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More Efficient Public Expenditure for Strong and Inclusive Growth

Significance

Cambodia has achieved impressive economic growth, with an average annual GDP growth rate of 8.1 percent over the period 2000-10, and a dramatic reduction in poverty from 53.0 percent in 2004 to 20.5 percent in 2011. Notwithstanding these achievements, further progress is needed to raise living standards of those living just above the national poverty line, and help the more than 2 million people who are still poor. The critical challenge ahead for Cambodia is to ensure sustained high growth without social exclusion. Sustained strong inclusive growth will require both public investment in physical infrastructure and human capital (including health and education), and assuring equal access to quality public services. The need for increased investment, coupled with the expected decline in Overseas Development Aid (ODA), will mean greater dependence on domestic revenues. This will require improved standards in the ways in which the Royal Government of Cambodia manages its public finances. Increasing fiscal space by reducing tax exemptions and improving collection should provide larger allocations. This is one side of improved public financial management (PFM). In addition, on the expenditure side, this should be accompanied by more efficient and effective spending, together with more transparent rule-based governance. Improving both aspects of PFM will promote strong, inclusive growth and better quality services for citizens.

Background

In 2011, the World Bank, in cooperation with the Government and development partners, conducted an Integrated Fiduciary Assessment and Public Expenditure Review (IFAPER). The IFAPER analyzed the structure and efficiency of government spending in Cambodia, with an emphasis on agriculture, education and health. This analysis was supplemented by a review of public financial management (PFM).

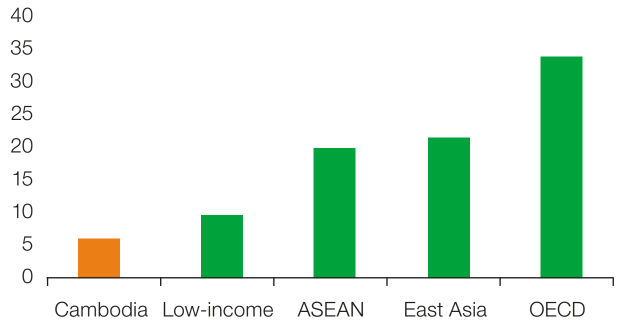
The key motivation of the IFAPER and the objective of its recommendations are to support sustained strong growth in income and employment, to help reduce poverty, and to ensure fiscal sustainability in Cambodia. This note summarizes some of the key findings of the IFAPER and sets out its main conclusions and recommendations to the RGC, taking into account developments since publication in November 2011.

Revenue

RGC's revenue has increased substantially, and is forecasted to reach 14.2 percent of GDP in 2013, up from 13.1 percent in 2010, reflecting the Government's commitment to enhanced revenue collection.

However, revenues (excluding grants) are lower in Cambodia than in other low-income countries (Figure 1), due in large part to generous tax exemptions and incentives, and widespread tax evasion. The foregone revenue incurred by the Government's tax holiday on companies' profits represents more than 2 percent of GDP. These tax exemptions, together with those from paying customs duty and excise and other tax incentives, represent a fiscal space that could be enlarged to enable more public investment that is critical to sustaining strong and inclusive growth.

Figure 1. Revenues excluding grants are lower in Cambodia than in other low-income countries
(in percent of GDP in 2008)

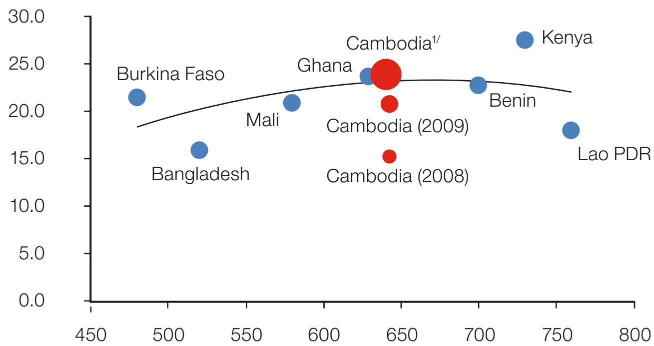


Source: World Development Indicators, the World Bank

Public Spending

Public spending in Cambodia to date has been substantial, is comparable to other countries with similar per-capita income, and has contributed significantly to positive development outcomes. There is also little difference in the composition of Cambodia's spending relative to comparable countries (Figure 2), although Cambodia is lagging behind on three of the nine MDGs.

Figure 2. General government spending is in line with that in countries with simmilar per-capita income
(in percent of GDP, 2008 and 2009)



Source: World Development Indicators
Note: [1/] Overall public spending for 2009

There is room for improvement, in terms of both allocations and efficiency in spending. Such improvements would make more funds available for priority areas without increasing the overall level of spending relative to GDP. This is illustrated in the following examples of public spending in agriculture, education, and health.

Agriculture Spending

Agriculture is a Government priority, as one of the core sources of economic growth and export earnings. Although from a low base, government spending on agriculture has risen from 1.3 percent of GDP in 2007 to 1.5 percent in 2009, mainly through significant increases in outlays on irrigation and rural roads (in this note, spending on agriculture includes outlays on agriculture, rural roads, and water resources). This period of rising public spending on agriculture overlapped with relatively high annual growth rates of agricultural output. Although insufficient time has elapsed to assess with confidence whether there is a causal relationship between the level of public spending and agricultural growth in Cambodia, available evidence suggests that public expenditures, along with improvements in the policy environment, may indeed have had a significant impact in boosting and sustaining agricultural growth. The analysis confirms that government spending has rightly focused on the provision of public goods and services, which have high rates of returns, rather than on subsidies. There is, however, good potential for further efficiency gains on resources spent.

Cambodia has no policy-induced distortions in agriculture. However, a complex set of structural constraints have hampered the effectiveness and efficiency of public expenditures. These include a lack of continuity in public funding, especially for Operation and Maintenance (O&M) costs, for extension services, and for agricultural research. Deeper institutional issues that could limit the long-term effectiveness of these expenditures also need to be addressed. Other challenges include an excessive focus on rehabilitating primary irrigation infrastructure and a neglect of secondary and tertiary systems; a neglect of maintenance of irrigation and rural roads; and the slow pace of development of new technologies for rural roads.

The Government could get better value for money by reallocating spending within the existing envelope on agriculture. In the short term, more resources for agricultural research, extension services and secondary irrigation canals, and smaller allocations for strategy and planning, are among the recommendations for the authorities to consider. Researching mitigation and adaptation measures will help prepare Cambodia for climate change. An extension of funds within the existing budget envelope, or larger allocations from donor grant resources, to secondary canals and associated infrastructure will also bring substantial benefits. Over the medium term, the authorities are invited to consider the economic viability of new technologies for rural road rehabilitation and maintenance.

Health Spending

Cambodia has achieved remarkable health gains over the past decade. Overall spending on health increased, but out-of-pocket spending outlays still predominate, placing a burden on the poor and making catastrophic care too expensive for people of most income levels.

While spending more on certain categories of healthcare could help improve health outcomes, it is crucial that any such allocations be accompanied by measures to increase the efficiency of existing spending and be funded, at least in the medium term, by savings within the sector. First, the efficiency of expenditures on healthcare could be enhanced by more efficient purchasing, particularly for pharmaceuticals, medical equipment, and supplies. Savings could exceed US$50 million a year, or one-third of government health spending—the equivalent of 0.4 percent of GDP. Second, budget allocations for central departments, hospitals, and provinces should be based on transparent formulas and clearly agreed outputs. Third, mechanisms for budgeting and expenditure tracking should be strengthened at operational district and facility levels. Fourth, the shift toward semi-autonomous service delivery arrangements for hospitals and some health districts should be accompanied by measures to limit increases in user fees and to establish appropriate financing arrangements to ensure quality and continued access by the poor and near-poor.

Education Spending

Cambodia has achieved substantial progress in improving access to primary and tertiary education. The emphasis now needs to be on improving access to early childhood education and secondary education, and raising the quality of outcomes. As in other fields, education in Cambodia remains highly dependent on development partner support. Even with extensive external aid, however, overall government spending is still only as large as spending by households, placing a large burden on segments of the population.

Government spending on education is in line with targets, but is lower relative to GDP than in countries with comparable per-capita GDP. Before considering increases in overall spending on education, the authorities are invited to consider the potential savings from the large decline in enrollment in recent years. Such savings would be reaped only if the authorities can reallocate resources from schools and districts with declining enrollment. A small part of these savings—about 0.1 percent of GDP—could be used to allocate sufficient funds to increase the availability of textbooks. Some of these savings, or additional development-partner support, could provide additional resources for student scholarships.

The framework of planning and budgeting works well in education in general. There is scope for improving the sub-program for providing school operating budgets. While devolving more responsibility, the authorities should work to ensure that governance issues are adequately addressed so that outcomes are improved. The capacity of the Ministry of Education, Youth and Sports also needs to be strengthened to process data for decisions related to policy planning and implementation. In particular, monitoring of the Educational Strategic Plan needs to provide an opportunity to revise policy actions on the basis of the level of achievements. Educational quality, as measured by student assessment, needs to be mainstreamed and scaled up from the current project-based approach to provide a solid metric on which to base decisions and evaluate whether public resources are being well spent.

Improving the Foundation of PFM

Savings from increased efficiency, together with potential revenues from enlarged fiscal space, could provide more substantial spending for development outcomes. However, this will require improvements in the ways the Government manages its public finances. The RGC has committed to enhanced PFM by adopting a public financial management reform program (PFMRP) and has achieved solid progress since 2004. This is reflected in, among other things, improved budget credibility, enhanced revenue collection, and key technical upgrades. However, progress has yet to match the Government's ambitions and targets.

Deeper achievements from PFMRP require better integration of public administration, decentralization, and public finance management reform. The allocation of responsibility for service delivery and resource management is linked to staffing, and to how the whole civil service is organized. Delays in comprehensive civil service and institutional reform directly influence progress in PFM, and put at risk the sustainability of many hard-earned gains. Assigning and devolving functions will better align responsibilities and sources of funding, and will help improve the efficiency and effectiveness of service delivery.

The Government can benefit from better alignment of strategic planning, budget preparation, and aid coordination. Development-partner support for public spending is substantial (at about 40 percent of overall public spending), but is poorly coordinated. As a result, it is less impact than intended. The recommendations for enhanced PFM are presented below. The cost implications of the recommendations in agriculture, health, education and PFM are shown in the final box.

Recommendations

In summary, the IFAPER report presents the following key messages to strength public financial management:

- **Increasing fiscal space through reducing tax exemptions, tightening collection, and restructuring existing spending should offer room for larger allocations to areas crucial for sustaining strong and inclusive growth.** This includes infrastructure, adequate funding for rehabilitation and maintenance of existing capital spending, research and extension in agriculture, textbooks and guidebooks in education.
- **Improving the quality, coverage and classification of items in the government budget is crucial for designing, executing and monitoring government policy and strengthening accountability.** The authorities could benefit from bringing all government spending on budget, including disbursements on development-partner-financed projects, development-partner-financed technical cooperation and development-partner top-ups of civil service wages. Agreement is needed on the expenditure reports on development-partner-supported projects prepared using the Government's chart of accounts (COA), which will enable their better integration into the budget.
- **There needs to be better alignment between the budget, strategic planning and development-partner support.** Sector strategies need to be designed with full cooperation between development partners and the Government. Achieving these goals will require improved collaboration among development partners to overcome existing fragmentation and heightened government leadership.
- **Advancing reforms of PFM is crucial for ensuring public money is spent effectively and budgets, responsibilities, and rewards are better aligned.**
- **PFM reforms need to be better integrated with reforms of the public administration and decentralization and deconcentration.** The allocation of responsibility for service delivery and resource management is linked to wage levels, staffing and the internal organization of the Government.
- **The functioning of Cambodia's processes for managing and spending public money needs to be set in the broader context of the manner in which the overall public sector operates.** Substantial progress has been achieved in developing the foundations for an effective state. But several issues constrain the Government's ability to deliver core services and all available studies point to persistent high levels of corruption.
- **Establishing more effective, transparent and rule-based governance remains at the heart of Cambodia's development challenge (and at the center of the World Bank's support for the country's future).** Progress in improving public finances is critically dependent on progress in enhancing transparency, accountability, and participation.

Cost Implications of Main Recommendations

Main recommendation	Fiscal impact per year	Notes
Agriculture Allocate more resources for research, extension and secondary irrigation canals: less for strategy and planning.	*Overall: broadly neutral*	Reallocation of spending within existing envelopes
Health Improve the efficiency of purchasing pharmaceuticals and medical supplies. Increase outlays on health equity funds	*Overall: cuts spending* **Saves 0.4% GDP** **Spends 0.01 – 0.05% GDP**	Equivalent to one-third of health outlays
Education Free space from the 12.5 percent drop in primary enrollment Spend more on early shildhood education, scholarships and student textbooks	*Overall: broadly neutral* **Saves 0.02 GDP** **Spends 0.05 GDP**	Possible increase in development-partner support
Public Financial Management Reduce tax exemptions	*Overall: increases revenue* **Saves 0.6% GDP**	Potential of achieving 6-7% GDP

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