

# NPRS-PRF

Helping Accelerate Poverty Reduction in Asia and the Pacific

## STRENGTHENING PUBLIC EXPENDITURE MANAGEMENT IN THE LAO PDR

A technical assistance (TA) was prepared in early 2005 to contribute to the realization of public expenditure management (PEM) reform strategy of Lao People's Democratic Republic (Lao PDR).

Many countries have started to initiate reform measures to improve resource allocation and public financial management. Their governments are beginning to appreciate the importance of public expenditure as a tool for achieving socioeconomic development and poverty reduction. Public expenditure management (PEM) has especially become an important element in the process of Poverty Reduction Strategy Papers and national poverty reduction strategies over the last decade, as it determines the efficiency and effectiveness of the allocation and use of resources to implement the poverty reduction strategy.

More specifically, PEM has become both an important task and a tool in deciding the amount to be spent, the balance between revenue and expenditure, how funds are allocated among public activities and entities, and how these resources will be managed and accounted for. If properly implemented, PEM guides governments to direct resources to activities that support the poor and pro-poor growth.

### Sound Budgeting and Financial Management

The Government of the Lao People's Democratic Republic (Lao PDR) aims to achieve economic growth, reduce poverty, and graduate from its least-developed-country status by 2020. The country's National Growth and Poverty Eradication Strategy (NGPES), adopted by the Government in 2003, is a broad strategic framework from which future growth and poverty reduction programs will be developed and implemented. Implementing the NGPES requires the mobilization and allocation of public resources effectively applied in line with the Government's policy and development priorities. The NGPES emphasizes the need for capacity building for PEM at all levels of public administration. Although some progress has been made in recent years, structural weaknesses in the PEM system remain and constitute a critical constraint on NGPES implementation.

Structural weaknesses of the Lao PDR's PEM system include poor articulation of expenditures with policy priorities and of the relationship between recurrent and investment spending; weak expenditure control leading to increases in arrears; weak compliance with procurement and payment procedures; and ineffective independent audit.

The Government's PEM reform strategy up to the end of fiscal year 2009 has been laid out in its Public Expenditure Management Strengthening Program<sup>1</sup> (PEMSP), approved by the Ministry of Finance (MOF) in January 2005. PEMSP's strategic objective has been to improve policy consistency, efficiency, transparency, and accountability, and progress toward appropriate international financial management standards.<sup>2</sup>

The improvement of fiscal planning and budget preparation is the first of PEMSP's five components.<sup>3</sup> The current practice in fiscal planning and budgeting does not provide a sound basis for aligning resources with NGPES policies.

Likewise, among its many objectives, PEMSP envisions the development of a consolidated medium-term expenditure framework (MTEF),<sup>4</sup> covering recurrent and capital expenditures funded by both domestic and external sources, which will help the Lao Government gradually shift resources in line with its policy goals.

In early 2005, Technical Assistance (TA) 4627-LAO: Public Expenditure Planning for National Growth and Poverty Eradication Strategy<sup>5</sup> was prepared to contribute to the realization of PEMSP, specifically in the implementation of the program's fiscal planning and budget preparation component and in the development of the Government's MTEF. The TA also aimed to assist in the capacity improvement of relevant MOF departments and government agencies involved in the fiscal planning process. The approval of the Nam Theun 2 Hydroelectric Project at that time<sup>6</sup> also accelerated the sense of urgency for such capacity improvement, as part of the revenues to be

generated by the electricity sales would be channeled into the poverty reduction programs. The Department of Fiscal Policy of the MOF became the Executing Agency of the TA.

## Developing Medium-Term Fiscal Framework (MTFF) and the Medium-Term Expenditures Framework (MTEF)

The MTFF ensures consistency of the Government's budget with overall macroeconomic policy objectives, i.e., high private sector-led real gross domestic product (GDP) growth, low inflation, comfortable levels of international reserves, and debt sustainability. TA 4627 supported the preparation of the MTFF, including the training for the framework's application. Among the participants to the training were staff members from the Fiscal Planning Department (FPD) of the MOF, the Committee of Planning and Investment (CPI), and the Bank of the Lao PDR. The MTFF spreadsheet and accompanying notes have been officially turned over to FPD.<sup>7</sup>

The TA provided the Government with the general MTFF and MTEF models, together with detailed explanatory notes on the basic concepts and workings of the models. The Excel-based spreadsheet MTEF has also been converted into a database model (in Access software), which is a simpler, more standardized, and better tool for data management of large cumulative annual data. A strategy and manual for implementation of a government-wide MTEF was likewise submitted to the MOF.

The MTEF is an analytical tool<sup>8</sup> that would assist the Government in budget preparation. The methodology used for developing MTEF has been the baseline/forward estimates approach. It means that as a first step, government expenditures are projected over the medium term (typically 3 years) on the basis of existing expenditure levels. The projection is adjusted for projected inflation and pay increases, projections of the numbers of beneficiaries of public services<sup>9</sup> and commitments for future spending that have already been made by the Government.

As a second step, and at the start of a new budget preparation cycle, ministries and agencies can request the MOF for additional funding in order to reduce underfunding of existing policies or to fund new policies. Such requests have to be fully justified. If approved, the baseline/forward estimates are adjusted accordingly. The MTEF is a moving process: every year, the MTEF is rolled forward 1-year and reprioritized.<sup>10</sup>

Indicative MTEFs for the education and health subsectors (that is, primary education and expansion of rural health infrastructure) were developed and presented to the Government. The basis of the MTEFs is the cost of implementing sector programs (at the subsector level) over the medium term according to existing government policies at existing service levels (i.e., the baseline). The MTEF and the procedures for updating and revising it are firmly anchored in the budget preparation process and the overall spending ceiling (derived from MTFF), which lays out the parameters for budget preparation.<sup>11</sup>

## Review of Budget Management Processes

For the successful integration of the MTEF into the budget preparation process, sound budget management processes and capacity are crucial. A major component of the TA, therefore, focused on the strengthening of the budgeting tools and procedures. A review of the existing budget classification systems and the chart of accounts was made. The TA recommended some changes to bring the existing systems in line with international standards, specifically the inclusion of a new classification for the source of funds for expenditure transactions. TA 4627 also developed a budget preparation model that included a revised budget calendar, revised content of the budget circular, and new budget request templates.

More importantly, the TA provided useful advice on the revisions to the draft Budget Law, the draft Implementation Decree, the budget nomenclature system and chart of accounts, and budget preparation procedures. The various comments on revenue and expenditure assignments requiring the National Assembly to approve the detailed budget, including the budgets of each province at sub-functional level, were incorporated into the final draft of the Budget Law, which was passed by the National Assembly in December 2006.<sup>12</sup>

## Public Expenditure Management Framework

The outputs generated by TA 4627 were effectively used to inform the Lao PDR's fiscal planning and budget policies. Institutional measures were also recommended to ensure more effective capacity for managing the MTFF and MTEF. In particular, the TA continued capability development that includes appreciation and applied skills in basic macroeconomics (and basic economics in general) and in basic principles of public expenditure management. Similarly, the need for interagency coordination with respect to the macroeconomic framework was identified, and it was suggested that this could be developed through the establishment of a formal committee process.

Given the gains achieved by TA 4627, a follow-through TA amounting to \$1.1 million funded under the Asian Development Bank's TA Special Fund will be initiated in 2008 for a more extended implementation of the models developed under the TA across line ministries and select provinces.

Continued reforms in the Lao PDR's public expenditure management process and practice will help realize the country's national poverty reduction objectives. Notwithstanding the progress to date, this challenge can only be met over the long term.

### Endnotes

<sup>1</sup> The PEMSP is a 5-year program covering government initiatives focusing on strengthening management systems and the capacity of the Ministry of Finance (MOF) and provincial finance departments with pilot interventions at the provincial and sector levels. Its strategic objective is to improve policy consistency, efficiency, transparency, and accountability, and progress toward appropriate international financial management standards.

- <sup>2</sup> ADB. 2005. *Technical Assistance to the Lao People's Democratic Republic for Public Expenditure Planning for National Growth and Poverty Eradication Strategy*. Manila.
- <sup>3</sup> The PEMSP's five components are (i) fiscal planning and budget preparation; (ii) budget execution, accounting, and financial reporting; (iii) local government financial management; (iv) financial legislation and regulatory framework; and (v) capacity building.
- <sup>4</sup> A medium-term expenditure framework (MTEF) consists of a top-down estimate of aggregate resources available for public expenditure consistent with macroeconomic stability; bottom-up estimates of the cost of carrying out policies, both existing and new; and a framework that reconciles these costs with aggregate resources. It is called "medium-term" because it provides data on a prospective basis, for the budget year (n+1) and for following years (n+2 and n+3). MTEF is a rolling process repeated every year and aims at reducing the imbalance between what is affordable and what is demanded by line ministries. MTEF does this by bringing together policy-making, planning, and budgeting early in the budgeting cycle, with adjustments taking place through policy changes. <http://www.un.org.vn/undp/projects/vie96028/whatis.pdf>
- <sup>5</sup> TA 4627: Public Expenditure Planning for National Growth and Poverty Eradication Strategy. Total TA amount was \$825,000, of which \$700,000 was financed by the Cooperation Fund in Support of the Formulation and Implementation of the National Poverty Reduction Strategies (contributed by the Government of the Netherlands and administered by ADB) TA Approval Date: August 2005. TA Completion Date: December 2007. Executing Agency: Department of Fiscal Policy of the Ministry of Finance.
- <sup>6</sup> For more on this project, see <http://www.adb.org/Projects/Namtheun2/default.asp>
- <sup>7</sup> Peter Fairman and Lesleigh Henning of PDP Australia. 2007 Draft Final Report. *Lao Peoples Democratic Republic: Public Expenditure Planning for National Growth and Poverty Eradication Strategy*.
- <sup>8</sup> The MTEF is a spreadsheet model that is parameterized. During workshop discussions, the TA team demonstrated how assumptions concerning changes in parameter values (such as changing the maintenance cost factor with regard to new capital assets from 2% to 10% or changes to the civil service size) will impact the expenditure prioritization process.
- <sup>9</sup> Where changes in numbers of beneficiaries, for example, student enrollments, have a direct and mandatory impact on spending.
- <sup>10</sup> Peter Fairman and Lesleigh Henning of PDP Australia. 2007 Draft Final Report. *Lao Peoples Democratic Republic: Public Expenditure Planning for National Growth and Poverty Eradication Strategy*.
- <sup>11</sup> Peter Fairman of PDP Australia. 2007. Interim Report. Lao Peoples Democratic Republic: Public Expenditure Planning for National Growth and Poverty Eradication Strategy. May.
- <sup>12</sup> Peter Fairman of PDP Australia. 2007. Interim Report. Lao Peoples Democratic Republic: Public Expenditure Planning for National Growth and Poverty Eradication Strategy. May.

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