Subsector Analysis
Public Financial Management Reform Program and Rural Development Ministries

1. **A strong PFM system supports aggregate control of budget resources, prioritization, accountability, and efficiency in the management of public resources and delivery of services.** This is critical to the achievement of public policy objectives, including the Millennium Development Goals (MDGs).[1] In the country context and due to Cambodia's recent past, there exist overwhelming challenges to public financial management. A joint assessment of the World Bank and the ADB - the 2003 Integrated Fiduciary Assessment and Public Expenditure Review (IFAPER) - concluded that weaknesses in PFM had high costs in terms of allocative and operational efficiency, and identified the need for critical public financial management reforms as a key priority[2]. The assessment noted that Government capacity was seriously constrained, both human and financial. In the area of public financial management, there was a scarcity of qualified and competent finance specialists and line managers. Civil service was not adequately compensated; salary continued to be meager and often an outright disincentive for efficient performance and outcome. Institutional accountability arrangements were regarded as insufficient, and a system of systematic legislative oversight over budget was not fully established.

2. In response to the above findings, the Cambodian Government, in partnership with development partners, designed a 'platform' approach to reforming the existing PFM system.[3] The Public Financial Management Reform Program (PFMRP) platforms were designed to impact two key visions of the Royal Government. First, the Royal Government recognized that a strong PFM system is vital to achieving the objectives identified in the National Poverty Reduction Strategy (NPRS). Second, the PFMRP will help Cambodia achieve international best practice in PFM, as defined through the adoption of 15 characteristics of an effective PFM system, based on an adaptation of the Public Expenditure and Financial Accountability (PEFA) PFM Performance Measurement Framework). The Government instituted the Public Financial Management Program (PFMRP) in December 2004 and commenced implementation in January 2005.[4] &[5] The reforms involved a wide range of improvements in budgeting, accounting, auditing and control systems as well as related capacity development, organizational and motivational measures. To achieve these objectives, the PFMRP adopted a platform approach, with appropriate sequencing. Each individual platform provides a clear basis for launching to the next platform, based on the premise that a certain level of PEFA competence is required to enable further progress to take place.

[1] PFM includes all the upstream (preparation and programming) and downstream components (execution, accounting, control, reporting, monitoring and evaluation) of a budget process, including the legal and organizational framework and arrangements etc.

[2] World Bank and Asian Development Bank. 2004. *Integrated Fiduciary Assessment and Public Expenditure Review(2003): Cambodia.* Manila.

[3] The platform approach in Cambodia was informed by the suggestions of Peter Brooks. Brooke, P., 2003. "Study of measures to Address Weaknesses in Public Financial Management in the Context of Policy-Based Support, "final report for the Public Expenditure and Financial Accountability (PEFA) Secretariat (Washington: PEFA Secretariat). The Platform approach aims to implement a package of measures or activities designed to achieve increasing levels ('platforms') of competence over a manageable timeframe. The focus of each platform is on an intended outcome (e.g. a credible annual budget) rather than the achievement of a particular output or activity (e.g. production of a budget manual). The initial activity is for the government to define its overall vision for public financial management and accountability. .

[4] MEF. 2004 *Public Financial Management Reform Program: Strengthening Governance in Cambodia through Enhanced Public Financial Management*. Phnom Penh, Cambodia.

[5] The PFMRP, supported by a multiagency trust fund, is a 10-year comprehensive reform program.

3. **A number of countries, including Cambodia, Uganda, Kyrgyzstan, Kenya, India (Orissa State) and Russia have used the Platform Approach.** In Cambodia, the first of four platforms designed to meet the government's long-term vision for PFM was to have a credible budget delivering predictable resources. In Russia, with the basic systems in place, the delegation of financial powers to budget holders and the introduction of results-based management were seen as essential first steps. The hypothesis behind the Platform Approach is that it can help facilitate genuine government leadership, a politically acceptable pace of change, donor harmonization and greater levels of trust. These problems were identified as the main reasons for lack of progress on PFM reforms. Once the platforms are defined, the approach then proposes a series of iterative steps to develop the action plan for that particular platform, including initial activities required for subsequent platforms. In all cases, the reforms are at their early stages. Initial lessons from the Cambodian example suggested that for the process to be successful, it is necessary that the government should lead as is the case, that the pace of reforms is realistic with timescales, that there is an openness and flexibility about strength and underlying constraints, and that the process should be open to change and reprioritization without diluting the fundamental long term objectives.

A. Progress under Platform I of the PFMRP

4. The first phase of the PFMRP was undertaken from 2005–2008 with the support of a number of development partners. Significant progress has been made in achieving the goals of Platform I, which focused on *building budget credibility,* although there is a continuing need to reinforce Platform 1 activities.[6] Overall, progress has been made in most areas of PFM reforms.[7] External assessment of the design of the PFMRP in Cambodia considers the PFMRP to be credible. Development partners agree that the reform program has moved beyond theory into concrete implementation; there are tangible outputs. A recent ADB OED evaluation underlined that while progress has been made in budgeting, fiscal controls and accountability, the effects of improvements in public sector financial management on service delivery have been relatively modest. The evaluation study attributes these to weaknesses in project formulation and implementation, and to low levels of spending on government pay (1.5–2 percent of GDP); low levels of Government capital spending (4–5 percent of GDP) and equally low levels of non-wage current outlays (4–5 percent of GDP).

5. The Platform 2, corresponding to Stage 2 was launched in December 2008, building on the lessons of an extensive evaluation of the first phase for implementation between late 2008 and 2011. The main theme of Platform 2 is increased financial accountability of those who are responsible for the safe, efficient and effective management of public resources. While the main thrust of PFMRP Stage 2 is the implementation of Platform 2 activities, there are also some Platform 1 objectives which require further strengthening, and some advance work will also be carried out on some Platform 3 objectives. The External Advisory Panel (August 2009) and a Public Expenditure and Financial Accountability (PEFA) Assessment emphasize that while the implementation of Stage I entailed minimum institutional changes that contributed to success, Stage 2 face several institutional challenges that require significant capacity development. Implementation of Financial Management Information System and measures to deepen fiscal decentralization within the framework of Decentralization and Deconcentration Reforms (D&D) under Stage II is technically, managerially and politically demanding as institutional change will

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[6] Royal Government of Cambodia, PFMRP Stage 2, Building on Improved Budget credibility towards achieving better financial accountability, December 2008; Progress Report, 2009, the Secretariat of the PFM Steering Committee, 16-7 January 2010, Ministry of Economy and Finance.

[7] The 2010 Externally Advisory Panel Report and PEFA assessment underlined the significant achievements under Stage 1.

be an inherent part of the process and strong coordination is required between the MEF, Ministry of Interior, and the Line Ministries. The government recognized these challenges, and reviewed the strategic prioritization and sequencing of the program during the PFMRP annual retreat in January 2010. The Government is currently deciding on the strategic core areas, and the process is expected to be completed by end of May 2010. The Government is aware that full implementation of PFM reforms across all ministries will be a long drawn-out process and developing the capacity of the line ministries is critical to the successful implementation of the PFMRP. The 2007 External Advisory Panel assessment recognized the challenge of rolling out PFM reform to line ministries.

6. The Government's strategy for enhancing growth, employment generation, and poverty reduction envisages the need for significant public expenditures for rural development with a corresponding need for adequate expenditure management and control mechanisms. It is expected that spending will increase in this sector. To achieve the MDG target for poverty reduction (20% of the population by 2015) will require average economic growth of 7.5% per annum from 2008 to 2015, inflation in the range of 3%, and no change in the distribution of income between urban and rural families. If inequality between rural and urban areas increases, higher growth may be necessary to achieve this target.[8] This will be no easy task with half the population under 20 years of age and more than 85% of employment in the informal sector (mainly subsistence agriculture), not to mention the relatively high rural poverty rate. Thus, increasing the efficiency of public resources targeted for rural development and increasing private sector-led economic opportunities in rural areas will be crucially important to accomplishing Cambodia's MDG for poverty reduction. The Government's economic strategies, such as those articulated in its Diagnostic Trade Integrated Strategy, underline the critical importance of agriculture and rural development as the key to economic diversification. The institutional framework supporting rural development, therefore, requires sustained support in PFM mechanisms (refer to the problem tree in the Sector Assessment Summary: Public Sector Management). In addition, a summary of the performance of agriculture and rural sectors is detailed in Subsector Analysis: Summary of Performance of the Agriculture and Rural Sectors.[9]

7. Of particular concern for rural development, is the fact that the line ministries which support rural development in Cambodia are currently some of the most under-funded ministries. The three Ministries are the Ministry of Rural Development (MRD), Ministry of Agriculture, Forestry, and Fisheries (MAFF), and Ministry of Water Resources and Meteorology (MOWRAM). Each of the three ministries has significant shortages of qualified staff that affect effective delivery of service delivery in rural areas that reduce economic opportunities for the rural poor. In Cambodia, inadequate budget resources deter progress in rural development. Public investment in agriculture, including funding by development partners have grown in recent years but still remain low. While there are major difficulties in accurately estimating what portion of public resources go to rural development or the rural population, based on available data it is estimated that total national budget allocation for the three line ministries (MAFF, MOWRAM, and MRD) was 3.7% in 2006, 3.3% in 2007, 3.0% in 2008, and 2.8% in 2009 (the year Cambodia faced an economic downturn). The budget for the three rural development

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8 Oum, S. 2007. *A Recursive Dynamic CGE Assessment of the Cambodian Millennium Poverty Reduction Target. Center for Policy Studies*. Melbourne, Australia: Monash University.

9 Based on the study on "Rural Development Sector Strategy and Road map for Public Financial Management Reform in Cambodia, prepared by Tim Purcell, Managing Director, Agriculture Development International, June 2010.

ministries is about 3.3% of the national budget allocation in 2010.[10] This has increased over time from 0.5% in the mid-1990s.

8. The under-funded budgets contribute to public expenditure inefficiencies. MRD, MAFF, and MOWRAM currently use an incremental approach to planning and budgeting that relies on donor financing for most financing of new investment projects. Government recurrent expenditure arising out of existing and proposed activities on donor financed projects is usually under-funded, adversely impacting on service delivery to the poor. The focus of these ministries is on projects, which creates a vacuum for policy and budget strategizing. In addition, there are overlaps of responsibilities in the three ministries. They suffer from weak inter-ministerial and intra-ministerial coordination mechanisms, and tend to operate within "policy silos", despite recent initiatives such as the joint strategic plan for water and agriculture. They have shortages of qualified staff. In the future it will be important for the three ministries to harmonize their rural development efforts and avoid policy overlap. The key areas of weakness related to PFM in the three line ministries targeted under the PFMRDP are: (i) weak link between their policies, programs, and the budget process (ii) program duplication; (unrealistic budget estimation without identified sources of funding; (iii) inadequate budget execution process, including lack of effective internal control in the procurement processes. Although some progress in legislation has been made, changes on the ground have been limited. An ADB Assessment of MRD conducted in May–June 2007 found that MRD's financial and accountability systems needed urgent strengthening. Procurement risks for donor-assisted projects were also identified. The ADB (Office of the Auditor General) findings on NRDP raised concerns across the board (works, goods, services, running costs).[11] Over the years, lessons from ongoing projects also underlined major weaknesses in internal control and procurement practices.[12] Internal audit departments in MOWRAM and MAFF were established in 2007 and in MRD in 2008. However, the capacity for effective internal audit in line ministries remains low.

9. Increasing the quality of PFM systems in these ministries is a priority for the Government and also for the Asian Development Bank (ADB), which currently provides sizeable investment resources to these sectors. The Government is aware that the rollout of ongoing PFM reforms to the three rural development ministries is, therefore, critical to NSDP objectives. In the three

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[10] Analyzing expenditure patterns for rural development as a sector on its own is very difficult in Cambodia and it is unlikely that this figure is wholly accurate. In reality, it is nearly impossible given the paucity of existing data to define exactly how much of the Government's and donor's resources is allocated to rural development to support the joint sector budgets and strategies of the three priority ministries. In the area of rural development there are multiple agencies responsible for broadly similar policy and program areas, resulting in fragmentation and even program duplication. Rural development is also not limited to the activities of the three ministries of Rural Development (Ministry of Agriculture, Forestry and Fisheries, Ministry of Rural Development and Ministry of Water Resources and Meteorology), so suggesting a figure that only takes these ministries into account does not provide an accurate picture of the real level of expenditure for rural development sector priorities. Finally, it is very difficult to determine expenditure patterns at the central line ministry (sector) level because parallel negotiations also take place between provincial departments under line ministries and MEF. As incremental adjustments are made throughout the year to cover cash deficits at the provincial level, the actual budget execution levels presented by the MEF for the sectors are likely to be inaccurate. However, increasing expenditures in productive areas will not lead to an optimum result in the absence of serious investment in capacity development and strong support for PFM reforms in these ministries by the Government and the development partners.

[11] ADB. 2006. *Report and Recommendation of the President to the Board of Directors on the Proposed Loan to the Kingdom of Cambodia for* the *Northwest Rural Development Project*. Manila (Loan 1862-CAM).

[12] ADB. 2003. *Report and Recommendation of the President to the Board of Directors on Proposed Loans and Technical Assistance Grant to the Kingdom of Cambodia for the Agriculture Sector Development Program*. Manila (Loan 2022-CAM); ADB. 2003. *Report and Recommendation of the President to the Board of Director on a Proposed Loan to the Kingdom of Cambodia for the Northwest Irrigation Sector Project*. Manila (Loan 2035-CAM); ADB. 2000. *Report and Recommendation of the President to the Board of Directors in a Proposed Loan to the Kingdom of Cambodia for the Stung Chinit Irrigation and Rural Infrastructure Project.* Manila (Loan 1753-CAM).

rural development ministries it will be important to build commensurate capacity by rolling out the training program and other measures designed under the PFMRP on a priority basis. Accordingly, ADB provided a grant of 6.71 million in December 2008 to support efforts by Cambodia to improve its public financial management to ensure that much-needed government funds reach the rural poor.[13] In addition, the ADB PFM project amounting to $4.1 million is complementing government-wide capacity development in strengthening PFM reform measures in MAFF, MRD, and MOWRAM with the focus on PFM sub-systems relating to budget formulation, execution, procurement, and reporting; and internal audit for better service delivery to rural communities. The rational of ADB support to strengthen PFM systems is specifically targeted to the rural Ministries given (i) their importance in delivering services to the rural population (which are most affected by poverty) and (ii) potential to increase government expenditure in these ministries to reduce poverty.

B. Estimating the economy-wide gains from the PFMRDP -SP2

10. This section presents estimates of the economy-wide benefits and costs of the Program. The methodology used is to estimate benefits to the Cambodian economy assuming Cambodia achieves PFM outcomes in line with its PFM results based framework. This is essentially measured by budgetary and resource savings from implementation of PFM reforms in budget execution, greater competition and transparency in procurement across the national government, strengthened internal control systems to minimize wastage and reduce corruption, and better public debt management at MEF. These are long run benefits. The Program addresses key PFM inefficiencies that raise the costs of budget execution and wastage in procurement. Hence, the potential benefits from these reforms are the savings to the Government and better delivery of public services to rural households and enterprises. The costs of the reforms estimated are primarily the short to medium term costs of administering reforms, the direct fiscal costs of selected PFM investments and costs to rural enterprises and households from shift towards cost recovery in some rural services. In cost-benefit analysis, the present value lump sum of permanent costs to the budget and new revenues should be estimated where possible to provide an accurate calculation of policy adjustment costs and benefits.

11. Inefficient PFM impose several types of costs on budget and the economy that reduces long-term potential economic growth rate and poverty reduction. The first type of costs is operational costs through inefficient budget execution, weak internal control and audit systems and weak governance in procurement leading to high cost procurement of goods and services. Inefficient public debt management leads to suboptimal debt composition and tenure leading to higher debt servicing costs. The second is high cost of public service delivery and therefore poor quality services. In rural development high cost delivery of services exist in water supply, irrigation and extension services. This in turn leads to high cost rural production which is a drag on growth and rural household income generation. Thus, there are potential gains from implementing PFM reforms in line ministries engaged in rural development.

12. Tables 1 (page 6) presents quantifiable (gross) gains to Cambodia from selected reforms implemented under the Program. We estimate that such reforms could create budgetary savings of at least $120 million per year from shifting at least 50% of all procurement to a competitive basis (currently 76% of procurement not subject to competitive bidding - we assumed this lowers prices by 20%) and efficiencies gained in budget execution and internal

[13] ADB. 2008. *Proposed Program Cluster, Grant for Subprogram 1 and Grant Assistance, Kingdom of Cambodia: Public Financial Management for Rural Development Program*. Manila (Grant 0133-CAM).

control systems (about 15% of recurrent expenditures and 1% debt servicing costs). There are second round effects through better delivery of public services to rural enterprises. We estimate these at $60 million increased rural productivity.

Table 1: Cambodia: Potential Economic Gains

	Gains
1. NG savings from improved competition in procurement of goods and services	$100.0 million
2. Savings from improved budget execution, strengthened internal control systems in IAs and better public debt management	$20.0 million
3 Improved productivity from better service delivery to rural enterprises and households	$60.0 million
Total Gains	**$180.0 million**

Source: ADB Staff estimate.

13. A comprehensive PFM training plan with broader management skills development has been formulated, and is under implementation. The targeted training during 2010 will be to hold 21 training courses in EFI, 21 ministry seminars and 24 IT courses within ministry facilities – a total of 3,300 staff-courses, addressing the training of some 2,000 different members of staff. By end of 2010, these staff will have been trained in strategic budget plan, annual budgeting budget execution, procurement, accounting, and IT. In addition, the internal audit departments of the three rural development ministries, comprising about 57 staff, are being trained. The ADB supported team of experts is working with the PFM Working Groups, and providing support for the implementation of the Ministerial Action Plan formulated for implementation of Stage 2 of the PFM Reform program. Following the PFMRP Annual Review (Sihanoukville January 2010) for the sequencing of PFMRP CAP activities into (i) 'catalyst' areas for immediate action in 2010; and (ii) activities that can be delayed to 2011 and beyond, an assessment of the CAP and MAPs for the three rural development ministries was undertaken. The most significant concern for these ministries is that nearly all of the 'catalyst' areas suggested as top priority for 2010 require work from MEF to produce guidelines before the line ministries can do useful work.

14. To improve coordination, the Government has recently established the PFM Coordination Working Group for rural development ministries. This will direct focused attention on the PFM issues for the rural development ministries. In addition, the Economic and Financial Policy Committee (EFPC), chaired by Minister for MEF, also cover PFMRP as a high level policy forum in which key members of line ministries are members. The PFMRC[14] was renamed MEF Reform Commission (MEFRC), chaired by Secretary of State in which all MEF directors are members, and a new PFMRP Steering Committee (PFMRSC) has been established, chaired by the Secretary of State for MEF, in which the Director General or Secretary General in charge of Finance functions in each line ministry are members. A new Steering Committee Secretariat (SCS) has also been established, which serves both PFMSC and MEFRC and supports MEF departments and PFMR Working Groups (PFMRWGs).[15]

[14] PFMRSC is a high level forum to monitor and coordinate among all government agencies.

[15] PFMRWGs were established in all ministries, chaired by Director General/Secretary General, who is also a member of PFMRSC; members would be at least Deputy Directors from Finance, Accounting, Planning Departments, and, if applicable, a representative from a Project Management Unit.