Partnership for Local Governance

Establishing the Commune/Sangkat Fund

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Leonardo G. Romeo
Institute of Public Administration (IPA)
New York University

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Part 1 - Introduction

The need for fiscal transfers

Cambodia local Councils need resources. They need them for
(i) Their basic functioning as an elected body and local administration and
(ii) Promoting local development and delivering local infrastructure and services.

Devolving revenue-raising powers to the Councils is the longer-term answer, and the most appropriate one to foster local accountability. At some point in the future the Councils should be able to cover their operating costs through own-source revenue and to finance at least part of their local investment needs through savings on recurrent expenditures.

But at the outset of their mandate and for a long time to come, Cambodian local Councils will have to rely heavily on fiscal transfers to cover both their administration and development expenditures. And, even in the long run, as worldwide experience shows, fiscal transfers are likely to remain important features of the Cambodian local finances system.

The legal basis of the Commune Sangkat Fund

The Commune Law establishes the right of the Councils to receive "*grant resources from the national revenue*" *(art. 75)* and the obligation for the state to create a "*Commune/Sangkat Fund [...] in order to transfer national revenues and other revenues to Commune / Sangkat budgets* " *(art. 77).*

For the design of such Fund, the Law provides a few important principles.

First, it states that the level of capitalization of the Fund from domestic resources should be fixed, through "*a formula or a rate*" *(art.77)* for a period of "*not less than 3 years and not more than 5 years*" *(art.77)*. The Law therefore aims at providing a certain predictability of the transfers, to promote effective multi-year local expenditures management.

However the Law stops short of fixing the share of national revenue to be channeled to Councils. It leaves this *"to be determined by a sub-decree" (art.77).* Since the Fund will be capitalized by provisions of the annual National Budget Law, (which will not be legally bound by a sub-decree), the predictability of the Fund capitalization is actually not strictly guaranteed by the Commune Law. The provisions of the sub-decree establishing the Fund, in this respect, may be more of a "bona fide" statement of policy, and a moral RGC commitment, than a legal obligation.

Second, the Law states that the Fund should be capitalized by both "*a specific portion of the state revenues*" and other resources "*from inside and outside the country*" *(art.78)*. This suggests the desirability of a mechanism for channeling to the Fund contributions from donors and IFI. But raises a number of Fund design problems related to donors' and IFI's requirements, that can be addressed only through effective partnership arrangements. A most practical and urgent challenge is that of merging the externally-funded facility for commune-level development financing (the Local Development Fund) operating in the frame of the national Seila program, with the nascent Commune/Sangkat Fund.

The Law also stipulates that Fund's resources should be distributed to recipient Councils by formula. This is meant to prevent "ad hoc" or arbitrary transfers and again to increase the predictability of the transfers.

Equally importantly, however there are things that the Law does *not* specify. For example, the law does not specify:

- What are the specific policy objectives of the Fund and how these should be reflected in the design of the transfers' formula.
- How the Fund resources should be managed, disbursed and accounted for
- Whether all communes or only those fulfilling certain minimum "capacity conditions" should benefit from the Fund or specific portions of it.
- Whether the access of the Communes to the resources of the Fund, should be "automatic" or if certain conditions of access should apply.
- To which type of local expenditures the Fund's resources should be applied or whether specific portions of the transfers should be earmarked for operating or investment spending.

These questions are left to a sub-decree, or other derivative regulations, to answer.

Background of the preparation of the sub-decree on Commune/Sangkat Fund

The preparation of the sub-decree establishing the Commune/Sangkat Fund is the responsibility of the "Finance Sub-committee" of the recently established National Committee to Support the Communes (NCSC). The Finance sub-committee, and 4 other inter-ministerial sub-committees of the NCSC[1], have not yet been established.[2] However, since July 2000, the Ministry of Finance, which is expected to chair the NCSC Finance Sub-Committee, has set up an internal "Fiscal Decentralization Task Force" (FDTF)[3] and has done some preparatory work in all the three areas that the S/C will have to regulate. These are: (1)

[1] These are : the S/C on Planning, the S/C on Commune Boundaries, the S/C on Commune Powers, Functions and Structures, and the S/C on Commune Councils Capacity Building. Preparatory work on the matters to be regulated by these sub-committees has been done by the Ministry of Interior (Dept. of local Administration) with technical assistance by GTZ.

[2] The Sub-committees are expected to be formally created at the 2nd meeting of the NCSC, now scheduled for the end of August 2001.

[3] With technical assistance from UNDP

Fiscal Transfers, (2) Councils own-revenue sources and (3) Local budgeting and accounting systems.

With respect to fiscal transfers, an "issues paper" was developed by the FDTF and presented to a national workshop in March 2001. The "issues paper" was well received by concerned ministries, donors and NGOs, who could use the workshop for an open discussion of the issues and policy options related to the set up of the "Commune/Sangkat Fund".

The next step was therefore to draft, on the basis of the above "issues paper", a legal text for the sub-decree on the Commune /Sangkat Fund. This is presented in Part II of this report. This draft must be understood as a contribution to the work of the MEF-FDTF, which is now responsible for:

- Thoroughly analyzing it,
- Revising it as necessary and then
- Presenting it for discussion and approval at a meeting of the NCSC Finance Sub-Committee, as soon as this sub-committee is established.

The above sequence of actions is expected to be completed within the next 2 to 3 months.

Part II - A commented Draft Sub-Decree on the establishment of the Commune/Sangkat Fund

What follows is the proposed text of the Sub-Decree (Anukret) on the establishment of the Commune/Sangkat Fund with comments on each of its 23 articles to highlight their rationale, and the policy or technical issues that are raised by their formulation. The full text of the proposed Anukret, without comments is reflected in Annex 1

Chapter 1
Purpose and Structure of the Fund

Article 1 – **Establishment of the Fund**

A special treasury account denominated "Commune/Sangkat Fund", (the "Fund") is hereby created pursuant to Articles 77 and 78 of the Law on the Administration and Management of Communes/Sangkats (the "Commune Law"), to transfer domestic and external resources to the Communes/Sangkat councils.

This article clarifies that "the Fund" is not a new agency or organization (as it's the case, for example, of the "Social Fund"), but it's a special account in the National Treasury established to transfer both domestic and external resources to Commune/Sangkat Councils. This is important to avoid any confusion that the introduction of a Fund Board (see below) may create on the nature of the Fund itself. The article also reaffirms that the establishment of the Fund is an obligation of the RGC under the Commune Law.

Article 2 – **Purpose of the Fund**

The purposes of the Commune/Sangkat Fund are:

(a) To enable the Communes/Sangkats to assume their general responsibilities for promotion of local development in accordance with the provisions of art. 42, 43.and 44 of the Commune Law

(b) To correct differences in the relative potential of the Communes/Sangkats to mobilize their own revenue, because of different demographic, social and economic conditions

(c) To act as an incentive for building the capacity for good governance of the Communes/Sangkats Councils.

This article suggests that the Fund should serve three basic purposes:

First, it should provide resources to the Councils to enable them to assume gradually increasing responsibilities for (a) general administration of the Commune's affairs and (b) development of the Commune's social and economic infrastructure and delivery of local public services. This purpose may be restated as filling the "*vertical gap*" between the cost of the local administration and services delivery responsibilities, and the own-source revenue that the newly created Councils may be able to mobilize.

However, neither specific responsibilities for local-level infrastructure provision and services delivery, nor specific taxing powers have yet been assigned to the Communes. It is also likely that such assignments will require substantial negotiations among multiple agencies of the national administration, and may take some time to be finalized and actually implemented.

At the outset therefore, it may be difficult to assume, as the main justification and calculation basis for the Fund's transfers, the correction of a clear "vertical gap" created by the devolution of substantial mandatory administrative functions and services delivery responsibilities.

On the other end, while the devolution process may take some time to unfold, the very creation of the local Councils will create a "gap" to be filled. The Councils, as soon as elected, will need to cover the cost of their own set-up as a new level of elected authority and local administration (e.g. pay Councilors' allowances and salaries of accountants and other essential personnel and cover the cost of premises, transport, communications and sundries for the functioning of both the local council and local administration), and will be under pressure by the local communities to show that they can effectively promote local development and carry out the broad range of permissive functions that the Law assigns to them (Ch. 4, Art. 43 to 46). The conclusions are that:

(i) "Some" level of transfers will be needed

(ii) Such level may be determined by the available pool of transferable resources rather than by detailed calculation of actual "gaps" and

(iii) Transfers should be in accordance with the size of the Council. Those for administrative expenditures should be proportional to the number of Councilors and those for development spending should be proportional to the Commune/Sangkat population[4]. (see formula below).

[4] This way of allocating funds for development spending assumes that (a) development costs per capita are homogeneous across jurisdictions and (b) development costs are a "continuous" function of the Commune's population.

The second purpose of the Fund should be to correct structural differences in the respective potential of the local Councils to mobilize own source revenue.

No matter what type own-source revenue the local Councils may be able to assess and how efficiently they may be able to collect it, "horizontal gaps" (imbalances between Communes in the potential yield of their fiscal base) will continue to exist. A main objective of the Fund may therefore be the correction of such imbalances and the equalization of the fiscal capacity (per capita revenue) of the Councils.
Ideally, as soon as a clearer picture emerges from the work of the NCSC, with respect to the establishment of local tax and non-tax revenue sources, an attempt should be made to estimate the potential yield of the individual Communes' fiscal base. This would allow the explicit use of transfers to reduce horizontal imbalances between Communes.
Meanwhile, however an approximation to this objective may be obtained by including an indicator of relative needs/poverty in the formula for allocation of the Fund's resources to individual Communes (see below).

Third, it should act as an incentive for the Commune Authorities to adopt improved local governance practices.

The establishment and the early stages of operation of the Fund should offer also an opportunity to create incentives for the newly established Commune Councils and administrations to increase their capacity and adopt accountable, transparent, effective and efficient local governance practices. This will require the specification of some "conditions of access" to the resources of the Fund and a system of oversight and certification of the compliance of the local Councils with them. (See below the role of the provincial governors and MOI/Dept. of Local Administrations)

Article 3 – **Structure of the Fund account**

The Fund account shall reflect:
As revenue:
(a) Contributions from a share of the RGC domestic revenue
(b) Contributions from grants and loans made available by donors agencies and international financial institutions.
(c) Any other legal contribution.
As expenditures:
(d) Annual transfers to the budgets of Commune/Sangkat Councils.
Any revenue of the Fund not transferred in any given year shall be carried over to the subsequent year.

This article specifies that both domestic and external resources may be contributed to the Fund. This is a key feature of the proposed system. It implies that a mechanism should be set up to capture external resources and channel them into the Fund. Considering the donors and IFIs reporting requirements the implementation of such mechanism will require new and advanced "partnership"

To lift them may require (a) the application of coefficients to account for cost increasing factors like the "remoteness" or "accessibility" of certain areas and (b) the adoption of some "thresholds" of development costs. Some consideration may be given to these factors at the time of establishing the actual transfer allocation formula.

arrangements to be developed between them and the RGC. Given the importance of the national Seila program as a mechanism for external financing of decentralized development spending, the "Seila Forum" is a logical, and potentially key, venue where such arrangements should be discussed and agreed upon, so that both the current and prospective Seila external funding agencies can immediately contribute to the capitalization of the Commune /Sangkat Fund.

The article also specifies that any revenue of the Fund that is not transferred to Communes/Sangkats in any given year shall be carried over to the following year. This reflects a "re-phasing" practice which is rather common for external funds, but that must be specifically mandated by legislation to be applied to domestic funds.

Chapter 2
Management of the Commune/Sangkat Fund

Article 4 – *Establishment and functions of the Fund Board*

The Fund shall be managed by a "Commune / Sangkat Fund Board" (the Fund Board). The Fund Board shall be responsible for:

(a) Recommending to the RGC the share of total domestic revenue to be allocated to the Fund
(b) Monitoring the flow of resources into the Fund from external grants and loans, and establishing targets for mobilization of external resources by the RGC
(c) Adopting the formula for distribution of the resources of the Fund, referred to in Art. 11 below, and annually revising the value of the population, poverty and other indexes in the formula.
(d) Adopting and annually revising a classification of Communes/Sangkats, for the purpose of allocating the components of the Fund, as described in Art. 12 below.
(e) Approving the annual plan of distribution of the resources of the Fund, based on the above classification and formula.
(f) Communicating to Communes/Sangkats their individual annual entitlement to resources of the Fund and the indicative forecast of such entitlement over a 3-years period.
(g) Monitoring the actual transfers of the resources of the Fund to the Communes/Sangkats, against the approved annual distribution plan
(h) Approving the annual financial statement of the Fund

Within two weeks from its creation the Board shall adopt internal regulations to guide its process of decisions making.

Article 5 – *Composition of the Fund Board*

The Fund Board shall be composed by:

- The Minister of Economy and Finance or his/her representative (chair)
- The Minister of Interior or his/her representative
- The Minister of Planning or his/her representative
- The Minister of Rural Development or his/her representative
- The Minister of Land Management or his/her representative
- The Chairperson of the Commission of the National Assembly in charge of Communes/Sangkats Councils affairs
- A representative of the Commune Councils selected by drawing lots among all Mekhums elected in rural communes.
- A representative of the Sangkat Councils selected by drawing lots among all Mekhums elected in urban Sangkats.

To ensure proper coordination between the Fund Board and the National Committee to Support the Communes (NCSC), during the NCSC period of operation, the Fund Board and NCSC member Ministries shall be represented by the same individuals in the two bodies.

These two articles set up the upper-level management structure of the Fund. They propose the creation of a Fund Board and spell out the tasks to be performed by such Board. Several issues were raised in preliminary discussions with members of the MEF-FDTF, MOI/DOLA and the Seila TF-Secretariat.

The first issue is whether there is a need for such high level policy-making and monitoring structure. Consensus however seems to develop on this point. As it was pointed out at the MEF-organized March 2001 workshop, in the operation of the Fund there will be "... a need to carry out a number of tasks that cannot be settled by a decree. These include the calculation and use of the poverty index; the criteria and selection of the communes that will, year by year in the transition period, benefit from full funding; the handling of donor's money; the negotiation of the percentage of total taxes allocated to the Transfers Fund; the adjustments in transfers to be made when tax receipts are higher or lower than budgeted; etc..."[5] It seems clear that such tasks do require continuous negotiations and flexible management and cannot be settled once and for all by the sub-decree.

The second issue is whether a Board is actually needed or the above tasks could be better performed just by the MEF, in consultation with the Ministry of Interior. In advancing the second option, many point at the proliferation of non-performing "Inter-ministerial Committees" in Cambodia, which actually don't work as forums for real dialogue, negotiation and collective decision-making but only dilute responsibilities and retard action. These are legitimate concerns. However two points should be considered by the NCSC before reaching a conclusion on this issue.

First, there are more actors than MEF and MOI alone, who have a stake in the Fund management, particularly at provincial level. The Provincial Departments of Planning and Rural Development, for example, will be particularly active, under the provincial governor's coordination, in the monitoring of the Fund use by the Councils and in the related capacity building effort. The respective Ministries will thus want to have a say in the design and management of the transfers system, particularly on issues of poverty and capacity assessment and the design of the conditions of access to the Fund.

Second, the Board should not be seen only as another "inter-ministerial Committee". It could in fact also provide an opportunity for more direct participation, in the design and monitoring of transfers, for the national legislative committee in charge of local Councils affairs, as well as to elected local Councils themselves. In fact, as soon as a National Association of Cambodian Local Authorities will be formed, this body could be represented in the Fund Board.

A third issue is whether the proposed Board should be merged with the NCSC. This was also discussed in the March 2001 workshop, and here we can only restate what Remy Prud'homme wrote in his report on the workshop discussions[6] : " A question was raised: should this Board of Management be independent of the NCSC (National Committee to Support the Communes) of be part of it? We advised that it be independent. The NCSC will have many things to do and might neglect the important tasks to be performed by the Board. The NCSC has a limited life, whereas this Board will be permanent. The NCSC will be largely

[5] Remy Prud'homme Mission report, Paris, 20 March 2001
[6] Ibidem

political, when many of the tasks of the Board have a basic technical dimensions (albeit with political implications). The NCSC will largely be captured by MOI, when the tasks of the Board are largely economic and financial."

Nevertheless the issue of relationship between the NCSC and the Board cannot be completely brushed away. After all, there is a need for the decisions of the two bodies to be consistent and mutually supportive. It was suggested that a practical way to secure such coordination would be to make sure that the same individuals representing concerned Ministries in the NCSC be appointed to represent the same Ministries in the Fund Board.

Considerable further discussions on the Board's rationale, functions, composition and operating rules seem however to be needed at this point. The NCSC will eventually have to decide whether the Board should be set up as a Fund policy decision-making and management mechanism, as suggested by the above draft articles, or just to perform an advisory function for the MEF involving more actors than the MOI alone.

Article 6 – *Establishment and functions of the Fund Board Secretariat*

The Fund Board shall be supported by a permanent technical secretariat. The secretariat shall be established, by the Minister of Economy and Finance and shall be responsible for:

(a) Facilitating and recording the discussions and deliberations of the Fund Board
(b) Preparing quarterly financial and activity reports on the operations of the Fund
(c) Providing all technical support required by the Fund Board to effectively assume its functions as described in Art.4.

This article states the obligation of the Ministry of Finance, to set up a technical secretariat that would assist the Board in carrying out the above-mentioned tasks. The assignment of this responsibility to MEF, rather than MOI may be based on the same arguments that support the establishment of a Fund Board distinct from the NCSC. In this connection it should be noted that, to support and monitor the implementation of the decentralization reforms, the MEF is considering setting up a Local Finances Department, which could in time assume the functions of the Board's secretariat.

Article 7- *Authorizing Power of the Minister of Interior*

The Minister of Interior shall be responsible for:

(a) Authorizing all transfers of resources from the Fund account to the individual Commune/Sangkat accounts, after verification that the beneficiary Communes/Sangkats have complied with the conditions of access stated in Art. 17 below
(b) Monitoring the performance of the Councils in the utilization of the Fund's resources.
(c) Providing the Fund Board with periodic detailed information on the transfer and utilization of the resources of the Fund

In performing the above tasks, the Minister of Interior shall act in accordance with all the deliberations of the Fund Board.

Having established the Board as the higher level Fund management institution, the sub-decree goes on to specify, in this article, the role of the Ministry of Interior as responsible for the Fund's operational controls. Once the Board has adopted a plan for distribution of the Fund resources, including provisions applicable to different categories of Communes and conditions of access, the MOI will be responsible for authorizing the transfers to participating communes after verification of their compliance with the conditions of access. The Minister of Interior will therefore be the "authorizing officer" (*"l'ordonnateur"*) of the Fund. In performing this role, the MOI will remain however bound to the execution of the transfers plan adopted by the Board.

Article 8 - *Delegation of powers to the Provincial Governors*

To discharge its responsibilities under Art.7 (a) and (b) above, the Minister of Interior shall delegate to the Provincial Governors the powers to:

(a) Monitor and certify the compliance of the Commune/Sangkat Councils with the conditions of access to the Fund specified in Art.17 below

(b) Monitor the performance of the Communes/Sangkats Council in the use of Fund resources.

Detailed instructions shall be issued by the Minister of Interior in consultation with the Minister of Finance to guide the Provincial Governors in the performance of the above functions.

The certification of the Councils' compliance with the Fund's conditions of access will be carried out by MOI through the Provincial Governors, who will also be responsible for monitoring the performance of the participating Councils and for providing them with technical assistance as required. This provision opens the question of how the Governor and the provincial administrations will assume the responsibility for support and supervision of the local Councils. To the extent that, following the Seila model, the Governor will coordinate and make use of selected provincial departments (Planning, Finance, Rural Development) to support and supervise the Councils, these tasks will involve several ministries and not only MOI, strengthening the argument for a Board-managed Fund. These issues will have to be carefully considered by the NCSC sub-committee on "capacity building", which will deal with the structuring of the inter-governmental support and supervision functions.

Chapter 3
Financing, Allocation and Use of the Fund

Article 9 - *Financing from the RGC domestic revenue*

Pursuant to Art. 77 of the Commune Law, the minimum level of contribution from the RGC domestic revenue to the Fund account, shall be established in advance for at least 3 fiscal years.

For the fiscal year 2002 the transitional arrangements described in Chapter 5 shall apply. For all subsequent years in the period of the first mandate of the Councils (2002-2006) the contribution of the RGC to the Fund account, shall be no less than the following percentages of the RGC domestic revenue of the year:

FY 2003:	3.00% (three percent)
FY 2004:	4.00% (four percent)
FY 2005:	4.75% (four point seventy five percent)
FY 2006:	5.00% (five percent)

The RGC may consider increasing such percentage, upon recommendation of the Fund Board, as indicated in Art 4 above.

This article specifies the minimum level of RGC contributions to the Fund over the first mandate of the new elected local Councils (2002-2006) . It is essential that realistic, but specific targets be set, as they will represent the clear commitment of the RGC to the Fund as a key piece of the fiscal decentralization system. The percentages of domestic revenue indicated in the article are rather low by international standards, but it must be noted that the 3% minimum adopted for FY2003 is substantially higher than the 1.2% proposed by the RGC for FY2002 (see Annex 2). Again it should be stressed that the percentages indicated in the sub-decree have essentially the value of a policy statement as the actual share of RGC domestic income contributed to the Fund will eventually be set by the annual Budget Law. Setting clear targets in the sub-decree will not legally bind the RGC, but will nevertheless require that the RGC, in its dialogue with the elected Councils, and the Cambodian society at large, provide reasonable justification for any actual reduction of its planned contributions to the Fund.

Article 10 – *Financing from external grants and loans*

The Fund Board shall set annual targets for mobilization of external contributions to the Fund.

A Deposit Account in foreign currency entitled "Commune Fund – NBC" shall be opened, in the name of the Ministry of Economy and Finance (MEF) with the National Bank of Cambodia (NBC) to receive resources from grants and loans made available by donors' agencies and international financial institutions.

All revenue of the "Commune Fund-NBC" account shall be transferred to the Fund's special treasury account and converted in Cambodian Riels as and when required.

This article refers to the responsibility of the Board to set annual targets for external resources mobilization. It then states that such external contributions, deposited in foreign currency in an MEF deposit account should be converted into Riels at the time of their transfer into the Fund. Clearly there is a need to develop new "partnership" arrangements between donors and the RGC, if some of the traditional concerns of external agencies with respect to funding regular fiscal transfers mechanisms must be overcome.
As the Seila program has redefined itself as a national aid-coordination and funding framework for support to the implementation of decentralization reforms, it is clearly in the frame of the Seila program and through the Seila Donors Forum, that the first practical arrangements to channel external contributions to the Fund must be worked out.

Article 11 – *Allocation by Formula*

The share of the total Fund resources transferable to individual Commune/Sangkat Councils shall be determined by a formula. The formula shall be consistent with the purpose of the Fund as stated in Art. 2 above.

At the latest, by the 1st of October of the fiscal year preceding the one in which the transfers will be effected, the Fund Board shall adopt the formula and announce the amounts to which each Commune/Sangkat will be entitled.

The article restates the law's provision that Fund's resources should only be allocated by formula (no "deficit filling", "ad-hoc" or other types of transfers). It also stipulates that a close connection should be kept between the formula and the stated policy objectives of the transfers. Such connection is often lost because of political negotiations and attempts to reconcile diverging interests in the development of the transfer formulas.

Article 12 – *Components of the Fund*

The total resources of the Fund shall be divided into three components as follows:

(a) A Basic Entitlement Component
This component shall be not more than 1/3 of the total distributable resources of the Fund
(b) A Population Component
(c) A Poverty Component
The sum of these two components shall be not less than 2/3 of the total distributable resources of Fund.

The Fund Board shall determine the way in which the total Fund resources are divided among these three components, within the above limits.

The first and the second components are related to the first purpose of the Fund i.e. the need for transfers to cover basic administration costs (first component) and development responsibilities (second component) of the Councils.

The third component is related to the second purpose of the Fund, i.e. the need for transfers to equalize the resources of the Councils contributing more to the poorer among them.

As funds from the first (basic entitlement) component may be used to cover purely administrative costs (not directly related to development management or delivery of specific services) the article sets a limit of 1/3 of the total resources of the Fund for this component. In doing so it characterizes the Fund as essentially a fund for "development" spending, to which not less than 2/3 of the resources should be dedicated.

Article 13 – *Classification of Councils for access to the Components of the Fund*

The Fund Board shall establish a classification of the Commune/Sangkat Councils in two categories.

Category 1	shall include all the Communes/Sangkats that the Board deems capable of making effective and efficient use of the Fund transfers earmarked for development spending.
Category 2	shall include all other Communes/Sangkats

Each year, the Fund Board shall assess the development of local Councils capacity, based on criteria to be adopted and made public by the Board not later than the 1st of February 2002, and accordingly, shall revise the number of Communes/Sangkats included in category 1.

The classification of Councils in two categories is essential to ensure that substantial resources for development spending be allocated only to those councils (Category 1) that are likely to make an effective and efficient use of them. It will not be easy to determine which ones fit this description. Initially (FY 2002) this category can be restricted to the Councils (some 508 out of the total 1,621) participating in the Seila Program. However, starting in FY 2003, the restriction of category 1 Councils to those participating in the (expanding) Seila Program, may prove politically very difficult and also somehow unfair, given the actual absorptive capacity of other communes and Sangkats. It will then be necessary for the Board to develop transparent criteria for inclusion in category 1 of a substantial number of "non-Seila" communes, starting in FY 2003. These criteria should be as transparent and simple as possible and may be limited to just the size/viability of the local jurisdiction as a services delivery unit.
One additional issue is the inclusion of urban Sangkats in Category 1. As recommended during the March 2001 workshop, this issue should be further investigated. In principle, urban Sangkats should not be given access to

development spending resources (should not be included in Category 1) unless they have formed a syndicate or consortium at the relevant urban scale.

<u>Article 14</u> – *Distribution and use of the three components of the Fund*

Resources under the three components of the Fund shall be distributed and used according to the following provisions.
(a) Basic Entitlement Component
Resources under this component:
- Shall be accessed by all Councils in categories 1 and 2
- Shall be shared in proportion to the number of elected councilors in each Council.
- May be applied by the recipient Councils to any eligible administration or development expenditures as defined in art. 15 below

(b) Population Component
Resources under this component:
- Shall be accessed only by Councils included in category 1
- Shall be shared in proportion to the population of the Commune/Sangkat.
- May be applied by the recipient Councils only to development expenditures as defined in art. 15 below

(c) Poverty Component
Resources under this component:
- Shall be accessed only by Councils included in "category 1"
- Shall be shared in proportion to a poverty index, weighted by the population of the Commune/Sangkat.
- May be applied by the recipient Councils only to development expenditures as defined in art. 15 below

For the purpose of calculating the individual entitlements of all Councils under the three components of the Fund, the Ministry of Planning shall, not later than the 1st of September of each year, provide the Fund Board with updated official estimates of:
- The total population of all Communes/Sangkats
- The poverty indexes applicable to all Communes in category 1.

An issue raised by this article is the availability of data for the construction of the formula. The number of Councilors and the total population of the Councils do not pose particular problems and can be officially provided by the MOI and MOP. The poverty index however is available at present only for the communes covered by the Seila program. If the number of Councils accessing the third component of the Fund is restricted in FY 2002 to the "Seila Communes" this again should not be a problem. However there is an immediate need to support the MOP in an effort to include all Communes in the country in the database used to develop the poverty index.

<u>Article 15</u> – *Eligible expenditures*

Transfers from the Commune/Sangkat Fund may be used by Commune/Sangkat Council to cover, in full or in part, any operating and investment expenditure that is reflected in the Council's approved budget and does not violate the Commune Law or any other law and regulation issued by the RGC.

For the purpose of application of the three Components of the Fund referred to in art. 12 and 13 above, "administration" and "development" expenditures shall be defined as follows:
(a) "Administration expenditures" are operating and investment expenditures incurred by the Councils in the performance of their general administrative duties. They may cover the cost of:
- Allowances to Councilors and staff,
- Salaries of local staff and other personnel expenses
- Purchase or rental of Council's premises,
- Furniture and office equipment for the Council's or administration's facilities
- Repair and maintenance of administrative facilities
- Utility charges
- Purchase or rental of vehicles
- Fuel, lubricants and vehicles maintenance
- Other consumables and miscellaneous

(b) "Development expenditures" are operating and investment expenditures incurred by the Council for the development of local infrastructures (with the exception of administrative facilities) and the delivery of local economic and social (but not administrative) services. They may include:
- The survey, design, construction, repair and maintenance of roads, bridges, markets, educational and health care facilities, community centers, irrigation networks and structures, agricultural storage facilities, water and power supply and other economic and social infrastructure.

- Personnel and other recurrent costs associated with the operation of the local infrastructure and the delivery of related services.
- Support of community development programs managed by local NGOs and community-based organization, including local education and information campaigns for women and youth, environmental protection and natural resources management and other programs impacting on the welfare of local population.

Detailed instructions shall be issued by the Ministry of Finance, in conjunction with the regulation of the Commune/Sangkat budget to reconcile the "administration" and "development" categories with the classification of expenditures in the budget.

This article introduces the distinction between "administrative" and "development" expenditures as more relevant than the classic budget classification of "operating" and "investment" expenditures. Using this distinction allows the Fund to limit "administrative" expenditures without necessarily cutting "operating" costs that are associated to the delivery of local infrastructure and services. It also clarifies that client's and technical services costs associated with the preparation of investment projects and the delivery of local services, should be part of the "development" and not the "administrative" budget[7]

Chapter 4
Operation of the Fund's Special Treasury Account

Article 16 – *Transfers procedures*

All Communes/Sangkats shall hold a deposit account at the Provincial Treasuries or in a commercial bank as authorized by the MEF.

Pursuant to the provision of Art.7, the National Treasury, at the request of the Minister of Interior, shall transfer the approved annual allocation to which the individual Communes/Sangkats are entitled, into the accounts held by the Communes/Sangkats in their respective provincial treasuries or commercial banks. The annual transfers shall be made in two equal installments not later than the 1st of March and 1st of September respectively.

This article raises an issue, which is still very much under discussion. This is whether the local Councils should hold an account at the Provincial Treasury or in a commercial Bank. Or whether such choice should be left open and depend on local circumstances. The critical point is whether (i) the Councils will be allowed to use their own accountants and internal control procedures and (ii) payments controls by the Treasury will not be applied. If both conditions are satisfied, the provincial Treasuries will act essentially as Banks, at which point one may ask if some commercial banks (e.g. ACLEDA) do not present an advantage over the Treasury, given the fact that they are extending their network and opening District-level branches, closer to many rural Communes than the Treasury offices in the provincial capitals. The article assumes that this discussion will be resolved in favor of a flexible approach in which the provincial treasuries will indeed play only the role of banks and both the use of the treasury and of commercial banks will be allowed, after review of the local conditions by the MEF. The issue remains however unresolved and the seminar on local financial management to be organized by the MEF-FDTF in early September should help advance towards its resolution.

Article 17 - *Conditions of access*

To receive the transfers, the Councils shall demonstrate that they have:

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[7] This includes the 3% allowance for client's management cost introduced under the Seila program

- Followed a process of participatory planning, budgeting and implementation and
- Completed all financial reports on the execution of their budget and their development plan,

as required by the regulations on Commune/Sangkat planning and Financial Management Systems issued by the Ministry of Planning and the Ministry of Finance jointly with the Ministry of Interior [ref. Other sub-decrees]

Not later than the 1st of February 2002, the Ministries of Planning, Interior and Finance shall issue jointly detailed guidelines and reporting formats, to assist the Councils in documenting their compliance with the above conditions.

Within 15 days from the receipt of the Councils applications for the Fund transfers, the Provincial Governors, on behalf of the Minister of Interior, shall:

- Verify the Council's compliance with the conditions of access to the Fund
- Recommend to the Ministry of Interior the finalization of the transfer

In case of non-compliance by the Council, the Governor shall recommend the applicable corrective actions and provide the necessary technical assistance. The Governor may then request to the Ministry of Interior to withhold the transfer until the Council has taken the recommended actions and complied with all conditions of access to the Fund.

In case of conflict between the Council and the Provincial Governor, the case should be submitted for review and decision to the Fund Board. The decision of Fund Board shall be final.

In accordance with the third objective of the proposed transfer system (providing incentives for local capacity building) the transfers will be used to promote the adoption by local Councils of improved local public expenditures management. Conditions of access to the Fund are therefore defined in terms of the Councils' compliance with some basic planning, budgeting and reporting requirements as defined by MEF/MOI/MOP and reflected in simple guidelines and reporting formats. The role of the Governor and the provincial administration in assisting the Councils to comply with the Fund's conditions of access will be critical.

Chapter 5
Transitional Arrangements for the FY 2002

Article 18- *Interim management arrangements*

Pending the establishment of the Fund Board, all its functions as described in art. 4 above, shall be exercised by the Ministry of Finance in consultation with the Ministry of Interior

Decisions on the allocation of the Fund's resources for FY 2002 must be made within the next few months, in order not to disrupt the planning cycle in the Seila Communes. This article aims at facilitating such decisions.

Article 19 -*Level of financing from RGC domestic revenue*

The contribution of the RGC to the Fund shall be 20,000,000,000 (twenty billion) Cambodian Riels

This has been repeatedly confirmed by the MEF and should be reflected in the FY2002 National Budget Law.

Article 20 - *Level of financing from external grants and loans*

The contributions to the Fund from external grants and loans shall be not less than 1,400,000 (one million four hundred thousand) US dollars, to be transferred into the Fund account from the Seila program.

This is the level of resources pledged to the Seila program and potentially transferable to the Fund, subject to a final agreement between the Seila Task Force Secretariat and concerned Donors at the next meeting of the Seila Donors Forum.

<u>Article 21</u> – *Components of the Fund*

The share of the total distributable resources of the Fund to be allocated to the components of the Fund referred to in article 21 shall be determined as follows:

(d) Basic Entitlement Component: 35% (thirty five percent)
(e) Population Component: 33% (thirty three percent)
(f) Poverty Component: 32% (thirty two percent)

This reflects a slight over-allocation of Fund resources to the basic Entitlement Component in consideration of the very low overall level of the Fund in FY2002 and the need to provide a minimum of resources to all Councils to cover basic administrative costs.

<u>Article 22</u> – *Classification of Councils for access to the Components of the Fund*

The Communes to be included in Category 1, for the purpose of distributing the Population and Poverty components of the Fund, are those participating in the Seila program. Their number in FY 2002 is 508. The list of all Communes included in Category 1 is reflected in Annex 1.

The inclusion of other "non-Seila" communes in Category 1 (eligible for development financing) will start only in FY 2003, but should be announced by the Fund Board in early 2002.

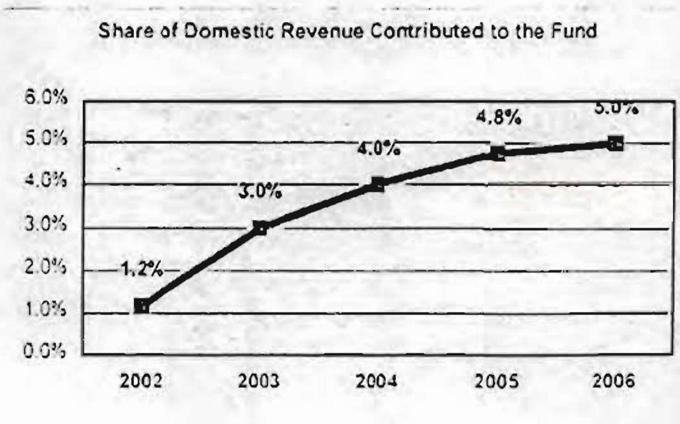
<u>Article 23</u> - *Conditions of access*

No conditions of access shall apply to the first installment of the transfer of Fund resources in FY 2002. The Ministries of Planning, Interior and Finance shall jointly issue special instructions and reporting formats, applicable to the second installment, not later than the 1st of February 2002.

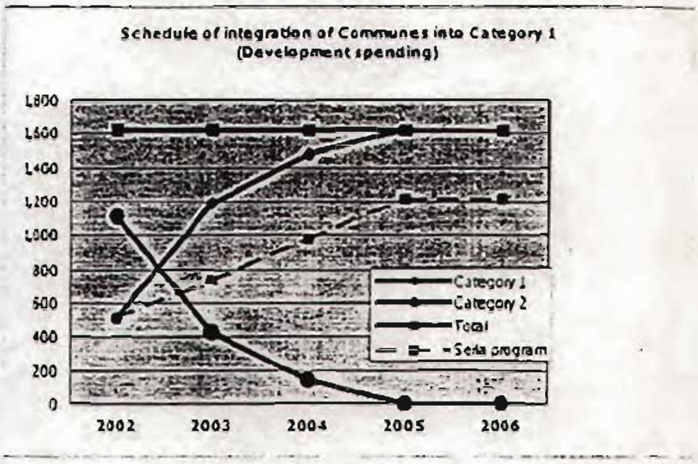
Part III – A scenario of the Fund's operations during the first mandate of the newly elected Councils (2002-2006)

Below, a scenario of the Fund's operations during the 2002-2006 period, is presented, based on the following assumptions.

- An average annual rate of growth of the RGC domestic revenue of 5%. This appears to be a conservative assumption. Already in FY 2002 the domestic revenue is expected to be 10% higher than in the previous year.
- A growth in the share of domestic revenue allocated to the Fund, from 1.2% in FY 2002 to 5.0% in FY 2006. This is the evolution suggested in the proposed sub-decree establishing the Fund. (see figure)



- The expansion of the Seila program coverage as planned in the RGC Seila program document and a rapid integration of "non-Seila Councils" into Category 1 (accessing Fund resources for development spending) (see figure)



- The decrease in the share of the Fund's resources allocated to Component 1 (basic entitlement) from 35% in FY 2002 to 25% in FY 2006.

The results of the simulation are presented in the table below.

	2001	2002	2003	2004	2005	2006
Domestic Revenue (in B.CR)	1,626	1,707	1,793	1,882	1,97	2,075
Domestic Revenue (in M.USS)	406.50	425.83	448.17	470.57	494.1	518.81
Share Contributed to the Fund (%)		1.2%	3.0%	4.0%	4.8%	5.0%
Domestic Contribution to the Fund (in B.CR)		20	54	75	94	104
Domestic Contribution to the Fund (in M.USS)		5.06	13.44	18.82	23.4	25.94
External Contribution to the Fund (in M.USS)		1.40	3.35	3.50	4.0	4.00
Total Fund Resources (in B.CR)		26	67	89	110	120
Total Fund Resources (in M.USS)		**6.46**	**16.79**	**22.32**	**27.4**	**29.94**
Total Category 1		**508**	**1,187**	**1,479**	**1,62**	**1,621**
Category 1 Communes (Seila)		*508*	*737*	*979*	*1,21*	*1,216*
Category 1 Communes (Board determined)		*0*	*450*	*500*	*405*	*405*
Total Category 2		**1,113**	**434**	**142**	**0**	**0**
Grand Total		**1,621**	**1,621**	**1,621**	**1,52**	**1,621**
Share of T1 Resources (% of Fund)		35.0%	33.0%	30.0%	27.0%	25.0%
Share of (T2+T3) Resources (% of Fund)		65.0%	67.0%	70.0%	73.0%	75.0%
T1 Resources (Administration) (M.USS)		2.26	5.54	6.70	7.4	7.49
T2+T3 Resources (Development) (M.USS)		4.20	11.25	15.63	20.0	22.46
Total Allocation to Category 1 Communes (M.USS		4.91	15.31	21.74	27.4	29.94
Total Allocation to Category 2 Communes (M.USS)		1.55	1.48	0.59	0.0	0.00
Average Alloc.to Category 1 Communes (USS)		9.665	12,395	14,697	16,94	18,470
Average Alloc.to Category 2 Communes(USS)		1,396	3,418	4,131	n.a.	n.a.

The following points are worth noting:

- Because of the low level of capitalization of the Fund in FY 2002, only the 508 Seila communes may be able to receive transfers for development spending. In fact even the Seila communes cannot receive capital financing at the same annual level enjoyed in the past and planned in the Seila program (over 10,000 US$/year) if a minimum of 1,000 US$ for administrative costs must be guaranteed for even the smaller Councils (those with only 5 councilors).
- On average therefore in FY2002 the Category 1 Communes will receive 9,665 US$ (including 1,396 US$ applicable in full or part to administrative costs)
- Allocations for Category 2 Communes will vary between about 1,000 US$ and 2,000 US$ and be equal on average to 1,396 US$ per Council.
- The situation should improve dramatically in FY 2003, if the minimum target of 3% of RGC domestic revenue allocated to the Fund will be respected. Under this assumption the total number of Category 1 Councils may jump to almost 1,200 already in FY 2003.
- If subsequent increases are made to the total RGC contributions to the Fund, in line with the proposed sub-decree, all Communes may be able to receive transfers for development spending already in FY 2005, regardless of the pace of expansion of the Seila program.
- Also average allocations for the diminishing number of Category 2 Communes will increase substantially, reaching almost 3,500 US$ in FY2003 and over 4,000 US$ in FY 2004. As mentioned before no Council will remain in Category 2 after 2004.

Annex 1

Sub-decree

On the establishment of

The "Commune / Sangkat Fund"

1^{st} Draft -

Phnom Penh, 20 August 2001

Chapter 1
Purpose and Structure of the Fund

Article 1 – *Establishment of the Fund*

A special treasury account denominated "Commune/Sangkat Fund", (the "Fund") is hereby created pursuant to Articles 77 and 78 of the Law on the Administration and Management of Communes/Sangkats (the "Commune Law"), to transfer domestic and external resources to the Communes/Sangkat councils.

Article 2 – *Purpose of the Fund*

The purposes of the Commune/Sangkat Fund are:

(a) To enable the Communes/Sangkats to assume their general responsibilities for promotion of local development in accordance with the provisions of art. 42, 43, and 44 of the Commune Law

(b) To correct differences in the relative potential of the Communes/Sangkats to mobilize their own revenue, because of different demographic, social and economic conditions

(c) To act as an incentive for building the capacity for good governance of the Communes/Sangkats Councils.

Article 3 – *Structure of the Fund account*

The Fund account shall reflect:

As revenue:

(a) Contributions from a share of the RGC domestic revenue

(b) Contributions from grants and loans made available by donors agencies and international financial institutions.

(c) Any other legal contribution.

As expenditures:

(d) Annual transfers to the budgets of Commune/Sangkat Councils.

Any revenue of the Fund not transferred in any given year shall be carried over to the subsequent year.

Chapter 2
Management of the Commune/Sangkat Fund

Article 4 – *Establishment and functions of the Fund Board*

The Fund shall be managed by a "Commune / Sangkat Fund Board" (the Fund Board). The Fund Board shall be responsible for:

(a) Recommending to the RGC the share of total domestic revenue to be allocated to the Fund

(b) Monitoring the flow of resources into the Fund from external grants and loans, and establishing targets for mobilization of external resources by the RGC

(c) Adopting the formula for distribution of the resources of the Fund, referred to in Art. 11 below, and annually revising the value of the population, poverty and other indexes in the formula.

(d) Adopting and annually revising a classification of Communes/Sangkats, for the purpose of allocating the components of the Fund, as described in Art. 12 below.

(e) Approving the annual plan of distribution of the resources of the Fund, based on the above classification and formula.

(f) Communicating to Communes/Sangkats their individual annual entitlement to resources of the Fund and the indicative forecast of such entitlement over a 3-years period.

(g) Monitoring the actual transfers of the resources of the Fund to the Communes/Sangkats, against the approved annual distribution plan

(h) Approving the annual financial statement of the Fund

Within two weeks from its creation the Board shall adopt internal regulations to guide its process of decisions making.

Article 5 – *Composition of the Fund Board*

The Fund Board shall be composed of:

- The Minister of Economy and Finance or his/her representative (chair)
- The Minister of Interior or his/her representative
- The Minister of Planning or his/her representative
- The Minister of Rural Development or his/her representative
- The Minister of Land Management or his/her representative
- The Chairperson of the Commission of the National Assembly in charge of Communes/Sangkats Councils affairs
- A representative of the Commune Councils selected by drawing lots among all Mekhums elected in rural communes.
- A representative of the Sangkat Councils selected by drawing lots among all Mekhums elected in urban Sangkats.

Article 6 – *Establishment and functions of the Fund Board Secretariat*

The Fund Board shall be supported by a permanent technical secretariat. The secretariat shall be established, by the Minister of Economy and Finance and shall be responsible for:

(a) Facilitating and recording the discussions and deliberations of the Fund Board
(b) Preparing quarterly financial and activity reports on the operations of the Fund
(c) Providing all technical support required by the Fund Board to effectively assume its functions as described in Art.4.

Article 7- *Authorizing Power of the Minister of Interior*

The Minister of Interior shall be responsible for:

(a) Authorizing all transfers of resources from the Fund account to the individual Commune/Sangkat accounts, after verification that the beneficiary Communes/Sangkats have complied with the conditions of access stated in Art. 17 below
(b) Monitoring the performance of the Councils in the utilization of the Fund's resources.
(c) Providing the Fund Board with periodic detailed information on the transfer and utilization of the resources of the Fund

In performing the above tasks, the Minister of Interior shall act in accordance with all the deliberations of the Fund Board.

Article 8 - *Delegation of powers to the Provincial Governors*

To discharge its responsibilities under Art.7 (a) and (b) above, the Minister of Interior shall delegate to the Provincial Governors the powers to:

(a) Monitor and certify the compliance of the Commune/Sangkat Councils with the conditions of access to the Fund specified in Art17 below
(b) Monitor the performance of the Communes/Sangkats Council in the use of Fund resources.

Detailed instructions shall be issued by the Minister of Interior in consultation with the Minister of Finance to guide the Provincial Governors in the performance of the above functions.

Chapter 3
Financing, Allocation and Use of the Fund

Article 9 - *Financing from the RGC domestic revenue*

Pursuant to Art. 77 of the Commune Law, the minimum level of contribution from the RGC domestic revenue to the Fund account, shall be established in advance for at least 3 fiscal years.

For the fiscal year 2002 the transitional arrangements described in Chapter 5 shall apply. For all subsequent years in the period of the first mandate of the Councils (2002-2006) the contribution of the RGC to the Fund account, shall be no less than the following percentages of the RGC domestic revenue of the year.

FY 2003:	3.00% (three percent)
FY 2004:	4.00% (four percent)
FY 2005:	4.75% (four point seventy five percent)
FY 2006:	5.00% (five percent)

The RGC may consider increasing such percentage, upon recommendation of the Fund Board, as indicated in Art 4 above.

Article 10 – *Financing from external grants and loans*

The Fund Board shall set annual targets for mobilization of external contributions to the Fund.

A Deposit Account in foreign currency entitled "Commune Fund – NBC" shall be opened, in the name of the Ministry of Economy and Finance (MEF) with the National Bank of Cambodia (NBC) to receive resources from grants and loans made available by donors' agencies and international financial institutions.

All revenue of the "Commune Fund-NBC" account shall be transferred to the Fund's special treasury account and converted in Cambodian Riels as and when required.

Article 11 – *Allocation by Formula*

The share of the total Fund resources transferable to individual Commune/Sangkat Councils shall be determined by a formula. The formula shall be consistent with the purpose of the Fund as stated in Art. 2 above.

At the latest, by the 1st of October of the fiscal year preceding the one in which the transfers will be effected, the Fund Board shall adopt the formula and announce the amounts to which each Commune/Sangkat will be entitled.

Article 12 – *Components of the Fund*

The total resources of the Fund shall be divided into three components as follows:

(a) A Basic Entitlement Component

This component shall be not more than 1/3 of the total distributable resources of the Fund

(b) A Population Component

(c) A Poverty Component

The sum of these two components shall be not less than 2/3 of the total distributable resources of Fund.

The Fund Board shall determine the way in which the total Fund resources are divided among these three components, within the above limits.

Article 13 – *Classification of Councils for access to the Components of the Fund*

The Fund Board shall establish a classification of the Commune/Sangkat Councils in two categories.

Category 1 shall include all the Communes/Sangkats that the Board deems capable of making effective and efficient use of the Fund transfers earmarked for development spending.

Category 2 shall include all other Communes/Sangkats

Each year, the Fund Board shall assess the development of local Councils capacity, based on criteria to be adopted and made public by the Board not later than the 1st of February 2002, and accordingly, shall revise the number of Communes/Sangkats included in category 1.

Article 14 – *Distribution and use of the three components of the Fund*

Resources under the three components of the Fund shall be distributed and used according to the following provisions.

(a) Basic Entitlement Component

Resources under this component:

- Shall be accessed by all Councils in categories 1 and 2
- Shall be shared in proportion to the number of elected councilors in each Council.
- May be applied by the recipient Councils to any eligible administration or development expenditures as defined in art. 15 below

(b) Population Component

Resources under this component:

- Shall be accessed only by Councils included in category 1
- Shall be shared in proportion to the population of the Commune/Sangkat.
- May be applied by the recipient Councils only to development expenditures as defined in art. 15 below

(c) Poverty Component

Resources under this component:

- Shall be accessed only by Councils included in "category 1"
- Shall be shared in proportion to a poverty index, weighted by the population of the Commune/Sangkat.
- May be applied by the recipient Councils only to development expenditures as defined in art. 15 below

For the purpose of calculating the individual entitlements of all Councils under the three components of the Fund, the Ministry of Planning shall, not later than the 1st of September of each year, provide the Fund Board with updated official estimates of:

- The total population of all Communes/Sangkats
- The poverty indexes applicable to all Communes in category 1.

Article 15 – *Eligible expenditures*

Transfers from the Commune/Sangkat Fund may be used by Commune/Sangkat Council to cover, in full or in part, any operating and investment expenditure that is reflected in the Council's approved budget and does not violate the Commune Law or any other law and regulation issued by the RGC.

For the purpose of application of the three Components of the Fund referred to in art. 12 and 13 above, "administration" and "development" expenditures shall be defined as follows:

(a) "Administration expenditures" are operating and investment expenditures incurred by the Councils in the performance of their general administrative duties. They may cover the cost of:

- Allowances to Councilors and staff,
- Salaries of local staff and other personnel expenses
- Purchase or rental of Council's premises,
- Furniture and office equipment for the Council's or administration's facilities
- Repair and maintenance of administrative facilities
- Utility charges
- Purchase or rental of vehicles
- Fuel, lubricants and vehicles maintenance
- Other consumables and miscellaneous

(b) "Development expenditures" are operating and investment expenditures incurred by the Council for the development of local infrastructures (with the exception of administrative facilities) and the delivery of local economic and social (but not administrative) services. They may include:

- The survey, design, construction, repair and maintenance of roads, bridges, markets, educational and health care facilities, community centers, irrigation networks and structures, agricultural storage facilities, water and power supply and other economic and social infrastructure.
- Personnel and other recurrent costs associated with the operation of the local infrastructure and the delivery of related services.
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Article 17 - *Conditions of access*

To receive the transfers, the Councils shall demonstrate that they have:

- Followed a process of participatory planning, budgeting and implementation and
- Completed all financial reports on the execution of their budget and their development plan,

as required by the regulations on Commune/Sangkat planning and Financial Management Systems issued by the Ministry of Planning and the Ministry of Finance jointly with the Ministry of Interior.
Not later than the 1st of February 2002, the Ministries of Planning, Interior and Finance shall issue jointly detailed guidelines and reporting formats, to assist the Councils in documenting their compliance with the above conditions.
Within 15 days from the receipt of the Councils applications for the Fund transfers, the Provincial Governors, on behalf of the Minister of Interior, shall:

- Verify the Council's compliance with the conditions of access to the Fund
- Recommend to the Ministry of Interior the finalization of the transfer

In case of non-compliance by the Council, the Governor shall recommend the applicable corrective actions and provide the necessary technical assistance. The Governor may then request to the Ministry of Interior to withhold the transfer until the Council has taken the recommended actions and complied with all conditions of access to the Fund.
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The Communes to be included in Category 1, for the purpose of distributing the Population and Poverty components of the Fund, are those participating in the Seila program. Their number in FY 2002 is 508. The list of all Communes included in Category 1 is reflected in Annex 1.

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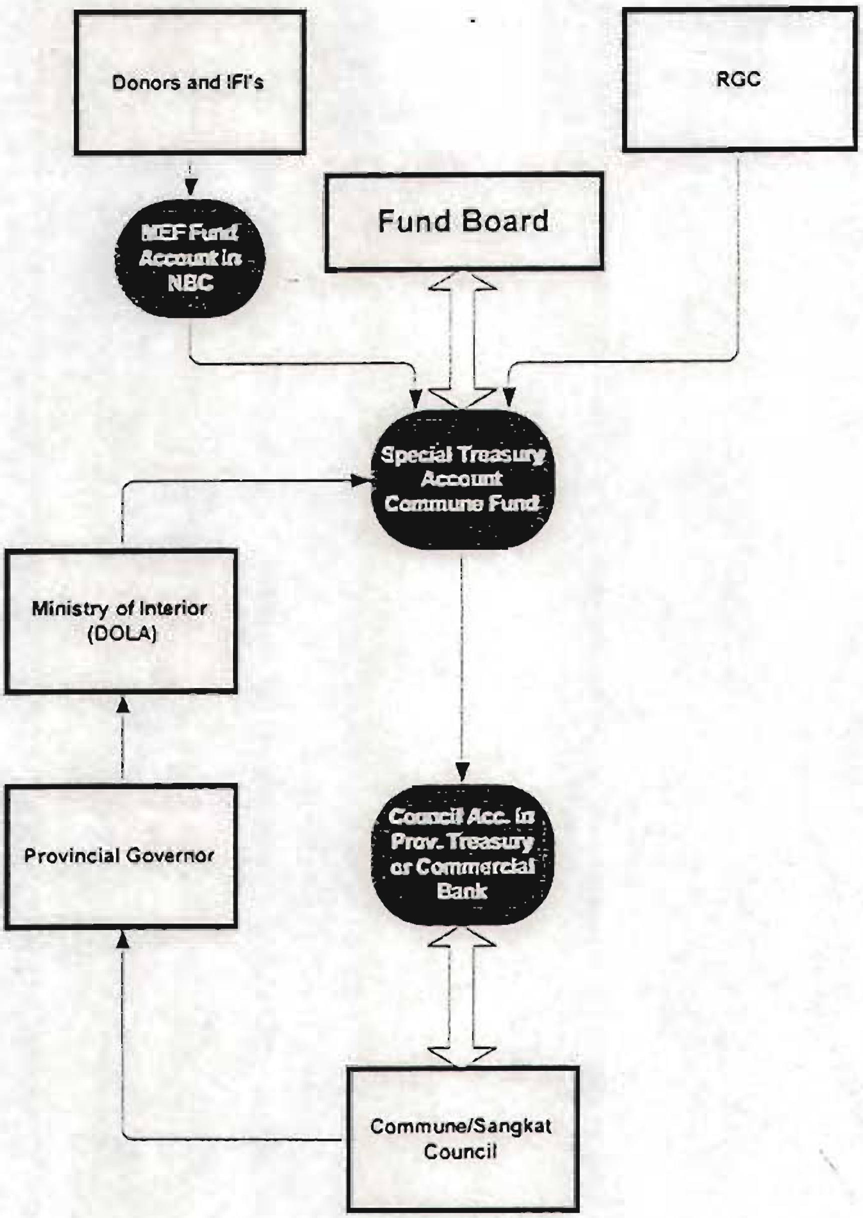
No conditions of access shall apply to the first installment of the transfer of Fund resources in FY 2002. The Ministries of Planning, Interior and Finance shall jointly issue special instructions and reporting formats, applicable to the second installment, not later than the 1st of February 2002.

Commune/Sangkat Fund Management Arrangements



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Ministry of Economy and Finance
Fiscal Decentralization Task Force
Sub-Committee on Commune Financial Management System

Issues Paper
Commune Financial Management System

Phnom Penh, 3 September 2001

Issues Paper

COMMUNE FINANCIAL MANAGEMENT SYSTEM

Introduction

Chapter 7 (Articles 75, 79, 82 and 83) of the Law on the Administration and Management of Commune/Sangkat (The Commune Law) defines the principles and the requirements for the development of the commune/sangkat financial management system.

The present paper was originally prepared on the basis of deliberations of the Ministry of Economy and Finance's Fiscal Decentralization Task Force (FDTF), with the assistance of a UNDP/PLG funded consultant. It reflects the current views of the FDTF on the issues relating to the design of the commune/sangkat financial management system. The paper will be revised based on the discussions and recommendations of the national workshop held at the Economics and Finance Institute at MEF on September 11-12, 2001.

This paper is intended as an input to the National Committee to Support the Communes (NCSC). It highlights the issues raised by the development of a commune financial management system. Its purpose is not so much the detailed technicalities (which will be specified later in regulations and guidelines to be issued by NCSC). The paper and the deliberations of the workshop should lead to reaching an understanding of the main administrative issues and principles involved. Indeed, the great challenge is how to develop a commune financial management system that is adequately consistent with the national public finance structure but recognizes the specifics and requirements of decentralization.

1. Objectives

The financial management system usually includes the rules and procedures that regulate the planning, management, accounting, and control of the use of the commune resources

The commune financial management system serves the following objectives:

- First, it should assist the commune chief and staff in managing the commune's resources, in an efficient, transparent, and accountable way, that is:
  - Resources are allocated in accordance with the commune priorities (*allocative efficiency)*
  - Resources are used in an efficient manner to deliver local services (*operational efficiency).*
  - Promoting financial discipline by ensuring that the commune does not spend more that it is needed and planned in the budget.

- Second, it should produce financial reports to inform about the commune's performance, and financial position.

- Third, it sets the basis and rules for financial controls through both internal and external audits.

- Forth, it makes the commune finances transparent and open for checks by local residents (holding the commune managers and the council accountable to their constituency).

2. The Commune Budget

The budget is the projection of the commune's future revenues and expenditures; it is an annual authorization of expenditures and collection of commune own-source revenues. The budget is, therefore, an instrument of financial decision-making and control of the commune's resources.

Budget Principles

The commune budget should comply with the following principles:

- The budget must be prepared and approved on an annual basis, before its implementation is started;
- All the commune's expenditures and revenues must be reflected in one single budget;
- The commune's own source revenues must be accounted for their gross amount - that is expenditures cannot be set off against revenues;
- Total planned expenditures must equal total expected revenues;
- The budget must reflect the priorities of the commune's development plan;
- The budget formulation process must be transparent and open for public debate.

Form of the Budget

Pursuant to Article 79 of the Commune Law, requiring that the commune/sangkat budget form must be in conformity with the national budgetary system, it is proposed to structure the commune budget into two self-balanced sections:

- The Recurrent (or Operating) Budget includes the expenditures and revenues that relate to the regular activity of the commune
- The Capital (or Investment) Budget relates to the creation of long-term assets.

The Recurrent Budget:

Expenditures:

Budget Line	Explanation
Salary and Allowances	Commune administration staff salary; Local Services staff salary; Councilors allowances
Administration Costs	Non-salary operating costs of commune administration: office suppliers; utilities; travel and transport costs; meeting costs; etc...
Local Services Costs	Non-salary operating costs of local service provision: repair and maintenance; supplies; utilities; etc...
Social Intervention	Assistance provided to poor residents and subsidies to local organizations
Agent Function Costs	Operating costs of tasks mandated by provincial or national authorities.
Contribution to Capital Budget	Recurrent budget surplus reallocated to finance capital expenditures.
Contingency	

Revenues:

Budget Line	Explanation
Local Taxes	To be detailed by type of tax when local taxes are established
Non-tax Revenues	Local Services User Charges; Administrative Fees; Commune Property Income, other revenue,..
Commune Fund Transfer	Share of Commune Fund Transfer that can be used for administration and local services provision costs.
Agent Function Transfer	Financial compensation received from provincial or national authorities for mandated functions.
Other Recurrent Revenue	Recurrent Revenues not included in any of the above categories.

The Capital Budget:

Expenditures:

Budget Line	Explanation
Administration Investment	Costs of purchase or creation of fixed assets relating to the commune administration such as property purchase, works, office equipment and furniture.
Local Services Infrastructure	Costs of purchase or creation of fixed assets dedicated to the provision of local services: property purchase, works, equipment.

Revenues:

Budget Line	Explanation
Contribution from Recurrent Section	Recurrent budget surplus
Commune Fund Transfer	Share of Commune Fund Transfer earmarked for capital expenditures
Betterment Levies	Contribution of residents to the costs of local infrastructure
Property Sale Income	Sale Proceeds of commune-owned assets
Reserve Fund	Budget surplus from previous years
Other Capital Revenues	Capital revenues not included in any of the above categories.

Several issues, relating to the form and content of the budget, need further discussion:

(1) Should there be mandatory expenditure items? Which ones?

(2) Should caps be put on some expenditure lines? Which ones? How to set such limitations? It should be noted that there is already one constraint imposed on the commune: *Capital Revenues can not be used to finance recurrent expenditures.*

(3) Should there be a simplified budget format for small communes, and a standard form for large communes? Which criteria should be used for ranking communes? *A uniform format for all communes has the preference of the Task Force.*

(4) What would be the appropriate level (as a percent of total budget) of the "Contingency" budget line?

Budget Calendar:

As for the form, Article 79 of the Commune Law requires that the commune budget be adopted in conformity with the national budgetary system timeframe. Given the national budget calendar, and the necessity for the commune to have its budget legally enacted before January 1, the commune budget cycle could be as follows:

	Steps	Who is in Charge	Time Frame
1	**Revenue and Expenditures Forecast:** ▪ Non Tax Own Income ▪ Tax Income (where applicable) ▪ Central Government Transfers ▪ Other Revenue ▪ Commune Expenditures	 Commune C. Chief MEF MEF Commune C. Chief Commune C. Chief	September
2	**Draft Budget**	Commune C. Chief	1st week October
3	**Review by CC Finance Committee**	Finance Committee	2nd week October
4	**Draft Budget Disclosed to Citizens**	Commune C. Chief	3rd week October
5	**Vote on adoption of Budget**	Commune Council	1st week November
6	**Budget Approval**	Qualified Authority	1st week December.

Budget Approval

To become legally binding, the commune budget must be duly approved by a qualified higher authority. It is proposed to assign the approving authority to the provincial/municipal governor.

The governor shall exercise a legality control of the commune budget: That is checking whether the budget was prepared and adopted in accordance with the legal provisions required by the prevailing regulations. These legality controls may include the following:

- compliance with the budget form and calendar
- compliance with the conditions attached to the use of the Commune Fund Transfers
- participation of citizens in the budget debates
- compliance with regulations on mandatory appropriations (where applicable)
- Coherence between the budget and the commune development plan.

It should be made clear that the governor shall not have the right to question or oppose the spending and revenue decisions made by the commune council, to the extent that the commune has complied with the legal requirements.

Community Participation

In order to enhance transparency of the budgeting process and ensure that the budget choices are responsive to the residents needs and preferences, the commune chief must make the draft budget available to the public in due time. The commune council must hold a public hearing before it takes final decision on the draft budget.

This measure is intended to increase the participation of the citizens in the commune's affairs, and promote greater accountability of the commune council towards its constituency.

Amendment of the Budget

The commune budget may be amended in the course of the fiscal year to account for changes in the local economic and financial conditions affecting the initial forecasts, or the implication of central government decisions on the commune finances.

The commune chief shall submit the revised budget to the commune council for review and final decision before 30 June. As for the legality control, it is proposed that:

- In the event the variation does not exceed a certain level (expressed as a percent of the initial total budget), the commune chief could be required only to submit a copy of the revised budget to the governor for information;
- Otherwise the commune chief must solicit the governor's approval of the revised budget to become effective.

Budget Surplus/Deficit

Specific measures should be included in the commune budget regulations in order to deter the commune from incurring *budget deficit* or expenditure commitments, which are in excess of the legally appropriated resources. Such measures could be the following:

- Disciplinary actions;
- Requiring the commune to absorb the deficit during the following fiscal year through a mandatory budget allocation;
- Subjecting the commune operation to a tight financial monitoring until the deficit is settled.

In the event of *budget surplus*, the commune chief may propose to the commune council:

- To transfer all, or part of, the surplus to a *Reserve Fund* to be used in the future for capital expenditures
- To allocate the surplus to the capital expenditures budget of the following fiscal year.

3. Commune Accounting and Financial Reporting

3.1 Accounting

The commune accounting system must be *simple and user-friendly*. Nevertheless, it should be designed is such way that it:

- Meets the internal control requirements and safeguards in respect of accountability for the use of public money;
- Produce timely and accurate financial reports which can be subject to control and verification
- Provides the basis for appropriate budgetary control.

System Design

It is proposed to build the commune accounting system based on the following principles:

- *Cash-basis Accounting*: Commune revenues are not recorded in accounts until cash is received, and expenditures are recorded only when cash is disbursed.

- Simplified *double-entry* method: Any transaction must be recorded in at least two accounts (a cash account, and a revenue or expenditure account).

- *Accounts*: The system can be built around the *Cash-Book* (serving as a General Journal), and Revenues and Expenditures accounts, in conformity with the budget lines nomenclature. Each account must show the budgeted amount, the actual transaction entries, and the balance.

- Fixed assets are first recorded as expenditure (for the purpose of cash and budget control), then posted to the *Fixed Assets Ledger* (for the purpose of monitoring their utilization).

Issue: Should the accounting system be tailored as per to the size or administrative capacity of the commune:

- ❑ A *simplified system* for communes with "small" budget, or limited management capacity
- ❑ A *developed system* for large communes?

This issue must be discussed in connection with the budget structure: There should be always coherence between the accounting system design and the budget format.

The Accounting Function

Should the commune follow the standard public accounting rules as defined in Anukret 82/95 – that is assigning the accounting function to the provincial treasury? Or should the commune operate its own accounting and financial reporting system? An important remark is in order here: The Regulations on public accounting, issued in 1995, deal explicitly only with the implementation of the State budget (see articles 1 and 19 – Anukret 82/95). Communes are indirectly mentioned in article 122 of the same Anukret, stipulating that "the basic principles applying to the State budget financial and accounting transactions, *could be* extended to territorial collectivities and public institutions". Therefore, there is no legal obligation to subject the communes to the very detailed procedures included in the 1995 Regulations.

The provincial treasury acting as the commune's accountant-cashier:

As such, the provincial treasury would perform the tasks of cash management (payments and receipts), maintaining accounting records, and preparing financial reports and statements. This option has three advantages:

- To reduce the commune's administrative costs
- To relieve the commune chief and the commune council from the risks and accountability obligations associated with accounting and cash handling
- To produce consolidated local financial statements and statistics.

However, these advantages could be outweighed by the following risks:

- The physical distance, and the bureaucratic gap between the commune and its accountant (who will be located at, and will be under the authority of, the provincial Treasury) could result is bad communication and conflicts, and poor accounting performance.
- The provincial Treasury may lack the capacity (human and organizational), or the incentives to assume the required tasks, unless district treasury offices are established

and staffed with trained accountants – such system will need time and financial resources to be put in place.

The commune operates its own accounting system

Under this scheme, the accountant will be a staff member of the commune administration, working under the supervision of the commune chief. The advantages of this option are obvious:

- The commune has full control over, and ownership of, its accounting system;
- It enhances the accountability of the commune chief and the commune council in respect of managing local resources
- It contributes to building a local capacity in financial management.

However, this option may raise 3 objections:

- It increases the commune's administrative costs, although these would not burden the local finances as the commune resources develop over time;
- Communes could find it difficult to recruit well trained accountants;
- The commune chief may lack the capacity to monitor the performance of the accountant; though, proper training of commune chiefs on financial management could easily overcome this risk.

3.2 Financial Reporting

Financial reporting serves four purposes:

- Monitoring the commune operation by comparing actual transactions (revenue and expenditures) with the budget forecasts;
- Evaluating the commune's financial position by providing information about the sources and uses of financial resources and about how the commune financed its activities;
- Assisting in fulfilling the commune chief's duty to be accountable to the commune council, as well as the commune council's obligation to be accountable to its constituency and to the higher authorities.
- Assisting in determining compliance with the adopted budget and with other finance-related legal or contractual requirements.

The commune should produce the following reports:

Monthly Financial Report:
This report can be in the form of a "Revenues and Expenditures Statement" that compares actual achievements with the budget objectives, and shows the commune's cash position. The report is adopted by the commune council before it is disclosed to the public (provincial authorities and local residents).

Annual Financial Statements:
The commune should prepare annual financial statements to be discussed and adopted by the commune council. The annual financial reports could include the following:

- Final "Revenue and Expenditure Statement"
- Commune Cash Position
- Fixed Assets Statement.

The annual financial statements must accurately and fairly inform about the budget implementation conditions and the commune financial position. They should be disclosed to the public.

Along with financial information, the commune council must also discuss and adopt the narrative report on the commune activity and budget implementation. The annual activity report describes and assesses:

- The commune's fiscal performance;
- The commune's achievement in terms of provision of public services against the planned objectives;
- The social and economic conditions in the commune and the impact of the commune council operations on the welfare of the citizens.

Both the financial statements and the narrative report will serve as supportive documents for closing the fiscal accounts of the related period.

4. Expenditure Procedures

Organizational Arrangements

The commune should follow clear, formalized procedures for the commitment and payment of expenditures. The following basic principles should be considered in the design of the local expenditure process:

- *Segregation of incompatible tasks*: This rules implies that:
  - ❑ The commune council chief should act the budget officer (ordonnateur): as such he authorizes expenditure commitments, and payments within the limits and purposes set forth in the approved budget;
  - ❑ The commune cashier (or finance officer) executes payments as requested by the commune chief.

- Specific *procurement procedures* need to be designed in order to ensure transparency, efficiency, and fairness in the procurement process. The commune's procurement system could be derived from the existing government regulations and the Seila experience. In particular, the procedures should specify the role and powers of the commune chief, the local procurement committee (if any) and the commune council in respect of the procurement decisions.

Expenditure Control

The commune should monitor the budget implementation to ensure that expenditures are authorized and paid within the limits of the approved budget and relevant regulations, and ovoid (or minimize) the risk of expenditure overruns (in case of revenue shortfalls for instance). Since the commune has more control over its expenditures than revenues, it should therefore closely control budget outlays.

Expenditure control may occur in two ways:

- Before initiating any expenditure, the commune chief (or any other person as duly authorized by the commune chief) must ensure that (i) the expenditure is reflected in the budget, (ii) cumulated expenditures are kept within budget appropriations, and (iii) the commune cash position permits payment.

- The preparation of monthly reports that combine expenditure control and cash flow management: the reports must show the following information (i) actual expenditures; (ii) budgeted expenditures; (iii) expenditures expressed as a percent of the budget; and (iv) unpaid expenditures. Comparing budgeted expenditures to actual spending on at least a monthly basis helps the commune chief take prompt actions to curb potential overspending.

It should be emphasized that national or provincial authorities should not exercise any *pre-control* over the commune's expenditure decisions. In return, these authorities have the right to carry out ex-post verifications and controls over the commune financial transactions and accounts (whether during the course of the fiscal year or when certifying the commune annual financial statements).

5. Payment System

The payment system must ensure that the commune's funds are kept in safe conditions and that they are available when needed for meeting spending commitments. Usually, two institutions can fulfill these requirements: commercial banks, and the provincial treasury.

Obviously, communes will have to resort to the *provincial treasury* for managing their cash flows transactions. Indeed, Article 75 of the Commune Law requires that grant resources be provided through the provincial treasury. Needless to mention that central government transfers will be the major source of commune revenue. In practice, each commune will have an account open at the nearest provincial treasury. The commune will use the account to house revenues collected locally as well as transfers from the central government (or from any other sources), and to make payments.

The treasury payment system presents, however, at least three potential deficiencies that need to be addressed in due time:

- The difficult physical access of communes in remote rural areas to the provincial treasury may jeopardize the regular conduct of commune affairs. Extending the treasury network to the district level is therefore highly recommended;
- As previously mentioned, provincial treasuries may lack the required resources to develop their district operations, handle an increased number of deposit accounts and transactions (in addition to being the accountant-cashier of both the central government and the de-concentrated provincial administrations).
- The liquidity risk: the treasury payment system has, so far, experienced frequent cash shortfalls at the provincial level.

There are a number of issues that should be discussed in respect of the commune payment system:

(1) The commercial bank option should not be excluded: It is suitable that communes be allowed, when deemed necessary, to use commercial banks for managing their cash transactions. This could happen, for instance, when the provincial treasury is not in position to deliver efficient service, or when external resource providers require the use of the banking payment system.

(2) What measures should be devised to ensure that the provincial treasury fulfills its obligations towards communes?
(3) What is the role of provincial authorities (the governor) in the event of conflicts arising between communes and the treasury?

6. Assets Management

The assets management system includes the rules and procedures dealing with the use, the control, and the safeguard of fixed assets owned by, or assigned to, the commune. Fixed assets are usually defined as items that have a useful life of more than one year. They include different classes or categories such as land, buildings, professional or technical equipment, office equipment and furniture, transport means (cars, motorcycles), etc...

The assets management system can be designed based on the following principles:

Accounting:
Acquisition of assets must be, first, entered in the accounting system as expenditure, then posted to the "*Fixed Assets Ledger*". The Ledger is made of the individual forms for each category of assets. Information posted to the ledger include, in particular, the date of acquisition (or transfer), the value, the quantity (where applicable), and the location of the asset. A summary of the Asset Ledger is attached to the commune annual financial statements.

Identification:
All fixed assets should be marked by a numerical code (tag), so that each item can be identified, located, and traced back to the Asset Ledger.

Physical Inventory:
The commune must complete regular physical counts of all assets (at least once a year) in order to check losses, correct recording errors, and assess the physical condition of assets, with respect to repairs, maintenance, or replacement. Physical inventory must be reconciled with the Asset Ledger records. Any discrepancies must be investigated and the Asset Ledger updated accordingly.

7. Audit of Commune Accounts and Operations

Internal Audit:

Internal audit is the responsibility of the commune itself. Its objective is to ensure that the control procedures imbedded in the operation system (accounting, budgeting, and asset management) are enforced, so that:

- Resources are used in accordance with the approved budget, within the limits of laws, and regulations;
- Resources are safeguarded against waste, loss, and misuse; and
- Reliable financial data are produced, and fairly disclosed in reports.

The internal audit function can be assigned to a commune staff member (internal auditor), or to an "*audit committee*" to be set up under the authority of the commune council.

External Audit:

The primary purpose of external audit is to ascertain the reliability and fairness of the commune's financial reports. It can also assess the management systems and procedures.

External audit can take the following forms:

- *Certification of the commune's annual financial statements*

This is a regular annual audit that is intended to review and certify the end-of-year accounts, and evaluate the commune's financial performance. This assessment could be carried out under the responsibility of the General Auditor (National Audit Agency- NAA). But, since the NAA is not yet operational, it is proposed to assign the auditing task to a "Provincial Audit Team", under the authority of the provincial department of economy and finance. The audit report, including the commune council's comments, must be disclosed to the public with the commune's financial statements. Therefore, Provincial Audit Teams should be formed and adequately trained.

- *Consultative auditing*

Consultative audit can be regarded as a technical assistance and capacity building provided to the commune, in financial and operations management. The provincial department of economy and finance, the provincial treasury, and the provincial administration (salakhet), as well as the Seila programme, should be called to deliver such kind of audit-assistance.

- *Popular "auditing"*

Citizens should be encouraged to participate in local affairs, and monitor the performance of the commune administration. This can be achieved through public hearings, consultations (during the planning-budgeting process), and attending the commune council meetings.