Cambodia's Development Financing and Collaboration with Japan

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Abstract

This Development Finance Assessment (DFA) of Cambodia analyzes the public, private, international, and national finance flows available to support investments in the country. The analysis and projection are based on data collected from various secondary sources. This DFA also offers policy recommendations for Cambodia to maximize its level as well as quality and allocation of finance inflows to achieve long-term development objectives.

Keywords:

climate finance, development finance, domestic revenue, domestic investment, official development assistance, remittance

1. Introduction

Cambodia is one of the Least Developed Countries in Asia. The conflicts and destructions it has witnessed over the years have made it weak and vulnerable in several aspects, including social and physical infrastructure, health and education, governance and institutions, and knowledge and technology. Despite these critical challenges, the country has made tremendous progress over the past three decades. Its greatest achievements are the restoration of political stability and significant improvements in the law-and-order system, enabling the country to reap the benefits of "peace dividends." In addition, the country has surpassed the post-conflict reconstruction stage and entered a new phase of economic development, characterized by open economic policies, with a focus on private-sector-led development and far-reaching macroeconomic reforms.

In the past two decades, as a result of sustained peace and prosperity, Cambodia has, for the first time, met all the three established thresholds for graduation, as declared in the 2021 triennial review organized by the Committee for Development Policy. Committed to transforming Cambodia into an upper middle-income country by 2030 and a high-income country by 2050, the Royal Government has formulated long-term development plans and goals—namely the "Cambodia Vision 2050" and "Cambodia Sustainable Development Goals (CSDGs)"—as well as mid-term plans, such as the Rectangular Strategy (RS) and the National Strategic Development Plans (NSDPs), as policy instruments to achieve these long-term objectives. However, there are many implementation challenges to be overcome while implementing these plans, one of which is the mobilization of financial resources.

This article aims to assess the public, private, international, and national finance inflows available to support investments in the country. It offers policy recommendations on maximizing the level as well as quality and allocation of finance inflows in order to achieve long-term development objectives for Cambodia. The trends, projections, and recommendations are on a mid-term basis (5-year timeframe). Moreover, since the COVID-19 pandemic has had serious financial repercussions on the country, this study estimates the potential losses to be incurred by Cambodia and establishes a short-term policy response for such emergencies. This policy response focuses on the significance of earmarking solutions for the growing budget deficits in 2020 and 2021.

2. Cambodia's Long-Term Planning System

The government has facilitated long-term planning through its five-year plan (NSDP), which entails socioeconomic development priorities shortlisted by the government across a 5-year period starting from 2008. However, it is only when the NSDP 2014-2018 and NSDP 2019-2023 were formulated that the link between the mid-term financial estimates for capital investments from private and public sources, along with financial strategy and plan of action, were introduced.

Since 2014, the government has attempted to identify and assemble the resources and concrete plans of action required to achieve its long-term goals. The latest NSDP recognizes Cambodia's specific resourcing constraints in relation to the level of ambition projected by the CSDGs as well as the Vision 2030 and 2050 objectives. Achieving these objectives would require considerable investments and a proportionate increase in the availability of resources.

Table 1 demonstrates the capital investments required from both private and public sectors as well as domestic and foreign sources to achieve the 2019–2023 growth targets estimated by the government. Nearly 60 billion dollars of capital investment, of which 72.5% would be funded by the private sector, is required to drive sectoral delivery and implement all actions specified in the NSDP 2019-2023.

Table 1: Capital Investments to Achieve the 2019–2023 Growth Targets

(Unit: Millions of US dollars)

Source of Finance	2019	2020	2021	2022	2023	Tota
Total Public Investment	2,257	3,382	3,376	3,527	3,912	16,454
Domestic finance	738	1,636	1,519	1,539	1,566	7,000
Foreign finance	1,298	1,476	1,561	1,634	1,974	8,154
Total Private Investment	6,519	7,447	8,524	9,774	11,174	43,438
Domestic finance	2,853	3,118	3,405	3,719	4,012	17,107
Foreign finance	3,666	4,328	5,119	6,055	7,162	26,331
Total Investment	8,776	10,830	11,901	13,301	15,086	59,890

Source: Adapted from NSDP 2019–2023.

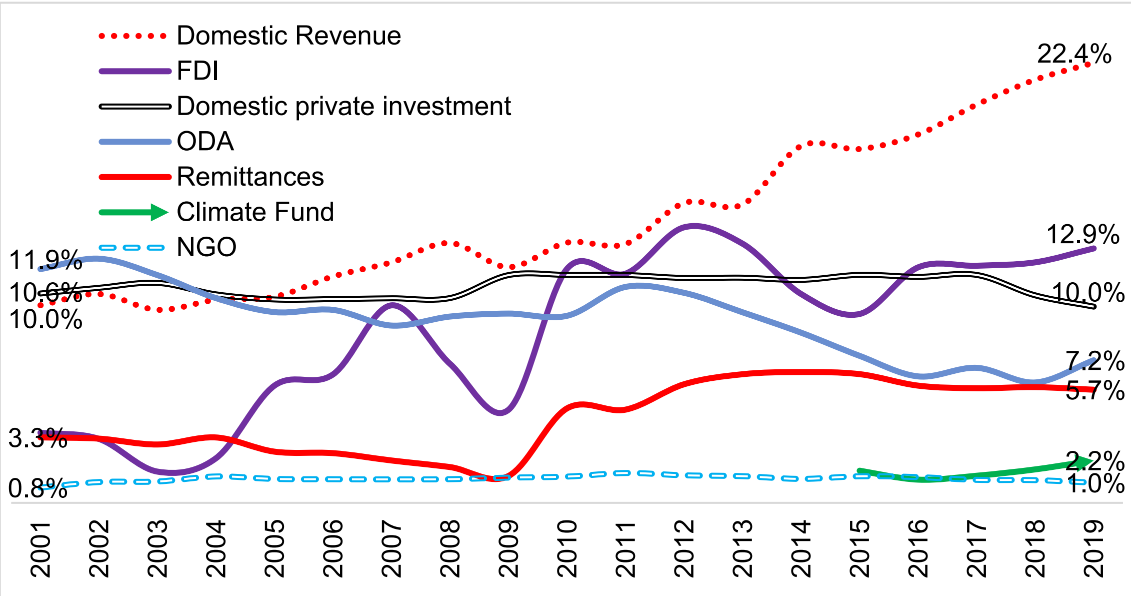
3. Cambodia's Development Financing Landscape

In September 2015, the United Nations hosted a summit to adopt an ambitious and transformative post-2015 development agenda, including sustainable development goals (SDGs). This agenda is supplemented by equally ambitious and credible means of implementation, one of which is financial resources.

Figure 1 delineates the possible sources of development funds, i.e., from domestic and international avenues as well as public and private sectors, as a share of the GDP from 2001 to 2019. The subsequent sections discuss each of these sources in detail to determine the ways in which the government can capitalize on domestic sources. These sections also highlight Japan's contribution to development financing from the perspective of international sources.

Figure 1: Finance Inflows to Cambodia from 2001 to 2019

(Calculated in terms of percentage of GDP)



Source: Author's illustration based on data collected from various sources.

3.1. Domestic Sources

1) Domestic Tax Revenue

Domestic tax revenue increased from 10.0% of GDP in 2001 to 22.0% in 2019 as a result of reforms in tax policy and administration over two decades. Due to this increase in revenue, Cambodia has emerged among the best performers in ASEAN. Nonetheless, in the long run, an effective resource mobilization strategy, especially in terms of non-tax revenue collection, will demand higher levels of coordination and commitment from ministries and other institutions. Significant capacity development is still required to raise non-tax revenues. Some potentially effective strategies for Cambodia to widen its tax base include utilization of income and other personal taxes, expansion of the property tax base, and further strengthening of the tax administration. New and higher taxes, coupled with higher excise duties on alcohol, tobacco, and luxury goods, may also be required. Capital markets as potential means of issuing bonds may be explored as a mid-term financing option to augment domestic revenues.

2) Domestic Private Investment

The share of domestic private investment in GDP is relatively stable compared to other domestic finance sources. However, it decreased marginally from 10.2% of GDP in 2001 to 10.0% in 2019. From the economic development perspective, the private sector has been the primary catalyst for Cambodia’s GDP growth, exports, and fiscal revenue in the last decade. However, the level of domestic private investment is lesser than that of other countries in the regions that have sustained high economic growth in the past. One of the most significant challenges faced by the industrial policy in Cambodia is the need to develop financing instruments to establish a broad base of firms in the competitive productive sector. The establishment of operating firms that effectively manufacture goods of universal standards at globally competitive prices requires high levels of organizational and technological capabilities. These operating firms are largely developed through hands-on practice. However, financing such advances is not a simple task, as funds may be used ineffectively.

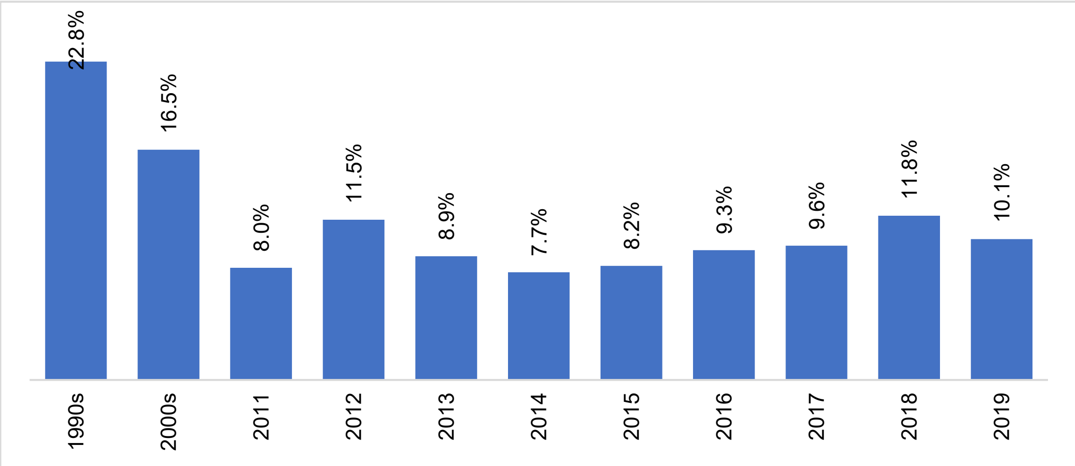
3.2. Foreign Sources and Japan’s Contribution

1) Official Development Assistance (ODA)

ODA for grants and loans is intended to strengthen the economies of and promote human welfare in recipient nations, including Cambodia. The ODA inflow to Cambodia has been increasing in absolute terms; however, it has been steadily declining —i.e., from 11.9% in 2011 to 7.2% in 2019—as a share of GDP. Figure 2 depicts the share of Japanese ODA in the overall

ODA to Cambodia from the 1990s to 2019. Consistent with the overall trend, the share declined from 22.8% in the 1990s to 16.5% in the 2000s and further to 10.1% in 2019. This decline in share was expected since the size of the economy is growing and ODA donors need to divert their attention and resources toward countries lesser developed and more vulnerable than Cambodia.

Figure 2: Share of Japanese ODA to the Overall ODA Received



Source: Author's illustration based on data from the Cambodia Development Council.

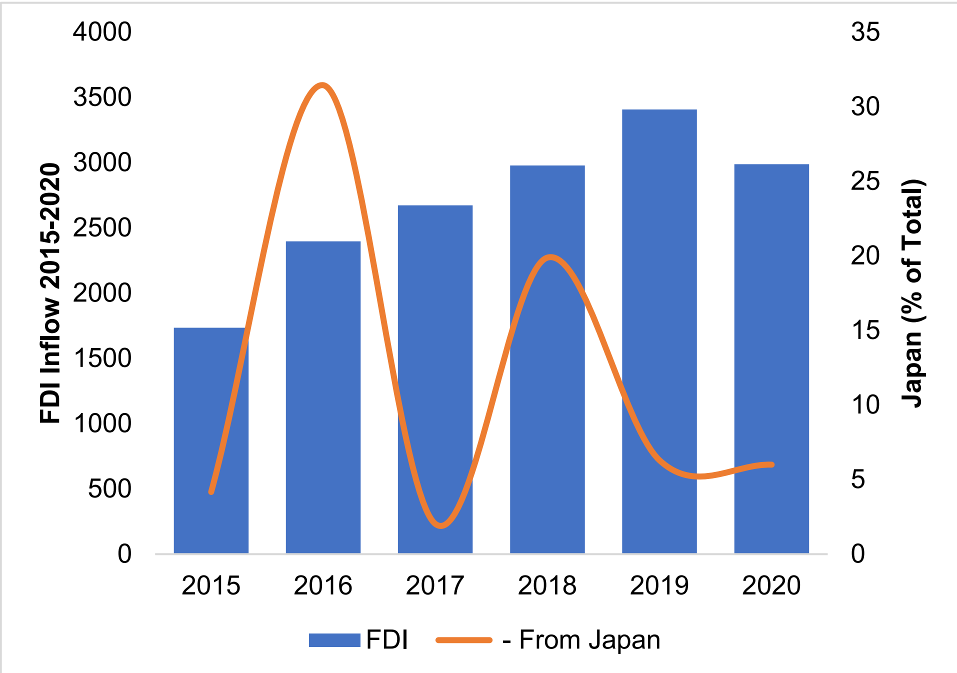
There are several approaches to mobilizing more ODA and utilizing it more effectively and efficiently. First, although ODA is an important component of budget capital expenditure, it still requires alignment with the country's policies and goals through key strategies of public financial management reforms, such as the Industrial Development Policy and climate change. Second, recording non-ODA flows and other resources from non-aid providers requires improved and more comprehensive data management. Third, there are benefits of strategically linking the NSDP with the Development Cooperation and Partnership Strategy results framework, as this could help external resources align appropriately with prioritized development projects. Fourth, promoting a more systematic integration of aid from the central and ministerial levels into budget processes depends largely on key public financial management reforms, especially program budgeting.

2) Foreign Direct Investment (FDI)

The volume and the share of FDI in GDP increased in 2019. Although the trend has not been smooth, the estimated amount in 2019 was USD 3.4 billion, equivalent to 12.7% of the GDP. The FDI in Cambodia is concentrated primarily in the garments, tourism, and real-estate subsectors. In 2019, the construction and real-estate sectors received the largest share, i.e., 51%, of the total approved FDI project value, followed by 24% in the tourism sector. Most FDIs are regional investments.

Figure 3 depicts the evolution of recent Japan FDI flow to Cambodia as a share of the total FDI inflow from 2015 to 2020. Despite its unstable trends and relatively low share, Japanese FDI has earned a good reputation in Cambodia. It focused on sectors such as electronic parts, electricity, automobile parts, technical equipment, agro-industry, processing food, hotels, tourism, hospitals, and shopping malls. Japanese businesses and investments in Cambodia are renowned for their quality. They add value to local goods, generate jobs, and help improve the living standards of Cambodian workers. Such reforms are consistent with the vision and mission of the Royal Government of Cambodia.

Figure 3: Overall FDI and Japanese FDI inflow to Cambodia (2015–2020)



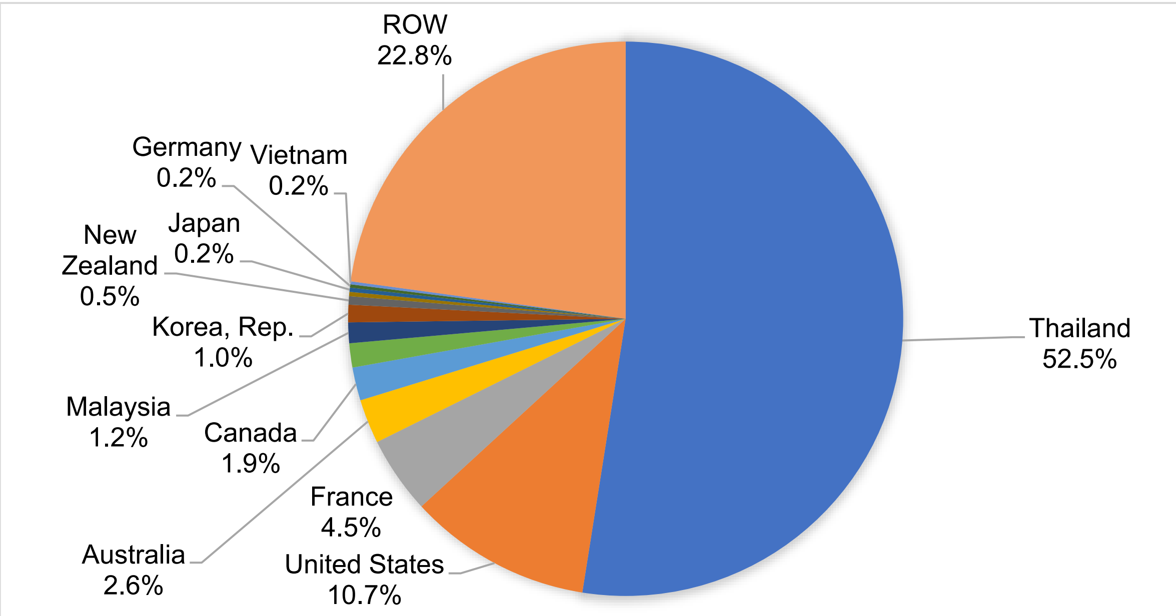
Source: Author’s illustration based on data from the Cambodia Development Council.

Several measures can be used to address the key challenges in terms of the mid-term competitiveness of infrastructure, energy, and skills in attracting FDI inflow. First, since any reform takes a while to produce results in Cambodia, specific attention should be paid to skill shortages already limiting the quantity and quality of FDI. Second, the short-term expansion of FDI should be linked primarily to the expansion of the Special Economic Zones. Third, the zones should be used to attract FDI of higher qualities and in larger quantities. Fourth, the tax exemption system should be reviewed to maximize its benefits.

3) Remittance

A growing number of Cambodians, especially young people, are moving abroad to find jobs that offer higher wages. Thailand is their most preferred destination for migration, followed by the Republic of Korea and Malaysia. Remittances, which play a key role in improving the skills of workers and livelihoods in Cambodia, increased significantly over the decade leading up to 2019. Data from the Ministry of Labour and Vocational Training suggests that in 2019, around 1.28 million Cambodians were employed abroad and sent USD 2.8 billion back home. The World Bank remittance report estimates that around 0.2% of migrants were employed in Japan (Figure 4).

Figure 4: Distribution of Cambodian Migrants Abroad (by Country) in 2019,



Source: Author's illustration based on data from the World Bank.

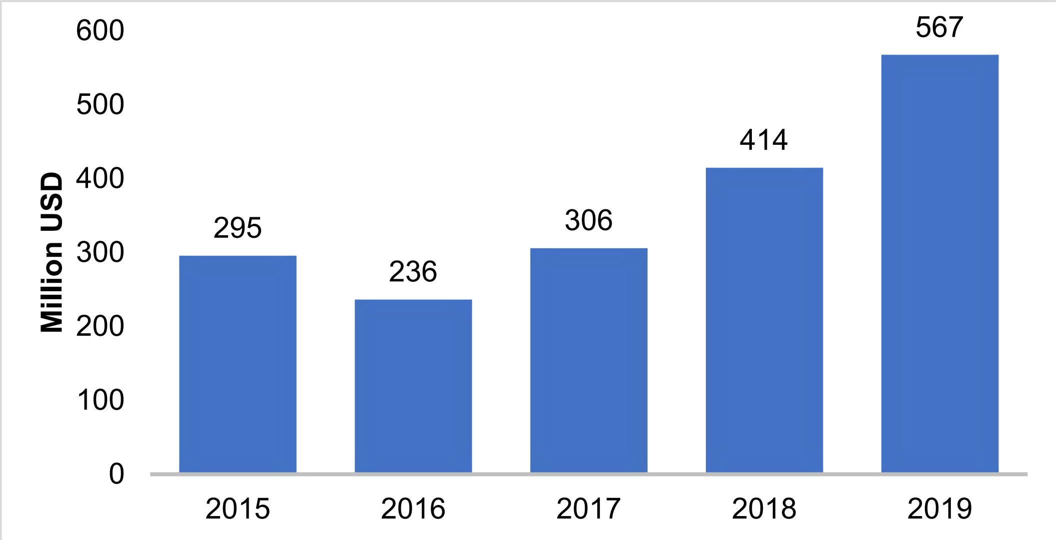
Some recommended steps to optimize the potential benefits of remittances begin with the acceleration of national and local implementation of the Labour Migration Policy through the best utilization of government capacities and approaches. As the engagement of stakeholders outside the Ministry of Labour and Vocational Training is limited, creating a specific technical working group and joint monitoring indicators might increase the dialogue on migration issues. Expanding migrant workers' resource centers and their services is essential to boost the impact of remittances on local development and uphold migrants' rights. Finally, there are ample opportunities through South–South cooperation to learn from other experiences in the region.

4) Climate Financing

Climate finance is channeled through multilateral funds, such as the Green Climate Fund, Global Environment Facility, and Climate Investment Funds, as well as targeted loans by multilateral development banks and International Financial Institutions, and bilateral channels. In addition, there are national and regional climate funds as well as private and philanthropic sources of finance. Different climate funds target diverse activities, such as activities for adaptation, mitigation, reducing emissions from deforestation in developing countries known as REDD, and capacity building. They span across sectors and regions. Climate finance has grown significantly in Cambodia, from USD 295 million in 2015 to USD 567 million in 2019 (Figure 5).

Numerous measures that have been implemented to mobilize climate finance include improved and focused oversight to align national priorities and influence development flows. Cambodian bank lenders need to be informed about and aware of how to steer the economic potential of low-carbon, climate-resilient development. Moreover, increasing engagement with small and medium enterprises (SMEs) and the informal sector is crucial in mobilizing finance for climate projects. Microfinance institutions are a valuable resource in providing advice on climate-related financing, such as supporting the distribution of home solar systems and mobilizing bank engagement. Integrating the Climate Change Strategic Plan and the Industrial Development Policy can help identify and prioritize mitigation investments and coordinate policy responses on private-sector investments.

Figure 5: Climate Financing



Source: Author's illustration based on data from the Ministry of Environment.

4. Impact of the COVID-19 Pandemic and Availability of Finance up to 2025

4.1. Impact of the COVID-19 Pandemic on Development Finance Flows

The absolute loss in all finance inflows in 2020 owing to the COVID-19 pandemic was estimated to be USD 3.6 billion or 19.8% of GDP. This is broken down as follows: public revenue, USD 1.5 billion; FDI, USD 1.3 billion; domestic private-sector flows, USD 410 million; and remittances, USD 330.9 million. Public revenue is in steep decline because of the rapid fall in economic activity, particularly trade and the purchase of high-value imports. Likewise, private-sector flows—particularly FDI and domestic flows—are also estimated to have declined substantially. The crisis presents challenges to remittance flows, which are set to decline because of the lockdown policies in the host economies.

4.2. Projected Development Finance Availability in 2025

The forecasts suggest that the total financing potentially available for supporting national development may have more than doubled to USD 23.4 billion by 2025 (Table 2). However, as a share of GDP, this figure will have risen to 69.8%, driven principally by domestic resource mobilization, FDI, and remittances.

Table 2: Development Finance Projections in Millions of USD

DFA Flow	2015		2019		2020		2025	
	Mn USD	% GDP	Mn USD	% GDP	Mn USD	% GDP	Mn USD	% GDP
Domestic Revenue	3,250	18.0%	5,893	22.4%	4,967	18.9%	8,488	25.3%
FDI	1,735	9.6%	3,407	13.0%	2,988	11.4%	4,573	13.7%
Private domestic investment	2,094	11.6%	2,628	10.0%	2,102	8.0%	3,439	10.3%
Remittances	1,182	6.5%	1,515	5.8%	1,306	5.0%	2,007	6.0%
Loan	555	3.1%	994	3.8%	1,333	5.1%	2,123	6.3%
Grant	795	4.4%	916	3.5%	736	2.8%	634	1.9%
NGO	226	1.3%	246	0.9%	218	0.8%	230	0.7%
South-South	349	1.9%	394	1.5%	349	1.3%	349	1.0%
Climate Fund	295	1.6%	567	2.2%	607	2.3%	1,543	4.6%
Total	**10,482**	**58.0%**	**16,559**	**63.1%**	**14,606**	**55.6%**	**23,386**	**69.8%**

Source: Author's projection based on data from various sources.

To provide a better perspective, in 2005, the total development cooperation funding from ODA, nongovernmental organizations (NGOs), and South–South was approximately equal to the domestic revenue. In 2025, the domestic revenue is projected to be almost twice the value of aid receipts. Assuming the broad validity of the assumptions made for all finance flows, this projection emphasizes the potential criticality of domestic revenue mobilization, coupled with the need for the maximization and better management of key flows.

5. Policy Options

Based on this study's findings, the following set of policy options can be provided. In the short term, the public sector should adopt an emergency financing strategy to address budget deficit challenges from 2021 onward. The key measures include the following:

1. Strengthen revenue collection capacities and mechanisms, such as through Tax Inspectors Without Borders, to ensure that multinationals and other large companies are paying their due share of tax.
2. Accelerate the expansion of domestic lending instruments. Bond issuance in Khmer riels will help to de-dollarize the economy, reduce the crowding-out effect in the banking sector, and expand monetary policy options.
3. Restore the level of FDI and private domestic investments, such as through credit guarantees to firms, especially SMEs, and use tax concessions to boost FDI and domestic investments.

4. Realign expenditures in favor of pro-poor economic growth, such as investment in social protection, which have proven to be effective ways of strengthening the economy and controlling poverty.

In the mid to long term, this study recommends that policy innovations be implemented to boost the state's capacity to manage public finances and secure high levels of private capital flows. It suggests the following measures, which are consistent with the conceptual framework of an Integrated National Financing Framework:

1. Implementation of "Sin" taxes, such as taxes on gambling, tobacco, and alcohol, as well as other taxes with positive social and environmental externalities should be implemented. This will not only increase revenue collection but also help reduce future public expenditure, such as those on healthcare services.
2. The implementation of blended finance that draws on various capital resource flows to increase private investments to achieve CSDGs should be strengthened.
3. Engage in innovative, green, and climate change–related financing mechanisms, such as green or SDG bonds, impact investments, and biodiversity finance, to expand sources of finance for development.
4. Improve capacity building and institutional changes to enable the state to better facilitate and oversee the ongoing expansion of private-sector flows, with a focus on delivering high-quality investments.

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