TECHNICAL BRIEF

REVENUE AND EXPENDITURE MANAGEMENT

Nam Theun 2 Hydroelectric Project

Adrian Fozzard,
Senior Public Sector Specialist
The World Bank

MARCH 16, 2005

THE WORLD BANK

LAO PEOPLE'S DEMOCRATIC REPUBLIC

TECHNICAL BRIEF

NAM THEUN 2 REVENUE AND EXPENDITURE MANAGEMENT

1. Revenue and expenditure management is central to the achievement of the NT2 project's development objective: "to generate revenues that will be used to finance spending on priority poverty reduction and environmental programs in Lao PDR through environmentally and socially sustainable exploitation of NT2's hydropower potential." This annex provides an overview of the NT2 revenue and expenditure management arrangements that seek to support the achievement of this project objective.

2. The approach adopted in the design of NT2 revenue and expenditure management arrangements focuses on strengthening of national public expenditure management systems. This serves a broader development purpose, since an effective, transparent expenditure management system is essential if Lao PDR is to use its limited resources effectively in support of its poverty reduction and development objectives. Section A outlines the current status of the public expenditure management system, resource allocation issues and the potential impacts of NT2 revenues. Section B outlines the Government's proposed public expenditure management reforms and external partners' support to the reform and capacity building agenda. Section C outlines specific NT2 revenue and expenditure management arrangements which provide a framework for the application of NT2 revenues in line with the project's allocational and transparency objectives from the time of project commissioning. Details of the NT2 revenue and expenditure management arrangements are laid out in the Technical Annex to the Government's Letter of Implementation Policy. Section D concludes with a review of the benefits and risks, risk mitigation and the alternative approaches to revenue and expenditure management considered.

A. Public Expenditure Management Context and NT2 Impacts

3. ***Status of public expenditure management systems***. The 2002 PER and CFAA identified serious weaknesses in Lao PDR's systems for budget preparation, budget execution and control.[1] Some progress has been made in recent years. The Government has resumed publication of the state budget, together with budget outturn data for the previous year, and has revised its chart of accounts for the FY2005 budget cycle. Work has started on the design of medium-term expenditure programs for the NGPES sectors. These will be integrated into the expenditure plan supporting the forthcoming Five Year Economic and Social Plan for 2006-10. The Ministry of Finance has approved a new procurement decree and internal regulations, standard bidding documents and a procurement manual are currently under review, providing a framework for a more transparent and efficient procurement system. Progress has also been made in computerization of payments processing and accounting for four central agencies. The

[1] *Lao PDR Public Expenditure Review and Country Financial Accountability Assessment*, Report 24443-LA, Joint Report of World Bank, International Monetary Fund and Asian Development Bank, June 28 2002.

computerized system is now being rolled out across central and provincial government. Nevertheless, the expenditure management system still does not reach any of the HIPC public expenditure management benchmarks. Despite recent revisions to the budget classifications and chart of accounts, it is still difficult to link resources to specific functions and programs. These problems are compounded by the decentralization of responsibility for budget preparation, which allows for differing interpretations of policy priorities. As a result, there are significant per capita variations in resource allocations to priority sectors between provinces. Reporting by agencies and particularly provinces is incomplete and difficult to reconcile. Effective treasury operations and cash management are hampered by multiple accounts, lack of systematic commitment controls and weak cash planning mechanisms. This has contributed to arrears to suppliers and delays in the payment of salaries. Revenue retention at provincial level exacerbates the central administration's cash constraints and results in delays in transfers to the poorest provinces. Although the budget books include budget outturn data, the administration does not publish consolidated end-of-year financial statements or in-year budget execution reports. The recently created State Audit Organization (SAO) has limited resources in relation to its broad mandate. The SAO undertakes limited compliance audits of a few line agencies. Audit reports are not published.

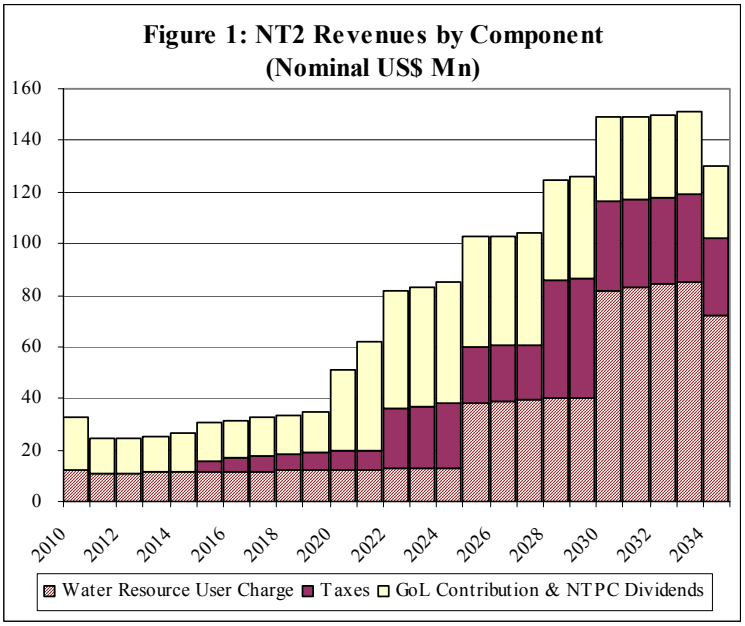
4. ***Resource Allocation***. Since FY2001, following the successful conclusion of the fiscal stabilization program launched in late 1999, the Government has made some progress shifting resources in line with its development and poverty reduction objectives. The share of total spending (excluding debt service) allocated to the education and health sectors increased from 13 percent in FY2001 to 18 percent in the FY2004 budget. However, this was largely due to increases in the share of externally financed capital expenditures: allocations to education and health have remained at around 14 percent of domestically financed expenditures over this period. Furthermore, health and education expenditures in real per capita terms still fall short of the levels seen in the mid-1990's and are well below regional comparators at just 1 and 1.4 percent of GDP, respectively. In the economic sectors, allocations to agriculture fell sharply from FY2001 and FY2004 as the Government cut back on large irrigation schemes, while allocations of domestically financed expenditures to the roads sector have increased steadily. About one half of domestically financed expenditures are allocated to public administration (including security and the justice sector), with the share of these sectors rising slightly in recent years, partly driven

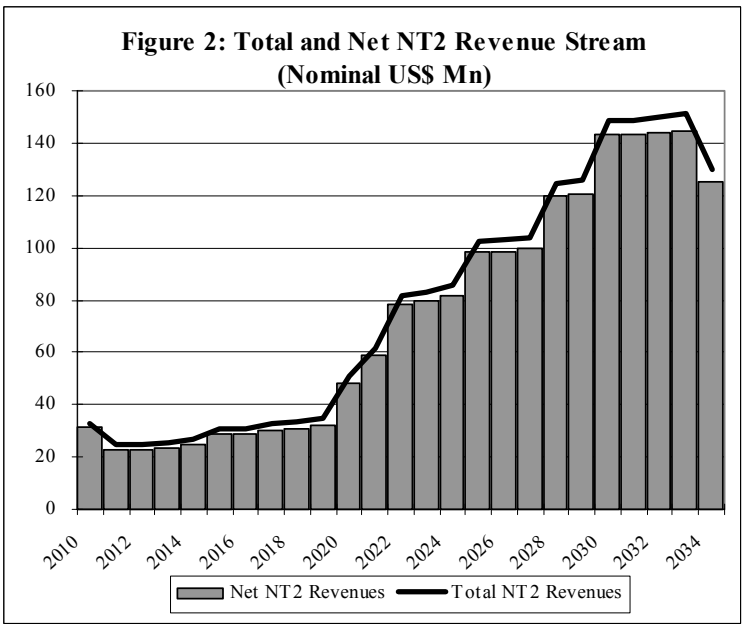
Table 1: Lao PDR Structure of Expenditure in Percent
(Excluding Debt Service)

	Total Expenditure				Excluding Extermal Capital			
Sector/Component	Actual 2000/01	Actual 2001/02	Actual 2002/03	Budget 2003/04	Actual 2000/01	Actual 2001/02	Actual 2002/03	Budget 2003/04
Public Administration	32	40	34	29	47	47	49	54
Economic Sectors, of which	50	35	41	38	34	31	31	25
Agriculture	19	13	13	9	23	15	14	6
Transport and Communications	26	19	25	26	8	12	13	16
Social Sectors, of which	18	25	24	24	18	22	17	19
Education	9	13	11	12	10	12	10	11
Health	4	6	6	6	4	4	3	3
Other / Reserve	0	0	1	9	0	0	2	2
Capital	68	63	64	69	47	47	42	34
Recurrent	32	37	36	31	53	53	58	66

Source: Ministry of Finance, Budget Books

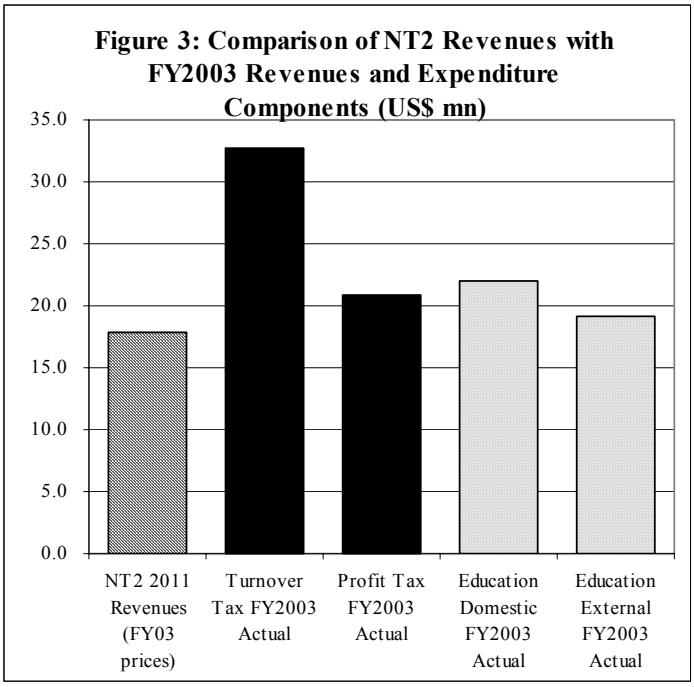
by increases in personnel costs. Across all sectors, there has been a marked shift in domestically financed expenditures from capital to recurrent spending, with recurrent spending increasing from just 53 percent of domestically financed expenditures in FY2001 to 65 percent in the FY2004 budget. Nevertheless, operating and maintenance expenditures are still under-funded across all sectors. Civil service pay fell in real terms in the late 1990's and has yet to recover. In the absence of reductions in staffing, Government-wide pay reform is likely to result in a further shift in resources towards public administration. Ultimately, the pace at which the Government can increase spending on NGPES sectors, recurrent expenditures and pay reform will be determined by improvements in revenue performance. In this context, NT2 plays an important role as one of a number of policy and administrative measures intended to mobilize the domestic resources needed to finance Lao PDR's poverty reduction and development strategy.





5. ***Revenue impact***. Revenues from the NT2 project are expected to be available to Government from FY2010, including: GOL contributions under Article 19.1 of the Concession Agreement, water resource user charges, NTPC dividends and taxes. Estimated NT2 revenues to GOL rise gradually in the early years, while commercial debt service is paid, from an average of US$28 million in the first five years to an average of US$33 million from 2015 to 2019, rising sharply thereafter to an average of US$73 million from 2020 to 2024 (see Figure 1 and 2)[2]. On the basis of economic and revenue growth projections used for the recent debt sustainability analysis, NT2 revenues will account for between 3 to 5

[2] Estimates of nominal NT2 revenues are based on the lenders' financial model dated February 2005, adjusted to coincide with Lao PDR financial years. NT2 revenues available for allocation through NT2 revenue and expenditure



percent of total revenues in the period to FY2020[3]. While NT2's contribution to total revenues is likely to be fairly modest, the project's revenue impact is significant when compared with other revenue sources. NT2 revenues in 2011, adjusted to FY2003 prices, are equivalent to around 50 percent of turnover tax collections and 80 percent of profit tax collections in FY2003.

6. ***Expenditure impact***. Similarly, NT2 revenues can have a significant impact on expenditures if well targeted (see Figure 3). Projected NT2 revenues in 2011, adjusted to FY2003 prices, are equivalent to about 60 percent of domestically financed expenditures on education and health in FY2003. If the NT2 revenues were allocated to the wider range of priority sectors identified in the NGPES, they would still have an appreciable impact: estimated NT2 revenues in 2011, at FY2003 prices, would be equivalent to about 19 percent of domestically financed expenditures on health, education, agriculture and transport and communications. The impact of NT2 revenues in terms of increments of expenditure for narrowly targeted programs would be significantly higher than the broad sector comparators suggest.

B. Strengthening National Systems

7. The NGPES recognizes that "sound, accountable and transparent financial management is an integral part of the Government efforts to increase efficiency of public management and resource allocation". Development of these systems requires interventions at various levels: in the Ministry of Finance, oversight bodies, notably the State Audit Organization, the sector ministries and the provinces. This section outlines the various reform programs underway and the external support to these reforms.

8. ***Public Expenditure Management Strengthening Program***. The Government's public expenditure management reform strategy to end FY2009 is laid out in its Public Expenditure Management Strengthening Program (PEMSP), approved by the Minister of Finance. The program builds on an extensive body of analytical work, including a joint IMF, ADB and World Bank Public Expenditure Review of 2002[4]. The PEMSP also draws on the Government's

management arrangements will be slightly lower, owing to the deduction of EIB and ADB debt service related to acquisition of equity in NTPC and the project related costs of LHSE, the Government's equity holder.

[3] IMF, *Lao People's Democratic Republic: Selected Issues and Statistical Appendix*, Country Report 05/09, January 2005.

[4] *Lao PDR Public Expenditure Review and Country Financial Accountability Assessment*, Joint Report of International Monetary Fund, Asian Development Bank and World Bank, Report No. 24443-LA, June 28, 2002.

Table 2: Progress against HIPC Public Expenditure Management Indicators under PEMSP

INDICATOR	Benchmark	FY2004	FY2007	FY2009
COMPREHENSIVENESS				
Budget reporting follows GFS definition of consolidated general government.	A	B	B	**A**
Government activities not funded through extrabudgetary sources.	A	B	B	**A**
Budget outturn data (levels, functional allocation) close to that of the original budget.	B	C	**B**	**B**
Budget includes capital and current expenditure financed by donors.	A	B	B	**A**
CLASSIFICATION				
Budget classified on an administrative, economic, functional basis.	B	C	**B**	**B**
Poverty-related expenditure clearly identified in the budget .	A	C	**A**	**A**
PROJECTION				
Multi-year expenditure projections integrated into the budget cycle .	A	B	B	**A**
INTERNAL CONTROL				
Stock of expenditure arrears; little accumulation of new arrears over past year.	A	C	B	**A**
Internal audit is active.	A	B	B	B
Tracking surveys supplement internal control.	B	C	**B**	**A**
RECONCILIATION				
Fiscal and banking reconciliation undertaken in a routinely.	A	B	B	**A**
REPORTING				
Internal budget reports from line ministries/Treasury received within four weeks.	B	C	**B**	**B**
Functional classification is reflected in the in-year budget reports.	A	C	B	**A**
FINAL AUDITED ACCOUNTS				
Closure of the accounts occurs within two months after the end of the fiscal year.	A	B	B	B
Audited account presented to the legislature within 12 months.	B	C	C	**B**

Source: World Bank assessment using HIPC PEM indicators and benchmarks.

governance strategy[5] and the expenditure management reform strategy laid out in the NGPES.[6] The program lays out the broad objectives for reforms, identifies the intended outcomes and indicators to monitor improvements in system performance, and lays out an implementation schedule. The program covers the key expenditure management functions: fiscal planning and budget preparation, treasury, accounting and reporting, the development of information systems and the legislative framework for public expenditure management. Capacity building figures prominently in the program, with particular emphasis on training to support program implementation and the introduction of accredited courses to develop the core skills of financial management personnel at all levels of the administration. The program will also focus on the development of capacity at the provincial level, through development of appropriate systems and training. Implementation of the program as currently scheduled would allow the Government to make significant progress towards meeting international benchmarks for public expenditure

[5] *"Priority Areas for Governance Reform: A Policy Paper of the Government of Lao PDR on Governance Issues"* A Policy Paper of the Government of Lao PDR on Governance Issues, Roundtable Process, Vientiane, March 2003. See pages 50 – 64.

[6] "*National Growth and Poverty Eradication Strategy*", Vientiane, June 2004, page 6 and 7, see Annex 2.4 for the *"Action Plan for Improving Public Expenditure Management"*. See also, Lao PDR, National Round Table Process Steering Committee, *"Note on Progress Towards Implementation of the NGPES"*, October 2004.

management by FY2009, the year in which NT2 is scheduled to be commissioned (see Table 2).[7] The approved program overview and implementation schedule are attached.

9. ***PEMSP Implementation Arrangements***. The Ministry of Finance has established an internal "Program Steering Committee", chaired by the Vice-Minister, to approve and monitor department's annual work plans. A "Program Coordination Committee", chaired by the Ministry of Finance with participation of contributing partners will meet twice-yearly to: review and update the program in line with progress in program implementation and the Government's policy directives; and program external support, including training and technical assistance inputs, required for program implementation. The Ministry of Finance will prepare biannual progress reports on program implementation.

10. ***External support to PEMSP***. PEMSP will provide a framework for mobilizing and coordinating external assistance in support of the Government's public expenditure management reforms. The World Bank will support program implementation through a sequence of PRSCs, from 2005 through 2007, with PRSC prior actions linked to implementation of key reforms scheduled under the PEMSP. Initially, core financing for technical assistance and the capacity building activities foreseen under the program will be provided through the World Bank's on-going Financial Management Capacity Building Credit (FMCBC). The Government has approved the recruitment of two long-term advisors to assist the Ministry coordinate PEMSP implementation: one advisor covering technical aspects of the program, the other supporting capacity building activities. These advisors will assist the Ministry implement, coordinate and oversee short-term consultancies under the program. Following a programmatic approach, the PEMSP will integrate assistance provided by on-going and programmed assistance including World Bank Institutional Development Fund small-grants (supporting procurement reform), ADB technical assistance grants (accounting regulations and computerization in agencies and provinces) and pipeline projects financed by AFD (vocational training in accounting), UNDP (fiscal decentralization policy) and JICA (fiscal planning). The World Bank and ADB will assist the Ministry of Finance mobilize grants from bilateral partners to cover core program financing requirements.

11. ***Next steps in PEMSP implementation***. The Ministry of Finance intends to integrate PEMSP activities for FY2005 into departmental workplans during the mid-year revision. In the meantime, a number of PEMSP activities are already underway. The Ministry of Finance is currently undertaking a review of Treasury functions with the assistance of a Treasury Advisor financed under the FMCBC. Work on updating the medium-term expenditure framework is underway, starting with expenditure programs for the key NGPES sectors. The Ministry is also undertaking a training needs assessment and preparing capacity building plan to support PEMSP implementation, with the assistance of the European Union. On the basis of this capacity building plan, the Ministry intends to finalize detailed schedule of training activities and short-term technical assistance inputs, together with PEMSP financing requirements for the period to FY2009, by end of September 2005.

---

[7] In Table 2, Lao PDR's public expenditure management system and the impact of PEMSP implementation have been mapped against the HIPC public expenditure management performance indicators and the corresponding benchmarks, as explained in: IMF and World Bank, *Public Expenditure Management Country Assessment and Action Plan for HIPCs,* October 2003. *http://www1.worldbank.org/publicsector/pe/FinalHIPCAAPGuidance2003-04.pdf*

12. ***State Audit Organization***. In parallel with the PEMSP, the State Audit Organization (SAO) has recently approved a strategic plan for FY2005 to FY2009. The strategic plan anticipates: preparation of draft audit legislation in 2005, providing for institutional independence and clarification of the institution's authority and reporting requirements; financial audits of State Owned Enterprises including banks and of loan projects in accordance with international standards by 2006; and audits of the consolidated financial statements of government by 2009. The strategic plan includes a five year audit plan and a human resource development plan, which calls for extensive training of State Audit Organization staff and modest increases in staffing levels. ADB assistance to the SAO, which supported preparation of the strategic plan and audit manuals, is scheduled to terminate in late 2005. Further assistance will be needed to support implementation of the SAO's strategic plan. This assistance will be provided, in part, through an audit peer review by an INTOSAI partner institution which will provide guidance on progress towards international standards. Peer reviews are scheduled for FY2006 and FY2009 and funded under NT2 monitoring arrangements.

13. ***Sector interventions.*** Alongside support to core institutions (the Ministry of Finance and State Audit Organization), the World Bank supports the development of financial management systems and capacity building through its portfolio of sector projects. Recently approved and pipeline projects in the education, health and roads sectors together with the Poverty Reduction Fund, include components geared to the development of agency financial management systems, particularly systems designed to channel resources close to the field level, as well as the formulation of sector level expenditure policies[8]. These projects are designed to meet the expenditure management needs at sector level. The challenge in coming years will be to coordinate the various initiatives across government, so that the core systems reforms, under PEMSP, support the initiatives taken by line agencies. At the same time, it will be important to ensure consistency in approach, particularly as regards reporting and accounting standards and compatibility of information systems. The recent establishment of sector working groups provides a framework for development of a consistent approach among development partners in the diverse NGPES sectors. Within Government, the Ministry of Finance is expected to assume a stronger role in guiding and supporting financial management reforms at sector level.

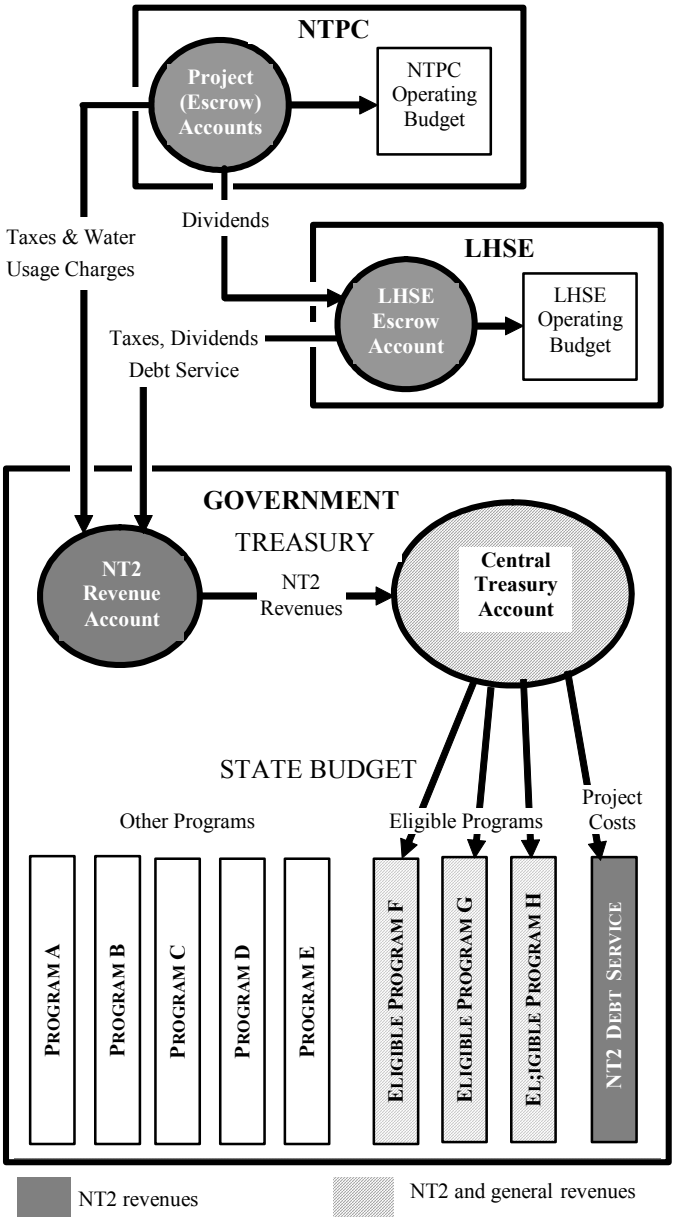
C. Specific Arrangements for Managing NT2 Revenues and Expenditures

14. ***Objective.*** The NT2 revenue and expenditure management arrangements seek to ensure that NT2 revenues are applied transparently and efficiently in financing of poverty reduction and environmental conservation programs reflecting the Government of Lao PDR's policy priorities as laid out in the National Growth and Poverty Reduction Strategy and its successors. These arrangements have been designed within the framework of the Budget Law, which requires a unitary and unified state budget, and guided by the principles of sound public expenditure management. They have also taken into account the need for allocational flexibility, given that development policies and needs are likely to change before and after NT2 commissioning, in FY2010, when revenues first come on stream. The arrangements build on and accelerate system-wide reforms under the PEMSP by focusing attention on a few high priority programs benefiting

---

[8] Second Education Development Project, Approved 2004, P078113; Second Road Maintenance Project, Approved 2004, P083543; Poverty Reduction Fund, Approved 2002, P077326; and Health Services Improvement Project, in preparation.

Figure 4: FLOW OF FUNDS



from NT2 revenues. These programs will be required to meet financial management and reporting standards and put in place adequate monitoring systems, including mechanisms for performance evaluation in consultation with stakeholders close to the field level. In this way, the implementation of NT2 revenue and expenditure management arrangements is expected to have a direct impact on the core systems used to manage all public resources, leading to improvements in transparency and the policy alignment of spending. The continuing need for specific NT2 revenue and expenditure management arrangements will be reviewed before project commissioning and periodically thereafter, taking into account progress in strengthening of the Government's public expenditure management systems.

15. ***Capture of NT2 revenues.*** There are two sources of NT2 revenues. The first source of NT2 revenues are revenues paid by NTPC, as provided for under the Concession Agreement, including water resource usage charges and taxes. Until commercial debt is fully repaid, these revenues will be paid from a project escrow account to the Ministry of Finance's "NT2 Revenue Account": thereafter, these revenues will be paid to the "NT2 Revenue Account" by NTPC (see Figure 4). The second source of NT2 revenues are revenues paid by the Lao Holding State Enterprise (LHSE) related to its equity holding in NTPC. Dividends from NTPC payable to LHSE will be channeled through an escrow account. Part of the funds transferred to the LHSE will cover operating expenses, on the basis of a budget approved annually by the Ministry of Finance as shareholder, and the company's cumulative fund required by law. The remainder of the funds derived from NTPC dividends will be transferred to the "NT2 Revenue Account", comprising the repayment and service of funds on-lent by the Government of Lao PDR for the purchase of equity in NTPC, taxes and dividends, and any payments under Article 19.1 of the Concession Agreement. Both NTPC and LHSE are required to prepare annual financial statements clearly indicating all payments of NT2 revenues. These financial statements will be subject to independent audits. In

this way, it will be possible to verify that all the NT2 revenues have been transferred to the NT2 revenue account.

16. ***Allocation of NT2 revenues***. NT2 revenues will be allocated to priority poverty reduction and environment programs identified in the NGPES and its successors. The Ministry of Finance will be responsible for verifying that the programs to benefit from NT2 revenues meet eligibility criteria (see Box 1). These criteria are intended to ensure that programs have a clear poverty reduction or environmental orientation, a track record of financial reporting and adequate monitoring systems, including mechanisms for consultation with key stakeholders. Programs will be budget entities, defined at the sub-sector level. Further refinement of program definitions may include geographical targeting of NT2 financed expenditures. The Government has identified five indicative eligible programs on the basis of NGPES priorities: basic education; basic health care; rural roads; local development initiatives identified through a participatory planning process; and environmental protection initiatives. These programs are implemented, in part, through statutory funds – the Road Maintenance Fund, the Poverty Reduction Fund Poverty and the forthcoming Lao Environment and Conservation Fund – which have specific oversight and governance arrangements. The selection of eligible programs will have to be adjusted periodically to take account of changing development objectives, as the Government prepares successors to the NGPES. Indicative allocations to the eligible programs will be included in the Government's medium-term expenditure plans. Funds will be allocated to eligible programs as part of a comprehensive State budget. For budget administration purposes NT2 revenues and NT2 revenue financed expenditures will constitute a "virtual fund": budget documents will clearly indicate the proposed allocations of NT2 revenues between priority programs for

Box 1: NT2 Eligible Program Selection Criteria

- Programs are identified as priorities in the Government's National Growth and Poverty Eradication Strategy, and its successors; with
- A significant and verifiable poverty reduction impact, providing public goods, services and infrastructure used by the poor in rural areas, including public services which aim to promote economic growth by increasing productivity and incomes of the poor; and / or
- A significant and verifiable conservation or environmental impact; and
- Clearly defined objectives, performance indicators and systems in place for monitoring performance in terms of the volume and quality of services provided;
- Established mechanisms for program performance evaluation, involving key stakeholders at or close to the field level;
- Programs are clearly distinguished in the Government's budget and chart of accounts (through a detailed administrative / organizational or program classification) at all levels of administration, with institutional responsibility for program management clearly assigned;
- Programs have administrative and financial management arrangements in place allow them to meet financial reporting requirements, and have demonstrated compliance with these financial reporting requirements;
- Programs have benefited from budgeted expenditures prior to selection and have a continuing recurrent financing requirement over the medium to long-term, and with a medium-term financing plan. In some cases, the Government may introduce new medium to long-term programs, reflecting policy initiatives launched under NGPES successors.

information purposes, but NT2 revenues would be subsumed within appropriations. Since NT2 revenues will be co-mingled with other Government funds, it will not be possible to identify individual transactions financed by NT2 revenues. Instead, additionality of NT2 revenues will be assessed against the base expenditures of eligible programs funded from general revenues. This will reduce the risk of NT2 revenues substituting for funding from other sources. The method for determining the additionality of NT2 revenues – and the need for continued monitoring of additionality – will be reviewed and agreed with the NT2 financing partners three years after project commissioning and thereafter as deemed necessary. The purpose of this review will be to ensure policy consistency and efficiency in the application of NT2 revenues, taking into account the structure of expenditure across the budget and absorptive capacity of eligible programs.

17. ***Flow of Funds.*** All NT2 revenues will be channeled through a segregated Treasury account held at the Bank of Lao PDR, the "NT2 Revenue Account" (see Figure 4). Funds will be released from this account to the Central Treasury Account for the purposes of budget execution on the basis of the approved apportionments (funds release authorizations) for the eligible programs. NT2 revenues will be co-mingled with other public resources and managed following standard budget execution procedures. However, the Minister of Finance may withhold the release of part of the funds held in the "NT2 Revenue Account" where: the application of funds is no longer justified or appropriate, for example where alternative sources for funding are made available; the agency responsible for the program has not complied with reporting requirements; there has been a serious control failure; funds have not been used for the purposes intended; or where budget execution has slowed significantly. This allows the Ministry of Finance to restrict the flow of funds to programs that persistently fail to meet adequate financial management standards. In order to ensure efficiency in the allocation of NT2 revenues, the Ministry of Finance will adjust allocations of NT2 revenues between eligible programs in-year following normal budgetary procedures. Funds retained in the account at the end of the year will be applied in financing eligible programs in the following fiscal year. The Ministry of Finance will prepare an annual statement for the "NT2 Revenue Account".

18. ***Reporting and oversight***. The reporting and oversight requirements for NT2 revenues are intended to promote transparency in public expenditure management. The Ministry of Finance will prepare and publish quarterly budget execution reports and annual financial statements for the eligible programs. If these reports are prepared for the state budget as a whole, clearly identifying the application of NT2 revenues, as currently scheduled under the PEMSP, specific reports on the NT2 programs would not be necessary. The control environment of eligible programs will be assessed through regular internal audits, undertaken by the Ministry of Finance. A summary report on internal audit findings will be published. The "NT2 Revenue Account" and eligible programs will also be subject to annual audit, carried out by the State Audit Organization, following INTOSAI standards. The State Audit Organization will be peer-reviewed by an INTOSAI member acceptable to the Government and NT2 financing partners to verify that standards are being applied and recommend corrective action where they are not. The peer review process will be funded by NT2 financing partners. Audit reports and a summary of peer review findings will be published.

19. ***Monitoring***. Monitoring of NT2 revenue and expenditure management arrangements will assess progress implementation of public expenditure management reforms, compliance with arrangements after project commissioning and the impact of NT2 financed eligible program expenditures (see Table 3 below). The key monitoring instruments are Public Expenditure

Reviews and Public Expenditure Tracking Surveys to be carried out every two years. The first Expenditure Tracking Survey focuses on the health and education sectors. Field testing is expected to take place in April 2005 and the main survey in October 2005. The results of this survey will feed into a Public Expenditure Review covering all NGPES sectors scheduled for the second half FY2006. The intention is to develop action plans for strengthening expenditure management and improving the impact of public spending in the indicative eligible programs. Impact will be assessed in terms of the pro-poor orientation of spending and progress against program performance indicators. Follow-up PERs and PETs will take place every two years, funded by the NT2 financing partners and other development partners. Analytical work will provide recommendations for strengthening of expenditure management arrangements.

Table 3: Monitoring Framework for NT2 Revenue and Expenditure Management

Monitoring Instrument	Before NT2 Commissioning	After NT2 Commissioning
PEMSP Progress Reports	Biannual	
Revenue Management Report		Annual
NT2 Consultation	Annual	Annual
Public Expenditure Tracking Surveys	2005, 2007	Every 2 yrs
Public Expenditure Reviews	2006, 2008	Every 2 yrs
Audit Peer Review	2006, 2009	Every 3 yrs

20. ***Consultations***. Prior to project commissioning, the Bank, together with other financing partners, will assess progress in implementation of public expenditure management reforms and the implementation NT2 revenue and expenditure management arrangements. The review will include a technical assessment as to whether the measures taken by Government are sufficient to meet agreed allocational and transparency requirements. If little progress has been made, and arrangements are not sufficiently robust, the review may recommend that part or all of NT2 revenues should be withheld in the "NT2 Revenue Account" until the necessary fiduciary safeguards are in place. Following commissioning, the Ministry of Finance will publish a summary report each year on the application of NT2 revenues, compliance with the financial management requirements and the measures taken to ensure that eligible programs meet allocational requirements and transparency standards. This report, together with the results of periodic PERs, PETs and audit peer reviews, will serve as the basis for annual consultations with NT2 financing partners. These annual consultations will provide an opportunity for the Government and NT2 financing partners to assess compliance with agreed revenue and expenditure management arrangements and recommend adjustments in line with progress in public expenditure management reforms.

Benefits, Risks and Alternatives

21. ***Benefits.*** The principal benefit arising from the NT2 revenue and expenditure management arrangements will be an increase in the level of spending on priority poverty reduction and environmental programs. As a secondary benefit, NT2 revenue management arrangements will improve transparency by requiring publication of budget allocations, quarterly budget execution reports, financial statements and audit reports, as well as requiring the

involvement of key stakeholders at or close to the field level in program evaluation. This represents a significant step forward in the Lao PDR context. However, the ultimate test of the NT2 revenue and expenditure management arrangements is that the additional expenditures contribute to improvements in public service performance, and thereby on poverty reduction and conservation outcomes – even if the achievement of these outcomes is influenced by a range of governance, policy and management arrangements that go far beyond the scope of the project. Regular public expenditure reviews and expenditure tracking surveys will provide a means of assessing these impacts and provide feedback that will help improve the development impact of NT2 financed expenditures.

22. ***Risks and Risk Mitigation***. While the NT2 revenue and expenditure management arrangements should ensure that NT2 revenues will be applied transparently and accountably in financing poverty reduction and environmental programs, there are risks associated with using the Government's expenditure management system. Delays in the implementation of the Public Expenditure Management Strengthening Program could mean that the key elements of revenue and expenditure management arrangements (the revised chart of accounts, program level financial reporting and monitoring mechanisms) are not in place by the time NT2 is commissioned. Implementation of PEMSP will benefit from support from the Bank and other development partners, with a considerable emphasis placed on capacity building at all levels. Support to PEMSP capacity building initiatives, close monitoring of PEMSP implementation and the linking of PEMSP milestones to PRSC prior actions should mitigate the risk of delay, by focusing attention on implementation of the reform program in the period before NT2 commissioning. Key elements of the revenue management arrangements are reflected in project agreements. Six months before COD, the status of NT2 revenue management arrangements will be assessed as part of the comprehensive project review. If little progress has been made, NT2 revenues will only be applied in financing those programs that meet the eligibility requirements, as stipulated in the project agreements. The Ministry of Finance can withhold program allocations in the "NT2 Revenue Account" until the eligibility criteria have been fulfilled or reallocate these resources to other eligible programs.

23. ***Alternatives***. Design of the NT2 revenue and expenditure management arrangements has drawn on the World Bank's experience in a variety of contexts: dams, oil and gas projects, and budget support operations. Key considerations in assessing the suitability of this experience in the Lao PDR context include the structure and volume of resource flows relative to total revenues, the prevailing governance arrangements and the legislative framework for public expenditure management. The alternatives considered are reviewed below:

(a) *Channeling of NT2 Revenues directly through the Poverty Reduction Fund and the forthcoming Lao Environment Fund.* This would target NT2 revenues to small-scale, community identified projects and environmental initiatives, and may reduce fiduciary risks, by segregating funds and providing for additional external oversight arrangements. Two concerns arise. First, NT2 funds are public funds and management of these funds should follow the procedures laid out in relevant legislation: NT2 revenues should be channeled through Treasury and allocated through the budget process. NT2 revenues may be allocated to statutory funds through these mechanisms but cannot be earmarked to the Funds directly. Second, the activities supported by these funds may not represent the most effective application of all NT2 revenues, particularly since these Funds would not be able to finance the recurrent costs of service delivery. Reflecting these concerns, NT2

revenues will be channeled through Treasury and allocated through the budget process. The indicative eligible programs identified include, but are not restricted to, the Poverty Reduction Fund, the Lao Environment Fund and the Road Maintenance Fund.

(b) *Establishment of an independent oversight body for NT2 revenue and expenditure management arrangements*. Independent oversight bodies can play a role in verifying regulatory compliance, improving transparency in decision-making and, in some cases, providing policy guidance. NT2 revenues and expenditures on eligible programs are subject to oversight by the National Assembly through the budget process and financial reporting process. While it may be appropriate for the National Assembly to delegate its oversight responsibilities in the case of single purpose funds, delegation to another body would be inappropriate where funds are applied across a range of sectors and institutions. The publication of key financial reports should ensure that adequate standards of transparency are maintained. Furthermore, preparation of the NGPES and the successors provides an opportunity for consultation with key stakeholders on expenditure priorities. Implementation of regular public expenditure reviews and public expenditure tracking surveys, together with the annual report on NT2 revenue management arrangements, should provide ample opportunity for consultation and oversight regarding expenditure priorities and performance.

(c) *Audit of NT2 Revenue Account and eligible programs by or in conjunction with a contracted independent auditor*. Given the limited capacity of the recently created State Audit Organization, involvement of an experienced auditor might lead to greater rigor in the audit process. Participation of a contracted auditor in the audit of the NT2 Revenue Account would be relatively straightforward but not particularly informative, since this is effectively a transit account and the Government's receipt of NT2 revenues can be independently verified from audits of the source of funds (NTPC and LHSE). Participation of a contracted auditor in the audit of eligible programs would be impractical: since NT2 revenues are co-mingled with general revenues in the Treasury account and disbursed through a large number of institutions at central, provincial and district levels, any contracted auditor would require significant scope limitations. In this context, the INTOSAI peer review process is considered the most appropriate means of helping the State Audit Organization gradually move towards international standards. Regular public expenditure reviews and public expenditure tracking surveys will also assess the adequacy of the control environment, identify fiduciary risks and provide a framework for consultation on the measures needed to improve financial management systems.