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Chapter I

POLITICAL DEVELOPMENT AND MACROECONOMIC REVIEW

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This session was chaired by Professor Haruhiko Kuroda, Special Adviser to the Prime Minister of Japan, now President-elect of the Asian Development Bank, and discussed by Dr. Homi Kharas, Chief Economist of The World Bank for East Asia and Pacific region.

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Introduction

Cambodia has, since the Khmer Rouge era, been undergoing a triple transition. It has moved from command economy to free market, from war to peace, and from authoritarian rule to apparent democracy; especially in the 1990s, democratization and globalization have become the two essential challenges to the development of Cambodia. After two decades of war, the first democratic-style election took place in May 1993. By the end of that October, a new National Assembly and a new Royal Government that incorporated members of the three main political rivals – Funcinpec Party, Buddhist Liberal Democratic Party, Cambodian People's Party (CPP) – began to govern the country. The first two parties, which were made up of royalists and liberals, had fought the former communist party CPP for more than a decade.

Following the formation of its coalition government in mid-1993, Cambodia intended to re-establish itself as a democracy and a prosperous country. Fundamental rules of human rights were stipulated in the Constitution. Social justice and human development were to be promoted. To support these political aims, a process of market-oriented policy was strengthened and links were re-established with the international financial community. In 1994, a medium-term adjustment and reform programme aiming to restore macro-economic stability was launched, and a process of institutional strengthening supported by the international community was undertaken. A very liberal investment law was promulgated in 1994, and trade was liberalised. The private sector was promoted and longer-term structural reforms were also set to boost sustainable economic growth and help alleviate poverty. As a result, foreign investment sharply increased during the first years of reforms, boosting a rapid development of emerging industries such as the garment industry, telecommunications and tourism. External trade significantly expanded and has become the main source of economic growth and job creation.

The initial solidarity of the three former antagonists brought notable successes in economic liberalization and reforms in the early years of their partnership. Foreign direct investment in Cambodia significantly increased, starting from 3.5 percent of GDP in 1994 to 8.3 percent of GDP in 1996. The investment covered almost all sectors of the economy. Economic growth was strong, reaching the Government target of 7 to 8 percent per year, and generating significant employment. Household income increased by almost 20 percent per year (in US\$

Especially in the 1990s, democratization and globalization have become the two essential challenges to the development of Cambodia.

terms). The achievements were mainly due to the successes of the coalition Government in soliciting foreign assistance.

It seems that the country has been democratizing not from a desire for genuine reform, but in response to the imperatives of aid dependency.

Nevertheless, the long-term antagonism among the major political parties remained. Indeed, that antagonism was rather well observed back at the signing of the 1991 Paris Peace Accords that made way for the 1993 elections. At that time, the political parties made no effort to signal a rapprochement, and made no joint celebration. As a result, it seems that the country has been democratizing not from a desire for genuine reform, but in response to the imperatives of aid dependency. Numerous studies have found that countries orienting their political systems primarily in response to external pressures rather than emerging endogenous forces, whether economic or political, have difficulties in making democratic procedures work in a manner that encourages both widespread participation and empowerment, and stability. In Cambodia's case, it took four years for the political animosity to rear up again. In July 1997, an armed clash between the two major coalition partners resulted in a decisive win and complete power to the CPP. Perhaps the 1991 Paris signing just marked another stage of the political factions' war in Cambodia.

The second national election in 1998 saw a disappearance of the Buddhist Liberal Democratic Party and emergence of another democratic force – the Sam Rainsy Party, which took up an opposition role, while the Funcinpec Party became a less influential partner in a new coalition Government with the CPP. Again, a coalition was necessary, as none of the parties could secure a two-thirds majority of seats in the National Assembly – as called for in the Constitution – to govern the country alone. After the 2003 election, none of the three winning parties won the majority to rule alone and failed to agree upon a formula for a new coalition. The Funcinpec Party and the Sam Rainsy Party joined forces under a banner of the Alliance of Democrats to demand that the new Government have clear policies and reforms, and commitment to implementing them. A political impasse continued until the Funcinpec broke away from the Alliance, and went into a coalition government again with the CPP in July 2004.

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Although Cambodia's initial market-oriented reforms have yielded some positive results in attracting notable foreign direct investment (FDI), the country has not yet seen these reforms' full benefits, or an equitable distribution of benefits. The economic recovery has been largely confined to urban centres. Little has trickled down to

the rural areas, where the vast majority of the population lives. Though the overall economic growth has been relatively strong, this growth has been narrowly based, very fragile and unevenly distributed. Although overall crop production has risen on a national basis to the level of self-sufficiency, on an individual level the incomes generated from agricultural production have not improved and a significant number of the population still do not produce enough to eat. Natural resources have been largely destroyed, due to uncontrolled deforestation. Progress remains elusive in areas such as education and health. The number of landless people has accelerated over the last few years. Today, Cambodia remains one of the poorest countries in East Asia and has some of the worst human development indicators of the world.

In September 2003, however, Cambodia was invited to join the World Trade Organisation (WTO). As a least developed country, Cambodia could export most of its products free of tariffs to other WTO members. This opportunity will be of benefit only if the Cambodian economy is competitive, requiring prompt and serious domestic reforms. Under its WTO accession agreement, Cambodia has to fulfil a large number of reforms, especially legal reforms.

Macroeconomic Performance since 1994

During the first years of economic liberalisation and reforms, foreign direct investment in Cambodia significantly increased, starting from 3.5 percent of GDP in 1994 to 8.3 percent of GDP in 1996. The investment covered almost all sectors of the economy. Economic growth was strong, reaching the government target of 7 to 8 percent per year and generating significant employment. Household income increased by almost 20 percent per year (in US\$ terms). However, persistent weak governance and a political crisis in 1997 over power-sharing, combined with the Asian financial crisis at the same period, led to a sharp economic slowdown. Some critical reforms, such as civil service reform, were shelved and investor confidence was shaken. Despite large investments in the garment industry since 1997 and in the tourism industry since 1999, the Cambodia's FDI has continuously declined, and sank to less than 1.5 percent of GDP in 2002.¹

As a result, Cambodia's real GDP growth steadily slowed, from 7 percent in 2000 to 5.5 percent in 2002 and 4.8 percent in 2003.² In

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¹ IMF, International Financial Statistics, April 2004

² The World Bank, "Strong Fundamentals to the Fore: Regional Overview", April 2004

Income disparity between rich and poor is growing, and income disparity is also growing among various provinces

addition, income distribution has been uneven. Drawn from government data, an estimate made by the Economic Institute of Cambodia (EIC) showed that income disparity between rich and poor is growing, and income disparity is also growing among various provinces.³ In 2002, GDP per capita in Phnom Penh was about US\$1,000, while that of the provinces was only about US\$180. Moreover, GDP per capita in rural areas slightly declined, while that of Phnom Penh has steadily increased since 1997. The decline of rural livelihoods has likely been caused by successive natural calamities due to intensive deforestation, lack of irrigation and increasing underemployment.

Investment and Trade

Productivity of workers in the garment sector has sharply increased. However, Cambodia's productivity remains low compared to other countries, such as China and India.

Investment has played a crucial role in improving worker productivity and in generating income. Statistics compiled by EIC from various sources show that stocks of capital in the agriculture sector, which employs more than 70 percent of Cambodia's labour force, were estimated in 2002 to reach only US\$240 per worker, generating a modest value added of US\$275 per worker (or about US\$0.75 per day). This productivity has been on a declining trend since 1995, resulting in a steady decrease in rural income. Lack of investment, both public and private, in the agriculture sector constitutes serious concerns for sustainable economic development and social stability.

Table 1. Productivity and Stocks of Capital per Worker in 2002 (US\$)

	Productivity of Worker	Stocks of Capital per Worker
Agriculture	275	240
Industry	1,930	1,860
Services	2,200	2,960
Total	700	770

Source: EIC, compiled from government primary data

Though it started to slow down in 2001, investment in the garment sector has been relatively strong during the last seven years.

³ Phalla Kim, Cambodia's Economy in the Election Year 2003, EIC Economic Review, September 2003, pages 13-15, Available at <http://www.eicambodia.org/publications/publication.htm>

Productivity of workers in that sector has sharply increased, reaching US\$2,200 in 2002, from about \$1,050 in 1995. However, according to a recent World Bank study on the investment climate in the region, Cambodia's productivity remains low compared to other countries, such as China and India.⁴ Facing the incoming huge competition following the elimination of the quota system in 2005, this study recommends that Cambodia improve its public governance to support the sector.

External trade played a beneficent role in Cambodia's economic development during the last seven years, thanks to the FDI in the garment and tourism sectors. From 1995 to 2002, Cambodia's external trade grew at an annual rate of 12 percent in real terms, while domestic demand expanded only about 5 percent per year. Despite the slowdown in the garment industry and a significant decline in timber exports, the IMF figures show that the volume of Cambodia's external trade has continued to grow steadily, exceeding the nominal GDP in 2001 for the first time in Cambodia's history.⁵ However, the total trade deficit significantly increased, reaching 14 percent of the nominal GDP in 2002, against 10 percent in 1995. Thank to the expansion in tourism and sharp increase in worker remittances, the current accounts was almost in balance in 2002 (-1.6 percent of GDP in 2002, against -5.5 percent in 1995).

However, this relatively good performance will diminish if the garment industry and tourism lose their competitiveness in the wake of the WTO agreement, and/or the international environment becomes unstable. In addition, although amounts of exports in the garment and tourism industries are very high (51 percent of total GDP in 2003), it is estimated that less than 15 percent of these amounts remained in Cambodia.⁶ Raw material imported represents the most important share in the production cost, meaning that Cambodia's garment industry is still largely dependent upon foreign suppliers in textile and semi-finished garment products. The labour cost in Cambodia's garment sector represented only 13 percent of sale. The situation is quite the same in the tourism industry, as long as Cambodia could not develop its own national carrier. The labour cost in the tourism sector is estimated to reach only 3 percent of total foreign tourist total cost visiting Cambodia.

Although the export incomes from the garment and tourism industries are very high - they made up 51 percent of total GDP in 2003 - it is estimated that less than 15 percent of these amounts actually remain in the local economy.

⁴ World Bank, Interim Report, Investment Climate Assessments, 2003

⁵ IMF, International Finance Statistic-IFS, April 2004

⁶ Hach Sok, Interim Report on Investment Policies and Human Development in Cambodia, UNDP Trade Initiative Project, February 2004, pages 7-11

The monetary system in Cambodia is characterised by a high degree of dollarisation and cash transactions, which limit the government's scope for active and effective monetary intervention.

Inflation stabilisation was seen as the most successful action of the government during the reform period. After experiencing a very high rate of inflation from 1989 to 1993 (three digit inflation in some years), Cambodia's inflation has been basically under control since 1994. This was true even during the aftermath of the political crisis in 1997 and 1998. During 2000-2003, inflation was basically nil. However, this recent good performance was mainly due to the decline in price of agriculture products, while the price of imported energy significantly increased. This means that the income of rural people also declined because of low agriculture market prices and high production costs due to high energy prices.

The monetary system in Cambodia is characterised by a high degree of dollarisation and cash transactions, which limit the government's scope for active and effective monetary intervention. The total money supply recorded by the NBC was only about 21 percent of GDP in 2003. This included the liquidity in riel (5 percent) and the amount of foreign currencies (mainly US dollars) circulating through the banking system (16 percent). The amount of foreign currencies circulating outside the banking system is unknown, but is widely supposed to be at least three times higher than that circulating through the banking system. With the exception of small transactions and wage payments, the use of the riel is confined largely to the government and the poor in rural areas. Large financial transactions are conducted in foreign currencies, particularly the U.S. dollar.

Despite many fiscal reforms undertaken since 1994, government budget revenue has remained mostly flat.

Cambodian financial development is also characterised by severe lack of credit to the private sector, resulting in a very high interest rate, especially in the poor rural areas. Action to enhance public confidence towards the banking system in Cambodia still seems a long way off. Despite a rapid development of some emerging industries, the banking system in Cambodia is still quite weak. The large number of commercial banks poses particular challenges in banking supervision. No financial instrument has been yet established.

Fiscal Developments

Fiscal policy has been the core of the government's adjustment and reform strategy. The aim was to strengthen the role of the budget as

a key tool of economic management and also to develop a fiscal structure that generates the domestic resources required for increasing public spending in priority social and infrastructure areas. Unfortunately, this target has not been met. Despite many fiscal reforms undertaken since 1994, government budget revenue has remained mostly flat. The introduction of VAT in 1999 allowed the government to increase its revenue relative to GDP by about 2 percent.

However, five years later, this gain has mostly disappeared, reflecting the acceleration of problems caused by weak governance and lack of a clear fiscal policy. As a result, government budget revenue reached only about 10.1 percent of GDP in 2003 (against 9.6 percent in 1994), the lowest in the region. Implementation of a very generous investment law and various *ad hoc* tax exemptions cost the country millions of U.S. dollars per year in revenue. To compensate for this loss, the government has repeatedly increased taxes on gas and utilities. But these increases have not generated sufficient revenue. On the contrary, they have encouraged smuggling and tax evasion, strongly penalised local producers, and served to weaken national competitiveness.

On the expenditure side, given the limited domestic revenue, the first government priorities were to pay the existing very meagre public sector salaries on time, and if possible to contribute to the foreign financed investment counterpart funds. These minimal targets were basically reached. Public investment and social development were basically left to the funding sources of foreign aid. Expenditures on defence and security remained a heavy burden within the national budget, although official figures attempt to show some decline related to the total expenditure. The official figures have not shown, within the defence portion of the budget, a large amount of extra-budgetary revenue (tens of millions dollars per year) granted to the military since 1995. This has included revenue generated from military logging concessions, lands provided to the military for soldier demobilisation, and many other tax exemptions.

Foreign Aid and External Debts

To help stimulate Cambodia's recovery, the international community has pledged at every Consultative Group (CG) meeting to provide Cambodia with an average of more than US\$500 million per year in aid. This amount represents about 15 percent of nominal GDP,

Of the total pool of foreign assistance monies, 53 percent went to economic development, such as for road construction, power and water supply rehabilitation; 41 percent to social development; and 6 percent to general administration.

or 20 percent higher than Cambodia's domestic budget revenue. Meanwhile, the balance of payments figures compiled by the International Monetary Fund (IMF) from 1994 to 2002 show that real aid disbursements in Cambodia reached only about 70 percent of what was pledged. Of this amount, the World Bank and the Asian Development Bank (ADB) were the two biggest lenders, providing about 20 percent of foreign assistance. Of the total pool of foreign assistance monies, most (53 percent) went to economic development, such as road construction, power and water supply rehabilitation. Social development accounted for 41 percent, and was mostly executed by non-governmental organisations (NGOs). The rest of foreign aid (6 percent) went to general administration, mainly through foreign experts appointed to advise different ministries or public institutions.

Although foreign aid to Cambodia is very substantial and has helped the country to rebuild or rehabilitate economic and social infrastructure, and to facilitate some structural reforms, a Cambodia Development Resource Institute study⁷ noted that an increasingly-large proportion of external assistance goes to technical assistance (57 percent in 1998, up from 34 percent in 1994). Gradually reducing the proportion of technical assistance and using it for other purposes would be very beneficial for Cambodia's sustainable development.

With regard to Cambodia's external debts, the amount outstanding is not clear. After 1993, the Cambodian government started to borrow again from the World Bank and the Asian Development Bank to rehabilitate the country's infrastructure. At the end of 2003, these new debts were estimated to total about US\$800 million. However, debts contracted with some bilateral countries, such as China, remained unclear. The government holds this information confidential. As all the Cambodian debts contracted after 1993 are concessional (low interest rates with long grace periods), debt services should remain relatively low as a percentage of GDP or government budget incomes. However, if government revenue does not significantly improve, and new loans continue to be contracted at current trends, Cambodia's debt services ratio will reach a worrisome level in the next 10 years.⁸

⁷ CDRI, Godfrey Martin, al., August 2000, "Technical Assistance and Capacity Development in an Aid-Dependant Economy: The Experience of Cambodia", Working Paper No 15.

⁸ Based on the current trend of new loans and budget revenue, EIC estimates that the ratio debt services/budget revenue will reach about 4.5 percent in 2008 and 8.8 percent in 2013.

The Poverty Trend and its Social Implications

Poverty alleviation is supposed to be the overarching goal of the government's development plan. But, with an estimated per capita income of US\$280, Cambodia is the poorest and least developed country in the East Asian region and one of the poorest in the world. According to a recent World Bank report,⁹ although the country experienced some economic growth (about 6 percent per year on average during the last 10 years), the poverty rate has not been perceptibly reduced. In contrast, the poverty rate significantly declined in Laos and Vietnam during the same period. This report showed that the poverty rate in Cambodia grew from 36.7 percent in 1996 to 45.5 percent in 2003. Cambodia's total population has grown rapidly in the past 10 years, and the report also indicated that the number of poor in Cambodia consequently increased about 1.8 million, from 4 million in 1996, to 5.8 million in 2003.

With an estimated per capita income of US\$280, Cambodia is the poorest and least developed country in the East Asian region

In addition, successive socioeconomic surveys and poverty assessments made by the government showed that the poverty rate¹⁰ in rural areas was particularly high (40 percent) compared with urban areas (10 percent).¹¹ This gap was likely explained by the very low incomes earned by rural people relative to urban people, because of low productivity, uneven land distribution and lack of public infrastructure, such as roads and irrigation.

Underemployment in Rural Areas

High levels of underemployment, especially in the rural areas, constituted another factor of poverty in Cambodia. Based on a population structure that has been affected by years of war, Cambodia's labour force is estimated to have been increasing at an accelerating rate every year since the mid-1990s. And this trend is expected to be stabilised only in the next 15 years. Drawing on the 1998 census, The Economic Institute of Cambodia estimated that Cambodia had an average of 150,000 new entrants to the labour market per year between 1994 and 1998. New entrants numbered approximately 200,000 per year for the period 1999 to 2003. For the period 2004 to 2008, an estimated

While current underemployment rate is already very high, new entrants to the labour market will continue to grow over the next 10-15 years

⁹ The World Bank, "Strong Fundamentals to the Fore: Regional Overview", April 2004

¹⁰ The Cambodian poverty line was about US\$0.50 per day per capita, while that of the World Bank was PPP\$1.00 per day per capita.

¹¹ Ministry of Planning, A Poverty Profile of Cambodia - 1999", 1999

In order to provide employment for the rapidly-expanding numbers of rural youth reaching working age, private investment in Cambodia must increase at least three times

230,000 people per year will enter the labour market. However, the number of jobs created during the next five years is likely to decline relative to the previous five years because of the recent drop in productive investment. Consequently, Cambodia faces a huge challenge in the medium and long term in generating adequate employment in rural areas for the new labour force. This expansion of the labour pool could be a driving force for economic growth or a significant burden if adequate employment opportunities are not created.

In order to prevent farmers from becoming poorer, the size of farm per farming household should not decrease. However, due to the small size of most Cambodian farms, when farmers' children reach working age, they will have to find employment elsewhere. In order to provide employment for the rapidly-expanding numbers of rural youth reaching working age, private investment in Cambodia must increase at least three times the total from the past 10 years. Cambodia's balance of payments statistics show that private investment in the modern sectors averaged about \$150 million per year from 1994 to 2002. Of this amount, less than \$100 million per year was invested in the productive sectors (mainly garments and tourism), which created labour-intensive employment. Lower-than-expected economic growth and moderate private investment have had a significant impact on employment and revenue.

Between 1994 and 2003, Cambodia's labour force increased by an estimated two million people. However, the modern sector absorbed only about 20 percent of this labour force, and perhaps another 5 percent migrated to neighbouring countries, particularly Thailand.¹² The other 75 percent remained in rural areas and shared small portions of land owned by their families, or they have been obliged to accept informal jobs in the cities.

Furthermore, based on the current level of land and productivity, the Cambodian agricultural sector can efficiently support only about one to two million workers; currently about four million are employed. In order to provide employment for two or three million of the young jobless, investment in non-farm activity in rural areas should be strongly encouraged.¹³

¹² DAN: Impact of the Asian Financial Crisis on the Southeast Asian Transitional Economies, Conference paper, January 1999, Phnom Penh (page 158).

¹³ Hach Sok, Long Term Prospects of the Cambodian Economy: A Quantitative Assessment of the WTO Membership, EIC Economic Review, March 2004, page 3

Landlessness is increasingly recognised as a critical development issue in Cambodia. According to Oxfam, which has contributed several studies on land issues, the number of landless¹⁴ people in rural areas has increased at an accelerated rate over the last few years. In 1984, landless families represented about 3 percent of the total number of households. This was slightly lower than in 1969 (about 4 percent). In 1999, however, this ratio jumped to about 12 percent (equivalent to about 1.2 million people), while landlessness in female-headed families was much higher (21 percent). Oxfam also estimates¹⁵ that this trend will worsen in the near future.

The causes of landlessness are numerous, but the most important are new marriage (22 percent), illness (21 percent), lack of food, indebtedness and other economic reasons (13 percent). Oxfam surveys also showed that landlessness is one of the main causes of migration. In 2000, about 22 percent of families left their village after becoming landless.

On the migration issue, the 1996 demographic survey and the 1998 census figures confirmed an acceleration of rural out-migration during 1990's. This is occurring in provinces that have high population density and are close to cities, particularly Phnom Penh. The proportion of newcomers in urban areas almost doubled between the demographic survey and the population census. The "recent" and "very recent" arrivals at urban areas increased from 17 percent in 1996 to 30 percent in 1998. This means that in 1998 about 30 percent of the urban population came from rural areas over the five previous years.

The 1998 census also showed that the flow of migrants from rural to urban areas increased from less than 150,000 people in 1994, to more than 300,000 people in 1997. This movement mostly reflects growing under-employment and landlessness in rural areas. Promoting development in rural areas and better land and natural resources management are crucial to address this issue.

Acceleration of rural out-migration mostly reflects growing under-employment and landlessness in rural areas. Promoting development in rural areas and better land and natural resources management are crucial to address this issue.

¹⁴ The landless family is defined as a family in rural areas, which has no agricultural land and no means with which to purchase agricultural land.

¹⁵ Oxfam, Robin Biddulph "Interim Report on Findings of Landlessness and Development Information Tool (LADIT) research September 1999 to April 2000", June 2000

Cambodian public health indicators are among the worst in the world. Low levels of income and education are exacerbated by the woeful condition of the country's public health system, particularly in rural areas.

Data compiled by WHO show Cambodian public health indicators to be among the worst in the world.¹⁶ The mortality rate of children under five was 124 per 1,000 live births in the year 2000, an appallingly high figure in relation to the estimated mortality rate in the East Asia region of 40 per 1,000 live births. In the past three years, the figures have gotten even worse, as shown by 2003 United Nations Development Programme (UNDP) statistics that put the mortality rate for children under five up to 138 per 1,000 live births. The main causes of death for the general population are malaria, acute respiratory infection, tuberculosis, diarrhoea and dengue fever. Gaining fast on those causes is the human immunodeficiency virus (HIV), which has been spreading rapidly in the kingdom. HIV is becoming a factor in the low life expectancy numbers in Cambodia. Life expectancy is estimated at only 52 years for men and 57 years for women, numbers which are about 15 years less than life expectancy in the region.

These poor statistics are the result of myriad problems that Cambodians face. Low levels of income and education are exacerbated by the woeful condition of the country's public health system, particularly in rural areas. As shown by the Ministry of Finance statistics for 2003, the public health system has suffered severe shortages of resources; for example, in 2003, actual expenditures on health were about half that of the budgeted level.¹⁷

The current lack of funding and physical equipment for the public health sector has meant that health professionals from the public sector have been siphoned off to private health institutions. Quite simply, government-determined wages of public sector health professionals at about US\$25 per month are not enough when the minimum cost of living is estimated to reach at least five times higher. Consequently, the public sector health professionals spend only the bare minimum of time in their official positions and do the bulk of their work in private clinics. In addition to the wage issues, public sector health institutions suffer from outdated equipment, and government neglect. As a result of low wages and a crumbling health infrastructure, the quality of public health service decreases.

¹⁶ WHO, Country Health Profiles 2001 Revision available at <http://www.wpro.who.int/chips/index01.htm>

¹⁷ Ministry of Finance, State Budget Implementation of Cambodia for 2003, March 2004

To reverse this trend, the Cambodian government must make solid commitments to social and health spending, and it must adequately regulate public health staff to promote efficiency and dependability. The government has consistently made pledges to increase substantially the public health budget, but in fact, disbursement has been extremely irregular. Government routinely spends less than half the public health budget it allocates for a fiscal year and during extraordinary periods, such as an election year, some public health expenditures can drop to as low as twenty percent of budgeted amounts.¹⁸ The ministries and public institutions responsible for public health do not have the political clout to wrest consistently its budget from a system of internal government financing that is ruled by patronage and kickbacks.

According to WHO¹⁹ and World Bank figures,²⁰ Cambodians paid US\$30 per capita for health care in 2001. The government contributed merely US\$2. Non-governmental organizations (NGOs) and donors contributed about US\$4. The remaining US\$24 was spent by individuals. That means that eighty percent of total expenditures on health come out of individual pockets. The current weaknesses in the public health care systems mean that seeking health care, particularly for a serious medical condition, can quickly push a middle class family into poverty and a poor family into utter destitution.

Implications on Education

As in the health sector, education in Cambodia is characterised by limited budget allocation, low-quality teachers and the lack of relevant policy. School facilities are very poor and rely largely on foreign aid and private donations. According to official figures, progress has been made regarding the literacy rate and school enrolment. But the quality of education is still very poor. A recent survey²¹ undertaken by the Cambodian government, with the assistance of UNESCO and UNDP, showed that about half of those who identified themselves on the national Census as literate, are not able to read and write.

¹⁸ Ministry of Finance, State Budget Implementation of Cambodia for 1997 to 2003, annual publication

¹⁹ WHO, Select Health Indications, 2001 available at <http://www.who.int/country/khm/en/>

²⁰ World Bank, Cambodia: Public Expenditure Review, Enhancing the Effectiveness of Public Expenditure, January 1999.

²¹ So Chhun and Supote Prasertsri: "Literacy Rates Much Lower than Estimated", Cambodia Development Review, June 2000.

The quality of education in Cambodia remained very poor. This situation will have a significant impact on the future development of industry in Cambodia, as qualified Cambodians become more and more scarce.

According to the figures released by the Asian Development Bank,²² the government policy on education has not met with great success. Early in the 1990's, Cambodia's secondary school enrolment rate was higher than that of Laos and Vietnam. Nine years later, however, the situation has reversed, with Cambodia's enrolment rate in decline while its neighbours show an increase. From 1990 to 1999, the secondary school enrolment rate in Vietnam almost doubled (from 30 to 62 percent), while it declined from 32 to 24 percent in Cambodia.

This decline will have a significant impact on the future development of industry in Cambodia, as qualified Cambodians become more and more scarce. This weakness has been caused primarily by the increase in poverty in rural areas. To attend secondary school, Cambodian children have to go far from their home village (in general to the commune or district centre), and costs for transporting them are high because of the poor state of rural roads. Moreover, because the salaries of teachers and the recurrent education expenditures provided by government are very meagre, private households have to contribute money to operate the school. This cost to parents is even higher at the secondary school level, than it is for primary school.

Improvement is more visible in higher education, as a result of significant foreign assistance and private investment. However, the cost for higher education keeps increasing, as most Cambodian students have to pay tuition to finance both teachers' salaries and other recurrent costs. In addition, the Cambodian education system is not yet meeting the needs of the labour market. Cambodian students have not fully benefited from rapid economic growth in some sectors, such as garments and tourism. Vocational and professional schools are not yet well developed in Cambodia, and those that are in operation are private-sector funded and thus quite costly. To improve the situation, the government has to secure enough funds to pay a decent salary to teachers and to cover other recurrent costs. To achieve this, administrative reform should be accelerated and good governance should be enhanced.

Lessons and Policy Implications for the Future

During the past 10 years, Cambodia has taken many steps to open its economic policies and to foster growth and development. In

²² The Asian Development Bank, Key Indicators 2002

1994, a medium-term adjustment and reform programme aiming to restore macro-economic stability was launched, and a process of institutional strengthening supported by the international community was undertaken. Private sector growth has been promoted and efforts have been made at longer-term structural reforms that would allow sustainable economic growth and poverty alleviation. A liberal investment law was promulgated and trade was liberalized.²³

As a result, foreign investment flowed into Cambodia during the first years of those reforms; this, in turn, allowed rapid development of some emerging industries, such as the garment industry and tourism. External trade significantly expanded and became the main source of economic growth and job creation.

However, income distribution has been uneven. According to estimates by the Economic Institute of Cambodia (EIC), income disparity between rich and poor is growing, and income disparity is also growing among various provinces.²⁴ Globalization is primarily benefiting higher-income people in urban areas, whereas traditionally poorer people in rural areas are not only seeing fewer benefits but are in a larger sense being left behind as globalization continues.

Cambodia has been invited to join the WTO. The fear is that Cambodia's WTO membership will result in even wider income distribution inequalities unless there are clear economic and institutional reforms. According to a recent EIC study on the impact of foreign investment on human development, the poor will not likely be able to seize the opportunities provided by liberalized trade without government support in implementing strict rules and regulations.²⁵ This is because the poor are often uneducated in general and unaware of specific opportunities in particular. Trade liberalization might serve to further expand their vulnerability to exploitation and to missed chances. If private sector development occurs in a vacuum, without concurrent attention by the government to the provision of good quality public sector services, poor people will be increasingly worse off, especially as

During the past 10 years, external trade significantly expanded and became the main source of economic growth and job creation. However, income distribution has been uneven.

²³ Hach Sok, "Economic Development and Reforms Policy in Cambodia", Cambodia Development Resource Institute Annual Economic Review, 2001

²⁴ Phalla Kim, Cambodia's Economy in the Election Year 2003, EIC Economic Review, September 2003, pages 13-15, Available at <http://www.eicambodia.org/publications/publication.htm>

²⁵ Hach Sok, Interim Report on Investment Policies and Human Development in Cambodia, UNDP Trade Initiative Project, February 2004, pages 7-11

An unsustainable exploitation of natural resources intensified. Corruption was widespread. Economic reforms were very slow.

measured by growing income inequality.²⁶ Globalization and economic liberalization will have potentially huge impacts on social development in Cambodia.

The recent history of Cambodia shows that this country has the capacity to develop rapidly and that the fruits of development can be distributed equitably when government actions are consistent with its policy. During 1954-1963, Cambodia's economic and social developments were rapid and sustainable within a free market system. Cambodia was even more prosperous than its neighbours, which is hard to believe today. More recently, during 1994-1996, the lives of many Cambodians sharply improved, reflecting the dynamism of reforms. During that period foreign direct investment almost tripled and contributed significantly to generating enough employment for new labour force entrants.

The overall situation started to deteriorate in early 1997. A power sharing arrangement between the two main political parties in the coalition government reached a crisis, which led to the factional fighting in July 1997. An unsustainable exploitation of natural resources, such as forestry, intensified. Corruption was widespread. Economic reforms were interrupted. As a result, economic activity stalled and social development significantly deteriorated. Since the formation of the second coalition government at the end of 1998, the government's rhetoric has pledged reforms and as a result huge amounts of foreign aid have resumed flowing in. However, key structural problems remain and the previous in-flows of FDI have not returned.

- Economic activity is recovering. But the growth rates of the economy are below targets, unevenly distributed, and not enough to curb growing under-employment. Foreign direct investment is stagnating and Cambodian savings still fly abroad. To date, government budget revenue remains very low, and the national budget is structurally inadequate to support economic and social development programmes.
- From a social perspective, landlessness and the subsequent migration from rural to urban areas are accelerating. Land disputes

²⁶ Hack Sok, Addressing Social Justice for Economic Development and Democracy, EIC Economic Review, December 2003, pages 12-15, Available at <http://www.eicambodia.org/publications/publication.htm>

are widespread around the country. Poverty is visibly and measurably increasing in rural areas.

- State institutions continue to grow and expand their influence. Corruption is widespread with the judiciary enjoying a particularly dismal reputation. Civil service reforms advance very slowly. Military demobilization has stalled.

Facing these challenges, what should the development strategy be? What are the priorities?

- Restructuring public administration is the highest priority, starting with civil service reforms. Economic and social development cannot be achieved without an accountable and efficient public administration. It is becoming a cliché, but good governance is key.
- Re-adjusting fiscal policy is crucial to improve private sector competitiveness and service delivery performance. Strengthening the monetary system and financial sectors is essential. In lieu of adequate levels of FDI, there is a pressing need to mobilize domestic savings to support productive sectors for rapid and sustainable economic growth.
- And last but not least, there must be a review of the role of foreign assistance to Cambodia in support of economic development and the reform programme. Particular attention must be given to good governance and transparency.

Restructuring Public Administration

Improving good governance and fighting corruption in the public administration are key factors for achieving rapid and sustainable development in Cambodia²⁷. To reach this target, first of all, public administration should be restructured and strengthened. The current administration is a legacy of years of war. Following the formation of the first coalition government in 1993, and conforming to the Paris Peace Agreement signed in 1991, administrations from different factions, mainly from the CPP and Funcinpec, have been merged into

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²⁷ Kato Toshiyasu, al., May 2000 "Cambodia: Enhancing Governance for Sustainable Development", (Phnom Penh: Cambodia Development Resource Institute, and Manila: Asian Development Bank).

The structure of the state institutions should be improved but the power of decision-making should also be decentralised.

unified administration at the national and provincial levels. In many cases, staff was not selected based on competency, but rather with a view to party loyalty and nepotism. Lucrative positions are bought outright by the highest bidder. Furthermore, the whole public administration is overstaffed, representing almost 7 percent of the total labour force, which is as much as the whole manufacturing sector. Salaries for civil servants are so low that the structure is inevitably inefficient. The government has publicly recognised some of these weaknesses and for years has pledged reforms.

Progress has indeed been made in some areas, like computerising the registration of the civil servants. But the most difficult task has been avoided - assessment of the real societal needs that the civil service must address with the appropriate hierarchies and functions tailored to meet them. This assessment should be done now in collaboration with different ministries and the donor countries. The selection of core groups of civil servants will be crucial, and should be made on the basis of competence. Competent personnel can also be found outside the current civil service structure. Salaries should be raised further for core staff beyond subsistence levels.

Military and police reforms should be just as thorough. The sheer numbers - 130,000 soldiers and 70,000 policemen - are simply too large. The real challenge for Cambodia is to transform surplus public administration staff and military/police personnel into a productive group. As the effected personnel are often not well educated and would unlikely find good private sector employment, rural economic development zones need expansion to assist them with land usage and cultivation as they return to the countryside.²⁸ The budget for the Ministry of Rural Development should be substantially increased for this purpose.

The structure of the state institutions should be improved but the power of decision-making should also be decentralised. During the last ten years, the number of Ministries, State Secretariats, National Authorities, Supreme Councils, and so on, has multiplied. At the same time, real decision-making has been increasingly concentrated in the Council of Ministers. This institutional multiplication is ineffective,

²⁸ Joint Study by the Finance and Banking Commission of the Senate and the Economic Institute of Cambodia, *Could Cambodia's Farmers Be Rich?*, EIC Economic Review, March 2004, pages 8-11, Available at <http://www.eicambodia.org/publications/publication.htm>

inefficient and costly to the national budget. The central government could easily reduce the current number of more than thirty ministries and state secretariats. The number of secretaries of state and under-secretaries of state, the number two and three position at ministries, should be significantly reduced. Key areas of authority should be returned to relevant ministries.

Fiscal and Monetary Reforms

Enhanced fiscal reform is absolutely crucial for sustainable development. Despite some progress, particularly the initial success with VAT implementation, several major concerns remain. The national budget in recent years reflected an effort by the government to improve social development. Education and health expenditures increased, but much lower than planned and obviously insufficient compared to the real needs. The government contribution to social development is still very far from that in other less-developed countries. Lessons learned from the experience of the past years show that the government can substantially, in a sustainable manner, raise budget revenues. But the political will to pursue governance reform must come first. Corruption and weak governance harm revenue collections.

According an EIC estimate, smuggling in gasoline alone costs the national budget one hundred million US dollars per year. EIC recommends that the oil tax policy be readjusted.²⁹ To improve revenue collection in the non-tax areas, it is strongly recommended that the Ministry of Economy and Finance be the sole authority in charge of monitoring and collecting revenues. The line ministries should only be in charge of technical aspects of the budget, not collection.

Furthermore, Cambodian budget revenues rely heavily on international trade taxes. However, joining ASEAN Free Trade Agreements and WTO will mean that revenues from international trade will be automatically and largely reduced. To prevent a revenue collapse and to increase tax revenues to adequate medium-term levels (at least 15 percent of the GDP against just 10 percent in 2003), the policy of tax exemptions should be revised. Tax exemptions have several counter-productive features. As long as the monitoring system is weak (in Cambodia due to corruption), tax exemptions encourage fraudulent

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activities and adversely affect both the domestic industry and competitiveness. It is clear that a rapid expansion of the garment industry in Cambodia was created not by tax exemptions, but rather by the MFN status granted by the US and Europe. Tax exemptions alone, especially ones that are unevenly and unfairly collected, will do little to attract FDI and foster economic growth.

On the monetary side, the National Bank of Cambodia's policy to stabilise the value of riels around 4,000 riels per US dollar has significantly curbed inflation, as the Cambodian economy is strongly dollarised. This policy also contributes to enhancing the confidence in the national currency, so that Treasury bills denominated in riels can be issued with a low interest rate. It is also extremely important to reinforce institutions in charge of domestic savings mobilisation. First of all, the banking system should be put in good order, because it plays the biggest role in mobilising private savings to finance the economy. The Cambodian economy is characterised by the lack of adequate lending to the private sector, even though currency deposit levels have dramatically increased. Statistics compiled by the National Bank of Cambodia show that lending from commercial banks to the private sector amounts to less than 50 percent of deposits. The remainder is simply sent abroad. This situation is disastrous, as the financing needs of the economy are urgent and unmet by inflows of FDI. Strengthening the supervision system is, at this stage, the most crucial reform needed. Given low inflation and the stability of the riel, monetary authorities should also have a clear and active policy on the de-dollarisation of the economy.

The amount of foreign assistance to support economic development and reforms in Cambodia has been substantial. However, with poverty actually on the increase, questions are arising as to the real impact of this foreign assistance.

Role of Foreign Assistance

Since 1993, according to the Council for Development of Cambodia and the Ministry of Economy and Finance, foreign assistance to Cambodia has amounted to about US \$5 billion, of which about US \$1 billion was in form of loans. The amount of foreign assistance to support economic development and reforms in Cambodia has been substantial. However, with poverty actually on the increase, questions are arising as to the real impact of this foreign assistance. According to

²⁹ Hack Sok, Rethinking Gasoline Pricing Policy, EIC Economic Review, September 2003, pages 9-12, Available at <http://www.eicambodia.org/publications/publication.htm>

a World Bank study³⁰ and a CDRI estimate, most economic infrastructure development was financed directly by donors. Most social and community development was also financed by donors, mainly through NGOs. Given the weakness of the Cambodian public administration, another large portion of foreign aid was given in the form of technical assistance³¹.

However, foreign assistance focussed on institutional reforms has been very limited. The IMF's funds, through its ESAF and PRGF programme, are earmarked to support monetary policy and cannot be used for financing reforms. The World Bank has been active in financing the structural reform programme. To support the ESAF programme, particularly in the fiscal area, the World Bank provided substantial non-earmarked budget support (US\$102 million), without any conditions, to the government from 1994-1997. But results have been very poor, as domestic revenue related to GDP declined during that same period. In 1999, the World Bank implemented a new structural adjustment programme, aimed at fighting corruption, reforming the civil service and accelerating demobilisation. Despite the support, the achievements of these critical reform efforts seem strikingly meagre over the last five years.

However, foreign assistance should focus more on a structural adjustment programme aimed at improving good governance and transparency.

As stated above, Cambodia's economic development cannot be sustainable without restructuring the public administration and drastically reforming fiscal and monetary systems. For these reasons, foreign assistance should focus more on a structural adjustment programme aimed at improving good governance and transparency. Credit allocated to this programme should be strictly earmarked. To increase the effectiveness and public credibility of these reform efforts, the transparency of foreign assistance should also be enhanced.

Concluding Remarks

Strengthening public administration and fighting corruption are the keys to sustainable economic development and effective poverty alleviation in Cambodia. But this will only happen if Cambodia's leaders have the political will to develop the country with rule of law dominant over the rule of man in conjunction with a sound economic

³⁰ World Bank, January 1999, "Cambodia: Public Expenditure Review, Enhancing the Effectiveness of Public Expenditures".

³¹ CDRI, Godfrey Martin, al., August 2000, "Technical Assistance and Capacity Development in an Aid Dependant Economy: Experience of Cambodia".

development strategy. The rule of law means there is real reform of the judicial system, police force and the army. A sound economic development strategy includes drastic fiscal and monetary reforms, better natural resource management, good governance reform and decentralisation.

By successfully implementing these main reforms, Cambodian administration will become more efficient, transparent and credible. Cambodia will be able to mobilise savings, externally and internally, for development. Economic growth will be strong enough for formal sectors to absorb new entrants to the labour market. Foreign reserves will grow steadily, reducing potential volatility in the exchange rate. Inflation will be low, and the Cambodian economy's competitiveness will grow.

With the rule of law and consistent macro-economic stability, thoughts can turn to introducing a stock market. The banking and other financial systems, as the main actors in mobilising private savings, will be revived and strengthened. A virtuous cycle will boost private investment. Incomes will broadly rise for all, and the nation's basic infrastructure –physical, economic and social- will be rehabilitated in about 10 years. And the core economic goal – to reduce poverty in Cambodia on a sustainable basis - will have been achieved.

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