

CAMBODIA

Rural Investment for Local Governance

Deconcentration: Provincial Budget Operations

Final Report

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Abbreviations and Acronyms

Bn	Billion
CAR	Council for Administration Reform
CPAR	Country Procurement Assessment Report
CSF	Commune/Sangkat Fund
D&D	Decentralisation and deconcentration
DEF	Department of Economy and Finance
IFAPER	Integrated Fiduciary Assessment and Public Expenditure Review
KPC	Kompong Cham
MEF	Ministry of Economy and Finance
MOI	Ministry of Interior
Mn	Million
PAP	Priority Action Programme
PEAC	Pre-evaluation Award Committee
PEM	Public Expenditure Management
PFM	Public Financial Management
PIF	Provincial Investment Fund
PIP	Public Investment Programme
PNP	Phnom Penh
PO	Payment Order
RGC	Royal Government of Cambodia
RILGP	Rural Investment and Local Governance Project
SK/K	Sala Khet/Krong
TORs	Terms of Reference

Executive Summary

Background

1. Despite significant emphasis in Cambodia in recent years on improving efficiencies in public finance by de-concentrating and decentralising services to lower levels of government, there have not been many analytical studies on budget systems, practices and performance at the provincial level. The aim of the current study, funded as part of World Bank support to RILGP, is to address this need. Its focus is to examine provincial budget operations and prepare a detailed assessment of current budget operations, including revenues and expenditures within the Sala Khet/Krong.¹ A key focus of the analysis is to distinguish between official guidelines, which outline what should happen, and what actually happens in practice.

2. The study provides a comprehensive description and analysis of the way provincial budgets work in two chosen provinces, Phnom Penh municipality and Kompong Cham. It reviews how provincial governments allocate their scarce budgetary resources, as well as how effective they are in executing their plans. The study concentrated on the provincial budgets and thus did not look at the budget operations of the commune/sangkat, including the transfers to the Commune/Sangkat Fund (CSF) from the Provincial Treasury. The analyses concentrated mainly on resources which are on-budget, i.e. those channelled through official budget channels and which are recorded in official budget reports. Finally, the study provides recommendations to the Seila Task Force Secretariat on budget issues requiring detailed further investigation, options for improving provincial budgeting, for possible piloting in the short term, and issues for inclusion in the draft Organic Law on Deconcentration and Decentralisation.

Analysis of Budget Performance

3. Provincial budgets comprise two aspects: (i) the *budgets of the Sala Khet/Krong*, which cover the administrative expenses of running the Sala Khet/Krong administrations and funds for limited development projects in the province; and (ii) the *provincial share of national budgets*, which finance primary and secondary-level national services, such as health and education, managed by the national-level ministries and administered in the province by the deconcentrated provincial-level line departments.

4. The Sala Khet/Krong budgets, with the exception of Phnom Penh, are significantly smaller than provincial-level national budgets. The desire to ensure similar levels of public services across provinces means that the difference in expenditure levels in terms of provincial-level national budgets between provinces are much smaller than with Sala Khet/Krong budgets.

5. With one of the lowest per capita Sala Khet/Krong expenditures in Cambodia, Kompong Cham's total budget, at 5.5 bn riels, is less than 20% of the level for Phnom Penh (at 37.9 bn riels). In the Sala Khet/Krong budgets, whilst per capita administrative expenditures lie within a relatively small range across most provinces, the biggest difference between provinces is in the amount of non-administrative development expenditure per head of the population. The majority of development funds in both Phnom Penh and Kompong Cham are spent on the improvement of roads. Improvement in other infrastructure, such as water supply and street lighting, is also important.

6. In all provinces/municipalities except Phnom Penh, expenditures by the Sala Khet/Krong exceed their revenue-raising ability. The resulting budget deficits, to the tune of 700 mn riels in 2003 for Kompong Cham, are financed by transfers from MEF. However, the use of deficit financing to bridge

¹ The term *Sala Khet* is used to refer to provincial administrations, whilst *Sala Krong* is the term used for municipal administrations.

the gap between expenditures and revenues does not promote good budget discipline and represents poor budget management.

7. The study analysed the budgets of the Sala Khet/Krong and the provincial share of national budgets for 2002, 2003, and the first 10 months of 2004. Diagrams 1 and 2 below compare the two types of budgets for Phnom Penh and Kompong Cham for 2003.

Diagram 1: Sala Khet/Krong Budgets

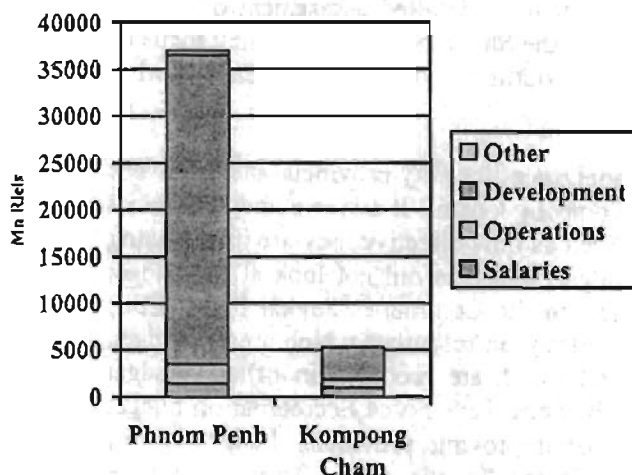
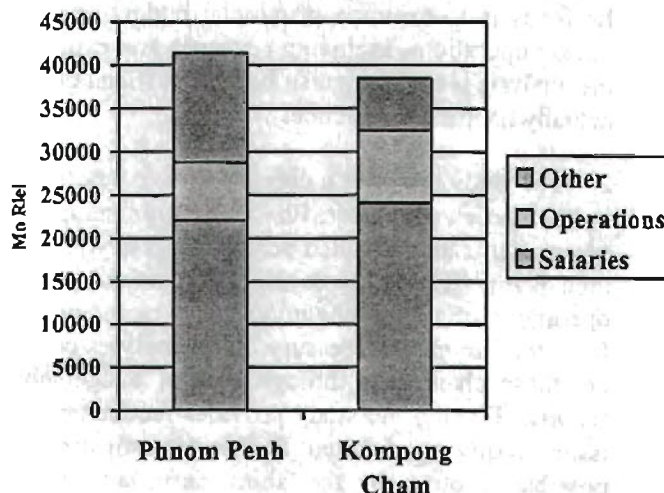


Diagram 2: Provincial Share of National Budgets



Provincial Resources

8. The system provides poor incentives for the reporting and collection of on-budget provincial/municipal resources. The emphasis on achieving the level of planned revenues discourages the collection (or, more likely, the recording) of revenues above the budget plan. It also encourages the retention of excess revenues off-budget. In addition, the system provides incentives for collecting some revenues over others, such as those which provide additional "incentives" for the revenue collector as part of the negotiation process in determining the revenue amount to be collected (i.e. sales taxes on services, such as the patente tax, from small traders who do not have published accounts). At the same time, the revenue plan is incremental, being based on the previous year's planned (not necessarily actual) revenues, rather than on a macro/fiscal analysis. Individual revenue collectors do not have set targets, nor are there incentive payments for reaching such targets.

9. The dual subordination (double reporting lines) for revenue collectors provides potentially conflicting incentives for revenue collection agents. In particular, although revenue collectors are under the authority of the central Tax Department, part of MEF, they are also nominally under the jurisdiction of the governor. Although evidence is difficult to obtain, these dual reporting lines can lead to pressures to make relatively greater effort to collect revenues assigned to the province/municipality, which are kept in the Provincial Treasury, over revenues assigned to the national level, which do not stay in the province/municipality. This can encourage rent-seeking behaviour by revenue collectors.

10. The governor's ability to manage the resources allocated to the Sala Khet/Krong budget is limited by the centralised nature of revenue collection. Good public financial management suggests that provincial/municipal governments should have adequate revenues to discharge their designated responsibilities. However, Governors do not have complete control over the level of resources collected in, and intended for, their provinces/municipalities. In terms of the revenue

sources assigned to the Sala Khet/Krong, the administration cannot itself affect the amount of resources it receives since it is the central level which is responsible for both the setting of tax rates and the administration of provincially-assigned taxes. At the same time, administrative delays from the central-level MEF (e.g. in setting the annual schedule of rates for transport tax) significantly affect the collection of these revenue sources, impeding the flow of resources intended for provincial/municipal services. These and similar issues cause significant and disruptive fluctuations in revenue receipts throughout the year and hinder good budget management.

11. While the governor's influence over the availability of on-budget resources is limited, off-budget resources provide a degree of discretion and flexibility to the Sala Khet/Krong administration to supplement budgetary resources. Estimates suggest that an additional 30% of total funds may be available to provincial/municipal administrations from a combination of retained revenues, private contributions, in-kind assistance from NGOs, and external financing. These off-budget resources are not subject to the same planning and accounting procedures as on-budget resources and hence undermine good public financial management. Indeed, it is difficult to obtain comprehensive information on the total resources provided to the Sala Khet/Krong.

12. The perception that the Sala Khet/Krong budget is in reality a slush fund for the governor is misleading. This perception is most likely based on the existence of these off-budget resources. However, the off-budget resources available to provincial/municipal governors provide additional discretion to supplement the relatively small size of budgetary expenditures as well as provide valuable liquidity when on-budget resources are delayed. In many cases, these resources are used for important local expenditure needs, such as road building or repair.

13. The lack of a comprehensive statement of resources available to provincial/municipal administrations discourages effective budget planning and management.

Budget Planning and Programming

14. The budget systems for both the Sala Khet/Krong and provincial-level national budgets do not give appropriate incentives or adequate accountability for the provision of priority, locally-based services to the local population. For provincial/municipal budgets, Governors, as head of the Sala Khet/Krong administrations, are perceived to have responsibility for providing services to the local populations but without appropriate accountability, supported by an adequate level of resources.

15. For effective accountability, clear lines of responsibility must be established and maintained. The unclear expenditure responsibilities at the provincial/municipality level (both Sala Khet/Krong and the provincial-level national budgets), combined with dual subordination (double reporting lines) for budget management, undermine accountability for budget outcomes. In particular, the roles of the Provincial Finance Office, the DEF and the MOI in the Sala Khet/Krong budget process are not clearly defined and delineated, as is the role of the provincial/municipal Finance Office and the DEF in provincial-level national budgets. This lack of clarity can lead to delays in the budget process, opens the budget process to negotiation through dual subordination, and encourages rent-seeking behaviour to ensure the budget passes its numerous approval hurdles. At the same time, unclear expenditure responsibilities and dual subordination undermine accountability to the local population for the services provided. The public does not necessarily have a clear idea who has responsibility for particular services and thus whom to approach for complaints about the lack of, or poor, services or to express their views on priority needs.

16. The lack of empowerment for decision-making by accountable senior management undermines the ability of those charged with managing services to do so effectively. That is, those purportedly charged with responsibility for managing services at provincial/municipal level are rendered passive by the decision-making process required from the centre. This lack of empowerment and inability to manage effectively is the result of:

- The lack of control over the allocation of the total level of resources, both planned and actual. There is no single pot of resources for funding services in the province/municipality; the separation of provincial-level resources between those provided as part of the Sala Khet/Krong and those provided through the line departments dilutes the decisions on the use of resources for priorities in the province/municipality. At the same time, the predictable flow of funds is undermined by central-level decisions, including the role of the National Treasury.
- Limited ability to decide what to fund, both because of the limited amount of resources available and because of the oversight and approval required by the central level.
- The lack of authority to manage service delivery, including over decisions on staffing levels, on whom to employ, and on the balance between personnel and operations expenditures.

17. For the governor to be appropriately accountable for the provision of local services, s/he needs to have discretion in planning and allocating resources to meet priority needs in the province/municipality. With the provincial/municipal governor's budget under the ultimate authority of the Ministry of the Interior, the budgetary autonomy of the governor to make allocative decisions in response to the needs of the local population without going through multiple levels of approval is limited. In practice, however, provincial governors may have more influence than it appears, both over the total size of the governor's budget and over in-year implementation. It is likely that the overall budgetary resource envelope, including the transfer from MEF to provinces/municipalities, is the result of negotiation between the governor, MOI and MEF; politically-stronger governors are more likely to obtain more resources for their province/municipality.

18. **Provincial budget planning does not promote good budget management focussed on service delivery.** The budget system should provide incentives for sound fiscal management and discourage inefficient practices. However, the short timetable for budget preparation provides very limited opportunity for analyses of needs and priorities and the allocation of budgets against expenditure programmes to meet policy objectives. At the same time, the line-item (chapter) basis of budgeting provides no incentives to redeploy inputs to be more cost-effective at providing services. Expenditure planning is concerned with managing budgetary inputs (staff and supplies and materials), rather than the resulting outputs and outcomes of public expenditure in terms of the efficiency and effectiveness of public services and their impact on the realisation of government policies at the provincial/municipal level.

19. **Both provincial budgets and provincial-level national budgets are non-transparent and lack comprehensiveness,** with a not insignificant proportion of resources operating outside of the Provincial Treasury system and hence not subject to the government's planning and prioritising processes. This undermines good budget management.

Budget Implementation

20. **Efficient budget implementation at provincial/municipal level is undermined by cash shortages.** Affecting the implementation of both Sala Khet/Krong and line department budgets, these problems are largely the result of shortages in the transfer of funds from the National Treasury to Provincial Treasuries and the displacement of funds intended for one purpose to another. For the provincial share of national budgets, resources intended for use by one line department may be used for other line departments sectors or for other provinces/municipalities. There is also informal evidence of the displacement of funds intended for C/S Fund. At the same time, delays in revenue collections contribute to the release of funds for implementing provincial budgets.

21. **Ineffective commitment controls disrupt budget implementation.** Authorisations of spending commitments are processed without checking the availability of cash until payment orders are

submitted to the Provincial Treasury; this gives the Provincial Treasury tremendous power. What is needed is to ensure that commitments are controlled in line with both budgetary plans and the availability of cash resources.

22. These cash shortages have an important impact on the degree of accountability for budget implementation. The Provincial Treasury's role as gatekeeper for cash disbursement potentially undermines appropriate accountability for budget implementation. For the governor to be appropriately accountable for the provision of local services, s/he needs to have discretion in the implementation of resources to meet priority needs in the province/municipality. In terms of procedures, the provincial/municipal governor's office has limited discretion in managing the implementation of Sala Khet/Krong budgets since they should be implemented in accordance with the budget plans agreed with the MOI and MEF. Implementation of line department budgets is under the authority of their parent ministries.

23. In practice, provincial governors potentially have more influence than it appears over in-year implementation of Sala Khet/Krong budgets in two ways. The first is in response to the unpredictable and sometimes limited flow of cash resources from the National and Provincial Treasuries, which allows the governor and provincial treasurer to have a key role in prioritising the payment of payment orders. The evidence on this type of influence by the governor on budget implementation is not definitive but the degree of influence is likely to be stronger where the governor has a good relationship with the Provincial Treasury. The second type of discretion by the governor in budget implementation is in the allocation of off-budget resources.

24. The problem of cash shortages relative to planned resources for budget implementation is that it dilutes accountability for the use of these resources. Ultimately, in practice, the decision-making authority for allocating resources lies with the Provincial Treasury. However, since the cash shortages are the result of problems further up the line, accountability for budget implementation lie not just with the Provincial Treasury but also with decisions by the National Treasury, MEF and line ministries. As with budget planning, there is no single government official accountable for budget implementation of both the Sala Khet/Krong and line department budgets, reflecting poor public financial management practices at all levels. At the same time, decisions on the allocation of limited cash resources are non-transparent.

25. Weaknesses in the public financial management system itself lead to incentives for poor budget practices. The difficulties with implementing budgets and unpredictable releases of budget funds lead to pragmatic solutions to meet cash shortages and to meet required expenses for service delivery. Such practices include the under-reporting and retention of national and municipal-level revenues or reliance on private contributions, payment of facilitation payments to gain necessary approvals since the large number of steps required for approval encourages rent-seeking behaviour, the use of suppliers' credit, and signing off on projects before they have been completed in order not to lose the funds. These practices should be viewed as distinct from budget leakage and corruption *per se*, the extent of which at provincial level is difficult to assess.

26. The line-item (chapter) basis of budgeting and the restrictive virement procedures discourage any emphasis or accountability for delivering services.

27. The emphasis on implementing the budget plan in full encourages a virtual budget process. This leads to a divergence between the accounting for budget authorisation (committed expenditure) and the cash provided to inputs and services (actual expenditure). Thus, submitted but as-yet-unpaid payment orders (due to the lack of cash) are nonetheless counted as expenditure (i.e. these payment orders are counted as used budget authorisation, known as credits) so that this part of the budget is not taken away by MEF at the end of the year. No systematic reporting of the cash position of budget implementation is made. This practice undermines good budget discipline.

28. Implementation of the Priority Action Programme (PAP) was found not to be taking place as intended in the province/municipalities studied. Whilst the PAP is intended to provide funds predictably throughout the year, the study has found that this is not the case, and budget implementation in PAP sectors face similar problems of cash shortages as in other sectors. Evidence of this is shown by the fact that budget implementation rates in the two study provinces, particularly in the education sector, are lower than with other sectors.

Financial Administration, Management and Control

29. **The internal control system has a great deal of control but weak accountability.** The internal control system at the provincial/municipal level is based on multiple layers of approval. This is compounded by the unclear lines of accountability for provincial administrations – both line departments and the Sala Khet/Krong. In practice, there are too many controls and insufficient accountability.

30. In spite of the multiplicity of controls and the centralised nature of the PEM system, weak financial management practices pose significant fiduciary risks. The fundamental problems result from a weak control environment, weaknesses in the Provincial Treasury system, especially in the area of cash management, inadequacies in the public accounting system, and weak internal and external auditing capacity. Consequently, the Government's budget and reporting systems cannot be relied upon to expend resources in an accountable manner.

31. These issues represent a broader financial management problem relating to the overall budget system, rather than one that is centred solely on provincial budgets and provincial-level national budgets, and hence need to be addressed as an integral part of the wider PFM reform programme.

32. **A lack of detailed information on budget implementation hinders financial management.** Budget information is unreliable due to the lack of reconciliation and incomplete recording of all government transactions, and the accounts are not subject to independent audit. These weaknesses would appear to undermine the usefulness of the accounting system to provide assurance that public funds are used for purposes intended.

33. Neither financial nor budget management is carried out at the provincial/municipal level – accounting and reporting are done to keep the books tidy (i.e. in accordance with the budget plan and regulations, as opposed to reflecting what happens in practice and for good budget management). The focus of the Provincial Treasury is on compliance and control through multiple regulations and procedures. An illustration of this is the mixture of cash and accrual accounting used and the submission of a high proportion of payment orders in December to ensure that unused budget authorisations are not lost at the end of the year. At the same time, the financial management function of the Provincial Treasury is undermined by the extent of resources and financial transactions that take place outside of the system.

34. No overall financial statements of accounts are produced by the DEF or the Provincial Treasury; only the ledger balances (trial balances) are prepared. More concerning is that fact that there is no recording of cash (as opposed to authorised [credit]) expenditures against the budget. There are also significant problems in reconciling the books held by the line departments and the General Ledger held by the Provincial Treasury. In the provincial/municipal treasuries, the accounting system does not provide easily accessible information on individual transactions, and this restricts the ability of the system to provide adequately detailed management information.

35. **In short, public oversight of provincial/municipal financial management remains very weak.** This has resulted in rent-seeking behaviour at different levels of financial control. Weak financial management is further hindered by a lack of basic skills and capacities.

Conclusions and Recommendations

36. The study's main conclusions fall under four major themes which cut across all aspects of the provincial/municipal public financial management process and are highlighted throughout the report.

Appropriate accountability for service delivery with appropriate resources

37. While the governor is responsible for the planning and implementation of services provided by the Sala Khet/Krong budget and has discretion over which activities receive funding, s/he can exercise little control over the resource envelope which is allocated to the budget as a whole. This results in the governor having responsibility for service delivery without the authority to ensure that revenues are collected or that funds planned for the budget can be accessed. Thus, in practice, the Sala Khet/Krong budget is not effectively owned by the province/municipality. In order to ensure that the deconcentration process can bring resources and decision-making closer to the people, more control over resources and the Sala Khet/Krong budget funds must be delegated to the governor to ensure not only accountability, but also that the appropriate resources are in practice made available.

Incentives for good budget management

38. In order for good budget management practices to be encouraged, it is essential that the incentives built into the system work to reinforce these practices rather than undermine them. It is clear that poor incentives are in operation at all levels of the system for both the planning and implementation of the Sala Khet/Krong and provincial share of national budgets. In particular, there is no incentive to collect municipally-assigned revenues over and above the revenue plan as these are only able to be retained with permission from MEF, the granting of which can take substantial time. At the same time, there are weak incentives to deliver public services, since the budget system is focused on managing inputs rather than on outputs or outcomes. This is exacerbated by the lack of accountability within line departments for service delivery, which is further undermined by the insufficient level of resources to provide such services.

Comprehensiveness and transparency in budget operations

39. There is a lack of transparency in the roles, responsibilities and decision-making for the Provincial Finance Office, DEF and MOI. This opens the system up to negotiation between these agencies when allocating resources, potentially delaying decision-making and encouraging rent-seeking behaviour at all levels. The emphasis on the budget plan for the Sala Khet/Krong and provincial-level national budget results in what can be termed a virtual budget process. Budget commitments are made without recourse to the level of funds available. This results in delays in the implementation of activities due to erratic funding. At the same time, budget implementation is measured by the issuing of payment orders, giving a distorted picture of budget performance. This process is designed to ensure that budgets appear to be fully implemented at the end of the financial year, but does not reflect actual budget implementation in physical resources nor the impact on the delivery of public services.

40. Comprehensiveness of the resource envelope is compromised by the fact that not all resources available to the province/municipality are on-budget. There are indications that significant off-budget resources are available to provincial/municipal administrations from a combination of retained revenues, private contributions, in-kind assistance from NGOs, and external financing. These off-budget resources are not subject to the same planning and accounting procedures as on-budget resources and hence undermine good public financial management.

Appropriate control and authority

41. There are too many controls and insufficient accountability within the provincial/municipal budget system. The fundamental problems result from a weak control environment, weaknesses in the provincial treasury system, especially in the area of cash management, inadequacies in the public

accounting system, and weak internal and external auditing capacity. Despite these controls there is a lack of authority delegated to the governor and to the DEF to make decisions regarding the Sala Khet/Krong budget; *de facto*, power tends to be concentrated in the Provincial Treasury as the result of cash shortages due to problems further up the line.

Recommendations

42. The majority of the problems highlighted in the study are the result of wider weaknesses in the public financial management system, rather than problems specific to provinces/municipalities. Thus, strengthening public financial management at the central level will be critical, particularly in terms of moving away from line-item (chapter) budgeting, clarifying lines of accountability and addressing dual subordination, strengthening accountability for service delivery rather than for fulfilling the budget plan, improving Treasury operations and the system for the release of funds, improving the internal control system, introducing an effective commitment control system, and strengthening financial management, including introducing international standards for accounting.

43. International experience suggests that comprehensive reform of the PFM system will take considerable time, particularly, given the severe capacity constraints at provincial/municipal levels. These capacity constraints would suggest that reforms should be undertaken gradually, concentrating first on ensuring that basic good budgeting practices are in place. Progress is likely to be slow.

44. Given the severe weaknesses in public financial management and the associated fiduciary risks, it is unlikely that Seila would wish to harmonise its future support with government systems in the short term (i.e. from 2005). Therefore, in these recommendations, the study concentrated instead on indicating areas that Seila might consider for further investigation regarding provincial/municipal budgets, recommendations for improvements in budget management that may be piloted, and relevant points that should be incorporated into the Organic Law on Decentralisation and Deconcentration.

Areas for further Seila investigation

45. This study has provided an initial overview of budget practices at the provincial/municipal level and has highlighted a number of weaknesses in their budget processes. Further analyses will be required to provide the basis for further support. In particular, a number of areas should be investigated in greater detail to understand some of these budget processes better. In particular, it is recommended that Seila consider the following areas for more detailed analysis:

- An investigation of the provincial/municipal revenue system in more detail, as well as ways to improve the incentives for revenue collection.
- A study of the expenditure process at the provincial level for one sector in-depth (i.e. expenditure tracking) for a non-PAP sector with significant expenditure, e.g. public works. The study would examine both Sala Khet/Krong budgets and the provincial share of national budgets.
- A study of how to incorporate some of the good practices used by Seila into government systems, including the stakeholder workshops for determining budgetary priorities during budget preparation, the use of commercial bank accounts for budget funds, more transparent procurement procedures, and greater accountability for the provision of services. On the basis of the study, these practices could be introduced in some provinces/municipalities as a pilot (see below).
- A study of ways to streamline provincial/municipal administrative procedures, including the decision-making process and the number of levels of approvals required.

Proposals for piloting

46. Following further study of provincial/municipal budget processes, Seila could pilot improvements to budget processes. Many of these recommendations are aimed at discrete interventions that could

be implemented effectively without wider PEM reforms. Options for pilots that Seila may wish to consider include:

- In conjunction with the wider PFM reform programme, introduce a pilot aimed at promoting good practices in budget management. MEF would provide additional discretionary budgetary resources to provinces/municipalities as a reward for good budget management and introducing good PFM practices. Success would require MEF to guarantee to provide such resources in exchange for agreed good budget practices. With a finite amount of additional resources to allocate across all provinces/municipalities, this would introduce a competitive element between provinces/municipalities designed to encourage implementation of good practice. A pilot at the Sala Khet/Krong level could then be extended to the provincial-level national budget.
- Following the results of the study described above, introduce particular measures to improved incentives for revenue collection and recording for the Sala Khet/Krong. This would allow the Sala Khet/Krong to keep a surplus of revenues over the planned amount and would focus on improving the projections of planned revenues based on analyses in accordance with a consistent macro framework such as the MTEF. It could also institute performance-based incentives for staff involved in tax collection and enforcement.
- A pilot aimed at ring-fencing the budgets of Sala Khet/Krong and line departments would help increase transparency of resource allocation and help prevent the diversion of resources intended for one use to other uses. The use of commercial separate banks or Treasury sub-accounts for the budgets of line departments and Sala Khet/Krong would not only give more control over budget resources to the province level, it would also weaken the discretion of the Provincial Treasury in deciding which departments receive disbursements.
- There is a clear need for district and provincial-level training in both budget management and accounting practices. Budget management training should focus on good budget principles and service delivery and could be delivered in conjunction with PFM reforms. Training in accounting principles and practices could be geared towards the granting of a qualification, which in turn could be rewarded through higher remuneration for qualified personnel.
- Seila should consider piloting a public meeting or consultation process to set priorities for the Sala Khet/Krong budget to ensure the participation and meeting of needs of local people. This could be undertaken in a similar manner to the district integration consultations undertaken by Seila for allocation of PIF resources.
- Undertaking a pilot project (e.g. associated with poverty reduction) with the aim of incorporating Seila good practice procedures and mechanisms. This would involve the allocation of government money with matching Seila resources. A stakeholder workshop/public meeting would be used to agree on the scope of the project, based on relative priorities, and provide some accountability to local people. Management of the project would focus on outputs and service delivery, rather than on inputs, and could involve a resource contract specifying outputs and clarifying lines of responsibility. The project would incorporate Seila good budget implementation practice, such as transparent procurement and accounting procedures and the use of commercial bank accounts.
- Following the results of the study described above, undertake a pilot for particular Sala Khet/Krong to streamline administrative budgetary procedures.
- In conjunction with wider PFM reforms, a pilot could be introduced to make monthly or quarterly budget releases for the Sala Khet/Krong budget against cash projections in conjunction with DEF and the Provincial Treasury.

Areas to Cover in the Organic D&D Law

47. The Organic Law which is currently being developed will also include issues related to sub-national governance that are addressed in this report. Specific recommendations for consideration for inclusion in the organic D&D law include:

- Clarification of the lines of accountability, roles and responsibilities for the planning and implementation of the provincial/municipal budget.
- Incorporation of a law on accounting principles and practices at central and provincial/municipal levels.
- Currently, the provincial governor has responsibility for the provincial budget but little authority to ensure delivery of outputs. Given the fact that the governor is not elected, more delegated authority to strengthen the provincial governor's role might be considered in conjunction with a service delivery contract that outlines responsibilities and activities for which the governor will be accountable.
- Ring-fencing of provincial level budgets to ensure access to designated resources through the operation of bank accounts.
- Consideration of methods by which the focus on the implementation of budget plan can be changed towards strengthening incentives towards service delivery. This might include the use of service delivery contracts for provincial administration and line departments as discussed above.

1. Introduction

1.1 Moving away from the central provision of public services is regarded as a critical tool to help align public expenditures to local priorities, improve management incentives, and provide a greater degree of accountability to users close to the point of service delivery. With its emphasis on greater decentralisation to the commune/sangkat level and its desire to introduce improvements to the management of provincial management, the Royal Government of Cambodia (RGC) has signalled its intention to strengthen the provision of sub-national services. In order for the benefits of deconcentration to be realised, it is important that the deconcentrated system provides appropriate incentives for sound fiscal management and discourages inefficient practices. At the same time, it is important to ensure that objectives of central government are adhered to by sub-national governments.

1.1 The study focuses on the first sub-national administrative level, the provinces/municipalities and districts. At this level, central government has handed over a certain degree of administrative responsibility to provincial levels of central government ministries and agencies. At this same time, whilst the authority for responsibility for functions has been shifted by the central government to provinces and districts, it remains within the central government structure. Local offices are local branches of central agencies and, as such, are accountable to them.

1.2 In order to help Seila to meet its objective of assisting the RGC to improve provincial management, the current study was commissioned to examine how provincial budgets are planned, programmed and executed in practice. The results of the study will assist in the public financial management (PFM) reform programme activity of investigating options for improving fiscal decentralisation.

1.3 There has not been significant work carried out to date on the operations of provincial budgets. Not a great deal is known about how provincial budgets are planned, implemented and reported, and this study appears to be the first detailed look at how provincial budget operations work in practice. The study's specific objectives are: (i) to explain how sub-national (provincial) budgets are planned, implemented and reported, in terms of both procedures and practice; (ii) to analyse the actual flow of funds to the provincial level in the context of planning, budgeting and revenue systems; and (iii) to provide recommendations for areas of further investigation or piloting by the Seila Task Force Secretariat.

1.4 This report provides a comprehensive description and analysis of the provincial/municipal budget processes in Phnom Penh and Kompong Cham. It reviews how provincial governments allocate their scarce budgetary resources, as well as how effective they are in executing their plans. Specifically, the analysis and assessment of provincial budget operations covers:

- A description of the scope and methodology of the study (Section 2);
- Analyses of expenditure responsibilities and trends in the provincial/municipal budgets for Phnom Penh and Kompong Cham (Section 3);
- Discussion of the sources and performance of provincial/municipal resources (Section 4);
- Review of budget planning and programming at provincial/municipal level (Section 5);
- Procedures for implementation of provincial/municipal budgets (Section 6); and
- Overview of provincial/municipal financial management arrangements (Section 7).

1.5 Supplementing the main text are a number of annexes, which include: the TORs (Annex A), list of people met (Annex B), and documents consulted (Annex C).

2. Scope and Methodology of the Study

2.1 In order to understand provincial budgets, the study concentrated on examining in detail the budget operations of two provinces. In agreement with the Ministry of Interior (MoI) and the Ministry of Economy and Finance (MEF), the chosen field sites were the municipality of Phnom Penh and the province of Kompong Cham. These provinces/municipalities were selected because they have larger budgets than other areas.

2.2 The methodology for the study involved extensive face-to-face discussions with stakeholders involved in the budget process in the two chosen provinces. During the field visits, which took place between 8-23 November 2004, a wide-ranging consultation process was undertaken, involving interviews with: (i) staff from the Seila Task Force Secretariat; (ii) the governors of Phnom Penh municipality and Kompong Cham province; (iii), senior and technical staff of the Sala Khet/Krong administrations, at both provincial/municipal and district levels; (iv) senior and technical staff of the line departments in Phnom Penh and Kompong Cham; (v) staff concerned with provincial budget operations in the MEF and MOI; and (vi) representatives of the donor community. The consultations involved both the gathering of information as well as discussions on initial analyses and conclusions. During the discussions, the study team cross-referenced and triangulated information to verify the accuracy and consistency of the analysis.

2.3 In addition, the team studied a large number of documents and gathered extensive budgetary data from the two field sites. At the end of the field visit, a wrap-up meeting was held for a variety of stakeholders to test the study's initial conclusions and recommendations.

2.4 The analyses have necessarily been limited by the quality and extent of the data provided to the study team. In particular, the study has examined official budget data for the analysis of trends; there are several weaknesses of these data, and these are discussed in Section 6.

2.5 A number of areas were considered beyond the scope of the study. Firstly, the team concentrated on the provincial budgets and thus did not look at the budget operations of the commune/sangkat, including the transfers to the Commune/Sangkat Fund (CSF) from the Provincial Treasury. Secondly, the team concentrated its analyses on resources which are on-budget, i.e. those channelled through official budget channels, as well as official budget reports. The team has attempted to discuss the likely nature and extent of off-budget resources, but, due to their nature, we cannot be definitive and are thus unable to provide detailed analyses of these resources. Finally, whilst the TORs indicate that the study should formulate design options for institutionalising or harmonising external Seila support with provincial/municipal management, guidance was subsequently given during the field visit to concentrate more on providing guidance to the Seila Task Force Secretariat on budget issues requiring detailed further investigation and on options for good budget practices which could be piloted in the short term.

2.6 Before turning to an analysis of budget performance, Box 2.1 provides a brief overview of the two study provinces.

Box 2.1: Background to Study Provinces

	<u>Phnom Penh</u>	<u>Kompong Cham</u>
Population	1,006,995	1,717,769
Number of Districts	7	16
Number of Communes/Sangkats	76	173
Number of Villages	637	1,758
Sala Khet/Krong budget, 2003 (US\$'000)	8,365	899
As % of Total Sala Khet/Krong Budgets (%)	39%	4%
Provincial-level National Budget, 2003 (US\$'000)	10,350	9,615
As % of Total Provincial-level National Budgets (%)	10%	9%

Source: MoF, Phnom Penh and Kompong Cham Finance Offices

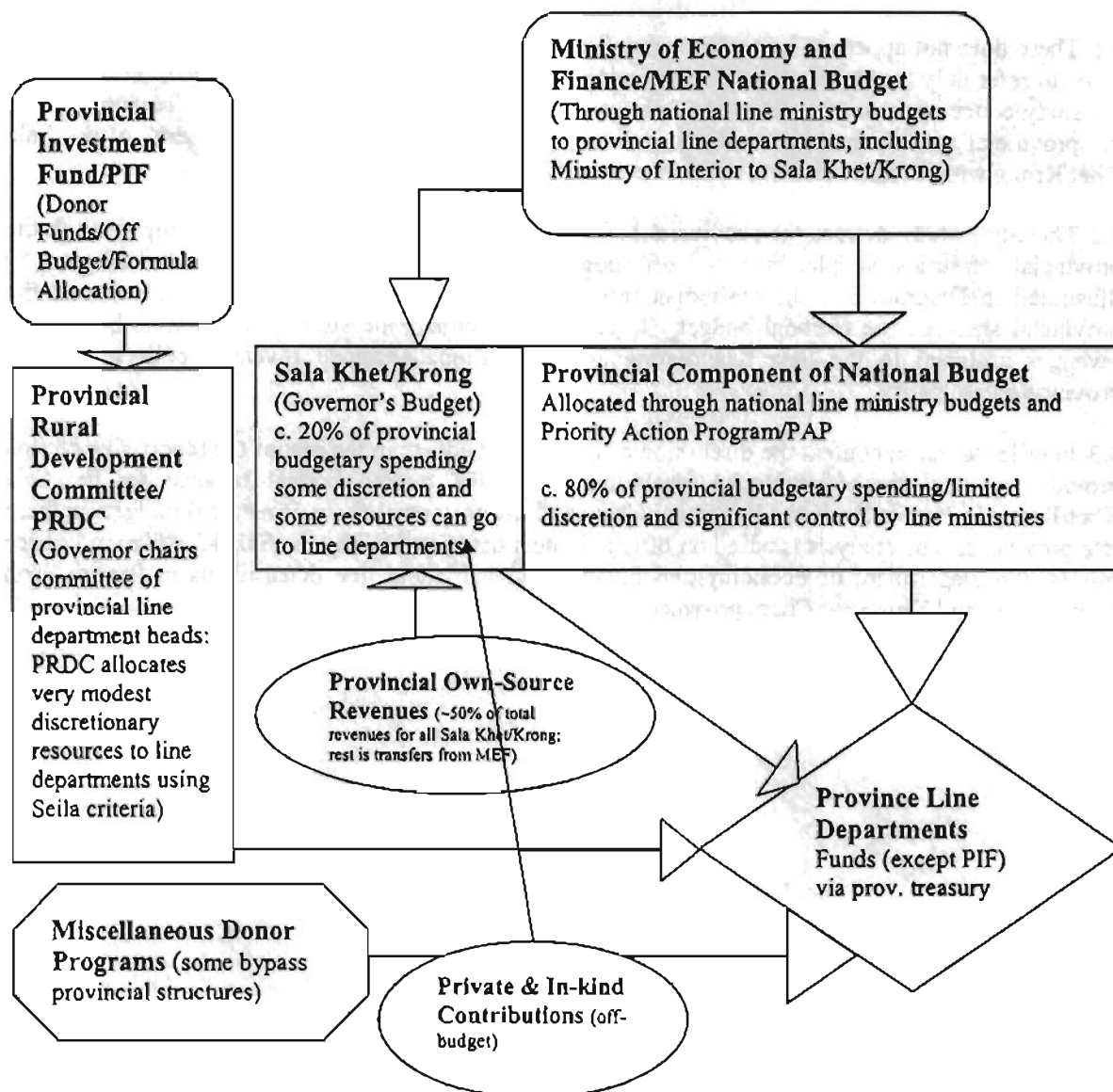
3. Analysis of Provincial/Municipal Budget Trends

3.1 There does not appear to be a common definition of provincial budgets. In common parlance, it tends to refer only to the Sala Khet/Krong budgets, which are relatively small. Indeed, the TORs for the study concentrate on this definition. However, given the role of the Provincial Treasury in both the provincial and the national budgets, it is not possible to understand the problems of the Sala Khet/Krong without also referring to the experience of implementing national budgets.

3.2 Thus, this study defines the provincial budget to refer to on-budget resources going through the provincial treasuries, supplemented by off-budget resources to the provincial administrations. As illustrated in Diagram 3.1, the on-budget resources include the Sala Khet/Krong budgets and the provincial share of the national budget. In terms of revenues, the study will examine both those revenues assigned to the Sala Khet/Krong and the national-assigned revenues collected in the province/municipality.

3.3 In order to put in context the discussion of provincial budgets in the rest of the report, this section provides an analysis of provincial expenditures and the overall budget balance for the Sala Khet/Krong in Phnom Penh and Kompong Cham and the provincial share of national budgets in these two provinces. The analysis is based on official budget data provided by the Sala Khet/Krong finance offices, the Department of Economy and Finance and individual line departments in Phnom Penh municipality and Kompong Cham province.

Diagram 3.1: Overview of Budgets at Provincial Level²



² Adapted from Local Governance and Accountability, CAS Background Paper, World Bank, April 2004.

Expenditure Assignment

Provincial share of the national budget

3.4 The majority of public services are provided either by national-level programmes administered by central ministries in Phnom Penh (not discussed in this report) or by provincial programmes administered by the deconcentrated line departments at provincial/municipality and district levels. The deconcentrated provincial-level services refer primarily to basic (primary- and secondary-level) services. For example, in education, the provincial share of national budgets refers to primary and secondary education services (e.g. pre-primary, primary and secondary schools). This includes salaries for teaching and non-teaching staff, the cost of school supplies and equipment, school operating costs (e.g. utilities) and the maintenance and repair of schools. Similarly, in the health sector, the deconcentrated services include primary (health centre) and secondary (district hospital) health services. However, as will be discussed in Section 6 below, the ability of line departments to carry out their assigned services depends on the availability of resources and the appropriate incentives for good budget management.

3.5 Box 3.1 provides an overview of the expenditure responsibilities for the provincial/municipal line departments.

Box 3.1: Expenditure Assignment for Provincial Share of National Budget

Sector	Expenditure Responsibility	Type of Expenditure	% Share of 2003 Overall Expenditures ¹
Health	Primary/preventive level care through health centres and secondary-level care through district referral hospitals, provincial administration	Salaries for medical and non-medical workers, health centre/hospital supplies and utilities, repair and maintenance of buildings	7% (PNP) 18% (KPC)
Education	Primary, secondary education services, some teacher training, provincial administration	Salaries for teaching and non-teaching staff, office costs (e.g. supplies and utility costs), repair and maintenance of buildings	46% (PNP) 57% (KPC)
Social protection, women's affairs	Social transfers, social allowances, women's educational issues, legal protection, food security, poverty issues at local level, provincial administration	Social transfers/allowances, salaries and office costs, limited poverty alleviation projects.	30% (PNP) 16% (KPC)
Rural development	Water and sanitation services (clean water), rural road improvement/ maintenance, maintenance of health posts, provincial administration	Salaries and office costs, repair and maintenance costs for rural infrastructure	1% (PNP) 1% (KPC)
Agriculture, land management	Provincial administration, agricultural subsidies, maintenance and upkeep of irrigation infrastructure	Salaries and office costs, agricultural subsidies, repair and maintenance costs for irrigation infrastructure	3% (PNP) 3% (KPC)
Public Works	Upkeep and maintenance of infrastructure (e.g. primary and secondary roads, drainage), provincial administration	Repair and maintenance costs for transport and drainage infrastructure, salaries and office costs	7% (PNP) 1% (KPC)
Commerce, industry, tourism	Registration of SMEs, conducting price surveys (e.g. consumer basket), quality control/standards for goods, trademark issues, regulation	Salaries and office costs (e.g. supplies and utility costs)	1% (PNP) 1% (KPC)
Other (environment, religion, culture, recreation, law and public order, finance, planning, information)	Provincial administration, provision of local culture and recreation services, environmental protection, administration of provincial courts	Salaries, office costs (e.g. supplies and utility costs), repair and maintenance costs of buildings	4% (PNP) 4% (KPC)

Note: 1. Expenditure data are based on official budget reports.

Sala Khet/Krong

3.6 Whilst the majority of public services are managed vertically by central ministries and their provincial/district branches, the specific expenditure responsibilities of the Sala Khet/Krong in terms of service delivery are not clearly defined in legislation. There is no provincial-level organic budget law, which sets out definitively the roles and responsibilities for the Sala Khet/Krong and the reporting lines with respect to the line departments.³ In practice, operating in effect as a branch line department of the Ministry of Interior (MoI), the Sala Khet/Krong are responsible primarily for administration of the Sala Khet/Krong at the municipal/provincial and district levels. Thus, their budgets fund the salaries and running costs (e.g. office supplies, building and equipment maintenance) of the Sala Khet/Krong provincial and district administrations.

3.7 In addition to running the administration, a relatively small amount is given to the Sala Khet/Krong to carry out or support priority projects of importance to the local population in each area. These activities include: maintaining public security, road repairs, provision and upkeep of water supply and sanitation, provision and upkeep of electricity supplies, provision and upkeep of public

³ The main law governing public finance in Cambodia is the "Budget Organic Law" (93) passed in December 1993. A draft Provincial Organic Budget Law has been under preparation since 2002.

spaces, provision and upkeep of some public buildings (e.g. meeting rooms), and specific activities during local festivals.

3.8 Box 3.2 provides a summary of the services covered by the Sala Khet/Krong budgets.

Box 3.2: Sala Khet/Krong Expenditure Assignment			
Sector	Expenditure Responsibility	Type of Expenditure	2003 Expenditures ¹
Public Administration	Primary responsibility for provincial/municipal and district administrations.	Salaries, office costs (e.g. supplies and utility costs) Repair/ maintenance of buildings	3.7 bn riels (PNP) 1.8 bn riels (KPC)
Roads	No specifically defined role. Limited investment for provision, repair and maintenance of road infrastructure when funds are available.	"Development" (as part of operational expenditures under Chapter 11)	15.6 bn riels (PNP) 1.1 bn riels (KPC)
Water supply	No specifically defined role. Limited investment for provision, repair and maintenance of water supply infrastructure when funds are available.	"Development" (as part of operational expenditures under Chapter 11)	4.0 bn riels (PNP) 76 mn riels (KPC)
Public lighting	No specifically defined role. Limited investment for provision, repair and maintenance of public lighting infrastructure when funds are available.	"Development" (as part of operational expenditures under Chapter 11)	4.5 bn riels (PNP) 248 mn riels (KPC)
Sanitation, health, security	Firefighting, rubbish collection, public safety/security	"Development" (as part of operational expenditures under Chapter 11)	2.1 bn riels (PNP) 259 mn riels (KPC)
Social transfers	No specifically defined role. Limited finance for poverty alleviation (e.g. for relocation of urban poor) when funds are available.	"Development" (as part of operational expenditures under Chapter 11)	2.4 bn riels (PNP) 132 mn riels (KPC)
Other	No specifically defined role. Sport, culture, maintenance of market places (e.g. slaughterhouses)	"Development" (as part of operational expenditures under Chapter 11)	1.2 bn riels (PNP) 137 mn riels (KPC)

Note: 1. Expenditure data are based on official budget reports.

Analysis of Budget Performance

3.9 Having discussed the expenditure responsibilities of the Sala Khet/Krong and the line departments, this sub-section turns to an analysis of the Sala Khet/Krong and line department budget performance over the last three years. Official budget data were used for the analyses. As discussed in Section 6 below, there are severe limitations to these data, and the analyses are intended to reflect the relative importance of different sectors and budget line items over time and between Phnom Penh and Kompong Cham.

Sala Khet/Krong expenditures

3.10 Tables 3.3 and 3.4 set out the budget balance for Phnom Penh and Kompong Cham, respectively, over the last three years. Budget expenditures in Phnom Penh have grown by around 12% per year over the period, whilst expenditures in Kompong Cham have been squeezed due to problems with revenue collections (see section 4 below)⁴. Differences between expenditure requirements and revenue-raising ability are met by transfers from central government. Phnom Penh is the only province/municipality in the country which does not receive such a transfer. The transfer to Kompong Cham has averaged between 300 and 1,000 mn riels (between US\$80,000-300,000, or 10-20% of the Sala Khet's total budget) annually since 2002.

⁴ Although Phnom Penh experienced similar problems with shortfalls in vehicle tax, the municipality was able to cover this shortfall through other non-tax revenue sources.

Table 3.3: Phnom Penh Sala Krong Budget Balance, 2002-2004 (US\$ '000)

	2002	2003	2004	2004
	Actual	Actual	Budget	Jan-Oct
Total Revenues	7,567	8,405	9,591	11,125
Total Expenditures	7,304	8,405	9,591	5,334
Balance	263	0	0	5,792

Note: 1. Includes transfer from/to MEF (negative amount refers to transfer from MEF)

Source: Official budget reports, Phnom Penh Sala Krong Finance Office

Table 3.4: Kompong Cham Sala Khet Budget Balance, 2002-2004 (US\$ '000)

	2002	2003	2004	2004
	Actual	Actual	Budget	Jan-Oct
Total Revenues	858	721	1,113	1,127
Total Expenditures	938	893	1,391	477
Balance ¹	-80	-172	-278	651

Note: 1. Includes transfer from/to MEF (negative amount refers to transfer from MEF)

Source: Official budget reports, Kompong Cham, Sala Khet Finance Office

3.11 Details of the Sala Krong budget for Phnom Penh and the Sala Khet budget for Kompong Cham are shown in Diagrams 3.2 and 3.3, respectively. "Development" expenditures, specifically, non-administrative expenditure on service provision, including repair, maintenance and investment, represent the largest proportion (around 50% in Kompong Cham and more than 80% in Phnom Penh) of Sala Khet/Krong expenditures. These expenditures typically include road repair and maintenance; the maintenance of lighting, water supply and other public utility infrastructure; as well as social transfers to the poor. A breakdown of development expenditures for Phnom Penh and Kompong Cham is given in Diagram 3.4 below. In both provinces, improvement of the road infrastructure represents nearly half of all development expenditures. The improvement of infrastructure as a whole was repeatedly mentioned as key priorities for both Sala Khet/Krong.

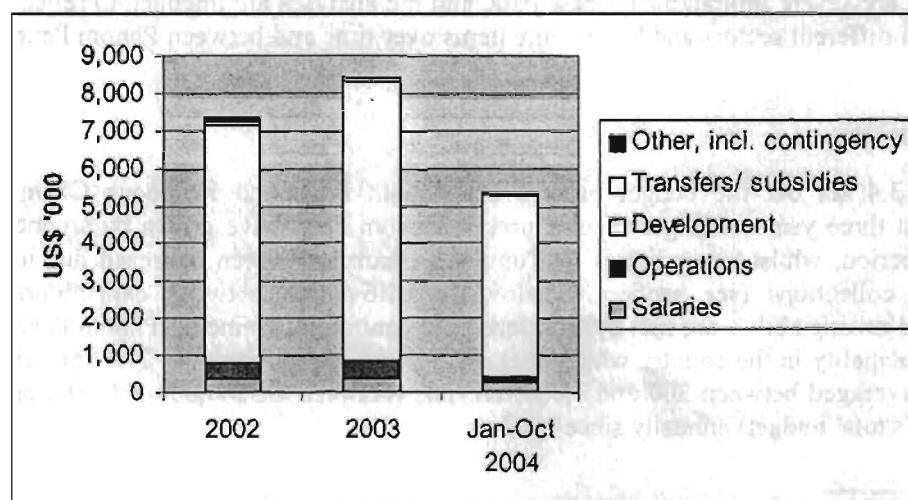
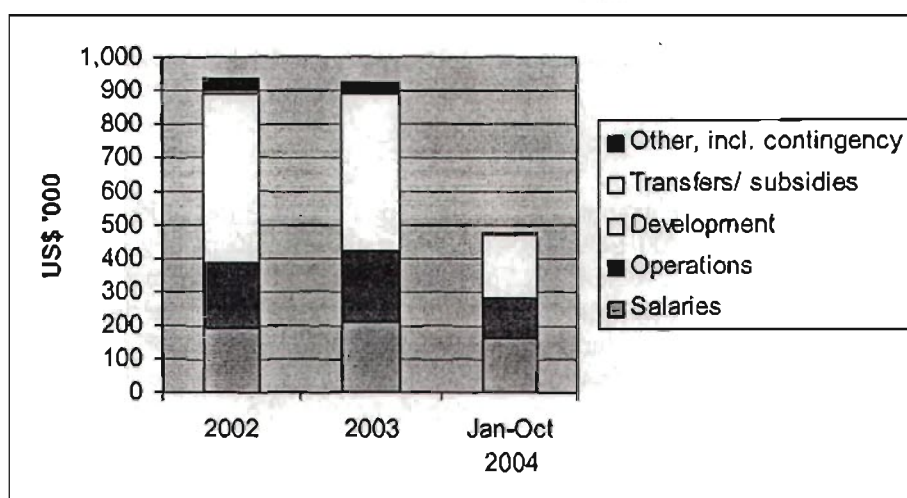
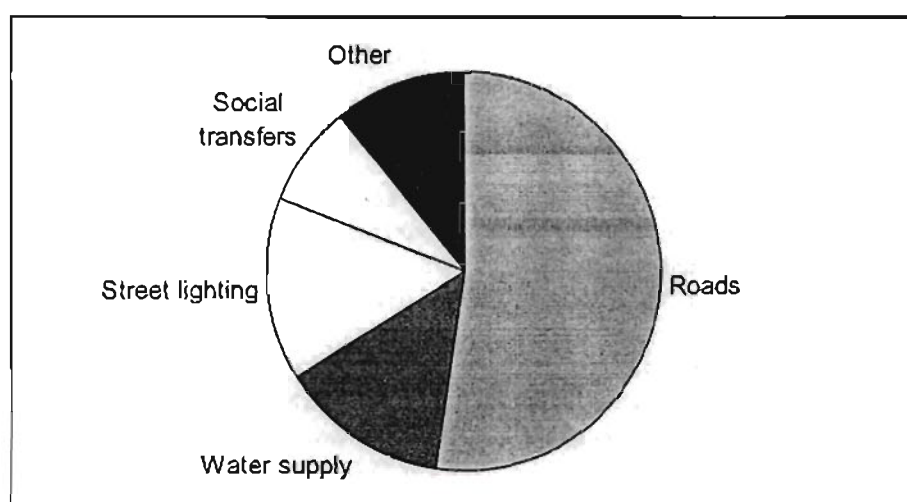
Diagram 3.2: Phnom Penh Sala Krong Expenditures, 2002-2004 (US\$ '000)

Diagram 3.3: Kompong Cham Sala Khet Expenditures, 2002-2004 (US\$ '000)



3.12 The relatively high implementation rates for the Phnom Penh Sala Krong and Kompong Chang Sala Khet budgets shown in the series of tables in the annex are the result of the way that the Provincial Treasuries account for expenditures. As discussed in Section 6 below, the requirement that unused budgets cannot be carried over to the next financial year leads Provincial Treasuries to use a mixture of cash and accrual accounting to reduce the amount of unused budget credits (i.e. authorisations) to a minimum. Thus, whilst cash disbursements are recorded for the majority of the financial year, if, at the end of the year, the availability of cash resources is lagging behind the amount of unused budget authorisations (i.e. if there is a cash shortfall relative to the amount budgeted), then the receipt of payment orders (rather than cash) is recorded against budget authorisations. Provided that payment orders are received before the end of the financial year (December), these are recorded as in-year expenditures, even though matching cash disbursements have not necessarily taken place. As can be seen annex tables D.2 and D.3, the percentage of the two Sala Khet/Krong budgets implemented during the first 10 months of 2004 is significantly lower than what would be expected if cash disbursements were made evenly throughout the year.

Diagram 3.4: Development Expenditures, Sala Khet/Krong, 2003



3.13 Budgetary expenditures per capita by the Phnom Penh Sala Krong is more than five times greater than the average for all provinces/municipalities, reflecting its greater revenue-raising potential. At 33,200 riels (US\$8.30), expenditure per person is amongst the highest levels across the country, with only Krong Kep and Mondul Kiri averaging more per person. The most populous province of Kompong Cham has the lowest expenditure per capita by any Sala Khet/Krong, at 2,070 riels (US\$0.52).

Provincial share of national budgets

3.14 Turning to the provincial share of the national budget, per capita expenditures in Phnom Penh on all deconcentrated services average 41,000 riels (US\$10), whilst those in Kompong Cham are closer to 22,400 riels per person or US\$5.60 (Table 3.5). The largest share in both provinces is spent on the social sectors, including education, social protection, and health, followed by agriculture and public works. Whilst the overall level of expenditures is similar between the two areas, Phnom Penh spends significantly more per capita on public infrastructure, such as transport and public works, and relatively less on health. Expenditures are also higher on average in the capital on social welfare and education.

Table 3.5: Total and Per Capital National Expenditures, Phnom Penh and Kompong Cham, 2003

	Phnom Penh		Kompong Cham	
	Total	Per capita	Total	Per capita
	(US\$ '000)	(US\$)	(US\$ '000)	(US\$)
General public services	104	0.10	137	0.08
Public order/safety	194	0.20	94	0.05
Agriculture, forestry, fisheries, water	448	0.45	373	0.23
Transport, communications, public works	704	0.70	88	0.05
Other economic affairs	112	0.10	77	0.05
Environmental protection	40	0.05	27	0.03
Health	727	0.73	1,767	1.03
Recreation, culture, religion	109	0.10	88	0.05
Education	4,800	4.77	5,468	3.19
Social protection	3,160	3.14	1,544	0.90
Total	10,399	10.33	9,663	5.63

Source: Official expenditure reports, DEF, Phnom Penh and Kompong Cham

3.15 Tables 3.6 and 3.7 show provincial-level national expenditures for the 2002-2004 period for Phnom Penh and Kompong Cham, respectively. Expenditures have increased somewhat (around 5% per year) over the three-year period. Whilst one would expect that the Priority Action Programme (PAP) priority sectors⁵ would exhibit an increase in their share of overall expenditures, this does not appear to be the case across the board in either Phnom Penh or Kompong Cham. The health sector has increased its share in Phnom Penh but has decreased its relative importance in Kompong Cham. In Phnom Penh, the education sector experienced a reduction in its relative share, with actual expenditures having fallen in 2003; in Kompong Cham, by contrast, education expenditures maintained their level. These inconsistent trends in the two priority sectors are concerning, since the PAP programme was intended to ensure both that greater expenditures were allocated to these two sectors and that planned disbursements were more regularly and fully provided. As the tables show,

⁵ PAP sectors are health, education, agriculture, and rural development.

the implementation rates for these two sectors, particularly in Phnom Penh, were lower than those experienced in other sectors, including agriculture and public works. Indeed, growth rates in public works expenditure have been higher in both Phnom Penh and Kompong Cham than in other sectors, possibly indicating its relative national importance to the government. However, without taking into account national and provincial expenditures, including external financing, conclusions are necessarily tentative. These trends could reflect a growing importance for national programmes, managed centrally, or a degree of substitution of external financing for domestic resources (particularly in health and education).

Table 3.6: Phnom Penh Share of National Expenditures, 2002-2004 (US\$ '000)

	2002			2003			2004		
	Author- ised	Actual	Actual as % of total Auth	Author- ised	Actual	Actual as % of total Auth	Author- ised	Actual 6 months	Actual as % of total Auth
General public services	125	112	89.8%	114	104	91.6%	N/A	74	N/A
Public order/safety	109	99	91.3%	213	194	91.2%	N/A	148	N/A
Agriculture, forestry, fisheries, water resources	514	480	93.3%	482	448	93.0%	N/A	301	N/A
Transport, communications, public works	618	583	94.4%	717	704	98.2%	N/A	557	N/A
Other economic affairs	124	105	84.0%	124	112	90.6%	N/A	64	N/A
Environmental protection	42	38	91.1%	41	40	96.8%	N/A	28	N/A
Health	743	623	83.8%	766	727	94.9%	N/A	700	N/A
Recreation, culture, religion	127	106	83.6%	123	109	88.5%	N/A	76	N/A
Education	5,866	5,108	87.1%	5,150	4,801	93.2%	N/A	3,881	N/A
Social protection	2,624	2,573	98.1%	3,174	3,160	99.5%	N/A	2,350	N/A
Total	10,893	9,828	90.2%	10,904	10,399	95.4%	N/A	8,179	N/A
			100.0%			100.0%			100.0%

Source: Official expenditure reports, DEF, Phnom Penh

Table 3.7: Kompong Cham Share of National Expenditures, 2002-2004 (US\$ '000)

	2002			2003			2004		
	Author- ised	Actual	Actual as % of Auth	Author- ised	Actual	Actual as % of Auth	Author- ised	Actual 10 months	Actual as % of Auth
General public services	136	109	80.4%	156	137	87.8%	138	45	32.5%
Public order/safety	69	53	76.8%	61	94	153.2%	100	42	41.7%
Agriculture, forestry, fisheries, water resources	453	330	72.9%	419	373	89.2%	409	120	29.3%
Transport, communications, public works	104	85	81.5%	96	88	91.6%	98	29	29.6%
Other economic affairs	123	85	69.3%	85	77	90.2%	90	26	29.5%
Environmental protection	36	28	78.1%	31	27	88.4%	32	10	31.5%
Health	1,885	1,809	95.9%	1,869	1,767	94.5%	2,054	805	39.2%
Recreation, culture, religion	83	68	81.3%	97	88	91.0%	80	28	35.2%
Education	5,698	5,203	91.3%	5,822	5,468	93.9%	5,565	2,431	43.7%
Social protection	1,688	1,529	90.6%	1,642	1,544	94.1%	1,650	682	41.3%
Total	10,276	9,300	90.5%	10,278	9,663	94.0%	10,214	4,218	41.3%
			100.0%			100.0%			100.0%

Source: Official expenditure reports, DEF, Kompong Cham

4. Provincial/Municipal Resources

4.1 Resources collected in provinces/municipalities include: (i) tax and non-tax revenues assigned to the Sala Khet/Krong; (ii) tax and non-tax revenues assigned to the national (central) level; and (iii) additional off-budget resources, which consist mainly of cash and in-kind contributions from donors, NGOs and private sources.

4.2 The budgets of the provincial/municipal administrations are financed from the revenues assigned to the Sala Khet/Krong, as well as deficit financing provided by the MEF. The provincial-share of national budgets are financed from transfers from MEF to parent line ministries and hence to provincial/municipal line departments. Revenues assigned to the national-level budgets which are collected in the provinces/municipalities are transmitted to the national level and thus are not held in the province/municipality. In other words, there is little relationship between revenues collected in the province/municipality and services provided in that province/municipality.

4.3 This section assesses the contribution to provincial/municipal budgets of all of these revenue sources, analyses trends in revenue performance, as well as key issues and constraints that have an impact on the effectiveness of revenue collection and budget planning.

Revenue Sources

Tax assignment

4.4 Revenues from specific revenue sources are divided between (assigned to) the Sala Khet/Krong and national budgets, with the national level assigned the revenue from eight tax and non-tax sources and the municipal/provincial level assigned revenues from six types of taxes, plus a number of non-tax sources. This allocation is outlined in Table 4.1 below.

Table 4.1: Assignment of Revenue Sources

National Level	Provincial/Municipal Level
Income tax	Unused land tax
Profit tax	Land transfer tax
Turnover tax	Animal slaughter tax
Excise	Patente tax
Stamp duty	Vehicle tax
Penalties & fines	Public lighting tax (on alcohol and cigarettes)
Administration fees	Non-tax revenues
Property/asset rental	

4.5 The Tax Departments in Kompong Cham province and Phnom Penh municipality are responsible for collecting the resources assigned for both the national and provincial/municipal levels. Certain non-tax revenues are collected by line departments, while fees for civil registration, for example, are collected at sangkat/commune level or district level. In provinces/municipalities, public utilities, such as water and electricity supplies, are provided by autonomous companies who pay taxes on their profits and profit-based dividends. In Phnom Penh, these companies are also required to set aside 10% of fees from customers to make infrastructure improvements to the system; this money is deposited in an account in the Municipal Treasury and is intended to be earmarked for such improvements.

4.6 Details of the taxes assigned for the Sala Khet/Krong budget are shown in Table 4.2. They include:

- The tax on unused land levied each year on undeveloped land at a rate of 2% of the land value. The Department of Land Management provides the Tax Department with a list of those required to pay from their land registry records. Unofficial exemptions are likely to be granted to certain large landowners. The Tax Department reported that payment of this tax is low, at an estimated 30% of potential yield.
- The land transfer tax is levied on land purchased, at a rate of 4%. The purchaser is unable to gain title to the land until the fee is paid, resulting in a relatively high collection rate.
- The tax on animal slaughter is levied per animal. In Phnom Penh the vet in charge provides verification in the form of a letter to the tax department outlining the number of livestock killed, and the tax is paid monthly. No other external verification by the tax department is undertaken. In Kompong Cham an agent of the tax department visits slaughterhouses on a monthly basis to collect the tax. This occurs on a less regular basis for more distant slaughterhouses.
- Patente tax is collected annually from businesses and is based on actual (on those with published accounts) or estimated (on those without published accounts) turnover. It is levied through either submitting business accounts or estimated through negotiations between the Tax Department and the owner. The tax schedule is divided into industrial and service companies. For industrial companies the minimum turnover threshold is 7 million riels and for service orientated companies 3 million riels.
- Vehicle tax applies to all modes of transport, with a sliding scale of fixed charges to be paid annually. Often, the tariff schedule and authorisation for collecting this tax are not issued until the middle of year, resulting in revenues normally collected between July and September. This has a major impact on revenue receipts as the vehicle tax comprises a significant source of taxation for the Sala Khet/Krong budget.
- Public lighting tax is a sales tax levied at a rate of 3% on sales of alcohol and cigarettes. The revenue is intended to be earmarked for expenditure on public lighting. Collections are on a monthly basis with estimates provided by the retailers themselves. As it is another sales tax, it is said to be an unpopular tax and collection rates are reportedly low.

Table 4.2: Taxes Assigned to the Sala Khet/Krong Budgets

Tax	Description	Collection Method	Compliance	Comments
Tax on Unused Land	Tax on land which is undeveloped is levied at 2% of original land value	Annually in September based on Department of Land records	Low Penalty for late payment is 40% of tax due plus interest.	Many unofficial exemptions are reported to be granted. Often only a portion of land owned is registered which is below the 1000ha threshold for tax liability
Transfer Tax	Tax of 4% levied on purchasing property, based on sale price.	Paid when sale is registered at the Department of Land with land title not issued until the tax is paid	Payment rate high	
Patente Tax	Tax on businesses based on turnover. Sliding scale of tax levied depending on level of turnover.	Quarterly. Based on accounts of the business or estimated through negotiation with owner and tax agent.	High in Kompong Cham Low in Phnom Penh	
Public Lighting	Levied on sales of alcohol and cigarettes at 3%	No guidelines on collection. Tax Dept asks businesses for estimate of monthly sales. Larger companies must submit accounts	Low	The revenue from this tax is supposed to be earmarked for expenditure on public lighting.
Animal Slaughter	Tax on slaughter of animals based per head. 1 pig head is 1,500 riels. 1 cow/buffalo head is 3000	Paid monthly by slaughter house. A letter from a vet verifies the number of heads in Phnom Penh and in Kompong Cham a tax agent verifies	High, but no means to verify that head count is accurate	
Vehicle Tax	Vehicle tax levied on all means of transport. Tariff depending on type of vehicle	Paid annually	High	MEF guidelines and tariff schedule, issued annually, are often issued late in the year

Non-tax revenues

4.7 A number of non-tax revenue sources are collected by line departments for assignment to provinces/municipalities and to the national level. The non-tax revenue sources assigned to the Sala Khet/Krong are shown in Table 4.3.

Table 4.3: Provincial/Municipal-Assigned Non-Tax Revenues, Phnom Penh and Kompong Cham in 2003 ('000 riels)

Non-Tax Revenue	Phnom Penh	Kompong Cham
Dividends from public utility companies	1,000	10
Royalties Fees	-	10
Market Stall Rental	-	250
Parking Lot	139	350
Port fee	78	318
Slaughter House	-	135
Market Fee	-	383
Fishing Lots	57	-
Boat Mooring Fee	6	40
Administration Fee	-	20
Licences	1,700	195
Others	140	-
Total	3,120	1,711

Source: MEF Consolidated Revenues of Provincial Budgets

Off budget resources

4.8 Off-budget resources to which the province and municipality have access are estimated to be significant. The main sources of off-budget funding are:

- *External finance* There is no official register of external finance at provincial/municipal level. Seila is one of the main donors to sub-national governments through the Provincial Investment Fund (PIF), which gives block grants to provinces. In 2004 Kompong Cham received USD 2.0 mn from the PIF and Phnom Penh USD 0.98 mn.
- *In-kind resources* Both the province and the municipality receive in-kind resources from NGOs or other organisations, which can be in the form of the construction of school buildings or clinics, for example. The total value of these in-kind resources is not officially recorded nor known in many cases.
- *Private contributions* Whilst it is difficult to obtain specific information about the size of these resources, they are known to take the form of donations by private companies or individuals. They may finance road building or infrastructure improvements in their local area. Contributions from individuals and businesses provide partial funding when public events are held such as festivals.
- *Retained revenue* As discussed below, due to the problems reported in Section 6 with releasing provincial/municipal funds from the Provincial/Municipal Treasury, the tax system provides incentives to under-report revenues and retain resources collected above the plan rather than transfer them to the Provincial/Municipal Treasury.

4.9 Box 4.1 outlines the main off-budget and on-budget sources of provincial/municipal revenue.

Box 4.1: Summary of Sala Khet/Krong Revenue Sources: On-budget and Off-budget

<i>On-Budget</i>	<ul style="list-style-type: none">• Taxes assigned to the province/ municipality which are deposited in the Provincial/Municipal Treasury• Non-tax revenues collected by line departments. These are deposited in the Provincial/Municipal Treasury• Transfer from MEF for Kompong Cham since expenditures exceed revenues (deficit financing). Phnom Penh does not receive these.
<i>Off-budget</i>	<ul style="list-style-type: none">• Private Contributions to the Sala Khet/Krong: companies and private individuals fund infrastructure and security. It is assumed that these do not go through the treasury.• In-kind resources from donations of infrastructure e.g. clinics and schools• Donors: Projects and investment that are donated to the province/municipality• Retained revenues

Deficit financing

4.10 Additional finance is provided by the MEF in the form of deficit financing. Provinces receive additional resources from the national budget if the planned annual Sala Khet/Krong expenditures exceed their revenue-raising ability. As outlined in Section 3, the Kompong Cham provincial budget receives approximately 10-20% of its resources through this mechanism, whereas Phnom Penh does not receive any such deficit financing.

Institutional Arrangements and Tax Collection Process

4.11 Provincial/municipal Tax Departments, and their district subordinate offices, are under the authority of the MEF as deconcentrated offices of the central main Tax Department. These offices provide administrative functions and collect cash-based revenue receipts in the province/municipality. Unused land tax, land transfer tax and vehicle tax must be paid at the municipal or provincial tax office, and these taxes are paid in cash. For profit tax, public lighting, income tax, slaughter tax, turnover and excise, the tax collector goes to the business to collect taxes owed, and often their tax bill is determined through negotiation. Patente tax is either paid at the Tax Department by large companies or at their premises for small ones. An enforcement section based in the main provincial/municipal Tax Department has the mandate to collect arrears and ensure compliance. Non-payment of taxes results in warning letters being sent to the taxpayer with fines and various penalties levied if payment is not made.

4.12 The annual tax collection process begins with the development of the revenue plan for the province/municipality by the MEF, which draws up a schedule for revenue collection in consultation with the DEF and the provincial/municipal Tax Departments. The plan outlines the amount of revenue receipts which the Tax Department is expected to collect for both the provincial/municipal and national levels. The plan is based on revenue collections from the previous year rather than on forecasts supported by macro/fiscal analyses. The MEF also draws up guidelines for individual tax collection and issues tariff schedules outlining the collection rates for those taxes, such as vehicle tax, whose rates change annually.

4.13 Once the Sala Khet/Krong revenue payments have been collected by the Tax Department, cash payments are deposited in the Municipal Treasury, while bank transfers are sent to the National Treasury by the company paying and are then transferred back to the Municipal Treasury in cash. The majority of tax payments are paid in cash, with less than 10% of taxpayers paying by bank transfer.⁶ Revenues assigned to the national level are deposited directly in the National Treasury.

⁶ Note, however, that the size of these transfers may be significant, as they come from some of the largest companies (this affects the balance between national and provincial/municipal revenues in Tables 4.5 and 4.7, where data from transfers are excluded due to difficulties in collection).

Revenue Performance

Phnom Penh

4.14 For municipal revenues, public lighting tax represents the largest source of tax revenue with 59% of total revenues from this source in 2003, and it has been growing in importance, as shown in Table 4.4. The drop in the share of vehicle tax in 2003 was due to the delay in the MEF issuing the tax schedule, which was not published until late in the year. Patente tax was the second largest source of receipts in 2003 at 12% followed by land transfer tax.

Table 4.4: Share of Taxes in Total Tax Revenues: Phnom Penh – Municipal Budget

Municipal Treasury	2002	2003	Jan-Sept 2004
Unused land	1%	1%	4%
Land transfer	11%	10%	12%
Patente tax	13%	12%	11%
Animal slaughter	1%	1%	0%
Vehicle Tax	22%	10%	12%
Public Lighting tax	47%	59%	45%
Non-tax revenues	6%	7%	14%
Total	100%	100%	100%

Source: Municipality of Phnom Penh Tax Department

4.15 Trends in revenue performance for Phnom Penh are outlined for both national and municipal revenue sources for 2002-2004 in Table 4.5. Overall, national-level revenues have grown by around 3% per year over the three-year period, whilst provincial/municipal revenue levels have increased annually by 15-20%. The percentage of the planned revenue collected for the national budget was 80% in 2002, 71% in 2003 and 73% for the first 9 months of 2004. For municipal revenues the proportion of the planned amount collected was significantly higher, at 122% in 2002, 100% in 2003 and 106% for the first nine months of 2004.⁷ It should be noted that forecasts are based on previous year's revenues which means that the plan represents not targets as such, but rather what it is expected to be achievable⁸. At the same time, annual revenue performance is affected by problems at central level, such as delays in issuing tariff schedules. The figures also reflect changes in enforcement policies, as evidenced by the increase in collection of unused land tax in 2004, which reflect the threat to confiscate land on which there are tax arrears.

4.16 Collection of both national and municipal taxes by the Tax Department could lead to a problem with dual incentives as the Tax Department is based in the municipality. This may result in greater pressure or incentives to focus on municipal tax collection. From Table 4.5, this appears to be the case; revenues collected for the municipality are higher than the revenue plan, whereas for the national budget actual revenue receipts were lower than planned in all three years.

⁷ Note also that fluctuations in revenue receipts are caused by administrative problems, such as delays in the setting of annual tariff schedules (e.g. for vehicle tax) or the planned imposition of penalties for non-payment, as happened with the unused land tax in 2004.

⁸ Table 4.5 gives no figures for profit tax in 2002 and income tax in 2003. This is due to omissions in the figures given by the municipal tax department as these taxes were in fact collected in both years.

Table 4.5: Annual Planned and Actual Revenues for Phnom Penh National and Municipal Revenues – 2002-2004 units, US\$ '000

National Revenues**	2002			2003			2004 (9 months)		
	Planned	Actual	Actual as % of Planned	Planned	Actual	Actual as % of Planned	Planned	Actual	Actual as % of Planned
Income	N/A	N/A	N/A	3	N/A	N/A	3	2	70%
Profit tax	102	65	64%	120	72	60%	83	48	57%
Turnover tax	867	778	90%	913	777	85%	784	591	75%
Excise	15	4	28%	25	4	16%	13	4	30%
Stamp Duty	319	152	48%	251	181	72%	278	239	86%
Penalties/ fines	33	6	18%	33	1	3%	25	30	118%
Administration fees	10	16	155%	18	7	37%	18	14	79%
Asset rentals	579	510	88%	804	501	62%	582	367	63%
Total	1,926	1,531	80%	2,166	1,543	71%	1,786	1,295	72%
Municipal Revenues*	2002			2003			2004		
	Planned	Actual	2002 %	Planned	Actual	2003 %	Planned	Actual	Jan-Sep 2004 %
Tax revenues									
Unused land tax	153	70	46%	75	58	77%	76	427	563%
Transfer tax	893	804	90%	879	830	94%	885	1,261	142%
Patente tax	893	966	108%	1,005	1,029	102%	1,138	1,068	94%
Tax on slaughter houses	77	52	68%	75	43	57%	63	33	53%
Vehicle tax	1,530	1,635	107%	1,691	846	50%	1,771	1,266	72%
Public lighting tax	2,296	3,578	156%	3,153	4,973	158%	4,807	4,601	96%
Sub-total tax revenues	5,841	7,105	122%	6,879	7,778	113%	8,741	8,657	99%
Non-tax revenues									
Dividends	0	0	N/A	251	206	82%	379	961	253%
Rental fees	73	76	103%	70	80	114%	71	67	94%
Other, incl. fees for service	309	386	125%	462	341	74%	400	436	109%
Sub-total non-tax revenues	383	462	121%	784	627	80%	850	1,464	172%
Total	6,223	7,567	122%	7,663	8,405	110%	9,591	10,121	106%

* The amount collected is 1.5% higher in all cases as the tax department is allowed to retain this to supplement salaries. The figures in the table above represent the amounts that were deposited in the national and municipal treasuries. **Figures represent cash receipts and exclude receipts collected by other means. Also exclude other non-tax revenues. Source: Municipality of Phnom Penh Tax Department

Kompong Cham

4.17 Kompong Cham's total revenues are considerably smaller than those of Phnom Penh. However, in Kompong Cham, non-tax revenues, particularly, rental fees from public assets, are much more significant than in Phnom Penh. Amongst tax revenues, vehicle tax is the most important source of revenue receipts. As in Phnom Penh, the delay in MEF's issuance of the tax schedule in 2003 caused severe disruption in the province's revenue receipts. The percentage amount that each tax contributed to total provincial tax revenues is shown in Table 4.6 below.

Table 4.6: Share of Taxes in Total Tax Revenue: Kompong Cham – Provincial Budget

Provincial Revenues	2002	2003	Jan-Oct 2004
Unused Land	0%	0%	0%
Land Transfer	2%	3%	2%
Patente Tax	6%	7%	5%
Animal Slaughter	3%	3%	2%
Vehicle Tax	40%	15%	37%
Public Lighting Tax	0%	1%	0%
Non-tax Revenues	49%	71%	54%
Total	100%	100%	100%

Source: Province of Kompong Cham Tax Department

4.18 Trends in revenue collection for Kompong Cham compared with planned revenues are outlined in Table 4.7. As in Phnom Penh, Kompong Cham collects a higher proportion of planned revenues for the provincial budget than for the national budget. Significant increases in profit tax receipts have boosted national-level revenues. Provincial revenues have fluctuated significantly over the three-year period due in large part to administrative problems, for example with the vehicle tax. In both 2003 and to-date in 2004 the collection rate for the national budget has exceeded the budget plan, largely due to better-than-expected collection of non-tax revenues. For the Sala Khet, budget revenue collections exceeded the budget plan in 2002, but were half of the budget plan in 2003 due to the problems with vehicle tax collection that Phnom Penh also experienced. The worst performer of the Sala Khet revenues is unused land tax, which has consistently been less than two-thirds of the budget plan and reflects poor enforcement.

Table 4.7: Annual Planned and Actual Revenues for Kompong Cham National and Provincial Revenues – 2002-2004 units, US\$ '000

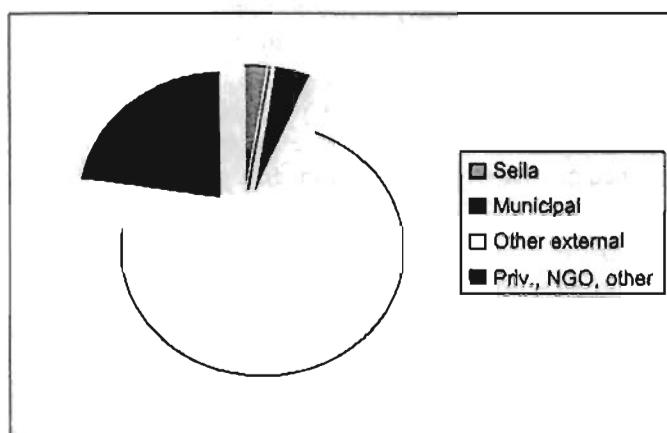
National Revenues***	2002			2003			2004 (9 months)		
	Planned	Actual	Actual as % of Planned	Planned	Actual	Actual as % of Planned	Planned	Actual	Actual as % of Planned
Income tax	1	3	200%	3	8	250%	10	7	72%
Profit tax	402	323	80%	555	551	99%	638	1,094	172%
Turnover tax	221	177	80%	191	175	91%	200	135	68%
Excise	3	0	6%	8	1	13%	1	1	80%
Stamp Duty	17	26	158%	18	19	106%	29	13	46%
Penalties & fines	10	5	48%	10	23	233%	8	10	133%
Administration fees	2	7	325%	7	5	73%	7	7	112%
Asset rentals	6	6	96%	8	6	80%	10	16	163%
Total	712	588	83%	857	871	102%	991	1,384	140%
Provincial Revenues									
	2002 Planned	2002 Actual	2002 %	2003 Planned	2003 Actual	2003 %	2004 Planned	Jan-Sep 2004 Actual	Jan-Sep 2004 %
Tax revenues									
Unused land tax	5	2	40%	3	2	70%	3	1	50%
Transfer tax	15	16	102%	15	23	153%	18	18	101%
Patente tax	51	49	97%	58	53	91%	53	58	109%
Tax on slaughter houses	23	23	99%	23	20	89%	24	15	61%
Vehicle tax	281	349	124%	318	109	34%	430	391	91%
Public lighting tax	4	3	73%	4	4	107%	4	3	73%
Sub-total tax revenues	379	441	116%	419	211	50%	531	485	91%
Non-tax revenues									
Dividends	5	2	40%	3	2	80%	3	1	30%
Rental fees	269	414	154%	371	506	136%	521	548	105%
Other, incl. fees for service	33	1	2%	57	3	4%	58	25	43%
Sub-total non-tax revenues	307	417	136%	430	510	119%	582	574	99%
Total	686	858	125%	849	721	85%	1,113	1,059	95%

* The amount collected is 1.5% higher in all cases as the tax department is allowed to retain this to supplement salaries. The figures in the table above represent the amounts that were deposited in the national and municipal treasuries. **Figures represent cash receipts and exclude receipts collected by other means. Also exclude other non-tax revenues. Source: Province of Kompong Cham Tax Department

Comparison of total revenues in Kompong Cham and Phnom Penh

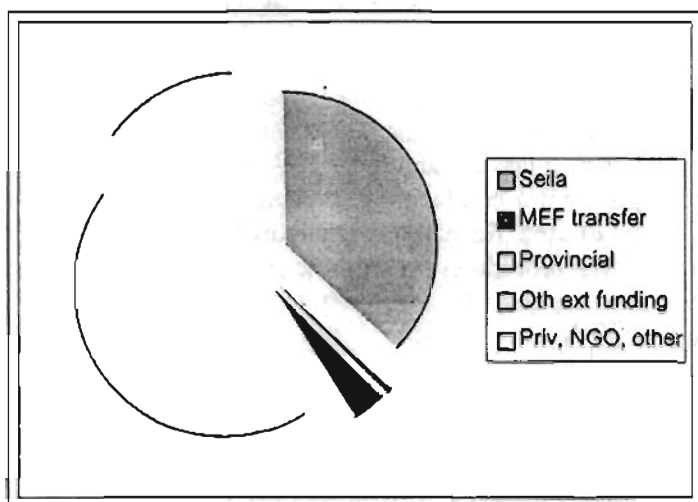
4.19 The figures discussed above refer to official or on-budget resources, which is only a proportion of total resources available to Sala Khet/Krongs. The pie charts in Figures 4.1 and 4.2 represent estimates of total resources available to both Kompong Cham and to Phnom Penh provincial/municipal budgets. The resource estimates put on-budget resources alongside Seila and other external funding, and private contributions. The proportion that each of these represent are indicative and were estimated by the authors on the basis of discussions with interviewees.

Figure 4.1 Total Resources: Phnom Penh



4.20 As the pie chart for the Phnom Penh Sala Krong indicates (Figure 4.1), the municipal budget allocation is a small percentage of the total resources available. By far the largest contribution originates from donor funding of municipal level projects, including Seila, followed by resources from private and other contributions.

Figure 4.2 Total Resources: Kompong Cham



4.21 Kompong Cham's Sala Khet budget resources are shown above in Figure 4.2. Unlike Phnom Penh, Seila and other external funds are the largest resources available at provincial level, followed by private and other contributions. The provincial budget allocation and the extra national-level funding provided to the provincial budget are extremely small in comparison.

Assessment and Key Issues

4.22 The discussion above has described the revenue sources available to the Kompong Cham province and Phnom Penh municipality and outlined the processes for revenue collection. The following section assesses the key issues and constraints relating to provincial/municipal resourcing and the problems which occur in providing timely and efficient resources for the Sala Khet/Krong budgets.

Dual subordination

4.23 The dual subordination (double reporting lines) for revenue collectors provides potentially conflicting incentives for revenue collection agents. In particular, although revenue collectors are under the authority of the central Tax Department, part of MEF, they are also nominally under the jurisdiction of the governor. Although evidence is difficult to obtain, these dual reporting lines can potentially lead to pressures to make relatively greater effort to collect revenues assigned to the province/municipality, which are kept in the Provincial Treasury, over revenues assigned to the national level, which do not stay in the province/municipality. This can encourage rent-seeking behaviour by revenue collectors.

Accountability

4.24 Good public financial management suggests that provincial/municipal governments should have adequate revenues to discharge their designated responsibilities. However, Governors do not have complete control over the level of resources collected in, and intended for, their provinces/municipalities, with the majority of revenues are assigned to the national level. At the same time, the governor's ability to manage the resources allocated to the Sala Khet/Krong budget is limited by the centralised nature of revenue collection. In terms of the revenue sources assigned to the Sala Khet/Krong, the administration cannot itself affect the amount of resources it receives since it is the central level which is responsible for both the setting of tax rates and the administration of provincially-assigned taxes. At the same time, administrative delays from the central-level MEF (e.g. in setting the annual schedule of rates for vehicle tax) significantly affect the collection of these revenue sources, impeding the flow of resources intended for provincial/municipal services. These and similar issues cause significant and disruptive fluctuations in revenue receipts throughout the year and hindering good budget management.

4.25 While the governor's influence over the availability of on-budget resources is limited, off-budget resources provide a degree of discretion and flexibility to the Sala Khet/Krong administration to supplement budgetary resources. Estimates suggest that an additional 30% of total funds may be available to provincial/municipal administrations from a combination of retained revenues, private contributions, in-kind assistance from NGOs, and external financing.⁹ These off-budget resources are not subject to the same planning and accounting procedures as on-budget resources and hence undermine good public financial management. Indeed, it is difficult to obtain comprehensive information on the total resources provided to the Sala Khet/Krong.

4.26 The perception that the Sala Khet/Krong budget is effectively a slush fund for the governor is misleading. This perception is most likely based on the existence of these off-budget resources. However, the off-budget resources available to provincial/municipal governors provide additional discretion to supplement the relatively small size of budgetary expenditures as well as provide valuable liquidity when on-budget resources are delayed. Indeed, given problems with budget implementation outlined in Section 6, these off-budget funds play an important role in relieving the financial constraints that are experienced at provincial/municipal level. In many cases, these resources are used for important local expenditure needs, such as road building or repair.

⁹ Estimates have been made on the basis of discussions with stakeholders and review of data from a variety of sources.

Poor incentives for revenue collection

4.27 The system provides poor incentives for the reporting and collection of on-budget provincial/municipal resources in three ways. Firstly, the emphasis on achieving the level of planned revenues discourages the collection (or, more likely, the recording) of revenues above the budget plan. In practice it makes no difference whether the planned amount is collected or not; if the revenue targets in terms of the revenue plan are not reached, there are no penalties. As discussed above, taxes collected for the national budget are not retained at provincial/municipal level, and for locally-assigned taxes any revenues collected over and above the plan cannot be kept without permission. If the plan is exceeded the surplus revenues are deposited in the National Treasury and are not retained for use by the Sala Khet/Krong. A request can be made to the MEF to use surplus tax collections for the provincial/municipal budget over and above the plan, but approval from MEF is often delayed, leaving insufficient time to spend the money, which then reverts back to the MEF at the end of the year. These issues can encourage the retention of additional revenues off-budget rather than transmitting all national fund budget revenues to the national level.

4.28 Indications were also made that tax officials attempt to overcharge businesses, and different line departments try to raise revenues by levying additional unofficial charges on services. These practices are in the light of problems with delayed disbursements from the Provincial Treasury and the fact that allocated funds often do not filter down in full to provincial level, both of which provide a strong incentive for revenue retention at the municipal/provincial level.

4.29 Further disruptions leading to incentives to retain revenues include the delay in receiving MEF authorisation for the collections of those revenue sources whose tariff schedules are set on an annual basis. This actually delays the process of tax collection as the province/municipality must wait until the authorisation comes through before commencing tax collection. In practice, authorisation for the collection of some taxes is sometimes not given until June/July of a given year, causing considerable disruption to provincial/municipal budgets, as occurred with collections of vehicle tax in 2003. This undermines provincial/municipal autonomy over their budgets.

4.30 Secondly, the system provides incentives for collecting some revenues over others, such as those revenue sources assigned to the province/municipality rather than national level taxes, as well as those for which there is more of a discretionary element in the amount collected and which can 'incentivise' the tax collector. As described earlier, a significant proportion of taxes, particularly for small businesses, e.g. in the service sector, is collected by negotiations between the tax collector and the business owner. One example is the collection of sales taxes on services, such as the patente tax, from small traders who do not have published accounts.

4.31 Individual revenue collectors do not have set targets, nor are there incentive payments for reaching such targets. Although the Tax Department can keep 1.5% of all revenues collected (apart from penalties and administration fees) this does not provide individual performance-related incentives, particularly as it is unclear how these funds are redistributed. Interviewees variously reported that they were given on a monthly basis to top-up salaries, while others said that they were kept by the MEF and used for bonuses at festival times.

4.32 This lack of incentives also leads to poor tax enforcement and low rates of compliance for many taxes. Businesses are reluctant to pay taxes as the system of estimating taxes leads to inconsistent tax assessments and in many cases over-charging, while the penalties for not paying are weak. Although the tax departments have enforcement units, if payment is not made, warning letters are sent outlining penalties, which usually consist of charging interest on outstanding taxes, but these are rarely enforced.

4.33 The issue of poor incentives to collect revenues is further underlined by the fact that tax buoyancy is very low for some revenue sources, as there is little indication of any consistent relationship between GDP growth and growth in receipts. It would be expected that revenue receipts

would increase broadly in line with GDP growth, but those revenue sources which would be most closely related to GDP growth, such as turnover tax, profit tax, excise and patente tax, have shown mixed results. Interestingly, provincial/municipal revenue sources seem to be more buoyant, with patente tax and public lighting tax showing relatively high levels of buoyancy. For national-level revenue sources, turnover and excise tax show relatively low buoyancy, particularly in relation to profit tax. This may indicate a greater incentive to collect provincial/municipal revenues than national-level ones.

4.34 Finally, the revenue plan is based on the planned (not necessarily actual) revenues, rather than on a macro/fiscal analysis. Projections of tax revenue would provide more accurate information about potential tax revenue and could then be used as a basis for developing revenue targets which would be more realistic. This would indicate the extent to which the tax department is under-performing as at present there is no account taken of economic growth or expansion of the tax base when the revenue plan is developed. As a result, the revenues officially collected are likely to be significantly less than the potential tax yield. Overall, it is estimated that an additional 20-30% could be raised if better incentives for tax collection existed and better enforcement measures were in place. In the recommendations for further investigation outlined in Section 8 below, a suggestion is made that Seila could commission a separate study of the provincial/municipal revenue system in detail, focussing particularly on ways to improve the incentives for revenue collection.

4.35 In short, better incentives and a better basis for estimating revenue collections are needed to encourage more efficient and effective revenue collection for both the Sala Khet/Krong and national budgets.

Comprehensiveness and transparency of revenue plans

4.36 The lack of a comprehensive picture of resources available to provincial/municipal administrations discourages effective budget planning and management. As indicated above, the official revenue plan does not cover all revenue sources available to the Sala Khet/Krong budgets and hence not all resources are subject to the planning process. With external finance, in-kind and private contributions excluded from the total resource envelope, this reduces transparency in resource allocation diminishes the effectiveness of the budget planning and allocation framework, and undermines good budget discipline.

5. Budget Planning and Programming

5.1 This section sets out the budget planning and programming processes for the Sala Khet/Krong and the provincial share of the national budget. It provides a description of the process for budget planning/programming for the Sala Khet/Krong budgets, as well as for the preparation of provincial-level national budgets.

5.2 The discussion below looks at the processes for planning/programming of recurrent and development expenditures together. In Cambodia, investment expenditures in the international understanding of the term (capital expenditures or that included in the Public Investment Programme [PIP]) are classified under Chapters 50 and 51. At the provincial level, specifically, in Phnom Penh municipality and Kompong Cham province, neither the budgets of the line departments nor those of the Sala Khet/Krong administrations contain expenditures classified under Chapters 50 and 51. Regular repair and maintenance expenditures are included under the recurrent Chapter 11 category (which also includes operating expenditures such as supplies and utilities). This makes it less meaningful to separate maintenance and "development" from non-maintenance expenditures and hence more relevant to consider the budget preparation process for all non-capital investment expenditures together.

5.3 The budgeting process for both the Sala Khet/Krong and the provincial-level national budgets follow a traditional incremental practice, centred on allocating resources to individual line items. Salaries are allocated on the basis of the number of staff and in line with salary scales issued by the Council for Administrative Reform (CAR). Operations and maintenance expenditures are allocated on the basis of supply-side (input) norms, which in reality means on an incremental basis.

Sala Khet/Krong Budget Planning

5.4 The budget preparation process begins at the end of June or beginning of July with the issuing of budget guidelines by the MEF to Sala Khet/Krong; these include the budget "package" – a total ceiling for the whole Sala Khet/Krong budget. The budget ceilings are calculated on an incremental basis, being based on the previous year's plan plus around 10% on salaries and social allowances. The guidelines give the table formats to be used, procedures to follow to prepare the budgets, and deadlines for budget preparation. The MEF guidelines may contain instructions on individual expenditure items, such as the requirement to decrease operations costs from the previous year (as is stated in the 2005 guidelines).¹⁰

5.5 The Sala Khet/Krong finance department, together with the governor, province/municipality Tax Department and relevant line departments including the DEF, revises the tax and non-tax revenue estimates (which must be approved by the MEF as part of its review of the Sala Krong/Khet budget). The Finance Department prepares the budget estimates in a top-down manner for each district by individual chapter. The bases for the allocations are:

- Salaries (Chapter 10) – based on the number of staff and the salary scale determined by CAR;
- Operations (part of Chapter 11) – based on supply-side norms per staff and per institution (e.g. materials required for a particular size of school);
- Subsidies/transfers (Chapter 31) – social allowances (e.g. pension fund payments) are allocated in accordance with norms determined by the central ministry;
- Contingency (Chapter 41) – at 3%.

¹⁰ For 2005, for example, government policy is for a reduction of 6% in administrative expenditures.

- Development (rest of Chapter 11) – this is the residual. The allocation of development expenditure is made by the governor, in conjunction with the heads of the relevant line departments (e.g. Department of Public Works). The governor requests line departments to prepare project proposals, which are reviewed by the governor and discussed with the heads of the relevant line departments at an inter-department committee meeting. The main priorities are public lighting, water supply, road maintenance, security, and the provision of fuel for pumping stations. Written explanations of the choice of projects allocated funding are required to accompany the budget proposals given to MEF and MoI.
- Any additional amount requested from MEF for deficit Sala Khet/Krong (all Sala Khet/Krong except Phnom Penh municipality) is determined by the gap between expenditure needs and own-source revenues.

5.6 The process of preparing the draft budget proposals takes a maximum of 2 months – the process is usually completed in August, and by law the budget must be submitted to MEF by 1 September.

5.7 Once the budget proposals have been prepared, they are reviewed by the DEF, endorsed by the governor and sent to the MEF and MoI for review and approval. The Sala Khet/Krong are required to defend their budget proposals to MoI and MEF during national-level meetings in September. If any changes are made during these discussions, the resulting revisions are fed back down through the system to alter the figures for the budget chapters for individual districts. The budgets are usually given final approval by October.

5.8 Box 5.1 summarises the Sala Khet/Krong budget planning process.

Box 5.1: Sala Khet/Krong Budget Planning Process			
Time	Step	Responsibility	Remarks
July	Receive budget guidelines from MEF, containing Sala Khet/Krong budget ceiling – based on previous year's expected/planned	MEF	MEF Guidelines contain the budget package (ceilings) for preparing annual budget by SK/K
July/August	Revision of tax and non-tax revenue estimates. Preparation of Sala Khet/Krong draft budget proposals – allocation of ceilings for each district by individual chapter.	SK/K Finance Department Governor DEF Provincial/Municipal Tax Department Relevant line departments	Allocations of salaries (Chapter 10) are based on the number of staff and the salary scale determined by CAR Allocations of operational expenditures (part of Chapter 11) are based on supply-side norms per staff and per institution. Subsidies/transfers (Chapter 31): social allowances are allocated in accordance with norms determined by the central ministry; Development expenditures (rest of Chapter 11) are allocated as residual. Allocations are made by the governor, in conjunction with the heads of the relevant line departments (e.g. Department of Public Works).
July/August	Sala Khet/Krong budget plan is reviewed by the DEF. It is submitted to the governor for endorsement. Then, it is submitted to DEF. Finally, it is submitted to Mol and MEF	SK/K Finance Department Governor DEF Mol MEF	
September	Sala Khet/Krong defend draft budget to Mol and MEF.	SK/K Finance Department DEF Mol MEF	
September/October	If any changes are made during these discussions, the resulting revisions are fed back down through the system to alter the figures for the budget chapters for individual districts.	SK/K Finance Department Districts DEF	The budgets are usually given final approval by October.
January	Start of budget year and budget implementation		

Provincial-Level National Budget Planning

5.9 The basic process for preparing provincial-level national budgets is essentially the same as that for the Sala Khet/Krong. It begins slightly later, with MEF issuing guidelines to line departments through their parent ministries in mid-July. These guidelines contain the budget “package” – ceilings for individual line departments.¹¹ The budget ceilings are calculated on an incremental basis, being based on the previous year's plan plus around 10%. In theory, these ceilings should also reflect the relative priority of key sectors, such as health and education. The guidelines tend not to contain

¹¹ MEF indicated that there were moves to eliminate the requirement that MEF would provide ceilings for individual line departments for each province/municipality; instead, ceilings would be provided for line departments as a whole, and it would be up to Mol, in conjunction with provinces/municipalities, to determine the line department's block ceiling across provinces/municipalities. The study team were unable to get confirmation of these changes.

guidelines on individual expenditure items – they are largely procedural, containing the ceiling and table formats to be used.

5.10 Line departments usually take one week to draft their budgets, based on allocating the resource envelope (based on the MEF-provided ceiling) by chapter to districts. The bases for the allocations are similar to those for the Sala Khet/Krong, being incremental in nature and input-based.

- Salaries (Chapter 10) – based on the number of staff and the salary scale determined by CAR.
- Operations (Chapter 11) – based on supply-side norms per staff and per institution (e.g. materials required for a particular size of school).
- PAP allocations (Chapter 13) – largely for health and education, these allocations are based on a bottom-up process of identifying and costing out the expenditure needs (although the allocations are less than the requirements). In the health sector, all operations expenditures are subsumed in Chapter 13, whilst, in education, only priority expenditures under the agreed programmes are contained in Chapter 13 (other operational expenditures are contained in Chapter 11).
- Subsidies/transfers to economic entities (Chapter 30) – agricultural subsidies are allocated in accordance with norms determined by the central ministry.
- Subsidies/transfers for social allowances (Chapter 31) – social allowances (e.g. pension fund payments) are allocated in accordance with norms determined by the central ministry.

5.11 Once line departments have prepared their draft budget proposals, they are submitted to their parent ministry and to DEF, who produces the consolidated budget for all line departments in the province/municipality. The consolidated budgets are endorsed by the governor (who normally does not request any changes), and are then submitted to MEF. These steps usually take place in August.

5.12 In early September, line departments defend their budget proposals in discussions (negotiations) with MEF and their parent line ministries. Once these have been approved for all line departments, the MEF sends the budget proposals to the Council of Ministers, who forwards them to the National Assembly in November and to the Upper House in December.

Assessment and Key Issues

5.13 The budget preparation processes for both the Sala Khet/Krong and the provincial-level national budgets exhibit a number of weaknesses. The very short timetable (in effect, one week for preparation) provides very limited, or no, opportunity for analyses of needs and priorities and the allocation of budgets against expenditure programmes to meet policy objectives. Moreover, given the line item (chapter) basis of budgeting, the budget process provides no incentives to redeploy inputs to be more cost-effective at providing services. In the absence of more strategic budget allocation procedures, budgets become led by inertia rather than by policy, with incremental budgeting the result¹¹. Thus, expenditure planning becomes an exercise of managing budgetary inputs (staff and supplies and materials), with little attention being given to the outputs and outcomes of public expenditure in terms of the efficiency and effectiveness of public services and their impact on the realisation of government policies. At the same time, the deficit financing nature of the inter-governmental transfer for Sala Khets/Krongs undermines good budget discipline and provides opportunities for negotiation (and rent-seeking by MEF).

5.14 The unclear expenditure responsibilities, combined with dual subordination (double reporting lines) for budget management, at the provincial/municipality level (both Sala Khet/Krong and the

¹¹ Incremental budgeting refers to the practice by budget planners of merely adding percentages, guided by an inflation projection in the budget circular, to their previous year's budget. With this "bottom-up" approach (in usual budget parlance), budget planners tend to overstate their needs, exerting upward pressure on overall spending.

provincial-level national budgets) undermine accountability for budget outcomes. In particular, the roles of the Provincial Finance Office, the DEF and the MoI in the Sala Khet/Krong budget process are unclearly defined and delineated, as is the role of the provincial/municipal Finance Office and the DEF in provincial-level national budgets. This lack of clarity can lead to delays in the budget process, open the budget process to negotiation through dual subordination, and encourage rent-seeking behaviour to ensure the budget passes its numerous approval hurdles.

5.15 Moreover, in terms of accountability, the provincial/municipal governor has real discretion in effect only over the Sala Khet/Krong budget; provincial governors have no real authority over the budgets of the deconcentrated offices of the line ministries (serving mainly to "endorse" provincial-level national budgets but rarely to make or recommend changes). Even with the Sala Khet/Krong budgets, the provincial administration's discretion is limited. As discussed in Section 4, on the revenue side, the administration cannot affect the amount of resources it receives since it is the central level which is responsible for both the setting of tax rates and the administration of provincially-assigned taxes. On the expenditure side, with the provincial/municipal governor's budget under the ultimate authority of the Ministry of the Interior, the budgetary autonomy of the governor to make allocative (or administrative) decisions in response to the needs of the local population without going through multiple levels of approval is limited.

5.16 Having said this, the study team believe that in practice provincial governors may have more influence than it appears, both over the total size of the governor's budget and over in-year implementation. In practice, it is likely that the overall budgetary resource envelope, including the transfer from MEF to provinces/municipalities, is the result of negotiation between the governor, MoI and MEF; politically-stronger governors are more likely to obtain more resources for their province/municipality. The evidence on the extent of in-year influence of the governor on budget implementation is not clear but any influence is likely to be stronger where there is a shortage of cash and where the governor has a good relationship with the Provincial Treasury (see Section 6 below). At the same time, off-budget resources available to provincial/municipal governors provide additional discretion to supplement budgetary expenditures (see Section 4 above).

5.17 In terms of deconcentrated budgets, the degree of discretion and budgetary autonomy for provincial-level national budgets is limited by the strong vertical nature of sector budgets, the relatively low level of cash resources allocated to them (both in terms of planning and more importantly in terms of budgetary disbursements), the non-strategic nature of budget planning and implementation at both central and provincial levels, and limited capacities to manage provincial budgets in a strategic manner.

5.18 Both provincial budgets and provincial-level national budgets lack comprehensiveness. A not insignificant proportion of resources (see Section 4 above) operates outside of the Provincial Treasury system and hence is not subject to the government's planning (and, in theory, prioritising) processes. This undermines good budget management. At the same time, budget management is not geared to the provision of services but to the fulfilment of these plans, regardless of the fact that they are effectively meaningless.¹³

5.19 In short, the budget systems for both the Sala Khet/Krong and provincial-level national budgets do not give appropriate incentives for accountability for the provision of priority, locally-based services to the local population.

5.20 Section 6 below turns to a description of the budget implementation process and assesses the extent to which approved budgets are used as planned.

¹³ The implications of this for incentives for budget implementation are discussed in Section 6.

6. Budget Implementation

6.1 Budget implementation commences once the National Assembly has approved the budget plans submitted by the line departments and the provincial/municipal administrations for the national and Sala Khet/Krong budgets. This usually occurs at the beginning of each year, although 2004 was an exception as a new government had not yet been formed and therefore authorisation for the budget plans could not be given.¹⁴ This section outlines the official process of budget implementation, examines to what extent this is adhered to in practice and provides an assessment of key issues and constraints experienced in budget implementation.

Budget Implementation Procedures

6.2 Procedures for budget implementation at provincial/municipal level follow national guidelines. The main characteristics of the system include: (i) ex-ante expenditure controls; (ii) the institutional separation of the roles for those who commit expenditures and those who give the order to pay for committed expenditures from those who make the payments; and (iii) the strong role of the MEF/DEF and the Treasury. There is an emphasis on formal controls at all stages of the implementation process.

Sala Khet/Krong procedures

6.3 The steps that are undertaken at provincial level and the responsible agencies for the implementation of the Sala Khet/Krong budget are outlined in Table 6.1. The budget implementation process begins once the national assembly has approved the budget plans and the MEF issues guidelines (authority) for budget execution. These guidelines indicate the approved budget allocations and give official authority to execute the budget. The MOI is the line ministry with responsibility for the Sala Khet/Krong budget and the local finance department (DEF) has responsibility for managing the funds. Once the budget is authorised by the National Assembly the MOI notifies the DEF of the approval of the Sala Khet/Krong budget plans, who in turn informs the line department of their budget allocations. The line departments then delegate authority to the provincial/municipal governor as the authorising officer for the Sala Khet/Krong budget. The governor appoints for each line department a petty cash officer, revenue collection agent and payment agent in each of the line ministries that receives the Sala Khet/Krong budget; these officials are responsible for budget execution within the line departments.

6.4 The province/municipality can begin undertaking spending commitments once the notification of the transfer of credit (i.e. official paper authorisation of the amount which may be spent) is given to line departments by the MEF.¹⁵ Once credit authorisation is received for the Sala Khet/Krong budget, line departments are required to prepare quarterly expenditure plans and submit to the governor for endorsement.¹⁶ Departments can then begin making expenditure commitments.

¹⁴ This was resolved by allowing both the Sala Khet/Krong and provincial share of national budgets to execute expenditure each month based on one-twelfth of the 2003 budget.

¹⁵ If this credit authorisation is given late, this can affect timely budget execution.

¹⁶ For the provincial share of national budgets, 100% of the budget tends to be authorised near the beginning of the year, in contrast to the Anglophone system of issuing expenditure warrants, where monthly or quarterly authorisations for some categories are given. For the Sala Khet/Krong, quarterly credits tend to be authorised, based on the quarterly expenditure plans.

Table 6.1: Sala Khet/krong Budget Execution Process

Time	Step	Responsibility	Remarks
January	Approval of budget plans	National Assembly	Did not occur in 2004 as presentation/authorisation of budget plans was delayed by formation of new government
Feb/March	MOI notifies DEF of approval of Sala Khet/Krong budget plans. DEF informs line departments of Sala Khet/Krong budget allocations	MOI DEF	
Feb/March	Official delegation of authority to execute the budget is given to the governor	Line Departments	
Feb/March	Appointment of petty cash officer, revenue collection agent, payment agent in each line department	Governor	
Feb/March	Transfer of budget credit given: paper authorisation of expenditures	MOI/MEF	
From March	Line Departments submit quarterly expenditure plans to the governor for approval	Line Departments Governor SK/K Finance	
March – Dec	Expenditure commitments in line with expenditure plans and in line with procurement procedures are undertaken by the line departments.	Line departments Governor Procurement Committee SK/K Finance MEF	
March – Dec	DEF checks and certifies line department expenditure commitments and prepares payment orders for submission to the Provincial Treasury.	Line Departments Governor Provincial Treasury	
March – Dec	Payment orders are paid by the Provincial Treasury provided sufficient funds are available.	Provincial Treasury	
March – Dec	Payment is then made to suppliers or contractors	Line departments	
March – Dec	If line departments want to reallocate expenditure within budget lines they must submit a request to the MOI. If they want to switch expenditure between budget lines both the MOI and MEF must approve	Line Departments MOI MEF SK/K Finance	

Provincial share of national budgets

6.5 The budget implementation process for the national budget at provincial level is very similar to the Sala Khet/Krong process outlined in Table 6.1 above. The main difference is one of responsibility as the MEF has overall control over the budget and line departments are answerable to their sectoral ministries rather than the provincial/municipal authorities for budget execution. Furthermore, line departments can only authorise up to 20 million riels of expenditure without MEF approval, whereas for the Sala Khet/Krong budget the governor can authorise up to 100 million riels.

Expenditure Controls and Disbursement of Funds

6.6 Disbursements of budgetary funds for both the provincial-level national budget and the Sala Khet/Krong budget are made on the basis of the submission of payment orders; with the exception of cash advances (see below), funds are not allocated in advance, on the basis of cash projections, for example. Line departments enter into expenditure commitments, and these are checked by the DEF, who approves and certifies the commitment, issues the payment order and submits it to the Provincial Treasury. In the case of the Sala Khet/Krong budget, the governor is also required to certify the commitment. These ex-ante checks by DEF are intended to check compliance with the expenditure plan and financial control procedures rather than to verify whether or not there are sufficient funds to meet the commitment.

6.7 All payments from the Provincial Treasury are made in cash. Where there is a shortage of cash, budgetary regulations outline that priority should be given to the payment of salaries (Chapter 10), PAPs (Chapter 13), social obligations (Chapter 31), followed by operations and development activities (Chapter 11). Salaries are paid according to monthly submissions of payroll lists issued by line departments for the provincial and national budgets which originate from the CAR. Based on these the line department issues a PO which the Dept of Planning checks against the payroll sheet and this is then submitted to the DEF and then the governor for authorisation.

6.8 PAPs refer to Chapter 13 expenditures on goods and services, primarily for health and education for the provincial-level national budget (see Box 6.1). Under the PAP arrangements, both sectors should have access to 25% of their funds for PAP automatically on a quarterly basis. This was designed to remove their budgets from the discretionary allotment of funding which occurs at the Provincial Treasury level. This does not seem to have had a significant effect as line departments reported that they still had to provide supporting documentation with their POs and disbursements were not occurring on a regular basis.

Box 6.1: Priority Action Programme (PAP)

The Priority Action Programme (PAP), introduced in 2000, was designed to provide better predictability in the disbursement of resources in priority sectors to participating provinces. These were intended to bypass the requirement for pre-audit of expenditures by the Ministry of Economy and Finance prior to budget release and the degree of expenditure discretion through the provincial treasuries, both of which were seen as contributing to the reduction or delay in the availability of funds to the priority sectors.

Greater predictability of funding is intended to be provided by supplying one-quarter of PAP funds at regular, quarterly intervals (in contrast to most releases, which occur in a lumpy fashion, largely towards the end of the fiscal year). Greater budgetary autonomy is intended through giving budget managers discretion to use the non-wage and non centrally-procured recurrent expenditures with fewer administrative controls. Expenditure controls on these funds are intended to occur ex-post instead.

However, the success of these programmes in providing greater predictability in budget releases has been limited over the past two years; in the health sector, for example, only 53% and 80% of planned national and provincial priority funds respectively were released by the end of the 2002 fiscal year, whilst the figures for 2003 were even lower, with the release of only 37% and 56% of planned national and provincial priority resources respectively.

6.9 In practice, the payment of POs is dictated by cash availability at the municipal/Provincial Treasury once payment orders are submitted. As there is no pre-verification that funds are available, the Provincial/Municipal Treasury decides which POs get paid. This results in substantial power for the Provincial Treasury, an issue which is discussed further below.

6.10 For both the national and provincial budgets it is not possible to carry over budget allocations to the following year. The only method through which this occurs is if POs have been issued by line departments and submitted to the Provincial Treasury. This is why most POs are submitted at the end

of the year as if a PO has not been issued for line department expenditure then the budget allocated will be lost.

Cash advances

6.11 Line departments are allowed petty cash advances for 30% of planned Chapter 11 funding for both Sala Khet/Krong and provincial-level national budgets. This can be requested up to 8 times a year. For the Sala Khet/Krong budget every line department prepares a plan for using petty cash and submits these to the DEF for verification and endorsement by the governor. The Director of the Sala Khet/Krong Finance Office or line department submits a PO with supporting documents for a petty cash advance to the Provincial Treasury. The same procedures are followed for both the provincial and national budget for payment transactions which allow petty cash payments for amounts below 100 million riels. The difference between petty cash advances and normal POs is that procurement procedures do not have to be followed for petty cash advances so in theory the process is faster.

Budget revisions/virement

6.12 There is no official mechanism to review budget plans and priorities mid-year or to reallocate funds within line items or between them without prior approval. Approval is needed from the MOI to change allocated expenditure within budget lines and approval from MOI and MEF to change between budget lines for both the national and Sala Khet/Krong budgets. This results in inflexible budget execution and an inability to adjust expenditure to changing circumstances. If an emergency occurs such as the current drought, then an application must be made to MOI for extra funding.

Treasury operations and cash management

6.13 Treasury operations and cash management systems are undermined by weak PFM systems, limited institutional capacities, and the rudimentary basis of government financial systems. This means that the main function of the National Treasury is to collect cash and provide liquidity to line departments and provincial agencies, while provincial treasuries act as cashiers with the power effectively to provide or withhold cash from line departments through making cash available to meet bill payments. Provincial Treasury acts as accountant for Sala Khet/Krong and the provincial share of national budgets. Other Treasury functions, such as cash management, financial planning and cash flow projections, and management of government bank accounts at provincial level, are not actively carried out.

6.14 Nearly all transactions are carried out in cash. Limited transfers are made through the banking system from private companies to the National Treasury but 95% of inter-governmental transactions involve physically moving cash from national to provincial treasuries. All salaries are paid in cash (Chapter 10), as are payments for administrative expenses and development expenditure (Chapter 11). The processes involved in transferring cash to pay POs are not simple with signatures to authorise transactions needed at different stages of the transaction. Furthermore, particularly when procurement is involved there is considerable paperwork needed at each stage of the process which can be complex and result in a significant amount of work for line departments.

6.15 The national and provincial treasuries hold bank accounts at the National Bank of Cambodia (NBC). The practice of holding funds in liquid cash means that the opportunity cost of these holdings is high.

Procurement and Contracting Procedures¹⁷

6.16 Although the procedures are the same, the authority to approve procurement at the provincial/municipal level differs between the Sala Khet/Krong budget and the provincial-level national budget. For the national budget, only contracts below 20 million riels can be approved at the provincial level by the DEF, whereas for the Sala Khet/Krong budget the governor can approve contracts of up to 100 million riels.

6.17 The procedures for the Sala Khet/Krong budget are as follows:

- For less than 10 million riels departments are permitted to purchase goods directly by procuring goods and submitting POs to the Provincial/Municipal Treasury.
- For contracts valued between 10-20 million riels three quotations must be requested from a pre-approved list of bidders provided by the MEF¹⁸. The quotations are reviewed by the Procurement Unit/ the Pre-evaluation Award Committee (PEAC) in the Sala Khet/Krong, with the winning bid approved by the governor. For civil works projects, this process of three bids can be used for contracts of up to 50 million riels.
- Bidding for contracts for goods and services between 20-100 million riels is organised by the Pre-Evaluation Award Committee (PEAC) and the Procurement Unit based in the Sala Khet/Krong, which can carry out the bidding and contracting procedures. The PEAC is chaired by the First Vice governor of the province/municipality, while the MEF has a representative who attends committee meetings to monitor the process but does not have a say in awarding contracts. The committee makes a recommendation to the governor regarding award of the contract and the government authorises the decision. The procurement unit of the PEAC prepares the paperwork and undertakes the administration of the contract. Clearance from the budget unit is then required before procurement commences.
- The bidding process for amounts over 20 million riels for the Sala Khet/Krong is undertaken via sealed bids. Advertisements of the bid are given in the media, listing the criteria for award of the contract. When companies apply they are sent guidelines for the bid process, technical specification, an application form and sample contract. When bids are submitted, 2% of the bid price must be included with the bid, kept as a deposit in case companies withdraw from the bidding process and is returned to unsuccessful companies. Once the winning bid has been awarded, 10% of the final contract price must be paid by the contractor in advance. This will be forfeited if the company does not complete the contract and returned at the end of the bidding process. The contract is supposed to be awarded based on the technical expertise, qualifications of staff and price, although most interviewees indicated price was the most important criteria.
- The governor is the only person authorised to sign contracts and after this the line departments contract with the winning supplier. The work undertaken by contractors is monitored by the Monitoring Committee and once it is finished and the contract fulfilled an expenditure monitoring voucher is issued and a delivery report is completed by the Sala Khet/Krong and signed by the MEF. A PO is then issued which is signed by the DEF and the governor and is then submitted to the Provincial/Municipal Treasury for payment.

6.18 The national budget procedures allow line departments to purchase up to 10 million riels of goods and services directly, while three quotations are needed for amounts between 10 and 20 million riels. The contract and bidding procedures for amounts over this value are undertaken by the MEF who also award the contract.

¹⁷ This section looks at procurement procedures at provincial/municipal level and does not deal with centralised procurement, e.g. of drug supplies.

¹⁸ The list is based on those contractors who have previously bid and have been vetted according to certain criteria such as operating on a legal basis.

6.19 In reality, procurement and contracting procedures are not only lengthy but for those contracts over 100 million riels for the Sala Khet/Krong and over 20 million riels for the national budget, decisions are centralised in the MEF, giving less power to the provincial level to award contracts. The procurement process is relatively time-consuming both because there is extensive documentation involved requiring signatures at each stage of the process, and because any mistakes result in the documentation being sent back to the line department.¹⁹ This is often the result of officials involved having relatively little experience in preparing technical documentation and specifications. Even when contracts are awarded and the work undertaken, payments to contractors are often substantially delayed. This problem is discussed further below.

Assessment and Key Issues

6.20 The system outlined above leads to a variety of problems in budget implementation for both the Sala Khet/Krong budgets and the provincial-level national budget. The major issue is that resources allocated for both budgets do not reach the appropriate line departments and this in turn has an impact on the provinces'/municipalities' ability to deliver services and manage their budgets efficiently and effectively.

Implications of cash shortages

6.21 As noted earlier, no ring-fencing of funds in the Provincial or National Treasuries takes place. In practice, this leads to the displacement of funds intended for one purpose to another, with Sala Khet/Krong funds being diverted to the provincial-level national budget if there is a cash shortage and vice-versa. For the provincial share of national budgets, resources intended for use by one line department may be used for other line departments sectors or for other provinces/municipalities. There is also informal evidence of the displacement of funds intended for C/S Fund. This creates uncertainty over the timing of disbursements with substantial delays often experienced in POs being paid.

6.22 At the same time, delays in revenue collections for the Sala Khet/Krong contribute to problems in the availability of funds for implementing provincial budgets. Delays in the issuing of tariff schedules for specific revenues sources by the MEF mean that tax collection often does not begin until the middle of the year. This results in provinces/municipalities having no access to revenues from tax collection until the second quarter of the financial year. This problem is resolved by using deficit funding whereby extra resources are requested from the MEF on a monthly basis to cover shortfalls. This practice indicates the weaknesses in budget planning and execution and also strengthens MEF control over the provincial/municipal authorities.

6.23 Ineffective commitment controls disrupt budget implementation. Since authorisations of spending commitments are processed without checking the availability of cash until payment orders are submitted to the Provincial Treasury, the existence of cash shortages gives the Provincial Treasury tremendous power. In practice, although the role of the Provincial/Municipal Treasury is supposed to be restricted to disbursing funds, cash shortages give the Provincial/Municipal Treasury considerable power to act as gatekeepers and decide which POs will be paid. What is needed is to ensure that commitments are controlled in line with both budgetary plans and the availability of cash resources. In the meantime, stronger procedures are needed over both how and who determines the sequencing of commitments to be paid.

6.24 Systemic weaknesses in budget implementation and chronic cash shortages dilute accountability for the use of these resources. Ultimately, in practice, the decision-making authority for allocating resources lies with the Provincial Treasury. However, since the cash shortages are the result of problems further up the line, accountability for budget implementation lie not just with the

¹⁹ It was difficult to get consensus on the average length of the procurement process for different contract levels. The process can take days, weeks, or months.

Provincial Treasury but also with decisions by the National Treasury, MEF and line ministries. As with budget planning, there is no single government official accountable for budget implementation of both the Sala Khet/Krong and line department budgets, reflecting poor public financial management practices at all levels. At the same time, decisions on the allocation of limited cash resources are non-transparent.

6.25 Problems with implementing budgets and unpredictable releases of budget funds lead line departments to undertake pragmatic solutions to overcome these systemic problems and to meet required expenses for service delivery. These are outlined in Box 6.2. Examples of some of these practices include:

- Purchasing goods on credit to ensure timely delivery of supplies when no cash is available from the Provincial/Municipal Treasury;
- Under-reporting of provincial/municipal budget and national budget revenues collected as discussed in Section 4;
- Reporting projects as completed when they are not yet finished. This allows a PO to be submitted and the funds to be disbursed, providing additional revenue for line departments which can be diverted to other more urgent expenditure.
- Attempts by line departments to collect non-tax revenues for activities that they are not authorised to collect or they will charge more than the designated fee in order to compensate for shortfalls in budget funds.

6.26 Chronic cash shortages can also encourage rent-seeking behaviour. Facilitation payments are made in order to access funds from both the national and provincial treasuries. This can lead to requirements for payments at each stage of the disbursement process when an authorisation or a signature is needed. This can result in significant leakage of resources intended for service delivery and reflects weak budget management.²⁰ It also leads to distorted incentives as line departments find ways of retaining, or raising additional cash, (as outlined above).

Non-transparent procurement and virtual budget implementation

6.27 A number of issues affecting transparent budget implementation relate to the procurement process. In practice guidelines are sometimes not followed due to the cumbersome nature of the procedures and the disbursement problems discussed above; examples of ways project implementers circumvent the procurement process are outlined in Box 6.2. Firstly, delays in payments can deter businesses from bidding so it can be difficult to get a good selection of companies to bid. Payment delays lead companies to find pragmatic solutions, undermining the transparency of the procurement process. In some cases, bidding contractors add an additional amount to the contract price to cover the costs of forgone interest. Alternatively, winning bidders may use payments owed to offset their own liabilities to government, e.g. revenue payments. Secondly, as the winner is evaluated on price alone rather than value for money, the quality of work and materials used can be poor; it was noted that the standard of roads built is often low for this reason. Thirdly, the Country Procurement Assessment Review (CPAR) notes that businesses are deterred from bidding as the process is not transparent; cash payments mean that facilitation payments for the award of contracts can occur. Finally, the province/municipality can sidestep the procurement process altogether by using off-budget resources to build infrastructure such as roads.

²⁰ Some estimates arising from discussions with stakeholders indicate the extent of budget leakage to be around 10-20% at each level (national, provincial, district). For obvious reasons, documentary evidence of this is difficult to obtain.

Box: 6.2 Informal practices to by-passing disbursement and procurement problems

Procurement

- To compensate for late payment contractors routinely add an additional amount to the contract which covers forgone interest and is in the region of 4-5% a month
- Making facilitation payments to bypass the need for 3 bidders for a contract or the need for extensive documentation at all stages of the process.
- Reliance on off-budget funds, such as local contributions from private companies, to build roads which by-pass the procurement process.
- Off-setting of company's tax liabilities against money owed for contract implementation.
- Borrowing from private suppliers (ordering on credit) to circumvent long authorisation procedures. The supplier then adds a percentage to the price to compensate for this.

Delayed Budget Disbursements

- Under-reporting and with-holding of national and municipal revenues.
- Agencies attempting to collect taxes and fees from businesses or collecting too much tax when they are not authorised to do so
- Reporting projects as completed when they are unfinished. This allows release of all disbursements for the project and enables a carry-over of funds until the next year to ensure completion.
- Requesting facilitation fees for the authorisation of documents

6.28 The emphasis on implementing the budget plan in full further encourages the virtual budget process described in Section 5. The stipulation that any unspent budgetary authorisations left at the end of the year are lost leads to a divergence between the accounting for budget authorisation (committed expenditure) and the cash provided to inputs and services (actual expenditure). Budget execution is defined as POs issued, whether or not they have been paid, which accounts for the very high rates of budget execution reported. In order to ensure that provincial/municipality gets paid its full budget allocation, all POs must be submitted by the end of the financial year or the funds will not be disbursed. In reality, these POs may not be paid until the following year. This leads to practices to ensure that as many POs get paid or at least submitted to the Provincial/Municipal Treasury by year-end. Line departments will often report activities as completed as this then allows them to submit a PO and not lose the funding that would be required to complete the project. It also results in the majority of POs being submitted to the Provincial/Municipal Treasury at the end of the year.

6.29 The problems of cash shortages affect the timely and complete execution of all budgetary resources. Implementation of the Priority Action Programme (PAP) was found not to be taking place as intended in the province/municipalities studied. Whilst the PAP is intended to provide funds predictably throughout the year and to overcome delays in budget implementation, the study has found that this is not the case, and budget implementation in PAP sectors face similar problems of cash shortages as in other sectors. Evidence of this is shown by the fact that budget implementation rates in the two study provinces, particularly in the education sector, are lower than with other sectors. The reason for problems with PAP disbursements is that since the funds are held in the Provincial/Municipal Treasury they are subject to the same procedures and weaknesses as other resources.

6.30 Overall, budget implementation is poor, with the system clearly unable to deliver funds to line departments in a timely fashion or indeed able to deliver the amount of resources planned in the budget. Unpredictable releases of funds from both the national and Provincial/Municipal Treasury and delays in disbursements hinder efficient budget execution, which results in weak control of public funds, increased opportunities for rent-seeking and high levels of fiduciary risk. This not only undermines the performance of service-delivery agencies but also the overall system of budget planning and implementation.

7. Financial Administration, Management and Control

7.1 The internal control system at the provincial/municipal level is based on multiple layers of approval.²¹ This is compounded by the unclear lines of accountability for provincial administrations – both line departments and the Sala Khet/Krong. In practice, there are too many controls and insufficient accountability. This section describes and assesses the system of accounting and financial controls, reporting arrangements and internal and external audit.

7.2 In spite of the multiplicity of controls and the centralised nature of the PEM system, weak financial management practices pose significant fiduciary risks. The fundamental problems result from a weak control environment, weaknesses in the Provincial Treasury system, especially in the area of cash management, inadequacies in the public accounting system, and weak internal and external auditing capacity. Consequently, the Government's budget and reporting systems cannot be relied upon to expend resources in an accountable manner.

7.3 These issues represent a broader financial management problem relating to the overall budget system, rather than one that is centred solely on provincial budgets and provincial-level national budgets, and hence need to be addressed as an integral part of the wider PFM reform programme.

Accounting and Financial Controls

7.4 As indicated in Section 6, budgetary controls are based on the French system of separating the role of budget authorising officer (responsible for authorising payment) from the cashier (responsible for making the payment). At provincial/municipal level, this separation is achieved through designating the governor as budget authorising officer and designating the head of the Provincial Treasury as cashier. In practice, however, with the Provincial Treasury acting as gatekeeper for budgetary resources, combined with the reporting lines of the Provincial Treasury to the National Treasury, rather than to the governor (the governor and the head of the Provincial Treasury are effectively at the same hierarchical level), the real power lies in the hands of the head of the Provincial Treasury for both the Sala Khet/Krong and the national budget; in effect, the role of the budget authorising officer becomes one of negotiation with the Provincial Treasury. As indicated above, the control system is based on ex-ante controls during budget implementation.

7.5 In terms of the institutional structure, the Provincial Treasury is a branch of the National Treasury, which officially is subordinate to the MEF (and hence DEF at provincial/municipal level). In practice, however, the Treasury and MEF/DEF operate somewhat independently. DEF (in conjunction with line departments) and the Sala Khet/Krong Finance Office are responsible for formulating the expenditure plans and submitting payment orders in line with these plans, whilst the Provincial Treasury is responsible for accounting and making payments against these payment orders.

7.6 In terms of financial administration, the Provincial Treasury acts as financial accountant for the Sala Khet/Krong and for line departments on behalf of the National Treasury.²² It is difficult to tell whether or not accounting procedures are clearly defined and enforced. Basic double-ledger accounting takes place, based on the General Ledger. Each line department maintains its own financial ledger, and reconciliation with the General Ledger takes place monthly. District finance offices rely on the Provincial Treasury to do its accounting/bookkeeping.

²¹ As indicated in Section 6, approvals (signatures) for expenditure commitments are required at each stage of the process, involving district finance offices, provincial finance offices, line departments, DEF, and the Governor (see Table 6.1).

²² The breakdown in the number of transactions in Kompong Cham province across the three levels of transactions by the Provincial Treasury was reported as 50% for C/S, 40% for provincial-level national budgets and 10% for provincial budgets. The staff distribution appears to reflect this distribution adequately.

7.7 The accounting system is not based on international accounting standards. There is no accounting manual detailing policies, procedures and rules except for several decrees or sub-decrees that govern expenditure management. There are no standards to govern the treasury operations or public sector accounting, except some decrees and ad hoc circulars issued from time to time.

7.8 The accounting system is primarily based on cash accounting. However, in the same set of accounts, accrual accounting in terms of recording commitments (payment orders) is used as a pragmatic way of ensuring that budget credits (authorisations) are accounted for by the end of the year. In other words, whereas the majority of accounting is cash accounting, the Provincial Treasury use accrual accounting at the end of the year in order to close the books and account for near-100% fulfilment of the plan, regardless of the cash position.²³ Book balances and cash flows are rarely reconciled with stocks of cash, and there does not appear to be a record of the final cash position of the budget. At the same time, it is possible that credits are treated as cash in the cash accounting system, as is the case for communes.

7.9 Manual, paper-based systems are used in the two provinces visited, with little or no use of information technology. The large number of accounting transactions is carried out by using hand-held calculators or manually. As a result, the system is incapable of providing timely and accurate financial information.

7.10 The Chart of Account does not include all government financial transactions (assets, liabilities, bank and cash accounts, revenues, expenses, end-of-year results). It is highly aggregated, showing control accounts with limited subsidiary ledgers for analysis. Furthermore, the information is unreliable due to the lack of reconciliation and incomplete recording of all government transactions, and the accounts are not subject to independent audit. These weaknesses would appear to undermine the usefulness of the accounting system to provide assurance that public funds are used for purposes intended.

7.11 Neither financial nor budget management is carried out – accounting and reporting are done to keep the books “tidy” (in accordance with the plan and regulations, as opposed to reflecting what happens in practice and for good budget management). The focus of the Provincial Treasury is on compliance and control through multiple regulations and procedures. An illustration of this is the mixture of cash and accrual accounting and the payment orders coming in December. At the same time, as the report has suggested above, the financial management function of the Provincial Treasury is undermined by the extent of resources and financial transactions that take place outside of the system.

7.12 Furthermore, there is a lack of basic reconciliation systems to verify the accuracy of the information held within the accounting system. Whilst information is held at an aggregate level on revenue collection there is no reconciliation between the treasuries and revenue collecting departments on the detailed composition of the flows to the treasury. Line departments keep records of their expenditure, but these are rarely reconciled with the accounting records in the treasury. Line ministry records of expenditure are not reconciled with DEF/Treasury information to develop agreed records of expenditure reports. There is no systemic reconciling of accounting information with the banking sector. In the case of advance payments made by the treasury for programs under the PAP, the advance is adjusted on the basis of expenditure accounts rendered by the Budget Management Centres. It is likely that the Treasury does not play a significant role in the scrutiny of these accounts beyond compiling them.

7.13 Provincial treasuries are authorised to allocate provincial revenue directly to the C/S Fund. However, as indicated above, the fungibility of resources (cash) in provincial/municipal treasuries mean that it is likely that resources provided to the C/S Fund are displacing cash intended for other

²³ Thus, the accounts include a mixture of cash and accrual accounting.

purposes (if only temporarily) and vice-versa. The lack of transparency in accounting procedures, both at the C/S and provincial/municipal level, make tracking the extent of this practice difficult.

Reporting Arrangements

7.14 For the Sala Khet/Krong, the following accounting/financial reports are produced monthly: (i) trial (ledger) balance, setting out treasury deposits, the debit and credit position; (ii) cashiers' report, setting out cash transactions and the cash balance, including the use of cash advances; and (iii) changes to the revenue and expenditure credit position and the cumulative balance by chapter. For the line departments, the following accounting/financial reports are supposed to be produced monthly:²⁴ (i) reconciliation reports between line departments and the Provincial Treasury; (ii) changes to the revenue and expenditure credit position and the cumulative balance by chapter and by line department; and (iii) consolidated report of the national budget, including the detailed financial position (e.g. cash, deposits at Provincial Treasury), covering the provincial budget, provincial-level national budgets and commune/sangkat budgets. These reports are sent to the National Treasury, DEF, line department and the governor.

7.15 The recording system for monthly balances is limited to the operations carried out by the Provincial Treasury. It does not contain detail on transactions outside of its control, such as transactions carried out with cash retained by line ministries and through off-budget activities. As was discussed in Section 4 above, these could be significant.

7.16 No overall financial statements of accounts are produced by the DEF or the Provincial Treasury; only the ledger balances (trial balances) are prepared. More concerning is that fact that there is no recording of cash (as opposed to authorised [credit]) expenditures against the budget. There are also significant problems in reconciling the books held by the line departments and the General Ledger held by the Provincial Treasury. Reliable reporting of financial information requires timely and frequent reconciliation of data from different sources to ensure data reliability. In the provincial/municipal treasuries, the accounting system does not provide easily accessible information on individual transactions. Most accounting data are confined to aggregate information from manual trial balances, and balance sheets not directly from accounting registers of individual transactions. The aggregates refer to different accounting documents, and complementary tables are needed for consolidation. This restricts the ability of the system to provide adequately detailed management information.

Auditing Procedures

7.17 The basis of oversight for provincial administrations is the system of financial inspections. Financial inspections of line departments and the provincial administration are carried out by DEF. There is a regular schedule for undertaking so-called normal transaction audits once a year. Ad hoc special audits are also undertaken to examine unusual financial activity. The results of these inspections are sent to the line department, the MEF, and the governor. Line departments should take action to rectify any problems which arise, and the governor and MEF are required to follow up these reports.

7.18 In terms of line departments themselves, there is no system of internal audit to provide regular and adequate feedback to management on the performance of internal control systems, such as procurement. In the absence of adequate oversight, the accuracy of provincial/municipal and line departments' financial information cannot be independently verified.

7.19 In short, the public oversight of government financial management remains very weak. This is likely to have resulted in rent-seeking behaviour at different levels of financial control.

²⁴ Although, as indicated above, some of these reports (e.g. reconciliation of accounts between line departments and provincial treasury) are not always produced regularly.

8. Conclusions and Recommendations

Conclusions

8.1 The study has concentrated its analyses on the municipality of Phnom Penh and the province of Kompong Cham. Whilst the scope of the study has been relatively limited, in many cases, its conclusions serve to corroborate and provide local colour to conclusions made elsewhere. In other cases, they serve to highlight where official practice is subjugated to pragmatic solutions or where the incentives provided by the system distort behaviour of agencies and individuals involved.

8.2 The study's conclusions have been drawn from four major themes which cut across all aspects of the provincial/municipal public financial management process and are highlighted throughout the report. These issues are:

- Accountability and resources: the degree to which provincial administrations, particularly those responsible for provincial budgets, are sufficiently accountable, have appropriate authority and an adequate level of resources to address priority needs for the province/municipality. Critical to this issue is the emphasis on the delivery of services by budget managers and the related arrangements for budget performance management.
- Incentives: the incentives for good public financial management are important, including those to collect revenues, manage budgetary and non-budgetary resources, and provide appropriate financial oversight. There are also implications for good budget management which stem from the extensive use of cash resources through the system.
- Appropriate control and authority: the appropriateness and effectiveness of measures for control and accountability, both in terms of budget management and resources and in terms of the delivery of services (i.e. outputs and outcomes). The extent to which control systems support or undermine budgetary authority and accountability must also be considered.
- Transparency and comprehensiveness: the degree of transparency and comprehensiveness of provincial budget operations in terms of overall resources and their use. If resources are mainly off-budget, this potentially undermines the comprehensiveness and transparency of the budget process.

Accountability supported by control over an appropriate level of resources

8.3 While the governor is responsible for the planning and implementation of services provided by the Sala Khet/Krong budget and has discretion over which activities receive funding, s/he can exercise little control over the resource envelope which is allocated to the budget as a whole. This results in the governor having responsibility for service delivery without the authority to ensure that revenues are collected or that funds planned for the budget can be accessed. Thus, in practice, the Sala Khet/Krong budget is not effectively owned by the province/municipality. Discretion is further undermined by the relatively low level of cash resources allocated to Sala Khet/Krong (both in terms of planning and more importantly in terms of budgetary disbursements). At the same time, the governor's authority over the provincial share of national budgets is limited by the vertical nature of sector budgets.

8.4 The unclear expenditure responsibilities at the provincial/municipality level (both Sala Khet/Krong and the provincial-level national budgets), combined with dual subordination (double reporting lines) for budget management, undermine accountability for budget outcomes. In particular, the roles of the Provincial Finance Office, the DEF and the MOI in the Sala Khet/Krong budget process are not clearly defined and delineated, as is the role of the provincial/municipal Finance Office and the DEF in provincial-level national budgets. This lack of clarity can lead to delays in the

budget process, opens the budget process to negotiation through dual subordination, and encourages rent-seeking behaviour to ensure the budget passes its numerous approval hurdles. At the same time, unclear expenditure responsibilities and dual subordination undermine accountability to the local population for the services provided. The public does not necessarily have a clear idea who has responsibility for particular services and thus whom to approach for complaints about the lack of, or poor, services or to express their views on priority needs.

8.5 In order to ensure that the deconcentration process can bring resources and decision-making closer to the people, more control over Sala Khet/Krong budget funds should be delegated to the governor to ensure not only accountability, but also that the appropriate resources are in practice made available. At the same time, greater delegation needs to be accompanied by measures to ensure appropriate accountability.²⁵

Incentives for good budget management

8.6 In order to encourage good budget management practices, it is essential that the incentives built into the system work to reinforce these practices rather than undermine them. It is clear that poor incentives are in operation at all levels of the system for both the planning and implementation of the Sala Khet/Krong and provincial share of national budgets. The main issues relating to incentives are as follows:

- There are perverse incentives for collecting and recording revenues officially, particularly those above the revenue plan. Any revenues over and above the plan for both the national and provincial budgets must be transferred to the National Treasury. For provincial budget revenues, a request can be made to MOI and MEF to retain these funds, but delays in approval and lengthy implementation processes mean that normally this money cannot be spent by year-end and reverts back to the National Treasury. This then leads to unofficial practices such as retaining revenues at provincial level, particularly those above the planned amount.
- Unpredictable intra-year funding releases, delays in disbursements of PO and budget leakages all result in an erratic flow of funds from the centre to provincial level and down to the district level. In practice, the full value of allocated funds tend not to reach their intended destination due to budget leakage and facilitation payments that must be met at every level to ensure disbursements. This provides further incentives to withhold revenues collected at provincial level, to charge additional facilitation payments for provincial services, and to verify projects as completed when they are unfinished in order not to preserve budget entitlements. It should be noted that these are pragmatic solutions to the situation faced by budget managers, and they should be seen in this context rather than necessarily as attempts to circumvent the system deliberately.
- As the revenue sources assigned to the Sala Khet/Krong budgets are relatively small and the governor has no control over revenue policy, which is determined centrally, there is an incentive for the provincial level to generate revenues from other sources (e.g. off-budget). Although the true extent of off-budget resources is not known, it is common to collect private contributions from local companies for activities such as road building and provide additional funding for festivals and local events.
- The main objective of good budget management is to provide adequate funds for service delivery. In the Cambodian context there is little incentive to provide services as the focus of the system is on implementing the budget plan, which, when combined with the line item-based nature of budgets, encourages control over inputs with the no output-based targets. There is also little accountability within line departments for service delivery, which is further undermined by a lack of resourcing.

²⁵ The issue of accountability and appropriate checks and balances for deconcentrated and decentralised administrations will be addressed in detail as part of the D&D Strategic Framework and Action Plan.

- The cash-based nature of the system facilitates opportunities for budget leakage at all levels of the system. It is often difficult to track the flow of funds and this lack of a paper trail combined with weak auditing procedures, reporting and overall financial management results in opaque financial procedures, no accountability for funds and incentives for rent-seeking.
- Cash shortages give significant power to the provincial treasurer who, in the role of cashier, in practice operates effectively as the gatekeeper for disbursements, through making decisions on which POs will be paid. This can result in rent-seeking behaviour.

8.7 In short, poor incentives are in operation at all levels of the system for both the planning and implementation of the Sala Khet/Krong and provincial share of national budgets. As discussed, there is little incentive to collect municipally-assigned revenues over and above the revenue plan. At the same time, there are weak incentives to deliver public services, since the budget system is focused on managing inputs rather than on outputs or outcomes. This is exacerbated by the lack of accountability within line departments for service delivery, which itself is further undermined by the insufficient level of resources to provide such services.

8.8 Given the centralised nature of budgeting, addressing these perverse incentives will need to be part of the overall PFM reform process. In the recommendations set out below, the study team recommends that further investigation be carried into options for improving incentives, particularly for revenue collection.

Comprehensiveness and transparency in budget operations

8.9 Comprehensiveness of the resource envelope is compromised by the fact that not all resources available to the province/municipality are included in the official budget process. There are indications that significant off-budget resources are available to provincial/municipal administrations from a combination of retained revenues, private contributions, in-kind assistance from NGOs, and external financing. These off-budget resources are not subject to the same planning and accounting procedures as on-budget resources and hence undermine good public financial management.

8.10 The emphasis on the budget plan for the Sala Khet/Krong and provincial-level national budget results in what can be termed a virtual budget process. Budget commitments are made without recourse to the level of funds available. This results in delays in the implementation of activities due to erratic funding. At the same time, budget implementation is measured by the issuing of payment orders, giving a distorted picture of budget performance. This process is designed to ensure that budgets appear to be fully implemented at the end of the financial year, but does not reflect actual budget implementation in physical resources nor the impact on the delivery of public services.

8.11 The roles of the Provincial Finance Office, DEF and MOI in the budget process are not clearly defined. This opens the system up to negotiation between these agencies when allocating resources, potentially delaying decision-making and encouraging rent-seeking behaviour at all levels. Combined with cash shortages, which significantly enhance the power of the provincial treasurer, this further confuses lines of responsibility and accountability in practice.

Appropriate control and authority

8.12 As indicated above, there are too many financial management controls and insufficient accountability within the provincial/municipal budget system. The fundamental problems result from a weak control environment, weaknesses in the Provincial Treasury system, especially in the area of cash management, inadequacies in the public accounting system, and weak internal and external auditing capacity. Despite these controls there is a lack of authority delegated to the governor and to the DEF to make decisions regarding the Sala Khet/Krong budget and, *de facto*, power tends to be concentrated in the Provincial Treasury as the result of cash shortages due to problems further up the line.

8.13 These weaknesses at the provincial/municipal level are systemic and relate to the overall system of public financial management as a whole. Therefore, the strengthening of provincial/municipal budget operations will need to take place as part of the wider PFM reform programme, particularly in terms of moving away from line-item (chapter) budgeting, clarifying lines of accountability and addressing dual subordination, strengthening accountability for service delivery rather than for fulfilling the budget plan, improving Treasury operations and the system for the release of funds, improving the internal control system, introducing an effective commitment control system, and strengthening financial management, including introducing international standards for accounting. A specific set of activities needs to be centred on decentralisation and deconcentration to ensure that not only are sufficient resources allocated to the provincial and district level to undertake service delivery commitments, but that also the capacity exists to implement the required activities.

8.14 International experience suggests that comprehensive reform of the PFM system will take considerable time, particularly, given the severe capacity constraints at provincial/municipal levels. These capacity constraints would suggest that reforms should be undertaken gradually, concentrating first on ensuring that basic good budgeting practices are in place. Progress is likely to be slow.

8.15 The RGC's PFM reform programme provides the fundamental platform for improvements to the provincial/district budget system. The reform programme is based on the notion that strengthened public financial management at all levels is critical for facilitating good governance, a key Government policy goal. Specifically, the reforms aim to address a number of weaknesses preventing provincial budget systems from meeting several fundamental PFM objectives, highlighted in the report and including:²⁶

- *Budget realism.* As indicated in the report, there is little relationship in practice between budget plans and in-year actual budget outcomes. This reflects both problems with the comprehensiveness of provincial/municipal budgets, as well as weaknesses in budget execution, accounting and reporting.
- *Comprehensive, policy-based budget.* The report has highlighted the lack of an explicit or implicit link between policies and budget allocations, with the result that provincial/municipal budgets are driven by inertia rather than by strategic objectives.
- *Fiscal management.* Problems with fiscal management were highlighted in Section 7 above.
- *Information.* There are significant weaknesses in the basic systems and procedures for accounting for provincial/municipal resources.
- *Control.* As indicated above, a poor internal control environment results in significant fiduciary risks.
- *Accountability and transparency.* Weaknesses in auditing standards and procedures undermine accountability and transparency in provincial/municipal budget systems.

8.16 The PFM reform programme includes a number of priority areas for action which potentially affect provincial/municipal budget systems.²⁷ These include:

- Improvements to the comprehensiveness and integration of the budget, including identifying revenue sources not currently captured, integration of recurrent and capital budgets, mainstreaming of PAP expenditures and provincial programmes. One of the

²⁶ These PFM objectives need to be strengthened at all levels, but the concentration in this discussion is on provincial budgets. Source: RGC, "Public Financial Management Reform Program: Strengthening Governance in Cambodia through Enhanced Public Financial Management", Phnom Penh, August 2004.

²⁷ See RGC, *ibid.*

activities listed in the action matrix is the implementation of a pilot from which to draw lessons for further strengthening resource basis at local and provincial levels.

- Measures to improve the realism and sustainability of the budget, including identification of measures to improve resource mobilisation and widen stakeholder engagement in resource allocation decisions
- Streamlining the ability of budget holders to spend in line with budget provision, including:
 - ◊ streamlining approval process and phased budget release by central level (MEF);
 - ◊ progressive deconcentration of expenditure commitment, procurement and payment authority;
 - ◊ widening of scope for payment by cheque and transfer through the banking system, and transparent cash management plan.
- Steps to avoid re-accumulation of payment arrears, including effective commitment controls.
- Development of revised procurement procedures, including speeding up administrative processes and decentralising authority for procurement.
- Measures to redesign and integrate accounting and budget classification system, including Financial Management Information System (FMIS).
- Improvements to accounting and reporting procedures.
- Definition of arrangement for managing and leading internal audit function, including standard-setting and capacity building.
- Piloting of expenditure tracking work.
- Pilot programme-based budget analysis in order to improve the link between policies and budgetary allocations.
- Investigation of options for improving fiscal decentralisation, including the financing of local governments (e.g. the basis of inter-governmental transfers) and clarifying roles, functions and responsibilities between levels of government.
- Measures to increase institutional capacities for these reforms.

Recommendations

8.17 In terms of specific recommendations for provincial/municipal budgets, the TORs for the current study indicate that the study should highlight ways for Seila to institutionalise and/or harmonise its external support for provincial/municipal management with the government's own provincial/municipal budget framework. Given the severe weaknesses in public financial management and the associated fiduciary risks, it is unlikely that Seila would wish to harmonise its future support with government systems in the short term (i.e. from 2005). Therefore, in these recommendations, the study concentrated instead on indicating areas that Seila might consider for further investigation regarding provincial/municipal budgets, recommendations for improvements in budget management that may be piloted, and relevant points that should be incorporated into the Organic Law on Decentralisation and Deconcentration.

8.18 Many of the issues described in the report are intended to be addressed in detail as part of the D&D Strategy Framework and Action Plan.²⁸ Specifically,

²⁸ RGC's Decentralisation and Deconcentration Working Group, "Support for the Formulation of a Decentralisation and Deconcentration Strategy Framework, Action Plan and Donor Support Program for Cambodia: Inception Report", October 2004.

- Structure of provincial governance system/administration;
- Role of line ministries vs. provincial level and degree of devolution of management responsibility;
- System of accountability and checks and balances;
- Comprehensiveness of budget and accounting system;
- Range of services provided by provinces and the degree of discretionary power;
- Stakeholder participation and accountability; and
- Decentralised provincial payroll.

8.19 The recommendations set out below are intended to highlight specific short-term measures which complement the PFM reform programme and which can be used to inform further D&D analyses. These recommendations cover short-term activities; the exact timing of these measures and personnel responsible would be determined by Seila and other stakeholders.

Areas for further Seila investigation

8.20 This study has provided an initial overview of budget practices at the provincial/municipal level and has highlighted a number of weaknesses in their budget processes. Further analyses will be required to provide the basis for further support. In particular, a number of areas should be investigated in greater detail to understand some of these budget processes better. In particular, it is recommended that Seila consider the following areas for more detailed analysis: Many of the recommendations are consistent with, or provide initial analyses for, activities in the Government's PFM Reform Matrix; the relevant activities are indicated under each of the recommended measures.

- An investigation of the provincial/municipal revenue system in more detail, as well as ways to improve the incentives for revenue collection and recording (this is consistent with activity 3 of the PFM Reform Matrix concerning resource mobilisation policy). The official resources available for the provincial budget are not only small, but limited by the revenue raising capacity of the Tax Department. Changing incentives has the potential to improve the efficiency of revenue collections and the amount collected. Investigating the options for implementing more effective incentive schemes and changing regulations on surplus revenue that can be retained could significantly enhance the resources available for the provincial budget. This study should also examine the relative incentives in revenue collection between different assigned levels of government.
- A study of the expenditure process at the provincial/municipal level for one sector in-depth (c.f. expenditure tracking) for a non-PAP sector with significant expenditure, e.g. public works (this is consistent with activity 24 on expenditure tracking work). The study would examine both Sala Khet/Krong budgets and the provincial share of national budgets. This would provide useful additional detail on both the official and unofficial mechanisms and incentives. As many of the private contributions relate to road projects, this study could also examine how off-budget resources could be incorporated into the budget system.
- A study of how to incorporate some of the good practices used by Seila into government systems, including the stakeholder workshops for determining budgetary priorities during budget preparation, the use of commercial bank accounts for budget funds, more transparent procurement procedures, and greater accountability for the provision of services (this is consistent with activity 27 on the development of the D&D strategic framework). On the basis of the study, these practices could be introduced in some provinces/municipalities as a pilot.
- A study of ways to streamline provincial/municipal administrative procedures, including the decision-making process and the number of levels of approvals required (this is

consistent with activity 6 on streamlining budgetary processes at all levels of administration). This would assist in finding solutions to the bottlenecks that exist at all levels of the system. The study would include a focus on extended lines of reporting and the need for signatures at every stage and documentation; these hurdles provide opportunities for rent seeking, and, although there are likely to be vested interests in retaining them, the budget process would work more effectively if these could be rationalised.

Proposals for potential pilots

8.21 Following further study of provincial/municipal budget processes, Seila could pilot improvements to budget processes. Many of these recommendations are aimed at discrete interventions that could be implemented effectively without wider PEM reforms. Options for pilots that Seila may wish to consider include:

- In conjunction with the wider PFM reform programme, introduce a pilot aimed at promoting good practices in budget management (this is consistent with activity 32 on setting out criteria by which spending units might be invited to “compete” to attract more freedom and flexibility, activity 13 on improving procurement, activities 20 and 21 on improving accounting and recording, and activity 25 on strengthening preparation and implementation of provincial governors’ budgets). MEF would provide additional discretionary budgetary resources to provinces/municipalities as a reward for good budget management and introducing good PFM practices.²⁹ Success would require MEF to guarantee to provide such resources in exchange for implementation of agreed good budget practices. With a finite amount of additional resources to allocate across all provinces/municipalities, this would introduce a competitive element between provinces/municipalities designed to encourage implementation of good practice. A pilot at the Sala Khet/Krong level could then be extended to the provincial-level national budget.
- Following the results of the study described above, introduce particular measures to improve incentives for revenue collection and recording for the Sala Khet/Krong (this is consistent with activity 3 concerning resource mobilisation policy and activity 27 on the development of the D&D strategic framework). This would allow Sala Khet/Krong to keep a surplus of revenues over the planned amount and would focus on improving the projections of planned revenues based on analyses in accordance with a consistent macro framework such as the MTEF. It could also institute performance-based incentives for staff involved in tax collection and enforcement.
- A pilot aimed at ring-fencing the budgets of Sala Khet/Krong and line departments would help increase transparency of resource allocation and help prevent the diversion of resources intended for one use to other uses (this is consistent with activity 7 on increasing the efficiency of cash handling/management and activity 8 on budget releases). The use of commercial separate banks or Treasury sub-accounts for the budgets of line departments and Sala Khet/Krong would not only give more control over budget resources to the province level, it would also weaken the discretion of the Provincial Treasury in deciding which departments receive disbursements.
- There is a clear need for district and provincial-level training in both budget management and accounting practices (this is consistent with activity 25 on training for changes to budget practices and activity 30 on capacity building). Budget management training should focus on good budget principles and service delivery and could be delivered in conjunction with PFM reforms. Training in accounting principles and practices could be

²⁹ MEF could allocate a certain (limited) amount of resources in the central budget which would be distributed only in the event that provinces/municipalities achieved the desired improvements.

geared towards the granting of a qualification, which in turn could be rewarded through higher remuneration for qualified personnel.

- Seila should consider piloting a public meeting or consultation process to set priorities for the Sala Khet/Krong budget to ensure the participation and meeting of needs of local people (this is consistent with activity 27 on the strategic D&D framework).³⁰ This could be undertaken in a similar manner to the district integration consultations undertaken by Seila for allocation of PIF resources.
- Undertaking a pilot project (e.g. associated with poverty reduction) with the aim of incorporating Seila good practice procedures and mechanisms (this is consistent with activity 27 on the strategic D&D framework). This would involve the allocation of government money with matching Seila resources, centred on achieving a particular objective. A stakeholder workshop/public meeting could be used to agree on the scope of the project, based on relative priorities, and provide some accountability to local people. Management of the project would focus on outputs and service delivery, rather than on inputs, and could involve a resource contract specifying outputs and clarifying lines of responsibility. The project would incorporate Seila good budget implementation practice, such as transparent procurement and accounting procedures and the use of commercial bank accounts.
- Following the results of the study described above, undertake a pilot for particular Sala Khet/Krong(s) to streamline administrative budgetary procedures (this is consistent with activity 6 on streamlining budgetary processes at all levels of administration).
- In conjunction with wider PFM reforms, a pilot could be introduced to make monthly or quarterly budget releases for the Sala Khet/Krong budget against cash projections in conjunction with DEF and the Provincial Treasury (this is consistent with activity 8 on cash management and budget releases).

Recommendations for Organic D&D Law

8.22 The Organic Law which is currently being developed will also include issues related to sub-national governance that are addressed in this report. Specific recommendations for consideration for inclusion in the organic D&D law include:

- Clarification of the lines of accountability, roles and responsibilities for the planning and implementation of the provincial/municipal budget.
- Incorporation of a law on accounting principles and practices at central and provincial/municipal levels.
- Currently, the provincial governor has responsibility for the provincial budget but little authority to ensure delivery of outputs. Given the fact that the governor is not elected, more delegated authority to strengthen the provincial governor's role might be considered in conjunction with a service delivery contract that outlines responsibilities and activities for which the governor will be accountable.
- Ring-fencing of provincial level budgets to ensure access to designated resources through the operation of bank accounts.
- Consideration of methods by which the focus on the implementation of budget plan can be changed towards strengthening incentives towards service delivery. This might include, for example, the use of service delivery contracts for provincial administration and line departments as discussed above.³¹

³⁰ As part of this process, the expenditure responsibilities for the Sala Khet/Krong could be discussed.

³¹ The issue of accountability is critical here. The D&D Strategic Framework aims to address this issue and should inform this point further.

ANNEX A

Terms of Reference

SECOND DRAFT

Project Number: CMB/01/R72/RILG
Project Title: Rural Investment for Local Governance
Consultancy: Deconcentration: Provincial Budget Operations
Location: Phnom Penh Municipality and Kompong Cham Province
Duration: 40 working days before June 2004. in 2004 (Does not have to be consecutive).

Background and Context

The Seila Program is a national effort to achieve poverty reduction through improved local governance. It is the collective responsibility of an inter-Ministerial body³², the Seila Task Force. In its first phase, 1996-2000, the Seila Program designed, piloted, evaluated and continuously strengthened decentralized systems for planning, financing and implementation of local development at commune and province levels increasing coverage over time as capacity and resources allowed. Beginning in five of the 24 provinces and 20 of the 1,621 communes in its first year, Seila Program coverage expanded gradually over five years to include half of the provinces and one third of the communes in the country.

Based largely on the positive experience generated under this first phase of Seila, in 2001 the Royal Government of Cambodia adopted two laws on Commune Elections and Commune Administration that would usher in a new tier of decentralized local governance in Cambodia. The National Committee for Support to the Communes (NCSC) was established as a policy body to oversee the formulation, training and implementation of a decentralized regulatory framework. In the same year, the Council of Ministers approved a second phase of the Seila Program, 2001-2005, defined as an aid mobilization and coordination framework for support to local governance.

In February 2002, Commune Councils were elected in all 1,621 communes to a five-year mandate. Working closely with the NCSC since 2001, technical and financial resources programmed under Seila in support to NCSC-member Ministries have provided the primary means of support for both the design of the decentralized regulations and the design of national training programs to enable the regulations, systems and procedures to be managed and implemented. Through this effort, the systems and experience generated under five years of piloting at commune level have significantly influenced the conceptualization of the new regulatory framework. At the specific request of the NCSC Chairman, between 2002 and 2003 Seila coverage was rapidly expanded to the remaining provinces and communes to ensure consistency and equity in support to the national reform process across the entire country. Technical and financial resources continue to be programmed each year to NCSC-member Ministries to support national supervision, ongoing monitoring and evaluation of implementation, systems development and training in order to strengthen both the decentralization framework and the performance of local governance and development.

³² Members are: the Ministry of Economy and Finance (MEF); the Ministry of Planning (MOP), the Ministry of Interior (MOI), the Ministry of Rural Development (MRD), the Ministry of Women and Veteran Affairs (MWVA), the Ministry of Agriculture, Fisheries and Forestry (MAFF), the Ministry of Water Resources and Meteorology (MWRM) and the Ministry of Social Affairs.

Provincial Management

From its inception in 1996, the Seila Program has recognized the strategic role of the province, as a territorial administration, in relation to the coordination and provision of support to both decentralized local governance and deconcentrated provincial development. Well over half of the \$ 200 million in technical and financial assistance programmed and disbursed under Seila since 1996 has been allocated to the provincial level against annual work plans and budgets formulated by the provincial authorities in support to both development and local governance. A comprehensive provincial management system mandated by the Seila Task Force has been designed, piloted, annually reviewed, documented in manuals and continuously strengthened over the past eight years.

Following the adoption of the Commune Administration Law and the election of the commune councils, considerable powers were delegated to the provincial governor by the national level for coordination of support to commune councils and a new Provincial Unit of Local Governance established in the governor's office. In consultation with the NCSC and Ministry of Interior, the Seila Task Force revised the composition and terms of reference of the provincial management structure in 2002 in line with the delegation of authority to the governor and the decentralized reforms. At present, it is through the provincial management structure developed by Seila and mandated by sub-decree signed by the Minister of Economy and Finance as chairman of the Seila Task Force that the Provincial Governors in all 24 provinces are able to execute their delegated authority for coordination of services to the commune councils. At present, virtually all of the technical and financial resources required for the provincial management functions and provision of services to communes are financed through Seila.

Provincial Development

The 1998 law on the provincial budget provides a basis for provinces to receive and/or retain revenue for development purposes. In practice, however, very few discretionary resources for development purposes are allocated to provinces from the national budget. With an objective that includes both the strengthening of local governance and poverty alleviation, for the past eight years resources mobilized under the Seila framework have been allocated annually to provincial administrations who have been given the responsibility for planning, programming and implementation of a wide range of public goods and services focused at the local level. These resources are programmed under two specific financial facilities: the Provincial Investment Fund (PIF) and national deconcentrated sector programs (DSP).

Under the PIF, annual block grants are allocated to provinces which are then responsible for programming these resources against a set of criteria incorporating both the National Poverty Reduction Strategy and the priorities identified through commune planning. The DSP resources on the other hand relate to longer term project agreements negotiated between donors, national ministries and the Seila Task Force with a specific design and strategy and targeted sectors and provinces. The concerned national ministries retain oversight on policy and technical matters but devolve the planning and implementation function to the concerned provinces. Once the provincial annual work plan and budget is prepared by the provinces and technically appraised and approved at the national level, the bulk of the financial resources are transferred directly from the Ministry of Finance to the provincial administrations who then sign implementation contracts with the concerned line departments.

From the provincial management perspective, both the PIF and DSP resources follow the same contracting, procurement, financial management and reporting procedures which have been developed under Seila. From the policy perspective, the PIF can be seen as piloting reformed procedures for a decentralized provincial development budget while the DSP is piloting reformed procedures for a deconcentrated approach to development.

The current provincial management structure, consisting of a Provincial Rural Development Committee and its Executive Committee, is designed to manage and execute all of the resources mentioned above: costs for supervision, support and capacity building of Commune Councils and development resources under both the PIF and DSP facilities. The following table reflects the scale of resources being managed in 2004 under the Seila framework as described above.

FUND TYPE	RIELS	DOLLARS
Commune Fund	58,000,000,000	
Provincial Investment Fund		3,700,000
Deconcentrated Sector Programs		7,500,000
Provincial Program Support		5,400,000
TOTAL	58,000,000,000	16,600,000

Two major issues that must be addressed in the evolving reforms are as follows:

1) **Provincial Management Structure:** While designed and mandated by government, the management structure described above has not been institutionalized through law and regulations. An Organic Law on the Province and District, still at the early stage of formulation, is expected to clarify the structure, mandate and functions of the provincial and district administration within the overall local governance reform framework. Similiar to what happened at the commune level, it is expected that the experience generated to date under the Seila Program will contribute to the design of the future provincial management structure and system. Once adopted, Seila will support the establishment and strengthening of the structure and systems through the provision of financial and technical support.

2) **Provincial Budget:** Nearly all of the costs of the current management structure, as well as the resources which are managed, are financed from external resources mobilized by or in partnership with the Seila Program. With the exception of allocations to the C/S Fund, which are converted to riels and transferred through the treasury system, these resources are held in US dollar accounts, transferred through the commercial banking system and managed by the Provincial Departments of Finance under the authority of the governor. As such there are two currencies and two parallel systems operating. In designing the dollar-based system, the STF and the Ministry of Economy and Finance have made a considerable effort to harmonize the budgeting and accounting procedures with the government budget cycle and accounting procedures. The dollar-based system has clear advantages over the cash-based treasury system as funds are held in commercial bank accounts, transferred electronically, enable bank reconciliation statements to be obtained and is supported by information technology. In addition, there is greater predictability in the flow of funds as the combined annual disbursement rate of both loan and grant funds through the dollar-based system is well over 90%. As the system is entirely operated by government at national and provincial level with a steadily decreasing level of support from national staff advisors, it has also demonstrated that capacity is not a serious constraint.

The fact remains, however, that the external resources, retained largely in dollars, are being managed outside the national budget framework. Furthermore, the budget resources allocated for the provincial management structure and for provincial development (PIF) are almost entirely externally financed at present. As the Royal Government takes steps towards formulation of the organic law, which should result in an institutionalized provincial management structure, work must also be carried out at the same time on the provincial budget and expenditure framework and the financial management systems that will be required by donors to enable the required budgets to be financed from both domestic and external resources. While the long-term goal for donors is to work towards the provision of budget support, there are numerous reforms that will be necessary before sufficient confidence on

the part of donors can be secured. As such, the dollar-based system is likely to continue in parallel to the national budget for some time to come.

Inherent to the reform needed at provincial level is the reconceptualization of the provincial budget as a budget for administering and developing the territory of the province. At present, the only discretionary resources allocated to the province that can be used for development purposes sit within the budget of the governor's Office (the Sala Khet) and are managed as a line agency budget under the Ministry of Interior. While both these resources and the PIF resources fall under the authority of the governor, the manner in which these two sets of resources are planned, programmed and managed are quite different. It is anticipated that the organic law will clarify and strengthen the mandate of the governor and the provincial management functions of the Sala Khet. As such the primary focus for institutionalizing the experience generated to date under Seila at provincial level is within the Sala Khet.

Several preparatory studies on the current status of the provincial budget operations have been carried out under Seila and the reports from these studies constitute important background for this consultancy (two of the studies by Hugh Evans are available on the Seila website).

The World Bank Rural Investment and Local Governance Project (RILGP)

In April 2003, the World Bank approved the RILGP with the objective of contributing to rural development and poverty reduction through financing of priority public goods and services at the commune level as well as promoting good local governance through support of decentralized and deconcentrated participatory local governance systems at the commune and provincial levels. The RILGP is executed by the Seila Program and consists of two components. Component 1 (Local Planning and Investment) reimburses the Royal Government's C/S Fund against eligible expenditures for development investments planned and managed by the Commune Councils. Component 2 (Policy Support and Project Management) consists of capacity building, technical assistance, buildings and equipment, and operating costs at national, provincial and commune levels of implementing Component 1. Component 2 also includes a budget for consulting services for the purposes of conducting strategic studies related to decentralization and deconcentration reforms, socio-economic follow-up studies, mid-term and final project evaluations, and an annual independent audit. This TOR relates to the consultancy services budget in Component 2 and to the topic of strategic studies related to the deconcentration reforms.

Objectives

One of the objectives of the Seila Program is to assist the Royal Government to study and formulate an institutionalized provincial management system that will enable greater coherence in budgeting, programming and execution of a provincial budget for the administration and development of the province.

As a contribution to this longer-term objective, the objectives of this consultancy are to:

1. Carry out an investigation and prepare a detailed description and analysis of the current budget operations, including revenues and expenditures within the Sala Khet/Krong with a particular focus on Chapter 11 resources allocated for provincial services;
2. Prepare design options, for consideration by the Royal Government, on how to institutionalize and harmonize support currently being provided through Seila for provincial/municipal management and development services and investments through the provincial/municipal budget framework.

The investigation and analysis to be carried out will focus on the Sala Khet/Krong budget operations for the 2003 financial year and records and will cover the following areas:

- **Revenue generation:** verify all sources of revenue (table from Paul).
(a)
- **Budgeting:** budgeting framework, guidelines, formulation and timelines, roles/responsibilities, processing and approval.
- **Programming (focus on Chapter 11):** design/formulation of proposals for review and approval by MoI/MEF, nature and description of services, roles/responsibilities, reporting.
- **Execution:** procurement and contracting, administration of contracts/service provision, budget releases, disbursements, cash management and roles/responsibilities.
- **Financial Management:** payments, accounting and reporting, line of supervision, internal auditing, inspections, accountability, roles and responsibilities.

Methodology and tasks

The primary government counterparts for the study are the Director General of Administration in the Ministry of Interior and Ministry of Economy and Finance officials to be identified. In agreement with the Ministry of Interior, investigations at provincial/municipal level will focus on Phnom Penh Municipality and Kompong Cham Province. Phnom Penh and Kompong Cham have been proposed as both locations have considerably higher levels than other places in terms of revenue collected as well as having reasonably forward thinking governors who would support such a study.

The consultant will organize their work program based on the following proposals:

1. Review available documentation on the management systems and procedures applied to provincial budget operations under the Seila Program as well as relevant reports carried out to date through previous consultancies on the Sala Khet/Krong budget operation. Ensure coordination with the UNCDF team who are working on commune/sangkat own source revenue. [This is very important. See my cover note.]
2. Through consultations with counterparts in the Ministries of Interior and Economy and Finance:
 - i) clarify the status of thinking within MOI and MEF on the policy direction related to provincial management and the provincial budget in the context of the study objectives;
 - ii) develop and agree on the methods of data collection and survey instruments for the investigation to be carried out in Phnom Penh Municipality and Kompong Cham Province on budget operations;
 - iii) discuss and agree on the method and frequency of interaction with the Ministries during the assignment.
3. At province/municipal level hold an initial meeting with the governor to explain the purposes and terms of reference for the investigation on provincial/municipal budget operations; discuss and agree on the primary counterparts that will assist and/or be involved in the work to be carried out; discuss and agree on the method and frequency of interaction with the governor and Sala Khet staff during the assignment including a debriefing session prior to departure.
4. Prepare a first draft descriptive analysis of provincial budget operations based on the provincial/municipal investigations and discuss with Ministry counterparts to check for accuracy;

5. Through discussions with Ministry counterparts, STFS staff and PLG and other technical advisors identify key issues and constraints to the current Sala Khet/Krong budget operations and formulate recommendations on how they may be addressed through further studies in the course of formulating the Organic Law and the future provincial/municipal management system.
6. On the basis of the consultations above, formulate design options on how best to institutionalize and/or harmonize support currently being provided through external resources under Seila for provincial/municipal management and development services and investments through the provincial/municipal budget framework.
7. Present a summary of the findings and recommended design options to a wrap-up meeting with Ministry counterparts, STFS staff and relevant advisors for final discussions and comments.

Expected Outputs

1. The consultant will prepare an Inception Report (within 5 days of commencement of the assignment), outlining the Consultant's interpretation of the TOR, detailing modifications proposed and agreed with the Seila Task Force Secretariat, a program of work, including consultative process, workshops and validation seminars, (5-7 pages). The inception report will include a description of the stakeholders, survey instruments and participatory methodology that will be used to complete the study. This will be submitted to the STF Secretary General and the PLG Senior Program Adviser for approval. Changes to the work plan and schedule can be made after consultation and agreement with the PLG Senior Program Adviser and STF Secretary General.
2. An outline for the mission report agreeable to all parties.
3. A mission report on completion of the assignment which addresses the TOR, with recommendations and conclusions. A draft and final report will be prepared in English and Khmer and data will be provided to the Seila Task Force Secretariat on diskette. The report will contain a detailed analysis of the data and recommendations. A concise executive summary of findings and recommendations of the study should be included in the report. The Consultant will present the findings to the Ministries of Interior and Economy and Finance, the Seila Task Force Secretariat, the World Bank and PLG staff towards the end of their research.

Copying and distribution of the final documents is the responsibility of STFS.

Logistical Support:

STFS will be able to provide transport to and within provinces. However if there are heavy demands on STFS vehicles, then a budget will be provided for vehicle rental. It is expected that the consultant have their own computer however STFS can provide office space to work from in the provinces and in Phnom Penh. STFS will also provide support with scheduling provincial visits/work. STFS will coordinate with the Ministry of Interior and Ministry of Economy and Finance to provide one government staff who will work with the consultant and the PLG advisers will be available to support the consultant during the national and provincial work.

Qualifications

The Consultant should also have the desired qualifications listed below:

- Post graduate degree, or equivalent, in public finance, public administration and/or related fields.
- Proven experience in conducting studies of this type in Cambodia.
- Proven experience in public expenditure management and reforms.
- Familiarity with the application of good governance and decentralisation.

Background documents:

- Seila 2001-2005 Programme Document, Seila Task Force.
- RILGP Project Appraisal Document
- RILGP Project Implementation Manual
- Medium Term Expenditure Framework
- Seila Support to Deconcentration Framework: An Update and Agenda (Hugh Evans, November 2003)
- Hugh Evans, Seila Support to Deconcentration Framework. (Draft 7 May 2002) May 2002)

Links:

- Seila: <http://www.seila.gov.kh>
- RILGP: <http://www4.worldbank.org/sprojects/Project.asp?pid=P071146>

ANNEX B

People Consulted

Name	Position/Organisation
H.E. Kep Chuktema	Governor of Phnom Penh Municipality
Mann Chhoeurn	Chief of Cabinet PNP Municipality
Tiv Kim Piseth	Deputy Chief of Cabinet PNP Municipality
Bun Serey	Chief of Finance Office PNP Municipality
Preap Ny	Chief of Administration Office PNP Municipality
Nget Chan Davy	Director, Dept of Economy and Finance, PNP
Keo Chhan	Director of Tax Department, PNP
Touch Sarom	Director Dept of Women's Affairs, PNP
Nhem Saran	Director, Dept of Public Works, PNP
Phneg Sokham	Director of Dept Agriculture, PNP
Chhoun Sothy	Director Dept of Land Management, PNP
Veng Thay	Director Dept of Health, PNP
Mom Sandap	Director Dept of Planning, PNP
Chin Ratha	Director Dept of Rural Development, PNP
Oum Satha	Director Dept of Commerce, PNP
Thach Savy	Fiscal Decentralization Advisor, Partnership for Local Governance Project
Ros Sokha	Senior Municipal Program Advisor, Partnership for Local Governance Project
Sok Sothirak	Planning and M&E Advisor, Partnership for Local Governance Project
Tan Visal	Local Capacity Building Advisor, Partnership for Local Governance Project
Ung Sirivong	Finance Advisor, Partnership for Local Governance Project
Lam Vay	Sector Advisor, Partnership for Local Governance Project
Joanne Morrison	Operations Advisor, Partnership for Local Governance Project
H.E. Sak Setha	Director General, Dept of General Administration, MOI
H.E. Chieng Am	Governor of Kompong Cham Province
Director	Finance Office, Kompong Cham Sala Khet
Director	Dept of Economy and Finance, Kompong Cham
Director	Tax Department, Kompong Cham
Director	Administration Office Kompong Cham
Kol Thearin	Director, Kompong Cham Provincial Treasury
Krec Longheng	Deputy Director, Kompong Cham Provincial Treasury
Chief Accountant	Kompong Cham Provincial Treasury
Director	Dept of Health, Kompong Cham province
Director	Dept of Education, Kompong Cham province
Director	Dept of Women's Affairs, Kompong Cham province
Director	Dept of Agriculture, Kompong Cham province
Director	Dept of Rural Development, Kompong Cham province
Director	Dept of Planning, Kompong Cham province
Kung Munichan	Senior Advisor, Partnership for Local Governance Project
Chou Kim Leng	Deputy Secretary General, MEF
Liv Bun Hy	Director of Local Finance Department
Jennifer Thomson	Senior Financial Management Specialist, World Bank
Jan Rudengren	Permanent Advisory Team, SPM Consultants
Louise Fallon Scura	Lead Natural Resources Economist, World Bank
Roland White	World Bank
Rob Taliercio	World Bank
Pierre Landell-Mills	Permanent Advisory Team Leader, Seila PLG
Jesper Steffensen	Nordic Consulting Group
Soren Villadsen	Nordic Consulting Group

ANNEX C

Documents Consulted

Royal Government of Cambodia 'Royal Decree on Provincial/Municipal Budget and Durable Assets Ration', Unofficial translation.

Royal Government of Cambodia 'Volume One: The longer term PFM strategic vision in the policy context and the plan for implementation stage one', Unofficial translation, 2004.

Royal Government of Cambodia 'Public Financial Management Reform (PFM) Program: Strengthening governance in Cambodia through enhanced financial management', August 2004, Phnom Penh.

Seila 'PAT Empowerment Study: Final Report', November 2003.

Seila/PLG 'MTR Debriefing Note', November 2003.

Seila Task Force, 'Seila Programme: Annual Work Plan and Budget 2004' January 2004.

Tax Department, Kampong Cham 'Revenue Plan' 2002,2003,Oct 2004.

Tax Department, Kampong Phnom Penh 'Revenue Plan' 2002,2003,Oct 2004.

UNDP/DFID/Sida 'Mid-Term Review: Seila Program and Partnership for Local Government', 2004.

UNDP/UNOPS 'Seila Support to the Deconcentration Framework', May 2002.

UNDP/UNOPS 'Seila Support to the Deconcentration Framework: An Update and Agenda', Nov 2003.

World Bank 'Cambodia: Joint Public Financial Management Preparation Mission', January-February Mission 2004.

World Bank 'Cambodia: Second Joint Public Financial Management Preparation Mission', March Mission 2004.

World Bank 'The Bank's Approach to Supporting 'Local Governance and Accountability' in Cambodia: some thoughts and proposals', EASPR, April 2004.

World Bank/ADB 'Cambodia: Enhancing service delivery through improved resource allocation and institutional reform', May 2004.

World Bank 'Cambodia: Third/Final Joint Public Financial Management Preparation Mission', September 2004.

World Bank 'Cambodia: Country Procurement Assessment Report', September 2004.

World Bank 'Cambodia – Enhancing Service Delivery Through Improved Resource Allocation and Institutional Reform: Integrated Fiduciary Assessment and Public Expenditure Review', May 2003.

ANNEX D

Statistical Appendix

Table D.1: Exchange Rate (Riel/US\$)

2002	2003	Jan-Oct 2004
3,921	3,980	3,953

Table D.2: Phnom Penh Sala Krong Expenditures, 2002-2004 (US\$ '000)

	2002			2003			2004	Jan-Oct 2004	
	Author- ised	Actual	Actual as % of Author- ised	Author- ised	Actual	Actual as % of Author- ised	Author- ised	Actual	Actual as % of Author- ised
Salaries	352	350	99.6%	402	359	89.3%	405	262	64.8%
Operations	459	458	99.9%	497	496	99.8%	501	187	37.3%
Development	6,331	6,330	100.0%	7,696	7,478	97.2%	6,497	4,862	74.8%
Transfers/ subsidies	102	102	100.0%	73	72	99.3%	73	23	31.0%
Other, incl. contingency	131	131	100.0%	0	0	N/A	240	0	0.0%
TOTAL	7,375	7,372	100.0%	8,668	8,405	97.0%	7,716	5,334	69.1%

Note: Actual expenditures are those given in the budget closing report prepared by the Provincial Treasuries (PTs) and refer to payment order requests received by the PTs prior to year-end, rather than necessarily to cash disbursements made. See text for further discussion of this point.

Source: Budget closing report

Table D.3: Kompong Cham Sala Khet Expenditures, 2002-2004 (US\$ '000)

	2002			2003			2004	Jan-Oct 2004	
	Author- ised	Actual	Actual as % of Author- ised	Author- ised	Actual	Actual as % of Author- ised	Author- ised	Actual	Actual as % of Author- ised
Salaries	869	767	88.3%	1,039	845	81.4%	1,039	640	61.6%
Operations	760	749	98.6%	856	852	99.5%	836	482	57.6%
Development	2,007	1,966	97.9%	2,462	1,837	74.6%	2,462	745	30.3%
Transfers/ subsidies	54	54	99.3%	28	20	72.6%	28	17	60.5%
Other, incl. contingency	187	141	75.4%	135	115	85.2%	135	0	0.0%
TOTAL	3,877	3,677	94.8%	4,520	3,669	81.2%	4,500	1,884	41.9%

Note: Actual expenditures are those given in the budget closing report prepared by the Provincial Treasuries (PTs) and refer to payment order requests received by the PTs prior to year-end, rather than necessarily to cash disbursements made. See text for further discussion of this point.

Source: Budget closing report

Table D.4: Development Expenditures, Sala Khet/Krong, 2003 (US\$ '000)

	Phnom Penh				Kompong Cham			
	2002	2003	2004	2003	2002	2003	2004	2003
	Actual	Actual	Planned	% of total	Actual	Actual	Planned	% of total
Street lighting	753	1,141	1,049	15%	67	62	91	14%
Firefighting	72	80	105	1%	1	0	1	0%
Rubbish collection	73	78	81	1%	16	19	32	4%
Sanitation, health, security	359	364	381	5%	15	46	38	10%
Maintenance of marketplaces	42	46	50	1%	0	0	30	0%
Road improvement	2,629	3,916	4,305	52%	259	266	426	58%
Water supply maintenance	480	1,015	1,090	14%	13	19	95	4%
Building maintenance	317	95	112	1%	0	0	91	0%
Sport, culture	91	114	166	2%	5	6	6	1%
Social transfers	443	607	1,409	8%	6	33	46	7%
Other	0	42	43	1%	0	10	13	2%
Total	5,259	7,500	8,790	100%	383	462	869	100%

Source: Official expenditure reports, Sala Krong, Phnom Penh, Sala Khet, Kompong Cham

Table D.5: Total and Per Capital National Expenditures, Phnom Penh and Kompong Cham, 2003

	Phnom Penh		Kompong Cham	
	Total	Per capita	Total	Per capita
	(US\$ '000)	(US\$)	(US\$ '000)	(US\$)
General public services	104	0.10	137	0.08
Public order/safety	194	0.20	94	0.05
Agriculture, forestry, fisheries, water	448	0.45	373	0.23
Transport, communications, public works	704	0.70	88	0.05
Other economic affairs	112	0.10	77	0.05
Environmental protection	40	0.05	27	0.03
Health	727	0.73	1,767	1.03
Recreation, culture, religion	109	0.10	88	0.05
Education	4,800	4.77	5,468	3.19
Social protection	3,160	3.14	1,544	0.90
Total	10,399	10.33	9,663	5.63

Source: Official expenditure reports, DEF, Phnom Penh and Kompong Cham