CHAPTER ONE

Introduction

1.1 BACKGROUND

The Royal Government of Cambodia (RGC) has achieved substantial progress in public financial management (PFM) since the inception of the reform program in 2004. PFM is the backbone of RGC reforms, but its objectives and benefits are not widely known to the public. While many components of PFM are present throughout the government, the overall system and its benefits are not widely understood or recognized. This is, in part, due to the holistic and long-term successes of PFM reform in Cambodia having never been described in one place.

This book offers a remedy to this problem by providing an overview of PFM and Cambodia's reform experiences. This examination includes a recent history of PFM reform, a delineation of its components in the RGC, a discussion of how PFM affects planning and budgeting, case studies within the RGC, and a comparison of reform experiences of selected OECD and ASEAN countries. Finally, the book draws key lessons from reform experiences (successes and failures) in both developed and developing countries that may be useful in the Cambodian context.

1.2 WHAT IS PFM?

PFM can be explained with a simple analogy as the following. In everyday life, each household is faced with questions about earned income and spending. These questions may include:

- What do we need with regard to food, clothes, education and entertainment?

- Where does the money come from to pay for it?
- Do we have enough money to cover all the expenses we need? Should we borrow money from somewhere? Are we able to pay back our borrowed loan?
- Is everyone in the family adequately taken care of?

These questions are familiar to every household and if we do not properly address them can lead to dire consequences for the family.

A government is like a household, but larger. Every citizen is a family member of that household. The process by which the government manages its resources to meet the needs of its citizens is called Public Financial Management (PFM). In a family, parents work and get paid, and this may constitute the whole income for the household. The government gets its revenue from tax and non-tax sources domestically and from external sources, such as loans and grants from bilateral[1] and multilateral[2] aid agencies. The government wants to use its revenues efficiently, equitably and in a manner that provides stability and sustainability of the operation of the government.

Sound management of government revenue and expenditure is the key to maintaining good fiscal discipline. It contributes to establishing a stable environment for growing businesses, maintaining good living standards, promoting sustainable economic development and providing protection against external shocks. Citizens have an obligation to contribute to the government's revenue through payments of taxes and other required fees, while the government has a reciprocal obligation to manage these resources properly. Transparency in how funds are managed is important to ensure that public funds are spent efficiently and for their intended purposes.

PFM has been defined as the practice of allocating financial resources through political processes to serve different human purposes (Wildavsky 1986); it has also been described as the way governments manage public resources in the short- and medium-term and the impact of these resources on the economy (Andrews 2014). In broad terms, PFM is concerned with the laws, rules, organizations, systems, processes and procedures available to governments to secure and use resources effectively, efficiently and transparently. Sound PFM supports accountability in the management of public resources, which is critical to the achievement of public trust in meeting government policy objectives.

In summary, a PFM system is similar to a pipe structure through which water (monetary resources) is channelled and managed within the whole government, with the ultimate goal of positively impacting the economy and society.

1.3 GLOBAL TREND OF PFM REFORM

Cambodia launched a Public Financial Management Reform Program (PFMRP) in 2004 with detailed, prioritized and sequenced action plans for public financial management reform. The program is guided by a long-term step-by-step platform approach with the aim to install high standards of management and accountability in the mobilization of government resources.

Historically, one of the catalysts for embarking on public financial management reform stems from "shocks" such as financial or economic crises that pressure governments to focus on reforming their inefficient financial systems for better governance. PFM systems are improved over time: however, as a set of improvements is made, a new set of challenges arise that must be met, which keeps the momentum of the reform process going.

In 1987, New Zealand, which had experienced deficits for the previous two decades, was faced with a currency crisis that led to the need to devalue its currency by 20 per cent, affecting the overall fiscal balance. A new government at the time took radical steps to address the crisis and passed the Public Finance Act 1989, which required the government to produce a proper "corporate" balance sheet, making it the first sovereign government to do so. The 2008 financial crisis led many governments to undertake significant financial management reforms. In Asia, the 1997–98 Asian Financial Crisis prompted countries such as Thailand and Indonesia to accelerate their measures for reforms. For other countries such as Timor-Leste and Afghanistan, the impetus came from a profound political change with an urgent need for reconstruction and development. PFM reforms often require a trigger to establish the political consensus for reforms.

Today, in an increasingly technological age, more detailed analyses of government spending and efficiency in the provision of public services can be easily made available to citizens. They need to be reassured that their governments are exercising an appropriate level of diligence in collecting taxes and non-tax revenues and turning these revenues into meaningful public services. Effective communication can help reinforce the delivery of services and obtain the trust of the public.

However, the last couple of decades have shown that PFM reforms are not always easy to achieve and have met with limited success in many countries. This finding holds regardless of whether PFM reforms were tried in low, middle- or upper-income countries (Asian Development Bank 2001). There is a growing realization that ambitious, large-scale reforms may not always work. On the other hand, pragmatic, targeted reforms, and quite simply, a better sequencing of reforms, might lead to more success. Cambodia fits with this model of long-term, step-by-step reforms.

Theories of Public Financial Management

Two significant theories on PFM have evolved and have relevance to Cambodia's reform efforts: New Public Financial Management (NPFM) and the New Political Economy of PFM. NPFM evolved in response to citizens' demand for more information and refers to reforms introduced in systems, procedures, organizations and laws for obtaining and effectively using public financial resources. Implicit in NPFM is the assumption that private sector management techniques and models are generally superior to traditional public administration approaches. On the other hand, New Political Economy is a relatively new branch of economics that examines non-technical factors of money management.

The new approach to PFM moves away from the traditional annual budgeting process, where the focus is on just one year's revenue and expenditure and introduces multiyear budget planning that addresses emerging needs and demands. Cambodia's approach to its PFM reform followed this global trend of taking the longer-term approach to budget reform. In Cambodia, Stage 1 focused on budget creditability, in line with the early technical approaches to NPFM; Stage 2 focused on financial accountability and, Stage 3 moved into policy-budget linkages. Finally, Stage 4 will focus on performance accountability, a key aspect of NPFM.

Initially, budget reform in Cambodia was about adopting "performance-based budgeting" (PBB) by 2020; however, that direction has changed to "performance-informed budgeting" (PIB) to be implemented by 2025 after the adoption of the new Budget System Reform Strategy. Other countries such as Australia, Sweden and Estonia have already evolved to performance-informed budgeting. In this system, the allocation of resources is indirectly related to proposed future performance and thus responds more directly to strategic and policy-based directions. PIB ensures that performance is taken into consideration but is not a technical procedure linked to budget allocation. On the other hand, PBB needs spending priorities and program performance to be formally integrated into the budget process, leaving little flexibility in changing government policy priorities in the short term.

The New Political Economy of PFM is a way of looking at financial management that focuses on factors of production, including land, labour, capital, entrepreneurship and trade, and examines their relationship with the law and government. Political economists study how economic theories such as capitalism, socialism and communism adopted by a society affect the economic structure of a country in its use of scarce resources. Studies exploring the political economy of PFM reform examine the construction of budgets and the impacts of different actors with conflicting interests and incentives, including private individuals, elites and governmental institutions, all acting as economic vehicles within society.

For political economists, the appropriate focus of attention is not on the individual, but on key social groups. These groups are located throughout the economy, with different interests and different sources of power to their interests. In their models, society is conceptualized as structurally unequal, with certain groups consistently dominating agendas and decision-making over time and across issue areas. Analysis of relative political power becomes a significant focus of attention for development practitioners seeking to promote reform programs, particularly those that seek to significantly redistribute resources among social groups (Hudson and Leftwich 2014).

The political economy shifts the focus to the interaction between structure and agency in different development contexts (Hughes and

Hutchison 2012). One example of this is "problem-driven" political economy analysis, which requires understanding the interactions between structural and institutional constraints and stakeholder interests in any particular reform context, where the activities of stakeholders are primarily determined by certain incentives (World Bank 2014). This approach raises the question of what drives such variation in PFM reform across nations and the extent to which structural factors may explain these variations. The analysis looks at the country's characteristics, including macro-social, economic, fiscal, as well as political variables (World Bank 2017).

The underlying political economy shapes PFM reform policy decisions and helps to explain the successes and failures of individual reform efforts. A more in-depth look at how PFM reform has fared in OECD and ASEAN countries is provided in Chapter 7.

1.4 SCOPE AND STRUCTURE

This book is structured into seven chapters. Chapter 1 outlines the book's objectives and scope, and then provides an overview of PFM and global trends in PFM reforms.

Chapter 2 begins with an overall description of economic development in Cambodia and the PFM Reform Program (PFMRP), including a historical overview of the economy and public financial situation since 1993. The chapter also highlights key achievements, challenges and possible ways forward for the PFMRP. Cross-cutting reform programs, including their impact on the budget process, civil service reform and Decentralization and De-concentration (D&D), are also discussed in this chapter.

Chapter 3 provides a deeper exploration of how PFM reform affects strategic planning and budgeting. It uses the Medium-Term Fiscal Framework and the Medium-Term Budget Framework to put PFM reform in the context of overall planning and budgeting in the RGC.

Chapter 4 examines the various components of PFM in a more detailed manner, including the management of revenues, expenditures, investment and public debt. Furthermore, this chapter also touches on state property management, public procurement, accounting systems, the financial management information system and auditing.

Chapter 5 focuses on tools for PFM system assessment, including Public Expenditure and Financial Accountability Framework (PEFA), Open Budget Survey (OBS), Public Investment Management Assessment (PIMA) and Tax Administration Diagnostic Assessment Tool (TADAT).

Chapter 6 provides case studies of the PFMRP's implementation at the Ministry of Education, Youth and Sport, the Ministry of Rural Development and at Subnational Administration.

Chapter 7 examines the PFM experiences of selected ASEAN and OECD countries, including Thailand, Vietnam, the Philippines, Malaysia, Indonesia, New Zealand, France, Australia, Sweden and Estonia. The chapter also describes lessons that are useful for building a robust PFM system in Cambodia.

NOTES

1. Bilateral aid is the assistance given by a government directly to the government of another country.
2. Multilateral aid is delivered through international institutions such as the various agencies in the United Nations, World Bank and Asian Development Bank. The OECD estimates that in 2018 around 73.3 per cent of international assistance was channelled through multilateral institutions.