

FISCAL DECENTRALIZATION REFORM IN CAMBODIA

PROGRESS OVER THE PAST DECADE AND OPPORTUNITIES

DECEMBER 2018

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6 ADB Avenue, Mandaluyong City, 1550 Metro Manila, Philippines
Tel +63 2 632 4444; Fax +63 2 636 2444
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On the cover: The new district office and meeting hall in Cambodia were funded by the Asian Development Bank (photos by ADB).

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Foreword

The Asian Development Bank (ADB) has long recognized the importance of sound decentralization policies as a key part of the broader policy framework needed for successful economic development and reduced poverty levels. As a result, ADB has developed a very close relationship with Cambodia in support of its deconcentration and decentralization reform program, with particular focus on the development of policies and funding for fiscal decentralization.

I am pleased to present this report reviewing Cambodia's progress with fiscal decentralization since passing the Law on Administrative Management of the Capital, Provinces, Municipalities, Districts and Khans (Organic Law, 2008), and commencing the National Program for Democratic Development, 2010–2019, extended to 2020. I am sure it will make a useful contribution to the work of ADB, the Royal Government of Cambodia, and other development partners, and will inform a broader audience.

The report notes that solid progress has been made in providing the architecture for an intergovernmental fiscal transfer system, containing unconditional and conditional transfers, including recent introduction of the Subnational Investment Fund for which ADB has provided design advisory support and initial capital funding. Notwithstanding this progress, total fiscal transfers to date have been modest. Increasing intergovernmental flows will depend on continuing and extending the recent process with the reassignment of functions, and convincing all government agencies of the merits of providing, in fiscally responsible ways, additional unconditional resources to support necessary discretionary spending of the subnational administrations.

Even at current modest transfer levels, significant improvements in vertical and horizontal balances could be achieved through simplifying and better focusing unconditional fiscal transfers and shared taxes around population and poverty variables. Unless unconditional funding levels can be increased, the main scope for targeting additional resources to districts and municipalities—which is central to government planning—will be through gradually reducing the growth of funding to the provinces and Phnom Penh. Implementing such reforms will not be easy. The report does provide a simulation of reforms to allocation methods for unconditional transfers and shared taxes, which at current funding levels would provide for considerable improvements in vertical and horizontal balances. These and other similar possible reforms to improve horizontal and vertical balances should be closely considered by the government.

The report suggests it will be many years before subnational administrations develop financial or legal capacities for borrowing. However, other options are available for increasing much needed development spending over the medium term, including by gradually allowing subnational administrations greater access to the government's national investment funding, better targeting of decentralized development funding by development partners, and through the provision of additional domestic and external support to the Subnational Investment Fund.

Continued ADB funding of fiscal decentralization efforts has been programmed well into the future. We look forward to working with the government toward achievement of increasingly tangible results, particularly in the reassignment of further significant functions to the subnational administrations matched by more substantial resource flows, including the assignment of local taxing powers, and through the reduction in substantial vertical and horizontal imbalances in the fiscal transfer and tax sharing systems.

Ramesh Subramaniam

Director General

South East Asia Regional Department

Asian Development Bank

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We gratefully acknowledge and thank persons who assisted from the following institutions: (i) Ministry of Interior; Ministry of Economy and Finance; Ministry of Planning; Ministry of Education, Youth and Sport; Ministry of Public Works and Transport; Ministry of Rural Development; Ministry of Social Affairs, Veterans and Youth Rehabilitation; Ministry of Environment; Ministry of Health; Ministry of Civil Service; Ministry of Agriculture, Forestry and Fisheries; Ministry of Tourism; and the Secretariat of the National Committee for Sub-National Democratic Development; (ii) councillors, boards of governors, and officials of Takeo and Kampot provinces and of Tram Kak and Chhouk districts; (iii) provincial and district office directors and officials of the Ministry of Education, Youth and Sport; Ministry of Health; Ministry of Public Works and Transport; Ministry of Environment; Ministry of Agriculture, Forestry and Fisheries; Ministry of Rural Development; Ministry of Social Affairs, Veterans and Youth Rehabilitation; and Ministry of Water Resources and Meteorology in the abovementioned provinces and districts; and (iv) officials from various development partners, academia, and civil society.

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Abbreviations

ADB	– Asian Development Bank
CSF	– commune and <i>sangkat</i> fund
DMF	– district and municipality fund
GDP	– gross domestic product
IP3	– 3-year implementation plan
MEF	– Ministry of Economy and Finance
MOI	– Ministry of Interior
NCDD	– National Committee for Sub-National Democratic Development
NCDDS	– National Committee for Sub-National Democratic Development Secretariat
OECD	– Organisation for Economic Co-operation and Development
PFM	– public financial management
SNIF	– Subnational Investment Fund

Currency Equivalents

Currency Unit – riel (KR)

KR1.00 = \$0.000244

\$1.00 = KR4,100.00

Glossary¹

Term	Definition
Assignment of functions	The distribution of functions of government between the central government and the different tiers of subnational administrations.
Coefficient of variation	A statistical tool commonly used in analyzing horizontal fiscal balance. It is the ratio of the standard deviation to the average and measures the extent of dispersion from the average. Higher numbers indicate greater dispersion from the average and vice versa.
Conditional intergovernmental fiscal transfers	Transfers that can only be used in ways that the transferring level of government has agreed with the receiving level of government (usually set out in laws, regulations, or legal instruments).
Decentralization	Transfer or delegation of competences owned by the central government, accompanied by corresponding resources, toward lower tiers of administration.
Deconcentration	Central government redistribution of administrative and management responsibilities (and finance) to lower levels of the central government (typically provincial departments and district and municipal offices of central ministries in Cambodia).
Delegation	Transfer of central government functional responsibilities to subnational administrations or other independent agencies that are ultimately responsible to the central government (usually by a contract based on principal and agent relations).
Devolution (or Transfer)	Transfer of central government functional responsibilities to local administrations, which are primarily accountable to their electorate and operate at arm's length and largely outside the direct control of the central government.
Fiscal decentralization	Devolution of powers, responsibilities, and finance of the central government to subnational administrations, typically involving (i) assignment of functions, (ii) assignment of revenues, (iii) intergovernmental financial transfers, and (iv) subnational borrowing powers.

¹ This glossary is not based on any original work, but rather draws on the author's experience, which has been informed by a wide range of fiscal decentralization publications, including those published by the World Bank, the United Nations Development Programme, the United Nations Capital Development Fund, the Asian Development Bank, and various academic authors.

Term	Definition
Horizontal balance	The extent of balance in financial resources (revenues and expenditures) within a particular tier of government or administration. For example in Cambodia, balance within the district and municipality tier.
Intergovernmental fiscal transfers	The transfer of finances between tiers of government or administration; usually financial transfers from the central government to subnational administrations.
Own source revenues of subnational administrations	Tax and/or nontax revenues over which the subnational administration has been assigned significant powers, including powers over the tax base and tax policies, including setting of tax rates. Subnational powers may be complete, or may be constrained (i.e., with powers to set tax rates only within legislated bands).
Shared revenues	Tax and/or nontax revenues under the control of one tier of government (usually the central government), which are shared with other tiers of administration. Sharing may be general, such as a percentage of total central government revenues, or may be specifically related to one or more revenue sources (i.e., sharing an agreed proportion of excise or property taxes).
Subnational administrations	Collectively refers to levels of administration below the central government (in Cambodia, this means provinces, Phnom Penh capital city, rural districts, urban municipalities, capital city <i>khans</i> akin to municipalities, rural communes, and urban <i>sangkats</i>). The extent of fiscal decentralization depends on the ability of these lower-level administrations to make independent revenue and expenditure decisions for the provision of public services autonomously, and independent of the central government.
Subnational administration councils	Elected bodies with powers to control their assigned resources and functional responsibilities (in Cambodia, they exist at commune, <i>sangkat</i> , <i>khan</i> , district, municipality, province, and capital city levels, though only the commune and <i>sangkat</i> councils are directly elected, with the remainder indirectly elected by commune and <i>sangkat</i> councilors).
Unconditional intergovernmental fiscal transfers	Funds received can be allocated autonomously by the recipient subnational administration (though some general constraints may apply such as meeting standard public financial management and audit requirements).
Unified administrations	In Cambodia, applies to well-managed and coordinated activities between deconcentrated units of the central government (provincial departments, and district and municipal offices) and subnational administration councils and their boards of governors and officials in corresponding provinces, districts, and municipalities. Governors are usually responsible for coordination of unified approaches.

Term	Definition
Unitary state	A state governed as a single power in which central government is ultimately supreme and any administrative divisions (e.g., subnational administrations) exercise only the powers that the central government chooses to delegate in laws or legal instruments, and which it may change from time to time. Cambodia is a unitary state.
Vertical balance	The extent of balance in financial resources (revenues and expenditures) between the different tiers of government and/or administration. In Cambodia, between the four tiers of (i) commune and <i>sangkat</i> ; (ii) district, municipalities, and <i>khans</i> ; (iii) provinces and Phnom Penh; and (iv) the central government.

Executive Summary

The objective of this report is to review Cambodia's progress with fiscal decentralization since the passing of major decentralization legislation in 2008 and commencement of the National Program for Sub-National Democratic Development, 2010–2019, extended to 2020 (national program). The review focuses on progress over the past 10 years since enactment of the Law on Administrative Management of the Capital, Provinces, Municipalities, Districts and Khans (Organic Law, 2008), and the identification of opportunities for future reform. Given the extended association of the Asian Development Bank (ADB) with decentralization reform, the report will inform future ADB operations and should also help foster broader policy discussion. Fiscal decentralization is defined as having four core pillars: revenue, expenditure assignments, intergovernmental fiscal transfers, and subnational borrowing (though subnational borrowing is not yet permitted in Cambodia and is therefore only briefly touched upon). The report focuses on fiscal decentralization because ADB has targeted most of its support for decentralization in Cambodia in this area, and also because progress with broader decentralization reform is closely linked to fiscal decentralization reform.

Chapter 2 reviews key drivers of the fiscal decentralization system. Good progress with political, institutional, and legal reforms has provided the foundations from which targeted fiscal decentralization outcomes can be realized over time. The review of the key drivers is structured as follows:

- (i) The policy and planning framework is assessed, particularly objectives and performance under the national program and the two medium-term implementation plans introduced to date. Government objectives and plans for fiscal decentralization are taken as the key starting point for this report's recording of progress since passing of the Organic Law (2008).
- (ii) Subnational structures and funding mechanisms are explained.
- (iii) The complex range of sometimes competing institutions involved in fiscal decentralization is reviewed: Ministry of Interior, National Committee for Sub-National Democratic Development, Ministry of Economy and Finance, subnational administrations, National Audit Authority, line ministries, and development partners.
- (iv) The impressive legal and regulatory framework is outlined. It was developed to contain six foundation laws and numerous lower-level regulations, not all of which are philosophically or legally consistent. In many key areas, gaps and problematic content remain.
- (v) The political economy and accountability framework is reviewed, including consideration that the fiscal decentralization system may provide insufficient fiscal or political accountability for local citizens and also lack transparency.
- (vi) The framework for subnational personnel management is reviewed.

- (vii) The subnational public financial management (PFM) framework is set out and reviewed, with a focus on the limited financial management autonomy provided to subnational administrations and challenges in strengthening their budget preparation and execution as well as monitoring and audit frameworks. Proposed PFM reforms to introduce enhanced performance and accountability mechanisms, including consideration of fiscal incentives, should assist to raise the effectiveness and efficiency of expenditures.
- (viii) Finally, the significant ongoing need for capacity building at all levels is outlined.

The key reform opportunities for the future lie in building on the strong legal and institutional foundations created, so as to develop clearer consensus on the vision and nature of fiscal decentralization reforms and accountabilities being pursued and to apply the consensus model to developing a more consistent set of laws, policies, and procedures.

Chapter 3 commences with an analysis of subnational expenditure trends. These include the following:

- (i) International comparisons indicate Cambodia remains a lowly decentralized country.
- (ii) Total expenditures of all subnational levels have grown over the decade, though in absolute terms less significantly than for the central government.
- (iii) Expenditures are extremely imbalanced between (vertical) and within (horizontal) the four levels of administration.
- (iv) The composition of expenditure is imbalanced with limited occurrence of development spending.
- (v) Deconcentrated expenditures of central ministries have continued to grow more rapidly than their central offices, though growth has been focused on a small number of key ministries, and on current expenditures.

Important reform opportunities relate to rectifying both vertical and horizontal expenditure imbalances throughout the fiscal decentralization system. Their causes have been broadly agreed for a long time. Reaching consensus on how to address them would assist in designing an improved system.

The chapter also reviews expenditure policy development, particularly progress in the assignment of functions to subnational administrations. After a decade of considerable effort, satisfactory final outcomes from the reassignment of functions will require more time to achieve. The key decentralization laws provide a basis for functional reassignments and delegations to subnational administrations, and lower-level regulations and practical approaches have been put in place. Key ministries have mapped and reviewed their functions, and, more recently, there has been movement to higher-level direct actions. New arrangements for permissive functions funded by unconditional grants in the districts and municipalities are beneficial, though significant new funding has not yet emerged. The government is currently reviewing the possibility of reassigning all functions and resources of district and municipal offices of provincial departments to subnational administrations. This provides a good reform opportunity, though many of these offices are weakly skilled and resourced. Recent improvements to the legal infrastructure have been matched by tangible progress in eight key ministries that the National Committee for Sub-National Democratic Development is currently focusing on, particularly with the three largest spenders responsible

for education, health, and social affairs. Progress has been less substantial with less active but still strategically important ministries, but there is scope for more action and progress over time. Opportunities also exist to enhance levels of subnational development expenditure through more proactive financing approaches.

Chapter 4 reviews subnational revenue trends including shared taxation and intergovernmental fiscal transfers over the past decade. Trends indicate (i) growing but still low levels of subnational revenues by international standards; (ii) strong reliance of communes and *sangkats* (the urban equivalent of the rural commune) on central transfers from the commune and *sangkat* fund; (iii) heavy reliance of districts and municipalities on central transfers from the district and municipality fund; and (iv) increased reliance of the provinces and Phnom Penh on shared taxation revenues relative to direct transfers. The three tiers of subnational administrations all experience horizontal revenue imbalances with districts and municipalities having wider horizontal imbalances than the communes, though municipalities are better resourced than districts. Very substantial horizontal imbalances exist between Phnom Penh and less well-resourced provinces.

On the revenue policy side, no progress has yet been made in assigning autonomous taxation revenues to subnational administrations over the review period, although a pilot is planned for the next 3 years. The most recent reform was the establishment and sharing of property tax revenues with the provinces and municipalities as well as some *sangkats* and *khans* (the capital city equivalent of district and municipality). Provinces and Phnom Penh continue to receive all shared central tax revenues, which has been a major source of vertical imbalance, particularly favoring them over the other two administrative tiers. Nontax revenues can be retained within the administration collected, but these are relatively minor. Only a few of the taxes assigned for sharing with the provinces raise any significant revenues. Phnom Penh captures the major portion of shared taxes with very wide per capita funding differences between large and smaller urban centers.

Significant policy study and discussion have covered what own-source revenue reforms could be introduced, but to date no reform has occurred, though some further downward sharing of the taxes shared with the provinces is being considered. Unless assignment of functions further progresses and significant own-source revenues are assigned to subnational administrations, future reform opportunities will need to rely mainly on improving unconditional transfer and shared tax mechanisms, which are the main funding sources of all subnational administrations. The reform of these systems is of highest importance in the short term as they are the main instruments currently available to address vertical imbalances.

The main unconditional transfers and shared taxes lead to extreme vertical and horizontal imbalances between and within subnational levels. To address these issues, suggested reforms are to (i) undertake a longer-term review and revisions to all subnational boundaries; (ii) clarify objectives of the fiscal transfer system around equalization of the gap between fiscal capacities and fiscal needs; (iii) consider increasing the size of the unconditional funding pool—though important distributional benefits can nevertheless be achieved without an increase in the pool; (iv) treat shared taxation revenues in future as part of the unconditional transfer pool and not confine allocations to the provinces and Phnom Penh; (v) address large vertical imbalances by policy judgment and directive; (vi) address large horizontal imbalances by moving to a simplified allocation formula based on population adjusted for poverty for each of the subnational tiers; and (vii) consider removing other parameters in

existing unconditional transfer formulae including equal shares, administrative structures, and land area.

A simple reform simulation, based on the above suggested reforms, indicates that significant improvements to vertical and fiscal imbalances can be achieved at no additional central government cost. Only a very small number of currently highly resourced administrations would be worse off in real terms, providing such reforms are phased in over a medium-term time frame.

In terms of future longer-term reform opportunities, conditional transfers are likely to end up the most important longer-term source of funding for subnational administrations through well-designed functional reassignments and delegations. The Subnational Investment Fund (SNIF) has been established and will provide one mechanism for increasing conditional fund transfers.

Chapter 5 provides an overall summary and recommendations. Cambodia has made good progress with political, institutional, and legal reforms and these provide a solid foundation from which targeted fiscal decentralization outcomes can be realized over time. To date, only modest progress has been made toward achievement of the main fiscal decentralization outcomes set out in the Organic Law (2008) and the national program. The absence of a shared vision between stakeholders as well as inconsistencies between key laws and regulations have slowed progress. Policy makers will need to seek stronger consensus on the direction of fiscal decentralization and establish more consistent policies and legal instruments.

In terms of sequencing, continuing and extending the encouraging progress made recently with the reassignment of functions remain the key to allowing increased financial resources to flow to subnational levels. Based on pilots to commence over the next few years, policy makers should also look for options for medium- to longer-term reforms to provide autonomous taxation powers to subnational administrations. This will contribute to forming stronger links between elected councils and their constituents.

Progress has been good in providing the architecture for an intergovernmental transfer system containing unconditional and conditional transfers, including the recent introduction of the SNIF. However, funding flows to date have been modest and increasing these will depend on further progress with the reassignment of functions and in convincing all stakeholders of the merits of providing—in a fiscally responsible way—additional unconditional resources to support much needed additional discretionary spending by subnational administrations.

Even at current unconditional transfer and shared taxation levels, policy decisions on vertical arrangements can lead to major improvements in vertical and horizontal balances. Moreover, simplifying and better focusing unconditional fiscal transfers and shared tax formulas around population and poverty can help improve horizontal imbalances. If levels of existing unconditional funding are not increased, the main scope for targeting additional resources to districts and municipalities—a key aim of government policy—is through gradually reducing the growth of funding to provinces and Phnom Penh. The report provides a simulation of possible reforms of unconditional transfers and shared taxes, which at current funding levels would provide for considerable improvements in vertical and horizontal balances. It is recommended that a high-level policy working group review these and other similar options

for reform with a view to developing a consensus model for reforming unconditional transfers and shared taxes over time.

The decentralization and subnational finance laws prohibit subnational borrowing, and it will be many years before the subnational administrations develop financial and legal capacities for borrowing. Notwithstanding, options are available for increasing much needed subnational development spending over the medium term, including by allowing gradual access to the government's national investment funding, development partners further targeting decentralized investments, and providing additional domestic and external support to the SNIF. These options should be gradually pursued over time.

Introduction

The Asian Development Bank (ADB) in 2011 published a report reviewing the new round of deconcentration and decentralization reforms then underway in Cambodia.¹ The report included recommendations for an institutional framework to guide future ADB strategies, in anticipation of expected substantial deconcentration and decentralization reforms in the years ahead, under a major national program for subnational development 2010–2019 (extended to 2020) that at the same time was being finalized (hereinafter referred to as the national program).² Fiscal aspects of decentralization figured prominently in this report, particularly with regard to revenue and expenditure powers that might be assigned to subnational levels and the manner in which any such reassigned functions would be funded. However, it also covered broader administrative and political aspects of decentralization.

The current report logically follows on from the earlier study. The objective of this report is to review what has happened over the decade since the government passed the Law on Administrative Management of the Capital, Provinces, Municipalities, Districts and Khans in 2008 (Organic Law, 2008) and finalized the national program and two subsequent 3-year implementation plans (IP3s). The report largely focuses on fiscal decentralization matters, which are defined as containing the four commonly used fiscal decentralization pillars: revenue, expenditure assignments, intergovernmental fiscal transfers, and subnational borrowing (though less attention is on borrowing, which appears premature in Cambodia). After reviewing the progress in implementing fiscal decentralization components of the national program and medium-term plans, the report identifies future reform opportunities that could enhance the effectiveness and efficiency of Cambodia's fiscal decentralization system.

Because of ADB's extended association with decentralization reform since 2002, the report will help inform future ADB operations, both directly in terms of support to fiscal decentralization matters and indirectly in terms of how broader ADB support might take into account the emerging landscape for deconcentrated and decentralized activities. Furthermore, the report will hopefully benefit a broader audience, including the Royal Government of Cambodia, fellow development partners, and civil society organizations.

The report focuses on fiscal decentralization primarily because most ADB funding and technical support to decentralization has gone to fiscal decentralization, and secondly to allow consideration of commonly held views that gradual progress with fiscal decentralization reform has impacted the extent of progress made with broader decentralization reform. The focus on fiscal decentralization does not mean that governance, administrative, political, and other aspects of reform have not been important. Indeed, they are integrally related to fiscal decentralization and elements are touched on.

¹ T. H. Niazi. 2011. *Deconcentration and Decentralization Reforms in Cambodia: Recommendations for an Institutional Framework*. Manila: Asian Development Bank.

² Government of Cambodia, National Committee for Sub-National Democratic Development. 2010. *National Program for Sub-National Democratic Development, 2010–2019*. Phnom Penh.

The modern phase of Cambodia's fiscal decentralization reforms is commonly dated from 2001, with the passing of the Law on Commune and Sangkat Administrative Management (Law on Communes and Sangkats, 2001). The movement to a unified state with a strong centrally controlled democratic government is a relatively new feature in Cambodia, with the more distant history indicating extended periods of fragmentation with different regions having their own autonomous powers and financial arrangements. Apart from some pre-World War II experimentation with more devolved and powerful provincial governors, the post-World War II period has largely focused on strong, vertically deconcentrated approaches to territorial management, through centrally appointed governors responsible for meeting political and security goals.³ The passing of the reformist Law on Communes and Sangkats (2001) and the Organic Law (2008) was, in important respect, a recognition that a strong centralized management has constraints in effectively providing goods and services to far-flung local communities. Meeting continuing desires for centralized political and security control while addressing subnational aspirations for local development have been and continue to be important considerations in the design and implementation of fiscal decentralization reforms.

The report methodology focused on exploring progress and opportunities with implementation of reforms under the four pillars of fiscal decentralization, though broader institutional and systemic issues, particularly public financial management, are briefly reviewed. The following approaches were used: (i) semi-structured interviews with key stakeholders, including those within the central government, development partners, civil society organizations, academia, and ADB officials; (ii) literature review; (iii) review and analysis of fiscal data; and (iv) field visits to subnational administrations at provincial, district, and municipality levels in Takeo and Kampot provinces. Resources did not allow for systematic field-based surveys, but the field visits—and numerous previous visits to subnational administrations by the main study team members—helped improve understanding of recent developments and thus supplemented the interviews, data, and materials reviewed at the central level.

While the collection and analysis of fiscal data took up a large part of the resources of the report, as in most countries, specific features of Cambodia's history, politics, and geography have largely determined the architecture of fiscal decentralization in the country. Technical fiscal solutions to address constraints and issues with fiscal decentralization in Cambodia are not likely to succeed if they do not have history, geography, and the support of political leadership on their side.

The report focuses on a review of trends, policies, and reform opportunities with fiscal decentralization:

- Chapter 2 reviews the key drivers of the fiscal decentralization system;
- Chapter 3 analyzes subnational expenditure trends and functional reassignments;
- Chapter 4 reviews subnational revenue trends, including shared taxation and intergovernmental fiscal transfers; and
- Chapter 5 provides brief conclusions and recommendations.

³ D. Chandler. 2008. *A History of Cambodia (Fourth Edition)*. Bangkok: Routledge.

Drivers of the Fiscal Decentralization System in Cambodia

2.1 Policy and Planning Framework for Fiscal Decentralization Reform

2.1.1 The Broad Policy and Planning Framework

Most policy and planning work since 2008 has occurred through the National Committee for Sub-National Democratic Development (NCDD), though other ministries play important roles, including the Ministry of Economy and Finance (MEF) with fiscal decentralization, the Ministry of Civil Service with personnel management, and line ministries with the reassignment of functions. Work occurs under the umbrella of the national program and is implemented through rolling 3-year plans as well as annual work plans and budgets. The current report takes the national program and the two 3-year plans to date as the basis for reviewing progress with fiscal decentralization over the past decade. The data and key policy pillars reviewed in chapters 3 and 4 represent a review of the progress under the government's policy and planning framework.

2.1.2 National Program for Sub-National Democratic Development, 2010–2019

A strategic framework prepared in 2005 was a critical document as it provided direction for preparation of the Organic Law (2008) and the national program.⁴ The strategic goal was to strengthen and expand democracy as well as promote local development to reduce poverty. In terms of fiscal decentralization, adequate revenues would be provided to meet clearly assigned subnational functional responsibilities. There would be effective systems of intergovernmental financing with transparent formula that consider fiscal equalization, vertical compensation, incentives for revenue collection, and improvements in public financial management. The government would pursue unified administration with each level of administration responsible for performance based on functions assigned to it, though subnational administrations would have flexibility to fund undefined matters to meet the needs of their constituents.

The national program provided for implementation in three phases: (i) institutional reform to prepare for subnational service delivery, (ii) commencement of substantive service delivery at subnational levels, and (iii) consolidation and strengthening of democratic decentralized service delivery (footnote 2). In terms of fiscal decentralization, the strategic vision was to transfer powers and resources to subnational administrations based on clear roles and

⁴ Government of Cambodia. 2005. *Strategic Framework for Decentralization and Deconcentration Reforms*. Phnom Penh.

responsibilities with locally elected officials to be accountable to local citizens. The objectives for fiscal decentralization were (i) clear assignment of functions to subnational administrations matched by transfer of human and financial resources, (ii) delegation of powers to subnational administrations to raise local revenues and to set revenue policies and rates, and (iii) control of subnational administrations over their civil service. Provincial administrations were to focus on planning and coordination roles and to address cross-district matters and national policies; districts and municipalities were to work closely with communes and *sangkats* and become the key service delivery point; and communes and *sangkats* were to remain providers of localized infrastructure and services. The attainment of unified administration and a phased movement to more horizontal forms of deconcentration—and eventually decentralization—were central to the strategy. Responsibilities for reassignment of functions and fiscal decentralization were split between the NCDD and MEF.

The strategy provided for five interrelated program components, the two most important for fiscal decentralization being component 3 on the reassignment of functions between tiers of government and component 4 on budget, financial management, and asset management systems. The program recognized the importance of the NCDD and the MEF in ensuring coordinated approaches, particularly to ensure that funding followed function.

Only broad (nonquantified) fiscal decentralization performance indicators were set out:

- (i) percentage of functions assigned to subnational administrations,
- (ii) percentage of functions transferred that are adequately resourced,
- (iii) institutional arrangements for mapping and reviewing functions as a basis for reassigning functions,
- (iv) percentage of national budget assigned to subnational administrations,
- (v) subnational finance and revenue laws in place,
- (vi) percentage of own-source revenues collected,
- (vii) effective and equitable systems of intergovernmental fiscal transfers in place, and
- (viii) all basic services and local development functions to be transferred by 2019.

2.1.3 Medium-Term Implementation Plans

The two medium-term implementation plans to date, which have been supported by annual work plans and budgets, have been the key mechanisms for implementing the program.⁵ All the medium-term and annual plans have had subprograms and key outcome areas related to the assignment of functions and fiscal decentralization.

The 3-year Implementation Plan-I or IP3-I (2011–2013 and extended to 2014) focused on the development of institutions that would create a system of new subnational and national accountabilities, and also sought to develop capacities to realize the new decentralized accountabilities. This included developing the legal and policy framework for autonomous subnational administrations. For fiscal decentralization, the plan aimed to develop (i) the apparatus for identifying functions to be reassigned and the financial architecture, including a district and municipality fund (DMF); (ii) the Subnational Investment Fund (SNIF);

⁵ Government of Cambodia, National Committee for Sub-National Democratic Development. 2010. *The First Three Years Implementation Plan (2011–2013) of NP-SNDD (IP3)*. Phnom Penh; and Government of Cambodia, National Committee for Sub-National Democratic Development. 2014. *3 Year Implementation Plan, Phase II (2015–2017) of the National Program for Sub-National Democratic Development (IP3-II)*. Phnom Penh.

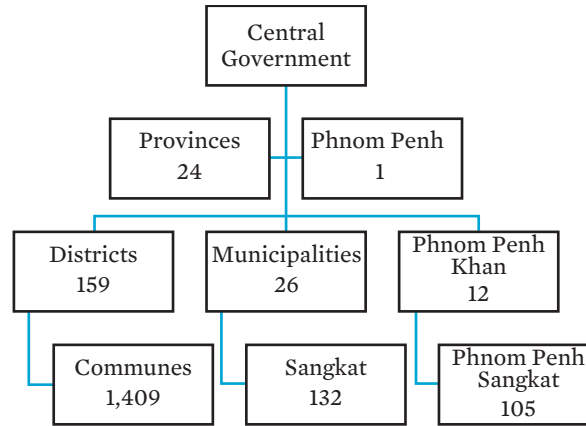
(iii) formula-based mechanisms for conditional and unconditional intergovernmental fiscal transfers; and (iv) the provision of additional capital funding to the communes and *sangkats*. This initial plan understandably put more emphasis on administrative than fiscal aspects of decentralization.

IP3-II (2015–2017) provides greater urgency to progressing the reassignment of obligatory functions to subnational administrations and pursuing more substantial levels of funding for them to improve service delivery. Most emphasis is on prioritizing support to the districts and municipalities. The plan targets significant additional funding for local development through the DMF, conditional grants, and the SNIF, and through own-source tax and nontax revenue powers. It also envisages progress in funding the general mandate and permissive functions as well as the transfer of urban service roles from ministries and provinces to municipalities. Progress is also expected from having district offices take over the functions of deconcentrated offices of the ministries.

There have been various reviews of program and plan implementation, including a midterm review of IP3-I in June 2012, a midterm review of IP3-II in September 2016, and annual reports of the NCDD. In addition, a preliminary draft of IP3-III was prepared in mid-2017 and finalized in October 2017, which in part assesses past performance. Taken together, these reviews indicate important but mixed implementation progress with fiscal decentralization reforms. Nontax revenue collections recorded some progress, but only in introduction of the central property tax to be shared with provinces and not in the reassignment of taxes. The latest draft of IP3-III indicates that, while this original core objective of the program has not been pursued, there will be trialing of own-source subnational revenues during the next 3 years. Some progress has been recorded with reassigning functions, including in education, environment, and social affairs, and also with regulating funding for permissive functions. However, the reviews increasingly indicate a need for more urgency in progressing the reassignment of functions in key ministries. Good progress has been recorded in establishing the basic financial architecture for intergovernmental transfers, including the Law on Financial Regime and Property Management of Subnational Administrations (2011), the DMF, regulations for conditional and unconditional transfers, and establishment of the SNIF. However, concerns have been raised in recent reviews that only limited development funding has been allowed, in part relating to slow progress with functional reassignments and also the constraint of rapid growth in salary costs.

2.2 Structure of Government Administration and Financing Sources

Figure 1 sets out the current structure of subnational administration. Cambodia has a unitary system of government in which the central government exercises ultimate supremacy over policy and legislative matters. Below the central government, there are 24 provinces plus the capital city Phnom Penh, which also has the status of a province. The next tier covers districts and municipalities (referred to as *khan* in the case of Phnom Penh). The fourth and lowest formal tier relates to communes and *sangkats*, though there are less formal structures for village-level administration below the fourth tier. There are very wide dispersions in population levels within each tier of administration (section 4.4.1). Provinces, districts, *khans*, and municipalities all have councils that are indirectly elected by commune and

Figure 1: Structure of Subnational Administrations

Source: National Committee for Sub-National Democratic Development.

sangkat councilors, while commune and *sangkat* councils are directly elected by citizens. The councils are meant to operate along decentralized lines, while there are a significant number of provincial departments and district, municipal, and *khan* offices that operate as deconcentrated units of the central ministries in provincial and district locations. There have been attempts to provide a unified government through coordination of decentralized and deconcentrated units, mainly under the leadership of governors at each level.

Table 1 sets out core funding sources for subnational administrations: (i) taxes shared by the central government (provinces and Phnom Penh only); (ii) nontax revenues; (iii) formula-based unconditional transfers from central government; (iv) negotiated unconditional transfers from the central government (provinces); (v) conditional transfers from central

Table 1: Subnational Administration Core Funding Sources

Provinces/Phnom Penh	Districts/Khans/ Municipalities	Communes/Sangkats
<ul style="list-style-type: none"> Assigned taxes shared by CG Nontax revenues Formula-based unconditional transfers from CG Negotiated unconditional transfers from CG Conditional transfers from CG (including potentially SNIF) Others, including project funding from DPs 	<ul style="list-style-type: none"> Nontax revenues Formula-based unconditional transfers from CG (DMF) Conditional transfers from CG (including SNIF) Conditional and unconditional transfers from province and Phnom Penh (which directly funds its <i>khans</i>) Others including project funding from DPs 	<ul style="list-style-type: none"> Nontax revenues Formula-based unconditional transfers from CG (CSF) Conditional transfers from CG (including potentially SNIF) Conditional and unconditional transfers from district, <i>khan</i>, and municipality Others including project funding from DPs

CG = central government, CSF = commune and sangkat fund, DMF = district and municipality fund, DP = development partners, SNIF = Subnational Investment Fund.

Source: Asian Development Bank.

government (including SNIF); (vi) conditional and unconditional transfers from provinces and Phnom Penh to districts, municipalities, and *khans*; (vii) conditional and unconditional transfers from districts and municipalities to communes and *sangkats*; and (viii) others, including development partner funds. Most transfers from higher to lower subnational levels are small. However, Phnom Penh directly funds its 12 *khans* with the amount in 2015 equivalent to 85% of total DMF transfers in 2015, which cover all other 185 districts and municipalities.

2.3 Key Institutions

The **Ministry of Interior** (MOI) was initially responsible for designing the modern phase of decentralization reforms, though the pivotal role of the NCDD in reform design and implementation has more recently emerged. The MOI remains a key institution with around 10,000 employees in subnational administrations countrywide. Under the Organic Law (2008), the government appoints governors on advice of the MOI, which directly appoints directors of administration, while councils on prior approval of both the MOI and MEF appoint finance directors. The MOI also supervises subnational performance; supports capacity development; and adjudicates on subnational irregularities, including discipline and dismissals. The MOI also chairs the NCDD and provides the bulk of staff of the NCDD Secretariat (NCDDS). The MOI thus retains important political and administrative powers. The respective roles of the MOI and NCDD are sometimes difficult to separate.

The **National Committee for Sub-National Democratic Development** (NCDD), since its establishment in 2008, has coordinated and led the implementation of the Organic Law (2008). It has 16 members (at levels of minister and state secretary) and is chaired by the Minister of Interior, who is also the Deputy Prime Minister. The NCDDS provides secretarial support. Responsibilities include transfer of functions, civil service arrangements, and financial policies and public financial management (PFM) procedures. All ministries and subnational administrations are required to implement decisions of the NCDD; where they fail to do so, the Prime Minister makes final decisions and the MOI is authorized to obligate implementation. While the NCDD has significant powers, in practice it has sought to gradually develop political consensus (which has been difficult). The Organic Law (2008) required the NCDD to establish subcommittees on functions and resources, financial and fiscal affairs, and personnel administration, but these committees have not been active. The role of the NCDDS—although constrained by limited resources—has been influential as one of the key advocates of better fiscal decentralization. It should thus continue to play a major role in fiscal decentralization reform, providing it receives adequate funding and political support.

The **Ministry of Economy and Finance** (MEF) to date has taken cautious and gradual approaches to fiscal decentralization reform. The NCDD, rather than the MEF, has taken the lead role in redesigning the functions of different government levels, and the MEF has not pursued policies of providing significant additional funding to subnational administrations, in part due to uncertainties as to their functional responsibilities and also in support of a transitional approach for maintaining fiscal stability and effective control. Many in the MEF have also questioned the large numbers of subnational administrations and point to the need for reforms to boundaries before functional and fiscal reforms proceed substantially. The MEF adopts a centralized approach to treasury management in subnational administrations. Furthermore, transfers of any direct taxation powers to subnational administrations have stalled, instead preferring revenue-sharing arrangements. Professional working relationships

have been established between the MEF and NCDD, though their fiscal decentralization policy views often differ.

Subnational administrations, particularly at district, *khan*, and municipality levels, have been the key stated focus of fiscal decentralization reforms. Fiscal arrangements for the provinces, Phnom Penh, and the communes and *sangkats* are also important. Chapters 3 and 4 largely focus on reviewing capacities, resources, and performance of the subnational administrations, so they are not addressed in detail here.

The **National Audit Authority**, under the Audit Law (2000), has full responsibilities for auditing all public monies, including subnational administrations. However, it has been able to undertake only a few external audits of subnational administrations to date. This has importantly prevented attainment of adequate performance and financial accountability supervision of subnational operations. Focus has been on ex ante controls and compliance rather than on ex post fiduciary and performance impacts of subnational public expenditures.

Line ministries have important roles in defining and facilitating the reallocation of functions and resources between levels of government. With a small number of exceptions, however, they have played passive roles. The NCDDS is now pursuing alternative approaches, by obtaining ministerial and cabinet support (including support of the Prime Minister) to force the reform of functional assignments through central direction. Progress with unified administration, particularly at provincial levels, has been slow with deconcentrated vertical integration approaches continuing to prevail in most locations.

Development partner support to decentralization has been strong for more than a decade with much of the external support coming in broad governance and accountability areas. ADB has consistently supported fiscal decentralization since 2002 and continues to do so. There has been some pullback from around 15 active partners in 2009 to around 8 at present. In part, this reflects a response to slow progress with decentralization. Development partner funding support through the NCDDS has declined from around \$30 million in 2011 to an estimated \$16 million in 2017.⁶ The European Union and some of its members (including the Government of Sweden) as well as Switzerland have been moving away from projects and support to the NCDDS-managed basket fund to policy-based budget support (including top-up funding to subnational transfer mechanisms). The largely development partner-funded pool system to finance the IP3 annual work plans and budgets will likely be revamped in coming years, with the NCDDS to become an “on budget” entity rather than continue as a development partner-funded “off budget” entity. An earlier objective of redirecting significant external funding through subnational administrations rather than ministries has not yet seen substantial progress.

⁶ National Committee for Sub-National Democratic Development Secretariat (NCDDS). 2017. *Draft Strategy for Third Three-Year Implementation Plan (IP3-III, 2018–2020) of National Program for Sub-National Democratic Development*. Phnom Penh.

2.4 Legal and Regulatory Framework

Since 1998, Cambodia has passed a significant number of laws and lower-level regulations to guide decentralization reform. The passing of the Organic Law in 2008 represented a major milestone for fiscal decentralization. The broad legal structure for fiscal decentralization is briefly reviewed here.⁷ Furthermore, the current regulatory arrangements for each of the key pillars of fiscal decentralization are spelled out in related sections of chapters 3 and 4.

There are six core foundation laws addressing fiscal decentralization matters:

- (i) **Core decentralization laws.** Three important core laws were passed prior to 2008. These were (i) the Law on Provincial and Municipal Budgets and Assets Management (1998), (ii) the Constitution of the Kingdom of Cambodia (1999 revision), and (iii) the Law on the Administration and Management of Communes and Sangkats (2001). There are also two quite important earlier laws: (i) the Taxation Law (1997) and (ii) the Audit Law (2000).
- (ii) **Organic law on decentralization.** The Law on Administrative Management of the Capital, Provinces, Municipalities, Districts and Khans (Organic Law, 2008) provides the core foundation for administrative and fiscal structures for the upper two subnational tiers, covering council structures, powers, and responsibilities, including powers in relation to own-source revenue raising and establishment of intergovernmental fiscal transfers.
- (iii) **Public finance law.** The Law on Public Finance Systems (2008) comprehensively covers all financial aspects of the state (taxes, budget, assets, and liabilities), including subnational administrations (including powers in relation to subnational revenues and budgets), though it required a subnational finance law to be passed to provide the subnational details.
- (iv) **Subnational finance law.** The Law on Financial Regime and Property Management of Subnational Administrations (2011) covers PFM arrangements (including budget preparation and execution) for the upper two tiers of subnational administration. Own-source revenues are provided for but are dealt with in a separate law (to be developed). The broad architecture for the system of intergovernmental fiscal transfers is also provided (to be elaborated with sub-decrees).

Many lower-level regulations have been approved supporting the operation of fiscal decentralization matters. The more important of these regulations passed since 2008 are the following: (i) Sub-decree number 68 on general processes for transferring functions and resources to the subnational administrations, including mapping, review and reassignment implementation procedures (2012); (ii) Sub-decree number 36 establishing the DMF and setting out operating procedures, including funding levels and formulas (2012); (iii) Sub-decree number 285 on management of permissive functions for subnational administrations, setting out procedures for them to regulate their permissive functions in consultation with ministries (2014); (iv) Sub-decree number 32 on establishment and management of the SNIF, including institutional funding and development of the fund portfolio (2016); and (v) Sub-decree number 6 on management of conditional grants, including procedures to apply to

⁷ The superiority of legal instruments in Cambodia is normally in the following descending order: (i) Constitution, (ii) organic laws, (iii) laws, (iv) royal decrees, (v) sub-decrees, (vi) *prakas*, (vii) decisions, (viii) circulars, and (ix) bylaws.

the identification, reassignment, and funding of functions to be supported by conditional grants (2017). There have also been some ministry sub-decrees and *prakas* on delegation and transfer of functions to subnational administrations (Ministry of Tourism; Ministry of Rural Development; Ministry of Education, Youth and Sport; Ministry of Social Affairs; and Ministry of Environment).

Legal coverage of fiscal decentralization has been relatively comprehensive, though there are important gaps. The main gaps (both of which are being worked on) relate to the following: (i) central fiscal transfers to the provinces are still finalized in ad hoc ways, though some informal formulas are being used for a portion of the transfers, and (ii) while specific taxes are currently assigned for sharing with provinces and Phnom Penh, the arrangements for revenue assignments need updating, including the passing of a subnational revenue law as required by the Organic Law (2008) and the Subnational Finance Law (2011) (Chapter 4).

There are legal and philosophical inconsistencies between some legal instruments, mainly between the Law on Communes and Sangkats (2001) and the Organic Law (2008), on the one hand, and the Law on Public Finance Systems (2008), on the other. These inconsistencies create uncertainties as to what decentralization means in the unitary state of Cambodia. The two decentralization laws provide for significant devolution of powers to subnational administrations (raising their own revenues, managing their own assigned expenditures, and taking responsibility for the management and accounting of funds). Conversely, the Law on Public Finance Systems (2008) is centralist in nature in that all revenues are central revenues, and key expenditure management, accounting, and reporting tasks are the responsibility of the central government. At the same time, the two decentralization laws contain provisions inconsistent with common models of decentralization, even in unitary states, including (i) central appointment of boards of governors and directors of administration; (ii) indirect district, municipal, *khan*, and provincial council elections; (iii) limited clarity regarding unified administrations referred to in the laws; and (iv) failure to codify the main functions assigned to different tiers of administration in the Organic Law (2008) or revision to the Constitution. Formally addressing such issues, perhaps by a specially convened commission, would make the path forward much smoother, by allowing pursuit of one agreed system.

2.5 Political Economy and Accountability Framework

Standard models of fiscal decentralization are commonly based on the subsidiarity principle, whereby public sector activities occur at the lowest level of administration possible, providing they meet efficiency criteria (mainly economies of scale). Political accountability elsewhere is seen to be best achieved through local electors choosing candidates who will best meet their welfare and other needs, and removing those who will not. Such models have typically been used where democratic institutions are well developed, usually involving multiple political parties and situations where partisan political dynamics can influence the nature and pace of changes in the geographical distribution of state powers.

Simultaneously pursuing central political control through democratic subnational administrations and allowing devolution of powers aimed at improving local welfare is challenging. Political economy approaches indicate a need to consider whether

decentralization reform aims to fit into or transform the existing centralized system of power. Moving speedily to fully empower local citizen-led accountability in Cambodia has been challenging. To date, citizens have been slow to demand additional powers and resources, and this has influenced the pace of decentralization reform.

In response to concerns about low levels of local citizen accountability, the NCDD approved the Strategic Plan for Social Accountability in Sub-National Democratic Development (2013). The plan seeks to promote citizen engagement in local councils and affairs. The NCDD has developed a framework for action focused on rural areas and has pursued social accountability activities (such as training and awareness raising) to be implemented in approximately 120 districts (70% of rural districts). By implementing this plan, the NCDD hopes local citizens will demand more from subnational administrations, including through their voting decisions in elections. Notwithstanding such accountability initiatives, recent Cambodian approaches to decentralization continue to involve a strong central government pursuing deconcentrated objectives through centrally appointed governors and officials. Under the centralized unitary state model, gradualist approaches to decentralization have been pursued.

2.6 Personnel Management Framework

Personnel management and salary policies at subnational levels are important for fiscal decentralization as salaries take up very significant portions of subnational expenditures. Important progress has been made since the enactment of the Organic Law (2008) with extended efforts to establish a legal basis for employing and managing subnational administration civil servants. A sub-decree issued in 2013 delegated powers to subnational administrations to appoint, transfer, and terminate civil servants working at subnational levels, including for provinces and the capital to appoint, transfer, and dismiss civil servants (apart from directors) in provincial departments of line ministries (so providing support to the unified administration approach).⁸ This sub-decree was supplemented in 2016 with approval of a royal decree on the management of subnational civil servants, which covers a broad range of personnel management areas (recruitment, termination, transfers, working conditions, etc.).⁹

Significant powers are delegated to subnational managers, but standards, salary levels, staff ceilings, and working conditions are still subject to national regulations. Some scope is provided for location allowances to attract quality staff in the regions. Further work is still proceeding to finalize lower-level regulations providing detailed procedures for managing subnational personnel. Finalization of the regulations will allow the MOI to finally transfer around 9,000 of its staff based in subnational administrations to those administrations (though key positions such as boards of governors and heads of administration will remain centralized MOI positions).

One area of particular importance for fiscal decentralization is the staffing and organizational structures of subnational administrations, which currently allow for little flexibility between

⁸ Government of Cambodia. 2013. *Subdecree No. 497 on Delegation of Powers to Subnational Administrations to Appoint, Move, Terminate Civil Servants Working at Subnational Levels*. Phnom Penh.

⁹ Government of Cambodia. 2016. *Royal Decree No. NS/RKT/0416/373. Management of Subnational Civil Servants*. Phnom Penh.

administrations of different sizes and with different resource levels. Smaller subnational administrations tend to have larger staffing levels per head of population and spend a larger proportion of their resources on staffing. There is only limited flexibility for subnational administrations to employ fewer staff and to divert the savings to services or investment. The DMF, for example, is heavily focused on funding staffing and administrative costs with very little residual for development spending. The MOI and the Ministry of Civil Service are reviewing this issue and also considering how civil servants working for ministries at district level could be subsumed under the management of subnational administrations. They are considering revising the structures of subnational administrations and potentially providing more flexibility to administrations to set their own structures according to their sizes and available resource levels.

2.7 Subnational Public Financial Management Framework

Many unitary states operate quite decentralized PFM systems because the central government devolves important financial resources and management powers to lower-level administrations (e.g., Indonesia, Japan, the People's Republic of China, the Philippines, and the Republic of Korea). In Cambodia, all key aspects of the PFM system are centralized (approval of budgets, payment system, accounting, and reporting). Central and subnational PFM systems are essentially identical, which provides the advantage of being able to prepare consolidated general budgets and accounts. Centralized PFM approaches adopted have strongly influenced the design and implementation of the fiscal decentralization system. Inconsistencies between the finance and decentralization laws have constrained subnational administrations from becoming more autonomous and weakened prospects for local citizens to be drivers of local-level accountability.

The centralized PFM system also lessens the efficiency of subnational administration operations. Subnational officials need to make frequent visits to MEF offices in the provinces (and also quite regularly to the MEF in Phnom Penh) and get approval for both complex (e.g., budgets and capital investments) and simpler (e.g., processing minor payments) matters. This gives rise to significant transaction costs and governance risks in financial management and also diminishes responsibilities and accountabilities of subnational administrations.

Some studies of fiscal decentralization include PFM systems and performance as a fifth enabling pillar. For reasons of space and focus, this report will not. This does not mean that PFM reform issues do not warrant addressing to improve overall decentralized fiscal management. Without being exhaustive, these include (i) suboptimal cash flow planning in both the MEF and subnational administrations with significant nonwage expenditure occurring late in the year; (ii) slow and inefficient budget execution and payments processes; (iii) limited comprehensive internal and external reporting by subnational administrations and nationally; (iv) suboptimal subnational budget preparation and resource allocation decisions; and (v) negligible coverage of internal and external audit, which limits oversight of both fiduciary and performance aspects of subnational budgets. These and other matters are being worked on under the PFM Reform Program.

The NCDDS has advised that additional attention will be given to PFM reforms during IP3-III to ensure that resource allocation is more performance based, especially with regard to functions to be transferred. As part of strengthening performance and accountability mechanisms, they will consider introducing fiscal incentives as tools for redirecting funding to priority areas, including the targeting of increased investment and development spending with less emphasis on administrative outlays.

2.8 Capacity Building to Improve Fiscal Decentralization

Developing capacity at the center to design and implement a more effective system of fiscal decentralization is paramount. While technical and skills training, and gaining access to knowledge of alternative systems in other unitary states could be beneficial, capacities in the central government to design a more effective system are generally adequate, though more capacities for rigorous evidence-based analysis of fiscal decentralization could always be developed. Lessening central controls and providing more meaningful powers and resources to more autonomous subnational administrations would require changes to the current PFM reform model.

Raising capacities of subnational officials to take on new functional responsibilities, to prepare better plans, and to operate more effective PFM systems has been the main approach to date, but this has limitations without more substantive fiscal decentralization reform. Much effort and funding has already gone into training, advice, and capacity building for subnational administrations and citizens (planning, management, PFM, accountability, etc.). Those preferring centralized approaches in Cambodia frequently argue that subnational officials lack the technical and management capacities to take on more local responsibilities. Additional technical, management, and financial capacity building is likely to be of benefit, but is not likely to address all the capacity constraints confronting local officials. Limited resources to provide public services due to a lack of assigned functions and resources constrain the capacities of many subnational administrations. Many are frustrated by a lack of power and resources; in situations where officials do not feel responsible or accountable, motivation to raise their own or their institution's capacities is likely quite low. Local-level capacity building needs to be matched at the center by more effective decentralization of functions and resources.

2.9 Summary Assessment

Cambodia has undergone significant and successful institutional and legal reform since passing the Organic Law (2008). The government has established a strong and clear planning, policy, and monitoring framework through the national program and the IP3s. Important new institutions have been established that are functional, including the NCDD, NCDDS, and deconcentration and decentralization working groups in all ministries, which have led efforts in the mapping and review of functions and other reform efforts. A comprehensive legal framework that includes the Organic Law (2008) and the Subnational Finance Law (2011) exists, and these laws have led to important implementing regulations, including

those relating to the mapping and review of functions, as well as the commune and *sangkat* fund (CSF), the DMF, permissive functions, conditional grants, the SNIF, and civil service arrangements. There are coordination arrangements through the NCDD and its ministerial members and also for coordination of the two closely related reform programs for PFM and public administration. Subnational administrations have built up significant capacity, including in PFM areas.

Key institutional and legal reform opportunities for the future lie mainly in the scope for working hard at developing a shared vision—that is, greater consensus between key stakeholders regarding the appropriate nature and content of fiscal decentralization reforms and accountabilities to be pursued. Another is the need to apply the consensus model to finalizing a more consistent set of laws, policies, and procedures. There are also longer-term opportunities for increasing awareness and actions that address the importance of providing and responding to local community voices.

Expenditure Trends and Functional Assignments

3.1 Overview

This chapter reviews expenditure trends and policies with a focus on outcomes sought under the national program: that there would be clear assignments of functions to subnational administrations after the ministry mapping and review, matched by provision of adequate human and financial resources (section 2.1.2). The review covers (i) international comparisons; (ii) total expenditures of all subnational levels; (iii) composition of subnational expenditures, particularly between administrative and development expenditures; (iv) extent of vertical and horizontal expenditure imbalances; and (v) deconcentrated expenditures of central ministries. The data indicate that there are important reform opportunities for rectifying both vertical and horizontal expenditure imbalances, and for improving the composition of expenditures. Much of this chapter consists of reviewing the legal framework and policy approaches to the reassignment of functions from the central to subnational administrations.

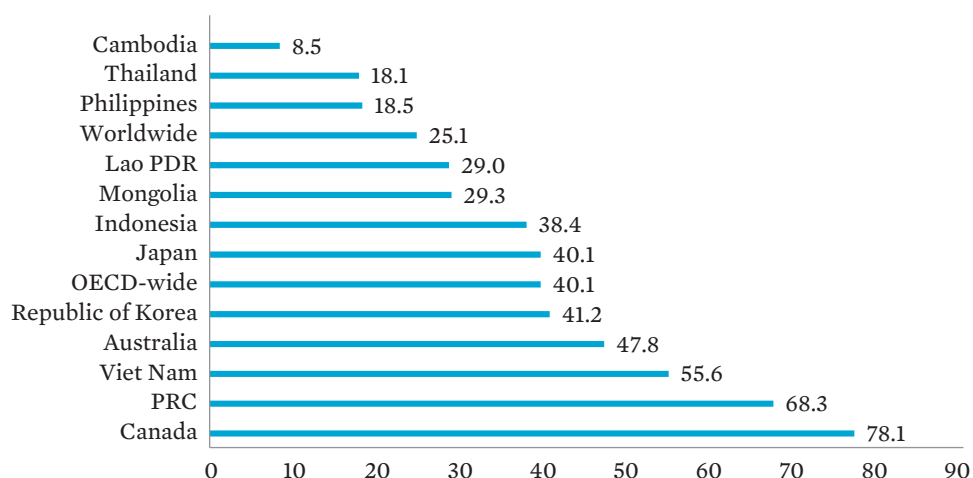
All key stakeholders in Cambodia recognize the fundamental importance of clearly defining the functional responsibilities of the four different levels of administration. However, since the enactment of the Organic Law (2008), tangible outcomes have been weak. This has constrained expenditure levels of the subnational administrations. Many countries started defining their functional assignments by enshrining the division of responsibilities in a constitution or higher-level law. Then through trial and error, often over decades, they made corrections along the way to improve the clarity and quality of the division of responsibilities. Cambodia has proceeded more cautiously, providing mainly general statements in the laws and then applying a combination of bottom-up and top-down approaches to tease out a consensus on the responsibilities. More recently, the National Committee for Sub-National Democratic Development (NCDD) has accelerated legal and political processes. Although progress remains gradual and piecemeal, there are some expectations of accelerated reform in the years ahead.

3.2 Trends in Subnational Expenditures

3.2.1 International Comparisons

Cambodian subnational administrations have low levels of direct expenditures. In 2015, only 8.5% of actual total general expenditures were undertaken by subnational administrations (of which 32.8% by Phnom Penh, 30.3% by provinces, 14.5% by districts and municipalities, and 22.3% by communes). There has been modest growth in the subnational portion, which was

Figure 2: Share of General Expenditures of Subnational Governments by Country, Various Years 2010–2015 (%)



Lao PDR = Lao People's Democratic Republic, OECD = Organisation for Economic Co-operation and Development, PRC = People's Republic of China.

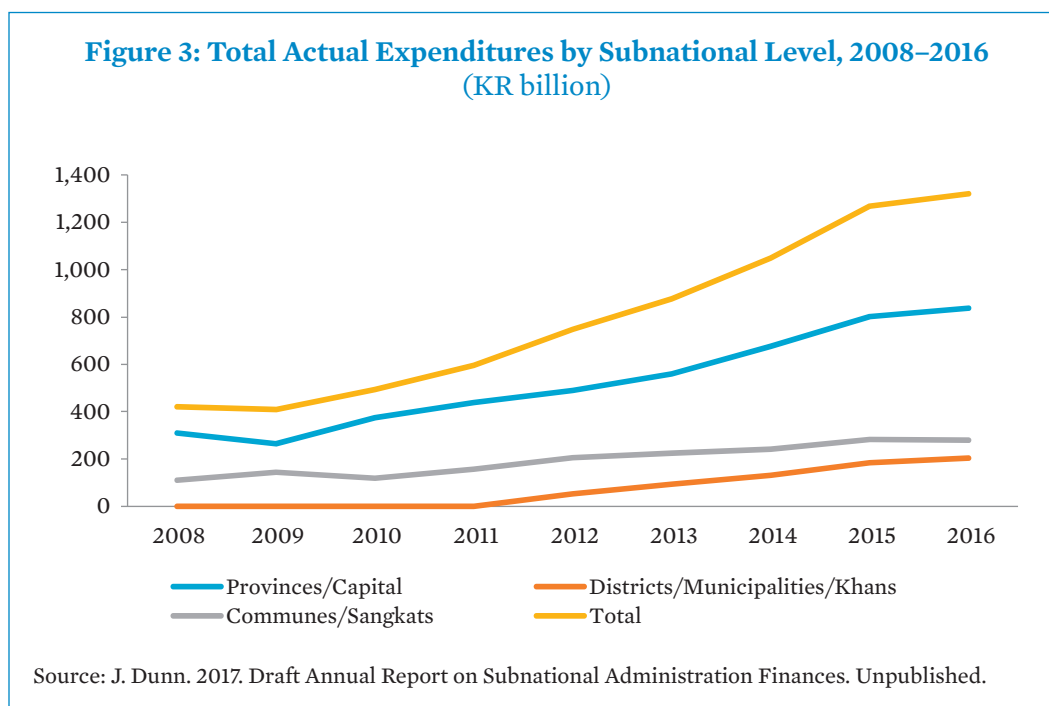
Sources: D. Allain-Dupre. 2016. *Decentralization Trends in OECD Countries*. Paris: OECD; J. Martinez-Vasquez. 2011. *Fiscal Decentralization in Asia: Challenges and Opportunities*. Manila: Asian Development Bank; International Monetary Fund. 2016. *2016 Article IV Staff Reports for Mongolia and Indonesia*. Washington, DC; World Bank. 2015. *Making the Whole Greater than the Sum the Parts: A Review of Fiscal Decentralization in Vietnam*. Ha Noi; and J. Dunn and K. Vutha. 2016. Subnational Fiscal Database for Cambodia. Unpublished.

6.6% in 2008. The great majority of general government spending (91.5% in 2015) belongs to the central government. This indicates a low level of decentralization compared to regional and international examples as measured by the extent of expenditure decentralization (Figure 2). While Cambodia's expenditures are comparatively modest, the National Committee for Sub-National Democratic Development Secretariat (NCDDS) has pointed out that, besides the level of funding, there is likewise scope to improve the effectiveness and efficiency of current spending levels.

3.2.2 Total Subnational Expenditures

There has been significant growth in nominal (and real) total expenditures in 2008–2016 with total expenditures of all subnational administrations growing from KR420.3 billion to KR1,320.8 billion, with compound growth of 15.4% nominal and 12.8% real per year (Figure 3).¹⁰ Significant expenditure growth has occurred for the provinces and the capital city (13.2% nominal and 11.0% real per year). The communes and *sangkats* have grown a little more slowly at 12.1% nominal and 10.0% real per year. While from a very low starting base in 2012 and initial years of slow implementation, the districts and municipalities have grown

¹⁰ Real growth estimates in this paragraph were calculated by applying gross domestic product deflators to nominal expenditure growth.



quite rapidly at 40.2% nominal and 33.4% real per year over the period (though per capita funding remains quite low; see Figure 4). As a proportion of gross domestic product (GDP), total expenditures of all subnational administrations increased modestly from 1.0% of GDP in 2008 to 1.6% of GDP in 2016.

3.2.3 Composition of Expenditure by Subnational Tier

The composition of actual expenditure by subnational tier is summarized in Table 2 based on average expenditures over the 3-year period, 2014–2016.¹¹ For the communes and *sangkats*, salaries and allowances plus administrative expenses represented 49.3% of expenditures with developmental expenditures at 50.7%. Salaries and allowances at 42.0% of expenditures have grown rapidly, with an earlier study indicating that from 2002 to 2007 these only averaged 24.2% of total expenditures (footnote 5). For the districts, municipalities, and *khans*, salaries and allowances plus administrative expenses represented 75.9% of expenditures, with developmental expenditures at a low 9.6%. After a decade of targeting the districts and municipalities as the key focus of local-level development, very little development funding is flowing to them. For the provinces and Phnom Penh, salaries and allowances plus administrative expenses represented only 16.9% of expenditures, with development expenditures much higher at 75.4%. Provinces, especially Phnom Penh, have significantly more fiscal space for development expenditures.

¹¹ Reliable expenditure composition data prior to 2014 are not available.

Table 2: Actual Expenditure of Subnational Tiers by Type, Average of 2014–2016 (%)

Expenditure Type	Communes and Sangkats	Districts, Municipalities, Khans	Provinces and Phnom Penh
Salaries and allowances	42.0	45.3	4.7
Development (capital + maintenance)	50.7	9.6	75.4
Administrative (goods and service + social)	7.3	30.9	12.2
Transfers and subsidies	0	14.2	7.7
Total	100.0	100.0	100.0

Source: J. Dunn. 2016. ADB Technical Assistance to Cambodia for Decentralized Public Service and Financial Management Sector Development Project. *Subnational Fiscal Database for Cambodia*. Manila: ADB.

3.2.4 Horizontal Imbalances in Expenditures

Apart from Phnom Penh, other larger municipalities are poorly resourced. Shared tax revenues outside Phnom Penh flow to provinces and not municipalities or districts. In 2016, excluding Phnom Penh, there were five municipalities with populations exceeding 75,000. Table 3 sets out wide per capita expenditure differences between small, medium, and large urban centers. Phnom Penh is particularly advantaged with high per capita expenditures itself (14 times the median per capita spending of all provinces), and also through its *khans*, which on average receive twice the per capita funding of the five next-largest urban centers. These differences largely reflect imbalances in the distribution of shared tax revenues and failure to explicitly consider revenue-raising capacities of different locations within the transfer formula.

Table 3: Per Capita Actual Expenditures of Municipalities, *Khans*, and Phnom Penh, 2016

Municipality	Population (2016)	Per Capita Expenditure (riel)
Ta Khmao	76,733	28,271
Preah Sihanouk	78,380	27,612
Serei Sophoan	91,158	30,707
Battambang	155,584	25,424
Siem Reap	230,157	22,997
Average of remaining 19 municipal province centers	37,904	41,338
Average of 12 <i>khans</i> within Phnom Penh	120,612	54,157
Phnom Penh City	1,447,340	342,522
Memorandum items		
Median per capita all (rural) districts	...	7,812
Median per capita all provinces (excluding the capital)	...	24,066

Source: J. Dunn. 2016. ADB Technical Assistance to Cambodia for Decentralized Public Service and Financial Management Sector Development Project. *Subnational Fiscal Database for Cambodia*. Manila: ADB.

Table 4: Measures of Horizontal Expenditure Imbalances, 2016

Subnational Level	Expenditures				
	Median Per Capita (\$)	Highest Per Capita (\$)	Lowest Per Capita (\$)	Ratio of High to Low Per Capita	Coefficient of Variation (%)
Communes	4.64	23.33	1.74	13:1	47.5
Districts, municipalities, <i>khans</i>	2.26	20.33	0.67	30:1	100.7
Provinces and Phnom Penh	5.96	81.55	3.24	25:1	133.3

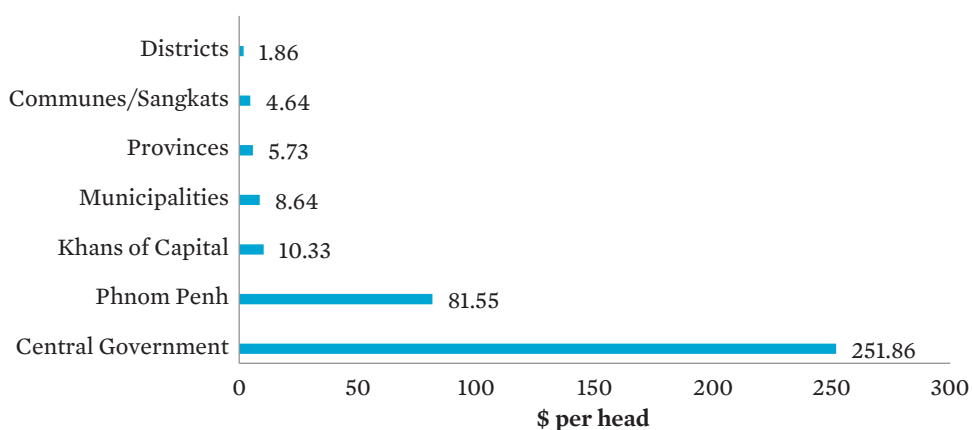
Source: J. Dunn. 2016. ADB Technical Assistance to Cambodia for Decentralized Public Service and Financial Management Sector Development Project. *Subnational Fiscal Database for Cambodia*. Manila: ADB.

There is significant horizontal imbalance within each of the three subnational levels, particularly within tiers for districts, municipalities, and *khans* and for provinces and Phnom Penh, with less imbalance for communes and *sangkats*. Table 4 summarizes the measures of variation in total per capita revenues and expenditures (2016 data). Such large horizontal variations are very high by international standards and would not be sustainable in many countries. Chapter 4 returns to the reasons for such wide variances in more detail.

3.2.5 Vertical Imbalances in Expenditures

There is significant vertical imbalance in expenditures between levels of administration in Cambodia (Figure 4). The fiscal system remains heavily centralized and provides significant per capita benefits to Phnom Penh and its citizens. This raises important policy questions. While districts have been the focus of the national program and its two IP3s, their per capita revenues and expenditures are much lower than all other administrative tiers, including the

Figure 4: Median Per Capita Expenditures of Different Administrative Tiers, 2016
(\$)



Source: Actual data from J. Dunn. 2016. ADB Technical Assistance to Cambodia for Decentralized Public Service and Financial Management Sector Development Project. *Subnational Fiscal Database for Cambodia*. Manila: ADB.

municipalities. It also raises questions as to the appropriate role and funding levels of the provinces, which under the national program are meant to play largely coordinating roles and in practice spend little on province-wide infrastructure or other major development projects. Chapter 4 will return to the provision of such high per capita resources to Phnom Penh, and its *khans*, which is largely due to an outdated revenue-sharing system.

3.3 Deconcentrated Expenditure Trends

Cambodia's national program is based on both deconcentration and decentralization reforms with unified approaches to subnational administration. Deconcentrated and decentralized administrations are expected to cooperate closely to enable functions and resources to be gradually transferred from deconcentrated to decentralized administrative units. It is thus important to understand trends and the nature of deconcentrated expenditures.

Significant deconcentrated activities of line ministries in provinces and districts have occurred for extended periods. In 2016, 24 of the 35 core central ministries and budget agencies (68.6%) were represented in the provinces and districts. In almost all cases, this involves a permanent presence in each of the 24 provinces through provincial departments (including in Phnom Penh) and some (less extensive) presence through district offices in most of the 197 districts, municipalities, and *khans*.

The extent of total deconcentrated expenditure has expanded between 2010 and 2016, with budgeted expenditure of provincial departments of all ministries rising as a proportion of total ministry spending from 26.9% in 2010 to 31.4% in 2016.¹² Between 2010 and 2016, total central office budgeted activities of ministries grew by 56.8%, while those of provincial departments grew by 111.3%.

Growth in provincial department budgeted expenditures has been heavily concentrated in a small number of ministries. Between 2010 and 2016, the five with the highest growth were the (i) Ministry of Land Management (391.7%); (ii) Ministry of Education, Youth and Sport (202.0%); (iii) Ministry of Justice (188.9%); (iv) Ministry of Labour and Vocational Training (150.3%); and (v) Ministry of Health (129.8%). All other ministries grew well below total provincial department average growth of 111.3%.

In terms of expenditure composition, the great bulk of deconcentrated provincial department-budgeted expenditure occurs in a small number of ministries. As set out in Table 5, 83.8% of provincial department-budgeted expenditures in 2016 were concentrated in three ministries (Ministry of Education, Youth and Sport; Ministry of Social Affairs; and Ministry of Health)—and this trend to concentration has intensified between 2010 and 2016.¹³ While the 21 other

¹² Section 3.3 is based on government budget data from Government of Cambodia, Ministry of Economy and Finance, General Department of Treasury. 2017. *Special Report on Budgeted Deconcentrated Expenditure of Ministries, 2010 to 2016*. Phnom Penh. Estimates exclude consideration of unallocated expenditures and are thought to underestimate capital expenditures. If all unallocated expenditures are assumed to be undertaken in the central offices of ministries, the proportions spent through provincial departments are 14.6% in 2010 and 19.0% in 2016.

¹³ Note that most large projects and capital expenditures of ministries are recorded in their central office accounts. Unallocated expenditures are also significantly applied to capital expenditure. The main capital spending ministries are considered to be understated in Table 5, particularly the Ministry of Public Works and Transport, Ministry of Rural Development, and Ministry of Water Resources and Meteorology.

Table 5: Provincial Department Budgeted Expenditure by Ministry, 2010 and 2016
(%)

Ministry	Total Ministry Expenditure	
	2010	2016
Ministry of Education, Youth and Sport	36.3	51.8
Ministry of Social Affairs	12.7	19.6
Ministry of Health	11.4	12.4
Ministry of Agriculture, Forestry and Fisheries	2.2	1.7
Ministry of Land Management	0.7	1.7
Ministry of Public Works and Transport	2.2	1.5
All remaining 18 ministries and agencies	34.5	11.3
Total	100.0	100.0

Source: Government of Cambodia, Ministry of Economy and Finance, General Department of Treasury. 2017. *Special Deconcentration Report*. Manila: ADB.

ministries have a presence in all provinces, in most cases it is smaller with low levels of mainly current expenditure.

Budgeted expenditures of provincial departments are heavily focused on current expenditure, particularly wages. In 2010–2016, wages accounted for 79.5% of all provincial expenditures. The three largest ministries in terms of provincial department expenditures (Ministry of Education, Youth and Sport; Ministry of Social Affairs; and Ministry of Health) accounted for 88.9% of total provincial department wage expenditures, with the Ministry of Education, Youth and Sport accounting for 56.4% of the total (mainly for teachers' wages).

Ministries are increasingly locating more staff in the provinces and districts—generally junior and lower-cost staff—though this trend may be changing. In 2010, 60.2% of total ministry wages were spent in central offices with 39.8% spent in the provincial departments. By 2016, only 51.8% of total ministry wages were spent in central offices with 48.2% spent in the provincial departments. Relatively low pay levels in the provinces and districts, particularly for teachers, and health and social welfare workers, mean that per worker unit wage costs are higher in Phnom Penh than in the subnational administrations.

There are important implications of deconcentration trends for decentralization policy. Since the bulk of deconcentrated expenditures occur through the three largest ministries, these are the ministries to pursue if significant fiscal decentralization is desired—and indeed, these have been high priority for the NCDD in their efforts to achieve more functional transfers and delegations. The larger capital spending ministries, although not fully reflected in the data analysis, also require close consideration (particularly the Ministry of Ministry of Public Works and Transport, Ministry of Rural Development, and Ministry of Water Resources and Meteorology). This would, however, require central offices, particularly the Ministry of Economy and Finance (MEF), to release their current strong control over their projects. The lower deconcentrated expenditures of some other ministries do not lessen their potential for more decentralized approaches. For example, the Ministry of Agriculture, Forestry and Fisheries and the Ministry of Labour and Vocational Training have functions that appear well

suited to more decentralized approaches. In such cases, they would need additional funding to make their services more effective in the regions.

Taking on poorly functioning and underfunded activities in the subnational administrations may not be a palatable outcome for subnational administrations, unless additional conditional or unconditional funding can be found. Other ministries with low spending—operating in the provinces and districts—may well be undertaking useful administrative type functions, but would have only moderate fiscal impact should significant reassignments occur. In a significant number of cases, the units with lower spending may have opportunities to transfer all or at least a major proportion of their functions to subnational administrations. These include activities of the Ministry of Commerce, the Ministry of Culture and Arts, the Ministry of Environment, the Ministry of Culture and Religion, the Ministry of Women’s Affairs, the Ministry of Tourism, the Ministry of Land Management, and the Ministry of Industry and Handicrafts. A government task force is currently exploring procedures for merging such deconcentrated district offices under the district councils.

3.4 Addressing Low Levels of Subnational Developmental Expenditure

Section 6 of the Organic Law (2008) prohibits subnational administrations, including Phnom Penh, from borrowing or raising bonds. Subnational administrations (with the exception of Phnom Penh) have negligible opportunities to fund even small-sized infrastructure or development projects (section 3.2) from current funding sources. It is not unreasonable to think that a portion of future public development spending should occur through the subnational administrations, particularly the larger ones (though it is recognized that the central government also has limited, albeit growing, funding to support investment spending, and that capacities to design and manage subnational projects are constrained).

Proposed conditional transfers for reassigned and delegated functions are not likely to bring with them much additional capital funding. It is indeed more likely that they will bring with them a lot of future investment needs (e.g., school buildings, medical equipment, irrigation systems) but with no clear medium-term arrangements for financing ongoing and new development requirements. At present, the subnational administrations are largely excluded from central processes for formulating public investments, for both domestic- and foreign-financed projects, which are typically formulated and managed by the central ministries, including the MEF. Formulation of the Public Investment Program itself has weaknesses which the MEF and Ministry of Planning are working to address, including through a current expenditure review of public investment supported by the World Bank.

The government could consider treating larger subnational administrations as potential beneficiaries of projects from revamped public investment processes that might be introduced following an investment review in 2017. This could include donors arranging financing directly with subnational administrations, which could be their principal implementing agencies, though still with the agreement and guarantees of the MEF. Bilateral development partners and civil society organizations are less constrained in dealing directly with subnational

administrations as the law allows them to provide direct grants and they have more than a decade of such experience. The NCDD may also consider introducing fiscal incentives to encourage more productive expenditure patterns from subnational administrations.

3.5 Key Laws on the Assignment of Functions

The following important laws were in place before 2008 and retain relevance today:

The **Law on Provincial and Municipal Budgets and Assets Management (1998)** defined a list of obligatory functional expenditures of provinces and municipalities, and also provided scope for miscellaneous nonobligatory expenditures. As a result of this law, many provincial administrations, in conjunction with provincial departments of ministries, still see their role as providing basic management services in the capital town of the province. Broader coordination and planning roles of provinces, and the promotion of cross-district infrastructure spending, do not appear to be well-defined or implemented.

The **Commune and Sangkat Law (2001)** provided for elected councils to use all resources to address basic local community needs, serve common interests, and support national policies. Broad functional responsibilities were set out in the law. Further powers and responsibilities were to be assigned in line with higher laws and regulations, but these have not been passed. As a result, commune responsibilities and activities have been practically shaped and constrained by limited budget resources. Despite resource constraints, most commune councils have been able to get on with local projects and administration flexibly and effectively.

The **Organic Law (2008)** provided only general advice on functional responsibilities of all levels of subnational administrations. It did not set out in any detail the different roles, for example, of districts versus provinces. Instead, processes for reviewing functions at different levels were set out with the view that subsequent legal instruments would address the actual functions to be assigned or delegated. The NCDD was made responsible for undertaking reviews and defining responsibilities in later legal instruments. Reviews covered key priority sectors: (i) agriculture; (ii) education; (iii) forestry, natural resources, and environment; (iv) health, nutrition, and services; (v) industry and support to economic development; (vi) land use; (vii) electricity production and distribution; (viii) water management; (ix) infrastructure and facilities; and (x) special local needs, including tourism, historical sites, and cultural heritage. The central government can permanently assign or delegate function in line with agreements. The roles of different levels of administration would include obligatory functions and permissive functions. While the NCDD subsequently undertook a significant number of technical reviews of different sector ministries from around 2010 to 2015, no clear overall picture of the full roles and responsibilities of different levels of subnational administration has appeared.

The **Subnational Finance Law (2011)** was largely silent on the assignment of functional responsibilities, focusing mainly on budget and public financial management (PFM) procedures, though it did make clear that if the government were to assign or delegate obligatory or permissive functions, these should be fully funded by the transfer or creation of budget resources.

3.6 Practical Approaches and Lower Level Regulations for Reassigning Functions

Functional mapping and review. Following the enactment of the Organic Law (2008), for a period from around 2010 to 2015 and with development partner support, the NCDD focused on undertaking detailed mapping and then reviews of the functions of key ministries, including those responsible for education, health, social affairs, agriculture, forestry, fisheries, rural development, and irrigation. In line with detailed NCDD guidelines, this work produced a lot of very detailed functions and subfunctions for possible assignment or delegation (hundreds in some ministries and thousands in one ministry). However, this did not lead to many substantive or well-coordinated decisions by either the NCDD or the ministries concerned, many of which were reluctant to give up powers and resources. To some extent, this mapping and review work continues today within other ministries (including those responsible for public works, transport, the environment, and tourism), though work is proceeding in less detail. While the results of this less detailed work seem easier to follow, there appears to be no identification and agreement of major functions to assign or delegate, or, more importantly, substantive government-wide coherence to a reform strategy for reassigning substantial assignments.

The NCDD has concluded in recent years that it needs a more direct top-down politically led approach, particularly with the backing of the Deputy Prime Minister and Minister of Interior—and in some cases, the Prime Minister and the Cabinet. This approach is starting to produce results, though still at the level of individual ministries. Many remain reluctant even if politically pressured. Key sectors and ministries broadly agreed on the transfer of 28 functions across the following: (i) education; (ii) public works; (iii) transport; (iv) environment; (v) agriculture; (vi) forestry; (vii) fisheries; (viii) rural development; (ix) social affairs; (x) tourism; and (xi) irrigation. These are at varying stages of development with a small number having been recently approved for functional reassignments or delegations. Section 3.7 reviews the more substantive of these initiatives by ministry.

Progressing permissive functions and the general mandate. Running concurrently with this work, the NCDD has spent significant time working on defining and progressing the role of permissive functions (the so-called general mandate) at subnational levels and particularly for municipalities and districts. Sub-decree No. 285 (November 2014) addresses permissive functions of subnational administrations, setting out management arrangements for permissive functions for all three subnational tiers. It focuses on procedures for identifying and regulating discretionary actions that the local administrations choose themselves, which either must not be the responsibility of a central government ministry or, where it is a central ministry responsibility, the relevant ministry has no objection to local provision of the activity.¹⁴ Principles whereby local discretionary functions can be selected (i) are not legally prohibited; (ii) are under the jurisdiction of the relevant council; (iii) can be effectively and efficiently managed locally; (iv) can provide benefits to local citizens; and (v) meet the needs of local citizens, especially women, children, and the vulnerable. The council shall approve agreed permissive functions to be included in the relevant subnational development and

¹⁴ Government of Cambodia. 2014. *Sub-decree No. 285 on The Selection, Management Arrangement and Execution of Permissive Functions by Subnational Administrations*. Phnom Penh.

investment plans and budgets (if necessary, after agreement with the responsible ministry is formally reached).

The permissive functions approved can be financed by any legal source (unconditional transfers, shared taxes, nontax revenues, etc.) and fees can be charged for services provided (subject to a joint *prakas* of the MEF and MOI). In 2015, the NCDDS issued a technical manual to assist subnational administrations to prepare permissive functions with advice on their identification, planning, budgeting, and implementation. This work has allowed subnational administrations to asymmetrically develop permissive functions in line with local needs, resources, and capacities. However, further work is needed to delineate responsibilities of the three levels of subnational administration. Even with a very minimalist model of decentralization, there is a strong case to agree and codify that districts—not provinces or provincial departments of central ministries—should manage all basic urban services such as streetlights, markets, public parks and spaces, footways, curbs and gutters, local water systems, and sanitation, which are properly local functions. The architecture for permissive functions now allows this to occur.

The NCDD and the government are currently considering reassigning all functions and resources of deconcentrated district and municipal offices of provincial departments to subnational administrations. This proposal may come to fruition over the coming years in one form or another. Most of the 24 ministries and agencies with provincial departments also have district and municipal offices, with the average district typically being physically represented by at least 20–25 national ministries, with a total of around 100–120 staff members (mostly in education and health offices, and service centers). Such deconcentrated proliferation creates inefficiencies not found in too many other countries, even unitary states.

Most district offices (apart from education and health) have very limited resources and relatively junior staff members (often generalists not technically qualified), ranging from 1 to 12 staff members with most offices at the lower end of the range. Most have quite limited or, in many cases, no office building to work out of and many are expected to use their own vehicles. Generally, district offices have very few recurrent resources such as funds to travel outside the district center, or even to have electricity or running water. The district offices of education and health are better resourced with permanent offices, significant staff numbers, and access to reasonable recurrent resources.¹⁵ District education offices typically have around 15–30 administrative and professional staff, with the number of teachers varying widely according to district size (between 500 and 2,000 teachers per district). Regional health offices have between 150 and 250 staff, including those in health centers and referral hospitals. In most cases, there is reasonably good coordination and cooperation between the ministry district offices and the subnational administration through the Office of the Governor and the Chair of the Council, so it would not be a huge step to put these officials under the management and supervision of the subnational administration. However, simply transferring in most cases very poorly resourced units to the subnational level alone would not be enough.

¹⁵ The Ministry of Health is not represented in all districts and municipalities, instead locating in regions based on where most of its clientele resides. There are 90 health regions with approximately one health center for every two districts. The General Departments of Forestry and Fisheries of the Ministry of Agriculture, Forestry and Fisheries similarly are not in all districts but rather in line with where fisheries and forestry resources are located, respectively. These exceptions present interesting alternative service delivery models and also point to likely needs and opportunities for subnational administration boundary revisions.

The current interministerial task force will need to give broader consideration to the following: (i) additional human and financial resources will be needed, with some transfers from provincial departments possible; (ii) the lack of basic office and other infrastructure for many agencies needs to be addressed; (iii) the current lack of technical skills (e.g., engineering, agriculture, social welfare, etc.) will need to be bolstered whether directly or through coordination with provincial departments; (iv) the need for presence of so many poorly resourced national agencies at district level warrants review with scope for operational efficiencies, allowing freeing of some resources for higher-priority areas; (v) there may be a need to amalgamate some very small districts or to follow the health model and provide services regionally; and (vi) most fundamentally, additional resources will need to be found to properly fund agreed public services at the district level if service delivery is to improve.

The legal infrastructure to enable assignment and delegation of functions from central ministries has improved. This has included a sub-decree (2017) on conditional grants for subnational administrations, various sector-specific sub-decrees making arrangements for functional transfers, and fairly standardized ministerial *prakas* setting out procedures and arrangements within each ministry. For delegations, fairly standardized legal agreements setting out detailed arrangements for particular ministries have been prepared. In many cases, sector laws will need to be revised to reflect functions that have been transferred to subnational administrations, which is expected to be a time-consuming exercise. Progress in preparing and utilizing the new legal architecture has been important as it provides fairly well-established means to bring into effect specific transfers and delegations.

3.7 Approaches to Reassigning Functions in Targeted Ministries

Ministry of Education, Youth and Sport. Following significant functional mapping and review in 2010–2014, a sub-decree and ministerial *prakas* (2016) provided for transfers to district and municipal office operations for primary schools management, early childhood learning, and nonformal education. The ministry plans to pilot the reforms in Battambang Province from late 2017. Limiting transfers to staff and funding of the district offices, with exclusion of teachers' wages and grants to individual schools, resolved the earlier implementation delays. The limited activity and funding of early childhood and nonformal teaching at district levels in the past have restricted the resources that can be transferred.

Ministry of Health. Despite significant functional mapping and review, there has been no sub-decree or *prakas* formalizing the transfer of major functions. The use of health centers, which typically manage two districts (footnote 21), raises complexities as to how to manage the 1,158 health centers going forward. In 2015, regulatory and licensing powers were delegated to provinces and districts for private health services (pharmacies, postnatal clinics, physiotherapists, dentists, and nurseries). Ten special operating agencies manage hospitals and specialized facilities under local governing boards, though still under ministry supervision. Piloting of transfers of functions to provincial and district health centers (including functions, personnel, and financial resources) is planned for 2018 or 2019.

Ministry of Public Works and Transport. The ministry has undertaken functional mapping and reviews, and has prepared a 2017 action plan containing transfers and delegations of eight functions. The proposed delegations are (i) management of roadside rights of way in provincial

and district towns, (ii) licensing examinations for vehicles, and (iii) issuance of drivers licenses. Proposed transfers are (i) construction, repairs, and maintenance of provincial and municipal roads; (ii) management of vehicle cleaning agencies; (iii) licensing motorbikes and *tuk-tuk* (motorized rickshaw) vendors and service providers; (iv) examination of motorbikes and *tuk-tuks* for licensing and safety; and (v) inspection of motorbike and vehicle cleaning services. The ministry plans to issue a sub-decree and *prakas* in 2017, including provision for the transfer of personnel and resources.

Ministry of Environment. Sub-decree No. 113 (2015) and a joint *prakas* (2016) transferred obligatory responsibilities for garbage and solid waste management to the districts and municipalities, leaving policy development, technical support, and supervision with the ministry. These services were previously only available in a small number of municipalities and, in most cases, there were neither assets nor budgets to transfer. About 26 municipalities now receive modest additional central funding to support this function (around \$2 million in total per year), but many districts will need to find the resources from their unconditional funding. Other initiatives approved and underway are (i) delegation of certain responsibilities for management of protected areas to 64 districts, (ii) provision of climate change resilience responsibilities through small district grants, and (iii) transfer of responsibilities for environmental education. The ministry is also pursuing preparatory work on other functional transfers, including (i) liquid waste and sewerage management, (ii) management of plastic waste, and (iii) employment of rangers for protected areas.

Ministry of Agriculture, Forestry and Fisheries. The ministry undertook extensive functional mapping and review exercises from 2010, and continues to review transfer and delegation possibilities without tangible progress. Work in 2017 aims to identify six functions (one for each of the general departments) and to then pilot reforms in three provinces and selected districts. The ministry has only moved gradually to date in supporting implementation of the reforms with no sub-decree or *prakas* in place.

Ministry of Rural Development. The ministry, in 2014 and 2015, through ministerial *prakas* and memorandums of understanding, commenced piloting the transfers for two functions to rural districts (both are still underway). The pilots are (i) operation and maintenance of water supply pumps and facilities (seven districts in three provinces, with plans to extend the pilot to dig new wells and increase coverage from 7 to 11 districts), and (ii) training and community development in sanitation and health, and hygiene matters (10 districts in two provinces, with plans to extend the pilot to a further five districts in 2017 and 2018). The ministry provided no permanent officials and only moderate training resources to support these pilots. Pilots to transfer rural roads maintenance to four rural districts in three provinces are also being considered.

Ministry of Social Affairs, Veterans and Youth Rehabilitation. The ministry has undertaken detailed functional mapping and review since 2010. Three functions are being actively pursued (including piloting in Battambang in 2016), with a sub-decree and *prakas* (2017) providing for transfers of (i) national orphan centers to provincial administrations (all 22 centers are located in 18 provinces); (ii) monitoring of civil society organizations working with orphans to provinces and municipalities and districts, though primarily the responsibility of municipalities and districts; and (iii) community management of orphan centers and operations to provinces, districts, and communes, though primarily the responsibility of communes. Conditional grants through the 2018 budget and beyond (transitional funding through the ministry budget in 2017 has been provided) will ensure sufficient funds for

the transfer of assets, budgets, and personnel. Whether future conditional grants will be adequate remains to be seen. Development partner funding support is being sought to assist in the transition.

Ministry of Tourism. The ministry commenced mapping and reviewing functional responsibilities in 2015. This led to a plan to delegate the licensing, management, and supervision of adult entertainment venues (karaoke, discotheques, and beer gardens) to provinces and eventually districts. Piloting commenced in four provinces, but the absence of one-stop service centers in these locations has slowed progress. A sub-decree and MOI *prakas* will be issued soon to address this problem. No transfer of personnel or finances from the ministry are planned, but a portion of the licensing and other fees will be passed on to the subnational administrations in line with a schedule of approved fees issued by joint *prakas* of the Ministry of Tourism and MOI. One further functional transfer under close consideration is the licensing and management of smaller hotels and guesthouses with fewer than 20 rooms.

3.8 Summary Assessment

The assessment focuses on progress toward the key expenditure and functional assignment outcomes pursued under the national program (sections 2.1.2 and 3.1). The trend data presented in this chapter suggest that important opportunities for the future relate to rectifying both vertical and horizontal expenditure imbalances and improving the composition of expenditures. The causes of the imbalances (which are discussed further in Chapter 4) are well understood and have been agreed for some time, and reaching consensus on how to address them would assist in designing an improved system of fiscal decentralization for the future. Furthermore, the analysis of deconcentration data indicates areas that are likely to be most productive in terms of (i) pursuing functional transfers and delegations (particularly the larger spending and more strategically important ministries, including those responsible for education, health, and social affairs), and (ii) achieving efficiencies through rationalization of central deconcentrated actions in the provinces and districts, most probably commencing with subsuming all district office functions of provincial departments under subnational administrations.

The NCDD has been very active with regard to expenditure policy since 2008, particularly on pursuing the transfer and delegation of functions to subnational administrations, notwithstanding the limited final outcomes so far, with further work and effort still needed over the medium term. The Organic Law (2008) and the national program have provided substantive legal and policy frameworks for transferring significant functions to the subnational administrations. Line ministries have carried out extensive mapping and reviews of their functions. Recently, more direct legal and political approaches have been pursued, including passing of the 2014 sub-decree on permissive functions (general mandate) and the 2017 sub-decree on conditional grants, both of which considerably enhance the scope for intensifying the pace of transfers and delegations of functions over time. Under the increasingly proactive approaches of the NCDD, the reassignment of functions in the ministries responsible for health, education, social affairs, the environment, rural development, and tourism has progressed well, and it is likely that these efforts will lead to even more substantial achievements in coming years. For lagging ministries, more proactive approaches are needed, including more arbitrary enforcement of legal and political requirements on them.

Subnational Revenues Including Intergovernmental Fiscal Transfers

4.1 Overview

This chapter reviews subnational revenue trends and policies, including intergovernmental fiscal transfers, with a focus on outcomes sought under the national program: passing of an own-source revenue law with subnational administrations having powers over policies and rates, along with establishment of an effective and equitable system of shared taxes and intergovernmental fiscal transfers (section 4.2).

Section 4.1 reviews data trends with subnational revenues (which comprise tax and nontax revenues and intergovernmental fiscal transfers). Section 4.2 reviews the legal and regulatory framework for subnational revenues. Section 4.3 reviews policy issues for own-source revenues. Section 4.4 reviews policy issues for shared taxes and fiscal transfers, and section 4.5 concludes with a simulation of an option for reforming current fiscal transfer and shared taxation arrangements. In this chapter, shared taxes and intergovernmental fiscal transfers both form part of the revenues of subnational administrations. While they represent different approaches to sharing revenue, they contain many identical features. The main fiscal transfers—commune and sangkat fund (CSF), district and municipality fund (DMF), and formula-based provincial transfers—are all calculated according to prescribed shares of the general revenue base, while shared taxes are linked directly to specific taxes that are raised at the central level. The simulation provided is based on consideration of a merging of the current two approaches into one.

Theory and practice internationally suggest that devolving revenue powers to subnational administrations can be beneficial in terms of enhancing their revenue adequacy and through improving accountability of local administrations to citizens, by having local revenues fund local services.¹⁶ Limited progress with devolving functional responsibilities has slowed progress with devolving revenue powers in Cambodia, with administrations reluctant to assign revenues while functional responsibilities are unclear. The prevailing policy has been to take a cautious approach to assigning own-source revenues to lower administrative levels, notwithstanding that Article 6 of the Organic Law (2008) and the Subnational Finance Law (2011) mandate the passing of laws to codify such devolution. Since 2008, solid progress has been made in designing comprehensive systems of intergovernmental fiscal transfers, though limited funding has flowed through these mechanisms to date. Furthermore, there are major allocation distortions and imbalances that need to be addressed along with the system of shared taxation. The simulation set out in the chapter provides one example of how current distortions and imbalances might be simply addressed.

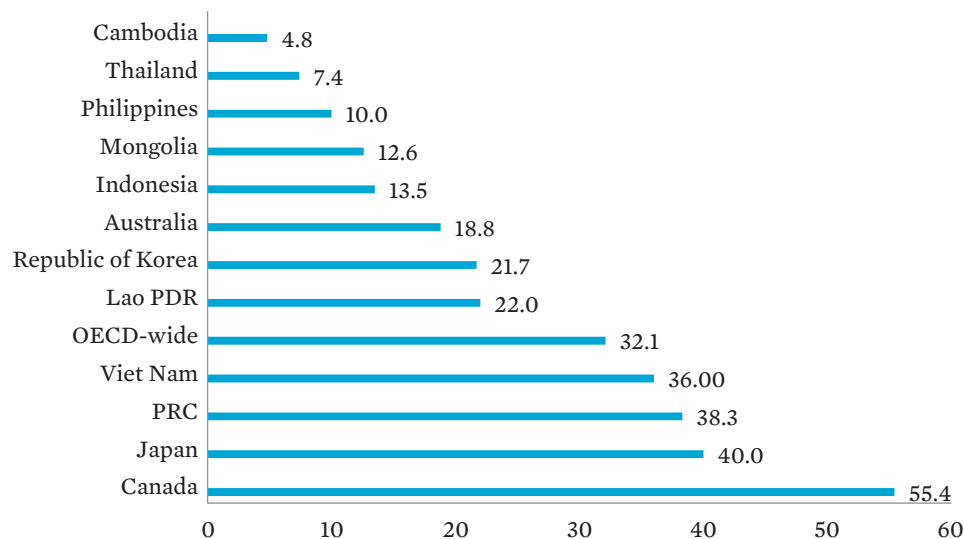
¹⁶ J. Martinez-Vazquez. 2014. *Implementing Subnational Revenue Assignment Reform in Cambodia*. Atlanta, GA: Georgia State University, Andrew Young School of Policy Studies, International School for Public Policy.

4.2 Trends in Revenue Collections

4.2.1 International Comparisons

In Cambodia, subnational administrations have low levels of own-source and shared tax revenues directly allocated to them. In 2015, only 4.8% of actual total general revenues went to subnational administrations as own-source or shared tax revenues (with 97.3% going to provinces and the capital city).¹⁷ Apart from some minor nontax revenues, virtually all revenues (excluding fiscal transfers) going to subnational administrations are in the form of shared taxes directly allocated to provinces and Phnom Penh (section 4.2). The remaining 95.2% of all revenues in 2015 went directly to the central government. This indicates a low level of decentralization in Cambodia compared to regional and international examples as measured by the extent of tax and nontax revenue decentralization (Figure 5), which in Cambodia has increased only modestly over the past decade. In 2008, 3.7% of tax and nontax revenues were assigned to subnational administrations compared with 4.8% in 2015.

Figure 5: Subnational Governments Tax and Nontax Revenues as Share of Total General Government Revenues, by Country, Various Years 2010–2015 (%)



Lao PDR = Lao People's Democratic Republic, OECD = Organisation for Economic Co-operation and Development, PRC = People's Republic of China.

Sources: D. Allain-Dupre. 2016. *Decentralization Trends in OECD Countries*. Paris: OECD; J. Martinez-Vasquez. 2011. *Fiscal Decentralization in Asia: Challenges and Opportunities*. Manila: Asian Development Bank; International Monetary Fund. 2016. *2016 Article IV Staff Reports for Mongolia and Indonesia*. Washington, DC; World Bank. 2015. *Making the Whole Greater than the Sum the Parts: A Review of Fiscal Decentralization in Vietnam*. Ha Noi; and J. Dunn and K. Vutha. 2016. ADB Technical Assistance to Cambodia for Decentralized Public Service and Financial Management Sector Development Project. *Subnational Fiscal Database for Cambodia*. Manila: ADB.

¹⁷ Own-source revenues in section 4.1.1 include central taxes shared with provinces and Phnom Penh, and nontax revenues assigned to subnational administrations. These exclude fiscal transfers to subnational administrations. Thus, tax and nontax revenues in Figure 5 (4.8% of general revenues) are lower than subnational expenditures in Figure 2 (8.5% of general expenditures), as expenditures are also funded by fiscal transfers.

4.2.2 Total Subnational Revenues

In the analysis in this and remaining parts of section 4.1, total subnational revenues come from central government taxes shared with provinces and Phnom Penh, nontax revenues collected at all three subnational levels, and central government transfers.¹⁸ There has been significant growth in nominal (and real) total revenues available over 2008–2016, with consolidated actual subnational revenues growing from KR510 billion to KR1,441 billion (compound growth of 13.8% nominal and 11.5% real per year). Significant growth has occurred for the provinces and Phnom Penh (12.9% nominal and 10.8% real per year), with the communes and *sangkats* growing more slowly at 8.8% nominal and 7.3% real per year. From a low base in 2012 when they first received transfer funding and startup was slow in the early years, the districts and municipalities have grown rapidly at 34.3% nominal and 28.6% real per year. As a proportion of gross domestic product (GDP), total revenues available to all subnational administrations have risen modestly from 1.2% of GDP in 2008 (or 9.3% of total general budget revenue) to 1.7% in 2016 (or 9.8% of total general budget revenue). Over the same period, central government revenues have grown from 12.4% to 17.0% of GDP. While some relative subnational improvement has occurred, the greatest absolute gains have accrued to the central government.

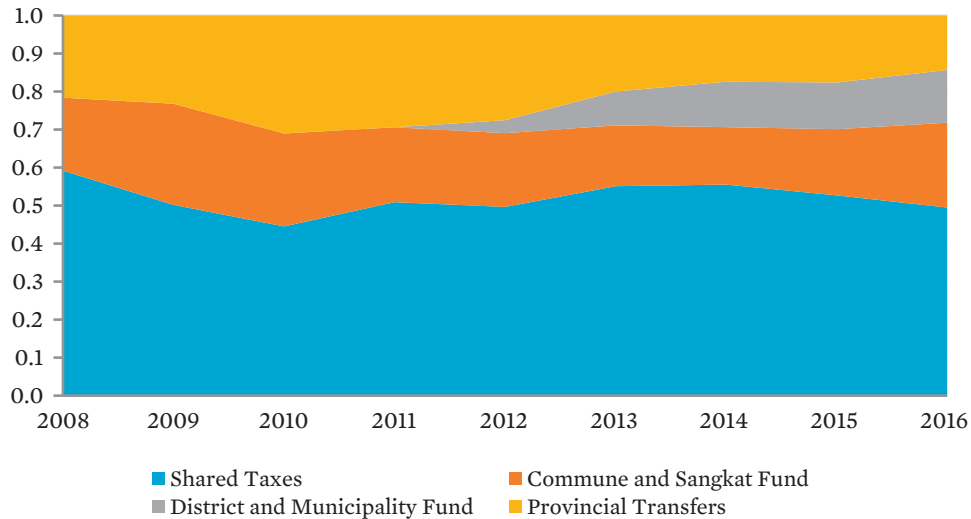
4.2.3 Components of Subnational Revenues by Tier

Components of revenue differ markedly by tier of subnational administration. An overwhelming 98.4% of commune and *sangkat* revenues in 2016 came from fiscal transfers, predominantly from the CSF. Although the Commune and Sangkat Law (2001) provides powers for communes and *sangkats* to raise taxes, none have ever been codified or collected. The great majority of revenues for districts and municipalities outside of Phnom Penh come from the district and the DMF. There are also significant transfers directly from Phnom Penh City to its 12 *khans*, and also much smaller transfers from provinces to their districts and municipalities. About 93.0% of total district, municipality, and *khan* revenues in 2014–2016 were from central, Phnom Penh, and provincial transfers. The districts and municipalities do not have any tax revenues assigned to them, though from 2017 some municipalities, *khans*, and *sangkats* will share a proportion of the property tax. Nontax revenues collected at this level mainly accrue to *sangkats* and *khans* in larger urban locations, particularly Phnom Penh. The great bulk of provincial and Phnom Penh revenues come from shared tax and nontax revenues, which provided 78.3% of total revenues (2016). Taxes shared with provinces and Phnom Penh are all collected through the General Department of Taxation of the MEF.

There are effectively no own-source revenues at any level of subnational administration in Cambodia. None of the levels of subnational administration have powers to raise new taxes or to change the nature or rates of existing taxes. Furthermore, all subnational levels have only limited powers to impose or reform nontax revenue policies and rates. All tax and most nontax revenues are administratively collected by the General Department of Taxation and the General Department of Non-tax Revenues of the MEF, with an absence of revenue-collecting units in subnational administrations. As revenue arrangements are applied in a deconcentrated fashion, there is only limited scope for generating local accountabilities.

¹⁸ Phnom Penh directly funds its 12 *khans* from shared taxes received from the central government (in 2016, each *khan* received transfers of KR5 billion, or KR60 billion for all *khans*). To avoid double counting, KR60 billion have been deducted from shared taxes received by Phnom Penh and are recorded as transfer income of the 12 *khans*.

Figure 6: Percentage Shares of Transfer Plus Shared Tax Revenues, 2008–2016



Source: J. Dunn. 2017. ADB Technical Assistance to Cambodia for Decentralized Public Service and Financial Management Sector Project. *Draft Annual Report on Subnational Administration Finances*. Manila: ADB.

Provinces and Phnom Penh are less dependent on transfers with shared tax and nontax revenues providing significant resources, with Phnom Penh accruing most of them. In 2015, Phnom Penh received 74.9% of all shared taxes, with the next-highest recipient being Siem Reap province, which received only 5.4% of the total. Most remaining provinces receive relatively small amounts. Similarly in 2015, Phnom Penh received 52.9% of all nontax revenues going to the provinces, with the next-highest recipient being Kandal province (adjacent to Phnom Penh), which received 9.3% of the total. Most remaining provinces receive relatively small amounts, though there is less horizontal imbalance with nontax than with tax revenues.

Taken together, shared taxes have been more significant than the CSF, DMF, and provincial transfers. Figure 6 illustrates that the fiscal transfers and shared taxes from 2008 to 2016 have been dominated by shared taxes (around 50% of the total), followed by the CSF (around 20% of the total), the DMF (which has recently grown to 14% of the total following commencement in 2012), and provincial transfers (which have fallen in share from 29.4% in 2011 prior to commencement of the DMF to recent levels of around 16%).¹⁹

Only a few of the taxes shared with the provinces and capital raise any significant revenue. From the full list of taxes shared, by far the most important revenue raisers for provinces and Phnom Penh are (i) the property transfer tax, (ii) the tax on means of transportation, and (iii) the public lighting tax (effectively an excise on tobacco and alcohol). The property tax has

¹⁹ Central taxes shared with provinces and Phnom Penh are akin to transfers as recipients have no autonomy over tax policies or rates. Most fiscal transfers in Cambodia are directly related to total revenue levels. International practice treats shared taxes and fiscal transfers as identical for policy purposes. See R. Bahl. 2014. *Cambodia Intergovernmental Transfers: Review of the System and Options for Reform*. Atlanta, GA: Georgia State University, Andrew Young School of Policy Studies.

the potential to raise significant revenues, but due to a low tax rate and slow implementation has not yet done so. Many other tax rates are low by international standards, particularly excise rates on tobacco and alcohol (3% for both). While the “benefit principle” is sometimes raised to justify high revenues applying to Phnom Penh, this is in many cases erroneously based on where the head offices of larger companies are located. For example, tobacco and alcohol are widely consumed throughout the country and, in some cases, their production is also dispersed, yet almost 100% of the public lighting revenue flows to Phnom Penh. In most countries, excise on tobacco and alcohol is a central tax.

4.2.4 Horizontal Imbalances in Revenues

There is significant horizontal revenue imbalance within each of the three subnational levels, particularly for districts, municipalities, and *khans* and for provinces and Phnom Penh, with less imbalance for communes and *sangkats*. Table 6 summarizes the measures of variation in total per capita revenues (2016 data). Such large horizontal variations are very high by international standards and closely follow the trends in expenditure horizontal imbalances (section 3.2.5).

Table 6: Measures of Horizontal Revenue Imbalances, 2016

Subnational Level	Revenues				
	Median Per Capita (\$)	Highest Per Capita (\$)	Lowest Per Capita (\$)	Ratio of High to Low Per Capita	Coefficient of Variation (%)
Communes	5.16	26.50	1.82	15:1	43.5
Districts, Municipalities, <i>Khans</i>	2.35	21.81	0.75	29:1	99.4
Provinces and Capital	6.60	82.64	3.18	26:1	125.1

Source: J. Dunn. 2016. ADB Technical Assistance to Cambodia for Decentralized Public Service and Financial Management Sector Development Project. *Subnational Fiscal Database for Cambodia*. Manila: ADB.

4.2.5 Vertical Imbalances in Revenues

The per capita revenue information contained in section 4.1, along with central government data, point to significant vertical revenue imbalance between levels of administration (see Figure 4 for expenditure imbalances that are closely correlated to revenue imbalances with a revenue figure not presented here due to the close similarity of results).

4.3 Legal and Regulatory Framework for Revenues (Tax, Nontax, and Transfers)

Powers between different levels of subnational administration vary significantly. The Law on Commune and Sangkat Law (2001) provided powers to collect tax and nontax revenues, including land taxes, immovable property taxes, and rental taxes. However, a revenue law as required was never enacted and no collections have occurred in practice. Districts have no practical powers in relation to taxation matters, though general taxation powers were

provided for in the Organic Law (2008) and in the Subnational Finance Law (2011), both of which also provided powers to collect nontax revenues. However, no law as required has been prepared. Under the Taxation Law (1997), as subsequently amended, and the Law on Provincial and Municipal Budgets and Asset Management (1998), provinces and the capital city were assigned a schedule of tax and nontax revenues on the basis that these were to remain central taxes to be shared 100% with the provinces (including Phnom Penh). A central property tax was subsequently enacted in 2011, with all revenues shared with the provinces and capital city. Further revisions to allow some sharing of property taxes by *sangkats* and *khans* were made in 2017.

Provinces and Phnom Penh have been provided with important shared taxation and nontaxation revenue rights since 1997, augmented by the property tax since 2011. The current shared taxes (2017) are the property transfer tax, unused land tax, public lighting tax, accommodation tax, slaughter tax, patent and licensing tax, means of transportation tax, and property tax (individuals and legal entities). Phnom Penh essentially receives all of its revenues from shared taxes and nontax revenues, though the *sangkats* within Phnom Penh also receive per capita funding directly from the CSF, and the *khans* are funded directly from the Phnom Penh budget.

Relatively broad powers to raise nontax revenues are provided under the above legislation and a subsequent joint *prakas* of the Ministry of Economy and Finance (MEF) and Ministry of Interior (MOI) in 2013, including (i) local electricity supply; (ii) local water supply; (iii) managing state assets (markets, parking, harbors, etc.); and (iv) other nontax revenues such as administrative and public service fees. The 2013 *prakas* is a prescriptive listing of fixed fees and charges for each of the three subnational levels of administration as well as conditions for issue of certain permits, licenses, and so on. In most cases, the functions specified in the 2013 regulation have not yet been transferred to subnational administrations with services (e.g., water, electricity, markets) largely provided by the private sector under contracts arranged by central ministries. Such services (particularly water and markets) and the related nontax revenues represent important opportunities for functional transfers to districts and municipalities, but these have not yet been formalized. The MEF is of the view that further subnational capacity building is needed before such responsibilities can be transferred and that the government is working to build such capacities.

Introduction of the property tax in 2011 represents the only substantial subnational shared taxation reform implemented over the past decade. This tax, which is 100% shared with the provinces and Phnom Penh, applies to properties (land and buildings) with values exceeding KR100 million with the tax rate set at 0.1% of 80% of the assessed value, which is determined by the MEF in a *prakas* for municipalities in all provinces and Phnom Penh. Until recently, all revenues collected were shared 100% with the provinces and the capital city, but a 2017 reform provides that (i) in Phnom Penh, 70% of the revenues will go to the city, 20% to *sangkats*, and 10% to *khans*, and (ii) for all other provinces, 70% of the revenues will go to the province and 30% to the *sangkats* in the province.

Alternative tax-sharing proposals to apportion some provincial and capital-city shared revenues to districts and municipalities have been discussed within the government. The broad details of such proposals, which were provided to the study team by the MEF, indicate that around 4% of taxes shared with the provinces may be “on-shared” with the districts and municipalities (3%) and also the communes and *sangkats* (1%). It is not yet clear if funding

will be drawn from all taxes of the provinces equally or from specifically designated taxes scaled up to equal 4% of total provincial taxes. The MEF has indicated that taxes shared will most likely be in line with the benefit principle, which allocates taxes according to where they are generated, although this principle in other countries usually applies only to autonomous revenues rather than shared central revenues. The MEF has also indicated that the new sharing is likely to exclude the *khans* in Phnom Penh, which are funded directly by the city.

Based on 2016 actual provincial data, excluding Phnom Penh (shared tax collections of KR221.563 billion), additional revenues of 3% flowing to districts and municipalities would equal KR6.646 billion representing a 3.2% increase in total available resources of the districts and municipalities outside of Phnom Penh. Similarly, additional revenues of 1% flowing to communes and *sangkats* would equal KR2.216 billion representing a smaller 0.7% increase in total available resources of the communes and *sangkats* outside of Phnom Penh.²⁰ As very few lower-level administration locations have any significant tax bases, it is likely that using the benefit principle (in the unusual context of shared revenues) will affect a very narrow range of subnational administrations. There are also risks that the provinces will cut back on voluntary transfers they currently make to lower-level administrations, though in most cases these are modest in nature. Reasons for excluding sharing the resources of Phnom Penh are not clear, but this will significantly limit the level of additional funds shared.

Arrangements for conditional fiscal transfers have been set out in a new sub-decree (2017) that addresses procedures for transfer of assets and financing, including arrangements for ongoing budget financing of reassigned and delegated functions. To date, conditional transfers and delegations have been quite limited. However, under arrangements of the new sub-decree, there is scope for significantly increasing funding for conditional transfers in the years to come, particularly if current efforts of the National Committee for Sub-National Democratic Development (NCDD) in pursuing transfers and delegations from the largest spending ministries in the regions prove successful. Introduction of the Subnational Investment Fund (SNIF) from 2017 (an incentive-based investment fund and a form of conditional transfer) will further enhance the role of conditional funding (Box 1 provides a more detailed explanation of the SNIF). The fund is also likely to improve vertical imbalances as it will target the lowly funded districts. However, not all districts will be funded initially, so horizontal imbalances within the district tier may increase. If decentralization of the core areas of deconcentrated spending progresses and the SNIF grows significantly from foreign and domestic sources, the proportion of all subnational expenditures to total general government expenditures could grow significantly over the medium to longer term. Progress in practice will depend largely on successes or other achievements in the reform of functional assignments (Chapter 3).

The provinces (excluding Phnom Penh) also receive fiscal transfers. These are partially determined by a formula (capped at 0.96% of current central revenues lagged by 1 year and based on population, administrative provision, and poverty, with 10% of the pool held back to cover discretionary MEF adjustments later in the year) and an arbitrary portion based largely on excess revenues accruing to the provinces (due to consistent underestimation) and settled late in the year by negotiation with the MEF. The provincial formula closely mirrors the DMF formula with a focus on administrative structures rather than services, with low impact of population and poverty variables.

²⁰ Note that total revenues of the districts, municipalities, communes, and *sangkats* here include all resources (tax and nontax revenues as well as fiscal transfers).

Box 1: Overview of the Subnational Investment Fund—A Key Vehicle for Enhancing Subnational Investment

Legal framework: Sub-decree No. 32 (2016). *Establishment and Functioning of the Subnational Investment Fund.*

Objectives: To provide funding from central government and other sources for public investment projects prepared and implemented by subnational administrations.

Board: Sets policies and direction, and makes major decisions, including in relation to investments. It is chaired by the Senior Minister and Minister of Economy and Finance, with two deputy chairs being the Secretary of State (Ministry of Economy and Finance) and a representative of the Ministry of the Interior. There are 18 other board members, including from the National Committee for Sub-National Democratic Development Secretariat and most major ministries. The Subnational Investment Fund (SNIF) Board has now met on several occasions and is operational.

Secretariat: Undertakes day-to-day management functions under supervision of the board. It is based in the Ministry of Economy and Finance, and the head and deputy heads come from the General Directorate of Subnational Administration Finance. It assesses and processes project proposals for board consideration and undertakes annual eligibility assessments. It also monitors and evaluates project performance. The SNIF Secretariat is now operational but not yet fully staffed.

Tier(s) of subnational administration to be supported: The sub-decree allows for all three subnational tiers to be supported with priorities to be set by the board, which has determined that the focus in the first few years will be solely on districts and municipalities.

Funding sources: The central government, development partners, and other sources may contribute funds. Development partners and other sources can reach specific agreements on the conditions of funding. Government funding for the SNIF has been determined for 5 years. In 2016, it was based on 0.02% of recurrent revenue, to scale up to 0.07% of recurrent revenue by 2020. From 2017 to 2020, a maximum of 30% of government funding can be used for administrative costs of the SNIF Secretariat with a minimum of 70% to be applied to project financing. Year-end balances can be carried forward.

Allocation of funds to subnational administrations: The SNIF Board determines eligibility criteria, which initially include adequate assessments (to be undertaken annually) in relation to public financial management and procurement capacities. Within each tier, funding is allocated in line with a formula that specifies allocations will be 60% according to population and 40% according to poverty indexes (though scarcity of funding seems to have prevented full use of this formula in the initial round of grants allocated and it is not clear how this formula will be operationalized in future).

Project preparation and approval: Only eligible and selected subnational administrations prepare projects with budgets not to exceed ceilings provided by the SNIF Secretariat and SNIF Board. Prepared projects are approved by the SNIF Board and are included in annual budgets of the subnational administrations, with budget execution and procurement in line with normal public financial management procedures.

Supervision and oversight: The SNIF is subject to internal and external audit requirements and is required to prepare an annual financial and performance report. Citizens in the regions are to be transparently involved in project preparation and performance evaluations.

Source: Overview prepared by ADB staff based on a review of Government of Cambodia's Subdecree No. 32 of 2016. *Establishment of the Subnational Investment Fund.* Phnom Penh, and also discussions with Ministry of Economy and Finance's officials.

Districts and municipalities outside of Phnom Penh are mainly funded through the DMF, though in the future, these will possibly receive a small proportion of taxes currently shared with the provinces. The DMF is driven by a maximum cap (originally in 2012, 0.8% of current central revenues lagged by 1 year, but has since risen to 1.0% in 2017, with likely increase to 1.34% around 2019, based on a results matrix agreed as part of European Union general budget support for decentralization). Some development partners (notably the European Union and Sweden) have agreed to provide top-ups to the prescribed amounts in the DMF. Main drivers of DMF allocations by complex formula from the capped pool are population, poverty, salary and administrative arrangements, equal share per entity, development share, and area size (number of communes and *sangkats* in the area), with heavy bias toward administrative structures rather than services, low impact of population and poverty variables, and funding levels mainly targeted to meet salary and administrative costs only.

The communes and *sangkats* (including those in Phnom Penh) are largely funded through the CSF, though in the future, these will possibly also receive a small proportion of taxes currently shared with the provinces. The CSF is driven by a maximum cap (currently 2.8% of current central revenues lagged by 1 year). Some development partners provide modest top-ups to the prescribed amounts, while others provide the communes and *sangkats* with conditional project funding. Main drivers of CSF allocations by complex formula from the capped pool are population, poverty, salary and administrative arrangements, equal shares per entity, and development spending share.

4.3 Policy Issues for Own-Source Revenues

Significant policy studies and discussions over the past decade have focused on the potential form of revenue autonomy for subnational administrations. The majority of studies have recommended modest reforms to allow subnational administrations some revenue-raising autonomy and powers (both in tax and nontax areas), alongside reform of the outdated tax-sharing arrangements for the provinces and Phnom Penh following the introduction from 2008 of autonomous districts and municipalities. The most recent and comprehensive work was an ADB-supported study by the MEF and the Andrew Young School of Policy Studies at Georgia State University in the United States. Their medium-term recommendations (3–5 years), assuming that provinces retain elements of a decentralized approach through indirectly elected councils, are set out in Box 2. The study emphasized the need for modestly enhanced autonomy with regard to both tax and nontax revenues.

After due consideration, the government has not adopted the recommendations contained in Box 2 and similar previous recommendations, reflecting the cautious approach to fiscal policy. The NCDD has not yet persisted with the adoption of such own-source revenue policy, though the National Committee for Sub-National Democratic Development Secretariat (NCDDS) has indicated that it will include provision for piloting own-source revenues in IP3-III, the implementation document of the national program.

Box 2: Medium-Term Reforms Recommended for Subnational Revenue Assignments

The provinces would do the following:

- Retain the tax on property transfers, the patent tax for larger businesses, and the public lighting tax (effectively excises on tobacco and alcohol).
- Assign an excise surcharge on electricity and phone services, and a “piggyback” local personal income tax.

The districts and municipalities would be assigned the following:

- Taxes (currently assigned at the provincial level): unused land tax, tax on means of transportation, patent tax for smaller businesses, slaughter tax, accommodation (hotel) tax, and property tax (which would be assigned to all districts and municipalities and not just to the capital city and the provincial center municipalities)^a
- A new betterment levy (a levy on new capital developments where benefits only accrue to a limited number of properties in the administration)

The communes and sangkats would be assigned the following part of the means of transportation tax on motorcycles only.^b

Tax policy and administrative arrangements would be revised as follows:

- Subnational administrations would be provided autonomy to set tax rates for their assigned taxes (within centrally imposed bands).
- All subnational taxes would continue to be administered, enforced, and collected according to the law by the General Department of Taxation of the Ministry of Economy and Finance.

Arrangements for nontax revenues of subnational administrations would be revised as follows:

- There will be clear differentiation between what the fees and charges are and what should be defined as taxes.
- Remaining fees and charges should be associated with a clear unit cost or marginal cost of providing the additional service.
- The fee structure must contribute to the revenue autonomy of subnational administrations. Thus, a degree of autonomy should be provided to subnational administrations to set tariffs, in some cases with maximum and minimum values, and in others without maximum values, as long as they reflect the unit cost of the service.

^a It has since been decided that 30% of property taxes assigned to provinces and Phnom Penh would be shared with urban municipalities, *khans*, and *sangkats*.

^b Note that the government has since abolished the previous tax on motorcycles.

Source: Based on the recommendations contained in J. Martinez-Vazquez. 2014. *Implementing Subnational Revenue Assignment Reform in Cambodia*. Atlanta, GA: Georgia State University, Andrew Young School of Policy Studies, International School for Public Policy.

4.4 Policy Considerations for Reforming the Unconditional Transfer and Shared Tax Systems

4.4.1 Need for a Fundamental Review of Subnational Boundaries

There are currently very wide variations in population levels within each of the three subnational levels of administration, and even inconsistencies between levels. As with most countries, these wide variations reflect historical, political, geographic, and economic considerations, but appear too wide and inconsistent to allow economic efficiency or electoral equity. The situation at different levels is as follows:

- **Provincial level.** Excluding Phnom Penh (population 1.4 million), provincial population sizes range widely from 40,006 (Kep Province) to 1.2 million (Kandal Province), with an average size of 580,152. Eight of the 24 provinces (33.0%) have populations below 250,000.
- **Districts, khans, and municipalities.** District, *khan*, and municipality population sizes range widely from 5,124 (Ou Reang district in Monduliri Province), to 230,157 (Seam Reap municipality in Siem Reap Province), with an average size of 79,589. Twenty-nine of the 197 districts, *khans*, and municipalities (14.7%) have populations below 25,000. There are many districts that have larger populations than many provinces.
- **Communes and sangkats.** Average commune and *sangkat* population sizes by province range widely from 3,925 (Rattanak Kiri Province) to 15,235 (Phnom Penh), with the average size by province being 8,754. There are many communes and *sangkats* that have larger populations than many districts.

Greatest imbalances lie at the provincial level, and to a lesser extent the district, *khan*, and municipality levels. It is extremely difficult to design efficient and equitable transfer systems where population sizes vary so widely, particularly where staffing and administrative structures for all administrations are almost identical within each subnational level, irrespective of population.²¹ Given geographic, cultural, and other differences, the aim is not to approximate equal population size within each tier, but instead consider closer dispersion around the average, along with minimum threshold sizes. Separating predominantly urban centers from predominantly rural districts for fiscal management purposes would also be useful. To address current large variations and inconsistencies, the government—following the 2018 elections—could consider establishing a specially convened commission under the NCDD to review and recommend changes (i.e., within an 18-month period following appointment) to current subnational administration boundaries at all three levels of administration.

²¹ See, for example: J. Martinez-Vazquez. 2011. *Territorial Arrangements and Managing Pressures for Proliferation of Regional Governments. Indonesian and International Experiences*. Paper submitted to the International Conference on Fiscal Decentralization Convened by Ministry of Finance Indonesia. Jakarta. It presents international evidence on economies of scale, suggesting that districts require a minimum size of around 20,000 to be efficient and that states or provinces would thus need to be significantly larger still. A minimum threshold of 400,000 (20 districts) would be reasonable for Cambodia.

4.4.2 Objectives for a Reformed System

The starting point for designing (or reforming) any system of subnational transfers and shared taxes should be a clear set of system objectives. The national program and its implementation plans do not appear to provide adequately clear objectives and targets for fiscal decentralization or its component parts. International best practice suggests a formula-based approach to decide objectives for unconditional transfers and shared taxes, with balanced funding based on the gap between fiscal capacities and fiscal needs of each administration. Thus, administrations with higher fiscal capacities and lower fiscal needs receive lower transfer and shared tax funding than administrations with lower fiscal capacities and higher fiscal needs. There are constraints to immediately using such an approach in Cambodia as fiscal needs have not been clearly defined (i.e., by subnational GDP levels). Moreover, in the absence of own-source revenues, it is also difficult to define fiscal capacities. The relevance of such an objective for Cambodia is considered in the remainder of this section, to frame suitable objectives and to simulate an alternative approach.

4.4.3 Overall Size of the Pool for Unconditional Fiscal Transfers and Shared Taxes

As elaborated in section 4.1.1, the total pool of revenues (mainly transfers and shared taxes) available to all subnational levels is low by international standards. A potential increase of these amounts will need to come about in deficit-neutral ways for the central government. Thus, conditional transfers may eventually become the main source of increased decentralization funding through the parallel transfer of functions and finance from central to subnational levels. The government will likely continue to mainly use unconditional fiscal transfer and shared tax systems to finance discretionary or general purpose activities of the subnational administrations. Currently, the provinces, municipalities, communes, and *sangkats* have modest fiscal space to engage in small infrastructure and social development projects. However, most districts have very limited fiscal space after meeting their salaries and administrative costs. On the other hand, relatively speaking, Phnom Penh and its *khans* have significant fiscal space.

As districts and municipalities are the key focus of government policy for improving service delivery and infrastructure, several options are available to enhance their discretionary spending capacities. The first would be to find additional resources from the center, for example, using the proposed takeover of all deconcentrated offices in the districts to force efficiencies and savings (see section 3.3 for the significant scope for accessing deconcentrated expenditures in the regions, which in total are more than double the resources available for all subnational administrations). The second would be to reform vertical fiscal arrangements by relative reductions in funding to either the provinces, Phnom Penh, and/or communes. The third would be to provide more flexibility to districts and municipalities to determine their administrative structures, providing some scope to replace administrations with more productive outlays. In practice, all three of these options could be pursued simultaneously to improve the fiscal space of the districts.

While some absolute increase in funding available to subnational administrations for permissive purposes seems reasonable to many as part of broader budget restructuring, it does not seem consistent with the currently cautious overall fiscal policy stance. Furthermore, the NCDDS is considering ways to improve the use of current funding levels as well as additional

funding. Additional funding for districts and municipalities is likely to come from changes in the vertical funding arrangements between subnational levels, and from increased efficiencies within districts and municipalities including rationalization of central district offices. Fiscal decentralization to date has been fiscally responsible (national fiscal deficits have remained manageable and no subnational debt has been incurred). Fiscal decentralization reforms, as demonstrated in the simulation in this chapter, could be designed to maintain fiscal responsibility while improving resource allocation, income distribution, and service delivery, particularly for the rural districts.

4.4.4 Treatment of Shared Taxation Revenues

Subnational administrations currently have no fiscal capacities and no taxation autonomy (this is not to say that particular administrations do not have potential fiscal capacity, merely that subnational administrations do not control or capture revenues directly). Thus, in a formula based on the gap between fiscal capacities and fiscal needs, the fiscal needs of individual subnational administrations become the determining factor, subject to the constraint of the size of the funding pool. If it is accepted that countries (e.g., Cambodia) that provide no taxing powers to subnational administrations ideally should manage shared revenues as just another form of transfer, there are opportunities to simplify the system of unconditional transfers, by moving toward a single system of unconditional transfers and away from the current outdated system of shared revenues formulated in 1998 before the modern era of decentralization.²² Under such a system, a total pool for subnational unconditional transfers would replace current funding arrangements that treat tax sharing and fiscal transfers separately and instead treat them as one. This would require the respective vertical shares between subnational levels to be clearly defined by government policy. In circumstances where the transfer and shared taxation systems are largely funding discretionary spending at each subnational level, there is no need for having very diverse formula for each level or totally separate funding arrangements for the *khans* of Phnom Penh, which in the future would have their funds allocated in the same manner as other administrations.

4.4.5 Addressing Vertical Imbalances between Subnational Levels

The causes of the severe vertical imbalances between the three levels of subnational administration include (i) sharing of tax revenues only with the provinces and Phnom Penh and its *khans*, (ii) allocation of the major portion of shared taxes to Phnom Penh, and (iii) districts (and to a lesser extent municipalities) as the last level of subnational administration to be established are severely constrained for funding so as not to worsen the central fiscal deficit. Without significant additional funding from the center, one way to address subnational vertical imbalances could be by revising the shares of each level in line with the government's priority of establishing the districts and municipalities as the main service delivery points. This would require limiting the role of provinces to coordination and infrastructure development on a province-wide basis, and having conditional grants from the central government fund provincial infrastructure, thus reducing the funding needs of the provinces for discretionary activities. Phnom Penh and its *khans* will need to make an important contribution to realize any vertical reforms. These would need to be phased in over

²² Even if taxes shared with the provinces and Phnom Penh are to continue, amounts received should be netted out of transfers to provinces (currently they are partially netted out only for Phnom Penh taking it to zero transfers, but in the future these could become negative transfers in a system based around equalization).

time (e.g., 5–8 years)—that is, no subnational tier should be worse off in the initial period, but over time the districts and municipalities would grow their resources considerably and more rapidly than the lower-priority levels of administration. The MEF would need to carefully manage the allocation of lower growth rates to the provinces and Phnom Penh so as not to undermine policies for the development of urban areas.

4.4.6 Addressing Horizontal Imbalances within Subnational Levels

The reasons for significant horizontal imbalances at each level include the following: (i) within the province and Phnom Penh level, the large amount of shared revenues going to Phnom Penh as well as the allocation of equal salary and administrative grants irrespective of size; (ii) within district, municipality, and *khan* levels, allocations for equal shares of the pool to support inflexible and costly administrative structures, provisions based on land area, and special arrangements for Phnom Penh *khans*; and (iii) within the commune and *sangkat* level, allocations for equal shares of the pool to support inflexible administrative structures. Simplifying the distribution formula in each tier could fix horizontal imbalances, for example by basing them on a smaller number of parameters. Many countries have moved to simplified systems based on population and poverty only.²³ Simplification would involve removing from the formula any reference to equal shares, salary and administrative structures, land area, and the sharing of any specific taxes with particular levels of administration.

4.4.7 Fixed or Flexible Administrative Structures

Standardized levels of employees and council members determine formulas for all levels of subnational administration and particularly for the district and municipality tier, with only very limited variations in council and employee numbers occurring between administrations that serve widely varying constituent sizes. Provincial and DMF formulas also give considerable bias to funding administrative structures. A significant number of districts have virtually no discretionary funding for service delivery or development outlays after deducting wages and salaries, and administrative costs. While some defined levels of council numbers are reasonable for governance purposes, this is not the case with boards of governors or professional and administrative employees. While councils ideally have full flexibility to determine their own organizational structures, a less dramatic reform would be to set standard maximum employee numbers with councils able to employ fewer numbers, if they so choose. A maximum proportion of spending on salaries and administration could also be phased in over time (e.g., targeting a 25% cap), with penalties after transitioning for noncompliance.

4.4.8 Population and Poverty as Key Drivers

Given that unconditional transfers in the future would essentially relate to administration and permissive expenditures at all levels of administration, it is reasonable to give most weight to population, with adjustment for poorer regions. This is consistent with trends in international best practice to simple formulas around population and poverty (footnote 33), with special care when designing the poverty component. Past approaches in Cambodia appear to have

²³ J. Martinez-Vazquez. 2014. *Key Issues for the Medium and Long Term Strategic Roadmap for Fiscal Decentralization in Cambodia*. Atlanta, GA: Georgia State University, Andrew Young School of Policy Studies, International School for Public Policy.

used poverty scores correlated to population and have not allocated adequate resources to the very poorest of locations (normalization of the values has resulted in very little variation across jurisdictions). Further technical work is needed to develop more direct targeting in the formula of the number of administrations (or perhaps persons) classified as very poor. The NCDDS has indicated that it will undertake further modeling during IP3-III and give high priority to poverty targeting.

Remoteness of land areas of particular jurisdictions, while important, are difficult to deal with in a formula and can generally be secondary considerations. Certainly, some of the remote and sparsely populated regions of Cambodia have significant cost and operational difficulties as well as cultural heritages that the government wishes to support. While additional loadings in a small number of such cases could be considered, the proposed transfers are confined to discretionary expenditures, with scope for special regional considerations related more to special conditional transfers for disadvantaged and other identified regions.

4.5 Simulation of Simplified Option for Reforming the Unconditional Transfer and Shared Taxation Systems

4.5.1 Design Elements of the Simulation Case

Based on the considerations in section 4.4, and by way of an example of one reform option, the main design elements of the simulation case are as follows:

- **Objectives of the unconditional transfer system.** These are to achieve (i) clearly defined vertical balance between the three subnational levels, and (ii) clearly defined horizontal balance within each of the three subnational levels (see below for definitions of vertical and horizontal balance).
- **Size and nature of the funding pool.** A single funding pool is set at actual 2016 funding levels for unconditional funding of all subnational levels (CSF + DMF + negotiated transfers to provinces + subnational transfers + shared taxes). There is no new funding and no cost to the central government deficit.
- **Revisions to current vertical financing shares.** These are made by policy decision with the simulation revisions as set out in Table 7 (and the notes thereto) to be phased in over an extended medium-term period of 8 years.²⁴
- **Revisions to current horizontal financing shares.** These are made by simplifying the formula for distribution within each defined subnational level. Horizontal allocations are based on population levels with a weight of 33% on top of the basic population calculation applied to the 33% of administrations with the highest poverty rates. Thus, eight of the poorest provinces get a 33% loading on top of their basic allocation by population, with the remaining 16 provinces sharing the costs of the loading equally. Similarly, 66 of the 197 districts, *khans*, and municipalities receive a

²⁴ The simulated vertical reforms represent significant change and, apart from the phasing over 8 years, would require strong leadership from the government, possibly supported by incentives for the provinces and Phnom Penh (e.g., commitment to transfer or delegate infrastructure projects to them, including diverting other ministry infrastructure investments and relaxing controls over subnational investment budgets).

Table 7: Simulated Revisions to Vertical Shares of Subnational Administrations

Subnational Level	2016		2024		Compound Growth per Year
	Actual (KR million)	% of Pool	Simulated (KR million)	% of Pool	
Provinces (excluding Phnom Penh)	410,181	29.3	561,361	18.8	4.0
Phnom Penh	486,688	34.8	666,066	22.3	4.0
Districts, municipalities, <i>khans</i>	192,881	13.8	1,091,400	36.7	24.2
Communes and <i>sangkats</i>	309,402	22.1	663,231	22.2	10.0
Total	1,399,152	100.0	2,982,058	100.0	10.0

Notes:

1. 2016 data based on estimates of actual revenues from transfers and shared taxes (excluding nontax revenues).
2. Total pool assumed to grow nominally at 10% per year in 2016–2024, which is below the average national nominal revenue growth over the past decade of 13.7%.
3. Provinces and Phnom Penh are allowed nominal annual growth of 4% in line with inflation, thus retaining real levels of expenditure, though their shares of the total pool decline markedly.
4. Communes and *sangkats* grow in line with the growth of total revenues (at 10.0% per year), thus allowing real growth and retention of their share of the total pool.
5. Districts and municipalities are the major beneficiaries with annual growth of 24.2% and an increase in share of the total pool from 13.8% to 36.7%.
6. In future under this simulation, the *khans* of Phnom Penh would not be funded by Phnom Penh (which would have reduced resources) but rather by the central pool.

Source: Authors' estimates.

loading of 33% with the costs met equally by the remaining 132 districts. The same principles were also applied to commune and *sangkat* allocations.²⁵ The NCDDS has indicated that its planned future modeling will consider scenarios where the weighting for poverty is higher than 30%.

4.5.2 Results of the Simulation

The results of the simulation are by way of example only and are not specific recommendations for reform. Many more simulations and policy discussions are necessary to achieve consensus around an agreed reform model. Nevertheless, the simulation indicates that significant benefits could be achieved over time by addressing current vertical and horizontal imbalances in unconditional funding, with the great majority of subnational administrations (particularly the districts) ending up better off, thus making such reforms politically saleable. A smaller number would be relatively (but not absolutely) worse off (mainly Phnom Penh and a small number of provinces), so their cases would require strong political leadership and perhaps alternative incentives such as enhanced access to national infrastructure funding. The results of the simulation are as follows:

²⁵ Required allocations can be simply calculated using a two-step approach. The first step works out allocations for all entities in a particular tier based on population. In the second step, the poorest 33% of administrations receive a loading of 33% on top of their calculated amount under step 1. The remaining 67% of entities are then recalculated on the reduced amount for the step 2 pool based on population, thus proportionately sharing the loading costs for the poorer regions.

- **Improved vertical balance** is achieved by government policy determination. Phnom Penh's share of total subnational resources falls from a very high 34.8% to 22.3% (still very high with 9% of the population getting 22% of total subnational resources).²⁶ The provinces share also falls sharply from 29.3% of the total subnational resources to 18.8%, which is still high by international comparisons for unitary states where provinces typically have more limited roles than states in federations (i.e., the provinces are confined to 10% of unconditional transfers in Indonesia, though they are assigned modest own-source revenues). If phased in over 8 years, Phnom Penh and the provinces continue to grow nominally at 4% per year and thus retain current real levels of expenditure, though their relative shares do decline markedly. The communes and *sangkats* retain their current share of 22.1% of total subnational resources and thus experience significant real and nominal growth over the 8 years. The major beneficiaries are the districts and municipalities whose share of total subnational resources grows from 13.8% in 2016 to 36.7% in 2024 with total resources for this level growing from KR192.9 billion in 2016 to KR1,091.4 billion in 2024, which is in line with current government policies of promoting this level of administration to be the major service delivery component.
- Despite their worsening vertical share, **significantly improved horizontal balance among the provincial administrations** is achieved, with 15 of the 24 provinces (excluding Phnom Penh) improving their real per capita funding levels by 2024, with most larger rural and poorer provinces gaining significantly. It is mainly provinces with smaller populations that lose out relatively (e.g., Kep: population 40,006; Pailin: population 66,976; and Monduliri: population 79,502), though a small number of larger population provinces (mainly Siem Reap) experience modest real per capita funding declines. The dispersion of per capita results narrows significantly with the coefficient of variation for all provinces (excluding Phnom Penh) falling from 106.9% at present to 21.5% by the end of the reforms. Under this simulation, Phnom Penh is treated as its own category, though the majority of provinces improve their situation relative to Phnom Penh.
- **Horizontal balance among the district, municipal, and khan administrations** is improved with the large policy-driven vertical shifts instrumental in 188 of the 197 district, municipal, and *khan* administrations ending up significantly better off in real per capita terms over the 8 years (particularly the rural districts). Nine administrations end up moderately worse off due to their existing favorable situations (five of the Phnom Penh *khans*, two administrations in Monduliri, and one each in Kep and Koh Kong provinces). On average, 33% of poorest district, municipal, and *khan* administrations improve their per capita resources 6.1 times, while the 67% of better-off administrations improve their per capita resources 3.7 times. The dispersion of per capita results narrows significantly with the coefficient of variation for all districts, municipalities, and *khans* narrowing from 98.1% at present to 20.0% by the end of the reforms.
- **Horizontal balance among the communes and sangkats** is also improved, though to a lesser extent. This is because the current formula is more equalizing than for districts, municipalities, and *khans* and also because population sizes between communes and *sangkats* are more standardized. Because communes and *sangkats* are allowed by policy decision to maintain their vertical share of resources, all but a very

²⁶ For extended periods, citizens of Phnom Penh with around 9% of the national population have been able to receive 33% to 40% of total subnational resources.

small number of outlying communes and *sangkats* (around 2%) continue to grow very significantly in both nominal and real terms over the 8 years. On average, the 33% of poorest commune and *sangkat* administrations improve their per capita resources 2.2 times, while the 67% of better-off commune and *sangkat* administrations improve their per capita resources 1.6 times. The dispersion of per capita results narrows with the coefficient of variation for all communes and *sangkats* decreasing from 44.9% at present to 23.0% by the end of the reforms.

4.6 Summary Assessment

The assessment focuses on progress toward the key revenue and intergovernmental fiscal transfer outcomes sought under the national program (section 2.1.2 and overview to Chapter 4). Significant progress has been made since 2008 in designing and implementing a comprehensive system of intergovernmental fiscal transfers. Unless revenue autonomy is granted to subnational administrations and the reassignment of functions progresses more rapidly, immediate future reforms are likely to rely mainly on improving unconditional transfer and shared tax mechanisms.

Existing systems of unconditional transfers and shared taxes contain significant distortions and imbalances that lessen their effectiveness and thus provide significant scope for vertical and horizontal reforms that provide results consistent with government objectives, particularly for the districts and municipalities to be the focus of public service delivery. Important opportunities for future reforms relate to addressing the trend of fiscal imbalances, including low levels of funding available to priority subnational tiers of districts and municipalities.

The causes of imbalances (including major inconsistencies in population levels within and between the different subnational tiers of administration) have been agreed for some time and reaching consensus on how to address them would assist in designing an improved system of fiscal decentralization. Over the longer term, conditional transfers are likely to constitute the most important source of funding for subnational administrations through well-designed functional transfers and delegations and the Subnational Investment Fund (SNIF).

Conclusions and Recommendations

Progress with fiscal decentralization since enactment of the Organic Law (2008) has been gradual. This brief concluding chapter restates the conclusions and provides broad recommendations for improving and further developing Cambodia's system of fiscal decentralization.

Legal, policy, and institutional opportunities. While significant progress has been made in reforming the policy, legal, and institutional framework for fiscal decentralization, the government has not yet achieved its key target outcomes for fiscal decentralization. It is recommended that key policy makers continue to develop greater consensus between the key stakeholders regarding the appropriate nature and content of fiscal decentralization reforms and accountabilities to be pursued. Following agreement on a consensus model, policy makers should improve the consistency of laws, policies, and procedures. Policy makers should also pursue longer-term opportunities for growing political awareness and actions regarding the importance of providing appropriate financing mechanisms in response to local community voices. Gradual introduction of more performance-informed PFM systems, including the possible introduction of fiscal incentives, will assist in the reallocation of funding to priority areas.

Opportunities arising from addressing both vertical and horizontal imbalances throughout the fiscal decentralization system. The causes of these revenue and expenditure imbalances should be addressed to assist in designing an improved system of fiscal decentralization. It is further recommended that consideration be given to the analysis of deconcentration data in this report, which indicate areas that are likely to be most productive in terms of pursuing functional transfers and delegations (particularly the larger spending and more strategically important ministries) and also in achieving efficiencies through rationalization of central deconcentrated actions in the regions, commencing with subsuming all district office functions of provincial departments under subnational administrations. There are also good opportunities for enhancing levels of development expenditure of subnational administrations over time, including through growth of the SNIF, and it is recommended that such reform options be pursued.

Reform opportunities with functional assignments. Under increasingly proactive approaches of the National Committee for Sub-National Democratic Development (NCDD), some recent progress has been made with the three current big spenders of deconcentrated funding (education, health, and social affairs) and it is likely that these efforts will lead to more substantial achievements on the ground in the next few years. Progress has been less substantial with less active but still strategically important ministries, particularly the Ministry of Agriculture, Forestry and Fisheries; the Ministry of Rural Development; and the Ministry of Water Resources and Meteorology. It is recommended that even more proactive

approaches for these and other strategically important ministries be considered, including more direct enforcement of legal and political requirements. The proposed integration of all district, *khan*, and municipal offices of ministries under the district, *khan*, and municipal councils and administrations will be an opportune time to more directly and proactively pursue substantive reforms with ministries that are lagging—and it is recommended that policy makers actively pursue these opportunities.

Reform opportunities with own-source revenue assignments. With government policy exercising caution in providing any significant own-source revenue autonomy to the subnational administrations, future opportunities for reform appear to rely mainly on improving unconditional transfer and shared taxation mechanisms. It is recommended that policy makers over the medium to longer term keep open the prospect of providing some initially modest, and over the longer term, growing own-source revenues to the subnational administrations. The proposed piloting of own-source revenues over the next 3 years of IP3-III is supported.

Reform opportunities with intergovernmental transfers and shared taxes. Providing subnational administrations continue to operate without any own-source taxing powers, the transfer and shared taxation mechanisms, which are the only substantial forms of funding for subnational administrations, become critical in considering and reforming Cambodia's system. Significant progress has now been made in developing a comprehensive system of intergovernmental fiscal transfers in Cambodia. Conditional transfers are likely to constitute the most important source of funding for subnational administrations over the longer term, and it is recommended that policy makers continue to focus on pursuing well-designed functional transfers and delegations and growing the SNIF. In the shorter term, the existing systems of unconditional transfers and shared taxes provide significant scope for reform. It is therefore recommended that key policy makers form a high-level working group or a similar body to develop reform scenarios along the lines of the simulation option provided in this report, with a view to better define the objectives of the unconditional transfer and shared taxation mechanisms, and to addressing in a more simplified and better targeted way the current major vertical and horizontal imbalances and the limited funding currently flowing to the priority subnational tier of districts and municipalities. It is further recommended that over the longer term, a separate high-level review be undertaken with a view to reforming boundaries of all subnational administrations to improve both efficiency and equity.

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Persons Met

Central Government Officials

1. Chea Bunheng, Director, Department of Municipality, District, Commune and Sangkat Administration, Ministry of Interior
2. Bun Neary, Deputy Director General, General Department of Taxation, Ministry of Economy and Finance
3. Hou Tain Eng, Secretary of State, Ministry of Planning
4. Kim Sann (PhD), Inspector General and Chair of Deconcentration and Decentralization Working Group, Ministry of Public Works and Transport
5. M. Kimhov, Deputy Director General, Statistics, Ministry of Planning
6. Kuong Vutha, NCDD Senior IT Adviser
7. Meas Monika, Undersecretary of State and Chair of Deconcentration and Decentralization Working Group, Ministry of Public Works and Transport
8. Ngan Chamroeun, Deputy Executive Head, National Committee for Sub-National Democratic Development (NCDD) Secretariat
9. Nuon Someth, Undersecretary of State and Chair of Deconcentration and Decentralization Working Group, Ministry of Tourism
10. Prak Samouen, Director General, General Department of Local Administration, Ministry of Interior
11. San Visal, Undersecretary of State and Chair of Deconcentration and Decentralization Working Group, Ministry of Rural Development
12. Sao Vannserayvuth, Undersecretary of State and Chair of Deconcentration and Decentralization Working Group, Ministry of Agriculture, Forestry and Fisheries
13. Savy Thach, Fiscal Decentralization Adviser, NCDD Secretariat
14. Say Siphonn, Secretary of State and Chair of Deconcentration and Decentralization Working Group, Ministry of Social Affairs, Veterans and Youth Rehabilitation
15. Sem Sareoun, Government Adviser and Deputy Chair of Deconcentration and Decentralization Working Group, Ministry of Environment
16. Sokha Bou Vong, General Department of Sub-National Administration Finance, Ministry of Economy and Finance
17. Sovuthea Hay, General Department of Sub-National Administration Finance, Ministry of Economy and Finance
18. Thor Sethana, Undersecretary of State, Ministry of Civil Service
19. Lo Veasnakiri, Director of Planning and Information and Chair of Deconcentration and Decentralization Working Group, Ministry of Health
20. Vong Bunintreavuth, General Department of Treasury, Local Treasury Management and Statistics, Ministry of Economy and Finance
21. Youk Bunna, Secretary of State and Chair of Deconcentration and Decentralization Working Group, Ministry of Civil Service

Subnational Administration Councilors and Officials

Takeo Province

1. Council Chair and Councilors of Takeo Provincial Administration
2. Provincial Adviser, Takeo Province
3. Deputy Governor and administration officials, Takeo Province
4. Director General and officials, Provincial Department of Education, Youth and Sport, Takeo Province
5. Director General and officials, Provincial Department of Health, Takeo Province
6. Director General and officials, Provincial Department of Public Works and Transport, Takeo Province
7. Director General and officials, Provincial Department of Environment, Takeo Province
8. Director General and officials, Provincial Department of Agriculture, Forestry and Fisheries, Takeo Province
9. Council Chair and Councilors of Tram Kak District Administration, Takeo Province
10. Governor and administration officials of Tram Kak District Administration Takeo Province
11. District Office Manager, Education, Youth and Sport, Tram Kak District, Takeo Province
12. District Office Manager, Health, Tram Kak District, Takeo Province
13. District Office Manager, Agriculture, Forestry and Fisheries, Tram Kak District, Takeo Province

Kampot Province

1. Council Chair and Councilors of Kampot Provincial Administration
2. Deputy Governor and administration officials, Kampot Provincial Administration
3. NCDD Secretariat Adviser, Kampot Provincial Administration
4. Director General and officials, Provincial Departments of (i) Ministry of Education, Youth and Sport; (ii) Ministry of Environment; and (iii) Ministry of Agriculture, Forestry and Fisheries, Kampot Province
5. Director General and officials, Provincial Department of Health, Kampot Province
6. Director General and officials, Provincial Department of Public Works and Transport, Kampot Province
7. Director General and officials, Provincial Department of Environment, Kampot Province
8. Director General and officials, Provincial Department of Agriculture, Forestry and Fisheries, Kampot Province
9. Council Chair and Councilors of Chhouk District, Kampot Province
10. Deputy Governor and administration officials, Chhouk District, Kampot Province
11. District Office Manager, Education, Youth and Sport, Chhouk District, Kampot Province
12. District Office Manager, Rural Development, Chhouk District, Kampot Province
13. District Office Manager, Social Affairs, Chhouk District, Kampot Province
14. District Office Manager, Water Resources and Meteorology, Chhouk District, Kampot Province
15. District Office Manager, Chhouk District, Health, Kampot Province

Others

1. Javier Castillo Alvarez, Attaché, Aid Effectiveness, Budget Support and Public Finance Management, Delegation of European Union
2. Many Cheng, Functional Assignments Consultant, ADB Technical Assistance to Cambodia for Decentralized Public Service and Financial Management Sector Development Project in NCDD Secretariat
3. Jonathan Dunn, Fiscal Decentralization Consultant
4. Eng Netra, Research Fellow, Cambodian Development Resource Institute
5. Anna Guittet, Counsellor Governance and Environment, Embassy of Government of Sweden
6. Jan Hansen, Senior Economist. ADB Resident Mission Cambodia
7. Tomas Jensen, Program Officer, United Nations Children's Fund
8. Daniel Kobb, Adviser to NCDD Secretariat
9. Men Kunrath, GIZ Coordinator and Policy Adviser, Decentralization and Administrative Reform Program
10. March Luon, Program Manager Governance, Embassy of Government of Switzerland
11. Samiuela Tukuafu, Country Director, ADB Resident Mission Cambodia

Fiscal Decentralization Reform in Cambodia

Progress over the Past Decade and Opportunities

This report reviews Cambodia's progress in fiscal decentralization since passing the Law on Administrative Management of the Capital, Provinces, Municipalities, Districts and Khans (Organic Law, 2008) and commencing the National Program for Democratic Development, 2010-2019 (which was extended to 2020). Solid progress has been made in providing the architecture for an intergovernmental fiscal transfer system, including recent introduction of the Subnational Investment Fund for which ADB has provided design advisory support and initial capital funding.

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6 ADB Avenue, Mandaluyong City

1550 Metro Manila, Philippines

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