

Forging Ahead

Restoring Stability & Boosting Prosperity



PUBLIC FINANCE REVIEW



3. Public Expenditure



3. Public Expenditure

Enhancing the quality of public spending is crucial for rebuilding human capital and accelerating economic growth, particularly given pressing fiscal constraints. Government expenditure levels have declined from 24 to 15 percent of GDP between 2013 and 2022, largely because of poor revenue performance, and are very low by international standards. An expenditure-led fiscal consolidation has compressed spending in many categories, jeopardizing the quantity and quality of public service delivery. While public expenditure has had a positive impact on economic activity, there is limited fiscal space to support a strong and sustained recovery. With debt service obligations growing, non-interest spending will remain under pressure. Expenditure trends on education and health are worrying, especially since the economic, health, and social impacts of COVID-19 have drastically eroded human capital. The combined spending on education and health fell from 4.9 to 2.6 percent of GDP during 2013–2022, which would have been less than interest payments in the absence of large debt service deferrals. Fiscal pressures are compounded by several challenges relating to public financial management, with poor planning and weak commitment controls appearing to be major weaknesses. Institutional fragmentation is also a concern. Despite limited fiscal space, there is scope for fiscal adjustments, particularly to reprioritize and reallocate resources across and within categories. More and better spending on growth-enhancing sectors is crucial to enhance medium-term economic prospects, but the lack of comprehensive information (i.e., budget transparency) undermines an assessment of potential budget savings. Overall, fiscal discipline is essential to secure fiscal sustainability, while improving the quality of public spending is critical for rebuilding human capital and accelerating economic growth, as well as for reducing poverty and promoting inclusiveness.

Main recommendations: (i) reallocate spending toward education, health, and social protection to avoid a collapse in human capital; (ii) strengthen spending controls to avoid the accumulation of further expenditure arrears; (iii) report data for all spending units to increase budget transparency and accountability; (iv) enhance budget preparation and execution, with a focus on procurement and public investment management, to improve the impact of public spending; and (v) improve human resource planning to enhance the effectiveness of the civil service.

Chapter structure: The chapter starts by providing a brief overview of aggregate expenditure trends, followed by a detailed analysis of the composition of spending. Subsequently, it discusses issues related to the efficiency, effectiveness, and equity of public spending. Granular analysis is based on data published in state budget implementation reports for the period 2011–2020. The main public financial management, bottlenecks are highlighted. Key recommendations are presented with a view to improving the impact of public spending while securing fiscal sustainability.

3.1 Background

The five-year National Socio-Economic Development Plans guide the preparation of sector plans and state budgets. The planning process is led by the Ministry of Planning and Investment (MPI) and is articulated through five-year National Socio-Economic Development Plans (NSEDPs). These plans include aspirational targets for several economic indicators, but it is unclear to which extent the underlying assumptions are based on a consistent macroeconomic framework. The NSEDP provides guidance for the state budget prepared by the Ministry of Finance (MoF) and sector plans.⁹⁸ The NSEDPs are not fiscally constrained, which puts pressure on MoF to increase revenue.⁹⁹ Plans are seldom revisited to reflect new developments, while the availability and reliability of timely and comprehensive budget data also pose challenges.

The budget planning process is established in the State Budget Law, although it is not always strictly complied with. The State Budget Law, which was revised in 2015 and 2021, provides a sound basis for the budget process based on a budget calendar with sequenced activities. However, substantial delays are often experienced, which

⁹⁸ Lao PDR has a dual budgeting system, whereby the recurrent budget is under the responsibility of the Ministry of Finance (in coordination with line ministries), while the elaboration of the capital budget is under the mandate of the Ministry of Planning and Investment.

⁹⁹ The recently approved NSEDP Financing Strategy outlines useful qualitative approaches to mobilizing resources for development, but it is not intended to define an expenditure framework.



undermines the process. In recent years, the MoF has been working toward implementing the law's provisions to strengthen the medium-term orientation of the budget. Aggregate expenditure ceilings for the budget year were approved by the government and issued for the fiscal years 2021, 2022, and 2023. In April 2023, the government adopted a new prime ministerial decree on budget planning, which implements the law's provisions for the preparation of a state budget policy statement and medium-term budget plans with ceilings (for the next budget year and indicative allocations for the two outer years) for budget entities. The decree also sets out a detailed budget planning process.

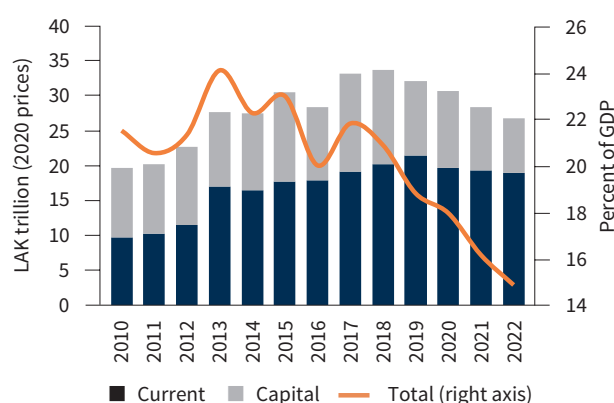
Fiscal accounts have shortcomings in terms of data availability, coverage, and quality.¹⁰¹ Fiscal data is compiled and reported on a cash basis. The current Government Financial Information System (GFIS) does not cover the entire public sector and is not yet deployed at the district level, which leads to delays in consolidating information. Public spending is recorded with the support of a chart of accounts, which comprises an economic classification (by appropriation category) and an administrative classification (by institution).¹⁰² However, there is currently no functional classification to enable an accurate analysis of spending by sector, such as education and health. This is approximated through spending undertaken by related administrative units (i.e., ministries and provinces) and may thus not include relevant spending that takes place under other spending units. A new chart of accounts is being finalized, which will improve the comprehensiveness of recording and reporting of public spending. Some spending items are likely misclassified, such as externally financed recurrent expenditures recorded under capital spending. Budget data is not reported for all ministries and organizations, which considerably undermines budget transparency, while large expenditure arrears and extra-budgetary funds are also a concern.

3.2 Level and composition of spending

The level of government spending has declined considerably and is very low by international standards.

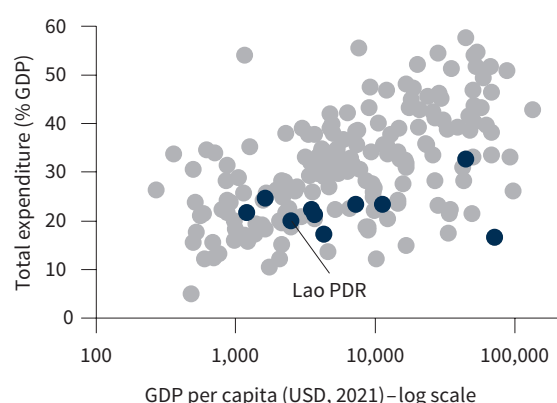
Total public spending has been falling in real terms since 2018, but the decline is even more pronounced as a share of GDP (Figure 3.1).¹⁰³ Expenditure declined from 24 to 15 percent of GDP between 2013 and 2022. This spending compression was mainly caused by weak revenue performance and the need to avoid high fiscal deficits. The level of aggregate public spending is lower than most regional and income peers, especially considering that it was even lower in 2022 (Figure 3.2). Given population growth and large needs associated with the impacts of COVID-19, the decline in spending is likely undermining public service delivery. There are concerns about spending adequacy, particularly in sectors that have a lasting impact on economic growth, poverty, and equity.

Figure 3.1: Expenditure (Lao kip and % GDP)



Source: Ministry of Finance and World Bank staff calculations.

Figure 3.2: Expenditure (% GDP, 2016–21)



Source: International Monetary Fund and World Bank staff calculations.
Note: Blue dots represent ASEAN countries. Vertical axis limited to 60 to improve readability.

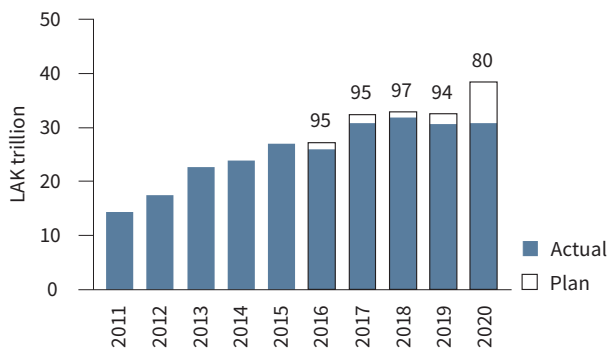
¹⁰⁰ Data quality refers to accuracy, completeness, reliability, relevance, and timeliness.

¹⁰¹ Detailed data has been compiled from the yearly state budget implementation reports published in the official gazette. Given the lack of access to the raw data from the GFIS, this chapter relies on a newly compiled fiscal database drawing on the digitized hardcopies of these detailed reports.

¹⁰² The fiscal year ran from 1 October to 30 September until 2016. From 2017 onwards, the fiscal year coincides with the calendar year. For the purposes of this chapter, the last year of the old fiscal year will be mentioned in the text (e.g., 2015-16 will be 2016).

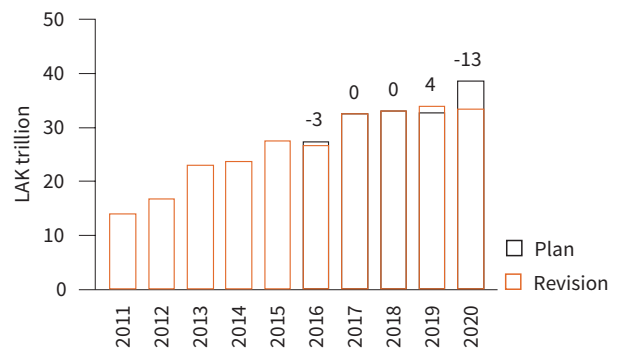
Budget execution has been relatively high, but the large accumulation of expenditure arrears undermines budget performance. The lack of a (credible) fiscal framework and a medium-term perspective on planning and budgeting contributes to a weak linkage between policy and the budget. To assess budget execution, a focus on the initial (rather than the revised) budget is warranted since it is likely to provide better insights into the credibility of the budget process and implementation capacity. Systematic over- or under-budgeting can reflect poor planning, budgeting, or implementation. For instance, there might be a weak link between planned activities and the proposed budgets, or an inability to adjust initial budget requests to the approved allocation. Budget execution averaged 95 percent between 2017 and 2019, although it dropped significantly in 2020, likely due to COVID-19 (Figure 3.3). High execution rates partly reflect the large share of wage expenditure (which are typically simple to execute), but the data masks challenges in the capital budget, namely expenditure arrears. Large arrears have been accumulated, largely due to off-budget projects in the context of weak commitment controls.¹⁰³ Improving planning, budgeting, and implementation is key to enhancing budget performance. For instance, plans should be realistic and adequately costed, budgets should be aligned with stated priorities, and implementation should be improved through public financial management reforms (e.g., commitment controls, procurement, internal controls, and treasury operations).

Figure 3.3: Budget execution (Lao kip and %)



Source: MoF and World Bank staff calculations.

Figure 3.4: Budget revisions (Lao kip and %)



Source: MoF and World Bank staff calculations.

Budget revisions have been relatively small, except in 2020, when the COVID-19 pandemic affected budget implementation. The initial budget approved by the National Assembly can undergo modifications, usually through a ‘budget adjustment’ that revises the budget in case of higher/lower-than-expected revenue collection, policy changes, or unexpected events. For instance, if revenue collection is 5 percent or more below target, then the Ministry of Finance can request the government to propose an adjustment of the budget plan to the National Assembly. While this flexibility enables the budget to respond to changing circumstances, it can also undermine the credibility of the budget as a statement of government policy, if adjustments are due to poor planning and budgeting or are politically motivated. In the Lao PDR, the need for budget adjustments seems to stem from the overestimation of revenue, which is linked to poor revenue forecasting. The budget was revised downwards in 2020, as the COVID-19 pandemic affected budget execution owing to revenue shortfalls and implementation challenges (Figure 3.4).

3.2.1 Economic classification

The decline in public spending has affected most categories, particularly wage and capital spending. The economic classification comprises the following divisions (numerical codes in brackets): wages & salaries (60), allowances (61), materials & supplies (62 and 66), subsidies & transfers (63), financial (64), miscellaneous & contingencies (65), and capital (67).¹⁰⁴ Public expenditure increased up until 2013, reaching a peak of 24 percent of GDP (Figure 3.5). This was mostly driven by large hikes in capital spending and wages & salaries. Capital spending reached 11 percent of GDP in 2012, while wages & salaries reached 9 percent of GDP in 2013 (Figure 3.6). However, public expenditure has been falling in relative terms since 2013, especially wages & salaries and capital expenditure.

¹⁰³ Expenditure arrears have been identified as a major weakness of the public financial management (PFM) system. See the 2018 Public Expenditure and Financial Accountability (PEFA). These arrears mainly relate to sub-national investment projects that, although approved by the planning authorities (e.g., MPI and National Assembly), have not been included in state budgets. The existence of large expenditure arrears undermines an accurate assessment of budget execution, since these imply over-execution.

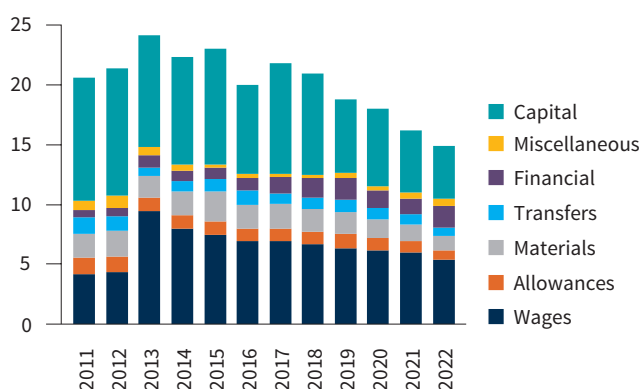
¹⁰⁴ Materials & supplies includes operations & maintenance (division 62) and purchasing of materials (division 66).



Curbs on wages & salaries (e.g., wage freeze and lower recruitment), capital spending (limits on new projects), and other recurrent expenditures (e.g., purchase of goods and services) have been necessary due to declining revenue, limited access to finance, and emerging expenditure arrears. However, financial expenditure (mainly interest payments) has been increasing, despite recent debt service deferrals, which is further compressing fiscal space. In the absence of these deferrals, interest payments would have surpassed 3 percent of GDP in 2022.¹⁰⁵

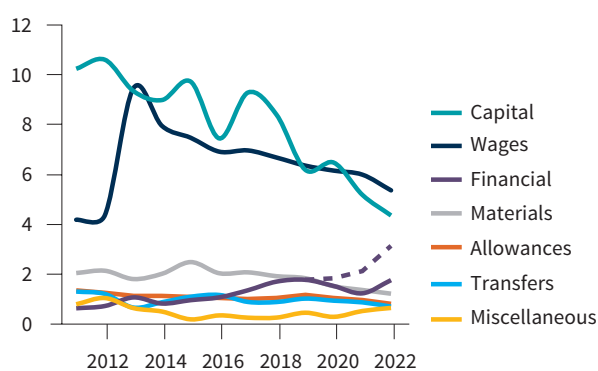
Wage and capital expenditures continue to account for most outlays, despite recent declines. The relative weight of each category can provide an indication of the overall fiscal strategy. Wage and capital spending have been the largest categories despite some volatility (Figure 3.6). Wages & salaries rose sharply to 39 percent of total spending in 2013, declining to 35 percent in 2022. Capital expenditure has gradually fallen from 50 to 32 percent of total spending between 2012 and 2022. Nonetheless, wage and capital spending still accounted for about two-thirds of total expenditure in 2022. Wage expenditure is dominated by salaries, while capital spending is mostly financed through external sources such as loans and grants (Figure 3.7).

Figure 3.5: Expenditure (% GDP)



Source: MoF and World Bank staff calculations.

Figure 3.6: Expenditure (% GDP)



Source: MoF and World Bank staff calculations.

Note: Dashed lined represents financial expense in the absence of external debt service deferrals.

Recurrent spending is low by international standards, and it is likely undermining public service delivery.

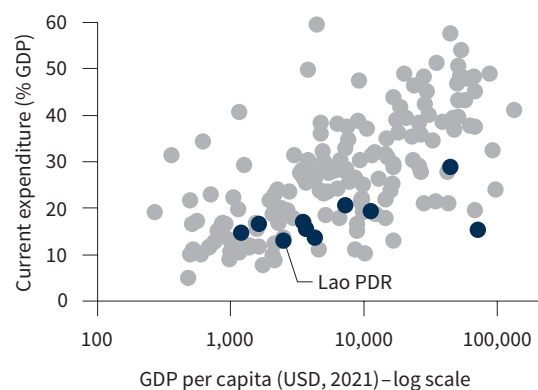
Recurrent spending is typically associated with expenditures necessary for the basic functioning of the government and public service provision. Spending restraint, particularly on wage expenditure, has led to a relative decline of recurrent spending from 17 to 11 percent of GDP between 2013 and 2021, which is low by regional and income standards (Figure 3.8). However, there is significant variation across categories. Spending on wages accounts for a

Figure 3.7: Expenditure (2020, % total)



Source: Ministry of Finance and World Bank staff calculations.

Figure 3.8: Current spending (% GDP, 2016–21)



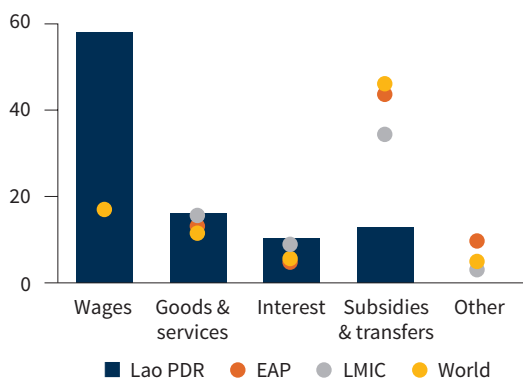
Source: International Monetary Fund and World Bank staff calculations.

Note: Vertical axis limited to 60 to improve readability.

¹⁰⁵This is based on data from the MoF's public debt bulletin. There are discrepancies across official sources. The budget implementation reports state 2.6 trillion kip in 2020, compared to 3.2 trillion kip in the public debt bulletin. This might be due to a recording issue (e.g., timing), as fiscal data reported by the MoF shows 2.3 trillion kip in 2021, compared to 1.6 trillion kip in the public debt bulletin.

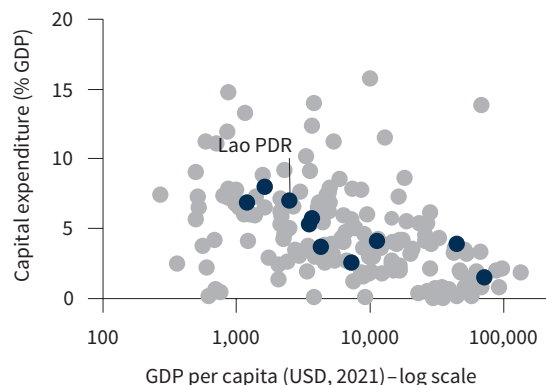
very large proportion of current spending, although most is not directly related to basic service delivery (Figure 3.9). Expenditure on goods & services is low, at under 2 percent of GDP, compared to a world average of 4 percent of GDP. Interest payments are deceptively low as they have been nearly halved due to debt service deferrals. Subsidies and other transfers (e.g., grants and social benefits) typically account for a large share of current expenditures globally, partly owing to fairly developed social protection systems. Overall, there are concerns that declines in recurrent spending are undermining public service delivery, particularly education (e.g., lack of teaching materials) and health (lack of medicines and medical equipment).

Figure 3.9: Expense (% current expenditure, 2021)



Source: World Bank and staff calculations.
Note: Aggregate data represents the median.

Figure 3.10: Capital spending (% GDP, 2016–21)



Source: International Monetary Fund and World Bank staff calculations.
Note: Vertical axis limited to 20 to improve readability.

There has been a strong prioritization of capital spending, despite recent declines. Capital spending peaked in 2012, when it accounted for half of total expenditure (11 percent of GDP). This reflected a strong focus on public investment to promote economic development, particularly to develop power and transport infrastructure.¹⁰⁶ The relative decline in capital spending (observed since 2012) coincided with a steady deceleration of GDP growth and a build-up of public debt, highlighting the unsustainability of the economic growth model. Despite declines in recent years, capital outlays remain higher than many regional and income peers (Figure 3.10).¹⁰⁷

An analysis of fiscal force and momentum provides further insights into the drivers of public spending. Decomposing expenditure growth into its key drivers can provide insights into recent dynamics. The approach used here is based on the concepts of ‘momentum’ and ‘force’. Momentum relates to the contribution of a particular spending item to the percentage growth in total spending in a given time period, while force measures the percentage point change in spending between years. Force and momentum convert expenditure shares and growth rates into units that can be added to equal total expenditure growth (momentum) or acceleration in growth (force), highlighting the most important items of expenditure. The force measure is additive, meaning that components add up to ‘acceleration’, and is also comparable across time and budget categories. Force can help identify relatively small budget items that are growing fast (i.e., small size but large acceleration), or items growing at a modest pace but are still driving trends owing to their large size (i.e., small acceleration but large size). Cases where both size and acceleration are large are of particular concern.¹⁰⁸

Spending growth has been mainly fueled by a positive momentum in wage and capital expenditures. Wage and capital spending accounted for most spending growth (momentum) between 2011 and 2020 (Figure 3.11). In terms of the overall force, most items cancel each other out (Figure 3.12). The large changes in momentum and force for capital spending may imply some weaknesses in public investment management, especially regarding planning. A rapid (and volatile) scaling up of public investment may fail to deliver strong economic growth if it creates significant inefficiencies.

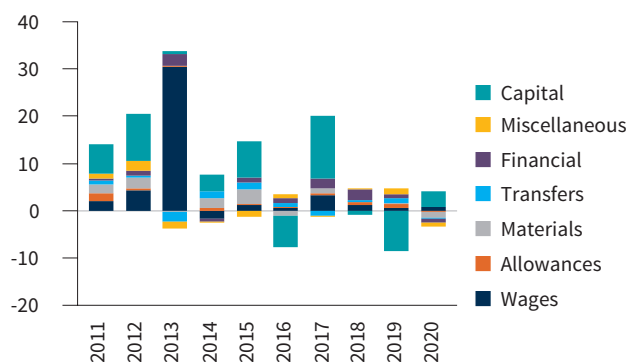
¹⁰⁶ However, some recurrent expenditures may be recorded under capital spending, particularly if they are externally financed. Capital spending may include allocations for clearing expenditure arrears.

¹⁰⁷ These values do not include the large investments made by state-owned enterprises and public-private partnerships.

¹⁰⁸ The approach is similar to assessing drivers of economic growth, whereby it is not just the growth of a component that matters, but also its weight in overall output.

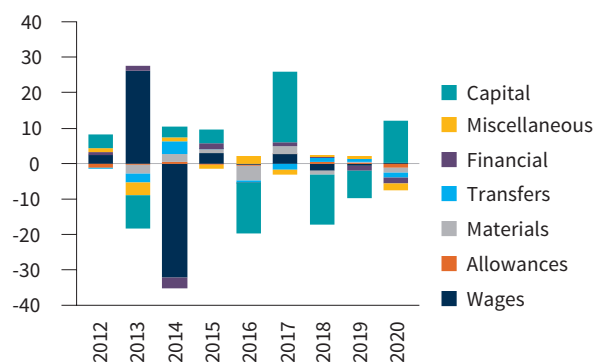


Figure 3.11: Momentum (percentage points)



Source: Ministry of Finance and World Bank staff calculations.

Figure 3.12: Force (percentage points)



Source: Ministry of Finance and World Bank staff calculations.

An analysis of budget rigidities can help fiscal consolidation efforts by shedding light on discretionary spending items. Budget components vary within a spectrum of flexibility since not all can be easily modified by the authorities in the short-term. Having a clear understanding of the budget items driving expenditure growth, and how inflexible they are, can support policymakers in anticipating fiscal pressures. Budget items that cannot be reassigned without entailing a high cost are generally said to be ‘rigid’. Budget components classified as rigid are thus not subject to the immediate discretion of the authorities. For the analysis, a typology of expenditure rigidity is applied to the economic classification (Table 3.1).¹⁰⁹ Civil servant basic salaries and interest payments on public debt fall under the high rigidity category, since these cannot be easily reduced. The other components of wages & salaries, allowances, and subsidies & transfers are classified as medium rigidity. Lastly, spending on materials & supplies, miscellaneous & contingency, and capital is categorized as low rigidity (or discretionary spending).

Table 3.1: Fiscal rigidity

Rigidity level	Appropriation category (budget item)
High	Wages & Salaries (basic salary), Financial
Medium	Wages & Salaries (general allowance and social assistance benefits), Allowances, Subsidies & Transfers
Low	Materials & Supplies, Miscellaneous & Contingency, Capital

Source: World Bank staff.

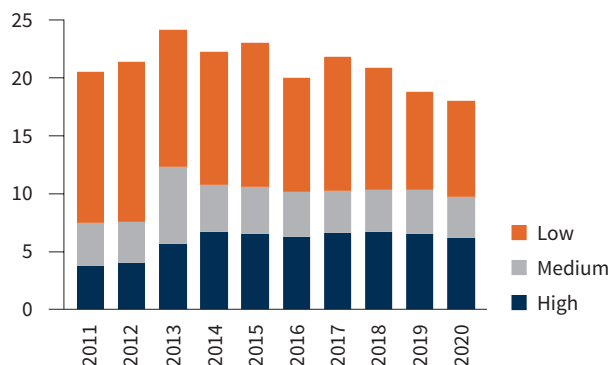
Note: Spending on social assistance appears to be reported under wages in the Ministry of Labor and Social Welfare.

Discretionary spending is high, albeit declining, suggesting that there is scope for fiscal adjustments. A significant share of public expenditure comprises items classified as having low rigidity (Figure 3.13). On the other end of the spectrum, high rigidity expenditures averaged 34 percent of total expenditure in 2020 (Figure 3.14). The combined share of high and medium rigidity expenditures in total spending has risen over time. Given the need to secure fiscal sustainability, and in the absence of public debt restructuring or stronger revenue mobilization efforts, a fiscal adjustment would likely need to be driven by a further compression in capital spending – which would undermine economic growth prospects. An increase in the share of rigid expenditures, particularly those legally binding (e.g., interest payments), limits the scope for reprioritizing budget allocations. At present, the relatively low degree of budget rigidity suggests that there is some scope for consolidating and reallocating budget resources across categories to improve efficiency and effectiveness. However, there are some risks in wages & salaries and allowances (owing to inflationary pressures), financial expenditure (due to rising debt service obligations), as well as other categories.

¹⁰⁹ The definition of expenditure rigidity that is used in this analysis follows a conceptual framework from the literature, which lists the broad categories by rigidity level. Herrera and Olaberria (2020) define budget rigidities as “institutional, legal, contractual, or other constraints that limit the ability of governments to change the size and composition of the public budget, at least in the short term”.

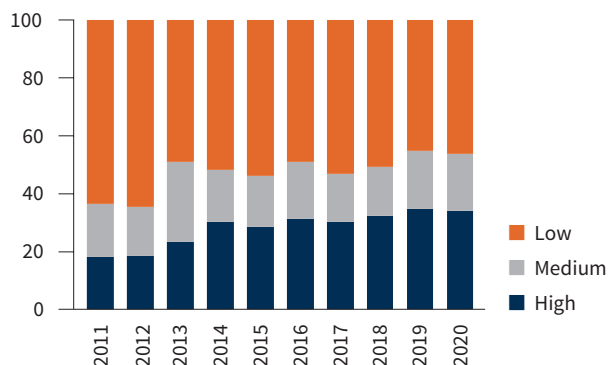


Figure 3.13: Fiscal rigidity (% GDP)



Source: MoF and World Bank staff calculations.

Figure 3.14: Fiscal rigidity (% total)



Source: MoF and World Bank staff calculations.

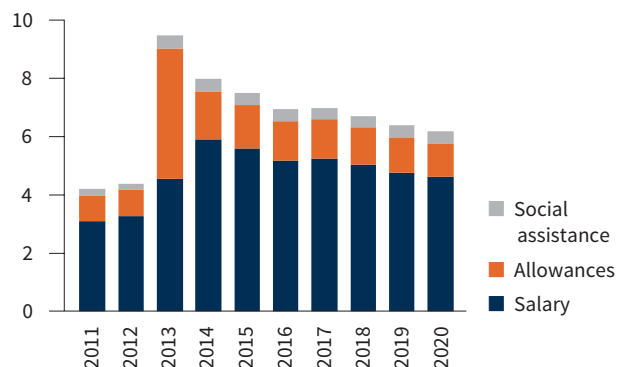
Wages & salaries and allowances

Spending on wages & salaries increased considerably in 2013, although it has been declining since then.

Wage expenditure more than doubled to over 9 percent of GDP in 2013 (Figure 3.15). This increase was largely due to a sharp rise in allowances that were subsequently converted to wage increases. Most wage expenditure relates to the payment of salaries, but allowances also account for a significant amount. Spending on social assistance (related to civil servants) is comparatively smaller. Since 2013, modest salary index increases and curbs on recruitment have contributed to a steady decline in the wage bill in relative terms. The execution rate of this spending category has been relatively high, as expected, averaging about 94 percent in 2016–2020. The education and health sectors typically account for a large proportion of wage expenditure, given the large number of teachers and health staff required to deliver basic public services to the population. General public services (i.e., administration), public order & safety (i.e., police), and defense (i.e., army) are also thought to account for a significant share, but data is not reported for these sectors or their ministries.

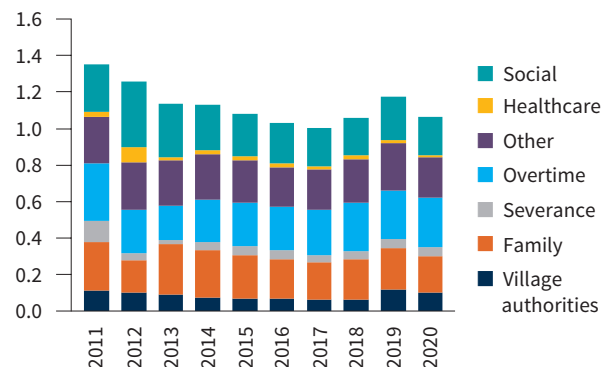
There are a range of allowances, which differ from those included in wages & salaries. This category differs from the allowances included under wages & salaries because it mainly relates to benefits, such as family, ‘extra work’, ‘other’ (mainly study-related), and social allowances. Although these partly relate to civil servants, they also include allowances to village authorities (e.g., chiefs) that should probably be better classified as transfers. In fact, the IMF’s Government Finance Statistics (GFS) includes some (but not all) allowances under wage expenditure. Overall, allowances declined as a share of GDP until 2017, after which they appear to have increased (Figure 3.16).

Figure 3.15: Wages & salaries (% GDP)



Source: MoF and World Bank staff calculations.

Figure 3.16: Allowances (% GDP)



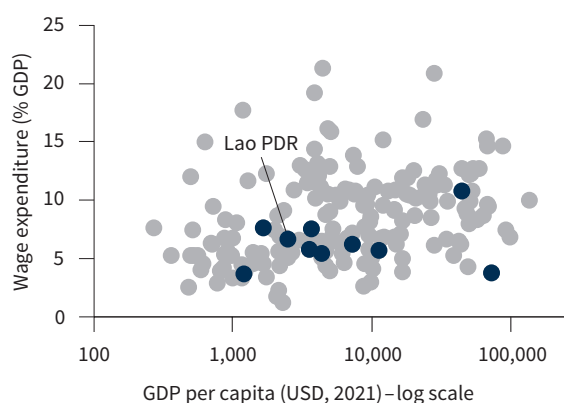
Source: MoF and World Bank staff calculations.



The wage bill is broadly in line with that of regional peers, but its share of total spending is relatively high.

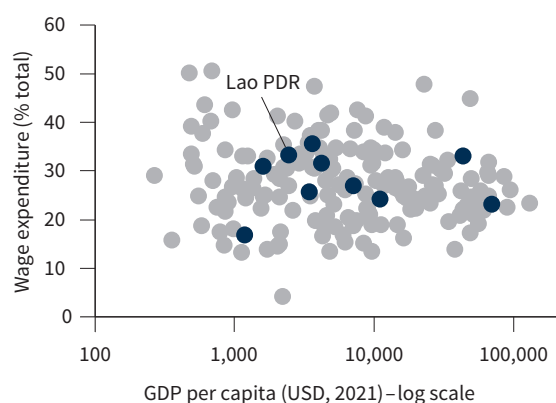
Spending on wages (including some allowances) averaged about 6 percent of GDP in recent years, which is around the average for regional peers (Figure 4.17).¹¹⁰ This partly reflects recent efforts to contain the wage bill, which peaked at 9 percent of GDP in 2013.¹¹¹ Nonetheless, wages & salaries still account for a relatively large share of total spending (Figure 3.18). High inflation is severely undermining the purchasing power of civil servants, which will put pressure on the wage bill, as the government may have to increase salaries to retain (qualified) essential workers.

Figure 3.17: Wages (% GDP, 2016–21)



Source: International Monetary Fund and World Bank staff calculations.
Note: Vertical axis limited to 25 to improve readability.

Figure 3.18: Wages (% total spending, 2016–21)



Source: International Monetary Fund and World Bank staff calculations.

Public employment is relatively high, and there are concerns over its composition. Public sector employment grew significantly from 7 to nearly 12 percent of total employment between 2005 and 2017, of which about two-thirds were men. Official statistics reported 176,151 civil servants in 2021, including more than 74,000 teachers and about 16,250 medical staff.¹¹² However, these numbers exclude many public sector workers because major employers are not included in the personnel information system (e.g., police and armed forces). Estimates suggest there were over 367,000 public sector employees in 2022, implying that teachers and medical staff only account for one-quarter of total public employment.¹¹³ Recent curbs on recruitment may have affected key service delivery sectors. The government target is to reduce civil servants from 2.3 to 1.8 percent of the population (it was 2.8 in 2019). This will likely put pressure on public service delivery, particularly since the commitment does not include jobs outside the personnel information system. Moreover, low average pay (and even volunteering) may undermine staff morale and productivity, particularly given the impact of high inflation on the cost of living.

Materials & supplies

Spending on operations & maintenance is not in line with the needs related to service delivery and the preservation of public assets. Most expenditures in this category pertain to utilities & purchasing and, to a lesser extent, external services (Figure 3.19). Utilities & purchasing includes costs related to fuel, electricity, and water, as well as purchasing of equipment (e.g., pedagogical and medical), uniforms, and office supplies. External services include repairs & maintenance, rental, and telecommunications. Overall, it is concerning that spending in this category has been declining, since it is likely affecting the quality of public services. For instance, limited budgets for teaching materials and medical equipment undermine the provision of education and health services. Moreover, given the fast accumulation of public infrastructure assets, limited provisions for maintenance costs can limit their usage and value.¹¹⁴ Spending

¹¹⁰ It should be noted that IMF data includes some allowances (division 61) in wage expenditure, but not all. Small states tend to have high wage-to-GDP ratios, often above 10 percent of GDP, partly reflecting diseconomies of scale in the provision of public services.

¹¹¹ The wage index, which is used to calculate public sector wages, increased from 1,800 kip in 2005 to 6,700 in 2014, and is currently at 7,350.

¹¹² Around 6,600 were contract staff and 14,500 were volunteers, of which 7,900 were volunteer teachers and 3,000 volunteer medical staff, partly to fill vacancies in remote areas.

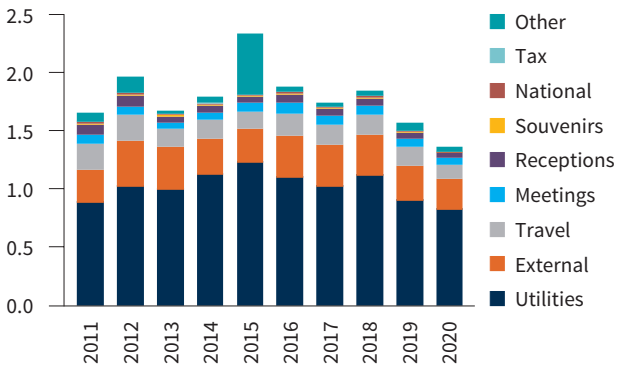
¹¹³ The 2015 Population and Housing Census shows that 347,000 people were government employees, while an additional 38,000 were employed in state enterprises.

¹¹⁴ Increases in capital spending (e.g., construction of public infrastructure) ought to be accompanied by an increase in (related) recurrent costs, to avoid a fast depreciation of the public capital stock and ensure that infrastructure remains fully functional.

on the maintenance of roads and bridges appears to be a fraction of construction and rehabilitation.¹¹⁵ Adequate spending on routine (preventive) maintenance would avert higher costs in the future and sustain service delivery standards, especially owing to existing vulnerabilities to extreme weather events.¹¹⁶

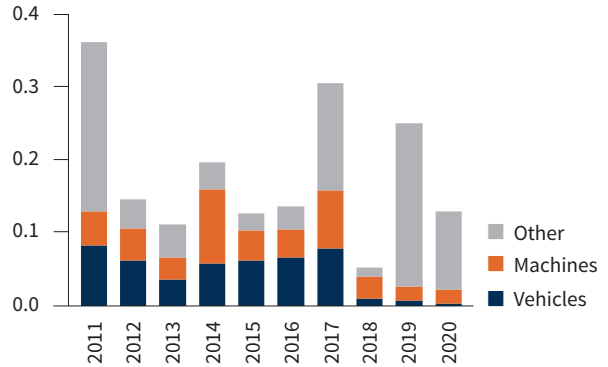
Purchasing of materials is a relatively small category, but it is quite volatile. Spending on materials relates to the purchase of fixed assets for administration (Figure 3.20). Trends show a containment in the purchase of vehicles since 2017 while spending on machines and equipment has also declined. Other fixed assets for administration (e.g., computers and furniture) are often the largest item, although showing significant volatility.

Figure 3.19: Operations & maintenance (% GDP)



Source: MoF and World Bank staff calculations.

Figure 3.20: Purchasing of materials (% GDP)

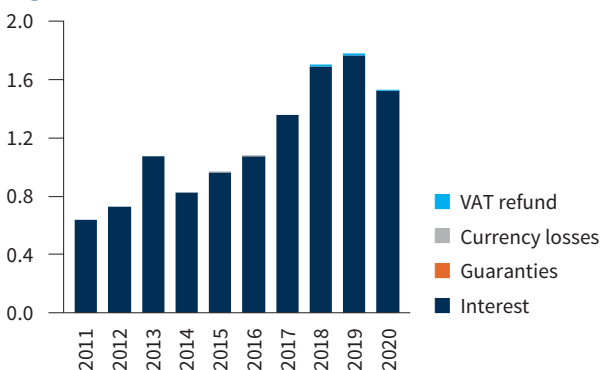


Source: MoF and World Bank staff calculations.

Financial

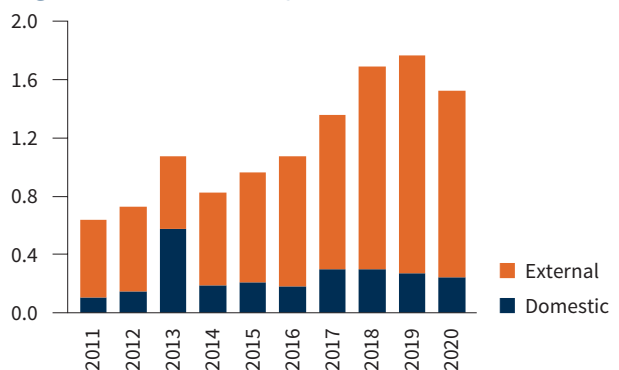
Financial expenses have increased considerably, although recent debt service deferrals have provided temporary relief. Most financial expenditures relate to the payment of interest on the current public debt stock (Figure 3.21). These payments have grown significantly over time.¹¹⁷ This is due to the fast accumulation of public debt, in part to finance large public investments in infrastructure (e.g., power and transport). Most interest payments are related to external debt (Figure 3.22).¹¹⁸ The sharp depreciation of the Lao kip in 2021–2022 has increased the domestic currency value of these payments, although sizable debt service deferrals by China have provided

Figure 3.21: Financial expenditure (% GDP)



Source: MoF and World Bank staff calculations.

Figure 3.22: Interest payments (% GDP)



Source: MoF and World Bank staff calculations.

¹¹⁵ In 2020, spending on maintenance (and minor repairs) of roads and bridges was reported at 500 million kip [62.20.02.05], compared to 807 billion kip for construction [67.80.02/03] and 596 billion kip for rehabilitation [67.90.07.02/03].

¹¹⁶ Public asset databases (e.g., roads, buildings, etc.) that are updated, interconnected, and fed into a performance management system can enhance the planning of routine maintenance and limit the need for emergency maintenance and rehabilitation.

¹¹⁷ Data from the MoF's public debt bulletin implies a value of 1.8 (rather than 1.5) percent of GDP in 2020. The 2020 budget implementation report lists 3.7 trillion kip as 'plan', but only 2.6 trillion as 'actual'. In 2020, debt service deferrals were mainly on principal repayments rather than interest. The discrepancy might be due to a recording issue (e.g., timing).

¹¹⁸ The hike in domestic interest payments in 2013 was linked to short-term borrowing undertaken to pay the large increase in wage expenditure.

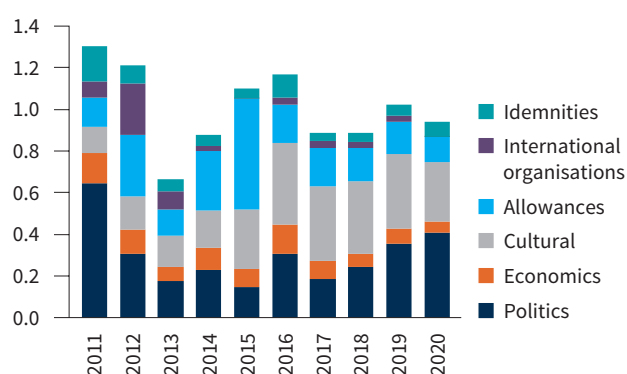


temporary relief, which has accumulated to 8 percent of GDP by the end of 2022. Without debt restructuring, interest payments will lead to a significant reduction in fiscal space and further squeeze the budget available for critical sectors. In the absence of debt deferrals, interest payments would have surpassed the combined spending on education and health in 2022. Financial expenditure (particularly interest payments) is a key driver of budget rigidity, while recent deferrals may come at a (large) cost in the future.

Subsidies & transfers

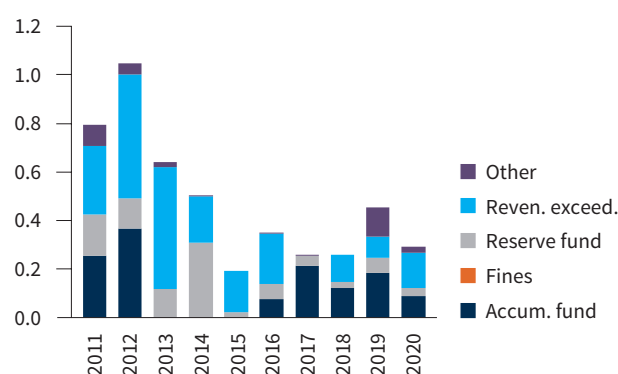
Subsidies & transfers, which mainly relate to political and cultural & social activities, have remained broadly stable. Spending on subsidies & transfers averaged 1 percent of GDP since 2011 (Figure 3.23). This category includes subsidies and transfers related to political activities, economic subsidies (e.g., promotion of goods production), cultural & social activities (e.g., preventive healthcare and education quality), allowances (e.g., technical extension), contributions to international organizations (e.g., membership fees), and indemnities (e.g., natural disasters). In recent years, the allocation for political activities has increased, resulting in a squeeze on cultural & social activities.

Figure 3.23: Subsidies & transfers (% GDP)



Source: Ministry of Finance and World Bank staff calculations.

Figure 3.24: Miscellaneous & contingencies (% GDP)



Source: Ministry of Finance and World Bank staff calculations.

Miscellaneous & contingencies

Spending on miscellaneous & contingencies has declined over time and is relatively small. Miscellaneous categories are typically used for expenses that cannot be mapped to an existing category in the chart of accounts, while contingencies are ‘set asides’ to cover unexpected expenditure needs.¹¹⁹ Spending on miscellaneous & contingencies declined from 1.0 to 0.3 percent of GDP between 2012 and 2020 (Figure 3.24). However, it increased to over 0.6 percent of GDP in 2022. A key component is ‘expenditure for revenue exceeding plan’, which relates to bonus payments for budget units exceeding revenue targets.¹²⁰ The budget law provides for reserve funds to meet contingencies and urgent requirements (e.g., defense, security, mitigation of natural calamities, and epidemics), which comprises contributions to the state accumulation fund, as well as government and local reserve funds.

Capital

There has been a strong focus on public investment, most of which has been funded by external sources. This category is associated with the creation of tangible capital assets. The capital budget is prepared by the Ministry of Planning and Investment, in coordination with line ministries and provinces, and is based on public investment plans (PIPs). As in many East Asian economies, public investment has been seen as a key ingredient for accelerating economic growth, although it should be noted that public investment excludes investments undertaken by SOEs and PPPs.¹²¹ Capital spending has been declining as a share of GDP (Figure 3.25). Most

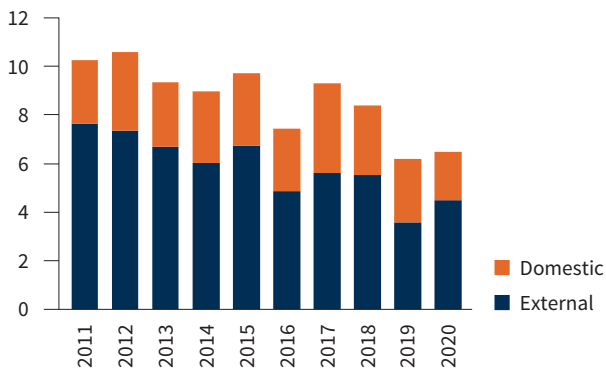
¹¹⁹ High spending on miscellaneous categories may be due to a misuse of the classification or limitations in the chart of accounts.

¹²⁰ Since excess revenue from provinces is often not recorded on time, those amounts are reported under domestic financing (like a cash balance) and expenditure (bonus payment) in the following budget year.

¹²¹ There are concerns that some recurrent spending is likely misclassified as capital spending (particularly if related to donor-executed projects), while this category may also include expenditure arrears (from sub-national investment projects).

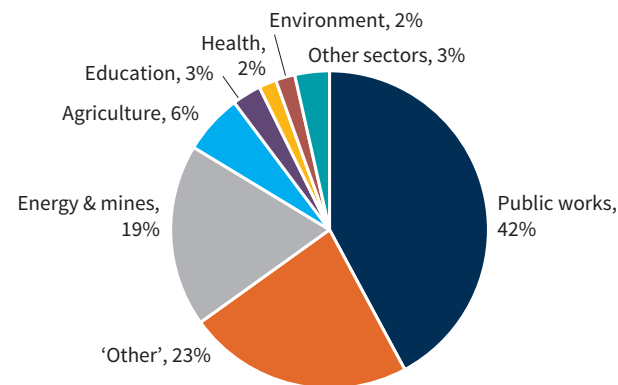
spending is financed externally through grants and loans. In 2020, the public works & transport and energy & mines sectors accounted for 42 and 19 percent of total external capital spending, respectively (Figure 3.26). This implies that most externally funded capital spending is devoted to transport and energy infrastructure. However, investments in several key sectors have lagged, particularly agriculture, education, and health.

Figure 3.25: Capital spending (% GDP)



Source: Ministry of Finance and World Bank staff calculations.

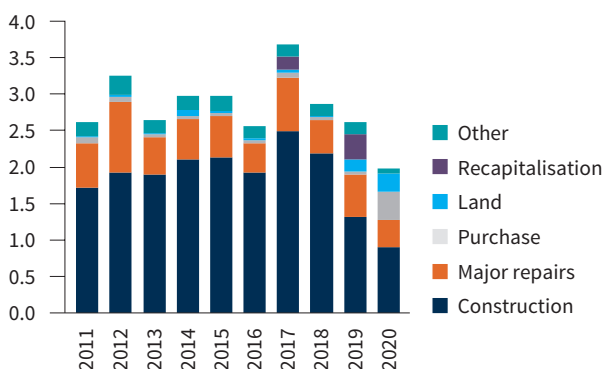
Figure 3.26: External capital spending (% GDP, 2020)



Source: Ministry of Finance and World Bank staff calculations.

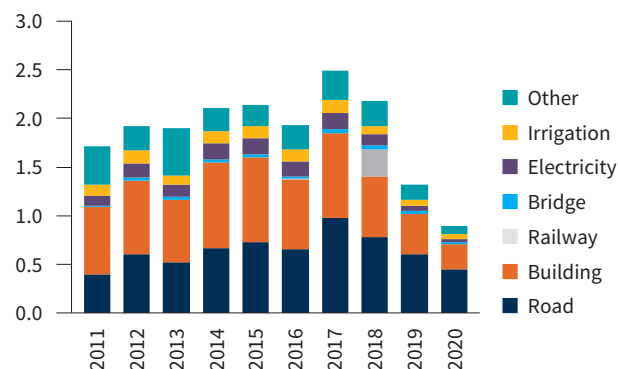
Domestic capital spending has mainly comprised construction expenditure. Although most capital expenditure relates to foreign capital, official data only offers a detailed disaggregation of domestic capital spending. Most of this has been associated with construction expenditures, followed by major repairs – mainly related to roads (Figure 3.27). In recent years, spending on land compensation increased, while there were two SOE recapitalizations and a large purchase of telecom equipment. Most construction expenditures relate to roads and buildings (Figure 3.28). Overall, domestic capital spending has steadily declined during 2017–2022, owing to growing fiscal pressures. A deteriorating fiscal position (underpinned by poor revenue mobilization efforts) has led to recent limits on new capital projects, which will likely further reduce the capital budget.

Figure 3.27: Domestic capital spending (% GDP)



Source: Ministry of Finance and World Bank staff calculations.

Figure 3.28: Construction spending (% GDP)



Source: Ministry of Finance and World Bank staff calculations.

Capital spending is likely underreported due to off-budget projects, but future spending is likely to be constrained. Large expenditure arrears mostly arise from sub-national off-budget investment projects. In 2021, the government issued bonds amounting to nearly 10 trillion kip to clear some of these arrears (5 percent of GDP), while an additional 23 trillion kip are undergoing a verification process. The amounts verified and certified might be cleared through a combination of domestic bond issuances (which increase domestic public debt) and future allocations in the capital budget.¹²² The resources available for new capital projects are limited, owing to the backlog of ongoing projects and potential allocations to clear arrears. This may create an incentive for budgetary units to generate and underreport their own resources. It is therefore important to reassess spending needs and prioritize projects, which may require delaying or even canceling (non-priority) projects.

¹²² In the past, the Ministry of Planning and Investment (MPI) has requested spending units to allocate a significant share of their public investment plan (PIP) allocation to clear arrears (up to 30–35 percent in 2017).

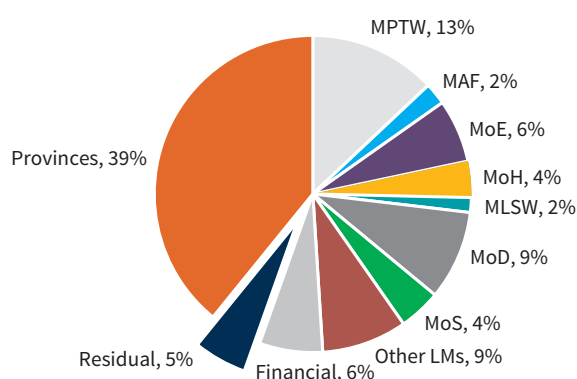


3.2.2 Administrative classification

The assessment of institutional spending over time is made difficult by changes in administrative units and a lack of comprehensive reporting. The administrative classification disaggregates spending by relevant public institutions, such as ministries, other public organizations (e.g., National Assembly), and provinces.¹²³ Changes in government structures have led to some ministries splitting or merging, while some institutions were created or eliminated. For the analysis, adjustments were made to provide consistent insights on key spending units. The focus is on the Ministry of Public Works and Transport (MPWT), Ministry of Energy and Mining (MEM), Ministry of Agriculture and Forestry (MAF), Ministry of Education (MoE), Ministry of Health (MoH), and Ministry of Labor and Social Welfare (MLSW). Moreover, the reporting is not comprehensive, with spending from several important ministries and organizations aggregated and reported in a category called ‘Others’.

Budget transparency has been gradually eroded by the absence of reporting for key ministries and other organizations. In 2005, central government spending was reported for 15 ministries and organizations, accounting for 81 percent of the total at the central level. In 2020, central government spending was reported for 19 ministries and organizations, but those only covered 48 percent of the total. This means that over half of spending at the central level cannot be attributed to a specific spending unit. These values remain high when considering total spending (i.e., including the 18 provinces) and excluding financial expenditure (mainly interest payments, which are made at the central levels but not allocated to a specific administrative unit). While this ‘residual’ accounted for only 5 percent of total spending in 2005, that value increased to nearly 30 percent by 2020 (Figure 3.29 and Figure 3.30).¹²⁴ This significantly undermines budget transparency and the ability to scrutinize the quality of public spending. Moreover, it also undermines decision-making, since it is not clear how unreported data is used in the budget process.

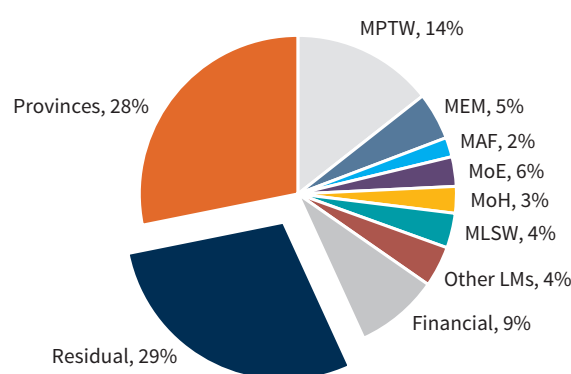
Figure 3.29: Administrative units (% , 2005)



Source: Ministry of Finance and World Bank staff calculations.

Note: ‘Residual’ excludes financial expenditure and relates to ministries and organizations not reported. LM stands for line ministries.

Figure 3.30: Administrative units (% , 2020)



Source: Ministry of Finance and World Bank staff calculations.

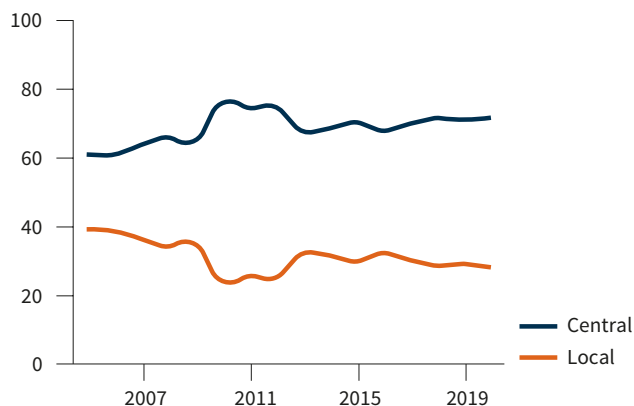
Note: ‘Residual’ excludes financial expenditure and relates to ministries and organizations not reported. LM stands for line ministries.

There is a significant level of fiscal decentralization, with about 30 percent of spending executed at the local level. In 2005, nearly 40 percent of spending was executed at the local level, but that value has gradually declined to 28 percent in 2020 (Figure 3.31). These trends and magnitudes do not change significantly when excluding financial expenses from central spending. Most spending at the local level relates to wages (Figure 3.32). Capital spending is predominantly executed at the central level, partly because foreign-financed projects are recorded and managed at the central level. Provinces only execute domestically-financed capital projects. Additional decentralization of budget responsibilities and plans for self-sufficient units may contribute to further institutional fragmentation and should be carefully considered.

¹²³ In this report, the term ‘provinces’ includes the Vientiane Capital prefecture.

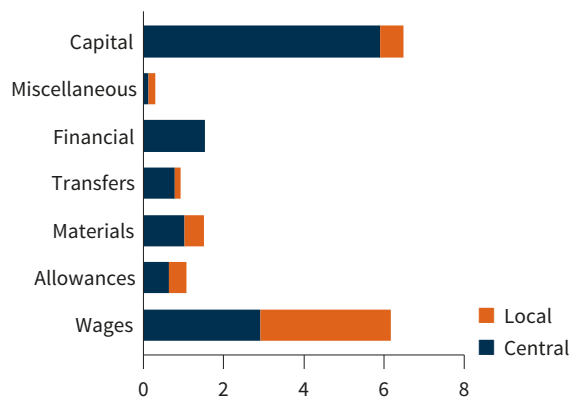
¹²⁴ In 2020, ‘residual’ spending (i.e., ‘others’ excluding financial expenditure) accounted for 40 percent at the central level. At the local level, spending is reported by sector for each province, but 38 percent cannot be allocated to a specific sector.

Figure 3.31: Expenditure by level (% total)



Source: Ministry of Finance and World Bank staff calculations.

Figure 3.32: Expenditure by level (% total, 2020)



Source: Ministry of Finance and World Bank staff calculations.

At the central level, most spending is not reported for individual ministries or organizations. In 2005, about 21 percent of spending at the central level was undertaken by the Ministry of Public Works and Transport, followed by the Ministry of Defence (15 percent), Ministry of Education (11 percent), Ministry of Public Security (7 percent), and Ministry of Health (6 percent) (Table 3.2). From 2006 onwards, spending was no longer reported for the Ministry of Defence and the Ministry of Public Security, likely included in the category ‘Organizations and administrative office’ (admin.) from 2006 until 2015, and then in ‘Others’ from 2016–2020. Over 50 percent of spending at the central level is unallocated to a specific ministry or other public organization, although 12 percent of this can be attributed to financial expenditure (mostly interest payments) executed through the Ministry of Finance, even if it is not part of their budget.

Table 3.2: Expenditure (% central level)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
‘Residual’	9	11	12	20	18	57	33	13	17	24	27	48	33	31	34	40
Admin.	2	26	24	23	30	22	21	21	27	27	24	..	..	..	..	..
MoD	15	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..
MoS	7	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..
MPWT	21	27	25	15	14	5	9	28	17	14	12	13	17	13	17	20
MEM	..	..	1	3	0	0	0	1	1	1	1	1	10	16	3	7
MoE	11	17	16	9	8	2	9	8	7	7	5	7	6	7	6	4
MoH	6	1	1	2	7	1	8	2	4	5	6	6	6	4	5	4
MLSW	2	2	3	3	4	2	4	2	5	5	4	5	4	4	6	5
MAF	4	4	4	5	3	1	3	4	7	3	3	3	5	4	6	3
Other LMs	12	5	9	15	11	6	8	16	10	9	10	9	10	9	8	6
Financial	11	8	5	6	5	4	4	4	7	5	6	8	9	11	13	12

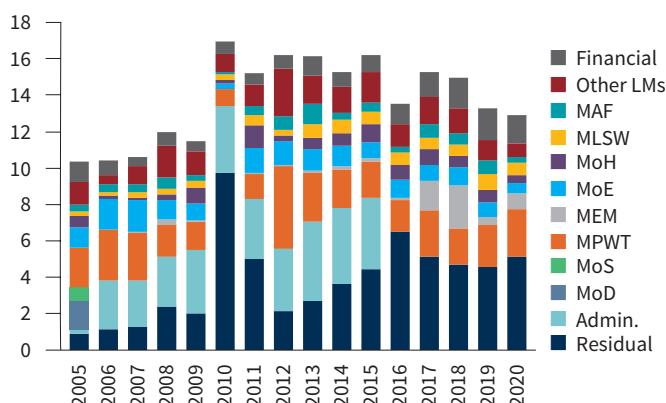
Source: World Bank staff calculations.

Note: ‘Residual’ excludes financial expenditure (i.e., interest payments), which is not allocated to a specific spending unit. Data from 2005 to 2016 relates to a different fiscal year (October to September).

The proportion of central government spending allocated to social ministries is very limited. Despite some volatility, the Ministry of Public Works and Transport remains the main spending unit reported at the central level (Figure 3.33). The Ministry of Energy and Mines had significant allocations in 2017 and 2018, while the Ministry of Agriculture and Forestry averaged 0.5 percent of GDP in 2013–2020. The combined spending of the Ministry of Education and Ministry of Health (at the central level) has gradually declined from 1.9 to 1.0 percent of GDP between 2015 and 2020. Apart from capital spending executed by the Ministry of Public Works and Transport and the Ministry of Energy and Mines, most other spending is not allocated to a specific spending unit (Figure 3.34). The large proportion of wages in ‘residual’ may include wages for general administration, police, army, and the party – if these are mostly paid at the central level.

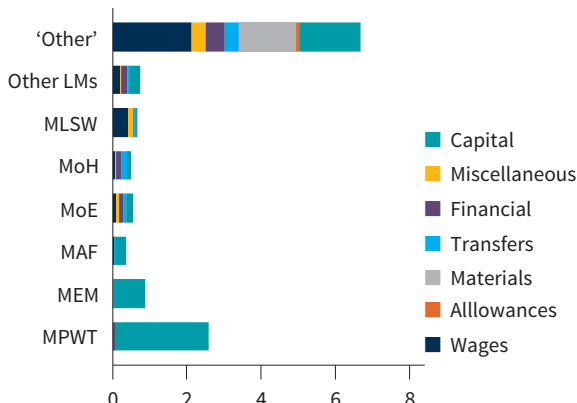


Figure 3.33: Central spending (% GDP)



Source: Ministry of Finance and World Bank staff calculations.

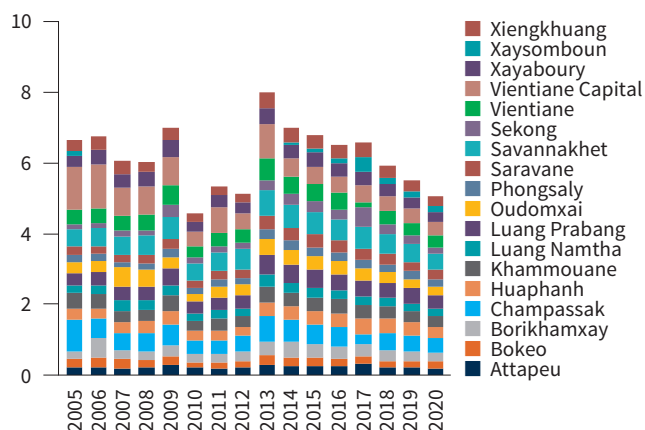
Figure 3.34: Central spending (% GDP, 2020)



Source: Ministry of Finance and World Bank staff calculations.

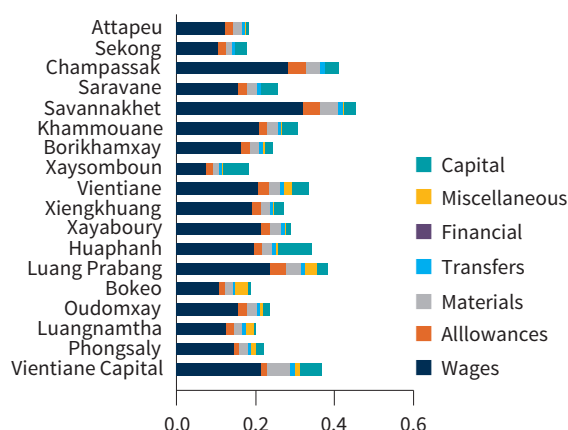
Spending levels vary significantly across provinces, but budget allocations do not seem to reflect specific needs. The hike in overall spending in 2013 and its subsequent decline are also noticeable at the sub-national level (Figure 3.35). No province stands out significantly in terms of spending, although Vientiane Capital did account for a disproportionately large share until 2013. In 2020, spending ranged from 0.18 percent of GDP in Sekong to 0.45 percent of GDP in Savannakhet (Figure 3.36). In per capita terms, it ranged from about 66,500 kip in Vientiane Capital to 2,900,000 kip in Xaysomboun. Most spending relates to wages. Budget allocations appear to be predominantly based on political decisions, rather than following a predefined formula (e.g., based on population, land area, poverty levels, or spending capacity). There is no evidence of targeting. Budget execution may not always follow the declared priorities of the central government, since the (functional) allocation of the provincial budgetary resources is flexible.

Figure 3.35: Local spending (% GDP)



Source: Ministry of Finance and World Bank staff calculations.

Figure 3.36: Local spending (% GDP, 2020)



Source: Ministry of Finance and World Bank staff calculations.

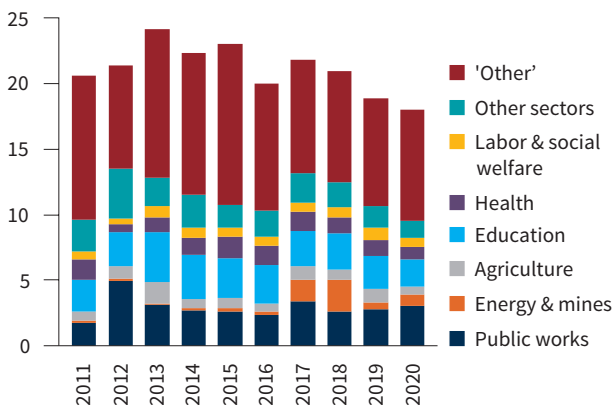
Despite the lack of a functional classification, existing data suggests that spending on the social sectors is very limited. A functional classification consolidates spending in key areas of interest (i.e., sectors), which is particularly pertinent for policy making. The administrative classification does not accurately map spending into typical sectors, as relevant spending can be undertaken across several administrative units (e.g., ministries). Hence, the absence of a functional classification makes it difficult to reliably track total spending on education and health.¹²⁵ Nonetheless, available data suggests that spending on critical social sectors is limited (Figure 3.37).¹²⁶ For instance, the combined

¹²⁵ Spending on these sectors could potentially be underestimated if significant education and health expenditures are undertaken by unrelated spending units. The classification of the functions of government (COFOG) classifies government expenditure into ten categories: general public services; defense; public order and safety; economic affairs; environmental protection; housing and community affairs; health; recreation, culture and religion; education; and social protection.

¹²⁶ In the state budget implementation reports, spending by sector comprises central government spending by ministry and related sub-national spending. For instance, the education sector comprises the Ministry of Education (central level) as well as provincial and district education offices (local level).

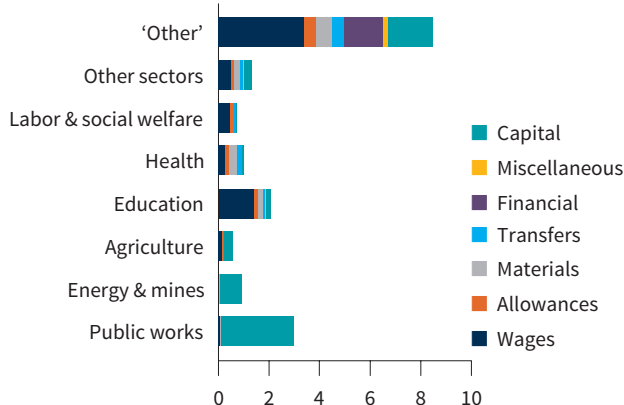
spending on education and health declined from 4.9 to 2.6 percent of GDP between 2013 and 2022, and is now one of the lowest levels in the region and the world (e.g., the combined average in ASEAN countries is nearly 6 percent). It is important to develop a functional classification that is built bottom-up (by program and activity) rather than top-down (by institution) to provide a more accurate representation of spending. In addition to financial expenditure, a large proportion of wage and capital spending is not allocated to a specific sector (Figure 3.38).

Figure 3.37: Expenditure by sector (% GDP)



Source: Ministry of Finance and World Bank staff calculations.
 Note: 'Other' is the difference between total spending and the aggregated spending of all sectors reported.

Figure 3.38: Expenditure by sector (% GDP, 2020)

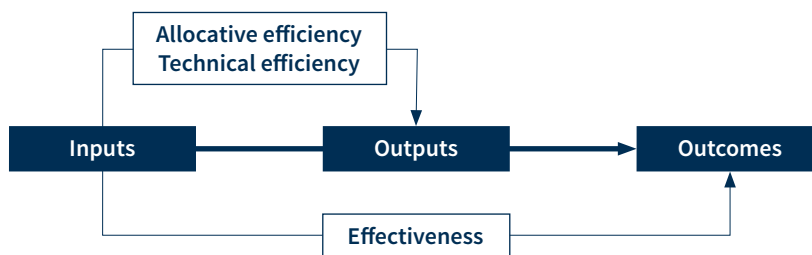


Source: Ministry of Finance and World Bank staff calculations.
 Note: 'Other' is the difference between total spending and the aggregated spending of all sectors reported.

3.3 Quality of spending

Assessing the efficiency, effectiveness, and equity of public spending suggests that the use of budget resources can be improved. Improving the efficiency and effectiveness of government spending is key to ensuring that public resources have a strong impact on service delivery. For this, it is essential to evaluate how spending units translate their budgets into physical inputs (e.g., staff and infrastructure), then into outputs (e.g., years of schooling or outpatient visits), and finally into outcomes (e.g., test scores and child survival rates). Efficiency analysis evaluates how inputs translate into outputs, while effectiveness relates to how inputs translate into outcomes (Figure 3.39). Moreover, it is also important to consider the distributional impact of spending (to promote shared prosperity) and reflect on the future demand for basic public services.

Figure 3.39: Efficiency and effectiveness



Source: World Bank staff.

3.3.1 Efficiency

Given the mounting fiscal pressures, it is crucial to enhance the efficiency of public spending. The concept of efficiency relates to how inputs translate into outputs, and often includes two sub-dimensions: (i) allocative efficiency, which evaluates whether the distribution of inputs (both across and within sectors) is conducive to achieving desired outputs; and (ii) technical efficiency, which assesses whether a certain output is achieved with the least possible amount of inputs.¹²⁷ Identifying sources of inefficiency is key to ensuring that scarce public

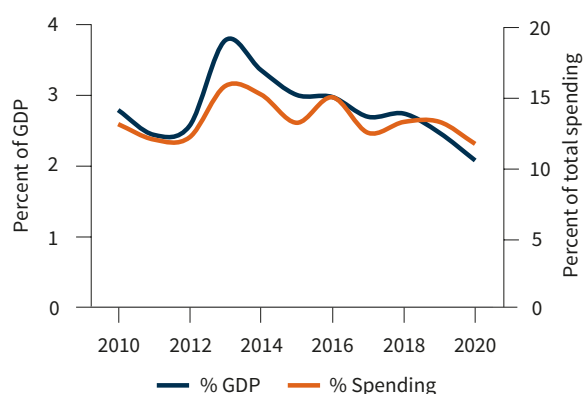
¹²⁷ Efficiency entails consistency of aggregate spending allocations (across and within sectors) with policy priorities and cost minimization.



resources are not wasted. Given fiscal constraints, it is pertinent to uncover potential savings to create fiscal space for more productive spending. In fact, recent research suggests that governments can reduce income inequality by simply changing the composition of public spending while keeping total expenditure constant.¹²⁸

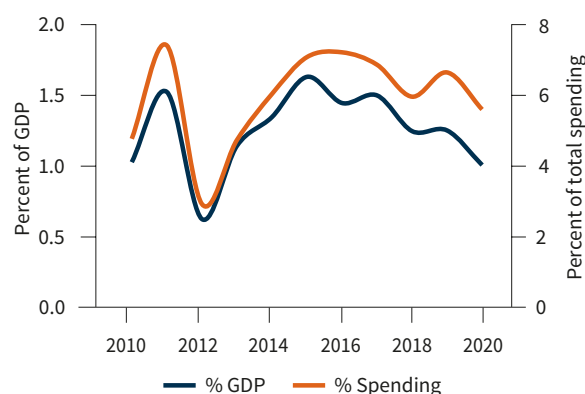
The allocation of budgetary resources can be considerably improved, particularly when considering stated policy objectives. The Ninth National Socio-Economic Development Plan (NSEDP), which covers the period 2021–2025, is an ambitious plan to realize the government’s medium-term vision for the country. The NSEDP outlines six outcomes related to economic, human capital, well-being, environment, integration and connectivity, and governance dimensions.¹²⁹ However, development spending has been under pressure from declining revenues and rising debt service obligations, jeopardizing spending adequacy. Moreover, budgetary resources do not seem fully aligned with policy priorities. For instance, public spending has declined for sectors directly influencing human capital outcomes, both as a share of the total budget and as a share of GDP (Figure 3.40 and Figure 3.41). A renewed focus on the social sectors will likely require budget increases across different spending categories (e.g., wages, goods & services, and capital). If this additional spending cannot be financed through stronger revenue mobilization, then spending on ‘others’ (i.e., unreported sectors) should be deprioritized, particularly since it is unclear how these expenditures are contributing to stated socioeconomic objectives.

Figure 3.40: Allocative efficiency (education)



Source: Ministry of Finance and World Bank staff calculations.

Figure 3.41: Allocative efficiency (health)



Source: Ministry of Finance and World Bank staff calculations.

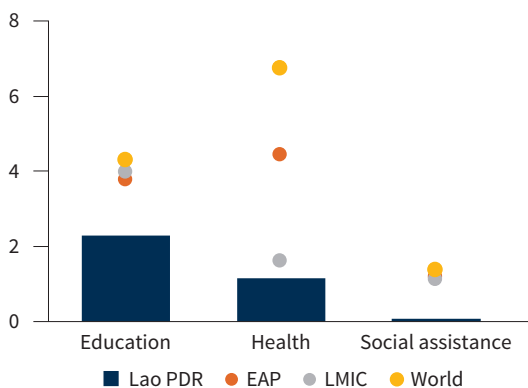
The lack of prioritization of the social sectors is concerning, particularly given the impacts of COVID-19 on learning and health outcomes, and it is undermining public service delivery. Public spending on education, health, and social assistance is very low by regional and income standards (Figure 3.42). It is also considerably below international benchmarks. For instance, the Education 2030 Framework for Action recommends that governments allocate between 4 to 6 percent of GDP and 15 to 20 percent of their budgets to education. While the government has committed to achieve an education spending target of 18 percent of the total budget, the current value is only around 13 percent. Meanwhile, development spending is being squeezed by poor revenue mobilization and rising interest payments. The combined spending on education and health declined from 4.9 to 2.6 percent of GDP during 2013–2022, which would have been less than interest payments in the absence of large debt service deferrals (Figure 3.43). Reprioritizing public spending toward education, health, and social protection would help ensure that scarce fiscal resources are allocated efficiently in the pursuit of stated policy objectives. Rebuilding human capital is critical to improving medium-term growth prospects, as well as reducing poverty and inequality. The allocation of spending within sectors (internal efficiency of spending) and the technical efficiency of spending are also important, but they are beyond the scope of this Public Finance Review.¹³⁰

¹²⁸ See the IMF report "Reallocating Public Spending to Reduce Income Inequality: Can It Work?"

¹²⁹ The NSEDP identifies six priority outcomes: (i) continuous quality, stable and sustainable economic growth; (ii) improved quality of human resources; (iii) enhanced well-being of the people; (iv) enhanced environmental protection and reduced disaster risks; (v) engagement in regional and international cooperation and integration through robust infrastructure and effective utilization of national potentials and geographical advantages; and (vi) public governance and administration. The lack of a functional classification makes it difficult to compare spending with stated government priorities.

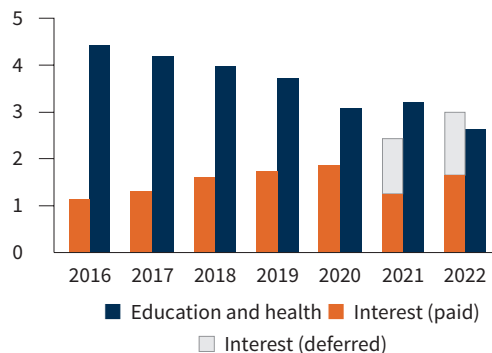
¹³⁰ For a detailed analysis on the education sector, see the World Bank’s report "Preventing a Lost Decade in Education in the Lao PDR".

Figure 3.42: Spending on social sectors (% GDP, 2020)



Source: World Bank and staff calculations.

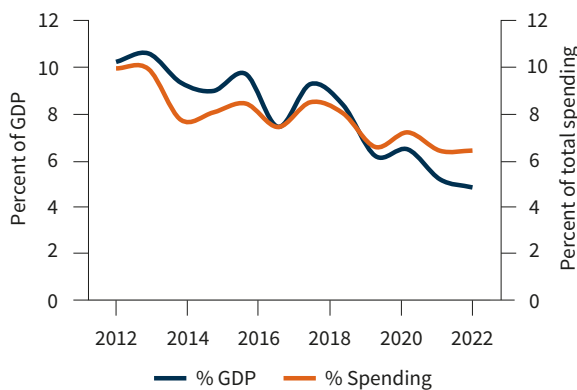
Figure 3.43: Spending on social sectors and interest (% GDP)



Source: Ministry of Finance and World Bank staff calculations.

Infrastructure development remains a key policy priority despite a gradual decline in capital spending. An important policy challenge is to ensure that the composition of spending is efficient, from an allocative point of view, to yield maximum economic and social benefits. The construction of public assets (e.g., transport) can generate considerable gains, especially in countries with large infrastructure gaps. Capital spending has steadily decreased as a share of GDP and as a share of total spending, even if it remains high by international standards (Figure 3.44).¹³¹ This decline has been partly due to growing fiscal pressures, stemming from lower revenue collection and rising interest payments. However, there has been a strong focus on public-private partnerships, initially in hydropower but more recently on transport infrastructure, which masks the full involvement of the public sector in infrastructure development.¹³² Nonetheless, without strong investments in human capital, the return on physical capital investments will likely be limited. This may require a rebalancing from the prevalent focus on large-scale infrastructure toward more selective and impactful spending. Hence, there is a need to prioritize projects with high socioeconomic returns. Higher selectivity with a focus on impact should also be the criteria for selecting PPPs.

Figure 3.44: Allocative efficiency (capital)



Source: Ministry of Finance and World Bank staff calculations.

¹³¹ However, capital spending is likely underreported due to off-budget projects.

¹³² PPPs can be seen as frontloading of capital spending, since the private sector typically provides the initial financing that is subsequently paid for by the government or end-users.

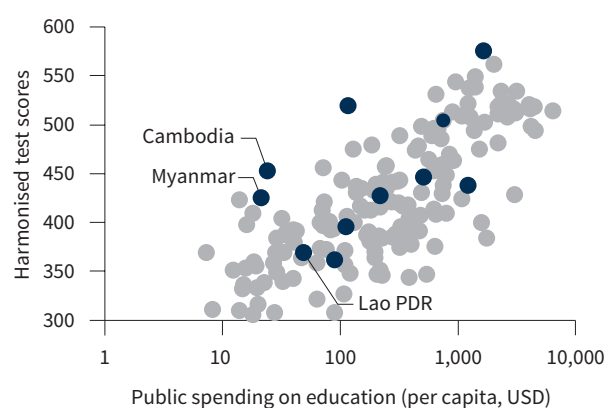


3.3.2 Effectiveness

Assessing the effectiveness of public spending is vital to ensure that the use of public resources achieves desired impacts. Measures of spending effectiveness evaluate how inputs translate into outcomes (i.e., the attainment of intended objectives). At the aggregate level, fiscal multipliers can provide insights into the extent to which fiscal policy is effective in stimulating economic activity. At the sectoral level, basic tools can be used to evaluate how inputs (i.e., spending) translate into outcomes (e.g., learning and healthy living).

While it is critical to allocate additional resources to the education and health sectors, the effectiveness of public spending also needs to be enhanced. Public spending on education is low by international standards (Figure 3.45). However, mobilizing additional resources will not be sufficient to significantly improve outcomes. There is also a need to enhance the effectiveness of spending. For instance, Cambodia and Myanmar spent less on education in per capita terms during 2010–2019, but had better outcomes as measured by harmonized test scores. Public spending on health is also low by global standards, albeit not to the same extent as education (Figure 3.46). Spending effectiveness can also be improved in the health sector. Cambodia allocated a similar amount of resources per capita during 2010–2019, but had significantly better outcomes as measured by the probability of survival to age 5, while Myanmar had similar outcomes with less spending. Given expenditure levels per capita, better education and health outcomes could be achieved.

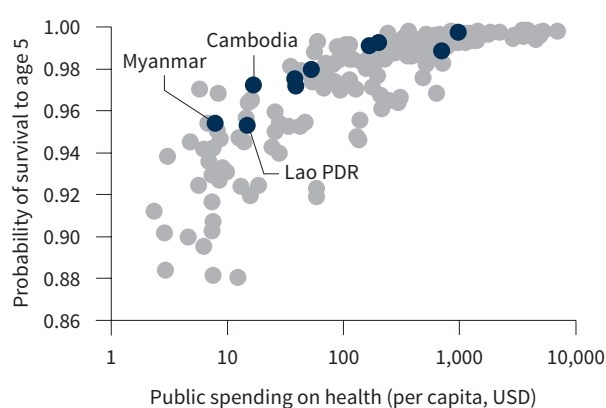
Figure 3.45: Spending effectiveness (education)



Source: World Bank and staff calculations.

Note: Latest data and average spending for 2010–19.

Figure 3.46: Spending effectiveness (health)



Source: World Bank and staff calculations.

Note: Latest data and average spending for 2010–19.

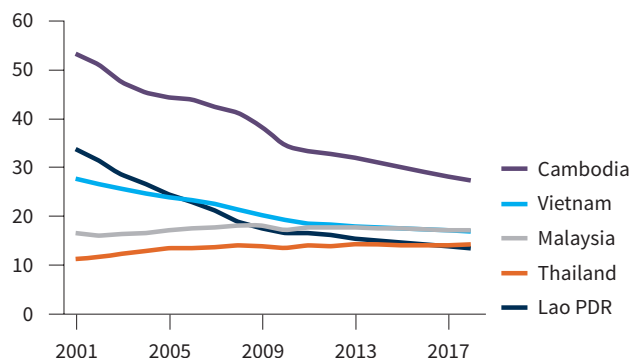
The rate of return on public capital has been relatively strong, but public investment management can be improved. Economic theory postulates a strong relationship between capital spending and economic growth. Public spending can engender an endogenous process of (private) capital accumulation, productivity growth, and economic dynamism required to accelerate and sustain economic growth.¹³³ The rate of return on capital (RoRK) measures the change in output brought about by a unit change in the capital stock. The return on total (public and private) capital has declined over time and is now below many regional peers (Figure 3.47). However, the return on public capital has been relatively strong, albeit mostly financed by external borrowing (Figure 3.48).¹³⁴ Nonetheless, there remains considerable scope for improving public investment management through a more judicious assessment of needs, particularly given existing fiscal pressures.¹³⁵ Overall, the selection of future investment projects (including public-private partnership projects) should rely on robust cost-benefit analysis and prioritize growth-enhancing cost-effective infrastructure. This is key to ensuring that public expenditure addresses supply-side constraints and supports medium-term economic growth.

¹³³ The lack of information on externally-financed capital spending undermines a more in-depth assessment (e.g., effectiveness of road spending). Nonetheless, while the road network has expanded (closing gaps in remote areas and lack of all-weather roads), there are growing concerns about quality, owing to inadequate maintenance and a bias toward large projects.

¹³⁴ The capital stock is estimated through the perpetual inventory method, with initial capital calculated through two methods: (1) initial-year gross fixed capital formation, and (2) ‘rule of thumb’ for capital output ratio. See the World Bank’s Rate of Return to Capital (RoRK) tool.

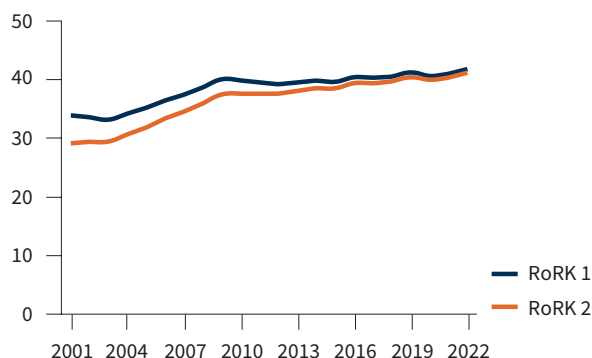
¹³⁵ Lao PDR ranked 65th (out of 71 low- and middle-income countries) in a Public Investment Management Index produced by the IMF. See “Investing in Public Investment: An Index of Public Investment Efficiency.”

Figure 3.47: Rate of return on total capital (p.p.)



Source: World Bank and staff calculations.
Note: p.p. stands for percentage points.

Figure 3.48: Rate of return on public capital (p.p.)



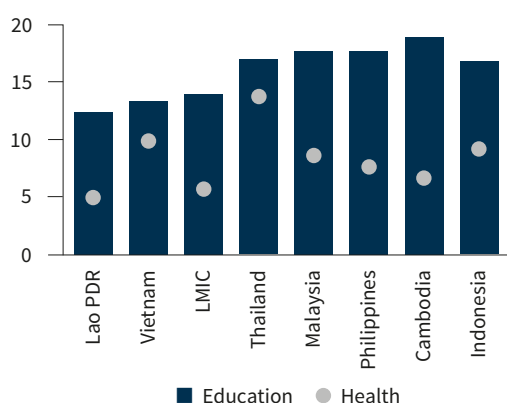
Source: Ministry of Finance and World Bank staff calculations.
Note: p.p. stands for percentage points.

3.3.3 Equity

The impact of public spending on poverty and inequality is limited owing to the low levels of social spending.

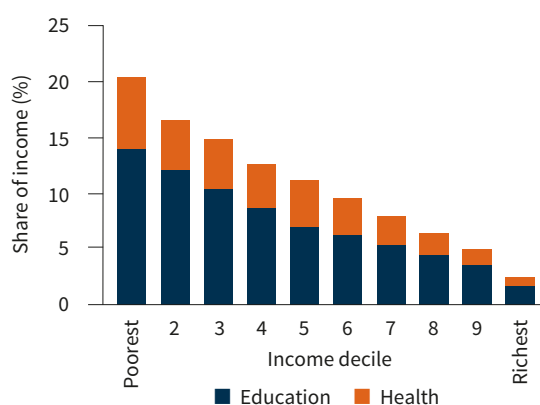
Fiscal policy is often deployed to stabilize the economy (e.g., cushion the impact of shocks), support economic growth, and reduce poverty and inequality. Scrutinizing the distributional impact of public spending is key to a better understanding of the latter.¹³⁶ Among lower-middle-income countries (LMICs) with available data, the Lao PDR ranked 16th out of 20 countries in terms of the inequality-reducing effect of the fiscal system and 15th out of 18 countries in terms of the poverty-reducing effect. Low levels of social assistance transfers do not provide sufficient income support to poor households to help them escape poverty or protect them from falling into poverty. During 2018–2021, despite the need to safeguard the poor and vulnerable during COVID-19, social assistance accounted for less than 0.1 percent of GDP. This is well below the spending levels in Cambodia (0.9 percent in 2015), Vietnam (1.6 percent during 2015–2016), and Thailand (1.6 percent during 2018–2020). Spending on education and health are also low compared to regional and income peers (Figure 3.49). While richer households tend to benefit more from public spending on health and education, due to different utilization rates and service types, the benefit represents a greater share of income for poorer households (Figure 3.50). The recent declines in health and education spending have, therefore, worsened inequality.

Figure 3.49: Education and health (% public expenditure, 2019)



Source: World Bank.

Figure 3.50: Incidence of spending



Source: World Bank staff calculations based on the Commitment to Equity Framework 2018.

Stronger investments in lagging regions would support greater equity in education and health outcomes.

There are significant spatial disparities in terms of inputs, outputs, and outcomes within the country. This is particularly evident regarding access to (and quality of) public services and socioeconomic outcomes. Aligning sub-national spending to existing needs can therefore enhance equity in economic and social outcomes. For instance,

¹³⁶ See the World Bank's report "Raising the Bar: Towards an Equitable and Inclusive Fiscal Policy". The report conducts an analysis using the Commitment to Equity (CEQ) methodology.



budget allocations to provinces and districts could follow a formula comprising key dimensions (such as population, land area, poverty levels, and spending capacity) to enhance the spatial efficiency and effectiveness of spending. The 2025 Population and Housing Census presents a major opportunity to collect and use geospatial data for public service delivery. Since dwellings and basic public services will be geographically tagged (e.g., schools and health centers will be referenced by location), several tools can be then deployed to support planning and budgeting processes – and thus the quality of spending.¹³⁷

3.3.4 Sustainability

Demand for public services will likely increase due to demographic, epidemiological, and income factors. Demographic and epidemiological trends are expected to raise the demand for public services. A demographic transition tends to raise the demand for education, placing pressure on the education system.¹³⁸ A rising burden of non-communicable diseases places pressure on health systems to adapt and provide prevention and treatment services. Moreover, public expenditure levels (as a share of GDP) tend to increase with a country's income level. This is partly because citizens demand more and better public services, such as higher education, specialized health services, and pensions. In the absence of additional resources, the quality of public service delivery can be expected to deteriorate.

Financing transitions will place further pressure on the budget, especially given poor domestic revenue performance. The Lao PDR graduated from the World Bank's low-income country (LIC) group in 2011 and is scheduled to graduate from the United Nations' Least Developed Country (LDC) category in 2026. As income levels increase, financial assistance from development partners tends to decline, at least in relative terms. Financing transitions, particularly in the education and health sectors, may thus reduce the availability of external resources and increase budget pressures, which are already strained by poor revenue performance and rising debt service obligations. Declining development assistance would need to be offset by domestic financing sources to maintain the same level of spending. Nonetheless, it is equally important to improve the efficiency and effectiveness of public spending. A reprioritization of the overall state budget could yield more human and physical resources for the social sectors without impacting fiscal sustainability.

3.4 Public financial management

Public financial management has gradually improved over time, but significant challenges remain. The 2018 Public Expenditure and Financial Accountability (PEFA) assessment identifies key strengths and weaknesses of the public financial management (PFM) system (see Annex, Figure 3.54). Emerging strengths include a more solid treasury and cash management system at the central level, and the increasing automation and integration of PFM processes (e.g., tax). Weaknesses are linked to the limited credibility of the budget (as an instrument to achieve policy objectives), lack of a medium-term perspective on budgeting, and weak links between strategic development plans, sector plans, and annual budget allocations. Budget monitoring is hampered by the manual consolidation of expenditures below provincial level and the absence of systems to track resources available at the service delivery level. The absence of a unified chart of accounts to track expenditures by functional classification hinders informed decision-making. Fiscal data consolidated by the National Treasury relies on manual processes that may affect reliability. The Government Financial Information System (GFIS) has limited coverage and functions, which affects timely and comprehensive budget execution reporting. The internal and external audit functions are not sufficiently resourced to mitigate the control weaknesses identified.

Improving public financial management systems would help enhance aggregate discipline, strategic allocation of resources, and efficient service delivery. Sound public financial management systems are essential to support domestic revenue collection and more sustainable and effective public expenditure. The weak fiscal position, accumulation of public debt, and emergence of expenditure arrears imply there is significant scope to improve public financial management. Improvements are needed along the entire budget cycle

¹³⁷ See the World Bank's Public Expenditure Review for Timor-Leste (chapter 6 on Digital Information).

¹³⁸ Lao PDR has one of the youngest populations in the region (60 percent of the population were under 25 in 2015). However, seizing a demographic dividend requires a healthy and educated labor force. Investments in education and health can support a more productive workforce and thus enhance economic growth. Recent phone surveys conducted by the World Bank show that households are cutting back on education and health spending as they cope with high inflation. The rising level of school dropouts is a growing concern.

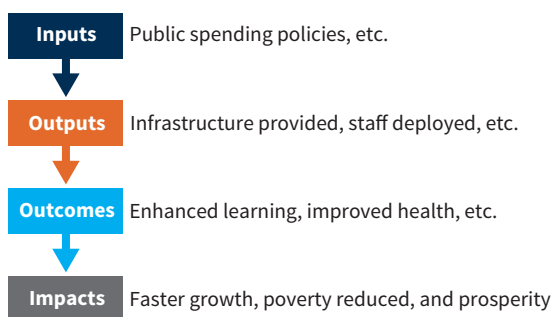
(Figure 3.51). There is a need for a more credible fiscal envelope, strengthening the medium-term perspective, adherence to budget ceilings, continuing the implementation of a Treasury Single Account, improving core government systems, implementing the revised chart of accounts, publishing timely and accurate budget information, and strengthening the capacities of the State Audit Organization and the National Assembly. Ensuring that planning and budgeting processes are results-based is key to accelerating economic growth and reducing poverty and inequality (Figure 3.52).

Figure 3.51: Main phases of the budget cycle



Source: World Bank staff.

Figure 3.52: Results-driven planning and budgeting



Source: World Bank staff.

Implementing the Decree on State Budget Planning would help enhance the quality of public spending. To implement key provisions of the 2015 State Budget Law (revised in 2021) and improve the budget formulation process, the MoF began to develop a Prime Minister’s Decree on State Budget Planning in early 2020. The decree mandates the use of a State Budget Policy Statement as a driver of the budget planning process.¹³⁹ It defines the budget timelines and processes, as well as the responsibilities of relevant parties (notably MPI and MoF, responsible for the capital and recurrent budget, respectively) to ensure the submission of a credible state budget. The decree requires the government to issue ceilings for the next budget and indicative allocations for two outer years for the budget units (including ministries and provinces) to prepare their medium-term budget plans. The successful implementation of the decree would contribute to improving the efficiency and effectiveness of public spending.

Implementing the new Financial Management Information System would help strengthen spending controls. The existing GFIS is limited in its capability to provide the technological backbone of a core Financial Management Information System (FMIS). The GFIS covers only a subset of functionalities required for a fully functioning budget execution system, since bank reconciliation is not yet in place and district offices are not included in its coverage. The GFIS has no commitment control function. In its absence, government entities enter into commitments without confirmation of budget availability, which results in payment arrears. There is no interface for data exchange between GFIS and other government systems.¹⁴⁰ The implementation of the new FMIS, based on a revised chart of accounts, is expected to provide comprehensive and timely data for planning, monitoring, and decision-making. It will help strengthen spending controls (and thus minimize the accumulation of arrears) and improve the comprehensiveness and reliability of the government’s financial statements.

Modernizing human resources management would help strengthen strategic decision-making and wage bill controls. The wage bill accounts for a very large share of recurrent spending. Improving human resource management, which requires comprehensive information on civil service headcount and composition, is critical to enhance public service delivery. The government’s ability to manage human resources is hampered by a Personnel Information Management System (PIMS) that has considerable limitations. The PIMS is estimated to cover less than 25 percent of the public sector workforce, as major employers (e.g., police and armed forces) and employment regimes (e.g., contract and casual workers) are outside the system. The PIMS also has limited functionalities in key areas such as recruitment, performance appraisal, and training. Moreover, its architecture cannot be extended to

¹³⁹ The State Budget Policy Statement comprises five sections: (i) macroeconomic projections; (ii) five-year rolling fiscal framework; (iii) rolling medium-term state budget; (iv) annual state budget plan; and (v) fiscal risks.

¹⁴⁰ Other key information systems include the Automated System for Customs Data (ASYCUDA) of the Customs Department, the Tax Revenue Information System (TaxRIS) of the Tax Department, the Debt Management and Financial Analysis System (DMFAS) of the Public Debt Management Department, and the Personnel Information Management System (PIMS).



become a modern solution that goes beyond a recording system to one of engagement, analytics, and innovation. Adopting a new human resource management information system with expanded coverage and functionalities would help reduce costs for employee management and preparation of payrolls, while supporting planning and rightsizing. Professionalizing the civil service through a shift from personnel administration to talent management would also be important.

Implementing a Treasury Single Account would improve cash management, modernize treasury operations, and help minimize borrowing costs. The transition toward a Treasury Single Account (TSA) is incomplete. While the Bank of the Lao PDR (BoL) and commercial banks provide daily information on the balances of all accounts under the control of the National Treasury, these are not consolidated in a single account at the end of each day. In addition, some earmarked fund accounts and all donor fund accounts are kept outside the TSA. Consequently, the National Treasury is working on a weekly cash cycle, resulting in cash rationing (including delays in salary payments) and taking on expensive short-term borrowing.¹⁴¹ The implementation of a TSA will improve cash management, modernize treasury operations, and help minimize borrowing costs by preventing cash shortages and making better use of idle balances.¹⁴²

Scrutinizing and publishing the reports of the State Audit Organization would enhance transparency and accountability. Comprehensive and reliable external audits are essential for promoting transparency and accountability in the use of public funds. The government's annual financial reports are submitted to the State Audit Organization (SAO), which then submits a report to the National Assembly. The president of the SAO makes a formal presentation of the main conclusions and recommendations, which is broadcast and disseminated. However, there are no in-depth hearings of the SAO findings by the National Assembly, and when the SAO report is presented, the National Assembly does not summon the representatives of the audited agencies whose findings have been highlighted. In addition, the reports are not published on the SAO website and are not publicly available. SAO reports should be scrutinized by the National Assembly and published to enhance transparency and accountability.

Promoting transparent competition in public procurement would improve spending efficiency. Open, transparent, and fair procurement processes can ensure an efficient use of public resources, especially since this is an area often prone to abuse. While the legal framework for public procurement has been strengthened, its implementation is limited, and capacities are weak.¹⁴³ The 2017 Law on Public Procurement provides the foundation for public procurement. An implementing instruction was adopted in 2019, tools were developed (such as a procurement manual, standard bidding documents, templates, and procedures for complaint handling), and capacity building was provided. However, there is no data on the application of the various procurement methods stipulated in the law. Hence, the implementation of the law is not systematically monitored, thereby providing opportunities for using procedures outside the law. Establishing a mechanism to collect and disclose information, and to monitor and enforce the implementation of the law in procurement operations by government entities, is important to enhance competition and reduce inefficiencies.

Improving public investment management is essential to enhance the quality and impact of government spending. Public investment management suffers from limitations in planning capacity, inadequate application of pre-feasibility and selection criteria, incomplete costings, and fragmented implementation monitoring.¹⁴⁴ Detailed guidelines are available at the central level, but the management of public investments is decentralized to line ministries and provinces, with no standardized quality assurance for evaluations and no pre-feasibility studies. Setting up a centralized and robust public investment management monitoring system will be crucial. Meanwhile, government line ministries and provinces should follow their five-year investment budget plans as a reference for infrastructure development. It is also fundamental to clearly allocate responsibilities for investment decisions and enhance transparency in decision-making, including for public-private partnerships. Given existing fiscal pressures, prioritizing infrastructure projects with high economic and social returns (and financing these at concessional terms) would be key to securing fiscal sustainability and improving spending effectiveness.

¹⁴¹ The reconstituted TSA Committee is currently reviewing three options for a TSA mechanism and is expected to develop a roadmap for implementation.

¹⁴² Inefficient cash management can lead to negative carry (e.g., if government deposits at commercial banks are relatively high compared to public domestic debt). Some deposits are kept outside the control of the National Treasury.

¹⁴³ This is reflected in the very low scores on the PEFA Indicator PI-24 on Procurement Management and its sub-indicators (e.g., monitoring, methods, public access to information, and complaints management).

¹⁴⁴ This is reflected in the low scores on the PEFA Indicator PI-11 on Public Investment Management and its sub-indicators (e.g., economic analysis of proposals, project selection, project costing, and project monitoring).



3.5 Conclusion and recommendations

Government spending declined significantly in the past decade, raising concerns about spending adequacy and public service delivery. Weak revenue performance and limited access to finance have forced an expenditure-led fiscal consolidation that is jeopardizing the quantity and quality of public service delivery. Expenditure declined from 24 to 15 percent of GDP between 2013 and 2022, fueling concerns that spending levels are currently insufficient to meet increasing needs. Public spending is low when compared to regional and income peers. With debt service obligations growing, non-interest spending will be further under pressure. Limited fiscal space has undermined the government's ability to protect households and businesses from recent shocks (e.g., COVID-19 and high inflation). Fiscal pressures are compounded by several challenges relating to public financial management, with poor planning and weak commitment controls appearing to be major weaknesses. Improving planning, budgeting, and implementation can enhance budget performance and thus improve the quality of public spending.

Wage and capital expenditures account for most outlays, but low spending on operations & maintenance is undermining service delivery. The need to reduce fiscal deficits has compressed spending in many categories. Curbs on wage and capital spending have been particularly noticeable. Low recruitment can have a significant impact on public service delivery. Capital spending, which has been mainly aimed at developing power and transport infrastructure, has been affected by limits on new projects. Nonetheless, wages & salaries and capital still account for about two-thirds of total spending, which partly reflects the government's policy priorities. Spending on operations & maintenance seems insufficient to meet existing needs. Large investments in public infrastructure need to be accompanied by rising budget allocations for cost-effective routine maintenance, while the purchase of goods is key to supporting staff in delivering quality public services (e.g., books, medicines, and medical equipment). Meanwhile, interest payments have increased despite recent debt service deferrals. This has placed additional pressure on other spending items. There is a significant level of fiscal decentralization to the provinces.

There is considerable scope for improving the efficiency, effectiveness, and equity of public spending. Budgetary resources do not seem fully aligned with stated policy priorities. For instance, public spending has declined for sectors directly influencing human capital, which is a key element of the Ninth National Socio-Economic Development Plan (NSEDPP). The lack of prioritization of these sectors is concerning, especially given the impacts of COVID-19 on learning outcomes, and likely undermines public service delivery. Public spending on education and health has declined in real terms and is very low by international standards. Evidence suggests that spending on these sectors has a positive effect on poverty reduction and equity. Hence, there is significant room to improve the allocation of budgetary resources across categories and spending units. Discretionary spending is relatively high, implying that there is scope for fiscal adjustments, if there is political will. However, the lack of comprehensive information (i.e., budget transparency) undermines an assessment of potential budget savings.

Reallocating spending toward education, health, and social protection is key to avoiding a collapse in human capital. The combined spending on education and health declined from 4.9 to 2.6 percent of GDP between 2013 and 2022. This is very low by international standards. Spending on social assistance is negligible. COVID-19 and high inflation have eroded human capital, which may undermine economic prospects for an entire generation. Meanwhile, demand for public services is expected to increase due to demographic, epidemiological, and income factors, while financing transitions (i.e., decline in development assistance) will place further pressures on the budget. In the absence of additional domestic resources, the quality of basic public service delivery will deteriorate considerably. However, the relatively low degree of budget rigidity suggests that there is scope for reallocating budget resources across and within categories to improve efficiency and effectiveness. The lack of comprehensive reporting hinders an evaluation of potential savings, but there is likely scope within the wages & salaries and capital categories, while fiscal space could be increased through stronger revenue mobilization efforts and debt restructuring.¹⁴⁵ A reprioritization of the overall state budget could yield more human and physical resources for the social sectors without impacting fiscal sustainability. Nonetheless, benchmarking suggests that the quality of spending in these sectors also needs to be improved (e.g., improved spatial and group-based targeting). Therefore, there is a need for more and better spending on sectors that boost productivity and enhance economic growth.

¹⁴⁵ For instance, it is not clear which budgetary units (e.g., ministries) or sectors are responsible for spending much of the wage and capital budgets. Without detailed information, it is difficult to identify spending items that could be cut or deprioritized.

**Strengthening spending controls would help to avoid the accumulation of further expenditure arrears.**

Recurring expenditure arrears arising from sub-national investment projects are a significant concern. To clear these arrears, the government issued bonds amounting to nearly 10 trillion kip (5 percent of GDP) in 2021. However, an additional 23 trillion kip of potential arrears are undergoing a verification process, which could further threaten fiscal and debt sustainability. The implementation of the new Financial Management Information System (FMIS) could strengthen commitment controls and help avoid future arrears accumulation. The new FMIS is also expected to provide comprehensive and timely data for planning, monitoring, and decision-making. Moreover, implementing a Treasury Single Account would improve cash management, modernize treasury operations, and help minimize borrowing costs.

Reporting data for all spending units will increase budget transparency and help promote accountability.

Budget transparency has been eroded over the past two decades. In 2005, about 5 percent of total spending could not be allocated to a specific spending unit (e.g., ministry, organization, or province). That value increased to nearly 30 percent in 2020, largely due to the absence of reporting for several large ministries and organizations (e.g., Ministry of Defence and Ministry of Public Security). These trends significantly undermine budget transparency and thus the ability to scrutinize the quality of public spending. Moreover, this also likely affects decision-making, since it is not clear how unreported data is utilized in the budget process. Reporting data for all spending units is particularly critical at a time when fiscal pressures are compressing spending in areas fundamental for medium-term economic growth. Moreover, scrutinizing and publishing the reports of the State Audit Organization would also enhance transparency and accountability. Comprehensive and reliable external audits are essential for promoting transparency and accountability in the use of public funds.

Enhancing budget preparation and execution, with a focus on procurement and public investment management, will improve the impact of public spending.

Budget preparation and execution can be improved. The recently approved Prime Minister's Decree clearly defines timelines, processes, and the roles of different entities. It also sets out a medium-term budget perspective to facilitate strategic decisions and prioritization. However, these reforms need to be fully implemented. Moreover, promoting transparent competition in public procurement will improve spending efficiency. While the legal framework for public procurement has been strengthened, its implementation is limited and capacities are weak. Finally, improving public investment management is essential to enhance the quality and impact of capital spending. This ought to include public-private partnerships, which should be seen as a procurement option for public projects rather than a financing instrument. Setting up a centralized and robust public investment management monitoring system will be crucial. It is also fundamental to clearly allocate responsibilities for investment decisions and enhance transparency in decision-making, including for public-private partnerships.

Improving human resource planning will enhance the effectiveness of the civil service. The government's ability to manage human resources is hampered by a Personnel Information Management System (PIMS) that has considerable limitations. For instance, the PIMS is not comprehensive (because major employers and employment regimes are not recorded) and has limited functionalities (e.g., recruitment and performance appraisal). Modernizing human resources management would help strengthen wage bill controls. Adopting a new PIMS would help reduce costs while supporting planning and rightsizing. Professionalizing the civil service through a shift from personnel administration to talent management would also be critical to enhance public service delivery.

Annex: Public Financial Management

The Public Expenditure and Financial Accountability (PEFA) framework enables a comprehensive diagnostic of public financial management systems. PEFA assessments follow an established methodology to measure performance across different areas relating to public financial management (PFM): budget reliability, transparency, asset management, budget preparation, execution controls, accounting, and audit. The PEFA framework is based on the stages of the annual budget cycle and evaluates the strengths and weaknesses of PFM systems using a letter-grade scoring system.¹⁴⁶ Quantitative indicators are used to measure 94 characteristics (known as dimensions) across 31 components (indicators) in seven broad areas of activity (pillars).

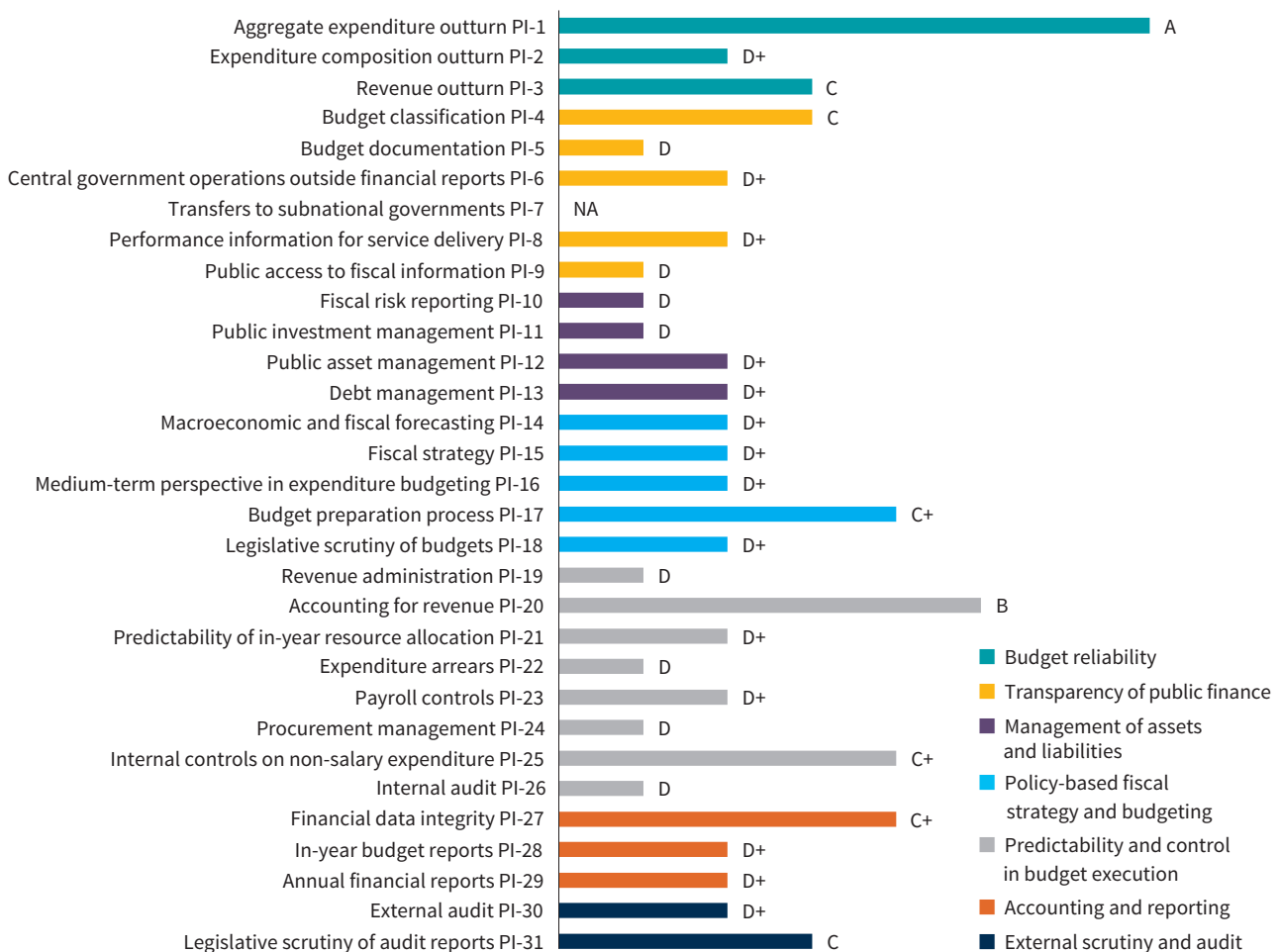
¹⁴⁶ The scoring system is as follows: (A) high level of performance that meets good international practices, (B) sound performance in line with many elements of good international practices, (C) basic level of performance, and (D) less than the basic level of performance.

PEFA assessments evaluate the impact of PFM performance on the three main fiscal and budgetary outcomes.

Good public financial management is crucial to link available resources, delivery of services, and achievement of government policy objectives. Strong PFM systems ensure that revenue is collected efficiently and used appropriately and sustainably. Hence, a good PFM system is an enabling element of the following three desirable fiscal and budgetary outcomes: (i) ‘aggregate fiscal discipline’, which requires effective control of the total budget and management of fiscal risks; (ii) ‘strategic allocation of resources’, which involves planning and executing the budget in line with government priorities aimed at achieving policy objectives; and (iii) ‘efficient service delivery’, which requires using budgeted revenues to achieve the best levels of public services within available resources.

The 2018 PEFA assessment shows that most dimensions are not aligned with international standards. The 2018 PEFA assessment for the Lao PDR reveals that only 8 out of the 31 indicators showed a basic alignment (or better) with good international practices, represented by a score of C or above (Figure 3.53). However, 22 indicators scored below C, suggesting weak performance. Out of the 94 dimensions, 43 dimensions were scored at C or above, 48 were scored D, and three were not scored. Nonetheless, these results need to be contextualized, since some reforms that would lead to higher scores in the short-term may not be pertinent for the country. It is, therefore, crucial to develop a prioritized and sequenced reform plan that aims to maximize the impact of PFM reforms on public finance outcomes.

Figure 3.53. PEFA scores



Source: PEFA 2018.



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