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LAO PEOPLE'S DEMOCRATIC REPUBLIC

Joint Staff Advisory Note of the PRSP

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and the International Monetary Fund

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I. OVERVIEW

1. **The Lao People's Democratic Republic's (Lao P.D.R.) National Growth and Poverty Eradication Strategy (NGPES) is the first full poverty reduction strategy prepared by the government.** The strategy builds on a number of government documents including the Interim Poverty Reduction Strategy Paper (I-PRSP) approved by the government in March 2001, and followed by the National Poverty Eradication Program (NPEP), which was developed through a participatory process with full ownership of the government. The first draft of the NPEP was presented to and discussed with the international community in a Mini-Round Table Meeting on May 30, 2003. The NPEP was reviewed and upgraded to become the NGPES, and was approved by the National Assembly in February 2004. It was transmitted to the World Bank and IMF in September 2004. The strategy is based on the 2001-05 National Socio-Economic Development Plan.
2. **The NGPES describes the participatory process underpinning the development of the strategy.** It also provides a poverty diagnosis, and presents sector programs and policy measures for sustainable economic growth and poverty reduction over the 2004-06 period. It also includes a thorough treatment of cross-cutting issues, such as private sector development and business environment, regional integration, natural resource management, and public sector performance and governance, and steps to develop detailed indicators to monitor implementation of the program.
3. **Overall, the NGPES is an important step toward achieving sustainable economic growth and poverty reduction in Lao P.D.R., but risks remain.** It reflects an enhanced effort to broaden consultation with civil society and stakeholders and the three main pillars of the NGPES address the country's key development challenges (see below). Nevertheless, there are risks to its successful implementation. Capacity constraints, weak governance, and a difficulty translating strategic objectives into concrete actions, are the main obstacles to the reform process. These shortcomings, which could hamper the credibility of the reform program and consequently the mobilization of donor assistance, pose a serious risk to the achievement of the NGPES goals.
4. **This Joint Staff Advisory Note (JSAN) provides staffs' advice on key priorities for strengthening the NGPES and for ensuring effective implementation.** It also highlights areas where current policies may undermine successful implementation of the strategy and hence hamper concessional assistance. This note has four sections. Section II highlights key characteristics of the NGPES. Section III identifies key priorities actions for success of the NGPES and provides suggestions for strengthening the strategy and addressing implementation risks. The final Section concludes and proposes issues for discussion by the Boards.

II. CHARACTERISTICS OF THE NGPES

A. Participatory Process

5. **The process of preparing the NGPES was led by the government.** The NGPES Committee formed to oversee the process drew membership from key ministries and agencies, and representatives from several mass organizations. The government implemented a Participation Action Plan supported by the UNDP and other donors during the NGPES process. In addition, there has been intensive consultation with donor partners in the context of the 7th and 8th Roundtable meetings. The 7th Roundtable meeting in November 2000, at which the government's medium-term strategy, *"Fighting Poverty through Human Resource Development, Rural Development, and People's Participation"* was endorsed, laid the foundation for the NGPES. The final draft was presented at the 8th Roundtable Meeting in September 2003. The consultative process was broadened to increase participation by civil society and the private sector. In addition to consultations with official mass organizations, such as the Lao Women's Union, discussions were held with the private sector, academics, and provincial representatives.

6. **The next Five Year Plan for 2006-2010, now in preparation, should incorporate and build on the policies outlined in the NGPES.** Given that the preparation of the Five Year Plans is largely dealt with internally, this can best be achieved through continued policy dialogue, supported by the work of sector working groups and the preparation of short policy briefs on key issues, aimed at senior policy makers. Ideally, the Five Year Plan, or part of this plan, would serve as the successor to the current NGPES process. This should further consolidate a consensus around key policy initiatives.

7. **Further efforts are needed to increase participation of all stakeholders in the NGPES process.** Greater participation will be critical to enhancing transparency and accountability. This will require the development of a communication strategy that increases use of local languages to enable the broader population to participate more effectively. Parliamentarians' involvement also needs to be strengthened, as the National Assembly was involved relatively late in the formulation of the NGPES, and in budget preparation in general.

B. Poverty Diagnosis

8. **The incidence of poverty in Lao P.D.R. was reduced from 46 percent in 1992/3 to an estimated 32 percent in 2002, as a result of robust economic growth.** In the 1990s, the economy grew at an annual average rate of more than 6 percent. Agricultural growth—in traditional farm products as well as increasingly in cash crops and timber/wood products—was a key contributor to this progress. There have also been improvements in social indicators, although from a low base, with gains in adult literacy rates, net enrollment rates, the ratio of girls to boys in school, infant/under 5/maternal mortality rates, and life expectancy. However, social indicators still remain below averages for low-income countries, and for the East Asia region. Lower enrollment and completion rates than in

neighboring countries, unequal access, low quality, and inefficient allocation of public expenditure remain problems in the education system. High maternal and child mortality and morbidity, low health care utilization, poor quality of services, and inefficient public expenditures continue as problems in the health system. Vulnerability remains high, especially for upland and ethnic minority communities. The NGPES provides an effective portrayal of the dimensions of poverty in Lao P.D.R.

9. **The NGPES long-term poverty reduction goals are appropriately ambitious, although the shorter-term targets may be difficult to achieve.** In particular, the short-term target of reducing poverty to under 25 percent is optimistic, as is the targeted eradication of mass poverty by 2010. Although the targets for improving social indicators in the education and health sectors are more realistic, overall, the government's aiming at achieving objectives that are more ambitious than the MDGs seems to be a challenge.

10. **Going forward, further disaggregating the poverty diagnostics could help better identify policy actions that are pro-poor.** The authorities could draw on available survey and administrative data to strengthen the analytical basis of the poverty diagnosis, especially with regard to the causal relationship between growth and poverty reduction objectives. Further analysis of sources of income and coping strategies at the household level would also provide for a more informed discussion of pro-poor strategies, including, for example, the role of private sector growth and rural development. The results of the 2002/03 household survey should help set a baseline for monitoring future progress in reducing consumption-based poverty, but staffs encourage the authorities, in addition, to undertake further analysis of ethnic and gender-specific gaps and issues, and regional disparities in all aspects of poverty, including the allocation of government and donor resources, access to basic infrastructure, vulnerability to food insecurity, unexploded ordnance (UXO), natural disasters, and the poverty environment links such as in the case of deforestation affecting the livelihoods of the poor.

C. Main Pillars of the Strategy

11. **The three pillars of the strategy aim at: (i) fostering economic growth with equity; (ii) developing and modernizing Lao P.D.R.'s social and economic infrastructure; and (iii) enhancing human resource development.** These pillars are consistent with the multi-dimensional nature of poverty alleviation, and the policy action matrix set out in the NGPES is generally consistent with these pillars.

12. **The NGPES stresses the government's commitment to sound macroeconomic policies to sustain growth.** Prudent monetary and fiscal policies combined with broad-based structural reforms to promote private sector-led development are viewed as key to achieving the government's economic goals. The NGPES also recognizes that the feasibility of its development strategy depends on Lao P.D.R.'s ability to attract foreign direct investment by improving its international competitiveness through far-reaching structural and governance reforms and improvements in the business environment. Priority is also given in the NGPES to mobilizing revenue to provide adequate resources to fund critical public sector programs

for poverty alleviation. The medium-term macroeconomic framework also assumes that inflation will continue subsiding to the single-digit levels, reflecting prudent monetary policy combined with restraint on government spending and borrowing. On the macro-structural front, the broad strategy articulated in the policy matrix of the NGPES is appropriate for addressing state-owned banks and enterprise reform.

13. **The government correctly emphasizes the importance of rural infrastructure to achieving the goals of the NGPES.** A large part of Lao P.D.R.'s population is rural, and the rural poor constitute the majority of the country's total poor. The NGPES puts high priority on the need to tackle issues of equity, for example, between upland and lowland rural communities. Progress has been made since the I-PRSP in involving the infrastructure sector agencies in the formulation of the NGPES. On land administration, the NGPES outlines the issues and long-term goals of establishing a nationwide land administration system and providing secure tenure to all eligible land holdings.

14. **The government's strategy for enhancing human development is comprehensive, and the NGPES contains a strong agenda for improving education.** With a central focus on basic education, the priorities are likely to result in better basic education services and greater pro-poor public expenditure in this sector. The strategy is especially strong in its approach to inclusiveness and equity. The strategy in health while comprehensive, is not sufficiently focused on the poor, and not adequately prioritized. The overall objectives of strengthening health care delivery, particularly in underserved areas, and improving the quality of health services, are appropriate. The NGPES places adequate emphasis on reducing vulnerability and social exclusion as an integral element of the poverty reduction strategy. Other cross cutting issues such as population, gender, social security, information and culture, and capacity building have been well integrated throughout the document.

III. PRIORITY ACTIONS: CRITICAL AREAS FOR SUCCESS

15. **The main challenges for Lao P.D.R. will be to:** i) sustain growth and ensure macro-fiscal sustainability, in particular, by enhancing revenue mobilization; ii) strengthen public financial management and governance; iii) improve social outcomes and reduce vulnerability; iv) strengthen natural resource and environmental management; and v) build capacity for implementing and monitoring the NGPES.

A. Sustain Growth and Ensure Macro-Fiscal Sustainability

16. **The NGPES, appropriately, contains ambitious targets for economic growth.** Staffs consider that the government's long-term goal of raising economic growth to 6-7 percent is achievable, given that a number of large mining and hydroelectric projects are in the pipeline. However, achievement of the NGPES goals will require significant structural reforms and that the country's considerable natural resources are managed effectively.

17. **The NGPES recognizes that growth will need to be sustained through trade liberalization, higher agricultural productivity, foreign direct investment, and private sector development.** Further liberalization of the trade regime, consistent with ASEAN Free Trade Agreement (AFTA) commitments, is key to regional integration. The authorities' intention to seek accession to the WTO should further advance this process. Staffs also encourage the authorities to develop time-bound plans to eliminate remaining quantitative restrictions in the trade regime. The government's development strategy will depend on Lao P.D.R.'s ability to increase agricultural productivity, and to attract foreign direct investment and foster domestic private sector growth by creating a favorable legal and regulatory environment, and improving its international competitiveness through implementing far-reaching structural and governance reforms. Enhancing the role of the private sector and linking into, and capitalizing on, regional opportunities are important aspects of the Lao growth strategy and need to be strengthened in the NGPES. More analytical work is needed, especially on an investment climate assessment to translate the government's private sector development agenda into a set of actions.

18. **Sound management of Lao P.D.R.'s substantial hydroelectric power and mining resources will be critical to achieving NGPES goals.** Natural resources and large projects such as the Nam Theun 2 hydroelectric dam could significantly boost Lao P.D.R.'s development, if the resources generated are soundly managed and used to combat poverty and promote the sustainable development of the economy. Such projects would also help Lao P.D.R. become better integrated into the global market and build relationships with the international private sector, which could help draw foreign investors into the country. While the NGPES highlights the importance of these two sectors, more work is needed to establish a transparent and clearly defined framework governing the investment decisions in these sectors and the management of the public revenues that they will generate.

19. **The staffs welcome the government's commitment to macroeconomic stability and enhancing fiscal sustainability through increased revenue mobilization.** Maintaining disciplined monetary and fiscal policies will be critical to achieving the government's economic goals. Reinvigorating efforts to mobilize revenues will be central to the government's efforts to maintain macroeconomic stability, while making progress in addressing the country's pressing development needs. Given the unfortunate decline in revenues in 2002/03, the authorities have revised the revenue targets in the NGPES to provide a more realistic framework for budget planning. The revised targets seek to increase the revenue-to-GDP ratio to 12 percent of GDP by 2005/06; targets that, in staffs' view, provides an appropriate balance between realism and ambition, especially given the loss of customs revenue associated with the AFTA related tariff reforms. To achieve even the revised targets will require an acceleration of the recent pace of reform, and the staffs urge the authorities to expedite progress on a number of long-standing reforms, including most notably the restoration of an effective national revenue administration and the establishment of a sound framework for implementing the value-added tax (VAT).

20. **The 2004/05 budget plan approved by the National Assembly in October deviates in some important respects from the NGPES revised budget framework.** In particular, the budget plan proposes to raise revenues at a faster pace than envisaged in the NGPES, which, while welcome, is not realistic in the absence of additional measures. The budget plan also proposes a large increase in personnel expenditures. The staffs recommend that the authorities review the budget plan to ensure that it is founded on achievable revenue targets and incorporates sustainable expenditure plans, particularly with regard to civil service remuneration.

21. **Lasting reform of the state-owned banks and enterprises is essential to ensuring a sustainable fiscal outlook.** While some progress has been made in improving credit evaluation and control at the state banks, the NGPES acknowledges that much remains to be done to put these banks on a sound commercial footing and in developing a financial sector that will support private sector development, including in the rural areas. In addition to completing the restructuring of the state banks, efforts to strengthen bank supervision and enhance bank competition will need to be advanced. As noted in the NGPES, bank reform should ensure that credit is extended purely on a commercial basis, and in this regard staffs urge the authorities to avoid any directed lending by banks. Sustainable financial sector reform will require further reform of state-owned enterprises (SOEs) and of public expenditure management, as public sector arrears to private contractors remains a pressing problem for financial institutions. The majority of SOEs are either marginally profitable or loss making, account for a large share of the state banks' nonperforming loans, and continue to be a drain on the economy. There is a need to reinvigorate the SOE reform program through implementing the agreed restructuring plans in earnest, and thereby sending a clear message to SOE directors and stakeholders alike about the government's commitment to improving SOE performance.

22. **The assumptions on the availability of external financing are reasonable.** However, more work needs to be done to establish mechanisms to ensure the alignment of these resources with NGPES priorities. While there is some uncertainty over the exact debt service burden, as the authorities have requested further discussion on the terms of Lao P.D.R.'s Russian debt, the stock of public and publicly guaranteed debt is high. Therefore, future borrowing will need to be carefully managed to ensure that debt service flows remain manageable and do not crowd out public service delivery, and the burden of debt is lowered over the medium-term. The Annual Progress Report should accordingly emphasize the need to secure grant financing wherever possible, and maintain a high level of concessionality in new borrowing. In addition, mobilizing increased revenues and a steady process of fiscal consolidation will be needed to reduce the public sector's borrowing requirement over time.

B. Strengthen Public Financial Management and Governance

23. **Successful implementation of the NGPES will depend on improving the effectiveness of public expenditure management.** The main priorities in this regard will be to: (a) strengthen treasury controls, by bringing sub-treasuries in the provinces under the

direct authority of the central treasury; (b) improve information, through implementation of a revised chart of accounts and budget nomenclature based on international standards; (c) improve the timeliness and quality of reporting, through the preparation and publication of budget execution reports and financial statements; and (d) strengthen oversight, through improvements in audit quality, the audit of consolidated financial statements and submission of audit reports to the legislature. The PEM implementation schedule presented in the NGPES needs to be updated and translated into annual actions plans. Effective implementation will require an extensive capacity building effort for financial management personnel. The impact of the reform program will need to be monitored closely, using key performance indicators, particularly in view of the decentralized expenditure management systems currently in place.

24. Over the medium-term, public expenditure management reforms have to be supported by civil service and territorial administration reforms. The absence of specific measures on civil service or on public administration reform is an important weakness of the NGPES. Development of a strategy and financing plan to restore civil service pay to competitive levels is an important challenge for the medium to long-term. The NGPES recognizes the need to strengthen central-local relations by clarifying the functional responsibilities of levels of administration. These reforms should be closely linked to improvements in public financial management, so that: (i) revenue and expenditure assignments and the system of inter-governmental transfers are aligned with functional responsibilities; (ii) national policies are supported by all levels of administration; and (iii) provincial administrations comply with financial management regulations, particularly as regards the transfer of funds to central administrations.

25. More work is needed in developing a medium-term expenditure framework (MTEF). In particular, the MTEF needs to be extended to cover recurrent expenditures and linked to the budget process—if it is to become an effective policy tool, as forward expenditure estimates now focus exclusively on the public investment plan. Another priority is to strengthen the information on public expenditure allocations—for both economic and functional expenditure classifications—as this is crucial if the government is to effectively align available resources with its developmental priorities. Work is also needed on the expenditure policy analysis including costing of key policy objectives. Preliminary work is currently underway in this area, but is unlikely to be ready for the first annual report. Subsequent updates of the NGPES should also make use of planned expenditure tracking surveys, as well as data from existing surveys, such as the household survey, to examine the links between poverty and expenditure.

C. Improve Social Outcomes and Reduce Vulnerability

26. Achieving sustained improvements in social outcomes will require bold steps. The main priorities are: i) improve access, targeting, and efficiency of service delivery in general; ii) develop adequate pay and employment policies in the social sectors, as a starting point for a broader civil service reform; iii) explore alternative service delivery options for

remote communities; and iv) take an integrated approach to improving upland rural livelihoods, including access to land and natural resources.

27. **More resources need to be directed to education and health, redirecting limited resources to ensure greater access of the poor to quality basic services.** The main impediments to progress on this front identified by the NGPES have been: (i) slow progress on civil service reform, that has constrained progress in providing more competitive salaries to teachers and health care providers, and reduced the ability of the education and health sectors to deliver sufficient services to rural areas; and (ii) untimely and uneven budget disbursements that have hindered planning and improvement processes. These impediments continue to place a burden on the poor, as schools and health centers have had to depend on user fees to cover operational costs. As identified in the NGPES improvements in cash management and public expenditure management are essential to reversing this trend. More analytical work is needed to: (i) clarify the links between public expenditure and social outcomes, in order to develop better targeting programs; and (ii) develop an action plan to address regional and ethnic inequalities in social outcomes.

28. **The NGPES proposal to use ‘focal sites’ as a means of delivering more efficient services, stabilizing shifting cultivation, and reducing poverty, needs to be reviewed in light of implementation.** Staffs note that experience from Lao P.D.R. and other countries indicates that the relocation of remote communities may have negative consequence on livelihoods. New approaches to service delivery for “focal sites” based on consultations with communities and other key stakeholders could be explored, including options for traditional land management and communal tenure; sustainable rotational agriculture and upland livelihoods; cost effective services and on-site development to remote upland villages; and institutional strengthening for government agencies and mass organizations.

D. Strengthen Natural Resource and Environmental Management

29. **The NGPES advocates that improving natural resource management in Lao P.D.R. will require the development of more participatory forestry management schemes.** In particular, the government should give greater prominence to initiatives to bring forestry management under greater control and integrate it into poverty reduction efforts. Participatory forestry schemes, through which local people are directly involved in managing forest resources, have had remarkable success in Lao P.D.R.. The government will soon establish a system of National Production Forest Areas (NPFA), beginning with eight areas totaling 500,000 hectares and should commit itself to expanding it to at least half of the commercially valuable forest outside the National Biodiversity Conservation Areas. This would directly benefit about 1.5 million people.

30. **Improving transparency in natural resource management is needed.** The authorities should increase efforts to improve transparency in the management of natural resources, especially forests. As discussed earlier, timber and wood products are responsible for an increasing share of the country's growth; yet, increasing natural resource degradation and poor governance with regards to natural resources remain an issue. It is important to

ensure transparency with respect to exploitation of forests and other key components of the resource base (e.g. mining). Improving allocation of forestry concessions and the use of natural resources revenues are a few examples that may assist in mitigating negative impacts on current and future generations. In the coming year the government will need to address the following priority issues in forestry: i) independent certification of ongoing participatory forestry management areas; ii) development of timber royalty and revenue sharing arrangements that provide incentives for local communities to support sustainable utilization practices, and iii) capacity building at national, provincial and district levels in support of participatory forestry.

31. Reform of the legal and institutional framework governing the environment faces a number of major challenges. The NGPES reflects recent efforts to develop policies and implement programs. These include: weak institutions, poor coordination, and weak enforcement of laws. As a result, environmental trends in Lao P.D.R. continued to decline in recent years. The government has made some modest progress in recent years, including the enactment of an environmental assessment law, the creation of a specialized agency to protect and manage the Nakai Nam Theun Watershed, decentralizing environmental functions to provinces, improving water and air quality monitoring, and establishing a third-party system of monitoring and reporting on environmental impacts of development projects. These reforms need to be consolidated and scaled up in order to establish the government's credibility in managing the impacts of hydropower and mineral development and exploiting its natural resource potential (including its forests) in a sustainable manner.

E. Build Capacity for Implementing and Monitoring the NGPES

32. The NGPES acknowledges that substantial capacity building efforts will be needed. The main priority will be to strengthen public financial management and improve service delivery. Capacity building programs should address needs at the points of service, rather than simply in the central administration. Pay reform will be critical in bringing sustained improvements in institutional capacity.

33. The NGPES is an opportunity to gain the support of donors in effective capacity building efforts. A set of donor working groups has been organized along the NGPES priority sectors to support NGPES implementation. The implementation arrangements for the NGPES will include improved coordination of donors' activities.

34. The authorities should conduct an assessment of the institutional capacity constraints likely to undermine implementation of the NGPES. This assessment could use a simple but consistent framework which identifies individual capacity challenges related to specific results—at macro, sectoral or cross-sectoral levels—in terms of institutional incentives, organizational competencies, and individual skills. Local learning and training entities would be key in undertaking the assessment and the monitoring of capacity enhancement. It would also reinforce a shift from the traditional focus on improvement of skills to a stronger focus on building the competencies of organizations and creating

incentives that enable organizations and individuals to achieve and sustain development results.

35. **An effective monitoring system is needed for the NGPES.** Lao P.D.R. has established a relatively comprehensive data collection system, which includes annual village and household surveys, quarterly and annual establishment surveys, a 5-yearly expenditure and consumption survey, various health surveys, and administrative data from line ministries. However, a comprehensive improvement in statistical capacity building is needed, as is a clear set of summary indicators to monitor progress across various dimensions of poverty. This involves defining key NGPES indicators and targets, determining the levels of disaggregation, identifying for each indicator the agency in charge of monitoring, and setting-up a reporting cycle in line with NGPES reporting requirements. The staffs recommend particularly an improvement in statistical capacity building, as a clear set of summary indicators is needed to monitor progress across various dimensions of poverty in this regard, it would be helpful if the Annual Progress Report included a commitment to participate in the General Data Dissemination System. The staffs particularly encourage the government to go beyond population averages by targeting and tracking changes in poverty by income group (e.g., education and health disparities between the richest and poorest quintiles), by gender (e.g., health, education, employment and political participation), by district (e.g., reliable indicators to assess the progress in priority districts), and by ethnic group (e.g., health, education, employment, and participation). The staffs recommend that the government accelerate its efforts towards setting up an institutional framework for monitoring implementation of the NGPES.

IV. CONCLUSIONS AND ISSUES FOR DISCUSSION

36. **Overall, the NGPES is an important step towards developing a strategy to sustain economic growth and poverty reduction in Lao P.D.R..** It reflects enhanced efforts to broaden consultation with civil society and stakeholders. While the strategy outlined in the NGPES is comprehensive and addresses the key development needs of the country, there remain shortcomings, as well as risks to its successful implementation.

37. **The risks include a difficulty in translating strategic objectives into concrete actions** due to: i) to severe capacity constraints in the civil service, related in part to lack of incentives; ii) lack of clear assignment of responsibility and accountability for policy implementation between institutions and levels of administration; and iii) a weak public expenditure management system. There are also shortcomings in the governance framework, particularly as regards the effectiveness of the judiciary and oversight institutions. More generally, staffs remain concerned that despite recent progress, there is still a gap between public pronouncements and the pace of achievements with regard to reforms to strengthen the budget's revenue base, improve public expenditure management, strengthen the financial sector and SOE performance, and enhance governance. These shortcomings could hamper credibility of the government's reform program and thereby donor assistance, and dampen economic growth.