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Cambodia's Development Finance Assessment

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ABBREVIATIONS

ASEAN	Association of Southeast Asian Nations
BIOFIN	Biodiversity Finance Initiative
CDC	Council for the Development of Cambodia
CRDB	Cambodian Rehabilitation and Development Board
CSDGs	Cambodia Sustainable Development Goals
CSR	Corporate social responsibility
DFA	Development Finance Assessment
FDI	Foreign direct investment
GDP	Gross domestic product
IFIs	International financial institutions
GNI	Gross national income
KHR	Khmer riels
LDC	Least developed county
MEF	Ministry of Economy and Finance
NBC	National Bank of Cambodia
NGO	Non-governmental organization
NSDP	National Strategic Development Plan
ODA	Official development assistance
OECD	Organisation for Economic Co-operation and Development
PPP	Public-private partnership
SDGs	Sustainable Development Goals
SMEs	Small and medium enterprises
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNESCO	United Nations Educational, Scientific and Cultural Organization

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EXECUTIVE SUMMARY

This Development Finance Assessment (DFA) for Cambodia analyses the public, private, international and national flows available to support investment in the country. It offers findings and policy recommendations for the Royal Government of Cambodia, specifically the Ministry of Economy and Finance (MEF) to maximize the level of flows, and their quality and allocation, in order to achieve long-run development objectives.

The report adopts a medium term (five-year timeframe) in charting trends, making projections and offering recommendations. In recognition of the COVID-19 emergency and its serious financing impacts, however, the report also estimates the likely losses to Cambodia and sets out a possible near-term policy response. This is focused on the imperative of finding financing solutions for growing budget deficits in 2020 and 2021.

Estimated trends in resource flows:

- Financing available to support development is expected to double to $23.4 billion, accounting for 69.8 percent of gross domestic product (GDP) by 2025.

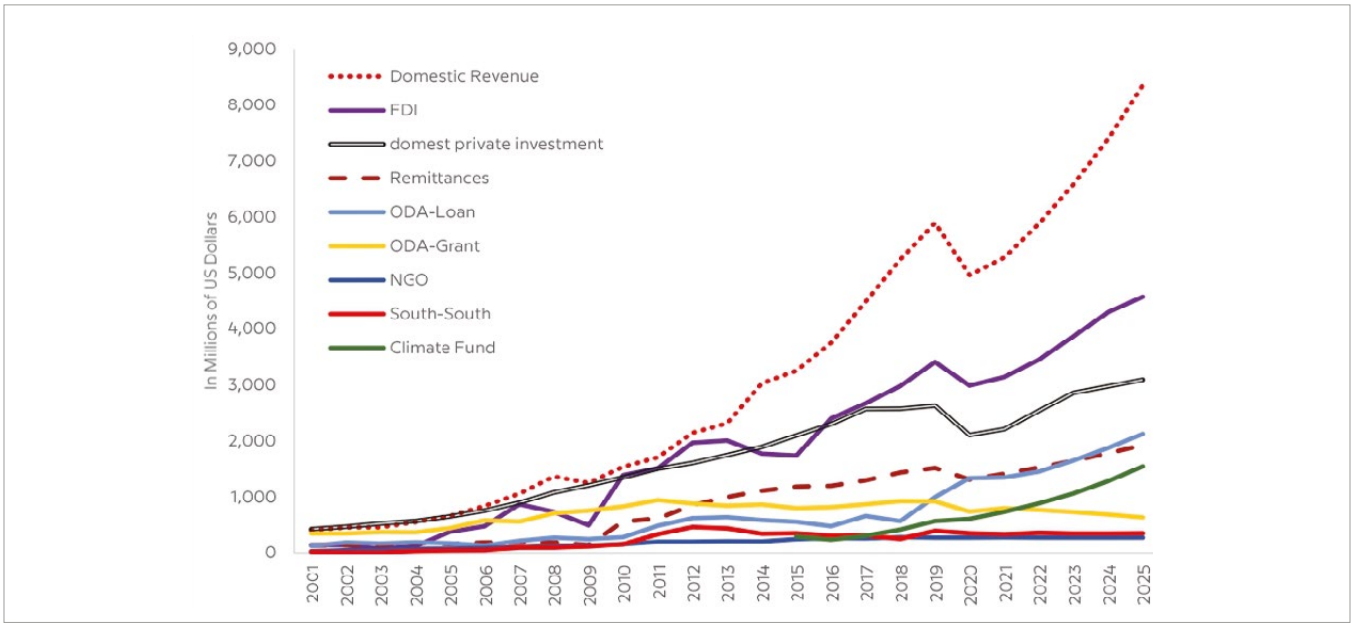
- Domestic revenue, domestic private investment, and remittances are increasingly the most important source of financing for development in Cambodia, altogether rising to 32.3 percent of GDP in 2020 and continuing to 36.0 percent towards the end of the 2025.

- Official development assistance (ODA) flows, which include both grants and loans, remained significant at 7.9 percent of GDP in 2020, but are expected to fall to 7.4 percent by 2025. At the same time, their composition has increasingly shifted from grants to loans, and often with less concessional terms.

- COVID-19 has led to total financing flow losses estimated at $3.6 billion, accounting for 19.8 percent of total flows in 2020. The three most significantly affected financial sources have been domestic revenue, foreign direct investment (FDI) and private domestic investment, as follows:

  - Domestic revenue is estimated to drop by 23.6 percent due to reduced tax income on a smaller economy.
  - FDI investment may be 31 percent lower, reflecting Cambodia's vulnerability to the pandemic's impact on global value chains.
  - Domestic private investment is estimated to decline by $410 million, indicating reduced activity in Cambodia's main sectors, mainly ready-made goods, construction and tourism.

Figure 1: Total financing flows will recover from the pandemic and keep increasing toward 2025



Source: Author's projection based on data from various sources. It was made based on available data in 2020.

Policy recommendations

Even though policy recommendations are offered for the near and medium term, underlining modern development finance practice aimed at developing harmonies and synergies between state and private sector players, with the government acting as an orchestrator and facilitator of all development resources available to a country.

In the near term, for the public sector, DFA suggests adopting an emergency financing strategy to address budget deficit challenges from 2021 onwards. Key measures include:

- **Strengthen revenue collection capacities and mechanisms**, for example, through Tax Inspectors Without Borders to ensure multinationals and other large companies are paying their fair share of tax.

- **Accelerate expansion of domestic lending instruments** – Bond issuance in Khmer riels (KHR) would help to de-dollarize the economy, reduce a crowding out effect in the banking sector and expand monetary policy options.

- **Restore the level of FDI and private domestic investment,** for example through credit guarantees to firms, especially small and medium enterprises (SMEs), and by examining the use of tax concession to boost FDI and domestic investment.

- **Realign expenditures,** in favour of pro-poor economic growth, such as investment in social protection which has proven an effective way to prevent people from sliding back into poverty and in stimulating the economy.

In the medium to long term, the DFA emphasizes policy innovations to boost State capacity to manage public finances and secure ongoing high levels of private capital flows. It suggests measures in line with the conceptual framework of an Integrated National Financing Framework (INFF). These include:

- **Consider implementation of sin taxes,** for example, on gambling, tobacco and alcohol, as well as other taxes with positive social and environmental externalities. These not only increase revenue collection but also help reduce future public expenditures such as for health-care services.

- **Further implement blended finance,** drawing on increasingly varied capital resource flows, in particular to raise private investment in the achievement for achieving Cambodia's Sustainable Development Goals (CSDGs).

- **Engage in innovative, green and climate change- related financing mechanisms,** such as green or SDG bonds, impact investment and biodiversity finance to expand sources of finance for development.

- **Improve capacity building and institutional changes** to enable the State to better facilitate and oversee the ongoing expansion of private sector flows with a focus on delivering higher quality investment.

- **Improve the delivery of resources,** strengthening accountability and transparency, and enhancing cost-effectiveness, but also making government expenditure more progressive, such as through procurement with positive redistributive effects.

CHAPTER

01

Introduction

1.1 Background

With policies to ensure macroeconomic stability and an open economy, Cambodia achieved annual average GDP growth of 7 percent for the last two decades, enabling it to raise incomes and deliver tax revenues to support the expansion of public services. Annual per capita growth rates have been lower, at around 5.5 percent, however, due to ongoing population growth (see Figure 2). Pre-COVID-19, poverty was estimated to fall to under 10 percent. But the pandemic is likely to have profound consequences for both the economy and progress in reducing poverty.

Cambodia continues to demonstrate good economic performance with great strides towards sustained and rapid economic development. The level of economic growth has been striking, accompanying progressive structural change within the economy. Nevertheless, there are many issues and challenges. Financing is a key constraint on future progress, not only in maintaining the high level of growth but also in improving the quality of national economic development in terms of its depth, inclusiveness and environmental sustainability.

Figure 2: Various Measures of Economic Growth

Source: World Bank World Development Indicators, accessed on 8 August 2020.

In the near term, Cambodia faces crippling economic consequences from the COVID-19 crisis. It has suffered due to very large demand shocks in its primary export markets in Europe and the United States. Equally problematic have been dislocations in global markets and hence capital inflows to Cambodia. These impacts are mirrored in domestic resource flows (public and private). COVID-19 fallout is therefore a key concern for this DFA.

This is the second DFA produced for Cambodia. It adopts a similar focus and format to the first, which was developed in 2017 for the Council for the Development of Cambodia (CDC) under the Partnership for Development Results Project. Although not officially launched, the initial DFA provided a data set and analysis that have proved useful to government decision-makers in a number of institutions. It served as a basis for analysis in devising the National Strategic Development Plan 2019-2023 (NSDP) and other government strategies.

The second DFA aims to replicate but also improve on past work and analysis. It is more inclusive of all developmental resources in the private and public sectors, offers better disaggregation of data and applies a more sophisticated projection methodology. It seeks to provide better quality and more reliable data for decision-making about long-term directions. Crucially, in light of the pandemic, which has hit economies around the world and disrupted capital flows, it gauges losses now and in the near term.

The report has two prongs. The first involves resource mapping of current and potential medium-term flows of development finance to Cambodia. This mapping is geared towards: (1) understanding current large resource flows and funding priorities such as domestic public resources and the budget, ODA, domestic private financial investment and FDI, and remittances; (2) identifying possible changes to ODA and other external cooperation; and (3) defining new and innovative development finance resources that may support national priorities and implementation of the CSDGs, specifically through public borrowing, public-private partnership (PPPs) and impact investment.

The second prong entails a discussion of policies and a roadmap for attracting development financing. It offers a guide for managing all development finance to achieve development results by setting out recommendations for: (1) identifying institutional, partnership and capacity gaps that affect resource management; (2) managing resources in a manner potentially leading to an INNF linked to NSDP costing, especially in strengthening the facilitating, partnering and economic role of the Government in promoting and supporting development partnerships, including with the private sector; (3) reviewing and strengthening institutional arrangements around government agency coordination, resource mobilization, capacities to manage private and public resource management and relationships, data issues and so on; and (4) promoting a results focus in resource management, especially in linking the CSDG frameworks to the full range of public and private development finance resources.

This DFA has six chapters. Chapter 1 discusses Cambodia's economic context by reviewing performance in key macroeconomic sectors. Chapter 2 reviews the financial landscape. Chapter 3 discusses links between policies, resources and results. Chapter 4 analyses the current flow of development assistance. Chapter 5 provides a future trajectory for the key development financing sources discussed in Chapter 4 by accounting for the impact of COVID-19. The last chapter frames a policy discussion around Cambodia's development financing needs based on the main findings from the DFA.

1.2 Output, Growth and Employment

Long-term unemployment rates have been exceptionally low at less than 1 percent, according to Cambodia Socio-Economic Survey data. Labour market participation has been high at around 82.3 percent (90.5 percent for men and 79.8 percent for women). Underemployment is reportedly widespread, however, and the level of informality is also high. An estimated 270,000 new workers join the workforce each year. Labour market flexibility and the responsiveness of the labour supply have supported macro stability yet utilization remains high. Along with downward pressures on economic output, COVID-19 is expected to drive steep rises in unemployment.

1.3 Macroeconomic Balance

Inflation has generally been low, secured by de facto dollarization; the money supply is constrained by the value of dollar reserves. Nevertheless, given the highly open nature of its economy, Cambodia is exposed to global inflationary and now likely disinflationary pressures. While commodity prices have generally been rising, dollar appreciation has provided an effective

break on these pressures. COVID-19 impacts are more complex.

Over a long period, the balance of payments position has remained strong, with Cambodia's current account deficit of around 15 percent of GDP in 2019 easily financed by high capital inflows. Like Cambodia's industrial base, however, exports remain constrained within a limited number of sectors and focused on a small number of distant markets.

The budget deficit has been contained to well below the international financial institution (IFI) policy target of 5 percent of GDP. The Government runs a small surplus on the primary fiscal balance to finance small capital works. Major capital works continued to be financed by IFI and bilateral lending since Cambodia lacks any formal borrowing instruments. As a result, the public debt stock remains comparatively low, at 28.2 percent of GDP as of 2019,[1] beneath the Debt Sustainability Analysis threshold of 55 percent. This position ensures that Cambodia has considerable room for additional borrowing. In contrast, private sector and household borrowing are comparatively high, with estimated outstanding credit reaching 103 percent of GDP by mid-2019.[2] The aggregate savings rate is unusually low for South-East Asia.

Dollarization, although supportive of macroeconomic stability, presents challenges. Cambodia has no effective monetary policy, and interest rates are determined without regard to economic conditions in the country. No exchange rate mechanism allows for adjustment, and dollar appreciation in recent years has harmed competences, given that Cambodia's primary markets are in the European Union and United Kingdom. Systemic financial security issues inevitably arise without a lender of last resort or bank deposit insurance. Moreover, dollarization requires the authorities to maintain a large dollar reserve that is currently almost 80 percent of GDP, and forgo sizeable seigniorage benefits given that the value of dollars in circulation is estimated at $21 billion as of 2019.[3]

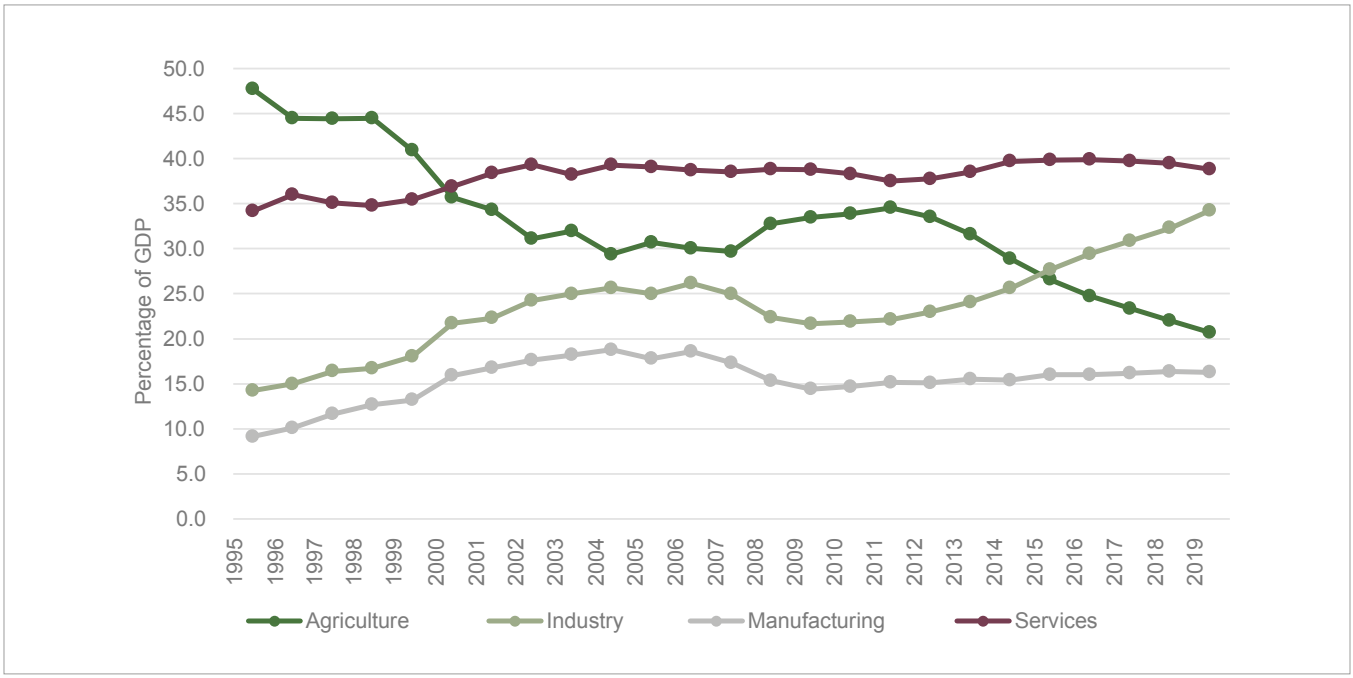
1.4 Structural Change

Growth in Cambodia's leading manufacturing sector, garments and footwear, continues to support positive structural change and growth in value added. There has been some diversification of the industrial base, notably to automotive parts and electronics. The service sector has also grown strongly with annual growth of over 6 percent between 2012 and 2019, especially via better performance in domestic trade and transportation. Yet there are challenges. While the industrial share of value added has risen significantly during the past decade, from 21.7 percent to 34.2 percent over 2009-2019, manufacturing has remained relatively flat (see Figure 3). There has been little industrial depending and the economy has seen minimal diversification, with output and exports dominated by garments and construction.

Productivity growth has slowed in recent years with World Bank analysis suggesting a rate of only 1.3 percent for the 10-year average compared to 2.2 percent for the 20-year average. The highest rate is in agriculture. Troublingly, data also suggest that productivity growth in garments has been static in recent years, speaking to allocative constraints despite high investment flows.

1 NBC, "Gross External Debt Position by Sector."
2 World Bank Group 2020a, p. 22.
3 NBC, "Monetary Survey.".

Figure 3: Sectoral Value Added

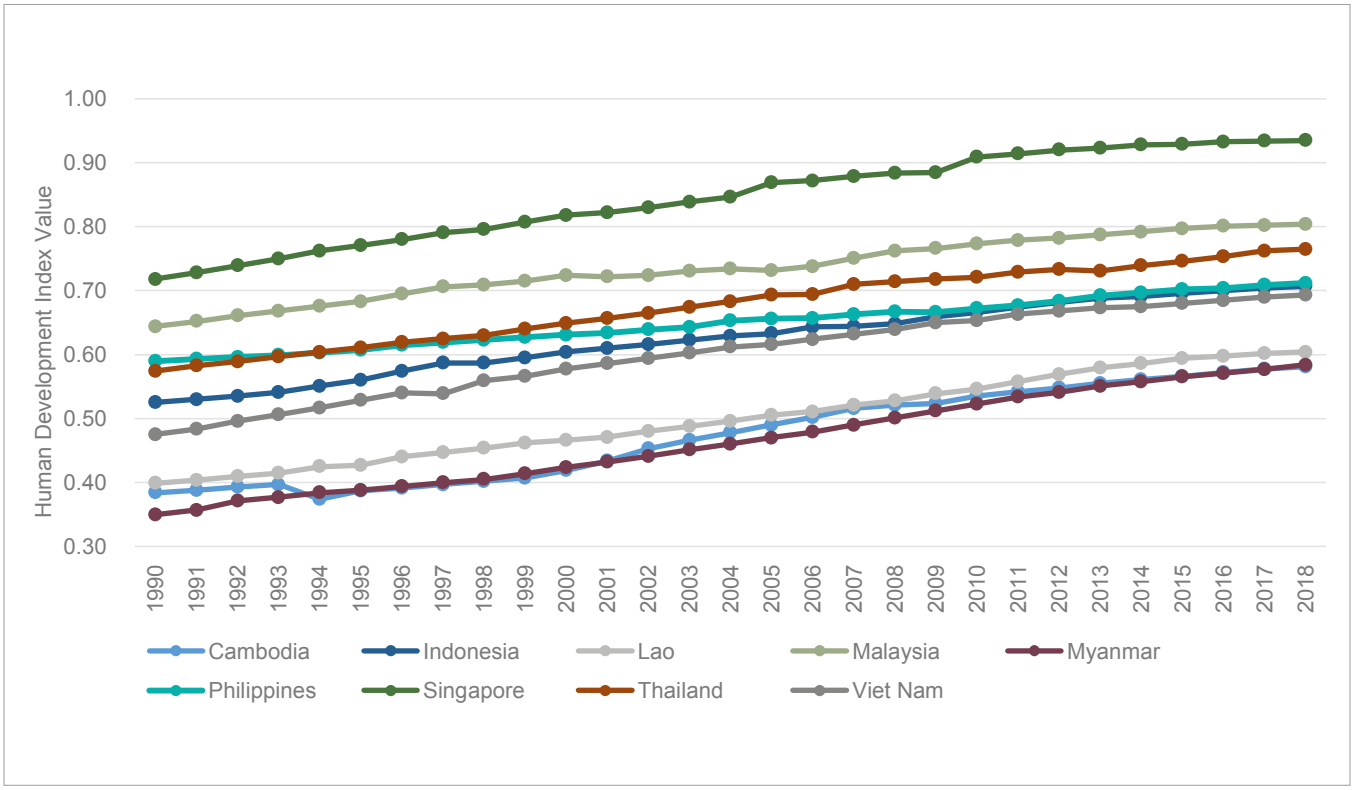


Source: World Bank World Development Indicators, accessed on 8 August 2020.

1.5 Social Progress

Cambodia achieved the Millennium Development Goals and has made impressive gains on the Human Development Index, where its score rose by 51 percent between 1990 and 2018, making it one of the world's best performers (Figure 4).

Figure 4: Human Development Index 1990-2018



Source: Human Development Index data 1990-2018, accessed on 8 August 2020.

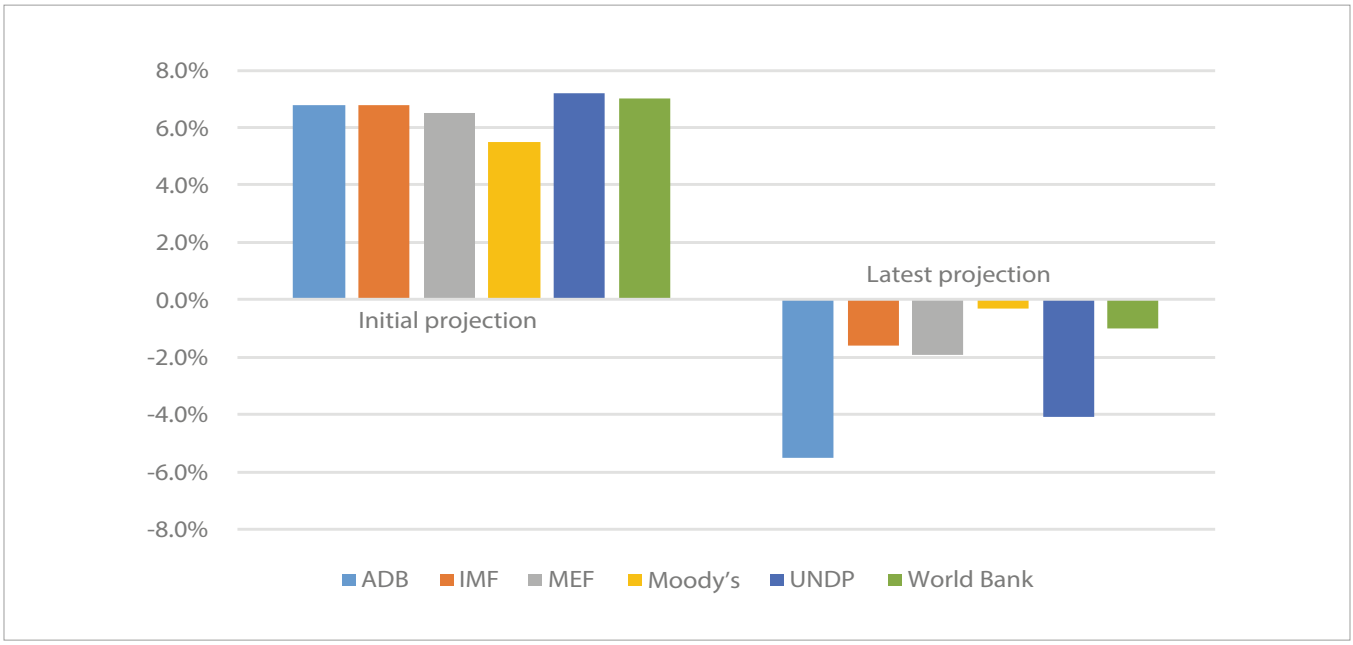
Cambodian society is undergoing major transformation driven by a rapid demographic transition and progressive urbanization and industrialization. While classified as a lower-middle-income country, Cambodia remains among the least developed countries (LDCs). It aims to become an upper-middle-income country by 2030 and a high-income economy by 2050.

1.6 The Impact of COVID-19 and Other Contemporary Developments

The COVID-19 crisis and the slowdown in the global economy checked Cambodia's growth performance in 2020 and growth prospects in the medium term, posing the greatest threats to development in the country's 30 years of modern history. GDP growth, projected between 5.8 percent to 7 percent pre-COVID-19, was downwardly adjusted to between –1 percent to –5.6 percent in 2020 (Figure 5). The spill-overs are felt largely through three key channels: tourism, exports and FDI. Cambodia has been heavily reliant on tourists from East Asia and the Pacific, especially Chinese tourists, who account for 35 percent of total international arrivals. These suffered a rapid decline after the COVID-19 outbreak in China.

The pandemic is causing a collapse of global trade with significant negative direct and indirect impacts on Cambodia. In the United States and Europe, demand has evaporated for Cambodia's key exported products such as garments, footwear, travel goods and rice, which comprise about 52 percent of total merchandise exports. Imports of intermediate goods (raw materials for the garment, footwear and travel goods industries) have experienced supply chain disruptions. Job losses have resulted, including for more than 150,000 garment, footwear and travel goods factory workers, over 90,000 migrant workers who returned from Thailand, more than 17,000 tourism-sector workers, and an unknown but significant number of informal sector entertainment workers.[4]

Figure 5: GDP Growth Projection Before and After COVID-19



Source: United Nations 2020.

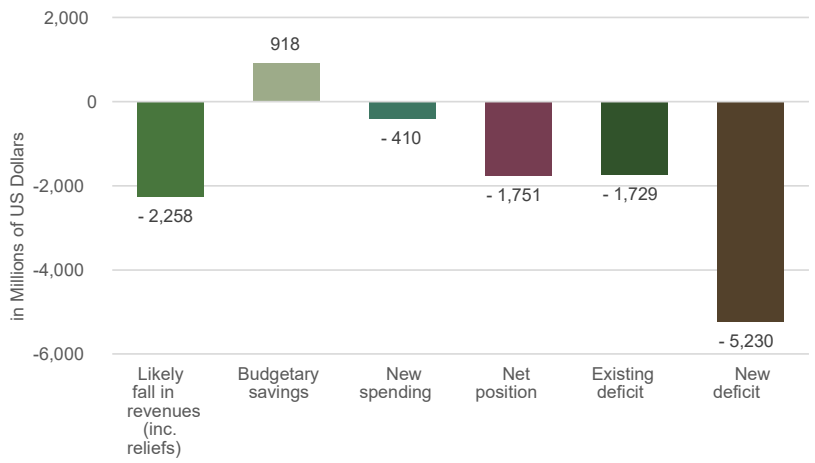
4 Human Rights Watch 2020.

COVID-19 will have consequences for macro stability. Inflation is expected to decline with falling aggregate demand, but its direction is complicated by supply restrictions at land borders. The balance of payments position, given demand shocks, and the deficit, given falling economic activity, are likely to worsen, the latter considerably so.

The Government has deployed fiscal stimulus to support the economy and protect vulnerable groups. Based on initial MEF data, this involves additional spending, largely on social protection and employment support, of around 1.6 percent of GDP, and tax cuts and relief targeted at businesses of 0.7 percent of GDP. The primary social protection intervention is a cash transfer programme covering all identified poor and near poor households, with additions for life-cycle characteristics (elderly and disabled children). This amounts to a substantial $300 million per year.

Yet with serious deterioration in the fiscal position due to the pandemic, the Government has been forced to match new spending with cuts in discretionary (mainly capital) spending of 3.5 percent of GDP, based on provisional MEF data. The net fiscal change is –1.2 percent of GDP against the planning numbers in the 2020 budget law. As illustrated in Figure 6, the deficit is still set to rise, including an overall stimulus. This is illustrated by net additions and leakages to the economy relative to the budget's macroeconomic framework. Data are from June 2020, however, and are subject to change as the fiscal position continues to evolve.

Figure 6: Summary of the Government Fiscal Position, Existing Deficit and New Deficit



Source: United Nations 2020.

The Government has taken measures to protect the banking system by easing bank and microfinance institution reserve requirements and relaxing the few monetary policy measures available to the National Bank of Cambodia (NBC). The NBC has strengthened liquidity buffers.

A slowdown in China and an overextended financial sector pose further downside risks to Cambodia's growth prospects given its heavy reliance on capital inflows from China. There are impacts on a variety of other flows ranging from remittances to ODA loans. The Government's fiscal position is anticipated to come under further pressure.

1.7 Cambodia's Long-term Planning

Cambodia's impressive economic performance was to some extent based on the country's capacity to build quality national development plans aligned with available national and external financing. Two decades of public financial management reform have been complemented by quality national planning and aid management.

The national planning system

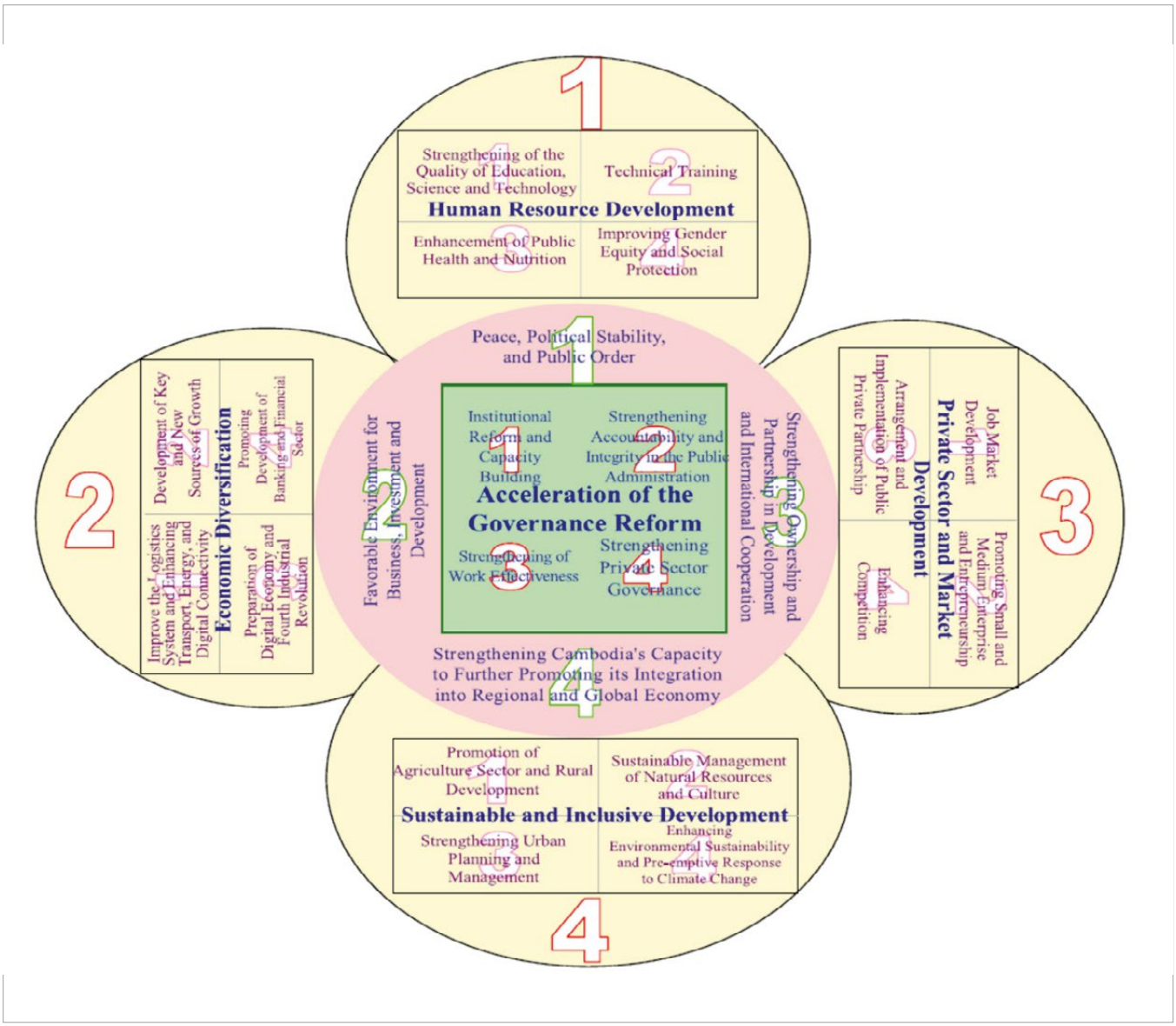
The Government has coordinated planning with the NSDP Update 2009-2013 to implement the Rectangular

Strategy, which entails government socioeconomic development priorities across a five-year time span starting in 2018. This has improved national planning by creating an organized approach to introduce and implement results frameworks and indicators.

The Rectangular Strategy Phase IV (Figure 7) feeds into the current NSDP, which in turn drives sector planning and delivery, and hence budgeting (Table 1).

The Government is confident that the CSDGs are well integrated at the national level through their synthesis within the NSDP. The NSDP 2014-2018 and NSDP 2019-2023 introduce medium-term financial estimates for capital investment from private and public sources that link finance and actions. The NSDP Update 2009-2013 was the first to introduce costing estimates making such links.

Figure 7: Rectangular Strategy Phase IV



Source: Rectangular Strategy Phase IV.

Table 1: Capital Investment Required to Achieve Growth Targets from 2019-2023

Source of Finance	2019p	2020p	2021p	2022p	2023p	Total
			(Millions of US dollars)			
Total Public Investment	**2,257**	**3,382**	**3,376**	**3,527**	**3,912**	**16,454**
Domestic finance	738	1,636	1,519	1,539	1,566	7,000
Foreign finance	1,298	1,476	1,561	1,634	1,974	8,154
Total Private Investment	**6,519**	**7,447**	**8,524**	**9,774**	**11,174**	**43,438**
Domestic finance	2,853	3,118	3,405	3,719	4,012	17,107
Foreign finance	3,666	4,328	5,119	6,055	7,162	26,331
Total Investment	**8,776**	**10,830**	**11,901**	**13,301**	**15,086**	**59,890**
			(Billions of KHR)			
Total Public Investment	**9,257**	**13,870**	**13,845**	**14,463**	**16,043**	**67,479**
Domestic finance	3,028	6,711	6,230	6,310	6,421	28,700
Foreign finance	5,324	6,053	6,404	6,738	8,096	32,615
Total Private Investment	**26,727**	**30,532**	**34,950**	**40,073**	**45,812**	**178,096**
Domestic finance	11,697	12,786	13,960	15,246	16,447	70,138
Foreign finance	15,029	17,746	20,990	24,826	29,364	107,957
Total Investment	**35,984**	**44,402**	**48,795**	**54,536**	**61,855**	**245,574**

Source: NSDP 2019-2023.

Building a robust ODA management system

The Government has succeeded in mobilizing significant development cooperation resources to support socioeconomic development, reaching levels over $1 billion annually since 2008 and accounting for approximately 10 percent of GDP. The Development Cooperation & Partnerships Strategy 2019–2023 identifies the main principles and tools, including results frameworks, use of programme based approach and resource transparency that will serve as the basis for further strengthening development cooperation.

CHAPTER

02

Progress on Financial Landscape

2.1 The Banking System

Cambodia's financial system largely consists of 51 commercial banks, along with 14 specialized banks, 75 microfinance institutions, 7 microfinance deposit-taking institutions and 15 leasing companies (Table 2). In line with the changing landscape of the banking system and the economy, the composition of credit to economic sectors has evolved, with an increasing share going to the construction, real estate and retail sectors. Credit from microfinance deposit-taking institutions and microfinance institutions has been dominated by credit to households, at 36 percent and 40 percent, respectively.

Table 2: Major Financial Institutions in Cambodia in 2020

No.	Institutions	Number
1	Commercial banks	51
2	Specialized banks	14
3	Licensed microfinance institutions	75
4	Microfinance deposit-taking institutions	7
5	Leasing companies	15

Source: NBC.

A number of basic but important features in Cambodia's banking system have developed in recent years. First, as in other countries at a similar development stage, the Cambodian economy is cash-based and highly dollarized, with 95 percent of bank deposits in US dollars. The high degree of dollarization hampers the NBC's lender-of-last-resort capability. Moreover, limited interbank lending hinders banks' liquidity management. The use of negotiable certificates of deposit, a financial instrument to enhance liquidity management, has gradually improved from a low level. Second, financial stability requires the development of a crisis management framework at the national and institutional levels. The authorities have focused on this, but in-depth development with closer interagency coordination within the newly established National Committee for Financial Stability is required. Last, the absence of financial safety nets, a thin foreign exchange market, a weak interbank market, a lack of a government bond market and fast-growing FinTech development amid traditional financial infrastructure all increase risks to financial sector stability.

2.2 Securities Market

The Cambodia Securities Exchange is at an early stage of development but it continued to grow despite the lack of initial public offerings. As of 2020, seven companies have listed stocks: Pestech (Cambodia) Plc., Acleda Bank Plc., Sihanoukville Autonomous Port, Phnom Penh SEZ Plc., Phnom Penh Autonomous Port, Grand Twins International (Cambodia) Plc. and Phnom Penh Water Supply Authority.

The market capitalization of the exchange increased from KHR 1.23 trillion in 2017 to KHR 1.77 trillion in 2018, a 44 percent rise.[5] It has a cooperation agreement with the Korea Stock Exchange to develop its infrastructure. Similar to other new and small stock exchanges, the Cambodia Securities Exchange faces several challenges, including a small number of listed companies, thin trading volumes and unreliable data. It needs more listed companies and interest by larger institutional investors to boost trading volumes and generate enough income for its operations.

5 NBC 2020b, p. 29.

The Government in 2015 provided incentives to prospective companies to list on the exchange by the end of 2017, offering a three-year, 50 percent tax break on all corporate income taxes. A new subdecree in early 2019 provided more attractive incentives, with firms listing within three years gaining a 50 percent reduction in income tax and eliminating all tax debt. Concerns around data quality and corporate governance should be taken into account to protect minority investors, however. There is no government bond market to set an official sovereign yield curve, and the interbank foreign exchange market remains weak, with the majority of players being retail money changers. Limited financial markets impede the efficient allocation of resources and risk sharing.[6]

A bond market was launched on 5 December 2018 with the listing of the first KHR-denominated corporate bond in Cambodia. Eight institutions have been listed for bonds:[7] Hattha Bank Plc., LOLC Cambodia Plc. (LOLC22A and LOLC22B), Advanced Bank of Asia Limited, PPCB Bank (PPCB 23A and PPCB23B), RMA (Cambodia) Plc. and Prasac Microfinance Institution Plc.

2.3 Insurance Market

The development of the insurance sector started in 1956 but was disrupted in 1975 due to the Khmer Rouge regime. Development resumed in the early 1990s with a few necessary regulations to serve social and economic development needs and compensate for losses caused by natural catastrophes, accidents and other mishaps. The full functions of insurance, namely, general insurance, only started with the Insurance Law in 2000 and regulations in subsequent years. Life insurance began only in 2012.

According to the Insurance Association of Cambodia, 63 insurance companies and insurance-related firms have set up shop. They comprise 13 general insurers, 9 life insurers, 1 reinsurer, 9 microinsurers and 33 intermediary companies.[8] Joining their ranks are two Japanese insurers, Dai-ichi Life Insurance (Cambodia) Plc and Newa Insurance Cambodia Plc. The industry saw continued growth as of 2018, with total gross premiums increasing by nearly 30 percent to $196.4 million in 2018 from $151.6 million a year earlier, according to the Insurance Association of Cambodia. The association reported an annual compound average growth rate of 15.7 percent for general insurance and 120.6 percent for life insurance between 2013 and 2018.[9]

2.4 Financing Development

To finance and support its next stage of national development, the Government needs to mobilize and manage a wide range of diverse development resources. It should proactively engage with public and private development actors, including to coordinate and direct their resources towards achieving development results in line with national plans and priorities, particularly as the country works towards becoming stronger financially. Recognizing that an increased range of development resources are potentially available to lower-middle-income countries, Cambodia is now preparing to adapt its development strategies and resource mobilization efforts accordingly.

As Cambodia has achieved lower-middle-income status, its development financing needs will change along with the available sources of finance. Some forms of finance, such as grant-funded ODA, have fallen dramatically. Other flows, such as domestic resources, remittances and FDI, are expected to continue to increase. Additional new resource mobilization opportunities are also anticipated, including through public channels, such as for climate change financing, especially the Green Climate Fund and Asian Infrastructure Investment Bank. Private channels include the Association of Southeast Asian Nations (ASEAN) and regional integration.

Despite its lower-middle-income status, Cambodia will likely continue to be classified as an LDC until 2027-2028, meaning that ODA may decline but will continue to be a resource for the medium term as well as a catalyst for other sources of development finance. It is important to use the LDC status as it offers preferential and highly beneficial trade privileges. Continued access to concessional development finance can help consolidate recent advances and address current and emerging development challenges and opportunities.

Cambodia's domestic resource mobilization effort has improved rapidly in recent years. The domestic private sector has driven growth and job creation, even as the national and global development landscapes have changed significantly and will continue to evolve. Shifts include an expanded role for private sector finance to

6 NBC 2018, p. 6.
7 Cambodia Securities Exchange 2020.
8 Sok 2019.
9 Insurance Association of Cambodia 2018.

promote transformational investment in sustainable national development, South-South cooperation, and innovative non-governmental organization (NGO) strategies such as crowd-sourcing and impact bonds.

Public financing is a major part of the pool of financing needed for development and specifically delivery of the CSDGs. With current increases in taxes and other revenues, it will be even more impactful. Tax revenue makes up about 20 percent of GDP currently, a figure set to rise as Cambodia becomes better in collecting taxes. Additionally, Cambodia does not currently borrow domestically, with public sector borrowing entirely reliant on IFI concessional loans. The Government is exploring public borrowing through bonds to increase cash flows as needed, which should be encouraged, given benefits that include the deepening of capital markets.

CHAPTER

03

Financial Development Update

This chapter focuses on current development finance flows in Cambodia. Building on the previous DFA, it updates information on financing sources over the past decade, covering seven types: domestic revenue, FDI, domestic investment, remittances, ODA grants and loans, climate fund flows and NGO flows. Each source is examined through a situation analysis, and in terms of the policy and institutional set-up and recommended approaches.

3.1 Domestic Public Revenue

Consistent reforms in tax policy and administration over two decades have yielded positive results. Domestic tax revenue increased from 10.0 percent of GDP in 2010 to 19.7 percent in 2019. This makes Cambodia among the best performers in ASEAN, compared to 9.8 percent in Indonesia, 12.0 percent in Malaysia, 13.2 percent in Singapore and 14.6 percent in Thailand, during the same period (Figure 8).

Figure 8: Domestic Revenues as % of GDP (2019)

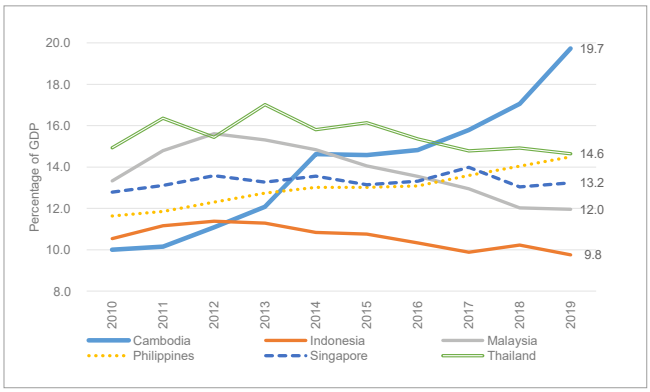
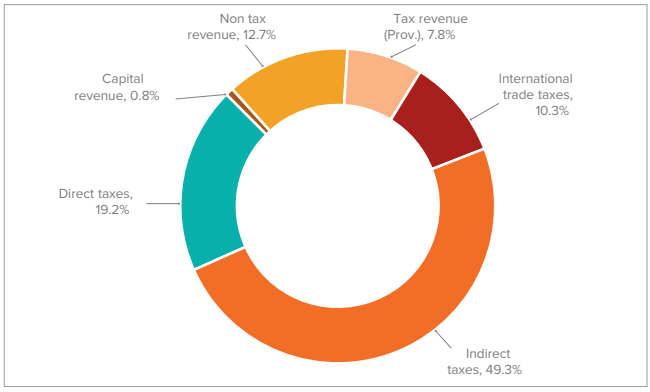


Figure 9: Composition of Domestic Revenues, 2019

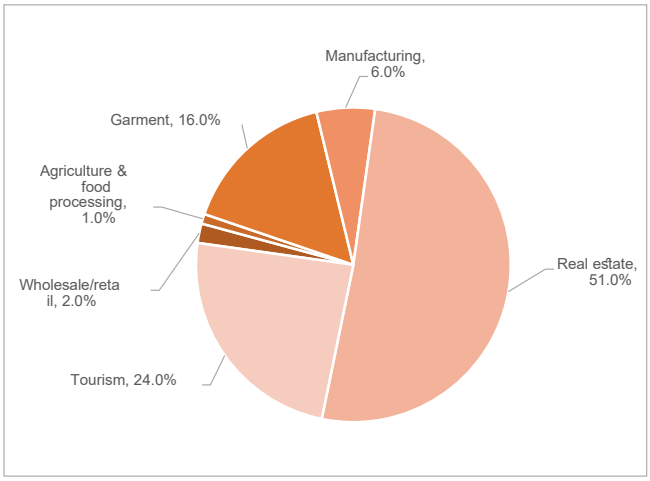


Sources: Macroeconomic Framework (MEF 2019) and World Bank World Development Indicators.

Indirect taxes dominate tax revenue, accounting for 49.3 percent of the total in 2019. Domestic and import value added taxes and excise duties generated the majority of indirect tax revenue. Direct taxes progressed from 16 percent of total tax revenue in 2010 to 19.2 percent in 2019 and are mainly concentrated in profit taxes (81 percent of direct taxes) and payroll taxes (19 percent) (Figure 9). Customs revenue is stationary at around 10 percent of total revenue and is generated by a relatively narrow tax base comprising a few imported goods. Non-tax revenue contributed to 13 percent to 14 percent of total revenue in each of the last five years.

Moving forward, an effective resource mobilization strategy will demand higher levels of coordination and commitment from ministries and other institutions especially in non-tax revenue collection. Significant capacity development is still needed to raise non-tax revenues. Cambodia's options for widening the tax base include income and other personal taxes, expansion of the property tax base and further strengthening of tax administration. New and higher taxes may also be needed along with higher rates for excise taxes on alcohol, tobacco and luxury goods. Potential use of capital markets for issuing bonds may be explored as a medium-term financing option to augment domestic revenues.

Figure 10: FDI by Sector, 2019



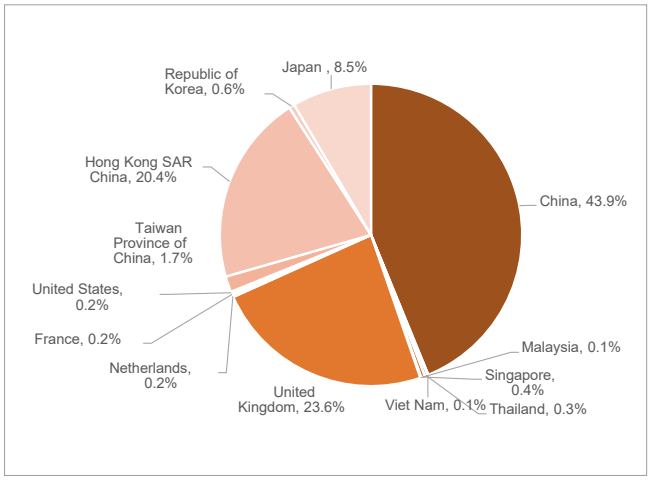
Source: World Bank Group 2020a.

The top three investor countries in Cambodia include China, Hong Kong Special Administrative Region of China and Japan (Figure 11).[11] Competitiveness through low wages and LDC-related preferential access to European Union markets has helped mobilize FDI from investors incentivized by tariff-free access to ASEAN and the European Union. In the foreseeable future, Cambodia's low-labour costs will no longer be a comparative advantage; wage increases will likely diminish overall competitiveness in low-cost manufacturing. More efforts need to be made to create more favourable conditions to support export-oriented manufacturing investment and attract FDI to the Special Economic Zones.

3.2 Foreign Direct Investment

FDI increased in volume and GDP share in 2019. Although the trend has not been smooth, the amount in 2019 was estimated as $3.4 billion, equivalent to 12.7 percent of GDP. FDI investments in Cambodia are mainly concentrated in a few subsectors: garments, tourism and real estate. In 2019, the construction and real estate sector received the largest share of 51 percent of total approved FDI project value, followed by 24 percent for the tourism sector (Figure 10).[10] Most FDI is regional investment.

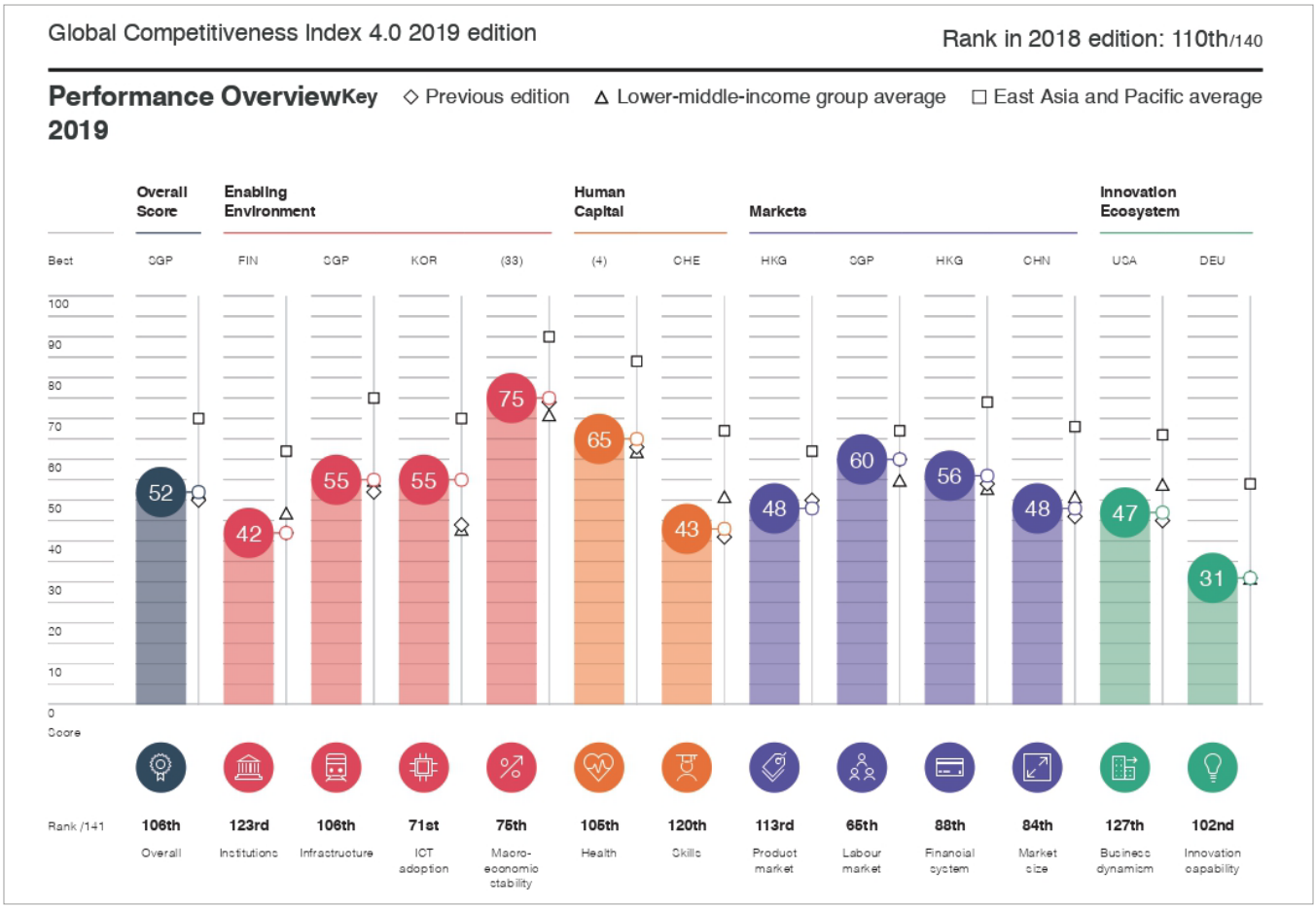
Figure 11: FDI by Country, 2019



The World Bank's *Ease of Doing Business Report 2019* ranks Cambodia as 127 out of 189 economies, with its lowest scores related to access to energy and cross-border trade. The Global Competitiveness Index produced by the World Economic Forum ranks Cambodia as 108 out of 141 countries (Figure 12). The most challenging issues are related to institutional and policy capacity, including the legal framework and governance, infrastructure (energy and transportation), and education and training.

10 World Bank Group 2020a.
11 Ibid.

Figure 12: Global Competitiveness Index



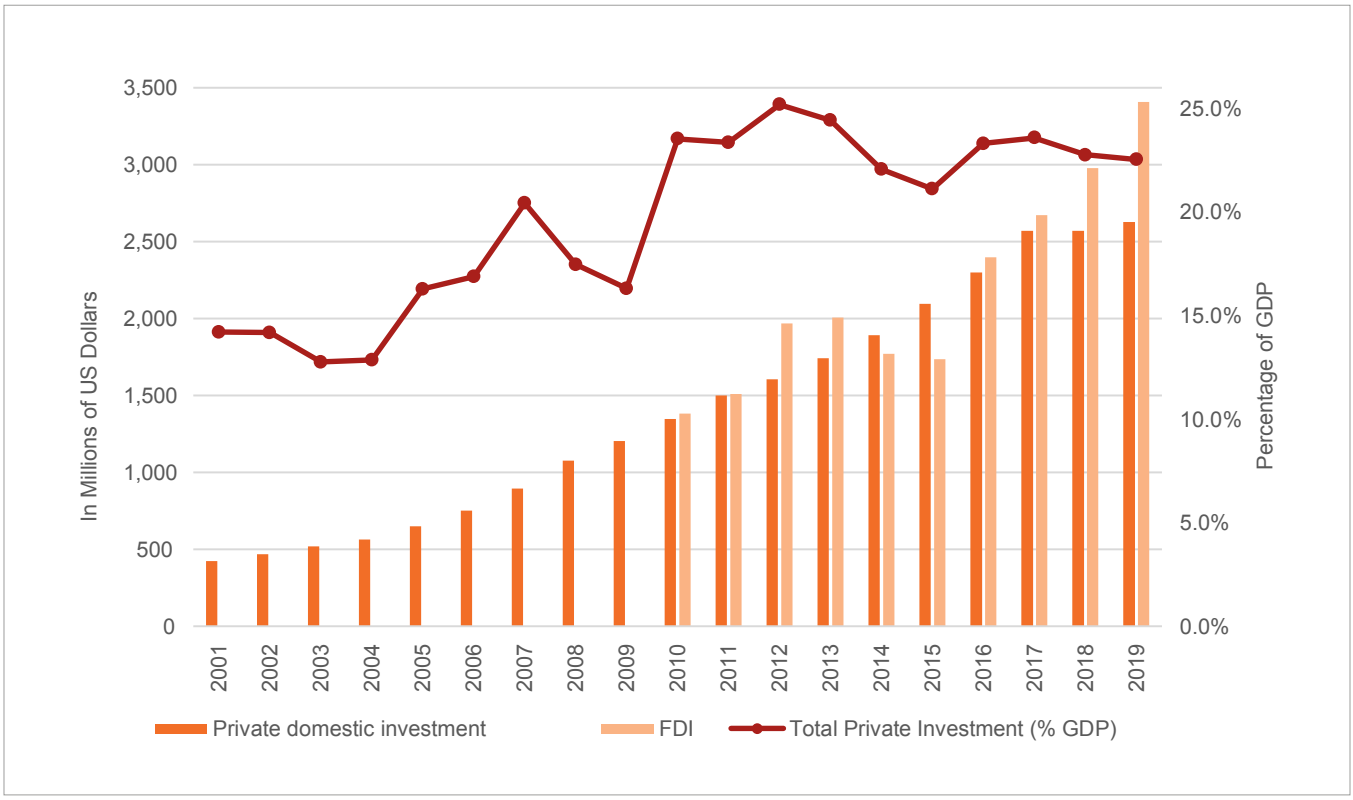
Source: Klaus 2019.

Within the coming decade, a number of measures can address key challenges to medium-term competitiveness in terms of infrastructure, energy and skills. First, particular attention should be paid to skill shortages already limiting the quantity and quality of FDI as changes here take time to produce results. Second, short-term expansion of FDI should be mainly linked to the expansion of the Special Economic Zones. Third, the zones should be used to attract more and higher-quality FDI. Last, the tax exemption system may need to be reviewed to maximize its benefits.

3.3 Domestic Investment

From an economic development perspective, the private sector has been the key driver of Cambodia's GDP growth, exports and fiscal revenue in the last decade. Private investment has recovered from a downturn during the global crisis in 2009, and in 2019 accounted for approximately 22.5 percent of GDP (Figure 13).

Figure 13: Private Sector Investment 2010-2019 in Millions of US Dollars



Source: Macro Economic Framework (MEF, 2019).

Cambodia's domestic investment levels are lower than in other South-East Asian countries, however. Higher levels are crucial to maintain high growth, as shown in the Republic of Korea, Malaysia and Thailand, where domestic investment in the 1980s and 1990s averaged 30 percent, 32 percent and 34 percent of GDP, respectively. In 2000-2003, China recorded levels reaching 43 percent.

In assessing Cambodia's industrial sector, the Industrial Development Policy 2015-2025 described it as "weak as reflected by its simple structure, narrow base and low level of sophistication, while its growth is mostly concentrated in a few industries." Furthermore, "most of the production activities are family based with lack of entrepreneurship and inadequate use of technology, thus limiting their ability to compete in international markets." These conditions could be attributed to varying access to bank financing, unfavourable conditions within the labour market and industrial relations, all of which affect economic competitiveness.

One of the most important challenges for industrial policy in Cambodia is to develop financing instruments to establish a broad base of firms in the competitive productive sector. Operating firms effectively to produce products of global quality, at a globally competitive price, requires high levels of organizational and technological capabilities. These are largely developed through learning-by-doing. Financing such advances is not a simple task, however, as funds may be ineffectively used.

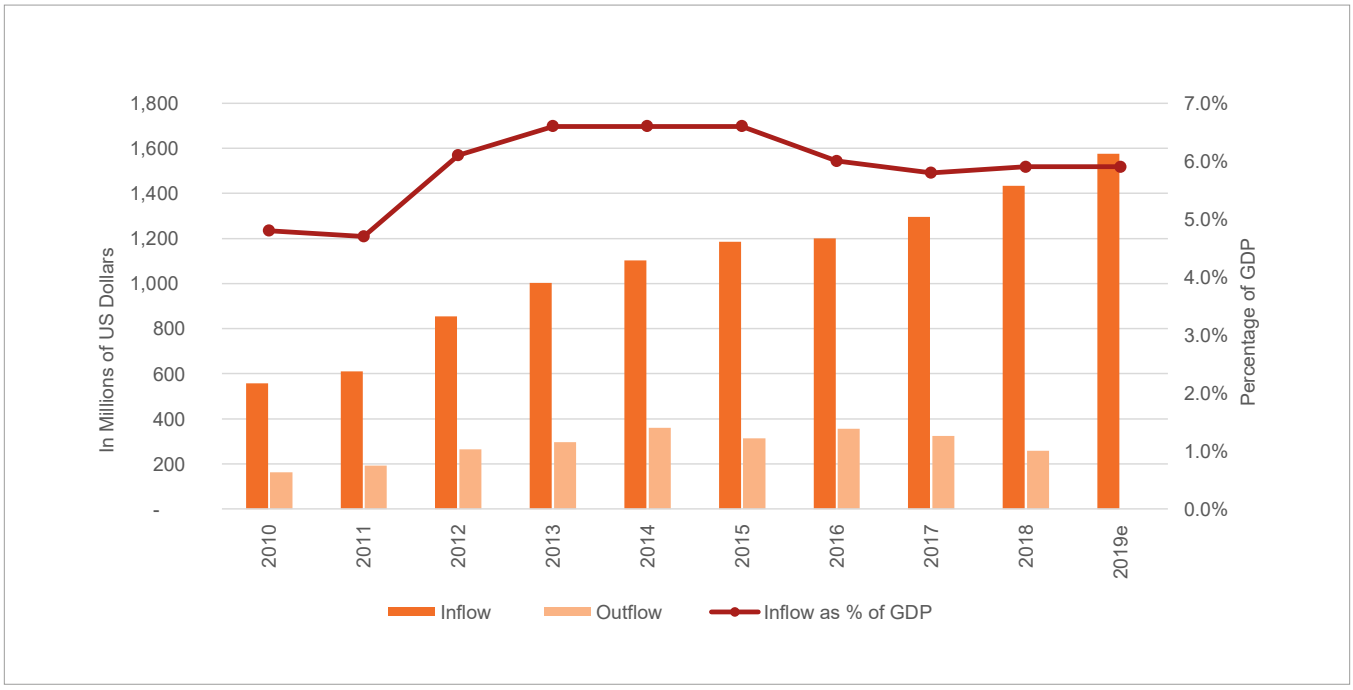
3.4 Remittances

Despite improving economic and social development in recent decades, Cambodia is still challenged by limited employment opportunities in the domestic labour market and relatively low wages compared to other countries in the region. As a result, a growing number of Cambodians, especially young people, are moving abroad to find jobs with higher wages. Thailand is the main destination, followed by the Republic of Korea and Malaysia. Remittances, which play a key role in improving worker skills and livelihoods in Cambodia, significantly increased over the decade leading up to 2019.

Data from the Ministry of Labour and Vocational Training showed that in 2019, around 1.28 million Cambodians worked abroad and sent $2.8 billion back home.[12] International sources[13] estimated only about a $1.6 billion inflow in 2019, representing 5.9 percent of GDP (Figure 14).

12 Vireak 2020.
13 World Bank Group 2020b.

Figure 14: Remittances 2010-2019 in Millions of US Dollars



Source: World Bank Group 2020b.

Some recommended steps to optimize potential benefits from remittances start with whole-of-government capacities and approaches to accelerate national and local implementation of the Labour Migration Policy. Since engagement of stakeholders outside the Ministry of Labour and Vocational Training has been limited, creation of a specific technical working group and joint monitoring indicators might increase dialogue on migration issues. The expansion of migrant worker resource centres and their services is essential to boost the local development impact of remittances and uphold migrants' rights. Finally, there are ample opportunities through South-South cooperation to learn from other experiences in the region.

3.5 ODA Grants and Loans

ODA grants and loans are intended to promote the economies and human welfare of recipient nations, including Cambodia. ODA to Cambodia has been increasing in absolute terms but declining as a share of gross national income (GNI) (Figures 15 and 16). This is expected as the size of the economy is growing, and ODA donors need to divert attention and resources to countries that remain less developed and more vulnerable than Cambodia.

Cambodia and Lao People's Democratic Republic are less dependent on ODA compared to the LDCs as a whole but more dependent than Myanmar and Viet Nam (Figure 16). While ODA alignment with national priorities has moved in a positive direction, CDC analysis of NSDP requirements highlights room for improvement both across and within sectors.

Figure 15: Loans and Grants 2010-2019

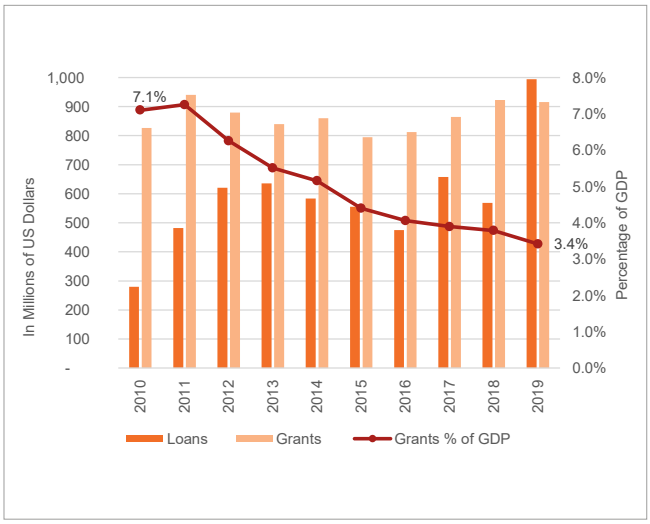
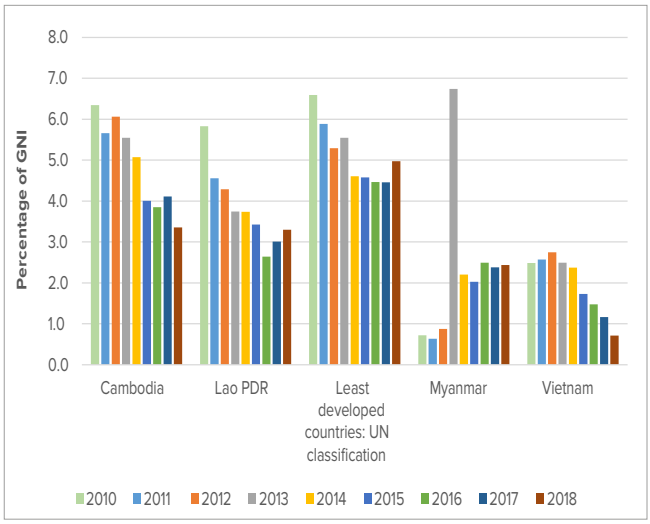


Figure 16: ODA as a percentage of GNI



Sources: CRDB/CDC database 2020 and World Bank World Development Indicators.

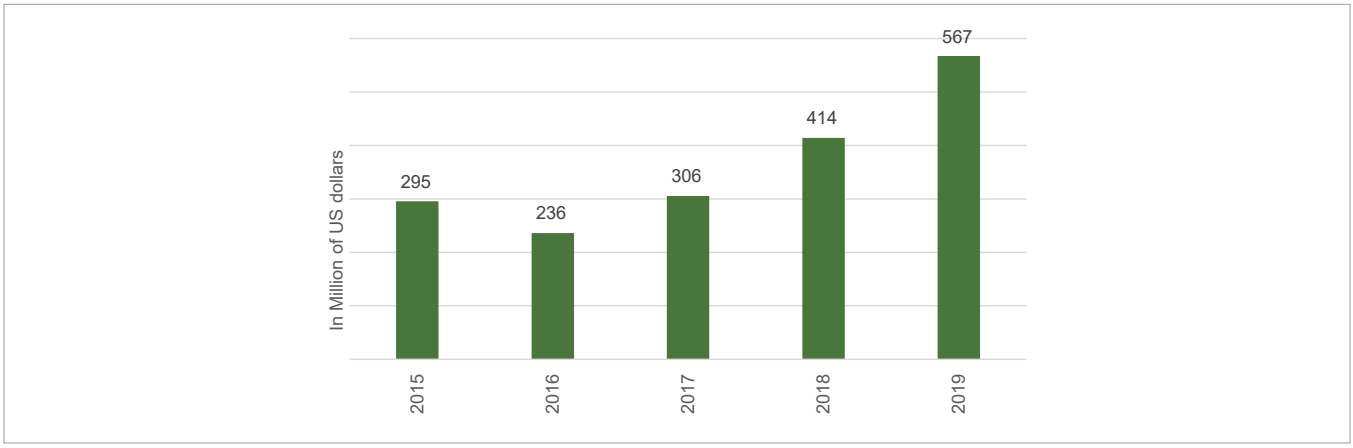
There are several approaches to mobilize more ODA and/or use it more effectively and efficiently. First, while ODA is an important component of budget capital expenditures, it still requires alignment through public financial management reforms, key strategies such as the Industrial Development Policy and on climate change, and so forth. Second, recording non-ODA flows and other resources from non-aid providers requires improved and more comprehensive data management. Third, there are benefits from strategically linking the NSDP with the Development Cooperation and Partnership Strategy results framework as this could help external resources align appropriately with priority development impacts. Last, promoting more systematic integration of aid from the central and ministerial levels into budget processes largely depends on key public financial management reforms, specifically, programme budgeting.

3.6 Climate Fund Flows

Climate finance is channelled through multilateral funds such as the Green Climate Fund, the Global Environment Facility, the Climate Investment Funds, and targeted loans by multilateral development banks and IFIs, as well as increasingly through bilateral channels. In addition, there are national and regional climate funds as well as private and philanthropic sources of finance. Different climate funds target diverse activities, such as for adaptation, mitigation, REDD (reducing emissions from deforestation and forest degradation) and capacity building. These span varying sectors and regions.

Climate finance has grown significantly in Cambodia from $295 million in 2015 to $567 million 2019 (Figure 17).

Figure 17: Climate Financing



Source: CRDB/CDC database 2020.

While private sector investment in climate finance mechanisms, such as the Clean Development Mechanism, continues to be fairly limited, the private sector role is expected to grow, with one example being Japan's bilateral Joint Crediting Mechanism. A disadvantage that the Cambodian Government faces is a lack of reliable and comprehensive data on private climate-related investments, which hinders the ability to monitor, influence and improve them. In 2015, the Government produced an initial mapping of private sector contributions and found varied opportunities in agriculture, forestry, fisheries, energy, water, construction, transport and tourism.

Numerous measures to mobilize climate finance include improved and focused oversight to align national priorities and influence development flows. Cambodian bank lenders need to be informed and aware of how to steer the economic potential of low-carbon, climate-resilient development, while increasing engagement with SMEs and the informal sector will be crucial in mobilizing finance for climate projects. Microfinance institutions are a valuable resource in providing advice on climate-related financing, such as support to solar home system distribution, and in mobilizing bank engagement. Combining the Climate Change Strategic Plan and the Industrial Development Policy can help identify and prioritize mitigation investments and coordinate policy responses around private sector investment.

3.7 Corporate Social Responsibility

The concept of corporate social responsibility (CSR) extends beyond the legal or profit-related frameworks that companies are obliged to follow. It refers to the behaviour and operations of private companies in maintaining moral and ethical standards, and providing social benefits and promoting public welfare. CSR includes but is not limited to community engagement projects, green business operations and integration of environmentally sustainable practices in business activity. The concept is still at a nascent stage in Cambodia but can be viewed as a vital and relatively untapped opportunity for private companies to collaborate with the Government and other partners to mobilize resources for collective development efforts.

CSR has already become commonplace among some private sector companies in Phnom Penh. This has been the case, for example, with Unilever in supporting water management and Manulife in assisting hospitals. According to the Global Banking & Finance Review, an exemplary CSR example is Maybank, the Malaysian bank, which was recognized as the Best CSR Bank in Cambodia in 2015. Local companies such as EZECOM, which supports technology in schools, and the Royal Group have contributed their own well-established and highly regarded CSR programmes as well as resources for development efforts.

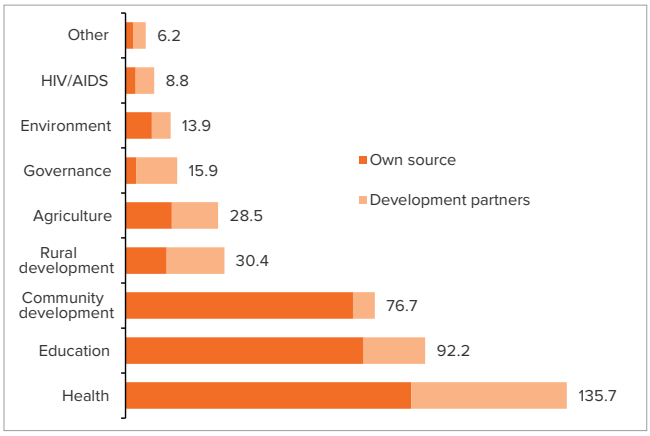
In 2015, Smart-Axiata, the Cambodian telecoms company, earned recognition as the Best Corporate Social Responsibility Program based on supporting literacy for around 92,000 young people in collaboration with the United Nations Educational, Scientific and Cultural Organization (UNESCO) and the Ministry of Education, Youth and Sports. Smart-Axiata continues to sponsor Cambodia's participation in the Homeless World Cup.

CSR opens the possibility for private companies and the Government to invest in learning and applying new models to scale up support for development. This effort will reinforce the concept of CSR as more than a marketing strategy. It is in fact a powerful opportunity to further propel development.

3.8 NGO Sector Flows

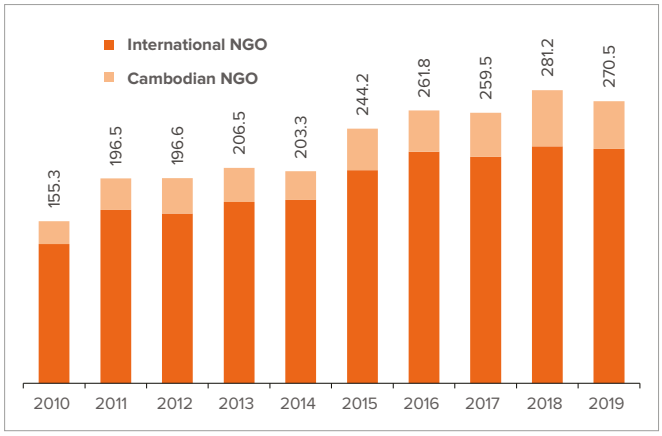
Since Cambodia's first general election in 1993, an impressive proliferation of NGOs across various sectors of development cooperation (Figure 18) has been largely due to the belief that they offer advantages over the public sector in aid effectiveness. NGO disbursement increased from 2009 to 2015 but remained relatively stable after that point. Flows made up only 0.9 percent of GDP in 2019, a share expected to decrease as GDP enlarges.

Figure 18: NGO Sector Support in 2019 (Millions of US Dollars)



Source: CRDB/CDC database 2020.

Figure 19: NGO Type, 2010-2019 (Millions of US Dollars)



Total NGO finance encompasses international and local NGOs (Figure 19). The former not only support their own programmes but also fund the latter. Local NGOs disbursed $45.8 million in funding in 2019, representing 0.17 percent of GDP. To establish partnerships between the Government, donors and private for-profit sector, innovative mechanisms such as development impact bonds were successfully tested, presenting favourable indicators for partnership growth.

Strengthening and expanding access to NGO funds can promote alignment with national priorities, with success more likely through appropriate and consistent coordination between NGOs and the Government, at the national and subnational levels. This includes building on the NSDP, the Development Cooperation and Partnership Strategy and a technical working group mechanism. There are relatively unexplored opportunities to foster strategic dialogue and create more complex and comprehensive engagements to achieve development results, such as through social PPPs.

Making appropriate use of NGO data in budget formulation and avoiding current duplications calls for programme budgeting by the MEF. Research on the 50 largest groups would provide an adequate understanding of development impacts from the allocation and mobilization of NGO resources. This research bolsters the strategic allocation of government support, underwriting of risk and access to innovative external finance such as impact investment. For climate finance, there is potential from substantial untapped NGO resources, but since this area is relatively unexplored, it requires increased government research to understand how best to identify, mobilize and secure such funds.

CHAPTER

04

Future Trends in Development Financing and COVID-19 Impacts

This chapter estimates trajectories of key development financing sources, taking into account the impacts of the COVID-19 pandemic. It discusses different forecasting methodologies used to project flows and analyses future flows. An exploration of development finance availability up to 2025 includes scrutiny of COVID-19 fallout.

4.1 Forecasting Methodology

Three basic types of forecasting include qualitative techniques, time series analysis and projection, and causal models. The first type uses qualitative data (expert opinion, for example) and information about special events. It may or may not take the past into consideration. The second type focuses entirely on patterns and pattern changes, and thus relies exclusively on historical data. The third type uses highly refined and specific information about relationships among system elements. It is powerful enough to take special events into account. This report uses three key forecasting approaches, which mainly fall in the last two categories.

The first of these approaches is a moving average, which can be employed where data do not exhibit any significant trend. When using an average to calculate a future expected value, earlier historic observations may have less relevance than more recent observations, especially where there is little evidence of a trend or seasonality. Early values may be dropped as later values are added.

The second approach is exponential smoothing, a weighted moving average technique that is especially effective when frequent reforecasting is required and when forecasts must be achieved quickly. It is a short-term forecasting technique often used for production and inventory where only the next period's value must be forecast. Because only three numbers are required to perform exponential smoothing, this technique is simple to update. Requisite data are the historic observation, the latest data observation and the smoothing coefficient or constant.

The third approach is regression analysis, a popular forecasting and estimating technique. Although many users might find the mathematics involved quite difficult, the technique itself is relatively easy to use, especially when a model or template has previously been developed. Users who do not understand the underlying mathematics, however, should obtain some assistance in interpreting results. Having established a linear relationship between the two variables, it is useful to fit a least square line to the data; this is referred to as simple linear regression. Simple here implies that only one variable is used to predict another. When two or more dependent variables are required for a prediction, the analysis is referred to as multiple linear regression.

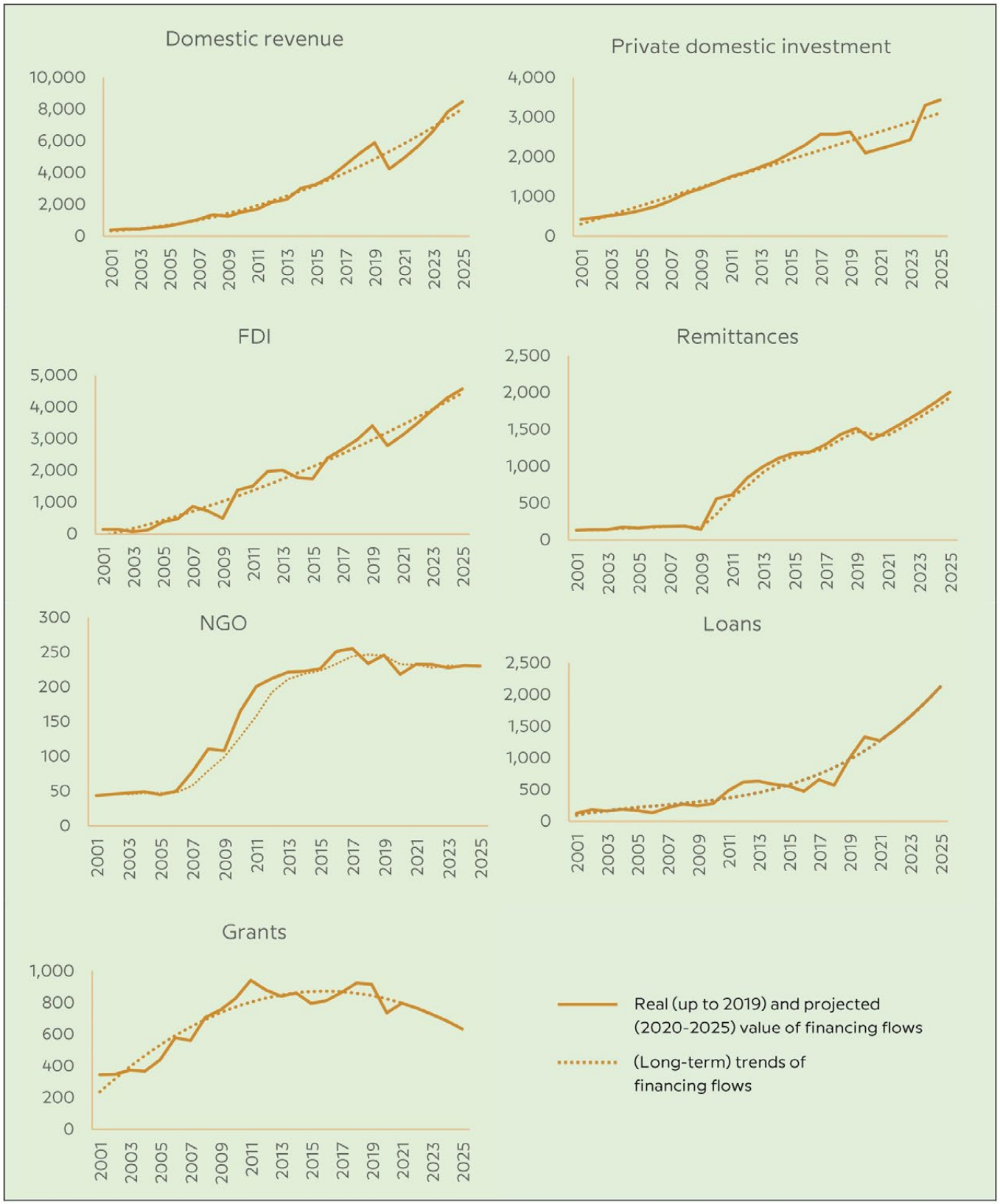
Table 3 summarizes methodologies used for each financing flow as well as the assumptions applied in estimating COVID-19 impacts on these flows.

Table 3: Techniques and Assumptions for Forecasting Development Financing by Sources

Financing Source	Technique	COVID-19 Impact	Data
Domestic revenue	Multiple linear regression (polynomial order 2)	Based on the macro framework estimate, domestic revenue declined to $4.9 billion in 2020 or a 15.7 percent drop from 2019.	MEF
FDI	Multiple linear regression (polynomial order 2)	Based on the macro framework estimate, FDI declined to $2.9 billion in 2020 from 3.4 billion in 2019.	MEF
Private domestic investment	Simple linear regression	UNDP estimated that COVID-19 would reduce private domestic investment by 20 percent.	MEF
Remittances	Moving average	In East Asia and the Pacific countries, including Cambodia, remittances reportedly declined sharply by 13.8 percent from 2019 due to COVID-19.	World Bank
Grants	Multiple linear regression (polynomial order 2)	Past trend (no impact)	CDC
Loans	Multiple linear regression (polynomial order 3)	Past trend (no impact)	CDC
South-South cooperation	Moving average	Past trend (no impact)	CDC
NGO	Moving average	Past trend (no impact)	CDC
Climate finance	Exponential smoothing	Past trend (no impact)	Ministry of Environment

Figure 20 displays trends in different financing flows from 2001 to 2025. In the current study, a specific forecasting technique was selected based on the most fitted shape of the trendline from 2001 to 2020. Based on equations derived accordingly, projected figures for each flow from 2021 to 2025 were produced.

Figure 20: Trends of Development Financing by Source (in Millions of US Dollars)

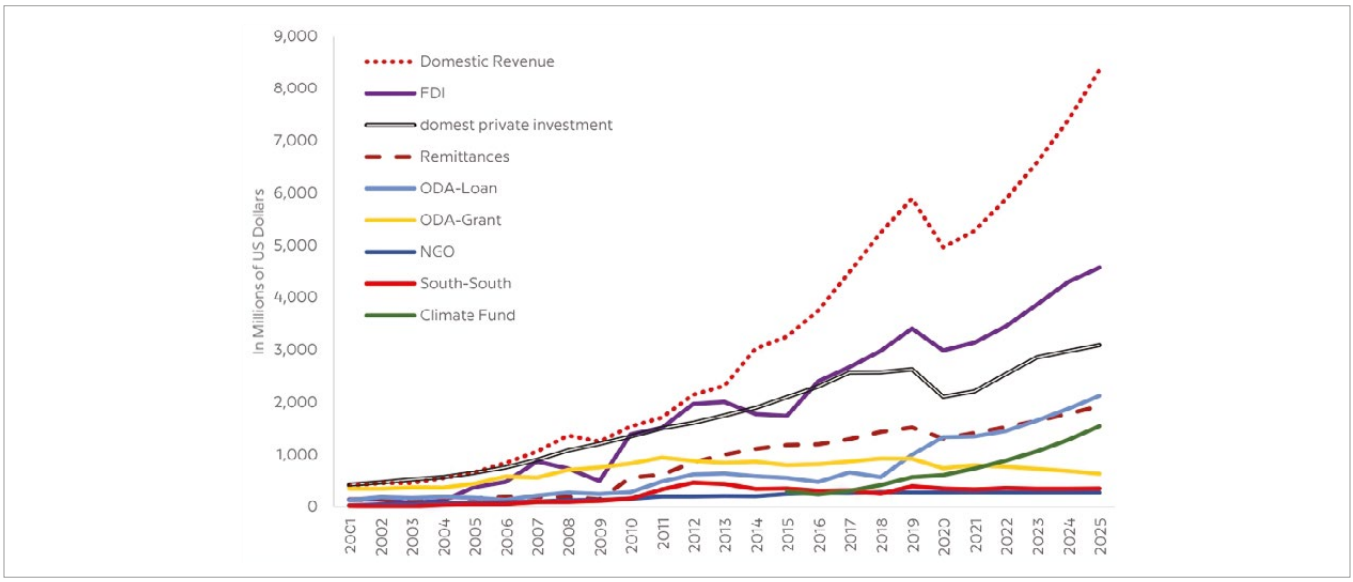


4.2 Analysis of Future Development Finance Flows

The Rectangular Strategy Phase IV (2019-2023) intends Cambodia "to move resolutely and confidently forward on a journey of reform and development, aimed at graduating from a low-income country to a lower-middle income status in the very near future and further to become an upper-middle income country by 2030 and high-income country by 2050." Accordingly, this section assesses potential development financing options and associated actions to maximize impacts on medium and long-term development goals.

Recent policy initiatives such as the Industrial Development Policy recognize that the current socioeconomic development paradigm is nearing its outer limits. Moving to a new growth model is necessary. The rest of this chapter outlines how such a transformation may be financed while maintaining and consolidating the current growth model and its gains for the longest possible time, and identifying reforms and investments to establish the foundations of a new growth model.

Figure 21: Trends of Development Financing Flows in Millions of US Dollars



Source: Author's projection based on data from various sources. It was made based on available data in 2020.

Figure 21 summarizes the evolution of the main flows, including those that can be directly programmed by the Government (domestic revenues, grants and loans) as well as those outside of the public sector that are harder to manage (FDI, remittances, domestic private investment). Except for grant and NGO flows, all of these resources have been increasing over time. Domestic revenue is the biggest source of financing for the Government, followed by FDI, and remittances. While few financial flows are under direct government control, public policy can be used to coordinate or leverage the development impacts and monitor results.

4.3 Detailed Results of Development Finance Availability Projected to 2025

The forecasts suggest that total financing potentially available for supporting national development could more than double to $23.4 billion by 2025 (Table 4). As a share of GDP, however, it would rise to 69.8 percent, driven principally by domestic resource mobilization, FDI and remittances. To provide a better perspective, in 2005, total development cooperation funding (from ODA, NGOs and South-South) was approximately equal to domestic revenue. In 2025, domestic revenue will be almost double aid receipts. Assuming the broad validity of the assumptions made for all finance flows, this projection emphasizes the likely critical importance of domestic revenue mobilization, and the need to maximize and better manage key flows.

Table 4: Development Finance Projections in Millions of US Dollars

DFA Flow	2015		2019		2020		2025	
	Mn USD	% GDP	Mn USD	% GDP	Mn USD	% GDP	Mn USD	% GDP
Domestic Revenue	3,250	18.0%	5,893	22.4%	4,967	18.9%	8,488	25.3%
FDI	1,735	9.6%	3,407	13.0%	2,988	11.4%	4,573	13.7%
Private domestic investment	2,094	11.6%	2,628	10.0%	2,102	8.0%	3,439	10.3%
Remittances	1,182	6.5%	1,515	5.8%	1,306	5.0%	2,007	6.0%
Loans	555	3.1%	994	3.8%	1,333	5.1%	2,123	6.3%
Grants	795	4.4%	916	3.5%	736	2.8%	634	1.9%
NGOs	226	1.3%	246	0.9%	218	0.8%	230	0.7%
South-South cooperation	349	1.9%	394	1.5%	349	1.3%	349	1.0%
Climate funds	295	1.6%	567	2.2%	607	2.3%	1,543	4.6%
Total	**10,482**	**58.0%**	**16,559**	**63.1%**	**14,606**	**55.6%**	**23,386**	**69.8%**

Source: Author's projection based on data from various sources.

An additional challenge is to incorporate the financial implications of implementing the CSDGs into planning and modelling. Further research is needed to model how the main changes expected during the next decade will impact growth and major finance flows. These shifts include especially Cambodia's emergence as a middle-income country and its LDC graduation process, resulting in the gradual reduction of grants and increase in non-concessional loans as well as reconfigured trading arrangements. Modelling should also incorporate interlinkages among critical flows.

4.4 The Impact of COVID-19 on Development Finance Flows

The COVID-19 outbreak, in addition to dramatic implications for the health of people around the world, has triggered major economic and financial consequences. In 2020, global GDP is expected to contract by 6 percent; trade could fall by 12 percent to 32 percent; FDI flows may drop by around 40 percent; equity markets initially suffered sharp sell-offs before recovering somewhat; and financial conditions have substantially tightened. These developments in turn are significantly influencing global capital flows and countries' external positions.

The pandemic has knee-capped rich and poor economies, but for developing countries, the economic shocks will be magnified by interruptions of development financing. This subsection discusses how each type of flow is affected in Cambodia using hypothetical assumptions that predict flows without COVID-19.

Domestic revenue

Cambodia's domestic revenue is dominated by tax revenue at around 80 percent of the total in 2019. Tax revenue comes from direct, indirect and international trade taxes that accounted for 22 percent, 29 percent and 10 percent of domestic revenue, respectively, in 2019. As is true in most countries, Cambodia is seeing a major decline in tax revenue due to the pandemic. According to the MEF, domestic revenue may significantly drop to $4.9 billion, while the DFA predicts that revenues would be 23.6 percent higher, standing at $6.5 billion, if the pandemic had not occurred (Table 5). Revenue losses stem directly from the economic slowdown and indirectly from tax policy and administrative measures taken in response. The crisis has disrupted economic activity in unique ways. For instance, the need for social distancing has affected the tax base, tax administration and taxpayer compliance.

Table 5: The Impact of COVID-19 on Development Financing Flows

Financing Sources in Millions of US Dollars	2020 without COVID-19	2020 with COVID-19	Impact (Difference)	Impact (Percentage Drop)
Domestic revenue	6,503.0	4,967.4	1,535.6	-23.6%
FDI	4,328.0	2,988.3	1,339.7	-31.0%
Domestic private investment	2,512.4	2,102.3	410.0	-16.3%
Remittances	1,636.9	1,306.0	330.9	-20.2%
Loans	1,332.5	1,332.5	-	
Grants	735.6	735.6	-	
NGOs	218.0	218.0	-	
South-South cooperation	348.8	348.8	-	
Climate funds	607.0	607.0	-	
Total	**18,222.2**	**14,605.9**	**3,616.3**	**-19.8%**

Source: Author's Estimation based on available data from authorities in 2020.

Foreign direct investment

The pandemic is a supply, demand and policy shock for FDI. The lockdown measures are slowing existing investment projects. But most problematically, demand has fallen in key sectors, with a dramatic decline in FDI inflows in Cambodia. A key component is demand for real estate, where FDI flows lately have gone largely to construction. These flows have originated from a small number of countries in the surrounding region, especially China, which accounted for more than 50 percent of total FDI inflows in recent years. According to MEF, net FDI inflows contracted to $2.9 billion in 2020.[14] Based on that assumption and the DFA projection model, FDI would suffer a 31 percent loss compared to the case without COVID-19. This fall is expected because of Cambodia's heavy reliance on investment in global value chain-intensive industries, which have been severely hit, and because it cannot afford to adopt the same economic support measures as developed economies.[15]

Domestic private investment

Domestic private investment on average accounted for around 11 percent of GDP before the COVID-19 pandemic. According to the CDC, domestic private investment represented around 50 percent of total approved investments,[16] and around 30 percent of these are classified as capital investment.[17] UNDP estimated that such investment would decline by around 20 percent in 2020 from a year earlier. Based on an estimate following this assumption and the forecasting technique in Table 3, the cost of COVID-19 in terms of private investment would be around $410 million. The Government has sought to ease financing for businesses impacted by COVID-19 through a variety of measures, including lowering the withholding tax rate to between 5 percent and 10 percent on interest applied to new and existing loans starting from April 2020, and an injection of an additional $200 million to help business secure working capital loans and investment loans.[18]

14 World Bank Group 2020a.
15 The United Nations Conference on Trade and Development (UNCTAD) projected a greater 30 percent to 45 percent drop in FDI.
16 investment which are approved by the Government in particular year may differ from actual investment.
17 CDC, CIB and CSEZB 2017.
18 ASEAN 2020.

Remittances

As in other low-income countries, remittances in Cambodia play an important role in supporting and smoothing household consumption. COVID-19 has exerted a profoundly negative impact on remittances, with a recent World Bank report predicting that in East Asia and the Pacific countries, including Cambodia, remittances will decline by more than 10 percent.[19] Applying this assumption with the forecasting technique in Table 3, Cambodia's remittance inflow could fall by $331 million or 20.2 percent. A drop is likely to heighten economic, fiscal and social pressures on the Government, which is already struggling to cope even in normal times.

Official development assistance

Unlike private flows, ODA as well as financing through NGOs, South-South cooperation and climate funds could take a positive trajectory. Despite unique challenges posed by the COVID-19 pandemic, historical trends suggest that ODA can be resilient in 2020 and 2021. It may even increase but in the current study, a more conservative approach was taken with an assumption that flows do not deviate from the trajectory predicted by the forecasting models. Given the unprecedented nature of the COVID-19 crisis, and the fact that it is still unfolding globally, development cooperation should be enhanced to support sustainable development and protect global public goods.

Summing up: profound consequences

In sum, the pandemic has had profound consequences on development financing as a whole, which is predicted to decline by $3.6 billion or 19.8 percent in 2020 compared to a scenario without COVID-19. Of all the financing flows, FDI may suffer the sharpest drop followed by domestic revenue, remittances and private investment, declining by 31.0 percent, 23.6 percent, 20.2 percent and 16.3 percent, respectively.

19 World Bank Group 2020b.

CHAPTER

05

Green, Blue and Innovative Financing Tools for the 2030 Agenda

5.1 Financing Solutions

A major task for policy-makers in financing the 2030 Agenda for Sustainable Development will be to attract and direct investments that achieve greater co-benefits and multiplier effects. UNDP has identified four broad financing strategies and objectives to consider in SDG implementation:[20]

- **Generate revenues:** Any existing or innovative mechanism or instrument that generates and/or leverages financial resources for the SDGs. Examples include attracting impact investment, introducing green taxes, issuing debt instruments, etc.

- **Realign current expenditures:** Any measure that reorients existing financial flows towards the SDGs. This can be achieved, for instance, by phasing out and reforming fossil fuel subsidies and using freed resources to invest in renewable energy or green infrastructure instead. Another example is increasing budget allocations for poverty eradication programmes.

- **Avoid the need for future expenditures:** Freeing up future resources for investment in other areas includes any measure that can prevent or reduce future investment by eliminating or amending existing counter-productive policies and expenditures. This can be achieved by taxes that generate a double dividend, such as sugar or tobacco taxation, or fines for introducing alien invasive species.

- **Deliver financial resources more effectively and efficiently:** Any measure or instrument that can enhance cost-effectiveness and efficiency in budget execution, achieve synergies and/or favour a more equitable distribution of resources. Examples include enterprise challenge funds, central procurement units or staff incentives to increase delivery of resources.

5.1.1 Revenue Optimization

Reduction of tax avoidance/evasion

The challenge of increasing public revenues remains one of the critical impediments to fulfilling the ambitious 2030 Agenda for Sustainable Development. This is explicit in SDG target 17.1, "Strengthen domestic resource mobilization, including through international support to developing countries, to improve domestic capacity for tax and other revenue collection." The Addis Ababa Action Agenda also acknowledges that significant additional domestic public resources will be critical to realizing sustainable development and achieving the SDGs.

Tax systems can be improved by modernization (for instance, digitalization) and the expansion of the tax base. One way of increasing revenue is through mechanisms to make tax collection more efficient, minimizing tax elusion and evasion. The Addis Ababa Action Agenda stresses assuring that all companies, including multinationals, pay taxes to the governments of countries where economic activity occurs and value is created, in accordance with national and international laws and policies. Improving auditing capabilities could boost revenues, in particular towards assuring large companies pay their fair share of taxes.

20 UNDP 2021d.

The Cambodian Government has issued a directive aimed at supporting efficient, effective and transparent tax arrears collection. Tax arrears are defined as all taxes and duties that have not been paid within mandated deadlines and are now subject to penalties for late payment. The directive classifies arrears as being the result of negligence, severe negligence or deliberate tax evasion by individuals or enterprises. To ensure the effectiveness of tax arrears management and tax collection, the General Department of Taxation will communicate with or visit taxpayers' homes or business places to seek clarity on why delays in payment continue and give any additional information needed on how to pay the arrears. Mechanisms to discourage tax arrears include a temporary ban on property or real estate transfers, the withdrawal of tax incentives provided by the tax authorities, the suspension or cancellation of business permits and licenses issued by the tax administration, disqualification from tax registration, and public announcement of the names of individuals or enterprises in arrears.

Nevertheless, Cambodia's efforts at comprehensive tax reform are still far from complete. Paying taxes can be an intimidating task, particularly since lower-level officials often are not completely aware of the regulations. UNDP and the Organisation for Economic Co-operation and Development (OECD) have initiated a programme called Tax Inspectors Without Borders to share tax audit knowledge and skills with tax administrations in developing countries (Box 1).

Box 1: TAX INSPECTORS WITHOUT BORDERS

Tax Inspectors Without Borders is a joint UNDP-OECD initiative to support developing countries to build tax audit capacities through a targeted, real-time, 'learning by doing' approach. Tax administrations are on the front line in the battle against tax avoidance. Tackling complex international tax arrangements that divert profits otherwise liable for corporate taxes calls for skilled tax auditors. A well-trained tax team can identify high-risk cases and uncover arrangements that strip much needed tax revenue from governments. Tax Inspectors Without Borders facilitates well-targeted, specialized tax audit assistance through programmes on pre-audit risk assessment and case selection, investigatory techniques, audit cases involving transfer pricing issues, anti-avoidance rules and sector-specific issues relating, for example, to natural resources, e-commerce, financial services or telecommunications.

Through such programmes, tax administrations can improve the quality and consistency of audits, potentially yielding more certain and greater revenues. Over the longer term, the overall investment climate is likely to improve, and a culture of taxpayer compliance can be built through more effective enforcement. More broadly, the State-society relationship can also be enhanced through taxpayers' greater engagement and confidence in the taxation process. This may lead ultimately to more effective and accountable governance.

Source: Tax Inspectors Without Borders, http://www.tiwb.org/about/.

Smart taxation and the reform of public subsidies

Successful tax reform could increase tax collection capabilities and better regulate Cambodia's significant informal economy. While comprehensive studies should be carried out before implementing new taxes, a reform could start by exploring the performance of the existing framework and the potential of making it greener, and more inclusive and effective. A larger review of the revenue regime may include:

1. Completion of the recalibration of the fiscal reform programme;
2. Increased efforts to expand the tax base with further modernization of the tax administration and reduction of tax avoidance, evasion and tax arrears to increase fiscal space for the SDGs;
3. Opportunities to review and introduce smart taxation, including environmental, sugar and 'sin' taxes and other economic incentives that can shift behaviours and investment decisions; and
4. Negotiation of new parameters for reviews conducted by the financial supervision authority that go beyond GDP and finance, and include SDG dimensions (see also Box 2).

Box 2: THE FINANCING SOLUTIONS FOR SUSTAINABLE DEVELOPMENT PLATFORM AND SMART TAXES

The Financing Solutions for Sustainable Development platform (http://www.undp.org/content/sdfinance/) provides online guidance to review and operationalize financing solutions to implement SDG-oriented strategies, such as a national development plan, biodiversity strategy or nationally appropriate mitigation actions. The platform helps navigate different financing solutions, and describes their potential, advantages, disadvantages, risks and characteristics. The platform compiles case studies and links to external sources, including e-learning and advanced guidance. Examples of fiscal policy solutions reviewed include:

- Taxes on fuel for any individual or firm purchasing fuel for an automobile or home heating. Such taxes can reduce fossil fuel consumption and greenhouse gas emissions while generating public revenues.
- Taxes on renewable natural capital include any fee, charge or tax on the extraction and/or use of renewable natural capital, such as water or timber.
- Taxes on tobacco can raise fiscal revenues, improve health and well-being, and address market failures.

5.1.2 Budget Realignment

Results-based budgeting and SDG budget alignment

Results-based budgeting aims to improve the efficiency and effectiveness of public expenditure by linking the funding of public sector organizations to the results they deliver, making systematic use of performance information. While Cambodia has already engaged in results-based budgeting, its reach remains limited. It has been implemented mostly for government office supplies but not for programmes, ministries or national development goals. Work still needs to be done to improve capacities within the Government to work according to results-based management principles and to further apply this to budgeting.

The United Nations Development Group defines results-based management as "a management strategy by which all actors, contributing directly or indirectly to achieving a set of results, ensure that their processes, products and services contribute to the achievement of desired results (outputs, outcomes and higher-level goals or impact). The actors in turn use the information and evidence on actual results to inform decision-making on the design, resourcing and delivery of programmes and activities as well as for accountability and reporting."[21]

Given the requirement for increased accountability to support implementation of the 2030 Agenda, results-based budgeting or even more broadly results-based management can be effective tools to move from input and activity accountability to a focus on results achieved for resources invested. There is no single road to implement these tools; each organization needs to adapt based on specificities, mandates and context (Box 3).

21 United Nations Development Group 2011, p. 2.

Box 3: BUDGETING FOR THE SDGS AROUND THE WORLD

Mexico in 2018 presented the first budget aligned to the SDGs. The President's Office and Ministry of Finance established a joint unit working along with spending agencies to link their budget programmes to the 17 global goals. Other countries have made similar alignments. Brazil, for example, has linked multi-year programmes, objectives, goals and initiatives to the SDGs.[22]

In Nepal during annual budget preparations for fiscal years 2016-2017 and 2017-2018, ministries working with the National Planning Commission and the Ministry of Finance classified 484 programmes based on the SDGs. Coding was done only for development programmes and not for regular spending. This identified 58.4 percent of the total budget as allocated for development.

The province of Assam, in India, decided to redesign its budgetary process around the SDGs and discussed new approaches to mobilizing resources accordingly. In 2016, the government released an SDG-oriented outcome budget for fiscal year 2016-2017, the first in India. The 2017-2018 budget tagged 55 percent of allocations for achieving the SDGs.[23]

Fiscal progressivity

Fiscal policy, understood as the combination of direct and indirect taxes and subsidies, can be informed by collecting evidence on its impact on progressivity. Based on functional definitions of income and using microsimulation models, it is possible to conduct a detailed analysis and assess the effects of fiscal policy on the redistribution of income and poverty, covering evaluation of the status quo, planning for future reforms and necessary preparations for the implementation of reforms. The models use micro-data, usually from household income and expenditure surveys, to develop a statistical representation of the entire population.

As a planning tool, the so called "fiscal toolkit" quantifies ex ante variations in well-being across levels of a population and applies hypothetical tax or expenditure reforms. Results obtained through these simulations can facilitate the design of public policy and the creation of indicators for income distribution, poverty and inequality levels, both for the total population and population subgroups.

5.1.3 Avoid Future Expenditures

Sin taxes

A sin tax is levied on specific goods and services at the time of purchase. These items are taxed based on their ability to harm or be costly to society. Applicable items include tobacco products, alcohol and gambling ventures. Sin taxes seek to deter people from engaging in socially harmful activities and behaviours but also provide a source of revenue for governments. For example, taxes on tobacco products can raise fiscal revenues, improve health and well-being, and address market failures, such as lost economic output from tobacco-related death and disease as well as the externalization of avoidable health costs for society to treat tobacco-related diseases.

In Cambodia, 15,000 people die each year due to tobacco-related diseases; 33 percent of those deaths occur among the lowest income group. This costs Cambodia an estimated KHR 2.7 trillion every year, equivalent to 3 percent of GDP. Investment in five tobacco control measures, including a smoking ban in public places, bans of tobacco advertising, tobacco taxation, graphic warning labels and anti-tobacco mass media campaigns could save 57,000 lives and avert KHR 7.9 trillion in health costs and economic losses by 2033.

Tobacco taxation is efficient because tobacco is relatively price elastic, meaning that consumption will go down as prices go up and vice versa. When tobacco prices rise, people are less likely to start smoking, and current smokers are more likely to quit or smoke less often. A common misconception voiced by the tobacco

22 Ministry of Economy 2021.
23 For more information on good practices in integrating the SDGs into development planning, see UNDP Asia and the Pacific 2017.

industry is that when taxes are increased, the burden will fall disproportionately on lower-income groups since the tax burden represents a higher proportion of their income than for wealthier tobacco users. In reality, Cambodians with lower incomes stand to benefit from raised taxes, since relative to rich smokers, lower-income smokers are more likely to quit smoking when taxes increase. Thus, tobacco users with lower incomes benefit disproportionately from the subsequent decrease in tobacco-attributable health-care costs and productivity losses. Avoiding these costs is critical to lift those in the lowest-income quintile out of poverty and to reduce inequalities. Lower household spending on tobacco products and tobacco-attributable diseases can unlock income for food, children's education and other productive investments.

A uniform excise tax based on quantity is considered the best instrument for tobacco taxation. Other excises, such as ad valorem taxes based on value, may subvert the goal of reducing consumption by encouraging consumers to switch to cheaper brands, substitute one tobacco product for another that is taxed less, or switch categories of the same product (such as filtered versus unfiltered). Where countries incorporate an excise ad valorem system, introducing a specific excise tax floor can offset some of these risks.

Currently, Cambodia has the lowest taxes on tobacco products of any ASEAN country, imposing only a 25 percent tax on domestic cigarettes and 31 percent tax on imported cigarettes.[24] These numbers are very insignificant compared to neighbouring countries, such as Thailand, with a tax up to 70 percent, and Singapore, with a 69 percent tax. A UNDP study[25] showed that if Cambodia increased the tax on tobacco to 75 percent of the retail price of cigarettes, the Government would collect additional revenues of KHR 920 billion ($230 million) over the next five years or about KHR 183 billion ($45.8 million) annually.

Growing alcohol consumption is another major concern. A 2015 study found that Cambodian men drank 9.7 litres of pure alcohol a year, 3.5 litres above the global average of annual alcohol consumption per capita.[26] The study also revealed that Cambodian men tend to drink six times as much as their female counterparts. Not only is excessive alcohol consumption unhealthy, but it is linked to traffic accidents, with drunk driving among the major risk factors for crashes and fatalities in Cambodia. Since the police do not systematically test drivers for alcohol, many other causes of fatal crashes, such as speeding or dangerous overtaking, may be related to drunk driving. In 2019, around 11 percent of at-fault motorbike drivers were suspected of alcohol abuse and 7 percent were speeding during crashes.[27] Alcohol taxes, therefore, may lead to lower consumption, increased tax revenue, safer roads and fewer deaths.

A sin tax can also be added to gambling ventures. Cambodia is becoming one of the most popular destinations for casino gaming in Asia, and casinos are playing a bigger part in the economy. Every year, tens of thousands of foreigners, mostly from China, Thailand and Viet Nam, visit the 150 casinos in Cambodia, the largest number in any country in South-East Asia. While gambling establishments contribute hundreds of millions of dollars to tax revenues every year, they have also been blamed for an array of social problems.

Over 2018, the Government granted 52 gaming licenses to casinos in Cambodia, a 53 percent increase from 2017. Increasing demand, especially from record numbers of Chinese tourists, has spurred the growth. In 2011, casinos generated $20 million in tax revenue, a figure that grew to $29 million in 2015.[28] Casinos generated $2 billion for casino owners, mostly foreign investment companies, in 2015.[29] In 2018, casinos paid $46 million in taxes, with $12.4 million from publicly listed casinos NagaWorld and Donaco, which had a combined $1.5 billion in gross gaming revenue that year. The rest of Cambodia's casinos contributed $33.6 million, with each paying on average around $260,000 in taxes.[30]

Tax incentives for electric vehicles

Electric vehicles are becoming an option given the increasing cost of fuels and the need to lower pollution. Prices of these vehicles are still high, however, so government incentives such as tax credits or exemptions can play an important role in encouraging more use of them. Federal policies in the United States, for instance,

24 Kunthear 2020.
25 UNDP 2020a.
26 The Asia Foundation 2016.
27 National Road Safety Committee 2019.
28 Noble 2021.
29 Sor 2015.
30 B2B Cambodia 2020.

have included purchase incentives and income tax credits of up to $7,500 for electric vehicles.[31] The tax incentive covers the vehicle and the charging station. A study in 2016 found the federal tax credit resulted in a 30 percent increase in plug-in electric vehicle sales.[32]

Cambodia has not yet developed a low-carbon vehicle policy or strategy, but it has potential to promote low-carbon buses, eco-driving and electric vehicles.[33] Low-carbon vehicles in Cambodia currently include hybrid cars, electric cars and electric motorcycles, yet the number of these is unknown. The Cambodian Angkor EV, a Cambodian made electric car, was launched in 2013, but locally produced vehicles have not proved popular. Companies that import electric cars include LevDeo and Blue Mobility. In 2020, the import duty on purely electric family and passenger cars fell from 30 percent to 10 percent.[34]

5.1.4 Improving Delivery

Transparency and collective accountability among public and private actors is key to an integrated approach to financing the SDGs. Well-functioning mechanisms to uphold transparency and accountability build trust, promote collaboration, support scrutiny of how resources are used and contribute overall to greater effectiveness.

Transparency and accountability are two-way responsibilities. For the Government, they encompass making information accessible on how finance is raised and spent, and the outcomes that are generated, as well as the degree of openness to scrutiny from actors including Parliament, civil society, the media and others. Private actors and development partners also have a responsibility to publish information on their activities. Transparent reporting helps hold all actors to account and supports enhanced public and private contributions to the SDGs. Mutual accountability and transparency back effective partnerships, stronger monitoring and learning, and greater effectiveness and impact from public and private financing.[35]

Transparency

Government transparency and openness about how public resources are used ensure that government spending responds to the priorities of the country, and is efficient and effective. They are important precursors to government advocacy for greater transparency among private actors. According to Transparency International, Cambodia ranks 160 out of 180 countries on the Corruption Perception Index in 2020. To create more resilient institutions, systems and people, UNDP emphasizes:

1. Strengthening institutions to integrate anti-corruption measures across different sectors;

2. Using technology and innovation to promote transparency, accountability and integrity across sectors;

3. Promoting business integrity and collective action for a fair business environment; and

4. Supporting social accountability, inclusion and participation of communities and civil society to enhance oversight.[36]

Accountability

Working with the Ministry of Planning and the Government as a whole, UNDP supports the development, adoption and monitoring of the CSDGs, and their integration within national planning and sector budgeting. It assists the Government to prepare voluntary national reviews, and works with the Government and other partners to help strengthen public service accountability and feedback mechanisms, and guide reforms and innovations to implement and monitor the CSDGs.[37]

5.2 Innovative Financing Tools

The Addis Ababa Action Agenda advocates for countries to use their own national development strategies and plans to respond to the SDGs. It calls for the adoption of INFFs to support cohesive, nationally owned sustainable development strategies, reiterating that each country has the primary responsibility for its own economic and social development, poverty eradication and sustainable development. This implies that countries may need to reshape thinking about

31 Asia-Pacific Economic Cooperation 2017, p. 23.
32 Tal and Nicholas 2016.
33 Mao, Zhang and Li 2017.
34 Vireak 2021.
35 UNDP 2019.
36 UNDP 2020a.
37 UNDP 2020b.

development finance to respond to the SDG challenge of achieving inclusive and sustainable economic, social and environmental development. The United Nations has devised tools to respond to the growing demand among countries to understand and manage the increasing complexity of national and international financing sources.

Public-private partnerships

PPPs are a mechanism for a government to procure and implement public infrastructure and/or services using the resources and expertise of the private sector. In cases of ageing or absent infrastructure or inefficient services, a partnership with the private sector can help foster new solutions and attract finance.

PPPs combine the skills and resources of both the public and private sectors through sharing risks and responsibilities. Governments benefit from the expertise of the private sector and can focus on policy, planning and regulation by delegating day-to-day operations.

A successful PPP requires careful analysis of long-term development objectives and risk allocation. The legal and institutional framework needs to support this model for service delivery, and provide effective governance and monitoring mechanisms. A well-drafted PPP agreement should clearly delineate risks and responsibilities.

In Cambodia, the Private Sector Development Steering Committee acts as a substeering committee on decisions related to private participation in infrastructure and sets a policy framework for developing PPPs. It is chaired by the MEF. Since 1990, 32 PPP projects have reached financial closure with a total investment of $4.3 billion.[38] Currently, 31 active PPP projects have investment of $4.3 billion.[39] The majority of projects are in the electricity sector, including renewable resources such as solar, hydropower and biomass. Achieving sustainable development requires ongoing emphasis on climate-resilient, sustainable infrastructure as well as economic diversification plans.

Bonds and SDG bonds

Bonds are issued by governments and corporations to raise funds. They are typically issued for the long term with low risk, especially when backed by governments. Throughout the industrialized world, bonds have been effective in raising capital for many years. With $6.7 trillion in annual issuance, they can provide a cheap, reliable and scalable source of capital for a variety of stakeholders involved in the 2030 Agenda, including companies, governments, cities and PPPs. A diverse portfolio of SDG bonds, encompassing sovereign, municipal, corporate and project bonds, across developed and emerging markets, could fulfil mainstream investors' growing demand for impact while matching their risk-return appetite.

Currently, only corporate bonds are listed on the Cambodia Securities Exchange, but the Senate recently approved the Draft Law on Government Securities to allow the Government to issue bonds on the capital market for national development.[40]

Impact investment/impact bonds

Impact investment is defined as "investments made into companies, organizations, and funds with the intention to generate a measurable social and environmental impact alongside a financial return."[41] Impact investment has three guiding principles:

1. Impact investors expect to earn a financial return on the capital invested, below the prevailing market rate, at the market rate or even above it;

2. In addition to a financial return, impact investors aim to achieve a positive impact on society and/or the environment; and

3. Impact investors commit to using standardized metrics to measure performance on the intended social and environmental impacts.

Impact investment is not limited to a specific asset class or sector. It includes, for example, fixed income, venture capital, private equity, and social and development impact bonds. Private equity and private debt are the most common products, while social and development impact bonds take the largest share in value terms.

Impact bonds are outcome-based contracts. They use private funding from investors to cover the upfront capital required to set up and deliver a service that

38 PPP Knowledge Lab 2017.
39 Ibid.
40 Kunmakara 2020.
41 UNDP 2021b.

can achieve measurable outcomes specified by the commissioner. The investor is repaid only if these outcomes are achieved. For social impact bonds, the outcome payer is the government, which represents the target group. For development impact bonds, the outcome payer is an external donor such as an aid agency of a government or multilateral agency, or a philanthropic organization.

Impact investors often, but not exclusively, invest in innovative businesses and enterprises in sustainable agriculture, affordable housing, health care, energy, clean technology and financial services for the poor.

According to the Global Impact Investing Network, Cambodia has garnered around $400.9 million from 37 deals with private impact investors. Such investors deployed almost as much capital in Cambodia as in Indonesia, the Philippines and Viet Nam combined, likely due to Cambodia's open, dollarized economy. The financial services sector, specifically microfinance, accounts for almost all private impact investor deals and capital deployed in Cambodia, mostly since 2013. Unfortunately, sectors such as energy, agriculture and services have received limited investment.[42]

Public guarantee schemes

A guarantee scheme is an assurance by a guarantor to a beneficiary that the former will pay the latter a specified amount in the event of a specified default by an obligor. Generally, this financing instrument covers lenders or bond investors against payment defaults by a borrower. Its characteristics of sharing risks and freeing financial institutions' balance sheets make lending possible and more attractive. The guarantees can replace collateral to allow access to commercial lending and expand available credit. Public guarantee schemes secure financing or improve the terms of financing for borrowers, reduce losses to beneficiaries (usually creditors) in the event of a default, support long-term financial stability and enhance the credit quality of the borrower or project. For governments, the schemes demand less funding compared to loan programmes, and can leverage multilateral and bilateral support for the fiscal and macroeconomic framework. They also facilitate access to commercial funding. The objective of the schemes is to catalyse lending to priority sectors or classes of borrowers, such as SMEs, low-income households or green investments.[43]

Four key elements characterize the schemes. First, the extent of loss coverage can vary from a full to a partial amount of the potential loss. Second, the schemes may protect lenders against default regardless of the cause or only defaults arising from specified events. Third, the range of coverage can be individual (bond issuance), portfolio (a bank credit facility for SMEs) or a class of investment meeting certain requirements (such as home mortgages). Finally, the guarantor levies a guarantee fee that may depend on the creditworthiness of the creditor. Options are a one-time or annual fee, or a blend of both; a percentage of the underlying loan amount; and/or a percentage of the guaranteed portion of the loan.

The Credit Guarantee Corporation of Cambodia was established in September 2020 with $200 million in registered capital from the Government. Its tasks are, among others, to provide credit services, evaluate and manage risks, and cooperate with banks, financial institutions and development partners that also provide credit services. The guarantee coverage is 80 percent of the loan principal amount for agriculture and industry, and 70 percent for services and non-priority sectors.

Unclaimed property legislation

With unclaimed property legislation, unclaimed assets of dormant bank accounts are released to fund social purpose activities. This policy was fully enforced in Japan in 2019 to withdraw funds from bank accounts inactive for 10 years or more. The State-owned Deposit Insurance Corporation of Japan receives funds and distributes them to newly created private entities under government monitoring. The entities select regional and community foundations and allocate the funds through grants, loans and investments for projects by local civic groups. Between $440 million and $525 million is expected to be mobilized each year to build social investment and target priority issues.

One downside of such a policy is that it might work more effectively in more advanced economies. Feasible implementation in Cambodia might be over the longer term. Three lessons come from the experience in Japan and other countries with similar legislation. First, the impact measurement should be rigorous in assessing outputs or inputs within target sectors, ensuring they are financially and socially impactful. Second, more consideration has to be extended to the compliance of the banking sector. Third, robust and transparent

42 Mudaliar, Bass and Dithrich 2018.
43 UNDP 2021c.

fund management processes are required along with mechanisms for preventing conflicts of interest and guaranteeing adequate oversight.[44]

Enterprise challenge fund

Established by a public entity, foundation or development partner, an enterprise challenge fund gives grants in small but effective amounts to private sector projects deemed socially or environmentally worthwhile. Risk-sharing subsidies—private firms also contribute their own resources—encourage the private sector to innovate while lowering the risks and costs of investment. The private sector leads the design, co-financing and implementation of solutions, which are selected through a competitive process. Projects should have a commercial focus and strong scope for innovation. An enterprise challenge fund is suitable when the private sector is expected to do better in solving a development challenge or a market failure exists in the financial sector for servicing inclusive businesses and/or innovative enterprises.[45]

Enterprise challenge funds are not new for Cambodia. The Enterprise Challenge Fund for the Pacific and South East Asia was a six-year (2007-2013) pilot grant fund backed by the Australian Government that provided $11 million to 21 projects in eight countries. Four projects in Cambodia were funded with $2.6 million in total. Estimated benefits to the poor over five years reached $5.6 million. The Government supports other challenge funds, and the MEF has called for challenge fund service providers for a project on sustainable assets for agriculture markets, business and trade. It aims to improve productivity among rural youth, enterprises and the broader rural economy.[46]

5.3 Green, Blue and Climate Change Financing

BIOFIN

Biodiversity finance entails raising and managing capital and using financial incentives to support sustainable biodiversity management. It includes private and public financial resources to conserve biodiversity, investments in commercial activities that produce positive biodiversity outcomes, and the value of transactions in biodiversity-related markets such as habitat banking. Currently, biodiversity financing sources are mostly derived from public funds, in particular domestic public budgets, biodiversity-positive agricultural subsidies and international transfers of public funds.[47]

The Biodiversity Finance Initiative (BIOFIN) is a UNDP-managed global collaborative partnership to develop and implement an evidence-based methodology that improves biodiversity outcomes using finance and economics. The Biodiversity Financial Needs Assessment is one of the components of BIOFIN. It is an attempt to estimate the financial resources required to achieve biodiversity targets set by a country in a methodical and comprehensive manner. The BIOFIN Workbook[48] provides a descriptive guide to assessing the financial needs of a country and recommends that the analysis cover both national and subnational biodiversity targets.

UNDP estimated that Cambodia in 2018 needed around $301 million to achieve the goals of the National Biodiversity Strategy and Action Plan and biodiversity conservation.[49] Total biodiversity expenditure (without the recurrent budget) was approximately $165 million that year, however, indicating a finance gap of $136 million. This estimation tracks the 24 themes of the national plan to define the largest budgets for implementation as well as responsible ministries and institutions.

Estimating biodiversity conservation finance needs assists in devising a plan to generate new resources and/or improve the allocation of existing resources. It also highlights issues surrounding biodiversity conservation and the importance of investing in biodiversity as crucial for sustainable development. Significant economic returns come from healthy ecosystems and ecosystem services.

Green and blue bonds

Green and blue bonds are similar to conventional bonds but commit the issuer to invest proceeds exclusively in green projects that generate climate or other environmental benefits, such as renewable energy,

44 UNESCAP 2017a.
45 UNDP 2018b.
46 MEF 2021.
47 BIOFIN 2017.
48 UNDP 2018a.
49 UNDP forthcoming.

energy efficiency, sustainable waste management, sustainable land use, biodiversity, clean transportation and clean water. There has been exceptional growth in green bonds in recent years, which were up by 50 percent between 2018 and 2019 alone, reaching a total global issuance of $259 billion. The Climate Bonds Initiative reports a range of green-related financial instruments used in combination with green bonds, including asset-backed securities, corporate bonds, project bonds, bonds issued by international financial institutions, municipal bonds, and sovereign bond and loans.[50]

Strong growth in green bonds in ASEAN saw issuance almost doubling in 2019 alone, adding $8.1 billion to the regional total. The Climate Bonds Initiative reported a cumulative $13.4 billion in green bond issuance in ASEAN by the end of 2019. Six out of the 10 countries have issued green bonds, with Singapore emerging as the regional leader in the green finance market, issuing $4.4 billion in green bonds in 2019, up fourfold from 2018.[51] In Thailand, two renewable energy companies recently issued green bonds certified under the Climate Bonds Standard, while in the Philippines, seven new green bonds, mostly for renewable energy, were issued as the Government sought to integrate a new sustainability financing roadmap.[52]

Cambodia's bond market is still in its infancy with only seven corporate bonds listed on the Cambodia Stock Exchange. The issuance of government bonds signals the deepening of the domestic capital market and establishment of a risk-free benchmark for pricing locally issued corporate bonds. Cambodia has also recently taken some key steps towards expediting the introduction of green bonds. In 2019, the Association of Banks in Cambodia signed a memorandum of understanding with the United States Agency for International Development's Green Invest Asia to establish national risk management and sustainable finance principles. This could open the door for banks to set up institutional structures for green finance. The principles are generally aligned to the 2017 green bond standards from the ASEAN Capital Market Forum.

Corporate social responsibility law

CSR investment can be unlocked through various policies to align funds to solving social and environmental challenges. The Government should promote CSR but also encourage the private sector to move beyond conventional notions of it so that social and environmental values become integral to business strategies. This will generate more positive impacts on society, the environment and SDG achievement.[53]

Although the concept of CSR has been discussed and implemented among some private sector firms in Cambodia, it remains largely unknown to local businesses as the private sector is still in the early phases of development. The philanthropic nature of CSR in some companies has limited their actions to supporting scholarships and community work, donating to charities and sponsoring sports events.[54]

Transforming CSR into an obligation is one option for new financing. In India, a CSR law directs companies with a certain turnover and profitability to spend 2 percent of their net profit on addressing social and environmental challenges. This increases private financing[55] particularly for poverty reduction, education, health, environmental sustainability, gender equality and vocational skills development, all of which are core to the SDGs. For Cambodia to adopt a similar law, the Government would need to clearly indicate the firms subject to it, areas and activities to be supported, conditions for spending and enforcement mechanisms.

50 UNDP 2016.
51 Climate Bonds Initiative 2020.
52 UNDP 2021a.
53 UNESCAP 2017b.
54 Chhabara 2008.
55 UNESCAP 2017b.

CHAPTER

06

Discussion and Policy Recommendations

This chapter captures the main findings from the DFA to frame a policy discussion around Cambodia's development financing needs. In line with the DFA approach, which is focused on the medium term, the chapter adopts a five-year time horizon. But in light of the COVID-19 crisis, it first pays attention to immediate resourcing issues.

6.1 Key Conclusions

In the near term, the pandemic has had a profound impact on Cambodia's overall financing position. All resource flows except ODA have been negatively affected, but public sector resources are especially challenged. The situation is serious enough to merit an emergency response to public financing and rapid policy changes for private sector flows to support businesses and protect value chains.

On estimated COVID-19 impacts, key findings include:

- Financing available to support development is expected to double to $23.4 billion, accounting for 69.8 percent of GDP by 2025.
- The total loss in all flows due to COVID-19 in 2020 was an estimated $3.6 billion or 19.8 percent of GDP. This is broken down as: public revenues $1.5 billon, FDI $1.3 billion, domestic private sector flows $410 million, and remittances $330.9 million.
- Public revenues are in steep decline, due to the rapid fall in economic activity, particularly trade and the purchase of high-value imports. This is set to drive a considerable increase in the budget deficit.
- Given the absence of domestic borrowing instruments, the Government faces an acute deficit financing challenge.
- Private sector flows, and especially FDI and domestic flows, are also estimated to have declined very substantially. There is a risk of a credit squeeze on domestic and foreign-owned enterprises. It is vital to secure access to investment to deliver liquidity and enable key sectors to reinvest and promote reopening and recovery.
- The crisis presents challenges for remittance flows, which are set to decline given closures in host economies. This will have microeconomic consequences, given that these flows support domestic consumption.
- There are overall risks to financial stability, given the high level of dollarization and the lack of monetary instruments, a lender of last resort and deposit protection insurance.

In the medium term, the patterns depicted in the previous DFA continue, albeit with some important distinctions revealed by finer disaggregation and more sophisticated projection methods.

- Foremost, linking to the crisis, a rapid return to previously strong growth in flows is unlikely. Trends may take a minimum of two to three years to re-establish themselves, depending on progress in ending the pandemic. This implies continued financing pressures for both the public and private sectors.
- In the medium term at least, further increases in private sector flows, especially FDI, can be anticipated. Yet crucially, this will also depend on recovery at the global and regional levels, and Cambodia's post-COVID-19 trade performance.

- While it is vital to restore the level of investment, it is also important to pay attention to the quality of flows, their sectoral composition and purposes, and their sources.

- ODA continues to decline in relative terms, yet its absolute value, especially through concessional lending, will remain significant, having grown in real terms in recent years. Its composition has and will continue to evolve, however, favouring loans over grants. The level of loan concessionality will decline as Cambodia progressively exits preferential terms.

- Public sector domestic revenues will recover slowly as the crisis abates, although solid growth is expected to return. In time, recurrent revenues will reach ceilings as a proportion of GDP, and then record GDP equivalent growth.

- Given this, and the decline in ODA, it is vital that the Government establish mechanisms for long-term sovereign borrowing in domestic currency.

6.2 Policy Responses

In **the near term**, the impact of the pandemic on financing flows requires that Cambodia rapidly find new sources of finance for both the public and the private sectors, in as strategic a manner as possible, protecting ongoing stability and future productive potentials. Given the emergency, some immediate choices may be suboptimal from a longer-term perspective.

- Strengthen revenue collection capacities and mechanisms, for example, through the Tax Inspectors Without Border to make sure multinationals and other large companies are getting their fair share of tax.

- Accelerate expansion of domestic lending instruments – bond issuance in Khmer Riels would also help to de-dollarize the economy, reduce crowding out effect in the banking sector and expand monetary policy options for Cambodia.

- Restore the level of FDI and private domestic investment through credit guarantees to firms, especially SMEs, and examining the use of tax concession to boost FDI and domestic investment. Offering credit guarantees to firms, especially SMEs, and earmarked lines of credit to private sector lenders to ensure ongoing access to finance.

- Realign expenditures, in favour of pro-poor economic growth, such as investment in social protection which has proven an effective way to prevent people from sliding back into poverty but also to stimulate the economy.

- Further building official US dollar reserves by extending existing de-dollarization efforts by the NBC. This might include further measures to withdraw smaller US dollar bills from circulation, the roll-out of KHR-based bank deposit insurance, and increasing commercial banks' KHR-denominated reserve requirements.

- Providing emergency (public) finance to certain key businesses, notably those in the finance sector, to secure financial stability and ongoing lending. Moreover, consider extending these facilities to other major enterprises in the most COVID-19 affected sectors, such as construction, tourism and garments, where a commercial lending case can be established.

- Maximizing ongoing remittance flows by easing constraints on electronic transfers, and working with host governments to promote regularization of transfers.

In the medium to longer term, the DFA predicts that a finance transition will continue to take place in Cambodia. It has two dimensions: vast growth in private sector financing and a shift in public flows from international to domestic. The DFA concludes that new approaches, policies and institutional adaptations are needed to respond to these changes. These must be underpinned by national leadership and aimed at delivering ongoing growth in investment required to achieve the ambitious development objectives in the national Vision 2050, and the medium-term Rectangular Strategy Phase IV and NSDP. The management of a wider set of flows, especially private sector ones, requires different approaches focused on facilitation and influencing actions, over regulation and direction.

The Integrated National Financing Framework initiative developed by the United Nations offers a useful template for moving forward by providing a holistic approach encompassing all resource flows, and linking their management to achieving the SDGs. This initiative and resources allocated under it can help further develop Cambodia's existing strategic financing arrangements. Specifically, the following steps are recommended.

- Consider implementation of sin taxes to gambling, tobacco and alcohol, as well as other taxes with social and environmental positive externalities, that not only increase revenue collection but also avoid future public expenditures such as provision of health services. Sin taxes seek to deter people from engaging in socially harmful activities and behaviours but also provide a source of revenue for governments. For instance, as indicated earlier in increase of tobacco tax to 75 percent of the retail price could help the government collect additional revenues of $45.8 million per year and could reduce the mortality due to tobacco-related diseases in Cambodia which stands at 15,000 deaths annually.

- Further implementation of blended finance to increase efforts to deliver governance of increasingly varied capital resource flows, in particular to raise private investment in the achievement of Cambodian SDGs. The development of new blended modalities of finance can maximize the potentials of private sectors flows in achieving broader developmental objectives, including the CSDGs. These models involve pooling finance from public and private investors (and from ODA and other actors). One promising innovation for Cambodia is impact investing, where blended finance capital is invested in commercial projects with social and/or environmental gains. As this modality is underdeveloped, major gains can be made with minimal investments.

- Engage in innovative, green and climate change financing mechanisms, such as green or SDG bonds, impact investment and Bio-Fin to expand sources of financing for development. These bonds can commit the issuer to invest proceeds exclusively in green projects that generate climate or other environmental benefits, such as renewable energy, energy efficiency, sustainable waste management, sustainable land use, biodiversity, clean transportation and clean water. They can provide a cheap, reliable and scalable source of capital for a variety of stakeholders involved in the 2030 Agenda, including companies, governments, cities and PPPs.

- Improved data and analysis, and supporting analytical capacity are also needed. This DFA and its databases and analyses represent a key base input. But going forward, additional evidence and capacity building on analysis and interpretational skills will be necessary. This extends to public financial management tools such as the national chart of accounts and budgeting practices, and the quality of the System of National Accounts.

- Expanded efforts should be made to govern increasingly varied capital resource flows. This implies strategic changes and adaptations under a lead agency, presumably the MEF, which would take overall responsibility for wider financing issues. Such efforts must be linked to delivery and further national development as defined in the Government's wider strategic policy stance, namely, the Rectangular Strategy Phase IV, the Industrial Development Plan and the NSDP.

- Enabling the issuance of sovereign bonds can accelerate development of the private capital market. By specifying a de facto risk-free rate and a foundation for long-term monetary policy, this has the potential to greatly expand the scope and depth of markets, but will require complementary reforms, including, improved prudential regulation of market actors via the Cambodia Securities and Exchange Commission; the formation of secondary bond and repurchase markets in concert with private sector intermediaries; and an expansion of the role and capacity of the NBC and its tools to grow private investment.

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