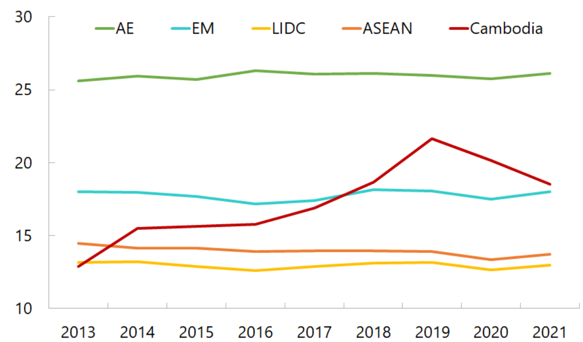
REVENUE MOBILIZATION[1]

The authorities have done commendable efforts to mobilize revenues over the past years. Nonetheless, additional public spending to support development needs and an expected decline in grants call for continued efforts. Based on past TA advice, we propose three potential areas to enhance revenue mobilization: excises, property taxes, and tax incentives.

1. **Over the past decade, the tax-to-GDP ratio in Cambodia has averaged 17 percent, near the average for emerging market countries.** Tax revenue as a share of GDP in Cambodia rose from around 13 percent in 2013—the average tax-to-GDP ratio in low income developing countries—to almost 22 percent in 2019. Since the Covid-19 shock, the tax-to-GDP ratio has fallen, reaching 18.5 percent in 2021. All in all, tax-to-GDP in Cambodia averaged 17 percent over the 2013-2021 period, near the EM average ratio of 17.8 percent.

Figure 1. Cambodia: Tax Revenue

(In percent of GDP)



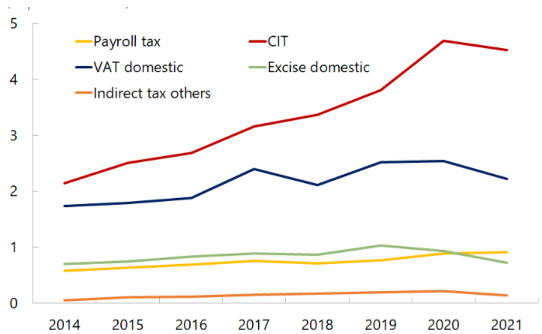
Sources: IMF World Economic Outlook Database
Note: ASEAN includes Singapore, Thailand, Philippines and Indonesia

2. **The rise in revenues-to GDP was supported by the authorities' robust administrative reforms and policies.** Since 2014, clear efforts were made to mobilize domestic revenues as laid out in the government's medium-term revenue mobilization strategies of 2014-2018 (RMS I) and 2019-2023 (RMS II). In particular, corporate income taxes (CIT) rose by 2.5 percentage points of GDP from 2013 to 2020. In 2016, Cambodia increased excise tax rates on items such as tobacco, automobiles, and petroleum products (in line with the recommendations of the March 2016 IMF tax policy technical assistance mission), as excise taxes were considerably lower than in comparator countries. Excise on imports increased by 2 percentage points of GDP by 2019 compared to 2016. Further, in 2017-2018, the authorities updated real-estate valuations for tax purposes which helped boost property tax revenues by about 1 percentage point of GDP (captured by the higher province tax revenues).

[1] Prepared by Juliana Araujo.

Figure 2. Cambodia: Income Tax, Domestic VAT and Excises

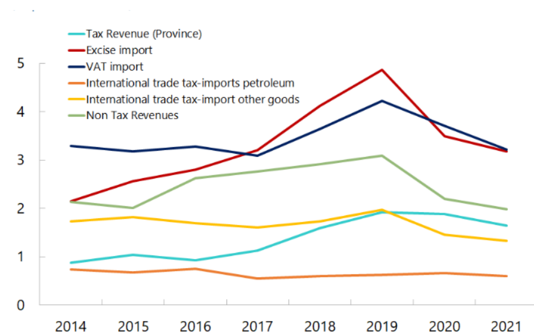
(In percent of GDP)



Sources: Cambodia authorities

Figure 3. Cambodia: Import Duties, Local Tax and Non-Tax Revenues

(In percent of GDP)



Sources: Cambodia authorities

3. **Despite improvements in revenue mobilization, a few factors point to the need of further efforts.** First, Cambodia aims at becoming an upper middle-income country by 2030 (and an advanced economy by 2050). A higher revenue:GDP ratio would be needed to finance the higher public spending (such as on health, education, and infrastructure) typically associated with middle income countries. Second, substantial revisions to GDP are expected as part of the GDP rebasing scheduled to take place in March 2023 translating into significantly lower tax-to-GDP ratios. Third, as Cambodia graduates from low-income country, grant revenue will keep declining and will need to be replaced.

4. **Technical assistance advice [from 2017] remain broadly relevant, proposing three potential areas to enhance revenue mobilization: excises, property taxes, and tax incentives**. The advice pointed to three potential areas to improve revenue collection that are yet to be explored: (i) excises; (ii) property taxes and (iii) tax incentives. This would be in line with the current RMS II which aims at targeting current revenue growth at 0.3 percentage of GDP per year while improving efficiency of the current tax policies (e.g. rationalization and modernization of tax administration). The recommendation is also in line with the objectives of the on-going Tax System Reform Study which include the assessment of existing tax policies and incentives for proposing changes where needed and omitting ineffective tax policies and incentives.

A. Excises

5. **Correcting for negative externalities generally points to use of specific taxes, while ad valorem excise taxes on vehicles could play a redistributive role.** In Cambodia, all excise taxes at present are on ad valorem basis, and are not determined by calculation of market externalities. Tobacco and petroleum taxes are a clear case for transition to specific excises, which directly address underlying externalities (health implications and pollution). An additional benefit of specific petroleum taxes is that they would reduce fluctuations in retail prices and revenues. While externalities can be addressed by specific fuel excises, ad valorem excises on vehicles (and luxury goods in general) complement existing consumption taxes by increasing the overall progressivity of indirect taxes. The Public Lighting Tax is particularly distortionary, because of cascading and

earmarking of its revenues. Moreover, it is not needed to address externalities, as it is raised on goods which are already subject to excises. Specific taxes are also easier to administer and provide greater incentives for quality improvements.

6. The overall revenue consequences of modernizing excise taxes via a shift to specific taxes computed (in part) based on externalities should be estimated to inform policy decisions. In the short-term, authorities should be mindful about striking a balance between using excise taxes as an instrument to correct for externalities (i.e., restoring efficiency) and as a tool for raising revenue. Smuggling (and possibly illicit production) can increase as a result of higher excise taxes. Thus, a strong tax administration is crucial for achieving the objective of the excise tax policy. The authorities are currently contemplating a move from ad valorem to a mixed system for certain products to match the government's objective of maximizing revenue collection and addressing fairness while also mitigating negative externalities. While excise taxes for petroleum in Cambodia could be considered as a mixed system, the specific component constitute only a small fraction of the overall excise tax.

Box 1. Recommendations on Excises

Tobacco. Replace ad valorem by specific tobacco excises, which should be regularly updated in line with inflation. Choose a specific excise of slightly higher value than the current average excise and consider further increases after assessing the implications for compliance. Over the medium term, raise the tax further toward the estimated costs of the negative health externalities.

Petroleum Products. Replace ad valorem by specific fuel excises. Choose a fixed amount that is slightly higher than the average over the year implied by the current ad valorem rate. Over the medium term, raise the tax further toward the estimated costs of the negative environmental externality.

Alcoholic Beverages. Specific taxes are also recommended for alcoholic beverages such as beer, but in the case of wine and spirits an argument can be made in favor of a mixed system

Vehicles. Maintain an ad valorem rate for motor vehicles.

Public Lighting Tax. Phase out the PLT. Replace local government revenues by higher property taxes (see Section III) and transfers if needed. Do not earmark the replacement revenues, but let local governments choose how best to use them. Raise alcohol excises to maintain on average the same (or a higher) final price to consumers.

B. Property Taxes

7. Strengthening recurrent property tax should be a precondition for abolishing the unused land tax and reducing the property transfer tax. The unused land tax raises minimal revenue and is costly to administer. Strengthening the recurrent property tax, in particular land valuation and rates, would also help address property speculation. The property transfer tax raises significant revenue, but is distortionary: such taxes reduce the number of transactions and labor mobility, and may lead to collusive under declaration of sales values, which are needed for administration of the recurrent property tax. The basic exemption of KHR100 million excludes a large share of the population, reducing the administrative burden and enhancing progressivity. However, as the property tax is a local benefit tax, there is no justification for exempting government and SEZ properties.

8. **Administrative measures will be essential to fully realize revenue potential.** Raising rates without strengthening other components, such as the tax base, coverage, valuation, and collection, would increase inequities, reduce transparency and discourage compliance. A phasing period to allow administrative improvements could be considered. Administrative improvements should include measures for: (1) property registration; (2) property valuation in a dynamic property market; (3) enforcement of tax collection, and finally (4) revenue estimation capability. The broad tax base, including both land and buildings is common and appropriate. Currently, property market values for tax purposes are assessed and updated every five years in line with the mandate of the National Assembly but no indexing in the interim periods is in place. The last assessment of property values was conducted in 2019/2020. Recent efforts have been made to increase the property tax register through better access to property information from the Ministry of Land Management, Urban Planning and Construction.

Box 2. Recommendations on Property Taxes

Valuation of property. Provide in law or regulation a requirement for valuations to be reassessed at least every five years, with indexing in the interim years. Provide to the local valuation sub-commissions clear guidelines for valuation.

Exemptions. Repeal exemption for government properties over the medium term. Repeal exemption for property in SEZs over the medium to long term.

Recurrent property tax. In the short term: start raising the tax rate from its current level of 0.1 percent to strengthen revenue. In the medium term: continue raising the rate to 0.5 percent in tandem with administrative progress. In the long term: provide local governments the option to set local rates within a modest range set by the central government.

Unused land tax. Repeal the tax on unused land over the medium term.

Property transfer tax. Reduce the property transfer tax rate over the medium term (but only to the extent that its revenue can be at least replaced by increased revenue from the recurrent property tax).

Property tax administration. (i) Establish an independent dispute resolution process for the property tax. (ii) As improved administrative capabilities allow, gradually expand the geographical coverage of the property tax to the whole of the country over the medium to long term. (iii) Seek technical assistance to formulate a detailed multi-year roadmap for administrative reform, specifically aimed at improving: property registration for tax purposes; property valuation to better track market developments; tax enforcement; revenue estimation and simulation capabilities.

C. Tax Incentives

9. Foreign investors face higher effective tax rates than domestic investors under the standard tax system due to the combination of the CIT and withholding on dividends. The corporate income tax rate is low, and various tax incentives are offered. However, a relatively high withholding tax rate on dividends of 14 percent (10 percent in some future double taxation treaties) raises the effective tax rate and creates profit-shifting incentives. As a result, foreign investors face higher effective tax rates than domestic investors under the standard tax system, despite a likely more elastic investment demand.

10. The corporate income tax holiday, which is just a deferral of tax until distribution, should be abolished. If the deferred tax is paid, the tax saving is a timing advantage only. If, however, the deferred tax is avoided, then the usual disadvantages of tax holidays apply, such as being particularly attractive to relatively short-lived or footloose investment and encouraging rent-seeking behavior and corruption. Exemptions from customs duties and VAT remain important, but better solutions are available. VAT would not present a problem for exporters if VAT credits were reliable and timely. Finally, reducing or abolishing customs duties on intermediate or capital goods would be preferable to exemptions for selected taxpayers. The exemption from the minimum tax is less relevant now. The minimum tax does not apply anymore to companies that maintain strong accounting records—which is likely the case for most international investors. As reflected in the new Law on Investment promulgated in September 2021, which retain CIT exemptions, the authorities continue to view CIT as one of the key attractions for investors but recognize that there is room to minimize/rationalize the tax incentives.

11. Tax incentives should be costed and published regularly (i.e., a tax expenditure budget). All tax incentives should be moved into the Law on Taxation and the responsibility for approving and monitoring all tax incentives should be assigned to MEF. This recommendation aim at improving transparency and allowing a coherent design of tax policy.

12. VAT refunds should be timely. Under the Revenue Mobilization Strategy (RMS) 2019-2023, the government has improved VAT refund processing through the adoption of the e-VAT refund system, internal crosscheck of invoices between GDT and GDCE, and the use of the Key Performance Indicator in the RMS to reduce the time of VAT refund on an annual basis. All VAT refund requests remain subject to a review process that includes the verification of VAT invoices. Only a small share of VAT refund requests are processed within 30 calendar days.

Box 3. Recommendations on Tax Incentives

Corporate income tax holidays. Abolish corporate income tax holidays for new investments, but grandfather those of QIPs that have already been authorized (including those in the "trigger" period before the tax holiday).

Repatriated dividends withholdings. Reduce the withholding tax rate on repatriated dividends to 10 percent. Consider further reduction in medium term.

Box 3. Recommendations on Tax Incentives (concluded)

Corporate income tax. Maintain the statutory CIT rate at 20 percent. There may be pressure for further reductions in the future, but there is no need for pre-emptive cuts.

Publish regular estimates of the costs of tax incentives (i.e., a tax expenditure budget). Move all tax incentives into the Law on Taxation. Assign the responsibility for approving and monitoring all tax incentives to the MEF.

VAT refunds. Ensure timely VAT refunds, so that VAT indeed is a tax on domestic consumption.