of the GFIS has been completed. Users have been given adequate training in entering information into the system, and appropriate procedures have been devised to gather information from districts (which record and report information manually as they are not connected to the GFIS) to be entered by the respective provincial finance departments. In addition the PER, the PETS, and the SAO audit reports will also be published.

2.8 MAIN CONCLUSIONS AND RECOMMENDATIONS

109. **The immediate priority of the GOL is to strengthen public expenditure management.** It is imperative that the GOL and donors are strategic and selective in phasing and prioritizing numerous actions proposed in the PEMSP. The PEMSP should be used to promote a high-level dialogue on central-local fiscal relations in Lao PDR. The GOL and donors need to pay more attention to capacity building. The NT2 Revenue Management Arrangements need to be fined-tuned to fit the revised and rephased PEMSP.

110. **Financial accountability, a key aspect of the governance framework, requires sound financial management of all resources.** Overall, the fiduciary risk in the use and management of public funds is high. The reasons for this are a lack of realism in budgets and weaknesses in the budget processes as well as in budget execution, accounting and control, and reporting. Weak institutional arrangements and capacity for internal and external audits and insufficient legislative oversight of budget execution contribute to the high fiduciary risk. Skills shortages in the PFM and insufficient capacity building mechanisms and coordination

exist at all levels. Risk at the sub-national level is compounded by a lack of adequate skills and experience in the PFM and procurement and by a lack of accountability institutions.

111. **The GOL is aware of the need to increase the amount of public resources allocated to planning and management** to overcome the significant weaknesses in the basic systems and processes for budget preparation, execution and control, reporting, and oversight. Since 2002, the GOL has taken the following significant actions (Box 10) to implement the last PER/IFA recommendations:

- Enhancing the integration of capital and budget spending and costing and the transparency of budgetary information, with the annual publication of budget plans and outturns in the Official Gazette.
- Strengthening the public accounting framework by issuing implementation regulations and by implementing a unified budget nomenclature and COA throughout the government.
- Progressively implementing a computerized GFIS that has introduced an automated system for accounting, budget execution control, and reporting that will improve the capture and timely reporting of data and increase budget control.
- Issuing a new Procurement Decree and supporting implementation regulations; creating a Procurement Monitoring Office (PrMO); drafting and circulating standard procurement documents for stakeholder feedback; completing a baseline assessment of the public procurement system; and developing the framework for a procurement performance measuring tool.
- Providing the State Audit Office with continued assistance culminating in the development of strategic audit plans, standardized audit methodologies, and training of staff to strengthen the auditing oversight of public expenditures. In January 2005, the GOL approved the PEMSP and implementation arrangements for addressing these key weaknesses.

112. **Overcoming the challenges in strengthening the management of public resources will require prioritizing and sequencing actions**, coordinating government and donor actions, and continual monitoring, reviewing, and updating of the PEMSP. *Seven key recommendations emerge from the analysis undertaken in this chapter:*

- **Relationship between center-provinces:** (a) Establish a credible mechanism for revenue sharing and intra-governmental transfers and (b) clarify the allocation of revenues and expenditures between the center and provinces.
- **Fiscal planning and budgeting preparation:** (a) Develop a budgeting system with budgets based on NGPES priorities; (b) strengthen fiscal planning underpinning the annual budget process, which should be based on reliable forecasts; and (c) make the budget cycle less compressed.
- **Budget execution, accounting, and financial reporting:** (a) Reassert the authority of the central Treasury over provincial Treasuries by recentralizing tax and customs; (b) make the GFIS fully functional; (c) effectively implement the revised public procurement rules and regulations; and (d) finalize, approve, and enact the new Audit Law for the SAO.

- **Local government financial management:** (a) Promote a high-level dialogue on central-local fiscal relations in Lao PDR, (b) base budget allocations to provinces on more realistic revenue forecasts, and (c) strengthen transparency and accountability of institutions at the local level by posting budgets and end-year accounts on public notice boards in the provinces.
- **Financial legislation and regulatory framework:** (a) Finalize, approve, and enact the Budget Law and Treasury Decree and (b) finalize and adopt standard bidding documents and procurement manual.
- **Capacity building:** (a) Establish the PFM Capacity Building Committee; (b) conduct a needs assessment; and (c) elaborate, adopt, and enact a capacity building strategy.
- **NT2RMAs:** (a) Implement the PEMSP to strengthen management of *all* public spending; (b) ensure that the improved public expenditure system becomes eligible to use NT2 revenues from 2009; (c) identify *priority* sub-sector spending for poverty reduction, establish data on actual spending in relevant priority sub-sectors, adopt a modified COA to track sub-sector spending, and provide timely and reliable quarterly and annual financial statements on relevant priority sector and sub-sector spending.

Box 10. The GOL's Actions to Improve Public Expenditure Management, 2002-05

Following the last PER/IFA, the GOL took various actions to improve its public expenditure management:

Fiscal Planning and Budget Preparation

- In 2002, steps were taken to integrate capital and recurrent spending by working out the recurrent expenditure implications of public investment projects (PIP). Decree No. 57/PM issued in May 2002 on the Management of Public Investment required that, starting with the FY02/03 budget, PIP submissions for new public projects in excess of 1 billion Kip include estimates of associated recurrent costs during the operation of proposed project. In mid-2003, a methodology to estimate recurrent costs was developed for core PIP project construction and applied to actual PIP projects after CPC and MOF staff had been trained. This methodology was followed up under the NGPES costing exercise in 2005 focused on the five-year investment program for the four priority sectors (that is, both investment and recurrent) as part of the NGPES-NSEDP process.

Budget Execution, Accounting, and Financial Reporting

- In 2002, *transparency of budgetary information* was increased through the publication of the FY 2000-01 budget outturns and the FY 2001-02 budget plan (classified by ministry, province, and services) in the Official Gazette. This practice has continued.
- In May 2002, steps were taken to enhance the *transparency of information on state-owned enterprises (SOEs) and accountability* of management. Decree No. 54/PM on the Management of State-invested Enterprises and Implementing Regulations (December 2002) clarified the roles and responsibilities of directors and managers of SOEs and their financial reporting requirements. The decree provided guidance on capital investments, procurement/transfer/replacement of assets, and treatment of dividends, as well as sanctions. In early 2004, the State Asset Management Board (SAMB) finished developing its database and its classification of all SOEs by performance. The board issued another annual assessment of SOE performance in 2005.
- In 2002, the GOL issued Implementing Regulations for Decree 20/PM (July) on General Regulation of Public Accounting to enhance financial accountability and transparency as well as internal financial control over budget revenues and expenditures in each ministry, province, district, and agency. The regulations required each of these bodies to submit financial statements to the National Assembly in each fiscal year. In 2004, the COA was modified.
- In 2005, the government's Financial Information System (GFIS) was put into operation after a couple of years of piloting. Its purpose was to improve budget execution, accounting, and reporting (MOF Ministerial Decision 0607 dated March 10, 2005). Data on accounts payable and Treasury balances now can be maintained at the central level and in the 14 provinces. However, the accuracy of data entry and coding remains an issue, as do communication links and business processes. Also, reporting by the provinces to the center using the GFIS needs to be improved. The system is currently being upgraded, coupled with additional modifications of the COA.

Financial Legislation and Regulatory Framework

- In December 2003, to addressing the problems identified by the Country Procurement Assessment, a new Procurement Decree (no. 03/PM) was issued. It was followed by Implementing Regulations to establish a new legislative and regulatory framework for procurement.
- In early 2004, the Procurement Monitoring Office (PrMO) was established within the Ministry of Finance to oversee the implementation of better procurement processes and to assist in related capacity building activities. A new charter for PrMO was approved that enhanced its authority to oversee procurement issues across government agencies. New staff with relevant competencies were hired and trained.

Sources: Government of Lao PDR and World Bank, 2006.

3. AGRICULTURE

Agriculture remains the most important sector in Lao PDR, accounting for nearly half of GDP and providing employment for 80 percent of the workforce. Because of its strong growth over the last decade, agriculture has been the most important driver in reducing rural poverty. The agricultural budget increased by 25 percent between 2002 and 2004, but agriculture's share of total public expenditure decreased slightly.

However, centrally approved budgets often do not materialize at the provincial level. Capital expenditures account for more than 90 percent of total sector expenditure and remain biased toward physical investments, without appropriate consideration for recurrent spending requirements. The rural poor still suffer much more from road infrastructure constraints and limited access to markets and social services than do the rural non-poor. The immediate priority is to address capacity constraints in planning, tracking, and monitoring agriculture expenditure at the central level. In addition, there is a strong case for increasing allocations to agriculture because it has been the major engine for rural poverty reduction. Furthermore, the GOL should achieve a better redistribution of public funds between richer and poorer provinces. Equally important is to promote agricultural research and provide more effective extension services and rural credit to strengthen farmers' capacity and competitiveness. Redressing geographical inequalities is important as well. Linking remote upland areas to the rest of the country by providing better public services in those areas is a priority in this regard. Helping subsistence-based communities become more productive and market-oriented is also a key task in the medium term.

3.1 INTRODUCTION

113. **This chapter reviews the performance of the agricultural sector in recent years.** It starts by analyzing the roles that government and the private sector must play to provide services to the population (section 3.2). It then reviews the GOL's record of public expenditure on agriculture between 2001 to 2005 and looks at the resource needs and financing for 2006-10 (section 3.3). The effectiveness in agriculture spending is assessed in section 3.4, and eligible priority programs in agriculture under NT2 are considered in section 3.5. Section 3.6 presents the main conclusions and recommendations.

3.2 AGRICULTURE SECTOR OVERVIEW AND RATIONALE FOR GOVERNMENT INTERVENTION

3.2.1 Agricultural Sector in Lao PDR

114. **Agriculture remains the most important sector in Lao PDR and has grown strongly over the last decade, averaging nearly 5 percent growth per year.** Agriculture employs 80 percent of the Lao workforce, mostly as self-employed or unpaid family workers. The sector is dominated by smallholder farm families engaged in near-subsistence production who have only a tenuous connection to the cash economy.

115. **Lao PDR's transition from agriculture toward a service-based economy is much slower than those of its neighboring countries.** During the last decade, the share of agriculture to total GDP in Lao PDR has been declining very slowly. In 2003, agriculture still contributed approximately 50 percent of total GDP. In comparison, agriculture constitutes only 15 percent of total GDP in China and approximately 22 percent in Vietnam. Both of these countries have high growth rates, and their transitions from agriculture to industry and services-based economies have been swift. Agriculture remains important to Lao rural households because non-farm income-generating opportunities are limited in rural areas. Even the marketing of agricultural products is not yet done by all rural households. In a given year, only approximately 50 percent of the farming households outside the Vientiane Plain sell livestock, and nearly 33 percent sell rice. In upland areas, non-timber forest products are the dominant source of cash income for rural families.

116. **From a sub-sectoral perspective, rice is the single most important crop in Lao PDR.** Rice accounts for approximately 60 percent of total agricultural GDP (2003). Rice production is mainly from lowland rain-fed areas. Livestock, including fisheries, accounts for 35 percent of GDP and forestry for approximately 5 percent. In recent times, some cash crops that are increasing in production areas are coffee, maize, and soybeans (Table 9).

Table 9. Comparison of Sub-sector Shares in Lao PDR Total Agricultural GDP (US\$mil)

<i>Agricultural GDP</i>	<i>Rice</i>	<i>Livestock and fisheries</i>	<i>Forestry</i>
985.44	591.00 (60%)	344.90 (35%)	69.00 (5%)

Source: FAOSTAT 2005.

3.2.2 Rationale for Government Intervention in Agriculture

117. **Reducing poverty and increasing food security are important priorities for public sector intervention.** Strong agricultural growth over the last decade has been the most important driver in reducing rural poverty in Lao PDR. One of the GOL's important challenges and the principal justification for public intervention in agriculture is to maintain the gains made so far in reducing poverty. Thirty-eight percent of the rural population still lives in poverty, of whom a significant portion faces seasonal food shortages. Thus, the GOL has a clear rationale for promoting household food security by improving the often inefficient subsistence farming methods used by the poor. In the context of food security, the government must move gradually toward a policy that promotes sufficient and stable rural incomes and integrated and functioning rice markets rather than only household-level rice production.

118. **Helping subsistence-based farmers become more productive and market-oriented is a goal for the government in the medium term.** The GOL plays a key role in providing the public goods (such as physical and productive infrastructure) that will create a more market-oriented environment for agriculture. Continued public investments in these goods are needed, but it will be equally important to promote agricultural research and provide effective extension services and rural credit to strengthen farmers' capacity and competitiveness. In light of the weak capacity of village-level institutions to manage

irrigation and other infrastructure, the *de facto* responsibility to operate and maintain the country's productive infrastructure rests with the GOL.

119. **Redressing growing geographical inequalities is important.** An important aspect of the rural development agenda in Lao PDR concerns geographical inequality among rural areas, which are likely to increase as agriculture intensifies and market integration advances more rapidly in more advantageous areas, such as the lowlands. This transformation is likely to take much more time in the remote upland areas. Therefore, the GOL also needs to redress these inequalities to maintain social cohesion. Linking upland areas to the rest of the country by providing better public services is a priority.

3.3 ANALYSIS OF PUBLIC EXPENDITURE TRENDS AND FUTURE RESOURCE NEEDS

3.3.1 Allocation of Agriculture Spending

120. **The agricultural budget increased by 25 percent during 2002-04.** In this period, the agricultural budget increased by nearly 25 percent from US\$38.8 million to US\$50.8 million (Table 10). Agriculture's share of total public expenditure decreased slightly from 12.7 percent (in 2002) to 11.2 percent (in 2004). From a cross-country perspective, the share of sector spending to total spending was markedly higher in Lao PDR than in Vietnam (6 percent in 2002) and Thailand (7.5 percent in 1998). In Lao PDR, agricultural spending decreased as a proportion of GDP from 2.3 percent in 2002 to 2.1 percent in 2004. Rural per capita agricultural expenditures appear to have increased from US\$8.3 in 2002 to US\$10.7 in 2004 (see

121. Table 10).

Table 10. Shares of Public Resources Devoted to Agriculture in Lao PDR, Vietnam and Thailand

Year	GDP (US\$ mil)	Total public expenditure (US\$ mil)	Agriculture expenditure (US\$ mil)	Total expenditure (%)
2001-02	1,668.5	302.3	38.5	12.7
2002-03	2,053.9	383.0	48.8	12.7
2003-04	2,362.5	452.2	50.8	11.2
2004-05	-	-	-	-
Projected spending (Ministry of Agriculture and Forestry estimate)				
2005-06			24.3	
2006-07			24.3	
2007-08			24.3	
2008-09			24.3	

Source: Lao PDR-Ministry of Finance-State Gazette, 2002-03, 2003-04; Ministry of Agriculture and Forestry-World Bank discussions, 2006.

122. **Recording of and reporting on actual agricultural expenditure is inconsistent and incomplete.** While the data in Table 10 come from the budget published by the MOF, the Ministry of Agriculture and Forestry (MAF) estimates that average actual sector expenditure was only US\$18.5 million during the examined period. Inconsistencies in expenditure reporting between various central-level authorities as well as between the center and provinces often occur and cannot satisfactorily be reconciled. Such inconsistencies are the result of a number of public expenditure management issues, which are discussed below.

123. **Centrally approved budgets often do not materialize, while locally generated revenues and expenditures are largely unrecorded.** Provinces and districts regularly experience shortfalls in the annual budgets approved by the National Assembly. These shortfalls hamper the implementation of sector priority programs. When budgeted resources fail to materialize, the provinces resort to raising revenue locally to compensate for these shortfalls. These sub-nationally generated revenues are allocated according to province-level priorities, most of which are in line with the central government's priority programs. However, actual expenditures are only partially reported back to the center, and neither the MOF nor the MAF is able to monitor sector expenditure at the sub-national level adequately. In the agricultural sector, recurrent expenditures vary significantly across provinces. For example, while the Phongsali province spends 2,190 Kip per capita, the Khammouan province spends 6,782 Kip (data from FY 2003-04). The average expenditure across all Lao provinces is 4,324 Kip per capita and the standard deviation is 1,787. Finally, sub-national administrations have core responsibilities for delivering agricultural support and extension and water supply and reticulation.

124. **Provinces have accumulated high levels of arrears to private contractors but fail to monitoring those arrears adequately.** While provinces' work programs in a given year are implemented based on their budgeted resources, shortfalls in resource allocations and revenue generation often mean that the provinces have to delay paying their contractors. These deferred payments are then budgeted for in subsequent years, but continued budget shortfalls mean that the provinces are unable to honor their commitments. In the case that the Provincial Finance Offices (PFOs) actually do pay their private contractors, they often do not make this information available to the Provincial Agriculture and Forestry Offices and hence this is not reported to the MAF. As a result, overall information on the size of provincial arrears in the agricultural sector is very limited. Anecdotal evidence suggests that in some provinces private contractors are paid in kind through allocations of logging quota or timber.

125. **Capital expenditures account for more than 90 percent of total sector expenditure and remain biased toward investments in physical infrastructure.** Overall, expenditure policies have continued to be biased toward physical investments. The policies do not give a high enough priority to recurrent spending requirements, particularly allocations for O&M. An initial improvement began with the 2002 budget planning process. The MOF now requires the line ministries to estimate O&M costs for all investment projects of a total cost of more than 2 billion KIP, as well as to identify appropriate funding sources. Prior to this, O&M expenditures were not estimated and not budgeted for any investment project.

126. **Provinces and districts report on their capital expenditures only in the aggregate rather than disaggregated into functional categories.** Capital expenditures include investments for construction and expenditures for training, capacity building, and research and extension. The MAF has been trying to guide provinces and districts to redirect investments in physical infrastructure toward investments in human resource development, particularly for agricultural research and extension services. However, it is difficult to assess whether this shift in investment priorities has actually occurred because: (a) capital expenditures are primarily donor-funded and therefore reflect donor priorities and (b) capital funds are not disaggregated into subcategories but are reported only as aggregate capital expenditures.

127. **The irrigation sector remains the most important recipient of public resources. Nevertheless,** key issues in irrigation management still must be resolved, including the absence of effective incentives to maintain infrastructure, weak management capacity, and lack of functioning cost recovery mechanisms. Given the GOL's continuing emphasis on promoting national rice self-sufficiency, irrigation remains the most important sub-sector in agriculture. A large part of public investment is directed toward the construction and rehabilitation of irrigation infrastructure. The GOL's requirement that farmers grow rice, which has lower economic returns than alternative cash crops, may have contributed to undermining the viability of many irrigation schemes. The recovery of O&M costs from water user fees (in cash or in kind) has not provided insurance against the deterioration of irrigation schemes. In addition, weak capacity at the village level, particularly to manage and maintain larger-scale schemes, has contributed to the deterioration of irrigation schemes. Flooding during the wet season, a recurrent event, also contributes to the quick deterioration of infrastructure. In the absence of proper flood protection, existing schemes require large rehabilitation investments every three to four years.

128. **Irrigation investments are targeted primarily to the Mekong Corridor with a strong bias toward Vientiane Province.** The most recent irrigation investment plan includes the construction and rehabilitation of a total area of 25,800 ha for wet season rice cultivation and 16,800 ha for dry season cropping. This plan covers 10 provinces and a total required investment of approximately US\$95 million over five years. While the northern provinces of Oudomxay, Luang Prabang, Xayabury, Bokeo, and Xiengkhuang have received approximately one-third of the actual investment during this period, the majority of the rehabilitation has taken place in the provinces of the Mekong Corridor, namely, Vientiane Municipality, Vientiane Province, Savannakhet, Champasack, and Saravane. There has been a clear bias toward Vientiane Municipality, which has received nearly as many funds as all of the provinces in the northern highlands combined. The stock of arrears accumulated during the period is estimated to be US\$17 million (Table 11).

Table 11. Concentration of Investments in Irrigation Infrastructure

	Capacity (ha)		Total planned investment (US\$)	Total realized investment (US\$)	Actual payments (US\$)	Accumulated arrears (US\$)
	Wet	Dry				
Northern Uplands						
Oudomxay	200*	150	2,002,273	2,002,273	583,239	1,418,939
Luangprabang	1,800	1,500	4,035,795	2,508,144	2,064,299	444,129
Xayaboury	1,450	950	5,733,239	5,693,277	3,923,958	1,769,318
Bokeo	550	550	302,557	302,557	134,470	167,992
Xiengkhuang	4,200	500	6,912,879	3,663,826	2,508,333	1,155,492
Mekong Corridor						
Vientiane Mun.	4,000	3,300	24,989,867	11,405,871	8,229,356	3,123,864
Vientiane Prov.	4,850	2,550	6,035,890	6,693,655	4,050,568	2,643,087
Savannakhet	4,512	4,200	27,249,905	7,101,989	4,970,833	2,131,061
Champasack	2,750	1,800	12,549,527	7,461,174	4,231,629	3,229,451
Saravane	1,500	1,300	5,539,394	1,683,239	909,470	773,674
	Total		95,360,000	48,520,000	31,610,000	16,860,000

Source: Ministry of Agriculture and Forestry-Department of Irrigation: Irrigation Investment plan 2001–05; World Bank discussions 2005, 2006.

Note: * = Capital investments include new schemes or rehabilitated schemes.

129. **Links between agricultural research and extension are weak, and the extension system remains grossly under-funded.** Approximately 12 percent of the public resources budgeted at the central level are allocated to agricultural and forestry research and extension. These funds are primarily counterpart funds to a number of foreign-funded research projects at the National Agriculture and Forestry Research Institute (NAFRI) and the National Agriculture and Forestry Extension Service (NAFES). Most technical extension personnel are assigned to District Agriculture and Forestry Office (DAFOs). However, no channels exist to transfer extension knowledge from the central institute to the grassroots level. Moreover, in the face of the regular funding shortages at the provincial and district levels, local extension personnel are able to perform their duties only under the umbrella of donor projects. Meanwhile, the major part of the country lacks a functioning and effective extension system.

3.3.2 Financing and Future Resource Needs

130. **The MAF has developed four priority programs for the agricultural sector and has formulated a medium-term expenditure plan.** Average annual central government expenditures during the next Five-year Plan (2006-10) are projected to equal US\$24.3 million, for a total of approximately US\$120 million over the five years. Spending projections are somewhat lower than previous annual sector spending (see Table 12). The projections indicate that food security concerns and diversification in agriculture and forestry will absorb the main share of the central capital budget (approximately 95 percent). However, it is unclear whether the planning and preparation of this medium-term expenditure plan has involved provinces and districts. At this time, no provincial breakdown of this national expenditure plan exists.

Table 12. Food Security and Agricultural Diversification: Priorities in the

Medium-term Expenditure Plan 2006-2010

	<i>Priority Program I</i>	<i>Priority Program II</i>	<i>Priority Program III</i>	<i>Priority Program IV</i>	<i>Total</i>
I. Wages, salaries, benefits	55,952	1,285,713	13,595,236	15,390,000	30,326,901
Central	16,785	385,714	4,078,571	4,617,000	
Local	39,166	899,999	9,516,665	10,773,000	
Foreign	44,762	1,028,571	10,876,189	12,312,000	
II. O&M	22,381	514,285	5,438,094	6,156,000	12,130,760
Central	6,714	154,285	1,631,428	1,846,800	
Local	15,666	359,999	3,806,666	4,309,200	
Foreign	17,904	411,428	4,350,475		
IV. Subsidies/transfers	11,190	257,142	2,719,047	3,078,000	6,065,379
Central	3,357	77,142	815,714	923,400	
Local	7,833	179,999	1,903,333	2,154,600	
Foreign					
VI. Capital expenditure	134,286	3,085,713	32,628,567	36,936,000	72,784,566
Central	40,285	925,713	9,788,570	11,080,800	
Local	94,000	2,159,999	22,839,997	25,855,200	
Foreign	26,857	617,142	6,525,713		
Total expenditures	222,810	5,142,855	54,380,946	61,560,000	121,307,606

Source: Ministry of Agriculture and Forestry-World Bank discussions 2006.

131. Wages and salaries and other staff benefits will account for 30 percent of the total projected budget over the next five years. O&M expenditures are expected to increase to 10 percent of total sector spending. At the same time, capital investments will decrease to 60 percent (from the current 90 percent), of which 30 percent are expected to come from foreign sources. This medium-term plan appears to be broadly realistic in terms of overall spending. Nonetheless, if the history of annual budget shortfalls is taken into account, the MAF's expectations of domestic resource allocations from the MOF seem to be overly optimistic. Of particular concern is the fact that salary payments take priority above all other spending. Therefore, the implementation of the agricultural priority programs could be severely hampered if the practice of under-funding approved budget plans continues and budget shortfalls cannot be effectively met.

132. Financing plans for the MAF's NT2-related expenditures as well as the mounting provincial arrears need to be included in the medium-term expenditure plan. The current fiscal plan for 2006-10 does not involve any provisions to tackle the problem of provincial arrears. In addition, the MAF recently was tasked with the supervising the clearing of the NT2 reservoir, so the ministry is building up its stock of arrears by procuring equipment and employing specialists to carry out this new task. Initial revenues allocated under the NT2 to the MAF are likely to be used to repay arrears, but these revenues will not materialize for several years. *Since no separate financing plans appear to be available at the central or provincial levels, the medium-term expenditure needs to assess the size of the liabilities and incorporate a repayment schedule.*

3.4 EFFECTIVENESS OF PUBLIC SPENDING IN AGRICULTURE

133. Although the effectiveness of public spending is difficult to evaluate, poverty headcounts and levels of per capita agriculture expenditure are negatively correlated. Agricultural labor productivity, measured as agriculture sector value added per agricultural worker, is a proxy for the effectiveness of public spending on agriculture. This labor productivity increased by approximately one-third over the 1990s. The reason for this increase is likely to have been increased access to irrigation and roads (Table 13) and also from economic reforms that have improved market incentives. This rate of growth compares favorably with those of other countries in the East Asia region. However, it is noteworthy that, in terms of absolute levels of productivity, Lao agricultural workers surpass workers from countries that face important land constraints and in which rural households obtain a significant portion of their incomes from non-agricultural sources.

Table 13. Unequal Access to Road infrastructure and Social Services

	<i>Vientiane Plain</i>	<i>Mekong Corridor</i>	<i>Central / South Highlands</i>	<i>Northern Lowlands</i>	<i>Northern Highlands</i>
Dry season road access (% of rural households)	96.7	94.5	79.3	79.0	45.7
Wet season (all year-round) road access (% of rural households)	88.7	72.3	58.4	60.2	33.8
Distance to nearest road (km)	0.1	0.9	1.3	4.7	11.4
Distance to community health center (km)	12.3	14.5	16.7	20.4	25.9
Distance to primary school (km)	0.1	1.1	0.22	0.8	0.8
Distance to post office (km)	14.7	18.8	23.3	24.3	29.9
Distance to district markets (km)	16.8	17.5	22.9	26.6	29.3
Distance to provincial markets (km)	31.9	98.4	73.6	110.7	101.2

Source: Government of Lao PDR, 2006e.

134. **Over the past 10 years, the GOL has increased its investments in roads and has expanded the country's road network from 23,000 km to 32,600 km.** However, the access that the rural poor have to road infrastructure, markets to sell agricultural produce, and social services is still severely constrained. Although the share of rural households with no road access is declining, the rural poor still suffer much more than the rural non-poor from road infrastructure constraints. Their lack of access to roads implies not only a lack of access to markets but also much less access to agricultural and forestry extension services, including information on products and prices, livestock vaccination, and other public support to strengthen agriculture. The most disadvantaged regions in terms of access to roads and social services remain the Central Southern and Northern Highlands and the Northern Lowlands. Much more attention and public support is needed to integrate and link these areas with the overall rural economy.

3.5 ELIGIBLE PRIORITY PROGRAMS IN AGRICULTURE UNDER THE NT2

135. **Under the Sixth Five-year Plan, NT2 priority programs are likely to build on and expand the existing sector programs in the MAF.** Supplementary funding from NT2 revenues to be allocated to the priority poverty reduction and environment programs as identified in the NGPES and the Sixth Five-Year Plan is predicted to become available to the MAF in 2009. For agriculture and rural development, it is likely that the existing four priority programs under the Sixth Five-year Plan will remain largely as they are and be adjusted and expanded only as additional funding becomes available. These four programs all address poverty and rural development and reflect the recent strategic thinking and policies of the GOL. Thus, they present a reasonable framework for planning and allocating additional NT2 revenues to reduce poverty in rural areas. The draft medium-term expenditure framework discussed above, therefore, can serve as an initial baseline to monitor the additionality of NT2 funds.

136. **In the short-term, NT2 revenues are likely to be used to pay for salary increases and to repay the outstanding arrears that the MAF is incurring to clear the NT2 reservoir.** Potential issues with regard to NT2 revenues are indications from the MAF that, in the short term, NT2 revenues are likely to be used primarily to increase the timeliness of

wage and salary payments to MAF staff and to increase the wages of personnel stationed in remote rural areas. Potential new areas for the use of NT2 revenues include: (a) the development and application of sanitary and phytosanitary standards and quality control measures to food and agricultural products and (b) the formulation of a legal framework and set of regulations for trade and commerce in agricultural products.

3.6 MAIN CONCLUSIONS AND RECOMMENDATIONS

137. **The immediate priority is to address capacity constraints in planning, tracking, and monitoring agricultural expenditures at the central level.** In addition, there is a strong case for increasing allocations to agriculture because it is the major engine for rural poverty reduction. Furthermore, the GOL should redistribute public funds more equitably between richer and poorer provinces. The following key recommendations emerge from the analysis undertaken in this chapter:

- **Resource allocation:** (a) The GOL should increase the allocation of public funds to the agriculture sector, specifically for agricultural extension and research in support of commercialization and diversification and (b) the GOL should involve the MAF more closely in the budget formulation process led by the MOF and the CPI.
- **Agriculture information system:** (a) The MAF should collect, organize, and analyze data on agricultural and rural development expenditure carried out by the central and sub-national authorities and the private sector; (b) the GOL should strengthen consultation, information exchange, and data access among the MOF, the CPI, and the MAF by requiring regular interaction among them; and (c) districts and provinces should provide better information to the center on local arrear levels as well as on locally generated revenues.
- **Equity:** (a) The GOL should allocate more resources to the most disadvantaged provinces (those with the highest number of priority districts) and (b) the MAF should ensure that the allocation of provincial-level expenditures is consistent with national priorities.

4. ROADS

Road travel is the dominant mode of transportation in Lao PDR. The road network is extensive on a per capita basis. Nevertheless, it is vulnerable during the rainy season, which cuts off as many as 40 percent of the country's villages from roads. During 2000-05, Lao PDR public road expenditures totaled nearly US\$400 million or one-quarter of the national budget. Almost 80 percent of these resources, or \$320 million, were provided by multilateral and bilateral donors. This spending improved the network and connected an increasing number of rural inhabitants to both markets and social services, resulting in significant socioeconomic benefits. In addition, the institutional set-up for road management is structurally sound. A Road Maintenance Fund functions on a user pay principle. The unit costs of road works appear to be reasonable compared with those of other low-income countries. While the GOL increasingly is emphasizing road maintenance, road expenditures are still heavily concentrated in the construction of national roads. Looking forward, the GOL will face competing demands for road maintenance, providing all-weather road access to district centers and villages, and upgrading primary roads to handle growing traffic. However, the available financial and human resources will be far from adequate to meet all of these needs. The immediate priority is to ensure the sustainable financing of road maintenance. The GOL also should make more effort to increase the efficiency and cost-effectiveness of road spending. This can be achieved by strengthening local institutional capacity and by promoting market competition and private sector participation in delivering road works.

4.1 INTRODUCTION

138. **This chapter reviews the performance of the road sector in recent years.** It starts by analyzing the role of the GOL and the private sector in providing road infrastructure (section 4.2). It then reviews the GOL's road expenditures from 2001 to 2005 and looks at the resource needs and financing for 2006-10 (section 4.3). Section 4.4 discusses the effectiveness of road spending. Section 4.5 considers the eligible priority programs in rural roads under the NT2. Section 4.6 presents the main conclusions and recommendations.

4.2 ROAD SECTOR OVERVIEW AND RATIONALE FOR GOVERNMENT INTERVENTION

4.2.1 Road Sector in Lao PDR

139. **Travel by roads is the dominant mode of transportation in Lao PDR.** The country is mostly mountainous and has a large land area and a low population density (23 people per sq km). An extensive road network is required to connect the sparsely distributed settlements and markets. The road network consists of national, provincial, district, and rural roads with a total length of 33,800 km and 2,450 bridges (Table 14). It carries 75 percent of all freight and 93 percent of all passenger traffic. Road length per 1,000 people is 6.04 km, compared with 2.86 km in Cambodia and 2.73 km in Vietnam. While Lao's road network is extensive, it is

vulnerable to rainy seasons as only 53 percent of the national roads and 3 percent of the local roads are paved. Seasonal closures are frequent due to poor pavement and deficient cross drainage. More than 10 percent of all district centers and over 40 percent of the villages do not have year-round road access.

Table 14. Lao PDR: Road Lengths by Road Class and Pavement Type, 2004

<i>Road class</i>	<i>Paved</i>	<i>Gravel</i>	<i>Earth</i>	<i>Total</i>
National	3,771	2,327	1,146	7,244
Provincial	264	3,565	3,240	7,069
District	51	2,123	1,981	4,155
Urban	409	866	472	1,747
Rural	31	2,628	10,290	12,949
Special Roads	52	311	269	632
Total	4,578	11,820	17,398	33,796

Source: GOL, 2006c.

140. **Lao's institutions for road management are structurally sound.** Clear assignment of institutional responsibilities for managing different parts of the road network is a prerequisite for managing the network effectively. Without this clarity, road agencies cannot be held accountable for the condition of the road network. The responsibility for road management is divided among the Ministry of Communications, Transport, Post and Construction (MCTPC), the Provincial Departments of CTPC (DCTPC), and the District Offices of CTPC (OCTPC) (Box 11). Road works are carried out by a mixture of private contractors and state-owned construction enterprises, but private sector participation has been increasing.

Box 11. The Institutional Framework for Roads in Lao PDR

The MCTPC manages the construction and maintenance of the national roads but also assists the DCTPCs with implementing road improvement and maintenance programs. The responsibility for the construction and maintenance of provincial, district, and rural roads rests with the DCTPCs. The responsibility for executing all routine and periodic maintenance has been delegated to the DCTPCs. The OCTPCs are in charge of the district and rural roads, but due to their weak capacity, they rely heavily on the DCTPCs to manage the road works.

MCTPC has a simple and reasonably sound budget planning process. At the strategic level, the MCTPC follows a Medium-term Transport Sector Development Strategy. It was prepared in 2001 with technical assistance from the Asian Development Bank (ADB). The strategy serves as the basis for sector's inputs to the NGPES and the NSEDV-VI. In the annual budget planning process, both the MCTPC and the DCTPCs first prepare their annual implementation plans in accordance with the five-year development plan. Then the MCTPC consolidates these plans and submits them to the CPI for approval. In contrast, the projects to be funded by the Road Maintenance Fund (RMF) do not pass through this process. Funding to maintain national roads is determined by the RMF Board. Funding to maintain local roads is nominated by provincial DCTPCs and reviewed by the MCTPC.

The MCTPC has increasingly adopted rigorous planning tools to ensure that the construction and, especially, the maintenance of the national and provincial roads are prioritized, well planned, and budgeted. Various planning tools also have been adopted or are being introduced to the district and rural road levels. In addition, the MCTPC has developed a community road model to plan and manage basic access roads.

The MCTPC manages the implementation of donor-funded road projects through its line divisions rather than through the individual Project Implementation Units (PIUs), which are outside the structure of the MCTPC. All PIUs were disbanded a few years ago when the MCTPC agreed with donors to harmonize standard bidding documents for the road sector, to adopt a single financial management system, and to shift the responsibility for implementation (including procurement, financial management, disbursement, and reporting) to MCTPC divisions.

Source: World Bank, 2005.

4.2.2 Rationale for Government Intervention in Roads

141. **For many years, the GOL has made road development a high priority and has used road spending as a policy instrument to achieve socioeconomic objectives.** The GOL has set a clear long-term objective for the sector, which is to provide the necessary transport infrastructure for people in all parts of the country to easily communicate and participate in development activities inside the country and interact with the people and markets outside the country. In particular, the GOL emphasizes allocating investments to assist inaccessible areas, to open up economic exchanges and border trade, and to provide a conducive environment for economic development in the least developed provinces.

142. **The public sector is solely responsible for the financing of roads.** There is virtually no private financing of roads. It is not financially viable given the current low level of traffic. According to traffic surveys, only 9.4 percent of the national roads carry 1,000-3,000 vehicles (including motorcycles) per day, 2.0 percent between 3,000 and 10,000, and 0.3 percent over 10,000 (for short stretches in urban areas). There is no highway with a traffic level high enough to qualify for the Build, Operate, and Transfer (BOT) type of project financing. Therefore, the public provision of roads is expected to continue for the foreseeable future.

4.3 ANALYSIS OF PUBLIC EXPENDITURE TRENDS AND FUTURE RESOURCE NEEDS

4.3.1 Allocation of Road Spending

143. **Public expenditures for roads, urban development, and communications amount to approximately \$17 per capita, of which roughly \$12 goes to roads.** This amount is significantly higher than the \$9 that goes to agriculture, the \$7 to education, and the \$5.50 to health. Annual public expenditures for roads during fiscal years 2000/1-2004/5 ranged from 20 to 35 percent of the national budget, including donor assistance. The total over the five-year period amounted to roughly 4 trillion Kip (US\$400 million).²⁴ However, during that period, annual road expenditure fluctuated significantly, partly because *the lion's share of road expenditure came from donors.*

144. **The pattern of road spending by category of road works over the last three years indicates the high priority that the GOL has given to the national roads, especially their construction.** Approximately 70 percent of the road spending is by the MCTPC on the national roads, and over 50 percent of this national road expenditure is on construction (Table 15). In the last two years, road maintenance expenditure for all roads reached almost 30 percent of total road spending, reflecting a shift of policy emphasis to road preservation. Spending on district roads increased significantly in FY05-06, indicating an initial shift of government attention toward rural accessibility. These amounts appear to be consistent with the GOL's policies and priorities in the sector. However, as discussed below, there is a need to shift funds from construction to maintenance because maintenance is not yet fully funded.

Table 15. Expenditure by Road Type and Road Work Category, FY2002–06

	FY02–03		FY03–04		FY04–05		FY05–06	
	(mil Kip)	(%)	(mil Kip)	(%)	(mil Kip)	(%)	(mil Kip)	(%)
National roads								
Maintenance	36,700	8	108,220	18	155,742	35	240,222	31
Rehabilitation	-	0	-	0	9,970	2	97,591	12
Construction	447,600	92	506,620	82	276,796	63	443,514	57
Subtotal	484,300	100	614,840	100	442,508	100	781,327	100
Provincial roads								
Maintenance	58,030	27	29,481	14	5,852	10	38,751	34
Rehabilitation	52,019	25	27,463	13	49,206	80	44,832	40
Construction	101,050	48	151,336	73	6,428	10	29,224	26
Subtotal	211,099	100	208,280	100	61,486	100	112,807	100
District roads								
Maintenance	20,759	16	21,958	26	8,492	9	47,685	21
Rehabilitation	16,446	12	2,600	3	1,735	2	136,092	60
Construction	96,285	72	60,341	71	82,235	89	44,393	19
Subtotal	133,490	100	84,899	100	92,462	100	228,170	100
All roads								
Maintenance	115,488	14	159,659	18	170,086	29	326,658	29
Rehabilitation	68,466	8	30,063	3	60,911	10	278,515	25
Construction	644,935	78	718,297	79	365,459	61	517,131	46
Total	828,889	100	908,019	100	596,456	100	1,122,304	100

Source: Based on data provided by the Disbursement Division, DOR 2006.

²⁴ In comparison, Cambodia's public spending for the entire transport sector (roads and other modes of transportation) from 1996-2001 was less than 10 percent of total public spending.

145. **Local road expenditure varies significantly by province.** Local roads consist of provincial, district, and rural roads. As the 2004 data indicate (Table 15), provinces varied significantly in their local road expenditure per km of local roads or per person. The several northern mountainous provinces and Khammouan spent much more on each kilometer of local roads than most other provinces (except Xekong and Champasak), in which the topography is mostly rolling or flat. A similar pattern was seen on a per capita basis. This may reflect the impact of three factors – the higher unit costs of road works in hilly areas, the GOL prioritizing the poor and mountainous provinces, and the interventions of the World Bank (in the Provincial Infrastructure Project for Phongsalai and Oudomxai) and the ADB (in the southern provinces).

Table 16. Local Road Length and Expenditure by Province

<i>Province</i>	<i>Population</i>	<i>Area</i> (sq km)	<i>Local road length</i> (km)	<i>Local road expenditure</i> (mil Kip)	<i>Expenditure per km</i> (mil Kip)	<i>Expenditure (US\$/ person)</i>
Vientiane Mun.	695,473	3,920	1,696	78,116	46.0	11.23
Phongsali	167,181	16,270	773	26,357	34.1	15.77
Louangnamtha	145,231	9,325	925	12,431	13.4	8.56
Oudomxai	264,830	15,370	1,089	75,654	69.5	28.57
Bokeo	145,919	6,196	759	10,340	13.6	7.09
Louangphabang	405,949	16,875	1,088	30,685	28.2	7.56
Xaignabouli	280,780	16,500	1,555	5,699	3.7	2.03
Houaphan	338,044	16,389	1,262	7,864	6.2	2.33
Xiengkhouang	228,882	15,880	1,476	3,226	2.2	1.41
Vientiane Prov.	386,558	15,927	1,769	1,052	0.6	0.27
Bolikhamxai	225,167	14,863	1,247	8,747	7.0	3.88
Khammouan	336,935	16,315	2,654	39,698	15.0	11.78
Savannakhet	824,662	21,774	4,347	9,622	2.2	1.17
Salavan	324,470	10,691	1,311	3,667	2.8	1.13
Xekong	85,316	7,665	510	26,915	52.8	31.55
Champasak	603,880	15,415	2,378	16,118	6.8	2.67
Attapeu	112,171	10,320	650	1,703	2.6	1.52
Xaisomboun	38,549	7,105	494	3,751	7.6	9.73
Total	5,609,997	236,800	25,981	361,644	13.9	6.45

Source: Road length and expenditure data provided by Planning and Technical Division, DOR 2006.

146. **Central and local authorities need to coordinate their activities.** Sub-national administrations have the core responsibility for the delivery of non-national roads and other transport infrastructure. Significant differences have been recorded in recurrent expenditure among provinces. In 2003–04, the range per capita varied from 798 Kip per capita in Luang Prabang province to 3,960 in Xiengkhouang, with an average of 1,757 and a standard deviation of 1,114.

147. **The unit cost of maintenance work, an indicator of expenditure efficiency, appears to be reasonable in Lao PDR compared with other countries** (Table 17). However, there is room for cost reduction. Market competition in Lao's construction industry is limited due to the existence of state-owned construction companies. The capacity of the

construction industry and local road agencies is still weak. In this sense, the unit costs in real terms could be reduced with more market competition and additional capacity building of both the construction industry and road agencies.

Table 17. Average Cost of Road Maintenance Contracts in Selected Countries

Country	Type of roads	Average cost per km per year (US\$)	
		Routine	Periodic
Lao PDR (2001/02)	National roads mostly paved	–	6,000–13,000
	Rural roads (mostly gravel)	–	2,000
Albania (2002/03)	National roads mostly paved	1,985	16,000
	Paved rural roads	3,035	9,850
Lesotho (2000)	Paved rural roads	600–700	20,000–40,000
	Gravel rural roads	900–1,000	10,000–15,000
Peru (2002)	Gravel rural roads	700–800	–
Zambia (2003/04)	Main paved roads	360	–

Source: Burningham and Stankevich, 2005.

4.3.2 Financing and Future Resource Needs

148. **Funds for road construction, rehabilitation, and maintenance come mainly from three sources –: foreign assistance, domestically generated revenues from the national budget, and the RMF.** Since 1990, multilateral and bilateral donors together have contributed almost 80 percent of all public expenditures on roads. However, in recent years, revenues from domestic sources, especially direct user charges, have been increasing steadily. Since its creation in 2001, the RMF has contributed significantly to the quality improvement of the road network (Box 12). The fund meets 45 percent of the country's road maintenance needs. The RMF funds 60 percent of the maintenance of national roads, but only 10 percent of provincial roads, district, and rural roads. The GOL's target is to raise the fuel levy gradually to 300 Kip/liter by 2008-09. However, without injections of funds from donors, this increased levy would enable the RMF to cover only the current annual average level of maintenance spending and, by 2008-09, maintenance needs would be more than the RMF could support alone.²⁵ Therefore, the GOL needs to make continuous efforts to increase the domestic sources of revenues (mainly the fuel levy) for the RMF. The current fuel levy at 150 Kip/liter (or 1.5 US cents) is one of the lowest rates for road funds in the world. In comparison, the fuel levy for the Road Fund in Zambia is equivalent to 750 Kip/liter. Thus, Lao PDR has room to increase its fuel levy significantly.

²⁵ According to Bray (2006), the value of depreciable road assets could be roughly \$3 billion (in approximate April 2006 prices) by 2008-09. An average annual expenditure of approximately \$69 million (circa April 2004 prices) is needed to preserve this infrastructure, including \$31 million for national roads. In contrast, from 1999-2000 to 2003-04, the GOL's average annual expenditure on non-emergency maintenance of national roads was \$5.5 million. Given planned increases in road maintenance funding by 2008-09, domestic resources of \$18 million are expected to be available for road maintenance in Lao PDR. Even at this level of expenditure, the road system will continue to deteriorate, will require earlier rehabilitation than should be necessary, and will result in higher overall transport system costs. This sub-optimal position is exacerbated by the often poor construction quality in road improvement projects, which necessitates higher maintenance expenditure than should be needed.

Box 12. The Lao PDR Road Maintenance Fund

The GOL established the Road Maintenance Fund (RMF) early in 2001 on the user –pay principle. The fuel levy is the main source of domestic revenue for the RMF. The levy started at 40 Kip per liter in 2001 and gradually increased to the current level of 150 Kip per liter (1.5 US cents). Other domestic funding sources include road tolls, heavy vehicle surcharges, overload fines, and international transit charges. IDA, Sida, and the ADB have been making substantial financial contributions to the RMF through the Road Maintenance Program Phase 2 (RMP-2), the only ongoing road conservation program in the country.

In 2004–05, the total income to the RMF was 134 billion Kips, of which 38 percent (\$5.1 million) came from the fuel levy and 46 percent (\$6.2 million) from donor funds. The GOL is committed to raising the fuel levy progressively to 300 Kip per liter by 2008-09 to endow the RMF with sufficient revenue to sustain the average level of maintenance expenditure undertaken during the RMP-2.

The RMF is managed by an advisory board, which comprises seven representatives from the MCTPC, the Ministry of Finance, the Ministry of Commerce, the state fuel company, the Chamber of Commerce, the state bus company, and a privately owned freight forwarding business. The board meets quarterly. The RMF's balance sheet is published annually in the national newspapers.

Sources: Government of Lao PDR and World Bank, 2006.

149. **The GOL also faces the enormous challenges of having to provide all-weather basic road access to a large number of villages and to upgrade existing roads to accommodate increasing traffic.** The available financial and human resources are far from adequate to meet all of these competing demands, and this dynamic is expected to continue for the next five to ten years. The NGPES cost estimates for both the transport and the urban sectors for FY 2006-10 greatly exceed the FY 2000-05 actual expenditures for the two sectors (Table 18). This emphasizes the need for realism in the budget planning process, as well as the need for increased prioritization and efficiency of public expenditures, especially in the road sector.

Table 18. Transport Sector Expenditures in 2000-05 and Planned Expenditures for 2006-10

Year	MCTPC + DCTPCs		MCTPC		Year	NGPES cost estimates (US\$ mil)		
	Transport and urban		Roads and bridges only			Transport	Urban	Total
	(bil Kip)	(US\$ mil)	(bil Kip)	(US\$ mil)				
2000–01	754	75	423	42	2005–06	102	1	103
2001–02	689	69	533	53	2006–07	194	37	231
2002–03	985	98	613	61	2007–08	221	38	260
2003–04	1,275	128	916	92	2008–09	229	43	272
2004–05	1,471	147	564	56	2009–10	171	96	268
2001–05	5,174	517	3,048	305	2005–10	918	215	1,134

Sources: (a) Data for 2000-05 are provided by Disbursement Division, DOR 2006; (b) data for 2006-10 are from Hedemalm, 2005.

4.4 EFFECTIVENESS OF PUBLIC SPENDING IN ROADS

150. **The socioeconomic benefits of road spending should be measured by the increased efficiency and outputs of production and the increased use of social services**

such as education and health care enabled by the road improvements. These benefits are usually translated from the savings in vehicle operating costs and travel time. In the case of rural access roads, making these roads more accessible enables outreach social services to reach remote communities. However, quantifying these benefits would require the application of double-differencing method and settlement-level data collected before and after the road improvements as well as from both the project-affected area and a selected control area, which are not available. Therefore, to assess the likely socioeconomic benefits, the authors used several readily available pieces of evidence including road network data, road condition surveys, and *ex-post* economic evaluations of donor-funded projects.

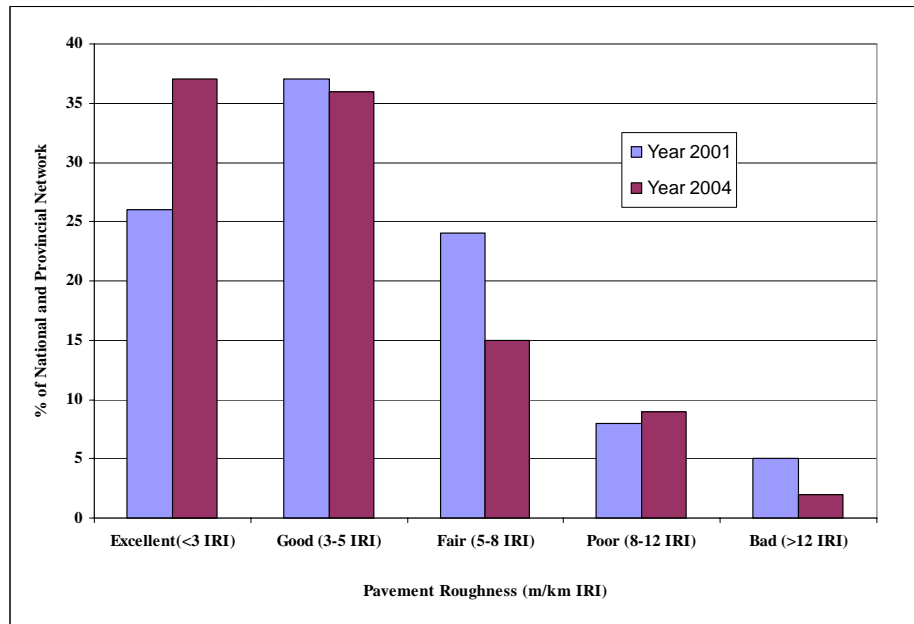
151. **Heavy spending on roads improved overall road conditions.** Lao's roads were largely destroyed during the Indochina war. After the war, the network deteriorated further due to a lack of maintenance. Since the late 1980s, the GOL with assistance from a number of multilateral and bilateral donors has made significant efforts to rehabilitate the network. During the first half of the 1990s, the government allocated roughly 50 percent of the Public Investment Program to the road sector. Also in the 1990s, the GOL spent approximately US\$600 million to rehabilitate national and provincial road networks. As a result, by the end of the 1990s, approximately 3,000 km of roads had been improved (World Bank, 2001). Heavy spending totaling roughly US\$400 million continued over the next five years. From 2000-04, the road network in Lao PDR grew annually by an average of 1.3 percent for paved roads, 9.4 percent for gravel roads, and 4.2 percent for the entire network (Table 19). Today, the road network is in much better condition than it was at the beginning of the 1990s. Approximately 73 percent of the national roads and 23 percent of the provincial roads are in good or better condition than they were then.

Table 19. Lao PDR: Road Length by Surface Type, 2000-04 (km)

Road Type	2000	2001	2002	2003	2004	Average annual growth (%)
Paved	4,351	4,321	4,592	4,498	4,587	1.3
Gravel	8,107	9,278	9,661	10,097	11,609	9.4
Earth	16,280	18,702	18,372	16,616	17,667	2.1
Total	28,738	32,301	32,625	31,211	33,863	4.2

Source: Government of Lao PDR, 2006f.

152. **The Road Maintenance Program supported by the RMF has resulted in major improvements in the pavement condition of the roads and has generated substantial net economic benefits.** Pavement condition is usually measured by the International Roughness Index (IRI). A comparison of road condition survey results between 2001 and 2004 shows that the percentage of the national and provincial road network in excellent condition has increased significantly from 25 percent to 35 percent and that the share of roads in bad condition has shrunk from 5 percent to just 2 percent (Figure 9). By international standards, this is quite an achievement in just three years. Public expenditures on road maintenance are also highly economically efficient. The *ex-post* economic evaluation of the first year's work program of 320 km under the Road Maintenance Program Phase I yielded an overall economic rate of return (ERR) of 33 percent, with the ERR for individual projects varying from 14 percent to 103 percent.

Figure 15. Pavement Condition Survey Results

Source: World Bank 2005a

153. **Significant socioeconomic benefits have resulted from the completion of donor-funded road projects.** *Ex-post* economic analysis for all five completed road projects funded by the World Bank shows that they have a high ERR: 72 percent for the Southern Transport Project,²⁶ 23 percent for the Highway Improvement Project, 22-28 percent for the Second Highway Improvement Project, 27 percent for the Third Highway Improvement Project, and 30 percent for the Road Maintenance Project. In the case of the ADB-funded Champasack Road Improvement Project, a project performance evaluation carried out in 2005, four years after the project was completed, found that significant socioeconomic benefits were realized from the investment. Traffic on the project road had grown by 22 percent per annum since the project was completed. The average reduction in travel time was 40-50 percent. Economic reevaluation yielded an ERR of 26.3 percent. More importantly, a household survey conducted as part of the evaluation indicated that there had been general increase in household income, land ownership, and access to health care, education, markets, and credit (ADB, 2005a).

4.5 ELIGIBLE PRIORITY PROGRAMS IN ROADS UNDER THE NT2

154. **Financing the needed road expenditure will be a major challenge for the GOL.** Total maintenance and rehabilitation needs (unconstrained by any budget) for the national and provincial roads are estimated to be US\$460 million over the next 10 years (World Bank, 2005a). Moreover, the GOL faces an enormous task to finance the expansion of the basic road network to connect all district centers and a large number of villages. Additional financing sources are much needed to fill the gaps. One additional source expected in the near future is the NT2 revenue. One suggestion is to use a fraction of the NT2 revenue to scale up the RMF. Although the intention is good, the injection of NT2 funds might eventually undermine the user pay principle of the RMF, reducing the incentive for the GOL

²⁶ The very high *ex-post* ERR is due to higher than anticipated traffic growth.

to raise funds from users. In this sense, it is more desirable for NT2 funds to support the expenditures on roads that have little prospect of being directly financed by users or by the private sector and thus generally require general budget support, such as those covered by the rural access road improvement program.

4.6 MAIN CONCLUSIONS AND RECOMMENDATIONS

155. **The GOL faces competing demands for resources to maintain existing road assets, to provide all-weather basic road access to all district centers and a large number of villages, and to upgrade primary roads to meet growing traffic demand.** The available financial and human resources are not adequate to meet these goals. The main challenge is how to set the right priorities. Three key recommendations emerge from the analysis undertaken in this chapter:

- **Resource allocation and use:** (a) Firmly prioritize preserving the existing road assets over expanding the asset base by (b) updating the medium-term transport development strategy and (c) refining and improving the current process for road expenditure prioritization, including the appropriate use of economic criteria.
- **Resource mobilization:** (a) Increase effort and political commitment to bring the fuel levy to a level that would make the RMF sustainable as soon as possible and (b), in providing rural “basic-access” roads, complement the NT2 revenue sources with in-kind contributions (such as labor) or cash from rural communities.
- **Private sector participation:** (a) Promote private sector participation in the delivery of road works and encourage market competition to increase efficiency and (b) corporatize and privatize state-owned construction enterprises and expose them to market competition.

5. EDUCATION

Enrollment growth has recovered strongly after the collapse in public expenditure in the late 1990s. However, the completion rate is low, notably in primary and secondary education. Financial flows to the education sector have approached the pre-crisis levels but still are insufficient. A high proportion of education spending consists of capital spending, mainly externally financed. Recurrent spending has not kept pace with this. However, its budget allocation has increased as nearly 80 percent of recurrent spending comprises salaries.

There also are widespread disparities in educational access and outcomes. Children from low-income households, ethnic minority groups, and rural areas display different enrollment trends than children from urban areas. Salary increases for teachers are a high priority. A critical requirement is for Lao PDR to increase the proportion of national resources allocated to education. In addition, the most disadvantaged districts should receive adequate public funds. However, there is no system for collecting, analyzing, and disseminating data, notably at the provincial level. If the GOL does not take urgent action to address teachers' conditions, many graduates will continue to take jobs outside teaching, there will be a continuing shortage of teachers, especially in poor and remote districts, and the EFA goals and the MDGs will not be achieved. Finally, the MOE and donors need to tackle jointly the problem of separate recurrent and capital budgeting.

5.1 INTRODUCTION

156. **This chapter reviews the performance of the education sector in recent years** and analyzes the role of the GOL and the private sector in providing education services to the population (section 5.2). The chapter then reviews the record of the Lao PDR government in public expenditures on education from 2001-05 and looks at the resource needs and financing for 2006-10 (section 5.3). Issues of efficiency and equity in education spending are examined in section 5.4, while eligible priority programs in education under NT2 are considered in section 5.5. Section 5.6 presents the main conclusions and recommendations.

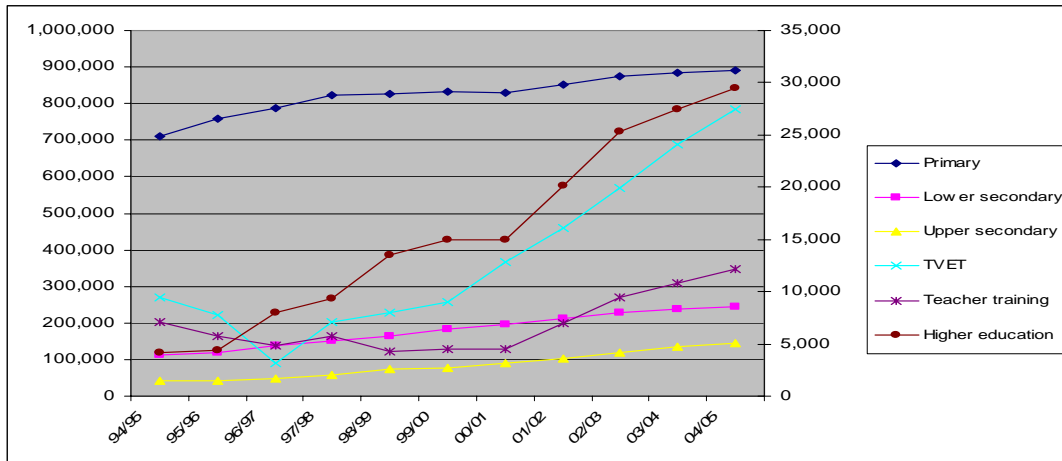
5.2 EDUCATION SECTOR OVERVIEW AND RATIONALE FOR GOVERNMENT INTERVENTION

5.2.1 Education Sector in Lao PDR

157. **Overall, enrollment growth has recovered strongly following the collapse of public expenditure in the late 1990s.** Primary and secondary enrollments have grown over the past 10 years, driven strongly by increased female enrollment. The largest growth in enrollment among women has been achieved by the majority Lao-Tai women. According to LECS III data, urban girls often have higher age-specific participation rates in school than urban boys. However, there are signs of divergence within the female population, with a widening schooling gap between Lao-Tai and non-Lao-Tai women in rural areas and between

rural and urban women. Enrollment growth is clearly greater at higher levels of education. Technical and vocational education and training (TVET) and teacher training have led the way in recent enrollment growth.

Figure 16. Enrollment Growth Greatest at Higher Education Levels, 1994-2005



Source: Government of Lao PDR, 1994-2005.

Note: Numbers represent number of students. Primary, lower secondary, and upper secondary are measured by the left vertical axis. TVET, teacher training, and higher education are measured by the right vertical axis.

158. **Although the internal efficiency of the national education system has steadily increased, only a small proportion of students completes the full cycle of primary and secondary school.** Ten years ago, barely one-half of students entering Grade 1 completed Grade 5, but today nearly two-thirds do so. While dropout rates have remained at the same level over the past decade, progress has been made in reducing the repetition rate (from 30.1 percent in 1991-92 to 16.5 percent in 2001-02) and increasing the promotion rate (from 58.7 percent in 1991-92 to 72.4 percent in 2001-02). However, it is proving difficult to keep children in school long enough to complete primary and secondary schooling. For every 100 males who enroll in Grade 1, only 27 will subsequently graduate from Grade 11. For every 100 females who start Grade 1, only 23 will complete Grade 11.

159. **There are widespread disparities in education access.** A closer focus on access and outcomes by income level shows that the poorest districts in Lao PDR experience systematic disadvantages in a wide variety of educational indicators.²⁷ Children from low-income households, ethnic minority groups, and rural areas display prominently different enrollment trends than those from urban areas. Majority Lao-Tai male and non-poor children are all more likely to be in school than non-Lao-Tai female and poor children. Leaving income differences aside, the age-specific participation rates range from 92 percent for urban girls to 52 percent for rural non-Lao-Tai girls, a range of 40 percentage points. When income is taken into account, the participation rates range from 93 percent for non-poor children (boys and girls) in urban areas to less than 46 percent for poor, non-Lao-Tai rural girls, a 47 point difference. The most disadvantaged populations cannot be reached using conventional approaches (such as increasing classrooms, teachers, and textbooks) alone. New and group-specific approaches are required that meet the special needs of these groups, such as multi-grade teaching and multi language (other than Lao) teaching.

²⁷ King and van de Walle, 2005.

160. **Data on learning outcomes are lacking but will soon become available.** A 2001 survey of functional literacy in the Lao language among adults aged 15 years and over found that only 54 percent of men and 37 percent of women reached the level of “basic literacy.” There were significant disparities by urban/rural location, ethnic group, and socioeconomic quintile. Despite having information from sporadic surveys of this type, until recently, the GOL has had no regular access to data on students’ learning achievement. Regular data are an essential tool for stewarding the education system effectively. Now, however, the Ministry of Education has developed a sample-based testing instrument that will provide regular information on students’ performance (initially just Grade 5 students) in the Lao language, mathematics, and general science. The first round of testing was done in May 2006.

5.2.2 Rationale for Government Intervention in Education

161. **Governments have an interest in ensuring a well-educated populace.** Evidence worldwide shows that investing in education yields significant public and private economic returns. Government interventions in education can reduce inequality and open up opportunities for the poor and disadvantaged. They can also compensate for market failures in education, thus ensuring access for households too poor to pay private fees and making information about the benefits and availability of education generally available. In practice, basic education (primary and lower secondary) is a priority area for government involvement because it yields many externalities. There are broad benefits to society as a whole from widespread functional literacy and numeracy. Post-basic education (upper secondary, TVET, and higher education) in which key “skills for development” are nurtured, also offers a way out of poverty for the poor. Lao PDR needs a critical mass of technically skilled people, including health care workers, journalists, accountants, administrators, agriculturalists, and environmentalists, if it is to solve its multiple governance, social, economic, and environmental problems.

162. **The GOL sees progress in education as contributing both to poverty reduction and economic growth.** Universal participation in basic education of adequate quality is a critical factor in first reducing and then eradicating poverty. Unequal access to education is one of the strongest correlates of income inequality. The GOL’s education policy is set out in the National Growth and Poverty Eradication Strategy, the National Socioeconomic Development Plan, and the National Education-for-All Action Plan. The policy includes the Millennium Development Goals (MDGs). The first priority of the GOL is to universalize primary education by 2015. To move toward this fundamental goal, the GOL will focus on reducing gender and geographic disparities in access, on improving the quality and increasing the relevance of education, and on strengthening education management within a decentralized governance structure.

163. **To achieve EFA and MDG targets for national enrollment, the GOL will need to increase the enrollment of rural populations, especially girls and non-Lao-Tai.** Consecutive Lao Expenditure and Consumption Surveys have shown that children are entering school late, and experience shows that late enrollment is linked to early dropout. This Lao pattern suggests that the government would focus on to raise enrollment rates and improve educational attainment by focusing on measures to increase *on-time enrollment*. These measures could include starting nutritional programs for preschoolers, implementing

an information campaign stressing compulsory education, and giving additional incentives to poor and remote households to send their children to school.

5.3 ANALYSIS OF PUBLIC EXPENDITURE TRENDS AND FUTURE RESOURCE NEEDS

5.3.1 Allocation of Education Spending

164. **Public educational expenditure is recovering from the financial crisis of the late 1990s but is still very low.** Public spending on education increased substantially during the early 1990s. However, with the onset on macroeconomic difficulties, which were exacerbated by the Asian financial crisis of 1997-98, public expenditure virtually collapsed. During the recovery over the last five years, the education budget grew in real terms by 12 percent a year. Despite this, public educational expenditures still have not recovered to their 1994—95 level, either in relation to GDP or as a proportion of total public spending (Table 20). Although education expenditures in Lao appear to be higher than in some of its neighbors, the ratios still remain below the Asia-Pacific developing country average (Table 21).

Table 20. Increases in Lao PDR Public Expenditure on Education, 1990-2005 (%)

	1990-91	1994-95	1999-2000	2004-05
Education budget as % of GDP	1.	3.	1.4	2.
Education as % of total GOL budget	7.	13.9	7.1	11.1

Sources: Data for 2004-05 are estimates by Ministry of Education reported in UNESCO and ADB 2005b. Data for earlier years are from Noonan, 2001 and SIDA/WB, 2001, Table 1.

165. **The dominant features of recent public expenditure are the high proportion of capital spending and the high percentage of donor-financed spending.** At the beginning of the 1990s, capital spending amounted to less than 5 percent of public expenditure, with foreign funds accounting for zero. Throughout the last 10 years, investment spending has been approximately 50 percent of total public expenditure, and by 2004-05, foreign funds accounted for over 90 percent of educational investment (Table 22).

Table 21. Low Public Expenditure on Education in Lao PDR by Regional Standards, 1990-2005 (%)

	<i>Public expenditure on education as % of GNP</i>	<i>Public expenditure on education as % of total public expenditure</i>
Cambodia	2.1	15.3
Indonesia	1.4	9.8
Malaysia	8.5	20.0
Myanmar	1.3	18.1
Thailand	5.1	28.3
Asia-Pacific developing country average (21 countries)	4.7	16.2
Lao PDR	2.3	11.6

Sources: Data for Lao PDR are for 2004-05 as reported in Table 20. Data for all other countries are for 2001 from UNESCO, 2005, Table 14.

166. **However, the GOL must recognize the changing nature of donor funds.** The GOL should have matched the rapidly rising foreign investment by substantial increases in the recurrent budget if both budgets were to be spent effectively. It has been argued cogently that this did not happen (Table 23).²⁸ If recurrent spending is too low relative to investment, schools will be built but little learning will cannot take place due to a lack of operating funds to pay teachers, buy textbooks, or carry out essential maintenance. Today in Lao PDR, less than 20 percent of ODA consists of “classic” infrastructure activity. Most ODA in education is capacity building or training of one sort or another. This is still measured (correctly) as investment in conceptual terms, but *de facto* the funds are administered and spent as though for recurrent items.

Table 22. Recurrent Spending Too Low Relative to Investment, 2001-05

(mil Kip)	2001-02	2002-03	2003-04	2004-05 (planned)
Current prices:				
Education budget	386,126	451,922	457,481	658,080
Recurrent	184,655	185,804	246,601	304,654
Capital	201,471	266,118	210,880	353,426
Constant prices:				
Education budget	386,126	404,018	393,434	613,331
Recurrent	184,655	166,109	212,077	283,938
Capital	201,471	237,909	181,357	329,393
Average annual rate of growth over 4 years (%)				
Education budget				12.3
Recurrent				11.4
Capital				13.0
Education recurrent as % of education	47.8	41.1	53.9	46.3
Education investment as % of education	52.2	58.9	46.1	53.7
% of capital domestically financed	40.8	23.9	18.1	7.8
% of capital foreign financed	59.2	76.1	81.9	92.2
Education budget as % of GDP	2.3	2.35	2.45	2.49
Recurrent as % of GDP	1.0	1.0	1.0	1.1
Capital as % of GDP	1.3	1.4	1.5	1.4
Education budget as % total budget	10.1	10.8	10.8	11.6
Recurrent as % total public recurrent budget	10.0	10.4	8.7	9.6
Capital as % total public capital budget	10.2	11	12.6	14

Source: Calculated from MOE data 2005.

²⁸ See, for example, Noonan, 2001 and Sida/World Bank, 2001.

Box 13. Education Expenditure Data: Where Do They Come From?

Education expenditure data for 2001-02 to 2004-05 come from two major sources: (a) provincial data from the Department of Finance of the Ministry of Education and (b) the Official Gazette prepared by the Ministry of Finance. The data used for this analysis are actual (for 2001/02 to 2003/04) and planned (for 2004 to 2005) expenditures officially published in the MOF Gazette. Provincial data include actual expenditures until 2004/-05. The authors reviewed all data, verified discrepancies between the two sources with the Department of Finance of the MOE, and checked back with provincial education offices. In these cases, data from the provinces appeared to be more reliable and were used in the database. The sub-sector data are estimates provided by the Department of Finance of the MOE, using (a) available data from provinces; (b) calculations from MOE data (that is, average teacher salary and estimate numbers of teachers at different educational levels); and (c) approximate trends of expenditure categories at different levels of education.

Sources: Government of Lao PDR and World Bank, 2006.

167. **Improvements can be seen in the composition of the recurrent budget.** The GOL arrested the sharp decline in the share allocated to salaries in the latter half of the 1990s, hence also the major fall in teachers' wages. The proportion allocated to salaries is now approximately 80 percent of recurrent expenditure, close to their share before the collapse. Although the share of the recurrent budget allocated to salaries has increased, the level of teachers' pay remains a critical issue. The latest data show that the ratio of the average primary teacher's salary to GDP per capita is 65 percent compared with 165 percent in 1994 and compared with an Asian average of 240 percent. Consequently, as suggested by anecdotal evidence, many teachers teach for fewer hours than they are employed to teach because they need time for outside employment to compensate for their very low salaries or because they simply reduce their effort as their pay is reduce in value. Low salaries often lead to a low quality of teaching and low motivation among teachers and makes it difficult for the government to find teachers to move to poorer and more remote areas. Improving educational outcomes will necessitate raising the salaries of teachers. Nevertheless, it is important to accompany any salary increase with a broader teacher management policy that covers recruitment and training as well as accountability for performance.

Table 23. Composition of Recurrent Expenditure, 1995-2005 (%)

	1995-96	1999-00	2001-02	2002-03	2003-04	2004-05 (planned)
Salaries	82.2	67.4	75.4	77.5	82.9	78.4
Textbooks/teaching materials*	N.A	N.A	16.3	15.0	10.9	15.9
Operations and maintenance	N.A	N.A	8.3	7.4	6.2	5.7

Source: Calculated from MOE data 2006.

Note: * = Includes student subsidies and scholarships.

168. **The fact that a declining percentage of the recurrent budget is being allocated to basic education is inconsistent with national priorities.** The recent rapid increase in upper secondary, technical/vocational education, teacher education, and higher education enrollments has already been noted. This enrollment growth is underpinned by an increased flow of public money as allocated by the provinces. This pattern of recurrent budget allocation stands in contrast with the government's declared policy to focus on basic

education and to achieve the goals of the EFA initiative. *This mismatch between national priorities as set out in government strategies and the allocation of resources by provincial authorities highlights a weakness in the country's public expenditure management arrangements.*²⁹ The GOL needs to mandate minimal per capita budget allocations for basic education and improve management information systems to ensure that, by 2009, Nam Theun II revenues are properly directed to basic social services, including primary and lower secondary education for disadvantaged populations.

169. **Unit costs emphasize that the Lao education system operates with very few resources, to the particular detriment of basic schooling.** The international developing country ratio for primary unit costs as a proportion of GDP per head varies from 7 to 14, but the Lao ratio is twice GDP per head (Table 25). The lower secondary ratio for Lao PDR is less than 3 percent, a mere fraction of the 20-24 percent typical of other Asian developing countries. In many Lao secondary schools, especially those outside major towns, classrooms, textbooks, and learning materials are in desperately short supply. Thus, additional teaching resources and the maintenance of infrastructure are crucial to ensure that teachers can perform effectively in the classroom.

Table 24. National Priorities not Reflected in Allocation of Recurrent Expenditures (%)

	1994-95	1999-00	2001-02	2002-03	2003-04	2004-05 planned
Early child care and education	3.3	3.6	2.7	2.4	2.2	3.7
Primary education	46	48.7	40.2	42.6	37.1	39.3
Lower secondary education	16.9	16.7	16.9	15.1	13.9	12.1
Upper secondary education	7.1	8.3	13.6	13.6	13.0	10.4
Technical and vocational education	6.5	2.6	6.3	6.1	8.0	7.6
Teacher training	4.8	2.7	7.3	7.3	9.3	11.9
Higher education	8.4	6.8	6.9	6.6	10.2	9.7
Non-formal education			1.9	1.5	2.6	2.2
Administration and management	7.2	11.1	6.1	6.4	6.3	5.4

Source: Calculated from MOE data 2006.

170. **The opportunity costs of the existing allocation pattern are severe:** each higher education student costs the equivalent of 13 primary enrollments. Lao PDR undertook a major rationalization of teacher colleges in the late 1990s, but it is apparent that the cost structure of teacher education needs further attention. Its enrollment is only half that of higher education, but it receives 80 percent of the amount received by higher education. Its unit costs substantially exceed any other sub-sector of education.

²⁹ See Chapter 2 for a discussion of this mismatch in the general context of public expenditure management.

171. **Variations in provincial spending do not appear to correlate with measures of “need.”** The observed disparities in spending may partly reflect data limitations or may be the outcome of provincial objectives other than merely the costs of providing education. Examining provincial disparities by relating the differences in spending per student to the incidence of poverty in each province does not yield any systematic relationship. In practice, provincial authorities in general do not have the planning and management capacity to relate educational objectives to resources or to monitor the benefits or impact of expenditure. Nor are there any standardized cost formulae (apart from broad guidelines on, for example, teacher ratios) that the provinces could apply on a consistent basis. There is nothing in the current transfer system to ensure compliance with overall national policies or to even out spending disparities among provinces.

172. **Because of this disconnect between national priorities and provincial spending, the GOL must redefine the center-local relationship to ensure greater accountability of provinces for performance outcomes.** The current lack of clarity creates a disconnect between the responsibilities of local governments and their financing and makes it difficult for local governments to develop budgets that meet national service delivery goals. Moreover, since the government has identified priority districts, it needs to review resource allocations, spending patterns, and governance modalities to ensure that they reflect these priorities and are adapted to local needs and capacities. This problem is significant in the education sector, as sub-national administrations have the core responsibility to deliver primary and secondary education. Recurrent expenditures in education vary significantly across provinces. For example, while Bolikhamxay Province spends 18,641 Kip per capita, Luangnamtha Province spends 56,846 (FY2003-04 data). Average expenditure across all Lao provinces is 40,546 Kip per capita, and the standard deviation is 15,565.

173. **The GOL needs to manage the flow of education funds better.** At present, not much is known about how much of the “education Kip” reaches districts and schools. The results of the first public expenditure tracking survey, carried out in the education and health sectors in May 2006, will provide the GOL with the information necessary to determine what proportion of public expenditure actually reaches the level of the local service provider. However, in addition to regularly using this kind of financial management tool, the GOL needs to streamline the decision-making processes that facilitate (or hamper) the flow of funds from the central level to the school level (via the provincial and district levels). Simplification, delegation, and capacity development all are required to ensure not only that the “education Kip” pays for teachers and textbooks but also that it reaches the local level in a timely fashion.

5.3.2 Financing and Future Resource Needs

174. **Implementing the NGPES will require an additional US\$12.9 million.** The NGPES and the National Education-for-All Action Plan set out the following priorities in levels of education: (a) primary, (b) lower secondary, (c) non-formal and adult education, especially skills development, (d) teacher training, (e) upper secondary, (f) preschool, (g) tertiary education, and (h) technical education and vocational training. A related objective is to increase recurrent expenditure on inputs to ensure the long-term sustainability of education development (such as additional teachers, textbooks, and teacher guides), improve quality, increase efficiency (both of which are also prerequisites for expansion and sustainability), and promote equity. The NGPES proposed also to increase teachers’ base salaries by 2

percent per annum, with the ratio of the average salary to GDP per capita remaining constant at approximately 0.87. In a scenario that would take these salary increases into account and increase transition rates from lower to higher education levels to 85 percent by 2010, the MOF would experience a total funding gap of US\$12.9 million for the overall plan period in relation to its preliminary envelope for education. Since investments are funded by donors to a very large extent (approximately 75 percent), this scenario relies on the ability and willingness of donors to invest, which in turn calls for the adoption of a Sector Wide Approach (SWAp) to investment in the sector.

5.4 EFFICIENCY AND EQUITY ISSUES: BENEFIT INCIDENCE ANALYSIS

175. **Children of wealthier households account for higher rates of the enrollment but receive the lowest subsidy at the primary level.** The wide provincial variation in expenditure per student suggests that incidence analysis ideally should be based on provincial expenditure rather than on the national average. However, given the absence of disaggregated data, Tables 26 and 27 show the basic results for incidence analysis by comparing enrollments by expenditure quintile with quintile shares of subsidy derived from national average expenditure per student. While children from all quintiles participate substantially in primary schooling, quite clearly the children of wealthier households account for much of the enrollment in lower and upper secondary education (Table 26).

Table 25. Relative Costs of Students in Primary and Higher Education

<i>Unit cost</i>	<i>Primary</i>	<i>Lower secondary</i>	<i>Upper secondary</i>	<i>TVET</i>	<i>Teacher education</i>	<i>Higher</i>
US\$	9.87	13.65	22.71	90.28	173.27	122.66
as % of per-capita GDP	2.1	2.9	4.8	19.2	36.9	26.1

Source: Calculated from data provided by Department of Finance, and Annual Bulletins, Ministry of Education 2003-04.

Table 26. Enrollment Rates of Children from Different Quintiles

	(%)					
	<i>Poorest</i>	<i>II</i>	<i>III</i>	<i>IV</i>	<i>Richest</i>	<i>Total</i>
<i>Primary</i>	91	110	120	127	128	112
<i>Lower secondary</i>	23	41	51	71	88	53
<i>Upper secondary</i>	12	17	27	38	53	29

Source: Calculated from Lao Expenditure and Consumption Survey 2002-03 (LECS III).

Note: Enrollment rates are gross enrollment ratios (GERs).

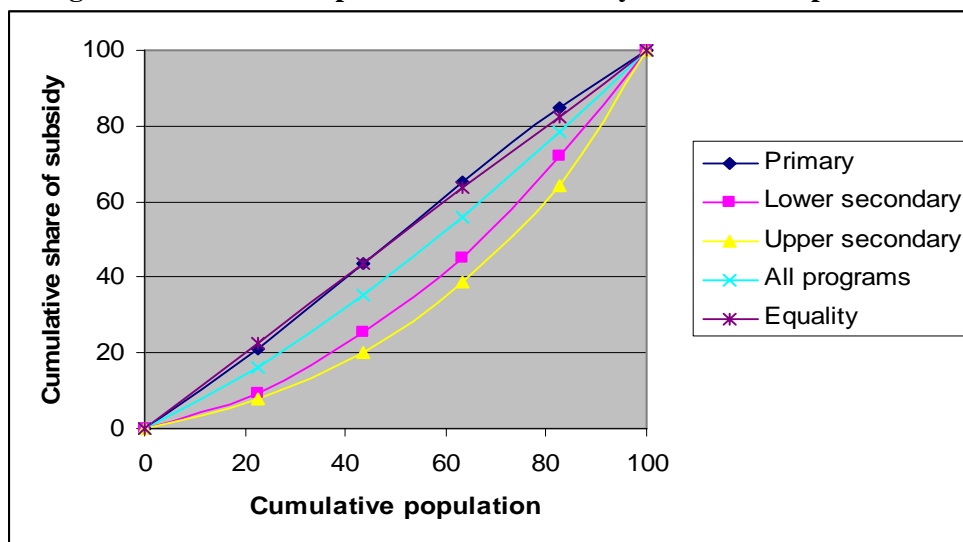
176. **These enrollment rates are then adjusted to a per capita basis from the ratio of the school-age group to the population of each quintile and combined with the per-student subsidy for each school level** (Table 27). The concentration curve (Figure 17) demonstrates that the secondary subsidies are quite strongly regressive. However, the low coefficient for “All Programs” signifies that there are no large overall differences between the five quintiles, making these subsidies quite equitable. The high GER rates, even for the better-off students, could be a sign of significant inefficiencies in primary schooling and therefore require the government to focus on increasing efficiency.

Table 27. Pro-poor Bias of Primary Education Expenditures (%)

	Poorest	II	III	IV	Richest	Total
Primary	21.2	22.5	21.7	19.5	15.2	100
Lower secondary	9.4	16.2	20.0	26.6	28.1	100
Upper secondary	7.6	12.4	18.5	25.6	35.9	100
All programs	16.1	19.2	20.7	22.2	21.8	100

Source: Calculated from enrollment data by quintile and school level from LECS III, expenditure by sub-sector from the Department of Finance at the MOE, and enrollment data from Annual Bulletins, MOE 2002-03.

Note: Share of public subsidies = per capita subsidy per student/national average; *percentage share of population.

Figure 17. Lack of Pro-poor Bias in Secondary Education Expenditures

Source: Calculated from enrollment data by quintile and school level from LECSIII, expenditure by sub-sector from Department of Finance at the MOE, and enrollment data from Annual Bulletins, MOE (2002-03).

5.5 ELIGIBLE PRIORITY PROGRAMS IN EDUCATION UNDER NT2

177. **The GOL identified basic education as a broad NT2 revenue priority program, in line with the education priorities that it had set out in the NGPES, the NSEDP, and the National Education-for-All Action Plan.** However, the disconnect between the GOL's strategy and provincial resource allocations have led to a declining percentage of the recurrent budget going to basic education. Estimates based on provincial data show that, in 2004-05, primary education took 39 percent of recurrent public expenditures for education, down from 49 percent just five years earlier. During the same year, the share for lower secondary fell from 17 percent to 12 percent.

178. **In preparing to allocate NT2 revenues, the GOL will need to strengthen public expenditure management and define its "education priority program" more specifically.** Given its commitment to ensuring universal primary completion by 2015 in line with the MDG, the government may wish to spend this additional revenue on primary and lower secondary education or on primary education alone. The GOL should base its decisions about the focus of the program on a sound cost-benefit analysis. The increase in demand for primary education that is likely to come from providing more opportunities in lower secondary education is an argument in favor of widening the coverage. Initially concentrating the additional resources exclusively on primary education may focus resources on the most

disadvantaged children in the shorter term. In light of the current imbalances between capital and recurrent expenditures and between salary and non-salary expenditure, the government also should consider focusing on non-salary recurrent expenditures for primary/lower secondary education, with sub-programs in teacher upgrading, textbook development and distribution, and EMIS strengthening (including the assessment of student learning outcomes). Alternatively, the government may wish to overlay a geographic focus, limiting the program to deliver primary/lower secondary education in the NGPES 47 priority districts. In any event, GOL will need to consult on the strengths and risks of broad or narrow coverage for the education priority program.

179. **The GOL also must establish a reliable and accurate set of baseline data before the revenue becomes available to ensure additionality in program allocations.** Establishing this baseline in turn will depend on public expenditure management tools that are adequate to the task and constitute a significant improvement on the current system of *ad hoc* data collection at the provincial level. Central and provincial capacity in public expenditure management, financial management, and monitoring and evaluation requires considerable strengthening.

5.6 MAIN CONCLUSIONS AND RECOMMENDATIONS

180. **A critical requirement for Lao PDR is to increase to 15 percent the proportion of national resources spent on education and to ensure that this spending favors priority districts.** However, no information system exists for data collection, analysis, and dissemination, notably at the provincial level. The low level of teachers' salaries is another concern that deserves attention. Finally, the MOE and donors jointly need to tackle the problem of separate recurrent and capital budgeting. The following key recommendations emerge from the analysis undertaken in this chapter:

- **Resource allocation:** (a) Focus additional spending, including the NT2 revenues, on meeting EFA and MDG targets for basic education and (b) improve allocation of resources, notably to improve the benefits accruing to education personnel, including reviewing their salaries and performance-based incentives while at the same time assessing the apparent cost-inefficiency of teacher education.
- **Education information system:** (a) Improve the comprehensiveness and reliability of the Education Management Information System (EMIS) and integrate it fully into the planning and budgeting processes and (b) collect, analyze, and disseminate data on education expenditures in the provinces by program and educational sub-sector (for example, add a line in the budget).
- **Equity:** (a) Allocate more resources to priority districts (as identified by the government in its poverty eradication strategy) so that expenditures match “need” (defined as the gap in each district between the current status and the EFA/MDG targets); (b) ensure that NGPES priorities are reflected in budget allocations; and (c) develop group-specific approaches to attract and retain non-Lao-Tai students in the education system, especially girls.

6. HEALTH

Although health outcome indicators in Lao PDR have improved significantly over the last 30 years, there is little reliable information about trends over the last five years. What is known is that the government is facing significant challenges in delivering adequate public health services to the population. The coverage of key maternal and child health programs is low. Compared with other Asian countries, aggregate public and private health spending remains low. Capital expenditures account for a substantial share of government health expenditures, reflecting significant donor support. However, there is a shortage of recurrent funds for the operation of health services. Domestically financed government health expenditure is declining and is biased toward the central level. User fees have been introduced to fill the gap, but they have created financial barriers to access for the poor. In particular, user fees for hospital care may be impoverishing some poor households. Current user fee exemptions are not effective in protecting the poor as the top income quintile captures nearly 30 percent of public health subsidies. Use of public health services and the productivity of health sector staff are both low, indicating a lack of quality and of adequate incentives to improve it.

The immediate priorities for the GOL are to increase and improve resource allocation for public health programs. The changes must ensure that adequate resources are provided for non-wage recurrent expenditures, front-line health services at the district level, and incentives to improve the performance of health personnel. The GOL also should strengthen the targeting of the poor to ensure that they have access to essential health services and are protected from catastrophic health expenditures. Low execution rates reflect a need for strengthening financial management systems to ensure transparent execution and effective monitoring of public spending. It also is important for the GOL to harmonize and align its own and donor programs with its health sector priorities. .

6.1 INTRODUCTION

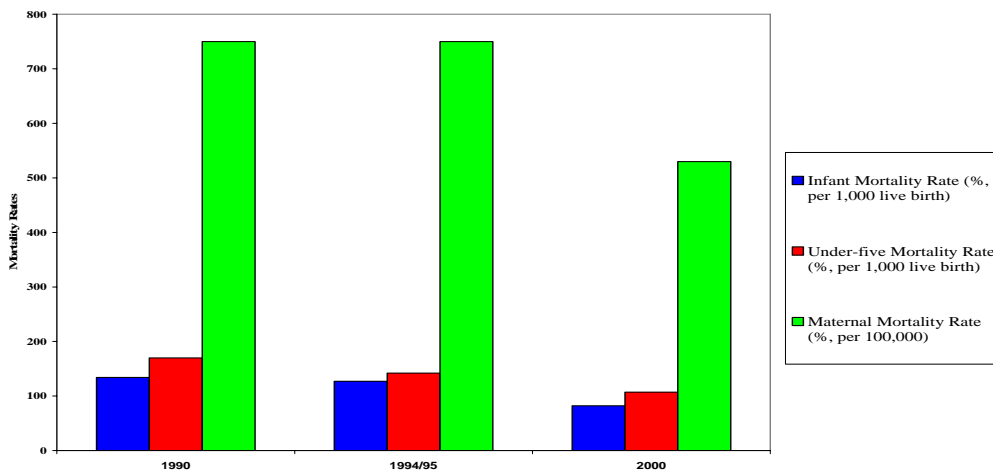
181. **This chapter reviews the performance of the health sector in recent years** and analyzes the role that the government and the private sector must play in providing health services to the population (section 6.2). The chapter then reviews the record of the Lao PDR government with respect to public expenditures on health from 2001-05 and looks at the resource needs and financing for 2006-10 (section 6.3). Issues of efficiency and equity in health spending are examined in section 6.4, and eligible priority programs in health under NT2 are considered in section 6.5. Finally, section 6.6 presents the main conclusions and recommendations.

6.2 HEALTH SECTOR OVERVIEW AND RATIONALE FOR GOVERNMENT INTERVENTION

6.2.1 Health Sector in Lao PDR

182. The available data³⁰ show that there have been significant improvements in health outcome indicators in Lao PDR during the last 30 years. Indicators that improved markedly in the 1990s include child mortality, maternal mortality, and fertility rates, although progress has been relatively slow compared with other countries in the region (Figure 19). In recent times, Lao PDR has made inroads in combating malaria and tuberculosis (TB). The TB case detection rate increased from 24 percent in 1996 to 55 percent in 2004, and the cure rate rose from 55 percent in 1996 to 79 percent in 2003.³¹ Deaths associated with malaria fell from 9 per 100,000 population in 1990 to 1.8 in 2004. Another reproductive health survey was conducted in 2005, and results will be released very soon.

Figure 18. Trends in Key Lao PDR Health Indicators, 1990-2000



Source: World Bank, 2006.

183. **By and large, the Lao public health care system has failed to deliver adequate health services to its population.** Coverage of key maternal and child health programs in Lao is low compared with coverage of similar programs in other countries in the region (Figure 19). The worsening trend in immunization rates is worrying. Despite some improvement, coverage of water and sanitation remains low. The latest household data show that only approximately 30 percent of the population has access to acceptable sanitation, and only 40 percent has access to clean water (LECS III, 2006). The poor have the least access. Use of curative health care is low compared with most other countries in the region, with an annual average of 0.7 outpatient consultations per capita and an inpatient admission rate of 30 per 1,000 people.

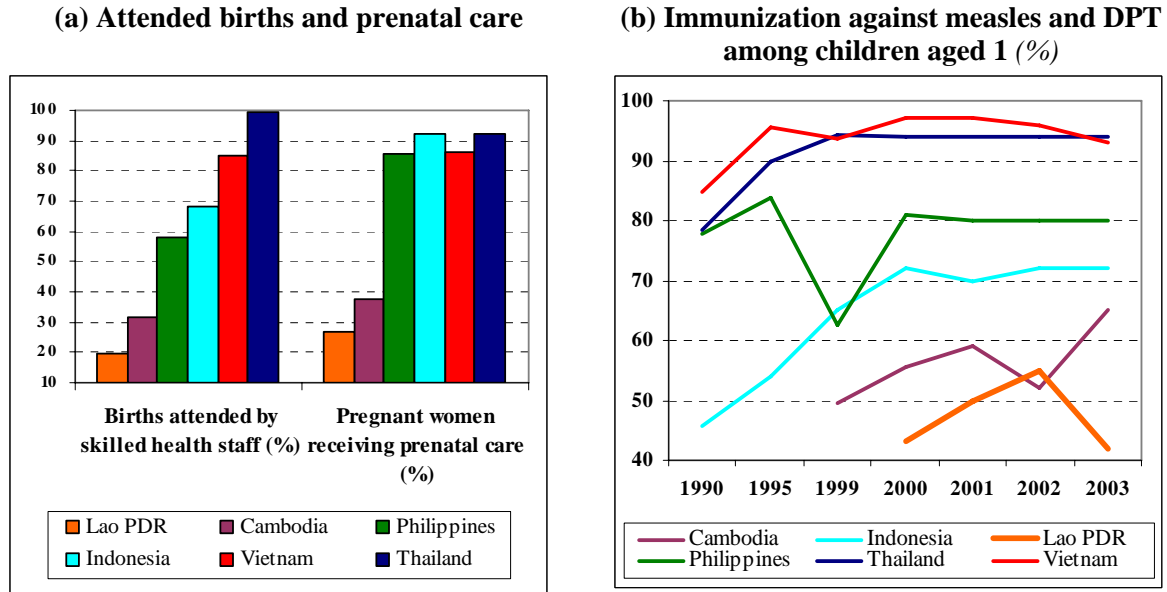
184. **Moreover, better-off groups use substantially more public health facilities, including health centers, than the poorest.** Better quality health services provided by

³⁰ While finalizing this chapter, new data - updated up to 2005 - became available (see the National Policy on Population and Development, 2006, by CPI and the National Health Accounts, 2006). However, due to time constraints, it was not possible to analyze this newly released information.

³¹ Source: UN MDG Database; <http://mdgs.un.org/unsd/mdg/Data.aspx>

central hospitals are concentrated in urban areas and serve mainly better-off populations. There also are geographic disparities. Coverage of key primary health services varies widely among provinces. The most favorable outcomes have been observed in the Vientiane Municipality and in most Central Region provinces. For example, antenatal care coverage ranges from 7 percent of pregnant women in Phongsaly in the North to 79 percent in Vientiane.³²

Figure 19. Coverage of Key Maternal and Child Health Services



Sources: World Bank, World Development Indicators, 2000–02 and 2003.

6.2.2 Rationale for Government Intervention in Health

185. **The GOL has four important roles to play in the health sector.** They are: (a) to provide health services with a “public good” nature, which would not be provided if left to the market, such as surveillance and control of communicable diseases, sanitation, and mass education; (b) to provide access to health services that create large spillover effects (such as vaccinations) or that produce greater social than private benefits (such as family planning); (c) to ensure that the poor do not face unaffordable financial barriers in accessing essential health services and to put in place arrangements to protect the population (in particular, the poor and near-poor) from the impoverishing impact of catastrophic health care costs; and (d) to ensure that institutions and a regulatory environment exist to correct for “market failures” in the health sector (such as incomplete information on the quality and appropriateness of care and potential risk selection by insurers).

186. **The GOL’s role in health is even more important in Lao PDR given that the poor rely heavily on low-quality health services from the non-governmental sector.** The GOL’s main instruments to fulfill these key roles are sufficient, well-targeted, and well-managed public health expenditures; as well as clear policies and regulations and institutions to enforce them. GOL-run health services dominate the sector with a significant level of decentralization to the provincial level that requires the provinces to take direct responsibility

³² Source: Lao Reproductive Health Survey 2000: Summary of Provincial Data Analysis. NSC, 2003.

for providing services. However, as GOL health services are underused and a significant share of outpatient health care is provided by the private sector, the existence of private sector regulations and mechanisms to enforce them is also important.

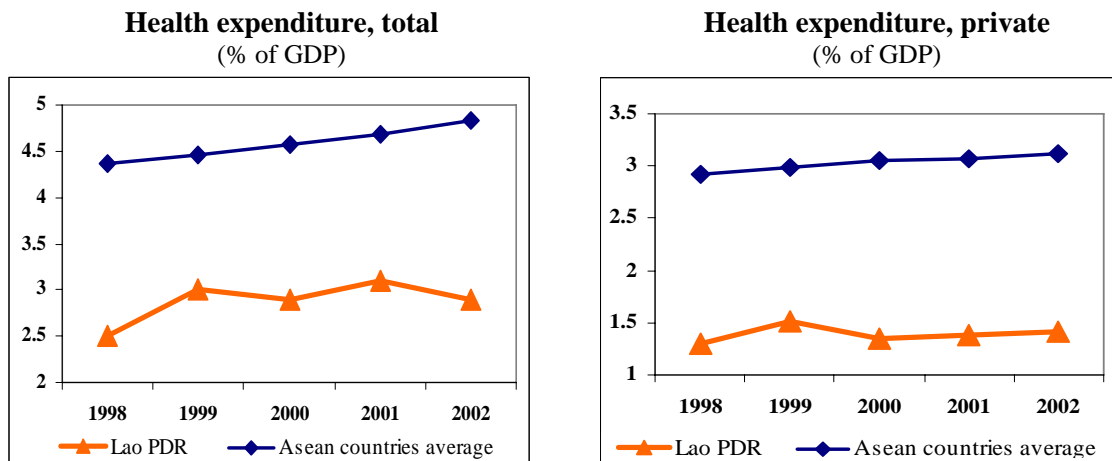
187. **Ensuring that the key government functions are performed well is even more important in the face of emerging public health challenges such as SARS and avian flu.** Avian flu is endemic in Asia, and Lao shares borders with countries that have all had outbreaks among poultry and human deaths. This underscores the need for an effective public health surveillance system and for health professionals and institutions to have the capacity to detect and respond to outbreaks and to prepare for human pandemics.

6.3 ANALYSIS OF PUBLIC EXPENDITURE TRENDS AND FUTURE RESOURCE NEEDS

6.3.1 Allocation of Health Spending

188. **Lao PDR's public and private health spending is low compared with that of other Asian countries.**³³ Total health spending in 2002 amounted to US\$8.7 per capita or more than 2 percent of GDP. The proportion of GOL-financed expenditure is low both as a proportion of total health expenditure (16 percent) and as share of GDP. The aggregate share of domestically financed government spending for health declined from 50 percent of total government health expenditure in 2002 to 27 percent in 2005. Donors and households shoulder significant proportions of total health expenditure (39 percent and 44 percent respectively). WHO estimates that, in 2003, health expenditures were even higher than in 2002 (US\$11.5 per capita, with an estimated 60 percent of this consisting of household expenditure, 30 percent consisting of donor funding, and 10 percent consisting of domestically financed government expenditure.³⁴

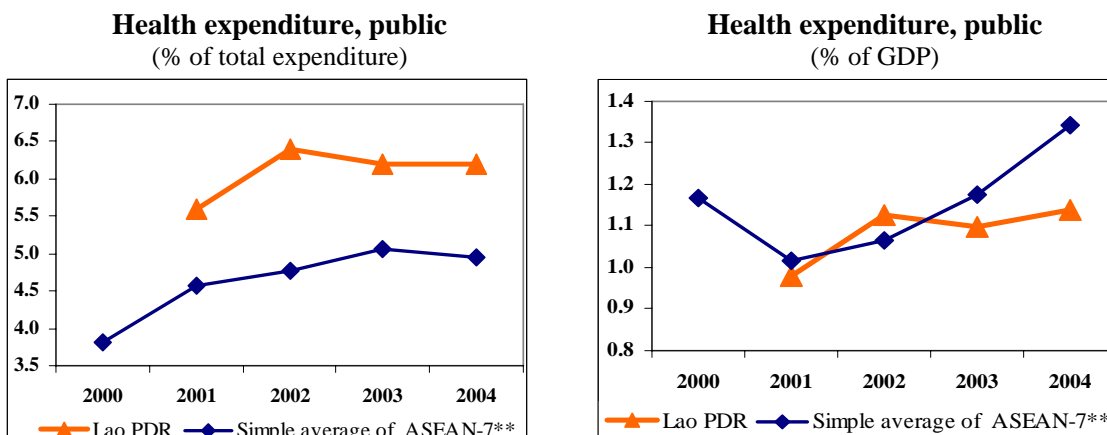
Figure 20. Total (Public and Private) Health Expenditures, 1998-2002



Source: World Development Indicators 2002.

³³ In 2006, WHO released the National Health Accounts 1996-2005 (www.who.int/nha). Due to time constraints, it was not possible to analyze this newly released information. The PER estimates do not include health expenditures by social security funds.

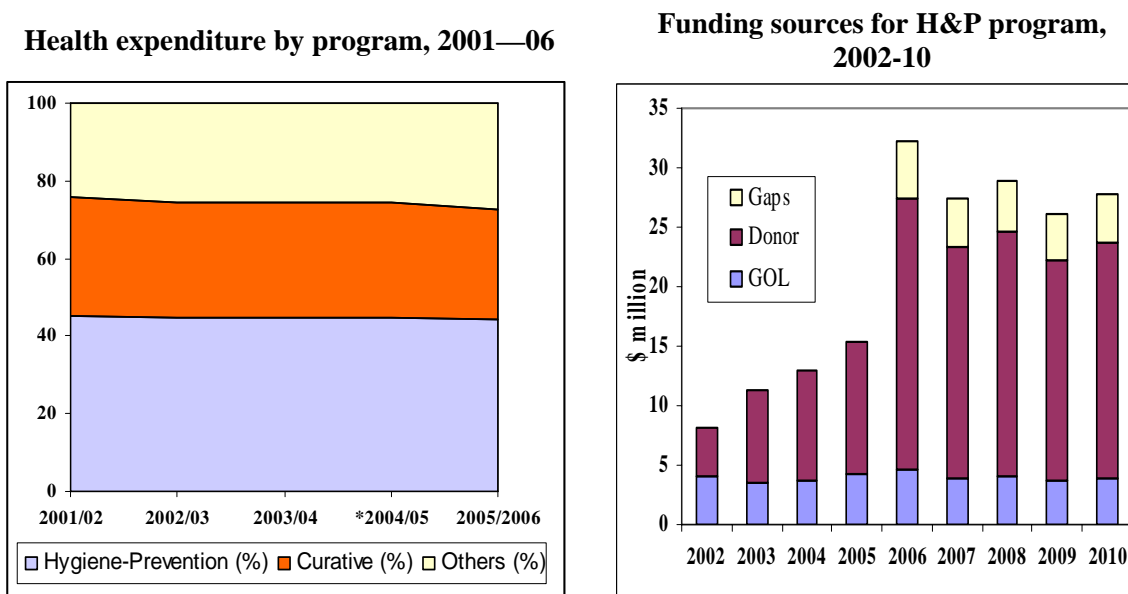
³⁴ Western Pacific Country Health Information Profiles, Health System of Lao PDR, 2005 rev., Western Pacific Regional Office (WPRO) of the WHO, 2005.



Sources: ADB’s country data for simple average of ASEAN-7 2004; MOF data for Lao PDR 2004.
 Notes: ASEAN-7 includes Indonesia, Lao PDR, Malaysia, Philippines, Singapore, Thailand, and Vietnam. Public expenditure includes external financing.
 * = data for Thailand is based on fiscal year (Sept-Oct.); otherwise, calendar year.
 ** = Indonesia 2004 data are not available.

189. **The GOL has relied heavily on external financing for public health and preventive programs**, especially operational expenditure. According to the functional classification, the GOL estimates that the Hygiene and Preventive (H&P) programs account for more than 40 percent of total health spending (Figure 21, left panel). H&P programs are key to delivering essential public goods in the health sector. External financing has been playing an increasingly important role in supporting these programs. The GOL’s projections predict an additional increase in the donor-financed share of H&P programs in the future. This issue raises crucial questions about the long-term sustainability of these programs.

Figure 21. Estimates (FY02-FY05) and Projection (FY06-FY10) of the GOL’s Health Expenditures (Ministry of Health Programs by year)



Source: Estimates based on MOH budget data (2002-2005) and MOH costing data (2006-2010).

6.3.2 Financing and Future Resource Needs

190. **Capital expenditures account for a substantial share of government health expenditure** (Table 28), nearly 40 percent during 2002-05. The share of capital spending is projected to increase to 45 percent in 2006, then to drop gradually to 22 percent by 2010. Lao PDR has been overspending on capital investment. These increased inflows of capital investment will exacerbate the current shortfall of recurrent expenditures to operate existing facilities due to additional demands for recurrent expenditures. Of the declining share of domestically financed government health expenditures, less than 10 percent was allocated to non-wage recurrent expenditures during 2002-05.

191. **Looking forward, there will be a significant gap in financing for health sector recurrent spending.** The GOL's projections for health public expenditure considerably exceed its available resources. For example, the total projected budget for 2006 is double the 2005 budget (Table 28). Therefore, it is plausible to assume that the GOL will once more rely

**Table 28. Total Expenditure in Public Health
by Major Economic Category
FY 2002-10**

(\$ million)	Actual			Planned			MOH projected budget		
	2002	2003	2004	2005	2006	2007	2008	2009	2010
Total expenditure	23.5	30.6	34.1	39.1	78.6	71.3	60.4	56.2	56.4
Current (%)	66.1	59.3	59.3	60.4	55.1	60.8	77.7	78.6	78.4
Capital (%)	33.9	40.7	40.7	39.6	44.9	39.2	22.3	21.4	21.6
<i>Domestically financed health expenditure</i>									
Recurrent (*)	12.1	11.3	12.1	14.1	11.9	12.3	12.7	13.1	13.4
Wage	3.7	3.4	4.1	4.8	5.5	5.7	6	6.2	6.4
Non-wage (*)	8.4	7.9	8.0	9.2	6.4	6.6	6.7	6.9	7
Capital	2.8	2.3	1.8	1.2	1.2	0.8	0.2	0	0

Source: Estimated from MOH's costing data 2005.

Notes: Figures include donor-financed and user fee expenditure

For 2002-05, 40 percent of external financing for health was assumed to be recurrent expenditure.

* = included revenue from user fees of \$6.4 million per year as projected in costing the MOH budget for 2006-10.

heavily on donor funding.³⁵ The World Bank's team estimates that the funding gap for staff and salary increases alone will be roughly US\$14 million by 2010, even assuming that the necessary levels of external funding are forthcoming (Table 29). An additional gap will exist in non-wage recurrent spending. These considerations point to the need to identify priority areas to which to target the additional resources.

³⁵ In practice, the necessary increase in donor funding may not materialize to the projected extent and/or there may be limited capacity at the local level to use these amounts even if they do materialize. In addition, even these high projections may not be sufficient to accommodate the GOL's plans to increase health sector staff and to implement a nationwide salary increase.

Table 29. Projection of Funding Needed for Key Spending Items, 2006-10

(\$ million)	2006	2007	2008	2009	2010
Financing for non-wage recurrent expenditure of H&P	19.0	16.1	17.0	15.4	16.4
Of which drug and medical supplies	10.3	8.8	9.2	8.4	8.9
Increase in salary payment	1.4	2.5	5.2	9.0	14.3
Total	20.3	18.7	22.2	24.4	30.7

Source: Estimated from MOF and MOH costing data 2005.

192. **User fees play an increasingly important role in financing public health services but may increase barriers to access, especially in remote areas.** The GOL first introduced cost recovery in public health care facilities in 1992. Initially, cost recovery comprised revolving Drug Funds, but from 1995, it was extended to cost recovery from user fees. The GOL's own estimates show that more than 50 percent of the operational costs of central hospitals and 33 percent of district, hospitals are met by cost recovery.³⁶ A recently approved Decree (No. 381/PM 2005) provides a platform for introducing more user fees. These additional user fees are intended to be an additional source of financing for operational expenses in public health facilities to fill the current gaps in recurrent expenditure. However, while user fees for the well-off (that is, in urban hospitals) are appropriate, a wider application of user fees is likely to create financial barriers for access to health services for the poor. Therefore, if these fees are adopted, they should be accompanied by effective exemption policies. The GOL should protect the poor from the impact of these fees by increasing domestic financing for recurrent expenditures. User fees should *not* be introduced for public health activities that have public good characteristics, such as immunizations and infectious disease control.

6.4 EFFICIENCY AND EQUITY ISSUES: BENEFIT INCIDENCE ANALYSIS

6.4.1 Geographic and Income Disparities

193. **The majority of the poor in Lao are ethnic minorities living in remote mountainous areas.** A special approach is necessary to deliver health services to these groups. The GOL has identified 47 highest priority districts and has solicited donor support for targeted interventions. Although commendable, this approach does not cover the poor who live in other districts.

194. **Per capita government health spending varies considerably across provinces and districts.** In 2001–03, it ranged from US\$1.5 per capita in Vientiane and Bolikhamxay Provinces to US\$7.5 in Luang Prabang.³⁷ Moreover, GOL health spending is not statistically related to factors such as income, poverty, or health need.³⁸ Therefore, it is necessary to develop a transparent need-based formula to ensure that adequate allocations are made for recurrent health expenditures across all provinces. This formula would apply to donor financing as well. An official formula is particularly important given that, because of the high

³⁶ Source: Study on Income, Expenditure and Activity in 16 Selected Hospitals. MOH, 2003.

³⁷ Source: Calculated from the MOF budget data in Official Gazettes.

³⁸ The district-level index of "health need" is constructed from 10 health and poverty indicators using the principal components analysis methods popularized by Filmer and Pritchett (1999, 2001).

level of decentralization in Lao PDR, the central government has little control over local resource allocation decisions and implementation. Sub-national administrations have the core responsibility for delivering primary and secondary health care services.

195. **Government health spending is biased toward the central level. Resources available at the district level are extremely limited.** After adjusting for types of expenditures that actually benefit front-line health services (such as centrally procured drugs), the central level absorbs at least 27 percent of government health expenditures. Total government health spending at the district level in FY 2002-03 was below US\$1 per capita (including only \$0.50 government-own-financed recurrent expenditure) in the Health System Improvement Project. This means that the GOL spent only one-fifth of total health expenditures on district health facilities and health centers, which should play the key role in delivering essential health services to the population, especially to the poor. Differences in recurrent health expenditures among provinces are significant. For example, while Bolikhamxay Province spends 7,215 Kip per capita, Sekong spends 22,990. Average expenditure is 11,040 Kip per capita, with a standard deviation of 4,466.³⁹

196. **Although the average Lao household makes a modest payment for health care, catastrophic health expenditures pose a poverty risk.** On average, household health expenditures constitute 2.1 percent of total annual household consumption, or 6.6 percent of household non-food expenditure (LECS III). The currently relatively low prevalence of catastrophic out-of-pocket (OOP) payments in Lao is due partially to the extremely low use of professional health services. However, for those in the poorest quintile who are hospitalized, the OOP for care and transport amounts to 14 percent of their annual consumption expenditure. In actuality, the poor have no protection against catastrophic health care expenditures.⁴⁰

197. **There is a lack of effective mechanisms to protect the poor from unaffordable health care costs.** The 2006 Poverty Assessment points out that some of the key health service indicators, such as use of health facilities when sick and childbirths at health centers, had *declined* in the 47 priority districts in 2002-03 compared with 1992-93. *More analysis is necessary on why geographic targeting has not produced better outcomes.*

198. **The poor in urban and lowland areas also need to be targeted, as 6 of 10 poor people live outside high-priority districts.** The Drug Revolving Funds can charge 25 percent over cost, but there is no guideline on whether and how this surcharge can subsidize the poor patients who cannot pay for drugs. Pilot Integrated Community Health Centers supported by the World-Bank-funded Health Services Improvement Project (HSIP) plan to cross-subsidize the poorest to a limit of up to 10 percent of the population and 10 percent of revenues. However, even these fall far short of need in Lao PDR, where the overall poverty rate is 33.5 percent and even higher in the rural areas.

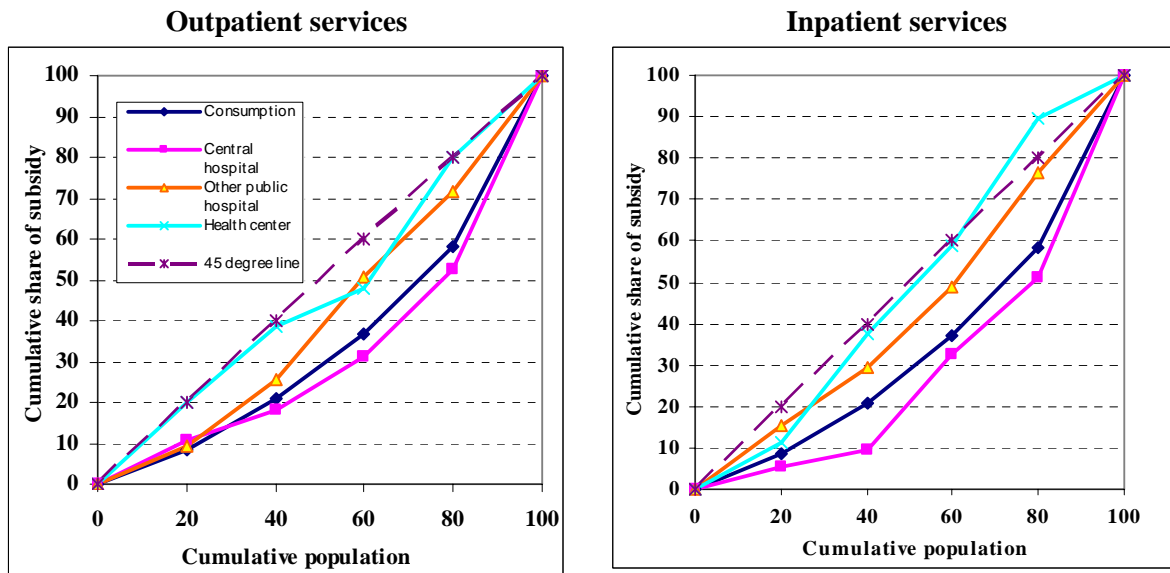
³⁹ Data analysis based on MOF budget data as they appeared in Official Gazettes and district-level databases for the eight provinces covered by the Health Services Improvement Project.

⁴⁰ Catastrophic payments are defined as OOP exceeding 10% of annual household consumption (Wagstaff and Doorslaer, 2003).

199. **The GOL is developing health insurance plans to subsidize health care for certain groups, but most of these groups are not poor.**⁴¹ The GOL is promoting Community-based Social Health Insurance, but, although it may improve risk pooling for private expenditures, it is unlikely that the poor will be able to afford to participate. In two locations, donors have supported NGOs in operating equity funds to cover user fees for the poor, and the HSIP plans to support more. These field experiences need to be used to develop effective mechanisms to ensure that the poor have access to essential health services. A combination of measures may be needed, including better geographic targeting (such as poverty mapping) and linking budget allocations with socioeconomic indicators, working with communities to identify the poor, and exploring the possibility of getting equity funds to provide community-based health insurance .

200. **Public subsidies tend to favor the upper-income quintiles.** The richest quintile captures 27 percent of public subsidies for health services, compared with 13 percent for the poorest. In particular, public subsidies to central hospitals are heavily biased in favor of the richest quintile. This group alone gets nearly one-half of total subsidies for central hospitals, whereas the poorest group gets only 7 percent. Even in the case of the health centers, the top 40 percent of the population receives more subsidy than the poorest (Figure 22). These data prove that GOL health expenditures fail to ensure access to essential health care for the poor. Given that health subsidies at the central level favor the upper income quintiles and the government's potential capacity to generate revenue from user fees, there is scope for directing the additional subsidies from these extra user fees to the lower quintiles. This increase would require changes in the resource allocation mechanisms that are currently based on existing facilities and staff, which are concentrated in urban areas.

Figure 22. Concentration Curves of Consumption and Health Care Subsidies



Source: Estimated from LECS III 2002.

⁴¹ Civil servants, military officials, retirees, and their dependents are exempt from payment. The Social Insurance Fund will cover their health care costs.

6.4.2 Health System Efficiency

201. **The allocative efficiency** of health financing is measured by how effectively all of the resources are allocated to meet the government's objectives, based on the rationale for the government's involvement in the health sector outlined above. As discussed in this chapter, improving allocative efficiency has several dimensions: (a) cost-effective public health interventions such as EPI programs and the front-line health services (health centers and outreach) that deliver these programs need to be better funded and delivered; (b) as benefit incidence analysis shows, public funding should be targeted more accurately toward the poor; and (c) the allocation of public resources for the health sector among provinces should be linked to need as defined by socioeconomic and health indicators to ensure that poor provinces with greater health problems receive and can commit adequate resources to health.

202. **The technical efficiency** of government health services can be measured in terms of the productivity of hospital beds and health care personnel. Although no aggregate figures exist, data from seven HSIP provinces from 2003 showed that, on average, a health worker at a health center saw less than 1 patient per day; district hospitals had 34 admissions per bed and 48 consultations per health worker per year; and provincial hospitals had 27 admissions per bed and 74 consultations per health worker per year. The reasons for this low efficiency of government health services are on both the supply and demand side. On the supply side, some of the underused capacity may not be needed, and the quality of services is low because of a lack of motivation and the limited qualifications of the staff and because of a lack of funds to run the services. Demand is low because of financial barriers to access, distances, perceptions that the quality of care is low, and cultural care-seeking behavior. To increase technical efficiency, both supply and demand side factors must be addressed.

203. **Low wages hamper the availability and quality of health services, particularly in rural areas.** Public health sector wages in Lao PDR are among the lowest in the world. The average salary for health sector personnel is less than \$450 per year, or 1.1 times GDP per capita (HSIP database). These low salaries are a direct result of the low level of recurrent budget for the health sector, as well as relatively low salary increases for health sector workers between 2002 and 2004. The MOH received the second lowest salary increase among all GOL sectors during this period. To increase health personnel salaries to the same level as other civil servants, an estimated US\$14 million would be needed by 2010 (Table 29).

204. **Looking ahead, a more comprehensive and strategic incentive policy for health sector staff is necessary.** The policy should take into account the capacity of health institutions to generate revenues depending on their level of service (such as higher-level hospitals) and the nature of the services provided (for example, delivery of preventive services of a public good nature should not depend on user fee revenues). In addition, management needs to be improved, first, to monitor the performance of health workers to ensure that their higher remuneration leads to improved performance. Second, better management would prevent inappropriate care such as the over-prescribing of drugs.

205. **There also is scope for improving the allocation and use of health sector staff.** Most health personnel, whether skilled or not, are concentrated at the central and provincial levels. Only 9 percent of postgraduate and high-level health staff are employed at district hospitals and health centers (HSIP database). In addition, more than 50 percent of

postgraduate and high-level personnel work in health admission offices rather than in delivering health services. This is a waste of skills, particularly given that there is a serious shortage of professional health staff in health facilities. Human resource management in the health sector urgently needs to be improved to address the issues of skills mismatch, the timely payment of salaries, incentives, and the redundancy of unskilled health personnel versus the shortage of skilled personnel. Finally, as mentioned in Chapter 2, the health sector would greatly benefit from having a better budget planning and execution process, including clearer criteria for center-province allocations and a more agile procurement process (Box 14).

Box 14. Public Financial Management in the Health Sector

The Lao PDR Ministry of Health (MOH) plays a relatively limited role in the budget planning process. The Ministry of Finance is responsible for the overall fiscal framework and for sector allocations from the recurrent budget, while the CPI is responsible for developing the capital budget. Although the PHO plays a major role in developing the annual budget in all provinces, the MOF and the Committee for Planning and Investment (CPI) are key players in the whole process and influence budget plans at the provincial level. Under overall guidelines provided by the MOF and the CPI, the MOH and provincial health authorities independently prepare their budget proposals for the health sector. The MOH and provincial governors submit their proposals to the MOF and the CPI during the early spring. The MOH usually is well informed about donor-financed investments at the local level; but it typically has little advance information about the health investments that are locally funded. However, the MOH plays a direct role in making central budget allocations to central hospitals, national programs, and its own departments. The MOH also plays an indirect role in making budget decisions through setting norms and standards for staffing, drugs, and health care institutions that are used to cost out budget needs.

The Committee for Planning and Investment (CPI) and donors are key players in the allocation of capital budget. The capital budget is financed mainly by donors. Thus, a large share of the capital budget is determined by previous decisions made by donors, the MOH, and the CPI concerning the allocation of resources provided through donor-funded projects. As a result, the allocation of external funding drives allocation of domestically funded expenditure. Districts in rural areas receive far too small a share of the very limited public health resources; including donor resources. Since Lao PDR is likely to require heavy donor support for many years, changing how external financing is allocated would play an important role in increasing the efficiency and equity of health sector expenditure. There is urgent need to take steps toward harmonizing and aligning government and donor programs. This objective first requires a common understanding about health sector challenges and strategies followed by better coordination in the allocating of external financing. The current donor support is best illustrated by the three separate project units within the Ministry of Health supporting different donor-funded programs: the World Bank, the ADB, and the Global Fund to Fight AIDS, Tuberculosis and Malaria.

There is little flexibility for local governments in preparing their health sector budgets. As discussed above, capital financing decisions are made at the central level and/or by donors. At the provincial level, the preparation of the recurrent health budget is usually a straightforward process closely linked to the number of personnel assigned. In addition to rigidity, input-based budgeting creates adverse incentives for provinces to lobby for more infrastructure and staffing to increase their government budget allocation. These incentives lead to further non-urgent use of limited public funds and to a proliferation of underused facilities. The revolving drug funds' operations are off-budget except for their small annual subsidy. Given the project approach of most donor support, district-level expenditures from donor-funded projects are not included in recurrent budgets. All of these processes exacerbate funding shortages for district-level government health services.

Budget execution rates are high for salaries but are especially low for capital expenditures. Paying civil servants' salaries is a government priority, and the payments are now being made in an increasingly timely way. However, the capital expenditure execution rate was below 50 percent in 2002-04, including

the execution of donor funding. As a large share of the central MOH capital budget is financed by donors, problems sometimes arise from delays in implementing the various financial management and procurement procedures mandated by various donors. The lack of harmonized financial management (FM) guidelines and procedures is a serious problem in Lao PDR. It is worsened by the limited number of local personnel with accounting and FM expertise. Donor-funded per diems and other salary supplements that differ among donors also need to be harmonized as these differences lead to inequities and other personnel problems.

At the provincial level, budget execution is more problematic. Cash frequently is unavailable due to incorrect revenue projections and/or problems in transferring revenue from surplus to deficit provinces. Actual expenditures by provinces may differ significantly from their approved budgets because decentralization means that the central government has little control over provinces. Recurrent budgets have often failed to include realistic inflation factors. Even the high priority given to salaries may not be effective, and there are delays in paying for supplies and shortages of funds to finance other non-salary recurrent expenditures. A lack of cash at the provincial levels is a continuing and serious constraint on the implementation of vertical health programs, such as the Immunization and Family Planning programs.

In the current planning and management system in the health sector, there is a disconnect between resource allocation and achieving health outcomes at all levels. This disconnect and the absence of a pro-poor focus in budget management and planning has resulted in an inequitable and inefficient health system. This indicates the need to develop a national surveillance and monitoring system in line with the priority health NGPES and national health targets.

A more transparent and need-based formula for provincial level resource allocation should be considered to ensure more adequate funding levels for essential health services, which would mean that those provinces with the greatest health and social needs would receive the most funding. Furthermore, delinking funding allocation from staffing would enable more flexible and efficient use of these funds based on local needs. Timely reporting of expenditures at the provincial level is a perennial problem and another aspect of weak public financial management. Currently, provinces do not report to the MOH on their budget execution. Neither the MOF nor the MOH has information on budget allocations or on the implementation of national programs at the provincial level.

Procurement problems are often cited as a major reason for delay in project implementation at all levels but most seriously at the central and provincial levels. Anecdotal evidence from donor-supported projects shows that government administrative procedures contribute significantly to delays in implementation. In some cases, each step took approximately 30 days to be approved. The substantial delays in procurement, from drugs to the staffing of PCU, result in implementation schedules that are significantly slower than was originally planned.

Sources: Government of Lao PDR and the World Bank, 2006.

6.5 ELIGIBLE PRIORITY PROGRAMS IN HEALTH UNDER THE NT2

206. **Under the framework of NT2 revenue management, health was selected as an eligible priority sector.** From 2010, there will be an additional approximately \$5 million per year available for health sector programs. Also from 2010, the GOL will have to identify pro-poor programs in the health sector to take advantage of this fund. Among the main criteria in the selection of eligible programs are: (a) those areas identified as priorities in the GOL's NGPES and (b) those programs that will have a significant and verifiable poverty reduction impact; and (c) those with clearly defined objectives, performance indicators, and systems in place for monitoring and evaluation. Therefore, it is recommended that immediate steps be taken to identify such programs for the health sector and to put in place the necessary institutional arrangements to implement the selected programs before 2008. Among the three

criteria identified above, financing health care for the poor could be a good candidate from the health sector.

207. **The GOL has identified 12 programs as priority health programs in connection with the NGPES, but they exceed the available budget envelope so will need to be targeted very directly to the poor.** The MOH prepared a projected budget for 2006-10 and a budget for these NGPES programs (Table 30). The projected costs of the priority programs are significantly higher than the total government health expenditure in 2005. This projection points up not only a significant funding gap that is not likely to be filled but also to the need for further prioritization. Moreover, it is not clear to what extent the proposed programs are poverty-oriented. An estimate based on the MOH's costing data shows that the 47 high priority poverty districts are estimated to receive a smaller share of projected NGPES health priority program expenditure than their share of the population (that is, 22.5 percent versus 24.0 percent).

Table 30. Costs of Priority Health NGPES Programs, 2006-10 (US\$ mil)

		2006	2007	2008	2009	2010	Total
1	Health education	1.2	0.8	0.5	0.5	0.5	3.5
2	Expansion of rural health network	16.5	15.2	12.2	12.0	12.2	68.1
3	Upgrading capacity of health workers	6.2	8.4	4.2	3.5	2.7	25.0
4	Maternal and child health promotion	4.6	4.1	4.7	4.3	4.9	22.6
5	Immunization for women and children	4.3	4.3	4.3	4.3	4.4	21.5
6	Water supply and environmental health	3.9	4.0	4.0	4.0	4.0	19.9
7	Communicable disease control	12.5	8.9	10.3	8.3	9.1	49.2
8	HIV/AIDS/STD control	5.7	5.3	5.0	4.6	4.8	25.4
9	Drug Revolving Fund (DRF) expansion	0.5	0.5	0.3	0.3	0.3	1.9
10	Improved food and drug safety	2.2	2.2	1.1	1.1	0.5	7.2
11	Promotion of traditional medicine	0.5	0.6	0.5	0.5	0.5	2.6
12	Law and regulations	2.6	2.7	2.2	2.2	2.2	12.0
Total NGPES programs		60.7	57.0	49.3	45.7	46.1	258.8
Other		17.9	14.3	11.1	10.5	10.3	64.0
Total MOH budget		78.6	71.3	60.4	56.2	56.4	322.8

Source: Government of Lao, MOH's costing data 2005.

208. To take advantage of NT2 revenue purposes, the government will need to identify a program that is strongly pro-poor and in which additionality can be demonstrated. The government could consider selecting a top priority program from among the 12 NGPES programs that are aimed at meeting the key MDGs and that demonstrate additionality in the priority districts. Alternatively, the government could consider introducing a program that directly targets poor individuals and households and protects them from excessive out-of-pocket costs, for example through an equity fund or a health –care –fund –for –the –poor. As discussed earlier in this section, no such programs currently exist.

6.6 MAIN CONCLUSIONS AND RECOMMENDATIONS

209. **The immediate priority is to increase and improve resource allocation for public health programs.** The GOL should also strengthen its targeting of the poor to ensure their access to essential health services and protection from catastrophic health expenditures. Low

execution rates indicate the need to strengthen financial management systems to ensure transparent execution and effective monitoring of public spending. It is also important for the GOL to harmonize and align government and donor programs with high priority areas in the health sector. The following key recommendations emerge from the analysis undertaken in this chapter:

- **Resource allocation:** (a) Increase public resources allocated to public health programs, notably from domestic sources; (b) align budget planning and monitoring with the key functions of the public health sector (stewardship, public health, and the delivery of preventive and clinical health services); (c) develop a more transparent need-based budget allocation formula at both the central and provincial levels; and (d) ensure adequate resources are available for the non-wage recurrent expenditures of H&P programs and human resources, such as monetary and non-monetary incentive packages.
- **Health System Management Information System:** (a) Improve the budget recording system to permit reliable analyses of health expenditure by level of care, program, and economic function and (b) to permit proper management and accounting for user fees and Drug Revolving Funds.
- **Equity:** (a) Ensure that the poor are effectively protected from unaffordable health care costs imposed by user charges and consider and pilot targeting the poor through demand-side financing by ensuring sufficient resources, developing appropriate targeting mechanisms, and selecting cost-effective performance-based methods to pay health care providers (more analysis is needed on why geographic targeting has not produced better outcomes); (b) target external financing more directly and align government and donor health programs to priority areas as identified above (greater coordination among donors will be needed for this purpose); and (c) ensure that NT2 revenues finance health programs and services that benefit the poor (better coordination among donors will also be needed for this purpose).

7. ENVIRONMENT

Natural resources contribute to more than half of the GDP of Lao PDR and constitute a significant part of people's livelihood. Nonetheless, increasing population growth and unchecked economic activities have led to a noticeable deterioration of natural resources and environmental quality. Forest coverage is shrinking fast. Widespread soil erosion has led to declining agriculture productivity. Increasing hydropower developments put additional pressure on the water resources. Human use of once-remote protected areas is rising. As a result, expanding agricultural frontiers, illegal hunting, illegal logging, and uncontrolled burning have led to a decline in biodiversity resources.

Public environment expenditures (PEEs) account for only 0.7 percent of total public expenditures and declined by 36 percent between 2002 and 2005. This decrease was driven by a sharp reduction in foreign grants, which still contribute more than 90 percent to public environment expenditures. Recurrent expenditures on environment-related activities have not kept pace with capital expenditures. The immediate priority is to adopt a systematic and disaggregated approach to record and analyze PEE at both the national and provincial levels. Recurrent expenditures need to be increased to ensure the sustainability and effectiveness of the capital expenditures and grant funding. NT2 revenues should be used only to fund poverty reduction and environmental conservation measures.

7.1 INTRODUCTION

210. **This chapter reviews the performance of the environment sector in recent years** and analyzes the roles of the government and the private sector in providing services to the population (section 7.2). It then reviews the GOL's record on public expenditure on the environment in 2001-05 and looks at the resource need and financing for 2006-10 (section 7.3). The effectiveness of environment spending is examined in section 7.4, and eligible NT2 priority programs are considered in section 7.5. Section 7.6 presents the main conclusions and recommendations.

7.2 Environment Sector Overview and Rationale for Government Intervention

7.2.1 Environment Sector in Lao PDR

211. **Natural resources not only contribute more than half of the country's gross domestic product but also constitute a significant part of the people's livelihoods.** Lao PDR is blessed with abundant natural resources especially forest, water, and mineral resources. Valuable, productive, and ecologically unique forests and wetland cover nearly half of the country's area. The majority of the population greatly depends on forest resources for food, timber, raw materials for handicrafts, and traditional medicines. In addition, with more than 32,000 cubic meters (cu m) of fresh water available per capita, Lao PDR has the largest per capita water availability in Asia. Recent explorations have revealed that the

extraction of mineral resources including gold, lignite, and copper also has become financially viable.

212. **Increasing population growth and unchecked economic activities have caused natural resources and environmental quality to deteriorate noticeably.** Due in part to logging and unregulated commercial exploitation, population pressures, shifting cultivation, and unsustainable exploitation practices, forest coverage has shrunk from 70 percent of the total land area in 1940 to 47 percent in 1998. With 70 percent of the land area having a slope of more than 20 degrees, the potential for expanding permanent agricultural area is quite limited. Widespread soil erosion, especially in the upland areas, and shorter fallow periods have lowered agriculture productivity. Increasing hydropower development has put additional pressure on the water resources. Waste generation is increasing, especially in the urban areas and small towns.

Table 31. Key Natural Resources and Environmental Indicators, Selected Years (1987-2004)

	<i>Average annual deforestation (%) 1995–2005</i>	<i>Naturally protected areas (% of total land area) 2004</i>	<i>Renewable internal freshwater resources per capita (cu. m) 2004</i>	<i>Water productivity (GDP/water use 2000 \$ per cu. m) 1987–2004</i>	<i>Access to improved water source (% of total population) 2002</i>
Lao PDR	0.5	3	32,878	0.6	43
Cambodia	1.3	18.5	8,738	1	34
Myanmar	1.2	0.3	17,611	N/A	80
Thailand	0.6	13.9	3,297	1.5	85
Vietnam	-2.5	3.7	4,461	0.5	73
East Asia and Pacific	-0.2	N/A	5,062	2.1	78
Low income	0.5	7.7	3,456	0.8	75

Source: World Bank *World Development Indicators 2006*

213. **The GOL is taking major steps to more effectively manage the declining forest resources.** In 1940, forests were estimated to cover 17 million ha, approximately 70 percent of the Lao land area. Recent surveys suggest that this figure dropping by an average of 53,000 ha per annum. By 2004, it was only 43 percent.

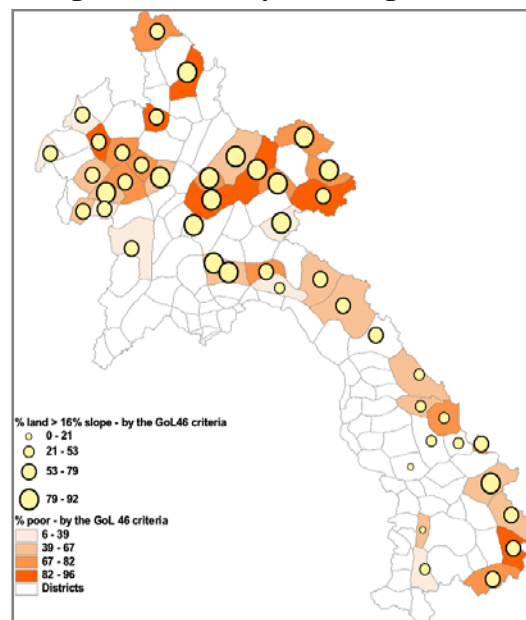
214. **Non-timber forest products (NTFPs) are crucial to the majority of rural Lao households for meeting their subsistence needs and achieving food security.** The role of NTFPs is important given the frequent occurrence of droughts and the prevalence of pests and rodents, which often reduce the rice yields. In addition, the sale of excess NTFPs provides an average of 55 percent of family cash income. The MAF recently approved new reforms to promote sustainable forest management. Participatory forestry, by which local people are enabled to manage and directly benefit from the sale of timber and other forest resources, has had a remarkable and demonstrable success. This, and other improved commercial forest management approaches, if effectively applied, will help to prevent illegal logging and form the core of a viable forestry reform program.

215. **The GOL can no longer depend on the remoteness of the protected areas to guard against their exploitation.** Human use of these once remote areas has been growing rapidly as a result of increased international wildlife market demand, population growth in traditional communities, migration and settlement, and the expansion of the transport network. Furthermore, expanding agricultural frontiers, illegal hunting, illegal logging, and uncontrolled burning have led to a decline in biodiversity resources. With the exception of the Nakai Nam Theun and Phou Khao Khoay National Protected Areas (NPAs) in which more resources are available from the NT2 and Nam Leuk's hydropower projects, protected areas are under-resourced. The approach used with the two NPAs offers a model that could be replicated in other protected areas of the country.

216. **Steeply sloping land and increasing soil erosion have disproportionately affected the poor.** Approximately half of the total land area in the 47 poorest districts has an average slope of more than 30 percent. With little technical and financial support to find more productive options for dry rice cultivation, the poor have had to supplement low crop yields by resorting to already declining NTFPs. Soil erosion is compounded by shortened fallow periods, resulting in lower productivity and ever-increasing demand for land.

217. **The hydropower potential of Lao PDR is high compared with other countries in the lower Mekong River Basin.** Hydropower generation has quintupled in the last 25 years and is expected to triple in the next five years.⁴² Environmental resource user charges for hydropower development are the most promising market-based instrument to generate funding for environment expenditures. However, to derive the necessary benefits, the exploitation of this hydropower potential must be carefully balanced with environmental and social pressures.

Figure 23. Poverty and Fragile Land



Source: Dasgupta et al, 2002.

218. **Environmental health risks from inadequate management of urban waste are increasing due to the rapid expansion of urban areas.** The urban population is already experiencing growing environmental health risks from the lack of adequate treatment of wastewater and the inadequate collection and disposal of solid waste. Proper solid waste management is available in some urban areas.⁴³ Landfills have been established only in Vientiane and the four secondary towns (Luangprabang, Thakek, Savannakhet, and Pakse). Collection services are limited to accessible areas and to profitable target groups such as

⁴² Over the next quarter of this century, Lao PDR has the potential to generate 18 percent of the 23,000 megawatts of hydropower that can be generated in the Mekong River Basin.

⁴³ Between 1997 and 2002, the GOL, with support from NORAD/UNDP, invested a total of US\$4.5 million to improve solid waste management in Vientiane, Luangprabang, Thakek, Savannakhet, and Pakse.

markets and high-income households.⁴⁴ This service is only likely to be provided if waste collection fees are charged. The current scale of recycling in Lao PDR is still very small, although approximately 70 percent of municipal solid waste consists of plastic, paper, glass, cans, and metals. All of these materials can be recycled commercially and reused in manufacturing and industrial activities.

7.2.2 Rationale for Government Intervention in Environment

219. **Through the NGPES, the GOL recognizes the importance of sound management of the country's rich natural resources to ensure sustainable economic growth and poverty reduction.** Past experiences in Lao PDR and elsewhere have demonstrated that unchecked exploitation of natural resources inevitably leads to rapid depletion and degradation and further damages interrelated ecosystems and human habitats. The adverse effects of natural resource exploitation fall on the entire society, whereas the benefits are enjoyed only by the extractors. For example, the discharge of heavy metal and other pollutants from a mining operation can increase the health risks of people living downstream. These health risks and subsequent health care costs are not fully borne by the mining operation. Therefore, the GOL has a critical role to play in ensuring sound management of the natural resources in the public domain and in managing the external effects of economic activity when market participants cannot, or will not, internalize these effects.

220. **Sufficient resources are needed to implement sound and effective natural resources and environmental management.** During the past decade, the GOL has formulated and established a wide-ranging legal framework for sustainable natural resources and environmental management. This framework includes the 1996 Forest Law, the 1999 Environmental Protection Law, the 2000 Environmental Impact Assessment (EIA), the 2005 Resettlement and Compensation Decree, and the 2005 Sustainable Hydropower Policy. However, *less than 1 percent of the GOL's budget is allocated to the core environment agencies.*⁴⁵ With such a small budget allocation, these environment agencies have very limited capacity to properly: (a) monitor and enforce the laws, (b) manage natural resources, (c) protect environmental quality, and (d) implement biodiversity conservation.

⁴⁴ Collection efficiency of the average urban household in the five larger urban areas is 45 percent. Only in Luangprabang does collection efficiency reach more than 50 percent. In smaller towns, solid waste collection is often limited to commercial establishments in the town center and the market place.

⁴⁵ The Science, Technology, and Environment Agency (STEA), under the PMO, is the lead environment agency comprising the Department of Environment (DOE) with Environmental Impact Assessment (EIA) mandate and the Environment Research Institute (ERI). On EIA issues, the STEA is working in coordination with various Environment Management and Monitoring Units (EMMUs) in key agencies such as the Ministry of Industry and Handicraft (MIH) and the Ministry of Communication, Transport, Post, and Construction (MCTPC). On conservation issues, the Ministry of Agriculture and Forestry (MAF) is playing the leading role through the Division of Forest Resources Conservation (DFCR) of the Department of Forestry. Provincial offices of the STEA are responsible for carrying out environmental-related activities in the provinces as well as for preparing the Provincial Environment Strategy in consultation with other provincial agencies.

7.3 Analysis of Public Expenditure Trends and Future Resource Needs

7.3.1 Allocation of Environment Spending

221. **Lao PDR has no systematic categorization of public environment expenditure (PEE).**⁴⁶ Two major hurdles need to be overcome before PEE data can be collected at the national and provincial levels faces: (a) environment is not one of the key sectors for which expenditure data are available and (b) expenditure data are aggregated at the ministerial or provincial level. Therefore, data on expenditures by the core environment agencies, which normally are at the department, division, and office levels, are not readily available. Consequently, additional data must be collected both at the national and provincial levels to estimate recurrent as well as capital expenditures by the core environmental agencies. These estimates should be based on the number of staff and programs related to natural resources and environmental management. Once this categorization is available, the GOL will need to ensure that allocations follow stated policy priorities, Because sub-national administrations have core responsibilities in environmental management and spending, the GOL will need to improve central-local relations.

222. **PEE, which accounts for only 0.7 percent of total public expenditure, has been declining,** from LAK 30 billion in 2002 to LAK 19 billion in 2005 - a 36 percent decline (Figure 25). The sharp reduction in foreign grants of LAK 11 billion (LAK 9.6 billion of which came from the MCTPC) during 2002-05 was the main reason for the decline. On the other had, recurrent and capital expenditure amounts have been quite stable. Thailand and Vietnam have allocated considerably higher amounts to public expenditures for environmental protection - 1.4 percent and 1.0 percent respectively.

223. **Foreign aid makes up more than 90 percent of PEE.** Principal donors during the last four years have been the ADB, Sida, and the World Bank. Since 2001, Sida has provided capacity building support to the Science, Technology and Environment Agency's (STEA) Strengthening Environment Management (SEM) project, now in Phase II. The ADB has completed the Environmental and Social Program Loan, which supported critical measures of environmental and social management in the energy and transport sectors. The 2005 Environmental Protection Fund (EPF) was supported by the ADB and the World Bank. The EPF is an independent and autonomous entity managed independently by the Board of Directors chaired by the Deputy Prime Minister. Its day-to-day management is the responsibility of its Executive Office, which is staffed by non-governmental personnel. The ADB is providing US\$5 million of the Program Loan as the initial endowment fund to cover operational and sub-project costs. Through the Lao Environment and Social Project (LEnS), the World Bank is adding US\$4 million to the LEnS Window of the EPF. The EPF will also be eligible to receive future revenue from NT2 and from natural resources extraction.

⁴⁶ PEE can be defined as expenditures by public institutions for purposeful activities aimed directly at preventing, reducing, and eliminating pollution or any other degradation of the environment resulting from human activity, as well as natural resource management activities not aimed at resource exploitation or production (World Bank, 2003).

Figure 24. Declining Total Public Environment Expenditures by Type of Expenditure, 2002—05

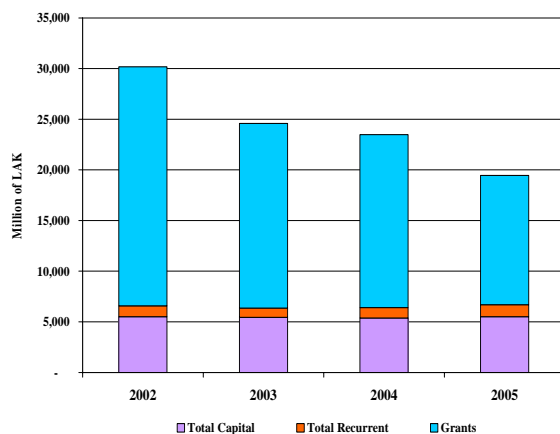
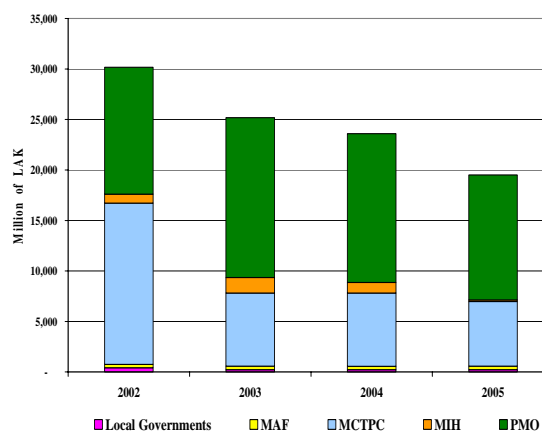


Figure 25. Total Public Environment Expenditures by Agency, 2002-05



Sources: Government of Lao PDR and World Bank calculations 2006.

224. **More than 90 percent of PEE has been spent by only two key agencies - the MCTPC (36 percent) and the STEA (58 percent).** Within MCTPC, the Department of Road (DOR) and Department of Housing and Urban Planning (DHUP) are the two key units with environmental mandates. The Environment and Social Division of the DOR ensures that road projects comply with environment and social safeguards. The DHUP supports municipalities in collecting and disposing garbage. Five major cities have received support from the DHUP in garbage management, including the construction of landfills. The STEA's core environment units include the Department of Environment, the Environment Research Institute, and the Multilateral Environment Agreements Unit.

225. **Recurrent PEE has not kept up with capital expenditures.** Recurrent PEE accounts for only 4 percent of the total. Approximately 60 percent of the total recurrent expenditures consist of wages and salaries, while other operating expenses make up the rest. During the last four years, recurrent PEE has increased, undermining the GOL's commitment to increase recurrent expenditures. However, without sufficient recurrent expenditures, investments in capital expenditures are unlikely to achieve their desired outcome - sustainable development.

226. **The implementation of the NT2 project has brought unprecedented attention to environmental issues, especially biodiversity conservation and the participatory management of natural resources.** The World Bank's IDA supported the GOL's preparation of the NT2 Social and Environment Project (NTSEP) with a US\$20 million grant. The NTSEP will finance the GOL's environmental and social mitigation measures as part of Lao PDR's equity in the NT2 Power Company (NTPC). Besides these mitigation measures, the grant will also facilitate the establishment of a revenue system, of which a significant portion will be targeted to environmental protection and conservation measures.

Figure 26. Environmental Capital Expenditures by Agency and Source of Fund, 2002-05

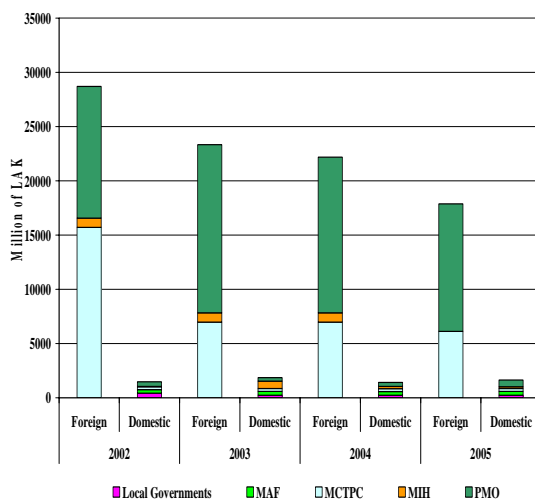
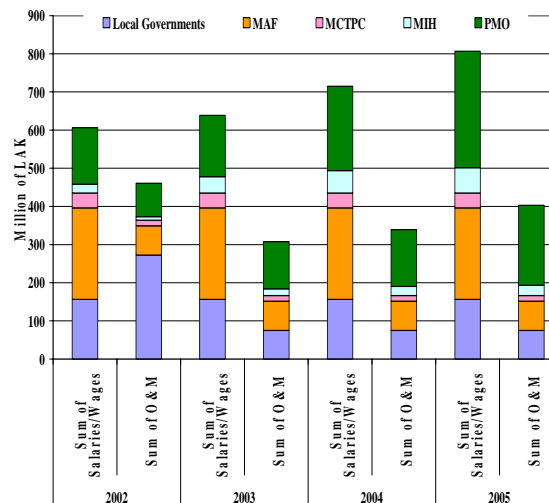


Figure 27. Environmental Recurrent Expenditures by Type and Agency, 2002—05



Sources: Government of Lao PDR and World Bank calculations 2006.

7.3.2 Financing and Future Resource Needs

227. **Following the NT2 project, a number of environment-related projects in Lao PDR are emerging with strong support from the key donors.** The Global Environment Facility (GEF) is financing the Integrated Ecosystem and Wildlife Management in Bolikhamxay Province project. One National Protected Area (Nam Kading, 169,000ha) and one Provincial Protected Area will be brought under effective management to test and demonstrate the model. The EPF will provide a sustainable financing mechanism to strengthen environmental protection and sustainable natural resources management, specifically biodiversity conservation, and community development in Lao PDR. Moreover, the EPF may reserve resources to respond to the environmental and social impacts of natural disasters. Grants, preferential loans, or interest rate subsidies will be provided by the EPF or by its Specialized Financing Window. National, provincial and district government agencies, communities, mass organizations, and civil society organizations will all be eligible to submit proposals to the EPF for funding.

228. **The declining trend in public environment expenditures observed between 2002 and 2005 is expected to be reversed.** The major factors that will contribute to this trend reversal are that: (a) funding from the EPF (US\$9 million) will become available and (b) the activities of the Watershed Management and Protection Authority (WMPA) are accelerating to the tune of US\$3 million. Taking into account that recurrent and capital expenditures are unlikely to be increased, the only source of increased public environment expenditure will be external grant support. Therefore, the rate of increase will depend on the rate at which these grants are disbursed. The conservative estimate of 2.5-5 percent grant disbursement rate would result in a 5-21 percent increase in the total public environment expenditure in the next fiscal year, from which a 15-27 percent annual growth could be expected.

7.4 EFFECTIVENESS AND EQUITY OF PUBLIC SPENDING ON THE ENVIRONMENT

229. **The GOL has established a solid legal and institutional foundation for sound management of natural resources and environment, and PEE has benefited the public.** Important laws and regulations have been enacted in recent years. Implementation guidelines, awareness raising, and capacity building programs have received greater support from the international community. With a rising trend in large development projects such as hydropower and mining, it is vital that the EIA system is effectively enforced and monitored to prevent and mitigate adverse environmental and social effects on the population, especially the poor who have fewer means to cope with such effects. To build a stronger capacity in central environmental agencies, the GOL could draw more resources from the newly established Environmental Protection Fund. With cost sharing, the residents of the five major urban areas (less than 10 percent of the total population) have benefited directly from the PEE in solid waste management including waste collection, transport, and disposal at the landfills.

230. **Community participation in natural resources management is recognized by the GOL and donors as one of the most effective ways to allocate benefits from PEE to the people, especially the poor.** Lessons learned from projects such as the Poverty Reduction Fund and Sustainable Forestry for Rural Development have demonstrated that communities and the poor are able to share benefits from participating in natural resources management provided that community capacity building and empowerment are available. The GOL in partnership with international partners can play a significant role in supporting this capacity building.

7.5 ELIGIBLE PRIORITY PROGRAMS IN ENVIRONMENT UNDER THE NT2

231. **Collaboration between the national and provincial core environment agencies has produced mixed results.** On the one hand, the STEA and its Provincial Science Technology and Environment Office (PSTEO) have been working well together to develop the Provincial Environment Strategy and Action Plans. Most of the plans have been approved by the Provincial Governors. However, the provincial authorities are not obliged to provide adequate funding for the action plans. With the EPF becoming functional soon, these funding gaps could be filled. On the other hand, while the national agency is responsible for the management of the NPAs, they must be implemented by the provincial staffs, who are directly responsible for the management of the provincial protected areas with little support from the national agency.

232. **Environmental protection and conservation expenditures are eligible to receive revenue from the NT2 project.** The EPF will be one of the key institutions eligible to receive NT2 revenue for the purpose of environmental protection and conservation. However, the EPF will still need to: (a) demonstrate that appropriate administrative and financial management arrangements are in place and complied with; (b) develop a track record of successfully managing its funds and supporting sub-projects to its stakeholders; (c) institutionalize its monitoring, reporting, and performance evaluation mechanisms; (d) ensure transparency in fund allocation, (e) develop the capacity to set funding priorities; and (f) solve any outstanding issues regarding the inclusion in the state budget. Moreover, the EPF may have to establish a special financing window for better monitoring and accountability of the NT2-supported programs.

7.6 MAIN CONCLUSIONS AND RECOMMENDATIONS

233. **The immediate priority is to adopt a systematic and disaggregated approach to recording and analyzing PEE at both the national and provincial levels.** There is a need to: (a) ensure the sustainability of natural resources; (b) increase recurrent expenditures; and (c) apply NT2 revenues transparently and efficiently to fund poverty reduction and environment conservation measures. The following key recommendations emerge from the analysis:

- **Resource allocation:** (a) Increase funds (including from NT2 revenues and the EPF) earmarked for the environment, especially to the natural –resources intensive sectors such as hydropower and mining; (b) increase recurrent expenditures to ensure both the sustainability and the effectiveness of capital expenditures and grant funding by gradually increasing the number of qualified staffs at the provincial level (a target level, such as 8 percent of PEE in 2010, should be set to monitor progress); and (c) apply the NT2 experience by requiring proponents of natural extraction projects to allocate part of their expected revenues toward environmental conservation and management.
- **Environment information system:** (a) Develop a system to collect and monitor PEE data at the national and provincial levels by building a disaggregated environmental database at the department (such as DOE and ERI) and division (such as EMMUs and DFRC) levels (and pilot the system in three provinces before extending it to all provinces) and (b) require the STEA and the MOF to collaborate to establish a consistent and reliable baseline to monitor both outcomes and the impact of the use of the NT2 revenue on the environmental programs.
- **Equity:** (a) Ensure the transparent and efficient use of NT2 revenues to finance poverty reduction and environmental conservation programs as defined in both the NGPES and the NSEDP and (b) ensure an equitable allocation of the benefits proceeding from natural resources use by preventing them from being captured by elites.

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