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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
Internet: <http://isp-aysps.gsu.edu>

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Reigning in Provincial Fiscal ‘Owners’: Decentralization in Lao P.D.R.¹

(Draft: not to be quoted)

Juan Luis Gomez, Jorge Martinez-Vazquez and Cristian Sepulveda
International Studies Program, Andrew Young School of Policy Studies
Georgia State University

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Introduction and Background

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 6 million over a total surface of 236,800 square kilometers. Latest estimates would place poverty rates at around 33 percent of households (ADB 2002). With an estimated per capita income of \$500 in 2006 (World Bank 2006), 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 2007).

Recent economic growth is reportedly high, with an annual average rate of over 6 percent between 2001 and 2006, mostly fuelled by the expansion of the resource sector (IMF 2007). Agriculture accounts for the largest share of the GDP, while mineral exports and investments in hydro-power have recently been the most important engines of growth. Reform of State Owned Enterprises (SOEs) remains allegedly timid and a number of measures have been recommended to encourage the development of a nascent private sector (World Bank 2005).²

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 large government expenditure arrears (World Bank 2005). Lao PDR reports a ratio of revenues over GDP of around 11 percent, one of the lowest among developing countries (IMF 2006). A fourth of the real growth in fiscal revenues over the last years is accounted for by the expanding energy sector, a situation that contrasts with decreased revenue collections at the provincial level.

Success in regaining a solid fiscal footing, especially in the areas of improved revenue collection and conservative public service hiring policies, has remained largely the responsibility of sub-national levels of government.³ Almost 40 percent of all national expenditure on basic

² 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.

³ As explained further below, the vertical system of governance in Lao PDR should more properly be designated as a de-concentrated 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 (de-concentrated) parts of the central government, without separate legal standing. However, because of the current high degree of de-concentration,

social services is conducted at the local level (World Bank 2007). Although, in light of Lao PDR developmental needs, resources available may not suffice to meet expenditure needs for social services and infrastructure, in this chapter we make the case that structural deficiencies in the system of inter-governmental fiscal relations may be as important a constraint for sustainable development of the country and pose substantial barriers for effective reform.

Back and forth: 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.) Following Vaillancourt (2001) and UNCDF (2002), the Lao history of central-local relations can be divided into four well-defined periods and characterized as a recurrent pattern of decentralization and re-centralization. The first period, from 1975 (year of the 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, the autonomy enjoyed by provinces increased 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 fiscal 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.⁴

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.

⁴ See UNCDF (2002) for further discussion.

The new decade witnessed initially 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,⁵ and also in the fragmented geography of the country. Some authors however bring further back the origins of this institutional inertia of provincial autonomy in the ancient organization of countries in district-like units called *meuangs*. The *meuangs* were ruled by aristocratic families that, although officially pledged alliance to the royalty, enjoyed considerable discretion in local affairs (Stuart-Fox 2005).

On the other hand, even though many of the governors are ranking members of the Politburo and seem to enjoy substantial discretion in their operations, in more recent times they have been far from being immune to central government action. In fact, of the cohort of governors appointed or re-appointed in the recent 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.⁶ But, in any case, the governors are accountable ultimately to the Revolutionary Party and not to the populations they are meant to serve.

The current system seems 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

⁵ Similar patterns of geographical self-sufficiency develop during Mao's long march in China or Vietnam's war of independence.

⁶ 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.

will examine below, 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 being able to strengthen central government institutions, especially at the Ministry of Finance by controlling revenue collections (the apparatus of tax administration and Customs) 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 will require a significantly stronger central government in key areas of the budget process.

This assessment, shared by many international observers, seems to have ushered in the consideration of reforms conducive to the re-centralization of the critical functions of Treasury and Tax Administration, currently under the control of provincial governors. This new change in the course of the reform of central-provincial fiscal relations has been formally sanctioned in a new Budget Law in place since 2007. It is early to evaluate the results of this fourth and last stage of the recent history of decentralization in Lao PDR. Although we would argue that the principles and direction of reform seem correct, reforms are still very much in the drawing board and it is unclear whether political agreement is widespread in the Government and Party.

The continued swings in the direction of reform of intergovernmental fiscal relations are a very specific characteristic of the decentralization process in Lao PDR. One would be hard-pressed to find another country where continued drives towards both decentralization and re-centralization of fiscal authority have alternated so widely over such a short period of time. In the background and as origin of these reforms, we should consider the balancing of political power between center and provinces rather than responses to the self-expressed needs of citizens.

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.
2007. - New Budget Law. Orders the centralization of Treasury, Customs and Tax Administration functions.
- 2008 - National Budget Law Implementation Decree



1. Barriers to decentralization design: A model of extreme de-concentration

The current vertical structure of government

The Constitution of the People's Democratic Republic of Lao, in its Article 75 (amended in 2003), states the republic is divided into three levels of administration. There are currently 18 provinces,⁷ sub-divided in turn into 141 districts and municipalities, and 11,293 villages.⁸ The Law on Local Administrations defines, in its Article 59, two levels of budget for sub-national 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 somewhat reflected in policy design, as the means of maintaining national cohesion. For example, the provincial governor or deputy governor is routinely a member of the majority ethnic group of the province.

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.⁹ This practice is also sanctioned in

⁷ This includes one prefecture (Vientiane, the capital city) and one special zone (Saysomboun, Special zone)

⁸ 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).

⁹ The principle of "dual subordination" of sub-national 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 sub-national employees.

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

A decentralized vertical structure of government: Necessary Conditions

An efficient system of fiscal decentralization requires the existence of elected local councils at all levels of government (Bahl 1999). Otherwise the self-expressed preferences of local citizens over the mix of public goods and services are unlikely to be channeled into expenditure and tax policies. In addition, local officers must also be appointed locally and the accountable to the elected authorities.

States confront two main choices in the definition of their vertical structures of government. An alternative is to define a hierarchical structure where sub-national governments are "creatures" of and accountable to their immediately higher level of government. Conversely, a "bi-furcated" system of government would include at least two level of sub-national governments, each of them directly accountable to the central level.

In principle, either model would allow reaping the potential efficiency gains from a decentralized system of government. However, hierarchical systems of government may present greater challenges in the monitoring of sub-national inter-governmental fiscal relations. In Vietnam for instance, provinces were allocated in the new State Budget Law of 2002 full responsibility over the definition of the expenditure and revenue responsibilities of district and commune level governments. This has resulted in a wide array of intra-provincial expenditure and revenue assignments. The lack of uniformity in the application of general principles for fiscal decentralization may result in perverse incentives for provinces to exercise excessive fiscal control over districts and communes. As it happens, districts and communes provide an important number of public services over which they would require the adequate autonomy and adequate funding.

It is thus important that, even if hierarchical designs of vertical structures of government are favored, the expenditure and revenue assignments of each level of government, as well as the

transfer mechanisms required to finance expenditures at the local level, are defined formally in the relevant legal documents (i.e. Budget Law, Organic Laws of sub-national governments, etc.)

Bi-furcated systems in turn, due to their nature, present potential problems of coordination among the different level of government. From that point of view, it is especially important the institutional mechanisms are in place to resolve administrative conflicts in the expenditure and revenue raising responsibilities of the different levels of government. Eventually, last resort to the highest judiciary institution (e.g. the Supreme Court) may be required in this type of administrative conflicts, but as mentioned, this need be a last resort option once all administrative conflict resolution channels are exhausted.

Barriers from the current Vertical Structure of Government to Efficient Decentralization in Lao PDR

Conventionally, a structure of de-concentrated government at the sub-national level provides a good basis for evolving a fiscal system toward a more genuine decentralized structure. In Lao PDR, paradoxically, the current de-concentrated structure may represent one of the most important limitations to efficient decentralization.

First, in order to capitalize the potential advantages of fiscal decentralization, provincial and district representative assemblies, with power to approve their respective sub-national budgets and with popular representation in their jurisdictions are required. Providing autonomous legal standing to sub-national units would not go against the unitary system of government in Lao PDR, but the current structure of vertical government does not allow for their creation without a significant overhaul of the system.

Second, there needs to be a careful assessment of whether there are currently too many levels of sub-national administration and whether some of the sub-national units are too small to operate efficiently in a decentralized system of governance. 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.¹⁰ On the issue of size, there are perhaps real gains in

¹⁰ In addition, it would not make much sense to eliminate either the provinces or the districts for historical and all sorts of practical reasons.

efficiency to be realized by the consolidation of provinces into a smaller number of jurisdictions. Similar gains are likely to be possible by the consolidation of some districts into a smaller number. We must note, however, that the “optimal” size of sub-national 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. From that point of view, inter-municipal or inter-provincial cooperation may allow access the available economies of scale without surrendering political representation. In short, the current level of fragmentation of sub-national governments would not seem to pose serious limitations to a transition towards an efficient system of fiscal decentralization.

Expenditure Assignments

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

As a prior point to the discussion of expenditure assignments, it is important to underline the current pervasive role of the state in the economy, which in itself is preventing an adequate assignment of responsibilities to the different levels of government. The constraints here are many-fold. First, the state still has important presence, as is the case in other Communist countries, in productive industries where its role is generally much less efficient than that of the private sector, but nevertheless the state enterprises compete unfairly with those in the private sector. And second, even if the role of the state could be importantly limited to activities where its presence is more efficient than the private sector's, the involvement of the Revolutionary Party and even the Army in productive activities complicates an efficient assignment of government responsibilities. There would appear to be no economic justification for the involvement of these two institutions in the process of service delivery at all, let alone their role in productive activities (such as in the forestry sector by the Army); it is apparent that there is

currently little or no conviction that the role of the state should be limited to creating an enabling environment for the development of the private sector.

Local governments in Lao PDR play an important role in the provision of government services, as they are assigned the responsibility of delivering key public services such as education, health services, agriculture and infrastructure. The actual assignment of expenditures partially follows the subsidiarity principle and broadly coincides with standard principles of expenditure assignment.¹¹ However, the absence of explicit expenditure assignments for lower levels of government at district and village levels must 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. As we discussed in the earlier sub-section, this hierarchical approach to the vertical structure of government may potentially threaten the efficient and uniform application of best practices of fiscal decentralization. Traditionally, these type of hierarchical design, absent a formal statement of expenditure and revenue raising responsibilities for all levels of government, leads to unpredictability and instability in intergovernmental fiscal relations (as no consistent expenditure and revenue frameworks are provided for some sub-national levels of government). Added to the perceived lack of monitoring and enforcement capacity of central and provincial administration, the end potential result is a highly inefficient system of inter-governmental fiscal relations, prone to corrupt practices and absent of any kind of political accountability.

Another important shortcoming of expenditure assignments in Lao is that the current assignment of expenditure responsibilities in the local government is vague. Importantly, the expenditure assignments fail 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 de-concentrated fashion) and those functions that are truly own functions of sub-national levels (in a decentralized fashion). A second issue is the lack of clarification of expenditure assignments for concurrent or joint responsibilities, between central and sub-national governments on the one hand, and between different levels of sub-national governments on the other; that is, the legislation does not clarify

¹¹ 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.

who is supposed to be responsible for what in the case of many joint responsibilities (see Table 1 below). A way to introduce clarity in the case of co-responsibility is to be explicit in the law about the distribution of competencies for the regulation, the financing, and the implementation of the responsibility.

Ideally, this assignment of expenditure responsibilities would be sanctioned in Organic Laws for Provincial and District Governments or in the Budget Law. However, in Lao PDR sub-national levels of government do not have separate legal status (as separate from the central government which embodies the State). Legally this importantly limited the possibility of rationalizing the roles and responsibilities of the different levels of government.

In order to account for heterogeneity and the different levels of administrative capacity in each of the provinces and sub-provincial levels of government, expenditure assignments could have considered asymmetric assignments below the provincial level, at district and village levels. However, in Lao like in other single-party communist regimes, the authorities have favored one-size-fits-all approaches to the restructuring of the government institutions.

Traditionally it is also desirable to complement explicit expenditure assignments with the strengthening of institutions for intergovernmental dialog and coordination, especially between central government agencies and the provinces.¹² However, to date there appears to have been little or no communication in many areas. In fact, , the nature of the state in Lao PDR limits importantly the options available for the implementation of these institutions of dialogue and conflict resolution. Single-party transition states are commonly developed along strongly hierarchical vertical structures of power and sub-national units, nearly operate as fiefdoms and whereby communication across sectors is rare and unstructured. A traditional example at the central government level is the problem posed by the separation of budgeting processes between the MOF (recurrent expenditure) and the Committee for Planning and Investment (which controls the capital expenditure budget). The lack of coordination between these two agencies results in operation and maintenance budgets that underestimate needs and are poorly aligned to ongoing investment efforts. The all-mighty Party cadres are usually, in a scenario of a lack of

¹² Even with an explicit and clear statement of expenditure responsibilities, 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.

separation of powers, a last resort for all conflict resolution. This unnecessarily slows down processes that would be better left out to administrative coordinating committees and inescapably it leads to the considerable concentration of power as is currently placed upon the highest political organs of the Revolutionary Party.

In summary, in addition to suffering from many common problems in other decentralized countries related to the definition of expenditure assignments (e.g. vague and informal statements, lack of definition of assignments for lower levels of governments, no consideration of the multi-faceted nature of expenditure assignments, etc.), Lao PDR presents other challenges particular to single-party communist states. Among the latter, the services and roles played in the economic arena by the Revolutionary Party and the Army rank as top limitations towards a modern definition of government and an efficient assignment of functions across government levels.

Table 1: 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

Source: Martinez-Vazquez, Gomez and Yao (2005), compiled from Decree 192/PM (Prime Minister decree on the implementation of the 1994 Budget Law)

2. Institutional barriers: The Hollowing-out of the Ministry of Finance

In the previous section we argued that the government of Lao PDR is not truly decentralized because no effective autonomy has been devolved to the communities. Whatever decisions are made at the sub-national level, they are unlikely to incorporate the voice of residents; in particular, the communities are not able to elect their own representatives. In this context the sub-national authorities are not really accountable to their constituents, and therefore the system would hardly be able to generate gains in efficiency due to a better fit of the preferences of the community.¹³ This argument suggests that the lack of real decentralization is mainly (but not exclusively) associated with the expenditure side of the budget.

In this section we explain how the system has evolved into an exaggerated de-concentrated fiscal structure where the center currently lacks the ability to collect enough revenues and coordinate nationwide expenditure policies. Although the de-concentrated scheme can be observed in both the expenditure and the revenue side of the budget, it is in the latter where we find the most extreme features, posing the most serious obstacles to moving forward with the decentralization process. In particular, our focus is on the problems associated with revenue collections by the tax administration and customs.

The assignment of revenues and administrative functions

As we remarked already above, an advanced level of de-concentration in the public sector is usually considered as a positive foundation for a process of fiscal decentralization because it is supposed to develop the administrative and technical capabilities of sub-national governments, and thus facilitates the transfer of new expenditure and revenue responsibilities (Bahl and Martinez-Vazquez, 2006). However, there are exceptions to that generally accepted rule, and Lao PDR is an important one. The high degree of de-concentration in Lao is one of the main

¹³ Here the term “sub-national,” the same as “central” government, must be interpreted with caution. Since provinces, districts and villages do not have a separate legal standing, they are only territorial representations of the central government. For convenience, however, and considering that their authorities have real decision-making power, here we loosely refer these territorial representations as sub-national governments, and also use the term “central” to refer national authorities.

problems to be addressed in moving forward to decentralize the current system of intergovernmental fiscal relations.

Several concerns about the inappropriate assignment of revenues and organization of tax administration have been raised in numerous studies and also by multilateral agencies (Vaillancourt (2001) and IMF (2006)). There seems to be a widespread agreement about the need to strengthen the authority of the Ministry of Finance by recentralizing the tax and customs administration¹⁴. However, there are additional factors slowing down the reform process. Some of these factors, related with the structure of the intergovernmental fiscal relations, will be addressed in the following discussion, while other institutional and political factors are discussed in the next section.

Provincial governments in Lao are assigned some sources of own revenues that roughly meet the best international practices. However, provincial governments are also responsible for administering and collecting some taxes assigned to the central government, notably those defined as shared revenues with the local governments, like the turnover or value-added tax, excise taxes and the corporate profit taxes.¹⁵ These sources of revenues represent around 30% of total revenues at the local and central levels (see Table 2.) Additionally, provincial governments are in charge of collecting all import duties, the natural resource tax, and the timber royalties. In total, around the 60% of overall government revenues are collected at the sub-national level, while a relatively weak central government tax administration focuses almost exclusively on the group of large taxpayers. Indeed, out of a total 1,180 employees for the entire tax administration in the country in 2006, only 43 were located at headquarters (World Bank 2007).

The performance of the tax administration is limited also by the lack of modern administrative procedures and updated technological improvements, as well as by the low technical capacity and expertise of its personnel. The resultant lack of capacity for the monitoring and enforcement of tax regulations leads to opaque practices that likely increase compliance costs and reduce tax collections. In this context it is not surprising that the overall tax revenue performance of the tax administration is very low. It has been estimated that the central and provincial tax departments currently collect only around 30% of all revenues that could have been collected (Martinez-Vazquez, Gomez and Yao, 2005). What complicates matters further is

¹⁴ See, for instance, Martinez-Vazquez, Gomez and Yao (2005) and World Bank (2007, 2008).

¹⁵ Article 16 of the National Budget Law Implementing Decree, February 2008.

The power of provincial administrations and the distortion of incentives for revenue mobilization

Many of the problems associated with the collections of government revenues in Lao PDR are associated with the excessive power embodied in provincial administrations and particularly on the governors. In the context of the New Economic Mechanism (NEM) introduced in 1986 the provinces were given a great deal of authority regarding the collection of revenues, including those of the central government, and were even allowed to set the interest rates and exchange rates at the provincial branches of the State Bank. This atypical arrangement, which has been only partially corrected, of course, has the potential of severely complicating the macroeconomic and monetary policies at the national level, and at the same time it provides poor incentives to the financial administration of the provinces.

Under the current system, the central government defines revenue targets and expenditure limits for each province. In theory, the excess of revenue collections (over the targets) are supposed to be transferred to the center. In the case the revenue targets are not reached, the transfers to the central governments are still expected to be made, while the adjustment should be done solely in the level of provincial expenditures. In practice, however, these rules are not applied, and collections under the target only imply a reduction of the transfers to the center. Moreover, if actual collections are higher than the target, a 50 percent of the excess can be kept in the province to finance capital expenditures (see Table 3).

Although this set of rules is clearly conceived to impose budgetary discipline and encourage revenue collections, its actual effects might be very different. On the one hand, the expenditure limitations are not credible and can potentially be manipulated by the central government in order to maximize its revenues. On the other hand, increasing revenue collections locally is less attractive when the gains must be shared with the central government. And even worse, given the weak tax administration at the central level a very rational alternative for the provincial administrations consists simply in declaring fewer revenues formally and shift some to extra-budgetary accounts or let domestic-local companies pay less in central taxes; all these seem to have been a common practice among sub-national governments.

As an attempt to overcome these shortcomings the Instruction 2372 of the Ministry of Finance, issued in 2005, established a fee-based bonus system for revenue collections that awards local authorities and line ministries with a percentage of the total revenue collections in

each revenue category. This type of solution, however, has not been powerful enough to solve the revenue problem and to address the structural deficiencies of the system.

The setting of expenditure limits and revenue targets is supposed to follow transparent and simple methodologies based on historical performance and subject to marginal adjustments due to changes in policies and regulations. But again, the actual practice differs from the original intention of the Law. Both the expenditure limits and revenue targets are not necessarily set with strict attention to the technical criteria but rather significantly defined in a bargaining process between the central government and the provincial authorities during the budget elaboration.

The political unwritten aspects of the budgetary process have been routinely exacerbated by mutual allegations. While the central government is accused of underestimating sub-national expenditure needs and setting unrealistic revenue targets, the sub-national authorities are accused of concealing revenue collections and overestimating their expenditure needs.

From an institutional point of view, economic management agencies of the State suffer strong pressure to show significant growth in a series of “national-importance” indicators, such as GDP and revenue growth. Absent substantial changes to the tax system, budget planning is left to inaccurate estimates of economic growth and of the tax base to account to justify the desired increases in revenue growth (World Bank 2007). Subsequently, the unrealistic revenue estimates provide the platform for non-sustainable expenditure patterns.

There may be yet another perverse incentive for the definition of unrealistic revenue targets in that it is assumed provinces report only a fraction of the revenues collected on behalf of the central government. Higher revenue targets may have been thought to provide a stimulus to improved disclosure of collection, but the lack of capacity to enforce sanctions (in the form of obligatory lower expenditure if revenue targets are not met) water down the debatable strength of this incentive. In fact, even though the sub-national governments are supposed to deposit the collection of fees in the provincial governments’ treasury accounts, this requirement is not always met and a portion of the collections are deviated to alternative accounts and sometimes simply “lost” and never reported.

In any case, the bargaining power of the provinces is substantial, and depends not only on the fact that they control an important share of the central government revenues, but also on the legal provisions defined by the Law on Local Administration. In its Article 14, paragraphs 12-14,

the governor is granted with an important degree of discretion in appointing and removing most of the positions at the sub-national level, including those of de-concentrated national agencies like tax administration and the Treasury. The provincial administration is also paying the salaries of all public servants, thus in practice the governor can exercise firm control over the personnel in the province.

The consequences of the excessive revenue de-concentration

Given the natural asymmetries in the ability to collect revenues, the lack of centralized coordination and control can be expected to exacerbate inequalities among sub-national governments. Vientiane municipality, for instance, collects much more revenues than the rest of the provinces, and in general a great variation in revenue collections can be observed at this level of government. Another factor contributing to fiscal inequalities is the sub-national collection of central revenues whose derivation is erratically distributed across the country, like the import duties, which in practice can be retained only by those provinces where the collection takes place.

These inequalities are difficult to reverse. But more importantly, the current system does not provide the mechanisms to ensure an equitable and efficient allocation of the available resources. As explained, the use of expenditure limits and revenue targets –which are also the foundations of the main program of intergovernmental transfers in Lao PDR, is not working properly. This system has led to the non transparent and unpredictable financing of all levels of government and it does not provide a sound rationale in the distribution of available resources. In short, the current system is not properly addressing the vertical and horizontal inequalities associated with the existence of certain degree of autonomy at the sub-national level.

This outcome is partly the result of a poorly designed system of the intergovernmental fiscal relations, but it might also be understood as an endogenous factor imposing perverse incentives to the government authorities at every level. For instance, even though the sub-national administrations are, legally speaking, mere de-concentrated governmental units without autonomous legal standing, the lack of adequate control mechanisms implies that they are not truly accountable to the center. Since the system is virtually disassembled and unable to ensure

fairness or efficiency gains to all participants, then every actor is virtually compelled to extract selfishly all the benefits that can extract from it.

As explained before, there is currently widespread agreement about the need of re-centralizing some key dimensions of the fiscal management, mainly through the strengthening of the Ministry of Finance and in particular the Treasury function. But so far the reforms have been slow and have not lead to a sound structure in intergovernmental fiscal relations. A strong central government with the ability to monitor and evaluate the progress of the several components of the system is a necessary condition for the implementation of a sound fiscal decentralization reform (Bahl, 1999).

Table 3: Expenditures Shortfall / Excess from Plan Expenditure by Provinces (2000 -2004)

[illegible]

3. Political Barriers: The challenges of single party systems

With the new constitution of 1991, a unicameral National Assembly composed of 115 representatives was created in Lao PDR. The members to the Assembly are elected for a period of five years from a list prepared by the People's Revolutionary Party. In recent years, "properly screened" independents have been allowed to run for the Assembly; however, in the most recent election of 2006, only two of the delegates elected were classified as independents (CIA 2008). The National Assembly has been criticized for representing little more than a legislative "rubber-stamp" institution that sanctions the political proposals channeled from the party and through the executive. The overlap between the Party and the Army is also substantial, with 6 out of the 11 members of the Politburo (the highest political organ within the Party) being current or former members of the Army.

The reform of the current structure of central-provincial fiscal relations will thus face significant barriers due to the political "status-quo". First, for efficient fiscal decentralization, the current Provincial Governors' extensive fiscal powers would have to be vested upon a legislative body elected by citizens in order to ensure proper accountability of Provincial Governments and the matching of expenditure decisions to local preferences. One would expect arduous resistance on the part of the powerful group of Governors to a change of this kind. The power and autonomy given to the Governors has allowed them to develop relations of patronage with the local elites in the historical Laotian way, reinforcing somewhat resembling a political constituency. Institutional resistance should also be expected from the Revolutionary Party, as any move towards further decentralization that does not include the implementation of elected councils would extend its power. Currently, local representatives are Party members and represent the interests of the Party, not necessarily of their supposed local constituencies. Thus, the required political link allowing the preferences of citizens to be reflected in expenditure decisions via the accountability of their representatives has been absent.

Moreover, the Central Government capacity to directly appoint Governors - capacity, it can be assumed, adequately sanctioned by the Revolutionary Party – accords an element of political control to the President and the Party that may not be easily surrendered. Similarly, heads of the district administrations are appointed by the Provincial Governors, again according them an important instrument of control of sub-provincial units of government. The transition

experience of Vietnam, highly regarded in Lao as a critical reference, may however allow considering the creation of representative institutions at the sub-national level. In Vietnam, Provincial People's Councils directly elected by the population are increasingly important in the determination of sub-national fiscal structures.

The overlap between the Party and the Executive, and the Party and the Army are considerable, and usually the highest ranking bureaucrats and politicians are also serving or former army officers. The ranks are filled with veterans from the Revolutionary struggle that brought the Party to power and who view any kind of reform that may limit the power of the Party and the Army with extreme reticence (Stuart-Fox 2005). From that perspective, the restructuring of central-provincial fiscal relations, including the re-allocation of sources of revenue to the central level or the proposed increased monitoring capacity required for the Ministry of Finance would alter very substantially the current balance of power.

This re-organization of intergovernmental relations along the best practices of fiscal decentralization would also pose a significant threat to the control of state-owned enterprises by the Party and the Army. The presence of the latter is particularly important in the forestry sector, including the exploitation of timber and related industries. These state owned enterprises, as it is the case in other Revolutionary regimes and in particular in the neighboring Vietnam, have traditionally represented a significant source of income for the Army. The re-assignment of revenues to a central tax office would directly impinge upon the huge freedom with which the Army has managed these industries.

The successful reform of intergovernmental fiscal relations will require a political champion that leads the debate and maintains it at the forefront of the development topics. It is far from clear at the present time who that champion may be. To a certain extent, multiparty systems allow for a greater multiplicity of positions and the emergence of leaders in different political areas. Within a single party system, however, being labeled as a "reformist" without having ensured sufficient political backing may be the more direct ticket to political oblivion. There are no alternative political outlets in single-party systems. No "exit" options in Hirschman's terminology. Thus, altering the political equilibrium typically require long processes of debate, external events that open political windows of opportunity, and extreme political valor to advocate for reform. Under these conditions, the emergence of political

decentralization champions is made more unlikely. However, the current political leadership may be open to the “testing” of some reforms on a piloting basis, similar to the approach that China has quite successfully adopted for now several decades. But a strong case needs to be made that those reforms can bring substantial benefits to Lao. That case is being built if ever so slowly by the interaction of the international donor community and upper echelon bureaucrats at the Ministry of Finance.

Grassroots participation and demands for devolution is another element of the political process that could bring decentralization reform. Local participation, either directly channeled through elections or via the work of civil society, is an important counter balance to the state that increases the accountability of government. However, there are presently substantial barriers to this process taking hold. In Lao PDR the operations of non-governmental organizations so prevalent in western countries are not allowed, and the existing grassroots organizations are mostly satellite organizations of the Revolutionary Party.

Some observers have also pointed to certain cultural traits of the Laotian society which may allow the perpetuation of an obviously unbalanced system of representation in which the interests of the population at large are subject to the designs of the Revolutionary Party and by extension, the Provincial Governors. These observers have argued that the Buddhist predominant culture in Lao, which focuses on human spiritual development in contrast to materialistic achievements, fosters a certain alienation of the population of Lao PDR from the political process and the practices of its rulers. Aware of the formidable challenges to the development of the country, and in particular of the constraints the current de-concentrated structure of government poses to fiscal reforms, Buddhists’ beliefs may quiet the demands for long-awaited reforms.

4. Conclusions

Lao PDR is a small poor country but with significant cultural and ethnic diversity and a large and inefficient public sector. Low and behold, the potential for sustained economic development lies on larger investments in human capital, via social service expenditures in education and health, and physical infrastructure. Against this background, Lao confronts a tight fiscal resources

envelope that underlines the need to improve the efficiency of both public expenditure and revenue collection. Fiscal decentralization reform has the potential of improving the overall efficiency of the public sector and to allow the country to advance in the path of sustained growth.

In many important ways, the central government in Lao is fiscally too weak to command the resources and institutional leadership and control necessary to implement decentralization reform. From the revenue side, the tax administration and customs service remain largely under the control of the provincial governments, and from the expenditure side, the central government authorities lack the means, such as a centralized Treasury function, to control actual disbursements at any level.

In addressing the reform of the current system of inter-governmental fiscal relations in Lao PDR, it should underlined that future progress requires a clear and well-sequenced medium-term government strategy and implementation plan that is widely agreed and supported by the political establishment, and championed by the highest political leaders. Any future shorter term (or stop gap) measures would have to be consistent with the reform pillars outlined in this medium-term strategy.

Importantly, the strategy would require a refinement and clarification of the current assignments of expenditure responsibilities, and the definition and quantification of budget expenditure norms that provide an adequate system on estimation of expenditure needs at sub-national levels of government. Additionally, the centralization of the Treasury system, already in process of evaluation, is a critical piece in the strategy to accord the central government the monitoring and enforcement capacity it requires to lead an efficient process of fiscal decentralization. Secondly, a fine tuning of tax assignments along economic efficiency line is required to allow improving the accountability and fiscal responsibility of all levels of government in their revenue raising responsibilities. Along those lines, the re-centralization of the tax administration would assist critically in endowing the central government with the fiscal prowess required to re-structure the financing system of local governments. That would include the implementation of transfer mechanisms that do not rely on faulty collection incentives, but on an adequate definition on expenditure needs and fiscal capacities.

However, the current institutional setup, which displays an extreme degree of inefficient de-concentration and a lack of democratic institutions that ensure public accountability, make the chances for successful decentralization reform pretty slim. The political and institutional forces that were behind the design of the current system largely remain in place. As with any other single-party state, the rigid control of the political thought by the ruling elite limits the consideration of alternatives for the vertical structure of government that increase the political accountability of sub-national government representatives. It is difficult to envision in the short-term the rising of a champion for decentralization reform. However, economic pressures and the need to develop may lead the current regime to experiment with some forms of fiscal decentralization reforms. There is significant interest within the government to imitate to certain extent the reforms that have taken hold in neighboring Vietnam. This and the nudging forward of the international donor community may still produce some significant progress in the immediate horizon.

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