

**International Studies Program  
Working Paper 06-22  
September 2006**

**Fiscal Decentralization in the  
People's Democratic Republic of  
Lao**

Jorge Martinez-Vazquez  
Juan Luis Gomez  
Guevera Yao





**International Studies Program  
Working Paper 06-22**

**Fiscal Decentralization in the People's  
Democratic Republic of Lao**

**Jorge Martinez-Vazquez  
Juan Luis Gomez  
Guevera Yao**

**September 2006**

International Studies Program  
Andrew Young School of Policy Studies  
Georgia State University  
Atlanta, Georgia 30303  
United States of America

Phone: (404) 651-1144  
Fax: (404) 651-4449  
Email: [ispaysps@gsu.edu](mailto:ispaysps@gsu.edu)  
Internet: <http://isp-aysps.gsu.edu>

Copyright 2006, the Andrew Young School of Policy Studies, Georgia State University. No part of the material protected by this copyright notice may be reproduced or utilized in any form or by any means without prior written permission from the copyright owner.

## **International Studies Program Andrew Young School of Policy Studies**

The Andrew Young School of Policy Studies was established at Georgia State University with the objective of promoting excellence in the design, implementation, and evaluation of public policy. In addition to two academic departments (economics and public administration), the Andrew Young School houses seven leading research centers and policy programs, including the International Studies Program.

The mission of the International Studies Program is to provide academic and professional training, applied research, and technical assistance in support of sound public policy and sustainable economic growth in developing and transitional economies.

The International Studies Program at the Andrew Young School of Policy Studies is recognized worldwide for its efforts in support of economic and public policy reforms through technical assistance and training around the world. This reputation has been built serving a diverse client base, including the World Bank, the U.S. Agency for International Development (USAID), the United Nations Development Programme (UNDP), finance ministries, government organizations, legislative bodies and private sector institutions.

The success of the International Studies Program reflects the breadth and depth of the in-house technical expertise that the International Studies Program can draw upon. The Andrew Young School's faculty are leading experts in economics and public policy and have authored books, published in major academic and technical journals, and have extensive experience in designing and implementing technical assistance and training programs. Andrew Young School faculty have been active in policy reform in over 40 countries around the world. Our technical assistance strategy is not to merely provide technical prescriptions for policy reform, but to engage in a collaborative effort with the host government and donor agency to identify and analyze the issues at hand, arrive at policy solutions and implement reforms.

The International Studies Program specializes in four broad policy areas:

- Fiscal policy, including tax reforms, public expenditure reviews, tax administration reform
- Fiscal decentralization, including fiscal decentralization reforms, design of intergovernmental transfer systems, urban government finance
- Budgeting and fiscal management, including local government budgeting, performance-based budgeting, capital budgeting, multi-year budgeting
- Economic analysis and revenue forecasting, including micro-simulation, time series forecasting,

For more information about our technical assistance activities and training programs, please visit our website at <http://isp-aysps.gsu.edu> or contact us by email at [ispaysps@gsu.edu](mailto:ispaysps@gsu.edu).

# *Fiscal Decentralization in the People's Democratic Republic of Lao*

**Jorge Martinez-Vazquez, Juan Luis Gomez and Guevera Yao\***  
*Andrew Young School of Policy Studies, Georgia State University*

## **1. Background**

### **1.1 A Snapshot of the Current Situation**

The People's Democratic Republic of Lao (Lao PDR), landlocked between Myanmar, Thailand, Cambodia, China, and Viet Nam in the core of Southeast Asia, accounts for a population of some 5.8 million over a total surface of 236,800 square kilometers. Latest estimates would place poverty rates at around 39 percent of households (ADB 2002). With an estimated per capita income of \$320, Lao PDR stands among the poorest countries in Asia. Inequality, measured by an estimated Gini coefficient of some 0.36 (UNDP 2004) is high for such a low level of income. Lao's set of basic human development indicators rank the country 133 out 177 states in the Human Development Index (UNDP 2005).

---

\* We are grateful for comments and exchanges from Nguyen Van Minh, Ronald White, Ed Moubtfield, Stuart Webster, and John Russ.

Recent economic growth is reportedly high, with an annual average rate of around 6% during the 1990s, despite the effects of the Asian financial crisis. Agriculture accounts for the largest share of the GDP (around 47%), while mineral exports and investments in hydro-power have recently been the most important engines of growth. Reform of State Owned Enterprises remains allegedly timid and a number of measures have been recommended to encourage the development of a nascent private sector (World Bank 2005).<sup>1</sup>

Despite the macroeconomic stability experienced in recent times, serious concerns have been raised over the country's weak fiscal position, with upward pressures on the wage bill and the presence of government expenditure arrears (World Bank 2005). As the country fiscal system is largely decentralized, success in regaining a solid fiscal footing, especially in the areas of improved revenue collection and conservative public service hiring policies, has become largely the responsibility of sub-national levels of government.<sup>2</sup> A large share of the national expenditure on basic social services is conducted at the local level. Although, in light of Lao PDR developmental needs, resources available may not suffice to meet expenditure needs for social services and infrastructure, the analysis contained in this paper argues that structural deficiencies in the system of inter-governmental fiscal relations may be as important a constraint for sustainable development of the country.

---

<sup>1</sup> Viet Nam's experience with its 2000 Enterprise Law, which significantly simplified enterprise registration procedures, is being held as a best practice in the region and a model of reference for initiatives in this area for Lao PDR.

<sup>2</sup> As explained further below, the vertical system of governance in Lao PDR should more properly be designated as a deconcentrated system, as opposed to a decentralized system. Similarly, using the term "sub-national levels of government" may be misleading as the territorial units are integral (deconcentrated) parts of the central government, without separate legal standing. However, because of the current high degree of deconcentration, especially decision-making autonomy, these territorial units will be loosely referred to in this report as sub-national governments and the entire system as the decentralization system.

## **1.2 A Brief History of Decentralization Patterns in Lao PDR**

Decentralization policy has for many years played a central role in different Lao PDR attempts to reform its public sector (see Box 1 for a chronology of the main landmarks.) As has been reported elsewhere (Vaillancourt, 2001; UNCDF 2002), Laos history of central-local relations has three well-defined periods and a recurrent pattern of decentralization and re-centralization. The first period, from 1975 (establishment of the Lao PDR) to 1986 was characterized by the coexistence of a significant level of autonomy allocated to provinces, and a centrally-planned economy. Despite the autonomy granted, provinces were largely dependent on transfers from the central government during the period.

With the implementation of the New Economic Mechanism in 1986, decentralization proceeded further. The provincial administration in general was endowed with most of the planning and budgeting responsibilities, and the provincial governors in particular with authority over the provincial and district tax offices (Keeulers & Siboungueuang 1999). In a move that has proven to have important consequences, provincial governors acquired management responsibility over provincial civil servants, including wage and hiring policies (Vaillancourt 2001). As Keeulers and Siboungueuang (1999) note, devolution in Lao PDR reached a point where provinces were able to set interest rates and exchange rates for the local currency, for a period of time effectively dismantling the central State banking system.

Unsustainable fiscal imbalances and the intrinsic macro-economic instability derived from this system prompted a first drive towards the re-centralization of

expenditure and revenue autonomy in 1991, explicitly reflected in the new Constitution of 1991, and the 1994 Budget Law and that continued during most of the 1990s.<sup>3</sup>

The new decade has witnessed a rebirth of the decentralization impetus, with the approval of Decree 01/PM and 192/PM on the Implementation of the Budget Law. In particular, Decree 01/PM had the main objective of defining the province as the strategic unit (focus on planning activities) and the district as the budget execution unit (Vaillancourt, 2001). Both decrees are supported by Instruction Note/Recommendation 475, defining revenue sources by levels of government, and Instruction Note/Recommendation 128, detailing planning responsibilities at each level of government.

Given the central importance of the power granted to governors in the system, both in the diagnostic of the problems now faced by Lao PDR in the area of decentralization and the options available to move the system forward, it is quite critical to understand why this institution (of all-powerful governors) came about in the system in the first place and why it has endured over time.

It would appear that a highly deconcentrated system run by provincial governors has roots in the war of independence efforts,<sup>4</sup> and also in the fragmented geography of the country. These historical reasons should have little weight, other than historical inertia, today as advances in communication technologies should have permitted the elimination of those barriers.

On the other hand, it does not appear that the high level of deconcentration and power vested upon provincial governors within the system has just been imposed by a

---

<sup>3</sup> See UNCDF (2002) for further discussion.

<sup>4</sup> Similar patterns of geographical self-sufficiency develop during Mao's long march in China or Vietnam's war of independence.

group in the political elite. Even though many of the governors are ranking members of the Politburo and seem to enjoy substantial discretion in their operations, they are far from immune to central government action. In fact, of the cohort of governors appointed or re-appointed in the V Party Congress, few remain in office, with the rest having been removed at different points allegedly for reasons having to do with provincial finances.<sup>5</sup>

The current system seems rather to respond to the ingrained belief among the top authorities of the country that the current arrangement is the best way to govern the country, either because of historical developments or the geographic and ethnic diversity of the country. However, as we will examine in this paper, it is highly unlikely that the decentralization reform agenda of the Lao PDR will be able to move forward without finding a way to reign in the power and discretion now exercised by the provincial governors and at the same time strengthening central government institutions, especially at the Ministry of Finance by controlling revenue collections (the apparatus of tax administration) and controlling expenditures (the Treasury system of budget execution). Although it may seem a bit paradoxical, one of the most important lessons from the international experience with decentralization for the Lao PDR is that an effective system of decentralized governance requires a strong central government in key areas of the budget process.

---

<sup>5</sup> There are other signs that the provincial governors' power can be reigned in. For example, the Ministry of Finance holds the power to issue orders to correct governors' fiscal policies. However, the enforcement of this authority seems to be more the problem, as governors are granted also Ministerial rank.

## Box 1. A chronology of decentralization in Lao PDR

- 1975 Proclamation of the Lao People's Democratic Republic  
Considerable independence granted to the provinces despite the implementation of the centralized state.  
Provinces largely dependent on transfers from the central government
- 1986 Adoption of the New Economic Mechanism  
Accelerated fiscal and administrative devolution to the provinces.  
Provinces come under the responsibility of the Provincial Governor. Links with the central tax office and line Ministries are severed.  
Each government tier replicated the same tax instruments at each level.  
Provinces determine their own interest and exchange rates.
- 1991 Fifth Party Congress Resolution on re-centralization  
New Constitution is approved re-stating the unitary nature of the state.
- 1992 First National Budget is approved since 1975. Includes both central and local government expenditures.
- 1994 New budget law approved.  
Establishes the principles of State Budget formulation.
- 2000 New wave of decentralization.
- Instruction 01/PM. Defines the province as the strategic unit (focus on planning activities) and the district as the budget execution unit.
- Decree 192/PM on the Implementation of the Budget Law
- Instruction 475, defining revenue sources by levels of government.  
Instruction 128, detailing planning responsibilities at each level of government.
- 2005 Draft of New Budget Law being discussed
- 2006 Forthcoming Decree on Decentralization (?)

The rest of the paper is structured as follows. Section 2 outlines Lao PDR territorial and administrative structure. Section 3 discusses the current assignment of expenditure responsibilities by level of government and options for reform. In Section 4, we analyze the revenue system and discuss the current proposals under the framework of the draft new budget law; we also list priority areas for reform. In Section 5, we look at the system of intergovernmental transfers, while Section 6 analyzes budget formulation and execution. We conclude by pointing out the importance of appropriately sequencing decentralization initiatives and the most fundamental policy alternatives for Lao PDR in the area of fiscal decentralization.

## **2. Territorial and Administrative Organization**

Lao PDR's Constitution, in its Article 75 (amended in 2003), states the republic is divided into three levels of administration. There are currently 18 provinces,<sup>6</sup> subdivided in turn into 141 districts and municipalities, and 11,293 villages.<sup>7</sup> (See Table 1). The Law on Local Administrations defines, in its Article 59, two levels of budget for subnational finance, the province and the district. The village is defined as the basic revenue collection unit, with its expenditure tasks to be defined by the district.

Provinces and cities are ruled by governors, while districts are governed by mayors and municipalities and villages by chiefs. Importantly, there are no provincial legislative organs, in the way of the locally elected assemblies. Provincial governors are appointed by the President upon the Prime Minister's recommendation for a five year period (Article 16 Law on Local Administrations). The country's multi-ethnic dimension is typically reflected in policy design, as the means of maintaining national cohesion. For

---

<sup>6</sup> This includes one prefecture (Vientiane, the capital city) and one special zone (Saysomboun, Special zone)

<sup>7</sup> Although it is not accorded official recognition, districts group villages for administrative purposes into zones or "khets" (UNCDF 2002). There are other administrative units without separate budgetary standing; these are 4 Urban Development Administrative Authorities (UDAAs) and the Vientiane UDAA (VUDAA).

example, the provincial governor or deputy governor is routinely a member of the majority ethnic group of the province.

Provincial administrations play a critical role in the current Lao vertical structure of government. The provincial administrations are provided in the Law on Local Administration the general responsibilities to manage political, economic, and socio-cultural affairs and human resources; to protect, preserve and utilize natural resources, the environment and other resources. They are also to manage national and local defense and security and foreign affairs as assigned by the central government.

The organizational structure of the provincial administrations (Article 8 of the Law on Local Administrations), includes the provincial cabinet and the local, de-concentrated divisions of the line Ministries. The same structure is replicated at the district level.

Although Article 10 of the Law on Local Administrations establishes a principle of dual accountability of local divisions of line Ministries to the provincial administration and national Ministry, in practice it is the governor that exercises control over the provinces' personnel.<sup>8</sup> This practice is also sanctioned in the legislation since Article 14.12-14 establishes the governor's capacity to "propose the appointment, transfer or removal of chiefs of districts and municipalities," to "appoint the directors of the local

---

<sup>8</sup> The principle of "dual subordination" of subnational public personnel is a characteristic trait of the Soviet budgeting system. Although *a priori* it appears to be convenient, in practice dual subordination has failed to work well in many other countries that in the past have used or today continue to use a Soviet budgeting approach. The main reason is that both theoretically and in practice it is not possible for public employees to respond to two different bosses. When there is conflict of interest between the two bosses, as there always is in any public administration, public employees by force have to respond to one boss and not the other. Other institutions and incentives, such as physical proximity or who ultimately appoints and fires and who pays for salaries and other benefits determine which authority actually controls subnational employees.

divisions of the line ministries,” and to “appoint, transfer, or remove the chief and deputy chief of the provincial or city cabinet.”

Several issues must be highlighted with the territorial and administrative organization of Lao PDR. First, as discussed above, there is a need to reach for better balance in the distribution of government attributes between central and deconcentrated organs of government, in particular the powers of provincial governors in a number of matters which, as will be discussed below, range from tax collection activities to budget implementation needs to be transferred to central government agencies.

Second, the current structure of deconcentrated government at the subnational level provides a good basis for evolving this system toward a more genuine decentralized structure by, among other things, creating provincial and district legislative assemblies, with power to approve their respective sub-national budgets and with popular representation in their jurisdictions. Providing autonomous legal standing to subnational units will not go against the unitary system of government in Lao PDR.

Third, there are the issues to consider whether there are too many levels of subnational administrations and whether some of the subnational units are too small to operate efficiently in a decentralized system of governance. These are important questions that will need more research in the future. However, it would appear from the current vantage point that three levels of budget determination (central, provincial and district) does not seem excessive for a country of Lao PDR size.<sup>9</sup> On the issue of size, there are probably real gains in efficiency to be realized by the consolidation of some provinces into a smaller number of these jurisdictions. Similar gains are likely to be

---

<sup>9</sup> In addition, it would not make much sense to eliminate either the provinces or the districts for historical and all sorts of practical reasons.

possible by the consolidation of some districts into a smaller number. We must note, however, that the “optimal” size of subnational units must not be considered exclusively along the lines of economies of scale or efficiency but also along other dimensions, including access of citizens to government units and eventually the accountability of local officials to the residents in those communities.

### **3. Assignment of Expenditure Responsibilities**

As we have seen in the previous section, the recent central–local relations in Lao PDR are the product of a sequence of state management reforms. These series of reforms have naturally influenced the distribution of functions and competencies among the different levels of governing structure.

In assessing the performance of the system of intergovernmental fiscal relations in Lao PDR, it is important to first determine what functions and activities should be carried out at the different levels of government. This first step in expenditure assignments represents the foundation for a sound system of local government finance. Making this the first step in the design of the system respects the fundamental principle that “finance should follow function.” Logically, it would be impossible to get the system of local government finance “right” if the expenditure responsibilities that the system should be funding through revenue assignments and transfers are improperly assigned.

Like in many other countries, local governments in Lao PDR often have unclear expenditure responsibilities. However, Lao PDR is considering a series of reforms which, if carefully designed, have the potential for introducing much more clarity and transparency to the issue of expenditure assignments. This step will be crucial for successful decentralization policy reform. In what follows, we first review some general

principles of expenditure assignments which allow us to assess the appropriateness of the current expenditure assignments in Lao PDR. Once the appropriateness of the expenditure assignments has been determined, we identify the policy issues of the current practices and discuss options for reforms.

### **3.1 General Principle of Expenditure Assignments<sup>10</sup>**

Expenditure assignments answer the fundamental question of which level of government – local, regional or central – should be responsible for the specific functions and activities that do belong and will remain in the public sector.

Although there is no absolute best way for assigning particular public services to a level of government, commonly accepted objectives for expenditure assignments exist and include, among others, the following:

(i) *The critical role of the efficiency criterion*: The efficient provision of government services requires that governments satisfy the needs and preferences of citizens as well as possible. This is best achieved by the "subsidiarity" principle. Responsibility for the provision of services should be at the lowest level of government compatible with the size of "benefit area" associated with those services. Efficiency in the provision of public services is enhanced if consumption benefits are linked to costs of provision via fees, service charges, or local taxes.

(ii) *The objectives of redistribution and stability best pursued by the central government*: Expenditures undertaken by government for equity or income equalization reasons, such as social welfare, low income housing, should be the domain of the central government; while implementation can very well be left to local governments which may

---

<sup>10</sup> For further discussions on this topic see, for example, Martinez-Vazquez (1998).

have informational and other comparative advantages. Expenditures undertaken for the stabilization of the economy such as massive investment or unemployment compensation are by their scale naturally ascribed to the central government.

(iii) *No Single Best Assignment*: The application of these rules largely facilitates the assignment of expenditure responsibilities to different levels of government. However, the rules do not always yield an unequivocal answer. Some public services, e.g., primary education and primary health services, may be of a local nature by the size of their benefit area, but because of their relevance in welfare and income redistribution they may also be considered a responsibility of the central government. In a sense, there is no single best assignment of expenditure responsibilities. What is considered the best assignment is likely to change over time with changes in costs and technological constraints, as well as changes in preferences. However, there is a need at any given moment in time to have a concrete assignment of expenditure responsibilities among the various assignments that could be considered optimal. Failure to have a concrete assignment may lead to instability in intergovernmental relations and to the inefficient provision of public services.

(iv) *Importance of a Clear and Stable Assignment*: As unitary systems become more decentralized, and also in federal systems, the failure to establish by law a clear assignment of expenditure responsibilities for each government level can become a source of conflict between the central and subnational governments and can lead to an inefficient provision of public services. In situations where government budgets are tight, which is almost always, the lack of clear assignments may lead to the under-provision of key public services.

(v) *Recognizing the multi-dimensional nature of some expenditure responsibilities.* It is important to recognize that the assignment of expenditure responsibilities often involves different levels of government for a variety of reasons; for example, the central authorities may have an interest that all citizens receive a certain level of a particular service but at the same time local authorities may have an advantage in providing that service in a more efficient manner. These shared responsibilities create a problem for having a clear assignment. But actually considerable clarity can be regained by realizing that any expenditure responsibility has a multi-dimensional nature: any expenditure responsibility can be broken down into the responsibilities for (1) actually producing a good or delivering a service, (2) providing or administering the service, (3) financing a service, and (4) setting standards, regulations or policies guiding the provision of government services.<sup>11</sup>

For example, while local governments provide elementary education in many countries, higher-level governments often share the responsibility of financing and regulating local education. At the same time, primary education may be produced either by local public schools or by publicly funded private schools. Thus, additional policy issues need to be resolved when the responsibilities to produce, provide, finance and regulate a certain government function do not all fall within the jurisdiction of a single level of government in order to ensure that different levels of government effective work together.

Box 2 presents a representative assignment of expenditure responsibility for a number of government functions, showing which level of government (national, regional

---

<sup>11</sup> There is a difference between providing and producing a service. For instance, a local government may provide garbage collection services to local residents. This service may in fact be delivered by a private firm which has been contracted by the local government.

or local) could properly be involved in the regulation, financing, provision or production of these government functions. Among others, the summary confirms that indeed there is no single best assignment of responsibilities. For instance, the responsibility for secondary education may properly be placed at the regional level in some countries, whereas in other countries and under other conditions secondary education could be appropriately considered a local government function. The summary further reveals that many (if not most) government services ultimately will involve more than one level of government. The fact that the devolution of expenditure functions often involves several levels of government emphasizes the need for intergovernmental cooperation and dialog in order to assure the successful delivery of public services.

Box 2: A Representative Assignment of Expenditure Responsibility				
Function	Regulation	Financing	Provision / Administr.	Production
International affairs	N	N	N	N
Defense	N	N	N	N
Public order and safety	N,R,L	N,R,L	N,R,L	N,R,L
Primary and secondary education	N,R,L	N,R,L	R,L	R,L,P
Higher education	N,R	N,R	N,R	N,R,P
Health care	N,R,L	N,R,L	R,L	R,L,P
Social security and welfare	N,R	N,R	R,L	R,L
Community services (water, sewer, refuse, fire protection)	N,L	L	L	L,P
Highways, roads and streets	N,R,L	N,R,L	N,R,L	N,R,L,P
Parks, recreation and culture	N,R,L	N,R,L	N,R,L	N,R,L,P
National transportation / communication networks	N	N,R	N,R,L	N,R,L,P
Regional/local public transportation	R,L	R,L	R,L	R,L,P

Note: N denotes National Government; R denotes Regional Government; L denotes Local Government, and P denotes the private, non-government sector / civil society.

### **3.2 The Current Expenditure Assignments in Lao PDR**

After a decade of a centrally planned economy, a new policy referred to as New Economic Mechanism (NEM) was introduced in 1986 to liberalize the economy and, among others, to provide the provinces with a significant devolution of power to manage political, economic, and socio-cultural affairs and human resources. As a result of this policy, provincial governors were given practically complete power over expenditures, revenues, and even setting the interest rates and exchange rates at the provincial “State” Bank. These policies had several important consequences including a significant reduction in tax revenues for the central government. In 1992, the first National budget law was adopted along with a new constitution, in an attempt to re-centralized government financial activities. But, as we have seen, the most recent policy trend has been essentially geared toward a re-decentralization.

The current system of division of expenditure responsibilities is based on three legal provisions: (i) the Prime minister’s decree (Decree 192/PM, dated 02 November 1999), which tried to redefine local governments’ responsibilities by identifying provinces as the strategic units, districts as the budget planning units and villages as the implementing units; (ii) the State Planning Committee’s recommendation (Recommendation 128/SPC, dated 11 March 2000), that aimed at improving the responsiveness to local needs and increasing ownership and participation at the local level; (iii) the Ministry of Finance’s recommendation (Recommendation 475/MF, dated 22 March 2000), which specified the revenue collection and the expenditure assignment for provinces, districts and villages by listing the types of expenditures and revenues sources assigned to each level of governments. Annex Table 1A provides the actual text

for the expenditure assignments in articles 39, 46, 48 of the Decree 192/PM on the implementation of the National Budget law; while following article 28 and 30 of the revised Law on State Budget, Annex Table 1B, gives the expenditure assignment of each level of government.

The current expenditure assignments are outlined in Table 2 below. This distribution of responsibilities has several features. First, as outlined in instruction 01/PM, local governments (mainly provinces) are given significant authority over the national budget. Second, the formal expenditure assignments in Lao PDR use several forms of budget classification to define government expenditure responsibilities. For instance, Decree 192/PM uses both economic classification (recurrent expenditures, salaries, interest, capital investment, etc.) and functional classification (education, health services, national defense and etc.). By contrast, expenditure assignments in the international practice focus on the functional classification of the budget with further breaks down at different tiers of governments. Notice also the numerous concurrent or joint responsibilities among different levels of government without any further clarification. Third, expenditure responsibilities for all practical purposes are defined only among the central government and the provinces; in reality, there is no concrete assignment to the local governments (the districts, municipalities, and villages).

In practice, these expenditure responsibilities have translated into substantial expenditures at the subnational level. The share of subnational government expenditure in total (state budget) expenditure was an average of 36 percent, with a steadily increasing trend over the period 1996-2003 (Table 3). This expenditure decentralization ratio is quite high by international standards.

Capital expenditures have also increased during this period and represent the bulk of subnational total expenditure. The ratio of local capital expenditures to local recurrent expenditures is somewhere between the ratio one-to-one (1:1) in 1996-1998, to a ratio of three-to-one (3:1) in 2001/02 (see Table 3). For instance, using four key functional expenditures (infrastructure, education, health and agriculture), spending on infrastructures represents about half of the total budget (Table 5).

With regards to the composition of expenditure in the state budget, subnational governments have a substantial presence, with 40% and 56% in recurrent and capital expenditures respectively in the fiscal year 2002/03 (Table 4). However, the budget allocation between recurrent expenditures and capital expenditures at the local level is, by international standards, very lopsided, 28% and 72% respectively. This distribution adversely impacts the share allocated to wages, salaries and benefits, which represent only 15% of subnational total expenditures. Despite the fact that there is a need for local infrastructure, there is clearly the risk of under-funding the operation and maintenance activities that must accompany the provision of local services. Last, we must note that the data are not available to provide any breakdown about the functional compositions of expenditure at the local level; of course, this is a direct consequence of the lack of functional classification of the budget.

### **3.3 Issues in Expenditure Assignments in the Lao PDR**

According to the legislative framework, local governments in Lao PDR play an important role in the delivery of government services, as they are assigned the responsibility of delivering key public services such as education, health services,

agriculture and infrastructure. Although the responsibilities assigned to local governments are typically “local” services, the actual assignment of expenditures partially follow the subsidiarity principle and broadly coincide with standard principles of expenditure assignment<sup>12</sup>.

Notwithstanding the above instruction guideline, there are a number of shortcomings in the current assignment of expenditure responsibilities that need to be addressed for a successful fiscal decentralization process in Laos. One important shortcoming of expenditure assignments in Lao is that the current assignment of expenditure responsibilities in the local government is vague. The expenditure assignment in PM Decree 192 fails to consider the multi-dimensional nature of expenditure assignments. The Budget Law does not distinguish either between national functions that are delegated for implementation to the sub-national level (in a deconcentrated fashion) and those functions that are truly own functions of subnational levels (in a decentralized fashion)

A second issue is the lack of clarification of expenditure assignments for concurrent or joint responsibilities, between central and subnational governments on the one hand, and between different levels of subnational governments on the other; that is, the legislation does not clarify who is supposed to be responsible for what in the case of many joint responsibilities. A way to introduce clarity in the case of co-responsibility is to be explicit in the law about the attribution of competencies for the regulation, the financing, and the implementation of the responsibility. It is indeed crucial to know what

---

<sup>4</sup> The subsidiarity principle stipulates that the responsibility for the provision of goods and services should be placed at the lowest level of government, (i.e. compatible with the smallest benefit area of the service) that is able to deliver the good or service in an efficient manner.

specific service delivery functions and subsequent public expenditure management responsibilities are appropriately assigned to provinces, districts and villages. For example, take the case of education. It would be very helpful to know the following: (i) which government entity is in charge of school construction, school repair and maintenance; (ii) for school materials, who should provide school furniture and the procurement of books and other materials?; (iii) for school administration, who is hiring and supervising the teachers; (iv) who is responsible for the overall supervision of primary education quality and so on.

The absence of explicit expenditure assignments for lower levels of government at district and village levels must also be highlighted as an important shortcoming of the current system. The 1994 State Budget Law leaves it to provincial governments to arrange all expenditure assignments with districts and villages within their territories, with very minor exceptions. The objective pursued by this measure has been to increase the flexibility and adaptability of the budget to regional circumstances as well as to provide monitoring of local activities. Although these arguments have some merits, there should be some alternative ways to increase predictability, certainty and efficiency of the local budget system while pursuing the objective of flexibility and adaptability. For example, it may be possible to allow for asymmetric assignments, as long as they are explicit, in order to better adapt to particular conditions of certain local governments.

The legal base for expenditure assignments is too fragmented. The draft Budget law would be a desirable vehicle for clarifying expenditure responsibilities and unifying in a single legal document the entire assignment. We must note that in order to provide a clear assignment, the draft Budget law will require specifying for all shared or concurrent

responsibilities which level of government is responsible for the different attributes of regulating, financing and implementing that function.

Note also that accountability of subnational levels to their residents is missing in the system not only because of the lack of clarity regarding who is responsible for what, but also because of the absence of election of local officials. Currently, in a formal way subnational governments are only accountable to the central government, but given the extraordinary powers of provincial governors it would even seem that in many ways they are not, in reality, accountable even to the central government.

### **3.4 Policy Options for the Reform of Expenditure Assignments in the Lao PDR**

A fundamental issue observed in the Lao PDR's expenditure assignment is that the lack of clarity originates from, among other causes, the fact that the budget currently lacks a functional classification. For this reason, and other reasons such as the need to clearly establish budget priorities, it is desirable in the shortest term possible to adopt a functional classification of the budget, preferably along GFS lines.

The current draft of the State Budget Law would be a good instrument to clarify expenditure responsibilities. This improved expenditure assignment should strive wherever it is feasible to introduce exclusive assignments to different levels of government. Otherwise, for each shared responsibility the new assignment should clearly specify the competencies for: (i) regulating and establishing norms for provision; (ii) financing the service; and (iii) actually delivering the service for all levels of government that share the responsibility.

The government should also consider introducing an explicit assignment of expenditure responsibilities below the provincial level, at the district and village levels in the draft State Budget Law.

In order to account for heterogeneity and the different levels of administrative capacity in each of the provinces, the expenditure assignment may consider asymmetric assignments below the provincial level, at district and village levels. In this way there may be two or more standard packages of services for districts and villages. However, provincial governments could retain some of the functions when the implementation capacity at the local level is not existent. If the principle that 'provinces should be able to decide expenditure assignments for local governments' is retained, it will be important to introduce a practice, similar to the one used in Vietnam, that expenditure assignments be kept fixed during a "stability period" of 3 to 5 years for districts and communes. In addition, these temporary assignments should be made explicit (written). In this case also, the Ministry of Finance should conduct a periodic survey of expenditure assignment practices in the provinces.

It would be also desirable to complement the clarified expenditure assignments with the strengthening of institutions for intergovernmental dialog and coordination, especially between central government agencies and the provinces. At present, there appears to be little or no communication in many areas. The reason for this recommendation is that even with an explicit and clear statement of expenditure responsibilities along the lines recommended here, it must be recognized that it is generally impossible to make provisions, in the law, for all possible situations encountered in delivery of services. Rather than introducing more and more details and

complexities in the law, one effective way to deal with these additional uncertainties is to create or strengthen institutions of coordination among agencies at different levels of government that share a particular expenditure responsibility. For example, holding regular meetings and providing information at all levels facilitates coordination for clarifying an effective assignment of expenditure responsibilities.

Table 2: Assignment of Expenditure Responsibility in LAO PDR.

	Central Government	Provinces and Cities	Districts and Municipalities	Villages
Health	National health and disease prevention programs	Provincial and district hospitals services	District and Municipal services as assigned by provincial government	Implementation unit
Education	National program Educational instruments	Provincial services Primary and secondary program	District and Municipal services as assigned by provincial government	Implementation unit (school construction, and assignment of teacher)
Economic Activities	Services managed centrally	Provincial and district services	District and Municipal services as assigned by provincial government	Implementation unit
Culture and Sports	International and state level movement and performances	Sports and cultural performances at local levels	District and Municipal services as assigned by provincial government	Implementation unit
Social	National programs State Pension programs	Provincial and district services	District and Municipal services as assigned by provincial government	Implementation unit
Defense	National defense	Local defense and security	District and Municipal services as assigned by provincial government	Implementation unit
Police and Security	National police and official forces	Provincial and district police and security	District and Municipal services as assigned by provincial government	Implementation unit
Political Organs	National party and central level agencies	Provincial and district political organs	District and Municipal political organs	Implementation unit
Prices Subsidies	Central programs	Provincial and district services and programs	District and Municipal services as assigned by provincial government	n/a
interest	Overseas and national debt service	Debt services on programs that benefited Provincial and district levels	n/a	n/a
Other Expenditure	Disaster, disease and poverty relief	Disaster, disease and poverty relief	District and Municipal services as assigned by provincial government	n/a
Capital expenditures	Centrally managed Infrastructure projects	Provincial and district infrastructure management	District and Municipal infrastructure as assigned by provincial government	Implementation unit
Transfers	Transfer to subnational governments	Transfer to Provincial and district and municipalities	District and Municipal services as assigned by provincial government	n/a

Table 3: General Government Expenditure Trend 1996 - 2003

Expenditure		1996/97	1997/98	1999/00	2000/01	2001/02	2002/03
General	<u>Total</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	<u>100.0</u>
	current	44.7	44.6	35.8	41.6	43.6	31.8
	capital	55.3	55.4	64.2	58.4	56.4	57.3
Ministries	<u>Total</u>	<u>66.1</u>	<u>65.9</u>	<u>69.5</u>	<u>61.2</u>	<u>56.4</u>	<u>55.29</u>
	current	25.1	25.6	27.5	31.4	33.6	19.28
	capital	41	40.3	42	29.7	22.9	25.12
Provinces	<u>Total</u>	<u>28</u>	<u>28.7</u>	<u>30.5</u>	<u>38.8</u>	<u>43.6</u>	<u>44.71</u>
	Current*	14.5	13.3	8.4	10.2	10.1	12.55
	Capital**	13.6	15.4	22.2	28.6	33.5	32.16
	Ratio(**)/(*)	0.9	1.2	2.6	2.8	3.3	2.6
Other Unaccounted	<u>Total</u>	<u>5.9</u>	<u>5.4</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>
	current	5.1	5.7	0.00	0.00	0.00	0.00
	capital	0.8	-0.3	0.00	0.00	0.00	0.00

Source: Own calculations based on Ministry of Finance data.

Table 4: Expenditure Per Capita (kip/person) FY 2002-2003

		Total of Central and Province		Total of Line Ministries		Total of Provinces	
			%		%		%
Total Expenditure		776,334	100	429,250	100	347,084	100
Recurrent	Total Recurrent	247,087	31.83	149,687	35.00	97,398	28
	Wages, Salaries and Benefits	118,212	15.22	66,335	15.45	51,876	15
	Operation and Maintenance	57,112	7.36	42,551	10	14,560	4
	Subsidies and Transfers	60,104	7.74	33,339	7.76	26,765	8
	Misc. Expenditure and contingencies	11,659	1.5	7,462	1.74	4,197	1
Capital	Total Capital	444,685	57.23	195,000	45.43	249,685	72
	Local	183,277	26.00	36,780	8.57	143,916	42
	Foreign	263,989	31.23	158,220	36.86	105,769	30

(in percentage)

Total Expenditure		100.0	55.3	44.7
Recurrent	Total Recurrent	100.0	60.6	39.4
	Wages, Salaries and Benefits	100.0	56.1	43.9
	Operation and Maintenance	100.0	74.5	25.5
	Subsidies and Transfers	100.0	55.5	44.5
	Misc. Expenditure and contingencies	100.0	64.0	36.0
Capital	Total Capital	100.0	43.9	56.1
	Local	100.0	20.4	79.6
	Foreign	100.0	59.9	40.1

Source: Own calculations based on Ministry of Finance data

Table 5: Government Expenditure for Four key sectors

	act.	est.
	2002/03	2003/04
<u>Overall Public Spending</u>	<u>100</u>	<u>100</u>
Central	55.3	67.3
Provincial	44.7	32.7
<u>Agriculture</u>	<u>11.5</u>	<u>7.9</u>
Central	16.7	39.9
Provincial	83.3	60.1
Recurrent	4.5	5.7
Capital	94.6	93.1
<u>Infrastructure (MCTPC)</u>	<u>22.3</u>	<u>22.6</u>
Central	50.6	62.5
Provincial	49.4	37.5
Capital	0.7	0.6
Recurrent	98.2	98.4
<u>Education</u>	<u>9.9</u>	<u>10.5</u>
Central	44	50.8
Provincial	56	49.2
Recurrent	28.5	26.4
Capital	61	64.9
<u>Health</u>	<u>5.8</u>	<u>5.2</u>
Central	32	44.7
Provincial	68	55.3
Recurrent	17.8	18.4
Capital	79.6	79.2
<u>Total four Sectors</u>	<u>49.6</u>	<u>46.3</u>

Source: World Bank, 2005

Table 6: Expenditures Shortfall / Excess from Plan Expenditure by Provinces (2000 -2004)

	Expenditures											
	2000-2001			2001-2002			2002-2003			2003-2004		
	Plan	Actual	Shortfall/ Excess	Plan	Actual	Shortfall/ Excess	Plan	Actual	Shortfall/ Excess	Plan	Actual	Shortfall/ Excess
Total Revenue	.	2351	.	2770	2662	-108	3051	2909	-142	3460	.	.
Central	.	1334	.	1591	1388	-203	1826	1539	-287	2385	.	.
Total Provinces	.	1017	.	1179	1274	95	1225	1370	145	1075	.	.
1. Vientiane Municipality	.	200	.	200	197	-3	198	201	3	235	.	.
2. Phongsaly	.	88	.	119	75	-44	79	46	-33	90	.	.
3. Luangnamtha	.	37	.	48	40	-8	67	69	2	79	.	.
4. Oudomxay	.	65	.	87	66	-21	151	145	-6	169	.	.
5. Bokeo	.	57	.	69	54	-15	54	55	1	46	.	.
6. Louangphabang	.	70	.	161	130	-31	175	170	-5	111	.	.
7. Houaphan	.	71	.	115	87	-28	114	113	-1	105	.	.
8. Sayabouly	.	109	.	110	109	-1	99	103	4	102	.	.
9. Xiengkhouang	.	82	.	82	78	-4	88	63	-25	72	.	.
10. Vientiane	.	85	.	91	86	-5	98	99	1	83	.	.
11. Borikhamxay	.	40	.	59	59	0	73	74	1	69	.	.
12. Khammouan	.	69	.	111	176	65	165	250	85	153	.	.
13. Savannakhet	.	128	.	164	156	-8	152	150	-2	163	.	.
14. Saravane	.	79	.	55	59	4	80	79	-1	59	.	.
15. Sekong	.	28	.	37	32	-5	44	45	1	64	.	.
16. Champassak	.	111	.	184	265	81	167	224	57	135	.	.
17. Attapeu	.	38	.	38	41	3	46	50	4	57	.	.
18. Xaisomboun Sp. Zn	.	21	.	29	21	-8	36	35	-1	42	.	.
Maximum	.	200	.	200	265	81	198	250	85	235	.	.
Minimum	.	21	.	29	21	-44	36	35	-33	42	.	.
Average	.	76.6	.	97.7	96.2	-1.6	104.8	109.5	4.7	101.9	.	.

Source: Own calculation based on Ministry of Finance data

Table 7: General Government Expenditure Trend 1996 - 2002

	1996/97 (1)			1997/98 (2)			1999/00 (1)			2000/01 (1)			2001/02 (2)		
	Total	current	capital	Total	current	capital	total	current	capital	total	current	capital	total	current	capital
Total	100	44.7	55.3	100	44.6	55.4	100	358	642	100	416	58.4	100	43.6	56.4
Ministries	66.1	25.1	41	65.9	25.6	40.3	69.5	27.5	42	61.2	31.4	29.7	56.4	33.6	22.9
Agriculture and forestry	2.5	0.2	2.3	3.2	0.3	3	1.7	0.1	1.6	2.3	0.2	2.1	2	0.1	1.9
Industry and handicraft	10.1	0	10.1	8.4	1.9	6.5	2	0	2	1.4	0	1.4	0.4	0	0.3
Communication, transport	15.6	0.1	15.4	20	0.9	19.1	30.6	0.1	30.5	18.4	0.4	18	6.8	0.2	6.6
Commerce	0	0	0	0.1	0.1	0	0	0	0	0.1	0	0.1	0	0	0
Finance	0.3	0.3	0	0.4	0.3	0	14.2	13.8	0.4	15.4	15.3	0.2	18	16	2
Planning	0.1	1.1	0	0.1	1	0	0.3	0	0.3	0.1	0	0.1	0.2	0	0.2
Education	7.2	1.1	61	6.9	1.6	5.4	2.5	0.5	1.9	3.1	0.9	2.2	4.9	0.9	4
Health	2	1	1.1	3.2	0.8	2.4	0.4	0.3	0.2	0.7	0.4	0.3	2.1	0.3	1.9
Culture and information	1.8	0.9	0.9	1.1	0.4	0.7	1.7	0.1	1.6	0.7	0.2	0.5	1.4	0.2	1.3
Labor and social welfare	4.5	1.7	2.8	2.8	1.1	1.6	2	0.1	1.8	2.3	0.3	2.1	2.5	0.2	2.3
Justice	0.1	0.1	0	0.1	0.1	0	0	0	0	0.1	0.1	0	0.1	0	0.1
Foreign affairs	1.1	1.1	0.1	3.3	3	0.3	1.7	1.6	0.1	2	2	0	1.9	1.8	0
Defense	11.4	11	0.4	9.9	9.5	0.4	8.1	7.4	7	7.8	7.1	0.8	8	7.3	0.7
Interior	3.6	3	0.6	3.2	2.6	0.6	2.8	2.4	4	2.8	2.6	0.3	3.1	2.6	0.5
Prime Minister's office	5.7	4.6	1	3.3	3	0.3	1.4	0.8	0.6	3.9	2.1	1.7	3.6	2.5	1.1
Other										0	0	0	1.1	1.1	0

Table 7: General Government Expenditure Trend 1996 – 2002 (continued)

	1996/97 (1)			1997/98 (2)			1999/00 (1)			2000/01 (1)			2001/02 (2)		
	Total	current	capital	Total	current	capital	total	current	capital	total	current	capital	total	current	capital
<u>Total</u>	<u>100</u>	<u>44.7</u>	<u>55.3</u>	<u>100</u>	<u>44.6</u>	<u>55.4</u>	<u>100</u>	<u>358</u>	<u>642</u>	<u>100</u>	<u>416</u>	<u>58.4</u>	<u>100</u>	<u>43.6</u>	<u>56.4</u>
<u>Provinces</u>	<u>28</u>	<u>14.5</u>	<u>13.6</u>	<u>28.7</u>	<u>13.3</u>	<u>15.4</u>	<u>30.5</u>	<u>8.4</u>	<u>22.2</u>	<u>38.8</u>	<u>10.2</u>	<u>28.6</u>	<u>43.6</u>	<u>10.1</u>	<u>33.5</u>
Vientiane Prefecture	4.9	1.6	3.3	2.5	1.5	1	5	0.8	4.2	5.6	1.2	4.4	5	1	4
Phongsali	1.7	0.5	1.2	1.3	0.4	0.9	1.5	0.3	1.2	2.5	0.3	2.2	2.9	0.3	2.6
Louangnartha	1.6	0.5	1.1	1.3	0.4	0.8	0.8	0.2	0.6	1	0.3	0.7	1.2	0.3	2.6
Oudornxia	1	0.5	0.5	1.2	0.5	0.6	1.8	0.3	1.5	1.8	0.4	1.4	2.2	0.4	1.7
Bokeo	0.8	0.4	0.4	1.3	0.4	0.9	2.7	0.2	2.5	1.6	0.3	1.4	1.7	0.3	1.4
Louang Prabang	2	1.1	1	2.1	1	1.1	1.1	0.5	0.6	3.1	0.6	2.5	2.7	0.7	2.1
Houaphan	1.2	0.7	0.5	2.2	0.6	1.6	2.4	0.4	2	2	0.6	1.3	4	0.8	3.2
Xatnabouli	1.5	0.9	0.6	1.9	0.8	1.1	1	0.4	0.5	2	0.5	1.5	2.9	0.5	2.3
Xiang Khoang	1	0.6	0.3	1.2	0.6	0.6	1.8	0.4	1.4	2.3	0.5	1.8	2	0.5	1.5
Vientiane Province	1.4	1	0.4	1.6	0.8	0.7	1.7	0.6	1.1	2.4	0.6	1.7	2.3	0.6	1.6
Bolikharnxai	1	0.6	0.4	1.1	0.6	0.5	1.3	0.3	1.1	1.1	0.4	0.8	1.5	0.4	1.1
Khamnouan	1.3	0.9	0.4	1.7	0.8	0.9	1.7	0.5	1.2	1.9	0.6	1.3	2.8	0.6	2.1
Savannakhet	3	1.8	1.2	2.8	1.6	1.2	2.5	1.1	1.4	3.6	1.3	2.3	4.1	1.4	2.7
Salavan	1	0.6	0.4	1.2	0.6	0.6	1.4	0.3	1.1	2.2	0.4	1.8	1.4	0.4	1
Xekong	0.9	0.4	0.6	1	0.4	0.6	0.9	0.2	0.7	3.1	1.5	1.7	4.6	1.1	3.5
Champassak	2.4	1.8	0.7	2.8	1.5	1.3	2.2	1.6	0.5	0.8	0.3	0.5	0.9	0.2	0.7
Attapu	0.7	0.3	0.3	0.8	0.4	0.4	0.5	0.2	0.3	1.1	0.3	0.8	0.9	0.3	0.7
Xtasomboun Special Z.	0.7	0.3	0.3	0.7	0.3	0.5	1.9	0.1	0.2	0.6	0.1	0.4	0.7	0.1	0.6
<u>Other Unaccounted</u>	<u>5.9</u>	<u>5.1</u>	<u>0.8</u>	<u>5.4</u>	<u>5.7</u>	<u>-0.3</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>

Source: World Bank 2002

Table 7: General Government Expenditure Trend 1996 - 2002

	1996/97 (1)			1997/98 (2)			1999/00 (1)			2000/01 (1)			2001/02 (2)		
	Total	current	capital	Total	current	capital	total	current	capital	total	current	capital	total	current	capital
Total	100	44.7	55.3	100	44.6	55.4	100	358	642	100	416	58.4	100	43.6	56.4
Ministries	66.1	25.1	41	65.9	25.6	40.3	69.5	27.5	42	61.2	31.4	29.7	56.4	33.6	22.9
Provinces	28	14.5	13.6	28.7	13.3	15.4	30.5	8.4	22.2	38.8	10.2	28.6	43.6	10.1	33.5
Ventmane Prefecture	4.9	1.6	3.3	2.5	1.5	1	5	0.8	4.2	5.6	1.2	4.4	5	1	4
Phongsali	1.7	0.5	1.2	1.3	0.4	0.9	1.5	0.3	1.2	2.5	0.3	2.2	2.9	0.3	2.6
Louangnartha	1.6	0.5	1.1	1.3	0.4	0.8	0.8	0.2	0.6	1	0.3	0.7	1.2	0.3	2.6
Oudornxia	1	0.5	0.5	1.2	0.5	0.6	1.8	0.3	1.5	1.8	0.4	1.4	2.2	0.4	1.7
Bokeo	0.8	0.4	0.4	1.3	0.4	0.9	2.7	0.2	2.5	1.6	0.3	1.4	1.7	0.3	1.4
Louang Prabang	2	1.1	1	2.1	1	1.1	1.1	0.5	0.6	3.1	0.6	2.5	2.7	0.7	2.1
Houaphan	1.2	0.7	0.5	2.2	0.6	1.6	2.4	0.4	2	2	0.6	1.3	4	0.8	3.2
Xatgnabouli	1.5	0.9	0.6	1.9	0.8	1.1	1	0.4	0.5	2	0.5	1.5	2.9	0.5	2.3
Xiang Khoang	1	0.6	0.3	1.2	0.6	0.6	1.8	0.4	1.4	2.3	0.5	1.8	2	0.5	1.5
Vientiane Province	1.4	1	0.4	1.6	0.8	0.7	1.7	0.6	1.1	2.4	0.6	1.7	2.3	0.6	1.6
Bolikhamxai	1	0.6	0.4	1.1	0.6	0.5	1.3	0.3	1.1	1.1	0.4	0.8	1.5	0.4	1.1
Khamnouan	1.3	0.9	0.4	1.7	0.8	0.9	1.7	0.5	1.2	1.9	0.6	1.3	2.8	0.6	2.1
Savannakhet	3	1.8	1.2	2.8	1.6	1.2	2.5	1.1	1.4	3.6	1.3	2.3	4.1	1.4	2.7
Salavan	1	0.6	0.4	1.2	0.6	0.6	1.4	0.3	1.1	2.2	0.4	1.8	1.4	0.4	1
Xekong	0.9	0.4	0.6	1	0.4	0.6	0.9	0.2	0.7	3.1	1.5	1.7	4.6	1.1	3.5
Chamnpassak	2.4	1.8	0.7	2.8	1.5	1.3	2.2	1.6	0.5	0.8	0.3	0.5	0.9	0.2	0.7
Attapu	0.7	0.3	0.3	0.8	0.4	0.4	0.5	0.2	0.3	1.1	0.3	0.8	0.9	0.3	0.7
Xtasomboun Special Z.	0.7	0.3	0.3	0.7	0.3	0.5	1.9	0.1	0.2	0.6	0.1	0.4	0.7	0.1	0.6
Other Unaccounted	5.9	5.1	0.8	5.4	5.7	-0.3	0	0	0	0	0	0	0	0	0
Total	28.1	14.5	13.6	28.7	13.2	15.3	32.2	8.4	22.1	38.7	10.2	28.5	43.8	9.9	35.4
Maximum	4.9	1.8	3.3	2.8	1.6	1.6	5	1.6	4.2	5.6	1.5	4.4	5	1.4	4
Minimum	0.7	0.3	0.3	0.7	0.3	0.4	0.5	0.1	0.2	0.6	0.1	0.4	0.7	0.1	0.6
Average	1.56	0.81	0.76	1.59	0.73	0.85	1.79	0.47	1.23	2.15	0.57	1.58	2.43	0.55	1.97

Table 8 :General Government Expenditure Trend 1996 - 2002

	1996/97 (1)			1997/98 (2)			1999/00 (1)			2000/01 (1)			2001/02 (2)		
	Total	current	capital	Total	current	capital	total	current	capital	total	current	capital	total	current	capital
<b>Total</b>	<b>100</b>	<b>44.7</b>	<b>55.3</b>	<b>100</b>	<b>44.6</b>	<b>55.4</b>	<b>100</b>	<b>358</b>	<b>642</b>	<b>100</b>	<b>416</b>	<b>58.4</b>	<b>100</b>	<b>43.6</b>	<b>56.4</b>
<b>Ministries</b>	<b>66.1</b>	<b>25.1</b>	<b>41</b>	<b>65.9</b>	<b>25.6</b>	<b>40.3</b>	<b>69.5</b>	<b>27.5</b>	<b>42</b>	<b>61.2</b>	<b>31.4</b>	<b>29.7</b>	<b>56.4</b>	<b>33.6</b>	<b>22.9</b>
<b>Provinces</b>	<b>28</b>	<b>14.5</b>	<b>13.6</b>	<b>28.7</b>	<b>13.3</b>	<b>15.4</b>	<b>30.5</b>	<b>8.4</b>	<b>22.2</b>	<b>38.8</b>	<b>10.2</b>	<b>28.6</b>	<b>43.6</b>	<b>10.1</b>	<b>33.5</b>
Ventmane Prefecture	4.9	1.6	3.3	2.5	1.5	1	5	0.8	4.2	5.6	1.2	4.4	5	1	4
Phongsali	1.7	0.5	1.2	1.3	0.4	0.9	1.5	0.3	1.2	2.5	0.3	2.2	2.9	0.3	2.6
Louangnartha	1.6	0.5	1.1	1.3	0.4	0.8	0.8	0.2	0.6	1	0.3	0.7	1.2	0.3	2.6
Oudornxia	1	0.5	0.5	1.2	0.5	0.6	1.8	0.3	1.5	1.8	0.4	1.4	2.2	0.4	1.7
Bokeo	0.8	0.4	0.4	1.3	0.4	0.9	2.7	0.2	2.5	1.6	0.3	1.4	1.7	0.3	1.4
Louang Prabang	2	1.1	1	2.1	1	1.1	1.1	0.5	0.6	3.1	0.6	2.5	2.7	0.7	2.1
Houaphan	1.2	0.7	0.5	2.2	0.6	1.6	2.4	0.4	2	2	0.6	1.3	4	0.8	3.2
Xatgnabouli	1.5	0.9	0.6	1.9	0.8	1.1	1	0.4	0.5	2	0.5	1.5	2.9	0.5	2.3
Xiang Khoang	1	0.6	0.3	1.2	0.6	0.6	1.8	0.4	1.4	2.3	0.5	1.8	2	0.5	1.5
Vientiane Province	1.4	1	0.4	1.6	0.8	0.7	1.7	0.6	1.1	2.4	0.6	1.7	2.3	0.6	1.6
Bolikharnxai	1	0.6	0.4	1.1	0.6	0.5	1.3	0.3	1.1	1.1	0.4	0.8	1.5	0.4	1.1
Khamnouan	1.3	0.9	0.4	1.7	0.8	0.9	1.7	0.5	1.2	1.9	0.6	1.3	2.8	0.6	2.1
Savannakhet	3	1.8	1.2	2.8	1.6	1.2	2.5	1.1	1.4	3.6	1.3	2.3	4.1	1.4	2.7
Salavan	1	0.6	0.4	1.2	0.6	0.6	1.4	0.3	1.1	2.2	0.4	1.8	1.4	0.4	1
Xekong	0.9	0.4	0.6	1	0.4	0.6	0.9	0.2	0.7	3.1	1.5	1.7	4.6	1.1	3.5
Chamnpassak	2.4	1.8	0.7	2.8	1.5	1.3	2.2	1.6	0.5	0.8	0.3	0.5	0.9	0.2	0.7
Attapu	0.7	0.3	0.3	0.8	0.4	0.4	0.5	0.2	0.3	1.1	0.3	0.8	0.9	0.3	0.7
Xtasomboun Special Z.	0.7	0.3	0.3	0.7	0.3	0.5	1.9	0.1	0.2	0.6	0.1	0.4	0.7	0.1	0.6
<b>Other Unaccounted</b>	<b>5.9</b>	<b>5.1</b>	<b>0.8</b>	<b>5.4</b>	<b>5.7</b>	<b>-0.3</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>Total</b>	<b>28.1</b>	<b>14.5</b>	<b>13.6</b>	<b>28.7</b>	<b>13.2</b>	<b>15.3</b>	<b>32.2</b>	<b>8.4</b>	<b>22.1</b>	<b>38.7</b>	<b>10.2</b>	<b>28.5</b>	<b>43.8</b>	<b>9.9</b>	<b>35.4</b>
<b>Maximum</b>	<b>4.9</b>	<b>1.8</b>	<b>3.3</b>	<b>2.8</b>	<b>1.6</b>	<b>1.6</b>	<b>5</b>	<b>1.6</b>	<b>4.2</b>	<b>5.6</b>	<b>1.5</b>	<b>4.4</b>	<b>5</b>	<b>1.4</b>	<b>4</b>
<b>Minimum</b>	<b>0.7</b>	<b>0.3</b>	<b>0.3</b>	<b>0.7</b>	<b>0.3</b>	<b>0.4</b>	<b>0.5</b>	<b>0.1</b>	<b>0.2</b>	<b>0.6</b>	<b>0.1</b>	<b>0.4</b>	<b>0.7</b>	<b>0.1</b>	<b>0.6</b>
<b>Average</b>	<b>1.56</b>	<b>0.81</b>	<b>0.76</b>	<b>1.59</b>	<b>0.73</b>	<b>0.85</b>	<b>1.79</b>	<b>0.47</b>	<b>1.23</b>	<b>2.15</b>	<b>0.57</b>	<b>1.58</b>	<b>2.43</b>	<b>0.55</b>	<b>1.97</b>

Table 9: General Government Expenditure Trend 1996 - 2002

	1996/97 (1)			1997/98 (2)			1999/00 (1)			2000/01 (1)			2001/02 (2)		
	Total	current	capital	Total	current	capital	total	current	capital	total	current	capital	total	current	capital
<u>Total</u>	<u>100</u>	<u>44.7</u>	<u>55.3</u>	<u>100</u>	<u>44.6</u>	<u>55.4</u>	<u>100</u>	<u>358</u>	<u>642</u>	<u>100</u>	<u>416</u>	<u>58.4</u>	<u>100</u>	<u>43.6</u>	<u>56.4</u>
<u>Provinces</u>	<u>28</u>	<u>14.5</u>	<u>13.6</u>	<u>28.7</u>	<u>13.3</u>	<u>15.4</u>	<u>30.5</u>	<u>8.4</u>	<u>22.2</u>	<u>38.8</u>	<u>10.2</u>	<u>28.6</u>	<u>43.6</u>	<u>10.1</u>	<u>33.5</u>
<u>Ministries</u>	<u>66.1</u>	<u>25.1</u>	<u>41</u>	<u>65.9</u>	<u>25.6</u>	<u>40.3</u>	<u>69.5</u>	<u>27.5</u>	<u>42</u>	<u>61.2</u>	<u>31.4</u>	<u>29.7</u>	<u>56.4</u>	<u>33.6</u>	<u>22.9</u>
Agriculture and forestry	2.5	0.2	2.3	3.2	0.3	3	1.7	0.1	1.6	2.3	0.2	2.1	2	0.1	1.9
Industry and handicraft	10.1	0	10.1	8.4	1.9	6.5	2	0	2	1.4	0	1.4	0.4	0	0.3
Communication, transport	15.6	0.1	15.4	20	0.9	19.1	30.6	0.1	30.5	18.4	0.4	18	6.8	0.2	6.6
Commerce	0	0	0	0.1	0.1	0	0	0	0	0.1	0	0.1	0	0	0
Finance	0.3	0.3	0	0.4	0.3	0	14.2	13.8	0.4	15.4	15.3	0.2	18	16	2
Planning	0.1	1.1	0	0.1	1	0	0.3	0	0.3	0.1	0	0.1	0.2	0	0.2
Education	7.2	1.1	61	6.9	1.6	5.4	2.5	0.5	1.9	3.1	0.9	2.2	4.9	0.9	4
Health	2	1	1.1	3.2	0.8	2.4	0.4	0.3	0.2	0.7	0.4	0.3	2.1	0.3	1.9
Culture and information	1.8	0.9	0.9	1.1	0.4	0.7	1.7	0.1	1.6	0.7	0.2	0.5	1.4	0.2	1.3
Labor and social welfare	4.5	1.7	2.8	2.8	1.1	1.6	2	0.1	1.8	2.3	0.3	2.1	2.5	0.2	2.3
Justice	0.1	0.1	0	0.1	0.1	0	0	0	0	0.1	0.1	0	0.1	0	0.1
Foreign affairs	1.1	1.1	0.1	3.3	3	0.3	1.7	1.6	0.1	2	2	0	1.9	1.8	0
Defense	11.4	11	0.4	9.9	9.5	0.4	8.1	7.4	7	7.8	7.1	0.8	8	7.3	0.7
Interior	3.6	3	0.6	3.2	2.6	0.6	2.8	2.4	4	2.8	2.6	0.3	3.1	2.6	0.5
Prime Minister's office	5.7	4.6	1	3.3	3	0.3	1.4	0.8	0.6	3.9	2.1	1.7	3.6	2.5	1.1
Other										0	0	0	1.1	1.1	0
<u>Other Unaccounted</u>	<u>5.9</u>	<u>5.1</u>	<u>0.8</u>	<u>5.4</u>	<u>5.7</u>	<u>-0.3</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>

Source: World Bank 2002

## **4. Revenue Framework**

Once expenditure responsibilities are clarified, the next step in the design of a system of intergovernmental relations is the assignment of different sources of revenues to different levels of government.

### **4.1 General Principles for Revenue Assignment**

For efficient decentralization to proceed, the assignment of revenues to subnational levels of government needs to meet several basic criteria. First, it would need to provide sufficient resources to local level governments so as to allow them to perform the expenditure tasks assigned. These include local own tax revenues and fees and other user charges local governments may be allowed to levy, revenues from transfers including revenue sharing, and borrowing powers.

In practical terms, this criterion requires that the legal documents specifying the roles and responsibilities of different tiers of government define explicit (and guaranteed for a certain period) revenue assignments for all levels of governments in order to ensure predictable financing. Otherwise, vagueness may create perverse incentives for revenue mobilization at the local level.

Second, the revenue assignment should endow local governments with a degree of revenue collection autonomy at the margin in order to be able to increase or decrease those expenditures over which they are allocated responsibilities. A level of revenue autonomy is a good policy alternative to address fiscal vertical imbalances, it leads to greater accountability and it creates the basis for local creditworthiness. The best way to promote revenue autonomy at the subnational level is to provide subnational level

governments with the ability to change the tax rates of a closed list of taxes. One downside of revenue autonomy is that it may exacerbate horizontal inequalities. For that reason revenue assignment design must internalize this issue, at the same time recognizing that horizontal fiscal disparities can be effectively addressed with a system of equalization grants (as discussed in the next section).

Third, as principles of optimal taxation would advise, the allocation of taxes to local government should minimize distortions in the allocation of resources (neutrality principle). As will be discussed below, the government, in its draft new budget law, is considering the implementation of a system of tax sharing. This will require, importantly, the definition of adequate criteria for the distribution of tax revenues. For example, in the case of the corporate income tax this will require an apportionment formula to allocate the tax base across different sub-national jurisdictions. In the case of other taxes, such as the VAT, it is not advisable to share this tax on an origination basis because it will result in rather arbitrary subnational allocations. If the VAT is to be shared at all, it should be on the basis of a simple formula, such as population or estimates of aggregate consumption expenditures in each jurisdiction.

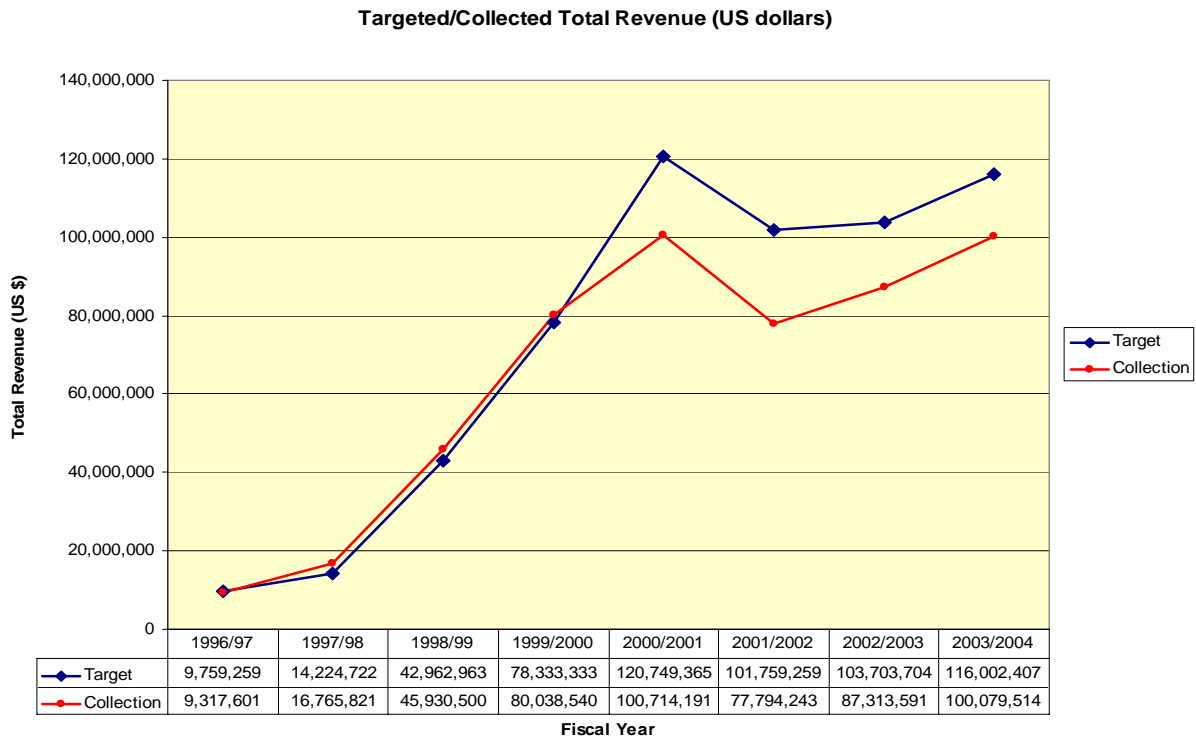
Fourth, the use of fees and user charges to finance local services is a good practice and perfectly justified for direct services rendered by local governments to their residents. However, the use of fees for general government services, such as education, can have very adverse effects on the access of the poor to those services and generally a negative impact on equity. In the case of Lao PDR, it would be desirable to conduct a survey of fees currently being charged at the local level to assess their impact on welfare.

Fifth, despite conventional wisdom in the definition of good “local taxes,” in depth, individualized analysis of the available revenue sources need to be undertaken to confidently decide that the level of government assigned the revenue source can manage the tax efficiently.

#### 4.2 Fiscal Overview in Lao PDR

The general trend in revenues is unstable. In the latest Public Expenditure Review 2002, the World Bank estimated that revenues should reach 15% of GDP by 2005. More recent data from the IMF seem to show that revenues as a share of GDP dropped from 13.1% in 2003 to around 11% in 2005 (among the lowest in Southeast Asia.)

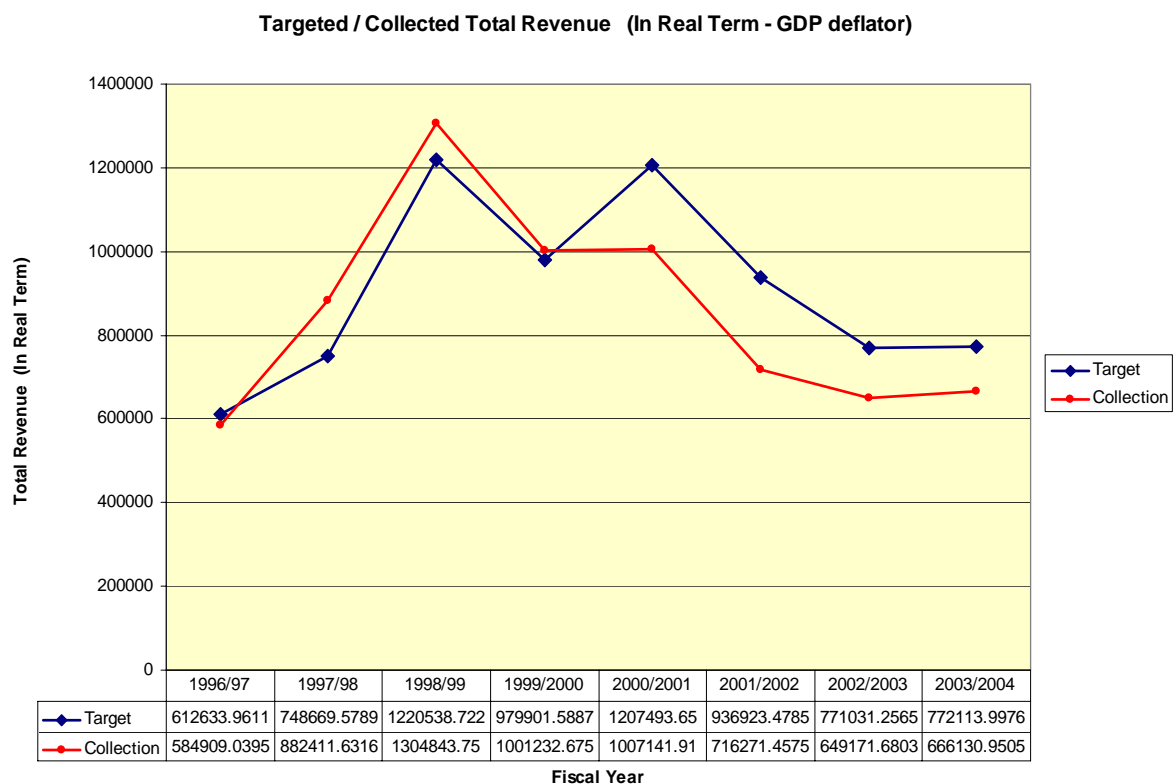
Chart 1. Current revenues trend 1996-2004



Source: SIDA/Vientiane 2005

Despite overall growth on current revenues since 1996/97 (see Chart 1), the analysis of real revenue figures shows a declining trend since the 1998/99 fiscal year (Chart 2). Revenues declined from USD1.3 billion in 1998/99 to some USD 660 million in 2003/04. The situation shows certain parallelism with that of China between 1984 and 1994 (see Box 2), and advises caution with respect to the mix of policies required to incentivize and improve efficiency in revenue collection, and in particular, continuing the practice of having provincial governments (as further discussed below) in charge of collecting a substantial part of central government revenues.

Chart 2. Real revenue collection trends 1996-2004 (in USD)



Source: Own calculations based on data from SIDA/Vientiane, 2005

Recent fiscal crises seem to have been caused between 1998 and 1999 by overspending on capital infrastructure, particularly on irrigation projects, in order to meet the food safety policy targets in rice production (World Bank, 2002). The deficit was financed via central bank borrowing, ensuring high inflation. Recurrent expenditure was therefore constrained, with the result of accumulation of arrears, mostly salary payments. The kip lost 90% of its value and inflation peaked at 167%. Although in recent years government policies have managed to contain inflation, expenditure seems to have not fully recovered to the pre-crisis real levels.

Low revenue collections seemed to be one of the causes of the crisis, since it forced the government to resort to fiduciary financing of the deficit. A pattern of diversification in revenue sources has been observed since 1995, with trade taxes and hydropower royalties losing ground to consumption and direct taxes (mostly as a result of the creation of the Large Taxpayers Unit). The trend is expected to continue, with Lao PDR accession to AFTA, and among the most important initiatives in this area will be the introduction of a VAT to replace the turnover tax. However, realistically speaking and extrapolating for the experience of other developing economies that have reduced their taxes on international trade and substituted with the introduction of a VAT and raising domestic taxes in the past, it will be very difficult for Lao PDR to fully replace the lost revenues from international trade, at least in the short run.

### **4.3 Local Government Revenues**

#### 4.3.1 Recent evolution and performance:

Available data for local government revenues shows, as would be expected, enormous variation among provinces. Vientiane municipality leads the country in

revenue collection with some 503 billion kip in fiscal year 2002-2003, over 50 times more than the bottom ranked province of Xaisomboun and 30 times more than second lowest Phongsaly. Average revenue collection in 2003 was 83.9 billion kip, slightly less than the 85.3 billion reported in the previous fiscal year.

Importantly, overall revenue collection fell considerably short of the target in several of the richest provinces both in 2002 and 2003, including Vientiane municipality, Savannakhet and Luangnamtha. Increased revenue collection in 2003 was driven by improved performance in Vientiane municipality, with revenues rising from 409 billion in 2002 to 503 billion kip in the fiscal year ending in 2003.

The 2002-2003 Budget Book (national Gazette) for Lao suggests that provinces (including districts) accounted for 60 percent of national revenue collection, with the remaining 40 percent being collected by central government. Revenue shares by tax differ widely, with the provincial government accounting for most of the revenues from turnover tax, excise taxes, and income tax. Provincial governments also collect nearly 100 percent of import duties, natural resource tax and timber royalties. The central government collects nearly 100 percent of dividends from State Owned Enterprises and hydro-royalties.

Besides the formal revenue assignments, provincial and local governments appear to levy fees for which the revenues are retained at the local level and never reported to the central government.<sup>13</sup> Supposedly, revenues collected from these fees are to be deposited in the provincial governments' treasury accounts, but they typically end up in extra-budgetary funds in separate bank accounts or are "lost" in the process. The so

---

<sup>13</sup> For instance, the livestock fee or the bed fee may be approved by the district governors and in some cases by the provincial governors.

called “timber fee,” among the most important in terms of revenue amount, is used by the provinces (with the consent from the central authorities) to compensate for any shortfall in revenues toward the end of the fiscal year. Revenues from the timber fee thus appear to work as a buffer, or more precisely, out-gap filling transfer (-- and part of the soft budget constraint for sub-national governments--) since the revenues from this source are in theory assigned at the central level. It is interesting to note and quite telling as to the use of the timber fee, that the revenue forecasts from this source are never included in the annual budget projections.

#### 4.3.2 Revenue Assignment:

The National Budget Law 1994, in its Article 3, defines the consolidated national budget by providing that the State's total revenues and expenditures are included in a unique and unified state budget plan. In Article 6, the law instructs that revenues will be remitted in their totality to the Budget. State agencies are not allowed to issue regulations for the collection of revenues (Article 7).

As discussed above, these articles reflect the drive towards re-centralization of budgetary expenditures of the 1990s, after a period in which largely autonomous provincial rule had led to an increase in inequalities and threatened macro-economic stability. In Chapter 2 of the National Budget Law, the law defines the State's revenues and expenditures. There is no direct definition of financing sources for local administrations but just a brief mention in Article 18 stating that budget expenditures would be distributed along the vertical management line of ministries and agencies. The

law instructs that the national budget be broken down by province and municipality (Article 26).

Expenditure and revenue responsibilities of different government tiers are made somewhat more explicit in Decree 192/PM of 1999, as shown in Annex Table 1.<sup>14</sup>

The draft Budget Law currently being circulated explicitly states, in its Article 3, that revenues from Customs Taxes are part of the State Budget. Concerns about retention of these revenues at the provincial level have prompted their more visible inclusion in the new law. International observers estimate that 50 to 70 percent of revenues from custom duties are not reported at the provincial level (SIDA, Vientiane). Regardless of existing formal revenue assignments, these do not seem to be followed. Already the Decree 192 very explicitly instructed that custom revenues are central taxes. However, in practice, these revenues are retained by provinces that have customs collection points. Importantly, customs agents are paid by the province and so there is a sense of ownership of the custom collection points by this level of government.

The de facto revenue assignments seem to be guided, however, by several criteria other than the type of tax, including the type of taxpayers and the location of business for the taxpayer. As is the practice of the Soviet budgeting system in other countries, in Lao PDR different types of taxpayers are assigned to different levels of government for the same tax. So in practice, as we will see below in the discussion of tax administration issues, some of the large taxpayers are assigned to the central government and revenues are collected by the central tax administration. Other large taxpayers are, however,

---

<sup>14</sup> The distinction between revenues at different levels of government currently in Lao PDR is quite artificial. For example, Articles 49 and 50 of Decree 192/PM of 1999 guarantee the level of provincial expenditures in the budget in the case of shortfall by resorting to central government assistance.

assigned to the provinces and those revenues, collected by the provincial tax offices, are to a large extent retained there.

In the draft Budget Law there is a clear attempt at clarifying the legal provisions for revenue collections (Article 8). This is a step in the right direction. The draft Law should also clarify how the system will apply the sanctions that may be required to tackle punishable behavior from provincial administrations. It may not be a practice in budget law drafting, but reference to a dispute resolution mechanism between different tiers of the public administration may be required at this legal level. The retention of revenues at the provincial level is a critical area of contention and should probably be addressed more explicitly in the law.

The draft Law also states (article 15) that all revenues will be managed by the State Treasury, coming under the responsibility of the Ministry of Finance. This would represent an extremely important step ahead towards re-centralizing control over revenue management. However, in the same draft Law, one misses a more explicit reference to the exclusive accountability of provincial treasuries to the central one, and not to the provincial governors. This is a key issue. Maybe a decree in the regulation and composition of the State Treasury is required to accompany the law, where provincial governors are explicitly stripped of their power to appoint, promote or fire treasury officials.

#### **4.4 Tax Administration Issues**

The structure of tax administration in Lao PDR remains heavily de-concentrated. The provincial governor acts as chief financial officer (in direct translation from Laotian,

the governor is the “owner” of the revenue and expenditure accounts). He pays the salaries and bonuses of tax administration officials and has de facto veto power on who gets appointed. Fitting the classic Soviet model for tax administration, the country’s tax administration structure is extremely weak at the central level. Out of a total 1,180 employees for the entire tax administration in the country, only 43 are located at headquarters<sup>15</sup>. As the central tax administration manages 102 large taxpayers (out of the total 636 large taxpayers in the country<sup>16</sup>), it is likely that headquarters have little time left nor the ability to plan and carry out national programs for audit, taxpayer registration and the like. In fact, emphasizing the high degree of de-concentration in the current system, there does not seem to be any national programs of any sort and very little or no oversight by the central Tax Department of the provincial offices. However, it must be noted that, in terms of tax revenues, the 102 taxpayers directly administered by the tax department at the center represented for fiscal year 2003-2004 almost half of all tax revenues (Kip 533 billion out of Kip 1,081 billion).

The performance of the entire tax administration apparatus appears to suffer from low skill levels, a lack of modern administrative procedures and inadequate computerization of services. There are serious concerns about lack of transparency in dealing with taxpayers, including a lack of respect for regulations and norms. The accumulation of all these circumstances leads to higher taxpayer compliance costs and lower tax compliance overall.

---

<sup>15</sup> The figures and statistics cited here were provided to the World Bank mission by Henrik Konkel, of the SIDA tax project at the Ministry of Finance.

<sup>16</sup> Besides the 636 large self-assessed taxpayers for the entire country as of 2004, the provincial administration were also in charge of 2,301 normal self-assessed taxpayers (of which 1,538 belonged to the Vientiane municipal office). In addition, the provincial tax departments cope with over 36,000 small taxpayers who pay through a ‘card holding’ system.

It would not come as a surprise that the overall tax revenue performance of the tax administration is very low. Reports from the SIDA-funded support initiative at the Ministry of Finance suggest, using tax gap analysis, that the central and provincial tax departments currently collect around 30 percent of all revenues that could have been collected. This estimate excludes an unknown quantity of foregone revenues due to “tax expenditures” involving tax holidays and fiscal incentives of all sorts. As mentioned elsewhere in this report, the provincial governments are now entitled to grant tax holidays and fiscal incentives at the cost of central government revenues.

A new Tax Law in Lao PDR and implementing regulations were issued in late 2005. The new legislation does not address, however, the issue of revenue assignments. Regarding tax administration, the new Law declares it to be a central government agency under the Ministry of Finance, but at the same time, it may provide legal backbone to the governors' control of the provincial tax administrations. The articulation of the latter provisions, found in article 97 of the law, is vague and does not seem to establish clearly the formal authority of the governors over the administration. Instead, that function is allocated to the “Provincial Financial Services.” It is probably the inertia of certain practices in the field, and not the legal provisions of the Tax law, that justify inefficient practices and the governors' control.

Box 2. A cautionary tale from China on how to organize the Lao PDR Tax Administration

The current situation in which the Lao PDR central government finds itself today with respect to the lack of control over the local tax administration parallels well the situation faced by China's central government during the period 1984 to 1994. The Chinese experience during that period and the solution China pursued in reforming the system can offer some important lessons for Lao PDR.

In the Contractual System Reforms of 1984, the Chinese government introduced a negotiated system with the provinces whereby the provinces were put in charge of collecting all taxes, central and provincial (and local). Provinces were given in addition a series of incentives to collect and mobilize revenues, while they were supposed to remit certain contracted amounts to the central government. Different provinces cut different deals with the central government but for the most part these deals included a fixed level of remittance (which could be zero) and otherwise a share of the collected taxes above certain thresholds.

It was not long after the provinces came to the realization that they could benefit more by not necessarily following the contracts with the central government. During this period, overall budgetary revenue as a percentage of GDP decreased in China from 22.9 percent in 1985 to around 13 percent by 1998. In the process, the share of the central government in total revenues also declined dramatically. The provinces used two main avenues to further profit from the contractual system. First, they provided local state owned enterprises with all kinds of tax benefits and fiscal incentives; and second, they developed ways to deviate funds, sometimes through the use of the so called "illegal fees" (or taxes not authorized by the center), to extra-budgetary funds (which were outside the knowledge much less the control of the central government).

In 1994 the government of China reacted to this situation by introducing the Tax Sharing System reform, which had the twin objectives of increasing the "two ratios," that is, the overall tax revenue effort in the country with respect to GDP and the share of central government in total revenues. The two main measures incorporated in the Tax Sharing System reform were first, the creation of separate tax administrations at the central and provincial level, putting the central administration in charge of collecting all central taxes as well as all shared taxes with the provinces, and second, the design of an explicit revenue assignment uniform for all provinces across the country.

It is of course a matter of interpretation how closely the current situation in the Lao PDR parallels that in China in the 1984-94 period. However, it is inescapable that there are a number of key similarities between the two cases. First, a trend of declining real revenues as a share of GDP, as shown in Chart 2 above. Second, the Lao PDR also has some sort of a negotiated system for revenue collection with the provinces, which takes the shape of determining the revenue (and expenditure) targets in the budget process each year. The Lao PDR tax administration is, as in the Chinese case back then, also practically fully decentralized (deconcentrated) to the provinces. In addition, as in the Chinese case, the provincial governments are able to provide tax benefits and fiscal incentives to enterprises and can "deviate" resources or withhold the remittance of revenues that are formally due to the central government.

#### **4.5 Revenue Target Setting**

Revenue targets are defined at the central level, together with expenditure ceilings. The difference between revenue collection and expenditure targets must be transferred back to the central government. If the provincial government's revenue collection exceeds expenditure targets but does not meet revenue targets, then they are obliged to reduce expenditure and maintain the same transfer level to central government. No province, however, does that. They instead reduce the amount transferred to the central government and maintain the level of expenditures. If revenue collection exceeded revenue targets, the province could retain 50 percent of the excess and devote it to capital investment.

In the draft Budget Law, clearer specification of revenue sources at the local level are introduced. However, it is unclear what the criteria and process would be for the definition of intra-provincial fiscal frameworks. Since the only legislative institution in the country is the National Assembly, it would be advisable (in the absence of more specific legislation) that proposals distributing revenue sources between provincial, district and village administrations be approved centrally. In addition, stability periods, as currently used in Vietnam, could be included for the duration of the arrangement. Amendments to provincial revenue frameworks would need to be sanctioned by the National Assembly.

The current system of revenue targeting introduces some perverse incentives for revenue mobilization:

1. The central government may define arbitrarily low expenditure targets (no stable, clear rules for expenditure determination seem to exist) and high

revenue targets in order to maximize the transfers received from the “surplus” provinces.

2. Provinces, if enforcement capacity is not strong, may retain revenues over their defined level of expenditure.
3. Provinces do not have much incentive to exceed targets in revenue collection, as the central government is able to claw back an important part of the collection. The incentive would be more positive if revenue targets were defined in a clearer, transparent way and a premium were defined over the entire amount of collection over and above the expenditure target.

As discussed, in 2002 and 2003, most of the surplus provinces reported collection well below the national targets. This may have to do with the incentives outlined above or just with inaccurate revenue estimation methods. Both should be reviewed.

With Instruction 2372/MoF of Nov 7 2005, the Ministry of Finance outlined the guidelines for the implementation of the State Budget Plan for the fiscal year 2005-2006. Importantly, the instruction establishes a new fee-based bonus system for revenue collection that is meant to replace the current one described above. The new system defines the bonus as a percentage of total revenue collection in each income category.

- a. Local authorities (we assume provinces, districts and villages are all included) and line ministries and departments will receive a bonus of 0.7 percent of the total amount collected from customs revenues, excluding export duties assigned 100 percent to the central government (i.e. electricity, timber and others as decided).

- b. Local authorities and ministries will receive a bonus of 1.5 percent of the amount collected from state properties, technical income (not clear what it is), land tax and various fees. Revenues from principal and interests of subsidiary loans, loans from the national budget, income from overflights, timber sale, royalties, leases, sale of state properties, and transfers.

Accompanying documentation is required to make operational the new system. Until then, Instruction 2372 “recommends” that all revenues be collected and booked at the treasury accounts, while bonuses be calculated on a quarterly basis. A final consolidation should be conducted at the end of the year. It is also instructed that only the Minister of Finance will have the authority to approve the bonuses, which can only be used for capital projects already included in the provincial PIP.

#### **4.6 Policy Issues and Options for Reform in Revenue Assignments**

##### 4.6.1 On the need to strengthen central government fiscal structures

As noted in the introductory section of this report, an orderly and well-functioning deconcentrated or decentralized system of finance requires a strong central government that has the ability to control and monitor expenditures and also the ability to collect its own revenues without leakages at the subnational level, so it has the necessary resources to follow its own programs of national importance and it has the ability to redistribute fiscal resources from richer to poorer regions of the country.

At present the Lao PDR central government lacks those basic strengths and therefore cannot function properly as most other central governments do around the world.

In order to strengthen the central government ability to conduct policy, two initiatives will be necessary. First, there is a need to strengthen the treasury system. The government is moving in the right direction in this area, but the new treasury function will have to be extended to all provinces and to the district level both on the side of expenditures and also in revenue collections. This latter is critical for the effectiveness of the second kind of initiative the government needs to follow. The implementation of a full treasury system extending to the subnational level, which started its implementation several months back, will mean that the central governments would be able to monitor the use of conditional grant moneys, or the realization of minimum standards of expenditure in particular budget areas, such as education and health.

Second, there is a need to centralize tax administration.<sup>17</sup> Unlike in the case of the Treasury system, where the government has been moving in the right direction, recent reforms (the introduction of a new Tax Code and MOF Instruction No. 2349/MOF) have further deconcentrated the tax administration system, weakening the ability of the central government to monitor and enforce current budget regulations on revenue sharing and assignments.

What options are available for reform in this area? Either of two approaches could be followed here. One is, for example imitating Vietnam, to centralize the collections of all taxes by putting all tax administrators at the provincial and district level under the direct control of the Ministry of Finance through the general directorate of tax administration. This will mean that all appointments and removals of personnel are only decided by the central authorities and that all wages, bonuses, housing and so on of tax administrators are directly paid by the central government. The second approach would

---

<sup>17</sup> The term 'tax administration' is used here in a generic sense

be, for example imitating China, to create two separate tax administrations; a central government tax administration, in charge of collection all taxes and other revenues 100 percent assigned to the central government as well as all shared revenues between the center and the provinces (and local governments); and a provincial tax administration in charge of collecting the taxes and all other revenues 100 percent assigned to the provinces and local governments.

#### 4.6.2 On the new bonus system

It is unclear the extent to which the new bonus system will solve the problem of inaccurate revenue estimations, which seems to be more of a technical and probably institutional nature. It may help limit the negative incentives introduced by the former system though. Since no upper or lower revenue collection limits are defined for granting a bonus, local governments have greater incentives to increase collections, because the premiums are calculated on the overall collection.

But it should be noted that a strengthened auditing and monitoring system will still be required. As stated, money that is not reported does not have to be shared, and no positive retention incentives would be able to address this issue. The system needs to include severe sanctions for non-compliant local administrations, and be endowed with sufficient monitoring capacity to avoid funds being siphoned out of the government accounts.

It is somewhat common in decentralized systems to have local governments pay the central tax administration a fee for collection of subnational governments' taxes. Paradoxically, in the case of the Lao PDR, it is the central government that pays a fee to

the tax administration services in the provinces (although it is a central government agency according to the Tax Law) for the collection of central government revenues, which until now were retained apparently in full by the provincial governments. In any case, one may be dubious about the effectiveness of the new incentive scheme to increase revenues for the central government as there is nothing in the new approach that deals with the much larger issue of the ability of the provincial governors to withhold remittances due to the central government in many forms and ways. One should expect this behavior to continue and be unaffected by the new incentive scheme.

The impact on the revenue bases of the provinces is unclear. Most of the poorer provinces exceeded their revenue collection targets, but are far from reaching their expenditure needs.<sup>18</sup> Will the bonuses be counted against the transfers received from the central government? If so, we should expect no incentive for further collection from poor localities.

The structural deficiencies of the current fiscal management system cast doubts about the impact of this and any other incentive plan. If accountability is not strengthened (including the centralization of the Treasury system), we could have a situation whereby provinces would continue to miss their revenue collection targets (with funds allegedly being kept in accounts outside the government system), and still receive bonuses on overall collection. Lack of data does not allow us to simulate the grant amounts localities would be receiving under the new system.

Instruction 2372 explicitly confirms that funds from the bonus on revenue collection will be used on capital projects. In light of the current imbalance between recurrent and capital expenditures in the state budget, we would recommend that

---

<sup>18</sup> Data used in this section is that from the WB that we are not able to quote unless permission is granted.

operations and maintenance (probably not salaries and wages, but including payment of arrears) were also possible destinations for the bonus funds.

As an indication of the strength of the proposed bonus system, Table 10 offers an estimate of the bonuses that would have been received by provinces on customs duty collection if the proposed system had been applied in 2002-2003.

Of the sample of provinces analyzed, only Vientiane would have been better off with the implementation of the new bonus system in 2003, as opposed to retaining the assumed excess of actual expenditure amounts over planned expenditures (denoted in column 5 of the table).

	2002-03 Actual - billion kip			"Appropriated" under old scheme*
	Revenue Collection	New Bonus Fees	New bonus scheme	
Vientiane	503		4.8	4
Tax revenues	175	1.5	2.6	
Customs	305	0.7	2.1	
Other	23			
Savannakhet	181		1.5	2
Tax revenues	58	1.5	0.9	
Customs	93	0.7	0.7	
Other	30			
Champassak	167		1.2	63
Tax revenues	51	1.5	0.8	
Customs	66	0.7	0.5	
Other	50			
Khammouan	167		0.8	94
Tax revenues	35	1.5	0.5	
Customs	36	0.7	0.3	
Other	96			
Luangphabang	34		0.4	4
Tax revenues	27	1.5	0.4	
Customs	0	0.7	0.0	
Other	7			
Sayabouly	39		0.4	6
Tax revenues	18	1.5	0.3	
Customs	15	0.7	0.1	

Source: Produced by Stuart Webster, World Bank (2005)

Arguably, more data are needed to simulate the effects of the new bonus system. However, in light of the differences observed in Table 10, it is unlikely that the new system would provide a solid incentive for revenue collection at the local level if it does not improve the alternative of retaining revenues. As the latter is not an option, strengthened monitoring capacity remains the only effective alternative.

#### 4.6.3 On the limits to improved revenue collection<sup>19</sup>

Among the most important barriers to improved revenue collection in Lao is the extensive use of exemptions, tax holidays and tax concessions. However, estimates on the size of incentives provided by local governments in the form of exemptions and tax holidays are not available. A distributional effect of the revenue impact would be required if tax holidays focus on areas that are likely to be geographically concentrated (like resource extraction). Clear regulations that limit the authority of provincial governors (as chief financial officers) in granting tax holidays or other fiscal incentives, and determined enforcement by the appropriate agencies may be required to address this issue.

Despite obvious shortcomings, lack of enforcement of government regulations would be the most significant variable restricting improved revenue collection. As expected, low technical capacity in the tax administration, allegations of widespread corruption (contextualized by the very low salary level of tax officials), and irregular treatment of corporate incomes are prevalent faults in the system.

---

<sup>19</sup> The analysis contained in this section drew exhaustively from information provided by Henry Konkol (SIDA, Vientiane) on tax issues to the PER mission.

As in the case of Treasury, the ascendancy of the Provincial and District Governors over public officials introduces managerial constraints and conflicts of interests between tiers of government. As has been proposed in the case of Treasury, the re-strengthening of the tax administration departments, establishing a unique accountability line to the central level, and defining for them an advisory and operational capacity at the local level would be required.

The process for the definition of provincial revenue targets should be further looked at, as there are claims of overestimation on the side of the central government, which would increase transfers from the provinces. The causality however could work the other way around too. It might be the case that, as provincial governments do not report a large share of their revenues, the central government is forced to overestimate their revenue targets to get closer to their fair share of resources. Either way, the system is plagued with inaccuracy and gaming. The new draft Budget Law establishes that revenue forecasting will be a function of economic growth, and of the relevant provisions of law. It is still unclear how this would be put into operation. It would be important to know if the government is working, while the new budget law is drafted, on the accompanying implementation regulations that should specify the technical process to be followed in revenue target setting, the definition of sharing rates on taxes between the central and the local government, and the provisions that would guide the design of revenue bases at the sub-provincial level.

Alternatively, provinces may gladly accept revenue overestimation on the part of the central government if that comes accompanied by expanded expenditure assignments. As the central government seems unable to enforce the current system, when revenues

fall below targets, provincial expenditure levels are maintained and the central government budget assumes the shortfall. This is not a sustainable framework especially when the sub-national governments can affect collections and can positively benefit from lesser collections (for attracting enterprises, leakages to off-budget purposes, and so on).

#### 4.6.4 On local government borrowing powers

Subnational governments do not have, under current arrangements, the capacity to borrow from commercial or state banks. The provision is justified by the fact that provincial and local governments currently do not have a separate standing as legal entities. In theory at least they are just agencies of the central government, as corresponds to deconcentrated systems of governance (and despite the discretion they exercise in many other areas).

It may not be advisable in the near future to grant borrowing powers to local governments, at least until the priority objective of strengthening mechanisms of central government control over decentralized public finances is achieved. In the future however, once the system has reached a certain degree of stability and as the country further develops economically, the allocation of borrowing powers to provinces with demonstrated fiscal stability and strength, to finance the implementation of high-priority specific projects, and within strict criteria (e.g. limits to provincial public debt limits) should be considered. Borrowing is a desirable (equitable and efficient) source of financing local infrastructure but this may be done under a prudent set of rules to ensure fiscally responsible behavior by local governments.

Table 11: Revenue Shortfall / Excess from Plan Revenue by Provinces (2000 – 2004)

	Revenues											
	2000-2001			2001-2002			2002-2003			2003-2004		
	Plan	Actual	Shortfall/Excess	Plan	Actual	Shortfall/Excess	Plan	Actual	Shortfall/Excess	Plan	Actual	Shortfall/Excess
Total Revenue	.	2166	.	2595	2475	-120	2696	2971	275	2945	.	.
Central	.	988	.	1299	939	-360	1295	1241	-54	1285	.	.
Total Provinces	.	1179	.	1296	1535	239	1402	1510	108	1660	.	.
1. Vientiane Municip.	.	399	.	495	409	-86	522	503	-19	665	.	.
2. Phongsaly	.	6	.	6	10	4	8	17	9	18	.	.
3. Luangnamtha	.	31	.	37	64	27	82	65	-17	85	.	.
4. Oudomxay	.	11	.	10	17	7	16	22	6	26	.	.
5. Bokeo	.	26	.	28	26	-2	30	27	-3	34	.	.
6. Louangphabang	.	24	.	26	29	3	30	34	4	35	.	.
7. Houaphan	.	9	.	10	13	3	13	18	5	16	.	.
8. Sayabouly	.	63	.	35	35	0	39	39	0	42	.	.
9. Xiengkhouang	.	15	.	17	18	1	19	24	5	24	.	.
10. Vientiane	.	35	.	36	53	17	44	56	12	45	.	.
11. Borikhamxay	.	47	.	55	62	7	62	70	8	66	.	.
12. Khammouan	.	99	.	91	253	162	99	167	68	110	.	.
13. Savannakhet	.	261	.	264	199	-65	210	181	-29	234	.	.
14. Saravane	.	27	.	39	65	26	32	45	13	40	.	.
15. Sekong	.	7	.	8	18	10	9	28	19	11	.	.
16. Champassak	.	101	.	124	195	71	161	167	6	184	.	.
17. Attapeu	.	14	.	12	55	43	20	37	17	23	.	.
18. Xaisomboun sp. Zn	.	4	.	3	14	11	6	10	4	6	.	.
Maximum	.	399	.	495	409	162	522	503	68	665	.	.
Minimum	.	4	.	3	10	-86	6	10	-29	6	.	.
Average	.	65.5	.	72.0	85.3	13.3	77.9	83.9	6.0	92.4	.	.
Coef. Of Variation	.	1.6	.	1.7	1.3	3.8	1.6	1.4	3.3	1.7	.	.

Source: Own calculations based on Ministry of Finance, 2005 data

Table 12: Revenue Per Capita (kip/person) FY 2002-2003									
	Total Revenue	Total Revenue Non Timber	Tax Revenue	Customs Revenue	Land Management	State Owned Assets	Capital Revenue	Hydropower Royalties	Timber Royalties
Total	441,193	402,819	166,019	118,487	5,109	151,577	35,812	7,922	38,374
Total of Central	175,357	175,357	76,836	1,431	-	97,090	35,493	7,766	-
Total of Provinces	265,836	227,458	89,183	117,056	5,109	54,488	319	-	38,374
Vientiane M.	774,003	897,529	313,139	544,525	9,171	31,561	2,186	-	869
Phongsaly	88,516	83,453	22,584	48,758	4,268	12,905	-	-	5,063
Louangnamtha	467,450	459,586	74,836	370,964	2,829	18,821	-	-	7,864
Oudomxay	85,678	81,789	42,892	29,615	3,999	10,031	-	-	3,869
Bokeo	195,221	183,429	57,421	106,814	3,179	27,800	-	-	11,793
Louangprabang	67,024	67,024	53,322	3,286	3,518	6,898	244	-	-
Houaphan	60,437	39,963	22,723	8,530	2,177	27,007	307	-	21,573
Xayaboury	97,268	46,035	46,035	38,698	3,983	8,553	-	-	1,605
Xiengkhouang	80,917	39,467	39,467	26,347	2,223	12,877	680	-	8,847
Vientiane Pro.	140,353	68,540	68,540	10,135	6,433	55,245	-	2,215	43,190
Bolikhamxay	347,695	274,350	91,430	164,740	4,360	87,165	-	-	73,345
Khammouane	490,224	231,032	102,385	104,829	5,891	277,121	-	-	259,191
Savannaket	225,735	216,954	72,070	116,328	7,924	29,414	105	-	8,781
Saravan	141,294	111,291	51,072	42,347	4,028	43,847	175	-	30,003
Champasack	259,219	223,586	82,761	106,857	4,882	74,729	-	-	45,634
Xekong	345,688	141,288	99,188	11,188	2,413	232,913	-	-	204,400
Attapru	338,909	184,082	140,627	13,246	3,300	181,746	246	-	154,827
Xasomboun	203,020	114,280	85,660	13,020	1,860	102,480	-	-	88,740
Maximum	774,003	897,529	313,139	544,525	9,171	277,121	2,186	n/a	259,191
Minimum	60,437	39,467	22,584	3,286	1,860	6,898	105	n/a	869
Average	244,925	192,427	81,453	97,790	4,247	68,951	563	n/a	57,035
Coef. Of Variation	0.7733	1.0673	0.7993	1.4554	0.4705	1.1742	1.3118	n/a	1.3623

Source: World Bank (2005).

## **5. The System of Transfers**

It is very rarely the case in any decentralized country that there is a perfect match between the expenditure needs arising from the assignment of expenditure responsibilities and the revenue capacity respectively arising from the revenue assignments. Both horizontal and vertical fiscal imbalances are a common feature in most fiscally decentralized countries, and Lao PDR is not an exception. Horizontal imbalances are a consequence of different local economic conditions leading to differences in fiscal capacity to raise revenues and expenditure needs. Vertical imbalances may arise because one level of government is able retain revenues exceeding the relative expenditure needs vis-à-vis other levels of government. A system of transfers is typically designed to deal with both types of imbalances. In addition, central governments can introduce earmarked or conditional transfers to stimulate expenditure at the sub-national level in areas of national importance or where subnational governments may under-spend because they do not internalize the benefits that residents of other jurisdictions may receive from their expenditures (a problem described in economics as “externalities”).

Lao PDR has system of transfers, but one, as we see below, that is very much in need of reform. Therefore, in this section of the report we first describe desirable principles for the design of transfers which then are used to assess the structure and performance of the current system of transfers in Lao PDR, We close the section with a discussion of the main issues and options for reform.

### **5.1 Features of a Good Transfer System**

As discussed below, a large number of approaches can be followed for the design of a transfer scheme and in the apportionment of the available funds among subnational governments. The manner in which a transfer program is structured and the method used to divide its funds among eligible subnational governments is ultimately a political choice, but the design of the mechanism should be guided by sound economic principles. Thus, independently of its final structure, all transfer formulas should obey a number of universal principles.

(i) Providing revenue adequacy. A transfer formula should provide a source of adequate resources to local governments to achieve its policy objective.

(ii) Preserving budget autonomy. As much as possible, a transfer system should preserve budget autonomy at the subnational level. While there are sound policy arguments for conditional (targeted) transfers, general-purpose transfers and equalization funding should be lump-sum in nature and unconditional. After all, the benefits from decentralization arise due to increased flexibility and spending discretion at the subnational level.

(iii) Enhancing equity and fairness. The transfer mechanism should support a fair allocation of resources. For instance, an equalization transfer should provide more resources to districts with lower tax capacity and greater fiscal needs. While fairness is a subjective social concept, transfer systems that provide disproportionately more resources to wealthier local governments are often considered “unfair.”

(iv) Stability. Transfers should be provided in a predictable manner in a dynamic sense. The formula should be stable over a period of years to promote revenue predictability and overall budget certainty.

(v) Simplicity and transparency. Transfer formulas should be, to the extent possible, simple and transparent. An important way to keep transfer programs simple is to limit their objectives and to only pursue one policy objective with each transfer program. The formula should also be understandable to all stakeholders, in particular regional officials and legislators, and not be subject to political manipulation or negotiation in any of its aspects.

(vi) Incentive compatibility. The transfer system should not create negative incentives for revenue mobilization by subnational governments, nor should they induce inefficient expenditure choices. For example, negative incentives to revenue mobilization would be created if the amount of equalization transfers were reduced every time a subnational government made a greater effort to increase its own revenues. Similar negative inducements to expenditure choices are present, for example, if the amount to be received from the intergovernmental transfers is increased when local governments hire more employees or hoard excess physical capacity in the form of half empty hospitals or idle school rooms. In order to avoid these negative incentives it is critically important that the formulas do not try to equalize actual revenues and expenditures but instead fiscal capacity and expenditure needs. (These two concepts are defined below.) A similar negative incentive arises when central authorities provide “deficit grants” to cover local government deficits at the end of the fiscal year. This gives local governments an incentive to incur budget deficits.

(vii) Avoid sudden large changes. During the introduction of the new transfer mechanism, the transfer system should avoid sudden large changes in funding for local governments. Changes in the existing formula should strive to hold local governments “harmless” during the transition to a new allocation mechanism.

## **5.2 Current Transfers Schemes in Lao**

As discussed previously in section 4, there is no direct definition of a transfer system in Laos, but just a brief mention in Article 18, stating that budget expenditures would be distributed along the vertical management line of ministries and agencies. The law instructs that the national budget be broken down by province and municipality (Article 26).

### **5.2.1 The concept of equalization transfers**

Lao PDR uses a a version of the gap-filling transfers that were used in the former Soviet Union to address simultaneously horizontal and vertical fiscal imbalances. The essence of this approach is to provide gap-filling transfers to those lower-level jurisdictions which show a budget gap between estimated expenditures and forecasted revenues and demand some sort of transfer or remittance to the center from those jurisdictions where forecasted revenues exceed estimated expenditures. As there are significant fiscal disparities between just a few provinces and all the rest, fiscal equalization in Lao means shifting resources from the relatively richer to the relatively poorer jurisdictions.

Expenditure estimates and revenue targets are supposedly defined at the central level based on simple methodologies but in actuality they are the result of a bargaining process at budget time between the central and provincial authorities. The initial expenditure estimates are based on last year's budget plus some adjustment for changes in budget policies with repercussions for subnational budgets (e.g. increases in salaries); there is no automatic indexation for inflation of the like. On the revenue side, the revenue targets are eventually negotiated but the initial determinations by the central government are based on historical performance with discrete adjustments for changes in legislation with repercussions in revenue performance as well as discrete identifiable changes in the tax base (new enterprises, the closing of old ones and so on).

The difference between revenue collection targets and the expenditure estimates in the case of the richer provinces can be expected to be transferred to the central government. In case the provincial government's revenue collection exceeds expenditure targets but does not meet revenue targets, then they are instructed to reduce expenditures and maintain the same transfer level to the central government. As mentioned above, this latter never happens.

The incentive provided by the central government to achieve this goal is that provinces are given the opportunity to retain 50 percent of any excess of their revenue target, set ex-ante by the central government. This revenue share is supposed to benefit that region through capital investments, after submission to the State Planning Commission (SPC), now called the Committee for Planning and Cooperation (CPC). In practice however, this procedure is not followed by any province; instead they reduce the amount to be transferred to central government and maintain their level of expenditures.

Apparently, the incentive compatibility mechanism put in place by the central government to increase revenue collection effort does not seem to be a credible constraint for the local government (provinces). In fact, provinces do not have incentives to exceed expenditure targets in the revenue collection since the money is to be transferred back to the central government without any benefit for the province. Even among the surplus provinces, the majority reported below the target set by the central government. Indeed, the incentive mechanism is not appropriate and, as already discussed, seems to produce some perverse effects on the revenue collection at the local level. Of course, this issue needs to be addressed for many reasons, in particular from the perspective of this section on transfers, the failure of the “surplus” provinces to remit the right amount of revenues to the center adversely affects the center’s ability to implement equalization transfers to the “deficit” or poorer provinces in Laos.

### 5.2.2 The performance of the system

Table 14 below presents information on provincial budgets for the fiscal year 1999-2000. Ten out of eighteen provinces have a budget deficit, and the rest of the provinces have at least a balanced budget. Among the latter group, five provinces have a budget surplus<sup>20</sup>. In terms of transfer of funds from provinces to the central government, Vientiane Municipality, Champassak and Savannakhet are the major providers, with 52%, 30% and 13% respectively. Khammouane and Bolikhamxay provinces both

---

<sup>20</sup> See table 14 for more details. These five surplus provinces are Vientiane Municipality, Champassak, Savannakhet, Khammouane and Bolikhamxay. The three balanced provinces are Luang Nam Tha, Vientiane Province and Sayabouri.

contribute less than 10% (2% and 3%, respectively) of the total revenue transferred to central government.

Although these comparisons should be done in the future in per capita terms, actual revenues across provinces showed a coefficient of variation of 1.4 in 2003, up from 1.3 in 2002. The coefficient of variation on expenditure at the local level is significantly lower, at 0.7 in 2002 and 0.6 in 2003, once transfers from the central government are added to local revenue figures. The data therefore suggests that despite the problems discussed above with the current transfer system, the current transfers do provide a significant degree of equalization across provinces.

### **5.3 Policy issues and Options for Reform in the Transfer System**

Significant policy issues need to be addressed to clarify the transfer system in Lao PDR. The current system of equalization grants is non-transparent and it yields negative incentives for revenue mobilization and quite likely expenditure efficiency. Furthermore, the current system of transfers is incomplete since it basically does not allow the central government to pursue policy objectives different from equalization.

First, and foremost there is a need to have a better understanding of both horizontal and vertical imbalance at the local government level in Lao. These are not small issues but without better measurement of these imbalances it will be impossible to move away from the current negotiated system toward a more transparent, objective and stable system of transfers. The most important step here will be to define a more objective way to measure expenditure needs. This can be done most preferably by the use of standard financial norms per inhabitant (or client) adjusted for service delivery costs.

For example, the current system used in Vietnam for these purposes is a good system to replicate. The methodology used to quantify revenue capacity would also have to be updated and modernized moving away from subjective assessments.

The second step would be to consider the reform of the system of equalization grants, even when preserving the current “fraternal” system of having relatively richer provinces contribute to the pool of equalization funds to be distributed to the poorer provinces. Once expenditure needs and fiscal capacity of each jurisdiction are more accurately measured, it would be possible to reconsider whether the current pool of funds is sufficient for the level of equalization that is desirable. It would also be possible to introduce an objective and transparent formula for the distribution of the available funds. The international experience provides a good range of best practices in this regard.

The third step would be to consider the introduction of a system of conditional grants as an important set of tools for the central government to pursue national priorities such as targeted sectoral programs or to address spillovers or externalities across subnational boundaries.

Table 14: Expenditures, Revenues and Transfers, 1999 - 2000 (Millions of Kips)

	Population 1995	Poverty 1997/98	Revenues	Expenditures	Rev-Exp 5=(3) - (4)	Total Transfers to(+), from(-) Center	
*	1	2	3	4	6	7 (in %)	
All Government	4,581,258	39	1,779,593	2,777,766	-998,173		
Central Government	n/a	n/a	1,014,558	1,929,228	-914,670	523,775	
All Provinces	n/a	n/a	765,034	848,534	-83,500	-69,854	
Houaphan	D 246,414	75	2,898	65,535	-62,637	-11,480	16.43
Ouadomxay	D 210,820	73	6,348	49,582	-43,234	-6,614	9.47
Phongsaly	D 158,820	64	5,018	40,446	-35,428	-7,738	11.08
Luang Nam Tha	B 114,519	58	18,151	23,546	-5,395	1,002	-1.43
Saysomboun Special Zone	D 54,112	55	3,890	10,428	-6,538	-7,438	10.65
Luang Phrabang	D 365,333	49	15,835	31,930	-16,095	-7,760	11.11
Sekong	D 63,836	46	5,312	23,751	-18,439	-7,530	10.78
Attapeu	D 87,182	45	9,289	13,004	-3,715	-6,559	9.39
Bolikhamxay	S 163,847	42	28,840	37,453	-8,163	11,275	2.15
Khammouane	S 273,779	42	60,604	46,377	14,277	18,596	3.55
Saravane	D 256,550	40	16,548	39,183	-22,635	-3,138	4.49
Bokeo	D 113,847	37	13.04	75,434	-62,394	-1,316	1.88
Savannakhet	S 671,581	37	187,730	70,586	117,144	157,211	30.01
Champassak	S 500,994	36	70,389	59,727	10,662	66,943	12.78
Xieng Khouang	D 200,075	35	9,262	49,100	-39,838	4,411	6.59
Vientiane Province	B 286,089	24	18,157	46,515	-28,358	-5,869	8.40
Sayabouri	B 291,705	21	23,920	26,407	-2,487	890	-1.27
Vientiane Municipality	S 528,109	12	269,804	139,521	130,283	269,750	51.50
Maximum	671,581	75	269,804	139,521	130,283	269,750	52
Minimum	365	12	3	10,428	-62,637	-11,480	-1
Average	234,591	44	41,617	47,140	-4,611	25,813	11
Coef. Of Variation	0.756895	0.381138	1.732289	0.627435	-11.1879	2.833726	1.133262

**Source:**

Column (1) UNDP document "Facts about the country"

Column (2) Poverty analysis and the government's Development Strategy Table2, mimeo, 2001

Column (3) and (4) "Budget 2000-2001, Official Gazette, April 2001

Column (6) Treasury department data, July 2001

S- Surplus, D - Deficit, B - Balanced

Table 15: Budget Surplus (Actual Budget 2000 – 2004)

	Actual Budget (2000 - 2004)											
	2000-2001			2001-2002			2002-2003			2003-2004		
	Revenue	Expend.	Surplus	Revenue	Expend.	Surplus	Revenue	Expend.	Surplus	Revenue	Expend.	Surplus
Total (Ctrl + Prov)	2166	2351	-185	2475	2662	-187	2971	2909	62	2945	3460	-515
Central	988	1334	-346	939	1388	-449	1241	1539	-298	1285	2385	-1100
Total Provinces	1179	1017	162	1535	1274	261	1510	1370	140	1660	1075	585
1. Vientiane Municipa	399	153	246	409	167	242	503	163	340	665	128	537
2. Phongsaly	6	32	-26	10	25	-15	17	19	-2	18	53	-35
3. Luangnamtha	31	33	-2	64	40	24	65	54	11	85	41	44
4. Oudomxay	11	41	-30	17	40	-23	22	59	-37	26	49	-23
5. Bokeo	26	33	-7	26	36	-10	27	47	-20	34	40	-6
6. Louangphabang	24	52	-28	29	67	-38	34	80	-46	35	74	-39
7. Houaphan	9	39	-30	13	53	-40	18	71	-53	16	53	-37
8. Sayabouly	63	75	-12	35	69	-34	39	78	-39	42	61	-19
9. Xiengkhouang	15	46	-31	18	60	-42	24	44	-20	24	58	-34
10. Vientiane	35	70	-35	53	75	-22	56	81	-25	45	62	-17
11. Borikhamxay	47	33	14	62	40	22	70	56	14	66	45	21
12. Khammouan	99	59	40	253	132	121	167	162	5	110	72	38
13. Savannakhet	261	128	133	199	125	74	181	115	66	234	105	129
14. Saravane	27	34	-7	65	57	8	45	59	-14	40	49	-9
15. Sekong	7	28	-21	18	29	-11	28	39	-11	11	34	-23
16. Champassak	101	103	-2	195	200	-5	167	164	3	184	87	97
17. Attapeu	14	38	-24	55	41	14	37	45	-8	23	34	-11
18. Xaisomboun Sp. Z	4	20	-16	14	18	-4	10	34	-24	6	30	-24
Maximum	399	153	246	409	200	242	503	164	340	665	128	537
Minimum	4	20	-35	10	18	-42	10	19	-53	6	30	-39
Average	65.5	56.5	9.0	85.3	70.8	14.5	83.9	76.1	7.8	92.4	59.7	32.7
Coef. Of Variation	1.6	0.7	7.9	1.3	0.7	4.8	1.4	0.6	11.2	1.7	0.4	4.1

Source: Our own Calculations Based on World Bank 2005 dataset

## **6. Budget Formulation of the Current Situation**

### **6.1 Budgetary Autonomy**

The immediate needs of Lao's intergovernmental fiscal system are to strengthen central government capacities to manage and monitor the implementation of an efficient system of inter-governmental fiscal relations. Any other reform areas may be considered subsidiary to the priority objective of guaranteeing that the central government is able to record and control all revenues collected and expenditures conducted.

In the long term however, and depending on the institutional framework agreed for the country's administrative structure, local governments will need to be granted a degree of budgetary autonomy that allows the separation of budgets between the central and the provincial levels of government at least. The current institutional framework does not permit developments of this kind, as provincial administrations are not elected but appointed, and to be effective, budget separation would require a certain level of local accountability. Constitutional reforms would be required to grant this kind of capacities, and although arguably a not immediate objective, it would need to be considered in the long-term decentralization strategy horizon.

Budgetary autonomy would include a level of discretion over expenditure responsibilities and revenue collection capacities. In the current system, this discretion has gone unchecked due to lack of monitoring and enforcement capacity. In any case, strengthening mechanisms for central government control should not lead to stripping local governments of the flexibility required to attend to the specific development challenges faced in their areas.

## **6.2 Issues in Budget Formulation**

The draft Budget law introduces, among the fundamental principles of the State Budget, the need to ensure improved efficiency in public expenditure management and strengthened financial discipline. This is welcome development that clarifies the critical challenges the new law aims to address. Budgetary provisions should develop further this principle to clarify in practical terms their administrative implications.

Despite the rather elaborate bottom-up budget process the country now follows, there is evidence that at the end, the budget is negotiated at the top between the Office of the Prime minister and the provincial governors. The role of the Ministry of Finance appears to be secondary to just translate those agreements into the proposed budget draft.<sup>21</sup>

The Lao PDR has separate budgets for recurrent and capital expenditures<sup>22</sup>. Planning for recurrent expenditures for subnational budgets is based on historical figures adjusted for the changes in employment authorized by the Prime Minister. A ceiling for provincial staff is defined by PACSA, in the Office of the Prime Minister, while the Cabinet decides on wage levels. However, governors have in the past circumvented these regulations by hiring the so-called “contracted employees,” namely temporary workers that stay for an indeterminate period of time.

The revenue forecast and targets for the provinces are not done by MoF but by the Cabinet. The MoF does not conduct a provincial revenue forecast at all but rather a national aggregate forecast based on nominal GDP growth projections. There is no

---

<sup>21</sup> It should be noted that the National Assembly approves the budget only in terms of large aggregates and that it is the Ministry of Finance that does a second stage of disaggregating. Then it is up to agencies and the provinces themselves

<sup>22</sup> For additional discussion, see Stuart Webster’s report on Budget Planning, also a background report for this PER.

consistent adjustment for inflation in the budgeted forecasts but once in a while the National Assembly allows an increase in wages to account for this aspect. Typically, these wage increases have been financed by reductions in investment.

There seem to be evidence of extra-budgetary funds (outside the regular budget) at the provincial level but no information is available on their number and quantitative importance. This is one of the irregular circumstances that a strengthened Treasury system would help address.<sup>23</sup>

The new draft law proposes a set of shared taxes between the central and local governments. It, however, leaves the decision on the sharing rates to the Prime Minister. This is potentially very dangerous and increases the unpredictability of the system. It is not clear either whether the same sharing rate would be defined for all taxes in the same province (as in Vietnam) or if different sharing rates per tax will be defined for all provinces.

Although the law introduces the golden rule of balanced budgeting (allowing for deficit financing only for a share of capital expenditures), no limit to the budget deficit is defined in the draft. An explicit limit would provide a more stringent fiscal condition, but could be softened with the inclusion of exception clauses for natural disasters and the like.

The current budget law and the draft new law seem to provide for a consolidated budget that is approved by the National Assembly. Since in Lao there are no elected local government councils, there is no need for any other level of government to approve the

---

<sup>23</sup> At the central level there are both statutory special funds within the budget (such as the Road Fund, Social Welfare fund, etc.) as well as extra-budgetary funds outside the budget (such as the Environmental Protection Fund and several others)

budget. The small dimensions of the country may also recommend this centralized system where all revenues and expenditures are included in the same budget.

District level budgets have so far been included as budgetary lines in the provincial budgets. They are not disaggregated by task or economic function. Since the only thing approved is the budget's bottom line, and assuming little monitoring capacity of the provincial administration on districts' budgets, there may be important deviations between the draft budgets discussed with the Ministry of Finance and actual implementation.

Provincial and local governments have also separate capital budgets and they contain items not included in the Public Investment Programs. Some of these funds outside the PIP come from international aid and non-governmental organizations. However, international donors rarely talk to provincial authorities. It is more likely that after the provinces present proposals to the central government through the Committee for Planning and Investment (CPI) that the central government may look for donors to fund those particular investments.

For the deficit provinces, the central government pays for the counterpart funds earmarked for this purpose. If funds were not used appropriately by the local government, the projects would be delayed so it would be in the local government's interest to follow the instructions.

The CPI sets the investment ceiling for each province and the provinces send project proposals. If the project is under 5 billion Kip and an implementation period under two years, the CPI tends to automatically accept the project. For projects of value between 5 billion Kip and 50 million Kip, the CPI evaluates the project prior to granting

(or not) approval. For projects over 50 million Kip the CPI submits the proposal to the Cabinet. CPI officials explained that they use cost-benefit analysis and feasibility studies to rank projects sent by the provinces. The latter usually employ domestic and international consultants for making a better case. Of course this raises the possibility of a bias toward richer provinces but mitigated by the separate ceilings set for each province.

The setting of the investment ceiling for each province does not follow a formula. However, CPI considers a number of factors in its definition; for example, giving special consideration to the Northern mountainous provinces, etc.

An important issue of concern is the lack of precision in the definition of the process for setting subnational level budgets. There are some allegations against the central government of purposely underestimating local governments' expenditure needs and overstating the revenue collection targets. On the other hand, local governments are alleged not to disclose their full revenue collection and to exaggerate their expenditure needs to reduce the amount to be transferred to central government or increase the amounts they are supposed to receive from the center. Clearly, there is a basic problem in budget formulation that needs to be solved. Fundamentally, these behaviors that considerably diminish the usefulness and validity of the subnational level budgets arise from a bargaining or negotiation approach to the budget, typical of the Soviet budgeting approach.

#### 6.2.1 Planning process

As is the case in Viet Nam, a planning agency, the Central Planning and Cooperation Agency, directs the formulation of 5-year and annual plans that are

consolidated at the provincial and national level. As reported in UNCDF (2002), this process is “top down,” not participatory, and merely a translation of national policies.

In addition, it would seem no local government receives budgetary estimates prior to the preparation of their annual plans, which requires arbitrary, usually across-the-board, cuts to fit estimates once they are ready. Sub-provincial responsibilities in capital investment budgeting vary substantially by province. In sum, there does not seem to be a clear linkage between planning and budgeting, probably derived from unclear definition of expenditure responsibilities.

### **6.3 Issues on Budget Execution**

In terms of budget execution, there is positive progress in terms of a treasury function with national scope, which so far has been extended to central government ministries and just several functions at the provincial level. The concept is to roll out the treasury to all functions covering provinces and districts.

Lao’s government has also taken other actions to control budget execution. The recent Minister of Finance’s Instruction and Guidelines on the implementation of the Budget Plan for the Fiscal Year 2005-2006 (Instruction 2372/MoF), states clearly that off-budget expenditure is not allowed.

One weakness of the new treasury system is that it functions on a cash basis. Spending agencies cannot disburse funds unless there are remaining balances in their accounts. However, spending units are still quite free to commit future expenditures with suppliers, especially for capital investment purposes, as those do not get registered into

the system.<sup>24</sup> Thus there appears to have been significant increases in arrears arising from commitment to suppliers. The budget system has also recorded increasing recurrent budget arrears. These recurrent arrears, in particular from wages, although quite significant, appear to be under control and in decline. We should, however, observe that the treasury system is not particularly effective in controlling this type of arrears since wages and salaries are already committed in the budget and spending units have little discretion over these expenditures.

Another main weakness of how the treasury system is working so far is that there is no control of revenue collections. Tax payments do not appear to be deposited directly in treasury accounts. Instead the moneys get there only indirectly after there has been ample opportunity for diversion and leakages of funds to provincial government bank accounts and so on. It is quite common for provincial governments to have multiple bank accounts separate from the treasury system

Last, a budgetary stability clause may be introduced with new budget law. For the budgetary stability clause to work however, it should be clear (perhaps in the implementation decree) under which conditions may a provincial government (or the central) request a re-negotiation of the revenue framework, and establish which level of authority may mediate between them should there be a conflict of interest. Otherwise annual re-negotiation may be the outcome as revenue forecasting capacity is low.

---

<sup>24</sup> There is a practice of getting capital infrastructure investment projects started even when those do not appear in the budget with the hope that the project will be picked up by the central government at some point in the future.

### 6.3.1 Policy options

First and foremost, there is a need to substitute the current negotiated budget system for one that is based on explicit budget norms for expenditures and honest good forecasts for revenues.

The strengthening of the Treasury system and their detachment from the provincial administration seems to be critical. The single most important reason for Viet Nam's fiscal system stability is probably the level of professionalism and independence from the local administration that local Treasury offices have. That is supported now with a real-time connection system with the central Treasury in Hanoi, but even before that it was the case that provincial committees did not have the kind of discretion on the management of local Treasuries that is observed in Lao PDR. Treasury officials need to come under the authority of a central office subordinated to the Ministry of Finance. Otherwise any reform may be doomed to fail, as fiscal discipline will not be maintained.

## **7. Sequencing of Decentralization Reform**<sup>25</sup>

The Lao PDR government faces the possibility of completely overhauling over a period of time the entire system of intergovernmental finance. An issue of critical importance will be to sequence the decentralization reforms appropriately in order to ensure that the Lao PDR Government makes it clear where it wants to go with those reforms and to ensure that it arrives there and nowhere else.

A desirable sequencing of the reforms would involve the following steps:

---

<sup>25</sup> For an extended discussion see Bahl R. and Martinez-Vazquez, J. (2005) "Sequencing Fiscal Decentralization". Working Paper, AYSPS, Georgia State University.

a. Implement a comprehensive policy deconcentration of central government service delivery. Decentralization/deconcentration must be approached in a holistic way, with the design of a plan that involves every element of the service delivery system.

b. Carry out a national debate on decentralization policy in order to involve all relevant stakeholders in the deliberations leading to policy design. Two collectives may be particularly important:

i. The support of the bureaucracy for decentralization needs to be obtained. If it is perceived that this is yet another donor-led reform, the bureaucracy could be uncooperative and represent the greatest threat to reform in the area. For example, the strengthening of the Treasury system should include better remuneration for officials and higher incentives in the form of training. These however may be considered as unfair by personnel from other agencies, especially the Ministry of Finance. It is important that a general approach to the improvement of the personnel remuneration and career prospects include all relevant agencies and that it is conditional on clearly defined performance targets.

The reviews from donor-organized workshops on fiscal decentralization suggest that the public sector may share an understanding on the objectives of the decentralization policy and the need to re-centralize the management of revenues.

ii. It would seem that large international donors' investment in capital projects is behind the government's difficulty in limiting investment expenditure and may have contributed to cuts in recurrent expenditure. Whereas

the share of the budget going to capital investment in Viet Nam is between 25-30 percent, in Lao this is reverted, and the government is devoting a bit over one-third of its resources to recurrent expenditures. The Budget Law needs to include provisions in this area that ensure the provision of minimum services. It may be too hopeful to expect that the capital and recurrent budgets are merged in one under the responsibility of MoF. Without requiring the abolishment of the Planning Committee, it could however be decided that the annual investment plan would have to be limited to a ceiling defined by the MoF after careful consideration of priority expenditure requirements (wages and salaries, judiciary and the legislative, interest payments on debt, etc.). That would be a middle point between the current situation and the abolition of the planning agency. The implications of this issue at the local level are great and donors support would be required to ensure a balanced and more efficient distribution of official development assistance that allows meeting recurrent expenditure needs.

- c. Develop a “concept or strategy paper” for decentralization.
- d. Pass the decentralization law. It is indispensable that the decentralization policy be given a legal backbone. The law must clearly specify the roles and responsibilities of different tiers of government, and its scope and legal status must be adequate to the constitutional framework.
- e. Develop the detailed implementing regulations required to roll out the decentralization program. The need to be written jointly by all involved government

agencies once the decentralization law has been passed and before implementation is initiated.

f. Implement the decentralization program. International experience suggests gradual implementation of reforms has returned better results than “shock-therapy” approaches. In any case, political circumstances are likely to define available options. In addition, an asymmetric approach (varying speed of implementation by sector) may allow for a flexible and efficient program.

g. Monitor, evaluate, and retrofit the regulations in accord with the underlying policy design. Critical to perform this key function is the availability of a unit with skilled staff that can monitor government finances and comprehensive data that allows quantitative monitoring and evaluation.

There are in the immediate horizon good opportunities to follow the normative steps in the list above. The Lao PDR has certainly implemented a (probably too broad) policy of deconcentration, so it is not expected that much more will be needed for this step. The experience with the current system of deconcentration has involved some dialog of sorts although this dialog would need to be more explicit and deep. Because of the sensitivity and difficulties related to what may be the best system of decentralization/deconcentration for Lao PDR, there has been talk at the Ministry of Finance and elsewhere of designing a concept paper to guide the short term and longer term directions of reforms in this area. This would be a good opportunity for setting a general strategy for decentralization/deconcentration reform.

In addition, the Government is still discussing different drafts of a reformed Budget Law. The Government appears to have delayed this draft law until some time

later in 2006. This law, of course, provides the optimal vehicle for putting into law the desired decentralization/deconcentration reforms. Therefore, there is in the immediate horizon the potential to sequence decentralization quite properly and put things right. The other steps in the desirable sequence: implementation of regulations to accompany the Budget Law, implementation, monitoring and evaluation should, of course, follow.

Several principles should be kept in mind in the design of the concept paper and the re-drafting of the Budget Law. First, finance should follow function for an efficient assignment of revenues to local level governments. Second, this would also facilitate the implementation of hard budget constraints, as local financial resources would be well aligned with expenditure assignments. Third, sufficient local government taxing powers must be allocated. This would assist in increasing the accountability of public officials and would increase the visibility of local taxes. Fourth, on the basis of the expenditure and revenue assignments, the system requires an intergovernmental transfer system that assists the decentralization policy objectives. In Lao PDR's case, reducing poverty by ensuring minimum standards in the delivery of basic social services ranks among the top in the agenda.

Sequencing is thus critical. For instance, it may not be at all a good idea to re-centralize revenue sources in the law until the tax administration is itself centralized. The reason is that a tax administration controlled by the governors is likely to put less effort in enforcement of taxes and quite likely to increase the size of the leakages through tax holidays and incentives to enterprises and by diverting or remitting funds.

As we have argued in this report, the strengthening of the treasury system and the centralization of tax administration are prior conditions to the implementation of any

policy strategy on decentralization/deconcentration. It must also be noted that before this basic strengthening of central institutions takes place there may be little benefit from getting heavily involved in institutional reform at the provincial or sub-provincial level.

Annex 1A. Expenditure Assignment in Lao PDR on the Basis of current Budget Law 1994

Central Government	Provincial Level	District Level
1. Administrative Expenditure	1. Administrative expenditure:	1. Administrative Expenditure
a. Salary and support allowances for children and wives and Government, Party and employees at the central level.	a. Salary and support allowances for children and wives and Government, Party and employees at the provincial level.	a. Salary, allowances and support for children and wives including support to the Government, Party mass organization of employees of the district level.
b. Allowances to students, monks, monk teachers under the responsibility of the ministries, agencies of the central level.	b. Expenditures on lump sum retirement's compensation, pension and other allowances to pensioners accredited at the provincial level	b. Expenditure on lump sum retirement compensation including pension and other allowances to pensioners accredited at the district level.
c. Ordinary administrative expenditures: new purchases, meetings of Government, Party and mass organizations at the central level.	c. Allowances to students, monks, monk teachers under the responsibility of the organizations of the provincial level	c. Allowance for students, monks and monk teachers under the responsibility of the organizations of the district level. Also allowances to village committees and village self-defense forces.
d. Payment of interest on foreign loans: including structural adjustment credit, projects of the national level, property of the local level for the locality with budget deficit and interest on government or treasury bills	d. Ordinary administrative expenditure: new purchases, meetings of Government, Party and mass organizations at the provincial level.	d. Ordinary administrative expenditures: new purchases, meetings of the Government, Party and mass organizations at the district level.
e. Economic adjustment expenditure, e.g., price subsidies and	e. Payment of interest on foreign loans for projects at the local level. For the localities with budget deficit the Government assumes the responsibility to assist in the repayment.	e. Cultural-social adjustment expenditure.
f. Cultural-social expenditures	f. Economic adjustment expenditure: e.g., organization of the local trade fairs.	f. Health expenditures: purchases of medicine, medical instruments, patient allowance for the hospitals managed by the district; with budget deficit the Provincial Budget assumes the responsibility to assist in the payment.
g. Expenditures on national defense: includes disease prevention	g. Cultural-social adjustment expenditures.	g. Allocation for sport, art and literature of the organizations at the district level
h. Health expenditures: purchases of medicine, medical instruments, patient allowance for the hospitals managed by the ministry or provinces with budget deficit	h. Health expenditures: including purchases of medicine, medical instruments, patient allowance for the hospitals managed by the provinces; for provinces with budget deficit the Government assumes the responsibility to assist in the payment.	h. Expenditures on natural disasters: support to people affected by fires, natural calamities and epidemics at the district level
i. Expenditures on sport, art & literature at the central level.	i. Expenditures on sport, art & literature at the provincial level.	i. Expenditures on national defense and security of the district forces. For the districts with budget deficit the Provincial Budget assumes the responsibility to
j. Expenditures on the media: allocation for newspapers and magazines managed at the central level	j. Expenditures on the media: allocation for newspapers and magazines managed at	
k. Education: purchases of education materials at the central level.		
l. Scientific and technical research expenditures of the organizations at the central level.		

<ul style="list-style-type: none"> <li>m. Expenditures on natural disasters: support to people affected by fire, natural calamities and epidemics nation-wide, including at the local level.</li> <li>n. External Relations: expenditures related to membership fees to international and regional organizations, and contribution to activities of international level and intergovernmental relations.</li> <li>o. Expenditure on national defense and security of the state forces and those of the localities with budget deficit.</li> </ul>	<p>the provincial level.</p> <ul style="list-style-type: none"> <li>k. Education: Purchases of education materials for provinces that are self-sufficient</li> <li>l. Scientific-technical research expenditure of the organizations of the provincial level</li> <li>m. Expenditures on natural disasters: support to people affected by fire, natural calamities and epidemics at the local level.</li> <li>n. Expenditures related to external relations at the local level</li> <li>o. Expenditures on national defense and security of the local forces. For the localities with budget deficit the Government assumes the responsibility to assist with the payment.</li> </ul>	<p>assist in the payment.</p> <ul style="list-style-type: none"> <li>j. Expenditure to support the villages</li> </ul>
<p>2. Capital Expenditure</p> <ul style="list-style-type: none"> <li>a. Investment in the construction, maintenance and repairs of socio-economic and cultural infrastructure offices under the responsibility of the ministries in accordance with the lines of authority.</li> <li>b. Expenditure on counterpart funds for foreign loans and grants, and projects with strategic character, at the central level or at the local level for the localities with budget deficit</li> <li>c. Loan repayment: principal on foreign loans including Structural Adjustment credit and loans for strategic character of the national level, and projects of the local level for the locally with budget deficits.</li> <li>d. Redemption of government or treasury bills.</li> <li>e. Full investment and joint venture with enterprises managed by ministries</li> </ul>	<p>2. Capital Expenditures</p> <ul style="list-style-type: none"> <li>a. Investment in the construction, maintenance and repairs of socio-economic and cultural infrastructure and offices under the responsibility of the localities according to the division of responsibilities of the ministries and sectors.</li> <li>b. Expenditures on counterpart funds for foreign loan and grant projects at the local level: for the localities with budget deficit the Government assumes the responsibility to assist in providing the counterpart fund.</li> <li>c. Repayment of principal on foreign loans for projects of the local level: for the localities with budget deficit the Government assumes the responsibility to assist in the repayment.</li> <li>d. Full investment and joint venture with enterprises</li> </ul>	<p>2. Capital Expenditure</p> <p>Investment in the construction, maintenance and repairs of socio-economic and cultural infrastructure and offices under the responsibility of the districts in accordance with the division of responsibility of the provinces, prefecture and special zone</p>

<p>f. Loans to SOEs</p>	<p>managed by localities.</p> <p>e. Lending is an expenditure item the localities are not allowed to plan.</p> <p>f. Local budget expenditure should be classified by sectoral line of authority down to the district level and by the expenditure category.</p>	
<p>3. Subsidy to support the local budgets</p> <p>The Government subsidizes the local budgets for both the administrative and capital sides with a fixed allocation.</p>	<p>3. Subsidy to support Government and District Budgets</p> <p>a. The provinces, prefecture with revenue higher than expenditure as stated above will support the Government Budget.</p> <p>b. The provincial budget subsidizes the district budget deficit for both the administrative and capital sides with a fixed allocation.</p>	<p>2. Subsidy to Support Provincial Budget</p> <p>Districts with revenue higher than expenditure as stated above will support the Provincial Budget</p>

Source: Decree 192/PM of 1999 for the Implementation of the Budget Law 1994

Annex 1B. Expenditure Assignment in Lao PDR on the Basis of draft Budget Law 2005

Central Government	Local Governments
<p>1. Recurrent expenditure:</p> <p>a) Spending on salaries, allowance, policies, as well as family subsidies for officers of State, Party and central level personnel.</p> <p>b) Spending on severance allowance, retirement pension and other allowances extracted for centrally listed pensioners;</p> <p>c) Spending on allowance for pupils, students, monks, preachers governed by ministries, agencies of central level;</p> <p>d) Administrative recurrent expenditure (purchases, conferences...) of State, Party and central level agencies;</p> <p>e) Payment for interest of overseas borrowings;</p> <p>f) Payment for interest of domestic borrowings;</p> <p>g) Spending on economic and non-productive activities such as subsidies, goods collection, international exhibition attending and organizing state level exhibitions;</p> <p>h) Socio- cultural spending:</p> <ul style="list-style-type: none"> <li>- State level disease prevention;</li> <li>- Cure spending (medicines, medical equipments, patient allowances) in ministerial level hospitals;</li> <li>- Spending on sports, cultural performances of central level agencies to participate in international and state level movements;</li> <li>- Spending on newspaper and magazine publication managed by central level agencies;</li> <li>- Spending on purchasing educational instruments;</li> <li>- Spending on technical and scientific research of central level agencies;</li> </ul> <p>i ) Spending on foreign relationships: fees for international organizations, international contribution, expenditures for foreign relationship at governmental level;</p> <p>j) Spending on national defense and security of official forces.</p> <p>k) Other expenditures: disaster, disease and poverty relief.</p>	<p>1. Regular spending.</p> <p>a) Spending on salaries, allowance, policies, as well as family subsidies for officers of State, Party and local organizations.</p> <p>b) Spending on severance allowance, retirement pension and policy for pensioners belonging to local policy;</p> <p>c) Spending on allowance for pupils, students, monks, preachers managed by local agencies;</p> <p>d) Administrative regular spending (purchases, conferences...) of State agencies in the localities;</p> <p>e) Payment for interest of overseas borrowings relating to the foreign funded projects where the regions are beneficiaries;</p> <p>f) Spending on economic and non-productive activities (e.g. organizing local exhibitions);</p> <p>g) Socio- cultural spending managed by localities:</p> <ul style="list-style-type: none"> <li>- Disease prevention;</li> <li>- Cure spending (medicines, medical equipments, patient allowances) in hospitals;</li> <li>- Spending on sports and cultural performances;</li> <li>- Spending on newspaper and magazine publication;</li> <li>- Spending on purchasing educational instruments;</li> <li>- Spending on technical and scientific research;</li> </ul> <p>h) Spending on foreign relationships at local level;</p> <p>i) Spending on local defense and security.</p> <p>j) Spending on district activities</p> <p>k) Other expenditures: disaster, disease and poverty relief.</p>

<p>2. Investment spending:</p> <p>a) Investment in construction of infrastructure projects managed by central level;</p> <p>b) Counter funds for overseas aid-borrowing projects at state level.</p>	<p>2. Investment spending:</p> <p>a) Investment in construction of socio-cultural-economic infrastructure projects managed by local level;</p> <p>b) Counter funds for overseas aid-borrowing projects at local level.</p>
<p>3. Payment of borrowings:</p> <p>a) Payment of domestic borrowings;</p> <p>b) Payment of overseas borrowings;</p>	
<p>4. Allowance for balance the local budget.</p>	

Source: Draft of Revised Law on State Budget, dated 14 August 2005

Annex 1C. Revenue Assignment in Lao PDR on the Basis of current Budget Law 1994

Central Government	Provincial Level	District Level
<p>Current Revenue</p> <p>e. Customs, tax revenue and fees: import duty, turnover tax, and excise duty on imports; electricity, timber and mineral export royalties; fees on air travel and visa fees.</p> <p>f. Non-tax revenue: Administrative or government services revenue from Ministries; sales of minerals and timber; hydropower, minerals and other royalties; fines and sales of confiscated goods; rent of land and other State assets; interest on government loans; dividend from government shares; foreign aid; people's contributions.</p> <p>State Assets Revenue</p> <p>a. Sale of vehicles, equipment, materials.</p> <p>b. Sale of real state, and of shares from government businesses.</p> <p>c. Revenues from repayment of principal on loans and other property lent.</p> <p>Financing Sources</p> <p>a. Foreign Loans</p> <p>b. Treasury Bills</p> <p>c. Support from the subordinate budgets</p>	<p>Current Revenue</p> <p>g. Customs, tax revenue and fees: every export royalty except electricity, timber and minerals.</p> <p>h. Turnover tax, excise duty, profit tax and minimum profit tax not specified as Government revenue.</p> <p>i. Tax on salary on businesses that is not collected by central government.</p> <p>j. Revenues from stalls in large markets.</p> <p>k. Immigration fee from passengers and vehicles.</p> <p>l. Land transportation fee</p> <p>m. Other fees.</p> <p>Non-tax revenues</p> <p>a. Administrative or government services revenue from line divisions of Ministries.</p> <p>b. Fines, sale of confiscated property.</p> <p>c. Revenue from rent of land and other provincial assets.</p> <p>d. People's contributions.</p> <p>State Assets Revenue</p> <p>a. Sale of vehicles, equipment, materials.</p> <p>b. Revenues from repayment of principal on loans and other property lent.</p> <p>Financing Sources</p> <p>a. Revenue support from Government and District Budget</p> <p>b. Balance from previous year's budget</p>	<p>Current Revenue</p> <p>a. Land Tax, Natural Resources tax, Profit Tax from self-employed, income tax from salary, real state, real estate rental, from copyrights and other rights.</p> <p>b. Contracting tax except from large provincial markets. Revenues from stalls in large markets.</p> <p>c. River transportation fee.</p> <p>d. Gun and hunting license.</p> <p>e. Livestock registration fee.</p> <p>f. TV and Video Fee</p> <p>Non-tax revenue</p> <p>a. Administrative or government services revenue from line divisions of Ministries.</p> <p>b. Fines, sale of confiscated property.</p> <p>e. Revenue from rent of land and other provincial assets.</p> <p>f. Dividends from equity for which the district is shareholder.</p> <p>g. People's contributions.</p> <p>State Assets Revenue</p> <p>a. Sale of vehicles, equipment, materials.</p> <p>Financing Sources</p> <p>a. Revenue support from the provincial budget</p> <p>b. Balance from previous year's budget</p>

Source: Decree 192/PM of 1999 for the Implementation of the Budget Law 1994

## Annex 1D. Distribution of Revenues in draft State Budget Law

Sources of revenues of the central budget	Sources of revenues of the local budget
<p>1. The revenues assigned 100% at the central budget:</p> <ul style="list-style-type: none"> <li>a) Import tax;</li> <li>b) Sales tax, consumption tax on import goods;</li> <li>c) Revenue from exporting electricity, wood and minerals;</li> <li>d) Special consumption tax;</li> <li>e) Fees, charges of transit services;</li> <li>f) Air transportation charges (air transit charges);</li> <li>g) Visa charges collected in consulates or embassies and passport issuance charges;</li> <li>h) Fees for using air territory;</li> <li>i) Revenue from sales of wood and minerals;</li> <li>j) Revenue from administrative units or state service fee managed by ministerial level agencies;</li> <li>k) Revenue from fines and sales of property and goods seized and penalized by ministerial level agencies;</li> <li>l) Revenue from land, housing and other state property lending governed by ministerial level agencies;</li> <li>m) The Government lending interest;</li> <li>n) Revenue from State shares since ministerial level agencies are shareholders;</li> <li>o) Revenue from foreign aids;</li> <li>p) Revenues from sales of state vehicles and other properties managed by agencies of central level;</li> <li>q) Revenue from sales of state real estate and shares governed by agencies of central level;</li> <li>r) Revenues from the closing balance of the central budget;</li> <li>s) Other revenues in accordance with provisions of laws.</li> </ul>	<p>1. Revenues assigned 100% to provinces, cities and special zones</p> <ul style="list-style-type: none"> <li>a) License tax;</li> <li>b) Natural resources tax;</li> <li>c) Revenue from land, housing and other properties;</li> <li>d) Immigration fees (fees for exit and entry border, documentation fees of tourists and vehicles);</li> <li>e) Road transportation fees (road fees, car registration papers, technical check, driving license); waterway transportation fees ;</li> <li>f) Fees for issuance of ID cards for Laos's citizens and overseas compatriots, family record books, permanent resident fees in Laos;</li> <li>g) Fees for issuance of license for using shotguns; animal registration fees; television fees; stamp fees;</li> <li>h) Revenue from administrative and non-productive activities or state service fees managed by local level agencies;</li> <li>j) Revenue from fines and sales of seized properties and goods managed by local level agencies;</li> <li>k) Revenue from sales of vehicles, equipment and other materials owned by the State and managed by local level agencies;</li> <li>l) Revenue from interest on State share income owned by localities;</li> <li>m) Income tax from real estate (sales, lending) and copyright;</li> <li>n) Income tax from freelance occupation;</li> <li>o) Foreign direct aids for provinces;</li> <li>p) Revenue from the closing balance;</li> <li>q) Other revenues as provided for by law.</li> </ul>
<p>2. The revenues shared in percentage (%) between the central budget and the local budgets:</p> <ul style="list-style-type: none"> <li>a) Sales tax, excluding sales tax as stipulated in point b, Clause 1 of this Article.</li> <li>b) Revenue tax;</li> <li>c) Minimum revenue tax;</li> <li>d) Income tax ;</li> <li>e) Revenue collected from extracted profits of state companies.</li> </ul> <p>3. Balance collection:</p> <ul style="list-style-type: none"> <li>a) Domestic borrowings;</li> <li>b) Overseas borrowings;</li> </ul> <p>c) Other balance collection.</p>	<p>2. Revenues shared in percentage (%) between the central budget and the local budgets in accordance with Clause 2, Article 27 of this Law;.</p> <p>3. Revenues from balancing the local budget:</p> <ul style="list-style-type: none"> <li>a) Subsidies from the central budget.</li> </ul>

Source: Draft of Revised Law on State Budget, dated 14 August 2005

## References

- Asian Development Bank (ADB) (2002), *Poverty in the Lao PDR*, Vientiane.
- Bahl R. and Martinez-Vazquez, J. (2005) "Sequencing Fiscal Decentralization". Working Paper, AYSPS, Georgia State University.
- Roy Bahl. (1998). *Intergovernmental Transfers in Developing and Transition Countries: Principles and Practice*. Atlanta: Andrew Young School of Policy Studies, Georgia State University.
- Boex, J and Martinez-Vazquez (2001). *The Design of Equalization Grants: Theory and Application*. International Studies Program Working Papers. Andrew Young School of Policy Studies, Georgia State University.
- Government and Public Administration Reform Project (GPARP) (2001). *The District in the Local Administration in the Lao PDR*, Mimeo.
- Keuleer, Patrick and Lngsy Siboumheuang (1999). *Central-Local Relationship in the Lao PDR: Historical Overview, Current Situation and Trends*, in *Central-Local Relations in Asia –Pacific, Convergence or Divergence?* Mark Turner (Ed) London.
- Martinez-Vazquez (2004). *Making Decentralization work in Vietnam*. International Studies Program Working Paper. Andrew Young School of Policy studies, Georgia State University.
- Jorge Martinez-Vazquez. 1998. *The Assignment Of Expenditure Responsibilities*. Atlanta: Andrew Young School of Policy Studies, Georgia State University.
- UNDP (2004). *Millennium Development Goals, Progress Report Lao PDR*, Vientiane.
- UNDP (2005). *Human Development Report*, UNDP New York.
- Villancourt, Francois (2001). *Fiscal Decentralization in Lao PDR: Principle, Practices and Prospects in 2001*.
- Winter, Mike (2002). *Lao PDR – Fact Finding Mission Report*. Report prepared for the UNCDF.
- World Bank (2005). *Lao PDR Economic Monitor*, the World Bank Vientiane Office
- World Bank (2002). *Lao PDR Public Expenditure Review: Country Financial Accountability Assessment*. Joint Report of World Bank, International Monetary Fund and the Asian Development Bank.