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Strengthening Accountability to Reduce Poverty

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Abbreviations and Acronyms

ADD:	<i>Accelerated District Development.</i>	NGO:	<i>Non-Governmental Organization.</i>
ADESS:	<i>Agricultural Development Support to Seila.</i>	NPRS:	<i>National Poverty Reduction Strategy.</i>
ADHOC:	<i>Cambodian Human Rights and Development Association.</i>	NPV:	<i>Net Present Value.</i>
APR:	<i>Annual Progress Report.</i>	NT:	<i>National Treasury.</i>
ASEAN:	<i>The Association of Southeast Asian Nations.</i>	ODA:	<i>Official Development Assistance.</i>
ATC:	<i>Agreement on Textiles and Clothing.</i>	OECD:	<i>Organization for Economic Co-operation and Development.</i>
BMOs:	<i>Business Membership Organizations.</i>	PAP:	<i>Priority Action Program.</i>
BOT:	<i>Build-Operate-Transfer.</i>	PBC:	<i>Planning and Budgeting Committee.</i>
C/SC:	<i>Commune/Sangkat Council.</i>	PCB:	<i>Permanent Coordinating Body of the Council for Legal and Judicial Reform.</i>
C/SF:	<i>Commune/Sangkat Fund.</i>	PDRD:	<i>Provincial Departments of Rural Development.</i>
C/SF Board:	<i>Commune/Sangkat Fund Board.</i>	PIF:	<i>Provincial Investment Fund.</i>
CAR:	<i>Council for Administrative Reform.</i>	PIP:	<i>Public Investment Program.</i>
CDC:	<i>Council for the Development of Cambodia.</i>	PIUs:	<i>Project Implementation Units.</i>
CDRI:	<i>Cambodia Development Resource Institute.</i>	PFM:	<i>Public Financial Management.</i>
COM:	<i>Council Of Ministers.</i>	PLUAC:	<i>Provincial Land Use and Allocation Committee.</i>
CPIA:	<i>Country Policy and Institutional Assessment.</i>	PLUP:	<i>Participatory Land Use Planning.</i>
DDC:	<i>District Development Committees.</i>	PMATU:	<i>Poverty Monitoring and Analysis Technical Unit.</i>
DFW:	<i>The Department of Forestry and Wildlife.</i>	PPEM:	<i>Participatory Public Expenditure Management.</i>
DISHA:	<i>Development Initiatives for Social and Human Action.</i>	PPI:	<i>Private Provision of Infrastructure.</i>
FBC:	<i>The National Assembly's Finance and Banking Committee.</i>	PT:	<i>Provincial Treasury.</i>
HIPC:	<i>Highly Indebted Poor Country.</i>	RS:	<i>Rectangular Strategy.</i>
HRMIS:	<i>CAR's database.</i>	SARS:	<i>Severe Acute Respiratory Syndrome.</i>
IFAPER:	<i>Integrated Fiduciary Assessment and Public Expenditure Review.</i>	SCM:	<i>Supreme Council of the Magistracy.</i>
MDGs:	<i>Millennium Development Goal.</i>	SEDPII:	<i>The Second Socio-Economic Development Plan.</i>
MEF:	<i>Ministry of Economy and Finance.</i>	SFMPs:	<i>Strategic Forest Management Plans.</i>
MFA:	<i>Multi Fiber Agreement.</i>	SWIM:	<i>Sector-Wide Management.</i>
MFU:	<i>Municipal Forest Unit.</i>	TA:	<i>Technical Assistance.</i>
MoE:	<i>Ministry of Environment.</i>	TWGs:	<i>Technical Working Groups.</i>
MOE:	<i>Ministry of Education.</i>	VAT:	<i>Value Added Tax.</i>
MOH:	<i>Ministry of Health.</i>	VDCs:	<i>Village Development Committees</i>
MOI:	<i>Ministry of Interior.</i>		
MPTC:	<i>Ministry of Post and Telecommunications.</i>		
NAA:	<i>The National Audit Authority.</i>		
NCSC:	<i>The National Committee to Support the Communes/Sangkats.</i>		

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ABSTRACT

1. The Government of Cambodia has just adopted the Rectangular Strategy for Growth, Employment, Equity and Efficiency in Cambodia. This Strategy rightly describes governance as the “most important pre-condition to economic development” in Cambodia. The agenda for the up-coming Consultative Group Meeting on December 6-7, 2004 is designed around the Rectangular Strategy and the discussions at the CG Meeting will focus on the critical policies and investment that are needed to attain the vision for a more prosperous and better governed Cambodia that is laid out in this Strategy.

2. This Brief for the CG Meeting focuses on the key governance challenges facing Cambodia and aims to provide an analytical foundation for facilitating the debates and discussions on these issues at the upcoming CG Meeting. The Report *Cambodia at the Crossroads* argues that it will take more than the policies set out in the Rectangular Strategy to transform governance in Cambodia so that it is supportive of and not destructive to the development process. What is needed is a concerted effort to strengthen, and in many cases to build from scratch, the foundations of a modern chain of accountability. Such a reform effort will necessarily take a long time to implement, far longer than the life of Cambodia’s third Parliament. But if the current trends in governance can be reversed, and if the foundations are laid in a few key areas for enhancing accountability, a good beginning will have been made and strong signals sent to all players in the economy that the rules of the game are changing.

3. The Report includes an Overview followed by six chapters. The Overview provides a brief account of recent progress in Cambodia’s development efforts. It then sets out to describe Cambodia’s system of public accountability and analyzes why it breaks down at such cost to its poor and vulnerable. It provides a framework for examining how citizens can hold service providers accountable for better service delivery, both through the long route of accountability via politicians that they have elected who in turn hold the service providers accountable, and through the short route of accountability where they organize themselves to demand better services from civil servants and other service providers. It examines the role of various institutions such as the National Assembly, the judiciary, the press, NGOs and other civil society organizations in strengthening these chains of accountability.

4. The rest of the Report is organized as follows. Chapter 1 provides an IMF staff assessment of Cambodia’s recent economic performance and medium-term prospects drawing on the IMF’s recent Article IV Consultations. Chapter 2 examines why Cambodia’s poor do not benefit from public spending. It commends the Government for designing a comprehensive public financial management reform program to address this challenge and stresses the need for speedy implementation of the agreed reform program. Chapter 3 argues that deconcentration and decentralization can improve the

lives of ordinary citizens if focused on better service delivery by increasing participation, amplifying voice and enhancing transparency, and shortening the chain of accountability from local communities to their government. It argues that while some progress has been made on decentralization, deconcentration of state functions has made very little progress. A vision for the next steps for both decentralization and deconcentration is currently being developed. Chapter 4 tackles the tough subject of natural resources management and argues that despite the abundant natural resource endowments of Cambodia, these resources are not being used for the benefits of Cambodia's citizens, especially its poor. A more inclusive, transparent and accountable system of natural resource management is urgently needed in Cambodia. Chapter 5 describes the challenges of governance facing the private sector in Cambodia. It argues that urgent action is needed to reduce the costs of business so that the 6-7% growth that is needed for job creation and poverty reduction can be maintained in the medium-term once the garment quotas are removed at the end of 2004. Finally, Chapter 6 focuses on governance issues surrounding the effectiveness and management of aid provided to Cambodia. It argues that while there has been some improvement in 2004, donor practices in Cambodia still have considerable scope for improvement if donors are to become part of the solution rather than part of the problem in Cambodia. In particular, levels and composition of aid need to be better related both to Government priorities but also to Government performance.

Cambodia: At The Crossroads Overview

“Good governance is the most important pre-condition to economic development with sustainability, equity and social justice. Good governance requires wide participation, enhanced sharing of information, accountability, transparency, equality, inclusiveness and the rule of law. Good governance requires that corruption be reduced to the minimum, the views of minorities and the voices of the most vulnerable in society be fully heard and considered in decision-making processes.”

-The Rectangular Strategy 2004-The Royal Government of Cambodia.¹

1. The Consultative Group for Cambodia meets at a critical juncture in the nation’s history. A new government has taken charge following a prolonged hiatus after the July 2003 elections. The delay has proved costly in terms of the lost momentum to much needed reforms. But the process has nevertheless resulted in the emergence of a Rectangular Strategy (RS) reflecting agreement between the coalition partners and is characterized as the new Government’s “action plan for the next four years”.² The new strategy has four key goals: economic growth, employment generation, improved governance and accelerated implementation of reforms in all sectors to “reduce poverty and achieve sustainable development.” Good governance is seen as the heart of the strategy.
2. The Rectangular Strategy must be welcomed as an early sign that the new government is committed to a process of reforms. Such reforms could within the space of a generation transform the prospects for two-thirds of Cambodia’s population that lives on less than \$2 a day. The substantial additional wealth creation will also help meet the rising expectations of a population that increasingly demands more than just the physical security that peace has bought. The Strategy is also entirely right in describing governance as the “most important pre-condition to economic development” and it is indeed encouraging that the government sees this as the core of its strategy. That is why this Brief for the Consultative Group focuses on the key governance challenges facing Cambodia.
3. It will however, take more than the policies set out in the Rectangular Strategy to transform governance in Cambodia so that it is supportive of and not destructive to, the development process. What is needed is a concerted effort to strengthen, and in many cases to build from scratch, the foundations of a modern chain of accountability. Such a reform effort will necessarily take a long time to implement, far longer than the life of Cambodia’s third Parliament. But if the current trends in governance can be reversed, and if the foundations are laid in a few key areas for enhancing accountability,

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a good beginning will have been made and strong signals sent to all players in the economy that the rules of the game are changing.

4. This chapter provides a brief overview of recent progress in Cambodia's development efforts. It then sets out to describe Cambodia's system of public accountability and analyzes why it breaks down at such cost to its poor and vulnerable. It concludes with an overview of five key reform areas that would make a substantial impact on growth and poverty. Moving decisively on a governance agenda that is firmly grounded in a broader poverty reduction strategy, it is argued, will potentially create a strong positive momentum for poverty reduction.

A. Background

Cambodia has made impressive gains, but faces serious challenges

5. Cambodia's post-conflict record is a mixed one. On the one hand, there has been some remarkable progress in a number of dimensions. Three peaceful and apparently fair elections have been held. Peace and stability and a precious sense of normality have been restored. The institutions of government have resumed functioning. Democratic institutions are emerging. The web of civil society is spreading, and an undeveloped media is beginning to exercise its newly won freedoms. With the recent commune-sangkat elections, a tentative but impressive effort to spread democracy to local governments has begun.

6. On the economic side, the country has until recently enjoyed strong, if imbalanced growth. Preferential access to the US garments market, has led to a substantial increase in Cambodia's exports. The boom in garments exports, the revival of tourism, the substantial aid Cambodia has received, and the recovery from conflict have contributed to a 6.7% per annum average growth rate between 1994 and 2002. Macro-economic stability has been maintained through fiscal discipline and a modest but improving revenue effort. On the external front, Cambodia's recent entry into the World Trade Organization (WTO) is yet another sign of the country's return to the world stage. Structural reforms in the early years of the last government have contributed significantly to this relatively strong performance.

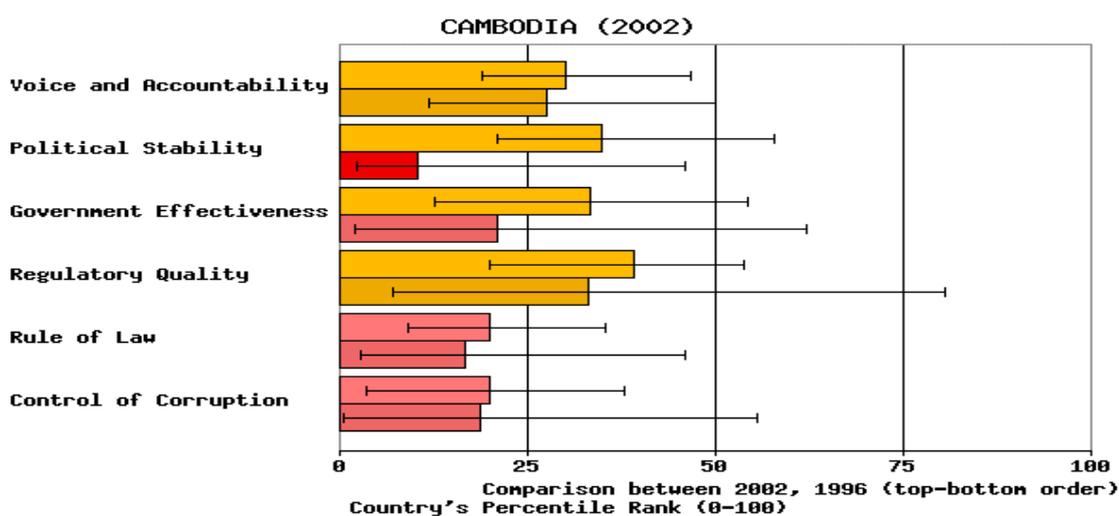
7. These favorable developments mask three serious challenges the new government faces. First, growth is seriously threatened in the short to medium term. The IMF estimates that growth could fall precipitously in 2005 to 2% recovering gradually to 6-6.5% only by 2009 and only then provided the government presses ahead with reforms that improve competitiveness and the climate for investment. The deceleration in growth reflects slow progress on structural reforms in recent years, and the elimination of the quota system under the Multi Fiber Agreement at the end of 2004, which will expose Cambodian exporters to severe competition from more competitive

producers. There is thus an urgent need to accelerate governance and structural reforms.

8. Second, income poverty levels are high (around 40%) and stagnant. The labor market is also failing to absorb most of the 200,000 new entrants annually entering the labor force. For non-income poverty, the story is mixed. Cambodia appears to be off track to meet most of the Millennium Development Goals. Food security is lagging: at 36%, the proportion of people suffering from hunger is far from the 2015 target of 19.5%. Child mortality has increased over the past 10 years particularly post-neonatal mortality. The main causes have been diarrhea, acute respiratory infections, and vaccine preventable diseases, particularly measles where the coverage rate of immunization is only 59%, well-below the 2015 target of 90%. Despite progress, the maternal mortality rate (MMR) remains extremely high at around 437 per 100,000 live births. Health and sanitary conditions are very poor: only 30% of the population has access to safe drinking water and only 17% has access to sanitation facilities. Cambodia could achieve primary education for all by 2015, but is unlikely to reach its secondary education and gender equality targets.³

9. Third, governance as the government recognizes, remains a serious challenge. Perception based data (Figure 1) show some improvement in all governance indicators between 1996 and 2002, although the margins of error are too high to allow confidence about the direction of change. In two areas, though, control of corruption and the rule of law, Cambodia ranks among the bottom quartile of performers among all countries. Domestic surveys confirm that corruption is endemic and high.

Figure 1: Cambodia's Governance Indicators 2002 and 1996.



Source: D. Kaufmann, A. Kraay and M. Mastruzzi, 2003: Governance Matters III: Governance Indicators for 1996-2002 (<http://www.worldbank.org/wbi/governance/pubs/govmatters3.html>)

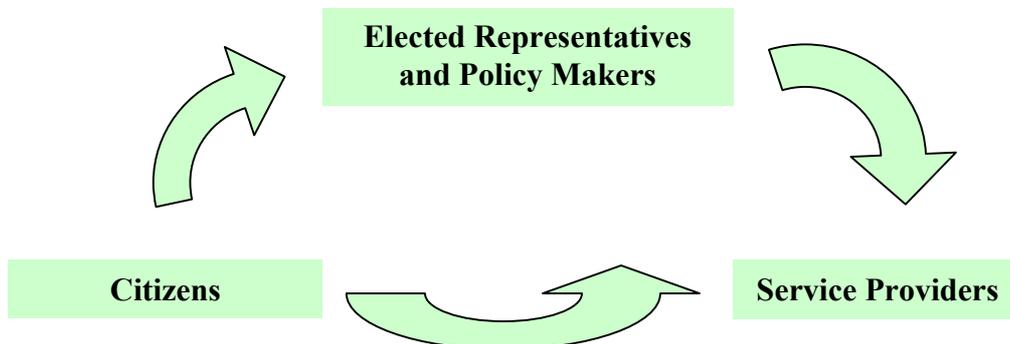
10. That corruption is not just a matter of perception is confirmed by a recent World Bank Investment Climate Assessment (World Bank, Cambodia: Seizing the Global

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Opportunity, 2004) where firms reported that payments to public officials are frequently, mostly, or always required. Of the 447 firms that answered the question on bribe payments, 82% (368) reported a positive level of bribe payments. The share of revenues consumed by such payments averaged 5%, more than double those found in parallel surveys in Bangladesh, Pakistan and China. Firms also reported that an average of 5% of the contract value was required to secure business with public agencies. Firms also perceived influence to be concentrated among certain privileged groups which dominate key sectors and have ties to political leaders, exercising substantial influence over national laws and regulations.

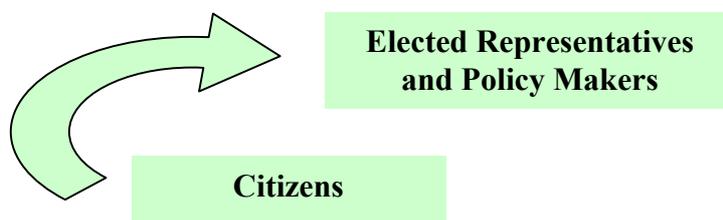
11. Weak governance and the failure to control corruption and enforce the rule of law underscore the country's limited institutional capacity, the lack of trust among the elite and strong resistance to reforms from powerful vested interests. These are the dark clouds from Cambodia's tragic past that have cast a shadow over what could be a bright future and that prevent the relatively young and weak institutions of restraint from working effectively to ensure accountability and transparency. How and why accountability breaks down is discussed next.

B. Cambodia's Governance and Accountability Framework



12. The Rectangular Strategy is unequivocal in committing the Royal Government of Cambodia to establishing a liberal democracy with respect for human rights, as enshrined in the country's sixth Constitution adopted in 1993 and amended in 1999. Like other democracies, Cambodia's framework of accountability, derived from the Constitution, is based on three key relationships of accountability: between citizens and the State; between the elected officials of the state and those responsible for delivering the essential services the state provides citizens; and between those who deliver services and the citizens who receive and consume these services.

Citizens and Elected Representatives/Policy Makers



13. The principle of the separation of powers and the need for executive power to be subject to legal restraints is established in the Cambodian Constitution. The principal instruments for such checks and balances are the National Assembly and the judiciary. Moreover, Government ministers and officials are individually and collectively accountable to the National Assembly for overall policy and individual conduct, as provided in Article 121 of the Constitution. Yet in the face of a powerful executive which tends to monopolize the policy making processes, both the legislative and judicial branches of government face severe challenges in performing their constitutional role.

14. Given that Cambodia’s democracy is rather young, it is not surprising that Members of the National Assembly face difficulties asserting their role vis-à-vis the Executive. Key constraints facing the National Assembly are little experience in drafting legislation or debating policies, late involvement of legislators in the analysis and review of proposed legislation, limitations imposed by political realities on the exercise of the National Assembly’s scrutiny and oversight functions and little knowledge and exposure to key development problems. The Secretariat to the National Assembly has limited resources and capabilities at its disposal. This contributes to poor services for parliamentary committees and individual members and lack of coordination between the House and the Senate. Moreover, loyalty to party appears to override loyalty to the constituencies that members of the National Assembly represent. Nor does the political platform of the Royal Government specifically discuss the role of the National Assembly in the oversight of the government’s economic programs and policies and of the national budget, though it does commit the Prime Minister and members of the Royal Government to “converse actively” with the National Assembly (Point #7).

15. The judiciary, the second principal source of restraint on the power of the executive, was decimated under the Khmer Rouge.⁴ The country’s judges either fled the country or were killed. From a legal profession of some 400-600 people prior to 1975, some 10 remained in the country five years later. The 1980s saw an effort to rebuild the judicial system, drawing on teachers and others to fill the posts of judges and prosecutors (Evan Gottesmann, 2002). But till today it remains largely devoid of legal talent. Only one in six of Cambodia’s 117 judges has a law degree, and only one of the nine Supreme Court judges. Only 10% of public prosecutors has a law degree. Thus the judiciary inherited by democratic Cambodia is ill-equipped to do its job, conditioned to being subservient to the executive branch, poorly paid and allegedly corrupt. The

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Supreme Council of Magistracy, a constitutional device aimed at ensuring the judiciary's independence and competence, is in urgent need of reform. The other components of the justice sector such as the police are also dysfunctional. What it would take to reform the judiciary, an issue that is high on the list of priorities of the Rectangular Strategy, is discussed later in this chapter.

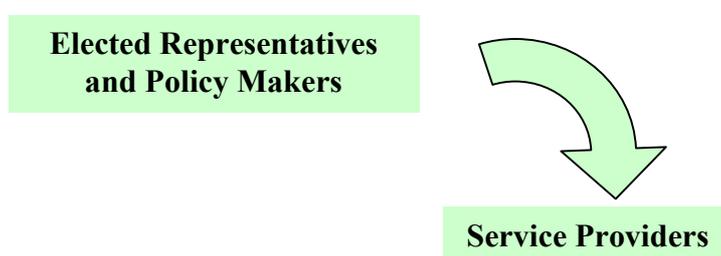
16. With parliament and the judiciary weak, Cambodians must rely on an underdeveloped media and civil society to amplify their voice and hold the executive accountable. A Law on Press Regime, enacted in 1995 guarantees press freedom, prohibits censorship, and guarantees the right to protect the confidentiality of sources. No prior licensing is required to publish a newspaper. The law however does restrict publication of reports that harm "national security or political stability" or "humiliate national organs". And journalists are vulnerable to legal prosecution for defamation or disinformation. This exposes the press to the risk of interventions by the government and opens the door to self censorship. Nevertheless the 10 or so newspapers that publish regularly appear to be relatively free. There is as yet no equivalent law for the broadcast media, which with 20 radio and 7 TV channels reaches far more people. Radio is particularly popular and an avenue for free speech. At the same time the press itself needs to be more responsible in terms of the accuracy and objectivity of its reporting. The media would therefore benefit from training in responsible investigative journalism, and self policing by media bodies may also be needed along the lines of a Press Council in other countries.

17. Civil society is growing rapidly, but it is far from effective in amplifying the voice of citizens and in particular the poor. Most indigenous NGOs are relatively young, inexperienced, and constrained by the familiar problems of collective action. There is little tradition of consulting NGOs prior to enacting an important law or developing a new policy, unless there is donor pressure for such consultations. Local NGOs rely on international ones to raise issues with government through their influence with bilateral donors. Heavy dependence on foreign funding tends to shift NGO accountability from the poor in Cambodia to foreign fund providers. The NGOs also need to practice what they preach by being responsible and ensuring that their management and finances are subject to the same degree of transparency and accountability that they demand of government. A law governing the operation of NGOs, proposed in the Rectangular Strategy, could potentially help ensure adequate accountability and transparency within the NGO sector. But such a law will need to satisfy domestic and international NGOs that it would safeguard NGO independence and would not be used by a government that resents their criticism of its policies to restrict their activities.

18. Most Cambodians today enjoy an unprecedented freedom to express their opinions. Civil protests are now common on a range of issues such as wages, corruption and electoral laws. Strikes have become more common as tolerance for poor management practices decreases and workers organize for collective action. These are

healthy trends although still rather tentative. Freedom of speech and dissent is not yet seen as a right but as something that is tolerated, with lack of clarity on the limits of such tolerance. Yet these new freedoms are an essential safety valve that create space for a healthier relationship between government and civil society and need to be encouraged. International experience shows that a free press, a vigorous civil society and a citizenry that is willing to hold its government accountable produces greater public accountability and improved public services. Recognition of this in the Rectangular Strategy can be seen in the invitation to civil society to be the government's partner in development and in the commitment to encourage the activities of NGOs.

Elected representatives/policy makers and service providers



19. In all governments, politicians are the primary policy makers, but to perform the main functions of the state, implement policies and deliver services they must delegate these functions to bureaucrats. This gives rise to what economists call the *principal-agent problem*⁵, the challenge of ensuring that the agents, the service providers to whom these functions are delegated actually undertake their responsibilities in the most economic and efficient manner. The *principal* must establish the rules which guide the bureaucracy through laws and regulations. They must then develop formal or informal “compacts” with the bureaucrats. In exchange for a given set of incentives, (salaries, allowances and other benefits) the bureaucrats are held accountable for undertaking tasks assigned to them. Accountability is enforced through a variety of means: internal checks and balances, (internal audits, ex-post program evaluation and reporting), formal channels for review of administrative decisions that affect the rights of individuals, and external restraints (the supreme audit agency, the proposed anti-corruption commission, freedom of information legislation and laws requiring disclosure of assets), and disciplinary action. Systems of accountability depend on the generation of adequate information on performance. When the compact breaks down, it typically results in corruption and poor service delivery. Corruption can either be administrative in nature, where civil servants derive rents during the implementation of policies, or it can involve the capture of the state by vested interests to influence laws, regulations and policies to their advantage. State capture usually involves corruption of the *principal*, i.e., the politicians, but it also usually requires collusion between the politicians and the bureaucrats who must help implement the corrupt policies or programs.

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20. In Cambodia, as we have seen above, corruption is endemic, reflecting a breakdown of the system of accountability. The compact between elected representatives/policy makers and service providers breaks down in several ways. First, the compact between politicians and civil servants is weakened by an inadequate legal framework that guides the behavior of civil servants and by the failures of enforcement. There is no modern civil, criminal, and commercial procedural code, nor an Anti-Corruption Law, though these are all being developed. Law enforcement officials and the courts, however, do not enforce the laws that do exist. Second, the state fails to ensure that civil servants have the capacity or the incentives to deliver the tasks assigned to them. Capacity is weak both in terms of skills and the resources to do the job. With the wholesale decimation of Cambodia's educated elite under the Khmer Rouge, the country has but a thin crust of well qualified and experienced public officials.

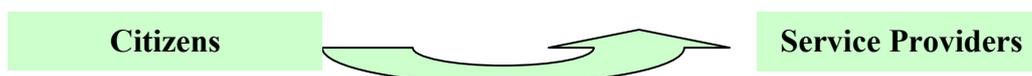
21. Incentives for civil servants are also perverse. Civil servants are poorly managed and underpaid, thus undermining their incentive to honor their side of the compact. Civil service salaries are ridiculously low. Category A employees with some 4 years of post secondary school education earn a paltry \$40 a month. The average civil service wage is only slightly more than the country's per capita GDP, one of the lowest in the region. The ratio of average pay of the highest to that of the lowest category is less than 2. Expenditure on direct service provision and maintenance is also pitifully inadequate.

22. Cambodia's low revenue effort, which offers opportunities for substantial improvement, contributes to this vicious cycle of corruption. Revenues are low in part because revenue collection is vulnerable to corruption. Lack of transparency in the private provision of infrastructure and land and other state property concessions reduces the amount of revenue that should be accruing to the Treasury. Low revenues in turn mean low wages and low service provision spending, which contributes to corruption. Cambodia's civil service needs to transition from the current patronage and network based system (Gottesman, 2002) in which powerful patrons manage their networks of loyal civil servants in a mutually dependent relationship to one that is merit based and professionally managed. The Rectangular Strategy commits the government to such a reform.

23. On the other hand, the systems of accountability are too weak to allow policy makers to check corruption even if they wanted to do so. Cash-based payment systems not only result in unpredictability in the release of budgetary allocations due to cash shortages, but when combined with deficient accounting and reporting systems, lead to a weak control environment and increasing opportunities for corruption. The institutions that exist to check such corruption, Parliamentary oversight and systems of internal controls of cash and financial management, do not function effectively. The systems of external accountability are underdeveloped. The national audit function is relatively new and the long proposed anti-corruption commission is yet to be established. Even without the severe capacity constraints that affect all institutions,

these agencies for external accountability are only likely to work in a political environment that respects their autonomy and is supportive of their functions.

Citizens and service providers



24. Cambodians deal with civil servants as service providers far more often than they deal with their elected representatives. From enrolling their children in school to attending a primary health care center, to obtaining a driving license or encountering the police, Cambodians see the public face of service delivery every day of their lives. Yet, while citizens should be able to directly hold officials accountable to them for the quality and efficiency of services they deliver, they have little authority or control over such officials. The culture of the bureaucracy is yet to become one where the bureaucrats see citizens as their masters and themselves as servants of the people. Further, a culture of transparency is needed among Cambodia’s civil servants where information held by them should be easily available to the public unless there is some overriding public interest stipulated in law that justifies secrecy.

25. In more mature democracies, citizens can enhance their leverage over the bureaucracy by organizing themselves through parents associations, religious organizations, or NGOs for instance. These are means of exerting pressure on the bureaucracy by enhancing voice and increasing the flow of information on the quality and efficiency of services they receive. In Cambodia, as we have seen above, NGOs are still relatively inexperienced and weak. The cost of organizing to protect common interests can be high. In a hierarchical society, efforts to organize can be viewed with suspicion and the poor may be afraid to speak out for fear of retribution. And information needed to monitor public officials is lacking. But if the government is serious about its commitment to work with civil society as a partner, it needs to encourage NGOs to organize communities and the poor, as well as monitor the performance of bureaucrats and service deliverers. There is considerable scope for a more systematic dialogue between citizens and service providers, facilitated by NGOs, which increases the latter’s service orientation. Access to information held by public authorities must be seen as the basis for citizens to participate effectively in formulating and implementing government policy and for informed public debate about the actions of government. A Freedom of Information Law could help bring about such a shift in culture.

Poverty and governance

26. The failures of accountability and transparency noted above, and the slow progress towards the rule of law represents a serious failure of governance for which Cambodia’s poor pay a heavy price. The poor suffer the most from physical insecurity

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and lack of access to justice. Poor governance weakens the ability of the state to deliver basic public goods: essential services that are crucial to the investments needed in the human capital of the poor. The poor are particularly helpless in the face of corruption. They depend disproportionately on public goods and are often unaware of what they are required to pay for public services, allowing the corrupt to trade on their ignorance. Poor governance also leads to inequality in land holdings which weaken future economic growth. It contributes to deforestation and misuse of the country's natural resources. But above all, corruption, inefficiency and the inability to enforce contracts and property rights combine insidiously to impose a high cost on domestic and foreign investors. Furthermore, this burden is also experienced by ordinary Cambodians who wish to make a living from agriculture, fisheries or trading. As a result private investment is deterred and economic growth is lower than it should be. With the impending decline in garments exports noted above, unless the government urgently addresses these governance issues, growth will decline and with it the ability of the country to reduce poverty significantly. Thus, though there are other factors that impact poverty, the government recognizes in the Rectangular Strategy that improved governance lies at the heart of the poverty reduction agenda.

C. Reform Priorities

27. The failure of accountability and governance described above is not untypical of countries undergoing simultaneous and complex transitions. Cambodia is transitioning:

- From a highly centralized and hierarchical governance, necessitated by the need to restore order and stability following years of conflict, to one where power is decentralized both vertically and horizontally;
- From a society dominated by networks and informal rules, to a society that is based principally on formal rules;
- From a state dominated but predominantly peasant based agricultural economy to a diversified market-based economy.

28. Such transitions are highly demanding on the political leadership of a country, because they require taking on powerful vested interests that are closely integrated in the country's power structure, and drastically changing the rules and incentives by which the country has been operating. Transition is further complicated by a weak and underpaid bureaucracy and fragile and corrupt institutions that reflect Cambodia's low income and least developed country status. On the other hand, the leadership has little choice. A continuation of the present state of affairs is not an alternative, since this at best will result in a deepening of poverty, and at worst could mean a slide back into an authoritarian and conflict-prone state.

29. Given the difficult reform environment, it is important that the government is highly selective and strategic; focusing on those areas where poor governance is

seriously impeding the country's development prospects. This report looks at a few such areas. Strengthening the chain of accountability in Cambodia will require strengthening checks and balances, in particular through a competent, honest, and independent judiciary. Judicial reform is also needed to restore investor confidence by enforcement of property rights and contracts. Urgent action is also needed to stop the plunder of the nation's financial and natural resources. This will require strengthening financial accountability and enhancing accountability and transparency in natural resource management, and through decentralization, bringing government closer to the people so they can better monitor its performance. Finally, a high priority is removing governance impediments to private sector growth and competitiveness, and hence to the diversification that is urgently needed in light of the threat to the country's garment exports. These areas of governance are firmly embedded in the Rectangular Strategy. In the case of public financial accountability, the government has already begun to implement a public financial management program. For the private sector, the government has developed an action plan to reduce the cost of doing business in Cambodia. Likewise, the Government has already done a great deal of homework on judicial reform and prepared short and medium term action plans. Similar strategy development processes are now beginning in the areas of decentralization and natural resource management.

30. The choice of these five areas is not intended to suggest that other governance areas are of less important. There are issues, such as the strengthening of the National Assembly or civil society that lie beyond the Bank's area of expertise, which are clearly important. Nor does this report suggest that governance is the only development challenge in Cambodia. But as is clear from the analysis above, it is increasingly an important precondition to growth and sustainable poverty reduction. Indeed the growing threat to Cambodia's growth prospects in the short to medium term arising from the projected deceleration of garment exports, which has driven much of the country's recent economic growth, and the close link between governance factors and the weak investment climate suggests that governance reforms must of necessity be high on the government's agenda.

D. Strengthening Checks and Balances through Reform of the Justice Sector

31. As noted above, an ineffective National Assembly and a malfunctioning justice sector undermine the separation of powers between the three branches of government that was clearly intended in Cambodia's Constitution. This section focuses on reform of the justice sector which is central to ensuring the accountability of the executive branch as well as enforcing the laws of the country, enforcing contracts and settling disputes. A comprehensive legal and judicial reform strategy was endorsed by the Council of Ministers in June 2003. Following this endorsement, the Royal Government, under the leadership of the Permanent Coordinating Body (PCB) of the Council for Legal and Judicial Reform undertook broad consultations with government agencies, civil society

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and donors. From this has emerged a short term (2004-2006) and medium term (2004-2008) plan of action. These plans are ambitious. But they represent a significant advance in the government's thinking in this area. The new government now needs to move decisively to begin the process of reform, devoting adequate financial and human resources to the task and demonstrating real progress in a few strategic areas. In particular:

32. ***Strong leadership is needed of the reform process.*** The legal and judicial reform effort needs to be entrusted to an inter-ministerial body on which the key agencies are represented, and led by genuine and dynamic reformers who enjoy credibility with both the legal profession and the general public, and strong political support at the highest level. This body must be empowered to rationalize the somewhat confusing and overlapping responsibilities of the key sectoral agencies, such as the Ministry of Justice, the Supreme Council of Magistracy (SCM), the Council on Legal and Judicial Reform and the Supreme Court in regard to the administration and regulation of justice, resolution of complaints, judicial inspections and disciplinary sanctions, and identify *all* players who will be involved in the process and their specific accountabilities. This body needs to take the current draft action plan and to prioritize it and focus on a few key strategic actions.⁶ Such a plan needs to be adequately funded and free from the uncertainties that mark the Cambodian budget process.

33. ***Reform must begin with the SCM.*** The SCM's current membership⁷ (apart from the now retired King who chaired it but rarely attended meetings) is affiliated to one or other of the ruling political parties. The government needs to consider instead appointing men and women of outstanding integrity and capability with no party affiliation or potential conflicts of interest. The appointment process needs to be seen to be objective and independent of executive influence, and there are a variety of international models that could be explored. A reformed SCM should be adequately funded and supported by the Ministry of Justice to fulfill its responsibility for oversight of draft laws pertaining to the judiciary and for decisions relating to judicial appointments, transfers, promotions and disciplinary actions.

34. ***The reformed SCM must begin by overhauling the high courts.*** It will take time to professionalize Cambodia's courts. But reform must begin with the Supreme Court, the Court of Appeals and perhaps one or two provincial courts. Reform of salaries, allowances and benefits for these courts must be tied to a fresh recruitment based on more rigorous criteria and clear codes of conduct. Passage of the long overdue Law on the Status of Judges and Prosecutors is necessary to regularize the recruitment, training, remuneration and retirement of judges as well as to clarify the disciplinary action that can appropriately be taken.

35. These three steps need to be accompanied by a number of other measures. The adoption of modern codes of civil and criminal procedure that reflect the needs of Cambodians today and that are based on adequate consultation, and their wide

dissemination through training and other means, will help the functioning of the legal system. Laws need to be published and widely disseminated, and court judgments need to be reasoned and made public. Reform of the Bar Association so that it enforces proper codes of conduct on its members will help. Reform of the police and prosecution system will also be needed if improvements in criminal courts are not to be subverted by incompetent and corrupt investigation of cases.

36. While the formal legal system is being reformed, the draft action plans are rightly stressing alternative dispute resolution. Foreign investors rely on international commercial arbitration, but domestic investors would benefit from an alternate dispute resolution center that would be facilitated by a law on commercial arbitration. Local conflicts are settled largely outside the formal legal and judicial system (see Chapter 4) through the cadastral commission and commune and village level dispute resolution committees. It is important to better understand how these work and how they can be strengthened further.

37. The noble goal of establishing the ‘rule of law’ will prove elusive until all Cambodian government officials consider themselves bound by the law, and until all individuals are treated equally and with dignity by the law and that justice is accessible to all. This will only happen when there are major changes in political, social and economic relationships in Cambodian society that shift the incentives facing government officials (Gary Goodpaster, 2003). It is, therefore, important to be realistic about what reforms in the judiciary can be expected to achieve. An increase in the budget for the Ministry of Justice would be an important signal from the Government of heightened commitment to legal and judicial reform in Cambodia. And donors can also help by increasing public awareness in Cambodia about the importance of an effective justice sector for restoring growth and fighting poverty.

Is an Anti-Corruption Commission the answer to a malfunctioning judiciary?

38. Governments with malfunctioning justice sectors are beginning to increasingly turn to anti-corruption commissions to address corruption issues in the judiciary itself and elsewhere. Cambodia’s Rectangular Strategy commits the government to “promote the implementation of the Anti-Corruption Law and create an independent body to fight corruption” (Royal Government of Cambodia, The Rectangular Strategy, 2004) but also “to take concrete actions that attack the roots of corruption” (Royal Government of Cambodia, The Rectangular Strategy, 2004). The draft Anti Corruption Law falls well short of international best practice as embodied in the UN Convention against Corruption (UNCAC), and there are serious questions about its internal coherence, compounding the inevitable problems of implementation and enforcement. It defines corruption broadly, which is the right way to go, but fails to define better its many dimensions. Nepotism and conflict of interest are addressed only inferentially. Greater clarity is needed on the requirements relating to declaration of assets: who it applies to, the need for such information to be made public, and the penalties associated with

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failure to declare. Well functioning and independent asset declaration systems are a useful deterrent to corruption. The law also fails to prohibit laundering or concealment of the fruits of corruption. Early action is needed to bring the law into conformity with UNCAC prior to its enactment. Accompanying regulations should use bright line rules that provide simple prohibitions that are not open to more than one interpretation.

39. The proposed Supreme National Council for Anti-Corruption is to be the principal vehicle for implementing the new law. The track record for similar bodies in other countries is not encouraging, and the conditions under which they succeed are rather demanding for a country with weak institutions (Patrick Meagher, 2002). If the Council is to work, it will at the very least need members of outstanding integrity and independence, and an adequate budget to do its work. The government also needs to ensure a supportive environment in which the independence and authority of the Council is respected and protected from political interference. The police and judiciary will need to work with, and not against, the Council if its decisions are to be enforced. The new Council will also need to be strategic and selective in setting its agenda, so that it does not spread itself thin, a common mistake made by other such bodies. Finally, a number of other complementary laws will be necessary to facilitate the work of the Council, such as a Freedom of Information Law, a Witness Protection Law and libel laws that protect the media from aggressive prosecution for reporting corruption. Cambodia will also benefit from international experience in the fight against corruption. It has already signed on to the ADB-OECD's Asia Region Anti Corruption Initiative. It needs now to become a signatory to the UN Convention against Corruption which has been signed by over 100 countries including most of Cambodia's ASEAN partners. Enforcement is critical to reducing corruption. But attacking the roots of corruption requires addressing the failures of accountability described earlier in this chapter. It is to this that we now turn.

E. Improving Public Financial Accountability

40. Governance failures systematically undermine the role of the Royal Government's budget as an instrument of service delivery and poverty reduction. As seen above, the entire chain of accountability from inadequate policy direction and oversight by the National Assembly to almost non-existent external accountability by way of external audits and civil society oversight is deeply flawed. Moreover, low revenues drive under-funding of the budget in part because a corrupt and weak bureaucracy is unable to mount a serious revenue effort. Under-funding in turn drives corruption because it robs civil servants of sufficient pay and other resources that they need to do their job. There are four key components to improved public financial accountability:

41. ***Reform must begin with an improved revenue effort.*** The new government is committed to raise revenues from their current inadequate 10% of GDP, well below the

average for low income developing countries (16%) to around 14% by 2009, which given declining growth prospects will not be easy without a substantial improvement in customs and tax administration. Such an improvement should not have to await a major civil service reform. Rather, the new government needs to consider piloting a major overhaul of incentives and performance management in the tax and customs department. It should do this either through an autonomous revenue authority – an approach tried successfully in many countries – or through a merit and performance based system in select departments or units. Improved non-tax revenues will require governance reforms in natural resource management, greater transparency in the use and lease of state assets, including strengthened management of government concessions, such as those relating to the Angkor complex.

42. ***The effectiveness of public spending on poverty oriented programs must be enhanced.*** Since 1998 the Government has significantly improved the alignment of resources with its developmental objectives through significant real increases in spending on priority sectors from 1.4% of GDP to 3.2% of GDP. And Cambodia plans to further increase the share of priority sectors in the coming years. This has already made education spending much more pro-poor, while health spending lags behind. However, this has yet to make a significant impact on social indicators reflecting the need to improve the effectiveness of spending by linking it much more closely to priority outcomes and by strengthening the mechanisms of accountability. Improving the accountability mechanisms and access to information that would help civil society and citizens hold government accountable for poor service delivery will be crucial to enhancing the impact of poverty reducing expenditures.

43. ***The fiduciary risks to public funds must be reduced.*** The fiduciary risk to public funds is high because of weaknesses in all three dimensions of public financial management: budget formulation, execution and reporting. Cambodia's system is rated below average compared to its peers among low income countries. Accountability is weak, transparency is low, and corruption is reported to be very high. Reforms are needed from the top to the bottom of the accountability chain. Parliamentary oversight needs strengthening. The Finance and Banking Committee (FBC) of the National Assembly needs to open its deliberations to the public and give itself and the National Assembly enough time to debate and discuss the budget. Strengthening the secretarial support to the FBC and helping members of the National Assembly better understand and contribute to budgetary policy making will help. The control environment for public spending needs to be improved. Shifting from a cash based payments system to bank transfers will help reduce the considerable abuse and the practice of facilitation payments to the Ministry of Economy and Finance and line ministries from government agencies. Internal financial controls need strengthening and the relatively new National Audit Authority needs further strengthening, and its reports need to be made public. Late release of budgets – nearly a third of all civil recurrent expenditures in 2001 were released in the last month of the year – which also contributes to poor financial management practices. Lack of transparency in budget processes contributes to weak

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accountability. The budget needs to be made more accessible to the public and civil society needs to be consulted at all stages of the budget cycle. This will require efforts to train NGO staff to better understand budgetary issues and practices.

44. Public procurement remains a principal source of corruption. While competition in procurement was formally introduced two years ago, it is still managed without effective competition or much transparency. The private sector complains that all short-listed parties are subject to informal fees for the privilege. The reliance on sole-source concessions for Build-Operate-Transfer projects has created a closed environment for the award of such concessions and encouraged direct negotiations with questionable outcomes. Reforms must include a clear sovereign law that supercedes the numerous and conflicting decrees, independent monitoring of procurement by civil society and the private sector, and greater transparency of the process including wide advertising and publication of outcomes.

45. Recognizing these problems, the Ministry of Economy and Finance's newly appointed Reform Committee has developed a public financial management reform program, endorsed by the Prime Minister, with a strategy statement and a rolling, prioritized action plan, a performance management framework and complementary organizational and management reform components. Many of the highest priority items in the Government's action plan are set for implementation according to a timetable agreed with the PFM partners. Serious political commitment to such a reform program by the new government will need to be matched by adequate donor support for it. Partners have recognized that they can improve their provision of technical assistance to the Government, based on recent experience. The most difficult problems—fragmented and contradictory advice from partners, lack of alignment of assistance with Government plans, lack of accountability of assistance to Government, and lack of Government leadership—have been addressed with the establishment of the PFM sector wide approach. This opens the way for early progress in this area.

46. ***Reducing fiduciary risk will ultimately require a reformed civil service.*** An underpaid and patronage based civil service is a recipe for high corruption. The Rectangular Strategy calls for a 10-15% per annum increase in civil service pay, accompanied by “special attention” to the management of civil servants (Royal Government of Cambodia, The Rectangular Strategy, 2004). Such special attention should take the form of a merit based management system accompanied by higher and decompressed pay consistent with fiscal sustainability. This will inevitably be a long term program given fiscal constraints. In the short term, the likely path for civil service reform is through a parallel phased introduction of merit based management and higher decompressed pay for selected high priority sectors, functions, and skills. Higher pay will be easier to bring about in the medium term if a functional review is undertaken to gradually rationalize and redeploy staff across sectors and regions addressing shortages of skills and staffing in some areas and surpluses in others. Finally, the government's commitment, in the Rectangular Strategy, to a politically neutral civil service needs to

be welcomed. Such neutrality needs to be firmly embedded in the way civil servants are recruited, promoted and transferred. This must be accompanied by a clear code of conduct that restricts civil servants from all partisan activities or actions or those which conflict with their responsibility to protect the public interest. Despite considerable work, progress to date on civil service reform has been disappointing. A prioritized, sequenced strategy and action plan for introducing the features of a meritocratic civil service with enhanced pay scales in a few high priority sectors, agencies and functions now needs to be developed for endorsement by Cambodia's partners.

F. Decentralization: Bringing Government Closer to the People

47. Cambodia has embarked on an impressive process of decentralization which carries both risks and opportunities. Weak capacity at lower levels of government and high fiduciary risks can increase opportunities for corruption. At the same time, decentralization could over time shorten the route of accountability, bringing government closer to the people. Cambodia's Rectangular Strategy rightly notes that proper implementation of decentralization and deconcentration "is crucial to the strengthening of democracy at the grassroots, improving the quality of public services and promoting the culture of participation and participatory local development in all sectors" (Royal Government of Cambodia, The Rectangular Strategy, 2004). The first two years of decentralization have seen considerable progress. The basic systems and processes have been established all over the country, thus enabling the elected commune and sangkat councils to begin functioning. Inevitably, there are design problems that need correction. This in part reflects the hesitancy that marks these tentative steps towards subnational democracy. Given the troubled history of Cambodia, a certain amount of caution and risk aversion is understandable. At the same time, the experiment is already showing immense promise and it is important that it not fail. Three steps are needed to put this initiative on a firmer footing.

48. ***Develop a broadly shared long term vision for governance at the subnational level:*** Articulating a vision for the nature of decentralized governance in the long term will provide direction and focus to policies and programs that take this initiative forward. This vision needs to embrace all tiers of government: the provinces, the districts and the communes, and attempt to correct the current overly centralized powers vis-à-vis the subnational tiers. A road map on how to get to the long term goals would help guide and strengthen the processes that are essential for success, such as participatory planning, fiscal transfers and service delivery. A consultative exercise that draws on the initial lessons from two years of decentralization will not only help develop a shared national consensus on the directions for change but also allow for some mid-course corrections, clarifying responsibilities and functions, and identifying the legal and policy framework needed to ensure progress towards the longer term goals. The recent initiative to establish a joint government donor Technical Working Group (TWG) on decentralization and deconcentration that would develop a strategic

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framework and action plan in this area provides an opportunity to take this work forward.

49. ***Clarify and strengthen internal and external accountabilities of the communes and sangkats.*** Currently, commune councilors are accountable to their electorates, to the leaders of the political party to which they are affiliated, and to the provincial and central governments. Being pulled in different directions, they are prone to yield to the most powerful: the ruling political party leaders. Accountability is compromised by a number of other factors. Commune budgets are subject to the same weak public financial management that prevails at the Center. Communes have no staff of their own and councilors lack authority over the public officials responsible for the delivery of services, since the latter are part of the provincial government, which in turn is entirely beholden to the Central government. Furthermore, civil society is unable to play an effective role in influencing the outcomes of commune budgets because of the lack of transparency and inclusiveness in commune and sangkat processes. Enhancing the voice of citizens and the influence of civil society, and clarifying and strengthening financial accountability are high priorities if the communes and sangkats are not to soon succumb to the same financial practices and corruption that prevail in the central government. The central government should also better monitor the performance of local governments in service delivery to encourage healthy competition between communes/sangkats. It is also critical that communes be allowed to increase their own revenue mobilization efforts not only to supplement central transfers but to enhance accountability to local taxpayers.

50. ***Increase the predictability, reliability and level of funds transferred to communes*** and assist communes to strengthen their own revenue collection efforts. Slow and incomplete cash transfers have made it difficult to fund commune work programs. Early establishment of the Commune/Sangkat Fund board that oversees and takes responsibility for the management of funds for communes (which come mainly from external aid to Cambodia) is a high priority. Moreover, there are large genuine needs for poverty-reduction related programs which remain unmet by the paltry \$6,000 average size of annual grants to communes and sangkats, a paltry 75 US cents per capita. The government needs to follow up on its recognition in the Rectangular Strategy of the need for “reasonable levels of financial resources to the communes” (Royal Government of Cambodia, The Rectangular Strategy, 2004) by gradually raising allocations for this purpose.

G. Managing Natural Resources for the Public Good

51. All formal property rights were destroyed by the Khmer Rouge, and the large scale displacement of populations undermined traditionally recognized claims on natural resources. In addition, following the end of civil war, lingering physical insecurity and weak enforcement of property rights led to rapid exploitation of resources

to the detriment of sustainability. High demand for unofficial revenues to support a poorly paid and patronage based civil service and military and to fund political campaigns provided additional incentives for trading away sustainable use of resources for short term financial gain.

52. About 75% of Cambodia's land area is technically under State management, including virtually all forested areas, much of the marine and fresh water resources, cultural heritage sites and large scale agricultural properties. The government's primary mechanism for management of natural resources has been to contract large areas to Cambodian and foreign investors. These concessions were usually granted through seemingly ad hoc and non-transparent processes. Designation of resources was not based on feasibility assessments; investors were not adequately screened to ensure technical and financial capacity to fulfill contractual obligations; and government institutions were unable to enforce the provisions of contracts. The direct revenue from concessions has been far below expectations, while the contribution of these concessions to growth and employment has been rather modest. The environmental consequences have been extremely negative. As a result, local communities have seen few benefits from these concessions. Landlessness is now estimated at 12-15% while average farm size is reportedly declining.

53. The Government has signaled at the highest levels its acknowledgement of the shortcomings of these policies and has cancelled some 40% of all concessions accounting for half the original area under concessions. In addition a suspension of logging in concessions has been in effect for over 18 months. The government is now committed to reorient natural resources policy consistent with the objectives of the Rectangular Strategy, and is increasingly exploring community based and benefit sharing approaches. Such a reorientation will require a number of steps.

54. ***Reform must begin with laying sound policy and legal foundations for natural resource management.*** A broad based consultative policy process is needed to develop a vision for natural resource management by the state. This process needs to explore the major trade-offs, including those between continued maintenance and expansion of forested and fisheries area, and pressures to expand land under agriculture and those between small-holder and community managed approaches versus commercial approaches. These trade-offs need to be informed by natural resource assessments and mapping of state lands. Several laws covering natural resources have been recently enacted or are under consideration. These need to better describe the hierarchy of claims to state resources, the mechanisms for resolving inconsistencies between these laws and those for resolving conflicting claims on resources. Property rights to natural resources need further clarification.

55. ***The institutions responsible for natural resource management need to be made more accountable and transparent.*** Institutional responsibilities are both concentrated and centralized in Cambodia. Concentration of functions in one agency at

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the national level has resulted in little attention to policy trade-offs and reduced checks and balances. Policies have been crafted without adequate consultation with those directly affected. When consultations did take place as with the Land Law, the benefits were significant. Reforms must include addressing the perverse incentives facing these institutions which result in their capture by vested interests. These include the perennial issues of civil service salaries and weak and patronage-based management. External checks and balances need to be strengthened including parliamentary oversight and external accountability including through the National Audit Authority. Required consultations with local communities and public disclosure as mandated in the subdecree on forest concessions management should be extended across all natural resources. Monitoring of state agency performance by civil society should become the norm.

56. ***Given that 85% of Cambodia's population lives in rural areas, with a large proportion poor, resource management approaches need to prioritize direct access of local communities to benefits from such approaches.*** Privatization of land in favor of individuals through recognition of their occupancy rights under the Land Law is considered likely and social concessions will also transfer land out of the public domain. Implementing the unused land tax will help prevent speculative land holdings and release additional land to the market. However, the bulk of natural resources are likely to stay in state hands. Concession arrangements may still be a good management approach provided these arrangements are transparent and accountable, and require consultation and sharing of benefits with local communities. Increased benefit sharing should also be required of all ongoing concession arrangements and state lands. Local communities can share both access to resources and direct monetary benefits. Local partnership approaches will shift the responsibility for generating public goods to a broader spectrum of local actors, including communities and commune councils and district and provincial staff. The challenges in generalizing local benefit sharing should not be underestimated. Care will be needed in particular to avoid elite capture and marginalization of the poor.

57. ***A high priority is to mitigate the not inconsiderable risk of land-grabbing*** as new institutional and management arrangements are put in place while large volumes of land come under state management from cancellation of concessions without a corresponding increase in the state's capacity to manage these. The best hope is to develop collaborative arrangements with local communities which extend the capacity of government agencies. NGOs in Cambodia already have experience with collaborative monitoring and enforcement. A multi-stakeholder system supported by independent monitors will require a rapid mobilization of government and donor resources to put in place.

H. Removing Governance Obstacles to Investment and Growth

58. Given the parlous state of its public finances, Cambodia has little choice but to rely on domestic and foreign private investors to finance much of the country's investment, to provide key infrastructure, and to be the principal engine of growth. Yet, governance obstacles heavily impinge on the private sector's ability to respond positively to this challenge. A malfunctioning justice sector greatly increases uncertainty and risk, particularly from arbitrary state action. Corruption increases the cost of starting and doing business in Cambodia to a point where it is threatening the country's relative competitiveness. And lack of transparency in dealings between the government and the private sector, particularly in the area of concessions and BOT type arrangements, encourage unscrupulous businesses to attempt state capture and reduce potential revenues to the exchequer from such arrangements. The Rectangular Strategy recognizes this, noting the need to strengthen both public and corporate governance and improve the investment climate (Royal Government of Cambodia, The Rectangular Strategy, 2004).

59. ***The regulatory burden on the private sector needs to be eased.*** The formal private sector faces a vast number of transaction costs and barriers to the establishment and operation of business. It takes 94 days to start a business in Cambodia, 30 days longer than in Vietnam, and 52 days longer than in Thailand. Trade facilitation practices are subject to high official and unofficial costs, delays, uncertainty and discretion. Cambodia is also among the slowest places to clear imported goods, vital for the country's nascent export industry, with a large number of agencies vying with each other to control such imports. As noted above, corruption is seen as so acute that private enterprises rank it above all the many other difficulties they face when operating in Cambodia. Fear of regulation drives many companies to stay informal and outside the government's net, a practice that carries its own costs. Reform will require clearing the undergrowth of regulations, disentangling overlapping jurisdictions of government agencies and following a risk management strategy towards controls.

60. ***Market supporting institutions need to be strengthened.*** In the absence of market supporting institutions such as an effective legal and judicial system, there are no mechanisms to ensure a level playing field, to resolve disputes between government and the private sector, and to help enforce contracts. Reforming the justice sector, as noted above, will take time. In the meantime, the government must address the widely held perception that a handful of conglomerates and firms with close ties to the political leadership exercise undue influence over policies. Broadening the dialogue with the private sector, in a manner that gives effective voice to other players and is seen to result in policies and practices that ensure competitive and fair markets, will be crucial to building confidence until market supporting institutions begin to play an effective role.

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61. ***Competition and transparency are needed in the private provision of infrastructure.*** Lack of competition has also been a key drawback in the private provision of infrastructure in Cambodia. As in most developing countries, the state in Cambodia has little capacity to provide infrastructure with its limited administrative and budgetary resources. Yet the tendency to directly negotiate contracts with private contractors without competitive bidding has resulted in projects not being commissioned on a least cost basis, and not meeting technical criteria that would limit the likelihood of delivery failure. The current legal and regulatory framework governing Private Provision of Infrastructure (PPI) is inadequate. Nor is there adequate planning and policy work that guides the development of infrastructure. There are few clearly defined procedures for processing unsolicited applications for PPI, and this results in total lack of transparency at all stages of implementation of such projects. These projects are often financed entirely by equity, partly to avoid scrutiny by a financial institution. This tends to drive up the expected rate of return. Lack of information on these projects makes it difficult to assess whether the public is getting adequate value in return for concessions of public assets such as land or public ownership rights. And the lack of proper laws implies that arbitrary decisions cannot be easily checked and the public interest cannot be easily protected.

62. Unsolicited or directly negotiated projects create opportunities for grand corruption and reduce public trust in government. Reform must begin with greater transparency on all such contracts. All contracts should be made publicly available, as is the practice in Mexico where they must be placed on government websites. A clear policy framework is needed, including the enactment of laws and regulations that establish clear transparent and accountable processes for PPI. And all existing contracts need to be audited with a view to ascertaining if the public interest is being served. The Ministry of Commerce, Ministry of Finance and the Council for the Development of Cambodia have begun work in this direction.

I. Conclusion

“...The successful solving of the political deadlock within a peaceful and stable environment and in a renewed spirit of national reconciliation and democracy has provided us with a renewed and hopeful opportunity to embark on faster pace, more diversified and in-depth reforms in all the sectors where we have started in earlier terms....Cambodia has no other better choice than moving forward with all these steadfast reforms. With commitment to continued reforms, our chance to survive would be 90%, while surrendering the reforms the chance would drop to only 10%.”

--Samdech Hun Sen, Prime Minister of the Royal Government of Cambodia⁸

63. The Royal Government clearly recognizes, as is evident from the above statement by Prime Minister Hun Sen that Cambodia is at a critical juncture in its

history. Much has been achieved over the past decade, but much remains to be done to break the stranglehold of poverty that grips the bulk of the population. Failure now to accelerate reforms will prove very costly for Cambodia's poor and for its future as a country. Without urgent efforts to remove governance impediments to investment and economic diversification, growth will decelerate sharply in the medium term. Without a serious effort to improve public financial accountability or to better manage the country's natural resources, the poor will pay a high price in terms of their human and physical capital.

64. This is not to suggest that the task ahead will be easy. Major structural and institutional reform will be needed. Such reforms will threaten powerful interests within and outside government and will be resisted. It will be very tempting to substitute process for genuine reforms. Process is important. But it often becomes an end in itself when the commitment to reform is weak, driven as it is by the desire to feed donor need to see some progress rather than by strong conviction and consensus. Thus Cambodia is indeed at the crossroads. It can choose to pursue reforms vigorously, empowered by broad local ownership, aimed at fundamentally changing the incentives that currently undermine long term sustainable development. Or it can continue to muddle along, with severe adverse consequences for the poor. The choice, as the Prime Minister recognizes, is indeed stark.

65. Given the human and institutional constraints facing Cambodia, the path of reforms is unlikely to be smooth and benefits will take time to be realized. Nevertheless it is important to move strategically in a few key directions and to try to show measurable progress over the next 12 months. Progress and quick wins in a few strategic areas can build political support and momentum and increase the confidence of reformers to stay the course. The considerable work the government has undertaken on public financial management and the private investment climate suggests that in these two areas there is clarity on what needs to be done, and the potential to show early results. Progress on public financial accountability is particularly important if Cambodia's international development partners are to increase their confidence that the development assistance they provide reaches those for whom it is intended. Other priorities will emerge as the underlying analytical work is completed.

Are Cambodia's development partners a part of the problem?

66. Cambodia's international development partners are strongly committed to Cambodian development and are anxious to be part of the solution. But they may also be part of the problem. The failure to speak out for Cambodia's poor with one voice or to link financial and technical support to performance and outcomes has sent mixed signals to the country's leadership which has shown itself rather adept at doing just enough to win donor support.

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67. The upcoming Consultative Group meeting marks an opportunity to make a fresh start. The intensified donor coordination effort that has preceded this meeting provides an opportunity to align donor support to a clear and shared message. The volume of bilateral and multilateral donor support needs to be conditioned on the adequacy of Cambodia's reform effort. If reform is forthcoming, donors need to consider ways of financing the likely shortfall in government revenues if growth should slow significantly in 2005 and beyond.

68. As Chapter 1 notes, growth is likely to fall significantly in 2004-2005 and is not likely to recover to the National Poverty Reduction Strategy (NPRS) target of 6-6.5% until 2009. Given this scenario, if Cambodia is willing to undertake the necessary governance reforms to improve its investment climate, it is imperative that donors are able to respond to Cambodia's needs to restore growth as much as possible during this transition period. During 1999-2003, large aid inflows, which averaged 12% of GDP, helped finance domestic investment and fueled construction activities (IMF, 2004). About half of the inflows were grants in the form of donor-financed projects and technical assistance, all of which were outside the budget. Aid inflows were used to improve health and education (24%), rebuild physical infrastructure (23%), and strengthen economic and social institutions (15%). Agriculture and forestry received only 8% of aid flows.

69. It is now time to review the current allocation of foreign aid flows with a view to focusing more on the growth agenda. Although weak administrative capacity may have required that during 1999-2003 about 50% of all aid flows be used for technical cooperation, a reallocation may be needed to more directly address poverty and boost long term growth. The enormous need to raise rural incomes argues for greater investments in agriculture and in rural infrastructure that links farms to markets. These investments would of course be predicated on the Government first designing adequate policy and investment strategies for these sectors.

70. Donors also need to ensure that technical assistance builds Cambodia's own capacity instead of substituting for it. Dependence on expatriate advisors is excessive: some 800 advisors who collectively cost donors more than the government's wage bill. Reliance on such advisors for reform processes or project management undermines national ownership and institutional capacity building, especially when these advisors are weakly integrated into the mainstream of internal government processes (Godfrey, et al 2003; Mysliwiec 2004). A time bound medium to long term program needs to be developed to reduce and eventually phase out foreign advisors and replace them with Cambodians. This needs to be accompanied by a program to replace the current practice of ad hoc salary supplements to Cambodian officials working on donor funded projects with a system of transparent payments to carefully selected priority groups critical to improve service delivery for the poor. Such a scheme would need to be linked to improved performance management of civil servants in chosen ministries (Chapter 3). It would also need to ensure such support over a sufficiently long period of

time (10-15 years) to allow Cambodia to increase its budgetary revenues sufficiently to ensure the civil service a living wage.

71. Donors also need to reduce the cost to Cambodia from failures in donor coordination. Aligning donor programs with the government's development program, ensuring that all donor assistance is recorded in the budget, undertaking joint analytical work, relying more on Sector Wide Assistance Programs, and harmonizing donor procedures to reduce the burden of the current wide variety of donor policies and practices that government must follow to qualify for assistance. The proposed Harmonization Action Plan to be considered at this meeting of the Consultative Group would begin the process of reform on the donor side. A first important step would be to provide coordinated assistance to the Government's next five year plan for 2006-2010 which will seek to develop the policies and investments that will turn the vision of the Rectangular Strategy into a reality for Cambodia.

72. The Royal Government of Cambodia and its international development partners face a unique opportunity to significantly accelerate the reform process at what appears to be a propitious time in the country's history. The leadership for this must come from Cambodia? Will Cambodia's leaders seize the moment?

End Notes

¹ Royal Government of Cambodia, *The Rectangular Strategy for Growth, Employment, Equity and Efficiency in Cambodia*, Prime Minister Samdech HUN SEN and The Third Legislature of the National Assembly, At The Office of the Council of Ministers, Phnom Penh, 16 July 2004, p12.

² Ibid. p.2.

³ UNDP and SIDA, Cambodia Millennium Development Goals Report 2003, in passim.

⁴ Cambodia Development Resource Institute (CDRI), supported and supervised by the Asian Development Bank (ADB), *Cambodia: Enhancing Governance for Sustainable Development*, April 2000., para 38

⁵ The *principal* may be the politician and the *agent* the bureaucrat. Or the *principal* may be the head of an agency or principal civil servant, and the *agent* may be the front-line service provider (such as the head of the postal department and the postman). The *principal-agent* problem arises because the interests of the *principal* and the *agent* diverge. The *principal* lacks sufficient information about the *agent's* behavior ("asymmetry of information") and *agents* have an incentive to hide information. An *agent* will be corrupt when in his judgment the benefits of doing so exceed the costs. Costs, here, refer to the risk of discovery and punishment, or the loss of personal reputation and self respect. Robert Klitgaard's stylized equation: CORRUPTION=MONOPOLY+DISCRETION-ACCOUNTABILITY implies that corruption is a matter of removing or restraining the monopoly over service delivery, reducing discretion in the hands of agents and increasing accountability for their actions (Robert Klitgaard, *Controlling Corruption*, Berkeley: University of California Press, 1988, p. 69-75.) This model assumes that the *principal* is free of corruption. Often, this is not the case, and the *principal* and the *agent* may conspire against the ultimate *principal*, the citizen.

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⁶ These issues were raised in a communication to the Royal Government from the informal donor working group on legal and judicial reform dated 16 July 2004 addressed to H.E. Sum Manit, Chair of the Permanent Coordinating Body of the Council for Legal and Judicial Reform.

⁷ The Council comprises the King, the Minister of Justice, the President of the Supreme Court, the General Prosecutor to the Supreme Court, the Chief of the Court of Appeal, the General Prosecutor to the Court of Appeal, and three judges elected by the judiciary for a five year term.

⁸ Address to the Seventh Royal Government-Private Sector Forum, Government Palace, August 20, 2004.

⁹ Godfrey et al 2003; Mysliwiec 2004.

SUMMARY OF CHAPTER 1
Recent Economic Performance and Medium-Term Prospects

This chapter, based on the IMF's recent Article IV Consultations, provides an assessment of recent performance and prospects for Cambodia's economy. Economic performance improved substantially in Cambodia beginning in 1999. With the advent of political stability following the 1998 elections, and cautious macro-economic policies, private sector activities began to flourish in urban areas. Gross domestic product expanded on average by 6-7% during 1999-2003, boosted in large part by garment exports, which rose from zero to \$1 billion thanks to preferential access to the US garments market; buoyant tourism; and large aid flows averaging some 12% of GDP. Growth is however expected to slow in 2004 due largely to weaker agricultural prospects. Rising petroleum prices are also expected to put pressure on inflation and the balance of payments. Despite the solid growth performance, poverty reduction has been lackluster, and many human development indicators did not improve as much as expected.

Fiscal policy has been supportive of growth by ensuring that it contributes to macroeconomic and financial stability. Government revenues rose from 8% of GDP in 1998 to 11.2% in 2002 reflecting strengthened tax and customs administration. Nevertheless, the revenue effort has been inadequate, and revenue buoyancy deteriorated in 2003. Cambodia's total revenue still remains well below the average of 16% of GDP in neighboring low-income countries. The eventual servicing of debt to the Russian Federation and the United States will also claim a significant share of any further rise in revenues.

Prospects over the medium term will depend on whether Cambodia succeeds in accelerating structural reforms and reversing the deterioration in competitiveness due to poor governance. The elimination of the quota system in January 2005 will expose Cambodia's exporters to severe competition from lower cost garment exporters like China. This requires that Cambodia move aggressively to diversify growth. Promoting agriculture is the best strategy to secure a key source of growth that could help absorb a part of the expected increase in the labor force, address poverty more directly, and provide a more rapid expansion of the domestic market for manufactured products. Accession to WTO also provides opportunities for growth otherwise not available to Cambodia, but capitalizing on these will require more rapid and far-reaching reforms. Efforts should focus on improving competitiveness to dampen the impact from the expected decline in garment exports and encourage diversification of its export base.

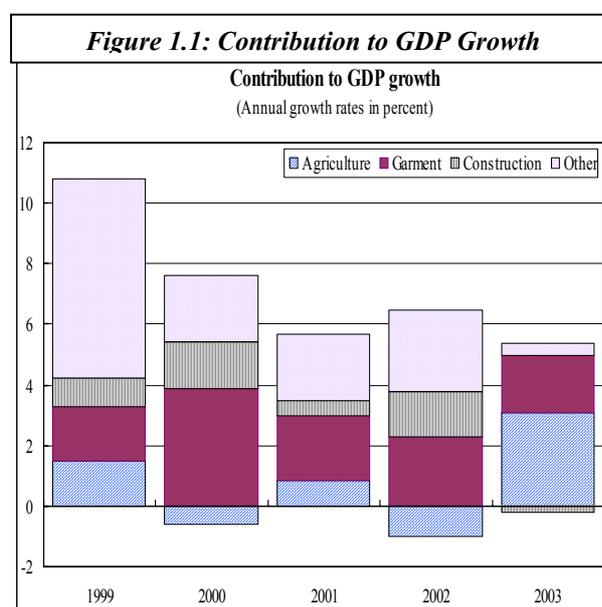
The value of garment exports could decline by 12% in 2005, which might reduce GDP growth to below 2% in 2005. Assuming strong implementation of reforms, growth will only reach the Government's target of 6-6½% by 2009. Failure to press ahead more resolutely with reforms will, however, limit growth to 2 - 4% annually in the medium term.

CHAPTER 1: Recent Economic Performance and Medium-Term Prospects

1. Broad based economic growth and sound fiscal management are central to successful poverty reduction strategy. As noted in the overview, Cambodia has made some impressive gains since its emergence out of conflict. This chapter provides an IMF staff assessment of Cambodia's recent economic performance and medium term prospects drawing on the Fund's recent Article IV Consultations.

2. Economic performance improved substantially in Cambodia beginning in 1999.

With the advent of political stability following the 1998 elections, private sector activities began to flourish in urban areas. Gross domestic product (in constant prices) expanded on average by 6-7% during 1999-2003, boosted in large part by external factors, booming garments exports, buoyant tourism, and large aid flows (Figure 1.1). Indeed, Cambodia has benefited from exceptionally large amounts of official development assistance, in both absolute and relative terms. Growth was also supported by generally cautious macroeconomic policies. These favorable developments mask troubling aspects of Cambodia's growth performance. First, despite the solid growth, poverty reduction has been lackluster, and many human development indicators, as noted in the Overview, have not improved as much as would have been expected. Second, as shown vividly later in this chapter, growth over the medium-term is expected to remain well below rates needed to reduce poverty, even under the best of foreseeable circumstances. This outlook reflects in large part the inadequate progress made on structural reforms in recent years. There is, thus, an urgent need to implement meaningful reforms—especially to improve governance—to foster more rapid and broad-based growth. There is also an urgency to concentrate on more direct approaches to reducing poverty.



A. Growth Performance

3. The robust economic growth, albeit narrowly based, can be traced to three external factors: booming garments exports; tourism; and substantial external assistance.

Recent Economic Performance

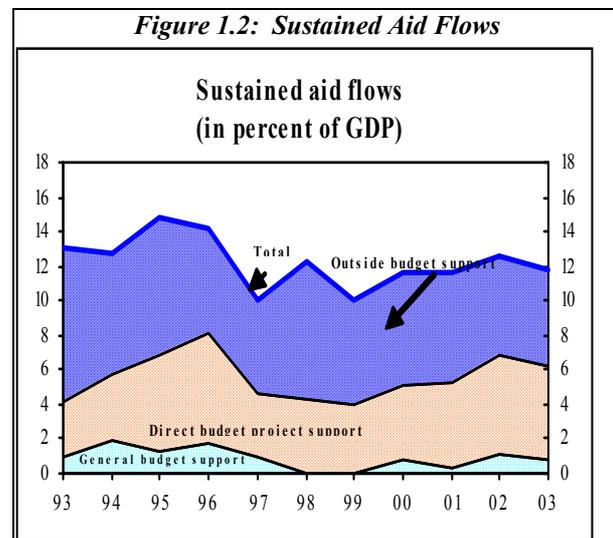
4. In 1996, Cambodia was granted preferential access to the United States garments market under the Agreement on Textiles and Clothing (ATC). Under the bilateral agreement, the average U.S. tariff for garments produced in Cambodia was effectively reduced from 50-70% to 10-20%. The 1996 trade agreement thus attracted a large number of foreign investors, contributing to a sustained surge in garment exports to the U.S., from nearly zero in 1995 to \$500 million in 1999 and to more than \$1 billion in 2003, accounting for about 70% of total garment exports. The benefit to the domestic economy, however, was limited, as almost all non-labor inputs were imported.

5. Tourist-related activities also contributed to overall GDP growth during the past several years. Tourist arrivals more than doubled during the period 1999-2002, reaching over 440,000 in 2002. The steady upward trend was interrupted briefly during 2003 as a result of the SARS outbreak.

6. A third external factor contributing to growth in recent years have been the substantial inflows of Official Development Assistance (ODA) (Figure 1.2). On a per capita basis, Cambodia has received significantly more ODA than low income countries on average during the past decade. Aid inflows averaging 12% of GDP, about half of the inflows were grants in the form of donor-financed projects and technical assistance, were used mostly to improve several areas. Namely health and education, rebuild physical infrastructure, and strengthen economic and social institutions and, of course, helped to finance domestic investment and fueled construction activities.

7. More recently, nonagricultural growth slowed to 3.2% in 2003 due to the SARS-related drop in tourism and election-related uncertainties. However, overall GDP still grew by 5.2%, mainly because favorable climatic conditions resulted in extension of the area under cultivation, which allowed for a strong rebound in agricultural production. The external current account deficit (excluding official transfers) widened by 1¼% to 10¼% of GDP due to buoyant merchandise imports, lower tourism receipts, and higher petroleum prices.

Gross official reserves continued to increase, reaching US\$737 million (close to 3 months of imports of goods and services) at end-2003. Inflation remained subdued and the exchange value of the riel against the U.S. dollar remained broadly stable, except for a short period early in the year when the riel depreciated slightly due to somewhat accelerated decline of government deposits.

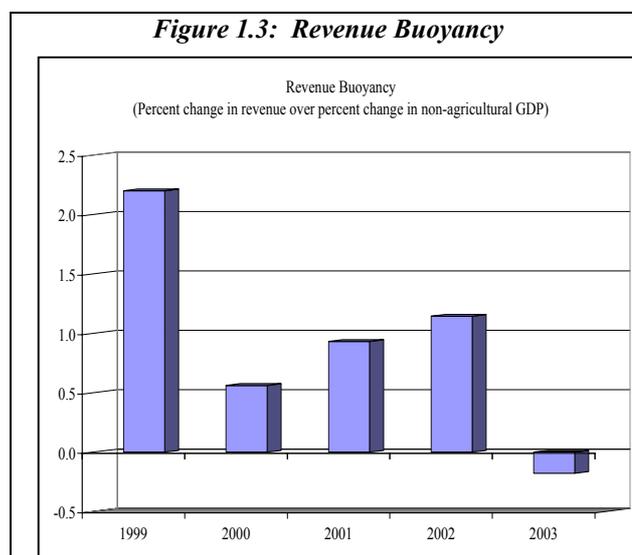


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8. The outlook for economic growth in 2004 has been tinted by weaker prospects for agricultural production. The Avian flu earlier in the year, the smaller fish catch due to the lower Mekong river level, and agricultural production that is unlikely to be much higher than last year's bumper crop, indicate weaker output growth. While non-agricultural growth is expected to rebound strongly due to a recovery in tourism, overall GDP would most likely increase by 4-4½%. The impact of rising petroleum product prices is expected to widen the external current account deficit by another ½% of GDP. Inflation is also likely to inch up reflecting price developments in trading partner countries.

B. Fiscal Performance

9. As noted earlier, fiscal policy *per se* has been supportive of growth by ensuring that it contributes to macroeconomic and financial stability. General government revenue rose from 8% of GDP in 1998 to 11.2% in 2002 (Figure 1.3). The improvement owed much to strengthened tax and customs administration, helped substantially by an extensive technical assistance (TA) program under the multi-donor Technical Cooperation Action Plan (TCAP) and TA provided bilaterally by others, including France and Japan.¹ Nevertheless, improvements in revenue collection have been lackluster overall, and the revenue buoyancy deteriorated in 2003 after several years of progress. Cambodia's total revenue still remains well below the average of 16% of GDP in neighboring low-income countries.



10. Naturally, low revenue has had adverse effects on public spending. Constrained by constant cash shortages, reflecting in part collection difficulties and in part a fragmentation of government revenue accounts, a disproportionate share of appropriated current spending continues to be committed at the end of the fiscal year. Not only does this pattern have adverse effects on contemporary program delivery in each fiscal year, but adversely impacts each following fiscal year, because end-year spending commitments become claims on the next fiscal year's revenue flows, or become new spending arrears. A serious effort was made by the Royal Government of Cambodia beginning during 2003 to address the short-run disbursement problems adversely affecting priority spending in health and education, with a degree of success. Nevertheless, substantial and durable improvements await the implementation of the government's recently adopted Public Financial Management Reform Program, which

provides a staged and sequenced set of reforms which have the support of Cambodia's development partners (Royal Government of Cambodia, PFM Reform Program, 2004).

11. The effectiveness of public finances as a tool for improving the allocation of resources or for contributing directly to poverty reduction has clearly been limited. But fiscal policy has helped to maintain macroeconomic stability by avoiding recourse to domestic bank financing. At the same time, the mismatch between revenues and spending commitments has resulted in a sustained increase in arrears to domestic suppliers, the repayment of which can be expected to weigh heavily on the budget over the next few years. Together with the eventual servicing of debts to the Russian Federation and the United States once debt restructuring negotiations have been completed, overall debt servicing can be expected to claim a rising share of revenue over the medium term, before subsiding afterward.

C. Structural Impediments to Growth and Poverty Reduction

12. Only modest progress on structural reforms has been made since 1999, and the pace of reform in some areas slowed during 2003 and 2004, in part due to the run-up to elections and the long political impasse that followed elections. This lack of progress in turn has implications for the medium-term outlook. Basic institutions were set up and various laws, ranging from commercial contracts to accounting, were adopted. A Financial Institutions Law was passed that provided the legal basis for successful bank regulation. But progress has been particularly slow in civil service and judicial reform, both of which are viewed widely as reflecting political resistance to such reforms. As a result of the failure to capitalize on the opportunities for reform during the past several years, especially against a backdrop of relatively strong, externally-driven growth, a solid foundation for sustainable growth has not yet been established, not even in urban areas.

13. Several inter-related structural weaknesses, complicated enormously by deeply rooted governance problems, remain significant barriers to Cambodia's take-off toward sustained poverty reduction. First, an underlying deterioration of competitiveness has been masked by the favorable external developments noted above. As discussed in Chapter 5, poor public administration and weak governance - partly due to slow progress in legal and judicial reform - have exacerbated uncertainty in the business environment and allowed the rich to set their own rules. In addition, embryonic and poorly maintained infrastructure and high wages have kept operating costs high.²

14. A second reason why poverty has not been reduced is that agricultural development has stagnated, for several reasons. There has been limited access to arable land and markets, and only a small proportion of ODA has been allocated to agricultural development. Slow growth in agriculture has made it more difficult for Cambodia to

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meet its Millennium Developments Goals and reduced its capacity to absorb the growing number of entrants to the labor market over the medium term.

15. Finally, government capacity remains severely constrained by lack of human capital and entrenched governance problems and this despite substantial external technical cooperation assistance. The quality of the civil service remains poor, and fiscal revenue, currently at 10.4% of GDP, is hardly enough to meet basic priority spending needs.

D. The Medium-Term Outlook

16. Prospects over the medium term will depend on whether Cambodia succeeds in diversifying growth, and on the government's ability to address poverty issues more directly than in the past. In this respect, urgent reform in the agricultural sector is essential. As a small open economy with ample unused arable land and a large unskilled labor force, agriculture is widely recognized to be Cambodia's comparative advantage. Promoting agriculture is the best strategy to secure a key source of growth that could help absorb a part of the expected increase in the labor force, address poverty more directly, and provide a more rapid expansion of domestic market for manufactured products. A more dynamic agricultural sector may also encourage foreign investment, which has been weak, partly because the population of 13 million does not provide a sufficiently large domestic market.

17. Accession to WTO provides opportunities for growth otherwise not available to Cambodia, but capitalizing on these will require more rapid and far-reaching reforms. Cambodia can no longer rely on the garment sector as the main engine of growth absent improvements to the sector's competitiveness. Efforts should focus on improving competitiveness to dampen the impact from the expected decline in garment exports and encourage diversification of its export base. This is particularly urgent because the elimination of the quota system in January 2005 will expose Cambodian exporters to direct competition from China, where production costs are estimated to be 15% to 30% lower than in Cambodia. It will take some time before Cambodia's exports could recover, even if all identified reforms are undertaken. The value of garment exports could decline by 12% in 2005, which might reduce GDP growth to below 2%. A depreciation of the exchange rate is likely to have only a limited impact on competitiveness because most costs, including wages, are denominated in US dollars. The overall impact of the quota removal on the balance of payments, however, would be modest since garment-related inputs are almost all imported, and profit remittances would also drop. Cambodia could gain some time if the US takes recourse in either the so called "product specific" safeguard against Chinese imports, available until 2013, or the special textiles safeguard, which expires in 2008. However, it would be highly risky for the government to formulate its economic strategy on the uncertain assumption that the US will adopt either of these two options. Furthermore, additional tariff reduction

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by the US or relaxation of rules of origin requirements by the EU and Canada would have only a marginally favorable impact.

18. The best scenario depicted above assumes implementation of reforms that effectively reduce costs and substantially improve governance. Even under this optimistic outlook, growth would only reach the annual *National Poverty Reduction Strategy* target of 6-6½% by 2009 (Table 1.1). Under this scenario, public debt, which was 75% of GDP at the end of 2003, is expected to be sustainable. Assuming that Cambodia reaches a debt rescheduling agreement with the Russian Federation and the United States on terms comparable to the 1995 Paris Club agreement, Cambodia's net present value (NPV) of public debt at the end of 2004 would be reduced to 33% of GDP. However, the NPV of public debt would still represent around 235% of total revenue (280% excluding grants); a significant strengthening of the revenue effort would be needed to reduce this below 200% after 2013.

Table 1.1: Cambodia Baseline and Non-Adjustment Scenarios

Cambodia: Baseline and Non-adjustment Scenarios (In percent of GDP, unless otherwise indicated)								
	2002	2003	2004	2005	2006	2007	2008	2009
Baseline scenario								
Real GDP growth (percent change)	5.5	5.2	4.3	1.9	4.3	5.5	5.9	6.1
Of which: Garment (percent change)	21.0	15.0	12.0	-12.0	-1.0	5.8	7.2	7.2
Of which: Agriculture (percent change)	-2.7	9.2	0.4	3.2	3.7	3.8	3.9	4.2
Of which: Other (percent change)	7.9	0.4	4.9	4.9	6.0	6.4	6.8	6.9
Government revenue	11.2	10.4	11.9	12.3	12.9	13.3	13.6	14.0
Current Expenditure, of which	10.1	11.0	10.7	11.2	11.9	11.9	12.2	12.2
Wages	3.7	3.7	3.7	3.8	4.0	4.2	4.5	4.7
Other	6.3	7.3	7.0	7.4	7.9	7.7	7.7	7.5
Of which: Social spending (excluding wages)	2.0	1.8	2.1	2.2	2.3	2.4	2.5	2.7
Primary deficit	3.6	4.3	3.2	3.1	3.1	2.7	2.5	2.1
Garment export (in US\$ million)	1,338	1,607	1,794	1,587	1,590	1,699	1,839	1,991
Current account balance, excluding official transfers (in US\$ million)	-359	-429	-489	-545	-565	-567	-566	-567
Gross international reserves (in US\$ million)	663	737	782	804	838	886	935	1,021
Non-adjustment scenario								
Real GDP growth (percent change)	5.5	5.2	4.3	0.9	2.7	3.1	3.4	3.7
Of which: Garment (percent change)	21.0	15.0	12.0	-15.0	-5.0	-2.0	0.0	3.0
Of which: Agriculture (percent change)	-2.7	9.2	0.4	3.2	3.3	3.1	2.7	2.7
Of which: Other (percent change)	7.9	0.4	4.9	4.0	4.0	4.2	4.5	4.5
Government revenue	11.2	10.4	11.1	10.9	10.9	10.9	11.0	11.0
Current Expenditure, of which	10.1	11.0	10.3	10.0	9.9	9.9	9.9	9.9
Wages	3.7	3.7	3.6	3.5	3.5	3.5	3.5	3.5
Other	6.3	7.3	6.7	6.5	6.4	6.4	6.4	6.4
Of which: Social spending (excluding wages)	2.0	1.8	1.9	1.9	1.9	1.9	1.9	1.9
Primary deficit	3.6	4.3	3.7	3.3	3.1	3.1	2.8	2.8
Garment export (in US\$ million)	1,338	1,607	1,794	1,579	1,516	1,490	1,495	1,545
Current account balance, excluding official transfers (in US\$ million)	-359	-429	-489	-621	-639	-647	-599	-575
Gross international reserves (in US\$ million)	663	737	782	728	688	656	672	749

Source: Fund staff estimates.

19. Failure to press ahead more resolutely with reform will limit growth to 2 - 4% annually in the medium term. Lack of strong commitment to improve governance will

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prevent improvement of the business environment, making a recovery from the negative shock of the quota elimination highly unlikely. Failing significant improvements to revenue collection, the government will be unable to meet even priority spending needs, not to mention spending needed to achieve the MDGs. Moreover, long-run growth will be jeopardized if agricultural sector reforms are not developed and implemented. In this non-adjustment scenario, the NPV of public debt will reach about 230 to 250% of fiscal revenue, threatening fiscal sustainability. While the economy is not likely to experience a financial or balance of payment crisis, the lack of reform will slow progress toward poverty alleviation, which in turn could lead to social unrest.

20. The next chapter reviews what it would take by way of improvements in public financial management to bring about an improved budgetary outlook for Cambodia, focusing in particular on the governance constraints that will need to be addressed.

End Notes

¹ The TCAP was a medium-term (2001-2004) technical assistance program mostly aimed at strengthening macroeconomic institutions such as the Ministry of Economy and Finance, the Customs and Excise Department, the Tax Department, the National Treasury, and the National Bank of Cambodia. Donors participating in the TCAP include: IMF, the Asian Development Bank, the Department for International Development of the UK, the UNDP, the World Health Organization, and the Government of the Netherlands.

² Cambodia is one of the most vulnerable countries among Asian low-income countries to the garment quota elimination. Chapter 2, "Implications of Removal of Quotas in 2005," Selected Issues.

SUMMARY OF CHAPTER 2

Increasing Public Financial Accountability

Cambodia's Constitution provides for a system in which public financial policy-makers and managers are accountable to citizens, with the government budget as the principal instrument for poverty reduction, through resource mobilization and expenditure policy, as well as expenditure management. In practice, however, the budget does not fulfill this key role. Resources do not reach their intended beneficiaries. Breakdowns in the chain of accountability create "governance failures" that undermine the budget's ability to reduce poverty. The National Assembly does not provide effective oversight of public financial management while citizens lack effective mechanisms to demand such oversight. Inadequate resources lead to a civil service with both weak capacity to deliver and strong incentives to divert funds for other uses. Weak internal and external controls contribute to a public financial management system in which abuses can, and do, occur.

Cambodia has made some progress in reforming its public financial management (PFM) system. However, much more headway on four principal fiscal, fiduciary, and institutional challenges needs to be achieved in order to implement the development agenda: First, Cambodia will need to improve resource mobilization to ensure aggregate fiscal sustainability. The government plans to raise revenues to some 14% of GDP by 2009. This will require improved tax administration in the short to medium term and improved tax policy in the medium to long term. Progress will depend on establishing merit and performance based systems in the key revenue collection agencies and addressing the culture of non-compliance through increased transparency in tax administration. Second, to reduce the fiduciary risk to public funds, the Government will need to engage in comprehensive reform of budget execution, cash management, and public financial control systems. The Government has committed to undertaking these reforms as part of its PFM reform program, as endorsed by the Prime Minister. In addition, efforts will be needed to strengthen the National Assembly's role in the oversight of the budget, to enhance the transparency of the budget process, and to invigorate the newly created National Audit Agency. Third, despite considerable progress in increasing key social expenditures for the poor, governance failures prevent the poor from fully benefiting from such expenditure rationalization. Accountability relationships will need to be strengthened between service providers and beneficiaries. Last, Cambodia will need to undertake an innovative civil service reform, focusing on selectively institutionalizing a merit-based pay and employment system, in order to deliver poverty-reducing services.

The PFM Reform Program, designed by Government and endorsed by ten of Cambodia's development partners, could begin to address some of these problems. With strong donor commitment to support this program, a delivery of some quick wins could energize reforms in the broader management of the government's budgetary process.

CHAPTER 2: Increasing Public Financial Accountability¹

1. Strengthening public financial accountability is at the heart of an effective poverty reduction strategy. A well functioning system for managing the nation's financial resources raises, allocates and spends adequate resources for programs that strengthen the human capital of the poor, provide for their physical security and ensure adequate public infrastructure to facilitate economic growth. And hence, reduce poverty. The ultimate responsibility to resource the fight against poverty ultimately rests in the hands of Cambodian citizens. In theory, the legal framework provides for a system in which public financial policy-makers and managers are accountable to citizens. The Constitution of 1993/1999 (Articles 90 and 113) provides that the elected and appointed representatives of the Cambodian people, sitting in the National Assembly and the Senate, shall have the power to "approve the national budget." The Constitution (Article 57) also provides that "Tax collection shall be in accordance with the law" and that "The National Budget shall be determined by law" ("Cambodian Law of Public Finance", Office of the Council of Ministers, 2000). The Government "determines the national priorities" to be addressed by the budget. The Council of Ministers then adopts the expenditure directives for the Ministry of Economy and Finance (MEF) to use in budget preparation (Organic Budget Law, 1993). The Royal Government delegates its authority and resources to line ministries, guided by the central oversight ministries, to deliver the goods and services provided for in the budget. Thus, the budget should be the principal instrument for poverty reduction, through resource mobilization and expenditure policy and management.

2. There is considerable evidence, however, that the budget does not fulfill this key role. Resources do not reach their intended beneficiaries. The principal reason is that breakdowns in the chain of accountability create "governance failures" that undermine the budget's ability to reduce poverty. This chapter reviews Cambodia's recent experience raising, allocating, and spending resources for poverty reduction in light of the citizen—policy maker—civil servant accountability framework. The framework, applied to public financial management (PFM) and civil service reform, highlights a number of critical weaknesses in practice. The National Assembly does not provide effective oversight of public financial management, and citizens do not have effective mechanisms to demand that oversight. Policy makers deliver inadequate levels of resources, including wages, to service providers through the budget, in part because revenues are low. In turn revenues are low, in part, because taxpayers do not want to pay for poor services and because taxpayers face few, if any, consequences for not paying their taxes. Inadequate resources creates a civil service with both weak capacity to deliver and strong incentives to divert funds for other uses, blurring the line between the public and the private. Weak internal and external controls allows for a PFM system in which abuses can and do occur. All of this means that the public resource management system falls far below expectations in the fight against poverty.

Increasing Public Financial Accountability

3. While Cambodia has made some recent progress in reforming its PFM system, it will have to make much more headway on four principal fiscal, fiduciary, and institutional challenges in order to implement its development agenda. First, Cambodia will need to improve resource mobilization to ensure aggregate fiscal sustainability. Second, to reduce the fiduciary risk to public funds, the Government will need to engage in comprehensive reform of budget execution, cash management, and public financial control systems. Third, the Government will need to further rationalize public expenditure policy and management to reach the goals it has set itself in its various national strategies.² The Government has committed to undertaking these reforms as part of its PFM reform program, which has been endorsed by the Prime Minister.

4. Last, Cambodia will need to undertake an innovative civil service reform, focusing on selectively institutionalizing a merit-based pay and employment system, in order to deliver poverty-reducing services. Unfortunately, however, credible plans and strategies to tackle these problems head on have not yet been articulated. The following sections elaborate on these four core challenges and provide an outline of proposed solutions.

A. Improving Resource Mobilization

5. Despite the need for higher revenues to finance growth and poverty reduction, by adequately funding government services, Cambodia's fiscal revenue ratios, especially tax revenue, remain among the lowest in the world, including as compared against other low income agricultural economies. Indeed, without significant increases in revenues, there are serious risks to Cambodia's medium term poverty reduction program.

6. To be sure, the Royal Government has made progress over the past several years, given its inheritance of a grossly inadequate revenue effort. As a result of the reform efforts, and to the Government's credit, revenue rose from 10.2% of GDP in 1999 to 11.2% in 2002, before falling back, however, to 10.4% in 2003. This fall is due to external factors (SARS, the anti-Thai riots, and the elections) coupled with the continued impact of leakage in the system. Overall, given the urgency of increasing revenues, the Government responded with a program of reform that generated results, and though incomplete, provides a foundation for a new set of revenue-generating reforms.

7. It is clear that continued further improvement will be considerably more difficult as growth prospects diminish. The Government plans to raise revenues to 14% of GDP by 2009.³ Improving domestic resource mobilization will have to depend on improved tax administration in the short to medium term and improved tax policy in the medium to long term. Recent experience suggests that for improvements in tax administration to be sustainable, they must get at the root of the problem. The path chosen by the

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Government in its PFM reform program is to establish a merit, and performance, based pay system in select departments. An improved tax administration will necessarily confront Cambodia's culture of non-compliance, in which a vicious cycle of taxpayer non-compliance feeds on poor and corrupt administration and inadequate service delivery. Thus, progress will depend on addressing underlying governance challenges, including by improving transparency. Improvements in accountability will also come from reducing reliance on external assistance and increasing reliance on citizens as well as firms operating in Cambodia.

8. Non-tax revenue collection is also an area where governance challenges dominate. This is especially true of state assets leased to and used by the private sector and the procurement practices associated with contract awards. Measures to improve transparency could help offset future declines in some non-tax revenue items. In addition, revenue from leases could increase with improved monitoring of the use of state assets and as a result of the inventory of states assets underway.

B. Aligning Public Expenditures to Poverty Reduction

9. Since 1998, the Government has significantly improved the alignment of resources with its developmental objectives by increasing allocations for priority sectors, notably education and health. Government-executed spending on the priority sectors increased from 1.4% of GDP in 1998 to 3.2% in 2001. Furthermore, the NPRS indicates that the RGC intends to continue this strategy, presenting ambitious targets for growth in priority sector spending to 2005.

10. However, given current growth prospects, the ability to pursue further relative reallocations based on revenue growth will be limited. In fact, the reallocations over the period 1999-2003 occurred in relative terms, for the most part, meaning that most ministries' budgets increased in nominal terms. Only five institutions actually experienced budget cuts over the period 1998-2001. It is likely that to implement the SEDPII/NPRS and meet the Cambodian Millennium Development Goals, the Government will need to reallocate resources away from non-priority sectors and programs.

11. Moreover, socio-economic indicators demonstrate that the impact of these recent reallocations to the social sectors has been muted. Expenditure policy can only go so far toward reducing poverty given the state of Cambodia's expenditure and financial management system. To reach the stated poverty reduction goals, it is necessary to improve the effectiveness of spending by linking it more closely to priority outcomes and by strengthening mechanisms of accountability. Increased effectiveness can be attained by improving the pro-poor targeting of resources through more tightly linked sector plans and budgets. In education and health planning processes have improved and planning and budgeting are better linked, resulting in improved prioritization of

spending. Agriculture and road transport have yet to make progress on this front, though it is critical that they do so, in order to provide the foundation for improvements in allocative efficiency by directing more resources to the economic sectors.

12. Expenditures are targeted to the poor in education, but less so in health, and only marginally in agriculture. A significantly greater amount of education related public spending is estimated to benefit the poor in 2002 as compared with 1997 (Table 2.1). In 2002, it is estimated that the poorest 40% of the population received 39% of total education expenditure, and 50% at the primary level.

Table 2.1: Share of Education Subsidy Received by Income Quintile
(RGC Spending)

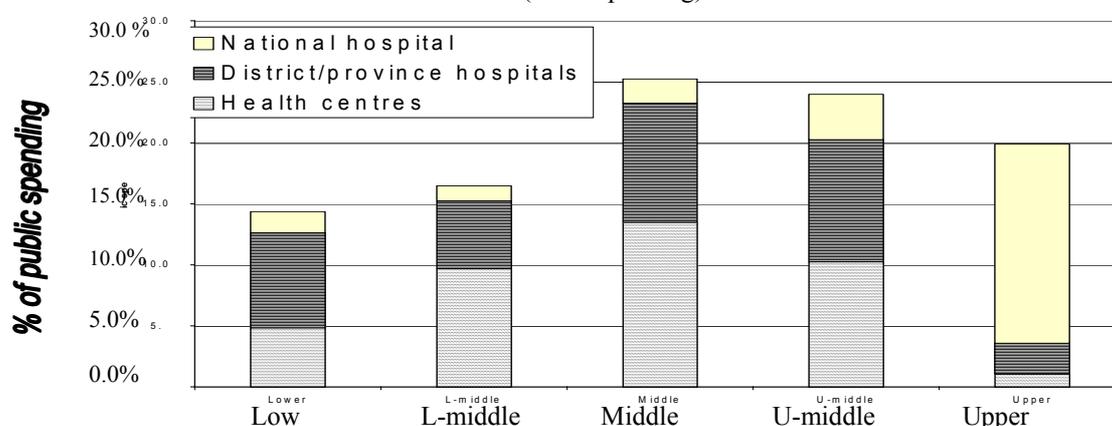
<i>Quintile:</i>	<i>I</i>	<i>II</i>	<i>III</i>	<i>IV</i>	<i>V</i>	
<i>% of Public Subsidy Using 1997 Enrolment Share</i>						
Primary	21%	21%	21%	20%	17%	100%
Lower Secondary	8%	12%	19%	23%	38%	100%
Upper Secondary	4%	4%	14%	21%	56%	100%
Post-Secondary	2%	0%	6%	15%	76%	100%
<i>Percentage of Government Subsidy Received, 2002 estimate</i>						
Total	19%	20%	19%	19%	23%	100%
Primary	25%	25%	21%	17%	12%	100%
Lower Secondary	11%	14%	19%	22%	34%	100%
Upper Secondary	7%	7%	13%	26%	46%	100%
Post-Secondary	1%	0%	12%	22%	65%	100%

Source: IFAPER, 2003

13. In health, on the other hand, the lowest income quintile consumes 13% of the resources, while the top quintile uses almost 20% (Figure 2.1). Inequality in resource distribution is most evident for the national facilities. By contrast, district hospitals appear to provide the greatest benefit to the poorest group. The budget formulation (and execution) process would need to radically reallocate health resources toward remuneration and steeply away from Phnom Penh and toward province/district services in order to have a material impact on MDGs for child and maternal health.

14. Resource scarcity thus makes expenditure rationalization a very high priority. There are a number of possible avenues for expenditure rationalization: (a) reduction of expenditures in the low priority sectors; (b) generation of additional savings from institutional rationalization, including consolidation of administrative structures; and (c) rationalization of operating expenditures by cutting administrative overheads while increasing maintenance spending and the wage bill.

Figure 2.1: Health Benefits Incidence Consumption Group
(RGC Spending)



Source: IFAPER, 2003.

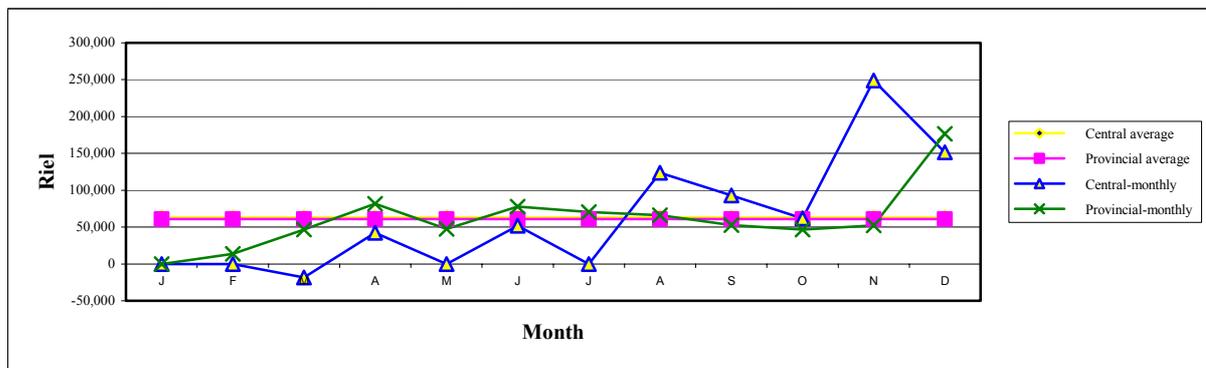
15. Development partners also share some of the responsibility for the allocation of resources. There has been a gradual shift in the functional composition of external assistance, though there is no marked trend toward the Government’s priority sectors. At the same time, Cambodia’s external assistance portfolio is heavily geared toward technical assistance. Spending on technical assistance, comprising both personnel charges and training and associated operational expenditures is estimated at around 45% of the external assistance project portfolio, excluding humanitarian assistance. On this basis spending on technical assistance is two to three times Government spending on civil administration wages. While technical assistance inputs provide an important contribution in terms of capacity building and institutional reform, over time there is a need to shift more resources toward investment, and, under the right conditions, toward financing operational costs through budgetary support. In the medium term, however, there is a case to be made for creative thinking about the possibility of re-channeling some technical assistance funds, including salary supplements, toward wage expenditures.⁴

16. Governance failures appear to be at the heart of why Cambodia’s poor do not benefit more from public spending. The weak policy-budget linkage is due principally to the underlying weakness in the accountability relationships between service providers and beneficiaries. Outcomes are more likely to improve when better information is available and opinion is mobilized that helps to hold politicians and civil servants to account.

C. Reducing Fiduciary Risk to Public Funds

17. Weaknesses in the public financial management system not only have high costs in terms of allocative and operational efficiency but also create unacceptably high levels of fiduciary risk to public funds. The cash-based payments system, which reflects historical difficulties as well as current ones, has endured as a major constraint. Increasingly, budget execution has suffered from delays and an unpredictable release of funds (even for salary payments; Figure 2.2), undermining operational planning and resulting in the build-up of arrears. Deficient accounting and reporting systems lead to a weak control environment and increase opportunities for corruption. Indeed, in comparative perspective, Cambodia's PFM system ranks below average, indicating the need for substantial upgrading.

Figure 2.2: Monthly Salary Payments in the Ministry Of Health, 2001



Source: IFAPER, 2003.

18. The impact of attempts to address these problems by implementing pilot initiatives, notably the Priority Action Program (PAP), has been muted by liquidity constraints and concerns about the adequacy of control arrangements. It is noteworthy that execution rates for the priority sectors have trailed those for the civil administration as a whole, despite the channeling of a substantial share of sector expenditures through streamlined disbursement mechanisms (Table 2.2). The situation in 2002 was largely unchanged, though there was some improvement in 2003. The costs, in terms of planning and procuring goods and services in a sensible and efficient manner, are enormous. The PAP initiative has, however, improved the alignment of resources with policy and helped channel funds to operational units.

19. The challenge for the Government is to consolidate recent initiatives while gradually addressing the structural constraints imposed by weak financial institutions and limited capacity. The Government recognizes the need to focus on improving budget execution, cash management, and the control environment, all of which are addressed in the PFM reform program. Moreover, in spite of a comprehensive legal framework and a multiplicity of controls, reform will also need to address weak

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financial management practices, which currently undermine transparency and accountability, posing serious fiduciary risks. For example, widespread anecdotal evidence suggests that “facilitation” of Treasury transactions, specifically the release of budgeted funds, is a common and accepted practice.

Table 2.2: The Back-loading Problem: Percentage of Expenditures Posted in December, 2000 and 2001

<i>Economic/Sector</i>	<i>2000</i>		<i>2001</i>	
	<i>Central</i>	<i>Provincial</i>	<i>Central</i>	<i>Provincial</i>
Civil recurrent expenditure	43.4	22.8	31.6	29.9
Ch. 10: Salaries	11.6	19.4	14.1	23.7
Ch. 11: Operating costs	38.2	25.0	42.2	34.9
Ch. 13: Specific program activities	47.7	100.0	47.3	70.0
Domestically funded capital expenditures	10.8		18.2	
Defense and security	17.2		18.5	
Education	63.2	21.1	34.7	30.2
Health	59.7	31.7	71.4	43.6
Agriculture	41.2	18.6	30.7	28.0
Rural development	31.5	22.1	13.2	27.4

Source: IFAPER, 2003.

20. Though there has been some progress in improving the audit function, public oversight of government financial management remains extremely weak. Legislation establishing the National Audit Authority (NAA) was passed in March 2000, providing for an institutional framework, responsibilities, and competencies that are consistent with international standards. The NAA is independent of the executive, reports to the National Assembly, enjoys financial and administrative autonomy, and is authorized to determine the scope and methods of audits. The NAA carried out an audit of the year 2001 budget implementation as its first audit assignment. The audit was completed in September 2002 and was submitted to the National Assembly. However, the report has yet to be made public, which means that its potential impact in terms of improving accountability is, as yet, unrealized.

21. In parallel with the creation of the external auditor, the RGC has sought to build up its internal audit capacity. MEF’s General Inspection Department undertakes compliance audits at the agency level, though its effectiveness is limited, in part because it does not appear to have a strategic or risk-based audit program. Moreover, most line ministries’ internal audit units do not seem to be functioning adequately.

22. The other critical link in the expenditure management chain is public procurement. Fiduciary risk in procurement has lessened somewhat since competitive bidding was introduced in stages over the past eighteen months.⁵ However, the fiduciary risk is still rated high due to: weaknesses in the existing regulatory framework; the absence of a sovereign procurement law with a single focal point for monitoring and

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enforcement; inadequate capacity at the line ministry level; the fact that civil servants have become used to negotiating contracts directly with contractors and suppliers, encouraging the making of unofficial “deals”; and the loophole in the 1998 Build-Operate-Transfer (BOT) Subdecree, which has encouraged the awarding of several concession contracts through direct negotiation on what appears to be a questionable basis.

23. Compared to countries that are recognized as having a sound basis for procurement activities, there are other weaknesses in the present legal framework pertaining to key areas such as company law, bankruptcy law, well-defined contract law, and commercial arbitration law. Another weakness is that procurement is governed by a range of sub-decrees, specifying different procedures for particular procurement activities rather than a sovereign law. Suppliers and contractors, as well as government procuring entities, often admit to being confused about the rules applying to a particular bid. In addition to the need for the establishment of a well-designed and enforced regulatory framework for the business and commercial sectors, it is important that RGC improves the dissemination of information related to procurement. All new laws, sub-decrees and prakas should be, but are not notified in the weekly *Official Gazette*, which should be made easily available to the public.

24. Efficient and transparent public procurement is a vital component of economic growth in any country and is a matter deserving of clear and unambiguous principles to be followed in all cases to minimize opportunities for corruption. As such, procurement reform is also featured prominently in the Government’s PFM reform program.

25. Legislative oversight of public spending, including procurement, is provided by the National Assembly’s Finance and Banking Committee (FBC), and the Assembly as a whole, though the link between legislative oversight and greater accountability is weak. The FBC reviews the RGC’s budget proposal and financial statements before submitting them to the plenary session. While there is active debate on budgetary issues, the FBC’s deliberations are neither public nor published. Though parliamentarians and senators have the authority to propose reallocations to the budget law, they rarely do so. The draft budget law is voted in plenary sessions after Government presentation and cursory debate. These debates are reported in the local press, though, for the most part, press coverage has tended to focus on investigations of corruption in the public sector rather than expenditure policy issues. Moreover, in past years the Assembly has given itself too little time to review the budget in detail.

26. Improving accountability is also hampered by a generalized lack of public sector transparency. The budget, for example, is not very accessible in its current format and is not widely disseminated. Budget execution data are not made public. Basic civil service information is closely guarded. Civil society is not consulted by the National Assembly on budgetary issues.

27. While on balance oversight arrangements are fairly sound, their effectiveness is severely limited, in part, due to capacity constraints. These will have to be addressed over the medium to long-term, by increasing both the numbers and in-service training of financial management personnel. At the same time limited capacity must not become an excuse for poor oversight, especially if the ability to report and combat abuse were constrained by a poor governance environment. In the meantime, the effectiveness of existing oversight arrangements could be greatly improved by ensuring that the NAA's audit reports are made available to the public. Moreover, attention should be given to the development of "bottom-up" oversight arrangements to complement formal oversight by the NAA and the National Assembly through beneficiary participation in monitoring service delivery and budgetary releases to regions.

D. The PFM Reform Program

28. The Government is aware of these difficult challenges and is committed to addressing them in a potentially far-reaching manner. MEF's newly appointed Reform Committee has developed a "Public Financial Management Reform Program," which has been endorsed by its ten development partners, with the following core components: (a) a concise strategy statement and a rolling, prioritized, sequenced, and costed, annual work program; (b) a performance management framework to assist in program formulation, improve transparency and accountability, monitor progress, and enable international comparisons; (c) complementary organizational reform and capacity building strategies, with a focus on appropriate incentives. The Government's program will build on past accomplishments, including, most recently, the reduction in arrears to suppliers, refinement of the chart of accounts, and higher tax arrears collections.

29. In the initial phase ("Platform One"), MEF's PFM reform program will focus on meeting the following objective: "...to achieve a position in which the budget becomes more credible as an instrument of strategic and day to day management of public resources, because it delivers a reliable and predictable resource to individual budget managers. This entails that the budget reflects all significant public resources and their deployment. It thereby enables steps in subsequent stages to hold budget managers more accountable for the proper, efficient and effective use of resources" (Royal Government of Cambodia, PFM Reform Program, 2004). In order to do this, the Government intends to: improve the comprehensiveness and integration of the budget (in formulation and execution); widen the scope for executing Treasury operations through the banking system by check or transfer; consolidation of Government accounts into the Treasury Single Account; establish procedures to prevent entering into commitments that exceed available budget resources; improve the realism of the budget in terms of forecasting and debt management; strengthen tax and non-tax revenue collection; streamline the ability of resource managers in the line ministries to spend in accordance with their budget allocations; rein-in extra-budgetary spending; strengthen procurement

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procedures; and enhance coordination and decision making within MEF, in part by introducing motivational and capacity development measures.

30. A subsequent stage which aims to improve internal control and thereby hold resource managers accountable, would: (i) improve lines of accountability by clarifying governmental roles, functions, and responsibilities; (ii) improve accounting data and management; (iii) enhance reporting for managerial and performance management purposes; and (iv) improve both internal and external auditing.

31. Many of the highest priority items in the Government's action plan are set for implementation according to a timetable agreed with the PFM partners (Third Joint PFM Mission, 2004). These include: designing new transaction processing systems from commitment to discharge; implementing measures to collect Tax and Customs revenues by check and by direct deposit to the National Bank of Cambodia and accelerating payment of suppliers by check/transfer; setting up a transparent cash release plan for 2005 and a system of rolling three month cash flow forecasts; implementing the transfer of the Foreign Currency Unit to Treasury and redesigning processes to integrate cash flow management; further planning and progress with elimination of old arrears of payment; and developing a strengthened system for ensuring effective management of budget supplementaries. Implementation of the Platform One measures would restore credibility to Cambodia's national budget and would lay the foundation for holding managers accountable for compliance with mandated financial management practices.

32. The donor community has indicated its willingness to make a concerted effort to provide the necessary support for this urgent reform initiative. Toward this end, a series of joint missions involving ten development partners—ADB, AusAID, DFID, EC, French cooperation, IMF, JICA, SIDA, UNDP, WB—visited Cambodia during the January-July 2004 period to assist MEF with its program and to develop a coordinated donor mechanism. Partners have recognized that they can improve their provision of technical assistance to the Government, based on recent experience. The most difficult problems—fragmented and contradictory advice from partners, lack of alignment of assistance with Government plans, lack of accountability of assistance to Government, and lack of Government leadership—have been addressed with the establishment of the PFM sector wide approach. Thus, on both the Government's and the partners' side the institutional mechanisms are now in place to support sustained reform. Now is the time for implementation.

E. Reforming the Cambodian Civil Service

33. One of the other major reasons for low quality public services is the absence of an effective system of incentives and accountability mechanisms in the Cambodian civil service. Weak merit-based civil service management, low pay and pervasive corruption

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are the leading causes of Cambodia's relatively poor standing on public sector performance. The World Bank's Country Policy and Institutional Assessment (CPIA) ranks Cambodia in the fourth lowest quintile among fellow low income countries on issues pertaining to public sector management and institutions, indicating the need for significant improvement. Given these serious problems, a strategically sequenced civil service reform will need to be initiated in the short term and carried out over the medium term if the Government's vision of poverty reduction is to become reality. The reform program will need to take a broad approach to strengthening civil service management, by introducing a merit-based system that guarantees that human resource expenditures are subject to controls (viz., on hiring and promotion) and fully integrated with the budget formulation process; improving civil service pay, to attract and retain skilled staff, especially for high level management and priority sector staff; and rationalizing civil service employment, to ensure that human resources are wisely deployed in high priority sectors. Indeed, one of the principal risks to the government's poverty reduction strategy is the capacity of the civil service to deliver.

34. Though the Government has made some modest progress, including carrying out a civil service census and developing an automated payroll system, much more is required. In some of these areas, establishment control for instance, key measures such as the introduction of an establishment register will allow the Government to build productively on its previous successes, while in other areas, notably institutionalizing a merit-based system reinforced by higher pay, the Government will be challenged to push itself farther and faster than currently envisioned.

35. Though the most pressing issue facing the Cambodian civil service is undoubtedly the lack of a merit-based system for managing, recruiting, and promoting civil servants, the most pressing problem facing civil servants themselves is the low level of pay, in relation not only to wage levels outside the service, but also to the cost of living (Table 2.3). Cambodia's ratio of the average civil service wage to per capita GDP is one of the lowest in the region.

Table 2.3: Median Monthly Remuneration, 2002 (US\$)

<i>Category</i>	<i>Level of Education</i>	<i>US\$/month</i>	<i>Compression Ratio</i>
A	Secondary school + 4 years	40	1.9
B	Secondary school + 2 years	32	1.5
C	Secondary school	26	1.2
D	Other	21	--

Source: Council for Administrative Reform

36. With the exception of a very limited number of high level staff (approximately 700 out of nearly 168,000 in 2003), most civil servants earn very little, in either absolute or relative terms. Moreover, the compression ratio (that is, the ratio of average pay of the highest category to the lowest category, which is under two) is very low by international standards. The 10-15% per annum increase in salaries contemplated by

the Government would have no significant impact on recruitment or retention of skilled civil servants over the next decade.

37. This pay structure, coupled with the lack of merit-based practices, will not be sufficient to motivate civil servants already in the system or to attract the necessary quantity of qualified candidates to the civil service. Indeed, the extremely low pay levels encourage corrupt practices by blurring the lines between the public and the private. Anecdotal evidence indicates that civil servants survive, and in some cases prosper, thanks to patronage networks in which they pass resources up to their patrons and down to their clients. Reports of job buying abound. In some cases, jobs are reported to have been purchased for tens of thousands of dollars. At the other extreme, poor people find they need to buy their jobs. Thus the cycle continues.

38. The overall size of the civil service has been growing since the mid-1990s, indicating that political pressures overwhelm weak merit and promotion and establishment control practices. According to the budget laws, public sector employment has increased by about 13% since 1994, from 148,353 to 167,778 in 2003. The analysis also suggests that improvements could be made in the deployment of civil servants, both geographically and to the priority sectors (redeployment from center to province is necessary in some sectors, including agriculture and health, for example). A functional review, covering the appropriate institutional arrangements, organization, processes, and staffing of government functions in order to improve efficiency and effectiveness in service delivery, would be necessary to ascertain what the overall level of employment ought to be, where exactly the sectoral inefficiencies are, and what composition of public sector employment makes most sense for Cambodia.

39. A transparent, merit-based system, reinforced by higher pay through sequenced and targeted salary increases must thus become the key element of the Government's reform program. It would neither be feasible nor sensible to enact an across the board pay increase for the Cambodian civil service, given the problems noted above as well as the fiscal constraints, especially in the absence of improved management. The promising path for civil service reform is through a parallel, phased introduction of merit-based management and higher, decompressed pay for selected high priority sectors, functions, and skills. Eventually, long term rationalization of staff levels would have to accompany pay rationalization. Moreover, paying civil servants through the banking system, instead of by cash, would diminish the scope for corrupt practices.

40. As elsewhere in Cambodia, greater transparency of basic information would help to improve accountability and, in this case, ameliorate human resource management. Information on the number and level of civil servants by ministry is publicly available in most countries, yet in Cambodia it is treated as confidential. The fact that the Government does not use one set of official numbers when counting its civil servants creates confusion and undermines robust analysis. The core of the problem is that CAR's database (HRMIS) is not utilized outside of CAR. It is

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imperative for the Government to use a single, unified database, and for the budget to control the size and distribution of the establishment. To attain this end, MEF and the line ministries, at a minimum, would need to have complete access to CAR's database for budget preparation purposes. Granting wider governmental access to the database would improve the quality of data and policy analysis and is necessary for promoting transparency. Greater transparency is necessary for improving the management of the workforce.

F. Conclusion

41. The question of why Cambodia's poor do not benefit more from public spending places good governance questions squarely on the table. Shortcomings in service delivery performance, manifested through ineffective links between policies and outcomes and inefficiencies in expenditure, are often due to the lack of effective accountability mechanisms. Outcomes, particularly for the poor, can only improve when better information is available and opinion is mobilized that helps to hold politicians and civil servants to account. This suggests that in terms of sequencing improving public sector transparency, especially through greater dissemination of information on data and decision making, is the first step on the road to greater accountability.

42. Building up and institutionalizing accountability mechanisms will take time, and will ultimately involve deepening engagement between citizens and their government. The Government appears to recognize the challenges that need to be tackled in key areas in order to improve the quality and quantity of pro-poor service delivery. Most promising and high on the list of priorities for poverty reduction is the development of a prioritized and sequenced *public financial management reform* program by MEF. The PFM reform program deserves the full and generous support of Cambodia's development partners.

43. A no less vital arena, civil service reform, has unfortunately seen less progress. A prioritized, sequenced strategy for introducing the features of a meritocratic civil service in high priority sectors, and buttressing these reforms with enhanced pay, is noticeably lacking. Progress on civil service reform, critical for implementing the Rectangular Strategy, is too important to be allowed to fall behind.

End Notes

¹ Much of this chapter is based on the 2003 WB-ADB *Integrated Fiduciary Assessment and Public Expenditure Review* (IFAPER).

² Second Socioeconomic Development Plan (SEDP) and its National Poverty Reduction Strategy (NPRS) and the Cambodia Millennium Development Goals.

³ Non-tax revenue, from post/telecommunications, quota auctions and garment licenses, civil aviation, timber royalties, and others, is particularly important in Cambodia, where it made up roughly 29% of total revenues in 2002. Downward pressure on collections is expected in the short term. For example, revenue from the auction of garment quotas would end if the quota system is phased out in 2005, as scheduled, and export licensing requirements could eventually be eliminated.

⁴ See Chapter 2, IFAPER, for a full exploration of the externally-financed expenditure issues.

⁵ Since January 2004 all government ministries have been required to adopt “open” tendering (competitive bidding), as compared to direct contracting (only the Royal Palace is excluded).

SUMMARY OF CHAPTER 3

Decentralization: Enhancing Accountable Service Delivery for the Poor

Decentralization and deconcentration are seen as corner stones of democratization and improved service delivery for poverty reduction by the Royal Government in its major strategy statements such as the Rectangular Strategy. ‘Decentralization’ refers to the delegation of political and administrative authority, from the central to the commune level. ‘Deconcentration’ refers to the delegation of administrative responsibilities, decision-making and authority from central ministries to sub-national provincial departments and/or district offices.

Deconcentration and decentralization can improve the lives of ordinary citizens if focused on better service delivery by increasing participation, amplifying voice and enhancing transparency, and shortening the chain of accountability from local communities to their government. But these gains are by no means assured. Local governments may not be sufficiently empowered, lack capacity and be prone to elite capture.

To date, deconcentration of state functions has made very little progress. However, the February 2002 elections of 1621 Commune and Sangkat councils mark the beginning of a process leaning towards reversing a highly centralized form of governance. This has been well received by the donor community and heavily subsidized through external grant and loan financing. However, the initial positive results and momentum built-up will soon run-out of steam unless the Government clarifies the broad direction in which it is headed and demonstrates a greater commitment to addressing some of the constraints that have arisen.

The functions and responsibilities of the sangkats and communes and the supporting role of the governor and the provincial administration need to be clarified. The very different roles of the urban sangkats and the rural commune need to be recognized.

The accountability framework needs to be strengthened. Subnational tiers are vastly weaker than the Central ministries, who are reluctant to let go of their powers. And related systems, such as participatory planning, fiscal transfer, service delivery and internal and external accountability (such as auditing) are weak. In the health sector, for instance weak alignments between plans and budgets, unpredictable budget releases and highly centralized financial management reduce the incentives of subnational participants to engage in bottom up planning. Commune/sangkat officials are elected on a proportional representation, party list basis making them more accountable to the party that selects them than to the citizens who vote for them.

Action is also needed to broaden the modest tax base of communes. This will also help increase accountability as local taxpayers will be more able to demand services from those who tax them.

CHAPTER 3: Decentralization: Enhancing Accountable Service Delivery for the Poor

1. Cambodia is tentatively moving towards strengthening its young democracy by bringing government closer to the people. Decentralization and deconcentration are seen in the Royal Government's major strategy statements, including the Rectangular Strategy, the National Poverty Reduction Strategy and the Governance Action Plans, as a means to further democratize the country and improve service delivery in the regions. This is viewed as fundamental to poverty reduction and rural development, and to empowering ordinary people to determine their own future. This chapter looks at the experience with the first two years of decentralization, analyses potential risks and opportunities and outlines key actions now needed to ensure that decentralization enhances accountability and voice for the poor in Cambodia.

2. In the development lexicon of Cambodia, 'decentralization' is used to refer to delegation of political and administrative authority to the commune level, and 'deconcentration' to delegation of administrative responsibilities, decision-making and authority from central ministries to sub-national provincial departments and/or district offices. Deconcentration of state functions to provincial governors and related reforms focusing on the province and the district as sub-national levels for budgeting, planning, finance and administration of development, has made very little progress to date. Nonetheless, with the election of 1,621 Commune/Sangkat Councils in February 2002, Cambodia began the process of reversing its highly centralized form of governance, empowering 11,261 newly elected local officials to take charge of a modest range of functions, including commune development planning, design and implementation of small-scale local development projects initially focused on provision of small-scale public infrastructure such as village roads, and civil registration. This first and rather tentative step in an as yet uncharted path to more comprehensive decentralization has been strongly supported by the donor community and heavily subsidized through external grant and loan financing. Progress to-date has been mixed with some significant achievements but with some important aspects severely lagging. Thus, there is still a long way to go with both deconcentration and decentralization. Many difficult policy choices lie ahead. Worldwide experience suggests that realization of the potential benefits of decentralization will depend in large part on how well these future choices are made.

3. The Royal Government is aware of the urgent need to develop a broad consensus around a vision of decentralization and deconcentration, and a visioning exercise has commenced recently, led by a inter-ministerial Working Group appointed by the Prime Minister. In the absence of such a shared vision, there is no strategy to translate the vision into action and results at the local level. Equally, donor coordination in this area has been less than satisfactory, and donor advice to the process has at times been contradictory.

A. Tentative Beginnings

4. Deconcentration and decentralization in Cambodia have the potential to make important changes for the better in the lives of average citizens, if focused to achieve more efficient and effective service delivery, and reduce corruption and waste. More specifically, given sound management of the process, there is considerable potential to improve governance and service delivery by increasing the level of meaningful participation and thereby amplifying the voice of local communities in decisions that affect their lives; increasing transparency in all aspects of government activities, enabling local communities to better monitor government performance; and shortening the chain of accountability from local communities to their governments so that local elections matter and provide strong incentives for local government to perform better.

5. The potential benefits from decentralization are by no means assured. There are many possible pitfalls. Local governments may not be sufficiently empowered nor have adequate capacities or funding to use the autonomy expected of them from the electorate. Also, local governments could be more prone to "elite capture," or to domination by local special interest groups, such as commercial interests. Decision making processes that do not allow for meaningful participation could reinforce such tendencies. Finally, reliable information on local government performance may be lacking, hampering constituents in the monitoring of their local governments. And even if information is available, local constituents may not have the political or legal means to discipline local government officials for bad performance, or corruption.

Genesis in Local Experimentation

6. While the February 2002 Commune/Sangkat elections created the first elected local governments in Cambodia's recent history, both provinces/municipalities and communes/sangkats have long existed as administrative levels of government in Cambodia. The 1993 Constitution of the Kingdom of Cambodia enshrined provinces (khet) and municipalities (krung) as the first-tier territorial sub-divisions of the country. Municipalities are the territorial equivalent of provinces in selected urbanized areas. Cambodia currently comprises 20 provinces and four municipalities (Phnom Penh, Kep, Pailin and Sihanoukville). Provinces are further divided into districts (srok) and communes (khum), and municipalities into sectors (khan) and urban communes (sangkat). There are 1,510 communes (rural) and 111 sangkats (urban). Villages are found in both rural areas and urban areas.

7. There is a wide range in the number, population and area of the second- and third-tier administrative sub-divisions across provinces/municipalities. The number of districts ranges from 16 in Kompong Cham to 5 in Mondulkiri. Similarly, the number of communes ranges from 173 in Kompong Cham to 21 in Mondulkiri. The average population of communes/sangkats is about 8,000, but varies considerably. Moreover, in the more remote and sparsely populated provinces, such as Rattanakiri, the geographic

area of communes can be quite large. As a result of this wide variation, and the related challenges it presents for efficient commune operations, the boundaries of the communes will be reviewed and may be readjusted before the second local government election slated for 2007.

8. During the post-1993 election reconstruction period that followed decades of civil war, the Royal Government reigned-in provinces, for both national security and political reasons, restricting the degree of independence to which the provinces had been accustomed in the 1970s and 1980s. Whereas earlier provincial governors reported directly to the Prime Minister and enjoyed significant discretionary authority within the province, the post-1993 political and fiscal reforms recentralized control and reduced the authority of the provincial governors, repositioning them under MOI. As national stability was established, however, the Royal Government refocused from internal security to development, and national leaders have progressively recognized the potentially important role of the provinces and communes in service delivery, and have since gradually increased responsibility and authority at sub-national levels.

9. The Royal Government authorized the Ministry of Rural Development¹ to establish a rural development and management structure for the country consisting of an entity at each of the territorial sub-division levels: Provincial Rural Development Committees (PRDC); District Development Committees (DDC); Commune Development Committees (CDC); and the Village Development Committees (VDCs). Many donor- and NGO-supported rural development projects and programs have worked within these rural development structures since their establishment. The Ministry of Rural Development's focus has been primarily at the village level, where VDCs have been established in nearly 8,000 villages by open elections. The planning and development activities of these VDCs have been supported by numerous NGO- and donor-funded projects in cooperation with the Ministry and the Provincial Departments of Rural Development (PDRD).

10. At the commune level, the most extensive donor-funded activity within the rural development and management structure has been the Seila Program. Villages were initially the focal point for sub-commune planning under Seila, but this was abandoned early on in favor of a commune-level focus, as intensive village-level planning was thought not to be replicable nationally and because communes represent the lowest administrative tier. Phase I of Seila (1996-2001) worked with PRDC and CDC (made up of representatives of VDCs) in a small but gradually increasing number of provinces², and piloted a model for the decentralized planning, financing and management of development activities at province and commune levels. The lessons from the experience of Seila have largely shaped the decentralization reforms, by demonstrating that "the seeds of decentralization can grow in Cambodian soil".

11. In practice, decentralization has progressed more rapidly than has deconcentration, employing an incremental approach. The key elements of the

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decentralization reforms have focused thus far on devolving political authority to a new semi-autonomous elected local government, the Commune/Sangkat Council (C/SC), establishing an initial set of Councils with responsibilities for local development and administration within their current, fairly limited, capabilities, as well as establishing an intergovernmental fiscal transfer system at the national-level, the Commune/Sangkat Fund (C/SF), to support the implementation of these initial responsibilities.

12. At the provincial level, however, there has been little substantive progress to date on deconcentration of state administrative powers and functions to provincial governors, and provincial and district administrations. There has been substantial experimentation at the provincial level, both on-budget (Accelerated District Development (ADD), and Priority Action Program(PAP)) and off-budget (Provincial Investment Fund (PIF), and Agricultural Development Support to Seila (ADESS)). However, these pilots have not as yet led to a unified approach to deconcentration.

13. A “weak” form of deconcentration, as in the transfer of responsibilities and functions from the central ministries to their sub-national offices, is being piloted by several ministries using a number of different, and not entirely consistent, models (e.g., ADD, PAP, ADESS). An analysis of the advantages and disadvantages of the various approaches has not been done, however, and would be an important input to a framework for deconcentration. A “stronger” form of deconcentration, giving the provincial/municipal administrations discretion in allocating provincial budget resources to sectoral departments, playing a greater role in personnel management, and using a variety of service delivery arrangement tailored to local conditions and to raise own-source revenues for these purposes, has also been piloted in a limited, off-budget way under Seila through the Provincial Investment Fund.

B. Towards a Long Term Strategy and Vision

14. The incremental approach that Cambodia has taken to decentralization has allowed it to draw on lessons of experience, seize political opportunity, and achieve significant progress in some areas. However, the useful limit of such an incremental approach is fast approaching. The initial tentative steps towards decentralization have yet to be followed by those political, administrative and fiscal reforms that would strengthen democracy at the grass roots and enhance the capacity of communes to reduce poverty and better deliver services. Also, there is no clarity on the degree of deconcentration that is envisaged. Changes in the legal and policy framework are needed to make the directions already embraced work better, and to better empower local communities.

15. To guide the needed policy and regulatory changes Cambodia needs to develop a long-term vision for governance at the sub-national level, based on a highly consultative process, and embracing a broad agenda of political, fiscal and administrative

decentralization and deconcentration. Strengthening governance at the province, district and service provider levels is critically important for the delivery of health, education and nutrition services. A consultative exercise that draws on the initial lessons from two years of decentralization and from the pilot initiatives in deconcentration will not only help develop a long term direction, but also allow for some mid-course corrections, clarifying responsibilities and functions and identifying the legal and policy framework needed to ensure progress towards the longer term goals. Given the caution that has characterized initiatives in this area, this will indeed be a long-term agenda. It is important nevertheless to ensure that changes in the legal and policy framework in the short to medium term are informed by a broad vision of future directions that Cambodia wants to go in the longer-term.

16. With this in mind, the Royal Government has established an inter-ministerial Working Group to develop by April 2005 a strategy framework, action plan and a related donor assistance program for decentralization and deconcentration. The Working Group is chaired by the chairman of the government-donor working group on decentralization and deconcentration who is also the Deputy Secretary General of the Council for Development of Cambodia (CDC), and has as its members representatives from the ministries of Interior, Economy and Finance, Planning, Women's and Veterans' Affairs, as well as the Council for Administrative Reform (CAR). The Working Group is supported by a multi-donor supported consultancy, as well as by a Technical Support Group comprised of resident technical advisors. The long-term vision needs to bring clarity to key issues, such as: the distribution of functions between the center and the regions, including the role of the provinces and districts; the appropriate functional assignments for the communes/sangkats, both own-mandates and possible agency functions, recognizing the differences between rural and urban areas.

Functional assignments at sub-national level require clarification

17. The *Law on Administration and Management of Communes/Sangkats* (the decentralization law) and the *Law on Commune/Sangkat Elections*, the basic legal framework for the decentralization reforms, were both adopted in 2001. These laws define the basic structure of the system: the overall structure and responsibilities of the Commune and Sangkat Councils, the criteria for eligibility to stand for election to the C/SCs and the procedures for electing the C/SCs. However, the decentralization law and regulations do not, as yet, provide sufficient details for full implementation of the system.

18. The National Committee to Support the Communes/Sangkats (NCSC), an inter-ministerial committee chaired by Ministry of Interior (MOI) is overseeing the completion of the regulatory framework and initial implementation of the decentralization reforms prior to the second C/SC election slated for 2007. NCSC made significant progress prior to the 2002 C/S Council elections in developing and refining the sub-decrees (anukret), administrative proclamations (prakas) and detailed guidelines

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which provide operational details on planning, finance and management for the C/SC and the C/SF. However, since that time there has been limited progress. The legal framework for decentralization, and supporting regulations and operational guidelines, are still incomplete or require review and adjustment now that lessons of initial implementation experience are available.

19. The decentralization law does not assign mandatory functions to the C/SCs. It simply provides a broad framework, subject to significant controls and support from higher levels, in which C/SCs are empowered to maintain public order and security, manage a limited set of public services, “enhance public welfare”, “promote development”, and meet various other obligations. To date, the C/SCs have largely provided small-scale infrastructure projects, such as local roads, culverts and bridges, irrigation canals, and water supply. In addition, the law provides for agency functions that C/S can perform on behalf of national ministries and Provincial/Municipal departments at their request, provided that an appropriate level of funding is provided to the C/SC to fulfill this agency function. Such delegated functions are currently limited and are likely to remain modest for the short- to medium-term. However, there are numerous ad hoc proposals being floated for additional agency functions for the C/SC. These proposals need to be considered carefully within the larger context of the appropriate role for the C/SC and their capacity.

20. There are two distinct, but related, aspects to the deconcentration of administrative powers and functions. These involve the role of the Governor and the provincial and district administration firstly in providing support to the Commune/Sangkat Councils, and secondly in the provision of sectoral services at the provincial level and below, through provincial departments and district offices of central ministries.

21. The support role of the Governor to the C/SC has been defined by the NCSC within the decentralization regulatory framework.³ Also, an instruction by the Seila Task Force provides interim arrangements for the structure of provincial-level support through the PRDC to the C/SC.⁴ These interim arrangements have not been fully institutionalized, however, and are heavily dependent on donor-provided salary supplementation and related technical assistance. During the first three years of implementation, the quality of the facilitation, technical support and accounting support has been mixed but are generally improving with experience. Institutionalization of the interim arrangements would require integration of the support functions into the regular functions of the provincial departments of the line ministries, or within an expanded Salakhet or governor’s office.

22. The *Organic Law for the Province*, which would supercede other laws and regulations and provide the legal foundation for deconcentration reforms, is still in early stages of discussion, and there is not yet agreement on its underlying principles. The mandate for leading the deconcentration reforms rests with the Council for Administrative Reform (CAR), under the Council of Ministers. Also, because

decentralization and deconcentration are closely related and need to be coordinated, the NCSC needs to be substantively engaged in the conceptualization and formulation of the deconcentration reforms. Additionally, substantive engagement of the MOH and MOEYS is critical, since the locus of managerial responsibility and contact with citizens and customers in these sectors is principally at sub-national level. For these sectors, the organic legal framework needs to address roles, functional and financial responsibilities, and accountability at central, provincial, district and service provider/facility levels.

Recognize Differences of urban Sangkats and Municipalities

23. The present system makes no distinction between *urban sangkats* and *rural communes* either in law or in practice. This, raises two major issues. First, activities appropriate for sangkats may be different from those appropriate for communes, or different approaches for the same services may be needed. Second, area-wide planning and service delivery is particularly critical in urban areas due to scale economies and externalities. Yet small elected sangkat councils within municipalities receive largely unconditional transfers to which municipalities do not have similar access. There is an urgent need to consider an appropriate approach to city-wide service planning and delivery and define the role the sangkats should play in this process. This matter requires some fundamental rethinking of the current decentralization law and the passage of new legislation governing the municipalities and other designated urban areas, including properly adapted urban governance and administrative systems.

C. Strengthen Accountability Framework at Sub-National Levels

24. The ability of local communities to influence the use of resources that can affect their lives and livelihoods needs strengthening: a number of ideas are on the table including a “provincial forum”, strengthening the District Integration workshops, and greater reliance on external facilitation of commune officials, including through civil society. The need to help local communities focus on development priorities most relevant to their communes and to hold sub-national officials accountable for delivering services that meet these goals is key.

Political and administrative structures need realignment to enhance accountability

25. Overall, the intergovernmental structure in Cambodia is weakly devolved in two important respects: (i) the powers and resources of the sub-national tiers are vastly weaker than those held or controlled by the center; and (ii) the related systems (participatory planning, fiscal transfer, service delivery, and internal and external accountability) are weak and have performed unevenly so far. The health sector has made substantial efforts to carry out “bottom-up” planning for 2005, but unless plans are better aligned to budgets, unless budget releases become more predictable, and

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unless there is greater decentralization of financial management and control, the motivation of sub-national participants to engage with the planning will remain limited. Participation of and consultation with citizens and consumers in the planning process has not yet been attempted.

26. The Provincial governor is not elected; s/he is appointed by the Prime Minister and is in effect an employee of the Ministry of Interior. Therefore, these unelected provincial governors see themselves as accountable to the Center. Beyond the Salakhet, “provincial administrations” exist only weakly, and should be understood as collections of departments of central ministries, operating at the provincial level and connected only by weak and tenuous co-ordination mechanisms. Also, “provincial service delivery” is really a spatial (“within the provinces”) rather than an administrative (“via provincial administrations”) concept. Service delivery in the key “provincial” functional spheres of health, education, roads, etc., is handled and budgeted by central ministries in a vertically integrated manner. The provincial offices of these ministries function largely as arms of the central administration. Accountability relationships and lines-of-command upwards are strong; lateral accountability into the governor’s office is weak or non-existent. Third, notwithstanding the efforts of certain ministries (Health and Education, for example) to devolve greater responsibilities to provincial agencies downwards within their sectors, actual progress has been fairly limited. Development of and experimentation with options for more direct accountability of service providers/facilities to citizens and consumers in these sectors – for example, through greater disclosure of performance data in “citizen report cards”, or through forums for citizen feedback on service delivery - is an important dimension of the unfinished agenda.

27. The *Law on Commune/Sangkat Elections* calls for five to eleven candidates to the C/SC, depending on the population of the commune, to stand for election to a five-year term on a proportional-representation and party-list basis. The party affiliation is a significant departure from the open election system piloted under Seila. Thus, there is a danger, given the significant constraint to ordinary citizens in ensuring that communes function in the community interest, that elected commune officials may be more accountable to political parties than to the local community.

28. Also, the Ministry of Interior exerts significant control. Importantly, the election of C/S Councilors can be overturned by MOI, which is empowered to dismiss C/S Councilors for cause. Each C/SC has one staff member, the commune clerk, who is a Ministry of Interior (MOI) employee and responsible to assist the C/SC with their administrative duties. Also, the commune chief appoints the village authority, who is paid by the C/SC out of the C/SF.

The role of the village still requires clarification

29. Territorial villages have no direct representation on the C/SC, but the decentralization law allows several avenues for village-level representation and participation in the commune development planning process. The most important avenue is through the establishment of a Planning and Budgeting Committee (PBC), which is responsible for assisting the commune chief to conduct the commune development planning process and to draft the C/S development and investment programs and the commune budget. The C/S Planning Prakas defines the composition of the PBC to include the commune chief as chair and the commune clerk as secretary, as well as members including: three representatives from the elected C/SC selected by the chair; 2-4 village residents including both genders selected by the chair; and two representatives, one of each gender, selected by the C/SC from the Village Authority or, for villages with VDCs, one representative each from the Village Authority and the Village Development Committees (VDC)⁵ consisting of a man and a woman.

30. Nonetheless, the longer-term arrangements for selection of the village representatives required for the participatory C/S development planning process remains unclear. The potential role for VDC representatives on the PBC beyond the first five-year mandate of the C/SC, and the relationship between the VDC and the village authority needs to be clarified. The decentralization regulations allow C/SC to appoint a village chief and the village chief to appoint deputies. There has been some suggestion that some type of village election be instituted, but the current internal deliberations have not come to closure. Given the importance of village representation on the PBC, it is critical to adopt an appropriate permanent mechanism for selecting village representatives as soon as possible.

Inclusiveness and Transparency of the Commune/Sangkat Development Process must be strengthened

31. The role of civil society in expressing demand for good governance at the sub-national level needs to be strengthened. Two key aspects of this are inclusiveness and transparency, both of which need to be increased through better implementation of existing rules and regulations, as well as adjusting the current processes to allow more scope for more meaningful participation and information access.

32. For example, the *Guideline on Commune/Sangkat Development Planning Process*, which outlines the details and scope for participation in each of the steps in the planning process, does not indicate, in line with the provisions of the C/S Planning Prakas, that meetings of the PBC are open to the public, nor does it suggest a process, such as public posting of notice of the date and time of the meeting, which would facilitate broader participation in the meetings. Also, reviews of initial implementation have raised concerns related to the inclusiveness and transparency of the Commune/Sangkat Planning Process. The provision in the Inter-Ministerial Prakas for

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broader public participation in the planning process is not generally known by villagers, civil society organizations, or even in some cases the C/SC, and is not consistently practiced. Immediate steps should be taken by MOI to ensure that measures are adopted to encourage broader dialogue, participation, and transparency. Standard practices for public notice of PBC meetings that are open to the public, as well as development and implementation of public awareness campaigns to apprise the public of opportunities for their participation in the C/S development planning process would facilitate better participation.

33. Also, more focus on transparency and broad accessibility of information, including broader information sharing by local governments with civil society, is needed to facilitate civil society monitoring of local government performance. The central government could also play a useful role in ensuring a stronger link between decentralization and improved governance, through monitoring commune-level performance and making this information publicly available. Conditioning the allocation of incremental funding to performance indicators would create a healthy competition among communes and strengthen governance linkages.

The role of the Governor and the PDRC requires clarification

34. The institutional arrangements which have emerged within the provinces to support the C/S development activities require review, and a permanent mechanism put in place drawing on the lessons of the current arrangements. Two dimensions are important. First, the Provincial Governor through the Provincial Rural Development Committee (PRDC) coordinates the C/S capacity building, facilitation of planning, technical assistance with bidding and development project implementation and accounting and cashiering services⁶. As this arrangement is governed by a prakas from the Seila Task Force, the longer-term role of the PRDC is uncertain. Some would like PRDC or similar structure to continue to coordinate the support activities to the communes, while others would like to see other options.

35. Second, the support service provided to the communes through the provincial departments is funded off-budget through the Seila Program.⁷ A serious weakness of this system, in terms of lines of accountability, is that the C/SC must rely on service delivery agents that do not report directly to them, and whose salary supplements and operating costs are paid “off-the-top” exclusively through donor funding. Nonetheless, the need for continuation of facilitation and technical support over the short- to medium term is obvious given the limited capacity at the commune level and in the provincial departments, and the options for alternative mechanisms to provide an adequate level of support need to be carefully assessed prior to the termination of Seila’s current mandate at end-2005.

36. A related but broader issue is the administrative structure of the provincial government, including the role of the Governor and Salakhet, and options for

mainstreaming the PRDC and its executive committee to coordinate all development activities at the provincial level. In the absence of elected provincial councils, ways to ensure accountability downward, as well as upward, needs to be formulated and enshrined in law, such as establishing a provincial forum to introduce greater accountability over budgetary decisions, and delegating greater authority from the central ministries to their provincial departments.

C/S Financial Management System needs strengthening

37. The *Sub-Decree on the Commune/Sangkat Financial Management System* outlines the system for commune budgeting, accounting, expenditure management, asset control and financial reporting and audit. Initial implementation has highlighted some deficiencies in the system, as well as demonstrated inconsistent application of agreed procedures for C/S Fund accounting and financial management by Provincial Treasury (PT) staff. For example, the accounting practice of recording notional allocations to communes as cash received distorts the record of actual cash received and cash availability for each commune. This is compounded by the PT practice that the C/S Fund cash transfers are held in a unified cash account at PT, and credited to a common C/S Fund sub-account, but not credited to individual C/S accounts. As a result, C/S Councils are unaware of the funds available at any given time and therefore are not able to manage their own accounts and work program. This practice, in combination with the slow and incomplete cash transfer releases to the C/S Fund experienced in 2003, has allowed PT to apply ad hoc rules—for example first-come-first-served basis, pro-rated basis—for setting payment priorities among payment orders received, opening the door to potential abuse. Also, the lack of transparency in procedures provides insufficient safeguards against the C/S Fund cash being diverted, even temporarily, to other purposes. These deficiencies need to be addressed urgently.

Move C/SC Accounts from Provincial Treasury to Commercial Banks

38. The *Sub-Decree on Establishment of the Commune/Sangkat Fund* allows the commune allocations for the C/SF to be transferred to C/SC commercial bank accounts if these are approved by the Ministry of Economy and Finance (MEF). However, MEF has to-date been reluctant to approve the use of commercial bank accounts. The use of the PT to provide commune accounting and cashiering services has also proved problematic. In order to reinforce appropriate lines of accountability by giving better control over cash use to Commune Councils, improve cash management at the commune level, and ensure use of C/S Fund for purposes intended, the use of C/SC commercial bank accounts should be piloted and progressively employed. A key question that such a pilot would need to address is the arrangements for the accounting services now performed by the provincial treasuries on behalf of the C/SCs.

Annual Audit of C/SF by National Audit Authority

39. Although the C/SF has been in existence since 2002, it was not subject to an external audit in its first year of operation. However, the 2003 C/S Fund is currently being audited by the National Audit Agency under a donor funded arrangement. The audit will cover a sample of transactions for all communes at PT and 10% physical examination at commune level. The draft audit report will be prepared and the audit findings will be discussed with the communes before finalization. It is envisaged that a summary of the audit report will be released as a public document after the audit report is endorsed by the National Assembly. It is imperative that the annual audit of the C/SF be institutionalized and that the operating cost for carrying out the C/S Fund audit for 2004 and beyond is properly budgeted in the government budget.

D. Increase Level and Predictability of Resources Available to Sub-National Levels

40. Communes need more resources and greater predictability of resources, including their own revenues, and the following measures are recommended.

Increase Predictability, Reliability and Timeliness of C/S Fund Releases

41. The Commune/Sangkat Fund (C/SF) is the financing mechanism through which C/SCs access resources, provided from the national budget, for local administration and development. Implementation of decentralization is at risk of being undermined because of slow and incomplete cash releases to the C/S Fund during 2003 and 2004. An important principle of an intergovernmental fiscal transfer from the national to the local level, is the reliability and predictability of the related cash releases. In order to ensure predictability of fund flows and thus allow C/S Councils to implement their annual work plans effectively and be held accountable by their constituents and national government alike, it is essential that both the timing and amounts of the C/S Fund cash transfer releases are non-discretionary, and proceed automatically on a periodic basis in pre-determined proportions of the total agreed allocation. As such, it is essential for the Government to commit to a non-discretionary, predictable and reliable cash transfer system so that all of the actors involved can plan accordingly. It is recommended that the C/SF cash release system be aligned with the general budget management system through monthly releases on a non-discretionary basis in line with the approved budget credit.

Establish the C/S Fund Board

42. Under the decentralization law⁸, the C/SF is to be governed by a Commune/Sangkat Fund Board (C/SF Board), comprising the ministers of MEF (chair), MOI, MOP, and Council for Development of Cambodia, and three representatives of C/SC selected from among the Chiefs of Communes/Sangkats. A secretariat within the

MEF is to support the Fund Board. Although the C/S Fund Sub-Decree called for the establishment of the C/S Fund Board in 2002 and the C/SF has been in operation for more than 2 years, the C/SF Board has not yet been formed. The delay in establishing the C/SF Board has been attributed most recently to a disagreement on the approach to be used to select the C/SC representatives notwithstanding that there is an interim procedure prescribed for this in the Sub-Decree. As of mid-2004, there does not appear to be any movement on this issue despite repeated government assurances that establishment of the C/S Fund Board would be expedited. The problems experienced with the operation of the C/S Fund in 2003 and 2004 are issues which the C/S Fund Board was meant to address, and the absence of C/S Fund Board has contributed significantly to the poor management of the C/S Fund during 2003 and 2004. It is recommended that the C/SF Board be established without further delay.

Increase Allocations to the C/S Fund

43. The Commune/Sangkat Fund Board⁹ allocates C/SF resources annually in accordance with an agreed formula to communes for two budgetary components of the C/SF. Allocations to communes of the Local Development component of the C/SF are based on a formula that includes factors for population and poverty. Allocations are not, however, affected by the performance of the commune in terms of governance or service delivery. In order to have access to the C/SF, the C/SCs need only demonstrate that they have followed a participatory planning, budgeting and implementation process; completed all financial reports on execution of their budget and development plan; and, mobilized beneficiaries contributions and other local resources to complement the Local Development component transfers.

44. In 2002, only 506 communes received funds from C/SF development component. In 2003 and 2004 all 1,621 communes/sangkats received development component funds, although some communes (those without previous experience under the Seila Program) received only a nominal amount of development component funds in 2003. While this has broadened access, it has also limited the amount available to each commune since the overall C/SF allocation has not increased.

45. The average amounts flowing to the communes via the C/S Fund need to be increased very substantially if decentralization is to become increasingly meaningful - \$6000/annum per commune is insufficient to sustain properly active communes in the longer term, or to provide sustained incentives to improve local service delivery.

46. The minimum level of contribution from the Royal Government's domestic revenue to the Fund account is established in advance for at least three fiscal years.¹⁰ The Sub-Decree on the C/S Fund, issued in February 2002, set the allocations for the C/S Fund for the period 2002 through 2004. More recently, Government has set the percentage of domestic revenue that will be allocated to the C/S Fund for the following three years, 2005-2007. The allocations will increase only slightly over the 2004

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allocation of 2.5% –2.52% for 2005; 2.54% for 2006; and 2.56% for 2007. It is recommended that for the following three years, these levels should be substantially increased over 2002-2004 and 2005-2007 allocations, aiming towards an average commune allocation of at least \$20,000.

Increase own-source revenues for sub-national levels

47. C/SCs have the right to raise tax and non-tax revenues and to charge for services. The decentralization law assigns land, real estate (currently only land transfer tax), and rental taxes to the C/S, but it does not provide details of how they are to be structured. The law requires further elaboration of C/S revenue sources, including types, rates and collection processes. It also allows for total or partial transfers of income from national tax or non-tax sources, and it requires communes and sangkats to be compensated for functions performed by them on behalf of a state agency.

48. In practice, the C/S own-sources of revenue are very limited. The C/S are allowed to impose fees previously used by the central/provincial government for administrative registration, such as birth, marriage and death registration, and to share in land transfer fees. These sources are very modest, although there is anecdotal evidence of C/S charging very high, effectively extra-legal administrative fees and in some cases using them to hire casual labor. C/S are also required to collect local contributions to cover a minimum of ten percent of the cost of C/S-funded development projects. Some C/Ss impose user charges for service delivery, although this practice is relatively limited. Work is underway to study options to expand and formalize C/S own revenue sources.

49. The 1997 Provincial Budget Law provides a basis for provinces to receive and/or retain revenue for development purposes. In practice, however, very few discretionary resources for development purposes are allocated to provinces from the national budget and provincial departments of central line ministries do not have authority to design and implement development initiatives within their provinces, except in the special cases of pilot activities.

50. Own source revenues currently account for negligible income at commune and provincial levels, but there appears to be scope for expanding volumes. However, this cannot be addressed separately for the commune and provincial levels, as both tiers would depend on the same potential sources of revenues. Two dimensions need to be addressed. The first relates to policy and legal issues. In the short term, the promulgation of a number of regulations to facilitate the collection of own-source revenues at sub-national levels is needed; in the longer term, a clearer allocation of revenue sources between communes and provinces, eliminating overlapping revenue jurisdictions, and clarifying rate-setting powers is required (given the intrinsic connections between provincial and local own source revenue issues, this effort will have to deal with commune and provincial revenues simultaneously). The second

dimension relates to the development of local systems and procedures for sub-national levels to administer revenue collection efforts.

Rationalize Provincial Planning and Budgeting

51. The term “provincial budget” is used to refer to two separate but related mechanisms, the provincial/municipal component of the central budget and the “salakhet” or governor’s budget. The former, which is fully subsumed under the national budget and largely managed by central ministries. The salakhet is effectively the “sectoral” allocation of the Ministry of Interior, which the governor represents in the province, plus the tax and non-tax revenues assigned to the province under the 1997 Provincial Budget Law.

52. There are several on-budget pilots outside of the conventional provincial budgeting system, including Accelerated District Development (ADD) and Priority Action Program (PAP). ADD is used to bypass problematic disbursement procedures at the provincial level and to get resources directly to sub-provincial front-line service providers. The main user has been the Ministry of Health (MOH). PAP is another and more prominent attempt to simplify administration and disbursement for basic services. PAP covers four sectors (agriculture, education, health, and rural development) and applies only to non-salary operating expenditures. To date, only the Ministry of Education (MOE) and MOH have used PAP, with MOE using it extensively and MOH using it in a several provinces instead of ADD. PAP has been constrained by serious cash flow problems, and cash releases are significantly behind schedule.

53. The principal off-budget deconcentration experiments are the Seila Provincial Investment Fund (PIF) and the Agricultural Development Support to Seila (ADESS). The five-year Provincial Development Plan (PDP) is the basis for an annual Provincial Investment Program (PIP) that budgets a Seila PIF block grant. The IFAD-funded ADESS uses Seila mechanisms but is restricted to the agricultural sector. These pilots have not, as yet, translated into a more unified approach to deconcentrated planning and budgeting.

54. There is an urgent need to re-conceptualize the provincial budget as a budget for administering and developing the territory of the province, and institute related improvements in the provincial planning and budgeting system. At present, the only discretionary resources allocated to the province sit within the salakhet, which is focused primarily on recurrent expenditures. Also, while both the salakhet resources and the Provincial Investment Fund resources fall under the authority of the provincial governor, the manner in which these two sets of resources are planned, programmed and managed are quite different. In addition, there are inconsistencies within the national planning and budgeting processes, as well as weak linkages between the national and provincial planning and budgeting processes.

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55. The organic law should clarify and strengthen the mandate of the provincial governor and the provincial management functions of the salakhet, as well as the accountability framework for the provincial administration. In addition, establishing an integrated provincial budget and linking the provincial development plans to both central government operations and to the commune development plans are important elements of a deconcentrated system. Systemic reform in these areas should focus on widening provincial discretion over at least a limited amount of provincial level sectoral expenditures, improving budget allocation transparency and enhancing provincial financial management.

E. Strengthen Capacity and Quality of Support at the Sub-National Level

Increase Effectiveness of Capacity Building

56. Current capacity is very limited in the C/SCs as well as in the key provincial support structures. The Ministry of Interior prepared a training needs assessment in 2003, which identified the training needs for these target groups, and Ministry of Interior's 2004 training program is making a good effort to address these needs. However, much more is needed. As a starting point, an in-depth assessment of the effectiveness of training to-date has recently been undertaken, and should be used as a key input to guide future training. Also, non-training related measures for capacity building should be further explored. For example, the creation of associations of commune chiefs will help exchange of experience among communes.

Improve Quality of Facilitation and Technical Support

57. Facilitation provided by the provinces does not meaningfully empower local communities, as there is too much direct control over the process. The voice of citizens could be better amplified by facilitation of more direct involvement by civil society and NGOs. Also, preliminary reviews of sub-projects raise some concerns related to the quality of technical support being provided by the provincial technical support units, and the related technical quality of some sub-projects. Thus, there is a significant need for focused capacity building, especially for the technical support staff who play a critical role in ensuring the design and implementation of sound commune projects, and for training staff who need training in facilitation skills and local democratic governance principles. In addition, greater attention should be given to increase the awareness of the public and government staff at all levels about the government's decentralization reforms and their role in it.

F. Conclusion

58. The Royal Government's hesitant approach to deconcentration and decentralization is understandable given Cambodia's troubled and conflict ridden history. But the tentative moves towards decentralization have already yielded results that show immense promise in empowering the country's poor communities to enhance their voice in the development process and to increase the accountability of government at the local level. Yet, the initial momentum built up will soon run out of steam without a greater government commitment to addressing some of the constraints that have arisen. The inter-ministerial working group to develop a strategy and action plan provides an opportunity over the coming months to initiate the preparation of a widely shared long-term vision for decentralization and deconcentration, clarify internal and external accountabilities at the sub-national level with a view to enhancing accountability to poor people rather than upwards to the central government or laterally to political parties, and match such enhanced accountability with an increased and more predictable flow of resources, including through own source revenues. These measures will also help local communities take greater responsibility for the management of the country's natural resources, a topic to which this report now turns.

End Notes

¹ Decision No. 136 dated December 1994, subsequently confirmed by Royal Government Decision No. 02 dated January 11, 1999.

² Including Banteay Meanchey, Battambang, Pursat, Siem Reap, Oudar Meanchey, Ratanakiri, and the Municipality of Pailin

³ Through the *Prakas on Delegation of Powers to Provincial /Municipal Governors in Support of Commune/Sangkat Councils* (No 1884, MOI, 24 April 2002).

⁴ *Prakas on Establishment of Structure, Roles and Responsibilities of the Provincial/Municipal Rural Development Committee of the Seila Program* (No. 292 STF, 8 November 2002).

⁵ VDCs are formed through an informal electoral process at the village level conducted in accordance with the procedures outlined by the MRD, which allows anyone in the village to stand for election, and guarantees that some of the elected VDC members must be women.

⁶ Provided by the commune accountants under the Provincial Treasury.

⁷ Currently Seila provides salary supplementation to the PRDC and related support units, as well as operating costs for the provision of support to the communes, as well as complementary technical assistance.

⁸ As further elaborated in the *Sub-Decree on Establishment of the Commune/Sangkat Fund*

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⁹ In the absence of the C/S Fund Board, the NCSC Sub-Committee on Financial Affairs chaired by the Ministry of Economy and Finance has taken on this role.

¹⁰ As required under Article 77 of the Commune Law.

SUMMARY OF CHAPTER 4
Managing Natural Resources for the Public Good

Physical, human and social capital was severely damaged in Cambodia during its civil war. The country's natural resources were, and remain, the only high value assets available for distribution to appease warring factions in the pursuit of peace, and to consolidate control over territory and populations. Formal property rights were destroyed by the Khmer Rouge and the large scale displacement of populations undermined traditionally recognized claims on resources. Lingering physical insecurity and weak property rights led to rapid exploitation of resources which became an easy source of unofficial revenues to support a poorly paid, patronage-based civil service and military system, and to finance political campaigns. Harvest rights were sold to investors through highly non-transparent processes and on terms which placed few controls on non-sustainable practices and ignored the impact on local populations.

Cambodia enjoys one of the highest natural capital endowments per capita in East Asia with a significant share under forests and highly productive freshwater fishery. About 85% of its population lives in rural areas, and mostly depends on agriculture. However, large areas of state land are illegally occupied while the state is not certain about what precisely it owns. The government's principal approach has been to contract out large areas to Cambodian and foreign investors, which has proved an ineffective mechanism for providing public goods. Local communities have seen little improvement in their access to natural resources while conflicts over scarce land are increasing.

The highest levels of Government have signaled their acknowledgement of the shortcomings of past policies, and taken several decisive actions to suspend or reduce inefficient management activities. Some 40% of concessions and commercial fishing lots covering almost half the concession area have been cancelled. Concessionaires have been required to submit strategic forest management plans. A suspension on logging and log transport on concession managed properties has been in effect for 18 months. At the same time community based approaches are being explored.

Natural resource assessments need to be carried out, as well as new laws clarifying property rights and institutional accountabilities need to be adopted and implemented. In addition, the technical capacity to assess, plan, implement/enforce and report on resource management must be strengthened. NGOs will need to work collaboratively with the Government and donors to integrate local benefit sharing arrangements into current and future natural resources management activities. Support to communities and sub-national governments which will assume new responsibilities under these arrangements, must be formulated. While these changes in government policy are being implemented, there is an urgent need for increased support to protect state lands through a multi-stakeholder approach. Donors need to respond to Government's commitment by providing financial and technical support to help build a more inclusive, transparent and accountable system of natural resource management.

CHAPTER 4: Managing Natural Resources for the Public Good

“In terms of land and natural resources, Cambodia is a country where the state possesses up to 80% of resources, more than other states in Asia which usually possess only 50%. However, our use of the resources is not yet effective, nor is it productive for economic growth and poverty reduction...The Government strongly commits to transform the land into an engine of growth and poverty reduction.”

-Opening address of Prime Minister Hun Sen to National Land Forum on October 18, 2004.

1. High levels of natural resource endowments are a mixed blessing. Developing countries with few natural resources grew two to three times faster than natural resource abundant countries over the past fifty years (Ascher, 2002). This is due, in large part, to the availability of revenues – official and unofficial – from the exploitation of natural resources. It provides an “easier” mechanism for supporting the state apparatus than developing institutions, which are accountable to the populace at large and hence support broader based, private sector led, economic development.

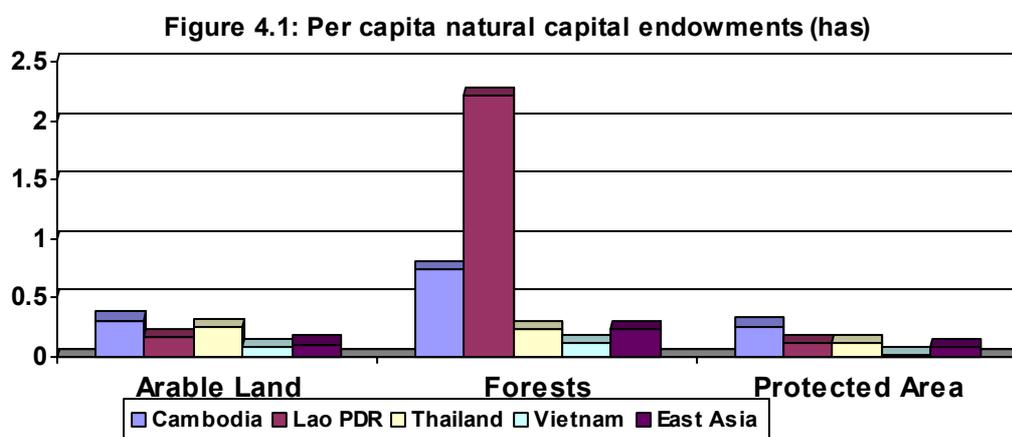
2. As is common in many post-conflict, civil war states, physical, human and social capital were severely damaged in Cambodia. The country’s forests, agricultural land, fisheries and mineral resources were the only high value assets available for distribution to appease warring factions in the pursuit of peace, and to consolidate control over territory and populations. All formal property rights were destroyed by the Khmer Rouge, and the large scale displacement of populations undermined the traditionally recognized claims on resources which have facilitated natural resource management in most societies, even in the absence of a formal property or use rights system. In addition, following the civil war, lingering physical insecurity and weak enforcement of property rights led to rapid exploitation of resources, anchored in the short run, to the detriment of sustainability. High demand for unofficial revenues so as to support a poorly paid, patronage-based civil service and military system, and to finance political campaigns, provided additional incentives for trading away sustainable use of resources for short term financial gains. Harvest rights were sold to international and domestic investors through highly non-transparent processes and under terms which initially placed few controls on non-sustainable practices and did not consider their impact on local populations.

3. Cambodia is at a crossroad. Natural resources, while still relatively abundant, are coming under increasing pressure. Current natural resource management policies, in addition to undermining the incentives for the broad governance reforms espoused in the Rectangular Strategy, are likely to lead to increased competition for resources from a growing population. Reorienting the governance of natural resources can improve

livelihoods in rural areas, thus reduce the potential for conflict, contribute more substantially to economic growth and exports, provide improved environmental services, and increase public revenues. Such a reorientation will also reinforce reforms in other areas such as private sector development. While several steps have been taken to improve the management of Cambodia’s natural resources, the strong coalition of vested interests both within and outside the government will continue to resist further reforms. The government’s challenge is to overcome these interests by moving from a highly centralized approach, to one which works to align the incentives of national and local stakeholders in realizing Cambodia’s economic growth and poverty reduction objectives.

A. The Importance of Natural Resources

4. Cambodia enjoys one of the highest natural capital endowments per capita in East Asia, with 1.5 hectares per capita of total land, of which just about one fourth is arable (Figure 4.1). Some 60% of Cambodia’s land area – about three quarters of a hectare per capita - is classified as forested, including 24% - or about 0.25 hectares (“has.”) per capita in protected areas or protected forests. Cambodia has the most productive freshwater fishery in East Asia, producing between 300,000 to 400,000 tons per year, or about 60 kilograms per capita. Freshwater resources, estimated at over 40,000 cubic meters per capita, rank second in the region, behind Lao PDR, while the percentage of annual withdrawals of available freshwater are the lowest in the region.



5. In the Rectangular Strategy, the Royal Government acknowledges its abundant natural capital and highlights the importance of broadly defined “agricultural”, or rural growth, as “the driving force for economic growth and poverty reduction” (Royal Government of Cambodia, “Rectangular Strategy”, 2004). The Strategy emphasizes the role of natural resources to support rural livelihoods through improvements in agricultural productivity, more equitable, efficient and sustainable use of land, water,

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fisheries and forest resources – including protected areas. It also recognizes the importance of diversifying the sources of growth beyond the current concentration in garments and tourism – in order to reduce vulnerability to external shocks, as well as to broaden the participation in economic growth to include the poor, 90% of whom live in rural areas.

6. Most Cambodian households are dependent on agriculture and other natural resource based activities for their livelihoods. About 85% of Cambodia’s population lives in rural areas, and about 70% of the population is dependent primarily on agriculture. However, most families, and particularly the poor, have diversified livelihood strategies which complement agricultural production with exploitation of common property resources such as fish and non-timber forest products, including natural resin (Table 4.1). Rapid population growth (2.5% per annum) is adding some 200,000 new entrants to the labor force each year, roughly equivalent to current employment levels in the garment industry. Employment opportunities in manufacturing and services are not keeping pace with these additions to the labor force, who will increasingly turn to rural and natural resource based occupations to avoid falling into severe poverty. Domestic, and some foreign, investors are increasingly looking for opportunities in agriculture, forestry and fisheries, and seeking exclusive rights to natural resources as new investment in manufacturing and services, as discussed in the next chapter, is deterred by the high cost of doing business in those sectors. In many countries, these conflicts have escalated quickly into violence – both between different private actors, as well as between private actors and the state (Bannon, Ian and Paul Collier, 2003). Even in the absence of conflict, experience from other countries suggests that poor management of natural resources which increases asset inequality – as has been the case in Cambodia - can create structural impediments not only to the quality of growth, but also inhibit growth itself, as well as reducing the returns to alternative investments such as education (Box 4.1)

Table 4.1: Average Percentage Share of Different Sources of Income in Rural Households

Source of income	Sources of rural household incomes by expenditure quintiles (%)					
	Poorest	Second	Third	Fourth	Richest	Total
Agriculture	50	54	54	55	37	50
Common Property Natural Resources	21	16	15	12	6	14
Wages	9	9	11	10	23	13
Non-farm	8	12	10	14	25	14
Transfer, remittances, other	12	9	10	9	9	9
Mean household income (1000 riel/year)	2,553	3,057	3,351	3,875	5,616	3,689

Source: CSES 1999

***Box 4.1: The Importance of Access to Natural Resource Assets
for Effective Poverty Reduction***

Recent World Bank studies of the effects of asset inequality demonstrate the linkages to growth and poverty reduction. One study of the relationship between asset inequality, growth and education based on data from 60 countries*¹ found that initial asset inequality, as measured by the land distribution, has a significant growth-reducing impact. In addition, the analysis suggests that policies to expand education will have less of an impact in countries where assets are distributed in a highly unequal fashion. A second study of factors explaining different rates of growth from 1960 to 1990 in 73 countries shows a strong, positive association of growth with the initial equity of land distribution.*² Countries such as Japan, Malaysia and Thailand with relatively equitable distribution of land in 1960 grew twice to three times as fast as countries such as Venezuela, Peru and Kenya. The study also found that given the important role of investment for growth, programs for redistributing land should help to accelerate growth as long as these programs and the associated policies do not suppress investment overall.

In Cambodia, increasing land inequality could serve as a drag on growth as well as reducing educational outcomes. A focus on large land holdings – primarily through economic concessions – has resulted, with very few exceptions, in little incremental investment. Therefore, reorienting the agricultural land policy emphasis from large concessions to supporting integration of smallholders into a market based system has potential to result in overall increases in productivity and growth. Regional experience suggests that there are several options for combining smallholder productivity with technology, processing and marketing advantages of larger agribusiness through contract farming, nucleus estates and other options which are just beginning to be introduced in Cambodia. In addition to securing smallholder land rights and distribution of land to the landless, this implies increased investment in organizing producers and rural infrastructure to reduce the costs in linking smallholders to agribusiness and markets.

*¹Deininger, Klaus and Pedro Olinto, “Asset Distribution, Inequality and Growth”, World Bank 2003

*²Deininger, Klaus and Lyn Squire, “Economic Growth and Income Inequality: Reexamining the Links”, Finance and Development, 2001

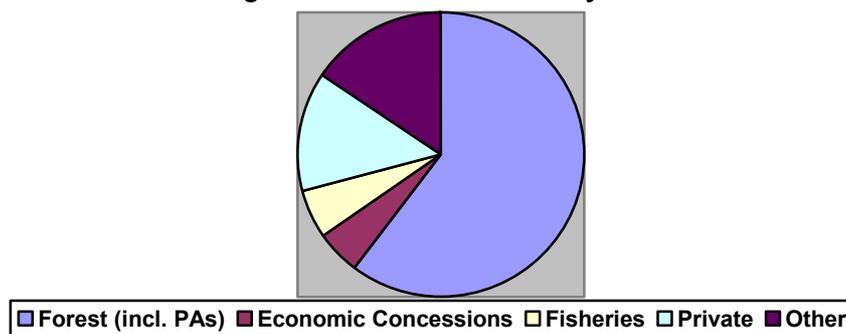
B. The State as Manager of Natural Resources – Experience to Date

7. The state is a trustee of the nation’s natural resources. State ownership of land is justified when privatization may lead to socially undesirable outcomes, when the state is able to ensure better provision of broader public goods or to redirect its share of rents and profits from such natural resources to the poor. Direct control of all property was vested in the Cambodian state from 1975 to 1992. As a result, the area under state management includes virtually all forested areas – including protected areas, production forests and forest concessions. Furthermore, marine and freshwater fisheries, water courses, protected areas, buildings and other public infrastructure, cultural heritage sites, and large scale agricultural properties are under state enterprises or concessions. The land area under recognized private management, about 2.5 million hectares, is essentially limited to those residential and productive (mainly rice paddy) lands which were redistributed by local authorities for private ownership in 1989 (Figure 4.2).³

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Extensive areas provided to the military, in particular prior to the 1997 Regulation on the Management of State Property, have unclear status as the land granted was intended to be distributed to former combatants, and some has been sold to private investors. Based on these figures, it is estimated that approximately 14 million hectares, or 75% of Cambodia's land area, are technically under state management. However, much of this land is under illegal occupation.

Figure 4.2: Land Allocation by Use



Note: "Other" refers to land of uncertain status – incl. military development zones, waterways and urban areas

8. Official categorization of land as public or private has little real meaning. Large areas of land under state control are occupied by smallholders, or claimed by more powerful interests. This scenario is applicable lands suitable for private use as well as state public land allocated for protection. Moreover, the area, location and boundaries of state land are not known with any certainty, and there is little clarity on the institutional responsibilities to identify, survey and demarcate state land. For example, forest conversion and land development are largely unplanned and not managed. The Independent Sector Review estimates the annual deforestation rate at 1%, with losses concentrated in a number of key areas (in the Northwest near the border with Thailand, in Rattanakiri, along national Route 4 and coastal roads, and flooded forest around the Tonle Sap).⁴ Cambodia's forest area is essentially the unplanned residual of the country's natural endowment, illegal logging, and the spontaneous growth of agricultural settlement. Numerous encroachments by farmers, often following illegal logging, are the most substantial threat to the forest resource. Conversion also takes the form of "economic land" concessions for large-scale crop development. While substantial areas of forest land have potential for sustainable utilization under agricultural and other land uses, the conversions currently taking place are problematic because the areas potentially suitable for agriculture have not been assessed or identified and no procedures or plans have been established to regulate the conversion of forest land to other uses and ensure that conversions are in the public interest and are conducted transparently and through sound land management practices.

9. Government's primary mechanism for management of natural resources has been to contract large areas to Cambodian and foreign investors. Some 57 officially

recorded economic land concessions for agriculture, covering 940,000 hectares, have been granted since the early 1990s – primarily for tree crop production - ranging in size from 500 to over 300,000 hectares each (Table 4.2). In forested areas, thirty concessions covering over six million hectares have been granted since the early 1990s. The fisheries concession system was introduced in the late-1980s, and by 1999, there were 270 fishing lots covering over 950,000 hectares. In addition to these “official” concessions, a number of concessions have been granted by the military on lands ceded to it in 1994 for security reasons. These concessions are generally granted without any coordinated process with the Ministry of Agriculture, Forestry and Fisheries or the Council of Ministers. The borders of these concessions, when defined, often overlap existing concessions, forests or protected areas.

Table 4.2: Management Status of State Controlled Natural Resources in has (number)

Management System	Agricultural Land	Forests	Fisheries	Total
Original Commercial Concessions	940,000 (57)	6,875,498 (29)	953,812 (270)	8,769,310
Cancelled Commercial Concessions	123,680 (16)	3,501,170	538,522 (110)	4,163,372
Remaining Concessions	816,320 (41)	3,374,328 (12)	415,290 (160)	4,605,938
Conservation Areas		4,650,000 (29)		4,650,000
Community-Based	50,000*	71,724	227,785	299,509

*Planned Social Land Concessions to year 2008

Source: MAFF, MoE, MLMUPC, McKinney and Tola

10. As in other sectors (Chapter 5), the concession system has not been an effective mechanism for providing public goods. Concessions were usually granted through seemingly ad hoc, and non-transparent processes. Designation of resources to be granted on concessions were not based on feasibility assessments; prior and conflicting claims on the resource were neither identified nor resolved; investors were not adequately screened to ensure technical and financial capacity to fulfill contract obligations; and government institutions were unable to enforce the provisions of the contract. The result has been poorly implemented concession plans with little generation of the “expected” public goods.

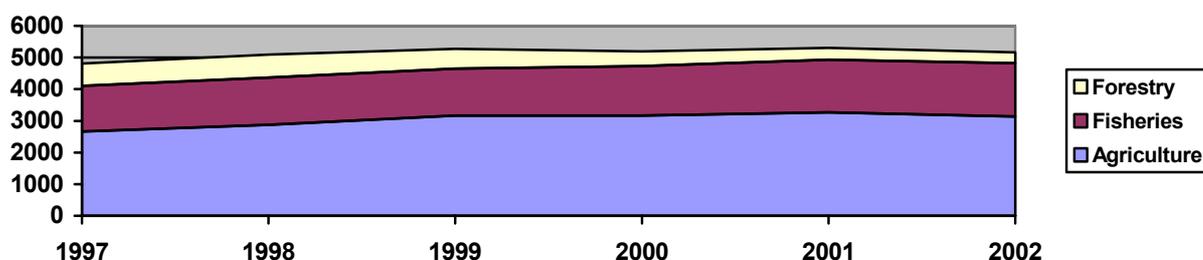
11. The direct revenues from concessions have been far below expectations, if not non-existent, indicating that the productive efficiency, in other words obtaining the highest price for the resource, has been very low. None of the contracted revenues from economic land concessions have been paid, reflecting the very low rate of utilization of land by concessionaires (estimated at less than 2% overall). However, it should be noted that some concessions have paid deposits to MAFF. Official forest revenue, originally forecast at US\$50 to \$100 million per year, averaged less than US\$10 million due to pervasive evasion of official royalty payments. Continued concerns about non-sustainable logging in concessions, and the inability of concessionaires to submit Strategic Forest Management Plans as required by the end of 2001, resulted in a

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moratorium on logging in concessions and log transport in January 2002. Fisheries revenues have averaged less than US\$3 million per year, over the past decade.

12. The generation of broad public goods resulting from state management of large areas of agricultural land, forests and fisheries has been relatively low. Overall, natural resource-based GDP has increased by just over 2% per year, on average from 1997 to 2002, with particularly low contributions to growth from forestry and agricultural production (Figure 4.3). This is reflected in weak contributions to employment and declining exports. The extensive area given protected status, over a quarter of Cambodia's land area, has not effectively protected biodiversity, watersheds or other nationally or globally important environmental attributes (NIS, 2003).

Figure 4.3: Natural Resources Contribution to GDP (in billions of riels, constant 1993 prices)



Source: IMF

13. Local communities have not seen an improvement in their access to natural resources. While no strictly comparable time series data is available, the average size of agricultural land holdings per household appear to be declining in rural areas below the threshold of food self-sufficiency. Various studies estimate landlessness at 12-15% of the rural population and the primary cause of landlessness – newly married couples seeking their own land, combined with current demographic trends and limited employment options - suggest that landlessness is increasing. Although the quality of information on land distribution is weak (Sophal, Chan, Tep Saravy and Sarthi Acharya, 2001), declining average farm size and increased landlessness suggest that the distribution of land may also be worsening, adversely affecting broad-based economic growth.

14. Declining access to common property resources may be undermining social stability in rural areas. Various local-level studies (Kim, Sedara, Chan Sophal and Sarthi Acharya, 2002) indicate that villagers are finding it increasingly difficult to harvest non-timber forest products and fish due to access restrictions imposed by concessionaires, resource depletion due to non-sustainable commercial harvesting, and increased population pressure. Not surprisingly, conflicts over land, forest and fisheries

resources appear to be increasing.⁵ There are different types of conflicts: 1) those between villagers; 2) those between villagers and outsiders illegally taking control of lands currently used by villagers for agriculture or common property activities; and finally 3) those between villagers and concessionnaires – particularly with military guards – either because concessions have been delineated to include village land or because they have resulted in destruction or reduced access to common property resources.

15. Government has acknowledged the poor performance of a number of existing concessions and has cancelled about 40% of concessions and commercial fishing lots covering almost half the original concession area (Table 4.2). Sixteen of the contracted economic land concessions are reported to have been cancelled, two are in the process of cancellation and 11 are inactive. In addition, all economic land concessions will have to be reduced to within the 10,000 hectare limit specified in the 2001 Land Law. Concerns regarding the inability to control the rate of logging in forest concessions have led to a framework and process for rationalizing the sector through outright cancellation and requirements for submission and review of strategic forest management plans (SFMPs). In addition, a suspension on logging in concessions and log transport has been in effect for over 18 months. All except 12 forest concessions, covering 3.3 million hectares, have already been cancelled or the investors have withdrawn, and more are likely to be cancelled based on the review of SFMPs. The high level of conflict between fishing lot owners and local communities led to reforms in 2001 which reduced the number of lots to 160 by 2003, and the total area to just over 400,000 hectares. Rationalization of the concession system is likely to result in the release of well of over half of the original forest, fisheries and agricultural areas from concession management.

16. The principal alternative mechanism for natural resource management supported by the Government to date has been community-based approaches. Though still quite limited relative to commercial concession areas, the extent of natural resources under community management is expanding rapidly. In terms of common property resources, CDRI estimates that 237 community forest projects covering just over 70,000 hectares, and 162 community fisheries covering approximately 225,000 hectares were operating in 2002, mainly with NGO support (McKenney, Bruce and Prom Tola, 2002). The government has indicated that it intends to distribute approximately 50,000 hectares of state land to at least 10,000 landless and land poor households over the next five years under a social land concession program which would essentially privatize state land holdings. Community management has traditionally focused on degraded or low-productivity areas and there is little assessment of the effectiveness of community based approaches to efficiently manage resources for local or broader benefits. However, the increasing interest from both the government and donors is leading to introduction of these approaches on higher value resources where the trade-offs with other management regimes can more readily be evaluated.

C. Strengthening the Foundations for Enhanced Natural Resources Management

17. The limited benefits from concessions reflect, in part, the need to strengthen the basic foundations for natural resources management in Cambodia. The policy and legal framework as well as the resource information base. This will also be essential for expanding community-based and other alternative management approaches.

18. Government policy, as stated in the Second Social and Economic Development Plan, the National Poverty Reduction Strategy and the Rectangular Strategy clearly acknowledges the important role of natural resources. However, these policy statements do not provide any guidance regarding the hierarchy of priorities in terms of the public goods to be received from these resources (Kirk, Michael, 2004). Priority setting is generally delegated to the resource management agencies which typically follow narrow, sectoral interests rather than analyze the tradeoffs faced in resource use and articulate clear national priorities. There are trade-offs between continued maintenance and expansion of forested and fisheries areas, and pressures to expand land under agriculture, as well as between the roles of smallholders and community management relative to commercial approaches, and between maintaining direct, community access to common property resources relative and the state's desire for revenues or other national goals (Box 4.2).

Box 4.2: The Need for Overall Policy Vision for Forestry

A Government and donor sponsored Independent Forest Sector Review assessed the current status of forest management in Cambodia. The review highlighted the need for a clearer statement of the objectives of forest management which explicitly takes into account the tradeoffs inherent in allocating land to protected areas, production forests and conversion to agriculture. The study concluded that:

“The absence of a politically approved vision to guide negotiations on the sector has some important implications. It creates space for decisions and regulations to be made outside the overall context of a vision and strategy, potentially leading to a fragmentation of the process. It also creates space for the hijacking of certain processes and securing of certain results without widely based consultation. It allows decisions over strategic direction to be taken through negotiations over the content of laws and sub-decrees. For example, there is a process of demarcation of forest estate to be started before it is clear what state public property means.

Many commentators argue for the need for implementation rather than further investment in developing and negotiating policy. However, as long as the sector remains unguided by policy where a public process has clearly articulated the choices and agreed priorities, it is vulnerable to the continued development of a fragmented application of process which is dominated by the strongest and most powerful voices. The need for a full and broad-based consultative policy process is clear and forms one of the major mechanisms through which to bring different actors together to address the fundamental questions:

1. what are forests for?
2. who are forests for?
3. where should forests be?
4. how much forest is needed to fulfill the what and who questions?”

Source: Forest Technical Working Group, Independent Forest Sector Review, 2004

19. The government’s role as steward of natural resources for the public good is clearly identified in Cambodia’s Constitution, and the emerging legal framework for natural resources is expanding the instruments available to the government to implement policy. But fundamental ambiguities remain unresolved. Laws covering land, forestry, fisheries, water and protected areas have recently been enacted, or are under consideration, by the National Assembly or Council of Ministers (Table 4.3). These laws clarify the state’s rights and obligations in management of natural resources, and associated subdecrees define the policy instruments, such as commercial concessions and community based management, available to the government to implement its natural resource priorities. However, the hierarchy of claims to state resources is not described in the laws, nor are the mechanisms for resolving inconsistencies between the laws or conflicting claims on resources well established. As a result, interagency struggles over control of resources facilitate anarchic and other illegal exploitation of state managed resources.

Table 4.3: Status of Key Policies, Laws and Subdecrees for Natural Resources Management

<i>Legal Instrument</i>	<i>Land</i>	<i>Forests</i>	<i>Fisheries</i>	<i>Water</i>	<i>Protected Areas</i>
<i>Policy Framework</i>	Land Policy Framework Paper (Interim)	National Forest Policy (passed in 2002)	<i>None</i>	National Water Policy (Council of Ministers)	<i>None</i>
<i>Law</i>	Passed in 2001	Passed in 2002	Pending at National Assembly	Pending at National Assembly	Submitted to Council of Ministers
<i>Community Management</i>	Social Land Concessions Subdecree Endorsed 2003	Forest Community Management Subdecree Endorsed 2003	Management of Fishing Communities Subdecree submitted to Council of Ministers	Farmer Water Users' Community Subdecree under preparation	
<i>Commercial Management</i>	Economic Land Concessions Subdecree under preparation	Forest Concession Management Subdecree Endorsed 2000	Decree-Law No. 33 on Fishery Management and Administration Enacted 1987		
<i>Institutional Coordination</i>	State Land Management Subdecree under preparation				

20. Property rights to natural resources, while improving, need further clarification under the new legal framework. The 2001 Land Law clarifies the status of most privately occupied land in Cambodia and provides the basis for a modern land registration system. A program of land titling is underway which seeks to complete titling across Cambodia by 2015. Other private rights to occupy or use lands currently under the control of the state are less clear. For example, state land comprises two categories: ‘state public land’ and ‘state private land’. State public land is intended only for conservation and management, and, therefore, cannot be disposed of by the state for private use. In contrast, state private land can be disposed of by the state for private use, and is often given out in concessions.

21. The Land Law recognizes claims to occupants of state private land prior to 2001, but it is not clear how claims of historical inhabitants, indigenous peoples for instance, of state public lands, such as national parks or forest reserves, will be addressed. In addition, it is uncertain what rights can be claimed by those historically dependent on forest resources over a larger area. A combination of specialized property rights, such as the planned Subdecree on Indigenous Peoples Lands providing for communal title, as well as some reclassification of state lands to permit recognition of occupancy or distribution as social land concessions will be needed. A forthcoming Subdecree on State Land Management will provide the regulatory framework for classification,

reclassification and management responsibilities of state land and will establish the legal framework for the institutional responsibilities to undertake these tasks. The government is expected to develop and adopt this Subdecree by June 2005.

22. There is an urgent need to complete natural resource assessments to facilitate planning and monitoring of natural resources management and the analysis of trade-offs. Government is initiating mapping of state land as well as land suitability, soils and use assessments which should progressively cover all of Cambodia by the end of 2006. Forest cover assessments were carried out in 1997 and 2003, however changes in the classification of forest cover may overstate both the extent and quality of forest resources in the later assessment. Fish stocks, both freshwater and marine, have not been assessed, and even catch information is highly unreliable (Coates, David, 2002). Water flows are monitored, and Cambodia is currently implementing its first ground water mapping, but there is no comprehensive monitoring of either groundwater or surface water withdrawals or water quality. Biodiversity status is not well documented and there is limited information on the status of flora and fauna. As high quality resource monitoring is critical for policy development, planning and monitoring of natural resources management, inter-ministerial mechanisms involving public consultations should be implemented to strengthen the quality and credibility of resource assessments. Government is piloting an approach by which Provincial Land Use and Allocation Committees (PLUACs), consisting of provincial authorities and line departments working with district staff, commune councils and villages, map state lands as well as prepare land management and allocation plans.

D. Broadening Institutional Roles and Responsibilities

23. The institutional responsibilities for natural resources management are both concentrated and centralized in Cambodia. Multiple functions which should generally be allocated across a number of agencies and stakeholders are often concentrated in a single natural resource management agency. In addition, responsibility for management of natural resources is legally (as in the case of forests) or practically (in the case of other natural resources) vested solely in national level authorities, providing little scope for resource use tradeoffs to be addressed, at least in part, by those directly affected or involved.

24. National policies, laws and subdecrees are generally drafted by the 'resource management agencies' responsible for implementing natural resources management, usually with project based technical assistance. In many cases, this single ministry focused approach has contributed to the lack of attention to tradeoffs, oversight and dispute resolution in policy, laws or regulations as the agencies are unlikely to impose increased accountability on their own activities, and as in other countries, these agencies are often subject to 'capture' by commercial interests in the sector. An exception is the 17 member Council for Land Policy established prior to drafting of the new Land Law,

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ensuring that inter-ministerial concerns were addressed in the formulation phase of legislation. In a number of cases, the government has built stakeholder support by inviting public participation in the preparation of the policy and legal framework. ‘Best practice’ examples to date, such as development of the 2001 Land Law and the draft Management of Fishing Communities Subdecree, demonstrate the benefits of open, participatory processes. In both cases, drafting of the legal instrument was preceded or accompanied by preparation and discussion of a policy paper which laid out in non-legal language, the government’s intended objectives and provisions under the legislation. The relevant ministries solicited comments and organized several consultative workshops to allow stakeholders to share their experiences and suggestions prior to finalization of the draft text. This process is generally credited with strengthening the content of the legislation, as well as building broad support for its implementation.

25. Resource management agencies are increasing their technical capacity to implement laws and regulations, but suffer from poor incentives and limited capacity to resolve issues locally. While technical skills have improved significantly over the past ten years, civil service salaries and operating budgets are insufficient to provide adequate incentives and support to carry out resource management functions. New laws and subdecrees which expand the responsibilities of staff are not matched by budgetary or donor funding to cover increased costs. As a result, resource management agency staff are often “captured” by the economic interests who wish to exploit resources legally or illegally. In addition, the lack of delegation of authority to develop alternative management arrangements with local communities and authorities forces resource management agency staff into either a confrontational position vis-à-vis the local communities, or complicity in permitting illegal activities. Finally, resource management agency staff are often bypassed by senior officials in the government, particularly in the process of granting concessions.

26. Dispute resolution mechanisms relating to land and natural resources need to be strengthened. Disputes between private individuals or organizations and the state which cannot be resolved by negotiations generally move to the courts, except in the case of land where extra-judicial cadastral commissions have been established in the hopes of lowering the cost of adjudicating land disputes. The situation for disputes between private entities is similar, with the difference that many of these disputes are arbitrated by the village or commune chief before being forwarded to the courts or cadastral commissions, as necessary. As in the case of enforcement, cases involving state officials or powerful business interests, subnational dispute resolution mechanisms are generally unable or unwilling to resolve the dispute which is referred to the national level where it can languish indefinitely. As there is no provision to effectively stay the action of the more powerful party pending resolution, the failure to resolve the case effectively works against the interests of the complainants. Given the inequities in access to justice, high costs and lengthy delays most rural inhabitants do not consider the court system to be a viable mechanism for receiving fairly prompt and fair

consideration of their disputes. Similar problems have been identified in the cadastral commissions.

27. Government accountability and oversight need to be strengthened in natural resources management. This is recognized in the Rectangular Strategy which states that “[f]rom this 3rd legislation onwards, the Royal Government of Cambodia will enable the responsible ministries and institutions to review and check on the commercial contracts and concession agreements on natural resources and state assets.” In Cambodia, oversight is carried out by the legislature, the executive, and civil society. Within the National Assembly the Third Committee dealing with Economy, Planning, Investment, Agriculture, Rural Development and Environment is responsible for issues related to management of natural resources. However, the Committee lacks technical support that would enable them to interpret technical reports on natural resource management issues. Within the executive, oversight is carried out by either specific, inter-ministerial councils (land) or committees (forestry and fisheries), as well as the Council of Ministers which do not have any reporting responsibility to the public. In addition, it is the responsibility of the Ministry of Economy and Finance to assess the status of all state managed assets and the Ministry of Environment to ensure that all environmental safeguard provisions are respected; though, again, this is done sporadically, at best, and the results not shared with the public. It is expected that the National Audit Authority, as it gains capacity, will carry out annual performance audits of natural resources management which will be reported to the National Assembly and eventually made public.

28. Civil society has generally played a more active role in oversight of natural resources management. International and local NGOs, as well as the local Khmer and foreign language media, have been drawing attention to the performance of resource management agencies. Some resource management agencies are integrating civil society oversight and participation into their management systems. The strongest accountability and oversight provisions are mandated in the Subdecree on Forest Concessions Management which requires consultations with local communities and public disclosure of submitted management plans for comment. In addition, independent monitoring of forest crime reporting and follow-up has been instituted. Monitoring has highlighted the resistance to processing cases involving senior state officials or powerful business interests.⁶ The difficulties experienced in implementing these provisions in forestry demonstrate the challenges in instituting a culture of transparency and accountability in natural resource agencies whose assumed mandate extends beyond implementation and without effective, external oversight institutions.

E. Looking Forward: Shared Benefits for Shared Responsibilities

29. There is an urgent need to develop and implement management systems which more effectively provide benefits to local communities. The rationalization of the

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concession system and limited coverage of community based approaches threatens to leave a significant portion of Cambodia's natural resources without effective management, creating a de facto open access situation (Box 4.3). Given the high proportion of Cambodia's population, and particularly the poor, which lives in rural areas and is dependent on natural resources, resource management approaches should prioritize direct access of these communities to benefits. Experience under the concession system demonstrates that centralized mechanisms for collection of natural resource rents have not worked well in Cambodia and are likely to play a much smaller role in the future. In addition, weaknesses in public expenditure systems limit the capacity to effectively distribute a reasonable portion of any rents collected to the affected communities through normal service delivery mechanisms.⁷

30. Transferring private rights to natural resources should transfer the benefits of the resources to local communities and/or the poor. Some areas of public land are expected to be privatized through recognition of their occupancy rights under the Land Law. In addition, social land concessions will effectively transfer land out of the public domain and full property rights will be provided to the land holders after five years. Implementation of the unused land tax will be important to reduce speculative pressures and release additional land to the market. In the case of indigenous land rights, it is expected that areas required for housing and agriculture will be recognized with communal titles with some restrictions on transferability.

Box 4.3: Impacts of Release of Fishing Lot Areas

An assessment of the impacts of the 2002 fisheries policy reforms was carried out based on interviews in 26 villages in three provinces. The study concluded, *inter alia*:

- Initial positive impacts from improved access to fisheries are now perceived to be declining due to unregulated competition for resources and widespread use of illegal fishing gear.
- Small scale fishers and traders have increased relative to large scale.
- Women and children have more secure access to fishing without fear of harassment from fishing lot guards.
- Reorientation of Provincial Fisheries Officers as facilitators of community fisheries can be expected to require considerable time and capacity building.
- Role of NGOs in representing the interests of a broader group of stakeholders in the process has been extremely important and needs to be extended to complement DOF.
- Widespread concern among fishers that there may be conflicts between needs of community fisheries and role of commune councils.

Source: Community Fisheries Department Office, Impacts of the Fisheries Policy Reforms: Kampong Cham, Pursat and Takeo Provinces IMM, Ltd. and DFID, March 2004

31. Further privatization or semi-privatization of forestry or fisheries resources through mechanisms such as transferable quotas require a better understanding of the status of these resources and the uses to which they are currently being put. Property

rights to water are not currently defined and therefore assumed to reside with the state. As competition for surface and ground water resources increases, private water rights will need to be defined. However, it can be expected that the majority of natural resources will remain as state property based on the need to ensure provision of public goods.

32. Concession arrangements may still be a good management approach under improved conditions and with explicit provisions to ensure coordination and benefit sharing with local communities. Many of the problems with the concession system in the past were due to inappropriate areas being offered in response to proposals from investors, and a complete lack of transparency in the contracting process and monitoring of investor performance. International experience indicates that concessions can be a mechanism to attract international capital, technology and market access to efficiently produce both public and private goods. Given the general institutional weaknesses in Cambodia, this would require very clearly defined and transparent procedures for identifying resources to be let on concessions, ensuring that social and environmental issues are assessed and significantly resolved prior to transfer to the concessionaire, implementing a transparent bidding process, ensuring monitoring and reporting of the technical and financial performance of the concessionaire, as well as implementation and public dissemination of independent oversight assessments. As the current debate around the future of forestry concessions demonstrates, there is considerable disagreement amongst Government, donors and civil society regarding the ability of the authorities to ensure that these procedures are properly implemented given institutional and governance constraints.

33. For most of the natural resources being managed by the state – including those managed under concession arrangements - increased local benefit sharing will be required. Experience from several countries indicates that benefit sharing mechanisms can provide increased transparency and accountability while enforcement and broader public revenue and expenditure systems are strengthened. Local communities can share both access to the resource itself, as well as the direct monetary benefits from commercial management. Mechanisms which ensure continued access of local communities to forestry and fisheries resources have shown more promise in providing incentives for villagers to support management regulations. Decentralization reforms, in particular the establishment of commune councils, as well as district planning mechanisms, provide a stronger basis for developing coordination and accountability amongst communities and between communities and resource management agencies (Box 4.4).

Box 4.4: Municipal Forestry in Bolivia

In Bolivia, the 1996 Forest Law reaffirmed the shift in power away from the center in and detailed new rights for municipalities. These include:

- The right to 25 percent of concession royalties to be used for forest development and social infrastructure;
- The authority to administer up to 20 percent of public forests which has been allocated to local community groups (as municipal forest reserves).

With these new rights come responsibilities. To receive a continued flow of forest revenue and authority over municipal reserves, the local government has to establish a municipal forest unit (MFU) within 6 months of receiving the first payment of concession royalties. The MFUs main responsibilities are to identify potential municipal forest reserve areas, to support local community groups in formulating forest management plans to receive concession and to help monitor compliance with forestry laws. The MFU's compliance with the law and capacity to carry out their responsibilities are supervised by the new autonomous national Forest Superintendent.

Some lessons to date from implementation include:

- Poor municipality capacity has hindered implementation in many areas. Low skill levels, low wages and political interference have limited municipalities' ability to establish MFUs.
- The potential for municipalities to raise the efficiency of forestry administration is evident in certain areas. Where municipalities have been active in establishing MFUs despite the lack of central support, they have illustrated a commitment not exhibited by the old centralized institutions.
- Decentralization has opened up opportunities for traditionally marginalized groups (e.g. indigenous people and small farmers) to participate in forestry and, in particular, gain access to forests in municipal reserves. The ability of these poorer sections of the community to take advantage of the new opportunities has varied.

There is a clear need for the central government to continue to play a role in the provision of technical assistance and finance and in formulating clear forestry policies which suggests the new division of responsibilities between different levels of government.

Source: Landell-Mills, Natasha: Financing sustainable forestry: a review of international experience, UNDP 2001

34. Locally-based benefit sharing needs to address the incentives facing resource management agency staff as well as local communities. While broader public administration and pay reforms are being put into place, monetary incentives should also be available to such staff based on clear and transparent performance measures

acknowledged by local stakeholders as well as central agency management. Several NGO projects have developed incentive mechanisms for government staff which have generally helped improve enforcement. (Box 4.5)

Box 4.5: Government and Civil Society Cooperation for Local Level Resources Management

In Mondulakiri Province, non-governmental organizations are working with local Phnong indigenous villagers and the Forest Administration to implement participatory land use planning (PLUP). Support includes training village coordinators, study tours for villagers to Ratanakiri Province where PLUPs have been implemented for several years, incentive payments to Forest Administration staff assisting villagers, and assistance in working with maps and with other villagers and commune and village authorities. The PLUPs are helping these communities to articulate their relationships to the natural resource base, including areas for swidden agriculture, resin trees and sacred and burial forests. Villagers have expressed the hope that by working together with provincial officials, they will have a voice in future land use allocation decisions and be able to protect their access to the resource base through communal title, community forestry agreements and more formal protection of resin trees. While the PLUP process by itself cannot ensure protection of access to resources, by all accounts, the support of civil society groups has been seen as crucial to provide the communities with the tools to engage constructively with provincial officials.

Source: Field visits with Wildlife Conservation Society and CIDSE in Mondulakiri

35. Developing this local benefit sharing approach should begin with local level resource planning. Responsibility for determining the allocation of natural resources amongst different uses should be delegated to provinces working with local communities, including commune councils. Experience to date with participatory land use planning (PLUP) and other variations has demonstrated that national and provincial priorities can be respected in the context of a local resource planning processes if national priorities are clearly articulated and well understood by all stakeholders (Box 4.5). The Provincial Land Use Allocation Committees being piloted under the Social Concessions Subdecree provides a model for inter-agency collaboration in assessing resource management options. The pending Subdecree on State Land Management provides an opportunity to institutionalize this deconcentrated approach more broadly in support of provincial level planning of state resource management.

36. Local benefit sharing approaches would shift the accountability chain and position central government more appropriately as a regulator, rather than generator, of public goods. Current management systems place responsibility almost exclusively on centralized, resource management agencies for ensuring efficient generation of public goods. Local partnership approaches shift the responsibility for generating public goods to a broader spectrum of local actors, including communities and commune councils, district and provincial staff of the resource management agency, and any private contractors. Centralized staff retain responsibility for oversight, along with provincial and other stakeholders, better aligning the interests of central ministries with civil

society monitors in reducing the costs of oversight and dissemination of information to the public on management outcomes.

37. Benefit sharing is not a ‘magic bullet’ for addressing governance problems in natural resources. Unless the poor are part of communities able to establish some claim to natural resources, increased sharing of benefits at the local level will decrease the potential for broader redistribution of the benefits to the poor. Capture by local elites is likely in many communities, particularly where local transparency and accountability mechanisms, including the presence of civil society groups, are not well developed. The economies of scale of natural resource management may increase the burden on district or provincial staff required to coordinate the participation of several villages and communes in management of the resource. Conflict resolution may also be complicated as complaints work their way from the local level to higher levels where the issues can be addressed effectively. Experience to date indicates that the structure of management committees, combined with initial, external support from civil society groups to strengthen local accountability and dispute resolution mechanisms can play a key role in reducing the likelihood of elite capture as well as improving the capacity for local dispute resolution. Nonetheless, the challenges in generalizing local benefit sharing approaches should not be underestimated.⁸

F. Addressing the Immediate Challenge of Natural Resources Protection

38. Cambodian and international experience clearly indicate that several years of capacity building are required amongst government staff and local communities when transferring significant management responsibilities for natural resources. This raises the question of what Government and its partners should do as new approaches involving local benefit sharing are developed, tested and extended. The limited capacity of resource agencies to police the large areas of natural resources released from concessions will require enhanced enforcement capacity, but through more collaborative arrangements with local communities which extends The capacity of Government agencies, and through enhanced transparency mechanisms. A multi-stakeholder approach is consistent with building capacity and experience for more formal, benefit sharing arrangements in the longer term. The experience of international NGOs such as Conservation International, Wild Aide and Wildlife Conservation Society provides an example of how NGOs can support collaborative monitoring and enforcement. Under a multi-stakeholder system, the role of an independent monitor becomes potentially critical in assisting Government and its broader array of partners in identifying weaknesses in the system which require attention. Putting a multi-stakeholder system in place will require rapid mobilization of resources from Government and donors to support technical assistance, training, equipment, incentives and monitoring costs.

G. Conclusion

39. In summary, while the state's management of natural resources has provided limited public benefits to Cambodians, and the governance framework for natural resources remains weak, there are real opportunities to rapidly address these constraints and increase the distributive benefits of natural resources management. Government has signaled, at the highest levels, its acknowledgement of the shortcomings of past implementation of natural resources management approaches, and taken several decisive actions to suspend or reduce inefficient management activities. Government has also clearly indicated its intention to reorient natural resources policy consistent with the objectives of the Rectangular Strategy.

40. Developing an alternative to the centralized, large scale concession approach to management will require substantial effort from Government, donors, and civil society working together. Donors need to respond to Government's commitment by providing financial and technical support to build more inclusive, transparent and accountable systems for management of natural resources through completion of the legal framework and strengthening of the technical capacity to assess, plan, implement/enforce and report on resource management. Oversight responsibilities need to be distributed effectively amongst governmental and civil society actors, and capacities increased at all levels, including the National Assembly, Judiciary, Inter-Ministerial bodies, villages, communes and the media. International NGOs and civil society groups will need to work collaboratively with Government and donors to integrate local benefit sharing arrangements into current and future natural resources management activities through support to the communities, communes, districts and provinces which will assume new responsibilities under these arrangements. While this is being implemented, there is an urgent need for increased support for protective activities through a multi-stakeholder approach which places primary responsibility with local actors operating under the oversight of national level agencies.

¹ World Bank, *Cambodia: Seizing the Global Opportunity: Investment Climate Assessment and Reform Strategy*, August 2004

² Ministry of Industry, Mines and Energy, *Private Sector Assessment for Kingdom of Cambodia*, December 2003

³ Based on Instruction No 3 and Subdecree No. 25 of the Royal Government of Cambodia.

⁴ In 2003, an informal consortium of the government, donor agencies and NGOs commissioned a team of independent experts to examine experiences in the Cambodian forestry sector, and particularly the recent controversy over the World Bank's role in advocating reforms in forestry concessions and forest law enforcement. The "independent forestry sector review" is intended to provide a perspective on the underlying challenges facing the sector and on the adequacy of the balance and range of the reform program which has been pursued by the government. Results are expected to be available in the second quarter of 2004.

⁵ Although no comprehensive data base of land, forest and fisheries conflicts exists – in part as many conflicts never enter official channels - existing studies based on village and NGO interviews indicate

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increasing incidence of conflicts. *c.f.*: *Cambodia: An Assessment of Forest Conflict at the Community Level* USAID, June 2004

⁶ Société Générale de Surveillance, *Second Quarterly Monitoring Report on Forest Crime*

⁷ World Bank, *Integrated Fiduciary Assessment and Public Expenditure Review*, 2004

⁸ For a more extensive discussion of the issues, *c.f.*: Van Acker, Frank, *Involvement of Commune Councils in Natural Resources & Environmental Management in Cambodia*, Ministry of Interior and GTZ, July 2004

SUMMARY OF CHAPTER 5
Governance for Private Sector Development

Private enterprises operating in Cambodia understand the need for improvements in governance. The top ten business constraints they cite are all directly, or indirectly, governance-related. Issues that any objective observer would recognize as urgent, such as the cost and availability of credit, the cost of energy, the quality of inputs, the availability of roads, the skill and education level of workers do not make the list of top ten. This is because so long as governance remains weak, businesses lack the certainty that they need to take long-term risks. While some may view bribes as a cost of doing business, they raise costs and make it difficult for firms to break even and survive, particularly in cost-competitive industries. Corruption also robs government of much needed revenues which gets passed back to businesses through the higher costs of transport and self-generated power.

The Protocol of Accession for Cambodia's landmark entry into the World Trade Organization requires 98 separate legal and policy reforms on an accelerated schedule, improvements in the regulatory framework for foreign direct investment and taxation and a framework for open consultations with the private sector on investment climate issues. Areas needing attention include:

- Improving the regulatory environment: Administrative controls are a heavy burden on Cambodia's private sector: it has the most annual inspections the highest costs to register businesses and the second highest time cost of management to deal with officials. Overlapping administrative mandates add uncertainty, discretion and high fees to the process of trading goods. Moreover, excessive regulation and corruption forces firms to stay informal.
- Establishing Credible Market Supporting institutions: Lack of property rights, contractual rights and agreed standards make Cambodia's investment climate unattractive. Legal and judicial reform and informal institutions are all needed. The private sector also needs to be better organized to help in the development of such institutions and to conduct a dialogue with government.
- Transparency and Competition in Public Private Partnerships: Laws and regulations do not provide for a coordinated process or establish clear, transparent procedures. As a result the process lacks transparency and competition and the benefits to the nation are not realized.

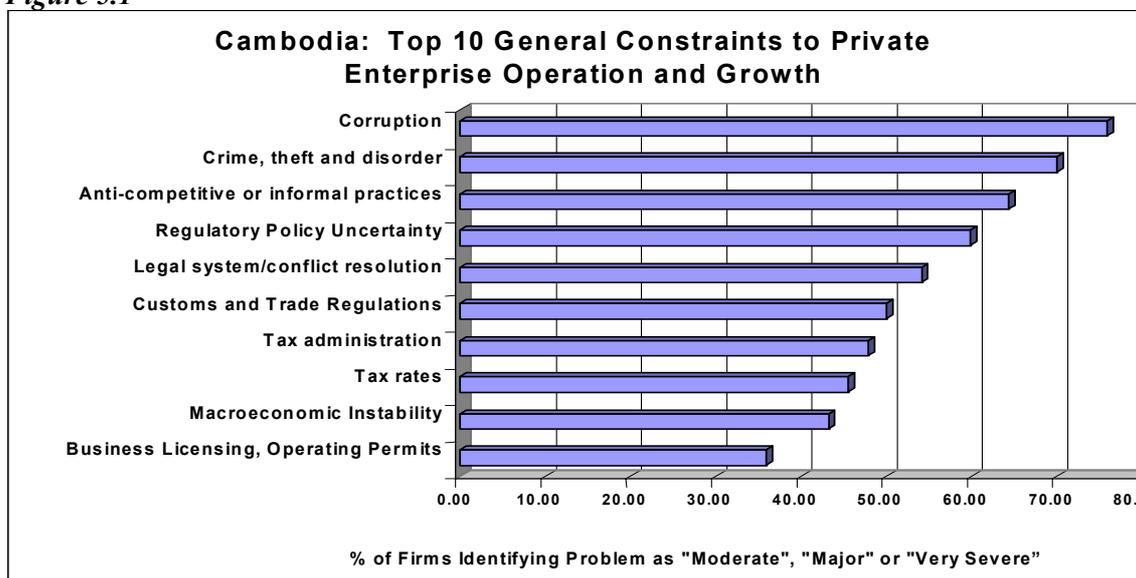
The Reform plan, devised by the Government to reduce the cost of doing business, would inter-alia, streamline and overhaul the trade facilitation process, introduce an overall risk management strategy to consolidate and rationalize inspection requirements, rationalize fees and charges, and streamline and rationalize the registration, licensing and taxation of companies. The private sector, on its part, will be encouraged to adopt a code of ethics and improve corporate governance. And it will join the Government in monitoring progress on reforms proposed based on a set of transparent performance measures.

CHAPTER 5: Governance for Private Sector Development

1. The Rectangular Strategy states that “The Royal Government considers the private sector as the engine of growth, while the government plays its role as the strategist in creating an environment conducive to enhanced private enterprise” (Royal Government of Cambodia, “Rectangular Strategy”, 2004). Governance is at the heart of this objective. The infrastructure development, capability building, and institutional investment needed for broad-based sustainable growth with equity constitutes a long and difficult agenda. Such broad based growth is central to poverty reduction in Cambodia. But without, a fundamental improvement in governance, such an agenda stands little chance of succeeding.

2. Private enterprises operating in Cambodia – both foreign and domestic – understand this intuitively. When asked about the constraints they face, the top ten issues they cite are all directly or indirectly governance-related (Figure 5.1).¹ The cost and availability of credit, the cost of power, the quality of inputs, the availability of roads, the skill and education level of workers – all issues that any objective observer of the business environment in Cambodia would recognize as urgent – do not crack the top ten. What matters to the private sector is improving governance.

Figure 5.1



Source: The World Bank, Cambodia Productivity and Investment Climate Survey 2003.

A. Why Governance Matters

3. Governance matters for two core reasons essential to any business: risk and reward. So long as governance remains weak, officials may be bribed not to enforce a law or regulation, and businesses cannot have the certainty provided by law necessary to take long-term risks. So long as the “rules of the game” are not certain, no long-term investment can be certain, and the only viable investments are short-term, speculative or depend on unique assets or monopolies. Without long-term investments, particularly in building skills and capabilities, there can be no long-term competitiveness. So long as governance remains weak, bribery and corruption become the rules of the game rather than fair competition. In terms of rewards and incentives to perform, an investment climate characterized by corruption penalizes those who would rather invest in improving their products and services than pay bribes, and rewards those who spend their available time and resources on obtaining favors from the state.

4. To some who think they can prosper in such an environment, bribes are just another cost of doing business like a tax. However, bribes are paid from “top line” revenue which raises fixed costs and makes it more difficult for firms to break even and survive. They undermine any capacity to compete in cost-competitive industries and, unlike a tax, are paid to intermediaries or individuals. This robs the state of official revenue needed to deliver the public services – electricity, roads, telecommunications, health, education – that are needed for long-term competitiveness. Such costs are then passed on to firms themselves, in the form of self-generated power or higher transport costs. Firms that bear such costs themselves stand little chance of being competitive unless labor costs are dramatically squeezed. Short term gains from paying bribes or accepting them always comes at the expense of a competitive, growing marketplace characterized by efficient public services, credible policy and decent wages.

5. Private enterprises require a measure of certainty and predictability in order to undertake long-term investments. As well, business now operates in a global marketplace that rewards competitiveness. As a result, and as the Government recognizes, Cambodia has little choice but to strengthen governance and reduce corruption. All stakeholders have a vested interest in the success of this bold direction: policymakers who have risked their credibility on this strategy; public officials who deserve the dignity of a wage that can support their family; workers who deserve the opportunity to put their educational investments to work; and above all, entrepreneurs who need not special favors but a chance to compete on a level playing field and the space to focus on improving their businesses. If Cambodia cannot provide such an environment, they will move to environments in which they can flourish.

6. This transformation must start with a fundamentally different vision of the role of government from an institution that controls private activity to one that facilitates its growth through competitive markets. As the country leaves the conflict that characterized its past behind, the heavy burden of checking and regulating – which may

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have made sense in the past – must also be left behind in favor of market-supporting tools to achieve the same goals. It is already clear that the Government understands that a vibrant private sector is in their interest; indeed a central part of its strategy. This commitment needs to manifest itself in a change in the governance culture from one that imposes registration, licenses, inspections and fees at each stage to one that encourages markets to work by targeting public interventions only where risks are greatest.

7. It is important to recognize the landmark step Cambodia has taken toward this objective by entering the World Trade Organization. As H.E. Cham Prasidh described in a recent speech, the Protocol of Accession requires the Government to undertake 98 separate legal and policy reforms on an accelerated schedule, improvements in the regulatory framework for foreign direct investment and taxation, and a framework for open consultations with the private sector on investment climate issues. WTO is an institution that derives its strength from the commitment of its members to managing trade with a common set of values: openness, transparency, predictability, non-discrimination/multilateralism and a rule-based dispute resolution. These are the same values that Cambodia is trying to instill throughout its economic and social development. Joining WTO improves market access, and also sends a strong signal to trade and investment partners about Cambodia's future direction. But WTO is not a panacea. Leveraging the benefits of market access will require substantial reforms, which entail shift from a culture of control to a culture of facilitation. From this basic premise flows four key strategies.

- (a) Improving the regulatory environment for business, including trade facilitation;
- (b) Establishing market-supporting institutions to facilitate competition;
- (c) Transparency and accountability in public-private partnerships; and
- (d) Development of key institutions including codes and standards of private sector governance.

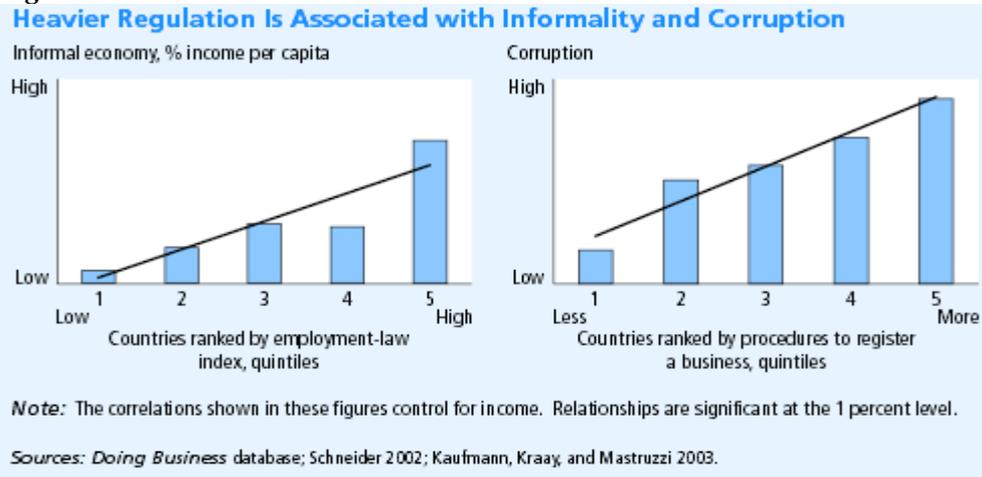
B. Improving the Regulatory Environment

8. Excessive regulation of firms and markets contributes to informality, corruption, and undermines the tax base (Figure 5.2). The impact of the regulatory governance breakdown is to reduce the size and scope of the formal private sector, limit productivity, and therefore reduce the impact the private sector has on poverty. A credible reform strategy must be based on replacing overlapping and sometimes discretionary administrative controls with a program that intervenes based on risk, removes overlapping mandates, and empowers markets through clear rules of the game.

9. Regulation, in this instance, refers to the use of state power to control the functioning of markets. Markets often require regulation to protect consumers, workers and the environment; to ensure efficient markets; and better balance the public interest with that of profit-seeking firms. The challenge for policymakers is not whether or not

to regulate, but rather how to design regulations that achieve social goals while still providing a conducive environment for investment.

Figure 5.2



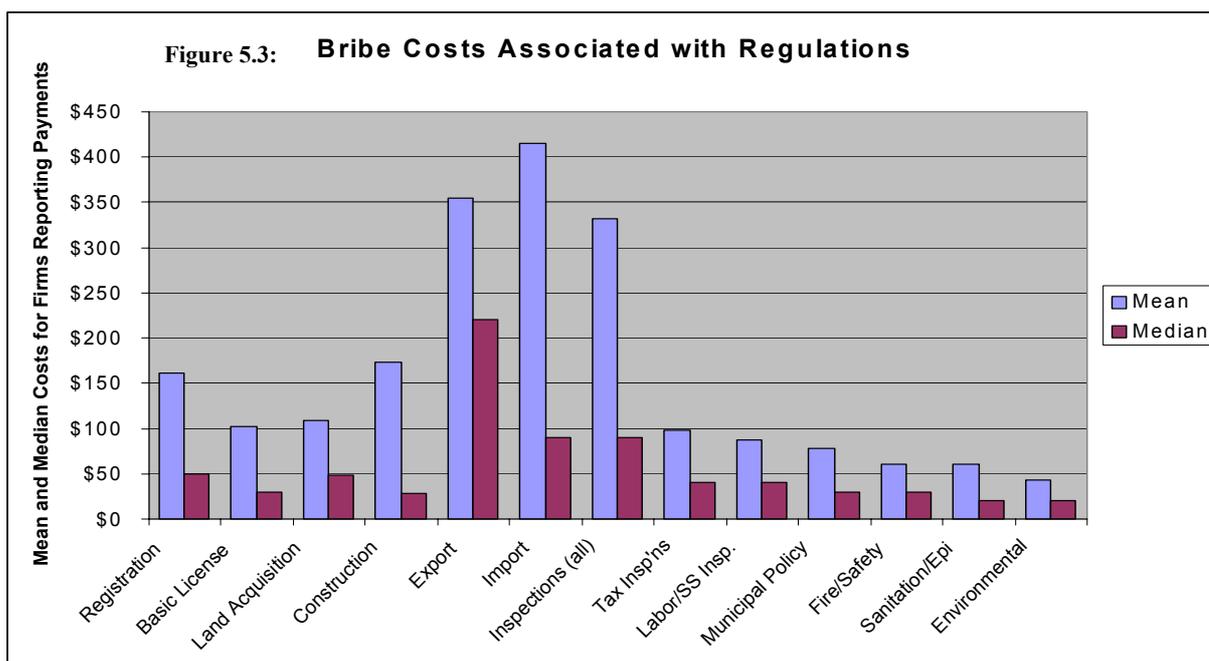
10. Poorly designed regulation can undermine the benefits of free trade. There is growing evidence that openness and trade do not produce growth in business environments that are heavily regulated (Bineswaree Bolaky and Caroline Freund, 2004). Heavy regulation limits the flexibility of markets and thereby prevents the deployment of factors – skilled and unskilled labor, capital equipment – in ways that would produce the productivity gains normally associated with trade. There is also substantial evidence that poorly-designed or excessive regulation is closely associated with both informality and with corruption.

11. Administrative controls are a heavy and costly burden to Cambodia’s private sector. The 2003 Investment Climate Survey revealed that Cambodia compares unfavorably with countries with which it competes in a number of regulatory issues. It has the most annual inspections, the highest cost per capita to officially register businesses, and the second highest “time cost” of management to deal with officials (after China). Trade facilitation practices are particularly constraining, with the second longest clearance times after Pakistan. In contrast with Cambodia’s reputation as a liberal environment, in several key respects Cambodia appears to be a restrictive market due to the cumulative impact of multiple agencies operating in an uncoordinated fashion. According to the *Doing Business Database*, (World Bank: *Doing Business: Understanding Regulation*, 2003) it takes 94 days to start a business in Cambodia - 30 days longer to start than in Vietnam, and 52 days longer than in Thailand. Cambodia has one of the slowest and most expensive systems for business entry in the East Asia region on a per capita basis.

12. These administrative measures create frequent interaction between public officials and firms, and therefore enable corruption to take place. Most firms

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acknowledge that payments to public officials are frequently, mostly, or always required to “get things done” (Figure 5.3). Our survey of 500 urban firms revealed that bribe paying is very frequent. Of the 447 firms that answered the question, 82% reported that they pay bribes, and 71% of large firms suggest such payments are frequent. These payments amount to a reported average of 5% of firm sales, but increase with firm size and formality, exceeding 6% of total sales for large firms.



Source: *The World Bank, Cambodia PICS 2003*

13. These overlapping administrative mandates add uncertainty, discretion and high fees to the process of trading goods. Among the major hurdles reported by trading firms are customs clearance, Ministry of Transportation border authorization or border police, veterinary and phytosanitary inspection, and CAM control. Each involves delays, management time, formal costs and informal payments. Customs clearance by itself imposes substantial delays and great variation, and hence, unpredictability. On average, firms report that imports take 6.5 days to clear customs, while exports take 4.5 days. However, this timing is variable, and firms report that in the last year they have had to wait an average of over 11 days for at least one shipment, and 16 days to clear an export shipment. Total costs of clearing goods also varies.

14. As a result of both excessive, unpredictable regulation and the frequency of bribe payments associated with regulations, firms react by staying informal (Figure 5.4). According to the Asian Development Bank, of the 27,000 firms operating in Cambodia, only 9,000 are registered. The strategy of remaining informal appears to make short-term sense: informal firms as well as rural firms are less constrained. In the long-term such a strategy is costly, as the informal sector has a reduced capacity to trade with the

formal sector, to obtain credit and to grow. Overall, the result appears to be a negative cycle in which firms remain small and informal, denying the Government the revenue base needed to improve public performance, which in turn contributes to weaknesses in the investment climate.

Figure 5.4

15. The key exception to the common response of staying informal is the garment sector, which has grown in an environment of a unique, non-competitive asset: quotas. The garment sector has proven its ability to export and grow, but it

Estimated % of Income Reported for Tax					
Large or Foreign:	SMEs:	Micros:	Urban- Informal		
61%	53%	40%	2%		

Unofficial payments as a share of sales revenue					
Foreign	Large	SMEs:	Micros:	Urban- Informal	Rural Non-farm
6.9%	6.1%	5.5%	4.0%	2.3%	1.3%

now faces the prospect of lower prices and therefore the need to increase its efficiency. Like garment exporters throughout the world, Cambodian firms must contend with the liberalization of garment trade at the end of 2004. Through the WTO Agreement on Textiles and Clothing, the US has given Cambodia a quota in its protected market, the volume of which depends on labor practices. Such agreements will be replaced by competition in 2005. There is a possibility that corporate social responsibility practices will become a source of competitive advantage, but Cambodia competes in high-volume segments where demand is likely to be cost-sensitive. The evolution of price behavior in Cambodia's non-quota exports to the US suggests declining margins. As the global industry consolidates to reap economies of scale, Cambodia's industry is at risk. The focus on improving regulation is perhaps even more urgent in the garment sector to allow some of the 240,000 workers to remain employed.

C. Establishing Credible Market-Supporting Institutions

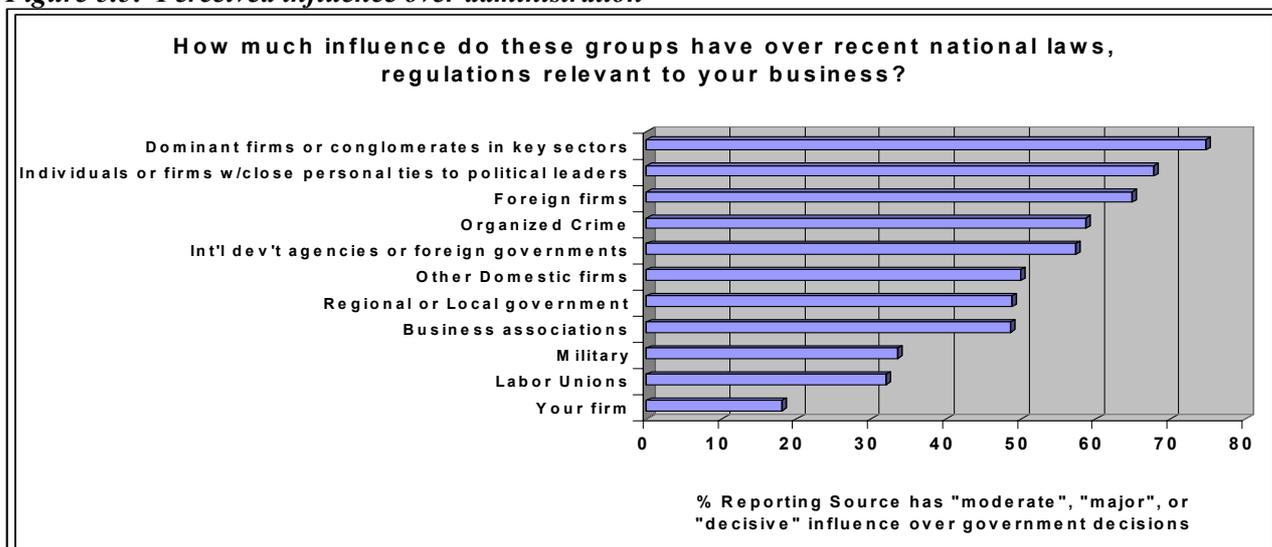
16. Many of the investment climate issues, particularly outside of the garment and tourism sectors, result from the lack of key institutions, including property rights, contractual rights, and agreed standards. The value of such rights depends on the presence of an effective judicial system. The functioning of markets, like any competition, depends on clear rules effectively and fairly enforced. This requires that the administrative power of the state be used not to intervene at all stages of the game, but to resolve disputes and enforce penalties for violations of rules to which competitors subscribe. Where those rules are clear and enforcement is credible, markets perform many of the functions intended by administrative control. This entails a shift of power and accountability from administrators to market participants.

17. Part of the process of establishing clear rules is to insulate the "referees" from influence by market participants through an independent judiciary (Figure 5.5). But few have confidence in the judiciary (Overview for a fuller discussion). Simply put, the

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Judiciary will need substantial reform to build up a track record of impartial and effective judgments before this perception is changed. Meanwhile, there are important roles that can be played by the private sector and civil society.

Figure 5.5: Perceived influence over administration



18. Cambodia has made substantial progress in drafting new laws particularly associated with WTO accession, and needs to make equally rapid progress in building the capacity to enforce these regulations. An effective Civil and Commercial Code is particularly important since it encourages arm’s length transactions.

19. The institutional development agenda goes well beyond legal reform. Informal institutions, such as product standards, trading rules, information systems and out-of-court mechanisms to resolve disputes all play a role in creating a market environment that supports fair competition. Even as Cambodia’s parliament undertakes the legislative agenda, there will be substantial work for the private sector to both change its behavior in light of new laws, and build other non-formal systems. As Douglass North explained in his Nobel lecture, “it is the admixture of formal rules, informal norms and the enforcement characteristics that shapes economic performance. While the rules may be changed overnight, the informal norms usually change only gradually.”

20. In many instances the private sector can undertake reform without public intervention. This includes self-regulated industries such as professional services, and those that are partially self-regulated such as construction. The private sector, particularly the domestic and rural private sector which accounts for the bulk of employment in Cambodia, needs to play a more active role in establishing institutions. Since Cambodia is at early stage of formalization and specialization the most important consideration may be the ability of local institutions to learn – to acquire information and experience that is an essential part of the process of technology adoption. The

Cambodian private sector has few institutions that can facilitate a dialogue on the “rules of the game” aside from the successful garment manufacturer’s association. The private sector needs to be better organized in order to help in the development of such institutions, to raise awareness among market participants of those rights, and to hold the state accountable to fair enforcement of those rights.

21. The Government-Private Sector Forum, designed as a bi-annual meeting of the Cabinet of the Royal Cambodian Government and representatives of the private sector, is a useful start, but more needs to be done to build the “voice” of the private sector – particularly in rural Cambodia. Social capital, networking and information sharing among the private sector can be facilitated by business associations, or business membership organizations (BMOs). BMOs are intermediary, networking, and self-regulative bodies.² As such, they represent an increasingly important form of participatory development in countries such as Cambodia. Because of their size, BMOs have extensive outreach capabilities and can contribute to improving the framework conditions for the private sector through facilitating a common understanding of the formal rules of commerce, taking collective action, delivering central services, and networking among members and other stakeholders. It is this unique combination of strengths that makes them effective tools to increase the growth of firms in a given country. Business associations can facilitate exchange by improving information flows and by facilitating learning through policy advocacy, through facilitation or direct provision of demand-driven services, and through advocacy aimed at creating a better business environment.

22. This will require investments in raising awareness and policy monitoring and advocacy capacity. No party has a larger stake in a successful reform than the private sector, which is directly affected by the quality of the investment climate. As such, building local capacity to monitor reform is more likely to be sustainable, and more consistent with a strategy that calls for maximum use of private, non-state resources.

D. Transparency and Competition in Private Public Partnerships

23. Cambodia’s Rectangular Strategy places an important priority on improving delivery of public services, which were particularly weakened by years of conflict and neglect. Because needs are so acute and resources so limited, the state will inevitably need to yield a substantial role for delivery of public services to the private sector. Because of its resource constraints, Cambodia has in fact been a center of innovation in public-private partnerships for delivery of services, including health, water, rural electricity provision, and even the introduction of labor protection standards linked to trade (Table 5.1). In the water sector, the RGC undertook private participation initiative which involved the use of competitive, output-based contracting of connections to the public water system that ended saving 30% relative to public provision.

Table 5.1 PPI Transactions in Cambodia and Form of Contract

<i>Sector</i> Project	Public Entities	Form of PPI contract /	Value US\$ mn
<i>Municipal Services</i>			
Waste management	APSARA Authority	Concession for Angkor Wat garbage collection with a private sector firm	N/A
	PP Municipality	Concession for Phnom Penh garbage collection with a Cintri Company	n/a
<i>Water</i>			
Rural	Various agencies		
	MIME, MRD, MOWRAM, MPWT	Ten rural systems privately negotiated MIME Six rural systems directly negotiated with MRD-MIME-PGs	< 0.25 < 0.1
<i>Transport</i>			
Roads	MPWT	National Route 4 negotiated with CoM	n/a
	Provinces	Rural concessions negotiated with provincial governors	n/a
Ports	MPWT	Oil terminal and dry ports negotiated with CoM	n/a
Airports	CoM, SSCA	Concession with Vinci subsidiary SCA for development of Pochentong Airport, Phnom Penh (PNH) negotiated with CoM	30.0
	CoM, SSCA, MPWT	Concession with Vinci subsidiary SCA extended to include Siem Reap International Airport, based on international exclusivity clause in PNH concession	n/a
	SSCA MIME, CoM, EDC, EAC	Air navigation services negotiated with CoM	23.0
<i>Electricity</i>			
Urban	MIME	Power Purchase Agreements for IPPs negotiated with MIME in cooperation with CoM in the presence of EdC as offtaker	n/a
Rural	MIME, EDC EAC (regulator)	Battambang and Siem Riep negotiated with MIME-EdC Licensing of (existing) small rural electricity providers >50kW	n/a 12.0
<i>Telecoms</i>			
Inter-national gateway	MPTC	Joint venture agreement with RTI	n/a
2nd fixed line network	MPTC	Joint venture agreement with Indosat for Camintel	n/a
Mobile Services	MPTC	Joint venture agreements with 4 operators: Mobitel, Samart, Camtel, Shiniwatra negotiated with MPTC/CoM	n/a
VOIP	CoM, MPTC	One License for Voice-Over-Internet Protocol (VOIP) granted to BCC, negotiated with CoM	n/a
<i>Internet</i>	MPTC	Licenses to Internet Service Providers	n/a

24. Increased private participation in infrastructure (PPI) in Cambodia, under an appropriate institutional and regulatory framework, is likely to provide opportunities for

augmenting budget resources and for improving efficiency. The benefits of the latter can be substantial, particularly when accompanied by pro-competitive reforms (or even monopolistic activities operating under an appropriate regulatory framework). Public-private partnerships need to be seen as part of a strategy to increase the efficiency of service delivery. To ensure the best outcomes for Cambodia's citizens and to support the NPRS service delivery goals, the Government would need to introduce the principles of transparency, competition, accountability and rational design in all transactions with the private sector.

25. But the practice of private participation in infrastructure in Cambodia is frequently characterized by a lack of competition and transparency, which denies the country the efficiency benefits that are the most important reason to involve the private sector. Because of the nature of public services, most of these efficiency gains can only be captured at the point of transaction. The process is sufficiently "broken" as to require firms to circumvent it to secure transactions – a process that denies Cambodia most of the benefits of private participation. In the absence of an appropriate legal, institutional, and regulatory framework, many of the benefits associated with PPI have not been secured. This also has severe adverse consequences for budgetary revenues.

26. In the telecom sector, each private license or cooperation agreement has been in a joint-venture between the operator and the Ministry of Post and Telecommunications (MPTC). The Ministry thus shares in the ownership of all mobile services, the fixed line network, and the international gateways. It also sets telecommunications policy and acts as the regulatory agency. The sector is characterized by a lack of transparency in the process for awarding licenses, forced large-scale revenue sharing between private operators and the MPTC, and very little price competition between service providers. In the transport sector too, it is difficult to determine whether the RGC and/or users are getting value for money from the airports, toll roads, and air traffic control concessions, since all the contracts were directly negotiated and the details regarding performance obligations and risk allocation are not publicly available.

27. The chain of accountability is broken at several levels. Policy-making, planning and project identification isn't closely aligned with the budget or with sector strategies. Current laws and regulations do not provide for any effective, coordinated process for agreeing policy on development of PPI, nor for setting priorities across projects or sectors. There is considerable institutional muddle, including cases where the allocation of roles and responsibilities between institutions is unclear. The existing laws do not clearly identify which governmental entity has the power to enter into negotiations and take decisions on all types of infrastructure projects, notably with confusion existing between the powers of the Council for the Development of Cambodia (CDC), line ministries, the MEF, and the Council of Ministers (CoM), and between these of the central government, the provinces, and the communes.³

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28. The sectoral laws also do not set out clear procedures for awarding and negotiating PPI projects. In several sectors there are multiple agencies providing oversight, licenses, and permissions to operate, but there is no or limited coordination between them. Government agencies tend to compete with each other to enter into concession negotiations with private sector investors. In some instances officially designated roles and responsibilities have been over-ridden by more senior individuals, departments, and ministries in government

29. Consumers ultimately pay, but have no avenue for redress. The consequences of these problems include:

- *non-bankable projects*, with investors to date completely unable to secure limited recourse or non-recourse project financing for infrastructure projects in Cambodia – all investments have been fully equity financed, which drives up required returns and hence the prices to consumers;
- *lack of information* on the value-for-money received by the public from infrastructure projects due to the inability of the public or third parties such as international development banks and agencies to assess the full value set of risk and the distribution of revenues and profits in concessions, and
- *limited protection of the public interest* – the lack of transparent, predictable, and enforceable laws and administrative procedures contributes to an environment where decisions can be made in an arbitrary or improper manner without due regard to the economy, efficiency, the long term sustainability of the project, or the interests of consumers and the wider public.

30. Citizens, service providers, and governments would all gain from increased accountability and transparency. With easy access to published concession contracts, citizens would be better able to determine which party has responsibilities for a particular aspect of the project, such as maintaining service quality, improving infrastructure, collecting fees, connecting and disconnecting service, and a variety of other daily operations. This would enhance the accountability of both service providers and governments to respond to citizens' issues and concerns. In many cases of troubled projects, governments and concessionaires simply exchange accusations through the press without allowing citizens to directly establish liability.

31. The Ministry of Economy and Finance and the Council for Development of Cambodia (CDC) are undertaking a program of reform that will establish a clear policy framework, an enabling law to supercede Anukret 60, and build institutional capacity with the support of the World Bank, UNDP, and PPIAF. The draft Law on Concessions and the Draft Implementing Regulations need to be finalized and adopted urgently.

E. Developing Codes and Standards

32. Improving governance cannot rest on public action alone. Any strategy to fight corruption, build better institutions, introduce transparency in public contracting must also rest on efforts to strengthen codes of ethics and standards of governance that are developed and enforced by the private sector itself. A culture of facilitation in the public sector must be encouraged by a culture of respect for legitimate “rules of the game” and regulations that protect the public interest when fairly enforced. For many foreign investors, bribe paying in foreign countries is a punishable offense.⁴

33. Forms of governance that the private sector can lead include corporate governance, codes of ethics, and selected instances of self-regulation and use of supply chains to promote good corporate behavior. Corporate governance in Cambodia is in its infancy, with the early focus primarily on establishing accounting standards as a basis for transparency. As long as financial markets remain in their infancy, the role of banks in disciplining the private sector will be limited. However, the development of a Civil and Commercial Code will stabilize such key issues as corporate structure, the role of boards of directors, and key corporate transactions. Shareholders, and regulators of markets, will be in a position to enforce standards of ethics as a function of their role as stakeholders to enterprises.

34. Self regulation makes sense when the collective interests of a private sector profession are sufficiently aligned with the public interest that the enforcement power of peers makes public sector enforcement unnecessary. Development of standards in most industries is first the responsibility of the private sector. Public enforcement is unnecessary because standardization of components across an industry is in the private sector’s interest: it enhances efficiency, reduces costs, improves the ability of firms to collaborate and lowers barriers to entry. At this point in Cambodia’s development, it appears that the garment industry, rice sector, and to an extent construction are the only sectors that have advanced significantly in the development of codes and standards due to their exposure to international trade. There is a large scope for further potential international collaboration in establishing standards. In construction, such standards organizations as ISO, and the British Standards Institute, the International Conference of Building Officials, the International Code Council, and the Australian Building Codes Standards Board can assist in the development of an internationally-compatible set of codes in Cambodia. Similar efforts can be undertaken in the customs brokerage industry.

35. Beyond owners as stakeholders, buyers and sellers as supply chain partners can insist on a degree of adherence to ethical conduct as a condition of doing business. The corporate social responsibility movement has proven that trade can be used to ensure compliance with Core Labor Standards and the environment, among other key public goals. Supply chains are effective at strengthening corporate governance due to their networking effect and the sustained feedback it enables.

F. From Control to Facilitation: Key Elements of Reform

36. The success of the transition depends heavily on three key elements: credibility, transparency and accountability. The specific reforms cited above, such as streamlining regulation, building market institutions and introducing competition in public private contracting, are essential to reduce opportunities for corruption and creating a more efficient business environment. None, however, can simply be undertaken as “stroke of the pen” reforms and be expected to have impact.

37. Credibility is necessary for all stakeholders to begin forgoing short-term behavior and begin investing in long-term competitiveness. Through the Rectangle Strategy, Public Sector Reform Strategy and WTO, the Government has established a clear vision.⁵ But to for this vision to be credible, it is essential to establish a track record of successful implementation that is visible to all stakeholders, which in turn requires approaches that consider the incentives to adhere to the reforms in both the public and private sectors. This includes policies that reward compliance and penalize non-compliance, as well as meritocratic rules for public sector employees that offer a living wage in return for successful policy implementation.

38. Transparency reduces the chances for, and perception of, corruption. In Cambodia, many projects that were negotiated through closed, non-transparent concessions are the subject of frequent allegations of corruption, and are also often the subject of calls for renegotiation of tariffs paid by users. A norm of publication could reduce the suspicions that sometimes surround the awarding of contracts. This would be very valuable when projects are unsolicited and/or contracts are directly negotiated. With this in mind, the Mexican Government recently passed a Transparency and Access to Public Government Information Law making government contracts available to requesting citizens within 20 days. The new Mexican law also dictates that federal agencies must place contracts on government websites by mid-2003. Although transparency laws like Mexico’s will not prevent all corruption, both government officials and companies would be less likely to engage in unethical behavior during the awarding phase if they know that their contracts will eventually be made publicly available.

39. Donors who fund infrastructure and other PSD projects can insist on transparency and competition in any sector where their funds are applied, since donors funds compensate in part for inefficiency. Publication of contracts could facilitate the evolution of standards in infrastructure transactions. Governments could obviously benefit from access to privatization agreements from other municipalities, agencies, and countries. Widespread availability of contracts would also make it easier for consumers to benchmark tariffs and other service obligations with similar systems in other jurisdictions.

40. It is ultimately citizens and businesses that must demand performance from Governments as voters and taxpayers. Governments that deliver against their commitments to achieve growth and successfully carry out reforms should be rewarded, through the mandate of citizens and by being entrusted with their tax revenues. The typical democratic cycle, however, is too broad and infrequent to target specific issues. Citizen report cards have been used effectively in India and other countries to monitor specific institutional and policy reform and can play a role in Cambodia. Citizen report cards can be used to ensure that public services are delivered. To ensure performance in areas relevant to private sector development, this depends crucially on the definition, for each institution or regulatory change, of clear and monitorable indicators of government performance. Many of these have been defined within Government projects and in donor documentation, but need to be converted to more effective use by citizens and business associations. It is important that citizens understand these indicators and that other stakeholders, particularly the media, make them public.

G. Conclusion

41. Recognizing some of these factors, the government has made a beginning, and developed a plan of action which would aim at reducing the cost of doing business in Cambodia and improving corporate governance. Under the plan, the government intends to, inter alia, establish a system of transparency performance measurement which would be monitored by the private sector and development partners. It would also streamline and overhaul the trade facilitation process, including licensing, documentation and overlapping and unnecessary approvals leading to a Single Administrative Document. An automated Single Window for trade facilitation at Port Sihanoukville would be set-up. The Government would also introduce an overall risk management strategy to consolidate and rationalize all inspection requirements of the different control agencies, rationalizing fees and charges, and streamlining and rationalizing the registration and licensing of companies. The private sector, on its part, will be encouraged to adopt a code of ethics and improve corporate governance. The private sector will join government in monitoring progress on the proposed reforms.

42. These are welcome developments. An energetic and dynamic reform process will now need to be quickly developed that can show results within a reasonable time period. This is another area where there are many quick wins that the government could achieve. The government needs to move energetically so that investor confidence improves quickly and gives a boost to the considerable scope for diversification away from the current heavy and risky dependence on one subsector: garments exports. Over the medium term, as described in the Overview, sustaining progress will depend on developing the legal and judicial system, on reform of the civil service. It will also depend on more broad-based development within the private sector of their ability to participate in, and hold the government accountable, for reform of the investment

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climate. The potential for growth and hence employment generation and poverty reduction is significant.

¹ *Towards a Private Sector Development Strategy for Cambodia: Investment Climate Assessment*, World Bank (2004). The perception data are based on the Cambodia Productivity and Investment climate Survey, conducted in February through August 2003.

2 BMOs have to be defined as non-profit and democratically guided membership organizations that finance themselves by a mix of membership dues, service fees, as well as subsidies from government or donors. There is no law regarding the regulation of business enterprises associations in Cambodia. With the exception of a few BMOs, such as the Chamber of Commerce, which has been established by law, most BMOs simply declare their existence with the Ministry of Interior.

3 The Law on Investment (LOI, 1994) established the Council for the Development of Cambodia (CDC) as the ‘one-stop’ service organization for investors and supposedly the sole responsible organization for evaluating and making decisions on all investment projects, both rehabilitation and new. However, numerous contracts, including the National Route 4 Highway; the oil terminal and dry ports; and the airport concession were each negotiated directly with the CoM. Similarly, power purchase agreements with independent power producers in Phnom Penh and electricity projects in Battambang and Siem Riep were each negotiated with the Ministry of Mines and Energy (MIME) and the CoM in the presence of *Électricité du Cambodge* (EdC).

⁴ Firm liability for bribe paying is an increasing trend in OECD countries, backed by both codes and laws, such as the US Foreign Corrupt Practices Act.

⁵ H.E. Keat Chhon, Sr. Minister of Economy and Finance, *A Vision of Growth and Governance*, and H.E. Cham Prasidh, Sr. Minister of Commerce, *Converting WTO Accession to Poverty Reduction*. Speeches at Government-Bank Workshop presenting “Seizing the Global Opportunity: Investment Climate Assessment” August 12, 2004.

SUMMARY OF CHAPTER 6
Improving Aid Effectiveness

There are a number of things both donors and Government could do differently to improve aid effectiveness in Cambodia. Over the last decade, poor aid management has not only resulted in technical inefficiency, but also contributed in part to the governance problems facing the Cambodian state. Similar experiences in many developing countries have given rise to a global call for *harmonization* (better donor-donor coordination through common management systems or joint programs); and *alignment* (donors structuring their aid in line with Government policy frameworks and – where such systems are adequate – managing aid delivery through Government systems). Donors have to a large degree committed to harmonization and alignment at the international level, at the UN Millennium Summit, the Monterrey Conference, and the Rome Agreement: they now need to put these commitments into practice at the country level.

There has been considerable progress on aid reform over the last year, with different strands of the process drawn together in a Harmonization and Alignment Action Plan. Several donors have combined their country- or sector-strategy processes in order to reduce the transaction costs to Government. The Government has led the call for existing coordination bodies to be redefined in standardized format as Government-donor Technical Working Groups (TWGs) – and for TWGs to be created for sectors or themes where such structures do not yet exist. The latest of these groups to be announced is a TWG to support pro-poor planning, with a stronger link to resource allocation. This will focus in its first year on coordinating donor support, under Government leadership, to the production of Cambodia's new five-year (2006-2010) strategic plan for development and poverty reduction and the Public Investment Program (PIP).

Both Government and donors need to sustain the progress made. There is a need for Government to develop, and donors to support, common principles for more strategic use of TA. The ad hoc salary top up system that exists needs to be rationalized and then phased out. The TWGs need to be supported and strengthened. Finally, donors need to engage in a collective debate with Government on development priorities and how external assistance can best support these.

While donors can do much to reduce the transaction costs involved in delivering aid (by harmonizing systems, forming partnerships, and reducing the number of missions and reports), maximizing the value of aid ultimately requires Government leadership, on policy issues but also on governance reforms. Many donors now give a large weight to progress on governance as a key criterion for giving aid to Cambodia, and some donors have been cutting back their assistance due to poor performance on this criteria. Implementation of the governance agenda laid out in the Rectangular Strategy could therefore result in aid levels increasing over the coming years.

CHAPTER 6: Improving Aid Effectiveness

1. There is increasing recognition in the development community that aid needs to be managed very carefully in least developed countries. If it is not, there is a risk of distorting the development of Government-institutions and, potentially, disrupting macroeconomic stability. The need for responsible donor behavior is particularly urgent in post-conflict societies in which the institutions of state, market and civil society are often weak, or take forms that do not necessarily serve long-term, collective interests. In these circumstances, carelessly given aid can prevent, rather than promote, the development of those fundamental "goods" without which long-term development will not be achieved (Box 6.1). When donors manage their aid badly, it can have a serious negative effect upon the development of political vision and commitment; of state institutions characterized by transparency, accountability and the capacity to deliver key economic and social services in a pro-poor manner; and of economic governance which promotes broad-based, sustainable and poverty-reducing growth.

2. These debates are highly pertinent to Cambodia. There is much that donors can and should do to make their assistance to Cambodia more effective. There are numerous examples of how donors have behaved, individually and collectively, which result in inefficient and ineffective aid; or which even make things worse by contributing to (or exacerbating) a culture of corruption and patronage in the use of public resources. Poorly managed aid can inadvertently impede the evolution of a coherent Government vision of long-term development; or undermine the capacity of institutions of the state and de-legitimize civil society organizations.

3. For convenience, discussion of how development assistance can best be organized so as to contribute to developmental ends at the national level can be

Box 6.1 The seven deadly sins of development cooperation

In Christian doctrine there are seven extremely serious – or "deadly" - sins. Nancy Birdsall of the Center for Global Development has used this concept of a typology of human failings to identify and frame discussion of the common mistakes made by donors in the design and management of the aid programs.

- 1 Impatience (with institution-building)
- 2 Pride (failure to exit when aid isn't working)
- 3 Ignorance (failure to evaluate)
- 4 Sloth (pretending participation equals ownership)
- 5 Envy (failure to collaborate)
- 6 Greed (stingy and unreliable financing)
- 7 Foolishness (underfunding of global and regional public goods)

These failings are particularly common, and particularly serious, in least developed and post conflict societies. Indeed, in such cases, formal institutions are weak, information is scarce, pressure for rapid results is intense, and an aid-dependent Government lacks the ability, or confidence, to discipline donors.

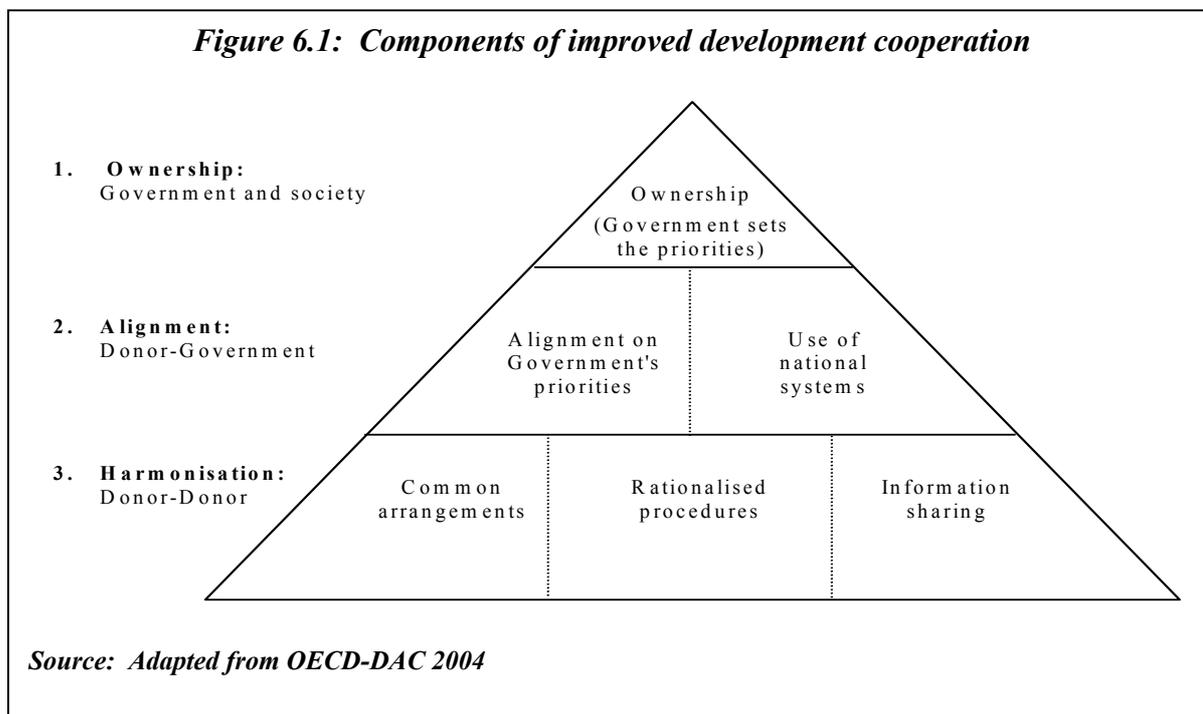
Source: Birdsall 2004

structured under a number of discrete headings (Figure 6.1). Ultimately, improved development cooperation relies upon credible indications of Government *ownership* of the development agenda. To simplify, the concept of ownership implies that the Government understands the problems it faces; has developed a strategy for tackling this, which the donors judge meets some minimal technical standard of quality and feasibility; and shows sign of real political commitment to implement this strategy.

4. If donors are persuaded of the adequacy and sincerity of the Government's development strategy, they should be willing to undertake *alignment* of their country cooperation programs with the Government's lead on policy directions and budget priorities. (Where such ownership does not exist, it is important that aid is managed in such a way as to promote the evolution of ownership - or, at a minimum, not to retard its development). Alignment of a different kind – which can to some extent exist even where donors are not willing to align with Government policy or priorities – involves a commitment by donors to use Government administrative and financial systems to manage aid transfers and activities, rather than (as has conventionally been the case) requiring Government to adapt its own processes to a multitude of different donor systems. This systems alignment, however, requires that donors can satisfy themselves (and their taxpayers or shareholders) that Government systems and procedures meet some minimum technical standard of efficiency and financial accountability.

5. Finally, there is in most developing countries considerable scope for donor-donor *harmonization* of their own procedures by: i) adopting common arrangements for planning and delivering aid (e.g. through greater clarity and commonality regarding the conditions that would lead to increased or decreased giving, or through support to agreed sector-wide aid frameworks); ii) wherever possible, streamlining and rationalizing their procedures (e.g. through joint, rather than single, donor missions and studies) so as to reduce the burden on Government; and iii) sharing as widely as possible analytical work and information on planned and actual aid flows. It is important to note that donor-donor harmonization can and should occur regardless of whether or not they can align their programming and systems with those of Government. That is, even when donors cannot align their policies or systems with those of Government (either because they judge that those policies are misguided or the systems are inadequate to ensure accountable, effective or efficient use of aid resources; or because their own internal rules prohibit use of Government systems), donors *can* take steps amongst themselves to harmonize.

Figure 6.1: Components of improved development cooperation



6. This chapter provides a brief review of some of these issues. It argues that the move to a partnership approach to the development of Cambodia requires reforms on the part of lenders and donors, as well as on the part of the Royal Government of Cambodia. The long-term objective is to make a reality of the principle of mutual accountability: Cambodia's development partners and Government need to agree and then follow a set of rules defining their obligations to each other, and to Cambodian citizens. Donors have to a significant degree committed to this general principle and specific reforms at the global level, notably at the Millennium Summit¹; the Monterrey Conference of Financing for Development; and the OECD-DAC Rome Agreement on Harmonisation. The challenge now is to live up to these commitments in Cambodia.

7. None of this, however, should detract from the central message that runs through this report (and which is explicit in the Government's Rectangular Strategy): namely, that Cambodia will not be able to escape poverty and marginality unless it achieves good governance. Donors could achieve more, even under current conditions, if they were to adopt more coordinated and harmonized approaches. Realizing the full potential of aid, however, requires that donors be able to interact with, and align their aid programs to, a Government that is demonstrably becoming increasingly transparent, accountable and internally coordinated in its pursuit of a coherent vision for poverty reduction. Without significant reform of Government institutions and systems, even well coordinated aid will achieve relatively little. In such circumstances, donors will

eventually be forced to reconsider the justification for continuing to support Cambodia rather than other, equally poor nations.

8. The chapter begins with a brief overview of how poorly managed aid has contributed to Cambodia's governance problems. It then summarizes some of the positive recent developments that have occurred, and lays out the current agenda for the near- and medium term. Broad themes are identified for how ODA might become more a part of the solution rather than part of the problem with regard to issues of incentives, institutional development and governance.

A. Development Assistance and Cambodia's Governance Problems

9. Due primarily to Cold War geopolitics, Cambodia was largely excluded from the international aid system for most of the 1980s. With the signing of the Paris Peace Accords in 1991, the volume of international assistance to Cambodia, as well as the number of actors involved in its delivery, expanded dramatically. Inevitably, aid management and effectiveness suffered as mechanisms that had proved effective at coordinating a small number of grant-funded projects in a given sector during the isolation / recovery phase of the 1980s proved inadequate for the much-expanded cast of actors, and much greater diversity and ambition of interventions, in the normalization phase of the mid and late 1990s. Table 6.1 provides a sense of the scale of the problem: although domestic revenues are starting to rise, Cambodia remains highly dependent on aid.

Table 6.1 Selected indicators of aid dependence in Cambodia

Indicator	Year	Value
Number of donors	2003	31
Number of donor-supported activities	2003	410
ODA as percentage of GNI	2002	12.7%
ODA as percentage of imports	2002	16.7%
Reported external assistance flows	1996-2001	\$2,672m
...compared to total Treasury-executed expenditures	1996-2001	\$2,122m
Percentage of total public spending accounted for by ODA in:	Year 2001	%
Health	2001	65.9%
Agriculture	2001	67.4%
Transport	2001	68.1%
Area / rural development	2001	88.8%

Sources: World Bank 2003 pp. 19-22; World Bank 2004.

10. The relationship between state capacity, governance and aid under these conditions is complex and recursive. Donors have tended to rely heavily on project implementation units (PIUs), either because they believe that weak state institutions and endemic corruption require that they manage their assistance under very close

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supervision, or simply because those are what donor country law or donor agency regulations demand. Through the use of donor systems, donors have thus attempted (not always successfully) to insulate project activities from Government failings, with reliance on PIUs and TA predicated as both a necessity for aid effectiveness in the face of weak capacity, and a way of building that capacity. These PIUs have indeed often achieved effectiveness in discrete project-defined goals, in large part by offering higher salaries to recruit, retain and motivate the best staff. Increasingly, however, it is recognized that there are severe limitations to what can be achieved through such a model of aid delivery (Box 6.2). Indeed, in practice such an approach often undermines the foundations for accountable and effective use of available resources (domestic and ODA) and the capability of Government to perform key functions.

Box 6.2: Capacity and governance: the limitations of projects

In its extreme form, the proliferation of PIUs has resulted in "islands of excellence in a sea of Government failure": that is to say, short-term improvements in specific outcomes are achieved with little, if any, impact on the systemic problems plaguing the mainstream of public administration and public financial management. At worst, the proliferation of stand-alone donor-administered projects actively undermines state effectiveness: the development of Government vision, strategy and systems is blocked or reversed as a Ministry comes to spend all its time seeking project funds, resulting in a set of uncoordinated (and often contradictory) objectives; the best staff are sucked out of core Ministry functions into PIUs; and achievements are ultimately unsustainable, being highly likely to collapse when donor support is withdrawn.

11. A particular concern of the Royal Government has been the excessive reliance of donors upon technical assistance (TA), the vast majority of which is expatriate in origin. The numbers of foreign TA advisors (estimated at c. 800) and the size of spending on TA (c. \$162m in 2001 - around 21% of combined domestic and externally-financed expenditures, or more than the Government's total wage bill) are extremely high. There is no doubt that there is an important role for TA, which, if managed correctly, can indeed contribute to long-term capacity development. Equally however, relying upon advisors to manage projects or reform processes can undermine national ownership and prevent the development of institutional capacity, especially when these advisors are weakly integrated into the mainstream of Ministry processes (Godfrey et al 2003; Mysliwiec 2004).

12. At a more macro level, Government leadership on the aid reform agenda depends critically upon the existence of a clear and comprehensive national development strategy. Without such an over-arching medium-term strategy, there can be only limited progress in aligning donor support to Government priorities. Such a strategy has not yet been fully developed in Cambodia. This is not surprising given the limited institutional capacity. In an effort to create such a strategy, there have been a number of alternative donor-funded efforts, in parallel or close succession, which have given rise to the Second Socio-Economic Development Plan (SEDPII), supported by the

ADB, and the National Poverty Reduction Strategy (NPRS), supported by the World Bank as Cambodia's PRSP. Although sharing much in common, they differ in some important respects, particularly with regard to the frameworks for monitoring and evaluating policy implementation and outcomes over the medium term. The situation with regard to progress monitoring was further complicated by the production (with UNDP support) in 2003 of the Cambodian MDG Report, which introduced a third, only partially compatible official set of baseline and target indicators.

B. Efforts to Reform Aid in 2004

13. As of late 2004, there are important grounds for optimism regarding donor-donor relations. A number of positive developments, many occurring over the last twelve months, have significantly improved the prospects for moving towards a more productive use of aid resources. All of these can be seen as responding both to a general global agenda for improved, government-led aid modalities at the country level (articulated most clearly in the OECD-DAC *Guidelines on Harmonizing Donor Practices*), and to a specific RGC critique of uncoordinated aid delivery to Cambodia (expressed in a number of Government studies and statements since the late 1990s²). Cambodia has over the last few years started to connect to the global debate, and is now a signatory to the Rome Declaration on Harmonization.³

14. Moves towards more coherent ODA first began in earnest at the sectoral level. Today, the aid reform agenda is most advanced in respect to education and health, where multi-donor partnerships have evolved gradually in support to developing sectoral strategies (a Sector-Wide Approach – SWAp – in education and Sector-Wide Management – SWIM – in health) which align ODA behind a Ministerial strategy and reduce transaction costs for Government.⁴ Multi-donor partnerships have also streamlined donor-Government relations and helped to reduce gaps and overlaps in regard to decentralization and local governance (Seila and the Partnership for Local Government) and, more recently, in PFM (with agreement on multi-donor support to a three-stage process of reform, including salary reform, in the Ministry of Economy and Finance).

15. In an effort to impose a basic common structure on sub-national alignment/harmonization initiatives and bring arrangements in less advanced sectors up to the standards seen in health and education, the Government has mandated that existing Government-donor coordination bodies at the sectoral and thematic level should be restructured along more standardized lines as Technical Working Groups (TWGs). At the pre-CG Meeting held on September 10, 2004, Prime Minister Hun Sen announced the launch of 17 new Technical Working Groups (TWGs) and laid out some basic principles for reforming the old working group structure:

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16. **First**, the Government and its development partners recognized the necessity to review and restructure these working groups into joint technical working groups as a mechanism at the sectoral/thematic level;

17. **Second**, to strengthen the ownership and leadership of the Government, the joint TWGs will be headed by a responsible ministry or agency with the participation by members from other ministries and development partners. Coordination on the donor side will be facilitated by a lead donor coordinator;

18. **Third**, each TWG must have a generic terms of reference (TOR) which clearly defines its roles and responsibilities.

19. While much can be achieved through sectoral-level initiatives, there is a need also for an overall, nation-level framework for aid management. Over the last year, both Government and donors have confirmed at the highest levels that the situation of multiple national strategies will be resolved with the production of the next five-year strategy for 2006-2010. This constitutes an extremely positive development. The new strategy will be produced by the end of 2005 and will unify the approaches previously developed in the SEDPII, NPRS and CMDGR. The Prime Minister has clearly, and repeatedly, signaled that it is the intention of the Government to consolidate around one national strategy. For their part, all three of the donors previously associated with the separate strategy documents of the past (i.e. the ADB, World Bank and UN) have stated publicly that they are committed to a unified approach. The new five-year plan will lay-out the concrete policies and investments that will be needed to realize the vision for Cambodia that is presented in the Rectangular Strategy.

20. There have also been positive trends towards better communication and greater cohesion of strategic vision amongst the donor community. This has been seen in a number of encouraging specific moves towards donor harmonization. These initiatives include joint analytical work⁵; the common country strategy development process involving ADB, the UK Department for International Development (DFID), the World Bank and now the UN; and the integration of UN agency analytical and planning cycles around a streamlined CCA-UNDAF process (which is, furthermore, directly aligned to the NPRS). The joint analysis in the World Bank-ADB Integrated Fiduciary Assessment and Public Expenditure Review (IFAPER) has provided the basis for an evolving partnership approach to public financial management (PFM) reform, with ten bilateral and multilateral donors aligning their financial and technical assistance in support to a staged series of reforms, designed to bring RGC PFM practices up to international standards by 2015 (see Chapter 3). At the level of systems and procedures harmonization, the Government, World Bank and ADB have collaborated on the preparation of a Manual of Standard Operating Procedures and a joint project financial management system and manual.⁶

Table 6.2 Summary of the RGC Action Plan for Harmonization and Alignment, 2004-2008

Section A: Ownership and Leadership

- 1. RGC leads the process and prepares a single Strategic National Development Framework for the next planning cycle (2006-2010)**
 - a) RGC prepares and adopts a single National Strategic Development Plan (2006-2010)
 - b) RGC uses a single national development framework for planning linked to resource allocation, including ODA.
- 2. RGC assumes leadership role in the coordination of development assistance**
 - a) Cambodia's Action Plan for Harmonization and Alignment—2004-2008, clearly stating RGC's priorities on harmonization and alignment, is prepared and agreed with development partners
 - b) RGC has one ODA coordinating body
 - c) RGC's ODA Management Policy prepared and agreed with donors
 - d) Joint planning and monitoring of the implementation of RGC's development priorities, involving donors and stakeholders, as outlined in its strategic development framework(s) and its Rectangular Strategy.
 - e) RGC has the information it needs to lead and coordinate development assistance
- 3. As one of the fourteen pilot countries, Cambodia plays an active role in the implementation of the Rome Declaration on Harmonization and Alignment (2003).**
 - a) RGC provides regular progress reports on implementation of Cambodia's Action Plan on Harmonization and Alignment

Section B: Capacity Development

- 1. RGC's capacity strengthened to effectively perform development coordination and management functions**
 - a) The capacity of CDC, coordinating agencies and sector ministries strengthened to effectively perform development coordination and management functions.
 - b) Agreement on principle and practices of donor support for allowances and salary supplements to Government employees

Section C: Alignment

- 1. RGC and donors adopt the consolidated Strategic Development Plan of the RGC as the common framework for planning ODA.**
 - a) Donor activities are aligned with government strategy and policy, and are consistent with a framework for private sector and civil society participation
- 2. Donor practices are harmonized around the generic elements of the program/project cycle**
 - a) Government introduces national operational guidelines for development cooperation activities covering all component of the program/project cycle
 - b) Development assistance is increasingly delivered in accordance with RGC's, civil soc, PS, priorities
- 3. Donors increasingly use Government's systems, procedures and practices, where appropriate**
 - a) Development partners seek to reduce the proportion of ODA that bypasses the National Budget and RGC commits to integrate ODA into budget
 - b) Medium Term Expenditure Framework (MTEF) is strengthened and expanded
 - c) Allocation and utilization of ODA resources are transparent and accountable

21. All of these mutually supportive processes have now been brought together over the last six months. Australia, Japan, the UN system, ADB and the World Bank have supported the CDC in managing a series of national and regional Government-donor workshops to assess the current state of play on harmonization (using the OECD-DAC questionnaire as a basis for assessment) and prepare documents defining roles and responsibilities in Government-donor partnerships. The last of these meetings - held at the CDC on the 26th and 27th October – resulted in the production of the RGC Action

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Plan for Harmonization and Alignment (summarized in Table 6.2) (RGC 2004). This document will be formally approved before the CG meeting takes place in early December 2004— one of the many signs over the course of the year that the harmonization and alignment agenda is clearly supported by Cambodia's political leadership.⁷

C. Moving Towards Mutual Accountability: The Development Cooperation Agenda in 2005

Sustained commitment to a poverty-focused, medium-term RGC strategy

22. It is critically important that the Government's commitment to a single, poverty-focused five-year development plan (2006-2010) be followed-through in practice. As described above, the "one strategy" approach has been endorsed at the highest levels by both the Government and donors. At the operational level however the legacy of parallel donor-specific programs of support to national strategy development is such that within the Ministry of Planning there remains a division of labor that allocates separate and divided responsibilities for SEDP, NPRS and CMDG projects. The senior political leadership and the donor community need to work with MoP to untangle this situation and establish the institutional groundwork required to promote Government ownership of, and jointly manage multi-donor inputs to, a unified, poverty-focused national strategy. There is an emerging consensus that what is required is some form of "SWAp for planning" – although the form this will take has yet to be defined.⁸ In starting to sketch out how budgets (investment and recurrent) should be driven by plans – and actual public expenditure management should in turn be driven by the budget – it will be critical to delineate the roles and relationships between the line Ministries, Ministry of Planning, and Ministry of Economy and Finance, and the functional links between plans and the progressive re-orientation of investment flows towards rural and pro-poor activities (notably through the Public Investment Program).

Government leadership on use of TA and tied aid

23. Goods and services procured using ODA should be based on strictly developmental criteria, with emphasis added on securing the best possible value for money. Donors are increasingly withdrawing from tied aid: the government and the donor community collectively need to sustain the pressure for this (RGC, 2004).

24. More broadly, donors need to work with Government to develop a set of basic principles guiding common approaches to capacity-building and the use of TA. There needs to be a commitment, enforced by peer pressure and Government counterparts, that the primary purpose of TA is long-term skills transfer (rather than skills gap-filling). The emphasis needs to be upon the development of institutional, rather than merely individual, capacities. In the short term, donors need to agree terms of reference for

technical assistance jointly with Government and in consultation with other donors in the sector; adopt institutional development approaches which take more account of Cambodian perceptions and preferences rather than de-contextualized international "best practice"; and develop a strategy to urgently address the current excessive level of reliance on expatriate advisors. Such a strategy would over the medium to long term evolve into a time-bound program to reduce and eventually phase out all expatriate advisors and replace them with qualified Cambodians. This needs to be accompanied by coherent approach to phasing out the *ad hoc* salary supplements and benefits that donors currently use to subsidize civil servants working on donor funded programs. The savings from this and from the reduced dependence on external advisors can be reinvested into a system of transparent payments to priority groups of civil servants who are seen as critical for ensuring improved public service delivery for the poor. Such a program will need to be developed ministry by ministry and be linked to the implementation of an overall reform program for the concerned ministry (including improved management of the performance of those better paid civil servants). Support of this nature will need to be assured until such time (10-15 years in the future) as Cambodia's own revenue effort is able to sustain an adequate living wage for the entire civil service – and subject, of course, to a continued long-term commitment on the part of the Royal Government to implement such institutional reforms.

Donor Flexibility to Respond to Cambodia's Changing and Urgent Needs

25. In Chapter 1 it is noted that growth is likely to fall significantly in 2004-2005 and not likely to recover to the NPRS target of 6-6.5% until 2009. During this transition period it is imperative that donors help to cushion the initial decline in growth rates and then, as soon and as much as possible, to restore faster growth. During 1999-2003, aid inflows averaging 12% of GDP helped finance domestic investment and fuel construction activities (IMF, 2004). About half of the inflows were grants in the form of donor-financed projects and technical assistance, all of which were outside the budget. Aid inflows were used to improve health and education (24%), rebuild physical infrastructure (23%), and strengthen economic and social institutions (15%). Agriculture and forestry received only 8% of aid flows.

26. It is now time to review the current allocation of foreign aid flows, focusing more attention on maintaining and increasing growth rates and on ensuring that growth is strongly linked to poverty reduction. In the past, weak administrative capacity may have justified channeling a large proportion of total ODA through technical cooperation (which accounted for 50% of all aid flows during the period 1999-2003). However, there is now a good case for reallocating ODA in order to more directly address poverty and boost long-term growth. The critical need to raise rural incomes argues for a better understanding of the constraints to rural growth and development, in particular in the agricultural sector where growth rates have been low and the potential has been unutilized. An agricultural strategy that identifies the constraints to agricultural growth

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and builds consensus on the necessary policies and investments that are needed to promote agricultural growth—is urgently needed as the first step.

Strengthening the Technical Working Groups

27. The sectoral level has been, and will remain, a critical level at which to improve Government-donor dialogue and aid effectiveness. The restructured TWGs thus assume a critical significance. To make them work, however, will require concerted attention on a range of issues:

- *Ensuring the right level of participation, from both Government and donors.* Making the TWGs work as a mechanism for sustained on-going dialogue requires that the participants in TWGs should be senior technical level staff, rather than political (Minister or Ambassador / Head of Mission) level, although there are some very rare exceptions. Donors and NGOs should attempt to send one delegate each to meetings; and there should be a preference for making sure that, as far as possible, the same individual attends each time. This is easier said than done, given the small size of donor offices and the limited resources available to both Government and NGOs for such work. This suggests that there may be a tradeoff between the effectiveness of groups and the large number that currently exist.
- *Membership that creates space for non-state national actors,* increasing the exposure of Civil Society Organization (CSOs) and private sector associations to Government and donor policy debates and processes. Selecting legitimate representatives from the large and often diverse panoply of non-state actors requires considerable thought and time.
- *Clear and relatively standardized ToR and partnership principles* to structure the work of the TWGs. The PFM TWG has developed excellent partnership principles, which could well serve as a model for other TWGs. These founding agreements, and discipline on the part of all members, should ensure that the focus of the Groups remains on the identification of sectoral problems and ways to improve sector policy, planning, budgeting and M&E – and does not get stuck on mere information-sharing and descriptions of individual projects.
- *Creating and sustaining a sense of purpose for the TWGs.* One way to do this would be to give them formal responsibility for elements in the annual Government-donor planning and budgeting cycle: for example, by requiring each TWG to compile an annual review of sector progress as an input to a MoP-led performance review and/or Government CG report.

28. The TWGs are the logical focus of many, if not most, of the other reforms described in this section. That is to say, these measures - joint evaluations, principles for harmonizing and aligning TA and capacity-building approaches, monitoring of both Government and donor performance indicators, and multi-donor or lead/silent partner partnerships - are all likely to take root first at the sectoral level, through the forum of the relevant TWG. If the TWGs are to fulfill this potential, it is essential that the Government believes in their importance and feels a sense of ownership of the Groups.

This will require efforts both from the Government (which will need to assert positive leadership of sectoral policy debates through the TWGs) and the donors (who must learn to exercise discipline, and to allow the space for Government leadership to develop).

Reduced transaction costs through stronger donor-donor partnerships

29. There are a number of significant reforms that individual donors can make in order to improve the effectiveness of their own aid program, without needing to wait for a high-level Government lead or a critical mass of donors to agree on a sector-wide approach. Donors who establish a shared understanding and basis of trust between themselves should increasingly aim to enter into lead donor/silent donor partnerships. For instance, donor A delegates to donor B the responsibility for managing donor A's support to a given sector or project, providing the funds and asking only for some basic regular reporting and joint review of activities and outcomes, along previously agreed lines. Such arrangements have the potential to reduce transaction costs for both Government and the donors involved, and significantly reduce the cacophony of donor voices to which the Government must listen.

D. Monitoring Donor Effectiveness and Behavior

Monitoring and Evaluating Aid More Effectively and in Ways that Build Capacity

30. With a few exceptions, donors generally do not spend enough time or resources on critical evaluations of the aid they give to Cambodia (Birdsall, 2004). There is a need to ensure that evaluations, once produced, are made public and actively disseminated to Government, civil society and other development partners (particularly those operating in the same sector or geographical area). Most importantly, the recommendations of the evaluations must result in concrete actions on the part of the donors.

31. In the first instance, it is important that evaluations are understood to be a requirement for development agencies (who need to demonstrate to their taxpayers or boards of governors that ODA resources are being used in a proper and effective manner). However, they should also be embraced as a vehicle for inculcating principles of accountability (upwards to political leaders and downwards to citizens) and evidence-based decision-making into the mainstream of national policy, planning and budgeting systems. Wherever possible, donors/lenders should seek to formulate their evaluations as joint (Government-partner) exercises, which should increase the opportunities for Government counterparts to learn evaluation principles and skills, and deepen the level of national ownership of the evaluation findings and recommendations.

32. Such evaluations, however, constitute a further demand upon the limited time and resources of Government counterparts. This is *particularly* true if there is no

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commensurate reduction in the number of evaluations – which would be the case if each donor continues to require its evaluations are carried out on a bilateral, project-focused basis. A number of actions can be taken to help reconcile the need for critical evaluations with the need to reduce transaction costs to Government. Less numerous but more meaningful evaluations would be one further benefit of a move towards concentrating ODA resources into fewer, larger and longer projects, and more multi-donor projects.

33. Donors also need to make more use of Cambodian universities, research institutes and consultancies to carry out monitoring and evaluation of aid. They could commission Cambodian researchers to conduct independent evaluations of ODA-supported projects, programs and modalities. This would serve to strengthen and embed the capacity of groups outside Government to hold Government, and donors, accountable for the management of aid.⁹

Monitoring Donor Behavior and Progress on Harmonization and Alignment

34. The donor community makes legitimate demands of the Government in order to establish that the aid resources they give are used in a transparent and accountable manner for the good of Cambodian citizens. They have also established benchmarks to monitor progress in these aspects between CG meetings. By the same token, the Government has a right to ask donors to account for their aid management practices. This could begin with transparent reporting and annual reviews of information relating to ODA management, against an expanded and more detailed set of performance indicators based on the information reported to the CDC. Box 6.3 provides a preliminary list of what indicators might be included in any benchmarking and peer reviewing of donor performance.

35. In reporting on donor performance as in all other aspects of donor activity, there is a pressing need for more donor material to be translated more promptly into Khmer, and more actively disseminated to the general public, civil society organizations and NGOs, and the private sector. Donor partnerships – ideally sector-wide through TWGs, but in the absence of this through multi-donor partnership clusters – provide a logical way to absorb the increased translation and public information costs required for a more transparent and accountable approach to the design, implementation and supervision of aid-financed activities.

Box 6.3: Indicators for benchmarking donor behavior: a preliminary list

Indicators of alignment

- % of country program on-budget
- % of country program spent as TA
- Government involved in drafting ToR for TA
- use of Government FM systems
- country program supports national development strategy
- % of country program provided within SWAs

Indicators of consolidation/concentration

- average project size/ratio of projects to total ODA
- ratio of number of projects: number of sectors in which a donor works
- ratio of total country program budget: number of sectors in which a donor works

Indicators of harmonization and reduced transaction costs

- number of missions p.a.
- % of missions that are joint
- % of analyses and evaluations that are joint
- average length of projects (years)
- participation in multi-donor projects (as % of projects in country program)
- use of tied aid (Y/N)

Indicators of transparency and predictability

- country programs made public
- commitment: disbursement ratio
- provision of multi-year envelope forecasts (indicative/firm)
- inter-annual volatility/variability

E. Donors and Governance

36. If donors are to support the Government's commitment to good governance, they need to devote significant attention and resources to supporting reform of certain core aspects of governance. These include strengthening Government's fiduciary capacity (including aligning donor procedures around an improved, Government-owned set of fiduciary controls and processes); raising, and where necessary decompressing, salaries; introducing human resource systems which assign positions on the basis of qualifications and rewards on the basis of performance; instituting effective monitoring and evaluation systems so that policies and plans are formulated with reference to analysis and evidence; and finally, linking policies and plans to annual and medium-term expenditure management processes which enable resources to be assigned on the basis of objectives rather than incremental budgeting.

37. Donors could also do much more to help strengthen the "demand side" of governance reform by engaging civil society and the private sector more systematically and substantively in the design, implementation and monitoring of development assistance. This can be used to incrementally expand the space for these groups to participate in Government policy processes. Experience in other countries in which donors have been criticized for past inaction on corruption and poor governance suggests some basic internal changes that donors can undertake – greater information disclosure, strengthened controls and supervision, engagement of communities and civil society organizations in project design and supervision as the norm, and better enforcement when abuses are discovered. These measures can significantly reduce the opportunities for misuse of ODA and, in doing so, contribute to clarifying the distinction between public and private resources.

F. How Cambodia's Development Partners Could Support Better Governance

38. A dilemma for international development partners is whether to prioritize need (e.g. poverty headcount) or performance (proven ability of governments to use aid effectively to make an impact) when allocating aid to developing countries. There is an increasing body of evidence that aid effectiveness depends heavily upon the existence of a sound institutional and policy environment. When such an environment is lacking, donors are increasingly wary of committing large amounts of grants or loans.

39. Some donors, such as the World Bank and the ADB, link the overall country program resource envelope to country performance in an automatic and non-discretionary manner. The World Bank, for example, uses an annual Country Policy and Institutional Assessment (CPIA) to score each country according to a range of criteria. The sub-set of governance indicators are now heavily weighted in the overall CPIA score. In the case of Cambodia, the scores for three of the five governance indicators remained largely the same or declined between 1999 and 2003, with slight increases in only two dimensions (Figure 6.2). In terms of comparison with other IDA countries, Cambodia in 2003 did as well as other countries on macroeconomic management and almost as well on structural and social equity issues - but scored worse than the average for IDA recipients in all five governance criteria (Figure 6.3). As a result, the World Bank's overall IDA allocation for assistance to Cambodia has been reduced. The ADB uses a similar performance rating to assign country-level funds and, on the same basis, has reduced allocations through its Cambodia country window. The implication is that since governance is weighted so heavily for both the Banks, improvements in governance - as laid out in the Rectangular Strategy - could result in aid levels increasing considerably over the coming years.

Fig. 6.2: Cambodia's Country Policy and Institutional Assessment (CPIA), scores in 1999 and 2003

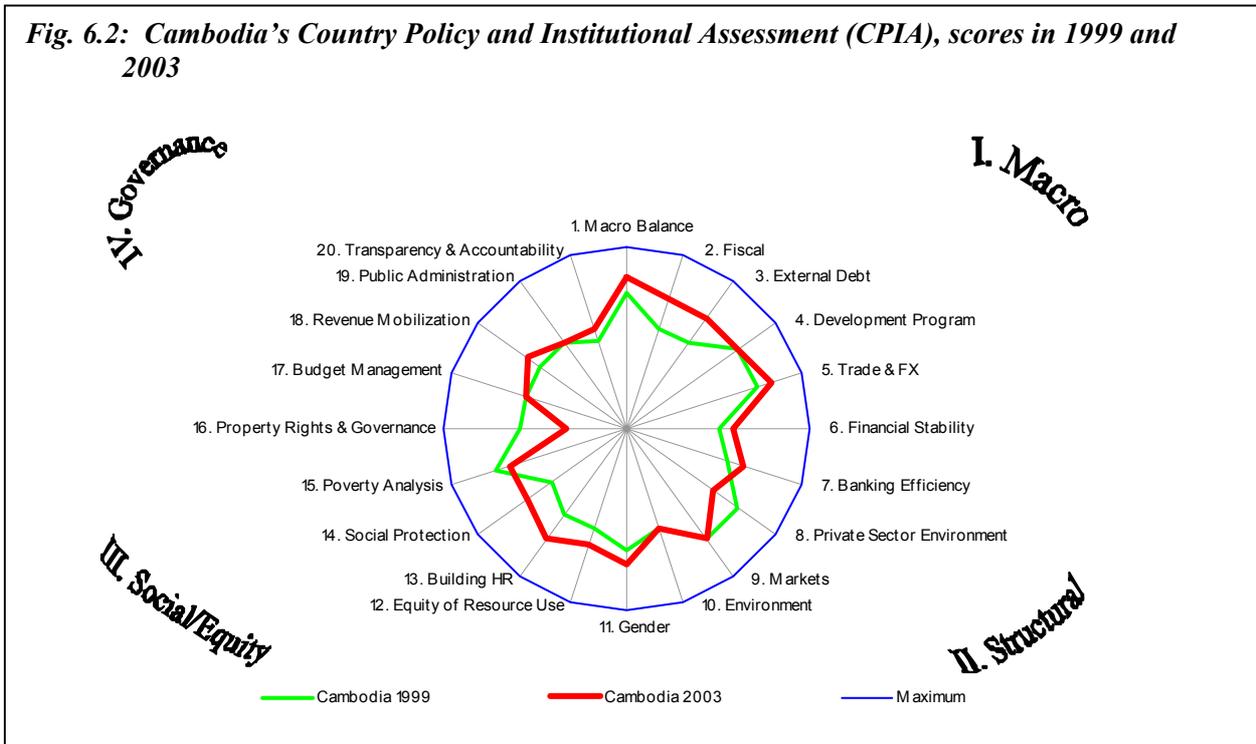
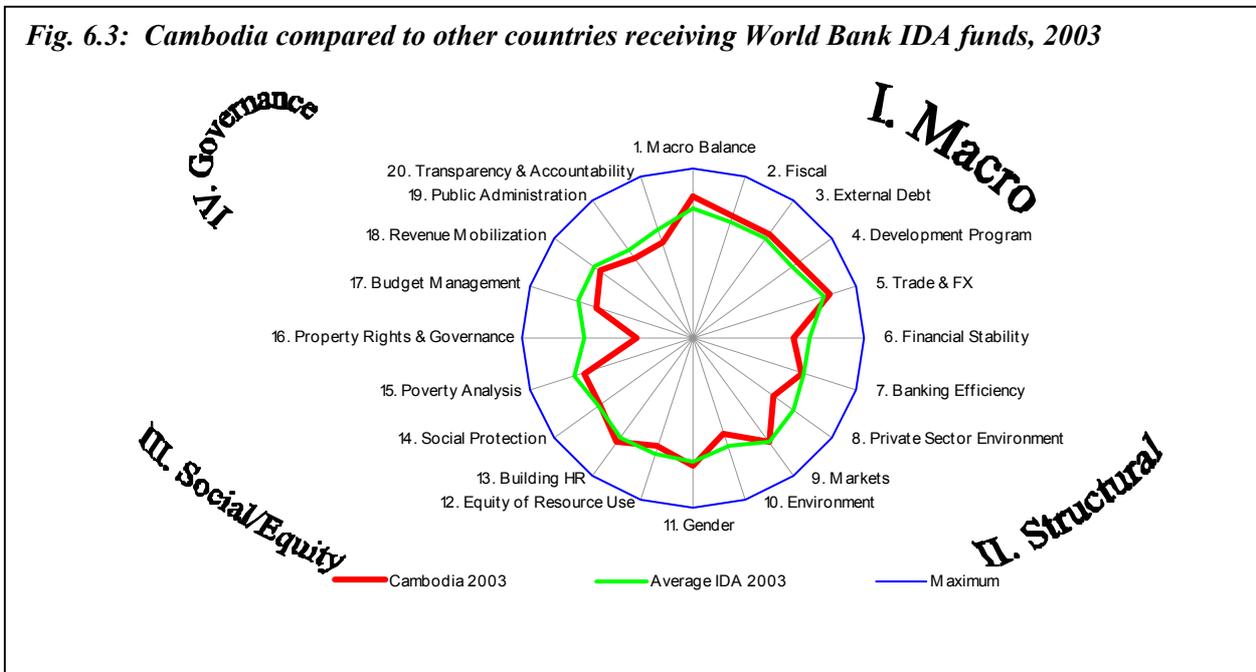


Fig. 6.3: Cambodia compared to other countries receiving World Bank IDA funds, 2003



End Notes

¹ The eighth MDG commits nations to "develop a global partnership for development": UN 2000.

² see for example the Annual Progress Report (APR) on NPRS implementation, which argues for combining funds currently allocated to project-based salary supplements in a pool for budget support for wage reform.

³ Cambodia has participated in the OECD-DAC Task Force on Donor Practices and was selected as one of the pilot countries for OECD/DAC work on harmonization.

⁴ for accounts of the sector approaches in education and health see CDC 2004 Chapters 6 and 7; H.E. Chhieng Yanara 2004b.

⁵ e.g. the *Integrated Fiduciary Assessment and Public Expenditure Review (IFAPER)* (World Bank and ADB 2004) and the *Cambodia gender assessment* (UNIFEM, World Bank, ADB, UNDP, DFID and MoWVA 2004).

⁶ H.E. Chhieng Yanara 2004a.

⁷ Note for example that the Prime Minister used the pre-CG meeting between Government and donors in early October to endorse the process and issue instructions to guide its completion.

⁸ One specific aspect to this donor-exacerbated weakness in planning and policy-making is the plurality, and limitations, of national frameworks for monitoring and evaluating change. Although there have been a number of attempts at establishing an overall system for collecting, processing, analyzing and making use of socio-economic data, the current situation is unhelpfully confused, with a lack of clarity about the respective roles for the Poverty Monitoring and Analysis Technical Unit (PMATU), CamInfo, sectoral M&E systems, and the indicator frameworks of the SEDP II, NPRS and CDMGR.

⁹ If there are doubts about the capacity of the Cambodian research and consultancy community to handle the technical complexity or (a more valid concern) the volume of evaluation work required, the facility could be designed to incorporate long-term call-down contracts with policy research institutes or suitable consultancy organizations elsewhere in the region or the world, providing opportunities for long-term skills transfer and institutional capacity-building.

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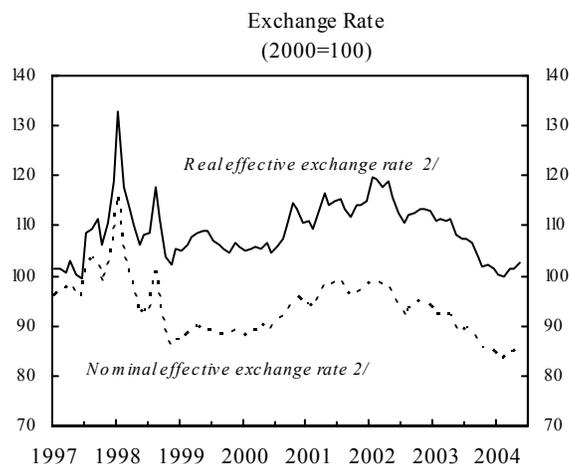
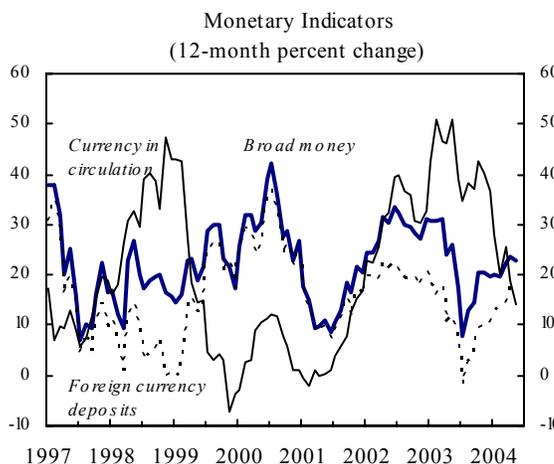
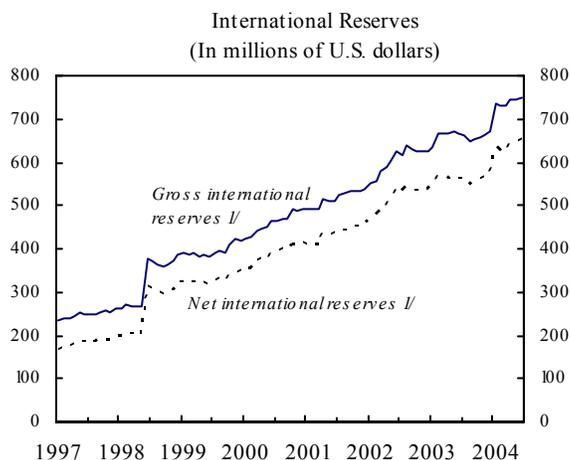
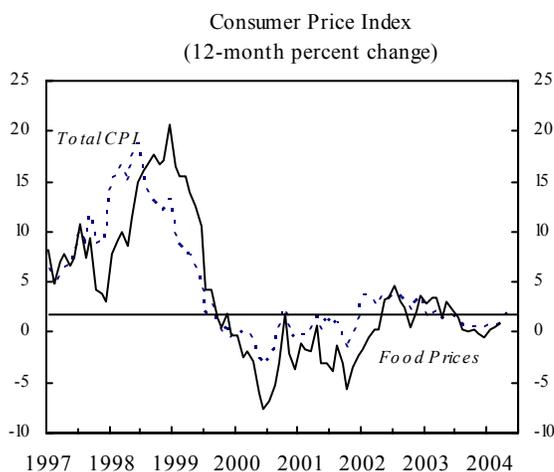
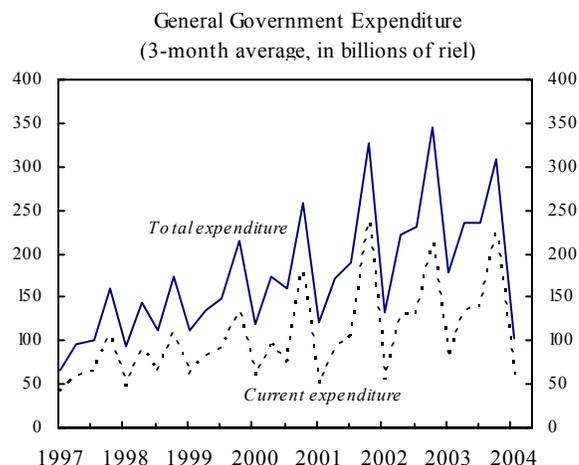
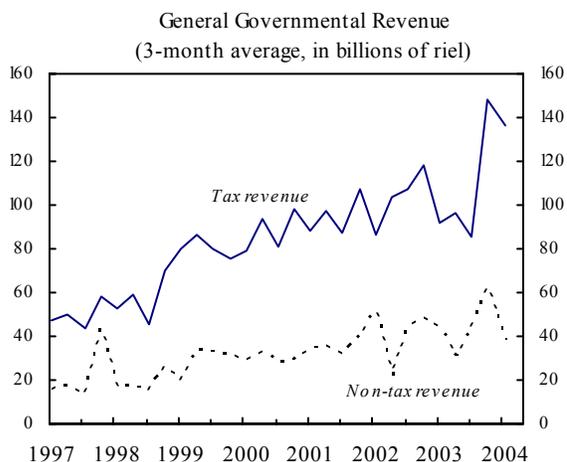
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Chart A.1.1: Selected Economic Indicators, January 1997- June 2004

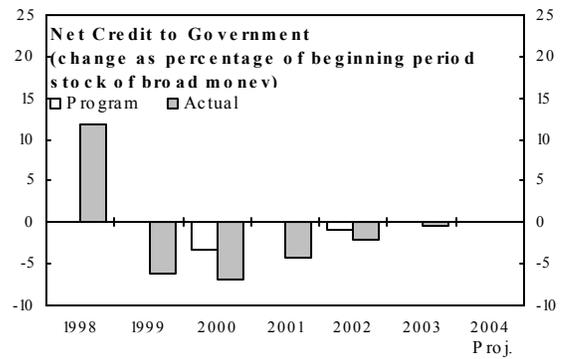
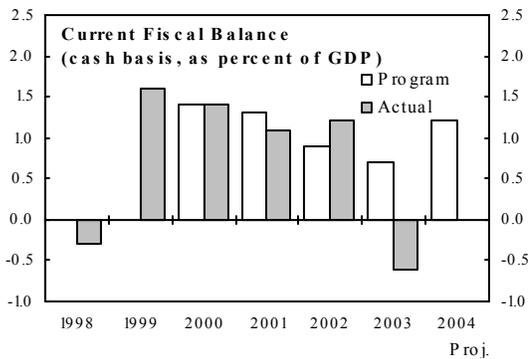
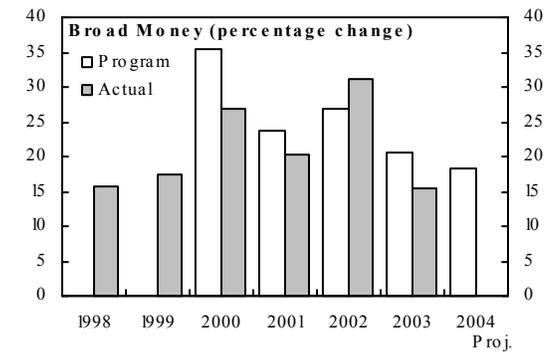
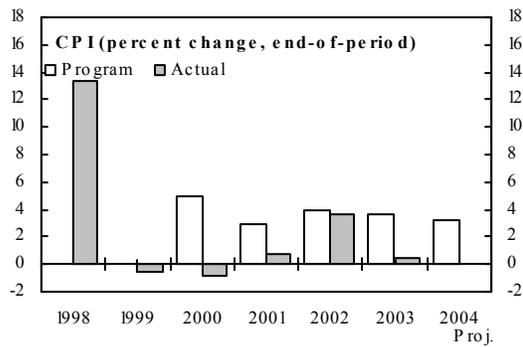
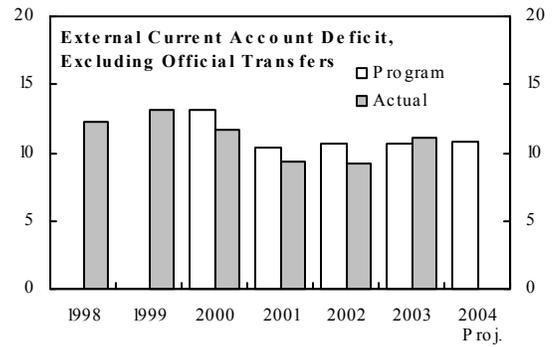
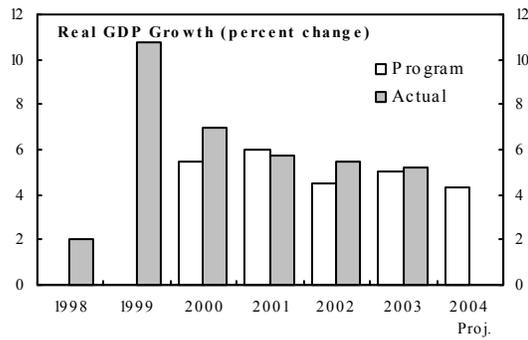


Source: Data provided by the Cambodia authorities

1/ Includes US\$117 million associated with the return in 1998 of Cambodian gold previously held by the BIS.

2/ Based on the official exchange rate; an upward movement indicates an appreciation of the exchange rate.

Chart A.1.2: Performance Indicators, 1998-2004



Source: Data provided by the Cambodian authorities, and IMF Fund staff estimates.

Table A.14a: Medium Term Budget Framework for Priority Sectors
(As % of Current Expenditures)

	2002*		2003*		2004		2005		2006		2007	
	% Str.	% GDP										
Current expenditure	100	10.1	100	10.5	100	10.6	100	11.5	100	11.9	100	12.3
o.w. Wage	37.25	3.74	34.96	3.67	35.14	3.61	40.00		40.00		40.00	
Health	10.44	1.05	9.84	1.03	12.05	1.28	11.29	1.30	11.76	1.40	11.75	1.45
Education	18.39	1.85	17.09	1.79	18.77	1.99	17.58	2.02	17.71	2.11	17.62	2.17
Defense and security	25.83	2.60	23.38	2.45	22.87	2.42	20.41	2.35	19.33	2.30	18.66	2.30
Agricultural sector	4.44	0.45	3.97	0.42	4.61	0.49	4.85	0.56	5.32	0.63	5.50	0.68
a. Agriculture	2.52	0.25	2.22	0.23	2.52	0.27	2.65	0.30	2.76	0.33	2.79	0.34
b. Rural development	1.17	0.12	0.96	0.10	1.24	0.13	1.32	0.15	1.38	0.16	1.39	0.17
c. Water Resources	0.75	0.08	0.79	0.08	0.85	0.09	0.88	0.10	1.18	0.14	1.32	0.16
Public Works and Transport	0.82	0.08	0.80	0.08	0.81	0.09	0.84	0.10	1.06	0.13	1.18	0.15
Women's Affairs	4.10	0.41	4.08	0.43	3.84	0.41	3.63	0.42	4.02	0.48	4.05	0.50
Justice	0.46	0.05	0.63	0.07	0.67	0.07	0.84	0.10	0.82	0.10	0.83	0.10
Memo												
Current expenditure, in billion riels	1,574.91		1,758.11		1,888.39		2,148.55		2,376.43		2,666.52	
Estimate for debt service					50		200		220		280	
Estimate for clearance of domestic arrears					45		120		120		120	
Current discretionary expenditures	1,575		1,758		1,793		1,829		2,036		2,267	
Health in percentage of discretionary expenditure	10.44		9.84		12.69		13.27		13.72		13.82	
Education in percentage of discretionary expenditure	18.39		17.09		19.76		20.66		20.67		20.73	
Nominal GDP, in billion riels	15,667		16,748		17,815		18,683		19,970		21,679	
Nominal GDP, in million US\$	3,996		4,208		4,507		4,730		5,011		5,387	
Exchange Rate Riels/US\$	3,921		3,980		3,953		3,950		3,985		4,024	

*Outturn

Current discretionary expenditures equal current expenditure minus spending on debt service and domestic arrears

Source: PRSP-Annual Progress Report, Royal Government of Cambodia (May 18, 2004)

Table A.14b: Budget Execution 2000–2003
(in Millions of Riel)

Million Riels	2000	2001	2002	2003		
	Outturn	Outturn	Outturn	Budget Law	Outturn	% of Budget Law
Total Current Expenditures ('000)	1,215	1,385	1,574	1,765	1,758	99.6
I. General	283,438	268,958	298,154	285,695	410,752	143.8
Royal Palace	19,775	19,006	23,456	22,740	23,065	101.4
National Assembly	20,650	31,657	33,160	35,190	34,190	97.2
Senate	10,140	13,999	16,600	18,050	17,871	99.0
Constitutional Council	2,165	2,781	3,023	3,300	3,453	104.6
Council of Minister	75,275	92,175	73,290	56,750	84,644	149.2
Civil Service Secretariat	613	699	1,105	1,250	1,234	98.7
CDC	2,030	2,408	2,961	3,980	2,770	69.6
Interior-Administration	8,574	10,956	31,511	16,400	29,046	177.1
Relations Assembly and Inspections	939	1,027	1,663	2,660	2,333	87.7
Foreign Affairs and Int'l Cooperation	36,199	41,266	52,244	52,000	54,082	104.0
Economy and Finance	95,558	19,331	36,762	50,530	111,281	220.2
Planning	3,247	3,632	4,900	5,375	5,240	97.5
Justice	5,784	6,298	7,195	9,650	11,099	115.0
Nat'l Election Committee	2,490	23,722	7,434	3,235	26,781	827.9
National Audit Authority	n.a	n.a	2,850	4,585	3,662	79.9
II. Defense and Security	450,724	417,323	406,753	413,500	411,014	99.4
National Defense	308,560	277,026	264,615	268,300	269,515	100.5
Interior - Security	142,165	140,297	142,139	145,200	141,498	97.5
III. Social	368,810	449,417	583,034	664,150	615,901	92.7
Information	8,943	8,296	8,795	12,615	12,084	95.8
Public Health	101,808	129,749	164,391	202,000	172,966	85.6
Education, Youth and Sport	165,816	209,246	289,669	323,000	300,458	93.0
Culture and Fine Arts	7,092	8,136	12,065	14,640	13,839	94.5
Environment	3,859	4,535	7,131	8,675	7,739	89.2
Social Affairs, Labor and Vocational Training	26,452	28,156	33,301	33,630	33,388	99.3
Public Worship and Religion	1,860	2,312	3,066	3,615	3,705	102.5
Woman Affairs and Veteran	52,980	59,040	64,617	65,975	71,721	108.7
IV. Economic	112,505	150,706	159,472	190,155	170,513	89.7
Civil Aviation Secretariat	3,826	5,580	5,073	7,300	6,514	89.2
Industry, Mines and Energy	5,487	5,972	6,983	8,155	7,009	85.9
Commerce	6,239	11,775	12,652	18,000	16,186	89.9
Agriculture, Forestry and Fishery	23,415	30,468	39,652	43,340	39,024	90.0
Rural Development	7,550	12,442	18,395	21,000	16,901	80.5
Posts and Telecommunications	28,766	40,960	36,108	42,750	34,710	81.2
Public Works and Transport	20,317	21,271	12,944	15,030	14,030	93.3
Tourism	6,396	8,687	9,670	12,140	15,462	127.4
Urbanization and Construction	4,311	4,786	6,134	8,005	6,833	85.4
Water Resources and Meteorology	6,199	8,764	11,861	14,435	13,844	95.9

Source: PRSP-Annual Progress Report, Royal Government of Cambodia (May 18, 2004)