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Financial and Administrative Systems in Lao PDR

Foreword

In Sida's work toward the alleviation of poverty, the importance of a well functioning financial system and public administration, is increasingly being recognised as a prerequisite for sound economic development.

The present study makes an overall assessment as to the capabilities and weaknesses of the Lao PDR financial and administrative systems, with special reference to the Sida financed development cooperation projects and programmes.

The relevance and timeliness of this study is indisputable as we see Lao PDR gradually taking tentative steps toward an increased openness. Nonetheless, there remains a lot to be done within the financial sector. Deleterious elements such as corruption, lack of transparency and unclear legal, regulatory and administrative procedures continue to act as serious bottlenecks in the development of the Lao economy.

The study is an integrated part of the current preparation of the formulation of the Country Strategy for Lao PDR for the period 2004-2008, and has been commissioned by Sida in consultation with the Government of Lao PDR.

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Executive Summary

This study has been commissioned by Sida in consultation with the Government of Lao PDR as a part of the preparation of the formulation of Sida's Country Strategy for Lao PDR for the period 2004–2008. The objective of the study is to describe and assess Lao PDR's financial and administrative systems and its auditing capabilities and the associated weaknesses and risks of corruption in general as regards development of Lao PDR and specifically in Sida financed development cooperation projects and programs.

The study assesses its findings against Lao PDR's existing development policies and legislation on financial management and accountability and Sida's policies regarding sector programme support and regulation on anti-corruption.

Sida has had a long development cooperation with Lao PDR and has, at present, a cooperation within:

- Road building and maintenance
- Forrest and land conservation
- Health care and clean water
- Education
- Justice and statistics
- Democracy and human rights

Further to the objective above, the Consultant has assessed three Sida supported development activities and their contribution to the financial management in the sectors where they operate.

The report describes in more detail the Government's financial management system in the areas of planning, budgeting, disbursement, procurement, accounting, internal and external audit and procedures for executing recurrent and development budget.

Furthermore, the report deals with issues like decentralisation, macro economic policies where they influence financial management and assesses the extent and risks connected with corruption for the development of the country.

The Government's financial management system is, at present, characterised by being a manually kept system with the associated problems in reconciliation and timeliness and therefore lack of ability to serve as a management tool.

Additionally, the system is very cumbersome in some areas and suffers under lack of adherence at the decentralised level to rules and regulations on revenue collection and submission and budget execution.

There is a lack of sufficiently qualified staff in the civil service and it is difficult to hire and retain qualified staff due to salary level and timeliness of payments.

At the macro level, the connection between the State Owned Banks (SOBs) and Enterprises (SOEs) constitute a risk for the macro economic stability due to SOEs' non-performing loans in the SOBs and the Bank of Lao's guarantee for these loans.

The Consultant has had the opportunity to study available material on the level of corruption and interviewing a number of government employees and others on this issue and it is concluded that corruption is wide spread in Government, but that there at the same time is a true Government commitment to address the problem.

Donors are funding a number of activities improving the Government's financial management system and there is reason to be optimistic due to several circumstances like:

- A relative stable macro-economic growth in Lao PDR
- Relatively few donors are involved in assisting capacity building in financial management which improves chances for coordination of these activities
- Many laudable activities are being undertaken to modernise Government's financial management system
- A strong commitment by Government to streamline management and combating corruption

The three examined Sida financed development activities give quite a diversified picture of their contribution to Government's financial management system. One can be considered as efficient, but mainly geared towards Sida's accountability requirements, one as highly successful in merging its financial system with Government's and other donors', and finally one with a highly complex and perhaps over-ambitious development objective causing that less attention has been given to develop a proper financial management system.

These observations lead the Consultant to recommend to Government to establish a more formalised and coordinated cooperation between Government and the donors committed to support Government's strive for ownership and management of one common financial management system.

This cooperation should take the form of a coordinating forum headed by Government.

This forum should deal with not only the identified basic challenges of macro economic stability and salary levels, but also with the following issues based on a detailed Government strategy:

- Rolling out of the accounting system at present being introduced in four ministries and one province
- Strengthen internal and external controls
- On the basis of a more transparent financial management system, resolutely continue the combat against corruption in civil service
- Separate responsibilities between institutions involved in internal and external audit and increase independence of the latter

- Seek to establish one common procurement system for all procurement in the public sector

As to Sida's contribution to those recommendations the report recommends the following support and activities:

- In future development activities should utilize the recently introduced accounting system and integrate, as far as possible, the project system with the Government system
- Assist Government in the rolling out of that system in the form of equipment
- Support the establishment of the coordinating Government/donor forum
- Assist the internal and external audit system in the form of training and establishment of a training centre
- Assist Government in drafting an anti-corruption legislation drawing on international experiences

1. Preface

The Country Strategy is the most important instrument governing Sweden's cooperation with its cooperating partner countries, and therefore also with Lao PDR. It states the Swedish Government's views on cooperation with the country and stipulates the scope, focus, design and expected impact of programme cooperation. The country strategy encompasses all Swedish support to the country in question.

The present Country Strategy Process for Lao PDR, which will result in a Country Strategy for the period 2004–2008, is in its preparatory phase. During this phase, Lao PDR's development in general is analysed and discussed, as are the issues that Swedish support can assist in addressing. Financial management and accountability for public funds, including combating corruption, are very important elements in the development process and have significant influence on the ability to reach overall development objectives like poverty eradication, economic development and the rule of law. Therefore, assessing and addressing these issues are cornerstones in the Swedish Government's and Sida's development Country Strategy.

In the preparatory phase of developing the Country Strategy Process for Lao PDR, the Swedish Embassy is commissioning two complementary studies: one related to poverty in the up-lands and one study on democratic governance in Lao PDR. The present report, however, is a separate exercise to describe and assess the present Lao PDR financial management system, its capacity and risks concerning transparency and accountability.

The objective of this study is to assess Lao PDR's financial and administrative systems and its auditing capabilities and the associated weaknesses and risks of corruption in general as regards development of Lao PDR and specifically in Sida financed development cooperation projects and programs.

Sida's Policy for Sector Programme Support and Provisional Guidelines, 1997, give guidance on Sida's policies in the processes of development of a given sector. From that document, the following extracts give a good indication of Sida's policies on how accountability and transparency should be given adequate consideration in the process of assisting in developing sectors in cooperating countries:

"One common constraint is weak institutional management capacity, both in general terms and in financial management terms. Institutional strengthening is thus in most cases a key component of sector programme support, to be jointly agreed upon."

"Accountability, transparency and adequate measures to counteract corruption are legitimate concerns that need to be addressed. Systems and structures for financial resource management need to be analysed. Gaps and weaknesses in budgeting, accounting and control of funds will require solutions based on existing national mechanisms."

"To make it easier for the public administration in the partner country, the financiers must also be prepared to harmonise their rules and routines. They shall have the ambition to channel their contributions in the form of budgetary support, and cease to earmark funds and to make demands for special administrative solutions, so-called bypass solutions, which most often have the effect that funds are channelled outside the government budget and thus not accounted for in the budget."

"In most cases the conclusion will be that supportive contributions need to be made in order to improve the structure of the government and payment systems. The suitability of doing this within the framework of sector programme support or separately as an individual project must be considered from case to case."

"Where audit is concerned, Sida's point of departure is to build on and reinforce the national system. It is normally the case that the system has deficiencies which must be analysed and assessed." "Audits which are undertaken by an external firm of auditors shall always be performed in cooperation with the national audit institution and in the presence of representatives of this institution."

2. Background

2.1. Lao PDR's goal and strategy on poverty reduction and good governance

The Government of Lao PDR has the overarching development goal, stated in its 20-year plan, to graduate by 2020 from the group of least developed countries by the year of 2020. This goal will be reached by reducing poverty nation wide through sustainable resource management and equitable distribution of the benefits of high economic growth, while safeguarding the social, cultural and political identity of the country.

To make such progress possible, and enable optimal implementation of poverty alleviation policies, good governance has been identified as one of the main supporting elements.

Government institutions have had difficulties in addressing inefficiencies and inequities in the provision and quality of services. The prime limiting factors have been the lack of capacity for change within the public sector, this being attributed mainly to human resource deficiencies.

The Government is therefore aiming at developing an efficient, effective and low cost administration that will enable Lao PDR to better manage and control its development.

In this process, Government of Lao PDR has identified three elements as being particularly important:

1. *Human resource development* – in the context of the governance framework, this means improving the capabilities and building the capacities of the people at all levels of state, civil service and the private sector
2. *Ethics and integrity* – lack of an ethics infrastructure and lack of systematic integrity seriously compromise poverty eradication targets. As such, building systems and providing education that ensures public servants at all levels and private citizens act ethically and with integrity is essential to the future of Lao PDR
3. *Transparency* – transparency is key to ensuring that society has the means to participate in the decisions of Government and ensuring that Government is accountable and legitimate.

Proper financial management is an integrate part of the three elements and even a prerequisite for reaching the overall goal of poverty eradication.

2.2. Sida's cooperation with Lao PDR

When Sweden's assistance to Lao PDR began in 1974, the country was badly damaged by war. Sweden was one of the first countries to give support to Lao PDR, and is even now one of the most important donors to the country.

The primary aims of Sida's development cooperation with Lao PDR are to reduce poverty in rural areas, to promote democratic development and respect for human rights. The assistance from Sida is further to promote economic development that is sustainable and will benefit the entire population.

The Swedish support is mainly focusing on the following sectors:

- Road building and maintenance
- Forest and land conservation (including research)
- Health care and clean water
- Education
- Justice and statistics
- Democracy and human rights (mainly through legal sector)

As outlined above, the Sida sector programme approach prescribes, in essence, within financial management, to utilise the recipients own systems for project implementation, i.e. planning, budgeting, disbursements, accounting, internal controls and external audit. If it is deemed that the national system is not capable of providing sufficient accountability, the Swedish assistance will assist the recipient to reach the required level.

In addition to the TOR for this assignment, the Consultant has been requested to assess the past experiences within financial management and accountability gained from Swedish assistance to Lao PDR. This assessment has been based on consulting material received from the Swedish Embassy on the following three initiatives that have received Swedish assistance:

1. Lao Swedish Forestry Programme (LSFP)
2. Lao-Swedish Road Sector Project (LSRSP)
3. National Water Supply and Environmental Health Programme (Nam Saat Central) (NWSEHP)

In addition, the Consultant has interviewed staff who either are, or have been, involved in the implementation of the three activities.

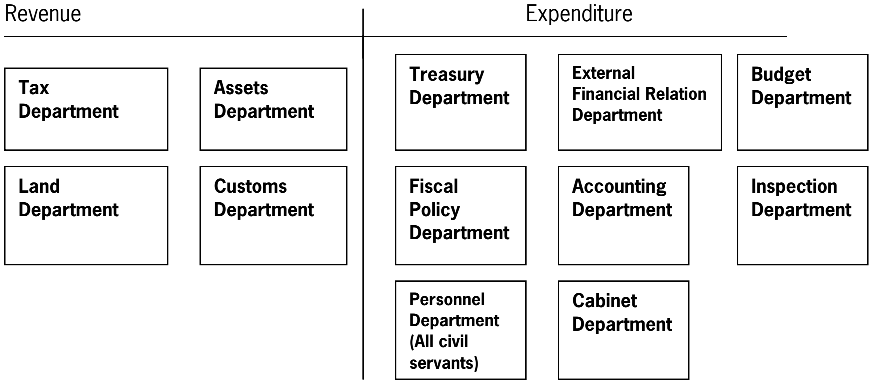
A description of the financial management related issues under these programmes and an assessment of those activities are given under paragraphs 6 and 7.11. respectively.

3. Government of Laos financial management system

As will be seen in paragraph 7.9. of this report, substantial changes in Government of Lao financial management system are under way. These changes are mainly undertaken by means of external funding in the form of loans, TA and grants and reflect the attempts of Lao PDR to streamline the public administration and improve the availability of management information, accountability and transparency.

Administratively 32 line ministries/central agencies and 18 provinces manage Lao PDR.

Ministry of Finance (MOF) that is the main responsible body for financial management and accountability of the Government of Lao PDR is divided into 12 departments:



3.1. Planning an budgeting system

The Government of Lao PDR's financial year runs from 1 October to 30 September and for the first time in many years, the Government of Lao PDR in March 2002 published the expenditure (2000/01) and budget (2001/02) for the Government and the provinces.

The *recurrent budget* is mainly based on last years budget. The line ministries/provinces submit their budget plan to Budget Department, MOF and negotiations are undertaken with the individual institutions. National Assembly approves the recurrent budget. The approved budget comes back to Budget Department (MOF) and ministries/provinces are informed on their allocation for the coming year. Based on the allocation, the line ministries and the provinces spilt the allocation into departments and expenditure categories and submit the split Budget to MOF for approval.

The annual *capital budget* spending in Lao PDR is undertaken in the context of a comprehensive planning framework. This framework includes a 20 year plan, a five year National Socio-Economic Development Plan (NSEDP), a five year and a one year Public Investment Plan (PIP).

The 20-year plan contains the Lao PDR's strategy for abolishing its status of least developed country by 2020 which goal is pursued through eight national socio-economic priority programmes. The Lao PDR's goal is to increase economic growth to minimum 6.6% per year and to improve especially food security. Sector ministries have their own complementary strategic plans.

This goal will be pursued in three stages:

1. Transition from a command to a market economy
2. Establishment of physical and human infrastructure
3. People centred development aimed at improving the well being of the populace (basic food security and decentralisation of development responsibilities)

The five-year NSEDP translates the 20-year plan into targets and objectives for sectors and regions. The targets and objectives reflect eight priority national programmes.

The PIP, which is a component of the NSEDP, lists the investment projects contained in the various sector programmes. The annual PIP sets the annual context of the five-year PIP.

3.1.1. Planning procedures

Yearly, the CPC issues Budget and Planning Operational Guidelines for provincial authorities, ministry authorities and project managers. The guidelines contain detailed instructions to be followed by the respective authorities during the project circle.

Projects are divided into three categories:

1. Large projects (5 bill. Kip or more)
2. Medium projects (500 mill. – 5 bill. Kip)
3. Small projects (0–500 mill Kip)

The procedures for approval vary for the three categories of projects. The large projects will go through ten steps of documentation before approved, medium size projects six steps and small projects two steps.

The annual process starts with the Ministry of Finance making a forecast of the total public capital budget available for the fiscal year. The forecast is submitted to CPC, which then makes a draft allocation by sector, executing agencies and projects. The allocation takes the current priorities and the performance of ongoing long-term projects into consideration.

CPC makes a detailed (project-by project) allocation for existing medium and large size projects, and distributed to all Government Executing Agencies (ministries and provinces). The agencies then collect project plans for all planned and on-going projects and draft separate

PIPs for ministries and provinces. These PIPs are presented and discussed at three regional planning meetings where after CPC combines the PIPs into a national PIP in cooperation with Ministry of Finance.

The PIPs include both donor and local funding of projects, split into the two sources of funding.

The draft national PIP is presented by CPC and discussed with the Ministry of Finance. The final draft PIP is then drafted in two volumes, one for provincial projects and one for line ministries' projects. The final draft PIP is then submitted by CPC to the National Assembly for approval.

Once the national PIP is approved, the Ministry of Finance is responsible for disbursing the agreed project allocations to individual projects.

3.2. Disbursement system

Once the National Assembly has approved the PIP, the Ministry of Finance takes over the responsibility for disbursements to projects. The Budget Department is responsible for final approval of disbursements of local funds while External Finance Relations Department is responsible for approval of loan draw downs. All physical payments are made by the Treasury Department in Ministry of Finance or by lenders directly to suppliers.

All payments to projects under provincial responsibility are made on a quarterly advance basis in accordance with expenditure projections in the PIP. Based on quarterly detailed financial returns from the provinces, quarterly disbursements continue. In case of non-submission of accounts, the quarterly disbursements are postponed by MOF until accounts are submitted.

Payments on domestically funded projects and where counterpart funds (in Kip) are involved, payments are approved by the executing agency/ministry and submitted to Budget Department for approval and availability of funds. From here the authorisation goes to Treasury for payment.

In the case of external loans, the project submits the payment or replenishment request to the executing agency. After approval the executing agency submits the request to Ministry of Finance, External Finance Relations Department which then submits the request to the lender. The lender then pays the supplier (in the case of direct payment) or submits replenishment funds to the BOL to an account in the name of MOF. In the case of the latter procedure, the project will submit individual payment requests through the executing agency for payment by national Treasury.

In case of Sida grants, the general procedure is that the replenishment request is submitted by the project through the executing agency on a quarterly basis to the embassy with copy to Ministry of Finance. The embassy submits the replenishment request to Sida HQ in turn instructing the Riksbank to submit the requested funds to BOL. BOL only transfers the funds to the project account when the transfer is approved by MOF. MOF is responsible for recurrent payments of line ministries' expenditure while provinces pay recurrent expenditure out of their own coffers.

3.3. Accounting system

MOF has two Departments responsible for each their elements of accounting. The Accounting Department is, roughly said, responsible for drafting rules and regulations and supervision of their implementation, while Treasury Department is responsible for the actual accounts processing.

The Accounting Department consists of three divisions:

Administration Division Personnel Administration Research Monitoring Training	**Private Enterprise Division** All regulations concerning private enterprise accounting and their enforcement	**Government Accounting Division** Government accounting regulations Project accounting (in cooperation with Fiscal Department)

The actual handling of funds is undertaken by the Treasury Department, which consists of five divisions:

Accounting Division Preparing consolidated reports of revenue and expenditure	Deposit Division Manage savings and deposit accounts	Cash Division Collection and disbursement of cash and preparing consolidated reports on cash	Revenue Division Recording of revenue and monitors the collection of revenue	Disbursement Division Monitors compliance with the approved budget, prepares consolidated

The *Accounting Division's* responsibilities include preparing consolidated reports of revenue and expenses that flow through the Treasury system. The *Deposit Division's* role is to manage the saving and deposit accounts with the Treasury, provide financial services such as withdrawal and transfer of funds and manage the Treasury bond account. The *Cash Division* is responsible for the collection and disbursement of cash. The Division is responsible for preparing daily, weekly, monthly and quarterly reports and an annual consolidated report on cash receipts and expenses. The division is responsible for monitoring petty cash advances and for the security of the cash in its custody. The *Revenue Division* performs the recording of revenue of the MOF. The Division monitors the collection and transfer of revenues to the Central government. The *Disbursement Division* is responsible for checking the correctness of payment vouchers and withdrawal requests submitted by the respective departments. The Division monitors compliance with the approved budget for expenditures, prepare budget reports of expenditure, prepares daily, weekly, quarterly and annual consolidated reports of budget expenditures incurred.

3.4. Procurement

The Implementing Rules and Regulations (IRR) on Government Procurement of Goods, Construction, Repairs and Services, No. 1639/MOF establish the implementing rules for Government procurement of goods and services. 1639/MOF is based on decree No 95/CM 5 December 1995. The purpose of the rules is to

- Ensure transparency of public procurement
- Achieve regularity and uniformity of procurement
- Achieve savings and efficiency in procurement
- Guarantee suppliers and contractors fair and equal access to the award of contracts

Invitation of bids shall be publicised in Lao language newspapers (domestic public bidding) in English language newspapers (international public biddings) and shall contain the identity of the procuring entity, a summary of the works or goods sought, cost of bidding documents, procedural requirements and final date for submission of bids.

The rules set certain thresholds for procurement procedures, thresholds that are to be reviewed every two years by Ministry of Finance.

Additionally, the rules open the possibility of limited bidding or direct contracting. Limited and direct contracting can be used where the value not exceeds certain thresholds or in case of urgency, or when no responsive bids were received in response to a public bidding procedure. Additionally, direct bidding may be used for technical reasons where additional supplies or works may be required to an ongoing contract.

In the case of foreign grants or loans, the provisions of national rules apply with full effect, amended where necessary to comply with donor requirements (such as threshold levels and access by member country contractors), unless the relevant donor country or financial institution requires adherence to its own specific procurement procedures, in which case such prescribed procedures shall be followed. In both cases, the procurement procedures shall be executed by way of a national procurement committee, operating under the following rules:

- In the case of public or limited bidding it shall be composed of 1–3 representatives from the procuring entity, 1 representative from MOF, 1 from BOL/CPC when international procurement is involved, or contracts involving foreign aid and loans
- In the case of direct contracting the committee shall consist of 3–5 persons from the procuring entity itself
- The price comparison is executed by a permanent committee headed by the relevant Vice Minister or Chief of Finance Division, 2 representatives from the Cabinet, 1 representative from the Finance Department and 1 representative from the department seeking the procurement
- In case of high value contracts (exceeding 50 mill. Kip) the decision by the procurement committee is subject to approval by a meeting of ministers or vice ministers
- In the case of any contract exceeding 1 bill. Kip, the contract must be approved by the Government

3.5. Internal control system

Internal controls are carried out to promote an economically efficient, effective and corruption free financial management environment. It is generally accepted that internal controls are best supported by an internal audit function that acts as a resource for senior management in the exercise of its duties.

Internal control is a process that is carried out by an entity's management and other personnel for the purpose of gaining reasonable assurance of achieving:

- Efficiency and effectiveness of operations (an entity's basic business objectives, performance and outputs, and safeguarding of resources)
- Financial reporting (the reliability of financial statements)
- Compliance (compliance with laws and regulations to which the entity is subject)

The Inspection Department, Ministry of Finance, (ID) has been in existence for approximately 27 years, but initially there were no clear rules regulating its roles and responsibilities as there are now. In total the ID has a staff of 15 inspectors. The roles of ID contrary to the IDs of line ministries are those of compliance audit while the IIDs of the line ministries are more looking at strict internal financial audit. The ID has carried out internal inspections of 15 SOEs and 3 provinces in the financial year 2000/01 and in Treasury, 10 SOEs, 3 line ministries and 3 provinces in 2001/02.

The ID has made inspections in State Fuel Company, Lao Aviation and Irrigation Project no. 1.

By Decree no. 0431/MF, April 2001, the new roles, duties, rights and organisational structure of the Inspection Department (ID), Ministry of Finance, are clearly established.

The role of the ID is to execute the overall control and monitoring of the administrative-technical Government agencies at all levels, state owned enterprises, enterprises in which the Government holds shares and other relevant institutions that are connected with the financial activities inside the country and abroad.

The ID has in essence the following duties:

- Control execution of financial regulations
- Control various sectors, provinces, and persons concerning the execution of laws/regulations on accounting, finance, national budget, customs, taxes, assets, and real estates
- Report to Minister of Finance and make recommendations on findings and measures to address deficiencies
- Make proposals for the improvements of regulations

The ID is comprised by 3 Divisions:

Division of Consolidation	Division of Budget Revenue-Expenditure Control	Division of State Owned Enterprises and State Hold Equity

As examples where ID inspections have resulted in punitive reactions the following were mentioned during discussions with management of the ID:

- In Attapeu Province where the Governor and 10 high-ranking officers have been punished for a number of irregularities, e.g. illegal timber trade.
- ID has also carried out inspections in Treasury where a number of mid-managers have been punished for irregularities.

In carrying out its duties, the ID has a close cooperation with the SAA (see paragraph 3.6.) and the SIA (see paragraph 4.3.).

3.6. External Audit

The State Audit Authority (SAA) was established by Prime Minister Decree No. 174/PM of 5 August 1998. SAA is the supreme audit institution in Lao PDR and reports to the Prime Minister.

SAA is authorised to carry out the auditing of the accounts and certify the appropriateness and reliability of accounts, data, and records of ministries, committees, organisations, provinces, municipalities, special zone, districts, state owned banks, state owned enterprises, and other institutions that are funded by the state budget or by international borrowings or grants.

The audit by the SAA is to identify agencies' strengths and weaknesses on the one hand and on the other to give directives for enhancing the efficiency, economy and effectiveness in their performance.

More specifically the SAA has the following tasks:

- Audit the accounts of organisations and projects which are funded by the state budget
- Audit the accounts of internal and external investment projects, infrastructure development and foreign grants, including other special programmes
- Audit the accounts of state enterprises, joint ventures between public and private enterprises funded by loans from state owned banks
- Certify, verify and express opinions on accounting, records, information and financial statements of the audited organisation
- Sum up and report on the audit findings to the Prime Minister in a systematical way
- Report on the audit activities to the National Assembly once a year
- Keep various documents that have been audited as confidential documents
- Develop its own work plan and yearly and five year budget plans

To execute above tasks, the SAA has the right to use the following tools:

- Obtain the necessary documents from various institutions for the purpose of auditing activities or require representatives of the relevant institutions to provide clear additional explanations concerning their activities
- Carry out the audit in various organisations in a timely manner
- Give instructions to the institution to be audited in view of ensuring the adequacy of means established to protect the public assets and the economy and efficiency
- Suspend all illegal activities of the audited institution

– Recommend relevant measures to suspend illegal operations of the audited institution
– Hire private auditors/firms to execute audit, if necessary
– Coordinate with various institutions for promoting the reliability and effectiveness in the audit activities

The SAA is organisationally divided into three departments with the following responsibilities (number of staff in brackets):

Cabinet Department	Government Agencies Department	Investment Cooperation Department
Administration Personnel Budget Accounting Foreign Corporations Research (7)	Ministries Provinces State Owned Enterprises (10)	Projects Loans Grants (14)

3.7. Other institutions

3.7.1. Bank of Lao (BOL), State Owned Banks (SOBs) and State Owned Enterprises (SOEs).

The central bank, state owned banks and state owned enterprises are normally not included in a description of a government's financial management system. In the case of Lao PDR, however, these institutions play a significant role in the overall macro economic situation and pose a potential risks for the system's sustainability that a description of their functions and an assessment is included in this report.

Fiscal policy in Lao PDR is crucial for both macro-economic stability and implementation of Government's key policy objectives through the national budget. Demands for spending to meet these policy objectives are high. However, the Government is dependent on its ability to raise domestic revenues, the level of donor inflows and the possibility of financing the budget deficit through borrowing from the banking system.

BOL financing of the deficit creates significant risks of inflationary pressures and previous experiences have demonstrated that a rapid expansion of credit to finance budgetary operations will increase the pressure on the exchange rate of the kip. This will swiftly result in a depreciation of the kip putting upward pressure on prices. The scope for BOL financed deficit spending is therefore limited.

There are approximately 34 fully state owned SOEs as well as 8 joint and 59 provincial SOEs and 4 state owned banks. Over the years the GOL has reduced the number of SOEs, but they still constitute a significant problem concerning GOL liabilities in the form of guarantees for non-performing loans by SOEs from the SOBs.

4. General GOL policies affecting the financial management system

4.1. Decentralisation

The current decentralisation policy of Lao PDR introduced new administrative and financial arrangements in 2000/01, which extended financial management responsibilities to provinces and districts in the formulation and execution of budgets.

Lao PDR has experienced several changes in policies governing the level of centralisation/decentralisation of decision-making processes and financial management. A centrally planned economy was established in 1975, even though logistical problems in reality allowed provinces to enjoy a large degree of autonomy. In 1986, a liberalisation of both internal and external trade, the privatisation of state-owned enterprises and a formal devolution of powers to the provinces was introduced. Until 1991, expenditures were under the control of the province governor and taxes were collected by the provincial branches of the MOF and were regarded as provincial revenues. Few resources were transferred to the central government by the provinces. Government employees were managed provincially rather than centrally. Local branches of the State Bank acted independently and even set exchange rates independently in each province.

This devolution resulted in large disparities between provinces in standards of service provisions due to the differences in tax base between the provinces. In 1991, a law was passed to achieve greater uniformity, requiring all revenues to be passed to the MOF as part of a unified budget.

In 1997, however, provincial governors were given responsibility for a wide range of government services and since 1997 budget allocations for those services have been channelled through the provinces and not through the line ministries. This decentralisation was reinforced in 2001 by Prime Minister Decree 01 and Instruction Note 128 from the State Planning Committee that had the objective of making the provinces the strategic unit, the district the budget planning unit and the village the implementing unit.

4.2. Line ministries role in financial management

The separation of responsibilities between provinces and line ministries is illustrated in this study through the example of Ministry of Health (MOH).

On Government budget, the Provincial Health Departments report financially directly to Provincial Management with copy to MOH. Budget forecasts are developed by the Health Department in the province and are approved by the Provincial Government. MOH receives copy of the budget forecast, but is not involved in the budget planning and implementation in the province. All health staff at the provincial level is provincial staff.

MOH is executing agency for all major grant and loan-funded projects in the health sector and typically establish a Project Management Unit (PMU) to manage the project. The provinces execute smaller grant funded projects and they receive contribution funds from MOF to meet those expenditures.

To execute financial management of externally funded projects finance sections are typically established within the PMU and PMUs forward requests for funding through MOH to MOF. MOF submits after approval the request to the donor agency in question. After approval by the donor, funds are forwarded to BOL and released to the project account in the name of MOF. MOH, in other words, has no direct access to the funds. Projects report quarterly to MOH on expenditure. MOH is, though, right now, with the assistance of the ADB, going through the process of setting up of a computerised budget system that will secure the registration of all projects in the health sector including project budget and expenditure. These changes will take some time to implement, but will eventually result in that line ministries will have the direct responsibility for financial management of especially grant funded projects

There is an Internal Inspection Department (IID) in MOH that has the responsibility for inspecting all MOH management issues, including financial management. It has a staff of ten and reports directly to the Minister and to the State Inspection Authority (SIA). The staff of the IID is MOH staff, appointed by the Minister of Health and approved by the SIA. The IID has the responsibility of inspecting health sector projects as well as the ministry proper.

4.3. Anti-corruption

> "There are still some state officials who cooperate with private companies to avoid correct tax payments, so we have to improve the management in this area. Over the previous year we have found some corrupt officials and some we have educated while others we demoted"
>
> *Deputy Head of the Prime Minister's Office, Dr. Khampheng Saysompheng to Vientiane Times 27–29 August 2002*

Corruption is a crime often confused with other financial crimes as theft, embezzlement and fraud or simply with poor financial management. A main reason for differentiating between types of financial crimes or neglects is that the way to address them is different. Theft, for instance, can be addressed through control mechanisms while corruption, like receiving a bribe for not giving a speeding ticket or for pressurising for a fee for giving an injection supposed to be free of charge, cannot.

Corruption can in its most strict form be defined as a person, serving the public, receiving an unjustified benefit for

– Rendering a service he or she should be giving for free

– Not executing his or her duties in accordance with rules and regulations
– Abusing public office for personal gains

Sida's anti-corruption regulation of May 2002 forms the basis of counteracting the risks of corruption and dealing with any cases of misuse of Swedish financing of development co-operation that may arise.

The motive of the regulation is to counter the negative effects corruption has on development objectives like poverty eradication, economic development, the rule of law and a democratic social structure. The regulation applies to all stages of cooperation between Sweden and its development partners.

Sida shall, according to the regulation, determine on a case-by-case basis, analyse and take account of the risks of corruption within the scope of the country strategy programme. In that context the regulation stipulates that it is important to assess the co-operating country's administration and the associated risks of corruption in development cooperation, together with national auditing capabilities and practices, in close cooperation with the cooperating country and other donors. Furthermore, the regulation e.g. stipulates that:
– Sida shall analyse and assess the cooperating partner's capacity when preparing for all major contributions. Conclusions on capacity including the risk of corruption must be borne in mind when arranging support
– Sida shall never accept corrupt behaviour and shall always raise any such concerns in its dialogue with the cooperating partner. Sida shall always follow up on such matters and demand that the cooperating partner takes any measures necessary

In Decree no. 193/PM on Anti-Corruption, dated 2 November 1999,

Lao PDR sets out the provisions, methods and responsibilities and procedures and solutions to corruption.

Article 1 in the Decree states that the concept of the decree is to
– Raise the effectiveness of prevention and suppression of corruption as well as to increase public awareness regarding regulations and laws
– Strengthen the transparency of both the party and the state, and mass organisations at all levels
– Create peace, discipline and justice within the society
– Protect the state, the collective and individuals and
– Strengthen the power and dignity of the people's regime.

Article 11 it says:

> "The Central Committee for Control (CCC) provides supervision for anti-corruption progress and works in cooperation with officers of the public prosecutor, the Ministry of Justice, the Ministry of the Interior, the Ministry of Defence and other agencies, with regard to inspecting and supporting other state agencies from the central and local levels in their anti-corruption activities throughout the whole nation."

The CCC is a committee more geared towards controlling the discipline and ethics of party members. In 2001 the control with financial issues was expanded to cover all employees in public service and a decision was made that these issues was to be handled by a separate institution reporting directly to the Prime Minister.

The State Inspection Authority (SIA) was established in June 2001, based on decree 98/PM, May 2001, which defines the function and role of the SIA. As mentioned above, the establishment of the SIA at the same time constituted a division of the tasks under the supervision of the CCC where SIA now has the following:

– Carry out audit inspections of state institutions and SOEs
– Prevention and suppression of corruption
– Ombudsman's functions

The SIA reports to and is under the direct instruction of the Prime Minister. Until now, the SIA has not had the capacity to develop and implement its own work plan, but has reacted on direct instructions by the Prime Minister based on complaints from the public.

As a special function, the SIA is also a kind of Ombudsman's Office handling people's complaints, also over court decisions. The SIA can establish whether the court has acted correctly and if it finds the court decision erroneous it can recommend that a higher court conduct a new hearing of the case.

There is no law guiding the procedures for solving people's complaints and the issue brings up questions of legitimacy and jurisdiction for the National Assembly, the administrative system and the court system.

Due to lack of capacity it is not possible for the SIA to deal with all complaints within appropriate time.

The VII Party Congress directed the SIA to combat corruption at all levels and secure transparency and accountability of Government by finding and secure that wrongdoings are punished.

5. Donor assistance in the area of financial management and accountability

In the 1997–2000 Lao PDR experienced a period of high inflation due to public over expenditure. After coming to grips with the situation in 2001 Lao PDR is now experiencing a stabile situation in terms of exchange rate and inflation. Lao PDR has entered into an agreement with IMF on a loan of 40 mill. $ for macroeconomic stabilization. On the structural side, the World Bank has established a financial management adjustment credit. Especially the IMF, WB and ADB have focused in their assistance on general financial management and accountability issues and macro-economic stability.

ADB is the major external partner to Lao PDR in relation to financial management. The ADB funded activities can be summarized as follows:

1. An ADB TA in 1996 provided grant funds to
   - Prepare national procurement regulations for the public sector
   - Prepare model bidding documents and establish a contractor's registration system
   - Develop the role and guidelines of the Procurement Monitoring Office (PMO) and train its staff

   The TA was successful in drafting the IRR 1639/MOF and establishing the draft charter for the PMO. The second ADB TA in 1998 funded institutional strengthening of the PMO, including further training.
2. ADB supported SAA in its establishment in the form of TA in 1998/99 and ADB is still willing to support SAA, but awaiting permanent appointment of a new Auditor General. The continuation of the project will mainly be for capacity building in the form of training of staff for meeting international audit standards. ADB has problems in funding equipment and the needed training facility.
3. Ongoing ADB TA with MOF, 3309/Lao: Enhancing Government Regulations and Procedures. The objectives of the project are:
   - Preparation of accounting regulations for implementing the Government accounting decree 20/PM
   - Design the form and content of the Government's financial statements
   - Development of a comprehensive accounting policies and procedures manual incorporating internal controls
   - Development of an in-depth training programme for counterpart

staff in MOF and SAA
- Conduct of training to establish and implement the improved accounting systems and procedures in four key Government ministries and one province
- Organisational design of MOF departments and key ministries and one provincial government for managing the accounting function
- Preparation of a financial inspection manual for the Department of Inspection in MOF and training inspection staff in using the manual

The TA has drafted regulations and procedures that were approved by MOF in June 2002. The assistance covers computerisation of accounts in four pilot ministries and one pilot province (Health, Education, Agriculture, Treasury Department, MOF, and Savannakhet). The system captures recurrent expenditure, including counterpart funds and domestic development expenditure. The general concept is to transfer this accounting responsibility from MOF to line ministries. The TA has also involved substantial training of accounting staff in the pilot ministries and province. It is estimated that the rolling out of the project to cover all ministries and provinces will cost approximately 1 mill. US$ to purchase necessary equipment.

The accounting system in line ministries (before commencement of this project), was manually kept or in spread sheets. E.g. MOH kept around 30 cash books for each health department. Now they use the computerized system that has got rid of all the cashbooks and they can retrieve information from the automated system by cost centre (Department) or by consolidation and by category. The most important feature is that the line ministries can now reconcile their books against national treasury on a timely basis. Accounting reports are now used as a management tool to see the exact recurrent budget situation of each cost centre.

The Inspection manual has been drafted and training is in progress and also for Accounting Regulations and Procedures. The TA is coming to an end in March 2003 and the recommendation on assistance from Sida (see par. 8.2.) in this area should be seen in that perspective.

4. Ongoing ADB TA 3626/Lao. Capacity Building in Project Financial Management. Objectives of this TA are to:
   - Improve the loan disbursements and budget mechanisms for the Government
   - Provide training on project accounting to the project staff as well as Government financial management staff

   The existing disbursement approval system had proved to be very cumbersome and lengthy especially due to numerous pre audit checks prior to a disbursement by Treasury. The main feature of the disbursement regulation is to change responsibility for bank accounts from MOF to the executing agency and shift the emphasis from pre- to post audit accentuating the later recommendation for possible Sida support to strengthen the internal inspection and external audit functions.

> Norad, IMF, and UNDP have been supporting a programme (Lao 96/005 strengthening Fiscal Management/Tax and customs Reform) on tax collection/submission and customs. The arrangement includes measures on tax and customs policy and administration. On the tax reform side, significant changes are currently being developed to implement a less distortional tax system, including the introduction of a value added tax (VAT) in substitution of the current turnover tax. In spite of the GOL's efforts and the TA to improve tax and customs administrations, improvements in revenue performance has fallen below expectations.

The main focus of the tax part of the programme is on structure, procedures and computerization of taxation. A Large Taxpayer Unit has been established in MOF, but it has been difficult to establish the unit as a national entity, mainly due to provinces' lack of enthusiasm to surrender national taxes to the centre. The centre furthermore lacks the capacity to monitor the provinces' performance in collecting taxes. On company taxes, it is estimated that there are 66,000 companies in Lao PDR of which 64,000 are termed as small businesses, representing 6% of the total company tax revenue. The centre has now fielded tax audit teams to visit the medium and large companies, but there is still room for improvements in this exercise.

The programme has provided the MOF with far better information on performance in revenue collection and a much higher level of transparency since the start of the programme.

Customs rules have been simplified and the amount of paper work has been significantly reduced. There are still problems in the valuation of goods in customs and a lack of conformity between the provinces in their practices resulting in costumers "shopping" between entry points.

Sida has committed itself to support the III. Phase of the programme, thereby replacing the Norad funding.

5.1. Donor relations and coordination in financial management and accountability

In most developing countries each donor, quite naturally, seeks to protect its investment and see to that the best possible accountability is rendered to those it in turn is accountable to. This practice results, in the best cases, in what could be termed as islands of excellency, but leaves the recipient with a fragmented financial management system that is incapable of rendering global accountability to its constituency.

External Financial Relations Department (EFRD), MOF; has the responsibility together with CPC for donor relations. EFRD has more specifically the responsibilities for:

- Securing external financing
- The entire project circle for credits and loans (in cooperation with CPC)
- Grants (on information basis)
- Authorising direct payments from lenders
- Authorising and monitoring repayments of loans

EFRD participates with CPC, line ministries and provinces in budget preparation and follows closely the budget circle when it comes to loans and Conditionalities for credits. Implementation of grant-funded activities is being decentralised to line ministries and other executing agencies. The EFRD is e.g. not involved in the monitoring of Sida funded grants, which is now exclusively in the hands of the involved line ministries.

EFRD confirmed during the study that different lender rules and regulations and modalities pose a significant problem in the consolidation and monitoring of external loans.

Effective donor coordination in financial management and accountability involves that all donors who subscribe to the concept of national management and ownership of the development jointly with the Government strive for the following:

- Follow one common strategy to develop the capacity of Government to a point where all revenue and expenditure, irrespective of its source, can be handled by one common government financial management system
- One common agreement and reporting system for activities to improve Government financial management and accountability and combat corruption
- All stakeholders discuss regularly deficiencies in Government financial management and agree on measures to address these deficiencies
- That donor requirements are discussed for the purposes of harmonisation

As indicated in previous paragraphs, a large number of activities are being undertaken in the area of improving GOL financial management, but the activities are not coordinated as indicated above.

6. Sida's assistance related to financial management and accountability

As mentioned in paragraph 2.2, the Consultant has been requested to describe, and assess three Sida financed development activities for the appropriateness of interventions concerning financial management and accountability. To this end, the Consultant has been requested to assess three specific Sida funded activities. The three activities are:

1. Lao Swedish Forestry Programme (LSFP)
2. Lao-Swedish Road Sector Project (LSRSP)
3. National Water Supply and Environmental Health Programme (Nam Saat Central) (NWSEHP)

The *LSFP* started in 1977 with the goal of promoting the sustainable use of forest and agricultural land. The assistance has been rendered through the Department of Forestry at the Ministry of Agriculture and Forestry and then through the provincial and district agricultural and Forestry Offices. The LSFP was terminated 31 December 2001.

The ambitions of the programme encompassed model development activities, competence development and research. The two first ambitions were mutually dependent. The LSFP was a process-oriented programme that stressed "learning by doing" and the development of methods, models and methodologies contributing to develop competence of Government staff.

The design of the latest phase (phase IV) of the programme was initiated towards the end of 1994. The structure of the programme centred around six sub programmes. These were all centrally based in Vientiane with the exception of the Shifting Cultivation Research sub programme. The Institutional Strengthening sub programme was responsible for the training and programme coordination functions. It was also responsible for the decentralised units covering four provinces, seven districts and two Extension Training Centres. The programme structure aimed at establishing a central and decentral focus and creating a foundation for accommodating future changes in decentralisation.

A key feature of the LSFP IV was that funds for each entity in the programme were planned/budgeted for, transferred to and accounted for by that entity. Extensive training was undertaken in connection with the start up of this approach.

Planning, budgeting and financial management was performed in 14 discrete steps. The programme cycle of planning, implementation and follow-up followed the financial year of the Lao Government and the planning process was closely linked to the Government's planning process. The provinces compiled the plans and budgets and submitted them to the central level for coordination and approval. Funds were allocated from the centre to the provinces/districts according to plans. Government procurement rules were followed. The accounting did not follow the Government accounting system, but was rather based on a more tailored system.

The SAA was not involved in the audit that was carried out by a private audit firm hired by Sida.

The Lao-Swedish Road Sector Project II *(LSRSP)* is a Sida funded project implemented under Ministry of Communication, Transport, Post and Construction (MCTPC) in accordance with the project document of 7 February 2001. The total budget for the project is SEK 180.7 mill including a Lao Government contribution of SEK 41 mill. The project period is from April 2001 to end December 2004.

The objective of the project is to ease poverty in Odomxay, Luang Prabang, Khammouane and Borikhamxay provinces through sustainable improvement of the rural road network, leading to the increased accessibility and decreased transport costs in these provinces.

The project is a continuation of the previous LSRSP I, 1998–2001.

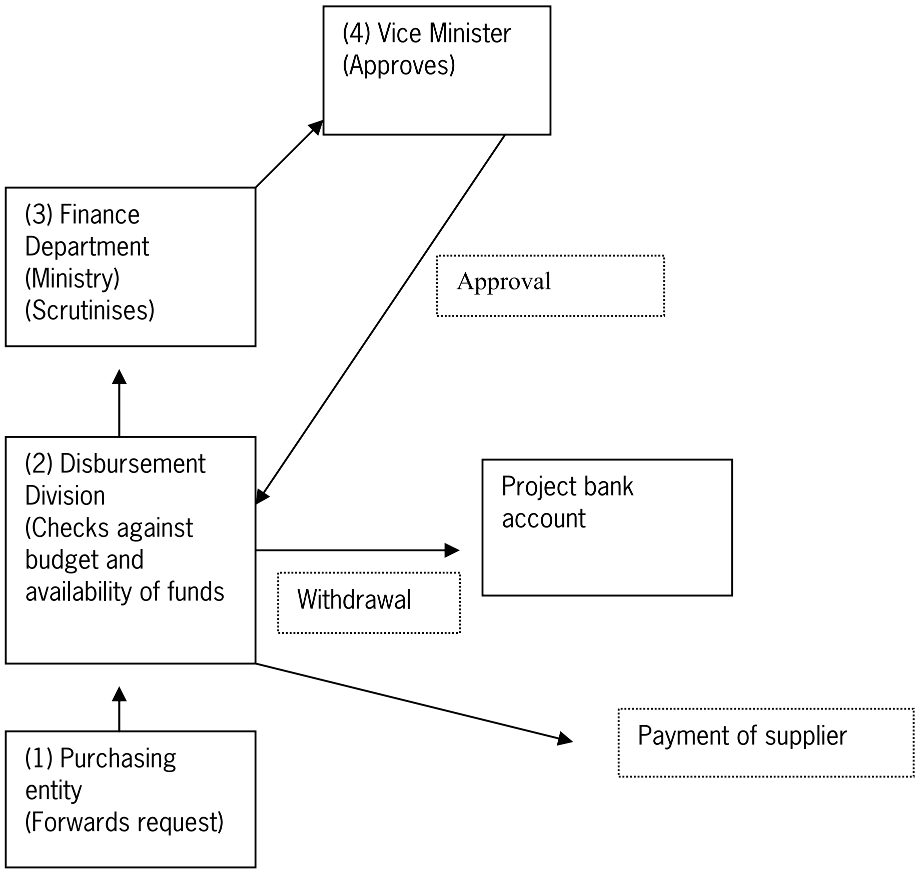
The project's accounts are maintained on an ACCPAC system which was already introduced in phase I of the project. The system was internalised in the Disbursement Unit in Department of Roads in 2001, meaning that all activities covered by Department of Roads (both external and local funds) are recorded in ACCPAC, which constitutes approximately 90% of the entire expenditure of the Ministry.

As mentioned, the Sida funded project covers 4 provinces, but the financial management system actually covers road maintenance activities in additional 5 provinces financed by WB and ADB (3 and 2 provinces respectively).

The Disbursement Division in Department of Roads assist the provinces whenever problems arise in accounting and has to that extent 3 (one international and 2 local) advisers who visit the provinces.

The Finance Department of the Ministry is not yet included in the computerised financial management system, but the intention is to include that department as soon as internal agreement on the subject is reached. The Finance Department is keeping its records on spreadsheets.

The procurement procedures for the project can be illustrated as follows:



In principle the project is using Government rules for procurement (IRR/98), with certain modifications, e.g. thresholds.

The project has not been subject to the Ministry's Inspection Department's scrutiny and is audited yearly by a private audit firm hired by Sida.

The *Nam Saat programme* originally started in 1981 as a cooperation between UNICEF and MOH. In 1992 the first phase of UNICEF/Sida and MOH cooperation was initiated with a number of other donors (UNDP, WB, ADB, WHO, JICA, AusAid) and NGOs supporting the concept of national water supply through the MOH and provinces.

The present phase of the programme is a cooperation (transitional support) between Sida/UNICEF and MOH. The programme aims at increasing the sustainability, impact and use of water supply and sanitation facilities and strengthening hygiene education. It targets poor, remote and under-served areas of the country. The programme will include construction of new water facilities, sanitation facilities, rehabilitation of older water and sanitation facilities, construction of school sanitation facilities, hygiene education, strengthening management and technical skills of Nam Saat staff at central, provincial and district levels so that the institution can become the lead supporters to coordination, planning, implementation, evaluation, learning, and community support as well as facilitators for the mobilisation of supplementary funding for the sector.

The entire Sida support to Nam Saat in the period 1998–2002 amounts to 5.5 mill. US$. 2.7 mill US$ is being channelled through UNICEF and 2.8 mill. US$ is disbursed by Sida through the Government to the project. The financial management system handled by the programme only encompasses the funds channelled by Sida through the Government. The funds channelled through UNICEF are accounted for by UNICEF to Sida and they are handled in accordance with rules and regulations of UNICEF, including direct payments by UNICEF to suppliers.

A financial management system was established for Nam Saat in 1999, but was not taken into use at that time. A spreadsheet system is at present being used for reporting to Sida. The procedure used for accessing the direct Sida funds is that a yearly budget is drafted by the Programme Unit and forwarded through MOH and MOF to Sida Vientiane and Sida Stockholm for approval. Once approved, funds are released by Sveriges Riksbank to MOF/BOL that in turn releases funds on a quarterly basis. The programme conducts its own internal controls of expenditure by decentralised levels and report on a quarterly basis to Sida Vientiane.

A private audit firm will audit the programme in the near future.

7. Assessment of the Lao PDR financial management system

(appropriateness, reliability, transparency and accountability)

7.1. General observations

The Government of Lao PDR is committed to create an environment of financial management and accountability and thereby contributing to the overall goal of Lao PDR departing from the status as least developed country by 2020. In spite of initiatives to improve the overall macro-economic climate and improve financial management, the Government is still facing substantial challenges.

Over the years, it has proven very difficult for the GOL to collect taxes and shifts in responsibilities have not made it easier to enforce the regulations with the result that especially large tax payers have had the possibility of evading tax.

The Accounting Department of MOF is responsible for drafting and enforcing accounting rules and regulations for private enterprises. In the assessment of the Department, now approximately 50% of all private enterprises of Vientiane follow proper accounting rules and maintain proper accounting system which makes it possible to establish the tax basis of the companies. Country wide it is probably less. Nevertheless, the Department is working on the enforcement of the regulations and it has some relative harsh measures at its disposal to discipline enterprises that don't comply. Furthermore, provinces, that have a responsibility to collect taxes and customs on behalf of Central Government and submit proceeds to the centre have failed to comply fully. In spite of new decrees to strictly adhere to the rules, provinces are still not complying. This phenomenon is likely to be caused by two factors:

1. Centrally employed staff seconded to provinces are paid by the provinces, likely to cause dual loyalty
2. Controls from the central Government on adherence is still weak and available sanctions are probably not sufficient

When the expenditure targets are closely connected to the revenue targets and the revenue targets fail, it is very difficult to manage/reprioritise the lower level of available expenditure.

Government salaries are very low and therefore it is difficult to attract and retain the necessary qualified staff. To add to that problem, the cash situation of the Government necessitates from time to time severe delays in payments of civil servants. This factor will also contribute to the level of corruption/financial irregularities of low and mid level civil servants.

7.2. Planning/budgeting

It becomes very clear that the national planning/budgeting circle is highly affected by the general lack of collecting taxes, or adherence to tax collection rules and regulations, primarily at the provincial level and subsequent submission of funds to the central government level. There are, though, initiatives under way to address this problem, mainly funded by UNDP and the ADB. Having said that, it must be emphasised that the CPC by own assessment is very weak in all aspects like number and qualifications of staff and equipment. Evaluation of the development process is practically absent.

7.3. Accounting

One of the major problems in government accounting is that the Decree 20/PM (and the regulations issued pursuant to the decree) on accounting regulating all Government entities' accounting is lacking detailed instructions on procedures and forms. This has resulted in somewhat anarchy in financial reporting to MOF where each entity has invented its own procedures and forms making it difficult at central level to consolidate accounts. The ADB supported TA has now developed a manual and procedures that have been approved by Government and are being implemented in four ministries (Health, Education, Agriculture and MOF) and one province. According to the ADB, there are probably not sufficient ADB funds for introducing the new accounting system in all entities that report to Ministry of Finance and therefore there is a need for both commitment to adhere to the new system as well as grant funding for implementation of the system countrywide.

During the interviews it has become clear that one of the major problems in accounting is the level of training (quality) of accounting staff in the Government system. In connection with project implementation, this fact very easily leads to that donor representatives in project implementation units take over the accounting without properly training those national accountants who should take over once donors withdraw from projects, leading to unsustainability.

7.4. Procurement

The Implementing Rules and Regulations on Government Procurement of Goods, Construction, Repair and Services (1639/MOF) leave room for arbitrary decisions on when to apply public bidding, limited bidding and direct contracting, opening up for, at least in theory, abuse of the spirit of the rules. Furthermore, the criteria for awarding a contract are phrased in a way so that they are open to interpretation.

Furthermore, the rules stipulate that where donor procurement rules differ from the Government rules, the donor rules may apply. In practise this has meant that approximately 80% of procurements has been executed according to rules different to Government rules.

The latest PER report highlights a number of areas for changes when/if revising the 1639/MOF: Record keeping, gratuities and inducements, single source procurement by price negotiation, examination, evaluation and comparison, review and signing of contracts.

Furthermore, a Country Procurement Assessment that was carried out in March 2002 by the WB made a number of observations. The observations include issues like the functioning of the Procurement Management Office, amendment of the IRR, shortage of qualified Government procurement staff, low salary level for Government staff, over-frequently rotation of government staff and distortion of the bidding process caused by participation of non-autonomous SOEs.

7.5. Internal controls

There seems to be a well-structured internal inspection system in place in Lao PDR even though there are differences in opinions about the efficiency and capacity of the inspection departments in the line ministries. There is general agreement that the inspection departments in the provinces are weak.

According to the ID in MOF they have carried out a number of internal controls and have detected severe irregularities. The ID has, though, a need for support in the form of especially training in internal audit techniques.

Finance Department in Ministry of Health was chosen as example of financial management in line ministries and here there was broad satisfaction with the level of the inspection arrangements even though training and number of staff were identified as deficiencies.

As one example of a very thorough and strict internal audit was mentioned an audit of the Centre of Skin Diseases carried out in 2001/2002 by the IID of MOH. The audit resulted in a number of critical findings and severe consequences for staff involved in improper financial management.

An issue that is related to payments and internal controls is the very cumbersome procedures a payment request has to pass before being effected. It has to go through a large number of approval points (on average 9 signatures). It is somewhat difficult to establish what benefit all these links serve in terms of control. One could even argue that the higher the number of control points, the unclear the responsibility becomes.

7.6. External Audit

The SAA was established in 1998 with a staff of only 7. By now the staff has increased to 31, whereof most are professionals. Nevertheless, it must be considered to be a very small number of staff by international standards, especially taking the task of the audit responsibilities of SAA and the present state of public accountability in Lao PDR into consideration.

On independence of the SAA it must be noted that the SAA reports on the individual audits to the Prime Minister and not to the National Assembly. Only by yearly reports the National Assembly is informed on the activities of the SAA. Normally, the supreme audit institution (SAI) is supposed to be the independent watchdog of the parliament and not an integrate part of government. Furthermore it is getting more and more internationally recognised that the SAI should have its own separate budget in order to be economically independent of the Ministry of

Finance. In the case of the SAA its budget is an integrate part of the Government budget. Finally, in order to protect the SAI against arbitrary transfer of staff, it is normally considered as a part of an assessment of the level of independence of the SAI whether it can hire and fire its own staff. In the case of the SAA, the staff is part of general civil service and thereby subject to replacement by the Civil Service Commission.

The SAA has aspirations of more international exposure by exchange of experiences with other SAIs and joining the International Organisation of Supreme Audit Institutions (INTOSAI) and is very much aware of its lack of trained staff in international audit standards. To that end the SAA would like to establish its own training institution and seek international exchange of staff and secondments.

The SAA operational budget is very limited making it difficult to conduct outreach audit on a regular basis. Adding to this, even though auditing donor-funded projects is a part of the SAA's mandate, most donors tend to outsource the audit to private audit companies without consulting or informing the SAA. In that way donors are depriving the SAA of possible earnings, experience, and information on audit results of externally funded activities. It must be noted that the SAA is in the process of applying for the retention of any audit fees it might earn, funds that could come in and supplement the expected TA support from ADB.

As earlier mentioned, the SAA is reporting to the Prime Minister's Office and on a yearly basis to the National Assembly, but there seems not to be formalised systems in place for follow up on the findings/criticisms in the SAA's reports.

There is no clear distinction of responsibilities between SAA and the SIA, but they seem to have a close cooperation.

KPMG and PriceWaterhouseCoopers are represented in Lao PDR. Besides them, there are 10–15 local accounting/auditing companies.

During interview with a representative of PWC it was stated that PWC has no direct experience with working together with the SAA. At the same time it was said that PWC would not mind cooperation on the individual audits carried out for donors. It could e.g. be in the form of training of staff from the SAA.

7.7. Other Institutions (BOL/SOBs/SOEs)

The BOL has during the last years executed a policy to maintain the exchange rate of the kip and has largely succeeded in this policy of macro economic stability even though the last two months have shown increased inflation up from 7% in June 2002 to more than 10% in August (indicated as 14.2% by WB). The exact reason for this increase is not yet known and can be caused by extraordinary Government payments, in which case it is a temporary phenomenon. Furthermore, BOL has significantly improved the accuracy of the recording of the status of national debt in a close cooperation with MOF. The BOL did, during discussions with the Consultant, agree that the inflation since June had risen to double figures, but only to 12%. The cause was allegedly a combination of rising oil prices, increased import of machinery and construction material and repayments of external loans. Another reason given was the increasing smuggling of goods over the borders from neighbouring countries. The problems of

SOEs and SOBs were also discussed and the BOL was of the opinion that the only lasting solution would be their privatisation. Some SOEs had been privatised, but it was indicated by BOL that it is difficult to sell off enterprises that are insolvent.

The tax law provides the basis for recording income and expenses for the purpose of computing the taxable income, but there is no requirement that an independent auditor audit the financial statements being submitted with tax returns by the SOEs. Audits of these enterprises are to be conducted by tax inspectors as and when irregularities are suspected. The financial statements of the SOEs are not published and there are no financial disclosures for accounting policies or any other information for interpretation of the accounts of the SOEs.

The four state-owned banks (SOBs) account for about 70% of total assets in the banking system. Most of their credit is directed to the SOEs, largely responsible for non-performing loans ranging at 50–70% of the total loan portfolio of the SOBs. Government has had a policy of encouraging SOBs to extend loans to both SOEs and private enterprises to implement public policy programmes. This direct lending is in effect credit to the Government and poses macro-economic risks similar to those of direct budget financing though the BOL. Additionally, directed lending has frequently failed to generate sufficiently high rates of return with the result that SOE projects have been unable to service their debts leading to an accumulation of non-performing loans in the SOBs.

7.8. General policies

7.8.1. Decentralisation

Decentralisation has since 1997 been an integrate part of Lao PDR's policy by transferring responsibility for management and implementation of development activities and transferring financial management responsibilities to a point as close as possible to the actual level of implementation. This means that Government has provided increasing autonomy to provincial and district authorities in respect of planning, budgeting, and implementation of development activities, including donor-funded projects. It must be assumed that quality of management decisions increases the closer to the point of implementation they are taken, providing the capacity to manage the process is present.

The decentralisation process in Lao PDR has been swift and radical, but there have been problems in the implementation, both in terms of balancing the horizontal and vertical control, adherence to rules and regulations concerning revenue and expenditure and loss of control with areas that ideally should be centrally controlled like tax and customs levels and equity.

It is widely recognised that provinces on the revenue side have executed discretion concerning customs and taxation and have been withholding revenues that should have been transferred to the centre. Furthermore, provinces have on the expenditure side implemented development activities that were not included in the PIP, and therefore technically illegal.

The main problems arising from this practise are paying centrally budgeted expenditure like salaries and achieve equity between the provinces.

It is apparent that the Central Government's control with revenue collection, transfer of revenue to the centre and expenditure is lacking capacity, even though the situation apparently has improved during the last year.

7.8.2. Corruption

In November 2001, Lao PDR participated in a regional conference of anti-corruption initiative for Asia Pacific.

The conference drafted an action plan (not signed by Lao PDR) under which governments can choose from a menu of anti-corruption actions that meet their needs. Among the possible actions is the creation of public sector recruiting systems that ensure openness, equity and efficiency and promote the recruitment of individuals of the highest levels of competence and integrity. Other steps include adopting public sector auditing practices, establishing transparent procedures for public procurement that promote fair competition and the public right of access to government information. Governments are also encouraged to adopt legislation with adequate sanctions against the bribery of public officials, support corporate responsibility and accountability on the basis of international standards, and promote good corporate governance.

It is very difficult to quantify the level of corruption in Lao PDR, especially when proper financial management is not in place. Within the last 18 months some arrests have been made which must be considered as a sign of Lao PDR's commitment to combat corruption.

That there is a need for decisive action against corruption and other financial crimes is illustrated not only by the SIA's report, but also by the findings in a report of June 2001 by WB/Sida/Gov. of Finland on Lao PDR, production forestry policy. In that report the problem of illegal logging is described and attributed to four main factors:

1. Regulatory framework is complex, incomplete, inconsistent, difficult to comply with and not geared to supporting effective forest management and utilisation
2. Some entities issuing logging permits do not have the authority to do so
3. Inadequate field demarcation, and even definition of protected areas
4. Strong pressure exerted by companies for logging permits combines the opportunities for corruption with confusion on what legal and administrative arrangements permit.

Furthermore, wood and timber companies often ignore legislation, regulations and official decisions.

The SIA is suffering under insufficient operational budget, transport, office facilities and staff (number and qualifications). According to the SIA, corruption is widespread especially at the provincial and district level. According to the SIA, corruption is also prevalent at the central level, but only at the executive level which makes Laos distinctly different from international experience where lower level corruption is a mirror of corrupt behaviour at top executive/po litical level.

During interviews it came out that corruption is wide spread in Lao PDR and that there are examples where officials apparently are involved in what would be termed as corrupt behaviour. The examples mentioned involve procurement (over pricing), licenses, and exploitation of natural resources and waivers of custom rates.

It must be emphasised that the mischievous behaviour was put in the context of lack of clear and simple rules in financial management, low salaries and the relatively low risk of detection pared with apparently light reactions from official side once detected.

On the positive side, the Lao People's Revolutionary Party has clearly taken the stance of eradication of corruption. The Party has raised the problem at its VII. Congress, aiming to warn Party members and alert them to corruption.

According to an article in Vientiane Times 30 August–2 September 2002, there has been much corruption during the last years as mentioned above and the country has lost a lot of money on these practices, therefore the Government has taken measures to eradicate corruption, actions that need the full support from the international community in Lao PDR.

According to the SIA's[1] report for 2001/02 the Party Congress instructed the SIA to combat corruption at all levels to pursue transparency and accountability in Government.

From its finding during the last year, corruption, bribery, stealing and fraud of public property are common, but are difficult, if not impossible, to address in some cases because highly positioned officials are involved. As examples are mentioned:

- Government staff make use of their position and status to collude with traders, businessmen on prices of biddings, procurement and hiring in various projects for getting bribes
- Violation of Government's regulations with respect to the technical and financial matters, falsification of official documents for getting compensation, swindle of public property by staff in high positions
- Stealing, substituting and diminishing public property under their protection for their own benefit
- Overusing authority or breaching laws and regulations by making decisions in matters not under their authority in order to get benefit, particularly concerning the collection of income, tax, custom, property, land, etc.

The SIA HQ has received 10 letters of complaints on corruption while provincial offices have received 248 letters.

The following emerges as concrete actions by the SIA in the year reported on:

- *Lao May Bank.* 8.9 billion Kip were missing due to various illegal methods. Suspected bank staff is now under custody of the court
- *Lao Aviation.* Loss of 3,786,000 Kip and USD 508,996.05 have been lost due to inflation of cost of plane maintenance and purchase of spare parts and plane leasing
- *Drug Factory no. 3.* Poor procurement, marketing and financial management, poor management of income and expenditure. It is somewhat unclear exactly how much is involved, but apparently at least US$ 138,471,342 and Thai Bath 28,100 and deceiving other state owned companies of 441 mill Kip

[1] It must be noted that several institutions' name in the English translation vary. What is referred to as NIO in this document is also named the State Inspection Authority (SIA), which name is used in this report. Also, the State Audit Authority (SAA) is named National Audit Office (NAO) in other documents.

- *Lao electricity Company.* Has apparently improved its performance significantly after a previous inspection and has generated a net surplus and brought down its obligations to Government. There are, though, still lack of transparency in several affiliates
- *Inspections in some Government organisations.* In the Central Rural Development Committee (CRDC) and national Sport Committee (NCS) there was found misuse of cash to the tune of 75,914,506 Kip and 3 bill Kip respectively
- *Forestry in Savannakhet Province.* It was found that the province had allowed over logging of branches, illegal logging of 5000 m3, under recording in logbooks
- *Inspection of illegal import of vehicles*. SIA found illegal import of vehicles with the complicity of officials, deflated prices to reduce customs, lack of control with vehicles on temporary import authorization, collusion between officials and vehicle owners to legalize illegally imported vehicles

The SIA finds in conclusion that staff at all levels are misusing their position for corrupt behaviour, extravagant use of public funds, loose inspection tools, lack of commitment of some party and administrative commissions.

On the positive side, the SIA finds that it has the appropriate mandate to combat corruption and that large amounts of money have been recovered and that guilty persons have been brought to book.

Furthermore, the SIA finds that the leadership is highly committed and that the staff of inspection committees at various levels is highly responsible and strive to fulfil their responsibilities. Furthermore, the close cooperation between the entities involved in combating corruption has significantly contributed to the result of the SIA's inspections.

On the basis of the findings, the SIA recommends in its internal report that:
- Existing regulations should be transformed into laws, determining clear measures against offenders
- Inspection staff should receive further training
- Mandate and coordination measures for inspection should be reviewed
- Number of staff involved in inspection work should be increased
- Higher level addresses the inspection results appropriately and enhance dissemination of information on corruption
- Culprits are punished according to findings
- Organisations doing the inspections are given clear mandates to avoid duplication
- Internal inspection functions are improved
- Inspection of loan and grant funded projects is improved
- Representatives from countries in the Region (Viet Nam and China) are invited to Lao PDR for sharing experiences and sending delegations of Lao officials to countries in the Region to learn from experiences.

7.9. Donor assistance in financial management

There are a significant number of donor-funded activities to promote government financial management and accountability in Lao PDR. The ADB must be seen as the most important external partner in this context. The high level of activities/reforms involves both opportunities and risks. On the opportunity side, if the reforms, currently under way, are carried out to their logical conclusions, there is no doubt that the Government financial management system will improve significantly over the years to come. The risk is that if the reforms are not concluded as anticipated, it will leave the system fragmented and more disillusioned.

There seems to be very little donor coordination of assistance in capacity building within financial management to Lao PDR. In the absence of donor coordination and lack of Government capacity in this area there is always the risk that donors will take a piecemeal approach to protect the accountability in their specific assistance areas. A piecemeal approach can possibly reach its immediate goal of project specific accountability, but will inevitably damage the overall government accountability and transparency, which at the end of the day compromise all stakeholders' accountability.

7.10. Sida's assistance related to financial management

The implementation modality used in the *LSFP* shows that the complexity of coordinating a larger programme is not solved through introducing separate management structures at the centre, but rather by transferring responsibilities and capabilities (training) to de-central entities where all involved can see the necessity of integration and coordination.

The responsibilities transferred under LSFP involved issues like planning, budgeting and accounting to point nearest possible to implementation. Decentralisation of these responsibilities freed manpower at higher levels to coordination and management responsibilities.

Another lesson is that the transfer of responsibilities have to be accompanied by appropriate systems and training, both theoretical and on-the-job.

The financial management system developed under the LSFP is going to be carried over to the Lao-Swedish Upland Agriculture and Forestry Research Programme. This system involves identification of components with their individual responsibilities for planning, budgeting and reporting. One central Finance Unit under the project does the accounting. An internationally recognised audit firm does the audit. Local contribution to the project is mainly in the form of staff salaries and office space, but these expenditures are not captured by the project financial management system.

Accounting is made in accordance with budget lines that accommodate the information needs of Sida and the MOF has not requested any specific reporting.

Audits were carried out by an internationally recognised audit firm and not by the SAA. To the knowledge of the project, project expenditures are not reconciled in MOF.

It must be assessed that the project introduced a well functioning financial management system that served the accountability needs. On the down side, the financial management system was not sufficiently internalised in Ministry of Agriculture, and all indications are that the project's financial management system is not sustainable unless other donors take over the project activities now that Sida has discontinued its support.

The *LSRSP* has not only succeeded in establishing a well functioning financial management system, but has also on the request of the executing agency expanded the scope of the system to encompass the remainder of the Department in which it works and has expanded to the 4 provinces the project covers. Furthermore, two additional donors (ADB and WB) to the sector (covering additionally 5 provinces) have subscribed to the system and plans are to expand the system to encompass the entire ministry and the remaining 9 provinces. Even though the system still is dependent on external technical assistance to operate, it can be envisaged that the system will be self-sustainable by the end of this project period. It must be considered as very positive that the project in this way has expanded in terms of financial management beyond its TOR to benefit the sector's financial management and accountability requirements.

The *Nam Saat* leaves the impression that there is room for improvement and still some way to go to reach the goal for the institution to become the lead of coordination, planning, implementation, evaluation, learning and community support as well as facilitator for the mobilization of supplementary funding for the sector.

The financial management system installed in the institution in 1999 is still not in use for the direct Sida funds. The Sida funds channelled through UNICEF, basically meant for the same purposes, are accessed and reported on in accordance with UNICEF rules and regulations.

The Programme Unit does, in the assessment of the Consultant, not seem to be in a position to fully overview the activities going on in the provinces funded by other donors. There are allegedly a large number of external funders involved in the Nam Saat without being coordinated by the Programme Unit. This observation leads to the assessment that there has been a lack of leadership and direction of the Nam Saat programme.

Due to time constraints, the study did not have the possibility to go into detail of the management of the programme, but the Consultant was left with the impression of a programme where there is not sufficient knowledge on all activities in the area meant to be coordinated by the programme.

8. Conclusions and recommendations

8.1. General conclusions and recommendations to improve Lao PDR financial management and accountability

The challenges in financial management facing GOL cannot be addressed in isolation from the basic economically related deficiencies identified in this and previous studies, and therefore those deficiencies are included in these conclusions and recommendations.

The basic challenges as prerequisites for proper accountability and transparency are:

- Level and timeliness of salaries of civil servants
- Macro-economic stability
- Discipline in revenue collection and budget execution

It is the main finding of the study that the Government in isolation cannot solve those challenges, but must be addressed in a close cooperation with donors to the country.

There are several advantages in the present situation of Lao PDR compared to most other development countries: The economy is experiencing growth, there are relatively few donors and the introduction of a modern financial management system is still only in the pilot phase.

In order to manage and own the process of developing a common Government financial management system, the Government of Lao PDR should establish a *coordination forum* consisting of central Government institutions like MOF, BOL, Prime Ministers Office, representative line ministries and provinces and those donors who subscribe to nationally managed financial management and accountability.

The forum would monitor the development in the above-mentioned basic challenges and formulate a strategy to develop the Government's financial management capacity and agree on a path leading to donor acceptance of one common Government financial management system. This would require comparison of donor requirements and identification of requirements to such a system. The forum would also be required to agree on specific activities (projects) to further the goal of a universal Government financial management system and a common reporting system on such activities so all stakeholders are informed on progress of activities whether they are direct funders to the activities or not. Only in this way common understanding, agreement and strategy is secured and donor competition avoided.

One of the prerequisites for a proper financial management system to be in place is to create the right environment for a financial management system to function in. This will require that the problems of level and timeliness *remuneration of civil servants* be addressed. This will in all likeliness need alterations in the division of the budget between recurrent and development expenditure, increasing the recurrent part. One way donors can play a significant role is by reducing the requirement of counterpart contributions to development activities and thereby releasing Government funds to the recurrent budget.

The donor/government forum should furthermore assess and address the following areas:

– The *accounting system* currently being introduced by Government in Treasury, three line ministries and one province will need additional support to become a system covering the entire Government and all provinces. According to the ADB, it will have some problems in financing all aspects of the rolling out of the project. Therefore, it is recommended that the forum discuss alternative sources of financing the different aspects of the continuation of the project.
– The second very important area to be covered by the forum would be *internal and external controls.* The ADB supported project of drafting a manual for internal controls combined with training comes to an end in March 2003 and will need to be continued by general training and capacity building in internal controls. Such a project could be combined with strengthening the SAA and the SIA (external control and anti-corruption). Strong and efficient internal and external controls would have a very positive effect on performance of central Government institutions, provinces and SOEs/SOBs and taking the eager the representatives from the inspection institutions have shown during the study promises well for their performance if the necessary support is provided.

Once a proper financial management system is in place combined with adequate internal and external financial controls, mismanagement and financial crimes in the system will be minimized. When financial mismanagement is minimised, corrupt behaviour will be much more exposed to detection and SIA will be in a much better position to investigate and concentrate on this type of financial crime.

The issue of separating responsibilities between internal and external inspection and between audit and investigation into corruption should be addressed. Furthermore, possibilities for expanding the relative independence of the SIA and the SAA should be explored. It must be emphasised that it is the conclusion of this study that there is wide spread corruption in Lao PDR, but that the problem is being addressed by Government. It is, though, necessary that the good initial results of the activities of the inspection institutions are continued and expanded. One of the instruments in the battle against corruption would be drafting of a more detailed legislation and giving the institution(s) that have the responsibility for combating corruption and other financial crimes the authority to effectively combat the phenomena. Strengthened internal and external inspection institutions would also improve the adherence by provinces to revenue collection and submission of proceeds to the Central Government and make the decentralisation function in accordance with intentions.

– From interviews during the study it has become clear that procurement is one source of confusion on regulations, delays and even corruption. It should be one of the tasks dealt with by the coordination forum to explore the possibility for uniform procurement rules irrespective of the source of funding. Not only would uniform rules secure clearer procedures, but would in all likeliness also over time reduce the possibilities of corrupt behaviour in connection with procurement.

8.2. Conclusions and recommendations as to Sida's cooperation with Lao PDR to improve financial management and accountability

Financial management and accountability

Financial management and accountability is one of the key general issues when it comes to successfully addressing development issues. Without proper financial management, it is very difficult to establish whether development objectives are being reached and consequently provide accountability on development investments.

In the absence of strict accountability the temptation of fraudulent or corrupt behaviour is increased simply due to lower risk of detection. Accountability does not in itself minimize corruption, but in an environment whereby the room for mismanagement and financial criminal practises is minimized, corrupt behaviour becomes more exposed and thereby more difficult to practise.

Therefore, financial management and accountability becomes one of the corner stones in a successful development programme upon which Sida rightly is putting much emphasis.

Furthermore, it is recognised that only if the proper financial management and accountability is achieved through national financial management systems sustainability can be secured. The goal of any development cooperation should be a proper national financial management system which can provide accountability both to the constituency and cooperating partners all with the goal of creating the basis for management to make policy decisions on the foundation of timely and accurate information.

Sida has through its cooperation with Lao PDR created a very good foundation for accountability in the programmes supported. Financial management systems have been integrated parts of the activities and accountability has, as far as it can be assessed during the limited time available for this study, been achieved.

Another question is whether the financial management systems created can be termed as nationally integrated, but here it should be emphasised that the Government financial management system so far has been unable to provide information suitable for monitoring development activities. In the context of national financial management systems, Sida supported activities should as far as possible utilise the new system being established on a pilot basis in MOF, MOA, MOE and MOH and one province. By utilising and thereby supporting the new system it will in all likeliness succeed being the universal government system intended.

LSFP succeeded in creating a very efficient financial management system and capacity has been developed at all levels. When withdrawing from a programme as the LSFP, a donor must carefully consider the consequences for the capacity built. In the case of LSFP, very much depends on the future financing and when it comes to the component on natural parks, it is clear that there is no future Government or donor funding to replace the Swedish support. For the rest of the programme it remains to be seen whether the capacity built will be utilised in future, meaning that it is in doubt whether the financial management system created will survive the exodus of Sida.

The LSRSP must be assessed as the most positive endeavour in terms of financial management of the three Sida funded activities assessed by this study, mainly due to the excellent cooperation between the executing agency and the project. The project has succeeded in internalising the project's financial management system into the administration of all activities under the auspices of the executing Department accounting for more than 90% of the total expenditure of the Ministry. The approach of the project is highly recommended to be a role model for integration of financial management system of Sida's assistance. Fortunately, the ACCPAC introduced by the project is the very same system that is being introduced in the above-mentioned four ministries and one province, making the linking to the central system so much easier.

The Nam Saat project represents a problem in that it is designed as a country wide coordinating unit for clean water and sanitation. Time constraints have not allowed a thorough assessment of the project's (financial) management system, but it must be concluded that there are serious doubts whether the funding mechanisms are appropriate (combining direct Sida funding with funding through UNICEF), and whether the present financial management system for Sida's direct funding is optimal and finally whether management is capable of getting an overview of the activities going on in the provinces in the area of fresh water and sanitation. The management of the Nam Saat has so far not taken the financial management system for the project into use. It must be added that it is in doubt whether all stakeholders accept the coordinating role of the project and therefore whether the Nam Saat is informed on activities funded by other sources.

None of the three projects were audited by the SAA. As indicated in paragraph 1 of this report, it is a strategy of Sida's sector programme support to involve the national audit institution in audits and never execute an audit without a representative of the audit institution is present. It is recommended that Sida on a trial basis commissions the SAA to conduct an audit of one of its projects and assesses the quality of the audit and on the basis of the assessment decides the form of future cooperation with the SAA. It should also be considered to pay an audit fee to the SAA. Such fees, if they can be retained by the SAA, would substantially boost the self-confidence of the SAA and assist in building its capacity.

Another issue is Sida's use of other developing agencies as managers of projects. It is hard to see the added value of such arrangements, especially if the agencies in question are further removed from using national financial management arrangements than Sida itself.

Donor coordination

Sida should actively assist Government in establishing a coordinating forum as outlined in paragraph 8.1. and actively work together with particularly ADB and the WB to assist the Government with a TA in this area to strive for above goals.

Accounting

The ADB is assisting in the pilot of the new computerised accounting system, but rolling out the system to cover the entire public sector will require additional assistance, especially in the form of equipment and training. It is recommended that Sida in cooperation with ADB find ways of assisting GOL in implementing the system countrywide. ADB has estimated that the cost for equipment would be around 1 mill. US$.

Internal controls

Internal control is an area where Sida can support both the transparency and accountability in the sectors where Sida has cooperation with Lao PDR and promote the general level of control and thereby accountability and transparency in GOL in general. To that end, two areas of overall weakness have been identified through the study: Number of staff and quality of staff. Sida has had cooperation with other developing countries on training of staff in audit and it is recommended as an area for Sida to offer assistance to Lao PDR. This could be supplemented by assisting in establishing a training centre in connection with the SAA office, which then could offer audit training to both internal (ID and IIDs) and external (SAA/SIA staff) auditors.

Corruption

As highlighted in previous paragraphs, there is admittedly wide spread corruption in Lao PDR, but by establishing the SIA and equipping it with a mandate to actively combat it, the Government has shown that it is devoted to take up the combat. Nevertheless, the situation and measures taken by GOL should be monitored and Sida should assist by providing training for SIA staff on combating corruption in conjunction with training of SAA and ID staff. Furthermore, short term TA could be offered by Sida to assist Government in drafting legislation to combat corruption, drawing on international and especially regional experience in this area.

Annex 1: Terms of Reference for the study

For consultancy services related to a study on financial and administrative systems in Lao PDR 2002-07-04

Background

The Country Strategy is the most important instrument governing Sweden's development co-operation with Lao PDR. It states the Swedish Government's views on co-operation with the country and stipulates the scope, focus, design and expected results of programs of co-operation. The strategy includes all Swedish support to the country in question.

The present Country Strategy Process, which will result in a Country Strategy for the period 2004–2008, is in a preparatory phase. During this phase, the country's development in general is analysed and discussed, as are the issues which Swedish support can help to solve. Financial mismanagement and misappropriation of public funds entails a significant risk and has unfavourable effects on development in, for example, combating poverty, economic development and the rule of law. Hence it is a priority of the Swedish government and Sida to study these issues as part of the Country Strategy process.

In the preparatory phase of the Country Strategy Process, the Embassy will commission two complementary studies: one related to poverty in the up-lands and one study on democratic governance in Lao PDR.

Sweden has signed and ratified various international conventions with the intention of increasing transparency and reduce the risk of corruption and has thereby undertaken to follow these conventions. In addition, Sida has instructions from the Swedish government to support measures to combat corruption.

Sida's anti-corruption regulation (enclosed) applies to all Swedish development co-operation financed by Sida and forms part of Sida's work of counteracting the risks of corruption. The rule applies when country strategies are being developed, when agreements and contracts are being drawn up and when procurements are taking place etc.

Sweden takes note of the fact that the effort to combat corruption is given high importance also by the Government of Lao PDR. An anti-corruption decree was issued in 1999. The decree defines corruption, identifies who is responsible for implementing the decree and lays out procedures how to deal with corruption cases. The Lao Penal Code contains several articles that criminalise mismanagement of public resources and swindle or embezzlement of state and collective assets. In addition, the Lao Government was represented at the 3rd annual conference of the ADB/OECD Anti-Corruption Initiative for Asia-Pacific. Even though the regional Anti-Corruption Action Plan for Asia-Pacific was not endorsed by Lao PDR at the meeting in Tokyo in November 2001, the Lao government stated that it agreed in principle.

In the agreement between Lao PDR and Sweden on General Terms and Conditions for Development Co-operation 2002–2006, the countries have agreed to co-operate on preventing corruption within and through the projects/programs. Sweden and Lao PDR undertake to take rapid legal measures in their respective countries to stop, investigate and charge any party suspected on good grounds of corruption or other wilful misuse of resources.

Objective

The objective of this study is to assess Lao PDR's financial and administrative systems and its auditing capabilities and the associated weaknesses and risks of corruption in general as regards development of Lao PDR and specifically in Sida financed development co-operation projects and programs.

Issues to be covered

The consultant shall assess the:
1. Public budgetary system
2. Public accounting system
3. Public procurement system
4. Public sector auditing system

All four sectors should be assessed on three levels:
1. The institutional level, including a description and assessment of the status, role and position of the bodies and institutions of relevance in the particular areas.
2. The regulatory context, including international obligations, national laws and decrees and policy documents of relevance in the particular areas.
3. How the institutions function *in practice* both as separate institutions/bodies and together as a comprehensive system.

The above should be assessed from the principles of independence (when relevant), reliability, transparency and accountability.

The study should, in accordance with what is said above, describe what the system looks like and how it functions today, as well as address what changes have taken place since the last country strategy process.

The consultant should try to identify problems and corruption risks affecting development of the country and Sida financed development co-operation projects and programs.

The consultant shall give recommendations on how the identified problems and risks can be mitigated and/or eliminated in general as concerns development of the country as well as in Sida financed development co-operation projects and programs.

Methodology and Implementation

The consultant shall study available documentation relating to the areas identified above, including documents from the Lao government, international organisations, bilateral donors and non-governmental organisations.

The consultant shall also discuss with and interview Lao and international stakeholders.

Requirements and qualifications

The team should consist of one international and one national consultant. The team should have the following qualifications:

- Independence
- Knowledge and experience from the public administration sector, including financial management, accounting, budgeting, auditing and procurement mechanisms.
- Experience from research based on written documentation and report writing in the field of financial management, accounting, budgeting, auditing and procurement.
- Experience from working with and in Lao PDR
- Related academic competence
- Good ability to write in English. Ability to read Lao.

It is expected that the international consultant will use four man weeks and the national consultant three man weeks to complete the study.

The study shall be conducted in September 2002. A draft report shall be submitted to the Embassy no later than the end of September. The final version shall not exceed 40 pages and shall be submitted to the Embassy no later than 14 October 2002.

Annex 2: List of literature consulted in connection with the study

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- Lao PDP, Committee for Planning & Cooperation: Public Investment Programme & Project Operations Guidelines, July 2001
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– Price Waterhouse, Audit of the Lao-Swedish Road Sector Project 2 for the 6 months ended 30 Sept. 2001
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– Lao PDR Decree on anti-corruption, No. 193/PM, 2 Nov. 1999
– Sida anti-corruption regulations, 6 May 2002
– Terms of reference for consultancy services related to a study on democratic governance in Lao PDR, Swedish Embassy, 9 July 2002
– Implementing Rules and Regulations on Government Procurement of Goods, Constructions, Repairs, and services
– Ministerial Decree on the Roles, Duties, Rights and Organisational Structure of the Inspection Department, No. 0431/MF, 4 April 2001
– Ministerial Decree on the Roles, Duties, Rights and Organisational Structure of the External Finance Relations Department, No. 0108/MF, 29 January 2001
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Annex 3: List of persons met

Name	Institution
Aksone Bouphakonekham,	Director General of Cabinet, Bank of Lao PDR
Vanhkham Keophanhdy,	Director, Inspection Department, MOF
Boun One Chanthavongsa,	Deputy Director General, Inspection Department, MOF
Somphet Sivongxay,	Chief of Division, Inspection Department, MOF
Soukkhamphet Heuangboutsy,	Chief of Cabinet, Prime Minister's Office, State Inspection Authority
Langsy Sibounheuang,	Vice Chairman of the State Management Inspection Authority, Prime Minister's Office
Dr. Bountheuny Mounlasy,	Director of CPC
Somsanouk Sinamountry,	Ministry of Finance, accounting Department
Sila Viengkeo,	Deputy Director General, Ministry of Finance
Phetsay Phiathep,	Deputy Director General, PCP. Department of Public Investment Programme Management
Somphone Phanousith,	Director General of Cabinet for Research, Training and Administration, State Audit Authority
Shakeeb Khan,	PIP, CPC
Kham Plme Phouthavonj,	Ministry of Health, Acting Director, Department of Finance and Budget
Soutsakhone Chanthaphone,	Deputy Director, MOH, National Centre for Environ mental Health and Water Supply

Jacquelyn Chagnon,	Participatory Development Associates
Enrique Crousillat,	Country Manager, South East Asia & Mongolia, World Bank
Alessandro Magnoli,	Economist, Europe and Central Asia Region, World Bank
Rickard Lindkvist,	Financial Adviser, Lao Swedish Road Sector Project II
Ulf Wallin,	Institutional Development Specialist, Team Leader, Lao-Swedish Road Sector Project II
Stephan Ekelund,	Road Administration Programme, WB/NDF
Nihal Fernandopulle,	Audit Adviser, Asian Development Bank
Rick V. Fisher,	Tax Advisor, Tax Department, MOF
Jan Erik Engstrom,	Chief Technical Adviser, Nam Saat
Carl Gustav Mossberg,	Senior Programme Management Adviser, Lao-Swedish Upland and Forestry Research Programme
Mark Gomez,	Manager, Pricewaterhouse Coopers
Mr. Hans Luther,	NOSPA
Eric Sidgwick,	Resident Representative, International Monetary Fund
Christer Holtsberg,	Charge d'Affairs a.i., Embassy of Sweden
Klas Rasmusson,	First Secretary, Embassy of Sweden
Sara Gustafsson,	Second Secretary, Embassy of Sweden
Paul V. Turner,	Country Director, Asian Development Bank
Rattanatay Luanglatbandith,	Senior Economist, Asian Development Bank
Wiveca Holmgren	Internal Auditor, Department for Evaluation and Internal Audit, Sida
Thorbjorn Bergman	Internal Auditor, Department for Evaluation and Internal Audit, Sida

Annex 4: Abbreviations used in the report

ADB:	Asian Development Bank
BOL:	Bank of Lao PDR
CCC:	Central Committee for Control
CPC:	State Planning Commission
GOL:	Government of Lao PDR
ID:	Inspection Department (Ministry of Finance)
IID:	Internal Inspection Department (Line Ministries)
IRR	Implementation Rules and Regulations (Procurement)
KIP:	Lao PDR currency (1US$ = approximately 10,000.00 KIP)
LSFP:	Lao-Swedish Forestry Programme
LSRSP:	Lao-Swedish Road Sector Project
MOF:	Ministry of Finance
MOH:	Ministry of Health
NSEDP:	National Socio-Economic Development Plan
PER:	Public Expenditure Review
PIP:	Public Investment Plan
PMU:	Project Management Unit
PWC:	PricewaterhouseCoopers
SAA:	State Audit Authority (Auditor General)
SAI:	Supreme Audit Institution
SEK:	Swedish Kronor
SIA:	State Inspection Authority
SOB:	State Owned Banks
SOE:	State Owned Enterprises
WB:	World Bank

Halving poverty by 2015 is one of the greatest challenges of our time, requiring cooperation and sustainability. The partner countries are responsible for their own development. Sida provides resources and develops knowledge and expertise, making the world a richer place.

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