United Nations Development Programme

THE ASIA-PACIFIC REGIONAL PROGRAMME ON MACROECONOMICS OF POVERTY REDUCTION

Pro-Poor Fiscal Policy in Cambodia

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1. Introduction

This chapter is divided into four sections. In the second section, we review Cambodia's macro-fiscal record, as well as institutional and macroeconomic strategic documents, highlighting major fiscal trends and policy positions. In the third section we present a series of deductions regarding aspects of Cambodia's current macro-fiscal strategy and point out the implications for the macroeconomics of poverty reduction. In the fourth section we present a summary of principal analytical conclusions together with some policy implications that can be derived from these conclusions. We then present some concluding comments on aspects of the overall macro-fiscal strategy currently in place in Cambodia which could serve as inputs for making that strategy more pro-poor.

2. The macro-fiscal situation: an overview

Table 4.1: Macro-fiscal statistics 1993-2002 (Billion riel)

Item	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Total revenue	290	590	643	749	881	943	1,338	1,442	1,561	1,834
Of which: central government							1,316	1,408	1,520	1,790
Tax revenue	234	365	445	534	597	679	966	1,055	1,128	1,279
Direct taxes	…	9	21	27	44	56	83	136	140	127
Of which: Profit taxes	14	8	19	18	35	42	61	101	113	96
Indirect taxes	…	75	104	164	206	248	433	500	571	686
Of which: Excise taxes	…	3	9	57	74	76	92	113	155	220
VAT (net VAT refunds)	…	...	...	...	...	…	316	371	403	452
Trade taxes	160	281	321	344	347	376	433	390	376	430
Nontax revenue	56	225	190	176	271	230	357	356	424	530
Capital revenue	0	1	8	39	12	33	15	31		25
Total expenditure	608	1,009	1,206	1,441	1,260	1,571	1,927	2,119	2,367	2,682
Current expenditure	373	674	695	813	808	941	1,119	1,223	1,391	1,620
Wages	…	293	326	354	382	451	525	512	488	524
Civil administration	…	101	110	125	132	154	194	211		259
Defence and security	…	192	216	229	250	297	331	301		265
Nonwage	…	380	368	459	426	490	572	677		1,052
Of which: Operating expenditures	…	324	290	345	322	372	410	497		676
Interest	…	1	2	13	10	15	22	21		25
Capital expenditure	235	335	511	629	452	630	808	896		1,062
Locally financed	23	79	57	62	110	120	303	303		362
Externally financed	212	257	454	567	342	510	504	592		700
Current balance	-83	-85	-59	-103	61	-32	205	188	160	189
Overall fiscal balance	-318	-419	-563	-692	-379	-628	-589	-677	-806	-848
Overall fiscal balance (including grants)	…	-69	-105	-113	-38	-286	-247	-293	-410	-369

Source: Data provided by IMF Country Office, Cambodia

The history of Cambodia's macro-fiscal development across the 1990s can be divided into two phases (a) the period from 1993-1997 and (b) 1997-2002. 1997 marks a structural break because of the east Asian crisis and domestic disturbances. IMF staff estimates, reproduced in Table 4.1 above, provide consistent and comparable data spanning both these periods from 1993 onwards.

The first phase of Cambodia's development marked attempts by a new administration to take control of fiscal operations in a country still divided by internal war, with only rudimentary fiscal administrative structures in place, inherited from the UNTAC administration. Following elections in May 1993, the government began formulating a comprehensive macroeconomic and structural reform programme with support from the international community. Major customs reforms were instituted and a taxation structure established. Non-tax revenues began to increasingly flow into government coffers rather than being appropriated by private agents. The bulk of revenues were generated by taxes on international trade and turnover taxes, with domestic excise accounting for a relatively small share.

Cambodia's domestic revenue as a share of GDP doubled between 1991 and 1994. However, the revenue/GDP ratio stagnated from 1996 to 1998, falling sharply in 1998 as a consequence of external and internal disturbances.(Table 4.2) Thus, a promising start on the resource mobilisation front can, with hindsight, be judged to have been unsustainable, and, ultimately, negated by adverse developments exogenous to the fiscal system.

Table 4.2: Cambodia Revenue GDP ratios 1991-1998 (%)

Year	Revenue/GDP	Tax Revenue/GDP	Non-tax revenue/GDP
1991	4.4	2.3	2.1
1992	6.2	4.4	1.8
1993	5.4	4.3	1.0
1994	9.6	5.9	3.7
1995	8.9	6.2	2.6
1996	8.1	6.5	2.2
1997	9.7	6.6	3.0
1998	8.1	5.9	1.9

Source: World Bank 1999: 113

In the first phase, current expenditures accounted for over half total expenditure and the government consistently incurred a current fiscal deficit (Table 4.1). This deficit was financed largely by foreign aid receipts from 1993 to 1997. Domestic public investment was therefore completely financed by foreign savings. A significant majority of recurrent expenditure was on military spending and civilian wage expenditures, with some donor financed current expenditures providing for basic non-wage operating expenses.

Since 1997, Cambodia has enjoyed a period of relative political stability that has allowed RGC to focus on achieving medium-term fiscal sustainability. This requires RGC current expenditures to be financed entirely out of domestic revenue. As the data in Table 4.1 demonstrates, since 1999, Cambodia successfully secured a small surplus of current revenues over current expenditures, in contrast with many developing countries. Fiscal discipline is adequate to ensure that despite macro-economic shocks (such as the 2001 floods), there is no recurrent deficit. This effort is complemented by active donor assisted capacity building initiatives to reform public expenditure management and improve fiscal and administrative governance. However, Table 4.1 also reveals that revenue mobilisation is inadequate for providing sustainable domestic financing of growth-enhancing and poverty-reducing investments.

The period 1999-2002 in particular has also been one in which several key changes have been initiated in Cambodia's macro-fiscal structure. First there is a concerted attempt to change the revenue structure, to reduce the share of taxes on foreign trade and to increase the share of taxes on domestic goods and services. This change is broadly revenue neutral. Tax collections from international trade activities are declining very marginally in absolute terms while there are significant increases in VAT collections and non-tax revenues as well as direct tax collections although the last contributes a small share. Thus, the modest growth in the revenue/GDP ratio comes largely from increasing absolute collections of direct taxes and non-tax revenue, with VAT growth offsetting the decline in international trade tax collections ratio.

In the case of public expenditures, Table 4.1 indicates that current expenditures have risen slightly. In terms of GDP share, such expenditures have risen from under 8% in 1997 to 11.3% in 2002. This increase has been marked by a fall in the share of wages and salaries and a rise in the share of non-wage operating expenditures. As we will show later, the main beneficiary of the rise in the expenditure/GDP ratio has been the social services sector, principally health and education, especially since financial year (FY) 2000.

RGC fiscal policy is thus to sustain macroeconomic and external sector stability by ensuring that current expenditures do not exceed current revenues and to avoid recourse to bank financing of the budget deficit. The strategy for doing this in recent years has been to compress civilian operating expenditures so as to ensure that current expenditures match current revenues.

2.1 Institutional and macroeconomic strategic initiatives: fiscal components

There is no dearth of strategic and policy documentation, on macroeconomic and macro-fiscal issues in Cambodia. Since 2000 there have been four overarching policy documents on the subject, each prepared with generous donor assistance. Each of these documents claims to have poverty reduction as the overarching goal. The macro-fiscal content of these documents are reviewed below as these constitute important strategic milestones linking fiscal policy with poverty reduction.

2.1.1 The World Bank public expenditure review

This document (World Bank 1999) provides a comprehensive assessment of the major macro-fiscal challenges in Cambodia's development history in the 1992-1998 period and sets the agenda, in many ways, for Cambodia's future development strategy and the key assumptions underlying the strategy. While acknowledging that Cambodia made considerable progress towards obtaining a stable macroeconomic structure in the 1993-96 period, the report found significant regress since 1996. The cause was clearly pinpointed. 'Weak physical infrastructure and, more important, inadequate capacity of human resources severely constrain Cambodia's development potential' (World Bank 1999: ii). Recommendations for future macro-fiscal strategy sought explicitly to address these constraints. The major recommendations were:

1. To increase resource mobilisation by improving the tax collection effort (World Bank 1999: iii-iv). The report estimated that regulatory and technical reforms could substantially improve Cambodia's tax effort from 8% in 1998 to close on 13% by 2002;
2. To improve the efficiency of non-tax revenue administration;
3. To reduce defence expenditure which crowded out spending on development activities;
4. To substantially increase outlays for social sectors financed from revenue enhancement and also savings from military demobilisation;

5. Implement civil service reform to improve operational efficiency of public service delivery so as to improve the quality of public services without increasing expenditures on general services;
6. Increase outlays on non-wage operating expenditures;
7. Enhance public expenditure effectiveness by improving the quality of public expenditure management.

The above recommendations have all been reinforced by various strategic documents on macro-fiscal issues produced in later years.

2.1.2 The PRGF Memorandum of Understanding

The international monetary fund and RGC signed a memorandum of economic and financial policies and technical memorandum of understanding on 26 December 2001 that underpinned IMF financial support for RGC under the poverty reduction and growth facility (PRGF) which aims to accelerate growth and reduce poverty. As a loan document, this memorandum also contains annexes outlining a series of policy conditionalities.

The document (IMF 2001) emphasises two urgent fiscal priorities:

- The need to improve revenue collection through better revenue administration;
- The need to optimise expenditure efficiency.

Thus the accent of the PRGF is on technical efficiency and not on policy issues. Following from the PER (1999) it assumes that the main objective of macro-fiscal policy is to secure technical improvements to increase the efficiency of fiscal policy implementation. Given the lack of policy content the main interest in this document remains its coercive content, i.e. the conditionalities. These, again are mainly technical in nature requiring improvement in cash management procedures, customs codes etc. (IMF 2001: 13-14). However, certain benchmark conditionalities continue to be enforced. The most important ones are (IMF 2001: 8):

- a ceiling on net domestic financing of the budget;
- zero foreign commercial borrowing;
- minimum maintenance of foreign currency reserves;
- a ceiling on National Bank of Cambodia credit to government.

Thus this document is both technocratic and prohibitory. The underlying strategy is to improve fiscal efficiency through technical improvements in fiscal governance and broad but restrictive prohibitions on credit acquisition to maintain a conservative fiscal stance.

2.1.3 The I-PRSP (2001)

The interim PRSP (I-PRSP 2001) for Cambodia emphasizes two issues in the macro-fiscal context:

(1) Increasing investments in health and education to improve human development achievements and enhance human capabilities;

(2) Maintenance of macroeconomic stability and investment by enhancing the efficiency of fiscal processes so as to maximise revenue and optimise expenditure allocation decisions so as to maximise growth and human development.

The I-PRSP presents a macroeconomic framework for the period 1997-2004 which seeks to secure modest increases in government expenditure/GDP ratios while maintaining an overall fiscal deficit under 5% of GDP. Increases in the revenue/GDP ratio are sought through fiscal consolidation, i.e. improved fiscal management (I-PRSP, 2001: 23), while expenditure increases are required to be targeted mainly at securing increases in social sector spending, both in terms of share in total spending and in terms of social sector spending as a percentage of GDP. The reasoning underlying the macroeconomic framework used is not analytically justified. The policy matrix for 2000-2002 contains a series of prescriptions for fiscal reform which deal exclusively with expenditure management and revenue administration without any explicit mention of policy goals for revenue growth or expenditure allocation.

The I-PRSP identifies four priority sectors from a poverty reduction perspective. These are: health, education, agriculture and rural development.

2.1.4 The SEDP-ii (2002)

The Socio-Economic Development Plan II (SEDP-ii 2002) is presented by RGC as the 'Royal Government of Cambodia's national economic growth and poverty reduction strategy' (SEDP-ii 2002: 1). The strategic message of the Plan is that 'economic growth is a pre-requisite for poverty reduction and the key to growth is private sector development, which will be achieved largely through improvements in the governance environment.' (SEDP-ii 2002: 3).

This very specific strategy ought to be backed by a complementary macro-fiscal strategy designed to maximise private sector development and improve governance. Unfortunately the SEDP-ii contains no such strategy and the intention apparently is to rely on other strategic documents to provide a complementary strategy. While the SEDP-ii does provide a public investment programme (PIP) consisting of a list of priority projects in different sectors, these projects have not been costed or justified within an overall capital resource envelope. In the words of a senior government economist the PIP is nothing but a 'shopping list'.

2.1.5 The D-MTEF

In the 2002 Budget circular RGC stated its intention to introduce multi-year budgeting which better links development plans programmes and budgets within a *Medium term expenditure framework (MTEF)*. This framework is to be produced by the finance ministry with long term peripatetic advice from an expatriate principal fiscal adviser. The original intention was for this process to be complete by 2003 (ADB 2001). However, the process has been advanced by a year and, in June 2002, RGC produced a draft MTEF document incorporating a three year macro-fiscal medium term expenditure framework for 2003-2005 (D-MTEF, 2002). The D-MTEF incorporates sectoral MTEFs for two priority sectors, health and education.

MTEFs are technical exercises that derive their policy inputs from the wider policy process and seek to reconcile the trade-offs between competing demands for resources within an overall agreed feasible resource envelope, and in accordance with strategic priorities that are decided at the highest level. Thus, MTEFs require a strategic mandate with which to prioritise resource allocation. They further require demonstrable evidence from each sector that the sector spending plans are in accordance with sector priorities and have been designed to maximise operational efficiency i.e. at minimum possible cost.

A MTEF demonstrates its effective incorporation of government's strategic concerns by incorporating a 'policy goals and strategies paper' which seeks to provide a critical review of existing strategic documents (such as those described above) and producing, after consultation a statement of government policy goals and strategies. This document is then approved at the highest political level (in Cambodia, the Cabinet). The document then binds all actors, and serves as the main justification for enforcing the MTEF.

Section 2 of the draft Cambodia MTEF (D-MTEF, 2002: 2) incorporates the policy goals and strategies component. It aims to achieve a balanced and sustained economic growth rate of 6%. It identifies the following macroeconomic and institutional strategies for achieving this growth rate

(1) Implementation of fiscal efficiency reforms and maintenance of stable macro environment;

(2) liberalisation of trade and investment policies and accelerated private sector development;

(3) financial sector development;

(4) improved governance and regulatory environment, including improving the access of the poor to social and economic services by removing anti-poor distortions in product and factor markets.

The MTEF also identifies four priority sectors in line with the I-PRSP and the SEDP-ii. These are health, education rural development and agriculture. Each sector is expected to produce a sectoral MTEF, which can then be used to work out sector medium term expenditure. For the 2002 D-MTEF a matrix of objectives, constraints and policy directions (costed expenditure-generating activities) exists for health and education only.

Section 3 of the D-MTEF presents a macroeconomic and medium term fiscal framework This provides a range of macro fiscal projections for GDP growth, inflation the exchange rate revenue, and current and capital expenditure. Based on these projections the D-MTEF also derives figures for current surplus and overall (fiscal) deficit, for the period 2002-2005. (Table 4.3). Thus, this section effectively provides an estimate of total resources available to RGC for various recurrent activities and the overall fiscal sustainability targets

Table 4.3: Key macro-fiscal forecasts 2003-2005
(% of GDP)

Item	2002	2003	2004	2005
Total revenue	12.8	13	13.6	13.9
Tax revenue	8.9	9.3	9.7	10.1
Non-tax revenue	3.7	3.7	3.7	3.6
Current expenditure	11.3	11.5	12	12.4
Capital expenditure	7.4	6.8	6.8	6.6
Current surplus	1.3	1.5	1.6	1.5
Overall deficit	-5.9	-5.3	-5.2	-5.1

Source: D-MTEF 2002: 4

Section 4 of the D-MTEF presents the Medium term Budget framework. This section tries initially to calculate the *baseline budget* for each sector i.e. the total expected expenditure on wages and salaries, and operating costs, as well as expected commitments to social and economic subsidies (which the D-MTEF assumes will be maintained over the period at 2002 levels) which are considered to be unaffected by future policy changes. In Cambodia, given that donors are responsible for almost all capital spending, most capital expenditure is also taken to be part of the baseline budget. The total baseline budget is then deducted from the projected total expenditure for each year to provide the total available *allocable* expenditure for each year. (Table 4.4 below provides the calculations). The allocable ceiling thus indicates the quantum of resources which the government can switch between sectors depending on its strategic priorities.

Table 4.4: Baseline and allocable ceilings 2003-2005

Item	2003	2004	2005
Baseline ceiling million riels	2410582	2564500	2752825
Allocable ceiling million riels	453551	642592	780035
Allocable ceiling (per cent of GDP)	2.9	3.77	4.2
Total expenditure (per cent of GDP)	18.3	18.8	19.0

Source: D-MTEF 2002: 5.

Finally the D-MTEF proves a distribution of resources by sector (Table 4.5). It seeks to switch allocable resources away from defence and security towards health and education and to a lesser extent towards agriculture and rural development This is sought to be done both in terms of the share of these sectors in total current expenditures and in terms of expenditure on these sectors in per cent of GDP.

Table 4.5: GDP expenditure shares (current and domestically financed capital expenditure as per cent of GDP) and sector shares in current expenditure

(figures in brackets indicate forecasted share of that sector in total current expenditure)

per cent

Item	2003	2004	2005
General administration	1.54	1.45	1.36
Defence and security	2.53(22.0)	2.5 (20.8)	2.4 (19.4)
Education	2.13(18.5)	2.34 (19.5)	2.5 (20.0)
Health	1.38 (12)	1.5 (12.5)	1.6 (12.9)
Agriculture	0.26 (2.3)	0.3 (2.5)	0.35 (2.8)
Rural development	0.13 (1.1)	0.15 (1.3)	0.20 (1.6)

Source: Compiled from D-MTEF 2002: Tables 4 and 5.

Thus the D-MTEF provides a comprehensive and reasoned statement of macro-fiscal priorities and intentions for the 2003-2005 period based on an assessment of historical macro fiscal trends , a clear statement of assumptions (summarised in Box 4.1 below) and a sectoral allocation of free resources. Given the sparse policy input in the macro-fiscal area in other strategic documents like the SEDP-ii and the I-PRSP, it is likely that the MTEF will in effect provide the medium term strategic blueprint for fiscal policy in the medium term[1].

[1] Since the forthcoming Cambodia PER will not be ready by the time the D-MTEF is presented to the National Assembly as a budget annex in December 2002, it appears that it will only influence policy marginally in the medium term. It is unclear what the utility of this document will be at the macroeconomic level given the blueprint set out in the MTEF; any radical departures in policy stance from the MTEF in the medium term will either be redundant or will cause great policy confusion.

Box 4.1: D-MTEF assumptions

The D-MTEF makes the following general assumptions. While these are quantified in the actual document the actual numbers are confidential, with good reason as the precise numbers are market sensitive and could trigger anticipatory action by private economic agents. Hence only the generic assumptions are presented here:

- New tax measures and expansion of coverage of existing taxes will generate rises in revenues in each of the fiscal years 2003-2005.
- Modest expansion of existing non-tax revenue sources will increase non-tax revenues in each of the three years 2003-2005. However, the growth in non-tax revenues is expected to be equal to or less than the forecasted GDP growth rate.
- Administrative and efficiency improvements will raise tax revenues modestly in 2003 and 2004 Thus growth, rather than improved revenue effort will drive revenue GDP increases.
- Capital expenditures will not grow faster than GDP thereby resulting in a small fall in the capital expenditure/GDP ratio.
- Current expenditures will rise as non-wage recurrent expenditure allocations in the priority sectors are enhanced. In addition current expenditure increases can be anticipated in 2004 and 2003 due to increased demobilisation costs, some wage adjustments and higher transfers to communes.

3. Analysis of Cambodia's Fiscal Stance

In this section we present a series of deductions regarding aspects of Cambodia's current macro-fiscal strategy and point out the implications for the macroeconomics of poverty reduction.

Our first analytical conclusion, explained below, is that **Cambodia's resource envelope is limited in the medium term**. This is so for two reasons:

- Only modest increases in public resources can be expected through growth in tax base and efficiency improvements in the medium term.
- Domestic resource mobilisation through domestic borrowing is not feasible in the medium term

3.1 Resource mobilization

A country can mobilize resources in the following ways:

- *By increasing tax and non-tax revenues.* This source of revenue is the most preferable from government's perspective, as it generates no future fiscal liabilities. However, taxation can have a variety of macroeconomic and sectoral effects on the spending and investment decisions of economic agents, which can have implications for equity, efficiency and growth.
- *By borrowing from the domestic private sector.* This source of revenue is attractive since it represents a transfer from the domestic private sector to the domestic public sector and so does not directly increase the country's liabilities to the rest of the world. It can also increase the propensity to save to the extent that the borrowing reduces domestic consumption. It is, to this extent, a 'free' transfer. It can, however, crowd out private investment and have distributional implications depending on the precise nature of the borrowing exercise. It can also have inflationary consequences, if domestic absorption

increases significantly before public investment generates increased output. Finally, borrowing for government *consumption* has purely negative implications for growth as it reduces national saving to the extent that the borrowing is financed out of private saving.

- *By borrowing internationally***.** This type of borrowing results in an increase in international debt and creates liabilities for the country. It represents a temporary increase in domestic resources, that can be amortised only if the pay-back from the investment of these resources results in an increase in GDP greater than the net present value of the loan. The greater the degree of concessionality in such borrowing (zero, in the limit when the international transfer is a full grant) the lower the net present value of the debt.

In Cambodia, the bulk of resources accruing to government for *recurrent* expenditure are generated through domestic revenues. As we saw in table 4.1, in recent years Cambodia has not been borrowing directly for meeting recurrent expenditure needs. Current revenues pay for current expenditures and, in fact, generate a small surplus for investment. Hence, the greater the prospects for increases in Cambodia's current revenues, the greater the potential for increasing domestically financed public investment.

In comparative terms, Cambodia's revenue/GDP ratio is lower than in many other countries in ASEAN at comparable levels of development (IMF, 2001). This indicates that there is considerable potential to increase the revenue/GDP ratio. However, the various policy documents cited in the previous section are fairly pessimistic about the potential to increase Cambodia's revenue/GDP ratio. As the D-MTEF (2002: 4) states, 'It is assumed that the significant increase in fiscal revenues in absolute terms will be driven mainly by high and sustained growth of the Cambodian economy rather than a dramatic improvement in revenue effort'. Revenues are expected to increase by one percentage point – from 12.8% of GDP in 2002 to 13.9% of GDP in 2005 (The macroeconomic framework presented in SEDP-ii (2002: 98) is even more modest assuming revenue GDP ratios of 13.5% for each year in the 2002-2005 period.). This figure already exceeds the tax/GDP ratio that the 1999 World Bank PER estimated could be achieved by improving the efficiency of the tax effort, though our discussions indicate that several expatriate economists and donors feel that there is still considerable scope for revenue increases through administrative and technical improvements in the taxation structure.

The projected increase in the tax/GDP ratio in the 2003-2005 period is expected to be generated through increases in taxation of domestic goods and services and some modest increase in direct tax collections (SEDP-ii 2002: 99; also see Box 4.1 above). Non-tax revenues are expected to be constant in terms of their share of GDP. These modest improvements will be secured through strengthening tax collections and by reducing tax exemptions. At the same time there is a projected fall in revenues from customs duties (due to trade liberalisation prior to accession to WTO in 2005). The net tax burden is therefore not slated to rise significantly.

There is a simple explanation for this moderate forecast for Cambodia's revenue growth even if it somewhat contradicts the assertions about private sector development in the policy documents. This explanation has two elements.

- *First,* Cambodia's direct tax collections account for about one per cent of GDP. Eighty per cent of this in 2000 came from taxes on profits (IMF 2001: Table 4). Unless there is rapid and sustained growth in *corporate* private activity, there will be no significant rise in the direct tax base. Hence, the implicit assumption in the policy documents cited must be that future increases in private sector activity, touted in so many policy documents, will occur mainly in the *non-corporate* private sector. If this is so, then, such increased activity will have a negligible fiscal impact, since increases in corporate and non-corporate tax *rates* are ruled out to encourage domestic private sector growth and to make Cambodia an attractive destination for private investment in a highly competitive environment.

- *Second*, taxes on international trade have historically accounted for a large segment of total tax collections in Cambodia. In the 2000-2002 period, such taxes accounted for 33% of total tax revenue (over 60% if VAT on international goods and services is added on). With customs duties slated to reduce in the run-up to WTO accession, the best that can be hoped for is a revenue neutral increase in taxes on domestic goods and services. Customs duties and VAT are roughly equal in scope at the present time. The strategy contemplated is to increase excise duty collections from luxuries marginally and to increase VAT collections by improving administration. This provides little scope for revenue increase.

  It is therefore clear that the even the modest increase in the tax/GDP ratio planned for the medium term is, given the preceding discussion, based on fairly brave assumptions regarding the non-quantifiable benefits of current technical assistance to improve tax administration. There are no planned specific economic events or policy interventions that can enable a rise in the tax/GDP ratio. Hence, the conservatism in revenue forecasting is well justified.

In these circumstances, it would be natural to look at resource mobilisation through domestic borrowing for public investment. Here, Cambodia is severely constrained by IMF conditionalities which prohibit government from any substantive recourse to domestic borrowing. While it is tempting to see this as yet another example of unwarranted Bretton Woods conservatism, a closer look at the facts reveals a rather complex picture.

Leaving distributional considerations aside, domestic borrowing adds to gross investment and to growth if it does not substitute for resources available for private investment and if the returns from public investment are sufficient to justify borrowing costs.[2] In Cambodia the public savings/GDP ratio has risen quite sharply from 7.4% in 1995 to 13.2% in 2001 (IMF 2001: Table 4.1). This rise in savings reflects less an increase in the *propensity* to save than the increased channelling of domestic savings into the formal sector. Our discussions revealed that this is an extremely low ratio, for two reasons:

- *Underdeveloped financial structure* (see Chapter 6).
- *Lack of trust in government.* In many developing countries with underdeveloped private financial markets, sovereign borrowing for public investment has often been used as an instrument to extract savings kept in forms that do not permit them to be used for productive investment (chiefly non monetary tradable assets like gold etc. and money kept at home or entrusted to informal agents). This process is known as the *realisation* of savings. Our discussions revealed that a considerable proportion of savings are presently stored in this form, in addition to deposits abroad. It is difficult to obtain precise quantitative volumes for such savings but there is enough indication that it would not be unreasonable to suppose that such savings would be around 5% of GDP. If realised for productive investment this would be a substantial amount, and would considerably boost government's resource mobilization efforts. However, given the absence of any track record of such mobilization by government and a constant fear of political uncertainty, it is doubtful whether government would be able to access such savings, account for them,

[2] Note that in poor countries domestic public debt increases can have negative distributional implications, which have to be offset against the benefits of increased domestic resource mobilisation. For details see Roy (1994).

and deploy them without considerable technical assistance and a visible transparent accounting mechanism for public debt. Without such a mechanism visibly in place confidence in government's capacity to use these resources effectively and repay national debt will remain low, and such savings continue to remain unrealised by the public sector.

The lack of confidence in government as a credible borrowing agent is perhaps the biggest obstacle to effective mobilisation of domestic resources for development. In part this has to do with the recent record of political instability and government solvency as well as doubts about the safety of private resources in government hands. Many doubts were expressed during our discussions about the capacity of government to handle domestic resources and to abide by the commitment to use these resources exclusively for investments that yield tangible returns. This lack of confidence in government as a financial agent implies that RGC must be seen as an institution whose financial sovereignty is bounded in the perception of private savers. The reasons underlying this have to do with governance issues that lie outside the scope of this report. The implication, however, is unmistakable – without a major improvement in the credibility of its financial sovereignty, RGC cannot expect to be able to use domestic borrowing as an instrument to improve savings realisation until financial markets are developed sufficiently .

The above institutional constraint is particularly ironic given the existing situation with bank credit. In the past year, deposit liabilities of commercial banks have been around 9% of GDP, while lending by commercial banks has amounted to around 6% of GDP. Thus, even with realised savings, commercial banks are unable to lend their total funds at prevailing rates of interest. In effect three per cent of GDP is idle, being neither consumed nor saved. Information we gathered indicates that a significant portion of these resources are placed on deposit with the National Bank of Cambodia, which then, *inter alia,* invests them in the Singapore inter-bank money market. Given the institutional background, this action (if information received is correct) is a perfectly understandable banking decision, though its sub-optimality from a development finance perspective is quite apparent.

3.2 Dependence on donor finance

Cambodia is heavily dependent on concessional donor finance for its development investments. This raises concerns regarding future debt service ratios.

RGC is effectively prohibited from recourse to commercial international borrowing by a conditionality agreed with the IMF. Given the conditions set out in the previous paragraphs this seems quite reasonable given the government's bounded financial sovereignty. Hence the main sources of international finance are concessional grants and loans from multilateral and bilateral donors. These have traditionally dominated public investment financing in Cambodia and are likely to do so in the medium term. Thus net foreign financing in 2002 is estimated to be 5.8% of GDP, while externally financed capital expenditure in the same year was 4.9% of GDP and locally financed investment was 2.4% of GDP (calculated from Table 4.1). Thus, around two thirds of total investment is financed by external concessional assistance.

The RGC's reports on development co-operation (RGC 2001; RGC 2002) provide an estimate of the past and projected structure of such concessional finance. Generally disbursements are around 75% of pledges and while grants currently provide the bulk of development assistance to the country as a whole, project loans to government as a recipient have been increasing quite sharply since 2001. They presently account for 2.1% of GDP compared with 1.6% of GDP in 1998. This indicates that while the stock of the country's overall external debt is rising quite slowly, government's direct debt service commitments are rising fast enough to cause concern regarding the contingent current expenditure commitments the rising debt stock generates. Hence, the present and projected grant:loan portfolio would make it imprudent for government to seek significant additional development assistance without reckoning on a concomitant rise in its future debt service obligations. Any further adverse change in the grant:loan ratio would exacerbate this fiscal constraint.

3.3 Costs associated with the chosen strategy

Given the resource envelope constraint, Cambodia's pro-poor macro-fiscal strategy seeks to secure growth through a highly specific expenditure switching policy from general services to social services, i.e. health and education. On the face of it, these sectoral expenditures have been designed to optimise their pro-poor impact, and most official documents highlight these *benefits*. They do not, however, highlight the implicit and explicit *costs,* which need to be taken into account when assessing the net pro-poor benefits of the chosen strategy.

To establish the above proposition we need to take a close look at the structure of government expenditure in the period 1997-2002, and its evolution from 2002 to 2005. Table 4.6 below presents data on the structure of government expenditure by functional classification in the period 1994-2002

Table 4.6: Functional classification of government current expenditure 1994-2002

(% of expenditure; figures in bracket are % of GDP)

Year \ Sector	General Services	Defence and Security	Social Services	Education	Health	Economic services	Agriculture	Rural development
1994	13.3 (1.44)	59.1 (6.38)	19.9 (2.15)	9.3 (1.01)	4.5 (0.49)	7.6 (0.83)	1.9 (0.2)	0.2 (0.02)
1995	14.7 (1.5)	58.5 (6.0)	20.2 (2.06)	10.0 (1.03)	3.5 (0.36)	6.5 (0.66)	1.8 (0.18)	0.3 (0.03)
1996	15.4 (1.47)	51.5 (4.93)	22.7 (2.18)	10.2 (1.0)	5.4 (0.52)	8.8 (0.84)	2.0 (0.2)	0.3 (0.03)
1997	16.7 (1.5)	51.4 (4.61)	23.2 (2.08)	10.2 (0.92)	5.6 (0.5)	7.5 (0.67)	1.8 (0.16)	0.2 (0.02)
1998	21.3 (1.89)	48.5 (4.31)	21.8 (7.5)	10.9 (0.97)	4.7 (0.42)	6.7 (0.6)	1.6 (0.15)	0.2 (0.02)
1999	16.6 (1.59)	42.7 (4.08)	27.4 (2.62)	13.7 (1.31)	6.9 (0.66)	8.6 (0.82)	1.9 (0.18)	0.3 (0.03)
2000	18.9 (1.88)	37.1 (3.69)	30.3 (3.02)	10.7 (1.36)	8.4 (0.83)	9.3 (0.92)	1.9 (0.19)	0.6 (0.06)
2001	19.5 (2.11)	30.5 (3.29)	35 (3.78)	16.4 (1.77)	9.9 (1.07)	11.8 (1.27)	2.5 (0.25)	1.0 (0.10)
2002	14.5 (1.6)	24.7 (2.72)	37 (4.07)	18.2 (2.0)	10.9 (1.2)	11.0 (1.21)	2.5 (0.28)	1.3 (0.14)

Note: 1994-2000 figures are final out-turns; 2001 figures are revised estimates; 2002 figures are provisional budget figures.

Source: based on data supplied by Ministry of Economy and Finance.

The above table marks a clear pattern. Since 1997, the share of civil administration in total expenditure has been roughly constant through to 2001, even rising slightly in GDP terms. The biggest fall has been in defence expenditure, often called the ‘peace dividend.’ This has resulted in a significant rise in the share of social services, particularly education and health. The Economic services share has also risen slightly though not for agriculture. Rural development continues to account for a small proportion of current expenditure.

This macro-fiscal change in the structure of current public expenditure has not happened accidentally. Most major policy documents celebrate this change. The I-PRSP, SEDP-ii and the PRGF, in line with the World Bank’s 1999 PER, all emphasise the virtues of a poverty reduction strategy that improves human development by improving access to, and quality of publicly funded education and health services. As we saw in the previous section the D-MTEF explicitly seeks to continue with this strategy. It is clear from Tables 4.4 and 4.5 that while there are four priority sectors, it is health and education that are slated to secure the lion's share of incremental resources in the 2003-2005 period

These documents do not, however, directly point out the trade-offs involved in the choice of such a strategy in Cambodia. With limited scope for additional revenue mobilisation, public expenditure on development benefits from reduced expenditure on defence and, to a lesser extent, on general services. The bulk of the resources thus released in the past five years have been allocated to social services especially health and education. Key economic services have received relatively little by way of increased allocations. In particular, agriculture – which provides livelihoods for over 70% of the population – and rural development have received insignificant amounts of resources compared to general and social services, even though these have been identified as 'priority sectors' in strategic policy documents like the I-PRSP and the D-MTEF. Far from being a strategy of balanced growth, the macro-fiscal picture reveals a clear decision to trade-off expenditure on economic services in favour of social development expenditures.

The contemporary discourse on public goods within the world of development economics (World Bank 1997; Atkinson and Stiglitz 1987) contends that, to the extent possible, the state should provide for those public goods which the private sector is unlikely to be able to deliver and let the private sector deliver public goods which it is able and willing to do. In practice countries are encouraged to experiment with private provision even of non-basic health and education services, and it is rarely, if ever, the case that provision of public goods in economic services is encouraged. Irrespective of the pro-poor consequences of this strategy for the developing world at large, in Cambodia, the stark question is whether the private sector is at all able and willing to provide economic public goods, particularly in areas like agriculture and rural development. Given the narrow base of the domestic private sector, inadequate development of a legal and regulatory framework for private sector development, limited FDI in labour intensive economic sectors, and the acceptance by most development agents that the process of private sector development is likely to be a long drawn out affair – in short the very reasons which justify the acceptance of a pessimistic scenario regarding the use of public debt as a resource mobilisation instrument by RGC — it is doubtful that private sector development of economic services will complement the development of social services by government. **The current strategy therefore implies that Cambodia sacrifices public investment in economic services, since private sector development is likely to be limited by several binding constraints (including those that limit the public resource envelope).**

The D-MTEF (2002) provides evidence that the present strategy is contemplated in the future as well. It forecasts a fall in the defence and general administration/GDP spending ratios of 0.18 and 0.13 respectively in the period 2003-2005. In contrast there is a planned rise in spending on social services of 0.57% of GDP (calculated from Table 4.3 above). The total forecast rise in contingency and debt service commitments is 0.40% of GDP (D-MTEF 2002: 12). The overall rise in the allocable resource envelope, is 1.3% of GDP (Table 4.3). Deducting debt service and contingency provisions, this leaves 0.9% of GDP as increased allocable resources. Almost two thirds of *total* re-allocated resources are earmarked for health and education. In contrast agriculture and rural development collectively receive just 0.16% (of GDP) which is less than a fifth of the total reallocated resources.

Thus, the D-MTEF presents an explicit expenditure switching policy whereby the entire projected fall in spending on general services and over half the projected increase in revenue is absorbed by social services, with only a small residual available for investment in current economic services and locally financed capital expenditure.

This strategic choice is further reinforced when reference is made to the current and forecast allocation of capital resources from the SEDP-ii. At first blush it appears that transport and rural development secure the largest share of capital spending. However, when the social development, health and education sector capital spending programmes are aggregated, they collectively constitute 39.5% of total donor disbursements, with rural development and transport accounting for 26% of total disbursements. In future years too, it appears that there will be a sharp rise in education and health funding although the transport sector continues to receive generous capital investment and technical assistance from specific donors (particularly the ADB and Japan). RGC in fact commits significant resources to the social sectors, relying on donors to fund projects in transport, water and sanitation, and infrastructure. Agriculture continues to receive a low share of total capital investment resources. Thus the importance accorded to public current spending on education and health finds a resonance in capital spending as well

However, its is certainly not the case that all of the projected capital spending is sought to be delivered in social services. The infrastructure sector receives almost 50% of the total spending on new projects (SEDP-ii 2002). This raises another serious issue: **the strategy does not address the issue of adequate resources for servicing the recurrent expenditure commitments generated by donor financed capital investment projects.** This is particularly a problem for economic services and infrastructure. The existing education sector development strategy and the proposed health sector development strategy both benefit from donor budget support for non wage recurrent expenditure. Indeed the conditionalities underpinning the release of the ADB education sector programme loan incorporate a commitment from RGC to provide adequate recurrent support for the investment programme (ADB 2001). Thus while donors provide (or influence RGC to provide) budget support for non-wage recurrent expenditures on social services, there is no corresponding support for economic services

While, there is no doubt that the design of the current strategy is pro-poor in nature, particularly if one examines the carefully crafted sector development plans for the education and health sectors outcomes, it may not be the optimal strategy for *income* poverty reduction. However, its appropriateness can be defended if a broader approach to poverty reduction is adopted. Devoting public resources to providing inclusive quality basic education to the poor has undoubted long term positive effects on growth, by improving the skills base of the country and thereby providing the younger poor with access to income generating opportunities. However, it must be clearly understood that investments in education do not in themselves generate such opportunities; at the very least a complementary income generation strategy is necessary for this latter purpose. In addition the benefits of enhanced education spending accrue in the first instance to the younger poor and this limits the immediate and medium-term impact of education spending on the poor as a whole. In the case of health too, similar arguments apply though it can be argued that improved health care reduces the vulnerability of the poor, and increases their disposable income by reducing private expenditure on health and increasing labour productivity. **Hence, fiscal strategies that focus *exclusively* on expenditure switching away from general services to social services run the risk of being sub-optimal from the point of view of income poverty alleviation since they do not devote sufficient resources to economic services.**

3.4 A form of Dutch disease

The scale of external assistance in Cambodia in comparison with domestic resources raises the question of whether the Cambodian fisc is subject to some form of Dutch disease. This question needs to be understood not in the usual context (Davis 1995; White and Wignaraja 1992) of aid inflows in comparison with export earnings but, rather in the context of:

- the opportunity cost of accessing a dollar of private sector savings for public investment.
- the 'spending effect' of donor employment policies on the costs of using skilled human resource inputs in domestic economic activities, including public administration.

The first issue has been typically posed in the literature in terms of the 'crowding out effect' of aid on government's tax gathering efforts. Since increased tax effort involves higher political and administrative costs, the availability of aid can often reduce the incentive to increase tax effort. In the Cambodian context this does not seem to have happened – the determinants of tax effort seem to be independent of aid inflows, largely because revenue resources are used cover current revenues. If this phenomenon were to reverse in the future, then stringent conditionalities in the PRGF and other donor *aide memoires* and memoranda of understanding actually put the government at risk of losing, rather than gaining, aid inflows. In a conditionality-based lending environment, fiscal 'discipline' in the form of low inflation, limited fiscal deficits and zero current deficits is rewarded with more generous sanctioned assistance and vice versa. **Hence the crowding out effect of aid on government's revenue efforts appears to be limited in Cambodia.**

The perverse incentive in the Cambodian fiscal regime comes when government attempts to secure domestic *savings* for public investment. For any investment project RGC can, in principle, choose between concessional external assistance and borrowing from the domestic private sector. In a previous section, we concurred with the widely held view within donor and central banking circles in Cambodia that confidence in RGC's capacity to manage domestic debt and deploy it with prudence was low, creating a *supply* problem.

On the *demand* side too, generous concessional terms for investment resources from donors can act as a disincentive when RGC considers measures to generate domestic resources. While such resources do not generate contingent domestic liabilities for Cambodia, they do generate public sector liabilities that need to be paid off. With private sector lending rates of 15% and above, the portfolio of viable lending opportunities in Cambodia is limited. There is excess liquidity in the banking system (see section 3.1 above) despite the fact that formal savings are low and the banking system is not the repository of most savings in Cambodia. Hence there is every incentive for the banking sector to lend to RGC at substantially lower rates of interest on a project by project basis. Even an interest rate of eight per cent could be viable particularly for economic services that generate a clear, costed, benefit stream. However, if RGC is able to access concessional resources for a fraction of that cost – for infrastructure, agriculture, rural development, etc. – then there is little incentive for it to seek private sector credit and, transitively, little incentive to reform its own image in the financial markets. Even if the resources are not actually forthcoming for such projects the *potential* access to such finance can act as a disincentive to consider seriously domestic debt financed public investment.

Thus, while the existence of excess liquidity negates the possibility of crowding out and offers RGC potentially attractive finance for development, the incentive for RGC to access such finance is limited given the *potential* availability of easy concessional money from donors who accept RGC's unbounded fiscal sovereignty (albeit with conditionalities) unlike domestic economic agents who, without recourse to conditionalities, seem reluctant to do the same. In such a situation there is little incentive for either RGC or the donors to speed up the financial reform process that would enhance RGC's credibility and remove the bounds on its financial sovereignty. It is this sense that there exists a Dutch disease in Cambodia's fisc.

3.5 Fiscal benefits from civil service reform

The analysis of the 'spending effect' of donor employment policies on the costs of using skilled human resource inputs in domestic economic activities, including public administration is linked with the question of the fiscal benefits from civil service downsizing.

Starting with the World Bank PER (World Bank 1999) several policy documents have argued the fiscal case for a civil service reform, and some donors pursue this agenda quite aggressively with RGC. The argument goes as follows: Cambodia's civil service is overstaffed and underpaid. It would make sense in terms of efficiency to downsize the civil service and pay the remainder a better wage, while at the same time releasing resources from general services for investment in social and economic services. Indeed this issue finds mention in the PRGF document as well (IMF 2001: 5-6). This document requires RGC to cap the wage bill, stating, 'The overall wage bill *will* be contained below 4% of GDP… further staff reductions through contracting out and privatisation *will* be carried out in 2003, contingent on establishing a donor supported safety net' (IMF 2002: 6, italics added).

There may be doctrinal and efficiency merits in changing the balance of employment between the public and private sectors and paying some civil servants better than others. These do not fall within the scope of this Chapter. The fiscal questions here are:

- What kind of fiscal savings would be secured by capping the wage bill at 4% of GDP?
- To what extent could civil service pay be increased within this cap?

The first question is a redundant one. Wages are already below 4% of GDP and are slated to fall to 3.6% of GDP in 2002. This leaves approximately 0.4% of GDP for RGC contributions to safety net measures and for improved civil service pay i.e. a sum of 60 billion riel approximately. Assuming donors grant finance the entire safety net expenditure, and assuming a constant military wage bill (both heroic assumptions) the total sum available for rewarding civil servants comes to approximately 15 million dollars. If this amount is spread over the 160,000 strong *administrative* (excluding teachers, health workers etc) staff of the civil service then it provides 9.4 dollars per civil servant per annum. With average civil service pay at around $360 per annum it is clear that the resources to increase significantly civil service pay are simply not available given the IMF cap.

By the same token the fiscal rewards from cutting the civil service are limited. Our discussions at the Council on Administrative Reform (CAR) revealed that a 20% cut in civil service size would yield approximately $ 960,000 – an insignificant saving for the fisc as a whole and insufficient to significantly increase remuneration of the remainder of civil servants

Our discussions with CAR also revealed that present RGC strategy is to target the moneys available to *priority mission groups.* These would be clusters of civil servants, retained to perform specific time-bound assignments, who would be rewarded with enhanced pay, tentatively $2400 per annum. One thousand civil servants would be selected to staff these groups. This would generate an incremental expenditure of around $2000 per annum per civil servant (assuming that personnel in these groups would belong to the middle and upper echelons of the civil service), generating a cost of $2 million per annum for such groups.

Thus, attempting further downsizing of general services has economic as well as political limits. Downsizing of non-wage operating expenditures would have a detrimental effect on the efficiency of present and future investment. Downsizing of the wage bill will not yield significant incremental resources for investment in economic services or, even, resources to significantly enhance average civil service pay. The present targeted, output driven, strategy of selective remuneration seems to the only feasible and optimal one for the immediate future, from a macro-fiscal point of view.

3.6 Additional payments to civil servants by donors

A more important macro-fiscal issue in respect of spending on general services is that of additional payments to civil servants involved in donor projects. Godfrey *et al.* (2000) establish that a large number of technical assistance projects provide additional remuneration to Cambodian counterparts in a variety of ways These additional payments amount, on average, to about $150 a month and therefore far exceed the payments provided as part of regular salary.

The micro and incentive impacts of this phenomenon are beyond the scope of this report. In macro-fiscal terms the sheer magnitude of these payments when aggregated is of interest. Over 45 percent of ODA disbursements over the 1992-2001 period was in the form of 'free standing technical co-operation' (RGC 2001: 14-15) amounting to around US$220 million in 2001. Since the bulk of technical assistance in Cambodia is channelled through RGC a reasonably conservative assumption would be that around 25% of this sum is spent on payments to counterpart project staff assigned to work on such projects from the civil service. This would amount to $55 million, which is almost four times the figure available for remuneration within the PRGF cap.

This is a significant macro-fiscal phenomenon that has received insufficient attention in terms of its macroeconomic impact First it indicates that in practice **a large sum of donor assistance in fact serves as indirect budget support** by significantly increasing the average remuneration of skilled Cambodian civil servants. Second, it indicates that **the principal incentive to work in public employment is the prospect of access to external salary supplements**. If these supplements are taken into account then the total expenditures on general services can be seen to be significantly higher than when looking purely at 'on-budget' expenditures. Further, these expenditures are controlled not by RGC but by the donor community and therefore there is little policy action that RGC can take to tackle this, particularly given the strong emphasis on 'technical capacity building' in the various macro-policy documents.

3.7 Disbursement of resources

The most important constraint to pro-poor fiscal policy in Cambodia is not directly macroeconomic in nature. It has to do with poor disbursement of resources allocated for pro-poor expenditures, resulting in weak budget implementation. There are political, institutional and economic reasons for this phenomenon. Donor designed technical assistance to resolve this issue (even in their chosen priority sectors) has been piecemeal in approach, and conditionality driven. There is as yet no comprehensive appraisal of the problem.

Table 4.7 provides a quantitative flavour of the disbursement problem. We can see that domestic revenue generation is fairly even through the year, while expenditures are extremely compressed in the initial months of the year. Current expenditure in particular merits attention with over a quarter of disbursements occurring only in December. Capital expenditure, on the other hand, is more evenly disbursed with domestic and foreign finance for capital expenditure also being generated fairly evenly throughout the year. Each and every component of current expenditure shows similar disbursement trends. The story repeats itself with respect to provincial expenditures.

There are several hypotheses seeking to explain the above. A detailed examination of these hypotheses is outside the scope of this Chapter. What is of fundamental importance, however, is the fact that during our discussions, RGC officials, donors, independent economists, consultants all agreed that this unevenness in disbursement caused severe problems in enhancing the effectiveness of fiscal spending, particularly in the priority sectors.

Recognising this problem, RGC has for the past three fiscal years attempted a solution by instituting a Priority Action Program (PAP). This program seeks to identify particular priority current expenditure items in the priority sectors (for example school equipment, or basic drugs) and sanctions release of half the budgeted amount for the priority item for immediate disbursement. The remaining amount is then to be disbursed following satisfactory accounting for expenditures incurred from the first tranche of funds. PAP has somewhat ameliorated, but not resolved the disbursement problem.

The limited success of PAP makes it clear that the solution to the disbursement problem is not simply a technical one of making cash available at the right time and the right place. There are more complex problems associated with release and disbursement of resources which need to be identified and addressed. Further, PAP in itself is not a long-term sustainable solution to the release problem, as it can only be used to ameliorate disbursement bottlenecks for highly specific expenditures. A comprehensive and sustainable solution to this problem is therefore of the highest importance if the effectiveness of public expenditure in Cambodia is to be improved.